Summary for non-specialists
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Spain – Post Programme Surveillance

Spring 2014 Report

The European Commission published the first post-programme surveillance (PPS)[1] report following Spain's exit from the Financial Assistance Programme in January 2014. The report is based on the findings of the mission to Madrid on 24-28 March and on 3 April 2014 by a staff team from the European Commission (EC), in liaison with staff from the European Central Bank (ECB). The European Stability Mechanism (ESM) participated in the meetings on aspects related to its own Early Warning System.

The report finds that the positive trends of policy progress, ongoing economic adjustment and diminishing financial stress that formed the basis for Spain's programme exit have continued, although important challenges to sustained economic and employment growth, public finances and the banking sector still remain. This assessment is consistent with the conclusions of the Commission's 2014 in-depth review under the macroeconomic imbalances procedure that vulnerabilities are still present and continue requiring specific monitoring and decisive policy action.

The correction of macroeconomic imbalances has continued, supporting a return to positive economic growth and prospects of a stabilisation in the labour market. The recovery is firming, as exports remain robust and domestic demand stops being a drag on growth amid rising confidence, easing financial conditions and a pick-up in employment. Inflation is expected to stay low as the internal adjustment of prices, supporting the redirection of resources towards the tradable sector and international competitiveness, continues. However, still high stocks of private and public debt and of external debt continue to pose risks for sustained growth and financial stability. Spain will have to continue on the economic adjustment path for quite some time to free itself from the burden of existing imbalances and reduce unemployment from the current alarming levels.

The budget deficit was 6.6%[2] of GDP in 2013, marginally above the deficit target, confirming that fiscal consolidation continued last year. Given the improved economic outlook, the 2014 deficit target should be well within reach with rigorous budgetary execution. However, reaching the deficit targets in 2015 and 2016 will still require considerable additional discretionary efforts on top of the support coming from positive GDP growth. In order to bring public debt back on a downward path, there would be merit in exploiting positive growth surprises to accelerate deficit reduction. Several measures have been adopted to strengthen further public finance management, including pension reforms, curbing health-care expenditures and tackling arrears in public administrations. Spain's Independent Fiscal Institution (AIREF) is gradually becoming operational, although later than originally planned. Finally, an independent expert committee submitted detailed proposals to simplify the tax system and increase its growth-friendliness.

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[1] PPS aims at a broad monitoring of the repayment capacity of a country having received financial assistance. There is no policy conditionality under PPS, although the Council can issue recommendations for corrective actions if necessary and where appropriate. PPS is biannual in terms of reporting and missions.

[2] This figure excludes capital transfers related to support to banks of about 0.5% of GDP.

Spanish financial markets have continued to stabilise and banks' liquidity situation and financing structure to strengthen. Sovereign risk premia have declined significantly (the 10-year bond yield spread over Germany was around 160 basis points in early April) and yields are at historical lows. Banks are shifting towards more stable funding, such as deposits, and rely less on borrowing from the Eurosystem. Their overall cost of funding has declined. This turnaround in financial markets is gradually feeding into some improvement in lending conditions and volumes to the private sector. However, the transmission to interest rates for small loans (a proxy for SME loans) is very gradual, and these loans remain relatively onerous.

The banking sector returned in 2013 to profitability, also due to one-off factors, but bank profitability remains under pressure. Solvency ratios have increased, also supported by a significant accounting impact for some institutions of amendments to the tax code regarding deferred tax assets. The supervisor continues to monitor banks' efforts to keep and reinforce, where needed, capital ratios amidst current regulatory and supervisory challenges. Robust capitalisation is essential in the context of an evolving regulatory and supervisory landscape – namely the new solvency regulation and the ongoing ECB comprehensive assessment. The restructuring of banks having received State aid is well underway, with burden-sharing exercises completed, although litigation is still ongoing. Measures to strengthen the regulatory and supervisory framework and to develop non-bank sources of finance have advanced. Sareb's[3] challenge of divesting its large asset portfolio while maximising value also remains significant, as indicated by the latest revision of its strategic business plan which includes important changes to its strategy and expected financial results based on improved knowledge of the portfolio of assets received.

Reabsorbing the large number of unemployed requires fully implementing, closely monitoring and, where needed, further strengthening the structural reform agenda. Large long-term unemployment and skills mismatches complicate the challenge of reducing unemployment substantially in the medium term, while ongoing reforms of active labour market policies are still to be completed and to deliver effects. Progress with product market reforms continues, although with some delays. The March revision of the corporate pre-insolvency framework to facilitate debt restructuring has the potential to avoid unnecessary bankruptcies and speed up corporate deleveraging. Conversely, the law on professional services and associations keeps being delayed. The complex implementation of the market unity law will continue to demand intense attention.

[3] **S**ociedad de Gestión de **A**ctivos Procedentes de la **Re**estructuración **B**ancaria S.A., the Spanish asset management company, http://www.sareb.es.