INTERNATIONAL MONETARY FUND

Spain: Concluding Statement of the 2015 Article IV Mission

June 8, 2015

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

Spain has rebounded strongly and employment is increasing, helped by past reforms. However, the level of unemployment is still painfully high and vulnerabilities remain. Sustaining job-rich growth at the current pace, further reducing public and private indebtedness, and maintaining confidence will require additional fiscal efforts and structural reforms.

The recovery has gathered speed and job creation has accelerated, but the level of unemployment is still high. Growth has surprised on the upside, and GDP growth is now expected at 3.1 percent in 2015 and 2.5 percent in 2016, well above the euro area average. Strong policy implementation has supported the return of confidence and business investment and consumption continue to recover, while the current account maintains a small surplus. Significant external tailwinds are now helping the rebound, including from lower oil prices, the depreciation of the euro, and the European Central Bank's (ECB) very supportive monetary policy. All this has contributed to lower government borrowing costs and improving financial conditions. Private sector deleveraging has continued, but the pace has slowed, and new credit is being extended. About half million new jobs have been created since mid-2014. However, more than 5 million Spaniards, many of them young, remain unemployed.

The reforms are making a difference. Labor market reforms and moderate wage growth have supported employment and helped Spain regain competitiveness lost during the pre-crisis boom. The Market Unity Law has begun to address some of the obstacles for firms to grow and raise productivity. The progress achieved by financial sector reform, supported by the European Stability Mechanism, has been confirmed by the positive outcome of the ECB's comprehensive assessment. Continued fiscal consolidation has reassured markets and further boosted confidence. These collective efforts of Spanish society are the foundation upon which the recovery has been constructed.

However, vulnerabilities remain and deep structural problems persist, so additional efforts will be needed to sustain robust growth over the medium term. Spain should seize on the current momentum to undertake additional reforms, which tend to be most effective when implemented in a highly supportive environment. By contrast, a reversal of past reforms would create uncertainty and could stall the recovery, especially if the external environment were to deteriorate. Spain needs to continue moving forward, especially with respect to three main priorities:

- *Increasing long-term growth and making it more inclusive*. Ensuring that wage growth differs more across firms to better reflect their specific circumstances, improving the skills of the long-term unemployed, and raising the productivity of Spain's many small firms will improve the prospects for higher and more inclusive growth, increasing employment opportunities, especially for the youth.
- *Continuing to reduce private debt*. Firms and, to a lesser extent, households have significantly deleveraged, but debt levels remain high. Further reducing legacy debt will support investment and growth going forward and help reduce Spain's highly negative net international investment position.
- *Anchor confidence*. Continued gradual and growth-friendly fiscal consolidation, well coordinated across all levels of governments, will help maintain strong market confidence.

Increase long-term growth and make it more inclusive

There is still significant scope for measures that will foster job creation. Further action in this direction will not only help reduce the high rate of unemployment but also raise Spain's longer-term growth potential. Steps towards this goal include:

- *Setting the right labor market conditions.* The 2012 reform has increased room for workers and firms to adjust wages and hours worked, and it is important to use this increased flexibility to promote employment during good times and protect it in bad times. Over the medium term, keeping wage growth in line with productivity and external competitiveness is key for sustaining job creation.
- *Ensuring more firm-level adjustment*. Wage developments still do not adequately reflect differences in business conditions across firms. To encourage workers and capital to move to the most productive sectors—which will boost growth and incomes—it is critical to ensure that the existing options for firm-level adjustment are well utilized. Remaining regulatory and legal obstacles to firm-level bargaining and opt-out should be removed.
- *Lowering duality*. The new incentives for permanent hires are promising, but the cost of dismissing a permanent worker is still much higher than that for a temporary one, and this gap should be closed. This could also be achieved, for example, by introducing a single

contract with tenure-based dismissal costs in sectors without high seasonal turnover. Reducing legal and administrative uncertainties in collective dismissals and streamlining the application of objective criteria for fair dismissals would also help support permanent hiring.
- *Making Active Labor Market Policies count*. To be effective, programs to improve the skills of the long-term unemployed need to be closely monitored and evaluated, including by the transparent use of regional coverage and enforcement data.

Helping small firms grow

Reducing obstacles for small- and medium-size enterprises (SME) to grow is critical. Spanish firms tend to be smaller, less productive, and less export-oriented than their European peers. A number of measures can help generate crucial economies of scale, both in domestic and external markets, which would increase long-term growth and employment.
- *Fostering competition.* Accelerating the implementation of the Market Unity Law and moving ahead with the long-delayed liberalization of professional services would make it easier for firms to enter markets and would foster competition, including by addressing regional differences in regulatory requirements and practices.
- *Lowering constraints.* The recent corporate tax reform is set to reduce obstacles for companies' growth. However, a careful review and assessment of all size-related rules and regulations is needed to eliminate unwarranted obstacles to growth.
- *Supporting exports.* While the number of exporting firms has increased significantly since the crisis, the government strategy for boosting Spain's internationalization could do more to help SME enter export markets and remain competitive.

In this context, efforts should continue to strengthen SME's access to market-based financing. Bank lending will remain dominant, and initiatives such as the Juncker plan will be helpful in this regard. However, non-bank financing should be developed further, including via alternative exchanges, venture capital, and securitization, while improving transparency and accuracy of financial reporting.

Further strengthening banks while reducing private debt

Continued strengthening of the Spanish banking sector will support growth as credit demand picks up. Banks' capital and earnings have increased, asset quality and specific provisioning have improved, and funding and liquidity conditions have become more favorable. However, operating conditions remain challenging: the low-interest rate environment in the euro area will further compress lending margins, upcoming international resolvability requirements will likely require additional loss-absorbing capacity including capital, and the profitability of some banks continues to be impacted by foreclosed assets and high levels of non-performing loans (NPLs). In this context, the authorities should continue to encourage banks to increase high-quality capital and find ways to reduce the carrying costs of high NPLs.

The recently introduced "fresh start" is a significant step to facilitate deleveraging of consumers and entrepreneurs acting in good faith. If implemented effectively, the reform can encourage demand and future entrepreneurial activity in the formal sector while preserving Spain's strong payment culture. The immediate impact on bank earnings is estimated to be small, and could be positive in the longer term. To maximize the positive effects, uncertainties regarding the post-liquidation payment plan and revocation of the fresh start should be clarified. In insolvency law, more generally, due consideration should be given to fully involving public creditors in restructuring processes and making obligations to them subject to discharge after liquidation.

Concerted and credible fiscal consolidation

Continued, coordinated and credible fiscal consolidation will help protect confidence and reduce vulnerabilities to potential adverse shocks. Spain has continued to bring down its fiscal deficit as the economy has recovered, but the level of public debt is very high and still increasing. Any windfalls from lower interest rates, higher-than-expected growth, and easing deflationary pressures should therefore be used to bring the deficit down further and ensure debt is put firmly on a downward path. This will require a concerted effort across all government levels through more ambitious and better specified measures than currently envisaged. Raising excise duties and environmental levies, and gradually reducing value added tax (VAT) preferential treatments would bring Spain's collection efforts more in line with those of other European countries. At the regional level, additional fiscal savings could be generated—for example, by reducing the costs of providing public health and education services and, as recommended by the Tax Reform Expert Committee last year, by increasing regions' responsibility to co-pay for these services.

Consideration should be given to strengthening the regional fiscal framework. The contribution of regional governments to post-crisis consolidation has been significant but uneven, suggesting possible implementation risks going forward. Further actions to enhance the regional fiscal framework are needed, including:

- Continuing to improve the monitoring and enforcement of regional fiscal targets, rules, and access to debt mutualization mechanisms under the Budget Stability Law and related instruments. Consideration could also be given to introducing alternative tax-based mechanisms to help finance regions in bad times.
- Addressing design drawbacks in the regional finance system that limit regions' capacity and incentives to consolidate.
- Allowing regions' fiscal targets to differ—in a rules-based and transparent fashion—taking into account structural differences in adjustment needs and capacity.