Summary for non-specialists
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Spain – Post Programme Surveillance

Autumn 2014 Report

The European Commission (EC) published the second post-programme surveillance (PPS) report following Spain's exit from the financial assistance programme in January 2014. The report provides an assessment of Spain's economic, fiscal and financial situation and is based on the findings of the mission to Madrid on 6-10 October by staff team from the 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 covers also the specific monitoring of policy progress by the Commission in the context of the Macroeconomic Imbalances Procedure (MIP).

Overall, recent economic and financial developments confirm the positive trends of stabilisation observed over the last two years. These trends have been supported by reforms carried out by the Spanish authorities, successful financial sector restructuring and fiscal consolidation, as well as by favourable developments in global financial markets. Yet, it will be important to remain vigilant, as the large imbalances from the pre-crisis period and challenges in the labour market and beyond are still substantial and some important reforms are not yet completed. Achieving sustainable economic and employment growth while completing the adjustment of imbalances and preserving social cohesion pose a considerable challenge, requiring implementation of the reform agenda advised in the country specific recommendations (CSRs) adopted by the Council in July 2014. Commitment of of both the central and regional government remains essential to the success of many reforms and to the correction of the high budget deficit.

The Spanish economy has been recovering in 2014 and is expected to continue growing at a faster pace than the euro area average. The European Commission Autumn Forecast projects gross domestic product (GDP) growth of 1.2% in 2014 and of 1.7% in 2015. Growth has been supported by a rise in domestic demand, while the balance of trade has deteriorated as a result of a slowdown in exports and higher imports. In 2013, Spain had a current account surplus (mainly reflecting a trade surplus) of 1.5% of GDP, the first in many years, but the surplus is likely to shrink in 2014. Domestic consumption and investment in equipment are supported by growing confidence, employment creation, recovered competitiveness, easier conditions of access to finance, and low inflation. Unemployment is declining but the unemployment rate is still very high at nearly 24% and there are many long-term and young unemployed. There is also a significant difference in employment conditions between indefinite and temporary contracts. Inflation is below the euro area average and expected to stay low as a result of developments in commodity prices and remaining unused capacity in the economy.

Debt reduction is advancing but still high stocks of private, public and external debt continue to pose risks to sustained growth and a challenge to the financial sector. The total stock of private sector debt in the second quarter of 2014 was some 36.5% of GDP lower than the peak reached in 2010, but still amounted to 182% of GDP. Public sector debt is still increasing, although the government expects it to peak in 2015 at slightly above 100% of GDP provided that the budget

deficit targets are met. The deterioration in external trade limits the prospects of rapidly reducing the high net debt of the Spanish state and its residents towards the rest of the world (-93% of GDP at the end of 2013).

The 2014 budget deficit target of 5.5% of GDP appears within reach, but the deficit still needs to be cut substantially in 2015 and 2016. Deficit reduction is being helped by the improving economy. In spite of that, the Commission's 2014 Autumn Forecast points to a risk that the 2015 target might be missed. A full analysis of fiscal policy developments is outside the scope of this report, as the Commission has issued its assessment of euro area Member States' draft budgetary plans in November.

The Spanish financial sector has further stabilised over the past six months. Indicators of systemic risk in the financial sector have continued to improve, reflecting positive trends in global financial markets, in the economy and in the financial sector itself. Financing costs of all sectors of the economy have further decreased and there is more bank credit available for firms. However, despite this further stabilisation, also Spain did not escape some financial market turbulences in mid-October. This shows that the country remains vulnerable to sudden changes in global investor sentiment. Therefore, vigilance is required as well as the continuation of financial sector reform.

The resilience of the banking sector has continued to strengthen, supported by higher bank profits in the first half of 2014. The average quality of loans granted by banks has started to improve, as the proportion of loans in default or close to default has started to fall since December 2013. Private credit is still contracting, although at a decreasing pace. In some segments, notably lending to SMEs, new credit has actually started to grow. However, credit volumes are still shrinking across the main areas of business (though at a decreasing pace), putting a potential strain on the prospective profitability of banks. The results of the comprehensive assessment conducted by the ECB and the European Banking Authority (EBA) confirm the regained resilience of Spanish banks in terms of generally adequate capital buffers after the implementation of the 2012-2013 financial assistance programme. Nevertheless, in the situation of economic stress some banks would face non-negligible weakening of their capital ratios.

The restructuring of banks having received State aid is well underway. Objectives under the 5-year restructuring plans have been already mostly achieved. In June 2014 the Commission approved the sale of NCG Banco to Banesco Group, and in July Catalunya Banc was sold to BBVA. Furthermore, preparations are under way to sell the FROB ([1]) stake in BMN. In the case of Bankia, after the sale of 7.5% of the government's stake last February, the privatisation has so far not progressed further. The implementation of the savings bank reform has been relatively slow: the secondary legislation implementing the savings bank law of December 2013 still has not been adopted.

SAREB ([2]) faces a significant challenge of selling its assets while maximising value. SAREB's sale of assets continues at a moderate pace, concentrated in key areas such as Barcelona, Madrid, Malaga and Alicante. Despite the gradual stabilisation of real-estate markets in Spain, and despite the fact that assets were initially transferred from the banks to SAREB at a discounted value, SAREB is still struggling to gain profitability. Going forward, a further stabilisation of real-estate prices should allow SAREB to progressively gain profitability.

The implementation of other structural reforms to address macroeconomic imbalances has progressed further over the last six months, although unevenly across policy areas:

- There has been some further progress in strengthening public finance management. Spain is gradually implementing the public administration reform. The independent fiscal institution, AIReF, has finally started operation, and issued a number of useful reports. A draft tax reform has been adopted by the Parliament. The reform, which is centred on cuts

([1]) ***F****ondo de* ***R****eestructuración* ***O****rdenada* ***B****ancaria*, Fund for Orderly Bank Restructuring.

([2]) ***S****ociedad de Gestión de* ***A****ctivos Procedentes de la* ***Re****estructuración* ***B****ancaria* S.A., an asset management company for bank restructuring.

in personal and corporate income taxes, can be seen as a first step towards a comprehensive simplification of the tax system but may complicate the achievement of the budgetary targets.

- Efforts to make active labour market policies more effective are moving ahead only gradually. Due to shared competences between the central and regional level this is proving a complex and lengthy process, whose impact on the ground will take time to be felt. A new single job portal that was made operational in July should facilitate labour mobility within the country. The government has established further temporary hiring incentives to youth employment. Reforms in the area of education and training aim at improving both learning outcomes and efficiency. Beyond the introduction in February of a temporary flat social security contribution on new and additional permanent contracts and some measures to promote indefinite hiring in September, there are no plans for new reforms to address differences in employment conditions between indefinite and temporary contracts. A sizeable increase in total social expenditure and measures to support weaker workers have not been sufficient to offset entirely the social impact of the crisis. New measures to increase protection of the most vulnerable are being considered.

- The insolvency framework is being modernised and the reform of the electricity sector is being completed but no progress has been made on the reform of professional services and associations. The reform of the corporate insolvency framework makes the pre-insolvency and insolvency proceedings for indebted firms more coherent and should facilitate restructuring of the firms' debt. Implementation of the important law on market unity is advancing, but the pace of implementation could be enhanced. Licencing requirements in retail and, more generally, procedures for business start-ups have been eased, although there is still scope for facilitating further the creation of new businesses. The reforms in the gas and electricity sectors are helping to contain the tariff deficits. Yet, some flagship measures have suffered delays: the de-indexation law is still awaiting parliamentary approval, and, most remarkably, the law on professional services and associations has so far not even been submitted to Parliament. It is doubtful whether the planned set-up for the advisory council on future infrastructure projects will guarantee its independence.

On the basis of the analysis in this report, repayment risks for the ESM loan are very low at present. This assumes that the authorities continue to improve the state of public finances and keep reforming the economy to address the challenges. The Spanish state can now borrow cheaper thanks to policy actions at national and European level, restored confidence in the Spanish economy and its public finances.