IMF Country Report No. 17/319

SPAIN

October 2017

2017 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 2017 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 September 20, 2017, 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 September 20, 2017, following discussions that ended on July 18, 2017, 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 August 8, 2017.
- 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
Financial Stability System Assessment

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

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October 6, 2017

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Washington, D. C. 20431 USA

IMF Executive Board Concludes 2017 Article IV Consultation with Spain

On September 20, 2017, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Spain. This also included a discussion of the Financial System Stability Assessment, based on the work of the Financial Sector Assessment Program (FSAP) missions.[2]

Strong, balanced, and employment-intensive expansion of the Spanish economy continued during the first half of 2017, and the recovery reached a significant milestone when real GDP surpassed its pre-crisis peak. The economy grew by 3.3 percent in 2016 and is expected to expand by 3.1 percent this year. Past structural reforms, wage moderation and resulting cost competitiveness gains, favorable monetary and external conditions, and fiscal relaxation have provided impetus to the recovery. As some external tailwinds dissipate, economic activity is projected to moderate to 2.5 percent in 2018 in the absence of any major boost in productivity growth.

A shift in resources toward the competitive export sector, with the services sector creating most new jobs, has played an important part in the economic rebound. Unemployment dropped to its lowest level in seven years, but at 17.2 percent the rate is still among the highest in Europe, with significant shares of youth and long-term unemployment and amid widespread labor market duality. The current account recorded its fourth consecutive annual surplus in 2016—a trend that is expected to continue in the medium term. Nevertheless, Spain’s net debtor position with the rest of the world is still large. Headline inflation increased earlier this year due to higher energy prices, but is gradually converging towards core inflation, which has remained below 1.4 percent

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[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] Under the FSAP, the IMF assesses the stability of the financial system, and not that of individual institutions. The FSAP assists in identifying key sources of systemic risk and suggests policies to help enhance resilience to shocks and contagion. In member countries with financial sectors deemed by the IMF to be systemically important, it is a mandatory part of Article IV surveillance, and supposed to take place every five years.

so far in 2017. Public debt is close to 100 percent of GDP, while population aging is contributing to fiscal pressures.

The banking system has become more resilient since the last FSAP. It has strengthened its solvency and continued to reduce nonperforming loans (NPLs) for business in Spain to 8.4 percent of total loans at end-June 2017. Nevertheless, NPLs remain especially elevated for some sectors. At the same time, private sector deleveraging has reduced the debt-to-GDP ratio by 70 percentage points from its pre-crisis peak to end-2016. Banking system profitability, though higher than the euro area average, declined and remains a challenge in the environment of low interest rates, high legacy problem assets, and continued excess capacity. Systemic interconnections of the financial system are on the rise with cross-sectoral and cross-border claims picking up.

Executive Board Assessment[3]

Executive Directors welcomed Spain's continued strong and balanced growth, accompanied by healthy job creation, which highlight the contribution of past structural reforms to making the economy more competitive, flexible and resilient. Nonetheless, Directors noted that structural weaknesses persist, vulnerabilities have not been fully overcome, and the unemployment rate remains high while productivity lags EU peers. In addition, public and private sector balance sheets remain vulnerable to shocks. With this backdrop, Directors recommended gradual fiscal tightening. They also underscored the need to preserve and deepen reforms, including steps to reduce structural unemployment, strengthen the business environment and competition, and make the financial sector more resilient along the lines of recommendations in the Financial Sector Stability Assessment (FSSA).

Directors welcomed the return to structural fiscal consolidation in 2017. Given the limited fiscal space and supportive cycle, Directors encouraged the authorities to maintain the current pace of adjustment until structural balance is reached. They noted that room lies mostly on the revenue side, including gradually reducing the number of goods and services that qualify for reduced VAT rates, reducing tax system inefficiencies, and raising environmental taxes, while adequately shielding vulnerable groups. Directors noted the importance of applying the expenditure rule and measures to increase expenditure efficiency. To alleviate age-related spending pressures, Directors called for full implementation of ongoing pension reforms and public disclosure of reform tradeoffs to support workers' retirement planning.

Notwithstanding strong employment creation, Directors stressed the need for further actions to reduce high structural unemployment. To this end, Directors called for a holistic approach,

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[3] 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.

including improvements in the quality of education and training which would also reduce the risk of poverty and exclusion among vulnerable groups. Maintaining competitiveness would be critical for sustaining employment gains. Directors emphasized that well-designed and targeted active labor market polices, along with enhanced performance of the Public Employment Services, could help low-skilled youth and the long-term unemployed to return to work. Further efforts are also needed to reduce labor market segmentation.

Directors stressed the need to accelerate competition-enhancing reforms to boost growth prospects. They emphasized the need to fully implement the Market Unity Law, jumpstart the liberalization of professional services, ease access to equity financing for startups, and make public research and development spending more efficient. Directors welcomed efforts to minimize regulation-induced disincentives for firm growth.

Directors commended the significant progress made in strengthening banking sector soundness, as reflected in the FSSA. They welcomed plans to enhance and modernize the financial sector institutional set-up and strengthen the cooperative sector. Recognizing remaining weaknesses and legacy issues, Directors encouraged the authorities to accelerate bank balance sheet cleanup, including through ambitious NPL reduction. Directors underscored the importance for banks to further raise high-quality capital and reduce operating costs to improve profitability and enhance resilience. Directors also called for rigorous monitoring of interest rate and bond market risks, and stressed the need for greater focus on contagion risk within the financial system and cross-border spillovers. The macroprudential toolkit should be expanded to strengthen the ability to deal with build-up of systemic risks. Establishing a systemic risk council would augment the capacity for risk oversight, policy coordination and crisis prevention.

Spain: Main Economic Indicators, 2012–2022

(Percent change unless otherwise indicated)

	2012	2013	2014	2015	Projections 2016	2017	2018	2019	2020	2021	2022
Demand and supply in constant prices 1/											
Gross domestic product	-2.9	-1.7	1.4	3.2	3.2	3.1	2.5	2.0	1.9	1.7	1.7
Private consumption	-3.5	-3.1	1.6	2.9	3.2	2.7	2.4	2.0	1.8	1.7	1.7
Public consumption	-4.7	-2.1	-0.3	2.0	0.8	0.7	0.7	0.7	0.7	0.3	0.3
Gross fixed investment	-8.6	-3.4	3.8	6.0	3.1	4.3	3.3	2.8	2.5	2.0	2.1
Total domestic demand	-5.1	-3.2	1.9	3.4	2.9	2.6	2.2	1.9	1.8	1.5	1.5
Net exports (contribution to growth)	2.2	1.5	-0.5	-0.1	0.5	0.5	0.3	0.2	0.2	0.2	0.2
Exports of goods and services	1.1	4.3	4.2	4.9	4.4	7.0	4.6	4.2	3.8	3.5	3.5
Imports of goods and services	-6.4	-0.5	6.5	5.6	3.3	5.9	4.0	4.1	3.7	3.3	3.3
Real GDP per capita	-3.0	-1.3	1.7	3.3	3.3	3.2	2.7	2.2	2.0	1.8	1.8
Savings-Investment Balance (percent of GDP)											
Gross domestic investment	20.0	18.7	19.4	20.1	20.4	20.6	20.7	20.8	20.8	20.8	20.9
Private	17.5	16.5	17.2	17.6	18.5	18.6	18.6	18.7	18.7	18.7	18.8
Public	2.5	2.2	2.1	2.5	1.9	2.0	2.1	2.1	2.1	2.1	2.1
National savings	19.8	20.2	20.5	21.4	22.3	22.4	22.6	22.7	22.8	22.8	22.9
Private	23.4	24.3	24.0	24.0	24.5	23.6	23.0	22.7	22.6	22.7	22.9
Public	-3.7	-4.0	-3.5	-2.6	-2.2	-1.2	-0.4	0.0	0.1	0.1	0.0
Foreign savings	0.2	-1.5	-1.1	-1.4	-1.9	-1.9	-1.9	-1.9	-1.9	-2.0	-2.0
Household saving rate (percent of gross disposable income)	8.5	9.6	9.0	8.2	7.7	7.4	7.5	7.6	7.7	7.9	8.0
Private sector debt (percent of GDP)	252.9	241.4	230.4	218.0	208.7	200.4	195.2	190.4	185.9	181.8	177.7
Corporate debt	167.8	159.6	152.8	145.3	139.4	135.5	130.7	127.2	124.4	121.9	118.7
Household debt	85.2	81.8	77.6	72.7	69.3	64.9	64.5	63.2	61.5	60.0	59.1
Credit to private sector	-9.9	-10.2	-6.5	-4.2	-4.1	0.9	1.4	1.4	1.5	1.6	1.7
Potential output growth	0.2	0.0	0.3	0.7	1.0	1.4	1.5	1.6	1.6	1.6	1.7
Output gap (percent of potential)	-6.1	-7.8	-6.8	-4.5	-2.3	-0.7	0.3	0.8	1.0	1.0	1.0
Prices											
GDP deflator	0.1	0.4	-0.3	0.5	0.3	1.2	1.5	1.7	1.6	1.7	1.8
HICP (average)	2.4	1.5	-0.2	-0.6	-0.3	2.0	1.4	1.7	1.7	1.8	1.9
HICP (end of period)	3.0	0.3	-1.1	-0.1	1.4	1.2	1.4	1.6	1.8	1.8	1.9
Employment and wages											
Unemployment rate (percent)	24.8	26.1	24.4	22.1	19.6	17.3	15.6	15.0	14.3	13.9	13.9
Labor productivity 2/	2.0	1.8	0.3	0.2	0.4	0.4	0.6	1.3	1.2	1.3	1.7
Labor costs, private sector	1.1	0.3	0.1	0.2	0.1	1.5	1.5	1.5	1.6	1.7	1.8
Employment growth	-4.3	-2.8	1.2	3.0	2.7	2.6	1.9	0.7	0.6	0.4	0.0
Labor force growth	0.0	-1.1	-1.0	-0.1	-0.4	-0.3	-0.1	-0.1	-0.1	-0.1	-0.1
Balance of payments (percent of GDP)											
Trade balance (goods and services)	1.5	3.3	2.5	2.4	2.9	2.9	3.2	3.3	3.5	3.6	3.7
Current account balance	-0.2	1.5	1.1	1.4	1.9	1.9	1.9	1.9	1.9	2.0	2.0
Net international investment position	-89.9	-94.3	-97.5	-91.3	-85.7	-79.9	-74.4	-69.3	-64.6	-60.1	-55.7
Public finance (percent of GDP)											
General government balance 3/	-10.5	-7.0	-6.0	-5.1	-4.5	-3.2	-2.5	-2.1	-2.0	-2.0	-2.1
Primary balance	-8.0	-4.1	-3.0	-2.4	-2.0	-0.6	0.0	0.3	0.5	0.5	0.5
Structural balance	-3.5	-2.5	-2.0	-2.4	-3.1	-2.6	-2.5	-2.5	-2.5	-2.5	-2.6
Primary structural balance	-0.5	1.0	1.5	0.6	-0.3	0.2	0.2	0.2	0.2	0.2	0.2
General government debt	85.7	95.5	100.4	99.8	99.4	98.5	97.1	95.6	94.3	93.2	92.2

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

1/ New GDP data for 2014-16 were received following the circulation of the staff report and are not yet incorporated.

2/ Output per worker.

3/ The headline balance for Spain includes financial sector support measures equal to 3.7 percent of GDP for 2012, 0.3 percent of GDP for 2013, 0.1 percent of GDP for 2014, 0.05 percent of GDP for 2015, 0.2 percent of GDP for 2016, and 0.1 percent of GDP for 2017.

INTERNATIONAL MONETARY FUND

SPAIN

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION

August 8, 2017

KEY ISSUES

Context. The economic recovery remains strong and balanced. Thanks to past reforms, the economy has become more competitive, flexible and resilient. A dynamic services sector has replaced the outsized construction sector as the engine of growth, the private debt burden is more manageable, and the banking sector is stronger. But challenges remain: public debt and structural unemployment are 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 world is still large, and financial sector adjustments and institutional reforms are yet to be fully completed.

Policies. Spain's recent economic dynamism should not be taken for granted. It is imperative that competitiveness gains and structural reforms be preserved. To make the recovery more inclusive and sustainable, balance sheet adjustments and additional efforts to enhance potential growth, including labor market reforms, must continue.

- **Fiscal Policy:** With the recovery maturing, it is time to lower fiscal vulnerabilities, and create the fiscal space to cushion future shocks, for example by relying more on indirect taxes. Full implementation of ongoing pension reforms and more public disclosure of reform tradeoffs would support future pensioners' retirement planning.

- **Labor market:** Large numbers of low-skilled and long-term unemployed workers risk permanent disenfranchisement. Better targeted, coordinated, and focused active labor market policies could put more unemployed individuals to work. Further steps to reduce labor market duality are critical too.

- **Structural reforms:** Shifting toward higher value added sectors and reducing within-sector inefficiencies could unlock a higher growth potential. Key ingredients are full implementation of the Market Unity Law, fewer size-related requirements, easier access to equity financing for startups, and more efficient public R&D spending.

- **Financial sector:** The Financial Sector Assessment Program observed significant progress in restoring the banking sector to health. But further action is needed in some areas—related to non-performing loans, capital, privatization of state-owned banks, medium-term bank funding, operations of the asset management company, the credit cooperative sector, and the supervision and resolution frameworks.

Approved By
Philip Gerson and Zuzana Murgasova

Discussions took place in Madrid during July 4–18, 2017. The staff team comprised Ms. Andrea Schaechter (head), Messrs. John Ralyea, Jorge Salas, Ara Stepanyan (all EUR), Mr. Phakawa Jeasakul (MCM), and Ms. Hanni Schoelermann (EUO). Mr. Jorge Dajani (Alternate Executive Director), and Ms. Estefania Sanchez Rodriguez (Advisor to the Executive Director) attended the discussions. Ms. Nina Budina and Mr. Daehaeng Kim (EUR) contributed to the report.
Mmes. Tingyun Chen and Dilcia Noren (EUR) supported the mission from headquarters. The mission met Economy, Industry and Competitiveness Minister De Guindos, Finance and Public Functions Minister Montoro, Bank of Spain Governor Linde, and other senior officials. The mission also met with representatives of the financial sector, industry, trade unions, academia, think tanks, parliament, and political parties.

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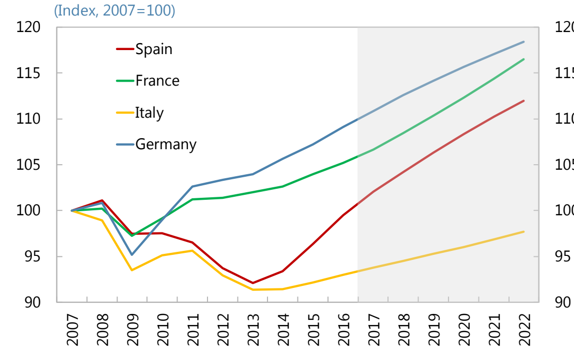
CONTEXT

1. **Spain is in the fourth year of economic expansion.** GDP as well as consumption and non-construction investment have rebounded close to pre-crisis levels. Structural and temporary factors have supported the recovery. Thanks to wage moderation and labor market reforms the economy has become more competitive, generating many new jobs. Banking sector reforms have enhanced the system's resilience and steered the allocation of credit to more productive firms (Box 1). At the same time, Spain has benefited more than its peers from low oil prices due to its large energy dependency, the ECB's monetary easing due to its high share of loans at flexible rates, and fiscal relaxation in 2015–16.

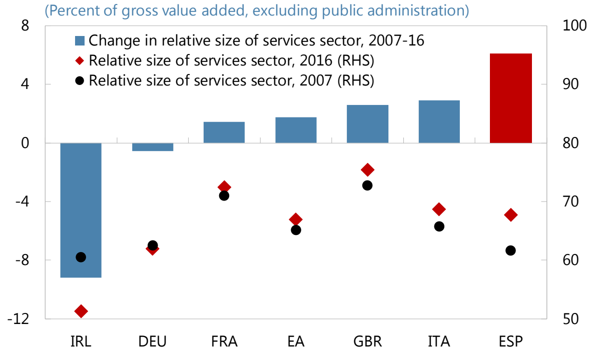
Real GDP
(Index, 2007=100)



Sources: WEO, and IMF staff calculations.

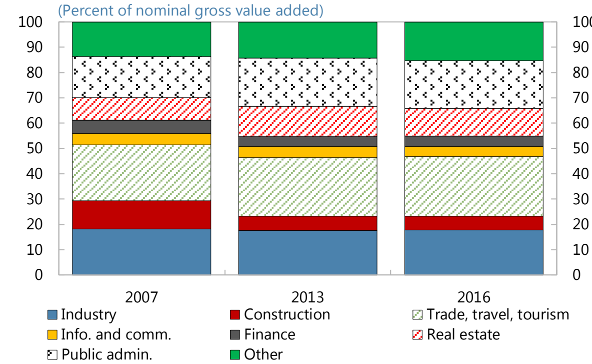
2. **The impressive recovery took place following structural rebalancing towards services.** The outsized construction sector has nearly halved its contribution to the economy from its pre-crisis level to about 6 percent of gross value added, with mostly services taking its place. The structural shift has been job rich, resulting in a strong increase in the employment share of services (Box 2). Much of the services sector expansion has been export-oriented and, together with a recovery in manufacturing, has contributed to sustained improvements in the current account balance. The sectoral shift has also been accompanied by some labor productivity gains, spread broadly across all sectors. These aggregate productivity improvements are mostly explained by productivity gains within sectors, while the contribution from resource allocation shifts between sectors has been more limited.

Size of the Services Sector
(Percent of gross value added, excluding public administration)



Sources: Haver Analytics and IMF staff calculations.

Composition of the Economy
(Percent of nominal gross value added)



Sources: Haver Analytics and IMF staff calculations.

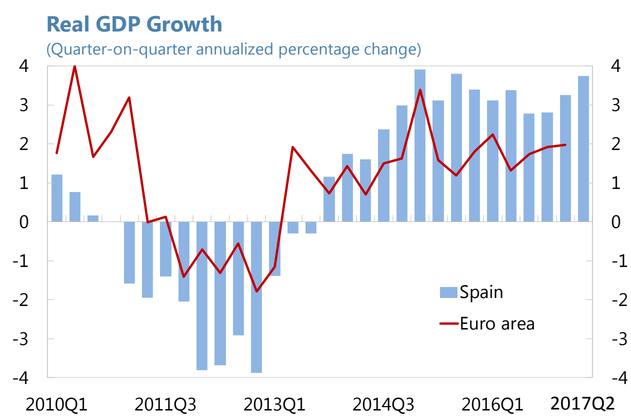
3. **Nevertheless, challenges remain.** The legacies of the crisis, while significantly diminished, have not been fully overcome. In addition, much of the post-crisis growth has been in lower-skill, lower-productivity sectors where the incentives to invest in workers is low. Spain's structural

unemployment rate remains one of the highest in Europe. Labor market measures are needed to move more unemployed into jobs, enhance job certainty, and facilitate employment in higher-value added jobs. There is also substantial room to boost productivity. Spanish firms, on average, are less productive than most of their EU peers. Moreover, the public and private sector balance sheets remain vulnerable to external shocks. Spain's public sector debt hovers around 100 percent of GDP. Further, additional efforts are needed to put the banking sector's challenges, such as a high level of non-performing loans, firmly in the past. Finally, balance sheet improvements, more broadly, would facilitate an adjustment in Spain's large negative net international investment position.

4. **A narrow policy agenda has emerged against the background of political fragmentation.** Policy priorities of the minority government are preserving past reform achievements (Appendix I), exiting the excessive deficit procedure, and completing the financial sector reform agenda. At the same time, it aims to refine active labor market policies, the pension system, and regional public finances. Policies to lower the medium-term structural fiscal deficit, tackle pervasive labor market duality, and foster competition in professional services and product markets are medium-term considerations, which have little traction at this stage.

RECENT ECONOMIC DEVELOPMENTS

5. **Spain's balanced recovery has continued, outpacing most EU peers.** Growth reached 3.2 percent in 2016 and remained robust in the first half of 2017 (3.1 percent y-o-y). Consumption, investment, and net exports all made positive contributions (Figure 1). Core inflation has remained subdued at 0.8 percent in 2016 and 1.2 percent (y-o-y) in June. Headline inflation, however, jumped to 3 percent (y-o-y) in January and February, before declining to 1.5 percent (y-o-y) in July, reflecting base effects from an increase in global energy prices and the one-off effects of electricity tariff adjustments.

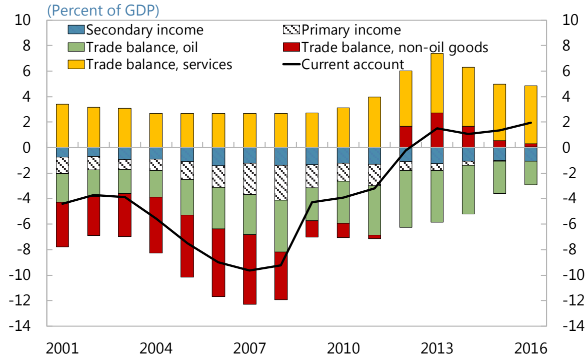


Sources: Eurostat and INE.

6. **Spain recorded its fourth consecutive annual current account surplus.** In 2016, the external current account increased by 0.6 percentage points, to 1.9 percent of GDP (Figure 2). This improvement was explained by a smaller energy trade deficit in the context of low oil prices, a sustained strong performance of services' exports (including tourism), and lower interest payments. In contrast, the trade surplus of non-oil goods declined, against the background of a slight deceleration of export volumes and lower-than-expected imports. But with continued wage and price moderation, the real effective exchange rate (REER) barely appreciated in 2016 and overall export performance remained healthy, including an increase by 4 percentage points in the number of regular exporters (defined as those that have exported for at least four consecutive years).

Current Account Components

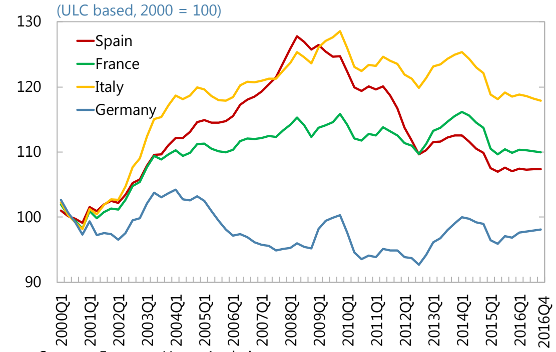
(Percent of GDP)



Source: IMF, *World Economic Outlook*.

Real Effective Exchange Rate 1/

(ULC based, 2000 = 100)

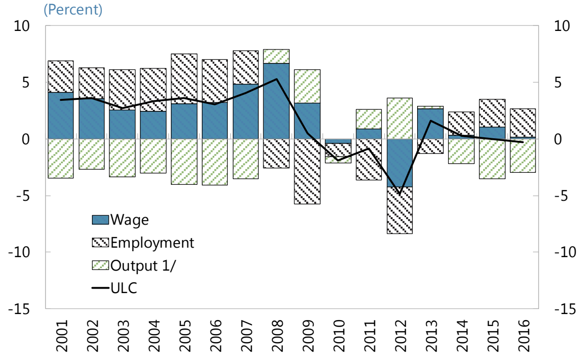


Sources: Eurostat, Haver Analytics.
1/ Relative to 37 trading partners.

7. Wage moderation underlines gains in cost competitiveness and job creation. Unit labor costs (ULC) have remained broadly unchanged during the recent recovery, as individual wages have grown at modest rates. This has allowed Spain to preserve competitiveness gains, with ULC relative to trading partners (i.e., the ULC-based REER) declining by about 15 percent since 2008. In absolute terms, Spain's ULC declined by around 6 percent between 2010–16, mainly because of the drop in employment until 2013 and, more recently, due to the increase in output. The cumulative growth of wages during that period was below 1 percent, much lower than the 34 percent increase observed during 2001–09. Cost competitiveness has supported job creation, with more than one third of the nearly 4 million jobs lost during the crisis recovered by 2017:Q1 (Box 2). The unemployment rate stood at 17.2 percent in 2017:Q2, a level last seen in the 2009:Q1, and 10 percentage points lower than the peak rate in 2013 (Figure 3). Youth and long-term unemployment rates have also improved but remain among the highest in Europe. At the same time, in 2016, temporary new hires still outnumbered permanent ones.

Decomposition of Changes in Unit Labor Costs

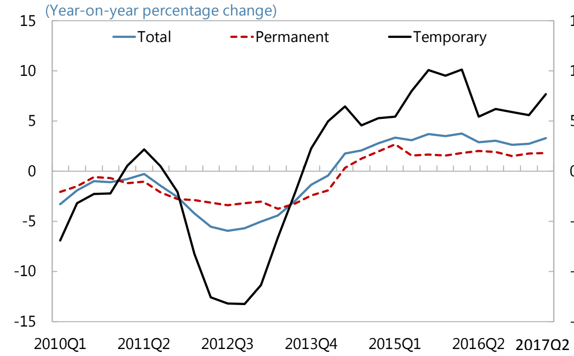
(Percent)



Sources: OECD; Eurostat; IMF staff calculations.
1/ Increases in output lead to declines in ULC.

Employment Growth by Type of Contract

(Year-on-year percentage change)

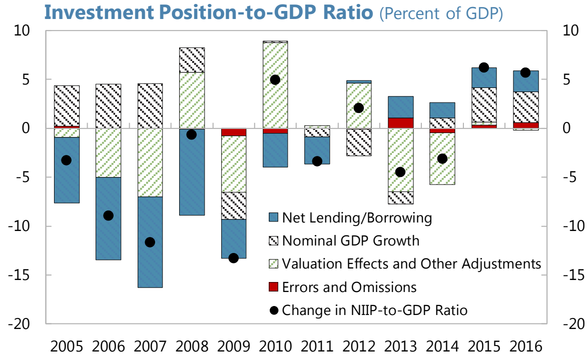


Source: INE.

8. The net international investment position (NIIP) is still highly negative. On the back of current account surpluses and the GDP recovery, the NIIP improved from -98 percent of GDP in 2014 to -86 percent in 2016. While the private sector has continued to deleverage and generated net savings after the crisis, the NIIP of the general government and the central bank has increased, reflecting mostly higher liabilities under Target2 as the ECB expanded its asset purchase program.

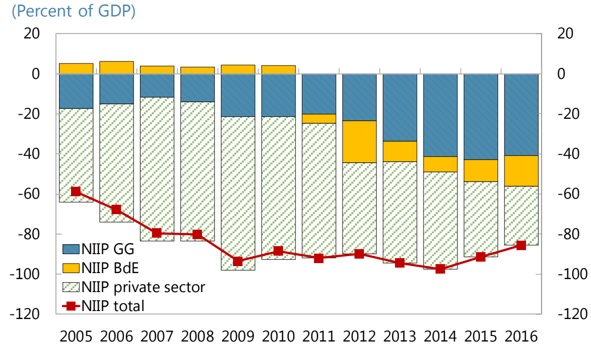
Total gross debt of the general government and the central bank held by non-residents stood at 85 percent of GDP at end-2016, with mitigating risk factors including a favorable maturity structure. Given external risks from a large and negative NIIP, the external position in 2016 was assessed to be weaker than consistent with medium-term fundamentals and desirable policy settings. Staff considers that the cyclically-adjusted current account is about 1 to 3 percent of GDP weaker than implied by fundamentals and desirable policies, and that the REER is about 5–10 percent overvalued (Appendix II).

Decomposition of Changes in Net International Investment Position-to-GDP Ratio (Percent of GDP)



Sources: Bank of Spain and IMF staff calculations.

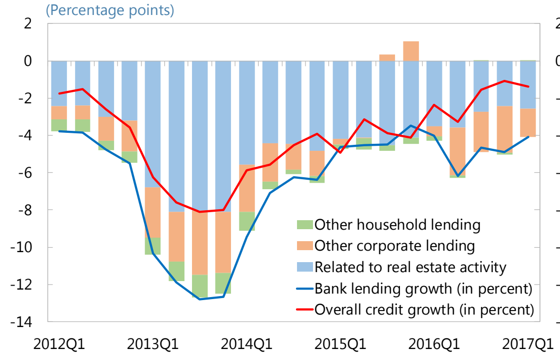
Net International Investment Position by Institutional Sector (Percent of GDP)



Source: Bank of Spain.
Note: GG = General government, BdE = Bank of Spain.

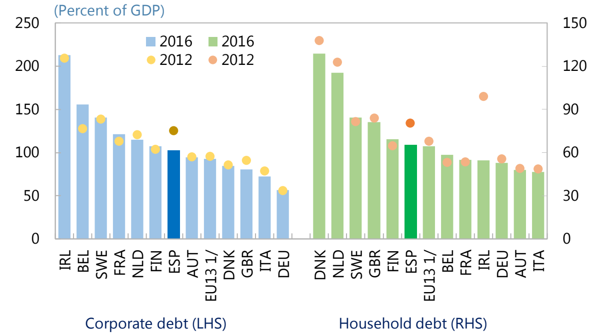
9. Financing conditions remain favorable, but bank lending has continued to contract. Despite low lending rates and somewhat more relaxed lending standards, bank credit growth stayed negative but the contraction has slowed. This reflects still weak credit demand, as corporates and households have continued to deleverage (Figures 4–6). Improved profit margins have enabled firms to finance new investment with retained earnings, while large corporations have shifted to more non-bank financing. Demand for home purchases has only recently started to pick up, from a very low base. While the total private sector debt-to-GDP ratio fell by 8 percentage points in 2016, certain segments of corporates (construction and real estate services) and households (low-income, jobless and self-employed) remain overly leveraged, and additional debt reduction is expected for them. The ongoing deleveraging does not appear to impede strong consumption and investment as the financing need of corporates and households is still limited (Chapter 2, Selected Issues Papers).

Contribution to Bank Lending Growth, 2012-17 (Percentage points)



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

Corporate and Household Debt, 2012-16 (Percent of GDP)

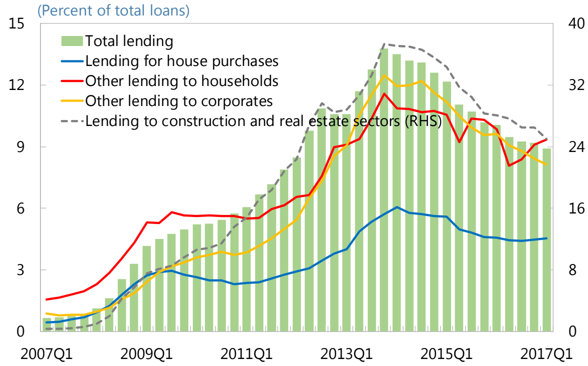


Sources: Haver Analytics; and IMF staff calculations.
1/ EU13 includes advanced European S29 economies.

10. The banking system has further gained strength amid persistent, multiple challenges. Asset quality has improved, with nonperforming loans (NPLs) for business in Spain falling to 8.9 percent of total loans at end-March 2017, 1.2 percentage points lower than a year ago; NPLs stood at 5.6 percent on a consolidated basis at end-2016. However, NPLs remain especially high for lending to SMEs and to the construction and real estate sectors, and foreclosed assets have not declined given the roughly equal pace of foreclosures and sales. Profitability, though higher than in the euro area, declined slightly in 2016:Q4, largely due to high provisioning costs of a large bank. Capitalization has remained broadly stable, as banks used retained earnings to maintain capital buffers during the transitional arrangement of Basel III implementation. Though generally less leveraged, Spanish banks have lower fully-loaded common equity tier-1 (CET1) capital ratios than European peers (Figure 7). With the ECB's extraordinary support, banks tend to have ample liquidity. However, Banco Popular, which lagged other banks in balance sheet adjustment and suffered large losses in 2016, encountered substantial deposit outflows and liquidity shortages. It was resolved in early June through a purchase by Spain's largest bank (Box 3), in a step that helped strengthen the banking system and safeguard financial stability. There was no contagion on banking system deposits, sovereign yields, or bank capital instruments, except for the share price drop of one medium-size bank, which was partially reversed following a short-selling ban. In general, domestic operating conditions have remained challenging amid low interest rates, weak credit demand, and still elevated legacy assets. For international Spanish banks, performance of their overseas subsidiaries has continued to be relatively strong despite growing uncertainties in some key host countries.

Nonperforming Loans in Spain, 2007-17

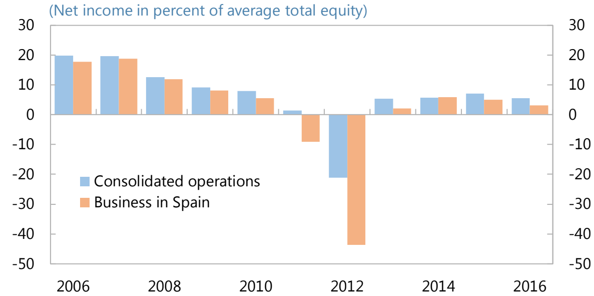
(Percent of total loans)



Sources: Bank of Spain; and IMF staff calculations.

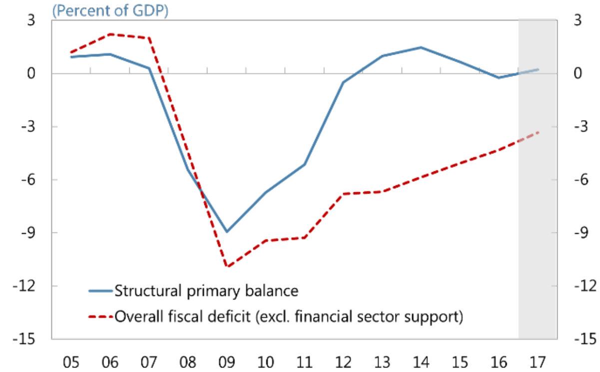
Profitability of Spanish Banks, 2006-16 1/

(Net income in percent of average total equity)



Sources: Bank of Spain; IMF, FSI database; and IMF staff calculations.
1/ For Banking business in Spain, the aggregate figure of net income in 2011 and 2012 is amplified by the segregation process of saving banks' business to newly-created banks. See BdE's *Statistical Bulletin* (2012) for more details.

11. The narrowing of Spain's headline budget deficit masks a relaxation of the fiscal stance in 2015 and 2016, which is set to partially reverse in 2017. A sharp reduction in the interest bill and the cyclical upturn that began in 2014 have reduced the overall deficit by 2.5 percentage points of GDP since 2013. However, stripping out these components reveals that fiscal policy has been expansionary the last two years. The primary structural balance went from a surplus of 1.5 percent of GDP in 2014 to a deficit of 0.3 percent in 2016. The 2017 budget reverses this recent trend.



Sources: Ministry of Finance, and IMF staff estimates.

- In 2016, the headline deficit reached 4.5 percent of GDP, marginally lower than the revised excessive deficit procedure (EDP) target of 4.6 percent of GDP, but 0.9 percentage point wider than initially budgeted. Revenues underperformed in part due to lower-than-expected VAT and social security revenue. Higher-than-projected social transfers and unanticipated support for the financial sector pushed expenditure 0.6 percentage points above budget. The higher deficit of the social security system and central government were partly compensated by surpluses at the municipal level. At the same time, regional governments' compliance with their ambitious deficit target improved significantly compared to 2015, following the central government's first time application of corrective measures (Figure 8). Public sector debt fell marginally to 99.4 percent of GDP.

- The 2017 budget, adopted in June, aims to reduce the deficit to the EDP target of 3.1 percent of GDP, including through revenue measures of about ½ percent of GDP.

Authorities' Views

12. The authorities emphasized solid growth and strong job creation. They see reform-induced competitiveness gains combined with private debt reduction and the financial sector cleanup as determinants in enabling a structural shift towards more balanced growth. While largely concurring with staff analysis, they stressed that the absorption of low-skilled labor from the construction sector in new predominantly low productive sectors is part of a transition towards a new equilibrium and will not necessarily weigh on productivity in the long run. The authorities also emphasized the positive contribution of the external sector to the recovery due to the dynamism of exports. The external sector improvement has been reflected in the current account balance, which has registered sustained surpluses compatible with strong growth over the last years. Maintaining current account surpluses in the medium term will continue to gradually improve the debtor NIIP, a source of vulnerability that is mitigated by the composition of external liabilities.

OUTLOOK AND RISKS

13. The growth momentum is expected to carry on in the near term, but slow over the medium term. The economy is projected to expand by around 3.1 and 2.5 percent in 2017 and 2018, respectively, with the output gap closing in 2018 (Table 1). As some external tailwinds and fiscal policy support dissipate, private consumption and investment are expected to soften gradually. Consumption growth will likely also be dampened by continued household deleveraging with a view to strengthening their still depressed overall net wealth position. Investment growth is expected to remain healthy over the medium term, though slower than in 2016, as financial conditions are set to tighten. The contribution of net exports is set to remain positive, as exports continue to benefit from the gradual pickup in euro area activity and the competitiveness gains. The current account surplus is projected to stabilize around 2 percent of GDP over the medium term, allowing for a gradual reduction of the NIIP. IMF staff estimates potential growth at around 1¾ percent over the medium term, constrained by weak productivity growth, unfavorable labor force demographics, and high structural unemployment (Figure 9). The slight upward revision in medium-term potential growth, compared with last year's estimate, is mainly driven by a higher capital accumulation reflecting the continued strong export performance and somewhat improved productivity owing to a better resource allocation (Box 1). In addition, it seems that the labor market efficiency has improved, which appears to have brought down structural unemployment a bit. However, there is a considerable degree of uncertainty surrounding the estimates of potential output, including the permanent impact of past reforms (Box 1, IMF Country Report No. 17/23). Inflation is picking up strongly this year to 2.0 percent due to base effects from higher fuel prices and electricity tariff adjustments, but it should moderate to 1.4 percent in 2018 in the absence of second-round effects.

14. Risks to the outlook are on the upside in the near term but tilted to the downside over the medium term (Appendix III). Externally, rising protectionism and uncertainties emanating from Brexit negotiations and US policies could weigh on the outlook. While Spain has strong trade and banking linkages with the United Kingdom (Figure 10), the impact from the Brexit decision has so far been mostly limited to somewhat weaker trade flows of goods with the United Kingdom than with other European countries following the recent depreciation of the pound. Weakening macroeconomic conditions in emerging economies would mostly weigh on the profitability of Spain's global banks and the contribution to group-wide capital (see FSSA and Box 3, IMF Country Report No. 17/23). When monetary accommodation is reduced in the euro area, investors could question the ability of high-debt countries to cope with higher borrowing costs, which could renew sovereign and financial sector stress. Furthermore, legacy assets in the euro area banking sector, including in Spain, and a structurally-weak profitability outlook, continue to pose risks of financial distress and medium-term credit supply constraints. Domestically, a reversal of earlier reform achievements could cloud the longer-term growth outlook, delays in fiscal consolidation would limit the room for maneuver in case of future shocks, and regional independence movements could add uncertainty. On the upside, the momentum created by past reforms may be bigger than estimated and a stronger-than-anticipated global recovery and pro-EU election outcomes could contribute to a more resilient euro area (2017 Staff Report for the euro area).

Authorities' Views

15. The authorities broadly agreed with staff on the economic outlook and balance of risks. The government's, Bank of Spain's and staff's growth projections are closely aligned. The authorities also see the pace of job creation continuing in the medium term without necessarily putting pressure on wages. While the authorities' model estimates for potential growth in the medium run are slightly below staff's, they stressed upside risks given the considerable uncertainty about the estimates of the NAIRU in the medium term.

POLICY AGENDA

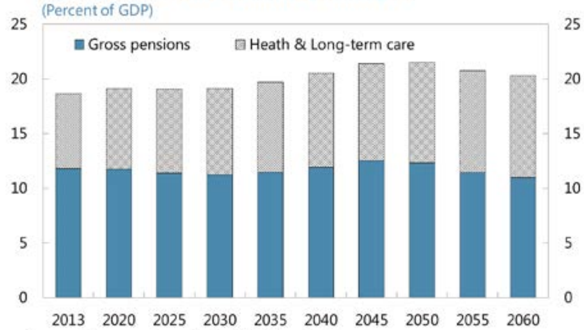
16. The success of past reforms demonstrates the potential payback from addressing remaining policy challenges. Financial sector, labor market, and early fiscal reforms have underpinned Spain's recent economic success. Further reforms could yield similar returns over the short and medium terms. First and foremost, full implementation of past reforms is critical. Second, gradual fiscal tightening, a more deliberate and focused effort to reduce structural unemployment, steps to improve the business environment, and further actions to make the financial sector more resilient are high-priority measures to reduce vulnerabilities and raise potential growth.

A. Fiscal Policy: Rebuilding Buffers

17. Spain's fiscal space is limited. Spain's public debt, at almost 100 percent of GDP, is nearly three times higher than on the eve of the global financial crisis and its annual gross financing need, relative to GDP, is the highest in the European Union (Figure 8). These levels leave little room for counter-cyclical fiscal policy responses to shocks. In addition, Spain's population dynamics imply significant pressure on age-related spending over the medium to long term. Moreover, fiscal support to the financial system, as a legacy of the banking crisis, is not yet complete with another 0.1 percent of GDP budgeted in 2017 (bringing the cumulative support to 5 percent of GDP). The FSAP has also laid out risks of contingent liabilities going forward, including from the asset management company Sareb, and highlighted the remaining sovereign-bank nexus, including from co-movement of bank and sovereign funding costs. These considerations argue for further fiscal consolidation to rebuild buffers.

Public Pension and Health Spending 1/

(Percent of GDP)

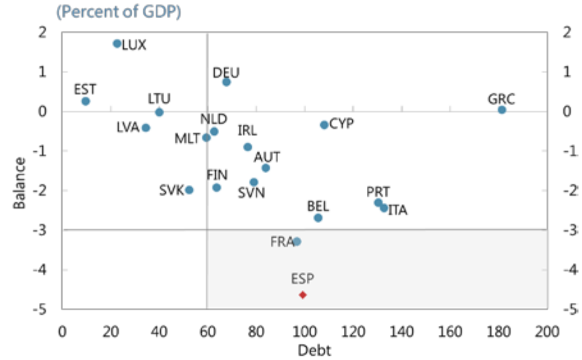


Source: European Commission 2015 Ageing Report.

1/ Projection assumes that the 2011 and 2013 reforms will be fully implemented.

General Government Balance and Debt, 2016

(Percent of GDP)



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

18. Structural measures underpin a return to a fiscal consolidation path in 2017. Corporate tax measures are projected to yield about 0.4 percent of GDP in additional revenue in 2017. In addition, the authorities estimate that measures to improve VAT administration and compliance have yielded around €600 million more in value added taxes in the first five months of 2017 compared to 2016. Nominal expenditure growth is anticipated to be kept in check at 2.3 percent, largely due to a fall in social benefit outlays as the economy and employment continue to grow. The budget also provides for around 0.1 percent of GDP in spending to cover guarantees issued for public-private partnerships. Under these policies, staff projects a headline deficit of 3.2 percent of GDP, including 0.1 percent of GDP in support to the financial sector, very close to the EDP target.

Fiscal Effort in 2017

(Percent of GDP)

Corporate direct taxes	0.40
Limits to negative tax base	0.19
Reverse equity loss provision	0.17
Remove dividend exemption	0.04

Source: Spanish authorities.

19. However, the planned medium-term deficit reduction is largely cyclical. For 2018, staff projects the headline deficit to comfortably drop below the 3 percent of GDP threshold needed to exiting the EDP. The approved expenditure ceiling for 2018, if implemented at all government levels, will contribute to lowering the deficit. But with the announced reduction in personal income taxes in 2018 for those in lower income brackets and families facing hardships (0.2 percent of GDP), a welcome measure targeted at reducing inequality, staff projects the deficit to reach 2.5 percent of GDP, higher than the deficit target of 2.2 percent, unless offsetting efforts are made. In the medium term, the authorities plan to lower the headline deficit to 0.5 percent of GDP by 2020, relying on continued expenditure restraint (i.e., letting expenditure grow less than nominal GDP) as well as on 0.2 percent of GDP unspecified fiscal effort. Absent the formulation of concrete measures, IMF staff projects the structural deficit to remain at around 2½ percent over the medium term, well above the medium-term objective of structural balance by 2020 under European and national rules.

Table. Fiscal Balance

(Percent of GDP unless otherwise noted)

		Projections			
	2016	2017	2018	2019	2020
Net lending (+) or net borrowing (-)					
IMF 1/	-4.5	-3.2	-2.5	-2.1	-2.0
Authorities 1/	-4.5	-3.1	-2.2	-1.3	-0.5
EC 2/	-4.5	-3.2	-2.6	...	...
Structural balance					
IMF	-3.1	-2.6	-2.5	-2.5	-2.5
Authorities	-2.5	-2.0	-2.0	-1.9	-1.6
EC (percent of potential GDP) 3/	-3.5	-3.4	-3.4	-2.7	-1.9
Primary structural balance					
IMF	-0.3	0.2	0.2	0.2	0.2
Authorities	0.3	0.8	0.7	0.8	1.0
EC (percent of potential GDP)	-0.7	-0.8	-0.9	...	...
Memorandum					
Output gap (percent of potential GDP)					
IMF	-2.3	-0.7	0.3	0.8	1.0
Authorities	-3.3	-1.5	-0.1	1.1	2.1
EC	-1.8	0.2	1.6	...	...

Sources: Spanish authorities; European Commission Council Recommmendation on the 2017 National Reform Programme of Spain and delivering a Council opinion on the 2017 Stability Programme of Spain; European Commission Spring 2017 Forecast; and IMF staff projections.

1/ IMF includes 0.18 percent of GDP and the authorities include 0.3 percent of GDP of contingent liabilities related to the financial sector and the motorways in 2017.

2/ Does not reflect expected materialization of contingent liabilities in 2017.

3/ Balance for 2019 is an extrapolation.

20. The economic cycle is supportive of fiscal consolidation over the next several years. In this environment, fiscal priming of the economy would be ill advised. Staff recommends maintaining the current pace of structural adjustment by identifying measures that would reduce the structural primary deficit annually by about 0.5 percent of GDP until structural balance is reached. This effort would send stakeholders a strong signal of Spain's commitment to meet agreed and legislated targets and, compared to the baseline, would translate into an additional 4–5 percentage points reduction of the public debt-to-GDP ratio to 88 percent of GDP by 2022, assuming a fiscal revenue multiplier of 0.6 (see Appendix IV).

21. Room for structural measures lies mostly on the revenue side. Expenditures are already projected to fall by 2.6 percentage points of GDP during 2017–20, leaving the size of Spain's government relatively modest compared to its EU peers. With medium-term adjustment needs of about 2½ percent to reach a structural balanced budget, structural revenue measures could contribute to reducing the deficit and debt. They could also expand the fiscal envelope, easing budget-neutral compositional shifts to priority spending areas such as active labor market policies and policies to support the most vulnerable. As detailed during the last Article IV consultation (IMF Country Report No. 17/23), there is ample scope to raise VAT collections, reduce tax system inefficiencies, and increase environmental taxes. These measures tend to be less distortive and have lower multipliers relative to other potential revenue raising steps. Reforms designed to increase expenditure efficiency would also help, especially to balance long-term spending pressures. A few examples of measures and estimated yields follow:

- ***Improve VAT collections*:** Spain had the largest VAT gap in the EU in 2014. Only 60 percent of the consumption basket is assessed at the standard VAT rate due mainly to exemptions and preferential tax rates, while the compliance gap is low. Gradually moving more items from the reduced to the standard VAT rate with a view to reducing Spain's VAT gap to the EU average gap of 44 percent could raise VAT collections by over 2 percent of GDP.

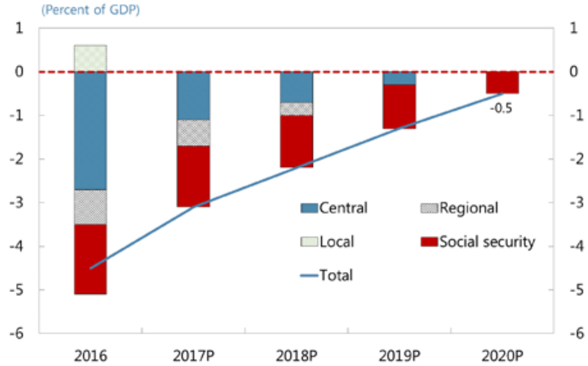
- ***Reduce tax system inefficiencies*:** Many deductions, exemptions, and fiscal incentives still litter Spain's tax system, despite the 2014 tax reform. Broadening the tax base by removing these distortions could yield ¼–½ percent of GDP in new revenue.

- ***Raise environmental taxes and levies:*** Harmonizing environmental taxes with those in other EU countries, particularly excises on unleaded petrol, could generate ¼–½ percent of GDP in additional revenue.

- ***Enhance expenditure efficiency:*** Planned expenditure reviews, including for pharmaceutical spending and hiring subsidies, could raise the quality and efficiency of service provision, and should be expanded to other areas, such as education spending.

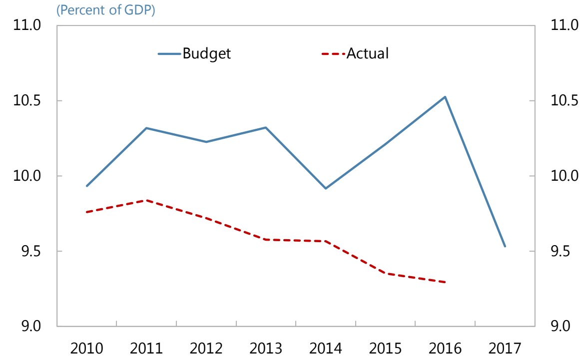
22. The deficit in the contributory pension's balance requires offsets elsewhere to meet the fiscal targets. To achieve their medium-term deficit target, the authorities anticipate a reduction of more than one percentage point of GDP in the social security budget deficit to 0.5 percent of GDP by 2020. This appears optimistic. For example, the authorities project social contributions to increase about 7 percent in 2017, despite a downward trend in the contributions-to-GDP ratio since 2011. However, local governments may record an aggregate surplus in 2017, as they did in 2016, which would provide a buffer for achieving the overall budget target if contributions underperform. This possibility highlights the importance of having institutional and financing arrangements that incentivize sub-national government fiscal discipline.

Authorities Fiscal Plan: General Government Deficit
(Percent of GDP)



Source: Spanish authorities; 2017 Stability Programme Update.

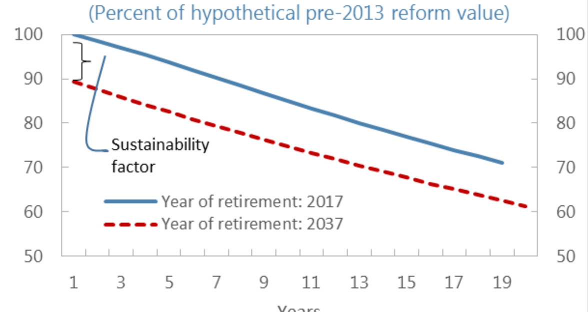
Social Security Contributions
(Percent of GDP)



Source: Spanish authorities.

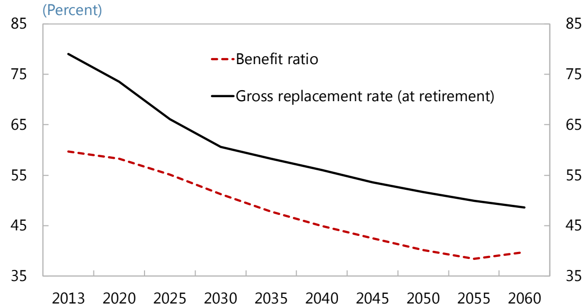
23. **More broadly, a tension between financial sustainability and social acceptability exists in the pension system.** The important pension reforms from 2011/13, if implemented as legislated, will ensure that pension outlays relative to GDP stay broadly stable over the long run. To do so, benefit indexation will need to remain at the legal floor of 0.25 percent per annum for several decades, under current demographic and macroeconomic projections. This implies a significant risk of a reduction in purchasing power for current and future pensioners, though the anticipated level of Spain's benefits in 2060 would remain above the EU average. To balance the opposing forces of pension system financial sustainability and generosity, a package of refinements could be developed to incentivize longer work lives and encourage supplementary savings, while keeping in mind intra- and inter-generational equity (Chapter 1, Selected Issues Papers).

Value of Pension Benefit During Retirement 1/
(Percent of hypothetical pre-2013 reform value)

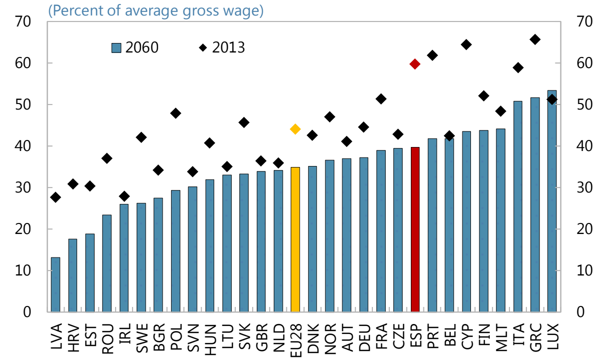


Sources: Spanish authorities; Banco de Espana; IMF staff calculations.
1/ Assumes a gradual rise in inflation to its long-run level of 2 percent p.a. by 2022 and an annual pension benefit increase of 0.25 percent.

- ***The significant pension reforms of 2011 and 2013 must be implemented in full.*** Key among these reforms was the introduction of a balancing mechanism (formally, the indexation of pension revaluation (IPR)) to ensure medium-term financial stability, linking pensions to life expectancy via the so-called sustainability factor (a discount applied to the first pension received by those that retire from 2019 onwards), gradually raising the statutory retirement age to 67, lengthening the accrual period for a full pension, and increasing the number of contributory years used to calculate the pension base. A permanent parliamentary committee on the pension system (Toledo Pact) is reviewing implementation of the reforms. One-off adjustments, for example to pension indexation, should be avoided.



Source: European Commission 2015 Ageing Report.
Note: Benefit ratio is the average pension benefit relative to the average economy-wide wage; Replacement ratio is the average initial pension relative to the average wage at retirement.



Source: European Commission 2015 Ageing Report.

- ***A package of refinements could balance pension sustainability and social acceptability.*** The package would entail tradeoffs with the aim of easing the reduction in pension benefits while maintaining financial viability of the pension system. For example, the contribution floor and ceilings could be raised faster than the maximum and minimum pensions. Other parametric refinements could include linking the statutory retirement age directly to life expectancy; further extending the length of the contributory period required to obtain a full pension; and lengthening the pensionable earnings reference period to the full contribution period. More transparency about the current and future health of the pension system is critical to support future pensioners' retirement planning, especially since public pensions are not meant to provide all of one's retirement income. One possible approach to encourage supplementary savings would be automatic enrollment, with an option to opt out, in a government-administered savings plan that is portable across jobs.

24. The regional financing framework is also in need of reform. In early 2017, the government created two committees of experts to promote the revision of the regional and local financing systems. The committees' reports were presented at the end of July. Reforms should aim at supporting the achievement of fiscal targets. As laid out in IMF Country Report No. 17/23, in the short term, priorities would be to enforce the existing fiscal framework, strengthen oversight institutions and procedures, reinforce conditionality, and step up monitoring under the regional liquidity mechanisms for non-compliant regions. The use of enforcement tools in 2016 that improved regional compliance with deficit targets was an important step. Over the medium term, the regions' revenue-raising capacity should be enhanced to better match the greater degree of expenditure decentralization.

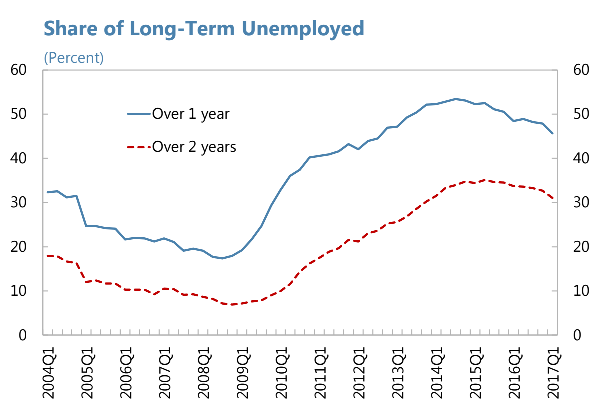
Authorities' Views

25. The authorities stressed that public debt reduction remains a top priority. They noted that a well-calibrated adjustment path is essential to ensure both fiscal sustainability and the continuation of solid economic growth and job creation. The authorities are also focused on exiting the excessive deficit procedure in 2018 and are aware of the tension within the pension system. They expect to meet the 2017 deficit target and noted that passage of the expenditure ceiling for 2018 also puts the 2018 target in reach. The authorities argued that keeping the growth in discretionary expenditure below the growth in nominal GDP was akin to undertaking structural measures. On pensions, the authorities plan to implement the 2011 and 2013 pension reforms. They also intend to scrutinize closely recommendations that the Toledo Pact committee may propose. On the issue of greater transparency, the authorities indicated that uncertainty surrounding population projections and assumptions underlying long-run macroeconomic projections complicate transparency about the future of the pension system and pension benefits.

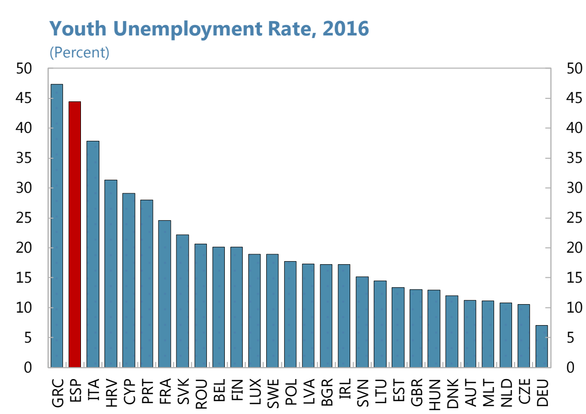
B. Labor Market: Toward Better Employability and More Flexibility

26. Despite recent strong job creation, Spain's labor market still has major weaknesses. Spain's unemployment rate remains among the highest in the European Union as 4.3 million Spaniards seek jobs. While exhibiting downward trends over the last year, the share of low-skilled youth and long-term unemployed in the unemployed population remains too high. Youth unemployment is still more than double the national average, those out of jobs more than a year account for almost half of the unemployed, and more than 60 percent of part-time employment is involuntary (Figure 3).

27. Fostering a dynamic and healthy labor market requires a holistic approach. Policies that keep the economy competitive and set working conditions in line with firm- and sector-specific conditions are critical to sustain labor demand. At the same time, well-designed and targeted active labor market polices (ALMPs) have a role to play in helping low-skilled youth and long-term unemployed return to work, particularly in the short run. To be the most effective, ALMPs should complement efforts to reduce labor market duality and improve the quality of formal education and training. Such a holistic approach towards creating a dynamic labor market would help Spain's youth remain competitive with those in other European countries in the acquisition of job skills. It would also reduce risks of poverty and social exclusion among vulnerable groups and inequality across generations.



Source: Haver Analytics.



Source: Eurostat.

28. ALMPs have limited participation rates in Spain and several policies are not targeted. Individualized support for the unemployed through ALMPs appears to be insufficient and imperfectly targeted. For example, less than 0.3 percent of the low-skilled long-term unemployed benefited from training programs offered by the Public Employment Services in 2015:Q1. These low penetration rates stand in stark contrast to the large number of ALMPs in place, hinting at efficiency problems. In addition, these policies are funded by a relatively low level of spending on ALMPs per person wanting work (Annex I). To ameliorate potential underfunding, the authorities increased spending on ALMP measures and labor market services significantly in 2015–16 and have budgeted another increase for 2017. While recent actions have also been taken to start tackling the severe capacity constraints of the Public Employment Services and relax the eligibility criteria for some activation programs, more could be done to ensure that ALMPs cost-effectively meet the needs of Spain's unemployed.

29. With broad-based political commitment, ALMPs can achieve better results. Most EU countries concentrate their expenditure on one or two specific ALMP measures (such as training or employment incentives). Given the scope of existing ALMPs and the decentralized delivery structure in Spain, the envisaged OECD peer review exercise would be an opportunity to help decide on optimal resource allocation and program selection based in part on approaches that have worked elsewhere in Europe. For example, one-stop shops that provide unemployment benefits, various forms of job search support (e.g., profiling, job search training, individualized counselling, and tailored job offers) and monitoring of job search efforts have been instrumental in the drastic improvement in the functioning of labor markets in countries such as Denmark and Germany. Other avenues to improve the cost-effective delivery of ALMPs would be much better-managed use of the EU's Youth Guarantee, refined collaboration with private job-placement agencies, and enhanced coordination between active and passive labor market policies. Strengthening the Public Employment Services' capacity to offer individualized support; better targeting job measures, particularly demand-driven skills training, to increase the employability of low-skilled and long-term unemployed; and conducting regular evaluations would likely improve the cost-effectiveness of existing ALMPs.

30. Further actions are needed to reduce long-standing labor market segmentation. While recent labor reforms have dampened labor market duality in some respects, the market remains segmented. The use of temporary contracts facilitates putting people back into jobs in the short run, but employers tend to invest less in these workers' human capital. So, those with temporary jobs tend to stay less productive and face great uncertainties. Spain has one of the highest shares of temporary employment in the EU, and many temporary contracts are of very short duration. As an extreme example of the latter point, the number of Spanish workers who sign more than 10 contracts a year surged from 150,000 in 2012 to 270,000 in 2016. In addition, transition rates from temporary to permanent contracts are very low relative to the EU average, though they have increased with the labor market reforms. These facts reflect the still significant gap between the cost to firms of permanent and temporary workers. As noted in IMF Country Report No. 17/23, there are several additional measures the authorities could take to improve the attractiveness of open-ended contracts for employers and to reduce administrative and legal obstacles that add to the cost of such contracts. Moreover, Spain could move forward on developing a comprehensive plan to fight labor market segmentation as agreed between the government and social partners in 2014.

Authorities' Views

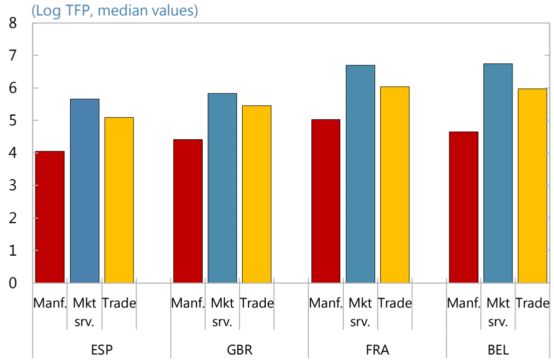
31. The authorities highlighted the fast pace of job creation on the back of labor market reforms, and broadly agreed with staff on the analysis of active labor market policies. Further reducing unemployment is a policy priority, and increasing the quality of the labor force is considered necessary for preparing for future digitalization and demographic challenges. Addressing labor market duality remains a goal which will require engaging social partners. The authorities agreed that more efforts are needed to boost the efficiency and impact of ALMPs. They recently approved a Royal Decree that develops the 2015 Law on Vocational Training System, introducing market-oriented "training vouchers." Committed to a better implementation of the Youth Guarantee, a new plan envisages an income aid for the youth working under apprenticeship and training contracts, and employment incentives for firms that turn those contracts into permanent ones. They agree that streamlining policies would be helpful, but this task requires coordinated efforts with the regions. To improve the efficiency of the Public Employment Services, deeper evaluations and profiling tools will be introduced in the future.

C. Structural Reforms: Raise Medium-Term Growth Prospects

32. Improving productivity is critical for boosting Spain's medium-term growth prospects and more rapidly reducing vulnerabilities. The exit of low-productivity firms has lifted total factor productivity (TFP) growth after the crisis. In addition, there is evidence that resources are flowing to more productive and financially healthier firms on the back of earlier banking sector reforms (Box 1). However, productivity levels in Spanish manufacturing, trade and market services sectors are considerably lower than in EU peers. This is explained in part by Spain's corporate structure, composed of low-productivity small and micro firms. The TFP gaps between small and large firms in the manufacturing sector are among the largest in Europe.

Total Factor Productivity of Selected Sectors

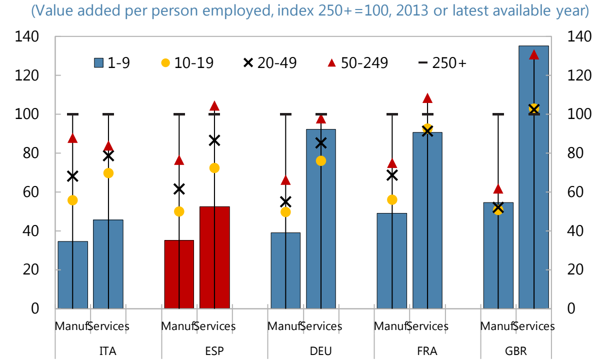
(Log TFP, median values)



Sources: ORBIS and IMF Staff Calculations.

Relative Labor Productivity by Enterprise Size

(Value added per person employed, index 250+=100, 2013 or latest available year)



Source: OECD.

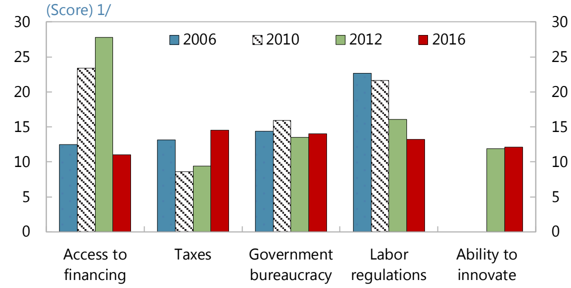
33. Progress with addressing the remaining impediments that hold back firm growth and productivity has been uneven. Policies that lower barriers to competition, foster firm growth and innovation, and facilitate access to equity financing for startups will be important to raise potential growth and competitiveness sustainably going forward.

- Implementation of the Market Unity Law, which establishes a single market in Spain by eliminating differential treatment of economic activity by the central, regional, and local authorities, has been slow. The recent decision by the Constitutional Court, which found one principle of the Market Unity Law to be in violation with the constitution, could delay its implementation but the court also laid out ways to address the principle. Further steps are needed to eliminate the remaining regulatory entry barriers and administrative burden from licensing requirements that are affecting competition and firm TFP growth particularly in sectors more exposed to regulation (SIP 2016, Chapter 2). Also, jumpstarting the delayed liberalization of professional services would level the playing field, increase transparency, and lower costs in many currently protected professions.

- Replacing the lower corporate income tax rate for small firms with targeted support for startups has addressed one important disincentive for firm growth. Tackling the remaining size-related rules and regulations, including on reporting, auditing, and labor regulation, could further stimulate firm growth and productivity.

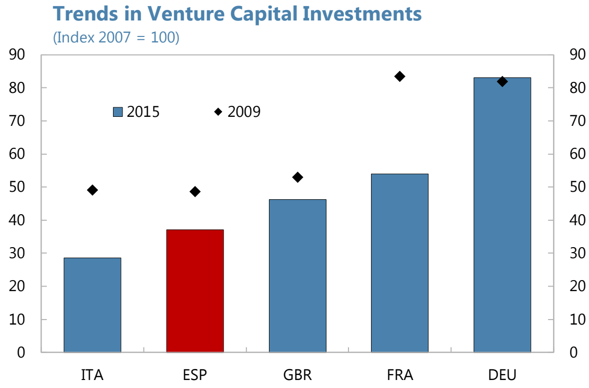
- In general, access to credit, including for SMEs, has improved, with interest rates for SMEs below those in Germany. But equity and credit financing for young and innovative start-ups is still limited. This places a premium on continued efforts to deepen market-based financing via alternative exchanges, venture capital, and securitization. The judicious use of guarantees and direct lending by the Instituto de Crédito Oficial (ICO) also remains relevant for riskier firms and projects.

Most Problematic Factors for Doing Business
(Score) 1/

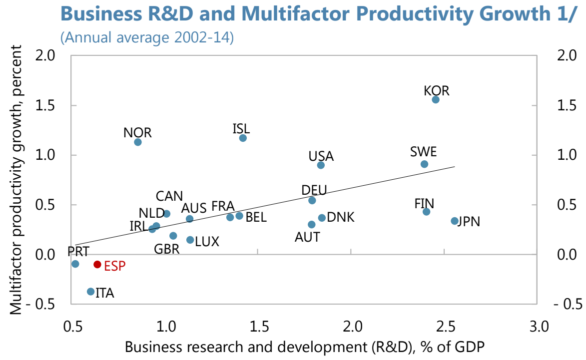


Source: Global Competitiveness Report, World Economic Forum.
1/ From the list of factors, respondents were asked to select the five most problematic factors for doing business in their country and rank them between 1 (most problematic) and 5. The score corresponds to the responses weighted according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

- Low private research and development (R&D) investment and the limited ability of firms to innovate remain largely unaddressed. Innovation capacity could be enhanced by increasing the efficiency of public R&D, improving public-private cooperation, and enhancing private R&D investment. These measures could facilitate the development of higher value-added industries and jobs.



Source: OECD.



Source: OECD.
1/ 2002-2011 for Australia and Iceland. 2003-2014 for Luxembourg and Sweden. 2002-2013 for the United States.

Authorities' Views

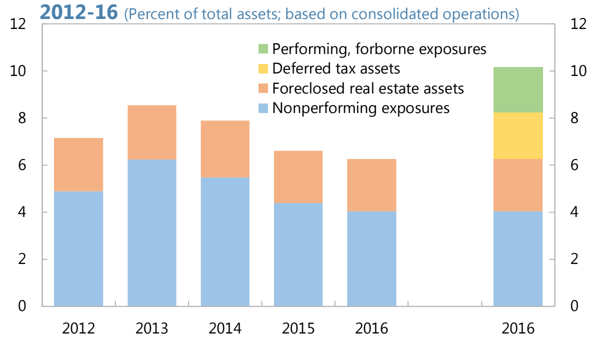
34. The authorities reaffirmed their commitment to maintain and deepen reforms. However, they are mindful of the time needed to generate consensus over these reforms considering the fragmented parliament. They identified more than 100 size-contingent regulations among fiscal, accounting, auditing and labor regulations. The government is developing a strategy to incentivize business growth that will include, among other measures, amendments of these regulations that might lead to disincentives for firms' growth. The authorities acknowledged that the decision by the Constitutional Court would slow somewhat the pace of the Market Unity Law implementation. However, they noted that it affects only about 20 percent of the cases dealt with in the framework of the mechanisms available to operators to claim against administrative rules and decisions contrary to the principles of the Law. In addition, they will attach higher priority to amending those regulations that cause frequent complaints from the private sector. In terms of R&D spending, the authorities noted that size-related regulations hamper the growth of innovative firms. Furthermore, reform of the education system is needed to enhance innovation.

D. Financial Sector: Complete Crisis Legacy Clean-Up and Reform Agenda

35. A more proactive approach is needed to deal with legacy issues and prepare for new challenges. The Financial Sector Assessment Program (FSAP) noted that Spanish banks are emerging from the crisis with stronger balance sheets, enabling them to perform credit intermediation despite lingering macrofinancial challenges. For the financial system to remain sound and resilient, and support economic growth, the FSAP highlighted three policy priorities—addressing banks' remaining weaknesses and legacy issues, preparing to handle headwinds, and strengthening and modernizing institutional arrangements. These policy actions would ensure that constraints on the credit supply do not emerge over the medium term, and the system is put in a stronger position to manage shocks (see the accompanying Financial System Stability Assessment (FSSA) report).

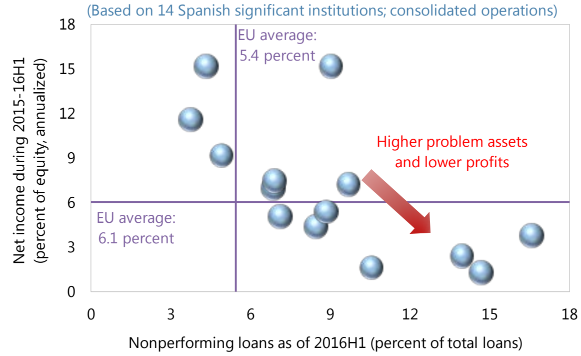
36. Lowering impaired assets, especially in banks that have lagged others in their adjustment process, deserves immediate attention. While the NPL reduction has generally proceeded well, non-performing and foreclosed assets remain relatively high in a few banks, weighing on their earnings. Efforts to accelerate balance sheet cleanup should build on the European Central Bank (ECB)'s guidance on reducing NPLs, the application of revised domestic accounting rules on provisions (Bank of Spain Circular 4/2016), and a careful analysis of banks' property value assumptions. Supervisory actions should be applied to incentivize progress. These efforts could also benefit from enhancing the insolvency framework and fostering the use of the out-of-court agreements on payments processes for small and medium-sized enterprises to support more efficient debt restructuring.

Nonperforming, Foreborne, and Non-earning Assets, 2012-16 (Percent of total assets; based on consolidated operations)



Sources: Banks' reports; Bank of Spain; ECB, Supervisory Banking Statistics; IMF, Financial Soundness Indicators database; and IMF staff calculations.

Asset Quality and Profitability, 2015-16H1
(Based on 14 Spanish significant institutions; consolidated operations)

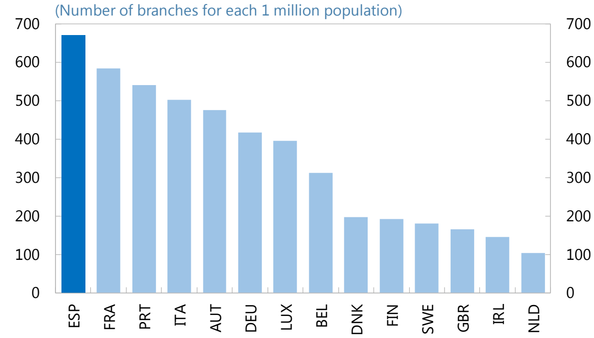


Sources: EBA, 2016 Transparency Exercise; SNL; and IMF staff calculations.

37. Timely privatization of state-owned banks, and managing the performance of the asset management company (Sareb), are also important. The process of the merger of the two state-owned banks, which started in July, should be concluded without delay, paving a way for divestment of public ownership by the deadline that was extended to end-2019. Sareb helped limit the fallout from the crisis but has realized losses since its inception. It may need to accelerate asset sales at a higher discount to generate sufficient cashflows, and Sareb's business plan, which appears to be based on unduly optimistic assumptions, should be regularly reviewed and adjusted, if needed, to ensure its consistency with the macrofinancial outlook and keep in check externalities to banks.

38. Banks need to continue improving profitability, building capital buffers, and adjusting funding positions. While constraints on the credit supply are not currently evident, strengthening banks' financial positions would ensure their lending capacity to accommodate credit demand as it picks up over the medium run and to increase resiliency to shocks.

Bank Branch Intensity, 2015
(Number of branches for each 1 million population)

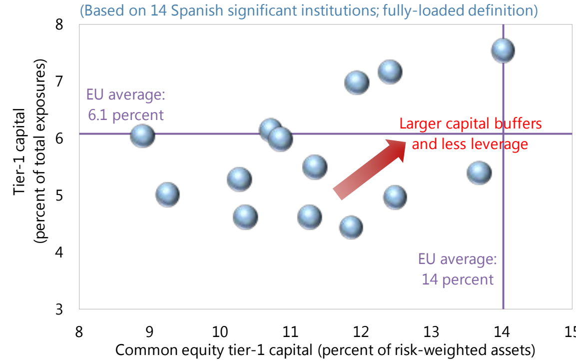


Sources: ECB, Banking Structural Financial Indicators database; IMF, World Economic Outlook database; and IMF staff calculations.

- **Address profitability pressures.** Although banks' profitability has improved, their return on equity is still lower than the cost of capital. The main drivers are common factors such as low interest rates in the euro area, as well as Spain-specific factors such as continued private sector deleveraging, still sizeable provisioning costs, and relatively high operating costs in relation to assets. To structurally improve banks' profitability, there is a merit to exploring the scope for further consolidation through mergers, rationalization of business lines and branch networks, and diversification of earnings away from interest income.

- **Raise more high-quality capital.** Spanish banks lag European peers in terms of fully-loaded CET1 capital and leverage ratios and should further increase capital to compensate for the phase-out of regulatory exemptions (Figure 7). Moreover, capital would support greater efforts in reducing impaired assets. And finally, more capital would provide buffers against unexpected shocks, including interest rate and sovereign shocks, given the system's relatively high sovereign exposure.

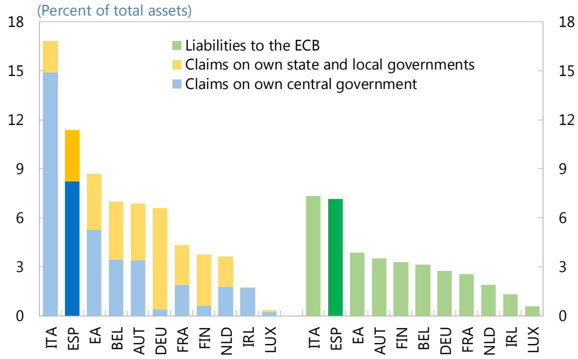
Capitalization and Leverage, 2016H1
(Based on 14 Spanish significant institutions; fully-loaded definition)



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

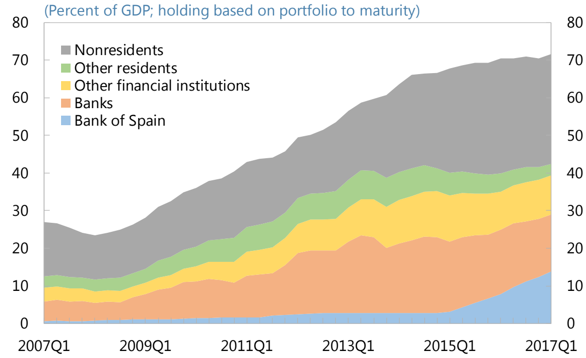
- **Prepare for the ECB's exit from accommodative policies.** Banks are enjoying ample liquidity and cheap funding thanks to the ECB's Targeted Longer-term Refinancing Operations (TLTROs) and asset purchase program. The FSAP stress tests suggested potential liquidity strains in the face of significant funding outflows and non-negligible trading losses and valuation effects from fixed-income portfolios, calling for enhanced monitoring and management of liquidity and interest rate risks. Funding challenges are set to rise over the medium term as the ECB's policy unwinding proceeds, potentially affecting both liquidity and profitability of banks. In addition, banks may need to adjust their liability structures to fulfill new regulatory requirements, such as Minimum Requirements for Own Funds and Eligible Liabilities (MREL).

Sovereign Exposures and Use of ECB Funding, 2017Q1
(Percent of total assets)



Sources: IMF, International Financial Statistics; and IMF staff calculations.

Holding of Government Bonds, 2007-17
(Percent of GDP; holding based on portfolio to maturity)



Sources: Haver Analytics; and IMF staff calculations.

39. **Prudential oversight and resolution could be enhanced to mitigate identified risks and weaknesses.** For banking supervision, the FSAP identified room to improve corporate governance of Spanish financial institutions. Building on the recent steps taken, a comprehensive reform of the credit cooperative sector is essential, particularly to strengthen corporate governance and improve resolvability. The latter is also important for smaller banks. The resolution process for systemically important banks is clearly established, but 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. For the insurance sector, additional efforts to improve matching of assets and liabilities are desirable. The FSAP also recommends further enhancing the Anti-Money Laundering/Combating the Financing of Terrorism regime (AML/CFT), including by providing additional resources to the AML/CFT supervisor (SEPLAC).

40. Systemic risk surveillance and the macroprudential toolkit should be enhanced. The significant international presence of Spanish banks, while providing welcome diversification, will likely increase cross-border spillovers. Intra-system connectedness is also gradually building with (i) linkages through conglomerate structures, cross-sectoral claims, and common exposures; (ii) non-traditional banking activities within banking groups; and (iii) the systemic role of the domestic public debt market. A legislatively established Systemic Risk Council, chaired by the Bank of Spain and comprising other financial oversight authorities and the Treasury, should help strengthen systemic risk oversight and enhance much needed inter-agency coordination. The Bank of Spain's role in safeguarding macrofinancial stability should be strengthened, including to lead systemic risk surveillance in support of the proposed Systemic Risk Council. Moreover, the legal basis should be established for the use of for more effective macroprudential tools, including possibly limits on loan-to-value and debt service-to-income given the continued importance of real estate exposures on banks' balance sheets.

41. The government plans to enhance the governance of certain parts of the institutional architecture. The envisaged and welcome reforms include a more transparent selection process for appointments to senior positions at the financial sector oversight authorities, the establishment of an independent insurance and pension supervisory agency, 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. The government also intends to introduce a single ombudsman scheme to centralize and strengthen consumer complaints handling related to financial products. The FSAP stressed that adequate resources and appropriate information sharing related to these institutional changes would be essential. The FSAP also recommended to further strengthen safety nets by improving the deposit insurance fund's payout system and setting up a guarantee scheme for insurance policyholders.

Authorities' Views

42. The authorities highlighted the significant turnaround of the financial sector after the ambitious restructuring and consolidation process over the last years. They stressed that this has led to a significant improvement in the financing conditions and continued improvement in the banking system since the last FSAP, including a good pace of NPL reduction. The authorities welcomed the recommendations of the 2017 FSAP and confirmed that they have already started to work on many of them. They also recognized remaining challenges, many shared by other European countries, such as low profitability. They explained their current focus on further pushing forward financial sector reforms, such as the strengthening of the regime for credit cooperatives, the draft bill on Mortgage Credit and other initiatives to improve the financial institutional framework, including the creation of an independent insurance and pension funds agency and a single financial

Alternative Dispute Resolution institution. Regarding the recent resolution of a domestically systemic bank, the authorities stressed that financial stability was preserved, with no negative impact on sovereign spreads and no contagion towards the rest of the financial system, while neither taxpayers nor depositors were exposed to any losses. The Spanish authorities also pointed out that recent experiences of resolution in Europe have shown the relevance of ensuring adequate access to liquidity for banks under restructuring and resolution.

STAFF APPRAISAL

43. **The Spanish economy has become more competitive, flexible and resilient but the growth momentum is set to slow without further reform.** A shift in resources toward the competitive export sector has played an important part in the rebound. The dynamic expansion is expected to continue over the next couple of years, with upside risks in the near term. But without further determined progress on structural reforms and rebuilding of fiscal buffers, the economy remains vulnerable to shocks and some segments of the population risk being left behind. Over the medium term, growth is projected to dip below 2 percent and unemployment to remain in double digits.

44. **The supportive economic environment makes this 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 negative shocks. In addition, population dynamics imply significant age-related spending pressure over the medium term. Any temptation to rely beyond 2017 on output growth alone to reduce headline deficit and debt ratios should therefore be resisted. Such an approach would leave a considerable gap in the structural balance (with a deficit of around 2½ percent of GDP) and risk that pro-cyclical adjustments would be needed when the economic cycle turns. All levels of government need to contribute to rebuilding fiscal buffers, which calls for implementing enforcement tools in the short run and enhancing the incentives and capacity for regional and other governments to build space over the medium term. Gradual fiscal consolidation would also help improve the external position, which is assessed to be weaker than consistent with fundamentals and desirable policies.

45. **Implementing fully the 2011 and 2013 pension reform package will ensure the system's financial sustainability.** But the implied reduction in the purchasing power of pensions does not seem to be widely understood. Thus, full transparency is critical, including about the need to complement income from public pensions with private savings. Should social acceptance be better matched with a smoother transition of pension benefits, the burden of required adjustments to the pension system should be spread across and within generations through a package of revenue and expenditure measures. One-off revisions, for example to pension indexation, should be avoided as they could set a precedent to resort to more one-offs in the future. This could ultimately put the financial sustainability of the pension system at risk.

46. **Employment creation and better job quality remain priorities.** 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 and tackle the long-standing issue of labor market duality. The large share of temporary contracts helped kick-start the recovery but is now weighing on productivity and wage growth. Moreover, problems with the efficiency and design of active labor market policies as well as capacity constraints of the Public Employment Services need to be addressed to better support the employability of the young and long-term unemployed. 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.

47. Raising productivity growth is critical for enhancing Spain's medium-term economic prospects and for faster reduction of vulnerabilities. Regional coordination will be critical but has proven to be difficult in the implementation of the Market Unity Law which aims at breaking down administrative barriers and fostering competition. Also, revisiting the many regulations that are linked to the size of firms would remove obstacles that have held them back from expanding. And finally, there is room for improvement in research and development spending to foster innovation.

48. A stronger financial system has emerged after the crisis, but the crisis legacy clean-up is still to be completed with a view to strengthening the system's resilience to new challenges. Solvency and profitability have improved for most banks, NPLs have come down, credit is more readily available, and adjustments to new regulatory requirements are progressing smoothly. Nevertheless, NPLs remain relatively high in a few banks, capital ratios lag those of European peers, and the system holds a relatively large share of long-duration sovereign debt. To address banks' remaining weaknesses and legacy issues, balance sheet cleanup should be accelerated, banks' property value assumptions should be carefully analyzed and supervisory actions applied to enhance progress. Moreover, banks need to continue improving profitability, building capital buffers, and adjusting funding positions. As regards the credit cooperative sector, stronger corporate governance and improved resolvability are critical.

49. Strengthening and modernizing financial sector institutional arrangements will raise preparedness to handle new risks. Establishing an interagency Systemic Risk Council would enhance systemic risk surveillance and macroprudential decision making. It would also help address the gradually rising intra-system connectedness of the financial system. Expanding the macroprudential toolkit would strengthen the Bank of Spain's ability to deal with future build-up of risks. While the current resolution arrangements for systemically important banks are working well, over time the fragmentation of resolution arrangements should be reviewed. Plans to enhance the governance of certain parts of the institutional architecture are welcome.

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

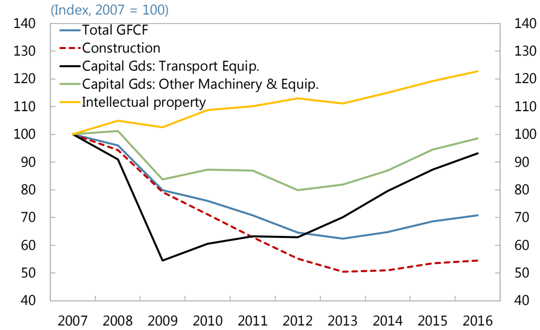
Box 1. Investment Recovery: Where is Investment Going to and How is it Financed?

The investment recovery has been broad-based across sectors. It is supported by credit flowing to financially healthier and more productive firms as well as corporate savings gains. Financially weaker firms have reduced their investment and continued to deleverage.

Investment is recovering and its composition has improved. Investment net of construction, including capital goods investment, has reached its pre-crisis levels. Firm level data shows that the share of firms that have expanded their investment has gone up across all sectors, firm sizes and firm ages. In 2015, about 40 percent of all firms (comprising more than half of aggregate value added) raised their investment. It was much lower among SMEs, however.

Gross Fixed Capital Formation

(Index, 2007 = 100)

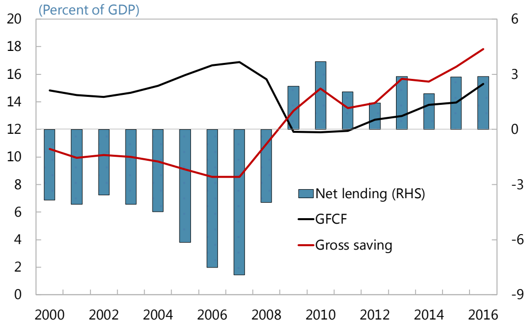


Sources: Haver Analytics, and IMF staff calculations.

Corporate savings have increased in post-crisis years. Following the credit boom, the corporate sector adjusted initially by sharp reductions in labor and investment, which led to a sizeable increase in its gross savings and a corresponding shift of the net lending position from a deficit to a surplus. Over time, lower interest costs also helped. Internal funding replaced parts of bank lending and was used to repay debt. At the same time, larger corporates have relied more on equity and bond issuance, which together with new bank loans, has financed the investment recovery.

Corporate Financing and Investment

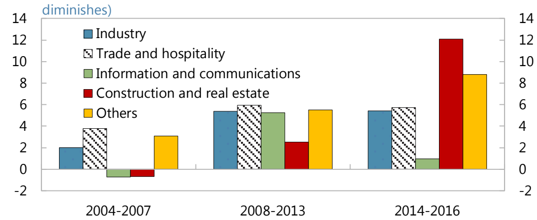
(Percent of GDP)



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

Average Difference of Total Factor Productivity 1/

(In t-1, between firms whose credit does not diminish and those whose credit diminishes)



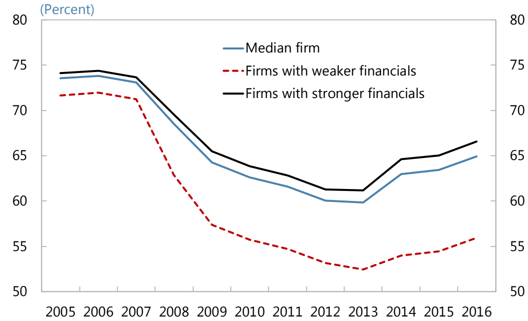
Source: Bank of Spain.

1/ Total factor productivity measures the relationship between the use of productive factors and the quantity of product obtained, and approximates the efficiency level of a given company. It is obtained from sector-level regressions of the logarithm of real gross value added on the logarithms of total capital, intermediate consumption and employment (temporary fixed effects are also included). Thus, an approximation of the weights of capital and employment in the production function is obtained, with which the total factor productivity at the firm level is calculated. The graph shows the difference of the sector averages, once normalized, taking as reference the value of the average productivity of companies whose credit decreases.

Credit reallocation towards more productive and financially sounder firms is supporting the investment recovery. Using firm-level data for loan applications from the Central Credit Registry, a Bank of Spain study (Annual Report, 2017) finds that the probability to obtain a loan is about 10 percentage points higher for financially stronger than weaker firms, proxied by the firm indebtedness, interest burden, and lagged non-performing loans. This sensitivity has increased significantly since the crisis, suggesting that banks have discriminated more between firms based on their financial situation after the crisis and related banking sector reforms, including at the EU level. At the same time, the difference in TFP between firms whose credit does not diminish and those for which it declines, suggesting improved allocation of credit likely explaining part of the gains in aggregate TFP since the crisis.

Probability of Obtaining a Loan from Any Bank

(Percent)



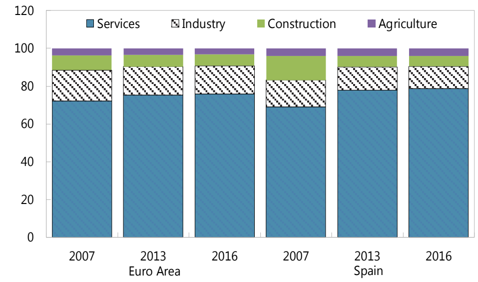
Source: Bank of Spain.

Box 2. A Closer Look at Employment Creation During the Recovery

Spain has recovered more than a third of the almost 4 million jobs lost during the crisis.[1] Services account for the majority of the employment creation, reflecting the structural shift of the economy between two lower-skill segments. Employment creation in higher-skill segments has also picked up, but from a low basis. Regional differences remain stark.

The service sector has been the motor of Spain's job recovery. This largely reflects the changed sectoral composition of Spanish employment since the crisis: compared to 69 percent in 2007, 79 percent of Spaniards held service-sector jobs in 2016. About one quarter of the new jobs are in economic activities benefitting from tourism (according to INE/Turespaña statistics). Whereas before the crisis, a comparatively large share of workers was employed in the construction sector (13 percent), Spain's sectoral distribution of labor is now close to the euro area average.

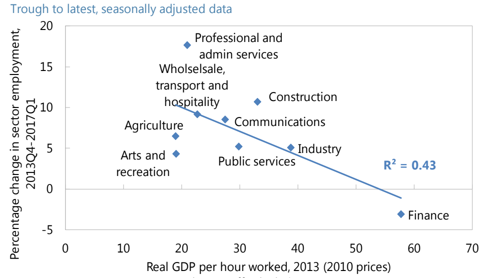
Employment by Sector in the Euro Area and Spain
Relative employment shares by sector, total=100



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

Most jobs have been created in the lower-skill segment. In absolute terms, employment creation has been strongest in the areas of wholesale, accommodation and food services, education and health, and professional and administrative services, which have labor productivity below the economy-wide average. While some high-productivity sectors like information and communications experienced high job growth, they account for a small share of employment. The recent recovery of manufacturing jobs reflects Spain's increased competitiveness and export market performance.

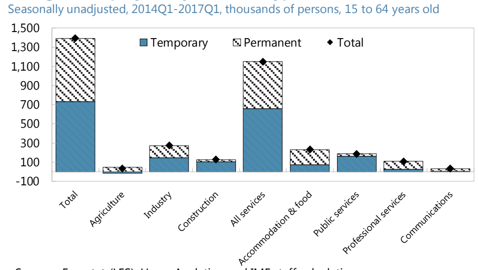
Labor Productivity and Employment Growth
Trough to latest, seasonally adjusted data



Sources: EU KLEMS, Eurostat, and IMF staff calculations.
Note: Excludes real estate, which is an extreme outlier with high labor productivity.

Temporary contracts have accounted for a bit more than half of the new jobs. In particular, new hires in construction and services have been more likely to be employed on a temporary basis. However, high employment growth sub-sectors such as professional and technical service activities, accommodation and food services (a tourism-related activity) and information and communications seem to extend more permanent contracts, especially of late.

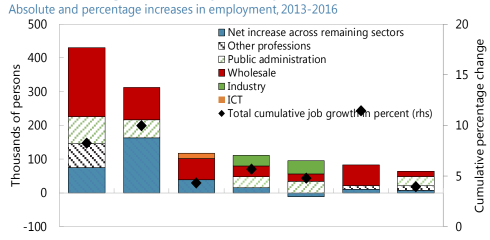
Change in Employees by Contract Type[1]
Seasonally unadjusted, 2014Q1-2017Q1, thousands of persons, 15 to 64 years old



Sources: Eurostat (LFS), Haver Analytics, and IMF staff calculations.
1/ Excludes the self-employed, who account for around 13 percent of total employment.

Some regions have outperformed others in employment creation. Whereas employment in the Canary Islands and the South has increased by around 10 percent, it has picked up by around 4 percent in the Northwest and Madrid. In absolute terms, job creation has been strongest in the East. In part, these differences in the pace of the employment recovery are explained by very different starting levels. Unemployment rates vary markedly, from around 13 percent in the Northeast to almost 28 percent in the South, reflecting limited regional labor mobility. While wholesale and other trade business has been the main job creator in the larger regions, Madrid and the Canary Islands, much of the employment recovery in Northern Spain is owed to increases in public employment. Employment gains in information and communications have been concentrated in the capital.

Increase in Regional Employment by Sectors
Absolute and percentage increases in employment, 2013-2016



Sources: Eurostat, Haver Analytics, and IMF staff calculations.
Note: Regions defined according to EU NUTS2 definition. Northwest (Galicia, Asturias, Cantabria), Northeast (Basque Country, Navarra, La Rioja, Aragon), Center (Castile and Leon, Castile-La Mancha, Extremadura), East (Catalonia, Valencia, Balearic Islands), South (Andalusia, Murcia, Ceuta, Melilla).

1/ Change in employment between 2014:Q1 and 2017:Q1, based on seasonally unadjusted national accounts data.

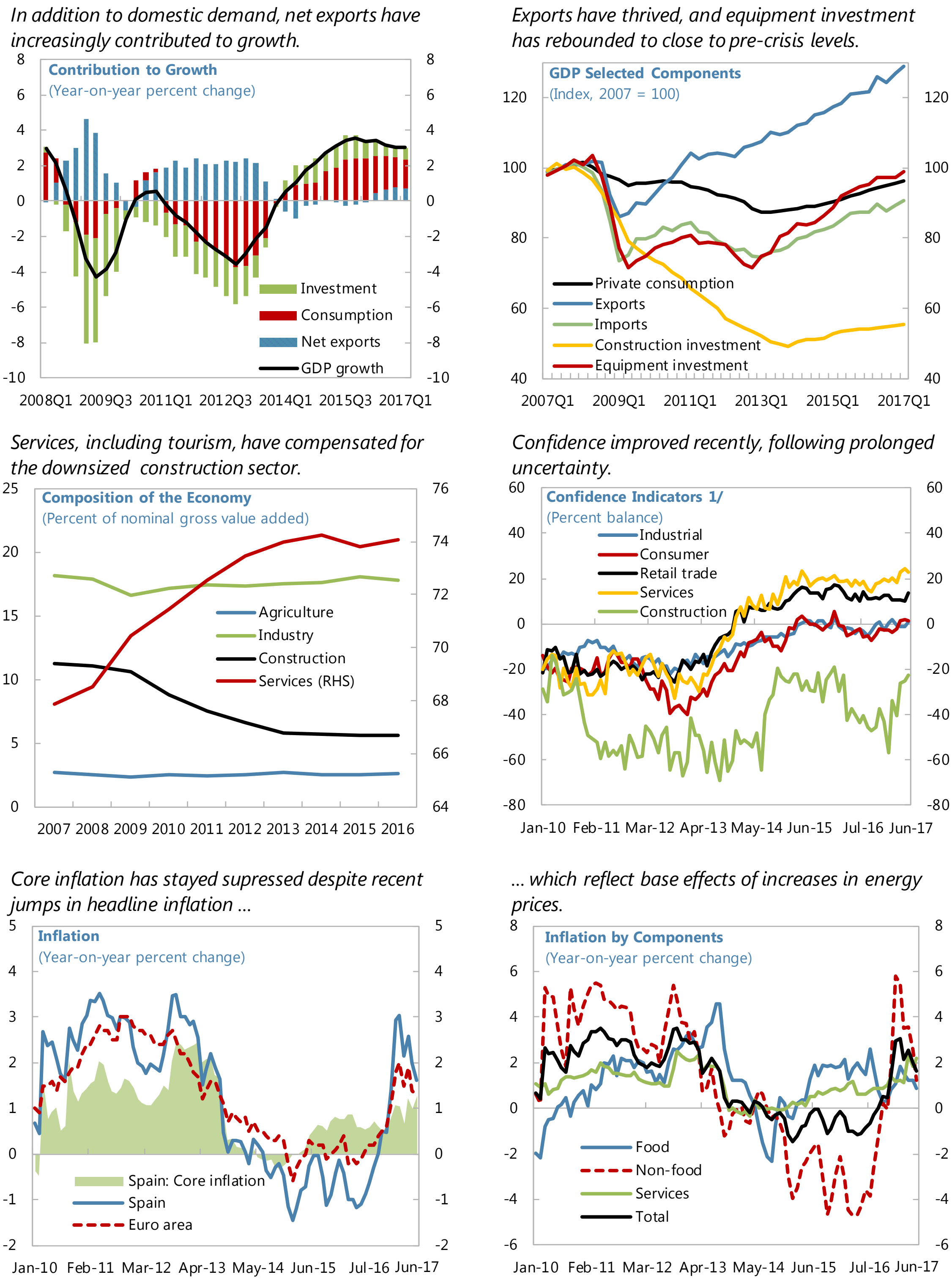
Box 3. The Resolution of Banco Popular

Spain's sixth largest bank, Banco Popular, was resolved in June via sale of business. The swift and well-coordinated resolution helped safeguard financial stability and did not involve public funds.

Banco Popular had lagged other banks in its balance sheet adjustment and came under market pressure following a series of bad news that led to the bank's illiquidity. Banco Popular met all regulatory capital requirements until recently but had sizeable problem assets and was among the weaker banks in the 2016 EBA stress test. In February, the bank announced a €3.5 billion loss for 2016 largely owing to the increase in provisions to accelerate the cleanup of legacy assets. In April, an internal audit uncovered additional provisioning needs of €600 million, and a plan was announced to sell noncore businesses and raise capital. In May, the bank reported another loss of nearly €150 million for 2017:Q1, and put itself up for sale, with a deadline of June 10. Market pressures intensified on June 1, prompted by media reports that Banco Popular might need to be resolved. Deposit outflows accelerated, and the Eurosystem approved substantial emergency liquidity assistance on June 2. Two working days later, on a Tuesday, Banco Popular could not provide sufficient eligible collateral to obtain further emergency liquidity assistance. Given its incapacity to meet its payment obligations on the next business day, the ECB thus determined that Banco Popular was failing or likely to fail on liquidity grounds.

On June 7, the SRB announced that Banco Popular would be resolved under the Bank Recovery and Resolution Directive via sale of business to Banco Santander. All existing shares (Common Equity Tier 1), and the Additional Tier 1 instruments (€1.2 billion) of Banco Popular were written down, while Tier 2 instruments (€700 million) were converted into new shares, which were transferred to Santander for the price of €1. Banco Santander also announced that it would make additional provisions for assets acquired from Banco Popular, supported by its effort to raise €7 billion in fresh capital. Following the purchase, Banco Santander will consolidate its market position in Spain and Portugal; it will also become the leading bank in the Spanish SME market, with a 25 percent share.

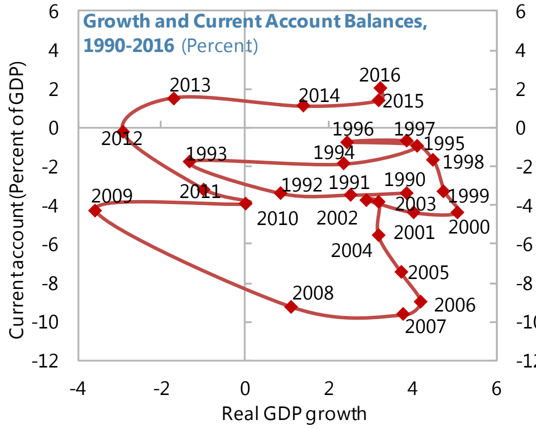
Figure 1. Spain: Real Sector and Inflation



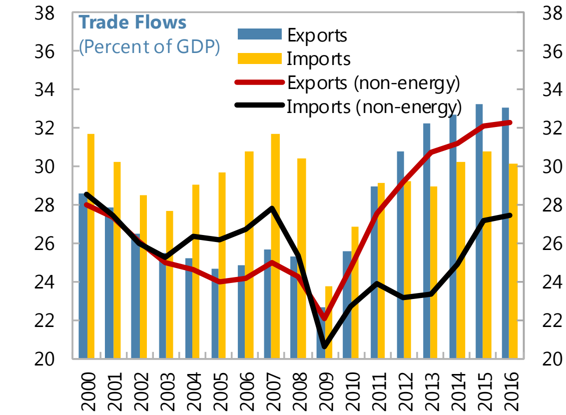
Sources: Bank of Spain; Eurostat; Haver Analytics; and IMF staff calculations.
1/ Confidence indicators: Percent balance equals percent of respondents reporting an increase minus the percent of respondents reporting a decrease.

Figure 2. Spain: External Sector

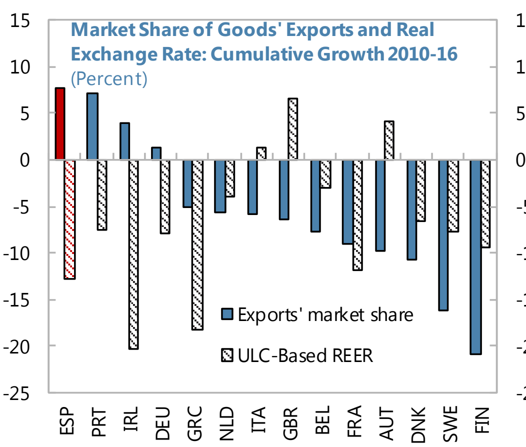
The current account strengthened in 2016, recording a surplus for the fourth consecutive year…



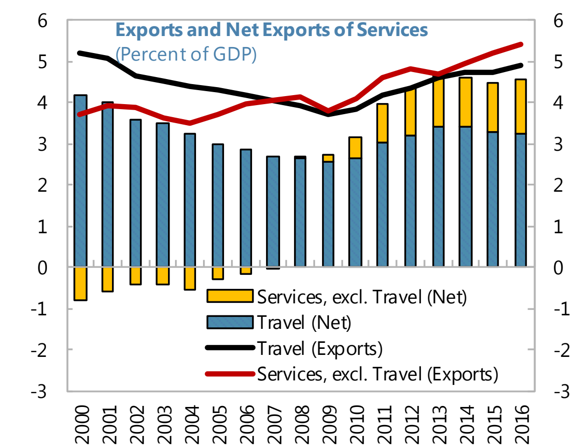
…helped by the declining energy trade deficit, due to low oil prices, and a strong export performance.



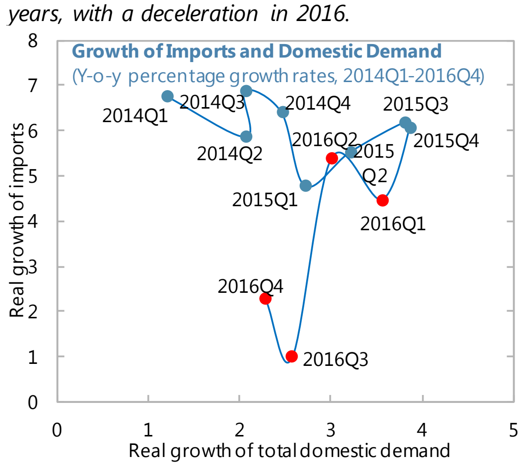
Wage moderation fostered competitiveness and Spain's world export share has increased.



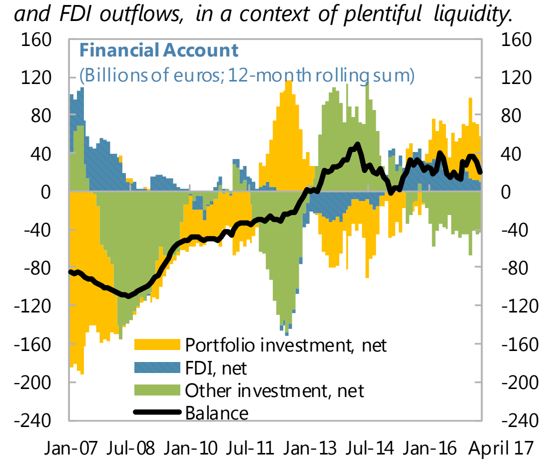
Receipts from services are rising, and net exports of non-travel services are now above 1 percent of GDP.



Real imports have recovered over the past three years, with a deceleration in 2016.



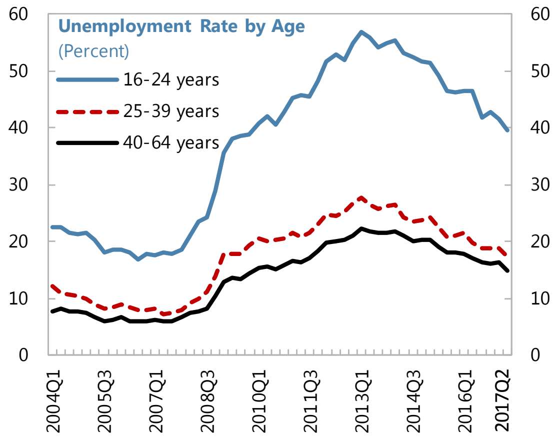
The financial account recently recorded portfolio and FDI outflows, in a context of plentiful liquidity.



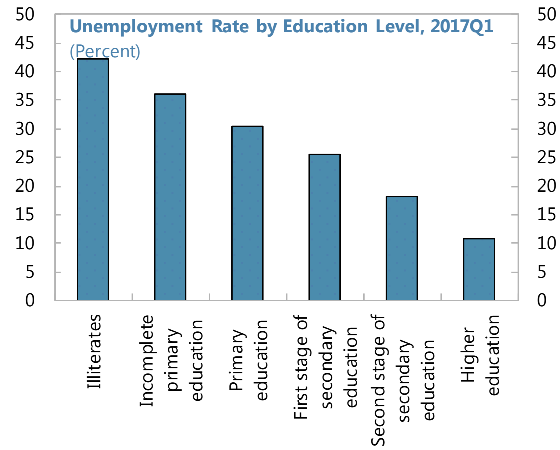
Sources: Bank of Spain; Eurostat; Haver Analytics; WEO; and IMF staff calculations.

Figure 3. Spain: Labor Market Developments

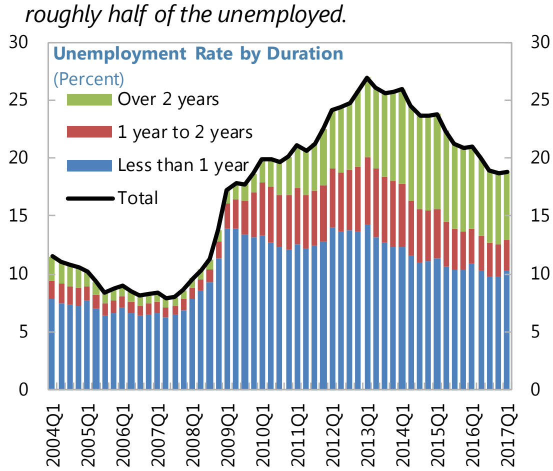
Unemployment has declined for all age groups, but remains higher than before the crisis…



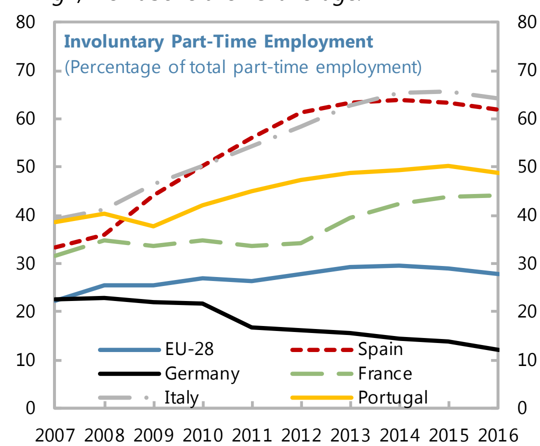
…disproportionately affecting low-skilled workers.



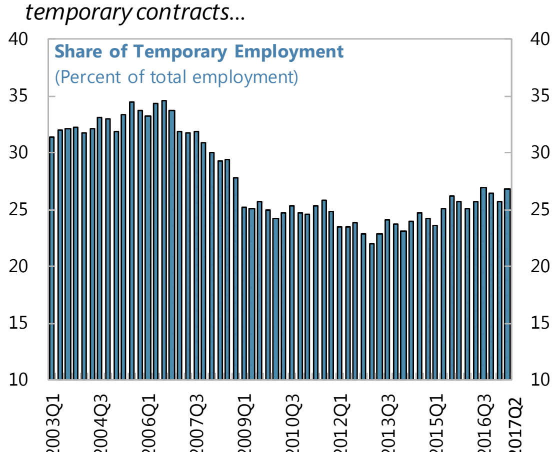
Those out of jobs more than a year account for roughly half of the unemployed.



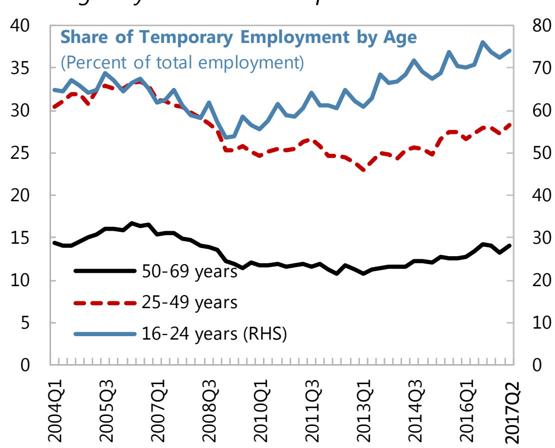
Involuntary part-time employment remains high, well above the EU average.



More than a quarter of workers are under temporary contracts…



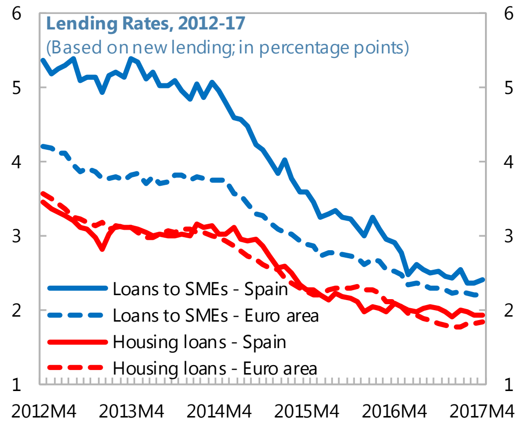
… and the share of temporary employment among the youth is above its pre-crisis level.



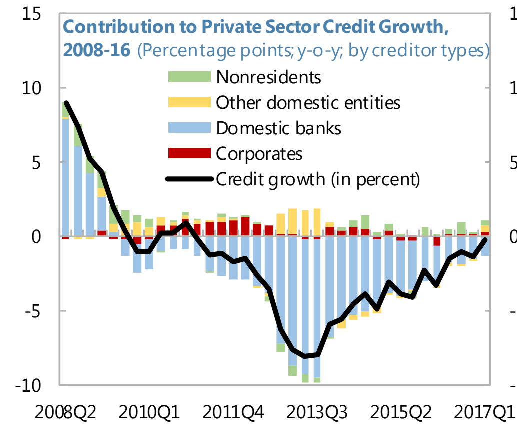
Sources: Eurostat, INE, Quarterly Labor Force Survey, Ministry of Employment and Social Security, and IMF staff calculations.

Figure 4. Spain: Credit Development and Financial Cycle

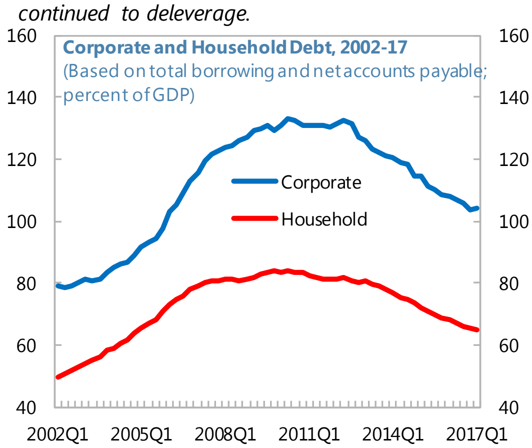
Despite declining lending rates, especially for SMEs, to levels in the core euro area ...



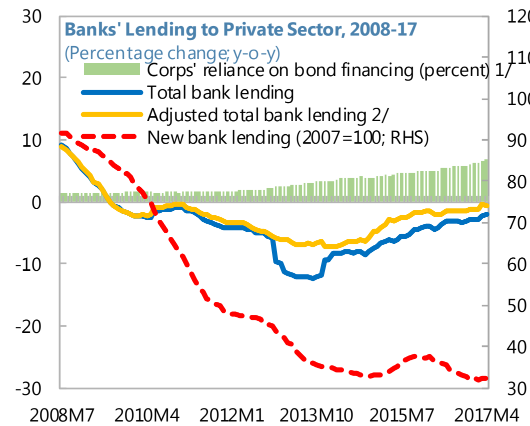
... credit growth has remained negative...



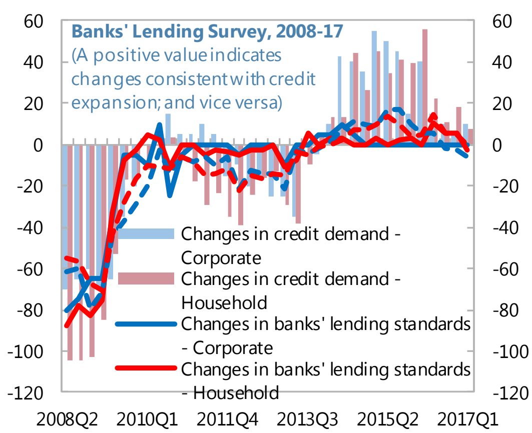
... as corporates and households have continued to deleverage.



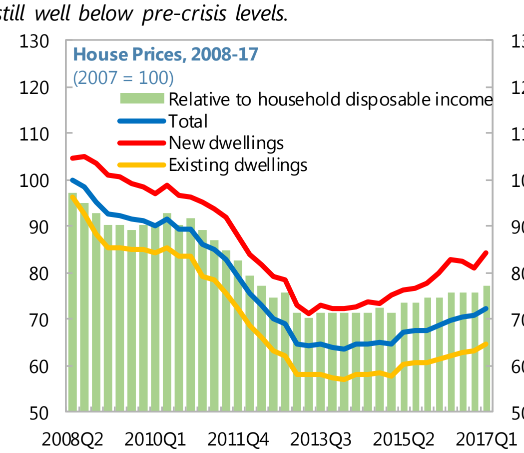
New lending has remained weak ...



...mainly due to weak credit demand.



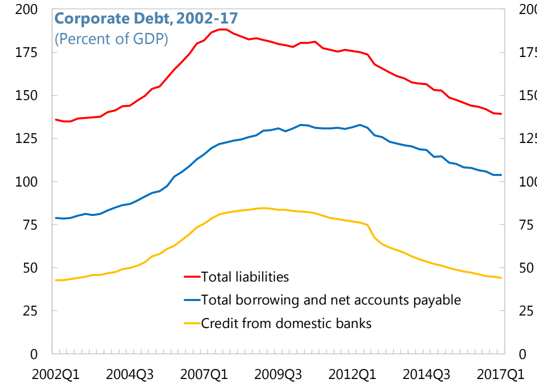
House prices have started to recover, but are still well below pre-crisis levels.



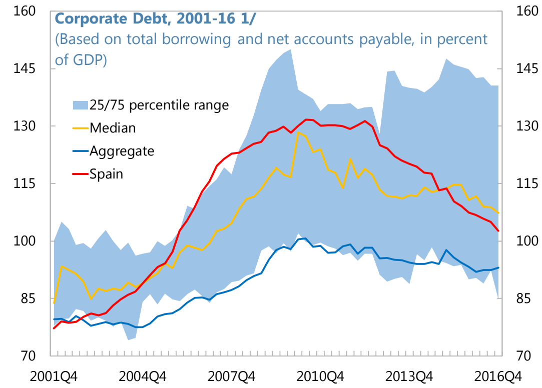
Sources: Bank of Spain; Haver Analytics; and IMF staff calculations.
1/ Based on outstanding corporate debt securities relative to outstanding banks' lending to corporates.
2/ The adjusted figure shows "effective flows", which comprise newly extended credit net of repayment (i.e., not including write-offs or adjustments).

Figure 5. Spain: Corporate Sector Financial Strength

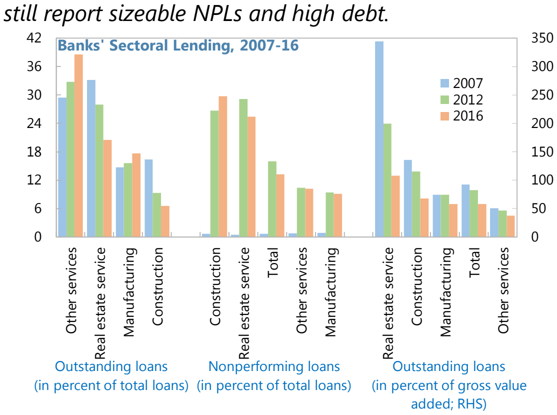
Corporates have significantly reduced their liabilities, including lending from banks and accounts payable.



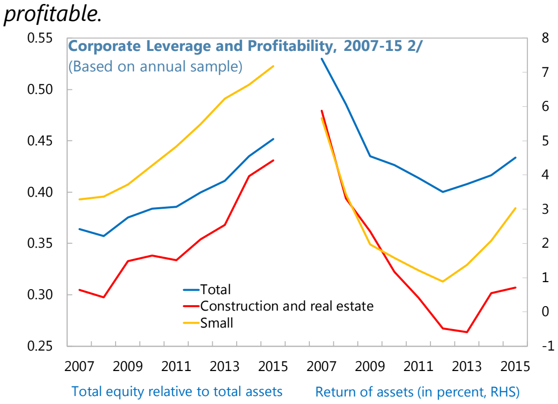
Overall indebtedness has fallen to levels comparable to European peers, with a similar pattern for leverage.



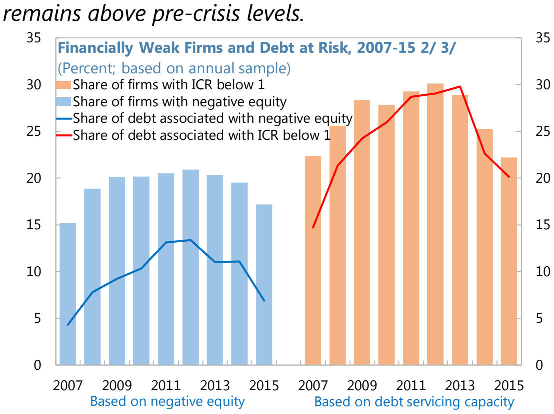
However, the construction and real estate services sector still report sizeable NPLs and high debt.



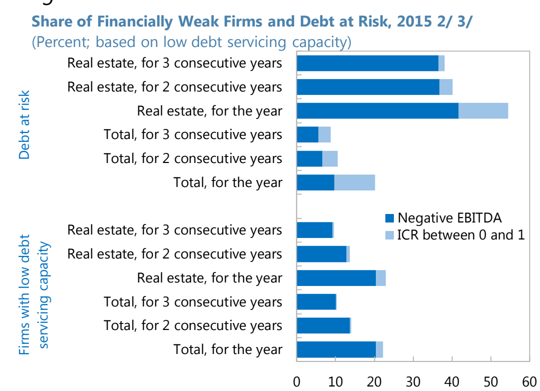
Firms have generally become less leveraged and more profitable.



Debt owed by financially weak firms has fallen but remains above pre-crisis levels.



Many firms have lacked the capacity to repay for years, raising the risk to recover their NPLs.



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

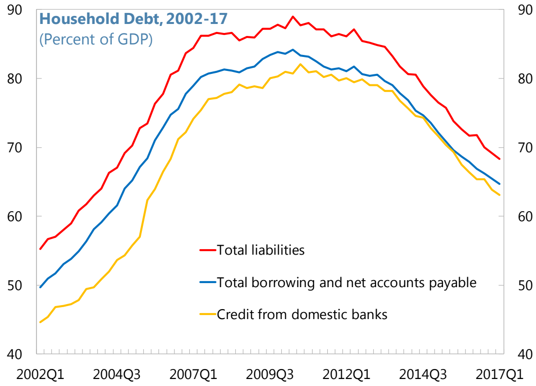
1/ The peer group includes AUT, BEL, DEU, DNK, FIN, FRA, GBR, IRL, ITA, LUX, NLD, SWE—all S29 countries in Europe. The fan chart may not necessarily cover all countries for every period due to missing data.

2/ Based on the sample of about 280 thousand companies (Bank of Spain's Central Balance Sheet Data Office database).

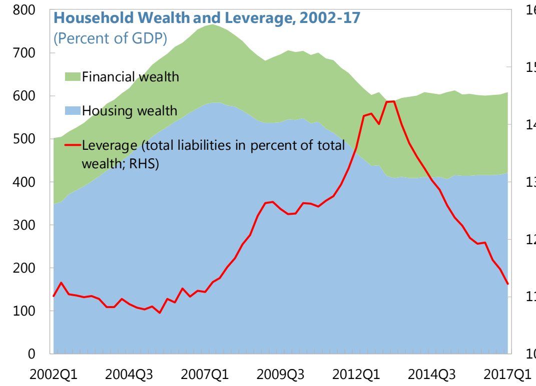
3/ Showing financially weak firms in 2015 (for the year), 2014-15 (for 2 consecutive years), and 2013–15 (for 3 consecutive years).

Figure 6. Spain: Household Sector Financial Strength

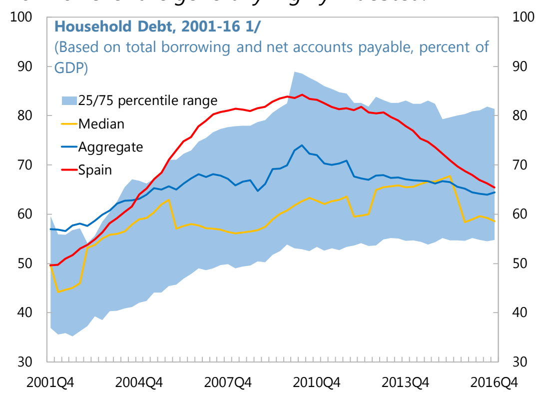
Household debt has fallen, in line with the decline in banks' lending to households.



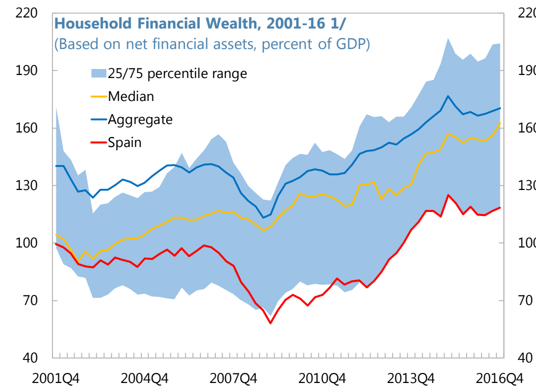
Leverage has come down significantly owing to debt reduction.



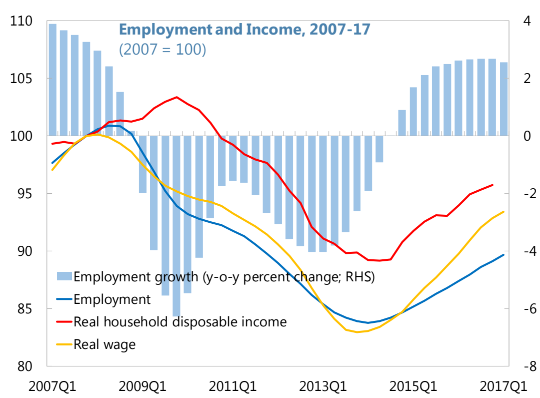
Indebtedness is now relatively close to European peers, which however are generally highly indebted.



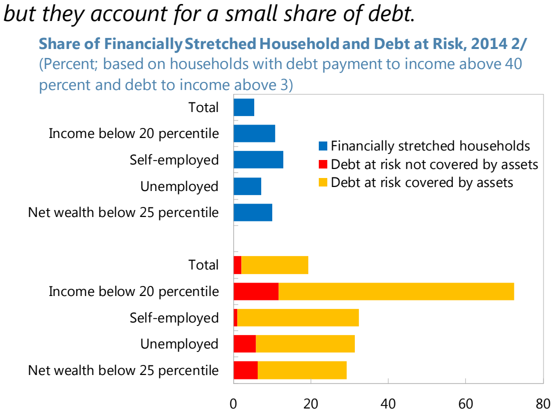
Liquidity buffers are also relatively low given traditionally low financial wealth.



With employment and real income still to fully recover ...



..., many low-income households are financially stretched, but they account for a small share of debt.



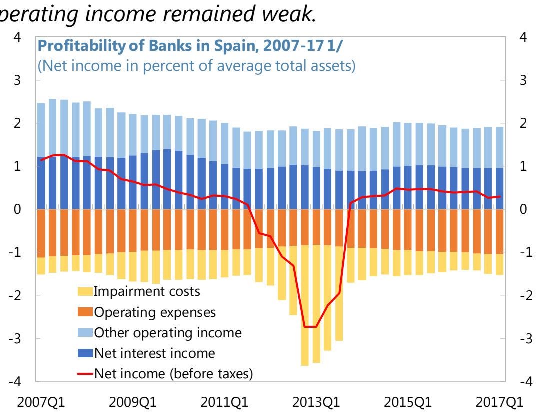
Sources: Bank of Spain; Haver Analytics; and IMF staff estimates.

1/ The peer group includes AUT, BEL, DEU, DNK, FIN, FRA, GBR, IRL, ITA, LUX, NLD, SWE—all S29 countries in Europe. The fan chart may not necessarily cover all countries for every period due to missing data.

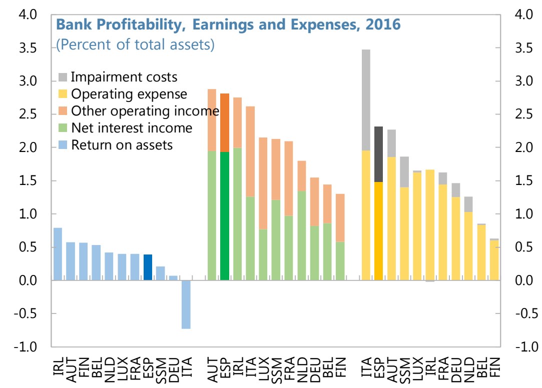
2/ Based on the 2014 Survey of Household Finances.

Figure 7. Spain: Banking System Performance

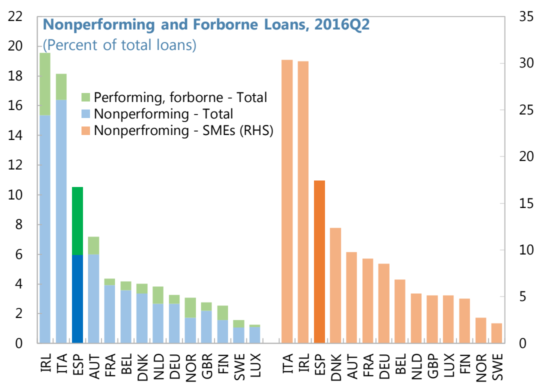
Profitability has recovered from the crisis trough, but operating income remained weak.



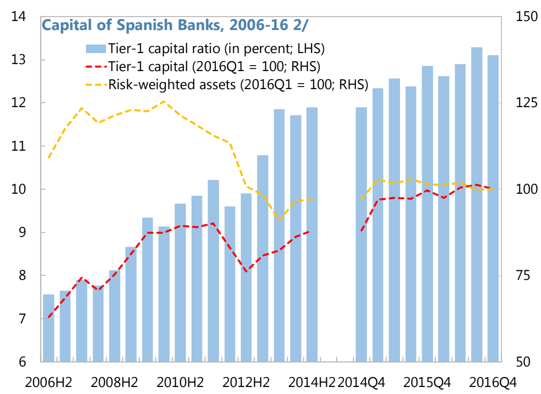
Impairment costs also weighed on net income.



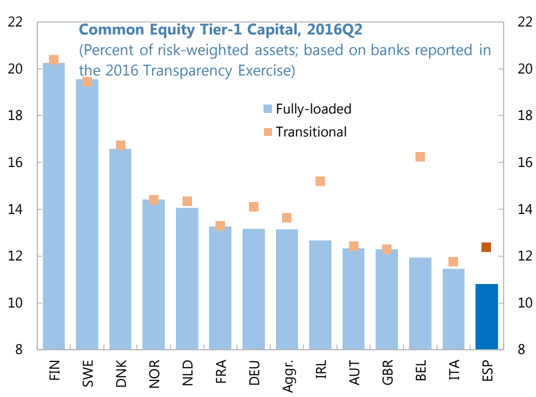
Nonperforming assets are still relatively high, especially related to SME lending.



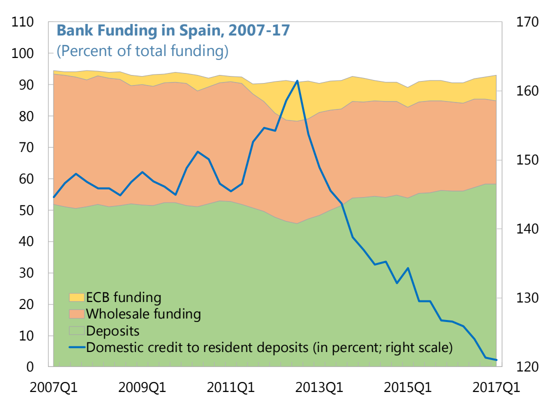
Banks have continued to increase capital …



…but fully-loaded CET1 capital lags those of European peers.



Funding conditions have improved, but banks rely heavily on ECB funding through TLTROs.



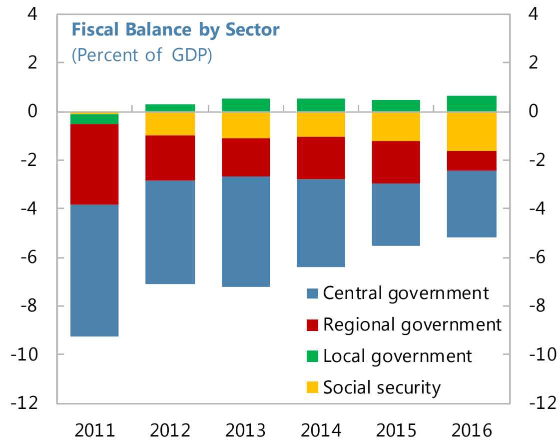
Sources: Bank of Spain; EBA, 2016 Transparency Exercise and Risk Assessment Report data; ECB, Supervisory Banking Statistics; IMF, Financial Soundness Indicators database; and IMF staff estimates.

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

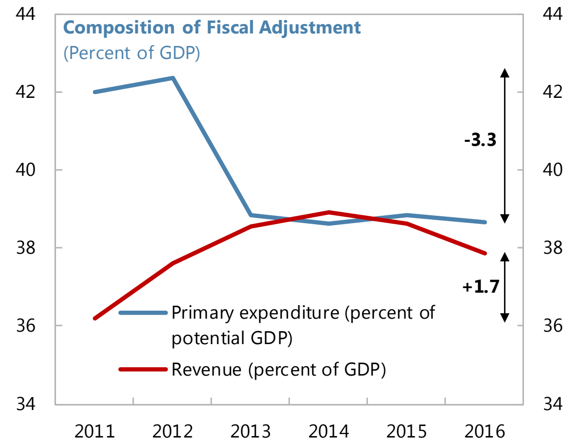
2/ Due to data availability, the chart shows semi-annual figures through 2014 and quarterly figures since then.

Figure 8. Spain: Public Finances

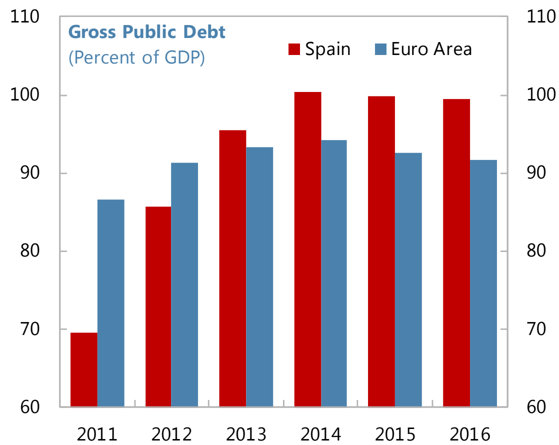
Fiscal consoliation stopped in 2015…



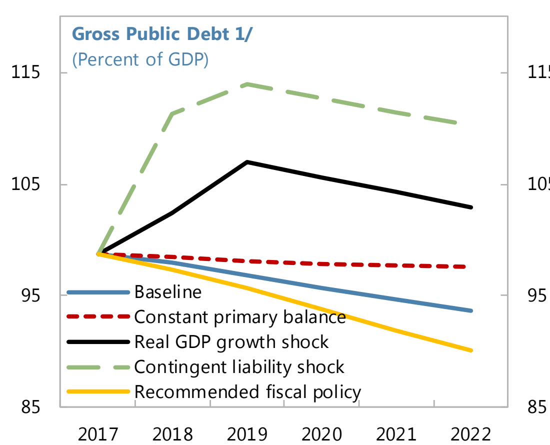
…as the primary balance turned negative …



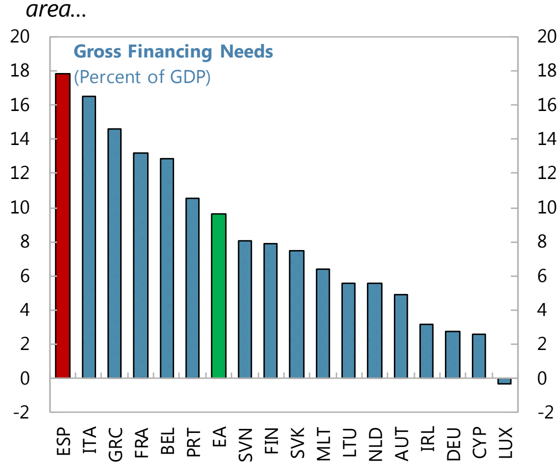
… delaying much needed debt reduciton…



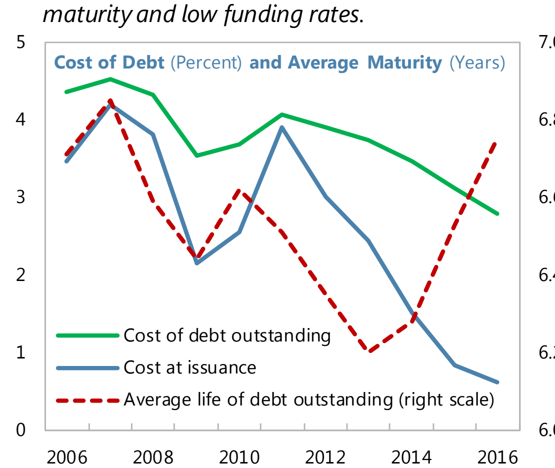
… and leaving Spain vulnerable to shocks.



Gross financing needs are the highest in the euro area…



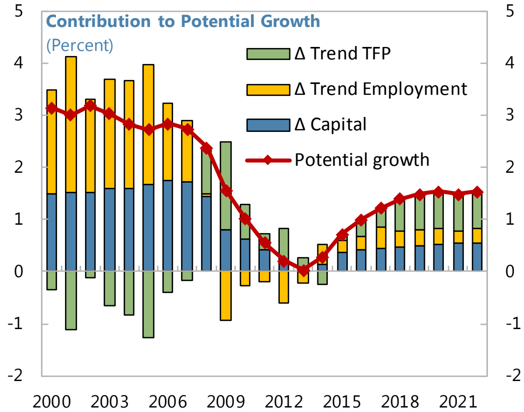
….despite efforts to lengthen the average maturity and low funding rates.



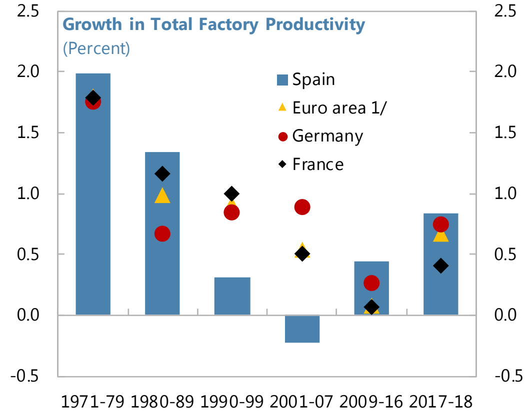
Sources: Bank of Spain; Fiscal Monitor (April 2017); Spain Ministry of Finance; and IMF staff estimates.
1/ For more details, see Debt Sustainability Analysis in Appendix IV.

Figure 9. Spain: Long-Term Growth Prospects

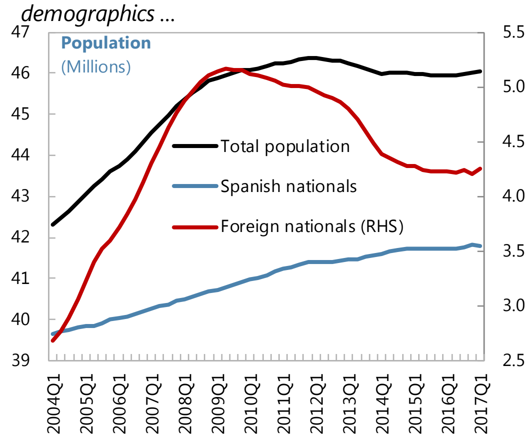
Post-crisis, potential growth is projected to remain subdued ...



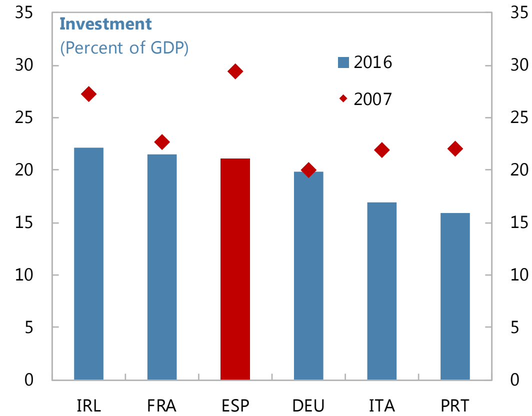
... despite a projected increase in TFP growth...



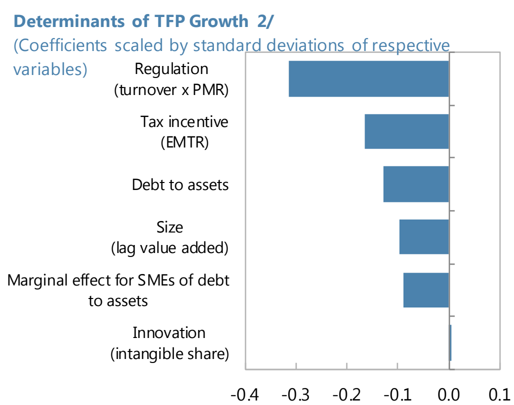
...which is not enough to offset unfavorable demographics ...



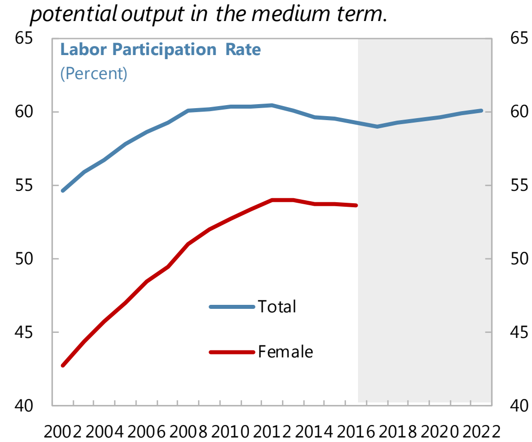
... and lower investment rate.



Regulatory burden will need to be eased...



... and labor participation rates raised further to lift potential output in the medium term.



Sources: AMECO; Bank of Spain; Eurostat; Haver Analytics; INE; ORBIS; WEO; and IMF staff estimates.
Note: EMTR = effective marginal target rate; PMR = product market regulation.
1/ EA-19, average annual growth, GDP-weighted.
2/ See Chapter I of the 2016 Spain Selected Issues Paper.

Figure 10. Spain: External Sector Linkages with the U.K.

Source: Bank of Spain, BIS, Colegio de Registradores, Datacomex, Eurostat, INE, and IMF staff calculations.

1/ Dashed lines indicate shares of trade with the UK for EU-28 countries (averages 2013-16).

2/ Primarily, through subsidiaries in the U.K.

Table 1. Spain: Main Economic Indicators, 2012–22
(Percent change unless otherwise indicated)

						Projections					
	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Demand and supply in constant prices											
Gross domestic product	-2.9	-1.7	1.4	3.2	3.2	3.1	2.5	2.0	1.9	1.7	1.7
Private consumption	-3.5	-3.1	1.6	2.9	3.2	2.7	2.4	2.0	1.8	1.7	1.7
Public consumption	-4.7	-2.1	-0.3	2.0	0.8	0.7	0.7	0.7	0.7	0.3	0.3
Gross fixed investment	-8.6	-3.4	3.8	6.0	3.1	4.3	3.3	2.8	2.5	2.0	2.1
Total domestic demand	-5.1	-3.2	1.9	3.4	2.9	2.6	2.2	1.9	1.8	1.5	1.5
Net exports (contribution to growth)	2.2	1.5	-0.5	-0.1	0.5	0.5	0.3	0.2	0.2	0.2	0.2
Exports of goods and services	1.1	4.3	4.2	4.9	4.4	7.0	4.6	4.2	3.8	3.5	3.5
Imports of goods and services	-6.4	-0.5	6.5	5.6	3.3	5.9	4.0	4.1	3.7	3.3	3.3
Real GDP per capita	-3.0	-1.3	1.7	3.3	3.3	3.2	2.7	2.2	2.0	1.8	1.8
Savings-Investment Balance (percent of GDP)											
Gross domestic investment	20.0	18.7	19.4	20.1	20.4	20.6	20.7	20.8	20.8	20.8	20.9
Private	17.5	16.5	17.2	17.6	18.5	18.6	18.6	18.7	18.7	18.7	18.8
Public	2.5	2.2	2.1	2.5	1.9	2.0	2.1	2.1	2.1	2.1	2.1
National savings	19.8	20.2	20.5	21.4	22.3	22.4	22.6	22.7	22.8	22.8	22.9
Private	23.4	24.3	24.0	24.0	24.5	23.6	23.0	22.7	22.6	22.7	22.9
Public	-3.7	-4.0	-3.5	-2.6	-2.2	-1.2	-0.4	0.0	0.1	0.1	0.0
Foreign savings	0.2	-1.5	-1.1	-1.4	-1.9	-1.9	-1.9	-1.9	-1.9	-2.0	-2.0
Household saving rate (percent of gross disposable income)	8.5	9.6	9.0	8.2	7.7	7.4	7.5	7.6	7.7	7.9	8.0
Private sector debt (percent of GDP)	252.9	241.4	230.4	218.0	208.7	200.4	195.2	190.4	185.9	181.8	177.7
Corporate debt	167.8	159.6	152.8	145.3	139.4	135.5	130.7	127.2	124.4	121.9	118.7
Household debt	85.2	81.8	77.6	72.7	69.3	64.9	64.5	63.2	61.5	60.0	59.1
Credit to private sector	-9.9	-10.2	-6.5	-4.2	-4.1	0.9	1.4	1.4	1.5	1.6	1.7
Potential output growth	0.2	0.0	0.3	0.7	1.0	1.4	1.5	1.6	1.6	1.6	1.7
Output gap (percent of potential)	-6.1	-7.8	-6.8	-4.5	-2.3	-0.7	0.3	0.8	1.0	1.0	1.0
Prices											
GDP deflator	0.1	0.4	-0.3	0.5	0.3	1.2	1.5	1.7	1.6	1.7	1.8
HICP (average)	2.4	1.5	-0.2	-0.6	-0.3	2.0	1.4	1.7	1.7	1.8	1.9
HICP (end of period)	3.0	0.3	-1.1	-0.1	1.4	1.2	1.4	1.6	1.8	1.8	1.9
Employment and wages											
Unemployment rate (percent)	24.8	26.1	24.4	22.1	19.6	17.3	15.6	15.0	14.3	13.9	13.9
Labor productivity 1/	2.0	1.8	0.3	0.2	0.4	0.4	0.6	1.3	1.2	1.3	1.7
Labor costs, private sector	1.1	0.3	0.1	0.2	0.1	1.5	1.5	1.5	1.6	1.7	1.8
Employment growth	-4.3	-2.8	1.2	3.0	2.7	2.6	1.9	0.7	0.6	0.4	0.0
Labor force growth	0.0	-1.1	-1.0	-0.1	-0.4	-0.3	-0.1	-0.1	-0.1	-0.1	-0.1
Balance of payments (percent of GDP)											
Trade balance (goods and services)	1.5	3.3	2.5	2.4	2.9	2.9	3.2	3.3	3.5	3.6	3.7
Current account balance	-0.2	1.5	1.1	1.4	1.9	1.9	1.9	1.9	1.9	2.0	2.0
Net international investment position	-89.9	-94.3	-97.5	-91.3	-85.7	-79.9	-74.4	-69.3	-64.6	-60.1	-55.7
Public finance (percent of GDP)											
General government balance 2/	-10.5	-7.0	-6.0	-5.1	-4.5	-3.2	-2.5	-2.1	-2.0	-2.0	-2.1
Primary balance	-8.0	-4.1	-3.0	-2.4	-2.0	-0.6	0.0	0.3	0.5	0.5	0.5
Structural balance	-3.5	-2.5	-2.0	-2.4	-3.1	-2.6	-2.5	-2.5	-2.5	-2.5	-2.6
Primary structural balance	-0.5	1.0	1.5	0.6	-0.3	0.2	0.2	0.2	0.2	0.2	0.2
General government debt	85.7	95.5	100.4	99.8	99.4	98.5	97.1	95.6	94.3	93.2	92.2

Sources: IMF, World Economic Outlook; data provided by the authorities; and IMF staff estimates.
1/ Output per worker.
2/ The headline balance for Spain includes financial sector support measures equal to 3.7 percent of GDP for 2012, 0.3 percent of GDP for 2013, 0.1 percent of GDP for 2014, 0.05 percent of GDP for 2015, 0.2 percent of GDP for 2016, and 0.1 percent of GDP for 2017.

Table 2a. Spain: General Government Operations, 2013–22 1/

(Billions of euros, unless otherwise indicated)

	2013	2014	2015	2016	Projections 2017	2018	2019	2020	2021	2022
Revenue	395.6	403.4	415.5	421.7	446.2	462.3	478.0	493.1	508.3	523.7
Taxes	227.2	232.3	243.7	248.1	263.6	273.2	284.0	294.2	304.6	315.7
Indirect taxes	115.0	119.6	127.6	129.5	137.5	143.1	148.5	153.7	159.2	164.9
o.w. VAT	62.1	64.9	70.0	71.6	76.7	80.0	83.0	85.9	88.9	92.1
o.w. Excise	33.8	34.6	36.7	37.1	39.0	40.5	42.1	43.5	45.1	46.7
Direct taxes	107.1	107.0	109.8	112.2	119.5	123.2	128.3	133.1	137.8	142.9
o.w. Private households	83.0	83.8	83.2	85.6	89.6	91.6	94.6	97.4	100.0	102.7
o.w. Corporate	22.2	21.8	25.9	25.7	28.9	30.6	32.7	34.6	36.7	39.0
Capital tax	5.1	5.7	6.4	6.4	6.6	6.9	7.2	7.4	7.7	7.9
Social contributions	128.2	130.1	132.3	136.3	142.7	147.6	151.0	154.4	157.6	160.4
Other revenue	40.2	41.0	39.6	37.2	39.8	41.4	43.0	44.5	46.0	47.6
Expenditure	467.5	465.6	470.7	472.2	483.0	492.0	504.0	518.5	535.0	552.7
Expense	466.9	464.8	471.4	471.3	482.0	491.0	503.0	517.5	534.0	551.7
Compensation of employees	114.7	115.2	119.1	121.4	124.2	128.5	131.6	134.6	137.4	139.8
Use of goods and services	54.7	55.1	57.1	55.9	56.9	57.7	58.7	60.8	62.9	65.1
Consumption of fixed capital	22.5	21.5	27.7	20.6	22.2	24.4	25.4	26.3	27.2	28.2
Interest	35.6	36.0	33.2	31.4	32.5	32.6	33.4	35.2	37.5	39.9
Social benefits	199.0	198.7	198.8	202.8	206.7	208.6	214.1	220.2	227.8	236.9
Other expense	40.4	38.2	35.4	39.1	39.5	39.2	39.9	40.5	41.2	41.9
Subsidies	10.9	11.4	12.5	11.5	11.6	13.8	13.8	13.8	13.8	13.8
Other	29.5	26.8	23.0	27.7	27.9	25.4	26.1	26.7	27.4	28.1
o.w. financial sector support	3.3	1.4	0.5	2.4	1.2	…	…	…	…	…
Net acquisition of nonfinancial assets	0.6	0.8	-0.7	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Gross fixed capital investment	23.1	22.3	27.0	21.5	23.2	25.4	26.4	27.3	28.2	29.2
Consumption of fixed capital	22.5	21.5	27.7	20.6	22.2	24.4	25.4	26.3	27.2	28.2
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	-71.3	-61.3	-55.8	-49.6	-35.8	-28.7	-25.0	-24.4	-25.7	-28.0
Net lending / borrowing	-71.9	-62.2	-55.1	-50.6	-36.8	-29.7	-26.0	-25.4	-26.6	-28.0
Net lending / borrowing (excluding financial sector support)	-68.6	-60.8	-54.6	-48.2	-35.7	-29.7	-26.0	-25.4	-26.6	-28.0
Memorandum items:										
Nominal GDP	1,025.6	1,037.0	1,075.6	1,113.9	1,161.7	1,208.5	1,254.4	1,298.3	1,342.6	1,389.4

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

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

Table 2b. Spain: General Government Operations, 2013–22 1/
(Percent of GDP, unless otherwise noted)

					Projections					
	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Revenue	38.6	38.9	38.6	37.9	38.4	38.3	38.1	38.0	37.9	37.7
Taxes	22.2	22.4	22.7	22.3	22.7	22.6	22.6	22.7	22.7	22.7
Indirect taxes	11.2	11.5	11.9	11.6	11.8	11.8	11.8	11.8	11.9	11.9
o.w. VAT	6.1	6.3	6.5	6.4	6.6	6.6	6.6	6.6	6.6	6.6
o.w. Excise	3.3	3.3	3.4	3.3	3.4	3.4	3.4	3.4	3.4	3.4
Direct taxes	10.4	10.3	10.2	10.1	10.3	10.2	10.2	10.3	10.3	10.3
o.w. Private households	8.1	8.1	7.7	7.7	7.7	7.6	7.5	7.5	7.5	7.4
o.w. Corporate	2.2	2.1	2.4	2.3	2.5	2.5	2.6	2.7	2.7	2.8
Capital tax	0.5	0.5	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Social contributions	12.5	12.5	12.3	12.2	12.3	12.2	12.0	11.9	11.7	11.5
Other revenue	3.9	4.0	3.7	3.3	3.4	3.4	3.4	3.4	3.4	3.4
Expenditure	45.6	44.9	43.8	42.4	41.6	40.7	40.2	39.9	39.8	39.8
Expense	45.5	44.8	43.8	42.3	41.5	40.6	40.1	39.9	39.8	39.7
Compensation of employees	11.2	11.1	11.1	10.9	10.7	10.6	10.5	10.4	10.2	10.1
Use of goods and services	5.3	5.3	5.3	5.0	4.9	4.8	4.7	4.7	4.7	4.7
Consumption of fixed capital	2.2	2.1	2.6	1.8	1.9	2.0	2.0	2.0	2.0	2.0
Interest	3.5	3.5	3.1	2.8	2.8	2.7	2.7	2.7	2.8	2.9
Social benefits	19.4	19.2	18.5	18.2	17.8	17.3	17.1	17.0	17.0	17.0
Other expense	3.9	3.7	3.3	3.5	3.4	3.2	3.2	3.1	3.1	3.0
Subsidies	1.1	1.1	1.2	1.0	1.0	1.1	1.1	1.1	1.0	1.0
Other	2.9	2.6	2.1	2.5	2.4	2.1	2.1	2.1	2.0	2.0
o.w. financial sector support	0.3	0.1	0.0	0.2	...	...	...	...	...	...
other one-offs										
Net acquisition of nonfinancial assets	0.1	0.1	-0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Gross fixed capital investment	2.2	2.1	2.5	1.9	2.0	2.1	2.1	2.1	2.1	2.1
Consumption of fixed capital	2.2	2.1	2.6	1.8	1.9	2.0	2.0	2.0	2.0	2.0
Other non financial assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross operating balance	-7.0	-5.9	-5.2	-4.5	-3.1	-2.4	-2.0	-1.9	-1.9	-2.0
Net lending / borrowing	-7.0	-6.0	-5.1	-4.5	-3.2	-2.5	-2.1	-2.0	-2.0	-2.0
Net lending / borrowing (excluding financial sector support)	-6.7	-5.9	-5.1	-4.3	-3.1	-2.5	-2.1	-2.0	-2.0	-2.0
Memorandum items:										
Net lending/ borrowing (EDP targets)	...	-5.8	-4.2	-4.6	-3.1	-2.2	...	...	...	...
Primary balance	-4.1	-3.0	-2.4	-2.0	-0.6	0.0	0.3	0.5	0.5	0.5
Primary balance (excluding financial sector support) 2/	-3.2	-2.4	-2.0	-1.7	-0.4	0.2	0.6	0.8	0.8	0.8
Cyclically adjusted balance	-2.8	-2.3	-2.7	-3.3	-2.8	-2.6	-2.5	-2.5	-2.5	-2.6
Cyclically adjusted primary balance (excluding financial sector support) 2/	0.8	1.1	0.4	-0.5	0.0	0.1	0.2	0.2	0.2	0.2
Primary structural balance 2/	1.0	1.5	0.6	-0.3	0.2	0.2	0.2	0.2	0.2	0.2
Structural balance	-2.5	-2.0	-2.4	-3.1	-2.6	-2.5	-2.5	-2.5	-2.5	-2.6
General government gross debt (Maastricht)	95.5	100.4	99.8	99.4	98.5	97.1	95.6	94.3	93.2	92.2
Net debt	74.1	78.7	79.9	80.1	80.0	79.3	78.5	77.8	77.2	76.7
Central Government net lending	-4.9	-3.7	-2.6	-2.7	-1.7	-1.4	-1.1	-1.1	-1.1	-1.1
Output gap	-7.8	-6.8	-4.5	-2.3	-0.7	0.3	0.8	1.0	1.0	1.0

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

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

2/ Including interest income.

Table 3. Spain: General Government Balance Sheet, 2010–16

	2010	2011	2012	2013	2014	2015	2016
				(Billions of euro)			
Financial assets	294.9	318.6	347.7	368.9	380.2	378.1	370.1
Currency and Deposits	95.1	77.5	84.7	72.7	83.9	85.5	79.3
Securities other than shares	22.4	14.4	4.9	14.0	8.5	3.8	3.0
Loans	34.0	46.7	55.7	60.6	61.4	58.8	57.7
Other assets	143.4	180.0	202.4	221.7	226.3	230.0	230.1
Liabilities	721.9	833.6	961.9	1,084.3	1,229.2	1,256.9	1,305.7
Currency and deposits	3.6	3.7	3.7	3.7	3.8	4.1	4.2
Securities other than shares	527.3	609.6	674.8	807.1	951.2	1,000.6	1,062.7
Loans	112.3	129.9	217.9	214.2	216.1	196.3	183.1
Other liabilities	78.7	90.4	65.5	59.3	58.1	56.0	55.6
				(Percent of GDP)			
Financial assets	27.3	29.8	33.4	36.0	36.7	35.1	33.2
Currency and Deposits	8.8	7.2	8.1	7.1	8.1	7.9	7.1
Securities other than shares	2.1	1.3	0.5	1.4	0.8	0.4	0.3
Loans	3.1	4.4	5.4	5.9	5.9	5.5	5.2
Other assets	13.3	16.8	19.5	21.6	21.8	21.4	20.7
Liabilities	66.8	77.9	92.5	105.7	118.5	116.8	117.2
Currency and deposits	0.3	0.3	0.4	0.4	0.4	0.4	0.4
Securities other than shares	48.8	57.0	64.9	78.7	91.7	93.0	95.4
Loans	10.4	12.1	21.0	20.9	20.8	18.2	16.4
Other liabilities	7.3	8.4	6.3	5.8	5.6	5.2	5.0
				(Billions of euro)			
Memorandum items:							
Public debt (EDP)	649.3	743.5	890.7	979.0	1,041.6	1,073.9	1,107.0
Net lending/borrowing	-101.4	-102.9	-108.9	-71.9	-62.2	-55.1	-50.6
Change in public debt (EDP)	80.6	94.3	147.2	88.3	62.6	32.3	33.1
Change in financial assets	-9.3	23.7	29.1	21.2	11.3	-2.1	-8.0
Change in net financial assets	-89.9	-70.6	-118.1	-67.1	-51.3	-34.4	-41.1
Unexplained change in net financial assets	11.6	32.4	-9.2	4.7	10.9	20.7	9.5

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

Table 4. Spain: Selected Financial Soundness Indicators, 2010–16
(In percent, unless otherwise indicated)

	2010	2011	2012	2013	2014	2015	2016
Depository institutions							
Capital adequacy							
Regulatory capital to risk-weighted assets	11.9	12.1	11.6	13.3	13.7	14.7	14.8
Regulatory tier-1 capital to risk-weighted assets	9.7	10.2	9.9	11.9	11.9	12.9	13.1
Capital to total assets	6.1	5.9	5.8	6.8	7.2	7.4	7.8
Asset quality: Consolidated basis							
Nonperforming loans (in billions of euro)	119	153	180	210	188	159	143
Nonperforming loans to total loans	4.7	6.0	7.5	9.4	8.5	6.2	5.6
Specific provisions to nonperforming loans	65.7	56.9	68.4	56.8	57.7	44.0	42.4
Asset quality: Domestic operations							
Nonperforming loans (in billions of euro)	103	136	163	192	167	130	112
Nonperforming loans to total loans	5.8	7.9	10.6	13.8	12.6	10.2	9.2
Specific provisions to nonperforming loans	38.7	36.6	44.4	46.6	46.4	46.6	45.7
Exposure to businesses - Construction (in billions of euro)	422	389	294	232	196	175	157
o/w: Nonperforming (in percent)	13.5	20.8	28.5	37.3	35.6	28.3	26.5
Exposure to businesses - Other (in billions of euro)	554	541	495	456	452	444	425
o/w: Nonperforming (in percent)	3.7	5.0	8.6	12.5	11.7	9.6	8.4
Exposure to households - Home purchase (in billions of euro)	624	614	593	569	546	520	506
o/w: Nonperforming (in percent)	2.3	2.8	3.8	5.7	5.6	4.6	4.5
Exposure to households - Other (in billions of euro)	183	171	157	136	134	134	134
o/w: Nonperforming (in percent)	5.6	6.1	9.0	11.6	10.7	10.3	9.1
Earning and profitability: Consolidated basis							
Return on assets	0.5	0.1	-1.4	0.4	0.4	0.5	0.4
Return on equity	8.0	1.5	-21.0	5.4	5.7	7.1	5.5
Earning and profitability: Domestic operations							
Return on assets	0.3	-0.6	-2.7	0.1	0.5	0.4	0.3
Return on equity	5.6	-9.1	-43.6	2.0	5.9	4.9	3.1
Funding							
Loans to deposits 1/	144.8	145.3	132.4	118.3	114.5	110.0	105.7
Use of ECB refinancing (in billions of euro) 2/	70	132	357	207	142	133	140
In percent of total ECB refinancing operations	13.2	18.4	32.0	28.8	26.2	25.0	24.8
In percent of total assets of Spanish MFIs	2.0	3.7	10.0	6.6	4.8	4.7	5.1
Total assets (in percent of GDP)	295	294	316	284	266	247	233
Other financial institutions							
Total assets (in percent of GDP)							
Insurance companies and pension funds	33	33	36	38	38	37	...
Other institutions 3/	114	103	100	93	93	87	...
Shadow banking activity 4/	25	22	21	22	25	26	...
Corporate sector							
Debt (in percent of GDP)	181	176	168	160	153	145	139
Debt to total assets	55.3	53.4	51.4	47.7	46.7	43.7	43.4
Liquid assets to short-term liabilities	160.1	177.5	194.4	249.2	261.4	271.0	312.9
Household sector							
Debt (in percent of GDP)	88	86	85	82	78	73	69
Debt service and principal payment to disposable income	23.2	22.4	22.4	20.0	12.8	12.2	15.9
Real estate market							
House price (percentage change, end-period)	-1.9	-11.2	-12.8	-7.8	1.8	4.2	4.5
Housing completion (2007=100)	43	28	21	9	8	7	6
Property sales (2007=100)	57	47	43	42	43	46	51

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

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

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

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

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

Table 5. Spain: Balance of Payments, 2011–22

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
							Projections					
						(Billions of euro)						
Current account	-34.0	-2.4	15.6	11.2	14.7	21.5	23.1	25.7	25.6	25.9	26.7	28.4
Trade balance of goods and services	-1.9	16.0	33.8	25.5	26.2	32.7	35.3	40.7	43.2	45.9	49.1	52.4
Exports of goods and services	309.9	319.5	330.8	339.0	356.9	368.3	403.3	427.3	452.7	478.5	504.6	532.6
Exports of goods	216.0	224.2	235.6	238.6	250.2	253.5	277.7	293.2	309.0	324.9	340.4	356.9
Exports of services	93.9	95.3	95.2	100.4	106.7	114.8	125.7	134.2	143.7	153.6	164.2	175.7
Trade of goods balance	-44.5	-29.3	-14.0	-22.4	-21.7	-17.9	-22.7	-22.8	-25.8	-29.5	-32.9	-36.7
Imports of goods and services	-311.8	-303.5	-297.0	-313.5	-330.6	-335.6	-368.0	-386.6	-409.5	-432.6	-455.6	-480.2
Imports of goods	-260.4	-253.4	-249.6	-261.0	-271.9	-271.4	-300.3	-316.0	-334.8	-354.4	-373.3	-393.6
Imports of services	-51.3	-50.1	-47.5	-52.5	-58.7	-64.1	-67.7	-70.6	-74.7	-78.2	-82.3	-86.6
Services	42.6	45.2	47.8	47.9	48.0	50.6	58.0	63.5	69.0	75.4	81.9	89.1
Of which:												
Tourism	32.2	33.3	34.8	35.4	35.2	36.3	…	…	…	…	…	…
Exports	44.7	45.3	47.2	49.0	50.9	54.5	…	…	…	…	…	…
Imports	-12.5	-12.0	-12.4	-13.6	-15.7	-18.2	…	…	…	…	…	…
Primary income	-18.4	-7.0	-5.3	-3.3	-0.7	0.8	-0.5	-2.9	-5.1	-6.9	-7.8	-8.1
Secondary income	-13.8	-11.4	-12.9	-11.0	-10.8	-12.0	-11.7	-12.1	-12.5	-13.0	-14.5	-15.9
Private remittances	-6.1	-3.8	-3.4	-2.8	-3.0	-4.1	-2.8	-2.8	-2.9	-3.1	-4.3	-5.3
Official transfers	-9.3	-8.2	-10.1	-8.8	-8.4	-8.5	-8.9	-9.3	-9.6	-9.9	-10.3	-10.6
Capital account	4.1	5.2	6.6	5.0	7.0	1.9	5.0	5.2	5.4	5.6	5.8	6.0
Financial account	31.2	-0.4	-31.3	-10.5	-22.3	-26.7	-28.1	-30.9	-31.0	-31.5	-32.5	-34.3
Direct investment	-9.2	21.1	18.5	-8.0	-29.4	-21.3	-21.3	-21.3	-22.1	-23.0	-24.0	-25.1
Spanish investment abroad	32.5	-1.9	20.8	33.9	52.2	47.6	48.3	49.0	49.8	50.6	51.6	52.6
Foreign investment in Spain	23.3	19.2	39.3	25.9	22.8	26.3	27.0	27.6	27.6	27.6	27.5	27.5
Portfolio investment	-31.0	-41.8	63.0	10.2	-10.1	-47.2	15.2	13.4	13.7	15.1	16.4	17.8
Financial derivatives	-2.1	8.3	-1.0	-0.1	1.2	2.9	0.0	0.0	0.0	0.0	0.0	0.0
Other investment	83.5	14.1	-111.3	-8.7	21.0	47.1	-22.0	-23.0	-22.6	-23.6	-24.8	-27.1
Change in reserve assets	-10.0	-2.2	-0.5	-3.9	-5.1	-8.2	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	-0.3	1.0	-11.1	4.8	-3.5	-4.8	0.0	0.0	0.0	0.0	0.0	0.0
						(Percent of GDP)						
Current account	-3.2	-0.2	1.5	1.1	1.4	1.9	2.0	2.1	2.0	2.0	2.0	2.0
Trade balance of goods and services	-0.2	1.5	3.3	2.5	2.4	2.9	3.0	3.4	3.4	3.5	3.7	3.8
Exports of goods and services	29.0	30.7	32.3	32.7	33.2	33.1	34.7	35.3	36.0	36.8	37.5	38.3
Exports of goods	20.2	21.6	23.0	23.0	23.3	22.8	23.9	24.2	24.6	25.0	25.3	25.7
Exports of services	8.8	9.2	9.3	9.7	9.9	10.3	10.8	11.1	11.4	11.8	12.2	12.6
Imports of goods and services	-29.1	-29.2	-29.0	-30.2	-30.7	-30.1	-31.6	-31.9	-32.6	-33.3	-33.9	-34.5
Imports of goods	-24.3	-24.4	-24.3	-25.2	-25.3	-24.4	-25.8	-26.1	-26.6	-27.3	-27.8	-28.3
Imports of services	-4.8	-4.8	-4.6	-5.1	-5.5	-5.8	-5.8	-5.8	-5.9	-6.0	-6.1	-6.2
Primary income	-1.7	-0.7	-0.5	-0.3	-0.1	0.1	0.0	-0.2	-0.4	-0.5	-0.6	-0.6
Secondary income	-1.3	-1.1	-1.3	-1.1	-1.0	-1.1	-1.0	-1.0	-1.0	-1.0	-1.1	-1.1
Capital account	0.4	0.5	0.6	0.5	0.7	0.2	0.4	0.4	0.4	0.4	0.4	0.4
Financial account	2.9	0.0	-3.1	-1.0	-2.1	-2.4	-2.4	-2.5	-2.5	-2.4	-2.4	-2.5
Direct investment	-0.9	2.0	1.8	-0.8	-2.7	-1.9	-1.8	-1.8	-1.8	-1.8	-1.8	-1.8
Portfolio investment	-2.9	-4.0	6.1	1.0	-0.9	-4.2	1.3	1.1	1.1	1.2	1.2	1.3
Financial derivatives	-0.2	0.8	-0.1	0.0	0.1	0.3	0.0	0.0	0.0	0.0	0.0	0.0
Other investment	7.8	1.4	-10.8	-0.8	2.0	4.2	-1.9	-1.9	-1.8	-1.8	-1.8	-1.9
Of which, BdE	11.6	16.7	-9.9	1.9	8.2	9.1	3.4	0.0	-0.4	-0.4	-0.4	-0.4
Change in reserve assets	-0.9	-0.2	-0.1	-0.4	-0.5	-0.7	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	0.0	0.1	-1.1	0.5	-0.3	-0.4	0.0	0.0	0.0	0.0	0.0	0.0
Net international investment position	-91.9	-89.9	-94.3	-97.5	-91.3	-85.7	-79.6	-73.9	-68.8	-64.1	-59.6	-55.1
Valuation changes	0.4	4.7	-6.3	-5.2	0.6	0.1	0.0	0.0	0.0	0.0	0.0	0.0

Sources: Bank of Spain; and IMF staff estimates.

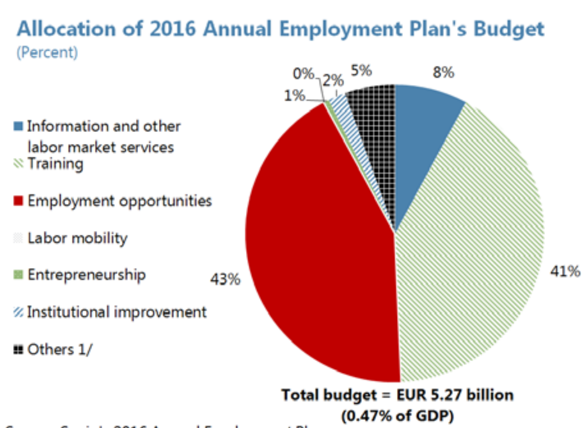
Annex I. Active Labor Market Policies in Spain[1]

Cost-effective active labor market policies (ALMPs) could be useful to reduce long-term and low-skilled unemployment in Spain. But the evidence so far indicates that spending on ALMP measures and labor market services is low relative to the number of unemployed persons and is diversified across a large number of programs. Moreover, ALMPs have limited participation rates, the Public Employment Services face capacity constraints to offer individualized support, several policies are not appropriately targeted, and evaluation mechanisms are uncommon. While the government has introduced some changes to its ALMP strategy, further improvements could increase the efficiency and effectiveness of these policies.

Expenditure and participation rates in ALMPs

1. Spending on ALMPs in Spain is relatively low. Based on 2014 data, spending on ALMP measures, such as training and employment subsidies, was disproportionately lower than expenditure on passive measures, which include unemployment benefits (0.5 percent of GDP versus 2.5 percent of GDP, respectively). Although Spain spends a larger fraction of GDP on ALMP measures than many other EU countries, its relative share is much weaker when this expenditure is adjusted for price level differences across countries ("purchasing power standards" or PPS) and by the number of persons wanting to work (see accompanying panel chart). This lower share is explained in part by the fact that Spain has one of the highest unemployment rates in the EU. After declining around 2012, the annual budget for ALMP measures and labor market services—such as job-search assistance and job brokerage services for employers provided by the Public Employment Services—increased on average by 13 percent in 2015 and 2016.

2. Spending is diversified across different ALMPs, especially on measures to increase jobseekers' employability. While most EU countries concentrate their expenditure in one or two specific ALMP measures, between 2012 and 2014 Spain allocated relatively similar shares of its overall spending to training, start-up incentives, direct job creation, and (to a lesser extent) employment incentives. Recent data from the 2016 Annual Employment Policy Plan show that training and "employment opportunities" (which includes programs related to direct job creation and employment incentives) are the two broad items with higher allocation in the budget for ALMP measures and services (see chart). The diversification across ALMPs is also prevalent at the region level: on average, each region applies 63 different measures and services. Moreover, the total number of policies included in the 2016 Annual Employment Policy Plan is 530, of



Source: Spain's 2016 Annual Employment Plan.
1/Includes quotas to international entities and other spending.

[1] Prepared by Jorge Salas.

which only 52 are common to all regions and the rest are region-specific. Overall, the evidence points to efficiency problems in the provision of ALMPs.

3. The coverage of ALMP measures and labor market services is limited. Between 2008 and 2014, the percentage of people wanting to work that participated in ALMP measures dropped from 84 to 25 percent. This reduction reflected the higher number of unemployed workers after the crisis and the budget cuts on ALMPs in 2012–13. Compared to other EU countries with relatively high rates of unemployment and long-term unemployment, Spain's participation rate in ALMPs as of 2014–15 was greater than that of Greece and Italy, but lower than Portugal's. The coverage of labor market services is also limited: for example, only 2 percent of vacancies are handled by the Public Employment Services, whereas the EU average is 10 percent, and the share of the unemployed that contacted the Public Employment Services to seek work was 27.5 percent in 2015, the lowest rate in the EU (European Commission, 2017). The provision of labor market services is affected by capacity constraints of the Public Employment Services; illustratively, one employee of Public Employment Services oversees more than 250 jobseekers (OECD, 2017).

4. ALMPs insufficiently target the long-term unemployed and the youth. In general, ALMP measures have not successfully targeted vulnerable groups of jobseekers, such as low-skilled workers and the long-term unemployed. In 2015:Q1, only 0.5 percent of the low-skilled unemployed for 1–2 years benefited from training programs offered by the Public Employment Services, with an even a smaller fraction of participants in the case of the low-skilled unemployed for more than two years (Jansen, 2016). Spain has three main activation programs for the long-term unemployed: *Renta Activa de Inserción*, the *PREPARA* plan for professional reskilling, and the Employment Activation Program, *PAE*. All these programs include income support and have a job search requirement attached, but an advantage of the PAE is that it involves the support of a personal tutor. The PAE has reportedly helped one third of its participants find a job; however, it has only covered about half of the initially estimated 400,000 persons. Furthermore, although Spain has received the highest share in total EU funding to implement the Youth Guarantee scheme (an EU initiative to tackle youth unemployment), the program had a slow start in part because Spain narrowly defined eligibility criteria and lacked adequate management systems to monitor its progress.

Institutional issues and recent measures to strengthen ALMPs

5. The decentralized delivery structure affects the performance of ALMPs. Coordination problems within regions, or between regions and the national authorities, arise due to the institutional approach to labor policies in Spain, for which different agencies and levels of government are responsible. A critical issue is that the central government manages unemployment benefits, while the provision of ALMPs is decentralized at the regional levels. Thus, the delivery of social and employment services and assistance is divided across the national and regional Public Employment Services, and the social services. This institutional configuration weakens the ties between passive and active labor market policies, distorting incentives for the unemployed, and more generally, it reduces the efficiency and effectiveness of activation strategies.

6. The 2014–2016 Strategy for Employment Activation aimed to improve the institutional framework for ALMPs. The multi-annual strategy adopted in 2014 introduced the following changes: a set of national strategic objectives (e.g., better targeting the long-term unemployed), an increased budget and a common catalogue of ALMPs, funding to the regions partially linked to results, monitoring through indicators of performance, a common IT system, and enhanced private-public collaboration in labor intermediation and training programs. Change in some of these areas, however, has been slow and uneven across regions. For example, performance indicators do not sufficiently focus on the impact of programs, many regions still operate their own IT systems, and several regions have either not worked with private job-placement agencies or have interrupted these collaborations. The forthcoming new multi-annual Strategy for Employment Activation should address these limitations.

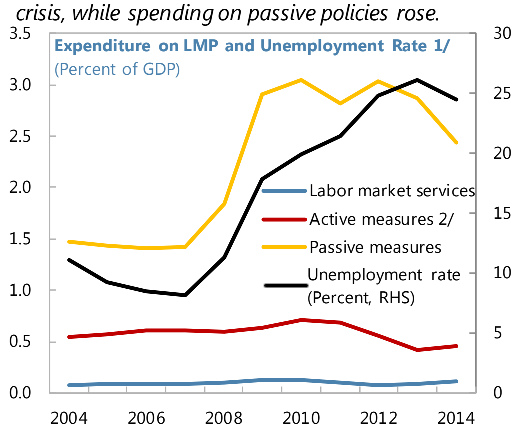
7. The government has continued revising its ALMP strategy. Two helpful reforms were introduced in December 2016. First, a new action plan to support one million long-term unemployed, with a budget of €515 million, envisaging more individualized assistance based on improvements in the capacity of the Public Employment Services and the development of profiling tools. Second, all young people registered as unemployed with the Public Employment Services are now eligible for support under the Youth Guarantee, improving the coverage of this scheme. More recently, the government approved the extension of the PAE until 2018 and introduced changes aimed at increasing the number of participants in this program. The government has also pledged to an enhanced management and implementation of the Youth Guarantee scheme.

The way forward

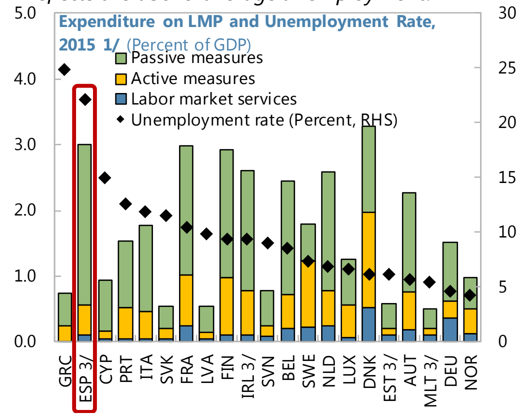
8. Further areas for improvement have been identified, for example by the OECD. Appropriate training to staff, higher staff-to-jobseeker ratios, profiling, better use of digitization to improve job search assistance, and establishing a single point of contact for labor market services and assistance would strengthen the capacity of the Public Employment Services. ALMP measures for the youth and long-term unemployed should be more focused and strongly oriented to skills training, aligned with private employers' needs. Re-training could be provided to low-skilled long-term unemployed in collaboration with vocational education and training institutions. A more successful involvement of private providers in job placement would require to strike a good balance between reasonable incentives for private job-placement agencies and the quality of the services provided by them. This public-private collaboration should continue to be mainly oriented to those who are furthest away from the labor market, and best practices need to be disseminated across regions. Finally, a cost-effective approach to ALMPs should be based on evaluation mechanisms to assess the short and long-term impact of programs relative to the amount spent on them, but such evaluations are uncommon in Spain. Targeting and cost-benefit considerations are important because the international evidence shows that ALMPs are not always very effective (Crépon and Van den Berg, 2016) and that the quality of their design can significantly influence their success.

Spain: Active Labor Market Policies (ALMPs)

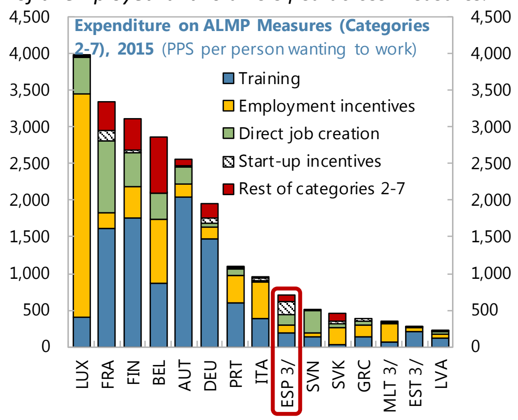
Expenditure on ALMPs remained stable after the crisis, while spending on passive policies rose.



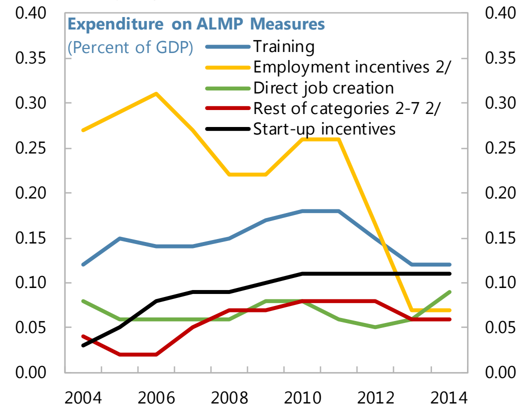
Most spending is for passive measures, which reflects the above-average unemployment.



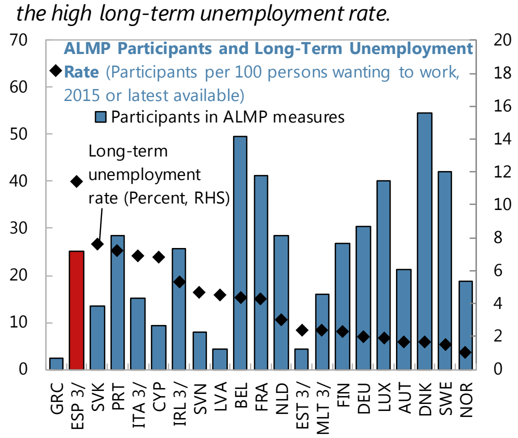
Expenditure on ALMPs is small relative to the number of unemployed and is diversified across measures.



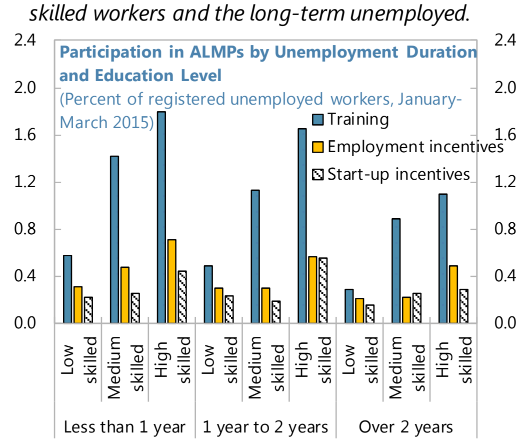
Recent spending on training and start-up incentives was barely higher than on other ALMP measures.



The participation rate in ALMPs is limited relative to the high long-term unemployment rate.



Several ALMPs have not successfully targeted low-skilled workers and the long-term unemployed.



Source: Eurostat, Jansen (2016), and IMF staff calculations.

1/ Labor market services refer to category 1 of Eurostat's LMP statistics, active measures to categories 2-7 and passive measures to categories 8-9 (Out-of-work income maintenance and support, early retirement).

2/ 2012 value is constructed by simple interpolation.

3/ 2014 value is used for LMP.

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Appendix I. Main Recommendations of the 2016 Article IV Consultation and Authorities' Actions

IMF 2016 Article IV Recommendations	Policy Actions
Fiscal Policy	
Resume gradual fiscal consolidation with an annual adjustment of the structural primary balance of about 0.5 percent of GDP.	The 2017 budget targets a structural primary balance adjustment of 0.4–0.5 percent of GDP. However, only 0.2 percent of GDP adjustment in the primary structural balance is planned from 2018–20.
Implement growth-friendly adjustment by gradually reducing VAT exemptions as well as raising excise duties and environmental levies. Conduct expenditure reviews to identify possible efficiency gains.	The 2017 adjustment closes CIT loopholes and increases excises a little. The authorities estimate VAT administration reform could yield around 0.1 percent of GDP. Expenditure reviews of pharmaceutical and active labor market policy spending are being launched.
Reform regional fiscal framework to improve regional compliance with fiscal targets by more automatic and stricter enforcement of targets and providing regions with greater power to mobilize their own revenues.	Regional and local public finance commissions are preparing reports on regional finance reform by August. IMF is supporting the work of the commissions. Reform proposals are to be sent to parliament by December.
Financial Sector Policies	
Further reduce legacy assets, ensure appropriate provisioning, implement ambitious NPL reduction plans, and address remaining deficiencies in the insolvency regime.	NPLs continued to fall from their peak in 2013. The Bank of Spain revised bank accounting rules to ensure appropriate valuation of collateral and foreclosed assets. Bank-specific NPL reduction plans remain to be fully developed. No further changes to the insolvency regime.
Further strengthen banks' capital and funding positions; improve profitability by lowering operating expenses, and boosting non-interest income.	Banks have strengthened their balance sheets by further improving asset quality and increasing capital buffers, though NPLs and foreclosed assets are still sizeable.
Fully put in place the macroprudential policy framework to bolster the capacity to manage systemic risk.	The national macroprudential authority remains to be established. The Bank of Spain has activated the countercyclical capital buffer (at zero) and the capital buffers for systemically important banks.
Further improve access to finance for SMEs, especially for market-based financing to support frontier innovation.	Lending rates for SMEs have declined further. Nearly all of the ICO's funds, channeled through on-lending and private capital facilities in the first half of 2017, were allocated to SMEs. ICO is also ramping up efforts to promote SME securitization and provide risk sharing for SME loans.
Structural Reforms	
Labor market reforms	
Improve the effectiveness of active labor market policies (ALMP), for example through consolidation of hiring subsidies into better-targeted schemes (particularly for the low-skilled and long-term unemployed).	The Youth Guarantee eligibility criteria were extended, a new program to strengthen individual support to the long-term unemployed (LTU) was approved, and an activation program for the LTU was extended until 2018.
Address the remaining gap between costs for permanent and temporary workers to lower labor market duality.	A working group on the quality of employment was established, but no policy actions were taken.
Allow firms more flexibility over working conditions.	No policy action taken.

Productivity growth	
Implement faster the Market Unity Law, advance the liberalization of professional services, improve access to non-bank financing for frontier innovation, and revisit size-contingent regulations, strengthen innovation and education policies.	The implementation of the Market Unity Law is ongoing, but differences in regulatory norms and practices across Spain remain. The 2017 budget foresees an increase in public support for R&D spending of 4.1 percent. The government identified more than 100 size contingent regulations and is preparing a strategy to revise some of them. No actions have been taken to liberalize professional services.

	Spain	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. The net international investment position (NIIP) dropped from -35 percent of GDP in 2000 to -98 percent of GDP in 2009, driven mostly by substantial current account (CA) deficits but also reflecting valuation effects. The CA improved subsequently, but the NIIP remains elevated at -86 percent at end-2016 which is a 12 percentage points improvement relative to at end-2014. Gross external debt is still high at 167 percent of GDP at end-2016. The share of public external debt in the gross liability position increased from 15 percent in 2010 to around 34 percent in 2016. Part of this increase is accounted for by TARGET2 liabilities, which reached € 333 billion (30 percent of GDP) by end-2016. 1/ **Assessment**. The large negative NIIP comes with external vulnerabilities, including from large gross financing needs from external debt and valuation changes. Mitigating factors are a favorable maturity structure of Spain's outstanding sovereign debt (averaging 6½ years) and current ECB measures such as QE.	**Overall Assessment**: *The external position in 2016 is estimated to be weaker than consistent with medium-term fundamentals and desirable policy settings*. In 2016, the CA has continued to improve, helped by lower oil import price, low interest rates, and regained competitiveness from wage moderation and larger firms' internationalization efforts. Spain recorded its fourth consecutive annual CA surplus, unprecedented in recent Spanish history. Despite the strong improvement in the CA since the pre-crisis peak deficit in 2007, achieving both a sufficiently declining NIIP and further reduction in unemployment would require a sustained weaker real effective exchange rate. **Potential policy responses**: The authorities' recent structural reforms, in particular the labor market reform with the resulting wage moderation, as well as the Market Unity Law to reform product markets, and fiscal deficit reductions are in line with reducing imbalances. In the medium term, further growth-friendly fiscal adjustment and moving forward with structural reforms of the labor market and faster implementation of product market reforms would be required to accelerate the adjustment. Continued monetary accommodation at the euro area level to lift inflation closer to the ECB's medium-term price stability objective should help increase external demand, which would also support Spain's adjustment efforts.
Current account	**Background**. After a peak CA deficit in 2007 of 9.6 percent of GDP, corrected initially by a sharp contraction in imports, exports and imports have since grown strongly along with the economic recovery leading to CA surpluses in 2013–16. With data up to 2016:Q4, the CA surplus was estimated at 2 percent of GDP in 2016 (or 1.1 percent of GDP cyclically adjusted); and is projected to moderate somewhat in 2017 as domestic demand continues to recover. Regained competitiveness from price and wage moderation, and the depreciation of the euro positively contributed to Spain's healthy exports growth and resilient export shares. ECB measures have helped to drive down interest rates on external debt, and the sharply lower oil price has reduced import costs. **Assessment**. The EBA CA model suggests a norm of 1.8 percent of GDP for 2016, which is somewhat higher than the observed cyclically-adjusted CA balance (1.1 percent of GDP). However, given external risks from a large and negative NIIP, staff's assessment puts more weight on external sustainability, and is guided by the objective of strengthening the NIIP position to above -50 percent over the medium term in an uncertain environment. This yields a CA norm of about 3 percent of GDP, with a range of 2–4 percent of GDP, implying that the cyclically-adjusted CA was about 1 to 3 percent of GDP weaker than desirable. 2/ Another factor supporting a relatively elevated CA norm is uncertainty about the output gap: if the output gap is larger (for example, reflecting a structural level of unemployment closer to international peers), the cyclically-adjusted CA would be lower and thus the gap with respect to the desirable level would be larger. Reducing the still sizable structural fiscal deficit will be a key policy requirement to lower the remaining imbalances.	
Real exchange rate	**Background**. In 2016 the CPI-based real effective exchange rate (REER) remained broadly unchanged (0.1 percent higher) from its average 2015 level, but it is still about 8 percent lower than its 2009 peak. This partially reversed the 17 percent appreciation from the euro entry in 1999 until 2009. The ULC-based REER shows the appreciation has been substantially reversed since euro entry, initially as a result of substantial labor shedding and, more recently, of wage moderation and the euro depreciation. After reaching its peak level in 2008, the ULC-based REER depreciated by 18 percent. As of May 2017, the CPI-based REER was down 0.1 percent relative to the 2016 average. **Assessment**. The two EBA REER regression model approaches, the index and level REER tools, estimate an overvaluation of 6.5 and -0.4 percent for 2016, respectively (with reference to the CPI-based REER). Taking into account also the historical REER (CPI and ULC based) and model-based analysis that considers NIIP sustainability, on balance, staff assesses a 2016 gap of around 5 to 10 percent above the level consistent with medium-term fundamentals and desirable policies.	
Capital and financial accounts: flows and policy measures	**Background**. Financing conditions have continued to be favorable, with sovereign bond yields near historical lows. At the same time, the private sector has continued its deleveraging against the rest of the world. TARGET2 liabilities, accumulated by banks over 2011–12, increased during 2015–16 (by an annual average of 6 percent of GDP), reflecting the creation of liquidity by the Bank of Spain within the framework of the Eurosystem's asset purchase program. In this context of higher liquidity, some resident agents increased their investment in foreign assets or reduced their external debt. Recent capital outflows are also explained by a net FDI outflow. **Assessment**. The ECB's actions as well as domestic reforms and fiscal consolidation have greatly helped improve investor sentiment. However, large external financing needs both in the public and private sector leave Spain vulnerable to sudden changes in market sentiment and spillovers from Europe.	
FX intervention and reserves level	**Background**. The euro has the status of a global reserve currency. **Assessment**. Reserves held by the euro area are typically low relative to standard metrics, but the currency is free floating.	

	Spain (continued)
Technical Background Notes	1/ Based on data available through 2016:Q4. 2/ The EBA CA regression-based approach estimate would suggest a CA surplus of 1.8 percent of GDP. The estimated EBA CA norm is roughly 1 percentage points of GDP higher than in 2015 largely as a result of revised demographic projections, which point to a faster aging speed than previously anticipated. That said, the empirically-based EBA norm does not fully account for the very negative NIIP, with around a quarter of liabilities in the form of equity. Given external stability considerations, a CA norm in the range of 2–4 percent of GDP is necessary to strengthen the NIIP by about 5 percent of GDP annually over the next 5–10 years.

Appendix III. Risk Assessment Matrix

Source of Risks	Relative Likelihood	Impact if Realized	Policy response
External Risks			
Structural weak growth in key advanced economies	**High** Low productivity growth, failure to fully address crisis legacies and undertake structural reforms, and persistently low inflation undermine medium-term growth.	**Medium** Slowing external demand would weigh on growth and employment. A rise in NPLs could weaken banks' balance sheets. Persistently low imported Euro Area inflation would worsen private and public debt dynamics; low Euro Area inflation would make Spain's adjustment more difficult.	• Enhance labor market performance and lower duality. • Deepen product market reforms and other structural reforms to raise productivity. • Let automatic stabilizers play in case the output gap widens. • Continue strengthening the financial sector and its capacity to support growth.
Retreat from cross-border integration	**Medium** Could lead to protectionism and economic isolationism, reducing policy collaboration and negatively affecting cross-border flows and growth.	**Medium** Increased uncertainty regarding the future of Europe may affect confidence and investment. However, ECB policies mitigate against excessive financial volatility.	• 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.
European bank distress	**Medium** Strained balance sheets and weak profitability lead to financial distress in one or more major banks, with broader effects on the financial sector.	**Medium** Tightening of financial conditions; bank-sovereign-real economy links could re-emerge via loss of market confidence. However, the ECB's policies mitigate against excessive financial volatility	• Accelerate structural reforms and formulate credible medium-term fiscal path to support investor confidence. • Banks to continue building capital buffers. • Further ECB policy actions could help depending on the nature of the shock.
Policy uncertainty	**High** Uncertainty from two-sided risks to US growth, negotiation of post-Brexit arrangements, and evolving political processes (including elections).	**Medium** Weaker external demand from the U.K. and the euro area if knock-on effects are stronger than in the baseline. Trade and banking linkages are strong.	• Accelerate structural reforms and formulate credible medium-term fiscal path to support investor confidence. • Let automatic stabilizers play in case the output gap widens.
Significant slowdown in emerging economies	**Medium** Turning of credit cycle and lower potential growth generates disorderly household and corporate deleveraging in emerging economies.	**Low** Weaker growth, especially in Latin America, could reduce the profitability of Spain's global banks (and large corporates) which would weaken contributions to the parents' capital buffers. Trade linkages are limited.	• Continue strengthening the financial sector and its capacity to support growth. • Close coordination with supervisors in host countries.

Domestic Risks			
Weak implementation of fiscal commitments and structural reforms or reversal of past policy achievements	**Medium** Traction for structural reforms is low in a fragmented parliament with a minority government. A credible medium-term fiscal path has yet to emerge.	**High** Lack of or reversal of reforms and fiscal consolidation could weaken confidence, investment, and employment, which would adversely impact public debt dynamics and could trigger adverse market reactions.	• Advance ongoing 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.
Higher than estimated growth momentum created by past reforms	**High** Past labor market reforms reduce structural unemployment rate more than currently estimated, increasing the economy's potential to growth.	**Medium** Robust job creation could continue in the medium term without creating wage pressures. This would also sustain strong private consumption growth in the medium term.	• Use any windfall revenues to reduce the high public debt. • Continue structural reform efforts, given still considerable structural weaknesses.

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

Appendix IV. Debt Sustainability Analysis

Public debt sustainability risks remain sizeable, despite the reduction of the headline fiscal deficit over the last seven years. Under the baseline scenario, public debt is projected to decline slowly over the medium term from the peak of 100.4 percent of GDP in 2014, on the back of a favorable growth-interest rate differential. However, at 92.2 percent of GDP in 2022, debt would remain at a risky level. A negative growth shock and the realization of contingent liabilities represent the largest risks to public debt sustainability. Returning to a gradual but steady and credible fiscal consolidation remains a priority. An annual structural adjustment of about ½ percent of GDP over the medium term would put debt firmly on a downward path, bringing it to around 88 percent of GDP by 2022—4–5 percentage points lower than under the baseline. Gross financing needs have declined below the 20 percent of GDP early warning benchmark and are projected to continue to fall gradually over the medium term. However, at 19 percent of GDP in 2017 it is the highest in the euro area.

A. Public Debt Sustainability Analysis

Background

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

Developments. The public debt-to-GDP ratio increased from 35.5 percent of GDP in 2007 to 99.4 percent of GDP in 2016, driven by large fiscal deficits (of about 7½ percent of GDP on average during 2008–16), and a largely unfavorable growth interest rate differential until 2015 (which contributed an annual average of about 2½ percent of GDP). The support to the banking sector added about 4½–5 percent of GDP to the public debt stock.

Gross financing needs have declined below 20 percent of GDP after peaking at 22 percent in 2012, on the back of an ongoing maturity extension and nominal deficit reduction. The ECB's quantitative easing has helped bringing sovereign bond yields down. The 10-year bond yield has declined from about 6¾ percent in mid-2012 to about 1½ percent in July 2017. The effective interest rate on outstanding debt has also declined, and interest payments are expected to remain below 3 percent of GDP in 2017.

Other factors. The amortization profile of public debt is tilted towards the long term (92 percent of total debt, on a residual maturity basis). The marginal life at issuance has increased steadily since 2012, from 5 years to over 11 years in 2016, with the average life of outstanding debt increasing from 6.2 to 7 years over the same period. Holdings of public debt are relatively well diversified. The share of marketable debt held by the Spanish banking system has continued to fall to about 20 percent, while that of the ECB has increased to 18 percent. The share of public debt held by residents declined by 12 percentage points since 2012 to 55 by end-2016, but remains above the 2007 level (50 percent). The stock of financial assets has gradually declined since 2014 to about 33 percent of GDP in 2016. Nonetheless, the assets are a risk mitigating factor, with net public debt levels amounting to 80 percent of GDP.

Baseline

Public debt is projected to fall marginally to 98.6 percent of GDP in 2017, and continue declining slowly to 92.2 percent by 2022. Gross financing needs are expected to remain below 20 percent, and gradually decline over the projection period. However, at 15.8 percent of GDP in 2022, they would remain relatively high compared to other euro area countries.

Assumptions. The baseline scenario is based on the medium-term projections (Table 1). In particular, (i) growth is projected to be 3.1 percent in 2017 and moderate to 2.4 percent in 2018, as the effect of tailwinds dissipates; (ii) over the medium term, growth is set to converge toward its potential rate of around 1¾ percent; (iii) a structural adjustment of around ½ percent of GDP in 2017, followed by a broadly neutral fiscal stance over the medium term in structural primary terms; (iv) inflation (based on the GDP deflator) is projected to increase gradually from 0.3 percent in 2016 to 1¾ percent in 2022; and (v) long-term sovereign spreads are assumed to increase slowly from 1.2 percent in 2017 to 1.8 percent in the medium term, with 10-year bond yields increasing moderately over the medium term in line with a gradual normalization of monetary policy.

Stress tests

Public debt levels would either remain broadly flat or increase under a number of standard shock scenarios. Debt dynamics would worsen significantly if contingent liabilities were to materialize or the economy is hit by a combination of negative shocks to GDP growth and the primary balance, with the stock of public debt peaking in 2019 at around 113 percent of GDP and 107 percent of GDP, respectively.

Growth shock. In this scenario, real GDP growth rates are assumed to be lower than in the baseline by one (10-year historical) standard deviation for two consecutive years, in 2018–19. This would imply real GDP would decline on average by 0.5 percent per year, compared to annual average growth of 2.2 percent under the baseline. Under this recession scenario, inflation would be lower and the primary balance weaker (by about 2 percent of GDP per year, on average). In this context, the debt-to-GDP ratio would raise substantially, reaching 106 percent of GDP in 2019 before declining slowly to 101.8 percent in 2022 (about 9 percentage points higher than the baseline). Meanwhile, gross financing needs would increase slightly above the 20 percent benchmark level reaching 20.6 percent in 2019, due to the larger fiscal deficit.

Primary balance shock. This scenario assumes a relaxation of fiscal policy in 2018–19, with a cumulative deterioration of the primary balance of 2 percent of GDP (that is, assuming a shock equal to ½ the 10-year historical standard deviation of the primary balance-to-GDP ratio). Under this scenario, the public debt-to-GDP ratio would continue to increase, peaking at 99.2 percent of GDP in 2019 and then declining gradually to 93.8 percent of GDP in 2022, 1.2 percentage points higher than in the baseline. The larger primary deficits would also imply more sizable gross financing requirements than in the baseline.

Interest rate shock. Over the five-year forecast horizon, the debt dynamics could withstand relatively well a nominal interest rate shock of about 240 basis points during 2018–22, 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 4.0 percent by 2022 compared to 2.8 percent in the baseline. The debt-to-GDP ratio would remain broadly stable, amounting to 94.6 percent in 2022. However, a sizeable and sustained increase in interest rates would reduce the (already limited) fiscal space.

Combined shock. A simultaneous combination of the previous three shocks would be particularly adverse for public debt dynamics, mostly due to the impact of lower growth and higher primary deficits. In this scenario, the public debt-to-GDP ratio would increase to 107.1 percent in 2019, remaining near this high level through 2022 (almost 13 percentage points higher than under the baseline). Gross financing needs would also be significantly higher, peaking at over 21.3 percent of GDP in 2019.

Contingent liability shock. Large, negative unexpected events could put debt sustainability at risk. A negative financial sector shock scenario, assuming a one-time increase in non-interest public expenditures (in 2018) equivalent to 10 percent of banking sector assets, combined with lower growth and lower inflation in 2018–19 (i.e., growth is reduced by 1 standard deviation) would be particularly adverse for public debt dynamics. The materialization of such contingency liabilities would raise the primary deficit to 10 percent of GDP in 2018, bringing gross financing needs to 27.7 percent of GDP (about 8 percentage points above standard early warning benchmark levels). Moreover, the debt-to-GDP ratio would continue to increase, peaking at 113 percent in 2019, then slowly declining to about 109.3 percent in 2022 (about15 percentage points higher than the baseline).

Heat Map

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

B. External Debt Sustainability Analysis

Under the baseline scenario, external debt is projected to decline over the medium term, from the peak of 169.1 percent of GDP in 2015 to about 144 percent of GDP in 2022, helped by the accumulation of trade surpluses. Although it will take time to significantly lower Spain's vulnerability to external shocks, some mitigating factors include the current low cost of debt, the limited share of debt denominated in foreign currency, a favorable maturity structure, and diversified exports and bank exposure.

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

Baseline. As for the public DSA, the baseline scenario is based on the medium-term projections (Table 1). In particular, it assumes a gradual convergence of real GDP growth over the medium term to its estimated potential growth rate of around 1¾ percent of GDP. The trade surplus is forecast to improve somewhat and the external current account balance would remain around 2 percent of GDP. After falling to 168 percent of GDP at end-2016, external debt is projected to decline to 144 percent of GDP in 2022. Driven by continued strong export performance, the external debt-to-exports ratio is projected to sharply decline (by around 100 percentage points) during 2017–22. Gross external financing needs will continue to decrease in the projection period, but are expected to remain high (around 62 percent of GDP in 2022).

Alternative scenarios. Alternative external DSA scenarios, including stress tests, suggest that Spain's external debt will remain high but gradually decline over the medium term unless key macroeconomic variables return to levels of the crisis episode, in which case external debt would increase. Overall, the external debt level remains a vulnerability factor given the risks surrounding the economic outlook over the medium term.

Historical shock scenario. The external debt path would fail to stabilize in a scenario based on historical data properties (2007–2016 period). Assuming a real GDP growth path of 0.4 percent since 2018, combined with a nominal external interest rate higher by 0.3 percentage points than in the baseline scenario, external debt would increase to 197 percent of GDP by 2022.

Interest rate shock. In the case of a one-half standard deviation interest rate shock (an increase from 2.5 percent in the baseline to 2.9 percent), external debt would be higher by 3 percentage points than in the baseline scenario at end-2022.

Growth shock. Assuming that real GDP growth averages 0.6 percent between 2018 and 2022, compared with 2 percent in the baseline, external debt would reach 154 percent of GDP in 2022.

Non-interest current account shock. A stress scenario in which the current account surplus (excluding interest payments) averages 3.7 percent of GDP, rather than 5.7 percent as in the baseline projection, leads to an external debt stock of 153 percent of GDP in 2022.

Combined shock. 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 155 percent in 2022.

Real depreciation shock. Compared to the baseline projection, a 30 percent real depreciation shock would increase the external debt ratio by 1 percentage point of GDP in 2022. In the external DSA, the mechanic transmission channel is via valuation effects, but Spain has a low share of debt denominated in foreign currency.

Spain Public DSA – Risk Assessment

Heat Map

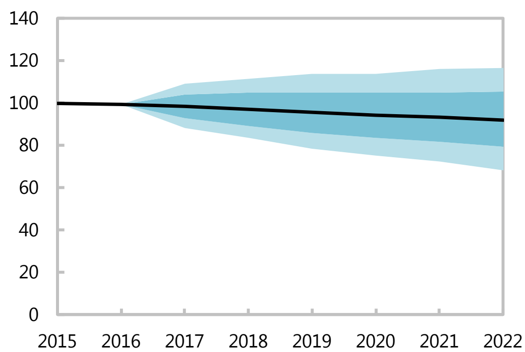
Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	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

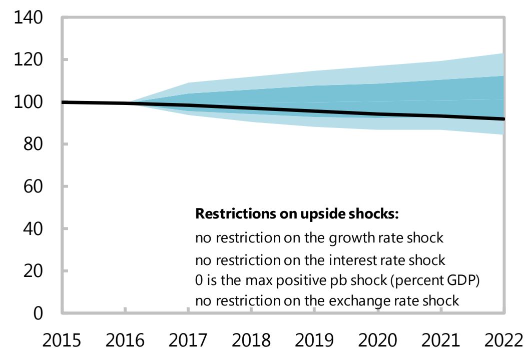
(in percent of GDP)

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

Symmetric Distribution



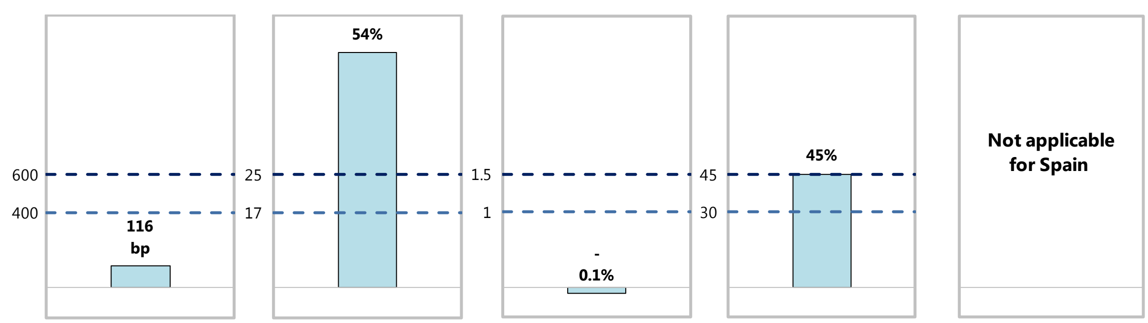
Restricted (Asymmetric) Distribution



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2016)

Spain Lower early warning Upper early warning



Bond spread	**External Financing Requirement**	**Annual Change in Short-Term Public Debt**	**Public Debt Held by Non-Residents**	**Public Debt in Foreign Currency**
(in basis points) 4/	(in percent of GDP) 5/	(in percent of total)	(in percent of total)	(in percent of total)

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.

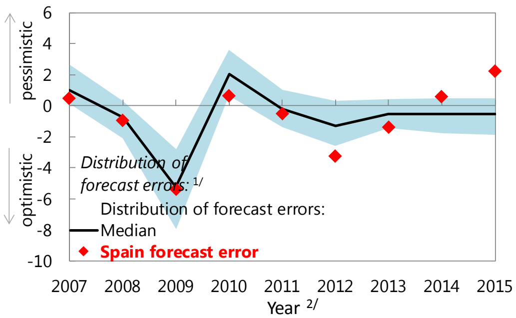
4/ Long-term bond spread over German bonds, an average over the last 3 months, 15-Apr-17 through 14-Jul-17.

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.

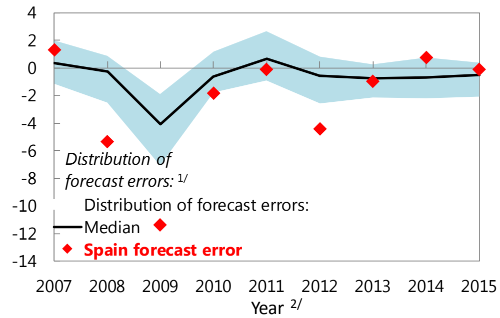
Spain Public DSA – Risk Assessment

Forecast Track Record, versus all countries

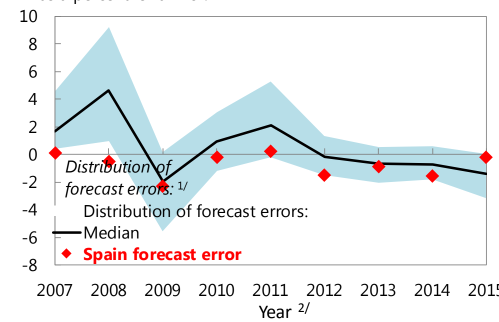
Real GDP Growth
(in percent, actual-projection)
Spain median forecast error, 2007-2015: **-0.48**
Has a percentile rank of: **51%**



Primary Balance
(in percent of GDP, actual-projection)
Spain median forecast error, 2007-2015: **-0.95**
Has a percentile rank of: **39%**

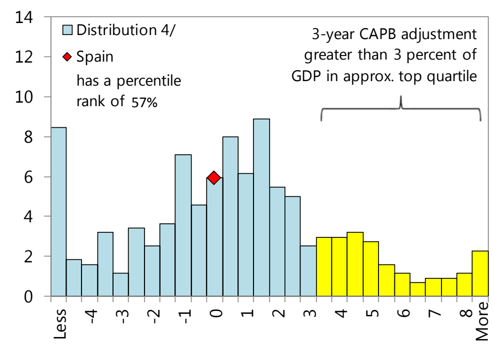


Inflation (Deflator)
(in percent, actual-projection)
Spain median forecast error, 2007-2015: **-0.54**
Has a percentile rank of: **28%**

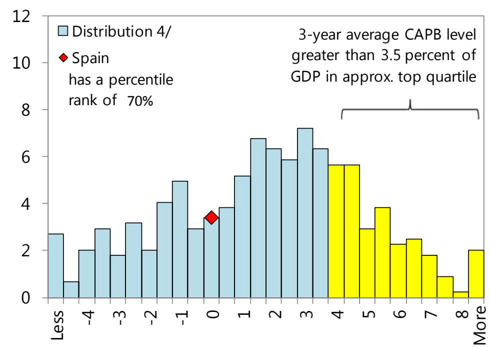


Assessing the Realism of Projected Fiscal Adjustment

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

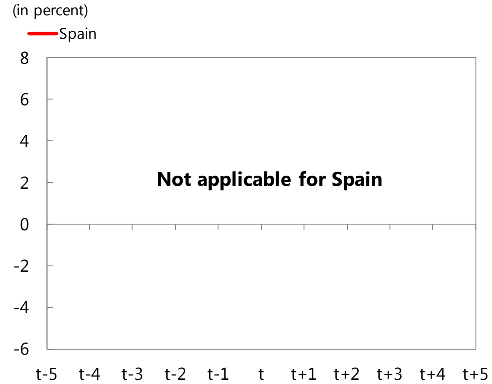


3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



Boom-Bust Analysis [3/]

Real GDP growth
(in percent)



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

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

(in percent of GDP unless otherwise indicated)

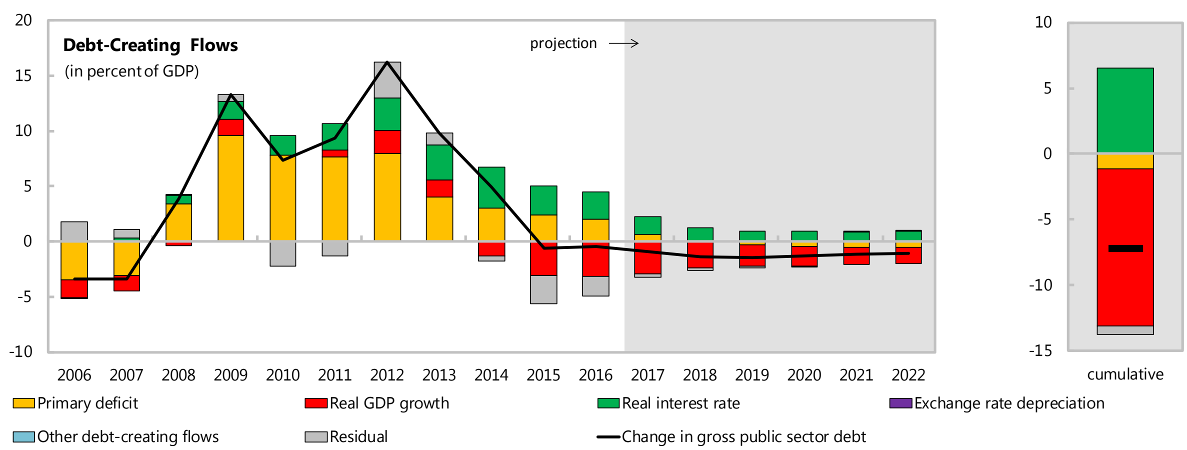
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2006-2014 [2/]	2015	2016	2017	2018	2019	2020	2021	2022
Nominal gross public debt	64.2	99.8	99.4	98.5	97.1	95.6	94.3	93.2	92.2
Public gross financing needs	15.1	20.0	19.4	19.1	16.9	16.4	16.1	15.9	15.8
Real GDP growth (in percent)	0.1	3.2	3.2	3.1	2.5	2.0	1.9	1.7	1.7
Inflation (GDP deflator, in percent)	1.1	0.5	0.3	1.2	1.5	1.7	1.6	1.7	1.8
Nominal GDP growth (in percent)	1.3	3.7	3.6	4.3	4.0	3.8	3.5	3.4	3.5
Effective interest rate (in percent) [4/]	4.1	3.2	2.9	2.9	2.8	2.7	2.7	2.7	2.8

As of July 14, 2017		
Sovereign Spreads		
EMBIG (bp) 3/		98
5Y CDS (bp)		64
Ratings	Foreign	Local
Moody's	Baa2	Baa2
S&Ps	BBB-	BBB-
Fitch	BBB	BBB

Contribution to Changes in Public Debt

	Actual			Projections							
	2006-2014	2015	2016	2017	2018	2019	2020	2021	2022	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	6.5	-0.6	-0.5	-0.9	-1.4	-1.5	-1.3	-1.1	-1.0	-7.2	
Identified debt-creating flows	6.1	1.9	1.4	-0.6	-1.2	-1.3	-1.2	-1.2	-1.1	-6.6	
Primary deficit	4.1	2.4	2.0	0.6	0.0	-0.3	-0.5	-0.5	-0.5	-1.1	-0.6
Primary (noninterest) revenue and grants	37.4	38.3	37.6	38.1	38.0	37.8	37.7	37.6	37.4	226.6	
Primary (noninterest) expenditure	41.5	40.7	39.6	38.8	38.0	37.5	37.2	37.0	36.9	225.5	
Automatic debt dynamics [5/]	2.0	-0.5	-0.6	-1.3	-1.2	-1.0	-0.7	-0.6	-0.6	-5.5	
Interest rate/growth differential [6/]	2.0	-0.5	-0.6	-1.3	-1.2	-1.0	-0.7	-0.6	-0.6	-5.5	
Of which: real interest rate	1.9	2.6	2.5	1.6	1.2	0.9	1.0	0.9	0.9	6.5	
Of which: real GDP growth	0.1	-3.1	-3.1	-2.9	-2.4	-1.9	-1.7	-1.5	-1.5	-12.0	
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	
Please specify (1) (e.g., drawdown of deposits) (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (2) (e.g., ESM and Euroarea loans)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	0.4	-2.5	-1.9	-0.3	-0.2	-0.2	0.0	0.0	0.1	-0.6	



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 - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) 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 - π (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.

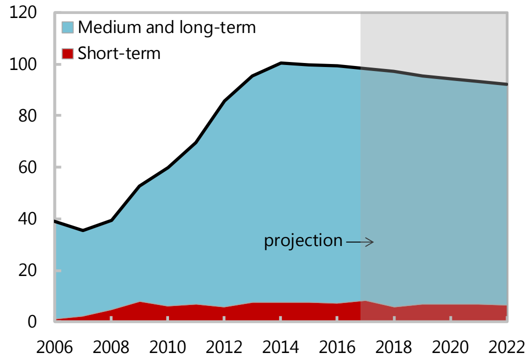
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Spain Public DSA – Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

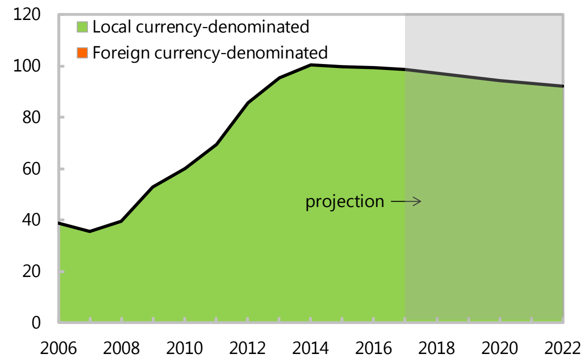
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

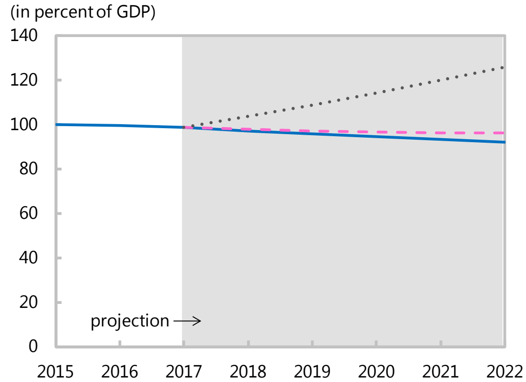


Alternative Scenarios

Baseline Historical Constant Primary Balance

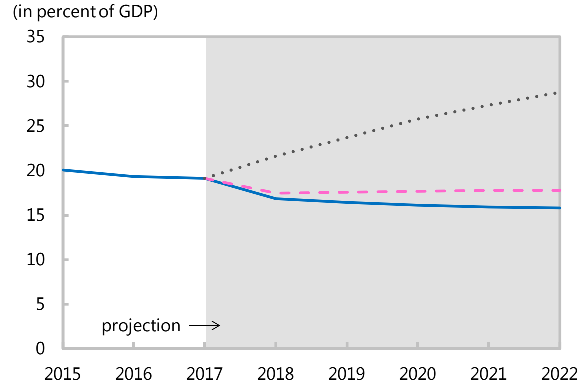
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

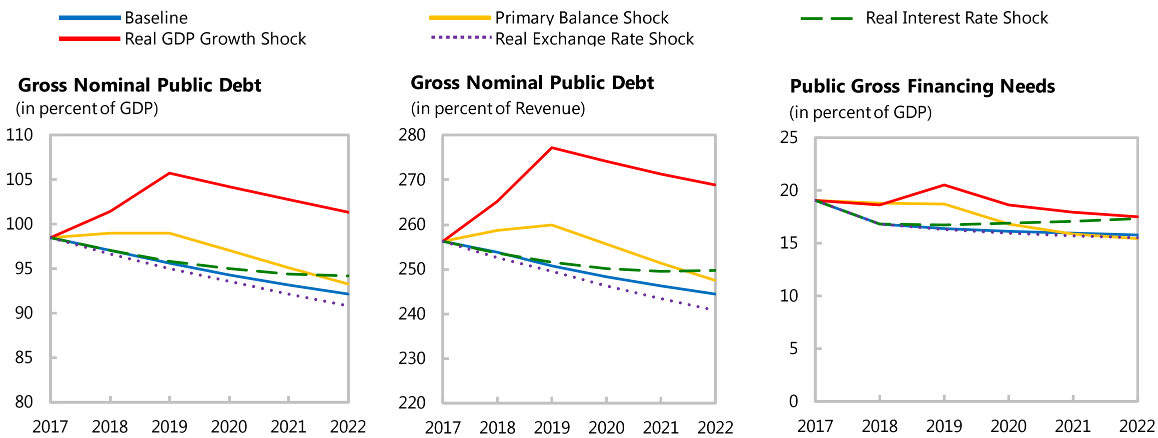
Baseline Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	3.1	2.5	2.0	1.9	1.7	1.7
Inflation	1.2	1.5	1.7	1.6	1.7	1.8
Primary Balance	-0.6	0.0	0.3	0.5	0.5	0.5
Effective interest rate	2.9	2.8	2.7	2.7	2.7	2.8
Constant Primary Balance Scenario						
Real GDP growth	3.1	2.5	2.0	1.9	1.7	1.7
Inflation	1.2	1.5	1.7	1.6	1.7	1.8
Primary Balance	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6
Effective interest rate	2.9	2.8	2.7	2.7	2.7	2.8

Historical Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	3.1	0.4	0.4	0.4	0.4	0.4
Inflation	1.2	1.5	1.7	1.6	1.7	1.8
Primary Balance	-0.6	-4.5	-4.5	-4.5	-4.5	-4.5
Effective interest rate	2.9	2.8	3.0	3.2	3.4	3.7

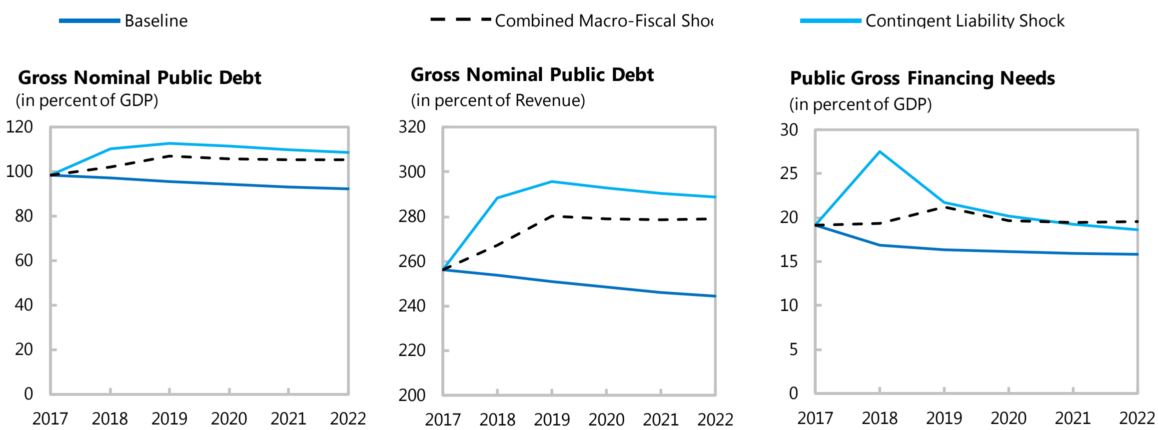
Source: IMF staff.

Spain Public DSA – Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

Primary Balance Shock	2017	2018	2019	2020	2021	2022
Real GDP growth	3.1	2.5	2.0	1.9	1.7	1.7
Inflation	1.2	1.5	1.7	1.6	1.7	1.8
Primary balance	-0.6	-2.0	-1.3	1.0	1.1	1.0
Effective interest rate	2.9	2.8	2.8	2.8	2.8	2.9
Real Interest Rate Shock						
Real GDP growth	3.1	2.5	2.0	1.9	1.7	1.7
Inflation	1.2	1.5	1.7	1.6	1.7	1.8
Primary balance	-0.6	0.0	0.3	0.5	0.5	0.5
Effective interest rate	2.9	2.8	3.1	3.4	3.7	4.0
Combined Shock						
Real GDP growth	3.1	-0.1	-0.6	1.9	1.7	1.7
Inflation	1.2	0.8	1.1	1.6	1.7	1.8
Primary balance	-0.6	-2.0	-2.2	0.5	0.5	0.5
Effective interest rate	2.9	2.8	3.2	3.4	3.7	4.1

Real GDP Growth Shock	2017	2018	2019	2020	2021	2022
Real GDP growth	3.1	-0.1	-0.6	1.9	1.7	1.7
Inflation	1.2	0.8	1.1	1.6	1.7	1.8
Primary balance	-0.6	-1.3	-2.2	0.5	0.5	0.5
Effective interest rate	2.9	2.8	2.8	2.8	2.8	2.9
Real Exchange Rate Shock						
Real GDP growth	3.1	2.5	2.0	1.9	1.7	1.7
Inflation	1.2	1.9	1.7	1.6	1.7	1.8
Primary balance	-0.6	0.0	0.3	0.5	0.5	0.5
Effective interest rate	2.9	2.8	2.7	2.7	2.7	2.8
Contingent Liability Shock						
Real GDP growth	3.1	-0.1	-0.6	1.9	1.7	1.7
Inflation	1.2	0.8	1.1	1.6	1.7	1.8
Primary balance	-0.6	-10.0	0.3	0.5	0.5	0.5
Effective interest rate	2.9	2.9	3.1	3.0	3.0	3.1

Source: IMF staff.

Spain External Debt Sustainability Framework, 2012-2022

(In percent of GDP, unless otherwise indicated)

	Actual							Projections					
	2012	2013	2014	2015	2016			2017	2018	2019	2020	2021	2022
1 **Baseline: External debt**	166.2	159.8	167.7	169.1	167.7			**166.0**	**161.0**	**156.1**	**151.7**	**147.6**	**143.6**
2 Change in external debt	5.8	-6.3	7.8	1.4	-1.4			-1.8	-4.9	-4.9	-4.4	-4.1	-4.0
3 Identified external debt-creating flows (4+8+9)	4.6	-4.0	-7.1	-7.4	-8.7			-7.9	-6.9	-6.2	-5.8	-5.4	-5.5
4 Current account deficit, excluding interest payments	-4.3	-5.5	-4.6	-4.6	-5.0			-4.8	-5.0	-5.3	-5.6	-6.0	-6.4
5 Deficit in balance of goods and services	-1.5	-3.3	-2.5	-2.4	-2.9			-2.9	-3.2	-3.3	-3.5	-3.6	-3.7
6 Exports	30.7	32.3	32.7	33.2	33.1			34.8	35.5	36.2	36.9	37.6	38.3
7 Imports	-29.2	-29.0	-30.2	-30.7	-30.1			-31.9	-32.3	-32.8	-33.4	-34.0	-34.6
8 Net non-debt creating capital inflows (negative)	-2.2	-4.0	-4.3	-2.7	-1.1			-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
9 Automatic debt dynamics 1/	11.2	5.6	1.8	-0.2	-2.7			-2.1	-0.9	0.2	0.9	1.6	2.0
10 Contribution from nominal interest rate	4.6	4.0	3.5	3.2	3.1			3.0	3.1	3.4	3.7	4.0	4.4
11 Contribution from real GDP growth	5.2	2.8	-2.2	-6.2	-5.3			-5.0	-4.0	-3.2	-2.8	-2.4	-2.4
12 Contribution from price and exchange rate changes 2/	1.4	-1.2	0.4	2.8	-0.5			...	...	...	...	...	...
13 Residual, incl. change in gross foreign assets (2-3) 3/	1.2	-2.4	15.0	8.9	7.3			6.1	2.0	1.2	1.4	1.3	1.4
External debt-to-exports ratio (in percent)	540.8	495.6	513.0	509.8	507.3			476.6	453.8	431.6	411.2	392.5	374.5
Gross external financing need (in billions of US dollars) 4/	1123.8	1058.0	962.4	968.2	881.5			900.5	922.6	938.5	944.8	948.8	949.7
in percent of GDP	84.1	77.7	69.8	81.1	71.5			71.0	69.1	67.6	65.7	64.0	62.2
Scenario with key variables at their historical averages 5/						10-Year Historical Average	10-Year Standard Deviation	**166.0**	**173.7**	**179.7**	**185.6**	**191.3**	**197.0**
Key Macroeconomic Assumptions Underlying Baseline													
Real GDP growth (in percent)	-2.9	-1.7	1.4	3.2	3.2	0.4	2.6	3.1	2.5	2.0	1.9	1.7	1.7
GDP deflator in US dollars (change in percent)	-7.5	3.7	-0.2	-16.1	0.0	-0.2	8.5	-0.1	2.6	1.9	1.7	1.4	1.3
Nominal external interest rate (in percent)	2.5	2.5	2.2	1.7	1.9	2.8	0.8	1.8	2.0	2.2	2.4	2.7	3.0
Growth of exports (US dollar terms, in percent)	-4.7	6.9	2.5	-12.1	2.9	3.3	12.2	8.4	7.2	6.0	5.6	5.1	5.0
Growth of imports (US dollar terms, in percent)	-10.0	1.1	5.6	-11.9	1.2	0.5	14.0	9.1	6.5	5.6	5.4	4.8	4.9
Current account balance, excluding interest payments	4.3	5.5	4.6	4.6	5.0	1.8	3.9	4.8	5.0	5.3	5.6	6.0	6.4
Net non-debt creating capital inflows	2.2	4.0	4.3	2.7	1.1	1.5	2.0	1.0	1.0	1.0	1.0	1.0	1.0

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

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

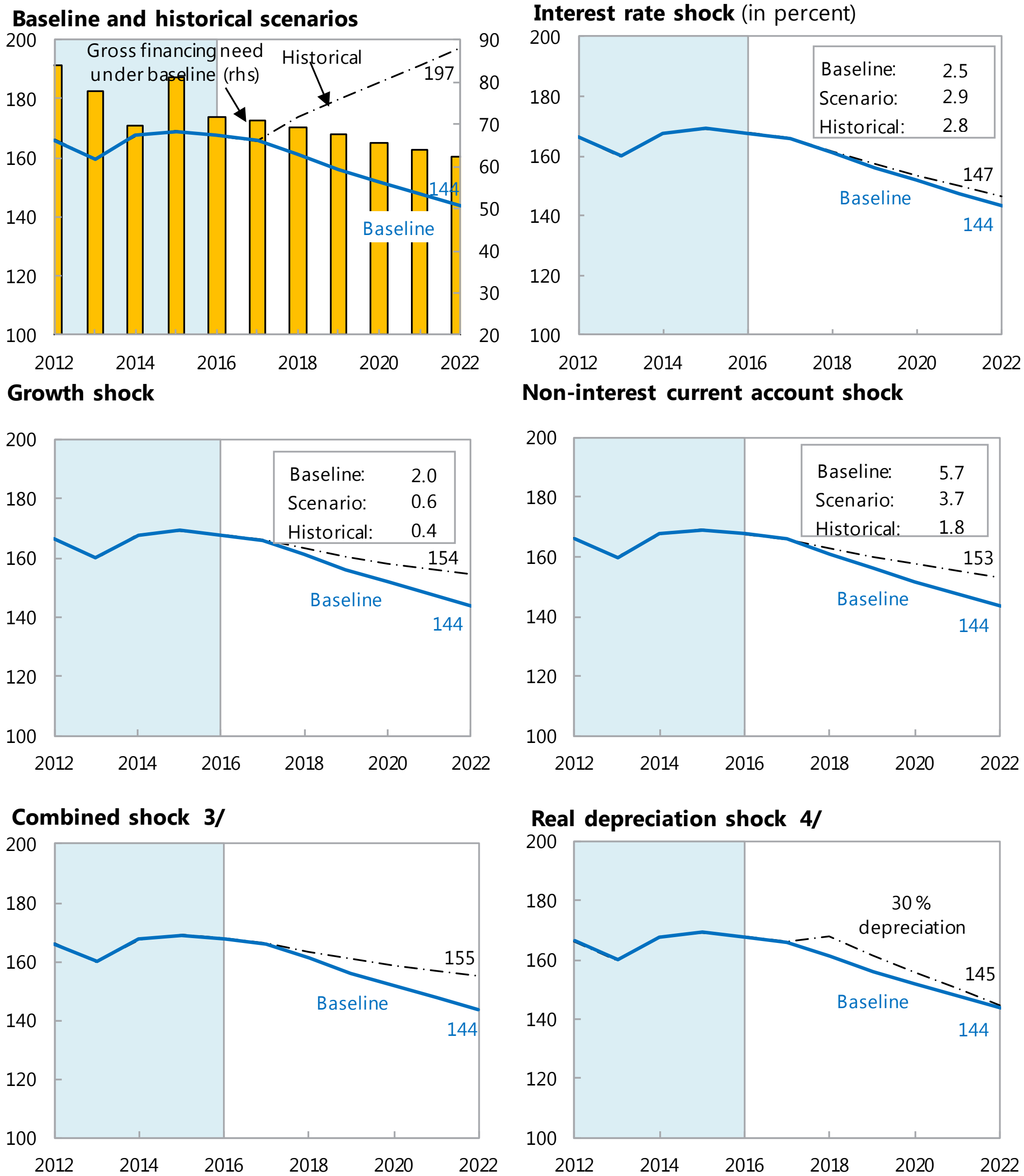
3/ For projection, line includes the impact of price and exchange rate changes.

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

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

Spain External Debt Sustainability – Bound Tests 1/ 2/

(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2018.

INTERNATIONAL MONETARY FUND

SPAIN

August 8, 2017

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By European Department

CONTENTS

FUND RELATIONS

(As of June 30, 2017)

Membership Status: Joined September 15, 1958.

General Resources Account:	SDR Million	Percent of Quota
Quota	9,535.50	100.00
Fund holdings of currency	8,736.58	91.62
Reserve position in Fund	798.94	8.38
Lending to the Fund		
New Arrangements to Borrow	425.23	

SDR Department:	SDR Million	Percent of Allocation
Net cumulative allocation	2,827.56	100.00
Holdings	2,782.25	98.40

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				
	2017	2018	2019	2020	2021
Principal					
Charges/Interest	0.14	0.35	0.35	0.35	0.35
Total	0.14	0.35	0.35	0.35	0.35

2017 Article IV Consultation: Discussions took place in Madrid during July 4–18, 2017. The staff team comprised Ms. Andrea Schaechter (head), Messrs. John Ralyea, Jorge Salas, Ara Stepanyan (all EUR), Mr. Phakawa Jeasakul (MCM), and Ms. Hanni Schoelermann (EUO). Mr. Jorge Dajani (Alternate Executive Director), and Ms. Estefania Sanchez Rodriguez (Advisor to the Executive Director) attended the discussions. Ms. Nina Budina and Mr. Daehaeng Kim (EUR) contributed to the report. Mmes. Tingyun Chen and Dilcia Noren (EUR) supported the mission from headquarters. The mission met Economy, Industry and Competitiveness Minister De Guindos, Finance and Public Functions Minister Montoro, Bank of Spain Governor Linde, and other senior officials. The mission also met with representatives of the financial sector, industry, trade unions, academia, think tanks, parliament, and political parties. The concluding statement was published and the staff report is expected to be published as well. Spain is on a standard 12-month cycle. The last Article IV consultation was concluded on January 27, 2017 (IMF Country Report No. 17/23).

Financial Sector Assessment Program (FSAP): An FSAP Update was conducted between October 2016 and July 2017 and included several missions. The FSAP team met with the Spanish authorities, the ECB, as well as representatives from banks, insurance companies and professional associations. The 2017 Financial Sector Stability Assessment (FSSA) is being discussed by the IMF Board in conjunction with the 2017 Article IV consultation.

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 June 30, 2017)

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 June 30, 2017)

	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]	Memo Items: Data Quality – Accuracy and reliability[9]
Exchange Rates	June 2017	June 2017	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	May 2017	June 2017	M	M	M		
Reserve/Base Money	May 2017	June 2017	M	M	M	O,O,LO,LO	O,O,O,O,LO
Broad Money	May 2017	June 2017	M	M	M		
Central Bank Balance Sheet	May 2017	June 2017	M	M	M		
Consolidated Balance Sheet of the Banking System	May 2017	June 2017	M	M	M		
Interest Rates[2]	June 2017	June 2017	D	D	D		
Consumer Price Index	June 2017	June 2017	M	M	M	O,O,O,O	LO,O,LO,O,O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q1 2017	June 2017	Q	Q	Q	LO,O,LO,O	LO,O,O,O,LO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	May 2017	June 2017	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	April 2017	June 2017	M	M	M		
External Current Account Balance	April 2017	June 2017	M	M	M	O,LO,LO,O	LO,O,LO,O,LO
Exports and Imports of Goods and Services	April 2017	June 2017	M	M	M		
GDP/GNP	Q1 2017	May 2017	Q	Q	Q	O,O,O,O	LO,LO,O,O,O
Gross External Debt	Q1 2017	June 2017	Q	Q	Q		
International Investment position[6]	Q1 2017	June 2017	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 on Spain
September 20, 2017

This statement provides information that has become available since the issuance of the staff report on August 8, 2017. The thrust of the staff appraisal remains unchanged.

1. Latest economic data point to a continuation of the economic recovery:

- Headline inflation edged up to 1.6 percent in August on a 12-month basis, 0.1 percentage point higher than in July and June, while core inflation decelerated to 1.2 percent—0.2 percentage point lower than the July reading. The divergence in paths between headline and core inflation is driven by increased fuel prices, which more than offset deceleration pressures coming from services inflation.

- Employment grew by 2.8 percent y-o-y in the second quarter of 2017 bringing the number of unemployed down to 3.9 million, the lowest level since 2009:Q1.

- Detailed national accounts data for the second quarter confirmed the flash estimate of real GDP growth of 0.9 percent q-o-q. The composition of first quarter GDP growth was revised and now shows somewhat higher public consumption as well as one percentage point lower import and export growth rates.

- The non-performing loan ratio for banks' operations in Spain declined to 8.4 percent at end-June from 8.9 percent at end-March.

2. Spain's National Statistics Institute revised historical national accounts data for the period 2014–16. This resulted in an upward revision of real GDP growth in 2015 and 2016 to 3.4 and 3.3 percent respectively compared with the previous estimate of 3.2 percent for each year. There have been also some revisions to GDP deflators. Consequently, in 2016, the level of GDP at current prices is now 0.4 percent higher compared with the previous estimate. In terms of the composition of growth for 2016, revised data suggest slightly lower growth of final consumption (2.5 percent vs. 2.6 percent); lower growth of gross capital formation (3.1 percent vs. 3.8 percent); and a stronger contribution of external demand (0.7 percentage point vs 0.5 percentage point).

**Statement by Jorge Dajani, Alternate Executive Director for Spain,
Estefanía Sanchez Rodriguez, Advisor to the Executive Director, and
Fernando Lopez, Advisor to the Executive Director
September 20, 2017**

On behalf of the Spanish authorities, we would like to thank Ms. Schaechter and Mr. Das and their teams for the candid dialogue held during last year and for their insightful analysis on the Article IV Report and the FSSA. Both exercises present a good picture of the current economic situation and challenges, acknowledging that bold structural reforms are the main drivers behind Spain's solid economic performance. Reforms have significantly reduced imbalances, allowing the economy to become more competitive and to fully harness current tailwinds. The authorities highly value the many constructive and useful economic policy recommendations and have a common understanding that any reversal of reforms would be a step backwards. Thus, they are fully committed to continuing the reform processes in key sectors, including the financial sector. The FSSA acknowledges the significant reforms undertaken since 2012 and the substantial progress achieved in increasing the resilience and solvency of the banking system.

Recent economic performance

Throughout 2017 Spain continued the expansionary trend that started four years ago, outperforming the Eurozone and the world's largest economies, and recovering the level of real income before the crisis. The IMF's latest upward revision for 2017 estimates GDP growth at 3.1 percent, in line with authorities' estimates. Moreover, the report acknowledges the increasing role of the external sector in supporting growth. During 2017 the Spanish economy has continued to reduce its imbalances: private and public debt, public deficit, unemployment and the net investment position. This virtuous circle that the IMF has labelled as "impressive recovery" is based precisely on the implementation of an ambitious reform agenda which has rendered the economy more competitive. Moreover, Spain is a case in point for showcasing the compatibility of both deleveraging and fiscal consolidation with solid economic growth thanks to structural reforms.

Labor market

Sustained high economic growth has been job-rich in all sectors of the economy, with employment creation currently growing around 3 percent. The number of unemployed has fallen below 4 million for the first time since 2008. IMF's projections for 2018 are broadly in line with authorities' estimates, with the unemployment rate expected to hover around 15 percent, well below the 27 percent peak reached during the crisis. Spain has already recovered close to half of the employment lost. Furthermore, youth unemployment continues to fall at historical maximum rates of 16 percent and long-term unemployment is falling at rates of over 20 percent. This intense job creation and unemployment reduction has helped to reduce inequality in Spain since 2014. In this context, the authorities would specifically like to welcome the emphasis of the Staff Report on active labor market policies, and the very useful Fund's policy advice on this issue.

The Government is cognizant of the need to tackle duality in the labor market. It has recently adopted specific measures to reduce it and to make permanent contracts more attractive. On this issue, the authorities have pointed out that IMF's recommendation to introduce a single open contract is not the best option to increase the attractiveness of permanent hiring for employers and to reduce duality.

External sector

In the coming years, the Spanish economy is expected to record surpluses in the current account balance of around 2 percent of GDP. This year will mark the fifth consecutive year of current account surplus, and the sixth year as a net lender to the world. Consequently, the NIIP and the ratio of external debt to GDP are expected to continue their downward trend in the future. Export growth, which is estimated to grow at 6 percent in 2017, has been a main driver of this correction. The positive behavior of exports can be explained by competitiveness gains derived from contained unit labor costs and by the increasing capacity of corporates to implement ambitious internationalization plans.

Fiscal Policy

The authorities concur with staff 's recommendations to continue with fiscal consolidation; there is a firm commitment to reduce public deficit and debt. During the first half of 2017, public deficit (excluding local Government) has been reduced by more than 22 percent, and there is broad consensus that the target of 3.1 percent of GDP for 2017 will be achieved. Staff's proposal to increase the VAT base and other environmental taxes is not shared by the authorities, as there has already been a significant shift towards indirect taxes. Moreover, proposals in this regard would require a thorough analysis of the potential costs and consequences in terms of competitiveness and equity.

The authorities appreciate staff's analysis in the SIP on the future of the pension system. They concur with staff on the need to continue ensuring financial sustainability while also considering social acceptability. The uncertainty surrounding population projections and assumptions underlying long-run macroeconomic projections are key elements that must be assessed with caution when making short-term recommendations to fine tune the system.

Private sector deleveraging

The remarkable deleveraging process of the private sector has continued throughout 2017. Spain's private deleveraging of both the corporate and the household sectors, by more than

50 percentage points of GDP since the peak, places their leverage ratios broadly in line with European peers. This process is concentrated in the real estate and construction sectors and it has been compatible with increased new credit flows to SMEs in industry and export-oriented sectors. The deep financial reforms undertaken have been key to foster deleveraging and to improve the banking system's capacity to finance the economic recovery.

Financial sector

The 2017 FSAP was carried out in a very different context from the last FSAP exercise in 2012. The bold reforms undertaken by the authorities since 2012, in line with IMF recommendations, have turned around the Spanish financial system which is now more resilient and solvent.

Spanish banks have continued to strengthen their capital ratios which is especially remarkable given that they have structurally higher asset densities than their European peers. The total capital ratio increased to 14.8 percent by end-2016. The system is in a good position to withstand severe shocks, as evidenced by the stress testing exercise results conducted under very extreme adverse scenarios.

NPLs have declined by 40 percent over three years, currently standing at 5.5 percent (1Q2017), very close to the EU average. This NPL reduction, which has taken place in a context of strong deleveraging, has been enabled by ambitious provisioning efforts and regulatory changes approved in 2012 that increased loss absorption capacity by more than 80 billion and helped build buffers.

SAREB, the asset management company, has been instrumental in the cleanup of bank balance-sheets, successfully limiting the fallout from the banking crisis. The experience of SAREB showcases the usefulness of asset management companies in dealing with legacy assets and reviving the lending channel. While there is broad agreement on the need to continue monitoring closely SAREB's medium term business plan, the authorities have pointed out that there is already a monitoring commission in place and the proposal to include FROB could raise potential conflicts of interest.

Liquidity analysis in the FSSA shows that all banks would have enough liquid assets to cover outflows for longer than a year. On this point, the authorities do not share concerns about an excessive reliance on ECB funding as there is no reason to expect a disorderly unwinding in the liquidity provision by the ECB that may trigger funding tensions. The excess of liquidity will be reduced in the medium term but this will be a gradual process.

The authorities concur that the current low interest rate environment places growing pressure on net interest margins, as the room for further decreases in financial costs is becoming increasingly limited. However, steepening of the yield curve may benefit Spanish banks in the medium term, given the prevalence of variable rates in their loan book. The results of the IRRBB (interest rate risk in the banking book) stress test recently conducted by the SSM has confirmed that Spanish banks are well positioned for an increase in rates. Moreover, the authorities would like to stress that, based on data from the latest EBA Stress Test exercise, the sovereign exposure of Spanish Banks is like the European average (13 percent for Spain and 11.5 percent on average for European banks).

The bank resolution framework has strengthened significantly following the transposition of the BRRD (bank recovery and resolution directive) into Spanish law. The new framework has contributed to break the bank sovereign nexus and to preserve taxpayers' money. The resolution of Banco Popular, the first carried out under the Single Resolution Board, is a case in point. All deposits were saved and no public funds were involved in the process, without any adverse effects on financial stability.

Having left the banking crisis behind, the Spanish authorities are determined to continue enhancing the resilience of the banking sector. In this process, they see FSSA findings and analysis as very useful and aligned with Spanish policy priorities. Particularly, authorities attach great value to the insightful FSAP recommendations regarding profitability and liquidity management of the banking system. They also agree on the need to improve institutional arrangements for macroprudential policy setting and see merit on staff's recommendation to establish a Systemic Risk Council.

Efforts are already under way to further strengthen the effectiveness, coordination and independence of the institutional supervisory authorities. The report acknowledges the positive reforms currently being undertaken: integrating accounting competences in the Securities and Exchange Commission (CNMV); setting up an independent supervisory agency for insurers and pension funds; and setting up a new Ombudsman to protect consumers. Other measures to be adopted soon include the new Mortgage Credit Law that will increase transparency requirements, and the transposition of MiFID II which will improve investor protection and foster SME's access to funding. Similarly, a new regulation will be adopted to further strengthen the transparency of the appointment system for the senior staff of financial authorities, as well as their accountability.