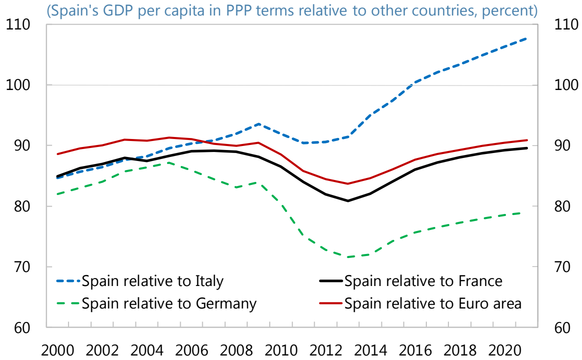
# CONTEXT

**1. The recovery is strong and imbalances are falling fast, helped by past reforms.** Real GDP and employment growth remain well above euro area averages, despite a prolonged period of domestic political uncertainty. Spain continues to reap the benefits of the major financial sector and labor market reforms taken during the crisis years, which in combination with external tailwinds and expansionary fiscal policy have buoyed activity. The Spanish economy has regained competitiveness, employment creation has been swift, and private sector balance sheets have continued to strengthen.

**2. But adjustments are not yet complete and structural problems persist.** Unemployment, particularly long-term and youth joblessness, is still painfully high, while temporary work remains wide-spread. Without a boost to the low productivity of Spanish enterprises and greater efficiency and inclusiveness of the labor market, growth is set to ease and structural unemployment risks staying exceptionally high. At the same time, elevated public debt, lingering debt overhang in parts of the private sector, and the large negative net international investment position continue to leave the economy vulnerable to shocks.

**GDP Convergence: Still a Large Gap**

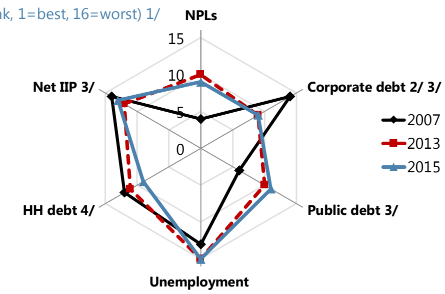
(Spain's GDP per capita in PPP terms relative to other countries, percent)




Source: IMF, *World Economic Outlook*.

**Spain's Vulnerabilities in the Euro Area Context**

(Rank, 1=best, 16=worst) 1/



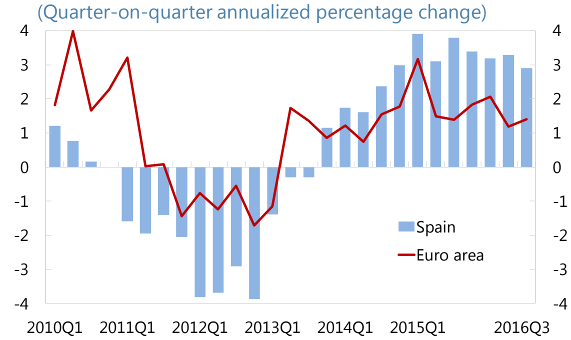

Sources: BIS; Haver Analytics; WBDI; national authorities; and IMF staff calculations.
1/ Based on the relative ranking of euro area countries excl. the Baltics.
2/ Ireland data excludes multinational enterprises debt.
3/ In percent of GDP.
4/ In percent of gross disposable income.

**3. Political fragmentation and reform fatigue have delayed fiscal adjustment and impeded deeper structural efforts.** The priorities of the new minority government, which took office with a 10-month delay, are preserving earlier reform achievements and meeting short-term fiscal commitments under the Stability and Growth Pact. However, rekindling the momentum for structural reforms and medium-term fiscal consolidation will be challenging (Appendix I), despite broad-based agreement on reform needs in areas such as regional public finances, active labor market policies (ALMP), and education and innovation policies.

# RECENT ECONOMIC DEVELOPMENTS

**4. Spain's strong rebound has continued.** Growth picked up to 3.2 percent in 2015 and stayed high in the first three quarters of 2016 at 3.3 percent year-on-year (y-o-y), though confidence indicators have continued to weaken amid lingering domestic political uncertainty (Figure 1). The rebound in private consumption, exports, and investment has remained the main driver of growth, buttressed by past structural reforms, robust growth in households' gross disposable income, lower oil prices, the depreciation of the euro, and the ECB's quantitative easing (Box 1). A relaxation of the fiscal stance has also provided stimulus to the economy. After returning to positive territory in September, headline inflation jumped to 0.7 percent in October and November (y-o-y), reflecting higher oil prices and moderate increases in food and services prices (Figure 1).

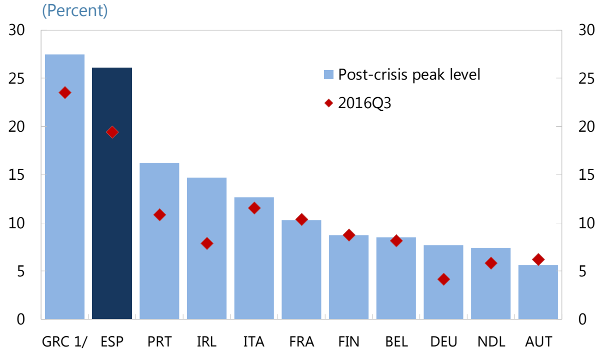
Real GDP Growth
(Quarter-on-quarter annualized percentage change)




Sources: Eurostat and INE.

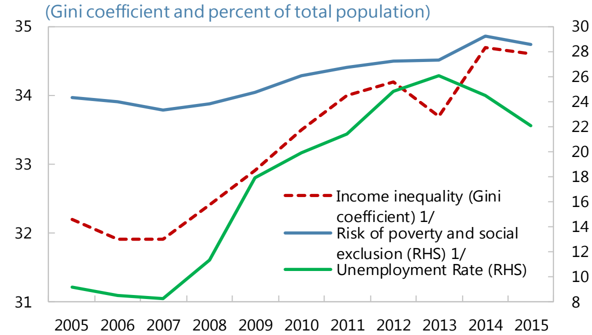
**5. Job creation has remained strong but further reducing unemployment—especially for those long out of work—is a key challenge.** Employment has been growing at more than 3 percent annually with almost 1.1 million jobs created over the past two years, supported by wage moderation and labor market reforms (see Annex I). Real unit labor costs have been growing at a modest pace (0.5 percent y-o-y in 2016: Q1–Q3). Temporary contracts still make up the largest share of new jobs (about 53 percent) even though there is some evidence that the share of permanent hires is picking up (Figure 2). Although the unemployment rate has declined by 8 percentage points from its peak three years ago, it remains very high at just under 19 percent; the rate for Spain's youth is more than double that level. Almost 50 percent of the unemployed have been jobless for over a year, a large share of them being low-skilled and previously employed in the construction sector. Prospects for this group appear particularly grim, with unemployment exit rates significantly lower than the average and higher risks of poverty and social exclusion. In contrast, exit rates for the short-term unemployed (less than a year) have improved by more than 5 percentage points since 2013. The ongoing positive labor market dynamics have been critical in starting to recoup some of the fall in living standards and reverse the rise in inequality caused by the crisis (Box 2).

Unemployment Rate in Selected EU Countries
(Percent)




Source: Eurostat.
1/ 2016Q2 value is used.

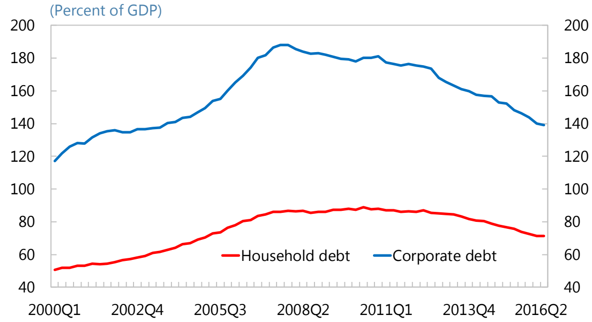
Income Inequality and Risk of Poverty and Social Exclusion
(Gini coefficient and percent of total population)




Source: Eurostat.
1/ The income reference period is the previous year.

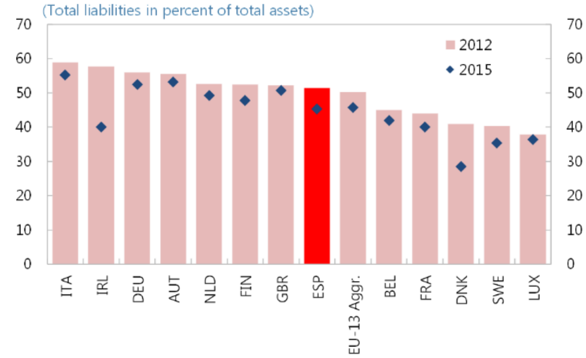
**6. The private sector has further deleveraged while access to credit has improved.** New bank lending has picked up in line with the strong economic recovery, in particular consumer credit, lending to agriculture, manufacturing, and non-real-estate services, but total credit growth is still negative (Figure 3). With private debt-to-GDP about 65 percentage points below its 2007 peak level, excess leverage is now concentrated mostly in a few corporate sectors for which the loan repayment capacity is still weak (construction and real estate) and in households (Figures 4–5). Improving profit margins since the crisis have helped the corporate sector finance new investment with retained earnings, along with more debt financing by large corporates. Households proceeded in rebuilding their net wealth positions and further reduced their bank debt. As a result, demand for loans is still weak, but credit supply—underpinned by a stronger banking system—is broadly supportive of the economic recovery, with financial conditions having eased further.

**Corporate and Household Debt, 2000-16 1/**
(Percent of GDP)




Sources: Haver Analytics; and IMF staff calculations.
1/ Based on total financial liabilities (excluding equity instruments), which include borrowings and accounts payable.

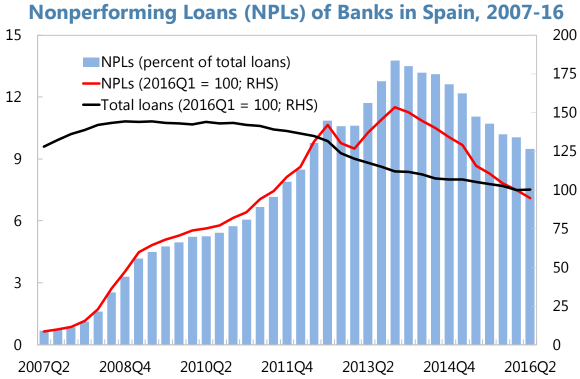
**Corporate Leverage, 2012-15**
(Total liabilities in percent of total assets)




Sources: Haver Analytics; and IMF staff calculations.

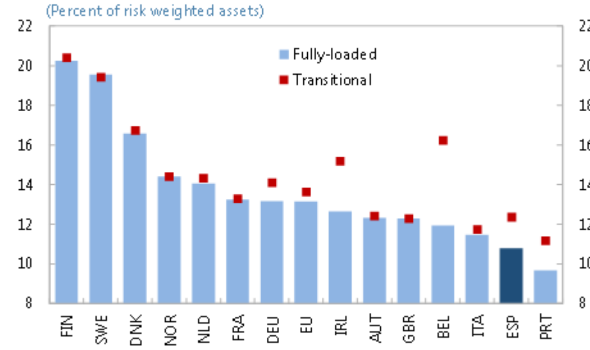
**7. Bank balance sheets strengthened further amid new challenges.** Asset quality has improved, but banks still hold sizeable nonperforming loans (NPLs), though much lower than in some EU countries. The NPL ratio stood at 9.5 percent for business in Spain at end-June 2016, which is 4.2 percentage points below its peak in 2013, despite the contraction of overall lending (Figure 6). Banks have also continued to build up capital buffers raising the regulatory capital ratio to 14.6 percent by end-June 2016. Although Spanish banks' holding of common equity tier-1 (CET1) still lags that of European peers, they are generally less leveraged than their European peers thanks to the higher risk weight intensity. Reduced profitability over the four quarters (2015:Q3–2016:Q2) indicates that the operating conditions for banks have become more challenging, amid low interest

**Nonperforming Loans (NPLs) of Banks in Spain, 2007-16**




Sources: Bank of Spain; and IMF staff estimates.

**Common Equity Tier-1 Capital, June 2016**
(Percent of risk weighted assets)

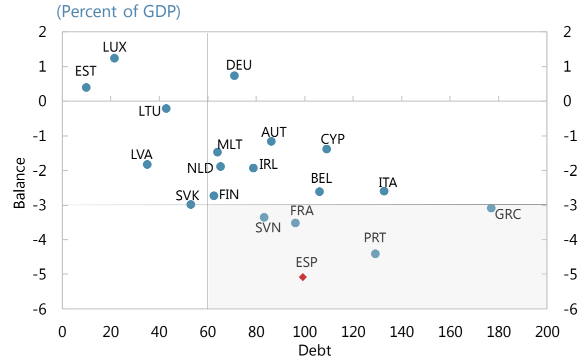



Sources: EBA, 2016 Transparency Exercise and IMF staff estimates.

rates, still elevated levels of legacy assets, continued deleveraging, and stiffened pricing competition for new loans.[1] Meanwhile, Spain's two largest banks have benefited from their globally-diversified earnings mainly accruing from retail banking, performing relatively well among major European banks during the period of market stress earlier this year. However, more difficult economic conditions outside Spain—in particular in Latin America, Turkey, and the U.K. where large Spanish banks have subsidiaries—risk lowering group-wide profits and their contributions to group-wide capital (Box 3).

**8. The fiscal stance turned expansionary in 2015–16.** Headline fiscal deficits have continued to fall to 5.1 percent of GDP in 2015 and a projected 4.5 percent of GDP in 2016. The 1½ percentage point reduction over two years has come on the back of the strong cyclical recovery and lower interest costs. In structural primary terms, the fiscal stance loosened by about 0.8 percent of GDP annually, reflecting mostly reductions in personal and corporate income taxes that had larger-than-anticipated impacts and overrun of non-entitlement expenditures (Figure 7).

**General Government Balance and Debt, 2015**
(Percent of GDP)




Sources: Eurostat; and IMF *World Economic Outlook*.

- In 2015, the overall deficit significantly exceeded the excessive deficit procedure (EDP) target of 4.2 percent of GDP. In particular, regional governments (1 percent of GDP) and social security (0.7 percent of GDP) underperformed, but this was partly compensated by over-compliance of the central and the local (i.e. municipal) governments. At the regional level, capital, health and education spending outpaced the budget plan. Moreover, the reclassification of regional public private partnerships (0.2 percent of GDP) into the public sector, despite stricter reporting requirements introduced in recent years that were expected to prevent such surprises, revealed weaknesses in public financial management. The Council of EU Finance Ministers found that Spain did not take effective action to reduce its excessive fiscal deficit in 2015 but cancelled potential sanctions.

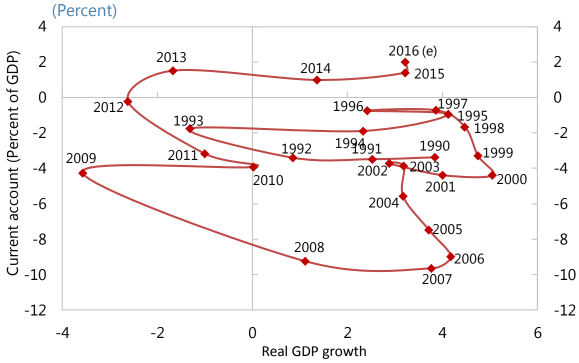
- For 2016, staff projects the fiscal deficit to decline to 4.5 percent of GDP in 2016, thus putting the new EDP deficit target of 4.6 percent of GDP within reach. The projected deficit is nearly 1 percentage point higher than budgeted and envisaged in Spain's April 2016 Stability Program (3.6 percent of GDP). Public debt remained high, at just under 100 percent of GDP.

**9. The current account registered another surplus.** In 2015, the external current account surplus increased by ½ percentage point to 1.4 percent of GDP and it is expected to be around 2 percent of GDP in 2016. While non-oil imports accelerated further as domestic demand rose, the external surplus increased on the back of lower oil prices and interest rates. Sustained and healthy

[1] Profitability will be negatively impacted by the December 2016 European Court of Justice's ruling on the full retroactivity of the nullity of floor clauses for variable-interest mortgage contracts. Banks may have to set additional reserves of up to €4.2 billion, which could potentially reduce the return of assets by about 0.1 percentage points.

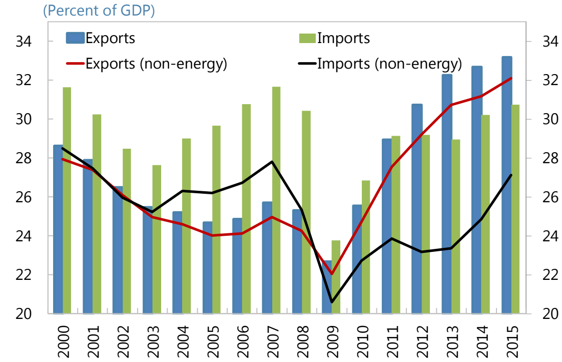
export growth, despite the slowdown in external demand, reflects both regained competiveness arising from price and wage moderation and larger firms' internationalization efforts.

**Growth and Current Account Balances, 1990-2016**
(Percent)




Sources: IMF, *World Economic Outlook* and IMF staff estimates.

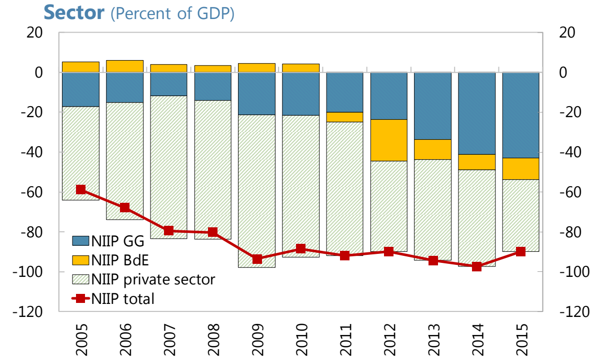
**Trade Flows**
(Percent of GDP)




Sources: Bank of Spain; Haver Analytics.

**10. But eliminating external vulnerabilities will take time.** At 87 percent of GDP at end-June 2016, Spain's negative net international investment position (NIIP) is still among the largest in the world, as the improved current account can only gradually reduce the stock vulnerability (Figure 8 and second chapter of the Selected Issues Paper (SIP)). Private sector deleveraging has driven most of the NIIP adjustment while external general government liabilities increased (Annex II). Given the need to sustainably strengthen the NIIP, the cyclically adjusted current account remained by some metrics up to 1 percent of GDP weaker than what would be consistent with medium-term fundamentals and desirable policy settings, and staff assesses that the real effective exchange rate (REER) is still about 5–10 percent overvalued (Appendix II).

**Net International Investment Position by Institutional Sector** (Percent of GDP)




Source: Bank of Spain.

***Authorities' Views***

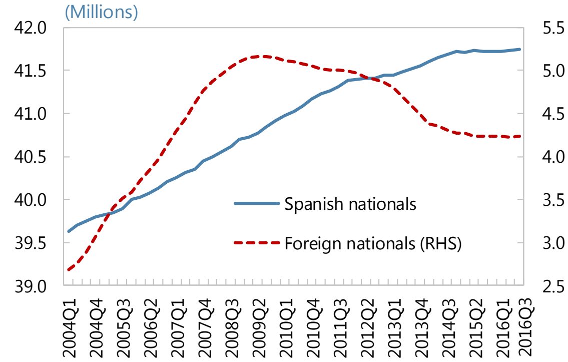
**11. The authorities stressed reform achievements and progress made in reducing imbalances, both having contributed to the solid growth performance.** They highlighted major improvements in employment, bank balance sheet cleansing, deleveraging, credit allocation, and external competitiveness. They emphasized that structural changes of the Spanish export sector are supporting sustained current account surpluses and, for the first time in decades, are considered to be compatible with strong growth. While broadly agreeing that the large negative NIIP remains a source of vulnerability, they stressed its gradual improvement over the last years as well as additional risk-mitigating factors such as equity holding and external debt held by the Bank of Spain.

# OUTLOOK AND RISKS

**12. After a strong performance this year, growth is expected to moderate next year but stay well above the euro area average.** Real GDP is projected to expand by 3.2 and 2.3 percent in 2016 and 2017, respectively, with domestic demand continuing to be the main driving force. Brexit is estimated to lower Spain's real GDP by about 0.3 percentage point through 2018 via confidence and trade channels. As the external tailwinds dissipate and fiscal policy envisages some tightening in 2017, real GDP growth is set to ease. Small positive spillovers in 2017 from potentially higher global growth on the back of a possible US fiscal stimulus are expected to more than offset somewhat tighter financial conditions, with Spain's 10-year government bond yields having risen by 19 basis points from end-October to end-December. Households are expected to further bolster their overall net wealth position and raise their still depressed savings ratio, implying a deceleration in consumption growth, though household deleveraging is set to moderate (see Box 1 in Country Report 15/232). Investment growth is also projected to slow with the unwinding of temporary factors but as the corporate debt overhang continues to shrink, prospects for investment and productivity growth should brighten somewhat.[2] As a result, credit growth is projected to turn positive but remain subdued. A small positive contribution from net exports is forecast for this and next year as exports continue to benefit from improved competitiveness and better partner-country prospects while import growth should moderate in line with domestic demand and higher public and private savings. The current account surplus is projected to rise a bit this year and stabilize at around 2 percent of GDP, allowing for a gradual reduction of the NIIP. Inflation will likely pick up gradually to an estimated 1.2 percent in 2017, in line with the projected gradual recovery of oil prices and euro area inflation.

**13. Spain's reform achievements are paying off but need to be enhanced to uphold high and job-rich growth over the medium term.** In particular, the 2012 labor market reforms have supported wage moderation and strong job creation, helping Spain reduce unemployment while regaining the external competitiveness lost during the pre-crisis boom. In total, the key structural reforms undertaken so far are estimated to lift the level of GDP by about a cumulative 2½ percent over a five-year horizon (Box 1). But under current policies Spain will continue to confront the challenges of feeble productivity, unfavorable labor force demographics, high structural unemployment, and slow capital accumulation that conspire against medium-term growth prospects. As a

**Population**
(Millions)




Source: INE.

[2] Empirical analysis in IMF Country Report 15/167 (chapter I) explains part of weak investment in Spain with weak corporate balance sheets. It finds that high indebtedness has weighed on productivity, in particular for SMEs.

result, once tailwinds dissipate growth is set to slow and converge in the medium term to its potential rate of around 1½ percent.

**14. Risks to the outlook are tilted to the downside.** External risks to the outlook include weak growth in key advanced and emerging economies or a significant slowdown in the latter, as well as uncertainty about the potentially protracted negotiations of a post-Brexit arrangement (Appendix III). Moreover, the recent erosion of support for European institutions and increased protectionist sentiment in many economies is a risk to international integration, trade, and coordination. Slowing external demand would generally weigh down Spanish activity through the trade channel, while weaker macroeconomic conditions in Latin America would mostly be transmitted through financial channels, including through potentially reduced profits of Spain's global banks (Box 3). Sharply tighter or more volatile global financial conditions could renew sovereign and financial sector stress via loss of market confidence, upward pressure on private sector lending rates, and resulting bank balance sheet effects, but the ECB's policies mitigate against excessive financial volatility and private sector balances have strengthened.[3] Domestically, reversal of past policy achievements could hurt market confidence, dampen investment, and weigh down medium-term growth prospects. Weak implementation of fiscal commitments could further delay the reduction of fiscal vulnerabilities, limiting the room for maneuver in case of future shocks.

***Authorities' Views***

**15. The authorities broadly agreed with staff on the outlook and balance of risks, stressing their commitment to preserve reforms in the face of pressure for their reversal.** The Bank of Spain's projections for real GDP growth and medium-term growth potential are similar to staff's, while the government expects somewhat stronger growth dynamics over the medium term. High unemployment and low productivity are considered to be the key structural challenges. Therefore, the authorities recognized that there is no scope for complacency.

# POLICY AGENDA

**16. Sustaining the strong momentum of the recovery while proceeding to make the economy more inclusive and robust to shocks requires continued broad-based policy efforts.** Priorities include (i) a return to gradual, credible, and growth-friendly fiscal consolidation; (ii) enhanced labor market performance, particularly by assisting the long-term unemployed and young; (iii) improved productivity, including by removing barriers to competition and obstacles for small firms to grow; and (iv) continued strengthening of the financial sector's position and its capacity to support growth. Undoing past reforms could create uncertainty and weigh on medium-term prospects.

[3] See Annex II for an analysis of sectoral financial cross-exposures.

## A. Fiscal Policy: Resuming Growth-Friendly and Inclusive Consolidation

**17. The fiscal stance is set to tighten in 2017.** The Council of EU Finance Ministers extended Spain's deadline to exit the EDP by two years, with new deficit targets of 3.1 and 2.2 percent of GDP in 2017 and 2018, respectively, calling for an annual structural adjustment of 0.5 percent of GDP. Fiscal measures adopted by the government for 2017 will offset part of the CIT revenue decline, by tightening CIT credit and deductions for large companies, raise excises for tobacco and alcohol, and introduce a tax on sugar-based drinks. These measures are expected to yield 0.4 percent of GDP additional revenue (mostly from CIT). The government also plans to improve VAT collection, in particular by eliminating the possibility of deferment and fractioning of VAT debts, and reducing tax fraud via changes to VAT administration. If part of the expected revenue impact (0.2 percent of GDP) materializes, the EDP deficit target for 2017 is in reach. Though a budget for 2017 still has to be adopted, the planned fiscal adjustment is an important step to reduce the structural deficit and public debt.

**Fiscal Projections 1/ 2/**
(Percent of GDP)

| | 2015 | 2016 | | | 2017 | | |
|---|---|---|---|---|---|---|---|
| | | Auth. | IMF | EC | Auth. | IMF | EC |
| Fiscal balance | -5.1 | -4.6 | -4.5 | -4.6 | -3.1 | -3.2 | -3.8 |
| Revenue | 38.6 | 38.0 | 38.1 | 38.0 | 38.2 | 38.3 | 37.8 |
| Expenditure | 43.8 | 42.5 | 42.5 | 42.6 | 41.3 | 41.5 | 41.6 |
| Structural balance 3/ | -2.4 | -2.9 | -3.0 | -3.8 | -2.4 | -2.6 | -3.8 |
| *Memorandum items:* | | | | | | | |
| Nominal GDP growth | 3.7 | 3.9 | 3.9 | 3.9 | 4.0 | 3.4 | 3.5 |
| Real GDP growth | 3.2 | 3.2 | 3.2 | 3.2 | 2.5 | 2.3 | 2.3 |
| Output gap 3/ | -4.5 | -2.9 | -2.4 | -1.5 | -1.3 | -1.3 | 0.0 |

1/ For EC, European Economic Forecast-Autumn 2016. The EC forecast for 2017 does not yet incorporate the new measures in the 2017 Budget Plan Update. For authorities, 2017 Budget Plan Update.
2/ The original fiscal balance target was -3.6 percent of GDP for 2016 and -2.9 percent of GDP for 2017.
3/ For 2015, structural balance and output gap refer to IMF staff estimates. EC estimate for structural balance is -2.8 percent and that for output gap is -4.0 percent.

**18. However, a credible medium-term consolidation path has yet to emerge.** The government projects the structural deficit to fall to about 1¼ percent of GDP by 2019 on the account of expenditure restraint, but no specific measures have been announced. Thus, under current policies, staff estimates the structural deficit to remain at around 2¼ percent of GDP over the medium term—still far from the structural balanced budget objective.[4] Risks to reach fiscal targets are also considerable at the regional level, given the poor compliance track record (see SIP chapter III), weak enforcement of regional targets, and weak market discipline related to support via the regional liquidity mechanisms (which lowered the regions' interest payments by 0.3 percent of GDP in 2015).

**19. Fiscal space is limited and remaining fiscal vulnerabilities demand gradual but steady and well-specified fiscal adjustment.** Under current policies, both gross and net debt ratios are projected to remain elevated over the medium term at around 95½ percent and 80 percent of GDP, respectively, despite the favorable interest-growth differential, thus limiting fiscal space for cyclical policy responses to shocks. Gross funding needs are still high at about 18 percent of GDP in 2017. The fiscal outlook faces risks, particularly from policy implementation shortfalls, potential negative growth shocks, and the realization of contingent liabilities. For example, in a growth shock scenario with two consecutive years of recession, debt levels would be pushed near 110 percent of GDP (11 percentage points higher than in the baseline projection) and annual gross financing needs above 22 percent of GDP in 2018 (Appendix IV). In contrast, returning to a gradual but sustained

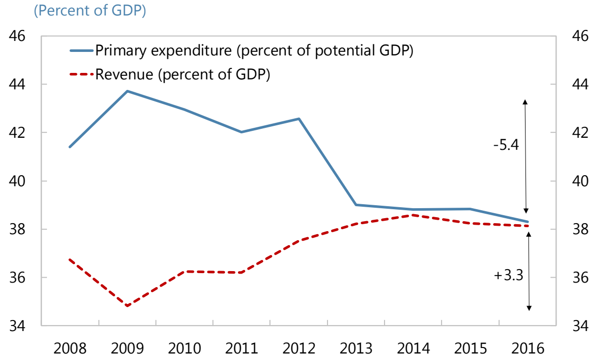
[4] Staff baseline projections (i.e., "current policies") include 0.4 percent structural revenue measures in 2017 and assume an unchanged structural primary balance from 2018.

fiscal consolidation would put debt firmly on a downward path. For instance, an annual adjustment of the structural primary balance of about 0.5 percent of GDP beyond 2017, and a multiplier of 0.6 (assuming revenue-based measures), would lower the debt-to-GDP ratio by 4 percentage points in 2021 compared to the baseline (Figure 7). Such an adjustment pace would strike an appropriate balance between preserving growth and ensuring public debt sustainability, while simultaneously lowering the sovereign-bank nexus (Annex II) It would also be consistent with the latest EC recommendation and with reaching structural balanced budget in five years, close to the target date set for meeting national rules.

- **Most of the medium-term adjustment will need to come from higher revenues and should also create space to support greater inclusiveness and employment creation.** While there is some room for spending restraint and rationalization, the public primary spending-to-GDP ratio is already relatively low compared to those of EU peers. So far, nearly two-thirds of the adjustment (5½ percent of potential GDP) has come from spending measures. And the expenditure-to-GDP ratio is expected to decline by another 2½ percentage points over the medium term under current policies, as expenditure is envisaged to rise only in line with the GDP deflator and thus fall relative to nominal GDP (according to the latest Stability Program). With total medium-term adjustment needs of 2¼ percent of GDP for structural balanced budget by 2021, priority should be given to the least distortive revenue measures that raise VAT collections, tackle the remaining inefficiencies in the tax system, and increase environmental levies or excises. Such revenue measures also have low multipliers, thus limiting their negative short-term impact on economic activity. Advancing expenditure rationalization could also contribute to the fiscal adjustment, but should not come at the expense of targeted incentives for employment creation and productivity growth.

**Composition of Fiscal Adjustment**

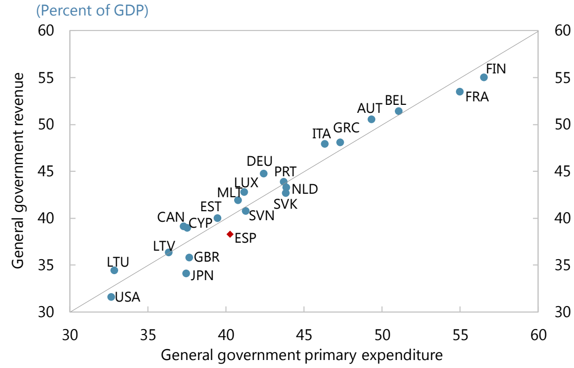
(Percent of GDP)




Sources: Ministry of Finance; and IMF staff calculations.

**Size of Government in Selected Countries, 2015**

(Percent of GDP)

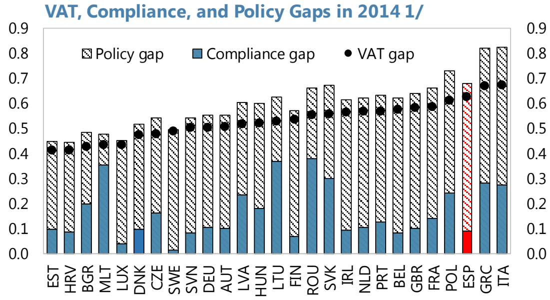



Source: IMF *World Economic Outlook*.

- **Improving the value added tax (VAT) efficiency.** VAT collection is about 3 percentage points of final consumption lower than the EU average, mirroring Spain's large VAT gap. Only about 60 percent of the consumption basket pays VAT at the standard rate in Spain, compared to 70 and 80 percent in France and Germany, respectively. VAT preferential treatments via lower rates and exemptions explain most of the VAT gap, while compliance is strong and recovered most of the deterioration during the global financial crisis. Lowering the VAT policy gap to the EU

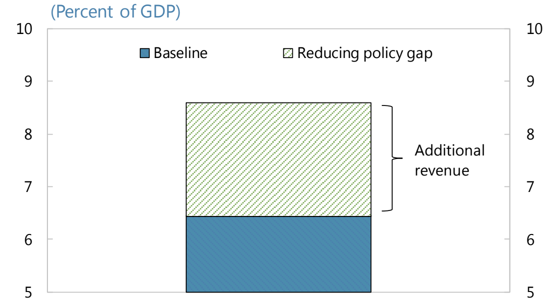
average, while maintaining VAT compliance at the pre-crisis level (2004-07) would raise Spain's VAT revenues by over 2 percent of GDP. This could be achieved by gradually raising the lower VAT rates in line with the medium-term fiscal adjustment needs.

**VAT, Compliance, and Policy Gaps in 2014 1/**




Source: EC "Study to Quantify and Analyse the VAT Gap in the EU Member States (2016)".
1/ VAT gap is defined as the ratio between the actual VAT revenue and theoretical VAT revenue collectable under the standard VAT rate with no exemptions and full compliance. Compliance gap is defined as the ratio between the actual VAT revenue and theoretical VAT revenue collectable under the existing rates and exemptions with full compliance. Policy gap is defined as the ratio between theoretical VAT revenue under the existing rates and exemption rules and that under the single rate with no exemptions.

**Simulated Additional VAT Revenue1/**
(Percent of GDP)

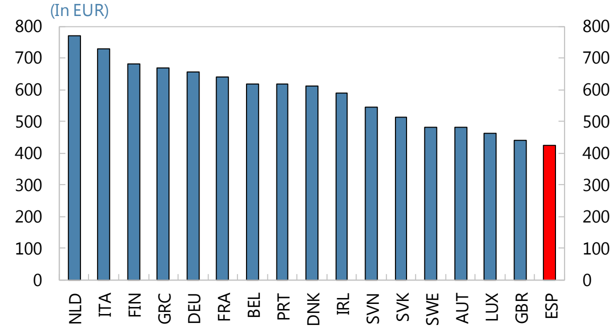



Sources: EC "Study to Quantify and Analyse the VAT Gap in the EU Member States (2016)", and IMF staff calculations and estimates.
1/ Estimated increase in VAT in a scenario in which the compliance gap reaches the pre-crisis (2004-07) average and the policy gap the EU average.

- **Addressing the remaining tax system inefficiencies.** Despite the 2014 tax reform, the tax system is still characterized by a large number of deductions, exemptions, and fiscal incentives, which tend to reduce the tax bases and collection even with the high marginal rates. Addressing remaining inefficiencies in the Spanish tax system, as recommended by the government-appointed committee of experts in 2014, would therefore be important and could yield additional revenue of ¼–½ percent of GDP. Continuing efforts against informality and tax evasion can also help improve the efficiency of revenue collection.

- **Raising excise duties and environmental levies.** Despite increases in recent years, environmental taxes remain significantly below the EU average, with reduced effective rates especially on energy. Harmonizing and enhancing the performance of environmental taxes could raise about ¼–½ percent of GDP in a relatively non-distortionary way.

**Selected EU Countries: Energy Excises for Unleaded Petrol, 2016 1/ 2/**
(In EUR)




Source: European Commission.
1/ Minimum excise duty: EUR 359 per 1000 litres.
2/ Showing the lowest values.

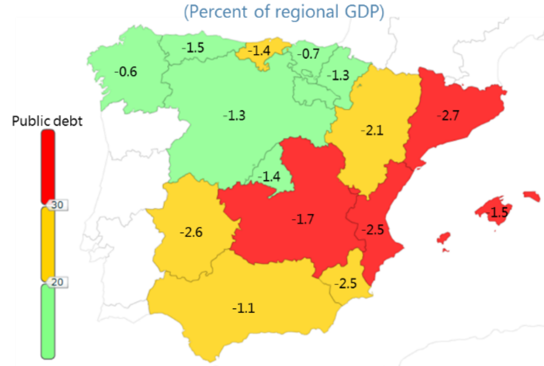
- **Rationalizing expenditure further.** The government's across-the-board spending cuts in 2016 could usefully be replaced by thorough expenditure reviews that focus on improving the quality and efficiency of public spending via better targeting, and eliminate unfunded mandates at the regional level. Conducting health and education reviews would be a priority to assess expenditure needs and minimum provision standards against the availability of financing resources at all government levels, including social security. Improved procurement procedures, in particular for pharmaceutical products (for which spending rose by 9½ percent in 2015), and introducing copayments for public health services—with exemptions or compensation for the most

vulnerable—could also help to lower or contain fiscal costs. And finally, better targeting hiring subsidies, as well as streamlining various hiring incentives—to lower further the tax wedge for the young and low-income earners—would provide more effective support for job creation for those that have difficulties in entering the labor market.

- **Supporting job creation and inclusion.** Active labor market programs and R&D fiscal incentives continue to be ineffective, calling foremost for better coordination and targeting, with fiscal resources to be reallocated to the most efficient programs (see Sections B and C). Any of the proposed fiscal measures should create sufficient space to provide better protection for vulnerable groups. Moreover, an introduction of fiscal incentive schemes could be considered, in the context of the regional financing system reform, to encourage regional governments to accelerate the implementation of structural reform measures, for example, in the area of the Market Unity Law and active labor market policies.

**20. Without bold reforms the regional financing framework remains a risk for the achievement of fiscal targets.** The last electoral cycle was a first true test for the fiscal governance framework adopted in the 2012 Budget Stability Law reform, and it exposed old and new fault lines, in particular of the sub-national fiscal regime. Compliance with the rules has been weak and uneven so far with limited enforcement (Figure 7). In addition to the weaknesses on the governance side, issues with fiscal autonomy—the intergovernmental fiscal mechanism—continue to hamper compliance and fiscal discipline. A two-pronged approach could address this:

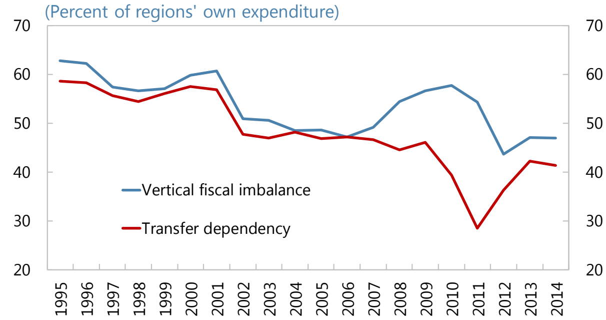
**Public Finances of Spanish Regions, 2015 1/**
(Percent of regional GDP)




Sources: Bank of Spain; General Comptroller of the State Administration.
1/ The numbers show the fiscal balance; the color refers to the level of public debt.

- **Strengthening governance.** In the short term, priorities would be to enforce the existing fiscal framework, strengthen the oversight institutions and procedures (e.g., providing the fiscal council timely and appropriate information as mandated by law; ensuring that public entities observe the 'comply and explain' principle by publishing explanations for non-compliance), as well as reinforce conditionality and step up monitoring under the regional liquidity mechanisms for non-compliant regions. Allowing regions' fiscal targets to temporarily differ would help to account for structural differences in adjustment needs and fiscal capacity. In the medium term, governance can be strengthened further by (i) enforcing more automatically sub-national fiscal rules, starting with

**Vertical Fiscal Imbalances 1/**
(Percent of regions' own expenditure)




Sources: OECD and IMF staff calculations.
1/ Transfer dependency is the ratio between central government net transfers to the regions and regions own expenditure. Vertical fiscal imbalance is the sum of the transfer dependency ratio and the ratio of net regional borrowing to regions own expenditure.

preventive actions and escalating to corrective and coercive mechanisms; (ii) harmonizing conditions, monitoring, and transparency requirements for regions that access the regional liquidity mechanism with those under the Economic and Financial Plans; and (iii) improving public financial management systems to allow for comprehensive and frequent evaluation of compliance with fiscal rules and targets.

- **Reforming the system of regional finances.** Enforcement will likely remain challenging unless the governance framework is matched with a regional financial system that improves the regions' capacity and incentives for fiscal discipline. In connection with a regional spending review (in particular for education and health), reforms should aim at (i) increasing the transparency and effectiveness of the fiscal equalization system to ensure meeting the public service provision standards without undermining regions' broader spending mandates; (ii) enhancing the regions' revenue-raising capacity so as to better match the greater degree of expenditure decentralization and raise accountability; (iii) enhancing the intergovernmental transfer settlement system by reducing the size discrepancies and time lags between advance payments and legal entitlements; and (iv) phasing out the use of regional liquidity mechanisms for non-emergency purposes and considering introducing rainy-day funds to improve fiscal resilience in normal times.

***Authorities' Views***

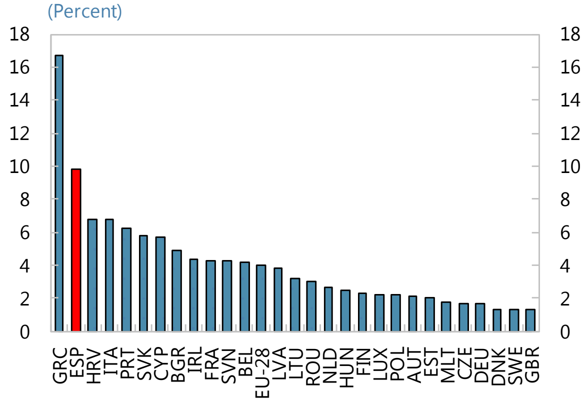
**21. The authorities are committed to achieving the 2017 deficit target and agreed with the need to improve regional public finances.** They considered that the adopted measures will deliver at least ½ percent of GDP structural adjustment, enough to reach the 3.1 percent of GDP deficit target. While the authorities generally agreed on the need for reducing the deficit and debt in the medium term in order to strengthen the resilience of the Spanish economy, they also stressed that the pace and composition of the fiscal adjustment should not weaken the momentum of growth and job creation. They stressed that the approach set out in the Draft Budgetary Plan for 2017 would allow for a progressive reduction in the structural deficit, including through improved fiscal compliance and the application of the spending rule, which would avoid the need for future tax hikes. Regarding the system of regional public finances, the authorities noted that fundamental reforms were necessary, particularly to enhance fiscal prudence, but the complexity of the issues would require strong political commitment, beyond the broad consensus on the reform needs, if progress was to be made. They also suggested that stricter enforcement of corrective measures introduced in the 2012 Budget Stability Law had started to improve the fiscal compliance of some regions and mitigated moral hazard risks.

## B. Labor Market: Tackling Long-Term Unemployment and Labor Market Rigidities

**22. An immediate priority is promoting job creation for the long-term unemployed and low-skilled youth.** The impact of ALMPs, especially for those who have been jobless for years and low-skilled youth, has been limited, and high unemployment had unfortunate implications for social

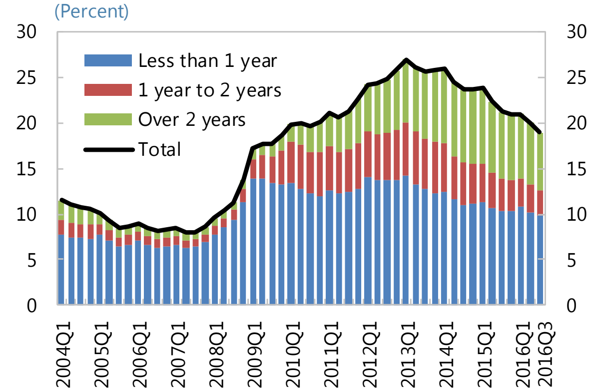
exclusion (Box 2). This calls for urgent improvement in policy effectiveness, particularly by better coordination with regional governments. Reviewing the effectiveness of the current toolkit of ALMPs, for example as part of the OECD peer review exercise, could guide the reallocation of resources to the most promising programs and development of new alternatives in line with the most successful programs in other EU countries. Specifically, profiling of job seeker's characteristics should be strengthened to provide more personalized assistance programs, and cooperation between the public employment service and private job-placement agencies will need to be improved for better outcomes of customized programs. Improving and modernizing training, apprenticeship, and education programs, including by better aligning them to current labor market needs, would help reduce skill mismatches, especially for low-skilled youth and individuals formerly employed in the construction sector. In this respect, reducing the high share of early school leavers is a key challenge. Making effective use of—and potentially enhancing—the EU's Youth Guarantee schemes could support the employability of low-skilled youth, too. At the same time, the ties between active and passive policies could be strengthened, for example by strictly enforcing the requirement of the verification of an active job search and participation in activation programs to receive unemployment benefits. Finally, various hiring subsidies, including lower social security contributions for all new contracts, could be consolidated to create effective and better-targeted subsidy schemes, particularly, for low-skilled and long-term unemployed.

**Long-Term Unemployment Rate in the EU, 2016Q2**
(Percent)




Source: Eurostat.

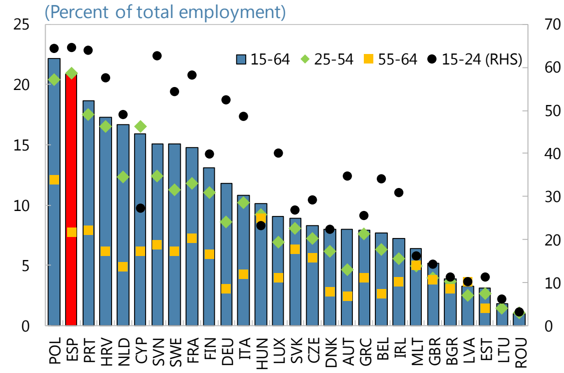
**Unemployment Rate by Duration**
(Percent)




Source: Eurostat.

**23. Lowering labor market duality requires making permanent contracts more attractive for employers.** The high labor market duality (particularly among the youth) exacerbates employment volatility, lowers human capital investment and workers' productivity, and increases inequality. While labor market reforms have lowered several obstacles for open-ended hires, the remaining significant gap between the costs for permanent and temporary workers continue to act as a disincentive for employers to

**Share of Temporary Workers by Age, 2015**
(Percent of total employment)




Source: Eurostat.

offer open-ended positions (Annex I). This could be tackled by, for example, simplifying the menu of contracts to choose from, while effectively reducing the employment protection gap. One option is to introduce a single open-ended contract with no ex-ante time limit and severance payments that increase gradually with tenure. This could co-exist with separate contracts that account for the specific needs and costs related to training staff and employment in sectors with high seasonal turnover (e.g., tourism and agriculture). An alternative is to gradually introduce the Austrian 'backpack' model, under which entitlements to severance payments acquired in one job can be carried to subsequent jobs, so that severance payments grow with tenure regardless of contract type. In the meantime, the persistent legal and administrative uncertainties that hamper the effectiveness of labor market reforms and affect open-ended employment should be addressed. In particular, a number of formal requirements for collective dismissals and the possibility of nullifying the dismissal on formal grounds have been associated with high cost of annulled dismissals on grounds of procedural mistakes. Simplifying the list of possible causes for nullifying a dismissal and differentiating the corrective actions between annulments based on procedural and substantial grounds would mitigate legal uncertainties that have served as disincentives to open-ended contracts.

**24. Enhanced flexibility to set working conditions, especially in SMEs, is also critical.** Ensuring that wage dynamics reflect differences in firm- and sector-specific conditions would promote a reallocation of resources toward more productive sectors, boost aggregate productivity and income, and reduce structural unemployment. The labor market reforms included steps in this direction: prioritizing firm-level agreements over higher-level ones; making it somewhat easier for firms in economic difficulties to 'opt-out' from higher level agreements; and limiting ultra-activity (the period during which an expired agreement would remain valid). However, the reform has not been able to promote a substantial change in the structure of collective bargaining. Wage flexibility generally improved, but the incidence of firm-level agreement has not increased significantly. Firm-level agreements remain especially unusual for SMEs, and 'opting-out' is the only possibility of wage adjustment for these firms, but only based on agreements with workers' representatives, as the procedures for resolving potential conflicts associated with 'opt-outs' remain excessively demanding. Enhancing the flexibility at the firm rather than sectoral-regional level could be facilitated by eliminating the automatic extension of negotiated working conditions to all firms in the corresponding sector, for example by strictly verifying the thresholds of unions and employers' representativeness.

***Authorities' Views***

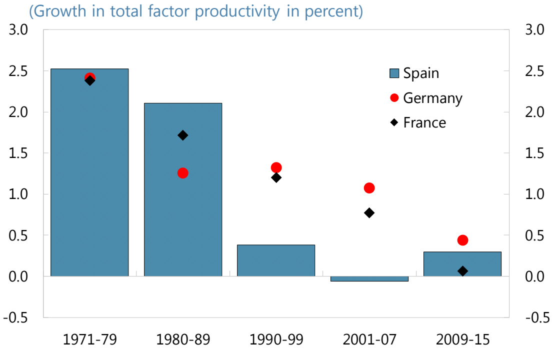
**25. The authorities emphasized the importance of continued job creation and the need not to reverse the 2012 labor market reforms, while recognizing scope for some fine-tuning.** Lowering unemployment, especially for the long-term unemployed and low-skilled youth, is a policy priority. The authorities stressed that there is broad political consensus that enhancing the effectiveness of ALMPs is critical, with efforts already underway, such as improving the incentive alignment with the regional governments and private sector partners. Tackling pervasive labor market duality is a longer-term goal that requires a consensus among social partners on the ways

forward. Therefore, an expert group will first develop policy options before engaging in a new dialogue. As regards the collective bargaining process, the authorities noticed that the labor reforms have given firms greater flexibility to adapt to their differentiated business needs, and the easier opting out has served as a disciplining tool, despite its muted uptake so far. Nevertheless, the issue of greater representativeness to conclude collective agreements with general effects could be explored over the medium term. The authorities stressed that their immediate focus is on preserving reform achievements, in particular in the context of the recent decision on temporary replacement workers by the Court of Justice of the European Union.

## C. Structural Reforms: Boosting Firm Productivity and Growth

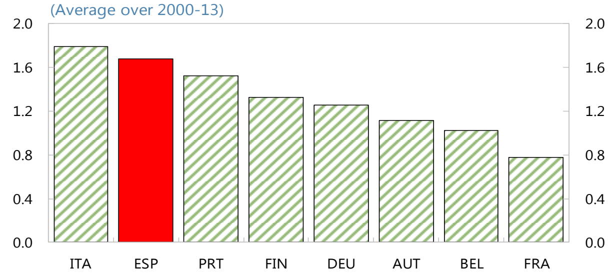
**26. Spain's weak productivity remains a core medium-term challenge.** A large part of the recent improvement in total factor productivity (TFP) growth was a result of drastic labor shedding and exit of low-productivity firms during the crisis. The reform agenda initiated in 2012 is likely to keep TFP growth at slightly above ½ percent over the next five years, implying that potential growth will rise gradually but not surpass 1½ percent without further reform efforts. Spain's corporate landscape, with many small firms that tend to be less productive, innovative, and export-oriented than European peers, is behind this phenomenon (Figure 9). At the same time, significant within-sector heterogeneity in firm productivity points to inefficient resource allocation.

**Spain: Medium-Term Productivity Growth Challenge**
(Growth in total factor productivity in percent)




Sources: European Commission, Haver Analytics, and IMF staff calculations.

**Resource Misallocation 1/**
(Average over 2000-13)

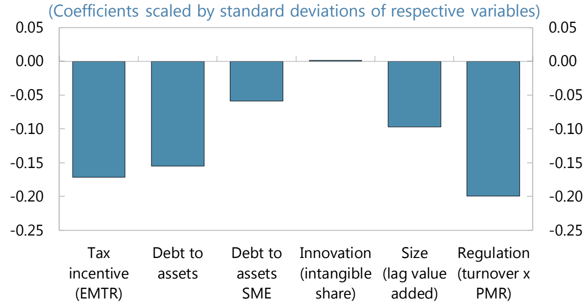



Sources: RES ORBIS data and IMF staff calculations.
1/ See Hsieh and Klenow (2009), "Misallocation and Manufacturing TFP in China and India," Quarterly Journal of Economics. The authors decompose the logarithm of sectoral TFP into the difference between the logarithms of the "clean" TFP, i.e. TFP that would exist in a sector without factor market distortions, and a measure of resource misallocation. Misallocation is proxied by the variance of the logarithm of the total factor revenue productivity of a firm in a specific sector, adjusted by the price elasticity of demand in the same sector. For illustration, imagine a two firm economy, where only one of the firms faces capital distortions, e.g. capital subsidies. Removing the distortion and reallocating the same amount of capital across all firms (so as to equalize their marginal products of capital) would increase the aggregate output. This would remove the firm-level distortion and also increase sectoral TFP, since the economy would produce more with the same inputs.

**27. A number of factors weigh on firm growth and productivity.** Staff analysis finds that product market regulation, in particular in more tightly-regulated sectors, has weighed on TFP growth. Moreover, different regulatory practices across regions, leading to an uneven business environment, have limited the capacity of firms to benefit from larger markets and exploit economies of scale. Size-dependent rules and regulations, including past tax incentives to SMEs, have also lowered firm productivity growth. Finally, the relatively high debt-to-asset ratio, by constraining access to finance and investment, has held back firm productivity and growth, in particular, for SMEs that tend to have weaker financial position compared to other firms (second chapter of SIP). Survey results corroborate these empirical findings.

**Determinants of TFP Growth**

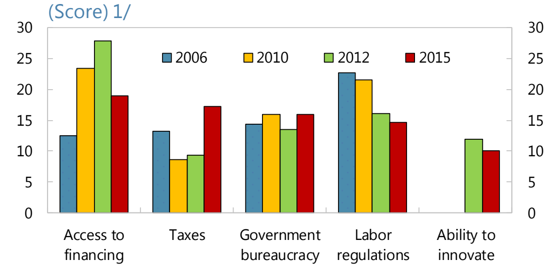
(Coefficients scaled by standard deviations of respective variables)




Sources: ORBIS data, and IMF staff calculations. See chapter I of the 2016 Spain Selected Issues paper.
Note: EMTR = effective marginal tax rate; PMR = product market regulation.

**Most Problematic Factors for Doing Business**

(Score) 1/

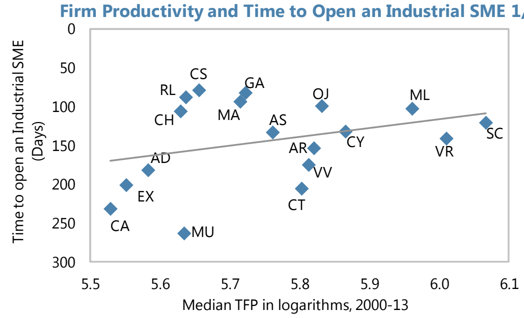



Source: Global Competitiveness Report, World Economic Forum.
1/ From the list of factors, respondents were asked to select the five most problematic factors for doing business in their country and ran them between 1 (most problematic) and 5. The score corresponds to the responses weighted according to their ranking.

**28. Boosting firm growth and productivity calls for progress in three key areas.**

- **Fostering competition.** As the implementation of the Market Unity Law has been delayed, little progress has been made on the intended reduction in regulatory barriers and administrative burden for Spanish firms that face three layers of administration (central, regional, and local). Sizeable differences persist in the business environment across regions, and Spain still lags in a number of areas compared to peers. For example, the time and costs to open a business are one and a half times the OECD average, while opening an industrial SME takes eight times as long and costs twice as much as of opening a normal business. Introducing performance-based transfers to regions that would incentivize them to accelerate the Market Unity Law implementation could be considered. The delayed liberalization of professional services also needs to be advanced in order to level the playing field, increase transparency and accountability of professional bodies, open up unjustified reserved activities and safeguard market unity in the professional services in Spain. The macroeconomic gains of these reforms are likely to be larger when undertaken in the context of the current cyclical recovery (IMF *World Economic Outlook*, April 2016).

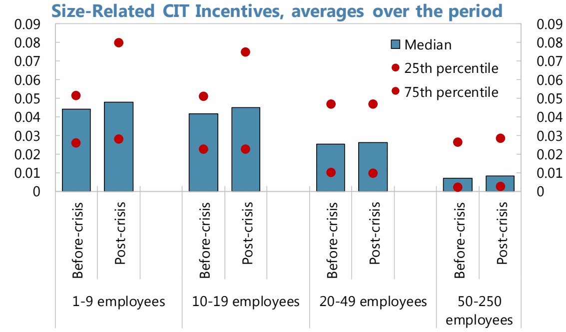
**Firm Productivity and Time to Open an Industrial SME 1/**




Sources: ORBIS, and Subnational Doing Business, World Bank, 2015.
1/ Region names are abbreviated as follows: AD-Andalusia, AR-Aragon, AS-Asturias, CA-Ceuta, CH-Castile-La Mancha, CS-Castile-Leon, CT-Cantabria, CY-Catalonia, EX-Extremadura, GA-Galicia, MA-Madrid, ML-Melilla, OJ-La Rioja, RL-Balearic Islands, RU-Murcia, SC-Basque Community, VR-Navarre, VV-Valencian Community.

- **Revisiting size-based regulations,** including those on reporting, auditing, labor regulation and CIT incentives, with a view to addressing disincentive effects that can create a "small business trap" and hamper productivity. The recent CIT reform did just that by eliminating the lower tax rate for small firms and replacing

**Size-Related CIT Incentives, averages over the period**




Sources: ORBIS Data, OECD (2015), national sources and IMF staff calculations.
Note: Pre-crisis defined as 2000-07, post-crisis - as 2008-13. CIT incentives are defined as the difference between effective marginal tax rates under the standard CIT rates and those under the lower CIT rates for smaller firms. Forward-looking marginal effective tax rates are simulated by combining firm level data with information from the tax code, following Egger et. al. (2009). For further details, see chapter I of the 2016 Spain SelectedIssues Paper.

it with targeted support for startups. At the same time, removing barriers to competition would ensure efficient market selection of new entrants.

- **Enhancing innovation capacity,** which is currently limited by low private R&D spending and weak public R&D spending efficiency. This could be addressed by improving the weak coordination across government layers, strengthening public-private sector cooperation, and enhancing internationalization and financing.

***Authorities' Views***

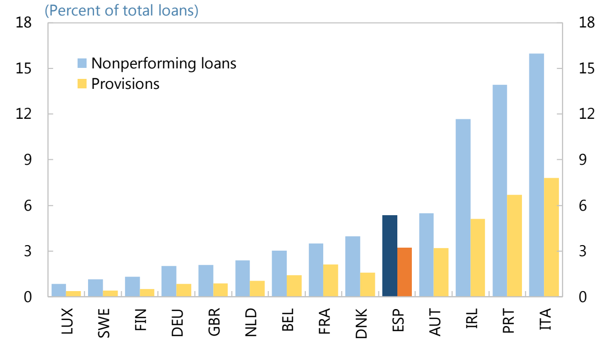
**29. The authorities broadly agreed with the main obstacles to firm-level productivity growth and the proposed policy options.** In particular, they shared the need to improve the regulatory environment and enhance competition by faster implementation of the Market Unity Law. While the authorities concurred with the benefits from liberalizing professional services, they stressed the importance to advance this agenda also at the EU level. Enhancing innovation would need to go beyond R&D spending and require reforms also to the education system.

## D. Financial Sector: Continue Strengthening Capacity to Support Growth

**30. Continued promotion of banks and borrowers' resilience is a critical part of the economic recovery.** Due to better asset quality, stronger capital and funding positions, and reduced debt overhangs, the system is closer to putting most of the crisis legacies behind it. Similarly, borrowers have also reduced their debt overhangs amid improving labor market conditions. Going forward, enhancing further the resilience of both sides and expanding the still limited access to non-bank funding, particularly for frontier innovation, will be key to ensure stable financing of the economy over the medium term.

**31. Efforts to reduce the level of impaired assets on banks' balance sheets should continue.** While the reduction in NPLs has generally proceeded well, though at different speeds across banks, efforts should continue to ensure banks' adequate provisioning and encourage the fuller use of the enhanced insolvency regime. Following bank-specific time-bound, realistic and ambitious NPL reduction plans as foreseen in the ECB Guidance to Banks on NPLs are therefore a welcome tool in the Spanish banking system's final stretch to fully put the crisis legacies behind. This process could also benefit from the insolvency reform, which supports more efficient debt restructuring and gives a "fresh start" to individuals. However, the use of the latter has been relatively limited so far. A stock-taking exercise of the framework's functioning would thus be beneficial as certain design changes could likely help the deleveraging process. These include addressing the special treatment for public creditors, and introducing the "cram-down" mechanism

**Nonperforming Loans and Provisions, December 2015**
(Percent of total loans)



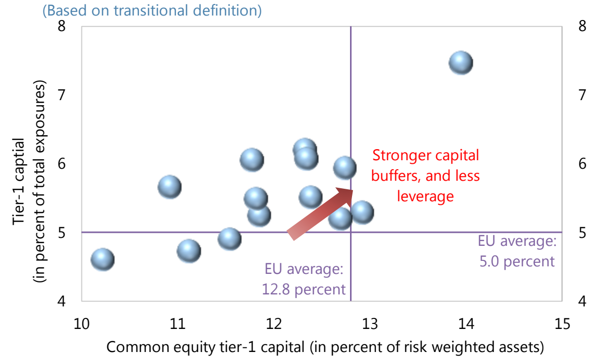

Source: ECB, Consolidated Banking Data.

(i.e., allowing to disregard the dissent of several voting classes of creditors as long as they receive a fair value under the restructuring plan), and further removing uncertainties around the "fresh start" regime.

32. **Continued efforts to strengthen banks' capital and funding positions will enhance the banking system's ability to support economic expansion and withstand shocks.** It remains important to encourage banks to increase high-quality capital through retained earnings. Additional capital would help ensure sufficient credit provision to financially-sound corporates and households as credit demand picks up. At this stage near-term supply constraints appear unlikely, but bolstering banks' capital would be prudent to safeguard financial stability and ensure adequate capital in light of regulatory initiatives. In addition, banks may need to adjust their liability structures to fulfill new regulatory requirements, such as Minimum Requirements for Own Funds and Eligible Liabilities (MREL) and Net Stable Funding Ratio (NFSR).

**Capital Adequacy and Leverage, June 2015**

(Based on transitional definition)

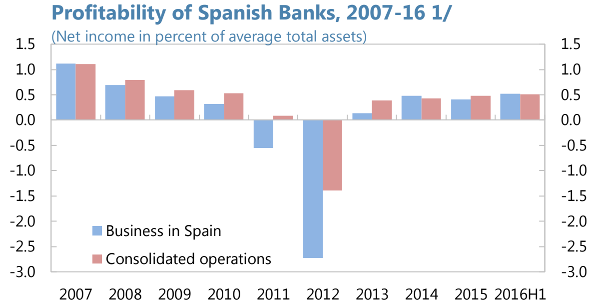



Sources: EBA, 2015 Transparency Exercise; and IMF staff estimates.

33. **Adjusting to profitability pressures is a key challenge, especially in the current macro-financial environment.** Similar to other European economies, banks' profitability in Spain is currently well below the pre-crisis level, with the return on equity lower than the cost of capital. Profitability has been stable in the past year, as for business in Spain reduced net interest and other income has been offset by falling impairment costs. The more difficult domestic and global operating conditions, in particular in a low interest rate environment, will put pressure on banks' cost structure and business models. Achieving greater efficiency, in particular since Spanish banks still rely on a larger branch network than European peers, further reducing operating expenses, and raising non-interest income will be central to addressing the profitability challenge.

**Profitability of Spanish Banks, 2007-16 1/**

(Net income in percent of average total assets)

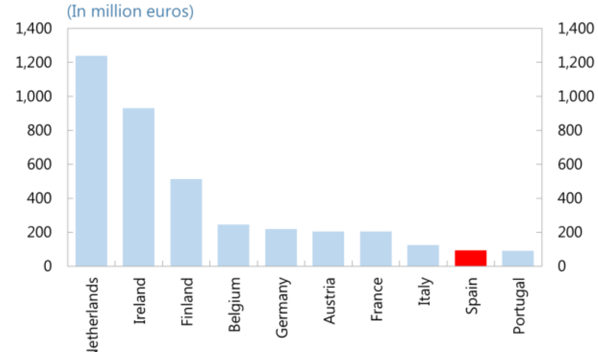



Sources: Bank of Spain; IMF, *Financial Soundness Indicators Database*; and IMF staff calculations.

1/ For banking business in Spain, the aggregate figure of net income in 2011 and 2012 is amplified by the segregation process of savings banks' business to newly-created banks. See Bank of Spain's *Statistical Bulletin* (2012) for more details.

**Size of Assets per Branch, 2015**

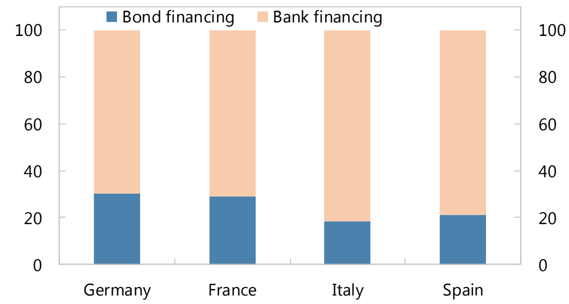
(In million euros)




Source: ECB, Banking Structural Financial Indicators.

**34. Efforts to further improve access to finance for SMEs should continue.** Access of Spanish firms to non-bank (typically equity) financing for frontier innovation, in particular, is low compared to their European peers. This suggests the need to step up ongoing efforts to increase market-based financing for SMEs, including via alternative exchanges, venture capital, and securitization. At the same time, the ongoing program providing guarantees and direct financing through Instituto de Crédito Oficial (ICO), a state-owned financial institution, remains highly relevant for financing of new firms, with its lending at more favorable conditions now more concentrated in tenures beyond three years. The efforts have started to be complemented by European efforts, including by guarantees extended under the Juncker plan.

**Corporate Debt Financing, 2016Q1**
(Percent of total debt financing)




Sources: BIS, Debt Securities Statistics and Locational Banking Statistics; IMF, International Financial Statistics; and IMF staff estimates.

**35. Three items under Spain's financial sector reform remain to be completed:** the divestment of public ownership in two banks and the liquidation of real estate assets owned by the Asset Management Company (SAREB). The framework for savings banks and banking foundations is now fully in place, and requires banking foundations either to divest relevant credit institutions or to set up reserve funds. The legal challenge related to the 2011 IPO of Bankia has been addressed, removing the deadlock for further privatization. However, the plan by the Spanish Resolution Authority (FROB) to sell its stakes in Bankia/BFA and BMN has stalled due to market conditions and political uncertainties, with the new government extending the deadline for the sale of both institutions by two years. FROB has recently hired a consultant to explore the option of merging the two institutions before a sale. At the same time, SAREB reduced its portfolio more slowly than planned (by 15 percent or about €8 billion) in the first three years due to difficult market conditions, but the recovery of the real estate market should bolster future sales. SAREB again registered a loss in 2015, following the adoption of the new accounting rule that requires appraisals of underlying collaterals in all loan books to properly reflect marking-to-market. The loss significantly eroded its capital and resulted in a conversion of subordinated debt into equity, with minimal impact on exposed banks given provisions made already.

**36. The macroprudential policy framework remains to be fully put in place.** The Bank of Spain has employed macroprudential powers, setting the amounts of countercyclical capital buffers (at zero) and capital surcharges for systemic banks, but the national macroprudential authority has not been established. Given the financial cycle, there are no imminent systemic risks in the cyclical dimension. Nevertheless, the macroprudential policy framework should be developed to safeguard financial stability by mitigating a buildup of systemic risk following the return to positive credit growth and rising housing prices in the near future.

**37. Progress towards the banking union continues.** In February 2016, the Bank of Spain completed the transposition of the capital requirements regulation and directive (CRR/CRD IV). The

Bank of Spain also plans to amend regulations so as to align national discretions of the CRR with the recent ECB regulation. Under the Single Supervisory Mechanism banks benefit from a more forward-looking supervisory approach that focuses on business model and risk management. Preparation for resolution plans remains work in progress, with banks preferring the multiple points of entry approach for their subsidiaries outside the euro area. The upcoming FSAP will review the overall financial stability architecture and advise on further enhancing the financial system's resilience.

***Authorities' Views***

**38. The authorities broadly agreed with staff's assessment on the recent progress and remaining challenges in the financial sector.** The authorities stressed that the positive trends in the banking system were the outcome of the decisive financial sector reform, including recapitalization and balance sheet cleansing. They highlighted the progress made in NPL reduction over the last years and considered this pace to be appropriate. The Bank of Spain has continued to ensure adequate provisioning and forced weak banks to take additional measures, as needed, to address legacy asset problems. The authorities considered that going forward, low profitability would be the main challenge for banks, as in virtually all other European banking systems. They viewed banks as being well-positioned to handle forthcoming regulatory changes and supported the finalization and implementation of pending financial reforms. The authorities are committed to develop the macroprudential framework.

# STAFF APPRAISAL

**39. The Spanish economy has continued its impressive recovery and strong job creation.** Real GDP and employment growth have outpaced the euro area average despite a prolonged period of domestic political uncertainty. The current account is projected to record its fourth consecutive annual surplus. And private sector balance sheets have further strengthened.

**40. Earlier reforms and confidence-enhancing measures have laid the ground for this rebound, and they need to be preserved.** In particular, wage moderation and greater labor market flexibility have helped the economy regain competitiveness and have contributed to strong job creation. Together with banking sector reforms they have made the Spanish economy more resilient. Reversing policy achievements could hurt market confidence and weigh on medium-term growth prospects.

**41. Despite considerable progress, adjustment is still incomplete and structural problems persist.** Far too many Spaniards are still without employment and many have been jobless for years. Together with still pervasive labor market duality this has raised social exclusion, inhibited human capital investment, and served as a drag on productivity. Lowering structural unemployment and raising medium-term potential growth above the estimated annual 1.5 percent remain key challenges. At the same time, high public debt, pockets of over-indebtedness in the private sector, and the still large negative net international investment position leave the economy vulnerable to shocks.

**42. Maintaining high job-rich growth calls for a comprehensive medium-term strategy.** Preserving past reform achievements is of utmost importance, but it cannot by itself sustain the dynamic economic performance. To advance the structural agenda, immediate attention should be given to those priority areas for which there is a commonly shared view on reform needs and objectives, though not necessarily on the preferred policy tools: enhancing ALMP to lower long-term and youth unemployment, reforming regional public finances to safeguard public finances, and strengthening innovation and education policies to lift productivity. Going forward, additional labor and product market reforms need to enhance such a strategy.

**43. Resumption of gradual fiscal consolidation would ensure that debt is firmly put on a downward path.** Building on the large fiscal measures adopted over 2010–13, adjustment can take a more measured pace but should be steady and be underpinned by well-defined policy actions. An annual adjustment of the structural primary balance of about 0.5 percent of GDP would bring the structural fiscal deficit into balance in five years and markedly lower the debt ratio. The pace would strike an appropriate balance between preserving the economic recovery and mitigating fiscal risks.

**44. A carefully designed adjustment can be growth and job-friendly.** In particular, Spain has room to raise revenues. Gradually reducing VAT exemptions as well as raising excise duties and environmental levies would bring revenue collection more in line with that of European peers. On the expenditure side, room for further efficiency gains could be best gauged by conducting thorough expenditure reviews—in particular in health and education. At the same time, it will be important to properly shield vulnerable groups and enhance the efficiency of expenditure programs that directly support employment and growth, such as ALMP and public research and development spending.

**45. Without reforms, the regional financing framework remains a risk for public finances.** Reforms should aim to improve regions' incentives to comply with fiscal targets while accounting for their different economic capacities to do so. This calls for more automatic and stricter enforcement of targets and providing regions with greater power to mobilize their own revenues. And finally, the introduction of performance-based transfers could be considered to strengthen regions' incentives to advance critical reform areas, such as the implementation of the Market Unity Law and ALMP.

**46. Reducing unemployment, in particular long term and youth joblessness, remains a key challenge.** Despite recent efforts, the limited effectiveness of ALMP calls for urgent improvements, particularly though better coordination with regional governments. The range of hiring subsidies could be consolidated into better-targeted schemes, particularly for the low-skilled and long-term unemployed. At the same time, the long-standing issue of labor market duality is still to be addressed. Allowing firms more control and flexibility over working conditions is also critical to enhance the functioning of the labor market.

**47. The current cyclical recovery is the right time to get a high pay-off from structural reforms.** In particular, three types of policies can help raise the low productivity of Spain's many SMEs. Implementing the Market Unity Law, advancing the delayed liberalization of professional services, and lowering the cost of doing business would promote competition. Enhancing private

R&D investment, increasing the efficiency of public R&D spending, and improving access to non-bank financing for frontier innovation would foster high productive investment. And finally, revisiting size-contingent regulations would help overcome the small business trap.

**48. The banking system has gained further strength amid new challenges.** Due to better asset quality, stronger capital and funding positions, and reduced debt overhangs, the system is closer to putting most of the crisis legacies behind it. However, banks have progressed at different speeds, and NPLs and foreclosed assets remain sizeable, though much lower than in some EU countries. At the same time, like other European banking systems, Spain's banks face challenges arising from the low profitability environment and new regulatory initiatives. Going forward, continuing to ensure adequate provisioning, further improving efficiency gains—possibly through mergers—, boosting non-interest income, and increasing further high-quality capital would enhance the banking system's ability to withstand shocks, and facilitate sufficient credit provision as credit demand picks up.

**49.** It is recommended that Spain remain on the standard 12-month Article IV consultation cycle.

## Box 1. What Has Been Driving the Recovery?

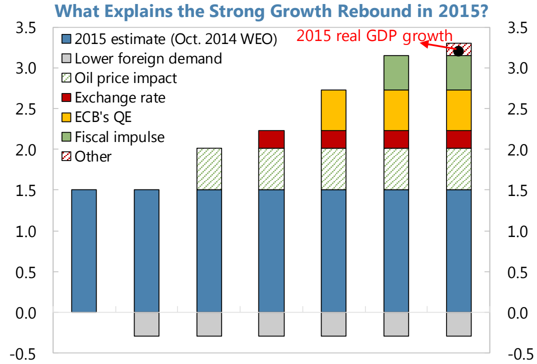
*A combination of temporary tailwinds and structural reforms has driven the strong recovery of the Spanish economy. Beginning in mid-2013, the rebound followed major labor market and banking sector reforms as well as falling long-term interest rates but otherwise still weak external conditions, which have since improved.*

**The stronger-than-anticipated rebound was largely driven by temporary factors.** At 3.2 percent in 2015, real GDP growth exceeded staff's (and consensus) projection in the 2014 October WEO by 1.5 p.p. A decomposition of the growth surprise reveals that external tailwinds and fiscal expansion account for the bulk of it.

- The decline in oil price and interest rates explains about two thirds of the better growth outturn, each contributing about ½ p.p. Compared to the projection in the October 2014 WEO, oil prices dropped by some 34 percent and long-term interest rates by about 100 bps.[1]

- The impact of weaker euro in combination with wage moderation (5 percent real exchange rate depreciation, unit-labor-cost based) was broadly offset by external headwinds from weaker growth in the euro area and the resulting softer foreign demand for Spanish exports (-¼ p.p.).

What Explains the Strong Growth Rebound in 2015?




Sources: Authorities and IMF staff calculations.

- A looser-than-projected fiscal stance (structural primary impulse of about 0.8 percent of GDP) provided an additional boost of about 0.4 p.p.

- The remaining part of the growth surprise (about 0.2 p.p.) can be attributed to other factors, such as stronger confidence effects of structural reforms.

For 2016, growth will likely exceed earlier staff projections by 0.6 p.p. of which two thirds can be attributed to a looser than expected fiscal stance and most of the rest to stronger foreign demand.

**At the same time, structural reforms, initiated in 2012, have made a difference.** A simple benchmarking exercise suggests that structural measures adopted so far could boost potential output by about 2½ percent over five years. Put differently, structural reforms are estimated to add annually about ½ percent to potential growth over a five-year horizon. This is reflected in staff's baseline projections.

- The labor market reforms explain close to half of the total growth impact from structural reforms. The reduction of the labor tax wedge, the 2012 reform of unemployment benefits and revisions to employment protection, combined with moderate wage growth over the last few years, are estimated to boost potential output by 1.1 percent over five years.

**Table 1. Benchmarking the Impact of Structural Reforms over the Medium Term**
(Impact on the level of potential GDP after 5 years, percent)

| | Potential output |
|---|---|
| Product market reforms | 0.4 |
| The market unity law (Dec 2013) 1/ | 0.2 |
| The retail reform (2012) 1/ | 0.2 |
| Labour market reforms | 1.1 |
| The 2012 reform of unemployment benefits 1/ | 0.3 |
| The EPL reduction | 0.3 |
| The labor tax wedge reduction | 0.5 |
| The 2013 pension reform 1/ | 0.2 |
| The reducion of the share of direct taxation | 0.7 |
| Total GDP Impact | 2.4 |

Sources: EC (2016), OECD and IMF staff calculations.
1/ Impact based on estimates in European Commission (2016), Box 2.5.1 "Potential macroeconomic impact of structural reforms" in Country Report Spain, 2016. For other reforms, the impact is derived using empirically estimated productivity and employment elasticities (Kastrop, 2015, "Assessing the impact of structural reforms", Presentation at the Public Finance Dialogue, 8 September 2015.).

- Efforts to make the tax system more growth-friendly by increasing its reliance on indirect taxation, and pension reforms are estimated to boost output by close to 1 percent over the medium term.

- Productivity enhancing reforms (the 2013 approved Market Unity Law and the 2012 retail trade sector reforms) are projected so far to raise potential output by about 0.4 percent in the medium term.

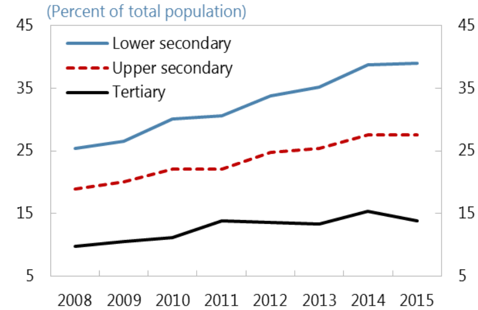
[1] The impact estimates use oil price elasticities from the Bank of Spain (Annual Report, 2015), and the authorities' REMS model for the effect of lower long-term interest rates (Ministry of Economy and Competitiveness, 2016).

## Box 2. Inequality and Poverty in the Aftermath of the Crisis

*Income inequality and risks of poverty or social exclusion increased markedly with the global financial crisis on the back of a dramatic fall in employment, which affected young, unskilled, and temporary workers disproportionally. Measures to address duality and increase the employability of long-term and young unemployed are a policy priority to reduce risks of social exclusion among vulnerable groups.*

**The swift job creation since 2014-15 has started to dent the rising risks of poverty and social exclusion.** But the benefit of the recovery has been uneven across generations and levels of education. Especially the employment of the young und low-skilled workers has lagged behind, making policies that improve their employability a priority.

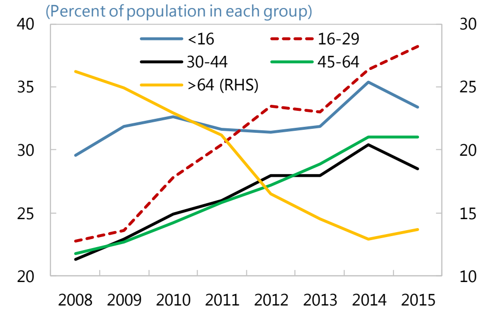
**Risk of Poverty and Social Exclusion by Education Level**
(Percent of total population)




Source: INE, Living Conditions Survey.

**As a result of the crisis, social indicators deteriorated sharply.** The number of people at risk of poverty or social exclusion increased by more than 23 percent between 2007 and 2015 in Spain. Low-skilled workers, youth, and immigrants have been particularly vulnerable. At the same time, income inequality also deteriorated markedly, with the Gini coefficient rising by 2¾ points during this period. Spain now exhibits the third highest income quintile share ratio in the EU, with the top 20 percent of the population earning almost 7½ times as much income as the bottom 20 percent.

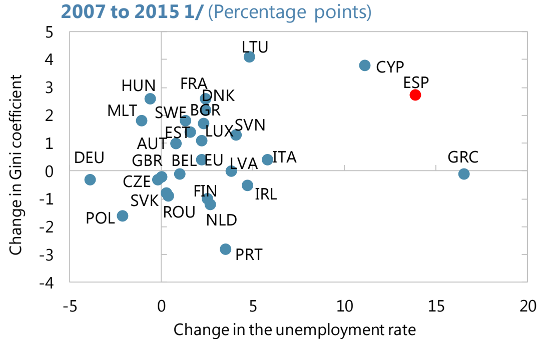
**Risk of Poverty and Social Exclusion Rate by Age Group**
(Percent of population in each group)




Source: INE, Living Conditions Survey.

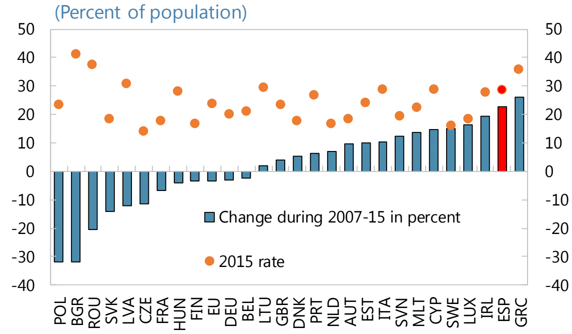
**The rise in inequality and poverty rates largely reflects the impact of the crisis on the labor market.** Employment fell by almost 20 percent between 2008 and mid-2013. Job losses affected disproportionally low-educated /low wage workers, youth, and immigrants, particularly working in the construction sector under temporary contracts. Moreover, unemployment spells of these groups have increased substantially, increasing the risks of social exclusion. At the same time, wage dispersion has risen, correcting in part the pre-crisis misallocation of resources to low productivity sectors and consequent wage inflation, including in the oversized construction sector, and in part reflecting the dual labor market. However, estimates suggest that the dominant effect on income inequality has been from the drop in employment (Bonhomme and Hospido, 2012; OECD, 2015).[1]

**Changes in Unemployment Rate and Gini Coefficient, 2007 to 2015 1/** (Percentage points)




Sources: Eurostat and IMF staff calculations.
1/ For Ireland, the 2014 Gini coefficient is used.

**Risk of Poverty and Social Exclusion Rate 1/**
(Percent of population)



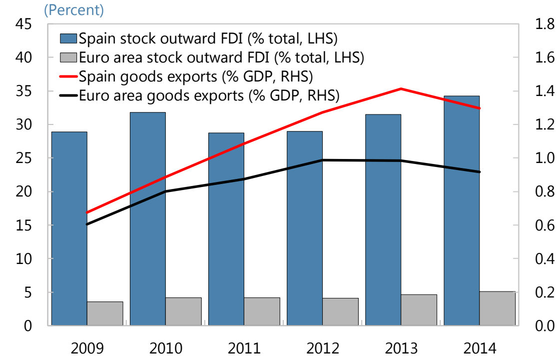

Sources: Eurostat and IMF staff calculations.
1/ For Ireland, the 2014 poverty risk rate is used.

[1] OECD (2015) *In It Together. Why Less Equality Benefits All*. Bonhomme, S. and L. Hospido (2012) "The Cycle of Earning Inequality: Evidence from Spanish Social Security Data," Working Paper 1225, Banco de España.

## Box 3. Spain: Spillovers from Latin America

**Potential spillovers from direct financial ties could be more relevant than the trade channel.** Spain's trade exposure to Latin America is small though growing. Exports of goods and services to this region represent 1¼ percent and ½ percent of Spanish GDP, respectively (average 2013–14) suggesting limited implications from growth deceleration. The exposure through FDI channels is larger, however. Latin America accounted for over a third of the outward FDI by Spanish firms (17 percent of outward FDI flows) in 2014. As a result, Spain's largest and publicly listed firms have a significant presence in the region, especially in Brazil and Mexico, which accounts for about one quarter of their total sales revenues. Thus, a prolonged recession and weak local currencies could harm some of these firms' profitability and their stock market prices. Meanwhile, FDI flows from Latin America to Spain have grown rapidly in recent years, but remain low in terms of FDI stocks (less than 5 percent of total FDI).

**Exposure to Latin America**
(Percent)

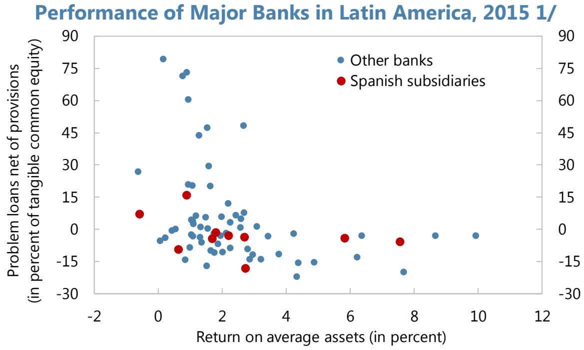



Sources: DOTS, CDIS, and IMF, *World Economic Outlook*.

**Spain's two largest and global banks maintain significant subsidiary operations in Latin America.** As of March 2016, they had about one-fifth of credit exposures to Latin America resulting in total claims of Spanish banks to the region of about 12 percent of total banking sector claims—a much higher share than other advanced economies' banking systems. In 2015, operations in Latin America accounted for 43 and 80 percent of group-wide profits (excluding centralized corporate operations) for the two Spanish global banks, respectively, contributing a higher return on assets than domestic-oriented banks. These banks operate with a subsidiary model primarily based on decentralized management and funded locally in domestic-currency.

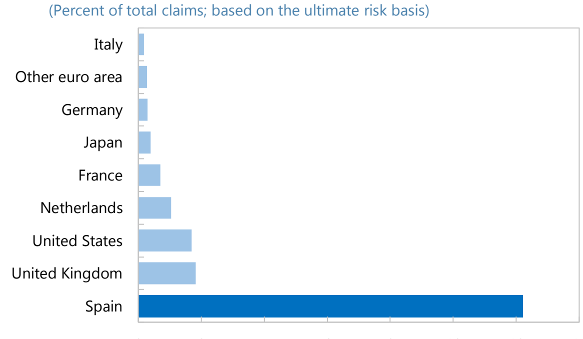
**Spanish subsidiaries appear to be in a solid position to deal with rising credit risk, but lower profits would weaken contributions to the parents' capital buffers.** So far, the adverse macroeconomic conditions, in particular in Argentina, Brazil and Venezuela, and asset quality deterioration have not yet significantly marked down profitability, although NPLs typically worsen with some lag. Spanish subsidiaries should be able to manage additional losses given their relatively strong profits and provisions. Their pre-impairment net income could potentially absorb about up to twice the current NPL level, but an increase in asset impairments could have a sizeable impact on group-wide profitability. For example, a 25 percent increase in the impairment of financial assets by subsidiaries could reduce the contribution of profits to group-wide capital by about 25 percent.

**Performance of Major Banks in Latin America, 2015 1/**




Sources: SNL; and IMF staff calculations.
1/ Based on a sample of largest banks in each Latin American economy, with total assets of at least €5 billions.

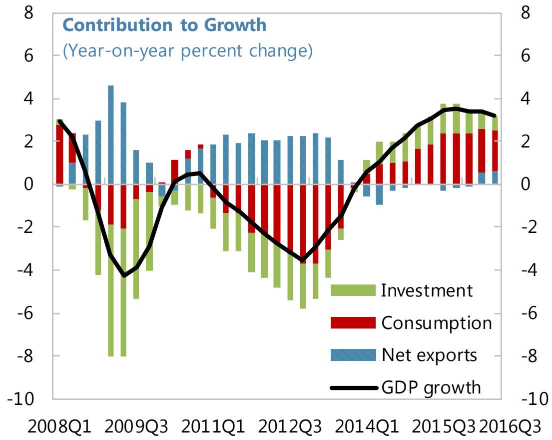
**Exposures to Latin America, March 2016**
(Percent of total claims; based on the ultimate risk basis)



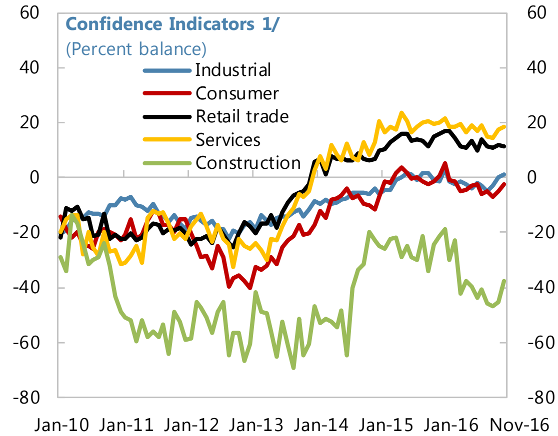

Sources: BIS, Consolidated Banking Statistics; and IMF staff calculations.

## Figure 1. Spain: Real Sector and Inflation

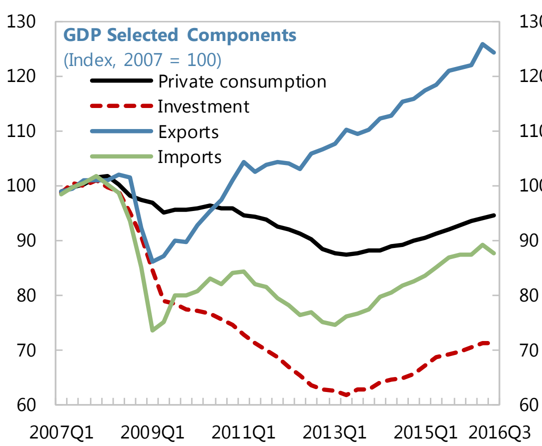
*The rebound in domestic demand remained the main driver of growth ...*



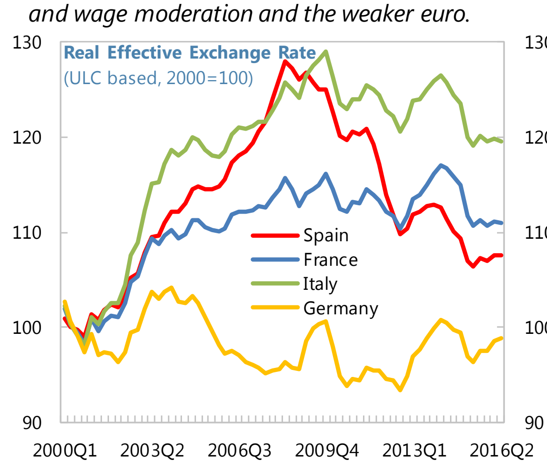

*... though confidence weakened amid prolonged uncertainty.*



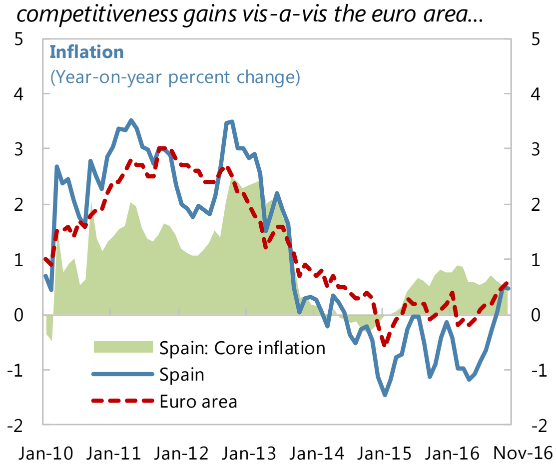

*Exports supported the recovery ...*



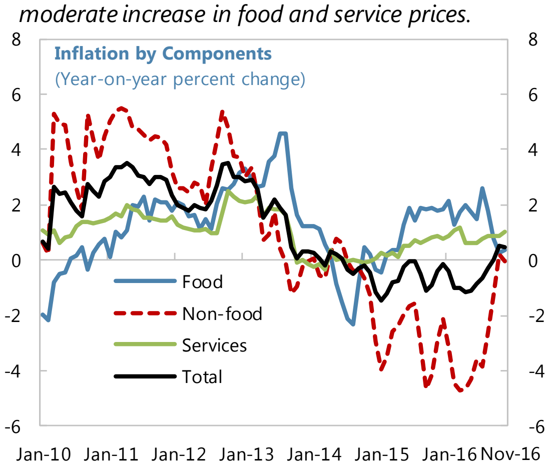

*...reflecting the regained competitiveness from price and wage moderation and the weaker euro.*




*Inflation stayed negative until recently, reflecting competitiveness gains vis-a-vis the euro area...*

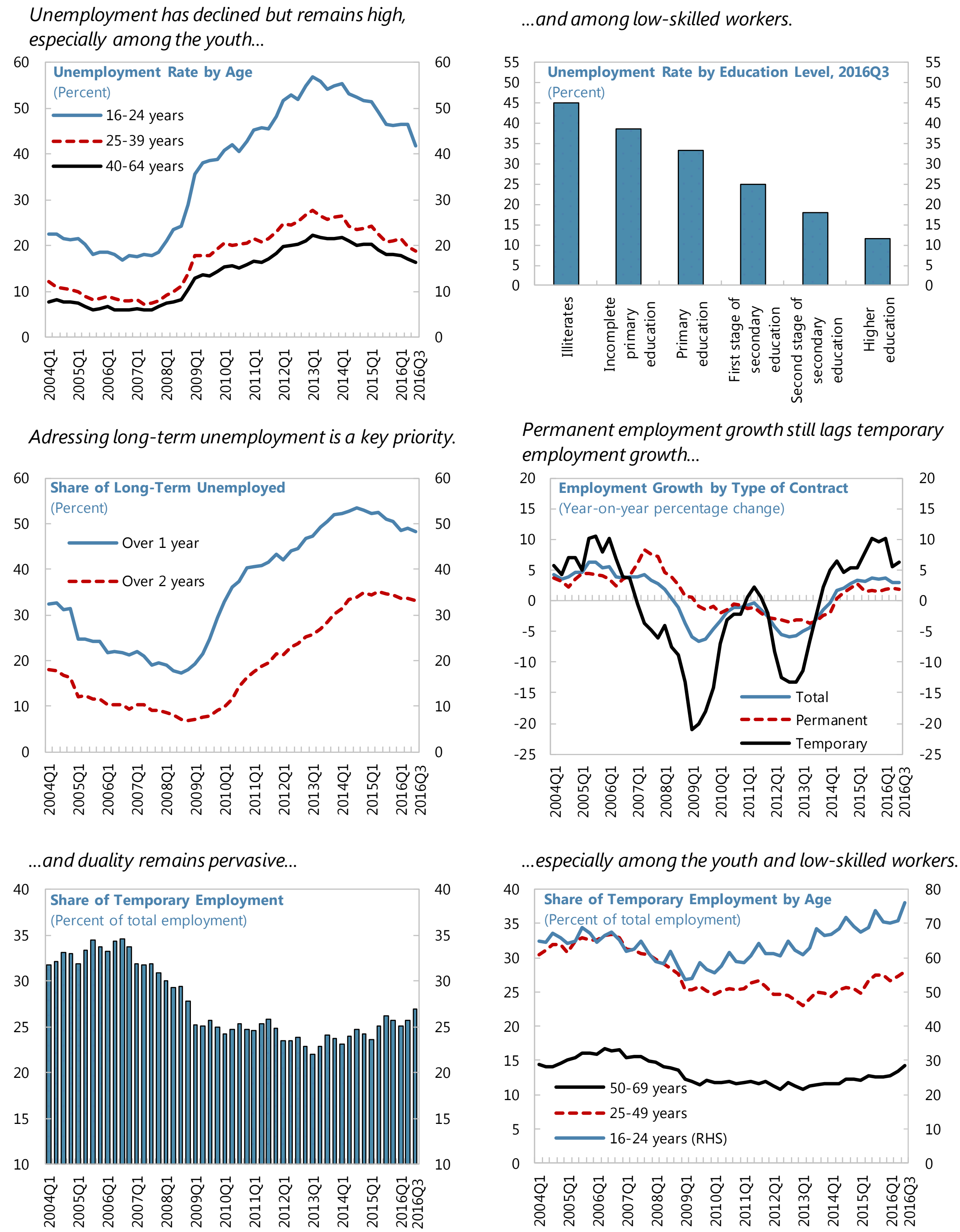



*...and lower oil prices, which more than offset the moderate increase in food and service prices.*




Sources: Bank of Spain; Eurostat; Haver Analytics; and IMF staff calculations.
1/ Confidence indicators: Percent balance equals percent of respondents reporting an increase minus the percent of respondents reporting a decrease.

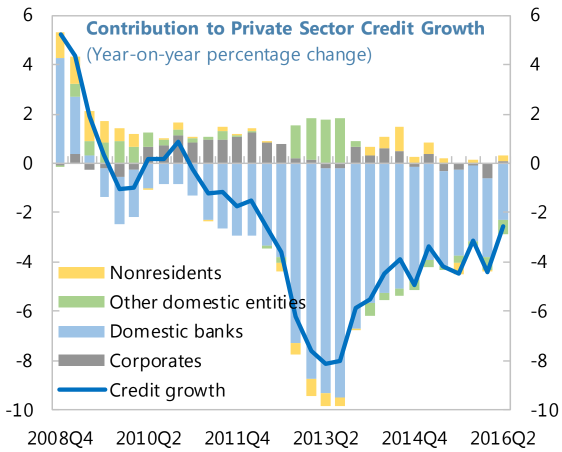
## Figure 2. Spain: Labor Market Developments



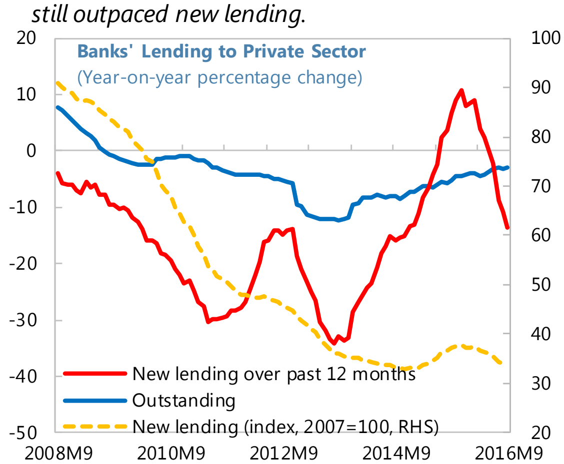

Sources: Eurostat, INE, Quarterly Labor Force Survey, Ministry of Employment and Social Security, and IMF staff calculations.

## Figure 3. Spain: Credit Development

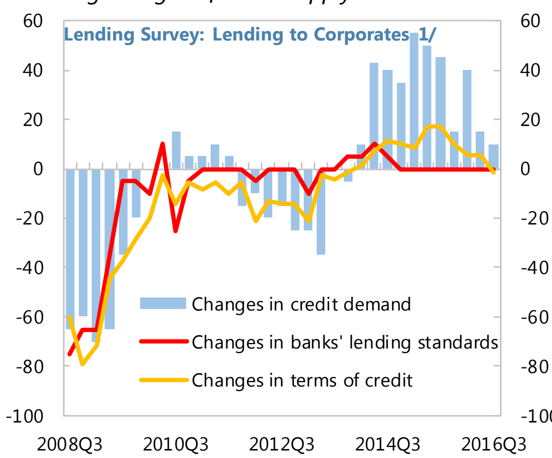
*Private sector deleveraging has continued.*



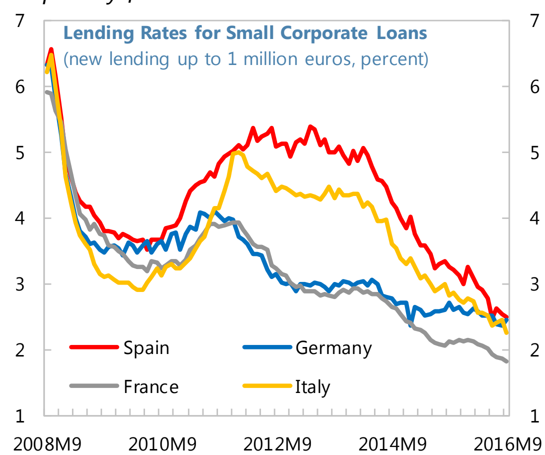

*Banks' lending has kept falling, as amortization has still outpaced new lending.*



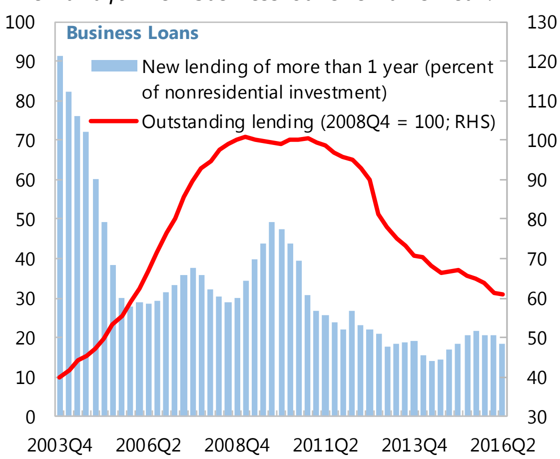

*Banks are competing for creditworthy borrowers, showing no signs of credit supply constraints.*



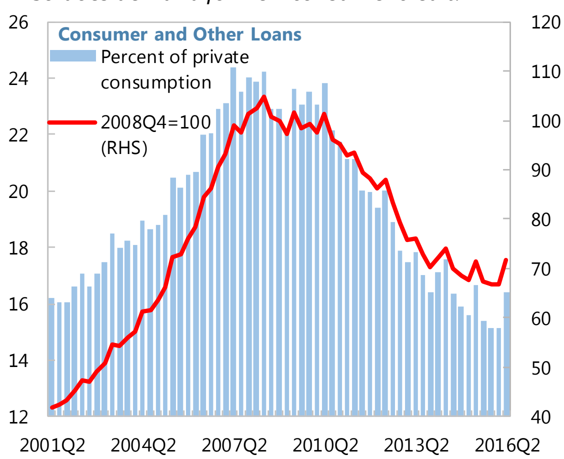

*Lending conditions have improved significantly, especially for SMEs.*




*Demand for new business loans remains weak.*



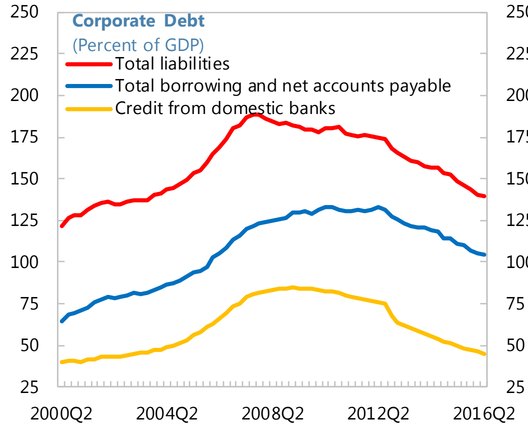

*So does demand for new consumer credit.*



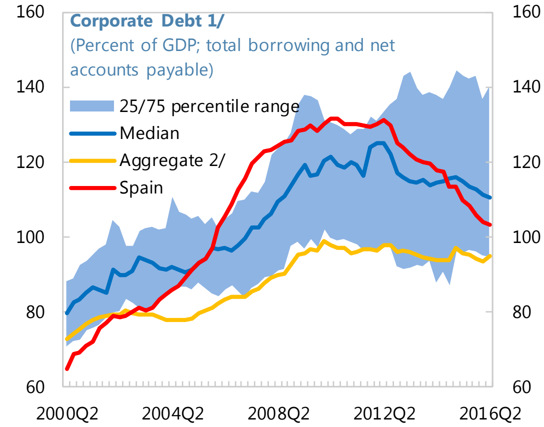

Sources: Bank of Spain; Eurostat; Haver Analytics; and IMF staff calculations.
1/ A positive value indicates changes consistent with credit expansion; and vice versa.

## Figure 4. Spain: Corporate Sector Deleveraging

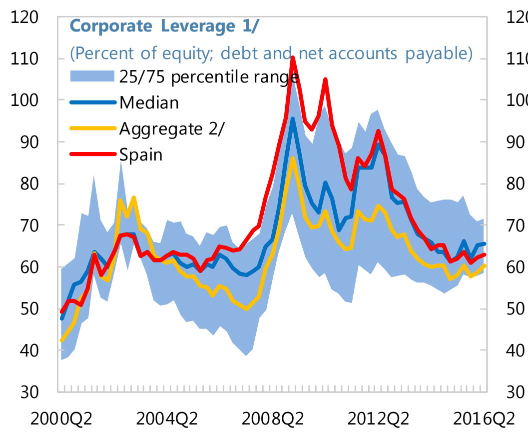
*Corporate debt has continued to fall.*



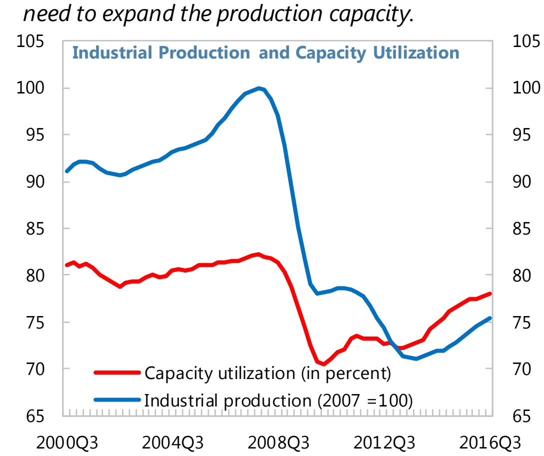

*Indebtedness thus has become more in line with European peers.*



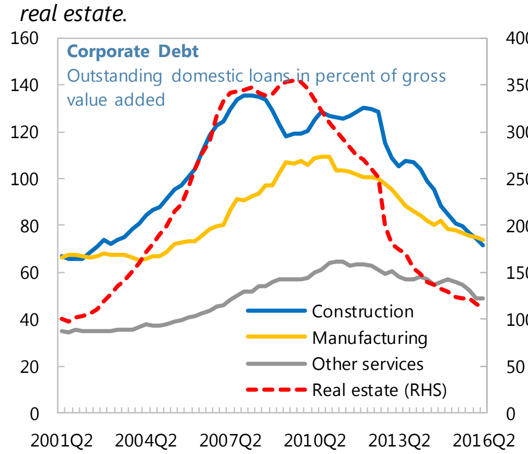

*Leverage has also come down to the EU-wide level.*



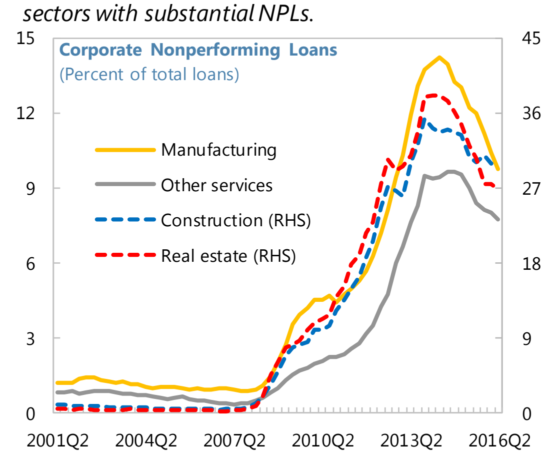

*Deleveraging has refected, in part, little financing need to expand the production capacity.*




*Debt remains high in some segments, such as real estate.*

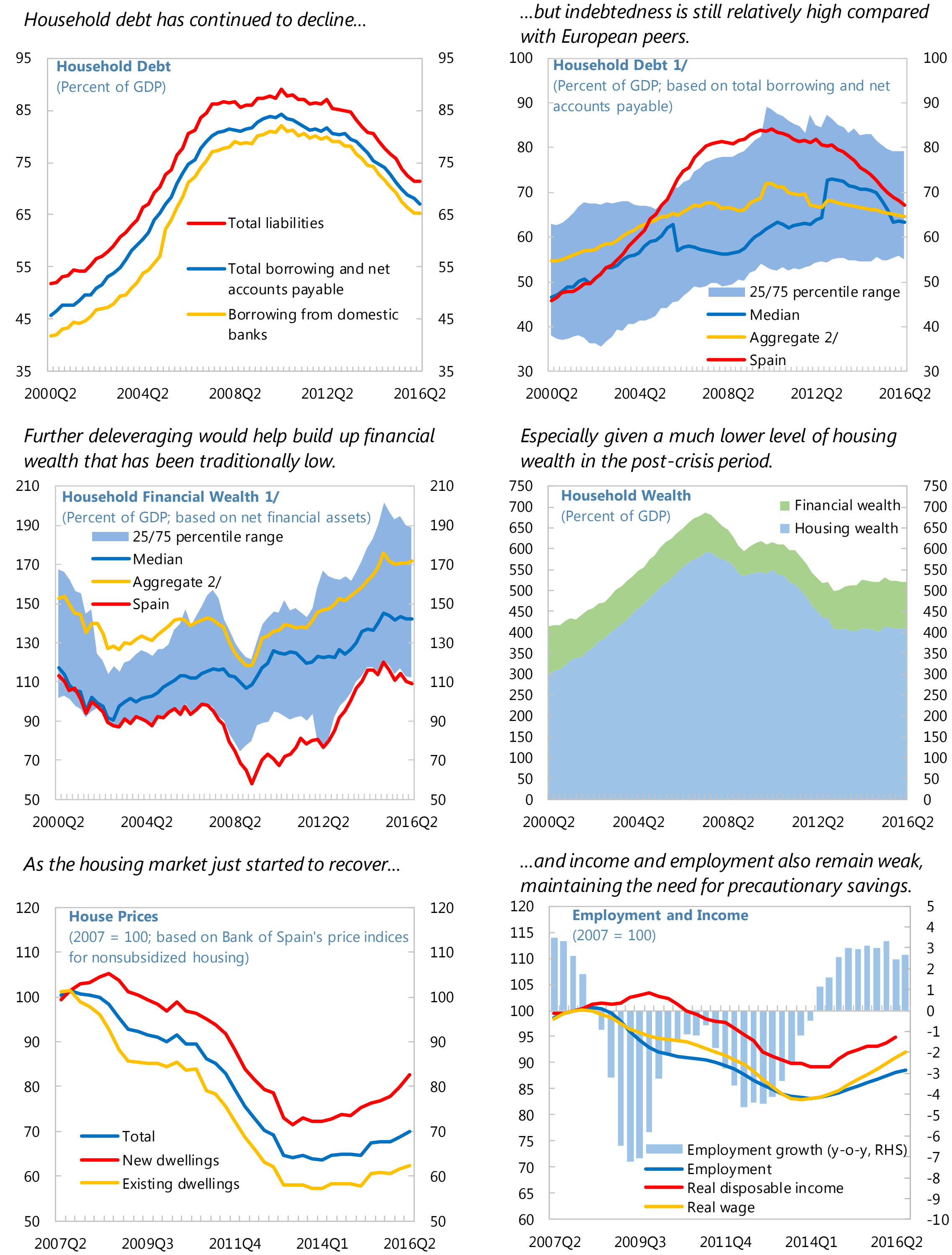



*Further deleveraging and restructuring are likely in sectors with substantial NPLs.*



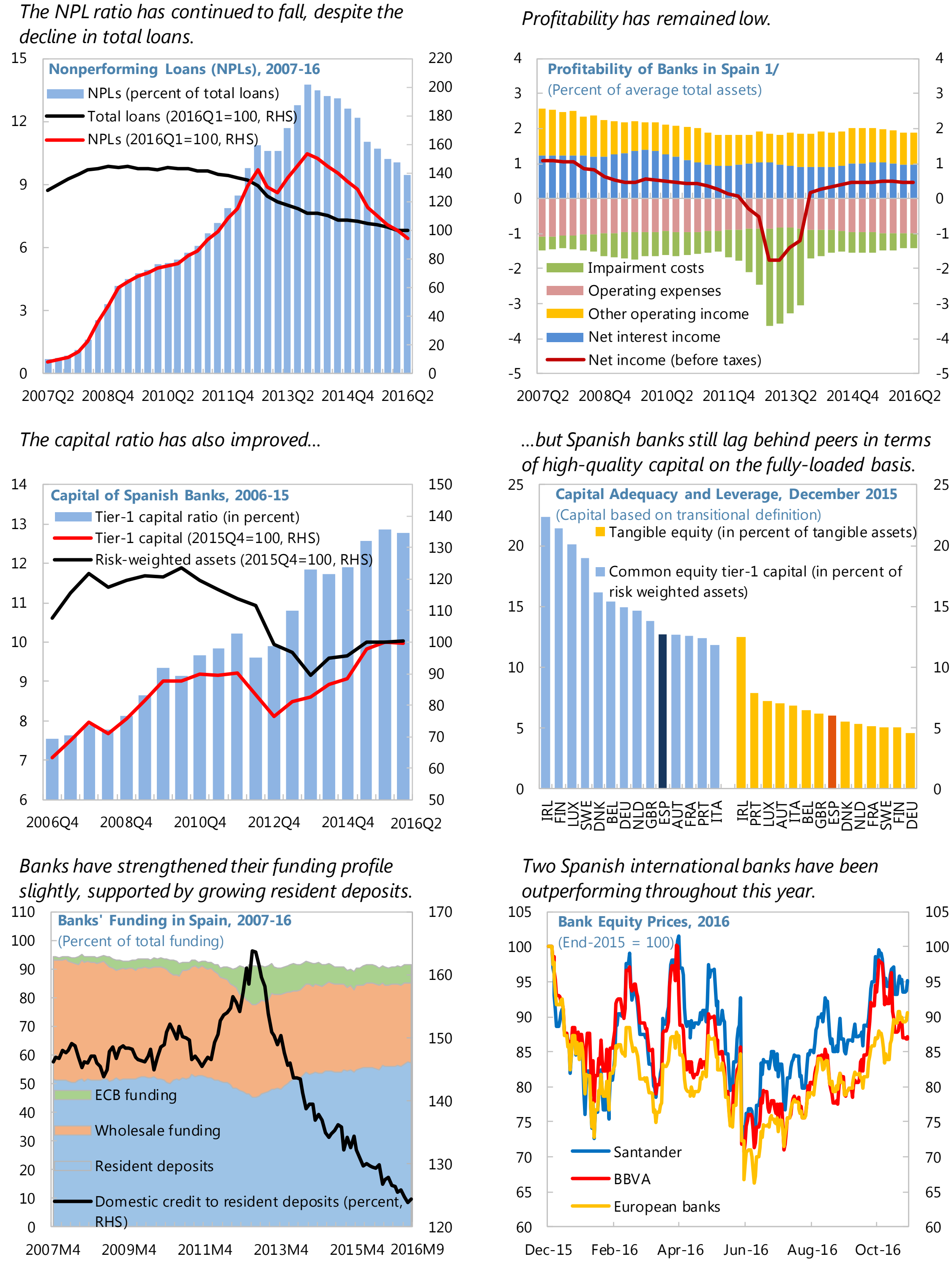

Sources: Bank of Spain; Eurostat; Haver Analytics; and IMF staff calculations.
1/ The peer group includes Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Sweden, and the United Kingdom -- all IMF's systemic (S29) economies in Europe. The fan chart may not necessarily cover all countries for every period due to missing data.
2/ Based on aggregated debt, equity and GDP of relevant economies.

## Figure 5. Spain: Household Deleveraging




Sources: Bank of Spain; Eurostat; Haver Analytics; and IMF staff calculations.
1/ The peer group includes Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Sweden, and the United Kingdom -- all IMF's systemic (S29) economies in Europe. The fan chart may not necessarily cover all countries for every period due to missing data.
2/ Based on aggregated debt, wealth and GDP of relevant economies.

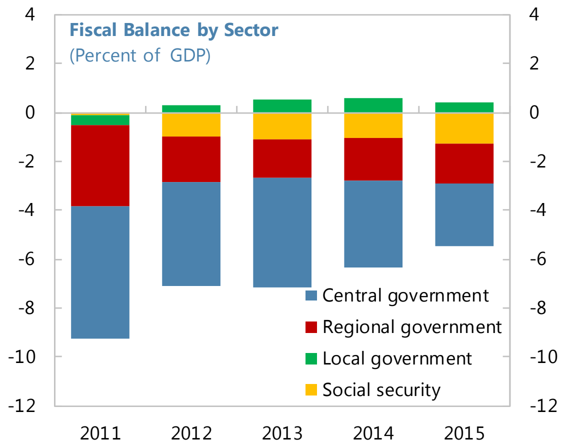
## Figure 6. Spain: Banking Sector Indicators



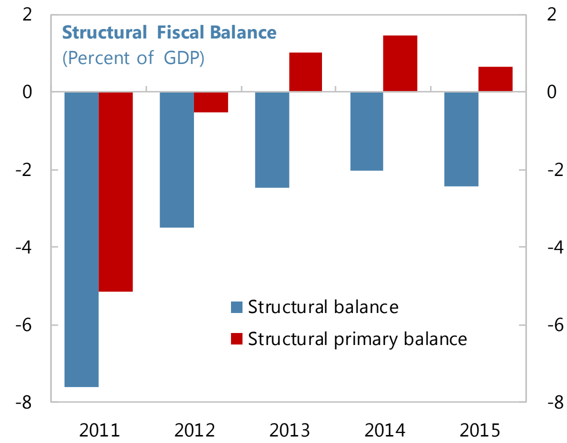

Sources: Bank of Spain; Bloomberg; EBA, 2015 Transparency Exercise; IMF, International Financial Statistics, and Financial Soundness Indicators database; and IMF staff calculations.
1/For banking business in Spain, the aggregate figure of net income in 2011 and 2012 is amplified by the segregation process of savings banks' business to newly-created banks. See Bank of Spain's *Statistical Bulletin* (2012) for more details.

## Figure 7. Spain: Public Finances

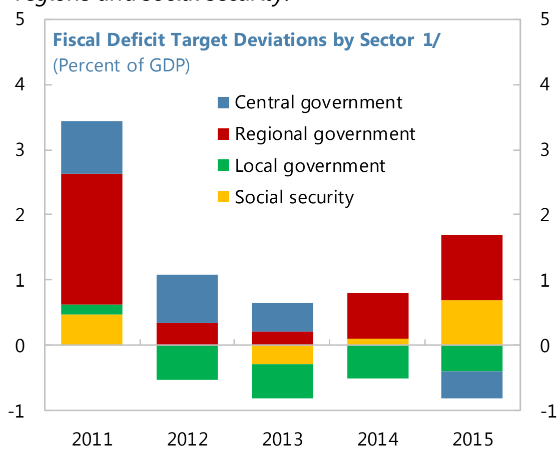
*Fiscal consolidation stopped in 2015…*



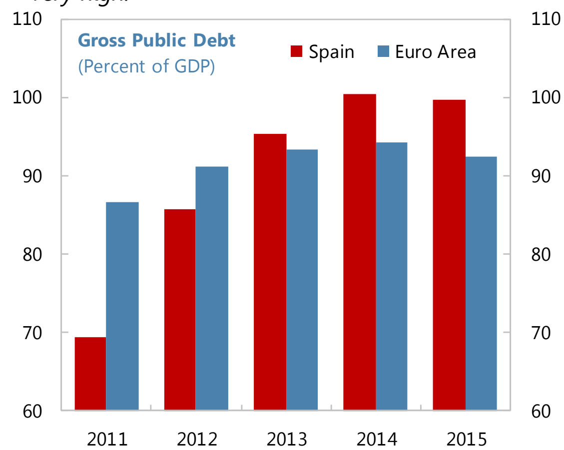

*…with fiscal policy relaxing significantly in structural terms…*



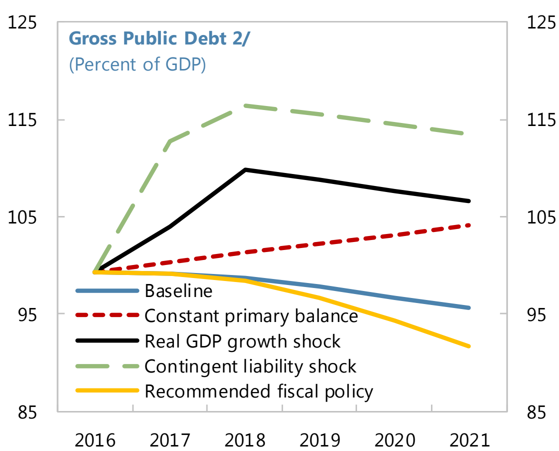

*… with deviations from targets coming from the regions and social security.*



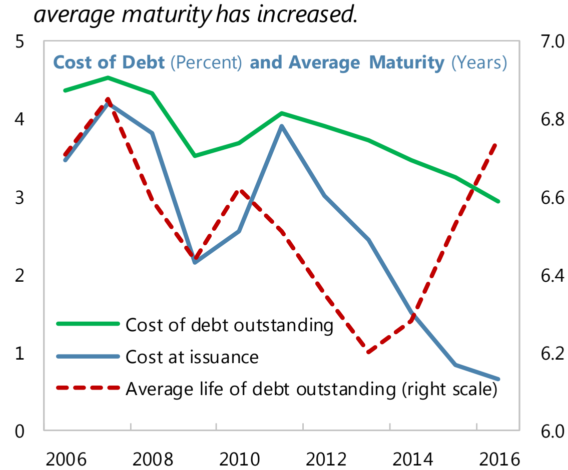

*Public debt, at near 100 percent of GDP, remains very high.*




*Risks to public debt sustainability remain sizable.*

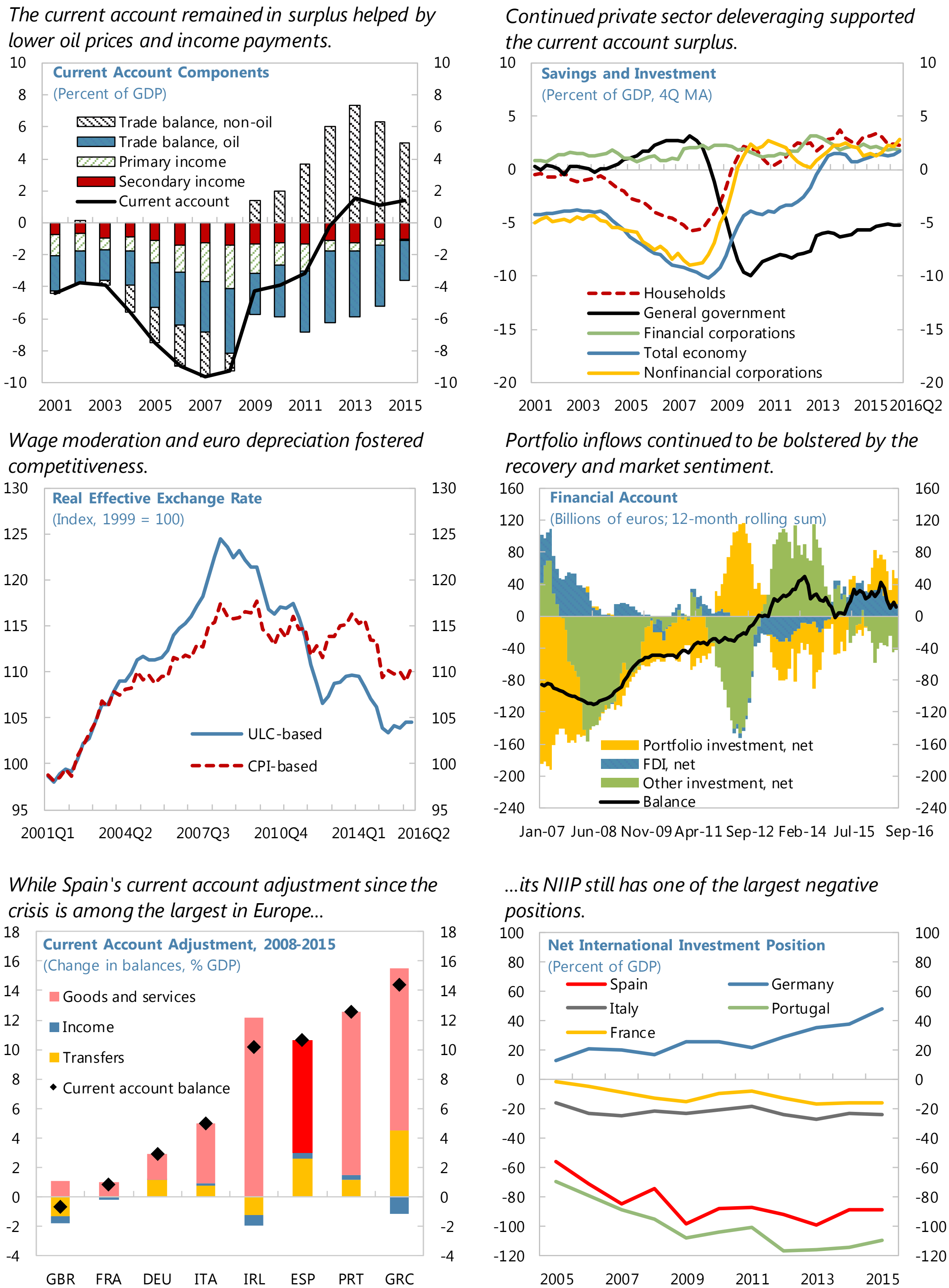



*The cost of debt has continued to decline while average maturity has increased.*




Sources: Bank of Spain; Spain Ministry of Finance; and IMF staff estimates.
1/ A positive deviation indicates a higher-than-targeted fiscal deficit.
2/ For more details, see Debt Sustainability Analysis in Appendix III.

## Figure 8. Spain: External Developments and Issues

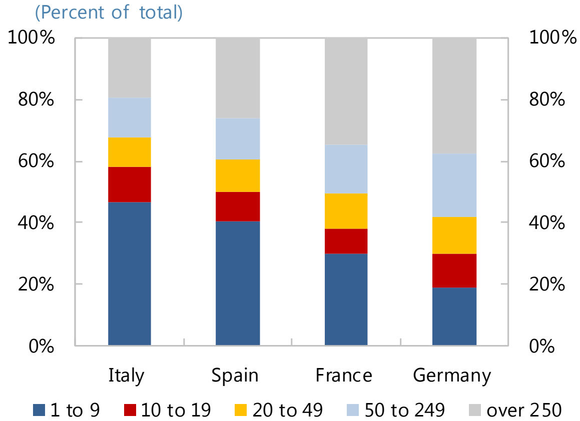



Sources: Bank of Spain; Eurostat; Haver; WEO; and IMF staff calculations.

## Figure 9. Spain: Structural Impediments

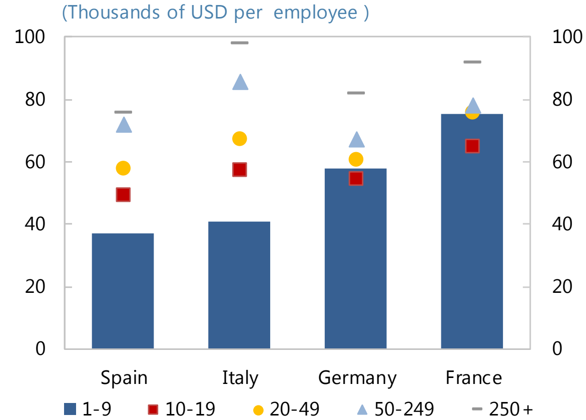
*Spanish firms are smaller and ...*

**Distribution of Firms by Number of Employees, 2012**
(Percent of total)



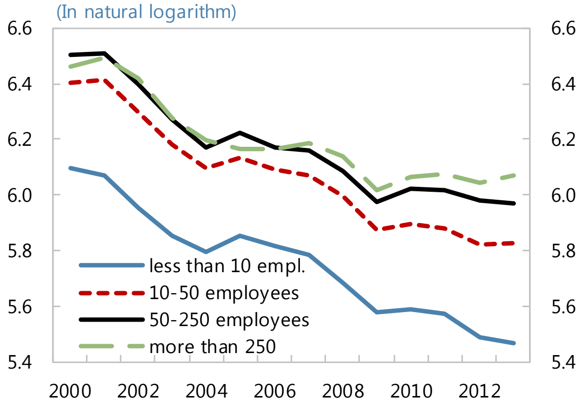

*... less productive than their European peers.*

**Productivity Level by Enterprise Size Class, 2011**
(Thousands of USD per employee )



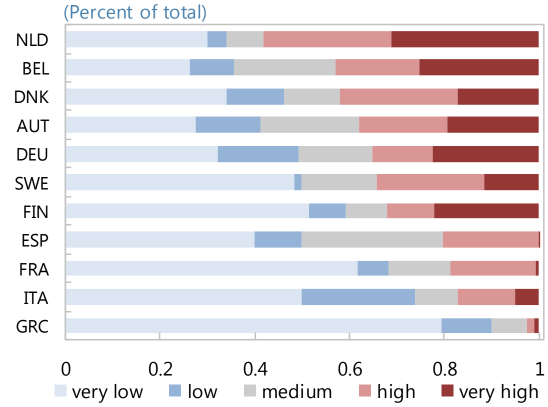

*Firm TFP level has been declining since 2000s, with smaller firms yet to reverse the decline...*

**Firm TFP by Firm Size**
(In natural logarithm)



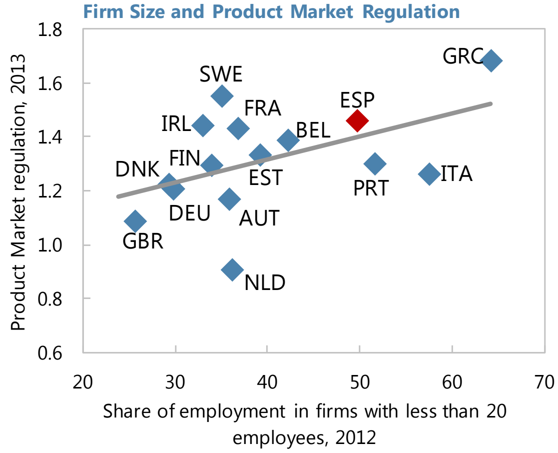

*with SMEs export intensity particularly low compared to their peers.*

**Number of SMEs by Levels of Export Intensity**
(Percent of total)



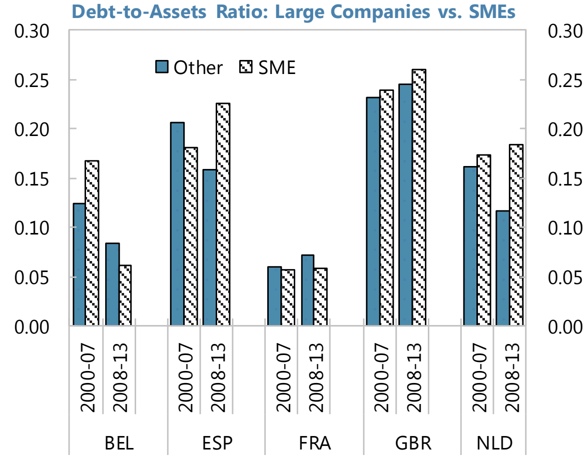

*Policy and firm-specific factors, including regulatory barriers, constrain TFP growth.*

**Firm Size and Product Market Regulation**




*Relatively high debt-to-asset ratio constrains access to finance, weighing on TFP growth.*

**Debt-to-Assets Ratio: Large Companies vs. SMEs**




Sources: EC, ORBIS, OECD, INE and IMF staff calculations.

## Table 1. Main Economic Indicators, 2012–21

(Percent change unless otherwise indicated)

| | | | | | Projections | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 |
| Demand and supply in constant prices | | | | | | | | | | |
| Gross domestic product | -2.9 | -1.7 | 1.4 | 3.2 | 3.2 | 2.3 | 2.1 | 2.0 | 1.9 | 1.7 |
| Private consumption | -3.5 | -3.1 | 1.6 | 2.9 | 3.0 | 2.4 | 2.1 | 2.1 | 1.9 | 1.7 |
| Public consumption | -4.7 | -2.1 | -0.3 | 2.0 | 1.3 | 1.2 | 0.9 | 0.7 | 0.6 | 0.4 |
| Gross fixed investment | -8.6 | -3.4 | 3.8 | 6.0 | 3.6 | 3.2 | 2.7 | 2.5 | 2.5 | 2.4 |
| Total domestic demand | -5.1 | -3.2 | 1.9 | 3.4 | 2.9 | 2.3 | 2.0 | 1.9 | 1.8 | 1.6 |
| Net exports (contribution to growth) | 2.2 | 1.5 | -0.5 | -0.1 | 0.4 | 0.1 | 0.1 | 0.2 | 0.2 | 0.2 |
| Exports of goods and services | 1.1 | 4.3 | 4.2 | 4.9 | 4.2 | 4.2 | 4.2 | 4.2 | 4.1 | 4.0 |
| Imports of goods and services | -6.4 | -0.5 | 6.5 | 5.6 | 3.2 | 4.2 | 4.1 | 4.1 | 3.9 | 3.9 |
| Savings-Investment Balance (percent of GDP) | | | | | | | | | | |
| Gross domestic investment | 20.0 | 18.7 | 19.4 | 20.1 | 20.4 | 20.6 | 20.7 | 20.7 | 20.8 | 20.9 |
| Private | 17.5 | 16.5 | 17.2 | 17.5 | 18.2 | 18.5 | 18.6 | 18.7 | 18.7 | 18.9 |
| Public | 2.5 | 2.2 | 2.2 | 2.5 | 2.2 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 |
| National savings | 19.8 | 20.2 | 20.5 | 21.4 | 22.3 | 22.3 | 22.5 | 22.7 | 22.8 | 22.9 |
| Private | 23.4 | 24.3 | 24.0 | 24.0 | 24.6 | 23.5 | 23.2 | 22.9 | 22.9 | 22.9 |
| Public | -3.7 | -4.0 | -3.5 | -2.6 | -2.3 | -1.2 | -0.7 | -0.3 | -0.1 | 0.1 |
| Foreign savings | 0.2 | -1.5 | -1.1 | -1.4 | -2.0 | -1.8 | -1.8 | -1.9 | -2.0 | -2.0 |
| Household saving rate (percent of gross disposable income) | 8.5 | 9.6 | 9.0 | 8.2 | 9.8 | 9.9 | 10.0 | 10.2 | 10.3 | 10.3 |
| Private sector debt (percent of GDP) 1/ | 266.7 | 254.4 | 240.7 | 228.5 | 220.3 | 215.4 | 210.7 | 205.9 | 201.3 | 197.0 |
| Corporate debt | 180.0 | 171.8 | 162.6 | 156.0 | 150.2 | 147.0 | 143.8 | 140.6 | 137.4 | 134.8 |
| Household debt | 86.7 | 82.6 | 78.1 | 72.5 | 70.2 | 68.4 | 66.9 | 65.4 | 63.9 | 62.2 |
| Credit to private sector | -9.9 | -10.2 | -6.5 | -4.2 | -0.5 | 0.8 | 1.0 | 1.1 | 1.2 | 1.3 |
| Potential output growth | 0.2 | 0.0 | 0.3 | 0.7 | 1.0 | 1.2 | 1.4 | 1.5 | 1.5 | 1.5 |
| Output gap (percent of potential) | -6.1 | -7.8 | -6.8 | -4.5 | -2.4 | -1.3 | -0.6 | -0.1 | 0.3 | 0.5 |
| Prices | | | | | | | | | | |
| GDP deflator | 0.1 | 0.4 | -0.3 | 0.5 | 0.7 | 1.0 | 1.2 | 1.4 | 1.5 | 1.6 |
| HICP (average) | 2.4 | 1.5 | -0.2 | -0.6 | -0.4 | 1.2 | 1.3 | 1.4 | 1.6 | 1.7 |
| HICP (end of period) | 3.0 | 0.3 | -1.1 | -0.1 | 0.7 | 0.9 | 1.2 | 1.4 | 1.6 | 1.7 |
| Employment and wages | | | | | | | | | | |
| Unemployment rate (percent) | 24.8 | 26.1 | 24.4 | 22.1 | 19.4 | 17.9 | 17.0 | 16.1 | 15.6 | 15.3 |
| Labor productivity 2/ | 2.0 | 1.8 | 0.3 | 0.2 | 0.2 | 0.3 | 1.0 | 0.9 | 0.9 | 0.8 |
| Labor costs, private sector | 1.1 | 0.2 | 0.2 | 0.2 | 0.5 | 1.1 | 1.2 | 1.3 | 1.3 | 1.4 |
| Employment growth | -4.3 | -2.8 | 1.2 | 3.0 | 2.9 | 2.0 | 1.1 | 1.2 | 1.0 | 0.9 |
| Labor force growth | 0.0 | -1.1 | -1.0 | -0.1 | -0.5 | 0.1 | 0.0 | 0.2 | 0.4 | 0.5 |
| Balance of payments (percent of GDP) | | | | | | | | | | |
| Trade balance (goods and services) | 1.5 | 3.3 | 2.5 | 2.4 | 2.9 | 2.7 | 2.8 | 2.9 | 3.0 | 3.1 |
| Current account balance | -0.2 | 1.5 | 1.1 | 1.4 | 2.0 | 1.8 | 1.8 | 1.9 | 2.0 | 2.0 |
| Net international investment position | -89.9 | -94.3 | -97.5 | -89.9 | -83.9 | -78.7 | -73.7 | -68.6 | -63.7 | -59.0 |
| Public finance (percent of GDP) | | | | | | | | | | |
| General government balance 3/ | -6.8 | -6.7 | -5.9 | -5.1 | -4.3 | -3.2 | -2.7 | -2.3 | -2.1 | -2.0 |
| Primary balance | -8.0 | -4.1 | -3.0 | -2.4 | -2.1 | -0.9 | -0.5 | -0.2 | -0.1 | 0.1 |
| Structural balance | -3.5 | -2.5 | -2.0 | -2.4 | -3.0 | -2.6 | -2.4 | -2.3 | -2.3 | -2.3 |
| Primary structural balance | -0.5 | 1.0 | 1.5 | 0.6 | -0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 |
| General government debt | 85.7 | 95.4 | 100.4 | 99.8 | 99.2 | 99.2 | 98.7 | 97.8 | 96.7 | 95.6 |

Sources: IMF, World Economic Outlook; data provided by the authorities; and IMF staff estimates.

1/ 2014-15 values are IMF staff estimates.

2/ Output per worker.

3/ The headline deficit for Spain excludes financial sector support measures equal to 3.7 percent of GDP for 2012, 0.3 percent of GDP for 2013, 0.1 percent of GDP for 2014, 0.05 percent of GDP for 2015, and 0.2 percent of GDP for 2016.

## Table 2a. General Government Operations, 2012–21 1/

(Billions of euros, unless otherwise indicated)

| | | | | | Projections | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 |
| Revenue | 391.2 | 395.6 | 403.4 | 415.5 | 425.4 | 442.4 | 456.4 | 470.7 | 487.0 | 502.7 |
| Taxes | 220.9 | 227.2 | 232.3 | 243.7 | 247.3 | 259.7 | 268.9 | 278.8 | 288.5 | 298.4 |
| Indirect taxes | 108.6 | 115.0 | 119.6 | 127.6 | 131.3 | 136.8 | 141.5 | 146.6 | 151.7 | 156.6 |
| o.w. VAT | 57.6 | 62.1 | 64.9 | 70.0 | 72.0 | 74.6 | 77.2 | 80.0 | 82.7 | 85.5 |
| o.w. Excise | 32.2 | 33.8 | 34.6 | 36.7 | 37.8 | 39.7 | 41.1 | 42.6 | 44.1 | 45.4 |
| Direct taxes | 108.5 | 107.1 | 107.0 | 109.8 | 109.5 | 116.1 | 120.3 | 125.0 | 129.4 | 134.0 |
| o.w. Private households | 79.7 | 83.1 | 84.5 | 84.0 | 84.3 | 87.1 | 89.8 | 92.7 | 95.4 | 98.3 |
| o.w. Corporate | 22.2 | 21.9 | 20.9 | 25.5 | 24.9 | 28.7 | 30.3 | 32.0 | 33.6 | 35.4 |
| Capital tax | 3.9 | 5.1 | 5.7 | 6.4 | 6.6 | 6.8 | 7.0 | 7.3 | 7.5 | 7.8 |
| Social contributions | 131.9 | 128.2 | 130.1 | 132.3 | 136.2 | 139.5 | 142.8 | 145.6 | 150.7 | 155.0 |
| Other revenue | 38.4 | 40.2 | 41.0 | 39.6 | 41.8 | 43.3 | 44.7 | 46.3 | 47.7 | 49.3 |
| Expenditure | 500.1 | 467.5 | 465.6 | 470.7 | 475.1 | 480.0 | 489.2 | 499.7 | 514.5 | 529.5 |
| Expense | 499.4 | 466.9 | 464.8 | 471.4 | 474.2 | 479.0 | 488.2 | 498.7 | 513.5 | 528.6 |
| Compensation of employees | 113.9 | 114.7 | 115.2 | 119.1 | 122.3 | 123.1 | 126.0 | 129.3 | 132.5 | 135.6 |
| Use of goods and services | 58.6 | 54.7 | 55.1 | 57.1 | 57.4 | 56.6 | 57.7 | 58.8 | 61.0 | 62.2 |
| Consumption of fixed capital | 25.2 | 22.5 | 21.5 | 27.7 | 23.5 | 23.2 | 24.0 | 24.9 | 25.8 | 26.7 |
| Interest | 30.9 | 35.6 | 36.0 | 33.2 | 30.9 | 31.4 | 30.8 | 30.8 | 31.6 | 33.2 |
| Social benefits | 197.0 | 199.0 | 198.7 | 198.8 | 202.6 | 206.6 | 211.2 | 216.3 | 223.4 | 231.1 |
| Other expense | 73.7 | 40.4 | 38.2 | 35.4 | 37.4 | 38.1 | 38.6 | 38.6 | 39.2 | 39.8 |
| Subsidies | 10.0 | 10.9 | 11.4 | 12.5 | 12.4 | 12.3 | 12.5 | 12.5 | 12.5 | 12.5 |
| Other | 63.7 | 29.5 | 26.8 | 23.0 | 25.0 | 25.8 | 26.1 | 26.1 | 26.7 | 27.3 |
| o.w. financial sector support | 38.3 | 3.3 | 1.4 | 0.5 | 2.2 | … | … | … | … | … |
| Net acquisition of nonfinancial assets | 0.7 | 0.6 | 0.8 | -0.7 | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 |
| Gross fixed capital investment | 25.9 | 23.1 | 22.3 | 27.0 | 24.4 | 24.2 | 25.0 | 25.9 | 26.7 | 27.6 |
| Consumption of fixed capital | 25.2 | 22.5 | 21.5 | 27.7 | 23.5 | 23.2 | 24.0 | 24.9 | 25.8 | 26.7 |
| Other non financial assets | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Gross operating balance | -108.2 | -71.3 | -61.4 | -55.8 | -48.8 | -36.6 | -31.8 | -28.0 | -26.5 | -25.8 |
| Net lending / borrowing | -108.9 | -71.9 | -62.2 | -55.2 | -49.7 | -37.5 | -32.8 | -29.0 | -27.5 | -26.8 |
| Net lending / borrowing (excluding financial sector support) | -70.6 | -68.6 | -60.8 | -54.6 | -47.5 | -37.5 | -32.8 | -29.0 | -27.5 | -26.8 |
| *Memorandum items:* | | | | | | | | | | |
| Nominal GDP | 1,039.8 | 1,025.6 | 1,037.0 | 1,075.6 | 1,117.8 | 1,156.0 | 1,194.7 | 1,236.2 | 1,278.6 | 1,320.9 |

Sources: Ministry of Finance; Eurostat; and IMF staff estimates and projections.
1/ Compiled using accrual basis and ESA10 manual, consistent with Eurostat dataset.

## Table 2b. General Government Operations, 2012–21 1/
(Percent of GDP, unless otherwise noted)

| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | Projections | | | | | |
| Revenue | 37.6 | 38.6 | 38.9 | 38.6 | 38.1 | 38.3 | 38.2 | 38.1 | 38.1 | 38.1 |
| Taxes | 21.2 | 22.2 | 22.4 | 22.7 | 22.1 | 22.5 | 22.5 | 22.6 | 22.6 | 22.6 |
| Indirect taxes | 10.4 | 11.2 | 11.5 | 11.9 | 11.7 | 11.8 | 11.8 | 11.9 | 11.9 | 11.9 |
| o.w. VAT | 5.5 | 6.1 | 6.3 | 6.5 | 6.4 | 6.5 | 6.5 | 6.5 | 6.5 | 6.5 |
| o.w. Excise | 3.1 | 3.3 | 3.3 | 3.4 | 3.4 | 3.4 | 3.4 | 3.4 | 3.4 | 3.4 |
| Direct taxes | 10.4 | 10.4 | 10.3 | 10.2 | 9.8 | 10.0 | 10.1 | 10.1 | 10.1 | 10.1 |
| o.w. Private households | 7.7 | 8.1 | 8.1 | 7.8 | 7.5 | 7.5 | 7.5 | 7.5 | 7.5 | 7.4 |
| o.w. Corporate | 2.1 | 2.1 | 2.0 | 2.4 | 2.2 | 2.5 | 2.5 | 2.6 | 2.6 | 2.7 |
| Capital tax | 0.4 | 0.5 | 0.5 | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 |
| Social contributions | 12.7 | 12.5 | 12.5 | 12.3 | 12.2 | 12.1 | 12.0 | 11.8 | 11.8 | 11.7 |
| Other revenue | 3.7 | 3.9 | 4.0 | 3.7 | 3.7 | 3.7 | 3.7 | 3.7 | 3.7 | 3.7 |
| Expenditure | 48.1 | 45.6 | 44.9 | 43.8 | 42.5 | 41.5 | 40.9 | 40.4 | 40.2 | 40.1 |
| Expense | 48.0 | 45.5 | 44.8 | 43.8 | 42.4 | 41.4 | 40.9 | 40.3 | 40.2 | 40.0 |
| Compensation of employees | 11.0 | 11.2 | 11.1 | 11.1 | 10.9 | 10.6 | 10.5 | 10.5 | 10.4 | 10.3 |
| Use of goods and services | 5.6 | 5.3 | 5.3 | 5.3 | 5.1 | 4.9 | 4.8 | 4.8 | 4.8 | 4.7 |
| Consumption of fixed capital | 2.4 | 2.2 | 2.1 | 2.6 | 2.1 | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 |
| Interest | 3.0 | 3.5 | 3.5 | 3.1 | 2.8 | 2.7 | 2.6 | 2.5 | 2.5 | 2.5 |
| Social benefits | 19.0 | 19.4 | 19.2 | 18.5 | 18.1 | 17.9 | 17.7 | 17.5 | 17.5 | 17.5 |
| Other expense | 7.1 | 3.9 | 3.7 | 3.3 | 3.3 | 3.3 | 3.2 | 3.1 | 3.1 | 3.0 |
| Subsidies | 1.0 | 1.1 | 1.1 | 1.2 | 1.1 | 1.1 | 1.0 | 1.0 | 1.0 | 0.9 |
| Other | 6.1 | 2.9 | 2.6 | 2.1 | 2.2 | 2.2 | 2.2 | 2.1 | 2.1 | 2.1 |
| o.w. financial sector support | 3.7 | 0.3 | 0.1 | 0.0 | 0.2 | ... | ... | ... | ... | ... |
| other one-offs | | | | | | | | | | |
| Net acquisition of nonfinancial assets | 0.1 | 0.1 | 0.1 | -0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 |
| Gross fixed capital investment | 2.5 | 2.2 | 2.2 | 2.5 | 2.2 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 |
| Consumption of fixed capital | 2.4 | 2.2 | 2.1 | 2.6 | 2.1 | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 |
| Other non financial assets | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Gross operating balance | -10.4 | -7.0 | -5.9 | -5.2 | -4.4 | -3.2 | -2.7 | -2.3 | -2.1 | -2.0 |
| Net lending / borrowing | -10.5 | -7.0 | -6.0 | -5.1 | -4.5 | -3.2 | -2.7 | -2.3 | -2.1 | -2.0 |
| Net lending / borrowing (excluding financial sector support) | -6.8 | -6.7 | -5.9 | -5.1 | -4.3 | -3.2 | -2.7 | -2.3 | -2.1 | -2.0 |
| *Memorandum items:* | | | | | | | | | | |
| Net lending/ borrowing (EDP targets) | ... | ... | -5.8 | -4.2 | -4.6 | -3.1 | -2.2 | ... | ... | ... |
| Primary balance | -8.0 | -4.1 | -3.0 | -2.4 | -2.1 | -0.9 | -0.5 | -0.2 | -0.1 | 0.1 |
| Primary balance (excluding financial sector support) 2/ | -3.8 | -3.2 | -2.4 | -2.0 | -1.7 | -0.5 | -0.2 | 0.2 | 0.3 | 0.5 |
| Cyclically adjusted balance | -7.2 | -2.8 | -2.3 | -2.7 | -3.2 | -2.6 | -2.4 | -2.3 | -2.3 | -2.3 |
| Cyclically adjusted primary balance (excluding financial sector support) 2/ | -3.9 | 0.8 | 1.1 | 0.4 | -0.4 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 |
| Primary structural balance 2/ | -0.5 | 1.0 | 1.5 | 0.6 | -0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 |
| Structural balance | -3.5 | -2.5 | -2.0 | -2.5 | -3.0 | -2.6 | -2.4 | -2.3 | -2.3 | -2.3 |
| General government gross debt (Maastricht) | 85.7 | 95.4 | 100.4 | 99.8 | 99.2 | 99.2 | 98.7 | 97.7 | 96.6 | 95.6 |
| Net debt | 66.0 | 74.0 | 78.6 | 80.2 | 80.4 | 81.0 | 81.1 | 80.7 | 80.2 | 79.7 |
| Central Government net lending | -7.9 | -4.8 | -3.7 | -2.8 | 2.3 | 1.7 | 1.4 | 1.2 | 1.1 | 1.1 |
| Output gap | -6.1 | -7.8 | -6.8 | -4.5 | -2.4 | -1.3 | -0.6 | -0.1 | 0.3 | 0.5 |

Sources: Ministry of Finance; Eurostat; and IMF staff estimates and projections.
1/ Compiled using accrual basis and ESA10 manual, consistent with Eurostat dataset.
2/ Including interest income.

## Table 3. General Government Balance Sheet, 2009–15

| | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|---|
| | | | | (Billions of euro) | | | |
| Financial assets | 304.2 | 294.9 | 318.6 | 347.7 | 369.0 | 380.4 | 374.2 |
| Currency and Deposits | 119.7 | 95.1 | 77.5 | 84.7 | 72.7 | 83.9 | 85.5 |
| Securities other than shares | 28.0 | 22.4 | 14.4 | 4.9 | 14.0 | 8.5 | 3.8 |
| Loans | 26.2 | 34.0 | 46.7 | 55.7 | 60.6 | 61.4 | 58.8 |
| Other assets | 130.1 | 143.4 | 180.0 | 202.4 | 221.8 | 226.5 | 226.1 |
| | | | | | | | |
| Liabilities | 668.4 | 721.0 | 832.8 | 961.1 | 1,083.5 | 1,233.4 | 1,256.6 |
| Currency and deposits | 3.5 | 3.6 | 3.7 | 3.7 | 3.7 | 3.8 | 4.1 |
| Securities other than shares | 498.9 | 527.3 | 609.6 | 674.8 | 807.1 | 955.7 | 1,000.6 |
| Loans | 92.6 | 111.4 | 129.1 | 217.2 | 213.5 | 215.3 | 195.6 |
| Other liabilities | 73.5 | 78.7 | 90.4 | 65.5 | 59.3 | 58.5 | 56.5 |
| | | | | (Percent of GDP) | | | |
| Financial assets | 28.2 | 27.3 | 29.8 | 33.3 | 35.8 | 36.5 | 34.6 |
| Currency and Deposits | 11.1 | 8.8 | 7.2 | 8.1 | 7.1 | 8.1 | 7.9 |
| Securities other than shares | 2.6 | 2.1 | 1.3 | 0.5 | 1.4 | 0.8 | 0.4 |
| Loans | 2.4 | 3.1 | 4.4 | 5.3 | 5.9 | 5.9 | 5.4 |
| Other assets | 12.1 | 13.3 | 16.8 | 19.4 | 21.5 | 21.8 | 20.9 |
| | | | | | | | |
| Liabilities | 61.9 | 66.7 | 77.8 | 92.2 | 105.1 | 118.5 | 116.2 |
| Currency and deposits | 0.3 | 0.3 | 0.3 | 0.4 | 0.4 | 0.4 | 0.4 |
| Securities other than shares | 46.2 | 48.8 | 57.0 | 64.7 | 78.3 | 91.8 | 92.5 |
| Loans | 8.6 | 10.3 | 12.1 | 20.8 | 20.7 | 20.7 | 18.1 |
| Other liabilities | 6.8 | 7.3 | 8.4 | 6.3 | 5.7 | 5.6 | 5.2 |
| | | | | (Billions of euro) | | | |
| *Memorandum items:* | | | | | | | |
| Public debt (EDP) | 568.7 | 649.3 | 743.5 | 890.7 | 978.3 | 1,040.9 | 1,073.2 |
| Net lending/borrowing | -118.2 | -101.4 | -102.9 | -108.9 | -71.9 | -62.2 | -55.2 |
| Change in public debt (EDP) | 128.9 | 80.6 | 94.3 | 147.2 | 87.5 | 62.6 | 32.3 |
| Change in financial assets | 26.4 | -9.3 | 23.7 | 29.1 | 21.3 | 11.3 | -6.2 |
| Change in net financial assets | -102.5 | -89.9 | -70.6 | -118.1 | -66.2 | -51.3 | -38.5 |
| Unexplained change in net financial assets | 15.7 | 11.6 | 32.4 | -9.2 | 5.6 | 10.9 | 16.7 |

Sources: Haver Analytics, Bank of Spain, and IMF staff estimates.

## Table 4. Selected Financial Soundness Indicators, 2010–16

(In percent, unless otherwise indicated)

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016Q2 | Latest data |
|---|---|---|---|---|---|---|---|---|
| Depository institutions | | | | | | | | |
| Capital adequacy | | | | | | | | |
| Regulatory capital to risk-weighted assets | 11.9 | 12.1 | 11.6 | 13.3 | 13.7 | 14.7 | 14.6 | June |
| Regulatory tier-1 capital to risk-weighted assets | 9.7 | 10.2 | 9.9 | 11.9 | 11.9 | 12.9 | 12.8 | June |
| Capital to total assets | 6.1 | 5.9 | 5.8 | 6.8 | 7.2 | 7.4 | 7.6 | June |
| Asset quality: Consolidated basis | | | | | | | | |
| Nonperforming loans (in billions of euro) | 119 | 153 | 180 | 210 | 188 | 159 | 149 | June |
| Nonperforming loans to total loans | 4.7 | 6.0 | 7.5 | 9.4 | 8.5 | 6.2 | 5.8 | June |
| Specific provisions to nonperforming loans | 65.7 | 56.9 | 68.4 | 56.8 | 57.7 | 44.0 | 43.2 | June |
| Asset quality: Domestic operations | | | | | | | | |
| Nonperforming loans (in billions of euro) | 103 | 136 | 163 | 192 | 167 | 130 | 118 | June |
| Nonperforming loans to total loans | 5.8 | 7.9 | 10.6 | 13.8 | 12.6 | 10.2 | 9.5 | June |
| Specific provisions to nonperforming loans | 41.4 | 38.3 | 46.0 | 48.2 | 48.2 | 48.5 | 47.9 | June |
| Exposure to businesses - Construction (in billions of euro) | 422 | 389 | 294 | 232 | 196 | 175 | 163 | June |
| o/w: Nonperforming (in percent) | 13.5 | 20.8 | 28.5 | 37.3 | 35.6 | 28.3 | 27.6 | June |
| Exposure to businesses - Other (in billions of euro) | 554 | 541 | 495 | 456 | 452 | 444 | 428 | June |
| o/w: Nonperforming (in percent) | 3.7 | 5.0 | 8.6 | 12.5 | 11.7 | 9.6 | 9.1 | June |
| Exposure to households - Home purchase (in billions of euro) | 624 | 614 | 593 | 569 | 546 | 520 | 513 | June |
| o/w: Nonperforming (in percent) | 2.3 | 2.8 | 3.8 | 5.7 | 5.6 | 4.6 | 4.5 | June |
| Exposure to households - Other (in billions of euro) | 183 | 171 | 157 | 136 | 134 | 134 | 142 | June |
| o/w: Nonperforming (in percent) | 5.6 | 6.1 | 9.0 | 11.6 | 10.7 | 10.3 | 8.1 | June |
| Earning and profitability: Consolidated basis | | | | | | | | |
| Return on assets | 0.5 | 0.1 | -1.4 | 0.4 | 0.4 | 0.5 | 0.5 | June |
| Return on equity | 8.0 | 1.5 | -21.0 | 5.4 | 5.7 | 7.1 | 7.3 | June |
| Earning and profitability: Domestic operations | | | | | | | | |
| Return on assets | 0.3 | -0.6 | -2.7 | 0.1 | 0.5 | 0.4 | 0.5 | June |
| Return on equity | 5.6 | -9.1 | -43.6 | 2.0 | 5.9 | 4.9 | 6.2 | June |
| Funding | | | | | | | | |
| Loans to deposits 1/ | 144.8 | 145.3 | 132.4 | 118.3 | 114.5 | 110.0 | 107.5 | June |
| Use of ECB refinancing (in billions of euro) 2/ | 70 | 132 | 357 | 207 | 142 | 133 | 127 | June |
| In percent of total ECB refinancing operations | 13.2 | 18.4 | 32.0 | 28.8 | 26.2 | 25.0 | 25.1 | June |
| In percent of total assets of Spanish MFIs | 2.0 | 3.7 | 10.0 | 6.6 | 4.8 | 4.7 | 4.5 | June |
| Total assets (in percent of GDP) | 294 | 279 | 322 | 293 | 248 | 303 | 290 | June |
| Total assets (in billion U.S. dollar) | 4,221 | 4,149 | 4,311 | 4,020 | 3,429 | 3,631 | 3,628 | June |
| Other financial institutions | | | | | | | | |
| Total assets (in percent of GDP) | | | | | | | | |
| Insurance companies and pension funds | 33 | 31 | 37 | 39 | 36 | ... | ... | ... |
| Other institutions 3/ | 99 | 87 | 91 | 87 | 75 | ... | ... | ... |
| Shadow banking activity 4/ | 21 | 18 | 20 | 20 | 19 | ... | ... | ... |
| Corporate sector | | | | | | | | |
| Debt (in percent of GDP) 5/ | 181 | 176 | 168 | 160 | 153 | 144 | 139 | June |
| Debt to total assets | 55.3 | 53.4 | 51.3 | 47.8 | 46.7 | 45.2 | 45.9 | June |
| Liquid assets to short-term liabilities | 160.1 | 177.3 | 194.4 | 249.8 | 262.8 | 273.5 | 298.2 | June |
| Household sector | | | | | | | | |
| Debt (in percent of GDP) 5/ | 88 | 86 | 85 | 82 | 78 | 73 | 71 | June |
| Debt service and principal payment to disposable income | 22.9 | 22.2 | 22.3 | 19.9 | 18.5 | ... | ... | ... |
| Real estate market | | | | | | | | |
| House price (percentage change, end-period) | -1.9 | -11.2 | -12.8 | -7.8 | 1.8 | 4.2 | 3.9 | June |
| Housing completion (2007=100) | 43 | 28 | 21 | 9 | 8 | 7 | 7 | June |
| Property sales (2007=100) | 57 | 47 | 43 | 42 | 43 | 46 | 49 | June |

Sources: Bank of Spain; Bloomberg; Haver analytics; FSB, Global Shadow Banking Monitoring Report 2015; IMF, Financial Soundness Indicators database and World Economic Outlook database; and IMF staff estimates.

1/ Based on loans to and deposits from other resident sectors.

2/ Based on main and long-term refinancing operations, and marginal facility.

3/ Include public financial institutions, other financial intermediaries and financial auxiliaries.

4/ Based on FSB's economic-based shadow banking measure.

5/ Based on total financial liabilities (excluding equity instruments), which include borrowings and accounts payable.

## Table 5. Balance of Payments, 2011–21

| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | Projections | | | | | |
| | | | | | | (Billions of euro) | | | | | |
| Current account | -34.0 | -2.4 | 15.6 | 11.2 | 14.7 | 22.2 | 20.6 | 21.9 | 24.0 | 25.3 | 26.1 |
| Trade balance of goods and services | -1.9 | 16.0 | 33.8 | 25.5 | 26.2 | 32.7 | 31.8 | 32.9 | 35.6 | 38.4 | 40.8 |
| Exports of goods and services | 309.9 | 319.5 | 330.8 | 339.0 | 356.9 | 368.6 | 390.1 | 412.2 | 436.0 | 461.3 | 488.0 |
| Exports of goods | 216.0 | 224.2 | 235.6 | 238.6 | 250.2 | 256.3 | 270.9 | 286.2 | 302.1 | 318.9 | 336.8 |
| Exports of services | 93.9 | 95.3 | 95.2 | 100.4 | 106.7 | 112.4 | 119.2 | 126.0 | 133.9 | 142.4 | 151.2 |
| Trade of goods balance | -44.5 | -29.3 | -14.0 | -22.4 | -21.7 | -15.7 | -17.9 | -20.7 | -22.9 | -25.4 | -27.7 |
| Imports of goods and services | -311.8 | -303.5 | -297.0 | -313.5 | -330.6 | -335.9 | -358.3 | -379.3 | -400.4 | -422.8 | -447.2 |
| Imports of goods | -260.4 | -253.4 | -249.6 | -261.0 | -271.9 | -271.9 | -288.8 | -306.9 | -325.0 | -344.3 | -364.5 |
| Imports of services | -51.3 | -50.1 | -47.5 | -52.5 | -58.7 | -64.0 | -69.5 | -72.4 | -75.4 | -78.6 | -82.7 |
| Services | 42.6 | 45.2 | 47.8 | 47.9 | 48.0 | 48.4 | 49.6 | 53.6 | 58.5 | 63.9 | 68.6 |
| *Of which:* | | | | | | | | | | | |
| Tourism | 32.2 | 33.3 | 34.8 | 35.4 | 35.2 | ... | ... | ... | ... | ... | ... |
| Exports | 44.7 | 45.3 | 47.2 | 49.0 | 50.9 | ... | ... | ... | ... | ... | ... |
| Imports | -12.5 | -12.0 | -12.4 | -13.6 | -15.7 | ... | ... | ... | ... | ... | ... |
| Primary income | -18.4 | -7.0 | -5.3 | -3.3 | -0.7 | -0.9 | -2.3 | -1.7 | -2.0 | -3.2 | -3.4 |
| Secondary income | -13.8 | -11.4 | -12.9 | -11.0 | -10.8 | -9.6 | -8.9 | -9.2 | -9.5 | -9.9 | -11.3 |
| Private remittances | -6.1 | -3.8 | -3.4 | -2.8 | -3.0 | -0.8 | 0.2 | 0.2 | 0.2 | 0.1 | -0.9 |
| Official transfers | -9.3 | -8.2 | -10.1 | -8.8 | -8.4 | -8.8 | -9.1 | -9.4 | -9.7 | -10.0 | -10.4 |
| Capital account | 4.1 | 5.2 | 6.6 | 5.0 | 7.0 | 7.3 | 7.5 | 7.8 | 8.1 | 8.3 | 8.6 |
| Financial account | 31.2 | -0.4 | -31.3 | -10.5 | -22.3 | -29.5 | -28.1 | -29.7 | -32.1 | -33.7 | -34.7 |
| Direct investment | -9.2 | 21.1 | 18.5 | -8.0 | -29.4 | -29.4 | -29.8 | -30.3 | -31.4 | -32.7 | -34.0 |
| Spanish investment abroad | 32.5 | -1.9 | 20.8 | 33.9 | 52.2 | 52.6 | 53.3 | 54.1 | 55.0 | 56.1 | 57.2 |
| Foreign investment in Spain | 23.3 | 19.2 | 39.3 | 25.9 | 22.8 | 23.2 | 23.5 | 23.8 | 23.6 | 23.4 | 23.2 |
| Portfolio investment | -31.0 | -41.8 | 63.0 | 10.2 | -10.1 | 37.7 | 37.7 | 37.3 | 38.4 | 40.3 | 41.5 |
| Financial derivatives | -2.1 | 8.3 | -1.0 | -0.1 | 1.2 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Other investment | 83.5 | 14.1 | -111.3 | -8.7 | 21.0 | -37.8 | -36.1 | -36.7 | -39.1 | -41.3 | -42.2 |
| Change in reserve assets | -10.0 | -2.2 | -0.5 | -3.9 | -5.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Errors and omissions | -0.3 | 1.0 | -11.1 | 4.8 | -3.5 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| | | | | | | (Percent of GDP) | | | | | |
| Current account | -3.2 | -0.2 | 1.5 | 1.1 | 1.4 | 2.0 | 1.8 | 1.8 | 1.9 | 2.0 | 2.0 |
| Trade balance of goods and services | -0.2 | 1.5 | 3.3 | 2.5 | 2.4 | 2.9 | 2.7 | 2.8 | 2.9 | 3.0 | 3.1 |
| Exports of goods and services | 29.0 | 30.7 | 32.3 | 32.7 | 33.2 | 33.0 | 33.7 | 34.5 | 35.3 | 36.1 | 37.0 |
| Exports of goods | 20.2 | 21.6 | 23.0 | 23.0 | 23.3 | 22.9 | 23.4 | 24.0 | 24.4 | 24.9 | 25.5 |
| Exports of services | 8.8 | 9.2 | 9.3 | 9.7 | 9.9 | 10.1 | 10.3 | 10.5 | 10.8 | 11.1 | 11.5 |
| Imports of goods and services | -29.1 | -29.2 | -29.0 | -30.2 | -30.7 | -30.1 | -31.0 | -31.8 | -32.4 | -33.1 | -33.9 |
| Imports of goods | -24.3 | -24.4 | -24.3 | -25.2 | -25.3 | -24.3 | -25.0 | -25.7 | -26.3 | -26.9 | -27.6 |
| Imports of services | -4.8 | -4.8 | -4.6 | -5.1 | -5.5 | -5.7 | -6.0 | -6.1 | -6.1 | -6.1 | -6.3 |
| Primary income | -1.7 | -0.7 | -0.5 | -0.3 | -0.1 | -0.1 | -0.2 | -0.1 | -0.2 | -0.3 | -0.3 |
| Secondary income | -1.3 | -1.1 | -1.3 | -1.1 | -1.0 | -0.9 | -0.8 | -0.8 | -0.8 | -0.8 | -0.9 |
| Capital account | 0.4 | 0.5 | 0.6 | 0.5 | 0.7 | 0.7 | 0.7 | 0.7 | 0.7 | 0.7 | 0.7 |
| Financial account | 2.9 | 0.0 | -3.1 | -1.0 | -2.1 | -2.6 | -2.4 | -2.5 | -2.6 | -2.6 | -2.6 |
| Direct investment | -0.9 | 2.0 | 1.8 | -0.8 | -2.7 | -2.6 | -2.6 | -2.5 | -2.5 | -2.6 | -2.6 |
| Portfolio investment | -2.9 | -4.0 | 6.1 | 1.0 | -0.9 | 3.4 | 3.3 | 3.1 | 3.1 | 3.2 | 3.1 |
| Financial derivatives | -0.2 | 0.8 | -0.1 | 0.0 | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Other investment | 7.8 | 1.4 | -10.8 | -0.8 | 2.0 | -3.4 | -3.1 | -3.1 | -3.2 | -3.2 | -3.2 |
| Of which, BdE | 11.6 | 16.7 | -9.9 | 1.9 | 8.2 | -1.3 | -0.9 | -0.6 | -0.4 | -0.4 | -0.4 |
| Change in reserve assets | -0.9 | -0.2 | -0.1 | -0.4 | -0.5 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Errors and omissions | 0.0 | 0.1 | -1.1 | 0.5 | -0.3 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Net international investment position | -91.9 | -89.9 | -94.3 | -97.5 | -89.9 | -83.9 | -78.7 | -73.7 | -68.6 | -63.7 | -59.0 |
| Valuation changes | 0.4 | 4.7 | -6.3 | -5.2 | 2.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |

Sources: Bank of Spain; and IMF staff estimates.

# Annex I. Taking Stock of the 2012 Labor Market Reforms[1]

**The labor market reforms enacted in February 2012 aimed at addressing Spain's structural problems.** Spain's labor market has historically been characterized by very high structural unemployment, employment volatility, wage rigidity, high shares of temporary employment, and low labor productivity. The 2012 reforms included measures to enhance market efficiency and reduce duality; to foster firms' internal flexibility and avoid employment destruction; and to enhance the employability and fungibility of workers (see first chapter of *Spain: Selected Issues Papers*, 2015 for a detailed list of measures).

**Overall, the 2012 labor market reforms have helped improve the functioning of the Spanish labor market, but important rigidities remain.** Although it is difficult to disentangle the effects of the reforms and the agreement reached by social partners in early 2012 when the recession was hitting employment hard, there is extensive evidence indicating that the reforms have supported wage moderation. Moreover, reforms and moderate wage growth have supported job creation and helped Spain regain competitiveness lost during the pre-crisis boom. The reforms have also made the labor market more resilient to shocks and promoted a moderate reduction in duality and structural unemployment. However, important structural problems remain. Unemployment is still painfully high with a high incidence of long-term unemployment. Labor market duality remains pervasive. And, although the reforms have enhanced macro-flexibility, micro-flexibility is still low.

The sections below summarize the main evidence so far of the impact of the reforms.

## A. Wages and Employment

*Overall, the empirical evidence suggests that the labor market reforms have supported wage moderation and contributed to a pickup in job creation. Although the evidence points to increased macro-flexibility, there is no evidence of increased micro-flexibility (i.e., changes in wages still do not reflect specific business conditions of firms and sectors).*

- Empirical analysis suggests that the reforms have contributed to significant wage moderation (Bank of Spain 2013, OECD 2014, Garcia-Perez 2016). OECD (2014) estimates a reduction in unit labor costs of 1.2–1.9 percent associated with the reforms (that is, half of the actual adjustment in the year following the reform).

- Analysis by IMF (2015), focusing on the variation of wages and employment across sectors during pre- and post-reform years, points to increased macro-flexibility of wages. Results show that before the reforms, wage growth accelerated in expansions, but also during downswings (though by lesser extent), slowing labor market adjustment and contributing to excessive labor shedding during recessions. Since the reform, employment contractions are no longer associated with higher wage growth. At the same time, there is no evidence that wage dynamics

[1] Prepared by Sebastian Sosa.

have responded systematically to sector-specific variation in economic conditions, pointing to persistent lack of micro-flexibility. Finally, the study finds that wage moderation has contributed to a recovery in headline employment growth, and the reforms have made the labor market more resilient to shocks.

- The extent of wage moderation, however, varied significantly across level of wages and between workers who kept their jobs (*stayers*) and those who had to change jobs (*movers*). Real wages of workers in the first and second lowest deciles fell by 25 percent and 15 percent, respectively, between 2008 and mid-2013, while those of the highest deciles increased slightly (10 percent in the top decile). The *movers*, especially those with temporary contracts, youth, and low-skilled workers, suffered the largest losses (Conde-Ruiz and others, 2015). As a consequence of the sharp adjustment in the low end of the wage distribution, wage inequality surged significantly (see Box 2 in the 2016 IMF Staff Report).

- Reforms have also supported hiring, in particular under permanent contracts through two channels: by increasing the probability of transition from unemployment to permanent employment and reducing the probability of dismissals for workers under temporary contracts—arguably due to the fact that firms started using the new internal flexibility provisions introduced by the reform (Garcia-Perez, 2016).[2] In fact, OECD (2014) suggests that about 25,000 new permanent contracts per month can be explained by the reforms (in the first 18 months), with the impact concentrated in SMEs. De Cea and Dolado (2013) find that the output growth rate threshold necessary for net job creation declined after the reform (estimating such threshold at 0.3–1.3 percent).

- What does the evidence show on the impact of the reforms on dismissals? OECD (2014) finds that the impact on separation rates in the first 1½ years since the reform was negligible. Meanwhile, there was evidence pointing to some negative effects of the changes introduced to the regulation on dismissals. The number of collective dismissals deemed null due to formal or administrative/procedural omissions or mistakes increased sizably, with employers being forced to re-hire dismissed workers.[3] This proliferation of nullifying provisions by the courts had increased legal uncertainty (Jansen, 2015; OECD, 2014).

- Latest estimates suggest the following quantitative impact from the increased wage moderation and firms' internal flexibility, using two counterfactual scenarios (Doménech and others, 2016). In the absence of the wage adjustment facilitated by the reform, additional 900,000 jobs would have been lost—basically offsetting the overall net job creation observed in 2014–15. Moreover, the loss of 2 million long-term jobs and an increase of about 8 percentage points in the

[2] However, as explained below, the overall impact on duality has been marginal in the short term.

[3] For instance, Palomo Balda (2013) shows that although litigation affected only about 5 percent of all collective dismissals between March 2012 and March 2013, in 40 percent of the cases the court ruled the collective dismissals to be null due to administrative reasons. This is the case even when in 85 percent of those cases the actual grounds for dismissal were considered to be valid.

unemployment rate could have been prevented had the extent of wage flexibility observed after the reform prevailed in the period 2008–12.

## B. Duality

*The empirical evidence suggests that the labor market reforms have helped reduce duality. However, although the impact is generally statistically significant, the economic significance is still quite small.*

- Although there is some evidence suggesting that the labor market reform promoted a pickup in permanent employment, a large share of the new jobs (53 percent) relies on temporary contracts and the share of temporary jobs in overall employment has remained fairly flat since 2008 at about 25 percent—among the highest in Europe. Compared to the pre-crisis levels, the share of temporary jobs declined by around 6 percentage points, but most of the reduction was due to the large destruction of temporary jobs (mostly in the period 2008–12) rather than a substitution of temporary for permanent contracts. At the same time, the share of permanent contracts in the flow on new contracts signed each month has remained fairly stable at around 8–10 percent, with no apparent change since the reform.

- Results in OECD (2014) indicate that, although the reform could have contributed to some increase in new permanent jobs and increase the share of permanent employment in new hires by 3 percentage points, duality remained very high.

- IMF (2015) finds some evidence that the share of new hires with temporary contracts has started to decrease due to the 2012 reform. However, the reliance on temporary workers remains strong overall.

- Garcia-Perez (2016) finds that the reform appears to have promoted the exit from unemployment into permanent employment both in absolute terms and relative to temporary employment. The results indicate that the reform has raised the transition probability from unemployment to permanent employment by about 50 percent, raising it from 1.7 percent to 2.6 percent, on average, in the first 12 months of unemployment. However, since the probability of transition to temporary employment, which continues to be—by far—the most likely option (12 percent in the first year of unemployment) the overall effect on the stock of permanent employment is still marginal in the short term. The results suggest a positive but very small impact of the reform on the still high duality, to the extent that exit from unemployment to a temporary job is still five times higher than to a permanent job (12 percent and 2.6 percent, respectively).

## C. Collective Negotiation

*Existing evidence indicates that the 2012 labor market reforms did not have a major impact on the structure of collective negotiation, with agreements still mostly negotiated at the sector-province level with few firms 'opting-out' from higher level agreements.*

- The evidence suggests that wage dynamics still do not adequately reflect differences in firms' business conditions. Although there has been an increase in the number of firm-level agreements, these affect only a small number of workers mostly in large firms, and collective agreements continue to be negotiated largely at the sector-province level. Firm-level agreements remain especially unusual for SMEs, and 'opting-out' is the only possibility of wage adjustment for these firms, but only based on agreements with workers' representatives, as the procedures for resolving potential conflicts associated with 'opt-outs' remain excessively demanding.

- The coverage of collective negotiation has not declined as many were concerned about (see, for instance, Bentolila and Jansen, 2016). Although the number of workers affected by collective agreements has declined since the reform, the number of private sector workers has fallen even more, so that the coverage rate has actually increased moderately.

## D. Structural Unemployment

*Although there is some evidence that the labor market reforms have helped reduce the structural unemployment rate, the later remains stubbornly high, at about 16 percent.*

- OECD (2014) finds that the reform appears to have reduced the duration of unemployment spells, which could help reduce structural unemployment.

- IMF staff estimates indicate that between 2012 and 2015, the estimated structural unemployment declined by around 3 percentage points. However, at about 16 percent, it remains very high, reflecting both long-standing problems and the impact of the crisis. Among the long-term issues are the pervasive labor market duality and its impact on workers' skill levels.

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# Annex II. Balance Sheet Approach: How Much Has Spain Adjusted?[1]

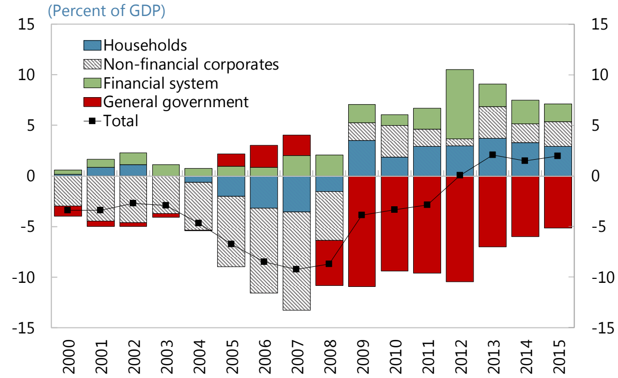
*Despite some adjustment, the Spanish economy remains vulnerable to balance sheet shocks that could be propagated through certain sectoral linkages. Potential sources of propagation are the high general government indebtedness with large exposures to the domestic financial sector and the rest of the world, lingering debt overhangs in parts of the private sector with banks, and the reliance on Euro Area monetary policy. Changes in the regional monetary policy stance, risk perception, or the occurrence of sizable shocks could put pressure on balance sheets via these sectoral linkages.*

**This note uses the balance sheet approach to assess the recent evolution of Spain's financial vulnerabilities.**[2] Given that many of the remaining vulnerabilities of the Spanish economy relate to stocks rather than flows, the balance sheet assessment summarizes these exposures, their interlinkages, and which sectors have adjusted their leverage and against whom (including the role of valuation effects). The approach uses a matrix of intersectoral financial claims. For this purpose, the economy is divided into seven sectors: general government (GG), the central bank (BdE), monetary financial institutions excluding the central bank (MFI), other financial institutions (OFI), non-financial corporates (COR), households (HH), and the rest of the World (RoW). By construction, the sum of the domestic sectoral net positions equals the country's net position vis-à-vis the rest of the world (i.e., the Net International Investment Position, NIIP).[3]

**Internal and external deleveraging reflects the ongoing but yet incomplete correction of pre-crisis imbalances and the impact of the crisis.** From euro adoption in 1999 to 2008, Spain experienced growing current account deficits that increased the private sector debt with the rest of the world. While households and corporates increased their indebtedness with domestic banks, these received funding from international capital markets. The gross exposure of the financial sector to the private non-financial sector peaked in 2010 at 192 percent of GDP (net exposure peaked in 2008 at 36 percent of GDP). The public sector had a very limited role in the pre-crisis deterioration of the current account deficit and worsening net international investment position with overall debt to GDP at just 51 percent of GDP in 2006. With the onset of the international financial crisis in 2008, as the non-financial private sector began its adjustment and deleveraging, the general government ran large deficits, increasing its total liabilities with

Domestic Sectors Surpluses

(Percent of GDP)




Sources: Haver, and IMF staff calculations.

[1] Prepared by Federico Grinberg and Phakawa Jeasakul.

[2] See also IMF "Balance Sheet Analysis in Fund Surveillance," IMF Policy Paper, June 2015.

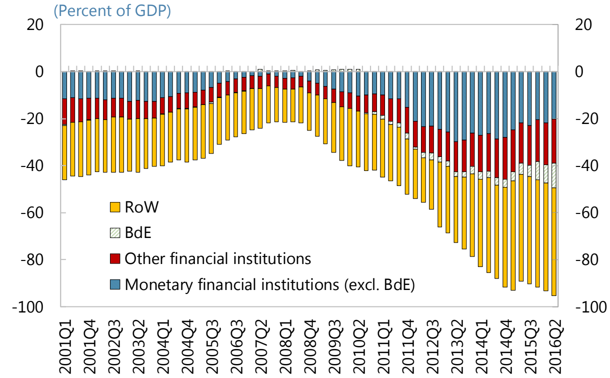
[3] For a balance sheet analysis of the banking sector, see Selected Issues Paper chapter II. For key indicators on household and corporate balance sheet strength and developments, see Figures 3–5.

domestic banks and the rest of the world from 35 percent of GDP in 2007 to its current peak of 114 percent in 2016:Q2.

**Spain's net position against the rest of the world has changed little since the beginning of 2013 but its composition has shifted** (Table A2.1). Even as Spain has exhibited large current account surpluses in the last three years, its position toward the rest of the world is still highly negative at 88 percent of GDP (2016:Q2). This is even slightly weaker than at end-2013, mostly due to valuation changes and the significant increase in public liabilities held by the rest of the world (17 percent) which more than offset the reduction in private sector's net liabilities to the rest of the world (by 16 percent of GDP).

**The public sector is now more exposed externally.** Of the overall increase in the public debt-to-GDP ratio of 21 percentage points since 2013, about 85 percent was absorbed by the rest of the world. The external sector has largely replaced the domestic financial system as the main investor in newly issued government securities, but banks' exposure to the Spanish sovereign remains large (see below).

**General Government Net Debtor Positions**
(Percent of GDP)




Sources: Bank of Spain, Haver Analytics, and IMF staff calculations.

**Non-financial sector borrowing from domestic banks has fallen from its peak in 2009.** Credit growth to the non-financial private sector has remained negative owing to the weak demand for new loans. While the demand for new loans has picked up in line with the economic recovery, amortization has continued to outpace new bank lending. Depressed consumption and investment levels, on the back of high unemployment, weak disposable incomes, low house prices, and the need for corporates and households to strengthen their financial positions are the main reasons behind the weak demand for new credit.

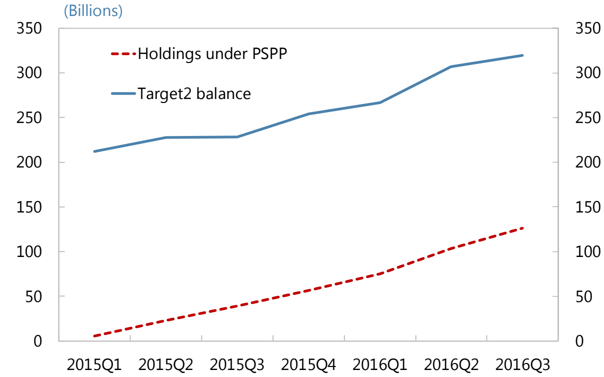
**Banks' exposure to households remains to be a vulnerability.** Household debt (both relative to GDP and disposable income) has been brought to a level that is comparable to other major EU countries. However, household indebtedness in EU countries has been on the rise and is generally considered to be a vulnerability. At the same time, the financial wealth of Spanish households is far below that of EU peers and housing wealth well below pre-crisis levels, even though it is high in international comparison.

**The domestic banking system has reduced its sovereign exposure facilitated by the Public Sector Purchase Program (PSPP).** Since 2015, the ECB's QE has purchased important amounts of government-issued securities. These operations are largely carried out by domestic central banks and kept on their balance sheets,[4] while increasing their liabilities against the ECB (i.e., the rest of the

[4] Nine percent is done directly by the ECB and kept in its balance sheet.

world). Banks receive liquidity in exchange for reducing their exposure to the general government. While in principle this liquidity could have any use, in the context of non-financial domestic private sector deleveraging, Spanish banks have used it to reduce their liabilities with the rest of the world. As a result, banks have reduced their balance sheets by selling assets (government securities) and paying back their liabilities (with the Eurosystem). In the BdE's balance sheet, which is the mirror image to that of banks in these transactions, assets (government debt) and liabilities increased (which is reflected in an increase in Target2 balances).

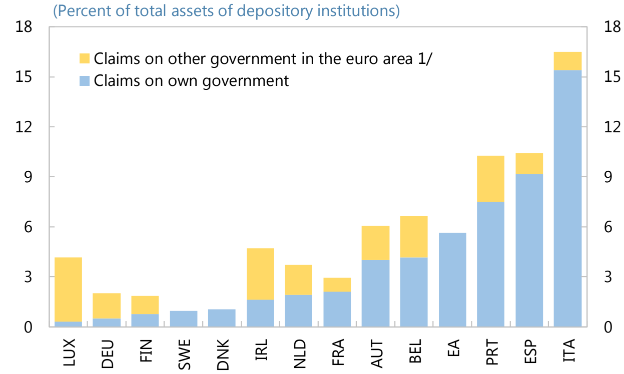
**Target2 and Quantitative Easing**
(Billions)




Source: Haver Analytics.

**Spanish banks still hold a large proportion of sovereign debt compared to peers.** Even after having stabilized their exposure to government debt, domestic banks are still highly exposed to sovereign risk. The fact that this exposure is mainly domestic is a source of vulnerabilities.

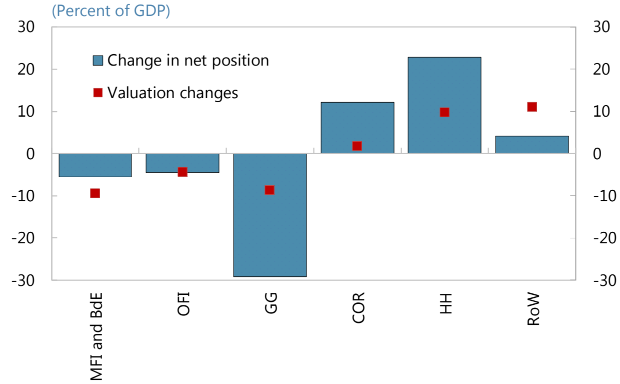
**Claims on Government, June 2016**
(Percent of total assets of depository institutions)




Source: IMF *International Financial Statistics.*

**Valuation changes, resulting from renewed confidence and monetary policy, contributed significantly to balance sheet changes.**[5] Between 2013:Q1 and 2016:Q2 the rest of the world received positive valuation gains equivalent to about 11 percent of GDP as Spanish-issued assets regained value.[6] Household deleveraging is also linked in large parts to positive valuation changes, accounting for about 10 percent of GDP, slightly less than half of their total net asset increase. On the other hand, net debtor sectors, such as the general government and monetary financial institutions (including BdE), experienced an increase in the value of their liabilities. This resulted in sizable negative valuation effects equivalent to about 9 percent of GDP for the general government and monetary financial institutions, respectively. The valuation loss for non-financial corporates was about 2 percent of GDP.

**Change in Net Position: 2013Q1-2016Q2**
(Percent of GDP)




Sources: Haver Analytics, and IMF staff calculations.

[5] Valuation changes are computed as the difference between the change in the stock and the cumulative net sectoral transaction flows.

[6] The counterpart of this is the reduction in Spain's liabilities yields and spreads compression (see SIP chapter II).

## Table A2.1. Changes in Cross-Sectoral Financial Exposures: 2013:Q1–2016:Q2

(percent of GDP)

**Net exposures (in percent of GDP)**

| | BdE | MFI | OFI | General government | Corporates | Households | Rest of the world | Total |
|---|---|---|---|---|---|---|---|---|
| BdE | | -13.4 | 0.2 | 8.2 | 0.0 | 0.0 | 2.5 | **-2.5** |
| MFI | 13.4 | | 9.1 | -5.5 | -18.3 | -8.6 | 6.3 | **-3.6** |
| OFI | -0.2 | -9.1 | | 6.4 | -2.3 | -10.6 | 11.1 | **-4.6** |
| General government | -8.2 | 5.5 | -6.4 | | 0.9 | -0.1 | -17.5 | **-25.8** |
| Corporates | 0.0 | 18.3 | 2.3 | -0.9 | | 3.1 | -3.0 | **19.7** |
| Households | 0.0 | 8.6 | 10.6 | 0.1 | -3.1 | | 1.4 | **17.6** |
| Rest of the world | -2.5 | -6.3 | -11.1 | 17.5 | 3.0 | -1.4 | | **-0.9** |

**Financial assets (in percent of GDP)**

| | BdE | MFI | OFI | General government | Corporates | Households | Rest of the world | Total |
|---|---|---|---|---|---|---|---|---|
| BdE | | -13.4 | 0.0 | 8.3 | 0.0 | 0.0 | 6.0 | **0.9** |
| MFI | 0.1 | | -12.4 | -7.9 | -19.1 | -13.4 | -10.1 | **-62.9** |
| OFI | -0.2 | -21.6 | | 6.2 | -2.0 | 0.0 | 6.0 | **-11.6** |
| General government | 0.1 | -2.4 | -0.3 | | -1.8 | -0.1 | -0.1 | **-4.4** |
| Corporates | 0.0 | -0.7 | 0.2 | -2.7 | | 0.0 | 6.9 | **3.7** |
| Households | 0.0 | -4.8 | 10.6 | 0.0 | -3.0 | | 1.4 | **4.2** |
| Rest of the world | 3.4 | -16.4 | -5.1 | 17.4 | 9.9 | 0.0 | | **9.1** |

**Financial liabilities (in percent of GDP)**

| | BdE | MFI | OFI | General government | Corporates | Households | Rest of the world | Total |
|---|---|---|---|---|---|---|---|---|
| BdE | | 0.1 | -0.2 | 0.1 | 0.0 | 0.0 | 3.4 | **3.4** |
| MFI | -13.4 | | -21.6 | -2.4 | -0.7 | -4.8 | -16.4 | **-59.3** |
| OFI | 0.0 | -12.4 | | -0.3 | 0.2 | 10.6 | -5.1 | **-7.0** |
| General government | 8.3 | -7.9 | 6.2 | | -2.7 | 0.0 | 17.4 | **21.3** |
| Corporates | 0.0 | -19.1 | -2.0 | -1.8 | | -3.0 | 9.9 | **-16.1** |
| Households | 0.0 | -13.4 | 0.0 | -0.1 | 0.0 | | 0.0 | **-13.4** |
| Rest of the world | 6.0 | -10.1 | 6.0 | -0.1 | 6.9 | 1.4 | | **10.1** |

## Table A2.2. Cross-Sectoral Financial Exposures: 2016:Q2

(percent of GDP)

**Net exposures (in percent of GDP)**

| | BdE | MFI | OFI | General government | Corporates | Households | Rest of the world | Total |
|---|---|---|---|---|---|---|---|---|
| BdE | | 12.6 | 0.0 | 10.7 | 0.0 | 0.0 | -19.0 | **4.3** |
| MFI | -12.6 | | -13.4 | 20.1 | 31.7 | -18.5 | -7.4 | **-0.1** |
| OFI | 0.0 | 13.4 | | 18.7 | 5.9 | -47.4 | 6.1 | **-3.2** |
| General government | -10.7 | -20.1 | -18.7 | | 10.3 | -1.0 | -45.7 | **-85.9** |
| Corporates | 0.0 | -31.7 | -5.9 | -10.3 | | -31.1 | -33.1 | **-112.2** |
| Households | 0.0 | 18.5 | 47.4 | 1.0 | 31.1 | | 11.3 | **109.3** |
| Rest of the world | 19.0 | 7.4 | -6.1 | 45.7 | 33.1 | -11.3 | | **87.8** |

**Financial assets (in percent of GDP)**

| | BdE | MFI | OFI | General government | Corporates | Households | Rest of the world | Total |
|---|---|---|---|---|---|---|---|---|
| BdE | | 14.8 | 0.0 | 11.6 | 0.0 | 0.0 | 13.8 | **40.2** |
| MFI | 2.1 | | 26.2 | 32.2 | 53.9 | 66.2 | 33.7 | **214.3** |
| OFI | 0.1 | 39.6 | | 19.2 | 17.4 | 2.3 | 26.0 | **104.5** |
| General government | 0.9 | 12.0 | 0.6 | | 13.9 | 1.7 | 5.2 | **34.2** |
| Corporates | 0.0 | 22.2 | 11.5 | 3.5 | | 1.1 | 49.6 | **87.9** |
| Households | 0.0 | 84.7 | 49.6 | 2.7 | 32.1 | | 11.5 | **180.7** |
| Rest of the world | 32.8 | 41.1 | 19.9 | 50.9 | 82.7 | 0.2 | | **227.6** |

**Financial liabilities (in percent of GDP)**

| | BdE | MFI | OFI | General government | Corporates | Households | Rest of the world | Total |
|---|---|---|---|---|---|---|---|---|
| BdE | | 2.1 | 0.1 | 0.9 | 0.0 | 0.0 | 32.8 | **35.9** |
| MFI | 14.8 | | 39.6 | 12.0 | 22.2 | 84.7 | 41.1 | **214.4** |
| OFI | 0.0 | 26.2 | | 0.6 | 11.5 | 49.6 | 19.9 | **107.8** |
| General government | 11.6 | 32.2 | 19.2 | | 3.5 | 2.7 | 50.9 | **120.2** |
| Corporates | 0.0 | 53.9 | 17.4 | 13.9 | | 32.1 | 82.7 | **200.0** |
| Households | 0.0 | 66.2 | 2.3 | 1.7 | 1.1 | | 0.2 | **71.4** |
| Rest of the world | 13.8 | 33.7 | 26.0 | 5.2 | 49.6 | 11.5 | | **139.9** |

# Appendix I. Main Recommendations of the 2015 Article IV Consultation and Authorities' Actions

| IMF 2015 Article IV Recommendations | Policy Actions |
|---|---|
| **Fiscal Policy** | |
| Continue fiscal consolidation by using windfalls towards deficit reduction, planning for an adjustment of ½ percent of GDP per year, and ensuring more ambitious and better-specified measures at all government levels, while protecting the most vulnerable. | At 5.1 percent of GDP the fiscal deficit exceeded the deficit target by 0.9 percentage points despite strong GDP growth and lower interest payments. The 2016 budget foresaw a small structural adjustment, but higher-than-expected revenue shortfalls from PIT and CIT changes and spending overruns are expected to weaken the 2016 structural primary deficit. |
| Further improve the regional fiscal framework by enhancing monitoring and enforcement of regional fiscal targets, rules, rebalancing risk sharing and discipline, and improving fiscal equalization and settlement procedures. | Some policy actions taken. |
| **Financial Sector Policies** | |
| Further encourage banks to increase capital and reduce the cost of carrying high NPLs. | Banks have significantly strengthened their balance sheets by further improving asset quality and increasing capital buffers, though NPLs and foreclosed assets are still sizeable. |
| Further strengthen SMEs access to finance by enhancing market-based financing, accuracy of financial reporting and transparency, by direct financing and guarantees for new firms through ICO, including European efforts. | New credit, including to SMEs, is being extended rapidly, while private sector deleveraging still continues. Efforts to increase market-based SME financing are also continuing. |
| Facilitate private deleveraging by ensuring effective implementation of the "fresh start" to encourage demand, while preserving the strong payment culture. | The "fresh start" reform has been implemented but additional efforts are needed to ensure the new system's efficacy. |
| **Structural Reforms** | |
| **Labor market reforms** | |
| Enhance labor market performance by (i) keeping wage growth in line with productivity and external competitiveness, (ii) ensuring the use of firm-level wage bargaining and opt-out, particularly by small firms, (iii) closing the gap between the dismissal costs of temporary and permanent contracts, (iv) reducing legal and administrative uncertainties in collective dismissals and streamlining the application of objective criteria for fair dismissals, (v) and increasing the effectiveness of active labor market policies (ALMP). | Wage moderation continued. The use of firm-level wage bargaining and opt outs is still being hampered by administrative obstacles. No new policy action was taken to close the gap between the dismissal costs of temporary and permanent contracts. Similarly, no action was taken to reduce legal and administrative uncertainties in collective dismissals and streamlining the application of objective criteria for fair dismissals. Progress toward raising the effectiveness of ALMP has been slow. |
| **Productivity growth** | |
| Support small firm growth by (i) fostering competition through faster implementation of the Market Unity Law and the liberalization of professional services, (ii) assessing all size-related policies to identify and eliminate unwarranted obstacles to growth, (iii) and supporting internationalization and innovation. | The implementation of the Market Unity Law is ongoing, but differences in regulatory norms and practices across Spain remain. Several size-dependent tax incentives were eliminated with the 2015 CIT reform. No actions have been taken to liberalize professional services. |

## Appendix II. External Sector Report

| | Spain | Overall Assessment |
|---|---|---|
| **Foreign asset and liability position and trajectory** | **Background**. The net international investment position (NIIP) dropped from -35 percent of GDP in 2000 to –98 percent of GDP in 2009, driven mostly by substantial current account (CA) deficits but also reflecting valuation effects. The CA improved subsequently, but the NIIP remains elevated at –88.5 percent at 2016Q2 which is 9 percentage point lower than in end-2014. Gross external debt is still high, around 171 percent of GDP.<br>**Assessment**. The large negative NIIP comes with external vulnerabilities, including from large gross financing needs from external debt and valuation changes. Mitigating factors are a favorable maturity structure of Spain's outstanding sovereign debt with an average of 6½ years and current ECB measures such as QE. | **Overall Assessment**:<br>*The external position in 2016 is estimated to be substantially weaker than that consistent with medium-term fundamentals and desirable policy settings*.<br>In 2016, the CA has continued to improve, helped by lower oil import price and low interest rates.<br>Despite the strong improvement in the CA since the pre-crisis peak deficit in 2007, achieving both a sufficiently declining NIIP and much lower unemployment would require a sustained weaker real effective exchange rate.<br><br>**Potential policy responses**:<br>The authorities' recent structural reforms, in particular the labor market reform with the resulting wage moderation, as well as the Market Unity Law to reform product markets, and fiscal deficit reductions are in line with reducing imbalances.<br>In the medium term, further fiscal adjustment and moving forward with structural reforms of the labor market and faster implementation of product market reforms would be required to accelerate the adjustment.<br>Continued monetary easing at the euro area level to lift inflation closer to the ECB's medium-term price stability objective should help increase external demand, which would also support Spain's adjustment efforts. |
| **Current account** | **Background**. After a peak CA deficit in 2007 of 9.6 percent of GDP, corrected initially by a sharp contraction in imports, exports and imports have since grown strongly along with the economic recovery leading to CA surpluses in 2013-15. In 2016, the CA surplus is projected to widen to 2 percent of GDP (or 1.2 percent of GDP cyclically adjusted). Regained competitiveness from price and wage moderation, and the depreciation of the euro positively contributed to Spain's healthy exports growth and resilient export shares. ECB measures have helped to drive down interest rates on external debt, and the sharply lower oil price has reduced import costs.<br>**Assessment**. While the EBA model-based estimates would suggest a CA norm for 2016 (1.6 percent of GDP) close to the observed cyclically adjusted CA (1.2 percent of GDP), the staff assessment considers the overriding need to sharply improve the NIIP and gauges the CA norm to be around 2 percent of GDP. This implies that the cyclically adjusted CA was almost 1 percent of GDP weaker than desirable. Surpluses of this magnitude will need to be maintained until the NIIP is at a safer and sustainable level. Under staff's current forecast, a gradually improving CA will strengthen the NIIP by about 4-5 percent of GDP annually in the medium term. Reducing the still sizable structural fiscal deficit will be a key policy requirement to lower the remaining imbalances. | |
| **Real exchange rate** | **Background**. In 2016 the CPI-based real effective exchange rate (REER) increased by nearly 1 percent from its average 2015 level and declined by about 6 percent from its 2009 peak. This partially reversed the 17 percent appreciation from the euro entry in 1999 until 2009. The ULC-based REER, however, shows the appreciation has been substantially reversed since euro entry, initially as a result of substantial labor shedding, and more recently, of wage moderation<br>**Assessment**. The two EBA REER regression model approaches, the index and level REER tools, estimate an overvaluation of 8.8 and 2 percent for 2016, respectively (with reference to the CPI-based REER). Taking into account also the historical REER (CPI and ULC based) and model-based analysis, that considers NIIP sustainability, on balance, staff assesses a 2016 gap of around 5 to 10 percent above the level consistent with medium-term fundamentals and desirable policies. | |
| **Capital and financial accounts: flows and policy measures** | **Background**. Financing conditions have continued to ease, with sovereign bond yields near historical lows. At the same time, the private sector has continued its deleveraging against the rest of the world.<br>**Assessment**. The ECB's actions as well as domestic reforms and fiscal consolidation have greatly helped improve investor sentiment. However, large external financing needs both in the public and private sector leave Spain vulnerable to sudden changes in market sentiment and spillovers from Europe. | |
| **FX intervention and reserves level** | **Background**. The euro has the status of a global reserve currency.<br>**Assessment**. Reserves held by the euro area are typically low relative to standard metrics, but the currency is free floating. | |
| **Technical Background Notes** | 1/ Based on data available through 2016Q2 and projections for 2016.<br>2/ The new EBA CA regression-based approach estimate would suggest that a CA surplus of 1.6 percent of GDP would be appropriate for Spain. However, the empirically-based EBA norm does not fully account for the very negative NIIP with less than 20 percent of liabilities in the form of equity. The staff assessment is thus based on somewhat higher norm level (about 2 percent of GDP) that is consistent with the overriding need to substantially strengthen the external balance sheet. | |

## Appendix III. Risk Assessment Matrix

| Source of Risks | Relative Likelihood | Impact if Realized | Policy response |
|---|---|---|---|
| **External Risks** | | | |
| **Structural weak growth in key advanced and emerging economies** | **High**<br>Weak demand, low productivity growth, and persistently low inflation from a failure to address crisis legacies leading to a lower medium-term path of potential growth. | **Medium**<br>Slowing external demand would weigh on growth and employment. A rise in NPLs could weaken banks' balance sheets. Persistently low imported Euro Area inflation would worsen private and public debt dynamics; low Euro Area inflation would make Spain's adjustment more difficult. | • Deepen product market reforms and other structural reforms to raise productivity.<br>• Accelerate structural reforms, in particular enhance labor market performance and lower duality.<br>• Let automatic stabilizers play in case the output gap widens.<br>• Continue strengthening the financial sector and its capacity to support growth. |
| **Rise in populism and nationalism in large economies** | **High**<br>Could slow down or reverse policy coordination, trade liberalization, cross-border flows; weighing on global growth and exacerbating financial market volatility. | **Medium**<br>Increased uncertainty regarding the future of Europe may affect confidence and investment. However, ECB policies mitigate against excessive financial volatility. | • Accelerate structural reforms, in particular enhance labor market performance and lower duality.<br>• Let automatic stabilizers play in case the output gap widens. |
| **Sharp rise in risk premia with flight to safety** | **Medium**<br>Investors withdraw from specific risk asset classes as they reassess underlying economic and financial risks in large economies. | **Medium**<br>Tightening of financial conditions; bank-sovereign-real economy links could re-emerge via loss of market confidence. However, the ECB policies mitigate against excessive financial volatility. | • Accelerate structural reforms and formulate credible medium-term fiscal path to support investor confidence.<br>• Banks to continue building capital buffers.<br>• Further ECB policy actions could help depending on the nature of the shock. |
| **Protracted uncertainty associated with negotiating post-Brexit arrangement and outcome with significantly higher barriers** | **Medium**<br>Weakened confidence and investment, especially if the process is volatile. | **Medium**<br>Weaker external demand from the U.K. and the euro area if knock-on effects are stronger than in the baseline. Trade linkages are moderate. | • Accelerate structural reforms and formulate credible medium-term fiscal path to support investor confidence.<br>• Let automatic stabilizers play in case the output gap widens. |
| **Significant slowdown in emerging economies, especially in Latin America** | **Medium**<br>Turning of credit cycle and fallout from excess household and corporate leverage in emerging economies. | **Low**<br>Reduction in the profitability of Spain's global banks (and large corporates) which would weaken contributions to the parents' capital buffers. Trade linkages are limited. | • Continue strengthening the financial sector and its capacity to support growth.<br>• Close coordination with supervisors in host countries. |

## Appendix III. Risk Assessment Matrix (concluded)

| Source of Risks | Relative Likelihood | Impact if Realized | Policy response |
|---|---|---|---|
| **Domestic Risks** | | | |
| **Weak implementation of fiscal commitments and structural reforms or reversal of past policy achievements** | **Medium**<br>Traction for structural reforms is low in a fragmented parliament with a minority government. Pressures to reverse earlier reforms. A credible medium-term fiscal path has yet to emerge. | **High**<br>Lack of or reversal of reforms and fiscal consolidation could weaken confidence, investment, and employment, which would adversely impact public debt dynamics and could trigger adverse market reactions. | • Return to gradual, steady and growth-friendly fiscal consolidation.<br>• Advance ongoing structural reforms and enhance labor market performance.<br>• Reform the regional financing framework to reduce fiscal risks. |

The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

# Appendix IV. Debt Sustainability Analysis

*Public debt sustainability risks remain sizeable, despite the reduction of the headline fiscal deficit over the last six years. Under the baseline scenario, public debt is projected to decline slowly over the medium term from the peak of 100.4 percent of GDP in 2014, on the back of a slightly favorable growth-interest rate differential. However, at 95.6 percent of GDP in 2021, debt would remain at risky levels. A negative growth shock and the realization of contingent liabilities represent the largest risks to public debt sustainability. Returning to a gradual but steady and credible fiscal consolidation remains a priority. An annual structural adjustment of about ½ percent of GDP over the medium term would put debt firmly on a downward path, bringing it around 91.6 percent of GDP by 2021—4 percentage points lower than under the baseline. Gross financing needs have declined below the 20 percent of GDP early warning benchmark and are projected to continue to fall gradually over the medium term. However, at 16½ percent of GDP in 2021 they would remain among the highest in the euro area.*

## A. Public Debt Sustainability Analysis

### Background

**Definitions and coverage.** Public debt comprises Excessive Deficit Procedure (EDP) debt in the hands of the General Government. The General Government includes the Central Government, Regional Governments, Local Governments, and Social Security Funds. It includes only those public enterprises that are defined as part of General Government under European System of Accounts. EDP debt is a subset of General Government consolidated debt (i.e., it does not include trade credits and other accounts payable) and the stocks are recorded at their nominal value.

**Developments.** The public debt-to-GDP ratio increased from 35.5 percent of GDP in 2007 to 99.8 percent in 2015, driven by large fiscal deficits (of about 7¾ percent of GDP on average during 2008–15), and a largely unfavorable growth interest rate differential (which contributed by an annual average of about 2½ percent of GDP). The support to the banking sector added about 4½ percent of GDP to the public debt stock.

Gross financing needs have declined below 20 percent of GDP after peaking at 22 percent in 2012, on the back of an ongoing maturity extension and nominal deficit reduction. The ECB's quantitative easing has helped bringing sovereign bond yields down. The 10-year bond yield has declined from about 6¾ percent in mid-2012 to about 1.5 percent in November 2016. The effective interest rate on outstanding debt has also declined, and interest payments are expected to fall below 3 percent of GDP in 2016.

**Other factors.** The amortization profile of public debt is tilted towards the long term (82 percent of total debt, on a residual maturity basis). The marginal life at issuance has increased steadily since 2012, from 5 years to over 9 years in 2015, with the average life of outstanding debt increasing from 6.2 to 6.6 years over the same period. Holdings of public debt are relatively well diversified. The

share held by the Spanish banking system has continued to fall to about 42½ percent, while that of the ECB has increased to 7½ percent. The Eurosystem's purchases under the public sector purchases programme (PSPP) amounted to about EUR61 billion in 2015 (28 percent of the gross financing needs). The share of public debt held by residents declined by 10 percentage points since 2012 to 57½ by end-2015, but remains significantly above the 2007 level (50 percent). The stock of financial assets has been increasing gradually since 2012, amounting to about 35 percent of GDP in 2015. This constitutes a risk mitigating factor, with net public debt levels amounting to 80 percent of GDP.

**Baseline**

Public debt is projected to remain at 99.2 percent of GDP in 2017, before declining slowly to 95.6 percent by 2021. Gross financing needs are expected to remain below 20 percent, gradually declining over the projection period. However, at 16½ percent of GDP in 2021, they would remain relatively high compared to other euro area countries.

**Assumptions.** The baseline scenario is based on the medium-term projections (Table 1). In particular, (i) growth is projected to remain at 3.2 percent in 2016 and moderate to 2.3 percent in 2017, as the effect of tailwinds dissipates; (ii) over the medium term, growth is set to converge toward its potential rate of around 1½ percent; (iii) a structural adjustment of around ½ percent of GDP in 2017, followed by a broadly neutral fiscal stance over the medium term in structural primary terms; (iv) inflation (based on the GDP deflator) is projected to increase gradually from 0.5 percent in 2015 to 1½ percent in 2021; and (v) long-term sovereign spreads are assumed to increase slowly from 1.2 percent in 2015 to 1.5 percent in the medium term, with 10-year bond yields increasing moderately over the medium term in line with a gradual normalization of monetary policy.

**Stress tests**

Public debt levels would either remain broadly flat or increase under a number of standard shock scenarios. Debt dynamics would worsen significantly in the event of a materialization of contingent liabilities and in case the economy is hit by a combination of negative shocks to GDP growth and the primary balance, with the stock of public debt peaking in 2018 at around 116½ percent of GDP and 111 percent of GDP respectively.

**Growth shock.** In this scenario, real GDP growth rates are assumed to be lower than in the baseline by one (10-year historical) standard deviation for two consecutive years, in 2017–18. This would imply real GDP would decline on average by 0.5 percent per year, compared to annual average growth of 2.2 percent under the baseline. Under this recession scenario, inflation would be lower and the primary balance weaker (by about 2 percent of GDP per year, on average). In this context, the debt-to-GDP ratio would raise substantially, reaching 109.8 percent of GDP in 2018 before declining slowly to 106.6 percent in 2021 (11 percentage points higher than the baseline). Meanwhile, gross financing needs would increase above the 20 percent benchmark level reaching 22.1 percent in 2018, due to the larger fiscal deficit.

**Primary balance shock.** This scenario assumes a relaxation of fiscal policy in 2017–18, with a cumulative deterioration of the primary balance of 4½ percent of GDP (that is, assuming a shock equal to ½ the 10-year historical standard deviation of the primary balance-to-GDP ratio). Under this scenario, the public debt-to-GDP ratio would continue to increase, peaking at 103.3 percent of GDP in 2018 and then declining gradually to 100.3 percent in 2021, 4.7 percentage points higher than in the baseline. The larger primary deficits would also imply more sizable gross financing requirements than in the baseline, and would peak at 20.9 percent of GDP in 2018.

**Interest rate shock.** Over the five year forecast horizon, the debt dynamics could withstand relatively well a nominal interest rate shock of about 240 basis points during 2017–21, given the relatively long debt maturity and the high share of debt at fixed interest rates. Under such a scenario, the effective interest rate would increase to 3.7 percent by 2021 compared to 2.7 percent in the baseline. The debt-to-GDP ratio would remain broadly stable, amounting to 98.3 percent in 2021. However, a sizeable and sustained increase in interest rates would reduce the (already limited) fiscal space.

**Combined shock.** A simultaneous combination of the previous three shocks would be particularly adverse for public debt dynamics, mostly due to the impact of lower growth and higher primary deficits. In this scenario, the public debt-to-GDP ratio would increase to 111.1 percent in 2018, remaining at this high level through 2021 (almost 15 percentage points higher than under the baseline). Gross financing needs would also be significantly higher, peaking at over 22.9 percent of GDP in 2018.

**Contingent liability shock.** Large, negative unexpected events could put debt sustainability at risk. A negative financial sector shock scenario, assuming a one-time increase in non-interest public expenditures (in 2017) equivalent to 10 percent of banking sector assets, combined with lower growth and lower inflation in 2017–18 (i.e., growth is reduced by 1 standard deviation) would be particularly adverse for public debt dynamics. The materialization of such contingency liabilities would raise the primary deficit to 10.9 percent of GDP in 2017, bringing gross financing needs to 28.7 percent of GDP (about 9 percentage points above standard early warning benchmark levels). Moreover, the debt-to-GDP ratio would continue to increase, peaking at 116.5 percent in 2018, then slowly declining to about 113.5 percent in 2021 (17.9 percentage points higher than the baseline).

### Heat Map

Risks associated with public debt remain high as the benchmark level (85 percent of GDP) is breached under the baseline scenario as well as in each of the shock scenarios. Gross financing needs would remain below 20 percent of GDP under the baseline, but would surpass that benchmark level in the case of output and primary balance shocks and the materialization of contingent liabilities. Regarding the debt profile, risks stem from the high level of external financing needs and—to a lesser extent—from the share of public debt held by non-residents.

## B. External Debt Sustainability Analysis[1]

*While external debt is set to continue its gradual decline over the medium term, it will take time to reach levels that significantly lower the vulnerability to external shocks. The currently low cost of debt, favorable maturity structure, export and bank exposure diversification, and competiveness gains since the crisis are mitigating factors.*

**Methodology.** The external DSA provides a framework to examine a country's external sustainability that complements the External Sector Report (Appendix 2). The external DSA estimates the external debt path under a number of alternative scenarios. While the assumptions are relatively mechanistic and the estimates do not employ full-fledged alternative macroeconomic scenarios, they can nevertheless provide useful insights on the potential impact of a range of shocks.

**Baseline.** As for the public DSA, the baseline scenario is based on the medium-term projections (Table 1). In particular, it assumes a moderation of the Spanish real GDP growth recovery over the medium term to its estimated potential growth rate of about 1½ percent of GDP. The trade balance and current account are forecast to remain in surplus, somewhat above the 2015 levels. Driven by continued strong export growth due to regained competitiveness, the external debt-to-export ratio is projected to sharply decline (by over 132 percentage points) during 2016–21. After falling to 168 percent of GDP by end-2015, external debt and is projected to decline to 142 percent of GDP by 2021. At the same time, gross external financing needs will continue to decline in the projection period but remain a vulnerability given their high level with around 61 percent of GDP by 2021.

**Stress scenarios.** The DSA scenarios suggest that Spain's external debt will remain high but continue to gradually decline over the medium term unless key macroeconomic variables return to levels of the crisis episode. Overall, the external debt level remains a vulnerability given the sizable external and domestic risks surrounding the Spanish economic recovery.

**Historical shock scenario.** The external debt path would fail to stabilize in a scenario based on historical data properties. Assuming real GDP growth path of only 0.4 percent over the next five years combined with a 1.2 percentage point higher nominal interest rate, would raise external debt by more than 30 percent of GDP by 2021. Under such a shock the external debt-to-GDP ratio would rise to 202 percent of GDP.

**Interest rate shock.:** In the case of a rather benign interest rate shock (an increase from 1.9 percent in the baseline to 2.7 percent), external debt would rise only slightly (3 percentage points by 2021).

**Real depreciation shock.** A 30 percent real depreciation shock would have a similar impact as the interest rate shock. In the external DSA, the mechanic transmission channel is via valuation effects,

[1] Historical data revisions by the authorities explain the increase in external debt from 160.1 percent of GDP in 2014 (as reported in the 2015 Staff Report) to the currently reported value of 168.5 percent of GDP for the same year. This one-off also affects the level of the projected external debt path.

but Spain has a low share of debt denominated in foreign currency, so the increase in the debt ratio would be small (2 percentage points of GDP).

**Growth shock.** Assuming that real GDP growth averages 0.6 percent, compared with 2 percent in the baseline, external debt would be around 11 percent of GDP higher in 2021 (153 percent of GDP).

**Combined shock.** A similar elevated external debt path is obtained in the combined shock scenario, which assumes one quarter standard deviation shocks to the real interest rate, real GDP growth rate, and the current account balance. As a result, the external debt-to-GDP would be 12 percent higher in 2021 at 154 percent of GDP.

### An Extended External DSA

**Methodology.** Using estimated equations for export and import demand (see second chapter of Selected Issues paper), the extended DSA incorporates some reduced form responses of the components of the trade balance to specific shocks. While this is still not a full-fledged general equilibrium exercise, it complements the standard external DSA presented above.[2]

**Real appreciation shock.** A 30 percent nominal appreciation of the Euro against the USD bilateral exchange would appreciate the real effective exchange rate by about 8 percent, slowing down export growth and thus reducing the trade balance to about 1/2 percent of GDP in the medium term. This alone would result in an external debt of 6 percent by 2021. However, the revaluation effect partially offsets this increase, with a resulting debt-to-GDP ratio of 149 percent by 2021.[3]

**Oil price shock.** A permanent reversion of the oil price to its 2001–15 average (US$ 66 per barrel) by 2017 would reduce the trade balance to 1.4 percent of GDP in the medium term, and external debt would increase by 10 percentage points by 2021 relative to the baseline.

**Global demand slow down shock.** Assuming sustained weak global demand, in particular that Spain's trading partners' import demand grows permanently by 1 percentage point less every year, would lower's Spain's export growth. As a result, the medium-term trade balance would fall to 1.3 percent of GDP and external debt would increase by 10 percentage points relative to the baseline.

**Combined shock.** A scenario that combines the EUR/USD appreciation, the oil price increase, and the external demand deceleration would imply an external debt of 157 percent of GDP in 2021, compared to the 142 percent of GDP in the baseline.

[2] See second chapter of Selected Issues paper for more details.

[3] As in all other shocks, this partial equilibrium analysis ignores the effect on GDP growth that the shock may have.

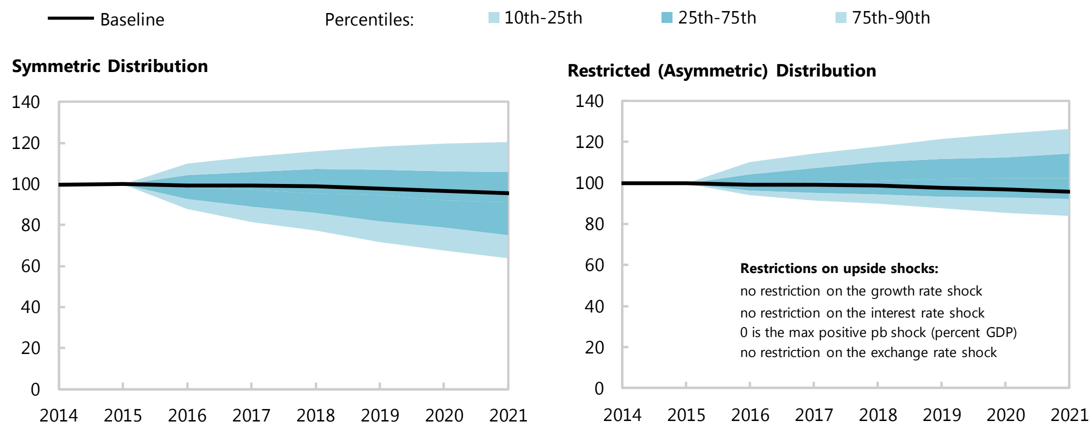
## Spain Public DSA Risk Assessment

### Heat Map

| | | | | | |
|---|---|---|---|---|---|
| Debt level 1/ | Real GDP Growth Shock | Primary Balance Shock | Real Interest Rate Shock | Exchange Rate Shock | Contingent Liability shock |
| Gross financing needs 2/ | Real GDP Growth Shock | Primary Balance Shock | Real Interest Rate Shock | Exchange Rate Shock | Contingent Liability Shock |
| Debt profile 3/ | Market Perception | External Financing Requirements | Change in the Share of Short-Term Debt | Public Debt Held by Non-Residents | Foreign Currency Debt |

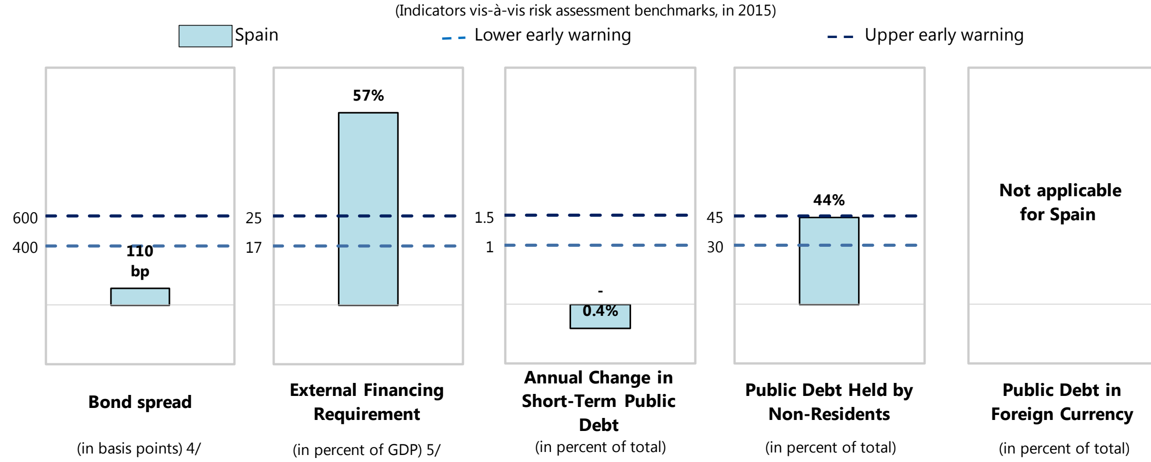
### Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)




### Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2015)




Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 85% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 20% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.

Lower and upper risk-assessment benchmarks are:

400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

4/ Long-term bond spread over German bonds, an average over the last 3 months, 01-Sep-16 through 30-Nov-16.

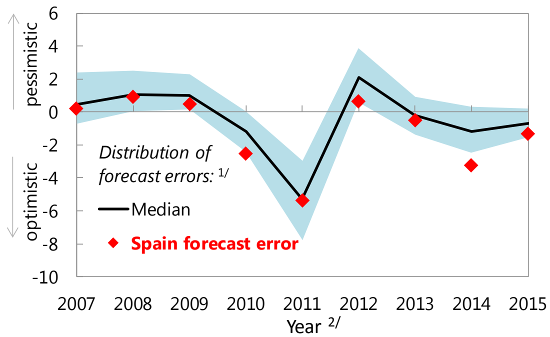
5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

## Spain Public DSA - Realism of Baseline Assumptions

### Forecast Track Record, versus surveillance countries

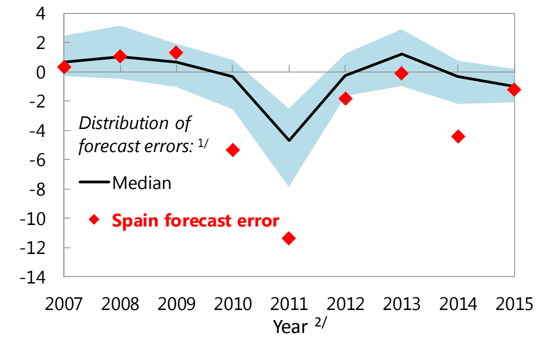
**Real GDP Growth**
(in percent, actual-projection)

Spain median forecast error, 2007-2015: **-0.48**
Has a percentile rank of: **38%**



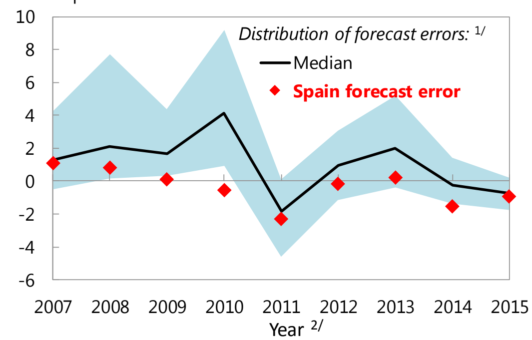

**Primary Balance**
(in percent of GDP, actual-projection)

Spain median forecast error, 2007-2015: **-1.22**
Has a percentile rank of: **30%**



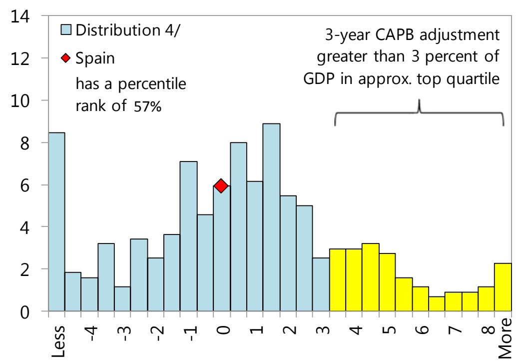

**Inflation (Deflator)**
(in percent, actual-projection)

Spain median forecast error, 2007-2015: **-0.18**
Has a percentile rank of: **19%**

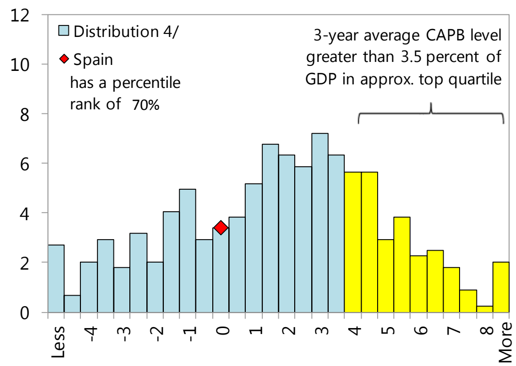



### Assessing the Realism of Projected Fiscal Adjustment

**3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)**
(Percent of GDP)

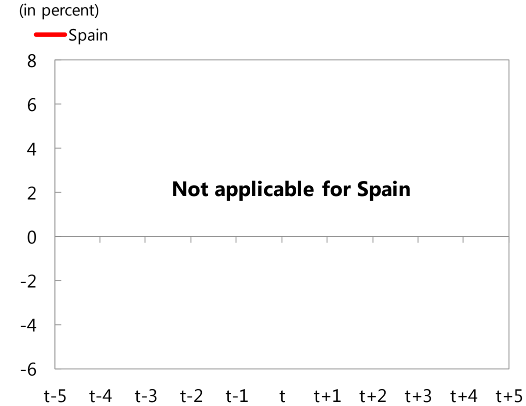



**3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)**
(Percent of GDP)




### Boom-Bust Analysis 3/

**Real GDP growth**
(in percent)




Source : IMF Staff.
1/ Plotted distribution includes surveillance countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Not applicable for Spain, as it meets neither the positive output gap criterion nor the private credit growth criterion.
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

## Spain Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

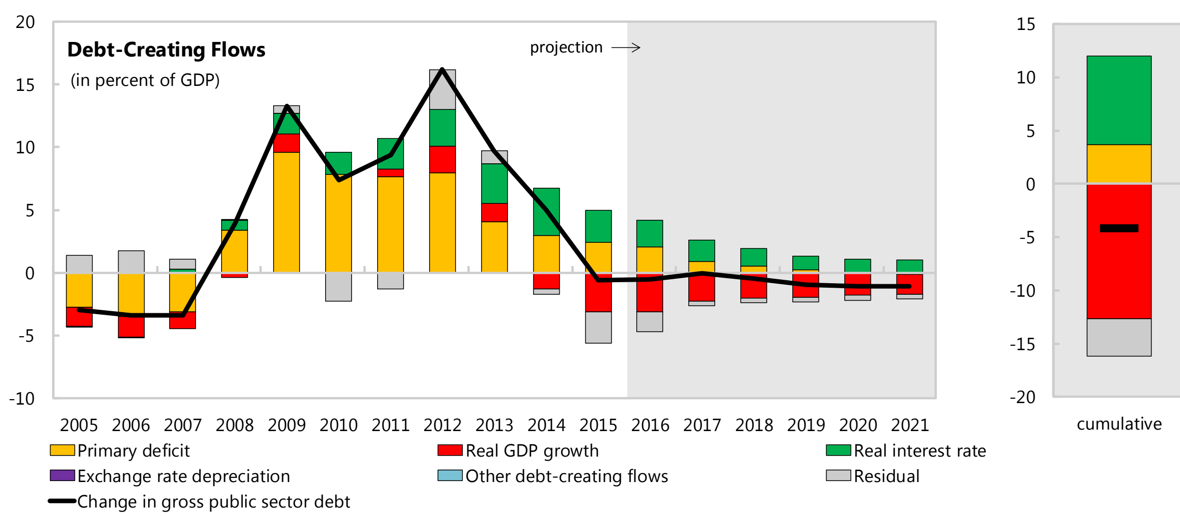
### Debt, Economic and Market Indicators 1/

| | Actual | | | Projections | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2005-2013 2/ | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 |
| Nominal gross public debt | 57.7 | 100.4 | 99.8 | 99.2 | 99.2 | 98.7 | 97.8 | 96.7 | 95.6 |
| Public gross financing needs | 13.4 | 20.8 | 19.9 | 19.2 | 18.0 | 17.5 | 17.0 | 16.7 | 16.4 |
| Real GDP growth (in percent) | 0.4 | 1.4 | 3.2 | 3.2 | 2.3 | 2.1 | 2.0 | 1.9 | 1.7 |
| Inflation (GDP deflator, in percent) | 1.6 | -0.3 | 0.5 | 0.7 | 1.0 | 1.2 | 1.4 | 1.5 | 1.6 |
| Nominal GDP growth (in percent) | 2.1 | 1.1 | 3.7 | 3.9 | 3.4 | 3.3 | 3.5 | 3.4 | 3.3 |
| Effective interest rate (in percent) 4/ | 4.1 | 3.7 | 3.2 | 2.9 | 2.8 | 2.7 | 2.6 | 2.6 | 2.7 |

| As of November 30, 2016 | | |
|---|---|---|
| Sovereign Spreads | | |
| EMBIG (bp) 3/ | | 128 |
| 5Y CDS (bp) | | 85 |
| Ratings | Foreign | Local |
| Moody's | Baa2 | Baa2 |
| S&Ps | BBB+ | BBB+ |
| Fitch | BBB+ | BBB+ |

### Contribution to Changes in Public Debt

| | Actual | | | Projections | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2005-2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | cumulative | debt-stabilizing primary balance 9/ |
| Change in gross public sector debt | 5.6 | 5.0 | -0.6 | -0.6 | 0.0 | -0.5 | -1.0 | -1.1 | -1.1 | -4.2 | |
| Identified debt-creating flows | 5.0 | 5.4 | 1.9 | 1.1 | 0.4 | -0.1 | -0.6 | -0.7 | -0.7 | -0.6 | |
| Primary deficit | 3.5 | 3.0 | 2.4 | 2.1 | 0.9 | 0.5 | 0.2 | 0.1 | -0.1 | 3.7 | -0.6 |
| Primary (noninterest) revenue | 37.5 | 38.4 | 38.3 | 37.7 | 37.9 | 37.8 | 37.7 | 37.7 | 37.7 | 226.5 | |
| Primary (noninterest) expenditure | 41.0 | 41.4 | 40.7 | 39.7 | 38.8 | 38.4 | 37.9 | 37.8 | 37.6 | 230.2 | |
| Automatic debt dynamics 5/ | 1.5 | 2.4 | -0.5 | -1.0 | -0.6 | -0.6 | -0.8 | -0.8 | -0.6 | -4.3 | |
| Interest rate/growth differential 6/ | 1.5 | 2.4 | -0.5 | -1.0 | -0.6 | -0.6 | -0.8 | -0.8 | -0.6 | -4.3 | |
| Of which: real interest rate | 1.4 | 3.7 | 2.6 | 2.1 | 1.7 | 1.4 | 1.1 | 1.0 | 1.0 | 8.3 | |
| Of which: real GDP growth | 0.1 | -1.3 | -3.1 | -3.1 | -2.2 | -2.0 | -1.9 | -1.8 | -1.6 | -12.6 | |
| Exchange rate depreciation 7/ | 0.0 | 0.0 | 0.0 | ... | ... | ... | ... | ... | ... | ... | |
| Other identified debt-creating flows | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | |
| Residual, including asset changes 8/ | 0.6 | -0.4 | -2.5 | -1.6 | -0.4 | -0.4 | -0.4 | -0.4 | -0.4 | -3.5 | |




Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi(1+g)$ and the real growth contribution as $-g$.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

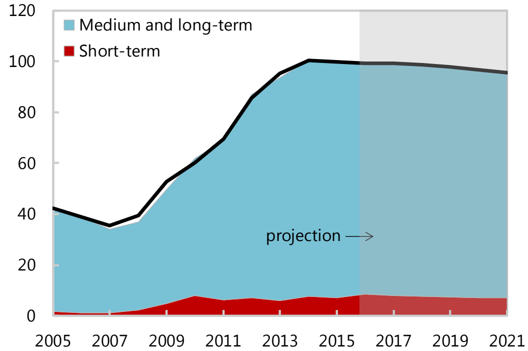
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

## Spain Public DSA - Composition of Public Debt and Alternative Scenarios

### Composition of Public Debt

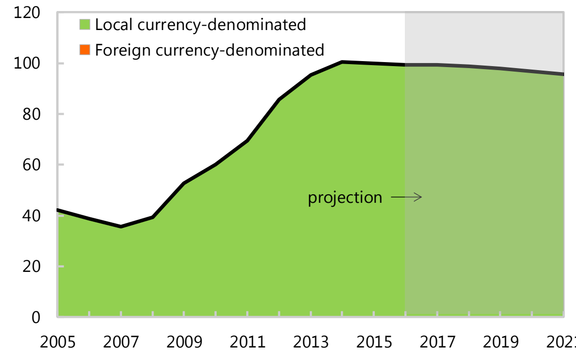
**By Maturity**

(in percent of GDP)




**By Currency**

(in percent of GDP)

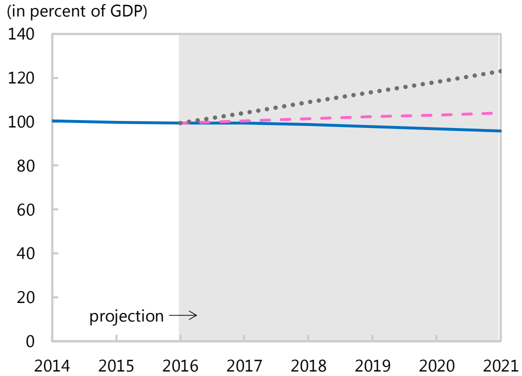



### Alternative Scenarios

Baseline    Historical    Constant Primary Balance

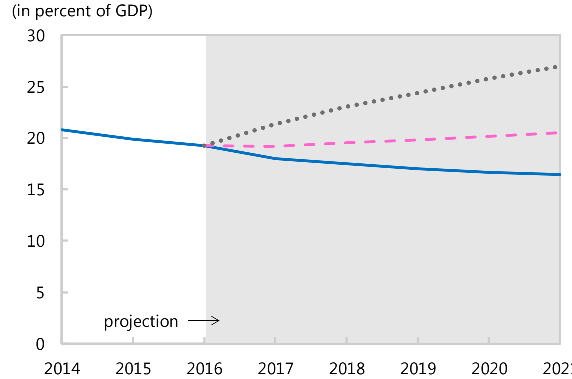
**Gross Nominal Public Debt**

(in percent of GDP)




**Public Gross Financing Needs**

(in percent of GDP)




### Underlying Assumptions

(in percent)

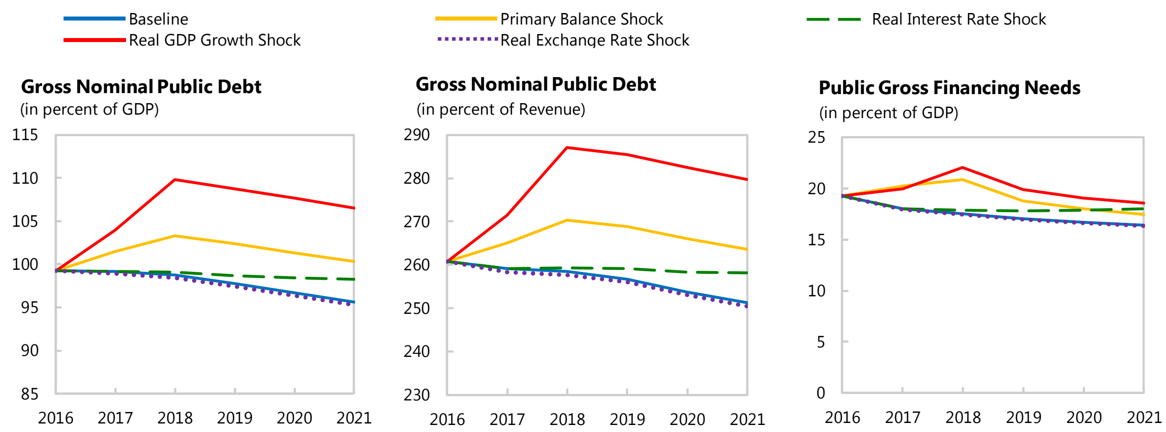
| **Baseline Scenario** | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 |
|---|---|---|---|---|---|---|
| Real GDP growth | 3.2 | 2.3 | 2.1 | 2.0 | 1.9 | 1.7 |
| Inflation | 0.7 | 1.0 | 1.2 | 1.4 | 1.5 | 1.6 |
| Primary Balance | -2.1 | -0.9 | -0.5 | -0.2 | -0.1 | 0.1 |
| Effective interest rate | 2.9 | 2.8 | 2.7 | 2.6 | 2.6 | 2.7 |
| **Constant Primary Balance Scenario** | | | | | | |
| Real GDP growth | 3.2 | 2.3 | 2.1 | 2.0 | 1.9 | 1.7 |
| Inflation | 0.7 | 1.0 | 1.2 | 1.4 | 1.5 | 1.6 |
| Primary Balance | -2.1 | -2.1 | -2.1 | -2.1 | -2.1 | -2.1 |
| Effective interest rate | 2.9 | 2.8 | 2.7 | 2.6 | 2.6 | 2.6 |

| **Historical Scenario** | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 |
|---|---|---|---|---|---|---|
| Real GDP growth | 3.2 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 |
| Inflation | 0.7 | 1.0 | 1.2 | 1.4 | 1.5 | 1.6 |
| Primary Balance | -2.1 | -3.9 | -3.9 | -3.9 | -3.9 | -3.9 |
| Effective interest rate | 2.9 | 2.8 | 2.9 | 2.9 | 3.1 | 3.2 |

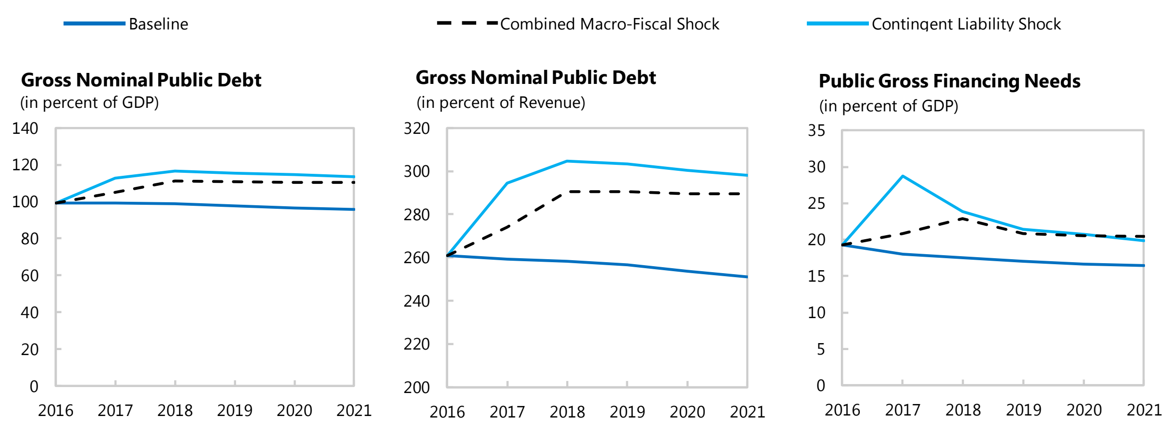
Source: IMF staff.

## Spain Public DSA - Stress Tests

### Macro-Fiscal Stress Tests




### Additional Stress Tests




### Underlying Assumptions

(in percent)

| **Primary Balance Shock** | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 |
|---|---|---|---|---|---|---|
| Real GDP growth | 3.2 | 2.3 | 2.1 | 2.0 | 1.9 | 1.7 |
| Inflation | 0.7 | 1.0 | 1.2 | 1.4 | 1.5 | 1.6 |
| Primary balance | -2.1 | -3.2 | -2.8 | -0.2 | -0.1 | 0.1 |
| Effective interest rate | 2.9 | 2.8 | 2.7 | 2.7 | 2.7 | 2.7 |
| **Real Interest Rate Shock** | | | | | | |
| Real GDP growth | 3.2 | 2.3 | 2.1 | 2.0 | 1.9 | 1.7 |
| Inflation | 0.7 | 1.0 | 1.2 | 1.4 | 1.5 | 1.6 |
| Primary balance | -2.1 | -0.9 | -0.5 | -0.2 | -0.1 | 0.1 |
| Effective interest rate | 2.9 | 2.8 | 3.1 | 3.2 | 3.5 | 3.7 |
| **Combined Shock** | | | | | | |
| Real GDP growth | 3.2 | -0.4 | -0.7 | 2.0 | 1.9 | 1.7 |
| Inflation | 0.7 | 0.4 | 0.5 | 1.4 | 1.5 | 1.6 |
| Primary balance | -2.1 | -3.2 | -3.3 | -0.2 | -0.1 | 0.1 |
| Effective interest rate | 2.9 | 2.8 | 3.1 | 3.2 | 3.5 | 3.7 |

| **Real GDP Growth Shock** | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 |
|---|---|---|---|---|---|---|
| Real GDP growth | 3.2 | -0.4 | -0.7 | 2.0 | 1.9 | 1.7 |
| Inflation | 0.7 | 0.4 | 0.5 | 1.4 | 1.5 | 1.6 |
| Primary balance | -2.1 | -2.3 | -3.3 | -0.2 | -0.1 | 0.1 |
| Effective interest rate | 2.9 | 2.8 | 2.7 | 2.7 | 2.7 | 2.7 |
| **Real Exchange Rate Shock** | | | | | | |
| Real GDP growth | 3.2 | 2.3 | 2.1 | 2.0 | 1.9 | 1.7 |
| Inflation | 0.7 | 1.4 | 1.2 | 1.4 | 1.5 | 1.6 |
| Primary balance | -2.1 | -0.9 | -0.5 | -0.2 | -0.1 | 0.1 |
| Effective interest rate | 2.9 | 2.8 | 2.7 | 2.6 | 2.6 | 2.7 |
| **Contingent Liability Shock** | | | | | | |
| Real GDP growth | 3.2 | -0.4 | -0.7 | 2.0 | 1.9 | 1.7 |
| Inflation | 0.7 | 0.4 | 0.5 | 1.4 | 1.5 | 1.6 |
| Primary balance | -2.1 | -10.9 | -0.5 | -0.2 | -0.1 | 0.1 |
| Effective interest rate | 2.9 | 3.0 | 3.0 | 2.8 | 2.8 | 2.9 |

Source: IMF staff.

## Spain External Debt Sustainability Framework, 2011-2021
(In percent of GDP, unless otherwise indicated)

| | Actual | | | | | | | | Projections | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2011 | 2012 | 2013 | 2014 | 2015 | | 10-Year Historical Average | 10-Year Standard Deviation | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 |
| **Baseline: External debt** | 160.3 | 166.2 | 159.8 | 167.7 | 168.5 | | | | **162.8** | **158.2** | **154.0** | **149.8** | **145.7** | **141.9** |
| Change in external debt | 3.9 | 5.8 | -6.3 | 7.8 | 0.8 | | | | -5.7 | -4.6 | -4.2 | -4.2 | -4.1 | -3.8 |
| Identified external debt-creating flows (4+8+9) | 1.5 | 4.5 | -3.8 | -7.1 | -5.4 | | | | -7.9 | -6.2 | -5.9 | -5.8 | -5.6 | -5.2 |
| Current account deficit, excluding interest payments | -0.8 | -4.3 | -5.5 | -4.6 | -4.6 | | | | -4.9 | -4.5 | -4.5 | -4.7 | -4.9 | -5.2 |
| Deficit in balance of goods and services | -58.1 | -59.9 | -61.2 | -62.9 | -63.9 | | | | 2.9 | 2.8 | 2.8 | 2.9 | 3.0 | 3.1 |
| Exports | 29.0 | 30.7 | 32.3 | 32.7 | 33.2 | | | | 33.0 | 33.7 | 34.5 | 35.3 | 36.1 | 36.9 |
| Imports | -29.1 | -29.2 | -29.0 | -30.2 | -30.7 | | | | -30.1 | -31.0 | -31.7 | -32.4 | -33.1 | -33.8 |
| Net non-debt creating capital inflows (negative) | -2.2 | -2.2 | -4.0 | -4.3 | -0.6 | | | | -0.7 | -0.8 | -0.8 | -0.8 | -0.8 | -0.8 |
| Automatic debt dynamics 1/ | 4.5 | 11.1 | 5.8 | 1.8 | -0.2 | | | | -2.3 | -0.9 | -0.5 | -0.3 | 0.2 | 0.8 |
| Contribution from nominal interest rate | 4.0 | 4.6 | 4.0 | 3.5 | 3.2 | | | | 2.9 | 2.7 | 2.7 | 2.7 | 2.9 | 3.2 |
| Contribution from real GDP growth | 1.5 | 5.2 | 2.8 | -2.2 | -6.2 | | | | -5.2 | -3.6 | -3.2 | -3.0 | -2.7 | -2.4 |
| Contribution from price and exchange rate changes 2/ | -1.0 | 1.3 | -1.0 | 0.4 | 2.8 | | | | ... | ... | ... | ... | ... | ... |
| Residual, incl. change in gross foreign assets (2-3) 3/ | 2.4 | 1.3 | -2.5 | 15.0 | 6.2 | | | | 2.2 | 1.7 | 1.6 | 1.6 | 1.5 | 1.4 |
| External debt-to-exports ratio (in percent) | 553.8 | 540.8 | 495.6 | 513.0 | 507.8 | -109.5 | | | 493.7 | 468.9 | 446.3 | 424.7 | 403.9 | 384.1 |
| **Gross external financing need (in billions of US dollars) 4/** | 1089.4 | 1123.8 | 1058.0 | 962.4 | 968.2 | | | | 879.4 | 891.3 | 901.9 | 909.6 | 920.3 | 929.9 |
| in percent of GDP | 73.1 | 84.1 | 77.7 | 69.8 | 81.1 | | | | 70.5 | 68.4 | 66.6 | 64.5 | 62.6 | 61.4 |
| **Scenario with key variables at their historical averages 5/** | | | | | | | | | **162.8** | **170.5** | **177.9** | **186.1** | **194.9** | **202.1** |
| **Key Macroeconomic Assumptions Underlying Baseline 6/** | | | | | | | | | | | | | | |
| Real GDP growth (in percent) | -1.0 | -2.9 | -1.7 | 1.4 | 3.2 | | 0.4 | 2.8 | 3.2 | 2.3 | 2.1 | 2.0 | 1.9 | 1.7 |
| GDP deflator in US dollars (change in percent) | 4.9 | -7.5 | 3.7 | -0.2 | -16.1 | | 0.2 | 8.7 | 1.3 | 2.0 | 1.7 | 2.1 | 2.3 | 1.4 |
| Nominal external interest rate (in percent) | 2.6 | 2.5 | 2.5 | 2.2 | 1.7 | | 2.9 | 0.8 | 1.8 | 1.7 | 1.8 | 1.8 | 2.0 | 2.3 |
| Growth of exports (US dollar terms, in percent) | 17.6 | -4.7 | 6.9 | 2.5 | -12.1 | | 4.0 | 12.4 | 3.9 | 6.8 | 6.2 | 6.4 | 6.6 | 5.6 |
| Growth of imports (US dollar terms, in percent) | 12.7 | -10.0 | 1.1 | 5.6 | -11.9 | | 1.7 | 14.6 | 2.2 | 7.7 | 6.4 | 6.2 | 6.4 | 5.5 |
| Current account balance, excluding interest payments | 0.8 | 4.3 | 5.5 | 4.6 | 4.6 | | 0.7 | 4.3 | 4.9 | 4.5 | 4.5 | 4.7 | 4.9 | 5.2 |
| Net non-debt creating capital inflows | 2.2 | 2.2 | 4.0 | 4.3 | 0.6 | | 0.2 | 3.6 | 0.7 | 0.8 | 0.8 | 0.8 | 0.8 | 0.8 |

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

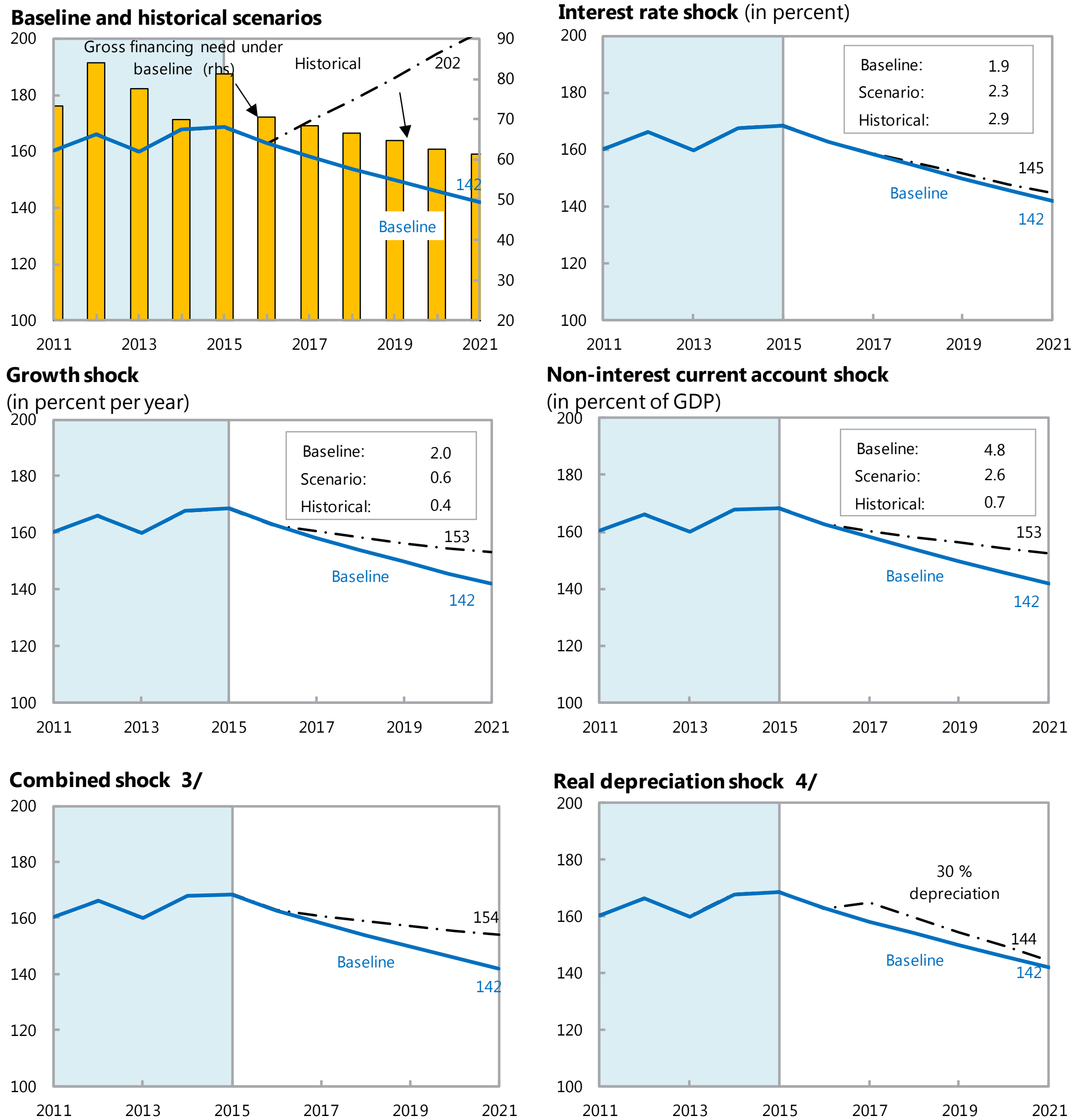
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

**Spain External Debt Sustainability - Bound Tests 1/ 2/**

(External debt in percent of GDP)




Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

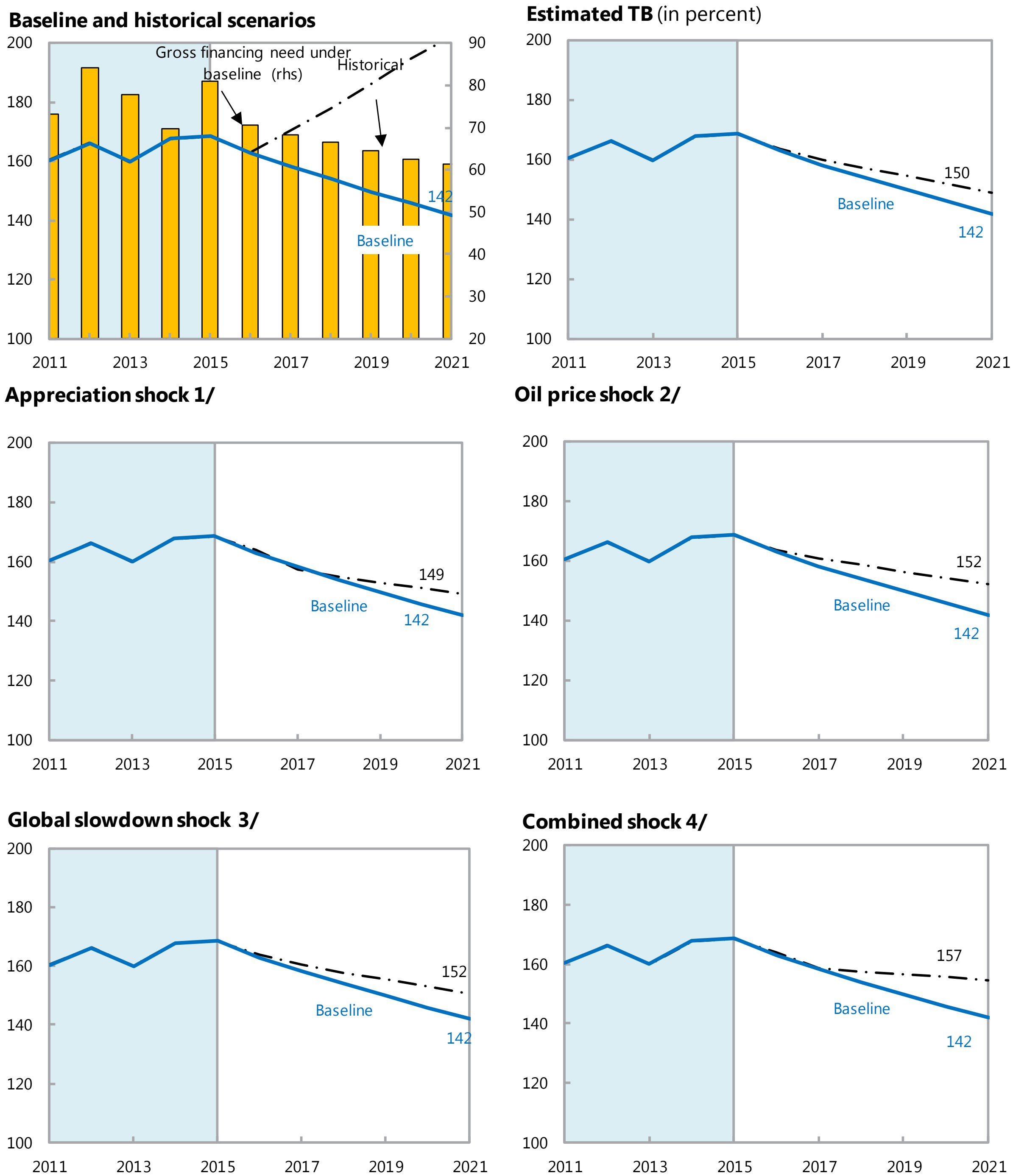
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

4/ One-time real depreciation of 30 percent occurs in 2016.

**Spain: External Debt Sustainability – Bound Tests** (concluded)

(External debt in percent of GDP)




Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ One time 30 percent nominal appreciation (euro/usd) in 2017.

2/ One time shock that brings the oil price level to its 2001-2015 average value by 2017.

3/ Global growth is reduced by 1 percent

4/ All the previous shocks are included