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European Commission
Directorate-General for Economic and Financial Affairs

In-Depth Review 2024

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Institutional Paper 272

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This in-depth review presents the main findings of the Commission's staff assessment of macroeconomic vulnerabilities for Spain for the purposes of Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances. It provides technical input to the Commission for the Communication "European Semester – 2024 Spring Package" that will set out the Commission's assessment as to the existence of imbalances or excessive imbalances in Spain. That Communication will be published in June 2024. The current version has been presented and discussed with the Member States in the Economic Policy Committee of the Council.

This publication reproduces staff working document SWD(2024) 80 final, that was discussed with Member States in the Economic Policy Committee of the Council on 20 March 2024.

CONTENTS

1. INTRODUCTION

This in-depth review (IDR) analyses the evolution of Spain's vulnerabilities related to high private, government and external debt, which have cross-border relevance, and possibly newly emerging risks. This year's IDR, which follows the 2024 Alert Mechanism Report (AMR) published in November 2023, assesses the persistence or unwinding of the vulnerabilities identified last year, potential emerging risks, and relevant policy progress and policy options that could be considered i for the future ([1]). Given the size of the Spanish economy and its interlinkages with the other EU Member States, these vulnerabilities have a cross-border relevance.

The Spanish economy is estimated to have expanded by 2.5% in 2023 and is projected to continue to grow in 2024, albeit at a slower pace than last year. ([2]) The strong growth outturn posted in 2023 was underpinned by the very positive labour market developments and the pick-up of wages sustaining private consumption, as well as the positive contribution from net exports and public consumption. Real GDP growth is forecast to moderate in 2024 to 1.7%, according to the Commission's Winter 2024 Interim Forecast, due to the weaker economic situation in Spain's main trading partners and to the lagged impact of recent years' interest rate hikes on aggregate demand. Consumption and investment, driven respectively by further real purchasing power gains for households, and the continued implementation of Spain's Recovery and Resilience Plan (RRP), are set to be the main drivers of r economic expansion. GDP growth is expected to accelerate again in 2025, to 2.0%. Headline inflation decelerated to 3.4% in 2023, largely thanks to the continued drop in energy prices throughout the year. Underlying price pressures eased gradually in 2023, to 5.8% on average, as the pass-through of high energy prices to other items, especially food and services, showed signs of fading only from the last quarter of 2023 onwards. Harmonised Index of Consumer Prices (HICP) inflation is set to decline further this year, to 3.2% on average (with underlying inflation projected to be 3.3%), despite the upward pressure of the expected phasing out of most government measures implemented to mitigate the impact of high energy prices.

High integration with other major European and non-EU partners, makes Spain prone to spillovers resulting from economic developments in these economies ([3]). The Spanish economy is highly dependent on imports of German and French goods and services, ([4]) while France and Germany are major destinations for Spain's exports. When it comes to external demand, the largest shares of total value added in the Spanish economy are generated to satisfy domestic demand in France, Germany and US while Spanish domestic demand is mostly satisfied by value added generated in China and Germany. Locational banking statistics show that sizeable shares of claims of Spanish financial institutions are located in France, Italy and UK. As Spain's exposures,

([1]) European Commission (2023), *Alert Mechanism Report 2024*, COM(2023) 902 final; and European Commission (2023), Alert Mechanism Report 2024, SWD(2023) 901 final.

([2]) Forecast figures for GDP growth and inflation come from the Commission Winter 2024 Interim Forecast (European Economy, Institutional Paper 268). All other forecast data in the IDR come from the Commission Autumn 2023 Forecast (European Economy, Institutional Paper 258), unless stated otherwise, and all calculations are carried out using these data to ensure the coherence of their various components. The cut-off date for the data for the preparation of this IDR was 20 February 2024. Actual outturn data that became available after the Autumn and Winter Interim forecasts, and before the cut-off date for the IDR, are used and supersede figures from those forecasts.

([3]) In the context of the multiple disrupting shocks that have affected the world economy and the EU in the past few years, Commission Services have run an exercise to estimate the spillovers and the degree of exposure of Member States' economies to various partners and industries, in terms of nominal trade, value-added trade, inflation and financial assets. See European Commission Institutional Paper 2024 (forthcoming), 'Economic spillovers and exposures in the EU'.

([4]) Germany and France account for 12.6% and 12% of Spain's imports, and for 15.2% and 10.6% of its exports.

directly or indirectly, to non-EU partners are high, geopolitical and trade tensions appear to pose a non-negligeable risk to its economy.

2. ASSESSMENT OF MACROECONOMIC VULNERABILITIES

In recent years, Spain has been marked by high, albeit declining, private, government and external debt. The decline in debt to GDP ratios has reduced the vulnerability towards economic shocks. The government debt-to-GDP ratio has declined despite persistent fiscal deficits, but risks to fiscal sustainability are assessed to be high overall in the medium-term. Pressures on household balance sheets have increased, particularly those with lower incomes. On the other hand, the share of financially vulnerable firms has continued to decline. The banking sector has remained resilient.

Assessment of the gravity, evolution and prospects of macroeconomic vulnerabilities

External balances

Spain's net international investment position (NIIP) continued its long-standing declining trend in 2023, supported by strong nominal GDP growth (Graph 2.3). The NIIP-to-GDP ratio improved to -54% in the third quarter of 2023, over 30 percentage points (pps) lower than the last quarter of 2020 and down from the –90% it was between 2013 and 2017. Its current level is above the prudential threshold (-61%), although still below the fundamental benchmarks of -17%. The NIIP is forecast to remain on an improving path in 2024 and 2025, increasing to -48% and -44%, respectively. Furthermore, the NIIP excluding non-defaultable instruments (NENDI), stood at -23% of GDP in 2023, compared with -52% reached in 2020, as its adjustment has been faster than that of the NIIP.

The NIIP is projected to further improve in the medium term. Under the baseline scenario, the negative NIIP is projected to continue shrinking in the next few years, supported by persistent current account surpluses in the medium-term, and, over the forecast horizon, by substantial capital transfers associated with the RRF funds (see Box 2). The main risks in the short-term correspond to tighter financing conditions increasing debt service and to the economic slowdown of main trading partners. Additional disruptions in global value chains prompted by the uncertain unfolding of geo-political events may exert upwards pressure on the evolution of energy prices and import prices of certain commodities, resulting in deterioration of the trade balance and of the terms of trade. The composition of Spain's external liabilities, including a higher share of non-defaultable instruments, in particular Foreign Direct Investment (FDI), helps to mitigate some of these vulnerabilities. In the medium term, a credible fiscal consolidation strategy and economic policies conducive to competitiveness gains would contribute to further improvements in the external position.

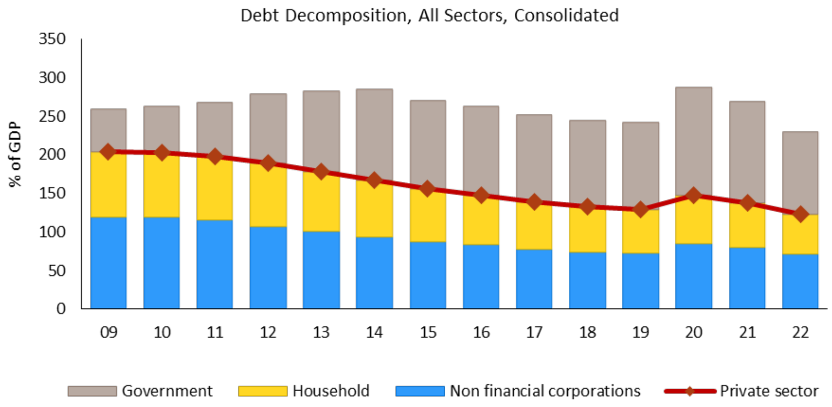
The current account balance has remained positive in the last decade and its surplus is set to increase in the coming years. The current account balance declined slightly, to 0.8% and 0.6% in 2021 and 2022 respectively, due to the impact of the pandemic on the economy (Graph 2.3). It is estimated to have picked up to around 2.5% in 2023, exceeding the benchmarks required to stabilise the NIIP above 35% of GDP (-1.0%) and that required to attain the specific NIIP target (1.1%). Last year, the evolution of the current account balance benefited from the sharp decline in energy prices and the significant surplus of both tourism and non-tourism service exports. From the lending-borrowing perspective, the public sector's negative position has been more than offset since

2012 by the markedly positive contribution of financial and non-financial corporations, and, to a lesser extent, of households. The current account balance is expected to remain in surplus over the forecast period, contributing to further reductions of the negative NIIP-to-GDP ratio.

Private sector debt

Private sector balance sheets continued to improve in 2023 thanks to high nominal output growth and contained new borrowing in a context of higher interest rates. Private debt declined to 138% of GDP in 2021 and 112% in 2023, over 65 p.p. below its level a decade ago but still above its prudential and fundamental benchmark, of 87% and 91%, respectively (Graph 2.1).

Graph 2.1: **Debt decomposition**



Source: Eurostat.

The household debt-to-GDP ratio has been steadily declining, reaching 52% in 2022 and 47% in 2023, down from 65% in the 2013-2020 period (Graph 2.3 and Box 2). It nevertheless remains slightly above its fundamentals-based (44%) and prudential (35%) benchmarks (Table 2.2). Credit flows turned negative in 2023, triggered by a marked increase in interest rates, contributing to the deleveraging process. For many debt-holding households, interest payments have increased over the last 2 years (Box 1). Interest rates on new loans for house purchase increased from around 1.5% in early 2022 to 3.8% in November 2023. Interest rates for outstanding loans for house purchase grew from around 1.1% early 2022 to 3.7% by November 2023. The strong co-movement of interest rates on existing loans with market conditions is attributed to the prevalence of variable-rate loans in the mortgage market. The percentage of new loans with a fixation period of less than a year has markedly decreased, dropping from around 90% in 2008 to 16% in November 2023, but there has been a pronounced shift to predominantly fixed-rate mortgages in recent years. If credit flows continue to follow the pattern of recent years, household debt can be expected to maintain its downward trajectory (Box 2).

The non-financial-corporation-(NFC)-debt-to-GDP ratio continued decreasing, down from 145% on average in the 2013-2020 period, to 71% in 2022 and 64% in 2023 (Graph 2.3). The NFC debt-to-GDP ratio remains, however, above its fundamental benchmark (47%) and prudential threshold (52%) (Table 2.2). The financial situation of firms has continued to display favourable developments over the past year, although with some degree of heterogeneity across market segments. Moreover, the corporate sector's profitability, and especially for large companies, is also above pre-pandemic levels across most sectors of the economy (Box 1). Credit flows turned negative in 2023 – particularly for loans above EUR 1 million – triggered by a marked increase in interest rates and tighter credit standards since mid-2022, contributing to the deleveraging process.

Interest rates on new loans for NFCs increased from less than 2% in early 2022 (and around 1% for loans above EUR 1 million) to around 5% in November 2023, with short-term and variable-rate loans having even higher interest rates. The overall average interest rate for outstanding loans for NFCs grew from less than 2% early 2022 to 4.3% by November 2023.

Banking sector

The banking sector has remained resilient in the face of geopolitical tensions and uncertainty, higher inflation and tightening financing conditions for borrowers ([5]). Asset quality has remained relatively robust over the last year. The share of non-performing loans at system level went down to 2.7% at the end of 2022 (from 2.9% a year earlier) and remained broadly unchanged in the first half of 2023 (but above the EU average of 1.8%) (Graph 2.3). The share of Stage 2 loans as a percentage of total loans and advances in turn stood at 6.9% at the end of September 2023, well below the EU average of 9.2%. Liquidity and profitability continue to be favourable. The capital ratios of Spanish banks, while in line or higher than the required standards, continue to be lower than EU peers. In the second quarter of 2023, banks in Spain recorded the lowest common equity tier 1 ratio in the EU and thus warrant close monitoring, as credit quality may come under pressure over the forecast horizon. Nonetheless, the latest EBA stress tests published in July 2023 found that Spanish banking institutions would remain resilient under an adverse scenario. As the impact of the past interest rate hikes is fully transmitted to the economy, risks related to private borrowers' repayment capacity are expected to rise, with low-income households and SMEs particularly vulnerable (Box 1).

Government debt

Government debt continued to decline in 2023, thanks to robust nominal GDP growth, but future improvements are expected to be limited as deficits remain relatively high. The debt-to-GDP ratio is estimated to have decreased to 107.5% in 2023, down from 115.9% in 2022, and is forecast to stabilise at around 106.5% from 2024 onwards. One reason for the slowdown in its decrease is the dwindling positive differential between nominal GDP growth and the cost of debt observed in 2022-2023. The snowball effect is expected to lower its deficit-reduction contribution in the next few years (Box 2) ([6]). On the other hand, the fiscal deficits projected for the future will keep adding to debt stock. According to the 2023 Commission Autumn Forecast, the fiscal deficit is set to improve to 3.2% of GDP this year (based on a no-policy change scenario), from 4.1% in 2023, mainly on account of the phasing out of energy-related measures implemented in the past years. However, the expiration of some temporary revenue-increasing measures at the end of 2024, such as the levy on financial institutions and the solidarity wealth tax, is forecast to weigh negatively on the government deficit in 2025, which is set to slightly increase to 3.4% of GDP.

Fiscal sustainability risks are low overall in the short term, high in the medium term, and medium in the long term, according to the Commission's Debt Sustainability Analysis

([5]) Autumn 2023 Post-Programme Surveillance report.

([6]) The results presented here are based on the debt sustainability analysis published in the Post-Programme Surveillance Report of December 2023 (European Commission, Institutional Paper 264), which follows the multi-dimensional approach of the European Commission's 2022 Debt Sustainability Monitor, updated based on the Commission 2023 autumn forecast.

(DSA). ([7]) Government gross financing needs are expected to remain large at close to 20% of GDP in both 2024 and 2025. Financial markets' perceptions of sovereign risk are investment grade, as confirmed by the main rating agencies. Under the baseline scenario, the government debt-to-GDP ratio is projected to remain high in the medium term (see Box 2 for more on medium-term fiscal sustainability risks). In the long term, the main source of risk is Spain's unfavourable initial budgetary position and high debt level despite the projected decline in ageing-related costs. At the same time, several additional risk factors need to be considered. On the one hand, risks may be further amplified by the adverse impact of the tighter financial conditions on households' and firms' financial position. 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. In addition, the structural reforms commitments under the Recovery and Resilience Plan (RRP), if fully implemented, could have a further positive impact on GDP growth in the coming years, and therefore help mitigate debt sustainability risks.

Labour market

The labour market continued to perform very well in 2023, underpinned by sustained job creation despite a weaker economy in the second half of the year. Employment growth accelerated considerably in the first two quarters of 2023 (1.2% quarter-on-quarter on average in seasonally adjusted terms), before moderating to 0.65% quarter-on-quarter on average in the second half of the year. In annual terms, employment increased by 3.8% in the last quarter of 2023. The bulk of job creation in 2023 took place in the private sector. The unemployment rate declined to 11.8% in Q4 of 2023 and is set to drop to 12.1% overall in 2023. It is forecast to continue improving over the next few years, to 11.6% in 2024 and 11.1% in 2025, according to the Commission's Autumn forecast, reaching its lowest level since 2007 and more than halving compared to the peak levels recorded in 2013 (26.1%). However, it remains well above the EU average, with structural pockets of vulnerability, such as the still-very-high long-term and youth unemployment rates. Nominal wage growth in 2023 remained broadly in line with or slightly above the threshold set out in the multi-year agreement signed last May, to around 4%-4.5%, helping to contain the rise of unit labour costs (ULCs).

Box 1: Spain – Financial situation of households and non-financial corporations (NFCs)

Over the past months, the financing costs of households and firms have continued to rise steadily, as a consequence of the process of monetary policy tightening initiated by the ECB in July 2022. Together with a reduced supply of funds and more restrictive conditions on private sector loans, this has resulted in a significant decline in new financing raised by both households and NFCs. Total credit to households is estimated to have declined by 1.0% year-on-year in 2023, whilst those of NFCs is estimated to have increased by 2.0% over the same period. For firms, the contraction mainly concerned larger loans and the issuance of debt securities, affecting larger businesses in particular. The drop in new financing flows has helped spur the deleveraging process across both segments, leading to a substantial improvement in households' and NFCs' balance sheets. At the same time, the ratio of non-performing loans to the resident private sector declined, reaching 3.6% on aggregate in November 2023.

The COVID-19 pandemic and high inflation triggered by, among other things, Russia's war of aggression against Ukraine, have put pressure on households' balance sheets. Spanish households' gross disposable income decreased in 2020 as a result of abrupt disruptions in economic activity, and took a further hit in 2022, due to the wide-spread impact of the inflationary shock throughout the year, in a context of stagnant wage growth. In 2023, the strong recovery of economic activity, the very positive performance of the labour market together with the pick-up of nominal

([7]) The results presented here are based on the debt sustainability analysis published in the Post-Programme Surveillance Report published in December 2023 (European Commission, Institutional Paper 264), which follows the multi-dimensional approach of the European Commission's 2022 Debt Sustainability Monitor, updated based on the Commission 2023 autumn forecast. See also Box 2 below.

wages and moderating price dynamics have sustained the recovery of purchasing power, almost reaching the pre-pandemic level in 2023.

Household savings evolved dynamically in the last years and remain above pre-pandemic levels. Household savings declined sharply between the peak of the pandemic period (25% in Q2 of 2020) and the trough in Q3 of 2022 (4%), before rising again to 9% in Q3 of 2023, still above the pre-pandemic level (7.7% in Q4 of 2019). The increase observed in the past quarters was largely driven by the simultaneous deceleration of private consumption and the pick-up in nominal wage growth, as well as the accumulation of liquid assets. Overall, households have strengthened their financial situation since the end of the pandemic period, while a note of caution is warranted as the aggregate hides substantial variation across categories of household as explained below.

For many debt-holding households, interest payments have increased over the last 2 years. Interest payments by households rose from 1.5% of gross disposable income in Q2 of 2022 to 2.9% by Q3 of 2023 ([8]). On average, this was more than compensated for by the simultaneous increase in households' interest receipts. However, interest payments and receipts are likely to accrue to different household types, typically with an age gradient: young households are more likely to see their mortgage costs increase, while older households are more likely to benefit from the increased returns on their savings. Lower income households are less likely to hold debt, but when they hold debt, their debt-service-to-income ratio tends to be higher, making them more vulnerable to interest rate shocks). This is attributable to the more pronounced impact of higher price levels on their disposable income and the relative rigidity of their consumption pattern, resulting in a lower saving capacity, and in turn difficulties to service their debt and sustain other expenditures.

The financial situation of firms has continued to improve over the past year, although with some degree of heterogeneity across market segments. Corporates' gross operating surplus (GOS) increased in the first half of 2023, driven by the positive momentum in economic activity and, in some sectors, boosted by a rise in profit margins, posting on average an annual growth rate of 32.8% in Q1 of 2023, up from 20.4% in Q1 of 2022. The sectoral breakdown shows that GOS increased sharply in the energy sector (103%) and the information and communication technology sector (20.3%) over the same period. Conversely, GOS fell the most in the industrial sector, by 15.6%, and to a lesser extent the trade and hospitality sector, by 1.7%. The rise in GOS recorded by energy firms is primarily attributable to the positive evolution of sales margins, reversing the sharp fall in margins observed in 2022 amidst the peak of the increase in energy costs.

The profitability of the corporate sector, and especially for large companies, is above pre-pandemic levels across most sectors of the economy. On the other hand, the increase in the average cost of debt is weighing on the debt-to-corporate-income ratio. The average cost of financial debt showed a stark increase in Q1 of 2023 compared to the same period a year earlier, from 0.8%. up to 2.3%.

In this context, the share of financially vulnerable firms continued to decline, and few or no signs of a significant deterioration in the credit quality of firms going forward has been detected. The financing cost for NFCs on aggregate in Q3 of 2023 rose to 2.8%, up from 1.7% in the third quarter of 2022. From a sectoral perspective, industry had the highest rate, at 4%, in Q3 of 2023. According to the Bank of Spain, the percentage of companies with high indebtedness, defined as those with a net-debt-to-surplus ratio higher than 10 (or which have deficits), also declined slightly in the first quarter of 2023, to 23.9%, a tenth less than during the same period in 2022. Similarly, the credit quality of companies has been widely preserved in the past year, as well as the relative stability in the credit ratings of bonds issued by Spanish companies. In Q1 of 2023, the credit rating for the outstanding bonds issued by NFCs, both resident and non-resident, remained virtually unchanged compared to a year earlier. Most of these outstanding debt instruments have a credit rating of BBB or BBB-, above the high-yield category (BB+ or lower). Corporates' ratio of non-performing loans for corporates in March 2023 declined by 0.7 pps to 4.5%, compared to the same period in 2022, while stage 2 loans registered a steeper decline, by 1.9 pps, to 9.7%.

([8]) Source: ECB Quarterly Sector Accounts: D41G: Interests received by households, before FISIM allocation.

Box 2: Spain – Medium-term external, private and government debt projections

This box summarises external and internal debt to GDP projections for Spain over the next decade, based on scenario analysis. It covers scenarios that take into account different underlying assumptions for external, corporate and household debt stocks, as well as the outcomes of the Commission's latest government debt sustainability analysis (DSA).

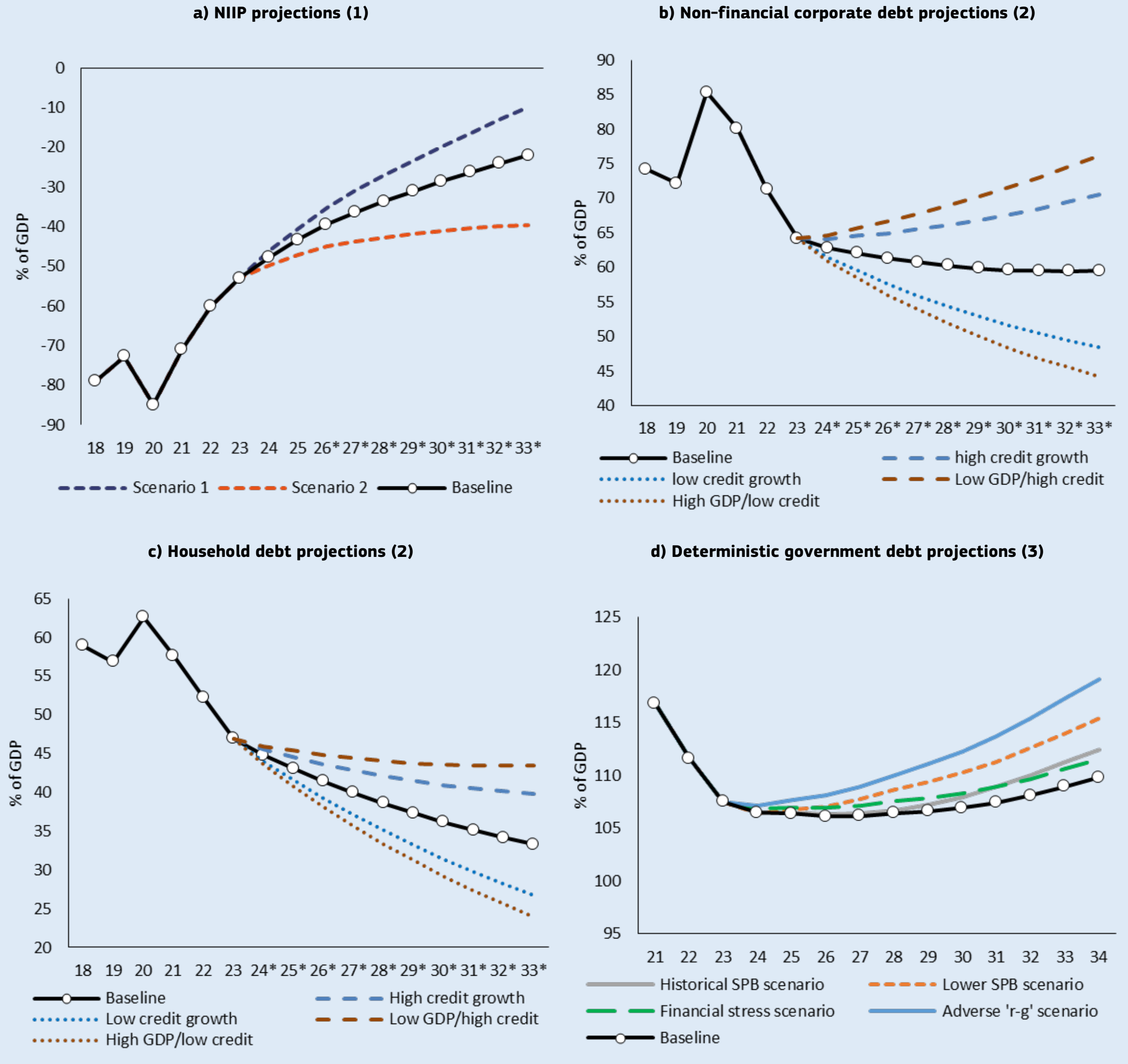
Spain's net international investment position (NIIP) is projected to continue steadily improving under all three scenarios. Under the baseline projections, which take the 2025 forecasts as a starting point, the NIIP increases to around -25% of GDP in 2033, comfortably above the prudential threshold but still below the fundamental benchmark (Graph 2.2, panel a). The NIIP is set to improve under a range of assumptions. The assumptions of an upside scenario (Scenario 1) imply a stronger pace of improvement with the NIIP below -10% of GDP at the end of the projection horizon. The NIIP also slightly improves in a downside scenario (Scenario 2), in which economic growth and the trade balance lag behind the baseline assumptions whereas the interest spread between liabilities and assets increases. Risks to the country's external position are further mitigated by the favourable NIIP structure, as non-defaultable instruments, foreign direct investments and equity, account for around 50% of net liabilities.

In the baseline scenario, the corporate-debt-to-GDP ratio is projected to decrease by 5 percentage points until 2033, to 59%. The baseline scenario takes the 2023 forecasts as a starting point and foresees an average real GDP growth of 1.3%, in line with Commission projections, and credit flows of 1.7% of GDP until 2032 (Graph 2.2, panel b). In this scenario, credit flows would be below the credit to GDP ratio that would stabilise NFC debt over the projection horizon, at 2.4%. Under an adverse scenario of credit flows being 1.3% of GDP higher – corresponding to half the intertercile range of the annualised quarterly credit flow to GDP ratio over 2018-2023 – the NFC debt to GDP ratio would be 11 percentage points higher. A permanent negative 1% GDP growth shock would increase the NFC debt to GDP ratio by another 6 percentage points.

The household-debt-to-GDP ratio is projected to almost halve over the next decade in the baseline scenario. The baseline scenario takes the 2023 forecast of 47% as a starting point and assumes as determining parameters average real GDP growth of 1.3% and credit flows of 0.1% of GDP for the 2024-2033 period[1]. It projects that the debt-to-GDP ratio will steadily decline to 33% by 2033 (Graph 2.2, panel c). In this scenario, annual credit flows remain significantly below the credit-flow-to-GDP ratio that would stabilise household debt over the projection horizon (1.7%). Depending on how interest rates and other economic conditions evolve, credit flows could also behave differently. Graph 2.2 panel c considers alternative scenarios on credit flows, that account for observed country-specific variability in credit flows since 2018, and permanent GDP shocks 1 ppt above or below the baseline scenario. Under the most adverse scenario considered (high credit flows and low GDP growth), the debt-to-GDP ratio would still decline, but more slowly, to reach 43% by 2033.

In Spain, medium-term risks to fiscal sustainability are high overall. The DSA for Spain shows that, in the baseline scenario, the government debt-to-GDP ratio is projected to remain high in the medium term, declining to 106% by 2026 before approaching 110% again in 2034 (Graph 2.2, panel d). That projection assumes a structural primary deficit of 1% of GDP, which appears plausible in the light of past performance. At the same time, until 2031 the projections benefit from a still favourable (although declining) snowball effect of around -0.6% of GDP annually on average over the 2025-2031 period, while growth is also supported by the impact of Next Generation EU (NGEU). Overall, annual real GDP growth will average at around 1.3% over the 2025-2034 period. Government gross financing needs are expected to remain large over the projection period, slightly exceeding 20% of GDP in 2034. The baseline projections have been stress-tested against four alternative scenarios to assess the impact of changes in key assumptions. For Spain, all those four alternative scenarios would lead to a more rapid increase in debt compared with the baseline and confirm the high-risk assessment. ([9])

Graph 2.2: **External, private and government debt projections, based on a scenario analysis for Spain**



(1) The baseline NIIP projections are based on Commission's medium-term forecasts for GDP and interest rates. Additionally, assumptions are made about the drawdown of NGEU and MFF funds, and the median value of the last three years is used for non-investment income. Scenario1 assumes higher GDP growth (+1 pp) and the trade balance (+1 pp) than in the baseline from 2024 onwards. Compared to the baseline scenario, Scenario 2 assumes lower GDP growth (-1 pp) and the trade balance (-1 pp) while the interest spread between liabilities and assets is higher by 0.3 pp in each year after 2023.
(2) For the NFC and HH debt projections, the baseline refers to the country-specific median annual credit flow to GDP ratio over 2018-2023. The high/low credit scenario assumes a higher/lower credit flow to GDP ratio, with the difference to the baseline calculated as half the intertercile range of the annualised quarterly credit flow to GDP ratio over 2018Q1-2023Q3. The latter is based on the moving sum of quarterly GDP. The high (low) GDP shock scenario reflects a permanent 1 percentage point increase (decrease) in GDP growth.
(3) 'Historical structural primary balance (SPB) scenario': the SPB returns to its historical 15-year average of -1.3% of GDP; 'Lower structural primary balance (SPB) scenario': the projected cumulative improvement in the SPB over 2023-2024 is halved; 'Financial stress scenario': the interest rates temporarily increase by 2.1 pps. compared with the baseline; 'Adverse interest-growth rate differential (r-g) scenario': the interest-growth rate differential is 1 pp. lower compared with the baseline.
Source: Eurostat, Ameco, Commission services calculations.

(9) The results presented here are based on the debt sustainability analysis published in the Post-Programme Surveillance Report of December 2023 (European Commission, Institutional Paper 264), which follows the multi-dimensional approach of the European Commission's 2022 Debt Sustainability Monitor, updated based on the Commission 2023 autumn forecast. See notes to Graph 2.2 for more details on the four scenarios used.

Assessment of MIP-relevant policies

Policy progress over the past year to tackle the identified vulnerabilities was underpinned by the broadening implementation of the Recovery and Resilience Plan (RRP). Recently implemented, ongoing and planned measures in the areas of public and private finances, business productivity, the strengthening of supply chains and the labour market are particularly relevant. The measures implemented as part of the RRP complement or adjust other major reforms adopted since 2010, such as the consolidation of the banking sector, the introduction of greater labour market flexibility, the establishment of an independent fiscal institution, and the progressive extension of the legal retirement age, all of which have supported the continued unwinding of the identified vulnerabilities over the past decade.

External debt sustainability benefits from the adoption of reforms and investments that favour the widespread use and production of renewable energy, together with investments in energy efficiency. The implementation of this set of measures is expected to decrease the import dependence for energy, leading to the improvement in external debt sustainability. Specifically, the modified RRP approved at the end of 2023 reinforces strategic investments (*Proyectos Estratégico para la Recuperación y Transformación Económica*, PERTEs), provides financing for the REPowerEU chapter and includes the set-up of financial instruments targeting private investment, particularly for the green and digital transitions. Furthermore, measures fostering business creation and growth, including innovative start-ups, the development of reforms of the educational and vocational training systems approved in recent years, as well as investments in skills, strategic sectors and the digitalisation of SMEs are set to strengthen the competitiveness of firms.

Spain recently introduced a new insolvency framework to support the unwinding of non-financial corporate debt vulnerabilities. A law establishing a new insolvency framework entered into force in 2022, to facilitate preventive debt restructuring and debt relief for natural persons. By preventing insolvency situations and facilitating resource reallocation, the application of the new law has contributed to a substantial increase in the filings for insolvency in 2023 ([10]). According to data from the Official Business Registry ([11]), filings for insolvency by individual debtors increased by 161.3% on annual terms in the year up to Q2 of 2023, following the entry into force of the new framework, and by 17.5% on quarterly terms, compared to Q1 of 2023. However, these figures reflect the very low starting level of insolvency filings before the law's application, and possibly the adverse effect of economic factors such as higher inflation, increased funding costs and supply chain disruptions. SMEs are benefitting from improved access to finance in form of guarantees, granted to SMEs until end-2023, via the '*Compañia Española de Reafianzamiento*' (CERSA). CERSA allows access to long-term financing and working capital helping to reduce debt overhang on businesses.

The new housing law aims to increase the supply of affordable and social housing, to contain the financial burden for vulnerable households. The sustained growth in purchase and rental prices, together with the income shocks following the COVID-19 pandemic and high inflation, have aggravated housing affordability problems, particularly for vulnerable households in urban areas. Supply remains constrained under the very limited provision of affordable and social housing, which is significantly lower than the EU average. Overall, the housing law contained in the RRP encourages the increase in the supply of affordable housing, including by providing higher tax

([10]) The new law created an incentive for individual debtors to file for bankruptcy in order to obtain a debt discharge (the so-called "fresh start"). It should be noted, however, the very low starting level of insolvency filings prior to the application of the Law.

([11]) https://www.registradores.org/actualidad/portal-estadistico-registral/estadisticas-concursales incentives and increasing the minimum share of protected housing in new developments, as well as the rehabilitation of the existing housing stock and the renovation of the residential environments in which those houses are located. The law also contains measures to limit rental price growth in stressed areas. These measures will be also supported by the investments planned under Cohesion policy programmes.

Boosting productivity and competitiveness remains pivotal for small and medium enterprises, and to further deleveraging of private, public, and external debt. Additional steps in this area, beyond those currently envisaged under the RRP, would be highly beneficial to improve public support for R&D and the quality of innovation output, the strengthening of science-business linkages and of knowledge transfer, as well as to improving the business environment by streamlining size-dependent regulation which hampers business growth. Spain remains one of the EU countries with the lowest investment in R&D as a percentage of GDP, with business R&D much lower than the EU average (0.8% GDP vs the EU average of 1.5%). Also, some gaps remain in the provision of the necessary skills to contribute to the green and digital transition, including, among others, information and communications technology (ICT) specialists, as well as engineering and mathematics (STEM) graduates. Such challenges are particularly acute for small and medium sized enterprises, which results in lower capacity to attract talent and thereby the competitiveness of Spanish firms.

Some policy progress has been made in improving legislative quality and judicial efficiency, although there is still room for improvement. Reforms completed last year included the setting up of the new National Evaluation public body, tasked with developing an effective framework for ex-ante public policy evaluation, and the modernisation of the justice system, by enabling judicial bodies with the necessary infrastructure to carry out telematic judicial actions in Spain's different jurisdictional bodies with full legal certainty. To address market fragmentation, tools have been introduced to encourage and support better coordination across public administrations, such as the establishment of an observatory of good regulation practices and the sectoral conference on improving the business environment. Additional policy action to reduce the time it takes to resolve civil and commercial cases would further reduce existing economic distortions that are hindering business creation and growth, making entrepreneurship difficult, adversely affecting investment rates and productivity growth.

Policy action to significantly reduce the high level of public debt and the structural deficit has been limited in the recent past, and an additional consolidation effort is needed for Spain to arrive at a sound budgetary position. To ensure a debt reduction in the medium and long term it will be necessary to clearly reduce the structural deficit while addressing future budgetary pressures on the expenditure side related to population ageing as well as health and long-term care. The implementation of a credible consolidation strategy could build on and complement the set of reforms envisaged under the RRP, targeting both the expenditure and revenue sides and expected to help reduce Spain's overall fiscal vulnerability in the medium term.

On the expenditure side, Spain started to implement the recommendations outlined in the spending reviews carried out by the independent fiscal authority (AIReF). These recommendations are aimed at improving the efficiency of public spending. A new set of spending review studies with recommendations for improvements are expected to be published annually until 2026 by AIReF, while the implementation of the over 150 recommendations outstanding from the previous reviews is now being closely monitored by the authorities. The national strategy for making public procurement more efficient and sustainable was adopted at the end of 2022. By contrast, relinking pensions to inflation poses additional fiscal sustainability risks for the future, although targeted actions are envisaged in legislation relating to this area, to offset the impact of potential higher expenditures.

On the revenue side, some already adopted measures are contributing to the increase of government revenues, helping to reduce the gap with the EU average. A number of factors, including active policies implemented by the government, the resilience shown by the economy, and high inflation, have contributed to the recent rise in government revenues. These factors include the robust performance of the labour market, coupled with the widespread digitalisation of the economy, the adoption of the law against tax evasion and fraud and the delivery of enhanced assistance to taxpayers. A solidarity tax for wealthy individuals and a temporary levy on energy companies and financial institutions were also introduced in 2023, although these were partially offset by some VAT cuts in response to the high inflation environment. According to the Commission 2023 Autumn Forecast, the EU's average tax revenue-to-GDP ratio was estimated at 41.2%, compared to 38.3% of GDP for Spain. This difference of about 3 pps indicates some improvement since 2019, when the difference in the revenue ratios was 5.6 pps. Against this backdrop, there would be scope to be more ambitious as regards additional policy actions, particularly given the recent increase in tax revenues being mostly of temporary nature. Possible further revenue-increasing action could include the simplification of the VAT system and other adjustments of tax benefits or certain indirect taxes, including environmental taxation, while protecting vulnerable individuals with targeted compensatory measures. An ambitious implementation of those measures would help ensure sustainable government revenues while contributing to fiscal consolidation going forward and achieving the level of ambition set out in the RRP.

The labour market reform approved in December 2021 has decisively contributed to the reduction of temporary employment in the private sector, even if further measures are needed to address the persistent high share of temporary employees in the public sector. New contracts signed in 2023 show a widespread reduction in the share of fixed-term contracts, falling overall to less than 60%, from 90% in 2019. As for temporary employees in the private sector, their share fell to 13.2% in Q4 of 2023, down from 23.9% in Q4 of 2021. However, The share of fixed-term contracts in the public sector remains very high, at 29.6% in Q4 of 2023. Moreover, building on the successful experience of short-time work schemes during the pandemic, a permanent mechanism was also set up supporting firms and workers in transition to adjust to cyclical and structural shocks (*Mecanismo RED*). Further labour market reforms under the RRP were adopted in 2023, such as the new Employment Law, the review of hiring incentives, and the modernisation of Public Employment Services (PES), which have the potential to improve job-matching efficiency and address skill mismatches. These are likely to contribute to reducing the still high unemployment rates, relative to the EU, increasing social cohesion and reducing at-risk-of-poverty rates. However, the persistent high share of temporary employees in the public sector calls for further action, besides the measures included in the RRP, to address such vulnerability. ([12])

The implementation of existing commitments in the RRP, and where possible additional steps could further improve external sustainability and private deleveraging, whilst a medium-term fiscal strategy would strengthen public debt sustainability. Measures in the RRP as well as under the European Regional Development Fund programmes to enhance competitiveness via investment in R&D and innovation, as well as further improvements in the business environment could contribute improving long-term external sustainability and support

([12]) Action should take into account the recent ruling by the European Court of Justice on joined cases C-59/22, C-110/22 and C-159/22 regarding the measures to prevent and penalise the abusive use of fixed-term contracts in the Spanish public administration.

corporate sector deleveraging. Improved external indebtedness would also benefit from the continued effort, including in the RRP in reducing the reliance on fossil fuels and accelerating the green transition, thereby decreasing the import dependency from abroad on some energy products. A medium-term fiscal strategy entailing a gradual and sustainable consolidation could address the unfavourable budgetary starting position and mitigate the impact on public finances of emerging fiscal costs related to population ageing and health care. Possible measures to further improve the taxation system, implementing the envisaged actions in the RRP, could also support fiscal consolidation. On the labour market side, additional policies could favour improvements in the remaining skills gaps and the reduction of the sizeable share of temporary employees in the public sector.

Table 2.1: **MIP-relevant policy progress in Spain:**

Vulnerability	Policies enacted since January 2023	Policies in progress since January 2023
External sustainability	Review of the National Energy and Climate Plan until 2030. Continued investments to develop PERTEs, support the digitalisation and innovation of SMEs, strengthen the R&D&I system, and support sustainable tourism.	Implementation of the modified RRP reinforcing strategic investments (PERTEs), including the REPowerEU chapter.
Household debt	Entry into force of the new Housing Law, including measures to support an increase in the supply of affordable and social housing. Implementation of the second chance procedure for natural persons under the new insolvency framework.	
Non-financial corporate debt	Financial guarantees offered by CERSA to support small businesses.	Implementation of the modified RRP including financial instruments targeting private investment: green and entrepreneur ICO lines, the Next Tech start-ups fund and the Regional Resilience Fund managed by the European Investment Bank.
Public debt	Approval of measures to modernise and digitalise public administration. Adoption of measures to ensure the financial sustainability of the pension system while preserving the adequacy of pensions. Publication of the reports of the third phase of the spending review by Spain's independent financial authority.	Phasing out of the emergency energy support measures adopted since 2021.
Unemployment	Entry into force of the new Employment Law and the review of hiring incentives, with the aim of improving employability and reducing unemployment. Approval of the new Organic Law on the university system, with the aim of making higher education more relevant to the labour market.	Action plan for the development of university micro-credentials as part of the modified RRP.

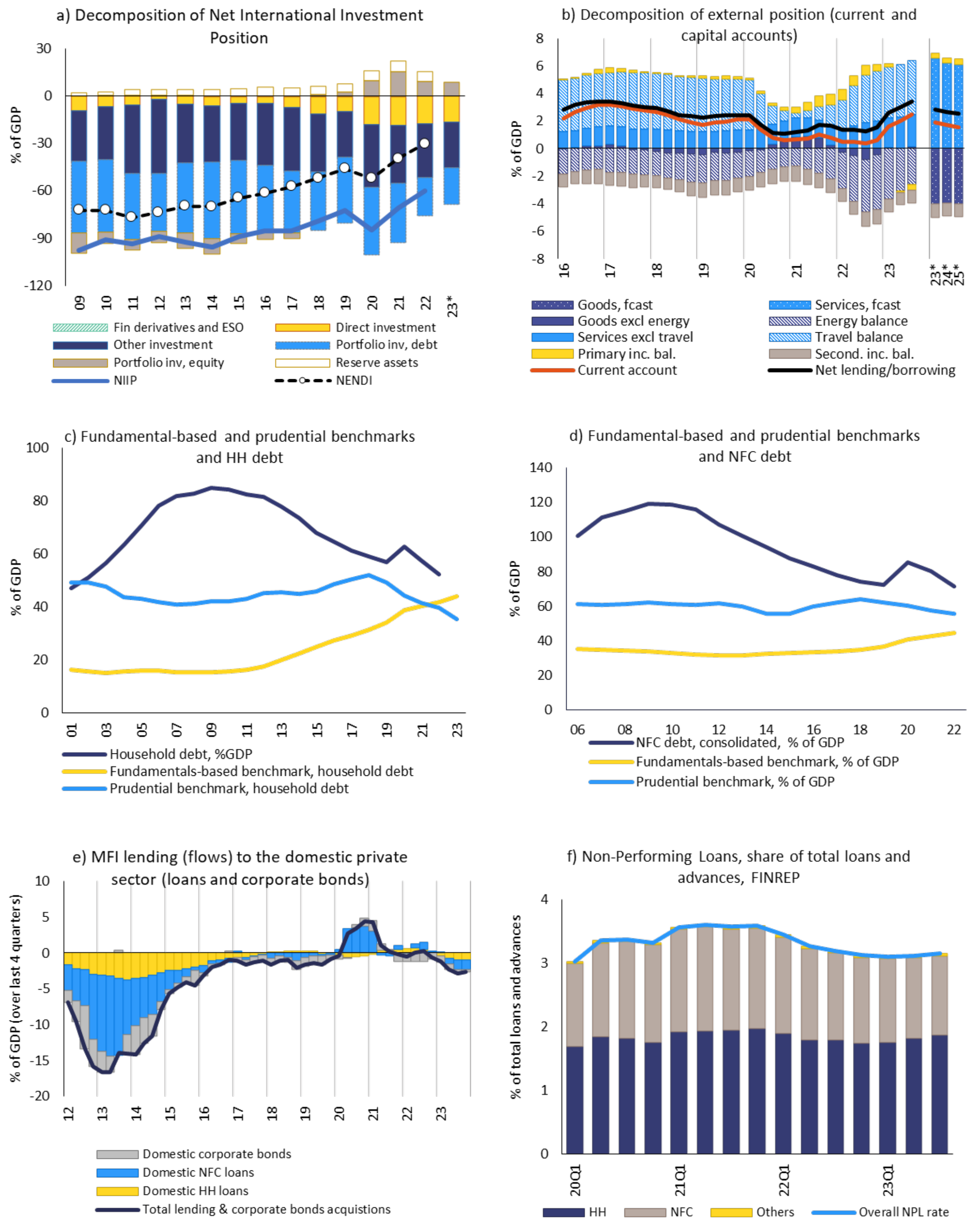
	Creation of new places in vocational education and training.

Conclusion

Strong reductions in the vulnerabilities associated with high private and external debt stocks of Spain are continuing, with public debt also having receded in recent years. External and internal debt ratios have resumed their steady decline that began in 2013, after a reversal in 2020 caused by the pandemic-induced shock to the economy. Their adjustment is expected to continue in the coming years, albeit more gradually than in the recent past, as nominal GDP growth is expected to be less supportive. On the external side, Spain's negative NIIP has been on a decade-long improving trend, only interrupted in 2020 by the pandemic. It is expected to improve further in the near future, underpinned by continued current account surpluses thanks to the growing positive contribution from tourism and exports of non-tourism services, as well as net capital transfers. Spain's private debt-to-GDP ratio declined steadily throughout the 2010s' until the outbreak of the pandemic, and again after 2022, and its dynamics appear favourable going forward. The government debt-to-GDP ratio improved from 120% in 2020 to 110% in Q3 of 2023, and is projected to keep doing so, although very gradually, in the next few years amid the deficit hovering slightly above 3% of GDP. The long-term evolution of the public-debt to-GDP ratio, however, is subject to more risks, given its elevated starting level and the still high structural deficits of recent years. Spain's unemployment rate has dropped sharply over the last decade, from 23.7% at the end of 2014 to 11.8% in Q4 of 2023, and is set to remain on a downward trend in the next few years.

Substantial policy progress has been made over the past decade, but more effort is needed to reduce high public debt in particular. The set of measures implemented so far under the RRP, and those whose implementation is planned until the end of 2024 include actions to improve access to finance for SMEs and facilitate preventive debt restructuring for companies. The focus on policies to reduce Spain's dependence on energy imports and make the business sector more competitive, once implemented, would support a further unwinding of external vulnerabilities. Some RRP measures addressing the expenditure and revenue sides of the government's budget also contribute to accelerating the downward trajectory of the public-debt-to-GDP ratio and to reduce fiscal vulnerabilities. Both past and current labour market measures have proven, and are proving, effective at reducing the number of temporary employees and labour market duality. They also have the potential to boost labour productivity. Additional measures would be needed to address the identified vulnerabilities. These include additional consolidation measures for Spain to arrive at a sound budgetary position and improve overall fiscal sustainability, address skills mismatches and shortages, and tackle the problem of the low levels of investment in R&D by companies. Boosting the competitiveness of the goods segment, given the high import intensity of domestic demand, particularly durable consumption and investment, could also help improve Spain's NIIP.

Graph 2.3: **Selected graphs, Spain**



Source: Eurostat, Ameco, ECB and European Commission calculations.

Table 2.2: **Selected economic and financial indicators (Part 1), Spain**

all variables y-o-y % change, unless otherwise stated	2003-07	2008-12	2013-19	2020	2021	2022	2023	forecast 2024	2025
Real GDP	3.5	-1.3	2.6	-11.2	6.4	5.8	2.5	1.7	2.0
p.m.: Real GDP (Winter 2024 interim Forecast)							*2.5*	*1.7*	*2.0*
Contribution to GDP growth:									
Domestic demand	4.7	-3.0	2.4	-8.2	5.3	3.1	1.9	1.9	2.1
Inventories	0.0	-0.2	0.2	-0.8	1.4	-0.2	-0.2	0.0	0.0
Net exports	-1.2	1.8	0.0	-2.2	-0.2	2.9	0.8	-0.2	0.0
Output gap (2)	2.9	-4.7	-2.2	-9.3	-4.3	0.0	0.7	0.6	0.6
Unemployment rate	9.7	19.1	18.8	15.5	14.8	12.9	12.1	11.6	11.1
Harmonised index of consumer prices (HICP)	3.2	2.3	0.6	-0.3	3.0	8.3	3.4	3.4	2.1
p.m.: HICP (Winter 2024 interim Forecast)								*3.2*	*2.1*
HICP excluding energy and unprocessed food (y-o-y)	2.8	1.6	0.7	0.6	0.7	5.2	5.8	3.2	2.0
GDP deflator	3.9	0.5	0.8	1.1	2.7	4.1	5.9	3.4	2.0
External position									
Current account balance (% of GDP), balance of payments	-7.0	-3.9	2.3	0.6	0.8	0.6	1.9	1.7	1.5
Trade balance (% of GDP), balance of payments	-4.4	-0.9	3.2	1.4	1.0	1.2	.	.	.
Primary income balance (% of GDP)	-1.5	-1.7	0.0	0.3	0.8	0.5	.	.	.
Secondary income balance (% of GDP)	-1.1	-1.3	-1.0	-1.1	-1.0	-1.1	.	.	.
Current account explained by fundamentals (CA norm, % of GDP) (3)	-2.1	-1.0	0.6	0.9	0.8	0.9	1.2	1.3	1.4
Required current account to stabilise NIIP above -35% of GDP over 20Y (% of GDP) (4)	-0.3	1.4	-0.7	-1.5	-1.3	-1.1	-1.0	-0.9	0.0
Capital account balance (% of GDP)	0.6	0.4	0.4	0.5	0.9	0.9	.	.	.
Net international investment position (% of GDP)	-66.5	-91.3	-84.6	-84.9	-71.0	-60.2	.	.	.
NENDI - NIIP excluding non-defaultable instruments (% of GDP) (5)	-35.6	-71.8	-58.7	-52.2	-39.6	-30.2	.	.	.
Net FDI flows (% of GDP)	3.3	0.1	0.9	1.4	-1.4	-0.1	.	.	.
Competitiveness									
Unit labour costs (ULC, whole economy)	3.1	0.4	0.0	9.2	0.4	1.0	6.1	3.5	1.8
Nominal compensation per employee	2.9	2.0	1.1	1.2	4.5	4.1	5.4	3.9	2.5
Labour productivity (real, hours worked)	0.5	1.7	0.5	-0.2	-0.8	1.8	0.3	0.1	0.4
Real effective exchange rate (ULC)	1.8	-1.6	-1.7	4.0	0.9	-2.8	-0.5	-0.4	-0.8
Real effective exchange rate (HICP)	2.2	-0.1	-0.1	0.1	0.7	-1.2	.	.	.
Export performance vs. advanced countries (% change over 5 years)	.	-4.1	0.4	-7.1	-8.4	-4.3	.	.	.
Private sector debt									
Private sector debt, consolidated (% of GDP)	158.6	198.3	145.3	147.9	137.7	123.5	111.1	.	.
Household debt, consolidated (% of GDP)	70.1	83.2	63.8	62.6	57.6	52.3	46.9	.	.
Household debt, fundamental benchmark (% of GDP) (6)	15.6	16.1	28.2	38.7	40.2	41.9	43.8	.	.
Household debt, prudential threshold (% of GDP) (6)	43.4	42.9	48.4	44.4	41.4	39.5	35.4	.	.
Non-financial corporate debt, consolidated (% of GDP)	88.5	115.1	81.6	85.3	80.1	71.2	64.2	.	.
Corporate debt, fundamental benchmark (% of GDP) (6)	35.1	33.0	34.0	40.9	42.6	44.4	47.1	.	.
Corporate debt, prudential threshold (% of GDP) (6)	62.5	61.4	59.9	60.2	57.4	55.9	51.5	.	.
Private credit flow, consolidated (% of GDP)	25.3	-0.7	-1.2	4.8	3.0	0.3	1.0e	.	.
Household credit flow, consolidated (% of credit stock)	15.4	-0.5	-1.4	-0.6	1.0	0.5	.	.	.
Non-financial corporate credit flow, consolidated (% of credit stock)	93.6	-2.0	-1.8	13.3	6.1	0.1	.	.	.
Net savings rate of households (% of net disposable income)	3.9	4.6	2.6	13.7	9.7	2.9	.	.	.

(e) estimate based on ECB quarterly data
(1) Potential output is the highest level of production that an economy can reach without generating inflationary pressures. The methodology to compute the potential output is based on K. Havik, K. Mc Morrow, F. Orlandi, C. Planas, R. Raciborski, W. Roeger, A. Rossi, A. Thum-Thysen, V. Vandermeulen, The Production Function Methodology for Calculating Potential Growth Rates & Output Gaps, COM, European Economy, Economic Papers 535, November 2014.
(2) Deviation of actual output from potential output as % of potential GDP.
(3) Current accounts in line with fundamentals ("current account norms") are derived from reduced-form regressions capturing the main determinants of the saving-investment balance, including fundamental determinants, policy factors and global financial conditions. See L. Coutinho et al. (2018), "Methodologies for the assessment of current account benchmarks", European Economy, Discussion Paper 86/2018, for details.
(4) This benchmark is defined as the average current account required to reach and stabilise the NIIP at -35% of GDP over the next 20 years. Calculations make use of Commission's T+10 projections.
(5) NENDI is a subset of the NIIP that abstracts from its pure equity-related components, i.e. foreign direct investment (FDI) equity and equity shares, and from intracompany cross-border FDI debt, and represents the NIIP excluding instruments that cannot be subject to default.
(6) Fundamental benchmarks are derived from regressions capturing the main determinants of credit growth and taking into account a given initial stock of debt. Prudential thresholds identify a threshold above which banking crises become more likely. The fundamentals-based and the prudential benchmarks are calculated following Bricongne, J. C., Coutinho, L., Turrini, A., Zeugner, S. (2019), "Is Private Debt Excessive?", Open Economies Review, 1- 42.
Source: Eurostat and ECB as of 2024-02-20, where available; European Commission for forecast figures (Autumn Forecast 2023).

Table 2.2: **Selected economic and financial indicators (Part 2), Spain**

all variables y-o-y % change, unless otherwise stated	2003-07	2008-12	2013-19	2020	2021	2022	2023	forecast 2024	2025
Housing market									
House price index, nominal	14.2	-6.6	4.4	2.2	3.7	7.4	.	.	.
House price index, deflated	10.4	-8.2	3.7	2.1	1.4	0.8	.	.	.
Overvaluation gap (%) (7)	20.5	14.6	-5.2	4.6	6.2	11.2	9.1	.	.
Price-to-income overvaluation gap (%) (8)	18.3	17.8	-4.7	5.8	4.9	8.9	7.4	.	.
Residential investment (% of GDP)	11.1	6.9	4.8	5.9	5.8	5.7	5.7	.	.
Government debt									
General government balance (% of GDP)	1.0	-9.3	-4.1	-10.1	-6.7	-4.7	-4.1	-3.2	-3.4
General government gross debt (% of GDP)	42.1	62.7	101.9	120.3	116.8	111.6	107.5	106.5	106.5
Banking sector									
Return on equity (%)	.	1.1	6.6	-3.6	10.5	10.1	.	.	.
Common Equity Tier 1 ratio	.	9.4	13.0	14.7	15.0	14.4	.	.	.
Gross non-performing debt (% of total debt instruments and total loans and advances) (9)	.	4.4	4.4	2.5	2.6	2.3	.	.	.
Gross non-performing loans (% of gross loans) (9)	.	.	5.2	2.8	2.9	2.7	2.7	.	.
Cost of borrowing for corporations (%)	4.1	3.6	2.0	1.5	1.3	3.3	5.0	.	.
Cost of borrowing for households for house purchase (%)	4.0	3.4	2.0	1.5	1.4	2.9	3.8	.	.

(7) Unweighted average of price-to-income, price-to-rent and model valuation gaps. The model valuation gap is estimated in a cointegration framework using a system of five fundamental variables; total population, real housing stock, real disposable income per capita, real long-term interest rate and price deflator of final consumption expenditure, based on Philiponnet, N., Turrini, A. (2017), 'Assessing House Price Developments in the EU', European Economy, Discussion Papers 2015, 048, Directorate-General for Economic and Financial Affairs (DG ECFIN), European Commission. Price-to-income and price-to-rent gaps are measured as the deviation to the long-term average (from 1995 to the latest available year).
(8) Price-to-income overvaluation gap measured as the deviation to the long-term average (from 1995 to the latest available year).
(9) Domestic banking groups and stand-alone banks, EU and non-EU foreign-controlled subsidiaries and EU and non-EU foreign-controlled branches.
Source: Eurostat and ECB as of 2024-02-20, where available; European Commission for forecast figures (Autumn Forecast 2023).

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