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**Statement by Mr. Bevilaqua, Mr. Saraiva, and Mr. Coronel on Spain
(Preliminary)
Executive Board Meeting
February 14, 2022**

We thank staff for the report and Mr. Moreno, Mr. Lopez and Ms. Moral Betere for the insightful and informative statement. While we generally agree with the thrust of staff's analysis and recommendations, we would like to elaborate on some points as follows.

The Spanish economy is successfully emerging from its deepest contraction in modern history, and we commend the authorities for their swift and decisive response to the crisis. Spain was severely hit by the repercussions of several waves of the Covid-19 pandemic. Mobility restrictions and lockdowns, as effective as they were to contain the outbreaks, were particularly harmful to economic activity, given its reliance on the hospitality and tourism industry—which represents about 15 percent of GDP. As in most countries, the economy has been affected by persistent global supply bottlenecks, elevated energy prices, and a significant inflation uptick—conditions that weigh down on the recovery and pose downside risks to the outlook. Nevertheless, the health situation has been stabilized by effective health-management and vaccination campaign, while the economic fallout has been cushioned by the authorities' sizeable fiscal and monetary responses. Such responses provided crucial support to protect jobs, shelter household incomes, and boost recovery, but must now be recalibrated to the evolving circumstances.

Minimizing the impact of the recurrent pandemic waves and supporting recovery should remain the near-term priority, but fiscal adjustment must proceed as warranted. The biggest risk in the near term remains a return to lockdowns, stalling growth. Containing the spread of subsequent waves of COVID-19 infections, coordinating the rollout of vaccines, including boosters, and facilitating economic recovery should be at the forefront of the authorities' near-term priorities. At the same time, policy support should become more granular and better targeted, and be phased out gradually as the recovery takes hold. Fiscal consolidation compatible with the stage of the recovery should not be delayed, so that risks to debt sustainability are properly mitigated, averting a costlier adjustment in the future.

With the recovery taking hold, a gradual but determined fiscal consolidation and debt reduction strategy should ensue. Restoring medium-term fiscal sustainability must remain a top priority and we welcome the authorities' commitment to fiscal discipline. Debt already stood high at 96 percent of GDP, just before the pandemic, and has climbed to 120 percent of GDP by year-end 2021. With the prospect of tightening financing conditions, an ambitious and credible consolidation path is required to provide the needed fiscal anchor. Sustained reduction in the public debt ratio remains key to rebuild buffers and improve Spain's medium-term prospects. Moving forward, we are of the view that fiscal consolidation should start soon and initially rely on revamping revenue mobilization in a progressive way, given Spain's low revenue-to-GDP ratio. In line with staff's advice, we also believe that ensuring sustainability of the pension system would go a long way to restore fiscal sustainability and would represent a solid contribution towards boosting business and investor confidence.

Thanks to the accommodative fiscal and monetary policies, employment recovery has exceeded expectations. That said, job creation has been uneven and slack in the labor market persists. Most of the new employment opportunities have come from activities boosted by the pandemic, while contact-intensive activities lagged. The unemployment rate and income inequality remain among the highest in the region, albeit, at 13.3 percent, the unemployment rate is the lowest since the global financial crisis, as pointed out by Mr. Moreno and colleagues. Within this context, the authorities have undertaken a labor market reform and seem set to address long-standing challenges, particularly the high incidence of youth unemployment and temporary employment contracts. Staff argue that some of these reforms subtract flexibility and could hinder SME and large enterprises potential to respond to fluctuations in the market with possible detrimental effects on employment. Indeed, given the high structural unemployment rate, one would expect that a more flexible labor market would be beneficial to create job opportunities. However, staff's overall assessment is that the reforms undertaken will help tackle some longstanding issues in the labor market. *Could staff elaborate on how the recent labor market reform would help enhance the functioning of the labor market and what else could be done to promote the creation of quality jobs?*

The efficient use of Next Generation EU (NGEU) funds, alongside the implementation of authorities' ambitious structural reform agenda, could provide a persistent boost to growth. Unlocking the pending NGEU resources could help support recovery by expanding the fiscal space and accommodating public investment, which will be key to narrow gaps in infrastructure and human capital, elevate productive capacity, and accelerate growth. In this respect, the availability of NGEU funds creates an opportunity for an early and smoother start of fiscal consolidation. In addition, implementation of projects supported by these funds and included Spain's Recovery, Transformation and Resilience Plan (RTRP) would help enhance potential growth. The agenda includes a wide range of reforms aiming to address issues related to the labor market, pension system sustainability, SMEs' low capital, small margins and propensity to insolvency, as well as other structural transformations on education, health, climate change and energy transition, innovation, housing, modernization of the public administration and the justice system, business climate, and social inclusion. *Could staff elaborate on how the authorities see the prioritization and sequencing of such a broad reform agenda?*

The corporate and banking sectors entered the pandemic in good shape and weathered the crisis well, but continuous monitoring is required. Financial stability was also shored up by the government's sizeable and timely provision of income and liquidity support, which dampened the effect of the pandemic on private sector balance sheets. However, as the situation normalizes, banks need to set aside sufficient provisions to cover eventual losses and continue to closely monitor loan quality. Continued strong financial system supervision must be supported by well-targeted macroprudential measures and the streamlining of debt resolution and liquidation regimes. At the same time, the authorities should stand ready to provide focused support to key segments or firms experiencing pandemic-related headwinds, but otherwise solvent.

With these comments, we wish the Spanish authorities the best in their endeavors.