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In-Depth Review for Spain

in accordance with Article 5 of Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances

Accompanying the

COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN CENTRAL BANK, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE, THE COMMITTEE OF THE REGIONS AND THE EUROPEAN INVESTMENT BANK

Economic policy coordination in 2021: overcoming COVID-19, supporting the recovery and modernising our economy

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EXECUTIVE SUMMARY

The 2021 Alert Mechanism Report concluded that an in-depth review should be undertaken for Spain to examine further the persistence of imbalances or their unwinding. In February 2020, under the previous annual cycle of surveillance under the Macroeconomic Imbalances Procedure, the Commission identified “macroeconomic imbalances” in Spain. These imbalances related to high external, public and private debt in a context of still high unemployment. The analysis shows that these vulnerabilities remain. It should be noted that the context of the assessment of vulnerabilities in this year’s in-depth review (IDR) for Spain is markedly different from last year. Also, the evolution of the COVID-19 pandemic, the strength of the recovery, and possible structural implications of the crisis are all still surrounded by high uncertainty, requiring caution in the assessment. In general, policy action over the past year focused on cushioning the impact of the COVID-19 shock and facilitating the recovery. This has added to indebtedness but should support adjustment in the medium-term. Looking forward, the Recovery and Resilience Plan provides an opportunity to address imbalances, investment and reforms needs.

Main observations and findings of this IDR analysis are:

- **This IDR is informed by the European Commission 2021 spring forecast, which expects a strong recovery in economic activity in Spain with the easing of the COVID-19 crisis**. After the steep drop of 10.8% in 2020, real GDP is projected to increase by 5.9% this year and 6.8% next year, allowing the economy to recover its pre-pandemic level by the end of 2022.

- **Spain’s net international investment position remains very negative.** The stock of net external liabilities had gradually declined before the COVID-19 pandemic on the back of current account surpluses of about 2% of GDP in recent years, but it has remained large (84% of GDP by the end of 2020) and exceeded prudential and fundamental-based benchmarks. The reduction of Spain’s external net debtor position in terms of GDP came to a halt in the first half of 2020, mainly due to the contraction in GDP. The current account surplus declined to 0.7% of GDP in 2020, and is forecast to turn slightly negative in 2021 before turning positive again in 2022.

- **Private sector deleveraging needs remain sizeable, despite a significant reduction of debt.** Private sector debt, in consolidated terms, had been reduced from a peak of 204% of GDP in 2009 to 130.6% of GDP before the COVID-19 pandemic. The crisis led the private sector debt ratio of the non-financial private sector to increase to 147.4% in the last quarter of 2020, up by 17.1 pp. since the beginning of the year, well above prudential levels and fundamental-based benchmarks. The stock of debt accumulated by non-financial corporations accounted to 84.9% of GDP while total household liabilities amounted to 62.5% of GDP. The increase of private sector debt reflects both the increase of indebtedness in the corporate sector and, to a larger extent, the sizeable fall in GDP experienced by Spain throughout 2020.

- **The COVID-19 pandemic led to an increase in the general government deficit by more than 8 percentage points to 11% of GDP.** The increase was due to the combined effect of the fall in economic activity and the measures put in place to combat the virus and to preserve employment while supporting businesses and households. The general government balance is projected at -7.6% of GDP in 2021. The general government debt-to-GDP ratio remains high. It rose by around 25 percentage points in 2020, to 120% of GDP due to the combined effect of the fall in economic activity and the fiscal measures. The debt ratio is forecasted to start declining gradually in 2021 and it is projected to reach 116.9% in 2022 as the recovery gains momentum.

- **The fall in employment pushed the unemployment rate up to 15.5% in 2020.** The unemployment rate is forecast to start falling in 2022. The severe impact of the crisis on labour intensive-sectors may still result in additional job losses, while further increases in unemployment cannot be ruled out once the short-time work schemes (ERTEs) are phased out (unless proper support is offered to concerned workers via effective active labour market policies).

- **The banking sector has remained resilient, but some challenges may emerge going forward.** The loan moratoria and the public guarantee schemes have prevented the deterioration in asset quality and facilitated the flow of credit to the economy. Banking sector capitalization has marginally improved, while the liquidity position of banks has also remained reassuring. While no significant cliff-edge effects are expected when loan moratoria expire fully, a more marked deterioration in asset quality is likely to emerge once support measures are phased out. Impacted by the increase in loan-loss provisions and by one-off measures adopted by several banks, banking sector profitability has remained under pressure. Banking sector consolidation has continued notwithstanding the difficult operating environment for banks.

1. ASSESSMENT OF MACROECONOMIC IMBALANCES

Introduction

In February 2020, over the previous annual cycle of surveillance under the Macroeconomic Imbalances Procedure, the Commission identified "macroeconomic imbalances" in Spain. These imbalances related to high external and internal debt, both public and private, in a context of still high unemployment and had cross-border relevance. The 2021 Alert Mechanism Report published in November 2020 concluded that a new in-depth review (IDR) should be undertaken for Spain with a view to assess the persistence or unwinding of imbalances.

The context of the assessment of vulnerabilities this year is markedly different from last year's IDRs, which took place before the COVID-19 pandemic. The evolution of the pandemic, the strength of the recovery, and possible structural implications of the crisis are still surrounded by high uncertainty requiring caution in the assessment. Policy action over the past year focused on cushioning the impact of the COVID-19 shock and on facilitating the recovery. While this avoided deeper imbalances and will support adjustment in the medium-term through stronger fundamentals, it also has added to indebtedness. Follow-up to country-specific recommendations from 2019 and 2020, including those that are MIP-relevant, is taking place in the context of the assessment of the Recovery and Resilience Plans (RRPs). The analysis of policies in the present report was finalised before the formal submission of RRPs and does not draw on information included in RRPs. It is therefore without prejudice to the Commission's assessment of RRPs, which is ongoing at the time of publication of this report.

The assessment follows a similar structure as the IDRs that were included in Country Reports in recent annual cycles. This chapter presents the main findings for the assessment of imbalances, also summarised in the MIP assessment matrix. The assessment is backed by selected thematic chapters that look more at length at the external position and private debt developments. Spillovers and systemic cross-border implications of imbalances are also taken into account. In addition, also assessments of structural issues made in previous IDRs and in the context of fiscal assessments are considered if relevant.

Macroeconomic context

The severe outbreak of the COVID-19 pandemic in Spain and the strict lockdown measures taken in response to it resulted in an unprecedented decline of 10.8% of GDP in 2020. With the lifting of some restrictions in March, and the acceleration in the pace of vaccination, economic activity is set to begin growing over the second quarter and to continue more vigorously in the second half of the year. Growth is forecast at 5.9% in 2021 and 6.8% in 2022. As a result, Spain's GDP is expected to return to its pre-pandemic level by the end of 2022. Potential growth is forecast to recover from the sharp drop in 2020 and reach 1.5% in 2022. The current account balance registered a surplus of 0.7% of GDP in 2020, but is forecast to turn slightly negative at -0.1% in 2021 before recovering to 0.3% in 2022. Unemployment is forecast to slightly increase in 2021 to 15.7% before starting to fall in 2022, when job creation is expected to reduce it to around 14.4% compared to 14.1% in 2019. HICP inflation was slightly negative in 2020, but should gradually increase to 1.4% in 2021 and 1.1% in 2022, driven by the gradual strengthening of demand as well as upward pressures from prices of electricity and fuels.

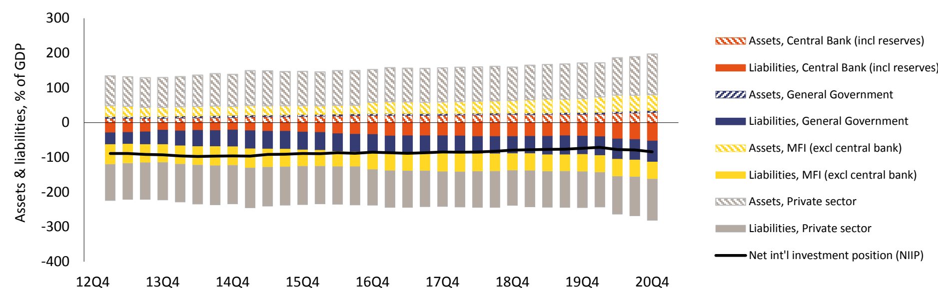
The economic recovery is expected to be mainly driven by a rebound in domestic demand. Consumption and investment are expected to strengthen, steered by improving economic conditions and lower uncertainty, as restrictions on economic activities are phased out. Part of the excess saving caused by the COVID-19 pandemic is expected to fade, spurring private consumption, but also boosting investment. As was the case with the downturn in 2020, the recovery is also expected to remain uneven across sectors. Manufacturing production is set to pick up faster, while sectors with high social-interaction, such as leisure and tourism-related activities, are set to recover at a slower pace. The implementation of the Recovery and Resilience Plan (RRP) is expected to play a decisive role, driving the rebound in the second half of 2021 and in 2022. The higher absorption of RRF funds envisaged in 2022,

with potential crowding-in effects on private investment and a carry-over effect from 2021, are forecast to provide a noticeable boost to economic growth in 2022. The contribution of external demand to GDP growth is set to turn positive again in 2022, when tourism-related activities are likely to approach their 2019 level. Corporate liquidity has been enhanced by a programme of public guarantees for new bank loans and payment moratoria, among other measures. Nevertheless, impaired profitability could lead to the materialisation of corporate insolvencies with risks for productive capacity and employment. To limit these risks in the short term, in March 2021 the authorities adopted a further package of measures to support small and medium-sized firms.

Imbalances and their gravity

Spain’s net international investment position (NIIP) remains very negative. Although the stock of net external liabilities (79.6% of GDP in Q3-2019) had gradually declined, it remained large and exceeded prudential and fundamental-based benchmarks (Graph 1.1). The reduction of Spain’s external net debtor position in terms of GDP came to a halt in the first half of 2020, mainly due to the contraction in GDP. The current account surplus declined to 0.7% of GDP in 2020. The reduction in GDP has led Spain's net international investment position to deteriorate from -74% of GDP at the end of 2019 to -84% of GDP by end-2020, which remains above prudential and fundamental-based benchmarks. Still, it is around 20 percentage points below the peak reached during the financial crisis, and most of the external debt is held by the Government and the Central Bank, which reduces vulnerabilities.

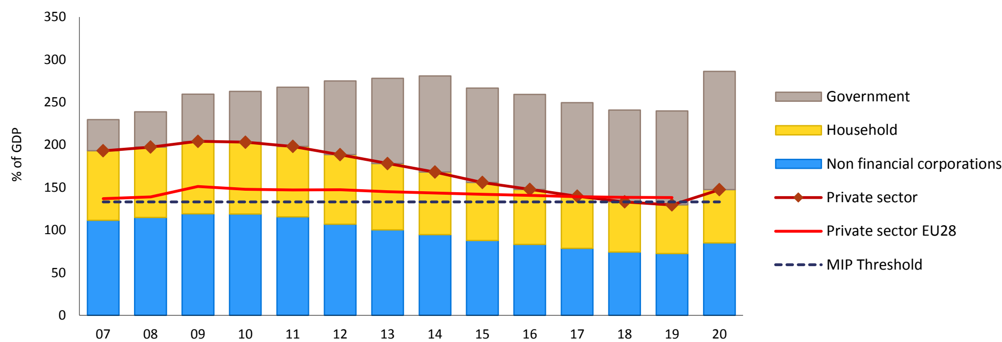
Graph 1.1: **Decomposition of Net International Investment Position (NIIP) by sector, Spain**



Source: Eurostat

Private sector deleveraging needs remain sizeable, despite a significant reduction of debt. Private sector debt, in consolidated terms, had been reduced to 130.6% of GDP in Q3-2019 (with household debt accounting for 57.4% of GDP and non-financial corporation debt for 73.2% of GDP). This is slightly below the MIP scoreboard threshold of 133%, but well above the prudential and fundamental-based benchmarks. The crisis caused by the COVID-19 pandemic led the private sector debt ratio of the non-financial private sector to increase to 147.4% in the last quarter of 2020, up by 4.1 pp. compared to the third and increased by 17.1 pp. since beginning of the year. The stock of debt held accumulated by non-financial corporations accounted to 84.9% while total household liabilities amounted to 62.5% in terms of GDP (Graph 1.2). The increase reflects both the increase of indebtedness in the corporate sector and, to a larger extent, the sizeable fall in GDP experienced by Spain throughout 2020. Both in the case of NFCs and households, debt ratios are lower than those recorded prior to the global financial crisis, and close or below average euro area levels. According to Commission estimates, both NFCs and households debt ratios remain above prudential levels and fundamental-based benchmarks.

Graph 1.2: **Decomposition of debt by sector (consolidated)**



Source: Eurostat

The general government debt ratio decreased slightly further in 2019, but it remained high at 95.5% of GDP. In 2020, the COVID-19 pandemic led to an increase in the general government deficit by more than 8 percentage points to 11% of GDP due to the combined effect of the fall in economic activity and the measures put in place to combat the virus and to preserve employment while supporting businesses and households. On the positive side, tax revenue did not contract as much as expected. In addition, some expenditure savings were recorded as certain public services could not be provided during the lockdown. According to the European Commission 2021 spring forecast, the general government balance is projected at -7.6% of GDP in 2021. In the following year, as the economic recovery gains momentum while some of the crisis-related measures expire, the balance is projected to continue improving, to -5.2% of GDP. In 2021-22, the use of funding from NGEU should contribute to the reduction of the deficit.

The government debt ratio reached 120% of GDP in 2020, but mitigating factors reduce the vulnerability of public finances. Given the large negative government balance, the fall in economic activity and the reclassification of SAREB into the government sector, the general government debt-to-GDP ratio rose by around 25 percentage points in 2020, to 120% of GDP. The Commission 2021 spring forecast projects the ratio to start declining gradually in 2021 and it is projected to reach 116.9% in 2022 as the recovery gains momentum.

Following the recession and fiscal support measures, Spain's gross financing needs, estimated at around 25% of GDP in 2020 and 2021, are larger than prior to the crisis. However, market conditions for financing debt have remained favourable, with comfortable demand for both long and short-term government securities. Yields on 10-year bonds are very low by historical standards, and spreads against the 10-year German bund remain contained. Consequently, expenditure on interest has fallen over the past 7 years to levels not seen since 2010, despite the fact that the total debt stock has doubled since that time. In 2020, interest rate expenditure was 2.3% of GDP.

Unemployment had fallen rapidly before the COVID-19 pandemic, but it remained high at 13.8% in Q4-2019. Long-term and, especially, youth unemployment has also fallen steeply since 2013, but more than 30% of the active population under 25 was still without a job in Q4-2019. This rate increased above 40% in Q4-2020. Moreover, the share of employees in temporary contracts (26.42% in Q4-2019) was significant. High labour market duality has a negative impact on potential growth, productivity, and social cohesion, and which, in turn, hampers the correction of imbalances. In response to the COVID-19 crisis short-term work schemes (ERTEs) were put in place and will remain in place at least until the end of May 2021, though now more targeted to the firms or sectors than at the beginning of the crisis. In addition, several measures were taken to protect the self-employed by means of tax deferrals and benefits for suspension of activity. These schemes have contributed to contain job losses but not to avoid them altogether. Hence, the fall in employment pushed the unemployment rate up to 15.5% on average in 2020 (16.2% in the fourth quarter). Job destruction has affected to a large extent employees on temporary contracts, whose share of total employees dropped to 22.4% in Q2-2020, before rising again to 24.7% in Q4-2020. The unemployment rate is forecast to keep increasing slightly in 2021 since the severe impact of the COVID-19 crisis on labour intensive-sectors may still result in additional job losses and high unemployment. The unemployment rate is expected to drop to 14.4% in 2022.

The Spanish economy could be a source of spill-over effects to the rest of the EU. This stems from its relatively large size and its level of integration with other Member States, especially those with which Spain has significant trade links, such as Portugal, and financial and/or banking linkages, such as Luxembourg (see Table 1.1). Box 1.1 provides a quantitative assessment of cross-border impact of declined Spanish demand in 2020. It shows rather heterogeneous impact across the Member States, with Portugal being the most adversely affected.

Table 1.1: **Outward spillover heat map for Spain**

	EU partner																										
	AT	BE	BG	HR	CY	CZ	DE	DK	EE	EL	ES	FI	FR	HU	IE	IT	LT	LU	LV	MT	NL	PL	PT	RO	SE	SI	SK
Imports	0.9	2.9	1.2	0.5	0.1	2.7	1.6	1.1	0.8	0.9		0.6	2.2	2.5	1.8	1.6	1.1	6.7	0.7	0.4	3.1	1.3	9.2	1	0.8	1.5	2.6
Imports (in value added)	0.5	0.9	0.8	0.5	0.2	1.1	0.8	0.6	0.5	0.3		0.5	1	1.3	1.5	0.8	0.7	1.8	0.4	0.7	0.8	0.8	3.6	0.7	0.5	0.7	1.1
Financial liabilities	4.5	9	0.9	0.2	1.4	0.5	7.6	4.4	1.7	4.2		2.3	12.4	1.3	25	8.7	0.5	325.6	2	21.6	29.7	0.6	29.1	0.3	4.4	2.7	3
Financial assets	1.7	3.2	2.3	0.2	1.6	1	2.2	1.4	0.6	6.9		2.4	5.7	1.07	23.2	10.2	0.2	285	0.8	4.7	15	2.4	50.7	1.1	1.3	0.1	0.7
Liabilities (to banks)	1.2	1.3					1.9			1.4		0.2	5		1	4.8					5.5	8.3			0.1		
Bank claims	1.6	1.4	0.2	0.1	0.4	0.1	2.1	1.7	0.1	0.2		2.2	3.7	0.1	6.2	5.2	0.04	34.1	0.03	7.8	2.3	9.7	55	1.2	1.3	0.1	0.3

Cross-border figures for Spain, expressed as a % of the GDP of the partner country. The darkest shade of red corresponds to percentile 95 and the darkest shade of green to percentile 5. The percentiles were calculated for each variable based on the full available sample of bilateral exposures among EU countries. The blank spaces represent missing data. Data refer to: Imports - 2018, Imports (in value added) - 2015, Financial liabilities - 2018, Financial assets - 2018, Liabilities (to banks) - 2020-Q3, Bank Claims - 2020-Q3.
Source: IMF, OECD, TiVa, BIS and Commission services

Evolution, prospects, and policy responses

Spain's current account surplus is forecast to remain lower than in the past. The COVID-19 pandemic has had a negative impact on both the goods and services balance, but in particular it led to a sharp drop in tourism with a drop in revenue of up to 80% in some regions. The current account is expected to turn slightly negative in 2021 for the first time in several years. It should recover and become slightly positive again in 2022 at 0.3% of GDP. The current account balance required to stabilise the NIIP above -35% is estimated at -0.1% of GDP in 2020. The current account norm explained by fundamentals is estimated to be 1.4% in 2020 and the cyclically adjusted current account balance is estimated at -0.9% in 2020.

Private sector deleveraging needs remain for both corporations and households. Due to the COVID-19 pandemic, the private sector debt ratio increased from 130.3% at the beginning of 2020 to 147.4% in the last quarter of 2020. The NFCs' debt amounted to 84.9% while total household liabilities totalled 62.5% in terms of GDP. This upward evolution reflects both the increase of indebtedness in the corporate sector, but also to a larger extent, the sizeable fall in GDP experienced by Spain in 2020. With the recovery, GDP growth should contribute to a significant deleveraging of the private sector.

The latest debt sustainability analysis confirms that the country faces *high* risk in the medium-term. ([1]) Due to the COVID-19 crisis measures, public debt has increased and is forecast to increase further going forward, and Spain's gross financing needs, estimated at around 25% of GDP in 2020 and 2021, are larger than prior to the crisis. However, the public debt to GDP ratio is forecast to fall with the recovery, to 116.9% of GDP in 2022, compared to 120% in 2020. Furthermore, asset purchases by the Eurosystem on the secondary market are expected to continue to stabilise the sovereign debt market. In addition, the government debt profile mitigates vulnerabilities. Its average maturity has lengthened over time, and is projected to reach 8 years this year. Longer maturities make it likely that interest payments would remain contained by historical standards throughout the projection period even under more adverse conditions.

Unemployment is set to gradually decline as the recovery picks up. The unemployment rate stopped its rapid decline from previous years and increased, to 15.5% in 2020. This increase will not be reversed in 2021, since the severe impact of the COVID-19 crisis on labour intensive-sectors may still result in additional job losses and high unemployment, while further increases cannot be ruled out once ERTEs are phased out. The unemployment rate is forecast to increase to 15.7% in 2021 and to start decreasing

([1]) See Article 126(3) report (June 2021) and also the Debt Sustainability Monitor 2020 for detailed methodological aspects.

afterwards, to 14.4% in 2022. Gross wages and salaries per employee declined by 4.2% in 2020, but are forecast to increase afterwards, with the growth rate increasing to 2% in 2022.

Overall assessment

After significant progress in reducing imbalances in previous years, the COVID-19 crisis has led to an increase in debt ratios, to a substantial extent due to the decline in GDP. Vulnerabilities linked to external, private sector and government debt remain. The negative impact of the COVID-19 pandemic on tourism has been very significant and will also be felt in 2021, where the current account is expected to turn negative for the first time in recent years. Government debt increased substantially in 2020 and, on account of high government deficits, is forecast to continue increase again this year and next. Private debt in percent of GDP increased due to the drop in GDP, but also due to a higher indebtedness of the corporate sector.

Up until the COVID-19 pandemic, policy action to reduce the stock of imbalances was limited across most policy areas. Notably, measures to reduce labour market segmentation by fighting the abuse of temporary contracts were not very effective; limited progress was made in the area of fiscal governance, and on reforms aimed at reducing skills mismatches, fostering research and innovation and improving the business environment. Complex administrative procedures and regulatory restrictions imposed on service providers continue to weigh on business environment. Furthermore, the relinking of pensions to inflation risks worsening long-term fiscal sustainability, unless the planned offsetting measures are sufficiently ambitious. The outbreak of the COVID-19 pandemic led the authorities to implement policies cushioning the economic impact of the pandemic and fiscal consolidation efforts were suspended with the activation of the general escape clause of the Stability and Growth Pact.

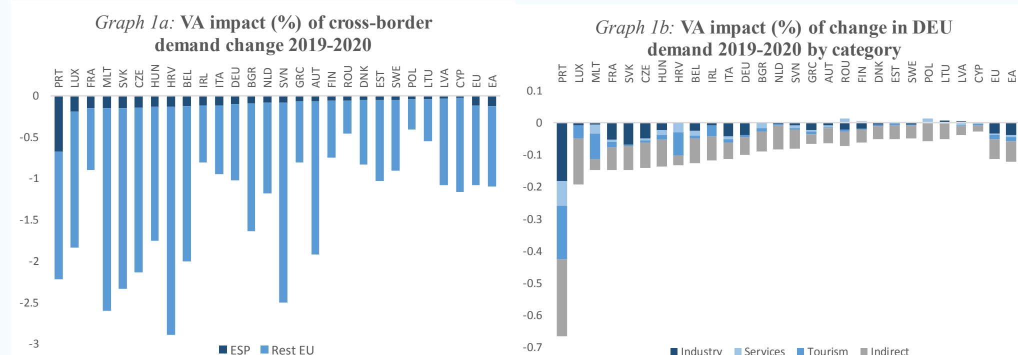
The implementation of policy measures in the Recovery and Resilience Plan can prove decisive in mitigating some outstanding vulnerabilities of the Spanish economy and steering a reduction of the existing imbalances. The economic impact of the RRF funds on the Spanish economy will be significant, particularly from 2022, when strong demand effects and possible carry-over effects from 2021 should be accompanied by a gradual contribution from the supply side. The Spanish authorities estimate that the fully-fledged implementation of the Recovery and Resilience Plan's measures will increase economic output by 2 percentage points on average per year. Sustained GDP growth will be a driver of the needed deleveraging process both in the private and public sector. In addition, measures may go some way towards addressing persistent labour market segmentation. Actions aimed at the upskilling of the labour force can enhance the country's competitiveness, producing positive spillovers and enhancing Spain's external position. The commitment to the industry-services ecosystem, and the boost to entrepreneurship will account for an estimated improvement of 0.2 percentage points in the long-term growth rate of exports, according to Spanish authorities. On the unemployment front, the Spanish Government estimates the RRP can generate up to 800 000 new jobs and push the unemployment rate below the pre-crisis levels by 2023.

Box 1.1: Spillovers Spain

The pandemic recessions in EU Member States also reflected faltering cross-border demand from trade partners. The drop in Spanish aggregate demand due to the pandemic and the containment measures played a significant role in the output declines of its closest partners. In the recovery, cross-border spillovers may undo their negative impact of 2020, yet the uncertain timing and extent of the recovery make a forward-looking assessment difficult. As a first step, this box thus aims to take stock of the heterogeneous spillovers of Spanish demand to other Member States' value added in 2020. It quantifies cross-border effects applying latest production data to input-output estimates. ([1]) This allows for synthesising supply chain effects, e.g. detailing how Spanish consumption from domestic providers affected those providers' foreign suppliers, and their suppliers in turn. While these results allow for country-specific sectorial detail, note that they reflect partial equilibrium effects in the goods and services market only – they do not include any second-round effects on foreign wage income, interest rates, prices etc., which may be stronger.

Graph 1a shows the overall cross-border impact of the heterogeneous final demand changes during 2020, and highlights the Spanish contribution therein. Overall, 1.2 pp of the 2020 EU output decline can be attributed to cross-border demand effects, with Spanish demand accounting for over 0.1 pp thereof. Yet small open service-intensive economies were hit stronger than the average. In contrast, RoEU demand spillovers accounted for only 0.3 pp of the Polish output slump. The importance of Spanish demand varies significantly across partners, with particular relevance for neighbouring Portugal. Namely, one third of the VA impact in Portugal due to intra-EU demand changes is driven by a reduction in Spanish demand, whereas this share is almost negligible for the Baltics.

Graph 1b highlights the heterogeneous effects of the pandemic by zooming in on the Spanish contribution by sector (the dark-blue bar in Graph 1a). ([2]) The most relevant are indirect spillovers, which captures supply chain interlinkages. ([3]) Such indirect cross-border spillovers account for a major part of the total impact of Spanish demand on the RoEU output loss. The decline in Spanish tourists accounted for the bulk of Spanish demand spillovers to Croatia or Malta, Bulgaria, and neighbouring Portugal. Demand changes for non-tourist services had relatively small impact. Changes in the final demand for industry products had an impact on Portugal, France, Czechia and Slovakia in particular.



Graph 1a: **VA impact (%) of cross-border demand change 2019-2020**

Graph 1b: **VA impact (%) of change in DEU demand 2019-2020 by category**

([1]) The estimates derive from a two-step analysis: 1) Compiling 2020 output declines at the sector-level across the globe. For the EU Member States, detailed information for 2020 is available in Eurostat. For non-EU countries, sectoral output changes in 2020 are approximated by IMF WEO GDP changes, thus implicitly abstracting from sectoral heterogeneity; 2) Using output changes in all country-sector pairs to trace back changes in final demand, based on global supply chain interlinkages as captured by the OECD ICIO tables. The resulting set of final demand changes can then be used to simulate the impact of the COVID-19 crisis on each country-sector's value added. Two important assumptions are made to allow for such a translation of output changes into demand changes. First, the technological coefficient matrix, which captures the required amount of supplies from any sector to produce a given sector's output, is assumed to have remained fixed since the latest ICIO data (2016). Second, the country allocation final demand for a specific sector is assumed to have remained proportional to 2016.

([2]) Distinguishing by the source of the demand allows to quantify the impact of demand changes in a certain country on VA production in all its trading partners, by type of good or service. Given the particular nature of the COVID-19 crisis, with a strong impact on hospitality sectors, the analysis distinguishes between tourism (NACE sector I), all other services (G-N excl. I) and industry (A-F).

([3]) For example, a drop in Spanish demand for Spanish cars reduces German production of engines, with a knock-on effect on Czech suppliers of engine parts.

Table 1.2: **Assessment of Macroeconomic Imbalances Matrix - Spain**

	Gravity of the challenge	Evolution and prospects	Policy response
	Imbalances (unsustainable trends, vulnerabilities and associated risks)		
External position	Spain maintains a highly negative net international investment position. It was improving up until the outbreak of the pandemic, but increased from -74% of GDP at the end of 2019 to 84% of GDP at end-2020, mainly composed of debt instruments. This is still clearly worse than the prudential benchmark and the level explained by fundamentals. The composition of Spain's external liabilities in terms of instruments and maturity contributes mitigates some of the vulnerabilities. The NIIP excluding non-defaultable instruments (NENDI), stood at -52% in 2020. Since 2017 and until the Covid-19 crisis, the current account balance remained steadily positive, around 2% of GDP. In 2020 it contracted by 1.4 pps to 0.7% of GDP.	The reduction of Spain's external net debtor position came to a halt in the first half of 2020, mainly due to the contraction in GDP. The current account surplus was 0.7% in 2020, and is expected to turn slightly negative in 2021 (-0.1% of GDP) before turning again positive in 2022 (0.3% of GDP) with the recovery of tourism. That as well as the recovery in GDP is expected to yield a resumption of the improving path of the NIIP. Since the global financial crisis, there has been a structural improvement in Spain's trade performance, as confirmed by the increase in the number of regular exporters, and as well as a reduction in the elasticity of imports to final demand, which plays an important role in preserving Spain's external surplus the next years. This is corroborated by the cyclically-adjusted current account balance, which has been in surplus since 2014. Cost competitiveness improved after the global financial crisis thanks to continued wage moderation. Productivity growth considerably worsened in 2020, partly due to labour hoarding, should turn positive in 2021 and 2022. Likewise, unit labour costs, after peaking in 2020, will shrink both in 2021 and 2022.	Before the pandemic Spain's current account surplus was about 2% of GDP. Reducing decisively Spain´s large external liabilities would require sustaining current account surpluses of this size for an extended period of time. The measures that will be implemented in the Spanish Recovery and Resilience Facility (RRF) can contribute to raising competitiveness by improving labour market skills and through investment in research and innovation. Moreover, the investment in renewable energy generation and energy efficiency should lead to a decrease in imported energy.
Public debt	Before 2020, the general government debt-to-GDP ratio was on a downward path and stood at 95.5% of GDP in 2019. It rose by around 25 percentage points in 2020, to 120% of GDP due to the large negative government balance, the fall in economic activity and the inclusion of SAREB's liabilities in the total public debt. While Spain does not appear to face fiscal sustainability risks in the short run, in the medium term risks persist due to the worsening outlook for public finances caused by the pandemic, both regarding the level of government debt and budgetary position.	Prior to the outbreak of the pandemic, the government debt ratio was on a declining trend. The drop in GDP and the crisis measures lead to a sharp deterioration of public finances in Spain with the public deficit increasing to 11% in 2020. However, the favourable conditions for debt financing and the longer average maturity of public debt over the past years (projected to reach 8 years in 2021) will mitigate vulnerabilities. According to the Commission forecast, with the rebound in nominal GDP growth, public debt is expected at 119.6% of GDP in 2021 and further decrease by 3 pps in 2022. The Commission 2021 Spring forecast foresees the deficit to gradually narrow in 2021 and 2022 (7.6% and 5.2% respectively), down from 11% in 2020, notably due to a recovery of GDP. The structural balance deficit is projected to remain high at 4.9% in 2021 and 5.2% 2022.	There has been little progress in the areas of fiscal governance, notably regarding the implementation of plans to strengthen the framework for public sector contracts and public procurement. The relinking of pensions to inflation risks to worsen the long-term fiscal sustainability, unless the planned offsetting measures are sufficiently ambitious.
Private debt	The debt of the private sector stood at 147.4% of GDP (in consolidated terms) in Q4-2020, representing an increase of 17.1 pps since the beginning of 2020. The debt of non-financial corporations (NFCs) accounted for 84.9% of GDP and household debt to 62.5% of GDP. Both in the case of NFCs and households, debt ratios are well above prudential and fundamental-based benchmarks indicating that strong deleveraging needs persist for both cases. Notably, NFCs debt level stands 30 pps and 25 pps above the prudential threshold and the fundamental benchmark, respectively.	Before the pandemic the debt to GDP ratio of the private sector had been on a declining path since its peak in 2010, mainly thanks to the strong growth of the Spanish economy and reflecting moderate credit flows. Following the outbreak of the pandemic, the private sector debt ratio level accelerated again, caused by notably an increase of indebtedness in the corporate sector right after the COVID-19 outbreak and, to a larger extent, the sizeable fall in GDP experienced by Spain in 2020. A slight tightening of credit standards for NFCs and households in the first quarter of 2021 was observed. This reflects primarily the perception by banks of a deteriorating general economic outlook and the increasing credit risk of borrowers. There has also been a decline in demand for housing, which is expected to be	A comprehensive reform aimed at the modernisation of the insolvency framework is expected to be implemented by end-2021. It will facilitate preventive debt restructuring while improving the effectiveness of pre-insolvency and second chance instruments.

(Continued on the next page)

Table (continued)

		reverse in the second quarter of 2021. The borrower relief measures coupled with the public guarantee schemes have prevented a deterioration in asset quality and kept bankruptcies at its pre-pandemic level. As a result the total volume of loans classified as non-performing (NPL) decreased to 4.6% at the end of 2020, down from 4.8% at the end of 2019. While no significant cliff edge effects are expected when such measures and moratoria expire, a more marked deterioration in asset quality is likely to emerge in 2022	
		Adjustment issues	
Unemployment	The unemployment rate increased by 1.5% pps from 2019 to 2020 to 15.5%, but there was a substantial amount of labour hoarding due to short-time work schemes (ERTEs). Persistently high unemployment hampers the adjustment process.	Unemployment had declined rapidly prior to the outbreak of the pandemic, but the pandemic is expected to accentuate the severity of pre-pandemic issues especially regarding youth and the long-term unemployed. The short-time work schemes (ERTEs) contributed to containing job losses although not avoiding them altogether. Thus, further job losses cannot be ruled out once the ERTEs will be phased out. The unemployment rate is expected to gradually revert to pre-pandemic levels from 2022, also on the back of the relatively strong projected growth in GDP. In particular, it is set to further increase slightly to 15.7% in 2021 as the severe impact of the crisis on labor intensive sectors may still result in additional job losses, before dropping to 14.4% the following year, according to the Commission Spring forecast. Youth unemployment remains very high (40.3% in Q4-2020). Both rates remain among the highest in the EU. High levels of labour market segmentation (permanent vs. temporary employment) persist.	Short-time work schemes ('ERTEs') have been extended several times over the COVID-19 crisis. In addition, several measures were taken to protect the self-employed by means of tax deferrals and benefits for suspension of activity.

Main takeaways

- The COVID-19 crisis has exacerbated the imbalances that existed for several years in Spain. In particular, Spain continues to be characterised by a combination of still large stock of external and internal debt, both public and private, which were improving before the COVID-19 crisis but which have been hiked with this latest crisis. This leaves the country exposed to adverse shocks or shifts in market confidence, which could translate into a tightening of credit conditions on the international markets, which would have harmful implications for the real economy, especially given the still high level of unemployment.
- The current account experienced a deterioration due to the impact of the pandemic and is expected to turn slightly negative in 2021 before rebounding in 2022. Reducing decisively Spain´s large external liabilities would require maintaining current account surpluses for a sustained period of time. Private sector debt hiked in 2020 due to the increase in corporate indebtedness and the fall in GDP, and substantial deleveraging needs persist. Public debt is set to gradually decrease after jumping up in 2020, with deficits forecast to significantly narrow, but remain high, after peaking to 11% in 2020. Sustained GDP growth in the next years will also be a driver of the deleveraging process both in the private and public sector. Unemployment and youth unemployment have increased during the pandemic and will remain very high and above pre-pandemic levels.
- The implementation of policy measures under the Recovery and Resilience Facility (RRF) can prove decisive in addressing the outstanding vulnerabilities of the Spanish economy. The RRF is expected to boost GDP, while the mix of reforms and investments funded by the RRF aim at raising Spain's competitiveness by upskilling the labour force and reduce the segmentation of the labour market. Investment in research and innovation can contribute to strengthening the external position by strengthening competitiveness, and investments in renewable energy and energy efficiency can reduce the import of energy. Moreover, measures strengthening the business environment, including the envisaged modernisation of the insolvency framework and debt relief for natural persons, could improve the outlook for private indebtedness and facilitate resource reallocation. While Spain does not face fiscal sustainability risk in the short turn, the worsening economic outlook could pose a challenges in the medium term. Further policy progress is also needed regarding fields such as the fiscal framework and removing unnecessary regulatory burden on firms.

Source: European Commission Services

Table 1.3: **Selected economic and financial indicators, Spain**

	2004-07	2008-12	2013-18	2019	2020	forecast 2021	forecast 2022
Real GDP (y-o-y)	3.6	-1.3	0.9	2.0	-10.8	5.9	6.8
Potential growth (y-o-y)	3.4	0.8	0.2	1.7	0.0	1.7	1.5
Private consumption (y-o-y)	3.9	-2.0	1.5	0.9	-12.1	6.4	5.8
Public consumption (y-o-y)	5.7	1.4	0.1	2.3	3.8	2.7	1.9
Gross fixed capital formation (y-o-y)	5.7	-8.5	3.3	2.7	-11.4	9.6	12.7
Exports of goods and services (y-o-y)	4.6	1.0	4.4	2.3	-20.2	10.4	12.8
Imports of goods and services (y-o-y)	8.3	-5.2	4.2	0.7	-15.8	11.7	11.7
Contribution to GDP growth:							
Domestic demand (y-o-y)	4.9	-3.0	0.7	1.5	-8.5	6.1	6.3
Inventories (y-o-y)	0.0	-0.2	0.1	-0.1	-0.3	0.0	0.0
Net exports (y-o-y)	-1.3	1.8	0.0	0.6	-2.0	-0.2	0.5
Contribution to potential GDP growth:							
Total Labour (hours) (y-o-y)	1.5	-0.3	-0.2	0.7	-0.5	0.9	0.6
Capital accumulation (y-o-y)	1.7	0.7	0.2	0.5	0.1	0.2	0.4
Total factor productivity (y-o-y)	0.2	0.4	0.2	0.5	0.5	0.6	0.6
Output gap	3.2	-4.1	-4.2	1.8	-9.3	-5.0	0.0
Unemployment rate	9.2	19.1	20.8	14.1	15.5	15.7	14.4
GDP deflator (y-o-y)	3.8	0.5	0.6	1.4	1.1	1.0	1.1
Harmonised index of consumer prices (HICP, y-o-y)	3.2	2.3	0.8	0.8	-0.3	1.4	1.1
Nominal compensation per employee (y-o-y)	3.9	2.6	0.6	2.1	1.4	0.5	2.0
Labour productivity (real, person employed, y-o-y)	-0.2	1.7	0.3	-0.3	-7.0	.	.
Unit labour costs (ULC, whole economy, y-o-y)	3.4	0.4	0.0	2.4	5.2	-0.8	-2.6
Real unit labour costs (y-o-y)	-0.4	-0.1	-0.6	1.0	4.1	-1.8	-3.6
Real effective exchange rate (ULC, y-o-y)	2.4	-1.7	-0.6	-0.8	.	.	.
Real effective exchange rate (HICP, y-o-y)	1.2	-0.5	0.2	-1.6	0.8	0.5	-0.8
Net savings rate of households (net saving as percentage of net disposable income)	3.1	4.6	2.3	2.0	.	.	.
Private credit flow, consolidated (% of GDP)	27.1	-0.7	-4.0	1.2	4.3	.	.
Private sector debt, consolidated (% of GDP)	166.6	198.3	154.8	129.5	147.4	.	.
of which household debt, consolidated (% of GDP)	73.5	83.2	67.8	56.9	62.5	.	.
of which non-financial corporate debt, consolidated (% of GDP)	93.1	115.1	87.0	72.6	84.9	.	.
Gross non-performing debt (% of total debt instruments and total loans and advances) (2)	.	4.4	5.4	2.7	.	.	.
Corporations, net lending (+) or net borrowing (-) (% of GDP)	-3.9	5.9	6.4	5.1	5.6	5.4	5.9
Corporations, gross operating surplus (% of GDP)	20.4	23.8	24.0	24.2	22.6	23.0	24.5
Households, net lending (+) or net borrowing (-) (% of GDP)	-4.5	-0.2	0.7	0.3	6.5	2.6	0.0
Deflated house price index (y-o-y)	9.7	-8.2	3.3	4.1	2.1	.	.
Residential investment (% of GDP)	11.3	6.9	4.6	5.7	5.5	.	.
Current account balance (% of GDP), balance of payments	-7.8	-3.9	2.1	2.1	0.7	-0.1	0.3
Trade balance (% of GDP), balance of payments	-5.0	-0.9	3.3	3.0	1.5	.	.
Terms of trade of goods and services (y-o-y)	0.5	-0.9	-0.1	-0.6	1.4	-0.4	-0.3
Capital account balance (% of GDP)	0.6	0.4	0.4	0.3	0.4	.	.
Net international investment position (% of GDP)	-70.5	-91.3	-88.2	-73.9	-84.3	.	.
NENDI - NIIP excluding non-defaultable instruments (% of GDP) (1)	-39.5	-71.8	-62.3	-46.8	-52.9	.	.
IIP liabilities excluding non-defaultable instruments (% of GDP) (1)	121.0	155.2	156.2	159.8	187.5	.	.
Export performance vs. advanced countries (% change over 5 years)	7.8	-4.4	-0.9	0.8	-2.0	.	.
Export market share, goods and services (y-o-y)	-2.7	-3.8	0.6	-1.0	-10.0	2.3	7.1
Net FDI flows (% of GDP)	4.0	0.1	0.0	0.8	1.0	.	.
General government balance (% of GDP)	1.3	-9.2	-4.6	-2.9	-11.0	-7.6	-5.2
Structural budget balance (% of GDP)	.	.	-1.8	-3.7	-4.2	-4.9	-5.2
General government gross debt (% of GDP)	40.7	61.9	98.1	95.5	120.0	119.6	116.9
Tax-to-GDP ratio (%) (3)	36.3	32.3	34.7	35.4	37.5	36.7	35.7
Tax rate for a single person earning the average wage (%) (4)	20.4	21.1	22.1	21.3	21.1	.	.
Tax rate for a single person earning 50% of the average wage (%) (4)	10.6	9.7	10.5	6.4	6.4	.	.

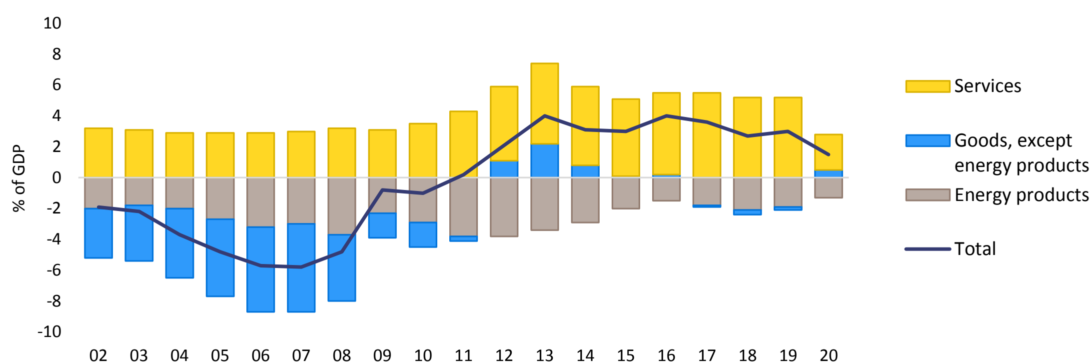
(1) NIIP excluding direct investment and portfolio equity shares
(2) domestic banking groups and stand-alone banks, EU and non-EU foreign-controlled subsidiaries and EU and non-EU foreign-controlled branches.
(3) The tax-to-GDP indicator includes imputed social contributions and hence differs from the tax-to-GDP indicator used in the section on taxation
(4) Defined as the income tax on gross wage earnings plus the employee's social security contributions less universal cash benefits, expressed as a percentage of gross wage earnings
Source: Eurostat and ECB as of 2021-05-05, where available; European Commission for forecast figures (Spring forecast 2021)

2. THEMATIC ISSUE: EXTERNAL POSITION

Prior to the outbreak of the COVID-19 pandemic, Spain's external net debtor position narrowed steadily. Notably, high nominal GDP growth and continued external surpluses drove a slow but persistent narrowing of Spain's negative net international investment position (NIIP) to 74% of GDP at the end of 2019.

Despite the impact of the COVID-19 pandemic and the large drop in tourism-related activities, Spain's current account surplus remained positive at 0.7% of GDP in 2020. It is forecast to turn slightly negative in 2021 (-0.1% of GDP) before turning positive again in 2022 (0.3% of GDP). The surplus is the result of a positive balance in services, which more than offsets the trade deficit in goods (see Graph 2.1). The large import of energy products accounts as the main factor underlying the negative trade balance in goods. Overall, the level of both exports and imports dropped in 2020, against a background of declining global growth due to the crisis and the sharp drop in tourism. Although the contribution of net exports to growth was negative in 2020, it is expected to turn positive again in 2021 and 2022.

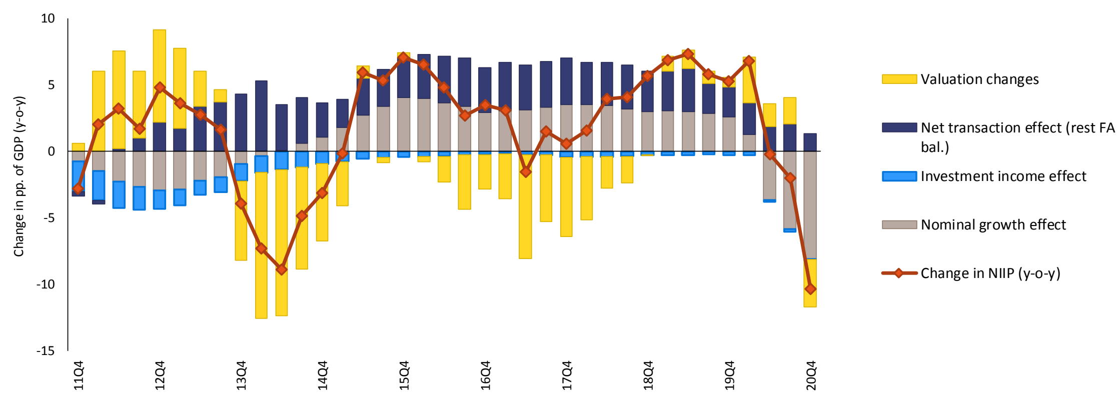
Graph 2.1: **Trade balance**



Source: Eurostat

The reduction of Spain's external net debtor position in terms of GDP came to a halt in the first half of 2020, mainly due to the sharp contraction in GDP. The reduction in the level of economic output led Spain's NIIP to worsen to -84% of GDP by end-2020, which remains below prudential and fundamental-based benchmarks, but still 7 percentage points above the trough reached during the financial crisis (Table 2.1). In 2020, the net borrowing position of the government widened substantially, partly offset by a considerable increase in household savings (Graph 2.3(b)).

Graph 2.2: **Decomposition of NIIP change**



Source: Eurostat

The composition of Spain's external liabilities in terms of instruments and maturity mitigates some of the vulnerabilities. The NIIP excluding non-defaultable instruments (NENDI), which accounts for the riskiest categories of external liabilities ([2]), stood at -53% of GDP in 2020, above the prudential threshold of -58%. The reduction of the NENDI since 2011 (by 25 p.p of GDP), has been faster than that of the NIIP (a decline of 14 p.p). This broadly reflects an improvement in the net foreign direct investment (FDI) position due to sizeable foreign investment inflows, which help mitigating the overall degree of vulnerability (Graph 2.2; Graph 2.3(c)). Moreover, a sizeable part of external debt – slightly over 40% in 2020 Q4 – is composed of central bank liabilities stemming from monetary operations of the Eurosystem (Graph 5), entailing substantial lower refinancing risk than that of the debt held by the private sector. In addition, the structure of government debt - displaying an increasingly longer average maturity of 8 years at the end of 2020- contributes to reducing the overall risk profile.

Reducing decisively Spain´s large external liabilities would require maintaining large current account surpluses for a sustained period of time. Spain's NIIP is still far from a level that could be considered prudential (-58% of GDP in 2020) or in line with fundamentals (-22% of GDP) (Table 2.1). The measures that will be implemented in the Spanish Recovery and Resilience Program to raise competitiveness by improving labour market skills and through investment in research and innovation will also help strengthening the external position. These measures will also help a reduction of imported energy through the promotion of renewable energy.

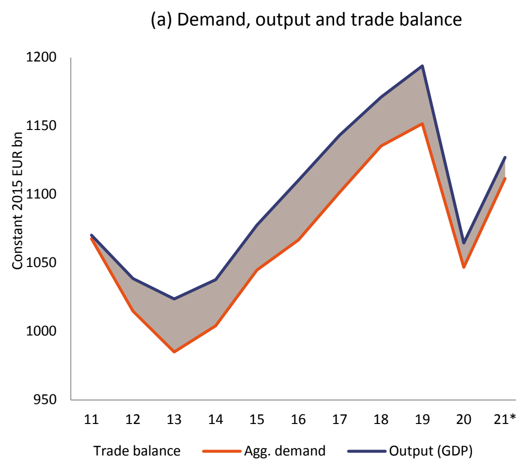
([2]) The instruments that make up the NENDI (mostly debt) are the most risky part of the NIIP as it excludes equity and equity-like instruments (inter-company debt). Equity does not carry the same risks as debt for external sustainability, as its remuneration (e.g. dividend payments) can be adjusted during economic downturns, unlike most of forms of debt.

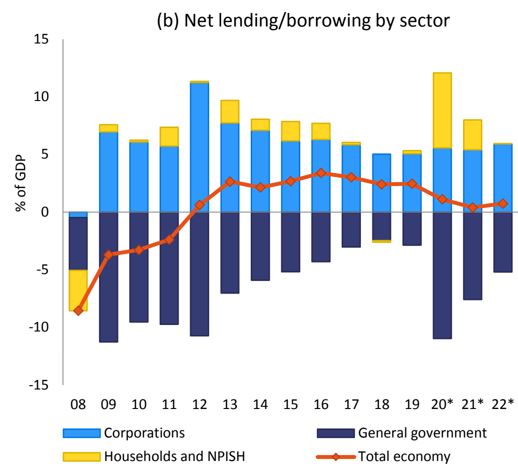
Table 2.1: **Selected external indicators, Spain**

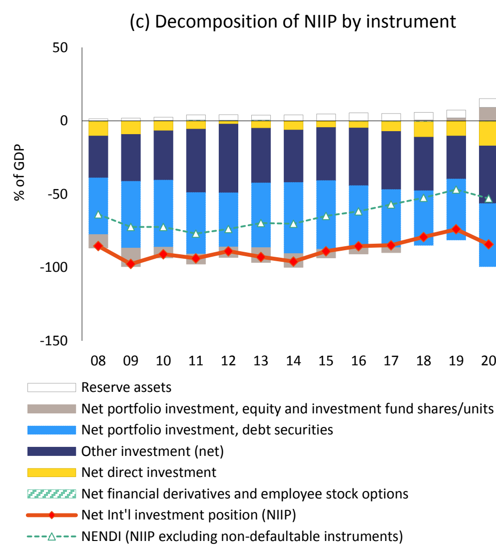
Flows [1]	Source:	2003-07	2008-12	2013-17	2018	2019	2020	2021f	2022f
CA balance as % of GDP, NA	(b)	**-7.0**	**-3.9**	**2.3**	**1.9**	**2.1**	**0.7**	**-0.1**	**0.3**
CA balance as % of GDP, BoP	(a)	-7.0	-3.9	2.3	1.9	2.1	0.7	-0.1	0.3
Cyclically adj. CA balance as % of GDP [2]	(c)	-5.8	-5.2	0.4	1.8	2.3	-0.9	-1.0	0.5
CA req. to stabilize NIIP above -35% [3]	(c)	-0.3	1.6	0.4	0.2	0.1	-0.1	-0.7	-0.6
CA explained by fundamentals (CA norm) [4]	(c)	-2.3	-0.9	0.5	1.2	1.3	1.4	1.2	1.6
Required CA for specific NIIP target [5]	(c)	0.0	2.4	2.0	2.3	2.3	2.3	2.0	2.2
Trade bal. G&S, % of GDP, NA	(b)	-4.4	-0.9	3.5	2.7	3.0	1.5	1.1	1.4
Required TB for specific NIIP target [5]	(c)	2.6	5.5	2.0	2.0	2.4	2.5	2.1	2.3
Capital account bal. as % of GDP, NA	(b)	**0.6**	**0.4**	**0.4**	**0.5**	**0.3**	**0.4**	**0.5**	**0.5**
Stocks									
NENDI as % of GDP	(a)	**-36**	**-72**	**-65**	**-52**	**-47**	**-53**		
of which: net portfolio debt	(a)	-20	-42	-44	-37	-42	-43		
of which: net mutual fund shares	(a)	3	4	13	17	19	24		
of which: net other investment	(a)	-20	-37	-38	-36	-29	-39		
NIIP as % of GDP	(a)	**-67**	**-91**	**-90**	**-79**	**-74**	**-84**	**-81**	**-78**
Prudential NIIP/NENDI benchmark [6]	(c)	-64	-61	-59	-62	-63	-58	-60	-60
Fundamentally expl. NIIP benchmark (NIIP norm) [6]	(c)	-23	-25	-28	-23	-22	-22	-18	-15

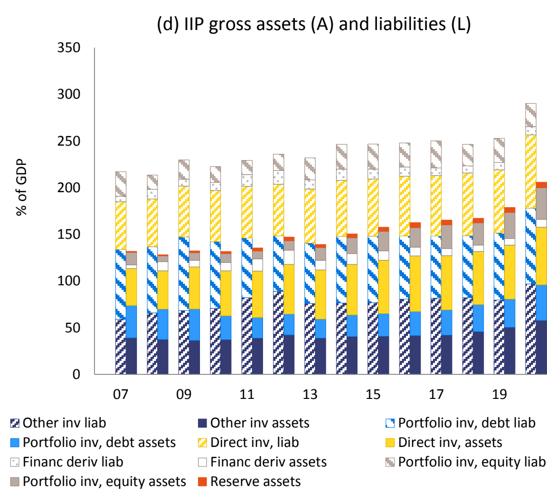
NA=National Accounts, BoP=Balance of Payments, CA=Current Account, NENDI= NIIP excluding non-defaultable instruments,TB= Trade Balance.
(1) Flow data refer to national account concept, unless indicated otherwise.
(2) Cyclically adjusted CA is the CA adjusted for the domestic and foreign output gaps, taking into account trade openness.
(3) The average CA needed in order to stabilise the NIIP in 20 years is based on T+10 Ecfin projections.
(4) Current account norm is the current account balance that can be explained by fundamentals. It is based on the empirical setup similar to IMF's EBA. Fundamentals are slow-moving variables including: demographics, relative income, natural resources, manufacturing intensity and reserve currency status. See Coutinho et al. (2018) "Methodologies for the assessment of current account benchmarks", European Economy, Discussion Paper 86/2018, for the description of the methodology.
(5) The CA or TB needed either to halve the distance to fund. NIIP benchmark, or to reach the prud. NIIP benchmark in 10Y, whichever is higher. Based on T+10 Ecfin projections.
(6) The country-specific prudential benchmark denotes the NIIP level beyond which the probability of an international economic and financial crisis becomes higher. The NIIP level explained by fundamentals ('NIIP norm') represents the NIIP that would result if a country had run its current account in line with fundamentals since 1995. For details see Turrini and Zeugner (2019), "Benchmarks for Net International Investment Positions", European Economy, Discussion Paper 097/2019.
Source: (a) Eurostat, (b) Ameco, (c) European Commission calculations

Graph 2.3: **Thematic Graphs: External position**









Source: European Commission Services

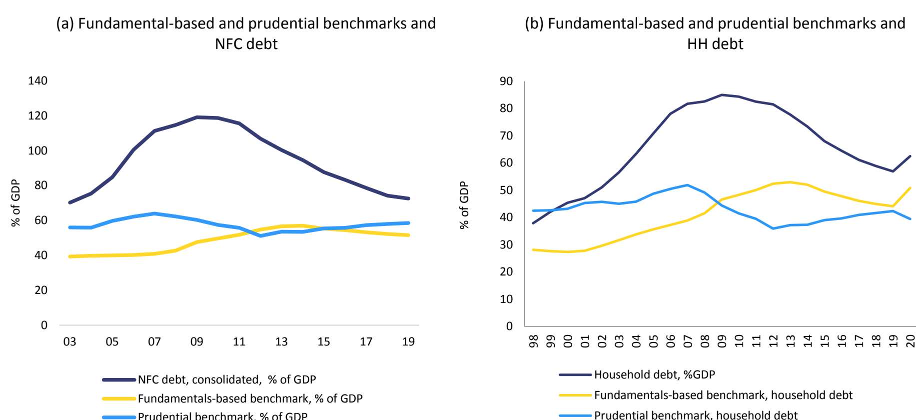
3. THEMATIC ISSUE: PRIVATE DEBT

Situation entering the COVID-19 crisis

Up until the end of 2019, the stock of private debt was on a declining trend, largely supported by the constant GDP growth- albeit deleveraging needs persisted. Private debt dropped from above 200% in 2010 to 129.8% of GDP in consolidated terms at the end of 2019.

Following the outbreak of the COVID-19 pandemic and the implementation of diverse support measures aimed at mitigating its impact, the private sector debt ratio accelerated. The debt accumulated by the non-financial private sector increased to 147.4% in the last quarter of 2020, up by 4.1 pp. compared to the third and increased by 17.1 pp. since beginning of the year. This upward evolution reflects both the increase of indebtedness in the corporate sector and, to a larger extent, the sizeable fall in GDP experienced by Spain in 2020. The NFCs' debt amounted to 84.9% while total household liabilities totalled 62.5% in terms of GDP. Both NFC and household debt ratios are significantly lower than those recorded prior to the global financial crisis, and in line or slightly below the euro area average. However, according to the Commission estimates, debt to GDP ratios of both NFCs and households remained above prudential levels and fundamental-based benchmarks (Graph 3.1). Notably, the NFC debt level stands about 30 pps and 25 pps above the prudential threshold and the fundamental benchmark, respectively.

Graph 3.1: **Thematic Graphs: Private debt**



Source: European Commission Services

Policy measures support borrowers and corporates

The Spanish authorities have implemented several measures to support borrowers and corporates since the beginning of the COVID-19 pandemic. The subsequent legislative and non-legislative payment moratoria adopted between March and July 2020 have played a crucial role in providing a temporary breathing space for borrowers and their banks. Such loan moratoria have recently been extended as the deadline for borrowers to apply for both legislative and non-legislative moratoria has been set to 31 March 2021. In addition, two public guarantee programs managed by the public development bank (Instituto de Crédito Oficial, ICO) to cover liquidity and investment needs for corporations and self-employed individuals, as well as specific measures relating to the tourism sector and the public transport of goods were deployed. Such guarantee programs have been extensively used by the corporate sector as according to ICO, bank funding backed by government guarantees represented around 40% of total new loans to non-financial corporations between April and December 2020. This percentage reached 60% in the case of SMEs.

Throughout the first quarter of 2021, Spain has put forward an additional package of measures aimed at further supporting the flow of credit to the economy. On 12 March, the government adopted new measures amounting to EUR 11 billion to help viable corporations whose financial situation has deteriorated as a result of the COVID-19 pandemic. This amount is broken down into EUR 7 billion for non-reimbursable aid to self-employed and firms in these sectors, EUR 3 billion to restructure the state-guaranteed loans granted by ICO and EUR 1 billion for a Recapitalisation Fund. The Bank of Spain recently indicated the need for sustained support to the corporate sector, which under the baseline scenario is estimated to be between 11bn and 20bn and susceptible to sizeable increase if worse-than projected macroeconomic conditions materialise.

Going forward, private debt developments may be less favourable than in recent years

Moving forward it will be vital to assess how firms will be emerging from the crisis. Excessive corporate indebtedness could hamper investment in the coming years or lead to insolvency situations affecting those corporates particularly stressed by the impact of the COVID-19 pandemic. Against this backdrop, the value of public guarantees have registered a sizeable increase, thereby accentuating the risk related to the materialisation of contingent liabilities, which shall be closely monitored in the near future, especially if macroeconomic fundamentals turn out being weaker than predicted under the current baseline scenario.

On the back of the government support schemes granted to mitigate the impact of the COVID-19 pandemic, banks have increased lending to the economy. Lending to the private sector turned positive in April 2020 – for the first time since April 2011. Total lending to the private sector (excluding interbank lending) increased by 3.2% y-o-y in December 2020. Credit activity has been mainly supported by the expansion of lending to non-financial corporations, which went up by 8.4 % y-o-y in December 2020. This was the highest growth rate registered since lending to corporates entered again positive territory in April 2020. This development has been driven to a large extent by new loans to corporates (Graph 3.3.d). A significant share of these new loans granted to corporates are backed by guarantees of the ICO. The loans guaranteed by ICO made up roughly 40% of total new loans granted to corporates between April and December 2020. In contrast to lending to corporates, lending to households has continued on the downward trend observed since June 2019 (Table 3.2). Lending to households decreased by 1.2% y-o-y in December 2020, in a context of a substantial increase of the household savings rate (Table 3.2).

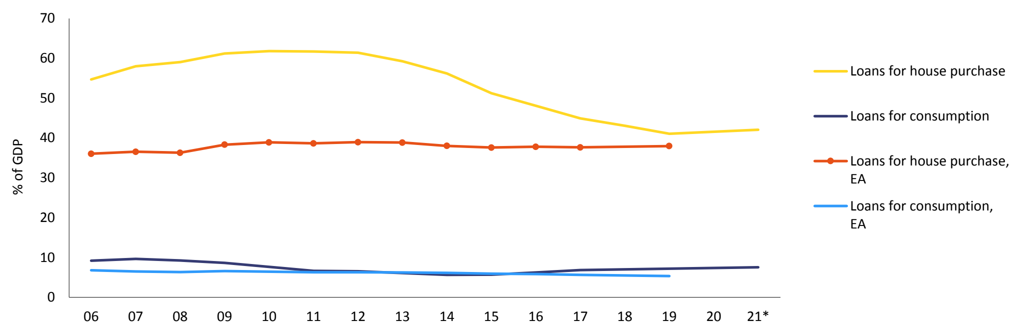
The rebound in lending fostered by the public support schemes also reversed the deleveraging trend in the banking sector observed since 2012. The domestic assets of Spanish banks increased by 10% in February 2021 compared with February 2020, reaching EUR 2.05 trillion. Meanwhile, the total assets of the Spanish banking sector (including the assets of foreign subsidiaries and branches) perked up by 5.9% to EUR 2.89 trillion during the same period. The total volume of loans increased during this same period by EUR 156 billion, out of which roughly EUR 120.8 billion are loans guaranteed by the ICO (2). For the first quarter of 2021, Spanish banks expect credit standards to tighten further for loans to non-financial corporations, while remaining unchanged for loans to households.

The pace of NPL reduction has significantly slowed down and NPLs may start to increase again once support measures will be phased out. Yet, thanks to borrower relief measures coupled with the public guarantee schemes, which have prevented a deterioration in asset quality, the NPL ratio at system level decreased to 4.6% at the end of 2020, down from 4.8% reported at end-2019. From a sectoral breakdown, the construction sector emerged as the area displaying the highest, although declining, share of NPLs. Real estate activities and productive activities have also followed on a downward path, while loans to households have registered the lowest level of impairment, with a NPL ratio of 4.3% at the end of September 2020. In addition, similarly to other banking sector across the EU, Spanish banks reported a marked increase in Stage 2 loans (according to IFRS 9) in the second half of 2020. According to the latest data published by the European Banking Authority (EBA), the share of loans classified as Stage 2 in the total loans covered by EBA-compliant moratoria went up to 26% at the end of 2020, 10 p.p higher than at end of June 2020. The loan moratoria have alleviated the impact of the COVID-19 pandemic on both banks and borrowers, in particular the most vulnerable ones. However, although no significant cliff edge effects are expected when moratoria expire, a more marked deterioration in asset quality is likely to emerge in 2022.

The COVID-19 crisis moderated house price growth

The lockdown measures weighed on activity and prices in the housing market, with a heterogeneous impact in local rental markets. Until end-2019, house prices had been on an upward path for six years and the valuation gap was closing at the national level, yet with considerable divergences across regions (Table 3.3). The lengthy stoppage to economic activity in the first quarter of 2021 accentuated the setback of investment in housing and the slowdown in property prices experienced in the fourth quarter of 2020, when the growth rate fell to 1.5% y-o-y, the lowest since the first quarter of 2015 (Graph 3.3.c). The drop in dwelling prices going into the first quarter of 2021 has been more pronounced in the second-hand segment as demand for new properties showed greater dynamism, possibly reflecting a shift in household preferences arising as a result of the COVID-19 pandemic.

Graph 3.2: **Bank loans to households by type**

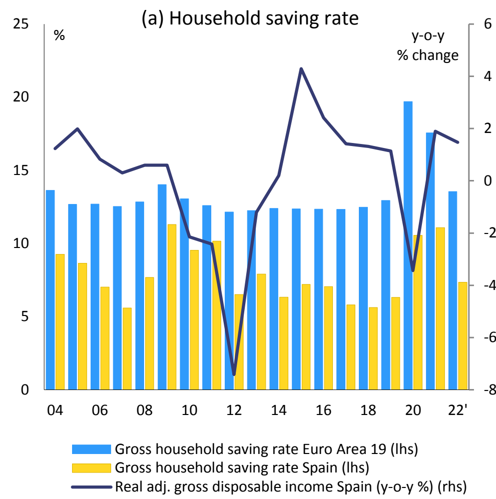


Source: ECB BSI

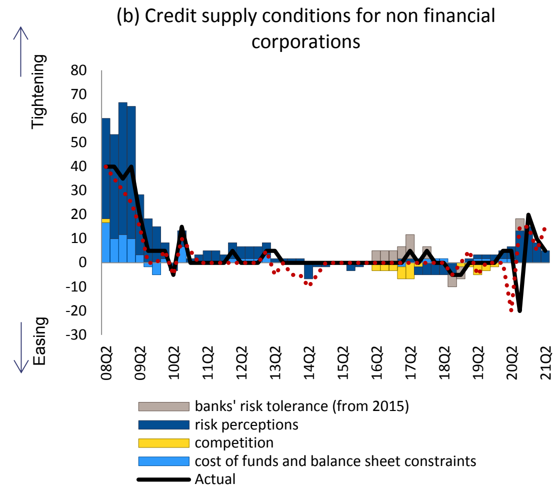
The latest Bank Lending Survey reported a slight tightening of credit standards for housing loans to households, despite the fact that the average interest rate on mortgages constituted on dwellings over the first months of 2021, set to 2.5%, was in line with the last quarter of 2020. This reflects primarily the perception by banks of a deteriorating general economic outlook and the increasing borrowers' credit risk. It also noted a modest decline in demand for housing, which is projected to reverse in the second quarter. In addition, within this scenario, the reduced financing cost associated with the prospect of a prolonged looser monetary policy in the euro area could make housing investment more attractive and affordable for households and investors, thereby accelerating the recovery of the housing sector.

The slowdown to economic activity in 2020 exacerbated housing supply constraints, adding a source of upward pressure on prices. Furthermore, the gradual pick up of tourism-related activities could contribute to lifting prices for the remainder of 2021, particularly in those areas where holiday accommodation constitutes an important driver of residential properties. A rebound of activity in the housing market is therefore expected when the current containment measures are eased and pent-up demand built during lockdown period is absorbed. Such momentum could be spurred in response to more favourable future income expectations of households, now undermined by a weak labour market outlook, despite the income support measures put in place by the government.

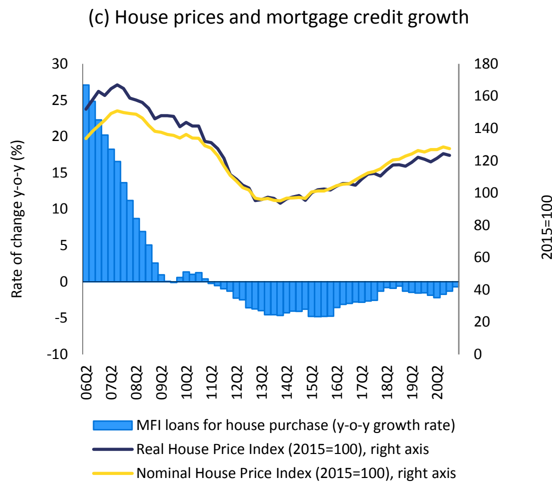
Graph 3.3: **Thematic Graphs: Private debt**



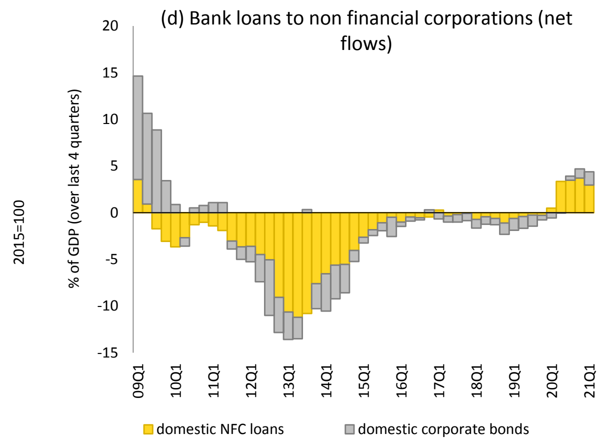
Source: Eurostat



Source: ECB bank lending survey



Source: ECB Bank Lending Survey



Source: ECB BSI

Source: European Commission Services

Table 3.1: **Non-financial corporations debt indicators, Spain**

	Source	2003-07	2008-12	2013-17	2019	2020	2021f	20Q2	20Q3	20Q4
Stocks										
Debt, consolidated (% of GDP)	(a,d)	89	115	86	73	85		80	82	85
Debt, consolidated (% of potential GDP)	(a,b,d)	91	110	83	74	77		77	76	77
Prudential threshold (% of GDP)(1)	(c)	60	57	56	59	56	56			
Fundamental benchmark (% of GDP)(1)	(c)	40	49	55	52	60	57			
Debt, consolidated (% of gross operating surplus)	(a,b,d)	432	485	362	299	376		341	356	376
Interest paid (% of gross operating surplus) (3)	(a,b)	17.7	15.8	6.3	3.8			2.7	3.7	
Debt, consolidated (% of gross financial assets)	(a,d)	119	137	100	85	85				
Domestic loans in forex (% dom. Loans)	(d)	1.4	1.2	1.7	2.1	1.7		1.8	1.7	1.7
Flows										
Credit flows (transactions, % of GDP) (2)	(a)	14.6	-0.3	-1.5	1.1	4.6	0.4	13.8	-0.3	1.4
Benchmark for flows (% of GDP)(1)	(c)									
Investment (% of value added)	(b)	28.7	21.3	24.5	27.2	27.0	28.0			
Savings (% of value added)	(b)	21.5	29.7	35.2	35.5	34.6	35.1			
p.m. Banks NFC NPLs (% of NFC loans) (2)	(d)			*10.8*	*4.7*					

(f) European Commission forecast. (1) Benchmarks for flows (% of GDP) are estimated on the basis of non-consolidated flows. (2) Gross non-performing bank loans and advances to Households and non profit institutions serving households (% of total gross bank loans and advances to Households and non profit institutions serving households). (3) Quarterly data is annualized.
Source: (a) Eurostat, (b) Ameco, (c) European Commission calculations, (d) ECB

Table 3.2: **Household Debt Indicators, Spain**

	Source	2003-07	2008-12	2013-17	2019	2020	2021f	20Q2	20Q3	20Q4
Stocks										
Debt, consolidated (% of GDP)	(a,d)	70	83	67	57	63		60	61	63
Debt, consolidated (% of potential GDP)	(a,b,d)	72	80	64	58	57		58	57	57
Prudential threshold (% of GDP)(1)	(c)	48	42	39	42	39	40			
Fundamental benchmark (% of GDP)(1)	(c)	35	48	49	44	51	48			
Debt (% of gross disposable income)	(a,b,d)	111	130	107	93	95		94	94	95
Interest paid (% of gross disposable income) (3)	(a,b)	3.1	3.4	1.1	0.6			0.2	0.7	
Debt (% of gross financial assets)	(a,d)	40.7	49.1	34.1	29.7	29.9		30.3	30.4	29.9
Share of variable rate loans for house purchase (%)	(d)	88.6	85.6	54.2	35.8	34.5				
Domestic loans in forex (% of dom. loans)	(d)	0.3	1.1	0.7	0.5	0.4				
Flows										
Credit flows (transactions, % of GDP) (4)	(a)	10.7	-0.4	-1.6	0.1	-0.4	-0.1	2.1	-2.8	0.4
Benchmark for flows (% of GDP)	(c)	4.2	2.3	0.0	0.7	0.8	0.7			
Savings rate (% gross disposable income)	(b)	8.3	9.0	6.7	6.3	14.8	11.1			
Investment rate (% gross disposable income)	(b)	15.3	9.9	4.9	5.6	4.9	5.2			
p.m. Bank HH NPLs (% of HH loans) (2)	(d)			*4.6*						

(f) European Commission forecast. (1) Benchmarks for flows (% of GDP) are estimated on the basis of non-consolidated flows. (2) Gross non-performing bank loans and advances to Households and non profit institutions serving households (% of total gross bank loans and advances to Households and non profit institutions serving households). (3) Quarterly data is annualized
Source: (a) Eurostat, (b) Ameco, (c) European Commission calculations, (d) ECB

Table 3.3: **Selected housing indicators, Spain**

	Unit	Source	2003-07	2008-12	2013-17	2018	2019	2020	20Q1	20Q2	20Q3	20Q4
House price developments												
Real house price, yoy growth	%	(a)	10.5	-8.1	0.6	5.2	4.1	2.0	2.3	2.1	1.9	2.1
Nominal house price, yoy growth	%	(a)	14.2	-6.4	1.1	6.7	5.2	2.2	3.3	2.2	1.8	1.7
Price to income in level (1)	years	(b)	12.7	12.6	9.9	10.7	11.0	11.4	12.0	10.9	12.3	10.6
Valuation gaps												
Price to income gap (2)	%	(c)	19.1	18.6	-6.7	0.4	3.7	7.4	4.6	6.8	9.4	8.8
Price to rent gap (2)	%	(c)	24.5	15.1	-11.0	2.8	6.5	7.7	5.7	7.3	9.3	8.5
Model valuation gap (3)	%	(c)	20.1	10.2	-7.3	8.8	11.5	9.9	8.9	9.6	11.1	10.1
Average house price gap (4)	%	(c)	21.2	14.7	-8.3	4.0	7.2	8.3	6.4	7.9	10.0	9.1
Housing credit												
Mortgages (% GDP)	%	(d)	46.9	61.0	51.9	43.1	41.0	44.9				
Mortgages, yoy growth	%	(d)	23.4	0.3	-3.8	-0.6	-1.5	-1.3				
Housing supply												
Residential construction - dwellings (% GDP)	%	(e)	11.1	6.9	4.3	5.4	5.7	5.5				
Residential construction - dwellings, yoy growth	%	(e)	4.3	-11.8	4.3	12.4	4.1	-16.6				
Non-residential construction (% GDP)	%	(e)	8.5	6.8	4.5	4.3	4.2	4.3				
Value added in the construction sector, yoy growth	%	(e)	2.7	-9.5	-0.1	4.1	4.3	-14.5				
Building permits, yoy growth	%	(a)	10.0	-35.9	3.5	24.2	12.8	-37.0				
Number of transactions, yoy change	%	(f)	-0.1	-13.8	8.9							
Other housing market indicatos												
Share of owner-occupiers, with mortgage or loan	%	(a)	32.0	32.8	31.1	29.4	28.4					

Forecast. The forecast of house prices is computed on the basis a housing valuation model shared with Member States in the context of the EPC LIME working group. The forecasts represent real house price percentage changes expected based on economic fundamentals (population, disposable income forecast, housing stock, long-term interest rate, and the price deflator of private final consumption expenditure), as well as the error correction term summarising the adjustment of prices towards their long-run relation with fundamentals. The source for the forecast of other variables is Ameco.
(1) Price to income in level is the number of years of income necessary to buy an assumed 100m2 dwelling. See Bricongne, J-C, A Turrini, and P Pontuch, 2019, "Assessing House Prices: Insights from HouseLev, a Dataset of Price Level Estimates", Discussion Paper 101, European Commission, available in ""https://ec.europa.eu/info/publications/assessing-house-prices-insights-houselev-dataset-price-level-estimates_en"".
(2) Price to income and price to rent gaps are measured in deviation to the long term average (from 1995 to the latest available year).
(3) The model valuation gap is estimated in a cointegration framework with nominal house prices as the dependent variable and five fundamental explanatory variables: total population, real housing stock, real disposable income per capita, real long-term interest rate and price deflator of final consumption expenditure. See Philiponnet and Turrini, Assessing House Price Developments in the EU (2017) available in ""https://ec.europa.eu/info/publications/economy-finance/assessing-house-price-developments-eu_en"" and revision notes presented to LIME in October 2019 and June 2020.
(4) The average house price gap is the simple average of the price-to-inome, price-to-rent and model valuation gaps.
Source: (a) Eurostat, (b) Eurostat, OECD, ECB, BIS, Ameco, national sources, European Commission calculations, (c) European Commission calculations, (d) ECB, Ameco (e) Ameco (f) ECB