MISSION CONCLUDING STATEMENT

Spain: IMF Staff Concluding Statement of the 2020 Article IV Mission

September 30, 2020

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 (https://www.imf.org/external/pubs/ft/aa/index.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.

Washington, DC: *Spain's people and economy have been severely hit by the global pandemic. The government's swift and resolute income and liquidity support, combined with the ECB's loosened monetary policy, have provided important lifelines. Amid a second wave of infections, the nascent economic rebound is at risk. P reserving people's health remains a top priority. The path of the pandemic and the corresponding policy actions will shape the economic outlook. It is critical to ensure the effectiveness of new containment measures and the preparedness of the healthcare system in dealing with new outbreaks as well as the purchase and distribution of a vaccine when it becomes available.*

- *Fiscal support should remain in place until the recovery is firmly underway. Continuation of income and liquidity measures in a targeted and flexible manner is key. It is especially important to calibrate the effective short-time work schemes and public loan guarantees so that they will continue to alleviate pressures for workers and firms. Corporate sector vulnerabilities must continue to be addressed. Private debt resolution frameworks should be enhanced promptly, and there is also a possible role for public equity support of viable firms facing pandemic-related financial strains. Strong supervision together with bank relief measures need to continue to prevent real-financial doom loops from taking hold.*
- *At the same time, policies should aim at limiting the longer-term damage to the economy and facilitate resource reallocation toward expanding sectors while providing a robust social safety net. Over the medium term, once the*

recovery is firmly underway, it will also be necessary to ensure a sustainable downward path for public debt while supporting more social inclusion and resilient growth.

- *The European Recovery and Resilience Facility can provide an important demand stimulus, support job creation, limit the scarring effect of the crisis, and catalyze greener and more digital activities. Efficient coordination, implementation, and oversight of plans will be key.*
- *But domestic policies need to tackle long-standing structural obstacles that have weighed on employment, incomes, and productivity growth. Addressing the duality in the labor market will be crucial for a more inclusive economy.*

Spain has been severely hit by the pandemic

The impact of the COVID-19 pandemic has been particularly grave for Spain. Already in the first half of the year, the Spanish economy experienced the sharpest GDP drop among major advanced economies. Getting the second wave of infections under control will be critical for the economic outlook. The structural features of the economy—including a large service sector dominated by SMEs, importance of tourism, and the widespread use of temporary contracts—exacerbated the lockdown impact and will make the economy particularly vulnerable to prolonged disruptions. Quickly launched fiscal, monetary and financial sector policy support has dampened the economic and social impact of the crisis.

The uncertainty about the outlook is unprecedented

In the near term, a further pick-up in activity will be highly dependent on the containment of the health crisis. We currently project an annual loss of real output in 2020 of 12.8 percent. For 2021 real GDP could grow by 7.2 percent, helped by the utilization of the EU Recovery and Resilience Facility and its confidence effects. Achieving such a rebound will be closely intertwined with the capacity to limit new infections. Moreover, it will depend on the size, timing, and composition of EU-funded additional spending, for which plans are being prepared. In the medium term, external demand is expected to increasingly support growth as exports recover and foreign tourists return in larger numbers to Spain. Output will take several years to reach its pre-pandemic level. The uncertainty around the short and medium-term projections is very high. Risks are tilted strongly to the downside. A failure to control new outbreaks, slower-than-anticipated progress on vaccines and treatments, a no-deal Brexit and escalation of trade tensions could subdue the outlook further.

Policy support remains critical in the near term

Fiscal measures need to continue focusing on overcoming the immediate health and economic crisis and contain the risk of the recession morphing into financial sector stress with even higher real and social costs. Policy efforts should be flexibly extended and scaled, while also becoming increasingly targeted. This includes, for example, extensions of the successful short-time work scheme (ERTE), particularly for the hardest hit sectors. Similarly, other income and liquidity support measures—such as loan guarantees, and various forms of income support—should be carefully reviewed and adapted where possible with a view to preventing severe and widespread "cliff effects"—such as bankruptcies, income loss and loan defaults— when they expire and payments come due. Policymakers face a formidable challenge of keeping policy actions agile and predictable to help reduce economic uncertainty. Should the outlook deteriorate sharply, they should be ready to temporarily upgrade the support in line with the demands of the pandemic. In this context, the new EU facilities and ECB monetary policy are critically supportive by keeping borrowing costs low.

At the same time, policy support should aim at limiting scarring and continuing to contain the social costs of the pandemic

Over time unemployment benefits should gradually become the predominant safety net. This will facilitate reallocation of jobs and workers, given the diminishing net benefits over time from maintaining the attachment of workers to their jobs through short-time work schemes. It would also mitigate the risk of keeping workers in unviable firms and sectors. Unemployment benefits and social assistance may need to be temporarily upgraded (in terms of eligibility criteria, benefits, and duration) to support those impacted by long-lasting economic changes.

Some systemic companies may require temporary equity support, and the newly created state-investment fund (under the umbrella of the Spanish state-owned industrial holding company SEPI) is a welcome tool in that respect. It will be crucial to create an exit strategy for the public sector from the "bailed-out" companies and transparently record and monitor the fiscal risk. Similar recapitalization options could be extended to certain segments of viable smaller firms facing financial strains due to the pandemic. Consideration could also be given to providing temporary injections that create public claims, for example in the form of future tax liabilities.

In addition to targeted direct balance sheet support, strengthening private debt resolution frameworks is necessary to respond to the expected surge of insolvency cases. On top of some measures already introduced by the authorities, further transitional policies as the economy gradually recovers should aim to improve out-of-court restructuring frameworks and enhance incentives to encourage debt restructuring, including for SMEs. A swift and adequate transposition of the EU Directive on restructuring and insolvency, which should also facilitate restructuring procedures involving public creditors, will further help address debt-overhang problems.

The recovery strategy should address long-standing structural and socio-economic weaknesses and be compatible with Spain's climate objectives

Ensuring the sustainability of private and public debt requires policies that raise medium-term growth in a socially and environmentally sustainable way. The use of the new EU funds provides an exceptional opportunity to partially fill the demand gap caused by the pandemic and facilitate the economy's structural transformation to increase its productive capacity in the medium term. Given the unprecedented size of the funds, a clear governance structure that monitors implementation of plans and achievements of key milestones is critical so as to allow for re-calibration of the plans, to ensure high effectiveness and address new needs that may arise.

The planned utilization of the EU Recovery and Resilience Facility to address green investment gaps is welcome. Retrofitting buildings, creating charging stations for electric vehicles, and upgrading water infrastructure and waste management are examples of investments that would create short-term employment while fostering the decarbonization of the economy and progress toward environmental sustainability over the longer term. Moreover, public support for firms —beyond lifelines—should be conditioned on binding sustainability commitments, to avoid locking in future emissions.

Enhancing the employability of those impacted by economic changes, through more and better active labor market policies and training, and overcoming the segmentation of the labor market remain key priorities for greater equity. In this regard, the availability of EU funds provides an opportunity to facilitate the introduction of labor reforms. For instance, any transition costs from introducing a separation fund while making open-ended contracts more attractive could potentially be eased by use of EU funds. Similarly, EU funds could become a catalyst for the ongoing efforts to expand vocational training, including in SMEs, and digitalize the economy. In addition, boosting firms' ability to innovate and absorb new technologies requires modifying size-related regulations that hinder firms' growth, improving competition, and fostering private-public innovation collaborations.

Socio-economic disparities, which were already high pre-COVID-19, are set to widen, and poverty is likely to increase. Despite the strong policy support in response to the crisis, those with precarious employment contracts, many of whom are young, low-skilled and employed in the hardest-hit sectors, have been the most impacted. The Minimum Vital Income scheme introduced by the government is a welcome step to address some of the socio-economic challenges. Expanding social rental housing and assistance programs for renting and relocation, as well as simplifying building and zoning regulations, would help enhance rental affordability and labor mobility. Policies to enhance gender equality in the labor market should focus on boosting family and childcare support and promoting working arrangement flexibility.

Over the medium term, efforts are needed to lower the public debt burden

The pandemic is expected to push the public debt ratio up by nearly 30 percentage points to over 120 percent of GDP in the coming years. A gradual fiscal adjustment that brings public debt on a firm downward path should start once the economy is on a sustainable growth path with falling unemployment. Under current projections that would be at the earliest in 2022. In the near term, an advanced announcement of a gradual adjustment plan—contingent on the state of the economy—could send a strong signal to markets and promote policy transparency. The plan should include sustainable structural measures, especially on the revenue side, that would help rebuild fiscal buffers while supporting more inclusion and innovation. A sustainable pension reform package is needed to balance pension sustainability and social acceptability. Renewed political commitment to structural reforms would also be important to support growth prospects that facilitate debt reduction.

Heightened risks will test the resilience of the banking system and warrant strong supervision

Largely because of a significant deleveraging, the private sector—including banks—entered the crisis with stronger balance sheets than a decade ago. Bank credit to the private sector, in particular to firms, has been robust in the wake of the COVID-19 shock. Lending activity has been supported by public loan guarantees and bank capital relief and conservation measures. Yet credit risk has deteriorated and loan defaults are expected to increase, especially in the non-financial corporate segment as borrower-support measures expire. Thus, banks' lending capacity could face constraints, their already low profitability is set to worsen, and in severe scenarios solvency challenges may arise. The impact of the pandemic on Spanish banks could be amplified by the severity of the economic downturn and the lower initial average CET1 ratio compared with EU peers. Banks with international business may be unable to benefit from geographic diversification as much as they did in the past.

Banks should continue adjusting their provisioning decisions on precautionary grounds as well as following prudent dividend policies. Timely recognition of problem assets remains critical, too. Banks should also keep pursuing cost rationalization and investing in technology. Where costs are manageable, efforts would be welcome to further dispose of legacy assets. As the recent merger announcement by two major Spanish banks suggests, some additional consolidation in the banking system is another adequate response to profitability challenges. Along with these actions, supervisors need to continue their monitoring and carefully review banks' forward-looking plans for resolving NPLs and ensuring resilient capital positions. Regulatory relief measures should help facilitate the use of capital and liquidity buffers, followed by their gradual rebuilding.

The role of the National Financial Stability Authority (AMCESFI) is critical to closely monitor financial stability risks, including beyond the banking system and those stemming from the interconnectedness between banks and nonbank financial institutions.

Finally, the crisis reinforces the need to enhance the crisis management frameworks at the European and national levels by tackling any shortcomings in the resolution and liquidation regimes. Completing the banking union with a common deposit insurance scheme would strengthen resilience.

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