



SPAIN

February 2022

2021 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR SPAIN

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2021 Article IV consultation with Spain, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its February 14, 2022, consideration of the staff report that concluded the Article IV consultation with Spain.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on February 14, 2022, following discussions that ended on December 21, 2021, with the officials of Spain on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on January 26, 2022.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Spain.

The documents listed below have been or will be separately released.

Selected Issues

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

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IMF Executive Board Concludes 2021 Article IV Consultation with Spain

FOR IMMEDIATE RELEASE

Washington, DC – February 16, 2022: on February 14, 2022, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation¹ with Spain.

The Spanish economy is recovering from the deep recession caused by the COVID pandemic amid recurrent waves of infections. A highly successful vaccination campaign helped limit the impact of the virus on hospitalizations, mobility, and economic activity in 2021. Employment has rebounded robustly and is already above pre-crisis levels. Economic growth in 2021 was 5 percent, although output is still significantly below its pre-pandemic level due to the slow recovery of contact-intensive sectors and persistent global supply bottlenecks. Headline inflation reached a 30-year high in December, mainly driven by the strong base effect from prices declines in 2020 and the continued rise in natural gas prices.

Supportive policies have played a key role in protecting jobs, household incomes, and firm balance sheets, and financial sector risks have evolved favorably so far. Nonetheless, mitigating the impact of the pandemic on the economy has taken a toll on government finances, with the public debt ratio at about 120 percent of GDP in 2021.

Economic activity is projected to grow 5.8 percent in 2022, reaching the pre-pandemic level of output by the end of the year. The Omicron-driven wave of infections is expected to have only a moderate impact on economic activity. The recovery will be supported by robust private consumption, a boost of public investment financed in part by Next Generation EU (NGEU) funds, and a gradual normalization in international tourism flows. Headline inflation is likely to remain elevated in early 2022 due to high energy prices and supply-chain disruptions, but should moderate in the second half of the year as these factors dissipate.

The outlook is highly uncertain and will depend on the evolution of the pandemic and the persistence of global supply bottlenecks. On the upside, a faster unwinding of households' accumulated savings could boost consumption more than expected. The pace of absorption and the effectiveness of use of NGEU funds will also affect growth in the coming years.

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

Executive Board Assessment²

Executive Directors commended the authorities' comprehensive policy response to the pandemic, which, bolstered by successful vaccination campaigns, mitigated the economic fallout. While a recovery is ongoing and employment has recovered strongly, output remains below pre-pandemic levels and the outlook is clouded by elevated uncertainty and risks. Directors noted that support to the economy should remain flexible until the recovery is broadly entrenched, and prudent policies are needed over the medium-term to support macro-financial stability and promote sustainable, greener and inclusive growth.

Directors emphasized that fiscal policy should remain supportive in the short-term and become increasingly targeted to support the vulnerable. As the recovery takes hold, public debt should be gradually reduced to rebuild fiscal space to respond to future shocks. They noted that an early formulation of a credible medium-term fiscal consolidation plan could help build the necessary social consensus and support investor confidence. Directors also highlighted the importance of ensuring the sustainability of the pension system.

Directors observed that the financial sector has weathered the crisis well and agreed that close monitoring is needed to ensure continued resilience. In this regard, they encouraged the authorities to be forward-looking in their assessment and supervision, and to ensure adequate buffers and prudent levels of provisioning in the banking sector. Directors appreciated the efforts to strengthen the macroprudential toolkit and the private debt resolution frameworks.

Directors commended the authorities' comprehensive structural reform and investment agenda. They observed that Next Generation EU (NGEU) funds provide an exceptional opportunity to support the recovery while promoting a transition to a more productive, inclusive, greener, and digital economy. Directors highlighted the importance of establishing a framework to ensure a transparent and efficient use of the investment funds.

Directors welcomed the recently approved labor reform aimed at addressing long-standing deficiencies and balancing increased protection for workers and preserving flexibility for firms. They noted the high level of ownership derived from the broad dialogue with social partners. Directors stressed the importance of strengthening education and active labor market policies to facilitate upskilling of the workforce and sectoral reallocation, and underscored the importance of coordination to ensure effectiveness. They considered that the impact of these reforms, including on public finances, should be closely monitored and saw as important making permanent contracts more attractive to firms.

Directors welcomed the recently adopted ambitious climate mitigation objectives. They saw merit in increasing carbon pricing in a gradual and predictable way, while protecting vulnerable households. Complementary policies will be essential to address sector-specific mitigation challenges, and Directors welcomed the authorities' plans to leverage the NGEU funds to support green investments.

² At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.IMF.org/external/np/sec/misc/qualifiers.htm>.

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

	2019	2020	Projections 1/						
			2021	2022	2023	2024	2025	2026	2027
Demand and supply in constant prices									
Gross domestic product	2.1	-10.8	4.9	5.8	3.8	2.3	1.9	1.7	1.6
Private consumption	1.0	-12.0	5.1	4.7	3.3	2.4	3.0	2.6	2.2
Public consumption	2.0	3.3	3.2	0.9	0.3	0.4	0.4	0.4	0.4
Gross fixed investment	4.5	-9.5	3.3	7.0	7.1	3.3	0.5	0.6	1.3
Total domestic demand	1.6	-8.9	4.7	4.5	3.4	2.1	1.9	1.7	1.6
Net exports (contribution to growth)	0.5	-2.2	0.3	1.4	0.5	0.2	0.0	0.0	0.0
Exports of goods and services	2.5	-20.2	12.4	9.9	4.6	3.7	3.3	3.2	3.3
Imports of goods and services	1.2	-15.2	12.0	5.9	3.6	3.4	3.5	3.4	3.4
Real GDP per capita	1.3	-11.3	4.8	5.4	3.4	1.9	1.5	1.4	1.3
Savings-Investment Balance (percent of GDP)									
Gross domestic investment	20.9	20.7	21.0	21.2	21.6	21.8	21.4	21.1	21.0
National savings	23.0	21.5	21.4	22.5	23.2	23.5	23.1	22.8	22.7
Foreign savings	-2.1	-0.8	-0.4	-1.3	-1.6	-1.7	-1.7	-1.7	-1.7
Household saving rate (percent of gross disposable income)									
	8.3	14.9	11.0	8.3	6.5	6.4	6.3	6.3	6.3
Potential output growth									
	1.5	-2.0	1.4	1.7	2.1	2.1	1.9	1.7	1.6
Output gap (percent of potential)									
	0.5	-8.5	-5.4	-1.6	0.0	0.1	0.0	0.0	0.0
Prices									
GDP deflator	1.3	1.1	1.6	1.9	1.1	1.6	1.7	1.7	1.7
Headline inflation (average)	0.7	-0.3	3.1	3.5	1.2	1.6	1.7	1.7	1.7
Headline inflation (end of period)	0.8	-0.5	6.5	0.5	1.3	1.5	1.8	1.7	1.7
Core inflation (average)	0.9	0.7	0.8	1.8	1.5	1.6	1.7	1.7	1.7
Core inflation (end of period)	1.0	0.1	2.1	1.8	1.5	1.6	1.7	1.7	1.7
Employment and wages									
Unemployment rate (percent)	14.1	15.5	15.0	14.0	13.5	13.3	13.1	13.0	13.0
Labor productivity 2/	-0.5	-3.5	-1.5	2.8	2.6	1.6	1.3	1.2	1.2
Labor costs, private sector	2.3	4.0	0.8	3.5	1.1	1.4	1.6	1.6	1.6
Employment growth	2.3	-2.9	2.7	2.0	1.2	0.6	0.6	0.5	0.4
Labor force growth	1.0	-1.3	2.1	0.8	0.5	0.4	0.4	0.4	0.4
Balance of payments (percent of GDP)									
Trade balance (goods and services)	2.9	1.5	1.1	2.1	2.6	2.8	2.9	2.9	2.9
Current account balance	2.1	0.8	0.4	1.3	1.6	1.7	1.7	1.7	1.7
Net international investment position	-75.0	-85.5	-78.7	-69.9	-63.5	-58.0	-53.9	-50.1	-46.4

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

	2019	2020	Projections 1/						
			2021	2022	2023	2024	2025	2026	2027
Public finance (percent of GDP) 3/									
General government balance	-2.9	-11.0	-7.8	-5.3	-4.3	-4.0	-4.0	-4.0	-4.0
Primary balance	-0.8	-8.9	-5.8	-3.5	-2.5	-2.3	-2.3	-2.3	-2.3
Structural balance	-3.1	-5.7	-4.5	-4.4	-4.3	-4.1	-4.0	-4.0	-4.0
Primary structural balance	-0.8	-3.5	-2.3	-2.3	-2.3	-2.1	-2.1	-2.1	-2.1
General government debt	95.5	120.0	120.4	117.0	115.8	115.4	115.5	115.6	115.9

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

1/ The projections incorporate allocation from the EU Recovery and Resilience Facility amounting to about 0.8 percent, 1.9 percent, 1.6 percent, and 1.3 percent of GDP from 2021 to 2024.

2/ Output per full-time equivalent worker.

3/ Fiscal projections from 2022 onwards assume an expiration of temporary COVID-19 measures and no further policy change.



SPAIN

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION

January 26, 2022

KEY ISSUES

The Spanish economy is recovering from the deep recession caused by the COVID pandemic and employment is already above its pre-pandemic level. A highly successful vaccination campaign helped limit the impact of the recent wave of infections on hospitalizations and economic activity. Output is expected to return to its pre-pandemic level by the end of 2022. However, there is significant uncertainty around the recovery path related to the evolution of the pandemic and the duration of global supply bottlenecks. The pace of absorption and the effectiveness of use of Next Generation EU (NGEU) funds will also affect growth in the coming years. In the near term, the key policy challenge is to continue to provide targeted pandemic support while facilitating resource reallocation and a transformation to a greener and more inclusive economy.

- Policy support should remain in place until the recovery is firmly underway and become increasingly targeted. Over time, Spain should lower public debt levels to create space for responding to future shocks. Fiscal adjustment should be gradual and growth-friendly, preserving space for public investment in climate change mitigation and infrastructure. An early formulation of credible medium-term plans would help support investor confidence. Additional measures will be needed to offset the increase in future pension spending resulting from the 2021 reform.
- Continued close monitoring of private sector balance sheets is warranted. Banks should maintain prudent levels of forward-looking provisions and be encouraged to use capital buffers in case downside risks materialize.
- The labor market reform aims to reduce reliance on temporary contracts while preserving flexibility at the firm level. In addition to the agreed reforms, permanent contracts should be made more attractive for firms. The effectiveness of the new short-time scheme RED would need to be reviewed over time to ensure that it does not put a significant burden on public finances. The implementation of the active labor market policies reform would benefit from close collaboration with the private sector and regular ex-post evaluations.
- A multi-pronged approach will be needed to reach Spain's new and more ambitious climate mitigation objectives, including gradual and predictable increases of the carbon price, as well as complementary policies to protect vulnerable households and to address sector-specific obstacles to reducing emissions.

Approved By
Mahmood Pradhan
(EUR) and
Bjoern Rother (SPR)

Discussions were held virtually and took place from November 29 to December 21, 2021. The staff team comprised Dora Iakova (head), Nicolas Arregui, Ana Lariau, and Yu Shi (all EUR). Pablo Moreno (Executive Director), Fernando Lopez, and Rosa Moral (Advisors to the Executive Director) attended the meetings. Yifei Wang, Jai-Ryung (Jenny) Lee, Yueshu Zhao, and Dilcia Noren (EUR) supported the mission. The mission met with Vice-President Nadia Calviño, Banco de España Governor Pablo Hernández de Cos, Secretary of State for the Economy and Business Support Gonzalo García Andrés, Secretary General of the Treasury Carlos Cuerpo, and other senior officials. The mission also met with representatives of the financial sector, labor organizations, think tanks, and political parties.

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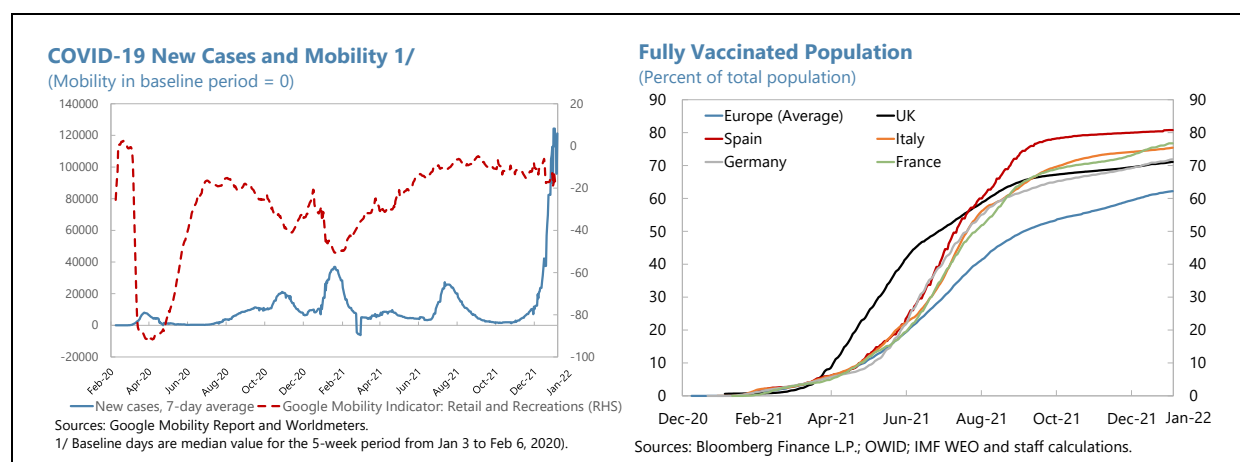
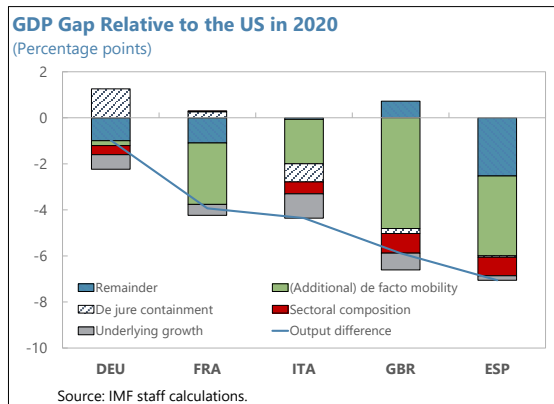
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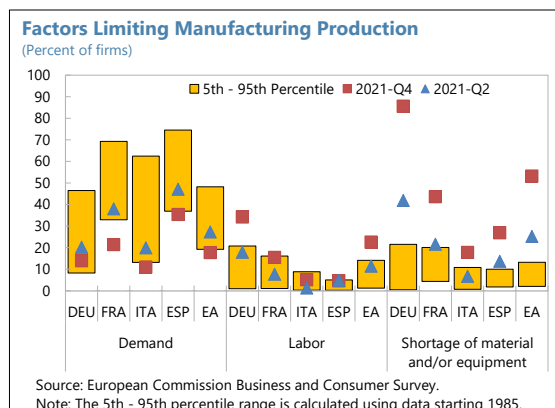
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CONTEXT AND RECENT DEVELOPMENTS

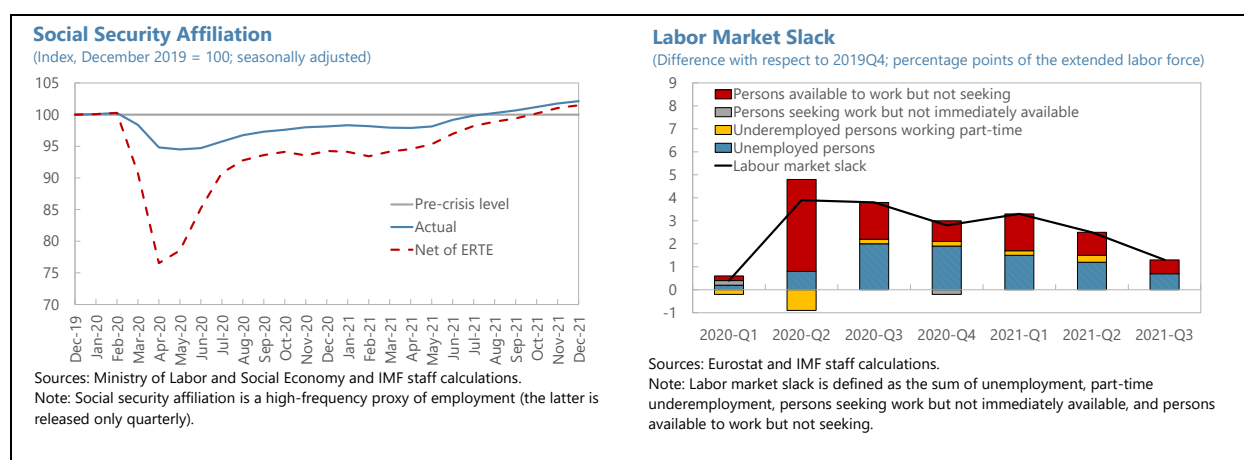
1. The Spanish economy is starting to recover from the deep recession caused by the COVID pandemic. Spain experienced the largest contraction (10.8 percent) among major advanced economies in 2020. The magnitude of the drop reflected the high number of infections and strict lockdown measures, but also structural features that made the Spanish economy more vulnerable to disruptions, such as prevalence of small and medium-sized enterprises (SMEs), high reliance on tourism and other contact-intensive sectors, and a widespread use of temporary employment contracts. Containment measures were eased in 2021 and mobility levels recovered compared to previous year (Figures 1 and 2). Spain has achieved very high vaccination rates—more than 80 percent of the population is now vaccinated—which has helped limit the impact of infections on hospitalizations, mobility, and economic activity.



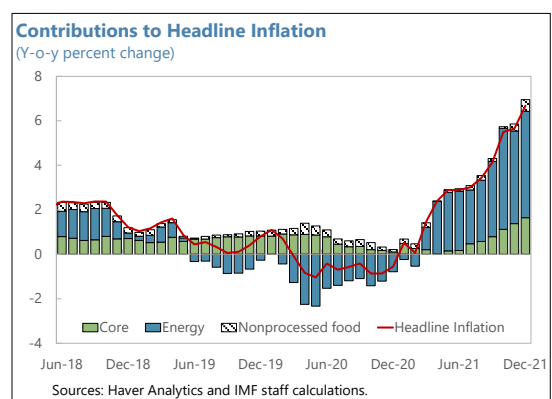
2. Growth has resumed since the second quarter of 2021, although output remains well below pre-pandemic levels. The rebound of activity was driven by private consumption and some recovery in tourism. However, investment remained weak due to elevated uncertainty related to the pandemic, manufacturing supply bottlenecks, and rising costs of energy and materials. More recently, high inflation has likely dampened consumption growth and the resurgence of infections slowed the recovery of contact-intensive sectors. At the end of the third quarter, output was 6 percent below its pre-crisis level.



3. Employment has exceeded its pre-crisis level, although some slack still remains in the labor market. Social security affiliation is now above its end-2019 level (even if workers in the short-time work scheme, ERTE, are excluded)¹ and the unemployment rate has been declining over the last year. Nonetheless, the employment recovery has been uneven across sectors: it has been strong in construction and activities boosted by the pandemic (like IT and sanitary services) but remains subdued in contact-intensive services (such as hospitality and tourism). There is still some slack in the labor market. Total hours worked are 3.2 percent below pre-crisis levels (Figure 3). Broader measures of unemployment, including inactive people available for work but not seeking a position and involuntary part-time workers, are 1.3 percentage points above the end-2019 level. The number of workers in ERTE and self-employed receiving COVID-related support has fallen to about 5 percent of its peak level in December, but remains large (1.2 percent of the labor force). Despite recent improvements, the unemployment rate and income inequality in Spain continue to be among the highest in the region.



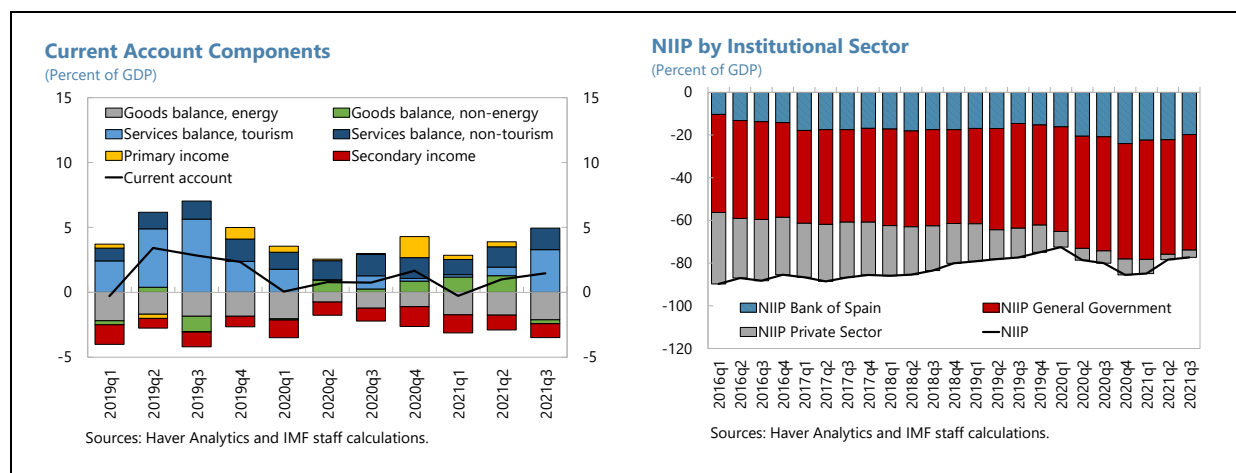
4. Consumer prices increased substantially due to higher energy prices. Headline inflation reached 6.5 percent y-o-y in December, the highest level in thirty years. The increase has been driven by a surge in energy prices and a strong base effect from low prices in 2020. Core inflation is also starting to rise due to broader supply constraints, reaching 2.1 percent y-o-y in December. So far, the change in core prices over two years (2021 compared to 2019) is still broadly in line with historical averages.



5. The current account surplus is still subdued. The surplus narrowed to 0.8 percent of GDP in 2020 mainly due to weak tourism receipts, which declined by about 80 percent from the previous year. Foreign tourist inflows recovered only partially in 2021. The balance on goods trade deteriorated in the third quarter of 2021 owing to rising energy prices and the underperformance of key exports sectors (such as the automotive industry) related to global supply bottlenecks. Foreign direct investment remained relatively stable in 2020 despite the impact of the pandemic and

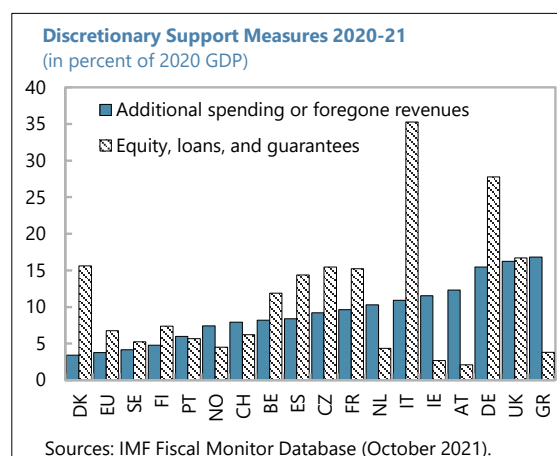
¹ Social security affiliation is a high-frequency proxy of employment (the latter is released only quarterly).

regulatory changes.² The preliminary assessment of the projected external position in 2021 is that it is broadly consistent with medium-term fundamentals and desirable policies (Annex I).



6. Macroeconomic policies remain highly accommodative.

- The cumulative fiscal response to the pandemic in 2020–21 is estimated at about 23 percent of GDP, including nearly 8 percent of GDP in direct fiscal measures, up to 14 percent of GDP in loan guarantees, and 1 percent of GDP to help firms meet liquidity needs. The headline fiscal balance was -11 percent of GDP in 2020, reflecting temporary discretionary measures and automatic stabilizers.³ The balance is projected to improve to -7.8 percent in 2021, primarily driven by the incipient economic recovery. The fiscal stance remained supportive in 2021.⁴



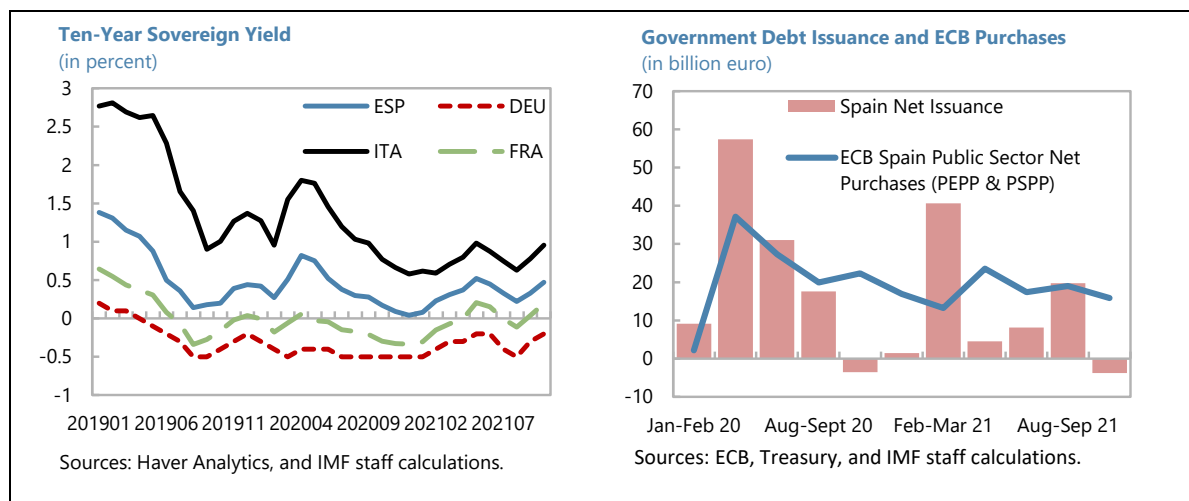
- The ECB has maintained a highly accommodative stance. Net purchases of Spanish public sector securities under the Pandemic Emergency Purchase Program (PEPP) and Public Sector Purchase Program (PSPP) have covered all net issuance in 2020 and in 2021, helping keep long-term yields at historically low levels.

² In 2020, Spain amended the existing FDI screening mechanism, in line with EU regulation and based on national security and public health reasons. The new regime introduces the requirement of prior authorization for FDI transactions by non-EU investors (broadly defined, including EU investors of non-EU ownership) that exceed €1 million and meet certain criteria defined by the law (e.g., that the investment is made in a strategic sector). A simplified authorization procedure has been established for FDI transactions below €5 million. Failure to file the required authorization would render the transaction void and would entail significant fines.

³ Excluding financial sector support (related to the reclassification of Spain's Asset Management Company SAREB into the general government), the fiscal deficit was about 10 percent of GDP in 2020.

⁴ While the change in the primary structural balance points is small, this measure does not capture the stimulus impact from the use of NGEU funds (which are deficit-neutral).

- Banks continued to provide credit to the economy, in stark contrast with the experience during the global financial crisis. In 2020, bank lending expanded for the first time since 2008, underpinned by the deployment of the public guarantee schemes (ICO) for loans to firms. In 2021, lending activity shifted from corporates to households, in line with demand developments. Lending rates have remained stable at historically low levels.

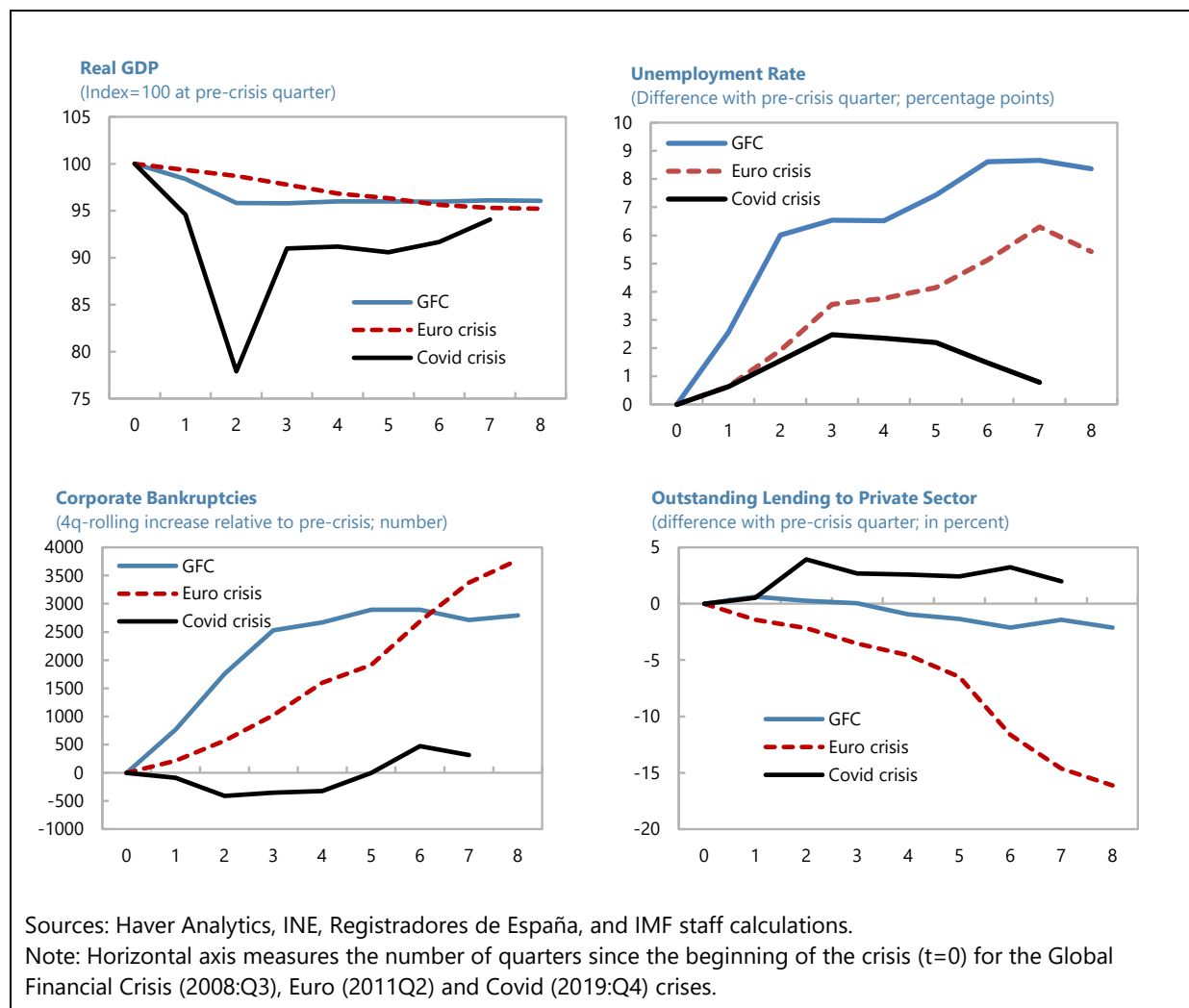


7. The unprecedented public support measures played a major role in limiting the economic fallout from the Covid crisis in 2020–21. The swift response of the Spanish government and the ECB cushioned the impact of the economic shock by providing income and liquidity support and ensuring favorable financial conditions. The successful ERTE scheme, along with support for the self-employed, covered about 25 percent of total employment at the peak of the crisis, facilitating adjustment via working hours. The number of firms benefitting from the state-backed loan guarantee program in Spain was the highest in Europe. Key support measures introduced in 2020 have been extended into early 2022 and made more targeted. A package of solvency support for the corporate sector was introduced in 2021, with an envelope of about 1 percent of GDP (€11 billion).

8. The current focus of policies is on the implementation of Spain's Recovery, Transformation and Resilience Plan (RTRP). Spain is one of the largest beneficiaries of NGEU funds. It is set to receive €69.5 billion in grants as part of the recovery and resilience mechanism. About 1.5 percent of GDP (€19 billion) in funding were disbursed in 2021. According to the plan, 40 percent of the funds will be used to facilitate the green transition, with major projects including increased production of electric vehicles and investments in renewable energy. Another 30 percent is allocated to boosting digitalization, including upskilling of the labor force.

9. Spain is undertaking a large reform effort in the context of the RTRP. Reforms cover a wide range of areas, including climate change and energy transition, innovation, housing, modernization of the public administration and the justice system, business climate, education, labor markets, social inclusion, and pensions. The labor market reform agreed at the end of 2021 aims to reduce labor market duality, enhance the ability of firms to adjust to shocks, and introduce changes in the collective bargaining process. The initial phase of the pension reform concluded in 2021 has

prioritized social acceptability and sufficiency, but sustainability remains a concern in the absence of additional measures.



OUTLOOK AND RISKS

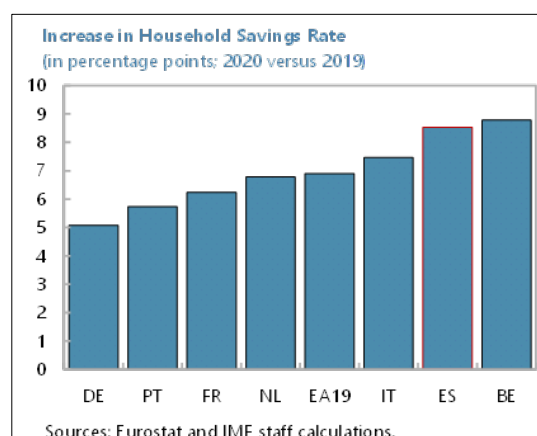
10. Economic activity is expected to maintain momentum, with output recovering to pre-crisis levels by the end of 2022. The baseline forecast assumes that vaccines will continue to be effective in protecting the population against severe cases of the virus and that global supply bottlenecks ease gradually in the course of 2022. Annual output growth is projected to reach 4.9 percent in 2021 and 5.8 percent in 2022. Private consumption should remain the main growth driver in the near term, underpinned by a continued normalization of the households' savings rate. Investment is expected to strengthen in 2022, reflecting robust demand, continued favorable financing conditions, and the easing of supply disruptions. The cumulative impact of the NGEU funds on the level output is estimated at 1½ to 2 percent by the end of 2022. This reflects a baseline assumption of additional spending of 0.8 percent and 1.9 percent of GDP in 2021 and 2022, respectively. External demand should recover further in 2022 as vaccination rates increase globally.

11. Headline inflation would remain elevated in early 2022. Consumer prices will remain high in the near term due to still elevated energy prices and a slow resolution of supply constraints, but should moderate in the second half of 2022 as these transitory factors ease. Core inflation is projected to average to 1.8 percent in 2022 (compared to 2.1 percent y-o-y in December 2021). Second-round effects from higher headline inflation rates are likely to be limited. Wage inflation has been modest so far and there is still slack in the labor market. However, risks around the inflation outlook remain significant, reflecting uncertainty about the path of energy prices and how fast global supply bottlenecks are resolved.

12. Over the medium term, potential growth is expected to return to pre-pandemic levels and scarring is likely to be limited. Scarring over the medium term is expected to be smaller than after previous crisis episodes. This reflects the different nature of this crisis, which was not caused by underlying vulnerabilities in the economy, as well as the authorities' prompt response, which helped preserve jobs and the health of private sector balance sheets. Investments and reforms under the RTRP would also play a critical role in limiting scarring, by compensating for slower capital accumulation during the pandemic and boosting productivity. Nonetheless, the sheer magnitude of the economic shock and the slow recovery in contact-intensive sectors could lead to some hysteresis, and the gradual process of reallocation of labor and capital could generate some productivity losses. Staff estimates that the loss of output relative to the pre-crisis trend could be between 2 and 3 percent of GDP in the medium term.

13. Uncertainty around the baseline forecast remains high (Annex II).⁵

- The main risk to the outlook continues to be the evolution of the pandemic, including the effectiveness of the vaccines against newer variants and the need for containment measures in case of new waves of infections. Rising uncertainty related to a global resurgence of the virus could further delay the return of international tourists. On the upside, reduced vaccine hesitancy globally and the development of more effective therapies can lead to increasing confidence and faster rebound of activity.
- The strength of the recovery in private consumption will depend crucially on the extent and pace of normalization of savings. Household savings increased significantly in 2020, with surveys suggesting that much of the increase was due to “forced” savings, which are likely to diminish over time.



⁵ See Annex II for a more detailed description of risks.

- The path of oil, gas, and other commodity prices and the speed with which global supply shocks will be resolved pose additional risks to the outlook. A prolonged period of rising energy prices and supply disruptions could lead to persistently higher CPI inflation, weighing on consumer spending and growth.
- If inflationary pressures in the euro area are persistent, expectations could shift to faster withdrawal of monetary support, and inflation risk premia and sovereign bond yields could increase. A rise in sovereign bond yields could increase vulnerabilities and further constrain fiscal space.
- The timing, composition, and effectiveness of EU-funded spending will also affect the speed of the recovery, as well as the magnitude of scarring over the medium term. A stronger-than-expected productivity boost driven by an acceleration of automation and digitalization could lead to higher potential growth.
- Over the longer term, the success of reforms targeting long-standing challenges in the labor market and other areas would determine Spain's ability to achieve efficient allocation of resources and higher potential output.

Authorities' Views

14. The authorities broadly agreed with staff's assessment of the economic outlook and the main risks. Bank of Spain's recent economic projections are similar to staff's. The government projects somewhat higher output growth for 2022 and stressed that the fast recovery of employment as compared to previous crises and the increase in fiscal revenues called for further analysis of the inconsistency between output, employment, and fiscal revenue growth. The authorities agreed that forecasts, in a context of high volatility of economic indicators, are marked by a high degree of uncertainty. The authorities shared staff's view on the key risks to the outlook and noted that the balance of risks had improved compared to expectations during the first year of the pandemic. Despite the rise in headline inflation, they do not expect significant second round effects as the share of wage contracts with automatic indexation clauses is relatively low and the contracts renewed in 2021 resulted in moderate wage increases. The authorities also concurred with staff's assessment that Spain's external position is broadly in line with fundamentals.

POLICY DISCUSSIONS

Fiscal policy should remain supportive until the recovery is firmly entrenched, but as economic activity gains momentum, it should become more targeted and focused on supporting the most vulnerable in order to facilitate resource reallocation and limit scarring. A key policy priority should be to facilitate a transition to a more resilient and inclusive economy and tackle long-standing structural challenges exacerbated by the pandemic, including addressing duality in the labor market, boosting the economy's productive capacity, reducing socioeconomic disparities, and rebuilding fiscal buffers over time.

A. Fiscal Policy

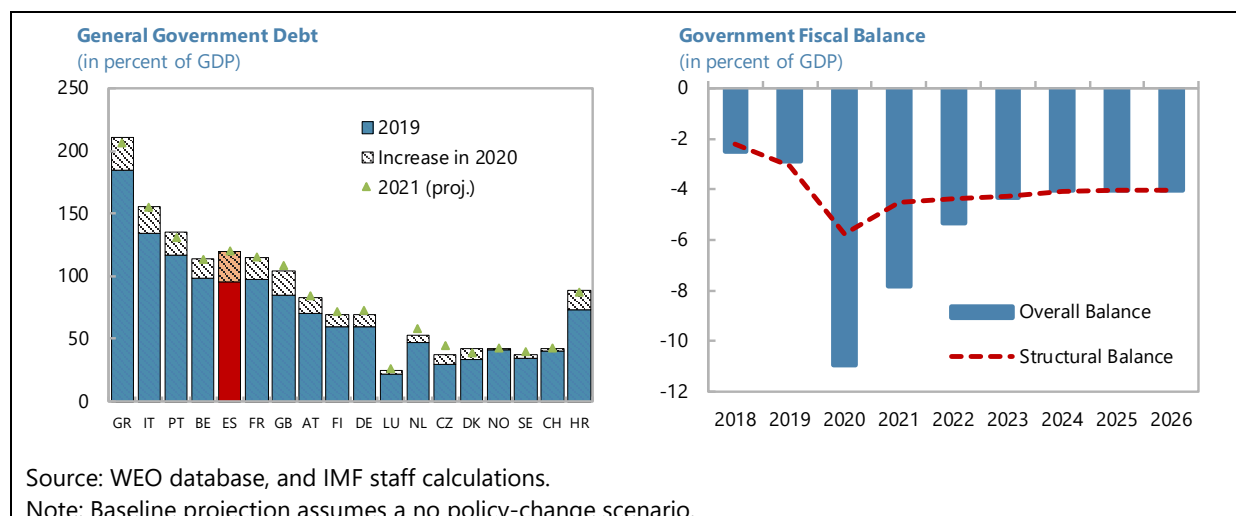
15. The fiscal stance has been appropriately expansionary in 2021, and support should remain in place until the recovery is firmly established to minimize economic scarring. With economic slack persisting and activity expected to return to pre-crisis levels only at the end of 2022, fiscal policy should remain accommodative.⁶ Fiscal consolidation in 2022 should be mainly driven by the economic recovery and automatic stabilizers, limiting discretionary adjustment to the unwinding of Covid-related emergency measures. The recently approved 2022 budget is consistent with these recommendations. The high share of investment in government spending in 2022, facilitated by the use of EU funds, is welcome. Judicious use of the limited available fiscal space would be needed if downside risks to growth materialize. Depending on the evolution of the pandemic, some support measures may need to continue to be flexibly extended, but should become increasingly targeted, with a focus on vulnerable groups and viable firms.

16. The NGEU funds provide an exceptional opportunity to support the recovery while promoting a structural shift to a more inclusive, greener, and digital economy. The European Commission has approved Spain's first disbursement request, and the implementation of projects is expected to gain pace in 2022. The selection of projects with high social returns, efficient coordination, and a focus on transparency and accountability are critical to ensure effective use of the investment funds. Spain's RTRP envisions a frontloaded use of funds during 2021–2023, but the expeditious and effective absorption of such large amounts could be challenging, in part due to the decentralized nature of the implementation. Staff's baseline scenario assumes that the use of funds is spread over four years.

17. The policy response to the pandemic has taken a significant toll on public finances. The government's deployment of fiscal resources to mitigate the economic and health effects of the crisis has been timely and forceful. Consequently, the debt to-GDP-ratio increased by nearly 25 percentage points to about 120 percent of GDP in 2020. Under the baseline scenario, deficit and debt ratios will fall in the near term as economic conditions improve, tax revenues recover, and emergency spending measures wind down.⁷ Nonetheless, in the absence of active consolidation, the structural deficit will stabilize above pre-crisis levels and the debt ratio will start increasing by 2024, once output growth rates slow down. In the long term, spending pressures related to population aging will pose a significant challenge to public finances.

⁶ The European Commission (EC) and the Council have activated the general escape clause of the Stability and Growth Pact (SGP) for the period 2020-22 due to the severity of the economic recession caused by the pandemic. The European fiscal supervisory framework that will prevail after that has yet to be defined. At the national level, the fiscal escape clause provided for in the national fiscal law has been active since 2020 and will be extended until 2022, as recommended by the fiscal watchdog.

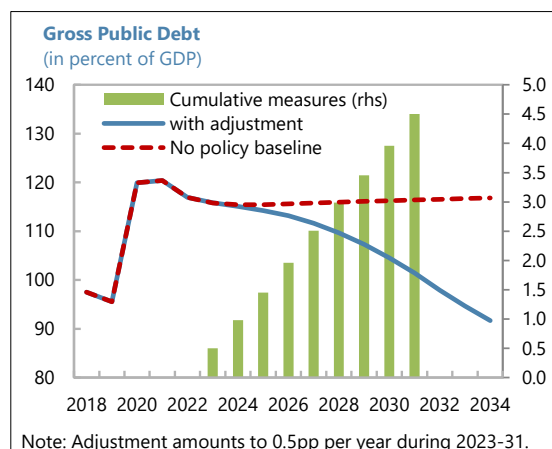
⁷ Staff's baseline scenario assumes no policy changes after 2022 beyond the expiration of temporary support measures.



18. Once the recovery is established, it will be necessary to implement gradual but steady fiscal consolidation to rebuild fiscal buffers and put public debt on a downward path.

- Timing.** A sustained and gradual discretionary fiscal consolidation process should be initiated once the output gap is closed, and the economy is on a sustained growth path. Under the baseline scenario, these conditions would be met by 2023 (Table 6). This approach will help protect the recovery and contain long-term scarring costs. The timing may need to be adjusted if downside risks materialize. On the upside, any positive fiscal surprises from faster-than-expected recovery should be saved.

- Pace and size.** A gradual reduction of the structural primary deficit by an average of about ½ percent of GDP annually would reverse the rising trend in the debt ratio and achieve a close-to-balanced structural fiscal position within a decade. The suggested average pace and cumulative size of the adjustment are in line with the results of a model that balances trade-offs between economic stability and debt sustainability (Annex IV). If growth in the coming years is higher-than-expected, the adjustment could be more front-loaded. This would signal the government’s determination to restore fiscal buffers and reduce potential political risks associated with an extended consolidation period.



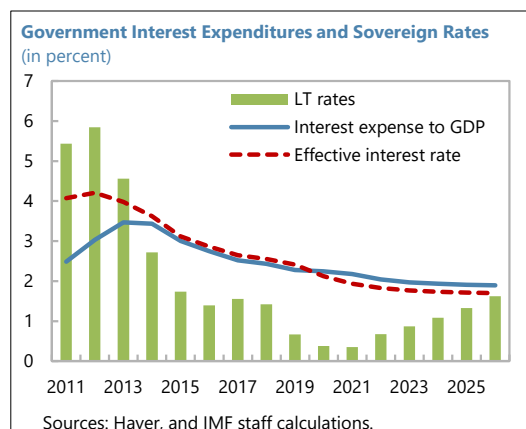
- Composition.** Fiscal measures may need to include both mobilizing additional revenues and enhancing spending efficiency, building on recent expenditure reviews. At the same time, space should continue to be made for investment in climate mitigation and adaptation. Spain's tax-to-GDP ratio is relatively low compared with regional peers. Revenue measures could include strengthening VAT collection, raising environmental taxes, and reducing tax system inefficiencies. Major tax reforms should be accompanied by targeted social transfers to mitigate the impact on vulnerable households.

Yield of Potential Revenue Measures (Percent of GDP)	
Measures	Yield
1. Lowering the VAT policy gap to EU average	1.5-2.0
2. Broadening the tax base by removing distortions in the tax system	0.3-0.5
3. Harmonizing environmental taxes with EU average	0.7-0.9

Source: Eurostat, Expert's Committee for the Reform of the Spanish Tax System (2014), and IMF staff estimates.

Spain's public primary spending is already relatively low compared to those of EU peers, so expenditure rationalization should include efficiency improvements, informed by spending reviews. The recent creation of a permanent division within the fiscal responsibility authority (Airef) to provide continuity to the spending review exercises is welcome. On public expenditure composition, Spain typically spends less than peers on growth enhancing activities, such as public investment and education, and more on social protection, such as pensions and unemployment benefits.

19. The early formulation of credible medium-term consolidation plans would be important to support investor confidence. The low-interest environment in recent years has led to lower total interest payments despite the significant increase in debt. Interest spending will remain low in the medium term even as market rates increase due to Spain's relatively long debt maturity. However, a sudden or sustained increase in interest rates would further reduce the limited fiscal space. The early formulation of specific plans to rebuild fiscal buffers would reinforce investor confidence and reduce the risk of sharp increases in financing costs. The findings of the ongoing expert review of Spain's tax system, which will be completed in early 2022, should provide valuable input for the formulation of a medium-term adjustment plan. The fiscal adjustment should be growth-friendly, which will require preserving space for public investment and education spending, and accompanying the process with growth-enhancing structural reforms.



20. Additional measures will be necessary to offset the rise in fiscal costs associated with the indexation of pensions to inflation. Under the recently adopted pension reform, pension payments will be permanently indexed to CPI inflation and the sustainability factor was repealed in 2021. This would raise annual pension outlays by 3½ percent of GDP by 2050, compared to a full implementation of the previous legislation. Only part of the increase is expected to be offset by the other measures adopted in the recent reform, such as the introduction of incentives to increase the effective retirement age and the temporary increase in social security contributions. Preserving the sustainability of public finances requires additional efforts to counterbalance pension spending

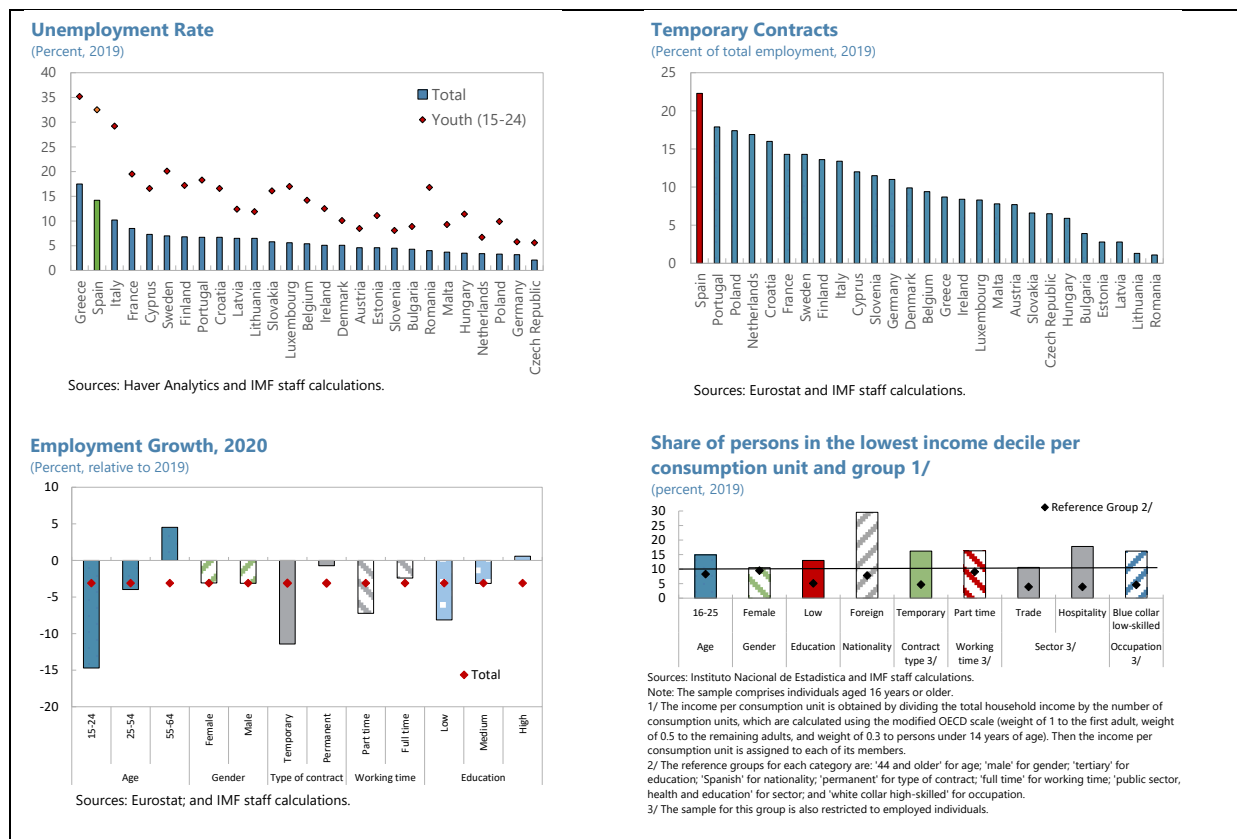
pressures, which would also help signal the authorities' commitment to fiscal responsibility and bolster the credibility of the forthcoming consolidation process. Annex V provides background on the pension system and discusses alternative reform options, including mechanisms for expenditure restraint (e.g., further extending work lives), and raising revenues (e.g., increasing the maximum earnings subject to contributions).

Authorities' Views

21. The authorities reiterated their commitment to fiscal discipline and also stressed the importance of prompt revisions to the European fiscal framework. The authorities agreed on the need to support the economy until recovery is firmly entrenched. They noted that key support measures have already been extended to 2022, including the short-time work scheme and the state-backed loan guarantee program. The authorities restated their commitment to fiscal discipline and pointed that, in their projections, the headline fiscal deficit would already significantly decline in 2021 and decrease to about 3.2 percent by 2024 from 11 percent in 2020 (based on no discretionary measures other than the expiration of COVID-related support). They also noted their intention to bring revenue levels closer to peer countries over time as the economy recovers. The authorities stressed their commitment to comply with both the EU and national fiscal frameworks, and highlighted the desirability of a prompt reform to the EU framework. On pension reform, the authorities noted that the previous legislation had been suspended in the past due to problems of political acceptability, while elements of the 2021 pension reform (such as CPI indexation) have broad consensus. They stressed that further measures are expected to be incorporated in the second phase of the pension reform in 2022, as committed to in Spain's recovery plan. Moreover, the contingent mechanism included as part of the intergenerational equity mechanism foresees the introduction of complementary measures if needed beyond 2032.

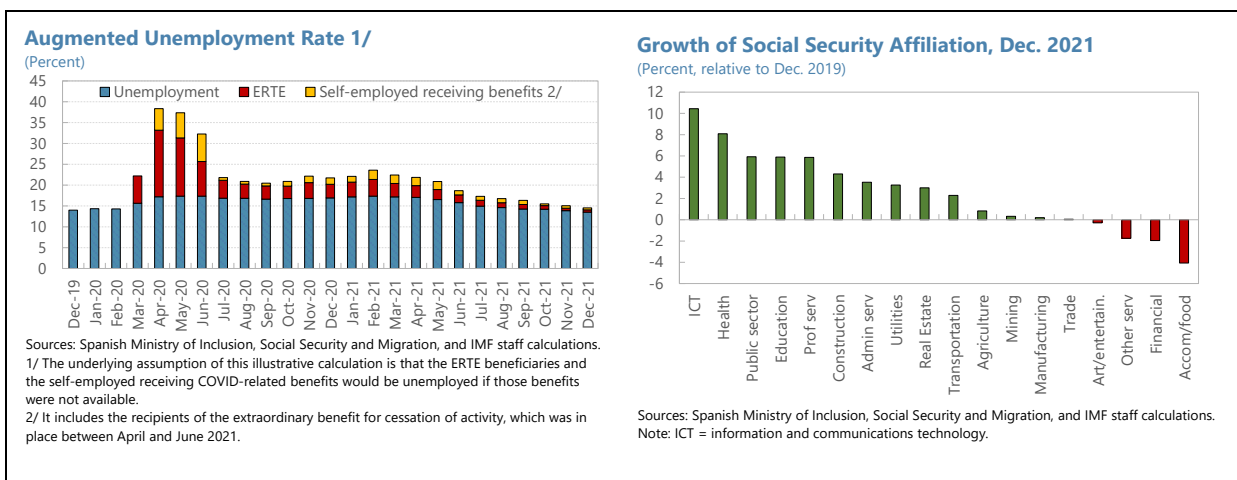
B. Labor Market Policies

22. Some long-standing structural weaknesses in Spain's labor market have been exacerbated by the pandemic. Spain's unemployment rate, particularly among the young population, has historically been one of the highest in the EU. Moreover, an overreliance on temporary contracts reduces incentives for training and accumulation of human capital. Vulnerable groups, including women, young, less educated, low skilled, and immigrant workers—many of whom worked in the hard-hit tourism and hospitality sectors, and were more likely to have a temporary contract—were affected disproportionately by the Covid pandemic (Lariau and Liu, 2022). Since these groups are overrepresented in the lower deciles of the income distribution, the pandemic likely has had an adverse impact on income inequality.



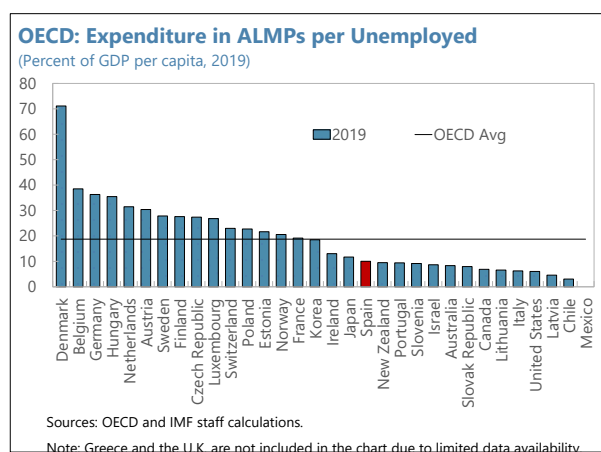
23. The employment recovery in 2021 masks significant heterogeneity across sectors.

Employment growth has been strong in pandemic-related activities such as health services, public administration, and ICT. On the other hand, employment in contact-intensive sectors remains subdued, and may recover only partially. Among the remaining 125,000 ERTE participants in December 2021, more than half were concentrated in accommodation, food, travel agencies/operators and wholesale/retail trade. Further reallocation of labor could be expected in the future due to structural changes triggered by the pandemic, including an acceleration of technology adoption and automation, and labor market policies should aim to facilitate this process.



24. As labor market conditions normalize, pandemic support programs should continue to be scaled back and become more targeted. The ERTE scheme and benefits for the self-employed have been recently extended until February 2022. In addition, the ERTE has been modified to increase incentives for returning to work and to better target sectors and companies most affected by the pandemic. Support for the self-employed has also become more targeted and benefits have been gradually reduced. Over time, unemployment benefits should become the predominant safety net to encourage reallocation toward expanding sectors.

25. Strengthening active labor market policies (ALMPs) would provide support to displaced workers, facilitate sectoral reallocation, and help reduce inequality and regional disparities. Spain ranks low in terms of ALMP spending per unemployed person compared to other OECD countries. Moreover, the resources have been directed mostly to job creation programs and start-up incentives. More ALMP resources should be allocated to well-targeted training. It would also be desirable to strengthen the public employment service and reduce the heterogeneity of service provision at the regional level (for details see [2022 Selected Issues](#)). The existing system of hiring incentives should be streamlined and target the most vulnerable groups. The planned ALMP-related



reforms and investments in the RTRP are consistent with these recommendations. The new Employment Law includes specific policy proposals, such as the development of a national digital job market platform, to facilitate labor matching and the provision of individualized services to the unemployed. An effective implementation and regular ex-post evaluation of these reforms, as well as close collaboration with the private sector, will be critical for their success.

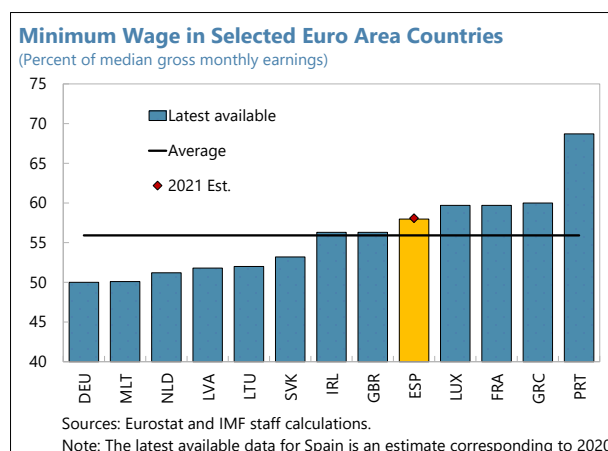
26. The recently agreed labor market reforms aim to limit the use of temporary contracts, enhance the ability of firms to adjust to shocks, and modify collective bargaining to provide more protection to workers. The reforms were supported by the social partners (see Annex VII for a detailed description of the reforms).

- *Tackle labor market duality.* The reforms restrict the use of temporary contracts and promote the use of open-ended contracts for the construction sector and for activities that are seasonal in nature. Effective enforcement will be needed to ensure compliance. While these reforms could help increase the share of permanent contracts, they do not address the fundamental problem driving duality, which is the large difference in the costs of dismissal of permanent versus temporary workers (see [2020 Selected Issues](#)). Complementing the streamlining of contracts with a reform of the severance payments system (possibly including the creation of an employer-based separation fund) and addressing the legal issues that add to the cost of dissolving permanent contracts would help increase further the share of permanent jobs, while ensuring continued protection for workers.

- *Enhance the ability of firms to adjust to shocks.* The reforms envisage a welcome easing of the administrative procedures for the existing ERTE scheme. In addition, a new and more generous short-time work scheme (RED) has been created to support firms dealing with cyclical macroeconomic fluctuations or sectoral shocks. Workers in the RED scheme will undergo training and get support to find new jobs. Operational details, such as the specific conditions that will warrant the use of this mechanism, have not yet been defined. The new scheme will be financed by the government. While the sectoral RED may help enhance the mobility of employed workers, the scheme could potentially put a significant burden on public finances and limit work opportunities for unemployed and first-time job seekers by encouraging hiring from the pool of RED participants.
- *Changes to the collective bargaining process.* The current agreement reverses some elements of the 2012 reform. Specifically, it restores the priority of sectoral agreements over firm agreements on wages, and reinstates indefinite extensions of prior agreements in case of failure to reach a new agreement. Firms will retain flexibility to set other working conditions and can negotiate with the unions an opt-out from sectoral agreements. The changes in the wage bargaining process attempt to strike a balance between protecting workers and maintaining ability for adjustment at the firm level. However, the option to extend indefinitely expired agreements is not in line with practices in peer countries and entails a reduction in flexibility for firms.

27. Future minimum wage increases should be aligned with labor market conditions and productivity growth.

The government targets an increase of the minimum wage to 60 percent of average net monthly earnings by the end of its term. This would leave Spain with one of the highest minimum wages as percent of median earnings in the EU. Staff analysis has shown that unintended adverse consequences on employment could partially offset the gains for low wage earners (see [2020 Selected Issues](#)). Wage increases should be consistent with productivity growth and cyclical conditions. Alternative policies could



be considered to support low-income households, such as the introduction of an Earned Income Tax Credit program, which would complement the Minimum Income Scheme.

Authorities' Views

28. The authorities concurred with staff on the need to effectively address long-standing challenges of the labor market, particularly the high incidence of temporary employment and youth unemployment. The labor reform, which was agreed with all social partners, aims to restrict temporary contracts by narrowing the definition of valid causes, strengthening enforcement, and widening the scope of open-ended seasonal contracts. The authorities expect that the use of the short-time work schemes and the provision of incentives to in-company training would offset any

potential reduction in firm-level flexibility stemming from a lower share of temporary workers. They envisage that the new RED mechanism would promote job stability and support the reskilling of workers transitioning to new sectors. The authorities expect that the net cost of this scheme would be low or even negative, as it is intended to be used only for severe shocks and should reduce flows into unemployment. They do not plan changes in the gap in dismissal costs or the adoption of an employer-based separation fund. Regarding collective bargaining, the government's objective is to prevent abuses in the wage-setting process at the firm level, while keeping other flexibility elements that already exist in the Workers' Statute. The authorities reiterated their intention to further increase the minimum statutory wage to achieve the 60 percent of average net monthly earnings target. They acknowledged the importance of revamping ALMPs and reforming the vocational training system to reduce structural unemployment and facilitate sectoral reallocation. The recovery plan foresees important reforms and investments in this area.

C. Financial Sector Policies

29. Public support measures have played a key role in cushioning the crisis impact on private sector balance sheets.

- **Households.** The pandemic impact on labor markets and households' income was in part offset by social transfers, including unemployment benefits, the ERTes, and the minimum vital income scheme. Temporary debt payment moratoria also helped ease financial pressures. Household leverage and debt service ratios increased only moderately, and remain significantly below the Global Financial Crisis (GFC) levels. Net assets have increased, driven by higher savings which were mostly channeled toward deposits.
- **Corporates.** Measures to ensure an uninterrupted flow of credit to firms helped limit financial distress during the crisis, although firms' financial vulnerabilities increased. There was a strong contraction in corporate earnings in 2020: the share of companies with negative profits increased to about 40 percent (from about 30 percent in 2019). Firms have taken on greater debt to cover short-term liquidity needs. Non-financial corporate leverage increased by about 15 percentage points, reaching 107 percent of GDP in 2020 (compared to about 140 percent in the aftermath of the GFC). While profitability improved in aggregate in 2021, the recovery has been uneven across sectors, and vulnerabilities have increased due to larger debt positions particularly in the most affected sectors.⁸

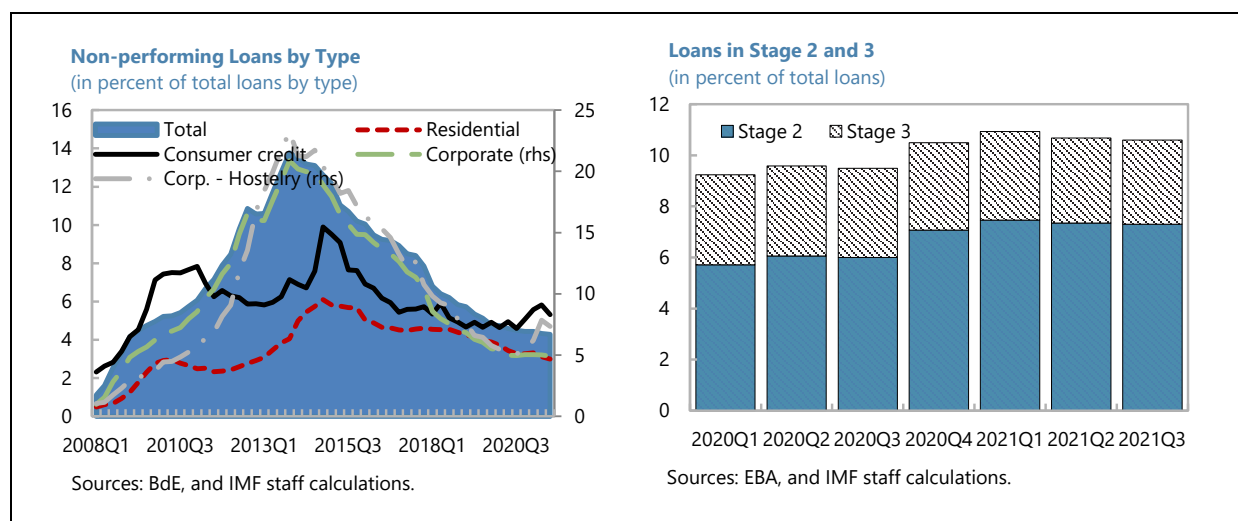
30. The roll-out of a corporate solvency support package during 2021 has aimed to prevent liquidity issues from morphing into solvency problems. Spain's policy response initially emphasized liquidity support for the corporate sector and was very successful, with high take-up rates. Nonetheless, with the crisis lasting longer than initially anticipated, there was a need to move to greater solvency support for viable firms to prevent debt overhang. The measures unveiled last year included direct aid, restructuring support, and recapitalization for medium-sized firms, with an envelope of about one percent of GDP (11 billion euro). The direct aid component accounted for

⁸ These include contact-intensive sectors such as hospitality, entertainment, and transportation (Figure 6).

60 percent of the package, and was administered by the regional authorities under national guidelines. While final implementation numbers are not yet available, simulation analysis suggests that it should have played a role in mitigating solvency risks, particularly for the SME segment (Annex VI).

31. There is no evidence of significant misalignment in residential prices. Residential prices increased moderately in 2020 despite a drop in transactions. More recently, transactions picked up, reflecting pent-up demand, and price inflation has accelerated, although there is no evidence of misalignment so far. The commercial real estate market has been affected more acutely by the pandemic than the residential market, but bank credit quality indicators in this sector have remained broadly stable. The Bank of Spain has recently expanded its macroprudential toolkit, including a sectoral countercyclical capital buffer, sectoral concentration limits, and limits and conditions on lending and other transactions. The expanded toolkit could be useful to address sector-specific pressure points, for example, if risks in the real estate sector become more pronounced.

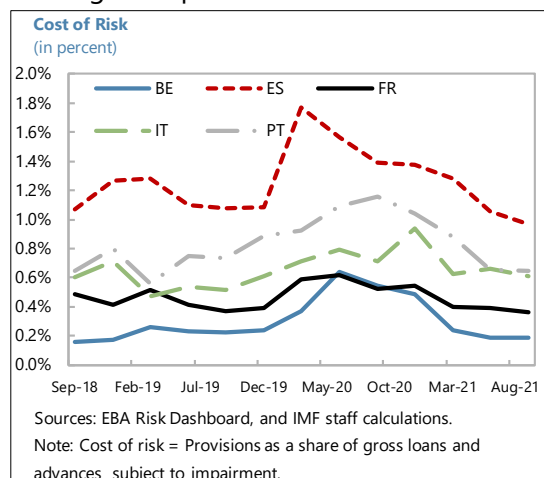
32. The financial sector has remained resilient, although the full extent of corporate distress may only become apparent over time. Aggregate borrower stress indicators (such as banks' non-performing loans and firms undergoing insolvency proceedings) remain low, but could deteriorate over time as payment holidays and other borrower support measures are phased out.⁹ Some signs of asset quality deterioration have already emerged in specific segments, for example NPLs have increased for consumer credit and in the hostelry sector, as well as for loans subject to expired moratoria and public guarantees (Figure 8). Moreover, stage 2 loans increased in the last quarter of 2020, as banks reclassified the most vulnerable loans in their portfolios, in accordance with regulatory and supervisory guidance.



⁹ About 85 percent of loans under moratoria already expired in the first half of 2021. Remaining loans under moratoria amount to less than one percent of total bank loans.

33. Close monitoring is needed to ensure continued resilience of the banking sector.

- Banks frontloaded provisioning in 2020 in anticipation of higher expected losses. Forward-looking provisions should not be reversed until the ultimate impact of the pandemic becomes more certain. Spanish banks' stage 2 loan reclassifications appear low compared to European peers given the size of the pandemic shock, albeit with relatively higher coverage ratios in this segment. There is also significant heterogeneity across banks' provisioning efforts. Supervisors need to continue making sure that loss recognition is sufficiently forward-looking and provisioning levels are appropriate, and that variations across banks are not driven by undue optimism or profitability considerations.



- On longer-standing issues, further progress in cost rationalization and digitalization would be necessary to improve the profitability outlook, in the context of a low interest rate environment, still subdued activity, and potentially large provisioning needs. Some additional consolidation may also be warranted, although the banking system has become more concentrated (measured by the market share of the top five banks) than the EU average.
- It will be necessary to monitor the willingness of banks to use capital buffers if risk scenarios materialize. It may be limited by concerns about stigma or the expected pace of rebuilding buffers. To avoid a potential tightening of lending conditions, prudential relief measures should not be withdrawn prematurely and, if risk scenarios materialize, capital buffers should be allowed to be built back only gradually.
- Stress-testing exercises by the Bank of Spain, EBA/ECB, and IMF suggest that the Spanish banking system is broadly resilient (although with some heterogeneity in the strength of buffers across banks) and meets the minimum prudential requirements under a severe stress scenario. Dividend payouts and share buybacks should continue to be assessed on a case-by-case basis, taking into account continued uncertainty over the economic impact of the pandemic and the lower CET1 capitalization level of the Spanish system relative to European peers.

34. Spain is in the process of amending its private debt resolution frameworks, including by incorporating the EU Directive on restructuring and insolvency into national law. The proposed amendments to the Spanish insolvency regime aim to (i) facilitate early restructuring for distressed enterprises; (ii) speed up restructuring and liquidation for microenterprises; (iii) simplify the procedure for discharging debts of individuals and entrepreneurs; and (iv) reduce the burden on the court system to increase their capacity to handle insolvency cases. The reform effort is commendable, particularly the inclusion of public creditors in the restructuring process for enterprises and the “second chance” procedure for individuals. Strengthening the insolvency regime is critical given that insolvency filings are likely to increase upon the expiration of the moratorium on

creditor insolvency filings. The policy choice to extend the moratorium until end-June 2022, when the insolvency reforms are expected to be implemented, allows time for the system to adjust. However, continued extensions may risk creating a cliff of insolvency filings and an increase in “zombie” companies that do not take timely steps to resolve financial difficulties.

Authorities’ Views

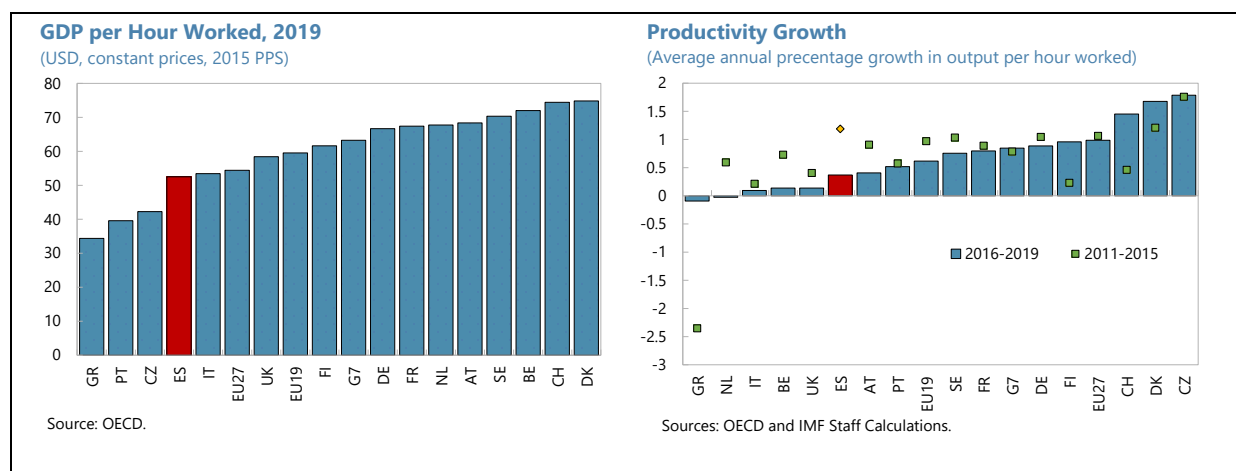
35. The authorities broadly concurred with staff’s risk assessment and recommendations.

The authorities highlighted the key role played by public support measures in cushioning the impact of the pandemic on private sector balance sheets, and stressed that financial sector risks have continued to evolve more favorably than originally feared. The authorities assess the level of provisioning, credit risk identification, and solvency buffers as adequate, and agreed with staff that the high uncertainty context calls for prudence and close monitoring to ensure continuous resilience. The authorities assess residential real estate prices broadly in line with fundamentals, but will continue to closely follow up developments in the sector. The authorities highlighted the ongoing efforts to enhance the efficiency of restructuring and insolvency procedures. The authorities strongly advocated actions to enhance resolution frameworks in Europe, noting that completing the banking union with a common deposit insurance scheme is critical.

D. Structural Reforms

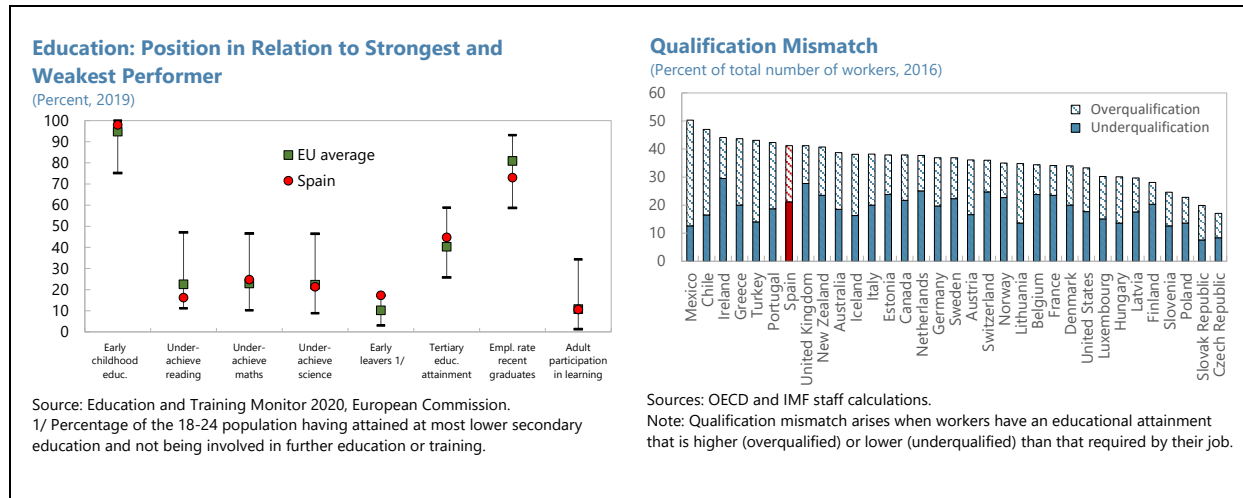
36. Structural policies should aim to raise productivity and make growth more inclusive.

Productivity levels in Spain are lower than in most peer economies, and productivity growth has been below the EU average in recent years. The pandemic has exacerbated these trends. A multi-pronged policy approach is needed to support productivity, increase living standards, and reduce income inequality and regional disparities.

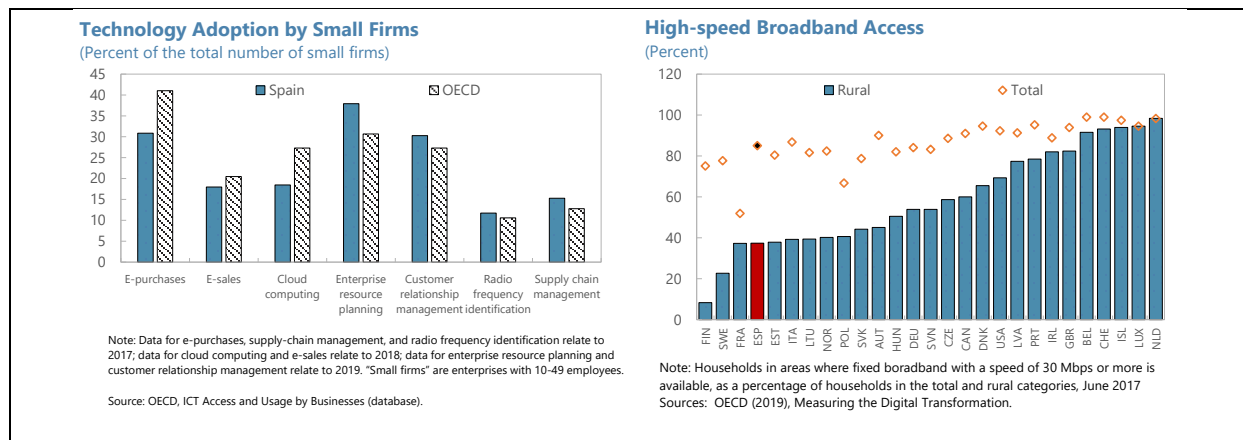


- **Human capital.** Spain has the highest share of early leavers from primary and lower secondary education in the EU (at 17.3 percent). Tertiary education attainment is above the EU average, but graduates face difficulties in finding jobs due to skill mismatches. Other challenges include low participation in vocational education and training and limited access to digital technology (about 10 percent of students do not have access to internet or digital devices at home). The RTRP

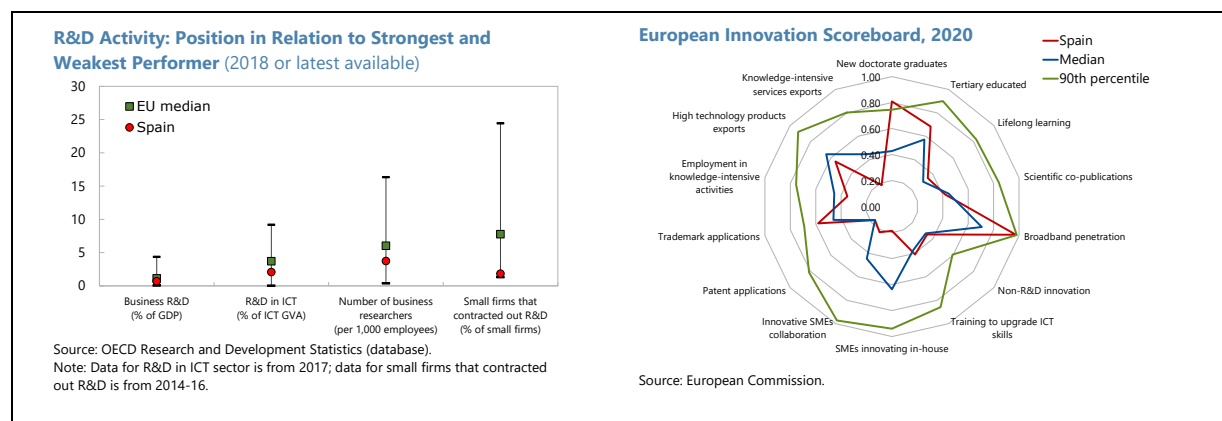
includes ambitious education reforms which would help boost human capital, including investments in digital skills, expansion of vocational training, and modernization of the education system. The plan also seeks to improve the employability of university graduates by adapting university courses to market needs and by strengthening collaboration with firms. It would be important to implement these reforms in a timely manner, and evaluate the effectiveness of the new programs once they have been in place for some time.



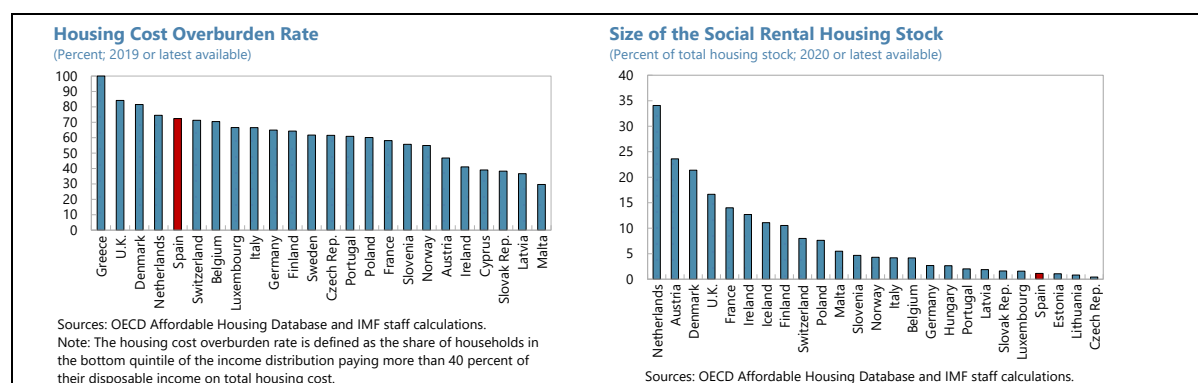
- Digitalization.** While Spain is above the EU average in terms of the overall level of digitalization, there is significant heterogeneity across firms and regions. The adoption rate of e-business and cloud computing technologies among SMEs, and the broadband usage in rural areas is low compared to peers. The authorities' emphasis on the digitalization of SMEs and the public administration in the RTRP is well-placed. The plan to achieve universal broadband and 5G coverage is critical to improving connectivity facilitating technological transformation. Additional policies to foster the adoption of digital technologies could include promoting the benchmarking of firms against other companies operating in similar sectors and sharing of best practices.



- Innovation.** Spain ranks relatively low on research and development (R&D) spending, SME innovation, and technology-intensive exports, in part due to its sectoral structure. Despite being generous, R&D incentives have had limited take up in the past. Conducting a review of the existing incentives to assess their effectiveness could be useful prior to their planned expansion under the RTRP. Further efforts could include strengthening the collaborations between public and private sectors, particularly among firms (especially SMEs) and research institutes (OECD 2021).



37. Continued efforts to address housing affordability challenges would support growth, facilitate labor mobility across regions and reduce inequality. Prior to the pandemic, limited rental housing supply hampered by relatively inefficient building regulations contributed to a surge in rental prices, creating affordability problems and limiting labor mobility (especially for young people and other vulnerable groups). The draft housing law and the national housing plan aim to address the existing challenges. To limit increases in rent prices in stressed areas, the law introduces rent caps on large landlords and tax incentives for small landlords to keep rents low. While these may benefit tenants in the short term, rent caps could introduce inefficiencies and restrict the availability of properties for future tenants. Further evaluation of these measures would be useful to gauge their impact. The envisaged targeted rent support programs for vulnerable groups are welcome. However, they should be combined with effective supply measures to avoid further pressures on rent prices. The increase of taxes on empty properties and the expansion of the social housing stock, which are contemplated in the proposed reform, should help increase rent supply. The RTRP envisages €1 billion for the construction of new public social rental dwellings in 2022–23. Additional policies to increase housing supply could include simplifying land use regulations and accelerating licensing processes at the regional government level.



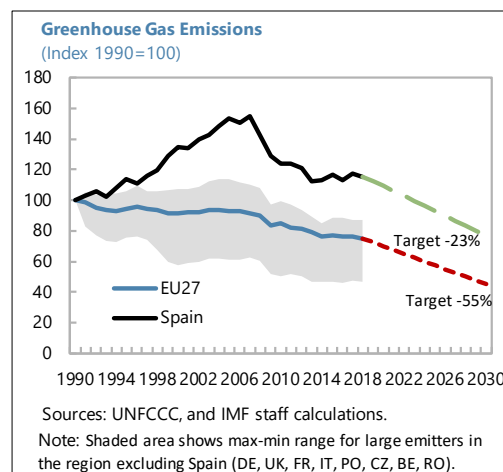
Authorities' Views

38. The authorities concurred with the need for a multi-pronged approach to achieve higher productivity and more inclusive growth. They highlighted the broad set of growth-enhancing structural reforms and investments contained in the recovery plan, some of which are underway. The government recognized the existence of education gaps and indicated that reforms in this area are progressing well, with key legislation—including the new Education Law—already being pushed forward in 2021. The authorities underscored that better coordination among agencies and the alignment of objectives between research centers and private sector needs are critical to improve the efficiency of public policies in the field of R&D and innovation, and pointed out that the recent establishment of the Sectoral Conference on Better Regulation and Business Climate could enhance best practice sharing and reinforce cooperation among different administrations. Also, a new Law on Creation and Growth of Businesses, a new Law on Start-ups and a reform on insolvency procedures will be adopted. To promote the digital transformation of the economy, the government has prioritized enhancing connectivity and the digitalization of SMEs and public administrations. Regarding housing affordability, the authorities do not expect a negative effect from the introduction of rent caps as they would be temporary and only restricted to very specific stressed areas.

E. Climate Change Mitigation¹⁰

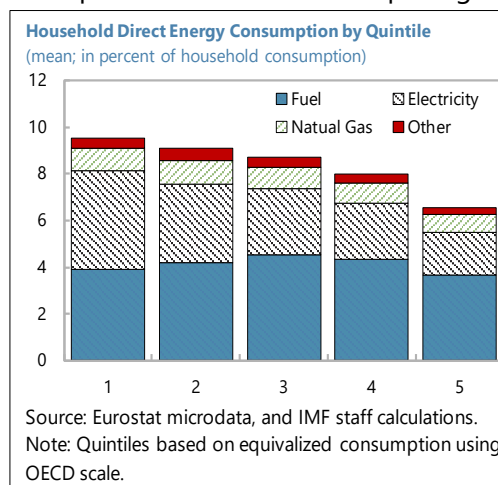
39. Significant effort will be needed to reach Spain's new more ambitious climate objectives, as reflected in the authorities plans.

In contrast to most other EU countries, greenhouse gas (GHG) emissions in Spain remain above 1990 levels (despite a material reduction since the global financial crisis). Spain's Law on Climate Change and the Energy Transition, passed in 2021, establishes the goal of carbon neutrality by 2050, together with an intermediate requirement to reduce emissions by 23 percent relative to 1990 levels by 2030 (about a one third reduction compared to 2018 levels). The authorities' 2030 strategic plans identify the right broad priorities. Nonetheless, implementation details are yet to be defined in certain areas, especially on the role of carbon pricing in driving decarbonization.



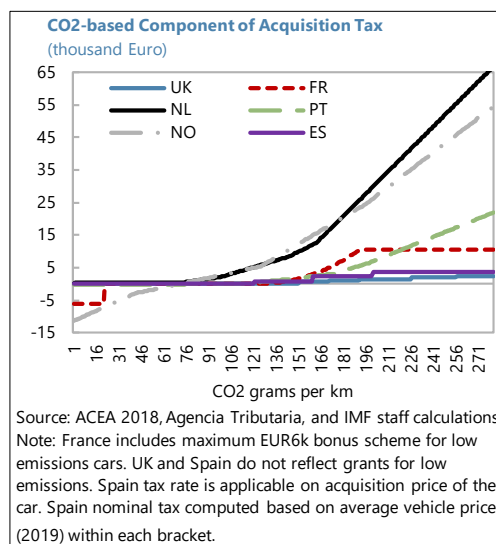
¹⁰ This section draws on [2022 Selected Issues "Climate Change Mitigation Policies in Spain."](#)

40. Gradual and predictable carbon price increases, complemented with distributive policies to protect vulnerable households, would set the right incentives for a reduction in emissions. While carbon pricing coverage is extensive in Spain, effective rates are low relative to estimates of emission damages, and tend to be lower than in peer economies. Carbon pricing for the power sector is expected to increase further within the EU ETS framework. It will be important to raise prices gradually in other sectors as well to provide incentives to accelerate electrification, energy conservation, and reduction in emission-intensive activities. The ongoing review of environmental taxation should provide the foundations for a broad tax reform. Higher carbon pricing in the residential and road transport sectors could be implemented in various ways, including raising current taxes, introducing a dedicated carbon tax, or via an ETS framework (proposed in “Fit for 55”). Support for low-income households and workers affected by the green transition will be critical to ensure broad social acceptability and to mitigate any regressive effects of carbon pricing. Predictability of carbon price increases is also critical, both to provide certainty to investors and also to avoid political backlash associated with sudden large increases.



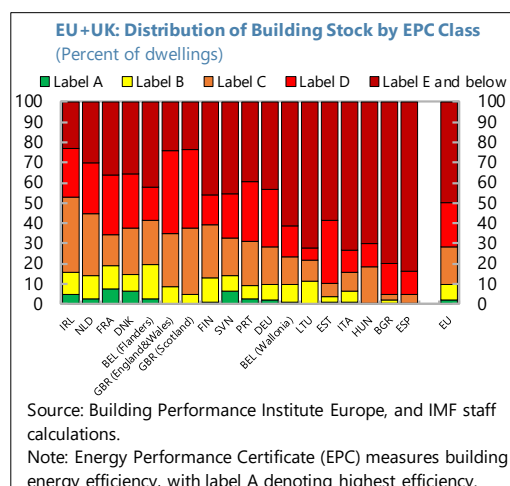
41. Complementary policies will be essential to address sector-specific obstacles to reducing emissions.

- Road transport sector.** Vehicle acquisition taxation could be strengthened, as the current schedule is coarse, flat within each bracket, and less ambitious overall compared to peer countries. “Feebates”—which combine a tax on high-emissions vehicles with a subsidy for low-emission ones—can be used to shift purchases toward cleaner vehicles. The authorities’ strategy envisages the establishment of low emission zones as a key policy to drive a shift in transport modes. The implementation of this policy is decentralized, and should be monitored closely to assess the need for further action. Local authorities should consider toll systems as a complementary policy, which could raise revenues to mitigate distributional concerns.¹¹



¹¹ The use of tolls as a complementary tool is consistent with recently released national guidance for the establishment of low emission zones.

- **Residential sector.** A package of fiscal measures, including feebates and differentiated property tax rates, could complement carbon pricing (see SIP for more details). On the regulatory front, a phased tightening of mandatory energy performance standards for existing buildings could help step up the pace of renovations. Favorable financing terms can help reduce the upfront costs of residential energy efficiency improvements.
- **Power sector.** Recent studies suggest that Spain's auction framework adequately supports investments in renewable energy (IEA 2021, del Rio 2021).



42. Across all sectors, public investment and financial support will be vital where market failures constrain private investment. Spain's 2030 strategy correctly identifies multiple areas for intervention, including the deployment of transport charging infrastructure, upgrades to rail freight infrastructure, and the expansion in coverage and interconnection of electrical grids. The authorities' plans to leverage NGEU funds to support green investment are welcome. About 40 percent of announced investments have been allocated to green projects, with initial investments prioritizing clean energy, sustainable mobility and building efficiency renovations.

Authorities' Views

43. The authorities welcomed staff's analysis, and broadly agreed with the main messages. The authorities highlighted that Spain's ambitious climate target, as reflected in its 2030 plan, is already aligned with the later-established 55 percent emission reduction objective at the EU level. They concurred with staff on the main barriers that are necessary to overcome to deliver on the country's objectives. The authorities support the EU's enhanced climate ambition that is to be operationalized by the "Fit for 55" plan. At the national level, the authorities noted that the ongoing expert review of Spain's tax system has been specifically tasked with analyzing environmental taxation. They agreed that carbon price increases should be gradual and predictable, and that it will be crucial to address the distributional consequences of the green transition to protect those most vulnerable and underpin public support going forward.

STAFF APPRAISAL

44. The Spanish economy is emerging from a deep recession amid recurrent waves of Covid-19 infections, persistent global supply bottlenecks, and elevated energy prices. Economic growth resumed in the second quarter of 2021, supported by a highly successful vaccination campaign. Employment has recovered strongly, although output is still significantly below its pre-pandemic levels due to the slow recovery of contact-intensive sectors. The authorities have maintained appropriately accommodative fiscal and financial sector policies which have helped protect jobs, household incomes, and firm balance sheets. The recovery should continue in 2022

with the normalization of households' savings rate and a faster deployment of NGEU funds, although the recent resurgence of Covid-19 infections and high inflation pose headwinds to growth. Some key support measures have been extended into 2022 and made more targeted. Over the medium term, output is expected to converge to the pre-pandemic trend with limited scarring.

45. Uncertainty remains elevated in the near term. The evolution of the pandemic continues to be a key risk, especially if newer variants reduce the effectiveness of vaccines. A prolonged period of global supply disruptions and high commodity prices could slow the recovery of consumer spending and growth and lead to more persistent inflation pressures. It is important that wage-setting negotiations continue to internalize the transitory nature of the current drivers of inflation and avoid a vicious cycle of higher wages leading to higher inflation. On the upside, a faster unwinding of households' accumulated savings could boost consumption. The pace of absorption and the effectiveness of use of NGEU funds, as well as the success of reforms aiming to address structural weaknesses will shape the path of growth in the coming years.

46. Fiscal policy should remain supportive until the recovery is firmly entrenched, while becoming more targeted and focused on supporting the most vulnerable. With economic slack persisting and activity projected to return to pre-crisis levels only in late 2022, fiscal policy should remain broadly supportive, in line with the authorities' FY2022 budgetary plans. Any positive surprises to the fiscal balance from faster-than-expected recovery next year should be saved. Conversely, the policy response should remain agile. Depending on the evolution of the pandemic, some support measures may need to continue to be flexibly extended, while becoming increasingly targeted to facilitate resource reallocation.

47. Over time, Spain will need to gradually bring public debt down to create space to respond to future shocks. In the absence of discretionary measures, the fiscal deficit is expected to remain above pre-crisis levels over the medium term. A sustained gradual fiscal consolidation process should be initiated once the output gap is closed, and the economy is on a sustained growth path. An early formulation of credible medium-term plans for a growth-friendly fiscal consolidation could help build the necessary social consensus and support investor confidence. Additional measures will need to be identified in the second phase of the reform to fully offset the increase in future pension spending resulting from the 2021 reform. Ensuring the fiscal sustainability of the pension system would help signal the authorities' commitment to fiscal responsibility.

48. The financial sector has so far weathered the crisis well, but close monitoring is needed to ensure continued resilience. The government's swift and forceful provision of income and liquidity support has limited the effect of the pandemic on private sector balance sheets. However, some losses may be realized with a lag. Therefore, banks need to maintain sizable safety buffers and continue to be forward-looking in their assessment of loan quality and maintain adequate levels of provisions. Efforts must continue to enhance private resolution frameworks to help address debt overhangs and facilitate resource reallocation. The increased activity levels in the residential real estate market do not point at elevated risks at this stage, but close vigilance is warranted.

49. NGEU funds provide an exceptional opportunity to support the recovery while promoting a transition to a more productive, inclusive, greener, and digital economy. Spain should use these funds to support strategic investment and facilitate needed structural reforms. The selection of projects with high social return, efficient coordination among different levels of government, close collaboration between public and private sectors, and a focus on transparency and accountability are crucial to ensure effective use of the investment funds. The comprehensive structural reforms – if well designed and implemented – will amplify the positive impact of planned investments. It will be important to establish a framework for regular data-based evaluation of the effectiveness of the reforms.

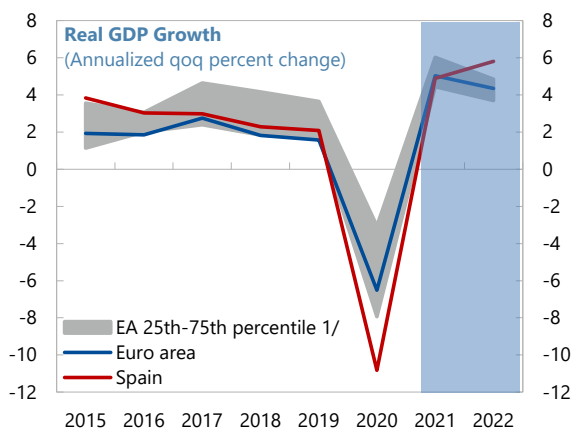
50. The recently agreed labor market reforms go broadly in the right direction, though further efforts are likely to be needed. Restricting the use of temporary contracts may help reduce duality if the new regulation is effectively enforced. However, it would be important to also make open-ended contracts more attractive to firms, including by reducing the costs and legal uncertainty associated with the dismissal of permanent workers and possibly creating an employer-based separation fund. The reforms to the collective bargaining system preserve some flexibility for setting working conditions at the firm level; however, the reinstatement of “ultra-activity” is a step backwards. More generous short-time work schemes could help limit dismissals, but could put a significant burden on public finances. Alternative financing mechanisms that entail risk sharing among all involved parties should be explored. Regular ex-post evaluation and close collaboration with the private sector are needed for an effective implementation of the ALMP reforms.

51. The authorities’ plans to leverage the NGEU funds to support green investments are welcome. Spain’s recently adopted Law on Climate Change and the Energy Transition has established new more ambitious climate mitigation objectives. The targets are attainable, but will require significant effort, in line with the authorities’ plans. Carbon price coverage in Spain is comprehensive, but the effective tax rates are low relative to estimates of emission damages, and also tend to be lower than in other euro area economies. Carbon price increases should be gradual, predictable, and complemented with distributive policies to protect vulnerable households. Complementary policies will be essential to address sector-specific obstacles to reducing emissions. Across all sectors, public investment and financial support will be vital where market failures constrain private investment. The use of NGEU funds to prioritize clean energy, sustainable mobility and building efficiency renovations should facilitate the green transition.

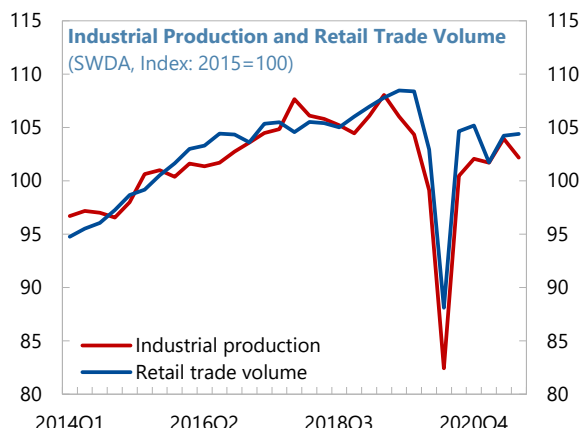
52. It is recommended that Spain remain on the standard 12-month Article IV cycle.

Figure 1. Spain: Real Sector and Inflation

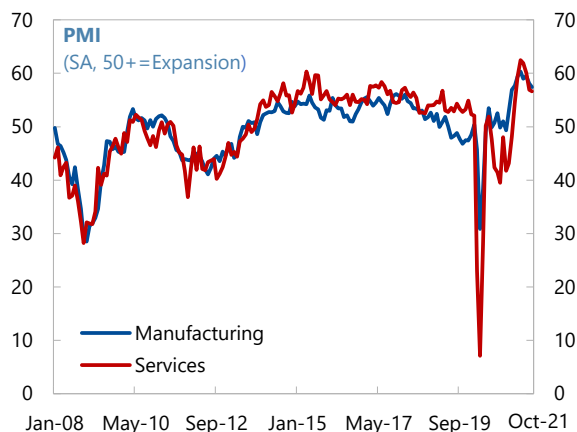
Spain experienced the largest contraction in the region in 2020 and a significant rebound is expected.



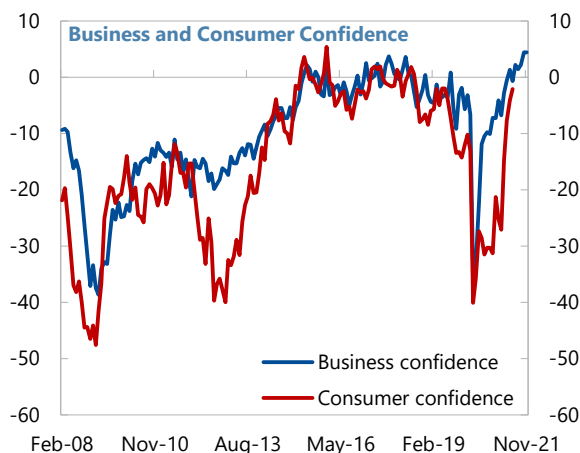
Industrial production and retail trade have started to recover.



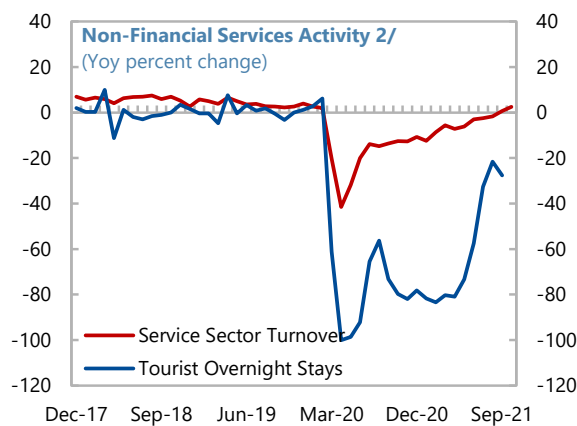
PMIs have remained in expansionary territory since April 2021.



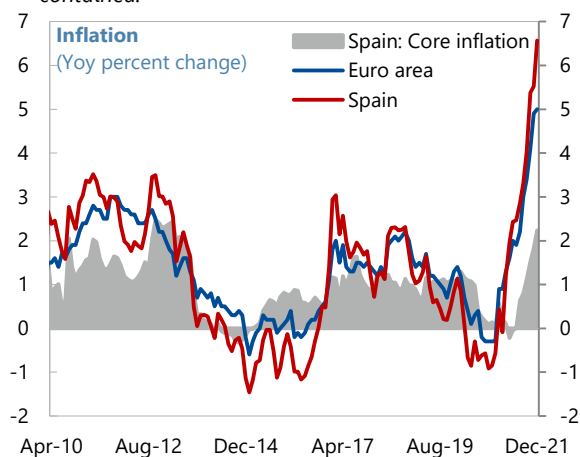
Business and consumer confidence are back to pre-crisis levels.



Service activities are recovering, although the tourism sector is still lagging.



Headline inflation has reached the highest level in the last three decades, while core inflation remains contained.



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

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

2/ 2021 data represents changes relative to the same period in 2019.

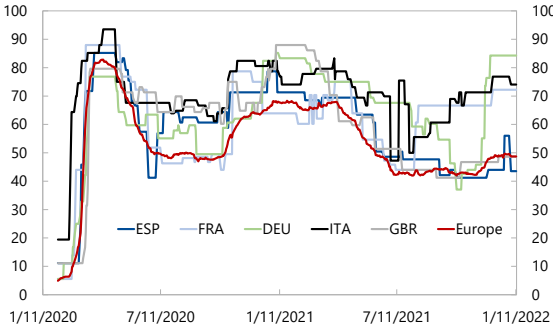
Figure 2. Spain: High Frequency Indicators of Covid-19 Pandemic and Real Activity

Following the end of the state of emergency in May, containment measures have been progressively eased.

Given wide vaccination coverage, the recent omicron-driven infection wave has shown lower hospitalizations and deaths.

Stringency Index

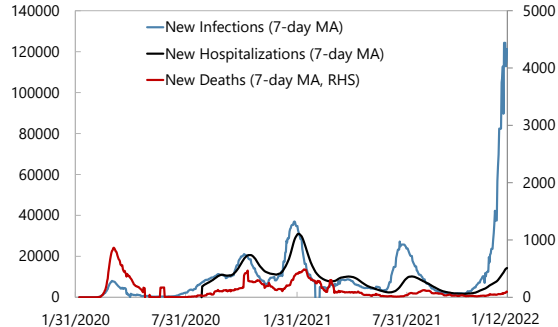
(Index: Strictest=100)



Source: Oxford COVID-19 Government Response Tracker.

Spain: Covid-19 Developments

(7-day moving averages)

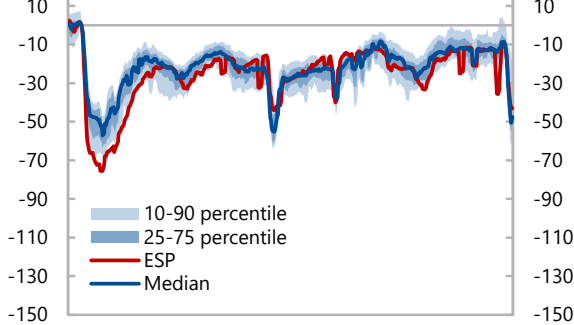


Sources: JHU/Haver, ECDC, and IMF staff calculations

Mobility in Spain has recovered significantly during 2021, but has started to decline again more recently amid the resurgence of infections.

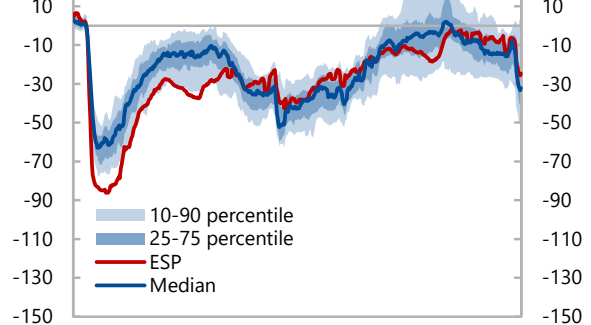
Mobility Indicators: Workplaces

(Percent deviation from baseline; 7-day moving avg)



Mobility Indicators: Transit Stations

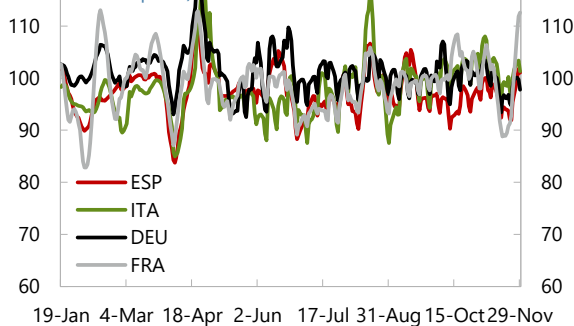
(Percent deviation from baseline; 7-day moving avg)



Electricity consumption and air pollution have come back to 2019 levels.

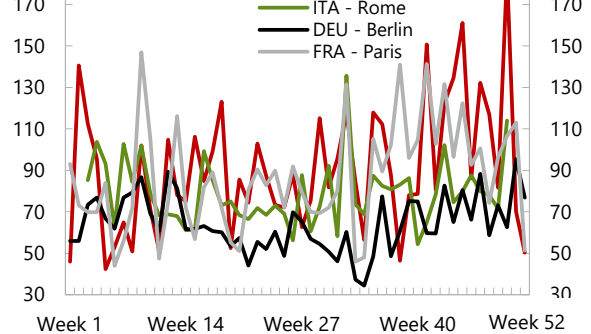
Actual Total Electricity Consumption, 2021

(7 day average, percent of 2019 electricity consumption)



NO2 Air Pollutant, 2021

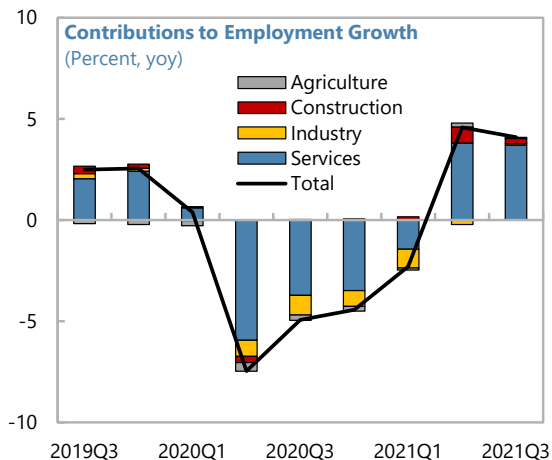
(Average concentration ug/m3, percent of 2019 pollution)



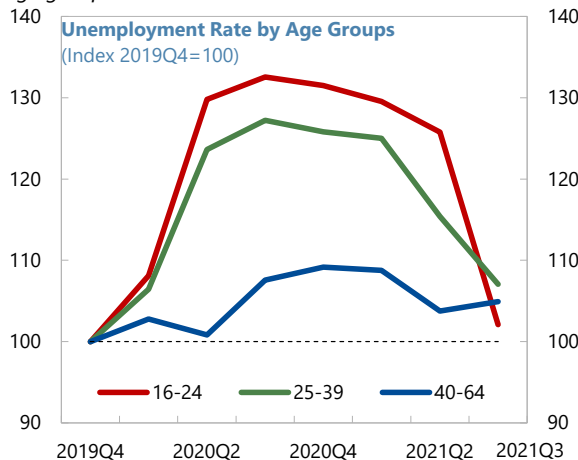
Sources: ENTSOE, European Environment Agency, Flight Radar 24, Google Mobility Report, Smith Travel Research, and IMF staff calculations.

Figure 3. Spain: Recent Developments in the Labor Market

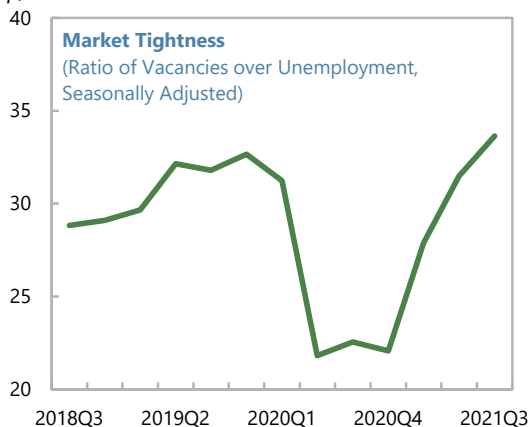
Employment growth has picked up, driven by services and construction.



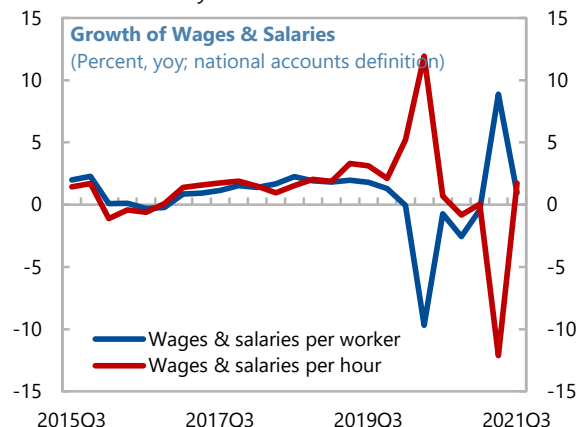
Unemployment has been progressively going down for all age groups.



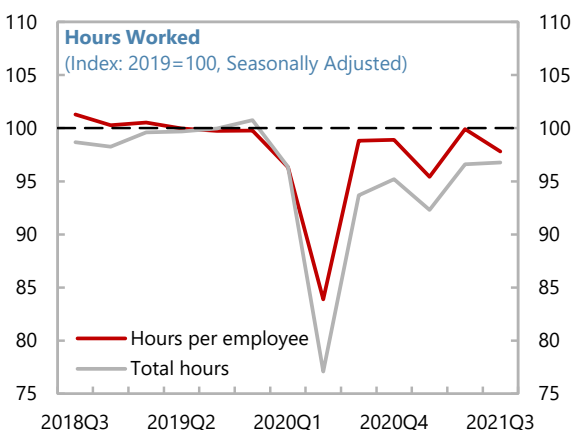
The labor market is tightening as vacancy-posting picks up,...



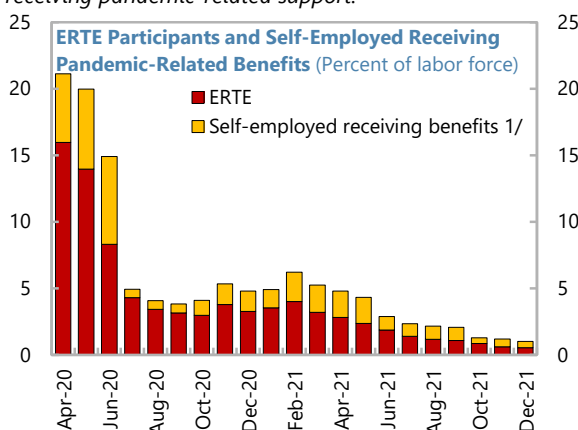
...but wage inflation remains modest due to remaining slack in the economy...



...with hours worked still lagging...



...partly because of a considerable number of workers still receiving pandemic-related support.

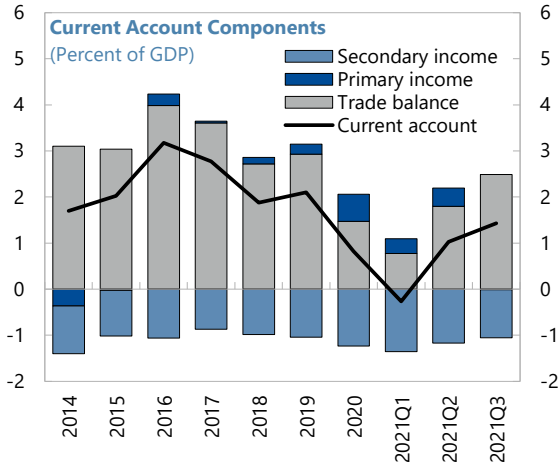


Sources: Ministry of Labor, Ministry of Inclusion, Social Security and Migration, Haver Analytics, and IMF staff calculations.

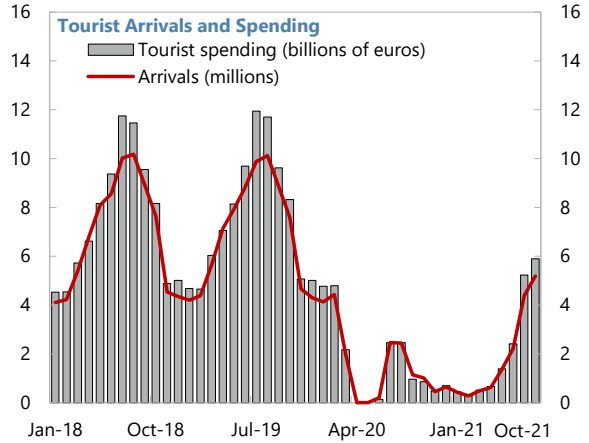
1/ It includes the recipients of the extraordinary benefit for cessation of activity, which was in place between April and June 2021.

Figure 4. Spain: Recent Developments in the External Sector

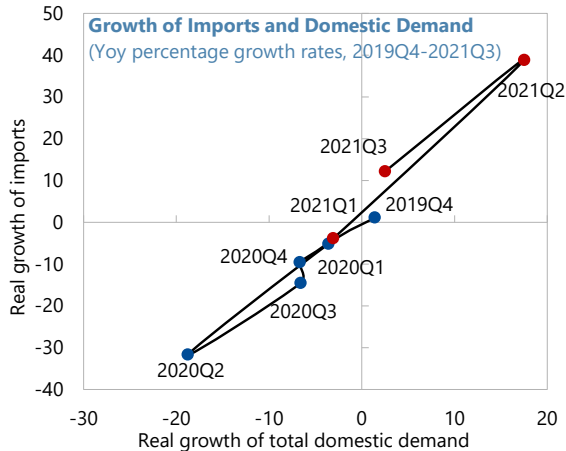
The deterioration of the current account in 2020 has persisted into 2021...



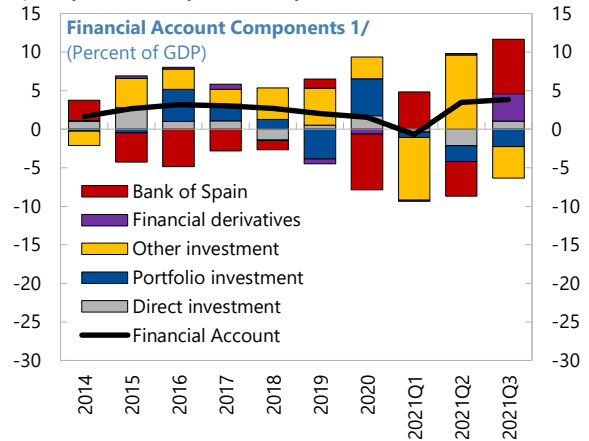
...as foreign tourism remains weak despite some recovery since the last summer season...



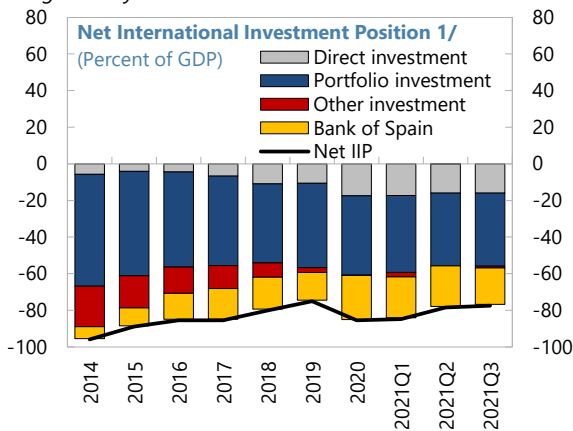
...and imports pick up with the recovery of domestic demand and the rise of energy prices.



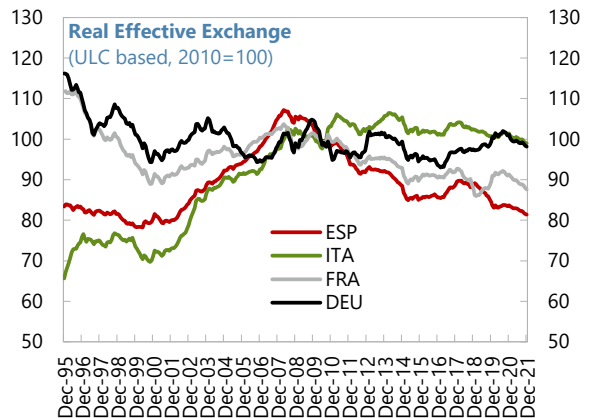
Net outflows in portfolio and other investment (excl. Bank of Spain) went up in 2020, facilitated by the increase in liquidity creation by the Eurosystem, but reverted in 2021.



The net international investment position deteriorated in 2020, worsening an already high negative balance, but has gradually recovered in 2021.



The ULC-based REER continued to depreciate in 2020 and 2021, reverting the appreciation in 1999-2008.



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

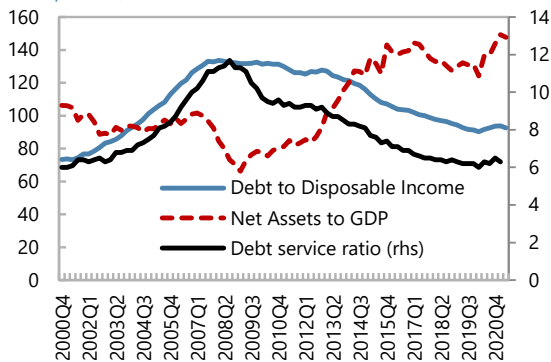
1/ Portfolio Investment and Other Investment exclude the Bank of Spain, which is shown separately.

Figure 5. Spain: Credit Development and Financial Cycle

Household's balance sheets have remained relatively stable despite the large impact of the pandemic.

Households Balance Sheet

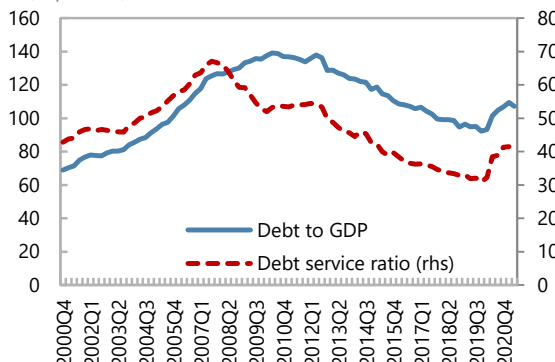
(in percent)



Leverage in the corporate sector has increased, but remains below GFC levels.

Non-Financial Corporates Balance Sheet

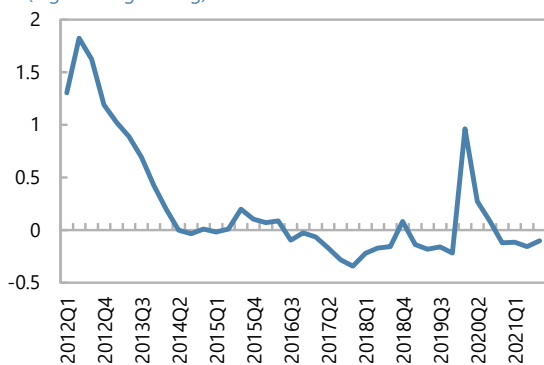
(in percent)



Following an initial tightening at the onset of the pandemic, financial conditions stabilized.

Financial Conditions Index

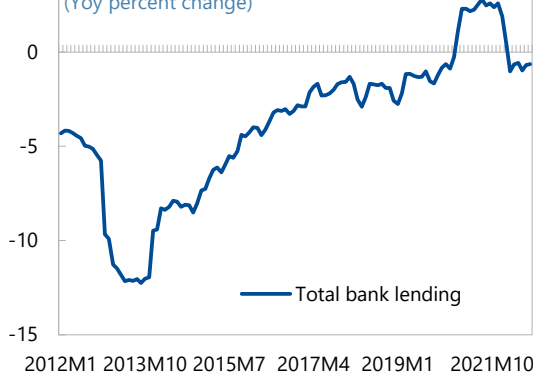
(higher = tightening)



Bank lending to the private sector expanded for the first time in about a decade....

Bank Lending to Private Sector

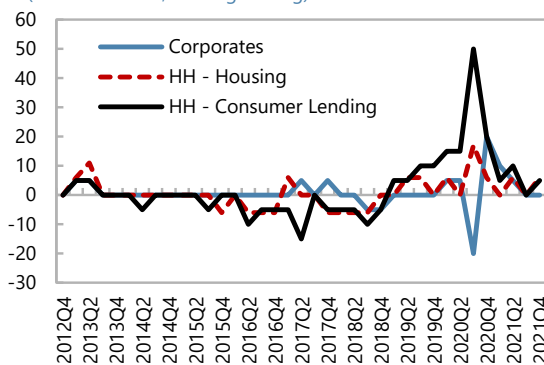
(Yoy percent change)



...initially tilted toward corporates, underpinned by public support measures,...

Change in Lending Standards

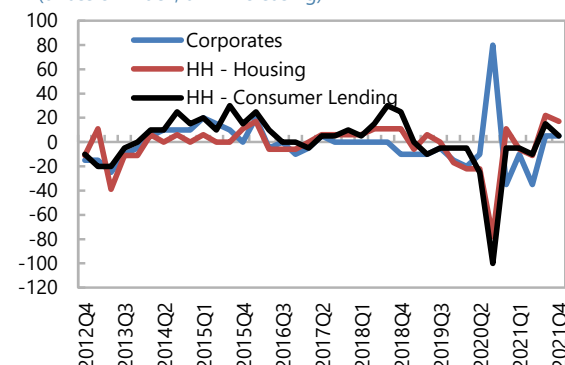
(difussion index; 0+ = tightening)



...and more recently toward households, meeting sectoral demands.

Change in Credit Demand

(difussion index; 0+ = increasing)

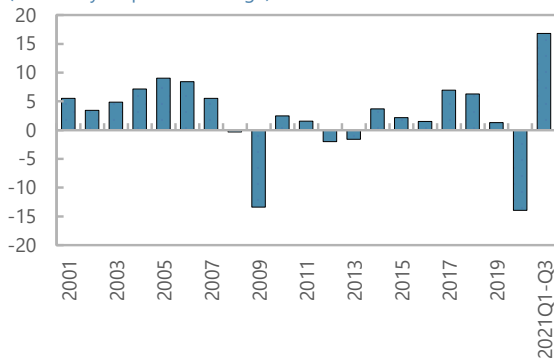


Sources: Haver Analytics, and IMF staff calculations.

Figure 6. Spain: Non-Financial Corporate Sector

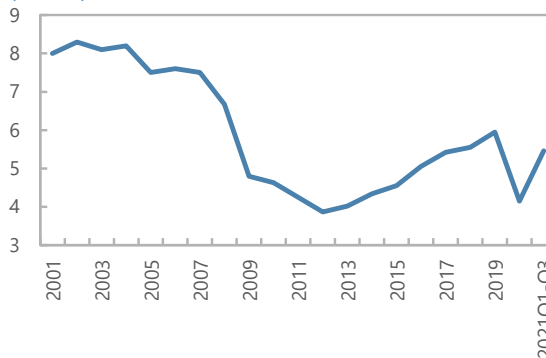
Corporate sector turnover improved in the first three quarters of 2021...

Corporate Sector Turnover
(Year-on-year percent change)



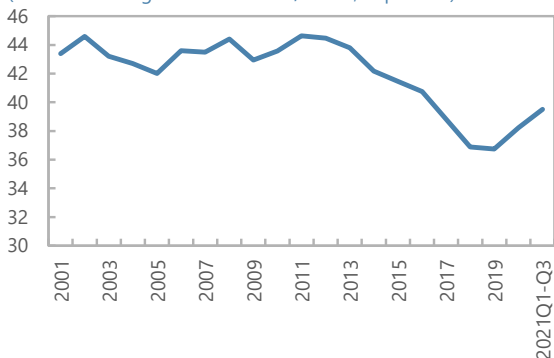
... and profitability has recovered from the low 2020 levels.

Return on Assets
(Percent)



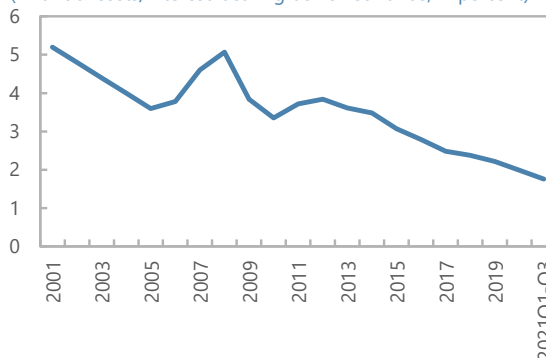
The debt-to-asset ratio has increased but remains low compared to the GFC....

Debt-to-Asset Ratio
(Interest-bearing borrowed funds/assets, in percent)



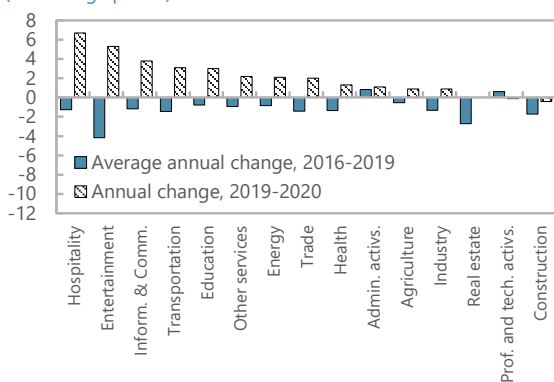
... and debt financing costs have continued to decline.

Debt Financing Cost
(Financial costs/interest-bearing borrowed funds, in percent)



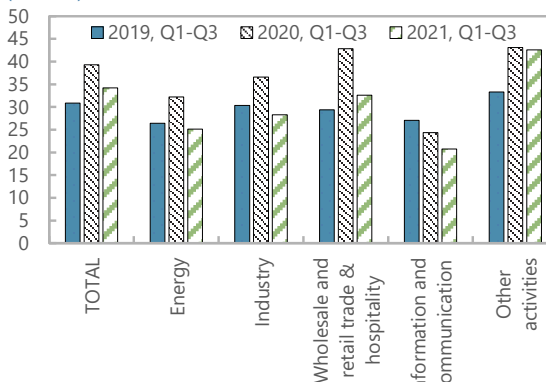
Leverage ratios have increased in most sectors, particularly those hit hardest by the pandemic.

Annual Change in Debt-to-Asset Ratio by Sector 1/
(Percentage points)



The share of firms with negative profits has started to decline in 2021.

Share of Firms with Negative Profits 2/
(Percent)



Sources: Bank of Spain Central Balance Sheet Data Office.

1/ "Energy" represents "Electricity, gas, steam and air conditioning supply", and "Industry" represents "Manufacturing".

2/ Based on the quarterly survey data (CBQ), which represents 11.6 percent of the gross value-added of the entire NFC sector.

Figure 7. Spain: Real Estate Developments

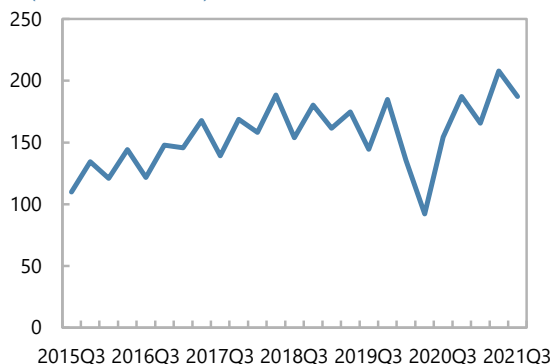
Residential price growth has accelerated recently...

Residential Prices
(yoy growth; in percent)



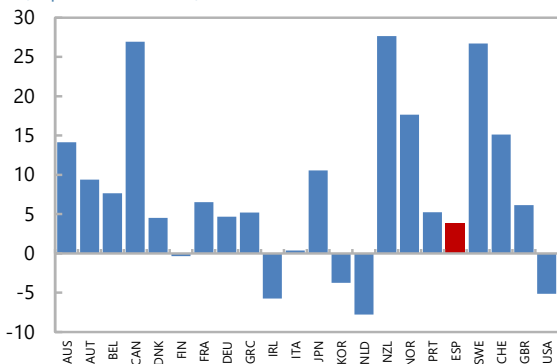
...coinciding with an uptick in transactions.

Residential Transactions
(Index 2015Q1=100)



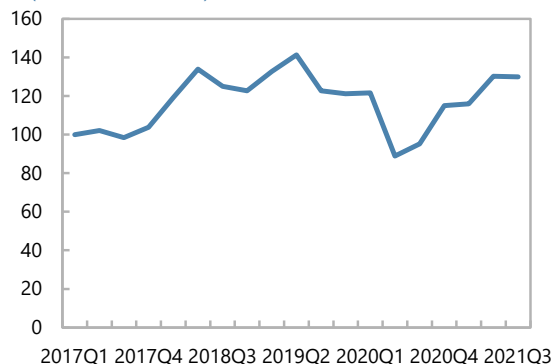
Nonetheless, the starting point is not one with significant misalignments in residential prices....

House Price Misalignment
(in percent; 2020Q4)



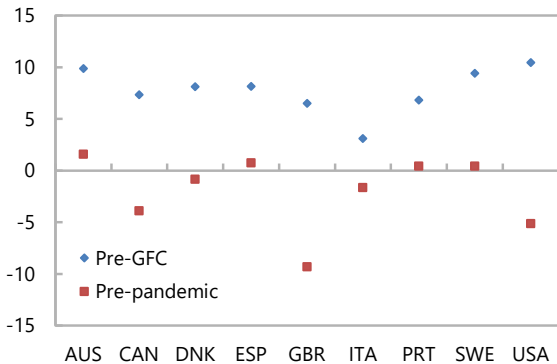
....and, going forward, supply should continue to catch up with demand.

Construction Approvals
(Index 2017Q1=100)



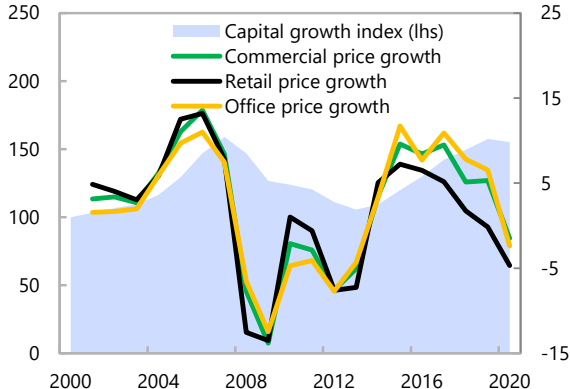
Commercial real estate (CRE) prices were broadly in line with fundamentals in the run-up to the pandemic...

Estimates Misalignment in CRE prices
(deviation from fair price; in percent)



...but have been impacted more severely than the residential segment in 2020.

Commercial Real Estate Market
(Index, 2000=100) (Percent change y/y)



Sources: IMF GFSR 2021 Figure 3.6.

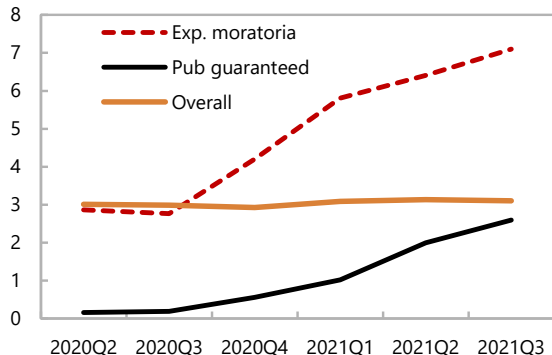
Sources: Haver Analytics, MSCI, and IMF staff calculations.

Note: Estimates of price misalignments from fundamentals are from IMF RESMF module 2020Q4, and IMF GFSR April 2021.

Figure 8. Spain: Banking System Performance

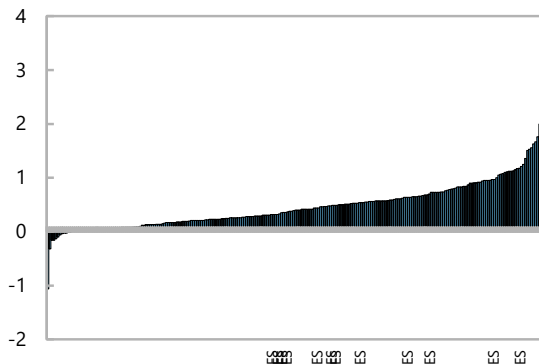
Aggregate NPLs have remained subdued, but loans benefitting from public support appear riskier.

Non-Performing Loans and Advances
(in percent)



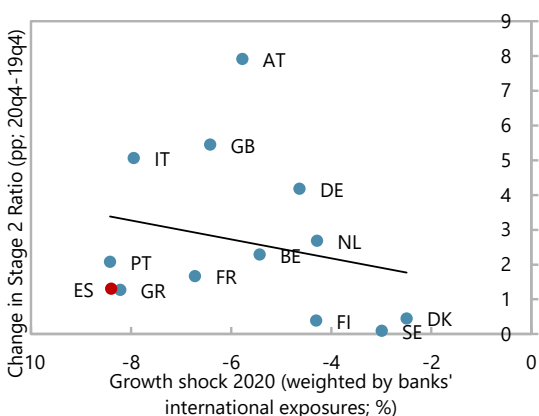
Spanish banks have increased provisioning during 2020.

Change in Cost of Risk
(in percentage points; 20Q4 vs 19Q4)



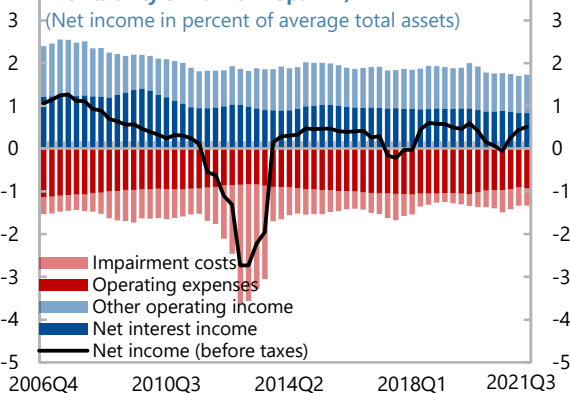
Stage 2 classifications have increased, albeit more moderately than in peer countries.

Crisis Impact and Stage 2 Ratio



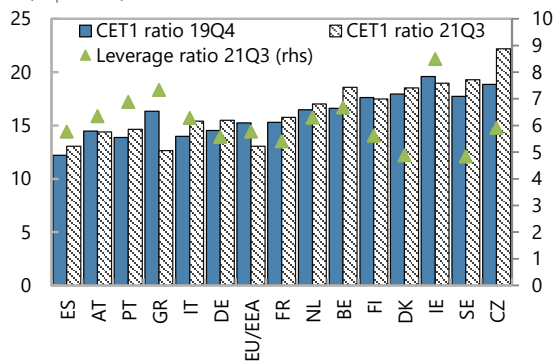
Profitability has recovered from 2020 lows, but remains below pre-pandemic levels.

Profitability of Banks in Spain 1/
(Net income in percent of average total assets)



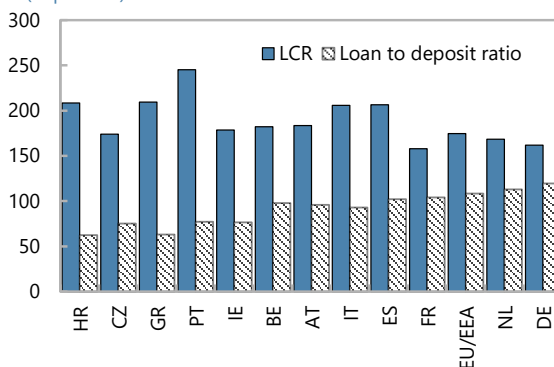
Bank capitalization is below peers on a risk-weighted basis, but in line for the leverage ratio.

Bank Capital
(in percent)



Bank liquidity ratios continue to be strong.

Bank Liquidity
(in percent)

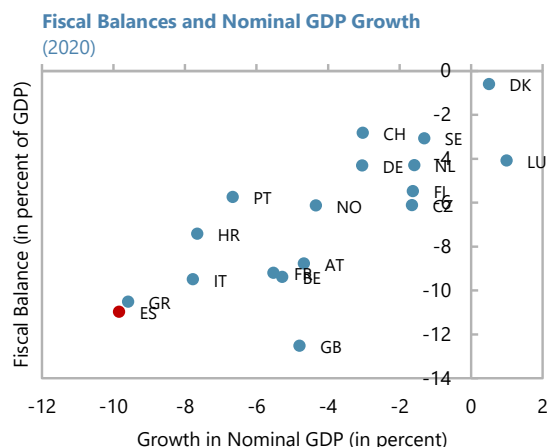


Sources: Bank of Spain, BIS, EBA, Fitch Connect, IMF *World Economic Outlook*, and IMF staff calculations.

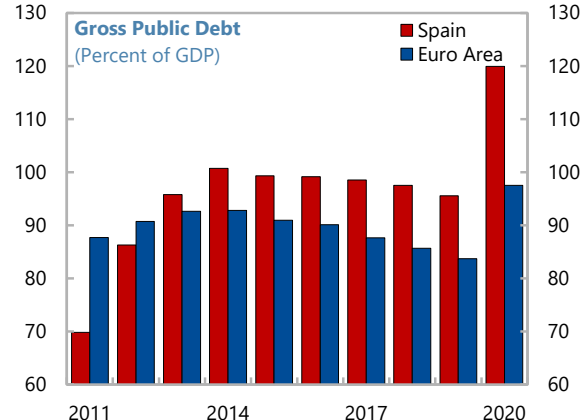
1/ For banking business in Spain, the aggregate figure of net income in 2011 and 2012 is amplified by the segregation process of saving banks' business to newly created banks. Bank level chart covers large (+20bnUSD in assets) banks rated by Fitch Connect in Western Europe, Canada, Japan, and US. "ES" denotes Spanish banks.

Figure 9. Spain: Public Finances

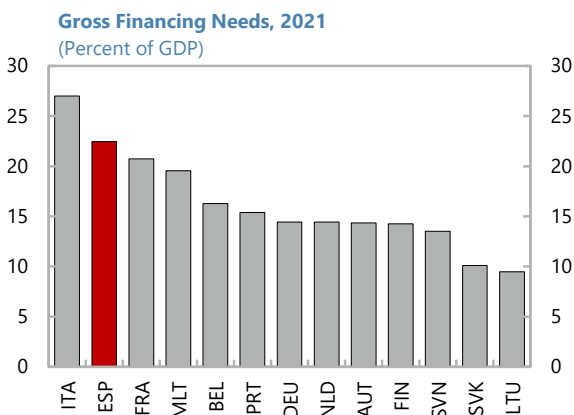
The pandemic has taken a significant toll on public finances...



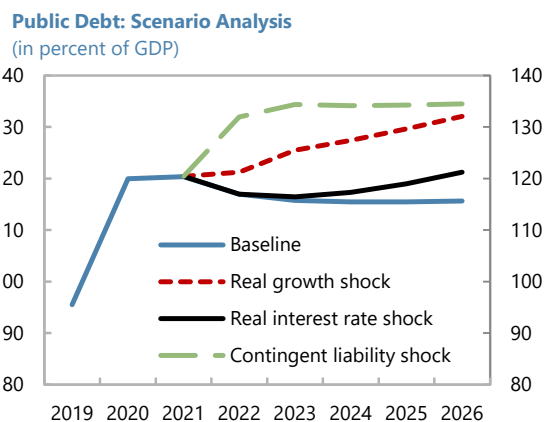
...with debt to GDP increasing by about 25 percentage points...



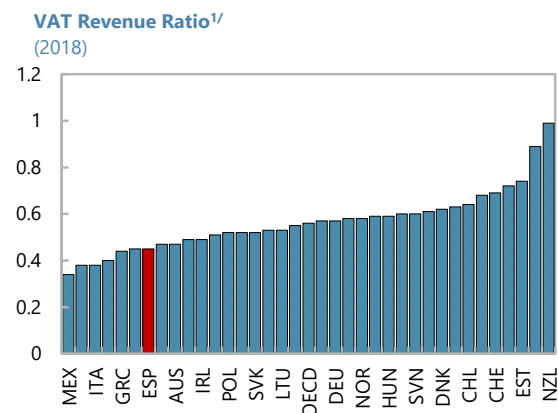
...keeping Spain's gross financing needs among the highest in the euro area...



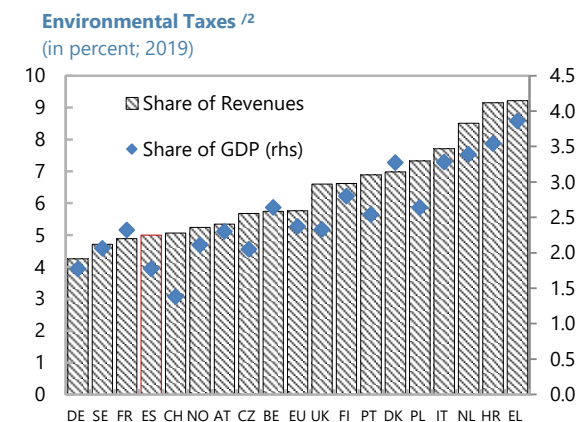
...and leaving the country vulnerable to shocks.



When the time comes to rebuild fiscal buffers, improving revenue performance will be crucial, ...



...as well as bringing environmental taxation more in line with peer economies.



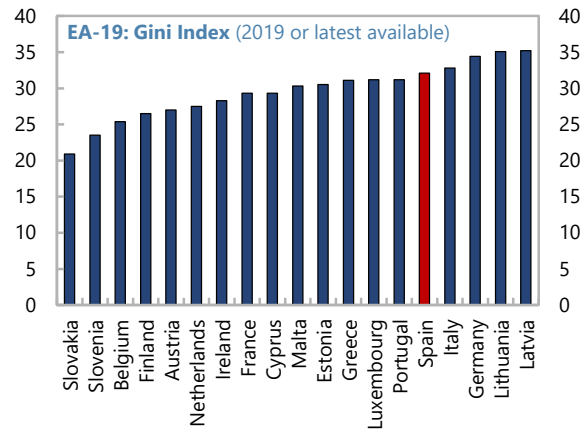
Sources: Eurostat, Haver Analytics, OECD, and IMF staff calculations.

1/ Ratio between the VAT revenue collected and what would be raised if the standard VAT rate were applied to the entire tax base.

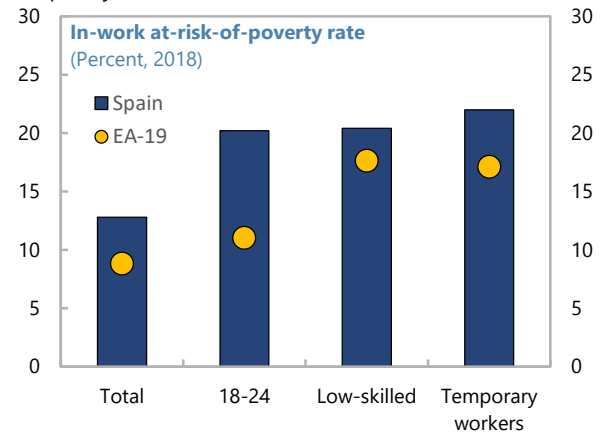
2/ Environmental taxes include on energy (including explicit CO2 taxes and EU ETS), transport, and pollution/resources.

Figure 10. Spain: Selected Social Indicators

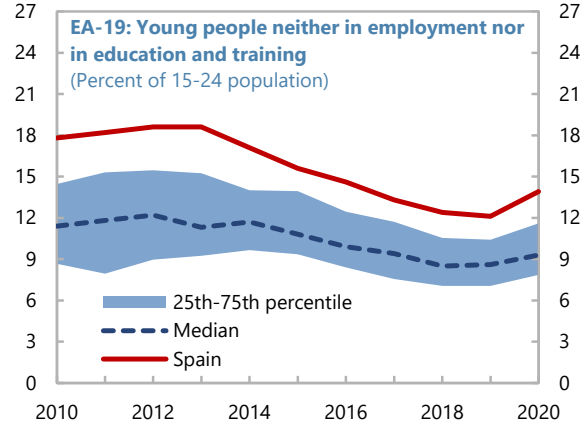
Income inequality in Spain is high relative to its peers.



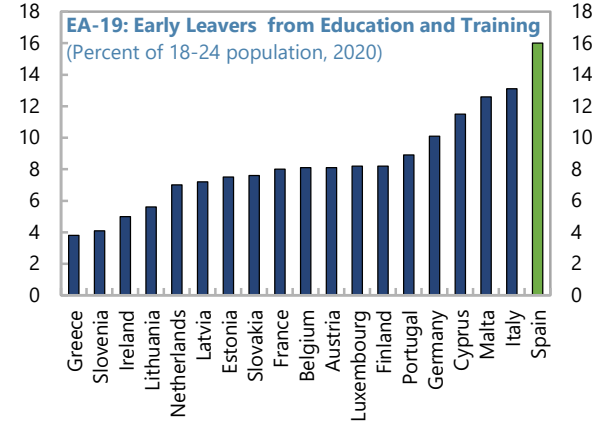
The share of workers at risk of poverty is also elevated, particularly among the young, low-skilled, and those with temporary contracts.



Spain is the third country in the euro area with the highest share of young people who neither work nor study...

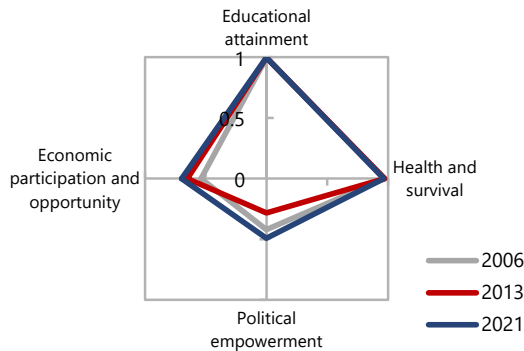


...and has the highest share of early leavers from education and training.

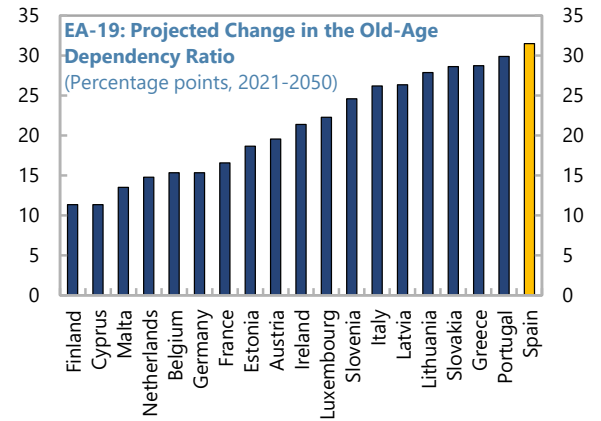


Despite progress in the past 15 years, sizeable gender gaps remain in economic and political empowerment.

Spain: Gender Gap Scores by Dimension
(0-to-1 scale; 0 = inequality; 1 = equality)



Over the next 30 years, the Spanish population is projected to age quicker than in the rest of the euro area.



Sources: Eurostat, World Economic Forum, and IMF staff calculations.

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

	2018	2019	2020	Projections 1/						
				2021	2022	2023	2024	2025	2026	2027
Demand and supply in constant prices										
Gross domestic product	2.3	2.1	-10.8	4.9	5.8	3.8	2.3	1.9	1.7	1.6
Private consumption	1.7	1.0	-12.0	5.1	4.7	3.3	2.4	3.0	2.6	2.2
Public consumption	2.3	2.0	3.3	3.2	0.9	0.3	0.4	0.4	0.4	0.4
Gross fixed investment	6.3	4.5	-9.5	3.3	7.0	7.1	3.3	0.5	0.6	1.3
Total domestic demand	3.0	1.6	-8.9	4.7	4.5	3.4	2.1	1.9	1.7	1.6
Net exports (contribution to growth)	-0.6	0.5	-2.2	0.3	1.4	0.5	0.2	0.0	0.0	0.0
Exports of goods and services	1.7	2.5	-20.2	12.4	9.9	4.6	3.7	3.3	3.2	3.3
Imports of goods and services	3.9	1.2	-15.2	12.0	5.9	3.6	3.4	3.5	3.4	3.4
Real GDP per capita	1.9	1.3	-11.3	4.8	5.4	3.4	1.9	1.5	1.4	1.3
Savings-Investment Balance (percent of GDP)										
Gross domestic investment	20.5	20.9	20.7	21.0	21.2	21.6	21.8	21.4	21.1	21.0
Private	18.3	18.8	18.1	17.7	17.6	18.3	18.6	19.0	18.7	18.6
Public	2.2	2.1	2.6	3.3	3.5	3.4	3.2	2.4	2.4	2.4
National savings	22.4	23.0	21.5	21.4	22.5	23.2	23.5	23.1	22.8	22.7
Private	22.7	23.8	29.9	25.9	24.2	24.1	24.3	24.8	24.5	24.3
Public	-0.3	-0.8	-8.3	-4.5	-1.7	-0.9	-0.8	-1.6	-1.6	-1.6
Foreign savings	-1.9	-2.1	-0.8	-0.4	-1.3	-1.6	-1.7	-1.7	-1.7	-1.7
Household saving rate (percent of gross disposable income)	5.5	8.3	14.9	11.0	8.3	6.5	6.4	6.3	6.3	6.3
Potential output growth	1.2	1.5	-2.0	1.4	1.7	2.1	2.1	1.9	1.7	1.6
Output gap (percent of potential)	0.0	0.5	-8.5	-5.4	-1.6	0.0	0.1	0.0	0.0	0.0
Prices										
GDP deflator	1.2	1.3	1.1	1.6	1.9	1.1	1.6	1.7	1.7	1.7
Headline inflation (average)	1.7	0.7	-0.3	3.1	3.5	1.2	1.6	1.7	1.7	1.7
Headline inflation (end of period)	1.2	0.8	-0.5	6.5	0.5	1.3	1.5	1.8	1.7	1.7
Core inflation (average)	0.9	0.9	0.7	0.8	1.8	1.5	1.6	1.7	1.7	1.7
Core inflation (end of period)	0.9	1.0	0.1	2.1	1.8	1.5	1.6	1.7	1.7	1.7
Employment and wages										
Unemployment rate (percent)	15.3	14.1	15.5	15.0	14.0	13.5	13.3	13.1	13.0	13.0
Labor productivity 2/	0.1	-0.5	-3.5	-1.5	2.8	2.6	1.6	1.3	1.2	1.2
Labor costs, private sector	2.0	2.3	4.0	0.8	3.5	1.1	1.4	1.6	1.6	1.6
Employment growth	2.7	2.3	-2.9	2.7	2.0	1.2	0.6	0.6	0.5	0.4
Labor force growth	0.3	1.0	-1.3	2.1	0.8	0.5	0.4	0.4	0.4	0.4
Balance of payments (percent of GDP)										
Trade balance (goods and services)	2.7	2.9	1.5	1.1	2.1	2.6	2.8	2.9	2.9	2.9
Current account balance	1.9	2.1	0.8	0.4	1.3	1.6	1.7	1.7	1.7	1.7
Net international investment position	-80.1	-75.0	-85.5	-78.7	-69.9	-63.5	-58.0	-53.9	-50.1	-46.4
Public finance (percent of GDP) 3/										
General government balance	-2.5	-2.9	-11.0	-7.8	-5.3	-4.3	-4.0	-4.0	-4.0	-4.0
Primary balance	-0.3	-0.8	-8.9	-5.8	-3.5	-2.5	-2.3	-2.3	-2.3	-2.3
Structural balance	-2.2	-3.1	-5.7	-4.5	-4.4	-4.3	-4.1	-4.0	-4.0	-4.0
Primary structural balance	0.2	-0.8	-3.5	-2.3	-2.3	-2.3	-2.1	-2.1	-2.1	-2.1
General government debt	97.5	95.5	120.0	120.4	117.0	115.8	115.4	115.5	115.6	115.9
Memo item										
Nominal GDP (Millions of euros)	1203.3	1244.4	1121.9	1195.9	1289.3	1352.9	1405.5	1456.1	1506.3	1556.5
Real GDP (Millions of 2015 euros)	1169.5	1193.8	1064.6	1116.6	1181.5	1226.1	1253.9	1277.2	1298.8	1319.9

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

1/ The projections incorporate allocation from the EU Recovery and Resilience Facility amounting to about 0.8 percent, 1.9 percent, 1.6 percent, and 1.3 percent of GDP from 2021 to 2024.

2/ Output per full-time equivalent worker.

3/ Fiscal projections from 2022 onwards assume an expiration of temporary COVID-19 measures and no further policy change.

Table 2a. Spain: General Government Operations ^{1/}
(Billions of euro, unless otherwise indicated)

	2018	2019	2020	Projections 2/						
				2021	2022	2023	2024	2025	2026	2027
Revenue	471.7	488.27	465.4	511.5	542.4	560.9	575.1	575.4	594.8	614.6
Taxes	275.0	279.47	256.8	285.9	297.5	309.8	320.6	331.8	343.0	354.4
Indirect taxes	141.2	143.02	126.5	140.0	147.2	154.2	160.1	166.1	172.2	177.9
o.w. VAT	79.2	80.89	70.6	77.8	81.8	85.7	88.9	92.3	95.8	99.0
o.w. Excise	40.6	40.39	34.5	37.9	39.6	41.4	43.0	44.6	46.3	47.9
Direct taxes	128.3	130.94	125.7	140.7	144.9	150.1	154.7	159.7	164.6	170.1
o.w. Private households	98.1	99.01	97.7	111.8	113.4	115.5	117.6	120.4	123.5	127.6
o.w. Corporate	30.9	32.68	26.9	29.6	32.3	35.4	38.0	40.2	42.0	43.4
Capital tax	5.6	5.51	4.6	5.1	5.3	5.6	5.8	6.0	6.2	6.4
Social contributions	149.5	160.66	162.2	167.2	172.2	177.9	182.3	187.4	193.6	200.0
Other revenue	47.28	48.15	46.3	58.4	72.7	73.2	72.2	56.3	58.2	60.1
Expenditure	501.8	524.0	588.3	605.2	610.9	619.1	631.5	634.0	655.4	677.2
Expense	501.6	523.7	587.8	604.8	610.4	618.7	631.0	633.6	654.9	676.7
Compensation of employees	127.6	134.7	140.5	145.4	151.2	153.6	157.0	160.6	164.6	170.0
Use of goods and services	61.6	64.1	65.9	70.3	72.9	73.7	75.6	73.7	76.2	78.8
Consumption of fixed capital	25.7	25.8	28.9	39.3	45.6	45.5	44.4	34.2	35.4	36.6
Interest	29.3	28.3	25.2	26.0	26.4	26.6	27.2	27.8	28.6	29.6
Social benefits	216.6	229.6	262.2	259.6	260.2	265.7	272.8	280.7	289.0	298.6
Other expense	40.8	41.0	65.1	64.1	54.3	53.6	53.9	56.5	61.2	63.2
Subsidies	11.9	12.4	21.5	17.2	14.8	14.8	14.8	14.8	15.4	15.9
Other	28.9	28.6	43.7	46.9	39.5	38.8	39.1	41.7	45.8	47.3
o.w. financial sector support	0.1	0.0	9.9	...	...	...	...	...	...	...
Net acquisition of nonfinancial assets	0.2	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.5
Gross fixed capital investment	25.9	26.2	29.3	39.7	46.0	45.9	44.9	34.7	35.9	37.0
Consumption of fixed capital	25.7	25.8	28.9	39.3	45.6	45.5	44.4	34.2	35.4	36.6
Other non financial assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross operating balance	-29.8	-35.4	-122.5	-93.3	-68.0	-57.8	-55.9	-58.2	-60.2	-62.2
Net lending / borrowing	-30.0	-35.8	-122.9	-93.7	-68.5	-58.2	-56.4	-58.6	-60.6	-62.6
Net lending / borrowing (excluding financial sector support)	-30.0	-35.7	-113.0	-93.7	-68.5	-58.2	-56.4	-58.6	-60.6	-62.6
<i>Memorandum items:</i>										
Nominal GDP	1,203.3	1,244.4	1,121.9	1,195.9	1,289.3	1,352.9	1,405.5	1,456.1	1,506.3	1,556.5

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

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

2/ Projections from 2022 onwards assume an expiration of temporary COVID-19 measures and no further policy change except for already legislated measures. Payments on government guarantees are assumed at an average of €5bn per year for 2022 and 2023. Projections incorporate allocation from the EU Recovery and Resilience Facility amounting to about 0.8 percent, 1.9 percent, 1.6 percent, and 1.3 percent of GDP from 2021 to 2024. Such funds are reflected as receipts in other revenue, and as expenditures in good and services and public investment.

Table 2b. Spain: General Government Operations ^{1/}
(Percent of GDP, unless otherwise indicated)

	2018	2019	2020	Projections 2/						
				2021	2022	2023	2024	2025	2026	2027
Revenue	39.2	39.2	41.5	42.8	42.1	41.5	40.9	39.5	39.5	39.5
Taxes	22.9	22.5	22.9	23.9	23.1	22.9	22.8	22.8	22.8	22.8
Indirect taxes	11.7	11.5	11.3	11.7	11.4	11.4	11.4	11.4	11.4	11.4
o.w. VAT	6.6	6.5	6.3	6.51	6.3	6.3	6.3	6.3	6.4	6.4
o.w. Excise	3.4	3.2	3.1	3.2	3.1	3.1	3.1	3.1	3.1	3.1
Direct taxes	10.7	10.5	11.2	11.8	11.2	11.1	11.0	11.0	10.9	10.9
o.w. Private households	8.2	8.0	8.7	9.4	8.8	8.5	8.4	8.3	8.2	8.2
o.w. Corporate	2.6	2.6	2.4	2.5	2.5	2.6	2.7	2.8	2.8	2.8
Capital tax	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Social contributions	12.4	12.9	14.5	14.0	13.4	13.2	13.0	12.9	12.9	12.9
Other revenue	3.9	3.9	4.1	4.9	5.6	5.4	5.1	3.9	3.9	3.9
Expenditure	41.7	42.1	52.4	50.6	47.4	45.8	44.9	43.5	43.5	43.5
Expense	41.7	42.1	52.4	50.6	47.3	45.7	44.9	43.5	43.5	43.5
Compensation of employees	10.6	10.8	12.5	12.2	11.7	11.4	11.2	11.0	10.9	10.9
Use of goods and services	5.1	5.2	5.9	5.9	5.7	5.4	5.4	5.1	5.1	5.1
Consumption of fixed capital	2.1	2.1	2.6	3.3	3.5	3.4	3.2	2.3	2.4	2.4
Interest	2.4	2.3	2.2	2.2	2.0	2.0	1.9	1.9	1.9	1.9
Social benefits	18.0	18.5	23.4	21.7	20.2	19.6	19.4	19.3	19.2	19.2
Other expense	3.4	3.3	5.8	5.4	4.2	4.0	3.8	3.9	4.1	4.1
Subsidies	1.0	1.0	1.9	1.4	1.1	1.1	1.1	1.0	1.0	1.0
Other	2.4	2.3	3.9	3.9	3.1	2.9	2.8	2.9	3.0	3.0
o.w. financial sector support	0.0	0.0	0.9 ...	...	...	...	...	...	...	...
Net acquisition of nonfinancial assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross fixed capital investment	2.2	2.1	2.6	3.3	3.6	3.4	3.2	2.4	2.4	2.4
Consumption of fixed capital	2.1	2.1	2.6	3.3	3.5	3.4	3.2	2.3	2.4	2.4
Other non financial assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross operating balance	-2.5	-2.8	-10.9	-7.8	-5.3	-4.3	-4.0	-4.0	-4.0	-4.0
Net lending / borrowing	-2.5	-2.9	-11.0	-7.8	-5.3	-4.3	-4.0	-4.0	-4.0	-4.0
Net lending / borrowing (excluding financial sector support)	-2.5	-2.9	-10.1	-7.8	-5.3	-4.3	-4.0	-4.0	-4.0	-4.0
<i>Memorandum items:</i>										
Net lending/ borrowing (EDP targets)	-2.2	...	...	...	...	...	...	...	...	...
Primary balance	-0.3	-0.8	-8.9	-5.8	-3.5	-2.5	-2.3	-2.3	-2.3	-2.3
Primary balance (excluding financial sector support) 3/	-0.1	-0.6	-8.7	-5.7	-3.3	-2.3	-2.1	-2.1	-2.1	-2.1
Cyclically adjusted balance	-2.5	-3.2	-5.9	-4.6	-4.4	-4.3	-4.1	-4.0	-4.0	-4.0
Cyclically adjusted primary balance (excl. fin. sector support) 3/	0.0	-0.9	-3.6	-2.4	-2.3	-2.3	-2.1	-2.1	-2.1	-2.1
Primary structural balance 3/	0.2	-0.8	-3.5	-2.3	-2.3	-2.3	-2.1	-2.1	-2.1	-2.1
Structural balance	-2.2	-3.1	-5.7	-4.5	-4.4	-4.3	-4.1	-4.0	-4.0	-4.0
General government gross debt (Maastricht)	97.5	95.5	120.0	120.4	117.0	115.8	115.4	115.5	115.6	115.9
Net debt	83.7	82.3	103.0	104.5	102.2	101.7	101.9	102.4	103.0	103.7
Output gap	0.0	0.5	-8.5	-5.4	-1.6	0.0	0.1	0.0	0.0	0.0

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

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

2/ Projections from 2022 onwards assume an expiration of temporary COVID-19 measures and no further policy change except for already legislated measures.

Payments on government guarantees are assumed at an average of €5bn per year for 2022 and 2023. Projections incorporate allocation from the EU Recovery and Resilience Facility amounting to about 0.8 percent, 1.9 percent, 1.6 percent, and 1.3 percent of GDP from 2021 to 2024. Such funds are reflected as receipts in other revenue, and as expenditures in good and services and public investment.

3/ Including interest income.

Table 3. Spain: Selected Financial Soundness Indicators
(Percent, unless otherwise indicated)

	2016	2017	2018	2019	2020	2021Q1	2021Q2
Depository institutions							
Capital adequacy							
Regulatory capital to risk-weighted assets	14.8	15.5	15.6	15.9	17.0	17.0	17.2
Regulatory tier-1 capital to risk-weighted assets	13.1	13.4	13.7	14.0	14.9	14.8	15.1
Capital to total assets	7.8	7.6	7.6	7.6	6.5	6.5	6.6
Asset quality: Consolidated basis							
Nonperforming loans (in billions of euro)	143	113	95	84	74	86	88
Nonperforming loans to total loans	5.6	4.5	3.7	3.2	2.9	3.0	3.0
Specific provisions to nonperforming loans	59.3	58.1	63.2	64.8	72.9	67.8	64.6
Asset quality: Domestic operations							
Nonperforming loans (in billions of euro)	112	94	67	54	52	52	51
Nonperforming loans to total loans	9.2	7.9	5.8	4.8	4.4	4.4	4.3
Specific provisions to nonperforming loans	45.7	41.8	41.1	41.2	46.4	45.5	44.7
Exposure to businesses - Construction (in billions of euro)	157	142	120	112	108	107	107
o/w: Nonperforming (in percent)	26.5	19.6	10.2	6.7	6.0	5.8	5.6
Exposure to businesses - Other (in billions of euro)	425	428	404	401	446	442	445
o/w: Nonperforming (in percent)	8.4	7.4	6.1	5.2	4.8	4.8	4.9
Exposure to households - Home purchase (in billions of euro)	506	493	491	483	478	479	481
o/w: Nonperforming (in percent)	4.5	4.5	3.9	3.2	2.9	2.9	2.8
Exposure to households - Other (in billions of euro)	134	136	136	140	143	142	151
o/w: Nonperforming (in percent)	9.1	9.3	8.4	7.5	7.2	7.4	6.7
Earning and profitability: Consolidated basis							
Return on assets	0.4	0.5	0.6	0.5	-0.2	1.0	0.7
Return on equity	5.5	6.7	8.1	6.7	-3.2	14.8	10.9
Earning and profitability: Domestic operations							
Return on assets	0.3	-0.03	0.6	0.6	-0.1	0.3	0.4
Return on equity	3.1	-0.3	6.7	6.9	-0.7	3.2	5.9
Funding							
Loans to deposits 1/	105.7	104.9	98.9	93.3	88.7	88.6	88.6
Use of ECB refinancing (in billions of euro) 2/	140	171	168	133	261	269	269
In percent of total ECB refinancing operations	24.8	22.3	22.8	20.5	14.7	14.3	14.3
In percent of total assets of Spanish MFIs	5.1	6.3	6.3	5.0	9.0	9.2	9.2
Total assets (in percent of GDP)	239	224	217	216	251	...	...
Other financial institutions							
Total assets (in percent of GDP)							
Insurance companies and pension funds	38	32	31	34	...	...	...
Other institutions 3/	86	71	63	67	...	...	...
Shadow banking activity 4/	25	22	21	23	...	...	...
Corporate sector							
Debt (in percent of GDP)	144.5	137.7	132.7	128.5	143.4	146.7	144.4
Debt to total assets	41.6	39.5	38.9	37.3	40.4	40.1	40.3
Liquid assets to short-term liabilities	279.2	287.1	288.6	298.7	417.7	399.3	432.0
Household sector							
Debt (in percent of GDP)	69	66	64	62	67	68	66
Debt service and principal payment to disposable income	11.7	11.4	11.3	11.1	...	...	...
Real estate market							
House price (percentage change, end-period)	4.5	7.2	6.6	3.6	1.5	0.9	3.3
Housing completion (2007=100)	7	8	10	12	13	14	15
Property sales (2007=100)	51	57	63	63	52	53	62

Sources: Bank of Spain; Haver analytics; FSB, Global Shadow Banking Monitoring Report 2017; IMF, Financial Soundness Indicators database and World Economic Outlook database; and IMF staff estimates.

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

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

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

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

Table 4. Spain: Balance of Payments

	2018	2019	2020	Projections						
				2021	2022	2023	2024	2025	2026	2027
	(Billions of euro)									
Current account	22.6	26.2	9.3	5.1	17.1	21.6	24.5	25.2	25.7	26.7
Trade balance of goods and services	32.7	36.5	16.5	13.5	27.4	34.6	40.0	42.3	44.1	45.8
Exports of goods and services	423.1	435.0	343.6	404.0	459.0	483.8	507.4	530.9	555.6	582.3
Exports of goods	291.2	294.7	264.6	314.2	342.9	357.7	371.5	385.7	401.3	417.8
Exports of services	131.9	140.3	79.0	89.8	116.1	126.1	136.0	145.2	154.3	164.5
Trade of goods balance	-29.3	-26.8	-9.1	-18.4	-21.4	-14.9	-12.9	-12.9	-12.6	-13.1
Imports of goods and services	-390.4	-398.5	-327.0	-390.5	-431.6	-449.2	-467.5	-488.6	-511.5	-536.5
Imports of goods	-320.5	-321.4	-273.6	-332.6	-364.3	-372.6	-384.4	-398.5	-413.9	-430.9
Imports of services	-69.9	-77.1	-53.4	-57.9	-67.3	-76.6	-83.1	-90.1	-97.6	-105.6
Services	62.0	63.2	25.6	31.9	48.7	49.6	52.9	55.2	56.8	58.9
<i>Of which:</i>										
Tourism	46.8	46.4	8.6	...	...	...	...	...	...	...
Exports	69.2	71.2	16.2	...	...	...	...	...	...	...
Imports	-22.4	-24.8	-7.6	...	...	...	...	...	...	...
Primary income	1.7	2.7	6.6	2.4	2.3	1.4	0.1	-0.2	-0.7	-0.6
Secondary income	-11.8	-13.0	-13.9	-10.8	-12.6	-14.3	-15.5	-16.9	-17.7	-18.5
General government	-7.6	-8.1	-9.8	-8.0	-5.8	-7.1	-8.5	-13.6	-14.0	-14.5
Other sectors	-4.2	-4.9	-4.1	-2.8	-6.8	-7.3	-7.0	-3.3	-3.7	-4.0
Capital account	5.8	4.2	4.5	13.1	22.8	21.1	18.7	5.2	5.2	5.1
Financial account	32.4	25.3	17.7	18.1	39.9	42.7	43.2	30.5	30.9	31.8
Direct investment	-16.9	6.6	19.6	21.4	22.3	23.0	23.9	23.8	23.8	23.7
Spanish investment abroad	31.8	28.5	49.3	53.0	56.4	58.8	61.0	62.3	63.6	64.8
Foreign investment in Spain	48.7	21.9	29.7	31.6	34.1	35.8	37.2	38.5	39.8	41.2
Portfolio investment	23.8	-47.8	79.7	43.0	30.8	26.9	26.6	26.3	26.1	24.7
Financial derivatives	-1.1	-7.6	-7.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other investment	24.3	73.4	-74.2	-57.3	-13.2	-7.2	-7.3	-19.7	-19.0	-16.6
Change in reserve assets	2.2	0.7	-0.3	11.1	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	4.0	-5.1	3.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	(Percent of GDP)									
Current account	1.9	2.1	0.8	0.4	1.3	1.6	1.7	1.7	1.7	1.7
Trade balance of goods and services	2.7	2.9	1.5	1.1	2.1	2.6	2.8	2.9	2.9	2.9
Exports of goods and services	35.2	35.0	30.6	33.8	35.6	35.8	36.1	36.5	36.9	37.4
Exports of goods	24.2	23.7	23.6	26.3	26.6	26.4	26.4	26.5	26.6	26.8
Exports of services	11.0	11.3	7.0	7.5	9.0	9.3	9.7	10.0	10.2	10.6
Imports of goods and services	-32.4	-32.0	-29.1	-32.7	-33.5	-33.2	-33.3	-33.6	-34.0	-34.5
Imports of goods	-26.6	-25.8	-24.4	-27.8	-28.3	-27.5	-27.4	-27.4	-27.5	-27.7
Imports of services	-5.8	-6.2	-4.8	-4.8	-5.2	-5.7	-5.9	-6.2	-6.5	-6.8
Primary income	0.1	0.2	0.6	0.2	0.2	0.1	0.0	0.0	0.0	0.0
Secondary income	-1.0	-1.0	-1.2	-0.9	-1.0	-1.1	-1.1	-1.2	-1.2	-1.2
Capital account	0.5	0.3	0.4	1.1	1.8	1.6	1.3	0.4	0.3	0.3
Financial account	2.7	2.0	1.6	1.5	3.1	3.2	3.1	2.1	2.1	2.0
Direct investment	-1.4	0.5	1.7	1.8	1.7	1.7	1.7	1.6	1.6	1.5
Portfolio investment	2.0	-3.8	7.1	3.6	2.4	2.0	1.9	1.8	1.7	1.6
Financial derivatives	-0.1	-0.6	-0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other investment	2.0	5.9	-6.6	-4.8	-1.0	-0.5	-0.5	-1.3	-1.3	-1.1
Of which, BdE	-2.1	1.1	-9.5	-4.5	-3.6	-2.6	-2.3	-2.3	-2.2	-2.1
Change in reserve assets	0.2	0.1	0.0	0.9	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	0.3	-0.4	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net international investment position	-80.1	-75.0	-85.5	-78.7	-69.9	-63.5	-58.0	-53.9	-50.1	-46.4
Valuation changes	-0.2	0.4	-3.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0

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

Notes: Based on the sixth edition of the IMF's Balance of Payments Manual. Projected grants under the EU Recovery and Resilience Facility—amounting to about 0.8 percent, 1.9 percent, 1.6 percent, and 1.3 percent of GDP from 2021 to 2024—are reflected in the secondary income and the capital account.

Table 5. Spain: External Debt

	2016	2017	2018	2019	2020	2021Q1	2021Q2
	(Billions of euro)						
Gross External Debt	1879.2	1980.0	2034.6	2133.0	2249.4	2231.2	2266.1
Short-term	719.3	789.0	804.3	793.4	890.1	881.9	896.8
Long-term	1159.8	1191.0	1230.3	1339.6	1359.3	1349.3	1369.2
General government	553.3	578.4	594.1	658.5	681.9	679.2	683.3
Bank of Spain	380.5	444.6	485.9	485.1	597.1	573.3	593.3
Other monetary financial institutions	408.8	446.8	432.3	457.7	432.5	445.7	439.9
Other resident sectors	310.7	282.2	291.2	305.3	301.4	296.6	298.8
Debt securities	753.8	786.1	803.4	901.2	915.8	907.2	917.4
Loans, trade credits and other liabilities	246.2	250.5	259.3	261.6	267.9	272.7	274.1
Deposits	649.6	711.9	737.3	740.3	825.8	811.4	820.5
Other	3.6	3.4	3.5	3.5	3.4	3.4	3.3
Direct investment debt liabilities	225.9	228.1	231.1	226.4	236.5	236.5	250.7
Net External Debt	982.2	1012.0	967.9	938.6	981.6	966.1	962.1
Short-term	403.5	439.7	396.8	334.1	423.7	418.3	411.1
Long-term	578.6	572.2	571.1	604.6	557.9	547.8	551.0
General government	513.5	537.6	552.2	611.5	633.4	633.3	635.6
Bank of Spain	168.7	209.5	222.6	204.9	285.7	258.8	268.1
Other monetary financial institutions	136.3	157.8	98.2	63.0	14.8	25.6	6.3
Other resident sectors	53.9	4.3	-9.1	-22.6	-34.4	-35.1	-38.2
Debt securities	422.2	426.1	413.6	482.1	449.9	434.9	435.0
Loans, trade credits and other liabilities	89.7	48.0	40.0	16.0	24.9	38.0	39.1
Deposits	123.2	435.8	410.9	359.4	425.3	410.1	398.3
Other	-0.6	-0.7	-0.6	-0.7	-0.5	-0.5	-0.5
Direct investment debt liabilities	109.7	102.7	104.1	81.8	82.0	83.5	90.2
	(Percent of GDP)						
Gross External Debt	168.7	170.4	169.1	171.4	200.5	186.6	189.5
Short-term	64.6	67.9	66.8	63.8	79.3	73.7	75.0
Long-term	104.1	102.5	102.2	107.7	121.2	112.8	114.5
General government	49.7	49.8	49.4	52.9	60.8	56.8	57.1
Bank of Spain	34.2	38.3	40.4	39.0	53.2	47.9	49.6
Other monetary financial institutions	36.7	38.5	35.9	36.8	38.5	37.3	36.8
Other resident sectors	27.9	24.3	24.2	24.5	26.9	24.8	25.0
Debt securities	67.7	67.7	66.8	72.4	81.6	75.9	76.7
Loans, trade credits and other liabilities	22.1	21.6	21.6	21.0	23.9	22.8	22.9
Deposits	58.3	61.3	61.3	59.5	73.6	67.9	68.6
Other	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Direct investment debt liabilities	20.3	19.6	19.2	18.2	21.1	19.8	21.0
Net External Debt	88.2	87.1	80.4	75.4	87.5	80.8	80.4
Short-term	36.2	37.8	33.0	26.8	37.8	35.0	34.4
Long-term	52.0	49.3	47.5	48.6	49.7	45.8	46.1
General government	46.1	46.3	45.9	49.1	56.5	53.0	53.1
Bank of Spain	15.1	18.0	18.5	16.5	25.5	21.6	22.4
Other monetary financial institutions	12.2	13.6	8.2	5.1	1.3	2.1	0.5
Other resident sectors	4.8	0.4	-0.8	-1.8	-3.1	-2.9	-3.2
Debt securities	37.9	36.7	34.4	38.7	40.1	36.4	36.4
Loans, trade credits and other liabilities	8.1	4.1	3.3	1.3	2.2	3.2	3.3
Deposits	11.1	37.5	34.1	28.9	37.9	34.3	33.3
Other	-0.1	-0.1	0.0	-0.1	0.0	0.0	0.0
Direct investment debt liabilities	9.8	8.8	8.6	6.6	7.3	7.0	7.5

Sources: World Bank Quarterly External Debt Statistics and IMF staff calculations.

Note: Net external debt is defined as gross external debt minus external assets in debt instruments.

Table 6. Selected Recovery Indicators

	2021									2022			2023		
	Growth	RGDP	Output	Unemp. rate	RGDP	Output	Unemp. rate	RGDP	Output	Unemp. rate	RGDP	Output	Unemp. rate		
	2020	Q4 vs 19Q4	Gap	diff vs 2019	Q4 vs 19Q4	Gap	diff vs 2019	23 vs 19Q4	Gap	diff vs 2019	23 vs 19Q4	Gap	diff vs 2019		
GR	-8.2	-4.4	-5.6	-1.5	6.3	-2.0	-2.7	5.4	-0.5	-4.2	5.4	-0.5	-4.2		
IT	-8.9	-1.3	-4.9	0.3	1.6	-1.4	1.6	2.3	-0.4	1.4	2.3	-0.4	1.4		
PT	-8.4	-2.3	-3.0	0.2	-0.1	-0.9	0.1	2.0	-0.9	-0.3	2.0	-0.9	-0.3		
BE	-6.3	-0.2	-1.6	0.9	2.0	-0.3	0.8	3.1	-0.1	0.5	3.1	-0.1	0.5		
ES	-10.8	-4.3	-5.4	0.9	0.5	-1.6	-0.1	2.1	0.0	-0.6	2.1	0.0	-0.6		
FR	-8.0	0.0	-2.2	-0.3	2.5	-0.2	-0.1	3.6	0.0	-0.4	3.6	0.0	-0.4		
GB	-9.8	-0.7	-2.1	1.2	1.5	-0.4	1.2	2.7	-0.1	0.9	2.7	-0.1	0.9		
AT	-6.2	0.0	-1.5	1.6	4.3	-0.5	1.2	4.3	-0.3	0.7	4.3	-0.3	0.7		
FI	-2.9	1.0	-2.3	1.1	4.3	-0.3	0.1	4.7	0.0	-0.1	4.7	0.0	-0.1		
DE	-4.6	1.1	-2.0	0.5	3.1	-0.3	0.4	4.4	-0.2	0.3	4.4	-0.2	0.3		
LU	-1.3	3.2	-0.7	0.2	9.6	-0.1	0.1	10.4	0.0	0.0	10.4	0.0	0.0		
NL	-3.8	0.9	-1.5	0.2	2.9	-0.8	0.6	4.3	-0.6	0.5	4.3	-0.6	0.5		
CZ	-5.8	-0.1	-1.4	1.4	2.0	-1.2	1.2	5.3	-0.8	1.0	5.3	-0.8	1.0		
DK	-2.1	3.4	-0.3	0.4	5.0	0.3	0.3	6.3	0.1	0.1	6.3	0.1	0.1		
NO	-0.8	3.2	-1.2	0.6	5.2	-0.2	0.3	7.7	0.0	0.2	7.7	0.0	0.2		
SE	-2.8	2.0	-0.6	2.1	4.3	-0.4	1.2	6.9	-0.2	0.9	6.9	-0.2	0.9		
CH	-2.5	2.9	-1.0	0.8	3.4	0.4	0.7	4.8	0.2	0.7	4.8	0.2	0.7		
HR	-8.0	-3.5	-1.5	0.6	6.1	-0.6	0.2	7.8	-0.3	-0.2	7.8	-0.3	-0.2		

Sources: 2021 October WEO and IMF staff calculations.

Note: Output comparison with pre-crisis level is computed at an annual frequency relative to four times the 2019Q4 level. Color grading is applied to individual variables for all years in the table.

Annex I. External Sector Assessment

<p>Overall Assessment: <i>The external position in 2021 is broadly in line with the level implied by medium-term fundamentals and desirable policies. Further strengthening the NIIP will require sustaining a relatively high CA surplus over the coming years. This assessment, however, is still preliminary given the absence of full-year data for 2021 and the uncertainty surrounding the economy's recovery; a complete analysis will be provided in the 2022 External Sector Report.</i></p> <p>Potential Policy Responses: To keep the current account balance in line with its norm, policies need to foster competitiveness to facilitate the recovery of the export sector (including tourism), while carefully managing the public debt load. Boosting competitiveness through productivity gains will require continued wage flexibility, implementation of reforms to address labor market duality, and actions to enhance education outcomes and encourage innovation. The recovery plan foresees investments and reforms in these areas, as well as specific measures to diversify and improve the quality of tourism services.</p>							
Foreign Asset and Liability Position and Trajectory	<p>Background. Following a 15-percentage-point increase in 2015–19 due to sustained CA surpluses, the NIIP declined in 2020, reaching -86 percent of GDP, mainly due to the contraction in GDP. In 2021, the NIIP has recovered and is expected to reach -78.7 percent by the end of the year, supported by a net increase in financial assets but also by positive valuation effects. Gross liabilities—of which 70 percent correspond to external debt—are projected to decline by about 8 percentage points of GDP, reaching 283.1 percent of GDP in end-2021. With continued deleveraging of the private sector, the NIIP accounted for by the general government and the central bank has increased markedly, with a share of 96 percent in 2021:Q3 (including TARGET2 liabilities, which amounted 41 percent of GDP in September 2021).</p> <p>Assessment. Despite its projected decline, the still large negative NIIP comes with external vulnerabilities, including from large gross financing needs and potentially adverse valuation effects. The favorable maturity structure of outstanding sovereign debt (averaging almost eight years), the limited share of debt denominated in foreign currency, and current ECB measures that keep the cost of debt low are mitigating factors.</p>						
	2021 (% GDP)	NIIP: -78.7	Gross Assets: 204.3	Debt Assets: 92.2	Gross Liab.: 283.1	Debt Liab.: 166.0	
Current Account	<p>Background. The COVID-19 crisis was associated with a stronger decline in exports than imports, largely due to the sharp contraction in receipts from travel services. As a result, the CA surplus declined significantly, from 2.1 percent of GDP in 2019 to 0.8 percent of GDP in 2020. With high uncertainty, in 2021 the CA surplus is projected to further deteriorate, as foreign tourism remains weak, and imports pick up with the recovery of domestic demand. Thereafter, the CA is projected to gradually recover in the medium term with resumption of foreign tourism flows and resolution of global supply bottlenecks, which will offset the increase in imports driven by stronger domestic demand, including due to NGEU-funded investments.</p> <p>Assessment. The 2021 cyclically adjusted CA balance is -1.0 percent of GDP, yielding a CA gap of -1.3 percent of GDP. However, this mainly reflects the pandemic's transitory impact due to shocks not captured by the EBA model, which amount to 1.9 percent for tourism, 0.3 percent for medical goods, and 0.0 percent for the global shift of household consumption from services to consumer goods. Adjusting for these effects, the 2021 cyclically adjusted CA balance is 1.2 percent of GDP. The EBA CA model suggests a norm of 0.3 percent of GDP for 2021. However, given external risks from a large and negative NIIP, the IMF staff views the appropriate CA norm to be 1.7 percent of GDP, with a range of 0.7 to 2.7 percent of GDP. This yields a CA gap of -1.5 to 0.5 percent of GDP. With a sustained CA surplus of about 1.7 percent of GDP, the NIIP is projected to reach -50 percent of GDP over the medium-to-long term under current policies, though with high uncertainty, as zero valuation effects are assumed.¹</p>						
	2021 (% GDP)	CA: 0.4	Cycl. Adj. CA: -1.0	EBA Norm: 0.3	EBA Gap: -1.3	COVID-19 Adj.: 2.2	Other Adj.: -1.4	Staff Gap: -0.5
Real Exchange Rate	<p>Background. In 2020 the CPI-based REER appreciated by 0.5 and the ULC-based REER depreciated by 4.1 percent relative to 2019. The CPI-based REER is only moderately lower than its 2008 peak, partially reversing the significant appreciation from euro entry in 1999–2009. The ULC-based REER shows that the appreciation in 1999–2008 has been largely reversed, with a depreciation in 2008–20 of 21 percent. The pattern observed in 2020 for both measures continued in 2021, with the CPI-based REER appreciating by 0.8 percent and the ULC-based REER depreciating by 1.3 percent relative to 2020.</p> <p>Assessment. The EBA REER models estimate an overvaluation of 5.8 (level) to 8.3 (index) percent for 2021. Based on the IMF staff CA gap, using an elasticity of 0.29, IMF staff assesses the REER gap to be in the range of -1.8 to 5.2 percent, with a midpoint of 1.7 percent.²</p>						
	<p>Capital and Financial Background. In 2020, net inflows by the Bank of Spain partially offset net outflows by the other resident sectors. On the one hand, Bank of Spain's negative financial account balance was driven by the substantial increase in liquidity creation by the Eurosystem through the expansion of asset purchase programs, which led to further</p>						

Accounts: Flows and Policy Measures	<p>accumulation of TARGET2 liabilities. On the other hand, the positive balance of the other resident sectors was explained by the purchase of investment fund shares/units, a net increase in deposits abroad and loans to non-residents, and a decrease of net purchases of Spanish long-term government bonds by international investors. Up to September 2021, the financial account balance remained positive, but the pattern changed relative to 2020, with net outflows by the Bank of Spain partially offsetting net inflows by the other resident sectors, particularly FDI and portfolio investment.</p> <p>Assessment. Large external financing needs leave Spain vulnerable to sustained market volatility, although the ECB's policies to maintain favorable liquidity conditions and monetary accommodation remain a mitigating factor.</p>
FX Intervention and Reserves Level	<p>Background. The euro has the status of a global reserve currency.</p> <p>Assessment. Reserves held by the euro area are typically low relative to standard metrics, but the currency is free floating.</p>
<p>¹ The EBA model suggests a cyclically adjusted CA norm of 0.3 percent of GDP, with a standard error of 0.8 percent of GDP. But the empirically based EBA norm does not fully account for the very negative NIIP. Given external stability considerations, including potentially adverse NIIP valuation effects, a CA norm in the range of 1 to 3 percent of GDP is necessary to raise the NIIP by at least roughly 3 percent of GDP annually over the next 10 years. Over 2013–20, valuation effects were on average -3.1 percent of GDP per annum. CA surpluses during 2013–20 of about 2.1 percent of GDP, on average, suggest that maintaining CA balances aligned with the IMF staff-assessed norm of 1 to 3 percent of GDP would be feasible under current policies.</p> <p>² The REER gap midpoint is obtained from the staff-assessed CA gap and an estimated semi-elasticity of the CA to the REER of 0.29. The range of the REER gap is +/-3.5 percent, which is obtained from Spain's estimated standard error of the EBA CA norm (1 percent of GDP) and the aforementioned CA-to-REER semi-elasticity.</p>	

Source of Risks	Relative Likelihood	Impact if Realized	Policy Response
Global Risks			
Global resurgence of the Covid-19 pandemic	Medium Local outbreaks lead to a global resurgence of the pandemic (possibly due to vaccine-resistant variants), which requires costly containment efforts and prompts persistent behavioral changes rendering many activities unviable.	High The needed containment measures could negatively affect economic activity directly; external demand and demand in contact-intensive service sectors could remain low for longer.	<ul style="list-style-type: none"> • Maintain certain public health measures to contain the virus and target at the most needed areas. • Stand ready to extend pandemic related support measures.
Disorderly transformations	Medium Covid-19 triggers structural transformations, but the reallocation of resources is impeded by labor market rigidities, debt overhangs, and inadequate bankruptcy resolution frameworks. This, coupled with a withdrawal of Covid-19-related policy support, undermines growth prospects, and increases unemployment, with adverse social/political consequences.	High/ Medium Skill mismatches and delays in bankruptcy resolution could lead to persistently higher unemployment and increased misallocation, eventually lower growth.	<ul style="list-style-type: none"> • Realign policy support measures more towards incentivizing reallocation of resources while supporting affected workers during the transition. • Accelerate structural reforms to tackle the long-standing bottlenecks, including in the labor market and the insolvency framework.
Rising commodity prices amid bouts of volatility	Medium Commodity prices increase by more than expected against a weaker U.S. dollar, post-pandemic pent-up demand and supply disruptions, and for some materials, accelerated plans for renewable energy adoption. Uncertainty surrounding each of these factors leads to bouts of volatility, especially in oil prices.	Medium Given relatively high oil intensity of the Spanish economy, higher oil prices would push up CPI inflation weighing on consumer spending and growth, while in a scenario of lower oil prices, the Spanish economy will benefit.	<ul style="list-style-type: none"> • Use any windfall revenues to reduce the high public debt. • Allow automatic stabilizers to operate and formulate a credible medium-term fiscal consolidation path in support of public debt sustainability.
Intensified geopolitical tensions and security risks	High Geopolitical tensions in selected countries/regions cause economic/political disruption, disorderly migration, higher volatility in commodity prices (if supply is disrupted), and lower confidence, with spillovers to other countries.	Medium Intensification of conflicts in the Middle East and Africa could lead to disorderly migration into Europe further deepening political division within the EU, higher commodity prices (if supply is disrupted), and lower confidence.	<ul style="list-style-type: none"> • Accelerate structural reforms, enhance policies for swift labor market integration and lower duality. • Let automatic stabilizers play in case the output gap widens and formulate a credible medium-term fiscal path in support of public debt sustainability and investor confidence.

Domestic Risks			
Unexpected pace of the run-down of excess savings	Medium Depending on the development of the Covid-19 pandemic, household excess savings could be spent faster or slower than expected.	High The extent and pace of the normalization of household savings are critical to growth in the near term.	<ul style="list-style-type: none"> Allow automatic stabilizers to operate if the output gap changes. In case of a rapid unwinding of savings, withdraw fiscal support faster to prevent overheating and rebuild fiscal space, and monitor closely developments in the real estate market to assess the need for macroprudential tightening.
Implementation of EU-funded projects	Medium The size, timing and composition of EU-funded spending to support investments and structural reforms are subject to significant uncertainty.	High Investment under the EU-funded projects is an important driver of the near-term economic recovery.	<ul style="list-style-type: none"> Ensure efficient coordination, implementation, and oversight of the Recovery, Transformation and Resilience Plan.
Higher and persistent inflation	Medium Persistent disruptions of production and logistical bottlenecks, combined with a stronger domestic and global recovery leads to significant second-round effects on wages and prices.	Medium Higher inflation could have a negative impact on domestic demand, slowing the recovery. If inflationary pressures at the euro area level more broadly persist, expectations could suddenly shift to faster withdrawal of monetary support, and inflation risk premia and sovereign bond yields could increase. A rise in sovereign bond yields could increase vulnerabilities and further constrain fiscal space	<ul style="list-style-type: none"> Wage-setting negotiations should continue to internalize the transitory nature of the current drivers of inflation and avoid a vicious cycle of higher wages leading to higher inflation. If persistently high domestic inflation leads to higher wages, the policy stance may need to be recalibrated. Formulate a credible medium-term fiscal consolidation path to support investor confidence.
Prolonged period of uncertainty related to political crisis in Catalonia	Medium Tensions related to Catalonia remain high with positions deeply divided and entrenched.	Medium Prolonged period of uncertainty could weaken business confidence weighing on investment.	<ul style="list-style-type: none"> Accelerate structural reforms and enhance labor market performance. Formulate a credible medium-term fiscal consolidation path to support investor confidence.
Weak implementation of fiscal commitments and structural reforms or reversal of past policy achievements	Medium Traction for structural reforms is low in a fragmented parliament. A credible medium-term fiscal plan has yet to be announced.	High Potential lack of or reversal of reforms and uncertainty about medium-term fiscal commitments could weaken confidence, investment, and employment, which would adversely impact public debt dynamics and could trigger adverse market reactions.	<ul style="list-style-type: none"> Accelerate structural reforms and enhance labor market performance. Return to gradual, steady, and growth-friendly fiscal consolidation. Reform the regional financing framework to reduce fiscal risks.

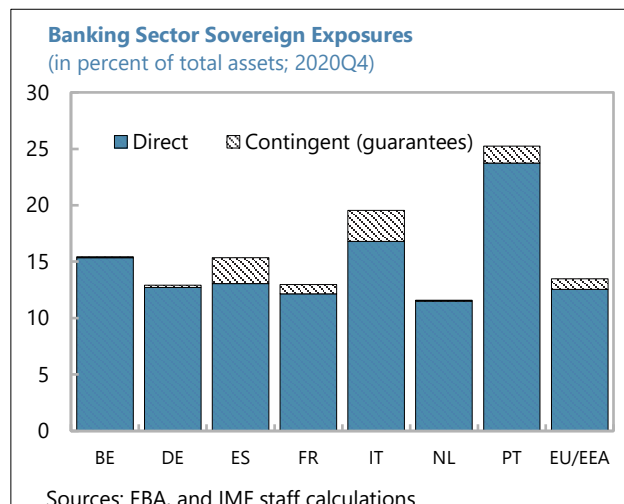
Annex III. Debt Sustainability Analysis

Public sector gross debt is high at about 120 percent of GDP, and in a no-policy baseline, debt dynamics do not stabilize by the end of the forecast horizon. Fiscal consolidation will need to play a role in the medium term to put the debt ratio on a downward path and rebuild buffers. The projected debt trajectory is susceptible to various shocks (especially a negative real GDP growth shock, and the materialization of contingent liabilities).

Background

1. **Definitions and Coverage.** Public debt comprises Excessive Deficit Procedure (EDP) debt in the hands of the General Government. The General Government includes the Central Government, Regional Governments, Local Governments, and Social Security Funds. It includes only those public enterprises that are defined as part of General Government under European System of Accounts. EDP debt is a subset of General Government consolidated debt (i.e., it does not include trade credits and other accounts payable) and the stocks are recorded at their nominal value.
2. **Public debt developments.** Before the pandemic, public debt had been on a gradual downward path since reaching a peak of 100.7 percent in 2014. The sharp increase in the public-debt-to-GDP ratio between 2007 and 2014 (about 65 percentage points) was driven by excessive fiscal deficits (of about 8½ percent of GDP on average during 2008–14), and a largely unfavorable growth interest rate differential (which contributed an annual average of nearly 3 percent of GDP). The support to the banking sector added about 4½ percent of GDP to the public debt stock. Public debt had declined since then, albeit at a slow pace, reaching 95.5 percent of GDP at end-2019. In 2020, the public debt ratio increased significantly to 120 percent of GDP, driven by the unprecedented output loss and the fiscal response to the pandemic. The reclassification of Spain's Asset Management Company SAREB into the general government worsened the debt-to GDP ratio by three percentage points (and the deficit ratio by about one percentage point).
3. **Financing condition developments.** Gross financing needs continued to decline after peaking at 22 percent in 2012, on the back of an ongoing maturity extension and nominal deficit reduction. The ECB's accommodative monetary policy contributed to a sharp decline in interest rates and funding costs. The benchmark 10-year bond yield fell from an average of about 6 percent in 2012 to an average 0.7 in 2019. The effective interest rate on outstanding debt has also declined, and interest payments on public debt fell to 2.3 percent of GDP in 2019. Despite a temporary mild tightening in sovereign markets at the onset of the pandemic, and early in 2021 with the increase in US LT rates, financing conditions have remained favorable (the long-term yield has averaged 0.3 percent from January to October of 2021) underpinned by the ECB's accommodative monetary policy stance.

4. Other factors. The amortization profile of public debt is tilted towards the long term (about 85 percent of total debt, on a residual maturity basis). The average life of outstanding debt had increased steadily since 2012, from 6.3 years to 7½ years in 2019. Despite the lengthening of debt maturity, the average cost of outstanding debt has continued to fall, reaching an all-time low of about 2 percent in July 2020. The share of total debt held by ECB has increased from about 20 percent pre-pandemic to 25 percent by mid-2021, while that held by non-resident has decreased by a similar amount to about 45 percent. Holdings by the resident financial sector has remained broadly stable at about 30 percent of total. Resident banking system’s holdings of sovereign debt amount to about 13 percent of total assets, with an additional contingent exposure of about 2.5 percent of total assets via government guarantees issued in 2020.



5. Baseline. Public debt is projected to remain at about 120 percent of GDP in 2021, as the recovery in growth broadly offsets the still high primary deficit. The public debt ratio is projected to decline in 2022, as economic conditions continue to improve and emergency spending measures wind down. Nonetheless, absent additional consolidation, the deficit would stabilize above pre-crisis levels, and the debt to GDP ratio will resume a rising trend beyond 2024, remaining at record-high levels over the forecast horizon. The gross financing needs of the government are expected at 25 percent of GDP in 2021, and re projected to decline to just below the 20 percent benchmark level in 2023.

6. Assumptions. The baseline scenario is based on the medium-term projections that assume disbursements under the EU Recovery and Resilience Facility in 2021–24 but with no other policy changes other than the expiration of some support measures. The structural primary balance to GDP ratio is kept broadly constant at its 2022 level throughout the remainder of the forecast horizon. Long-term sovereign spreads are assumed to increase slowly in the medium term, with 10-year bond yields rising moderately to 1.6 percent by 2026 in line with a gradual normalization of monetary policy.

7. Realism of projections. The median forecast error for real GDP growth during 2011–19 was 0.28 percent, suggesting a moderate downward bias in the staff projections. In contrast, the median forecast error was -0.95 percent for the primary balance and -0.42 percent for inflation. Both indicate some degree of upward bias in the staff projections. To assess the realism of projected fiscal adjustment, a comparison with high debt country experience suggests that the projected levels of the cyclically adjusted primary balance (CAPB) in Spain are below the thresholds that would question the feasibility of the adjustment.

Stress Tests

8. Growth shock. In this scenario, real GDP growth rates are assumed to be lower than in the baseline by one (computed from 2010 to 2019) standard deviation for two consecutive years, in 2022–23. This implies that real GDP would grow by an average of 2.6 percent per year in 2022–23, compared to annual average growth of 4.8 percent under the baseline. Under this adverse scenario, inflation would be lower (by an average of 0.5 percentage points per year) and the primary balance weaker (by about 1.8 percent of GDP per year, on average) in the shock years. For 2024–26, the scenario assumes a moderate fiscal tightening as primary expenditure is projected to grow only in line with the new GDP level which is lower than in the baseline. In this context, the debt-to-GDP ratio would rise to about 125 percent of GDP in the medium term (almost 10 percentage points higher than the baseline), and gross financing needs would stay above the 20 percent benchmark level through the forecast horizon. If, however, the scenario assumes no fiscal tightening and primary expenditure remains at the same nominal level as in the baseline, higher fiscal deficits in 2023–26 would push public debt to about 132 percent of GDP by the end of the forecast horizon.

9. Primary balance shock. This scenario assumes a relaxation of fiscal policy in 2022–23, with an average deterioration of the primary balance of 1.6 percent of GDP per year (capturing, for instance, a more gradual withdrawal of support measures). Under this scenario, the public debt-to-GDP ratio would reach about 119 percent of GDP by 2026 (about 3.5 percentage points higher than in the baseline). The larger primary deficits would also imply more sizable gross financing requirements than in the baseline.

10. Interest rate shock. This scenario assumes interest rates increase by 416 basis points from 2022 onwards. The projected impact on debt is back-loaded, as old debt gradually matures, and new debt is contracted at higher interest rates. Under such a scenario, the effective interest rate would increase to 3.6 percent by 2026 compared to 1.7 percent in the baseline. The debt-to-GDP ratio would rise to about 121 percent in 2026. A sizeable and sustained increase in interest rates would reduce the (already limited) fiscal space.

11. Combined shock. A simultaneous combination of the previous three shocks would be particularly adverse for public debt dynamics, mostly due to the impact of lower growth. In this scenario, the public debt-to-GDP ratio would increase to about 138 percent in 2026, about 22 percentage points higher than under the baseline). Gross financing needs would also be significantly higher, above 25 percent most of the years over the forecast horizon.

12. Contingent liability shock. Large, negative unexpected events could put debt sustainability at significant risk. A negative financial sector shock scenario, assuming a one-time increase in non-interest public expenditures in 2021 equivalent to 6 percent of banking sector assets, combined with lower growth and lower inflation in 2021–22 (i.e., growth is reduced by 1 standard deviation estimated over 2010–2019) would be particularly adverse for public debt dynamics. The shock assumed in this scenario is close to the average public support during the past banking crisis. The materialization of such contingency liabilities would raise the primary deficit to about 15 percent of GDP in 2022, bringing gross financing needs close to 35 percent of GDP. Moreover, the

debt-to-GDP ratio would rise sharply to 135 percent by 2023 and stay around that level in the medium term (around 19 percentage points higher than the baseline).

13. Heat map. Risks associated with public debt remain high as the benchmark level (85 percent of GDP) is breached under the baseline scenario as well as in each of the shock scenarios. Gross financing needs would remain close to 20 percent of GDP over the forecast horizon, and in most cases under the shock scenarios. Regarding the debt profile, risks stem from the high level of external financing needs and—to a lesser extent—from the share of public debt held by non-residents.

14. Vulnerabilities and policy response. Public indebtedness is relatively high, and the projected debt trajectory is susceptible to various shocks (particularly a negative real GDP growth shock, and the materialization of contingent liabilities). Debt maturities imply higher interest rates would have a backloaded impact, but sustained rate increases would ultimately further reduce the limited fiscal space. A process of fiscal consolidation will need to play a role in the medium term to create space for responding to fiscal shocks. The fiscal adjustment should be growth-friendly, which will require preserving space for public investment and education spending, and accompanying the process with growth-enhancing structural reforms. The early formulation of specific plans to rebuild fiscal buffers would reinforce investor confidence and reduce the risk of sharp increases in financing costs.

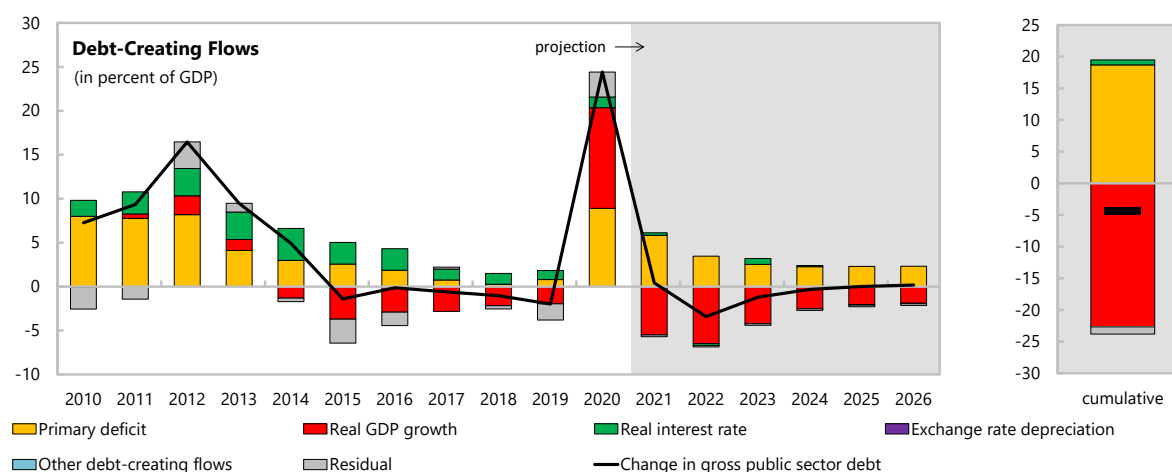
Annex III. Figure 1. Spain: Public Debt Sustainability Analysis (DSA)—Baseline Scenario

Debt, Economic and Market Indicators ^{1/}

	Actual			Projections						As of January 05, 2022		
	2010-2018 ^{2/}	2019	2020	2021	2022	2023	2024	2025	2026	Sovereign Spreads		
Nominal gross public debt	89.7	95.5	120.0	120.4	117.0	115.8	115.4	115.5	115.6	EMBIG (bp) ^{3/} 65		
Public gross financing needs	19.6	16.8	26.6	24.4	20.7	19.6	19.3	18.8	18.8	5Y CDS (bp) 32		
Real GDP growth (in percent)	0.9	2.1	-10.8	4.9	5.8	3.8	2.3	1.9	1.7	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	0.4	1.3	1.1	1.6	1.9	1.1	1.6	1.7	1.7	Moody's	Baa1	Baa1
Nominal GDP growth (in percent)	1.4	3.4	-9.8	6.6	7.8	4.9	3.9	3.6	3.4	S&Ps	A	A
Effective interest rate (in percent) ^{4/}	3.4	2.4	2.1	1.9	1.8	1.8	1.7	1.7	1.7	Fitch	A-	A-

Contribution to Changes in Public Debt

	Actual			Projections						cumulative	debt-stabilizing primary balance ^{9/}
	2010-2018	2019	2020	2021	2022	2023	2024	2025	2026		
Change in gross public sector debt	4.9	-2.0	24.4	0.4	-3.4	-1.2	-0.3	0.0	0.2	-4.3	
Identified debt-creating flows	5.4	-0.1	21.6	0.6	-3.3	-1.0	-0.1	0.2	0.4	-3.2	
Primary deficit	4.1	0.8	8.9	5.8	3.5	2.5	2.3	2.3	2.3	18.7	
Primary (noninterest) revenue and grants	37.7	39.0	41.3	42.6	41.9	41.3	40.7	39.3	39.3	245.1	
Primary (noninterest) expenditure	41.8	39.8	50.2	48.4	45.3	43.8	43.0	41.6	41.6	263.8	
Automatic debt dynamics ^{5/}	1.4	-0.9	12.7	-5.2	-6.7	-3.5	-2.4	-2.1	-2.0	-21.9	
Interest rate/growth differential ^{6/}	1.4	-0.9	12.7	-5.2	-6.7	-3.5	-2.4	-2.1	-2.0	-21.9	
Of which: real interest rate	2.4	1.0	1.2	0.3	-0.2	0.7	0.1	0.0	-0.1	0.8	
Of which: real GDP growth	-1.0	-2.0	11.5	-5.5	-6.5	-4.2	-2.5	-2.1	-1.9	-22.7	
Exchange rate depreciation ^{7/}	0.0	0.0	0.0	...	...	...	...	...	...	...
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes ^{8/}	-0.5	-1.8	2.9	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-1.1	



Source: IMF staff.

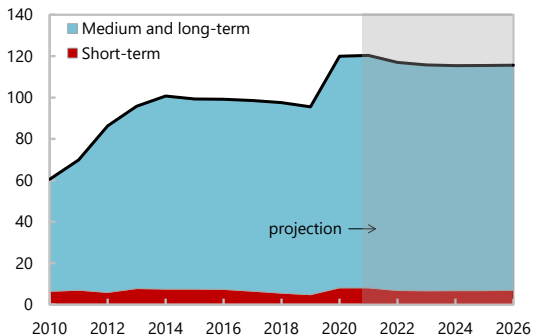
^{1/} Public sector is defined as general government.^{2/} Based on available data.^{3/} Long-term bond spread over German bonds.^{4/} Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.^{5/} Derived as $[(r - \pi(1+g) - g + ae(1+r))/(1+g+\pi+gr)]$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).^{6/} The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi(1+g)$ and the real growth contribution as $-g$.^{7/} The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.^{8/} Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.^{9/} Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Annex III. Figure 2. Spain: Public DSA—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

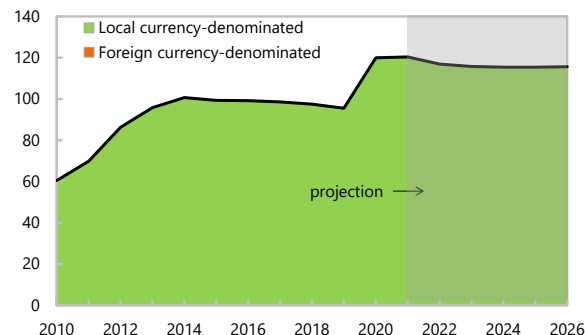
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)



Alternative Scenarios

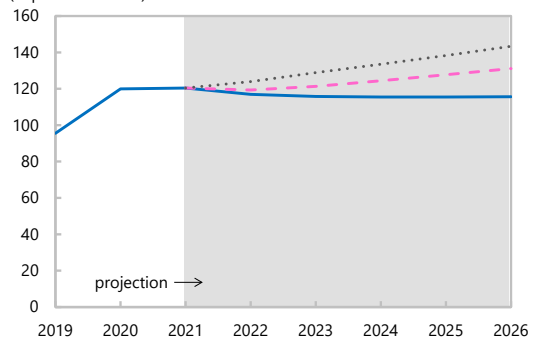
— Baseline

..... Historical

- - - Constant Primary Balance

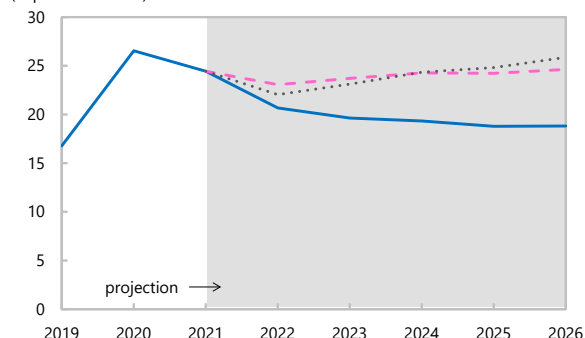
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

Baseline Scenario

	2021	2022	2023	2024	2025	2026
Real GDP growth	4.9	5.8	3.8	2.3	1.9	1.7
Inflation	1.6	1.9	1.1	1.6	1.7	1.7
Primary Balance	-5.8	-3.5	-2.5	-2.3	-2.3	-2.3
Effective interest rate	1.9	1.8	1.8	1.7	1.7	1.7

Constant Primary Balance Scenario

Real GDP growth	4.9	5.8	3.8	2.3	1.9	1.7
Inflation	1.6	1.9	1.1	1.6	1.7	1.7
Primary Balance	-5.8	-5.8	-5.8	-5.8	-5.8	-5.8
Effective interest rate	1.9	1.8	1.7	1.7	1.6	1.6

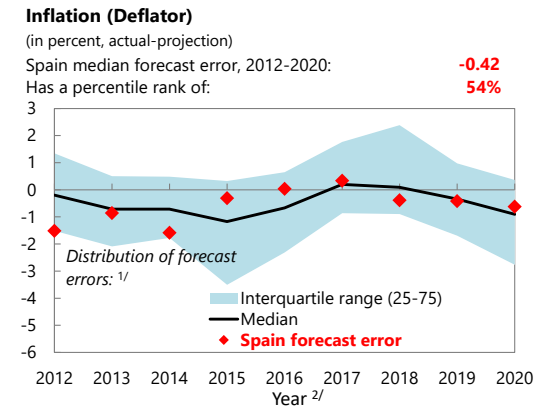
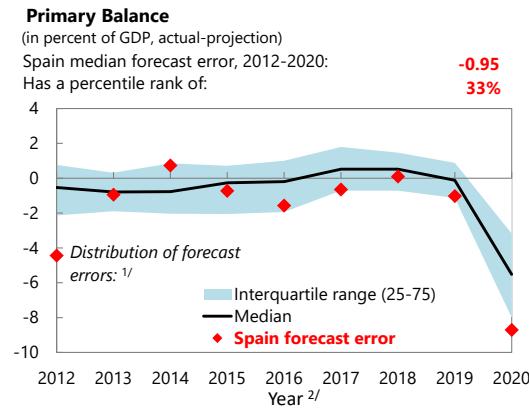
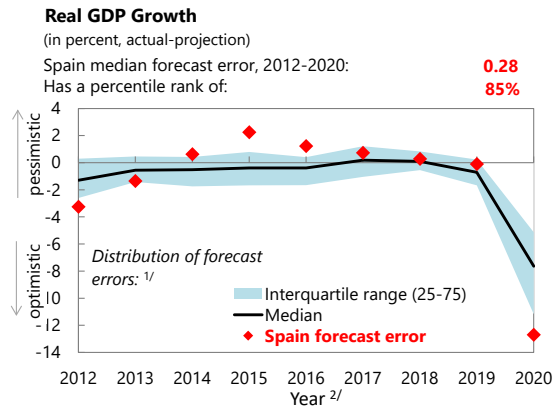
Historical Scenario

	2021	2022	2023	2024	2025	2026
Real GDP growth	4.9	0.0	0.0	0.0	0.0	0.0
Inflation	1.6	1.9	1.1	1.6	1.7	1.7
Primary Balance	-5.8	-3.8	-3.8	-3.8	-3.8	-3.8
Effective interest rate	1.9	1.8	2.1	2.3	2.6	2.8

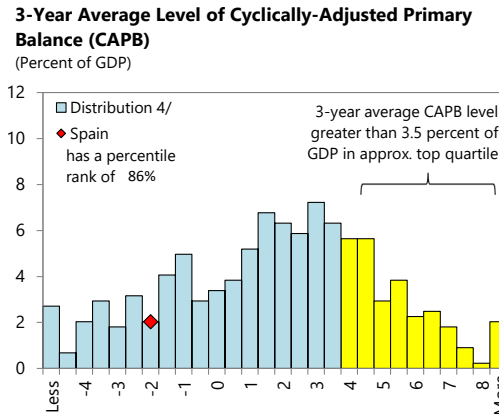
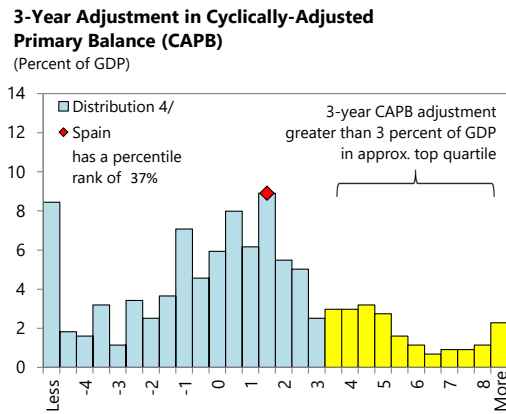
Source: IMF staff.

Annex III. Figure 3. Spain: Public DSA—Realism of Baseline Assumptions

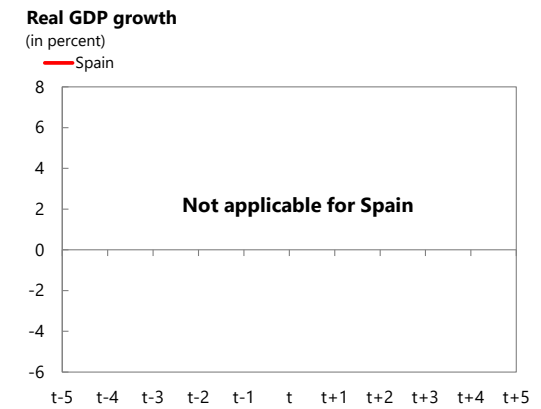
Forecast Track Record, versus all countries



Assessing the Realism of Projected Fiscal Adjustment



Boom-Bust Analysis ^{3/}



Source : IMF Staff.

1/ Plotted distribution includes all countries, percentile rank refers to all countries.

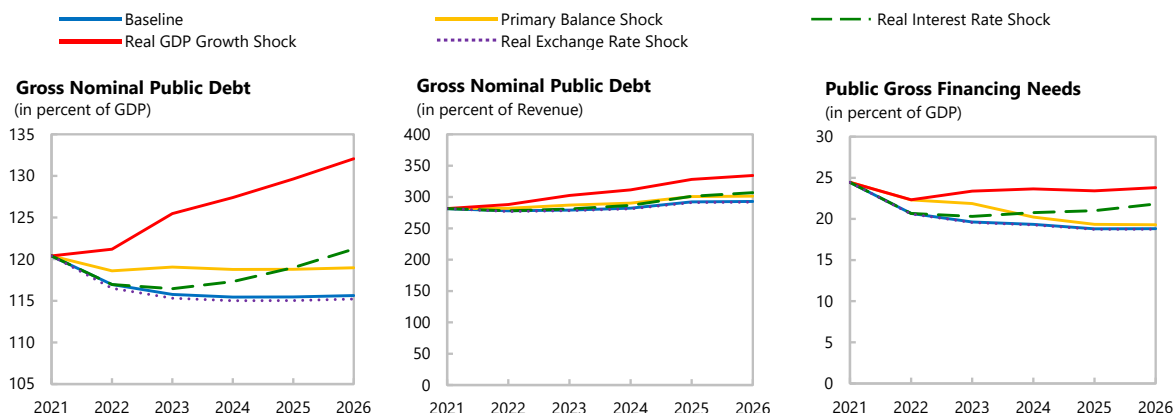
2/ Projections made in the spring WEO vintage of the preceding year.

3/ Not applicable for Spain, as it meets neither the positive output gap criterion nor the private credit growth criterion.

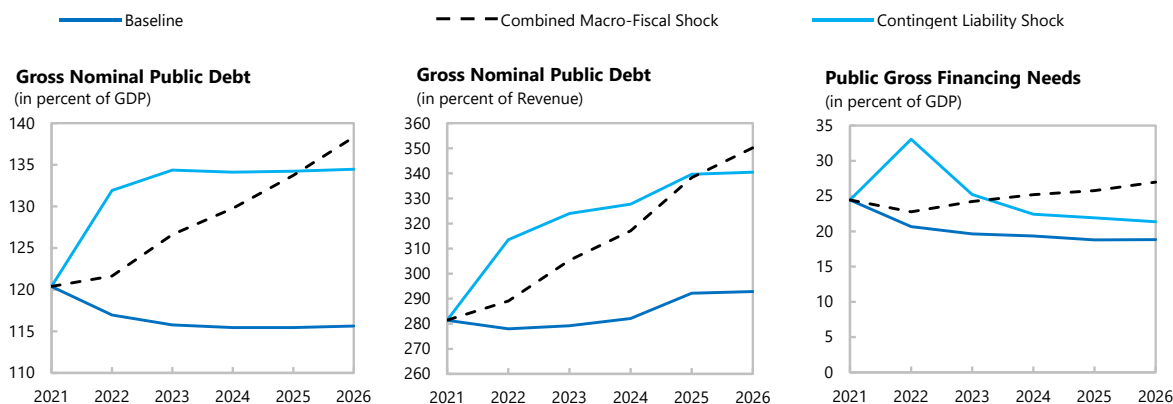
4/ Data cover annual observations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Annex III. Figure 4. Spain: Public DSA—Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions (in percent)

	2021	2022	2023	2024	2025	2026
Primary Balance Shock						
Real GDP growth	4.9	5.8	3.8	2.3	1.9	1.7
Inflation	1.6	1.9	1.1	1.6	1.7	1.7
Primary balance	-5.8	-5.1	-4.2	-2.3	-2.3	-2.3
Effective interest rate	1.9	1.8	1.8	1.8	1.8	1.8
Real Interest Rate Shock						
Real GDP growth	4.9	5.8	3.8	2.3	1.9	1.7
Inflation	1.6	1.9	1.1	1.6	1.7	1.7
Primary balance	-5.8	-3.5	-2.5	-2.3	-2.3	-2.3
Effective interest rate	1.9	1.8	2.4	2.8	3.2	3.5
Combined Shock						
Real GDP growth	4.9	3.6	1.6	2.3	1.9	1.7
Inflation	1.6	1.4	0.6	1.6	1.7	1.7
Primary balance	-5.8	-5.1	-4.9	-4.6	-4.6	-4.6
Effective interest rate	1.9	1.8	2.4	2.8	3.3	3.6
Real GDP Growth Shock						
Real GDP growth	4.9	3.6	1.6	2.3	1.9	1.7
Inflation	1.6	1.4	0.6	1.6	1.7	1.7
Primary balance	-5.8	-4.7	-4.9	-4.6	-4.6	-4.6
Effective interest rate	1.9	1.8	1.8	1.8	1.9	1.9
Real Exchange Rate Shock						
Real GDP growth	4.9	5.8	3.8	2.3	1.9	1.7
Inflation	1.6	2.3	1.1	1.6	1.7	1.7
Primary balance	-5.8	-3.5	-2.5	-2.3	-2.3	-2.3
Effective interest rate	1.9	1.8	1.8	1.7	1.7	1.7
Contingent Liability Shock						
Real GDP growth	4.9	3.6	1.6	2.3	1.9	1.7
Inflation	1.6	1.4	0.6	1.6	1.7	1.7
Primary balance	-5.8	-15.3	-2.5	-2.3	-2.3	-2.3
Effective interest rate	1.9	1.9	2.3	2.1	2.1	2.0

Source: IMF staff.

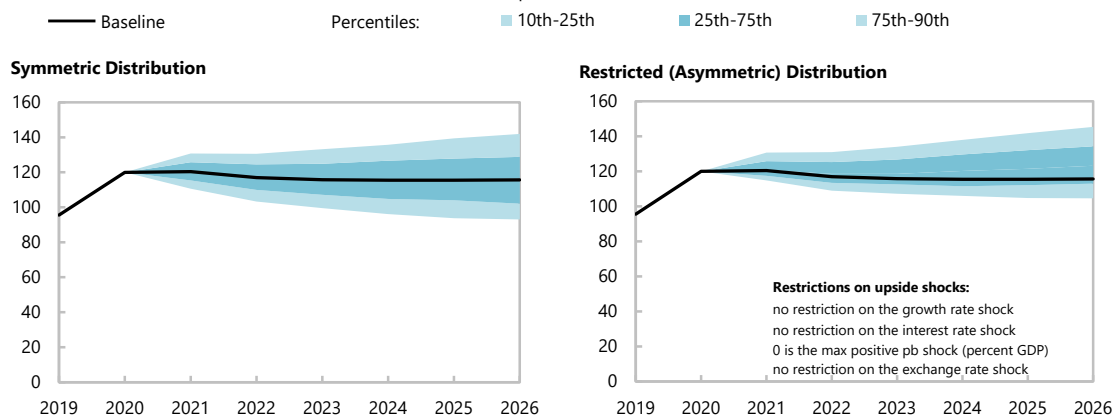
Annex III. Figure 5. Spain: Public DSA—Risk Assessment

Heat Map

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

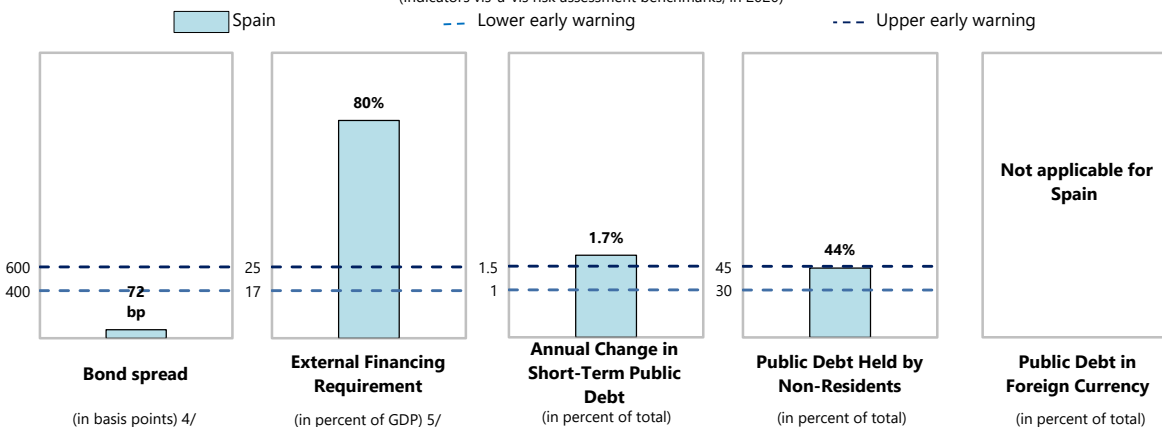
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2020)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 85% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 20% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.

Lower and upper risk-assessment benchmarks are:

400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

4/ Long-term bond spread over German bonds, an average over the last 3 months, 07-Oct-21 through 05-Jan-22.

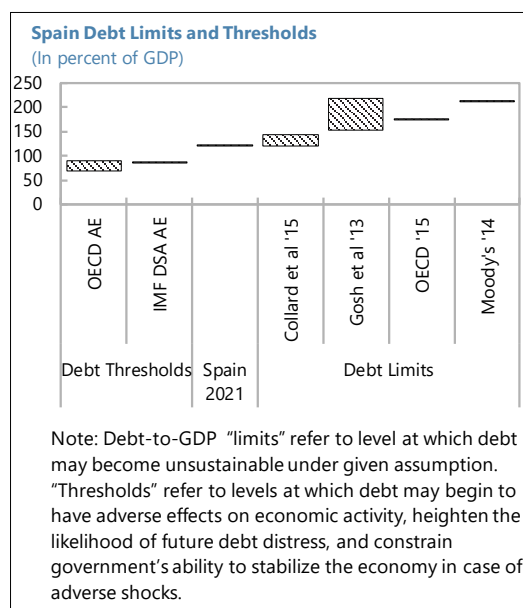
5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Annex IV. Withdrawing Fiscal Stimulus: When and How Fast?

Spain's decisive policy response to the pandemic has been critical in saving lives and alleviating the severity of the economic contraction, but has inevitably taken a toll on public finances. Fiscal buffers will need to be rebuilt gradually over time to maintain fiscal sustainability and economic stability. Staff's model-based analysis suggests that the fiscal stance should remain broadly supportive in the near term, and deficit reduction in 2022 should be mainly driven by the economic recovery and automatic stabilizers. A multi-year consolidation should start once the output gap has closed (in 2023 under the baseline forecast).

1. Fiscal policy needs to balance the tradeoff between ensuring economic stability and debt sustainability. A sizable countercyclical fiscal response to a downturn contributes to economic stability and helps reduce scarring. However, in the absence of subsequent consolidation, a persistent rise in the debt-to-GDP ratio may increase vulnerabilities and limit the fiscal space available to cope with future shocks. At the same time, providing insufficient stimulus or withdrawing fiscal support too fast could have detrimental effects on the recovery and lead to greater economic scarring, which in turn would weaken fiscal sustainability.

2. A crucial question is how to chart a prudent fiscal path in the current context of high debt and uncertainty about future economic shocks. In a stylized model (Fournier, 2019), the optimal fiscal stance—defined as a discretionary change in the structural primary balance—is derived by balancing the objectives of economic stabilization and debt sustainability.¹ The baseline specification calibrates to Spain's data the long-run $r-g$ (at about the 1990–2020 average), the potential growth rate (from the WEO baseline), the shock's persistence, and the probabilistic debt limit at which market access is lost with 50-percent probability (the debt limit is informed by estimates for Spain in the literature, see text figure). The fiscal multiplier is set above the short-run multiplier used in the baseline WEO projections to reflect the possibility of a larger impact over time (which the model does not allow for). Additionally, the baseline specification keeps Fournier's calibration for the interest rate sensitivity to debt levels and the degree of hysteresis, among others.



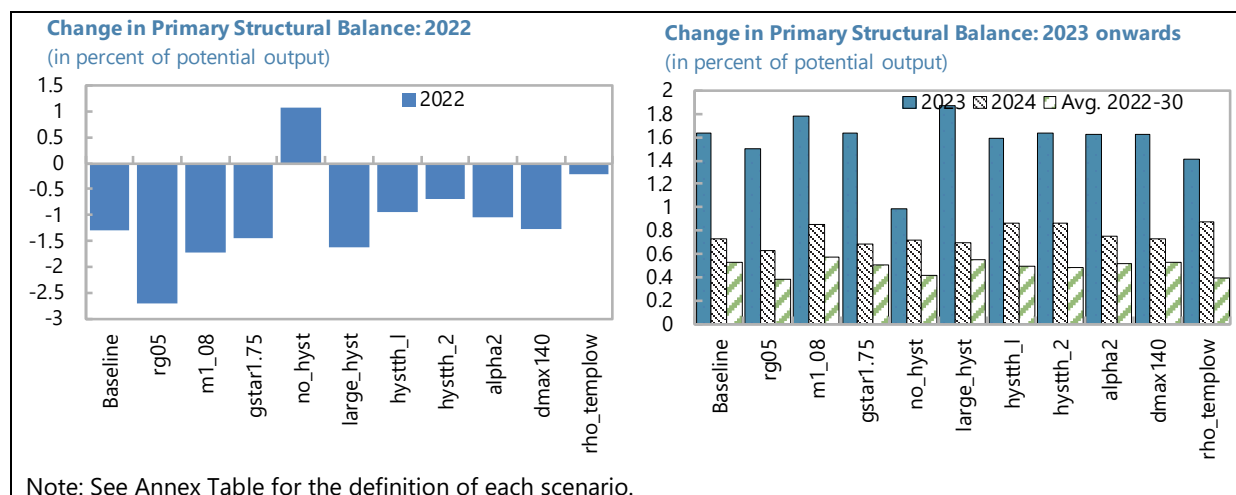
¹ The state of the economy is summarized by the structural primary balance, the public debt level, and the output gap. The government chooses a change in the structural primary balance that reduces the output gap and seeks to avoid a negative feedback to potential output (a hysteresis effect). Higher debt levels, however, increase the government risk premium and the risk of losing market access. Moreover, the model incorporates exogenous shocks, and assumes that the fiscal stance is decided one year ahead to reflect lags in the implementation of fiscal policy.

Summary of Model Alternative Parametrizations											
	Baseline	rg05	m1_08	gstar1.75	no_hyst	large_hyst	hyst_thres_l	hyst_thres_h	alpha2	dmax140	rho_templow
Long run r-g	1	0.5									
Fiscal multiplier (m1)	0.95		0.8								
Potential growth (g*)	1.55			1.75							
Hysteresis	0.1				0	0.2					
Hysteresis threshold	-0.1						-0.15	-0.2			
Rate sensitivity (alpha)	1.5								2		
Debt Prob. Limit	150									140	
Shock persistence (rho)	0.74										.74; lower in SR

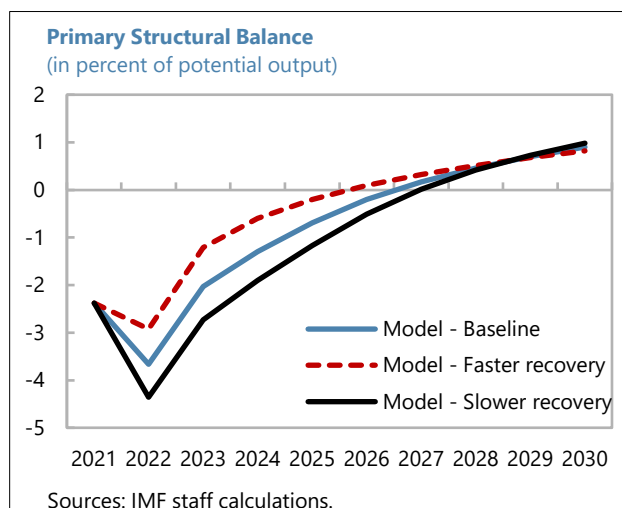
3. The baseline specification suggests that fiscal policy should remain supportive through 2022, with a sustained steady consolidation starting in 2023. The pace of consolidation should average about 0.5 percentage points per year until the end of the decade. These results are consistent with previous staff advice ([IMF Country Report No. 20/298](#)). The model prescribes a front-loaded consolidation path, instead of the constant pace of adjustment recommended by staff.

4. The model results are robust to different calibration assumptions. A range of alternative calibrations is considered: lower r-g, different multipliers, a higher potential growth, no hysteresis, larger hysteresis, higher sensitivity of interest rates to debt levels, lower probabilistic debt limit, and lower shock persistence (temporary or permanent).

- In the near term (2022), consolidation should begin in case of no hysteresis, and a more stimulative stance would be appropriate in case of a permanently lower r-g, higher hysteresis, or a low fiscal multiplier.
- Starting in 2023, all specifications suggest a sustained and front-loaded consolidation. The prescribed cumulative consolidation in the next 15 years is about 4 percent of potential GDP in most specifications. Two exceptions stand-out: the cases of no hysteresis, and of a lower r-g, which call for a higher and lower total consolidation, respectively. Over time, policy makers will need to assess developments and make the appropriate adjustment to fiscal policies.



5. Fiscal policy should respond flexibly to the ongoing circumstances. Changes in the model parameters have an impact on the desirable pace of adjustment, but less so on the cumulative size of the adjustment. Another uncertainty relates to the extent to which the economy is operating below potential, and how fast the gap will close. In the WEO baseline, activity is expected to remain 1.6 percent below potential in 2022. In comparison, the authorities anticipate a broadly closed gap in 2022 (-0.3 percent).² Faster-than projected growth would call for a more frontloaded pace of consolidation, relative to the baseline model prescription.³ Structural reforms that spur growth potential (see Structural Policies) would allow for rebuilding fiscal buffers faster.



² Projections correspond to the authorities' 2021 Stability Pact Update.

³ The faster (slower) pace scenario is computed by changing the WEO baseline output gap projection by 3/4 pp over the forecast horizon.

Annex V. Aging Pressures and Pension Reform

Spending pressures related to population aging will pose a significant challenge to Spain's public finances in a context of already high public indebtedness. Preserving fiscal sustainability will require difficult social choices.

1. Spain will undergo a dramatic demographic transformation in the coming decades.

Spain entered this century as one of the youngest countries in the EU, but will reach 2050 as one of the oldest (Conde-Ruiz and Gonzalez, 2021). The old-age dependency ratio (the proportion of people aged 65 and older relative to the working-age population) is expected to nearly double by 2050 (from about 30 percent at present), driven by continued life expectancy gains and by the baby-boom generation reaching retirement age. Demographic pressures will be acute relative to most European peers, reflecting one of the lowest fertility rates and one of the highest life expectancies. The old-age dependency ratio is projected to recede moderately after 2050, while remaining significantly above current levels.

2. Reforms to safeguard the financial sustainability of the pension system were implemented in 2011 and 2013.

The 2011 reform increased the statutory retirement age from 65 to 67 by 2027, and extended the contributory period for calculating the pension regulatory base (from the last 15 years to the last 25).¹ The 2013 reform introduced an index (IRP) linking pension increases to the structural balance of the social security system. The mechanism implied that the annual indexation rate would be at its minimum (0.25 percent) until at least 2050, given the outlook for pension finances. The reform also introduced a sustainability factor that would adjust the initial pension benefit according to life expectancy changes.

3. Some elements of these reforms created social tensions and were recently repealed, increasing future pension spending.

Improvements in financial sustainability rested on a decline in the pension benefit rate via a progressive reduction in replacement rates (sustainability factor) and payments indexation below inflation (IRP) during retirement. Facing social pressure to preserve the purchasing power of pensions, the government suspended the implementation of the IRP and indexed payments to CPI inflation since 2018. The introduction of a sustainability factor, initially set for 2019, was postponed to 2023. Starting in 2021, both adjustment mechanisms were permanently eliminated, and pensions have been indexed to CPI to preserve their purchasing power. The policy reversals are expected to increase the pension spending-to-GDP ratio by 3.2 to 3.5 percentage points by 2050 (which would come on top of nearly 1 percentage point increase due to aging that was projected under the 2011–13 reforms).

¹ However, retirement with full pension benefits continues to apply from age 65 for individuals with sufficiently long contributory history (e.g. at least 38.5 years of contributions by 2027).

4. Other measures included in phase one of the current reform only partly offset the increase pension spending. Additional measures are expected in the second phase of the pension reform in 2022, as committed in Spain’s recovery plan. Key recent measures include:²

- Some new measures have been introduced to narrow the gap between effective retirement age and the legal retirement age. Currently, about 40 percent of pensioners retire before the age of 65, and less than 25 percent delay retirement beyond such age. Airef estimates that increasing the effective age of retirement to the statutory age would result in about a 1½ percentage point reduction in expenditures as a share of GDP by 2050. However, it is generally not expected that the current measures would fully close the gap, so the above number is likely an upper bound.
- The reform also introduces a new mechanism (known as the intergenerational equity mechanism), composed of two elements. The first element is a temporary increase for a decade in social security contributions of about 0.6 percentage points to be accumulated in a reserve fund. A maximum of 0.2 percent of GDP per year could be withdrawn from the fund to cover pension expenses, starting in 2032 and for as long as the reserves last (estimated under 15 years). The second element is a contingent mechanism that requires further measures to be implemented if needed, starting in a about a decade. These measures are not specified and will need to be negotiated at the time with social partners.

Annex V. Table 1. Increase in Public Pension Spending to GDP Ratio by 2050 (in percentage points)		
	Airef 2020	Ageing Report 2021
Full Implementation of 2011&13 reforms	1	0.7
Elimination of sustainability factor	0.9	0.8
CPI indexation instead of IRP	2.3	2.7
Increase in effective retirement age to 67*	-1.6	
Policy linking retirement age to life expectancy		-1.1
Extending period for computing base from 25 to 35 yea	-0.6	
Source: IMF staff based on Airef 2020 and Aging Report 2021. Note: * Compared to 62.1 in 2019, and 64.1 projected from 2027 onwards under the central scenario. Estimations rest on different assumptions across the two reports. For instance, long-run CPI inflation (relevant for indexation) is taken at 1.8 percent by Airef 2020, and at 2 percent by the Ageing Report 2021. The intergenerational equity mechanism is not reflected in this table, as accumulated reserves are likely to be exhausted by 2050, and specific measures under the contingent mechanism are yet to be determined.		

² In addition, the reform redefines the expenditures that are to be financed from the general budget (such as non-contributory benefits) versus from the social security system. This measure does not have a direct impact on future spending pressures on a consolidated basis. Also, a “transparency rule” is introduced, by which any new future non-contributory policy executed by the Social Security will have to be agreed by the Ministry of Finance and funded accordingly.

5. The room for raising social security contributions or general taxes to fund the increase in pension payments is relatively limited.

- *In principle, the increase could be funded by raising social security statutory rates or eliminating ceilings on contributions.*³ However, the ability to do that may be constrained by the already relatively high contribution rates, and the potential negative consequences of higher labor costs for employment and productivity (Devesa and Domenech 2021, Hernandez de Cos 2021, IMF 2018). Social contributions do not apply to pensioners.
- *Alternatively, additional resources could be obtained by increasing general taxes, but there may be limited room to do so.*⁴ While Spain's tax-to-GDP ratio is currently relatively low compared with regional peers, the tax burden would likely have to rise to reduce Spain's sizable structural deficit. Moreover, aging pressures are expected to lead to higher spending on health and long-term care, which are funded from general resources. The Ageing Report 2021 estimates that age-related non-pension spending will increase by 1.5 percent of GDP by 2050.
- *A strategy that shifts the burden of funding large increases in pension spending to future generations may not be sustainable.* Absent expenditure restraint measures, the need for additional resources would be significant, increasing the risk that future generations cannot or choose not to deliver them (Conde-Ruiz and Gonzalez, 2021).⁵ This may lead to abrupt adjustments in pension generosity. Examples from Greece and Portugal illustrate that pensions can be cut by 20 to 30 percent in a short period of time if debt sustainability concerns intensify.

6. A mechanism for expenditure restraint would be necessary. A gradual, transparent, and predictable implementation of restraint measures is needed to give workers time to adapt.

- **System generosity.** The benefit ratio in Spain is one of the highest among European countries, mainly due to a relatively high replacement rate (i.e. initial public pension in relation to the last wage). Under the 2013 reform, which has now been repealed, the ratio would have gradually declined closer to the peer average due to indexation below CPI inflation and the implementation of the sustainability factor for future cohorts. Alternatively, the replacement rate could be lowered by increasing the number of contributory years taken into account when calculating the regulatory base for pensions, in line with the practice in most European peers.⁶ Airef (2020) estimates that extending the period from 25 to 35 years would reduce the pension spending-to-GDP ratio by 0.6 percentage points. Notional account systems, and sustainability

³ The complete elimination of the ceiling on contributions could yield additional resources between 0.4 and 0.8 percent of GDP (Hernandez de Cos, 2021).

⁴ Denmark, for instance, covers pension-related expenses with general taxation.

⁵ Pension contributions would need to increase by about one third by 2050 to match the projected increase in public pension spending (Ageing Report 2021).

⁶ Not taking into account the whole career is not a common practice among OECD countries (OECD, 2019).

factors are used in multiple European countries to adjust pension benefits to life expectancy and/or the system's sustainability.

Annex V. Table 2. Automatic Mechanisms			
	Balancing mechanism (indexation)	Benefit linked to life expectancy	Retirement age linked to life expectancy
CY			X
DE	X		
DK			X
FR		X	
FI		X	X
EL			X
EE			X
IT		X	X
LT	X		
LV		X	
NL	X		X
PL		X	
PT		X	X
PT		X	
SE	X	X	
NO		X	

Source: Ageing Report 2021, OECD 2019.
Note: Notional accounts systems are used in IT, LV, PL, SE and NO.

- **Retirement duration.** Further increases in the retirement age is another option to move towards sustainability. The statutory retirement will gradually increase to 67 years by 2027. However, people who will have contributed for at least 38.5 years will still be able to retire at age 65 with a full pension. It would be sensible for the system to keep up with increases in longevity. From 2030 to 2050, life expectancy is projected to increase by about two years (Airef 2020, Ageing Report 2021).

7. Expenditure restraint measures should seek to protect the most vulnerable. Long unemployment spells may lower the accumulation of pension entitlements. In contrast to employees, replacement rates for the self-employed are low compared to other countries (OECD 2021). Minimum pensions should be sufficient to cover basic needs. Increases in the statutory retirement age may disproportionately affect vulnerable groups with lower-than-average life expectancy. Therefore, ensuring fiscal sustainability should not rely solely on increases in the statutory retirement age.

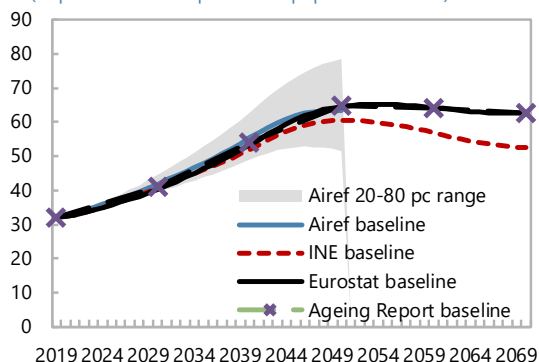
8. Complementary policies:

- Policies to promote higher employment and productivity would support pension sustainability.
- Longer working lives could be incentivized by promoting flexible working hours, part-time arrangements (while drawing partially on pension) and telework. With longer careers, access to lifetime learning opportunities could help mitigate human capital depreciation.
- Finally, it would be important to promote the role of private saving as a supplement to the public pension system. Participation in private voluntary pension schemes is low in Spain compared to the OECD average.

Annex V. Figure 1. Pension System Selected Indicators

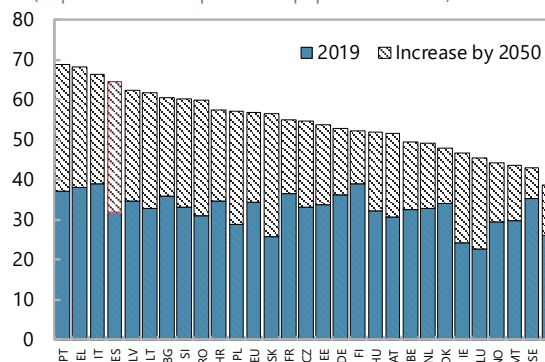
Old-Age Dependency Ratio: Spain

(Population 65+ in percent of population 20-64)



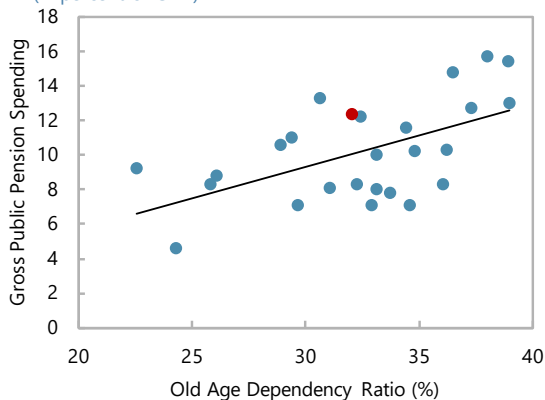
Old-Age Dependency Ratio: Cross-country

(Population 65+ in percent of population 20-64)



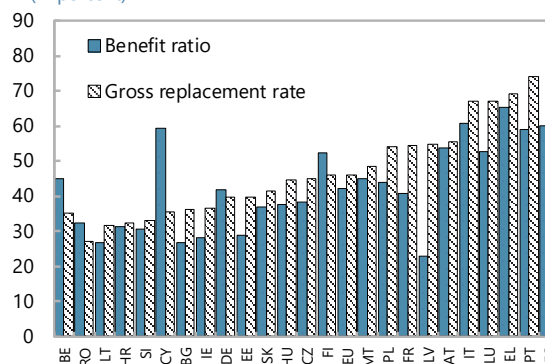
Public Pension Spending 2019

(in percent of GDP)



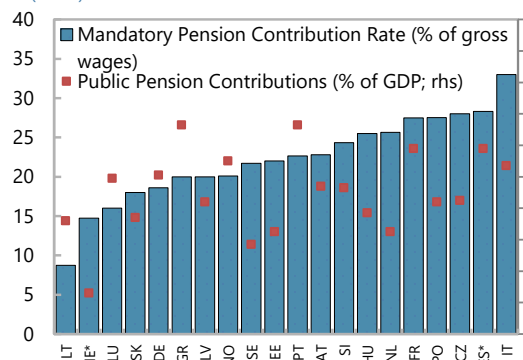
Public Pension Generosity: 2019

(in percent)



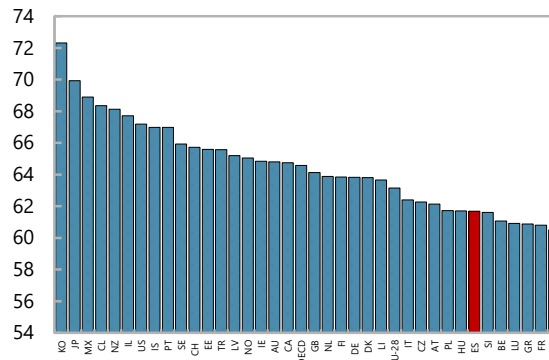
Pension Contributions

(2019)



Average Effective Age of Labor Market Exit

(2013-18)



Sources: Airef, Ageing Report 2021, Eurostat, INE, OECD, and IMF staff calculations.

Note: In chart 5, IE and ES refer to social security contributions. In Spain, contributions finance all schemes except for unemployment. In Austria, the Czech Rep., Germany, Iceland, Italy, Luxembourg, Poland, and Slovenia contribution rate also finances disability or invalidity benefits.

Annex VI. Non-Financial Corporate Sector Equity Shortfalls and Solvency Support Measures

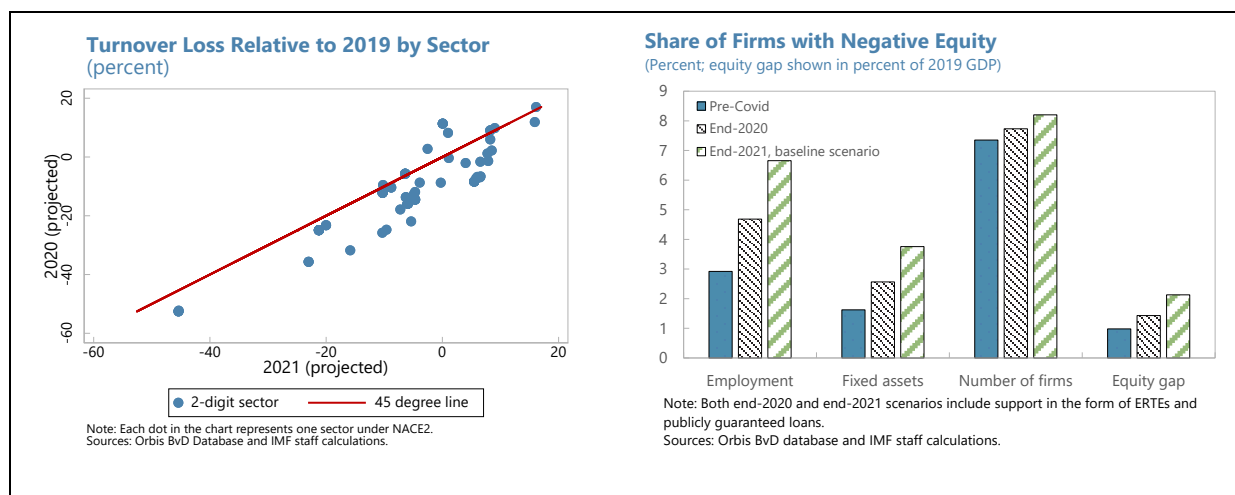
Non-financial corporates (NFC) in Spain have suffered severely from the COVID pandemic, particularly in sectors such as hospitality, entertainment, and automotive manufacturing. The governments' timely support measures have helped cushion the effect of the pandemic shock on corporate balance sheets. The roll-out of corporate solvency measures in 2021 is assessed to have mitigated NFC solvency risks.

- 1. The NFC sector in Spain entered the COVID crisis with stronger balance sheets than before the global financial crisis (GFC).** Prior to the pandemic, the corporate debt-to-GDP and debt service ratios had declined steadily since the GFC (Figure 5). This deleveraging was driven by both a decline in debt and an increase in equity liabilities, reflecting a shift in firms' financing structures towards equity which could serve as a better shock absorber during times of stress.
- 2. Firm-level data is used to assess Spain's corporate solvency risks two years into the pandemic.**¹ We use firm-level balance sheet data from the Orbis BvD database, which has a relatively good coverage of Spanish firms ([Ebeke et al.](#), [Gopinath et al.](#)). Data for 2021 is not yet available, but is simulated based on several assumptions. The starting point of the simulation is the 2018 or 2019 year-end balance sheets (depending on availability), which represent the corporates' financial health prior to the pandemic. Firm-specific turnover for 2020 is projected based on gross value-added data available at the sectoral level, and the turnover for 2021 is calibrated to staff's macro projections. The baseline scenario includes key support measures, including wage subsidies under the ERTes and the government-backed loan guarantees.² Solvency support measures are excluded from the baseline scenario, and are added in the simulation to quantify their impact. Importantly, the simulations are conducted using less data than were available to the authorities (e.g. tax data), so should be interpreted with caution.
- 3. The policy measures have helped support NFC balance sheets.** Based on the simulation exercise, corporate revenues are expected to have improved significantly in 2021, but to remain below their pre-crisis levels in many sectors. Under the baseline scenario (i.e. excluding solvency support measures but including ERTes and guarantees), the total equity gap widens from 1 percent of GDP in 2019³ to 2.1 percent in 2021, the share of firms with negative equity increases from 7.3 to 8.2 percent, and the increase in the total share of employment in those firms is even more pronounced.

¹ The methodology follows Ebeke and others, "Corporate Liquidity and Solvency in Europe during COVID-19: The Role of Policies," IMF Working Paper No. 2021/056.

² The government-backed loans are assumed to be equity-neutral, but interest payments associated with these loans would require payments using firms' cash inflows, resulting in a worsening of their equity positions.

³ In an independent study conducted by the government using internal data from the tax collection agency (AEAT), the widening of the equity gap by end-2021 was estimated to be 1.6 percent of 2019 GDP, slightly larger than our estimate. Firms which already had negative equity before the crisis accounted for half of the widening of the equity gap.



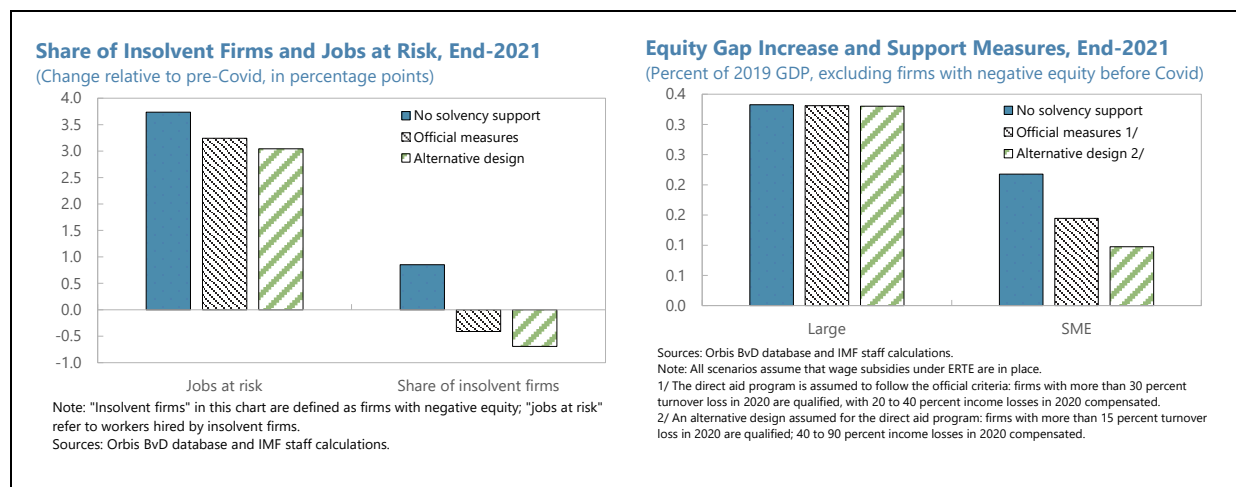
4. Several corporate solvency support measures were rolled out in 2021. The measures included: (i) a €7 billion fund providing direct aid to severely affected companies; (ii) a recapitalization fund of €1 billion for pandemic-affected companies, with a focus on medium-sized enterprises; and (iii) a €3 billion fund for bank restructuring of loans with a public guarantee, together with a range of other tools. The overall envelope of the programs (about one percentage point of GDP) is broadly in line with staff's estimates of the increase in the equity gap, although the actual impact will depend on how well the support is targeted to viable firms.

5. The direct aid package is added to the simulation to gauge its impact on corporate balance sheets. The initial design of the direct aid package restricted eligibility to firms that experienced more than 30 percent turnover loss in 2020 in certain sectors. The package covers 20 to 40 percent of the lost income for each eligible firm, depending on firm size, with a maximum limit of €3,000 for sole proprietors and €20,000 for others. The regional authorities had flexibility to modify some criteria (such as sectors to be included or treatment of non-recurrent losses in 2019). Both the initial design and an alternative design of the package (which does not reflect the diversity of actual criteria applied at the regional level) are simulated. The alternative scenario assumes that firms with a turnover loss of more than 15 percent in 2020 are eligible for getting direct aid from the government, and that compensation varies from 40 percent to 90 percent of the lost income depending on firm size.

6. The simulation suggests that the direct aid package has helped reduce debt overhang. The share of firms with negative equity falls significantly, which would in turn alleviate potential pressures on the commercial court system. Based on the initial design, the package is also estimated to have a significant positive impact on SME solvency, with about 30 percent of the total SME equity gap closed after the disbursement of funds.⁴ With strict application of the eligibility requirements,

⁴ The Orbis BvD database does not include the self-employed, who would take up about 20 percent of the direct aid fund according to the government's simulation. Another caveat of the simulation is that we assume the percent turnover loss for each firm is equal to the sectoral level turnover loss. Since the actual firm-level turnover for 2020 is available to the authorities, the distribution of the funds could have been more efficient than estimated in staff's simulation.

only 50 percent of the available funds would have been allocated. The assumed alternative design, with broader eligibility criteria, offsets more than half of the increase in the SME equity gap, while exhausting all available funds. However, it might also increase deadweight losses without significantly improving corporate solvency.⁵ In case further support to the NFC sector is needed in the future, indicators of firms’ financial health, such as the leverage ratio, could be used to target funds better. Moreover, the authorities should leverage the expertise of financial institutions to select viable firms. Large companies, which were not the main target of the direct aid facility, account for about 30 percent of the worsening in the equity gap. The use of the solvency support for large firms has been limited so far, possibly because they have the option to raise private equity as an alternative to public support.



⁵ For example, firms that are not expected to end up with negative equity could be eligible for the support.

Annex VII. 2021 Labor Market Reform

A new labor reform was agreed in December 2021 following a difficult negotiation between the government, unions, and firms. The reform aims to address duality and to adjust firms' internal flexibility mechanisms and the collective bargaining process, while striking a balance between flexibility and worker protection. It reverses some of the elements of the 2012 reform.

- 1. Past labor reforms were ambitious and successful in many respects, but challenges remained.** The 2012 labor reform included measures to enhance labor market efficiency such as reducing the gap in firing costs between permanent and temporary workers, giving priority to firm-level over regional- or sector-level agreements, and limiting the automatic extension of expired collective agreements to a maximum of one year. While successful in many dimensions, the 2012 reform did not fully address long-standing structural weaknesses in the labor market. The excessive use of temporary contracts continued (due to a remaining significant gap in firing costs between temporary and permanent contracts), and allegedly there were cases when firms set wages too low without an economic justification.
- 2. A new labor reform was agreed in December 2021, based on an agreement among all social partners.** The reform was one of the milestones of the recovery plan agreed with the European Commission, and its approval will unlock the next tranche of NGEU funds to be disbursed in 2022. It includes changes in four areas: simplification of contracts, modernization of subcontracting regulations, changes in collective bargaining, and expansion of firms' internal flexibility mechanisms. A royal decree law established the main elements of the reform, but some operational details have not been defined yet.
- 3. Simplification of contracts.** The reform aims to restrict the use of temporary contracts by limiting the set of circumstances which warrant their use, strengthening enforcement and imposing higher penalties on very short durations and fraudulent contracting. The new regulation also promotes the use of seasonal open-ended contracts ("fixed-discontinuous") for activities that are seasonal in nature (e.g., agriculture or retail around holidays) and creates a new permanent contract for the construction sector. Furthermore, the reform introduces new training contracts, establishing a stronger link with the education and vocational training systems, to facilitate the insertion of the young population in the labor market. Companies will have a transition period of three months to adapt their existing contracts to the new legislation (up to 6 months in some types of contracts).
- 4. Subcontracting.** To provide more protection to subcontracted workers and improve their working conditions, subcontracting will now be subject to the sectoral agreements, with firm-level agreements applying only if they provide better conditions than the sectoral agreement.
- 5. Collective bargaining.** The 2021 reform reverts, at least partially, two flexibility elements that had been introduced by the 2012 reform. First, it restores the priority of sectoral agreements over firm agreements on wages. Firms will retain flexibility on other aspects of the working relationship, as firm-level agreements will prevail over sectoral agreements regarding working time,

professional classification, type of contract, and measures to achieve work-life balance. Second, the new decree-law reinstates the indefinite extension of an expired collective agreement if a new agreement is not reached (“ultra-activity”); extensions had been limited to one year by the 2012 reform. These changes will only be applicable to new agreements. Other flexibility elements that had been introduced by the 2012 reform remain unaffected. For instance, firms will preserve their ability to unilaterally modify working conditions due to economic, technical, organizational, or productive causes. Firms can also negotiate with the unions an opt-out from sectoral agreements.

6. Internal flexibility mechanisms. The reform codifies enhancements to the existing short-time work scheme (ERTE) and introduces a new and more generous scheme (called “RED”), aimed at enhancing firms’ internal flexibility and employment stability. The authorities believe that the use of the two schemes will reduce the probability of entering unemployment.

- *ERTE.* There are two modalities of ERTE: ETOP (due to economic, technical, organizational, and productive causes) and force majeure. The reform eases administrative procedures and makes the scheme more flexible, particularly for small firms. The main innovations to the scheme include: (i) easier activation, as well as simplified and automated management; (ii) the possibility of adding/removing workers from ERTE dynamically based on the company’s level of activity; (iii) social security exemptions for firms: 20 percent in the case of the ERTE ETOP, subject to the provision of training for ERTE workers; 90 percent in the case of ERTE due to force majeure; and (iv) additional financing for training activities, with the benefit varying with the size of the company.
- *RED Mechanism.* Activation of the new short-time work scheme must be authorized by the Council of Ministers. There are two modalities depending on the nature of the shock: cyclical or sectoral. The cyclical RED is meant to respond to general economic fluctuations (as opposed to idiosyncratic shocks, for which the traditional ERTE apply). The maximum duration is 12 months. It provides discounts to social security contributions for firms, which decline over time (60 percent in the first four months, 30 percent in the next four months, 20 percent in the last four months). The sectoral RED is meant to support firm adjustment and reallocation of workers in sectors experiencing structural changes. The duration is initially set at 12 months, but employers can request up to two extensions of 6 months each. The firms also receive discounts to social security contributions (40 percent), conditional on providing training for the workers under the scheme. The government will provide financing to cover training activities associated with the RED, which varies with the company size. The expectation is that affected workers would eventually move to a different company/sector. To facilitate such moves, companies that hire workers on the sectoral RED would receive a 50 percent discount in social security contributions for six months. A special fund would be established to finance the RED mechanism (financed by social security contributions to unemployment, other budget allocations, and EU funds).



SPAIN

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

January 26, 2022

Prepared By

European Department

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FUND RELATIONS

(As of December 31, 2021)

Membership Status: Joined September 15, 1958.

General Resources Account:	SDR Million	Percent of Quota
Quota	9,535.50	100.00
Fund holdings of currency	7,134.81	74.82
Reserve position in Fund	2,400.79	25.18
Lending to the Fund		
New Arrangements to Borrow	80.39	

SDR Department:	SDR Million	Percent of Allocation
Net cumulative allocation	11,966.91	100.00
Holdings	11,861.26	99.12

Outstanding Purchases and Loans: None

Latest Financial Arrangements: None

Projected Payments to Fund

(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2022	2023	2024	2025	2026
Principal					
Charges/Interest	0.28	0.28	0.28	0.28	0.28
Total	0.28	0.28	0.28	0.28	0.28

2021 Article IV Consultation: Pablo Moreno (Alternate Executive Director) and Rosa Moral (Advisor to the Executive Director) attended some of the meetings. Jai-Ryung (Jenny) Lee and Dilcia Noren (EUR) supported the mission from headquarters. The mission met with First Vice-President Nadia Calviño, Banco de España Governor Pablo Hernández de Cos, Secretary of State for the Economy and Business Support Gonzalo García Andrés, Secretary General of the Treasury Carlos Cuerpo, and other senior officials. The mission also talked with representatives of the financial sector, labor organizations, think tanks, and political parties. The concluding statement was published December 22, 2021, and the staff report is expected to be published as well. Spain is on a standard 12-month cycle. The last Article IV consultation was concluded on November 13, 2020 (IMF Country Report No. 20/298).

Financial Sector Assessment Program (FSAP): An FSAP Update was conducted between October 2016 and July 2017 and included several missions. The 2017 Financial Sector Stability

Assessment (FSSA) was discussed by the IMF Board in conjunction with the 2017 Article IV consultation and published (Country Report No. 17/321).

Exchange Rate Arrangement: Spain's currency is the euro. The exchange rate arrangement of the euro area is free floating. Spain participates in a currency union (EMU) with 18 other members of the EU and has no separate legal tender. The euro, the common currency, floats freely and independently against other currencies. Spain has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange rate system free of multiple currency practices and restrictions on payments and transfers for current international transactions, other than restrictions notified to the Fund under Decision No. 144 (52/51).

STATISTICAL ISSUES

(As of December 31, 2021)

I. Assessment of Data Adequacy for Surveillance	
General: Data provision is adequate for surveillance.	
II. Data Standards and Quality	
Subscriber to the Fund's Special Data Dissemination Standard (SDDS) since September 1996. In 2015, Spain subscribed to SDDS Plus, together with the first group of adherents.	No data ROSC available.

Table 1. Common Indicators Required for Surveillance
(As of December 31, 2021)

	Date of latest observation	Date received	Frequency of Data ⁷	Frequency of Reporting ⁷	Frequency of Publication ⁷	Memo Items:	
						Data Quality – Methodological soundness ⁸	Data Quality – Accuracy and reliability ⁹
Exchange Rates	December 2021	December 2021	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	November 2021	December 2021	M	M	M		
Reserve/Base Money	November 2021	December 2021	M	M	M	O,O,LO,LO	O,O,O,O,LO
Broad Money	November 2021	December 2021	M	M	M		
Central Bank Balance Sheet	November 2021	December 2021	M	M	M		
Consolidated Balance Sheet of the Banking System	November 2021	December 2021	M	M	M		
Interest Rates ²	December 2021	December 2021	D	D	D		
Consumer Price Index	November 2021	December 2021	M	M	M	O,O,O,O	LO,O,LO,O,O
Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴	Q3 2021	December 2021	Q	Q	Q	LO,O,LO,O	LO,O,O,O,LO
Revenue, Expenditure, Balance and Composition of Financing ³ – Central Government	October 2021	December 2021	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt ⁵	November 2021	December 2021	M	M	M		
External Current Account Balance	October 2021	December 2021	M	M	M	O,LO,LO,O	LO,O,LO,O,LO
Exports and Imports of Goods and Services	October 2021	December 2021	M	M	M		
GDP/GNP	Q3 2021	December 2021	Q	Q	Q	O,O,O,O	LO,LO,O,O,O
Gross External Debt	Q3 2021	December 2021	Q	Q	Q		
International Investment position ⁶	Q3 2021	December 2021	Q	Q	Q		

¹ Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

² Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

³ Foreign, domestic bank, and domestic nonbank financing.

⁴ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

⁵ Including currency and maturity composition.

⁶ Includes external gross financial asset and liability positions vis a vis nonresidents.

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

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

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

**Statement by Pablo Moreno, Executive Director for Spain, Fernando Lopez and
Rosa Moral Betere, Advisors to the Executive Director
February 14, 2022**

Staff has provided a very useful analysis on the short and medium-term economic challenges. On behalf of the Spanish authorities, we thank staff for the very constructive dialogue and well-focused analysis, which usefully takes into account the still uncertain economic context and pays special attention to the longer-term objective of fostering a sustainable recovery. We welcome the smooth transition to the new mission team, which has very quickly engaged in insightful Article IV consultations. The authorities generally share staff's assessment. We will focus our comments on the outlook and main policy areas.

Economic outlook

The economy is undergoing a sustained recovery helped by a forceful policy response and a successful vaccination campaign. Spain was particularly hit by the pandemic due to strict lockdown measures and idiosyncratic factors, including a relatively high weight of contact-intensive sectors in its economy. The recovery, which started in the second half of 2020, followed an irregular pattern in line with the successive waves of the virus and regained momentum in the second half of 2021, leading to more solid and sustained growth prospects for 2022. The broad and sizeable policy support and the activation of strong automatic stabilizers have helped cushion the economic and social impact of the pandemic and fostered a gradual recovery. Notably, the short-time work scheme (ERTE) has been a key mechanism to protect employment and workers' incomes, while the public-guaranteed loan program (with take-up rates of around 74 percent, among the highest of similar programs in other countries) and the direct aid measures have helped cushion the impact of the crisis on businesses. Spain is among the top-ranked countries in COVID-19 vaccination with 91 percent of the target population fully vaccinated at the end of January 2022. This high rate of vaccination has facilitated the progressive normalization of economic activity. In parallel, it is also a leading country in vaccine donations, with more than 50 million doses donated (more than one dose per citizen), of which more than half have already been delivered to recipient countries.

The extraordinary rebound in the labor market is a salient feature of the recovery. In contrast with previous crises, employment has recouped much faster during the recovery, with a broad expansion for all worker groups, including the youth and low-skilled ones. More than 840,000 jobs were created in 2021 –a record since 2005 and contributing to more than a third of the Eurozone jobs created in 2021–, with the unemployment rate at 13.3 percent, the lowest level since the beginning of the global financial crisis. Additionally, the number of workers in ERTE continues to decrease at a good pace being now at around 100,000 people (down from more than 900,000 at the end of 2020). The scarring effect is milder than previously expected as employment is already above pre-crisis levels and many sectors have recovered their pre-pandemic activity levels, whereas GDP is expected to reach those levels in the second half of 2022. This decoupling between labor and output growth, together with the large increase observed in fiscal revenues, suggests a high degree of uncertainty and volatility around growth assumptions, which calls for a cautious approach to the revision of forecasts.

A strong recovery is expected in 2022, while uncertainty and downward risks remain. The main source of uncertainty continues to be the pandemic, although the better adaptation observed during the successive waves is limiting its impact on activity. In this respect, the economy has already recovered pre-pandemic levels of daily activity and Omicron is only marginally impacting the higher-frequency indicators (as reflected in a Q4 growth rate of 2 percent, QoQ). Other sources of uncertainty include inflationary pressures and the persistence of global supply-chain bottlenecks. Inflation expectations remain anchored at around 2 percent, and the main drivers of the CPI increase appear to be temporary, including base effects, supply-side bottlenecks, and energy prices. Importantly, there are no signs of second-round effects as a result of a still notable degree of slack in the labor market. The authorities are closely monitoring the different pass-through channels on inflation, especially those related to higher energy prices, while at the same time implementing measures to mitigate their impact on retail prices and on the more vulnerable households. These include a temporary reduction of the charges and taxes in the energy bill, or adjustments in the wholesale electricity market.

Fiscal Policy

In the short-term, fiscal policy will remain supportive, calibrated to recovery needs, and with a continued significant downward trajectory in the deficit and the debt ratio. The key support measures have been extended into 2022, and they have been recalibrated to target the most affected sectors. These measures include the ERTE (extended until the end of February) and the state-backed loan guarantee program (until June). The latest indicators suggest that the deficit for 2021 will be reduced below the official forecast of 8.4 percent of GDP, already 1.7 percent points below the 2020 figure. This dynamic has benefitted from a better-than-expected performance of revenues in line with the improved economic activity –according to the latest figures, they would have increased by 15.1 percent in 2021 compared to 2020 (5 percent with respect to 2019, before activity was affected by the pandemic)– while the impact of new taxes (e.g., taxation on financial and digital services) has been offset by fiscal exemptions on electricity or sanitary products. The 2022 budget foresees a further reduction in the deficit down to 5.0 percent of GDP, in line with domestic and international analysts’ and institutions’ forecasts. Expenditures are expected to fall by 4.2 percent thanks to the deactivation of automatic stabilizers and the phasing-out of temporary emergency measures, which also opens up room to accommodate record levels of social spending –including the boosting of scholarships, dependency benefits, access to housing, and an update of the Minimum Vital Income– as well as record spending on R&D&I. Revenues are expected to increase by more than 16 percent, favored by the access to EU funds, the reversal of temporary easing measures, and those taking effect in 2022 that will improve progressivity and expand the tax bases (e.g. rate increases on the highest incomes, and a limitation of exemptions for double taxation on dividends and capital gains) whose impact will be partly felt in 2022. The debt-to-GDP ratio already declined in 2021 and it is expected to fall by a further 4 percentage points to 115.1 percent in 2022, helped by lower financing needs and the recovery of the economy.

The authorities remain firmly committed to a medium-term consolidation strategy. Notwithstanding the activation of the escape clause of the EU Stability and Growth Pact (SGP), the authorities have maintained the commitment to budgetary stability and debt sustainability in the 2021-2024 Stability Program Update, which projects an ambitious reduction of the deficit by 5.2 percentage points down to 3.2 percent of GDP in 2024. The debt to GDP ratio is expected to continue its decline, reaching 112.1 percent of GDP in 2024, while the more favorable

composition of the debt portfolio –with an average maturity of 8 years and record-low cost at issuance of -0.04 percent for 2021– will help cushion the impact of the potential normalization of monetary conditions, guaranteeing medium and long-term financial sustainability. Going forward, Spain supports reaching a broad-based consensus at the European level on the reform of the EU economic governance framework. Spain considers that it is necessary to strengthen public finances in the long-term with a realistic and pragmatic fiscal framework. Deficit and debt reduction paths should be adapted to each country’s situation, and support growth, good quality job creation, and the necessary investment effort to support the green and digital transitions.

Additional reforms are in the pipeline to structurally improve the budget both on the revenue and expenditure sides. The authorities are working on a comprehensive review of the tax structure and the public transfers system to enhance fiscal progressivity, efficiency and revenue collection capacity, and to also better target spending. This process will be data-driven and informed by the regular spending and revenue reviews conducted by the independent fiscal authority. Last April, the government commissioned a Group of Experts to produce a report on a tax system reform guided by the overarching principles of fiscal consolidation, legal certainty, simplification, modernization, and strengthening under-taxed areas. The government aims to implement the necessary reforms in a timely manner to avoid compromising the recovery –the Group of Experts will publish its conclusions in February 2022. Additionally, the authorities are fully committed to the implementation of the agreement on international taxation.

The authorities are undertaking a broad reform of the pension system. In line with the ample social and political consensus, the recently adopted first phase of the pension reform has approved the indexation of pensions to CPI inflation to protect their purchasing power. The government has also approved offsetting measures to reduce pension spending, such as those aimed at narrowing the gap between the effective and legal retirement age, the rationalization of the financing structure of contributory and non-contributory pensions, and a new intergenerational equity mechanism to mitigate the impact of future increases in pension spending. The latter includes an increase in contributions, starting in 2023, and foresees a contingent mechanism to correct potential deviations from the expected pension spending path beyond 2032, if needed. The authorities are also discussing with social partners the second phase of the reform –to be approved during 2022– to underpin the sustainability of the system, including measures to ensure the adequacy of the social security contributions (adapting ceilings and expanding the contributory period considered to calculate the regulatory base), and the promotion of complementary workplace pension systems.

The financial sector

Despite the severity of the crisis, the banking sector remains sound and risks are balanced. The ample policy support and the efficiency of the banking institutions have facilitated a rapid and ample deployment of supportive policy measures, especially the public loan-guarantee program, which thereby has helped maintain supportive financial conditions. No significant increase in NPLs ratios has been recorded and the latest stress-test exercises indicate that Spanish banks are adequately capitalized, while provisions remain at comfortable levels. Financial support measures to firms and households only affect 13 percent of the banks’ credit exposures, thereby with a potentially limited impact on total NPLs ratios once they are fully reversed. Going forward, the main risks relate to a deterioration of the economic outlook and the potential tightening of financial conditions. However, these risks are mitigated by a limited exposure of banks to capital markets and the large share of mortgages in direct lending (mortgages

traditionally show lower default rates and credit standards are high, as 90 percent of the banks' mortgagees present LTV ratios below 80 percent). Additionally, there are no signs of overheating in the real estate sector, where prices are aligned with fundamentals and banks' lending standards remain stable.

The authorities have introduced several preemptive regulatory measures that limit cliff effects and reinforce the institutional framework. Following a cautious approach and given the current context of high uncertainty, new measures have been approved, including: (i) the extension of grace periods and maturity of loans, the introduction of debt-to-equity swaps and partial write-offs under specific conditions in the public loan guarantees program (all these measures under the umbrella of a Code of Conduct with the banking sector); (ii) an extension of the macroprudential toolkit for the banking sector, including a sectoral countercyclical capital buffer, the introduction of relative concentration limits in specific portfolios or sectors, and new borrower-based measures in the supply of credits to households and firms; and (iii) the revision of the insolvency and bankruptcy framework, which is expected by mid-2022, to make it more efficient and promote the use of out-of-court procedures –the draft Insolvency Law is aligned with the EU framework and includes elements to facilitate the early restructuring of viable companies, with possible debt restructuring and fast track processes, especially for microenterprises.

Structural reforms

The strong reform momentum, anchored in the dialogue with social partners, has been further boosted by the sizeable support of Next Generation EU (NGEU). The COVID-19 crisis has made the government's objectives set in January 2020 even more relevant: increasing potential growth, ensuring fiscal sustainability, lowering unemployment, improving the quality of jobs, enhancing social and environmental sustainability, and fostering gender equality. In 2021, the authorities approved a large number of reforms, reaching all planned milestones and targets, notably the Climate Change and Energy Transition Law, the National Plan on R&D&I, the labor market reform, and the implementation of different digitalization plans under Digital Spain 2025. Moving forward, the Recovery and Resilience Plan (RRP) sets a medium-term reform strategy supported by sizeable NGEU funds, which can mobilize up to EUR 140 billion in public investments and social development plans, with the complementary goal of catalyzing up to EUR 500 billion in private investments. The RRP is structured around four axes –green, digital, social and territorial cohesion, and gender equality– and 85 percent of the funds will be materialized in investment projects and capital transfers. Moreover, Spain has already launched a series of strategic projects for the recovery and economic transformation, so-called PERTE, including three projects in 2021 on Electric and Connected Vehicle, Vanguard Health, and Renewable Hydrogen and Energy Storage, as well as a PERTE on the agri-food sector in 2022. Three other PERTE are already in the pipeline on New Language Economy, the aerospace industry, and the New Care Economy. The European Commission already approved a first disbursement of EUR 10 billion in December 2021 (the first such approval at the EU level), and the authorities are planning to deploy up to EUR 28 billion of investments in 2022. As a policy priority, the authorities have reinforced the governance mechanisms for NGEU funds involving all public administrations. The ordinary budgetary control mechanisms have been strengthened with a three-tier structure that comprises the General Comptroller of the State Administration, the Ministry of Finance, as well as the National Anti-Fraud Coordination Service.

The 2021 labor market reform marks a milestone in addressing its longstanding structural weaknesses. It addresses the high incidence of temporary contracts, precariousness, and low productivity, and moves the Spanish labor market towards the European model of flexi-security with measures that foster the protection of employment over the cycle, training and upskilling, and internal flexibility. Importantly, the reform has been based on a broad social dialogue, agreed with all social partners, anchoring its ownership. It includes a wide range of measures in four main areas:

(i) The simplification of types of contracts in the labor market and the introduction of better incentives for the use of open-ended contracts as a means to reduce the share of temporary ones, and thereby facilitate human capital accumulation and productivity gains. Measures include the limitation of circumstances under which temporary contracts may be used, while reducing their maximum duration, and the promotion of permanent-discontinuous contracts for seasonal activities as well as more flexible training contracts.

(ii) A new employment flexibility and stabilization mechanism (RED) to reduce the procyclicality of employment. The reform includes a simplification of the ERTE modality that has been so successful during the pandemic, and the introduction of a new permanent and closely monitored RED mechanism to reduce the historically intense destruction of employment in contractionary phases of the cycle and to facilitate transitions during sector-specific structural changes. Measures include a temporary wage substitution payment, exemptions from social security contributions, and, importantly, the training and re-skilling of workers, to encourage cross-firm and cross-sector mobility. This new framework will be complemented with new measures to reinforce ALMPs, including under the new Spanish Employment Activation Strategy 2021-2024 approved in December 2021, and the new Employment Law, which is expected to be approved by the end of 2022. Importantly, the authorities estimate that RED will have a positive impact on public finances as it will reduce the costs of cyclical fluctuations and sectoral adjustments in terms of unemployment benefits and loss of employability.

(iii) A reform of the collective bargaining framework, including the reintroduction of the ultra-activity clause, i.e., the automatic extension of a collective agreement until a new one is reached –a clause already included in 2/3 of existing agreements– and the prevalence of the sectoral collective agreement on wage-related clauses, while maintaining the priority of company level agreements for the rest of the labor conditions.

(iv) Updating the regulation on sub-contracting activities with the aim of addressing labor precariousness, including through the application of sectoral collective agreements, unless the outsourcing company has its own collective agreement.

The Spanish authorities are strongly committed to an ambitious climate change agenda, including the goal of reaching carbon neutrality by 2050. The climate change strategy – specified in the Agenda 2030 and encompassed in the EU Energy and Climate Framework– constitutes a multilayered and holistic agenda aligned with the European targets. It involves carbon pricing, promotion of green investments, incentives for an economy-wide transformation of the production model and consumption habits, and addressing the distributional consequences of decarbonization. The strategy is instrumented through a governance framework that includes the setting up of planning, budgetary, and reporting standards, both for public administrations and the private sector. The key elements of the climate policy include an in-depth review of environmental taxation, a heightened focus on the three sectors –transport, building, and energy–

with the highest potential impact on climate mitigation, and the leveraging on NGEU funds, 40 percent of which will be dedicated to climate change policies. Implementation is progressing at a good pace in many areas, including, among other measures: on carbon pricing, a significant increase of prices within the EU Emissions Trading Scheme framework (ETS); the closure of the coal industry; the creation of a new auction scheme for new renewable capacity in the power market; and measures to guarantee the financial sustainability of the electric system. This strategy is already producing positive results: (i) Spain has lower per capita emissions than the European average (7.1 tCO₂e in Spain vs. 8.4 tCO₂e in EU27, according to Eurostat, 2019); (ii) emissions have fallen almost 40 percent compared to 2005, according to 2020 GHG inventory reported data; and (iii) renewable capacity in the electricity sector reached a record share of almost 50 percent in 2021.