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SPAIN

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SPAIN

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June 20, 2014

Approved By
The European Department

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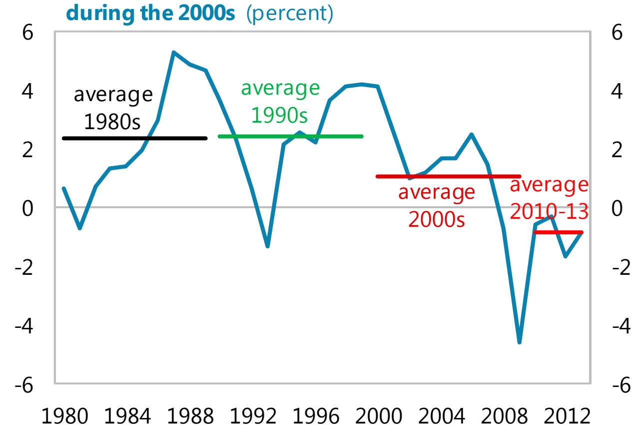
WHAT IS SPAIN'S SUSTAINABLE GROWTH RATE?[1]

A key question for policy makers is how much can Spain grow over the medium term. The answer to this question will determine what will happen to unemployment, living standards, public debt, and many other critical economic variables. This note attempts to shed some light on medium-term growth prospects by looking into the key factors driving potential growth, both in the past and likely in the future, and international experience of countries in the aftermath of financial crisis. The note suggests Spain is likely to face a long period of moderate growth (around 1½–2 percent) and high unemployment; but, policy action, especially directed towards reducing structural unemployment and raising productivity, could lead to much better outcomes.

A. Background: Growth and Productivity over Past Decades

1. The Spanish economy expanded at an impressive pace after the 1992–93 recession. It grew by 3½ percent on average between 1995 and 2007. This was the highest and longest growth period since the 1970s and helped Spanish GDP per capita surpass the EU average in the early 2000s. The unemployment rate reached the lowest level (8 percent) in almost 3 decades in 2007—between 1985 and 2007, employment almost doubled with the creation of more than 9 million new jobs. However, per capita growth decelerated significantly in the last decade, in part explained by the crisis, but also due to other factors as discussed below.

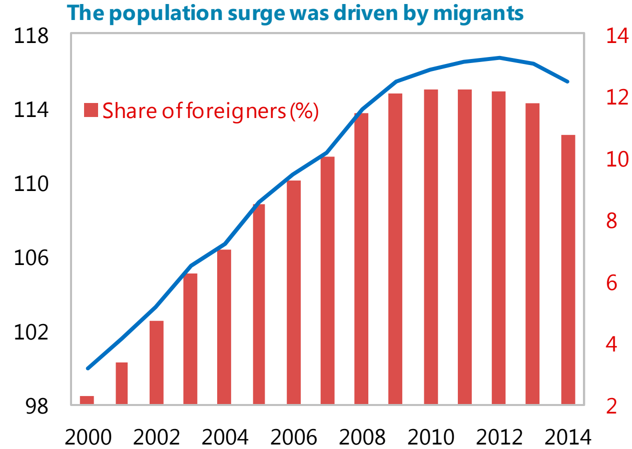
GDP per capita growth was already decelerating during the 2000s (percent)



Sources: Ameco; INE; and IMF staff estimates.

2. The boom was driven by a surge in population and capital. Using a production function approach to identify the composition of growth shows that the expansion relied heavily on accumulation of factors of production (labor and capital) rather than higher productivity.

The population surge was driven by migrants



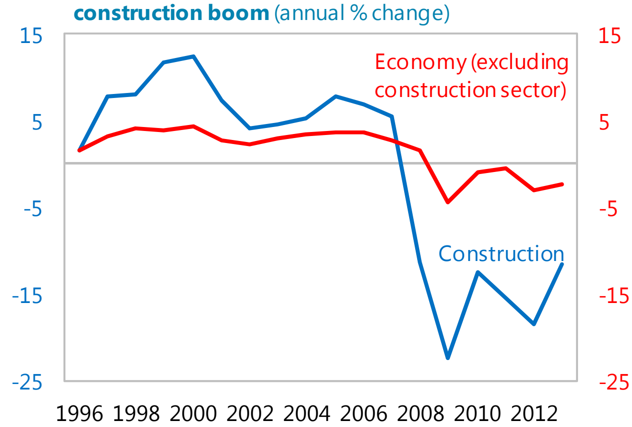
Source: INE.

[1] Prepared by Paulo Medas (EUR).

- Total hours worked expanded at an unprecedented pace, about 3 percent a year in 1995–2007. This was driven by several factors, including a fast growing working age population (in part reflecting large migration inflows) and a rise in the labor force participation rate. The rise in migration was partially driven by the housing boom—almost ¼ of all new jobs were created in the construction/real estate sectors.

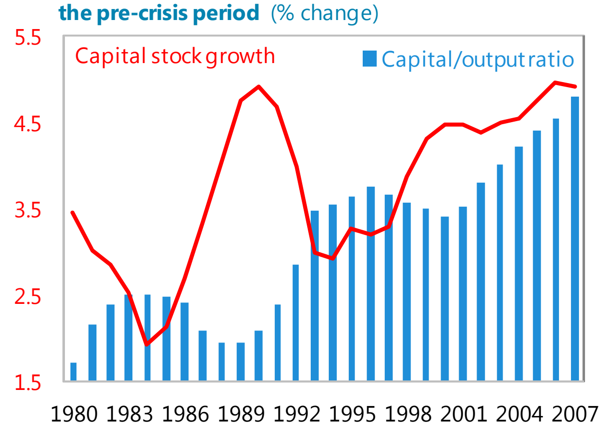
- The capital stock also grew at a robust pace benefiting from easy borrowing conditions. The construction sector played an important role—investment in construction jumped to 22 percent of GDP in 2006–07 from an average of 15 percent in the 1990s)—but, business investment (machinery and equipment) boomed as well in the years prior to the crisis. As a result the capital output ratio reached record high levels (and surpassed EU average of 2.8 in 2007)—indicating declining growth returns from the investment boom.

Employment growth received a big boost from construction boom (annual % change)



Sources: INE; and IMF staff estimates.

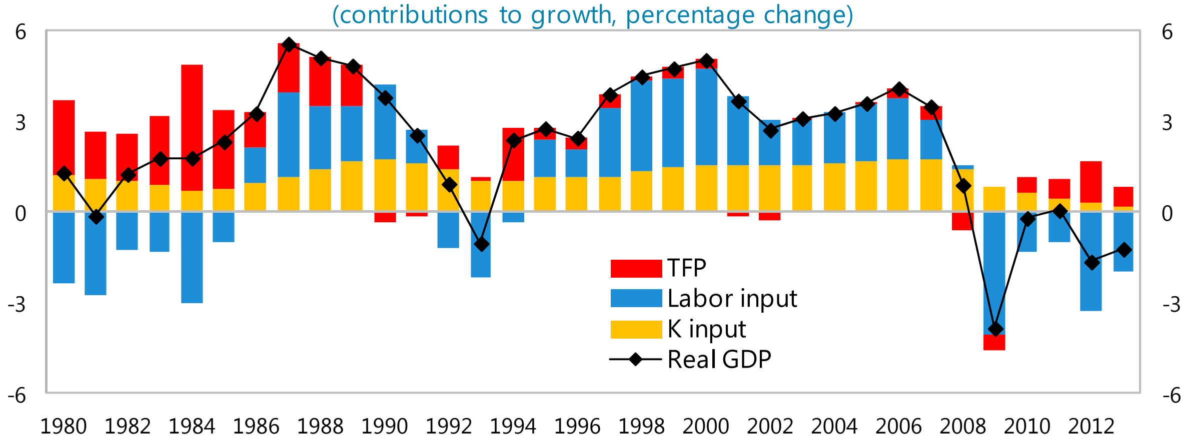
Capital stock expanded at a faster pace than GDP in the pre-crisis period (% change)



Sources: Ameco; and IMF staff calculations.

Growth and its components, 1980–2013

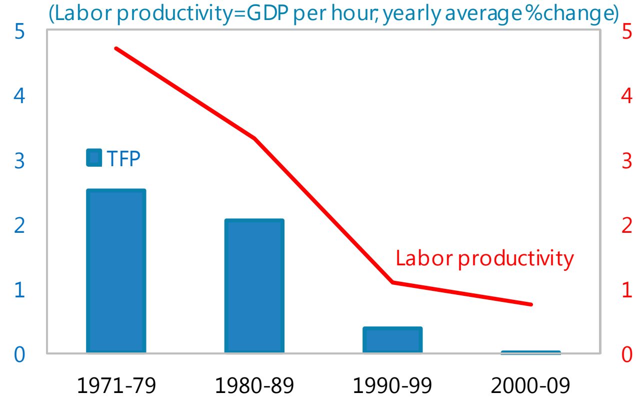
(contributions to growth, percentage change)



Sources: AMECO; Eurostat; INE; and IMF staff calculations.

3. But the productivity performance was very weak. While the expansion observed in the 1970s was driven to a large extent by productivity gains, this was not the case in the latest boom. Indeed, labor productivity growth has been declining for more than two decades. This trend continued in the 2000s despite significant capital deepening, reflecting very weak total factor productivity.

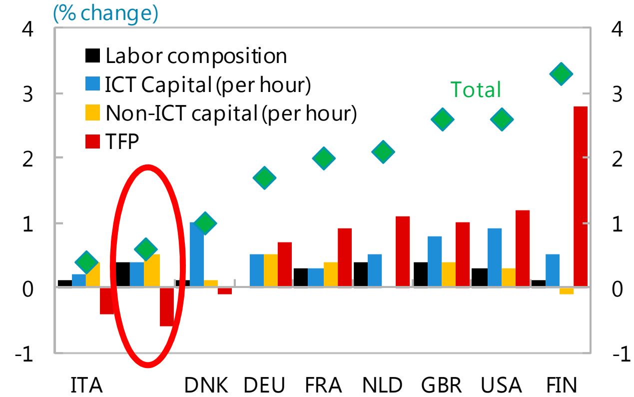
Productivity growth has declined sharply over the last decades
(Labor productivity=GDP per hour, yearly average %change)



Sources: INE; Eurostat; and IMF staff estimates.

- The large expansion of the financial sector and construction likely explain part of the decline in average productivity. Cecchetti and Kharroubi (2013) argue the expansion of the financial sector (and credit booms) hurt total factor productivity growth as they seem to undermine R&D intensive sectors. Related to that, overall productivity performance in the 2000s suffered from the construction boom.

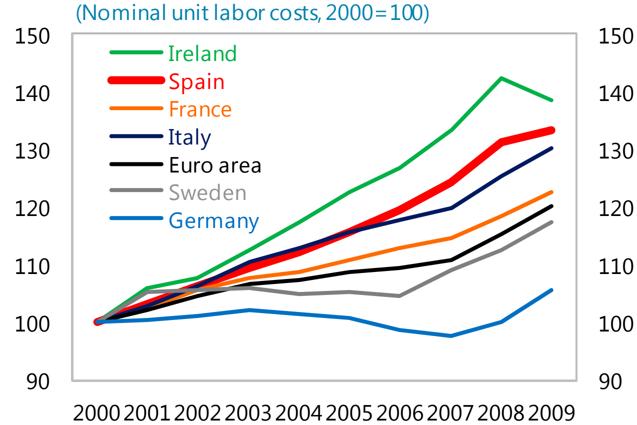
Labor productivity has been lower and composition worse than international peers, 1995-2007
(% change)



Source: OECD.

- But other factors have likely been more relevant. Mora Sanguinetti and Fuentes (2012) argue the expansion of the construction boom does not explain the large difference in productivity relative to other high-income countries—weak productivity growth was widespread across sectors. Several factors seem to be at play, including the inflexible and highly segmented ("dual") labor market, the large dependence on small firms that tend to have relatively lower productivity (Lopez-Garcia et al., 2007), and limited flexibility in the business environment (e.g. low turnover of firms). Several institutional characteristics appear to hamper productivity growth, including, inefficiencies in the judicial system and business bankruptcy legislation, as well as regulatory barriers (e.g. cost of starting a business, barriers to entry into the retail trade sector).

Spain's competitiveness deteriorated in the 2000s
(Nominal unit labor costs, 2000=100)



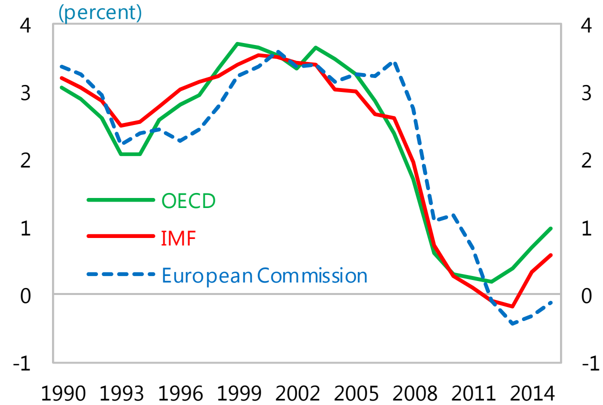
Source: Eurostat.

4. This growth model proved unsustainable and led to a deep recession, made worse by the global financial crisis. The expansionary growth period was sustained by a high degree of private sector leverage, a housing bubble, and accumulation of large external imbalances (the current account deficit reached 10 percent of GDP in 2007) as Spain lost competitiveness. Eventually, the credit/housing bubble burst, external funding dried up, and the economy entered a financial crisis and a double-dip recession lasting 6 years. Credit and house prices fell sharply, about a fifth of all jobs were destroyed, and poverty and inequality rose.

B. Potential (or Sustainable) Output Growth Has Declined Sharply in Recent Years

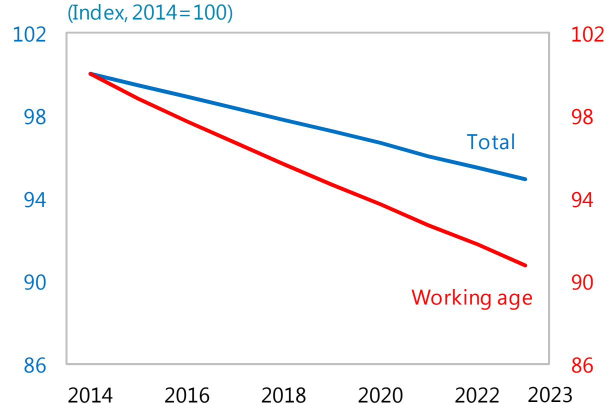
5. The crisis has led to a substantial decline in potential output growth. While it is always difficult to estimate potential output (especially in the aftermath of a deep crisis), there is evidence that potential growth has fallen sharply. After hovering around 3 percent in 1995-2007, potential growth is estimated to have fallen to somewhere between 0.4 percent (OECD) and -½ percent (EC) in 2013. Some of the reasons are directly linked to the crisis and may be reversed in the short-term to some degree, but others reflect structural weaknesses that are likely to have long-lasting effects.

Potential output growth
(percent)



Sources: Ameco; OECD; and IMF staff estimates.

Population is expected to decline over the next years
(Index, 2014=100)



Source: INE.

- Demographics turned negative. After expanding at a fast pace until 2007, population growth slowed significantly and turned negative in 2012. This is likely to be a new trend, as INE projects working-age population to continue to decline over the next years.

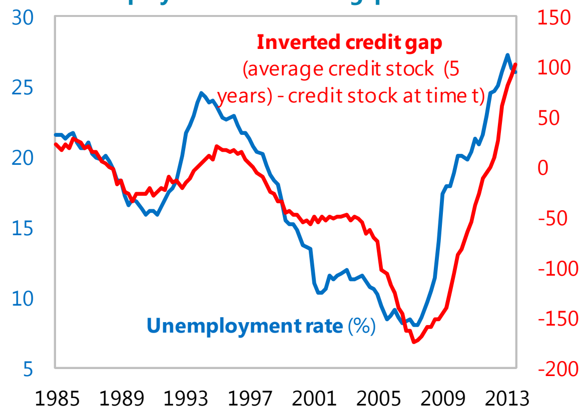
- Capital deepening has decelerated significantly as investment collapsed during the crisis. While there has been a recent rebound in business investment (from very depressed levels), construction continues to decline.

- The NAIRU has increased substantially. It is particularly challenging to estimate the level of structural unemployment in Spain given the wide and long unemployment cycles.[2] Still,

[2] Several studies have noted the difficulty in estimating robust measures of the NAIRU, especially based on the relation with inflation. Partially this reflects structural changes over the past decades, including the significant reduction in inflation, the entry in the Euro area, as well as the effect of migration. A study by the European

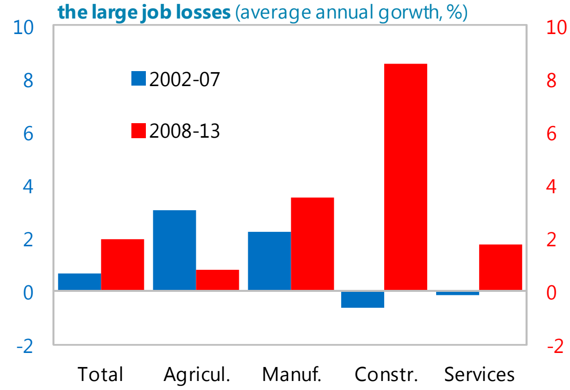
(continued)

the evidence suggests the NAIRU, after declining in the 2000s, increased significantly in recent years—partly reflecting the lack of flexibility in responding to the crisis. Both the EC and OECD estimate the (short-term) NAIRU to be around 20 percent, which seems plausible given the very large increase in long-term unemployment (which rose from 1 percent in 2007 to 16 percent in 2013). At the same time, the EC estimates the long-term structural unemployment to likely be around a still high 16 percent (unemployment averaged 17 percent since 1980).



Sources: Bank of Spain; INE; and IMF staff estimates.

- There has been some improvement in productivity, but to a large extent seems to reflect cyclical factors, namely the large labor shedding in some of the most affected sectors (construction and real estate services)—and not a substantive, long-lasting, improvement (Mora Sanguinetti and Fuentes, 2012; and Maroto-Sanchez and Cuadrado-Rouda, 2013). Latest data already shows signs productivity is slowing (as employment stops falling).



Sources: INE; and IMF staff estimates.

6. **However, traditional approaches may be underestimating the effect of other factors, namely credit and housing prices, on the sustainable level of output and unemployment.** The estimates of potential output discussed above are based on the traditional production function approach and tend to rely on a Phillips curve to estimate the NAIRU and potential output. However, these methods have been particularly unreliable (as per discussion above). In particular, growth could be based on accumulation of large imbalances, while CPI inflation remains under control. This was particularly the case with the credit boom in Spain. Unemployment cycles have been closely associated with credit cycles—periods of excess credit relative to historical averages tend to be associated with (unsustainably) low unemployment rates—which may have led to overestimating the sustainable level of unemployment and growth during the last boom. It also suggests the level of

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Commission (2014) also recently noted the estimates for the NAWRU using the Phillips curve approach are highly sensitive to specifications for Spain (much less so for other countries).

sustainable unemployment is well above the levels observed in the mid-2000s and possibly closer to 20 percent in the near term.

7. Alternative approaches indicate a larger output gap at the height of the boom, but confirm sustainable/potential output growth has declined with the crisis. While these approaches are still being developed and the results should be taken with some caution, they provide a useful complement to the analysis above. They suggest the traditional approaches underestimated how much the economy was growing above sustainable levels in the mid-2000s.

- Borio et al. (2013) estimate a "finance-neutral" measure of potential output, by taking into account financial factors that influence economic cycles (namely credit and property prices). The results suggest the positive output gap during the boom was larger than estimated by production function approaches—reflecting the fact credit (and house prices) was well above sustainable levels. At the same time, the analysis suggests the output gap in 2011 (around *minus* 2 percent) was smaller than other estimates, indicating that potential output grew at a slower pace than for example EC estimates.

Assessment of Output gap for Spain

	Boom (2007)	2011
Output gap (percent of potential output)		
Borio, Disyatat, and Juselius (2013)	4-5	-2
Alberola, Estrada, and Santabarbara (2013)	6	-4
European Commission	2	-4
OECD	4	-3

Sources: Ameco; EC; and OECD Outlook.

- Alberola, Estrada, Santabarbara (2013) estimate sustainable output growth defined as the output growth that does not generate or widen macroeconomic imbalances, identified through a wide set of domestic and external indicators (e.g. prices, current account, housing, debt). From 2000 to 2007, the sustainable growth rate was much lower than actual (around 2½–3 percent, as severe imbalances were building up), with the output gap reaching *plus* 6 percent in 2007. However, after the crisis, the correction of the imbalances meant that the decline in sustainable growth was far lower than that in potential growth. The output gap is also larger (negative) as sustainable output growth does not fall as much—sustainable output growth is estimated at slightly below 1½ percent in 2011.[3]

C. International Growth Experience Following Financial Crises

8. Countries tend to face deeper recessions and weaker recoveries after financial crisis and credit booms. The aftermath of financial crises are associated with deeper and more prolonged contractions, and the severity of these tends to be correlated with the size of the credit boom in the run up to the crisis (Jorda et al., 2012). Countries that experienced a credit boom and financial crisis,

[3] The key difference is that the Alberola et al (2013) approach has a more stable equilibrium unemployment (vis-à-vis the NAIRU)—according to the sustainable growth methodology, fell from 15.9 percent in 1993 to 14.2 percent in 2004 and then rose to 17.1 percent in 2011.

such as Spain, have a very high probability of facing a *creditless* recovery (Abiad et al., 2011), which tends to be weaker (studies suggest growth is about ⅓ lower in the first years than in normal recoveries). In particular, the fall in investment tends to be much larger and has a disproportionally lower contribution to growth than in "normal" recoveries.[4] Darvas (2013), however, notes that the incidence of creditless recoveries is much lower in high-income economies (which may be more dependent on credit) and exchange rate depreciation seems to play an important role to sustain growth.

9. The international experience also suggests that while per capita GDP growth tends to eventually return to pre-crisis levels, there is a permanent loss of output (WEO, 2009; Cerra and Saxena, 2008). Some of the main findings in the literature on prospects for medium-term growth following financial crisis:

- Output growth tends to be depressed substantially and persistently following banking crises. Studies suggest financial crisis can permanently reduce potential output by 1.5-4 percent (e.g. Furceri and Mourougane, 2009). Per capita growth does, however, eventually return to its pre-crisis rate for most economies.

- The weaker performance results from long-lasting reductions of the employment rate, the capital-to-labor ratio, and total factor productivity. The level of total factor productivity recovers somewhat to its pre-crisis trend over the medium term, although there is wide diversity across countries. In contrast, capital and employment suffer enduring losses relative to trend (e.g. Hobza et al., 2009, find that employment does not recover even after 10 years in the countries analyzed).

- Some economies succeed in avoiding the medium-term output loss. The evidence suggests that economies that apply countercyclical fiscal and monetary stimulus in the short run to cushion the downturn after a crisis tend to have smaller output losses over the medium run. There is also evidence that structural reform efforts are associated with better medium-term outcomes.

- In addition, a favorable external environment is generally associated with smaller medium-term output losses. Haugh, Ollivaud, and Turner (2009) note the importance of depreciated currencies to help the recovery.

10. The cases of Sweden and Japan illustrate two possible and very different paths after financial crisis and provide some additional insight on the challenges to Spain.

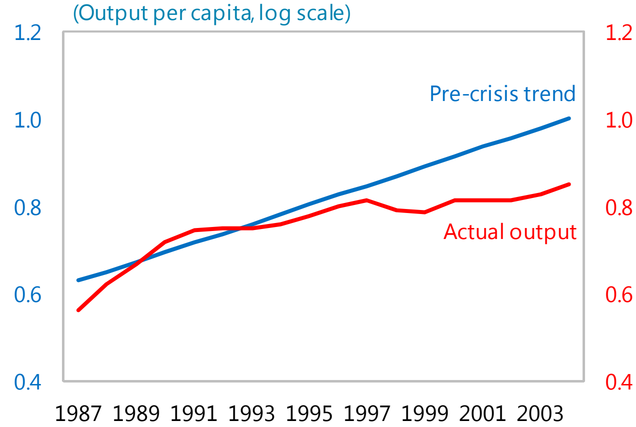
- **Japan**. Japan never fully recovered from the financial sector problems and bursting of asset bubbles in 1992. It faced a balance sheet recession, with private demand falling as the private

[4] A high pre-crisis investment share of GDP is a reliable predictor of high medium-term output losses, because of its correlation with the dynamics of capital after the crisis (WEO, 2009).

sector increased dramatically its savings during the deleveraging process (Koo, 2011). Potential output growth fell to less than half the 3½ percent average the decade before (Hobza et al., 2009). The loss in potential output was initially due to a drop in investment—leading to lower labor productivity (due to both weaker capital deepening and lower TFP growth); but over time adverse demographics become an even more key factor. Hoshi and Kashyap (2013) argue the long stagnation after the crisis partially reflects the lack of decisive policy action to recapitalize banks and not recognizing that major structural reforms were needed to support growth (and not just short-run stimulus policies).

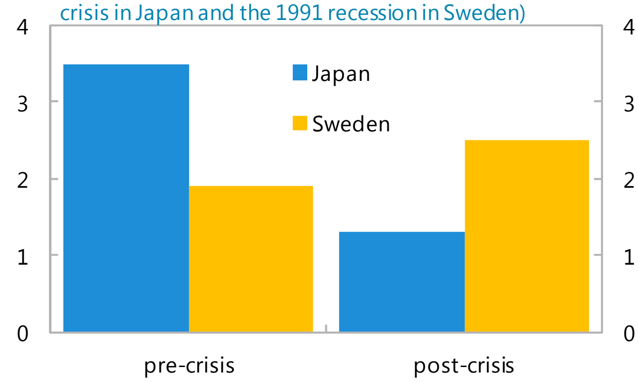
- **Sweden**. Sweden managed to quickly recover from a deep recession in early 1990s. While potential output fell in the immediate aftermath of the crisis, it rebounded in the years after, thanks to a significant increase in labor productivity (reflecting higher TFP and capital deepening). This compensated the negative impact due to a higher NAIRU and lower participation rate (partly reflecting a rigid labor market). Sweden benefited from a significant nominal depreciation in late 1992 and supportive policies (including a gradual fiscal tightening) to help boost the creditless recovery—credit only returned 3 years after the start of the recovery. Sweden managed to raise productivity growth over the long term also thanks to major structural reforms over the years (tax reform including broadening the tax base, pensions, labor market, fiscal, reforms to reduce excessive regulation and increase competitiveness, including liberalization of professional services).

Japan's output per capita growth never recovered
(Output per capita, log scale)



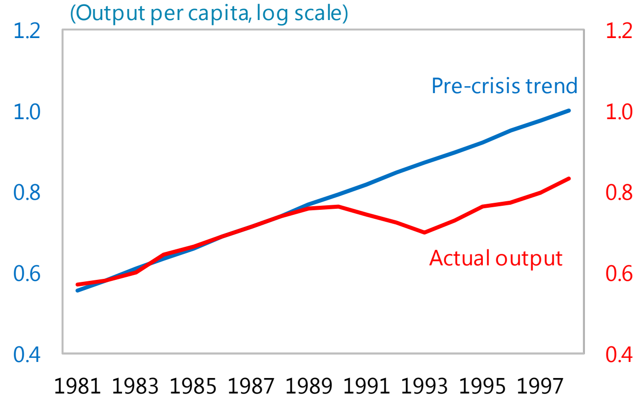
Source: WEO (2009).

Potential output growth declined in Japan, while it rebounded in Sweden after the crisis
(average growth 10 years before and after the 1992 banking crisis in Japan and the 1991 recession in Sweden)



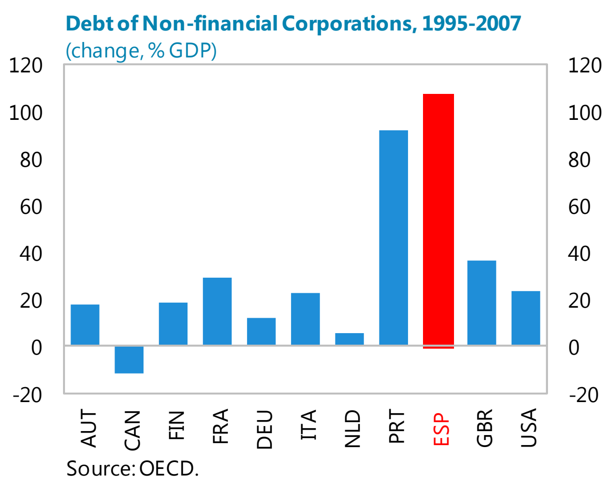
Source: DG-ECFIN (Occasional paper 49, June 2009).

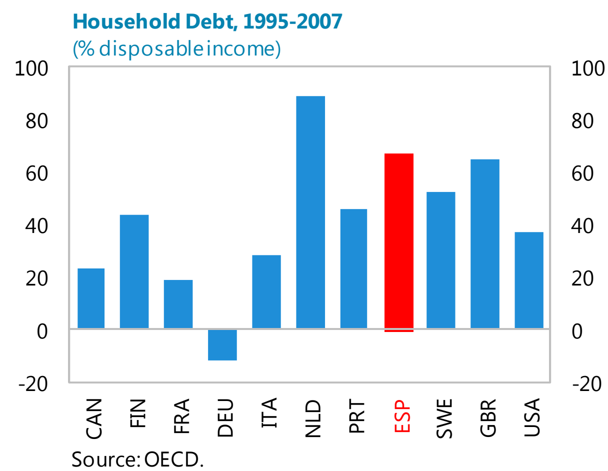
Sweden's output per capita growth accelerated, but did not recover fully from crisis
(Output per capita, log scale)



Source: WEO (2009) .

11. The international experience thus suggests Spain faces modest medium-to long-term growth prospects. The severity of downturn, size of credit boom, and limited policy space (fiscal, monetary, exchange rate) all indicate Spain faces a more modest, creditless, recovery than in the past. Even returning to the pre-crisis productivity growth trend, as cross-country experience suggests, would still imply weak growth prospects given the subpar productivity performance in recent decades. The international experience also suggests that aggressive macro and structural policies could significantly improve Spain's prospects (e.g. Sweden).





D. Looking Forward: How Much Can Spain Grow over the Medium-to Long-Term?

12. Potential (or sustainable) output growth is expected to be significantly lower than in the pre-crisis period over the medium/longer term. As discussed above, the crisis has led to a significant deterioration in potential growth and such dynamics are likely to persist for some time. Staff estimates that potential growth will gradually rise but remain modest over the medium term, around 1 percent (Table 1)—this is similar to projections by OECD for Spain and IMF staff projections for potential output growth for the Euro area (around 1 percent over 2014-19)—as:

- Capital deepening is likely to continue at a moderate pace. While business investment is rebounding based on higher corporate margins, other types of capital (e.g. construction) will likely remain weak due to fiscal consolidation, tight credit conditions, and the continued housing sector adjustment.

- Labor dynamics will make a much weaker contribution to potential output. Demographics will be a drag on growth due to declining working-age population (emigration and ageing). The Spanish statistical agency (INE) expects working-age population to fall by 1 percent a year over the medium term. Still, staff projections assume some compensation will come from further rises in labor force participation to levels somewhat above euro area average, but still lower than some other countries (e.g. UK, Portugal). The short-term NAIRU (the one more relevant for policy) is expected to remain high, though declining, over the coming years, reflecting rigidities in the labor market and high long-term unemployment.

- Labor productivity will be constrained by the slower capital deepening, but also by the weak total factor productivity (TFP). Staff assumes TFP growth to be close to the 1990s average (and above the 2000s)—the expectation is that ongoing reforms, and less dependence on construction, will contribute to increase productivity even as the unemployed return to work.[5]

13. Given the structural impediments and need to resolve the legacies from the crisis, a moderate recovery seems the most likely scenario. Staff projections over the medium-term of growth around 1½–2 percent, will allow to gradually close most of the output gap by end of the decade. However, it implies a pace slower than recoveries from past recessions—e.g. after both the early-1980s and early-1990s recessions growth quickly rebounded to rates around 3–4 percent (see also Box 1). A key issue is that aggregate demand is constrained: unemployment is very high, the private sector is deleveraging, fiscal consolidation needs to continue for many years (given need to reduce public debt), and Spain does not have an independent monetary policy or currency.

Table 1. Path for Potential Output Growth Components 1/

(Percent change)

	1980-1994	1995-99	2000-04	2005-09	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Potential Growth	2.5	3.1	3.4	2.2	0.3	0.1	-0.1	-0.2	0.3	0.6	0.8	0.9	1.0	1.1
Capital Stock	3.3	3.5	4.4	4.1	1.7	1.3	0.7	0.6	0.6	0.7	0.8	0.8	0.8	0.8
Labor Services	0.0	2.5	2.8	1.0	-1.0	-1.1	-1.3	-1.3	-0.6	-0.2	0.0	0.2	0.4	0.4
NAIRU	18.1	17.8	13.1	13.9	17.3	18.6	19.7	20.5	20.5	20.2	19.7	19.2	18.5	17.8
Working age population 2/	0.9	0.5	1.6	1.4	-0.1	-0.2	-0.5	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
Total Factor Productivity	1.4	0.3	0.0	0.1	0.3	0.4	0.5	0.5	0.49	0.48	0.53	0.51	0.47	0.56
memo item:														
output gap (percent of potential output)	-0.9	-2.3	0.3	0.8	-3.4	-3.4	-4.9	-5.9	-5.1	-4.2	-3.4	-2.5	-1.7	-0.8

Contributions to Potential Output Growth 1/

(Percentage points)

	1980-94	1995-99	2000-04	2005-09	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Potential Growth	2.5	3.1	3.4	2.2	0.3	0.1	-0.1	-0.2	0.3	0.6	0.8	0.9	1.0	1.1
Capital Stock	1.2	1.2	1.5	1.4	0.6	0.4	0.3	0.2	0.2	0.2	0.3	0.3	0.3	0.3
Labor Services	0.0	1.6	1.8	0.6	-0.7	-0.7	-0.9	-0.9	-0.4	-0.1	0.0	0.1	0.3	0.3
Working age population 2/	0.6	0.3	1.0	0.9	-0.1	-0.1	-0.3	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-0.6
Total Factor Productivity	1.4	0.3	0.0	0.1	0.3	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.6

Sources: AMECO; INE; and IMF staff estimates.

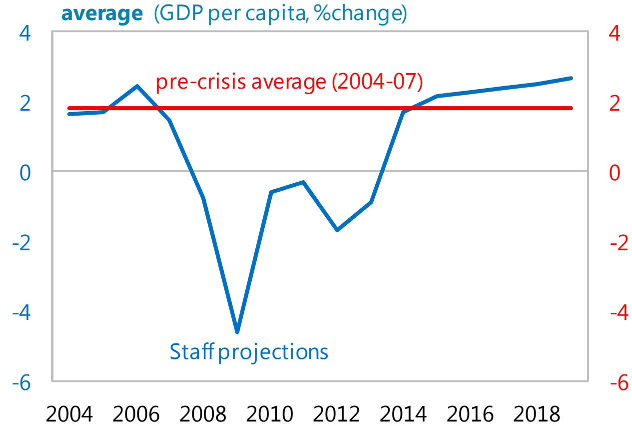
1/ Output-labor elasticity assumed to be 0.65 and output-capital elasticity assumed to be 0.35.

2/ Working-age population refers to population 16-65 years of age. Projections as published by INE.

[5] Spain's productivity tends to be countercyclical, contrary to other economies. As such, productivity growth would likely fall as the economy recovers, after rebounding during the crisis. Nevertheless, the projections assume that the reforms will help sustain trend TFP growth around the 1990s average.

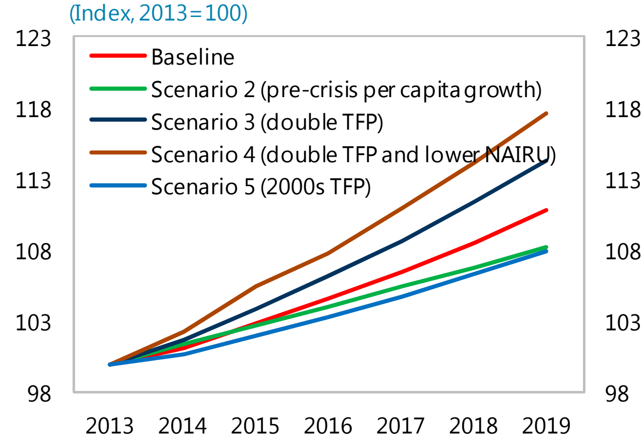
14. There is a significant degree of uncertainty around long-term projections. Staff's baseline already assumes a stronger path than what international experience suggests—i.e., per capita growth would be expected to return to pre-crisis trend. In particular, GDP per capita was already slowing during the years preceding the crisis to around 1¾ percent. Taking INE's population projections, this would translate in yearly GDP growth just above 1¼ percent over the medium term—while staff assumes 1½–2 percent. The baseline assumes stronger pace of growth reflecting the process of closing a very large output gap and the pay-off from the reform process. Still there are upside and downside risks to the baseline:

GDP per capita is projected to grow above pre-crisis average (GDP per capita, %change)



Sources: INE; IMF staff projections.

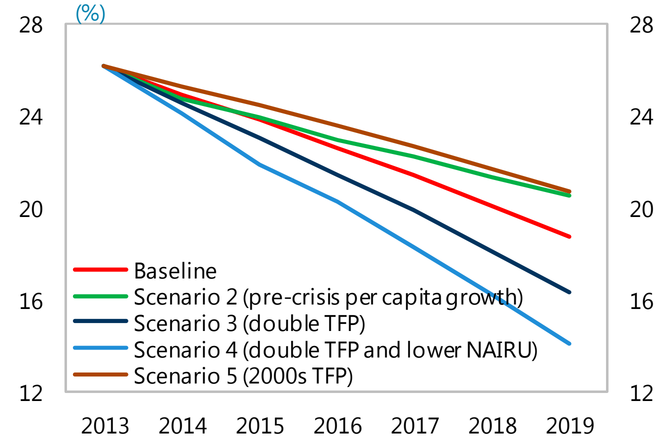
GDP over medium term
(Index, 2013=100)



Source: IMF staff projections.

- Population dynamics may prove better than projected by INE. In particular, population tends to be procyclical (and so do projections), as migration flows respond to the state of the economy. For example, if the fall in working-age population was half of projected, potential would be higher by about ⅓ percent a year. However, given ageing dynamics, high unemployment, and a much smaller construction sector (a driver of immigration) it is difficult to envisage a positive contribution from demographics over the medium term.

Unemployment rate over medium term
(%)



Source: IMF staff projections.

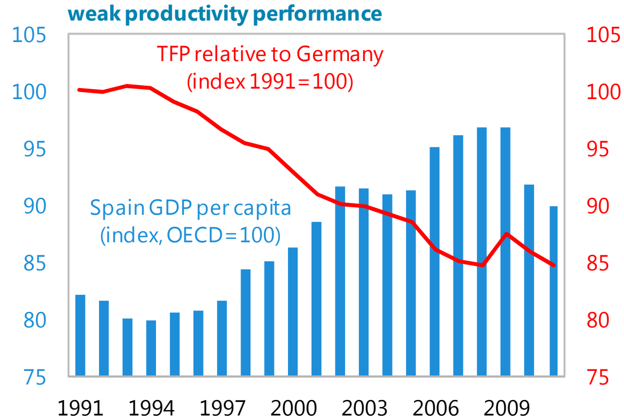
- Total factor productivity could prove stronger than projected. While staff assumes that Spain will be able to partially reverse the decades-long deterioration in productivity growth, further efforts could lead to even higher productivity—however, as shown by international experience, it would likely require significant reforms.

- An alternative scenario, where reforms (say by further liberalizing product markets and professional services, Box 2) are implemented increasing TFP growth to double the trend in the 1990s, would raise potential output by about ½ percent a year. Under such a scenario, GDP would be about 3 percent higher in 2019 than in the baseline and unemployment would be close to 16 percent (rather than 19 percent).

- On the downside, TFP growth could return to the 2000s sub-par growth, implying GDP growth below 1½ percent over the period and higher unemployment.

15. An ambitious reform program could double potential growth over the medium term. Under a reform scenario (chart above) where the NAIRU falls to 14 percent by 2019 and TFP grows at a faster pace, yearly potential growth would be 1 percentage point higher than staff's baseline (although the effect of the lower NAIRU would eventually die down). To achieve such gains (or even higher) it would require an aggressive implementation of planned reforms, but also a broader national effort to make the Spanish economy more competitive and increase its GDP per capita above EU/OECD averages. While there has been progress, recovering the lost productivity (and raising per capita income levels to OECD/European standards) will demand converging towards the best performers on many areas: business and regulatory environment, labor market, education, among others.[6] Andres and Domenech (2014) also stress the need for structural reforms, improve human and technological capital, and improve economic institutions in Spain. Dustman, Fitzenberger, Schonberg, and Spitz-Oener (2014) note that in Germany, such a positive outcome required a much more flexible labor market and improvements in productivity across both tradable and non-tradable sectors.

GDP per capita remains below OECD average due to weak productivity performance



Sources: OECD; and IMF staff estimates.

E. Policy Implications

16. Policies need to be directed not only to strengthen the cyclical recovery, but also to raise potential output and reduce structural unemployment. As indicated by international experience, the recovery from a financial crisis (and credit boom) is likely to be modest, especially if the room for policy stimulus is small (as it is in Spain). Both fiscal (gradual adjustment) and monetary (at European level) policies will need to remain as supportive as possible to protect the recovery and avoid more long-lasting negative effects (e.g. hysteresis from long-term unemployment). At the same time, international experience also shows that ambitious structural reforms can prevent a long period of low growth.

[6] Several indicators and studies from OECD (product and services regulation, education, labor market regulations), World Bank's *Doing Business*, and International competitiveness show that Spain's lags the best performers, most competitive economies in Europe and OECD.

Box 1. Can Spain Grow Without Credit? An Historical Perspective

Credit to the private sector is falling sharply and is not expected to grow until 2016. Spain's experience with (real) credit contractions suggests the economy can still grow, but slowly.

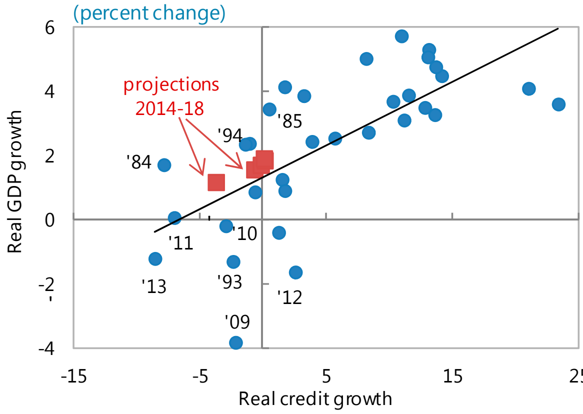
Since 1980, credit and output have been highly correlated. While there have been episodes of "creditless" growth, these were accompanied by a weak real effective exchange rate (REER) and little or no drag from fiscal consolidation—neither of which will apply in the next few years. Looking at the three episodes of real credit contraction:

1983–85: real credit fell about 3 percent a year and growth averaged almost 2 percent. The REER fell sharply in 1982 and 1983 and was well below its historical average during this period. The fiscal deficit widened.

1992–94: real credit fell about 1 percent a year and growth averaged ½ percent. The REER fell sharply following the 1992–93 ERM crisis to well below its historical average. The fiscal deficit widened.

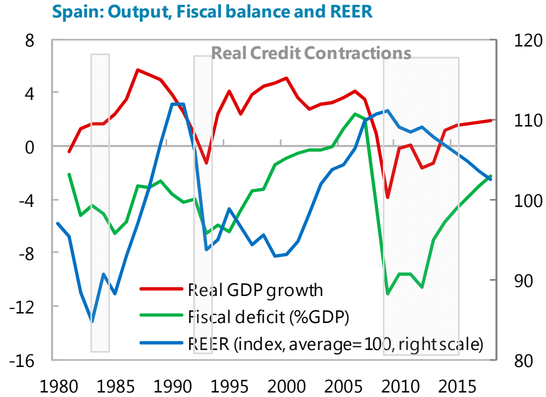
2009–13: real credit fell about 7 percent a year and growth averaged -1½ percent. The REER weakened slightly but remained above its historical average. The fiscal deficit also widened over this period, though with a sharp deterioration in 2009 and gradual consolidation since.

Spain: Real Credit vs. Real GDP, 1981-2013
(percent change)



Sources: BIS, WEO; and IMF staff calculations.

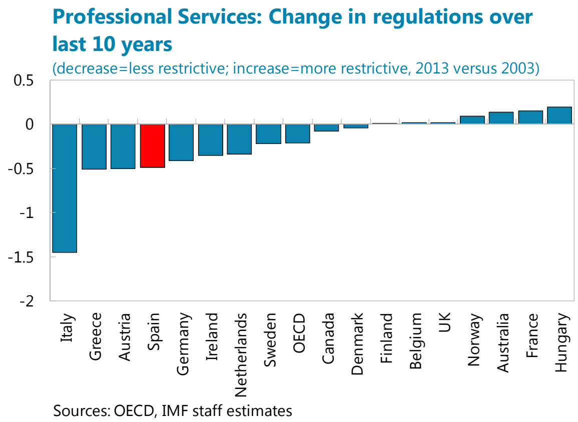
Spain: Output, Fiscal balance and REER

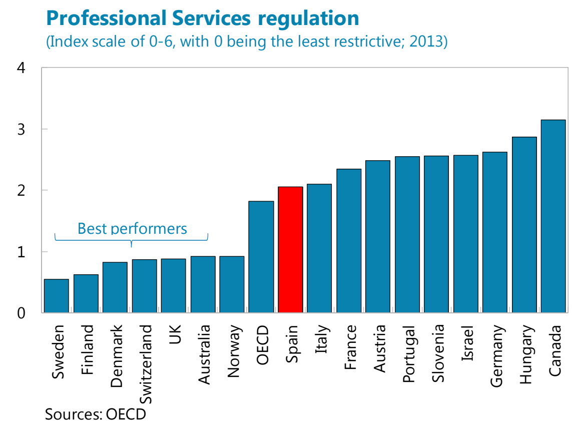


Sources: BIS; WEO; IMF staff projections.

Box 2. There Is Room to Further Liberalize Professional Services

Professional services are often highly regulated, although there is great diversity across countries. Some (Scandinavian countries, UK, and Switzerland) have already achieved low levels of regulation. Others, including Spain and Germany, have made important progress but remain far more restrictive than the more liberalized economies.





Spain has made important strides towards improving business environment and increase competition, but still lags the best performers. Over the decades, Spain has opened up markets to more competition including in the context of the EC services directive. However, it still lags in several areas—e.g., the range of professional services that have specific qualification requirements is unusually large and in some professions regulations remain more restrictive than the OECD average (engineers and architects) and in others more restrictive than best performers (accounting and legal services). The World Bank's Doing Business indicators also confirm that Spain continues to lag the best performers in some key dimensions—e.g. the cost of start a business remains one of the highest in the European Union despite important progress (Monteagudo, Rutkowski, and Lorenzani, 2012).

The evidence suggests excessive regulation hurts growth. While some degree of regulation is justifiable (e.g., safety standards), regulation restricts competition, thus raising markups in the rest of the economy and reducing the quality of services. The literature suggests that regulatory reform of product and service markets raises investment, productivity, and jobs—the positive spillovers for other sectors of the economy can be substantial (this is particularly important as Spain needs to improve competitiveness). Some countries have achieved significant liberalization and improvements in productivity. For example, Sweden adopted wide-ranging structural reforms including product market reform and deregulation of services, which helped boost productivity and growth—Sweden now has the least restrictive professional services regulations in the OECD. During the 1990s, the Netherlands greatly increased competition in product markets, including a new competition law. Many professional services were liberalized, including accountants, realtors, notaries, and lawyers (all inputs into business costs). Coinciding with these reforms, productivity growth improved in services.

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TACKLING THE CORPORATE DEBT OVERHANG IN SPAIN[1]

Non financial corporations (NFCs) in Spain accumulated large amounts of debt during the boom years. This process started to be reversed in the last couple of years. But a significant fraction of NFCs is showing symptoms of debt overhang such as little hiring, low investment, and financial distress. This note reviews lessons from country experiences in addressing corporate debt overhang and examines policy instruments that could play a role in this process. It concludes by recommending a comprehensive strategy, catalyzed by the official sector and aligning the incentives of all stakeholders, to lubricate the restructuring process and enhance growth prospects.

A. Background

1. Non financial corporations' (NFCs) debt increased quickly since 2000 (67 percent of GDP during 2002–10) but has been declining since 2010. Their debt was 129 percent of GDP by end 2013 (15 percent of GDP lower compared to the peak). However, debt levels are still high compared to other European countries and historical averages.

2. NFCs' debt reductions have been driven by a remarkable improvement in net lending flows that started in 2008. Debt restructurings/write-offs have not been significant. The adjustment in net lending flows was explained by a decline in investment and a sharp increase in savings supported by a very large reduction in employment.

3. The deleveraging process of NFCs has been uneven within the economy.[2] Debt reductions have been more intense in the construction/real estate sector than in other sectors, and by SMEs rather than by large firms. More generally, the decline in debt, investment, and employment has been (appropriately) more acute in those sectors that were more leveraged before the crisis.

4. The fraction of firms struggling to generate enough profits to meet interest payments has been increasing steadily since the beginning of the crisis.[3] It was 18 percent in 2007 and

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[1] Prepared by Pablo Lopez Murphy (EUR).

[2] Mendez and Menendez (2013a) conduct a thorough analysis of this issue.

[3] Mendez and Menendez (2013b) document this relying on a large sample of NFCs for which they compute interest cover ratios (ICR) below 1. They measure the ICR as the ratio between gross profits plus financial revenues, and financial costs.

reached 30 percent in 2012. Similarly, the fraction of debt at risk owed by these firms has also been increasing, especially for SMEs.[4]

5. Many firms under financial stress maybe unviable and should go bankrupt (i.e., be liquidated) to allow resources to shift to more productive uses. However, many other firms may be viable but are unable to invest, hire, and grow because they have too much debt. In those cases, some kind of debt restructuring could be in the interest of all stakeholders. Debt restructuring could include: extension of maturities, lower interest rates, debt-for-equity swaps, debt reductions, and others.

6. Corporate debt restructuring should entail operational restructuring. The latter is important to revamp profitability and remove obsolete or excessive capacity. It could include: replacing management, reductions in staff, sales of assets, revised business model, and others.

7. A period of corporate restructuring in Spain is unavoidable to realign the corporate sector to the post-crisis environment. However, experience has shown that a protracted corporate restructuring process would result in worse growth prospects. Indeed, this has been identified as one of the main drivers of sluggish economic performance in Japan since 1990.[5] A strategy to accelerate corporate restructuring could, therefore, assist economic recovery.

B. Lessons from Country Experiences

8. The experience from past crises, such as Latin America and Asia, provides lessons for designing strategies for corporate restructuring in the NFCs sector.[6]

9. The main lesson is that some degree of government intervention has occurred to jump start and sustain corporate restructuring. The level and modalities of government intervention depend on the dimensions of the debt problem, the capacity of debtors and creditors to burden-share losses, and the legal and financial resources available to the government. The insolvency law is one important tool to support corporate restructuring but other tools are usually needed.[7]

10. Governments may have both institutional limits (e.g., EU limits on State Aid) and fiscal space constraints on intervening to resolve private sector debt problems and large scale intervention by governments has the potential to lead to unsustainable public debt burdens.

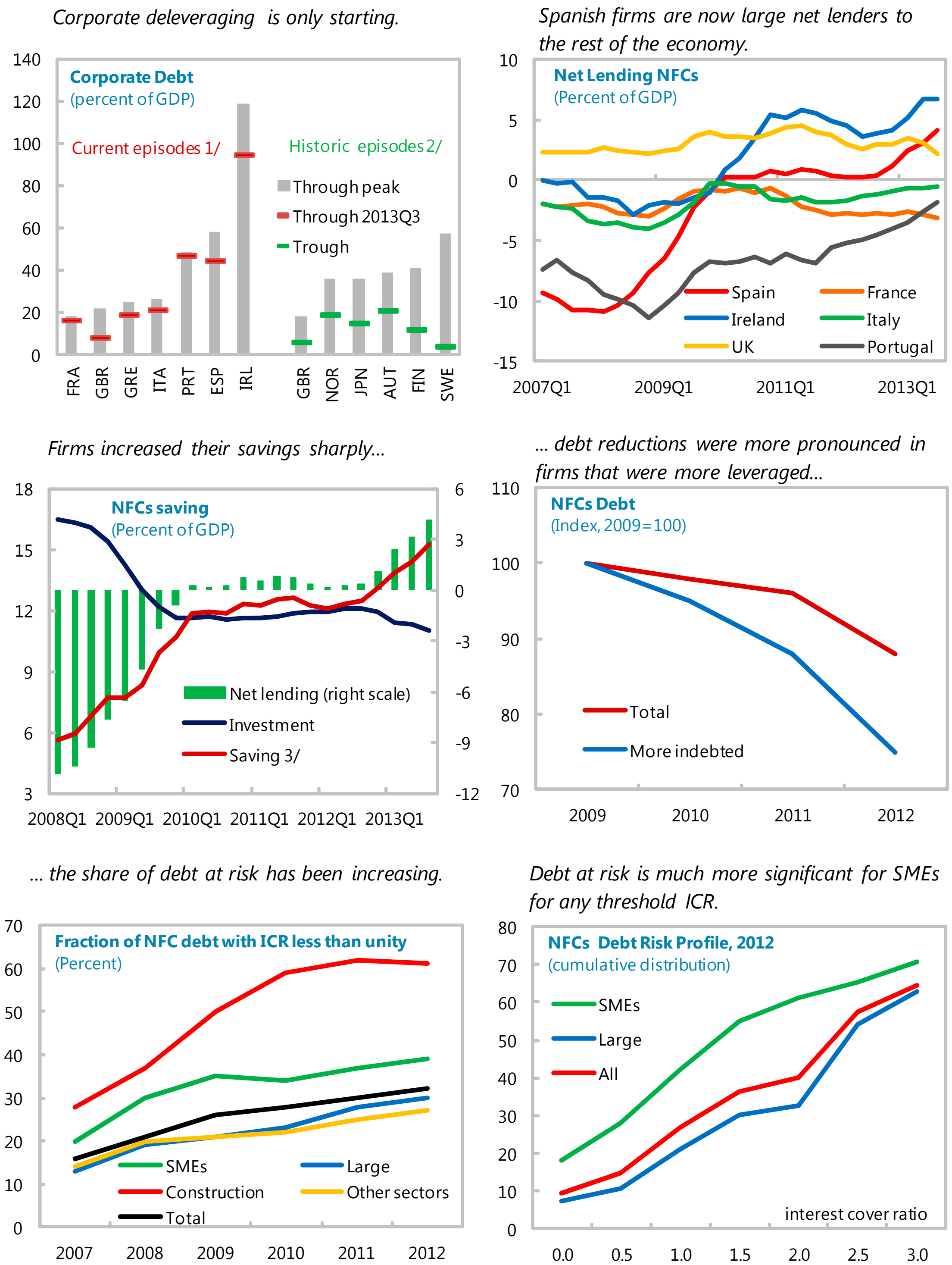
[4] Martinez Carrascal and Mulino Rios (2014) estimate that SMEs account for about 75 percent of domestic bank credit to NFCs, or about 50 percent of total NFCs debt.

[5] Caballero and others (2008) review the experience of Japan.

[6] Claessens (2005), Claessens and others (2001), Hoelscher and Quintyn (2003), and Stone (2000) review corporate restructuring country experiences.

[7] Laryea (2010) emphasizes these points.

Figure 1. Non Financial Corporations Are Deleveraging



Sources: Bank of Spain; ECB; INE; Bornhorst and Ruiz Arranz (2013); Menendez and Mendez (2013); and IMF staff calculations.

1/ Current episodes start in 2002.

2 /Historic episodes: Japan 1989-97; UK 1990-96; Austria 1988-96; Finland 1993-96; Norway 1999-05; Sweden 2001-04.

3/Saving is a residual equal to net lending plus gross fixed capital formation (investment).

11. The close links between the corporate and the financial sectors requires restructuring efforts on both fronts to resolve a financial crisis. Restructuring banks without addressing corporate weaknesses is a bad strategy.

12. The involvement of all stakeholders (e.g., firms, banks, government) in the formulation of a comprehensive strategy for restructuring enhances its credibility and effectiveness. Korea benefited from the early formulation of comprehensive restructuring strategies.

13. Corporate debt restructuring could entail various degrees of government involvement.[14] The experiences of Korea, Malaysia, and Thailand in the late 1990s were relatively decentralized. The experiences of Chile in 1982 and Mexico in 1983 were relatively centralized. The experiences of Mexico in 1995 and Indonesia in 1998 had elements of both approaches.

14. Corporate restructuring is challenging.[15] Distinguishing viable from non viable firms is far from trivial in the aftermath of a crisis. Many viable firms may be struggling during a cyclical downturn and could return to a more solid position once the economy recovers.

C. Instruments

In court bankruptcy regime

15. A sound bankruptcy regime distinguishes between viable and non-viable firms, fosters the restructuring/rehabilitation of the former and the liquidation of the latter, and provides an efficient process in both cases. It also facilitates out-of-court workouts by providing a credible threat against which the bargaining occurs.[16]

16. The bankruptcy regime in Spain is underutilized compared to other countries, mainly because:[17]

- the regime for individuals/SMEs[18] is too severe with the debtor
- the regime for corporations is slow, costly, and restructuring options are limited

[14] Claessens (2005) distinguishes government centralized and decentralized approaches to corporate restructuring.

[15] Stone (2000) highlights this.

[16] Laryea (2010) elaborates on these points.

[17] Celentani and others (2012), Garcia-Posada and Mora-Sanguinetti (2012a) and DeLong and others (2014) analyze this issue in detail.

[18] When a business is non-corporate, its debts are debts of the business' owner; and when a business is a small corporation, lenders typically ask for personal guarantees that remove the owner's limited liability.

17. The regime for individuals/SMEs does not allow for debt discharge, which entails unlimited liability. This is extreme and inefficient.[19] Even countries with very different legal traditions allow for some debt discharge. For example, debt discharge is immediate in France and is allowed after one year in UK.

18. In September 2013 the Law of Entrepreneurs introduced a special bankruptcy regime for self-employed individuals and entrepreneurs (including owners of SMEs).[20] One major novelty of this new regime is that it allows the possibility of debt discharge. However, it excludes privileged creditors, which is likely to leave the majority of debtors out of the benefit.[21]

19. The current bankruptcy regime should be upgraded by the establishment of a separate personal insolvency framework for individuals that includes some debt discharge for financially responsible individuals.[22] Other countries have introduced some debt discharge without undermining payment culture (e.g., Germany).

Out of court process

20. Greater reliance on out of court debt workouts could result in a speedy, cost effective, and market friendly alternative to court supervised insolvency regimes.

21. The court system many times does not have the resources to support a large number of cases. However, out-of-court workouts are often hampered by coordination and asymmetric information problems. Attrition wars can plague negotiations, with delays that could be in the interest of the individual stakeholders but not for the economy as a whole. These problems could be paramount for larger firms since they borrow from multiple banks and also from smaller firms that typically have debts with one bank and public creditors. Moreover, the reliance on secured loans[23] often discourages banks' incentives to participate in debt restructuring given that it is less costly for them to foreclose collateral.

22. The Law of Entrepreneurs approved in September 2013 introduced an expedited out-of-court procedure-the "out-of-court agreement on payments" (OCAP) designed to address financial stress of small businesses, facilitated by a professional mediator. This was a step in the

[19] Stiglitz (2001) argues that excessive deference to creditors reduces their incentives to engage in (ex-ante) due diligence, encourages predatory behavior by creditors, worsens the risk sharing between creditors and debtors, and weakens creditors' incentives to engage in (ex-post) monitoring.

[20] Garcia-Posada and Mora-Sanguinetti (2013) describe the main changes introduced by the Law of Entrepreneurs.

[21] Garcia-Posada and Mora-Sanguinetti (2013) document that SMEs rely more heavily on secured loans than large firms.

[22] IMF (2013a) and DeLong and others (2014) make this recommendation.

[23] Garcia-Posada and Mora-Sanguinetti (2013) document the importance of secured loans across firms of different size.

right direction. However, the procedure has three important limitations: i) secured creditors and public creditors are excluded; ii) the moratorium set forth in the plan may not exceed three years; and iii) any haircuts cannot exceed 25 percent.

23. The exclusion of secured creditors and public creditors limits the effectiveness of the procedure given that SMEs rely heavily on secured loans, and tax authorities are usually a significant creditor. The restrictions on moratoriums and haircuts are too rigid for a heterogeneous field of SMEs and should be relaxed to improve the effectiveness of the procedure.

24. The Decree of Refinancing Agreements and Debt Restructuring enacted on March 2014 aimed to promote out of court refinancing agreements by facilitating debt to equity swaps, among others. Specifically, firm owners may be personally liable if they reject a debt-to-equity swap that is considered "reasonable" by an independent expert. The Decree also allows banks in certain cases to benefit from lower provisions for the new loan after they exchange debt for equity.

25. This is a good initiative, especially for large firms under financial distress. In the case of smaller firms the benefits are likely to be more limited since banks will probably be reluctant to receive equity stakes that may require them to manage those firms and/or to increase capital to compensate for a more risky portfolio of assets. Other important measures in the Decree that supports restructurings include: i) reducing the risk of "claw back" of arrangements[24]; ii) increasing the space to "cram down" (i.e., bind) dissenting creditors to an agreement; and iii) eliminating several tax disincentives to restructuring.

Mediation

26. An independent entity could facilitate time-bound negotiations by fostering creditor coordination for cases that justify case-by-case negotiations (i.e., large firms). Although the collective interest of the creditors may be to restructure debts of the firm, the individual interests of all creditors may not be aligned, and this could block restructuring deals. International experience suggests that governments can play an important role in facilitating out of court workouts relying on mediation.

27. The best known form of official mediation is the "London approach" started by the Bank of England during the U.K. recession in the mid 1970s, encouraging creditors and debtors to adopt a coordinated approach to arrive at voluntary restructuring agreements.[25] The involvement of the Bank of England was possible because its statutes did not limit its activity to a narrowly defined role and because it was not involved in banking regulation. The approach was informal

[24] Claw back means set aside by a judge that declares invalid the agreement.

[25] Lieberman and others (2005) describe the origin and key features of the "London approach".

to maintain flexibility and adaptability. It was implemented in more than 160 cases during 1989–97.

28. Several countries relied on mediation by government agencies to facilitate voluntary workouts.[26] Korea created the Corporate Restructuring Coordination Committee (CRCC) to act as a mediator; in Mexico, the Unidad Coordinadora del Acuerdo Bancario Empresarial (UCABE); in Malaysia, the Corporate Debt Restructuring Committee (CDRC); in Thailand, the Corporate Debt Restructuring Advisory Committee (CDRAC); in Indonesia, the Jakarta Initiative Task Force (JITF). Annex 1 summarizes several features of out of court workout frameworks adopted in a number of corporate restructuring experiences.

29. To promote corporate out of court workouts it could be helpful to have a public body that is perceived as independent acting as a catalyst to facilitate debt restructuring workouts. Moreover, it would be useful to issue centralized guidelines for restructuring arrangements (e.g., Portugal).[27] Those guidelines should be based on the principles put together by the international federation of insolvency practitioners (INSOL)[28], built on the London approach.

Standardization

30. A standardized menu of voluntary restructuring agreements could play an important role to facilitate debt workouts for SMEs. The large number of SMEs implies that centralized case-by-case mediations are unfeasible. Similarly, the in court bankruptcy system cannot handle so many restructuring processes. However, failure to reorganize SMEs could have very adverse social implications given that they account for 75 percent of jobs and tend to employ those on lower incomes.

31. A standardized SME restructuring program could include: i) a simple method to assess viability (e.g., interest cover ratio (ICR) thresholds); ii) harmonized restructuring terms for viable firms (e.g., extension of loan maturities, improved interest payments terms, debt reductions/equity swaps); and iii) fresh funding for working capital for viable firms.

32. Standardized programs could obviously make mistakes. For example, simple methods to assess viability may result in mistakes at the time of dividing viable from non viable firms. However, those mistakes are unavoidable to avoid gridlock in the restructuring process.

33. The Bank of Spain compiles comprehensive data on SME balance sheets, which could be an important input into the triage process assessing SME viability. The translation of this data into such assessments/ratings, could be even out-sourced to a specialized private agency.

[26] Claessens (2005) reviews eight country experiences.

[27] Portugal issued centralized guidelines in September 2011 in line with international best practices (IMF (2013b)).

[28] See www.insol.org/statement

34. In Malaysia, SMEs received financing support from the central bank if companies were in the middle of a restructuring process. In Thailand, the central bank set targets for financial institutions to restructure a specific number of SMEs loans each month.[29]

Taxes

35. There are several ways in which tax reforms might help to tackle corporate debt overhang.

36. First, the tax authorities should be allowed to participate in out-of-court debt restructuring based on clear criteria. Many times a large fraction of a firm's liabilities are tax liabilities. Hence, tax authorities should be part of debt restructuring for viable firms under financial stress. In Spain tax authorities are not required to participate in out of court debt restructuring negotiations. Portugal made legal changes in 2011 requiring tax authorities to participate in out of court debt restructuring.[30]

37. Second, the tax system could eliminate the tax advantage for corporations that rely on debt financing (instead of equity financing).

- One way to do this is to introduce a deduction for equity financing similar to the one obtained for debt financing (i.e., interest payments are deductible).[31] The main problem with this measure is the potential fiscal cost, estimated at around 0.5 percent of GDP for an average developed country. However, the near-term cost could be reduced by granting the allowance only to new investment.

- The other way to do this is to eliminate interest deductibility. However, this would be very onerous for indebted firms.

- Spain implemented some measures in March and July 2012 limiting interest deductibility.[32] The Law of Entrepreneurs approved in September 2013 introduced a tax deduction for equity increases to promote capitalization. These measures have not fully eliminated the debt bias.

38. Third, written off debt could be deductible for the creditor, and should not be taxable income for the debtor. For example, under the current Spanish CIT, written off debt is taxable income to the debtor. The Decree of Refinancing Agreements and Debt Restructuring enacted on March 2014 established that written off debt is still taxable income for the debtor but this income could be carried forward to split the burden of taxation across time. In the case of debt-

[29] Claessens (2005) reviews special programs for SMEs in Asia.

[30] IMF (2013b) describes the reforms to the Legal Toolkit for Corporate Debt Restructuring in Portugal.

[31] De Mooij (2011) discusses options to eliminate the debt bias.

[32] Royal Decree Law 12/2012 and Royal Decree Law 20/2012.

for-equity swaps, the debtor is not taxed. Public deeds documenting debt write-offs and other refinancing agreements are now exempt from transfer tax and stamp duty.

Bank regulation

39. Stronger banks facilitate corporate restructuring, especially when they are the main source of financing for the non-financial corporate sector. Banks need to be viable and establish loss absorption capacity to play a positive role in corporate restructuring. Stronger banks are more likely to be willing to crystallize loses associated with debt restructuring. Similarly, non financial corporations are more likely to seek and accept debt restructuring deals when they face stronger banks.[33]

40. Spain implemented an ambitious program to put the banking system on a stronger footing during July 2012-January 2014. The program basically did the following: i) strengthened the system's capital after identifying undercapitalized banks and requiring them to address these shortfalls; ii) segregated the most illiquid assets into a single asset management company; and iii) revamped the frameworks for bank regulation and supervision.[34]

41. Policies that boost bank capital and ensure adequate provisioning support corporate debt restructuring. Recent actions by the Bank of Spain, such as tightening provision coverage for restructured loans[35] and limiting the distribution of dividends have been very important in this regard.[36]

42. Provisioning rules and bank supervision need to induce banks to undertake debt restructuring rather than continue rolling loans forward. Provisioning rules tend to be backward looking.[37] One way in which provisioning rules could further facilitate debt restructuring is to require banks to provision performing loans of viable firms whose metrics suggest they may be under financial stress. This could be combined, as per the recent Bank of Spain guidelines, with reduced provisions on exposure to viable firms that have lower financial stress after restructuring.

43. The tax treatment for provisioning loans by banks seems to be relatively restrictive in Spain.[38] Banks could be given more leeway in obtaining tax relief for provisioning to induce them to do that.

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[33] Otherwise they will expect to be better off negotiating with failed banks and choose a "strategic default".

[34] IMF (2014) reviews the achievements of the program.

[35] IMF (2012) documents this.

[36] IMF (2014) explains the case for limiting dividend distribution.

[37] Hoelscher and Quintyn (2003) make this point.

[38] European Commission (2012) reviews this issue.

Guarantees

44. Credit guarantees could be used to foster corporate debt restructuring by linking the eligibility for the guarantee to debt restructuring.[39] Banks may be highly risk averse in the aftermath of a bank restructuring process or may have doubts about the solvency of potential borrowers. By protecting a part of a loan with a guarantee, these schemes could induce banks to provide better financing terms in a more cost effective way (compared to direct subsidies) as banks have more expertise to scrutinize credit risk than government agencies.

45. The design of the scheme is crucial for its effectiveness and sustainability. The provision of guarantees should be limited in amount, conditional on the overall fiscal position of the country, and reported in a transparent manner. A significant part of the credit risk should be taken by the banks (i.e., the government should not be taking over all the credit risk of any lending arrangement).

46. The Spanish Guarantee System consists of a state owned company (CERSA) and 23 private mutual guarantee companies (SGRs). Its focus has been on improving SMEs access to credit by relying on guarantees.[40] The system has been in place for more than 30 years and is subject to supervision and regulation by the Bank of Spain. The main weakness of the Guarantee System in Spain is its relatively small size and its relatively low penetration. An expansion of this system could contribute in the corporate restructuring process. Some recent measures (e.g., Law 14/2013) aimed to address the problem of the small size of the Guarantee System by increasing capital requirements.

Asset management companies

47. To minimize the costs of financial crisis it is sometimes argued that good assets of financial institutions should be separated from their bad assets and a centralized asset management companies (AMCs) should take over these bad assets.

48. The pros for AMCs that are usually mentioned are: i) efficient division of labor; ii) facilitation of valuation; iii) strengthening credit discipline by breaking unhealthy links between banks and troubled firms; iv) economies of scale; and v) enhanced bargaining power. The cons are: i) loss of information[41]; ii) weakening credit discipline (borrowers are less likely to repay AMCs that cannot provide fresh funding); iii) difficulty in pricing assets; iv) political interference;

[39] Laryea (2010) discusses this issue.

[40] Garcia-Vaquero (2013) describes the Spanish Guarantee System.

[41] This is especially important in the case of loans to SMEs where banks collect valuable information on their borrowers.

and v) fiscal cost and the associated subsidy (which could raise State Aid considerations in the EU).[42]

49. AMCs have been used by governments to more directly support the corporate sector restructuring process in several countries. The experience with publicly owned AMCs in corporate restructuring, however, is not generally encouraging.[43] Successful experiences (e.g., Sweden) suggest that AMCs can be effective only when they have narrow mandates (e.g., for resolving insolvent financial institutions and selling their assets). And even this may require very special conditions: a type of asset that is relatively easy to price (e.g., real estate), remain clear from politicization, and be sufficiently funded. Hence, publicly owned AMCs do not seem promising instrument to facilitate corporate restructuring in Spain.

50. Private AMCs may also emerge from the desire of banks to transfer impaired assets to a specialized private entity for more efficient management and resolution. The establishment of those AMCs should be facilitated by removing legal obstacles, minimizing rigidities regarding incorporation, and securing tax neutrality for assets transfers.[44] Spanish banks are currently studying a private AMC to manage equity stakes from firms benefitting from debt-for-equity swaps.

D. Conclusion

51. A comprehensive strategy, catalyzed by the official sector and aligning the incentives of all stakeholders, could "fast-forward" the restructuring of corporate debt and enhance growth and employment prospects for the economy as a whole. A public body could usefully oversee and drive the overall process, compile qualitative and quantitative debt restructuring statistics, and report them.

52. All the "tools of the trade" should be considered to address this challenge. These include: (1) further increasing the effectiveness of in court and out of court workouts by including public creditors fully in the process and introducing a personal insolvency regime to help individual entrepreneurs; (2) for larger firms, issuing centralized guidelines for voluntary out of court workouts, coupled with independent mediation by a centralized agency; (3) for SMEs, developing a menu of standardized voluntary workouts, relying on simple methods to identify viable firms, harmonized restructuring terms, and indicative targets for financial institutions to offer/agree to restructurings; (4) temporary and limited fiscal incentives to accelerate the restructuring process; and (5) ensuring adequate provisioning.

[42] Woo (2000) discusses these issues.

[43] Klingebiel (2001) arrives to this conclusion after examining several country experiences with AMCs.

[44] Hoelscher and Quintyn (2003) elaborate on this.

53. The government recently announced plans to: (1) strengthen the in-court debt restructuring process along the lines of the recent enhancements in out-of-court mechanisms; (2) foster liquidation as a going concern (i.e., transferring the business as a whole) instead of piecemeal liquidation; (3) introduce a code of good practice to facilitate debt restructuring for SMEs and the self-employed; (4) expanding the options available for SMEs to timely restructure in and out of court, (5) reviewing the current legal framework of the insolvency administration to reduce the costs and time involved in insolvency procedures, and (6) take measures for institutional cooperation to evaluate the effectiveness of the reforms undertaken and the need for further reforms. These plans continue improving the corporate debt restructuring process and are thus highly welcome.

Annex 1. Features of Out-of-Court Restructuring Processes

Feature	Indonesia	Korea	Malaysia	Thailand	Czech Republic	Turkey	Mexico	Brazil
Name of initiative or coordinating body	Jakarta Initiative Force (JITF)	Corporate Restructuring Coordination Committee (CRCC)	Corporate Debt Restructuring Committee (CDRC)		None	Istanbul approach	Unidad Coordinadora del Acuerdo Bancario Empresarial (UCABE)	None
Basic approach	Forum for negotiations, followed by adoption of time-bound mediation procedures	Forum for negotiations	Forum for negotiations	Forum for facilitation, superseded by contractual approach (debtor-creditor agreements)	None	Forum for negotiations, superseded I the fall of 2001 by a legal approach (Law on Corporate Debt Restructuring)	Promotion of a voluntary debt workout program for the largest 40 corporations (only about 10 percent of all bank lending)	None
Onset of the crisis	Late 1997	Late 1997	Late 1997	Late 1997	1997	Early 2001	Late 1994	Early 1999
Resolution of inter-creditor disputes	No special procedure	Possibility to have loan of opposing creditor purchased; also arbitration committee consisting of private experts	Nothing special, apart from persuasion by central bank	Three-person panel to attribute differences, but any concerned creditor can opt out	No established framework for creditor coordination; efforts to reach settlements frequently undermined by minority and dissenting creditors	None	Possibility to form a convention; all creditors are treated equally and decisions bind all creditors	No possibility of consensual resolution among parties or establishment of creditor committees
Default structure for failure to reach agreement	JTIF may refer uncooperative debtor to government for possible bankruptcy [edition	Foreclosure, liquidation through court receivership	Foreclosure, liquidation or referral to asset management company with super-administrative powers	If less than 50 percent support the proposed workout, debtor-credit agreement obliges creditors to petition court for collection of debts	Regular bankruptcy	Regular bankruptcy	Criminal bankruptcy procedures or "suspension of payments" to banks permitted by courts	Financial institutions not allowed to invoke insolvency relief pledge for secured debt; unsecured debt can be deferred or reduced (concordat)

Source: Claessens (2005).

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STRENGTHENING THE INSOLVENCY FRAMEWORK FOR SMES[1]

Spain has recently introduced reforms to its insolvency regime aimed at facilitating out of court workouts for non-financial enterprises, including small and medium size enterprises (SMEs). These reforms represent significant advances in the system. However, further changes are necessary to make the insolvency regime a useful tool for SME deleveraging. Additional reforms could be made to increase effectiveness and incentivize use, including by involving public creditors in collective proceedings and by introducing a framework for personal insolvency with an effective discharge, coupled with measures to strengthen institutional capacity.

A. Overview

1. **Spanish SMEs rarely use the insolvency regime in spite of their high levels of debt distress.**[2] This is largely due to insufficient options for effective restructuring of the business or for the speedy liquidation of assets with the attendant ability to close up shop and start again. Specifically, the regime has the following gaps: (i) opportunities for successful restructurings within court are limited, as composition plans are overly restrictive in their scope and do not bind secured and priority (e.g., public) creditors; (ii) liquidation is not value-maximizing, as it is generally initiated in practice only as last resort and does not adequately facilitate the continued operation and sale of the business as a going concern; (iii) the lack of an effective discharge for natural persons offers scarce hope for individual entrepreneurs to emerge from their debt at the end of the process; and (iv) insolvency proceedings are costly and generally take too long, due to procedural inefficiencies and weaknesses in the institutional framework. While recent reforms attempt to make up for the weaknesses of in court procedures by promoting out of court agreements, changes could be made to make such procedures more attractive and effective for SMEs and to harmonize the insolvency regime as a whole. The authorities have recently announced general plans to address some of these gaps by (i) increasing flexibility and scope of in court restructuring plans; (ii) reviewing the current legal framework for insolvency administrators to incentivize speedy and less costly insolvency procedures; (iii) expanding the options available for SMEs to timely restructure in and out of court; and (iv) facilitating going-concern sales. These are welcome developments.

[1] Prepared by Chanda DeLong (LEG), Manfred Balz (LEG external consultant), and Ignacio Tirado (LEG external consultant).

[2] Despite the overall increase in insolvencies of medium and large firms since the financial crisis, use of the insolvency process by many of Spain's small enterprises is still rare, averaging only 12 bankruptcy filings per 10,000 firms in 2012. See Garcia-Posada M. and J. Mora-Sanguinetti, 2013, "Are There Alternatives to Bankruptcy? A Study of Small Business Distress in Spain," Bank of Spain Working Paper No. 1315.

2. Solving the problem of SME overindebtedness is important due to the structure of the Spanish economy. SMEs represent over 99% of the businesses in Spain, the majority of which are microenterprises.[3] Most of these businesses operate as sole entrepreneurs, who have unlimited personal liability. Other small businesses, albeit incorporated, secure business credit with mortgages in their personal assets, or with personal guarantees, of the business owners and directors and their family members. As such, commercial failure in Spain frequently entails household insolvency.

B. The Spanish Insolvency Regime

3. In Spain's post-crisis environment, an effective insolvency regime must provide adequate tools to assist in deleveraging the real economy, with a particular focus on SMEs. First, the insolvency regime should provide effective means to restructure a business both in and out of court (first section). Second, the regime should also allow for the speedy sale of a business (or business units) out of liquidation to preserve as much value as possible of the going concern and to facilitate changes in market structure and firm size (second section). In either case, speed is of the essence, so procedural efficiency and a strong institutional framework is crucial (third section). Moreover, the insolvency regime should provide for a debt discharge for individual entrepreneurs in order to preserve human capital after a business failure (fourth section). Finally, consistency among in court and out of court options is desirable to avoid moral hazard, forum shopping, and to facilitate transition from out of court to in court procedures.

Restructuring

In court

4. The Spanish insolvency regime provides debtors and creditors the ability to reach restructuring agreements within court. Formal insolvency proceedings are primarily regulated by the Insolvency Act of 2003 (Ley Concursal), which establishes a procedure allowing for the restructuring or the liquidation of corporates and other legal entities as well as individuals (entrepreneurs and consumers). Insolvency proceedings can be initiated by both the debtor and its creditors and can be either simplified or regular. SMEs typically use the simplified proceedings, which generally apply when the debtor has fewer than 50 creditors and the debtor's assets and liabilities do not exceed €5 million. Insolvency plans (convenio concursal ordinario) may be proposed by the debtor or by creditors. Once approved by the relevant majority of unsecured and non-priority creditors, the plan must be submitted to the court for approval, and once approved it binds all ordinary and subordinated creditors.[4]

[3] See Central Business Register, National Statistics Institute of Spain.

[4] While the regime also includes a type of pre-packaged plan (convenio anticipado), which may be presented at the time of the debtor's petition to open an insolvency proceeding or immediately after procedure is declared, together with the written consent of creditors holding at least 20% of total claims to the accelerated and simplified proceedings, this procedure is rarely used.

5. The in court restructuring process does not sufficiently involve secured or priority (e.g., public) creditors. Priority and secured creditors cannot be bound by majority acceptance of a restructuring plan. As the majority of SME debt is owed to secured and public creditors, the inability to mandate their involvement as classes with majority voting and a possible "cram-down" in the process makes the restructuring procedure within the insolvency system largely ineffective. In addition, the law generally restricts the content of the plan to debt reductions up to 50 percent of unsecured debt and rescheduling of only five years, which unduly limits the freedom of creditors and may be insufficient to resolve the debt overhang of many SMEs. The limitations are also inconsistent with the scope of out of court refinancing agreements, which have no limitations on write downs or rescheduling. An additional problem with insolvency plans is their procedural rigidity. It is not possible to negotiate and make amendments to the initial plan once it has been proposed, which thwarts negotiations and causes the rejection of plans that could have been approved with some changes. In addition, the classification of claims of counterparties of terminated executory contracts as administrative expenses (credito contra la masa), hinders the ability to restructure business activity.[5]

6. Consideration could be given to redesigning the restructuring procedure to include secured and public creditors and to abolish the limits on content. Secured and public creditors should be bound by a plan accepted by the requisite majorities. The latter could be achieved by forming separate classes for voting purposes, which would be bound by a majority vote of their members, as long as the minority receives at least as much under the plan as they would receive in a liquidation (i.e., the "best-interests" test). A dissenting class could be subject to "cram-down," provided that it is treated "fairly and adequately," meaning that it can be impaired without its majority consent as a class only if any junior class receives no value at all, and no senior class receives more than 100 percent.[6] Subordinated creditors should be wiped out when ordinary creditors take a haircut. Such a system could be designed to allow secured creditors to participate in the financial upside of reorganization, which would engage them in proceedings, and prompt them to file more often for insolvency and forego individual enforcement by foreclosure or repossession. In addition, to increase chances that a plan will be approved, the initial proposal for a reorganization plan should also be open to renegotiation and amendments. The ability for the parties to modify a restructuring plan during the plan execution phase following judicial approval would also maximize the chances of a successful restructuring. Finally, in line with international best practice, claims of counterparties of terminated executory contracts should be classified as ordinary insolvency claims.

[5] This limitation would also affect the ability to restructure business activity within a liquidation proceeding.

[6] See the UNCITRAL Legislative Guide on Insolvency Law, pp. 224-226, 235-236, available in the Internet: http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf

Out of court

7. Substantial changes were recently made to the insolvency regime to expand the options available to enterprises, including SMEs, to reach agreements out of court (see Box 1). These include the following:

- **Refinancing Agreements:** Substantially expanded with the Royal Decree 4/2014 (the "RDL") of March 2014, refinancing agreements now include partial refinancing agreements, which allow an enterprise to reach an agreement with any one or more of its financial creditors, and collective refinancing agreements including all financial debt. Refinancing agreements may include, subject to majority creditor approval, write downs and rescheduling of debts, as well as debt for equity swaps, which also require shareholder approval (which may not be unreasonably withheld). Judicial confirmation of agreements meeting the requisite majorities binds non-participating and dissenting creditors, including, under certain circumstances and to a limited degree, secured creditors.

- **Out of Court Agreements on Payments:** Introduced in 2013 by the Law to Support Entrepreneurs, the out of court agreement on payments or "OCAP" (acuerdo extrajudicial de pagos) is designed to address the financial stress of small businesses, facilitated by a professional mediator. The agreement, which must be approved by creditors holding at least 60% of the total general unsecured claims (claims of secured and public creditors are excluded)[7], must allow for the continuation of the business, and may include a moratorium of no more than three years, and a write down of no more than 25%.

8. These new out-of-court agreements do not stay public creditors or include them in collective creditor decision-making at the negotiation table. While public creditors are permitted by law to negotiate bilaterally with debtors to reach rescheduling of tax debts, these processes are separate from the formal out of court agreements that debtors may reach with other creditors, which limits their effectiveness for SMEs. This is because failure to bring public creditors to the negotiating table with other creditors hinders collective decision making. Involving public creditors would enable a more effective debt restructuring of the business, induce other, including secured, creditors to consent to a restructuring of their claims, and ultimately leave more working capital for the restructured enterprise. It would also allow public creditors to keep the debtor business afloat as a future taxpayer without disrupting employment and supplier and customer relationships, which benefits tax revenue in the longer run. In addition, leaving public creditors outside the restructuring process, even while secured creditors are included, is inconsistent with the status of public creditors in the insolvency law, who rank below secured creditors in a liquidation.

9. There are several options for involving public creditors in out of court agreements. In the parliamentary procedure to approve the RDL as a law, public creditors could be introduced as a

[7] Secured creditors may be bound by the plan if they voluntarily vote in favor and the plan is approved.

third class, in addition to the current two classes of ordinary and secured creditors. Under the OCAP, public creditors could be required to participate in the mediated creditor decision making process. At the very least, the start of the either of these two procedures should require the tax authorities to engage in a discussion with the debtor to restructure debt. Alternatively, as a temporary measure to "jump start" the restructuring of firms, the tax authority could announce that it would agree to participate in out of court refinancing agreements during a limited period of time. Such involvement could entail a design (subject to compliance with state aid rules) whereby public creditors (i) would agree to a stay on individual enforcement of their claims to the same extent as other creditors and (ii) agree to contribute actively to the financial restructuring of the debtor enterprise by accepting an impairment of their owed debt at a level in between those creditors of higher rank (e.g., secured creditors), but above those of more junior general unsecured creditors. In light of current limitations in the law with respect to the tools available to public authorities to restructure debt, in any event changes would need to be made to attendant legislation to permit more significant public creditor involvement.

10. In addition to the inclusion of public creditors, other amendments could be made to make the RDL process more attractive for restructuring SME debt. First, the four month period of stay is generally too long for renegotiating SME debt. More flexibility to allow creditors to vote to reduce the length of the period or to vote to revoke their consent would provide useful incentives to SME creditors to use the process and limit moral hazard. In addition, the provisions in the RDL with respect to liability for those debtors who refuse "unreasonable" debt for equity terms are unsuitable for SMEs and will discourage their use. As SMEs are generally closely, and often family, held, SMEs may refuse to enter in the RDL process for fear they will be forced to accept a debt to equity swap and lose control of their business or be held personally liable if they fail to consent.

11. The OCAP procedure for SMEs offers insufficient incentives for use. The inclusion of a mechanism to specifically tackle the financial distress of SME was a welcome development. However, improvements are likely needed for it to be truly effective. Public and secured creditors, who hold the majority of SME debt, are neither affected by the stay of execution nor are they included in the restructuring agreement.[8] In addition, the limits on the content of the plan—25 percent debt-forgiveness and extension of maturities of no more than three years—are too rigid to be useful. Additionally, the law currently provides that upon a failed OCAP procedure, a liquidation proceeding within the insolvency proceeding is automatically opened. Limiting the subsequent insolvency to liquidation unduly restricts the possible exits to financial distress and constitutes a clear disincentive to use the OCAP for fear that upon failure to reach agreement with creditors, the debtor will be liquidated and the liability and disqualification section (sección de calificación) opened.

[8] While the opening of an OCAP procedure provides the debtor the option of going through a parallel process to reschedule public debt, no write-downs of debt are permitted.

12. The OCAP should be amended to provide adequate options for SMEs and to eliminate disincentives to use, as follows:

- No limits should be placed on the extent of debt forgiveness or extension allowed under the plan.
- Public creditors (addressed above) and secured creditors should be bound by the agreements and called authoritatively by the mediator to negotiations and involved in the process.
- In a subsequent insolvency proceeding, all options should be available, not just liquidation. OCAP agreements should survive and not be challengeable under avoidance rules absent intent to defraud (other) creditors. The OCAP period of good faith negotiations should be counted towards the period of "best efforts" behavior for a debt discharge (see below).

Liquidation

13. Sales of a going concern out of liquidation may offer the speediest and most complete method of deleveraging a business while preserving value. Under the Spanish regime, if the debtor files for liquidation or if no plan is proposed or approved, the proceeding enters into the liquidation phase. While the Spanish regime aims at liquidation of going concern sales wherever possible, the vast majority of proceedings still end in piecemeal liquidation largely because (i) liquidation is generally not available in practice before other rescue techniques have been exhausted and (ii) the law is unclear as to whether essential contracts, licenses and permits may be transferred without the need for a previous authorization of the contractual counterpart. In addition, the law does not allow for the direct market sale/auction of the debtor entity, free and clear of debts and liens. Stakeholders have also indicated that social security claims often survive liquidation, inhibiting speedy and efficient going concern sales.

14. Liquidation should be made more conducive to going concern sales. To speed up transition to liquidation, the judge, upon a hearing of the administrator or a creditors' committee, could be empowered to convert the case to liquidation when lengthy attempts at restructuring endanger value. Clarification to the law should be made to specifically allow the transfer of contracts, licenses and permits (without the consent of contractual counterparties) in the case of asset sales of a going concern. The transfer of favorable tax attributes, such as loss carry-forwards, could also be considered. Consideration could also be given to allow for the sale of debtor entity, free of debt and liens, with subsequent distribution of proceeds to creditors. Such sales can be particularly quick, allow the simple maintenance of necessary contracts, and lead to the continuation of the debtor enterprise together with eventual subsidiaries. In addition, it should be clarified that social security debts do not remain after a going concern sale.

Procedural and institutional aspects

15. Insolvency procedures take too long. In 2012, insolvency proceedings on average lasted approximately 650 days or more. While partially a reflection of weaknesses in the institutional framework, problems also exist with the procedural rules. First, proceedings may be held up subject to resolution of challenges and appeals against the list of creditors and inventory. Although the 2011 reform improved efficiency by providing that the suspension of the procedure would only occur when the claims challenged amount to 20% of the total claims, the measure has proven insufficient. Second, the procedures do not facilitate rapid entrance and exit of smaller debtors, despite the existence of a simplified procedure for SMEs. Third, creditors do not have enough say in the insolvency process in order to facilitate the progression of the procedure and alleviate the burden on the judge.

16. To facilitate the insolvency procedures, the following changes could be made:

- Streamline the appeals procedure against the insolvency administrator's list of claims and creditors by either 'expediting the procedures' for resolving challenges to the insolvency administrator's list or allowing for closing the common phase and moving to the next stage despite the challenges.
- Consider the development of standardized forms for use by SME filers (to be used, e.g., in the simplified proceedings) to speed up the process.
- For larger cases, provide a "creditors committee" to enhance creditors' role and control and oversight of the proceedings (including over the insolvency administrators) and alleviate the current burden on the judge.

17. The institutional framework could also be improved to expedite proceedings and foster business rescue. Although insolvency cases are decided by specialized commercial judges, there are not enough judges, judges do not have assistance (e.g., in the form of clerks), infrastructures are obsolete and inefficient, and case management and the organization of courts could be improved. This—together with a sharp increase in cases caused by the crisis—has generated a backlog of cases that causes excessive delays. Much value is put at risk by months—even years—undergoing formal insolvency proceedings. Measures to improve capacity could include creating a body of clerks to assist judges, increasing the number of judges, and improving case management by speeding the process of digitalization of files. In the area of insolvency administrators, changes should be made as follows: (i) creditors should have significant influence over selection and compensation of insolvency administrators and (ii) compensation structures should be changed to incentivize restructuring and going concern preservation.

Personal insolvency regime

18. For the smallest Spanish enterprises, the principal hindrance to effective deleveraging through insolvency is the inability of financially responsible and cooperative individual

debtors to receive a fresh start.[9] The lack of an effective discharge of the debts remaining after liquidation operates as a powerful disincentive for the debtor to file for insolvency, as they will still face full personal liability even after a bankruptcy proceeding. It also gives only limited incentive to creditors to reach an agreement with the debtor to restructure their loans pursuant to a plan, as creditors know they always remain entitled to full payment no matter how small chances of recovery may be, even in the event of total liquidation of the debtor's non-exempt assets. The lack of a fresh start hinders entrepreneurship, as individuals fear they will be held personally liable indefinitely upon business failure. It also fosters activity in the grey economy, as individuals who are indebted for life will try to keep most of their future earnings concealed from creditors (and the tax authorities), in order to prevent the benefits from being pursued by previous creditors. The lack of a discharge is particularly problematic due to the fabric of the SME economy, where the majority of businesses are sole proprietorships subject to full personal liability for business debts, and a substantial majority of the remainder, albeit incorporated, has taken personal guarantees by owners and their family in order to secure business credit.

19. Spain could amend its insolvency system to include a framework for natural persons that affords a discharge of unresolved personal debt after liquidation.[10] In line with modern legislation, and with other EU countries (e.g., Germany, Ireland, Italy, Latvia), Spain would substantially benefit from a system that provided the opportunity for a full discharge of residual debts not paid off in a liquidation of all non-exempt assets, including one's residence, after a specified number of years of subsequent good faith efforts. The period of years after which discharge would be granted, while recommended by the European Commission at no more than three years[11], could be initially set in Spain based on the "indifference point." This would be the point at which creditors would have no overall negative impact on their finances and cash position, and at which debtors would still be incentivized to use the insolvency process and use their earning capacity following liquidation of existing assets. The period of best efforts could be reduced over time as stakeholders adapt to the process[12]. The insolvency framework for individuals should be a simplified and accelerated process with minimal professional and judicial involvement, standardized petition forms, and strong institutional support. It could also facilitate the joint resolution of business-related household debt, given the large number of family loans and guarantees, by staying enforcement actions against household members. In the case of incorporated SMEs, personal guarantees and third party security rights (mortgages, pledges) given by owners and family

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[9] While the Law to Support Entrepreneurs did introduce a very limited discharge, its requirements for full payment of secured claims, all (administrative) claims against the estate and the long list of privileged claims, as well as 25% of ordinary claims in certain cases, make it unlikely that it will benefit many SME debtors, particularly those with the largest amount of debt.

[10] While this note focuses on SMEs, including individual entrepreneurs, a discharge would also be recommended for individual consumers.

[11] See European Commission Recommendation of 12.3.2014 on a new approach to business failure and insolvency.

[12] In Germany, for example, the discharge period was initially seven years, and was subsequently reduced to five and then three.

members for business debt should be addressed and settled by appropriate rules within the insolvency of the company. Experience shows that countries with high payment discipline introduced a personal bankruptcy regime that was eventually welcomed by banks and the consumer credit sector, without undermining payment culture, or negatively affecting the supply or cost of credit. Such a regime would help to clean the balance sheets of banks of credits that are irrecoverable and would relieve the courts from useless enforcement actions that offer no or little return to creditors. On the societal and macro-economic level, such a regime would encourage entrepreneurship and foster modernization, social cohesion, and growth.

Box 1. Recent Changes to the Spanish Insolvency Regime

In 2013 and 2014, Spain introduced major changes to its insolvency regime, governed by the Ley Concursal of 2003, as amended. These changes, put in place by the Law to Support Entrepreneurs (September 2013) and the Royal Decree on Urgent Matters in Relation to Refinancing Agreements and Debt Restructuring (March 2014), are summarized below.

Law to Support Entrepreneurs and their Internationalization (effective September 29, 2013) (the "LSEI")

- Expedited out-of-court restructuring mechanism for SMEs: The LSEI created a new out-of-court procedure – the "out-of-court agreement on payments" or OCAP (acuerdo extrajudicial de pagos) designed to solve the financial crises of small businesses, facilitated by a professional mediator. The process puts in place a stay on executions (up to 3 months max); secured and public creditors are not affected. The proposed plan must be approved by creditors representing at least 60% of liabilities (again, secured and public claims not included). The plan must provide for the continuation of the business, the stay or moratorium set forth in the plan may not exceed three years, and the haircut must be no more than 25%. A parallel procedure is put in place for debtor with tax and social security debt which allows only for a postponement of payments (rescheduling of arrears) but no write downs.
- Fresh Start: For the first time, the insolvency regime in Spain includes the possibility for a "fresh start" or "discharge" for individual debtors. To receive a discharge the following claims must be fully paid: (i) all claims against the estate, (ii) all "privileged claims," and (iii) 25% of all ordinary claims. After a failed OCAP procedure, rules are slightly different (only claims against the estate and privileged claims must be fully paid).

Royal Decree ("Real Decreto") on Urgent Matters in Relation to Refinancing Agreements and Debt Restructuring (effective March 8, 2014)

- Refinancing Agreements: The reform makes a number of changes with respect to judicially approved and non-judicially approved refinancing agreements. Primarily, the following:
- Individual Scheme of Arrangement: allows a company to reach a pre-insolvency agreement with any one or more of its creditors, subject to strict criteria on content, that are not subject to avoidance action (or "claw back") in an insolvency proceeding.
- Collective Refinancing Agreements: strengthened to protect against avoidance actions and expanded scope of agreements to explicitly include reference to cancellation of debt (i.e., debt write offs) and other restructuring measures such as debt to equity swaps.
- Collective Refinancing Agreements, with judicial approval: can be imposed on dissenting creditors upon reaching approval of requisite majorities, depending on the creditors involved and the type of agreement. Secured creditors can be included, subject to higher majority requirements.
- Priority for Fresh Money: all new money granted in the context of the refinancing agreements are given priority for a period of two years from the entry of force of the reform.
- Stay on Enforcement: the decree allows for a stay of execution (subject to certain limitations) during the "pre-insolvency" period; public creditors are not included in the stay.
- Tax Incentives: including (i) in the case of debt write-offs/time extensions, debtor is taxed according to a new system of apportionment of tax income but has ability to use unlimited carried-forward tax losses to offset such income; (ii) in debt-to-equity swaps debtor is not taxed; and (iii) public deeds documenting debt write-offs or reductions of loans, credits or other obligations are now exempted from transfer tax and stamp duty.

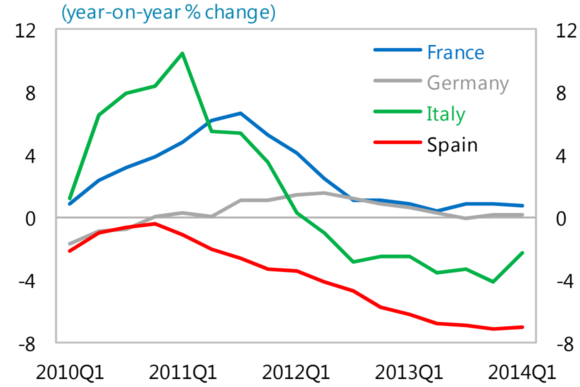
SPAIN'S BANKS: BOOM/BUST AND BEYOND—A LONG-TERM PERSPECTIVE OF THE SYSTEM[1]

Spain's banking system has made substantial progress in recovering from the bust that followed a domestic credit-fuelled real estate boom and the euro area sovereign debt crisis. Public and private capital injections, retention of earnings, disposal of problem assets and deleveraging have helped to strengthen banks' capital ratios and increase provisions against loan losses. Along with key complementary reforms at the European level, Spanish banks' funding costs have declined, share valuations have risen, and lending conditions have started to ease. Nonetheless, credit to the private sector is still contracting faster than desirable and lending rates remain relatively high within the euro area, posing headwinds for growth. The policy challenge is thus to further improve conditions for banks to lend to creditworthy borrowers in order to support the recovery. To achieve this end, banks should continue to raise high-quality loss-absorbing capital, address problem assets, reduce costs, and ensure adequate provisions. Such steps would also further strengthen the outlook for Spanish banks in the ECB's ongoing Comprehensive Assessment. The Bank of Spain (BdE) is appropriately conducting a forward-looking assessment of its banks pro-actively.

A. From the End of the Boom to Today

1. **Spain's banking system came under major stress in recent years**. During the boom of the last decade, lending grew rapidly, particularly for real estate purchase and development, leading to a large excess supply of housing by 2008. Following the collapse of Lehman Brothers, banks faced tighter funding conditions, prompting tighter lending conditions. This accelerated the bursting of the real estate boom, increasing credit losses for banks. These developments hurt profits and capital, as did subsequent financial market stress related to the euro area crisis. At the same time, tougher post-Lehman regulatory standards raised the need for capital.

Credit to the private sector has been contracting
(year-on-year % change)



Sources: Haver; and BdE.

2. **In response, Spain's banks have bolstered capital ratios and provisioning through a variety of resources**. Key contributors include retained earnings, with a considerable share of earnings coming from foreign operations; public and private capital injections; asset sales, including to the asset management company (SAREB); and credit contraction. This process has been fostered

[1] Prepared by Mustafa Saiyid (MCM).

by repeated domestic policy actions to require banks to repair their balance sheets and restructure their operations, culminating in the financial sector program of 2012-13. This program started with an asset quality review and stress test that identified a capital shortfall of about 5½ percent of GDP—which has subsequently been filled—at Spain's weakest banks. Attention has now switched from restructuring and resolution to reviving lending and disposing of public stakes in financial institutions.

3. **This section explores in more detail how banks' balance sheets have evolved during this period of bust and recovery**. In particular, it examines the evolution of banks' assets, liabilities, earnings, capital, liquidity, and efficiency.

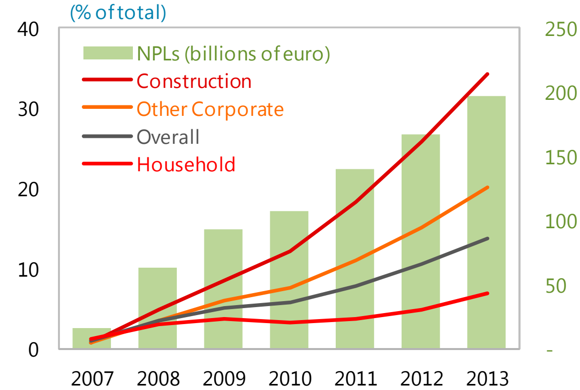
Assets

4. **Spain's real estate bust and associated financial crisis led to major changes in banks' assets**. In particular:

- **The real estate bust and broader Euro-area crisis caused credit quality to deteriorate sharply**. After more than doubling over a 5-year period prior to 2007, house prices fell sharply, some 30-40 percent through end-2013. Commercial property prices followed a similar trend. This led to significant deterioration in the quality of loans to property developers. By end-February 2014, the overall NPL ratio on banks' portfolios had risen to 13.4 percent compared with only 0.9 percent in 2007. The NPL ratio stabilized in the first quarter of 2014.

- **NPL ratios varied sharply across different loan types**. NPLs have reached 34 percent of lending in the construction sector, whereas household sector NPLs, including mortgages and other consumer loans, remain much lower at 6.9 percent. The relatively low NPLs on household sector loans despite very high unemployment reflect several factors, including the following: a strong payment culture, in which banks have full recourse to the debtor's assets in case of default; relatively low loan-to-value ratios on Spanish mortgages at origination; the transformation of mortgage NPLs into foreclosed assets; and a large drop in debt-servicing costs during the crisis due to lower interest rates in a context of variable-rate mortgages.

NPLs have been rising
(% of total)



Source: BdE.

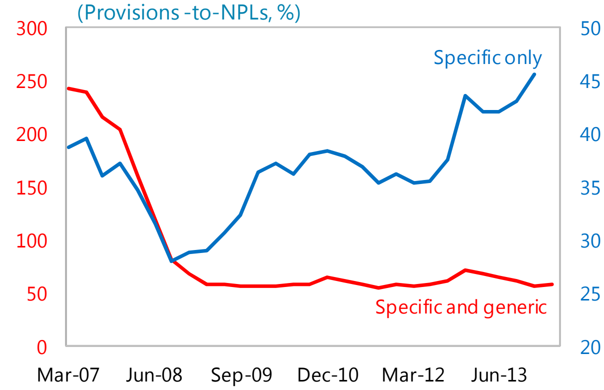
- **In this deteriorating loan environment, the authorities increasingly required banks to strengthen provisions**. The build-up in provisions on real estate portfolios was especially rapid during 2012 in response to government royal decrees, which required both higher specific provisions on non-performing loans and generic provisions on performing loans. During 2013, some generic provisions have been used up as previously performing loans have become delinquent. As a result, nearly half of all non-performing loans are now covered by specific provisions.

- **Financial stress prompted a sharp decline in lending**. Loans in proportion to banking sector assets dropped from 78 percent in 2007 to 64 percent in 2013, in part due to (i) banks seeking to strengthen capital ratios by reducing risk-weighted assets, (ii) concerns of falling credit quality among borrowers, and (iii) weaker loan demand amidst recession, among other factors. Between 2008 and 2013, deleveraging, including asset transfers to SAREB, represented a 21 percent contraction in lending, a reduction equal to 50 percent of annual GDP. The contraction in bank lending was partly offset by increased bond issuance by large corporates, but this effect was modest as bank lending remains by far the major funding source for Spanish corporates.

- **Lending to corporates contracted especially quickly**. Between 2008 and 2013, banks cut back lending to corporates, including SMEs, by 30.2 percent. Most affected was the construction industry, for which banks' loan portfolio contracted by 60 percent. In comparison, banks' lending to households contracted by 13 percent, of which banks' lending for mortgages fell by 7 percent.[2] As noted above, the decline in lending to large corporates has been partially offset by increased bond issuance.

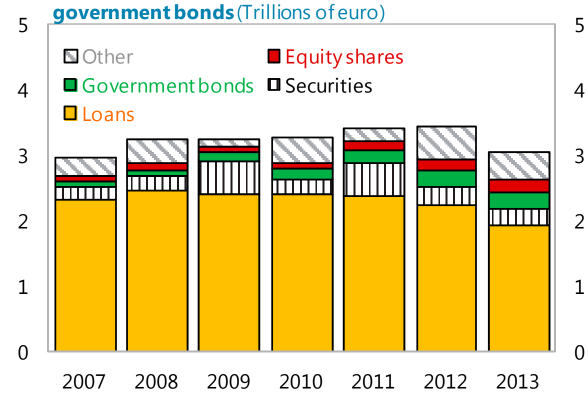
- **Banks were initially slow to dispose of impaired assets, but this process has accelerated during the last two years**.

Specific provisions have risen over time
(Provisions -to-NPLs, %)



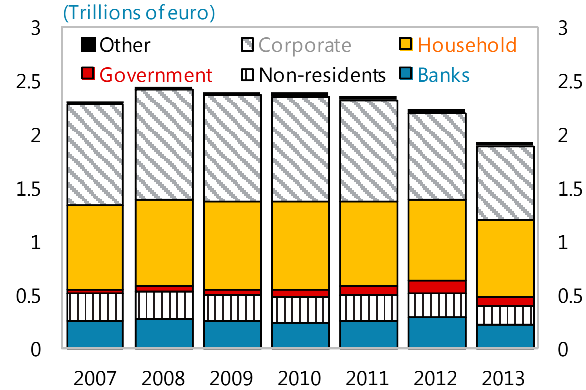
Source: BdE.

Banks' assets comprise fewer loans and more government bonds (Trillions of euro)



Sources: BdE; and IMF staff estimates.

Banks' loans have fallen
(Trillions of euro)



Sources: BdE; and IMF staff estimates.

  - A key component of the recent reform program was the clean-up of weak banks' problem assets, which consisted mainly of real estate loans to developers (REDs) and foreclosed

[2] The remainder of loans to households for other uses, such as auto purchase and credit cards, fell by 30 percent.

assets. In late 2012 and early 2013, banks receiving state aid were required to transfer most of these assets to SAREB, in order to create conditions for these banks to resume lending and to make state-owned banks more attractive to potential buyers.[3] Nearly 200,000 real estate-related assets with a gross book value of €108 billion were transferred at an average transfer price equal to 47 percent of the assets' gross book value.

- In early 2014, the sale of problem assets to other distressed debt funds also picked up. For instance, Catalunya Bank was able to dispose of its low-quality mortgage portfolio.

- By freeing up space on banks' balance sheets, such asset sales are contributing to a pickup in new lending to corporates, especially to SMEs, which has increased 7 percent year-on-year in February 2014 and have registered positive year-on-year growth rates since October 2013 and up until the latest available data (March 2014), which marks a clear change in trend given that these year-on-year rates had been systematically negative since April 2008. Nevertheless, total bank lending to corporates continues to decline at a pace of about 14 percent year-on-year since repayments are still higher than new credit flows. This overall decline may be partially explained by the recent increase in issuance of debt securities by large non-financial corporations as financial market conditions have improved.

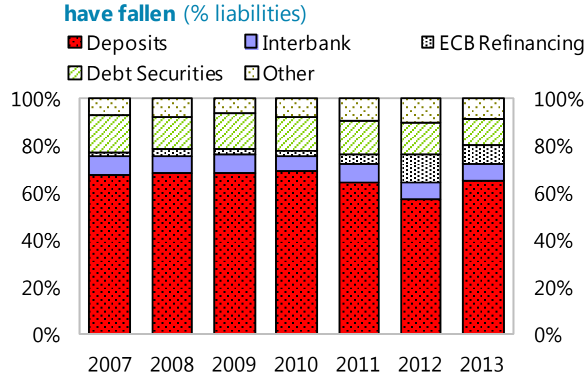
- **With loans declining sharply, there has been an increase in holdings of securities, particularly government issuance**. Since 2007, banks' holdings of government securities have more than tripled to €257 billion, representing 8.5% of total assets versus 2.6% in 2007, while loans to the government have doubled to €87 billion. Equity holdings have nearly doubled to €189 billion, representing 6.2% of total assets versus 3.5% in 2007.

Liabilities

5. The crisis had a significant impact on banks' liability structure.

- Between 2007 and 2012, the proportion of deposits in liabilities fell mainly due to a decline in non-resident deposits, including non-resident bank liabilities, which has more than offset an increase in domestic household deposits. Deposit growth rates improved considerably throughout 2013 and have been broadly flat so

ECB borrowing has increased as debt securities have fallen (% liabilities)

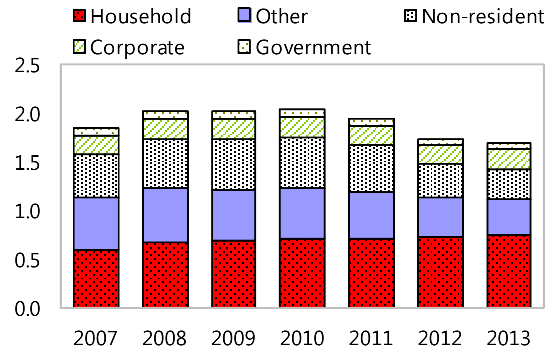


Source: BdE.

[3] In September 2012, an independent stress test of banks' balance sheets identified ten banks that were projected to face capital shortfalls relative to a benchmark of a 6 percent CT1 capital ratio by end-2014 under an adverse scenario. These banks were divided into three groups: Group 1 (banks that could not fill their capital needs on their own and were already controlled by the state); Group 2 (other banks that could not fill their capital shortfall on their own); and Group 3 (banks that could fill their capital shortfall through their own means).

far in 2014. The ratio of deposits to liabilities has returned to 2007 levels.

Household deposits rose as non-resident deposits fell (Deposits, trillions of euro)

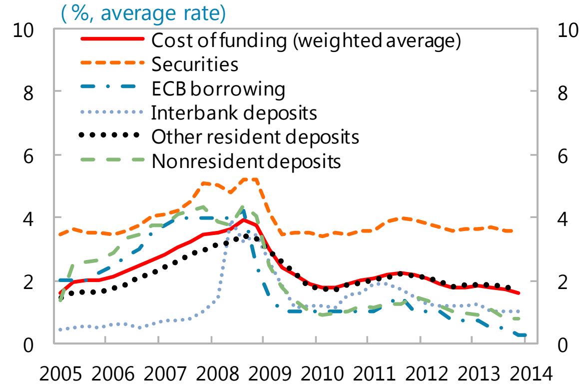


Source: BdE.

- Wholesale funding exposure has remained largely stable: interbank exposure, including to central banks, increased from 9 percent of the total in 2007 to 13 percent in 2013; but was largely offset by a decline in debt securities issuance. Correspondingly, the average maturity of funding has shortened, as interbank borrowing tends to be at shorter maturities than debt issuance.
- ECB funding rose sharply during the crisis, but now plays a reduced role. As of end-April 2014, ECB funding amounted to €182 billion, of which LTROs are €161 billion (about 5 percent of liabilities), compared with a peak amount of €357 billion at end-2012.

6. Banks' funding costs rose during 2010–11 as the euro crisis intensified and have since eased as it abates. Average funding costs have closely tracked the average interest rate on resident deposits, as this is banks' main source of funding.

The cost of bank funding has declined
(%, average rate)

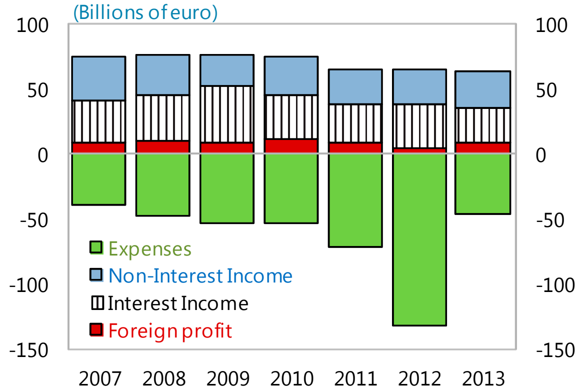


Sources: BdE; and IMF staff calculations.

Earnings

7. Banks' pre-provision profits have been affected by changes in funding costs. Net interest income was supported during the initial phase of the bust (2008–09), rising to a peak toward the end of 2009, after funding costs declined from their peak at the time of the Lehman collapse in late 2008. However, with the advent of the Euro area crisis, rising yields on sovereign debt led to higher costs on securities, raising marginal funding costs and eroding interest income. Nevertheless, during this period banks' non-interest income picked up as did earnings from foreign operations. Since 2012, deleveraging of banks' lending portfolios has reduced banks' ability to earn interest income even though funding costs have declined. During 2013, falling sovereign yields have contributed to capital gains on banks' holdings of government securities, supporting non-interest income. Throughout 2007–13, income from foreign operations, principally from two large internationally-active banks, has supported consolidated operating income of the overall banking system, making up more than 30 percent of the total each year. For these two banks,

Earnings are mainly affected by expenses
(Billions of euro)

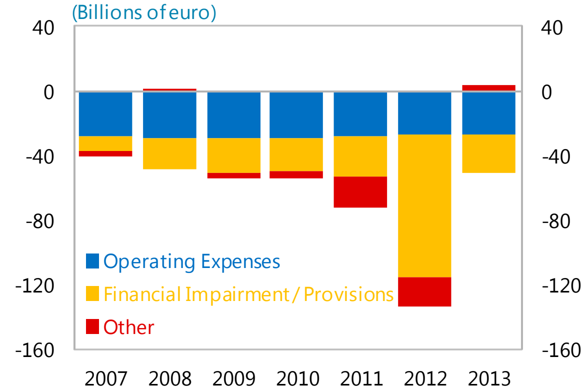


Source: BdE.

the use of autonomous subsidiaries and multiple-point-of-entry resolution models helps to reduce stability risks.

8. Credit losses and associated provisioning needs have weighed heavily on earnings. System-wide earnings fell from €33.6 billion in 2007 to -€69.5 billion in 2012.[4] During 2013, earnings turned positive again, at €16.1 billion, but remain below the level of the boom period and were partly boosted by non-recurring gains on financial assets and liabilities. The large variation in earnings, particularly in 2012, has been driven mainly by financial asset impairments and provisions. The latter has been a significant charge to the P&L account of banks, amounting to some €185 billion cumulatively over 2007–13 and reflecting a sharp step-up in provisioning requirements in 2012.[5]

Expenses are dominated by impairment
(Billions of euro)



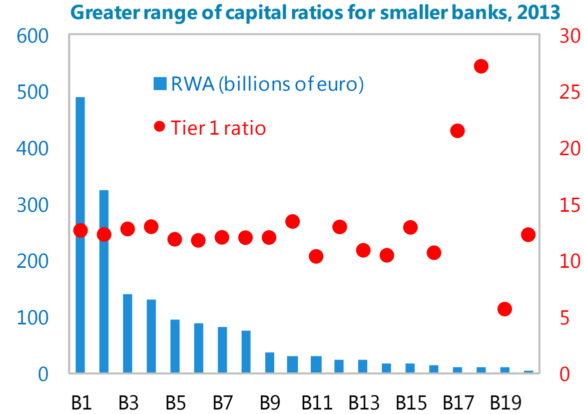
Source: BdE.

Capital

9. Capital ratios have been substantially strengthened.

- Since the end of the boom in 2007, Spanish banks have made substantial progress in strengthening capital buffers and improving the quality of capital. The Tier 1 ratio of the system has increased from 7.6 percent of risk-weighted assets at the start of 2007 to 11.8 percent at end-2013. Moreover, this improvement in solvency has been accompanied by an improvement in the quality of capital, with a decrease in subordinated debt (Tier 2) and preferential shares (low-quality Tier 1). All large and mid-sized banks are now operating above the new minimum regulatory capital requirement of 9 percent Core Tier 1 ratio although there is considerable variation in capital ratios for smaller banks.

Greater range of capital ratios for smaller banks, 2013



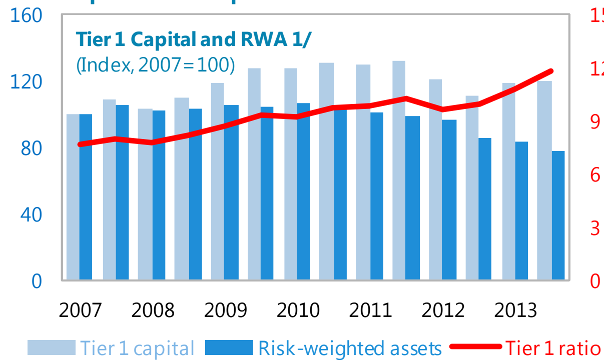
Source: SNL.

4 Earnings for foreign operations of the banking system are estimated from those of the two largest banks as reported in filings. The domestic profit of the banking system is calculated as the sum of the profit or loss of each institution taken individually.

5 Decrees mandating stepped up specific and generic provisions for REDs were adopted in the first half of 2012, before the start of the program.

- This improvement is owed to a combination of (i) falling risk-weighted assets (RWA), the denominator of the ratio, and (ii) higher capital, the numerator of the ratio. Over 2007–13, the impact of lower RWA on capital ratios has been greater than that of higher capital. This was especially the case during 2011-2012 when capital fell in absolute levels, though this trend reversed in 2013 under the program. RWA has fallen by some 22 percent since 2007 to €1.6 trillion, the result of both deleveraging of banking sector portfolios (for example, contraction of credit) as well as declining risk-weightings of portfolios, falling from 65 percent of assets in 2007 to 45 percent at end-2013, due in large measure to transfer of problem assets out of the banking system, particularly in response to the crisis in 2012. The shift in 2013toward increased reliance on capital generation (rather than just deleveraging) to boost capital ratios has positive implications for economic growth.

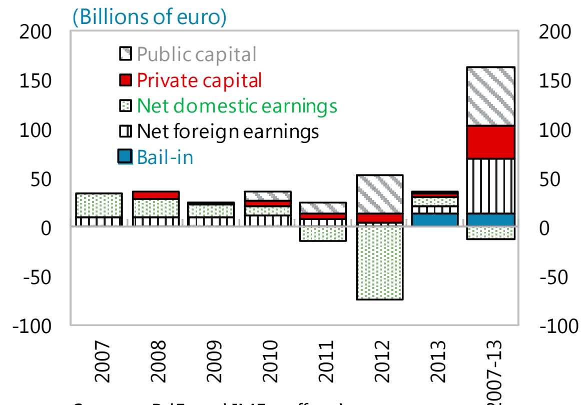
Capital ratios improved



Source: IMF, *Financial Soundness Indicators*.
1/ Based on consolidated data for banks domiciled in Spain.

10. Banks' capital has been strengthened from a variety of sources. Over 2007–13, the net increase in banking system Tier 1 capital has amounted to €16 billion. This has raised the overall level of capital to €179 billion and is due to a combination of factors, including capital injections from public sources, capital-raising in markets, bail-in of subordinated debt, and retained earnings supported by recent constraints on dividend distribution. The relative importance of each of these factors has varied over time: during 2007-09, higher capital was mainly achieved by earnings retention and to a lesser extent by issuance of new capital in markets. During the Euro-area crisis period (2010–12), as net domestic earnings turned negative and access to private capital declined, public capital injections became significant in stabilizing weak banks within the system. During 2013, use of the bail-in mechanism was important in improving the capital profile of the banking system, as was earnings retention amidst dividend restrictions. Public capital injections, including through purchase of equity shares and issuance of convertible preferred shares, over 2007–13 have amounted to €60 billion, while private capital has amounted to €33 billion.[6] Bail-in of subordinated debt has contributed a further €13 billion. Throughout 2007–13, net foreign earnings, estimated at some €55 billion, have provided substantial support to the system's capital,

Capital change owed to many sources



Sources: BdE; and IMF staff estimates.

[6] State support has also included issuance of guarantees on bank debt.

providing evidence of benefits from a geographically-diversified business model followed by the two largest banks.

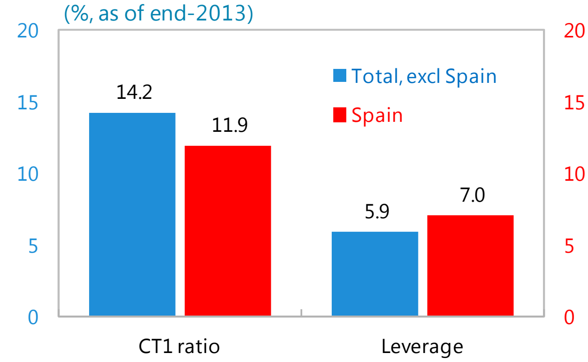
11. The authorities have also preserved banks' recorded capital by changing the tax treatment of deferred tax assets (DTAs). This change applied only to domestic DTAs arising from certain types of "temporary differences".[7] The change allows banks (and other firms) to convert these DTAs into refundable tax credits in the event

- the bank becomes insolvent;
- the DTA is still unused after 18 years, at which point it would have previously expired; or
- the bank has an accounting loss for a year (in this case, the percent of DTAs converted is limited to the accounting loss as a percent of a bank's capital).

Before this change, DTAs might not have had value in a situation such as bank insolvency. Consequently, these DTAs would have been gradually deducted from calculations of CET1 capital under CRD IV, Europe's regulations implementing the transition to Basel III prudential requirements, with a phased deduction, subject to a threshold, starting in 2014 and rising to 100 percent by 2026. The December law change ensures that these DTAs will retain value in all situations and thus will no longer be deducted from CET1 capital under CRD IV/Basel III rules.[8] In 2014, this change improves the system's regulatory capital ratio by an estimated 0.6 ppt relative to what it would have been otherwise.

12. Spanish banks perform relatively strongly in terms of leverage compared to European peers. This reflects Spanish banks more "traditional" banking model based on lending and thus a higher density of RWA to total assets.

Core Tier 1 and Leverage Ratios 1/
(%, as of end-2013)



Source: SNL.
1/ Based on 150 European banks, of which 11 are Spanish.

Liquidity

13. Banking sector liquidity has improved over time. The overall liquidity situation of banks has been supported by the transfer of state-aided banks' problem assets to SAREB in return for SAREB bonds,

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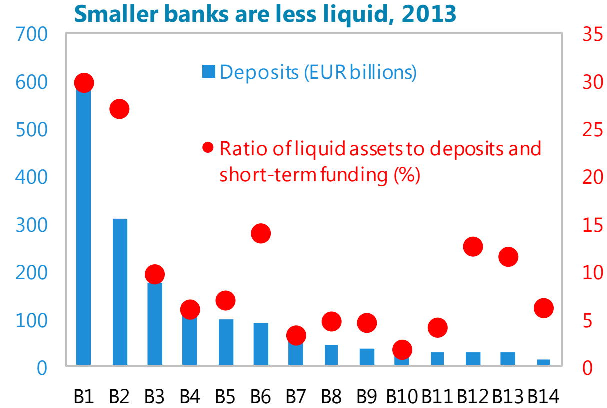
[7] DTAs arising from timing differences are eligible for the deduction. These arise when a bank incurs an accounting loss that is not tax-deductible until some point in the future – for example, when a bank makes a generic provision, it is typically not tax-deductible until assigned to a specific loan as a specific provision; in the meantime, the bank records a loss from the generic provision in its accounts and counts the expected future tax deduction as an asset (DTA).

[8] See Box 2.3 of the BdE's May 2014 Financial Stability Report for further explanation of this change and its rationale.

which can be more easily used as collateral, as well as an increase in holdings of government bonds over time. The system's loan-to-deposit ratio has improved from 168 percent in 2007 to 123 percent in 2013. However, liquidity data in terms of Basel III metrics, including the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio NSFR, are less readily available, and it is not clear the extent to which banks have made progress in providing full coverage of 30-day liabilities with liquid assets. For a 1-year liquidity window, the ratio of liquid assets to deposits and short-term funding suggests that the two largest banks in the system are more comfortably placed than other banks in the system.

Smaller banks are less liquid, 2013



Source: Bankscope.

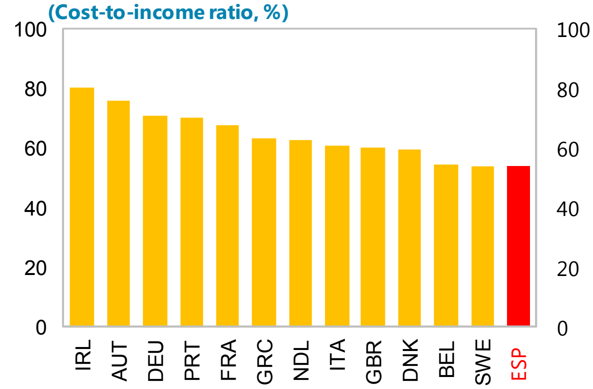
Efficiency

14. Banks are making substantial gains in efficiency. The number of large and mid-sized banks operating in Spain has fallen from 50 in 2007 to 14 in 2013, in part due to significant consolidation of the savings bank sector.[9] Branches of the entire banking system have been reduced from 45,000 to 33,000, while the number of banking sector employees (in thousands) has declined from 277 to 218. These developments have resulted in gains for some efficiency metrics, including loans per employee (in billions of euro) that has risen some 8 percent, and loans per branch that is up 11 percent. The cost-to-income ratio for the overall Spanish banking system compares favorably with that of banks in other advanced countries in Europe; however, there are significant differences in efficiency between different types of banks.

State ownership

- The authorities have made significant progress in divesting ownership stakes acquired in banks as part of public support efforts during the program and earlier. Nevertheless, the state still carries an estimated €12.1 billion in ownership of the banking system comprised of stakes in Bankia, Catalunya Banc, and Banco Mare Nostrum—that will have to be unwound (Table 1). After Bankia

Spanish banks have relatively low operating costs, 2013 (Cost-to-income ratio, %)



Sources: BdE; and ECB (end 2013 or latest available).

[9] These developments are in line with structural recommendations made by the IMF's Financial Stability Sector Assessment (FSAP) in 2012, as well as subsequent Staff monitoring missions for the Spanish program supported by the ESM.

turned a profit in 2013, the government sold a 7.5 percent stake in early 2014, which reduced its ownership to 60 percent of shares. Plans have recently been announced for an auction of Catalunya Banc in July; and BMN is meanwhile making progress in improving cost efficiency.

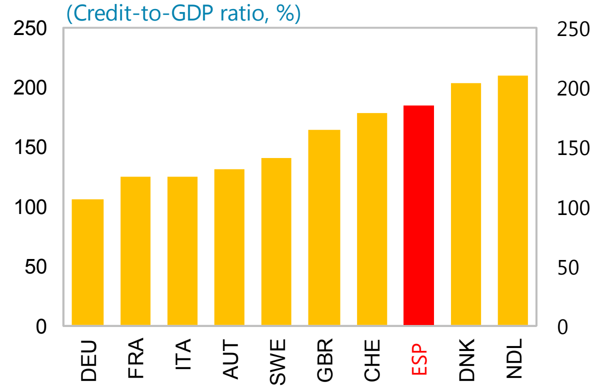
Estimate of Remaining State-Ownership of Banking System (May 2014)
(Millions of euros)

	Bank name	Injection of public capital	End-2013 Equity	Estimate of remaining public ownership
Group 1	BFA-Bankia	17,959	12,307	9,492
	Catalunya Banc	9,084	2,535	1,858
	Nova Caixa Galicia	5,425	2,715	0
Group 2	Banco Mare Nostrum	730	2,079	730
	Liberbank	124	1,585	0
	CEISS	604	654	0
	Caja3	407	52	0
	Total	34,333	21,927	12,080

Sources: BdE; FROB; and IMF staff estimates.

B. Looking ahead

Private sector credit is relatively high
(Credit-to-GDP ratio, %)



Source: IMF, *IFS*.

15. The overarching challenge now is to create conditions for banks to sustainably ease credit conditions to better support the recovery.[10] Any such easing will likely need to be consistent with credit falling as a ratio to GDP given Spain's ratio (swollen by the boom) is significantly above most Euro area peers. This suggests the following agenda for the authorities and for banks.

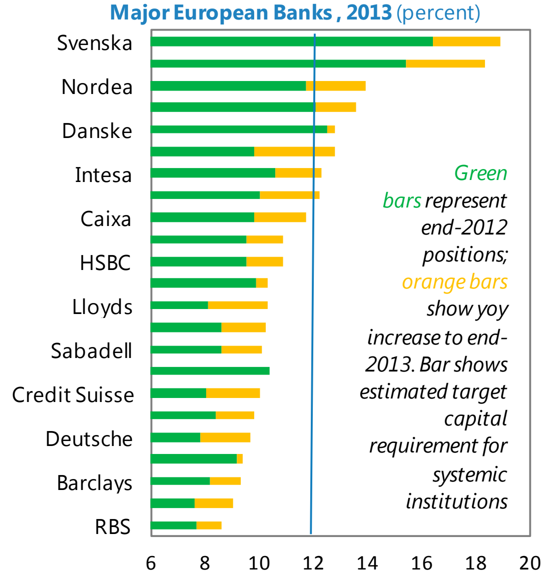
- **Continue to monitor banks' capital buffers closely in light of uncertainties regarding the exact outcome of the Comprehensive Assessment**. Actions have already been taken to bolster capital and provisions significantly—the leverage of the largest banks is lower than European banking peers. Nevertheless, as noted in the BdE's May 2014 Financial Stability Report, capital ratios of Spanish banks remain below-average for advanced Europe, in part due to higher

[10] For further discussion, see Box 2: "Would Slower Private-sector Deleveraging be Good or Bad?" in Spain: Financial Sector Reform, Final Progress Report, February 2014.

RWAs.[11] The ECB's ongoing Comprehensive Assessment's approach entails some important differences from the asset quality review and stress test undertaken under Spain's financial sector program, which will also impact the other EU banks subject to the Comprehensive Assessment. For example, unlike the program's approach, the Comprehensive Assessment will apply haircuts to sovereign bonds in relation to ratings and will also review samples of foreign loan portfolios of banks.[12] The Comprehensive Assessment will also extrapolate 2013 earnings of banks to the following 3-year period (with limited exceptions). Banks that suffered losses in earnings, for example due to high provisions, will therefore be at a disadvantage in the exercise, while those that generated significant earnings, for example from foreign operations, will be at an advantage.

- **Continue to improve capital ratios, with a focus on raising nominal capital**. Spanish banks have made very substantial progress in strengthening capital ratios and provisions. However, given the still-challenging economic environment, banks should continue to strengthen capital in absolute (euro) terms rather than seek to improve capital ratios by deleveraging. Further increasing nominal capital will allow banks to ease the pace at which lending is contracting, whereas faster deleveraging will lower broader economic growth and the performance of banks' loan portfolios, ultimately reducing capital through financial impairment. Importantly, as a general matter, capital ratios for financial institutions in Europe need to be improved in accordance with regulatory developments and market demands.[13]

Basel III Common Equity Tier 1 Ratios for Major European Banks, 2013 (percent)



Source: SNL, bank filings.

- **Toward this end, encourage banks to issue equity and restrain cash dividends and bonuses**. Present market conditions are favorable for equity issuance as banks' shares are attractively priced relative to book value. However, individual banks appear to be relying mainly on issuance of hybrid capital, some of which is Tier 2. While this may make sense from the perspective of an individual bank, it makes less sense from the perspective of the economy as a whole, given the positive externalities to higher bank capital (see Box 5 of the Final Progress Report[14]). There might thus be merit in the BdE taking action to address this collective action

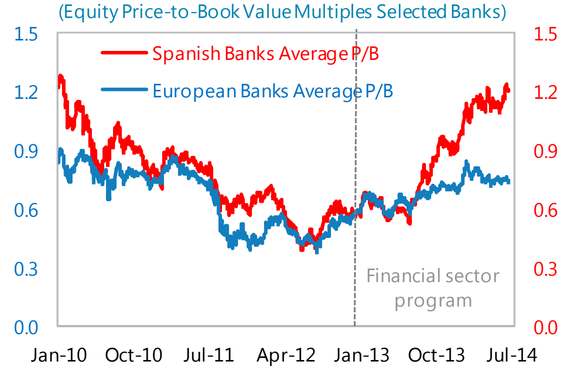
[11] Financial Stability Report, Banco de Espaňa, May 2014 (pp. 38).

[12] The ECB will analyze samples of Spanish banks' foreign portfolios in Portugal, Germany, UK, USA, Mexico, Brazil and Chile.

[13] See for instance, closing address by Mr Fernando Restoy, Deputy Governor of the Bank of Spain, at the XXI Meeting of the Financial Sector, organized by ABC, Deloitte and Sociedad de Tasación, Madrid, 1 April 2014.

[14] Available via the Internet: http://www.imf.org/external/pubs/ft/scr/2014/cr1459.pdf

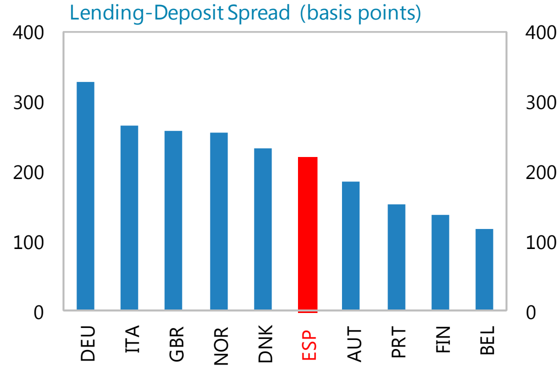
problem, as it did with the guidance on constraining cash dividends to 25 percent of net income in 2013 and 2014. Indeed, there seems to be merit in extending guidelines on restraining dividends to 2015.



Source: Bloomberg.

- **Support efforts to foster corporate debt restructuring**. The recent corporate debt restructuring initiatives should support the creditworthiness of corporate customers and improve banks' asset quality (see companion notes on corporate debt restructuring). The BdE could also consider other measures to foster corporate debt restructuring, such as accelerating the pace at which NPAs are written off and more forward-looking provisioning on loans to potentially insolvent firms.

- **Continue to improve profitability**. In the near term, banks' profitability will receive support from lower funding costs, as reflected in new term deposits and new ECB funding measures, as well as from capital gains on securities' holdings. Nevertheless, banks should continue to improve profitability by reducing operational costs and improving efficiency. There is scope to increase Spanish banks' net interest margin, for example in relation to banks in some other European countries.



Source: IMF, *FSI*.

- Actions at the European level would help this process. Recent ECB actions—including a rate cut, negative deposit rates and policy support for new bank lending to companies—should help address low inflation and financial fragmentation. Successfully executing the ongoing asset quality review and stress tests should spur balance sheet repair and help reverse fragmentation. Agreement on a single resolution mechanism and bail-in rules comprise important milestones towards banking union, but a common fiscal backstop is still needed.

Annex I. Spanish Banks: A View Through The Crisis, 2007–14 1/

	2007	2008	2009	2010	2011	2012	2013	2014 (latest)
				Part 1: Evolution of banking system structure (millions of euros)				
ASSETS	**2,946,499**	**3,223,716**	**3,238,236**	**3,251,535**	**3,400,435**	**3,422,611**	**3,025,756**	**3,008,430**
Total loans	2,303,673	2,439,203	2,385,126	2,386,644	2,357,168	2,229,670	1,926,174	1,881,394
Banks	246,129	263,091	246,806	234,095	250,867	278,914	210,536	165,932
Government	42,841	52,919	64,662	78,971	89,687	114,275	87,140	96,158
Non-bank residents	1,760,213	1,869,882	1,837,037	1,843,950	1,782,554	1,604,934	1,448,244	1,440,190
of which Households	789,250	819,412	813,939	812,781	793,430	755,689	714,984	714,984
For house purchase	595,929	626,620	624,755	632,449	626,550	605,057	580,784	580,784
Corporates	943,087	1,016,948	991,363	985,157	944,058	799,610	688,397	688,397
Construction	153,453	151,848	130,438	114,519	98,546	76,217	60,154	60,154
Non-residents	254,491	253,311	236,621	229,627	234,059	231,546	180,254	179,114
Securities other than shares	267,909	325,706	643,693	383,761	694,432	508,991	492,801	513,797
of which Government bonds	76,499	96,702	148,998	156,698	190,198	240,728	257,531	279,786
SAREB bonds						36,694	50,781	*50,781*
ESM bonds						36,968	38,833	*38,833*
Shares and other equity	101,817	92,206	99,414	103,150	160,679	167,292	189,028	192,064
Other assets	273,100	366,602	110,002	377,979	188,156	516,658	417,753	421,175
Memo Items:								
Doubtful Assets	17,147	65,617	96,846	111,014	143,470	172,225	202,734	198,237
Stock of NPLs	16,251	63,057	93,327	107,199	139,760	167,468	197,235	192,773
of which to Households	8,797	24,346	29,931	25,982	28,650	37,028	49,424	49,424
to Corporates	6,979	37,293	61,913	79,719	109,899	128,415	146,052	146,052
to construction	1,111	7,461	11,069	13,888	17,981	19,693	20,617	20,617
LIABILITIES	**2,946,499**	**3,223,716**	**3,238,236**	**3,251,535**	**3,400,435**	**3,422,611**	**3,025,756**	**3,008,430**
Banks	268,638	314,964	304,979	269,668	372,668	572,928	381,293	366,585
Government deposits	75,220	76,054	81,805	79,080	69,717	69,183	63,485	74,744
Deposits from non-bank residents	1,322,583	1,432,573	1,426,888	1,440,425	1,373,079	1,316,735	1,314,129	1,307,927
of which Households	592,099	661,312	687,348	710,613	710,472	716,939	742,584	734,005
Corporates	204,140	212,782	215,636	219,083	197,473	190,966	204,866	201,770
Non-resident deposits	441,690	504,745	506,518	511,046	491,675	339,019	306,493	310,470
Debt securities issued	426,416	398,626	439,877	432,892	434,512	394,300	297,410	282,229
of which government guaranteed	-	2,023	49,008	59,506	64,656	68,399	53,033	*53,033*
Equity and impairment allowance	206,284	242,426	269,798	282,515	363,348	402,901	428,347	434,071
of which Equity and reserves	174,922	180,567	190,369	178,166	220,161	195,221	232,648	239,476
Other	205,667	254,328	208,370	235,908	295,437	327,546	234,598	232,403
Memo item: Use of ECB refinancing	52,308	92,850	81,441	69,735	132,806	357,293	206,760	184,332
				Part 2: Selected items of capital increase and provisioning (billion of euros)				
Risk-weighted assets 3/	2,062,974	2,027,406	2,045,790	2,025,807	1,929,630	1,683,392	1,640,656	...
Tier 1 capital 3/	162,975	166,247	192,304	196,503	198,752	166,656	178,831	...
Actual change in capital 3/		3,272	26,057	4,199	2,249	(32,096)	12,176	...
Reinvested earnings 3/	33,556	27,659	21,408	20,119	(7,315)	(69,474)	16,103	...
Estimated profit from foreign operations 2/	8,444	9,238	8,452	10,446	7,402	4,232	7,313	...
Domestic book profit	25,112	18,421	12,956	9,673	(14,717)	(73,706)	8,790	...
of which Interest Income (Net)	32,141	35,158	43,035	34,292	29,565	32,739	26,816	...
Non-Interest Income	32,978	31,224	24,517	29,021	27,561	26,768	28,728	...
Operating Expenses	(28,074)	(29,508)	(29,400)	(29,431)	(28,464)	(26,951)	(26,798)	...
Provisioning Expense	(1,446)	(3,405)	(1,351)	(3,963)	(1,805)	(6,422)	(2,185)	...
Financial Asset Impairment	(8,029)	(15,245)	(19,551)	(16,719)	(22,668)	(82,547)	(21,800)	...
Other (incl. taxes)	(2,457)	197	(4,293)	(3,527)	(18,906)	(17,293)	4,030	...
Dividends paid out	...	...	...	...	...	...	...	...
Capital generation (public / private sources)	-	7,195	2,527	15,086	16,116	47,408	18,560	...
Private capital increases 3/	-	7,195	845	5,412	6,116	9,508	4,140	...
Capital augmentation through SLEs 3/	-	-	-	-	-	-	13,287	...
Injection of public capital	-	-	1,682	9,674	10,000	37,900	1,133	...
Provisioning effort								...
Charges to P&L account	-	15,070	23,810	18,956	29,571	85,365	26,352	...
Provisions created using reserves	-	-	-	23,945	8,902	12,479	235	...
Use of generic provision	-	4,873	7,583	3,465	2,178	2,120	3,026	...

Source: BdE.

1/ All line items are reported on solo basis except as noted otherwise.

2/ Banking system foreign profits are estimated from those of the two largest banks as reported in filings.

3/ On consolidated basis.

Annex II. Spain: Selected Financial Soundness Indicators, 2006–13

(Percent or otherwise indicated)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	Latest Data
Solvency										
Regulatory capital to risk-weighted assets 1/	11.9	11.4	11.3	12.2	11.9	12.2	11.6	13.3		Dec-13
Tier 1 capital to risk-weighted assets 1/	7.5	7.9	8.2	9.4	9.7	10.3	10.0	11.8		Dec-13
Capital to total assets	6.0	6.3	5.5	6.1	5.8	5.7	5.8	6.8		Jun-13
Profitability										
Returns on average assets	1.0	1.1	0.7	0.5	0.5	0.0	-1.4	0.4		Jun-13
Returns on average equity	19.5	19.5	12.0	8.8	7.2	-0.5	-21.0	5.3		Jun-13
Interest margin to gross income	50.3	49.4	53.0	63.7	54.2	51.8	54.1	52.3	52.3	
Operating expenses to gross income	47.5	43.1	44.5	43.5	46.5	49.8	45.4	53.8	53.8	
Asset quality 2/										
Non performing loans (billions of euro)	10.9	16.3	63.1	93.3	107.2	139.8	167.5	197.2	195.2	Feb-14
Non-performing to total loans	0.7	0.9	3.4	5.1	5.8	7.8	10.4	13.6	13.4	Feb-14
Specific provisions to non-performing loans	43.6	39.2	29.9	37.7	39.6	37.1	42.6	46.9	47.3	
Exposure to construction sector (billions of euro) 3/	378.4	457.0	469.9	453.4	430.3	396.9	300.4	237.0	237.0	
of which: Non-performing (percent)	0.3	0.6	5.7	9.6	13.5	20.6	28.2	37.1	37.1	
Households - House purchase (billions of euro)	523.6	595.9	626.6	624.8	632.4	626.6	605.3	580.8	580.8	
of which: Non-performing (percent)	0.4	0.7	2.4	4.9	2.4	2.9	4.0	6.0	6.0	
Households - Other spending (billions of euro)	203.4	221.2	226.3	220.9	226.3	211.9	199.1	179.1	179.1	
of which: Non-performing (percent)	1.7	2.3	4.8	6.1	5.4	5.5	7.5	9.2	9.2	
Liquidity										
Use of ECB refinancing (billions of euro) 4/	21.2	52.3	92.8	81.4	69.7	132.8	357.3	206.8	185.0	Mar-14
in percent of total ECB refin. operations	4.9	11.6	11.6	12.5	13.5	21.0	32.0	28.8	28.5	Mar-14
in percent of total assets of Spanish MFIs	0.8	1.7	2.7	2.4	2.0	3.7	10.0	6.6	5.9	Feb-14
Loan-to-deposit ratio 5/	165.0	168.2	158.0	151.5	149.2	150.0	137.3	123.0	124.4	Feb-14
Market indicators (end-period)										
Stock market (percent changes)										
IBEX 35	31.8	7.3	-39.4	29.8	-17.4	-13.4	-6.4	21.4	8.9	May-14
Santander	26.8	4.6	-51.0	73.0	-30.5	-26.3	2.2	6.7	15.7	May-14
BBVA	21.0	-8.1	-48.3	49.4	-38.2	-12.1	2.4	28.6	5.1	May-14
Popular	33.3	-14.8	-48.0	-13.9	-24.1	-9.1	-69.9	49.7	18.2	May-14
CDS (spread in basis points) 6/										
Spain	2.7	12.7	90.8	103.8	284.3	466.3	294.8	154.0	82.0	May-14
Santander	8.7	45.4	103.5	81.7	252.8	393.1	270.0	120.0	127.5	May-14
BBVA	8.8	40.8	98.3	83.8	267.9	407.1	285.0	122.0	94.1	May-14

Sources: Bank of Spain; ECB; WEO; Bloomberg; and IMF staff estimates.

1/ Starting 2008, solvency ratios are calculated according to CBE 3/2008 transposing EU Directives 2006/48/EC and 2006/49/EC (based on Basel II). In particular, the Tier 1 ratio takes into account the deductions from Tier 1 and the part of the new general deductions from total own funds which are attributable to Tier 1.

2/ Refers to domestic operations.

3/ Including real estate developers.

4/ Sum of main and long-term refinancing operations and marginal facility.

5/ Ratio between loans to and deposits from other resident sectors.

6/ Senior 5 years in euro.

A TARGETED CUT IN SOCIAL SECURITY CONTRIBUTIONS IN SPAIN—CAN IT BOOST EMPLOYMENT?[1]

Yes, it can. A reduction in employer's social security contributions targeted to low-wage earners has been an important ingredient in past and on-going job-rich recoveries in Europe. The scope for such reform in Spain is considerable in light of relatively high employer's social contributions and low indirect tax revenues. A reduction in employer's social security contribution of 1 percent of GDP offset by an increase in consumption tax revenue of similar magnitude would allow contribution rates on the low paid to be almost halved (a reduction of 12 percentage points) and is estimated to increase employment by 0.5–1.5 percent after 3–7 years. The proposed measure allows for a temporary increase in transfers to the most vulnerable of society of about ½ percent of GDP. It does not compromise Spain's fiscal consolidation and could be implemented by graduated reductions on employer's social security contributions to the low-paid delivered through a tax credit. Because the reduction would be via a tax credit from the general budget rather than lower rates, the social security system would not be affected.

A. The Unemployment Challenge

1. **Boosting employment among low-paid/low-skilled workers is critical to ensure a strong and sustainable economic recovery in Spain** (Figure 1). Unemployment is currently at 26 percent, second only to Greece in the EU. The labor market slack in Spain has been mostly a story of increases in unemployment, especially long-term, rather than declines in labor force participation. It affected mainly low-skilled/low-paid workers[2]. Young workers have been particularly affected, further compromising their employability and fueling (through hysteresis) increases in structural unemployment and lowering potential growth. Eliminating obstacles that prevent the low-paid/low-skilled returning to work should, therefore, be one of the policy priorities to ensure a strong, job-rich, economic recovery.

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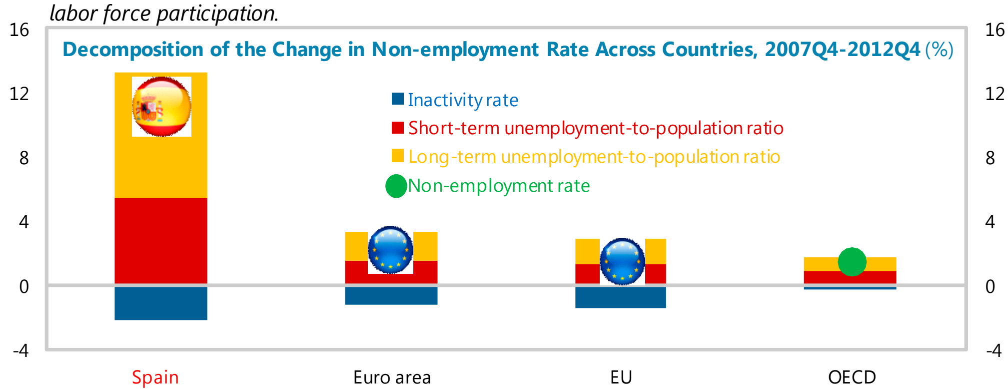
[1] Prepared by Victor Lledó (FAD) and Keiko Honjo (RES).

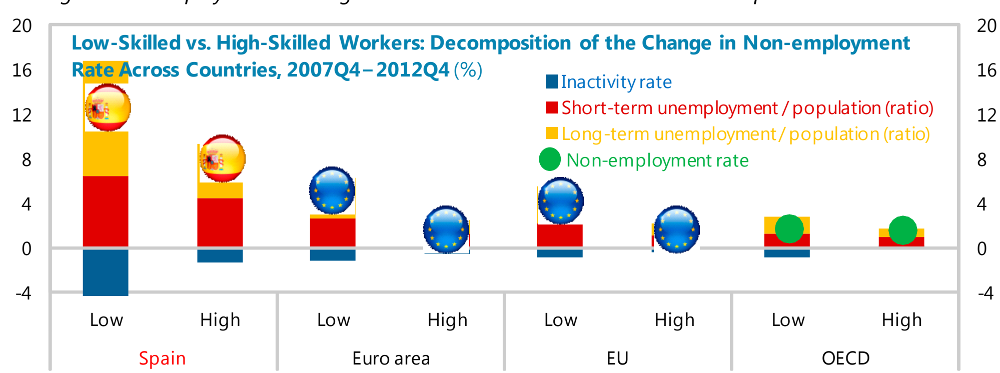
[2] Low-skilled (high-skilled) individuals are defined here as those without upper secondary education (with tertiary education). Low (high)-paid and low (high)-skilled will be used interchangeably hereafter. Although the association is far from perfect—low-skilled workers in Spain earn on average just over half of high skilled wages (OECD, 2013)—, it will likely be reinforced following recent increases in the skill premium (Bonhomme and Hospido, 2012).

Figure 1. Spain's Unemployment Challenge

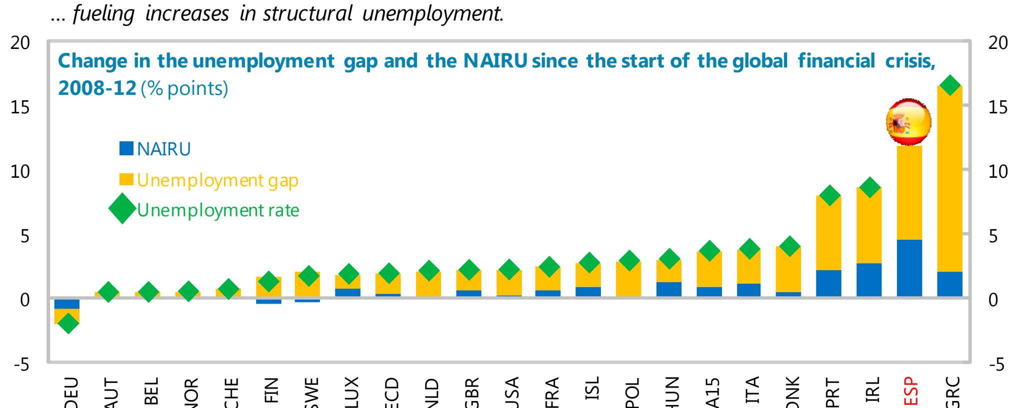
The labor market slack has been driven by long-term unemployment rather than declines in labor force participation.



Long-term unemployment among less skilled workers has been more widespread than elsewhere…



… fueling increases in structural unemployment.



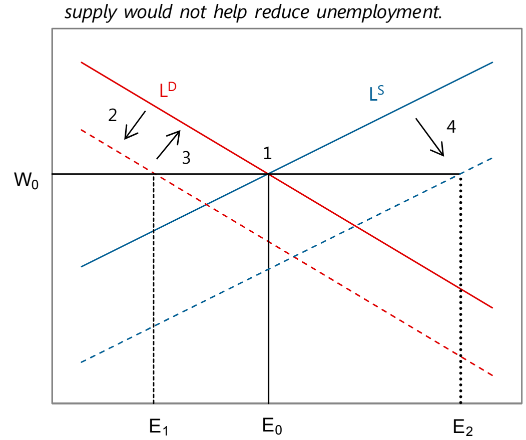
Source: OECD.

Notes: Unemployed: working-age individuals out of work and actively looking for a job. Short-term (long-term) unemployment: unemployment lasting less than 12 months (one year or more). Unemployment rate: percent of working-age individuals unemployed. Inactivity rate: percent of working-age individuals neither in employment nor searching for a job. Non-employment rate: percent of working-age individuals that are inactive or unemployed. Unemployment gap: difference between the unemployment rate and the NAIRU (Non-accelerating inflation rate of unemployment).

B. A Targeted Cut in Social Security Contributions Can Help

2. Tax reforms that increase labor demand can boost employment more expediently than those tackling labor supply constraints. Tax reform can help create jobs by reducing disincentives to work (labor supply) and hire (labor demand). In the short term, policies to increase labor demand are usually more effective in increasing employment than policies that increase supply, which usually take time to materialize in light of downward rigidities in nominal wages (IMF, 2012). In fact, reforms that increase labor supply such as reductions in personal income taxes (PIT) and employees' social security contributions may have a more limited effect on employment and may even increase unemployment until wages adjust.[3] They could still be considered in the short-run as part of compensatory measures for more effective reforms, as shown below. With limited scope to reduce nominal wages in the short-run, boosting labor demand would have to rely on reducing non-wage labor costs, mainly through reductions in business taxes and other social contributions levied on firms.

In the short-term, policies only increasing labor supply would not help reduce unemployment.



1 : Pre-shock W_0E_0 equilbrium with no unemployment.
↙2 : Negative output shock → wage floor at W_0, labor demand shifts downward to W_0E_1 → unemployment increases to $(E_0 - E_1)$.
↗3 : Demand side policy → Labor demand shifts upwards back to pre-shock equilibrium → unemployment back to zero.
↘4 : Supply-side policy→ Labor supply shifts downward→ wage floor at W_0, equilibrium remain at W_0E_1 → unemployment increases to $(E_2 - E_1)$.

3. Reductions in non-wage labor costs are most effective if targeted to the low-paid. Empirical evidence suggests that the demand for low-paid labor is relatively elastic (Hammermesh, 1993) and therefore reacts more strongly to policy measures. This is so because targeted reductions can relax wage floor constraints in countries where high labor costs limit job openings for low-skilled workers (OECD, 2011).

4. Reductions in business taxes can boost labor demand, but are likely to favor more skilled workers. By lowering the cost of capital, reductions in the effective tax rate on business income have a two-sided effect on labor demand: substitution from labor to capital reduces labor demand, while higher investment raises output and therefore labor demand. On balance, most empirical studies suggest that labor demand expands (Chirinko, 2002). Still, as substitution between capital and labor tends to be easiest for low-skilled labor (Duffy and others, 2004), reducing corporate taxes might have a relatively weaker effect on labor demand for low-skilled workers.

5. A targeted cut in employers' social security contribution (ESSC) has been a common element of previous and on-going reform packages to reduce unemployment (Box 1). When financed by higher consumption taxes (or higher recurrent property taxes) in a revenue-neutral way,

[3] This will be particularly the case if the indirect impact of such tax reductions may have on labor demand through increases in aggregate consumption fails to materialize.

Box 1. Targeted ESSC Cuts—International Experience

Targeted ESSC cuts have been associated with past job-rich recoveries. *France* and *Netherlands* share similar experiences. Both tried to address rising unemployment rates during the nineties (and early 00s in the case of France) with reform packages including significant ESSC cuts targeted to low-paid hires (50 and 60 percent reductions, respectively). Unemployment rates declined by about 4 percentage points in both cases, a result that was partly attributed to such targeted cuts along with other reforms in labor and product markets — Bakker and Halikias 1999, and Annett, 2007 (Netherlands); IMF, 2002 Espinoza and Perez Ruiz, forthcoming (France).

A number of EU countries implemented targeted ESSC cuts during the great recession (OECD, 2011). They have been targeted to low-paid workers in *Austria, Belgium, France*, and *Germany*. Unemployment seems to have been better contained in some of these countries, (Germany, in particular), with some concrete and positive evidence in the case of France (Noveau and Ourliac, 2012).

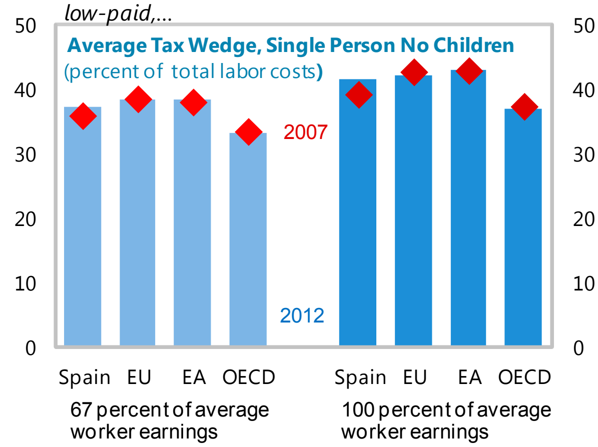
Concrete examples of fiscal devaluations are not abundant; only one has been targeted. Denmark (1988) and Germany (2007) are the only cases where ESSC cuts been financed by increases in VAT and other indirect taxes. In the case of Denmark, the ESSC was abolished with corresponding benefits financed by a VAT levy of 3 percentage points (OECD, 1988). Germany raised the VAT rate from 16 to 19 percent and used about one third of the additional revenues to cut employer contributions to their unemployment insurance scheme. Denmark's ESSC abolition was across-the-board, leaving Germany as the only example of a targeted fiscal devaluation.

reductions in ESSCs have been shown to mimic the impact of exchange rate devaluations in open economies with a fixed exchange rate in a process commonly referred to as "fiscal devaluations" (Fahri and others, 2013). Fiscal devaluations could speed up convergence to long-run equilibrium by reducing real labor costs and improving competitiveness, thus raising employment temporarily (IMF, 2011). This adjustment may be lengthy (De Mooij and Keen, 2012). Moreover, in line with other tax shifts from labor income to consumption, the long-term effects of a fiscal devaluation on growth and employment could also be permanent (IMF, 2012) owing, among other things, to permanent increases in the rate of return to labor or to permanent reductions in equilibrium unemployment. This is confirmed by model simulations (Auerbach and Kotlikoff, 1987) as well as empirical studies (Daveri and Tabellini, 2000; Arnold, 2008).

C. The Scope for a Targeted Cut in Spain

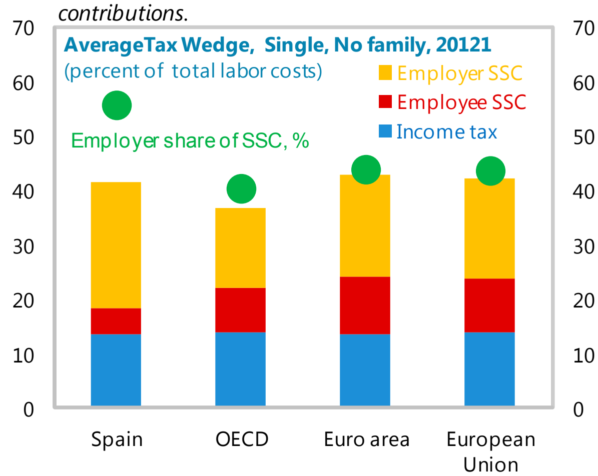
6. The scope for a targeted cut in ESSC is considerable. Measured by the tax wedge, the difference between labor costs to the employer and worker's take-home pay, Spain's labor tax burden has increased since the outset of the global financial crisis and is converging to the higher EU and EA averages. Employer's social security contributions account for more than half of the tax wedge and are above EU and OECD averages. Owing to a flat ESSC schedule (i.e. statutory rates do not increase with workers' earnings), firms employing low-wage workers in Spain do not seem to benefit from reduced contribution rates as much as those in other countries (Box 2). Targeted cuts on employee contributions seem less of a priority as social security contributions levied on employees are only a fraction of those levied on employers and are below regional averages.

Spain's labor tax burden is large, including for the low-paid,...



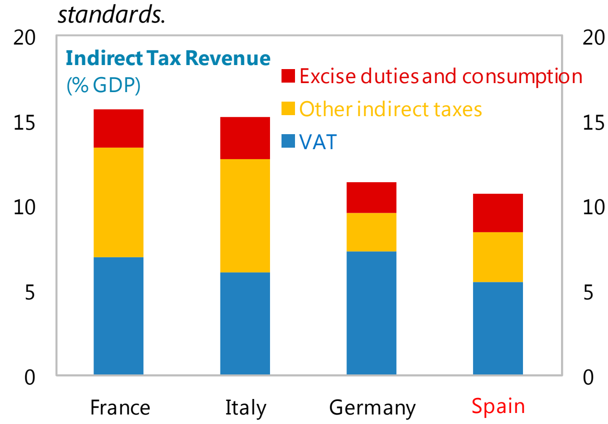
Source: OECD, Taxing Wages.
[1] 100 percent of average workers' earnings.

...and dominated by employers' social security contributions.



7. A targeted ESSC cut could be financed by increases in consumption and other indirect taxes. Indirect taxes, VAT in particular, are low by EU standards. Official estimates of total indirect tax expenses in the form of exemptions and preferential rates stand at €18 billion, about 2 percent of GDP (Ministry of Finance, 2013). A report by an expert committee for tax reform released in March 2014 estimates VAT expenses alone at almost twice that value (€33 billion, about 3 percent of GDP). This report estimates that about 1 percent of GDP of indirect tax revenues could be mobilized by (i) raising reduced VAT rates to the standard rate, excluding those levied on tourism, transport, and housing goods and services (0.6 percent of GDP), (ii) bringing excise duties on alcohol, tobacco closer to the EU average, and increasing diesel and other energy taxes. (0.4 percent of GDP).[4] An additional 1 percent of GDP could be raised if reduced rates for selected items, which are currently significantly below the EU average, are also increased.

Indirect taxes, VAT in particular, are low by EU standards.



Source: Eurostat.

Spain vs. EU: Super-reduced and reduced VAT rates, selected goods and services (%)

Category	Spain	EU average [1]
Foodstuff	4,10	12.8
Construction work on new buildings	4,10	18.9
Admission to sport events	10	11.5
Hotel accomodation	10	15.5
Restaurants	10	16.5
Bars and restaurants	10	18.3

Source: EC, list of VAT rates applied in Member States of the European Union, January 2014.
1/ Average of the simple country average of all applicable VAT rates for each given category.

[4] See Informe Comisión de Expertos para la reforma del Sistema Tributario Español. Available via the Internet: http://www.abc.es/gestordocumental/uploads/economia/fe007a24af859ec8ce790387ba6b7755.pdf

Box 2. Social Security Contributions in Spain : Features and Facts

Social security contributions rates are a fixed proportion of worker's covered earnings between a floor and a ceiling. Nominal rates vary according to the earmarked benefit, but not with earnings (i.e. are flat/not progressive). Floor and ceilings vary by professional categories. Earnings, until last year, excluded a number of in-kind and fringe benefits, such as per diem, transport supplements, relocation expenses, included under Spain's personal income tax base and in standard payroll taxes. Contribution rates, floors, and ceilings are determined every year in the budget law.

Spain: Floor and Ceiling for Employers' Social Security Contributions by Professional Category, 2014

Professional Category	Minimum base (Floor)	Maximum base (Ceiling)
Engineers and university graduates	1,051.50 €/month	3,597.70 €/month
Qualified technicians and assistants	872.10 €/month	3,597.70 €/month
Clerical and Workshop supervisors	758.70 €/month	3,597.70 €/month
Non-qualified assistants	753.00 €/month	3,597.70 €/month
Clerical Officers and Assistants	753.00 €/month	3,597.70 €/month
Subordinates	753.00 €/month	3,597.70 €/month
Administrative Assistants	753.00 €/month	3,597.70 €/month
Workshop Officers	25.10 €/day	119.90 €/day
Sub officers and Skilled workers	25.10 €/day	119.90 €/day
Laborers	25.10 €/day	119.90 €/day
Workers lower than 18 years old	25.10 €/day	119.90 €/day

Source: Ministry of Employment.

Spain : Social Security Contribution Rates by benefit, 2014
(percent)

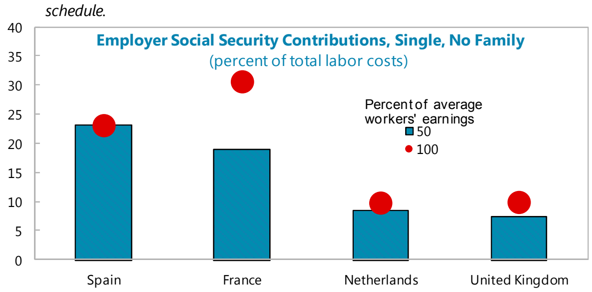
	Employers	Employees	Total
General Benefits Fund	23.6	4.7	28.3
Unemployment	5.5	1.5	7
Wage Guarantee Fund	0.2		0.2
Professional Training	0.6	0.1	0.7
Total	29.9	6.3	36.2

Source: Ministry of Employment.

Contribution schedules in Spain are not as progressive as in other countries…

Spain's flat *contribution rate* contrasts with the more graduated schedule adopted in a number of EU countries. In France, ESSC rates for workers earning half the average wage were about 60 percent lower in 2012 than it is was for the average earner. Employers in Spain must pay social security contributions even for their least paid employees (no ESSC floors). Minimum contributions are set by applying the flat rate to the minimum wage. Unlike most EU countries, Spain sets a *ceiling* to ESSC. At less than €13,000, this ceiling is not particularly high. In Italy, where ESSC rates are equally flat and just 2 percentage points higher than in Spain, the ceiling is almost three times higher.

Employing the low-paid in Spain is costly owing to a flat contribution schedule.



Source: OECD, Taxing Wages.

…Leading to almost half of employers' social security contributions being collected on behalf of workers earning less than three times the minimum wage

About 1 percent of GDP alone is estimated to have been collected on behalf of workers earning less than twice the minimum wage.

Spain: Employer Social Security Contributions by Wage Level

Minimum Wage Multipliers	Annual Salary Bands (euro)		Annual Average Salary (euro)	Workers 1/		Social Security Contributions (Annual)				
				(%)	(thousands)	Limits	Legal rate (%)	Individual (euro)	Revenues (millions euro)	(% GDP)
0-1	0	9,034	4,517	11.30	1,582		29.9	1,351	2,137	0.2
1-1.5	9,034	13,551	11,293	16.58	2,321		29.9	3,377	7,838	0.8
1.5-2	13,551	18,068	15,810	16.58	2,321		29.9	4,727	10,973	1.1
2-3	18,068	27,103	22,586	27.17	3,804		29.9	6,753	25,687	2.5
3-4	27,103	36,137	31,620	13.60	1,904		29.9	9,454	18,001	1.7
4-5	36,137	45,171	40,654	7.40	1,036		29.9	12,156	12,593	1.2
5-6	45,171	54,205	49,688	3.14	440	Ceiling	29.9	12,906	5,673	0.5
6-7	54,205	63,239	58,722	1.92	269	Ceiling	29.9	12,906	3,469	0.3
7-8	63,239	72,274	67,757	1.05	147	Ceiling	29.9	12,906	1,897	0.2
Greater than 8	72,274		72,274	1.25	175	Ceiling	29.9	12,906	2,259	0.2
							Total contributions		90,527	8.8

Sources: INE (earnings distribution); Ministry of Employment (social security rates and thresholds); and IMF staff estimates (social security contributions).
1/ Number of workers earning between 1 and 1.5 times the minimum wage and 1.5 and 2 times the minimum wage are IMF estimates.

D. Simulating a Targeted Fiscal Devaluation

8. The economic impact of a *targeted fiscal devaluation* was simulated using IMF's Global Integrated Monetary and Fiscal Model (GIMF).[5] The IMF's GIMF was used to simulate the impact of a reduction in employer's social security contributions targeted to low-income households and financed by an increase in consumption taxes, hereby referred to as a "targeted fiscal devaluation". GIMF has two types of households—intertemporally-optimizing (overlapping-generations) and liquidity-constrained ones, generally corresponding to higher- and lower-income households.[6] The model was calibrated to match the current conditions of Spain's labor market, characterized by a large pool of underutilized, non-employed labor willing to work at the prevailing wage rate should labor demand pick up, by (i) by augmenting the share of liquidity-constrained agents above that dictated by country-specific earning distributions, (ii) by increasing the labor supply elasticity to 1–1.5, and (iii) by allowing a permanent positive shock in labor force participation. GIMF builds sticky wages—a pre-condition for an active fiscal devaluation channel—through the gradual path through which unions set real producer wages following consumer price increases.[7] The model was also calibrated to match Spain's recent national accounts and fiscal data.

9. Against this backgrou*nd, an uncompensated and a compensated ta*rgeted fiscal devaluation were simulated. The *uncompensated targeted fiscal devaluation* consists of a reduction in the average effective labor tax rate equivalent to a reduction in employer's social security contributions of about 1 percent of GDP, as envisaged in the report prepared by the tax reform expert committee. The compensated targeted fiscal devaluation adds a temporary (two-year) increase in transfers to liquidity-constrained agents of about 0.5 percent of GDP (to simulate support for the most vulnerable). Both experiments are revenue neutral and financed by increases in the average effective consumption tax rate.[8]

10. Employment increases by 0.5 percent and 1.5 percent relative to the baseline after, respectively, three and seven years under both scenarios (Figure 2). In particular,

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[5] Kumhof and others (2010) for a description of the model.

[6] Heterogeneity is, therefore, only captured indirectly, a limitation of the model that should be acknowledged.

[7] Absent sticky wages, the increase in labor demand following a reduction in labor costs brought with lower labor taxes would have no employment impact, as it would be immediately reversed by instantaneous wage increases.

[8] As it is standard in other macro-simulation models tax rates are defined as implicit or average effective tax rates. Such rates capture more closely the actual burden from major taxes once exemptions, allowances, credits, progressive schedules, and other specificities of the tax are taken into account. They are not equivalent to statutory or nominal rates. The average effective labor tax rate is measured as the ratio of total revenues from labor income taxes and social security contributions to total wages. The average effective consumption tax rate is defined as the ratio of general consumption taxes on goods and services, including value-added and excise taxes, to total consumption.

- Average effective tax rates on labor decrease permanently by about 1.6 percentage points (pps) and are accompanied by permanent increases in consumption tax rates of the same magnitude, both with and without compensation.

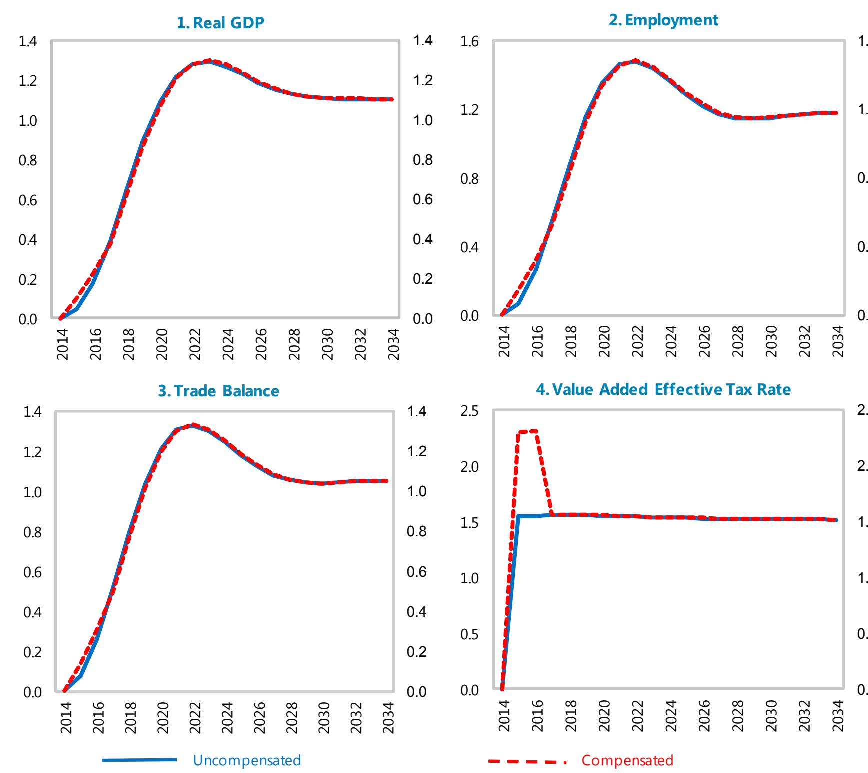
- Average consumption tax rates increase by 2.3 pps in the first two years following the implementation of a *compensated targeted fiscal devaluation* to cover additional expenses with transfers to liquidity-constrained households.

- Higher employment is accompanied by output increases of similar magnitudes, reflecting the positive impact on private consumption and aggregate demand of higher household income (of liquidity-constrained agents in particular) following lower income tax rates.

- The employment and output impact is slightly larger under the *compensated targeted fiscal devaluation* than under the *uncompensated* one in the short-term. This is because transfers to liquidity-constrained agents dampen the negative effect of higher consumption taxes and prices on household incomes, which, in turn, increase more vigorously.

- Both scenarios induce an internal devaluation reflected by a real exchange rate depreciation and an improvement in the trade balance.

Figure 2. Targeted Fiscal Devaluation
(Percent difference relative to the baseline)[1]



Source: IMF staff estimates.
1/ For valued added tax rate, difference in percentage points relative to the baseline.

11. The results are broadly in line with recent simulations done for Spain. Recent simulations have found total employment increasing up to 1.3 percent following a targeted fiscal devaluation with a fiscal cost at 1–1.5 percent of GDP (Bosca, Domenech and 2013, EC, 2014, Tax Reform Committee). GIMF results are broadly the same as those obtained by the EC and the Tax Reform Committee, all of which assume the same fiscal cost of 1 percent of GDP. GIMF delivers a lower employment impact over the short-term relative to that obtained in Bosca, Domenech, and Ferri (2013), mainly as the result of the larger fiscal cost (and hence larger shock) assumed in the latter (1.5 percent of GDP), with results broadly similar over the medium and long-term.

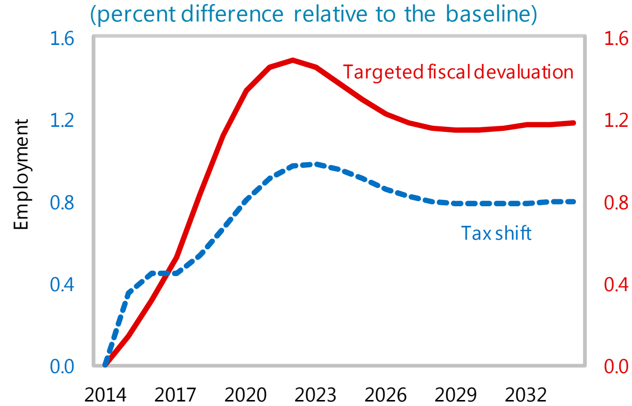
Spain: Fiscal Devaluation Impact—Alternative Analyses

Study	Reduction in effective labor income tax rate		Increase in effective consumption tax rate [1]	Employment Impact
	(% GDP)	(% points)	(% points)	(% difference to baseline)
Bosca, Domenech, and Ferri	1.5	3.5	2	1.3 after 2 years; 0.6 in the steady-state
Tax Reform Committee	1	3	n.a	0.7 after 2 years
European Commission (targeted)	1	7	1.2	0.7 after 3 years; 1.4 after 7 years
GIMF Targeted Fiscal Devaluation	1	1.6	1.6	0.5 after 3 years; 1.5 after 7 years; 1.2 in the steady-state

Sources: EC (2014); Tax Reform Committee Report; Bosca, Domenech, and Ferri (2013).
1/ Increase is revenue-neutral (i.e. equals the reduction in effective labor tax rate in percent of GDP).

12. After a brief initial period, a targeted fiscal devaluation delivers a stronger employment impact than a tax shift that combines reductions in both labor and capital income taxes. Reductions in labor and capital income nominal tax rates accompanied by measures to broaden the base of both these taxes through the elimination of exemptions and special treatment have also been recommended by the tax expert committee. When financed in a revenue-neutral way by increases in VAT and other indirect taxes, they are also expected to positively impact employment directly by reducing the fiscal costs to work and hire and indirectly as aggregate demand increases from higher households' disposable income and private investment, reflecting higher after tax returns on labor and capital. Simulations using GIMF of a permanent reduction in labor and capital income taxes amounting to 1 percent of GDP (0.7 and 0.3 percent of GDP, respectively) financed by an increase in consumption taxes of the same amount, as proposed in the report of the tax expert committee, deliver a permanent impact on employment. The employment impact of this proposed tax shift is stronger than the impact of the targeted fiscal devaluation in the first two years after the reform is implemented. This reflects the strength of the indirect impact on employment referred to above under the tax shift proposal relative to the targeted fiscal devaluation. This impact, however,

Figure 3. Fiscal Devaluation vs. Tax Shift[1]
(percent difference relative to the baseline)



Source: IMF staff estimates
1/ Tax shift defined as reductions in effective tax rates on labor and capital income amounting respectively to 0.3 and 0.7 percent of GDP accompanied by a 1 percent of GDP increase in consumption taxes. Liquidity-constrained agents are compensated with transfers of about 0.5 percent of GDP under both reforms.

declines over time and the impact of the larger cut in labor income taxes under the targeted fiscal devaluation dominates, resulting in a significantly higher employment.

E. Design and Implementation Issues

13. A graduated reduction of ESSC restricted to low-paid, employed workers *within a well-defined range* has been shown as cost-effective scheme. The range of low-paid workers covered by the wage-subsidy scheme will ultimately depend on available budgetary resources. However, attempts to heavily restrict coverage may backfire, as some firms will attempt to over-report the number of eligible low-paid workers under their payroll.[9] A wage-subsidy scheme with less strict coverage and where the subsidy rate tapers as wages moves further from the least paid has been shown to dampen firm's over-reporting incentives (Phelps, 1997). Therefore, from an efficiency standpoint, they could be a better option than purely exempting social security contributions for workers earning less than a given wage-rate threshold (e.g. by adopting a contribution floor).

14. Reductions in ESSC—graduated or not—should be in the form of a tax credit rather than reductions in statutory rates. Unlike general taxes, social contributions are generally earmarked to specific social benefits. Reductions in statutory rates will break this link and may result on the under provision of the corresponding benefits, which at the same time will bring the contribution closer to a tax increasing distortions, or to unfunded mandates. A tax credit would help preserve the link between social security contributions and benefits thus preserving the coverage and fiscal sustainability of the system as well as minimizing the economic distortions it creates.[10]

15. An illustrative exercise suggests a graduated cut for Spain. A ESSC cut targeting the low-paid through graduated reductions inversely proportional to worker's earnings (the g*raduated* scheme) delivers a smoother path of marginal rates than a cut with the same ex-ante fiscal cost (1 percent of GDP) delivered by creating a contribution floor to exempt individuals earning up to 1½ times the minimum wage (the *Floor* scheme). The graduate scheme envisages a smoother path of ESSC cuts for individuals earning up to three times the minimum wage. Effective rates are halved for workers earning up to 1 ½ times the minimum wage. This cut is of similar magnitude to those implemented in France during the nineties. The cost-effective merits of a graduated schedule would, however, need to be weighed against the more straightforward implementation and administration

[9] Firms could do that to reduce their contribution liabilities by reporting as low-paid, workers with salaries above the contribution threshold. They could also agree to pay such workers a reported salary below the contribution threshold to be complemented by an unreported additional payment. This would, of course, not hold if the government could fully observe reported and unreported wage payments among the beneficiaries of the targeted ESSC. Firms would also have fewer incentives to misreport the larger their demand for truly low-paid workers would increase as the result of reductions in ESSC. Full government information about firm payrolls and high demand elasticities for the low-paid would favor a less graduated approach.

[10] This depends of course on how distortionary social contributions are in the first place. The weaker the link between contributions and entitlements the more distortionay they are, the greater the employment impact of a reduction in ESSC is likely to be.

of the Floor measure. The latter would only involve the creation of a contribution floor by raising the minimum contribution with no other changes in the current social security contribution system.

Spain : Alternative Wage Subsidy Schemes [1]

Schemes		Wage rate thresholds (minimum wage multiples)						
		1	1.5	2	3	4	5	6 [3]
Status Quo	statutory rate	29.9	29.9	29.9	29.9	29.9	29.9	29.9
	marginal rate	0.2	0.0	0.0	23.0	23.0	23.0	7.7
Floor	effective rate [2]	0.0	0.0	29.9	29.9	29.9	29.9	29.9
	marginal rate	0.0	0.0	34.4	23.0	23.0	23.0	7.7
	reduction (%) [3]	100	100	0	0	0	0	0
Graduated	effective rate [2]	15.0	17.9	20.9	26.9	29.9	29.9	29.9
	marginal rate	13.0	16.6	17.8	18.3	27.2	23.0	7.7
	reduction (%) [4]	50.0	40.0	30.0	10.0	0.0	0.0	0.0

Source : IMF staff estimates
1/ Illustrative scenarios based on wage distribution set up in Box 2.
2/ Effective social security contribution rate paid by the employer upon receipt of the tax credit.
3/ Social security ceiling.
4/ Reduction in employer's social security contributions (ESSC), percent difference to status quo.

16. A targeted ESSC cut should not be attached to new jobs, firm size, or specific contracts. Wage subsidies for new jobs are notoriously difficult to monitor, end-up in low take-up (Neumark, 2011), and have small employment effects (Chirinko and Wilson, 2010). If badly targeted, they can be particularly costly, as subsidized workers would have been hired even without the subsidy. The economic rationale for having special tax advantages for small and medium-sized firms (SME) is also not clear (International Tax Dialogue, 2007). Wage subsidies to new jobs under permanent employment contracts (particularly pervasive in Spain) have been shown to be generally ineffective as they have mainly led employers to substitute workers under the unsubsidized temporary contract by those under subsidized permanent contracts with little or no impact on total employment (Box 3).

17. The increase in consumption taxes may require identifying compensatory measures for the most vulnerable and the fiscal space to implement them. A fiscal devaluation will improve income equality by increasing employment among the low-skilled. But the increase in consumption taxes, which are usually slightly regressive, may increase inequality. For example, pensioners will not benefit from higher employment but would suffer from higher VAT rates. This may require offsetting measures to address poverty and equity concerns. Such measures may come in form, for example, of direct transfers (e.g. pensions for widows, disabled individuals) or reductions in income taxes. Providing additional public transfers would reduce the scope for lowering social security contributions rates given that some of the additional indirect tax revenues would have to be used to fund such transfers. Improving the targeting of public transfers through better means-testing would be important to help finance those measures while preserving the fiscal space for the targeted ESSC cut. Increasing the ESSC for the top earners by removing or increasing the ESSC ceiling could also provide additional funding.

18. Bundling targeted ESSC cuts in a package of reforms will help to prolong the impact of a fiscal devaluation. The impact may only be temporary as, over time, increased labor demand feeds into higher wages and the beneficial effects on employment would be mitigated. An additional dampening effect comes from the labor supply side, as over time, firms are able to shift their tax burden to workers. *Labor market reforms* that allow for more decentralized wage-setting could moderate wage increases. *Product market reforms*, in turn, by limiting price-mark ups will reduce the speed with which tax burdens are shifted to workers and consumers thus moderating work disincentives and supporting real incomes. *Reforms that facilitate corporate sector deleveraging*, should also be included in this package, as this would give more space for highly indebted companies' to use labor cost savings to hire rather than build liquidity buffers for debt service.

Box 3. Wage Subsidies in Spain

Spain has a history of using wage subsidies to reduce the costs of hiring under permanent employment contracts. Wage subsidies have been granted mainly as reductions in employer social security contributions in the form of rebates. The key objective has been to reduce the duality that started to prevail in Spain's labor market after the introduction of tempor*ary contracts in 198*4. Wage subsidies have been subjected to numerous changes, most as part of labo*r market reforms (1997*, 2010, 2012), but remained conditioned on the hiring of individuals under a permanent contract.

Social security rebates have not targeted the low-paid. Targeting has been mainly on so*cio-demographic characteristics, particularly age and* gender. The amount of rebates varied according to these criteria as well as whether new hires were formerly unemployed or under a temporary contract. Recent laws have reduced the number of age categories, but added disabled individuals to the beneficiary list. The duration of rebates initially varied by category and former employment status, but more recent laws have harmonized them, and reduced their duration to no more than three years.

Spain: Rebates for Employers' Social Security Contributions for Permanent Contracts, selected groups

	2006		2010		2012[1]	
Group	Rebate	Duration	Rebate	Duration	Rebate	Duration
	Unemployed Workers					
Men						
16-30	€ 800 /year	4 years	€ 800 /year	3 years	€ (1,000;1,100;1,200)/year	3 years
> 45	€ 850-1,200/ year	4 years	€ 1,200 /year	3 years	€ 1,300 /year	3 years
Women						
16-30	€ 850-1,200/ year	4 years	€ 1,000/year	3 years	€ (1,100;1,200;1,300)/year	3 years
> 45	€ 850-1,200/ year	4 years	€ 1,400 /year	3 years	€ 1,500 /year	3 years
Group	Temporary Workers					
Men	€ 800 /year	3 years	€ 500/year	3 years	€ 500/year	3 years
Women	€ 800 /year	3 years	€ 700/year	3 years	€ 700/year	3 years

Sources: Law 43/2006; Law 35/2010; Royal Decree 3/2012.
1/ Only applies to small firms (less than 50 employees).

The impact of wage subsidies on total employment seems negligible, due to substitution effects. Hires under subsidized permanent contracts have tended to be netted out by dismissals under temporary contracts and non-subsidized permanent contracts (Mendez, 2008). Wage subsidies had a positive impact on the transition from unemployment to employment and from temporary to permanent employment, particularly for women and young people, but less so for low skilled workers (Arranz, Serrano, and Hernanz, 2013). But transitions from permanent employment to non-employment increased for older men (Kugler, Jimeno, and Hernanz, 2002) and the duration of subsidized permanent contracts have tended to be smaller than for non-subsidized permanent contracts, particularly among less skilled workers (Cebrian and others, 2011).

A new subsidy targeting new hires under permanent contracts set up this year may also not be particularly effective. Unlike previous subsidies, this is not granted as a rebate, but limits ESSC to a small fee (€100 for full-time hires) regardless of the income of the employee. All contracts signed between February and December 2014 would benefit for this flat fee for two years. As it is a flat fee, however, the low-skilled are not targeted; indeed the opposite, with the biggest benefit accruing to the higher-paid. Substitution effects, as per above, can also be expected to reduce the net employment impact.

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