

MISSION CONCLUDING STATEMENT

Spain: IMF Staff Concluding Statement of the 2018 Article IV Mission

October 3, 2018

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 \(/external/pubs/ft/aa/aa04.htm\)](/external/pubs/ft/aa/aa04.htm) 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 continued to make up economic ground lost during the crisis with job-rich growth helped by past reforms. But the economic cycle is maturing and several downside risks are clouding the medium-term outlook. At this juncture, it is critical to strengthen the economy's resilience to withstand shocks. Two policy areas are key for this goal: restarting structural fiscal adjustment and preserving the thrust of the labor market reforms. These policies can and should go hand in hand with efforts that foster more inclusive growth and promote social objectives. In particular, the younger generation needs to be better integrated into the labor market to sustainably enhance their income prospects.

Outlook

The economy maintains a strong momentum but has passed its cyclical peak. Real GDP growth is projected to moderate to about 2.7 percent in 2018 and 2.2 percent in 2019, still above the euro area average. This reflects both a less supportive external environment and weakening domestic demand. Beyond 2019, economic expansion is set to converge to its potential rate, estimated at about 1¾ percent. Important structural challenges, such as notably high public debt, high structural unemployment and sluggish productivity growth weigh on potential GDP growth.

Downside risks to the economy are building. Externally, they include sudden changes in investors' risk appetite, escalating global protectionism, and weakening conditions in emerging economies. Domestically, they still include pressures to reverse reforms and continued procyclical fiscal policy.

Fiscal Policy: Creating Needed Fiscal Space

Fiscal buffers, which were depleted during the crisis, need to be rebuilt. That means fiscal policy should take full advantage of the still strong economic conditions to bring down faster the high level of public debt. Otherwise, Spain would be forced to undertake a procyclical fiscal tightening when the economy is hit by future shocks. Thus, building buffers today creates more fiscal space in the future that will help to better shield the population from large swings in employment.

Structural measures will be key for a sustainable reduction of the fiscal deficit and public debt. The decline in headline deficits over the past three years has reflected entirely the strong economic cycle. At the same time, the structural balance—the fiscal balance after accounting for the economic cycle—deteriorated to about 2.5 percent of GDP. For 2018, additional structural loosening of 0.2 percent of GDP is projected. As a result, debt levels have only come down marginally while the economy has grown strongly. Therefore, the government's announced deficit target of 1.8 percent of GDP for 2019 is critical and appropriate. It implies a structural effort of about 0.5 percent of GDP. This pace of adjustment per year should persist until there is fiscal structural balance and debt is on a clear downward path.

The 2019 budget needs to include a credible package of measures. The authorities have not yet completed the budget preparations, and the mission cannot assess whether the preliminary proposals are sufficient to meet the deficit target. Revenue measures—the preferred adjustment tool by the government—can contribute to sustained medium-term fiscal adjustment. But it is critical to prudently project yields from new measures and plan for contingency actions that could promptly compensate any revenue shortfalls.

Measures to lower inequality can and should go hand in hand with fiscal deficit reduction. Raising additional revenues beyond those needed for the deficit reduction can help finance additional spending to protect the most vulnerable, support the employment prospects of the young and those long out of work, foster innovation capacity and environmental protection, as well as achieve distributional objectives. But a careful design of tax measures is key to limit distortions and growth implications.

The social acceptability of the 2011/13 pension reforms has been put into question. The pension system has shielded the older generation from the worst impact of the crisis, allowing for purchasing power increases that brought down significantly old-age poverty, but going forward it faces challenges. At the same time, the crisis has exacerbated high youth joblessness, leaving scarring effects on their income prospects. Looking ahead, population ageing implies that the pension system will face the challenge that fewer contributors will fund an increasing number of pensioners. Earlier reforms responded with financially appropriate measures to address the pressure on the pension system, but the expected reduction in future benefits has challenged the social acceptability of the reforms.

A sustainable and comprehensive pension package is needed to address the tensions in the system. The Toledo Pact recommendations of relinking pension increases to an indicator of purchasing power should not be translated into legislations without a comprehensive package. An ad hoc adjustment to pension benefits could put the system's financial sustainability at risk. Linking pension increases permanently to inflation is estimated to add about 3-4 percent of GDP in pension outlays by 2050 under current demographic and macroeconomic projections. Such a structural spending hike requires structural offsets. Tools available include, for example, increases in the minimum contribution for self-employed and the maximum earnings subject to contributions as well as linking the statutory retirement age directly to life expectancy. Unless they fully match the expected additional spending, a future benefit reduction can be moderated but cannot be entirely avoided. The distributional consequences of all possible measures need to be considered. Moreover, it is key to be fully transparent about the effect of changes in the pension system. Future pensioners can then make informed decisions on their work lives and savings.

Labor Market: Moving Toward Greater Inclusion

The labor market has continued to strengthen but significant challenges remain. With ample job creation, the unemployment rate dropped to 15 percent in the second quarter of 2018, below its long-term average. This helped particularly the long-term unemployed as they accounted for more than half of the total unemployed that found a job in the past 18 months. Nevertheless, many are still excluded from the formal labor market, face uncertainty in their employment or work fewer hours than they want. In some regions unemployment still stands at over 20 percent. Moreover, Spain's youth joblessness remains among the highest in the EU, and the young are still the age group at the highest risk of poverty despite the decline in poverty rates that started in 2015.

Making the labor market more inclusive requires a holistic approach. Greater wage flexibility, introduced with the labor market reforms, has underpinned Spain's job-rich economic recovery and regained competitiveness. It is critical to preserve the thrust of the reforms, in particular the prevalence of firm-level over sectoral agreements. At the same time, efforts are needed to address some shortcomings in the labor legislation. Future wage increases should follow productivity growth, and the guidelines agreed in July by social partners as regards general wage increase are welcome. However, steep increases in the statutory minimum wage could put at risk employment opportunities for the low-skilled and the young. Over the long term, the central driver to boost wage gains will be efforts to raise productivity. Such efforts need to tackle the pervasiveness of labor market duality which remains as a key obstacle to lift workers' productivity. It also limits regional mobility and contributes to the persistent unemployment gaps across regions. Thus, making open-ended contracts more attractive continues to be a policy priority. Addressing the labor market duality and high structural unemployment will also importantly contribute toward reducing inequality. Ongoing important efforts to tackle the abuse of temporary contracts contribute to this goal but by themselves will not be sufficient.

Better-targeted policies can enhance employment prospects, especially for the young. More coordinated and better-designed active labor market policies can foster employability. Strategies that improve training programs and education outcomes, increase labor-market relevance of tertiary education, expand vocational training and life-long learning, and reduce school drop-out rates are particularly important to address significant skills gaps. Furthermore, policies deserve consideration that provide incentives for people to move across regions to find jobs (for example, subsidies for moving expenses and temporary and targeted housing assistance).

Structural Reforms: Tapping into the Forgone Potential

Productivity has improved but remains notably below European peers. The gap is particularly large among small and micro firms. Labor productivity also varies widely across regions, with a gap of nearly 50 percent. This dispersion reflects not only different regional economic structures, but also differences in how efficiently regions utilize their resources. Regions with lower skills mismatch, higher foreign direct investment and greater reliance on research and development (R&D) activities tend to use resources more efficiently.

The structural reform agenda requires new impetus. Medium-term growth prospects would benefit from efforts to reduce regulatory fragmentation across the three levels of government, improve market access and competition—in particular for professional services—and lower barriers for firms to grow. Better coordination of research and innovation policies across the different levels of government, and actions to tackle the factors that hold back the uptake of R&D incentives and business-science cooperation could help expand firms' innovation capacity. Systematic exchanges of best practices in the education system and peer reviews among regions could contribute to reducing regional differences in education outcomes. The authorities' enhanced focus on gender policies should be beneficial to reduce inequality and raise long-term growth.

Financial Sector: Strengthening Resilience and Upgrading the Financial Architecture

The health of the banking system continues to improve while new risks are emerging. Reinforced efforts by major banks over recent months have notably lowered the system's nonperforming loans and foreclosed real estate assets, but some banks still need to follow suit. The ongoing economic and house price recovery is helping to mend banks' balance sheets. And while there is no clear evidence so far of a generalized house price overvaluation, vigilance is needed as housing-related new loans and especially consumer lending continue to pick up. Thus, for the Bank of Spain to be fully equipped to counter excessive risk-taking, its macroprudential toolkit should be swiftly expanded to include borrower-based tools such as limits on loan-to-value and debt service-to-income ratios. Moreover, rigorous management of liquidity and interest rate risks is needed, in particular ahead of the eventual normalization from the ECB's accommodative policies, and against the risk of market volatility and sudden changes in risk appetite. Spanish banks would benefit from accelerating the build-up of high-quality capital buffers to protect their business against shocks—including spillovers from more uncertain economic conditions in some emerging markets—as they still lag European peers in terms of capital ratios even though they are generally less leveraged.

The plans to modernize the institutional framework for financial oversight are welcome and should be expedited. The financial system is becoming increasingly interconnected, but oversight still lacks an integrated approach that focuses on potential risk transmission and amplification channels across sectors. Therefore, the planned creation of a national macroprudential authority—comprising the Bank of Spain, Treasury and other financial oversight agencies—should be a priority project. Its setup, including the agency's tasks and powers, should aim at bolstering systemic risk surveillance,

enhancing macroprudential decision-making and promoting coordination. Other projects to strengthen financial sector oversight, such as the creation of an independent insurance and pension supervisor as well as a financial consumer protection authority, and greater transparency of the appointment process for senior positions at financial oversight agencies, are welcome and should be promptly completed.

The IMF mission team would like to thank the Spanish authorities, the ECB, and other counterparts for the open and constructive discussions.

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