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Post-Programme Surveillance Report

Spain, Autumn 2024

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EUROPEAN ECONOMY

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Spain, Autumn 2024

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Institutional Paper 302

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The Post-Programme Surveillance assessment was prepared in liaison with staff from the European Central Bank (ECB) ([2]). The European Stability Mechanism (ESM) was consulted.

This report reflects information available and policy developments that have taken place up to 31 October 2024. The macroeconomic and budgetary projections, including those underlying the debt sustainability analysis are therefore in line with the Commission's 2024 autumn forecast published on 15 November 2024 (with cut-off date 31 October 2024).

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([1]) The executive summary of this report was adopted as Commission Communication C(2024)9068 on 25 November 2024. The rest of the report is the Staff Working Document SWD(2024)968 accompanying this Communication.

([2]) ECB staff participated in this mission, and in the drafting of this report, in line with the ECB's remit and therefore provided expertise on financial sector policies and macro-critical issues, such as headline fiscal targets and sustainability and financing needs.

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ABBREVIATIONS

DSA	Debt Sustainability Analysis
ECB	European Central Bank
EFSF	European Financial Stability Facility
Sareb	Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria S.A.

EXECUTIVE SUMMARY

The 22nd post-programme surveillance mission to Spain took place, in virtual format, on 2 and 4 October 2024. The meetings involved staff from the European Commission, in liaison with European Central Bank staff ([3]). European Stability Mechanism staff participated on aspects related to its Early Warning System.

The Spanish economy is projected to continue expanding strongly in 2024 amid continued geopolitical tensions. According to the Commission's Autumn 2024 Economic Forecast, real GDP growth is projected to gain pace this year to 3.0%, slightly up from 2.7% in 2023, before moderating to 2.3% in 2025, yet remaining well above the euro area average. Domestic demand is set to represent the key driver of the economic expansion over the forecast horizon, thanks to the expected gradual pick-up in investment and sustained by private consumption growth. In 2024 and 2025, consumer spending is projected to be supported by dynamic job creation and further real income gains by households. Investment growth is expected to rebound mildly this year before accelerating in 2025, underpinned by the more robust implementation of the recovery and resilience plan (RRP) and the healthy financial position of non-financial corporations. On the external side, the buoyancy of tourism activity and export of non-tourism services coupled with sluggish import growth is set to uphold a substantial contribution of net exports to overall GDP growth in 2024. The recovery in total imports, notably of goods, from next year is set to limit the contribution of external demand to economic activity in the future. Headline inflation is expected to continue its downward trend in 2024 to 2.8%, favoured by the sustained drop in energy and food prices throughout the year. Overall inflation is set to ease further in 2025 to 2.2% thanks to the expected continued slowdown of core components. Downside risks to the outlook mainly relate to geopolitical uncertainty and the further weakening of growth in Spain's main trading partners.

The private sector debt-to-GDP ratio continued to decrease in the first half of 2024, as did the external net debt position ([4]). The debt ratio of the non-financial private sector fell to 110.4% of GDP in the second quarter of 2024, down by 7.3 percentage points compared with the same period in 2023. This was mainly driven by strong nominal output growth and supported by the reduction of outstanding loans against a background of tighter financial conditions. Spain's negative net international investment position (NIIP) improved to −46.9% of GDP in the second quarter of this year from −54.5% of GDP in the same period in 2023, supported by the increasing surplus in the current and capital accounts, as well as nominal output growth. Despite subdued mortgage dynamics and the downward adjustment of sales from post-pandemic peaks, the housing market remained characterised by sustained demand in the first half of 2024, particularly for new dwellings, with prices exceeding inflation against a background of supply constraints.

The expiry of energy measures improves Spain's public finances, though the fiscal space to absorb new shocks remains limited. In 2023, the general government deficit decreased to 3.5% of GDP, and the public debt narrowed to 105.1%. This is 6.4 pps and 14.2 pps below 2020 levels, respectively. The 2024 deficit is expected to continue decreasing to 3.0% as the remaining energy measures are being phased out. In particular, some of the expected additional revenues are due to the discontinuation of the reductions of: (i) the value added tax reduction; (ii) the reduction in the special tax on electricity; and (iii) the exemption from the tax on the value of electricity. On the expenditure side, savings are driven by the phase-out of the fuel rebate. The strong momentum of revenues from direct taxation keeps driving the deficit reduction. These positive developments are expected to continue, underpinned by a dynamic labour market, robust corporate profits to be reflected in the October instalment payment, and a favourable macroeconomic scenario helped by an improved Recovery and Resilience Facility implementation. Risks surrounding the projections are related to the

([3]) European Central Bank (ECB) staff participated in this mission, and in the drafting of this report, in line with the ECB's remit and therefore provided expertise on financial sector policies and macro-critical issues, such as headline fiscal targets and sustainability and financing needs.

([4]) The evolution of the external and internal indebtedness position is also monitored as part of the In-Depth Review (IDR), which aims to identify and assess the severity of macroeconomic imbalances.

extent of nationally-financed expenditure necessary to address the impact of the recent floods in the Valencian Community. Going forward, the government expects to continue to gradually reduce the deficit to 1.8% by 2027. The limited fiscal space (considering the elevated public debt projected at 102.3% in 2024) makes the design and delivery of the medium-term plan's fiscal adjustment crucial to anchor market expectations against the background if an uncertain geo-political situation. In mid-October, Spain presented its medium-term fiscal-structural plan, as required by the new economic governance framework.

The banking sector in Spain remained resilient, liquid and profitable. Following strong declines in 2023, total lending to the private sector (excluding interbank lending) fell less significantly in the course of 2024. The Bank Lending Survey (BLS) for the third quarter of 2024 indicated a relaxation of credit standards for loans to households in Spain. For the second time since 2021, the BLS for Q3-2024 showed an increase in the demand for loans across all segments. During the first three quarters of 2024, concerns about possible risks of deteriorating debt servicing capacity of borrowers did generally not materialise, as non-performing loans remained broadly stable. In the second quarter of 2024, the anticipated reductions in the monetary policy rate started mitigating the adverse effects of past interest rate hikes on asset quality. After repaying almost all of the funding provided under targeted longer-term refinancing operations, the liquidity position of banks continues to be reassuring. Overall, the pass-through of past interest rate increases to deposits has been contained. Banking sector profitability continued to increase in 2024, driven by the still favourable impact of high interest rates on net interest income. Looking ahead, with lending rates on a downward path, price effects are expected to weigh on banks' net interest income in the near term, while volume effects stemming from increased loan demand will support profitability. The capital ratios of Spanish banks have remained broadly stable, but, on average, they continue to be among the lowest in the EU. The Bank of Spain has introduced a revised framework for the countercyclical capital buffer, setting it at 1% by October 2026, with an interim buffer of 0.5% in place by October 2025. The tax levy on credit institutions has generated revenues in 2024. Its planned permanence necessitates careful evaluation and potential adjustments to mitigate any adverse secondary effects on banks' ability to provide credit. The asset management company SAREB continues to reduce its balance sheet, having disposed of more than half of its assets.

Spain retains the capacity to service its debt. Spain's economic activity is expected to continue to expand and its fiscal situation is expected to further improve. Its financial situation remains resilient amid still high inflation in the short run and heightened geopolitical risks. Spain's government debt-to-GDP ratio is expected to continue to gradually decline and, based on unchanged policies, it is expected to reach levels of around 102.3% of GDP in 2024. According to the debt sustainability analysis, Spain is deemed to face low risks in the short term, but medium-term fiscal sustainability risks appear high. To mitigate risks to the pension system, the 2023 reform includes a regular review that will be carried out from 2025 onwards. This will lead to corrective measures being adopted, if necessary. Government gross financing needs are stable at around 16 % of GDP annually, while the average maturity of government debt remains at around 8 years. Spain made several voluntary repayments of the European Stability Mechanism loan in 2014-2018 and the first two scheduled repayments in 2022 and 2023. The next payment is due by the end of 2024, which would bring the total repayments to 69.1% of the total loan. According to the agreed repayment schedule, the payments will continue annually until 2027. Financing conditions for Spain are considered to have improved recently as market interest rates have declined and as the European Central Bank has started to ease monetary policy. Investors' confidence in Spanish debt has increased, which is reflected in the gradually narrowing sovereign spreads.

1. INTRODUCTION

This report presents the main findings from the 22nd post-programme surveillance (PPS) mission. Staff from the European Commission, in liaison with staff from the European Central Bank (ECB), participated in the virtual mission to Spain. Staff from the European Stability Mechanism (ESM) also attended the meetings on aspects related to the ESM's Early Warning System. Under the PPS, the Commission carries out regular review missions to euro area Member States that had a financial assistance programme. The objective of the PPS mission is to assess the economic, fiscal and financial situation to ensure the Member State maintains its capacity to service its debt to the European Stability Mechanism (ESM)([5]).

Spain received financial assistance to recapitalise its financial institutions in July 2012 and successfully exited the related programme in January 2014. The financial assistance programme was agreed by the Eurogroup on 9 July 2012 for a period of 18 months and provided financing from the euro area Member States of up to EUR 100 bn, to be lent by the European Stability Mechanism (ESM). Eventually, Spain used EUR 41.0 bn for bank recapitalisation, under restructuring and resolution plans approved by the European Commission in line with State aid rules, and around EUR 2.2 bn for capitalising SAREB, the Spanish asset management company.

This report reflects information available and policy developments that have taken place until 31 October 2024. The macroeconomic and budgetary projections, including those underlying the debt sustainability analysis, are in line with the Commission's 2024 autumn forecast published on 15 November 2024 (with a cut-off date 31 October 2024).

([5]) Under Regulation (EU) No 472/2013, PPS will continue until at least 75% of the financial assistance received under the programme has been repaid. Under the current repayment schedule, PPS will last until 2026.

2. MACROECONOMIC DEVELOPMENTS

1. Following the strong growth outturn posted in 2023 (2.7%), economic activity maintained its momentum in the first half of this year. Real GDP edged up to 0.9% in the first quarter, underpinned by public consumption growth and the impetus from tourism activity, and by 0.8% in the second quarter, thanks to the strong contribution of domestic demand and chiefly by private consumption - despite the slowdown in investment compared to the previous quarter. The economic expansion is set to continue in the second half of 2024 (GDP expanded by 0.8% in the third quarter) but to be slightly more subdued than in the first two quarters. This would be imputable to the softer projected contribution of total exports and tourism to economic activity, also due to weaker economic activity in main trading partners.

2. GDP growth is expected to reach 3.0% in 2024, according to the Commission's Autumn 2024 economic forecast. This outturn reflects a higher than-projected carry-over from 2023, stemming from the September's statistical revision carried out by INE for the years 2021-2023, and the robust outturn in the first half of 2024. Overall, private consumption is expected to be supported by still strong job creation and further real income gains for households. Investment growth is expected to rebound mildly compared to last year, lifted mainly by the contribution of non-residential construction and in the context of a healthy financial position of non-financial corporations.

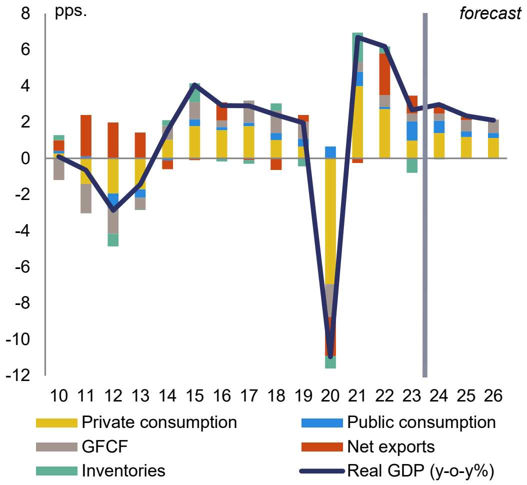
3. In 2025, real GDP growth is forecast to moderate to 2.3%, yet remaining well-above the euro area average. Domestic demand is set to represent the key driver steering the economic expansion, thanks to the expected broad-based pick-up in investment and sustained by consumption growth. On the other hand, the recovery in total imports from next year is set to limit the contribution of external demand. The unemployment rate is set to remain on a declining trend, reaching 11.5% in 2024, down from 12.6% in 2023, and 11.0% in 2025. These positive developments have been upheld by the sustained job creation rate observed since the beginning of last year and owing to a large extent to the considerable net migration flows to Spain taking place since end-2022, which are projected to linger over the forecast horizon, although at a gradually slower pace than in the past years.

4. Annual HICP inflation is forecast to ease to 2.8% in 2024, on the back of the continued deceleration of energy and food inflation. Underlying price pressures eased more gradually this year, especially services, in particular those related to hospitality, holiday packages and transport. Headline inflation is set to moderate further in 2025, reaching 2.2%, with the downward trend of underlying components expected to continue in the coming quarters. Nominal wage growth is expected to outpace inflation developments over the forecast horizon, while the wage drift observed from the second half of 2023 has been losing momentum and is set to fade in 2025.

5. Downside risks to the outlook relate mainly to geopolitical uncertainty and the further weakening of growth in Spain's main trading partners. The materialisation of risks related to the uncertain unfolding of geopolitical events, including potential rebound in commodity prices, as well as pressure from core components might result in a more sluggish slowdown of inflation and would negatively weigh on aggregate demand. Moreover, downside surprises in the evolution of economic activity in Spain's main trading partners could adversely impact the dynamism of activity. Furthermore, persisting low level of credit demand by the private sector over the next quarters as well as enduring markedly high saving rates could further negatively affect investment and consumption growth.

6. Housing market activity presented signs of stabilisation in the first half of 2024, while prices increased significantly above inflation. House sales continued to decline in the first half of the year (-4.5% y-o-y), although at a milder pace than in 2023 overall, when the drop stood at 10.2% y-o-y. Albeit housing transactions experienced a series of negative quarterly growth rates since 2023-Q1, their level remained well above pre-pandemic levels. The fall in house sales in the first half of the year was primarily explained by the developments in the second-hand market (-6.3% compared to 3.4% for new dwellings), which represents around 80% of the total transactions. House prices increased on aggregate by 6.3% in the first half 2024, representing a higher nominal growth than in 2023 (4.2%) and standing 2.9 percentage points above the headline CPI inflation in the same period. In the context of a mismatch between recovering demand and rigid supply, second-hand house prices rose by 6% in the first half of 2024 (compared to 3.6% in 2023), while prices of new dwellings increased by 8.4% in the same period (compared to 7.5% in 2023).

Graph 2.1: **Composition of GDP growth**



GFCF: gross fixed capital formation

Source: INE, European Commission Economic Forecast, Autumn 2024.

7. The private sector debt-to-GDP ratio continued to decrease in the first half of 2024. The debt ratio of the non-financial private sector decreased to 110.4% of GDP in the second quarter of 2024, down by 7.3 pps compared to the same period of 2023 ([6]). The stock of debt accumulated by non-financial corporations (NFCs) amounted to 65% of GDP, while total households' liabilities totalled 45.4% of GDP. The decline of the overall debt ratio over the last year has been similar in relative terms for both segments and mainly driven by strong nominal output growth, with the reduction of outstanding debt considerably contributing to the deleveraging process. After continuously declining since mid-2022, the amount of loans to the non-financial private sector rose by 0.4% year-on-year in the second quarter of 2024. This evolution is mainly explained by the increase in loans to non-financial corporations (NFCs) (1.3% year-on-year), while loans to households dropped by 1%. According to the ECB bank lending survey, credit standards in the second quarter remained unchanged for NFCs while presenting a moderate tightening for households.

8. Spain's external net debtor position continued to improve in 2023. The net international investment position (NIIP) improved to -46.9% of GDP in the second quarter of 2024 from –54.5.% of GDP in the same period of 2023. The change of the NIIP ratio over the last year has been mainly driven by strong nominal GDP growth, as well as supported by the increasing surplus in the current and capital account. The trade deficit has declined due to lower energy prices, while the service balance has kept its positive trend in both tourism and non-tourism revenues. The current account balance is expected to remain in surplus in 2024 and 2025 (4.2% and 4.5% of GDP respectively), helping to further reduce the negative NIIP ratio.

([6]) Data are expressed in consolidated terms. Source: Bank of Spain.

3. PUBLIC FINANCE DEVELOPMENTS

3.1. FISCAL PERFORMANCE

Spain's public finances improved even further, based on the 2024 autumn's annual data revision, with the general government deficit narrowing to 3.5% of GDP in 2023 and the public debt reducing to 105.0%, 0.1 pps. and almost 3 pps. lower than the pre-revision figure, respectively**.** Aided by strong economic growth and buoyant direct tax revenues (if RRF revenues are excluded, the non-indexation of personal income tax brackets explains a sizeable proportion of the revenue-to-GDP ratio increase since the outbreak of the pandemic), the deficit and the debt have declined by 6.4 pps, and 14.2 pps., respectively, since 2020. In 2023, tax revenues grew by 7.1%, largely helped by corporate income tax (up 15.8%) and personal income tax (up 8.9%), while consumption tax revenues slowed significantly due to reduced consumer spending and new regulations, resulting in a VAT shortfall of EUR 4.3 billion. Total expenditure as a percentage of GDP decreased in 2023, partly due to more targeted energy measures to combat inflation, which included subsidies and tax cuts. While overall spending fell by 1 percentage point of GDP, employee compensation, social benefits, and interest payments all increased, driven by inflation adjustments and rising costs in education and healthcare.

The accumulated deficit as of July 2024 is comparable to last year's in the same period (2.3%). Tax revenues based on cash data until August show continued strength, with indirect taxes growing by 6.9% and direct taxes by 7.7%, for an overall growth of 7.4% in the first two thirds of the year. The good performance of personal income tax (7.2%), corporate income tax (13.5%) and VAT (7.6%) are driving the growth in cash terms. The increase of households' gross income as well as the rise of capital income and pension withholdings are the key factors explaining the increase in revenues from personal income tax. Growth in corporate profits, particularly from large companies and groups (9.5%), reflected in the instalment payments in the first half of the year are driving the corporate income tax performance. After the deceleration in 2023, VAT revenues are recovering the dynamism of previous years spurred by a stronger domestic consumption and the end of several tax rebates approved to ease the consequences of the energy crisis. Finally, the end of both the exemption from the tax on the value of electricity production and the reduction on the special tax on electricity has underpinned the sustained strength of public revenues. Nevertheless, recent court rulings on the contributions made by citizens to mutual funds since 1967 and on the cancellation of the 2016 corporate income tax reform have compelled the government to return taxes to citizens and corporates with a negative impact on the revenue performance.

Total government expenditures until July are growing slightly above (6.4%) the nominal GDP. In particular, interest payments (13.7%) are growing well above expectations, while social transfers in cash (6.9%) and compensation of employees (5.8%) are driving the slightly higher-than-expected current expenditure growth. Energy-related subsidies and transfers are being gradually phased out in 2024 but some measures of support for companies (direct payments to electro-intensive companies and aids for companies in the electric vehicle sector) are having a higher budgetary impact than what was foreseen in last autumn's forecast. Additionally, the 2024 central government deficit has been impacted by the July settlements of the regional and municipal financing system. The Autonomous Communities and the local governments have been compensated for the higher-than-expected revenues in 2022 in a larger fashion than the compensation in 2023 for the revenues in 2021. Specifically, the final settlements of the regional and municipal financing system have increased, compared to last year, by some EUR 13.5 billion, therefore rising the 2024 central government deficit by 0.7 pps. in terms of GDP.

3.2. FISCAL OUTLOOK

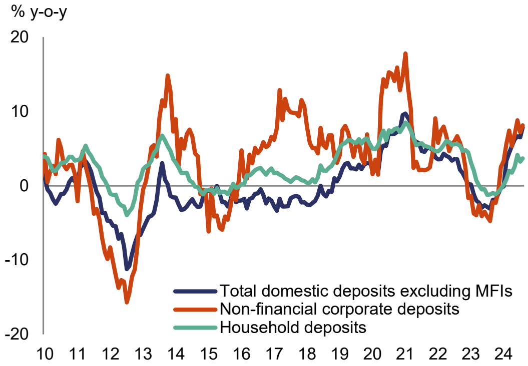
The 2024 general government deficit is expected to keep decreasing as the remaining energy measures are being phased out. According to the government's projections, the general government deficit will reduce further this year to 3.0% of GDP. The Commission's Autumn 2024 Economic Forecast also expects the general government deficit to narrow to 3.0%, helped mostly by the reduced cost of energy support measures. In particular, the removal of the reductions of VAT and of the special tax on electricity as well as the exemption from the tax on the value of electricity explain some of the expected additional revenues. The phase out of the fuel rebate drives the 2024 savings on the expenditure side, helped by the non-extension of several support measures for companies, notably the direct payments to the primary sector and to the road transport sector, and the end of the energy-related payments to low-income households. The positive direct taxation developments are expected to continue, underpinned by a dynamic labour market, robust corporate profits to be reflected in the October instalment payment, and a favourable macroeconomic scenario. The RRF implementation, relatively subdued at general government level, is set to reach its cruising speed in the second half of the year and keep it throughout the forecast horizon, contributing to improve Spain's public finances through sustained economic growth. Risks surrounding the projections are related to the extent of nationally-financed expenditure necessary to address the impact of the recent floods in the Valencian Community. Going forward, the government expects to keep reducing the deficit to 2.5%, 2.1% and 1.8% in 2025, 2026 and 2027, respectively, as stated in its updated projections. The limited fiscal space (considering the elevated stock of public debt) makes the commitment to fiscal adjustment crucial to anchor market expectations, against an uncertain geo-political situation.

The debt-to-GDP ratio is projected to keep reducing, but more moderately, remaining at high levels. The government expects the debt to decrease to 102.5% of GDP in 2024. This is in line with the Commission forecast that project a decline of the debt-to-GDP ratio to 102.3%, driven by strong nominal GDP growth. In the future, the debt-to-GDP ratio according to the government is set to continue reducing, but less dynamically, to 101.4% and 100.1% in 2025 and 2026, respectively. As required by the new economic governance framework, Spain presented in mid-October its medium-term fiscal-structural plan. By the cut-off date of this report (31 October 2024), the plan was under assessment by the Commission.

4. FINANCIAL SECTOR DEVELOPMENTS

4.1. RECENT TRENDS

Graph 4.1: **Bank deposits**



Source: BdE.

Despite the almost full repayment of the targeted longer-term refinancing operations (TLTRO) funding, the liquidity position of banks has remained strong. The Spanish banks' borrowing from the ECB has been declining at a fast pace over the recent quarters, on the back of the gradual repayment of the TLTRO funding. The ECB funding went down to EUR 0.5 billion in August 2024, from EUR 289.7 billion in September 2022 ([7]). Total domestic bank deposits from households and non-financial corporations have been increasing in year-on-year (y-o-y) terms since the beginning of 2024, following the steady declines in the second half of 2023. The deposits of non-financial corporations were the main driver of the increase in total deposits in 2024, on the back of the gradual pass through of past monetary policy interest rate increases to deposit rates. In August 2024, the deposits of non-financial corporations increased by 8.1% year-on-year, while deposits by households rose by 3.7% (Graph 4.1). The loan-to-deposit ratio declined to 97.3% in the second quarter of 2024, compared to 100.7% a year earlier, entirely driven by higher deposits, while lending also increased ([8]). Overall, the pass through of the increase in interest rates to deposits has been contained in the course of 2023. The rise in deposit interest rates has come to a halt as of the middle of 2024, except for new term deposits by households. The average cost of bank liabilities continued to grow in the first half of 2024, reaching 3%. The liquidity coverage ratio stood at around 186% in the second quarter of 2024, almost 9 pps higher than in mid-2023 (177%) and well above the regulatory minimum (at 100%).

Banks in Spain have continued to access the market with sustained issuances of debt securities. During 2024, the Spanish credit institutions have continued tapping the markets by issuing MREL compliant debt securities ([9]) in an environment of still elevated rates and amidst the challenging macroeconomic environment in the euro area and the escalating geopolitical tensions. According to the Bank of Spain, the Spanish credit institutions issued MREL compliant debt instruments of almost EUR 49 billion in 2023 and already roughly EUR 43 billion in the first nine months of 2024, with significant issuances of unsecured instruments. However, the cost of debt issuances remained high in 2024. Based on the latest available data, all Spanish banks have already complied with their MREL binding targets ([10]). In the meantime, Spain has already published information on its national bail-in mechanic in line with EBA guidelines ([11]).

The contraction in lending activity has continued to bottom out. Following strong declines in the previous year, total lending to the private sector (excluding interbank lending) has been falling less strongly in the course of 2024, by 0.8% year-on-year in August 2024 (Graph 4.2). This trend was notably observed as regards lending to non-financial corporations, which declined by 1.7% year-on-

([7]) Bank of Spain, Indicadores economicos, 2024.

([8]) Bank of Spain, *Nota de prensa estadistica*, 3 October 2024. Las ratios de capital de las entidades de crédito que operan en España aumentaron en el segundo trimestre de 2024.

([9]) Minimum Requirement for own funds and Eligible Liabilities (MREL).

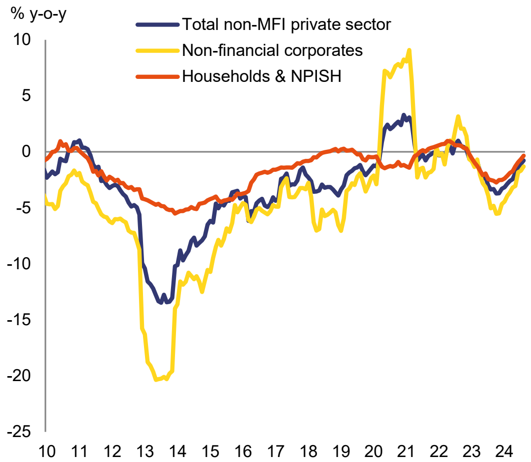
([10]) European Banking Authority's MREL Dashboard - Q4 2023.

([11]) Guidelines to resolution authorities on the publication of their approach to implementing the bail-in tool | European Banking Authority (europa.eu).

year in August 2024, after shrinking by 5.5% year-on-year in October 2023. Lending to households has been contracting since late 2022 and grew by 0.4% y-o-y in August 2024, a noticeable rebound from -2.7% in October 2023. New loans for housing have soared, with mortgage origination in the first eight months of 2024 slightly exceeding the 2021 levels before start of the monetary policy tightening. However, the stock of outstanding mortgage loans has still been contracting in the first months of 2024, as amortisation rates remain elevated. The cost of lending had been gradually increasing from mid-2022 till late 2023. The one-year Euribor®, which is used as main reference to set the interest rate on mortgage loans granted by banks, peaked at 4.160% in October 2023, but gradually declined thereafter, reaching 2.936% in September 2024. Taking the last twelve months as reference, the one-year Euribor® has declined by 121 basis points (bps) compared to September 2023 ([12]). New lending to non-financial corporations and households has been driven mainly by supply factors. As interest rates continue lowering, demand factors are expected to increasingly contribute to credit growth in the coming quarters.

The Bank Lending Survey (BLS) for the third quarter of 2024 indicated an easening of credit standards for loans to households in Spain. Overall, terms and conditions on new loans continued tightening, but only moderately ([13]). In particular, the lending standards remained unchanged in the corporate financing segment but tightened slightly in the two household lending segments (for housing and for consumption and other purposes). This reflects the lower risk tolerance by banks, the increase in risk perception, the increase in financing costs and the deterioration in general economic prospects. In the second quarter of 2024, credit conditions remained broadly unchanged for corporates. Conditions eased for housing loans, which translated into a slight decline in lending margins ([14]), while the share of rejected loan applications to households increased. In the first half of 2024, the credit standards tightened slightly in the construction sector, real estate activities and commerce. For the second half of 2024, the survey anticipated that the credit standards will tighten in the corporate loan segment, while credit conditions are set to tighten across all loan categories. According to the BLS, since the middle of 2023 the risks associated with climate change have affected banks' credit policies, leading to a tightening of the criteria for granting loans and the conditions applied to so-called "brown" companies, as well as a certain increase in credit demand by "green" companies.

Graph 4.2: **Bank loans to the private sector**



The decrease in the stock of loans in late 2012 and early 2013 was due to the transfer of assets to SAREB.

Source: BdE, own calculations.

For the first time since 2021, the BLS for Q2-2024 showed an increase in the demand for loans across all segments. The increase in loan applications was most pronounced for loans to households for consumption and other purposes. Increased demand in the corporate financing segment reflected greater needs to finance investments in fixed assets, inventories and working capital, as well as a more limited use of internal financing. As regards housing loans to households, increased demand was driven by greater consumer confidence, as well as by stronger competition, which offset the negative effect from the slight deterioration in the housing market outlook. For loans to households for consumption and other purposes, higher spending on durable consumer goods and greater consumer confidence boosted loan demand. As for the second half of 2024, banks anticipated an increase in loan

([12]) Bank of Spain, Boletín Estadístico, September 2024.

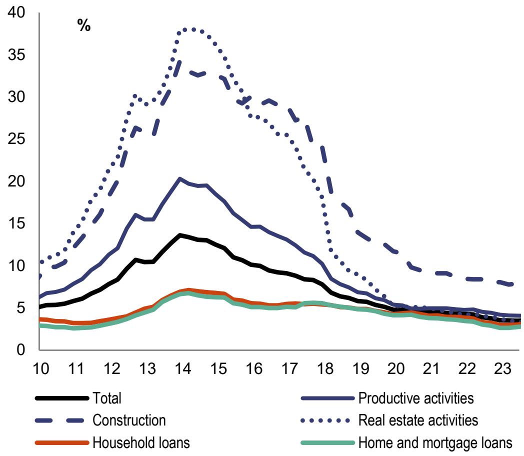
([13]) Bank of Spain, Nota de prensa estadistica, 16 July 2024.

([14]) For the purposes of the Bank Lending Survey, margins are calculated as the difference between the interest rates applied to new loans and the market rates that serve as a reference in each segment.

applications in all segments. According to the survey, loan demand is expected to grow for "green" companies, while loan applications by "brown" companies could decline further.

In the first half of 2024, the asset quality of Spanish banks remained broadly stable, with some improvement in loans to the real estate sector and productive activities, as well as lending to households. Supported by the decrease in the share of impaired assets in the loan book, due to the regular sales of NPLs by banks ([15]) and the rebound in new lending, the system wide NPL ratio went down to 3.4% in the middle of 2024, just below the 2023 level (Graph 4.3). The construction sector continued to have the highest share of NPLs. Following declines in the past, the construction sector's NPL ratio stood at 8.4% in the second quarter of 2024, 0.5 pps higher than a year earlier and slightly above the level at the end of 2023. Since the second quarter of 2022, the NPL ratios for real estate have declined steadily and stood at 2.8% in the first half of 2024. The NPL ratio for productive activities fell to 3.4% in the middle of 2024, the lowest level since March 2009. The NPL ratio for loans to households declined further to 3.0% in the second quarter of 2024, thus reaching its 2022 level. While the NPL ratio on mortgage loans had been on a declining path until the end of 2022, the level started increasing in the first half of 2023, driven by the higher reference rate (the one-year Euribor®). In the second quarter of 2024, the anticipated reductions in the monetary policy rate started mitigating the adverse price effects of past interest rate hikes. After the increase in the final quarter of 2023, Stage 2 loans (according to IFRS 9 ([16])) at consolidated level have remained broadly flat in the first half of 2024. According to the latest data by the European Banking Authority, the share of Stage 2 loans as percentage of total loans and advances stood at 7.3% in the middle of 2023, well below the EU average of 9.3%.

Graph 4.3: **Ratio of non-performing loans**



(1) The scope of non-performing loans covered in these figures overlap with BdE's definition of doubtful loans.
(2) Home loans comprise also loans that are not mortgages
Source: BdE, own calculations.

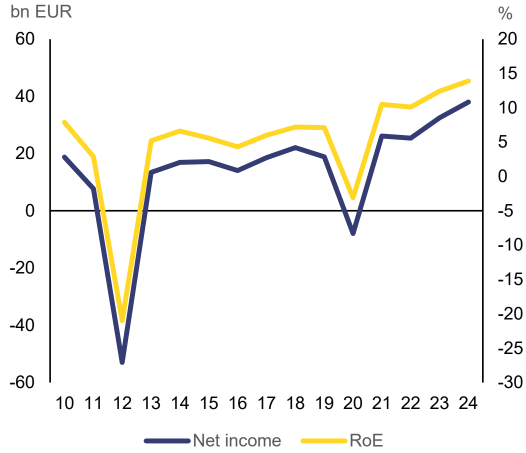
Banking sector profitability continued increasing in 2024, driven by the still favourable impact of high interest rates on net interest income. Banking sector profitability benefitted from the increase in net interest income and commissions, as the pass through of past interest rate increases has continued to drive up banks' revenue more than their financing costs (Graph 4.4). These positive developments in net interest income have more than offset the adverse change in operating costs, the rise in impairment charges and the impact of the levy on operations in Spain ([17]). Overall, Spanish banks are among the most efficient banks in the EU. The cost rationalisation in recent years (including from the recent banking mergers) has gradually fed into operational costs. According to ECB data, the cost-to-income ratio of Spanish credit institutions stood at 45.1% in the first quarter of 2024, down from 46.9% a year earlier and well below the EU average of 53.8%. The profitability of banking groups with an international footprint benefitted from the good results obtained by their subsidiaries outside the EU, particularly in Latin America. According to Bank of Spain data ([18]), the operating income was almost EUR 37 billion in the second quarter of 2024 compared to just above EUR 32 billion a year earlier, while the return on equity (consolidated basis) stood at just below 14%. At the same time, the cost of risk declined in the second quarter of 2024 compared to the previous quarter and stood at 0.9% (also lower than a year earlier). Looking ahead, with lending rates on a downward path, price

([15]) Non-performing loan (NPL).
([16]) International Financial Reporting Standards (IFRS).
([17]) For further details on the bank levy, see Section 4.2 on reforms and policy.
([18]) Bank of Spain, *Nota de prensa estadistica*, 3 October 2024.
https://www.bde.es/f/webbe/GAP/Secciones/SalaPrensa/NotasInformativas/24/presbe2024-80.pdf.

effects are expected to weigh on banks' net interest income in the near term, while volume effects stemming from increased loan demand will support profitability and help preserve asset quality.

Banking sector capitalisation only slightly improved in 2024, despite very strong profits. On the back of favourable profitability developments, banks in Spain opted for dividend pay-outs and share buy-backs. In line with EU peers, Spanish banks retained part of their 2023 profits, but the ensuing effect on capital was partially offset by the increase in risk-weighted assets. According to the latest data by Bank of Spain, the solvency ratio at banking system level in the second quarter of 2024 stood at 17.17%, by 0.3 pps higher than in the middle of 2023. Less significant credit institutions (LSIs) continued to have higher capital ratios than significant credit institutions (SIs). The total capital of LSIs stood at 22.4% in the second quarter of 2024, while the total capital of SIs reached 16.87%, slightly below the system-wide solvency ratio. In addition, the Common Equity Tier 1 (CET1) ratio at system level increased to 13.29% at the end of June 2024, from 13.14% a year earlier. From a broader perspective, the capitalisation of Spanish banks is aligned with their business model and stands above the capital requirements and supervisory guidance but on average remains among the lowest in the EU. According to the 2023 EBA stress test [19], the participating Spanish institutions fared better than the EU aggregate, as they experienced a comparatively smaller negative impact under the adverse scenario and showed a greater capacity to generate capital revenue under the baseline scenario. However, the continuing uncertainty as to macroeconomic and geopolitical risks and their possible adverse effects on the debt repayment capacity of some borrowers might affect the capitalisation of Spanish banks and their potential for organic capital generation.

Graph 4.4: **Bank sector profitability (consolidated basis)**



Since 2019, return on equity (RoE) is calculated dividing Net income by the average of total own funds, while before that year RoE was calculated according to the market standards, this means dividing the Income attributable to the controlling entity by the average of shareholders´ equity.

Source: BdE, Financial Stability Report.

4.2. REFORMS AND POLICY

The Bank of Spain has introduced a revised framework for the countercyclical capital buffer (CCyB), setting it at 0.5% for 4Q- 2024, with its implementation effective from 1 October 2025. This overhaul marks a significant departure from the previous framework, which relied primarily on the credit-to-GDP gap as the key indicator for quarterly decisions. Recognising the limitations of this single metric, Bank of Spain has developed a more comprehensive approach by incorporating alternative trends and additional indicators. The updated framework is designed to provide a more accurate assessment of systemic risk[20]. As part of this revised methodology, the Bank of Spain plans to introduce a 1% CCyB on domestic private-sector exposures by October 2026, with an interim buffer of 0.5% in place by October 2025. This initiative reflects a broader trend across Europe, where supervisory authorities are advocating for higher releasable capital buffers to strengthen the resilience of the banking sector. Previously, Spain maintained a 0% CCyB, as indicators did not point to significant vulnerabilities within the financial system. However, the recent policy shift is primarily a proactive measure aimed at enhancing banks' capital resilience in preparation for potential economic

(19) See the results of the EBA's 2023 EU-wide stress test, July 2023. The exercise involved 70 EU credit institutions, accounting for 75% of EU bank's total assets, including 8 Spanish institutions (BBVA, Bankinter, CaixaBank, Kutxabank, ABANCA, Sabadell, Santander and Unicaja).

(20) See the briefing note on the new Banco de España's CCyB framework: "Revision of the framework for setting the countercyclical capital buffer in Spain", and the technical document with details on the new indicators, calibration and cost-benefit analyses of the implementation of the CCyB under the new framework: "Analysis of cyclical systemic risks in Spain and of their mitigation through countercyclical bank capital requirements".

downturns, rather than a response to an immediate increase in systemic risks. In fact, key indicators, signal cyclical risks to be at standard level. The phased introduction of the CCyB, increasing to 0.5% by 4Q-2025 and fully implemented by October 2026, is designed to mitigate any potential negative impact on the banking sector. While the 1% CCyB is expected to place some pressure on banks' capital positions, the long phase-in period allows them sufficient time to adjust. Moreover, Spanish banks, despite having lower risk-weighted capital ratios than the EU average, are expected to manage this transition effectively due to their strong financial fundamentals. The measure's impact will vary, with domestically focused banks feeling the effects more acutely, while those with significant international exposure less affected. Nonetheless, the extended lead time ensures that banks can adequately prepare for the new requirements without compromising their financial stability.

CaixaBank's recent strong performance is contributing to favourable returns on FROB's investment and may influence considerations for the divestment strategy. CaixaBank's recent strong performance highlights the need for FROB to carefully evaluate the timing for divesting its stake, as the bank's robust financial results are yielding positive returns and reinforcing the necessity of maximising potential gain. As of August 2024, FROB's 17.88% shareholding in CaixaBank was valued at EUR 7.1 billion, representing a 50% increase since the start of the year and a 260% rise compared to the EUR 1.965 billion valuation prior to the Bankia-CaixaBank merger. Despite this positive market trend, CaixaBank's price-to-earnings ratio remains below the sector's historical averages, which may indicate room for further revaluation and improved long-term returns. Moreover, for the first time FROB received in May 2024 dividends amounting to EUR 355 million from its participation in BFA Tenedora de Acciones, the company holding FROB's stake in CaixaBank. The increase in the value of FROB's participation in BFA has led to a reversal of the impairment by EUR 405 million, contributing to FROB's financial results for 2023, which closed with a EUR 456 million profit. In parallel, on 31 July 2024, CaixaBank launched a share buy-back (SBB) programme valued at up to EUR 500 million. If FROB opts not to participate in this programme, its ownership stake in CaixaBank could increase to 18.12%. Moreover, CaixaBank is expected to release its 2025–2027 strategic plan in November 2024.

The tax levy on credit institutions generated revenues along expectations in 2024, but its permanence necessitates careful evaluation and potential adjustments to mitigate any adverse secondary effects. In 2024, the tax levy imposed on credit institutions generated revenues of EUR 1.695 billion, aligning with government projections and closely mirroring last year's figures. This financial levy specifically targets institutions with commission and interest revenues exceeding EUR 800 million, applying a rate of 4.8% to the taxable base, which encompasses the interest margin along with related revenues and expenses. The government is currently evaluating the potential permanence of this tax. This evaluation necessitates careful consideration of its long-term implications and any necessary adjustments to mitigate potential negative effects. Extending Spain's bank levy raises concerns about its impact on profitability prospects. Moreover, it is essential to ensure that the tax structure discourages risk-taking behaviour and does not penalise efficient banks, as its performance-based nature may undermine their solvency by limiting retained earnings. Additionally, this tax could disproportionately affect lower-income individuals, who constitute a larger share of borrowers impacted by potential rising interest rates on loans. Finally, ensuring a level playing across the EU field is vital. If domestic banks face a windfall tax while competing against foreign banks without similar levies, they may find themselves at a competitive disadvantage. Therefore, careful coordination with other Member States would be convenient to avoid market distortions and enhance the overall effectiveness of the levy.

The Management Company for Assets Arising from the Banking Sector Reorganisation (SAREB) has advanced its asset disposal process. More than half of assets have been sold or redeemed, effectively reducing its balance sheet from an initial EUR 50.8 billion. Over the past eleven and a half years of its projected 15-year lifespan (ending in 2027), SAREB's asset composition has increasingly shifted towards real estate-owned assets (REOs), which now make up the bulk of its portfolio. The remainder consists of Real Estate Development (RED) loans, almost all of which are non-performing, secured by real estate and have a cost-to-value ratio exceeding 100%, with collateral repossession progressing slowly. Despite ongoing asset disposal efforts, SAREB has faced significant losses primarily attributed to negative valuation adjustments. Recent legal amendments have allowed

SAREB to operate with negative equity by waiving certain corporate law obligations concerning compulsory winding-up and capital reduction. After incurring EUR 2.2 billion in losses in 2023, the total own resources reached -EUR 4.7 billion by year-end. Cumulative negative valuation adjustmentsdue to asset impairments, resulted in SAREB's negative equity exceeding -EUR 14 billion by the end of 2023.

SAREB is actively executing its Business Plan for 2023-2027, focusing on the "sustainability principle" to bolster social housing policies while maximising the value of its asset portfolio. To strengthen its Social Rental and Support Program, SAREB has approved 7,500 social rentals for vulnerable families. By June 2024, SAREB had transferred 1,700 homes to public administrations for social rentals, raising the total number of residential assets allocated for this purpose to 9,200, up from 7,200 in December 2023. Additionally, SAREB is offering regional and local administrations access to vacant houses and land on preferential terms, having sold around EUR 50 million in assets to these entities in 2023 and budgeting another EUR 55 million for 2024. Furthermore, SAREB is transferring long-term surface rights to private developers, notably through the Viena Project approved in July for the construction of 10,600 homes under an affordable rental regime. The first tender for this initiative has been already launched in October, requiring an investment of EUR 460 million for the promotion of 3,770 homes.

5. SOVEREIGN FINANCING AND CAPACITY TO REPAY

In the short run, public debt in relation to GDP is forecast to decline, but in the baseline scenario of the debt sustainability analysis (DSA), this trend is projected to reverse in the medium term and public debt is projected to reach around 112% of GDP in 2035 () ([21]). Based on data validated by Eurostat, general government debt stood at 105.1% of GDP at the end of 2023. The debt ratio has decreased by 14.2 pps from the 2020 level but remains still about 7.4 pps above the level reached before the pandemic. The general government debt-to-GDP ratio is expected to decrease to 102.3% in 2024 and 101.3% in 2025 according to the Commission's Autumn 2024 Economic Forecast. Based on the Commission's DSA baseline scenario, the debt ratio is projected to decline to 100.8% in 2027 and the debt ratio is expected to rise gradually to 112.1% of GDP in 2035. Based on the debt sustainability analysis, Spain is considered to face low fiscal sustainability risks in the short term. The medium-term fiscal sustainability risks are assessed to be high while the long-run risks are considered to be medium (see Annex B for the debt sustainability analysis).

The structural features of the outstanding government debt in terms of average maturity and investor base remain favourable. At the end of June 2024, according to the Bank of Spain, the central government debt-to-GDP ratio (net of financial assets vis-à-vis other general government sectors) was 75.0% while the ratio for the regional government sector (Autonomous Communities) was 21.9%. The local government sector's debt was 1.5% of GDP and the social security fund's debt was 7.0% of GDP. As regards central government debt, bonds that have maturities ranging from two years to up to 50 years accounted for 92% of the total outstanding central government debt according to the Treasury statistics. The outstanding stock of 10-year bonds represents about 42% of the total debt outstanding and it grew by around 7% year-on-year during the third quarter of 2024, above the growth rate of the total debt stock (5.5%). The recent increasing trend in the share of outstanding bonds with at least 10-year maturity appears to continue. This has helped the average maturity of the debt stock to remain steady at around 7.9 years during the third quarter of 2024, a level where it has been since 2021. The share of short-term debt accounted for about 5% of the total central government outstanding debt in the third quarter of 2024. Although this share has been gradually declining, since spring 2024, the outstanding short term debt stock has started to increase and stood at around EUR 73 billion. According to the Treasury's Funding Strategy for 2024, the target for the short-term debt portfolio is to keep its current size unchanged. As regards the holders of the central government outstanding debt (short- and long-term), non-resident investors' share accounted for 43.0% in July 2024. In July their share was 2.3 pps larger than 12 months earlier. Over the same period, the share of the outstanding debt stock held by the Bank of Spain declined by 3.3 pps to 28.1%, while the share of other resident holders increased by 0.9 pps to 28.8%. As part of the path to monetary policy normalisation, the ECB has decided to reduce the size of its balance sheet. While the reinvestments of maturing securities under the Asset Purchase Programme have already been discontinued, the monthly reinvestments under the Pandemic Emergency Purchase Programme will be reduced over the course of 2024 and discontinued at the end of 2024. ([22])

([21]) For a more detailed debt sustainability analysis, see Annex B.

([22]) The reinvestments under the Asset Purchase Programme (APP) were discontinued as of July 2023. As regards the Pandemic Emergency Purchase Programme (PEPP) the ECB Governing Council stated on 6 June 2024 that "The Governing Council will continue to reinvest, in full, the principal payments from maturing securities purchased under the PEPP until the end of June 2024. Over the second half of the year, it will reduce the PEPP portfolio by €7.5 billion per month on average. The Governing Council intends to discontinue reinvestments under the PEPP at the end of 2024. The Governing Council will continue applying flexibility in reinvesting redemptions coming due in the PEPP portfolio, with a view to countering risks to the monetary policy transmission mechanism related to the pandemic."

Spain has benefited from EU-financed instruments introduced during the pandemic. Under the RRF, which provides financial support to the Spanish recovery and resilience plan (RRP) ([23]), a total of EUR 48.0 billion (3.0% of GDP) in grants has been disbursed to Spain in the 2021-2024 period ([24]).

Following the approval of the revised RRP in October 2023, the maximum amount of RRF grants will be EUR 80 billion and Spain will also draw RRF loans up to EUR 83.2 billion by the end of 2026. In addition, under the Support to mitigate Unemployment Risks in an Emergency (SURE) to protect jobs during the pandemic, a loan which amounted to EUR 21.3 billion was disbursed to Spain in six tranches over 2020-2021.

While financing conditions for the government appear broadly favourable borrowing costs have increased. The average yield at issuance has recently been on a declining trend and stood at 2.9 % in September 2024, down from the recent highs of 4.0 % in October 2023. For the benchmark 10-year bond, the average nominal interest rate at issuance was 3.0 % in September 2024 (down by 0.6 pps from 12 months earlier and nearly 1 percentage point from October 2023, the recent peak). Lower interest rates at issuance also partly reflect the recent increase interest among investors towards Spanish debt. The yield curve points to a further reduction of interest rates in the short term. The recent easing of market interest rates is already reflected in the average interest rate of the outstanding short-term debt which stood at 3.4% in September. However, the central government average interest rate on outstanding debt overall continued to increase in 2024 reaching 2.21% in September, up by 0.2 pps from 12 months earlier reflecting the overall higher interest rate environment. The Treasury's funding strategy for 2024 estimates that the total net financing needs would be around EUR 55 billion, some EUR 10 billion less than the previous year. The gross issuance is projected at around EUR 257.6 billion (16% of GDP), around EUR 5.6 billion higher than in 2023. This indicates that the debt redemptions are increasing in 2024 from EUR 187 billion to EUR 202.6 billion (12.7% of GDP). As the short-term debt portfolio is projected to remain stable in 2024, the changes in net and gross issuances are driven by changes in the medium- and long-term debt portfolio. By 18 October 2024, the Treasury had already executed around 89% of the planned gross issuance, an indication of good market conditions.

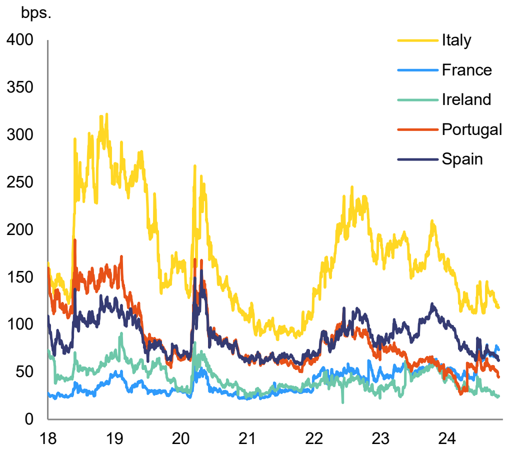
Spain's sovereign spreads peaked in October 2023, but have declined significantly since then. The expected slowdown in economic growth, the higher inflation and the less accommodative monetary policy stance led to an increase in spreads across the euro area in 2023. During 2024 Spain's 10-year government spread with respect to German bonds have narrowed and it has been trending around 70 basis points over the past three months on the back of sustained economic expansion. This level is around 15 bps below the average spread since 2020, indicating increased confidence among investors. S&P, Moody's, Fitch, Scope and DBRS all rate Spain's long-term sovereign debt as investment grade. Moody's changed the outlook from stable to positive in March 2024, DBRS changed the outlook positive in May 2024, and Scope upgraded the rating in September 2024. While the other agencies, S&P and Fitch, consider the outlook as stable.

([23]) See the Commission's proposal for the revised RRP: https://commission.europa.eu/publications/commission-proposal-council-implementing-decision-amending-council-implementing-decision-13-july_en.

([24]) Including pre-financing and four payment requests concerning grants. In addition, pre-financing related to loans, some EUR 340 million, has been disbursed in 2024.
See the RRF scoreboard https://ec.europa.eu/economy_finance/recovery-and-resilience-scoreboard/disbursements.html?lang=en.

The outstanding amount of the ESM loan is EUR 16.4 billion, which represents 39.7% of the total amount disbursed to Spain under the programme. The Spanish Government started their repayment of the loan's principal with voluntary repayments in July 2014. Between July 2014 and October 2018, Spain made nine voluntary early repayments. In December 2022 – in line with the agreed repayment schedule – Spain made the first scheduled repayment worth EUR 3.6 billion. This was followed by the second scheduled payment in December 2023. At the end of 2023, Spain had repaid nearly EUR 25 billion of the ESM loan. The next scheduled payments are EUR 4.6 billion in 2024 and 2025. The last repayment is expected in 2027.

Graph 5.1: **Sovereign spreads to the 10-year German bund**



Source: IHS Markit, own calculations.

Spain retains the capacity to service its public debt. Spain's public debt remains still above the pre-pandemic level. Nevertheless, the structure of outstanding government debt reduces the vulnerabilities arising from the elevated debt levels and rising market interest rates. The gross financing needs are expected to remain large at around 15% of GDP in 2024-2025. Based on the ECB's policy decisions, the Eurosystem's holdings of Spanish debt are expected to continue to be on a decreasing trend, while the roles of non-resident and resident investors continue to gain in importance. Against the background of high overall debt stock, relatively stable short-term financing needs and long average maturity, the increased market rates will only gradually result in an increase in actual interest expenditure. On the positive side, the increases in the average costs of financing come from low levels and recently the cost at issuance has started to decline as the monetary policy has started to ease. Furthermore, the spread in relation to German bonds has recently narrowed, which gives indications of increased market confidence towards Spain. In addition, the maturity has remained at a high level reflecting a policy choice of the Treasury. Owing to high average maturity, the Treasury is considered to have a buffer against possible shifts in investors' demand towards higher yield. As regards other government sector debt, the current situation is considered stable.

ANNEX A

Main macroeconomic and financial indicators

Table A.1: **Selected economic indicators**

	2020	2021	2022	2023	2024	2025	2026
Real economy			*(percent change)*				
Real GDP	-10.9	6.7	6.2	2.7	3.0	2.3	2.1
Domestic demand incl. inventories	-9.0	7.0	3.9	1.7	2.5	2.3	2.2
Private consumption expenditure	-12.1	7.1	4.8	1.8	2.5	2.2	2.0
Government consumption expenditure	3.5	3.6	0.6	5.2	3.4	1.6	1.5
Gross fixed capital formation	-8.9	2.6	3.3	2.1	2.0	3.2	3.7
Exports of goods and services	-20.1	13.4	14.3	2.8	3.4	2.9	2.7
Imports of goods and services	-15.1	15.0	7.7	0.3	2.2	2.8	3.0
Contribution to growth			*(percentage points)*				
Domestic demand (excl. inventories)	-8.1	5.3	3.5	2.5	2.5	2.1	2.1
Foreign trade	-2.2	-0.3	2.3	1.0	0.6	0.2	0.0
Changes in inventories	-0.7	1.6	0.4	-0.8	0.0	0.0	0.0
Inflation			*(percent change)*				
GDP deflator	1.1	2.6	4.7	6.2	3.1	2.4	2.0
HICP	-0.3	3.0	8.3	3.4	2.8	2.2	2.0
Labour market			*(percent change, unless otherwise stated)*				
Unemployment rate (% of labour force)	15.5	14.9	13.0	12.2	11.5	11.0	10.7
Employment	-4.4	2.6	3.5	3.0	2.3	2.1	2.0
Compensation per employee	0.8	4.8	4.9	5.8	4.6	3.1	2.2
Labour productivity	-6.8	4.0	2.6	-0.3	0.6	0.2	0.1
Unit labour costs	8.2	0.8	2.3	6.2	4.0	2.9	2.0
Public finance			*(percent of GDP)*				
General government balance	-9.9	-6.7	-4.6	-3.5	-3.0	-2.6	-2.7
Total revenue	41.5	42.8	41.8	41.9	42.4	42.8	42.9
Total expenditure	51.4	49.5	46.4	45.4	45.4	45.4	45.5
General government primary balance	-7.7	-4.5	-2.3	-1.1	-0.5	-0.1	-0.1
Gross debt	119.3	115.7	109.5	105.1	102.3	101.3	101.1
Balance of payments			*(percent of GDP)*				
Current external balance	0.8	0.8	0.4	2.7	4.2	4.5	4.4
Ext. bal. of goods and services	1.5	1.0	0.9	3.9	4.6	4.8	4.7
Exports goods and services	30.5	33.8	39.8	38.1	37.7	37.6	37.5
Imports goods and services	29.0	32.8	38.9	34.1	33.1	32.8	32.8
			(EUR bn)				
Nominal GDP	4.4	6.1	4.8	4.1	5.1	4.9	3.8

Source: Commission services.

ANNEX B

Debt sustainability analysis

This annex assesses fiscal sustainability risks for Spain over the short, medium and long term. It follows the multi-dimensional approach of the European Commission's 2023 Debt Sustainability Monitor, updated based on the Commission 2024 autumn forecast.

1 – Short-term risks to fiscal sustainability are low overall. The Commission's early-detection indicator (S0) does not signal major short-term fiscal risks (Table B.2) ([25]). Government gross financing needs are expected to remain large, at around 16% of GDP over 2024-2025 (Table B.1, Table 1). Financial markets' perceptions of sovereign risk are investment grade, as confirmed by the main rating agencies.

2 – Medium-term fiscal sustainability risks are high.

Under the DSA baseline, debt is projected to decline slightly before increasing again over the medium term, reaching around 112% of GDP in 2035 (Graph 1 and Table 1) ([26]). The increase in the government debt ratio is partially driven by the assumed structural primary deficit (excluding changes in cost of ageing) of 0.6% of GDP as of 2025. This level appears plausible compared with past fiscal performance, indicating that the country has room for corrective action (Table B.2) ([27]). Moreover, ageing-related expenditure is projected to increase, weighing on public finances. At the same time, the baseline projection benefits from a still favourable (although declining) snowball effect up to 2032, notably thanks to the impact of Next Generation EU. Government gross financing needs are expected to remain large and to increase over the projection period, reaching 20.1% of GDP in 2035.

The baseline projection is stress-tested against four alternative deterministic scenarios to assess the impact of changes in key assumptions (Graph 1). All four scenarios lead to higher debt levels than the baseline. Under the *adverse interest-growth rate differential scenario* (in which the interest-growth rate differential deteriorates by 1.0 pp. compared with the baseline), the debt ratio would exceed the baseline level by around 9 pps. by 2034. Under the other scenarios – namely the *historical structural primary balance (SPB) scenario* (in which the SPB returns to its historical 15-year average of -1.3% of GDP), the *lower SPB scenario* (in which the improvement in the SPB forecast for 2025 is halved) and *the financial stress scenario* (in which interest rates temporarily increase by 2.1 pps. compared with the baseline) – the debt ratio would also be higher than in the baseline by 2035, by around 5 pps., 2 pps. and 1 pp., respectively.

The stochastic projections indicate high risk due to the high probability of debt increasing over the next five years ([28])**.** These stochastic simulations indicate that the debt ratio will be higher

([25]) The S0 is a composite indicator of short-term risk of fiscal stress. It is based on a wide range of fiscal and financial-competitiveness indicators that have proven to be a good predictor of emerging fiscal stress in the past.

([26]) The assumptions underlying the Commission's 'no-fiscal policy change' baseline include in particular: (i) a structural primary deficit, before changes in ageing costs, of 0.6% of GDP from 2025 onwards; (ii) inflation converging linearly towards the 10-year forward inflation-linked swap rate 10 years ahead (which refers to the 10-year inflation expectations 10 years ahead); (iii) the nominal short- and long-term interest rates on new and rolled over debt converging linearly from current values to market-based forward nominal rates by T+10; (iv) real GDP growth rates from the Commission 2024 autumn forecast, followed by the EPC/OGWG 'T+10 methodology projections between T+3 and T+10 (average of 1.2%); (v) ageing costs in line with the 2024 Ageing Report (European Commission, Institutional Paper 279, April 2024). For information on the methodology, see the 2023 Debt Sustainability Monitor (European Commission, Institutional Paper 271, March 2024). Note that the anchoring of the structural primary balance on the first forecast year (T+1) as opposed to the second forecast year (T+2) implies that several projected variables, including debt, budget balance and GDP, for T+2 (in this case 2026) can differ from the Commission 2024 autumn forecast.

([27]) This assessment is based on the fiscal consolidation space indicator, which measures the frequency with which a tighter fiscal position than assumed in a given scenario has been observed in the past. Technically, this consists in looking at the percentile rank of the projected SPB within the distribution of SPBs observed in the past in the country, taking into account all available data from 1980 to 2024.

([28]) The stochastic projections show the joint impact on debt of 10,000 different shocks affecting the government's budgetary position, economic growth, interest rates and exchange rates. This covers 80% of all the simulated debt paths and therefore excludes tail events.

in 2029 than in 2024 with a probability of 48%, pointing to high risk given the high initial debt level. Some uncertainty surrounds the baseline debt projection, as measured by the difference of around 29 % of GDP between the 10th and 90th debt distribution percentiles in five years' time (Graph 2).

3 – Long-term fiscal sustainability risks are medium. This assessment is based on the combination of two fiscal gap indicators, capturing the required fiscal effort to stabilise debt (S2 indicator) and to bring it to 60% of GDP (S1 indicator) over the long term ([29]). This assessment is driven by the projected increase in ageing-related costs and by the unfavourable initial deficit and debt levels.

The S2 indicator points to medium risk. It signals that Spain would need to improve its structural primary balance by 5.6% of GDP to ensure that debt stabilises over the long term (Table B.1, Table 2). This result is mainly driven by the projected increase in ageing costs, which contributes 3.9 pps., of which 2.6 pps. stemming from pension expenditure and 1.8 pps. jointly from health care and long-term care expenditure, partially offset by a negative contribution from education. The remainder of the needed effort is due to the unfavourable budgetary position, contributing 1.6 pps. ([30])

The S1 indicator also points to medium risk. This indicator shows that a significant fiscal effort of 5.1% of GDP would be needed for Spain to reduce its debt to 60% of GDP by 2070. This result is also mainly driven by the projected increase in ageing costs (contributing 3.2 pps.). The initial deficit and high debt level contribute an additional 1.1 pp. and 0.8 pps., respectively (Table 2).

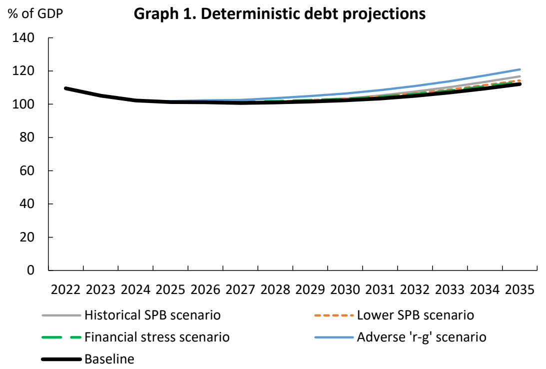
4 – Finally, several additional risk factors need to be considered in the assessment. On the one hand, risk-increasing factors relate to the context of higher interest rates given the elevated level of public debt. On the other hand, risk-mitigating factors include the lengthening of debt maturity in recent years, relatively stable financing sources featuring a well-diversified and large investor base, and the very large share of debt denominated in euro. In addition, the 'closure clause' introduced by the 2023 pension reform, if fully implemented, would contribute to addressing the emerging fiscal sustainability gaps related to public pension expenditure. Furthermore, while a number of investments and reforms in the RRP contribute to supporting the efficiency of the Spanish health system, measures may be required to further improve its efficiency and its fiscal sustainability.

([29]) The S2 fiscal sustainability indicator measures the permanent SPB adjustment in 2025 that would be required to stabilise public debt over an infinite horizon. It is complemented by the S1 indicator, which measures the permanent SPB adjustment in 2025 needed to bring the debt ratio to 60% by 2070. The impact of the drivers of S1 and S2 may differ due to the infinite horizon component considered in the S2 indicator. For both the S1 and S2 indicators, the risk assessment depends on the amount of fiscal consolidation needed: 'high risk' if the required effort exceeds 6% of GDP, 'medium risk' if it is between 2% and 6% of GDP, and 'low risk' if the effort is negative or below 2% of GDP. The overall long-term risk classification combines the risk categories derived from S1 and S2. S1 may notch up the risk category derived from S2 if it signals a higher risk than S2. See the 2023 Debt Sustainability Monitor for further details.

([30]) The pension reform includes measures aiming to preserve adequacy and intergenerational equity, including by increasing the effective retirement age and contributions to the pension system, while minimising the impact on the tax wedge on labour. The impact of the legislated revenue measures of the 2023 pension reform, such as the intergenerational equity mechanism, are not included in this projection.

Table B.1: **Debt sustainability analysis – Spain**

Table 1. Baseline debt projections	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035
Gross debt ratio (% of GDP)	**109.5**	**105.1**	**102.3**	**101.3**	**101.2**	**100.8**	**101.1**	**101.6**	**102.3**	**103.5**	**105.1**	**107.1**	**109.5**	**112.1**
Changes in the ratio	-6.2	-4.4	-2.9	-1.0	0.0	-0.5	0.3	0.5	0.7	1.1	1.6	2.0	2.4	2.6
of which														
Primary deficit	2.3	1.1	0.5	0.1	0.2	0.4	0.8	1.0	1.2	1.4	1.7	2.0	2.2	2.4
Snowball effect	-9.3	-6.7	-3.5	-2.2	-1.5	-0.8	-0.4	-0.5	-0.5	-0.3	-0.1	0.1	0.2	0.2
Stock-flow adjustments	0.8	1.2	0.2	1.1	1.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross financing needs (% of GDP)	18.6	18.5	15.9	16.3	16.5	15.7	16.2	16.6	17.0	17.4	18.0	18.7	19.4	20.1



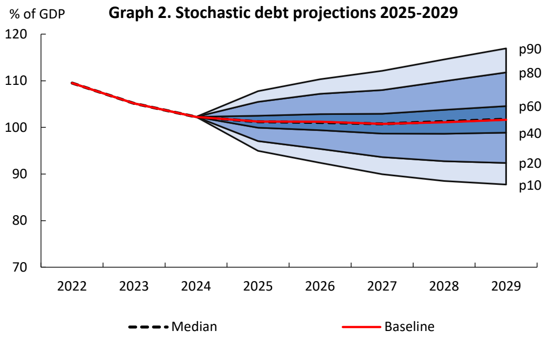


Table 2. Breakdown of the S1 and S2 sustainability gap indicators

		S1	S2
Overall index (pps. of GDP)		**5.1**	**5.6**
of which			
Initial budgetary position		1.1	1.6
Debt requirement		0.8	
Ageing costs		3.2	3.9
of which	*Pensions*	2.3	2.6
	Health care	0.9	1.1
	Long-term care	0.5	0.7
	Others	-0.5	-0.5

Source: Commission services.

Table B.2: **Heat map of fiscal sustainability risks - Spain**

Short term	Medium term - Debt sustainability analysis (DSA)								Long term		
Overall (S0)	Overall		Deterministic scenarios: Baseline	Historical SPB	Lower SPB	Adverse 'r-g'	Financial stress	Stochastic projections	S2	S1	Overall (S1 + S2)
LOW	HIGH	Overall	HIGH	HIGH	HIGH	HIGH	HIGH	HIGH	MEDIUM	MEDIUM	MEDIUM
		Debt level (2035), % GDP	112.1	116.7	114.3	121.0	113.4				
		Debt peak year	2035	2035	2035	2035	2035				
		Fiscal consolidation space	65%	75%	70%	65%	65%				
		Probability of debt ratio exceeding in 2029 its 2024 level						48%			
		Difference between 90th and 10th percentiles (pps. GDP)						29.2			

(1) Debt level in 2035. Green: below 60% of GDP. Yellow: between 60% and 90%. Red: above 90%. (2) The debt peak year indicates whether debt is projected to increase overall over the next decade. Green: debt peaks early. Yellow: peak towards the middle of the projection period. Red: late peak. (3) Fiscal consolidation space measures the share of past fiscal positions in the country that were more stringent than the one assumed in the baseline. Green: high value, i.e. the assumed fiscal position is plausible by historical standards and leaves room for corrective measures if needed. Yellow: intermediate. Red: low. (4) Probability of debt ratio exceeding in 2029 its 2024 level. Green: low probability. Yellow: intermediate. Red: high (also reflecting the initial debt level). (5) the difference between the 90th and 10th percentiles measures uncertainty, based on the debt distribution under 10000 different shocks. Green, yellow and red cells indicate increasing uncertainty.

Source: Commission services.

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