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Post-Programme Surveillance Report

Spain, Autumn 2023

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European Commission
Directorate-General for Economic and Financial Affairs

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Spain, Autumn 2023

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Contributors:

Gabriele Giudice, Maria Doval-Tedin, Simone Macchi, David Martinez Turegano, Samuli Pietiläinen and Alberto Vidán Bermúdez, Directorate General for Economic and Financial Affairs; Rainer Wichern, Elena Pavlova, Directorate General for Financial Stability, Financial Services and Capital Markets Union. Coordination and editing were ensured by Alberto Vidán Bermúdez, Simone Macchi and Andrea Cubells Enguidanos.

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This report reflects information available and policy developments that have taken place until 31 October 2023. Therefore, the macroeconomic and budgetary projections, including those underlying the debt sustainability analysis, are in line with the Commission 2023 autumn forecast released on 15 November 2023 (with cut-off date 31 October 2023).

Comments on the report would be gratefully received and should be sent, by mail or e-mail to:

Mr Gabriele GIUDICE
European Commission
Unit ECFIN.F.3
B-1049 Brussels

ECFIN-DESK-SPAIN@ec.europa.eu or

Mr Rainer WICHERN
European Commission
Unit FISMA.E.2
B-1049 Brussels

Rainer.Wichern@ec.europa.eu

⁽¹⁾ The executive summary of this report was adopted as Commission Communication C(2023)9802 on 19 December 2023. The rest of the report is the Staff Working Document SWD(2023)982 accompanying this Communication.

⁽²⁾ ECB Staff participated in this mission, and in the drafting of this report, in accordance with the ECB's competences and thus provided expertise on financial sector policies and macro-critical issues, such as headline fiscal targets and sustainability and financing needs.

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ABBREVIATIONS

BdE	Banco de España, Bank of Spain
CET1	Common Equity Tier 1
DSA	Debt Sustainability Analysis
EBA	European Banking Authority
ECB	European Central Bank
EFSF	European Financial Stability Facility
ESM	European Stability Mechanism
FROB	Fondo de Reestructuración Ordenada Bancaria
HICP	Harmonised Indices of Consumer Prices
ICO	Instituto de Crédito Oficial
IFRS	International Financial Reporting Standards
INE	Instituto Nacional de Estadística
LSIs	Less Significant credit Institutions
LTD	Loan-To-Deposit ratio
MREL	Minimum Requirement for own funds and Eligible Liabilities
NPL	Non-Performing Loan
RRP	Recovery and Resilience Plan
Sareb	Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria S.A.
SRB	Single Resolution Board

EXECUTIVE SUMMARY

The twentieth post-programme surveillance mission to Spain took place from 20 to 22 September 2023. The meetings involved staff from the European Commission, in liaison with European Central Bank staff⁽³⁾. The European Stability Mechanism (ESM) participated on aspects related to the ESM's Early Warning System.

The Spanish economy is projected to continue expanding in 2023, although at a slower pace than last year. Real GDP growth is projected to reach 2.4% this year, according to the Commission's Autumn forecast. This reflects a robust outturn in the first half of 2023 and a higher than-projected carry-over from 2022. The very positive labour market developments throughout 2023 and the pick-up of wages sustained private consumption and the resilience of the economy, despite the expected slowdown of activity in the second half of the year. In 2024, real GDP growth is forecast to moderate further to 1.7%, as the softening of economic activity expected towards the end of the year is set to extend into the first half of next year. Downside risks to the outlook relate mainly to the adverse impact of the tightening of financial conditions, notably in light of the still elevated, albeit declining, level of external, public and private debt, and the uncertainty stemming from international geopolitical tensions. On the other hand, some factors have the potential to mitigate the headwinds on consumption and investment, including increasing households' purchasing power, owing to easing of price pressures, rising nominal wages, and the marked decline in private sector indebtedness achieved in the past years. Moreover, the continued implementation of important structural reforms and investments under the Recovery and Resilience Plan (RRP) – now worth EUR 163bn in grants and loans following the adoption of the revised Council Implementing Decision on the approval of the assessment of the revised Plan in October – is expected to continue supporting investment growth over the forecast horizon.

Headline inflation is expected to decelerate in 2023 to 3.6% as the impact of past energy prices increases continue to fade. The decline in HICP inflation was favoured by the continued drop in energy prices experienced since the third quarter of last year. Headline inflation is set to decline further next year reaching 3.4% on average, despite the upward pressure exerted by the phasing out of government measures implemented to mitigate the impact of high energy prices. Core inflation is set to moderate more gradually this year and in 2024. Second-round effects on wages have been limited so far, in line with the multi-year agreement signed by social partners in spring. Additional disruptions in global commodities market prompted by heightened uncertainty related to the unfolding geo-political events may exert additional downward pressure on the evolution of inflation.

The private sector debt-to-GDP ratio continues decreasing and the external net debt improved further in 2023⁽⁴⁾. The debt ratio of the non-financial private sector decreased to 117% of GDP in the second quarter of this year, down by 14pps compared to the same period of 2022. The housing market experienced an orderly slowdown since mid-2022, after the strong growth of activity and prices following the pandemic. Spain's negative net international investment position (NIIP) declined to -57% of GDP in the second quarter of 2023 from -63% of GDP in the same period of last year, supported by the increasing surplus in both the current and capital accounts. The recent upward revision of the GDP level carried out by the National Statistical Institute (INE) has also contributed to the decline of debt ratios.

Spain keeps reducing its public deficit, although at a slower pace, as tax revenues seem to be decelerating. The general government deficit is expected to decrease to 4.1% of GDP in 2023, after having halved from 10.1% to 4.7% of GDP in the 2020-2022 period. After buoyant growth over several quarters, tax revenues are showing signs of moderation, particularly VAT and corporate income tax revenues, reflecting the effect of the narrowing inflation of imported goods and somewhat weaker

⁽³⁾ European Central Bank (ECB) Staff participated in this mission, and in the drafting of this report, in accordance with the ECB's competences and thus provided expertise on financial sector policies and macro-critical issues, such as headline fiscal targets and sustainability and financing needs.

⁽⁴⁾ The evolution of external and internal indebtedness position is also monitored in the context of the In-Depth Review (IDR), aimed at identifying and assessing the severity of macroeconomic imbalances.

corporate profits. This deceleration is occurring despite the sustained robustness of the personal income tax, which reflects both a base effect in the labour market dynamics, with more people working and declaring taxes, and the effect of higher pensions and salaries adjusting to inflation. Besides growing expenditure for pensions and public wages, the cost of transitory energy measures is also impacting the overall current expenditure. The government approved two packages of measures in May and June, with an expected combined cost of EUR 2.7 billion, that included subsidies in urban transport, increases in agricultural insurance subsidies, levies for water utilisation by professionals, an extension of the VAT reduction for basic food and direct support to the primary, road transport and maritime transport sectors. On the other hand, if the impact of the Recovery and Resilience Facility is excluded, public investment declined in the first seven months of the year. Going forward, the budgetary savings from the phasing out of energy measures are set to drive the fiscal adjustment in 2024, in the absence of new policy measures as the budget has not been presented to parliament yet. Both the headline and the structural deficit are expected to remain above the 3% reference value over the forecast horizon. While the implementation of reforms in the RRP is expected to contribute to fiscal sustainability over time, additional consolidation efforts are needed to achieve a sound budgetary position. The debt-to-GDP ratio is projected to decrease in 2023 to 107.5% of GDP, driven by strong nominal GDP growth, and then stabilise from 2024.

The banking sector has remained resilient, amidst continued geopolitical tensions and uncertainty, higher inflation and tightening financial conditions for borrowers. The contraction in lending activity that started in December 2022 gained further pace during the first eight months of 2023. The Bank Lending Survey (BLS) for the second quarter of 2023 indicated a further tightening of credit standards and weaker demand for loans in Spain. Supported by the decrease in the stock of impaired assets, the NPL ratio declined to 3.5% at the end of 2022 (from 4.3% a year earlier) and remained broadly unchanged in the first half of 2023. Still, while asset quality has remained relatively robust, the tightening of monetary policy and the higher inflation may start to impact adversely the debt repayment capacity of borrowers. Liquidity and profitability in the banking system continue to be favourable. After the repayment of most of the TLTRO funding, the liquidity position of banks has remained reassuring. The cost of deposit funding has increased only slightly, as the pass through of the increase in interest rates to deposit rates has been rather weak until the autumn. Banking sector profitability remained strong in 2022 and the first half of 2023, as the favourable impact of rising interest rates on net interest income more than offset the increase in loan-loss provisions in 2023 as compared to a year earlier. However, for the banks mainly operating in Spain profitability has been adversely impacted by the temporary bank levy introduced in 2022, which banks have paid in 2023 based on the 2022 financial results. While robust, the capital ratios of Spanish banks continue to be lower than EU peers and warrant close monitoring as credit quality may be under pressure in the next quarters. The asset management company SAREB continues to reduce its balance sheet, having disposed of roughly 48% of its assets since its inception. Its new Business Plan for 2023-2027 incorporates the “sustainability principle”, allowing for the transfer of assets to develop social housing policies, in addition to the objective of maximising the asset portfolio value. As of the end of 2022, the negative equity of SAREB has deteriorated further, due to the negative valuation adjustments of EUR 11.6 billion, the losses posted in 2022 and the negative own resources.

Spain retains the capacity to service its debt. Spain’s economic activity is expected to continue to expand and, its fiscal situation to improve while its financial situation remains resilient amid tighter monetary policy and still elevated inflation in the short run. Spain’s government debt-to-GDP ratio is going to decline gradually and expected to reach around 106.5% of GDP in 2024. According to the debt sustainability analysis, Spain is considered to face low risks in the short term, but medium-term fiscal sustainability risks appear high. Government gross financing needs are stable at 20% of GDP level annually while average maturity of the government debt remains broadly at around 8 years. Spain made several voluntary repayments of the ESM loan in 2014-2018 and the first scheduled repayment in 2022. The next payment is due by the end of 2023 and – according to the agreed repayment schedule – the payments will continue annually until 2027. Despite some widening of sovereign spreads in 2023, financing conditions for Spain are considered to remain favourable.

1. INTRODUCTION

1. Spain received financial assistance for the recapitalisation of financial institutions in July 2012 and successfully exited the related programme in January 2014.

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

2. This report presents the main findings from the 20th PPS mission.

Staff from the European Commission, in liaison with staff from the ECB, participated in the mission to Spain. Staff from the European Stability Mechanism (ESM) also attended the meetings on aspects related to the ESM's Early Warning System. Under the PPS, the Commission carries out regular review missions to EU Member States that have had an EU-supported financial assistance programme. The objective of the PPS mission is to assess the economic, fiscal and financial situation to ensure the Member State maintains its capacity to service its debt to the European Stability Mechanism (ESM).

3. This report reflects information available and policy developments that have taken place until 31 October 2023.

The macroeconomic and budgetary projections, including those underlying the debt sustainability analysis, are in line with the Commission 2023 autumn forecast released on 15 November 2023 (with cut-off date 31 October 2023).

2. MACROECONOMIC DEVELOPMENTS

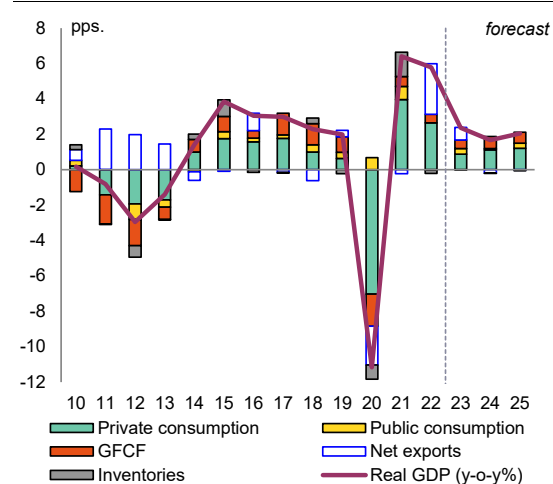
4. Following the strong growth posted in 2022 (5.8%), economic activity maintained its momentum in the first half of this year. Real GDP edged up by 0.6% in the first quarter, chiefly thanks to the strong contribution of external demand, and by 0.4% in the second quarter, underpinned by the rebound of domestic demand. The pickup of private consumption in 2023-Q2, which accelerated in the third quarter, was favoured by strong employment expansion, rising nominal wages and the moderation of inflationary pressures. Net exports registered a decline, on account of the weak performance staged by exports of goods, mirroring the slowdown in global trade. The economic expansion is set to continue (GDP expanded by 0.3% in the third quarter) but to be more subdued in the second half of 2023 due to weaker economic activity in main trading partners and the impact of tighter financing conditions on aggregate demand.

5. Overall, GDP growth is expected to reach 2.4% in 2023, according to the Commission's Autumn forecast. This outturn reflects a higher than-projected carry-over from 2022 and the robust outturn in the first half of 2023. In 2024, real GDP growth is forecast to moderate to 1.7%, as the softening of economic activity expected towards the end of 2023 is set to extend at least into the first half of next year. The recovery of households' purchasing power will partially mitigate the impact of headwinds on private consumption, which is set to benefit also from the continued resilience of the labour market. The unemployment rate will remain at elevated levels and above the euro area average, albeit on a declining trend over the forecast horizon 12.1% and 11.6% in 2023 and 2024 respectively).

6. Annual HICP inflation is forecast to moderate to 3.6% in 2023, on the back of the continued deceleration of energy inflation. HICP inflation excluding energy and unprocessed food is set to decline more gradually as the pass-through of high energy prices to other items, especially food and services, lingered throughout the first half of 2023. Second-round effects on wages have been limited so far, with the pick-up observed so far aligned with the multi-year agreement reached by trade unions and business associations (4% increase in 2023 and 3% in 2024 and 2025). A further slowdown of HICP inflation to 3.4% is

projected for next year despite the upward pressure from the expected phasing out of government measures implemented to mitigate the impact of high energy prices.

Graph 2.1: Composition of GDP growth



GFCF: gross fixed capital formation

Source: INE, European Commission Economic Forecast, Autumn 2023.

7. Downside risks to the outlook relate mainly to the adverse impact of the tightening of financial conditions for households' and firms. Given the still elevated, albeit declining, level of external, public and private debt, Spain remains vulnerable to the impact on activity of the interest rate hiking cycle. Moreover, while the bulk of new mortgage loans are granted with fixed interest rates, the outstanding stock remains concentrated on variable-rate loans. In addition, the potential persisting high levels of commodity prices prompted by heightened uncertainty related to the unfolding geo-political events, as well as pressure from core components might result in a more sluggish slowdown of inflation. The materialisation of these risks would negatively weigh on the dynamism of aggregate demand. On the other hand, some factors have the potential to mitigate the headwinds on consumption and investment. These include increasing households' purchasing power, owing to easing of price pressures, rising nominal wages, and the marked decline in private sector indebtedness achieved in the past years. Furthermore, the ongoing implementation of the Recovery and Resilience Plan (RRP) – now worth EUR 163 bn in grants and loans following the adoption of the Council

Implementing Decision on the assessment of the revised Plan in October – is expected to continue supporting investment growth over the forecast horizon.

8. Housing activity has moderated significantly, while prices show a gradual slow-down over the course of 2023. Demand has been negatively affected by the erosion of purchasing power in a context of high inflation and the increase of lending rates following the tightening of monetary policy. Nevertheless, moderate credit growth financing the recent expansion of housing sales, limited increases in housing valuation gaps and the resilience of the labour market are supporting an orderly slowdown in housing activity from its high levels in the first half of 2022. House sales decreased by 4.5% y-o-y in the first half of 2023, after posting strong growth in 2021 (34.8%) and 2022 (14.8%). The slow-down has been more pronounced in the second-hand market, for which sales had previously increased more significantly. House prices increased by 3.6% y-o-y in the first half of 2023, decelerating from 7.4% in 2022. In both periods growth rates remained below overall CPI-inflation, converging only recently due to the moderation of energy prices. The slowdown has been less pronounced for new houses in a context of sustained demand and in view of supply-side constraints, with prices rebounding in the second quarter of 2023 (7.7% y-o-y, compared to 2.9% y-o-y for the second-hand segment).

9. The private sector debt-to-GDP ratio continues decreasing in 2023. The debt ratio of the non-financial private sector decreased to 117% of GDP in the second quarter of 2023, down by 14 pps compared to the same period of 2022 ⁽⁵⁾. The stock of debt accumulated by non-financial corporations (NFCs) accounted for 67% of GDP, while total household liabilities amounted to the remaining 50% of GDP. The decline of the debt ratio for both segments has been mainly driven by a significant growth of nominal GDP in 2022 and the beginning of 2023 due to both strong economic activity and high inflation rates. Also, the recent upward revision of the GDP level carried out by the national statistical institute (INE) has

contributed to the decline of the debt ratios. In a context of economic slowdown and higher interest rates, the outstanding amount of loans has declined since the third quarter of 2022. The contraction has been more intense for NFCs (-5.0% y-o-y in August 2023) than for households (-2.5% y-o-y). Surveys on loan demand and the lagged transmission of monetary tightening suggest an extension of this trend in the short-term.

10. Spain's external net debtor position has continued improving in 2023. The negative net international investment position (NIIP) declined to -57% of GDP in the second quarter of 2023 from -63% of GDP in the same period of 2022. Strong nominal GDP growth, INE's upward revision of GDP levels, as well as the increasing surplus in both the current and capital accounts, have supported further reductions of the negative NIIP ratio. However, these positive developments were partially offset by strong negative valuation effects at the end of 2022 and beginning of 2023. The trade deficit has declined over the last year due to lower energy prices, while the service balance has recently reached a surplus above 6% of GDP supported by increases in both tourism and non-tourism revenues. The current account balance is expected to remain in surplus over the forecast period (1.7% of GDP in 2024 and 1.5% in 2025), contributing to further reductions of the negative NIIP ratio.

⁽⁵⁾ Data are expressed in consolidated terms. Source: Bank of Spain.

3. PUBLIC FINANCE DEVELOPMENTS

3.1. FISCAL PERFORMANCE

11. Spain kept reducing its headline deficit in 2022 despite the approval of energy measures.

Driven by the strong growth of total revenues (8.5% annual increase in 2022) and helped by the phasing out of most COVID-19 measures, the headline deficit decreased in 2022 by 2 pps to 4.7% of GDP. These positive budgetary developments occurred despite the approval of several packages of measures to protect firms' and households' income against energy price increases in the wake of Russia's war of aggression against Ukraine. Tax revenues showed sustained strength throughout the year. Corporate income tax, personal income tax and VAT recorded in 2022 growth rates of 10.9%, 15.5% and 12.8%, respectively, reflecting the regained momentum in the business sector, the continued positive developments in the labour market and the rise of private consumption and nominal imports.

12. Tax revenues are showing signs of moderation.

The cumulated tax revenues until July have recorded a growth of 4.7%, which is below the projections of the 2024 Draft Budgetary Plan for 2023 as a whole (7.6%). The main driver of the tax revenue deceleration is the lower than expected growth of indirect taxes. In particular, the growth of VAT revenue has decelerated by more than 11 pps compared with 2022. A less dynamic private consumption appears to be the main reason for such deceleration, but it was also driven by the narrowing inflation of imported goods, most notably energy products. Corporate income tax is also contributing to the overall tax revenue moderation, which can be explained partly by the evolution of refunds, but partly by a moderation in corporate profits, reflecting less dynamic demand. The overall revenue deceleration is materialising despite a sustained robustness of the personal income tax, that continues to record an almost double-digit growth (9.7%) until September in cash terms, and the positive impact of several discretionary measures as the levy on energy companies and financial institutions. This is supported by strong job creation and the decrease of undeclared work, as well as to the higher pensions and salaries adjusting to inflation. In cash terms, tax revenues until September show a 4.5% y-o-y growth following the 14.4% in 2022.

Overall, after having outperformed domestic demand and economic activity growth in 2021 and 2022, the aggregate tax base would be converging to their dynamics in 2023.

13. Current expenditure is increasing faster than planned, while nationally financed investment is dropping.

The government extended to the end of 2023 most of the energy measures to fight inflation, including, among others, the VAT cuts on electricity and gas, the suspension of the tax on the value of electricity production, the fuel rebate for targeted professional activities, and direct support for households and companies in the most affected economic sectors. In addition, the government approved two packages of measures in May and June with an expected combined cost of EUR 2.7 billion (0.2% of GDP). These two packages included subsidies in urban transport, increases in agricultural insurance subsidies, levies for water utilisation by professionals, an extension of the VAT reduction for basic food and direct support to the primary sector, and the road and maritime transport sectors. The expected budgetary cost of energy measures in 2023 amounts to 1.0% of GDP. Most current expenditure categories are growing above the projections of the 2024 Draft Budgetary Plan. The accumulated growth of intermediate consumption until July was 7.8%, 0.6 pps higher than projected by the government. Compensation of employees is also growing more than expected in the 2024 Draft Budgetary Plan (5.7%), with a cumulated growth until July of 6.2%. Likewise, interest payments, social transfers in cash and social transfers in kind are above the government's forecast. On the other hand, if the impact of the Recovery and Resilience Facility is excluded, gross capital formation has fallen by 8.4% in the first seven months of the year, but the government expects an acceleration in the second part of the year leading to an annual growth of 0.6%. At the same time, the government expects a decrease of investment grants and capital transfers by 17.5% for the entire year.

3.2. FISCAL OUTLOOK

14. The government deficit is expected to gradually decrease, while the implementation of a number of reforms in the RRP has the

potential to contribute to fiscal sustainability.

The cumulated fiscal balance of total public administrations (excluding the local entities) recorded a deficit of 2.2% in the first seven months of 2023, which is 0.2 pps higher than in the same period of 2022. According to the government's projections, the general government deficit is forecast to drop to 3.9% of GDP in 2023. The Commission's 2023 Autumn Forecast also expects the public deficit to narrow to 4.1%, helped by the reduced cost of energy support measures, and to decrease further in 2024 to 3.2%. The implementation of the Recovery and Resilience Plan is expected to continue in 2023 and 2024 at a brisker pace, as administrative procedures are completed. The RRF-financed expenditure at general government level could hence triple in 2023 and increase further in 2024, according to the Commission's projections. Additionally, the implementation of a number of reforms in the RRP is expected to contribute to fiscal sustainability over time, by improving the efficiency of public administration as well of government policies in a number of areas with a significant budgetary impact.

15. The budgetary savings from the phasing out of energy measures are set to drive the fiscal adjustment in 2024.

According to the government's projections, the public deficit is set to reduce to 3% of GDP in 2024 – hence, by 0.9 pps compared to 2023. Spain's projections assume the complete phase out of energy support measures, which would drive the deficit reduction. Revenues are set to remain robust helped by the impact of the temporary levies on energy companies and financial institutions (that are projected to add EUR 5.8 bn -0.2% of GDP per year- to the budget until the end of 2024), the temporary measure to limit the deductible business losses incurred by large companies (that may bring some extra EUR 2.2 bn -0.1% of GDP per year-until the end of 2024) and the solidarity wealth tax that would bring another EUR 1.3 bn. On the expenditure side, the 2024 Draft Budgetary Plan only embeds existing policies as it was submitted by a caretaker government. However, it contains additional spending for 2024 adopted before the general elections were called, such as the pension indexation to inflation and the public wages increases. Both measures are set to drive the growth of compensation of employees and social transfers in cash by 4.2% and 5.0%, respectively,

in 2024. Beyond 2024, the Stability Programme projected a gradual reduction of the general government deficit driven by sustained strong revenues. However, it is not clear how the overall revenue-to-GDP ratio will keep increasing once all the temporary revenue measures are phased out by the end of 2024. Given that both the general government and the structural deficit are expected by the Commission to remain above the 3% reference value over the forecast horizon, additional steps of consolidation on the expenditure side are needed going forward to achieve a sound budgetary position.

16. The debt-to-GDP ratio is projected to keep gradually decreasing and then stabilise at the end of the forecast horizon.

According to the Commission forecast, the debt-to-GDP ratio is projected to continue its declining path in 2023 to 107.5% of GDP, driven exclusively by strong nominal GDP growth. Going forward, as the favourable differential between nominal GDP growth and the cost of servicing debt is expected to fade, the debt-to-GDP ratio is set to stabilise from 2024 at around 106.5% unless the implementation of further measures puts the debt back on a clearly descending path.

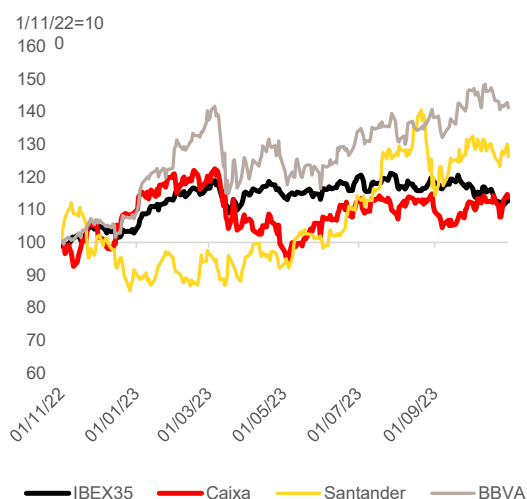
4. FINANCIAL SECTOR DEVELOPMENTS

4.1. RECENT TRENDS

17. After heightened market volatility in spring, the share prices of the largest Spanish banks have recovered.

The share prices of Spanish banks faced increased volatility already in the course of 2022, after the onset of Russia's aggression against Ukraine and the energy supply crisis, but recovered to some extent in late 2022 and the beginning of 2023, despite higher inflation and the moderation in the economic outlook. The heightened market volatility triggered by the developments related to the Silicon Valley Bank (SVB) and Credit Suisse in spring 2023 temporarily put renewed strain on the share prices of Spanish banks. However, by the end of October 2023, the share prices of all three large Spanish banks (Banco Santander, Banco Bilbao Vizcaya Argentaria and CaixaBank) stood above the prices from a year earlier (Graph 4.1), as banks in Spain tend to have benefitted from raising interest rates. The performance against the IBEX 35 index has varied across the three largest banks, with Banco Santander and CaixaBank underperforming compared to the main Spanish market index IBEX 35® until the middle of 2023 and gradually recovering ground thereafter.

Graph 4.1: IBEX35 and selected Spanish banks stocks



(1) Indexed at 03/10/2022=100.

Source: Madrid Stock Exchange, own calculations.

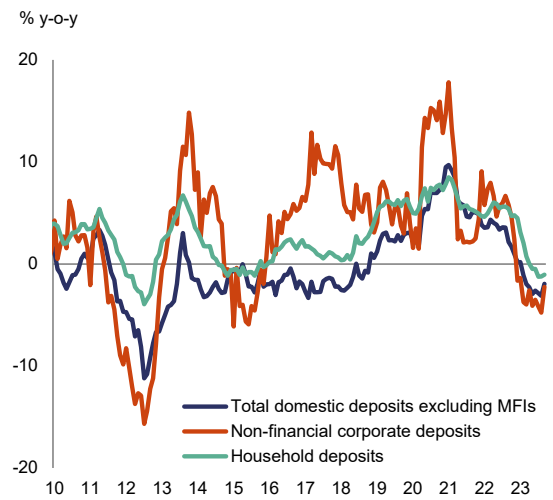
banks has remained overall robust. The Spanish banks' borrowing from the ECB has been declining at a fast pace over the recent quarters, on the back of the partial repayment of the TLTRO funding. The ECB funding went down by just above EUR 250 billion since March 2022 and stood at EUR 38.6 billion in August 2023 ⁽⁶⁾. Amidst rising prices and higher lending rates, the availability of deposit funding progressively weakened in the course of 2023. Total domestic bank deposits from households and non-financial corporations declined by 3.1% year-on-year (y-o-y) in August 2023. Non-financial corporations were the main driver of the decline in total deposits in 2023, with their deposits shrinking on an annual basis already since December 2022. Most recently, the deposits of non-financial corporations contracted by 4.8% year-on-year (y-o-y) in August 2023. Meanwhile, the deposits of households continued to expand but at a weakening pace until April 2023 and declined thereafter, and were down by 1.2% in the year to August 2023 (Graph 4.2). The loan-to-deposit ratio (LTD) slightly increased to 101.6% in the first quarter of 2023, compared to 100.7% a year earlier ⁽⁷⁾. The cost of deposit funding has increased only moderately for Spanish banks, as the pass through of the increase in interest rates to deposits has been rather low.

⁽⁶⁾ <https://www.bde.es/webbde/es/estadis/infoest/a0199.pdf>

⁽⁷⁾ Bank of Spain, *Nota de prensa estadística*, 20 July 2023. [El Banco de España publica las estadísticas supervisoras de las entidades de crédito correspondientes al primer trimestre de 2023.](https://www.bde.es/webbde/es/estadis/infoest/a0199.pdf)

18. After the repayment of a significant part of the TLTRO funding, the liquidity position of

Graph 4.2: **Bank deposits**



Source: BdE.

19. Banks in Spain have continued to access the market with sustained issuances of debt securities.

Despite the challenging macroeconomic environment involving continued geopolitical tensions, persistent inflation, tighter monetary policy and the Silicon Valley Bank and the Credit Suisse events in spring 2023, Spanish credit institutions have continued accessing the market with the issuance of MREL compliant debt securities⁽⁸⁾. According to Bank of Spain, the significant credit institutions issued MREL compliant debt instruments of roughly EUR 36 billion in 2022 and already a slightly higher amount as of mid-September 2023 (i.e., EUR 36.7 billion). However, the cost of debt issuances has increased in 2023. Based on the latest available data, Spanish banks do not have difficulties to comply with MREL targets.

20. The contraction in lending activity continued into 2023.

Following a positive evolution from July to November 2022, total lending to the private sector (excluding interbank lending) declined in the last month of 2022 and contracted further by 3.3% y-o-y in August 2023 (Graph 4.3). Due to the tightening of credit standards and the increase in interest rates, lending to corporates contracted by 5.0% y-o-y in August 2023. The support to lending to non-financial corporations provided by the ICO guaranteed loans

has been less pronounced in 2022, while following the enactment of the Royal Decree Law 34/2020, many companies have extended the maturity of their ICO guaranteed loans⁽⁹⁾. Lending to households has also been contracting since December 2022 and declined by 2.5% in August 2023. The cost of lending has gradually increased since mid-2022. The one-year Euribor®, which is used as main reference to set the interest rate on mortgage loans granted by banks, rose to 4.149% in September 2023. Taking the last twelve months as reference, the one-year Euribor® increased by 191.6 bps since September 2022⁽¹⁰⁾. In addition, in the recently endorsed revised Recovery and Resilience Plan⁽¹¹⁾, Spain has requested loan support to establish 14 financial instruments to stimulate private investment, including to support the green and digital transition, as well as the competitiveness of SMEs.

⁽⁹⁾ In order to support borrowers and corporates during the pandemic, the public development bank (*Instituto de Crédito Oficial*, ICO) managed public guarantee programs to cover liquidity and investment needs for corporations and self-employed individuals. The government guarantee programs have been used extensively by the corporate sector.

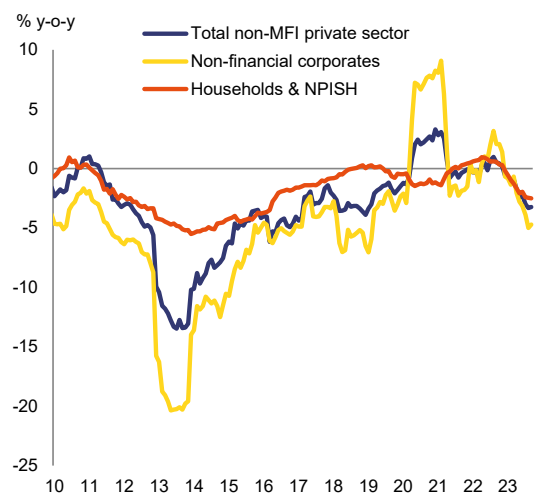
⁽¹⁰⁾ Source: Banco de España (BdE),

<https://www.bde.es/webbde/es/estadis/infoest/a0802e.pdf>

⁽¹¹⁾ See [Commission endorses Spain's €163 billion modified recovery and resilience plan, including a REPowerEU chapter](#), 2 October 2023.

⁽⁸⁾ Minimum Requirement for own funds and Eligible Liabilities (MREL).

Graph 4.3: 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.

21. The Bank Lending Survey (BLS) for the second quarter of 2023 indicated a further tightening of credit standards and weaker demand for loans in Spain.

Terms and conditions on new loans continued tightening for the fifth consecutive quarter, though more moderately than in the previous quarter⁽¹²⁾. This trend reflects the lower risk tolerance by banks, the increase in risk perception, the increase in financing costs and the more limited availability of funds. Tighter credit conditions mainly translated into an increase in lending margins, and the share of rejected loan applications increased slightly across segments. In the first half of 2023, credit standards tightened across all sectors, but most markedly in manufacturing, the construction sector and real estate activities. For the second consecutive quarter, the BLS for Q2-2023 showed a decline in the demand for loans across segments. The decrease in loan applications reflected mainly the rise in financing costs, while in the corporate credit segment lower investments also played a role. As regards households, the decline in loan demand could also be explained by lower consumer confidence, the greater use of accrued savings and the worsening outlook for the housing market. As for the second half of 2023, banks anticipated a

⁽¹²⁾ For further details see [Bank of Spain, Nota de prensa estadística, 25 July 2023](#).

renewed general decline in loan applications, somewhat more intense in real estate activities.

22. The asset quality of Spanish banks remained broadly stable in the first half of 2023.

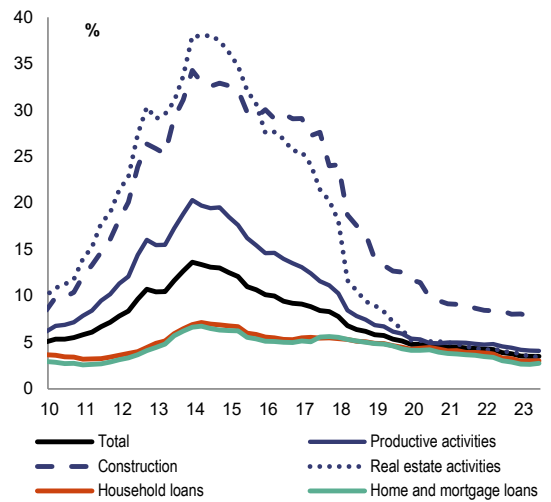
Supported by the decrease in the stock of impaired assets in particular due to sales of NPLs by banks⁽¹³⁾, the system wide NPL ratio went down to 3.5% at the end of 2022 (from 4.3% a year earlier) and remained broadly unchanged in the first half of 2023 (Graph 4.4). The construction sector continued to have the highest share of NPLs. Following declines in the past, the construction sector's NPL ratio stood at 7.9% at the end of June 2023, by 0.5 pps lower than a year earlier, but slightly above the level in the first quarter of 2023. Since the second quarter of 2022, the NPL ratios for real estate declined steadily and stood at 3.5% in the middle of 2023. The NPL ratio for productive activities fell to 4.1% at the end of June 2023, the lowest level since March 2009. Loans to households continue to have the lowest level of impairment, with the NPL ratio declining to 3.0% at end of June 2023, around 0.3 percentage points lower than in mid-2022. While the NPL ratio on mortgage loans has been on a declining path until the end of 2022, the level stagnated in the first quarter of 2023 and slightly increased thereafter, amidst a strong increase in the reference rate (the one-year Euribor®). The repricing of existing mortgage loans with variable interest rates is ongoing in 2023 and will continue in 2024 and could adversely affect banks' asset quality in Spain, albeit to a more moderate extent than in several other EU countries with higher shares of variable-rate mortgage loans. After the decline in the first three quarters of 2022, Stage 2 loans (according to IFRS 9⁽¹⁴⁾) at consolidated level slightly increased in subsequent months. According to the latest data by the European Banking Authority (EBA), the share of Stage 2 loans as percentage of total loans and advances stood at 6.9% at the end of March 2023, below the EU average of 9.1%, and by 0.1 percentage points lower than in March 2022. According to Bank of Spain, Stage 2 loans decreased again in the second quarter of 2023. While asset quality has been relatively robust, the tightening of monetary policy and higher inflation may adversely impact the debt

⁽¹³⁾ Non-performing loan (NPL).

⁽¹⁴⁾ International Financial Reporting Standards (IFRS).

repayment capacity of borrowers, notably of those more vulnerable.

Graph 4.4: **Ratio of non-performing loans**



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

23. Banking sector profitability remained strong in 2022 and 2023, driven by the favourable impact of rising interest rates on net interest income. Banking sector profitability benefitted from the increase in net interest income and commissions, which more than offset the increase in loan-loss provisions in 2023 as compared to a year earlier (Graph 4.5). The profitability of banking groups with international footprint benefitted from the good results obtained by their subsidiaries outside the EU, in particular in Latin America. According to Bank of Spain data⁽¹⁵⁾, the operating profit reached almost EUR 30 billion in the first quarter of 2023 compared to just above EUR 26 billion in the first quarter of 2022, while the return on equity (consolidated basis) stood at 11.15%. At the same time, following several quarters of moderation in 2022, the cost of risk increased in the first quarter of 2023 compared to the previous quarter and stood at 1.04% (still slightly below the level a year earlier). Interest income has continued to remain the main source of income for Spanish banks. The

⁽¹⁵⁾ Bank of Spain, *Nota de prensa estadística*, 20 July 2023. [El Banco de España publica las estadísticas supervisoras de las entidades de crédito correspondientes al primer trimestre de 2023.](#)

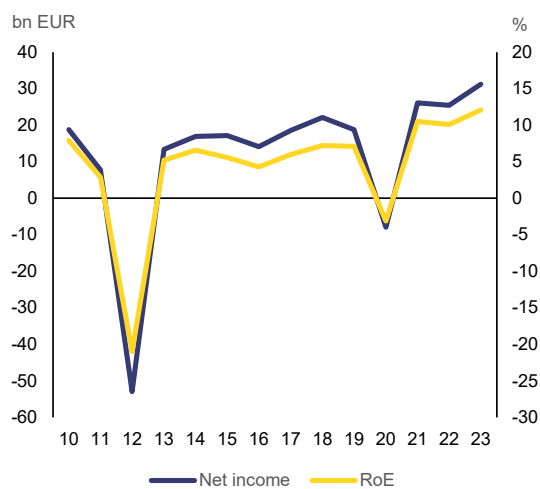
tightening of monetary policy in the euro area has led to an increase in interest income. Overall, Spanish banks are among the most efficient banks in the EU. The cost rationalisation in recent years (including from the recent banking mergers) has gradually fed into operational costs. According to ECB data, the cost-to-income ratio of Spanish credit institutions stood at 46.1% in the first quarter of 2023, down from 47.4% in the first quarter of 2022 and well below the EU average of 54.4%. For the largest banks, notably those mainly operating on the Spanish market, profitability has been also affected by the temporary bank levy introduced in 2022, which banks paid on the basis of the 2022 and 2023 financial results⁽¹⁶⁾.

24. Banking sector capitalisation declined slightly in 2022 but recovered partially in the first quarter of 2023. According to the latest data by Bank of Spain, the solvency ratio at banking system level increased slightly in the first quarter of 2023 and stood at 16.85%, by 0.1 ppt higher than at the end of 2022, but somewhat below the level of a year earlier. Less significant credit institutions (LSIs) continued to exhibit higher capital ratios than significant credit institutions (SI). The total capital of LSIs stood at 22.55% in the first quarter of 2023, while the total capital of SIs reached 16.48%, slightly below the system-wide solvency ratio⁽¹⁷⁾. Meanwhile, the Common Equity Tier 1 (CET1) ratio at system level increased to 13.32% at the end of March 2023, from 13.23% at the end of 2022. Overall, the capitalisation of Spanish banks continues to be robust, but lower than for the EU peers. Since the higher inflation and the increase in interest rates is likely to put strain on the debt repayment capacity of some borrowers, the capitalisation of Spanish banks continues to warrant close oversight. Most recently, the temporary bank levy has also been taking a toll on the profit of banks on operations in Spain, thus limiting the potential for the organic capital generation.

⁽¹⁶⁾ For further details on the bank levy, see Section 4.2 on Reforms and policy.

⁽¹⁷⁾ Bank of Spain, *Nota de prensa estadística*, 20 July 2023. [El Banco de España publica las estadísticas supervisoras de las entidades de crédito correspondientes al primer trimestre de 2023.](#)

Graph 4.5: Bank sector profitability (consolidated basis)



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

4.2. FINANCIAL SECTOR REFORMS AND POLICY

25. The latest credit and housing market developments in Spain have not called for a change in the macro-prudential policy stance. In September 2023, the Bank of Spain decided to keep the countercyclical capital buffer applicable to banks for their credit exposures in Spain at 0% in the fourth quarter of 2023⁽¹⁸⁾. The credit-to-GDP gap⁽¹⁹⁾ remains in negative territory and on a downward path, due to both the slower growth in economic activity and the contraction in credit that started at the end of 2022. The latest data indicate that housing purchases have significantly declined in year-on-year terms in the second quarter of 2023 but remained above their average pre-pandemic level. New mortgage loans also continued to lose momentum in 2023. Total outstanding mortgage credit also declined, albeit more moderately, owing to the decline in the flow of new lending and to the high rate of repayments. House prices increased in the second quarter of 2023, ending the gradual

⁽¹⁸⁾ Bank of Spain, [The Banco de España holds the countercyclical capital buffer at 0%](#), 27 September 2023.

⁽¹⁹⁾ The credit-to-GDP gap measures the deviation of the private non-financial sector credit-to-GDP ratio from its trend level.

easing in house prices that started a year earlier and thus warranting closer monitoring. Overall, the real estate market indicators still show some signs of overvaluation, although much more contained and lower than in the EU Member States that activated macro prudential measures for real estate market exposures. Going forward, the continued decline in the credit-to-GDP gap is subject to a high degree of uncertainty, owing to factors such as inflationary pressures and the monetary policy tightening to address them.

26. The cycle of resolution planning has continued smoothly for all credit institutions in Spain. Ten significant institutions under the resolution remit of the Single Resolution Board (SRB) and all less significant institutions have a resolution plan. For the 2022 cycle, the MREL decisions for the two significant institutions with a resolution college and the eight significant institutions without a resolution college were communicated in 2023. For the 2023 cycle, the MREL decisions for the banks with a resolution college are expected to be communicated in the second quarter of 2024. For the banks without a resolution college, the MREL decisions are expected in the first months of 2024. Regarding the less significant institutions, the MREL decisions for the 2022 cycle were communicated in the first half of 2023. In the first half of 2024, the MREL decisions for the 2023 cycle are expected for 38 less significant institutions. Furthermore, significant and less significant, host institutions and cross-border entities in Spain complied with MREL targets without difficulties. All credit institutions have already met their MREL targets for January 2024.

27. In the first half of 2023, the government collected the temporary levy on banks. The bank levy introduced in 2022 amounts to 4.8% of banks' net interest and fee income for operations in Spain and is applicable only to banks with taxable income above EUR 800 million in 2019. The levy is to be paid in 2023 and 2024 based on the 2022 and 2023 financial results and was initially expected to generate revenues of EUR 1.5 billion per year. The bank levy is not deductible from corporate tax, and banks are not allowed to pass on the cost of the bank levy to their clients. Banks have opened judicial litigations to challenge the bank levy, which are still ongoing. In 2023, the authorities collected tax revenue from the bank

levy of around EUR 1.2 billion, which reduced banks' return on equity by around 0.5 ppt.

28. The FROB has maintained its participation in CaixaBank ⁽²⁰⁾. According to the divestment strategy of FROB and with a view to maximising the recovery of public funds, the conditions needed to execute the sale of FROB's stake (17.32%) in CaixaBank have still not been met. Even though market volatility has been substantially lower than in spring 2023, liquidity remained low, and the discount assumed in case of a sale would be relatively sizeable. Overall, according to FROB the banking sector remained undervalued, whereby prices could pick up once uncertainty diminishes. While CaixaBank appeared to FROB fairly valued against peers, the expected earnings and good track record may not have been fully priced in recently. Depending on market conditions, the deadline for FROB to divest from CaixaBank (currently by the end 2025) can be postponed by a decision of the Council of Ministers.

29. The Management Company for Assets Arising from the Banking Sector Reorganisation (SAREB) has continued the process of asset disposal ⁽²¹⁾. After more than 10 years out of its total envisaged lifetime of 15 years (until 2027), SAREB sold roughly 48% of its asset portfolio – reducing its balance sheet from an initial value of EUR 50.8 billion to EUR 26.5 billion at the end of 2022. Since its creation, the asset composition of SAREB has tilted towards real-estate owned assets (REOs). Currently, REOs account for 59% of the portfolio, the remainder made up of Real Estate Developments loans (RED, out of which 96% are non-performing) secured with real estate. Around 80% of the RED assets have a cost to value above 100% and a very slow repossession of collateral. As of mid-2023, roughly 38% of the REO assets were published for sale, 20% in preparation for sale, 20% in development and 22% not for sale.

⁽²⁰⁾ *Fondo de Reestructuración Ordenada Bancaria* (FROB) was created in 2009 to provide public support for the consolidation of the Spanish banking sector by, inter alia, strengthening the capital buffers of credit institutions.

⁽²¹⁾ SAREB (*Sociedad de gestión de Activos procedentes de la Reestructuración Bancaria*) is an asset management company that was created to divest the assets transferred from the old savings banks and help the economy recover.

30. SAREB has accumulated sizeable losses, mainly on the back of negative valuation adjustments. SAREB has been enabled to operate with negative equity, following the legal amendments waiving the general corporate law obligations related to compulsory winding-up and capital reduction for the entity ⁽²²⁾. After posting losses of EUR 1.5 billion in 2022, SAREB's total own resources were of EUR -2.6 billion at the end of 2022. Mostly due to negative valuation adjustments of EUR 11.6 billion from the impairment on assets ⁽²³⁾, the negative equity of SAREB amounted to just over EUR -14 billion at the end of 2022 and may increase further over time. SAREB performed below its business plan in 2022, as it managed to generate 90% of the income estimated in the 2022 budget and roughly 82% of the budgeted cash. At the same time, the net margin exceeded the budget while the operating expenses were lower than initially budgeted.

31. In March 2023, the new SAREB Business Plan for 2023-2027 was approved by the Board of Directors, incorporating the “sustainability principle”. According to this principle, SAREB can transfer assets to develop social housing policies, adding this activity to its objective of maximising the asset portfolio value. The Plan foresees three main areas of activity, each with its own specialised servicers: sale of assets mainly through retail channels, socially responsible management of occupied housing and real estate development. As of the middle of 2023, SAREB had signed 3,641 social rentals, with more than 2,000 pending signatures. Around 76% of the new contracts were concluded under a Social Support Programme.

⁽²²⁾ Royal Decree Law 6/2020 and Royal Decree Law 1/2022.

⁽²³⁾ The increase in impairments is primarily a result of the increase in financial costs (due to higher interest rates) and the evolution of the real estate market (decrease in current appraisal values and moderation in price forecasts for the next years).

5. SOVEREIGN FINANCING AND CAPACITY TO REPAY

32. In the short run, public debt to GDP is forecast to decline, but this trend is expected to reverse in the medium term and the debt-to-GDP ratio is projected at 109.8% of GDP in 2034 in the baseline scenario of the debt sustainability analysis (DSA) ⁽²⁴⁾. Based on data validated by Eurostat, general government debt stood at 111.6% of GDP in 2022, 13.4 pps of GDP higher than in 2019. The general government debt-to-GDP ratio is expected to decrease to 107.5% in 2023 and 106.5% in 2024 according to the Commission's Autumn forecast. Based on the Commission's DSA baseline scenario, the debt ratio is projected to marginally decline to 106.1% in 2026 but thereafter the trend is projected to reverse, and the debt ratio is expected to rise gradually to 109.8% of GDP in 2034. Based on the debt sustainability analysis, Spain is considered to face low fiscal sustainability risks in the short term. The medium-term fiscal sustainability risks are assessed to be high while the long-run risks are considered to be medium (see Annex B for the debt sustainability analysis).

33. The structural features of the outstanding government debt in terms of average maturity and investor base remain favourable. At the end of June 2023, the central government debt ratio (net of financial assets vis-à-vis other general government sectors) was 79.1% of GDP while the ratio for the regional government sector (Autonomous Communities) was 23.2% of GDP. The local government sector's debt was 1.7% of GDP and the social security fund's debt was 7.3% of GDP. Long-term bonds that have maturities ranging from two years to up to 50 years accounted for 91% of the total outstanding central government debt. The stock of 10-year or longer maturity bonds represents 73% of the total and increased by 12.4% y-o-y during the first half of 2023, above the growth rate of the total debt stock (8.1% y-o-y). This reflects the Treasury's funding strategy to increase the amount of outstanding medium and long-term government bonds and to reduce the amount of outstanding T-bills and shorter-term bonds. The maturity of the debt stock overall averaged around 7.9 years in 2023, a level where it has been since 2021. As regards the

holders of the central government outstanding debt, non-resident investors' share accounted for 40.4% in May 2023. Their share has remained relatively stable over the last 12 months, indicating that the previous gradually declining trend in the share may be bottoming out. The share of the outstanding debt stock held by the Bank of Spain declined by 2 pps to 35.1% over the same period, while the share of other resident holders increased by 1.7 pps up to 24.5%. In particular, mutual funds increased their holdings of government bonds in the past 12 months. As part of the path of monetary policy normalisation, the ECB discontinued the reinvestments under the Asset Purchase Programme (APP) as of July 2023. As regards the Pandemic Emergency Purchase Programme (PEPP) the ECB Governing Council "intends to reinvest the principal payments from maturing securities purchased under the programme until at least the end of 2024." ⁽²⁵⁾

34. Spain benefits from EU-financed instruments introduced during the pandemic. Under the Recovery and Resilience Facility (RRF), which supports financially the Spanish recovery and resilience plan (RRP) ⁽²⁶⁾, a total of EUR 37.0 billion (2.5% of GDP) in grants has been disbursed to Spain in 2021-2023 ⁽²⁷⁾. Following the approval of the revised RRP in October 2023, the maximum amount of RRF grants will be EUR 80 billion and Spain will also draw RRF loans worth EUR 83.2 billion by the end of 2026. In addition, under the Support to mitigate Unemployment Risks in an Emergency (SURE) to protect jobs during the pandemic, a loan which amounted to EUR 21.3 billion was disbursed to Spain in six tranches over 2020-2021.

⁽²⁴⁾ For a more detailed debt sustainability analysis, see Annex B.

⁽²⁵⁾ The ECB press release on 14 September 2023 also states that: "In any case, the future roll-off of the PEPP portfolio will be managed to avoid interference with the appropriate monetary policy stance. The Governing Council will continue applying flexibility in reinvesting redemptions coming due in the PEPP portfolio, with a view to countering risks to the monetary policy transmission mechanism related to the pandemic."

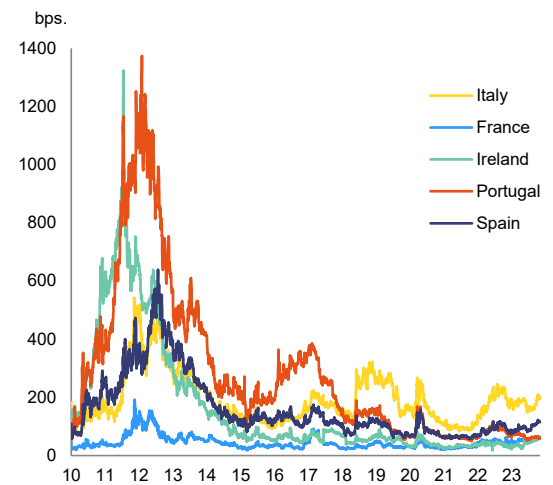
⁽²⁶⁾ See the Commission's proposal for the revised RRP: https://commission.europa.eu/publications/commission-proposal-council-implementing-decision-amending-council-implementing-decision-13-july_en

⁽²⁷⁾ See the RRF scoreboard https://ec.europa.eu/economy_finance/recovery-and-resilience-scoreboard/disbursements.html?lang=en

35. Financing conditions for the government appear broadly favourable but tighter financing conditions have led to increasing borrowing costs. the Treasury’s funding strategy for 2023, published in January 2023, estimated that the total net financing need would be EUR 70 bn while the gross issuance was projected at around EUR 256.8 bn. The Treasury has lowered these projections in October 2023 by five billion euros on the back of better-than-expected economic conditions. By September 2023, the Treasury had already executed around 76.8% of the planned gross issuance. In 2023, the redemptions are expected to increase by about 15% to EUR 187 bn as the redemptions of medium and long-term debt increase from previous year. By September, the Treasury had covered about 72.6% of the planned redemptions in 2023. The central government average interest rate on outstanding debt has continued to increase in 2023 reaching 1.96% in June 2023, up by 0.37 pps from 12 months earlier. In June 2023, the average yield at issuance increased to 3.47% from 1.8% in June 2022. For the benchmark 10-year bond, the average nominal interest rate at issuance was 3.56% in June (up by 1.04 pps from 12 months earlier).

36. Since the start of 2023, Spain’s sovereign spreads has increased modestly but more than in peer economies. The expected slowdown in economic growth, the higher inflation and the less accommodative monetary policy stance have led to an increase in spreads across the euro area. During the first half of the year, Spain’s 10-year government spread with respect to German bonds remained at around 85 bps. Since June, however, the average monthly spread has increased, going above 100 bps in September and widening further in October up to 115 bps (Graph 5.1). From 2020 to 2022 Spain’s and Portugal’s spreads developed in a similar manner with no major differences but in the course of 2023 the differential between the two has widened from around 10 to around 50 basis points. S&P Global, Moody’s, Fitch and DBRS all rate Spain’s long-term sovereign debt as investment grade with a stable outlook.

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



Source: IHS Markit, own calculations.

37. The outstanding amount of the ESM loan stands at EUR 20.1 bn, which represents 49% of the total amount disbursed to Spain under the programme. The repayment of the loan principal by the Spanish Government started with voluntary repayments in July 2014. Between July 2014 and October 2018, Spain made nine voluntary early repayments and in December 2022 – in accordance with the agreed repayment schedule – Spain made the first scheduled repayment worth EUR 3.6 bn. At the end of 2022, Spain had repaid EUR 21.6 bn of the ESM loan. The next scheduled payments are EUR 3.6 bn and EUR 4.5 bn in 2023 and 2024, respectively. The last repayment is expected in 2027.

38. The structural features of government debt reduce the vulnerabilities arising from the elevated debt levels and rising market interest rates, and Spain retains the capacity to service its public debt. Spain’s public debt remains well above the pre-pandemic level and in 2023, the gross financing needs will be higher than in the previous year. Assuming that the Eurosystem’s holdings of Spanish debt continue to be on a decreasing trend, non-resident and resident investors’ role will gain in importance going forward. Against the high overall debt stock, relatively stable short-term financing needs and long average maturity, the increased market rates will only gradually result in an increase in actual interest expenditure, as some older higher-rate debt can be refinanced at still cheaper rates. The spread

with respect to German bonds has recently widened, though it remains historically low. On the positive side, the increases in the average costs of financing come from low levels. Additionally, the maturity has remained at a high level reflecting a policy choice of the Treasury and the consistent demand indicates that investors are not seeking less risky, shorter maturity bonds from this issuer. Owing to high average maturity, the Treasury is considered to have a buffer against possible shifts in investors' demand towards higher yield. As regards other government sector debt, the current situation is considered stable. Overall, therefore, risks concerning Spain's public debt are currently sufficiently contained with respect to Spain's capacity to service its debt.

ANNEX A

Main macroeconomic and financial indicators

Table A.1: Main macroeconomic and financial indicators

	2000 -2007	2008 -2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023 (f)	2024 (f)	2025 (f)
Core indicators														
GDP growth rate	3.7	-1.3	1.4	3.8	3.0	3.0	2.3	2.0	-11.2	6.4	5.8	2.4	1.7	2.0
of which domestic demand incl. stocks	4.5	-3.1	1.9	3.9	2.0	3.1	2.9	1.6	-9.0	6.6	2.9	1.6	1.9	2.1
Private consumption (annual % change)	3.7	-2.1	1.7	2.9	2.7	3.0	1.7	1.1	-12.3	7.1	4.7	1.5	2.0	2.2
Public consumption (annual % change)	5.0	0.9	-0.6	2.0	1.0	1.0	2.3	1.9	3.6	3.4	-0.2	1.6	0.4	1.4
HICP (annual % change)	3.2	2.2	-0.2	-0.6	-0.3	2.0	1.7	0.8	-0.3	3.0	8.3	3.6	3.4	2.1
Unemployment rate (% of labour force)	10.6	20.2	24.5	22.1	19.6	17.2	15.3	14.1	15.5	14.8	12.9	12.1	11.6	11.1
Gross fixed capital formation (% of GDP)	27.7	21.4	17.8	18.0	18.0	18.7	19.4	20.0	20.4	20.1	20.4	20.5	20.5	20.8
Gross national saving (% of GDP)	22.3	18.8	19.6	21.0	21.9	22.2	22.3	22.9	21.1	22.4	22.1	23.7	23.6	23.6
General Government (% of GDP)														
Balance (g)	0.4	-9.0	-6.1	-5.3	-4.3	-3.1	-2.6	-3.1	-10.1	-6.7	-4.7	-4.1	-3.2	-3.4
Gross debt	46.7	69.0	105.1	103.3	102.7	101.8	100.4	98.2	120.3	116.8	111.6	107.5	106.5	106.5
Interest expenditure	2.2	2.4	3.5	3.0	2.8	2.5	2.4	2.3	2.2	2.1	2.4	2.4	2.5	2.5
Households														
Households saving rate	8.9	8.9	6.3	7.2	7.1	5.8	5.6	8.2	17.5	13.8	7.6	8.1	7.8	7.6
Rest of the world (% of GDP)														
Trade balance	-3.7	-0.1	3.1	3.0	4.0	3.6	2.7	2.9	1.4	1.0	1.2	2.5	2.3	2.1
Trade balance, goods	-6.8	-4.1	-2.1	-1.9	-1.3	-1.9	-2.4	-2.1	-0.8	-1.9	-4.4	-4.0	-3.9	-4.0
Trade balance, services	3.1	4.0	5.2	5.0	5.3	5.5	5.1	5.1	2.2	2.9	5.6	6.5	6.2	6.1
Current account balance	-5.9	-2.9	1.7	2.0	3.2	2.8	1.9	2.1	0.6	0.8	0.6	1.9	1.7	1.5
Net financial assets	-55.3	-91.5	-95.4	-88.3	-84.7	-85.2	-77.3	-73.3	-85.0	-71.6	-61.0	n.a.		
Net international investment position (h)	-56.5	-91.6	-95.9	-88.9	-85.4	-85.5	-79.1	-72.8	-84.9	-71.0	-60.2	-53.3		
Competitiveness (index, 2015=100)														
Real effective exchange rate relative to the rest of the euro area	104.6	107.9	100.4	100.0	98.3	98.1	97.8	99.8	103.7	104.6	101.8	100.2	100.0	99.4
Real effective exchange rate relative to the rest of the European Union	104.8	107.7	100.3	100.0	98.1	97.6	97.3	99.2	103.1	104.0	101.2	99.2	98.8	98.1
Real effective exchange rate relative to the rest of 37 industrialised countries	104.4	111.7	104.2	100.0	98.9	99.8	101.1	101.7	106.4	n.a.	n.a.	n.a.		
Banking sector														
Assets (% of GDP)	214.9	325.0	287.9	262.4	244.8	234.3	219.7	214.9	258.5	245.7	220.9	n.a.		
Private domestic credit (y-o-y %)	15.7	-3.0	-6.5	-4.2	-4.1	-2.0	-3.9	-1.5	3.3	-0.2	-0.6	n.a.		
Non-performing loans (NPLs), total (%) (i)	1.0	7.7	12.5	10.1	9.1	7.8	5.8	4.8	4.5	4.3	3.5	n.a.		
NPLs, productive activities (%)	1.0	10.8	18.5	14.6	13.1	10.3	6.9	5.4	5.0	4.8	4.2	n.a.		
* of which, construction, and (%)	0.9	17.3	32.6	30.0	29.1	24.1	14.0	11.7	9.2	8.5	8.1	n.a.		
* real estate activities (%)	0.5	19.8	36.2	27.5	25.5	18.1	9.0	5.2	5.0	4.1	3.8	n.a.		
NPLs, residential mortgages (%)	0.4	3.7	6.3	5.1	5.2	5.6	4.9	4.1	3.8	3.5	2.7	n.a.		
ECB ratios (%) (j)														
NPL (domestic and controlled foreign branches and banks)	n.a.	n.a.	8.1	6.3	5.7	4.4	3.7	3.1	2.8	2.9	2.7	n.a.		
* of which non-financial corporations	n.a.	n.a.	16.4	12.8	10.9	7.9	5.9	4.7	4.6	4.8	4.0	n.a.		
* of which households	n.a.	n.a.	5.3	4.5	4.5	4.4	4.0	3.6	3.4	3.8	3.4	n.a.		
Coverage	n.a.	61.7	46.4	46.8	45.0	42.7	43.7	43.7	45.6	41.7	43.3	n.a.		
Return on equity (k)	n.a.	1.8	6.7	6.6	5.0	7.0	8.2	6.7	-3.5	10.2	9.9	n.a.		
Return on assets (k)	n.a.	0.1	0.5	0.5	0.4	0.5	0.6	0.5	-0.2	0.7	0.6	n.a.		
Total capital	n.a.	12.1	13.6	14.5	14.7	15.4	15.4	15.7	16.8	17.3	16.5	n.a.		
CET 1	n.a.	n.a.	11.8	12.7	12.8	12.6	12.2	12.5	13.2	13.3	13.0	n.a.		
Tier 1	n.a.	9.8	11.8	12.7	13.0	13.2	13.5	13.8	14.7	15.0	14.4	n.a.		
Loan-to-deposit	n.a.	n.a.	90.3	91.7	92.5	89.3	90.6	92.6	85.5	82.8	87.0	n.a.		
Interest rates														
10 year spread vis-à-vis the Bund (%)	0.1	2.1	1.5	1.2	1.3	1.2	1.0	0.9	0.9	0.6	0.9	0.9		
CDS 5 year (basis points)	n.a.	221.5	90.3	84.1	82.0	67.4	62.6	52.0	68.0	33.6	48.8	46.6		

Updated on 31 October 2023.

(f) forecast

(g) General government balances include capital transfers related to support of banks

(h) ESA2010 and BPM6, latest quarter divided by a 4 quarters rolling GDP

(i) NPLs: ratios, in % of total loans, end-of-period, source: BdE

(j) ECB ratios, end-of-period

(k) annualised

Source: Ameco, BdE, Boursorama, ECB, Eurostat, IHS Datainsight.

ANNEX B

Debt sustainability analysis

This annex assesses fiscal sustainability risks for Spain over the short, medium and long term. It follows the same multi-dimensional approach as the European Commission's 2022 Debt Sustainability Monitor, updated based on the Commission 2023 autumn forecast and including a technical change to anchor the fiscal variables to the structural primary balance of the first forecast year (t+1) as opposed to the second forecast year (t+2) in previous publications. This change aims to ensure a higher degree of stability and consistency with the ongoing work on the revision of the economic governance framework. This means that the debt and budget balance projections for t+2 (in this case 2025) can differ from the Commission 2023 autumn forecast. A more detailed description and explanation of this update will be published in the forthcoming Debt Sustainability Monitor 2023.

1 – Short-term risks to fiscal sustainability are low overall. The Commission's early-detection indicator (S0) does not signal major short-term fiscal risks (Table A21.2)⁽²⁸⁾. Government gross financing needs are expected to remain large at close to 20% of GDP in 2023-2024 (Table A21.1, Table 1). Financial markets' perceptions of sovereign risk are investment grade, as confirmed by the main rating agencies.

2 – Medium-term fiscal sustainability risks are high.

Under the DSA baseline, the government debt ratio is projected to remain at a high level in the medium term, declining to 106% of GDP by 2026 before approaching again 110% of GDP in 2034 (Graph 1, Table 1)⁽²⁹⁾. This projection

assumes a structural primary deficit of 1.0% of GDP which appears plausible compared with past performance, indicating that the country has room for corrective action⁽³⁰⁾. At the same time, the projection benefits until 2031 from a still favourable (although declining) snowball effect of around -0.6 % of GDP annually on average over 2025-2031. It is supported by the impact of Next Generation EU (NGEU), with real GDP growth at around 1.3% over 2025-2034. Government gross financing needs are expected to remain large over the projection period, slightly exceeding 20% of GDP in 2034.

The baseline projection is stress-tested against four alternative deterministic scenarios to assess the impact of changes in key assumptions (Graph 1). All four scenarios lead to a more rapid increase in debt and confirm the high risk assessment. Under the *historical structural primary balance (SPB) scenario* (in which the SPB returns to its historical 15-year average of -1.3% of GDP), the debt ratio would be higher than under the baseline by around 3 pps. of GDP by 2034. Under the *adverse interest-growth rate differential scenario* (in which the interest-growth rate differential is permanently 1 pp. lower than in the baseline), the debt ratio would exceed the baseline level by around 9 pps. of GDP by 2034. Under the *financial stress scenario* (in which interest rates temporarily increase by 2.1 pps. if GDP compared with the baseline), the debt ratio would be higher by about 2 pps. of GDP by 2034. Finally, under the *lower SPB scenario* (where the projected cumulative improvement in the SPB over 2023-2024 is halved compared with the baseline), the debt ratio would be higher than under the baseline by around 6 pps. of GDP by 2034.

The stochastic projections also point to high risk⁽³¹⁾. The stochastic simulations indicate a

⁽²⁸⁾ The S0 is a composite indicator of short-term risk of fiscal stress. It is based on a wide range of fiscal and financial-competitiveness indicators that have proven to be a good predictor of emerging fiscal stress in the past.

⁽²⁹⁾ The assumptions underlying the Commission's 'no-fiscal policy change' baseline include: (i) a structural primary deficit, before ageing costs, of 1.0% of GDP from 2024 onwards; (ii) inflation converging linearly towards the 10-year forward inflation-linked swap rate 10 years ahead (which refers to the 10-year inflation expectations 10 years ahead); (iii) the nominal short- and long-term interest rates on new and rolled over debt converging linearly from current values to market-based forward nominal rates by T+10; (iv) real GDP growth rates from the Commission 2023 autumn forecast until 2025, followed by the EPC/OGWG 'T+10 methodology' projections until T+10 (on average 1.2%); (v) ageing costs in line with the 2021 Ageing Report (European Commission, Institutional Paper

142, November 2020). For information on the methodology, see the 2022 Debt Sustainability Monitor.

⁽³⁰⁾ This assessment is based on the consolidation space indicator, which measures the frequency with which a tighter fiscal position than assumed in the projections has been observed in the past. Technically, this consists in looking at the percentile rank of the projected SPB within the distribution of SPBs observed in the past in the country, taking into account all available data from 1980 to 2022.

⁽³¹⁾ The stochastic projections show the joint impact on debt of 2000 different shocks affecting the government's budgetary position, economic growth, interest rates and

49% probability that the debt ratio will be higher in 2028 than in 2023, implying a high risk given the high debt level. In addition, the uncertainty surrounding the baseline debt projections (as measured by the difference between the 10th and 90th debt distribution percentiles) is high, as 80% of the simulated debt paths lie in a wide range of 38.5 pps. in five years' time (Graph 2).

3 – Long-term fiscal sustainability risks for Spain are medium overall. This assessment is based on the combination of two fiscal gap indicators, capturing the required fiscal effort to stabilise debt (S2 indicator) and bring it to 60% of GDP (S1 indicator) over the long term⁽³²⁾. The risk mostly stems from Spain's unfavourable initial budgetary position and high debt level.

The S2 indicator (at 1.0 pp. of GDP) points to low risk. This suggests that Spain would need to improve its structural primary balance only by a limited amount to ensure debt stabilisation over the long term. This result is underpinned by the fact that the unfavourable initial budgetary position (contribution of +1.6 pps.) is partly offset by the projected decline in ageing-related costs (-0.6 pp.). Developments in ageing costs are primarily driven by a projected decrease in public pension expenditure (-2.0 pps.; the impact of the recently adopted pension reform under the RRP is not included in this projection), partly offset by a projected increase in health care and long-term care spending (+1.7 pps.) (Table A21.1, Table 2).

The S1 indicator, however, points to medium risk. It signals that a significant consolidation effort of 2.5 pps. of GDP would be needed to reduce debt to 60% of GDP by 2070 (Table 2).

exchange rates. This covers 80% of all the simulated debt paths and therefore excludes tail events.

⁽³²⁾ The S2 fiscal sustainability indicator measures the permanent SPB adjustment in 2024 that would be required to stabilise public debt in the long term. It is complemented by the S1 indicator, which measures the permanent SPB adjustment in 2024 to bring the debt ratio to 60% by 2070. For both the S1 and S2 indicators, the risk assessment depends on the amount of fiscal consolidation needed: 'high risk' if the required effort exceeds 6 % of GDP, 'medium risk' if it is between 2% and 6% of GDP, and 'low risk' if the effort is negative or below 2% of GDP. The overall long-term risk classification combines the risk categories derived from S1 and S2. S1 may notch up the risk category derived from S2 if it signals a higher risk than S2. See the 2022 Debt Sustainability Monitor for further details.

This result is mainly driven by the unfavourable initial budgetary position (contribution of +1.2 pps.) and the high level of the Spanish government debt ratio above the 60% reference value (+0.9 pp.), along with the projected increase in age-related public spending (+0.4 pp.)⁽³³⁾ (Table A21.1, Table 2).

4 – Finally, several additional risk factors need to be considered in the assessment. On the one hand, risk-increasing factors relate to the elevated level of public debt and large government gross financing needs in a context of higher interest rates - which 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, and the currency denomination of debt. In addition, the structural reforms 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.

⁽³³⁾ The impact of age-related public spending differs between S1 and S2 because S1 considers the period up to 2070 while S2 considers an infinite horizon.

Table B.1: Debt sustainability analysis - Spain

Table 1. Baseline debt projections	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034
Gross debt ratio (% of GDP)	116.8	111.6	107.5	106.5	106.4	106.1	106.2	106.4	106.6	106.9	107.4	108.1	109.0	109.8
Changes in the ratio	-3.4	-5.2	-4.1	-1.0	-0.1	-0.3	0.0	0.2	0.2	0.3	0.5	0.7	0.9	0.8
<i>of which</i>														
Primary deficit	4.6	2.4	1.6	0.6	0.5	0.5	0.6	0.6	0.6	0.6	0.6	0.7	0.7	0.8
Snowball effect	-8.0	-8.4	-5.6	-2.7	-1.5	-0.8	-0.5	-0.4	-0.4	-0.3	-0.1	0.0	0.1	0.0
Stock-flow adjustments	0.0	0.8	-0.1	1.0	0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross financing needs (% of GDP)	23.9	19.1	19.6	19.6	19.4	18.8	18.9	19.1	19.2	19.3	19.5	19.7	19.9	20.2

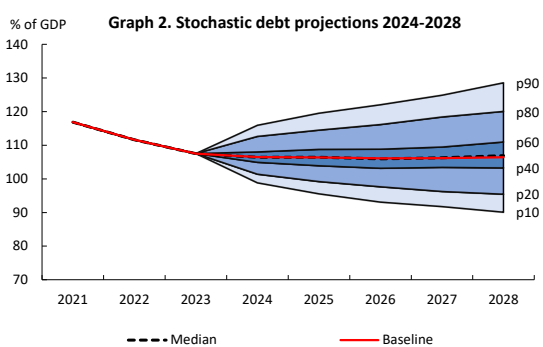
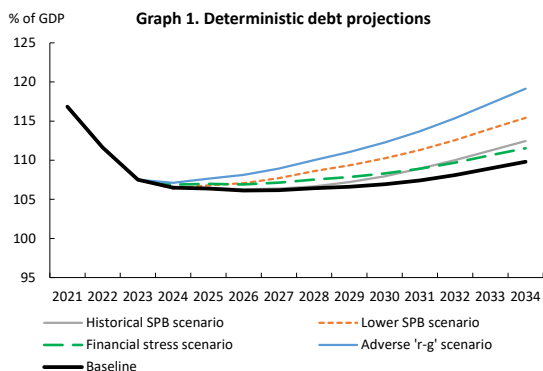


Table 2. Breakdown of the S1 and S2 sustainability gap indicators

	S1	S2
Overall index (pps. of GDP)	2.5	1.0
<i>of which</i>		
Initial budgetary position	1.2	1.6
Debt requirement	0.9	
Ageing costs	0.4	-0.6
<i>of which</i>		
Pensions	-0.5	-2.0
Health care	0.9	1.1
Long-term care	0.4	0.6
Others	-0.4	-0.4

Source: Commission services.

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

Short term	Medium term - Debt sustainability analysis (DSA)							Long term			
	Overall (S0)	Overall	Deterministic scenarios					Stochastic projections	S2	S1	Overall (S1 + S2)
			Baseline	Historical SPB	Lower SPB	Adverse 'r-g'	Financial stress				
		Overall	HIGH	HIGH	HIGH	HIGH	HIGH	HIGH			
LOW	HIGH	Debt level (2034), % GDP	109.8	112.5	115.4	119.1	111.5		LOW	MEDIUM	MEDIUM
		Debt peak year	2034	2034	2034	2034	2034				
		Fiscal consolidation space	67%	74%	75%	67%	67%				
		Probability of debt ratio exceeding in 2028 its 2023 level						49%			
		Difference between 90th and 10th percentiles (pps. GDP)						38.5			

(1) Debt level in 2034. Green: below 60% of GDP. Yellow: between 60% and 90%. Red: above 90%. (2) The debt peak year indicates whether debt is projected to increase overall over the next decade. Green: debt peaks early. Yellow: peak towards the middle of the projection period. Red: late peak. (3) Fiscal consolidation space measures the share of past fiscal positions in the country that were more stringent than the one assumed in the baseline. Green: high value, i.e. the assumed fiscal position is plausible by historical standards and leaves room for corrective measures if needed. Yellow: intermediate. Red: low. (4) Probability of debt ratio exceeding in 2028 its 2023 level. Green: low probability. Yellow: intermediate. Red: high (also reflecting the initial debt level). (5) the difference between the 90th and 10th percentiles measures uncertainty, based on the debt distribution under 2000 different shocks. Green, yellow and red cells indicate increasing uncertainty.

Source: European Commission (for further details on the Commission's multidimensional approach, see the 2022 Debt Sustainability Monitor)

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