KINGDOM OF SPAIN

STABILITY PROGRAMME

1998 - 2002

CONTENTS

TABLES AND FIGURES

I. INTRODUCTION

Spain's participation in the start-up of the third phase of Economic and Monetary Union (EMU), as a founding member of the euro, is a historical milestone which marks its full integration within Europe, simultaneously reinforcing the Spanish presence in the international economy.

This achievement springs from the firm determination of the Government and the Spanish people to form part of the euro and to create a stable macroeconomic climate free of traditional imbalances in inflation, interest rate differentials and the public deficit, all three dealt with in the convergence criteria laid down in the Maastricht Treaty. In short, the challenge was to break with the patterns of past performance, in which nominal imbalances choked off the expansion phases of the business cycle and ultimately hindered Spain's real convergence with the most advanced of its European Union (EU) partners.

Although the *Convergence Programme* submitted to the EU in 1997 may initially have seemed ambitious, particularly as regards the public deficit target, its objectives have actually been surpassed. The progress made towards nominal convergence and the credibility of economic policy have wrought a change in the expectations of economic agents and markets since the beginning of 1997, producing a sharp increase in consumption and investment and the consolidation of an economic expansion phase characterised by intense job creation. As a result, real GDP growth is now running ahead of inflation for the first time in Spain's recent history, thereby ensuring the continuity of growth and of the fiscal consolidation process.

The Spanish Government, however, is also aware that the challenge does not end with entry to EMU and that it is essential to press on with an economic policy that facilitates take-up of the advantages conferred by single currency membership and further advance along the path of real convergence.

This goal is addressed in the knowledge that EMU membership will of necessity involve a substantial change in the role of traditional economic policy instruments, with fiscal consolidation and structural reforms brought increasingly to the fore.

Responsibility for **monetary policy** design will be lodged exclusively with the European Central Bank (ECB), whose independence is enshrined in its statutes alongside the primary remit to maintain price stability. At the same time, exchange rates may no longer be used to bridge competitive gaps with our main trading partners.

Fiscal policy remains a national responsibility, but will increasingly be predicated on compliance with the rules of financial discipline and co-ordination with EMU partners embodied in the *EU Treaty* and the *Stability and Growth Pact,* whose impact extends to every layer of government. These rules can be summarised as the need to run a budget close to balance under normal economic conditions. Only by this means can the necessary margin be conserved for fiscal policy to play its traditional stabilising role at times of faltering growth.

The Spanish Government will accordingly persevere in its efforts to reduce the public deficit in the years ahead. Considering Spain's projected economic performance and the budgetary measures to be deployed, the aim would be to report a budget surplus by the year 2002.

The budgetary projections contained in this Programme are anchored on prudent economic assumptions and designed to facilitate macroeconomic stability in coming years. Provided they are accompanied by appropriate wage settlements, the logical outcome will be a consolidation of the job creation and the unemployment rate shrinkage which have characterised the recent performance of the Spanish economy.

Furthermore, budgetary policy design assigns a prominent role to public investment, which will increase its weight in GDP and become an increasingly key element in the process of real convergence.

At the same time, the Government will continue to prioritise **supply side policies, or structural reforms of factor and product markets**, as a means to counter the loss of domestic demand instruments and aid the achievement of fiscal policy objectives, while procuring a more efficient functioning of labour, goods, services and capital markets. This greater efficiency will also assure Spain a sound competitive footing in the Single Market whose completion will be achieved with the launch of the euro.

These reforms, set out in the *National Action Plan on Employment* and in the *Progress Report on the Reform of Goods, Services and Capital Markets*, constitute, along with the *Stability Programme* submitted here, the cornerstones of the Government's medium-term economic policy.

The *Stability Programme* of Spain has been drawn up in accordance with the formal rules laid down in Regulation 1466/97, on the reinforcement of budgetary surveillance, and those agreed at the ECOFIN Council of October 12, 1998. It likewise respects the political commitments undertaken in the *Stability and Growth Pact* and in the ECOFIN Council statement of May 1, 1998.

The Programme starts with a description of the economic policy implemented and the recent performance of the Spanish economy. It then moves on to explore economic policy goals in the short and medium term and economic and budgetary projections. This is followed by a sensitivity analysis of budgetary projections for alternative growth and interest rate scenarios. Finally, a series of annexes focus on the new Personal Income Tax, the main structural reform measures envisaged and the recent and future evolution of the debt/GDP ratio.

II. ECONOMIC POLICY AND THE SPANISH ECONOMY 1997-1998

1. Economic policy 1997-1998

The main lines of economic policy are as described below:

• Fiscal policy

Fiscal policy has been geared to reducing the structural deficit by means of expenditure contention, without recourse to tax hikes. Investment has not been affected by spending cuts, which have centred on current expenditures, and specifically on the primary component.

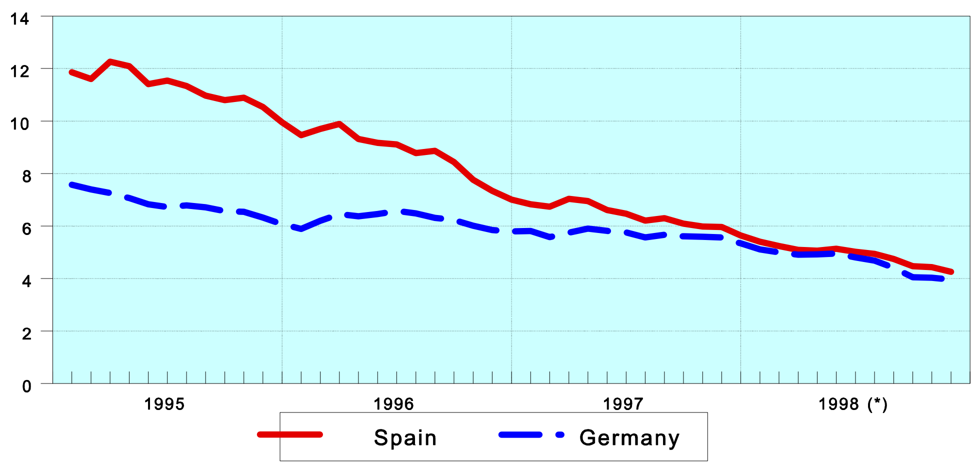
• Monetary policy

Achievement of the price control goals of monetary policy has been greatly aided by the progress made in fiscal retrenchment. Thus, the Bank of Spain could progressively reduce its intervention rates while simultaneously meeting the inflation criterion for single currency membership. Specifically, intervention rates have dropped from the 9% of end-1995 to the 3% rate set for the birth of the euro.

Long-term yields have likewise declined significantly, with the 10-year rate dropping from 11.3% in 1995 to under 4% in December 1998. The result has been a narrowing of the long-term spread against the German bond of over 4 percentage points in the past 3 years, down to the 20 basis points of December 1998.

FIGURE 1

LONG-TERM YIELDS
10-year bonds



(*) November data as at 30/11.
SOURCE: Bank of Spain.

• Supply-side policies

The demand-side policies described were accompanied by a wide-ranging programme of structural reforms. Measures taken divide into three large blocks: the liberalisation and reform of a range of goods and services sectors aimed at improving their efficiency by developing competition, an ambitious privatisation programme and actions to enhance labour market performance.

All these measures have been implemented with the ultimate aim of ensuring that the stable context of the Spanish economy translates, as far as possible, into economic growth and employment creation.

2. The Spanish economy 1997-1998

The keynote of Spain's economic performance in the last two years has been the advance made in nominal convergence, evident in sharply falling inflation and interest rates. Public deficit reduction has been the main motor of these convergence trends.

The nominal convergence achieved has, in turn, spurred a simultaneous advance in real convergence, materialising in the consolidation of the present upturn and a 1998 growth rate of 3.8%.

This signifies that annual growth rates are running around one point ahead of the EU average, lifting Spanish per capita income at end-1998 to 79% of the community average. Job creation is also outstripping the EU average by more than two percentage points.

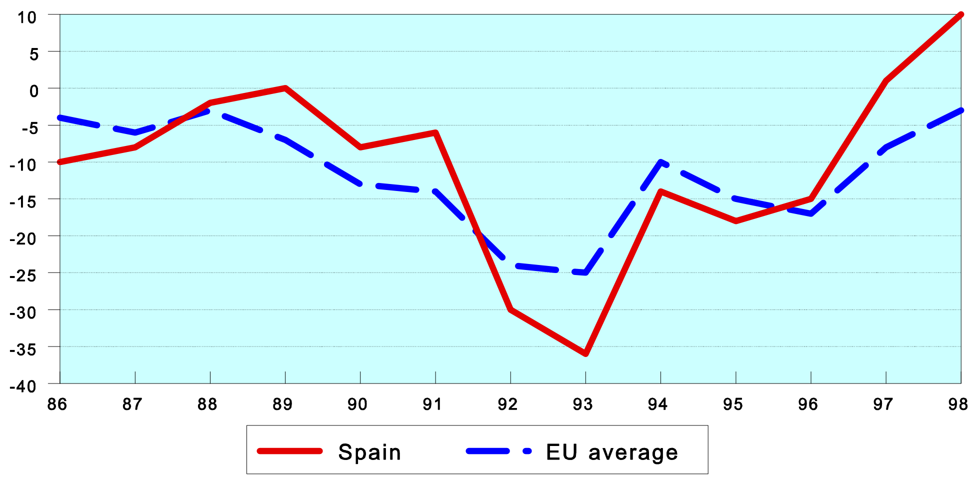
• Demand components

In the past two years, domestic demand has replaced foreign demand as the engine of GDP growth.

In the domestic sphere, the recovery of **private consumption** has been one of the salient features of recent economic performance, in stark contrast to the downturn of the early 1990s and the listlessness of the following years. The upturn here was favoured by accelerating job creation and the resulting increase in real disposable income, alongside households' growing optimism about the economic situation. Specifically, private consumption has increased 3.6% over 1998, a little short of real GDP growth, thereby shoring up the process of economic expansion.

FIGURE 2

CONSUMER CONFIDENCE INDICATORS
Net percentages. Data at November of each year



SOURCE: European Commission.

Equipment investment has been the main source of demand dynamism, as evidenced by the 13% growth registered in 1998. Factors pushing the uptrend were, firstly, private consumption buoyancy and the stable outlook ahead and, secondly, falling interest rates, lower inflation and moderation in labour costs. This process, moreover, has coincided with a drop in the price of energy inputs and sustained improvement in companies' financial health. **Construction**, as usual, was slower to recover, but has been gathering steam since the summer of 1997.

The robustness of private investment has raised the weight of total investment in Spanish GDP as far as 21.5% in 1998, some two percentage points above the EU average. This augurs well for the opening up of a positive gap in productivity and output growth potential versus Europe and, thereby, further progress in real convergence.

Meanwhile, **net exports** turned from a positive contribution to GDP growth of 0.5 points in 1997 to a negative 0.8 points in 1998. The change here is mainly due to the strength of imports, which climbed 12.4% in 1998 fuelled by domestic demand vigour.

Exports, however, have kept up a good growth pace (10.6% in 1998), the more so as international trade expanded below 4.5% as a result of the financial crisis. This scant impact of the recent international turmoil reflects the reduced exposure of Spanish exports to the Asian and Russian markets, and export volumes to Latin American countries amounting to no more than 6% of the total.

Table 1

PRODUCTION AND DEMAND
(% change in real terms)

	1997		1998	
	CP (1)	Real	CP (1)	Real (2)
GDP AND AGGREGATES				
Private consumption	2.7	3.1	2.7	3.6
Government consumption	-0.3	1.4	1.0	1.2
Gross fixed capital formation	4.0	5.1	7.1	9.1
Domestic demand	2.5	2.9	3.4	4.6
Exports of goods and services	9.9	14.8	9.5	10.6
Imports of goods and services	8.1	12.2	9.6	12.4
Net exports (contribution to GDP growth)	0.4	0.5	-0.2	-0.8
GDP	3.0	3.5	3.2	3.8
LABOUR MARKET				
Employment:				
- Change in %	2.0	2.9	2.2	3.5
- Change in thousands	- - -	357.0	- - -	450.0
Unemployment (% of labour force)	- - -	20.8	- - -	18.7
PRICES AND COSTS				
- Private consumption deflator	2.5	2.5	2.3	2.0
- CPI (December/December)	- - -	2.0	- - -	1.9
Collective wage agreements	- - -	3.0	- - -	2.6
ULCs, total economy	- - -	1.9	- - -	2.4
EXTERNAL SECTOR (% GDP)				
Trade balance FOB-FOB	- - -	-2.5	- - -	-2.9
Current account balance	- - -	0.4	- - -	0.0
Net lending (+) or borrowing (-) vs. rest of world	1.9	1.5	1.7	0.9

(1) Convergence Programme
(2) Estimate

SOURCE: National Statistics Office, 1997 and Ministry of Economy and Finance, 1998

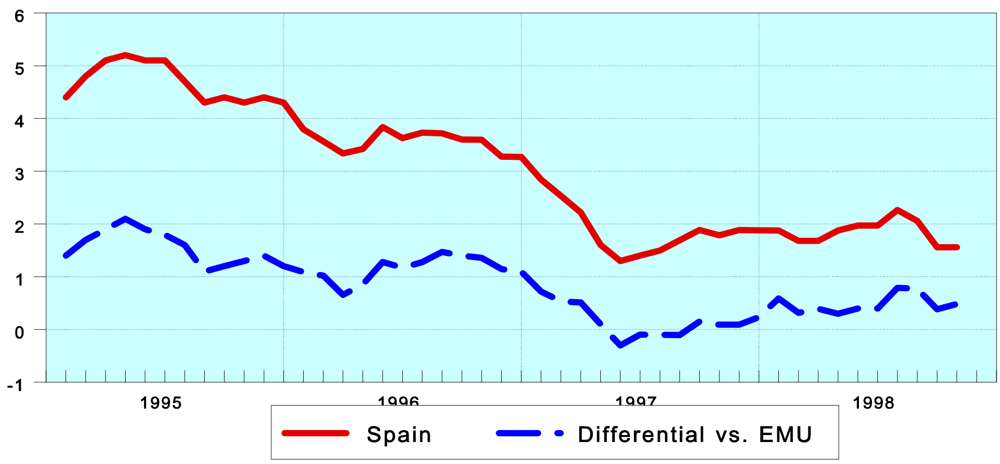
• Prices and wages

One of the economic highlights of 1997 and 1998 was the new-found compatibility of lower inflation and quickening economic growth. The firm and consistent application of monetary and fiscal policies was coherent with the goal of inflation control. Furthermore, liberalisation and competition-building in goods and services markets have enhanced supply-side responsiveness to demand growth, furthering the cause of price moderation. Another key piece in the fight against inflation has been the improved price expectations of economic agents in place since mid-1996.

Against this backdrop, **inflation** fell to a year-on-year rate of 2% in December 1997 from the 3.2% of one year before, on target with the convergence condition set in the Maastricht Treaty. The CPI has kept up this level through 1998, in line with the forecasts contained in the National Budget, and seems likely to close the year at a rate below 1.5%.

FIGURE 3

SPANISH INFLATION AND INFLATION DIFFERENTIAL VS. EMU
HICP annual variation rate in %



SOURCE: National Statistics Office and Ministry of Economy and Finance.

Wages gradually moderated, though without falling fully into line with inflation. Specifically, wages covered by collective bargaining agreements rose by 3% in 1997, eight decimal points less than the prior year but one point more than the CPI. In 1998, wages are expected to rise around 2.5%, almost one point above forecast inflation.

• Employment

Beyond any doubt, one of the most positive aspects of 1997-1998 economic performance has been the strong impact of growth on employment creation. Over the period, there has been an appreciable improvement in the relationship between GDP and employment growth, with an increasing employment-output elasticity which in 1998 was nearing the value of 1.

This greater job creation capacity of the Spanish economy derives, on the one hand, from the moderation of production costs encompassing both labour, financial and other input components. And on the other, from the greater flexibility allowed employers in tailoring their staff numbers to production needs under the labour market reforms of 1994 and 1997. Furthermore, the liberalisation of productive sectors in recent years has unlocked new investment opportunities capable of generating jobs.

Inestimable help was also provided by the *Interconfederal Agreement for Employment Stability*, institutionalised by the Government in its Royal Decree-Law 8/1997 of 16 May. The intent of this agreement was to enhance labour market efficiency and stability and its success is mainly attributable to social dialogue.

The result has been a significant increase in the number of net jobs created: over 800,000 in the last two years (up to the third quarter of 1998), averaging out at more than 1,000 jobs a day. This has translated, in turn, into a sharply falling unemployment rate: down from 22.2% in 1996 to 18.7% in the third quarter of 1998, despite labour force growth in the interim.

Progress also extends beyond job creation to encompass job stability. In the last two years, over 600,000 more people have been brought under permanent contracts, while the temporary employment ratio dropped almost one percentage point between the third quarters of 1996 and 1998.

• Balance of payments

The main feature of foreign accounts is the contrast existing between the present equilibrium of the **current account balance** and the deficits suffered in similarly mature phases of previous cycles.

This equilibrium, which evidences a sufficient flow of savings to investment, is essentially a product of public accounts consolidation. Specifically, the scales have shifted from a negative government savings ratio in 1996, amounting to around one decimal point of GDP, to a positive ratio of one and a half points. With private savings holding up at around 20% of GDP, investment growth has been successfully financed with no impairment of foreign accounts.

As a result, the Spanish economy has maintained **a net lending capacity with the rest of the world** for the fourth consecutive year, taken as the combined positive balance of the current and capital accounts.

However, this lending capacity has declined from 1.5% of GDP in 1997 to 0.9% in 1998, due principally to erosion of the current account surplus, which dropped from 0.4% of GDP in 1997 to the point of equilibrium in 1998. The main culprit here was the widening of 1998's trade deficit to 2.9% of GDP.

Meanwhile, the capital account stands out for the dynamism of foreign investment. Particularly telling is Spain’s escalating investment abroad, which has exceeded capital inflows in each of the last two years. Spanish investments abroad in 1997 almost tripled the figure for the prior year, increasing by 80% in the first nine months of 1998 compared to the same period in 1997, to ahead of 5 trillion pesetas.

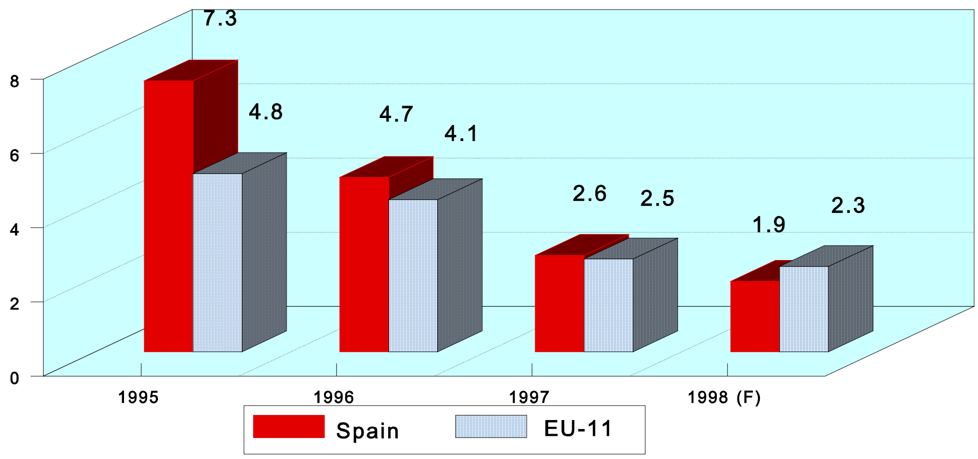
Despite interest rate decline, the peseta **exchange rate** has remained stable withing the exchange mechanism of the European Monetary System (EMS), hovering near its central parity since mid-1998. This performance has been consistent with a volume of reserves which in October 1998 amounted to 74 billion dollars.

3. Budgetary performance

The fiscal policy stance of recent years has successfully lowered the **public deficit** from the 7.3% of GDP recorded in 1995 to the 1.9% projected for 1998, four decimal points below the most optimistic scenario envisaged in the *Convergence Programme*. On these estimates, the Spanish 1998 deficit will stand below the EU-11 average.

FIGURE 4

GENERAL GOVERNMENT DEFICIT
As a percentage of GDP



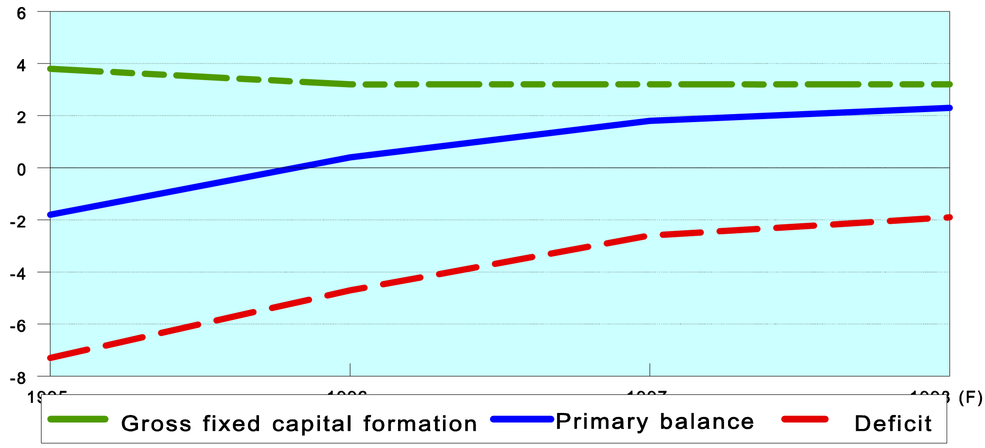
(F) Forecast
SOURCE: European Commission and Ministry of Economy and Finance.

Just as important as deficit reduction *per se* are the means by which it is being achieved. To remark in this respect the strong retrenchment of public spending, whose weight in GDP has come down from 47.8% in 1995 to an estimated 43.5% in 1998.

Spending contention has been selectively deployed, with savings falling heavier on current than investment expenditures, given the latter's impact on growth potential. In fact, public investment has repeated its 3.2% GDP weight in each of the last three years, exceeding the amount of the public deficit and thus fulfilling the golden rule of public finances from 1997 onwards.

FIGURE 5

EVOLUTION OF GENERAL GOVERNMENT ACCOUNTS
As a percentage of GDP



(F) Forecast.
SOURCE: National Statistics Office and Ministry of Economy and Finance.

These fiscal consolidation efforts have been recognised by the European Commission itself as among the most ambitious of all euro zone member countries. Significantly, budgetary imbalances have been corrected without recourse to one-off measures. Also, the deficit reduction strategy has been visibly independent of the economic cycle, as evidenced by Commission figures which locate the reduction of the Spanish structural deficit in terms of GDP at 4.6 percentage points since end-1995.

The re-balancing of public accounts is proceeding without recourse to tax increases, thus avoiding the damp-down effect which would accompany on economic and employment growth. The GDP weight of total revenues has accordingly stayed flat over 1997-1998.

As regards **public debt**, the upwards trend in terms of GDP has been successfully inverted. In 1997, the ratio dropped by some 1.2 percentage points to 68.9% of GDP, and the downtrend has continued in 1998, taking a further 1.5 points approximately off the ratio.

Table 2

GENERAL GOVERNMENT ACCOUNTS (National Accounts basis: % of GDP, as per GNP directive)	1997		1998	
	CP (1)	Real (2)	CP	Real (2)
Total revenues	40.7	41.7	40.7	41.6
Total expenditures	43.7	44.4	43.2	43.5
- Current expenditures	39.4	39.5	38.8	38.6
- Capital expenditures	4.3	4.8	4.4	4.9
Deficit (-) or surplus (+)	**-3.0**	**-2.6**	**-2.5**	**-1.9**
Central Government	-2.7	-2.3	-2.3	-1.6
- State	-2.5	-2.1	-2.1	-1.5
- Social Security	-0.2	-0.2	-0.2	-0.2
Territorial governments	-0.3	-0.3	-0.2	-0.2
Gross Debt	**68.2**	**68.9**	**67.7**	**67.4**
Primary surplus	1.9	1.8	2.1	2.2

(1) 1997 Convergence Programme
(2) Estimate

SOURCE: Ministry of Economy and Finance

III. ECONOMIC POLICY AND SHORT- AND MEDIUM-TERM FORECASTS 1999-2002

1. General economic policy guidelines

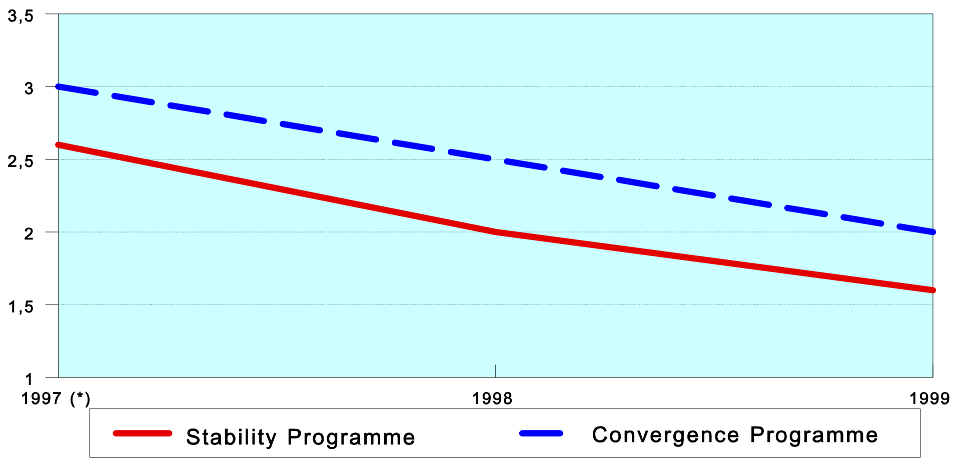
From 1999 onwards, economic policy will be drawn up in the context of the single currency and guided by the desire to advance along the path mapped out by the *1997 Convergence Programme* and by the commitments and rules enshrined in the *Stability and Growth Pact*, towards the ultimate achievement of real convergence in income and employment.

• Fiscal policy

Fiscal policy will pursue further public deficit reduction beyond the goals of Spain's *Convergence Programme*, the target being a budgetary surplus in the year 2002.

FIGURE 6

GENERAL GOVERNMENT DEFICIT TARGETS
As a percentage of GDP



(*) Actual
SOURCE: National Statistics Office and Ministry of Economy and Finance.

The efforts required to achieve this goal will not emanate only from the State, but from all layers of government. To this end, the Government will maintain its coordination and surveillance role within the framework of the *Fiscal and Financial Policy Council*, to ensure that public deficit targets are met not only by central government but also by territorial governments.

Fiscal policy will again prioritise **public spending** reduction, primarily under current expenditure heads. Investment spending, far from decreasing, will actually raise its weight in GDP, to facilitate a gradual narrowing of the capital stock gap with EU partners and ensure an efficient use of European funds.

As in the past two years, spending contention will fall heaviest on the primary component. The result will be a widening of the primary surplus achieved in 1998 and further progress towards reduction of the debt/GDP ratio initiated in 1997.

Progress in cost contention will permit action on the **public revenues** front, with the implementation of a Personal Income Tax reform designed to boost both the supply side and aggregate demand.

The main thrust of this new reform is a lowering of the tax burden on earned income, thereby reducing the tax wedge and shoring up job creation. Moreover, the higher disposable income resulting will simultaneously stimulate consumption and the household savings ratio. The fact that measures specifically target low-income groups will heighten the impact on the tax wedge and consumption.

The positive effects of the new reform on employee take-home pay will favour an appropriate level of wage settlements. Its impact will be felt as early as January 1999 in the form of a reduction in wage earners' withholding tax.

• **Monetary policy**

The ECB will take full charge of euro-area monetary policy as of January 1999, with a price stability remit defined as an annual increase in the euro-zone HICP of less than 2%.

To accomplish this goal without depressing growth or employment, the monetary policy of the ECB must go hand in hand with further progress in fiscal consolidation and the reform of goods, services and factor markets. This will ensure an adequate response of the supply side to growth in aggregate demand and of costs and prices at times of recession.

• Supply side policies

Aware of the prime importance of supply side policies in the EMU framework, the Spanish Government will assign particular attention to structural reforms such as those described in the *Progress Report on the Reforms of Goods, Services and Capital Markets.* Labour market reform will also be firmly to the fore, along the lines set out in the *National Action Plan on Employment.*

2. Macroeconomic forecasts 1999-2002

2.1. Macroeconomic projections for 1999

• The international setting

The Spanish economy will operate in an international framework presumably characterised by a slowdown in activity, with the positive impact of tentative recovery in the Asia region more than offset by decelerating growth in other emerging markets, the US and, to a lesser extent, Europe.

In short, the baseline projections, coinciding with those of the IMF, the OECD and the European Commission, are for worldwide growth of around 2% in output and 4.5% in trade. These projections include real GDP growth for the US of between 1.5% and 2%, and 2%-2.5% for the EU.

• Output and demand

Spanish output seems likely to grow at a similar rate to that of 1998, with some slight change in demand component performance in line with the current phase of the cycle. Domestic demand will pick up further, while net exports will contribute progressively less to product growth. GDP will rise 3.8%, driven primarily by private consumption and investment.

The factors fuelling the **private consumption** upswing since 1997 will again exert a positive influence, with job creation as the main motor. The trend will be further reinforced by the higher disposable income delivered by Personal Income Tax reform.

This last effect will be felt as early as January 1999. The lower withholding tax applied from this month on will particularly favour low-income households, those with a greater propensity to consume. Specifically, households will gain around Ptas 680 billion more in disposable income over full-year 1999, of which some 70% will go on consumption. The expected outcome is a 3.8% increase in private consumption, two decimal points higher than in 1998.

Government consumption, meantime, will expand by 1.2%, repeating the growth rate estimated for 1998 and based equally on a continuing moderation of public spending.

Gross fixed capital formation will stay on an upwards trend, attaining an annual growth rate of 10%, on the persistence of contributing factors like the stability endowed by euro membership, domestic demand robustness and a favourable cost climate encompassing financial, raw material, labour and other input costs.

The slightly higher growth rate posited versus 1998 rests on the dynamism of construction. The acceleration of this component since 1997 will continue to be buoyed up by the factors behind its initial upturn, namely the Budget priority assigned to infrastructures and rising investment in housing prompted by the greater disposable income of households, the low cost of mortgages and heightened consumer confidence.

Despite the less certain mood induced by recent international events, the high capacity utilisation Spain is now registering will prove an important spur to the accumulation and renewal of equipment.

Consistent with the trend projected for gross fixed capital formation, the Spanish investment rate should hold to the upwards course of recent years, reaching 22.7% of GDP. The stability of the current growth model, the high returns being earned in the corporate sector and low interest rates should outweigh the logical uncertainties provoked by the turbulent state of international financial markets.

These various factors combined should serve to slightly quicken domestic demand growth to 5%.

On the **foreign demand** side, the expectation is for a net negative contribution to real GDP growth, as normally occurs in the expansion phase of the cycle. That said, the effect will be far less acute this time round, as one of the features of the Spanish economy's current growth is that exports are still advancing strongly enough to partially counter the surge in imports.

As a result, net exports are projected to subtract 1.3 percentage points from GDP growth on a mild deceleration of exports and maintenance of the growth rate in imports.

• **Employment**

The economic expansion process should continue to be strongly generative of employment, as far as a projected rate of 2.8%. Furthermore, though the participation rate of women is rising, labour force growth will continue to moderate as a result of the slower enlargement of the working age population. This is expected to facilitate further decline in the unemployment rate as far as 17.1%.

• **Prices and wages**

The **wages** negotiated in collective bargaining agreements will likely increase at an annual rate close to 2%, as wage claims increasingly accommodate to greater price stability, and the improved inflation outlook for 1999. Factoring in non wage labour costs, compensation per employee should increase at an annual rate between 2% and 2.5%, while unit labour costs would increase around 1.5%, given the productivity growth projected.

These wage cost projections, and the favourable outlook for financial costs, permit the setting of a 1999 **inflation** target more ambitious than this year's. Intensifying competition both in international markets, where raw materials prices are projected to stay low, and in domestic markets, arising from the liberalisation policies deployed, will facilitate an inflation rate short of 2%. The Government's end-1999 inflation target of 1.8% is thus perfectly in keeping with the macroeconomic projections described and with the inflation target set by the ECB.

• **Balance of payments.**

Exports of goods and services will climb an estimated 9.8%. The deceleration implied with respect to 1998 reflects the more complex international situation. On the imports side, the projected advance of 12.4% repeats last year's rate, since the positive impact of strengthening private consumption and still vigorous investment will be offset in part by the lesser growth of exports.

The savings ratio of the economy is likewise projected to rise once more in 1999, due to steady improvement in public accounts. This growth, however, will lag behind that of the investment ratio, lifting the investment level higher than savings for the first time since 1995. The result will be a negative current account balance (in National Accounts terms) of 0.7% of GDP, with the trade deficit as the main contributing factor. Despite this deterioration of the current account balance, Spain will maintain a net lending capacity with the rest of the world. The figure, however, will be only mildly positive due to net capital transfer inflows.

2. 2. Macroeconomic projections 2000-2002 (baseline scenario)

The macroeconomic scenario assumed in the *Stability Programme* matches up with the **worldwide context** envisaged by international organisations for the years ahead. It is supposed, on the whole, that once today's financial crisis has abated, the right mix of economic policies and their international coordination will ensure that the industrialised countries (OECD) continue to grow by a healthy 2%-2.5% on average over 2000-2002.

The EMU area, which will henceforth exert the greatest direct influence on Spanish economic performance, should see some slight faltering of growth with respect to 1998. However the macroeconomic equilibrium dominating in the euro zone will smooth out the cyclical fluctuations of output and deliver more sustainable growth in activity, in the region of 2.5% on average over the three-year projection period.

This sustainability supports inflation forecasts below 2%, allowing interest rate levels which, in contrast with prior cycles, will not depress consumption and investment, but rather stimulate output and employment.

Within this framework, the Spanish economy will conserve a **growth** differential conducive to real convergence with the EU as a whole. Specifically, GDP growth will run at a projected average rate of 3.3% in the years 2000-2002. Following the growth surge of the preceding years, the economy will expand close to its long-term output growth rate over the projection period, albeit without generating the macroeconomic imbalances suffered in previous cycles.

The sustainable growth posited will be underpinned by a balanced policy mix and the stable international setting provided by Spain's membership of EMU. The endeavours made towards fiscal consolidation and the liberalisation of Spain's economic structure will continue to buttress price stability, even with a common monetary policy designed to stimulate activity.

Domestic demand will be the main engine of this growth differential with Europe, with investment as its most dynamic element. **Net exports** will again contribute negatively, though to an increasingly smaller extent given the growth envisaged for world output and trade, and the easing of domestic demand pressure on imports.

As stated above, **gross fixed capital formation** will be the most vigorous component of domestic demand. Equipment investment is expected to initially play the dominant role, with construction taking the lead towards the close of the projection period. On estimated growth rates for these two components of 5.1% and 6.5% respectively, overall investment will increase at an average rate close to 6%. Contributing factors are as follows:

- Firstly, the macroeconomic context of balanced growth and the stability conferred by EMU membership will ensure interest rates remain at record lows, raising positive expectations which will favour both investment components.

- Secondly, the moderation of company costs delivered by wage restraint, declining financial expenses and progressively lower prices of other production inputs in response to the greater competition unlocked by structural reforms.

- The third, associated, cause will be the high returns earned by Spanish companies, aided by the financial re-structuring of recent years.

The fast pace of investment expansion mooted is expected to be financed from domestic **savings**. Specifically, persistently strong household savings, coupled with the higher government savings ratio forecast, will allow investment opportunities to be taken up without recourse to foreign borrowings.

Table 3

MACROECONOMIC SCENARIO 1997-2002
(Annual % change at constant 1996 prices)

	1997	1998	1999	AVGE 2000-2002
GDP AND AGGREGATES				
Private consumption	3.1	3.6	3.8	3.1
Government consumption	1.4	1.2	1.2	1.2
Gross fixed capital formation	5.1	9.1	10.0	5.9
- Equipment	11.0	13.0	12.0	5.1
- Construction	1.3	6.5	8.5	6.5
Domestic demand	2.9	4.6	5.0	3.5
Exports of goods and services	14.8	10.6	9.8	8.5
Imports of goods and services	12.2	12.4	12.4	8.6
Net exports (contrib. to GDP growth)	0.5	-0.8	-1.3	-0.4
GDP	3.5	3.8	3.8	3.3
PRICES AND COSTS				
GDP deflator	2.0	2.4	2.1	1.9
Private consumption deflator	2.5	2.0	1.9	1.7
LABOUR MARKET (LABOUR FORCE SURVEY)				
Employment:- % change	2.9	3.5	2.8	2.3
- change in thsds (a)	357.0	450.0	370.0	959.0
Unemployment rate (% labour force) (b)	20.8	18.7	17.1	12.8
OTHER VARIABLES (as % of GDP)				
Net lending (+) or borrowing (-) vs. rest of world	1.5	0.9	0.0	0.0

(a) The average job creation rate stated for 2000-2002 is the difference between average employment in 2002 and 1999.
(b) The average rate stated for 2000-2002 is that corresponding to the year 2002.

SOURCE: National Statistics Office, 1997 and Ministry of Economy and Finance, 1998-2002.

Private **consumption** will continue robust, and will gradually supplant investment as the main motor of economic growth. In contrast to previous cycles, consumption growth rates will consistently trail those of GDP, effectively allaying inflationary pressures. On the public consumption side, growth rates will remain moderate, in response to the priority accorded to spending contention in the budgetary consolidation projected for 2000-2002.

In line with the model of the last few years, output growth will be intensely generative of **employment**, materialising in an estimated average increase of 2.3% over the projection period. This positive employment-output relationship is anchored on the economy's good response to three factors. Firstly, the prolonged decline in real-term interest rates is fuelling a sharp increase in the stock of physical, human and technological capital and thereby facilitating the productivity gains projected. Secondly, the reforms deployed in goods and services markets, which by reducing the price of critical inputs, favour a more flexible, employment-generating supply side able to keep abreast of demand growth. And finally, the economy's response to the labour market reforms carried through in recent years, which have enhanced its flexibility aided by labour cost moderation.

In relation to this last aspect, a moderate evolution of unit labour costs is forecast throughout the projection period; under 1.5% on average in annual terms. This evolution will be necessary to conserve the competitiveness of the Spanish economy and to ensure that demand growth continues to translate into employment creation without inflationary tensions. In short, to the extent that differential productivity gains are forthcoming, the increase in workers' purchasing power will be compatible with still strong job creation.

The labour force will likely continue to expand, as the Spanish participation rate has not yet caught up fully with that of neighbour countries. However, the scale of job creation projected will allow a reduction of the unemployment rate by more than four percentage points between 1999 and 2002, and further the real convergence of Spain's economy with its single currency partners.

Finally, on the **inflation** front, the GDP deflator is projected to climb by an average 1.9% over the three-year period, a moderate increase fully in line with the price stability objectives of the ECB. The duty of euro participant countries will be to facilitate achievement of these objectives by pressing on domestically with the process of fiscal consolidation and the boosting of competition.

The differential productivity gap envisaged for Spain’s economy and the resulting progress in real convergence will also mean differential growth in non tradeable goods and services prices, which should gradually align with the EMU average over the next decade.

This should not however erode the Spanish economy’s competitiveness in the three years considered, as long as the relative prices of the tradeable goods sector reflect a variation in unit costs on a par with remaining EMU participants. Such variation will respond, among other factors, to the projected contention of unit labour costs and financial expenses as well as raw material and other productive input prices. In addition, the efficiency gains unlocked by budgetary policy and structural reforms will be put precisely at the service of cost containment.

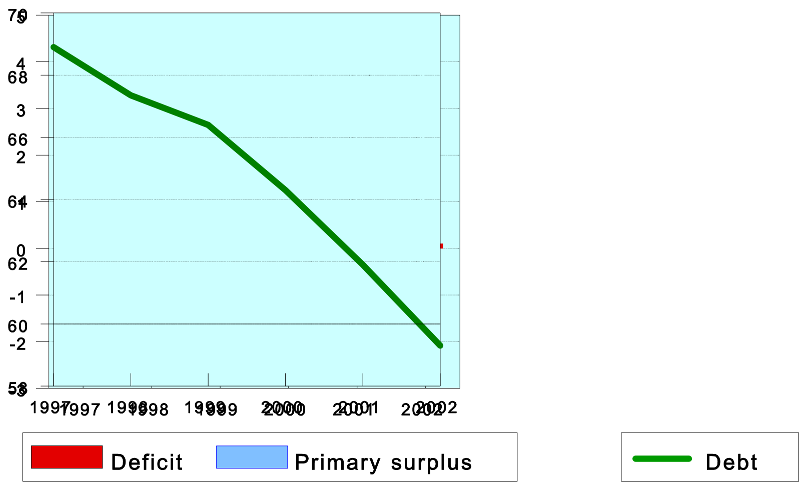
To conclude, inflation control is considered paramount in furthering convergence in income and employment and ensuring that the Spanish economy is equipped to confront the fresh challenges that may emerge in the new international framework prevailing in the 2000-2002 period.

3. Budgetary projections 1999-2002

In the framework described of macroeconomic stability and job creation, the Spanish economy will advance further in the correction of budgetary imbalances initiated in the last few years. Specifically, the objective is to press on with public deficit reduction as far as a surplus in General Government accounts in the year 2002. Achievement of this goal will rest on current expenditure contention and will therefore be compatible with heightened public investment and a lower weight of public revenues in GDP. Budgetary consolidation will likewise permit a sizeable reduction in the debt/GDP ratio.

FIGURE 7

DEFICIT, PRIMARY SURPLUS AND DEBT PROJECTIONS
As a percentage of GDP



SOURCE: National Statistics Office and Ministry of Economy and Finance.

Revenues are expected to grow at an average annual rate of 5.2% over 1999-2002, that is, less than nominal GDP. As a result of the Personal Income Tax reform recently approved, tax pressure will ease by 4 decimal points of GDP in the first two years of the period, and stabilise thereafter. This evolution reflects the Government’s 1998 commitment to a lower tax burden and, as stated, will be kept fully compatible with deficit reduction through the medium of ongoing expenditure containment.

On the tax side, the outstanding measure is the abovementioned reform of Personal Income Tax. The essential purpose of this reform, besides the lower tax pressure referred to, is to make the tax both fairer and more efficient. To this end, the number of tax brackets and the tax rates applied are reduced, a new initial tax-free allowance introduced and deductions rationalised.

The far-reaching changes involved will imply some slowing of tax revenues growth, particularly in the initial years of the projection period and in the ambit of Spanish households. In addition, the reform will enhance labour market functioning, by lowering the tax wedge on earned income, and stimulate capital markets by encouraging long-term private savings. The outcome, then, will be an increase in the output growth potential of the Spanish economy.

Public expenditure is targeted to rise an average 4% over 1999-2002, signifying a sharp reduction in its GDP weight. Cost contention, moreover, will be compatible both with the upkeep of social coverage, with the accent on education and active labour market policies, and additional efforts in public investment, to further the real convergence process with respect to other EU countries.

The envisaged 1999 modification of the National Budget Law seeks to enhance the control and efficiency of public spending through the establishment of a goals-oriented management approach and the assigning of direct responsibility to managers. In addition, the Law will establish as its basic principal the achievement of a balanced budget in the medium-term future, and provide for multi-annual budget management.

Table 4

GENERAL GOVERNMENT ACCOUNTS
(National Accounts basis: % change)

	1997	1998	1999	2000	2001	2002	Average 1999-2002
Total revenues	6.8	6.0	5.4	5.2	5.3	4.9	5.2
Total expenditures	2.0	4.2	4.9	3.7	3.8	3,7	4,0
- Current expenditures	2.3	3.8	4.5	3.3	3.3	3,2	3,6
- Capital expenditures	-0.8	7.2	7.9	7.1	7.4	7,4	7,5
Gross fixed capital formation	5.2	7.8	9.5	9.8	10.0	10,0	9,8

SOURCE: Ministry of Economy and Finance

Budgetary consolidation will thus fall heaviest on current expenditures, targeting a 2.7 percentage point reduction approximately in their GDP weight. The main lines of action will be as follows:

- Efforts will be stepped up to reduce the GDP weight of government consumption. Public employment in the State sector will grow no more than 25% the number of outgoing staff. Goods and services purchases will lose weight in GDP in line with the inflation moderation envisaged.

- Spending on social benefits will be kept at over 14% of GDP. Here too growth will be moderate, however, thanks to the impact of lower inflation on most component items, and the deployment of new rationalisation and control measures.

  Foremost among these last initiatives is the separation of Social Security financing sources, to be concluded in the year 2000, which will reinforce the contributive nature of certain benefits. To this same end, the Law of Consolidation and Rationalisation of the Social Security System lays down a longer contribution period for pension calculation, the abolition of contribution base ceilings for certain wage brackets and the indexing of pensions to the CPI.

  Furthermore, as established in the *Toledo Pact*, a new round of analysis and negotiation will be opened up pursuant to a greater rationalisation of the Social Security system, which takes account of both demographic and labour market changes.

Finally, to underscore the priority accorded to active labour market policies, in tune with the guidelines set at the Luxembourg Summit. Spain undertakes to assign most of the savings harnessed from unemployment reduction to strengthening these active policies. Specifically, the funding of active measures will double from 1997 to 2002, amounting to one percentage point of GDP at the period's close.

The priority accorded to active policies is rooted in the Government's objective of maintaining the job creation capacity that has characterised recent economic performance. Further steps will be taken to modernise and flexibilise the labour market, including the regulation of a new, more flexible contract format for part-time working offering greater social coverage and backed by economic incentives. Likewise, priority will be given to the decentralisation of collective wage bargaining as a means of adjusting production costs to productivity and to the concrete circumstances of individual companies in the framework of the single currency.

- The relative weight of financial charges is also envisaged to come sharply down, reflecting the benign influence of lower interest rates and ongoing public deficit and debt reduction in terms of GDP.

The drive to rein in current expenditures will contrast with an increase in capital expenditures, centring on investment heads. In response, the public component of gross fixed capital formation will rise at a rate of 10% approximately over the whole projection period, significantly raising its relative weight in GDP. The goals are to promote infrastructure investment and R&D activity and, by this means, to expand the real and potential growth capacity of the Spanish economy and hasten the advance in real convergence.

These greater efforts in government investment coincide, furthermore, with a setting of price stability and low interest rates conducive to private-sector participation in infrastructure projects once entirely reliant on public funds due to their long maturity and pay-out periods.

The projected performance of revenues and expenditures will have the following effects:

- A higher GDP weight of government savings in each year of the projection period, towards a final percentage doubling that of 1998.

- A steady reduction in the public deficit, delivered by the parallel consolidation efforts of all layers of government. To this end, an agreement has been concluded with almost all Spain's Autonomous Communities, whereby they undertake to attain a balanced budget in the year 2001, in line with the *Internal Stability Pact* referred to in the 1997 *Convergence Programme.* Local authorities, meantime, are expected to maintain the broadly in balance accounts now being reported.

- A consistently widening primary surplus, reflecting the efforts made towards public spending containment.

- Compliance with the golden rule of public finances in each projection year, through a combination of increased public investment and progress in fiscal consolidation.

- A reduction in the structural deficit in each year of the projection period, as far as a year-2002 level consistent with the mid-term budget objectives framed by the *Stability and Growth Pact*. Advance here will be delivered equally by the budgetary policy measures already implemented and the greater output growth potential of the Spanish economy. This enhanced capacity stems, in turn, from factors like the macroeconomic stability achieved, materialising in a differential decline in real interest rates, and the deployment of structural reforms in spheres like telecommunications, electricity, financial markets and income tax.

Table 5

GENERAL GOVERNMENT ACCOUNTS
(National Accounts basis: % of GDP, as per the GNP directive)

	1997	1998	1999	2000	2001	2002
Total revenues	41.7	41.6	41.4	41.2	41.2	41.2
Total expenditures	44.4	43.5	43.0	42.2	41.6	41.2
- Current expenditures	39.5	38.6	38.0	37.2	36.5	35.9
- Financial charges	4.5	4.1	4.1	3.8	3.6	3.4
- Capital expenditures	4.8	4.9	5.0	5.0	5.2	5.3
- Gross fixed capital formation	3.2	3.2	3.3	3.4	3.6	3.8
Gen. Govt. deficit (-) or surplus (+)	**-2.6**	**-1.9**	**-1.6**	**-1.0**	**-0.4**	**0.1**
Central Government	-2.3	-1.6	-1.4	-0.9	-0.4	0.1
- State	-2.1	-1.5	-1.3	-0.9	-0.4	0.1
- Social Security	-0.2	-0.2	-0.1	0.0	0.0	0.0
Territorial governments	-0.3	-0.2	-0.2	-0.1	0.0	0.0
Gross debt	**68.9**	**67.4**	**66.4**	**64.3**	**61.9**	**59.3**
Primary surplus	1.8	2.2	2.5	2.8	3.2	3.5
Gross saving	1.0	1.8	2.2	2.9	3.6	4.2

SOURCE: Ministry of Economy and Finance

- The widening of the primary surplus, alongside the projected moderation of the effective rate of interest on public debt and the projected growth of nominal GDP, will facilitate a steady decline in public debt volumes as a percentage of GDP, to under 60% in the year 2002 (see Annexe). Debt, furthermore, will be earmarked primarily for the funding of public investment projects, and will thus simultaneously build up the economy's future output capacity while reducing the financial burden on coming generations.

In conclusion, budgetary planning for 1999-2002 is geared to complying with the commitments assumed under the *Stability and Growth Pact,* while furthering Spain's real convergence with EU partners: two essential goals which have guided the Government's economic policy in recent years.

IV. SENSITIVITY ANALYSES

1. Alternative growth scenario

The modified assumptions introduced in this section have no bearing on the objectives of budgetary consolidation and public debt reduction in terms of GDP. For analysis purposes, we have drawn up an alternative scenario based on less optimistic forecasts for world economic performance, with real GDP growth of a lower 3.5% in 1999, followed by 2.5% on average over the 2000-2002 period.

Table 6

SENSITIVITY ANALYSIS: MACROECONOMIC VARIABLES
(Annual % change, unless stated otherwise)

	1997	1998	1999	AVERAGE2 000-2002
BASELINE GROWTH SCENARIO				
GDP	3.5	3.8	3.8	3.3
GDP deflator	2.0	2.4	2.1	1.9
Employment	2.9	3.5	2.8	2.3
Unemployment rate (a)	20.8	18.7	17.1	12.8
Net lending (+) or borrowing (-) vs. rest of world (b)	1.5	0.9	0.0	0.0
LOW GROWTH SCENARIO				
GDP	3.5	3.8	3.5	2.5
GDP deflator	2.0	2.4	2.0	1.8
Employment	2.9	3.5	2.5	1.5
Unemployment rate (a)	20.8	18.7	17.4	15.0
Net lending (+) or borrowing (-) vs. rest of world (b)	1.5	0.9	0.0	-0.2

(a) As % of the labour force. The average rate stated for 2000-2002 corresponds to the year 2002.
(b) As % of GDP

SOURCE. Ministry of Economy and Finance

These lower growth projections would translate into a more negative growth contribution on the net exports side and generally cooler expectations. This would logically produce a degree of slowdown in domestic demand across all its components and thus a slower pace of job creation and a more moderate evolution of prices. The unemployment rate, however, would steadily decrease as far as 15% of the labour force in the year 2002.

Even under these more pessimistic assumptions, the public deficit would still decline year by year as far as 0.7% of GDP at the close of the projection period. As in the baseline scenario, deficit contention would be primarily determined by a sharp drop in the GDP weight of public spending, with current expenditures reined in most tightly. Meanwhile, General Government gross fixed capital formation would steadily gain in relative weight.

In any event, assuming 1999 product growth were as projected in the low growth scenario, the resulting deviation in the public deficit ratio to GDP would be no more than one decimal point. Such a minor divergence could be easily steered back towards the target level set in the baseline scenario.

Table 7

SENSITIVITY ANALYSIS: GENERAL GOVERNMENT ACCOUNTS
(% of GDP as per GNP directive)

	1997	1998	1999	2000	2001	2002
BASELINE GROWTH SCENARIO						
Gen. Govt. deficit (-) or surplus (+)	-2.6	-1.9	-1.6	-1.0	-0.4	0.1
Public debt	68.9	67.4	66.4	64.3	61.9	59.3
LOW GROWTH SCENARIO						
Gen. Govt. deficit (-) or surplus (+)	-2.6	-1.9	-1.7	-1.3	-1.0	-0.7
Public debt	68.9	67.4	66.7	65.2	63.9	62.9

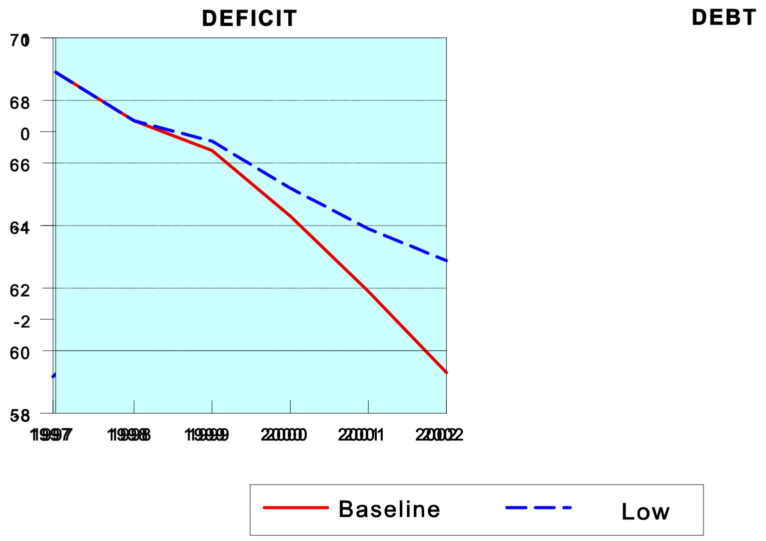
SOURCE: Ministry of Economy and Finance

Fiscal consolidation and interest rate moderation would deliver a steady increase in the government savings ratio. Despite this, the investment efforts of the economy as a whole would lead to a slight borrowing requirement vs. the rest of the world.

Finally, the low growth scenario assumes a reduction in the debt/GDP ratio of more than four percentage points. Spain would thus still meet the commitments acquired under the *Stability and Growth Pact,* even on the more pessimistic 1999-2002 scenario drawn up.

FIGURE 8

PUBLIC ACCOUNTS UNDER DIFFERENT MACROECONOMIC SCENARIOS
As a percentage of GDP



SOURCE: National Statistics Office and Ministry of Economy and Finance.

2. Interest rate sensitivity analysis

In order to check the consistency of the General Government account and debt forecasts contained in the baseline scenario, two alternative assumptions are posited for interest rate performance. Specifically, it is assumed that the yield curve traces a parallel movement, rising or falling by one percentage point. The public deficit responses identified are shown in table 8, in which the higher scenario represents rising interest rates and the lower, falling interest rates.

Table 8

SENSITIVITY ANALYSIS: INTEREST RATES
(National Accounts basis: % of GDP as per GNP directive)

	1999	2000	2001	2002
HIGHER RATE SCENARIO				
Gen. Govt. deficit (-) or surplus (+)	-1,7	-1,2	-0,7	-0,3
Public debt	66,5	64,5	62,2	59,6
BASELINE SCENARIO				
Gen. Govt. deficit (-) or surplus (+)	-1,6	-1,0	-0,4	0,1
Public debt	66,4	64,3	61,9	59,3
LOWER RATE SCENARIO				
Gen. Govt. deficit (-) or surplus (+)	-1,5	-0,7	-0,1	0,4
Public debt	66,2	64,0	61,6	59,0

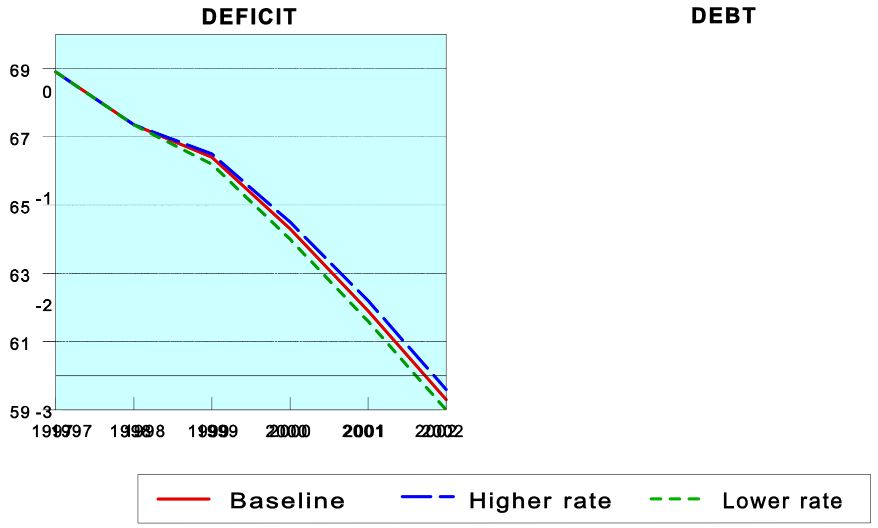
SOURCE: Ministry of Economy and Finance

This exercise evidences the lesser sensitivity of financial charges to interest rate evolution, following the enlargement of the average life of public debt instruments from the 3 years of end-1996 to the current 4.6 years.

Even on the assumption of rising interest rates, the public deficit would still be brought down to 0.3% of GDP in the year 2002. Meanwhile, the debt/GDP ratio would close the period under 60% in all the scenarios considered.

FIGURE 9

PUBLIC ACCOUNTS UNDER DIFFERENT INTEREST RATE SCENARIOS
As a percentage of GDP



SOURCE: National Statistics Office and Ministry of Economy and Finance.

V. CONCLUSIONS

The Government's chief economic policy objective within the time frame of this *Stability Programme* is to expand the Spanish economy's output growth potential as an essential step towards securing real convergence with EMU partners. The convergence achieved over the past two years in nominal macroeconomic variables -inflation, interest rates and public deficit- has served as a springboard for the attainment of differential income and employment growth with respect to the EU average.

In these two years, Spain's economy has performed in stark contrast with past business cycles. GDP growth has been successfully maintained above 3.5% without inflationary or balance of payments imbalances and accompanied by notably superior output-employment elasticity. What this proves is that the nominal convergence efforts made, and Spain's definitive entry to the single currency, have wrought a substantial change in the performance of our economy, clearly evidenced by its capacity to withstand the financial turmoil recently prevailing.

Against this backdrop, the mainstays of economic policy in coming years will be as follows:

- The culmination of fiscal consolidation efforts pursuant to Spain's full compliance with its commitments under the *Stability and Growth Pact,* and the achievement of a budgetary surplus in the year 2002. The budgetary policy set out in this *Stability Programme* envisages ongoing and substantial improvement across the full range of fiscal variables: the general government balance, the primary balance, the structural balance, the government savings ratio and the public debt ratio.

- The goal of real convergence entails the prioritisation in budget terms, within the fiscal consolidation drive, of the Government's commitments to infrastructure spending, R&D, education, training and active labour market policies. In all these cases, the weight of the corresponding budget headings in GDP will rise consistently over the projection period.

- In contrast, current expenditures, financial charges and passive employment policies will all fall back relatively in terms of GDP. Welfare policies, however, will conserve their current weight throughout the Programme time frame.

- The Personal Income Tax reform recently ratified by Parliament will lessen the tax pressure on the economy by approximately 4 decimal points of GDP in 1999 and the year 2000. The reform, nonetheless, will exert a markedly positive impact on the performance of labour and capital markets, and unlock further long-term output growth.

- The Government will press on with structural reforms in factor, goods and services markets. This is regarded as a vital means to advance in fiscal consolidation and to raise the employment-output elasticity embedded in Spain’s economic growth.

In conclusion, the Spanish Government will concede prime importance to compliance with the terms of the *Stability and Growth Pact.* These efforts, furthermore, will be kept fully compatible with the reform of personal income tax, and an increased weight of the spending heads strategically crucial to future growth (infrastructures, R&D, education and workforce training). Supply-side policy will remain at the top of the agenda within the context of the single currency. The final outcome envisaged from these policy stances is the steady alignment of Spain’s employment and income levels with the EU average.

ANNEXE 1

THE NEW PERSONAL INCOME TAX

THE NEW PERSONAL INCOME TAX

The Personal Income Tax model in force until 1999 was first introduced in Spain as part of the 1977 tax reform. Since then the tax has not only suffered the passing of time, but also a long string of legislative changes which have greatly increased its complexity. What these reforms failed to achieve, however, was a system satisfactorily consistent with the taxation principles of equality and progressivity enshrined in the Spanish Constitution. Personal Income Tax, in short, had lost much of its revenue-raising capacity, because of its deficiently streamlined rules and complex web of deductions, which made it costly to administer and structurally unconducive to an effective fight against fraud. This explains why Spain, with one of the highest tax rates of all the OECD countries, was actually registering lower-than-average tax receipts in relation to GDP.

At the same time, Spain's growing integration with the rest of Europe, culminating in entry to the third stage of EMU in 1999, required an income tax model adaptable to the new context marked by the euro, given the tax's profound influence on agents' decisions about savings and employment and, ultimately, on economic growth. The absence of such adaptability would have an adverse impact on the competitiveness and expansion potential of the Spanish economy.

In conclusion, the flaws accumulated by the previous system, the requirements of euro membership and compliance with the political commitment to provide a fairer tax, have placed Personal Income Tax reform firmly in the Government's economic policy sights since the start of its term in office.

After wide consultations with economic agents, including the creation in February 1997 of a "Commission for the Study and Proposal of Personal Income Tax Reform Measures", the Government submitted the corresponding draft legislation to the Congress of Deputies in April 1998. The parliamentary debate around the bill culminated in the enactment of Law 40/1998 of 9 December on Personal Income Tax.

The new law modifies almost every area of the old Personal Income Tax. However, its most important innovations are in the object of the tax and in its rate. On this first score, the new tax is levied on the economic capacity of taxpayers, understood as the income remaining after coverage of their and their families' basic needs. To this end, the new tax incorporates an initial tax-free allowance per person or household which varies according to the taxpayer's personal circumstances. This initial allowance does away with the previous web of deductions on taxable income, whose existence not only pushed up administrative costs but was also, frequently, hard to justify in the name of fairness or progressivity. The new allowance is therefore a welcome improvement on the zero rate bracket of the old tax scale.

Likewise, the new model offers greater neutrality in the tax treatment of financial products and support for long-term saving through pension schemes.

As regards rates, the law brings two major novelties: an across the board reduction in tax rates and the streamlining and redefinition of tax brackets, mirroring the legislative trend elsewhere in Europe towards a more simplified tax rate system. Specifically, the maximum marginal rate is lowered from 56% to 48%, while the minimum rate drops from 20% to 18%. The eight brackets currently in use are also cut back to six.

On the procedural side, the new legislation sets out to simplify the tax's administration and thereby reduce both the number of returns filed and the excessive withholding taxes being paid against the net tax charge. This will also free up the material and human resources of the tax authorities for redeployment to the fight against fraud.

Finally, to remark that the goals pursued by Personal Income Tax reform are structural in nature and, therefore, with an impact which extends beyond the short term. Essentially, the reformed tax will exert a more neutral effect on the decisions of economic agents, will provide a permanent increase in households' disposable income and will significantly lessen the tax wedge, namely the difference between employers' gross labour costs and workers' take-home pay. All this, in turn, will expand the output growth potential of the Spanish economy. In the short term, of course, income tax reform will diminish Inland Revenue receipts. Estimates quantify this effect at approximately 550 billion pesetas in 1999 and 2000.

ANNEXE 2

STRUCTURAL REFORMS

STRUCTURAL REFORMS

The Spanish Government's new economic policy design accords particular relevance to structural reforms in product and factor markets. Reform efforts, furthermore, will be more relevant still in the new context of EMU, when traditional demand-side policies (monetary and fiscal) will lose much of their scope, and productivity differences will largely arise from the flexibility of productive sectors.

The reform and liberalisation measures deployed to date have targeted a wide range of sectors, with particular attention to those which provide critical inputs bearing indirectly on other economic activities. Spain's liberalisation process has essentially mirrored those of other EU countries and, in certain cases, has run ahead of the schedules set.

The Government will pursue this reform line in the near-term future, building on the measures already deployed and making new changes to introduce competition and improve regulatory quality. The principal challenges remaining, which will shortly be addressed as described in the closing section of the *Progress Report on the Reform of Goods, Services and Capital Markets,* are the following:

- **Telecommunications**

  The definite free-up of the Spanish telecommunications market took place on December 1, 1998. New licences will shortly be granted for the provision of fixed and mobile telephony services, alongside the phased start-up of cable operators.

  The interconnection reference prices recently agreed are sharply down on current rates. Local interconnection charges, in particular, will reduce by as much as 34%.

- **Electric utilities**

  With new sector legislation now on the statute books, the next step will be the reduction (by between 25% and 40%) of the toll charges weighing on third-party operators for access to power transmission or distribution. Also under consideration is a lowering of the legal threshold whereby eligible consumers (those consuming more than 15 kwh) will be free to choose their electricity supplier.

- **Land**

  As zoning and planning powers are now lodged exclusively with the territorial authorities, the Government will redouble its efforts to build awareness at regional and local level of the need to harmonise rules and free up the land market.

  The policy stance on Subsidised Housing will also change. From now on, the mortgage rate subsidies of the past will progressively be switched for direct aids to home buyers in the down payment portion of the purchase cost.

- **Water**

  The forthcoming law will focus on a more rational use of water and on its consideration as an economic good, with the ultimate aim of securing a more efficient allocation of this resource.

- **Retailing**

  The priority for action in this sphere will be the assurance of a greater flexibility in retailers' commercial decisions as of the year 2001. The Government will strive to reach the corresponding agreements with the Autonomous Communities.

- **Privatisations**

  Further privatisations will be undertaken in the months ahead. The state holding company *Sociedad Española de Participaciones Industriales (SEPI)*, one of the bodies channelling privatisation policy, is planning the sale of another 15 companies (*Iberia*, *Casa*, *Indra, Santa Bárbara*, *Enatcar*, *Babcock Wilcox*, among others). The objective is that by the year 2000 the only activities left within the public enterprise sector will be mining and certain defence companies.

- **Bankruptcy law**

A draft is now being prepared for a new Bankruptcy Law modifying current regulations on bankruptcy and receivership proceedings. This reform will deliver a speedy and affordable process which endows economic relations with greater security and ensures that viable companies do not needlessly go under because of drawn-out and costly proceedings.

- **Rules of civil law procedure**

A Civil Law Procedures Bill is now before Parliament to replace and improve upon the procedural rules currently in force. Its most significant innovations in the economic sphere are the speed-up of court cases, the creation of more efficient procedures for the handling of small claims and rationalisation of the system of precautionary measures.

- **SMEs**

Economic policy measures targeting the small-firms sector include, on the one hand, a new *Plan de Agilización y Simplificación Normativa* to shorten and simplify administrative procedures and, on the other, new Government measures to facilitate the securitisation of loans extended to productive companies through the provision of guarantees. Though this initiative will impact across the board, it will prove particularly beneficial to small and medium-size enterprises.

- **Competition policy**

The development of the competition protection system is a priority objective of economic policy, to ensure that the gains unlocked by greater competition are passed on appropriately to consumers and users. Competition rules will accordingly be modified with the fundamental goals of strengthening competition institutions, tightening control of state aids, changing certain aspects of merger control and introducing conventional termination in sanction procedures.

- **Tax measures**

The Personal Income Tax reform already approved will be joined by other tax measures aimed at encouraging savings, notably the reduction of withholding taxes on capital income and their elimination in the case of private fixed-income securities.

- **R&D policy**

The Government is preparing a Draft Law for the Promotion of Industrial Innovation, which lays down the legal, tax and financial framework for industrial innovation policy. Its ultimate aim is to procure an economic and institutional framework which makes it worthwhile for companies to innovate.

- **The internationalisation of Spanish companies**

Further measures will be taken to facilitate and support the internationalisation of Spanish companies. A range of alternatives will be analysed in spheres like tax, financing, promotion, etc. pursuant to a greater presence of Spanish firms in international markets.

- **The capital market**

Salient measures in the drive to modernise Spain’s capital market include new legislation governing Venture Capital providers and U.C.I.T.S. In the case of the former, component measures provide for greater leeway in investment policy and their supervisory control by the Securities Exchange Commission (CNMV), as well as their operational adaptation according to investor category.

In the case of U.C.I.T.S, the reform efforts already initiated will conclude in a complete overhaul of the legal and functional rules governing mutual funds. The result will be a broadening and liberalisation of the investment policy and operational scope of these instruments.

- **Health**

The Law of Administrative, Fiscal and Social Measures brings a series of changes in the organisation of public hospitals, geared to procuring their greater efficiency. The new figure of *Fundaciones Públicas Sanitarias* introduced in this legislation will reduce the bureaucratic weight of hospital management, decentralise decision-making powers and increase administrative autonomy. These goals will be met by means of more flexible economic and human resource management, and a performance-linked system of remuneration.

Further advances are also targeted in the introduction of generic medicines and the establishment of reference prices.

- **Other public spending control measures**

The General Budget Law is likely to be amended in 1999 in order to reinforce the control and efficiency of public spending through a new goal-oriented management approach and the assigning of direct responsibility to managers. The reform will also establish the fundamental principle of balancing the budget in a mid-term future, and provide for multi-annual budget management.

Finally, further steps will be taken to rationalise the Social Security system along the lines envisaged in the *Toledo Pact,* taking account both of demographic and labour market changes. Moves will also be made to encourage the development and uptake of complementary social coverage.

ANNEXE 3

DETERMINING FACTORS IN PUBLIC DEBT/GDP VARIATION

DETERMINING FACTORS IN PUBLIC DEBT/GDP VARIATION

The present *Stability Programme* posits a steady reduction in the public debt/GDP ratio to below the Maastricht Treaty threshold level (60%) by the end of the projection period. This performance is consistent with the looked-for improvement in primary budget balances, the nominal GDP growth projected and the stable interest rate environment provided by EMU throughout the Programme time frame. The following table offers a more precise breakdown of the factors driving debt/GDP evolution over 1986-2002. These factors, in turn, are deduced from the budget constraint equation expressed as follows:

$$d_t - d_{t-1} = b_t + (r_t - \alpha_t) d_{t-1} + a_t \qquad [1]$$

in which **d** is the public debt/GDP ratio; **b** is the primary deficit, likewise stated as a proportion of GDP; **r** is the effective interest rate of public debt; **α** is nominal GDP growth; and **a** is an adjustment component which factors in ratio variations arising from changes in financial assets and from stock-flow adjustments.

DETERMINING FACTORS IN PUBLIC DEBT/GDP VARIATION
(In GDP percentage points)

Period	Change in the public debt/GDP ratio	Contribution of determining factors			Public debt/GDP ratio
		Primary deficit (1)	Interest rate and GDP growth	Adjustment (2)	
1986-1991 (3)	0.1	0.4	-0.7	0.5	45.5
1992-1996 (3)	4.9	0.9	1.8	2.3	70.1
1997	-1.2	-1.8	0.7	-0.0	68.9
1998	-1.5	-2.2	0.0	0.7	67.4
1999	-1.0	-2.5	0.2	1.2	66.4
2000	-2.1	-2.8	0.3	0.5	64.3
2001	-2.4	-3.2	0.4	0.4	61.9
2002	-2.6	-3.5	0.5	0.4	59.3

(1) A positive (negative) value signifies deficit (surplus)

(2) Variations in the ratio due primarily to changes in financial assets and to stock-flow adjustments

(3) Annual average, except the final column (end of period)

Three distinct stages can be identified in the evolution of the public debt ratio:

- Over 1986-1991 the ratio stayed more or less constant, reflecting the concurrence of fast growth and high inflation. This lead to strong GDP growth rates ahead of effective public debt interest rates, despite the 10% average recorded by the latter in this same period.

- Over 1992-1996, debt rose sharply in GDP terms, from 45.5% in 1991 to 70.1% in 1996, i.e. practically 5 percentage points of GDP a year. This increase can be ascribed to the three determining factors of equation [1], but even more to the spike produced in their adjustment component, indicating, on the one hand, large increases in financial assets - essentially, in the deposit kept by the Treasury at the Bank of Spain until the 1994 prohibition of its use as a funding source for the public deficit-, and, on the other, the sizeable gap opened up between cash and national accounting in the period concerned. This period, moreover, was characterised by a moderate pace of economic growth and high real-term interest rates, provoking sharp growth in the GDP weight of debt servicing charges. Finally, though the primary balance was in surplus in 1996, this variable, on average, evidenced a slight decline with respect to the prior period in the context of more subdued economic expansion.

- Nineteen ninety-seven and subsequent years witnessed substantial improvement in the parameters governing debt ratio performance. Specifically, 1997 marked the turning point in the evolution of the public debt/GDP ratio, ushering in the current phase of steady decline. A budgetary policy geared to halting the growth of structural public spending, and the more favourable economic setting, transformed primary deficits into steadily widening primary surpluses. The difference between effective public debt interest rates and nominal GDP growth narrowed significantly in 1997 and 1998, due mainly to record lows in interest rates. The gap, however, has not turned negative, owing equally to sharply reducing inflation and the influence of historical interest rates on a public debt stock with increasingly long average maturity periods. Finally, the adjustment component has faded in importance as a result, primarily, of the fiscal retrenchment strategy.

As regards the period covered by this *Stability Programme,* the reduction in debt/GDP will rest fundamentally on ongoing budgetary austerity, which will permit further expansion of the primary surplus in the context of rather more moderate economic growth. This more subdued expansion of economic activity, together with the lower inflation projected, will pave the way for nominal GDP growth below effective public debt interest rates.

Finally, the impact of stock-flow adjustments in raising the debt ratio is likely to wane slightly against the average contribution currently identified for the 1997-1999 period.

In conclusion, the public debt/GDP ratio is targeted to drop below the Maastricht Treaty threshold level (60%) at the end of the projection period, in line with the assumptions set out in the baseline scenario of the *Stability Programme.*

ANNEXE 4

STATISTICAL TABLES

STATISTICAL TABLES

Table 1

MACROECONOMIC VARIABLES 1990-2002
(Annual % change at constant 1986 prices)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	Average 2000-2002
GDP AND AGGREGATES											
Private consumption	3.6	2.9	2.2	-2.2	0.9	1.6	2.0	3.1	3.6	3.8	3.1
Government consumption	6.6	5.6	4.0	2.4	-0.3	1.8	0.9	1.4	1.2	1.2	1.2
Gross fixed capital formation	6.6	1.6	-4.4	-10.5	2.5	8.2	1.3	5.1	9.1	10.0	5.9
- Equipment	1.2	-1.9	-4.4	-17.0	3.7	11.2	7.1	11.0	13.0	12.0	5.1
- Construction	10.4	3.9	-4.4	-6.5	1.9	6.6	-2.0	1.3	6.5	8.5	6.5
Domestic demand	4.8	2.9	1.0	-4.2	1.3	3.2	1.6	2.9	4.6	5.0	3.5
Exports of goods and services	3.2	7.9	7.4	8.5	16.7	10.0	10.6	14.8	10.6	9.8	8.5
Imports of goods and services	7.8	9.0	6.9	-5.2	11.3	11.0	7.4	12.2	12.4	12.4	8.6
Net exports (contr. to GDP growth)	-1.3	-0.8	-0.4	3.4	0.9	-0.6	0.7	0.5	-0.8	-1.3	-0.4
GDP	**3.7**	**2.3**	**0.7**	**-1.2**	**2.3**	**2.7**	**2.4**	**3.5**	**3.8**	**3.8**	**3.3**
PRICES AND COSTS											
GDP deflator	7.3	7.1	6.9	4.3	4.0	4.8	3.2	2.0	2.4	2.1	1.9
Private consumption deflator	6.5	6.4	6.4	5.6	4.9	4.7	3.4	2.5	2.0	1.9	1.7
LABOUR MARKET (Labour Market Survey.)											
Employment - change in %	2.6	0.2	-1.9	-4.3	-0.9	1.8	1.5	2.9	3.5	2.8	2.3
- change in thsds (a)	328.5	31.1	-249.0	-542.0	-110.0	216.0	178.0	357.0	450.0	370.0	959.0
Unemployment rate (% labour force) (b)	15.7	15.8	17.9	22.2	23.7	22.7	22.2	20.8	18.7	17.1	12.8
OTHER VARIABLES (as % of GDP)											
Net lending (+) or borrowing (-) vs. rest of world	-3.4	-3.0	-3.0	-0.4	-0.8	1.2	1.3	1.5	0.9	0.0	0.0

(a) The job creation rate stated as the 2000-2002 average is the difference between average employment over 2000-2002 and the figure for 1999.

(b) The average rate stated for 2000-2002 corresponds to the year 2002.

SOURCE: Ministry of Economy and Finance

Table 2

GENERAL GOVERNMENT ACCOUNTS
(National Accounts basis: % of GDP as per GNP directive)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Total revenues	39.7	40.6	42.3	42.5	41.5	40.4	41.3	41.7	41.6	41.4	41.2	41.2	41.2
Total expenditures	44.0	45.1	46.4	49.5	47.8	47.7	46.0	44.4	43.5	43.0	42.2	41.6	41.2
- Current expenditures	37.2	38.5	40.6	43.3	41.9	41.4	40.8	39.5	38.6	38.0	37.2	36.5	35.9
Financial charges	4.0	3.9	4.4	5.2	4.8	5.5	5.1	4.5	4.1	4.1	3.8	3.6	3.4
- Capital expenditures	6.7	6.5	5.8	6.2	5.9	6.2	5.2	4.8	4.9	5.0	5.0	5.2	5.3
Gross fixed capital formation	5.0	4.9	4.1	4.2	4.0	3.8	3.2	3.2	3.2	3.3	3.4	3.6	3.8
Gen. Govt. deficit (-) or surplus (+)	**-4.3**	**-4.5**	**-4.1**	**-7.0**	**-6.3**	**-7.3**	**-4.7**	**-2.6**	**-1.9**	**-1.6**	**-1.0**	**-0.4**	**0.1**
Central Government	-3.3	-2.8	-3.0	-5.7	-5.4	-6.6	-4.0	-2.3	-1.6	-1.4	-0.9	-0.4	0.1
- State	-3.4	-2.5	-2.8	-6.3	-5.2	-6.3	-3.5	-2.1	-1.5	-1.3	-0.9	-0.4	0.1
- Social Security	0.1	-0.3	-0.1	0.5	-0.2	-0.3	-0.4	-0.2	-0.2	-0.1	0.0	0.0	0.0
Territorial governments	-1.0	-1.6	-1.1	-1.2	-1.0	-0.7	-0.7	-0.3	-0.2	-0.2	-0.1	0.0	0.0
Gross debt	**44.8**	**45.5**	**48.0**	**60.0**	**62.6**	**65.5**	**70.1**	**68.9**	**67.4**	**66.4**	**64.3**	**61.9**	**59.3**
Primary surplus	-0.3	-0.6	0.3	-1.8	-1.5	-1.8	0.4	1.8	2.2	2.5	2.8	3.2	3.5
Gross saving	1.8	1.3	0.8	-1.7	-1.5	-2.4	-0.9	1.0	1.8	2.2	2.9	3.6	4.2

SOURCE: Ministry of Economy and Finance

Table 3

GENERAL GOVERNMENT ACCOUNTS
(National Accounts basis: % change)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	Average 1999-2002
Total revenues	11.6	12.2	12.1	3.7	3.7	4.8	7.9	6.8	6.0	5.4	5.2	5.3	4.9	5.2
Total expenditures	13.2	12.4	10.9	10.0	2.7	7.4	1.7	2.0	4.2	4.9	3.7	3.8	3.7	4.0
- Current expenditures	13.4	13.4	13.6	9.9	2.9	6.4	3.9	2.3	3.8	4.5	3.3	3.3	3.2	3.6
- Capital expenditures	12.0	6.5	-5.0	10.4	1.2	14.2	-12.8	-0.8	7.2	7.9	7.1	7.4	7.4	7.5
Gross fixed cap. formation	26.3	7.2	-9.6	6.4	1.3	1.1	-12.0	5.2	7.8	9.5	9.8	10.0	10.0	9.8

SOURCE: Ministry of Economy and Finance