Spain: IMF Staff Concluding Statement of the 2017 Article IV Mission

July 18, 2017

Spain's economic recovery remains strong, with consumption, investment, and net exports all contributing to a more balanced growth pattern. A shift in resources toward Spain's competitive export sector, with the services sector creating most new jobs, has played an important part in the rebound. Banking sector balance sheets are stronger, private sector debt is coming down, and credit availability is improving. As the recovery is maturing, it is time to tackle the remaining vulnerabilities related to elevated public debt and complete the still-ongoing post-crisis banking sector adjustment. At the same time, reducing structural unemployment and fostering productivity growth remain priorities. Without farther determined progress on structural reforms and rebuilding of fiscal buffers, the economy would remain vulnerable to shocks and risk leaving some segments of the population behind.

Outlook

Spain is in the fourth year of impressive economic expansion and job creation. GDP likely surpassed its pre-crisis level in the second quarter, with growth remaining well above the euro area average. Thanks to past reforms, the economy has become more competitive, flexible and resilient. A dynamic services sector, much of which is export-oriented, has replaced an outsized construction sector, and together with a recovery in manufacturing contributed to the sustained improvements in the current account balance. Moreover, the private debt burden is more manageable, and the banking sector is stronger. Real GDP is projected to grow by 3.1 percent this year, and there is upside risk as the momentum created by past reforms may be bigger than estimated.

But challenges remain. They need to be fully addressed to offset the expected slow-down in medium-term growth and to build greater resilience. Public debt and structural unemployment are still high, population aging is creating fiscal pressures, and productivity lags that of EU peers. In addition, Spain's net debtor position with the rest of the world remains large, and financial sector adjustment and further reforms to strengthen and modernize the institutional arrangements are yet to be fully completed.

Fiscal Policy: Rebuilding Buffers

The supportive economic environment makes the present a good time to lower fiscal vulnerabilities further. Spain's high public debt ratio, close to 100 percent of GDP, leaves little room for fiscal policy to respond to shocks. In addition, Spain's population dynamics imply a significant increase in age-related spending over the medium term. Maintaining the gradual adjustment pace established for 2017, until the structural budget is in balance, would rebuild fiscal buffers faster, by accelerating debt reduction.

The envisaged expenditure restraint for 2018 will contribute importantly to lowering the deficit, requiring implementation of the expenditure rule at all government levels. Room for more structural measures lies mostly on the revenue side, though reforms designed to increase expenditure efficiency would also help. VAT collections in Spain are still significantly lower as a share of GDP than in other European countries, in part because of a large share of consumption that benefits from reduced rates. Gradually shifting more consumption to standard VAT rates would provide resources for debt reduction and create space to properly shield vulnerable groups. Similarly, bringing environmental taxes and levies more in line with EU peers and reducing inefficiencies in the tax system could also help reduce the deficit and debt. Planned expenditure reviews, including for pharmaceutical spending, could raise the quality and efficiency of service provision. The review should be closely tied to reforms of the regional financing framework.

Spain adopted a comprehensive package of pension reforms in 2011 and 2013 to address pressure on pension spending from an aging population. The reforms ensure the financial stability of the pension system, and annual nominal pension increases for all pensioners. As a result, thirty years from today the average pension of a Spanish pensioner relative to the average wage in the economy (the benefit ratio) would still be well above the projected EU average. It is critical that the reforms be implemented in full and one-off adjustments, such as in the pension indexation rate, should be avoided. If changes are deemed necessary to ensure the continued smooth transition to a financially sustainable and socially acceptable pension system, the burden of adjustment should be spread across and within generations. This would be best accomplished through a package of measures to incentivize longer work lives and encourage supplementary savings. Moreover, for the sake of pensioners today and tomorrow, full transparency about how the financial sustainability of the pension system is achieved and the implications for retirement income will be critical.

Labor Market: Towards Better Employability and Less Duality

Cost competitiveness has supported strong job creation. The unemployment rate in the first quarter of 2017 was 18.8 percent, lower than it was in the first quarter of 2010. Youth and long-term unemployment rates have also improved significantly. These developments have reversed some of the large median income loss suffered by Spain's younger generation relative to its older cohorts.

Nonetheless, youth and long-term unemployment rates are still among the highest in Europe, temporary hires have continued to outnumber permanent ones and involuntary part-time employment has remained high.

Fostering a dynamic and healthy labor market that provides job opportunities for all segments of society requires a holistic approach. To this end, it will be important to keep the economy competitive, which requires working conditions to be set flexibly in line with firm- and sector-specific conditions, and tackling the long-standing issue of labor market duality. Moreover, well-designed and targeted active labor market policies can play a greater role in helping low-skilled youth and long-term unemployed return to work. To be the most effective, active labor market policies should complement efforts to improve the quality of formal education and training. This would also help to address skills mismatches and to raise productivity.

Structural Reforms: Raising Medium-term Growth Prospects

Raising productivity growth is critical for Spain's medium-term economic prospects and faster reduction in vulnerabilities. It is particularly important as the working-age population is projected to shrink in the coming decades due to population aging. Some productivity improvements can already be observed. The exit of less productive firms has lifted aggregate productivity growth after the crisis. In addition, there is some evidence of improved credit allocation, with resources flowing to more productive and financially healthier firms on the back of banking sector restructuring. However, productivity levels in Spanish manufacturing, trade and market services sectors are still considerably lower than in EU peers.

Policies that lower barriers to competition (e.g., implementation of the Market Unity Law), support firms' capacity to grow and innovate (e.g., fewer size-related regulations and more research and development spending), and facilitate access to equity financing for startups will be important to raise growth and competitiveness going forward.

Financial Sector: Completing the Crisis Legacy Clean-Up and Reform Agenda

Bold reforms undertaken in 2012, and continued thereafter, have contributed to the emergence of a stronger and leaner banking system. Profitability and solvency have vastly improved for most banks, credit availability is better, and adjustments to new regulatory requirements are progressing smoothly. The swift resolution of a publicly listed domestically systemic bank has removed a source of uncertainty in the banking system, and consolidation efforts in the system are proceeding. However, the crisis legacies have not yet been fully overcome. Non-performing and foreclosed assets have come down notably but remain relatively high in a few banks weighing on their earnings. Banks have also continued to raise capital in line with regulatory requirements. While they still lag those of European peers, they are generally less leveraged thanks to the higher risk weight intensity. And like other European banks, Spanish banks are also facing challenges from the uncertainties related to the growth environment, prospective normalization of the ECB's monetary policy, and forthcoming regulatory compliance.

For the financial system to further enhance its resilience and support economic growth, the 2017 stability assessment under the Financial Sector Assessment Program (FSAP) highlighted three near-term policy priorities—addressing banks' remaining weaknesses and legacy issues, preparing to handle financial stability headwinds, and strengthening and modernizing institutional arrangements.

- A more proactive approach in dealing with legacy issues would help prepare the banking system for new challenges. Accelerating the balance sheet cleanup should build on the ECB's guidance on reducing non-performing loans and the application of the accounting rules on provisions (introduction of IFRS9). Banks' property value assumptions should be carefully analyzed and supervisory actions applied to enhance progress.
- Spanish banks need to continue improving profitability, further building capital buffers, and adjusting funding positions. The recent round of bank consolidation is welcome, but scope exists for further efforts that would structurally strengthen banks' profitability. Some banks also need to further increase regulatory capital or capital buffers to compensate for the phase-out of regulatory exemptions and to protect their business against unexpected shocks. Moreover, some banks may need to adjust their liability structures to fulfill new regulatory requirements, and be prepared for an eventual gradual tapering of the ECB's accommodative monetary policy. And finally, building on the recent steps taken, a comprehensive reform of the credit cooperative sector is essential, particularly to strengthen corporate governance and improve resolvability.
- Establishing an interagency Systemic Risk Council would enhance systemic risk surveillance and macroprudential decision making. It would help address the gradually rising intra-system connectedness of the financial system. Given the traditional importance of real estate exposures on banks' balance sheets, expanding the macroprudential toolkit to possibly include limits on loan-to-value and debt service-to-income would strengthen the Bank of Spain's ability to deal with future build-up of risks in exposures to real estate sectors. The current resolution arrangements for systemically important banks are working well for the present, although over time, the fragmentation of resolution arrangements should be addressed by reviewing the current set up that separates preventive and executive resolution responsibilities of banks and investment firms.
- Plans to enhance the governance of certain parts of the institutional architecture are welcome. They include reforms to the selection process for financial sector oversight authorities, the establishment of an independent insurance and pension fund agency, the introduction of single ombudsman scheme to handle consumer complaints related to financial products, and the transfer of responsibility for general purpose accounting standards and audit oversight from an institute within the Ministry of Economy to the capital markets regulator.