# Spain: Staff Concluding Statement of the 2022 Article IV Mission

November 23, 2022

**Washington, DC:**

***Economic Outlook***

**The Spanish economy continues to recover from the COVID pandemic, but it is facing new headwinds from Russia's invasion of Ukraine.** The unprecedented public support measures in 2020–22 have helped protect firms and households. The labor market recovery in 2022 has been robust, with employment exceeding its pre-pandemic level. Tourism and other services have performed especially strongly. However, the sharp rise in global energy and food prices, the slowdown of activity in Spain's trading partners, the deterioration of consumer and business confidence, and tighter financial conditions have slowed the recovery of output.

**The high inflation over the past year has been largely caused by surging energy prices and persistent supply constraints.** Headline inflation has declined from double-digit levels in the summer to 7.3 percent in October, largely reflecting the drop in European gas prices and the impact of the Iberian mechanism. Core inflation – a measure of price changes excluding energy and unprocessed food prices – remains elevated at around 6 percent, driven by a gradual passthrough of higher energy costs to broader prices and, possibly, diminishing spare capacity in the economy. So far, there have been no signs of a wage-price spiral as wage growth has been contained, but the share of workers affected by wage agreements with indexation clauses has ticked up. The increase in the price of imported energy is a negative terms-of-trade shock for the Spanish economy. The loss of purchasing power due to this shock cannot be avoided and will have to be absorbed through temporarily lower real incomes of households and firms. A broad agreement to share income losses across society (*pacto de rentas*) could reduce the risk of inflation persistence.

**Economic growth is projected to reach 4.6 percent in 2022 and 1.2 percent in 2023.** Growth is expected to be relatively weak in the coming quarters reflecting weak external demand and the deterioration of consumer confidence. Activity should pick up in the course of 2023, supported by further easing of supply constraints, continued recovery in contact-intensive services and the acceleration of Next Generation EU (NGEU) investment spending. Output is projected to reach its pre-pandemic level by early 2024. Headline inflation is expected to moderate gradually in 2023 reflecting a high base in 2022, the reduction of supply bottlenecks, and some normalization of global fossil fuel prices. Nevertheless, both headline and core inflation are likely to remain above the 2-percent target until 2024.

**Uncertainty around the outlook is high and risks are mostly to the downside.** Risks to energy security are relatively low given Spain's limited dependence on Russian gas and well-developed liquified natural gas infrastructure. The main downside risk is a possible further increase in energy prices caused by either continued disruptions in supply or insufficient adjustment in demand in the European energy market. Other risks include a more abrupt slowdown of the global economy or a sharper tightening of financial conditions, for instance due to a larger-than-anticipated increase in monetary policy rates in response to more persistent inflation in the euro area. On the upside, a faster unwinding of households' accumulated excess savings could boost private consumption.

***Energy Policies***

**The prompt rollout of public support has mitigated the impact from the steep rise in energy prices, although greater targeting of the measures would be desirable.** Several measures, including the expansion of the electric and thermal social bonds, the increase in the minimum vital income, and the sectoral direct aid for firms, have been appropriately targeted to the most vulnerable at a relatively low fiscal cost. Spain has also put in place an innovative cash-transfer program to provide support to lower-income households not covered by the minimum vital income. Nonetheless, similar to other European countries, most of the fiscal support has gone to measures that are untargeted and distort price signals, such as electricity tax reductions and fuel rebates. The latter have been fiscally costly, with benefits accruing disproportionately to higher-income households. The Iberian mechanism lowers electricity prices and therefore somewhat reduces incentives to adjust demand, but unlike most other measures that affect prices, it does not impose a fiscal cost.

**With gas prices likely to remain well above pre-crisis levels for some time, support policies should adapt to provide the right incentives to reduce demand and increase supply, while containing fiscal costs.** Direct transfers, for example in the form of lump-sum vouchers (ideally linked to income or household size), would be preferable to measures that reduce prices. Other possible measures that preserve price signals to a large extent include block tariffs (which increase with the amount of energy used) and/or further expanding social tariffs (discounts for vulnerable households, such as the Spanish *bono social*). These measures can be made more progressive by recouping the support from higher-income households through the tax system. Keeping the corporate support measures targeted is appropriate. Over the medium term, continued progress to overcome fossil fuel dependency and to increase energy efficiency would be needed to ensure energy security and bring energy prices down in a sustainable way.

***Fiscal Policies***

**Public finances continued to improve in 2022, but public debt remains high and sustained consolidation effort would be needed to rebuild buffers.** The government's response to the pandemic was very effective but also costly: public debt was 118 percent of GDP at the end of 2021. The expected reduction in the fiscal deficit in 2022 is driven by strong revenues and the withdrawal of Covid measures, which more than offsets the cost of the energy measures. Revenue performance has been supported by the recovery in activity, high inflation, a buoyant labor market, and a relatively high elasticity of revenue to output. The latter could be temporary in nature, and it is prudent to assume that it would come down over time, at least partially. The impact of inflation on several expenditure items, such as pension payments, will not materialize until next year. Moreover, the need for support to mitigate the impact of high energy prices would likely extend into 2023. In addition, the sustained rise in interest rates will increase the share of resources devoted to debt payments over time, narrowing the fiscal space. Over the longer term, rising spending on age-related programs due to demographic changes would put further strain on public finances. For all these reasons, it is important to implement a steady multi-year fiscal consolidation that would create space to respond to negative shocks in the future.

**Starting discretionary fiscal consolidation in 2023 will help boost investors' confidence and contain inflationary pressures.** In the context of diminishing spare capacity in the economy and rising financing costs, a moderate reduction in next year's primary structural fiscal deficit—by one quarter to one half percentage point of GDP—is recommended to help ease price pressures and reinforce commitment to fiscal discipline. The increased use of NGEU funds, which is deficit-neutral, could offset the negative impact of consolidation on growth. The draft budgetary plan envisages a reduction of the structural deficit by 0.3 percentage points. This pace of consolidation is broadly appropriate, although there are implementation risks since it relies in part on continued strength in revenues and on lower spending on energy support in 2023. The full extent of energy measures in 2023 is yet to be defined: moving away from broad to more targeted measures could indeed provide savings relative to the current year. Increasing the consolidation effort to at least 0.6 percentage points per year starting in 2024 would set debt on a firm downward path and help achieve a close-to-balanced structural fiscal position (consistent with Spain's national fiscal framework) by the end of the decade. The consolidation effort will ultimately be guided by the reformed EU fiscal framework once it is implemented.

**With energy prices expected to remain high next year, raising additional temporary revenues to fund support for the most vulnerable is welcome, but monitoring of the impact of the measures is warranted.** The budget proposes raising taxes temporarily for corporations and high-income households that have been less affected by the energy crisis, to fund support for the most vulnerable, which is appropriate. The new levies for the energy and banking sectors are applied on revenues instead of profits, and therefore do not take costs into account. While bank net interest income is expected to increase in the near term in tandem with higher rates, tighter financial conditions and a weaker macroeconomic outlook could have a material impact on costs via an increase in impaired assets in stress scenarios. It will be important to monitor the impact of the levies on credit availability, credit costs, and banks' resilience, as well as on the incentives of energy companies to invest. Finally, these measures should remain temporary and should not be considered substitutes for the necessary medium-term tax reform (see below).

**An early formulation of credible medium-term fiscal plans could help build the necessary social consensus and support investor confidence.** Over the medium term, fiscal consolidation should rely on mobilizing additional revenues and enhancing spending efficiency. A revenue reform could broaden tax bases and strengthen environmental taxes, in line with the recommendations of the expert review of Spain's tax system released earlier this year. Measures that may have a disproportional effect on the low-income population should be accompanied by targeted spending to protect the most vulnerable. To ensure steady progress towards emission reduction goals, carbon pricing can be strengthened in the future, when global fossil fuel prices decline. Spending efficiency improvements should be guided by the spending reviews done by the fiscal responsibility authority (AIREF).

**Additional measures will be needed to offset the increase in future spending resulting from the 2021 pension reform.** The reform permanently indexed pension payments to CPI inflation and repealed the sustainability factor, which is expected to raise annual pension outlays by more than 3¼ percent of GDP by 2050 compared to a full implementation of the previous legislation. Only part of the increase would be offset by other measures adopted in the first phase of the reform. Spain has introduced new measures in 2022, including the reform of the contribution system for the self-employed, and has committed to additional reforms by the end of 2022, including extending the computation period for the calculation of the retirement pension and raising maximum earnings subject to contributions. These measures could have a positive financial effect, but whether they are sufficient to preserve the sustainability of the pension system will depend on the specific design details.

***Financial Policies***

**The financial sector has weathered well the pandemic and the fallout from the war in Ukraine so far.** Private sector balance sheets have continued to strengthen, in line with the recovery in economic activity. Aggregate borrower stress indicators have remained low in 2022 so far, including for publicly-guaranteed pandemic loans. However, credit risks have increased for firms that have been affected by the energy crisis and for lower-income households, which have accumulated less savings and have been more affected (in proportion of their income) by the increase in energy and food prices. House prices have accelerated over the last year, but there is no evidence of a significant misalignment with fundamentals so far. While activation of sectoral macroprudential tools is not necessary at the moment, rising housing prices warrant close vigilance.

**The worsening of the macroeconomic outlook and the tightening in financial conditions will likely erode borrowers' repayment capacity going forward.** Spanish borrowers are highly exposed to rising interest rates, given the high share of variable-rate mortgages (about 75 percent of all mortgages). Higher interest rates are also set to increase firms' financial burden, with a more severe impact for small- and medium-sized enterprises (SMEs). As mitigating factors, most new mortgages in recent years have been extended at a fixed rate, the majority of publicly-guaranteed pandemic loans also have a fixed rate, lending standards have strengthened since the great financial crisis, and households and corporates have deleveraged significantly. Mortgage relief measures, currently under discussion, should be targeted to the most vulnerable households.

**Stress testing exercises suggest that bank capital buffers remain broadly adequate, but close monitoring is needed to ensure continued resilience.** Banks frontloaded provisioning during the pandemic, in anticipation of higher expected losses. While losses have not materialized, the economy is now facing new headwinds. In a context of high uncertainty, supervisors should continue making sure that bank loss recognition is sufficiently forward-looking and that provisioning levels are appropriate. Banks will need to continue taking into account the new macroeconomic context in their capital planning and use the positive near-term impact of interest rates on profitability to further strengthen resilience if needed. If risk scenarios materialize, banks should be encouraged to use capital buffers and be allowed to restore them only gradually. The recent reform to the private debt resolution framework in Spain is comprehensive, incorporating new tools to help resolve financial distress in order to address the unique needs of microenterprises and to align the framework with the European Directive. Strong implementation will be critical, including ensuring sufficient resources for the judicial system.

***Structural Policies***

**Sustained policy focus on raising productivity continues to be important to increase living standards, help rebuild fiscal buffers, and make growth more inclusive.** Spain's levels and growth rates of labor productivity have been lower than in peer economies, which has not favored income convergence. The weaker labor productivity performance relative to peers also holds across sectors, suggesting that cross-cutting drivers—such as prevalence of SMEs, still high incidence of temporary employment, and skill mismatches in the labor market—have played a greater role than sector-specific factors.

**The ambitious structural reform agenda in Spain's recovery plan aims to reduce the barriers to productivity growth.** For example, the reform to the vocational education and training system should help boost the workforce's skills and adapt them to the requirements of the labor market, especially in the context of the green and digital transition. The Startup and Business Growth Laws aim at reducing financial and administrative barriers to firm creation and growth. The success of the comprehensive reform effort, however, will ultimately depend on design and implementation details. Establishing a system of regular, data-driven, outcome-based evaluation of the reforms' effectiveness will be important. Regarding firm growth, further efforts are needed to address the large number of size-dependent regulatory thresholds and the differences in the regulatory frameworks for firms across regions.

**The labor reforms approved in December 2021 are showing positive results in increasing permanent employment, but it is still early to assess their overall impact.** There has been a significant shift from temporary to permanent contracts this year. Continued monitoring of the labor market will be important to determine whether the reforms are delivering the desired outcomes in terms of increasing employment stability while preserving flexibility for firms. Moving forward, it will be critical to revamp active labor market policies (ALMPs) to improve labor matching efficiency and address skill mismatches. The success of the new Employment Law and the reform of hiring subsidies will rely on their ability to reduce Spain's high structural unemployment. Adequate outcome-based evaluation will be critical to determine if the planned ALMPs achieve these goals.

**The use of NGEU funds is gaining speed.** Data on the awarding of tenders, and on transfers of funds to regional authorities and other public entities, suggest that the deployment of NGEU funds has accelerated in 2022. Nonetheless, the lack of systematic and comprehensive information on execution, including in national accounting terms, makes it difficult to assess the extent to which resources are reaching the real economy. Improving coordination at all government levels and with the private sector, and enhancing the collection and reporting of data on investment execution are critical to ensure an effective use of the funds.