



**STABILITY PROGRAMME
UPDATE
KINGDOM OF SPAIN
2000-2004**



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UPDATE

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2000 – 2004



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I. INTRODUCTION

Euro participants are obliged to furnish an annual update on their Stability Programmes to facilitate the multilateral supervision envisaged in article 99 of the Treaty on European Union and in Council Regulation 1466/97 on tighter surveillance of budgetary performance and economic policy co-ordination.

In 1996-2000, the Spanish economy maintained a consistent growth lead over the European Union (EU), averaging more than one percentage point. This was accompanied by a significantly faster pace of job creation and an intense process of modernisation and internationalisation of the Spanish economy.

The public deficit fell by 3.8 points of GDP between 1996 and 1999, closing this last year at 1.1%. The deficit target for 2000 has been reduced by an additional five decimal points to 0.3% of GDP, and the objective of a balanced budget rolled forward one year to 2001. This commitment to budgetary stability will deliver ongoing improvement in public finances over and above the targets set in the Stability Programme Update presented last year.

The present Update sets out new budget objectives for 2002-2004, framed by the implementation of the Law of Budgetary Stability which establishes strict rules for the management of public accounts (see Annexe I).

The primary objective of the Government's economic policy for the coming years is to attain rapid advance in Spain's real convergence with the core economies of the Economic and Monetary Union (EMU), building on the process of expansion and job creation initiated in the mid-1990s, while raising the standards of living and welfare of Spanish society. The main instruments used to achieve these goals will be budgetary stability and structural reforms.

Economic policy will be characterised by a strengthened commitment to budgetary stability consistent with a large increase in public infrastructure investment, and the deployment of further liberalisation and reform measures in goods, services and labour markets, with the ultimate aim of raising the potential growth of the Spanish economy.

Fiscal retrenchment will provide two key outcomes: the provision of a discretionary margin to cope with the economic performance and a guarantee of the mid-term sustainability of public finances. Fiscal decisions will be guided by the commitments acquired under the Law of Budgetary Stability, which will shortly be sent to Parliament. This Law makes it incumbent on all layers of government (central and territorial), save in exceptional circumstances, to draw up and return budgetary surpluses or, at least, zero deficits. Balanced budgets thus become the central contribution of fiscal policy to macroeconomic stability.

Within this framework of strict budgetary stability, government expenditures in the next four years will prioritise those areas with most impact on the potential growth of the Spanish economy. Action will be taken to foster investment in R&D, in education, as a means to increase human capital, and in infrastructure to eliminate Spain's current deficit in this area.

Pursuant to the Government's stated commitments, new direct income tax reforms will be enacted in 2002 building on the reforms undertaken in 1999. The main goals of the reform, aside from promoting tax equality, will be to stimulate saving, investment and the supply of labour.

Initiatives in goods and services markets will again pursue the greater liberalisation and flexibility of the supply side of the economy, and the entry or consolidation of alternative operators in network industries. The liberalisation drive will be accompanied, as before, by strict oversight of compliance with the tenets of competition policy as regards both restrictive practices and corporate mergers and acquisitions.

Labour market reform is seen as vital for the progress of the Spanish economy, and new modernisation measures will be implemented within the framework of social dialogue. A key objective here is the establishment of a collective wage bargaining system whereby wage settlements are tied in with productivity developments at micro and macro level. Part-time working will receive further encouragement in order to align its weight in total work contracts with the European average, while renewed efforts will be made to reduce Spain's high temporary employment rate. These initiatives will be backed by targeted support to the employability of disadvantaged job seekers, like women, the elderly and the lower skilled. The aim, then, is to raise the activity rate of the Spanish economy and develop a more efficient labour market fostering competitiveness, growth and job creation.

These policies will go hand in hand with incentive measures for private pension schemes, given their pivotal role in the generation of long-term saving, the development of capital markets and a wage conduct favourable to the economy's competitiveness.

This Stability Programme Update opens with a summary of the recent performance of the Spanish economy and economic policy design. This is followed by a section setting out budgetary projections for 2001-2004 anchored on prudent macroeconomic assumptions, and a sensitivity analysis of these projections for alternative growth and interest rate scenarios. Finally, two annexes describe the Law of Budgetary Stability and the structural reforms undertaken in product and factor markets.

The Stability Programme Update, the Progress Report on Reforms in Goods, Services and Capital Markets recently submitted to the EU, and the National Action Plan on Employment stand as the cornerstones of the Spanish Government's economic policy design.

II. ECONOMIC POLICY AND THE SPANISH ECONOMY 1999-2000

1. – Economic policy

Spain's entry to the EMU on 1 January 1999 marked the successful conclusion of an economic policy stage whose primary objective was the stabilisation of main macroeconomic variables and compliance with the convergence conditions set for euro membership. It also entailed a profound shift in the context in which economic relations develop.

As such, the adoption of the euro opens a new phase in economic policy in which the main goal of the economic authorities is to advance rapidly in the process of real convergence in employment and income with the most developed EMU countries. With responsibility for euro-zone **monetary policy** now lodged with the European Central Bank, the instruments available for securing this real convergence objective are fiscal policy and structural reform measures pursuing the greater competitiveness and flexibility of the Spanish economy.

Getting the right economic policy mix has become more vital than ever in these past two years, in which oil price escalation and euro weakness against the dollar hardened into a negative supply-side shock which has affected Spain and all other EU members. The achievement of ambitious budgetary objectives and more flexible product and factor markets are the best possible means to combat the effects of this shock.

In **fiscal policy**, the dominant note has been the public accounts consolidation initiated in 1996 and sustained over these last two years. The fruit of these efforts has been a reduction in the general government deficit from the 2.6% of 1998 to 1.1% in 1999 and a projected 0.3% of GDP at the year-2000 close. This last percentage improves on the objectives of the Stability Programme Update presented last year.

Also, budgetary consolidation has been kept compatible with, and even facilitated by, the tax reform drive of recent years, notably the Personal Income Tax reform whose first year in force was 1999. These reforms have increased tax revenues and engendered more efficient tax management, as well as promoting long-term saving, technological innovation and the internationalisation of the Spanish corporate sector. They are by this means supportive of growth, employment creation and budgetary equilibrium.

More specifically, personal income tax reform has sizeable reduced the individual tax burden of taxpayers, particularly benefiting the lowest income brackets who enjoyed a proportionally deeper cut. Marginal tax rates were also lowered to stimulate saving, investment, risk-taking and the supply of labour. According to the latest estimates available, the reform package delivered a reduction in the tax burden between 1999 and 2000 of approximately 0.8% of GDP, without jeopardising the advance of fiscal consolidation.

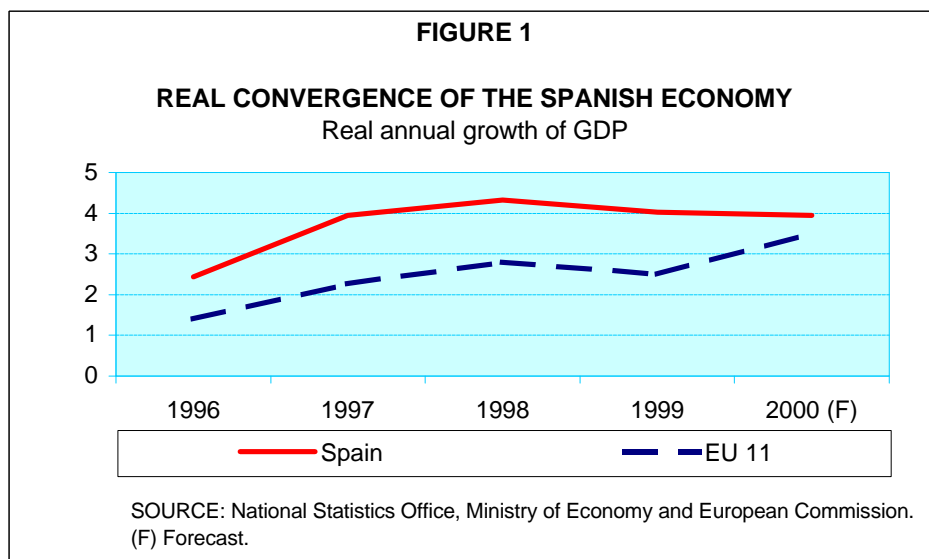
The years 1999 and 2000 also saw further **structural reforms** in goods, services and capital markets aimed at enhancing the flexibility and competitiveness of the Spanish economy. Competition was increased in sectors of particular strategic importance both as suppliers of basic inputs for the rest of the economy and for their decisive influence on the development of the knowledge society, like electricity, hydrocarbons and telecommunications (see Annexe II).

Competition policy was strengthened in recognition of its key role in ever more integrated European markets as one of the most useful tools available to national authorities for boosting the competitiveness of their economies.

Finally, the year 2000 marked the beginning of a new negotiations round between the social partners on the issue of **labour market reform**. The ultimate goal of these talks, from the Government's standpoint, is the modernisation of the labour market, so ensuring that Spain's economic growth remains rich in job creation.

2. – The Spanish economy

The keynote of the Spanish economy's performance in the last two years has been the upkeep of vigorous growth rich in employment. In 1999, the **real growth** of the Spanish economy was 4%, a rate which is likely to repeat in 2000. This strong expansion again secured Spain a significant growth differential, of around 1 percentage point, with respect to euro zone partners, thereby furthering the cause of real convergence with the core EMU economies.



The 1999-2000 period also marked a shift in the composition of output growth. While expansion in the first year was largely driven by domestic demand, countering the drain effect of the external sector, the pattern emerging in 2000 was of a more balanced mix by source component, with domestic demand slowing gently and a less negative contribution from the net export side.

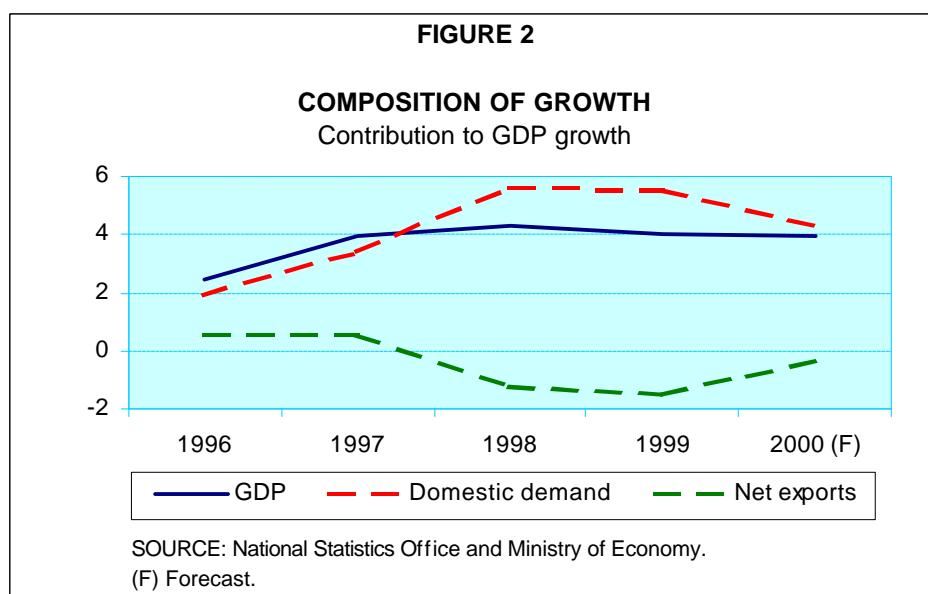
Domestic demand grew 5.5% in 1999, supported by the dynamism of its two components, consumption and investment. This vigour, however, began to appreciably slacken in 2000 bringing the growth sources of the Spanish economy into closer alignment.

Growth of **final consumption expenditure** in 1999 was primarily drawn from household consumption, which conserved the brisk pace recorded over 1998. One contributory factor was the lowering of personal income tax withholdings introduced by the new reform, which served to raise families' disposable income. This circumstance, plus the year's sturdy job creation and consistently high levels of consumer confidence explain the acceleration of household consumption.

Conversely, the year 2000 brought a moderation of private consumption growth attributable in part to agents' progressive internalisation of income tax cuts. Other factors at work were rising interest rates, the impact

of oil price escalation, a more subdued pace of job creation and the length of the expansion phase itself, which had left most families well stocked with consumer durables. Meantime **government consumption** growth rates dropped back significantly in 1999 and 2000 in keeping with the fiscal consolidation drive.

The second major component of domestic demand, **gross fixed capital formation**, has been showing some loss of momentum in the past two years, albeit with a divergent conduct by component sources. Specifically, growth of construction investment quickened in 1999, possibly as the sector moved to make up the investment shortfalls of the early nineties. But the remarkable expansion recorded in 1998 and 1999 began to taper off in the year 2000, due probably to higher interest rates and the large investment effort of the past few years. Equipment investment, meantime, registered slower growth in both years. Explanations, in this case, would likely be the strong run-up of the previous years, the effects of the interest rate upturn and the cooler expectations ushered in by rising oil prices.



The receding GDP contribution of domestic demand was fully offset by the lesser drain effect of **net exports**. The crisis in emerging markets, which reached its heights in summer of 1998, and its damper effect on the growth of Spain's main trading partners, provoked lower rates of increase in Spanish exports over second-half 1998 and, principally, in 1999. The result was a 1999 GDP growth contribution from the net exports side of -1.5% .

Export growth began to quicken once more as of end-1999, helped along by an improved international environment, the recovery of Europe's main economies facilitated by euro depreciation, and a parallel revival of international trade. This better export performance, allied with more moderate growth in imports, should allow net exports to close the year with a negative GDP contribution of approximately 0.4 points, that is, just over one point less than in 1999.

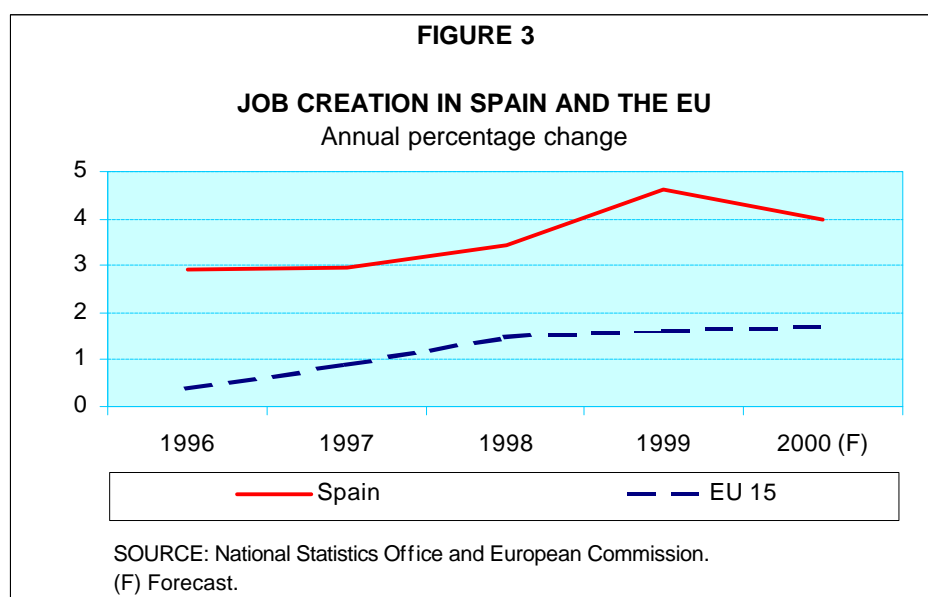
Inflation conduct since end-1998 evidences both the effects of real convergence and a series of exogenous factors like oil prices, euro weakness and the worsening behaviour of fresh food prices. However, Spain's inflation differential with the EMU average has held at around one percentage point.

The Spanish economy's advance in real convergence with Europe's central economies implies a simultaneous catch-up in prices. This process, fruit of the growing integration of European markets, could well be giving rise to an inflation differential while absolute prices progressively align.

Oil prices, meantime, soared from under US\$ 10/barrel in December 1998, in the wake of the international crisis, to upwards of US\$ 30/barrel in the closing months of 2000. Over the same period, euro exchange rates vs. the dollar dropped from €1.2 to €0.85. These two factors conspired to lift crude prices, in euro terms, almost four times higher in under two years.

The **wages** moderation of 1998 was conserved throughout 1999, as evidenced by both the rises pacted in collective wage agreements and the increase in total payments per employee. The year 2000, however, brought a break in this positive trend.

Employment growth continued robust. Over a million people found work in the two-year period, lowering the unemployment rate to 13.7% in the third quarter 2000. Spain thus maintains a sizeable job-creation lead over remaining EU countries. However, the upkeep of this labour-market dynamism will require a renewed commitment to wage moderation, so the conjunctural impact of the oil price rise does not translate into structural inflation through the medium of collective bargaining and wage settlements.



Finally, the **balance of payments** closed 1999 with a net borrowing requirement vs. the rest of the world amounting to 1.1% of GDP. This percentage will very likely enlarge to 2.3% in 2000, due principally to a widening current account deficit ascribable, in 80% at least, to the oil price spike.

3. – Budgetary performance

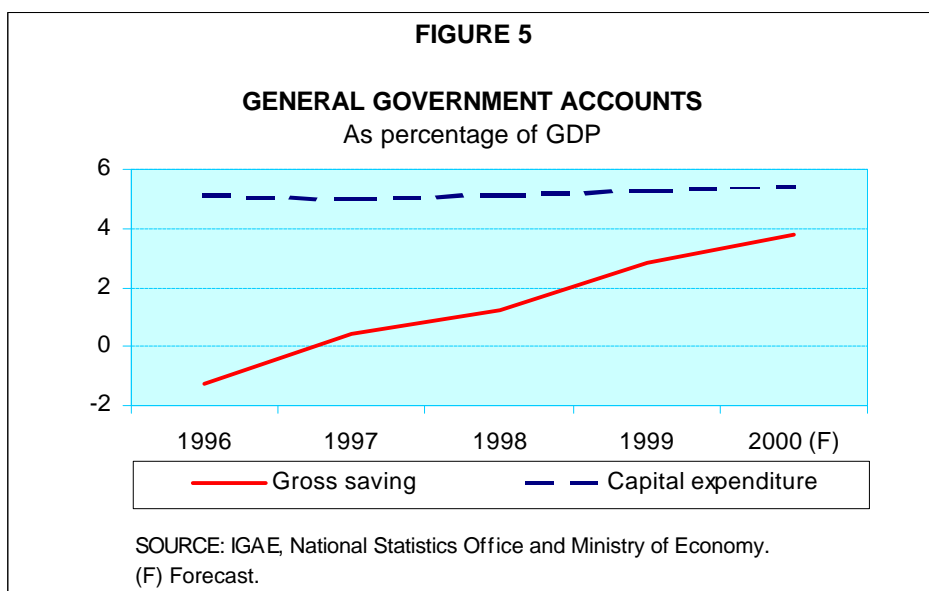
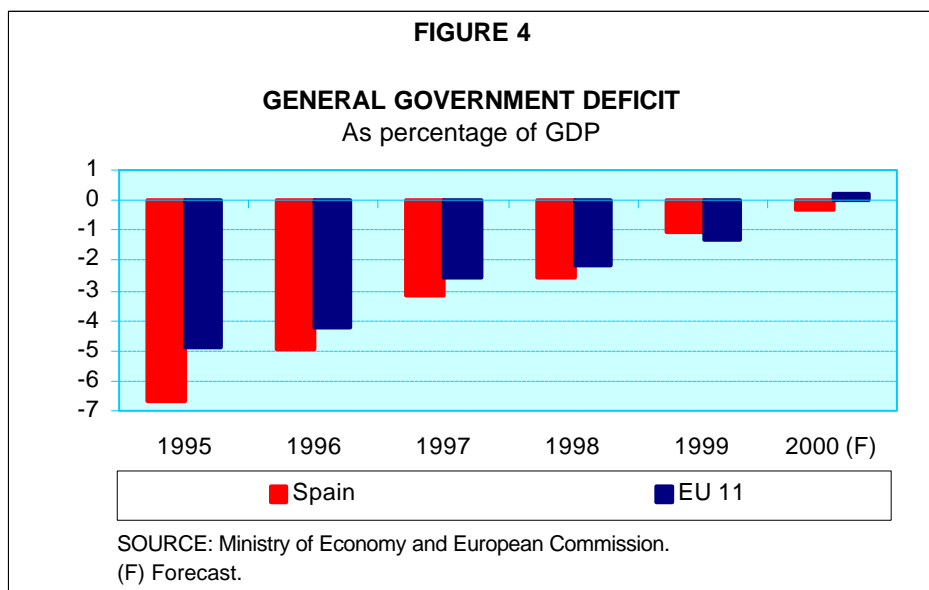
Prolongation of fiscal retrenchment over 1999 and 2000 has paved the way for elimination of Spain's **public deficit** in 2001, and ushered in a new era of balanced budgets.

- The subdued growth of government expenditure reduced its GDP weight by 1.4 points from 42.1% to 40.7% between 1998 and 2000. Current spending heads bore the brunt of the adjustment, primarily through redoubled efforts to contain general government final consumption expenditure. Public investment stayed high in keeping with the Government's commitment to real convergence with the core EMU economies, which demands greater investment in physical, human and technological capital.
- Government revenues held in the region of 40% of GDP in a framework of income tax reform. Revenues growth was primarily drawn from the tax reform itself, which has eliminated distortions weighing on the supply side of the economy, the good economic setting, which has boosted activity and job creation and, finally, the additional tax receipts unlocked by tighter collection management.
- The result of fiscal consolidation endeavours was a two-year reduction of 2.3 points in the general government deficit, from 2.6% of GDP in 1998 to 0.3% in 2000.

The steady reduction in general government borrowing requirements ensured that **public debt/GDP** held to the downtrend initiated in 1996, as far as an estimated 61.1% at the 2000 close.

TABLE 1 PUBLIC DEFICIT TARGETS (as % of GDP)		
	1999	2000
Stability Programme 1998 – 2002	-1.6	-1.0
Stability Programme 1999 – 2003	-1.3	-0.8
Stability Programme 2000 – 2004	-1.1	-0.3
Budgetary implementation (1)	-1.1	-0.3
(1) Provisional (1999) and forecast (2000).		
SOURCE: National Statistics Office and Ministry of Economy.		

Improvement in the budget balance throughout these last two years is due to a number of factors combined: a fiscal policy prizing budgetary equilibrium, as reflected in successive Stability Programmes, and the higher revenues secured from economic growth and stricter budgetary implementation.



III. ECONOMIC POLICY AND SHORT- AND MEDIUM-TERM FORECASTS 2001-2004

1. – Economic policy guidelines

The Government's principal economic objective is to maintain rapid progress in real convergence with euro-zone central economies. This goal will be pursued through the same economic policy mix as in previous years, namely a fiscal policy geared to the consolidation of public finances and an ambitious programme of structural reforms.

In the **fiscal policy** sphere, the zero deficit of 2001 will herald a new era in which balanced budgets become a permanent feature of Spanish public finances.

Once the deficit has been eliminated, and Spanish society is fully convinced how important it is to keep public accounts in balance, the focus of the fiscal policy will also be to conserve sufficient room for manoeuvre to ensure Stability and Growth Pact commitments are consistently complied with, to improve the quality of public finances and to assure the sustainability of social protection systems. Fiscal policy can exert a strong supply-side influence in both the short and medium term: in the short run by rationalising and improving the tax system and, further ahead, through action to enlarge and improve the physical and human capital of the Spanish economy.

This new agenda will echo the central commitment acquired under the Stability and Growth Pact: attainment of a healthy financial position that allows business cycle downturns to be successfully addressed without recourse to excessive deficits. It will also provide the leeway for a reform of direct taxation which reduces the tax burden, in order to promote tax equality and favour saving, investment and the supply of labour.

The future framework of budgetary balance will have its main reference in a new Law of Budgetary Stability (see Annexe I).

This law will apply equally to central government, the social security system, territorial governments and the dependent corporations. At its core is a balanced budget requirement, such that each administration is obliged to close its annual books in surplus or, at least, in balance. In the event of a deficit, the authority in question must explain the reasons and present a medium-term programme for restoring budgetary equilibrium. Likewise, publicly-owned corporations reporting losses must submit a detailed recovery plan.

Its aim, in essence, is that all layers of government should, under normal circumstances, close their annual budgets in balance or surplus. This obligation will ensure that public managers do not commit additional expenditures without first examining their medium-and long-term effects on budgetary sustainability. The Law, as such, is a mechanism to ensure that

growth of public spending does not overstep the limits imposed by revenue projections.

This strict fiscal framework will allow Spain to successfully address the issue of population ageing and guarantee budgetary sustainability in the medium- and long-term future.

Structural reform policies will persevere in the line mapped out over recent years. The priority will be to build up the flexibility and responsiveness of the Spanish economy in a changing international context as a means to further enhance its potential growth, thus guaranteeing higher sustainable growth rates. This will demand deeper liberalisation of product and factor markets and a continuing accent on competition policy as a guarantor of the free play of market forces in liberalised sectors.

Labour market modernisation measures, framed by social dialogue, will set out to raise the economy's activity rate and develop a more efficient market. The first objective will be to establish a collective bargaining system which promotes wage settlements in line with productivity. Part-time working will be encouraged to align its weight in total work contracts with the European average and action taken to reduce Spain's high rate of temporary employment. Finally, additional support measures will be targeted on less advantaged collectives like women, the elderly and the lower skilled.

2. – Macroeconomic forecasts (baseline scenario)

The **international economic context** envisioned in this Stability Programme Update matches up with the projections issued by main world economic organisations. Keynote assumptions, then, are a deceleration in world trade over 2001, after last year's expansion, and slower growth rates in main OECD economies. The international landscape will, in any case, be strongly influenced by the performance of these economies and oil price evolution.

Forecasts for the euro area point to a mild growth slowdown in 2001 and some easing of inflation as the year progresses, thanks to a more benign conduct of oil prices and the effects of monetary policy. It is also considered likely that the area's main economies will consolidate growth rates from 2002 onwards.

Growth of the **Spanish economy** is expected to cool from 4% in 2000 to 3.6% in 2001, and an average 3.2% approximately over 2002-2004. In any case, the rates projected are not far off the potential growth of the Spanish economy and, as such, should not give rise to macroeconomic imbalances.

Domestic demand growth will continue to recede to 3.9% in 2001 and an annual 3.3% over 2002-2004. The cause, in this case, will be a downturn in **household consumption**, in response to less vigorous job creation and a foreseeable increase in savings levels. **Government consumption** will expand at rates lower than GDP, in tune with the continuing consolidation of public finances.

Gross fixed capital formation will rein back slightly due to less buoyant consumption, the slowdown in world economic growth and the less expansive tone of exports. Investment, nonetheless, will remain the most dynamic domestic demand variable, supported by corporate earnings strength, interest rates near historical lows, the progressive fold-in of technological advances and progress in real convergence with the EMU's central economies.

The growth contribution of **net exports** will hinge largely on developments in world trade. International organisations are currently projecting a downturn in the next two years, as industrial countries' growth rates diminish. It seems likely, then, that Spanish exports will turn in a more moderate advance. That said, the outlook is for a less negative contribution from the net exports side, as imports too expand more slowly in response to lower-key domestic consumption.

Employment creation will remain intense despite the projected growth slowdown. Some mild deceleration is to be expected, however, due to the higher productivity that will presumably ensue from the strong investment cycle of recent years. Also, current activity rates and recent labour force data suggest yet more people will be entering the labour market in the next few

years. Unemployment rates, nonetheless, should continue receding steadily to around 9.5% in 2004.

Table 2				
MACROECONOMIC SCENARIO 1999 - 2004				
(Annual average percentage change at constant 1995 prices)				
	1999 (P)	2000 (F)	2001 (F)	Average 2002-04 (F)
GDP AND DEMAND AGGREGATES				
Final consumption expenditure	4.3	3.4	2.9	2.6
- households (a)	4.7	4.0	3.4	2.8
- general government	2.9	1.2	1.2	1.8
Gross capital formation	9.5	6.8	6.9	5.2
-Gross fixed capital formation	8.9	7.0	7.0	5.3
-Equipment and other products	8.7	5.5	8.0	6.2
-Construction	9.0	7.9	6.5	4.8
Domestic demand	5.5	4.2	3.9	3.3
Exports of goods and services	6.6	9.9	8.8	8.4
Imports of goods and services	11.9	10.5	9.5	8.1
Net exports (contrib. to GDP growth)	-1.5	-0.4	-0.4	-0.1
GDP	4.0	4.0	3.6	3.2
PRICES AND COSTS				
GDP deflator	2.9	2.8	2.3	2.5
Private consumption deflator	2.5	3.2	2.7	2.0
LABOUR MARKET (b)				
Employment: % change	3.6	3.0	2.5	2.1
change in thsds (c)	507.9	438.9	382.8	978.0
OTHER VARIABLES				
Net lending (+) or borrowing (-) vs. rest of world (d)	-1.1	-2.3	-2.7	-2.8
Unemployment (e)	15.9	14.2	12.7	9.5
(a) Includes Non-profit institutions serving households.				
(b) Full-time equivalent jobs.				
(c) The average job creation stated for 2002-2004 is the employment created during the period.				
(d) As % of GDP.				
(e) As % of the labour force (LFS). The average rate stated for 2002-2004 is that of the year 2004.				
(P) Provisional (F) Forecast.				
SOURCE: National Statistics Office and Ministry of Economy.				

Labour market modernisation is of vital importance to ensure lasting, employment-intensive growth. The primary requirement is a change in collective bargaining procedures, such that wage settlements take account of productivity factors and unit labour costs hold to appropriate levels.

Finally, **inflation** is expected to ease steadily to around 2%, in line with the price-stability definition of the European Central Bank. More settled energy prices, lesser demand pressures and euro appreciation will help keep inflationary tensions at bay.

3. Budgetary projections

The economic policy measures outlined will deliver full budgetary consolidation over the next few years, and take public accounts into surplus from 2002 onwards. Further progress will be made in reducing the public debt/GDP ratio, which is expected to drop below the 60% threshold as of the year 2001.

Government revenues will increase by an annual average 5.8% between 2001 and 2004, and should reduce their GDP weight by a small margin from 2002 onwards. These revenue growth projections imply that further tax reforms can safely go through without jeopardising the budgetary objectives presented.

Table 3							
GENERAL GOVERNMENT ACCOUNTS							
(National Accounts basis, ESA-95: annual percentage change)							
	1999 (P)	2000 (F)	2001 (F)	2002 (F)	2003 (F)	2004 (F)	Average 02-04 (F)
Total revenues	8.2	7.9	6.4	6.1	5.1	5.5	5.6
Total expenditures	4.4	6.0	5.5	5.6	4.9	5.4	5.3
- current expenditures	3.6	5.6	5.0	5.3	4.6	5.1	5.0
- capital expenditures	10.1	8.3	8.6	7.9	6.8	7.5	7.4
Gross fixed capital formation	7.7	9.3	10.0	9.0	7.5	8.5	8.3

(P) Provisional (F) Forecast
SOURCE: IGAE and Ministry of Economy.

Fiscal retrenchment, as in past years, will fall heaviest on **expenditures**, which should thus scale down further as a percentage of GDP. This trend will be encouraged by the aforementioned Law of Budgetary Stability (see Annexe I) which lays down a strict framework for the returning of surplus or, at least, balanced budgets. Spending moderation will target current expenditure items particularly, given the Government's commitment to public investment.

- Current expenditures in terms of GDP will drop around one percentage point, though spending on social benefit programmes will conserve a GDP weight upwards of 11.5%.

Interest payments will move higher for the first time since 1996, in response to the uptrend in rates from end-1998 onwards. Three factors, however, suggest the increase will be fairly moderate: a) current market expectations on interest rates; b) the advent of budget surpluses; and c) the average duration of Spain's public debt which has recently lengthened to more than five years.

- Public sector gross fixed capital formation will expand over 8% a year, on average, in the four-year period, in furtherance of the Spanish economy's real convergence with main EMU economies.

TABLE 4						
GENERAL GOVERNMENT ACCOUNTS						
(National Accounts basis, ESA-95, as percentage of GDP)						
	1999 (P)	2000 (F)	2001 (F)	2002 (F)	2003 (F)	2004 (F)
Total revenues	40.0	40.4	40.6	40.6	40.4	40.3
Total expenditures	41.1	40.7	40.6	40.4	40.1	40.0
- current expenditures	35.8	35.4	35.1	34.8	34.4	34.2
- financial charges	3.6	3.3	3.3	3.2	3.2	3.2
- capital expenditures	5.3	5.4	5.5	5.6	5.7	5.7
- gross fixed capital formation	3.4	3.4	3.6	3.7	3.7	3.8
General govt. deficit (-) or surplus (+)	-1.1	-0.3	0.0	0.2	0.3	0.3
Central government	-0.9	-0.2	0.0	0.2	0.3	0.3
a) State and Autonomous Agencies	-1.1	-0.7	-0.3	-0.1	0.0	0.0
b) Social Security	0.2	0.5	0.3	0.3	0.3	0.3
Territorial governments	-0.2	-0.1	0.0	0.0	0.0	0.0
Gross debt (a)	63.3	61.1	58.9	56.6	52.8	49.6
Primary surplus	2.5	3.0	3.3	3.4	3.5	3.5
Gross saving	2.9	3.8	4.3	4.6	4.8	5.0
(P) Provisional (F) Forecast.						
SOURCE: IGAE, National Statistics Office and Ministry of Economy.						

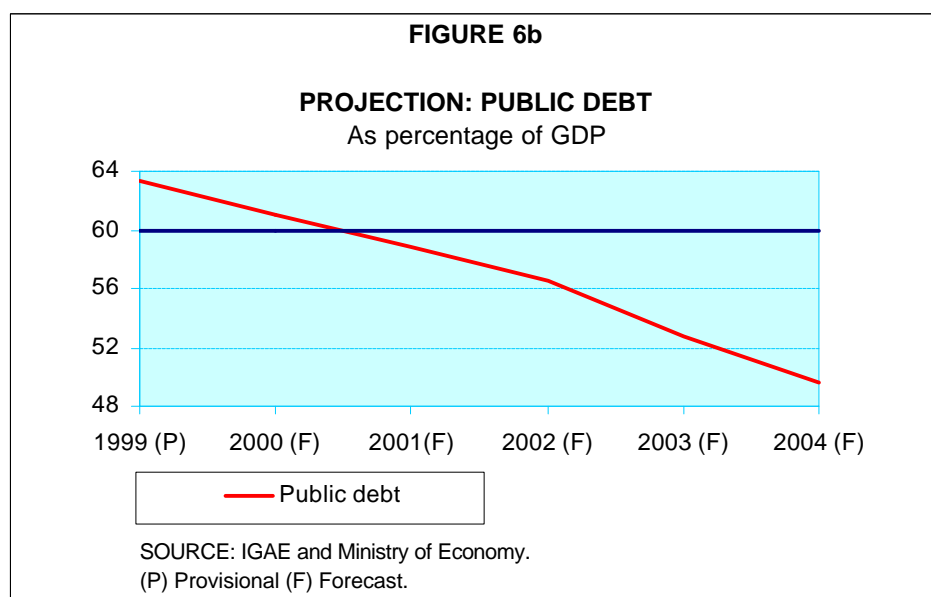
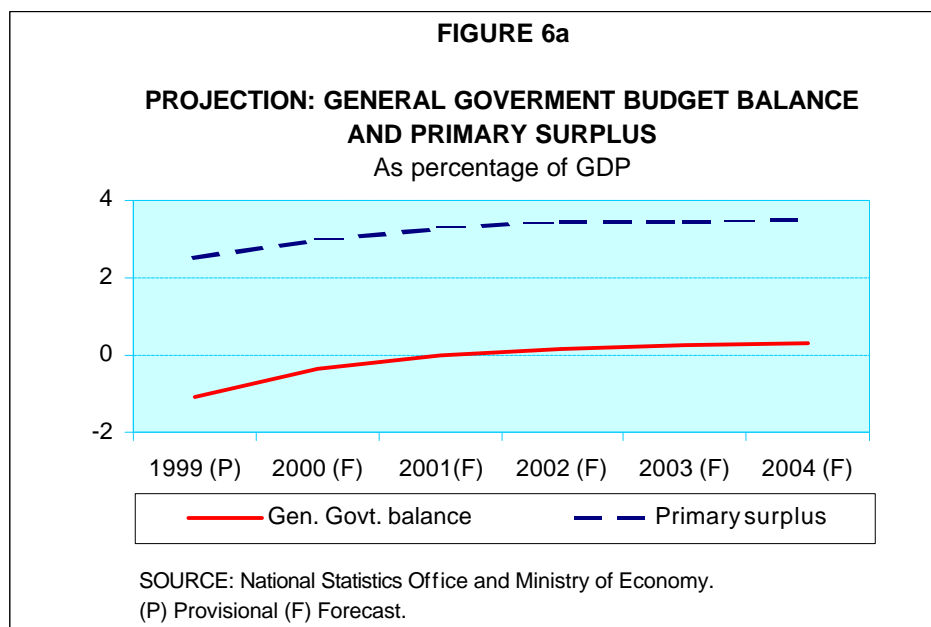
This ambitious budgetary policy will raise the GDP weight of gross saving by over one percentage point between 2000 and 2004, providing ample leeway for the financing of the Government's large-scale investment programme. Other outcomes projected are a five decimal point increase in the primary surplus in terms of GDP, a reduction in the cyclically adjusted deficit and enlargement of the primary structural balance.

The fiscal policy envisioned lays the groundwork for long-term budgetary sustainability by allowing further allocation to the Reserve Fund established for future pension commitments. Likewise, the latest round of Toledo Pact negotiations, to conclude in 2001, will facilitate new measures in support of long-term public pensions provision. Initiatives in the state sphere will be supplemented by new incentives to private pension schemes.

The Law of Budgetary Stability should also influence the amount of public debt outstanding via the mandate on central government to apply budget surpluses to redemption programmes. In the case of the social security system, job creation and the outcome of Toledo Pact negotiations portend the upkeep of surplus balances which, under the law, must primarily be assigned to the Reserve Fund. Finally, autonomous communities will return balanced budgets from 2001 onwards.

On these assumptions, the budget will reach equilibrium in 2001, and record surplus balances in successive years as far as 0.3% of GDP in 2004. The surpluses of the 2002-2004 period will permit a sizeable reduction in public debt/GDP from 58.9% in 2001 to 49.6% in 2004.

Reduction of the public debt/GDP ratio provides two important benefits, as an exercise in solidarity in favour of future generations and a means to buffer the budgetary impact of any future rise in interest rates.



IV. SENSITIVITY ANALYSES

1. – Alternative growth scenario

Fiscal consolidation and public debt/GDP reduction targets stand up reasonably well to modifications in the macroeconomic assumptions stated. In order to verify this affirmation, an analysis has been conducted on the macroeconomic and fiscal performance of the Spanish economy in a GDP growth scenario of 3.1% in 2001 and an average 2.7% in the three-year period 2002-2004.

The moderate growth scenario posits a slowdown in all domestic demand components and an international context in which world trade expands at a lower rate vs. the baseline scenario. In this framework, the relative contraction of domestic demand would allow for a slight improvement in the GDP contribution of net exports. Inflation rates and employment growth would also be more moderate than in the baseline scenario. The unemployment rate, however, would decrease to around 10%.

TABLE 5				
SENSITIVITY ANALYSIS: MACROECONOMIC VARIABLES				
(Annual % change unless otherwise indicated)				
	1999 (P)	2000 (F)	2001 (F)	Average 02-04 (F)
BASELINE GROWTH SCENARIO				
GDP	4.0	4.0	3.6	3.2
GDP deflator	2.9	2.8	2.3	2.5
Employment (a)	3.6	3.0	2.5	2.1
Unemployment rate (b)	15.9	14.2	12.7	9.5
Net lending (+) or borrowing (-) vs. rest of world (c)	-1.1	-2.3	-2.7	-2.8
LOWER GROWTH SCENARIO				
GDP	4.0	4.0	3.1	2.7
GDP deflator	2.9	2.8	2.3	2.2
Employment (a)	3.6	3.0	2.0	1.6
Unemployment rate (b)	15.9	14.2	12.9	10.3
Net lending (+) or borrowing (-) vs. rest of world (c)	-1.1	-2.3	-2.6	-2.6
(a) Full-time equivalent jobs.				
(b) As % of the labour force. The average rate stated for 2002-2004 is that of the year 2004.				
(c) As % of GDP.				
(P) Provisional (F) Forecast.				
SOURCE: National Statistics Office and Ministry of Economy.				

The commitment to budgetary stability would still deliver a balanced budget in 2001, even assuming a growth rate in the year five decimal points lower than in our baseline scenario, and this equilibrium would extend to the rest of the study period. As in the baseline scenario, improvement in the public accounts balance would spring from the declining GDP weight of government expenditures. Current expenditures would decline most steeply,

while government gross fixed capital formation would up its relative weight across the projection period.

TABLE 6						
SENSITIVITY ANALYSIS: GENERAL GOVERNMENT ACCOUNTS						
(National Accounts Basis, ESA-95; as % of GDP)						
	1999 (P)	2000 (F)	2001 (F)	2002 (F)	2003 (F)	2004 (F)
BASELINE GROWTH SCENARIO						
Gen. govt. def. (-) or surpl. (+)	-1.1	-0.3	0.0	0.2	0.3	0.3
Gross debt	63.3	61.1	58.9	56.6	52.8	49.6
LOWER GROWTH SCENARIO						
Gen. govt. def. (-) or surpl. (+)	-1.1	-0.3	0.0	0.0	0.0	0.0
Gross debt	63.3	61.1	59.2	57.4	54.3	51.8
(P) Provisional (F) Forecast.						
SOURCE: National Statistics Office and Ministry of Economy.						

Under these premises, gross government saving would continue to augment, providing ample financing leeway for the heavy public investments scheduled. This greater saving would exert a positive impact on the Spanish economy's borrowing requirements vs. the rest of the world. Finally, lower growth would not bar the way to a public debt/GDP ratio below 60% in 2001.

2. – Interest rate sensitivity analysis

Two alternative scenarios have been modelled to gauge the sensitivity of budgetary objectives to variations in interest rates. Both these scenarios assume a parallel shift in the interest rate curve over 2001-2004, which would rise or fall by one percentage point with respect to the rate variables factored in the baseline scenario.

The table below tracks the performance of general government budget balances and public debt in the higher, baseline, and lower rates scenarios. It shows that even in the event of a substantial interest rate rise across all curve segments, a balanced budget would still be secured in 2001 alongside a reduction in the public debt ratio to below the 60% threshold. Budget surpluses would be returned across the remainder of the reference period and the weight of public debt would continue to fall.

TABLE 7						
SENSITIVITY ANALYSIS: INTEREST RATES						
(National Accounts basis, ESA-95: as % of GDP)						
	1999 (P)	2000 (F)	2001 (F)	2002 (F)	2003 (F)	2004 (F)
HIGHER RATE SCENARIO						
Gen. govt. def. (-) or surpl. (+)	-1.1	-0.3	0.0	0.1	0.1	0.1
Gross debt	63.3	61.1	58.9	56.6	53.0	49.9
BASELINE SCENARIO						
Gen. govt. def. (-) or surpl. (+)	-1.1	-0.3	0.0	0.2	0.3	0.3
Gross debt	63.3	61.1	58.9	56.6	52.8	49.6
LOWER RATE SCENARIO						
Gen. govt. def. (-) or surpl. (+)	-1.1	-0.3	0.1	0.3	0.4	0.5
Gross debt	63.3	61.1	58.8	56.4	52.7	49.5
(P) Provisional. (F) Forecast.						
SOURCE: IGAE, National Statistics Office and Ministry of Economy.						

V. CONCLUSIONS

This Stability Programme Update sets out a prudent macroeconomic scenario, in which medium-term growth projections take as reference the potential growth of the Spanish economy as deduced from recent-year performance.

Budgetary objectives stand centre-stage in this scenario, and fiscal policy accordingly retains its primacy in economic policy design, mainly through:

- Approval of a Law of Budgetary Stability disseminating a culture of balanced public finances across all layers of government.
- Allocation of social security surpluses to a Reserve Fund, targeted to close the projection period at over 1% of GDP.
- A continuing accent on public investment, which will move up steadily as a proportion of GDP.
- The achievement of sufficient leeway for a new reform of direct taxation in 2002, with visible effects in 2003 and 2004, providing a cumulative reduction in tax pressure of three decimal points.
- Reduction of the structural deficit and public debt/GDP to ensure fiscal policy is working within the margins set in the Stability and Growth Pact and can address future challenges like the ageing population.
- Reduction of the GDP weight of government current expenditures, while social policies are maintained.

In short, fiscal policymaking weds the objective of budgetary stability with the upkeep of high social coverage and a major infrastructure investment programme, while providing room to enact a new reform of direct taxation. The aim, ultimately, is to create a framework of budgetary stability which can ease the burden on future generations.

These fiscal commitments will go hand in hand with deeper progress in structural reforms. Liberalisation of goods and services markets will remain an outright priority through measures to strengthen competition in a wide range of sectors, particularly key industries like energy and telecommunications. In capital markets, the primary goal is to develop markets and instruments able to leverage the progress of the SME sector and the knowledge-based society.

Labour market reform, framed by social dialogue, is essential for the Spanish economy. Efforts will be redoubled to improve training provision and

employability, with particular attention to the most disadvantaged groups, and to institute a collective bargaining structure in which wage settlements take due account of developments in productivity. Other measures will target an increase in part-time working and a reduction of the temporary employment rate.

In conclusion, economic policy design pursues the prolongation of Spain's expansion phase, advance in real convergence with the EMU's central economies and an increase in the welfare standards of Spanish society.

ANNEXE I: LAW OF BUDGETARY STABILITY

One of the mainstays of the Stability Programme Update 2000-2004 is the upkeep of fiscal discipline leading to a balanced budget in 2001, and the consolidation of account surpluses in the mid-term future across all branches of general government.

The main guarantor of this budgetary discipline will be the Law of Budgetary Stability shortly to come before Parliament, whose provisions will lay the framework for a new era of budgetary stability in Spain.

Fiscal consolidation and liberalisation have already ushered in a new model of stable, employment-generative growth which served to gain Spain its place as a founding member of Economic and Monetary Union.

But budgetary stability is, if anything, more crucial than ever in the EMU framework. Since 1 January 1999, monetary policy has been dictated by the stability and growth conditions of the euro area in general, and the ECB can make no allowance for the needs or peculiarities of any specific region.

Spain's economic and monetary integration within the euro area thus puts more responsibility on other economic policy components, basically budgetary and structural policies, which must assure the compatibility of macroeconomic equilibrium with single monetary policy.

Within a monetary union, the loss of exchange-rate and monetary policy as macroeconomic stabilisers brings fiscal policy strongly to the fore, particularly when price and wage flexibility and labour mobility lack sufficient force as adjustment mechanisms. Fiscal policy, in this setting, becomes the short-term instrument of choice to combat cyclical dislocations or asymmetric demand shocks. The discretionary use of budgetary policy as a stabilising mechanism is therefore extremely tempting for governments, despite the inefficiencies this might generate for remaining union partners.

The interdependence attendant on the EMU project calls for some type of fiscal policy co-ordination. This, precisely, is the rationale for the fiscal rules set out in the Stability and Growth Pact, without which the independence of monetary policymaking would not suffice to ensure the credibility of price stability objectives.

The Law of Budgetary Stability, a pioneering initiative in the euro area, will give legal force and thereby credibility to the budgetary discipline inherent to single currency membership.

Spain is a strongly decentralised country, and the Law addresses this circumstance by requiring that all layers of government share responsibility for the achievement of budgetary stability; a key means to prolong the new model of stable, employment-generative economic growth.

The Law of Budgetary Stability will accordingly extend to all branches of government: central and territorial governments, social security, and all dependent public corporations, enterprises and agencies.

Its application, however, will differ depending on the nature and legal regime of each, and the extent of their autonomous powers.

The financial independence of regional governments, underwritten by the Spanish Constitution, requires that the future Law may only establish a basic balanced budget undertaking, common to all layers of government. It is then left to each authority to adopt the corresponding organisational and regulatory measures. Likewise, each authority is free to decide whether the objective will be met through higher revenues or lower spending. The Fiscal and Financial Policy Council retains responsibility for budgetary co-ordination and surveillance mechanisms at nationwide level.

The stability objective is also defined differently for general government and for other entities within the scope of the Law. For general government, the principle of budgetary stability entails the drawing up and return of budgetary surpluses or, at least, a balanced budget, with borrowing requirements stated as stipulated by the European System of National and Regional Accounts. In the case of public corporations, enterprises and agencies, the stability objective is understood as their contribution to the budgetary equilibrium of the responsible authority, by means of efficient management geared to the generation of profits consistent with their corporate purpose.

The balanced budget principle is therefore more strictly defined than in the Stability and Growth Pact. Though deficit situations are envisaged, these will inevitably be of an exceptional nature, and must in all cases be duly justified and addressed by a mid-term remedial action plan.

The balanced budget principle is joined by three more principles: multi-annual modelling, transparency, and the efficient allocation and use of public funds.

From now on, in the first four months of each year, the Government will set global budgetary stability objectives on a three-year horizon, which will be forwarded to Parliament for their debate and approval. Thereafter, all government authorities will draw up their budgets.

At central government level, the Law introduces two novelties in budgetary procedures. First, an annual expenditure ceiling will be set in line with the multi-year scenarios previously drawn up. Secondly, a “Budgetary Implementation Contingency Fund” will be established to address any non discretionary needs in a given year, which were unaccounted for in the initial budget. This measure is designed to tighten fiscal policy discipline by precluding spending updrift due to the approval of credit modifications.

In the case of the regional governments, rules to guarantee budgetary stability wed the state's duty to ensure internal and external economic equilibrium with their financial autonomy under Spanish law. As such, it will be the regional governments themselves which implement the legal and administrative measures required.

The Fiscal and Financial Policy Council will play a key role in co-ordinating the budgetary policy of central and regional governments at the service of the balanced budget principle, and will specify the stability objectives to be met by each.

In the local authority sphere, the National Commission of Local Authorities, a standing commission channelling co-operation between central and local governments, will disseminate the budgetary stability objectives set by the Ministry of Finance.

In conclusion, the Law of Budgetary Stability will unite all layers of government in a commitment to expenditure discipline, the creation of efficient, modern budgetary institutions and the creation of institutions with powers of budgetary stability and control to ensure the decisions of subnational authorities are consistent with the global commitments acquired in the EMU context.

ANNEXE II: STRUCTURAL REFORMS

Structural reforms are seen as a key means for Spain to prolong the stable, employment-rich growth of past years in furtherance of its real convergence with central EMU economies.

Their worth is underscored in the conclusions of the Lisbon Summit, which state that structural reforms are pivotal to the development of the knowledge society and thereby to economies' competitiveness at a time of globalisation and rapid technological change.

Finally, Spain's participation in the euro configures structural reforms as one of the main instruments of economic policy. Exchange rates can no longer be used to correct competitiveness deficits vs. main trading partners, while monetary policy design attends to the overall conditions prevailing in the euro zone.

For these reasons, the Spanish Government has accorded a special relevance to structural reforms and has launched a global strategy taking in both structural elements in public finances (see Annexe I) and the improved functioning of product and factor markets. The main reform policies in this last sphere are summarised in the present annexe.

I. GOODS AND SERVICES MARKETS

Structural reforms in goods and services markets have focused on competition policy mechanisms and network industries.

Network industries are particularly important as providers, in many cases, of crucial inputs for the productive process, the case of the energy sector for instance, or as key development drivers for the knowledge-based society, like the telecommunications industry.

Measures deployed target greater competition in these sectors, primarily through improvements in market structure. One part of this focus has been the imposing of a wider separation between network infrastructure owners and operators or suppliers, and improvement in network access conditions. Another, the placing of certain constraints on the expansion of dominant operators. Finally, industry competition has been enhanced by guaranteeing better information to consumers and broadening their access to supplier choice.

Further initiatives were geared to the better functioning of a wide range of sectors, the introduction of a tax framework favourable to the SME sector and the development of the knowledge society.

Telecommunications

In fixed telephony, 1 January 2001 has been set as the deadline date for the opening up of the local loop, while the dominant operator has been obliged, since 15 November 2000, to facilitate local call access through alternative operators without the need to dial a prefix. These measures build on the prior introduction of operator choice in long distance and fixed-mobile calls.

Reporting requirements have been tightened up in respect of the accounting information of dominant operators in fixed and mobile telephony, and framework regulations introduced imposing price caps on dominant operator services. Over 2001-2002, for instance, the prices of a fixed telephony services basket and fixed-mobile calls are capped at CPI-9 and CPI-8 respectively.

In mobile telephony, number portability was made extensive to all operators as of 8 October 2000, four UMTS licences were issued and the decision has just been made to grant two more GSM licences.

Electricity

Restrictions have been placed on the growth capacity of dominant operators in power generation. Any group commanding a more than 40% share of total installed power is barred from adding capacity in the next five years, dropping to three years when the utility's share is between 20% and 40%.

The largest consumers in the liberalised segment may now access transmission networks at an approximately 10% lower cost, while unrestricted access to the condition of eligible consumer has been brought forward to 2003, four years before the deadline set by the corresponding Community directive.

Natural gas

ENAGAS (owner of the basic gas natural network) has been designated technical manager of the natural gas system, and a limit of 35% set on the ENAGAS shareholdings of any given company or corporate group.

Certain constraints have been imposed on the present monopoly provider: a) from 2003 onwards, no single operator may command a market share higher than 70%; and b) exclusive rights on natural gas distribution by geographical zone will lapse three years earlier than first stipulated (in 2005). Finally, 75% of the contract on natural gas brought in from Algeria will be assigned to ENAGAS, and the remaining 25% to suppliers for its subsequent sale to eligible consumers.

Liquid hydrocarbons

A 25% ceiling has been set on individual shareholders' participation in the capital or voting rights of Compañía Logística de Hidrocarburos (CLH), owner of the oil pipeline network and storage facilities. Likewise, the maximum combined ownership interest or share in voting rights held by companies with refining capacity in Spain is set at 45%.

Competition in oil product retailing was increased by the following measures: a) authorisation of additional sales points in certain key sites, like large shopping centres; b) oil product wholesalers with a market share of over 30% by retail sales points may not enlarge their networks over a five-year period, or c) three years if their market share stands between 15% and 30%.

Finally, service station owners and wholesale operators running retail networks must furnish regular reports to the Ministry of Economy specifying the retail prices applied. This information will be posted on the ministry's website so consumers can check the best price available via wired or wireless access.

Other sectors

Competition barriers have been dismantled in a large number of sectors. The most important of these initiatives are described below:

- Extension of shop opening hours: a) the number of hours per week above which regional authorities can regulate opening times on working days is raised from 72 to 90; b) the number of Sundays and public holidays on which large retail outlets can open for trading will be phased up gradually (one day per year) from the previous 8 to a total of 12 days in 2004; and c) small and medium-size stores are granted complete freedom of opening hours and days.
- Building on the advance entailed by single nationwide membership, professional associations are prohibited from setting eligibility and economic conditions for members registered in one area who wish to practise in another.
- Competition has been introduced in technical inspection of vehicles by replacing the administrative concession requirement for market participants by a simple administrative permit. Tariffs set by the autonomous communities will now mark the maximum service price.
- Full liberalisation of the discounts retailers can apply to the prices set by educational text book publishers and importers.
- Notaries may now apply discounts of up to 10%, while fees on operations over and above a pre-set amount have been fully liberalised.

- An absolute maximum has been imposed on the margins of pharmacy outlets and pharmaceutical distributors. Discounts of up to 10% are henceforth allowed on OTC pharmaceutical specialities.
- Concession periods for regular road passenger transport lines have been shortened from 8-20 years to 6-15 years.

Competition policy

Concentration control mechanisms were tightened up, to include the precautionary suspension of operations and a parallel reduction in the time limit for resolving case files from six to four months.

The risk that cross-shareholdings in newly liberalised markets might give rise to co-ordinated competitive conducts is addressed by new regulations barring any single shareholder from sitting on more than one Board of Directors, and imposing limits on ownership interests in more than one main operator. Specifically, when a single shareholder owns over 3% of more than one operator, it may only exercise voting rights on the excess over 3% in one of its investees.

Promotion of the knowledge-based society

The Spanish Government has introduced tax incentives for scientific research and development, technological innovation and the internationalisation of the corporate sector. A new National Research Development and Innovation Plan has been approved for the 2000-2003 period under the newly created Ministry for Science and Technology.

Fiscal and administrative barriers to entrepreneurship

Administrative formalities for business have been simplified with particular regard to tax, labour and registrational requirements. Further advances were made in the “one-stop shop for business” project.

In the small-firm sector, the turnover threshold for entry to the special SME tax regime has been raised from 1.5 to 3 million euros (500 million pesetas).

Other reforms

A series of initiatives focused on enlarging supply of developable land and rationalising the use of water. The keynote measure in land was the restriction placed on local authority discretionary powers to classify land as developable or otherwise. As to water, a preliminary draft of the National Hydrological Plan has been sent to the National Water Board, which will seek the maximum consensus for the reforms proposed.

II. CAPITAL MARKETS

Initiatives in capital markets and financial services seek to spur market development and provide support to savings and the SME sector:

- To promote the equity financing of SMEs: creation of the New Market, a specific stock-market trading segment devoted to companies in the high-tech sector with strong potential for growth; greater tax incentives for venture capital activity and the creation of UCITS specialising in unlisted securities.
- Reduction from two years to one year of the period in which capital gains generated are eligible for the standard tax rate, which is also brought down from 20% to 18%.
- Finally, financial institutions are obliged to inform borrowing parties in mortgage agreements of their right to use the appraiser, administrative service bureau, notary and insurer of their choice.

III. THE LABOUR MARKET

Several initiatives have been taken in the labour market sphere. Some of these, included in the Employment Action Plan, centre on training, employability, entrepreneurship and improving the market access of disadvantaged groups. Others, currently under discussion with the social partners, set out to influence labour market performance by improving employment quality, reducing the temporary employment rate, encouraging the use of part-time contracts and perfecting collective wage bargaining mechanisms.