INTERNATIONAL MONETARY FUND

IMF Country Report No. 20/298

SPAIN

November 2020

2020 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 2020 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 11, 2020 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 11, 2020, following discussions that ended on September 29, 2020, 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 October 26, 2020.
- An **Informational Annex** prepared by the IMF staff.
- A **Staff Statement** updating information on recent developments.
- 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.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
PO Box 92780 • Washington, D.C. 20090
Telephone: (202) 623-7430 • Fax: (202) 623-7201
E-mail: publications@imf.org Web: http://www.imf.org
Price: $18.00 per printed copy

International Monetary Fund
Washington, D.C.

© 2020 International Monetary Fund

PRESS RELEASE

PR20/339

IMF Executive Board Concludes 2020 Article IV Consultation with Spain

FOR IMMEDIATE RELEASE

Washington, DC – **November 13, 2020:** On November 11, 2020, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Spain.

The COVID-19 pandemic has hit Spain's society and economy severely following five years of strong job-rich growth. Spain experienced the largest contraction in the first half of the year (12.8 percent) among major advanced economies. The magnitude of the drop reflects the scale of the infectious spread, which required strict lockdown measures, and structural features that make the economy more vulnerable to disruptions, such as a high prevalence of small and medium size enterprises, importance of tourism, and widespread use of temporary employment contracts. The gradual relaxation of confinement measures breathed some life into activity during the summer, but the severity of the second wave of infections is worrying.

A suite of income and liquidity support measures has curbed the economic fallout of the pandemic. The short-time work scheme (ERTE) has been critical to limit the impact on unemployment. The banking sector—backed by policy measures such as public loan guarantees and the ECB's accommodative monetary policy—has continued to support the real economy with credit intermediation, in contrast with the global financial crisis. Mitigating the impact on the economy is taking a toll on government finances, with the public debt ratio expected to increase to about 120 percent of GDP in 2020.

Under a baseline scenario without new widespread strict containment measures, activity is forecast to contract by about 12 percent in 2020, and partially recover by about 7 percent in 2021. The recovery rests on a strong rebound in private consumption and a substantial increase in public investment financed mainly by a front-loaded utilization of funds under the EU Recovery and Resilience Facility (RRF). The outlook is highly uncertain, with risks heavily tilted to the downside, and will crucially depend on the containment of the second wave of infections; size, timing, and composition of EU-funded additional spending; as well as on the success of policy measures to mitigate the scarring.

Executive Board Assessment[2]

Executive Directors noted that the COVID-19 pandemic has severely hit Spain's economy and society, causing a tragic loss of lives, higher unemployment, and a sharp economic recession. The recovery will be protracted and subject to significant risks and uncertainty.

---

[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.

[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.

The near-term outlook will crucially depend on the effectiveness of new containment measures and preparedness of the healthcare system.

Directors commended the authorities for their swift and forceful implementation of income and liquidity support measures to mitigate the economic and social fallout of the pandemic. They stressed the importance of continued policy support until the recovery is firmly underway while maintaining flexibility to adapt it to evolving developments. Directors agreed that, as the pandemic recedes, fiscal support should become increasingly targeted at vulnerable groups and viable firms, facilitating resource reallocation toward expanding sectors.

Directors highlighted the urgency of addressing corporate vulnerabilities. They recommended prioritizing targeted equity support to viable firms, with a well-designed exit strategy. They encouraged continued efforts to strengthen private debt resolution frameworks and expand the capacity of commercial courts.

Directors noted the strength of the financial system, which has helped mitigate the economic impact of the crisis. They emphasized the need for continued strong supervision, together with relief measures and prudent dividend policies. Directors welcomed efforts to strengthen the AML/CFT framework. They also encouraged enhancing the crisis management frameworks both at the national and European levels by tackling any shortcomings in the resolution and liquidation regimes.

Directors welcomed the authorities' intention to use European funds to support the near-term economic recovery while promoting a structural shift to a more productive, greener, and digital economy, in line with the policy priorities of the national recovery plans. They stressed the need for efficient coordination, implementation, and oversight of plans.

Directors agreed that, over the medium term, fiscal consolidation will be needed to rebuild buffers and put debt on a downward path. They welcomed ongoing efforts to enhance tax progressivity and revenue collection capacity, and encouraged further pension reforms.

Directors noted that the pandemic has exacerbated already high socio-economic disparities in Spain. They welcomed the efforts to strengthen the social safety net with the introduction of the Minimum Income Scheme. They encouraged more retraining and reskilling for displaced workers, upgrading unemployment benefits, addressing labor market duality, and improving gender equality.

Spain: Main Economic Indicators (October 2019 WEO)
(Percent change unless otherwise indicated)

	2015	2016	2017	2018	2019	Projections 1/ 2020	2021	2022
Demand and supply in constant prices								
Gross domestic product	3.8	3.0	2.9	2.6	2.0	-12.8	7.2	4.5
Private consumption	2.9	2.7	3.0	1.8	1.1	-14.8	9.1	4.8
Public consumption	2.0	1.0	1.0	1.9	2.3	3.7	0.2	1.0
Gross fixed investment	4.9	2.4	5.9	5.3	1.8	-16.2	10.3	4.9
Total domestic demand	4.1	2.1	3.1	2.7	1.5	-11.4	7.2	4.0
Net exports (contribution to growth)	-0.1	1.0	-0.1	-0.3	0.5	-1.7	0.0	0.5
Exports of goods and services	4.3	5.4	5.6	2.2	2.6	-25.5	10.1	12.9
Imports of goods and services	5.1	2.7	6.6	3.3	1.2	-22.3	10.6	11.7
Savings-Investment Balance (percent of GDP)								
Gross domestic investment	19.0	18.8	19.4	20.4	20.8	20.3	20.8	20.9
National savings	21.0	21.9	22.1	22.3	22.8	20.8	21.7	22.1
Foreign savings	-2.0	-3.2	-2.7	-1.9	-2.0	-0.5	-0.9	-1.3
Household saving rate (percent of gross disposable income)	7.2	7.0	5.5	5.9	7.4	13.1	8.2	6.4
Private sector debt (percent of GDP)	222.0	213.0	203.4	196.9	189.8	208.9	195.8	186.9
Corporate debt	149.9	144.2	137.7	133.3	127.6	136.9	126.1	118.8
Household debt	72.2	68.9	65.7	63.6	62.2	72.0	69.7	68.1
Credit to private sector	-4.2	-4.1	-2.0	-3.9	-1.5	2.5	1.4	1.5
Potential output growth	0.6	0.9	1.1	1.3	1.5	-2.5	1.8	1.5
Output gap (percent of potential)	-4.6	-2.6	-0.9	0.2	0.6	-10.0	-5.3	-2.5
Prices								
GDP deflator	0.5	0.3	1.4	1.1	1.6	0.5	0.9	1.4
HICP (average)	-0.6	-0.3	2.0	1.7	0.7	-0.2	0.8	1.4
HICP (end of period)	-0.1	1.4	1.2	1.2	0.8	-0.3	0.8	1.6
Core inflation (average)	0.6	0.8	1.1	0.9	0.9	0.8	0.6	1.4
Core inflation (end of period)	1.0	0.9	0.9	0.9	1.0	0.8	0.6	1.4
Employment and wages								
Unemployment rate (percent)	22.1	19.6	17.2	15.3	14.1	16.8	16.8	15.7
Labor productivity 2/	0.6	0.2	0.0	-0.2	-0.3	-3.6	3.4	2.3
Labor costs, private sector	0.2	0.1	0.7	2.0	2.3	0.6	0.8	1.4
Employment growth	3.0	2.7	2.6	2.7	2.3	-4.9	1.0	2.1
Balance of payments (percent of GDP)								
Current account balance	2.0	3.2	2.7	1.9	2.0	0.5	0.9	1.3
Net international investment position	-88.9	-85.5	-85.5	-80.2	-74.4	-84.0	-75.4	-68.6

Spain: Main Economic Indicators (October 2019 WEO) (concluded)
(Percent change unless otherwise indicated)

	2015	2016	2017	2018	2019	Projections 1/ 2020	2021	2022
Public finance (percent of GDP) 3/ 4/								
General government balance	-5.2	-4.3	-3.0	-2.6	-2.8	-14.1	-7.5	-5.8
Primary balance	-2.6	-1.9	-0.7	-0.3	-0.8	-11.7	-5.1	-3.4
Structural balance	-2.4	-2.7	-2.5	-2.3	-3.1	-8.1	-4.4	-4.3
General government debt	99.3	99.2	98.6	97.6	95.5	123.0	121.3	120.4

Sources: IMF, October 2020 World Economic Outlook; data provided by the authorities; and IMF staff estimates.

1/ The projections incorporate disbursements from the EU Recovery and Resilience Facility amounting to about 1.5 percent of GDP per year in 2021–24.

2/ Output per worker.

3/ The 2020 fiscal projections include the discretionary measures adopted in response to the COVID-19 crisis, the legislated pension and public wage increases, and the minimum vital income support. Fiscal projections from 2021 assume an expiration of temporary COVID-19 measures and no further policy change. Disbursements under the EU Recovery and Resilience Facility in 2021–24 are reflected as receipts in other revenue in the form of grants and spending in public investment.

4/ The headline balance includes financial sector support equal to 0.2 percent of GDP for 2016, and 0.1 percent of GDP for 2017.

INTERNATIONAL MONETARY FUND

SPAIN

STAFF REPORT FOR THE 2020 ARTICLE IV CONSULTATION

October 26, 2020

KEY ISSUES

COVID-19 impact. The pandemic has hit Spain's society and economy severely following five years of strong job-rich growth. A large service sector dominated by SMEs, importance of tourism, and widespread use of temporary employment make the economy particularly vulnerable to the health crisis. It will take several years for the economy to recover, and the outlook is subject to strong downside risks.

Policies. Policies face the daunting task of continuing to support the recovery and reduce long-time scarring, and tackling long-term challenges exacerbated by the pandemic (such as boosting the economy's productive capacity, addressing socio-economic disparities and low bank profitability, and over time rebuilding fiscal buffers). The policy response must remain agile and be upscaled if the outlook deteriorates.

Near-term priorities. New outbreaks of infections need to be controlled to save lives and secure the rebound. Policy support should continue until the recovery is firmly underway to mitigate the risk of the recession morphing into financial sector stress with even higher real and social costs. Continuation of income and liquidity measures, especially the effective short-time work schemes and public loan guarantees, in a targeted and flexible manner is key. Unemployment benefit and social assistance may need to be temporarily enhanced. Corporate sector vulnerabilities must continue to be addressed. Private debt resolution frameworks should be enhanced promptly, and there is also a role for public equity support of viable firms facing pandemic-related strains. Strong supervision as well as macroprudential relief measures and prudent dividend policies need to continue supporting banks' lending capacity and their resilience.

Policies with medium-term impact. The EU Recovery and Resilience Facility is an exceptional opportunity for combining demand stimulus and closing gaps in green infrastructure and human capital investment toward a low carbon emission economy. The EU funds can also ease difficult structural reforms by covering transition costs. Efficient coordination, implementation, and oversight of plans will be critical. Policies to enhance the employability of dislocated workers through better active labor market policies and training and overcoming the segmentation of the labor market remain key priorities for greater social inclusion. Supervisors should ensure that banks pursue credible strategies to resolve NPLs and to remain profitable. A medium-term fiscal adjustment plan and pension reforms are needed to preserve fiscal sustainability.

Approved By
Joerg Decressin (EUR) and Chad Steinberg (SPR)

Before the intensification of the COVID-19 crisis, discussions took place in Madrid during February 25–29 and remotely through March 10, 2020 focusing on the government's pre-crisis policy priorities. A staff Concluding Statement was issued on March 11. As the health crisis and recession unfolded, regular exchanges between the Spanish authorities and IMF staff continued with comprehensive virtual meetings taking place during September 11–29. The staff team comprised Andrea Schaechter (head), Lucy Liu, Jorge Salas, Ara Stepanyan, William Oman, and Nicolas Arregui (all EUR). Svetlana Vtyurina contributed to the earlier discussions. Dora Iakova (EUR incoming mission chief) joined the February and September missions. Pablo Moreno (Alternate Executive Director) and Rosa Moral (Advisor to the Executive Director) attended some of the meetings. Jai-Ryung (Jenny) Lee and Dilcia Noren (EUR) supported the mission from headquarters. The mission met with Vice-President Nadia Calviño, Banco de España Governor Pablo Hernández de Cos, Secretary of State of the Economy Ana de la Cueva, Secretary of State of Digital Transformation and Artificial Intelligence Carmen Artigas, Secretary General of the Treasury Carlos San Basilio, and other senior officials. The mission also talked with representatives of the financial sector, labor organizations, think tanks, and political parties.

CONTENTS

CONTEXT ____ **4**

RECENT ECONOMIC DEVELOPMENTS ____ **6**

OUTLOOK AND RISKS ____ **10**

POLICY AGENDA ____ **14**

A. Fighting the Pandemic ____ 14

B. Nurturing the Recovery and Making the Economy More Sustainable and Resilient ____ 17

C. Addressing Long-Term Consequences of the Pandemic ____ 21

STAFF APPRAISAL ____ **27**

FIGURES

1. Real Sector and Inflation 30
2. High Frequency Indicators of Real Activity 31
3. Labor Market Developments 32
4. External Sector 33
5. Tourism Indicators 34
6. Credit Development and Financial Cycle 35
7. Banking System Performance 36
8. Public Finances 37
9. Selected Indicators of Social Outcomes 38

TABLES

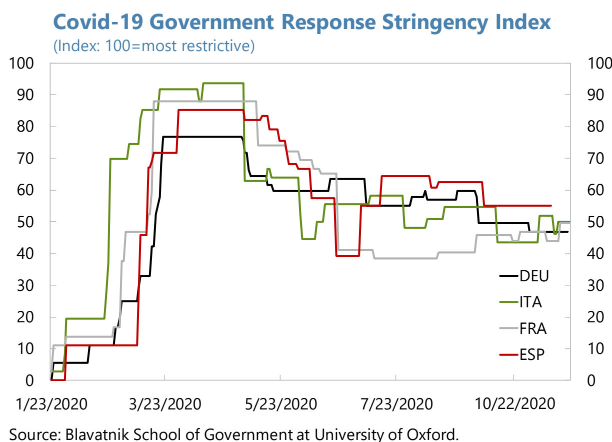
1. Main Economic Indicators, 2016–2025 39
2a. General Government Operations, 2016–2025 (billions of euro) 40
2b. General Government Operations, 2014–2025 (percent of GDP) 41
3. General Government Balance Sheet, 2010–2019 42
4. Selected Financial Soundness Indicators, 2010–2019 43
5. Balance of Payments, 2016–2025 44

ANNEXES

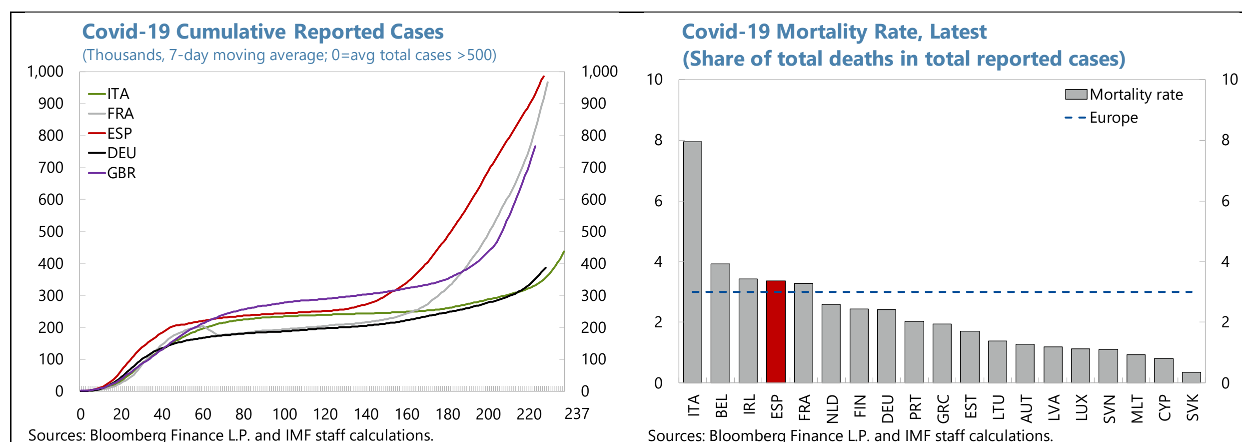
I. Main Recommendations of the 2018 Article IV Consultation and Authorities Actions 45
II. External Sector Assessment 47
III. Risk Assessment Matrix 49
IV. Debt Sustainability Analysis 51
V. Fiscal Measures in Response to COVID-19 64
VI. Key Income Support Programs 66
VII. Upgrades to Financial Sector Risk Management and Public Sector Governance 69
VIII. External Adjustment in Spain: Becoming More Resilient to External Shocks 70

CONTEXT

1. Spain is one of the hardest hit countries by the global coronavirus pandemic. Following a first wave of infections in March and April that caused nearly 28,000 deaths and severely strained the health care system, a second larger wave has spread since mid-July. While fatality rates have remained much lower, hospitalization rates increased again markedly in some regions against the backdrop of uneven regional containment measures taken. From October, the government launched criteria and a new state of emergency on October 26 in an attempt to legally cover more stringent restrictions and better coordinate responses by the regions which have responsibility for public health policy. During the first wave the government centralized health care measures as it declared a state of emergency during March 14 to June 21. It enacted strict movement restrictions for eight weeks, locked land borders, closed restaurants, shops and entertainment venues, and halted all non-essential activities from March 30 to April 10.[1] From May 10, activity and movement restrictions were gradually eased until some regions redeployed targeted and more limited new restrictions from late summer.



Source: Blavatnik School of Government at University of Oxford.



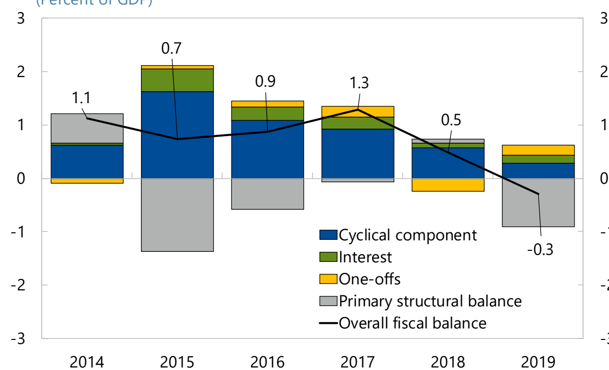
Sources: Bloomberg Finance L.P. and IMF staff calculations.

Sources: Bloomberg Finance L.P. and IMF staff calculations.

2. The pandemic struck the economy after five years of strong growth and job creation during which little progress was made to rebuild fiscal buffers. GDP growth exceeded that of the euro area average by nearly 1 percentage point annually during this period and unemployment dropped by nearly 10 percentage points (Figure 3). Nevertheless, social inclusion gaps narrowed rather slowly and remained higher than in European peers (Figure 8). Moreover, the reduction of the headline fiscal deficit, which during 2015–18 was primarily driven by the strong economic recovery

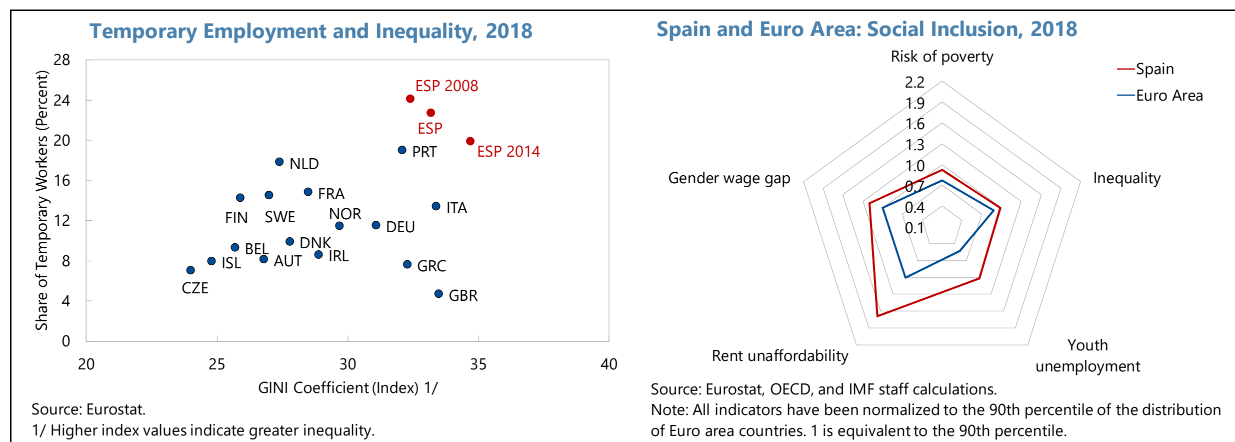
[1] Bank of Spain analysis suggests that infections were controlled fastest in municipalities with the most stringent sectoral shutdowns (Gutierrez, E., and E., Moral-Benito, 2020, "Containment Measures, Employment and Spread of COVID-19 in Spanish Municipalities," Banco de España.)

and lower interest rates, came to a halt in 2019 (text chart) as the headline deficit widened slightly to 2.8 percent of GDP. The primary structural balance loosened by nearly 1 percent of GDP, reflecting largely increases in public salary and pension spending and a small structural deterioration in tax collections (Table 2). Thus, Spain entered the COVID-19 pandemic with an estimated structural deficit of about 3 percent of GDP and a public debt ratio (at about 96 percent of GDP at end-2019) just 5 percentage points below its peak following the European debt crisis.



Sources: Ministry of Finance and IMF staff calculations.

3. The severe economic contraction is exacerbating high income inequality and further straining public finances. Spain has one of the highest shares of temporary employment in Europe. Employees under fixed-term contracts—many of whom work in the hard-hit tourism and hospitality sectors—are bearing a disproportionally high burden of the crisis. As the already elevated public debt is being pushed up further, a key challenge over the medium term will be to maintain sustainable public finances and fairly share the adjustment and financing burden.



Source: Eurostat.
1/ Higher index values indicate greater inequality.

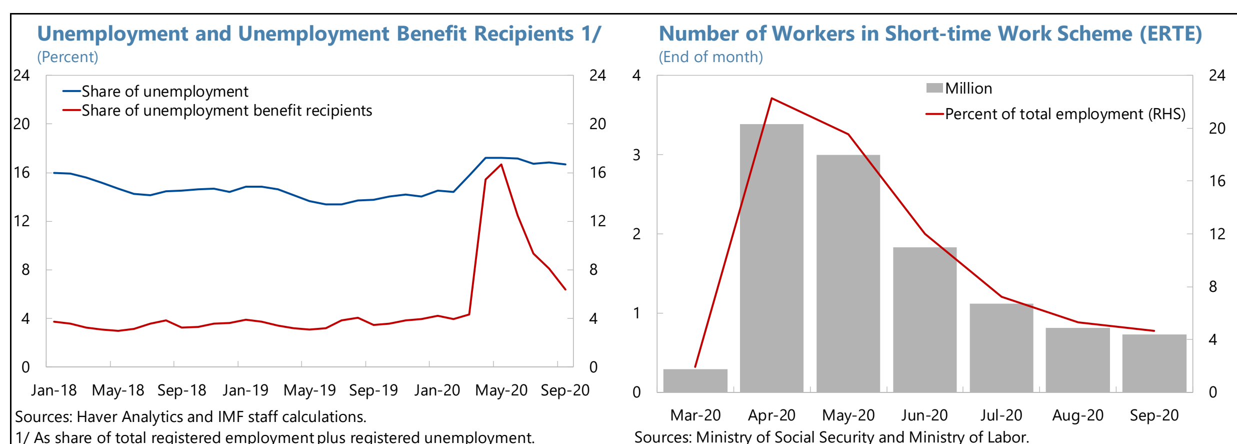
Source: Eurostat, OECD, and IMF staff calculations.
Note: All indicators have been normalized to the 90th percentile of the distribution of Euro area countries. 1 is equivalent to the 90th percentile.

4. After its initial crisis response, the government aims to orient the recovery process toward its medium-term social inclusion and climate-friendly agenda. Before the coronavirus outbreak, the coalition government of Socialist Party (PSOE) and Unidas Podemos, which took office in January 2020, had set out its key priorities of enhancing social inclusion and addressing new socio-economic challenges—including digitalization and climate change. The government is committed to pursuing these goals as part of the recovery strategy from the COVID-19 crisis, supported by resources from the EU Recovery and Resilience Facility.

RECENT ECONOMIC DEVELOPMENTS

5. After a massive fall in GDP, the gradual relaxation of confinement measures breathed some life into activity, but the second wave of infections has put a lid on the recovery. The lockdown measures, combined with supply disruptions and confidence effects, pushed the economy into a deep recession. Real GDP declined by 12.8 percent (y-o-y) in the first six months. This is the sharpest drop among major advanced economies (Figure 1). Domestic demand was the main culprit for the plunge in activity. Net exports also declined shaving about 1.6 percentage points off the annual growth in the first half of 2020. Since mid-May several high frequency indicators had displayed upward trends from very depressed levels. However, with the second wave of infections, many activity improvements have stalled or reversed in August and September (Figure 2). Core inflation, after remaining broadly stable around 1 percent (y-o-y) until June, declined to 0.3 percent during July–August. And the sharp fall in oil prices pushed headline inflation into negative territory (Figure 1).

6. Following significant job losses in March-April, the labor market partially recovered. Social security affiliated employment regained in June-September, though it was still more than 2 percent below the level in September 2019 (Figure 3). Temporary employment accounted for most of the job losses. Across industries, the construction and service sectors were hardest hit, together accounting for about 90 percent of the employment losses in March-September. At the height of the crisis, nearly 17 percent of the labor force was supported by unemployment benefits, almost four times higher than the pre-pandemic level.[2] The surge in the claims for social protections reflects both the increase in unemployment and the expanded coverage of the ERTE program (Spain's short-time work scheme, see Annex VI). At the peak of the take-up, nearly 3.4 million workers or 22 percent of the total employees (excluding the self-employed) had temporarily suspended contracts or worked reduced hours. The number of ERTE workers has since came down and stood at about 720,000 at end-September.



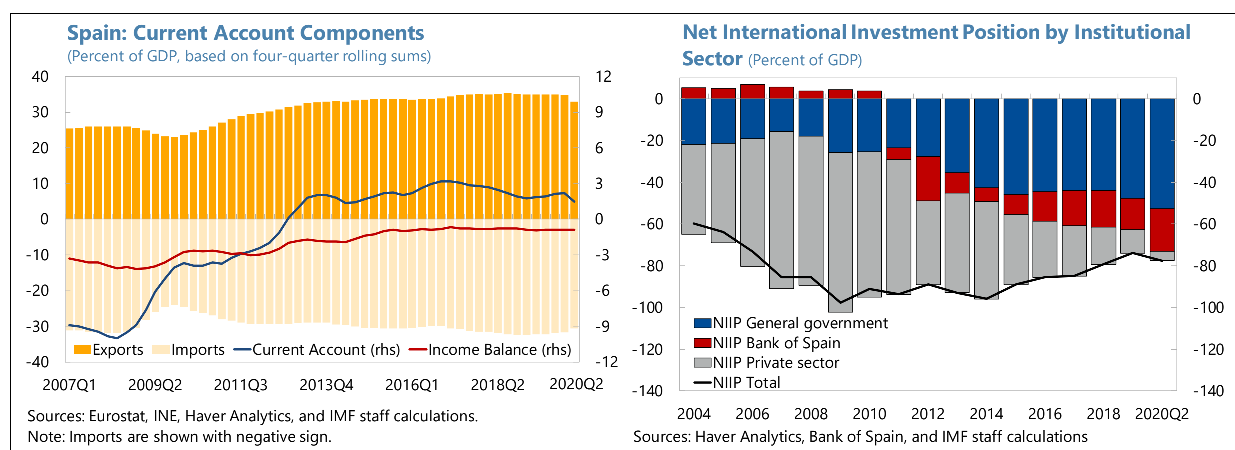
Sources: Haver Analytics and IMF staff calculations.
1/ As share of total registered employment plus registered unemployment.

Sources: Ministry of Social Security and Ministry of Labor.

[2] The low coverage is possibly due to both the eligibility criteria and the relatively large share of long-term unemployed. Spain's contributory unemployment benefit has a minimum contribution requirement of 360 days during the six years prior to becoming unemployed. The duration of the benefits varies between 120 and 720 days, depending on the length of the contribution time.

7. The current account remained in surplus in 2019, but the crisis has severely hit trade flows. The current account surplus was about 2 percent of GDP in 2019, close to the 2018 outturn.[3] But the COVID-19 crisis swiftly impacted trade flows. During March-June 2020, total exports and imports dropped by 34 and 29 percent, respectively (y/y). The effect on tourism, a key export-oriented sector that accounts for over 12 percent of Spain's GDP, was particularly hard as tourism receipts plunged by more than 90 percent (y/y) over March-June (Figures 4, 5). Foreign-tourism activity slightly recovered in July, when the number of tourist arrivals was around 75 percent lower compared with the previous year. But the resurgence of the virus is hurting this recovery.

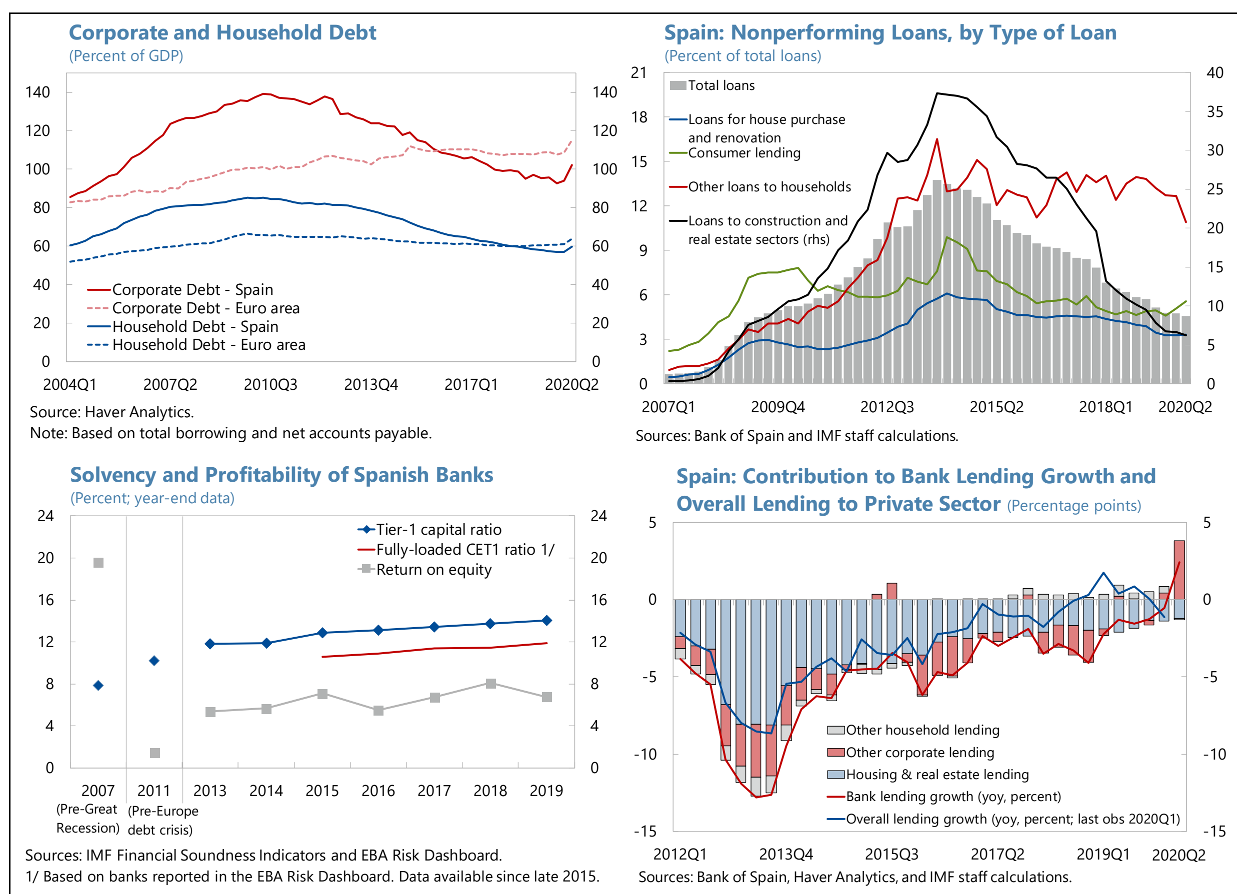
8. The net international investment position (NIIP) continues to be highly negative. Though improving in recent years, the NIIP amounted to minus 78 percent of GDP in 2020:Q2. While the NIIP-to-GDP ratio stands close to its pre-GFC value, its sectoral composition has changed: the share of the NIIP accounted for by the public sector increased from nearly 16 percent in 2006 to almost 85 percent in 2019, reflecting higher net liabilities against the rest of the world held by the general government and the Bank of Spain as well as significant deleveraging of the private sector. While taking into account external risks from Spain's large net debtor position, staff's assessment of the external position in 2019 improved to broadly consistent with medium-term fundamentals. The 2019 current account gap was assessed at -0.8 to 1.2 percent of GDP and the REER gap was estimated at -4.9 to 3.1 percent (Annex II). On a preliminary basis and adjusting for transitory factors, recent developments suggest a moderately weaker overall external position in 2020 compared to 2019. However, this assessment is highly uncertain given the lack of full-year data for 2020 and the COVID-19 crisis, and a complete analysis will be provided in the 2021 External Sector Report. A new study of Spain's external sustainability suggests that some moderate REER depreciation over the next few years might help ensure that the external position remains on a sustainable path (Annex VIII).



9. The private sector, including banks, entered the crisis with stronger balance sheets than a decade ago. Households and, especially, corporates have significantly deleveraged in recent years.

[3] Historical revisions to balance of payments data, notably including upward changes in tourism receipts, show that current account surpluses in recent years were higher than reported earlier—the annual average surplus over 2013–18 was revised from 1.5 to 2.3 percent of GDP. For details, see Bank of Spain's (2019) statistical note.

However, some groups of agents remained over-indebted, including segments of SMEs and low-income households. The banking system has also built important buffers and is stronger than before the 2008/2012 crises (Figure 7). By 2020:Q2 the aggregate NPL ratio was very close to the EU average. The Tier-1 capital ratio has clearly strengthened over the past decade. Nevertheless, the average Common Equity Tier 1 (CET1) ratio is still among the lowest in the euro area. And profitability challenges persist amid low-for-long interest rates. Facing higher credit risk, in 2020:H1 the six largest Spanish banks unveiled €14bn in loan-loss provisions, more than double the level in 2019:H1. Frontloaded provisions, together with some goodwill impairments, have contributed to erode profits. A recently announced merger by two major banks will create Spain's largest domestic bank. Supported by public loan guarantees, new loans to firms strongly increased in the wake of the coronavirus shock and bank lending to the private sector recorded positive annual growth rates for the first time in many years (Figure 6).



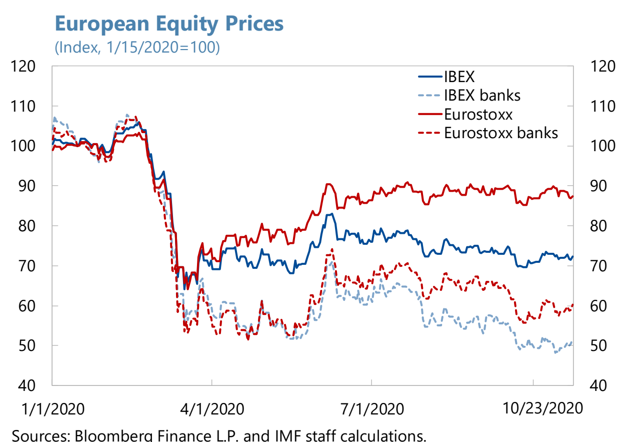
Source: Haver Analytics.
Note: Based on total borrowing and net accounts payable.

Sources: Bank of Spain and IMF staff calculations.

Sources: IMF Financial Soundness Indicators and EBA Risk Dashboard.
1/ Based on banks reported in the EBA Risk Dashboard. Data available since late 2015.

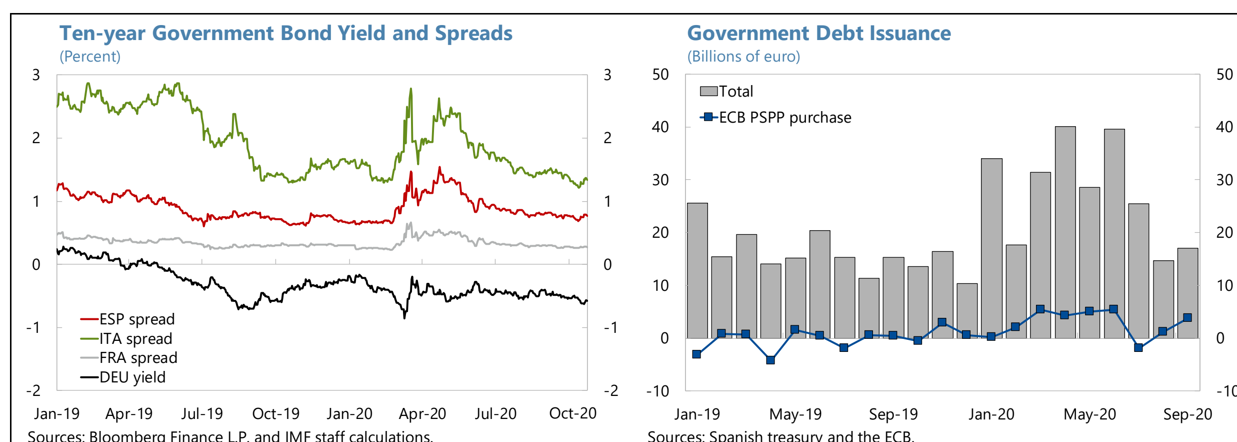
Sources: Bank of Spain, Haver Analytics, and IMF staff calculations.

10. Following a sharp initial correction, financial conditions in the corporate sector remain slightly tighter than pre-crisis, and prices in some real estate segments have declined. The onset of the crisis led to major corrections in European and Spanish equity markets. Following the twenty-one-month record levels reached in early 2020, Spanish stock market indices experienced historic declines of around 40 percent in February and March. Bank equity prices corrected even more sharply at around 47 percent but have since broadly stabilized, while the increase in banks' bond funding costs has been partly reversed. Corporate credit risk premia in Spain and the euro area remain high. As of June 2020, around half of Spanish companies' ratings had a negative outlook or were being reviewed for downgrades, according to Moody's. Against a backdrop of slowing residential activity and house prices some months before the crisis, house price growth decelerated further in 2020:Q2, with commercial real estate prices in nonprime areas experiencing a decline.



Sources: Bloomberg Finance L.P. and IMF staff calculations.

11. Financing costs for the government rose initially but came down in recent months. The 10-year sovereign bond yield reached a one-year peak in mid-March, with the spread over the German benchmark widening by more than 80 basis points from the average in February. But with a sharp drop in domestic consumption and investment and thanks to the expansion of ECB's asset purchase programs, the spread narrowed subsequently, and dropped in September/October below the 2019 average. The government front loaded its debt financing, issuing €165 billion of public debt during March to July, of which more than 11 percent was bought by the Eurosystem through the public sector purchase programme (PSPP).



Sources: Bloomberg Finance L.P. and IMF staff calculations.

Sources: Spanish treasury and the ECB.

OUTLOOK AND RISKS

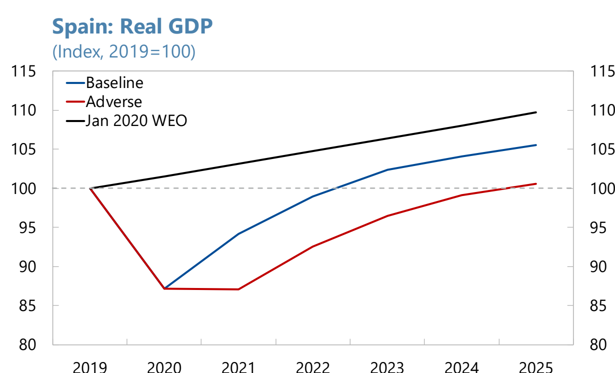
Overview

12. In 2020 the Spanish economy is projected to record its worst performance in the last half a century. With the reopening of the economy, only a gradual recovery is expected in the second half of 2020 in light of the second wave of infections. Therefore, real GDP for the year could shrink by 12.8 percent. The unemployment rate could rise to around 17 percent on average in 2020 despite the strong employment support program. The impact would be even more negative if the virus spread and associated containment measures become broader. Headline and core inflation are projected to decline to -0.2 and 0.8 percent respectively in 2020 before gradually recovering in 2021.

13. It will likely take several years to reach the pre-pandemic output level, and risks are strongly tilted to the downside. In the near term, a further pick-up in activity will be closely intertwined with the capacity to limit new infections. The baseline scenario assumes some persistence in social distancing, which is consistent with limited and targeted lockdown restrictions (by sector and region). For 2021 staff projects real GDP to grow by 7.2 percent, helped by the utilization of the EU Recovery and Resilience Facility (RRF) and its confidence effects. The recovery in 2021 is projected to come from a strong rebound in private consumption and a substantial increase in public investments financed mainly by EU grants. The latter will depend on the size, timing, and composition of EU-funded additional spending, for which plans are being prepared (staff baseline projections assume additional spending of about 1¼ percent of GDP in 2021 out a total grants package of about 7 percent of 2020 GDP). In the medium term, external demand is expected to increasingly support growth as exports recover and foreign tourists return in larger numbers to Spain. The outlook for 2021 and the medium term depends also on the success of policy measures to mitigate the scarring to the economy. All of these supporting factors are highly uncertain, reflecting a combination of public health and economic factors inherently difficult to predict. Overall, real GDP is projected to reach its end-2019 level only in 2023 while unemployment could stay elevated.

14. A failure to control new outbreaks would delay the recovery. An illustrative downside scenario assumes new economic disruptions and a tightening of financial conditions associated with heightened concerns about firms' balance sheets. Fiscal policy is assumed to provide similar but more extended support as in the baseline under broadly unchanged financing conditions. Under such circumstances real GDP would be stagnant in 2021, that means it would be 7.3 percentage points below the baseline outlook. The economy would experience an additional 4½ percent cumulative output loss over the medium term (text chart).

Spain: Real GDP
(Index, 2019=100)

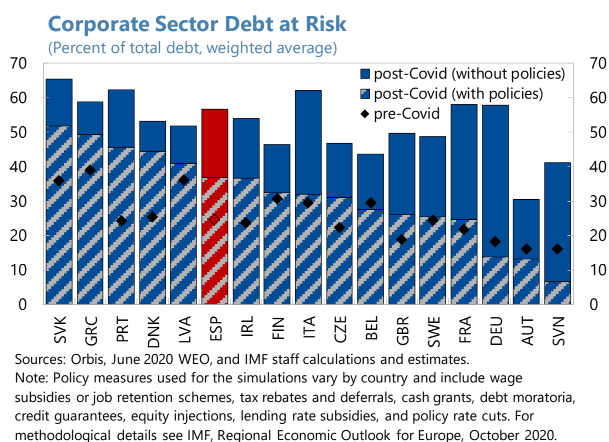


Sources: WEO and IMF staff calculations.
Note: The adverse scenario assumes new severe disruptions and tightening of global financial conditions in 2021.

Sector-Specific Outlook and Risks

15. Despite weaker tourism receipts the current account is forecast to remain in surplus, but this forecast faces considerable uncertainty, especially in the near term. Under the baseline projections, tourism receipts are weak even beyond 2020, which significantly contributes to the expected decline in the current account surplus. But two main factors help offset the impact of tourism losses on the current account: subdued imports, reflecting domestic demand and low oil prices, and relatively resilient exports of goods as global trade gradually recovers. Risks around the current-account baseline projection are assessed as tilted to the downside, compounded by trade tensions and possibly a disorderly Brexit. Should these risks materialize, the projected NIIP-to-GDP ratio could face a larger and more protracted setback than that assumed under the baseline.

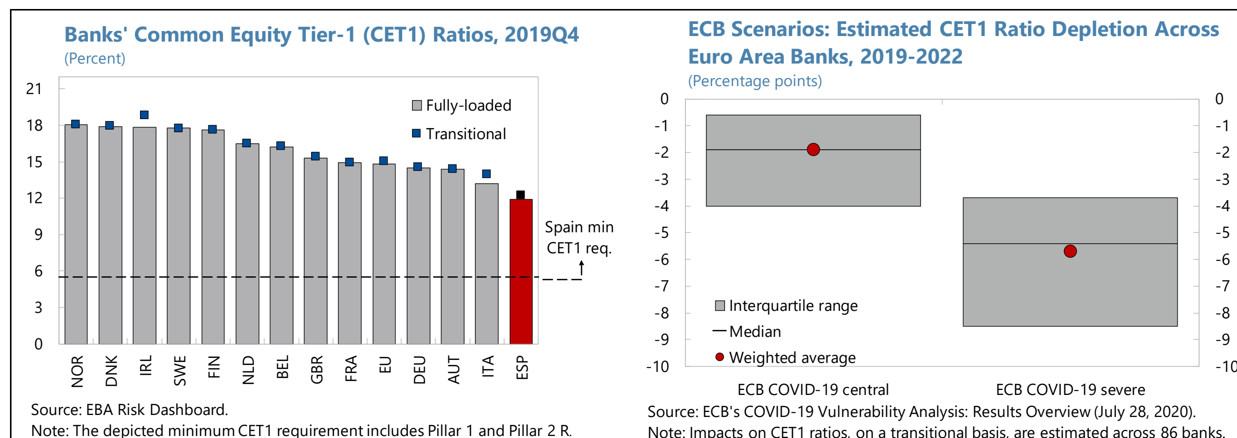
16. While starting from a relatively strong position, nonfinancial corporations face significant risks. IMF research (IMF, Regional Economic Outlook for Europe, October 2020) finds that, before the pandemic, Spain had a relatively strong starting position, with less than 30 percent of vulnerable firms, with vulnerability defined by an interest coverage ratio below one. Leverage was contained, with a median leverage ratio close to one. Simulations suggest that without policy support the share of vulnerable firms could rise to 57 percent, close to the average degree of corporate vulnerability among European advanced economies. However, accounting for policy measures the share of vulnerable firms is estimated to rise more moderately (by 7 percentage points) to about 37 percent. These simulations highlight the critical importance of the policy support. By some estimates, insolvency cases could increase significantly. Shortcomings in the insolvency frameworks, despite substantive reforms since 2012, if not addressed, will weaken the capacity to deal with a potential wave of insolvencies, repair balance sheets and address debt overhangs. In the medium term, a slow restructuring of the economy could dampen corporate profitability as well as investment and lower potential growth, with adverse implications for corporate solvency.



Sources: Orbis, June 2020 WEO, and IMF staff calculations and estimates.
Note: Policy measures used for the simulations vary by country and include wage subsidies or job retention schemes, tax rebates and deferrals, cash grants, debt moratoria, credit guarantees, equity injections, lending rate subsidies, and policy rate cuts. For methodological details see IMF, Regional Economic Outlook for Europe, October 2020.

17. Heightened risks will test the resilience of the banking system. Banks' profitability and their lending capacity may deteriorate as loan defaults materialize. NPLs will likely rise disproportionately in the non-financial corporate segment upon the expiration of some borrower-support measures. Compared to some EU peers, the impact of the crisis on Spanish banks could be amplified by the severity of the economic downturn, a possible broad rise in insolvencies, the lower initial CET1 ratio, and the moderately higher exposure to borrowers in vulnerable sectors such as accommodation and food. Against this background, banks are expected to draw down on capital and liquidity buffers to absorb potential losses and continue supporting lending. Regulatory flexibility and broader policy support in Europe and Spain should also help banks withstand the

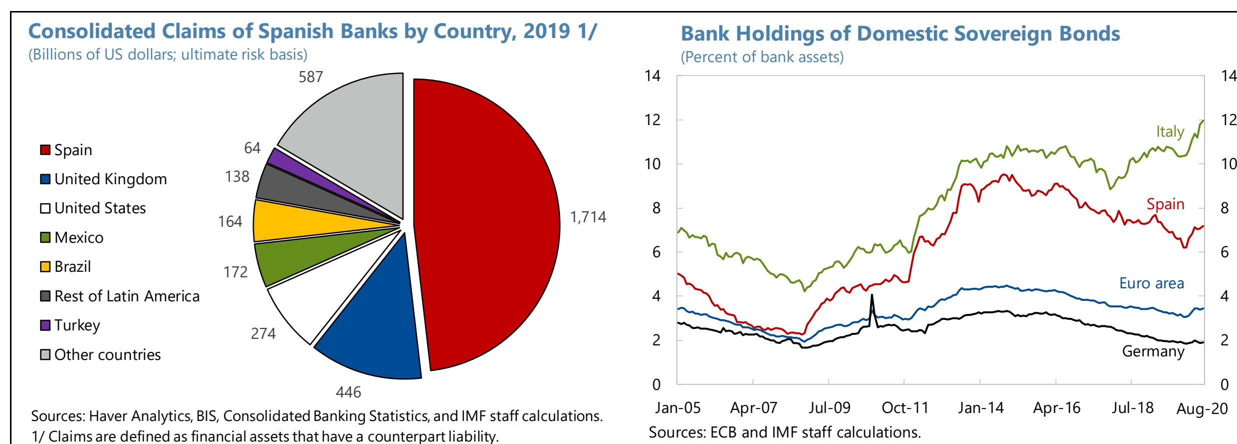
shock, albeit temporarily. But the impact on capital positions may still be significant. Illustratively, the ECB's COVID-19 vulnerability analysis (July 2020) found that euro area banks' average CET1 ratio could deteriorate by nearly 6 percentage points under a severe scenario. This result underlines the risk that some banks, including in Spain, might see their solvency materially affected if the crisis deepens.



Source: EBA Risk Dashboard.
Note: The depicted minimum CET1 requirement includes Pillar 1 and Pillar 2 R.

Source: ECB's COVID-19 Vulnerability Analysis: Results Overview (July 28, 2020).
Note: Impacts on CET1 ratios, on a transitional basis, are estimated across 86 banks.

18. Banks face additional risks, notably reduced gains from geographic diversification. Spanish banks maintain significant subsidiary operations abroad, with exposures to emerging markets (e.g., Brazil, Mexico, Turkey) and some advanced economies such as the United Kingdom. They largely operate with a subsidiary model under which there is virtually no intragroup funding. While geographic diversification generally aided profitability in recent years, including during crises, this time may be different. Further risks arise from new legal demands against banks, especially in connection with mortgage contracts; however, the European Court of Justice's March 2020 ruling on the use of a benchmark interest rate index for mortgage loans (the "IRPH") was perceived as mostly favorable for banks, hence mitigating legal and reputational risks. Other risks from the transition to the new or reformed interest rate benchmarks appear still to be manageable. With still important holdings of domestic government bonds (about 7 percent of bank assets), Spanish banks may also be subject to adverse feedback effects from a potential reemergence of the sovereign-bank nexus.



Sources: Haver Analytics, BIS, Consolidated Banking Statistics, and IMF staff calculations.
1/ Claims are defined as financial assets that have a counterpart liability.

Sources: ECB and IMF staff calculations.

19. The scarring effects of the pandemic will severely strain Spain's public finance, underlining the need for post-Covid fiscal adjustment and ECB policy support. The budget execution data is showing the signs of the crisis impact on public finance. The general government deficit, excluding local governments, reached 6.7 percent of GDP in the first seven months of the year, nearly 5 percentage points higher than the same period last year. For the year as a whole, staff projects the fiscal deficit to widen to around 14 percent of GDP, more than 11 percentage points above the pre-pandemic level (Figure 2). The deterioration is largely driven by automatic stabilizers (6.4 percent of GDP) and the temporary discretionary measures adopted in response to the crisis (3½ percent of GDP). In this baseline scenario, public debt is expected to rise by about 25 percent of GDP in the next two years and, in the absence of fiscal adjustment beyond 2021, would stay largely unchanged in the medium term. If, however, the crisis in Europe became more protracted and additional fiscal support was needed, the surge in Spain's public debt in the next five years could reach over 40 percent of GDP. Under such an adverse scenario with continued downward pressure on inflation, continued pressure from high global savings, low investment, and accommodative monetary policy would be key to keep borrowing costs low.

Spain: Contribution to Cumulative Changes in Public Debt
(Percent of GDP)

	2009-14	2020-25	
		Baseline	Adverse 1/
Change in gross public sector debt	61.0	23.3	43.2
Identified debt-creating flows	60.9	24.8	44.6
Structural primary deficit	15.7	14.4	18.5
Automatic debt dynamics	40.5	10.4	21.1
Automatic stabilizers (Cyclical primary deficit) 2/	20.6	11.9	18.5
Interest rate/growth differential 3/	19.9	-1.5	2.6
Real interest rate	15.9	6.4	7.7
Real GDP growth	4.0	-8.0	-5.1
Financial sector support and other one-offs	4.7	0.0	5.0
Residual, including asset changes	0.1	-1.5	-1.5

Source: Ministry of Finance and IMF staff calculations and projections.

1/ Assumes (i) a further outbreak in 2021 with tightening in global financial conditions; (ii) additional discretionary measures in 2021 (half of those in 2020); and (iii) financial and nonfinancial sector support (5 percent of GDP similar to support during the global financial and European debt crises).

2/ Excluding interest income.

3/ Derived as $[r - \pi(1+g) - g]/(1+g+\pi+g\pi)$ times previous period debt ratio, with r = average nominal interest rate; π = growth rate of GDP deflator; g = real GDP growth rate.

Authorities' Views

20. The authorities broadly shared staff's view on the economic outlook and balance of risks. Amid high uncertainty, the government has somewhat higher growth projections for 2021 compared with staff, while the Bank of Spain projects a slightly weaker recovery due to more scarring. The authorities underscored that the downturn would have been significantly sharper without the policy support package. The government expects the implementation of the EU Recovery and Resilience Facility to lift real GDP by 2–3 percent in 2021 and raise potential growth by about ½ percent annually over the medium term. While still confident about the competitiveness of Spanish tourism, the authorities acknowledged that policy support remains critical for this sector during the pandemic. They concurred that the current account will likely remain in surplus, though uncertainty is high, and that the external position in 2020 could be moderately weaker than fundamentals.

21. The authorities stressed that profitability challenges are a key risk for banks, as in most advanced economies, reinforcing the need to ensure that their business is viable and to address overcapacity in the system. They anticipated that loan delinquencies will start rising in the first half of 2021, the end date of the grace period (usually of one year) for loans made under the public loan guarantee scheme. While firms' increased bank deposits will play a mitigating role, the authorities

saw cliff effects as a material risk that will predominantly affect SMEs. While NPL ratios are expected to rise, the authorities highlighted that banks' solvency positions should be largely resilient under the baseline scenario, helped by the support measures adopted in Spain and Europe. They concurred that Spain's international banks may not benefit from geographical diversification during this crisis as much as they did in the past. They also emphasized that while a large fraction of sovereign holdings is held to maturity, risks related to the bank-sovereign nexus warrant close monitoring.

POLICY AGENDA

22. Combatting the health crisis and mitigating the economic impact remain the near-term priorities. The government acted quickly and forcefully by deploying a multifaceted rescue package to mitigate the economic fallout of the pandemic (text table and more details in Annex V). But the second wave of infections is putting the health of people and the economy again at risk. Thus, the near-term priority is to control the second wave of infections and ensure the preparedness of the healthcare system to deal with future outbreaks as well as purchasing and widely distributing vaccines and treatments when they become available. At the same time, fiscal support should remain in place until the recovery is firmly under way to avoid that the recession morphs into financial sector stress with even higher real and social costs. This calls for extending and flexibly calibrating fiscal income and liquidity measures as needed. Once the economy can remain open in the new environment, policies need to gradually shift from providing lifelines toward fostering the pick-up in activity especially towards a more inclusive, greener, and more digital economy. At the same time, efforts are needed to preserve the sustainability of public and private debt levels to ensure they do not impede the recovery.

Spain: Fiscal Discretionary Response to COVID-19

Measures	Billions of Euros	Percent of GDP
Healthcare sector	4.4	0.4
Households (incl. unemployment benefits)	7.6	0.7
Preserving employment linkages	24.2	2.2
Business (excl. guarantees)	3.9	0.4
Of which: SME and self-employed	2.9	0.3
Residual or undefined	0.5	0.0
Total:	40.5	3.7

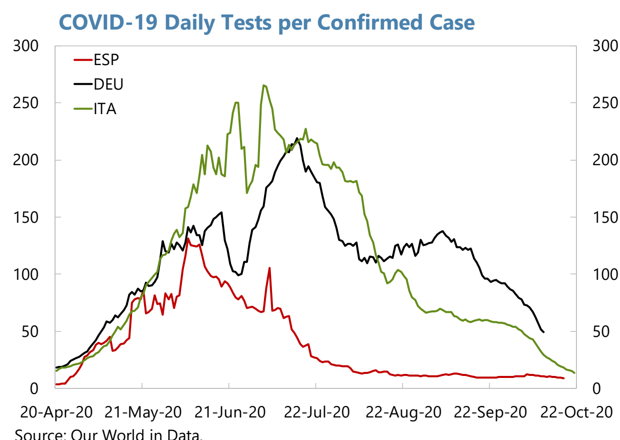
Source: Spanish authorities and IMF staff calculations.

A. Fighting the Pandemic

Health Sector Support

23. The government strengthened the health system by allocating additional resources to the sector, but responses to contain the second wave have been uneven. Spain rapidly expanded the healthcare capacity at the height of the first outbreak and substantially improved its virus testing ability. It remains crucial to maintain the preparedness of the healthcare system (including mass testing,

COVID-19 Daily Tests per Confirmed Case

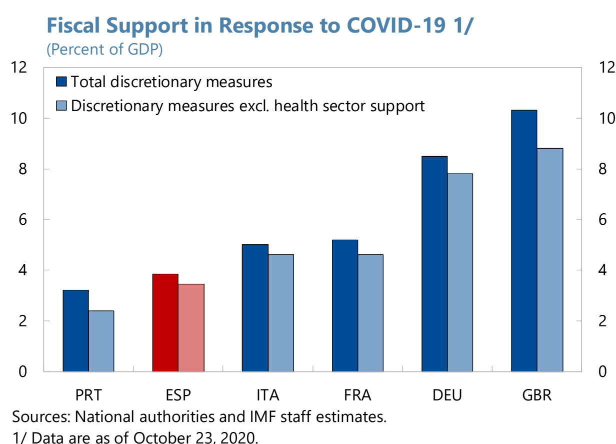


Source: Our World in Data.

sufficient personal protection equipment, adequate intensive care unit beds). As responsibilities for containment measures have shifted to the regions during the second wave, responses have been uneven. Going forward, reinstating targeted restrictions in a timely manner remains critical to control new outbreaks. Upgrades to contact tracing, as an effective means to contain infections while limiting the damaging effects on economic activity, need to continue (see for example IMF, October 2020 WEO, Chapter II).

Support for Households

24. Swift fiscal measures have helped preserve employment and provide income support. To mitigate households' income loss, the government streamlined and expanded the short-time work schemes (Annex VI), introduced a special subsidy for self-employed workers whose business activities were severely interrupted by the pandemic, and increased the sick pay for workers infected with COVID-19 or quarantined. Most of the measures were extended multiple times, through end-January, with some modifications made over time. The government also provided special benefits for affected temporary workers, domestic employees and workers under permanent discontinuous contracts (Annex V). The income support package was estimated to have benefited nearly 7 million workers or 30 percent of the working population, with a fiscal cost at about 2 percent of GDP. Though the amount of the fiscal package is less than in some other euro area countries (text chart), the programs have been effective with relatively swift disbursement.



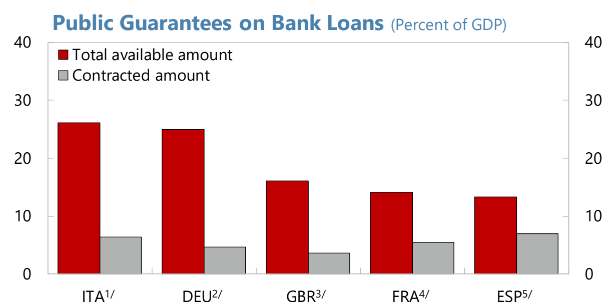
Sources: National authorities and IMF staff estimates.
1/ Data are as of October 23, 2020.

25. Efforts were also made to broaden social protections for the most vulnerable. To guarantee basic living standards, the government established a new rental aid program for vulnerable renters (see Selected Issues Paper) and provided subsidies for basic water and energy access. Additional resources were allocated to sub-national governments to meet increasing demand for social services. Moreover, several time-bound measures were adopted to alleviate the financial burden of the vulnerable individuals. These include moratoria on mortgage payments and other non-mortgage loans including consumer credit (as of September 30, these moratoria accounted for nearly 8 percent of the eligible domestic bank loans, counting also the moratoria voluntarily offered by banks), as well as moratorium and deferment of rental payment. Last but not least, the authorities launched a Minimum Income Scheme in late May, a permanent social security benefit aiming to reduce extreme poverty while promoting social inclusion and labor market participation (Annex VI).

Support for Firms

26. The government has provided extensive policy support to firms. To help bridge firms' liquidity needs and to strengthen risk sharing, the government has provided public loan guarantees worth over 13 percent of GDP with a focus on SMEs and the self-employed. Other official-sector loan programs include special credit lines by the Instituto de Crédito Oficial, such as for the tourism sector (€400 million) and the automotive industry (€500 million). The government also extended tax payment deferrals for SMEs and the self-employed, deferments of social security and tax debts, and flexibility in tax filing. A €4.2 billion support package for the tourism sector, including €2.5 billion in loans, was announced. The government also granted exemptions of social contributions for companies that maintain employment under the ERTE program (Annex VI).

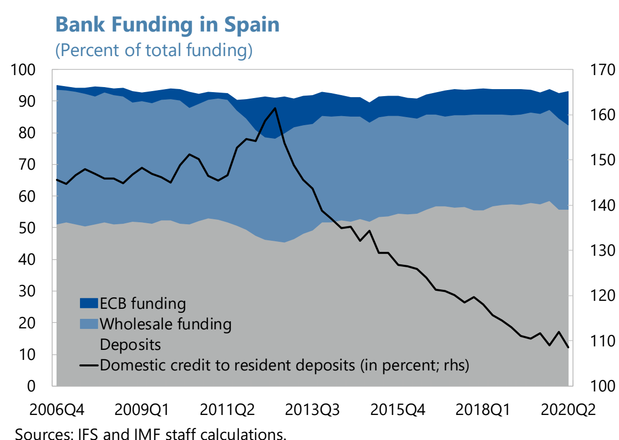
27. Quick take-up of loan guarantees has substantially helped firms' cash flows. As of September 15, of the €100 billion public loan guarantees available for companies and the self-employed, about €76 billion had been contracted, corresponding to 800,000 bank loans. Of the loans, 98 percent were granted to SMEs and the self-employed. The implied liquidity injection stands at €100 billion. Compared to similar schemes in other large European economies, Spain's loan guarantee scheme has the highest take-up rate (see text chart). Additional €40 billion public loan guarantees are available to finance working capital and investment.



Source: IMF Policy Tracker Responses to Covid-19.
1/ As of September 11, 2020. Does not include co-insurance program by SACE, which is estimated to free up an additional €200 billion in liquidity for exporting firms.
2/ As of end-June 2020. The information on contracted loan guarantees is only available for KfW programs amounting to €150 billion; information is not available for the remaining amount of the guarantee package. 3/ As of September 23, 2020. Includes the Coronavirus Corporate Financing Scheme administered by the Bank of England.
4/ As of September 18, 2020. Includes public reinsurance for loan insurance schemes.
5/ As of September 15, 2020. The contracted amount corresponds to the €100 billion loan guarantees covering loans and commercial paper of medium-sized companies that participate in Spain's Alternative Fixed Income Market (MARF).

Financial Sector Support

28. Significant capital and liquidity relief for banks has been provided. To help banks withstand potential losses and support lending activity, the ECB and the Bank of Spain have temporarily enabled banks to use their capital buffers and to operate below the minimum level set for the liquidity coverage ratio. These measures have been accompanied by a request to banks to refrain from paying dividends. Flexibility has also been introduced in the application of accounting and prudential regulations, particularly in connection with provisioning to avoid excessive procyclicality. Additionally, access to ECB's liquidity-provision facilities has been enhanced through additional longer-term refinancing operations (LTROs), more favorable terms of the targeted LTROs (TLTRO-III), and a new liquidity facility (PELTRO). Spanish banks have recently tapped the ECB's funding facilities to further strengthen their



Sources: IFS and IMF staff calculations.

liquidity positions. Prior to stabilizing in August, their borrowing via LTROs increased for five consecutive months and reached a six-year high of €257 billion in July, still below the historical maximum of €338 billion (August 2012).

29. Efforts have also aimed at mitigating non-bank financial risks. The National Securities Market Commission (CNMV) is closely monitoring liquidity conditions at investment funds, with special focus on funds with high exposure to illiquid assets and high-yield corporate debt. A short-selling ban in the stock market was in place between March and May. The National Financial Stability Authority (AMCESFI), created in 2019, is scrutinizing risks arising from linkages between the bank and non-bank financial sector (Annex VII).

Authorities' Views

30. The authorities emphasized their readiness to manage new outbreaks. They noted that the second wave was different, with fewer deaths and lower hospital admission rates. The healthcare system is now better equipped with protection and testing capacities. Efforts to improve mechanisms for contact tracing are underway, including the wider roll-out of a contact tracing app. Newly agreed criteria that trigger regional containment measures (from October) are expected to ensure greater consistency and quicker control of new infections. The government is not considering another wide-spread lockdown.

31. The authorities underlined the important impacts of the government's support measures on mitigating the economic and social fallout of the pandemic. In particular, the successful design of the short-time work scheme (ERTE) has enabled the program to reach an unprecedented coverage of companies and workers—including SMEs, temporary workers and seasonal employees—and facilitated recent job recovery. The introduction of the extraordinary benefits for self-employed and several vulnerable groups, together with the Minimum Income Scheme, has provided crucial income support for households. Furthermore, the authorities highlighted the critical role of the loan guarantee programs in alleviating firms' liquidity pressure, particularly for SMEs and self-employed.

32. Finally, the authorities stressed that policy actions have effectively supported banks thus far. In their view, these measures have contributed to boost credit flows, prevent the rise of NPLs, keep capital ratios broadly stable, and strengthen liquidity buffers. The authorities are analyzing the cliff effects that may arise as some of the policy measures expire—including a potential surge of loan defaults—and evaluating new actions to mitigate such effects. They also commended banks for building up provisions in adequate amounts. They argued that nonbank financial institutions have been generally resilient to the COVID-19 shock, and that coordination between financial supervisors has increased, including through frequent AMCESFI meetings.

B. Nurturing the Recovery and Making the Economy More Sustainable and

Resilient

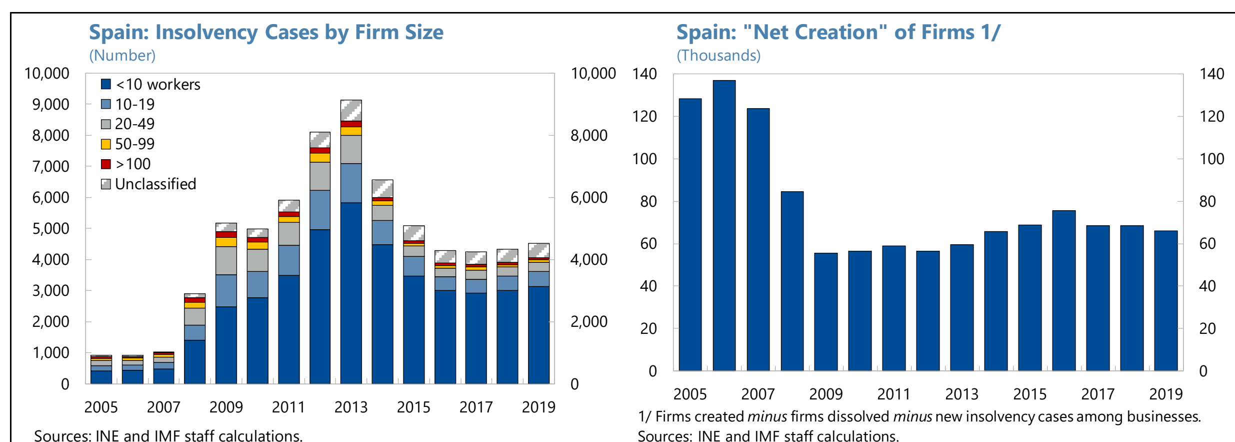
33. Fiscal support should remain in place until the recovery is firmly underway. The swift and broad-based rescue efforts have put a floor under the loss of economic activity during the lockdowns. Going forward, they should continue to do so. As long as the pandemic is not under control, new infection outbreaks occur, and the operating conditions for the economy remain highly uncertain, fiscal policy needs to maintain its support. In particular, the government's latest agreement reached with social partners to extend ERTEs through January 2021 but with the incentives for job reactivation, is welcome. Further extensions of ERTEs should be considered depending on the health and economic outlook. Likewise, the government should stand ready to flexibly calibrate and scale up other measures, should some of the downside risks materialize. In this context, the new EU instruments (including the €21.3 billion that Spain will receive through the temporary Support to Mitigate Unemployment Risks in an Emergency—SURE) and globally high saving/low investment together with supportive ECB monetary policy are providing critical assistance in keeping borrowing cost low. However, commitments to permanently raise current spending ratios, for example through the wage bill and pensions, should be avoided given the high structural fiscal deficit and long-term spending pressures from population aging.

34. Over time, policy support should become more targeted and facilitate the reallocation of resources. Economic activity and employment are unlikely to fully rebound quickly as contact-intensive activities remain impeded for some time. Thus, efforts need to shift from rescue packages toward recovery packages, in particular given Spain's limited fiscal space. Such a shift should be gradual—for example by adjusting size, conditions or target groups—to not disrupt the recovery process. For instance, given the diminishing net benefits over time from job retention schemes, unemployment benefits should gradually become the predominant safety net in the recovery phase. This would require a careful review of the unemployment benefits and temporary upgrade of the programs as needed (in terms of eligibility criteria, benefits, and duration) to ensure that they buffer the transition for those that need to shift to new employment which may take some time. Hardships need to be alleviated by potential temporary increases in social assistance, including rent support for those that have benefited from rent moratoria. With persistent structural economic shifts in train, policies are also needed to ease resource reallocation toward expanding sectors. In that respect, effective usage of the EU Recovery and Resilience Facility should aim to upgrade the physical infrastructure toward a more digital and resilient economy, while enhancing human capital especially of those impacted by the crisis (see also para. 46).

35. Some companies require temporary equity support. As fiscal cost of supporting all affected firms would be prohibitive and hinder needed resource reallocation, a case can be made for the government to intervene selectively to rescue or help solvent strategic firms facing pandemic-related difficulties. In line with EU State Aid rules, the newly created state-investment fund (under the umbrella of the Spanish state-owned industrial holding company SEPI) endowed with €10 billion (1 percent of GDP) targets firms that meet these criteria. To ensure the fund's effectiveness, it will be important to develop an exit strategy for the public sector from the "bailed out" companies and transparently record and monitor the fiscal risk. Similar recapitalization options could be extended

to certain segments of viable smaller firms facing financial strains due to the pandemic. Consideration could also be given to providing temporary injections that create public claims, for example in the form of future tax liabilities.

36. To address rising insolvencies and help viable debtors, the private debt resolution system needs enhancements. Despite recent reforms, some aspects of Spain's private debt resolution system remains relatively inefficient (see IMF Country Report No.17/340). Insolvency mechanisms are deemed slow and generally lead to liquidation rather than restructuring. The role of public creditors in these processes remains a key problem. In the wake of the crisis, commercial courts will face bottlenecks as personal and business insolvency cases increase. Ultimately, social losses stemming from firm destruction may prove too costly, considering also that the number of dissolved firms in Spain has tended to exceed by five times the number of insolvency cases. Recent temporary changes to corporate resolution frameworks (Royal Decree Law 16/2020) are welcome but likely insufficient to prevent rising insolvencies and liquidations. Additional transitional measures as the economy gradually recovers should aim to improve out-of-court restructuring frameworks and enhance incentives and penalties to encourage debt restructuring, including for SMEs.[4] A swift and adequate transposition of the EU Directive on restructuring and insolvency would further help addressing debt-overhang problems.



Sources: INE and IMF staff calculations.

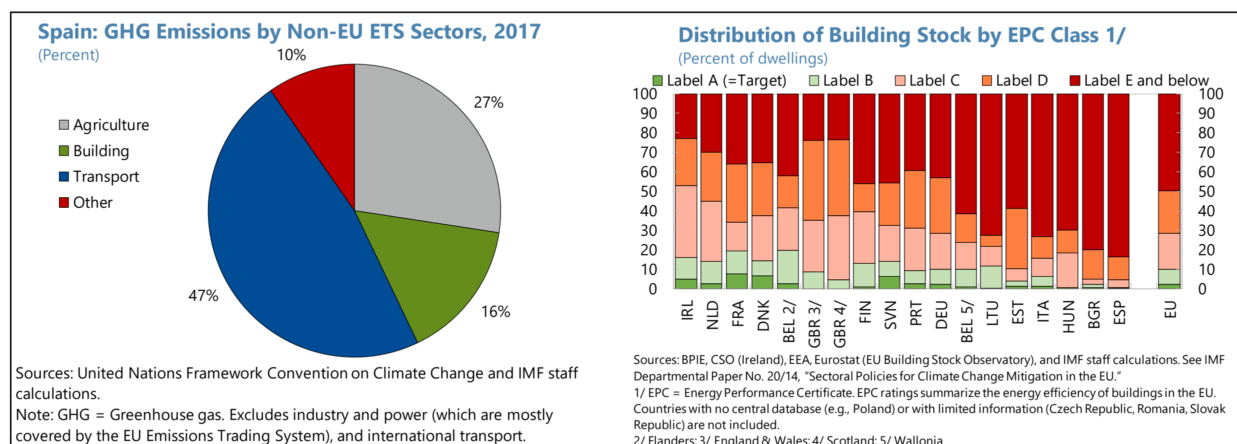
1/ Firms created *minus* firms dissolved *minus* new insolvency cases among businesses.
Sources: INE and IMF staff calculations.

37. Strong bank supervision must continue, and resolution frameworks should be enhanced. Supervisors need to continue their monitoring and carefully review banks' forward-looking plans for resolving NPLs and ensuring resilient capital positions. Regulatory relief measures should help facilitate the use of capital and liquidity buffers, followed by their gradual rebuilding. Along with these actions, banks need to continue recognizing problem assets in a timely manner, adjusting their provisioning decisions on precautionary grounds, and following prudent dividend policies. They should also keep pursuing cost rationalization and investing in technology. Some additional consolidation in the banking system is another adequate response to profitability challenges. Furthermore, it is necessary to enhance the crisis management frameworks at the

[4] See IMF's note on "Private Debt Resolution Measures in the Wake of the Pandemic" (May 2020).

European and national levels by tackling any shortcomings in the resolution and liquidation regimes. Completing the banking union would strengthen resilience.

38. The recovery strategy must be compatible with the country's climate policy objectives. By shaping the future structure and carbon intensity of the economy, the recovery strategy will be critical to Spain's longer-term growth prospects and ability to meet its climate objective of achieving carbon neutrality by 2050. Three general principles can help ensure the consistency of recovery plans with the country's climate goals. First, fiscal support should focus on addressing green investment gaps with high social returns (see IMF Departmental Paper No. 20/13, "EU Climate Mitigation Policy"). The EU Recovery and Resilience Fund could play a key role by enabling the financing of labor-intensive, large-multiplier, climate-compatible public investment, such as investment in insulation retrofits and clean energy infrastructure. One area where emission reductions could be achieved is the building sector, which accounts for around 16 percent of Spain's non-EU ETS emissions, is difficult to decarbonize, and is one of the most energy inefficient in Europe (text chart).[5] Second, public support for emission-intensive activities and sectors—beyond initial lifelines—should be conditioned on binding sustainability commitments, to avoid locking in future emissions. SEPI's operations should ensure that strategic public investment is aligned with the country's climate objectives. Lastly, finalizing the adoption of green budgeting principles in the public financial management system would make fiscal policy more responsive to climate change by systematically incorporating climate policy in a whole-of-government approach. In light of these principles, the government's holistic approach to climate and energy policy strategy is welcome.



Sources: United Nations Framework Convention on Climate Change and IMF staff calculations.
Note: GHG = Greenhouse gas. Excludes industry and power (which are mostly covered by the EU Emissions Trading System), and international transport.

Sources: BPIE, CSO (Ireland), EEA, Eurostat (EU Building Stock Observatory), and IMF staff calculations. See IMF Departmental Paper No. 20/14, "Sectoral Policies for Climate Change Mitigation in the EU."
1/ EPC = Energy Performance Certificate. EPC ratings summarize the energy efficiency of buildings in the EU. Countries with no central database (e.g., Poland) or with limited information (Czech Republic, Romania, Slovak Republic) are not included.
2/ Flanders; 3/ England & Wales; 4/ Scotland; 5/ Wallonia

39. Some governance aspects of fiscal and financial operations need to be improved further. With large additional public spending planned in support of the recovery, continued efforts are needed to strengthen public procurement practices by building on the progress made already to enhance its digitalization (Annex VII). In particular, coordination challenges with regions related to procurement should be tackled and on-site supervision strengthened to ensure an efficient and transparent use of public finances. In the financial system, some significant institutions have been

[5] The EU-wide Emissions Trading System (ETS) covers emissions from large companies in energy, industry, and aviation (flights within the European Economic Area).

facing idiosyncratic reputational risk events. Against this background, it is important to ensure that banks' corporate governance is aligned with best practices. COVID-19 is also increasing pressure on the AML/CFT supervisory framework. The banking system is not immune from money laundering risks and while improvements have been made to enhance coordination/information sharing between AML/CFT and prudential/conduct supervisors, the system would benefit from continuing efforts to integrate ML/TF risk into prudential supervisory considerations. In an integrated European financial market, the establishment of a European AML/CFT supervisor would further strengthen the framework, an initiative supported by the authorities.

Authorities' Views

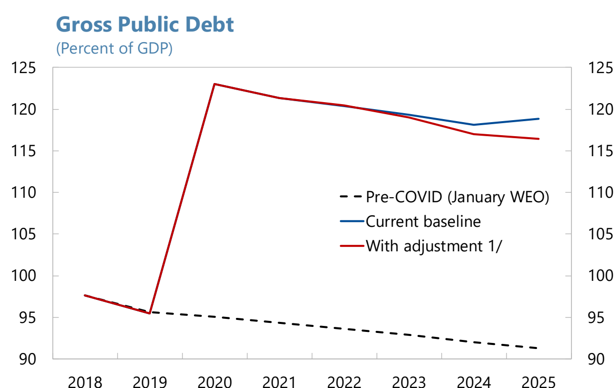
40. The authorities aim to continue policy support in a more targeted and flexible manner in the near term. The last extension of the ERTEs aimed at prioritizing the support to the most affected sectors and firms, while allowing for flexibility to prepare for the impacts of new containment measures. At the same time, the authorities recognize the need to promote professional transitioning through training. In this regard, they consider the recent introduction of special training opportunities to workers under the ERTEs to be an important step toward reskilling and upskilling workers. The government also underscored their commitment to protect the most vulnerable through extensions of some of the time-bounded support packages. They noted that the larger and more persistent impact of the pandemic could further raise corporate sector vulnerability and require solvency support for SMEs. Lastly, the authorities emphasized the ambitious, comprehensive and cross-cutting nature of their climate and energy policy strategy.

41. The authorities highlighted their efforts to enhance debt restructuring frameworks and to maintain strong bank supervision. They noted that a new Insolvency Law came into force in September and that work is under way to prepare the transposition of the EU Directive on restructuring and insolvency. They underscored other initiatives to increase the efficiency of insolvency procedures and strengthen the capacity of commercial courts. The authorities stressed that they are closely monitoring lending standards and credit portfolios, while also asking banks to be well prepared to deal with rising NPLs. They will welcome further cost cutting by banks and merger initiatives involving synergies. The authorities strongly advocated actions to enhance resolution frameworks in Europe, noting that completing the banking union with a common deposit insurance scheme is critical.

C. Addressing Long-Term Consequences of the Pandemic

42. In the medium term, a credible fiscal adjustment plan is needed to address the crisis legacy for a return to a close to balance fiscal position. Spain's fiscal space was already at risk before the pandemic (Figure 8). The damaging effects of the current crisis is expected

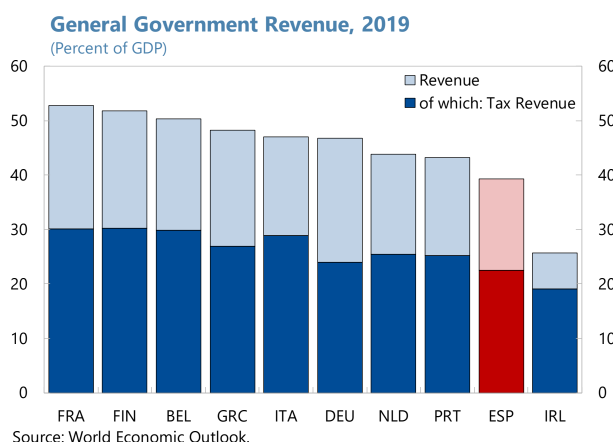
Gross Public Debt
(Percent of GDP)



Sources: Bank of Spain and IMF staff calculations.
1/ Assuming 0.5 percent of structural primary adjustment per year from 2022.

to further raise the country's fiscal vulnerability. The projected position would leave little fiscal room to cope with future adverse shocks especially in an environment of higher interest rates (Annex IV), putting public debt sustainability at substantial risk. To rebuild fiscal buffers over the medium term, staff recommends resuming a gradual consolidation once the economy is on a sustained strong growth path with falling unemployment. Under current assumptions such conditions could be in place at the earliest from 2022.[6] For example, staff estimates that an annual consolidation of the structural primary deficit by about ½ percent of GDP could revert the rising trend, put the debt ratio on a downward path from 2023 (text chart) and achieve a close-to-balance structural fiscal position within a decade under current estimates. While the starting point and pace of the adjustment would depend on the state of the economy, an advanced announcement of a credible adjustment plan could send a strong signal to the market and promote policy transparency. This is critical to prepare for future adjustments to the ECB's policy, especially should the recovery in the euro area be uneven.

43. Sustainable structural measures will be crucial for rebuilding fiscal buffers while supporting more inclusion and innovation. To tackle rising inequality and meet the investment demand in a post-COVID world, fiscal policy should focus on mobilizing additional revenues and enhancing spending efficiency building on the recent expenditure reviews. Spain's tax-to-GDP ratio is relatively low compared with regional peers (text chart), indicating room for structural improvement, especially by strengthening VAT collection, raising excise duties and environmental levies, and reducing tax system inefficiencies (for details of potential measures and expected yields see IMF Country Reports No. 18/330 and No. 17/319). The specific design of the adjustment package should be contingent on the state of the economy and social needs. For instance, measures that transfer savings from the private to the public sector, such as increases in the tax contribution from more affluent and less-affected groups, could already be considered in 2021. On the other hand, measures that may have a disproportional effect on the low-income population, such as expanding VAT collection or increasing environmental taxes, should wait until the recovery is on firm footing and be accompanied with effective targeted spending to protect the most vulnerable. Nevertheless, the groundwork should start in advance to ensure timely and effective policy implementation.



44. Preserving the sustainability of the pension system requires a long-term commitment to contain the pressure of pension spending arising from population ageing. The COVID-19 crisis will further set back the pension system's finances. A sustainable reform package is needed to

[6] In light of increased uncertainty associated with the estimate of potential GDP, staff's recommendation is anchored at growth and unemployment outcomes instead of the traditional trigger, output gap. Nevertheless, information from the output gap should be taken into consideration in the design of the fiscal strategy as one summary indicator of economic slack.

balance pension sustainability and social acceptability. Specific measures could include: (i) incentivizing longer work lives; (ii) raising revenues without raising the already high contribution rates; and (iii) encouraging supplementary savings (see IMF Country Report No. 18/330).

45. Spain faced the pandemic already with a subpar record of income equality.[7] Technological progress, amplified by countries' initial exposure to routinization, and global integration, contributed to the reduction of the labor share in Spain and other advanced economies since the mid-1990s with negative implications for income distribution (Figure 9). The destruction of 4 million jobs during the global financial crisis further worsened Spain's social outcomes and was not fully reversed even though the 2012 labor reforms catalyzed a job-rich recovery.[8] Staff analysis suggests that the strong job creation, helped by the reforms, improved the post-reform Gini coefficient without undermining the overall risk-of poverty.[9] However, the reforms might have reduced average hours worked and contributed to more in-work poverty. In addition, relatively weak redistributive effects of Spain's social spending fell short of protecting vulnerable groups adequately and equally.[10] Pre-COVID-19, limited rental housing supply hampered by relatively inefficient building regulations contributed to a surge in rental prices in some cities, creating affordability problems and compounding intergenerational inequality as well as labor immobility. Despite significant progress in recent decades, sizeable gender inequality still remains in employment and wages, and representation of women in top management positions in the private sector is low by the European standards (Figure 9).

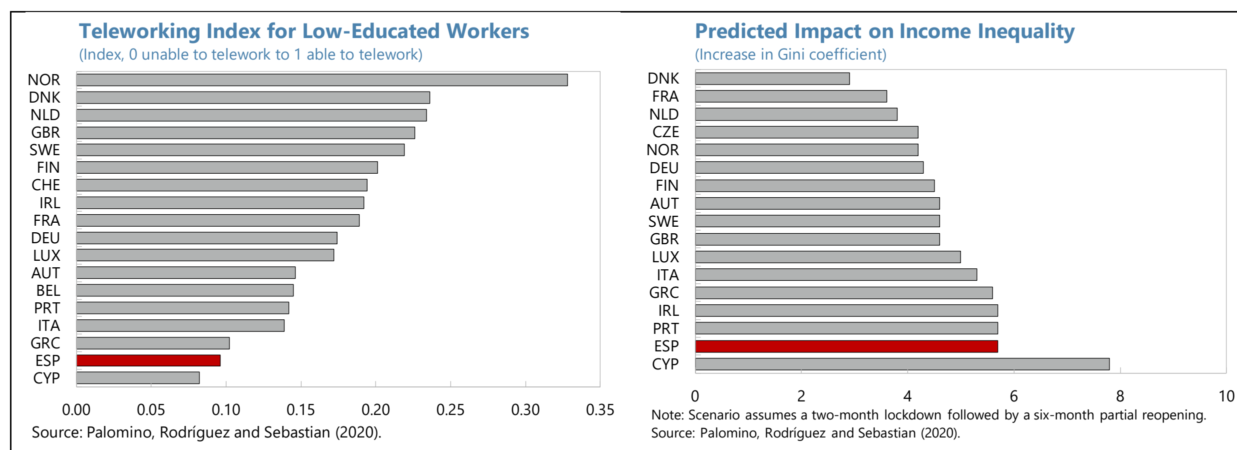
46. The pandemic is likely to widen Spain's social inclusion gaps. The impact of the pandemic will be particularly harsh for low-skilled temporary workers, many of whom are engaged in Spain's large and hard-hit tourism and hospitality sectors. Moreover, Spain's workers with lower levels of education have less options for teleworking compared with European peers, which will aggravate the impact of the pandemic on this group of workers (see text chart for an estimated deterioration of the Gini coefficient due to the lockdown). Income losses could aggravate the rental overburden if rental prices do not adjust simultaneously.

[7] See *Spain—Selected Issues Paper* (2020) for a more detailed analysis on challenges for greater social inclusion.

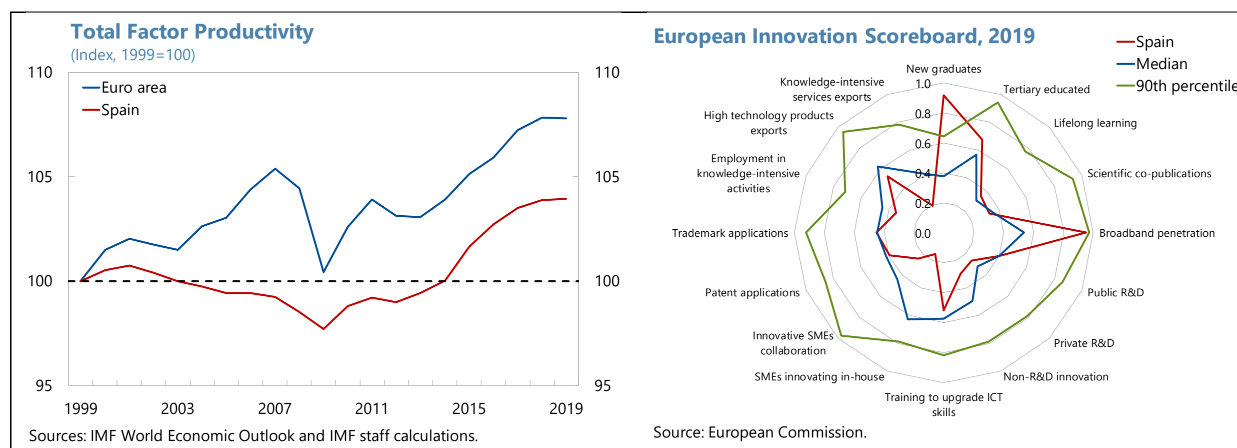
[8] The 2012 labor reforms involved changes to the collective bargaining framework, employment protection regulation, and active labor market policies.

[9] See Stepanyan and Salas (2020) "Distributional Implications of Labor Market Reforms: Learning from Spain's Experience", IMF Working Paper, 20/29.

[10] See Vtyurina (2020) "Effectiveness and Equity of Social Spending—The Case of Spain", IMF Working Paper 20/16.



47. Spain's growth potential will also be eroded by the pandemic. Mediocre total factor productivity growth pre-COVID-19 delayed income convergence to euro area peers. The two-tier labor market has hindered human capital accumulation and the dominance of small and micro firms has hampered the ability of small firms to innovate and absorb new technologies. Going forward, the business structure may limit the impact of the government's efforts to promote digitalization. Moreover, unevenness in adopting required new skills could elevate large skills mismatches further.



48. Policy efforts should focus on mitigating the impact of the pandemic on social outcomes and fostering the economy's structural transformation. The new EU funds provide an exceptional opportunity to buffer the crisis' social cost while accelerating technological upgrades and catalyzing long-standing reform needs.

- The availability of EU funds can facilitate the introduction of labor reforms. For instance, any transition costs from introducing a separation fund while making open-ended contracts more attractive could potentially be eased by the use of EU funds. Simplifying the menu of contracts[11] while introducing a separation fund has the potential to increase the share of permanent jobs

[11] One option is to introduce a single open-ended contract combined with separate contracts that allow firms in certain sectors (e.g. tourism and agriculture) to hire workers—from temporary worker agencies to restrict risk of abuse—based on seasonal demand fluctuations.

without necessarily raising the overall dismissal costs for employers and lowering the employment protection for most (see Selected Issues Paper). In addition, actions are needed to mitigate the legal and administrative costs of permanent contracts and continue to reduce improper use of temporary contracts, including by reinforcing the use of big data.

- The recent introduction of the Minimum Income Scheme addresses gaps in the coverage of disadvantaged groups in social spending and lowers administrative access hurdles to some social assistance programs (Annex VI). Going forward, its integration into the existing support tools at the regional levels needs to continue to be carefully reviewed and its financing needs to be embedded in a medium-term budgetary plan.

- In support of low-income households and to tackle in-work poverty, the authorities could consider an Earned Income Tax Credit (EITC) program as a complement to the Minimum Income Scheme. The EITC programs are typically more efficient than relying predominantly on the minimum wage in addressing poverty and income inequality, because they directly target low-income workers and stimulate their labor force participation.

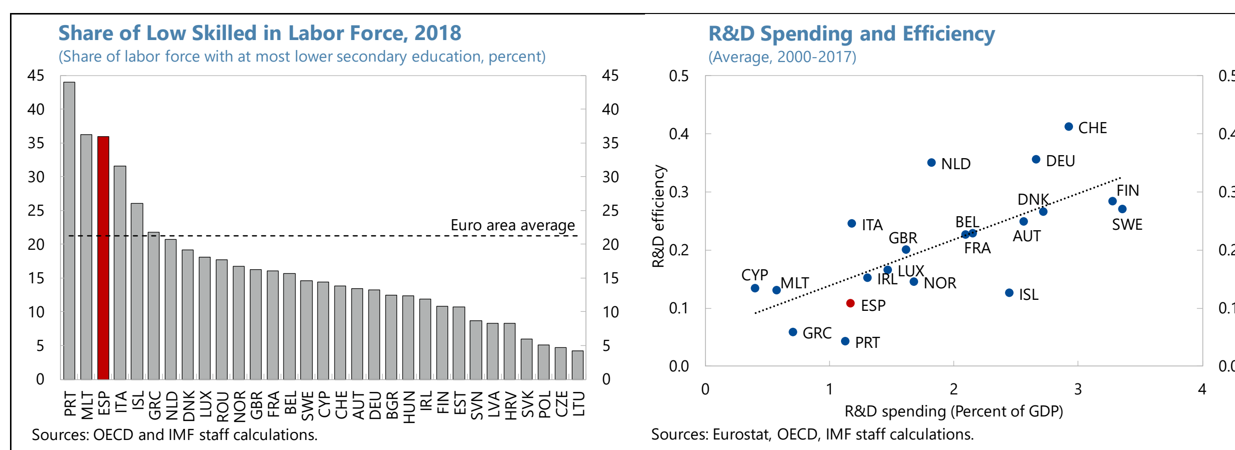
- Additional EU funds could also support an expansion of public housing, which is low in Spain, and could help with temporary upgrades in housing assistance (see SIP). Maintaining rent moratoria established during Covid-19 for too long could delay investment decisions and should therefore gradually be replaced with transfers or guaranteed loans to the neediest.

- The government's focus on boosting family and childcare support and promoting flexible working arrangements to enhance gender equality is well placed, especially against the COVID-19 backdrop (see SIP).

- The recovery plans associated with the EU funds should become a catalyst for the digital transition. The planned digitalization of the public administration is critical to improve its efficiency.

- To facilitate the transiting of workers into new sectors during the recovery, active labor market policies need to be quickly stepped up and support the acquisition of new skills. Measures to assist regional labor mobility could also help with the reallocation (see IMF Country Report No. 18/330).

- The government needs to rethink the existing R&D incentives and establish a system for periodic evaluations before expanding them under the EU recovery plans. In the past R&D incentives had very limited take up and constrained private-public collaborations that would encourage innovation. Eliminating or modifying size-contingent regulations could play a catalytic role for enhancing innovation.



Authorities' Views

49. The authorities reiterated their commitment to fiscal prudence in the medium term while boosting growth and fostering social cohesion. To this end, the 2021 draft budgetary plan will combine the short-term priorities of supporting economic recovery with the medium-term objectives of maintaining fiscal sustainability and reducing inequality. The budget will include a recovery plan outlining the use of about €27 billion grants under the EU Recovery and Resilience Facility and the REACT-EU funds (the decision about the use of loans is still pending). To support the medium-term adjustment needs, the government is contemplating several revenue measures, such as introducing a digital and financial transactions tax, boosting environmental taxation, and fighting against tax fraud and evasion. Moreover, policies to improve public service efficiency particularly through digitalization of public and judicial administration are also planned. On pension reforms, the authorities stressed the need to preserve the purchasing power of pension benefits while safeguarding the financial sustainability of the system. In this regard, a key policy area is to narrow the gap between the effective and the legal retirement age.

50. The authorities are considering a range of policies to address and accelerate the structural transformation of the economy and address socio-economic consequences of the crisis. In this regard, they view the EU Recovery and Resilience Facility as an opportunity to frontload and upscale their reform plans. The government aims to establish a special unit in the Prime Minister's office to oversee the implementation of RRF programs. The government has the following priority areas: ecological transition, digital transformation, social cohesion, and gender equality.

- *Ecological transition:* The authorities aim to undertake projects that create short-term employment while fostering the decarbonization of the economy and progress toward longer term environmental sustainability. Examples include retrofitting of buildings, creating charging stations for electric vehicles, and upgrading water infrastructure.

- *Digital transformation:* The authorities consider digitalization as an integral part of solutions to all structural economic challenges. The new National Digital Strategy (NDS) focuses on the data economy, digital skills, digitalization of public administration, healthcare, and agriculture sectors.

The authorities aim to capitalize on their leading position in the area of open data policies and network visualization, which attracts many startups. The government's new National Action Plan for Digital Skills aims to promote digital skills at all levels of education.

- *Social cohesion:* The authorities emphasized that precariousness of jobs and high level of structural unemployment hamper social cohesion. They are revamping the vocational training system and upgrading curricula to reskill workers affected by the ongoing structural changes. Furthermore, the authorities recognize the need to improve the efficiency of ALMPs, particularly the functioning and coordination of the regional Public Employment Services. To improve labor market flexibility, the authorities' key strategy is to streamline the number of contract types and continue the fight against the abuse of sub-contracting. They also intend to refine the ERTE program to promote its future use as an employment adjustment tool. The authorities underscored their plans to increase the stock of social rental housing, including by mobilizing public land and collaborating with private investors.

- *Gender equality:* The authorities underscored the disproportional impact of the COVID-19 crisis on women. While focus on promoting work-life balance and teleworking in the short term, the government is also preparing several proposals for fostering gender equality beyond the crisis. These include revamping the public childcare system, strengthening regulations to narrow the gender pay gap, and finalizing the ongoing full equalization of maternity and paternity leave.

STAFF APPRAISAL

51. The global pandemic has taken a significant toll on Spain's society and economy, posing formidable challenges for the years ahead. Policies face the daunting task of continuing to support the recovery and reduce long-time scarring, and tackling long-term challenges exacerbated by the pandemic (such as boosting the economy's productive capacity, addressing socio-economic disparities and low bank profitability, and over time rebuilding fiscal buffers), in a context of subdued growth and high downside risks. To remain effective, the policy response must continue to be flexible and agile, to adapt to fluidly evolving developments, while resolute and predictable, to help reduce uncertainty.

52. Containing the new wave of contagions and continued policy support remain critical in the near term. Securing a rebound in activity will depend upon the effectiveness of new containment measures and preparedness of the healthcare system. The government's swift and determined provision of income and liquidity support has so far played a major role in limiting the economic fallout. Policy measures, such as the short-term work scheme and public loan guarantees, should be flexibly extended and scaled. Fiscal support should remain in place, but should become increasingly targeted as the pandemic recedes, with a focus on vulnerable groups and viable firms. Over time, unemployment benefits should gradually become the predominant safety net, facilitating resource reallocation toward expanding sectors.

53. Policies need to continue to mitigate the risk of the recession morphing into financial sector stress with even higher real and social costs. Corporate sector vulnerabilities must

continue to be addressed. Private debt resolution frameworks should be enhanced promptly to help address debt overhangs, and there is a possible role for public equity support in certain corporate segments. In stark contrast with the global financial crisis, the banking sector (backed by government policies) has continued to support the real economy with credit intermediation, rather than amplify the shock. Continued strong supervision together with carefully calibrated macroprudential relief measures are needed to underpin the sector's resilience. In severe scenarios, solvency may be materially affected, reinforcing the need to enhance the crisis management frameworks at the European and national levels by tackling any shortcomings in the resolution and liquidation regimes. Completing the banking union with a common deposit insurance scheme would strengthen resilience.

54. Within this difficult context, funds available under the EU Recovery and Resilience Facility provide an exceptional opportunity. Their expeditious and effective use can underpin the near-term recovery while promoting a structural shift to a more productive, greener, and digital economy. Efficient coordination, implementation, and oversight of plans will be key. The authorities are committed to a front-loaded use of EU funds as a catalyst for structural transformation. However, the speed at which certain measures and reforms can be implemented remains uncertain. For instance, it may be difficult to reach agreement on changes to education policies given the current fragmented political landscape. Conversely, plans focused on green investment and digitalizing public administration may likely be more readily available.

55. Once the recovery is firmly underway, it will be necessary to ensure a sustainable downward path for public deficits and debt to rebuild fiscal buffers. This would require a substantial reduction in the structural deficit. Spain entered the pandemic with an already challenging fiscal position, owing to its limited adjustment efforts during the previous economic upturn. Since the onset of the crisis, government intervention has mitigated the impact on private sector balance sheets, but also has had a deep bearing on government finances. The public debt ratio is expected to increase by nearly 30 percentage points from the pre-pandemic level to over 120 percent of GDP. Authorities remain committed to a medium-term fiscal adjustment but, with policy efforts centered on crisis management and recovery support, they have yet to provide details about their future fiscal plans. Fiscal adjustment should only start once the economy is on a sustainable growth path with falling unemployment, but the early formulation of credible plans (contingent on the state of the economy) could support investor confidence.

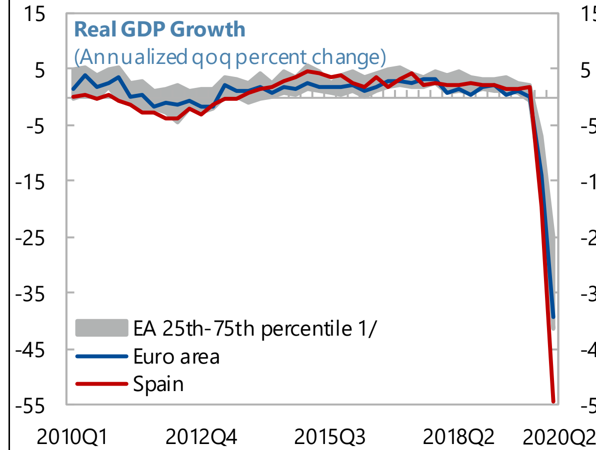
56. Recovery and consolidation policies should be inclusive and seek to address growing inequalities in the wake of the pandemic. Socio-economic disparities, which were already high pre-COVID-19, are set to widen. Support for displaced workers should include retraining and reskilling so they can seek employment in new or growing sectors, with income support as they transition. The new Minimum Income Scheme is a welcome step to expand the safety net. Unemployment benefits and other social assistance may need to be temporarily upgraded. Further measures for greater inclusion need to address labor market precariousness, support rental affordability and enhance gender equality. The eventual medium-term fiscal consolidation will also

need to be consistent with social inclusion and resilient growth. To protect critical social spending most space to lower the deficit lies on the revenue side.

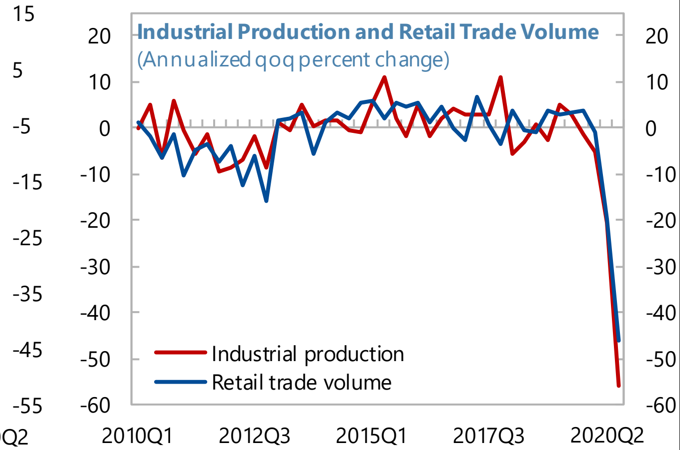
57. It is recommended that Spain remain on the standard 12-month Article IV cycle.

Figure 1. Spain: Real Sector and Inflation

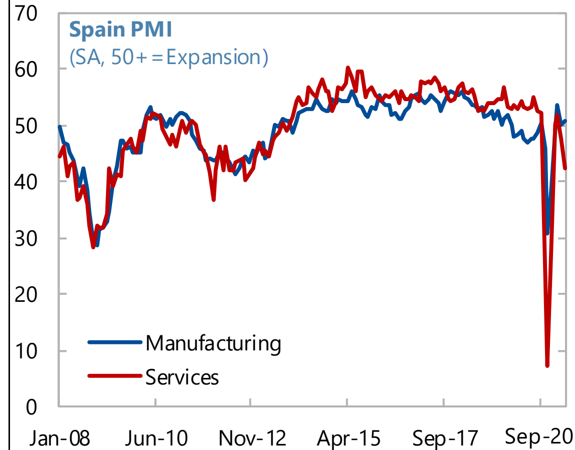
The COVID-19 pandemic severely disrupted economic activity in the first half of 2020.



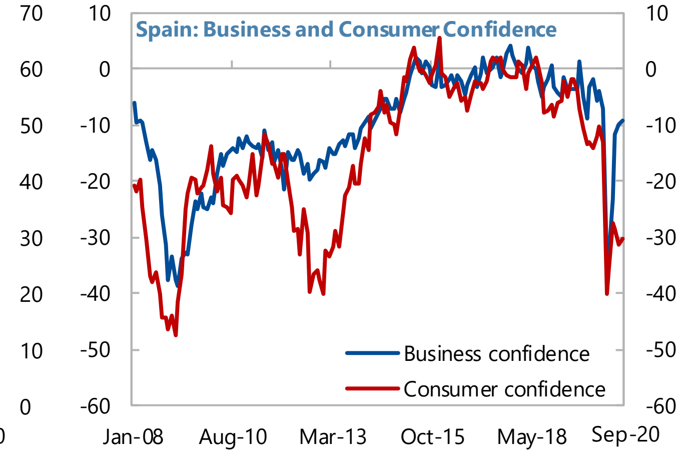
Industrial production and retail trade plunged.



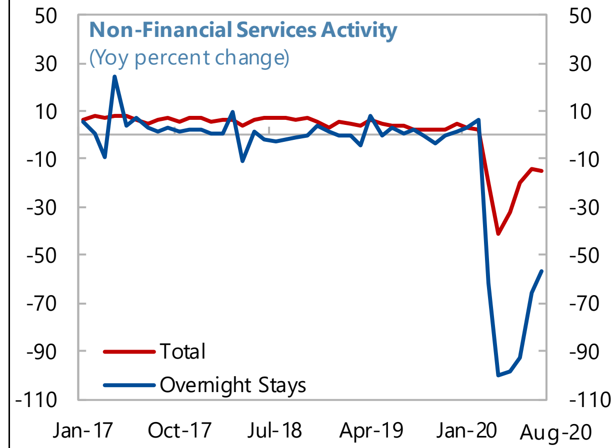
Since the reopening in June, PMIs have recovered but recently receded again.



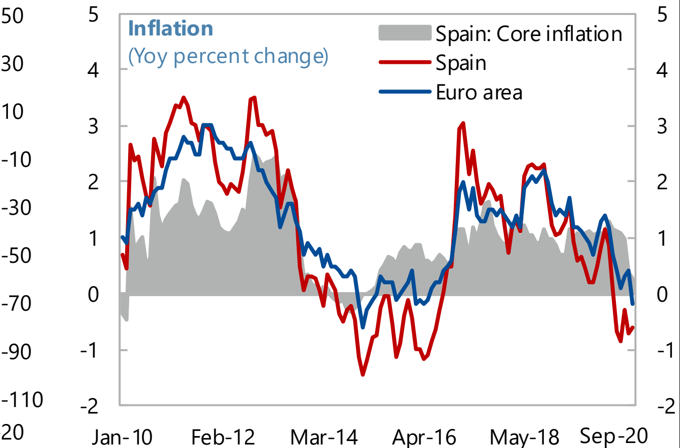
Confidence remains weak ...



...with the services sector, in particular accomodation, lagging.



After remaining stable until June, core inflation fell notably.

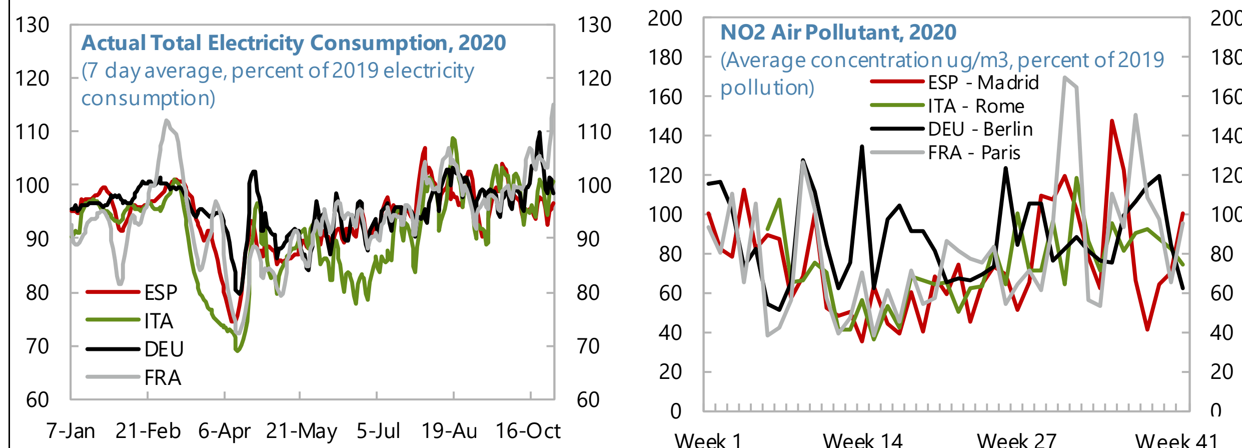


Sources: Bank of Spain, Eurostat, Haver Analytics, and IMF staff calculations.

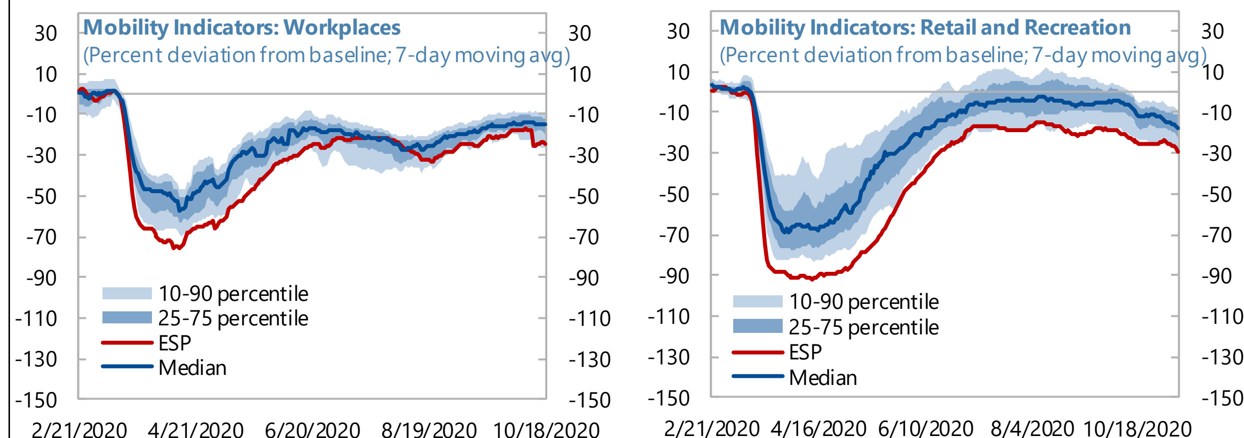
1/ Ireland is excluded for 2015Q1 due to methodological change and a growth rate of 119 percent.

Figure 2. Spain: High Frequency Indicators of Real Activity

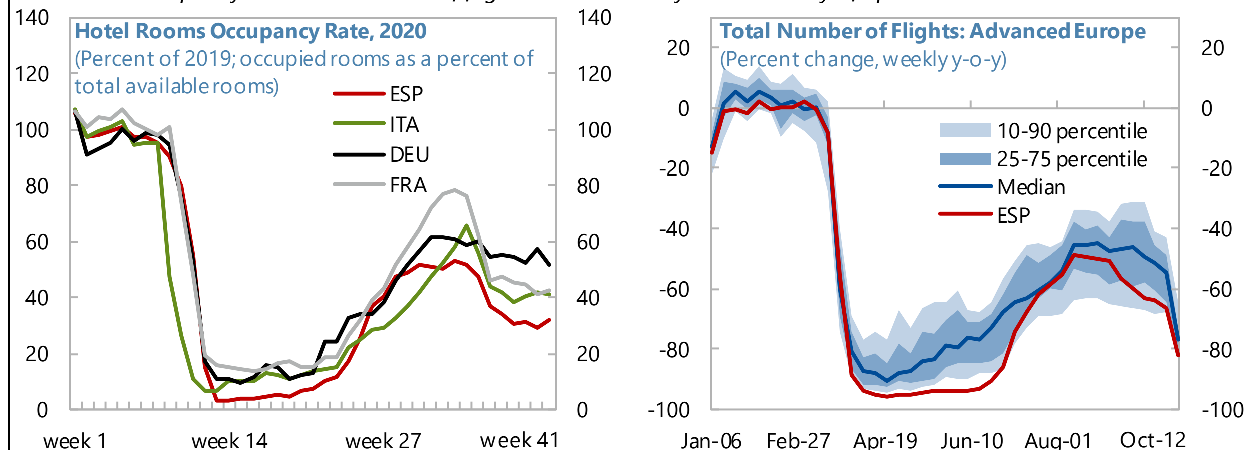
Electricity consumption and air pollution picked up from the lows observed during the lockdown but still remain below 2019 levels.



Reflecting the long period of strict movement restrictions, Spain's pickup in mobility related to workplace, retail and recreational areas has remained below European peers.



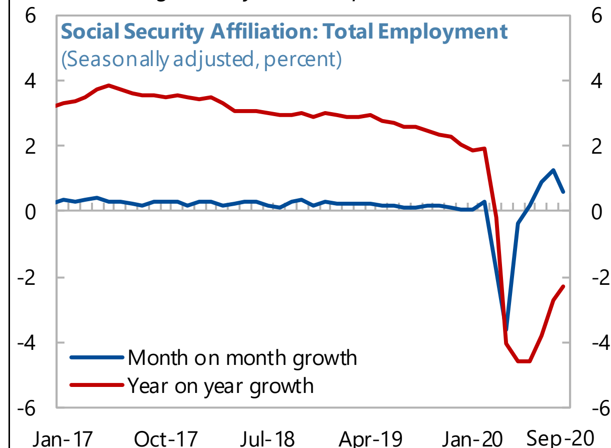
Hotel room occupancy rates and number of flights indicate a very slow recovery of Spain's tourism sector.



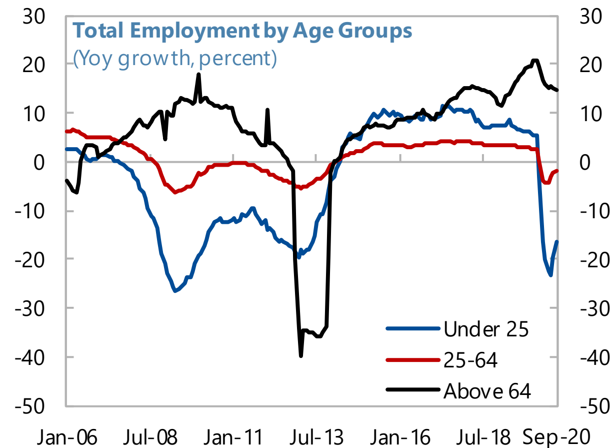
Sources: ENTSOE, European Environment Agency, Flight Radar 24, Google Mobility Report, Smith Travel Research, and IMF staff calculations.

Figure 3. Spain: Labor Market Developments

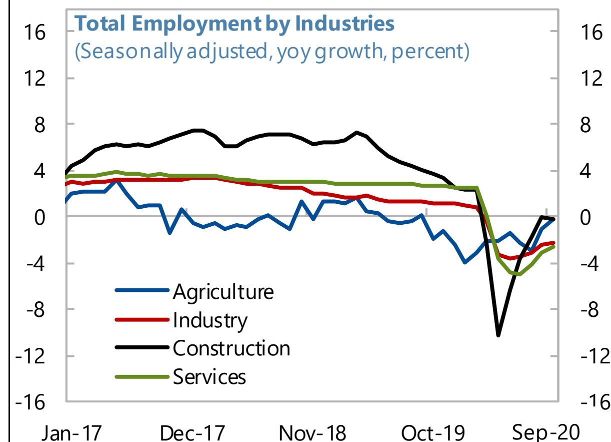
Total employment plummeted following the lockdown, but recovered gradually in subsequent months.



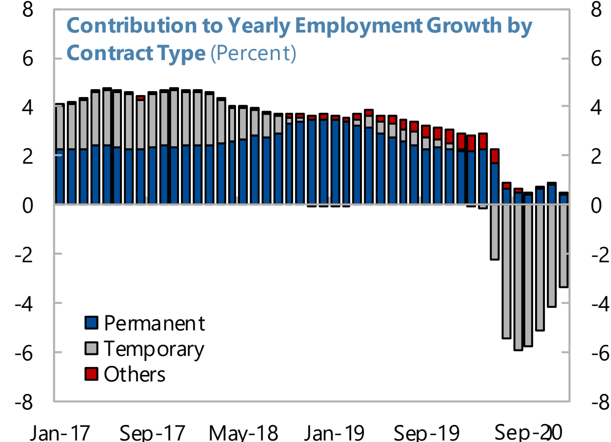
Young workers suffered the highest job loss rate.



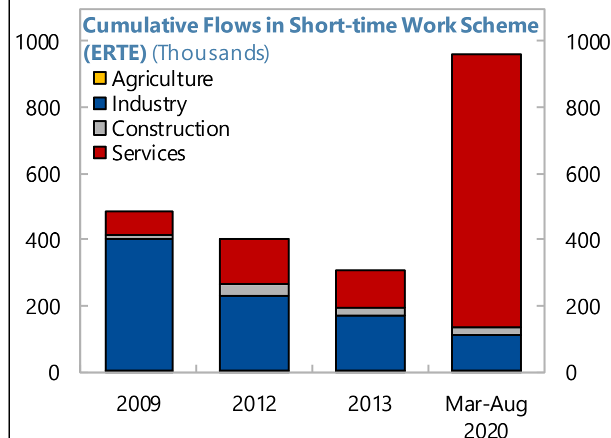
Construction and services sectors were the hardest hit, ...



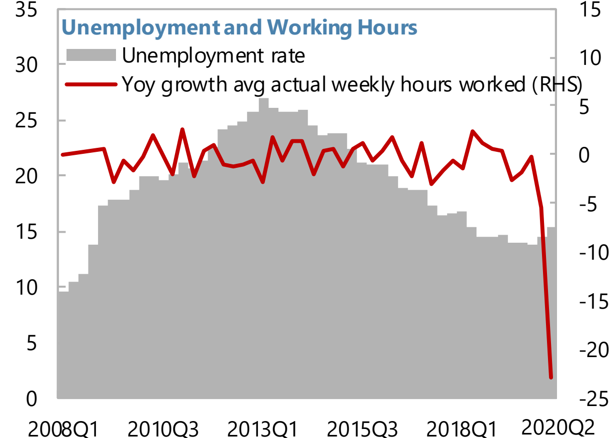
... while temporary employees shouldered most of the adjustment.



Measures that expand the short-time work schemes increased the takeup rate significantly, ...



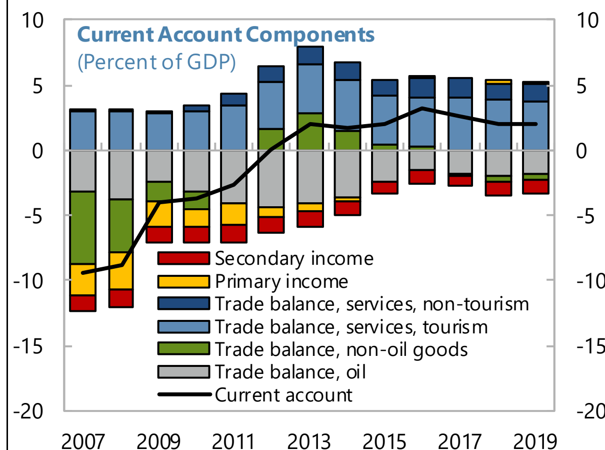
... and contained the immediate impact on unemployment, but the average hours worked has declined substantially.



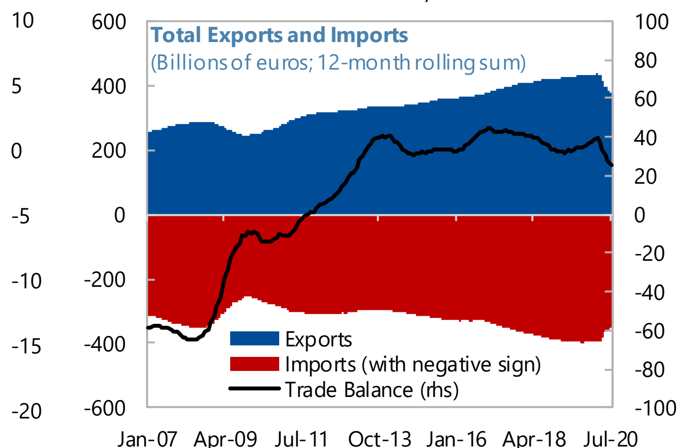
Sources: Ministry of Labor, Ministry of Inclusion, Social Security and Migration, Haver Analytics, and IMF staff calculations.

Figure 4. Spain: External Sector

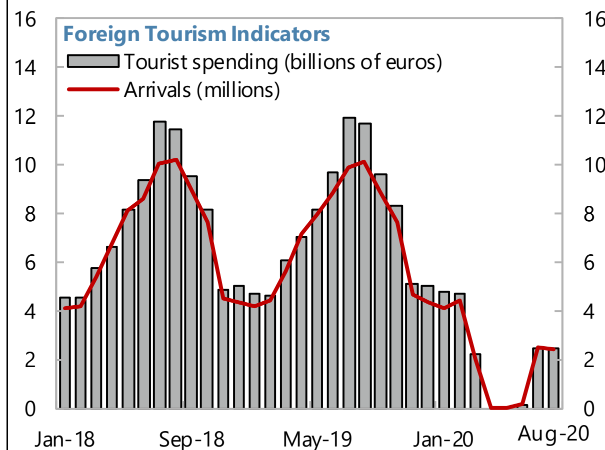
The current account remained in surplus in 2019…



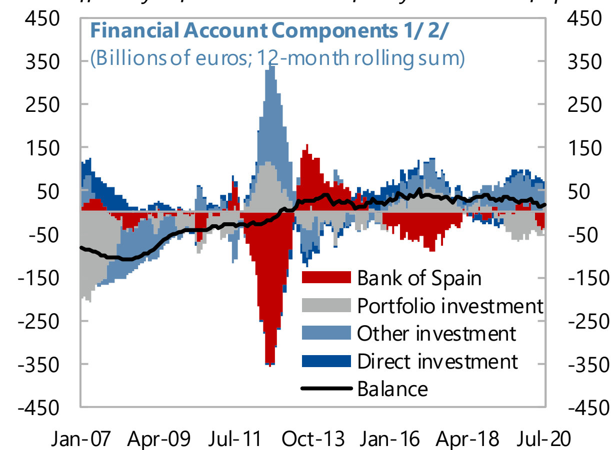
… but in the wake of the COVID-19 shock the trade balance has started to deteriorate, …



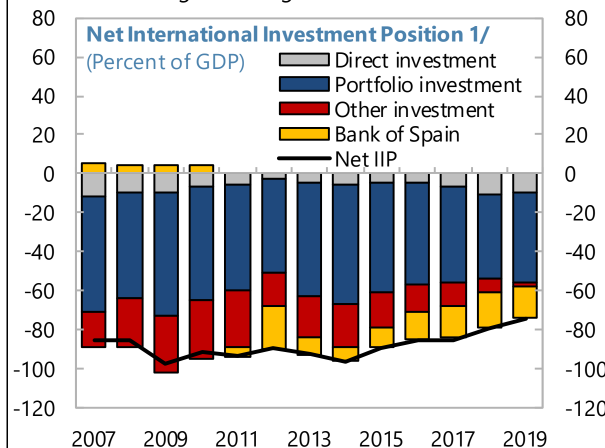
… with an acute impact from depressed international tourism.



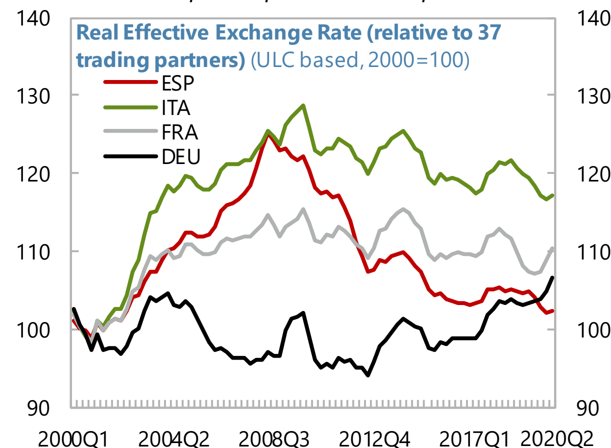
Recent net outflows in other and portfolio investment were offset by inflows accounted for by the Bank of Spain.



The net international investment position as a share of GDP remains large and negative…



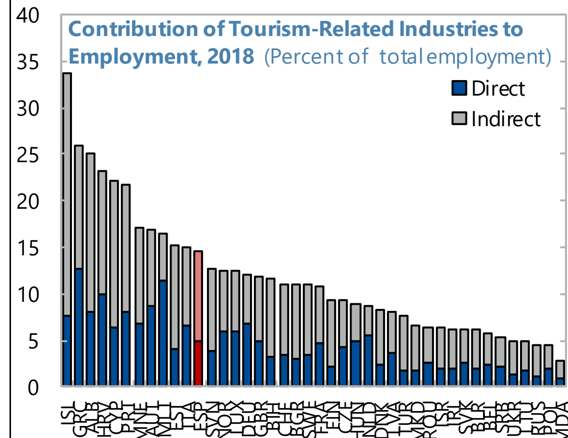
… though in recent years cost-competitiveness gains have contributed to improve Spain's external position.



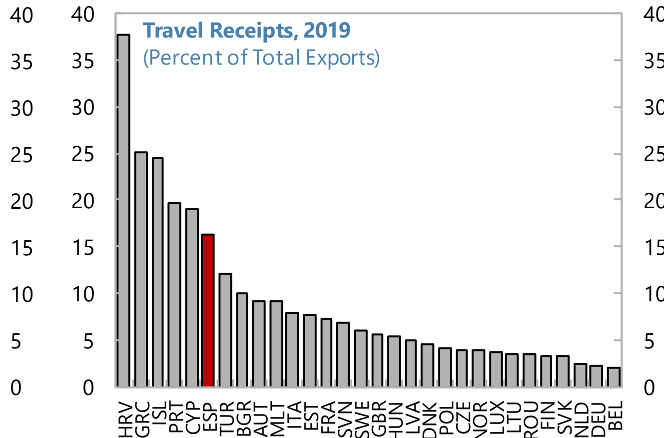
Sources: Bank of Spain, Eurostat, Haver Analytics, INE, WEO, and IMF staff calculations.
1/ Portfolio Investment and Other Investment exclude the Bank of Spain, which is shown separately.
2/ Positive (negative) values indicate net financial outflows (inflows).

Figure 5. Spain: Tourism Indicators

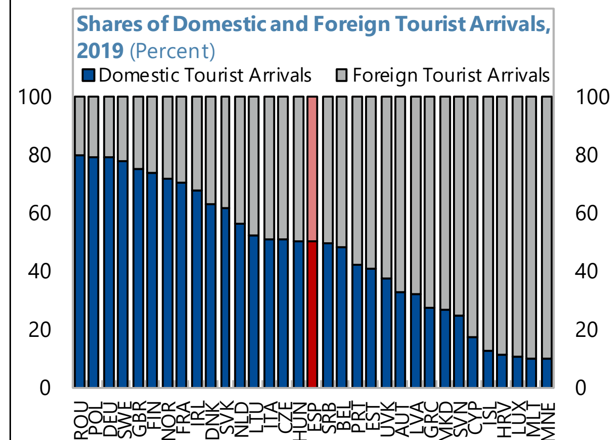
Tourism accounts for well over a tenth of Spain's employment...



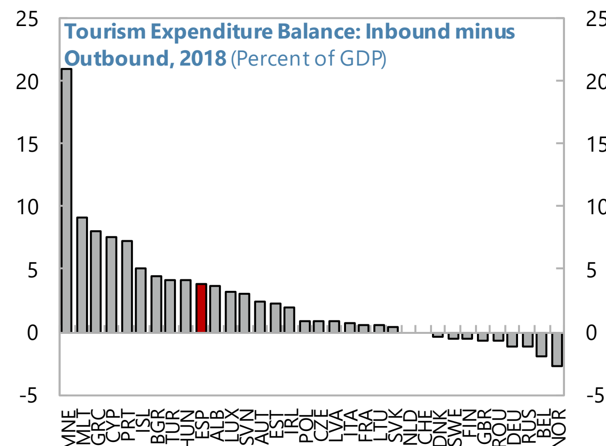
... and for above 15 percent of its total exports.



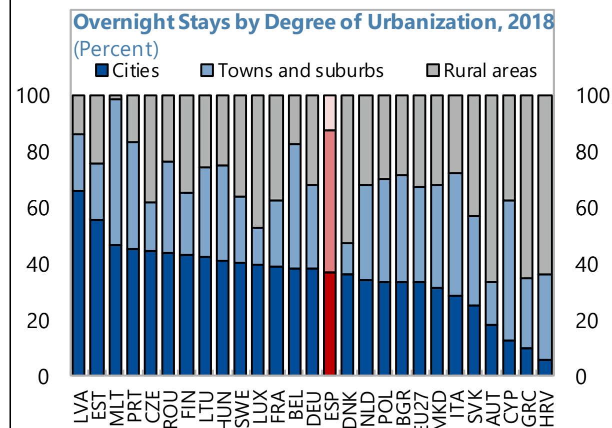
While domestic tourists represent about half of Spain's arrivals and should provide some cushion to the sector,...



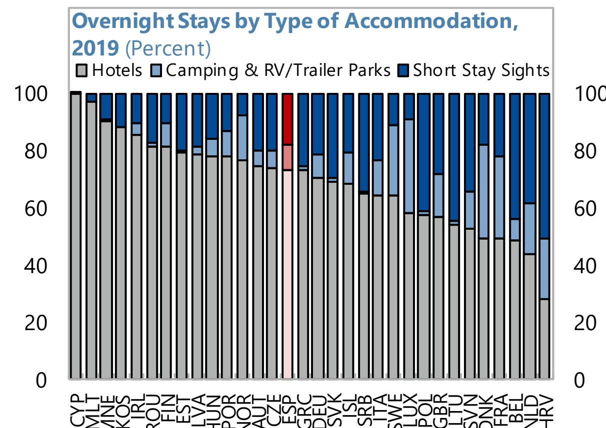
... outbound tourism expenditure has limited potential to offset the drop in inbound tourism.



Urban tourism, accounting for over one-third of overnight stays in Spain, is expected to be badly hit by COVID-19...



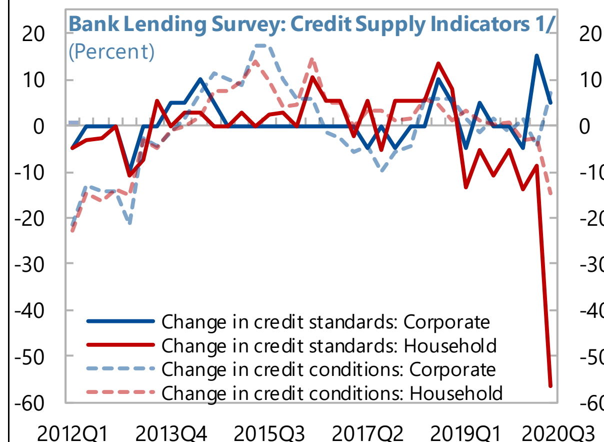
... as is the hotel business, which accounts for almost three-quarters of total overnight stays in Spain.



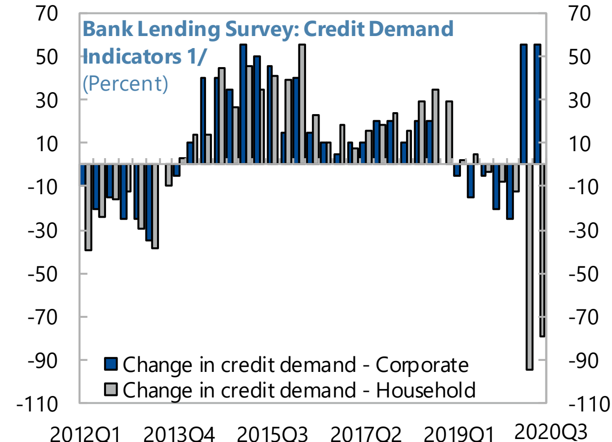
Sources: Eurostat; Haver Analytics, UNWTO, WTTC, and IMF staff calculations.

Figure 6. Spain: Credit Development and Financial Cycle

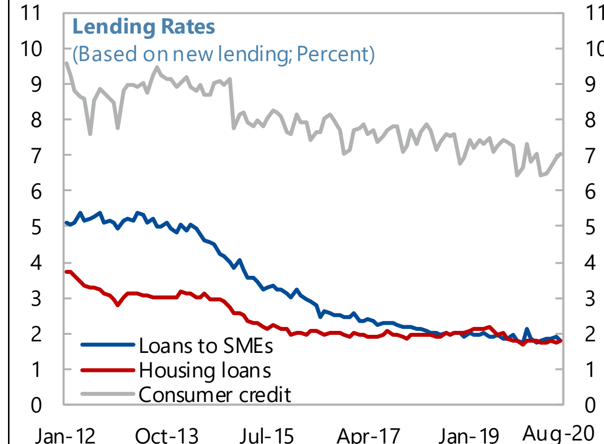
In the wake of the COVID-19 shock, credit supply to firms has eased, supported by public loan guarantees...



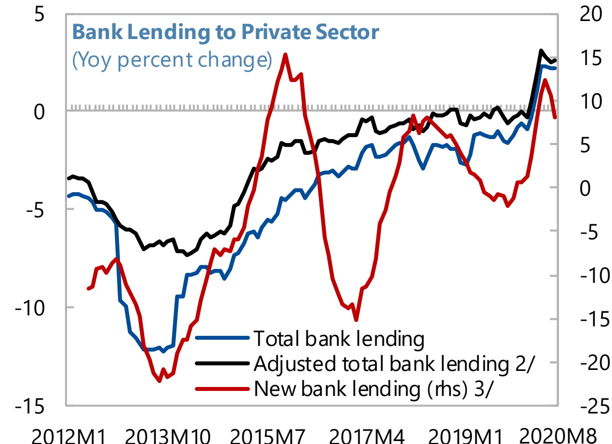
... whereas demand for credit rose among firms but declined among households. Against this background, ...



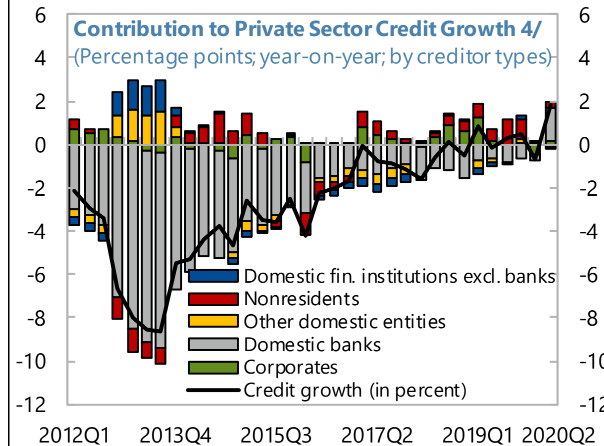
... lending rates remained relatively stable at low levels during the period from January to August 2020, ...



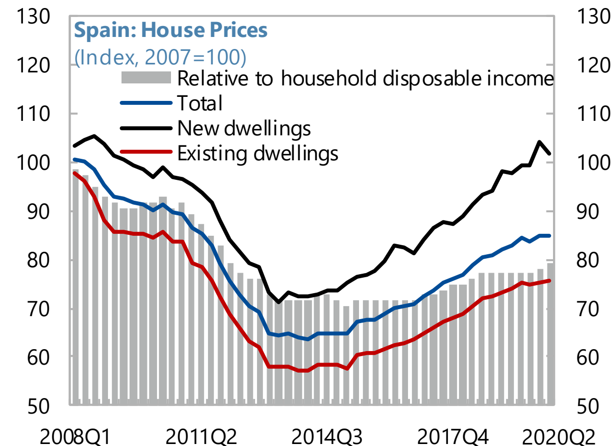
... and bank lending recorded positive annual growth rates for the first time in several years, ...



... driving an increase in a broader measure of credit to the private sector in 2020Q2.



By mid-2020, house prices had not been much affected by the crisis, and remained below their pre-GFC peak.



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

1/ Positive (negative) values indicate changes consistent with credit expansion (contraction), based on staff calculations.

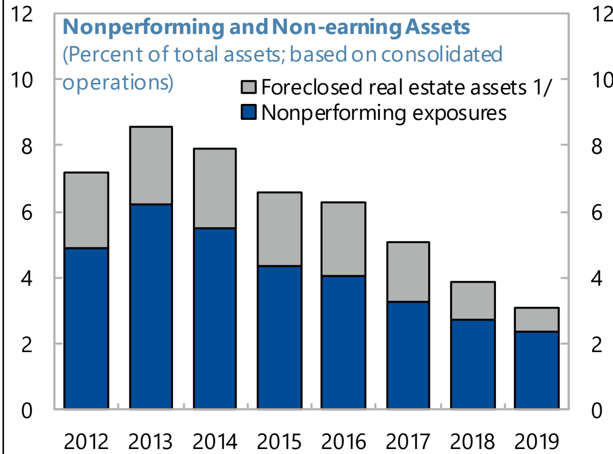
2/ Excludes write-offs and adjustments.

3/ Based on a twelve-month rolling sum.

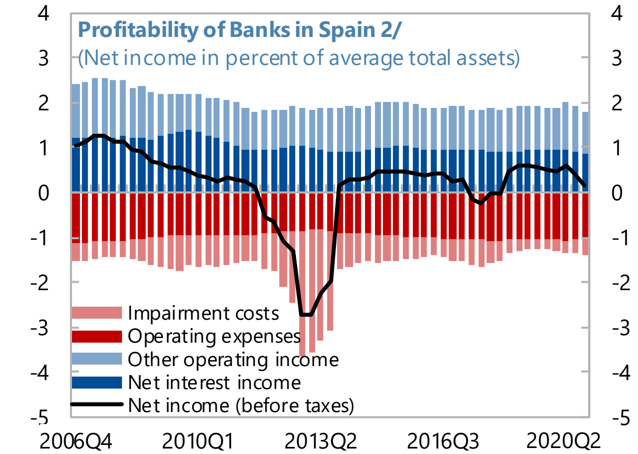
4/ "Other domestic entities" includes general government and households.

Figure 7. Spain: Banking System Performance

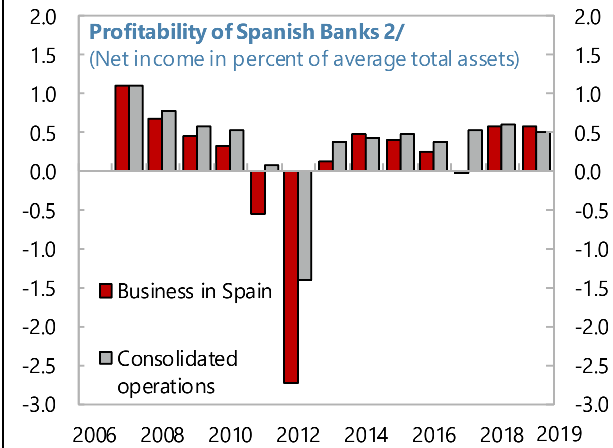
Prior to the COVID-19 shock, the continued decline of impaired assets, mainly through portfolio sales, ...



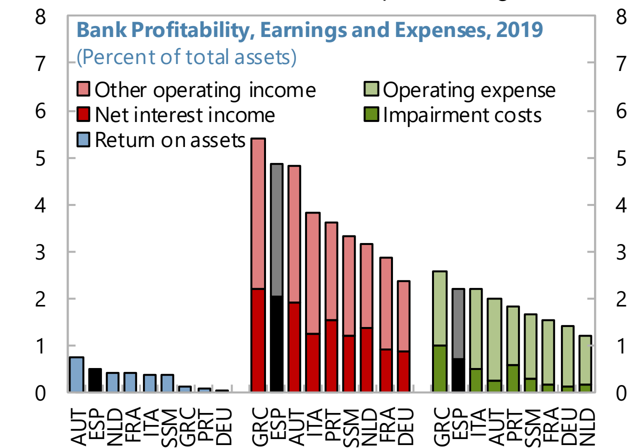
... had likely helped reduce impairment costs; but profitability for business in Spain has started to deteriorate in 2020; ...



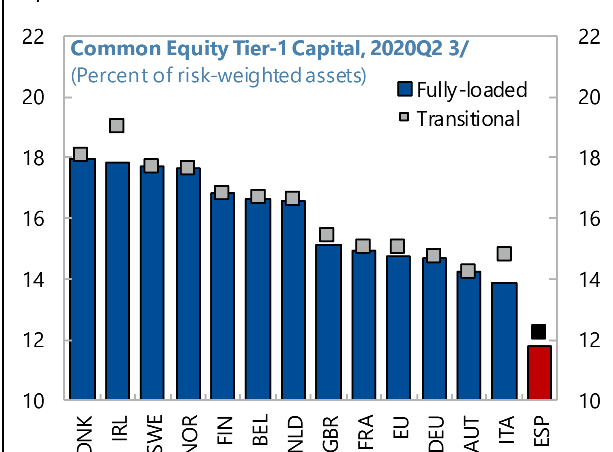
... in a context of already low profitability—in Spain and on a consolidated basis—before the crisis, ...



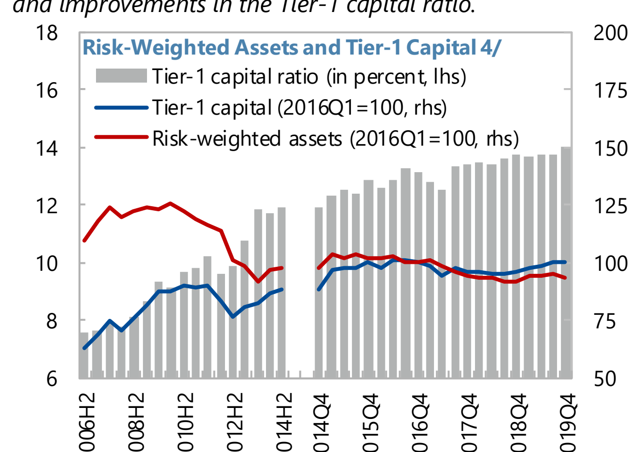
... similar to other European countries. While in 2019 Spain's return on assets was above the European average, ...



... Spain exhibits the lowest CET1 ratio in the euro area, ...



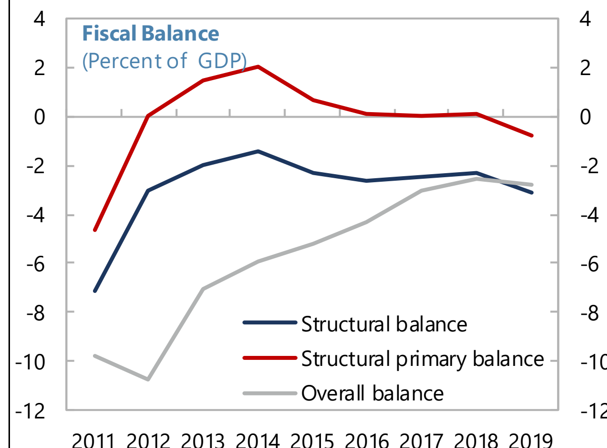
... despite the recent declining trend in risk-weighted assets and improvements in the Tier-1 capital ratio.



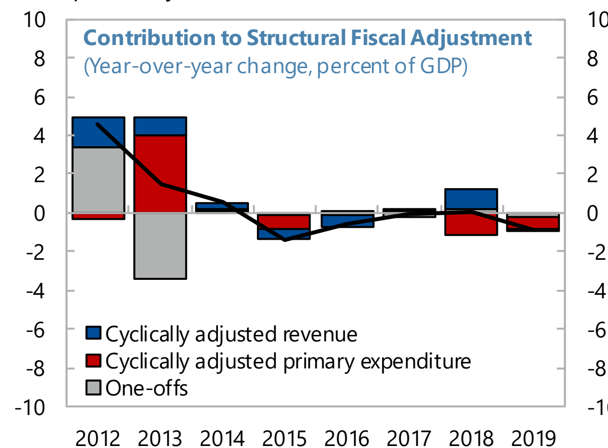
Sources: Bank of Spain; EBA Risk Dashboard; ECB Supervisory Banking Statistics; IMF Financial Soundness Indicators database; and IMF staff calculations.
1/ Data is on consolidated basis, but foreclosed property only reflects business in Spain.
2/ For banking business in Spain, the aggregate figure of 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.
3/ Based on banks reported in the EBA Risk Dashboard.
4/ Due to data availability, the chart shows semi-annual figures through 2014 and quarterly figures since then.

Figure 8. Spain: Public Finances

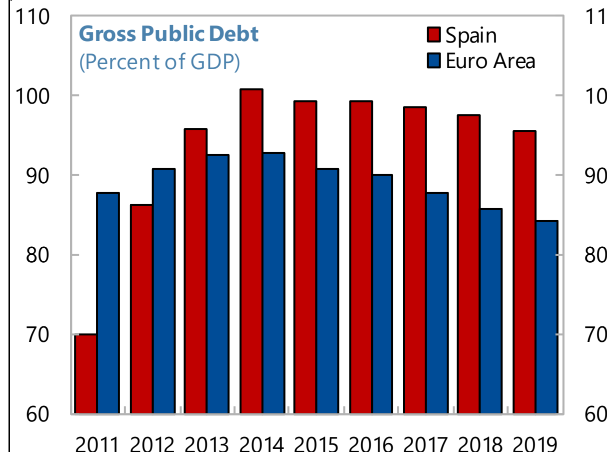
Fiscal consolidation has come to a standstill since 2015, …



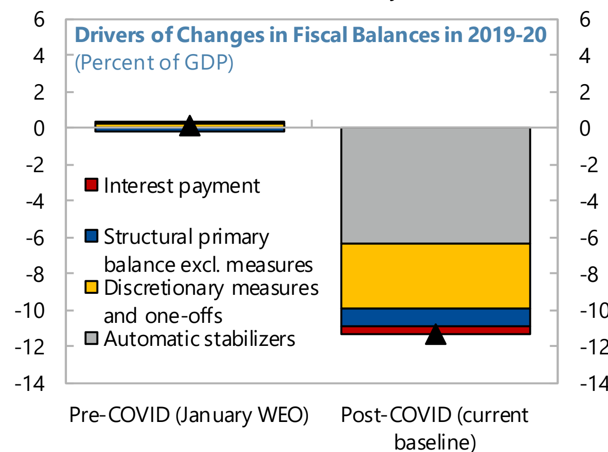
… as expenditure gradually expanded in structural terms in the past five years.



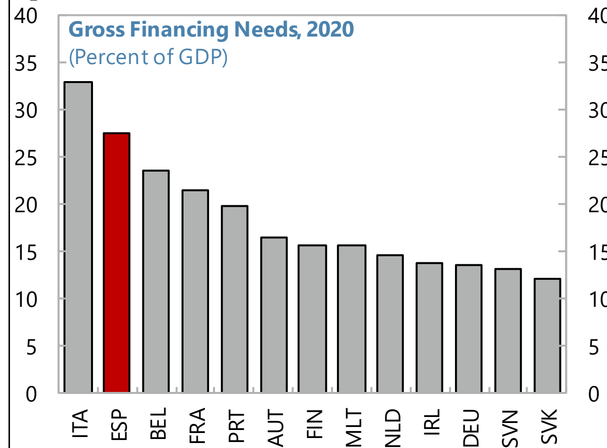
As a result, public debt remained elevated before the pandemic..



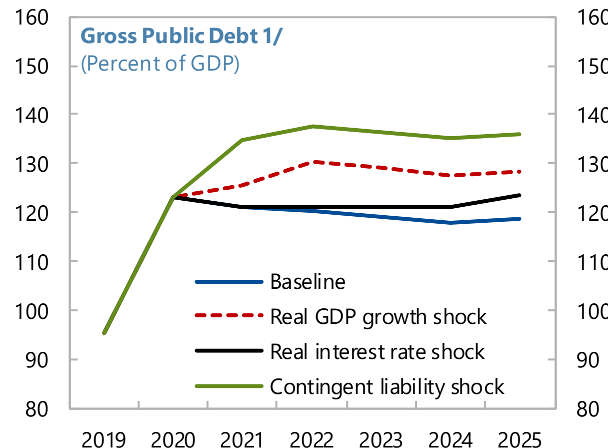
The economic recession and policy responses are expected to widen the fiscal deficit substantially, …



… keeping Spain's gross financing needs among the highest in euro area, …



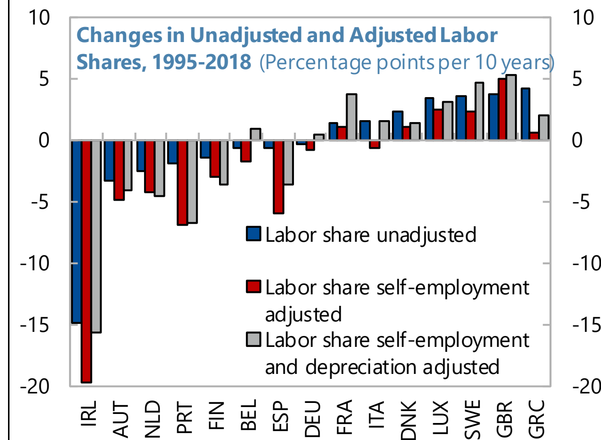
… and leaving the country vulnerable to shocks.



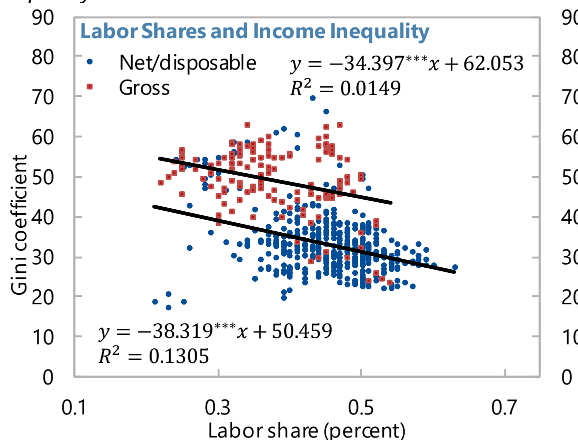
Sources: Bank of Spain; Fiscal Monitor (October 2020); Spain Ministry of Finance; and IMF staff estimates.
1/ For more details, see Debt Sustainability Analysis in Annex IV.

Figure 9. Spain: Selected Indicators of Social Outcomes

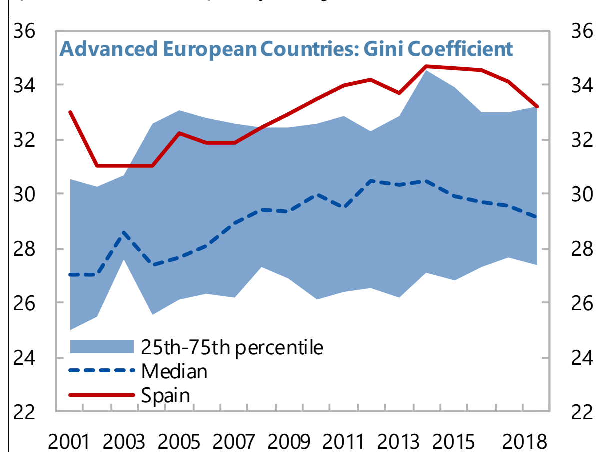
Spain's labor share declined considerably over the past two decades...



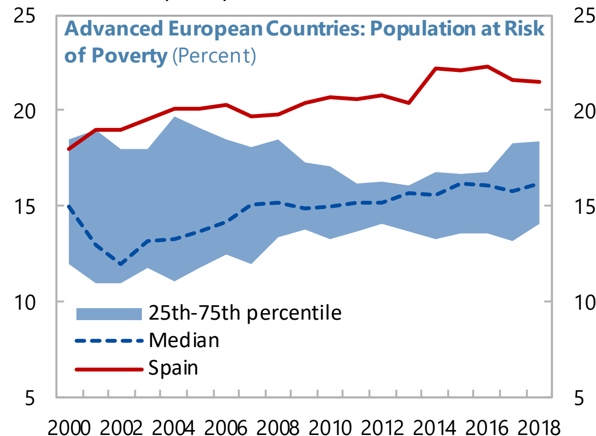
...which tends to be associated with more income inequality.



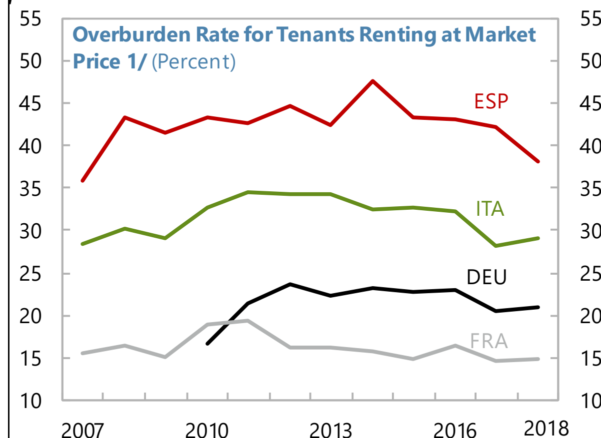
Spain's income inequality is high ...



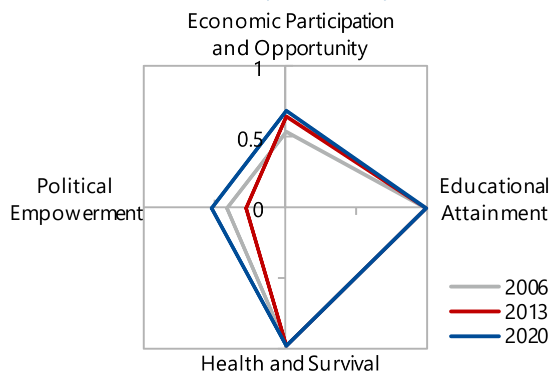
...and the share of population at risk of poverty elevated relative to European peers. 2/



Tenants in Spain are more overburdened than European peers.



Despite progress in the past decades, sizeable gender gaps remain in economic and polital empowerment.



Sources: Eurostat, Eurostat based on EU-SILC, Haver Analytics, World Economic Outlook, and IMF staff calculations.
1/ The overburden rate reflects the share of the population living as tenants with market rental prices whose total housing costs (net of housing allowances) represent more than 40 percent of the total disposable household income (net of housing allowances).
2/ Persons with an equivalized disposable income below 60 percent of the national median equivalized disposable income (after social transfers).

Table 1. Spain: Main Economic Indicators, 2016–2025
(Percent change unless otherwise indicated)

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
					Projections 1/					
Demand and supply in constant prices										
Gross domestic product	3.0	2.9	2.4	2.0	-12.8	7.2	4.5	3.4	2.8	1.5
Private consumption	2.7	3.0	1.8	1.1	-14.8	9.1	4.8	2.2	1.5	1.2
Public consumption	1.0	1.0	1.9	2.3	3.7	0.2	1.0	1.0	1.0	1.1
Gross fixed investment	2.4	5.9	5.3	1.8	-16.2	10.3	4.9	4.7	5.3	0.8
Total domestic demand	2.1	3.1	2.7	1.5	-11.4	7.2	4.0	2.5	2.2	1.1
Net exports (contribution to growth)	1.0	-0.1	-0.3	0.5	-1.7	0.0	0.5	1.0	0.6	0.4
Exports of goods and services	5.4	5.6	2.2	2.6	-25.5	10.1	12.9	7.2	4.5	3.9
Imports of goods and services	2.7	6.6	3.3	1.2	-22.3	10.6	11.7	4.5	2.8	3.1
Real GDP per capita	3.1	2.9	2.3	1.9	-12.8	7.1	4.0	2.9	2.4	1.1
Savings-Investment Balance (percent of GDP)										
Gross domestic investment	18.8	19.4	20.4	20.8	20.3	20.8	20.9	21.0	21.5	21.3
Private	16.8	17.4	18.2	18.8	17.6	17.7	17.8	18.0	18.5	19.0
Public	2.0	2.0	2.1	2.0	2.6	3.1	3.1	3.1	3.0	2.3
National savings	21.9	22.1	22.3	22.8	20.8	21.7	22.1	23.1	23.7	23.1
Private	24.3	23.1	22.7	23.6	32.2	26.1	24.9	24.7	24.6	25.1
Public	-2.3	-1.0	-0.4	-0.8	-11.4	-4.4	-2.7	-1.7	-0.9	-2.0
Foreign savings	-3.2	-2.7	-1.9	-2.0	-0.5	-0.9	-1.3	-2.0	-2.3	-1.8
Household saving rate (percent of gross disposable income)	7.0	5.5	5.9	7.4	13.1	8.2	6.4	6.5	6.7	6.7
Private sector debt (percent of GDP)	213.0	203.4	196.9	189.8	208.9	195.8	186.9	179.6	173.3	169.3
Corporate debt	144.2	137.7	133.3	127.6	136.9	126.1	118.8	112.7	107.9	104.5
Household debt	68.9	65.7	63.6	62.2	72.0	69.7	68.1	66.8	65.5	64.8
Credit to private sector	-4.1	-2.0	-3.9	-1.5	2.5	1.4	1.5	1.6	1.6	1.7
Potential output growth	0.9	1.1	1.3	1.5	-2.5	1.8	1.49	1.48	1.52	1.52
Output gap (percent of potential)	-2.6	-0.9	0.2	0.6	-10.0	-5.3	-2.5	-0.7	0.5	0.4
Prices										
GDP deflator	0.3	1.4	1.1	1.6	0.5	0.9	1.4	1.6	1.7	1.7
HICP (average)	-0.3	2.0	1.7	0.7	-0.2	0.8	1.4	1.6	1.6	1.7
HICP (end of period)	1.4	1.2	1.2	0.8	-0.3	0.8	1.6	1.6	1.6	1.7
Core inflation (average)	0.8	1.1	0.9	0.9	0.8	0.6	1.4	1.4	1.6	1.8
Core inflation (end of period)	0.9	0.9	0.9	1.0	0.8	0.6	1.4	1.4	1.6	1.8
Employment and wages										
Unemployment rate (percent)	19.6	17.2	15.3	14.1	16.8	16.8	15.7	14.9	14.4	14.2
Labor productivity 2/	0.2	0.0	-0.2	-0.3	-3.6	3.4	2.3	2.0	1.7	1.0
Labor costs, private sector	0.1	0.7	2.0	2.3	0.6	0.8	1.4	1.4	1.4	1.4
Employment growth	2.7	2.6	2.7	2.3	-4.9	1.0	2.1	1.4	1.0	0.5
Labor force growth	-0.4	-0.4	0.3	1.0	-1.8	1.0	0.7	0.5	0.4	0.4
Balance of payments (percent of GDP)										
Trade balance (goods and services)	4.0	3.6	2.7	2.8	1.4	1.4	1.8	2.7	3.2	3.6
Current account balance	3.2	2.7	1.9	2.0	0.5	0.9	1.3	2.0	2.3	1.8
Net international investment position	-85.5	-85.5	-80.2	-74.4	-84.0	-75.4	-68.6	-62.0	-55.9	-52.1
Public finance (percent of GDP) 3/, 4/										
General government balance	-4.3	-3.0	-2.5	-2.8	-14.1	-7.5	-5.8	-4.7	-3.9	-4.4
Primary balance	-1.9	-0.7	-0.3	-0.8	-11.7	-5.1	-3.4	-2.4	-1.7	-2.1
Structural balance	-2.7	-2.5	-2.3	-3.1	-8.1	-4.4	-4.3	-4.3	-4.3	-4.7
Primary structural balance	0.1	0.0	0.1	-0.8	-5.5	-1.7	-1.7	-1.7	-1.7	-2.1
General government debt	99.2	98.6	97.6	95.5	123.0	121.3	120.4	119.3	118.1	118.8
Memo item										
Nominal GDP (Millions of euros)	1113.8	1161.9	1202.2	1245.3	1091.2	1179.8	1249.7	1312.9	1371.7	1415.8
Real GDP (Millions of 2015 euros)	1110.2	1142.4	1169.2	1192.4	1039.4	1113.7	1163.5	1202.7	1235.9	1253.8

Sources: IMF, October 2020 World Economic Outlook; data provided by the authorities; and IMF staff estimates.

1/ The projections incorporate disbursements from the EU Recovery and Resilience Facility amounting to about 1.5 percent of GDP per year in 2021-24.

2/Output per worker.

3/ The 2020 fiscal projections include the discretionary measures adopted in response to the COVID-19 crisis, the legislated pension and public wage increases, and the minimum vital income support. Fiscal projections from 2021 assume an expiration of temporary COVID-19 measures and no further policiy change. Disbursements under the EU Recovery and Resilience Facility in 2021-24 are reflected as receipts in other revenue in the form of grants and spending in public investment.

4/ The headline balance includes financial sector support equal to 0.2 percent of GDP for 2016, and 0.1 percent of GDP for 2017.

Table 2a. Spain: General Government Operations, 2016–2025 1/

(Billions of euro, unless otherwise indicated)

					Projections 2/					
	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Revenue	424.8	443.5	471.0	486.75	421.6	478.1	505.5	528.9	550.5	545.4
Taxes	246.4	258.2	274.8	279.13	236.0	260.0	276.5	290.4	303.9	312.9
Indirect taxes	128.9	135.1	140.9	142.67	119.6	133.8	143.1	150.4	157.9	162.7
o.w. VAT	71.8	75.6	79.3	80.96	67.0	76.0	81.2	85.4	89.6	92.4
o.w. Excise	36.9	39.0	40.6	40.23	34.3	37.7	40.3	42.4	44.5	45.9
Direct taxes	111.1	117.4	128.2	131.04	111.7	121.0	128.0	134.3	140.0	144.0
o.w. Private households	85.6	91.5	98.1	99.01	87.8	93.3	97.4	100.9	104.0	106.3
o.w. Corporate	25.7	27.4	30.9	32.78	24.5	28.4	31.4	34.2	36.9	38.5
Capital tax	6.4	5.7	5.6	5.43	4.8	5.1	5.4	5.7	6.0	6.2
Social contributions	135.6	142.4	149.4	160.53	141.6	152.8	161.0	167.8	173.8	177.7
Other revenue	42.8	42.9	46.87	47.09	44.0	65.3	68.0	70.7	72.9	54.8
Expenditure	472.7	478.7	501.5	521.9	575.4	566.8	578.5	591.0	604.4	607.3
Expense	471.9	478.0	501.2	521.6	575.0	566.4	578.2	590.7	604.1	607.0
Compensation of employees	121.5	123.5	127.6	134.1	143.3	143.5	146.7	149.8	153.2	157.3
Use of goods and services	58.2	59.4	61.5	63.7	69.9	71.2	72.0	73.5	76.1	74.8
Consumption of fixed capital	21.0	22.5	25.4	25.0	28.7	36.9	38.5	40.0	41.3	32.9
Interest	30.7	29.3	29.3	28.5	28.7	31.5	33.3	34.1	34.6	36.0
Social benefits	203.0	207.4	216.3	229.6	264.1	243.3	247.5	252.5	257.9	264.0
Other expense	37.5	36.0	41.0	40.8	40.4	39.9	40.2	40.8	40.9	42.0
Subsidies	11.2	12.1	12.1	12.7	13.5	12.7	12.7	12.7	12.7	12.7
Other	26.2	23.8	28.9	28.1	26.9	27.2	27.5	28.1	28.2	29.3
o.w. financial sector support	2.4	0.5	0.1	0.0	0.0	...	...	...	...	...
o.w. other one-offs	0.3	0.0	3.4	1.2	0.0	...	...	...	...	...
Net acquisition of nonfinancial assets	0.9	0.7	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Gross fixed capital investment	21.9	23.2	25.7	25.4	29.0	37.3	38.8	40.4	41.6	33.2
Consumption of fixed capital	21.0	22.5	25.4	25.0	28.7	36.9	38.5	40.0	41.3	32.9
Other non financial assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross operating balance	-47.1	-34.4	-30.2	-34.9	-153.4	-88.3	-72.7	-61.8	-53.6	-61.6
Net lending / borrowing	-48.0	-35.1	-30.5	-35.2	-153.8	-88.6	-73.0	-62.1	-53.9	-61.9
Net lending / borrowing (excluding financial sector support)	-45.6	-34.6	-30.5	-35.2	-153.8	-88.6	-73.0	-62.1	-53.9	-61.9
Memorandum items:										
Nominal GDP	1,113.8	1,161.9	1,202.2	1,245.3	1,091.2	1,179.8	1,249.7	1,312.9	1,371.7	1,415.8

Sources: Eurostat; Ministry of Finance; and IMF staff estimates and projections as reported in the October 2020 World Economic Outlook.

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

2/ The 2020 fiscal projections include the discretionary measures adopted in response to the COVID-19 crisis, the legislated pension and public wage increases, and the minimum vital income support. Fiscal projections from 2021 assume an expiration of temporary COVID-19 measures and no further policiy change. Disbursements under the EU Recovery and Resilience Facility in 2021-24 are reflected as receipts in other revenue in the form of grants and spending in public investment.

Table 2b. Spain: General Government Operations, 2014–2025 1/

(Percent of GDP, unless otherwise indicated)

						Projections 2/					
	2014	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Revenue	39.2	38.1	38.2	39.2	39.1	38.6	40.5	40.5	40.3	40.1	38.5
Taxes	22.3	22.1	22.2	22.9	22.4	21.6	22.04	22.1	22.1	22.2	22.1
Indirect taxes	11.5	11.6	11.6	11.7	11.5	11.0	11.34	11.4	11.5	11.5	11.5
o.w. VAT	6.2	6.4	6.5	6.6	6.5	6.1	6.44	6.5	6.5	6.5	6.5
o.w. Excise	3.3	3.3	3.4	3.4	3.2	3.1	3.20	3.2	3.2	3.2	3.2
Direct taxes	10.3	10.0	10.1	10.7	10.5	10.2	10.26	10.2	10.2	10.2	10.2
o.w. Private households	8.1	7.7	7.9	8.2	8.0	8.0	7.91	7.8	7.7	7.6	7.5
o.w. Corporate	2.1	2.3	2.4	2.6	2.6	2.2	2.41	2.5	2.6	2.7	2.7
Capital tax	0.5	0.6	0.5	0.5	0.4	0.4	0.44	0.4	0.4	0.4	0.4
Social contributions	12.5	12.2	12.3	12.4	12.9	13.0	13.0	12.9	12.8	12.7	12.6
Other revenue	4.4	3.8	3.7	3.9	3.8	4.0	5.5	5.4	5.4	5.3	3.9
Expenditure	45.1	42.4	41.2	41.7	41.9	52.7	48.0	46.3	45.0	44.1	42.9
Expense	45.0	42.4	41.1	41.7	41.9	52.7	48.0	46.3	45.0	44.0	42.9
Compensation of employees	11.1	10.9	10.6	10.6	10.8	13.1	12.2	11.7	11.4	11.2	11.1
Use of goods and services	5.4	5.2	5.1	5.1	5.1	6.4	6.0	5.8	5.6	5.6	5.3
Consumption of fixed capital	2.1	1.9	1.9	2.1	2.0	2.6	3.1	3.1	3.0	3.0	2.3
Interest	3.4	2.8	2.5	2.4	2.3	2.6	2.7	2.7	2.6	2.5	2.5
Social benefits	19.2	18.2	17.9	18.0	18.4	24.2	20.6	19.8	19.2	18.8	18.6
Other expense	3.7	3.4	3.1	3.4	3.3	3.7	3.4	3.2	3.1	3.0	3.0
Subsidies	1.1	1.0	1.0	1.0	1.0	1.2	1.1	1.0	1.0	0.9	0.9
Other	2.6	2.4	2.1	2.4	2.3	2.5	2.3	2.2	2.1	2.1	2.1
o.w. financial sector support	0.1	0.2	0.0	0.0	0.0	0.0	...	...	...	...	...
o.w. other one-offs	0.0	0.0	0.0	0.3	0.1	0.0	...	...	...	...	...
Net acquisition of nonfinancial assets	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross fixed capital investment	2.2	2.0	2.0	2.1	2.0	2.7	3.2	3.1	3.1	3.0	2.3
Consumption of fixed capital	2.1	1.9	1.9	2.1	2.0	2.6	3.1	3.1	3.0	3.0	2.3
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	-5.8	-4.2	-3.0	-2.5	-2.8	-14.1	-7.5	-5.8	-4.7	-3.9	-4.3
Net lending / borrowing	-5.9	-4.3	-3.0	-2.5	-2.8	-14.1	-7.5	-5.8	-4.7	-3.9	-4.4
Net lending / borrowing (excluding financial sector support)	-5.8	-4.1	-3.0	-2.5	-2.8	-14.1	-7.5	-5.8	-4.7	-3.9	-4.4
Memorandum items:											
Net lending/ borrowing (EDP targets)	-5.8	-4.6	-3.1	-2.2	...	...	...	...	...	...	...
Primary balance	-3.0	-1.9	-0.7	-0.3	-0.8	-11.7	-5.1	-3.4	-2.4	-1.7	-2.1
Primary balance (excluding financial sector support) 3/	-2.4	-1.6	-0.5	-0.1	-0.5	-11.5	-4.8	-3.2	-2.1	-1.4	-1.8
Cyclically adjusted balance	-1.8	-2.9	-2.6	-2.6	-3.2	-8.1	-4.4	-4.3	-4.3	-4.3	-4.7
Cyclically adjusted primary balance (excluding financial sector support) 3/	1.6	-0.2	0.0	-0.2	-0.9	-5.5	-1.7	-1.7	-1.7	-1.7	-2.1
Primary structural balance 3/	2.0	0.1	0.0	0.1	-0.8	-5.5	-1.7	-1.7	-1.7	-1.7	-2.1
Structural balance	-1.4	-2.7	-2.5	-2.3	-3.1	-8.1	-4.4	-4.3	-4.3	-4.3	-4.7
General government gross debt (Maastricht)	100.7	99.2	98.6	97.6	95.5	123.0	121.3	120.4	119.3	118.1	118.8
Net debt	85.2	86.1	84.5	82.7	81.3	106.9	106.4	106.3	105.9	105.3	106.4
Central Government net lending	-3.6	-2.5	-1.8	-1.3	-1.1	-5.6	-3.0	-2.3	-1.9	-1.6	-1.7
Output gap	-7.6	-2.6	-0.9	0.2	0.6	-10.0	-5.3	-2.5	-0.7	0.6	0.5

Sources: Eurostat; Ministry of Finance; and IMF staff estimates and projections as reported in the October 2020 World Economic Outlook.

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

2/ The 2020 fiscal projections include the discretionary measures adopted in response to the COVID-19 crisis, the legislated pension and public wage increases, and the minimum vital income support. Fiscal projections from 2021 assume an expiration of temporary COVID-19 measures and no further policy change. Disbursements under the EU Recovery and Resilience Facility in 2021-24 are reflected as receipts in other revenue in the form of grants and spending in public investment.

3/ Including interest income.

Table 3. Spain: General Government Balance Sheet, 2010–2019

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
					(Billions of euro)					
Financial assets	308.6	332.3	360.6	383.7	398.3	399.9	399.5	416.9	432.6	429.6
Currency and Deposits	95.1	77.5	84.7	72.7	83.9	85.5	79.3	92.9	102.9	95.7
Securities other than shares	22.4	14.4	4.9	14.0	9.1	5.1	4.4	3.7	3.9	11.1
Loans	38.3	51.3	60.4	65.8	67.0	64.3	62.2	60.1	60.0	58.7
Other assets	152.8	189.0	210.6	231.2	238.3	245.1	253.6	260.2	265.8	264.0
Liabilities	725.0	835.6	963.6	1,087.3	1,233.4	1,261.8	1,307.1	1,345.4	1,379.2	1,460.8
Currency and deposits	3.6	3.7	3.7	3.7	3.8	4.1	4.2	4.5	4.7	4.9
Securities other than shares	526.4	608.4	673.3	805.2	948.9	997.4	1,059.5	1,105.0	1,143.0	1,220.2
Loans	112.3	129.9	217.9	214.2	216.1	196.6	183.6	170.1	155.3	153.0
Other liabilities	82.8	93.6	68.7	64.1	64.6	63.8	59.8	65.8	76.3	82.8
					(Percent of GDP)					
Financial assets	28.8	31.2	35.0	37.6	38.6	37.1	35.9	35.9	36.0	34.5
Currency and Deposits	8.9	7.3	8.2	7.1	8.1	7.9	7.1	8.0	8.6	7.7
Securities other than shares	2.1	1.4	0.5	1.4	0.9	0.5	0.4	0.3	0.3	0.9
Loans	3.6	4.8	5.9	6.5	6.5	6.0	5.6	5.2	5.0	4.7
Other assets	14.2	17.8	20.4	22.7	23.1	22.7	22.8	22.4	22.1	21.2
Liabilities	67.6	78.6	93.5	106.6	119.5	117.1	117.4	115.8	114.7	117.3
Currency and deposits	0.3	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Securities other than shares	49.1	57.2	65.3	78.9	91.9	92.6	95.1	95.1	95.1	98.0
Loans	10.5	12.2	21.1	21.0	20.9	18.2	16.5	14.6	12.9	12.3
Other liabilities	7.7	8.8	6.7	6.3	6.3	5.9	5.4	5.7	6.3	6.7
					(Billions of euro)					
Memorandum items:										
Public debt (EDP)	649.2	743.0	889.9	977.3	1,039.4	1,070.1	1,104.6	1,145.1	1,173.3	1,188.9
Net lending/borrowing	-102.2	-103.6	-110.7	-71.8	-61.1	-55.8	-48.0	-35.1	-30.5	-35.2
Change in public debt (EDP)	79.6	93.9	146.9	87.4	62.1	30.7	34.5	40.5	28.3	15.5
Change in financial assets	-8.5	23.7	28.3	23.1	14.6	1.7	-0.5	17.5	15.7	-3.0
Change in net financial assets	-88.1	-70.2	-118.6	-64.3	-47.5	-29.0	-34.9	-23.1	-12.6	-18.5
Unexplained change in net financial assets	14.1	33.4	-7.9	7.5	13.6	26.8	13.0	12.0	17.9	16.7

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

Table 4. Spain: Selected Financial Soundness Indicators, 2010–2019

(Percent, unless otherwise indicated)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Depository institutions										
Capital adequacy										
Regulatory capital to risk-weighted assets	11.9	12.1	11.6	13.3	13.7	14.7	14.8	15.6	15.6	15.9
Regulatory tier-1 capital to risk-weighted assets	9.7	10.2	9.9	11.9	11.9	12.9	13.1	13.4	13.7	14.0
Capital to total assets	6.1	5.9	5.8	6.8	7.2	7.4	7.8	7.6	7.6	7.6
Asset quality: Consolidated basis										
Nonperforming loans (in billions of euro)	119	153	180	210	188	159	143	113	95	84
Nonperforming loans to total loans	4.7	6.0	7.5	9.4	8.5	6.2	5.6	4.5	3.7	3.2
Specific provisions to nonperforming loans	65.7	56.9	68.4	56.8	57.7	61.5	59.3	58.1	63.2	64.9
Asset quality: Domestic operations										
Nonperforming loans (in billions of euro)	103	136	163	192	167	130	112	94	67	54
Nonperforming loans to total loans	5.8	7.9	10.6	13.8	12.6	10.2	9.2	7.9	5.8	4.8
Specific provisions to nonperforming loans	38.7	36.6	44.4	46.6	46.4	46.6	45.7	41.8	41.1	41.2
Exposure to businesses - Construction (in billions of euro)	422	389	294	232	196	175	157	142	120	112
o/w: Nonperforming (in percent)	13.5	20.8	28.5	37.3	35.6	28.3	26.5	19.6	10.2	6.7
Exposure to businesses - Other (in billions of euro)	554	541	495	456	452	444	425	428	404	401
o/w: Nonperforming (in percent)	3.7	5.0	8.6	12.5	11.7	9.6	8.4	7.4	6.1	5.2
Exposure to households - Home purchase (in billions of euro)	624	614	593	569	546	520	506	493	491	483
o/w: Nonperforming (in percent)	2.3	2.8	3.8	5.7	5.6	4.6	4.5	4.5	3.9	3.2
Exposure to households - Other (in billions of euro)	183	171	157	136	134	134	134	136	136	140
o/w: Nonperforming (in percent)	5.6	6.1	9.0	11.6	10.7	10.3	9.1	9.3	8.4	7.5
Earning and profitability: Consolidated basis										
Return on assets	0.5	0.1	-1.4	0.4	0.4	0.5	0.4	0.5	0.6	0.5
Return on equity	8.0	1.5	-21.0	5.4	5.7	7.1	5.5	6.7	8.1	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	0.6	0.6
Return on equity	5.6	-9.1	-43.6	2.0	5.9	4.9	3.1	-0.3	6.7	6.9
Funding										
Customer loans to non-interbank deposits	127.5	131.5	128.7	117.9	114.0	112.0	110.5	118.6	118.7	116.7
Loans to deposits 1/	144.8	145.3	132.4	118.3	114.5	110.0	105.7	104.9	98.9	93.3
Use of ECB refinancing (in billions of euro) 2/	70	132	357	207	142	133	140	171	168	133
In percent of total ECB refinancing operations	13.2	18.4	32.0	28.8	26.2	25.0	24.8	22.3	22.8	20.5
In percent of total assets of Spanish MFIs	2.0	3.7	10.0	6.6	4.8	4.7	5.1	6.3	6.3	5.0
Total assets (in percent of GDP)	254	257	259	224	238	245	236	222	215	213
Other financial institutions										
Total assets (in percent of GDP)										
Insurance companies and pension funds	28	29	31	32	38	43	38	33	31	…
Other institutions 3/	102	95	92	77	89	94	85	70	64	…
Shadow banking activity 4/	21	20	19	18	24	27	26	23	21	…
Corporate sector										
Debt (in percent of GDP)	187.4	178.7	170.4	164.7	158.8	149.8	144.1	137.4	134.1	129.7
Debt to total assets	54.5	53.3	50.3	47.0	45.8	42.4	41.5	39.5	39.6	37.5
Liquid assets to short-term liabilities	161.2	177.6	196.5	238.3	251.4	245.2	278.1	288.0	293.4	309.0
Household sector										
Debt (in percent of GDP)	90	87	87	83	78	72	69	66	64	62
Debt service and principal payment to disposable income	16.0	15.4	15.3	13.7	12.8	12.2	11.9	11.8	11.6	…
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	6.6	3.6
Housing completion (2007=100)	43	28	21	9	8	8	7	8	10	12
Property sales (2007=100)	57	47	43	42	43	46	51	57	63	63

Sources: Bank of Spain; Haver Analytics; FSB, Global Shadow Banking Monitoring Report 2019; 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, 2016–2025

	2016	2017	2018	2019	Projections 2020	2021	2022	2023	2024	2025
					(Billions of euro)					
Current account	35.4	31.1	23.3	24.6	5.9	10.9	15.9	26.3	31.2	25.7
Trade balance of goods and services	44.4	41.6	32.6	34.8	15.4	16.0	22.5	35.2	44.4	50.8
Exports of goods and services	377.4	408.7	422.2	434.3	321.0	357.0	408.2	443.7	471.1	498.0
Exports of goods	259.5	281.3	290.3	293.8	246.4	278.3	297.9	310.5	324.4	339.3
Exports of services	117.9	127.5	131.9	140.5	74.6	78.7	110.3	133.2	146.7	158.7
Trade of goods balance	-14.3	-22.1	-29.3	-28.2	-5.9	-4.0	-19.3	-22.3	-19.4	-18.6
Imports of goods and services	-333.0	-367.1	-389.5	-399.5	-305.6	-341.1	-385.6	-408.5	-426.7	-447.2
Imports of goods	-273.7	-303.4	-319.6	-322.0	-252.3	-282.3	-317.2	-332.9	-343.8	-357.9
Imports of services	-59.2	-63.8	-70.0	-77.5	-53.3	-58.7	-68.4	-75.7	-82.9	-89.3
Services	58.7	63.7	61.9	62.9	21.3	20.0	41.8	57.5	63.8	69.4
Of which:										
Tourism	43.4	47.1	46.3	45.9	...	...	...	...	...	...
Exports	60.4	66.7	69.0	71.2	...	...	...	...	...	...
Imports	-17.0	-19.6	-22.7	-25.3	...	...	...	...	...	...
Primary income	2.8	-0.3	2.7	2.5	1.7	1.0	0.0	-1.8	-4.6	-7.6
Secondary income	-11.8	-10.2	-12.0	-12.7	-11.3	-6.1	-6.6	-7.0	-8.6	-17.4
General government	-8.6	-6.0	-7.7	-8.1	-7.1	0.9	0.2	-0.4	-1.0	-10.1
Other sectors	-3.2	-4.2	-4.4	-4.6	-4.2	-7.0	-6.8	-6.7	-7.6	-7.3
Capital account	2.4	2.8	5.8	4.1	3.6	16.5	16.3	16.3	16.2	3.7
Financial account	35.4	32.7	31.3	30.7	9.4	27.4	32.2	42.6	47.3	29.5
Direct investment	11.2	12.0	-15.2	10.8	-1.8	2.7	2.6	3.4	4.4	4.7
Spanish investment abroad	50.8	35.0	25.4	20.8	11.1	24.9	26.1	27.1	28.2	28.3
Foreign investment in Spain	39.7	23.1	40.6	10.0	12.8	22.2	23.5	23.7	23.7	23.5
Portfolio investment	58.6	32.9	21.7	-50.0	34.7	37.9	32.8	26.6	29.3	26.3
Financial derivatives	2.6	7.5	1.6	-8.5	0.0	0.0	0.0	0.0	0.0	0.0
Other investment	-45.3	-23.3	21.0	77.7	-23.5	-13.2	-3.2	12.6	13.6	-1.6
Change in reserve assets	8.3	3.7	2.2	0.7	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	-2.3	-1.3	2.2	2.1	0.0	0.0	0.0	0.0	0.0	0.0
					(Percent of GDP)					
Current account	3.2	2.7	1.9	2.0	0.5	0.9	1.3	2.0	2.3	1.8
Trade balance of goods and services	4.0	3.6	2.7	2.8	1.4	1.4	1.8	2.7	3.2	3.6
Exports of goods and services	33.9	35.2	35.1	34.9	29.4	30.3	32.7	33.8	34.3	35.2
Exports of goods	23.3	24.2	24.1	23.6	22.6	23.6	23.8	23.7	23.7	24.0
Exports of services	10.6	11.0	11.0	11.3	6.8	6.7	8.8	10.1	10.7	11.2
Imports of goods and services	-29.9	-31.6	-32.4	-32.1	-28.0	-28.9	-30.9	-31.1	-31.1	-31.6
Imports of goods	-24.6	-26.1	-26.6	-25.9	-23.1	-23.9	-25.4	-25.4	-25.1	-25.3
Imports of services	-5.3	-5.5	-5.8	-6.2	-4.9	-5.0	-5.5	-5.8	-6.0	-6.3
Primary income	0.2	0.0	0.2	0.2	0.2	0.1	0.0	-0.1	-0.3	-0.5
Secondary income	-1.1	-0.9	-1.0	-1.0	-1.0	-0.5	-0.5	-0.5	-0.6	-1.2
Capital account	0.2	0.2	0.5	0.3	0.3	1.4	1.3	1.2	1.2	0.3
Financial account	3.2	2.8	2.6	2.5	0.9	2.3	2.6	3.2	3.4	2.1
Direct investment	1.0	1.0	-1.3	0.9	-0.2	0.2	0.2	0.3	0.3	0.3
Portfolio investment	5.3	2.8	1.8	-4.0	3.2	3.2	2.6	2.0	2.1	1.9
Financial derivatives	0.2	0.6	0.1	-0.7	0.0	0.0	0.0	0.0	0.0	0.0
Other investment	-4.1	-2.0	1.7	6.2	-2.2	-1.1	-0.3	1.0	1.0	-0.1
Of which, BdE	-6.7	-3.8	-2.1	1.1	-2.9	-1.6	-0.7	-0.4	-0.2	0.0
Change in reserve assets	0.7	0.3	0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	-0.2	-0.1	0.2	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Net international investment position	-85.5	-85.5	-80.2	-74.4	-84.0	-75.4	-68.6	-62.0	-55.9	-52.1
Valuation changes	-2.7	-6.3	-0.2	0.6	0.0	0.0	0.0	0.0	0.0	0.0

Sources: Bank of Spain and IMF staff estimates and projections as reported in the October 2020 World Economic Outlook.
Notes: Based on the sixth edition of the IMF's Balance of Payments Manual. Projected grants under the EU Recovery and Resilience Facility in 2021-24 are reflected in the secondary income account and the capital account.

Annex I. Main Recommendations of the 2018 Article IV Consultation and Authorities Actions

IMF 2018 Article IV Recommendations	Policy Actions
Fiscal Policy	
Resume fiscal adjustment with an annual reduction in the structural primary deficit by about 0.5 percent of GDP until structural balance is reached.	After a small structural improvement in 2018, the structural primary balance worsened by 0.9 percent of GDP in 2019. As a result of the Covid-19 crisis, the structural balance is projected to widen to about 4¾ percent over the medium-term absent adjustment measures.
Identify growth-friendly adjustment measures by gradually expanding VAT collection, raising excise duties and environmental levies, and lowering inefficiencies in the tax system.	Under the budget extensions for 2019-20, no major measures were introduced. Beyond 2021, the authorities plan to introduce a package of revenue measures. The first phase of the expenditure review was concluded with proposals to improve spending efficiencies. The second phase is ongoing.
Continue the implementation of the 2011/13 pension reforms and identify refinement options to balance pension sustainability and social acceptability.	Non-contributory pensions were increased by 3 percent in 2019 and 2020 deviating from the 0.25 percent implied by the pension formula. On the revenue side, maximum contribution bases were raised by 7 percent and the minimum contribution rate for professional contingencies (accidents at work) was increased to 1.5 percent. The government plans to permanently relink pension increases to inflation and eliminate the sustainability factor. New reforms consultations under the Toledo Pact are envisaged.
Structural Reforms	
Labor market reforms	
Improve the efficiency, coordination, and design of active labor market policies (ALMPs), implement a multi-year strategy on employment activation, and consolidate the vast amount of ALMPs from the programs with low participations to the most promising programs, such as those involving the support by a personal tutor.	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. The government's coalition agreement foresees additional measures.
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. Creating an employer-based separation fund ("Austrian backpack").	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. In this context, they have intensified inspections and increased sanctions to reduce the abuse of temporary and permanent contracts.
Provide incentives for people to move, such as subsidies for moving expense and temporary and targeted housing assistance.	No specific measure to enhance incentives for labor mobility have been taken.
Productivity growth	
Advance the implementation of the Market Unity Law and liberalization of professional services; tackle remaining size-related regulations; improve coordination between different levels of	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 authorities

government on research and innovation policies; clarify and simplify the eligibility criteria for firms to qualify for government's R&D incentives; increase labor market relevance of tertiary education; and reduce regional differences in education outcomes through exchanges of best practices.	started to use the regional conferences to facilitate the implementation of the Market Unity Law, though with limited impact so far.
Financial Sector Policies	
Keep reducing impaired assets by implementing ECB guidance on NPLs, while closely monitoring NPLs in consumer credit.	Partly driven by supervisory pressure, NPLs and foreclosed assets continued to decline as several banks continued to sell impaired asset portfolios. According to the SSM, progress is broadly in line with banks' NPLs reduction plans. The BdE has analyzed developments in consumer credit and concluded that greater vigilance on credit standards and on the most active institutions in consumer credit is necessary.
Encourage banks to build up high-quality capital and to pursue further cost-cutting and branch consolidation, as well as continue exploring the scope for further banking consolidation.	The BdE has emphasized that the subdued performance of CET1 capital in recent years differs from that of dividends distributed by Spanish banks, and that higher CET1 ratios should help reduce banks' debt issuance costs. Several banks are rationalizing costs, in line with BdE's advice. A merger of two significant banks is underway.
Ensure rigorous monitoring and management of liquidity and interest rate risks.	The Bank of Spain conducted a new round of liquidity stress tests in 2019. The National Securities Market Commission has started to monitor more closely liquidity risks at investment funds.
Strengthen areas of prudential oversight and resolution.	The BdE has asked banks to estimate their exposure to legal risk from new potential lawsuits. A new real estate credit law came into force in June 2019, transposing the EU mortgage directive into national law. The creation of an independent insurance and pension supervisor as well as a financial consumer protection authority are still under active consideration.
Modernize the institutional framework for financial oversight and enhance BdE's macroprudential toolkit.	A new macroprudential authority (AMCESFI) was created in early 2019. The sectoral supervisors have been empowered with new macroprudential tools since December 2018, including borrower-based tools for the BdE.

Annex II. External Sector Assessment

Overall Assessment: *The external position in 2019 was broadly in line with the level implied by medium-term fundamentals and desirable policies. On a preliminary basis, recent developments suggest a moderately weaker overall external position in 2020 compared to 2019. However, this assessment is highly uncertain given the lack of full-year data for 2020 and the COVID-19 crisis, and a complete analysis will be provided in the 2021 External Sector Report.* In 2019, the CA remained in surplus for the eighth consecutive year. Achieving a sufficiently strong NIIP will continue to require a relatively high CA surplus for a sustained period.

Potential Policy Responses: Structural reforms in response to the global financial crisis—in particular labor market reform, with the resulting wage moderation, and fiscal adjustment—helped reduce imbalances. To mitigate the impact of the COVID-19 crisis, targeted and temporary income and liquidity support is warranted. If sources of external vulnerability that existed prior to the COVID-19 outbreak persist in the medium term, policies should foster competitiveness and carefully manage the public debt load. Boosting competitiveness through productivity gains over the medium term would entail continued wage flexibility, reforms to address labor market duality, implementation of product and service market reforms, and actions to enhance education outcomes and innovation.

Foreign Asset and Liability Position and Trajectory	**Background.** The NIIP dropped significantly during 2000–09, driven mostly by high CA deficits but also by valuation effects. The NIIP was –74 percent of GDP in 2019, but has risen by 15 percentage points since 2015, partly due to sustained CA surpluses and despite some negative valuation effects. Gross liabilities stood at 250 percent of GDP in 2019, with about two-thirds in the form of external debt. Whereas the private sector has deleveraged since the 2008–12 crisis, the NIIP accounted for by the general government and the central bank increased, raising its share to more than four-fifths in 2019. Part of that increase is due to TARGET2 liabilities, which had reached 30 percent of GDP by end-2019.[1] **Assessment.** The large negative NIIP comes with external vulnerabilities, including from large gross financing needs and potentially adverse valuation effects. Mitigating factors are a favorable maturity structure of outstanding sovereign debt (averaging almost eight years) and current ECB measures, such as QE, that lower the cost of debt.				
2019 (% GDP)	NIIP: –73.5	Gross Assets: 176.1	Debt Assets: 80.9	Gross Liab.: 249.6	Debt Liab.: 151.7
Current Account	**Background.** After a peak CA deficit in 2007, corrected initially by a sharp contraction in imports, regained competitiveness from wage moderation and greater internationalization efforts contributed to strong export growth, leading to CA surpluses in 2012–19. Historical data revisions, including upward changes in tourism receipts, show that recent CA surpluses were higher than reported earlier—the annual average surplus during 2013–18 was revised from 1.5 to 2.3 percent of GDP. The CA surplus was close to 2.0 percent of GDP in 2019. With high uncertainty, the 2020 CA is projected to remain in surplus, with imports declining more strongly than exports partly because of low oil prices. Weaker-than-expected exports—particularly tourism receipts—are a key downside risk around this projection. Moderate CA surpluses are projected to continue in the medium term. **Assessment.** The EBA CA model suggests a norm of 1.1 percent of GDP for 2019, which is below the cyclically adjusted CA balance (2.2 percent of GDP). However, given external risks from a large and negative NIIP, the IMF staff's assessment puts more weight on external sustainability and is guided by the objective of raising the NIIP to at least –50 percent over the medium to long term. The NIIP is projected to reach –52 percent of GDP over the medium term under current policies, though with high uncertainty as zero valuation effects are assumed. Allowing for a safety margin,				

[1] Based on data available through 2019:Q4.

	the IMF staff therefore considers a CA norm of about 2 percent of GDP, with a range of 1 to 3 percent of GDP. This yields a CA gap of –0.8 to 1.2 percent of GDP.[2]					
2019 (% GDP)	Actual CA: 2.0	Cycl. Adj. CA: 2.2	EBA CA Norm: 1.1	EBA CA Gap: 1.1	Staff Adj.: –0.9	Staff CA Gap: 0.2
Real Exchange Rate	**Background.** In 2019, the CPI-based REER and the ULC-based REER depreciated from their average 2018 levels by 1.9 and 1.4 percent, respectively. The CPI-based REER is still moderately lower than its 2009 peak, partially reversing the significant appreciation from euro entry in 1999 until 2009. The ULC-based REER shows that the appreciation between 1999 and 2008 has been substantially reversed, initially because of labor shedding and thereafter due to wage moderation and strong output growth until 2019. After reaching its peak in 2008, the ULC-based REER depreciated by 19 percent. As of August 2020, the CPI-based REER had appreciated by 1.7 percent and the ULC-based REER had appreciated by 0.8 percent relative to their 2019 averages. **Assessment.** The EBA REER models estimate an overvaluation of 4.9 to 5.2 percent for 2019, whereas the IMF staff CA gap implies an undervaluation of 0.9 percent. Taking into account also the need for preserving competitiveness, and the risks from NIIP sustainability, on balance, the IMF staff assesses the 2019 REER gap to be in the range of –4.9 to 3.1 percent, with a midpoint of –0.9 percent.[3]					
Capital and Financial Accounts: Flows and Policy Measures	**Background.** Financing conditions have continued to be favorable, despite some increase in sovereign bond yields in the wake of the COVID-19 crisis. And by 2019:Q4 the private sector had continued its deleveraging against the rest of the world. In 2019, the financial account balance was largely driven by net outflows of loans and other bank-related instruments (especially from sectors other than the central bank). The accumulation of TARGET2 liabilities, reflecting liquidity creation within the framework of the Eurosystem's asset purchase program, was negative for the first time since 2015 (–3 percent of GDP in 2019). **Assessment.** Investor sentiment had continued to improve in 2019. However, amid the pandemic crisis, large external financing needs leave Spain vulnerable to sustained market volatility, although the ECB's policies to maintain favorable liquidity conditions and monetary accommodation remain a mitigating factor.					
FX Intervention and Reserves Level	**Background.** The euro has the status of a global reserve currency. **Assessment.** Reserves held by the euro area are typically low relative to standard metrics, but the currency is free floating.					

[2] The EBA model suggests a CA norm of 1.1 percent of GDP, with a standard error of 0.8 percent of GDP. But the empirically based EBA norm does not fully account for the very negative NIIP, with about 30 percent of gross liabilities in the form of equity. Given external stability considerations, including potentially adverse NIIP valuation effects, a CA norm in the range of 1 to 3 percent of GDP is necessary to raise the NIIP by at least roughly 3 percent of GDP annually over the next 10 years. Over 2013–19, valuation effects were on average –2.9 percent of GDP per annum. CA surpluses during 2013–19 of about 2.2 percent of GDP, on average, suggest that maintaining CA balances aligned with the IMF staff–assessed norm of 1 to 3 percent of GDP would be feasible under current policies.

[3] The REER gap midpoint is obtained from the staff-assessed CA gap and an estimated semi-elasticity of the CA to the REER of 0.22. The range of the REER gap is +/-4 percent, which is obtained from Spain's estimated standard error of the EBA CA norm (0.8 percent of GDP) and the aforementioned CA-to-REER semi-elasticity.

Annex III. Risk Assessment Matrix

Source of Risks	Relative Likelihood	Impact if Realized	Policy Response
Conjunctural Risks			
Unexpected shift in the Covid-19 pandemic	High **Downside.** The disease proves harder to eradicate (e.g., due to difficulties in finding/distributing a vaccine) requiring more containment. Monetary and fiscal policy response is insufficient amid dwindling policy space and concerns about debt sustainability. Financial markets reassess real economy risks. Pandemic-prompted protectionist actions (e.g., export controls) reemerge. Low **Upside.** Recovery from the pandemic is faster than expected due to the discovery of an effective and widely available vaccine and/or a faster-than-expected behavioral adjustment to the virus.	High The needed containment measures would negatively affect economic activity directly and through persistent behavioral changes (prompting costly reallocations of resources). Reassessing real economy risks would lead to a repricing of risk assets, unmasking of debt-related vulnerabilities, and weakening banks and nonbank financial intermediaries–forcing them to reduce credit. Protectionism actions will disrupt trade and global value chains. High/ Medium Faster-than-expected recovery would boost confidence and economic activity.	• Scale up rescue measures already in place. • Realign policy support measures more towards incentivizing reallocation of resources while supporting affected workers during the transition. • Enhance private debt resolution system. • Regulatory forbearance and broader policy support from the ECB would help banks withstand this shock. • 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. • In the case of faster-than-expected recovery, accelerate the unwinding of rescue measures, while ensuring that it does not disrupt the recovery process.
Intensification of geopolitical tensions and security risks	High Intensification of these risks in response to pandemic, cause socio-economic and political disruption.	Medium Intensification of conflicts in the Middle East and Africa could lead to disorderly migration into Europe further deepening political division within the EU, higher commodity prices (if supply is disrupted), and lower confidence.	• Accelerate structural reforms, enhance policies for swift labor market integration, and formulate credible medium-term fiscal path to support investor confidence.
Oversupply and volatility in the oil market	Medium Supply increases following OPEC+ disagreements and lower demand keep energy prices close to historical	Medium Given relatively high oil intensity of the Spanish economy, higher oil prices would push up CPI inflation weighing on	• Use any windfall revenues to reduce the high public debt.

	lows, but uncertainty about possible production cuts and the pace of demand recovery lead to bouts of volatility.	consumer spending and growth, while in a scenario of lower oil prices, the Spanish economy will benefit.	• Allow automatic stabilizers to operate and formulate credible medium-term fiscal path in support of public debt sustainability.
Structural Risks			
Accelerating de-globalization	**High** Geopolitical competition and fraying consensus about the benefits of globalization lead to further fragmentation, including to a no-deal Brexit.	**Medium** In the near term, escalating trade tensions, including a no-deal Brexit, could undermine growth both directly and through adverse confidence effects and financial market volatility. A March 2019 Royal Decree-Law to ensure the continuity of financial contracts in case of a no-deal Brexit should help mitigate adverse impacts. These policy shifts could reduce the cross-border flow of trade disrupting global supply chains and reducing FDI. In the medium-term, de-globalization would give rise to reshoring and less trade reducing potential growth.	• 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.
Prolonged period of uncertainty related to political crisis in Catalonia	**Medium** Tensions related to Catalonia remain high with positions deeply divided and entrenched.	**Medium** Prolonged period of uncertainty could weaken business confidence weighing on investment.	• Accelerate structural reforms and enhance labor market performance. • Formulate credible medium-term fiscal path to support investor confidence.
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. A credible medium-term fiscal plan has yet to be announced.	**High** Potential lack of or reversal of reforms and uncertainty about medium-term fiscal commitments could weaken confidence, investment, and employment, which would adversely impact public debt dynamics and could trigger adverse market reactions.	• Accelerate 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.

Annex IV. Debt Sustainability Analysis

Public Debt Sustainability Analysis

Due to unprecedented output loss and fiscal response to the COVID-19 pandemic, Spain's public debt sustainability risk has increased substantially. Under the baseline scenario, the public debt ratio is projected to surge by nearly 30 percentage points in 2020 and drift slightly lower in the medium term. Gross financing needs are projected to increase to 29 percent of GDP in 2020, raising rollover risks. Continued ECB monetary policy support will mitigate the government's funding risks. Another adverse growth shock and or the realization of contingent liabilities would put the public debt-to-GDP ratio on an upward trajectory. Over the medium term, a gradual but persistent fiscal adjustment is crucial to put public debt on a downward path and reduce fiscal vulnerability.

Background

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

2. Public debt developments. Before the pandemic, public debt had been on a gradual downward path since reaching the peak of 100.7 percent in 2014. The sharp increase in the public-debt-to-GDP ratio between 2007 and 2014 (about 65 percentage points) was driven by excessive fiscal deficits (of about 8½ percent of GDP on average during 2008–14), and a largely unfavorable growth interest rate differential (which contributed an annual average of nearly 3 percent of GDP). The support to the banking sector added about 4½ percent of GDP to the public debt stock. Public debt had declined since then, albeit at a slow pace, reaching 95.5 percent of GDP at end-2019.

3. Financing condition developments. Gross financing needs continued to decline after peaking at 22 percent in 2012, on the back of an ongoing maturity extension and nominal deficit reduction. The ECB's accommodative monetary policy contributed to a sharp decline in interest rates and funding costs. The benchmark 10-year bond yield fell from about 6¾ percent in mid-2012 to a historical low of 0.4 percent at end-2019. The effective interest rate on outstanding debt has also declined, and interest payments on public debt fell to 2.3 percent of GDP in 2019. Despite a temporary tightening of market pressure in mid-March, financing conditions have been generally favorable since the onset of the pandemic. Recent auctions of government securities continued to be successful, with strong market interest to the long-term debt and relatively robust bid-to-cover ratio.

4. Other factors. The amortization profile of public debt is tilted towards the long term (about 90 percent of total debt, on a residual maturity basis). The average life of outstanding debt had increased steadily since 2012, from 6.3 years to 7½ years in 2019. Despite the lengthening of debt maturity and small upticks of sovereign spread in recent months, the average cost of outstanding debt has continued to fall, reaching an all-time low of about 2 percent in July 2020. Holdings of public debt are relatively well diversified. The share of marketable debt held by the Spanish banking system continued to fall to about 15 percent at end-2019, while that of the ECB dropped to 19 percent. Almost half of public debt are now held by non-residents, nearly 20 percentage points higher than the lowest in 2012. The composition of the investor base remained broadly stable in 2020. While there has been a small retreat from non-EU foreign investors, this has been compensated by increases in holdings of non-resident investors in the EU countries and domestic investors, particularly banks. Despite a gradual decline in the stock of government financial assets over the past five years, the net public debt continued to fall, reaching 81.3 percent of GDP at end-2019.

5. Baseline. Public debt is projected to rise sharply to 123 percent of GDP in 2020, reflecting the sharp decline in growth and the discretionary fiscal responses to the crisis. In absence of fiscal adjustment beyond 2021, the debt-to-GDP ratio is expected to stay at around 120 percent in the medium term. The gross financing needs of the government would rise substantially to nearly 30 percent of GDP in 2020, and gradually decline to just below the 20 percent benchmark level in 2025.

6. Assumptions. The baseline scenario is based on the medium-term projections that assume disbursements under the EU Recovery and Resilience Facility in 2021-24 but with no other policy changes (Table 1). In particular, (i) real GDP is projected to shrink by 12.8 percent in 2020—reflecting the severe disruptions from the pandemic—before rebound with a growth of 7.2 percent in 2021; (ii) over the medium term, growth is set to converge toward its potential rate of about 1½ percent; (iii) the structural primary balance is expected to deteriorate by 4½ percent of GDP in 2020 followed by a 3.8 percent of GDP improvement in 2021, reflecting the temporary discretionary measures introduced in response to the COVID-19; (iv) inflation (based on the GDP deflator) is projected to increase gradually from 0.5 percent in 2020 to 1.7 percent in 2025; and (v) long-term sovereign spreads are assumed to increase slowly in the medium term, with 10-year bond yields rising moderately to 2.3 percent in line with a gradual normalization of monetary policy.

7. Realism of projections. The median forecast error for real GDP growth during 2011–19 was 0.28 percent, suggesting a moderate downward bias in the staff projections. In contrast, the median forecast error was -0.73 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 levels of the cyclically adjusted primary balance (CAPB) in Spain are below the thresholds that would question the feasibility of the adjustment. The near-term adjustment in the CAPB, while large compared with historical and cross-country experience, reflects mostly the

sizeable but temporary fiscal measures adopted in response to the pandemic, which is assumed to expire before the end of 2020.

Stress Tests

8. Main results. Debt dynamics would worsen significantly if contingent liabilities were to materialize, with the stock of public debt rising to around 135 percent of GDP in the medium term. In a scenario where the economy is hit by a combination of negative shocks to GDP growth and the subsequent deterioration in primary balance, public debt could revert to an upward trajectory reaching 136 percent of GDP by 2025.

9. Growth shock. In this scenario, real GDP growth rates are assumed to be lower than in the baseline by one (10-year historical) standard deviation for two consecutive years, in 2021–22. This implies that real GDP would growth by an average of 3.6 percent per year in 2021–22, compared to annual average growth of 5.8 percent under the baseline. Under this adverse scenario, inflation would be lower (by an average of 0.6 percentage points per year) and the primary balance weaker (by about 1.8 percent of GDP per year, on average) in the shock years. For 2023–25, 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 about 128 percent of GDP in the medium term (almost 10 percentage points higher than the baseline), and gross financing needs would stay above the 20 percent benchmark level in 2025. 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 2023–25 would push public debt into an upward trajectory, reaching 135 percent of GDP in 2025.

10. Primary balance shock. This scenario assumes a relaxation of fiscal policy in 2021–22, with an average deterioration of the primary balance of 2.1 percent of GDP per year. Under this scenario, the public debt-to-GDP ratio would about 124 percent of GDP in 2021 and stay around this level in the medium term (about 5 percentage points higher than in the baseline). The larger primary deficits would also imply more sizable gross financing requirements than in the baseline.

11. Interest rate shock. Over the five-year forecast horizon, the debt dynamics could withstand relatively well a real interest rate shock of about 335 basis points during 2021–25, given the relatively long debt maturity and the high share of debt at fixed interest rates. Under such a scenario, the effective interest rate would increase to 3.7 percent by 2025 compared to 2.2 percent in the baseline. The debt-to-GDP ratio would rise moderately to about 124 percent in 2025. However, a sizeable and sustained increase in interest rates would reduce the (already limited) fiscal space.

12. Combined shock. A simultaneous combination of the previous three shocks would be particularly adverse for public debt dynamics, mostly due to the impact of lower growth and higher primary deficits. In this scenario, the public debt-to-GDP ratio would increase to about

136 percent in 2025, about 17 percentage points higher than under the baseline). Gross financing needs would also be significantly higher, reaching a peak at 30.5 percent in 2021.

13. Contingent liability shock. Large, negative unexpected events could put debt sustainability at significant risk. A negative financial sector shock scenario, assuming a one-time increase in non-interest public expenditures in 2021 equivalent to 6 percent of banking sector assets, combined with lower growth and lower inflation in 2021–22 (i.e., growth is reduced by 1 standard deviation) would be particularly adverse for public debt dynamics. The shock assumed in this scenario is close to the average public support during the past banking crisis. The materialization of such contingency liabilities would raise the primary deficit to about 10 percent of GDP in 2021, bringing gross financing needs to 37.6 percent of GDP. Moreover, the debt-to-GDP ratio would rise sharply to 135 percent in 2021 and stay at around 136 percent in the medium term (around 17 percentage points higher than the baseline).

14. Heat map. Risks associated with public debt remain high as the benchmark level (85 percent of GDP) is breached under the baseline scenario as well as in each of the shock scenarios. Gross financing needs would remain above 20 percent of GDP under the baseline until 2024, and in most cases under the shock scenarios. 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.

Spain Public DSA Risk Assessment

Heat Map

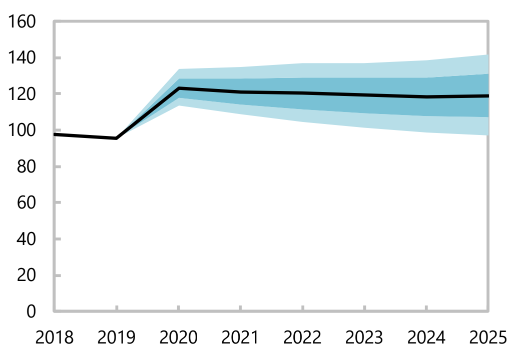
Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception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

Evolution of Predictive Densities of Gross Nominal Public Debt

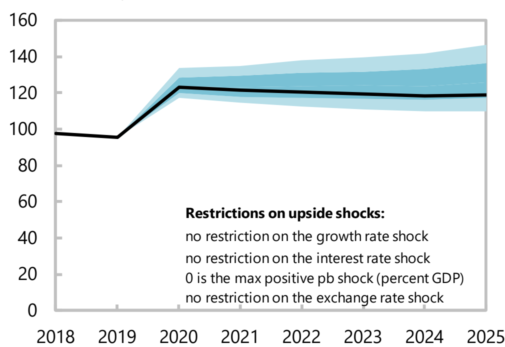
(in percent of GDP)

Baseline Percentiles: 10th-25th 25th-75th 75th-90th

Symmetric Distribution

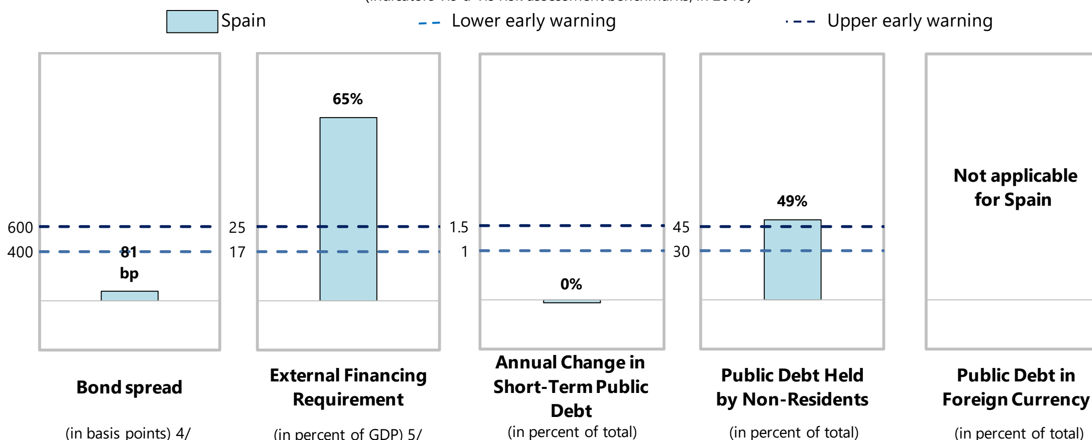


Restricted (Asymmetric) Distribution



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2019)



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.

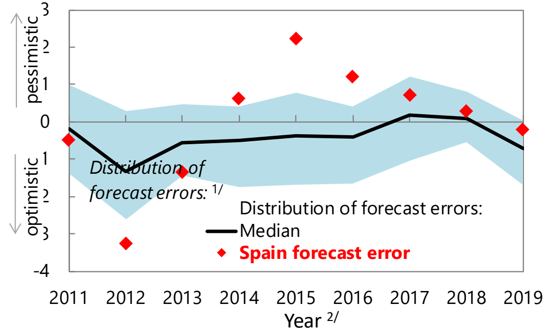
4/ Long-term bond spread over German bonds, an average over the last 3 months, 03-Jul-20 through 01-Oct-20.

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

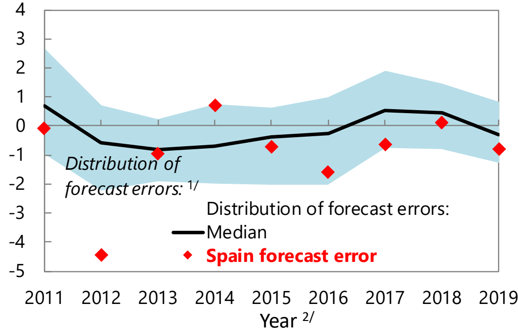
Spain Public DSA - Realism of Baseline Assumptions

Forecast Track Record, versus all countries

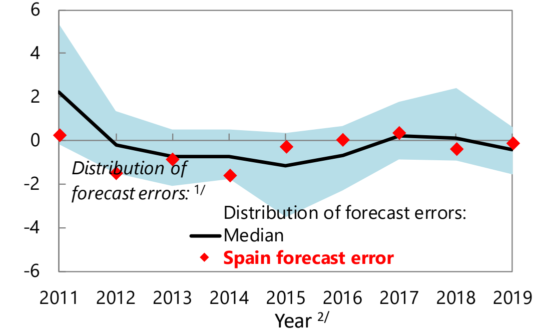
Real GDP Growth
(in percent, actual-projection)
Spain median forecast error, 2011-2019: **0.28**
Has a percentile rank of: **80%**



Primary Balance
(in percent of GDP, actual-projection)
Spain median forecast error, 2011-2019: **-0.73**
Has a percentile rank of: **29%**

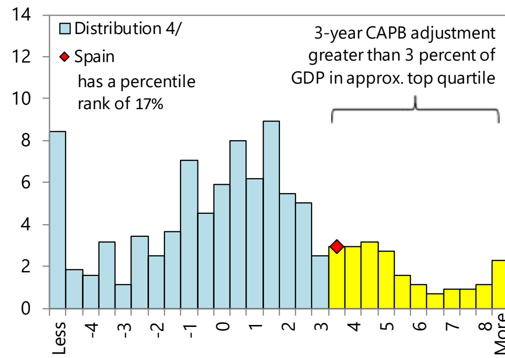


Inflation (Deflator)
(in percent, actual-projection)
Spain median forecast error, 2011-2019: **-0.31**
Has a percentile rank of: **47%**

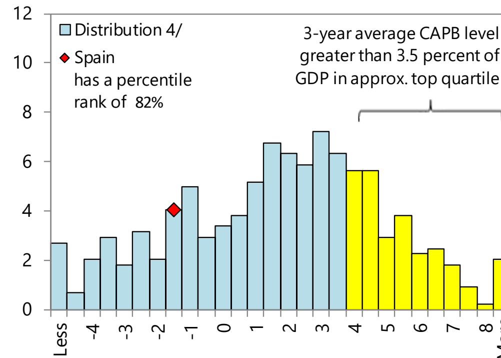


Assessing the Realism of Projected Fiscal Adjustment

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

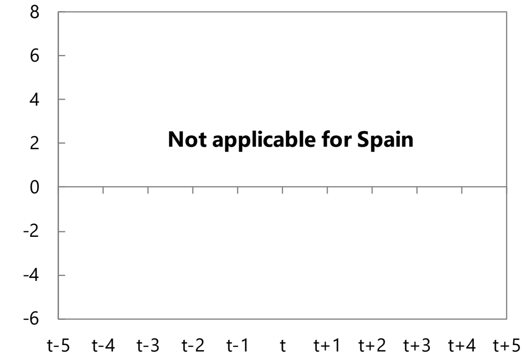


3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



Boom-Bust Analysis 3/

Real GDP growth
(in percent)
Spain



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 obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

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

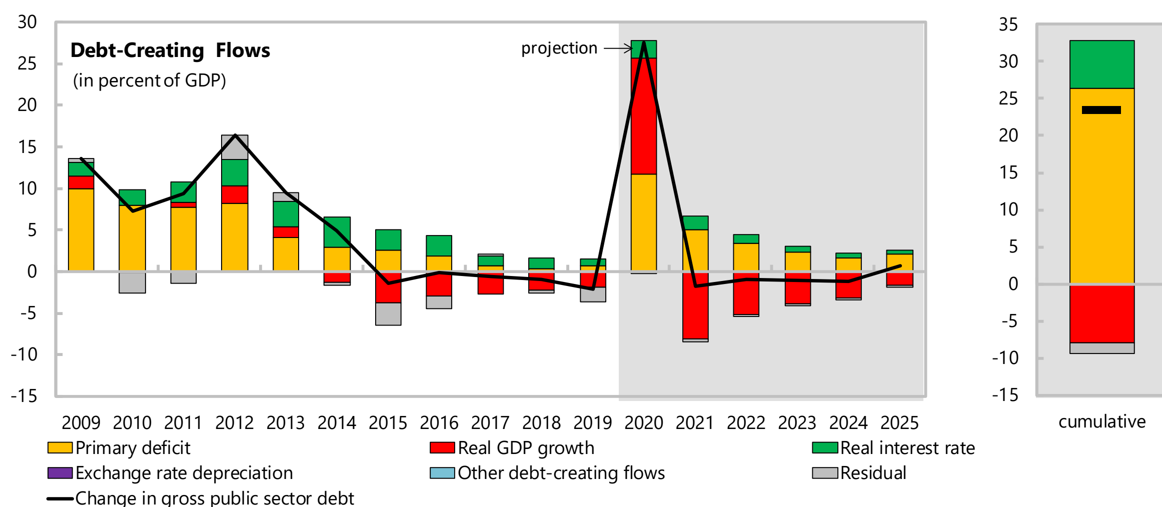
(in percent of GDP unless otherwise indicated)

Debt, Economic and Market Indicators [1/]

	Actual			Projections						As of October 01, 2020		
	2009-2017 [2/]	2018	2019	2020	2021	2022	2023	2024	2025	Sovereign Spreads		
Nominal gross public debt	84.8	97.6	95.5	123.0	121.3	120.4	119.3	118.1	118.8	EMBIG (bp) 3/		77
Public gross financing needs	19.7	17.0	16.7	29.1	26.6	21.6	20.5	19.6	19.5	5Y CDS (bp)		55
Real GDP growth (in percent)	0.3	2.4	2.0	-12.8	7.2	4.5	3.4	2.8	1.5	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	0.3	1.1	1.6	0.5	0.9	1.4	1.6	1.7	1.7	Moody's	Baa1	Baa1
Nominal GDP growth (in percent)	0.6	3.5	3.6	-12.4	8.1	5.9	5.1	4.5	3.2	S&Ps	A	A
Effective interest rate (in percent) [4/]	3.6	2.6	2.4	2.4	2.3	2.3	2.3	2.2	2.2	Fitch	A-	A-

Contribution to Changes in Public Debt

	Actual			Projections							
	2009-2017	2018	2019	2020	2021	2022	2023	2024	2025	cumulative	debt-stabilizing
Change in gross public sector debt	6.5	-1.0	-2.1	27.6	-1.7	-0.9	-1.1	-1.2	0.7	23.4	primary
Identified debt-creating flows	7.0	-0.6	-0.3	27.8	-1.5	-0.7	-0.8	-0.9	0.9	24.8	balance [9/]
Primary deficit	5.1	0.3	0.8	11.7	5.1	3.4	2.4	1.7	2.1	26.3	-1.1
Primary (noninterest) revenue and gr	37.2	39.0	38.9	38.4	40.3	40.2	40.0	39.9	38.3	237.1	
Primary (noninterest) expenditure	42.4	39.3	39.6	50.1	45.4	43.6	42.4	41.5	40.4	263.4	
Automatic debt dynamics [5/]	1.8	-0.9	-1.1	16.1	-6.6	-4.1	-3.2	-2.6	-1.1	-1.5	
Interest rate/growth differential [6/]	1.8	-0.9	-1.1	16.1	-6.6	-4.1	-3.2	-2.6	-1.1	-1.5	
Of which: real interest rate	2.4	1.4	0.8	2.1	1.6	1.0	0.7	0.6	0.5	6.4	
Of which: real GDP growth	-0.6	-2.2	-1.9	14.0	-8.1	-5.1	-3.9	-3.2	-1.7	-8.0	
Exchange rate depreciation [7/]	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	-0.4	-0.4	-1.8	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-1.5	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

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

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

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

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

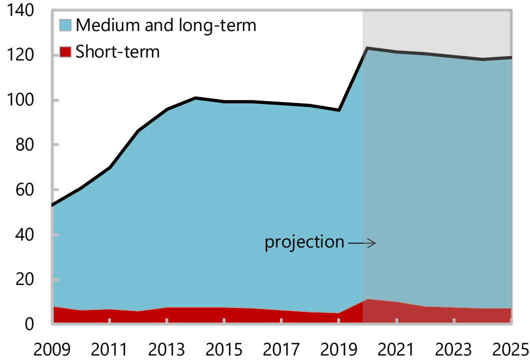
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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

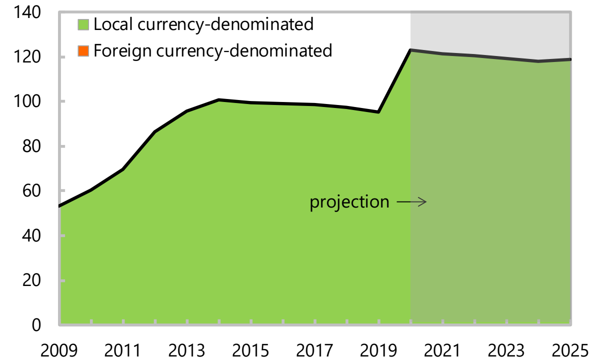
Spain Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



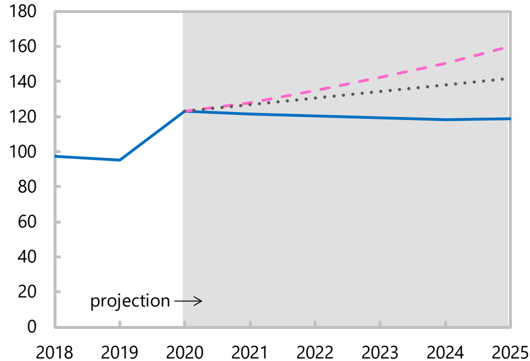
By Currency
(in percent of GDP)



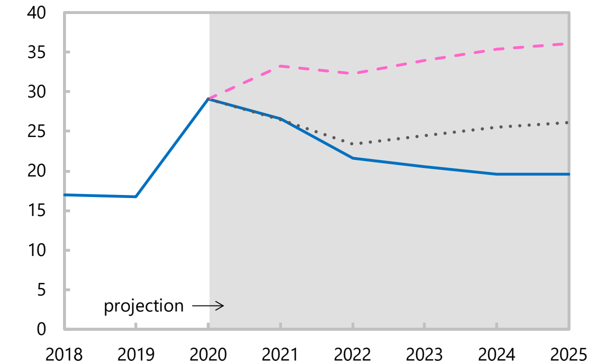
Alternative Scenarios

Baseline   Historical   Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

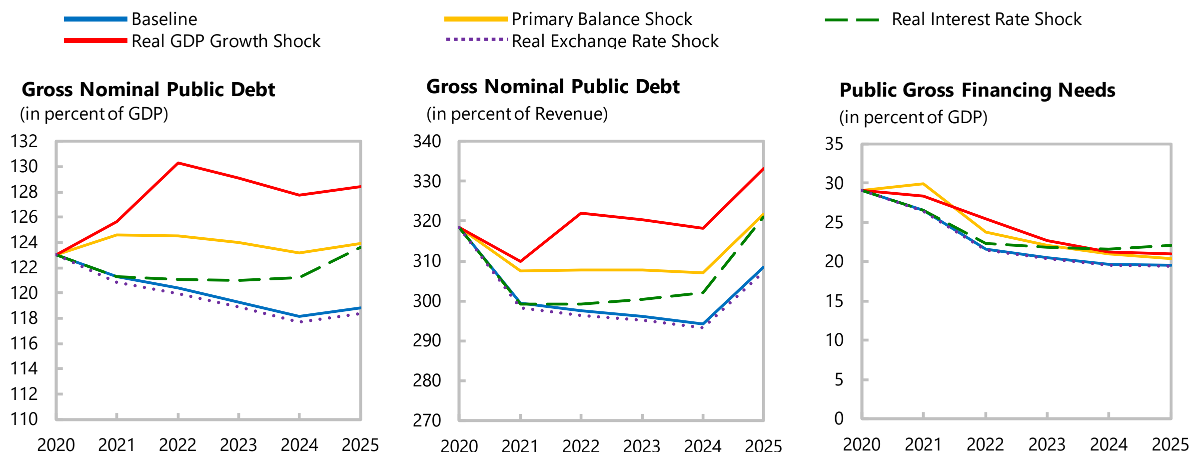
Baseline Scenario	2020	2021	2022	2023	2024	2025
Real GDP growth	-12.8	7.2	4.5	3.4	2.8	1.5
Inflation	0.5	0.9	1.4	1.6	1.7	1.7
Primary Balance	-11.7	-5.1	-3.4	-2.4	-1.7	-2.1
Effective interest rate	2.4	2.3	2.3	2.3	2.2	2.2
Constant Primary Balance Scenario						
Real GDP growth	-12.8	7.2	4.5	3.4	2.8	1.5
Inflation	0.5	0.9	1.4	1.6	1.7	1.7
Primary Balance	-11.7	-11.7	-11.7	-11.7	-11.7	-11.7
Effective interest rate	2.4	2.3	2.2	2.1	2.0	2.0

Historical Scenario	2020	2021	2022	2023	2024	2025
Real GDP growth	-12.8	1.0	1.0	1.0	1.0	1.0
Inflation	0.5	0.9	1.4	1.6	1.7	1.7
Primary Balance	-11.7	-3.7	-3.7	-3.7	-3.7	-3.7
Effective interest rate	2.4	2.3	2.7	2.8	2.9	3.0

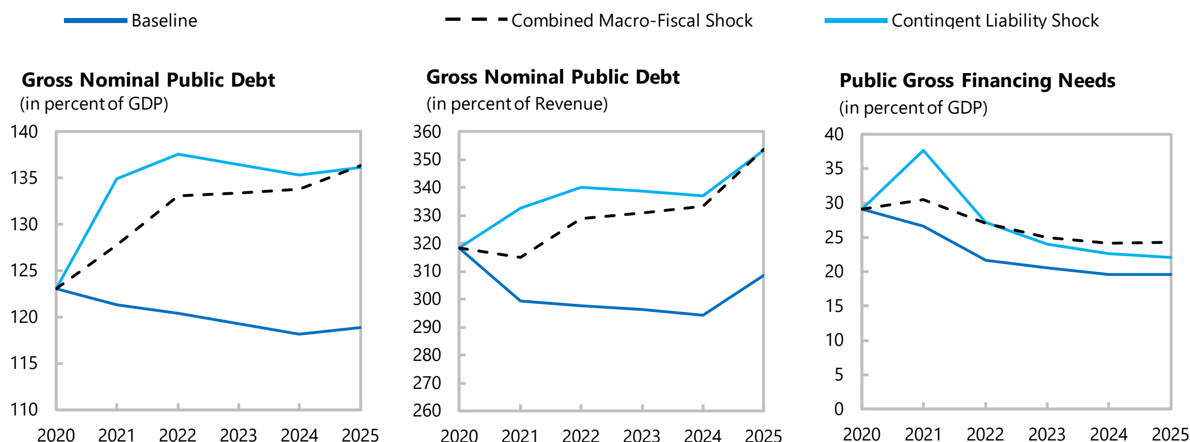
Source: IMF staff.

Spain Public DSA - Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

	2020	2021	2022	2023	2024	2025
Primary Balance Shock						
Real GDP growth	-12.8	7.2	4.5	3.4	2.8	1.5
Inflation	0.5	0.9	1.4	1.6	1.7	1.7
Primary balance	-11.7	-8.4	-4.3	-2.9	-2.0	-2.1
Effective interest rate	2.4	2.3	2.4	2.4	2.3	2.3
Real Interest Rate Shock						
Real GDP growth	-12.8	7.2	4.5	3.4	2.8	1.5
Inflation	0.5	0.9	1.4	1.6	1.7	1.7
Primary balance	-11.7	-5.1	-3.4	-2.4	-1.7	-2.1
Effective interest rate	2.4	2.3	2.9	3.2	3.4	3.7
Combined Shock						
Real GDP growth	-12.8	4.9	2.2	3.4	2.8	1.5
Inflation	0.5	0.3	0.8	1.6	1.7	1.7
Primary balance	-11.7	-8.4	-5.8	-2.9	-2.0	-2.1
Effective interest rate	2.4	2.3	2.9	3.2	3.5	3.7

	2020	2021	2022	2023	2024	2025
Real GDP Growth Shock						
Real GDP growth	-12.8	4.9	2.2	3.4	2.8	1.5
Inflation	0.5	0.3	0.8	1.6	1.7	1.7
Primary balance	-11.7	-6.3	-5.8	-2.4	-1.7	-2.1
Effective interest rate	2.4	2.3	2.4	2.4	2.3	2.3
Real Exchange Rate Shock						
Real GDP growth	-12.8	7.2	4.5	3.4	2.8	1.5
Inflation	0.5	1.3	1.4	1.6	1.7	1.7
Primary balance	-11.7	-5.1	-3.4	-2.4	-1.7	-2.1
Effective interest rate	2.4	2.3	2.3	2.3	2.2	2.2
Contingent Liability Shock						
Real GDP growth	-12.8	4.9	2.2	3.4	2.8	1.5
Inflation	0.5	0.3	0.8	1.6	1.7	1.7
Primary balance	-11.7	-15.5	-3.4	-2.4	-1.7	-2.1
Effective interest rate	2.4	2.4	2.8	2.6	2.5	2.5

Source: IMF staff.

External Debt Sustainability Analysis

Reflecting the COVID-19 shock, under the baseline scenario the external debt-to-GDP ratio is projected to reach a historical peak in 2020. Over the medium term, external debt is projected to decline, supported in part by the accumulation of trade surpluses, but would remain above 160 percent of GDP in 2025—only moderately below the pre-COVID ratio. Though 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, and the predominantly long-term maturity of debt.

Methodology

15. The External DSA provides a framework to examine a country's external sustainability that complements the External Sector Assessment (Annex 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 macroeconomic projections (Table 1). In the wake of the Great Lockdown these projections assume that real GDP growth plunges in 2020, significantly contributing to the projected rise in the external-debt ratio to GDP, and then recovers until reaching nearly 1.5 percent at the end of the forecast horizon. After declining in the near term, the trade surplus (goods and services) is forecast to gradually improve and the external current account balance would remain in surplus. External debt is projected to slightly decline from about 169 percent of GDP in 2019 to 164 percent of GDP in 2025. However, compared with the previous External DSA (IMF Country Report No. 18/330), the external-debt ratio is now expected to remain higher for longer (by almost 20 percentage points at the end of the forecast horizon), largely because of its surge in 2020.[1] Driven by a gradual recovery of export performance and helped by the low interest rates, the external debt-to-exports ratio is projected to decline during 2021–25. Gross external financing needs as a share of GDP would rise above pre-COVID levels in the near term and would remain high thereafter (above 70 percent of GDP by 2025).

Alternative Scenarios

17. Alternative External DSA scenarios, including stress tests, suggest that while Spain's external debt will remain high, it would gradually decline over the medium term. However, as already anticipated prior to the COVID-19 shock, the external-debt ratio would increase if key macroeconomic variables move closer to their levels observed during recent crisis episodes. Overall,

---

[1] Historical revisions to the national accounts and external sector data introduced in 2019 did not involve significant changes in the recent path of the external debt-to-GDP ratio.

the level of external debt remains a vulnerability factor given the risks surrounding the economic outlook.

Historical Shock Scenario

18. The external debt path would fail to stabilize in a scenario based on historical data properties (2010–19) 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 233 percent of GDP by 2025 (about 30 percentage points higher than in the pre-COVID historical shock scenario), driven in part by a real GDP growth path of 1 percent since 2020 and higher interest payments.

Interest Rate Shock

19. Following a one-half standard deviation interest rate shock (an increase from 1.2 percent in the baseline to 1.5 percent), **at end-2025 external debt would be higher by about 2 percentage points of GDP** than in the baseline scenario.

Growth Shock

20. Assuming that real GDP growth averages 2.7 percent between 2020 and 2025, compared with 3.8 percent in the baseline, **external debt would reach 174 percent of GDP in 2025.**

Non-Interest Current Account Shock

21. A stress scenario in which the current account surplus, excluding interest payments, averages 2.9 percent of GDP rather than 3.7 percent of GDP as in the baseline projection, leads to an **external debt stock of 168 percent of GDP in 2025.**

Combined Shock

22. A combination of ¼ 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 172 percent in 2025.**

Real Depreciation Shock

23. Assuming a 30 percent real depreciation shock, **external debt would increase to 173 percent of GDP in 2025.** 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 External Debt Sustainability Framework, 2015-2025
(In percent of GDP, unless otherwise indicated)

	Actual							Projections					
	2015	2016	2017	2018	2019			2020	2021	2022	2023	2024	2025
1 **Baseline: External debt**	168.9	167.7	167.0	168.3	169.4			**198.2**	**186.5**	**178.9**	**172.7**	**167.2**	**163.9**
2 Change in external debt	-0.3	-1.2	-0.7	1.3	1.1			28.8	-11.7	-7.6	-6.2	-5.5	-3.3
3 Identified external debt-creating flows (4+8+9)	-6.2	-9.1	-9.7	-9.0	-9.5			23.9	-13.7	-9.4	-8.0	-7.1	-4.4
4 Current account deficit, excluding interest payments	-4.8	-5.6	-4.8	-4.0	-4.0			-2.9	-3.0	-3.3	-4.0	-4.3	-3.9
5 Deficit in balance of goods and services	-3.0	-4.0	-3.6	-2.7	-2.8			-1.4	-1.4	-1.8	-2.7	-3.2	-3.6
6 Exports	33.6	33.9	35.2	35.1	34.9			29.4	30.3	32.7	33.8	34.3	35.2
7 Imports	-30.6	-29.9	-31.6	-32.4	-32.1			-28.0	-28.9	-30.9	-31.1	-31.1	-31.6
8 Net non-debt creating capital inflows (negative)	-1.8	-0.5	0.3	-0.8	-2.5			-0.4	-0.3	-0.3	-0.3	-0.2	-0.2
9 Automatic debt dynamics 1/	0.4	-3.0	-5.1	-4.2	-3.0			27.1	-10.4	-5.8	-3.7	-2.5	-0.3
10 Contribution from nominal interest rate	2.8	2.4	2.2	2.0	2.0			2.3	2.1	2.0	2.0	2.0	2.1
11 Contribution from real GDP growth	-7.4	-5.0	-4.6	-3.6	-3.4			24.8	-12.5	-7.8	-5.7	-4.6	-2.4
12 Contribution from price and exchange rate changes 2/	5.1	-0.5	-2.7	-2.6	-1.7			...	...	...	...	...	...
13 Residual, incl. change in gross foreign assets (2-3) 3/	5.9	7.9	9.0	10.2	10.7			4.9	2.0	1.8	1.8	1.6	1.1
External debt-to-exports ratio (in percent)	502.2	494.8	474.7	479.2	485.8			673.8	616.4	547.8	511.0	487.0	466.1
Gross external financing need (in billions of US dollars) 4/	964.3	866.5	898.3	970.0	1028.1			1054.1	1091.7	1143.8	1156.6	1170.3	1190.6
in percent of GDP	80.7	70.3	68.5	68.3	73.7			86.2	78.8	77.4	74.3	71.9	71.0
						10-Year	10-Year						
Scenario with key variables at their historical averages 5/								**198.2**	**211.5**	**217.3**	**223.2**	**228.6**	**233.4**
						Historical	Standard						
Key Macroeconomic Assumptions Underlying Baseline						Average	Deviation						
Real GDP growth (in percent)	3.8	3.0	2.9	2.4	2.0	1.0	2.2	-12.8	7.2	4.5	3.4	2.8	1.5
GDP deflator in US dollars (change in percent)	-16.0	0.0	3.5	5.8	-3.7	-1.4	6.8	0.7	5.7	2.1	1.9	1.7	1.7
Nominal external interest rate (in percent)	1.4	1.5	1.4	1.3	1.2	1.9	0.6	1.2	1.2	1.2	1.2	1.2	1.3
Growth of exports (US dollar terms, in percent)	-12.4	3.9	10.5	8.1	-2.5	3.9	8.7	-26.0	16.5	15.1	9.1	6.2	5.6
Growth of imports (US dollar terms, in percent)	-12.2	0.7	12.5	11.0	-2.8	2.7	9.0	-23.4	16.9	13.8	6.3	4.4	4.7
Current account balance, excluding interest payments	4.8	5.6	4.8	4.0	4.0	4.1	1.7	2.9	3.0	3.3	4.0	4.3	3.9
Net non-debt creating capital inflows	1.8	0.5	-0.3	0.8	2.5	1.8	1.5	0.4	0.3	0.3	0.3	0.2	0.2

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).

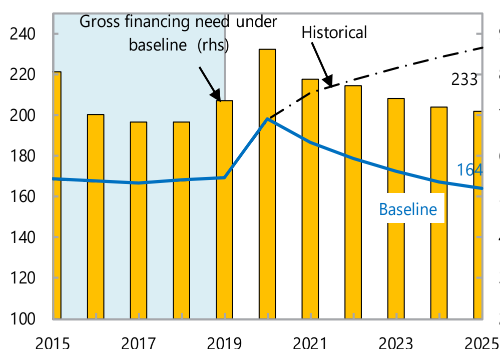
3/ For projection, line includes the impact of price and exchange rate changes.

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

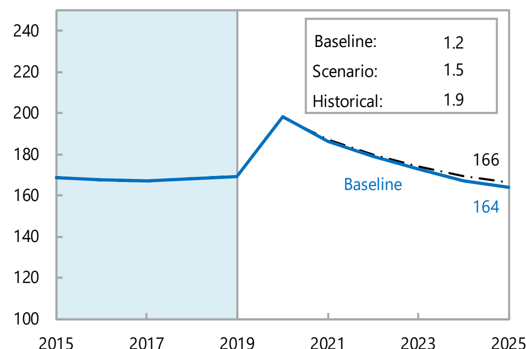
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

Spain External Debt Sustainability—Bound Tests 1/ 2/
(External debt in percent of GDP)

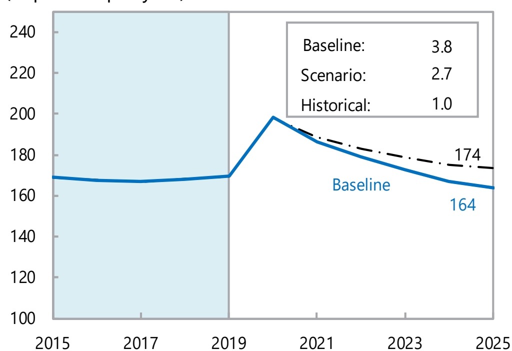
Baseline and historical scenarios



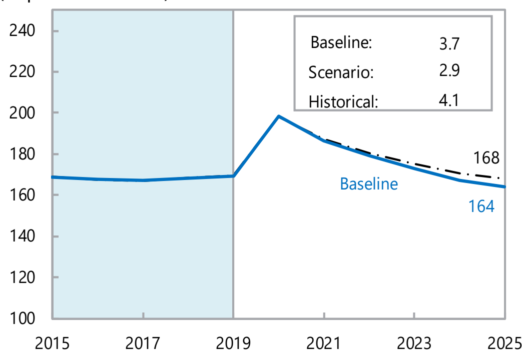
Interest rate shock (in percent)



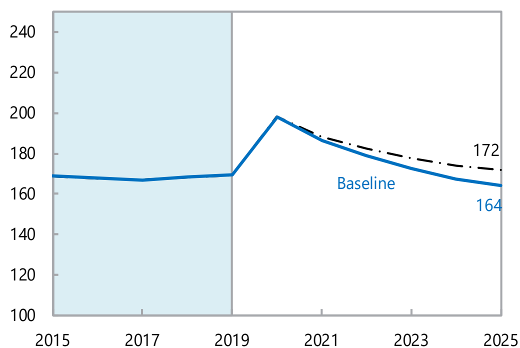
Growth shock
(in percent per year)



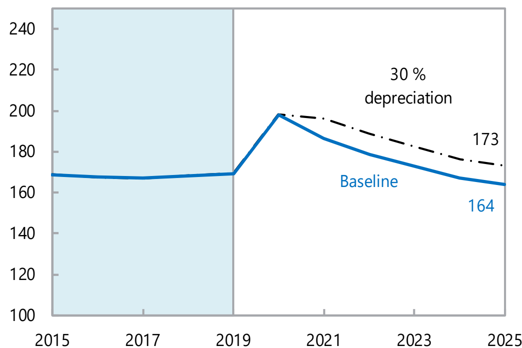
Non-interest current account shock
(in percent of GDP)



Combined shock 3/



Real depreciation shock 4/



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 the second year of projection.

Annex V. Fiscal Measures in Response to COVID-19

Measures	Billions of Euros	Percent of GDP
Discretionary measures	**40.5**	**3.7**
Health sector support	*4.4*	*0.4*
1. Advance transfer to the regions for the regional health services	1.4	0.1
2. Budget support from the contingency fund to the Ministry of Health	2.9	0.3
3. Other healthcare related spending including research	0.1	0.0
Support for households	*25.2*	*2.3*
1. Entitlement of unemployment benefit for workers temporarily laid off under the ERTE due to COVID-19, with no requirement for prior minimum contribution or reduction of accumulated entitlement	17.8	1.6
2. An allowance for self-employed workers affected by economic activity suspension	5.3	0.5
3. Increased sick pay for coronavirus infected workers or those quarantined	1.4	0.1
4. New rental aids programs for vulnerable renters and additional state contribution to the State Housing Plan 2018-21.	0.5	0.0
5 Benefits for workers under permanent discontinuous contracts with activities suspended due to COVID-19	0.1	0.0
6. Temporary entitlement to unemployment benefit for workers unemployed in their probationary period	0.0	0.0
7. Temporary monthly allowance for temporary workers whose contract (at least two months' duration) expired during the state of emergency and were not entitled to collect other benefits	0.0	0.0
8. A temporary subsidy for household employees affected by COVID-19	0.0	0.0
9. Other social spending for households	0.0	0.0
Support for firms	*10.5*	*1.0*
1. Exemptions of social contributions by impacted companies that maintain employment under the ERTE	6.3	0.6
2. Exemption from the payment of contributions for self-employed affected by the state of emergency	2.7	0.2
3. Deferral of social security debts for companies and the self- employed	0.5	0.0
4. Renewal Program of the Spanish fleet in 2020 (PLAN RENOVE 2020)	0.3	0.0
5. Flexibility for SMEs and self-employed to calculate their income tax and VAT installment payment based on the actual profit in 2020	0.2	0.0
6. Six-month moratorium on social security contributions for companies and the self-employed	0.0	0.0
7. Reduction in the contribution for Employed Agricultural Workers who have completed a maximum of 55 real days of contribution in 2019	0.0	0.0
8. Deferral of tax debts and debts arising from customs declarations	0.0	0.0
9. Suspension for one year of the interest payment and amortization on loans granted by the State Secretariat for Tourism through the Emprendetur Programme	0.0	0.0
10. Other sectoral support	0.4	0.0
Other support	*0.5*	*0.0*
1. Temporary zero VAT rate for healthcare material acquired by public, non-profit organizations and hospital centers	0.1	0.0
2. Additional budgetary funds of €300 million and further budget flexibility for the provision of assistance to dependents;	0.3	0.0

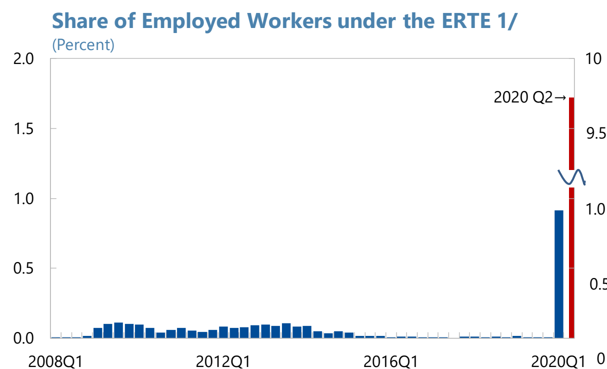
Measures	Billions of Euros	Percent of GDP
3. Reduction in VAT on digital publications from 21 to 4 percent	0.0	0.0
4. Other measures	0.1	0.0
Off-budget measures	**170.1**	**15.6**
1. Loan guarantees for firms and self-employed, covering both loans and commercial paper of medium-sized companies that participate in Spain's Alternative Fixed Income Market (MARF)	100.0	9.2
2. A new Instituto de Crédito Oficial (ICO) line of guarantees to promote investment activities particularly in the areas of environmental sustainability and digitization	40.0	3.7
3. Additional funding for the ICO credit lines	10.0	0.9
4. Creation of a state rescue fund to support strategic business	10.0	0.9
5. Guarantees for financing operations carried out by the European Investment Bank through the Pan-European Guarantee Fund in response to the COVID-19 crisis	2.8	0.3
6. Endorsement of European Temporary Support Instrument to Mitigate the Risks of Unemployment in an Emergency (SURE Instrument)	2.3	0.2
7. Public guarantees for exporters through the Spanish Export Insurance Credit Company	2.0	0.2
8. Line of guarantees to provide financial coverage for housing expenses by households in situations of social and economic vulnerability as a result of COVID-19	1.2	0.1
9. Additional loan guarantees for SMEs and the self-employed through CERSA	1.0	0.1
10. Loans through the State Financial Fund for Tourism Competitiveness (FOCIT) to promote sustainability in the tourism sector	0.5	0.0
11. Expansion of the ICO credit lines for the tourism sector from 200 million to 400 million euros.	0.2	0.0
12. Loans for the industrial sector to promote digital transformation and modernization	0.1	0.0

Annex VI. Key Income Support Programs

Spain's Short-Time Work Scheme in the Aftermath of COVID-19

1. Spain's Job retention scheme, Expedientes de Regulación Temporal de Empleo (ERTE), was introduced in 1980s, but utilization had been limited before the pandemic. The ERTE allows firms to temporarily suspend employment contracts or reduce employees' working hours for economic, organizational, technical or productive reasons, or when a force majeure situation is justified. Under the ERTE, the affected workers are entitled to receiving unemployment benefits, subject to the usual eligibility criteria. The amount is equal to a fraction of the regulatory base contribution that is linked to the employee's own wage, and proportional to the reduced working time. The maximum of the benefit varies with the number of children the affected worker has, with the highest currently at €1,411.83 a month (around 70 percent of the average total wage cost in 2019). Despite several rounds of reforms in the past decades, take-up of the ERTE was generally low during the past economic downturns.

Share of Employed Workers under the ERTE 1/
(Percent)



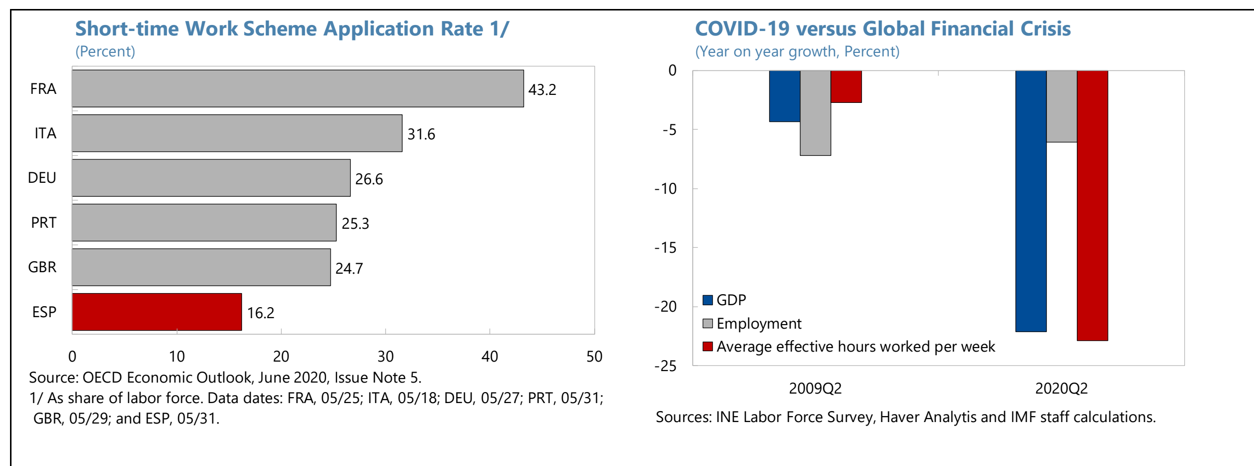
Sources: INE Labor Force Survey, Haver Analytics, and IMF staff calculations.
1/ Percent of employed workers who have not worked in the reference week due to the situation of being in the ERTE program.

2. In response to the COVID-19 crisis, the government expanded the ERTE as a main tool for income support. Measures were introduced to ease administration and increase the coverage. Under the expanded scheme, (i) the ERTEs caused by COVID-19 are considered force majeure; (ii) workers covered by the ERTEs due to COVID-19 are entitled to receiving unemployment benefits in an amount equal to 70 percent of the regulatory base contribution, with no requirement for prior minimum contribution or reduction of accumulated entitlement; and (iii) firms under the ERTEs are exempted from employers' contribution to social security contributions (100 percent for firms with less than 50 employees and 75 percent for the rest). The initial duration for the expanded ERTE scheme covered the period until the end of the state of emergency but later was extended three times to end-January 2021.[1]

3. The enhanced ERTE has mitigated the adverse effects of the pandemic, but it also came with a sizeable fiscal cost. Take-up of the ERTE reached a record high in April, with nearly 3.4 million workers or 22 percent of salaried workers benefiting from the scheme at the peak. Nevertheless, the coverage of Spain's program was among the lowest in large European countries, possibly reflecting different labor market structures and the generosity of the schemes. The expansion of the ERTE, to a large extent, has helped abate the job losses, which is evident when

[1] To incentivize job recovery, exemptions of social security contributions were reduced for employers that still maintain workers in ERTE, but new exemptions were introduced for firms that reinstate their employees. The latest extension also introduced mechanisms to distinguish companies that are partially or fully affected by the containment measures, thus focusing more intensely on those sectors that have been most affected.

compared with the labor market situation during the global financial crisis. Notwithstanding these positive effects, the fiscal cost of the ERTE is estimated to have reached about 1 percent of GDP at end-August. Prolonged use of the scheme could put pressures on public resources and reduce efficiency.

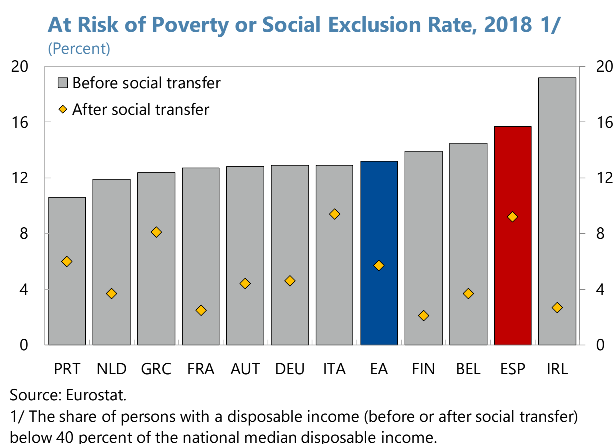


Source: OECD Economic Outlook, June 2020, Issue Note 5.
1/ As share of labor force. Data dates: FRA, 05/25; ITA, 05/18; DEU, 05/27; PRT, 05/31; GBR, 05/29; and ESP, 05/31.

Sources: INE Labor Force Survey, Haver Analytis and IMF staff calculations.

The Minimum Income Scheme in Spain

4. The Minimum Income Scheme (MIS) was introduced as a policy tool to address the stubbornly high inequality and extreme poverty. Despite the strong growth in the past years, inequality and risk of poverty remain high in Spain compared with euro area peers. The existing social transfer programs have not provided adequate protection for vulnerable groups (text chart), due partially to a weak and fragmented social assistance system (Vtyurina, 2020). The coverage of the regional minimum income system is low with large disparities across regions, since the regulatory development and financing of the programs are determined by each of the autonomous communities. The objective of introducing a national-level MIS is to improve the coverage and efficacy of the guaranteed income system, while promoting coordination across all levels of government. Beyond boosting incomes of the most disadvantaged group, the government also aims to use MIS as the baseline for a holistic inclusion public policy. Additionally, the program aims to foster labor force participation and reduce informality in the economy.



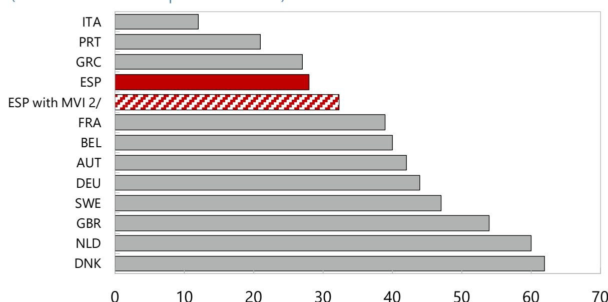
Source: Eurostat.
1/ The share of persons with a disposable income (before or after social transfer) below 40 percent of the national median disposable income.

5. The MIS is a non-contributory social security benefit. It provides a monthly monetary benefit that covers the difference between the total disposable income received by a household

(during the previous year) and a predetermined guaranteed income level.[2] Guaranteed income is differentiated by the type of household, with the level for a single-person household set at 100 percent of the annual amount of non-contributory social security pensions in force at any given time, divided by 12. The calculation of households' disposable income includes some pensions and transfers, but importantly excludes regional minimum income benefits. This essentially sets the MIS as a floor benefit, while allowing the flexibility for the autonomous communities to adjust the coverage and generosity based on their own situation. To be compatible with the incentives for labor force participation, the MIS includes several clauses linked to the job market, for instance, the applicant must register as job seekers (with some exceptions). Also, it is temporarily compatible with labor earnings immediately after finding a job. Incentives are also provided for employers to hire MIS recipients and for workers to take on jobs. Finally, to facilitate a swift and broad coverage, certain administrative procedures have been simplified and applications can be submitted via multiple channels.

6. The MIS is expected to significantly reduce extreme poverty in Spain, but its sizable fiscal cost would require additional mobilization of public resource. The government estimated that the MIS would benefit around 850,000 households with 2.3 million individuals, of which about half currently earning less than 310 euros per month. The program will substantially improve the protection for the most vulnerable, reducing the population under extreme poverty (income below 2,950 euros a year) by about 75 percent and under high poverty (income between 2,950 and 4,250 euros a year) by more than 50 percent, with the single-parent households benefitting the most. Nevertheless, with the MIS benefit alone (i.e., without taking into account additional minimum income benefits granted by autonomous communities), the adequacy of Spain's guaranteed minimum income system seems to be still low relative to European peers (text chart). The fiscal cost of the MIS is estimated at about 3 billion euros a year or 0.3 percent of 2020 GDP. Given its non-contributory nature, the program will be financed by the state budget through transfers to the social security budget. To limit further widening of the structural fiscal balance, the financing need of the MIS should be adequately considered in a medium-term budget plan. More importantly, there is a need to review and streamline the existing benefit programs to avoid coverage overlapping or inconsistency.

Adequacy of Guaranteed Minimum Income Benefits, 2019 1/
(Percent of median disposable income)



Sources: OECD and IMF staff calculation.
1/ Single person without children.
2/ Floor amount only, as some autonomous communities may supplement the national MVI with additional minimum income benefits.

[2] In light of the pandemic, an exception was made for 2020 during which the disposable income is assessed based on either the level in the current year or the previous year depending on the applicant's choice.

Annex VII. Upgrades to Financial Sector Risk Management and Public Sector Governance

1. Exceptionally large public policy support needs to be accompanied with stepped up risk management and governance. Already before the crisis, the Spanish authorities advanced their frameworks for financial sector oversight and public procurement. Both should be completed.

2. Financial oversight was enhanced by the creation of a macroprudential authority, as recommended in the 2017 FSAP. Created in early 2019, the National Financial Stability Authority (AMCESFI) is monitoring financial sector risks, including from the COVID-19 crisis. AMCESFI comprises officials from the Ministry of Economy and the sectoral supervisors: the Bank of Spain, the National Securities Market Commission (CNMV), and the Directorate General of Insurance and Pension Funds (DGSFP at the Ministry of Economy). AMCESFI has powers to analyze systemic risk and to issue opinions, warnings and recommendations, including on macroprudential measures by sectoral supervisors. The Bank of Spain provides the Secretariat for AMCESFI's Technical Committee. Moreover, sectoral supervisors have additional macroprudential tools since December 2018. For the Bank of Spain, these tools include sectoral countercyclical capital buffers (CCyBs), limits to sectoral concentration, and limits and conditions on bank lending and other operations. To minimize leakages, the CNMV and the DGSFP were also granted with additional tools. However, it is still necessary to finalize secondary regulations for some of the Bank of Spain's tools—notably for borrower-based instruments, such as limits to loan-to-value and debt service-to-income ratios. A further institutional upgrade can be achieved by creating a financial consumer protection authority and moving insurance and pension supervision outside the Ministry of Economy.

3. Additional enhancements to Spain's AML/CFT regime should be advanced; in particular, as recommended in the 2017 FSAP, the implementation of targeted financial sanctions (TFS) without delay. A corresponding provision is included in the new draft amendment of the AML/CFT Law, which is expected to be approved in the last quarter of 2020.

4. Continued efforts are needed to address weaknesses in public procurement. To enhance transparency, competition and economic efficiency in procurement processes a new institutional set-up is being established, following recommendations by the European Commission and the adoption of the Procurement Law. Good progress has already been made on enhanced digitalization through an electronic platform for all contractual information and documentation of procurement entities. But coordination challenges with regions remain and on-site supervision can be strengthened, including by ensuring appropriate funding of the newly established Office for Regulation and Supervision of Procurement.

Annex VIII. External Adjustment in Spain: Becoming More Resilient to External Shocks[1]

Spain has gone through a considerable external adjustment process prior to the COVID-19 outbreak. Trade surpluses in recent years have helped to gradually lower its high net external liabilities. Nevertheless, the net international investment position (NIIP) remains in deeply negative territory. A newly developed framework to assess external sustainability indicates that some further relative price adjustment, although not large, might help ensure that the external position remains on a sustainable path. This analysis aims to complement the findings from the IMF's External Balance Assessment Methodology (see Spain's External Sector Assessment, Annex II).

Introduction

1. Spain's net international investment position deteriorated after euro adoption. Spain's NIIP was around -30 percent of GDP in 1999 and peaked at roughly -100 percent of GDP in 2009. External borrowing of financial institutions, which financed the construction and consumption boom, was the main driver of the NIIP decline. Unit labor costs (ULC) rose sharply amid structurally rigid product and labor markets (IMF, 2015). Concerns about the structural weaknesses intensified during the European market turmoil of 2010–12, when the deeply negative NIIP conflated with Spain's large public debt and high unemployment.

2. A significant external adjustment has been underway in recent years. Significant relative price adjustment has been achieved after the 2008/12 crises, largely through a decline in ULC (Figure 1), contributing to sustained moderate trade surpluses, also underpinned by structural improvements in export performance (Salas, 2018). Despite the ULC improvements, productivity growth remained subdued, making competitiveness gains hinge largely upon cost advantage. Other price-based measures of competitiveness indicate more modest gains since the global financial crisis. The NIIP improved by about 22 percent of GDP over 2014–19 but Spain's net external indebtedness is still among the largest in the EU (Figure 2).

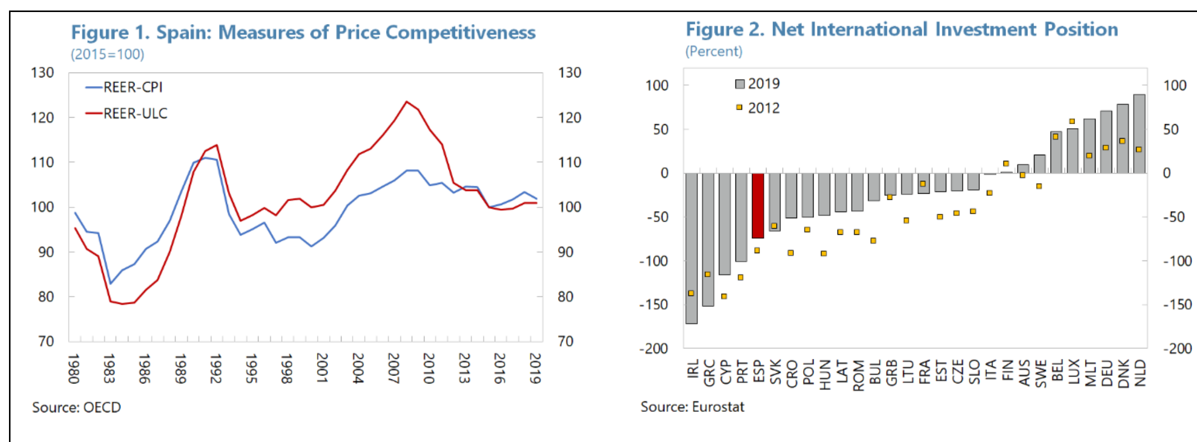


Figure 1. Spain: Measures of Price Competitiveness (2015=100)
Source: OECD

Figure 2. Net International Investment Position (Percent)
Source: Eurostat

[1] Prepared by Yevgeniya Korniyenko (MCD, formerly SPR) and Jorge Salas (EUR).

Methodology

3. This annex uses a new method to determine additional relative price adjustment needed to bring the NIIP to a safer level. Staff considers that a net external debtor position of at least -50 percent of GDP would be prudent, a level at which the economy would be less exposed to abrupt changes in financial market sentiment, increases in the risk premium and reversals of capital flows.[2] In this analysis, other threshold values close to -50 percent of GDP are also considered as sensitivity checks—including more ambitious targets that seem appropriate for precautionary reasons. How quickly to bring the NIIP to this prudent level is debatable. Typically, the IMF's External Sector Report assumes an adjustment horizon of five years. But in case of large adjustment needs that require structural policies to develop their full impact a longer horizon is warranted. Thus, this analysis considers a horizon of 15 years for the application of a new framework to assess external sustainability based on Blanchard and Das (2017).[3, 4]

4. The analysis relies on historical data and staff's forecasts. The assessment of external sustainability relies in part on staff's 5-year forecasts which are then extended to 15 years (Box 1). A key input—particularly for the deterministic approach, explained below—is the projection of the NIIP itself. Reflecting expected trade and capital account surpluses, and conservatively assuming zero valuation effects, the NIIP would improve to about -52 percent of GDP in 2025 under the baseline projection. Against the background of the COVID-19 shock, the risks around this projection are assessed as tilted to the downside.

5. A deterministic external sustainability assessment is first conducted. Following Blanchard and Das (2017), the deterministic approach estimates the real effective exchange rate (REER) depreciation required to lower the NIIP to a safer level. The framework considers that exchange rate adjustments affect both net exports and the NIIP valuation, and it allows for different (real) rates of return on external assets and liabilities. It is based on a present discounted value analysis—sustainability requires that the ratio of net external liabilities to GDP be equal or less than the present value of the ratio of net exports (inclusive of the secondary income balance and the capital account) to GDP plus the return differential times the ratio of gross assets to GDP.

6. Then, a probabilistic approach assesses the sustainability of the external position conditional on a range of historical shocks. Building on the deterministic assessment, the probabilistic approach underscores that the uncertainty of forecasts in turn implies uncertainty about the sustainability of the NIIP. This approach is well-suited to settings in which forecasts assume constant exchange rates. It uses historical data to construct (e.g., using a vector

---

[2] In an empirical cross-country study, Catao and Milesi-Ferretti (2014) estimate that external-crisis risk increases sharply as net foreign liabilities exceed 50 percent of GDP.

[3] A similar analysis was recently conducted for Portugal (IMF 2018).

[4] The Fund's EBA-lite methodology, updated in 2018, now includes the Blanchard and Das (2017) tool. The revised methodology can be found here: https://www.imf.org/en/Publications/Policy-Papers/Issues/2019/07/03/The-Revised-EBA-Lite-Methodology-47088

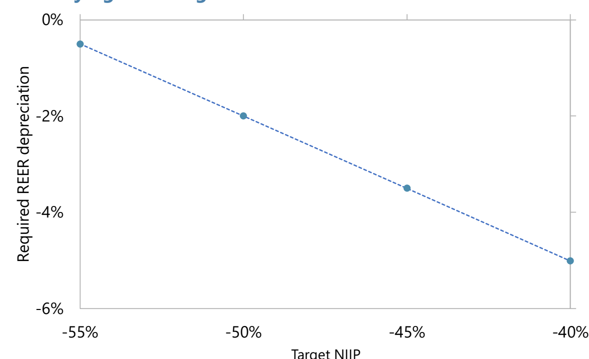
autoregression) the joint distribution of shocks to growth, the trade balance, returns on external assets and liabilities, and the gross external positions. Shocks are then drawn from this distribution. Assessing where the current exchange rate stands in the distribution of required REER adjustments yields the probability that a REER depreciation is required to ensure sustainability. Reflecting the variability of real and particularly financial shocks, the support of this distribution may be large.

7. The analysis requires to make some assumptions. The semi-elasticity of net exports to the REER is assumed at -0.22.[5] The shares of external assets and liabilities denominated in foreign currency are assumed at about 40 percent for assets and close to 10 percent for liabilities. For the present value analysis (deterministic approach), an ad-hoc discount factor of 0.95 is conservatively chosen, in part because of uncertainty about macro forecasts (especially for long horizons). Available data suggests a discount factor for Spain that could be very close to or even slightly above 1, based on the average difference between real GDP growth and the real return on external assets or liabilities. A discount factor above 1 would imply that debt is automatically sustainable, since for any arbitrary level of net exports, net debt eventually would reach a constant value. However, a discount factor permanently above 1 is arguably unlikely.[6]

Deterministic Approach

8. In the deterministic case, a REER depreciation of between 0.5 and 5 percent would stabilize the NIIP at lower levels. With an adjustment horizon of 15 years, a REER depreciation of about 2 percent would stabilize the NIIP at -50 percent of GDP. With a less ambitious NIIP target of -55 percent of GDP, the needed REER depreciation would be only 0.5 percent, while stabilizing the NIIP at -40 percent of GDP would require a decline of the REER by 5 percent (Figure 3). That means more ambitious NIIP target levels require larger real effective depreciation to generate the trade surpluses (and offset a small drag from the net investment income flows) that satisfy the external budget constraint. Thus, these results underscore that some additional relative-price correction, although fairly small, would help prevent the risk of remaining under or too close to potentially unsafe NIIP levels in the foreseeable future.

Figure 3. Deterministic Approach: Required REER Depreciation for Varying NIIP Targets



Source: IMF staff calculations.

[5] The semi-elasticity of net exports to REER is assumed constant over the forecast horizon as in Blanchard and Das (2017). The chosen value is consistent with evidence based on the CPI-based REER. For the probabilistic approach, a semi-elasticity of -0.15 is instead assumed in the case of the ULC-based REER.

[6] For a more detailed discussion on the role of the discount factor, see Blanchard and Das (2017).

Probabilistic Approach

9. Shocks to relative prices may arise from asymmetric price adjustments. As there are two deflators—the consumer price index (CPI) and the ULC—conventionally used in constructing the REER, joint distributions of shocks corresponding to each of them are considered, and sustainability is assessed using results from both. Two observations are relevant:

- The correlations of the real and financial variable shocks with CPI-REER shocks slightly differ from their correlation with ULC-REER shocks (Table 1), indicating that it is important to explore these differences and how they affect the assessment.[7]
- Trade shocks are negatively correlated with both CPI-REER and ULC-REER shocks, but are moderately more sensitive to changes in ULC-REER. To the extent that prices are more flexible in the tradable sector, this is what one would expect since, for instance, a labor productivity shock that lowers ULC will trigger expenditure switching via price adjustment in tradables; however, as non-tradable prices are less flexible, there will be a delayed adjustment in the CPI deflator with a correspondingly low shock in the external balance.

Table 1. Correlation Matrices of the VAR Innovations (Diagonal elements are standard deviations)

Real returns on external assets and liabilities exclude capital gains:

a)

	nx	g	rl	ra	a_y_t	reer_cpi
nx	0.012					
g	-0.22	0.016				
rl	0.25	0.20	0.012			
ra	0.46	0.02	0.87	0.013		
a_y_t	-0.51	-0.08	-0.46	-0.33	0.058	
reer_cpi	-0.28	0.06	-0.33	-0.35	0.13	0.021

b)

	nx	g	rl	ra	a_y_t	reer_ulc
nx	0.012					
g	-0.22	0.016				
rl	0.25	0.20	0.012			
ra	0.46	0.02	0.87	0.013		
a_y_t	-0.51	-0.08	-0.46	-0.33	0.055	
reer_ulc	-0.43	0.47	0.03	-0.07	0.10	0.024

Real returns on external assets and liabilities include capital gains:

c)

	nx	g	rl_cg	ra_cg	a_y_t	reer_cpi
nx	0.010					
g	-0.22	0.013				
rl_cg	-0.04	0.40	0.025			
ra_cg	0.17	0.02	0.57	0.030		
a_y_t	-0.51	-0.08	-0.12	-0.03	0.056	
reer_cpi	-0.28	0.06	-0.09	-0.57	0.13	0.019

d)

	nx	g	rl_cg	ra_cg	a_y_t	reer_ulc
nx	0.010					
g	-0.22	0.013				
rl_cg	-0.04	0.40	0.025			
ra_cg	0.17	0.02	0.57	0.028		
a_y_t	-0.51	-0.08	-0.12	-0.03	0.054	
reer_ulc	-0.43	0.47	0.26	-0.29	0.10	0.023

Note: The VARs were estimated with annual data for 1994-2019 and were assumed to be of order 1. Diagonal elements are standard deviations; below the diagonal elements are pairwise correlations. "nx" stands for a sum of trade balance, current transfers and capital account; "g" denotes real GDP growth; "ra" and "rl" are real returns on gross external assets and liabilities, respectively (panels a and b); "ra_cg" and "rl_cg" are real returns on gross assets and liabilities, including capital gains due to price and exchange rate changes (panels c and d); "a_y_t" stands for *detrended* gross assets; and "reer_cpi" and "reer_ulc" represent real effective exchange rates based on CPI (panels a and c) and based on ULC (panels b and d).

[7] Table 1 also reports alternative models with different definitions for the real returns on external assets and liabilities. Although the conceptually relevant capital gains embodied in those returns should reflect only price changes, due to data limitations the analysis is based either on capital gains that include price changes and exchange rate effects or on the exclusion of capital gains altogether. The evidence available for a few years suggests that exchange rate effects can significantly impact the evolution of the returns differential between assets and liabilities.

10. Taking into account the uncertainty of forecasts, the probability that the REER must depreciate to stabilize the NIIP at lower levels is estimated at between 51 and 53 percent. The findings are as follows (Table 2):

- While the moments of the distributions are relatively similar when using the ULC or CPI-REER, the average depreciations required to stabilize the NIIP are higher with the ULC-REER than the CPI-REER for all the analyzed NIIP target levels.
- For the CPI-REER, the probability the REER must depreciate (by about 12 percent) is around 51 percent when the NIIP target is -50 percent of GDP. That probability changes to 53 percent in the case of the ULC-REER, for which the needed depreciation is higher (14.5 percent). These results are based on models in which the real returns on assets and liabilities exclude capital gains.
- In unreported results, some differences emerge when real yields including capital gains are used. In this case, the probability that the REER must depreciate is generally higher, at about 59 percent. However, the average depreciations required to stabilize the NIIP in the range between -55 to -40 percent are around or below 5 percent.[8]
- Overall, as in the deterministic results, the probabilistic approach points to the need for some additional relative-price adjustment. At the same time, this approach reveals a reasonably high probability of a sustainable NIIP path at the current exchange rate and relative prices.

Table 2. REER Adjustment to Stabilize the NIIP: Moments of Frequency Distributions

CPI-Based REER				ULC-Based REER			
(a) Target NIIP	(b) Mean	(c) Std. Deviation	(d) Probability REER_CPI adjustment < 0	(a) Target NIIP	(b) Mean	(c) Std. Deviation	(d) Probability REER_ULC adjustment < 0
-55%	-11%	12%	51%	-55%	-13.4%	15%	52%
-50%	-11.8%	11%	51%	-50%	-14.5%	16%	53%
-45%	-12%	12%	51%	-45%	-15.5%	16%	53%
-40%	-13.0%	12%	51%	-40%	-16.7%	17%	53%

Notes: For each target NIIP, 15000 Monte Carlo simulations of the Blanchard and Das (2017) model are run using the joint distribution of VAR innovations in Table 1.a to construct a frequency distribution of the required REER adjustment. The probability that the REER adjustment is below zero (i.e. a depreciation is required to stabilize the NIIP at its target) is 1 minus the probability that the external position is sustainable.

[8] The relative size of financial account shocks versus current account shocks play a role in driving the NIIP, and thus in the likelihood and size of REER adjustment needed. For example, in the model with capital gains and CPI-REER: given a gross asset position, a simultaneous one-standard deviation shock to the return on assets (3 percent) and returns on liabilities (2.5 percent) may have a greater favorable impact on the NIIP than a one standard deviation shock to the trade balance (1 percent). So, the results consider the possibility that in some states of the world, future return-differentials may be positive and thus speed up the stabilization of the NIIP-to-GDP ratio.

Policy Recommendations

11. Over the medium term, structural reforms can be critical to preserve competitiveness gains and boost productivity. If sources of external vulnerability that existed prior to the COVID-19 outbreak persist in the medium term, productivity improvements should further enhance Spain's external sustainability. Increasing TFP growth and moving up the value chain of export products would thus help ensure that competitiveness achieved in recent years through relative price adjustments are sustained. Key reforms include tackling persistent labor market duality to enhance labor productivity; advancing product market reforms that support efficiency gains; upgrading education outcomes, labor skills, and innovation; and supporting labor market institutions that allow firms to align wage evolution with productivity gains.

Box 1. Medium-Term Forecasts and Extension to 15-Year Horizon

IMF's staff medium-term projections (2020–25) underlying the analysis are shown in the table below. A key baseline projection for the present value analysis is that the NIIP would significantly improve by 2025 to about -52 percent of GDP, as a result of projected trade surpluses and supported by post-2020 GDP recovery, though conservatively assuming zero valuation effects. Projected grants under the EU Recovery and Resilience Facility in 2021-24 also play a key role, as they impact current transfers and the capital account. Cumulative payments on investment income would negatively contribute to the NIIP improvement. An important caveat is that although the conceptually relevant capital gains embodied in the real returns of assets and liabilities should reflect only price changes, due to data limitations the analysis is based either on capital gains which include also exchange rate effects or on the plain exclusion of capital gains.

Medium-Term Projections of Key Variables

	2019	2020	2021	2022	2023	2024	2025
NIIP / GDP	-74%	-84%	-75%	-69%	-62%	-56%	-52%
Assets / GDP	177%	209%	201%	197%	195%	193%	193%
Liabilities / GDP	252%	293%	276%	265%	257%	249%	245%
(Trade Balance + Current Transfers + Capital Account) /GDP	2.1%	0.7%	2.2%	2.6%	3.4%	3.8%	2.6%
Real GDP growth	2.0%	-13.7%	6.9%	4.4%	3.3%	2.7%	1.4%
Real yield on assets 1/	1.9%	2.7%	1.6%	1.0%	0.8%	0.9%	0.9%
Real yield on liabilities 1/	1.1%	1.1%	0.9%	0.3%	0.1%	0.2%	0.2%

Sources: Bank of Spain and IMF staff calculations.

1/ Historical data (2019) on real returns on assets and liabilities are here calculated excluding capital gains either due to price or exchange rate changes.

The forecasts are extended until 2034 by assuming that the steady state is characterized by balanced growth. That is, medium-term forecasts are extrapolated requiring growth rates of exports, imports, nominal output and components of the balance of payments to converge to the 2025 forecast growth rate of potential output. Under this extrapolation, net exports plus current transfers and capital account balance in percent of GDP converge to a steady-state ratio of 2 percent.

References

Blanchard, Olivier and Das, Mitali, 2017, "A New Index of External Debt Sustainability", NBER Working Paper No. 24068. https://piie.com/publications/working-papers/new-index-external-debt-sustainability.

Catao, Luis and Gian Maria Milesi-Ferretti, 2014, "External Liabilities and Crises," *Journal of International Economics*, 94, 18-38.

International Monetary Fund, 2015, "The Mechanics of a Strong Euro Area: IMF Policy Analysis".

International Monetary Fund, 2018, Portugal: Selected Issues, IMF Country Report No. 18/274.

Salas, Jorge, 2018, "Drivers of Spain's Export Performance and the Role of Labor Market Reforms," IMF Working Paper 18/283.

INTERNATIONAL MONETARY FUND

SPAIN

STAFF REPORT FOR THE 2020 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

October 26, 2020

Prepared By European Department

CONTENTS

FUND RELATIONS 2

STATISTICAL ISSUES 4

FUND RELATIONS

(As of September 30, 2020)

Membership Status: Joined September 15, 1958.

General Resources Account:	SDR Million	Percent of Quota
Quota	9,535.50	100.00
Fund holdings of currency	7,464.59	78.28
Reserve position in Fund	2,071.17	21.72
Lending to the Fund		
New Arrangements to Borrow	162.58	

SDR Department:	SDR Million	Percent of Allocation
Net cumulative allocation	2,827.56	100.00
Holdings	2,525.05	89.29

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				
	2020	2021	2022	2023	2024
Principal					
Charges/Interest	0.06	0.28	0.28	0.28	0.28
Total	0.06	0.28	0.28	0.28	0.28

2020 Article IV Consultation: Before the intensification of the COVID-19 crisis, discussions took place in Madrid during February 25–29 and remotely through March 10, 2020 focusing on the government's pre-crisis policy priorities. A staff Concluding Statement was issued on March 11. As the health crisis and recession unfolded, regular exchanges between the Spanish authorities and IMF staff continued with comprehensive virtual meetings taking place during September 11–29. The staff team comprised Andrea Schaechter (head), Lucy Liu, Jorge Salas, Ara Stepanyan, William Oman, and Nicolas Arregui (all EUR). Svetlana Vtyurina contributed to the earlier discussions. Dora Iakova (EUR incoming mission chief) joined the February and September missions. Pablo Moreno (Alternate Executive Director) and Rosa Moral (Advisor to the Executive Director) attended some of the meetings. Jai-Ryung (Jenny) Lee and Dilcia Noren (EUR) supported the mission from headquarters. The mission met with Vice-President Nadia Calviño, Banco de España Governor Pablo Hernández de Cos, Secretary of State of the Economy Ana de la Cueva, Secretary of State of Digital Transformation and Artificial Intelligence Carmen Artigas, Secretary General of the Treasury

Carlos San Basilio, and other senior officials. The mission also talked with representatives of the financial sector, labor organizations, think tanks, and political parties. The concluding statement was published September 30, 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 November 18, 2018 (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, 2020)

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, 2020)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items:	
						Data Quality – Methodological soundness[8]	Data Quality – Accuracy and reliability[9]
Exchange Rates	September 2020	September 2020	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	August 2020	September 2020	M	M	M		
Reserve/Base Money	August 2020	September 2020	M	M	M	O,O,LO,LO	O,O,O,O,LO
Broad Money	August 2020	September 2020	M	M	M		
Central Bank Balance Sheet	August 2020	September 2020	M	M	M		
Consolidated Balance Sheet of the Banking System	August 2020	September 2020	M	M	M		
Interest Rates[2]	September 2020	September 2020	D	D	D		
Consumer Price Index	September 2020	September 2020	M	M	M	O,O,O,O	LO,O,LO,O,O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q2 2020	September 2020	Q	Q	Q	LO,O,LO,O	LO,O,O,O,LO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	August 2020	September 2020	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	July 2020	September 2020	M	M	M		
External Current Account Balance	July 2020	September 2020	M	M	M	O,LO,LO,O	LO,O,LO,O,LO
Exports and Imports of Goods and Services	July 2020	September 2020	M	M	M		
GDP/GNP	Q2 2020	September 2020	Q	Q	Q	O,O,O,O	LO,LO,O,O,O
Gross External Debt	Q2 2020	September 2020	Q	Q	Q		
International Investment position[6]	Q2 2020	September 2020	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 a vis nonresidents.

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

[8] Reflects the assessment provided in the data ROSC or the Substantive Update for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).

[9] Same as footnote 8, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment, and revisions.

Statement by the Staff Representative
Executive Board Meeting
November 11, 2020

This supplement provides information that became available after the staff report was issued on October 27, 2020. The thrust of the staff appraisal remains unchanged.

1. **Spain's rebound in the third quarter has beaten expectations, setting the stage for a smaller contraction in 2020 than projected by staff.** According to the preliminary data release, growth in the third quarter was 16.7 percent relative to the previous quarter. Despite the sharp rebound, the economy remains 8.7 percent below its level a year ago. The extent of the recovery has been more significant for private consumption and investment, and less so for external sector components, with tourist services holding back exports. In labor markets, effective hours worked also recovered substantially, increasing by about 25 percent relative to the previous quarter. Nevertheless, the unemployment rate rose further to 16.3 percent (up from 15.3 percent in Q2) due to a sizable flow of workers moving from being inactive to actively seeking a job. Given the strong GDP outcome in the third quarter, the drop in GDP for 2020 could be less severe than the 12.8 percent decline projected by staff, absent a material tightening in containment measures in the coming months.

2. **However, the virus resurgence and associated authorities' response needs pose risks for the near-term outlook.** Average daily new cases have doubled to about twenty thousand by end-October/early-November compared to the first half of October. Parliament has extended the recently launched state of emergency through May 9, 2021 (with an interim assessment by March 9). The decree empowers the government and regions to adopt measures that contain the spread of the COVID-19 virus. The scale of restrictions announced so far is still much milder than the fully fledged spring lockdown. Restrictions include a nationwide curfew (with regional variation on starting time), limits on social gatherings, and with a significant degree of regional variation: constraints to personal mobility at local levels, and limitations on hospitality and entertainment businesses in terms of closing time and capacity constraints as well as localized closures. There are no restrictions to most business activities including industry and trade, no home confinement restrictions, and schools and universities are to remain open. However, the situation remains fluid and risks are tilted toward further tightening.

3. **The macroeconomic outlook that underpins the government's draft budget is optimistic.** The government projects a recovery in activity of about 10 percent in 2021 compared to about 7 percent projected by staff. Discrepancies mainly arise from the use of EU funds and the associated multiplier. The authorities aim to absorb 2.2 percent of GDP and assume a multiplier impact of around 1.2. Staff assumes a somewhat slower absorption of EU funds, with additional spending of 1¼ percent in 2021 and an average short-term multiplier for investment of 0.8, based on past experience. Staff assumptions were made prior to the publication of the budget, and further analysis will be needed once more detail on specific

recovery plans is available. In addition to the EU funds impact, the evolution of the pandemic will shape the recovery. A weaker-than-projected fourth quarter GDP outturn would make the projected 2021 real GDP growth difficult to achieve.

4. **The Draft Budgetary Plan and the draft budget law envisage a narrowing of the fiscal deficit by 3.6 percent of GDP in 2021.** The anticipated deficit reduction in 2021 and over the medium term would be largely supported by the expected strong economic rebound and the expiration of some COVID-related measures. While the headline deficit for 2021 is broadly in line with the level projected by staff, the authorities' projections are underpinned by a stronger revenue forecast and a more expansionary spending plan. In particular, the government is planning to adopt a range of structural revenue measures (about 0.5 percent of GDP) that aim to improve the progressivity, equity, and efficiency of the tax system. The main proposals include the introduction of taxes on financial transactions and digital services, increases in income taxation targeted at high-income earners and large companies, measures to improve environmental taxation including new taxes on plastic bags and waste, as well as efforts to fight against tax fraud. On the expenditure side, the government is set to raise pensions and public wages by 0.9 percent in line with the projected inflation, and increase non-contributory pensions by 1.8 percent. Finally, the draft budget foresees using the entire budgeted amount of nearly €27 billion in grants under the EU Recovery and Resilience Facility for new government spending—of which about €21 billion is envisaged for investment—, thereby not changing the headline deficit in 2021.

Statement by Pablo Moreno, Executive Director for Spain, Fernando Lopez and Rosa Moral Betere, Advisors to the Executive Director

November 11, 2020

Staff has provided very useful feedback under the current highly uncertain economic scenario. On behalf of the Spanish authorities, we thank staff for the very constructive dialogue and well-focused analysis. The new coalition government that took office in January has adapted its policy strategy to address the new challenges posed by the COVID-19 crisis. The authorities have put in place forceful measures to sustain the economy, which have been complemented by decided European Union (EU) policies. Staff has usefully structured the report around a timeline distinguishing three main stages: fighting the pandemic, the recovery phase, and the longer-term challenges. There is broad agreement with staff on the diagnosis and the main policy recommendations on the need to maintain support measures to the economy through the pandemic, and to design a policy response for the recovery phase that, in line with the pre-covid policy agenda, is already guided towards addressing the structural challenges of the economy, including boosting productivity, ensuring fiscal sustainability, addressing gender inequality, and fostering social and environmental sustainability.

Economic outlook and fighting the pandemic

The Spanish economy has been especially hit by the COVID-19 crisis. After growing for more than five years well above its peers, unwinding in the process much of its previous imbalances, Spain has been especially hit by the COVID-19 crisis. The large economic impact in relative terms of the lockdown and social distancing needed to control the pandemic is mainly related to the stricter confinement measures adopted in Spain and to other idiosyncratic factors, including a larger weight of economic sectors most directly affected by the pandemic, such as tourism, an economic structure with a large weight of SMEs (the pandemic has impacted more significantly on smaller firm revenues), the higher share of temporary workers in the labor market, the high population density in big cities, and social standards of closer personal contact.

The authorities project a less depressed outlook than staff, albeit subject to high uncertainty. The authorities are projecting GDP growth rates of -11.2 percent, in 2020, mostly in line with consensus, up to +9.8 percent in 2021, after factoring in the effects of a full implementation of the Recovery and Resilience Plan, and a recovery of pre-covid GDP levels by 2022—these projections are above staff's growth estimates of -12.8 and +7.2 percent, respectively, and a recovery of GDP levels by 2023. The 2020 and 2021 forecasts have been endorsed by the independent fiscal authority (subject to the uncertain outlook) and are compatible with the positive surprise in 3Q20 (a GDP growth of 16.7 percent and employment growth of 3 percent, with 569.000 new jobs). The divergence with staff is mainly explained by differences in the pandemic scenario and the pace of implementation and the multiplier effect of the Recovery Plan—the authorities' estimation has been carried out using a detailed bottom-up approach, considering the heterogeneity of measures and reforms articulated in it. Nevertheless, the outlook is marked by high uncertainty and downside risks, which are the focus of staff's analysis, mainly associated with the evolution of the pandemic. There is, however, also the potential for upside risks, once the pandemic is under control and a medical solution (vaccine or treatment) is widely available. Spain is under a second wave of the pandemic with an earlier but similar evolution and intensity as in other European countries. The strengthened testing and tracing

have resulted in a higher contagion incidence than the first wave, but its severity is lower, with lower hospitalization and death rates.

The authorities have undertaken decisive and timely actions to support the economy, cushioning the impact of the crisis, preserving jobs and incomes, and supporting the most vulnerable. The government decreed a strict national lockdown in March, and gradually reopened the economy since May. In parallel, it has put in place decisive policy actions to face the immediate consequences of the pandemic and support the economy through both, budgetary (5.3 percent of GDP), and liquidity measures (15.3 percent of GDP), including, among the main policy actions: (i) on health, measures amounting more than €20 billion oriented towards providing essential products, reinforcing the health care system, and R&D to fight the pandemic (including €16 billion in direct transfers to the regions through the Covid Fund, covering also expenditures for the adaptation of the education system); (ii) the introduction of the Minimum Income Schemes (MIS), focused on reducing inequality and poverty, while incentivizing labor force participation, that will benefit 850,000 households and lift 1.6 million people out of poverty; (iii) other measures to support households, such as the extension of public leases, moratoria on mortgage and rental payments, and the provision of basic supplies to vulnerable households; (iv) the reinforcement and flexibilization of the short-time work scheme (ERTEs), which has sustained 3.4 million jobs through the pandemic—in comparison, the 3 pp increase in unemployment is substantially lower than that of the Global Financial Crisis, when the unemployment rate rose 6.6 pp between 2008 and 2009; (v) a revision of the Spanish insolvency law and the introduction of temporary provisions to avoid insolvencies for viable companies, which will be further improved with the transposition of the EU Directive on insolvency; (vi) a temporary moratoria on taxes and on payments of employers' Social Security contributions focused on SMEs and the self-employed; and (vii) an initial program of €100 billion of public guarantees though the national promotional bank, ICO, to facilitate liquidity provision to firms, specially SMEs, which has successfully supported a total of 550,500 companies with more than 842,000 operations granted, as of 15th October 2020.

National measures have been complemented by determined EU support. The EU has forcefully responded to the pandemic by deploying a joint and coordinated package materialized in a broad set of economic and financial supranational measures to provide a safety net for firms, people, and sovereigns. The measures include: the decisive monetary policy by the ECB to sustain liquidity and prevent financial market fragmentation; the SURE instrument to cover the expenses of partial and temporary unemployment schemes; the pan-European guarantee fund to promote investment projects through the European Investment Bank; the new ESM Pandemic Crisis Support facility to support health related spending; and the Next Generation EU as a new temporary EU budgetary instrument to guide and finance the recovery.

The recovery phase

Containment policies and temporary support measures will continue until the pandemic is under control. The authorities work under the assumption that there is no trade-off between the economy and health, and therefore, the economy cannot recover a sustained growth path until the pandemic is under control. The uneven spread of the pandemic across regions in the second wave requires a focalized effort. In this respect, on October 25 the government approved a six-month state of emergency that provides the legal umbrella for the regions to display the necessary containment, social distancing and mobility restrictions to control the pandemic (some previous measures enacted

until then had been rejected in courts, as they were not harbored in ordinary legislation). The government is also undertaking a more targeted design of the support measures including, for instance: in agreement with the social partners, an extension of the ERTEs until January 2021 with incentives to resume normal activity and focused on the most affected sectors of the economy such as tourism and self-employed workers; an additional ICO guarantee line of €40 billion, to cover not only liquidity and working capital needs but also investment ahead of the recovery phase; and an equity fund (the SEPI Fund equipped with €10 billion) to support the solvency of viable strategic companies. These measures are temporary (contingent on the evolution of the pandemic); the government rigorously monitors the epidemiological situation and does not rule out the extension of existing measures or the adoption of new targeted ones should the situation require it.

The 2021 Draft Budgetary Plan (DBP) aims at supporting the economic activity during the recovery phase and addressing structural challenges. The negative impact of the shock is aggravating some of the existing weaknesses that had already been identified for the government's term in office, such as raising productivity, underpinning fiscal sustainability, accelerating the green and digital transition, addressing gender equality, and social sustainability.

- **On the expenditure side, the DBP significantly boosts investment in health, education and social resilience, as well as R&D and infrastructure projects.** It envisages an increase of over 70 percent on health, education and social spending, including: additional €3 billion on health expenditures, largely oriented to reinforce primary care and buy vaccines; an increase in education and scholarship spending and a new plan for the modernization of vocational training; the consolidation of the MVI and additional social spending on dependency, child poverty and gender policies. The budget also reinforces horizontal policies on infrastructures (114 percent increase), R&D and innovation (80 percent increase), or support to SMEs (150 percent increase), as well as sectoral policies to decarbonize the industrial and energy sectors and support the tourism or retail sectors. Contributive pensions and public wages are increased by the expected inflation rate to sustain real purchasing power (0.9 percent).

- **On the revenue side, the DBP bolsters medium-term fiscal consolidation by increasing revenues through progressive taxation and new green taxes.** In line with the pre-COVID fiscal strategy, the authorities have taken steps towards increasing the tax collection bases and the progressivity of the tax system which shall move Spain's revenues closer to the EU average—at 41 percent of GDP, the revenue-to-GDP ratio in 2019 was 6 points below the EU average. New measures are expected to yield revenue increases over €6 billion. These measures include (i) an increase of the marginal rates of the personal income tax for the highest earning taxpayers—those with wage earnings above €300.000 and capital gains above €200,000 (affecting around 36,000 individuals, 0.17 percent of the total), and of the marginal rate of the wealth tax (for wealth over €10 million); (ii) for larger companies, a reduction from 100 to 95 percent in the tax credit applied to benefits from international subsidiaries, in line with the practice of other EU countries (it affects about 0.12 percent of the companies); (iii) reinforced green taxation, including new taxes on plastic packaging and waste; (iv) new taxes on financial transactions and digital services; (v) an increase in the VAT rate for sugary drinks; and (vi) new measures to prevent tax evasion and reduced tax elusion.

The authorities' Recovery, Transformation and Resilience Plan is also aligned with the medium-term challenges of the economy. The Plan delineates the use of the Next Generation EU

resources, which includes a financing pillar to member countries through lines such as the Recovery and Resilience Facility and React-EU—Spain is eligible for €140bn to finance public investment, including €72 billion in transfers, which are expected to be deployed in a period of six years, mobilizing up to €500 billion in private investment. It is structured around four axes: green transition, digitalization, gender equality and social and territorial cohesion, further detailed in ten traction policies with green and digital investment absorbing 37 and 33 percent of the resources, respectively. The use of EU funds will be accompanied by a structural reform agenda informed by the EU Semester recommendations. The authorities have designed a governance structure to ensure the efficiency, transparency and accountability in the use of funds, including a new office in charge of the strategic review in the Prime Minister's cabinet, a structure of commissions at ministerial, territorial and parliamentary levels, a set of expert and consultation committees with the private sector and social partners, and a reinforcement of public procurement and supervision procedures. The 2021 DBP includes €27 billion that can be subject to be financed with EU funds. Additionally, the React EU instrument will finance in 2021 up to €8 billion of initiatives to be included in the regional operational programs. The Recovery Plan is projected to create 800,000 new jobs, lift Spain's growth potential above 2 percent, and reduce by two thirds the inequality gap with respect to the EU average.

The authorities are closely monitoring the banking sector, which remains in sound grounds. The initial financial impact of the pandemic has been cushioned by the decisive economic policy response, in particular, credit support programs, the debt moratoria, and the expansionary monetary policy. Bank lending has shown positive growth since the end of March, financial conditions in the corporate sector have normalized, though they remain slightly tighter than before the COVID-19, and, so far, the volume of non-performing loans (NPLs) has increased only moderately. Solvency has improved slightly since 3Q19, supported in part by the flexibility introduced in the European banking regulation and supervision. In addition, there are significant capital buffers to absorb potential losses, and banks have undertaken extraordinary provisioning in anticipation of potential impairment losses, which has adversely affected income statements. The vulnerability analysis and the stress test performed by the ECB and Banco de España, respectively, show a high capacity to absorb losses under the central scenario. Nonetheless, given the severity of the macroeconomic scenarios, capital depletion can be expected to be significantly higher than in recent years and the supervisory authorities have reiterated that banks will have sufficient time to replenish capital buffers. In this scenario, consolidation processes in the banking sector, such as the ongoing merger of two banks into the largest bank measured by assets in Spain, might prove to be a useful response to the crisis, including cross border mergers. Going forward, the resilience of the euro area banking system can be improved with the completion of the Banking Union. We also support staff's recommendation to strengthen the European AML/CFT framework, currently coordinated by an ad hoc EBA Standing Committee.

Medium-term challenges

The COVID-19 crisis has heightened the need for social and economic transformation. The government took office in January 2020 with a coalition agreement that included among its medium-term economic objectives: increasing potential growth, ensuring fiscal sustainability, lowering unemployment and improving the quality of jobs, enhancing social and environmental sustainability and fostering gender equality. The COVID-19 crisis has made these objectives more urgent and there is political consensus on the need to strengthen the reform momentum in close coordination with social partners, including the opportunity of leveraging on the resources from Next Generation EU to accelerate the reform agenda.

The authorities are strongly committed to resume the fiscal consolidation strategy once the economic recovery stabilizes. Spain continues to enjoy a very strong market access and historic record-low levels in cost at issuance (0.21 percent) and record-high levels in average life of issued debt (7.82 years). The government projects reducing the fiscal deficit by 3.6 pp down to -7.7 percent of GDP in 2021 and is committed to resume fiscal consolidation and the pre-COVID downward trend in the debt-to-GDP ratio, once the recovery is firmly on track. The authorities have already taken steps in this direction by increasing the progressivity of the personal income tax and introducing new green, digital, and financial transactions taxes. Moving forward, they are already working on a complete review of the tax structure and of the public transfers system to enhance the progressivity and revenue collection capacity, and to better target spending. This process will be data-driven and informed by the expenditure and revenue reviews conducted by the independent fiscal authority. Measures in the pipeline include: a reform of the pension system—convergence of the different contribution regimes, sustaining purchasing power, incentivizing older effective retirement age, and encouraging the compatibility of work with the perception of pensions, while improving the complementary private pension system; and reordering non-contributory social benefits, with the MIS absorbing a series of non-contributory benefits to avoid duplications. Here, the authorities take note of the staff's recommendation to set an Earned Income Tax Credit program but prefer to continue working on the design of the MIS, which is already temporarily compatible with in-job earnings. In any case, the effects of the new MIS will be assessed in due course.

The new digitalization agenda plays a pivotal role in the strategy to raise productivity and improve social and regional equality. 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. The authorities are committed to devising a comprehensive regulatory and financing strategy in all these areas, which has already been strengthened in the 2021 DBP. The new digital strategy, Digital Spain 2025, is instrumental to increase productivity and reduce the carbon footprint, through the modernization of the productive structure, and to reduce social and regional inequalities, by leveling access and skills across society. It projects a public investment of €20 billion in the 2020–22 period and includes projects to ensure 100 percent connectivity and deployment of 5G, by 2025, and the digitalization of public administrations and companies, with a special focus on SMEs and start-ups. It will be articulated through public-private partnerships with the participation of social agents.

The authorities are undertaking a gradual reform of the labor market. They have implemented a number of measures to sustain jobs through the pandemic, most notably, the new provisions for ERTEs and the support program for the self-employed. Moving forward, the government will continue to tackle the main problems of the labor market such as duality, youth and long-term unemployment, gender gaps and facilitating resource allocation (staff has provided useful feedback on these issues, including in the SIPs). Reforms in the pipeline include: a reform of active labor market policies (reinforcing coordination between agents, enhancing profiling, fostering synergies with vocational training and evaluating and applying best practices); a review of the passive labor market policies to boost active job searching; and fostering open-ended contracts as the ordinary form of access to employment (increasing causality on the use of temporary contracts, fighting its abuse and enhancing the use of discontinuous fixed-term contracts). Additionally, the ERTEs have proven very effective, not only to limit the increase in unemployment, but also to provide added flexibility for companies, particularly for SMEs. In this respect, the authorities are working on the redesign of

ERTEs to address some of the traditional problems of the labor market. For example, they can be used to reduce duality by providing stability and quality for temporary workers and seasonal activities, or by introducing elements of professional training to increase capabilities.

Social and environmental sustainability are guiding principles of the government's policy strategy. Tackling climate change and deploying policies to reduce inequality in all its dimensions, such as income, gender, intergenerational or regional, are guiding principles of government policies. These policies are not only key for achieving socially and environmentally sustainable growth, but they are also instrumental to improving productivity and long-term potential growth (staff has provided useful feedback, including in the SI on housing and gender policies). A key achievement in 2020 has been the approval of the draft bill on Climate Change and Energy Transition targets net zero GHG emissions by 2050, in line with EU targets. It concentrates on three major sectors: transport, housing and energy; and provides an institutional framework to achieve more ambitious goals than the EU 2030 targets on renewables and energy efficiency. Some of its main provisions include ensuring that almost all new vehicles are zero carbon by 2040; establishing low-emission areas in cities with more than 50,000 inhabitants by 2023; or the promotion of electric charging infrastructures throughout the national territory. The bill also focuses on ensuring that the energy transition succeeds with a "no one left behind" approach, articulated through policies such as transition agreements for the most affected areas, work-training programs for low-carbon jobs, or climate change education in schools. According to the government' estimates, the ecological transition could attract more than €200 billion in investments over the next decade and create up to 350,000 new jobs annually.