European Commission

ISSN 2443-8014 (online)

Post-Programme Surveillance Report

Spain, Spring 2018

INSTITUTIONAL PAPER 082 | JULY 2018

EUROPEAN ECONOMY

Economic and Financial Affairs

European Economy Institutional Papers are important reports analysing the economic situation and economic developments prepared by the European Commission's Directorate-General for Economic and Financial Affairs, which serve to underpin economic policy-making by the European Commission, the Council of the European Union and the European Parliament.

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Luxembourg: Publications Office of the European Union, 2018

PDF ISBN 978-92-79-77463-8 ISSN 2443-8014 doi:10.2765/523266 KC-BC-18-014-EN-N

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ACKNOWLEDGEMENTS

The report was prepared in the Directorate General for Economic and Financial Affairs under the direction of Servaas Deroose, Deputy Director General and general oversight of Laura Bardone, Head of Unit –Croatia/ Spain.

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The cut-off date for the data included in this report is 7 June 2018

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ABBREVIATIONS

BBVA	Banco Bilbao Vizcaya Argentaria, S.A.
BdE	Banco de España, Bank of Spain
BFA	Banco Financiero y de Ahorros, S.A.
BMN	Banco Mare Nostrum, S.A.
BRRD	Bank Recovery and Resolution Directive
CCyB	countercyclical buffer
CDS	Credit Default Swaps
CSRs	Country-Specific Recommendations
DBP	Draft Budgetary Plan
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
EDP	Excessive Deficit Procedure
ESM	European Stability Mechanism
ESRB	European Systemic Risk Board
FROB	Fondo de Reestructuración Ordenada Bancaria, now Autoridad de Resolución Ejecutiva, the Spanish Executive Resolution Authority
HICP	Harmonised Index of Consumer Prices
IFRS	International Financial Reporting Standards
INE	Instituto Nacional de Estadística, the Spanish National Statistics Institute
IPO	Initial Public Offering
MREL	Minimum Requirement for own funds and Eligible Liabilities
NFCs	Non-Financial Corporations
NIIP	Net International Investment Position
NPLs	Non-Performing Loans
PPS	Post Programme Surveillance
RDL	Real Decreto-ley, Royal Decree-Law
REOs	Real Estate Owned assets
ROA	Return on Assets
ROE	Return on Equity
SAFE	Survey on the Access to Finance of small and medium-sized Enterprises
SAREB	Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria S.A.
SMEs	Small and Medium-sized Enterprise
SRB	Single Resolution Board
y-o-y	year on year

EXECUTIVE SUMMARY

This ninth surveillance report provides an assessment of Spain's economic and financial situation following its exit from the financial assistance programme in January 2014. A team from the European Commission (EC), in liaison with staff from the European Central Bank (ECB), carried out the ninth post-programme surveillance visit to Spain on 9-10 April 2018. The European Stability Mechanism (ESM) participated in the meetings on aspects relating to its own Early Warning System. The report focuses on macroeconomic and financial sector developments over the past months, complementing the surveillance by the Commission under the macroeconomic imbalances procedure, the Stability and Growth Pact and, more broadly, the European Semester of economic policy coordination.

Spain has continued to record robust economic growth. The volume of output grew by 3.1% in 2017, above the euro area average for the third year in a row. Private consumption continued to be the main growth driver, but investment and, in particular, residential construction, was stronger than expected. Net exports also contributed to growth in 2017, though less than anticipated. Dynamic job creation drove a marked decline in the unemployment rate, which however remains very high. The economic impact of the events in Catalonia last autumn remained contained, and GDP growth in the first quarter of 2018 showed no signs of deceleration compared to the two previous quarters. Including the positive economic impact of the draft 2018 budget, the Commission 2018 spring forecast projects growth to moderate only slightly, to 2.9% this year and 2.4% in 2019, driven by a slowdown in private consumption.

Amid continued strong economic growth, the Spanish banking sector enjoys overall comfortable liquidity, and several banks increased their issuance of debt securities. Profitability of domestic operations took a hit in the second quarter of 2017 due to the losses incurred by Banco Popular, but the sector returned to profitability in the following two quarters. Capital buffers have been supported by the issuance of both core and non-core capital instruments. This facilitated the continuation of NPLs reduction, including in banks with relatively high amounts of legacy assets. The NPL ratio for the Spanish banks, including on their international activity, declined to close to the EU average. However, the recent expansion of consumer credit deserves close monitoring. The merger of BMN with Bankia in January 2018, accompanied by FROB's sale of another minority stake in Bankia in December 2017, is the latest step in the process of restructuring of the Spanish banking sector. Successfully completing the privatisation of the merged entity and the divestment plans of banking foundations in savings banks will further reinforce the Spanish banking sector. In addition, banks continued to improve their business models and efficiency and increased the supply of new loans to the economy.

Although the low-interest-rate environment supports the reduction of doubtful loans and economic growth, it continued to put pressure on Spanish banks' margins, as on their European peers. Against this background, some Spanish credit institutions will have to continue to adapt their business models to achieve efficiency gains, through additional actions such as higher digitalisation. It will also be important to continue carefully monitoring litigation risks following some court rulings which may put downward pressure on profitability.

Despite having improved its gross margin, the asset management company SAREB([1]) recorded again negative financial results in 2017. SAREB's activity is challenged by the relatively low quality of its assets, slower than expected divestment of its portfolio and repayment of debt and high financial costs.

Strong and balanced growth, coupled with dynamic job creation, supports the correction of macroeconomic imbalances, but challenges remain. In its 2018 country report for Spain, published on 7 March 2018, the Commission concluded that Spain is still experiencing macroeconomic imbalances. In particular, the reduction of private sector debt has progressed, both for households and corporates, but deleveraging needs are still present in some segments of the economy. Despite strong nominal GDP growth, government debt as a share of GDP is only slowly decreasing. The still high but decreasing level of private and public debt is reflected in a sizeable amount of external liabilities. In addition, low

([1]) Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria S.A. (SAREB).

productivity growth makes competitiveness gains hinge upon cost advantages. The decrease in unemployment from a peak of 26.9% in the first quarter of 2013, to 16.7% of the labour force in the first quarter of 2018, has been remarkable, but the unemployment rate remains among the highest in the EU, especially among young and low-skilled workers, and the high degree of labour market segmentation impedes faster labour productivity growth. Drawing on the assessment of progress on the implementation of recommendations in recent years, as well as on the reform plans presented by Spain in its national reform programme and stability programme, on 23 May, the Commission proposed a new set of country-specific recommendations in the context of the European Semester. These include calls to ensure sounder public finances, improve the labour market and social policy and strengthen productivity through support to research and innovation, skills in the labour market and the business environment.

Spain's general government deficit has continued to narrow, mainly supported by the strong economic growth. The headline deficit amounted to 3.1% of GDP in 2017, in line with the Excessive Deficit Procedure (EDP) target. According to the Commission 2018 spring forecast, the deficit is set to decline further to 2.6% of GDP in 2018. On 23 May, the Commission assessed Spain’s compliance with the provisions of the Stability and Growth Pact (SGP), based on the Commission 2018 spring forecast, Spain's updated Draft Budgetary Plan (DBP) and the 2018 Stability Programme. It concluded that the updated DBP for 2018, the deadline for the correction of the excessive deficit, is broadly compliant with the provisions of the SGP, as the Commission 2018 spring forecast projects that in 2018 the deficit will be brought below the Treaty threshold in a timely and durable manner. However, the Commission forecast projects that neither the headline deficit target nor the fiscal effort requested in the 2016 Council notice will be met in 2018. On the contrary, the updated DBP is expansionary. For 2019, assuming that Spain will enter the preventive arm of the SGP in that year, the new country-specific recommendations call on Spain to ensure that the nominal growth rate of net primary government expenditure does not exceed 0.6% in 2019, corresponding to a strengthening of the structural balance of 0.65% of GDP in that year.

On the basis of the analysis in the report, repayment risks for the ESM loan appear very low. Overall, a healthier financial sector and the strong economic recovery keep repayment risks low. The government's debt issuance continues to decline and the average cost of outstanding debt in May 2018 was about 1.5 pp lower than in 2011, while the cost of issuance remains very low. This, combined with a lengthening average life of debt outstanding, further decreases repayment risks for the ESM. On 8 February 2018, the Board of Directors of the ESM approved two additional voluntary early repayments for Spain. As a result, Spain has already repaid 35.3% of the original loan.

The next post-programme surveillance mission will take place in autumn 2018.

1. INTRODUCTION

1. Spain successfully exited the financial assistance programme for the recapitalisation of financial institutions in January 2014. The Programme was agreed by the Eurogroup on 9 July 2012 for a period of 18 months([2]) and provided financing by the euro area Member States of up to EUR 100 billion. Eventually, Spain used EUR 38.8 billion for bank recapitalisation, under restructuring and resolution plans approved by the European Commission under State-aid rules, and around EUR 2.2 billion for capitalising SAREB, the Spanish asset management company. Both the bank-specific conditionality and the horizontal conditionality included in the Memorandum of Understanding were fulfilled as scheduled.([3]) From July 2014 to end 2017, Spain made six voluntary early repayments. On 8 February 2018, the Board of Directors of the European Stability Mechanism (ESM) approved two additional voluntary repayments of EUR 5 billion. The first repayment of EUR 2 billion was made in February 2018 and the second, of EUR 3 billion, was executed in May. Following this, the outstanding amount of the ESM loan stands at EUR 26.7 billion.

2. Staff from the European Commission, in liaison with the European Central Bank, undertook the ninth post-programme review mission to Spain from 9 to 10 April 2018. The ESM participated in the meetings on aspects related to its own Early Warning System. Post-programme surveillance (PPS) aims at a broad monitoring of the repayment capacity of a country having received financial assistance.([4]) There is no policy conditionality under PPS, although the Council can issue recommendations for corrective actions if deemed necessary and appropriate. PPS is biannual in terms of reporting and missions. The previous PPS mission took place in October 2017.([5])

3. The spring 2018 PPS focuses on the Spanish financial sector, complementing the surveillance under the macroeconomic imbalances procedure, the Stability and Growth Pact and more broadly the European Semester of economic policy coordination. This PPS report complements the 2018 Country Report for Spain([6]), published on 7 March 2018 in the context of the European Semester. That report included an In-Depth Review on the prevention and correction of macroeconomic imbalances under Article 5 of Regulation (EU) No 1176/2011. The Commission's analysis in the report led it to conclude that Spain is experiencing macroeconomic imbalances which have cross-border relevance([7]). On 23 May 2018, the European Commission presented its 2018 Country-specific Recommendations (CSRs). The Commission proposed that the Council recommend that Spain([8]) pursue structural reforms in the areas of the labour market, social policy, education, business regulation, and research and innovation. It also called on Spain to ensure compliance with the Council decision of 8 August 2016 giving notice under the excessive deficit procedure of the Stability and Growth Pact([9]) and set out the fiscal adjustment path for 2019, when Spain is expected to enter the preventive arm of the Pact. The responsibility for implementing the CSRs lies with the new government that was formed on 7 June 2018.

([2]) However, the completion of the restructuring of the banks receiving public support under the State aid rules was due to take place after the exit from the programme.

([3]) For more details see the report: https://ec.europa.eu/info/publications/economy-finance/evaluation-financial-sector-assistance-programme-spain-2012-2014_en.

([4]) PPS is foreseen by Art. 14 of the two-pack Regulation (EU) N°472/2013. It starts automatically after the expiry of the programme and lasts at least until 75% of the financial assistance has been repaid.

([5]) For more details see the eighth PPS report: https://ec.europa.eu/info/publications/economy-finance/post-programme-surveillance-report-spain-autumn-2017_en.

([6]) https://ec.europa.eu/info/sites/info/files/2018-european-semester-country-report-spain-en.pdf

([7]) https://ec.europa.eu/info/sites/info/files/2018-european-semester-country-report-communication_en.pdf.

([8]) https://ec.europa.eu/info/sites/info/files/2018-european-semester-country-specific-recommendation-commission-recommendation-spain-en.pdf.

([9]) http://data.consilium.europa.eu/doc/document/ST-11552-2016-INIT/en/pdf.

2. RECENT MACROECONOMIC AND FINANCIAL SECTOR DEVELOPMENTS

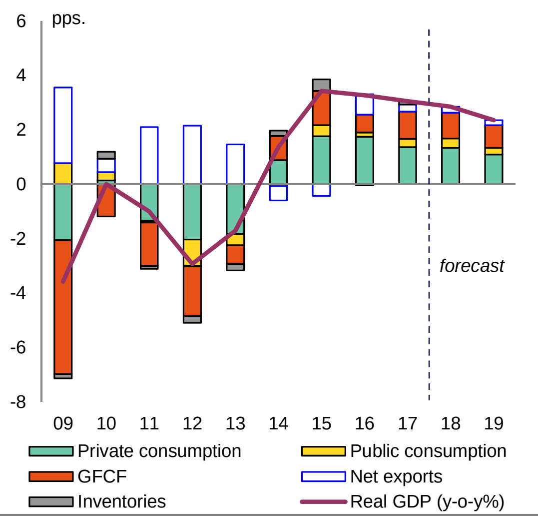
2.1. RECENT MACROECONOMIC DEVELOPMENTS

4. Spain has continued to record robust growth. Real GDP expanded by 3.1% in 2017, with a more balanced growth pattern than before the crisis. Private consumption continued to be the most important growth driver, but investment and, in particular, residential construction, was stronger than expected. Net exports also contributed to growth in 2017, though less than anticipated. The consequences for growth of the events in Catalonia remained contained, and GDP expanded by 0.7% q-o-q in 2018-Q1 and the two previous quarters, showing no signs of deceleration compared to the two previous quarters.

5. Economic activity is still expected to moderate in 2018 and 2019, driven by a slowdown in private consumption. After incorporating the measures planned in the 2018 draft budget law that was sent to Parliament in April, the European Commission 2018 spring forecast expects real GDP to moderate to 2.9% this year and 2.4% in 2019 (see Graph 2.1).([10]) If adopted, the measures in the draft budget, as well as continued strong job creation and increasing, though still contained, wage growth should support disposable income. However, as households are expected to increase their saving rate, private consumption growth would moderate. Investment is also expected to decelerate in line with final demand, but continue growing robustly, helped by the strength of the construction sector.

6. The external sector is expected to continue contributing to GDP growth. Since 2016, net exports have had a positive contribution to growth, on account of structural improvements in export performance, as confirmed by the increase in the number of regular exporters, supported by cost competitiveness gains. Besides, there is evidence of a structural reduction in import propensity, as firms have started to substitute imported inputs with domestic ones. In cyclically adjusted terms, the Spanish current account balance has been positive since 2016, corroborating the evidence of a structural improvement in trade performance. According to the European Commission 2018 spring forecast, net exports are projected to continue making a positive contribution to growth in 2018 and 2019. However, when combined with the expected movements in the terms of trade, this would result in a decline in the current account surplus in 2018 and an improvement in 2019.

Graph 2.1: **Composition of GDP growth**



GFCF: gross fixed capital formation
Source: INE, European Commission Economic Forecast, spring 2018

7. Core inflation is expected to gradually increase. The European Commission 2018 spring forecast projects HICP inflation to decline from 2% in 2017 to 1.4% in 2018, and remain at this level in 2019, as the pickup in core inflation is offset by base effects from oil price developments. Core inflation is forecast to reach 1.6% in 2019 as wage growth increases and the output gap, expected to turn positive this year, widens. However, the larger-than-expected increase in oil prices since the cut-off date of the spring forecast (23 April) implies an upward risk to these inflation projections.

8. The ongoing recovery of the housing market supports progress in cleaning up banks' legacy assets. After the sharp adjustment that followed the crisis, the housing market and construction sector are recovering. Unsubsidised house prices increased by 6.2% year-on-year in the

([10]) The European Commission spring 2018 has a cut-off date of 23 April, and only includes data released until that date.

first quarter of 2018.([11]) Prices of new dwellings went up by 5.7% and those of used dwellings by 6.3%. House price developments vary greatly across regions, with larger increases in areas where the stock of unsold houses is lower. Moreover, in 2018-Q1, the number of transactions on dwellings increased by 11.6% year-on-year, according to INE. Nevertheless, despite the rise in transactions, in 2018-Q1 residential investment was still at less than half the volume of its pre-crisis peak.

9. Job creation is expected to remain strong but decelerate over the forecast horizon. Employment expanded by 2.9% in 2017, the third year in a row of robust growth, bringing the number of people employed above 19.5 million (national accounts data). However, total employment is still almost 10% below its pre-crisis peak. Administrative employment data up to May 2018 point to sustained employment growth, above the pace of job creation reported by the Labour Force Survey in recent quarters. According to the European Commission 2018 spring forecast, employment growth is set to ease in 2018 and 2019, but remain strong, at 2.6% and to 2.2% respectively (total employment, national accounts). As a result, the unemployment rate would fall under 14% by 2019, the lowest level since 2008, well below the crisis peak in 2013. After remaining subdued in 2017, wage growth is projected to gradually pickup in both the public and private sector over 2018 and 2019. Productivity is forecast to grow very moderately, leading to contained increases in nominal unit labour costs. However, further cost-competitiveness gains vis-à-vis the rest of the euro area are expected.

10. The general government deficit came down further in 2017, helped by strong economic growth. After attaining 4.5% of GDP in 2016, the general government deficit narrowed to 3.1% of GDP in 2017. The Commission 2018 spring forecast projects that the deficit will decline to 2.6% of GDP in 2018 and 1.9% of GDP in 2019. The reduction of the deficit continues to rely mainly on the cyclical upturn, which is expected to support tax revenues and keep social transfers in check, and on total public expenditure growing by less than nominal GDP. The prevailing favourable financing conditions and a slightly decreasing public debt ratio imply that interest expenditure is likely to continue to fall in 2018, albeit at a slower pace than in previous years. At the same time, the measures contained in the 2018 draft budget law presented to parliament in early April, in particular the tax cut for low-income earners, the higher revaluation of pensions at the lower end and the 1.75% pay hike for public employees, are projected to dampen the pace of deficit reduction compared to 2017. The forecast for 2018 also includes a temporary increase in public investment, reflecting the general government's takeover of a number of distressed motorways. It must be noted that the Commission forecast does not include the additional increases in pension spending resulting from the budget negotiations in parliament, as they were agreed upon after the cut-off date for the Commission forecast. The budgetary impact of these additional measures is estimated in the Stability Programme at 0.1% and 0.2% of GDP in 2018 and 2019, respectively. At the cut-off date of this report, the draft budget still required final approval by Spain’s parliament.

11. The public debt ratio is set to continue slowly decreasing, but to remain at a high level over the forecast horizon. According to the Commission 2018 spring forecast, gross general government debt will decrease from 98.3% in 2017 to 95.9% of GDP in 2019, as strong nominal GDP growth more than offsets the impact of the negative budget balance in all forecast years. The Spanish Treasury's funding programme foresees net issuance of 40 billion EUR in 2018, 5 billion EUR less than in 2017. About 45% of the planned full-year gross issuance of around 215 billion EUR was issued in the first five months of the year. Of this, more than two thirds were of a medium- or long-term nature. The average life of debt outstanding as of 31 May 2018 has climbed to around 7.5 years, compared to the low point of 6.2 years in 2013, as the Spanish Treasury has benefitted from lower interest rates to extend maturities. While the cost at issuance has risen slightly from a low of 0.61% in 2016 to 0.82% at the end of May 2018, it remains significantly below the cost of debt outstanding, which stood at 2.52% on 31 May 2018. In 2011, both stood at around 4.0%. Over the last three years, Spanish banks have reduced their holdings of Spanish government debt instruments and now hold about 18% of total outstanding debt instruments of the

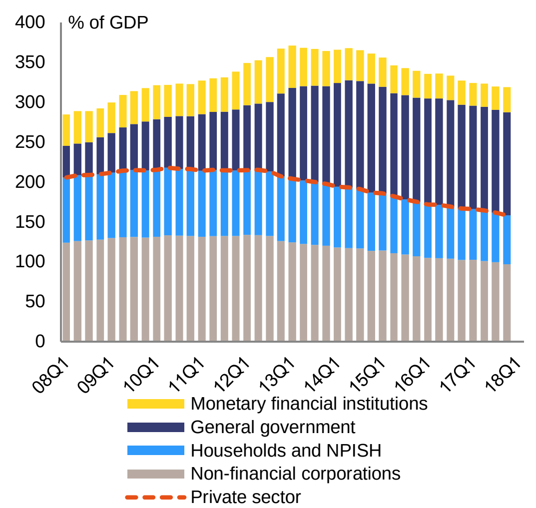
([11]) Source: INE; other data sources present different results, but all show price increases.

state, less than the Bank of Spain, which has seen a four-fold increase in its share from around 5% to more than 21%, mainly in the context of the implementation of the ECB monetary policy decisions. The share of non-resident investors has been rather stable at around 44%.

12. Private debt continued reducing over 2017, but remains high, especially for certain groups of households and companies. The total stock of debt of the non-financial private sector amounted to 158.1% of GDP in non-consolidated terms in the fourth quarter of 2017 (61.3% of GDP by households and 96.8% of GDP by non-financial corporations (NFCs); see Graph 2.2). This is 59.7% of GDP lower than its peak in the second quarter of 2010.([12]) Although most of the debt reduction is attributable to non-financial corporations (a reduction by 36% of GDP), progress in households' deleveraging was also remarkable (it dropped by 23.7% of GDP). In 2017, the pace of debt reduction slowed down in the case of households, while it remained stable in the case of NFCs. Debt reduction is taking place along with an increase in new credit towards households and companies, as well as with a rise in the issuance of debt securities by NFCs. GDP growth has thus become the main driver of private sector deleveraging. Despite its reduction, the outstanding stock of private debt remains above prudential levels and fundamental-based benchmarks for both households and NFCs (2018 Country Report for Spain), suggesting deleveraging needs persist. This is the case in particular for some over-indebted households (such as low-income or jobless households) and for companies in the construction and real estate services sectors that are particularly vulnerable to changes in the economic and financial situation.

([12]) In consolidated terms, the NFC debt decreased from 117.7% in Q2-2010 to 78.0% in Q4-2017. Financial derivatives are excluded from these figures.

Graph 2.2: **Indebtedness by sector**

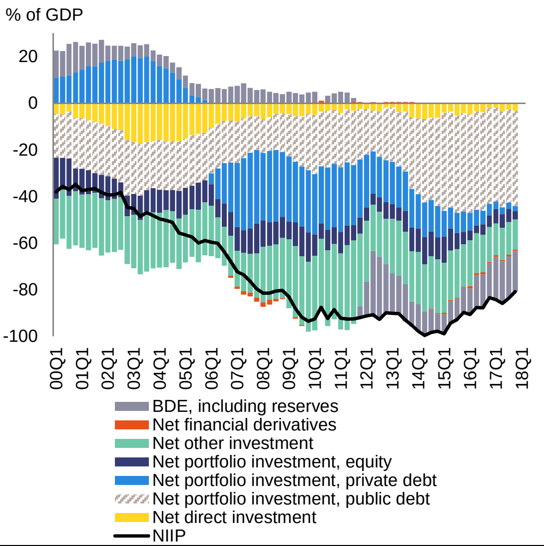


NPISH: Non-profit institutions serving households
Source: BdE, own calculations.

13. The still high level of private and public debt is reflected in a large, though declining, amount of net external liabilities. Spain's net international investment position (NIIP) improved in 2017, by 2.6 pps, to -80.8% of GDP from -83.4 pps. at the end of 2016. Negative valuation effects, mainly owing to the appreciation of the euro, offset the positive impact of the net lender capacity of the Spanish economy. By institutional sector, the external debt of both the public (mainly securities) and the non-financial private sector has declined (see Graph 2.3). Although much of the debt has long-term maturity and does not pose an immediate risk in terms of refinancing([13]), it still represents a vulnerability for the economy in case of shifts in market sentiment. Against this background, it will be crucial for Spain to continue recording current account surpluses over a sustained period of time in order to decisively bring down the still large negative NIIP to prudential levels (2018 Country Report for Spain).

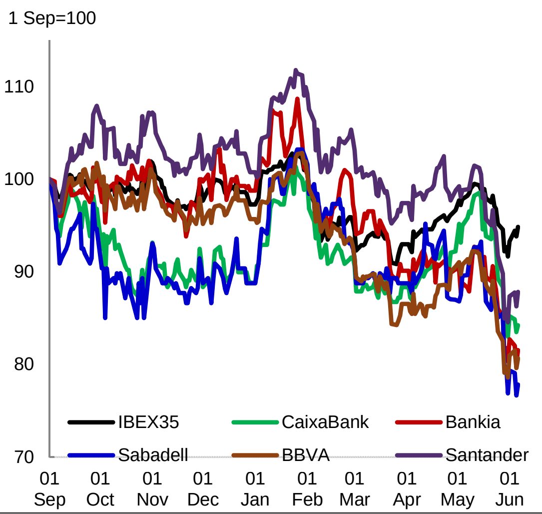
([13]) In addition, BdE's external debt (net Target-2 liabilities) that is not subject to refinancing risk amounted to 38% of GDP in 2017-Q4.

Graph 2.3: **NIIP by financial instruments**



Source: BdE, own calculations.

Graph 2.4: **IBEX35 and selected Spanish banks stocks**



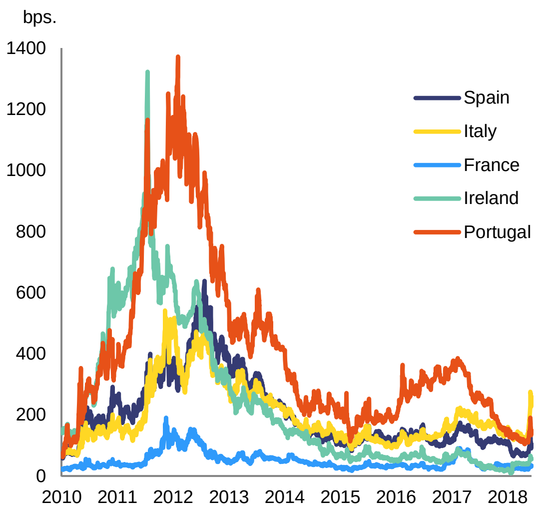
Source: Madrid Stock Exchange via Macrobond, own calculations.

2.2. FINANCIAL SECTOR DEVELOPMENTS

14. Spain's financial sector proved resilient in 2017 and early 2018. The resolution of Banco Popular in June 2017 and the events in Catalonia in the second half of last year have had no significant impact on financial stability. Between June 2017 and end-May 2018, the share prices of Spanish banks have broadly followed the IBEX 35 trend. The increased market volatility in Italy has not had a notable impact on the Spanish financial markets, and reactions to the vote of no confidence on June 1st have been muted (Graph 2.4).

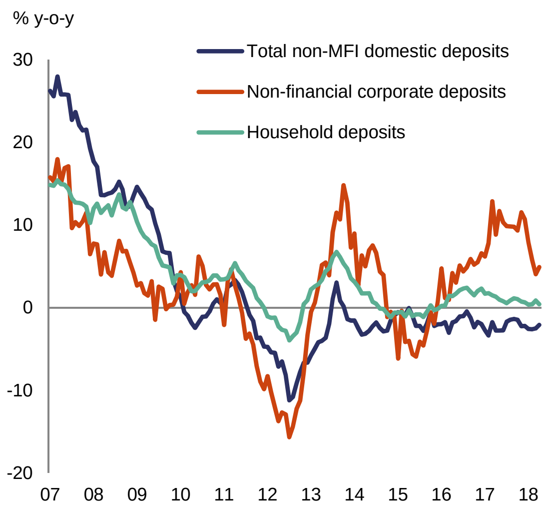
15. Spanish government bond yields and spreads declined further during 2017 and the first four months of 2018 despite a slight rebound in recent weeks (see Graph 2.5). The sovereign spread to the 10-year German bund fell by about 40 bps over the period to a record low level, helped by net purchases by the ECB of about EUR 80 billion or 7% of GDP under its Asset Purchase Programme. Likewise, the 5-year Spanish CDS spread steadily decreased from its peak of 75 basis points in October 2017 to around 40 points in April 2018. The CDS then started increasing at the beginning of May, and increased further in the days that preceded the vote of no-confidence in June 1st, but by the cut-off date of this report, the increase had been partly reversed, and spreads remained very low by historic standards.

Graph 2.5: **Euro area sovereign spreads to the 10-year German bund**



Source: IHS Markit, Macrobond, own calculations.

Graph 2.6: **Bank deposits**



Source: BdE.

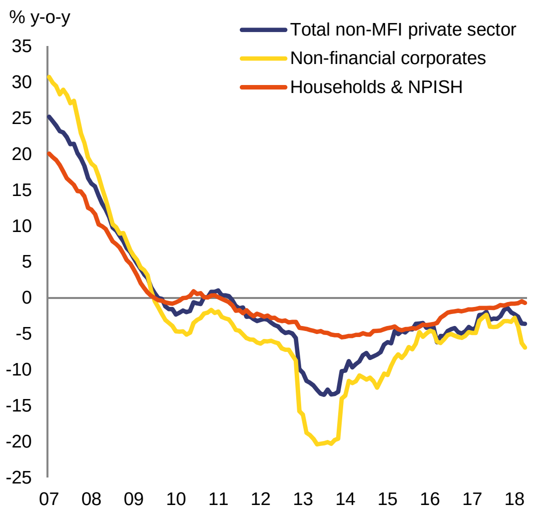
16. Spanish banks continued to diversify their funding sources, away from domestic bank deposits and towards the issuance of securities. Bank deposits by the private non-financial sector maintained a steady growth pace. In February 2018, deposits of households grew marginally, by 0.4% y-o-y, while deposits of non-financial corporations grew by about 6% y-o-y (see Graph 2.6). At the same time, the reduction of bank deposits of non-monetary financial institutions accelerated at a double-digit rate. In the context of ample liquidity available at favourable costs, the issuance of securities other than shares by credit institutions grew by about 15% y-o-y in February 2018. In particular the issuance of non-preferred debt instruments intensified, spurred by the upcoming MREL requirements ([14]). Finally, Spanish banks' total net borrowing from the Eurosystem has remained relatively stable in the last months, at EUR 169 billion in May 2018, much less than its peak of EUR 389 billion in August 2012.

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

17. The reduction of banks' balance sheets bottomed out. As of April 2018, banks' domestic assets remained flat relative to a year before as the increase in the stock of domestic private credit was compensated by the decline in the holdings of debt securities. The increase in domestic private credit was entirely due to certain operations of interbank lending as a result of Banco Popular's resolution, while the stock of loans to other resident sectors continued to contract slightly. The decline in the stock of credit to NFCs accelerated to almost 6% y-o-y as of April 2018 on account of growing redemptions and debt restructuring (see Graph 2.7). At the same time, new corporate lending has been on the rise: new lending to SMEs (proxied by loans under EUR 1 million) increased by 12.5% y-o-y in April 2018, whereas the volume of new loans over EUR 1 million increased by 15.8% in the same period. Also the issuance of debt securities by NFCs picked up by around 4% in April 2018 from a year before. The stock of credit to households shrank by about 1% y-o-y, as the stock of mortgage loans declined by more than 2.5% y-o-y in April 2018 while the stock of loans for purchases other than housing increased by almost 3.7% y-o-y.([15]) New loans for house purchases and consumer credit continued increasing y-o-y in April 2018.

([15]) Within this category of loans, the stock of consumer loans showed a double-digit growth of 12% y-y.

Graph 2.7: **Bank loans to the private sector**

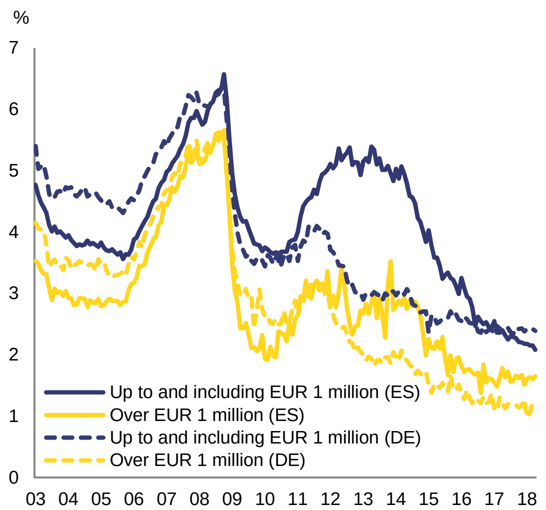


The decrease in the stock of loans in late 2012 and early 2013 was due to the transfer of assets to SAREB.
Source: BdE, own calculations.

18. In the first quarter of 2018, credit standards were eased for approving loans to households, while remained stable for NFCs. According to the Eurosystem Bank Lending Survey([16]) of April 2018, there was a moderate easing of credit standards on both mortgage and consumer loans. In addition, average bank's margins were further squeezed, although those applied to riskier loans were increased. This fact indicates that Spanish banks are discriminating across borrowers. Other conditions for both types of loans, such as maturity and collateral requirements, and non-interest charges in the case of consumer loans, remained unchanged vs. 2017-Q4. Additionally, general terms and conditions for NFCs' loans were eased in the case of SMEs. Margins on loans for companies were eased on average compared to end-2017, but they were kept unchanged for riskier loans.

19. Access to finance and availability of bank credit is not considered a problem by Spanish SMEs. This situation is in line with developments elsewhere in the euro area. In the latest SAFE survey([17]) (October 2017 – March 2018), only 8% of euro area SMEs considered access to finance as the most pressing problem, broadly the same share as in the previous survey. In Spain, this share is also 8%, up from 7% in mid-2017 and down from above 34% in December 2009. The share of Spanish SMEs signalling a further improvement in the availability of bank loans slightly increased from 23% to 24% between H1 and H2 2017, and it remained the highest in the euro area. In parallel, the average interest rate for new loans to NFCs of up to EUR 1 million (a proxy for SME financing cost) dropped in March 2018 by a further 5 bps from end-2017, to 2.15%, which is almost 30 bps lower than the interest rate charged in the same period in Germany (2.42 %).

Graph 2.8: **Cost of borrowing for NFCs**



Source: ECB.

20. On aggregate, Spanish banks continued to reduce their NPLs in the first three months of 2018. Against the background of continued positive economic growth over the past year, the stock of NPLs in both the corporate and household segment fell by around EUR 28 billion y-o-y until March 2018 This was due to disposals and write-offs, as well as to cured loans. As a result, the total stock of NPLs decreased by 25%. As the total volume of loans to NFCs and households decreased by about EUR 41.4 billion over the same period, the share of NPLs in total loans (NPL ratio) for credit business in Spain went down to 7.8 % at end-2017, but has since come down to 6.8% in March 2018, from 8.8 % a year before. The NPL ratios for NFCs and households amounted to around 10.3% and 5.4%, respectively in December

([16]) See the report at: http://www.bde.es/webbde/en/estadis/infoest/epb.html

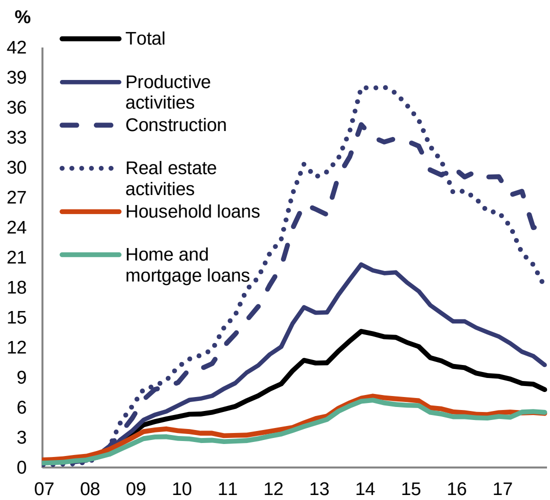
([17]) Survey on the access to finance of small and medium-sized enterprise in the Euro Area at: https://www.ecb.europa.eu/press/pr/date/2018/html/ecb.pr180604.en.html

2017 (see Graph 2.9). Data by the EBA show that the NPL ratio for consolidated business of Spanish banks dropped from 5.7% in December 2016 to 4.5% a year later, close to the EU average. This positive trend in asset quality was driven by loans to NFCs, including to the construction and real estate sectors. By contrast, for consumer loans, NPLs slightly increased in parallel with the rapidly growing consumer lending. Data by the EBA show a decline of the average ratio of coverage by provisions from 44.7% in June 2017 to 41.9% in December 2017.

21. Banks further reduced forborne and foreclosed assets in 2017. According to EBA data, forborne loans continued to decline and their ratio in total credit in Spain went down from 6.2% at end-2016 to 5.0% a year later. As in 2016, sales of existing foreclosed assets exceeded additions of new foreclosures. As a consequence, the stock of foreclosed assets across the sector declined to EUR 58 billion by end-2017 which corresponded to about 1.5% of total banks' assets (including international activity).

22. Further progress has been made in the restructuring of the banking sector. The entire Spanish banking sector and not only the state-aided banks has optimised its business model and lowered its cost base. Between end-2011 and December 2017, the number of banks declined by about a quarter while the branch network shrank by more than 30%. The number of employees was also reduced by more than 20% from end-2011 to end-2016. In 2017, the number of branches in Spain was reduced by almost 5%. Further consolidation and cost optimisation will result from the merger of the (majority) state-owned Bankia and BMN finalised in January 2018. At the same time, the efficiency of Spanish banks slightly deteriorated according to data by the EBA. Their cost-to-income ratio decreased from 52.9% in December 2016 to 50.9% in June 2017 and grew again to 52% at the end of the year. It was still below the EU average of 63.4%.

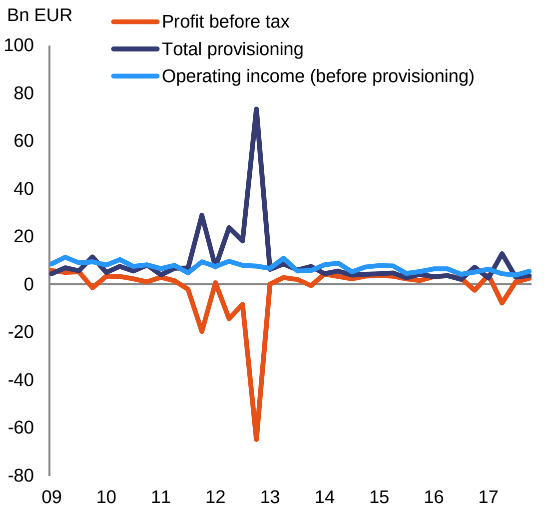
Graph 2.9: **Non-performing loans**



(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.

23. The negative financial result from the second quarter of 2017 triggered by the losses of Banco Popular was reverted into profits in the third and fourth quarters. The banking sector recorded profits before tax of EUR 930 million in Q3 and EUR 2.48 billion in Q4 2017. They followed the large loss of EUR 7.8 billion recorded in Q2 2017 resulting from the resolution of Banco Popular (see Graph 2.10). As a consequence, the banks' total profit on domestic operations in 2017 shrunk relative to 2016. Despite a fairly robust operating surplus, an increase of about 18% in provisioning took place in 2017. Both the ROA and the ROE slightly decreased for the consolidated operations to 0.5% and 7.0%, respectively as of December 2017.

Graph 2.10: **Bank sector profitability for domestic operations**



Source: BdE, own calculations.

24. The capital position of Spanish banks remained stable in the fourth quarter of 2017. Following the resolution of Banco Popular in June 2017, the average common equity tier 1 ratio for the banking sector decreased by 1% but quickly returned to its previous ratio of 12.4% in Q3 2017 and remained unchanged at end-2017. The issuance of both core and non-core capital instruments, such as contingent capital or subordinated debt instruments that qualify as own funds, and the profits recorded in H2 2017 also served to the strengthening of capital buffers in banks. This helped bring the total capital to 15.3% of the risk-weighted assets as of December 2017 compared to 14.6% at end-2016. Also smaller banks continued the cleaning-up of their balance sheets, thus reinforcing their capital buffers.

3. FINANCIAL SECTOR RESTRUCTURING AND REFORM

3.1. PROGRESS WITH BANK RESTRUCTURING

25. The implementation of the restructuring plans of state-aided banks has been completed. Almost all banks have reached their operational targets in terms of number of branches and employees. They also reduced their balance sheet size in line with their restructuring objectives. Banks have also completed the required divestments of subsidiaries. The monitoring of the restructuring plans reached its end in April 2018.

26. The divestment of the state's stakes in the banking sector has successfully restarted. After FROB sold its stakes in NCG Banco (now ABANCA) and Catalunya Banc to Banesco Group and BBVA respectively, and BFA sold a 7.5% stake in Bankia in 2014, further important steps were achieved as of late 2017. The merger of BMN with Bankia was legally finalised in January 2018. Moreover, in December 2017, FROB sold an additional 7% stake in Bankia through an accelerated book-building offer. After this transaction, FROB still holds the majority stake in Bankia (60.98% of the merged entity Bankia-BMN). The authorities committed to selling this stake by end-2019 (RDL 4/2016), either through successive small divestments or via larger corporate transactions, also depending on investor demand. When implemented, this privatisation will complete the restructuring of the Spanish banking sector undertaken after the finalisation of the financial assistance programme.

27. Some banks have shored up their capital levels. On 9 October 2017, Liberbank's shareholders approved a EUR 500 million share issue to strengthen the bank's capital standing. The transaction was completed in November 2017. The bank pursued further its course to increase provisioning levels and clean up its balance sheet by selling a large portfolio of foreclosed assets in Q4 2017. In consequence, Liberbank's CET1 ratio increased from 12.1% at end-2016 to 13.4% at end-2017. Also Cajamar raised additional capital from its member credit cooperatives and reduced its NPL ratio from 13.1% at end-2016 to 10.4% a year later.

3.2. SAREB – RECENT DEVELOPMENTS AND OUTLOOK

28. In 2017, SAREB slightly decreased the volume of its divestments and continued to post net losses, but its operational margin improved. In 2017 SAREB pursued its strategy to transform loans into real-estate owned assets (REOs), where possible, with a view to achieving higher margins on the assets' sale. This resulted in an increase in real estate revenues compared to 2016, at the expense of revenues from loans' divestment. SAREB also further engaged in the sale of assets through dedicated financial vehicles and joint-ventures with real estate developers. Nevertheless, SAREB's total income in 2017, at EUR 3.8 billion, was around 2% lower than in 2016. Loans accounted for EUR 2.6 billion revenue, and the remaining EUR 1.2 billion derived from the sale of REOs.

29. SAREB's new business plan foresees a back-loading of divestments towards the end of its projected existence in 2027. From its inception at the beginning of 2013 until end-2017, SAREB reduced its portfolio of financial and real estate assets by 27% (EUR 13.6 billion), i.e., by less than one third of its assets, and its debt by 25% (EUR 12.9 billion). The planned back-loading of its divestment may improve the institution's financial prospects as SAREB can afford to wait for the maximisation of the real estate price recovery now that it has hedged to a large extent its interest rate risks. At the same time, it puts at risk the successful completion of the divestment.

30. SAREB's loss in 2017 was slightly lower than the one posted in 2016. Notwithstanding its overall success in contributing to the stabilisation of the Spanish banking sector over the past years, SAREB continues to record losses. In 2017, the net loss after tax amounted to EUR 565 million. This is above the budgeted amount but below the loss recorded in 2016 (EUR 663 million). The reduction was due to the higher net margin achieved as well as slightly lower costs for the repayment of senior debt. Nevertheless, the mark to market value of the interest rate swap remained negative and represented a significant source of additional financial cost in 2017. At the same time, SAREB managed to reduce its operating costs by about 6% in 2017 vs. 2016. In 2017 SAREB booked impairments of EUR 840 million, much higher than the EUR 377 million recorded in 2016, pointing to an accelerated loss of value of its portfolio, as a result of its continued efforts to better reflect the market value of the remaining portfolio.

31. The key determinant of SAREB's financial results remains the evolution of real estate markets. From peak to bottom, average Spanish real estate prices declined by about 40%. They started growing again in 2016 but the growth rate is still negative y-o-y in 9 out of 17 regions. The slow recovery of real estate prices and the sub-optimal location of many of SAREB's real estate assets in areas where prices have still not recovered implies that an important part of the assets transferred to the company in 2013 appear now overvalued relative to their market prices. This in turn explains much of the persistently negative results of SAREB. Finally, SAREB continues incurring a high financial cost of the interest rate swap.

3.3. PROGRESS WITH FINANCIAL SECTOR REFORMS

32. The implementation of the legislation on banking foundations and the savings banks' reform continued. As from September 2017 "la Caixa" Banking Foundation holds only 40% of CaixaBank through Criteria, which is below the controlling stake. The three banking foundations which jointly control Kutxabank expressed their intention to maintain their stake in the bank. Therefore, the banking foundation BBK, which mantains its control, will have to build a reserve fund by 2023. According to its divestment programme, Ibercaja Bank will undergo an initial public offering (IPO) by 2020 following which the controlling foundation will reduce its stake in the bank to below 40%. The same applies to Unicaja Banco, and therefore the two banks do not need to set up reserve funds. Liberbank completed a EUR 500 million capital increase in November 2017 which led to the dilution of the combined stake by the three controlling banking foundations from more than 40% to below 25%.

33. As regards resolution planning under the bank recovery and resolution directive (BRRD), resolution plans for all 12 significant institutions and for 23 other banks were completed by end-2017. In addition, simplified resolution plans were prepared for 12 other smaller banks. MREL planning is well on track and binding targets for the three significant banks - college banks - and informative targets for other significant institutions at consolidated level were set by end-2017. No targets have been determined yet for less significant institutions. As stated by the Single Resolution Board, the objective is to set MREL targets for all banks at consolidated and individual level by 2020. Some of the largest banks have already started issuing relevant instruments.

34. The impact of the new IFRS 9 accounting framework on the most significant banking groups in Spain has been marginal and in line with the rest of the EU. It is considered that the Annex 9 accounting changes adopted before IFRS 9 helped prepare the banks for the implementation of IFRS 9, although their level of capital was adjusted slightly downwards on account of higher provisions.

35. The evolution of credit still does not seem to warrant the triggering of countercyclical macro-prudential tools. As required by Law 10/2014, the BdE started applying the countercyclical capital buffer (CCyB) in January 2016. As a result of the evolution of various indicators, the BdE continued to set the buffer rate at 0% for the third quarter of 2018. According to BdE data the credit-to-GDP gap was -50.9%, far from the 2% benchmark level that would warrant the activation of the CCyB rate, according to the BCBS Guidance (2010) and the ESRB Recommendation (ESRB/2014/1) followed by the BdE.

4. CHALLENGES AHEAD FOR THE FINANCIAL SECTOR

36. The low-interest-rate environment supports the reduction of doubtful loans, but continues to put pressure on banks' margins. Credit institutions' net interest margins are still compressed in the context of the protracted period of low interest rates. In response, banks might be increasingly induced to underwrite more risky credit. Against this background, banks and supervisors need to ensure a sufficiently conservative implementation of credit standards, in particular in light of the recent surge in demand for consumer credit. In addition, litigation costs in the form of compensation to consumers following some court rulings and additional provisioning requirements upon the entry into force of the new accounting rules based on the IFRS9([18]) could potentially put further downward pressure on profitability. As operational costs savings have already been extensively implemented, banks should pursue efficiency gains, for example through higher digitalisation.

37. NPLs have receded at a healthy pace for the aggregate banking sector, but some banks remain exposed. On average, NPLs continued to decrease and good progress was made in some institutions where legacy bad loans were above average. Nevertheless, some banks still have a relatively high share of NPLs and therefore need to continue cleaning up their balance sheets.

38. Banco Popular's resolution has been followed by some litigation in Spanish and EU courts. After the adoption of Banco Popular's resolution scheme by the Single Resolution Board (SRB), the buyer, Santander, adopted a number of measures to underpin the solvency and profitability of the bank as part of its group. The fact that depositors or taxpayers did not incur losses, the absence of a negative impact on financial stability and good coordination among all the national and EU authorities involved proved that the resolution was successful. Nevertheless, several entities brought legal actions against FROB for implementing the resolution of Popular([19]). The Spanish Supreme Court has suspended all trials until the European Court of Justice rules on the cases brought before it. All the precautionary measures requested to suspend the resolution decision were rejected. As no asset protection scheme was granted at the sale of Popular to Santander, in principle the latter would be responsible for other potential litigations on its handling of Popular's shareholders or creditors.

39. The privatisation of Bankia was recently resumed and is expected to continue in line with market conditions. The Spanish authorities need to find the best divestiture strategy and market opportunities to sell its remaining stake in the bank. In the short run, the smooth integration of BMN in Bankia should yield positive synergies that can enhance the value of the privatised entity and maximise the proceeds to be returned to the State.

40. SAREB's activity is challenged by the relatively low quality of its assets and slower than expected divestment of its portfolio, as well as, and high financial costs. In addition, the upcoming expiry of the contract with one servicer next year should be dealt with in an effective way. Therefore, SAREB needs to continue efforts to optimise its business activity, advance sales and improve financial margins, while implementing BdE's recommendations for the valuation of its (SAREB) assets.

([18]) International Financial Reporting Standards. Annex 9.
([19]) The Spanish executive resolution authority.

ANNEX A

Main macroeconomic and financial indicators

Table A.1: **Main macroeconomic and financial indicators**

	1995 -1999	2000 -2004	2005 -2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018 (e)	2019 (f)
Core indicators														
GDP growth rate	3.6	3.7	3.2	- 3.6	0.0	- 1.0	- 2.9	- 1.7	1.4	3.4	3.3	3.1	2.9	2.4
of which domestic demand incl. stocks	4.1	4.3	3.7	- 6.4	- 0.5	- 3.1	- 5.1	- 3.2	1.9	3.9	2.5	2.8	2.6	2.2
Private consumption (annual % change)	3.3	3.5	2.6	- 3.6	0.3	- 2.4	- 3.5	- 3.1	1.5	3.0	3.0	2.4	2.3	1.9
Public consumption (annual % change)	2.7	4.7	5.7	4.1	1.5	- 0.3	- 4.7	- 2.1	- 0.3	2.1	0.8	1.6	1.9	1.3
HICP (annual % change)	2.8	3.2	3.5	- 0.2	2.0	3.0	2.4	1.5	- 0.2	- 0.6	- 0.3	2.0	1.4	1.4
Unemployment rate (% of labour force)	17.8	11.3	9.3	17.9	19.9	21.4	24.8	26.1	24.5	22.1	19.6	17.2	15.3	13.8
Gross fixed capital formation (% of GDP)	22.9	27.0	30.3	24.3	23.0	21.5	19.8	18.8	19.3	19.8	20.0	20.6	21.2	21.6
Gross national saving (% of GDP)	21.9	23.0	21.7	20.3	19.7	18.6	19.5	20.2	20.4	21.4	22.4	22.9	23.2	23.8
General Government (% of GDP)														
Balance (g)	- 4.1	- 0.5	0.2	- 11.0	- 9.4	- 9.6	- 10.5	- 7.0	- 6.0	- 5.3	- 4.5	- 3.1	- 2.6	- 1.9
Gross debt	63.0	51.3	39.1	52.8	60.1	69.5	85.7	95.5	100.4	99.4	99.0	98.3	97.6	95.9
Interest expenditure	4.4	2.6	1.6	1.7	1.9	2.5	3.0	3.5	3.5	3.1	2.8	2.6	2.4	2.4
Households														
Households saving rate	12.8	10.8	7.8	13.4	10.1	10.8	8.6	9.6	9.3	8.6	7.7	5.7	5.5	5.6
Rest of the world (% of GDP)														
Trade balance	- 0.7	- 2.7	- 5.5	- 1.2	- 1.3	- 0.2	1.5	3.3	2.4	2.3	3.0	2.7	2.4	2.5
Trade balance, goods	- 3.6	- 5.8	- 8.2	- 3.8	- 4.4	- 4.2	- 2.8	- 1.4	- 2.1	- 2.1	- 1.6	- 2.1	- 2.3	- 2.3
Trade balance, services	2.9	3.1	2.7	2.7	3.1	3.9	4.3	4.6	4.6	4.3	4.6	4.7	4.7	4.8
Current account balance	- 1.4	- 4.3	- 8.9	- 4.3	- 3.9	- 3.3	- 0.4	1.5	1.0	1.0	1.9	1.8	1.5	1.6
Net financial assets	- 27.7	- 42.0	- 70.1	- 89.6	- 84.8	- 89.6	- 91.2	- 93.6	- 96.8	- 90.2	- 84.5	- 81.6	n.a.	n.a.
Net international investment position (h)	- 28.8	- 44.3	- 71.6	- 93.5	- 88.6	- 91.9	- 89.9	- 95.2	- 97.8	- 89.7	- 83.4	- 80.8	n.a.	n.a.
Competitiveness (index, 2005=100)														
Real effective exchange rate relative to the rest of the euro area	87.2	91.6	100.2	101.1	100.0	98.4	94.0	92.5	91.8	92.9	91.5	90.7	90.2	90.7
Real effective exchange rate relative to the rest of the European Union	88.6	90.0	98.4	102.4	100.0	98.6	93.6	92.5	91.6	91.6	91.3	90.8	90.2	90.6
Real effective exchange rate relative to the rest of 37 industrialised countries	87.7	88.1	99.7	104.2	100.0	98.6	92.5	93.1	92.6	90.3	89.5	89.8	90.7	90.7
Banking sector														
Assets (% of GDP)	170.8	189.9	267.9	319.4	321.1	338.3	344.4	307.3	286.5	261.9	243.9	234.0	220.3	n.a.
Private domestic credit (y-o-y %)	11.8	14.7	18.9	- 1.6	0.8	- 3.2	- 9.9	- 10.2	- 6.5	- 4.2	- 4.1	- 2.0	- 3.6	n.a.
Non-performing loans (NPLs), total (%) (i)	3.3	1.1	1.5	5.1	5.8	7.8	10.4	13.6	12.5	10.1	9.1	7.8	6.8	n.a.
NPLs, productive activities (%)	n.a.	1.2	1.5	6.2	7.9	11.3	15.5	20.3	18.5	14.6	13.1	10.3	n.a.	n.a.
" of which, construction, and (%)	n.a.	1.0	1.7	8.5	12.1	18.2	25.8	34.3	32.6	30.0	29.1	24.1	n.a.	n.a.
" real estate activities (%)	n.a.	0.6	1.8	10.1	14.0	21.4	29.1	38.0	36.2	27.5	25.5	18.1	n.a.	n.a.
NPLs, residential mortgages (%)	n.a.	0.4	1.0	2.9	2.6	3.1	4.4	6.6	6.2	5.1	5.1	5.5	n.a.	n.a.
Tier 1 ratio (%)	n.a.	n.a.	n.a.	9.3	9.6	10.2	9.7	11.7	11.7	12.6	12.9	13.1	n.a.	n.a.
Interest rates														
10 year spread vis-à-vis the Bund (%)	1.6	0.2	0.1	0.8	1.5	2.8	4.3	3.0	1.5	1.2	1.3	1.2	0.8	n.a.
CDS 5 year (basis points)	n.a.	n.a.	14.6	92.0	204.0	319.6	431.9	235.4	90.5	84.1	82.1	68.9	46.4	n.a.

Updated on 07 Jun 2018

(e) 2018: forecast or latest available data
(f) forecast
(g) General government balances include capital transfers related to support of banks
(h) ESA2010 and BPM6
(i) NPLs: ratios, in % of total loans
Source: Ameco, BdE, Bloomberg, Eurostat, Macrobond

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