

Spain: 2018 Article IV Consultation-Press Release; Staff Report; and Statement by the Executive Director for Spain



SPAIN

November 2018

2018 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR SPAIN

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2018 Article IV consultation with Spain, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its November 19, 2018 consideration of the staff report that concluded the Article IV consultation with Spain.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on November 19, 2018, following discussions that ended on October 3, 2018, with the officials of Spain on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on November 2, 2018.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Spain.

The documents listed below have been or will be separately released.

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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November 21, 2018

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IMF Executive Board Concludes 2018 Article IV Consultation with Spain

On November 19, 2018, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation¹ with Spain.

The Spanish economy continues to make up ground lost during the crisis, but the recovery is maturing. Real GDP growth is projected to moderate to 2.5 percent in 2018 and 2.2 percent in 2019 before gradually slowing to its potential rate, estimated at around 1.75 percent over the medium term. Strong private consumption and investment demand were the main drivers of growth. The external position strengthened further, supported by continued current account surpluses, but is still moderately weaker than suggested by medium-term fundamentals. The labor market has improved but significant challenges remain. While the unemployment rate fell to 14.6 percent, below its long-term average, Spain's youth joblessness, the share of temporary contracts, and involuntary part-time employment remain among the highest in the EU.

Public debt remains close to 100 percent of GDP. The headline fiscal deficit has continued to come down in 2017 and is projected to fall below the 3 percent of GDP Maastricht criterion in 2018. But much of this reduction can be attributed to the strong economic cycle and low interest rates, while there was no adjustment in the underlying fiscal position in 2018.

The private sector has deleveraged further amidst favorable lending conditions, while the health of the banking system has steadily strengthened. The total private sector debt-to-GDP ratio fell by nearly 10 percentage points in 2017. But some segments of corporates and households are still overly leveraged, and loans for consumer durables are expanding quickly, though from a low base. The decline in nonperforming loans (NPLs) and foreclosed assets has accelerated, helped by economic growth, rising property prices, and bank sales of troubled assets. Nevertheless, the NPL ratio for lending in Spain was still at 6.4 percent in the second quarter of 2018. Spanish banks continue to lag European peers in terms of capital ratios.

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

Executive Board Assessment²

Executive Directors welcomed Spain's continued strong economic growth and decline in unemployment, which reflects the economy's improved fundamentals. However, Directors noted that notwithstanding the achievements, several downside risks are clouding the medium-term outlook. They encouraged the authorities to persevere with policies and reforms aimed at further enhancing economic resilience, reducing public debt, improving productivity, reducing inequality and increasing employment, especially raising long-term and youth employment.

Directors called for rebuilding fiscal buffers. Given the still high level of public debt, they stressed the need to resume structural fiscal consolidation and bring public debt down faster. They welcomed the authorities' fiscal deficit target for 2019. In this context, they encouraged the authorities to adopt a sound package of measures and plan for contingency actions in case of potential fiscal shortfalls.

Directors noted the government's intention to raise additional revenues, given the relatively low revenue-to-GDP ratio. They considered that revenue measures can bring the deficit down, help finance more social spending, and support the government's goal of lowering inequality. However, a careful design of tax measures is key to limit distortions and negative growth implications. Directors encouraged the authorities to consider gradually reducing the number of goods and services that qualify for reduced VAT rates, addressing tax system inefficiencies, and raising environmental taxes.

Directors stressed the need to safeguard the pension system's financial viability while enhancing its social acceptability. They noted that linking pension growth permanently to inflation, without offsetting measures, could put pension spending on a sharp upward trajectory. Directors called for a comprehensive, transparent, and equitable approach to pension reforms.

Directors welcomed the further strengthening of the banking system. They stressed the importance for banks to continue raising high-quality capital as a shield against shocks, including from potential spillovers related to market volatility. Directors underscored the need for rigorous management of liquidity and interest rate risks, in particular, ahead of the eventual gradual normalization of the ECB's accommodative policies. They welcomed the authorities' plan to create a macroprudential authority to better address potential financial stability risks and to swiftly expand the Bank of Spain's macroprudential toolkit.

Directors welcomed the strong job creation and underscored the need to make the labor market more inclusive. They called for preserving the thrust of past labor market reforms. Directors encouraged the authorities to continue to address labor market duality, strengthen active labor market policies, enhance incentives for greater labor mobility across regions, and ensure wage flexibility. They emphasized that wage increases should be aligned with productivity growth.

² At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

Directors underlined that raising productivity growth requires new impetus. They highlighted the need for policies that facilitate competition, foster innovation, address skills mismatches, and dismantle barriers for firms to grow. Directors also encouraged the authorities to improve regional coordination with a view to lower regional productivity disparities.

Spain: Main Economic Indicators, 2013–20
(Percent change unless otherwise indicated)

	2013	2014	2015	2016	2017	Projections		
						2018	2019	2020
Demand and supply in constant prices								
Gross domestic product	-1.7	1.4	3.6	3.2	3.0	2.5	2.2	1.9
Private consumption	-3.1	1.5	3.0	2.9	2.5	2.4	2.1	1.7
Public consumption	-2.1	-0.3	2.0	1.0	1.9	2.1	1.7	0.8
Gross fixed investment	-3.4	4.7	6.7	2.9	4.8	5.8	3.8	2.7
Total domestic demand	-3.2	2.0	4.0	2.4	3.0	3.1	2.4	1.7
Net exports (contribution to growth)	1.5	-0.5	-0.3	0.8	0.1	-0.5	-0.1	0.2
Exports of goods and services	4.3	4.3	4.2	5.2	5.2	1.4	2.2	3.6
Imports of goods and services	-0.5	6.6	5.4	2.9	5.6	3.0	2.8	3.3
Savings-Investment Balance (percent of GDP)								
Gross domestic investment	18.7	19.5	20.4	20.4	21.1	21.9	22.2	22.3
National savings	20.2	20.5	21.6	22.7	22.9	22.9	22.9	23.0
Foreign savings	-1.5	-1.1	-1.2	-2.3	-1.8	-1.0	-0.7	-0.8
Household saving rate (percent of gross disposable income)	9.6	9.2	8.7	7.8	5.5	4.6	4.6	4.6
Private sector debt (percent of GDP)	241.4	231.3	217.8	207.9	199.6	192.2	185.7	180.6
Corporate debt	159.6	153.7	145.4	138.9	133.9	128.1	122.9	118.6
Household debt	81.8	77.6	72.3	69.0	65.6	64.1	62.8	62.0
Credit to private sector	-10.2	-6.5	-4.2	-4.1	-2.0	-0.2	0.2	1.2
Potential output growth	0.0	0.3	1.2	1.0	1.3	1.5	1.7	1.8
Output gap (percent of potential)	-7.8	-6.8	-4.5	-2.4	-0.8	0.2	0.8	0.9
Prices								
GDP deflator	0.4	-0.2	0.5	0.3	1.2	1.3	1.7	1.9
HICP (average)	1.5	-0.2	-0.6	-0.3	2.0	1.8	1.8	1.9
HICP (end of period)	0.3	-1.1	-0.1	1.4	1.2	2.2	1.7	1.7
Core inflation (average)	1.4	0.0	0.6	0.8	1.1	1.1	1.6	2.0
Core inflation (end of period)	0.3	0.0	1.0	0.9	0.8	1.3	1.8	2.0
Employment and wages								
Unemployment rate (percent)	26.1	24.4	22.1	19.6	17.2	15.6	14.7	14.3
Labor productivity 1/	1.8	0.3	0.3	0.1	0.1	0.3	0.8	0.9
Labor costs, private sector	0.3	0.1	0.2	0.1	0.7	1.6	1.7	1.7
Employment growth	-2.8	1.2	3.0	2.7	2.6	2.3	1.5	0.9
Balance of payments (percent of GDP)								
Current account balance	1.5	1.1	1.2	2.3	1.8	1.0	0.7	0.8
Net international investment position	-95.2	-98.0	-89.5	-85.3	-83.8	-79.5	-75.5	-71.7
Public finance (percent of GDP) 2/								
General government balance 3/	-7.0	-6.0	-5.3	-4.5	-3.1	-2.8	-2.4	-2.4
Primary balance	-4.0	-3.0	-2.6	-1.9	-0.7	-0.6	-0.3	-0.2
Structural balance	-2.5	-2.0	-2.6	-2.9	-2.6	-2.8	-2.8	-2.9
General government debt	95.5	100.4	99.3	99.0	98.1	97.3	96.0	94.8

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

1/ Output per worker.

2/ The 2019 projections assume unchanged fiscal policies except for the already legislated measures and the public wage increase agreed with the unions.

3/ The headline balance for Spain includes 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, 0.2 percent of GDP for 2016, and 0.1 percent of GDP for 2017.



SPAIN

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION

November 2, 2018

KEY ISSUES

Context. Spain's economy has continued to grow strongly, reflecting its improved fundamentals. However, especially the young generation still faces daunting economic challenges. In the meantime, several downside risks are clouding the medium-term outlook. Externally, they comprise sudden changes in investors' global risk appetite, escalating global protectionism, and weakening conditions in emerging economies. Domestically, they include pressure to reverse reforms, continued procyclical fiscal policy, and prolonged uncertainty related to Catalonia. These could hurt the economy particularly in an environment of high public debt and structural unemployment as well as sluggish productivity growth, which is set to slow Spain's income convergence.

Policies. As the economic cycle is maturing and new risks are emerging, there is a heightened urgency to further enhance the resilience of the economy. When coupled with measures that raise long-term employment prospects, especially for the young, this would also contribute to more inclusiveness.

- **Fiscal policy.** Public debt should be reduced faster. A clear medium-term fiscal strategy is crucial to decisively lower fiscal vulnerabilities while safeguarding the pension system's financial viability and enhancing its social acceptability.
- **Labor market.** The thrust of the past labor market reforms should be preserved. Broad-based efforts should aim at making the labor market more inclusive by raising the attractiveness of open-ended contracts for employers, strengthening active labor market policies, and enhancing incentives for labor mobility across regions.
- **Structural reforms.** Lifting productivity growth requires new impetus, particularly through policies that facilitate competition, foster innovation, address skills mismatches, and dismantle barriers for firms' growth. In these areas, there is also room for better regional coordination to lower their productivity disparities.
- **Financial sector.** Priorities include further cleanup of legacy bank assets, continued improvement in bank profitability and capitalization, rigorous management of interest rate and liquidity risks, and reform of the institutional framework for financial oversight.

Approved By
Mahmood Pradhan
(EUR) and
Zuzana Murgasova
(SPR)

Discussions took place in Madrid during September 19–October 3, 2018. The staff team comprised Andrea Schaechter (head), Lucy Liu, Jorge Salas, and Ara Stepanyan (all EUR). Poul Thomsen (Director of the European Department) joined the concluding meetings. Pablo Moreno (Alternate Executive Director), and José Manuel Montero (Advisor to the Executive Director) attended most of the discussions. Tingyun Chen and Dilcia Noren (EUR) supported the mission from headquarters. The mission met Economy and Business Minister Nadia Calviño, Finance Minister María Jesús Montero, Bank of Spain Governor Pablo Hernández de Cos, and other senior officials. The mission also met with representatives of the financial sector, labor organizations, think tanks, parliament, and political parties.

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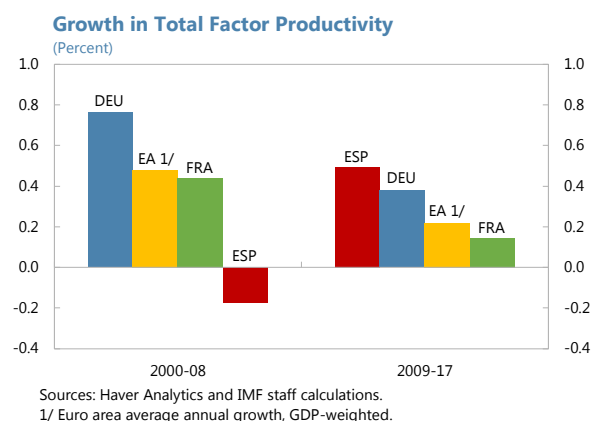
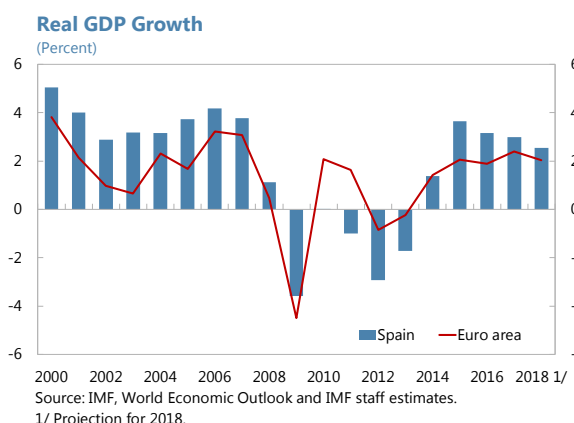
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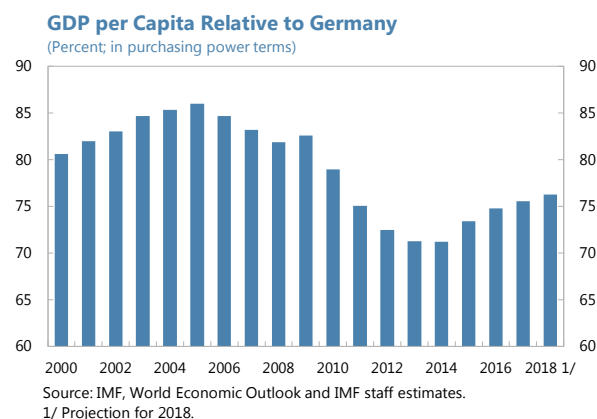
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CONTEXT

1. Spain continues to make up economic ground lost during the crisis. Real GDP and employment growth are set to exceed that of the euro area average for the fourth year in a row. Repeated upside growth surprises reflect the economy's improved fundamentals, including a turnaround in productivity growth from its pre-crisis negative trend, and suggest longer-term payoffs from past structural reforms. Growth has been broad-based across demand components, and much of the competitiveness has been restored. Against this background, international rating agencies have upgraded Spain's sovereign debt ratings.



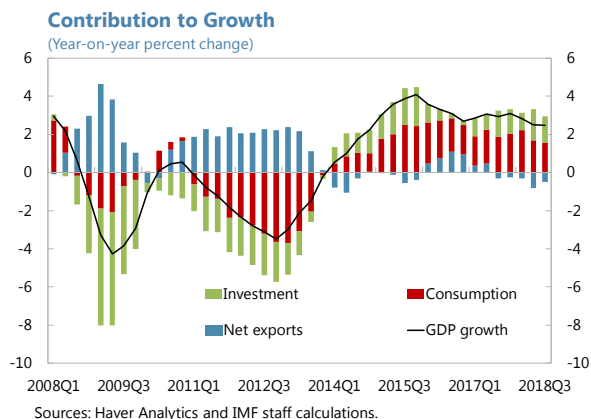
2. But efforts to address the remaining structural challenges have stalled. Since the important labor, pension, banking sector, and fiscal governance reforms taken through 2013, little new impetus has followed (Appendix I). Therefore, the steady narrowing of the income gap toward the richer European countries, that has occurred post crisis, is set to slow. The consequences would be felt predominantly by the young generation for which the crisis exacerbated preexisting high youth joblessness that left scarring effects on income and future pensions. Spain's still low, even though improved, productivity and high structural unemployment are the key obstacles for faster convergence and more inclusive growth. Behind these weaknesses at the economy-wide level are also persistent economic disparities across regions, pointing towards inefficient allocation of resources.



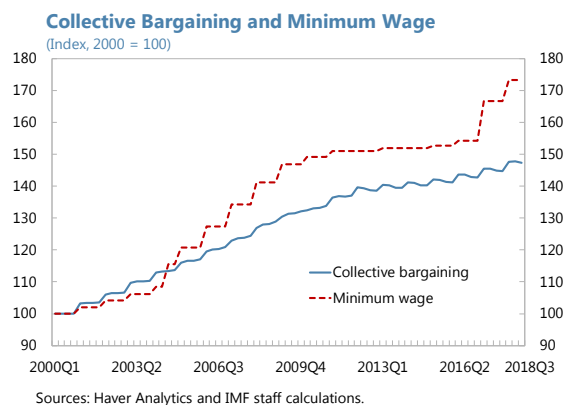
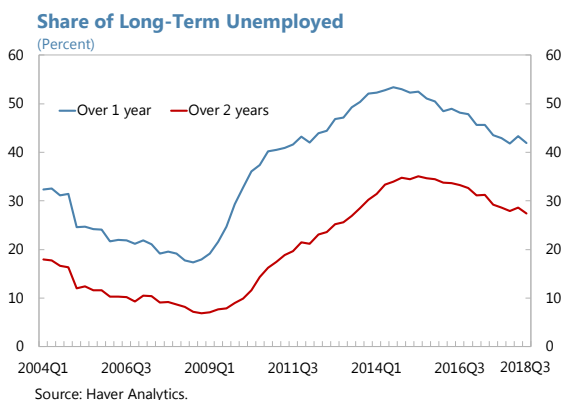
3. The new minority government of the Socialist Party aims to lower inequality and enhance quality of jobs. Its strategy for "fair and inclusive growth" is built on three pillars: (i) fiscal stability; (ii) social cohesion; and (iii) sustainable growth. Proposed policies include more social spending financed by new revenue measures, increases in pension benefits and minimum wages, and changes to the labor market. Some of the envisaged measures would partly reverse past reforms. However, absent a stable parliamentary majority, it will be difficult to advance legislative initiatives.

RECENT ECONOMIC DEVELOPMENTS

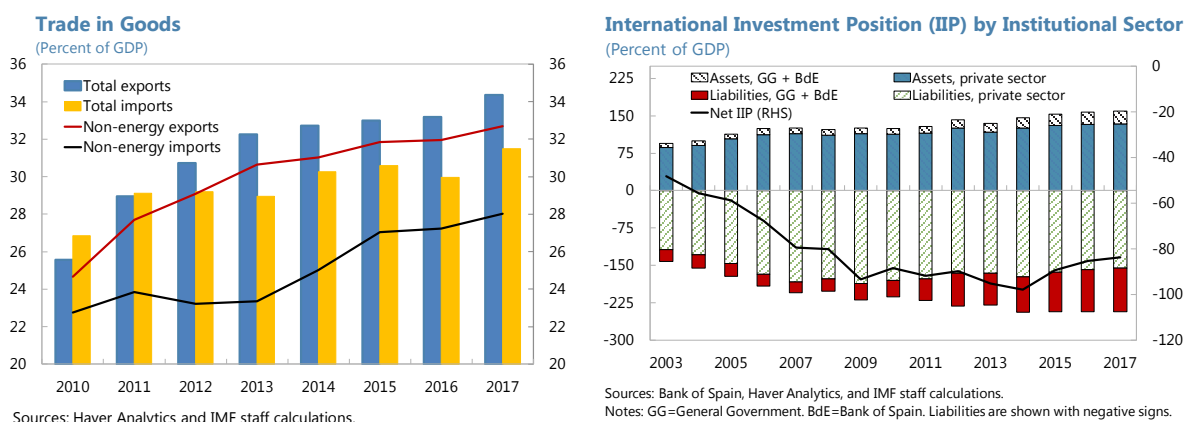
4. The Spanish economy maintained its strong momentum but has passed its cyclical peak. After expanding by 3 percent in 2017, growth has eased to 2.6 percent in the first three quarters of 2018. Private consumption growth, while decelerating, remained one of the key growth factors helped by strong job creation. At the same time, investment picked up, particularly in machinery and construction. However, weaker foreign demand has slowed export growth in the first three quarters of 2018. The economic impact from the political uncertainty related to Catalonia has so far been limited and contained to the region. Core inflation hovered around 1 percent in 2017 and through September 2018 (Figure 1). Headline inflation was higher, averaging around 2 percent last year and slightly more than 2 percent during May–October this year, reflecting higher energy prices.



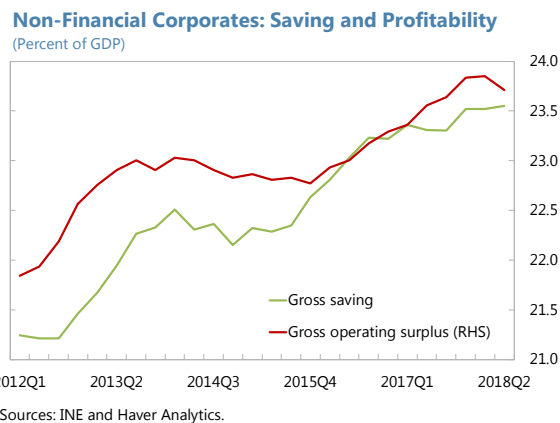
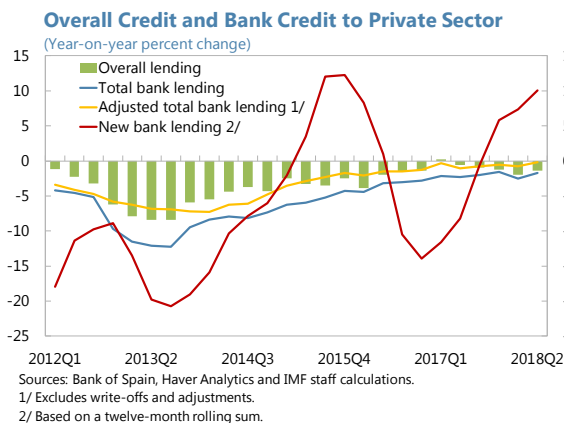
5. The labor market has continued to strengthen but significant challenges remain, especially for the young and those long out of work. The unemployment rate fell to 14.6 percent in 2018:Q3, below its long-term average. This helped particularly the long-term unemployed as they accounted for more than half of the total unemployed finding a job in 2017. There was also a notable shift toward more open-ended contracts for new hires (Figure 2). Nevertheless, Spain's youth joblessness—at 33 percent—the share of temporary contracts, and involuntary part-time employment remain among the highest in the EU. Wages negotiated in collective bargaining agreements rose moderately by 1.3 percent in 2017, while a much stronger hike (12 percent cumulatively in 2017–18) helped the relatively small number of minimum wage earners. For 2018–20, the guiding principle for wage increases, following the collective bargaining agreement of social partners, suggests annual wage hikes of 2–3 percent.



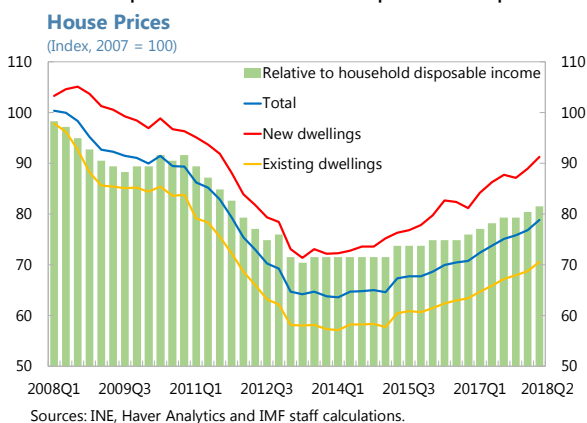
6. The external position strengthened further but is still moderately weaker than suggested by medium-term fundamentals. The current account surplus declined from 2.3 percent of GDP in 2016 to 1.8 percent of GDP in 2017, recording its fifth consecutive annual surplus. The larger energy trade deficit, due to higher oil prices, was partially offset by a greater services trade surplus, boosted by exceptionally strong tourism (Figure 3). Spain became the world's second-most visited country in 2017, surpassing the United States. Even though the CPI-based real effective exchange rate (REER) appreciated by nearly 2 percent, export volumes continued to grow robustly (see Box 1). However, export growth decelerated in the first three quarters of 2018, reflecting lower tourist arrivals and a slowdown of goods exports, while imports are rising. The net international investment position (NIIP) remained large and negative at minus 84 percent of GDP, with an adverse valuation effect recorded in 2017 mainly explained by the euro appreciation. Considering Spain's high net external liabilities, the 2017 current account gap was estimated at -2.5 to -0.5 percent of GDP and the REER overvaluation gap was assessed at 3 to 10 percent (Appendix II). Preliminary 2018 estimates are broadly unchanged. Staff's assessment of the external position improved from weaker in 2016 to moderately weaker in 2017.



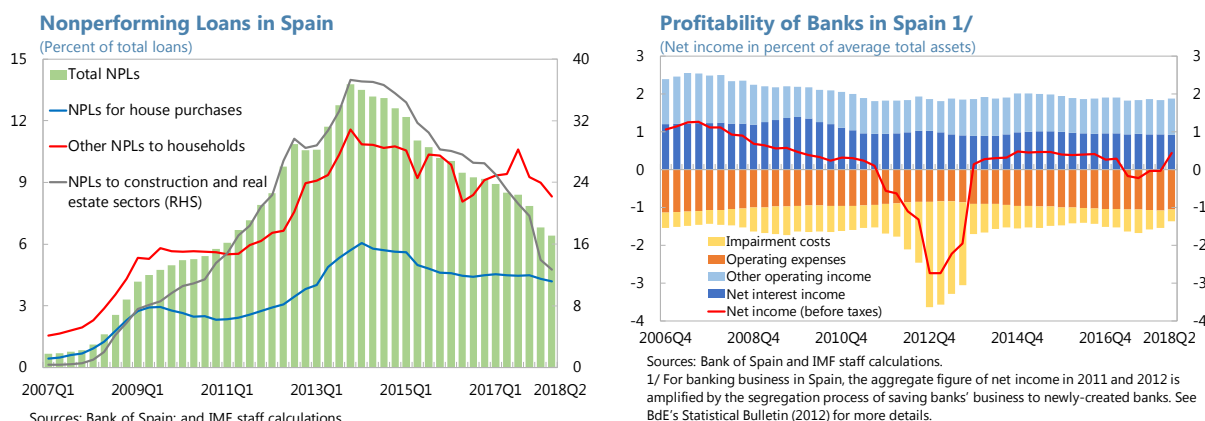
7. The private sector continues to deleverage amidst favorable lending conditions. The growth rate of overall (bank and nonbank) credit stayed negative at -1.4 percent in 2018:Q2, after a moderation during 2017. The ongoing correction of the real estate-related loan portfolio explains the still negative net credit dynamics, while in other segments the stock of loans is expanding, especially loans for consumer durables. Firms' contained demand for bank credit reflects in part increased internal funding, on the back of improved profitability and higher retained earnings, and a greater reliance on corporate debt securities. While some segments of corporates and households are still overly leveraged, the total private sector-debt-to-GDP ratio fell by nearly 10 percentage points in 2017, reaching a similar level to that of the euro area (Figure 4). Financial conditions have remained favorable with 10-year government bond yields below their 2017 average, despite some periods of increased market volatility related to spillovers from policy uncertainty in Italy.



8. Property prices are recovering from a low level, supported by robust demand. After an increase of about 7 percent in 2017, house prices were over 20 percent below their pre-crisis peak in 2018:Q2 (Box 2). However, dynamics differ notably across regions, including for pickup in rents. For example, Madrid and the Balearic Islands experienced a faster recovery, with house prices already at around 85 percent of pre-crisis levels. Several factors explain the strong demand in the property market, including growth in employment and disposable income, low interest rates on mortgage loans, purchases from institutional investors, and tourist demand for online accommodation services.

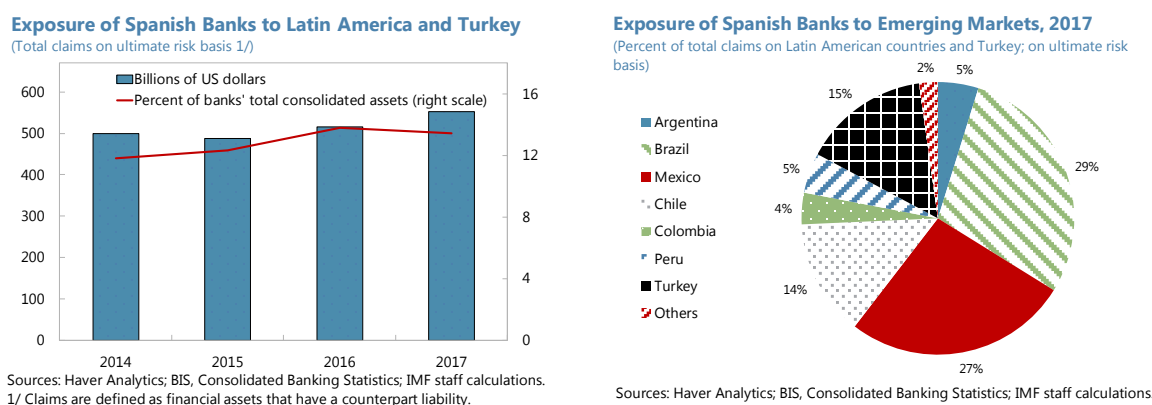


9. The health of the banking system continues to steadily strengthen. Asset quality improved as nonperforming loans (NPLs) on a consolidated basis dropped to 4.5 percent of total loans in 2018:Q1, just below the euro area average. The NPL ratio for business in Spain is still more elevated at 6.4 percent in 2018:Q2 with NPLs highest among SMEs, construction and real estate companies. Banks continued to build capital buffers, but progress has been slow and uneven. The common equity tier-1 (CET1) ratio inched up by 0.3 percentage points to 13.4 percent at end-2017 (Figure 5). Banks' profitability for business in Spain turned negative in 2017, reflecting the large loss (more than €12 billion) posed by Banco Popular after its resolution in June 2017. On a consolidated basis, profitability regained ground after a small dip in 2016. The resolution of Banco Popular through the purchase by Spain's largest bank, together with the merger of the two state-owned banks have consolidated the banking sector further, with a potential to improve the system efficiency.



10. Spanish banks maintain significant subsidiary operations in Latin America and Turkey.

Their consolidated exposure to these emerging markets, measured by total claims on ultimate risk basis, stood at over US\$ 550 billion at end-2017, or 15 percent of Spanish banks' total claims. Mexico and Brazil alone account for more than 8 percent of total claims. Operations in emerging markets contribute importantly to the profits of Spain's two global banks. In 2017, such operations generated about 40 and 80 percent of group-wide profits, respectively. Spanish banks largely operate with a subsidiary model, under which there is virtually no intragroup funding. Moreover, parent banks hedge against most exchange rate risk. However, the stock prices of Spain's global banks recently underperformed as prospects in emerging economies became more uncertain.



11. The fiscal stance was broadly unchanged in 2017 after two years of fiscal easing.

The headline fiscal deficit narrowed to 3.1 percent of GDP in 2017—in line with the excessive deficit procedure (EDP) target—nudging down the general government debt-to-GDP ratio (Figure 6). The strong cyclical recovery and lower interest payments were the main drivers for the lower deficit. Tax measures adopted in 2017 yielded only 0.1 percent of GDP additional revenue, 0.4 percentage points less than budgeted, partly due to an overly optimistic inflation assumption. Sub-national governments overperformed as the compliance of regional governments improved further along with the strong economic cycle—contrasting past episodes of weak fiscal discipline and target deviations—and municipalities continued to run a significant surplus.

Authorities' Views

12. The authorities concurred that the economy has passed its cyclical peak and welcomed staff's assessment that the external position has improved. They emphasized that external factors, particularly weaker demand from trading partners and higher oil prices, have slowed activity in 2018 more than they had expected. But regained competitiveness should help preserve current account surpluses in the medium term. The authorities also noted that recent strong investment reflects improved growth fundamentals, and they welcomed the continued deleveraging of the economy.

OUTLOOK AND RISKS

13. After the economy's impressive growth spell, it is expected to converge to its lower medium-term potential. Reflecting weakening cyclical forces and a less supportive external environment, GDP growth is projected to ease to 2.5 percent in 2018 before gradually slowing to its potential rate, estimated at around 1.75 percent over the medium term (Box 3). Lackluster productivity growth, unfavorable demographics, and high structural unemployment hold back higher potential expansion. The composition of growth is expected to remain broad based, reflecting the healthy change in the structure and competitiveness of the economy. The current account surplus is projected to be close to 1 percent of GDP, gradually reducing the high negative net international investment position. In line with the mature business cycle, core inflation is expected to gradually move to 2 percent in the coming years. Headline inflation is set to decelerate to 1.8 percent in the next few years as the base effect of higher energy prices that propelled inflation to 2 percent in 2017 and parts of 2018 fades away.

14. Risks to the outlook are tilted to the downside. Rising global protectionism and a no-deal Brexit could weigh on trade, potentially hurting Spain's exports and investment (Appendix III). Renewed market instability related to policy uncertainty in key euro area countries could increase Spain's bond yields and raise borrowing costs. A sharp tightening of global financial conditions, a perception that national buffers in euro area countries—including Spain—are insufficient, and an abrupt change in global risk appetite could rekindle sovereign and financial sector stress. Profitability of Spanish global banks could suffer from weakening economic conditions in emerging economies. Domestically, prolonged uncertainty related to the political crisis in Catalonia could undermine confidence with negative consequences for investment. A reversal of earlier reform achievements and delay in shoring up public and private sector balance sheets would exacerbate Spain's existing vulnerabilities. Meanwhile, room for upside surprises remains should Spain's past structural reforms still deliver higher-than-estimated payoffs or ongoing recovery in investment imply higher potential growth.

Authorities' Views

15. The authorities broadly shared staff's assessment of the outlook and the downside balance of risks. They expect GDP growth to moderate but stay above the euro area average. The authorities consider external factors as the main downside risk, while domestic risks are more

limited. In particular, they argued that economic activity in the past has proven to be resilient to political uncertainty, and healthier bank and non-bank balance sheets would help withstand shocks. Among external risks, the authorities highlighted an escalation of global trade tensions and the resulting slowdown in trading partners growth, a tightening of financial conditions due to monetary policy normalization, and an increase of oil prices.

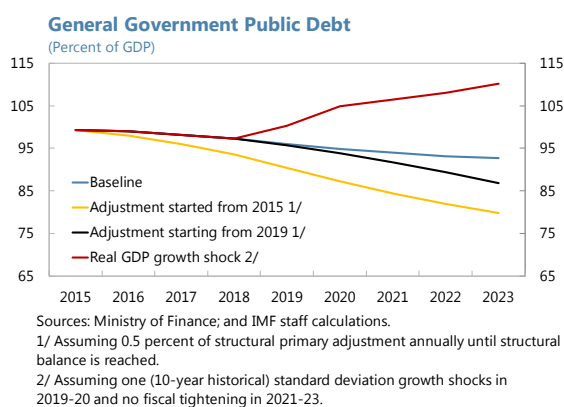
POLICY AGENDA

16. There is a heightened urgency to bolster the resilience and inclusiveness of the economy. With the economic cycle in Spain and the euro area maturing and new external risks rising, policy action should no longer be delayed. Fiscal policy should take full advantage of the good economic conditions to bring down faster the high level of public debt and the large gross financing needs. Otherwise, policy will have little room to proactively counterbalance adverse consequence of future shocks to the economy. Past reforms need to be preserved and enhanced, especially with a view to addressing joblessness and poverty among the young.

A. Fiscal Policy: Creating Needed Fiscal Space

17. The fiscal stance is easing in 2018, amid rising social and political demands. Several measures were adopted to support pensioners and low-income households, including broad increases in pension benefits in 2018–19 (higher than the 0.25 percent implied by the pension formula) and expansions in personal income tax (PIT) deductions for households with specific needs. The budget execution data up to August indicate that revenue performance has been in line with the budget target, whereas expenditure is expected to outrun the budget particularly due to higher-than-expected spending for public employment and pensions. As a result, staff projects the headline deficit to reach 2.8 percent of GDP this year, which is considerably above the 2.2 percent of GDP budget target but would still allow Spain to exit the excessive deficit procedure. In staff's estimate, the projected 2018 fiscal outcome would imply a worsening of the structural primary balance by about $\frac{1}{4}$ percent of GDP.

18. Resuming active fiscal consolidation is critical to rebuild fiscal buffers and put debt on a clear downward trajectory. Fiscal consolidation has come to a standstill since 2015 and the structural deficit deteriorated to about $2\frac{1}{2}$ percent of GDP. As a result, Spain's public debt sustainability remains at risk. With the debt-to-GDP ratio hovering around 100 percent of GDP, Spain would likely be forced to undertake a procyclical tightening when the economy is hit by future shocks unless buffers are swiftly rebuilt. In a scenario in which the economy goes through another recession and does not adjust its deficit immediately, public debt would quickly return to an upward path (see text chart and public debt sustainability analysis in Appendix IV).



Moreover, future increases in borrowing cost and pressure from population ageing also pose risks to the fiscal outlook (see Figure 6). Therefore, resuming consolidation of the structural primary deficit by at least 0.5 percent of GDP per year should no longer be delayed. Such an annual adjustment pace should persist until a fiscal structural balance is reached, and debt is on a clear downward path.

19. The 2019 budget needs to include a reliable package of adjustment measures. The government's draft budgetary plan envisages to bring the headline deficit down to 1.8 percent of GDP in 2019 while creating space for social spending, particularly targeting the most vulnerable. The implied improvement in the structural deficit of about 0.5 percent of GDP is set to come from a range of revenue measures that target mostly high-income earners, large corporates, and the financial sector. The main revenue proposals include (i) an introduction of a digital sales tax; (ii) an adoption of a financial transaction tax; (iii) an increase in excise on diesel; (iv) changes to the corporate income tax (CIT) system to enhance the collection; (v) a hike in PIT for high-income brackets; and (vi) anti-tax fraud efforts (see text table). Some of these measures have an uncertain yield, in particular those that relate to entirely new taxes and policy actions. Thus, to limit the risk of potential budgetary shortfalls and ensure that the envisaged improvement of the headline and structural balance can be fully met, it is important to add measures in the budget and stand ready to take contingency actions, in case any revenue shortfalls arise. Additional revenue measure would be preferable, but options on the spending side should also be identified.

Revenue Measures in the 2019 Draft Budgetary Plan
(Percent of GDP)

	Fiscal impact 1/
1. Changes to the corporate income tax (CIT) system to (i) reduce exemptions to dividends and capital gains generated abroad from 100% to 95%; and (ii) ensure a minimum effective CIT rate for large companies	0.14
2. Reduction of the CIT rate for SMEs (income less than €1 million) from 25% to 23%	-0.02
3. Introduction of 0.2% financial transaction tax on purchase of stock market shares issued in Spain by listed companies whose market capitalization is more than €1 billion	0.07
4. Introduction of a 3% tax on online advertising services, online intermediation services, and the sale of data (for large companies only)	0.10
5. Increase in the personal income tax (PIT) rate by 2 ppts for income above €130,000 and 4 ppts for income above €300,000	0.03
6. Increase the tax rate on wealth by 1% for the inheritance exceeding €10 million	0.03
7. Increase in the tax of diesel for automotive uses by €38 per thousand liters	0.05
8. Efforts to fight against tax fraud	0.07
Total impact:	0.45

Source: Draft budgetary plan Spain 2019 and IMF staff estimates.

1/ The authorities' estimation in the 2019 Budgetary Plan.

20. An extension of the 2018 budget or a no-policy-change scenario would not bring the deficit to its targeted level. In case there is no parliamentary majority to pass a budget for 2019 and the budget from 2018 is extended, the deficit is estimated to fall to around 2 percent of GDP. In a no-policy-change scenario, there would be an even bigger gap to the fiscal deficit target as staff projects the deficit to reach only 2.4 percent in 2019. This forecast includes the already legislated pension increase and PIT measures for 2019, as well as the public wage increases agreed with the unions. Thus, to stave off another year without a noticeable improvement in the structural primary balance, it is critical to take additional measures even if no new budget is approved.

Fiscal Balance

(Percent of GDP unless otherwise noted)

	2017	2018P	2019P
Net lending (+) or net borrowing (-)			
IMF 1/	-3.1	-2.8	-2.4
Authorities 1/	-3.1	-2.7	-1.8
Structural balance			
IMF	-2.6	-2.8	-2.8
Authorities	-2.2	-2.6	-2.2
Primary structural balance			
IMF	-0.1	-0.3	-0.5
Authorities	0.4	-0.2	0.1
Fiscal effort (percentage points)			
IMF	0.1	-0.3	-0.1
Authorities	...	-0.6	0.3
<i>Memorandum items:</i>			
Output gap			
IMF (percent of potential GDP)	-0.8	0.2	0.8
Authorities	-1.4	0.1	1.1

Sources: Draft budgetary plan Spain 2019 and IMF staff projections.
1/ Includes 0.1 percent of GDP of contingent liabilities related to the motorways in 2018. IMF staff projections are based on IMF staff macro-economic projections and assume unchanged fiscal policies except for the already legislated measures and the public wage increases agreed with the unions. This explains the difference to the authorities fiscal deficit projections.

21. Measures to lower the fiscal deficit can and should go hand in hand with inequality reduction. Since Spain's public primary spending, at 38.5 percent of GDP, is already relatively low compared to those of EU peers, the contributions that expenditure rationalization can make to fiscal adjustment are limited. Revenue measures—the preferred adjustment tool by the government—can bring the deficit down and help finance additional spending to achieve social and distributional objectives, as well as protect the most vulnerable, support the employment prospects of the young and those long out of work, as well as foster innovation capacity and environmental protection. But a careful design of tax measures is key to limit distortions and growth implications. Measures that expand VAT collection, raise excise duties and environmental levies, and reduce inefficiencies in the tax system tend to be less distortive to short-term economic activity. Therefore, they are the preferred options to fill any potential revenue shortfalls compared to the 2019 budget and achieve the needed adjustment in the medium term. If implemented gradually they could yield extra revenue of up to 2–3 percent of GDP, though they should be accompanied with targeted spending for the most vulnerable. In contrast, the planned introduction of the digital and financial transaction taxes may yield revenue in the short term but would be more distortive and best embedded in an internationally coordinated framework given the mobility of the tax base (see IMF Country Report No. 18/223, Box 3).

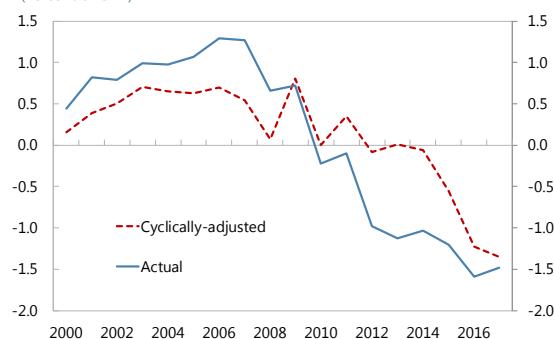
**Yield of Potential Revenue Measures
(Percent of GDP)**

Measures	Yield
1. Lowering the VAT policy gap to the EU average of 44 percent	2.0
2. Broadening the tax base by removing distortions in the tax system	0.3-0.5
3. Harmonizing environmental taxes with those in other EU countries	0.3-0.5

Source: IMF staff estimates; and Report of the Expert's Committee for Reform of the Spanish Tax System (2014).

22. Safeguarding the pension system's financial viability while enhancing the social acceptability is critical. The important 2011/13 pension reforms address the pressure on the Spanish pension system from population ageing, as fewer contributors are funding more and more pensioners. Limiting pension increases to the legislated minimum rate of 0.25 percent per annum over many years would eliminate the structural deficit of social security budget and keep pension spending relative to GDP broadly stable.¹ While pensions would rise less than the expected inflation rate and the purchasing power of benefits would fall, Spanish pensioners are nevertheless projected to receive higher pensions, relative to wages, than most other EU countries over the long run. The deviation from the pension formula in 2018–19 and delay in the implementation of the discount factor for changes in life expectancy ("sustainability factor") from 2019 to 2023 is estimated to cost about 0.3 percent of GDP in the short run. This might appear manageable. But if pensions were to be relinked permanently to inflation, pension spending would be put on a sharp upward trajectory, adding about 3–4 percent of GDP in outlays by 2050 under

**Social Security Balance
(Percent of GDP)**



Source: Spanish authorities; and IMF staff calculations.

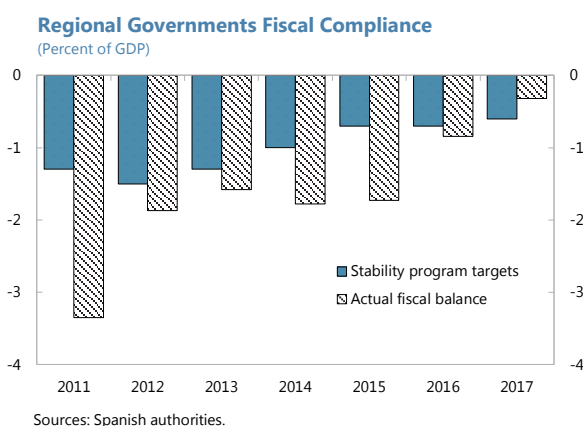
¹ The structural social security deficit is estimated at 1 percent of GDP (see AIREF Report on the Kingdom of Spain's 2017–2020 Stability Programme Update, May 10, 2017; BBVA Research; Bank of Spain (2017), Occasional Paper 1701).

current demographic and macroeconomic projections. Such a surge in pension spending would move Spain nearly to the top in the EU. While there is room to finance some additional pension spending, the space is rather limited given the already high contribution rates. Therefore, the recent Toledo Pact recommendations of permanently linking pension increases to an indicator of purchasing power should not be taken in isolation but needs to be carefully cogitated as part of a sustainable package.

23. A range of reform options could be considered to address the tensions in the pension system. These include efforts to (i) incentivize longer work lives (e.g., extension of the pensionable earnings reference period to a contributor's full career; automatic indexation of the retirement age to changes in life expectancy); (ii) raise revenues without raising the already high contribution rates (e.g., increase the minimum contribution for self-employed and the maximum earnings subject to contributions); and (iii) encourage supplementary savings (e.g., automatic enrollment in a saving plan with the ability to opt out). At the same time, it is critical to be fully transparent and aim to be equitable in how the needed adjustment will be split between the young and older generation. Future pensioners can then make informed decisions on their work lives and savings (see IMF Country Report No. 17/320, Chapter 1 for more details on pension reform options).

24. Reforms of the regional finance framework should be an integral part of Spain's overall fiscal adjustment strategy. The application of enforcement tools in 2016 combined with the strong recovery significantly strengthened regional compliance with deficit targets. Further reforms are needed to sustain these achievements and improve the functioning of the regional finance system.

- Regional finance framework.** Reforms to the regional public finances should primarily aim at making the system more transparent and consistent, thereby ensuring also equity. Moreover, it should strengthen the regions' incentives and capacity to meet their fiscal targets over the medium term. This would, for example, imply providing the regions with greater power to mobilize their own revenues so as to better match the greater expenditure responsibilities they have (see Experts Commission Report on Regional Financing, 2017 and IMF Country Report No. 17/23).



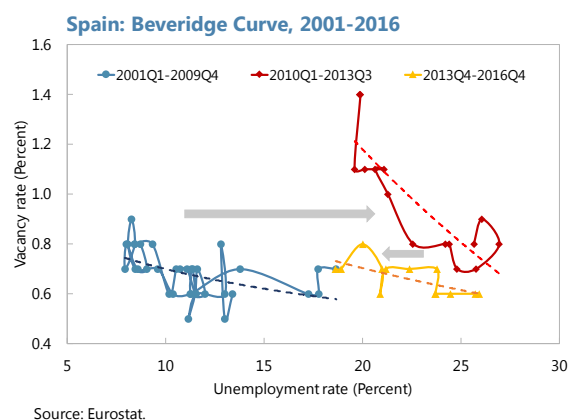
- Local government financing.** To support investment local governments with sound financial conditions have been allowed to use part of their surplus to fund investments considered financially viable. Proposals have been made to make such exceptions permanent. Experience shows that, even if well intended, such "golden rules" often lead to higher debt when the return of the investment projects do not pay for themselves. Thus, general exemptions should be avoided.

Authorities' Views

25. The authorities expressed their strong commitment to meet the fiscal targets while preserving growth and fostering social inclusion. They underlined the positive signal from exiting the excessive deficit procedure in 2018. For 2019, the government plans to adopt a structural adjustment of 0.4 percent of GDP. The increase in the revenue-to-GDP ratio by 0.6 percent of GDP would also aim to redistribute welfare, reduce social and gender inequality, and foster sustainable growth by supporting the transition to a low carbon economy. The authorities stressed that yields from new measures would be based on prudent projections. Moreover, the 2019 budgetary process would for the first time include a comprehensive gender perspective. On pension reforms, the authorities underlined the importance of safeguarding the financial sustainability of the system while also protecting the purchasing power of pension benefits. This would be achieved by measures that help lift future wage and GDP growth so as to enable a steady recovery in social security contributions.

B. Labor Market Policy: Moving Toward Greater Inclusion

26. Structural unemployment has been stubbornly high. This reflects both long-standing labor market issues and the impact of the crisis. Especially, high and prolonged youth unemployment and poverty have long-lasting effects on young people's productivity and incomes, as well as their social prospects (see Box 4). Various estimates, including those by IMF staff, put today's structural unemployment rate in the range of 12–16 percent, below its long-term average of 18 percent.² Several recent studies find that the 2012 labor markets reforms have supported a reduction in the structural unemployment rate and helped Spain's export performance (see Box 1 and IMF Country Report No. 17/23, Annex I). This is captured, for example, by a structural change in the empirical relationship between the unemployment rate and the job vacancy rate, known as the "Beveridge curve". An inward shift in the Beveridge curve suggests an improvement in the labor market matching efficiency. However, such an improvement only recouped part of the deterioration in the structural unemployment during the crisis, as today's labor market matching efficiency is still far below its pre-crisis level.

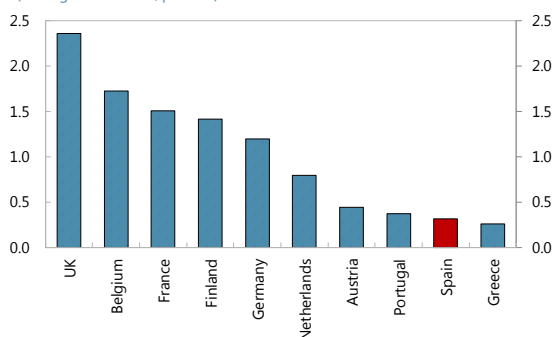


27. The high structural unemployment is linked to rigidities in the labor market, including a low mobility across regions. Spain's internal mobility rate has been historically low by international standards. According to Eurostat Labor Force Survey data, the gross flows of internal migration across regions accounted for only 0.3 percent of the overall working age population over the past decade, in contrast to 1.2 percent in Germany and 2.4 percent in the United Kingdom.

² The long-term average covers the period 1980-2017. There was a structural break in the unemployment series in 2001, when the National Statistics Institute (INE) introduced several methodological changes.

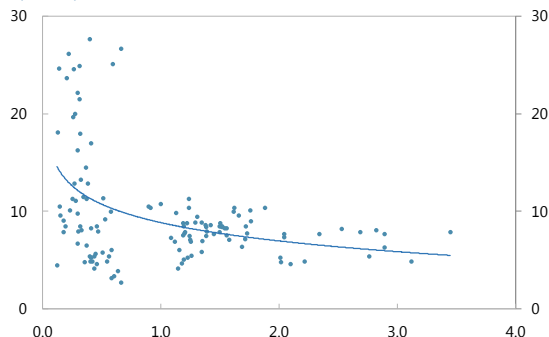
Limited regional labor mobility has been associated with persistently large disparities in labor market performance across regions, and thereby high unemployment at the national level. During 2008–17, the average gap of the unemployment rate between the top and bottom regions was about 18 percentage points. Staff’s analysis suggests that housing market prices, labor market conditions, and labor market duality are the main factors explaining the low regional labor mobility, besides the standard economic and demographic indicators (Box 5).

Internal Mobility Rate in Europe
(Average of 2003–16, percent)



Sources: Eurostat Labor Force Survey; and IMF staff calculations.

Internal Mobility Rate vs. Unemployment Rate
(Percent)

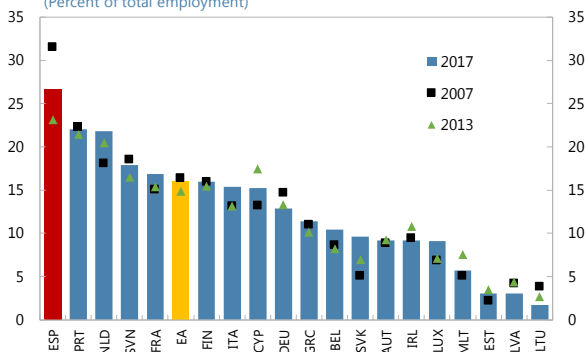


Sources: Eurostat Labor Force Survey; and IMF staff calculations.

28. Policy actions need to focus on tackling the rigidities in the labor market. The

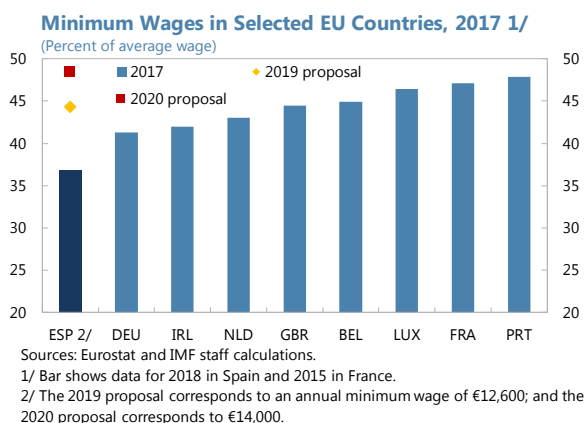
pervasiveness of labor market duality in Spain not only contributes to limited regional mobility, but also has a bearing on structural unemployment and workers’ productivity. Spain has the largest share of temporary employment in the euro area, especially among younger workers. To address this long-standing weakness, narrowing the gap between the costs for firms to hire permanent and temporary workers remains a key policy priority. In this regard, policy measures should focus on enhancing the attractiveness of open-ended contracts for employers, rather than increasing the cost of temporary contracts which would add more rigidities to the labor market. Specific measures could include further reducing the hiring costs and severance payments for permanent workers, creating an employer-based separation fund (“Austrian backpack”), and simplifying the list of possible causes for nullifying a dismissal to mitigate legal uncertainties that add to the cost of permanent contracts. The recently adopted plan to tackle the abuse of temporary contracts is an important effort in complementing the above measures to limit temporary hires.

Temporary Employment in Euro Area Countries
(Percent of total employment)



Sources: Eurostat (LFS) and Haver Analytics.

29. Preserving wage flexibility is critical. Future wage increases should follow productivity growth. In view of the important role of wage differentials in explaining regional mobility, ensuring that wage dynamics reflect differences in region- and sector-specific conditions would promote a reallocation of labor toward more productive sectors and regions. It is also critical to continue allowing firms to set wages in line with their business condition, which is particularly relevant to preserve external competitiveness at a time when the economy faces new risks. At the same time, efforts are needed to address shortcomings in the labor legislation. The guideline of the latest collective bargaining agreement as regards general wage increase is welcome. However, the government's proposed sharp increases in the annual statutory minimum wage by 22 percent to €12,600 in 2019 and €14,000 by 2020 could put at risk employment opportunities for the low-skilled and the young. It would also swiftly lift Spain's minimum-to-average wage ratio to one of the highest among EU peers. Thus, allowing greater minimum wage differentiation is warranted.



30. Policies that enhance employability and incentives for labor mobility remain priorities.

- The implementation of plans that improve education outcomes and upgrade skills should be expedited (see also Section C below). This includes implementing the multi-year strategy on employment activation. Moreover, more coordinated and better-designed active labor market policies (ALMPs) can foster employability. There is also room to consolidate the vast amount of ALMPs, which often have low participations, receive little funding and are not well-known, and instead expand the most promising programs, such as those involving the support by a personal tutor (see IMF Country Report No. 17/319, Annex I).
- Policies that provide incentives for people to move could include subsidies for moving expense and temporary and targeted housing assistance. There is also a need to centralize information on social benefits across regions to ensure that these benefits provide sufficient support to unemployed workers but without creating distortions in job search and reallocation.

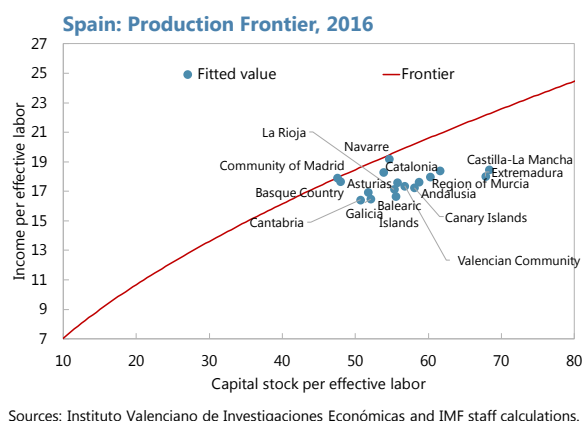
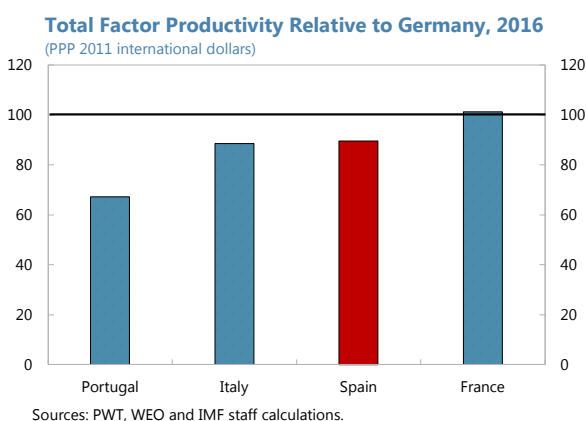
Authorities' Views

31. The authorities' main priority is to improve the quality of jobs with a view to boosting productivity and wage growth. They stressed that the intention is not to reverse the past labor market reforms, but only to fine-tune some aspects that have led to clear imbalances in the bargaining power, whilst maintaining flexibility. The authorities highlighted the need for wages to grow more strongly in the coming years to ensure better social equity. The planned increase in the statutory minimum wage would contribute to that and does not raise substantial concerns regarding negative employment effects, given the low wage level and experience with rapid minimum wage increases

in the past that coincided with strong employment growth. In support of wage growth, the government is also working on an action plan that aims to upgrade education outcomes—in particular through more opportunities for vocational training and life-long learning—, lower pervasive labor duality, and confront gender inequality. The government recently adopted a “masterplan for fair and decent jobs” to tackle the abuse of temporary and involuntary part-time contracts as well as improper claim of self-employed status. To strengthen the effectiveness of active labor market policies, the authorities plan to focus on greater coordination between the regions with enhanced profiling tools and information systems, as well as improving the identification of skills required by the labor market.

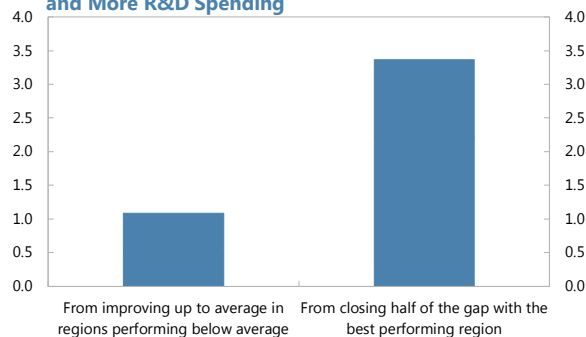
C. Structural Reforms: Tapping into the Forgone Potential

32. Helped by past structural reforms, productivity has improved but remains notably below some European peers reflecting inefficiencies at the regional level. After total factor productivity (TFP) declined during the pre-crisis decade, the trend has reversed in recent years and TFP growth reached 0.7 percent in 2017. This has allowed Spain to narrow its productivity gap against European peers, but the disparity is still more than 10 percent relative to Germany. Notable productivity variations across regions contribute to Spain’s relatively low level of overall productivity. TFP in the most productive region is about 60 percent higher than in the least productive one. Staff analysis suggests that inefficient use of available technologies, which distances regions from the production frontier—the maximum output that can be produced given the available capital and labor—contributes to the considerable productivity variation across regions (Selected Issues Paper).



33. Efforts to reduce skill mismatch and enhance innovation capacity at the regional level would benefit Spain's growth potential. Staff analysis suggests that technical inefficiency tends to be higher in regions with considerable skill mismatch and lower in regions with higher foreign direct investment (FDI) and research and development (R&D) spending relative to GDP (Selected Issues Papers). Reducing regions' distance to the frontier would potentially yield significant long-term gains. For example, if the regions that perform below average improved their efficiency up to the regions' average, GDP would be 1.4 percent higher. In a scenario in which regions close half of their distance to the production frontier, GDP would be 4 percent higher. Most of the improvement in technical efficiency could come through better skills match and greater reliance on R&D activities.

Spain: Potential Gains in GDP from Lower Skill Mismatch and More R&D Spending

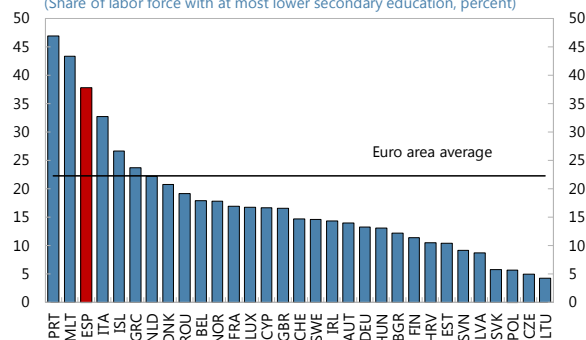


Source: IMF staff calculations.

- Spain faces a considerable skill mismatch and persistent skills gap among the lower-educated. Skill mismatch has several dimensions and is particularly high for the qualification mismatch. While underqualification is similar to the Euro Area average, overqualification is very high with 25 percent of workers being over-qualified. The mismatch has widened during the post-crisis years, when the share of workers with high-skilled education increased while net employment creation has been concentrated in medium-skill occupations (see IMF Country Report 17/320, Chapter II). At the same time, on the lower end of the skill distribution, skills gaps prevent many people from finding employment. Those with at most lower secondary education make up nearly 40 percent of the labor force—in some regions even over 50 percent—one of the highest shares among Euro Area countries.

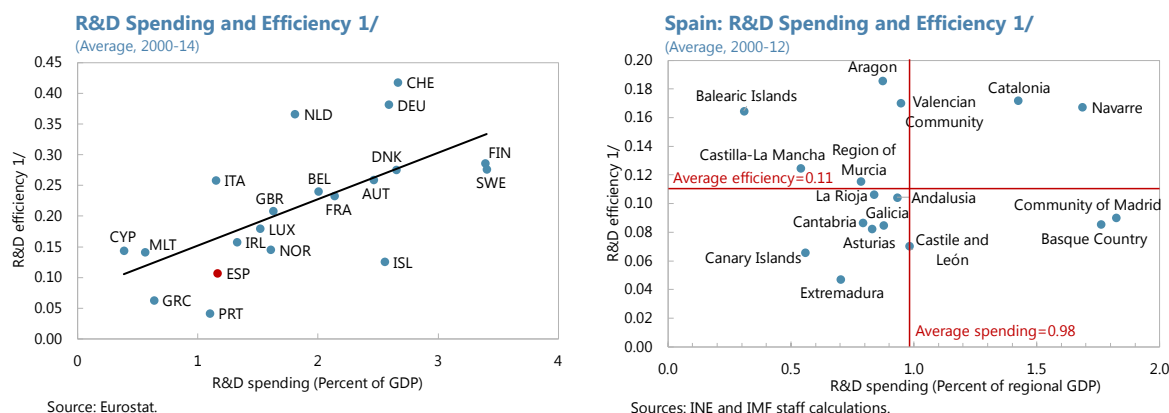
Share of Low Skilled in Labor Force, 2016

(Share of labor force with at most lower secondary education, percent)



Source: Eurostat.

- The quantity and quality of private and public R&D spending lags that of many European peers. Since 2000, Spain spent on average 1.2 percent of GDP annually on R&D—ranging from 0.3 to 1.8 percent of GDP across regions—compared with over 2 percent in Germany and France. Moreover, spending efficiency is low and diverse, as for example measured by the number of new patents per money spent on R&D.



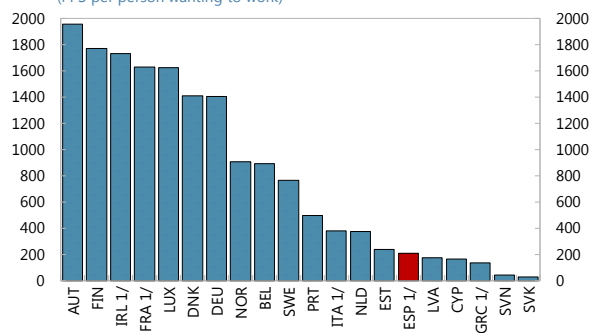
1/ R&D efficiency is measured by the number of new patents per money spent on R&D.

34. New impetus is needed to advance the structural reform agenda. In 2017, few measures were taken that will contribute to lifting productivity growth. Thus, past policy recommendations remain relevant. Reducing regulatory fragmentation and lowering barriers for firms' growth should be complemented by efforts to encourage labor mobility and better skills-matching, train the low-skilled, and expand firms' innovation capacity. Narrowing the interregional productivity gaps would also provide a boost to overall productivity. The authorities' enhanced focus on gender policies should be beneficial to reduce inequality and raise long-term growth.

- The application of the Market Unity Law, which aims to align regulatory requirements by the central, regional and local authorities, remains slow. While the Constitutional Court has declared the principal of nation-wide effectiveness of licenses null and void, the principle of necessity and proportionality that the Court has endorsed could be used to reduce cross-regional barriers to economic activity. New impetus is also needed to advance the liberalization of professional services.
- More than 100 size-related regulations have been identified that potentially create incentives for a "small business trap". However, the 2019 budgetary plan proposes to reintroduce a reduced corporate income tax (CIT) rate for certain SMEs, which could hamper firm growth and productivity as suggested by previous empirical studies (see for example IMF Working Paper WP/17/139). Going forward, modifying or eliminating the identified size-contingent regulations with an aim to eliminate disincentives for firms to grow and enhance their capacity to innovate and cooperate with research institutions is needed to yield tangible results.
- Governance of research and innovation has been streamlined and made more inclusive. However, coordination between different levels of government remains an area for improvement, including for the design, implementation, and evaluation of research and innovation policies. The government should review what holds back the uptake of R&D incentives and business-science cooperation. Particularly, clarifying and simplifying the eligibility criteria for firms to qualify for R&D incentives could increase demand for these incentives.

- Active labor market and education policies at the regional level could help address skill mismatches and improve education outcomes. Particularly, the focus on well-targeted training, for which spending has been lower than in other EU countries, could be enhanced. Policies to increase labor market relevance of tertiary education through better cooperation between the private sector and universities and to reduce school drop-out rates will be important. Systematic exchanges of best practices and peer review among regions could help reduce regional differences in education outcomes (see European Commission, Country Report Spain 2018).

ALMPs: Expenditure on Training, 2016
(PPS per person wanting to work)



Source: Eurostat.
1/ 2015 value is used.

Authorities' Views

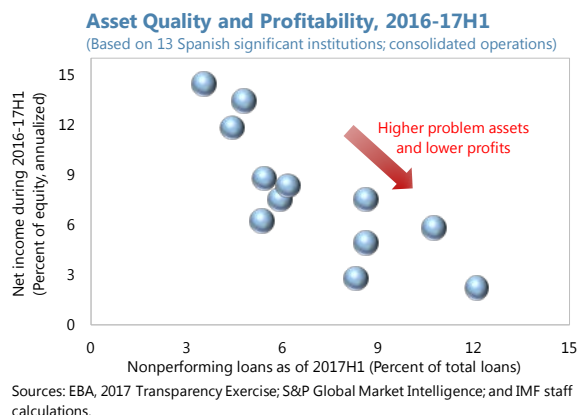
35. The authorities appreciated staff's multifaceted approach to address Spain's productivity challenge. The government is working on a set of targeted growth-enhancing structural reform initiatives that will fit within the 2019 budget. Nevertheless, they are mindful that broader legislative changes would be difficult to achieve in the fragmented parliament. Thus, they have started a range of consultative processes with social partners and political parties. The authorities highlighted that efforts are underway to strengthen support for SMEs (e.g., provision of financial counseling), implement the Market Unity Law (particularly through strengthened coordination with regions), and enhance innovation (e.g., by preparing a digitalization strategy). The authorities also pointed to some liberalization measures adopted or envisaged in the transport and energy sectors. Addressing obstacles to SME growth will continue to be a priority.

D. Financial Sector: Strengthening Resilience and Upgrading the Financial Architecture

36. Putting legacy issues fully behind and preparing to deal with new challenges remain the priorities for the financial system. Addressing these challenges is crucial to enhance the banking system's resilience against adverse developments, and support credit intermediation in the medium term. The 2017 Financial Sector Assessment Program (FSAP) identified four priority areas where momentum must endure (IMF Country Report 17/321): (i) accelerated cleanup of legacy bank assets; (ii) further improvement in bank profitability and capitalization; (iii) rigorous management of interest and liquidity risks; and (iv) reform of the institutional framework for financial oversight. Actions taken to address FSAP recommendations so far have been limited in some areas (Appendix V).

37. Implementation of the ECB's NPL guidance is critical to keep reducing impaired assets. Since August 2017, several major banks have announced plans to dispose of NPLs and foreclosed real estate assets. At least one of these transactions was already completed and the materialization

of remaining plans will keep accelerating the decline of impaired assets in the system. However, some banks still need to lower their elevated levels of NPLs and foreclosed assets. The FSAP called for a tough stance on the implementation of the ECB's NPL guidance, including promoting banks' disclosure of NPL reduction targets and progress. To secure effectiveness, evaluation of banks' NPL reduction strategies and targets should be based on a careful analysis of banks' property price assumptions. Additionally, the recent expansion of consumer lending, a segment where NPLs tend to be relatively high, warrants close monitoring.

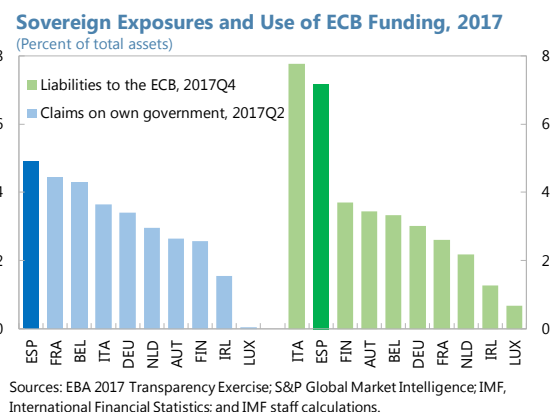


38. Banks would benefit from more capital and need to address low profitability.

Common equity tier-1 (CET1) capital on a fully-loaded basis remains lower than that of many European peers even though they are generally less leveraged. Similarly, by some estimates, the Spanish banking system may be among those in Europe facing relatively large shortfalls to comply with the upcoming Minimum Requirements for Own Funds and Eligible Liabilities (MREL) targets. Continuing the buildup of capital buffers and keeping on track the buildup of “bail in-able” debt in the largest banks would help to shield against shocks, especially related to interest rate and sovereign risks, where exposure of the Spanish banking system is relatively high. Larger capital buffers would also help protect banks from potential spillovers related to volatility in emerging markets, as any significant increase in asset impairment at Spanish banks' large subsidiaries would impact group-wide profitability. To improve bank profitability in a structural manner, the FSAP encouraged further cost cutting and branch consolidation, and an evaluation of the scope for more efficiency gains through mergers, branch reduction, and adjustments in business models, including coping with future challenges from digitalization and Fintech. With the sale of Banco Popular and the merger of Bankia and BMN, the banking system has already consolidated further.

39. Rigorous management of liquidity and interest rate risks is needed, in particular ahead of the ECB's gradual normalization from accommodative policies.

The failure of Banco Popular in 2017 on liquidity grounds and the temporary deposit outflows of banks with large operations in Catalonia during the height of the political crisis highlight the attention that should be paid to liquidity management. Moreover, while gradually rising interest rates might support profitability, stress tests performed during the 2018 Euro Area FSAP and the 2017 Spain FSAP suggest that sharp interest rate increases could erode margins via higher funding costs, and that some banks are



vulnerable to interest rate and government bond yield shocks through valuation effects and trading losses, given their significant exposures to long-duration sovereign bonds. Spanish banks also lend most mortgages at variable rates and should carefully manage credit and funding risks that could arise in an environment of rising rates as well as the transition to the new methodology to set the Euribor.

40. Several aspects of prudential oversight and resolution warrant attention. The FSAP stressed the need for greater supervisory focus on corporate governance practices across all credit institutions and nonbanks, and particularly the credit cooperative sector. To this end, the draft Mortgage Law presents an important opportunity toward better management of banks' conduct risk. The resolvability of small banks needs to be improved. Efforts are underway to create a resolution fund for credit cooperatives that could help mutualize potential losses and thereby improve their resolvability. For the asset management company Sareb, which has been loss-making so far, the Bank of Spain should regularly monitor and review its business plan to ensure that it is based on realistic macrofinancial assumptions. Ongoing efforts toward enhancing the Anti-Money Laundering/Combating the Financing of Terrorism regime (AML/CFT) should be advanced, in particular by: amending the AML/CFT Law so as to eliminate any delays in implementing targeted financial sanctions relating to terrorist financing, ensuring the implementation of a risk-based supervisory framework over money and value transfer services, and adding resources to the AML/CFT supervisor (SEPBLAC) beyond the planned increase.

41. The plans to modernize the institutional framework for financial oversight are welcome and should be expedited. Spain's financial sector oversight follows a strong sectoral approach. With increasing intra-system connectedness, there is an urgent need to establish a mechanism to ensure timely information sharing, monitoring, and action taking among agencies. The FSAP proposed to establish a Systemic Risk Council—chaired by the Bank of Spain and comprising the Treasury and other financial oversight agencies—to bolster systemic risk surveillance and promote interagency coordination. The Spanish authorities are moving in this direction, as they are drafting a proposal for a national macroprudential authority. Focus for institutional upgrades has also been on creating an independent insurance and pension supervisor as well as a financial consumer protection authority, and enhancing the transparency of the appointment process for senior positions at financial oversight agencies.

42. The urgency to enhance the macroprudential toolkit has risen. Even though there is no clear evidence so far of a generalized house price overvaluation (Box 2), it is critical that the Bank of Spain has a comprehensive toolkit at its disposal so that it can act promptly should misalignments emerge. That means that the legal basis should be established for the use of macroprudential tools, such as limits on loan-to-value and debt service-to-income.

Authorities' Views

43. The authorities emphasized the improvement of banks' asset quality and the ongoing work to establish a macroprudential authority over the next months. They highlighted that banks' strategies to reduce NPLs and foreclosed assets have become more ambitious. The

authorities agreed on the importance to monitor the growth of consumer credit, which is being mainly used to finance purchases of durable goods. They also concurred that banks should increase further their CET1 capital ratios, since low profitability remains a challenge. The authorities stressed that the Multiple Point of Entry resolution strategy used by Spanish global banks mitigates spillover risks from emerging market volatility. Thus, they expect the impact of those risks to be manageable. The Bank of Spain regularly reviews banks' funding plans and conducts annual liquidity stress tests since 2017. On the housing market, the authorities did not see signs of overvaluation or financial stability risks stemming from that sector. To tackle rent price pressures in some cities, they are evaluating measures to boost housing supply. The authorities have three near-term priority financial sector projects: setting up of a national macroprudential authority, transposing the EU mortgage directive into national law, and launching a sandbox for facilitating innovation in financial activities within a controlled framework.

STAFF APPRAISAL

44. **Spain's impressive economic recovery is maturing, while downside risks are building.**

After undergoing important structural changes in the aftermath of the global financial crisis, the economy's enhanced resilience and flexibility will likely be tested in the coming years. Therefore, it is essential to preserve the thrust of past structural reforms and take full advantage of the still strong economic growth to reinforce the economy further, in particular by accelerating the reduction in public debt and the build-up of capital buffers in the banking system.

45. Now is the time to restart structural fiscal adjustment. With a debt-to-GDP ratio close to 100 percent, public debt sustainability remains at risk. The 2019 budget needs to be the turning point toward persistently rebuilding fiscal buffers, following four years during which the structural fiscal deficit has widened. Thus, it is critical to meet the announced 1.8 percent of GDP deficit target in 2019. This requires adopting a reliable package of structural measures and planning for contingency actions that could promptly compensate any potential revenue shortfalls. A structural fiscal adjustment of at least $\frac{1}{2}$ percent of GDP annually should persist until there is fiscal structural balance and debt is on a clear downward path. Otherwise, Spain would be forced to undertake a procyclical fiscal tightening when the economy is hit by adverse shocks. Restarting structural fiscal consolidation would also help strengthen the external position, which is moderately weaker than suggested by fundamentals and desirable policies.

46. Fiscal deficit reduction is consistent with the goal of lowering inequality. Spain's revenue-to-GDP ratio is 7 percentage points below that of euro area peers. Narrowing this gap with revenue measures would not only contribute to a sustained medium-term fiscal adjustment but could also help to finance social and distributional objectives, in particular to create better opportunities for the young. But a careful design of tax measures is key to limit distortions and growth implications. To this end, options such as lowering tax exemptions, increasing environmental taxes, and shifting more items to the standard VAT rate should be seriously considered. Unintended distributional effects can be offset with targeted spending measures.

47. A sustainable and comprehensive package is needed to address the tensions in the pension system. The 2011/13 pension reforms responded with financially appropriate measures to address the pressure from unfavorable demographics. Because the social acceptability of the reforms has been put into question, further adjustments need to be made. It is critical, however, to avoid shifting the burden on to future contributors and pensioners by putting pension spending on a sharp upward trajectory, and to decide already today on a sustainable and equitable solution. It should also be clearly communicated that entirely avoiding a future reduction in real pension benefits will be extremely difficult unless there are fundamental changes to contributions and the labor market.

48. A better-functioning labor market is the core for more inclusion and higher wages. Greater wage flexibility is a critical achievement of the earlier labor market reforms and needs to be preserved, in particular the prevalence of firm-level over sector agreements. But high structural unemployment and pervasive duality are clear signs that the job market is not yet healthy. Additional labor market reforms should address these weaknesses as well as promote social cohesion and wage gains aligned with productivity. Forcefully tackling abuses of temporary contracts is important but by itself cannot be sufficient. Instead, a holistic approach is needed to lower the cost of open-ended contracts, improve training and education outcomes, and raise the low labor mobility across regions. The younger generation needs to be better integrated into the labor market to sustainably enhance their income prospects. However, the planned sharp increases in the statutory minimum wage could put at risk job opportunities of the young and low-skilled.

49. The structural reform agenda requires new impetus to lift productivity. The productivity gap to European peers is large, particularly among small and micro firms. Labor productivity also varies widely across regions. Therefore, policy efforts should focus on eliminating disincentives for firms to grow, improving market access, and expanding firm's innovation capacity. Since responsibility for regulatory policies, R&D initiatives, and education lies at the regional level, particular efforts are needed to enhance the coordination between the levels of government.

50. The health of the Spanish banking system continues to improve while new risks are emerging. The decline in nonperforming loans and foreclosed assets has accelerated, helping to clean up banks' balance sheets. But the process is not yet complete. Spanish banks still lag European peers in terms of capital ratios. They would therefore benefit from accelerating the build-up of high-quality capital buffers to protect their business against potential shocks, including from increased volatility in emerging markets and legal risks. Rigorous management of liquidity and interest rate risks is also needed, in particular ahead of the eventual normalization of the ECB's accommodative policies. Moreover, as consumer lending and housing-related new loans are picking up the Bank of Spain's macroprudential toolkit should be swiftly expanded to include borrower-based tools, to ensure that it is fully equipped to counter excessive risk-taking in the event of financial stability threats. At the same time, it is critical to complete the setup for systemic risk oversight, including a robust macroprudential framework, and more generally to continue following up on the 2017 FSAP recommendations.

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

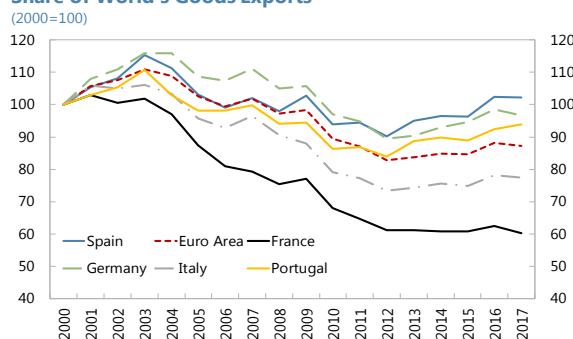
Box 1. The Drivers of Spain's Export Growth^{1/}

Exports now represent over a third of Spain's GDP. Key drivers of post-crisis export growth until 2017 included external demand, greater geographic diversification, regained cost competitiveness, and substitution effects triggered by low domestic demand. The impact of the 2010 and 2012 labor markets reforms is estimated to account for nearly one-tenth to above one-quarter of the real export growth rate over 2010–13.

Spain's export performance strengthened in the wake of the crisis.

Exports of goods and services increased from 26 percent of GDP in 2007 to 34 percent in 2017. The average annual real growth rate of goods exports increased from 4.5 percent in 2001–07 to 5.4 percent in 2010–17, while for services, the average annual growth rate surged from 2.9 to 4.3 percent over the same periods. This enhanced export performance was broad-based across the main categories of goods and services. In recent years, Spain has increased its share of world goods exports, outperforming other EU countries.

Share of World's Goods Exports

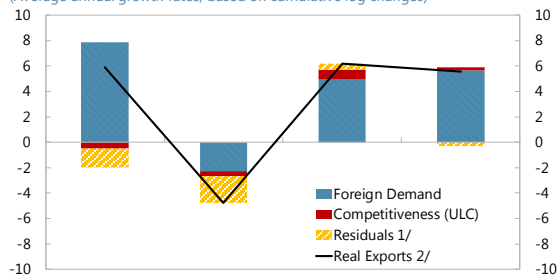


Sources: Haver Analytics, IMF, and IMF staff calculations.

Several factors contributed to strong export growth. A regression analysis indicates that *foreign demand* was the main driver of export growth. The impulse from foreign demand benefited from increased *geographic diversification*; particularly, larger exports to non-EU countries, including emerging markets in Asia and Latin America. Meanwhile, the contribution of *competitiveness*, measured by unit labor costs (ULC) relative to trading partners, switched from negative before the crisis to positive afterwards, partly because of wage moderation. Regained competitiveness supported the *greater export orientation* of Spanish firms, which was also triggered by *depressed domestic demand*. As more firms began to internationalize, the number of regular exporters rose by nearly one-third between 2007 and 2017.

Determinants of Real Exports of Goods and Services

(Average annual growth rates, based on cumulative log changes)



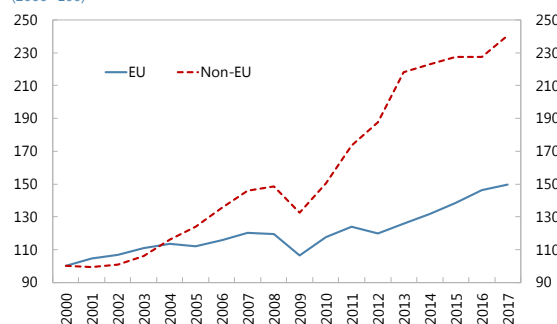
1/ Includes contribution of a dummy variable that takes the value of 1 in 2008Q4.

2/ Excludes contribution of the constant term in the regression.

Source: IMF staff calculations.

Exports of Goods by Destination

(2000=100)



Sources: Haver Analytics, Eurostat, IMF staff calculations.

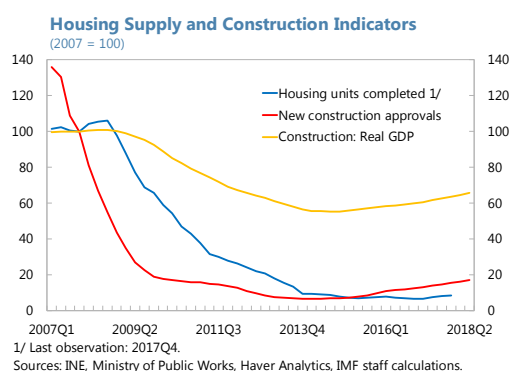
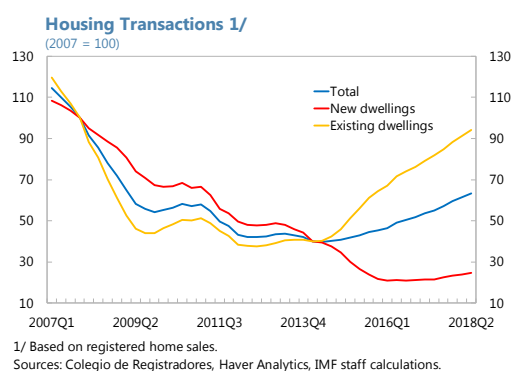
New cross-country evidence indicates an important effect of labor market reforms on exports. Labor market flexibility can strengthen export performance, including by enhancing cost competitiveness. Evidence from panel regressions confirm a statistically significant impact on exports of labor market reforms (LMR), as measured by OECD indicators of employment protection. These regressions imply that Spain's 2010 and 2012 LMR were associated with a faster growth of real exports in the order of 1 to 4 percentage points. This finding suggests that, on average, the LMR accounted for about one-fifth of the growth of real exports in the period from 2010 to 2013.

^{1/} For more details see Jorge Salas, "Drivers of Spain's Export Performance and the Role of Labor Market Reforms", IMF Working Paper (forthcoming).

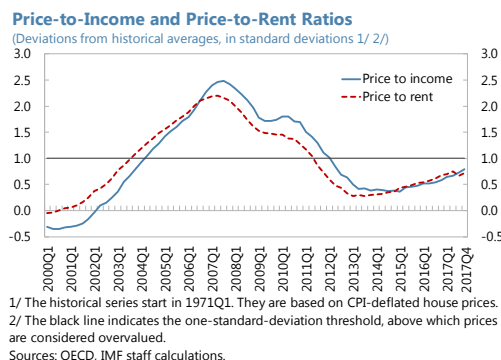
Box 2. Developments in the Housing Market: Already a Cause of Concern?

House prices have increased in recent years, although from a low level and without signs of a construction boom. While there is no clear evidence of a significant price misalignment yet, the authorities need to be vigilant. The set of macroprudential tools should be expanded to deal with potential financial stability risks.

The ongoing price recovery is not associated with a construction boom. House prices have increased by around 15 percent between 2014–17, boosted by fast recoveries in cities like Madrid and Barcelona. Registered sales have disproportionately risen among existing dwellings, whereas new-dwelling transactions are still well below their pre-crisis peak. Despite early signs of mild supply-side recovery, such as an increase in new construction approvals from a low level, the housing stock has barely risen so far. In the overall economy, the contribution of value added from the construction sector is nearly half of what it was before the crisis. These trends have been accompanied by a small decline in home ownership (from 80 to 77 percent between 2008–17), while renting activity has strengthened. Against this background, new rent subsidy programs and social home loans were recently introduced. The authorities are also considering expanding the social housing stock.



Although house prices are rising, there is no strong evidence of a clear overvaluation yet. Two approaches are used to assess house price misalignment. The first approach measures deviations from historical averages of the price-to-rent and the price-to-income ratios. As of 2017:Q4, both ratios stand at roughly similar levels as in mid-2003 and less than one standard deviation above their historical averages, thus indicating no overvaluation. The second approach is a regression that includes the growth rates of income per capita, working-age population, interest rates, equity prices, and construction costs, as well as a long-term equilibrium relationship with the price-to-income ratio, which measures housing affordability. This model suggests a slight overvaluation in 2017:Q4. However, this regression-based result should be treated with caution given that the model is particularly limited in capturing supply-side dynamics.



To prevent financial stability risks emerging, the macroprudential toolkit should be expanded and ready to be used. While housing valuation gaps are not significant so far and households' balance sheets have gradually improved since 2012, persistent demand pressures in the housing market could increase risks to financial stability. As noted in the 2017 FSAP, banks are highly exposed to real estate sector developments, and therefore the macroprudential toolkit should be expanded to deal with risks associated with that exposure (see IMF Country Reports No. 17/321 and 17/336). Other actions would be welcome to: (i) further improve balance sheets in the construction and real estate sectors; (ii) encourage greater use of fixed-rate mortgages; (iii) ensure that eligibility criteria for social home loans and rent subsidies are prudently assessed; and (iv) improve housing development regulation to address supply constraints. Any new measures aimed at reducing rent pressures should avoid causing negative supply-side effects with adverse impact on low-income renters.

Box 3. Measuring Spain's Position in the Economic Cycle

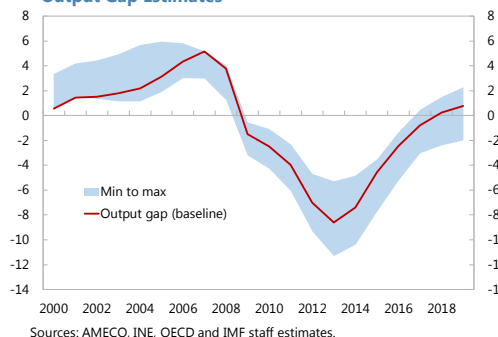
Repeated past growth surprises pose the question where the economy stands in the cycle. Considering a range of methods and indicators, the cycle appears to be maturing and the output gap closing soon.

Disentangling the cycle and the trend in economic activity is difficult. Uncertainty owing to measurement errors and challenges in identifying demand shocks complicate the estimation process. The estimation is even more challenging for an economy that experienced structural shifts. These difficulties gave rise to several potential output concepts and methods: (i) the traditional production function approach; (ii) a multivariate filtering approach (developed by Blagrove et al., 2015), which is based on a model that captures links between actual and potential GDP, unemployment, and inflation; and (iii) an extended multivariate filtering approach that accounts also for financial/credit cycles (Berger et al., 2015).

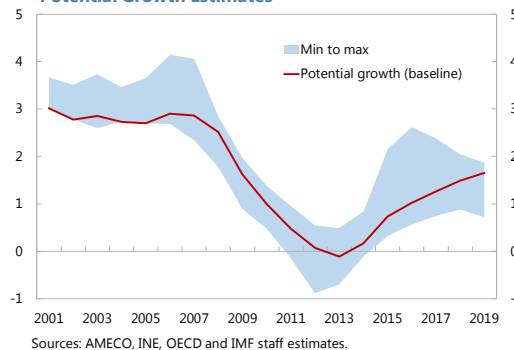
For Spain, traditional and non-traditional measures of output gap estimates range from -1.8 to +2.0 percent of potential GDP for 2018. The range reflects estimates from the European Commission, OECD, and three different estimates by IMF staff using the methods described above. The IMF's baseline estimate, which uses the multi-variate filter approach, suggests a slightly positive output gap for 2018. Out of five methods three produce a positive output gap for 2018. The differences in output gap estimates reflect the range of potential GDP growth estimates, which vary from 0.9 to 2 percent for 2018. The IMF's baseline estimates suggest 1.5 percent potential growth for 2018. The lowest level of potential growth estimate is suggested by the OECD, while the highest estimate is produced by the multivariate filter that considers financial frictions.

Several other measures of economic slack also point to Spain's economic cycle being largely completed. The unemployment rate at end-2017 was already slightly below its long-term average, while the ratio of vacancies to the number of unemployed has approached its long-term average. In addition, the negative deviation of hours worked from its long-term average and trend has almost disappeared. Capacity utilization for the overall economy surpassed its long-term average in 2017, while capacity utilization for investment goods has already reached its pre-crisis level. Nevertheless, the share of involuntarily part-time workers in active population has increased somewhat compared to the pre-crisis period pointing to a slack in the labor market.

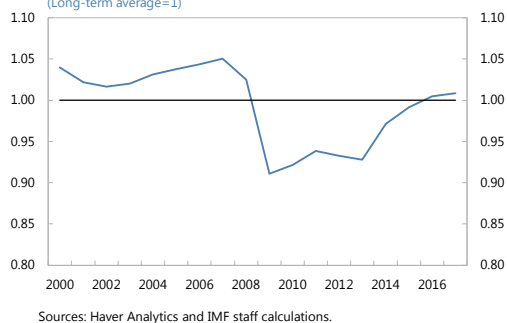
Output Gap Estimates



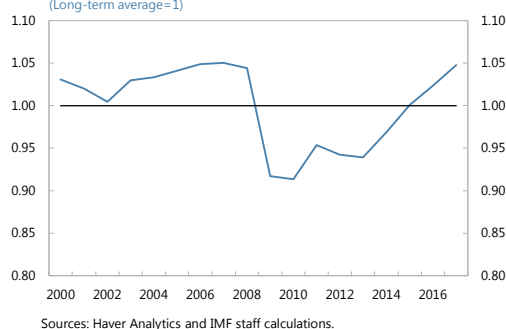
Potential Growth Estimates



Capacity Utilization: Overall Economy
(Long-term average=1)



Capacity Utilization: Investment Goods
(Long-term average=1)



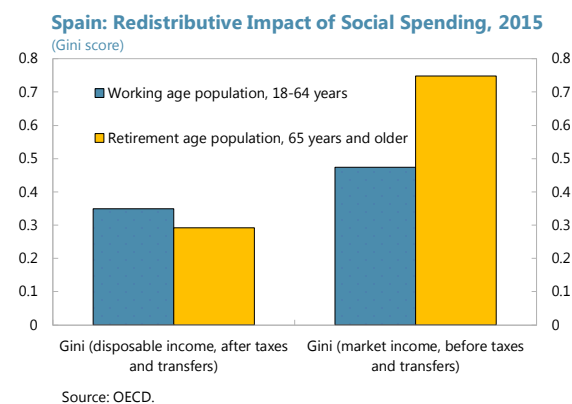
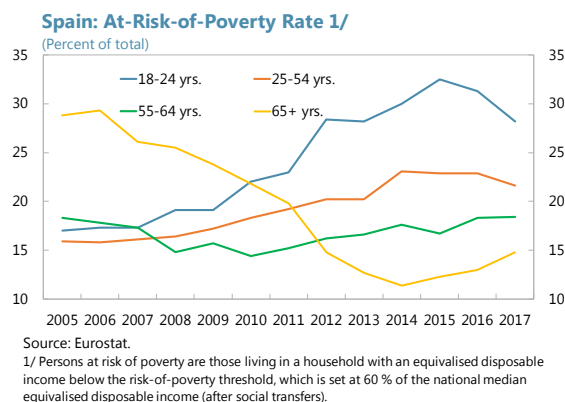
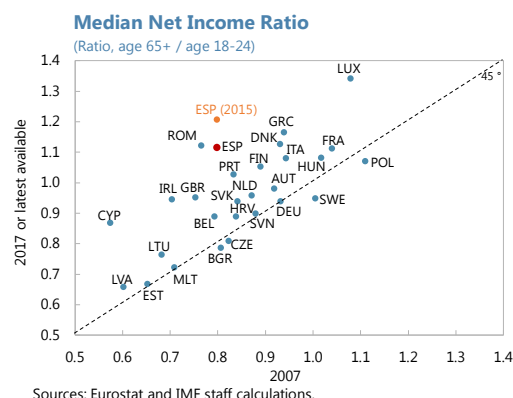
Box 4. Inequality and Poverty Across Generations^{1/}

A consequence of the global financial crisis in most of Europe was an increase in inequality and poverty across generations. Spain was no exception where its youth was particularly hard hit by economic stagnation, while the older generation was largely protected by the pension system. When deciding on revisions to the pension system going forward, it is important to explicitly take into consideration the impact on intergenerational equity.

Income developments across the younger and older generation have diverged. The median net income ratio of those over age 65 to those between the ages of 18–24 increased in 24 of 28 EU countries following the global financial crisis. Spain experienced the second largest increase. In 2015 those over 65 years earned 20 percent more than those between the ages of 18–24, a reversal of this ratio from the pre-crisis years. The gap has narrowed since then to 10 percent in 2017 helped by the recovery in youth employment. In 2015–17 the older age group saw its mean income increase annually by 1.7 percent on average, while the younger group enjoyed a larger average annual rise of 6 percent.

The risk of youth poverty has surged in Spain over the past decade. During the pre-crisis years, the risk of poverty for Spain's youth was slightly below the euro area average as many young people were employed in the booming construction sector. When the economy went into recession and job opportunities especially for the young disappeared, poverty for that age group rose rapidly. In 2015, one in three youths was at risk of poverty, defined as the share of persons with equivalized disposable income (after social transfers) of less than 60 percent of the median disposable income. At the same time, compared to all other age groups, the poverty rate for the elderly dropped sharply from 30 percent in 2005 to 12 percent in 2015. Since 2015, the trends have started to reverse with youth poverty on the decline.

The pension system helped shield the elderly through the worst of the crisis. While market income inequality in Spain is significantly higher for the elderly, after accounting for fiscal redistribution through taxes and transfers, disposable income inequality for the elderly is lower than for the working age population.



^{1/} See also IMF Staff Discussion Note 18/01 *Inequality and Poverty Across Generations in the European Union*.

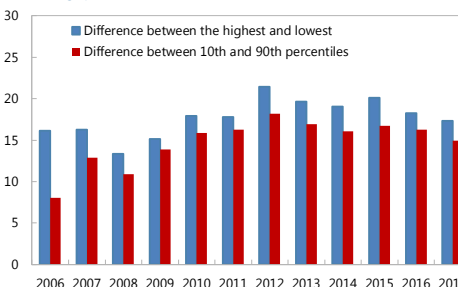
Box 5. Regional Labor Market Mobility¹

Spain's high structural unemployment and persistent regional labor market disparities are often associated with a low labor mobility across regions. Empirical analysis finds that housing prices, labor market conditions and labor market duality are the major factors explaining Spain's interregional migration flows.

The disparities in regional labor market performance have been large and persistent.

Over the last decade, the gap in the unemployment rates between the top (90 percentile) and bottom (10 percentile) regions fluctuated around 15 percentage points. Regions in the Northeast were consistently the best performers with an average unemployment rate of 13 percent, whereas the jobless rates in the Canary Islands and the South (average of 25 percent) were continuously among the highest. The regional dispersion increased notably during the crisis but has declined since 2013 on the back of strong economic recovery.

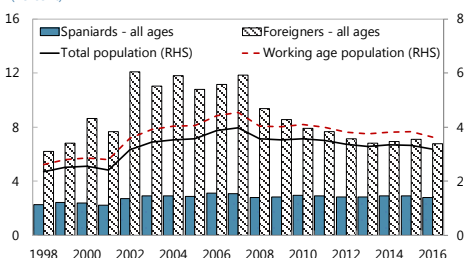
Regional Unemployment Dispersion
(Percentage point)



Sources: INE and IMF staff calculations.

The large labor market disparities are linked to a low labor mobility across regions. According to the Residential Variation Statistics data from Spain's statistical agency INE, about 3 percent of the population changed residence across regions during 1998–2016. The internal mobility rate grew steadily during the economic boom years but declined following the crisis as the overall labor market deteriorated. Much of this underlying trend was driven by labor movement of immigrants, whereas the mobility rate of Spaniards was relatively stable. On average, regional mobility among foreigners was around three times higher than that of Spaniards. In net terms, only a few regions have been consistently a net receiver (Navarra and Balearic Islands) or a net sender (Aragon and Extremadura). The crisis also brought some changes to the pattern of mobility flows, with some regions (e.g. Madrid and Basque Country) switching from net senders before the crisis to net receivers afterwards.

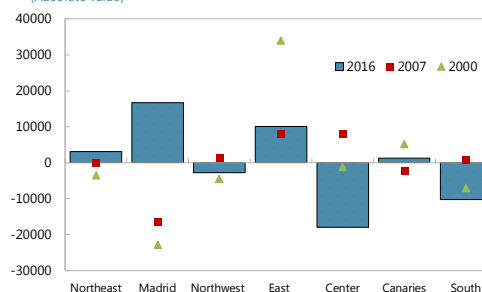
Internal Mobility Rate 1/
(Percent)



Sources: INE; and IMF staff calculations.

1/ Calculated as the number of residential variations within Spain divided by the size of the corresponding population.

Net Internal Migration Flows
(Absolute value)



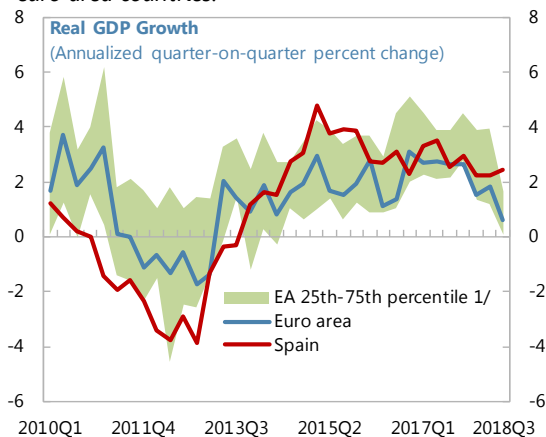
Sources: INE; and IMF staff calculations.

Staff's analysis suggests that housing prices, labor force education, labor market conditions, and labor market duality are the main factors determining Spain's internal mobility. The regression analysis controls for the standard macroeconomic, demographic, and geographic factors. All else equal, higher housing prices and larger unemployment rates in the destination regions, and greater share of temporary employment in the origin regions have a negative effect on labor mobility. Moreover, regions that have a larger share of low education labor force tend to generate more population outflows particularly after the global financial crisis. The analysis also finds that Spaniards tend to have a strong "home bias", which could be attributed to culture and unknown institutional factors. In light of this result, there may be a role for policies to provide additional incentives to promote labor movement. Finally, when comparing the behavior of Spaniards and foreigners, the study finds that push factors tend to be more important for foreigners' mobility, whereas pull factors matter more for Spaniards.

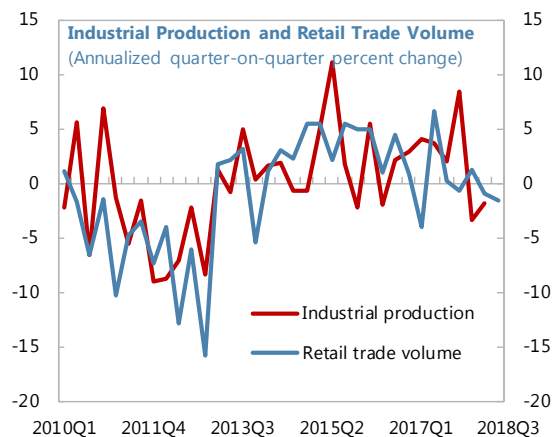
^{1/} For more details see Lucy Liu, "Regional Labor Market Mobility in Spain", IMF Working Paper (forthcoming).

Figure 1. Spain: Real Sector and Inflation

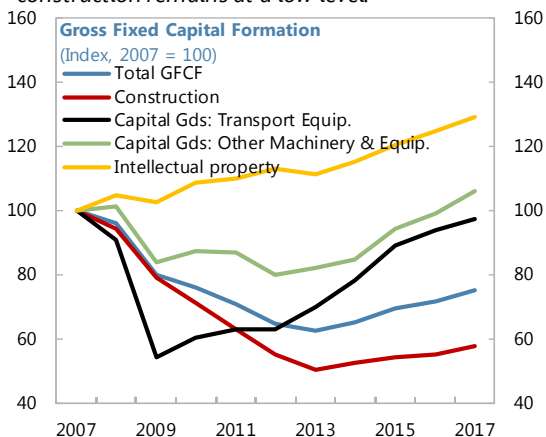
Spain's growth has outpaced that of other large euro area countries.



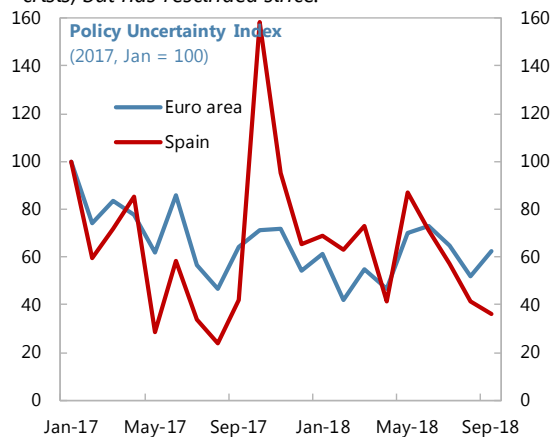
The strong dynamics have been broad based.



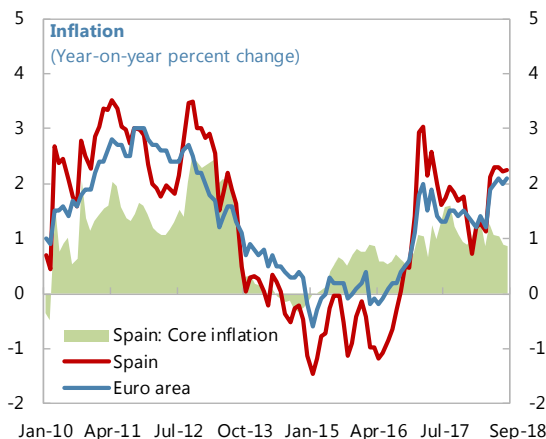
In particular, investment has picked up though construction remains at a low level.



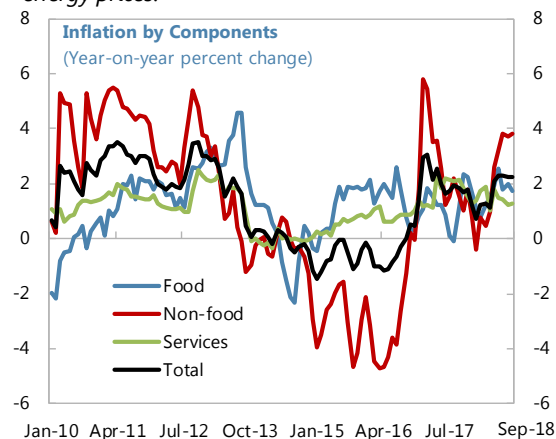
Political uncertainty surged related to the Catalonia crisis, but has resided since.



Core inflation has shown little upward movement ...



... while headline inflation jumped in 2017 due to energy prices.

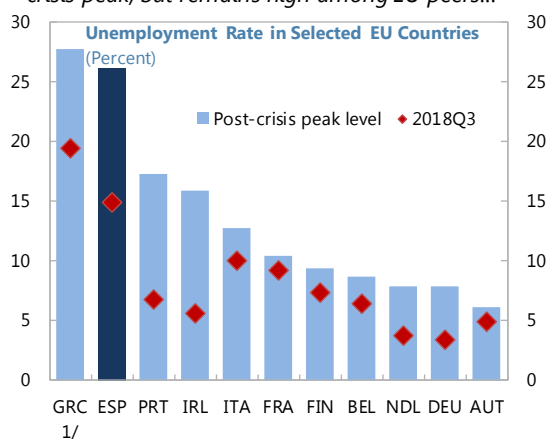


Sources: Bank of Spain; Eurostat; Haver Analytics; and IMF staff calculations.

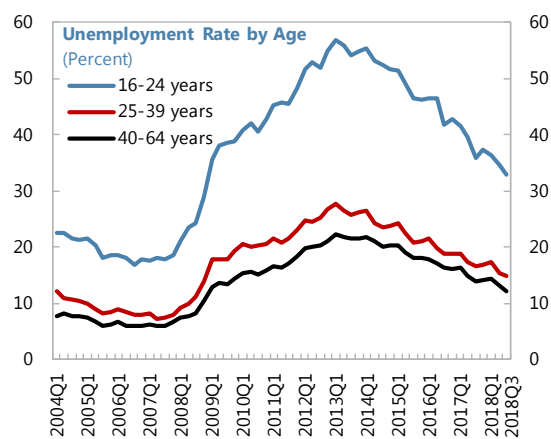
1/ Ireland is excluded for 2015Q1 due to methodological change and a growth rate of 119 percent.

Figure 2. Spain: Labor Market Developments

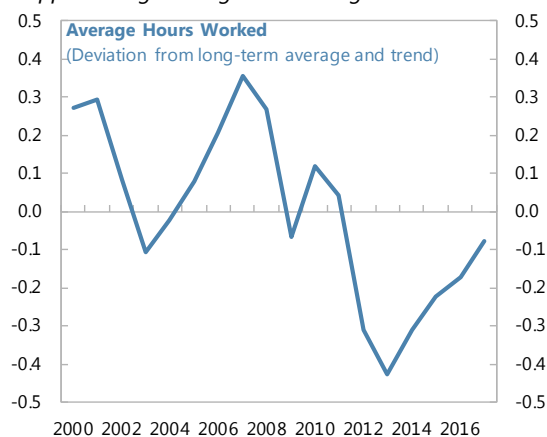
Unemployment has declined notably from its post-crisis peak, but remains high among EU peers...



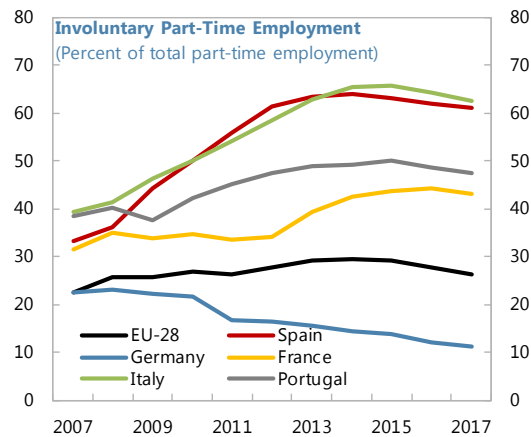
...particularly for the young.



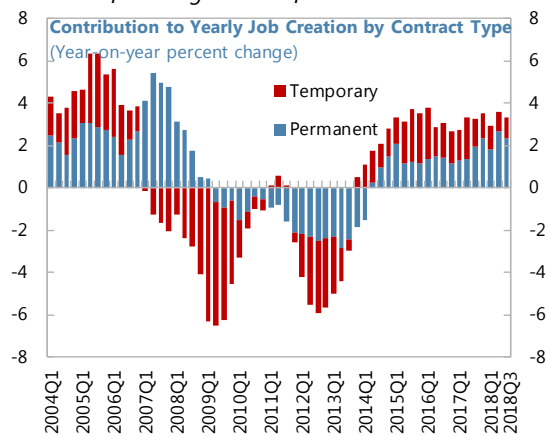
Average working hours, though still recovering, are approaching its long-term average and trend.



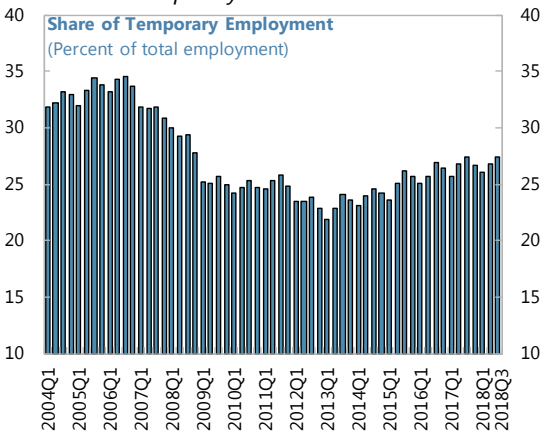
Nevertheless, the share of involuntarily part-time workers remains elevated.



Despite strong job creation, temporary jobs account for a large share of the new hires.



As a result, more than a quarter of workers are still under temporary contracts.

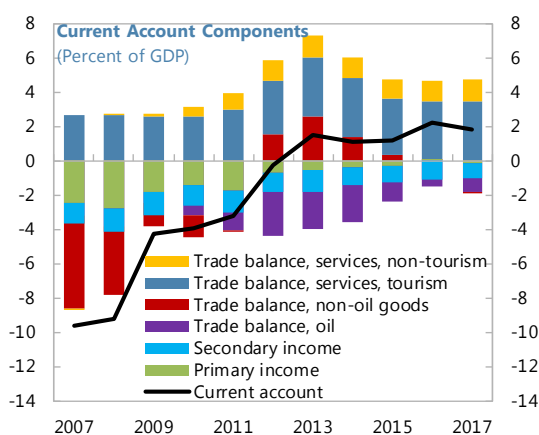


Sources: Eurostat, Haver Analytics, INE, Quarterly Labor Force Survey, Ministry of Employment and Social Security, and IMF staff calculations.

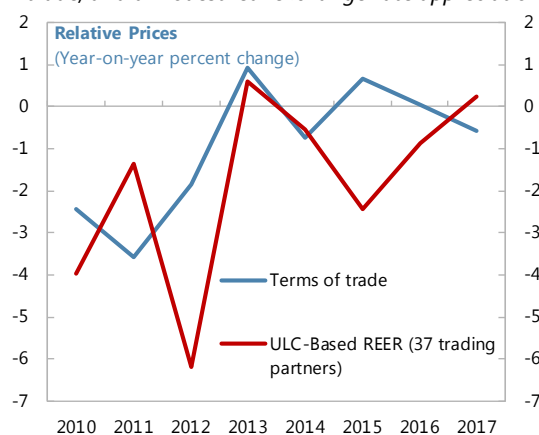
1/ 2018Q2 value is used.

Figure 3. Spain: External Sector

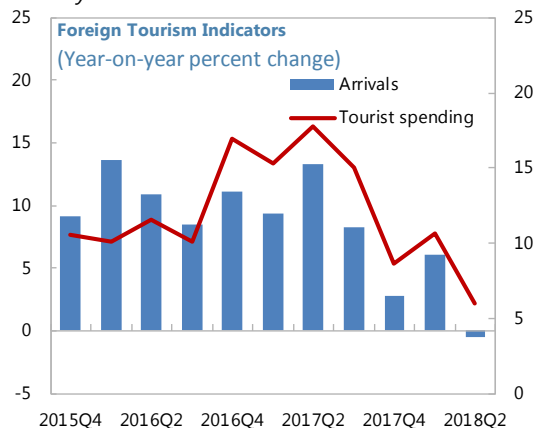
The current account remained in surplus in 2017...



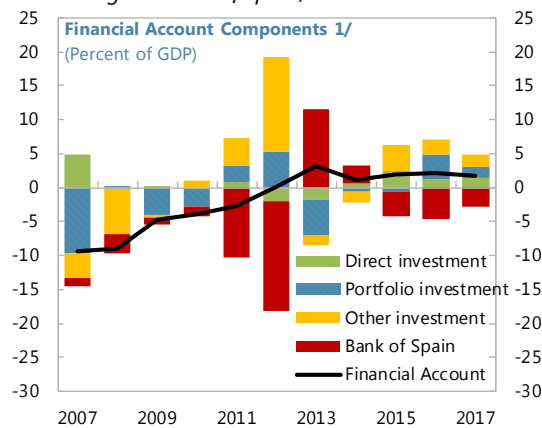
... despite higher oil prices, which lowered the terms of trade, and a modest real exchange rate appreciation.



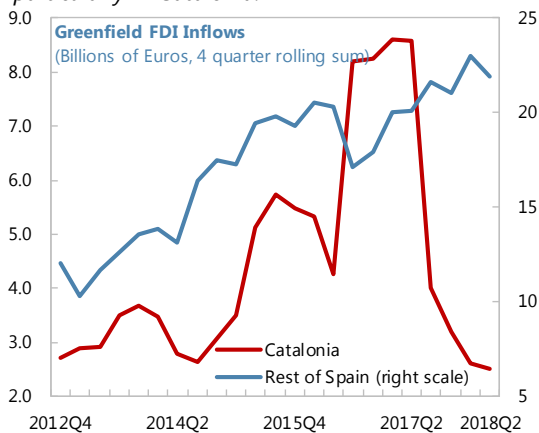
Tourism has increased, but arrivals and spending have recently decelerated.



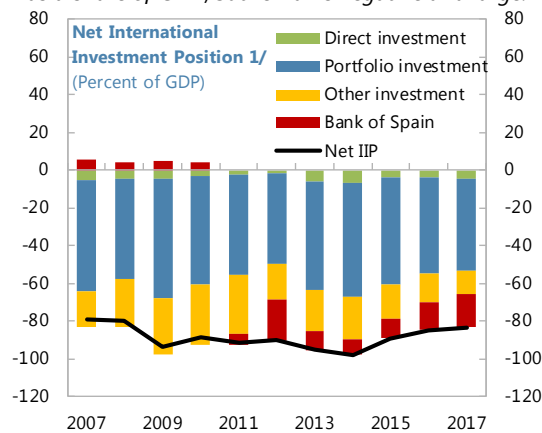
Net outflows in portfolio and other investment, excluding the Bank of Spain, decreased in 2017.



Greenfield FDI inflows decelerated in 2017, particularly in Catalonia.



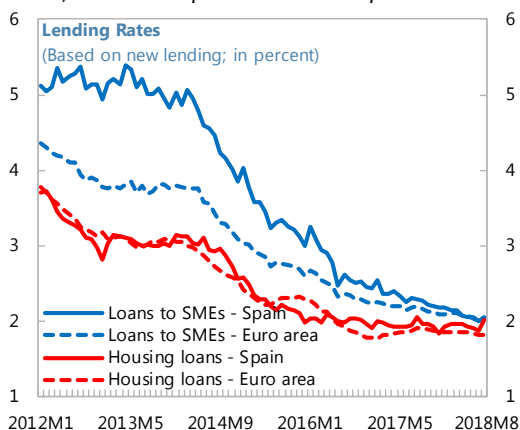
The net international investment position improved as a share of GDP, but remains negative and large.



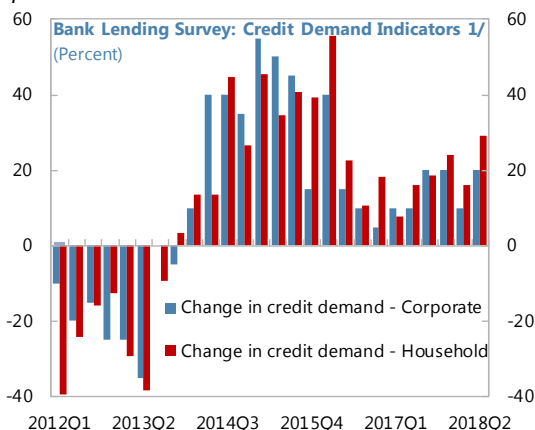
Sources: Bank of Spain; DataInveX; Eurostat; Haver Analytics; INE; WEO; and IMF staff calculations.
1/ Portfolio Investment and Other Investment exclude the Bank of Spain, which is shown separately.

Figure 4. Spain: Credit Development and Financial Cycle

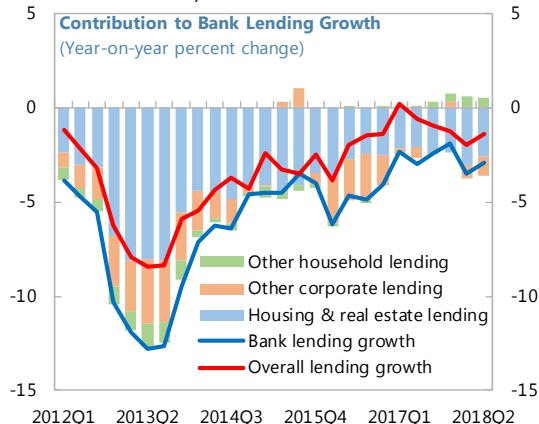
Lending rates for new housing loans remain at low levels, while those for SMEs declined further.



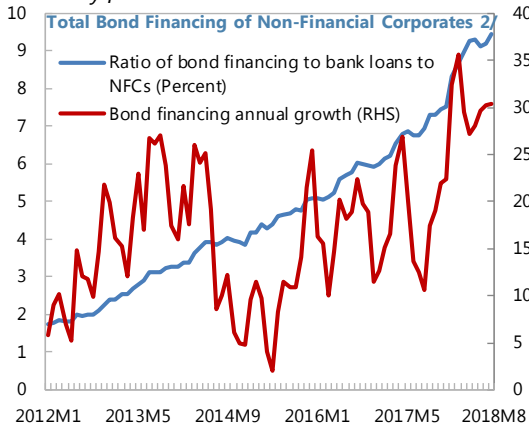
Demand for bank loans has increased, especially from households...



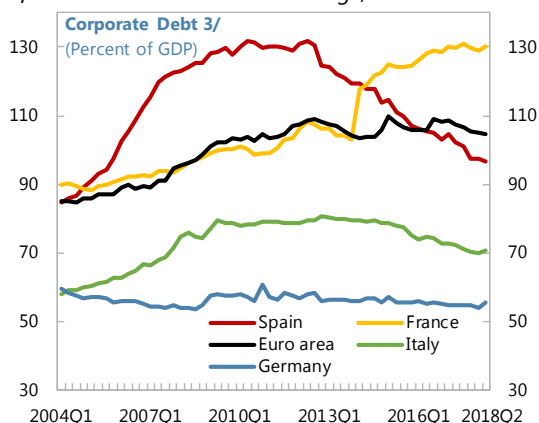
... and the decline in bank credit growth was more moderate in 2017, ...



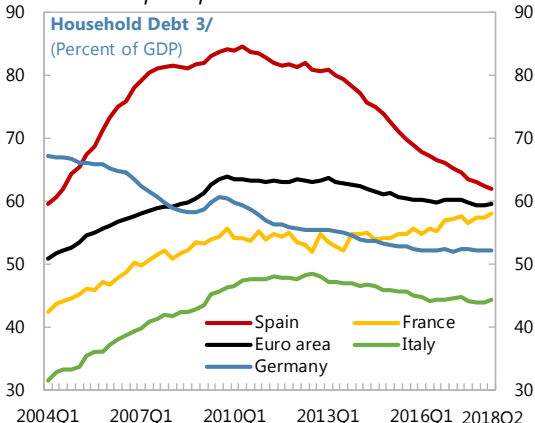
... while the outstanding balance of debt securities issued by firms continued to increase.



As deleveraging continues, corporate debt has fallen below the euro area average, ...



... and household indebtedness has also moved closer to European peers.



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

1/ Positive (negative) values indicate changes consistent with credit expansion (contraction).

2/ Bond financing reflects debt securities issued by non-financial corporates.

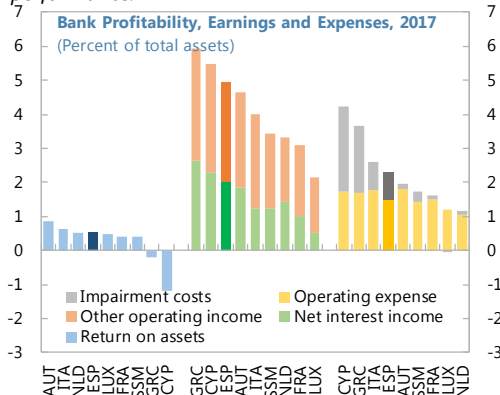
3/ Based on total borrowing and net accounts payable.

Figure 5. Spain: Banking System Performance

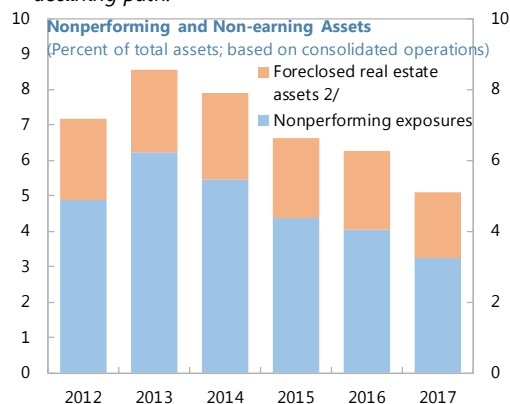
Profitability improved in 2017, but net income of business in Spain remains weak...



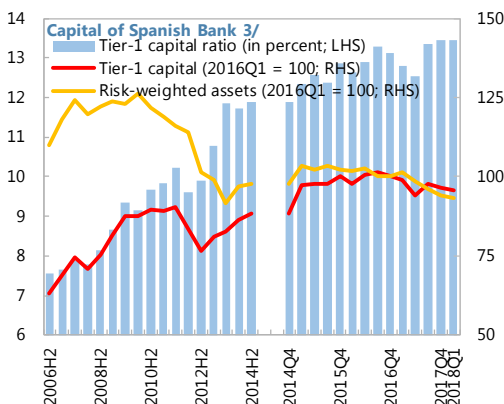
... with impairment costs still weighing on banks' performance.



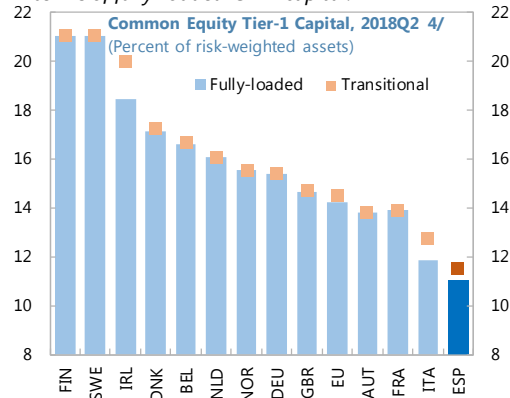
NPLs and foreclosed property remain on a declining path.



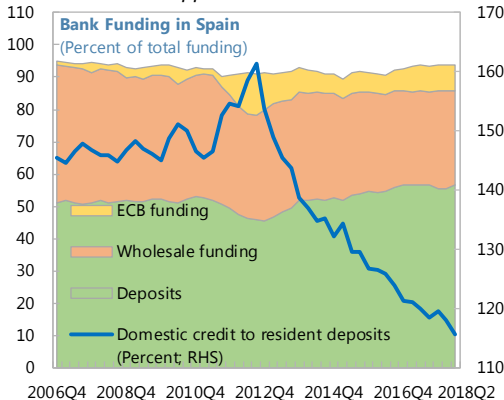
Despite continued improvement in the capital ratio...



... Spanish banks are still lagging behind peers in terms of fully-loaded CET1 capital.



Banks' funding conditions remain stable, but reliance on ECB support is still sizeable.



Sources: Bank of Spain; EBA, 2018Q2 Risk Dashboard; ECB, Supervisory Banking Statistics; 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 saving banks' business to newly-created banks. See BdE's Statistical Bulletin (2012) for more details.

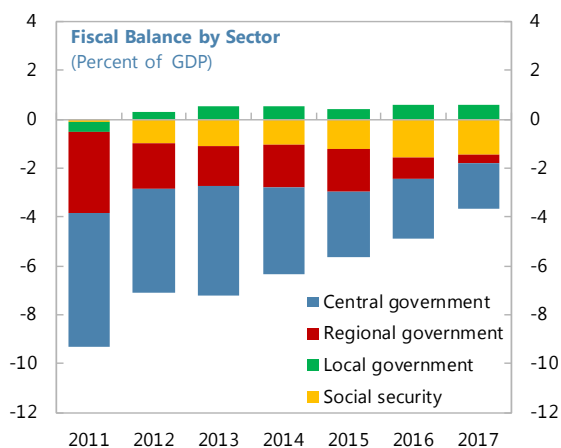
2/ Data is on consolidated basis, but foreclosed property only reflects business in Spain.

3/ Due to data availability, the chart shows semi-annual figures through 2014 and quarterly figures since then.

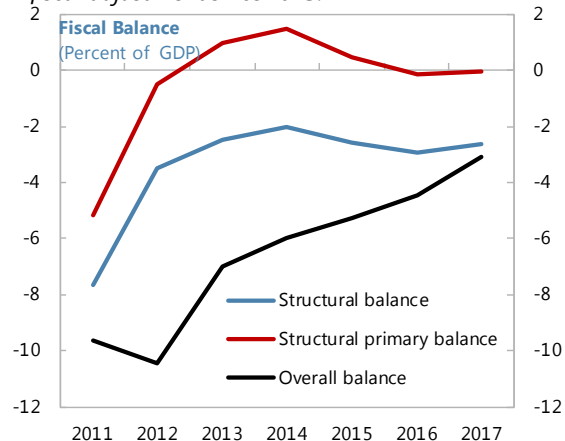
4/ Based on banks reported in the EBA Risk Dashboard.

Figure 6. Spain: Public Finances

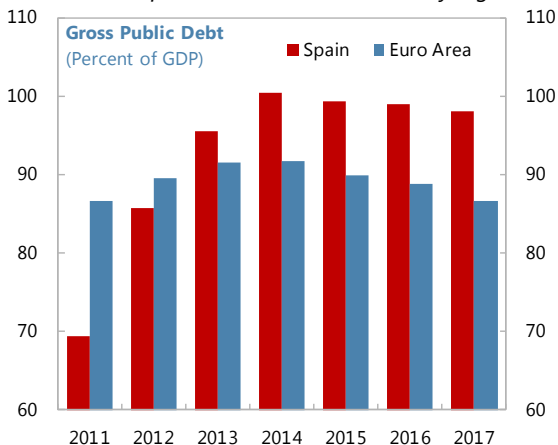
The headline fiscal deficit continued to decline ...



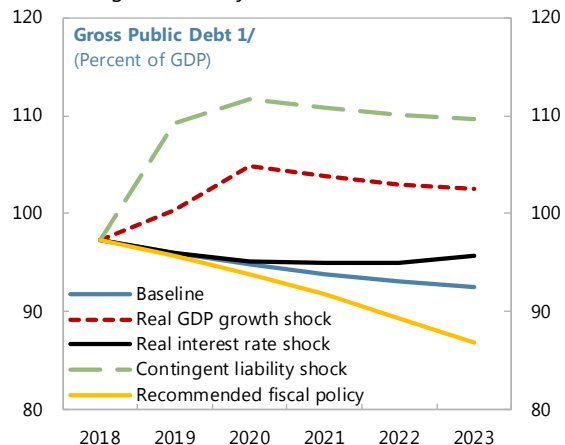
... but there has been little progress with structural fiscal adjustment since 2015.



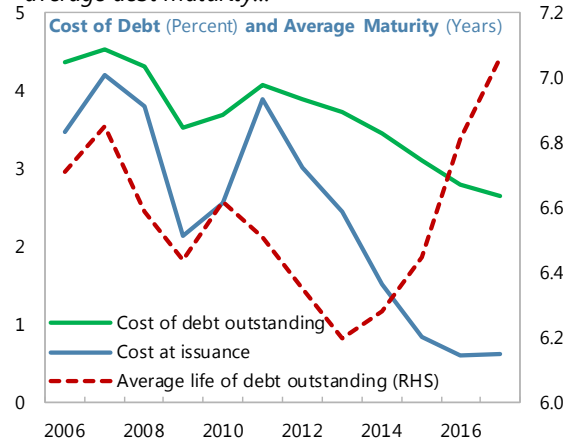
As a result, public debt remains relatively high ...



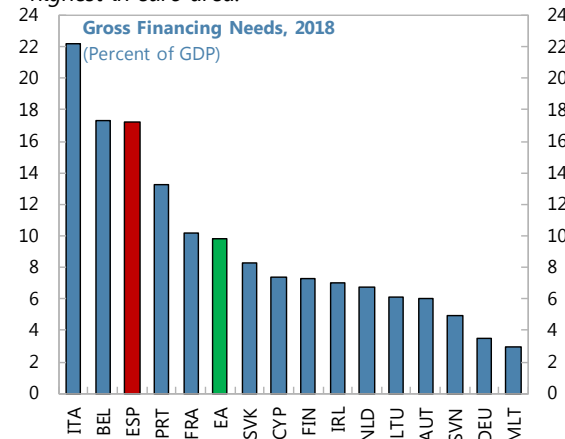
... leaving the country vulnerable to shocks.



Despite reductions in funding costs and extensions of average debt maturity...



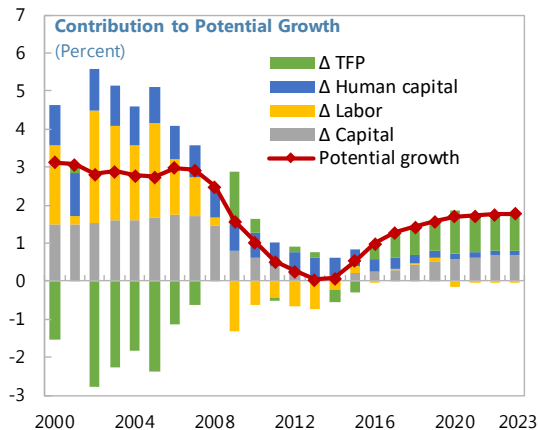
... Spain's gross financing needs are still among the highest in euro area.



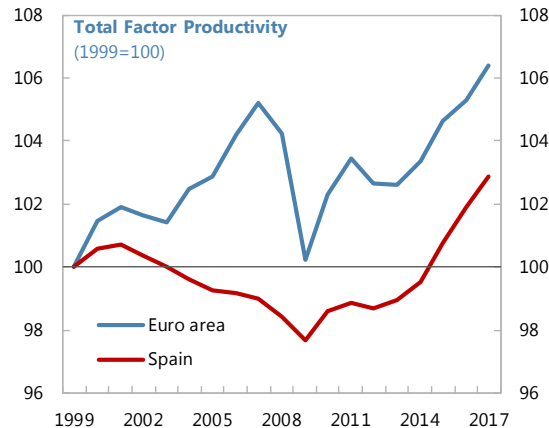
Sources: Bank of Spain; Fiscal Monitor (October 2018); Spain Ministry of Finance; and IMF staff estimates.
1/ For more details, see Debt Sustainability Analysis in Appendix IV.

Figure 7. Spain: Long-Term Growth Prospects

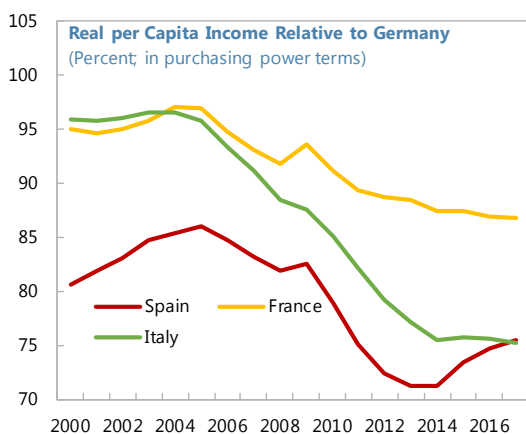
Potential growth is expected to remain subdued over the medium term.



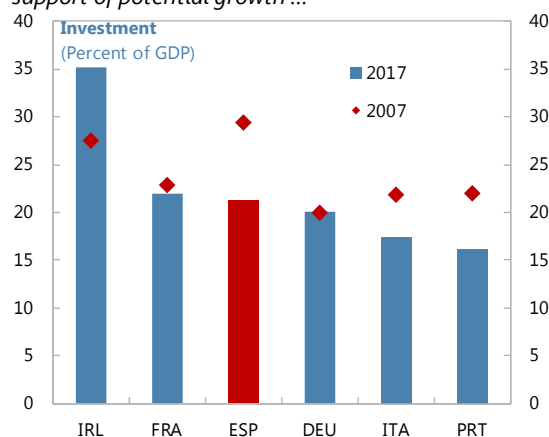
Despite the turnaround in TFP growth after the crisis, productivity lags that of peers.



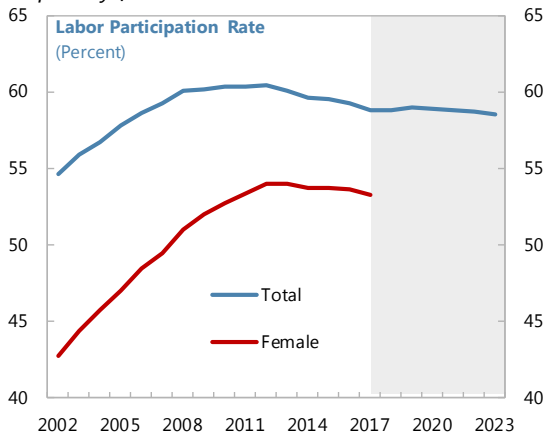
This leaves a large convergence gap.



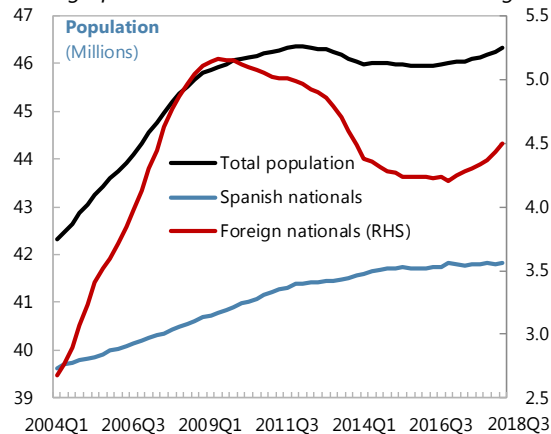
Efforts are needed to raise the investment rate in support of potential growth ...



... as well as to lift further the labor participation rates, especially for women.



Despite recent new net migrant inflows, unfavorable demographics also create headwinds over the long term.



Sources: AMECO; Bank of Spain; Eurostat; Haver Analytics; INE; ORBIS; WEO; and IMF staff estimates.

Table 1. Spain: Main Economic Indicators, 2013–23

(Percent change unless otherwise indicated)

	2013	2014	2015	2016	2017	Projections					
						2018	2019	2020	2021	2022	2023
Demand and supply in constant prices											
Gross domestic product	-1.7	1.4	3.6	3.2	3.0	2.5	2.2	1.9	1.7	1.7	1.7
Private consumption	-3.1	1.5	3.0	2.9	2.5	2.4	2.1	1.7	1.7	1.6	1.7
Public consumption	-2.1	-0.3	2.0	1.0	1.9	2.1	1.7	0.8	0.3	0.3	0.4
Gross fixed investment	-3.4	4.7	6.7	2.9	4.8	5.8	3.8	2.7	2.5	2.2	2.1
Total domestic demand	-3.2	2.0	4.0	2.4	3.0	3.1	2.4	1.7	1.6	1.5	1.5
Net exports (contribution to growth)	1.5	-0.5	-0.3	0.8	0.1	-0.5	-0.1	0.2	0.2	0.2	0.2
Exports of goods and services	4.3	4.3	4.2	5.2	5.2	1.4	2.2	3.6	3.6	3.3	2.6
Imports of goods and services	-0.5	6.6	5.4	2.9	5.6	3.0	2.8	3.3	3.2	2.9	2.2
Real GDP per capita	-1.3	1.7	3.8	3.2	3.0	1.8	1.8	1.4	1.3	1.2	1.3
Savings-Investment Balance (percent of GDP)											
Gross domestic investment	18.7	19.5	20.4	20.4	21.1	21.9	22.2	22.3	22.3	22.3	22.3
Private	16.5	17.3	17.9	18.5	19.1	19.7	20.1	20.2	20.2	20.2	20.2
Public	2.2	2.1	2.5	1.9	2.0	2.2	2.1	2.1	2.1	2.1	2.1
National savings	20.2	20.5	21.6	22.7	22.9	22.9	22.9	23.0	23.2	23.2	23.2
Private	24.2	24.0	24.4	25.2	24.1	23.5	23.2	23.3	23.5	23.7	23.9
Public	-4.0	-3.5	-2.8	-2.5	-1.1	-0.6	-0.3	-0.3	-0.4	-0.5	-0.6
Foreign savings	-1.5	-1.1	-1.2	-2.3	-1.8	-1.0	-0.7	-0.8	-0.9	-0.9	-0.9
Household saving rate (percent of gross di	9.6	9.2	8.7	7.8	5.5	4.6	4.6	4.6	4.6	4.7	4.8
Private sector debt (percent of GDP)	241.4	231.3	217.8	207.9	199.6	192.2	185.7	180.6	176.2	171.9	167.9
Corporate debt	159.6	153.7	145.4	138.9	133.9	128.1	122.9	118.6	115.0	111.4	108.1
Household debt	81.8	77.6	72.3	69.0	65.6	64.1	62.8	62.0	61.2	60.5	59.8
Credit to private sector	-10.2	-6.5	-4.2	-4.1	-2.0	-0.2	0.2	1.2	1.6	1.7	1.7
Potential output growth	0.0	0.3	1.2	1.0	1.3	1.5	1.7	1.8	1.8	1.7	1.8
Output gap (percent of potential)	-7.8	-6.8	-4.5	-2.4	-0.8	0.2	0.8	0.9	0.9	0.8	0.7
Prices											
GDP deflator	0.4	-0.2	0.5	0.3	1.2	1.3	1.7	1.9	1.9	2.0	1.9
HICP (average)	1.5	-0.2	-0.6	-0.3	2.0	1.8	1.8	1.9	1.9	2.0	1.9
HICP (end of period)	0.3	-1.1	-0.1	1.4	1.2	2.2	1.7	1.7	1.9	2.0	2.0
Core inflation (average)	1.4	0.0	0.6	0.8	1.1	1.1	1.6	2.0	2.1	2.2	2.1
Core inflation (end of period)	0.3	0.0	1.0	0.9	0.8	1.3	1.8	2.0	2.1	2.2	2.1
Employment and wages											
Unemployment rate (percent)	26.1	24.4	22.1	19.6	17.2	15.6	14.7	14.3	14.1	13.9	13.8
Labor productivity 1/	1.8	0.3	0.3	0.1	0.1	0.3	0.8	0.9	1.1	1.0	1.3
Labor costs, private sector	0.3	0.1	0.2	0.1	0.7	1.6	1.7	1.7	1.8	1.9	1.9
Employment growth	-2.8	1.2	3.0	2.7	2.6	2.3	1.5	0.9	0.7	0.6	0.4
Labor force growth	-1.1	-1.0	-0.1	-0.4	-0.4	0.4	0.3	0.4	0.4	0.4	0.4
Balance of payments (percent of GDP)											
Trade balance (goods and services)	3.3	2.5	2.4	3.2	2.9	2.1	1.9	2.2	2.5	2.8	3.0
Current account balance	1.5	1.1	1.2	2.3	1.8	1.0	0.7	0.8	0.9	0.9	0.9
Net international investment position	-95.2	-98.0	-89.5	-85.3	-83.8	-79.5	-75.5	-71.7	-68.1	-64.5	-61.1
Public finance (percent of GDP) 2/											
General government balance 3/	-7.0	-6.0	-5.3	-4.5	-3.1	-2.8	-2.4	-2.4	-2.5	-2.6	-2.7
Primary balance	-4.0	-3.0	-2.6	-1.9	-0.7	-0.6	-0.3	-0.2	-0.3	-0.3	-0.4
Structural balance	-2.5	-2.0	-2.6	-2.9	-2.6	-2.8	-2.8	-2.9	-2.9	-3.0	-3.1
Primary structural balance	1.0	1.5	0.5	-0.1	-0.1	-0.3	-0.5	-0.5	-0.5	-0.5	-0.5
General government debt	95.5	100.4	99.3	99.0	98.1	97.3	96.0	94.8	93.9	93.0	92.5

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

1/ Output per worker.

2/ The 2019 projections assume unchanged fiscal policies except for the already legislated measures and the public wage increase agreed with the unions.

3/ The headline balance for Spain includes 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, 0.2 percent of GDP for 2016, and 0.1 percent of GDP for 2017.

Table 2a. Spain: General Government Operations, 2013–23 1/

(Billions of euro, unless otherwise noted)

	2013	2014	2015	2016	2017	Projections 2/					
						2018	2019	2020	2021	2022	2023
Revenue	395.6	403.5	415.7	422.2	442.2	465.7	483.9	501.3	518.5	536.8	553.6
Taxes	227.2	232.4	243.8	247.8	259.9	273.6	284.2	294.9	305.8	317.2	328.2
Indirect taxes	115.0	119.6	127.5	129.5	135.2	142.0	147.6	152.8	158.3	164.1	170.0
o.w. VAT	62.1	64.9	70.0	72.2	75.7	79.4	82.5	85.5	88.5	91.8	95.0
o.w. Excise	33.8	34.6	36.8	37.2	39.0	40.9	42.6	44.1	45.6	47.3	49.0
Direct taxes	107.1	107.1	110.0	111.9	118.9	125.9	130.6	135.9	141.0	146.4	151.3
o.w. Private households	83.0	83.8	83.2	85.6	91.5	97.1	100.2	103.6	106.9	110.4	113.1
o.w. Corporate	22.2	21.8	25.9	25.7	27.4	28.6	30.3	32.1	33.9	35.9	38.0
Capital tax	5.1	5.7	6.3	6.4	5.7	5.8	6.0	6.2	6.5	6.7	6.9
Social contributions	128.2	130.1	132.3	136.0	143.1	149.7	155.6	160.6	165.3	170.4	174.5
Other revenue	40.2	41.0	39.6	38.3	39.2	42.3	44.0	45.7	47.4	49.2	51.0
Expenditure	467.3	465.4	472.7	472.2	478.1	499.8	514.2	532.1	551.8	572.7	593.2
Expense	466.7	464.6	471.8	471.3	477.5	499.2	513.5	531.4	551.1	572.0	592.5
Compensation of employees	114.7	115.2	119.4	121.5	123.0	126.5	130.5	134.6	139.1	143.8	148.2
Use of goods and services	54.8	55.2	57.5	57.2	58.8	60.6	61.6	64.0	66.3	68.8	71.3
Consumption of fixed capital	22.4	21.5	26.2	20.8	22.3	26.4	25.6	26.6	27.6	28.7	29.7
Interest	35.7	36.1	33.3	31.4	29.8	29.6	29.4	30.8	32.4	34.6	37.5
Social benefits	199.0	198.7	198.8	203.2	207.7	216.4	225.5	233.3	241.7	250.4	259.6
Other expense	40.2	38.0	36.7	37.2	35.7	39.7	40.9	42.1	43.9	45.6	46.3
Subsidies	10.8	11.3	12.3	11.2	12.1	12.0	12.0	12.2	12.4	12.7	13.2
Other	29.4	26.6	24.5	25.9	23.6	27.7	28.9	29.9	31.5	32.9	33.1
o.w. financial sector support	3.3	1.4	0.6	2.4	0.5	0.1	...	...	...	...	...
Net acquisition of nonfinancial assets	0.6	0.8	0.9	0.9	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Gross fixed capital investment	23.1	22.3	27.1	21.7	23.0	27.0	26.3	27.3	28.3	29.3	30.4
Consumption of fixed capital	22.4	21.5	26.2	20.8	22.3	26.4	25.6	26.6	27.6	28.7	29.7
Other non financial assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross operating balance	-71.1	-61.1	-56.1	-49.1	-35.2	-33.5	-29.6	-30.2	-32.6	-35.2	-38.9
Net lending / borrowing	-71.7	-61.9	-57.0	-50.0	-35.9	-34.2	-30.3	-30.9	-33.3	-35.9	-39.6
Net lending / borrowing (excluding financial sector support)	-68.4	-60.6	-56.5	-47.6	-35.4	-34.2	-30.3	-30.9	-33.3	-35.9	-39.6
<i>Memorandum items:</i>											
Nominal GDP	1,025.7	1,037.8	1,081.2	1,118.7	1,166.3	1,211.1	1,259.8	1,308.0	1,356.4	1,407.1	1,457.5
Sources: Ministry of Finance; Eurostat; and IMF staff estimates and projections.											
1/ Compiled using accrual basis and ESA10 manual, consistent with Eurostat dataset.											
2/ The 2019 projections assume unchanged fiscal policies except for the already legislated measures and the public wage increase agreed with the unions.											

Table 2b. Spain: General Government Operations, 2013–23 1/

(Percent of GDP, unless otherwise noted)

	2013	2014	2015	2016	2017	Projections 2/					
						2018	2019	2020	2021	2022	2023
Revenue	38.6	38.9	38.5	37.7	37.9	38.5	38.4	38.3	38.2	38.1	38.0
Taxes	22.2	22.4	22.5	22.2	22.3	22.6	22.6	22.5	22.5	22.5	22.5
Indirect taxes	11.2	11.5	11.8	11.6	11.6	11.7	11.7	11.7	11.7	11.7	11.7
o.w. VAT	6.1	6.3	6.5	6.5	6.5	6.6	6.6	6.5	6.5	6.5	6.5
o.w. Excise	3.3	3.3	3.4	3.3	3.3	3.4	3.4	3.4	3.4	3.4	3.4
Direct taxes	10.4	10.3	10.2	10.0	10.2	10.4	10.4	10.4	10.4	10.4	10.4
o.w. Private households	8.1	8.1	7.7	7.7	7.8	8.0	8.0	7.9	7.9	7.8	7.8
o.w. Corporate	2.2	2.1	2.4	2.3	2.3	2.4	2.4	2.5	2.5	2.5	2.6
Capital tax	0.5	0.5	0.6	0.6	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Social contributions	12.5	12.5	12.2	12.2	12.3	12.4	12.4	12.3	12.2	12.1	12.0
Other revenue	3.9	4.0	3.7	3.4	3.4	3.5	3.5	3.5	3.5	3.5	3.5
Expenditure	45.6	44.8	43.7	42.2	41.0	41.3	40.8	40.7	40.7	40.7	40.7
Expense	45.5	44.8	43.6	42.1	40.9	41.2	40.8	40.6	40.6	40.7	40.7
Compensation of employees	11.2	11.1	11.0	10.9	10.5	10.4	10.4	10.3	10.3	10.2	10.2
Use of goods and services	5.3	5.3	5.3	5.1	5.0	5.0	4.9	4.9	4.9	4.9	4.9
Consumption of fixed capital	2.2	2.1	2.4	1.9	1.9	2.2	2.0	2.0	2.0	2.0	2.0
Interest	3.5	3.5	3.1	2.8	2.6	2.4	2.3	2.4	2.4	2.5	2.6
Social benefits	19.4	19.1	18.4	18.2	17.8	17.9	17.9	17.8	17.8	17.8	17.8
Other expense	3.9	3.7	3.4	3.3	3.1	3.3	3.2	3.2	3.2	3.2	3.2
Subsidies	1.0	1.1	1.1	1.0	1.0	1.0	1.0	0.9	0.9	0.9	0.9
Other	2.9	2.6	2.3	2.3	2.0	2.3	2.3	2.3	2.3	2.3	2.3
o.w. financial sector support	0.3	0.1	0.1	0.2	0.0	0.0	...	...	...	...	...
Net acquisition of nonfinancial assets	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0
Gross fixed capital investment	2.2	2.1	2.5	1.9	2.0	2.2	2.1	2.1	2.1	2.1	2.1
Consumption of fixed capital	2.2	2.1	2.4	1.9	1.9	2.2	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	0.0
Gross operating balance	-6.9	-5.9	-5.2	-4.4	-3.0	-2.8	-2.4	-2.3	-2.4	-2.5	-2.7
Net lending / borrowing	-7.0	-6.0	-5.3	-4.5	-3.1	-2.8	-2.4	-2.4	-2.5	-2.6	-2.7
Net lending / borrowing (excluding financial sector support)	-6.7	-5.8	-5.2	-4.3	-3.0	-2.8	-2.4	-2.4	-2.5	-2.6	-2.7
<i>Memorandum items:</i>											
Net lending/ borrowing (EDP targets)	...	-5.8	-4.2	-4.6	-3.1	-2.2	...	...	...	...	...
Primary balance	-4.0	-3.0	-2.6	-1.9	-0.7	-0.6	-0.3	-0.2	-0.3	-0.3	-0.4
Primary balance (excluding financial sector support) 3/	-3.2	-2.4	-2.2	-1.7	-0.5	-0.4	-0.1	0.0	-0.1	-0.1	-0.1
Cyclically adjusted balance	-2.8	-2.3	-2.9	-3.2	-2.7	-3.0	-2.8	-2.9	-2.9	-3.0	-3.1
Cyclically adjusted primary balance (excluding financial sector support) 3/	0.8	1.2	0.2	-0.3	-0.1	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5
Primary structural balance 3/	1.0	1.5	0.5	-0.1	-0.1	-0.3	-0.5	-0.5	-0.5	-0.5	-0.5
Structural balance	-2.5	-2.0	-2.6	-2.9	-2.6	-2.8	-2.8	-2.9	-2.9	-3.0	-3.1
General government gross debt (Maastricht)	95.5	100.4	99.3	99.0	98.1	97.3	96.0	94.8	93.9	93.0	92.5
Net debt	80.8	85.2	85.3	86.2	84.8	84.5	83.6	82.9	82.4	82.0	81.8
Central Government net lending	-4.8	-3.7	-2.8	-2.6	-1.9	-1.7	-1.5	-1.5	-1.5	-1.6	-1.7
Output gap	-7.8	-6.8	-4.5	-2.4	-0.8	0.2	0.8	0.9	0.9	0.8	0.7

Sources: Ministry of Finance; Eurostat; and IMF staff estimates and projections.

1/ Compiled using accrual basis and ESA10 manual, consistent with Eurostat dataset.

2/ The projections for 2019 assume unchanged fiscal policies except for the already legislated measures and the public wage increase agreed with the unions.

3/ Including interest income.

Table 3. Spain: General Government Balance Sheet, 2009–17

	2009	2010	2011	2012	2013	2014	2015	2016	2017
(Billions of euro)									
Financial assets	306.9	297.6	321.3	351.3	372.5	383.3	382.6	376.9	389.9
Currency and Deposits	119.7	95.1	77.5	84.7	72.7	83.9	85.5	79.3	92.9
Securities other than shares	28.0	22.4	14.4	4.9	14.0	8.5	3.8	3.0	2.7
Loans	29.0	36.7	49.4	58.5	63.3	64.5	62.1	60.7	59.9
Other assets	130.1	143.4	180.0	203.3	222.6	226.4	231.2	233.9	234.3
Liabilities	669.2	721.8	833.9	962.1	1,084.5	1,228.8	1,257.5	1,303.8	1,337.5
Currency and deposits	3.5	3.6	3.7	3.7	3.7	3.8	4.1	4.2	4.5
Securities other than shares	498.9	527.3	609.6	674.8	807.1	951.2	1,000.6	1,062.5	1,104.1
Loans	93.4	112.3	129.9	217.9	214.2	216.1	196.3	183.4	169.3
Other liabilities	73.4	78.6	90.6	65.7	59.5	57.7	56.6	53.7	59.6
(Percent of GDP)									
Financial assets	28.4	27.5	30.0	33.8	36.3	36.9	35.4	33.7	33.4
Currency and Deposits	11.1	8.8	7.2	8.1	7.1	8.1	7.9	7.1	8.0
Securities other than shares	2.6	2.1	1.3	0.5	1.4	0.8	0.4	0.3	0.2
Loans	2.7	3.4	4.6	5.6	6.2	6.2	5.7	5.4	5.1
Other assets	12.1	13.3	16.8	19.6	21.7	21.8	21.4	20.9	20.1
Liabilities	62.0	66.8	77.9	92.5	105.7	118.4	116.3	116.5	114.7
Currency and deposits	0.3	0.3	0.3	0.4	0.4	0.4	0.4	0.4	0.4
Securities other than shares	46.2	48.8	57.0	64.9	78.7	91.7	92.5	95.0	94.7
Loans	8.7	10.4	12.1	21.0	20.9	20.8	18.2	16.4	14.5
Other liabilities	6.8	7.3	8.5	6.3	5.8	5.6	5.2	4.8	5.1
(Billions of euro)									
<i>Memorandum items:</i>									
Public debt (EDP)	568.7	649.3	743.5	891.5	979.0	1,041.6	1,073.9	1,107.2	1,144.6
Net lending/borrowing	-118.2	-101.4	-103.2	-108.8	-71.7	-61.9	-57.0	-50.0	-35.9
Change in public debt (EDP)	128.9	80.6	94.3	148.0	87.5	62.6	32.3	33.3	37.4
Change in financial assets	26.4	-9.3	23.7	30.0	21.2	10.7	-0.7	-5.6	12.9
Change in net financial assets	-102.5	-89.9	-70.5	-117.9	-66.3	-51.8	-33.0	-38.9	-24.5
Unexplained change in net financial assets	15.7	11.5	32.7	-9.1	5.3	10.1	24.0	11.1	11.4

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

Table 4. Spain: Selected Financial Soundness Indicators, 2010–17

(Percent, unless otherwise indicated)

	2010	2011	2012	2013	2014	2015	2016	2017
Depository institutions								
Capital adequacy								
Regulatory capital to risk-weighted assets	11.9	12.1	11.6	13.3	13.7	14.7	14.8	15.5
Regulatory tier-1 capital to risk-weighted assets	9.7	10.2	9.9	11.9	11.9	12.9	13.1	13.4
Capital to total assets	6.1	5.9	5.8	6.8	7.2	7.4	7.8	7.6
Asset quality: Consolidated basis								
Nonperforming loans (in billions of euro)	119	153	180	210	188	159	143	113
Nonperforming loans to total loans	4.7	6.0	7.5	9.4	8.5	6.2	5.6	4.5
Specific provisions to nonperforming loans	65.7	56.9	68.4	56.8	57.7	44.0	42.4	58.1
Asset quality: Domestic operations								
Nonperforming loans (in billions of euro)	103	136	163	192	167	130	112	94
Nonperforming loans to total loans	5.8	7.9	10.6	13.8	12.6	10.2	9.2	7.9
Specific provisions to nonperforming loans	38.7	36.6	44.4	46.6	46.4	46.6	45.7	41.8
Exposure to businesses - Construction (in billions of euro)	422	389	294	232	196	175	157	142
o/w: Nonperforming (in percent)	13.5	20.8	28.5	37.3	35.6	28.3	26.5	19.6
Exposure to businesses - Other (in billions of euro)	554	541	495	456	452	444	425	428
o/w: Nonperforming (in percent)	3.7	5.0	8.6	12.5	11.7	9.6	8.4	7.4
Exposure to households - Home purchase (in billions of euro)	624	614	593	569	546	520	506	493
o/w: Nonperforming (in percent)	2.3	2.8	3.8	5.7	5.6	4.6	4.5	4.5
Exposure to households - Other (in billions of euro)	183	171	157	136	134	134	134	136
o/w: Nonperforming (in percent)	5.6	6.1	9.0	11.6	10.7	10.3	9.1	9.3
Earning and profitability: Consolidated basis								
Return on assets	0.5	0.1	-1.4	0.4	0.4	0.5	0.4	0.5
Return on equity	8.0	1.5	-21.0	5.4	5.7	7.1	5.5	6.8
Earning and profitability: Domestic operations								
Return on assets	0.3	-0.6	-2.7	0.1	0.5	0.4	0.3	-0.03
Return on equity	5.6	-9.1	-43.6	2.0	5.9	4.9	3.1	-0.3
Funding								
Customer loans to non-interbank deposits	127.5	131.5	128.7	117.9	114.0	112.0	110.5	118.5
Loans to deposits 1/	144.8	145.3	132.4	118.3	114.5	110.0	105.7	104.9
Use of ECB refinancing (in billions of euro) 2/	70	132	357	207	142	133	140	171
In percent of total ECB refinancing operations	13.2	18.4	32.0	28.8	26.2	25.0	24.8	22.3
In percent of total assets of Spanish MFIs	2.0	3.7	10.0	6.6	4.8	4.7	5.1	6.3
Total assets (in percent of GDP)	295	294	315	281	260	241	225	212
Other financial institutions								
Total assets (in percent of GDP)								
Insurance companies and pension funds	33	33	36	38	39	40	36	...
Other institutions 3/	118	106	104	92	92	88	76	...
Shadow banking activity 4/	25	22	21	22	25	26	23	...
Corporate sector								
Debt (in percent of GDP)	181	176	168	160	154	146	140	133
Debt to total assets	55.3	53.4	51.4	47.7	46.9	43.8	42.4	41.4
Liquid assets to short-term liabilities	160.6	178.0	195.0	249.3	268.4	263.2	291.9	303.2
Household sector								
Debt (in percent of GDP)	88	87	85	82	78	73	69	67
Debt service and principal payment to disposable income	23.2	22.4	22.4	20.0	12.8	12.2	15.9	...
Real estate market								
House price (percentage change, end-period)	-1.9	-11.2	-12.8	-7.8	1.8	4.2	4.5	7.2
Housing completion (2007=100)	43	28	21	9	8	7	6	8
Property sales (2007=100)	57	47	43	42	43	46	51	57

Sources: Bank of Spain; Haver analytics; FSB, Global Shadow Banking Monitoring Report 2017; 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.

Table 5. Spain: Balance of Payments, 2013–23

	Projections										
	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
	(Billions of euro)										
Current account	15.6	11.2	12.6	25.2	21.5	12.0	8.6	10.2	11.7	12.5	13.4
Trade balance of goods and services	33.8	25.7	25.9	36.0	33.6	25.6	24.1	28.9	33.7	38.8	43.6
Exports of goods and services	330.8	339.7	356.8	371.2	400.8	412.9	428.9	450.5	473.6	497.4	519.7
Exports of goods	235.6	239.3	250.3	256.8	278.0	286.3	297.3	310.4	323.8	338.6	351.7
Exports of services	95.2	100.4	106.5	114.4	122.9	126.6	131.6	140.0	149.8	158.9	168.0
Trade of goods balance	-14.0	-22.2	-21.6	-15.3	-21.8	-29.6	-33.1	-34.3	-35.8	-35.9	-37.0
Imports of goods and services	-297.0	-314.1	-330.9	-335.3	-367.2	-387.3	-404.8	-421.6	-439.9	-458.7	-476.1
Imports of goods	-249.6	-261.5	-271.9	-272.1	-299.8	-316.0	-330.4	-344.8	-359.6	-374.5	-388.7
Imports of services	-47.5	-52.5	-59.0	-63.2	-67.4	-71.3	-74.5	-76.8	-80.3	-84.2	-87.4
Services	47.8	47.9	47.5	51.2	55.5	55.2	57.1	63.2	69.5	74.7	80.6
Of which:											
Tourism	34.8	35.4	35.3	37.2	40.6	...	...	...	...	...	...
Exports	47.2	49.0	51.0	54.7	60.3	...	...	...	...	...	...
Imports	-12.4	-13.6	-15.7	-17.4	-19.7	...	...	...	...	...	...
Primary income	-5.3	-3.4	-2.9	1.1	-1.2	-1.8	-3.1	-5.8	-8.0	-11.1	-13.7
Secondary income	-12.9	-11.1	-10.5	-11.8	-10.9	-11.8	-12.3	-12.9	-14.0	-15.2	-16.4
Private remittances	-3.4	-2.8	-2.5	-3.8	-5.5	-5.5	-5.7	-6.1	-6.9	-7.8	-8.8
Official transfers	-10.1	-8.8	-8.5	-8.6	-6.1	-6.3	-6.6	-6.8	-7.1	-7.4	-7.6
Capital account	6.6	5.0	7.1	2.5	2.7	2.8	2.9	3.0	3.1	3.2	3.4
Financial account	-31.3	-11.1	-19.0	-23.5	-21.8	-14.8	-11.5	-13.2	-14.8	-15.8	-16.8
Direct investment	18.5	-6.5	-25.6	-14.4	-16.9	-14.5	-15.0	-15.6	-16.3	-17.0	-17.8
Spanish investment abroad	20.8	31.6	48.3	49.9	23.6	50.9	51.8	52.8	53.9	55.0	56.2
Foreign investment in Spain	39.3	25.1	22.7	35.5	6.7	36.4	36.8	37.2	37.6	38.0	38.4
Portfolio investment	63.0	9.1	-10.6	-50.7	-25.3	-15.7	-16.0	-14.9	-13.0	-11.0	-8.7
Financial derivatives	-1.0	-1.3	1.2	2.9	2.2	0.0	0.0	0.0	0.0	0.0	0.0
Other investment	-111.3	-8.6	21.0	47.0	21.7	15.4	19.5	17.3	14.5	12.3	9.7
Change in reserve assets	-0.5	-3.9	-5.1	-8.2	-3.5	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	-11.1	4.2	-2.3	3.0	2.7	0.0	0.0	0.0	0.0	0.0	0.0
	(Percent of GDP)										
Current account	1.5	1.1	1.2	2.3	1.8	1.0	0.7	0.8	0.9	0.9	0.9
Trade balance of goods and services	3.3	2.5	2.4	3.2	2.9	2.1	1.9	2.2	2.5	2.8	3.0
Exports of goods and services	32.3	32.7	33.0	33.2	34.4	34.1	34.0	34.4	34.9	35.4	35.7
Exports of goods	23.0	23.1	23.2	23.0	23.8	23.6	23.6	23.7	23.9	24.1	24.1
Exports of services	9.3	9.7	9.8	10.2	10.5	10.5	10.4	10.7	11.0	11.3	11.5
Imports of goods and services	-29.0	-30.3	-30.6	-30.0	-31.5	-32.0	-32.1	-32.2	-32.4	-32.6	-32.7
Imports of goods	-24.3	-25.2	-25.2	-24.3	-25.7	-26.1	-26.2	-26.4	-26.5	-26.6	-26.7
Imports of services	-4.6	-5.1	-5.5	-5.6	-5.8	-5.9	-5.9	-5.9	-5.9	-6.0	-6.0
Primary income	-0.5	-0.3	-0.3	0.1	-0.1	-0.1	-0.2	-0.4	-0.6	-0.8	-0.9
Secondary income	-1.3	-1.1	-1.0	-1.1	-0.9	-1.0	-1.0	-1.0	-1.0	-1.1	-1.1
Capital account	0.6	0.5	0.7	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Financial account	-3.1	-1.1	-1.8	-2.1	-1.9	-1.2	-0.9	-1.0	-1.1	-1.1	-1.2
Direct investment	1.8	-0.6	-2.4	-1.3	-1.4	-1.2	-1.2	-1.2	-1.2	-1.2	-1.2
Portfolio investment	6.1	0.9	-1.0	-4.5	-2.2	-1.3	-1.3	-1.1	-1.0	-0.8	-0.6
Financial derivatives	-0.1	-0.1	0.1	0.3	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Other investment	-10.8	-0.8	1.9	4.2	1.9	1.3	1.5	1.3	1.1	0.9	0.7
Of which, BdE	-9.9	1.9	8.1	9.0	6.1	2.4	-0.4	-0.4	-0.4	-0.4	-0.4
Change in reserve assets	-0.1	-0.4	-0.5	-0.7	-0.3	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	-1.1	0.4	-0.2	0.3	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Net international investment position	-95.2	-98.0	-89.5	-85.3	-83.8	-79.5	-75.5	-71.7	-68.1	-64.5	-61.1
Valuation changes	-7.2	-4.9	2.8	-1.0	-3.9	0.0	0.0	0.0	0.0	0.0	0.0

Sources: Bank of Spain; and IMF staff estimates.

Appendix I. Main Recommendations of the 2017 Article IV Consultation and Authorities Actions

IMF 2017 Article IV Recommendations	Policy Actions
Fiscal Policy	
Implement gradual adjustment with an annual reduction in the structural primary deficit by about 0.5 percent of GDP until structural balance is reached.	Following a broadly neutral fiscal stance in 2017, in 2018 the structural primary balance is set to deteriorate by 0.2 percent of GDP. For 2019, the authorities plan to lower the structural deficit by 0.4 percent of GDP, with the budget still to be adopted.
As part of the fiscal adjustment strategy, identify measures to improve VAT collection, reduce tax system inefficiencies, consider raising environmental taxes and levies, and enhancing expenditure efficiency.	CIT and VAT measures implemented in 2017 yielded a much lower revenue than budgeted. For 2018, the budget lowered the PIT threshold for low-income workers. For 2019, the government plans to increase the revenue-to-GDP ratio by 0.6 percent of GDP, with the budget still to be adopted. The expenditure review is progressing, with recommendations on subsidies expected for end-2018.
Implement fully the 2011/13 pension reforms, and explore refinement options to balance pension sustainability and social acceptability.	The 2018 budget includes general pension increases in 2018–19 deviating from the 0.25 percent implied by the pension formula. It also delays the implementation of the “sustainability factor” from 2019 to 2023. The parliamentary pension committee (Toledo Pact) recommended to link pension increases permanently to an indicator of purchasing power.
Reform the regional financing framework to improve the compliance with fiscal targets in the short term and enhance regions’ revenue-raising capacity in the medium term	Fiscal compliance of regional governments improved. Two expert reports with recommendations to reform the regional and local public finance were published in August 2017. The new government has not yet made reform proposals, but is analyzing reform options. It is already allowing some regions to gradually return to market financing.
Structural Reforms	
Labor market reforms	
Improve the efficiency and design of active labor market policies (ALMPs), strengthen the Public Employment Services’ capacity to better support the employability of the young and long-term unemployed, and conduct regular evaluations of existing ALMPs.	The authorities published a multi-year strategy on employment activation. It lists initiatives to improve ALMPs’ effectiveness, including by conducting an external evaluation in 2018. A new bonus for the young working under apprenticeship contracts was introduced.
Reduce labor market segmentation by improving the attractiveness of open-ended contracts for employers and reducing administrative and legal obstacles that add to the cost of such contracts.	The authorities have intensified inspections and increased sanctions to reduce the abuse of temporary contracts. The government adopted a “masterplan for fair and decent jobs” to tackle the abuse of temporary and involuntary part-time contracts as well as improper claim of self-employed status.
Productivity growth	
Advance the implementation of the Market Unity Law and liberalization of professional services; tackle remaining size-related regulations; deepen market-based financing for young and innovative	The government has published a catalogue with good and bad regulatory practices and recommends all government levels to assess the compatibility of any new legislation with the Market Unity Law before it is adopted. The 2019 draft budgetary plan proposes to reintroduce differentiated

start-ups; and increase the efficiency of public R&D and improve public-private cooperation.	corporate income tax rates for SMEs by lowering the CIT rate for certain SMEs to 23 percent (from 25 percent). The 2018–21 ICO Strategic Plan includes actions to strengthen venture capital.
Financial Sector Policies	
Accelerate banks' balance sheet cleanup by implementing ECB guidance and BdE rules on NPLs, assessing banks' NPL reduction strategies, and strengthening the insolvency framework including for SME.	NPLs and foreclosed assets continued to decline as several significant banks have made important progress in selling distressed assets last year. According to the SSM, progress is broadly in line with banks' NPLs reduction plans. The government has established an expert group to draft a transposition proposal of the still-to-be-finalized EU directive on insolvency procedures.
Advance privatization of state-owned banks and manage the performance of Sareb by regularly reviewing its business plan.	A merger between the state-owned banks Bankia and BMN was completed last year, but the public ownership in Bankia remains to be divested. Sareb conducted sensitivity analysis in its business plan, including extreme adverse scenarios. No changes were made to the review process of Sareb's business plan.
Explore the scope for further banking consolidation, encourage banks to raise high-quality capital, and enhance monitoring and management of liquidity and interest rate risks.	Banks continued to build capital buffers, but progress has been slow and uneven. Interest rate risk in the banking book (IRRBB) is monitored in the annual Supervisory Review and Evaluation Process (SREP) as one of the risks to capital. The Bank of Spain introduced regular liquidity stress tests. Liquidity monitoring is being reinforced at the EU level.
Strengthen systemic risk oversight by setting up a Systemic Risk Council and enhance BdE's macroprudential toolkit.	The Treasury is drafting a proposal for a national macroprudential authority. The authorities are working on the introduction of new borrower-based macroprudential tools.
Improve corporate governance of Spanish financial institutions, particularly the credit cooperative sector, and enhance the governance of certain parts of the institutional architecture.	The work for transposing the EU mortgage directive into national law is proceeding. The new law would aim, among other things, at improving the management of banks conduct risk. Efforts are also underway to create a credit cooperative fund to facilitate resolution. Draft laws on the creation of an independent insurance and pension supervisor as well as a financial consumer protection authority are being prepared.

	Spain											Overall Assessment	
Foreign asset and liability position and trajectory	<p>Background. The net international investment position (NIIP) dropped from -35 percent of GDP in 2000 to -94 percent of GDP in 2009, driven mostly by high current account (CA) deficits but also by valuation effects. The NIIP remained elevated at -81 percent of GDP at end-2017, yet has improved by 14 percentage points since 2013, partly due to sustained CA surpluses during the period. Gross liabilities stood at 242 percent of GDP in 2017, with more than 2/3 in the form of external debt. While the private sector has deleveraged since the crisis, NIIP accounted for by the general government and the central bank increased, raising its share from around ¼ in 2010 to ¾ in 2017. Part of that increase is due to TARGET2 liabilities, which reached 32 percent of GDP by end-2017.^{1/}</p> <p>Assessment. The large negative NIIP comes with external vulnerabilities, including from large gross financing needs from external debt and potentially adverse valuation effects. Mitigating factors are a favorable maturity structure of outstanding sovereign debt (averaging 7 years) and current ECB measures, such as QE, that lower the cost of debt.</p>											<p>Overall Assessment:</p> <p><i>The external position in 2017 was moderately weaker than consistent with medium-term fundamentals and desirable policy settings. Based on preliminary 2018 estimates, that assessment remains unchanged. As the current account remains in surplus, the external position continues to gradually strengthen.</i></p> <p>Staff assesses Spain's current account (CA) norm to be relatively high, in part due to external sustainability risks from a large negative net international investment position (NIIP). In 2017, the CA remained in surplus, helped by robust external demand, low interest rates, and improved competitiveness from wage moderation. Spain recorded its fifth consecutive annual CA surplus, unprecedented in recent Spanish history. Despite the improvement in the CA since the pre-crisis peak deficit in 2007, achieving both a sufficiently strong NIIP and further reductions in unemployment continues to require a moderately lower real effective exchange rate for a sustained period.</p> <p>Potential policy responses:</p> <p>Staff authorities' structural reforms in response to the Global Financial Crisis, in particular the labor market reform with the resulting wage moderation, and fiscal deficit reductions supported the reduction in imbalances. Reducing the still sizable structural fiscal deficit is a key policy requirement to lower the remaining imbalances. Moving forward with additional structural reforms of the labor market and faster implementation of product market reforms are also required to achieve the necessary additional adjustment. Continued monetary accommodation at the euro area level to lift inflation closer to the ECB's medium-term price stability objective should support external demand and Spain's adjustment efforts.</p>	
Current account	<p>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 2013-17. The CA surplus reached 1.9 percent of GDP in 2017. Regained competitiveness from wage moderation and greater internationalization efforts by Spanish firms contributed to strong export growth, and an increase in Spain's share of world goods exports. CA surpluses are projected to continue in the medium term notwithstanding the recent appreciation of the euro and the projected moderately higher oil prices. The projected CA surplus for 2018 is around 1 percent of GDP.</p> <p>Assessment. The EBA CA model suggests a norm of 1.4 percent of GDP for 2017, which is roughly equal to the cyclically-adjusted CA balance (1.5 percent of GDP). However, given external risks from a large and negative NIIP, staff's assessment puts more weight on external sustainability, and is guided by the objective of strengthening the NIIP to above -50 percent over the medium term. This yields a CA norm of about 3 percent of GDP, with a range of 2-4 percent of GDP, and a CA gap of -2.5 to -0.5 percent of GDP.^{2/} Another factor supporting a higher CA gap is a high uncertainty about the output gap against the backdrop of past structural reforms and large structural changes of the economy: if the output gap is larger (for example, reflecting a structural level of unemployment closer to international peers), the cyclically-adjusted CA would be lower and thus the gap with respect to the desirable level would be larger. Based on preliminary figures for 2018, staff's assessment of the CA gap is unchanged relative to that of 2017, while the EBA CA gap is about -0.2 percent of GDP.</p>												
CA Assessment 2017	Actual CA	1.9	Cycl. Adj. CA	1.5	EBA CA Norm	1.4	EBA CA Gap	0.1	Staff Adj.	1.6	Staff CA Gap		-1.5
Real exchange rate	<p>Background. In 2017, both the CPI-based and the ULC-based real effective exchange rate (REER) appreciated by 2 percent from their average 2016 levels. The CPI-based REER is still about 8 percent lower than its 2009 peak, partially reversing the 21 percent appreciation from the euro entry in 1999 until 2009. The ULC-based REER shows that the appreciation since euro entry has been substantially reversed, initially because of significant post-crisis labor shedding and, more recently, of wage moderation and enhanced output growth. After reaching its peak in 2008, the ULC-based REER depreciated by 17 percent. As of August 2018, the ULC-based REER and the CPI-based REER appreciated an additional 1 to 1.7 percent, relative to their 2017 averages.</p> <p>Assessment. The two EBA REER models estimate an overvaluation in the range of 5.1 to 5.8 percent for 2017; whereas the CA model implies a close-to-zero overvaluation.^{3/} Taking into account also the historical CPI- and ULC-based REER, and the risks from NIIP sustainability, on balance, staff assesses a 2017 REER gap in the range of 3 to 10 percent.</p>												
Capital and financial accounts: flows and policy measures	<p>Background. Financing conditions have continued to be favorable, with sovereign bond yields near historical lows. At the same time, the private sector has continued its deleveraging against the rest of the world. TARGET2 liabilities increased during 2015–17 at an annual average pace of 5 percent of GDP, reflecting the creation of liquidity within the framework of the Eurosystem's asset purchase program. In this context of plentiful liquidity, resident agents increased their net investment in foreign assets and net liability flows against the rest of the world (excluding the Bank of Spain) declined. Recent net capital outflows are also explained by a net FDI outflow.</p> <p>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.</p>												
FX intervention and reserves level	<p>Background. The euro has the status of a global reserve currency.</p> <p>Assessment. Reserves held by the euro area are typically low relative to standard metrics, but the currency is free floating.</p>												

	Spain (concluded)
Technical Background Notes	<p>1/ This appendix is mostly based on data available through 2017:Q4.</p> <p>2/ The EBA model suggests a CA norm of 1.4 percent of GDP, with a standard deviation of 1.3 percent of GDP. This CA norm is 0.4 percentage points of GDP lower than that reported in last year's ESR, largely reflecting data updates and refinements to the EBA framework. In the case of Spain, a reduction in the contribution of demographic factors to the CA norm was partly offset by a more positive contribution of policy variables, particularly the refined private credit variable. That said, the empirically-based EBA norm does not fully account for the very negative NIIP, with around 30 percent of gross liabilities in the form of equity. Given external stability considerations, a CA norm in the range of 2–4 percent of GDP is necessary to strengthen the NIIP by about 5 percent of GDP annually over the next 5–10 years.</p> <p>3/ The semi-elasticity of the CA to the REER is estimated at 0.28.</p>

Source of Risks	Relative Likelihood	Time Horizon	Impact if Realized	Policy Response
External Risks				
Weaker-than-expected global growth	Medium Euro Area: Progress on fiscal adjustment, on addressing legacy banking-sector problems, and on other structural reforms slows or reverses, raising debt sustainability concerns, steadily pushing up borrowing costs, and undermining medium-term growth prospects.	MT	Medium Slowing external demand would weigh on growth and employment. A rise in NPLs combined with higher borrowing cost could generate a vicious circle of debt overhang and low growth and increase the likelihood of a forced, sharp adjustment.	<ul style="list-style-type: none"> Enhance labor market performance and lower duality. Deepen product market reforms and other structural reforms to raise productivity. Let automatic stabilizers play in case the output gap widens and formulate credible medium-term fiscal path in support of public debt sustainability. Continue strengthening the financial sector and its capacity to support growth.
Rising protectionism and retreat from multilateralism	High Global imbalances and fraying consensus about the benefits of globalization lead to escalating and sustained trade actions and spreading isolationism. This threatens the global trade system, regional integration, labor mobility, as well as global and regional policy and regulatory collaboration.	ST, MT	Medium In the short term, escalating trade tensions, including a no-deal Brexit, could increase uncertainty about growth leading to higher financial market volatility with negative consequences for growth and investments. These policy shifts could reduce the cross-border flow of trade disrupting global supply chains.	<ul style="list-style-type: none"> Accelerate structural reforms to strengthen competitiveness, in particular enhance labor market performance and lower duality. Let automatic stabilizers play in case the output gap widens and formulate credible medium-term fiscal path in support of public debt sustainability.
Sharp tightening of global financial conditions	High Tightening of financial conditions triggered by a sharper-than-expected increase in U.S. interest rates (prompted by higher-than-expected inflation) or the materialization of other risks amid monetary policy normalization.	ST	Medium Tighter financial conditions will increase debt service and refinancing risks; cause stress on leveraged firms, households, and vulnerable sovereigns. As a result, bank-sovereign-real economy links could re-emerge via loss of market confidence.	<ul style="list-style-type: none"> Accelerate structural reforms and formulate credible medium-term fiscal path to support investor confidence. Banks to continue building capital buffers. Further ECB policy actions could help depending on the nature of the shock.
Policy uncertainty	High/Medium Policies in systemically important countries to boost near-term activity beyond sustainable levels	ST, MT	Medium Unsustainable policies will exacerbate underlying vulnerabilities, undermine regional cohesion (already under	<ul style="list-style-type: none"> Accelerate structural reforms and formulate credible medium-term fiscal path to support investor confidence.

	due to domestic political pressures or in response to external policy spillovers		strain from Brexit) and, in some cases, backfire by hurting confidence and global growth. This will result in weaker external demand, weighing on Spain's export performance, and possible financial fragmentation.	<ul style="list-style-type: none"> Let automatic stabilizers play in case the output gap widens and formulate credible medium-term fiscal path in support of public debt sustainability.
Intensification of risks of fragmentation/security dislocation	<p>High</p> <p>Intensification of the risks of fragmentation/security dislocation in parts of the Middle East, Africa, Asia, and Europe, leading to socio-economic and political disruptions.</p>	ST, MT	<p>Medium</p> <p>Intensification of conflicts in the Middle East and Africa could lead to sharp rises in migrant flows into Europe further deepening political division within the union.</p>	<ul style="list-style-type: none"> Accelerate structural reforms and formulate credible medium-term fiscal path to support investor confidence.
Significant slowdown in China	<p>Low/Medium</p> <p>Disorderly deleveraging adversely affects near-term growth. In the medium term, insufficient progress in deleveraging and rebalancing reduces growth, with additional credit stimulus postponing the slowdown, but making it sharper.</p>	ST/MT	<p>Low/Medium</p> <p>China slowdown may adversely impact emerging markets; weaker growth, especially in Latin America, could reduce the profitability of Spain's global banks (and large corporates) which would weaken contributions to the parents' capital buffers.</p>	<ul style="list-style-type: none"> Accelerate structural reforms and formulate credible medium-term fiscal path to support investor confidence. Continue strengthening the financial sector and its capacity to support growth. Close coordination with supervisors in host countries. Further ECB policy actions could help depending on the nature of the shock.
Sizeable deviations from baseline energy prices.	<p>Medium</p> <p>Owing to steeper-than-anticipated export declines in some producers, possibly prompted by political disruptions, amid supply bottlenecks, oil prices could rise sharply. Prices could drop significantly if downside global growth risks materialize or supply exceeds expectations, possibly due to faster-than-expected U.S. shale production growth, or, over the medium term, higher OPEC/Russia production.</p>	ST, MT	<p>Medium</p> <p>Given higher oil intensity of Spanish economy, higher oil priced would push up CPI inflation weighing on consumer spending and growth, while in a scenario of lower oil prices, Spanish economy will benefit.</p>	<ul style="list-style-type: none"> Use any windfall revenues to reduce the high public debt. Allow automatic stabilizers to operate and formulate credible medium-term fiscal path in support of public debt sustainability.

Domestic Risks				
Prolonged period of uncertainty related to political crisis in Catalonia	Medium Despite the recent dialogue between the central government and Catalan authorities, long-term uncertainty remains high with positions deeply divided and entrenched.	MT	Medium Prolonged period of uncertainty could weaken business confidence weighing on investment.	<ul style="list-style-type: none"> • Advance ongoing structural reforms and enhance labor market performance. • Formulate credible medium-term fiscal path to support investor confidence.
Higher-than-estimated growth momentum created by past reforms	Medium Past labor market reforms reduce structural unemployment rate more than currently estimated, increasing the economy's potential to growth.	ST	Medium Robust job creation could continue in the medium term without creating wage pressures. This would also sustain strong private consumption growth in the medium term.	<ul style="list-style-type: none"> • Use any windfall revenues to reduce the high public debt. • Continue structural reform efforts, given still considerable structural weaknesses.
Weak implementation of fiscal commitments and structural reforms or reversal of past policy achievements	Medium Traction for structural reforms is low in a fragmented parliament with a minority government. Pressure for partial reform reversal is rising. A credible medium-term fiscal path has yet to emerge.	ST, MT	High Potential 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.	<ul style="list-style-type: none"> • Advance structural reforms and enhance labor market performance. • Return to gradual, steady and growth-friendly fiscal consolidation. • Reform the regional financing framework to reduce fiscal risks.
<p>Note: 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. ST=short term; MT=medium term.</p>				

Appendix IV. Debt Sustainability Analysis

A. Public Debt Sustainability Analysis

Spain's public debt sustainability remains at risk, despite the sizeable reduction of the headline fiscal deficit since 2010. Under the baseline scenario, public debt is projected to decline slowly over the medium term, on the back of a favorable growth-interest rate differential. However, at about 92.5 percent of GDP in 2023, debt would remain at a risky level. A negative growth shock and the realization of contingent liabilities represent the largest risks to public debt sustainability. Returning to a gradual but persistent fiscal consolidation remains a priority. An annual structural adjustment of about 0.5 percent of GDP over the medium term would put debt firmly on a downward path, bringing it to around 87 percent of GDP by 2023—about 5 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 17.4 percent of GDP in 2018 it is one of the highest in the euro area.

Background

Definitions and Coverage

1. 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

2. The public debt-to-GDP ratio increased from 35.5 percent in 2007 to the peak of 100.4 percent in 2014, driven by excessive fiscal deficits (of about 8.3 percent of GDP on average during 2008–14), and a largely unfavorable growth interest rate differential (which contributed 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. Public debt has declined since then, albeit at a slow pace, reaching 98.1 percent of GDP at end-2017.

3. Gross financing needs have dropped to 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 yields down, and its sovereign bond purchasing program has mitigated the refinancing risk. As a result, the 10-year bond yield declined from about 6¾ percent in mid-2012 to about 1.5 percent at end-October 2018. The effective interest rate on outstanding debt has also declined, and interest payments are expected to fall below 2½ percent of GDP in 2018.

Other Factors

4. The amortization profile of public debt is tilted towards the long term (93 percent of total debt, on a residual maturity basis). The average life at issuance has increased steadily since 2012, from 5 years to nearly 11 years in 2017, with the average life of outstanding debt increasing from 6.3 to 7 years over the same period. Despite the lengthening of debt maturity, the average cost of outstanding debt has continued to fall, reaching an all-time low of 2.6 percent in 2017. Holdings of public debt are relatively well diversified. The share of marketable debt held by the Spanish banking system has continued to fall to about 18 percent, while that of the ECB has increased to about 21 percent. The share of public debt held by residents declined by 11 percentage points since 2012 to 56 by end-2017, but remains above the 2007 level (50 percent). The stock of financial assets has gradually declined since 2014 to about 33 percent of GDP in 2017. Nonetheless, the assets are a risk mitigating factor, with net public debt levels amounting to 85 percent of GDP at end-2017.

Baseline

5. Public debt is projected to fall marginally to 97.3 percent of GDP in 2018 and continue declining slowly to 92.5 percent by 2023. Gross financing needs are expected to remain below 20 percent, and gradually decline over the projection period. However, at 16.5 percent of GDP in 2023, they would remain relatively high compared to other euro area countries.

Assumptions

6. The baseline scenario is based on the medium-term projections (Table 1). In particular, (i) growth is projected to be 2.5 percent in 2018 and moderate to 2.2 percent in 2019, as the effect of tailwinds dissipates; (ii) over the medium term, growth is set to converge toward its potential rate of around 1¾ percent; (iii) a structural loosening of around 0.2 percent of GDP is assumed in 2018 and 2019, 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 1.2 percent in 2017 to 1.9 percent in 2023; and (v) long-term sovereign spreads are assumed to increase slowly in the medium term, with 10-year bond yields increasing moderately to 3.6 percent in line with a gradual normalization of monetary policy.

Realism of Baseline Projections

7. The median forecast error for real GDP growth during 2009–17 is 0.62 percent, suggesting a moderate downward bias in the staff projections. In contrast, the median forecast error is -0.95 percent for the primary balance and -0.31 percent for inflation. Both indicate some degree of upward bias in the staff projections. To assess the realism of projected fiscal adjustment, a comparison with high debt country experience suggests that the projected adjustment and level of the CAPB in Spain are below the thresholds that would question the feasibility of the adjustment.

Stress Tests

8. Public debt levels would either remain broadly flat or increase under a number of standard shock scenarios. Debt dynamics would worsen significantly if contingent liabilities were to materialize or the economy is hit by a combination of negative shocks to GDP growth and the subsequent deterioration in primary balance, with the stock of public debt peaking in 2020 at around 112 percent of GDP and 106 percent of GDP, respectively.

Growth Shock

9. 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 2019–20. This implies that real GDP would contract by an average of 0.5 percent per year in 2019–20, compared to annual average growth of 2.0 percent under the baseline. Under this recession scenario, inflation would be lower (by an average of 0.6 percentage points per year) and the primary balance weaker (by about 1.9 percent of GDP per year, on average) in the recession years. For 2021–23, the scenario assumes a moderate fiscal tightening as primary expenditure is projected to grow only in line with the new GDP levels which is lower than in the baseline. In this context, the debt-to-GDP ratio would rise to 105 percent of GDP in 2020 before declining slowly to 102 percent in 2023 (almost 10 percentage points higher than the baseline), and gross financing needs would increase slightly above the 20 percent benchmark level reaching 20.8 percent in 2020. If, however, the scenario assumes no fiscal tightening and primary expenditure remains at the same nominal level as in the baseline, higher fiscal deficits in 2021–23 would push public debt into an upward trajectory, reaching 110 percent of GDP in 2023.¹

Primary Balance Shock

10. This scenario assumes a relaxation of fiscal policy in 2019–20, with a cumulative deterioration of the primary balance of 1.8 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 98.5 percent of GDP in 2020 and then declining gradually to 97.4 percent of GDP in 2023, nearly 5 percentage points higher than in the baseline. The larger primary deficits would also imply more sizable gross financing requirements than in the baseline.

Interest Rate Shock

11. Over the five-year forecast horizon, the debt dynamics could withstand relatively well a real interest rate shock of about 325 basis points during 2019–23, given the relatively long

¹ Alternative assumptions on the growth shock have also been considered, for example, a one standard deviation negative shock in 2019 with persistence parameters estimated using historical GDP data, and a one standard deviation shock in 2019–20 with a gradual recovery to potential growth in 2023. These scenarios generally produce similar results, with a debt-to-GDP ratio reaching the range of 110–15 percent of GDP in 2023, assuming no fiscal tightening in the projection years.

debt maturity and the high share of debt at fixed interest rates. Under such a scenario, the effective interest rate would increase to 4.1 percent by 2023 compared to 2.9 percent in the baseline. The debt-to-GDP ratio would remain broadly stable, amounting to 95.8 percent in 2023. However, a sizeable and sustained increase in interest rates would reduce the (already limited) fiscal space.

Combined Shock

12. 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 107.7 percent in 2023, about 15 percentage points higher than under the baseline). Gross financing needs would also be significantly higher, rising to 21.4 percent in 2023.

Contingent Liability Shock

13. 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 2019) equivalent to 10 percent of banking sector assets, combined with lower growth and lower inflation in 2019–20 (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 about 10 percent of GDP in 2019, bringing gross financing needs to 27.5 percent of GDP (about 7 percentage points above standard early warning benchmark levels). Moreover, the debt-to-GDP ratio would continue to increase, peaking at 111.7 percent in 2020, then slowly declining to about 109.8 percent in 2023 (about 17 percentage points higher than the baseline).

Heat Map

14. 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

Under the baseline scenario, external debt is projected to decline over the medium term, from the peak of 168 percent of GDP in 2015 to about 144 percent of GDP in 2023, helped by the accumulation of trade surpluses. Although it will take time to significantly lower Spain's vulnerability to external shocks, some mitigating factors include the current low cost of debt, the limited share of debt denominated in foreign currency, a favorable maturity structure, and diversified exports.

Methodology

15. The external DSA provides a framework to examine a country's external sustainability that complements the External Sector Assessment (Appendix II). The external DSA estimates the external debt path under several 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

16. As in the case of the Public DSA, the baseline scenario is based on the medium-term macro projections (Table 1). These projections assume a gradual convergence of real GDP growth to its estimated potential of around 1.75 percent over the medium term. The trade surplus is forecast to gradually improve somewhat and the external current account balance would remain close to 1 percent of GDP. External debt is projected to decline from 167 percent of GDP in 2017 to 144 percent of GDP in 2023. Driven by good export performance in the medium term, the external debt-to-exports ratio is projected to sharply decline during 2018–23. Gross external financing needs will continue to decrease throughout the projection period but are expected to remain high (around 60 percent of GDP in 2023).

Alternative Scenarios

17. Alternative external DSA scenarios, including stress tests, suggest that while Spain's external debt would remain relatively high, it will gradually decline over the medium term. However, if key macroeconomic variables move closer to their levels observed during the crisis, the external debt would increase. Overall, the level of external debt remains a vulnerability factor given the risks surrounding the economic outlook over the medium term.

Historical Shock Scenario

18. The external debt path would fail to stabilize in a scenario based on historical data properties (2008–17) for real GDP growth, the interest rate on external debt, the GDP deflator in US dollars, and the current account position excluding interest payments. The external debt would increase to 204 percent of GDP by 2023, driven in part by a real GDP growth path of 0.3 percent since 2019 and a lower current account surplus (excluding interest payments).

Interest Rate Shock

19. Following a one-half standard deviation interest rate shock (an increase from 2 percent in the baseline to 2.5 percent), **external debt would be higher** by about 4 percentage points of GDP than in the baseline scenario at end-2023.

Growth Shock

20. Assuming that real GDP growth averages 0.6 percent between 2019 and 2023, compared with 1.8 percent in the baseline, **external debt would reach 154 percent of GDP in 2023.**

Non-interest Current Account Shock

21. A stress scenario in which the current account surplus, excluding interest payments, averages 2.3 percent of GDP rather than 3.8 percent of GDP as in the baseline projection, leads to an **external debt stock of 151 percent of GDP in 2023.**

Combined Shock

22. A combination of $\frac{1}{4}$ standard deviation shocks to real GDP growth, the external interest rate, and the current account balance is associated with an **external debt-to-GDP ratio of 154 percent in 2023.**

Real Depreciation Shock

23. **Compared to the baseline projection, a 30 percent real depreciation shock would increase the external debt over the medium term, on average, by around 5 percent of GDP per year.** In the external DSA, the mechanic transmission channel is via valuation effects, but Spain has a low share of debt denominated in foreign currency.

Spain Public DSA—Risk Assessment

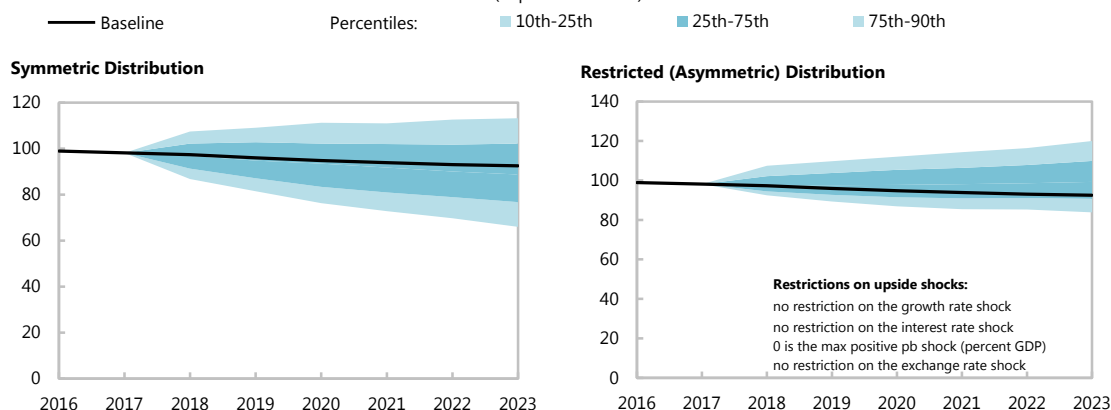
Heat Map

Debt level ^{1/}Gross financing needs ^{2/}Debt profile ^{3/}

Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

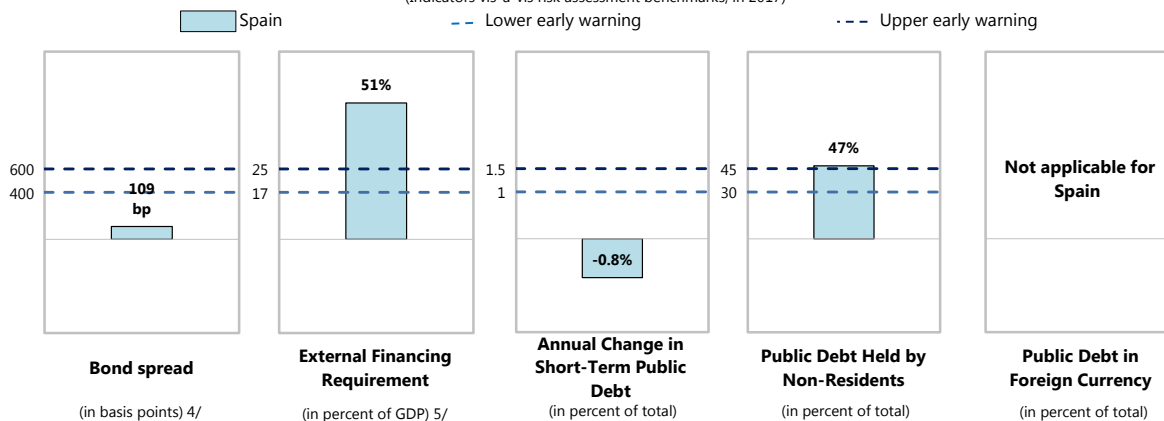
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2017)



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.

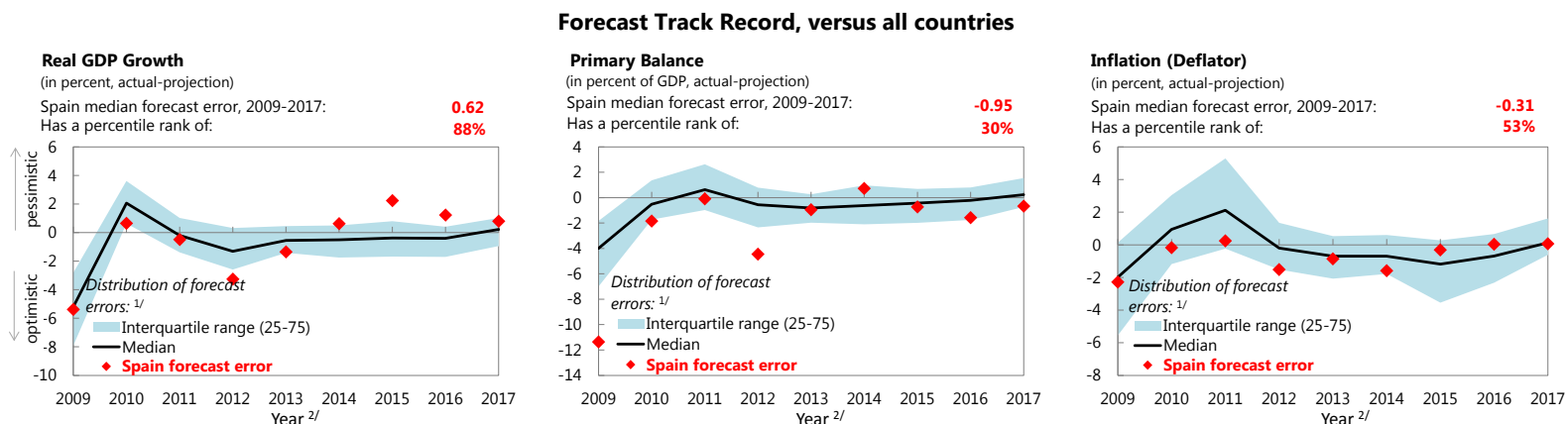
Lower and upper risk-assessment benchmarks are:

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, 31-Jul-18 through 29-Oct-18.

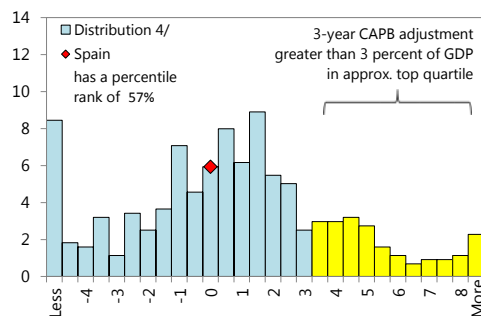
5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Spain Public DSA—Realism of Baseline Assumptions

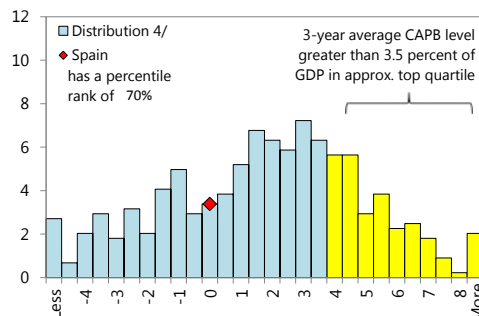


Assessing the Realism of Projected Fiscal Adjustment

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

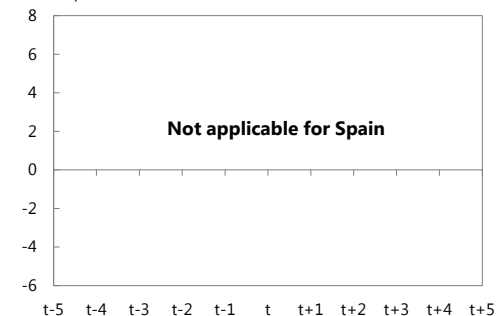


3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB) (Percent of GDP)



Boom-Bust Analysis^{3/}

Real GDP growth (in percent)



Source : IMF Staff.

1/ Plotted distribution includes all 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 observations 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

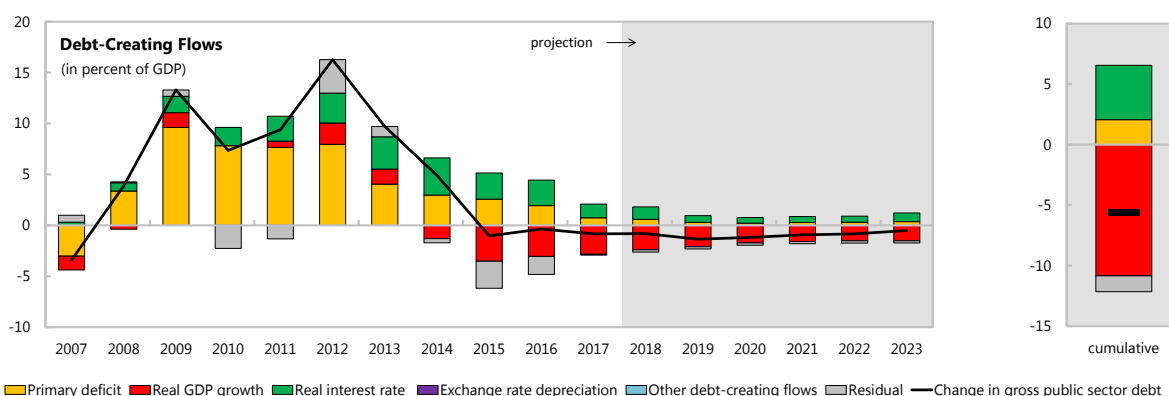
(in percent of GDP unless otherwise indicated)

Debt, Economic and Market Indicators ^{1/}

	Actual			Projections						As of October 29, 2018	
	2007-2015 ^{2/}	2016	2017	2018	2019	2020	2021	2022	2023		
Nominal gross public debt	70.9	99.0	98.1	97.3	96.0	94.8	93.9	93.0	92.5	Sovereign Spreads EMBIG (bp) ^{3/}	117
Public gross financing needs	16.9	19.2	18.9	17.4	16.8	16.6	16.5	16.5	16.5	5Y CDS (bp)	65
Real GDP growth (in percent)	0.1	3.2	3.0	2.5	2.2	1.9	1.7	1.7	1.7	Ratings	Foreign Local
Inflation (GDP deflator, in percent)	0.7	0.3	1.2	1.3	1.7	1.9	1.9	2.0	1.9	Moody's	Baa1 Baa1
Nominal GDP growth (in percent)	0.8	3.5	4.3	3.8	4.0	3.8	3.7	3.7	3.6	S&P's	A- A-
Effective interest rate (in percent) ^{4/}	4.0	2.9	2.7	2.6	2.5	2.5	2.6	2.7	2.9	Fitch	A- A-

Contribution to Changes in Public Debt

	Actual			Projections						cumulative	debt-stabilizing primary balance ^{9/}
	2007-2015	2016	2017	2018	2019	2020	2021	2022	2023		
Change in gross public sector debt	6.7	-0.4	-0.8	-0.8	-1.4	-1.2	-0.9	-0.8	-0.5	-5.6	
Identified debt-creating flows	6.8	1.4	-0.7	-0.6	-1.1	-1.0	-0.7	-0.6	-0.3	-4.3	
Primary deficit	4.8	1.9	0.7	0.6	0.3	0.2	0.3	0.3	0.4	2.1	
Primary (noninterest) revenue and grants	37.2	37.5	37.7	38.2	38.2	38.1	38.0	37.9	37.8	228.2	
Primary (noninterest) expenditure	41.9	39.4	38.4	38.8	38.5	38.3	38.3	38.2	38.1	230.3	
Automatic debt dynamics ^{5/}	2.0	-0.5	-1.5	-1.2	-1.4	-1.2	-1.0	-0.9	-0.6	-6.4	
Interest rate/growth differential ^{6/}	2.0	-0.5	-1.5	-1.2	-1.4	-1.2	-1.0	-0.9	-0.6	-6.4	
Of which: real interest rate	2.1	2.5	1.4	1.2	0.7	0.5	0.6	0.6	0.9	4.5	
Of which: real GDP growth	-0.1	-3.0	-2.8	-2.4	-2.1	-1.7	-1.6	-1.5	-1.5	-10.8	
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	
Please specify (1) (e.g., drawdown of deposits) (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (2) (e.g., ESM and Euroarea loans)	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/}	-0.1	-1.8	-0.1	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-1.3	



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 $[(r - \pi(1+g) - g + ae(1+r))/(1+g+\pi+gm)]$ 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.

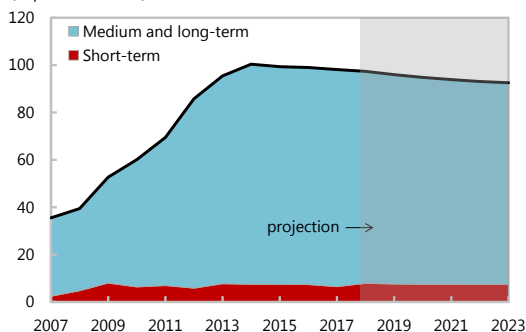
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Spain Public DSA—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

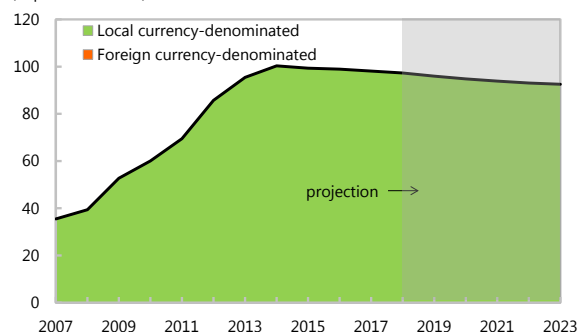
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)



Alternative Scenarios

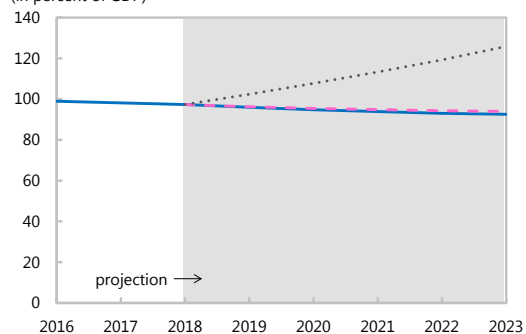
— Baseline

..... Historical

--- Constant Primary Balance

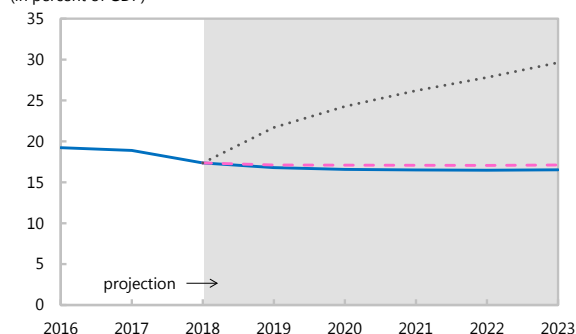
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

Baseline Scenario

	2018	2019	2020	2021	2022	2023
Real GDP growth	2.5	2.2	1.9	1.7	1.7	1.7
Inflation	1.3	1.7	1.9	1.9	2.0	1.9
Primary Balance	-0.6	-0.3	-0.2	-0.3	-0.3	-0.4
Effective interest rate	2.6	2.5	2.5	2.6	2.7	2.9

Constant Primary Balance Scenario

	2018	2019	2020	2021	2022	2023
Real GDP growth	2.5	2.2	1.9	1.7	1.7	1.7
Inflation	1.3	1.7	1.9	1.9	2.0	1.9
Primary Balance	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6
Effective interest rate	2.6	2.5	2.5	2.6	2.7	2.9

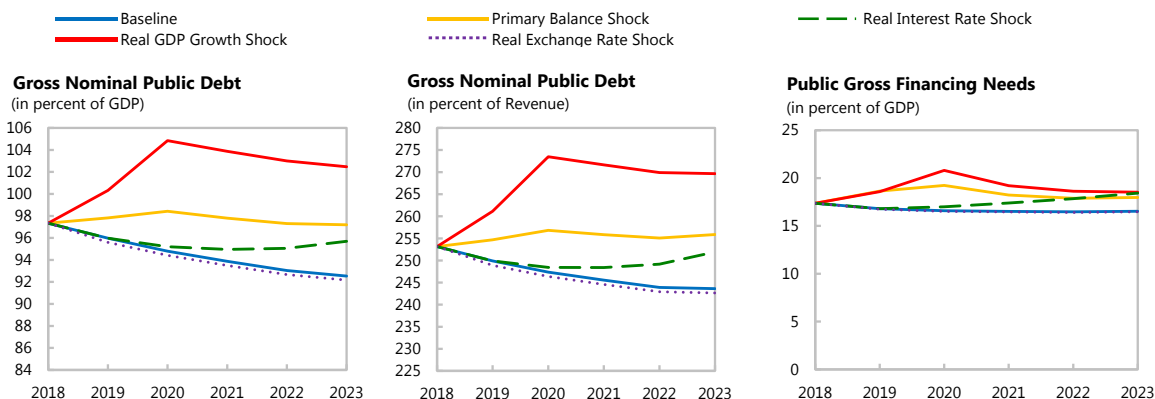
Historical Scenario

	2018	2019	2020	2021	2022	2023
Real GDP growth	2.5	0.3	0.3	0.3	0.3	0.3
Inflation	1.3	1.7	1.9	1.9	2.0	1.9
Primary Balance	-0.6	-4.9	-4.9	-4.9	-4.9	-4.9
Effective interest rate	2.6	2.5	2.9	3.2	3.5	3.9

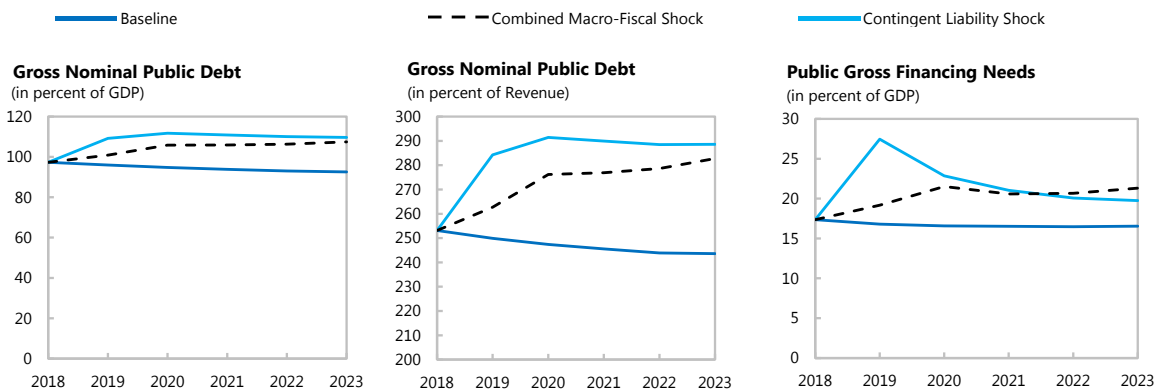
Source: IMF staff.

Spain Public DSA—Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests

Underlying Assumptions
(in percent)

	2018	2019	2020	2021	2022	2023
Primary Balance Shock						
Real GDP growth	2.5	2.2	1.9	1.7	1.7	1.7
Inflation	1.3	1.7	1.9	1.9	2.0	1.9
Primary balance	-0.6	-2.1	-2.0	-0.6	-0.6	-0.7
Effective interest rate	2.6	2.5	2.6	2.7	2.8	2.9
Real Interest Rate Shock						
Real GDP growth	2.5	2.2	1.9	1.7	1.7	1.7
Inflation	1.3	1.7	1.9	1.9	2.0	1.9
Primary balance	-0.6	-0.3	-0.2	-0.3	-0.3	-0.4
Effective interest rate	2.6	2.5	3.0	3.4	3.7	4.1
Combined Shock						
Real GDP growth	2.5	-0.3	-0.7	1.7	1.7	1.7
Inflation	1.3	1.1	1.3	1.9	2.0	1.9
Primary balance	-0.6	-2.1	-2.7	-0.6	-0.6	-0.7
Effective interest rate	2.6	2.5	3.0	3.4	3.8	4.2

	2018	2019	2020	2021	2022	2023
Real GDP Growth Shock						
Real GDP growth	2.5	-0.3	-0.7	1.7	1.7	1.7
Inflation	1.3	1.1	1.3	1.9	2.0	1.9
Primary balance	-0.6	-1.5	-2.7	-0.3	-0.3	-0.4
Effective interest rate	2.6	2.5	2.6	2.7	2.8	2.9
Real Exchange Rate Shock						
Real GDP growth	2.5	2.2	1.9	1.7	1.7	1.7
Inflation	1.3	2.2	1.9	1.9	2.0	1.9
Primary balance	-0.6	-0.3	-0.2	-0.3	-0.3	-0.4
Effective interest rate	2.6	2.5	2.5	2.6	2.7	2.9
Contingent Liability Shock						
Real GDP growth	2.5	-0.3	-0.7	1.7	1.7	1.7
Inflation	1.3	1.1	1.3	1.9	2.0	1.9
Primary balance	-0.6	-10.3	-0.2	-0.3	-0.3	-0.4
Effective interest rate	2.6	2.6	2.9	2.9	2.9	3.1

Source: IMF staff.

Spain External Debt Sustainability Framework, 2013-2023

(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
1 Baseline: External debt	160.2	168.0	168.4	167.0	166.6	164.9	160.1	155.7	151.6	147.7	144.1
2 Change in external debt	-6.0	7.8	0.4	-1.4	-0.4	-1.7	-4.8	-4.4	-4.0	-3.9	-3.6
3 Identified external debt-creating flows (4+8+9)	-4.0	-7.1	-6.7	-9.1	-8.8	-6.2	-5.7	-5.1	-4.9	-4.8	-4.8
4 Current account deficit, excluding interest payments	-5.5	-4.6	-4.0	-4.7	-4.1	-3.2	-3.0	-3.4	-3.8	-4.2	-4.5
5 Deficit in balance of goods and services	-3.3	-2.5	-2.4	-3.2	-2.9	-2.1	-1.9	-2.2	-2.5	-2.8	-3.0
6 Exports	32.3	32.7	33.0	33.2	34.4	34.1	34.0	34.4	34.9	35.4	35.7
7 Imports	-29.0	-30.3	-30.6	-30.0	-31.5	-32.0	-32.1	-32.2	-32.4	-32.6	-32.7
8 Net non-debt creating capital inflows (negative)	-4.0	-4.2	-2.3	-1.2	0.2	-1.5	-1.5	-1.5	-1.5	-1.5	-1.5
9 Automatic debt dynamics 1/	5.5	1.6	-0.4	-3.1	-4.9	-1.5	-1.2	-0.2	0.4	0.8	1.2
10 Contribution from nominal interest rate	4.0	3.5	2.9	2.5	2.2	2.2	2.3	2.6	2.9	3.3	3.5
11 Contribution from real GDP growth	2.8	-2.2	-7.0	-5.2	-4.7	-3.7	-3.5	-2.9	-2.6	-2.4	-2.4
12 Contribution from price and exchange rate changes 2/	-1.2	0.3	3.8	-0.4	-2.4	...	...	...	...	...	...
13 Residual, incl. change in gross foreign assets (2-3) 3/	-2.0	15.0	7.1	7.6	8.4	4.5	0.8	0.7	0.9	0.9	1.2
External debt-to-exports ratio (in percent)	496.7	513.2	510.3	503.2	484.8	483.8	470.2	452.0	434.3	417.8	404.2
Gross external financing need (in billions of US dollars) 4/	1058.0	963.4	971.9	876.9	908.1	998.4	1103.1	1124.6	1145.3	1164.0	1182.5
in percent of GDP	77.7	69.9	81.0	70.8	69.0	66.5	69.8	67.8	66.1	64.3	62.8
Scenario with key variables at their historical averages 5/						164.9	172.1	180.0	187.7	196.0	204.4
Key Macroeconomic Assumptions Underlying Baseline						10-Year Historical Average	10-Year Standard Deviation				
Real GDP growth (in percent)	-1.7	1.4	3.6	3.2	3.0	0.3	2.6	2.5	2.2	1.9	1.7
GDP deflator in US dollars (change in percent)	3.7	-0.1	-16.1	0.0	3.3	-1.2	7.4	11.2	2.9	3.1	2.6
Nominal external interest rate (in percent)	2.5	2.2	1.5	1.5	1.4	2.5	0.9	1.5	1.5	1.7	2.0
Growth of exports (US dollar terms, in percent)	6.9	2.8	-12.3	3.8	10.2	2.3	10.9	13.1	5.1	6.2	5.9
Growth of imports (US dollar terms, in percent)	1.1	5.8	-12.0	1.0	11.8	-0.4	12.9	15.8	5.7	5.3	5.1
Current account balance, excluding interest payments	5.5	4.6	4.0	4.7	4.1	2.7	2.9	3.2	3.0	3.4	3.8
Net non-debt creating capital inflows	4.0	4.2	2.3	1.2	-0.2	1.6	1.7	1.5	1.5	1.5	1.5

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.

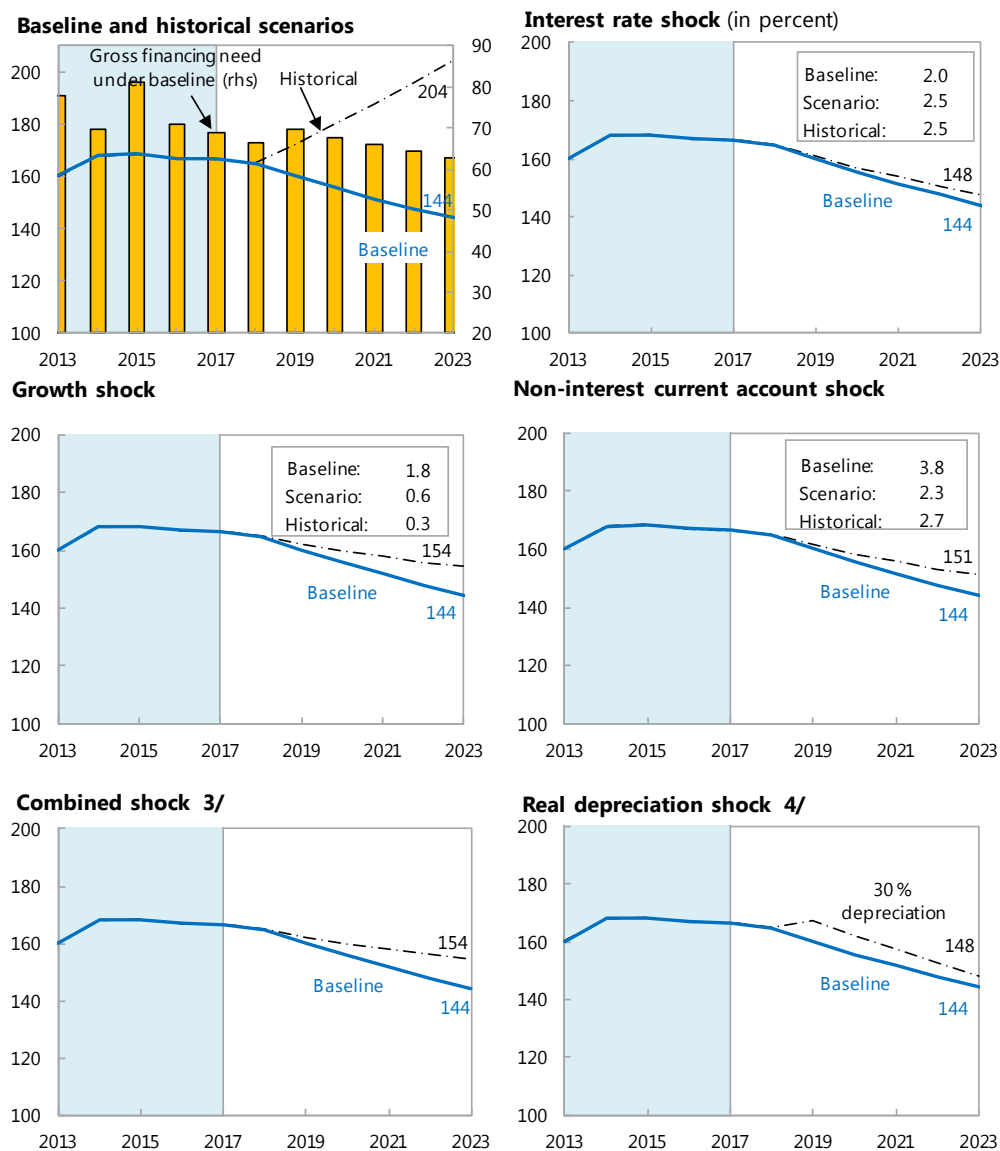
2/ The contribution from price and exchange rate changes is defined as $[-r(1+g) + ea(1+r)] / (1+g+r+gr)$ times previous period debt stock. r increases with an appreciating domestic currency ($e > 0$) and rising inflation (based on GDP deflator).

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.

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 2019.

Appendix V. Implementation Status FSAP Recommendations¹

Recommendations		Status
<i>To address crisis legacy issues and mitigate other risks to financial stability</i>		
1	Enforce implementation of the ECB guidance on NPLs, including promoting banks' disclosure of targets and progress (SSM, BdE)	<p>The SSM is assessing the credibility and ambition of banks' NPL reduction plans and considers progress so far to be in line with bank strategies. Significant transactions agreed in 2017 include sales of distressed assets by the two largest banks amounting to about €41 billion in gross value. One of these transactions was completed in the first half of 2018. During 2018 other wholesale transactions have been announced.</p> <p>Enhanced disclosure requirements on asset quality and NPLs to all banks have been mandated by end-2018. In addition, the EBA is planning to implement, with respect to all EU banks, additional disclosure items on non-performing exposures, forbearance and foreclosed assets, aligned with those currently recommended in the ECB guidance to banks on NPLs.</p>
2	Improve recovery of viable businesses by enabling the stay and involvement of public creditors in all pre-insolvency processes and enhancing the OCAP process for SMEs; strengthen commercial courts by resourcing them better (MoE, MoJ)	<p>The intention of the government is to make use of the transposition of the forthcoming Insolvency EU Directive to improve restructuring and second chance procedures. In particular, the proposed Directive includes public credit in the restructuring procedures.</p> <p>A high-level expert group has been established with the objective to prepare a report for legislative changes needed to improve restructuring and out-of-court agreements; pre-insolvency proceedings; and to define the basis of the exemption for outstanding debt.</p>
3	Evaluate the scope for further banking consolidation through mergers, branch reduction, and business model adjustments (SSM, BdE)	<p>Bank business models are a SSM supervisory priority for 2018. BdE supervision frequently reviews banks' profitability and analyzes possibilities to reduce their structural costs.</p> <p>Branch reduction has already been significant and continues.</p>
4	Monitor rigorously interest rate and government bond market risks; ensure appropriate capital requirements to mitigate such risks (SSM, BdE)	<p>Interest rate risk in the banking book is monitored in the annual Supervisory Review and Evaluation Process (SREP) as one of the four risks to capital. Additionally, the SSM conducted in 2017 a sensitivity analysis of the interest rate risk in the banking book. It provided with additional information on sensitivity of the Economic Value of Equity (EVE) and Net Interest Income (NII) of banks' banking book positions to several hypothetical interest rates shocks. Also, its bottom-up component (i.e. banks provide their own projections) fostered the development of banks' risk management capabilities. The results of the exercise fed into the SREP to ensure SIs' capital adequacy.</p>

¹ In addition to these near-term recommendation, the FSAP also had several other recommendations that are important but could follow after consideration has been given to the near-term recommendations.

5	Improve liquidity monitoring, including by closing reporting gaps; critically review funding structures and policies of banks with excessive reliance on ECB's liquidity support; overall, place a premium on effective liquidity risk management by banks (SSM, BdE)	Liquidity monitoring is being reinforced. At the EU level, a new financial statement for banks, "maturity ladder", has been introduced in March 2018. This information was already collected by the BdE. The BdE in its November 2017 Financial Stability Review included for the first time a liquidity stress test exercise for the entire banking sector (SIs and LSIs).
6	Initiate, supervisory and prudential steps to reduce the mismatching of assets/liabilities in insurer balance sheets (DGSyFP)	A new procedure based on quantitative reporting templates has been implemented.
7	Foster development of market-based financing and supply of nonbank financial services for corporates and households (MoE, BdE, CNMV, DGSyFP)	The CNMV identified as one of the four strategic areas for the period 2017–18 the promotion of confidence in the securities markets as a way for companies to finance their activities. To encourage more SMEs to be listed, the CNMV held several outreach events. The CNMV has also improved the efficiency of its actions, strengthened its culture of service and response. In addition, it promoted measures to foster financial business and followed closely the development of crowdfunding. Through "CNMV Innovates" it tries to boost new digital technologies and their possible applications to securities markets. In this context, the CNMV set up an innovation hub of fintech proposals.
8	Enhance capacity to monitor and analyze macro financial linkages, intra-system connectedness, and cross-border spillovers; close data gaps (BdE with CNMV and DGSyFP)	The BdE envisages to include a section in its Financial Stability Report about intra-system interconnectedness. In an initial step, a stock-taking exercise of information sources and data quality took place. The CNMV is concluding an analysis of the "shadow banking" (now re-named "market-based credit intermediation") sector, to be published in 2018. It will be followed by a regular "shadow banking monitor" twice a year, following closely the ESRB/FSB characterization and use of toolkits. The CNMV also published a detailed study on the redemption of participations in mutual funds under stressed conditions, will begin a study on market infrastructures' participants, and plans to develop a line of research on interconnectedness (starting in 2018).
9	Review, as a priority, SAREB's medium-term financial outlook based on adverse scenarios; set up a tripartite committee (BdE, MoE, and FROB) to work out any needed mid-course corrections (MoE, BdE, FROB)	SAREB's business plan is updated annually and includes simulations under different scenarios. The latest update, approved in March 2017, has been built on more conservative expectations. The BdE's supervisory approach includes the analysis of SAREB's assumptions incorporated in its business plan, which it can challenge and request to prepare an alternative plan. So far, the BdE has not seen the need to make use of this tool. SAREB's current business plan envisages the complete repayment of the senior debt and no need for additional capital-raising actions. Following the IMF recommendations, SAREB carried out various sensitivity analyses. Moreover, it has combined some of the worst scenarios to perform a stress test.

		A tripartite group has not been set up, since the authorities consider these functions to be already carried out by SAREB's Monitoring Commission.
<i>To strengthen systemic and prudential oversight</i>		
10	Set up a 'Systemic Risk Council' for inter-agency coordination on systemic risk factors, surveillance, and system wide financial sector policies (MoE with BdE, CNMV, DGSyFP)	The Treasury is in the process of drafting a proposal for a National Systemic Risk Council. The Financial Stability Committee (CESFI) reconvened on July 24, 2018 for the first time since 2013 and has set the goal of establishing a national macroprudential authority as soon as possible.
11	Expand the macroprudential toolkit to include borrower-based tools (All authorities)	The BdE has started an initial analysis of potential additional measures to be included in the toolkit. Any additions would require legislative changes. In this vein, the CNMV has proposed to develop borrower-based tools and measurements by using data from the Household Survey and Financial Competences.
12	Increase supervisory focus on corporate governance practices across all credit intermediaries, and the nonbank sector (SSM, BdE, DGSyFP, CNMV)	For banks, supervisory actions on corporate governance are part of the annual SREP and built on the SSM's 2015 thematic review on governance and risk management in SIs. Corporate governance has been included as a supervisory priority in the planning for LSIs in 2017 and 2018 and is one of the focus areas for on-site inspections. As a result, seven requirements and/or recommendations on governance, including some related to internal audit functions, have been sent to LSIs during the on-site inspections performed in 2017 (no on-site inspection started in 2018 was finalized as of May 2018). Moreover, in 2017 the SREP review of internal governance and risk management element was performed applying the SREP methodology for LSIs approved by the Supervisory Board. That methodology will also be applied in 2018. For its part, the CNMV has focused its supervisory activities on the quality of the audit committees and the compliance of the required criteria by independent board directors.
13	Assign the BdE full regulatory powers in matters not harmonized at the European level including authorizing mergers (BdE, MoE)	No specific action has been taken.
<i>To bolster crisis management, resolution, and safety nets</i>		
14	Develop a credible resolution strategy for credit cooperatives and other Less Significant Institutions (LSIs); prepare recovery and resolution plans for significant insurance companies (BdE, FROB, DGSyFP)	The BdE drafted and adopted resolution plans for 25 out of 55 LSIs during 2017, of which 12 under simplified obligations. For 2018, BdE plans to develop resolution plans for 30 LSIs, subject to the availability of resources. Resolution plans for LSIs have taken into account their specificities, with the sale of business being the default preferred resolution tool. Moreover, the BdE conducts an annual risk assessment system (as part of the annual SREP) for all LSIs, so that changes in the risk profile can be identified in order to keep recovery plans updated. In the cooperative sector, the creation of a platform to mutualize losses among 29 credit cooperatives and a bank (Banco Cooperativo Español) would facilitate resolution.

		No specific action was taken with regard to the preparation of recovery and resolution plans for significant insurance companies since no Spanish insurance company qualifies as a significant institution.
15	Strengthen and upgrade the deposit guarantee scheme; create a protection scheme for insurance policyholders (FGD, MoE, DGSyFP)	No specific action has been taken.
<p>BdE=Banco de España; CNMV=Comisión Nacional del Mercado de Valores (National Securities Market Commission); DGSyFP=Directorate General for Insurance and Pension Funds (Dirección General de Seguros y Fondos de Pensiones); EBA=European Banking Authority; ESRB=European Systemic Risk Board; FGD=Deposit Guarantee Fund (Fondos de Garantía de Depósitos); FSB=Financial Stability Board; FROB=Spanish Executive Resolution Authority; LSI=Less Significant Institutions; MoE=Ministry of Economy, Competitiveness, and Industry; SAREB=Management Company for Assets Arising from the Banking Sector Reorganisation (Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria); SI=Systemic Institutions; SREP=Supervisory review and evaluation; SSM=Single Supervisory Mechanism.</p>		



SPAIN

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

November 2, 2018

Prepared By

European Department

CONTENTS

FUND RELATIONS _____ [2](#)

STATISTICAL ISSUES _____ [4](#)

FUND RELATIONS

(As of September 30, 2018)

Membership Status: Joined September 15, 1958.

General Resources Account:	SDR Million	Percent of Quota
Quota	9,535.50	100.00
Fund holdings of currency	8,446.24	88.58
Reserve position in Fund	1,089.34	11.42
Lending to the Fund		
New Arrangements to Borrow	347.00	

SDR Department:	SDR Million	Percent of Allocation
Net cumulative allocation	2,827.56	100.00
Holdings	2,803.00	99.13

Outstanding Purchases and Loans: None

Latest Financial Arrangements: None

Projected Payments to Fund

(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2018	2019	2020	2021	2022
Principal					
Charges/Interest	0.06	0.29	0.29	0.29	0.29
Total	0.06	0.29	0.29	0.29	0.29

2018 Article IV Consultation: Discussions took place in Madrid during September 19–October 3, 2018. The staff team comprised Andrea Schaechter (head), Lucy Liu, Jorge Salas, and Ara Stepanyan (all EUR). Pablo Moreno (Alternate Executive Director), and José Manuel Montero (Advisor to the Executive Director) attended the discussions. Tingyun Chen and Dilcia Noren (EUR) supported the mission from headquarters. The mission met Economy and Business Minister Nadia Calviño, Finance Minister María Montero, Bank of Spain Governor Pablo Hernández de Cos, and other senior officials. The mission also met with representatives of the financial sector, labor organizations, think tanks, parliament, and political parties. The concluding statement was published, and the staff report is expected to be published as well. Spain is on a standard 12-month cycle. The last Article IV consultation was concluded on September 20, 2017 (IMF Country Report No. 17/319).

Financial Sector Assessment Program (FSAP): An FSAP Update was conducted between October 2016 and July 2017 and included several missions. The 2017 Financial Sector Stability

Assessment (FSSA) was discussed by the IMF Board in conjunction with the 2017 Article IV consultation and published (Country Report No. 17/321).

Exchange Rate Arrangements and Restrictions: Spain's currency is the euro, which floats freely and independently against other currencies. Spain has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange rate system free of restrictions on payments and transfers for current international transactions, other than restrictions notified to the Fund under Decision No. 144 (52/51).

STATISTICAL ISSUES

(As of September 30, 2018)

I. Assessment of Data Adequacy for Surveillance	
General: Data provision is adequate for surveillance.	
II. Data Standards and Quality	
Subscriber to the Fund's Special Data Dissemination Standard (SDDS) since September 1996. In 2015, Spain subscribed to SDDS Plus, together with the first group of adherents.	No data ROSC available.

Table 1. Common Indicators Required for Surveillance
(As of September 30, 2018)

	Date of latest observation	Date received	Frequency of Data ⁷	Frequency of Reporting ⁷	Frequency of Publication ⁷
Exchange Rates	September 2018	September 2018	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	August 2018	September 2018	M	M	M
Reserve/Base Money	August 2018	September 2018	M	M	M
Broad Money	August 2018	September 2018	M	M	M
Central Bank Balance Sheet	August 2018	September 2018	M	M	M
Consolidated Balance Sheet of the Banking System	August 2018	September 2018	M	M	M
Interest Rates ²	September 2018	September 2018	D	D	D
Consumer Price Index	September 2018	September 2018	M	M	M
Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴	Q2:2018	September 2018	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing ³ – Central Government	August 2018	September 2018	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt ⁵	July 2018	September 2018	M	M	M
External Current Account Balance	July 2018	September 2018	M	M	M
Exports and Imports of Goods and Services	July 2018	September 2018	M	M	M
GDP/GNP	Q2:2018	September 2018	Q	Q	Q
Gross External Debt	Q2 2018	September 2018	Q	Q	Q
International Investment position ⁶	Q2:2018	September 2018	Q	Q	Q

¹ Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

² Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

³ Foreign, domestic bank, and domestic nonbank financing.

⁴ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

⁵ Including currency and maturity composition.

⁶ Includes external gross financial asset and liability positions vis-à-vis nonresidents.

⁷ Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

**Statement by Pablo Moreno, Alternate Executive Director for Spain,
José Manuel Montero, Advisor to the Executive Director, and Marta Mulas, Advisor to
the Executive Director
November 19, 2018**

Staff has provided useful insights in a context where the authorities are developing a new economic strategy. On behalf of the Spanish authorities, we thank staff for its very constructive dialogue and its well-focused analysis. The new government that took office last June is pursuing an economic policy agenda articulated around three main pillars: fiscal discipline, social inclusion, and sustainable growth. The Art. IV usefully focuses on these areas. There is broad agreement with the staff on the diagnosis and on key policy objectives, such as ensuring fiscal discipline and rebuilding fiscal buffers, lowering inequality, or fostering a structural reform agenda. The authorities have different views on some policy recommendations, particularly in the area of labor market reform.

Economic outlook and challenges

The Spanish economy maintains a strong momentum and risks to the economic outlook are mainly linked to the external environment. GDP growth is expected to remain vigorous in 2018, at around 2.6 percent, and to maintain a solid path in 2019 above the euro area average. Growth composition remains broad-based across demand components, but a less favorable external environment has yielded a smaller contribution of net exports and, thus, a more moderate growth pattern. As pointed out by staff, the outlook is subject to downward external risks, mainly related to policy uncertainties that could deteriorate trade and further tighten financial conditions globally. On the domestic front, the authorities have a more benign view than staff. The challenge of reaching political majorities in a fragmented Parliament, more than a risk, is a new reality of Spanish politics since 2015, no different from other advanced economies, and it has not prevented strong growth. As stressed by staff, the economic impact from the political uncertainty related to Catalonia has so far been limited and contained to the region.

Spain has continued unwinding the imbalances accumulated during the crisis, including a significant reduction in unemployment and in private sector leverage. The unemployment rate has been cut by over 11 percentage points over the past five years, while corporate and household indebtedness has fallen to levels at or below the euro area average. The banking system has undergone a substantial restructuring to the extent that non-performing assets are below the EU average. We concur with staff that this process has occurred in a context of improved fundamentals, including changes in the structure and competitiveness of the economy, which has allowed Spain to sustain strong growth while, at the same time, enjoying important and persistent current account surpluses.

But the correction of several key challenges has lagged behind and needs to be addressed, notably: reducing the public debt-to-GDP ratio, further lowering unemployment—in particular, long-term and youth unemployment—improving the quality of jobs, reducing inequality and the risk of poverty, and fostering productivity. The authorities have prioritized the correction of these vulnerabilities.

Policy agenda

The policy agenda has three pillars: fiscal discipline, social inclusion and sustainable growth. These pillars require a gradual shift from the internal devaluation growth pattern that has characterized recent growth, to a productivity-based and more inclusive path. Pursuing budgetary discipline and rebuilding fiscal buffers are essential to anchor the economic strategy and to ensure the effectiveness of the policy agenda. Spain has a relatively high level of inequality, with a Gini coefficient of 34.1, far from the EU average (30.3), and is also among the European countries with the highest share of its population at risk of poverty or social exclusion. Social inclusion must be improved by reducing unemployment, but also by addressing underemployment and labor market duality, as well as by reducing inequality—defined more broadly than just income distribution, also encompassing gender and intergenerational equity. Sustainability requires a shift into a productivity-based and environmentally-sound growth pattern. These objectives demand a comprehensive approach in all economic policy fronts.

a. Fiscal policy

Reducing debt levels and building up fiscal buffers are key priorities, as shared by staff's assessment; the authorities are thus targeting a structural adjustment in 2019. Discretionary efforts and the growth momentum should mutually reinforce each other to reduce the government debt-to-GDP ratio and deficit levels. In this respect, the authorities are strongly committed to reversing the procyclicality exhibited by the fiscal stance in the past few years, which has widened the structural deficit by around 1 percentage points of GDP since 2015. The 2019 Draft Budgetary Plan targets a general government deficit of 1.8 percent of GDP in 2019, including a 0.4 structural adjustment effort. This path would imply attaining a primary surplus for the first time since 2007 (of 0.6 percent of GDP). Furthermore, it would bring forward an acceleration in the pace of debt reduction, which is projected to fall from 97.0 percent of GDP in 2018 to 95.5 percent in 2019, the biggest decline since 2014.

The 2019 Draft Budgetary Plan (DBP) is compliant with the requirements under the Stability and Growth Pact (SGP) of the EU and has been broadly endorsed by the Independent Fiscal Authority (AIRef). The authorities share staff's view that the structural adjustment is a fundamental objective and take note of its word of caution in the design of the budget, in order not to deviate from fiscal targets. Spain will exit the Excessive Deficit Procedure and the corrective arm of the SGP with a deficit below 3 percent of GDP in 2018. For 2019, notwithstanding the EU Council recommendation of a 0.65 percent of GDP structural adjustment, the targeted 0.4 adjustment is compliant with the Stability and Growth Pact, considering the flexibility embedded therein. AIReF has endorsed the macroeconomic scenario underpinning the 2019 DBP, and considers the budgetary provisions feasible, albeit its central scenario estimates point at a slightly higher deficit for 2019 of 1.9 percent of GDP. The authorities will closely monitor budgetary execution throughout 2019 to avoid target deviations. The 2019 draft budget law is scheduled to be brought forward for Parliamentary discussion in December and the authorities are working to obtain the required parliamentary support. It should be noted the Spanish budgetary provisions contemplate the extension of the 2018 budget into 2019 until a new budget is approved, preventing any paralysis or gridlock in public administration.

The fiscal strategy is based both on increasing revenues and better-targeted social and growth-friendly spending. There is room to increase general government revenues considering that the revenue-to-GDP ratio in Spain is estimated to be at 38.5 percent of GDP in 2018, well below the euro area average (46.2). Furthermore, the taxation system is partly outdated, with the bases of some taxes having been considerably eroded over the past few years and new forms of economic activity not contributing according to their revenue-generating capacity. The 2019 DBP projects this ratio to go up to 39.1 percent, because of both cyclical factors and an estimated €5.7 billion in new discretionary measures, which have been designed considering their revenue stream, progressivity, and environmental impact. They include, among others: a reform of the corporate income tax to ensure a minimum effective rate of 15 percent, increases in personal income and wealth taxes for the higher brackets, new taxes on financial transactions and certain digital services, increased taxation on diesel (environmental tax), and legal reforms to reduce tax fraud and tax evasion. The expenditure-to-GDP ratio is expected to go down to 40.9 (from 41.2 in 2018), as expenditures will grow at a slower pace than nominal GDP. The budget includes a reorganization of expenditures and a new package of up to €4.3 billion tailored to enhance social cohesion and productivity growth, including: an increase in long-term care expenditures, the reinstatement of the unemployment subsidy for workers over the age of 52, the progressive equalization of paternity leave to current maternity leave, or increases for scholarships and R&D&I expenditures.

The pension system reform needs a comprehensive approach. The authorities share the staff's view on the importance of a pension system that is both financially and socially sustainable. Last May, due to strong social demand, the previous government decided upon an increase in pensions in line with inflation for 2018 and 2019, above the legal provision of a 0.25 percent annual increase. This decision has later been endorsed by all political parties at the “Pacto de Toledo” (the Parliamentary committee dedicated to the pension system) with the aim of recovering pensioners' purchasing power. The authorities are well-aware of the budgetary implications that this measure would potentially have in the long-run and are approaching the necessary pension reform from the comprehensive perspective embedded in the Pacto de Toledo's twenty-one policy recommendations (sources of finance, contribution rate, non-contributive pensions, pensionable earnings) with a view to attaining a sustainable system in the long run.

Further steps to strengthen regional finances have been adopted and gender budgeting has been introduced. The government has set up a decision group to advance in the reform of regional financing and to reinforce regional compliance with deficit targets. New measures include establishing the procedure for a gradual return to market financing of financially-sound regions, the long-term refinancing of short-term, and better incentivizing compliance with a new spending rule that allows investment of regional surpluses, but only in financially sustainable investments. The 2019 DBP plan introduces gender budgeting which evaluates the gender impact of the different budget items and reinforces those with larger potential to reduce gender inequality.

b. Labor market policy

Labor market policies seek to continue reducing unemployment as well as addressing problems of labor market duality or in-work poverty, among others. Unemployment remains well-above euro area average, not only in aggregate ratios (14.9 percent vs 6.7 percent) but also for youth (33 percent vs 14.6 percent) and long-term unemployment (6.6 percent vs 3 percent). The rate of temporary contracts at 26.8 percent remains the highest in the EU. In parallel, productivity gains have not been fully translated into wage increases. Furthermore, the share of workers at risk of poverty is the second highest in the euro area. Addressing these labor market deficiencies is crucial to the objectives of productivity growth and reducing inequality.

These objectives require a multifaceted approach. The authorities share staff's view that a comprehensive approach should be pursued when addressing labor market reform including, for instance, the reinforcement of the education system and active labor market policies to increase human capital and address skill mismatches—here, the Government has announced new legislation to develop a dual vocational training model and to enhance the digital and language skills of the youth, while employment subsidies will be revised and reduced to focus only on the most vulnerable groups.

There is also a need to fine-tune labor market regulation to promote better-quality employment, including through increasing the minimum wage. The last reform dates back to 2012 and was designed in a context of recession. New measures will include streamlining the number of contractual modalities, as well as new requirements to register working time to avoid an inadequate use of part-time contracts. The authorities are also assessing collective bargaining taking into account its impact in a wide range of labor market outcomes, such as wages, employment, productivity or job environment, and have already introduced some measures such as the increase of the minimum wage to €12,600 in 2019, as well as measures to fight against excessive rotation in the workplace (the so-called “Master Plan for Decent Work,” launched in July 2018 with significant effects already in the very short-term). The authorities take note of the staff's caveats with respect to the increase in the minimum wage, that said:

- **The minimum wage is currently very low in Spain and previous experience suggests that raising it will likely have no substantial impact on job creation.** The minimum wage remained flat during the period 2010-2016 and the proportion of the minimum wage over the mean wage, at only 33 percent, is among the lowest within the OECD. The announced increase would raise this ratio to around 40 percent, in line with the OECD average. There is no consensus in the literature on the employment effects of the minimum wage. While, on average, studies tend to show small negative effects on employment, these are often not significant, and the results are not robust to alternative specifications. In this respect, the experience in Spain shows a large absorption capacity of increases in minimum wages, especially in high growth periods: the increases of 2004 (11 percent) and 2017 (8 percent) were consistent with an acceleration of job creation in the following years, particularly significant in the case of youth employment. In parallel, the empirical evidence suggests a

positive impact on domestic demand stemming from the increased consumption of minimum wage workers, as well as a reduction in poverty rates.

c. Structural reforms

The root causes of low productivity growth in Spain are multifaceted, including deficiencies in education, the prevalence of micro and small firms, or an insufficient investment in R&D. In Spain the share of young adults (25-34 years old) below upper secondary education is 33 percent, way beyond the OECD average of 14 percent, which partially explains the high share of low-skilled workers in the labor force. R&D investment is comparatively low, since 2000 the ratio of R&D spending over GDP has averaged 1.2 percent of GDP, which is well below its European peers. Additionally, the contribution of micro and small-sized enterprises (with lower average productivity levels) to employment in the non-financial business sector in Spain was 59.5 percent, almost 10 pp above the EU average.

In this context, the authorities are committed to devising a comprehensive strategy cutting across different policy dimensions and with an adequate sequencing. In this vein, we thank staff for providing particularly useful regional analysis in the areas of labor mobility and productivity, with some interesting policy implications in the fields of education, labor mobility, R&D spending, and ALMPs. The 2019 DBP aims to increase outlays on education and R&D spending. Additionally, the authorities are considering measures to improve the business environment (by removing obstacles to business growth and start-up creation) and to enhance the application of the Market Unity Law, strengthening the degree of coordination among regions. Other measures include the deployment of the 5G National Plan and regulatory changes in the pipeline to improve the functioning of some network industries, such as railways or energy.

Environmental and gender policy issues also rank high in the Government's agenda; staff's insights on these policy areas would be welcomed. These policies are not only key for achieving an equitable society from an intergenerational and a gender point of view and are also instrumental to improving productivity and long-term potential growth. The authorities are drafting a new comprehensive Law on Climate Change and Energy Transition to steer the transition towards a low-carbon economy. This could lead to higher growth given Spain's competitive edge on renewable energies. On gender policy, the gender perspective of the 2019 DBP aims for greater gender inclusion. Furthermore, eliminating gender pay gaps also has a high potential growth impact by raising women's participation rates. *For future Article IV reports authorities would welcome further staff analysis on these areas profiting from their comparative advantage in drawing from international practices.*

d. Financial sector

Spanish banks are steadily increasing their resilience. The Spanish banking system has made important efforts for reducing the volume of impaired assets in the last few years. Thus, non-performing loans have diminished by 60 percent compared to 2013, when they reached a peak, and foreclosed asset have been cut by 40 percent since its ceiling in

mid-2012. This adjustment has been a crucial contributor to the recovery of profitability, that now is above the European average, although it is still reduced from a historical perspective. In this context, solvency ratios are well above the regulatory standards; in fact, compared to December 2014 (the first full year of application of Basel III prudential standards), in 2017 capital ratios had increased by almost 2 pp for total capital (up to 15.4 percent), and by roughly 1 pp in highest quality CET1 capital (up to 12.7 percent). The recently released 2018 EU-wide stress tests produced by the European Banking Authority (EBA) reflect this resilience and capacity to withstand tail risk scenarios. The authorities share staff's view on the importance of continuing to strengthen bank capitalization to close the remaining gap with European peers. They also share staff's views on the need for continued vigilance of growth in consumption credit and property prices, which nonetheless remain contained. On the exposure to emerging markets, as highlighted by staff, Spanish banks operate with an autonomous subsidiary model, whereby subsidiaries are self-financed and do not receive intragroup support. Moreover, parent banks hedge against most exchange rate risks.

The authorities are stepping up the reform of the institutional set-up of surveillance, including through the creation of a national macroprudential authority and a fintech regulatory sandbox. The government has announced the creation of a national financial stability authority (ANESFI), which complies with the 2011 ESRB recommendation to create a macroprudential authority. The projected new authority will be comprised of representatives from the Ministry of Economy and Business, Banco de España and CNMV, and it will be empowered to issue opinions, warnings and recommendations. Macroprudential tools will remain under the responsibility of the sectoral supervisors while, following the recommendations under the 2017 FSAP, the toolkit of Banco de España will be expanded to include borrower-based measures, sectoral countercyclical buffers and limits to sector credit concentration. The government has already closed a public consultation on a draft Law to establish a Regulatory sandbox to allow FinTech startups and other financial entities to conduct live experiments in a controlled environment under regulatory supervision.