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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 18/96-3

2:30 p.m., November 19, 2018

3. Spain—2018 Article IV Consultation

Documents: SM/18/257 and Correction 1, and Supplement 1; and Supplement 2, SM/18/259

Staff: Schaechter, EUR; Goodman, SPR

Length: 58 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors	**Alternate Executive Directors**
	K. Obiora (AE)
	O. Diakite (AF), Temporary
	C. Moreno (AG), Temporary
	A. Park (AP), Temporary
	B. Saraiva (BR)
Z. Jin (CC)	
	P. Moreno (CE)
	N. Feerick (CO), Temporary
	C. Just (EC)
	A. Castets (FF)
	K. Merk (GR)
	H. Joshi (IN), Temporary
D. Fanizza (IT)	
	Y. Saito (JA)
	M. Daïri (MD)
H. Beblawi (MI)	
	N. Jost (NE), Temporary
T. Ostros (NO)	
A. Mozhin (RU)	
	R. Alkhareif (SA)
J. Agung (ST)	
	P. Trabinski (SZ)
	M. Chen (UK), Temporary
	A. Grohovsky (US), Temporary

G. Bauche, Acting Secretary
H. Malothra, Summing Up Officer
A. Bala / D. Alcantara, Board Operations Officers
M. McKenzie, Verbatim Reporting Officer

Also Present
Communications Department: A. Adriano. European Central Bank: K. Nikolaou. European Department: Q. Liu, M. Pradhan, J. Salas Maldonado, A. Schaechter, A. Stepanyan. Independent Evaluation Office: L. de Las Casas Perez de Orueta. Legal Department: C. DeLong. Strategy, Policy, and Review Department: M. Goodman.

Executive Director: H. de Villeroché (FF), L. Levonian (CO), M. Mouminah (SA), A. Tombini (BR), L. Villar (CE). Alternate Executive Director: A. Guerra (CE). Senior Advisors to Executive Directors: A. Del Cid-Bonilla (CE), M.Gilliot (FF), S. Rouai (SA), O. Stradal (EC), A. Tolstikov (RU). Advisors to Executive Directors: A. Arevalo Arroyo (CE), M. Coronel (BR), D. Fadhel (MI), J. Garang (AE), I. Lopes (IT), Y. Minoura (JA), K. Osei-Yeboah (MD), B. Parkanyi (GR), I. Skrivere (NO), U. Fritsch (GR), K. Hennings (BR), J. Montero (CE).

3. SPAIN—2018 ARTICLE IV CONSULTATION

Mr. Moreno, Mr. Montero and Ms. Mulas submitted the following statement:

Staff has provided useful insights in a context where the authorities are developing a new economic strategy. On behalf of the Spanish authorities, we thank staff for its very constructive dialogue and its well-focused analysis. The new government that took office last June is pursuing an economic policy agenda articulated around three main pillars: fiscal discipline, social inclusion, and sustainable growth. The Art. IV usefully focuses on these areas. There is broad agreement with the staff on the diagnosis and on key policy objectives, such as ensuring fiscal discipline and rebuilding fiscal buffers, lowering inequality, or fostering a structural reform agenda. The authorities have different views on some policy recommendations, particularly in the area of labor market reform.

Economic Outlook and Challenges

The Spanish economy maintains a strong momentum and risks to the economic outlook are mainly linked to the external environment. GDP growth is expected to remain vigorous in 2018, at around 2.6 percent, and to maintain a solid path in 2019 above the euro area average. Growth composition remains broad-based across demand components, but a less favorable external environment has yielded a smaller contribution of net exports and, thus, a more moderate growth pattern. As pointed out by staff, the outlook is subject to downward external risks, mainly related to policy uncertainties that could deteriorate trade and further tighten financial conditions globally. On the domestic front, the authorities have a more benign view than staff. The challenge of reaching political majorities in a fragmented Parliament, more than a risk, is a new reality of Spanish politics since 2015, no different from other advanced economies, and it has not prevented strong growth. As stressed by staff, the economic impact from the political uncertainty related to Catalonia has so far been limited and contained to the region.

Spain has continued unwinding the imbalances accumulated during the crisis, including a significant reduction in unemployment and in private sector leverage. The unemployment rate has been cut by over 11 percentage points over the past five years, while corporate and household indebtedness has fallen to levels at or below the euro area average. The banking system has undergone a substantial restructuring to the extent that non-performing assets are below the EU average. We concur with staff that this process has occurred in a context of improved fundamentals, including changes in the structure and competitiveness of the economy, which has allowed Spain to sustain strong growth while, at the same time, enjoying important and persistent current account surpluses.

But the correction of several key challenges has lagged behind and needs to be addressed, notably: reducing the public debt-to-GDP ratio, further lowering unemployment—in particular, long-term and youth unemployment—improving the quality of jobs, reducing inequality and the risk of poverty, and fostering productivity. The authorities have prioritized the correction of these vulnerabilities.

Policy Agenda

The policy agenda has three pillars: fiscal discipline, social inclusion and sustainable growth. These pillars require a gradual shift from the internal devaluation growth pattern that has characterized recent growth, to a productivity-based and more inclusive path. Pursuing budgetary discipline and rebuilding fiscal buffers are essential to anchor the economic strategy and to ensure the effectiveness of the policy agenda. Spain has a relatively high level of inequality, with a Gini coefficient of 34.1, far from the EU average (30.3), and is also among the European countries with the highest share of its population at risk of poverty or social exclusion. Social inclusion must be improved by reducing unemployment, but also by addressing underemployment and labor market duality, as well as by reducing inequality—defined more broadly than just income distribution, also encompassing gender and intergenerational equity. Sustainability requires a shift into a productivity-based and environmentally-sound growth pattern. These objectives demand a comprehensive approach in all economic policy fronts.

Fiscal Policy

Reducing debt levels and building up fiscal buffers are key priorities, as shared by staff´s assessment; the authorities are thus targeting a structural adjustment in 2019. Discretionary efforts and the growth momentum should mutually reinforce each other to reduce the government debt-to-GDP ratio and deficit levels. In this respect, the authorities are strongly committed to reversing the procyclicality exhibited by the fiscal stance in the past few years, which has widened the structural deficit by around 1 percentage points of GDP since 2015. The 2019 Draft Budgetary Plan targets a general government deficit of 1.8 percent of GDP in 2019, including a 0.4 structural adjustment effort. This path would imply attaining a primary surplus for the first time since 2007 (of 0.6 percent of GDP). Furthermore, it would bring forward an acceleration in the pace of debt reduction, which is projected to fall from 97.0 percent of GDP in 2018 to 95.5 percent in 2019, the biggest decline since 2014.

The 2019 Draft Budgetary Plan (DBP) is compliant with the requirements under the Stability and Growth Pact (SGP) of the EU and has been broadly endorsed by the Independent Fiscal Authority (AIRef). The authorities share staff´s view that the structural adjustment is a fundamental objective and take note of its word of caution in the design of the budget, in order not to deviate from fiscal targets. Spain will exit the Excessive Deficit Procedure and the corrective arm of the SGP with a deficit below 3 percent of GDP in 2018. For 2019, notwithstanding the EU Council recommendation of a 0.65 percent of GDP structural adjustment, the targeted 0.4 adjustment is compliant with the Stability and Growth Pact, considering the flexibility embedded therein. AIReF has endorsed the macroeconomic scenario underpinning the 2019 DBP, and considers the budgetary provisions feasible, albeit its central scenario estimates point at a slightly higher deficit for 2019 of 1.9 percent of GDP. The authorities will closely monitor budgetary execution throughout 2019 to avoid target deviations. The 2019 draft budget law is scheduled to be brought forward for Parliamentary discussion in December and the authorities are working to obtain the required parliamentary support. It should be noted the Spanish budgetary provisions contemplate the extension of the 2018 budget into 2019 until a new budget is approved, preventing any paralysis or gridlock in public administration.

The fiscal strategy is based both on increasing revenues and better-targeted social and growth-friendly spending. There is room to increase general government revenues considering that the revenue-to-GDP ratio in Spain is estimated to be at 38.5 percent of GDP in 2018, well below the euro area average (46.2). Furthermore, the taxation system is partly outdated, with the bases of some taxes having been considerably eroded over the past few years and new forms of economic activity not contributing according to their revenue-generating capacity. The 2019 DBP projects this ratio to go up to 39.1 percent, because of both cyclical factors and an estimated €5.7 billion in new discretional measures, which have been designed considering their revenue stream, progressivity, and environmental impact. They include, among others: a reform of the corporate income tax to ensure a minimum effective rate of 15 percent, increases in personal income and wealth taxes for the higher brackets, new taxes on financial transactions and certain digital services, increased taxation on diesel (environmental tax), and legal reforms to reduce tax fraud and tax evasion. The expenditure-to-GDP ratio is expected to go down to 40.9 (from 41.2 in 2018), as expenditures will grow at a slower pace than nominal GDP. The budget includes a reorganization of expenditures and a new package of up to €4.3 billion tailored to enhance social cohesion and productivity growth, including: an increase in long-term care expenditures, the reinstatement of the unemployment subsidy for workers over the age of 52, the progressive equalization of paternity leave to current maternity leave, or increases for scholarships and R&D&I expenditures.

The pension system reform needs a comprehensive approach. The authorities share the staff's view on the importance of a pension system that is both financially and socially sustainable. Last May, due to strong social demand, the previous government decided upon an increase in pensions in line with inflation for 2018 and 2019, above the legal provision of a 0.25 percent annual increase. This decision has later been endorsed by all political parties at the "Pacto de Toledo" (the Parliamentary committee dedicated to the pension system) with the aim of recovering pensioners' purchasing power. The authorities are well-aware of the budgetary implications that this measure would potentially have in the long-run and are approaching the necessary pension reform from the comprehensive perspective embedded in the Pacto de Toledo's twenty-one policy recommendations (sources of finance, contribution rate, non-contributive pensions, pensionable earnings) with a view to attaining a sustainable system in the long run.

Further steps to strengthen regional finances have been adopted and gender budgeting has been introduced. The government has set up a decision group to advance in the reform of regional financing and to reinforce regional compliance with deficit targets. New measures include establishing the procedure for a gradual return to market financing of financially-sound regions, the long-term refinancing of short-term, and better incentivizing compliance with a new spending rule that allows investment of regional surpluses, but only in financially sustainable investments. The 2019 DBP plan introduces gender budgeting which evaluates the gender impact of the different budget items and reinforces those with larger potential to reduce gender inequality.

Labor Market Policy

Labor market policies seek to continue reducing unemployment as well as addressing problems of labor market duality or in-work poverty, among others. Unemployment remains well-above euro area average, not only in aggregate ratios (14.9 percent vs 6.7 percent) but also for youth (33 percent vs 14.6 percent) and long-term unemployment (6.6 percent vs 3 percent). The rate of temporary contracts at 26.8 percent remains the highest in the EU. In parallel, productivity gains have not been fully translated into wage increases. Furthermore, the share of workers at risk of poverty is the second highest in the euro area. Addressing these labor market deficiencies is crucial to the objectives of productivity growth and reducing inequality.

These objectives require a multifaceted approach. The authorities share staff´s view that a comprehensive approach should be pursued when addressing labor market reform including, for instance, the reinforcement of the education system and active labor market policies to increase human capital and address skill mismatches—here, the Government has announced new legislation to develop a dual vocational training model and to enhance the digital and language skills of the youth, while employment subsidies will be revised and reduced to focus only on the most vulnerable groups.

There is also a need to fine-tune labor market regulation to promote better-quality employment, including through increasing the minimum wage and reforming collective bargaining. The last reform dates back to 2012 and was designed in a context of recession. New measures will include streamlining the number of contractual modalities, as well as new requirements to register working time to avoid an inadequate use of part-time contracts. Labor productivity will also be a priority, with initial work being done to explore an employer-based separation fund ("Austrian backpack"). This measure has the potential to substantially change labor market dynamics in Spain, allowing long-term employees and their employers a reasonable way out of their labor relationship when it is no longer mutually beneficial. The authorities are also working on the reform of collective bargaining and have already introduced some measures such as the increase of the minimum wage to €12,600 in 2019, as well as measures to fight against excessive rotation in the workplace (the so-called "Master Plan for Decent Work," launched in July 2018 with significant effects already in the very short-term). The authorities take note of the staff´s caveats with respect to the increase in the minimum wage and the its preference for firm-level agreements. That said:

The minimum wage is currently very low in Spain and previous experience suggests that raising it will likely have no substantial impact on job creation. The minimum wage remained flat during the period 2010-2016 and the proportion of the minimum wage over the mean wage, at only 33 percent, is among the lowest within the OECD. The announced increase would raise this ratio to around 40 percent, in line with the OECD average. There is no consensus in the literature on the employment effects of the minimum wage. While, on average, studies tend to show small negative effects on employment, these are often not significant, and the results are not robust to alternative specifications. In this respect, the experience in Spain shows a large absorption capacity of increases in minimum wages, especially in high growth periods: the increases of 2004 (11 percent) and 2017 (8 percent) were consistent with an acceleration of job creation in the following years, particularly significant in the case of youth employment. In parallel, the empirical evidence suggests a positive impact on domestic demand stemming from the increased consumption of minimum wage workers, as well as a reduction in poverty rates.

Higher-level collective bargaining can yield better labor market outcomes. The success of a bargaining system must be assessed against its ability to ensure adequate levels of coverage of collective agreements and, with it, of employment, wages, quality of job environment, degree of adaptability, and inequality. As highlighted in the latest OECD Employment Outlook, overall, organized decentralization—with sector level agreements setting broad framework conditions and firm-level negotiations dealing with detailed ones—tend to deliver good employment performance, better productivity outcomes and higher wages. By contrast, a decentralization to firm-level bargaining without coordination within and across sectors, can increase wage dispersion, but is also associated with somewhat poorer labor market outcomes. The experience with decentralized collective bargaining in Spain since the 2012 labor market reform suggests a preference for the sector model and for agreed solutions. By reinstating the prevalence of sector-level agreements, the authorities aim to balance improved coordination across different bargaining levels and social dialogue, whilst maintaining internal flexibility mechanisms (including wage flexibility) available for times of need.

Structural Reforms

The root causes of low productivity growth in Spain are multifaceted, including deficiencies in education, the prevalence of micro and small firms, or an insufficient investment in R&D. In Spain the share of young adults (25-34 years old) below upper secondary education is 33 percent, way beyond the OECD average of 14 percent, which partially explains the high share of low-skilled workers in the labor force. R&D investment is comparatively low, since 2000 the ratio of R&D spending over GDP has averaged 1.2 percent of GDP, which is well below its European peers. Additionally, the contribution of micro and small-sized enterprises (with lower average productivity levels) to employment in the non-financial business sector in Spain was 59.5 percent, almost 10 pp above the EU average.

In this context, the authorities are committed to devising a comprehensive strategy cutting across different policy dimensions and with an adequate sequencing. In this vein, we thank staff for providing particularly useful regional analysis in the areas of labor mobility and productivity, with some interesting policy implications in the fields of education, labor mobility, R&D spending, and ALMPs. The 2019 DBP aims to increase outlays on education and R&D spending. Additionally, the authorities are considering measures to improve the business environment (by removing obstacles to business growth and start-up creation) and to enhance the application of the Market Unity Law, strengthening the degree of coordination among regions. Other measures include the deployment of the 5G National Plan and regulatory changes in the pipeline to improve the functioning of some network industries, such as railways or energy.

Environmental and gender policy issues also rank high in the Government's agenda; staff's insights on these policy areas would be welcomed. These policies are not only key for achieving an equitable society from an intergenerational and a gender point of view and are also instrumental to improving productivity and long-term potential growth. The authorities are drafting a new comprehensive Law on Climate Change and Energy Transition to steer the transition towards a low-carbon economy. This could lead to higher growth given Spain´s competitive edge on renewable energies. On gender policy, the gender perspective of the 2019 DBP aims for greater gender inclusion. Furthermore, eliminating gender pay gaps also has a high potential growth impact by raising women's participation rates. For future Article IV reports authorities would welcome further staff analysis on these areas profiting from their comparative advantage in drawing from international practices.

Financial Sector

Spanish banks are steadily increasing their resilience. The Spanish banking system has made important efforts for reducing the volume of impaired assets in the last few years. Thus, non-performing loans have diminished by 60 percent compared to 2013, when they reached a peak, and foreclosed asset have been cut by 40 percent since its ceiling in mid-2012. This adjustment has been a crucial contributor to the recovery of profitability, that now is above the European average, although it is still reduced form a historical perspective. In this context, solvency ratios are well above the regulatory standards; in fact, compared to December 2014 (the first full year of application of Basel III prudential standards), in 2017 capital ratios had increased by almost 2 pp for total capital (up to 15.4 percent), and by roughly

1 pp in highest quality CET1 capital (up to 12.7 percent). The recently released 2018 EU-wide stress tests produced by the European Banking Authority (EBA) reflect this resilience and capacity to withstand tail risk scenarios. The authorities share staff´s view on the importance of continuing to strengthen bank capitalization to close the remaining gap with European peers. They also share staff´s views on the need for continued vigilance of growth in consumption credit and property prices, which nonetheless remain contained. On the exposure to emerging markets, as highlighted by staff, Spanish banks operate with an autonomous subsidiary model, whereby subsidiaries are self-financed and do not receive intragroup support. Moreover, parent banks hedge against most exchange rate risks.

The authorities are stepping up the reform of the institutional set-up of surveillance, including through the creation of a national macroprudential authority and a fintech regulatory sandbox. The government has announced the creation of a national financial stability authority (ANESFI), which complies with the 2011 ESRB recommendation to create a macroprudential authority. The projected new authority will be comprised of representatives from the Ministry of Economy and Business, Banco de España and CNMV, and it will be empowered to issue opinions, warnings and recommendations. Macroprudential tools will remain under the responsibility of the sectoral supervisors while, following the recommendations under the 2017 FSAP, the toolkit of Banco de España will be expanded to include borrower-based measures, sectoral countercyclical buffers and limits to sector credit concentration. The government has already closed a public consultation on a draft Law to establish a Regulatory sandbox to allow FinTech startups and other financial entities to conduct live experiments in a controlled environment under regulatory supervision.

Mr. Tombini, Mr. Fachada and Mr. Coronel submitted the following statement:

We thank staff for the set of documents, and Mr. Moreno, Mr. Montero, and Ms. Mulas for their helpful statement. Spain’s economic recovery has been one of the strongest in the euro area since the crisis thanks to, among other factors, labor and product markets reforms and decisive actions to fix the banking system. To maintain the current pace of growth and continue to reduce the income gap relative to higher income euro area peers, we agree with staff that the new Spanish authorities should accelerate the reduction of public debt relative to GDP, and continue to strengthen the banking system. At the same time, we agree with Mr. Moreno and colleagues that recent structural reforms, particularly in the labor market, did not eliminate imbalances and need to be corrected.

High public debt remains one of the legacies of the Spanish banking crisis. Limited progress has been made in reducing the public debt-to-GDP ratio since peaking at 100.4 percent in 2014. We associate ourselves with staff on the need to accelerate public debt reduction, rebuild fiscal buffers and increase the resilience of the Spanish economy to shocks. We take note that, in 2018, Spain is expected to exit the Excessive Deficit Procedure, with a fiscal deficit estimated at 2.8 percent of GDP. For 2019, we regret that the timing of the Article IV consultation was not fully aligned with the budget discussion in Parliament, but we are reassured by Mr. Moreno and colleagues that the authorities will closely monitor budget execution to avoid deviations from the 1.8 percent of GDP deficit target. More generally, we agree with both staff and the authorities that Spain has ample space to increase fiscal revenues and ensure that fiscal targets are met. Over the medium-term, staff's proposal to promote an annual 0.5 percent of GDP deficit reduction of the structural primary balance until public debt is firmly on a downward path seems appropriate.

Reforms to ensure the sustainability of the social security system remain at the forefront of policy priorities. We recognize the importance of advancing social security reforms to Spain's fiscal sustainability, social cohesion, and intergenerational equity. As in most countries, pension reforms are affected by political feasibility, social acceptance and timing, rather than just technical considerations. We take note of recent decisions to adjust pensions in 2018-2019 above the previously announced rate, and the recommendation of the Toledo Pact to link pension increases permanently to purchasing power. Again, we welcome assurances by Mr. Moreno, Mr. Montero, and Ms. Mulas that the authorities are aware of the budgetary implications that these measures entail, and their long-term commitment to social security sustainability.

The unemployment rate has gradually declined, but remains very high, particularly among the youth. Labor market duality, insufficient full-time quality jobs, skill mismatches, and lack of regional mobility weigh on the employment outlook. We take note of staff's assessment that low labor mobility across Spanish regions contribute to high structural unemployment, but wonder if the analysis would differ considering mobility at the provincial level, rather than on the regional level. Staff's comments are welcome. Also, given the importance of foreign nationals in the labor market, does staff consider the impact of economic factors on internal migration of foreigners the same as for Spanish nationals? Separately, Spain's labor productivity growth lags its euro area peers, and staff's considerations on the need for higher R&D spending and technological innovation are welcome.

Banking system soundness continues to improve steadily. However, the repair of banks' balance sheets remains incomplete, with still relatively high nonperforming loans and low capital buffers. We note staff's concerns regarding risks arising from the exposure of Spanish banks to emerging economies, particularly in Latin America, but we believe these concerns are overstated. Since their expansion to Latin America some 20 years ago, Spanish banks have experienced several real-life stress tests, without any major impact on their consolidated results. Indeed, as shown in the top left chart in Figure 5, except for one year in the last 12, the profitability of Spanish banks on a consolidated basis has always been higher than the profitability of domestic operations. As staff recognizes in the report, the robustness of their international operations can be attributed to the fact that Spanish banks follow a subsidiary model abroad, with independent management, very limited intragroup funding, and local regulation and supervision.

Mr. Gokarn and Mr. Joshi submitted the following statement:

We thank staff for their informative reports and Mr. Moreno, Mr. Montero, and Ms. Mulas for their insightful buff statement.

Spain's economy has experienced strong growth momentum in the past few years, accompanied by perceptible improvement in key macroeconomic attributes. However, even as surpluses in primary fiscal balance and CA including stable inflationary expectations tend to underpin macroeconomic resilience, the high level of structural unemployment and subdued productivity growth impede Spain's transition to higher potential growth. Going forward, staff projects the growth rate to decelerate over the medium-term while the inflation rate is expected to stay around the ECB's inflation objective of 2 percent. Downside risks from increasing protectionism, tightening of global financial conditions and change in risk appetite, euro area policy uncertainty and slowdown in EMs cloud Spain's economic outlook. Domestically, risks could stem from the reversal of reforms, weakness in fiscal discipline and regional disturbances, which could undermine confidence.

The overhang of general government debt warrants urgent structural fiscal adjustment. Good economic conditions prevailing currently provide the basis for resuming consolidation through expenditure management and enhancement in revenues. We note that the SGP compliant 2019 draft budget plan mainly includes measures aimed at mobilizing revenues through increasing and/or introducing new taxes and enhancing the efficiency of taxation. Given the uncertainty of tax yields, we believe that revenue measures outlined in 2019 draft budget plan should be complemented with expenditure side measures. Contingency measures suggested by staff in the event of revenue shortfalls should be placed appropriately in this context. We also remain concerned about the uncertainty of the passage of 2019 budget and support the need for interim measures for improving tax yields through base expansion and enhanced collections. We note that the authorities agree with the staff assessment and are committed to reducing debt and building buffers.

The pension system should suitably address population ageing risks. Elongating working lives as per changes in life expectancy, enhancing minimum contributions from self-employed workers and encouraging alternative savings plans would serve to assuage tensions in the pension system. Furthermore, limiting pension increase to the legislated minimum rate would minimize fiscal costs and serve to sustain the viability of the pension system. It is encouraging to note the authorities' commitment for reforming the pension system going forward.

Reforms of the regional finance framework should constitute an integral part of fiscal strategy. We support greater autonomy for regions to mobilize revenues for accommodating their expenditure requirements which would encourage them to meet their fiscal responsibilities. At the same time, we also support staff advice on carefully evaluating the fiscal risks due to investment of surplus funds held by local governments to prevent indebtedness resulting from poorly executed investment decisions. Given that Spain's primary spending is already low, which additional measures would staff possibly recommend on the spending side to ensure sustainability of fiscal finances?

Despite continued CA surpluses, staff has assessed Spain's external position as moderately weaker than suggested by medium-term fundamentals. The persistence of large negative NIIP, though gradually ameliorated by CA surpluses, is worrisome, and should be addressed by encouraging tourism and other exports while containing imports.

Apart from increasing capitalization and profitability of the banking system as suggested by the 2017 FSAP, it is important to clean-up legacy bank assets, bolster risk management practices and strengthen the institutional framework for financial oversight. Implementing ECB's NPL guidance on disclosure of NPL reduction targets and monitoring progress thereof would serve to inform on the outstanding volume of NPLs and limit their growth. Shortfalls in capital compared to regional peers including that in Minimum

Requirements for Own Funds and Eligible Liabilities (MREL) require strengthening of capital buffers to shield bank balance sheets against interest rate shocks and sovereign risk. Rigorous management of interest rate and liquidity risks including evaluation of credit and funding risks based on frequent stress testing scenarios would help in preempting financial instability. Besides, strengthening supervisory focus on corporate governance practices of all credit institutions and enhancing the AML/CFT regime would bolster the confidence in the financial system. We welcome the authorities' plan for setting up of an independent macroprudential authority, and support staff advice on establishing the framework for independent supervision of insurance and pension systems including setting up of a consumer protection authority. Could staff inform about the NPL incidence including prudential measures if any taken by the BdE in respect of banks' exposures to consumer loans? Further could staff inform about the risk management practices for market and credit risks in subsidiaries, and whether these are centralized within the parent banks?

Perseverance with past reforms including added emphasis on inclusiveness through appropriate changes in labor regulations and contracts, encouraging female employment, upgrading skill sets, facilitating worker mobility, better designed ALMPs, suitable wage differentiation and rationalization of minimum wages would serve to reduce the high level of structural unemployment. We welcome the emphasis placed by the authorities on organized decentralization of the wage bargaining process for improving labor market outcomes. We would like however staff to comment if they disagree with authorities' perception about the strong and positive impact of relatively large increases in statutory minimum wages on employment?

Structural reforms focused on enhancing education opportunities, encouraging R&D led innovations, facilitating competition through effective implementation of the Market Unity Law, narrowing inter-regional productivity differentials by reducing skill mismatches, easing size contingent regulations and rationalization of corporate tax for SMEs would go a long way in enhancing overall productivity. We are encouraged by the authorities' commitment to a comprehensive strategy for structural reforms. Could staff elaborate on the key reasons for the slow progress in the implementation of Market Unity Law?

We wish the authorities every success in future endeavors.

Mr. Ostros and Ms. Skrivere submitted the following statement:

We thank staff for their insightful report and selected issues papers in the context of Spain's Article IV consultation. We also thank Mr. Moreno, Mr. Montero and Ms. Mulas for their informative buff statement.

We consider the strong growth performance of the Spanish economy in the past couple years as a testament to the beneficial impact of previous reform efforts. Unemployment has declined substantially, external competitiveness has improved, banks have been strengthened, and government deficit was reined in. The work is not finished though: structural unemployment, especially youth unemployment, is still high, while high levels of external and public debt leave Spain vulnerable to adverse shocks. We therefore encourage the authorities to preserve the progress achieved and avoid a reversal of certain previous reforms, as well as to continue with reforms: to set public finances and the pension system on a sustainable footing, to improve the outcomes of education and active labor market policies, and to substantially reduce regional disparities by increasing potential growth rates in lagging regions. To better equip the financial sector to tackle future shocks, we welcome the recent measures to improve the macroprudential toolkit.

Macroeconomic Developments

Spain's strong recovery is broad-based and has been supported by buoyant job creation. Past labor market reforms are paying their growth dividends and have led to a double-digit decline in unemployment. Accordingly, the substantially negative output gap in the wake of the crisis has now been practically closed, signaling a new phase in the economic cycle. In addition, risks are tilted to the downside: main external risks stem from global protectionism, Brexit, and weakening economic conditions in emerging economies, while domestically a procyclical fiscal policy and a reversal of certain past reforms could undermine growth prospects. Nevertheless, structural unemployment, especially among the younger generations, is still high and, despite recording a current account surplus for five years in a row, external vulnerabilities exist. We concur with staff that sustainable current account surpluses are key to reduce Spain's sizable negative NIIP, despite the favorable maturity structure of external debt that mitigates exposure to unexpected volatility in financial markets.

Fiscal Policies

Notwithstanding significant reductions in the government deficit, a clear downward debt trajectory and a rebuilding of fiscal buffers are needed, as downside risks are accumulating. We commend the authorities for reducing the government deficit from 7 percent to 3.1 percent of GDP in just four years. However, the high government debt (in the vicinity of 100 percent of GDP) and the structural deterioration in the deficit in the past four years are sources of vulnerability. We encourage the authorities to maintain a firm grip on budgetary policy in the coming years when economic and financing conditions are likely to become less supportive. In this respect, we broadly concur with staff's recommendation to continue with structural adjustments that would put public debt on a firm downward path and observe European fiscal rules. We would encourage the authorities to consider tax revenue measures proposed by staff. Staff's calculation of the additional revenues from lowering the VAT policy gap seems, however, optimistic to us, as it assumes the complete closure of this gap notwithstanding the special VAT regimes that certain regions enjoy. While we see the need to have a simpler regional financing system, contrary to the staff report, we have no reasons to believe that it is currently not transparent as most information is publicly available. We would rather recommend complementing the regions' tax autonomy with strong fiscal rules, such as a stronger expenditure rule, whose implementation should be as automatic as possible. We also agree with staff that the authorities should be ready to take additional contingency budget measures should revenue projections prove to be overoptimistic. We note that Spain's government revenue-to-GDP ratio is one of the lowest in the Euro Area and could be raised by further efforts to tackle fraud and broaden tax bases.

In view of growing ageing-related fiscal costs and an already high government debt level, it is critical to keep pension expenditure on a sustainable footing. We welcome the report's focus on the sustainability and fairness of the Spanish pension system.

In particular, we fully share the view of the importance of accompanying a re-linking of pensions to inflation with other steps to keep pension expenditure sustainable.

Financial Market Policies

Spanish banks' balance sheets and funding structures are much more resilient today than before the crisis; however, more progress is needed to further strengthen the sector, in line with 2017 FSAP recommendations. The Spanish banking system has made good progress in improving its asset quality, strengthening solvency and access to liquidity. However, it is important to persist in the efforts to further reduce the legacies of the crisis, especially with respect to credit quality in the construction and real estate sectors. We encourage Spanish banks to develop business models that move away from their past overreliance on mortgage, real-estate development, and construction lending, and avoid excessive risk-taking. In this respect, we are encouraged by the authorities' strong public commitment to create a National Macroprudential Authority by end-2018 that can work towards equipping the Bank of Spain with a borrower-based macroprudential toolkit. While Spanish banks comfortably meet regulatory capital requirements there is a need to further strengthen their CET1 ratios and adjust funding plans to reduce reliance on central bank funding over the medium term. We would also see merit in accelerating the drafting of the resolution plans for all Spanish banks.

Structural Policies

We concur with staff on the positive impact of the 2012 Labor Market Reform in reducing structural unemployment and highlight the importance of preserving its main elements. Structural unemployment in Spain is stubbornly high and regional rigidities persist; however, we still consider the previous labor market reform to be a successful one. It helped substantially reduce unemployment and contributed to improving competitiveness. Encouraged by these results, the authorities should continue taking steps to address labor market duality while reviewing and streamlining active labor market policies. In addition, with a view to addressing skill mismatches and the quality of education, reforms to the education curriculum and apprenticeship system would be desirable. Wage moderation has been supportive of employment creation and competitiveness in the recent years.

Mr. De Lannoy and Mr. Jost submitted the following statement:

We thank staff for the comprehensive set of papers and Mr. Moreno, Mr. Montero, and Ms. Mulas for their informative buff statement. We welcome the authorities' commitment to reforms in key areas, including debt reduction, youth and long-term unemployment and addressing productivity developments. We agree with staff that reform efforts remain necessary and reversal of past reforms should be avoided. We associate ourselves with the Gray statement of Mr. Ostros and Ms. Skrivere and would like to make the following points for emphasis.

We welcome staff's thorough assessment on fiscal matters, both in the report and the DSA. Like staff, we remain concerned about the high debt stock and risk to debt sustainability. Possible increases of already high borrowing costs, i.a. caused by a possible normalization of monetary policy and/or possible future policy uncertainty in the Euro Area, add to the risk profile. We agree with staff's assessment that the current economic cycle is conducive to fiscal consolidation and support their call to continue efforts to reduce deficit and debt levels at this point in time. This would help increase the currently very limited room for maneuver in case risks materialize.

We very much appreciate staff's horizontal focus on intergenerational equity, which we deem to be a relevant topic more generally. For example, data on income disparities (Box 4) indicate that the last decade has been costlier for the younger generation – not only in Spain, but in a large share of European countries. In the Spanish context, we support staff's call for pension reform, efforts reducing the high youth unemployment levels, standing at 33 percent, and efforts aimed at tackling at-risk-of-poverty rate among the young. In our view, the discussion on debt reduction also has an intergenerational equity aspect to it.

Increasing the effectiveness of different ALMPs and investing in human capital will likely contribute to reducing the high long-term and youth unemployment rates. A relatively high share of temporary employment and high involuntary part-time employment rate require addressing labor market duality to reduce inequality and social exclusion. We appreciate staff's explanations of intra-national labor mobility. We would like to use the opportunity to inquire whether staff believes that intra-EU labor mobility has an impact on human capital development in Spain, and, in turn, might impact growth potential.

We welcome recent improvements in the Spanish banking sector, including in terms of reduced NPLs and foreclosed assets. Yet, relatively low capital ratios compared to European peers render Spanish banks more vulnerable to shocks, in part given their exposure to emerging markets. Therefore, and in order for Spanish banks to comply with the upcoming MREL targets, we agree with staff that they should continue building up capital buffers and bail in-able debt. We welcome efforts by the authorities to continue following up on FSAP recommendations.

Mr. Saito and Mr. Minoura submitted the following statement:

We thank staff for the informative reports and Mr. Moreno, Mr. Montero, and Ms. Mulas for their insightful statement. We welcome that Spain's economy has continued to grow strongly reflecting its improved fundamentals. Nevertheless, Spain faces many structural challenges, including high public debt, high structural unemployment rate, persistent productivity gap against European peers, population aging, and banks' weak profitability. Moreover, both internal and external risks have been building up. Against this background, we encourage the authorities to continue and scale up their reform efforts to tackle those challenges taking full advantage of the strong economic conditions. As we broadly agree with the thrust of the staff's appraisal, we will limit our comments to the following:

Fiscal Policy

Amid the high debt to GDP ratio of 100 percent, it is essential to resume active fiscal consolidation so as to rebuild fiscal buffers and preserve debt sustainability. In this light, we concur with staff that the 2019 budget needs to include a reliable package of adjustment measures. As Spain's public primary spending is already relatively low compared to those of EU peers, revenue measures – including expand VAT collection, raise excise duties and environmental levies, and reduce inefficiencies in the tax system – need to be pursued to reduce deficit and help finance additional spending to achieve social and distributional objectives. On the other hand, we share the staff's concern that the planned introduction of the digital and financial transaction taxes would be more distortive and best embedded in an internationally coordinated framework.

As for the pension system, safeguarding the pension system's financial viability together with enhancing the social acceptability is essential given the pressure from population ageing. In this regard, options suggested by staff, such as incentivizing longer work lives, increasing the minimum contribution for self-employed and encouraging supplementary savings could be considered to address the tensions in the pension system.

Structural Reform

We encourage the authorities' further efforts to address the rigidities in the labor market. While we commend that the 2012 labor markets reforms have supported a reduction in the structural unemployment rate, the still high structural and young unemployment would have long-lasting negative effects on productivity and incomes, as well as the social prospects. While staff propose more coordinated and better-designed active labor market policies (ALMPs) to enhance employability, could staff elaborate more on some details/examples of possible designs of ALMP measures? At the same time, given the important role of wage differentials in regional mobility, ensuring that wage dynamics reflect differences in region- and sector-specific conditions is important to promote a reallocation of labor toward more productive sectors and regions.

Given the productivity gap against European peers and notable productivity variations across regions, further efforts to reduce skill mismatch and enhance innovation capacity at the regional level would be essential. As staff pointed out, we encourage the authorities to implement the Market Unity Law, eliminate incentives for “small business trap” and review the R&D incentives to simplify and achieve better coordination between different levels of government.

Financial Sector Policy

While it is encouraging that Spanish banking system has further gained strength as asset quality has improved and nonperforming loans (NPLs) has decreased, we encourage the authorities continued efforts to address remaining vulnerabilities in line with the 2017 Financial Sector Assessment Program (FSAP) recommendation. Actions need to focus on accelerated cleanup of legacy bank assets, further improvement in bank profitability and capitalization, rigorous management of interest and liquidity risks and reform of the institutional framework for financial oversight. As for modernization of the institutional framework, we take note of the government announcement of the creation of a national macroprudential authority (ANESFI). We would appreciate it if staff could elaborate its details and share the staff’s evaluation on it. We also agree with staff that the legal basis should be established for the use of macroprudential tools, such as limits on loan-to-value and debt service-to-income.

We also take note that Spanish banks maintain relatively large exposure to Latin America and Turkey. Could staff share possible spillover effects on Spanish financial system from these emerging markets? In addition, we would like to know staff’s view on how Spanish banks are reacting to the increased uncertainty in these areas, e.g. their stance on rolling-over the current exposures.

Mr. Obiora, Mr. Garang, Mr. Raghani and Mr. Diakite submitted the following joint statement:

We commend the Spanish authorities for the reforms and policies, which have undoubtedly helped solidify Spain's economic growth over the past few years. Indeed, real GDP growth, for the fourth year in a row, exceeds those of the Euro Area, reflecting strong fundamentals. More gratifyingly, overall growth has become broad-based across demand components, while a turnaround in productivity growth, restrained inflationary pressures, and upgrading of Spain's sovereign debt ratings by international rating agencies have all made the macroeconomic outlook quite positive. Notwithstanding this noteworthy performance, Spain still faces several economic challenges and downside risks in the medium term, including rising trade tensions, adverse global financial pressures, and broader policy uncertainty. We broadly agree with staff appraisal and policy recommendations and would like to expand on some of the points made above.

Fiscal consolidation and debt sustainability remain critical. We urge the authorities to uphold fiscal consolidation and ensure public debt sustainability. In this regard, past reforms on fiscal deficit reduction and the ongoing three-pillar-strategy, underscored in Mr. Moreno, Mr. Montero and Ms. Mulas's lucid buff statement, need to be implemented steadfastly while maintaining some fiscal space for social spending. Further, the authorities should take advantage of current favorable conditions to address the pension system which could threaten the sustainability of public finances and reduce public debt and put it on a downward and sustainable trajectory. To this end, we consider appropriate the revenue enhancing measures considered by the authorities, including an increase in excise on diesel, adoption of a financial transaction tax, changes to the corporate income tax, and a hike in the tax rate for high income brackets. We would welcome staff comments on contingency actions, if any, the authorities could take if revenue shortfalls arise in the short- to medium-term.

Critical actions are also needed to address inequality and unemployment, especially among the youth population. In light of the fact that the country's primary spending, at 38.5 percent of GDP, is relatively low compared to EU peers, there is some fiscal room to undertake social spending to address inequality and unemployment. While efforts to bring down overall public debt and deficit to manageable levels are worthy pursuits, there is merit in addressing inequality by increasing the female labor force, and in supporting the employment prospects of the youth population, particularly for those out of work over considerably long periods. We believe that the overarching strategy in this context should be geared toward fostering innovation capacity and raising productivity through inclusive labor market policies while minimizing potential short-term distortions arising from adopting these measures.

Structural reforms should continue to address the remaining bottlenecks. While productivity has improved in the past, regional disparities remain, with the former falling below their European peers. In this connection, we support the analysis and conclusions in the Selected Issues Paper, which calls for mechanisms to reduce skills mismatch at the regional level given that this could greatly improve long term gains. To advance the structural reform agenda, we encourage the authorities to consider implementing the Market Unity Law, reducing corporate income tax for SMEs to spur their growth, and improving education at regional levels.

Strengthening the financial sector remains critical. We are encouraged by assurances in the buff Statement that the banking sector continues to build resilience. However, we point out that these efforts cannot be done in isolation of addressing legacy issues, as justifiably identified in the 2017 FSAP. In this connection, we associate ourselves with staff analysis and recommendations, and urge the authorities to undertake necessary reforms, including cleaning up of legacy banks and reforming institutional framework to meet oversight functions.

Prudential oversight and resolution framework need greater attention. Toward this end, we believe that the draft Mortgage Law presents an opportunity to manage bank risks through focusing supervision on corporate governance, including improving resolvability of small banks. We see merit in beefing up the AML/CFT law to eliminate delays in targeted financial sector sanctions. We welcome the efforts geared toward risk-based supervisory framework and enhancement of macroprudential toolkit to address any banking sector misalignments, should the need arise. Efforts aimed at creating a resolution fund for credit cooperatives are also very encouraging. On this, we would welcome staff comments on measures underway to address the issues arising from Sareb, an asset management company, which has been loss-making for quite some time.

Mr. Di Tata and Ms. Moreno submitted the following statement:

We thank staff for the comprehensive reports and Mr. Moreno, Mr. Montero, and Ms. Mulas for their insightful buff statement. Spain has been growing strongly owing to improved fundamentals. Risks are tilted to the downside and are mostly external, although domestic risks cannot be disregarded. Nevertheless, staff might have an overly pessimistic view regarding domestic risks and their possible impact on the economy. The new government that took office recently is in a minority position, which makes it challenging to advance major legislative initiatives. The government's strategy focuses on fiscal stability, social cohesion, and sustainable growth. Overall, we agree with the thrust of the report and offer the following comments.

Spain has continued to grow at rates that exceed the euro area average, but efforts to address structural challenges have stalled. Growth is expected to moderate, with potential growth projected by staff at around 1.75 percent over the medium term. Productivity, even though improved, is still low, and structural unemployment remains high. There are large differences in productivity at the regional level, as discussed in the Selected Issues Paper (SIP). Unemployment has declined but there is room for significant improvement, especially among young workers.

We agree with staff that resuming fiscal consolidation is crucial to rebuild fiscal buffers and put the public debt (at around 100 percent of GDP) on a clear downward path. Spain will exit the Excessive Deficit Procedure and the corrective arm of the SGP with a deficit below 3 percent of GDP in 2018. The 2019 draft budget envisages a reduction in the deficit to 1.8 percent of GDP, including a 0.4 percent structural adjustment effort. The authorities believe that the revenue projections are based on prudent assumptions, but staff notes that some of the proposals have an uncertain yield. Could staff elaborate on possible contingency actions in case the revenue projections do not materialize? We agree with staff on the need to gradually implement additional non-distortive revenue measures over the medium term while targeting further spending to the most vulnerable. As shown in the DSA, an annual structural adjustment of about 0.5 percent of GDP a year would be necessary to put the public debt on a firm downward path.

The external debt sustainability analysis shows that under the staff's baseline scenario the external debt is projected to decline from 167 percent of GDP in 2017 to 144 percent in 2023. At the same time, gross external financing is expected to decrease throughout the projection period but would remain high at around 60 percent of GDP in 2023. Could staff comment on the risk implications of these projections?

The pension system has undergone some changes in recent years. Previous reforms made important adjustments, which led to pensions being adjusted at rates below inflation, an issue that has been controversial. If pensions were to be relinked permanently to inflation, staff estimates that pension spending would be put on a sharp upward trajectory, adding about 3-4 percent of GDP in outlays by 2050. We understand the concerns raised by staff and welcome that the authorities intend to address this matter in a comprehensive way by ensuring the long-run sustainability of the system. We would encourage them to consider the reform options presented by staff in the report.

Regarding a possible reversal of the way wage negotiations are implemented from firm-level to sector-level, the authorities are of the view that coordinated negotiation delivers good employment performance, better productivity outcomes, and higher wages. Nevertheless, we would argue that, in a context in which wage dispersion is already low, firm-level negotiation would help increase wage dispersion, permitting wage differentials to better reflect different productivity levels. The authorities also note that the 20 percent increase in the minimum wage for 2019 is not likely to have a material impact on job creation. Could staff elaborate on this matter? How binding is the new minimum wage? How is the increase expected to impact wage dispersion, which is already low? More generally, we agree with staff that preserving wage flexibility and tackling rigidities in the labor market is critical. In this regard, we share the view that policy measures should focus on enhancing the attractiveness of open-ended contracts for employers.

The health of the financial system has strengthened, the private sector is deleveraging, and asset quality has improved. However, banks would benefit from further capitalization and low profitability needs to be addressed. Moreover, prompt implementation of ECB's NPL guidance is critical to keep reducing impaired assets, and the recent expansion of consumer lending warrants close monitoring. We welcome the authorities' plans to establish a national macroprudential authority, as well as to create an independent insurance and pension supervisor. We encourage the authorities to vigorously implement pending FSAP recommendations and to enhance the AML/CFT regime by amending the AML/CFT law to address some deficiencies. As mentioned in the report, the Bank of Spain should have a comprehensive macroprudential toolkit to address any emerging problems. We noticed that the authorities are considering distributing the responsibilities of toolkits between the Bank of Spain and sectoral supervisors, rather than concentrating the responsibility with the Bank of Spain. Could staff comment on the pros and cons of these two options?

On structural reforms, we agree with staff on the need to implement reforms to lift productivity. In this regard, we welcome the consultative process underway to seek support for some reforms, including implementation of the Market Unity Law and measures to enhance innovation. These reforms would need to be complemented by efforts to encourage labor mobility, eliminate disincentives for firms to grow, and improve education. We commend staff for the informational SIP that discusses productivity differences among regions and identifies some factors explaining these differences. Can staff comment on whether the policy implications derived from the SIP are aligned with the authorities' priorities?

With these comments, we wish Spain and its people the best in their endeavors.

Mr. Beblawi and Ms. Fadhel submitted the following statement:

We thank staff for the well-presented reports and Mr. Moreno, Mr. Montero and Ms. Mulas for the helpful buff statement. We were pleased to see Spain's strong growth and improved fundamentals, which were reflected in an upgrade of its sovereign debt ratings. Challenges remain in areas related to fiscal policy and public debt sustainability, pension system and structural unemployment, labor market mobility and productivity, and some banking system issues.

Fiscal Issues

Policies to mitigate vulnerabilities and rebuild buffers are warranted. With public debt at around 100 percent of GDP, policies are needed to put public debt on a sustainable downward trajectory. Implementation of the 2019 draft budget, which targets a general government deficit of 1.8 percent of GDP, including a structural deficit of 0.4 percent, would help to reduce debt, while creating fiscal space for social spending. In the same vein, we encourage the authorities to implement the 2011/13 pension reforms, including the "sustainability factor" from 2019 to 2023, and to avoid deviating from the pension formula in 2018-19. These measures would help to safeguard the viability of the pension system and ensure a more equitable split between the young and older generations. The draft budget proposes several revenue measures, including changes to the corporate income tax and introduction of a digital sales tax for large companies, as well as a financial transaction tax. Staff suggests a need for additional revenue measures, as well as spending cuts. Can staff elaborate on what measures would they recommend?

Labor Market

Reforms in 2012 have helped to achieve some flexibility and brought the structural unemployment rate below its long-term average of 18 percent. However, unemployment remains stubbornly high and well above euro area average, especially for the youth. We agree with staff that policies geared towards removing labor market rigidities and increasing mobility across regions would help to reduce structural unemployment and raise productivity. In this regard, we are encouraged by the initial work to explore an employer-based separation fund “Austrian backpack” which would allow for more flexibility in negotiating long-term employment contracts. Wage flexibility should help to reduce low-skilled and youth unemployment.

Financial Sector

The health of Spain’s banking sector continues to improve, which is partly reflected by the decline in nonperforming loans and foreclosed assets. However, Spanish banks still lag European peers in terms of capital ratios. We concur with staff’s recommendation to accelerate the build-up of high-quality capital (common equity tier-1). Increased capitalization would help to protect Spanish banks from potential spillovers related to emerging markets, to which Spanish banks have significant exposure. We take positive note of the announced creation of a national financial stability authority (ANESFI), which should help to enhance surveillance and macroprudential framework, particularly ahead of the expected normalization of the ECB’s policies. We also concur with staff on moving swiftly to enhance the macroprudential toolkit well in advance of any evidence of overvaluation in the housing market.

Mr. Johnston and Ms. Park submitted the following statement:

We thank staff for the informative reports and Mr. Moreno, Mr. Montero and Ms. Mulas for their detailed buff statement. The Spanish economy has been growing strongly, the overall unemployment rate has fallen, and corporate and household indebtedness has declined. Nonetheless, crisis legacies linger, with public debt and long-term unemployment remaining high and bank capital below the level of European peers. We agree with staff and the authorities that the focus needs to be on continuing to improve fiscal sustainability, addressing the factors contributing to persistently high youth unemployment and slow productivity growth and strengthening the financial system.

Continued fiscal consolidation is necessary to put Spain's high public debt on a downward path and enhance economic resilience. We welcome the authorities' strong commitment to meeting their fiscal targets while preserving growth and fostering social inclusion. However, reconciling these objectives can be challenging. With revenue-to-GDP well below that of euro area peers, there appears to be scope for additional revenue measures which could improve the medium-term fiscal position and at the same time finance social and distributional objectives. But, as staff highlight, some of the revenue measures proposed by the authorities may be distortionary and/or may not immediately generate the estimated revenues. On this point, we welcome the authorities' commitment to closely monitor budget execution throughout 2019 to avoid deviations from targets. We also see merit in staff's suggestion that revenue initiatives should include measures that expand VAT collection, raise excise duties and environmental levies and reduce inefficiencies in the tax systems. Similarly, the authorities' commitment to link pension increases to purchasing power should be implemented alongside measures to extend working lives, broaden the base for contributions, and encourage other saving for retirement.

Improvements in the functioning of the labor market are needed to achieve more inclusion and higher wages, and there is also scope to boost productivity. Insider-outsider problems can be addressed through measures that increase the attractiveness to employers of permanent employment, and we agree that these could include reducing hiring costs and severance payments, setting up an employer-based severance fund and addressing legal uncertainties around dismissals. Supporting wage flexibility, and allowing wage increases to follow productivity growth and reflect differences in region and sector specific conditions, can support the reallocation of labor and increase employment. We encourage the authorities to ensure that any fine tuning of labor market reforms maintains wage flexibility gains. While staff argue that the proposed increase in the minimum wage would increase the ratio of the average wage to one of the highest rates in the EU, the authorities argued that the proposed increase would take this ratio to around the OECD average; how can these different assessments be reconciled? Policies to enhance employability are also important, and given skills mismatches and skills gaps, we welcome the authorities' plans to improve the identification of skills required by the labor market alongside improvements in training and education.

Strengthening resilience and addressing crisis legacies is also a priority in the financial sector. We welcome the progress that has been made in reducing the volume of impaired assets and improving profitability. Further progress in building up capital buffers would increase resilience to potential shocks, including volatility in emerging markets, given Spanish banks' exposures to subsidiary operations in emerging markets. Planned progress with financial sector architecture is also welcome, including the creation of a national financial stability authority and a fintech regulatory sandbox.

Mr. Agung and Mr. Srisongkram submitted the following statement:

We thank staff for the concise set of reports and Mr. Moreno, Mr. Montero, and Ms. Mulas for their insightful buff statement.

We commend the authorities for implementing a comprehensive reform package that underpinned Spain's strong and broad-based growth performance. However, the economic outlook is subject to mounting downside risks from external developments. This underscores the need to build resilience while growth momentum is strong. At the same time, renewed impetus for reforms is warranted to lift potential growth as structural challenges pertaining to the labor market and productivity remain. We broadly agree with the thrust of staff's appraisal and offer the following comments for emphasis.

Credible and well-calibrated fiscal retrenchment is critical for ensuring fiscal sustainability and buffer for future shocks. We concur with staff that fiscal consolidation should be pursued more actively while economic conditions are favorable, and welcome the authorities' commitment to meet fiscal targets. In light of new revenue measures targeted at high-income earners in the 2019 budget, we agree with staff that less distortionary measures such as broadening tax collection and reducing tax inefficiencies could be more effective in creating space for social spending. The implementation of these measures should also be carefully considered in the context of the broader fiscal consolidation to minimize contractionary effects on growth, especially when urgency may lie more on the expenditure side. What are staff's view on prioritization and sequencing of fiscal adjustment? To improve the sustainability of the pension system, we agree with staff that reform options such as incentivizing longer work lives, increasing contribution from the self-employed, and encouraging supplementary savings should be considered. These could also serve to improve productivity as well as promote financial discipline.

Policies to reduce labor market rigidities and upgrade labor skills should be pursued to alleviate structural unemployment, especially the young, and uplift productivity growth. We concur with staff on the importance of promoting labor mobility across regions to allow better resource allocation towards more productive regions or sectors. Reducing labor market duality by incentivizing open-ended employment contracts would also create a more durable labor market. This would mitigate the loss of labor employability during a protracted economic downturn associated with high share of part-time employment. We acknowledge disparity in staff’s and the authorities’ views regarding the impact of the planned minimum wage increase on employment for low-skilled labor and the younger generations. Could staff provide some assessment on how much the proposed statutory minimum wage increase would impact employment opportunities for the low-skilled and the young, as well as details and sequencing of the authorities’ plan to improve labor quality in support of the envisaged wage growth?

Staff’s in-depth analysis of Spain’s productivity growth highlighted the need to address labor skill mismatches and innovative capacity across regions, and to incentivize firm growth and innovation. We support staff’s call for better coordination in implementing active labor market policies across regions to foster overall employability, as well as for the timely implementation of the Market Unity Law. We note staff’s view to modify or eliminate size-related regulations such as reducing corporate income tax for certain SMEs as these could lead to the “small business trap”. Nevertheless, SMEs would likely remain a major source of employment and innovation. Therefore, the authorities’ plan to strengthen support for SMEs is a step in the right direction. We would emphasize that policies should continue to focus on building capacity, reducing barriers, and incentivizing innovation for SMEs. Do SMEs play a big role in driving innovation in Spain?

We take positive note of the progress made in the banking sector to address the four priority areas identified during the 2017 FSAP and share staff’s view that there is growing urgency to further build resilience under tightening global financial conditions. Banking system health has continued to strengthen as asset quality improves, in part due to favorable economic conditions. Nevertheless, we share staff’s view that Spanish banks should accumulate higher capital buffers to cushion against potential shocks arising from volatility related to emerging markets as well as to foster confidence in the banking system. We also support staff’s call for more rigorous management of liquidity and interest rate risks ahead of pending monetary policy normalization by the ECB. In addition, we commend the authorities for their timely actions to strengthen financial stability oversight with the creation of the national macroprudential authority, and to support financial innovation with the launch of the new fintech regulatory sandbox.

With these comments, we wish the authorities well in their future endeavors.

Mr. Castets and Ms. Gilliot submitted the following statement:

We thank staff for their insightful set of documents that set clearly light on Spain's macroeconomic situation and challenges. We also thank Mr. Moreno, Mr. Montero and Ms. Mulas for their informative and useful buff statement, in particular on the detailed policy agenda. Despite the moderation of the global and euro area economic growth and the rise in uncertainty, Spanish economy has only moderately slowed down in 2018. In this respect, we agree with Staff's overall positive assessment both on the economic outlook and on the improvement of fundamentals allowed by past reforms. We also concur that, in the face of persistent vulnerabilities and of rising external risks, actions should be taken to maintain the progress made over the recent years and to further strengthen resilience and inclusiveness of the economy. Stronger and sounder path of public finances and the elimination of markets' rigidities from a demand and a supply-side perspective appear as priorities. Regarding the extensive policy agenda, we praise the authorities for the detailed reform plan put forward to lift productivity growth and unlock growth potential. We associate ourselves with the statement made by Mr. Ostros and would like to make a few additional comments.

Economic Outlook

Economic growth has been sustained since 2014, fueled by domestic demand revival, a dynamic labor market and strong export performances. According to staff, the economy seems to have passed its cyclical peak which, along with the weakening of goods and services exports, has started to translate into a gradual slowdown in economic activity. Part of the increase in the economic activity has been sustained by conjunctural factors – higher demand of its European and worldwide economic partners, lower oil prices, a favorable financing environment – whose positive effects have yet started to fade away translating into a moderation in growth that will continue over the coming years. Given the rise in the global uncertainty outlook, we understand that projections may highly depend on external risks occurrence. However, they are also depending on the evolution of structural factors like job creations and structural unemployment. developing. We would be interested in staff comments on the cyclical or structural nature of this slowdown linked somehow to the decline in tourism dynamism. With the economy projected to grow at 2,5 percent and 2,2 percent in 2018 and 2019 respectively, growth is slowly converging to its estimated potential rate.

Fiscal Policy

On the revenue side, we would also insist in the improvement of taxation efficiency. In line with staff's recommendations measures to expand VAT collection – along with the elimination of some of the exemptions regimes – and raise excises duties and environmental taxes are to be preferred as they are less distortive to short-term economic activity. Safeguarding the pension system's financial viability while preserving the intergenerational fairness are of upmost importance. We agree that increase in pension over several years should be limited to help eliminating the structural deficit of the social security budget but relinking them permanently to inflation would warrant compensation measures to preserve the sustainability of its pension system over the medium-term. Given its specific demography which includes a low birth rate and the high share of youth unemployment policy actions aimed at raising revenues should be carefully contemplated so as not to create distortion effects on long-term unemployed and more vulnerable people.

Labor Market

Regarding the high structural unemployment, specific policy measures should be taken to enhance long-term unemployed employability and the regional labor mobility through severance payments and housing costs coverage. Mobility across regions is crucial to promote the convergence of unemployment rates at a national level and avoid long-lasting effects of prolonged unemployment, especially with young and less-qualified people. We also agree with the authorities that the improvement in the quality of jobs could help boosting productivity and wage growth. On the latter, we note that the budget draft for 2019 includes a rise of the minimum wage. Wage increases must follow productivity growth, and in that, we share staff's cautious advice to preserve wage flexibility event if the impact on competitiveness and employment might be limited given the relatively low level of the minimum wage in Spain. Staff comments are welcome. Taxation and social transfers could prove to be more useful to reduce disparities and poverty than minimum wages hikes. The implementation of plans that improve education outcomes, upgrade skills and reduce skills mismatches, as detailed in Mr. Moreno, Mr. Montero and Ms. Mulas buff statement, should be encouraged. Incentives provided to recent graduated to set up their company seem promising.

Productivity Issues

We recognize that past structural reforms have helped improve productivity and narrow the country's gap against its European partners. As shown in Mr. Moreno's buff statement, the authorities are aware of the need to keep addressing this issue. We concur that more emphasis should be put on the rapid implementation of the Market Unity Law to remove barriers to free competition and make it easier for economic agents to settle and circulation among the national territory. The recent decision in 2018 to transfer chauffeur-driven cars licenses grants from the central authorities to regional and local authorities goes in the opposite direction. Moreover, the legislative plan does not seem to contemplate the elimination of regulatory thresholds effects on firms.

Mr. Mouminah, Mr. Alkhareif and Mr. Rouai submitted the following statement:

We thank staff for a well-written set of reports and Mr. Moreno, Mr. Montero, and Ms. Mulas for their candid buff statement. We broadly share staff conclusions and policy recommendations and would like to make the following comments.

Spain continues to bear the fruit of comprehensive structural and other economic reforms implemented in the aftermath of the euro area crisis. GDP growth remains strong and sizable reduction in unemployment has been achieved. Similarly, the private sector continues to deleverage, and the banking system performance has improved.

Spain remains, however, confronted with significant challenges. Youth unemployment remains high and little progress has been achieved in reducing the public debt ratio from its high. In addition, the limited gains in productivity are delaying Spain's income convergence to European peers and limiting the prospects for enhancing inclusive growth and reducing income inequality. Here, we welcome staff analysis in the Selected Issue paper on regional productivity and we encourage the authorities to consider staff recommendations.

Against the background of increasing downside risks, we encourage the authorities to continue to strengthen their reform efforts, in particular in the area of structural reforms, to enhance the resilience of the economy. While we welcome the authorities' intention to address current challenges and lower inequality, their reform efforts will be challenging in the absence of a clear majority in parliament. In this regard, we appreciate the recognition in the buff of the need to reduce the public debt-to-GDP ratio, further lower unemployment, and reduce inequality, even under the new political reality associated with a fragmented parliament. However, staff concludes that it will be difficult to advance legislative initiatives without a stable parliamentary majority. In this regard, we would appreciate staff elaborations on the prospects for the approval of the 2019 budget. More broadly, how staff is calibrating its policy recommendations to take into consideration Spain's particular circumstances? Specifically, what kind of measures the authorities could undertake to rebuild fiscal buffers and reduce public debt if no new budget is approved? In any case, we encourage the authorities to avoid reversing past reforms, which were critical in improving the resilience of the economy in recent years. They also should build on their exit this year from the European Union's Excessive Deficit Procedure to send a strong signal about their commitment to fiscal discipline.

We support staff recommendations to improve labor market performance. Despite recent gains, unemployment in Spain, particularly among youth, remains high, exceeding the euro area average. Staff has made a number of helpful recommendations to reduce the rigidities in the labor market through active labor market policies to increase human capital, address skill mismatches, and reduce labor market duality. While we can sympathize with the authorities' position to fine-tune labor market regulations to promote better-quality employment, including through increasing the minimum wage and reforming collective bargaining, we also encourage them to carefully consider staff recommendations.

We welcome the improvement in the soundness of the banking system and encourage the authorities to continue addressing crisis legacy issues. We welcome the decline in NPLs and the improvement in banks' capital and solvency ratios. Staff notes in ¶36 that "actions taken to address the FSAP recommendations so far have been limited in some areas." In our view, staff assessment could have been more balanced. Looking at Appendix V on the implementation status of the FSAP recommendations, our assessment is more sanguine, as the authorities were able to advance reforms in just one year in 13 out of the 15 areas.

With these remarks, we wish the authorities continued success.

Mr. Trabinski and Ms. Urbanowska submitted the following statement:

We thank staff for their candid set of reports and Mr. Moreno, Mr. Montero, and Ms. Mulas for their informative buff statement.

We broadly share staff's assessment of the economic outlook and the balance of risks. Spain's solid recovery, driven mainly by private consumption and investment, and supported by stronger job creation, is holding up. However, the economic cycle is maturing and growth is expected to level off at its medium-term potential. Moreover, emerging external and internal downside risks cloud the medium-term outlook. Tighter global financial conditions could further increase public debt servicing. We concur with staff that resuming past reform momentum is important to increase resilience further and to avoid a hard landing.

Encouraging further fiscal consolidation will be crucial. Despite public debt close to 100 percent of GDP and highly sensitive to multiple potential shocks, the fiscal stance eased in 2018. While we recognize the need for a shift toward policies protecting the most vulnerable and reducing income inequality, fiscal discipline will be essential to put debt on a firm downward path. The current favourable economic situation should be utilized to consolidate and further build on past policy achievements to reduce vulnerability to potential risks. Therefore, we concur with staff's recommendation to focus on revenue measures aimed at improving VAT compliance, reducing tax system inefficiencies, and increasing environmental and real-estate taxes. On expenditures, to alleviate age-related spending pressures, we encourage the authorities to take concrete action to achieve a sustainable pension system.

The labor market continues to strengthen, but significant challenges remain. Spain has made substantial progress in labor market reform. However, some longstanding weaknesses remain. These translate into still high structural unemployment, especially among the young. We welcome the authorities' efforts to address the labor market duality. However, the effectiveness of active labor market policies needs to be streamlined. In this regard, addressing skills mismatches and enhancing the quality of education would be desirable. Moreover, we think that a new impetus would be needed to boost productivity growth. This could be achieved by inter alia reducing regulatory fragmentation, lowering barriers for firms' growth, improving greater labor mobility, and better skills-matching. We also encourage the authorities to further implement the Market Unity Law. To lift productivity growth, more effort is needed to foster innovation, including advancements in a more efficient use of technology.

The banking system continues to strengthen. We share staff's overall assessment of the progress to improve asset quality and solvency. However, challenges remain. Spanish banks should continue the build-up of capital buffers and address low profitability. Moreover, there is a need to intensify efforts to implement the 2017 FSAP recommendations. In this context, we call on the authorities to further improve financial sector oversight, and in particular to expend the macroprudential toolkit. Given the uncertainties related to emerging markets and Spanish banks' exposure to Latin America, could staff elaborate on potential consequences of adverse shocks for the banks' capitalization?

Ms. Levonian and Mr. Feerick submitted the following statement:

We thank staff for their well-written report and focused selected issues paper. We also thank Mr. Moreno, Mr. Montero and Ms. Mulas for their useful buff statement. We commend the authorities for their commitment to reform since the low point of the crisis and observe that the outlook is reasonably positive. However, with high public debt and persistent structural unemployment, there is a need for Spain to take advantage of the cyclical upswing to underpin longer-term sustainability. We agree with the thrust of the staff assessment and offer the following comments for emphasis.

We note that Spain's public debt remains classified as at risk of debt sustainability which underscores the need to implement durable fiscal consolidation efforts. We welcome the authorities' 'strong' commitment, as set out in the buff, to reversing the last four years of procyclicality, including the specifying of measures in the 2019 Budget. With Spain's public debt sustainability at risk, it will be important to put debt-to-GDP, which currently stands around 100 percent, on a downward track. As with many advanced economies, a comprehensive approach to address the longer-term sustainability of the pensions system is warranted and we encourage the authorities to reflect on staff's recommendations. The improved budgetary process for 2019, where a comprehensive gender perspective will be included, represents a useful institutional reform.

Resilience in the banking sector has improved but could be strengthened further. We note staff's view on the significant reliance on profitability from emerging market subsidiaries for the largest Spanish banks. Given the elevated uncertainty at the moment, buttressing the capital position, including through improved organic capital creation, seems like a sensible recommendation. As regards liquidity, a review of the appropriateness of the funding model is warranted, given the significant dependence of Spanish banks on central bank liquidity provision. While overall credit remains subdued given ongoing deleveraging, perhaps the more appropriate metric to look at is new lending which is now growing relatively robustly. Relatedly, the time to enhance the institutional toolkit is now, not when a crisis occurs. In this regard, we are encouraged by the authorities' strong public commitment to create a National Macroprudential Authority by end-2018 that can work towards equipping the Bank of Spain with a borrower-based macroprudential toolkit.

Perhaps the key structural challenge relates to the labor market where structural unemployment remains stubbornly high, notwithstanding some progress under the 2012 reforms. Youth unemployment, which peaked at c. 55 percent during the crisis, remains high at 33 percent. Coupled with issues around underemployment and the prevalence of short-term contracts, there are substantial structural reforms needed to reduce inequality and improve the quality of jobs. We take positive note of the government's action plan to improve education outcomes, reduce pervasive labour duality, and confront gender inequality. More generally, we agree that future wage increases should be linked to productivity increases. Given the heterogeneity of productivity differentials across regions and sectors, allowing flexibility in the wage setting process would help competitiveness. As regards ALMPs, we welcome the authorities' plans to enhance coordination between regions and the better tailoring of skills required by the labor market. This is particularly important as 40 percent of the labor force is comprised of workers with, at most, lower secondary education, and skills gaps are a key impediment to taking up employment.

Mr. Just and Mr. Hagara submitted the following statement:

We thank staff for a well-balanced report and Messrs. Moreno and Montero and Ms. Mulas for their informative buff statement. Spain's economy has continued to grow strongly, reflecting longer-term payoffs from considerable past structural reforms. Domestic and external imbalances have been reduced, the unemployment rate has declined substantially, the fiscal deficit has been reduced, the financial sector has strengthened, and external competitiveness has improved. Nevertheless, despite these significant achievements, important vulnerabilities remain, including high debt levels and structural unemployment. Moreover, downside risks to the already softening outlook seem to be on the rise. As the economy has already recovered to its potential, priority should be given to rebuild buffers, while boosting the potential. We therefore encourage the authorities to continue with their reform efforts. We share the thrust of staff's appraisal and recommendations and associate ourselves with the statement by Mr. Ostros and Ms. Skrivere.

Fiscal consolidation has to be resumed to rebuild buffers and put public debt on a clear downward path. The headline fiscal deficit has been reduced from over 10 percent in 2012, to close to 3 percent in 2017-18, but most of the improvement in the past several years was of a cyclical nature. Moreover, public debt is close to 100 percent of GDP and restricts the room for policy activism. Against that backdrop, we call on the authorities to use the still good economic times to restart consolidation efforts. With relatively low public spending, these consolidation efforts should focus on the revenue side and we see scope to remove tax deductions and exemptions, in particular for the VAT, although the potential yield may be lower than presented in the staff report. We agree that the consolidation efforts should be accompanied by targeted shifts in the fiscal mix to protect the most vulnerable. Staff's comments would be appreciated whether the approach followed by the Portuguese authorities on addressing inequality while continuing with an overall restrictive fiscal policy and in particular the thoughtful communication by the Portuguese authorities could serve as an example for Spain.

Financial viability of the pension system needs to be preserved. The 2011/13 pension reform was quintessential in reining in spending pressures from population aging. While we agree on the importance of taking into account pension adequacy and acknowledge that the costs of recent government steps have thus far been limited, any further actions by the authorities need to be designed carefully to preserve the fiscal sustainability gains of the past pension reforms.

The continued improved soundness of the financial sector is welcome, but more needs to be done and we encourage the authorities to continue with implementing the 2017 FSAP recommendations. While NPLs have generally been reduced, they remain elevated in some banks and fully-loaded CET1 capital remains lower than in many European peers. Overall, house prices remain below pre-crisis levels, but the developments differ across regions. We encourage the authorities to expedite their work to expand their macroprudential toolkit to be able to introduce borrower-based tools, including limits on loan-to-value and debt service-to-income ratios should the need arise. Given the increasing intra-system connectedness as well as the strong cross-border presence of Spanish banks globally, the establishment of the Systemic Risk Council should be expedited to ensure effective oversight.

Renewed structural reform efforts are key for increasing medium-term potential growth and reducing high structural unemployment. While the unemployment rate has declined further in 2017, it is still high, in particular among the youth. With skill mismatches being a particular challenge in Spain, more extensive use of active labor market policies should be considered. At the same time, Spain's productivity remains below the European peers. In the medium term, further liberalization of product and service markets should be considered, while education system reform with a focus on science and technology teaching is key to equip the young with the requisite skills to succeed in the digital economy.

Ms. Riach and Miss Chen submitted the following statement:

We thank staff for a set of comprehensive reports, and Mr. Moreno, Mr. Montero and Ms. Mulas for their helpful buff statement. In these uncertain times, we welcome that the Spanish economy is continuing to grow strongly and is reaping the benefits of past reforms. As downside risks loom, many of which are externally driven, the authorities should focus on enhancing the economy's resilience and remain steadfast to their reform agenda. We broadly agree with staff's recommendations and associate ourselves with Mr. Ostros' statement.

Fiscal Policy

We welcome the authorities' strong commitment to meet the fiscal targets and the significant reduction in the fiscal deficit since 2010. Spain's public debt level remains high, we therefore agree with staff that active fiscal consolidation is a key component of a resilience enhancing policy package. The authorities should take full advantage of the current good economic conditions to bring down the public debt and avoid the need for procyclical contraction later in the cycle. We are therefore encouraged by the authorities' strong commitment to reversing the procyclical fiscal stance over the past few years as outlined in the buff statement.

Pension reforms are often emotive and difficult. Nonetheless, given the limited fiscal space and increasing aging associated costs the authorities should consider taking further steps to keep pension expenditure at a sustainable level. It is also important to recognize the need for intergenerational equality when considering further changes to the pension system. Especially since the young are facing much higher risk of poverty and unemployment, which will have a long-lasting impact on their prospects and the Spanish economy's.

Structural Reform

We welcome the authorities' intention not to reverse past labour market reforms. The planned increase in the statutory minimum wage, is sharp and bigger than any previous increase (22 percent). We agree with staff that the increase could put employment opportunities at risk and would make the minimum wage binding for more people. The negative employment effects are likely to be relatively small for the labour force as a whole and could be outweighed by expected wage gains. However, as staff note, there could be a disproportionate impact on the more vulnerable sections of the labour force such as the youth and this could worsen Spain's high youth joblessness problem. The authorities should consider staff's advice for greater minimum wage differentiation.

Financial Sector

We broadly agree that the recommendations from the 2017 FSAP remain relevant. We welcome the accelerated decline in non-performing loans, however in some banks the levels remain elevated and will need continued attention from the authorities. We note staff's recommendation on more rigorous management of liquidity risks: can staff elaborate on what the authorities could do and provide views on whether there are challenges to Spanish banks' implementation of the net stable funding ratio?

Mr. Merk and Ms. Fritsch submitted the following statement:

We thank staff for their report and Mr. Moreno, Mr. Montero and Ms. Mulas for their insightful buff statement. Spain has experienced a strong and durable recovery that helped to outgrow some of the losses incurred during the crisis and regained much of the economy's competitiveness. However, we would like to underscore the need to set public finances on a sustainable footing, to revitalize structural reform dynamics, and to further advance the resilience of the financial sector. We associate ourselves with Mr. Ostros' statement and would like to add the following comments for emphasis.

Although fiscal deficits have steadily narrowed, partly owing to strong economic tailwinds and monetary conditions that both are likely to gradually subside, risks to debt sustainability remain elevated and a clear downward debt trajectory and a rebuilding of fiscal buffers are needed. In this regard, the recent deterioration of the structural primary balance contrasts with the need to advance fiscal consolidation in good times. There is a need to rebuild sufficient fiscal buffers and to ensure full compliance with European fiscal rules. Additionally, long-term budgetary planning should account for demographic challenges and involve prudent choices of how to anchor age-related expenditures to ensure affordability and sustainability as well as social acceptability. Therefore, the financial sustainability of the pension system should be improved.

We tend to agree with staff's consideration that the scope for further expenditure rationalization is rather limited, supporting the notion that revenue measures seem to be the most promising avenue for reducing fiscal deficits. As the yields of some of the proposed tax measures are subject to uncertainty, the budget planning process should be guided by prudence and if necessary, by identifying additional revenue measures.

Notwithstanding substantial reductions in unemployment over the last years, stubbornly high structural unemployment, fragmentation, and skill mismatches are still characteristic features of the Spanish labor market. Pervasive labor duality – which mostly affects the young generation, women, and vulnerable groups – impedes labor productivity growth and hampers investment in human capital. To reduce employers' reliance on fixed-term contracts and to facilitate transition into open-ended positions, the flexibility of the labor market needs to be strengthened. In addition to wage flexibility, active labor market policies could play a role in the form of improved advisory and placement services and skill-building and skill-matching policies. In this regard, we welcome staff's recommendation to improve tertiary education that equips graduates with the relevant skills needed by firms. At the same time, we would put more emphasis than staff on the promotion of vocational education and training, which is in our view also highly relevant to address skill mismatches in the labor market against the backdrop of prevalent overqualification and newly created jobs often being found in the medium-skill segment. Staff comments welcome. We appreciate staff's insightful analysis of regional labor market mobility and concur that incentivizing higher mobility could reduce high structural unemployment. Could staff elaborate on its suggestion to provide targeted housing assistance and, in how far characteristics of the Spanish housing market (e.g. preference for owning vs. renting) might impede mobility?

We agree with staff that regulatory disparities between regions could hamper economic activity. In this regard, further progress to revitalize impetus to create a nation-wide regulatory level playing field for businesses seems to be particularly important. Could staff give specific examples of impediments caused by undue regulatory disparities, preferably those for which a regulatory reform would seem realistic and/or those having a major detrimental impact?

We encourage speeding up the reduction in the stock of NPL in the banking sector, whilst recognizing that progress has already been made. To enhance resilience and to keep pace with the risk reduction agenda, further efforts to endow the banking sector with higher capital buffers and actions to comply with MREL targets seem warranted. Higher capital buffers would also be instrumental in coping with the challenges related to the banking sector's sensitivity towards liquidity and interest rate risks.

We take note of staff's assessment that the recovery in the real estate market and rising house prices do not (yet) constitute an immediate concern, but price dynamics should be monitored closely. With this in mind, and given the recent expansion of consumer lending, we echo the suggestions to expand the macroprudential toolkit to have appropriate instruments ready should risks materialize.

Mr. Fanizza and Ms. Lopes submitted the following statement:

We thank staff for a good set of papers and Mr. Moreno, Mr. Montero and Ms. Mulas for the helpful buff. We associate ourselves with Mr. Ostros' statement and offer just a few additional comments.

We agree with staff that policies should continue to address the stock imbalances that were accumulated during the crisis, as the external environment is likely to become less benign. In particular, we stress the importance of the structural reform agenda that should foster productivity growth and help improving the country's NIIP.

We understand that authorities and staff do not share the same views on labor market issues. Staff seem to have doubts on the authorities' decision to raise the minimum wage, because of a possible adverse impact on employment. Whereas, the authorities do not believe there is sufficient empirical evidence in support of an adverse impact; they see it as a useful tool to improve job quality and improve living conditions for unskilled workers. We are wondering if staff could advice the authorities on how to device a monitoring system for the possible impact of minimum-wage levels on employment, so that, if confirmed, the measured could be rolled back.

Regional disparities stand out in Spain. The wealthiest region's per-capita GDP is twice as high as that of the poorest. The report calls for increased inter-regional workers' mobility and goes as far as to suggest considering relocation benefits. We would caution in this regard, not only because of the cost implications, but also because of possible perverse effects. Shouldn't, instead, wages be left doing their job? If there are obstacles to the needed wage adjustments to better allocate workers among regions, policies should focus on their removal.

Lastly, on the financial sector, we support the establishment of a National Macroprudential Authority, as well as the extension of the macroprudential toolkit available in Spain.

Mr. Mozhin, Mr. Palei and Mr. Tolstikov submitted the following statement:

We thank staff for the well-written papers and Mr. Moreno, Mr. Montero and Ms. Mulas for their informative buff statement. Strong recovery of the Spanish economy created conditions for the significant reduction of imbalances accumulated during the crisis. Spain achieved substantial progress in bringing down unemployment, boosting investment and reducing headline fiscal deficit. Banking system has been reshaped, credit conditions improved, and bank lending is recovering. Comprehensive structural reforms resulted in strengthened fundamentals and improved competitiveness.

Notwithstanding these positive developments, policymakers are still facing substantial legacy challenges and new risks. Unemployment is high, particularly for the young, and the share of workers employed under temporary contracts remains elevated. Despite recent progress in the fiscal area, public debt remains close to 100 percent of GDP and gross fiscal financing needs are still among the highest in the euro area, with elevated bank-sovereign nexus. Total factor productivity is lagging, while the share of low skill workers is high. Overall, the economy remains vulnerable to shocks. It is encouraging that the authorities recognize the need to reduce vulnerabilities and build up policy buffers.

Elevated public debt level remains a key vulnerability, and continued fiscal consolidation remains a key priority. We commend the authorities for their strong fiscal efforts aimed at allowing Spain to exit the Excessive Debt Procedure in 2018. At the same time, we agree with staff that in order to avoid procyclical fiscal tightening in case of a sizeable shock, it would be prudent to accelerate somewhat the accumulation of fiscal buffers by adjusting fiscal deficit target for 2019. There is still substantial room to increase fiscal revenues, which should be done in growth-friendly and non-distortive way.

Reducing tax exemptions, increasing effective CIT rate, and raising progressivity of income and wealth taxes would not only increase revenues but also bring down relatively high income inequality. In this regard, we support the advice to implement expenditure measures tailored to enhance social cohesion.

On the one hand, indexation of pensions in line with inflation is likely to eventually put pension spending on an upward trajectory. On the other hand, limiting pension increases to the legislated minimum rate of 0.25 percent will reduce purchasing power of pensions benefits. To address these tensions, the authorities need to embark on a comprehensive reform of the pension system, including changes to contributions and additional labor market reforms.

Despite the substantial labor market reforms in Spain, additional efforts are needed to increase potential growth and reduce inequality. High structural unemployment and the labor market duality, as well as persistently high youth unemployment, highlight the need for the next steps in the labor market reforms. We agree with staff that the complexity of the task requires a holistic approach, which may include reinforcement of education system, vocational training, improvement of language skills, etc. We note some divergence of views between staff and the authorities on the merits of increasing minimum wage and reforms of collective bargaining system. In our opinion, these issues deserve additional analysis at the time of the next Article IV consultations.

We welcome the ongoing improvement in the health of the Spanish banking system, including substantial decline of non-performing loans, recovery of profitability and higher capital ratios. Recent expansion of consumer lending warrants close monitoring. Having in place a comprehensive macroprudential toolkit is also essential to reduce risks of housing market misalignments. We welcome the strengthening of the financial system infrastructure, including the announced creation of a national macroprudential authority, as well as the progress in establishing a regulatory sandbox for Fintech startups.

With these remarks, we wish the authorities success in their endeavors.

Ms. Pollard and Mr. Grohovsky submitted the following statement:

Spain continues to experience strong growth in output and employment aided by strong fundamentals. Nevertheless, important structural and unemployment challenges remain. In addition, despite a significant fiscal consolidation public debt remains high. We thank staff for their report, concur with the assessment, and limit our comments to the most pressing issues facing the Spanish economy.

Despite recent gains, the labor market remains the largest structural challenge in Spain, with broad unemployment, youth unemployment, and long-term unemployment all significantly above euro area averages, and a labor mobility rate that is low by international standards. We welcome the recognition by the authorities, as noted in the buff statement of Mr. Moreno, Mr. Montero, and Ms. Mulas, of the challenges faced and the need for a comprehensive approach. Unfortunately, this is also the area where there is the biggest disagreement between the authorities and staff. We urge caution when considering policies that may negatively impact the young and unemployed, such as the proposed large increases in the minimum wage, as wage flexibility is paramount to help boost employment opportunities for these groups and improve labor mobility. Additionally, could staff comment on the projected effects on the youth and long-term unemployed of the latest collective bargaining agreement? Concerning labor mobility, what policies has staff examined or recommended to incentivize labor movement, especially to overcome a strong “home bias”?

We welcome the commitment of the authorities to reduce public debt levels, with a goal of attaining a primary surplus for the first time since 2007 and bringing debt levels down by the largest amount since 2014. However, we note staff’s assessment that an extension of the 2018 budget due to lack of parliamentary support for the 2019 budget would result in a larger gap with this target. We encourage the authorities to identify measures now, on both the revenue and expenditure sides, that could be implemented quickly to help reach fiscal targets. We also believe the authorities should consider revenue measures as outlined in the staff report that would reduce inefficiencies in the tax system, as opposed to digital or financial transaction taxes which would be more distortive and which should move in sync with an international framework. Risk of backsliding on pension reforms also poses a significant fiscal risk and should be considered within the overall fiscal context.

Finally, we welcome the authorities’ efforts to improve financial sector resilience. The 2017 FSAP provides useful recommendations in this regard. Some progress has been made on disposing of NPLs but strong implementation of the ECB’s NPL guidance is still needed. Further capital buffers and an improved legal framework for macroprudential policies would also help guard against a future shock to the financial system.

Mr. Jin and Mr. Fan submitted the following statement:

We thank staff for the comprehensive set of papers and Mr. Moreno, Mr. Montero, and Ms. Mulas for the buff statement. It is encouraging to see strong growth and fundamentals, including the decline of leverage, unemployment, and NPLs. However, daunting challenges remain, such as the stubbornly high public debt and structural unemployment. We broadly share staff's assessment and would like to limit our comments as follows.

Concrete efforts are warranted to resume active fiscal consolidation and create needed fiscal space. It is good to note that even if the headline deficit turns out to be considerably above the budget target due to the outrun of expenditure, Spain could still be qualified to exit the excessive deficit procedure. However, with public debt levels hovering around 100 percent of GDP, we would express our concern on the sustainability of Spain's public debt and its vulnerability under several shock scenarios, and agree with staff that more should be done to contain it and resume fiscal consolidation. We support the authorities' draft 2019 budgetary plan, which will bring deficit down to 1.8 percent of GDP mainly via revenue measures. We also welcome the authorities' measures to strengthen regional financing and reinforce compliance with deficit targets. We noticed from the buff that the authorities will move forward to link the pension increase to inflation and noted the potential implication on budget, as well as significant funding needs caused by such decision. We welcome staff's elaboration on what additional measures should be taken to make such sharp increase in spending sustainable.

Reducing long-term and youth unemployment by addressing rigidities in the labor market remains a top priority. Although unemployment declined during recent years, structural unemployment remains stubbornly high. We agree with staff that labor market duality, labor market conditions, and housing market prices might be the key factors associated with low regional labor mobility. We thus encourage the authorities to take concrete measures to improve the attractiveness of open-ended contracts to employers and improve the wage flexibility. We commend the authorities for their decision to raise the minimum wage and improve the organized decentralization in collective bargaining. We noticed the staff's recommendation to avoid a sharp increase in the annual statutory minimum wage and to allow greater minimum wage differentiations. We welcome staff's comment on whether the authorities' current plan meet their expectations.

Further action is needed to strengthen the resilience of the financial system by implementing staff's FSAP recommendations in a timely fashion. It is encouraging to see the decline of NPLs and resilience in the banking system. However, with the capital ratio still lagging behind European peers, we agree with staff that concrete measures should be taken to accelerate the build-up of high quality capital buffers. We see a strong need to manage liquidity and interest rate risks under increasing uncertainties that ECB might increase rates in the near future. We also encourage the expansion of the central bank's macroprudential toolkit to better monitor the risks embedded in the rising consumer lending and housing-related new loans. While we commend the creation of a national financial stability authority (ANESFI), we welcome staff's elaboration on the reasons why insurance regulation is not included in this institution.

Mr. Daïri and Mr. Osei Yeboah submitted the following statement:

We thank staff for a well-written set of papers and Mr. Moreno, Mr. Montero, and Ms. Mulas for the informative buff statement.

Spain's economic recovery continues to be impressive, with growth well above the Euro area average and significant employment gains amid moderate inflation, reflecting strong fundamentals. The broad-based nature of growth and significant improvement in productivity are a clear indication that past structural reforms are yielding results. However, with the economy maturing, downside risks are looming, with less favorable and more uncertain global environment and rising trade tensions. Moreover, the risk of renewed unrest in the Catalonia region, although diminishing, coupled with still high structural unemployment could adversely impact productivity growth and slow Spain's income convergence with the euro area. We are encouraged by the new Government's economic policy agenda focused on ensuring fiscal discipline and rebuilding fiscal buffers, lowering inequality, and strengthening structural reform implementation, as highlighted by Mr. Moreno, Mr. Montero, and Ms. Mulas. We broadly concur with the staff assessment and recommendations and have the following comments.

Procyclical policy stance over the past two years has brought gross government debt close to 100 percent of GDP, increasing the country's vulnerability to shocks. Although the cost of debt is on a downward trend and headline fiscal deficit continues to decline, while structural fiscal adjustment is showing some progress, gross financing needs of Spain is among the highest in Europe. Revenue measures introduced and improvement in monitoring and compliance of local government with sound fiscal management have helped, but fiscal vulnerabilities persist. Additional effort is required, and we agree with staff's view on the need for creating addition fiscal buffers. We are pleased to know from Mr. Moreno, Mr. Montero and Ms. Mulas that authorities agree with staff's views and are committed to ensure that debt accumulation is on a downward trajectory. We agree that more effort is needed to foster social equality while safeguarding the financial viability of the pension system. We note that fiscal measures are tilted to expenditure control, and agree with staff that there is scope to enhance revenue through improved VAT administration and adjustments to other taxes, especially the environmental tax.

The labor market suffers from protracted rigidity leading to high structural unemployment, including for the youth, a legacy of the crisis. Spain's labor mobility is one of the lowest compared to peers and is helping to exacerbate the structural unemployment problem. Structural reforms should aim at enhancing competitiveness, including by improving education and promoting innovation, as well as reforming the legal framework on labor issues to reduce uncertainty and strengthening an incentive-based workplace by linking wages to productivity and through training programs. We agree with staff that preserving wage flexibility will prove critical in allowing greater minimum wage differential which, while enhancing labor productivity will promote job creation. Nevertheless, we agree with the authorities' view that the announced increase in the minimum wage will not hurt employment in Spain, as illustrated by past experience, in particular since it will only raise the ratio of minimum to median wage to peers' average after six years of no increase, as highlighted by Mr. Moreno, Mr. Montero, and Ms. Mulas.

The financial health of the banking sector is improving but there are still lingering legacy issues from the crisis, which warrant addressing while strengthening the resilience of the sector. We agree with staff that tackling the flagged areas in the 2017 FSAP report, including further clean-up of bank assets, enhancing bank capitalization and profitability, implementing liquidity and interest rate risk management framework, and reforming the institutional framework to strengthen oversight will upgrade the financial architecture. Implementation of ECB's NPL guidance will be a good step forward. We take note of staff indication of the risks from Spanish banks operating in the Latin American region, given their large exposure to Mexico and Brazil, and agree that adopting a consolidated supervisory stance and collaborating with regional regulators will allay the risk of contagion. We welcome authorities' ongoing work to establish a macroprudential authority in the next few months, which will serve them well, especially in mitigating risks from the housing sector.

With this, we wish the authorities continued success.

The representative from the European Central Bank submitted the following statement:

We would like to thank Mr. Moreno, Mr. Montero and Ms. Mulas for their buff statement and Staff for their report. We associate ourselves with the statement by Mr. Ostros and would like to further highlight a few issues.

We share Staff's positive assessment on the economic outlook for Spain. We expect broad-based growth across demand components this year, supported by strong employment growth. However, weakening foreign demand, as suggested by the latest indicators, might weigh negatively on the medium-term outlook. As regards risks to the outlook, we agree that they are tilted mainly to the downside. Rising global protectionism, Brexit, and weakening economic conditions in emerging economies where Spanish banks have exposures, represent such downside risks.

A clear downward debt trajectory and a rebuilding of fiscal buffers are needed, while a viable fiscal position also requires addressing issues related to the pension system and regional finances, while supporting social equality. The structural balance should be reduced to facilitate a clear downward path for the debt-to-GDP ratio. In relation to this, we note that Spain's government revenue-to-GDP ratio is one of the lowest in the euro area and could be raised by further efforts to tackle fraud and broaden tax bases. As regard public finances, we welcome the focus of the report on the sustainability and fairness of the Spanish pension system, and stress that, while reversals of previous reforms should be avoided, socially acceptable reforms should be found, which would ensure viability of the social security system in the long-run. Moreover, the regional financing system currently involves maintaining significant, but unsustainable surpluses at the municipal level. A reform should ensure a more optimal allocation across sectors.

With regards to the financial sector, we share the Staff's overall assessment that the Spanish banking system has made good progress in improving its asset quality; challenges however remain. More precisely, Spanish banks should further improve credit quality, especially in the construction and real estate sectors, and sustain their profitability in the current low interest rate environment with low credit demand. In order to do so, they need to continue to develop business models that move away from their past overreliance on mortgage, real-estate development and construction lending and avoid excessive risk-taking. Spanish banks should also explore the possibility of further mergers and acquisitions as a way of making further cost-efficiency gains, without leading to excessive concentration of the domestic banking sector. Other challenges lie in strengthening CET1 ratios and adjusting funding plans to reduce reliance on central bank funding over the medium term. Finally, we consider a possible appeal of the Supreme Court Decision pertaining to the stamp duty on mortgages as an additional risk for bank profitability worth noting. On the macroprudential policy front, we support both the establishment of a National Macroprudential Authority and the extension of the macroprudential toolkit in Spain. These actions are fully in line with the Staff's FSAP recommendations for reforming the macroprudential institutional framework.

On the labor market, we concur with the need to preserve past reforms and on the importance to address important remaining rigidities, which contribute to the still very high structural unemployment. The attractiveness of open-ended contracts needs to be improved and Active Labor Market Policies (ALMP) need to be assessed and streamlined. In addition, with a view to addressing skill mismatches and the quality of education, reforms to the education curriculum and apprenticeship system would be desirable to equip new labor market entrants with the necessary skills required by digitalization. We note that wage moderation has been supportive of employment creation and competitiveness in the recent years and concur on the need to preserve wage flexibility. Nonetheless, further decentralization of wage bargaining, notably by reviewing the automatic extension of sector-level collective agreements, would also be warranted to foster greater wage differentiation. In addition, the pace of increase of the minimum wage needs to take into account the employment situation of some vulnerable groups, especially the young and the low skilled.

A new reform impetus is necessary to improve productivity and potential growth, as reforms have been rather limited since the start of the recovery. The implementation of the Law on Market Unity, a reduction in the size of contingent regulations and improved research and innovation policies are plausible main areas of reform. In addition, we would stress that further efforts are required to address remaining inefficiencies affecting the judicial system [e.g. protracted judicial procedures for corruption cases; low perceived independence of the system].

The Acting Chair (Mr. Furusawa) noted that Spain had made impressive economic progress. Growth was strong, more broad based, and unemployment was declining. But given the downside risks facing the outlook, it was important to strengthen the economy's resilience. In this regard, Directors' gray statements stressed the importance of fiscal consolidation and structural and labor market reforms, including the integration of the young generation into the labor market.

Mr. Ostros made the following statement:

Past reforms are bearing fruit in Spain, where we see a broad-based economic recovery, a double-digit decline in unemployment, strong job creation, improved external competitiveness, and a more resilient banking sector. However, the work should continue, especially as the risks are tilted to the downside. We encourage the authorities to preserve the progress achieved and avoid a reversal of previous reforms, and continue with new reforms on the financial, fiscal, and structural fronts.

We commend the Spanish authorities for reducing the government deficit from 7 percent to 3.1 percent of GDP in just four years. Yet sources of vulnerability persist. Government debt remains high, at around 100 percent of GDP, and there has been a structural deterioration in the deficit in recent years. In this regard, we encourage the authorities to maintain a firm grip on budgetary policy and to continue with structural adjustments that would put public debt on a firm downward path and rebuild fiscal buffers.

We note that Spain's government revenue-to-GDP ratio is one of the lowest in the euro area and could be raised by further efforts to tackle fraud and broaden tax bases. In view of growing aging-related fiscal costs and an already high government debt level, it is critical to keep pension expenditure on a sustainable footing. The Spanish banking system has made good progress on improving its resilience. However, it is important to persist in efforts to further reduce the legacies of the crisis.

We encourage Spanish banks to develop business models that move away from their past overreliance on mortgage, real estate development, and construction lending, and to avoid excessive risk taking. In this respect, we welcome the authorities' strong commitment to work toward equipping the Bank of Spain with a borrower-based macroprudential toolkit. We encourage the authorities to further strengthen their financial sector's resilience, in line with the 2017 Financial Sector Assessment Program (FSAP) recommendations.

The 2012 labor market reform helped substantially reduce unemployment and contributed to improving competitiveness. Therefore, we highlight the importance of preserving the main elements of the reform. However, given the still high structural unemployment and the remaining reasonable rigidities, we encourage the Spanish authorities to continue implementing their structural reform agenda. In particular, we note the need to address labor market duality, streamline active labor market policies, and improve education outcomes.

Mr. Obiora made the following statement:

We appreciate the staff's work in conducting this Article IV review. We enjoyed reading the lucid reports, and we broadly share their insights and recommendations. We commend the Spanish authorities for their reforms and policies, which have undoubtedly helped solidify Spain's economic growth over the past few years. Indeed, real GDP growth has exceeded the average of the euro area for the fourth year in a row. It is also gratifying to note that growth has become broad-based across demand components, while a turnaround in productivity growth restrained inflationary pressures, and the upgrading of Spain's sovereign debt ratings have all made the macroeconomic outlook quite positive.

Notwithstanding this remarkable performance, we are concerned that Spain still faces several economic challenges and downside risks, most of which are outlined in the report. Overcoming and dealing with some of these challenges will depend on the steadfast implementation of the fiscal deficit reduction reforms and the ongoing three-pillar strategy, which was underscored by the buff statement of Mr. Moreno, Mr. Montero, and Ms. Mulas.

As in life, one prepares for the best, but plans for the worst. To this end and to the extent possible, I wonder if the staff could share their insights into any fiscal contingency reform actions that the authorities may wish to take if revenue shortfalls occur in the short to medium term.

Mr. Alkhareif made the following statement:

We join others in thanking the staff for a well-written set of reports and Mr. Moreno and his colleagues for a comprehensive buff statement.

Since we have issued a detailed gray statement, I would like to make one additional point about the selected issues paper. The paper does an excellent job of addressing the differences in productivity across Spanish regions, which are affected by a skills mismatch, regulatory requirements, and procedures for doing business.

Against this background, we see merit in the staff's recommendations on the need to improve the business environment and to strengthen coordination across different levels of government, including for the design, implementation, and evaluation of research and innovation policies. Like Mr. Ostros, we see merit in applying active labor market policies at the regional level, which will help to close the skills mismatch and education outcomes.

Finally, I would like to ask the staff about its views on the relationship between the shadow economy and the weaker productivity in some regions. Early this year, Fund staff published a working paper titled, "Shadow Economies Around the World." They estimated the size of the shadow economy for 158 countries over a period from 1991 to 2015. The size of the shadow economy ranged between 9 percent to 60 percent of GDP.

In Spain, like other countries, the size of the shadow economy is relatively large. It is about one-quarter of the economy. We were wondering, given the high unemployment, and high compliance with taxes, how does the staff see the impact of the shadow economy, the size of the shadow economy in terms of addressing the productivity gaps across regions? We would appreciate staff's comments on this issue.

With these remarks, we wish the authorities and the Spanish people continued success.

Mr. Saito made the following statement:

We join others in thanking the staff for the informative papers and Mr. Moreno, Mr. Montero, and Ms. Mulas, for their insightful statement. As we have issued a gray statement, I would like to offer three comments regarding financial sector policies.

First, on the reduction of NPLs, it is encouraging that the Spanish banking sector has made good progress in improving asset quality. However, some banks still face elevated NPLs. In this light, we encourage the authorities' steady implementation of the European Central Bank's (ECB) NPL guidance, including promoting banks' disclosure of NPL reduction targets and progress.

Second, on the modernization of the institutional framework, we positively note the authorities' recent proposal for the creation of a national macroprudential authority, with functional independence and a clear mandate.

Having said that, the effectiveness of the new authority relies heavily on the coordination and interaction with the designated authorities going forward. We encourage the authorities' continued efforts to enhance systemic risk surveillance and to promote interagency coordination.

Finally, on the possible negative spillovers from Latin America and Turkey, while we positively take note that the liquidity risk would be limited by the Spanish bank subsidiary model, a significant increase in credit losses in these areas would have an impact on the Spanish financial system, not only through the profitability channel but also through the confidential channel. In this regard, we underscore the importance of rigorous monitoring of credit risks and market reactions stemming from these regions.

Mr. Saraiva made the following statement:

I thank the staff for the good reports and for the answers they provided to the technical questions, and Mr. Moreno, Mr. Montero, and Ms. Mulas, for their useful statement.

I commend the Spanish authorities for their successful economic adjustment, which continues to deliver positive results. In fact, we have a list of important achievements: GDP continues to grow above the euro area average; external accounts have strengthened; the fiscal deficit has declined year after year; the repair of banks' balance sheets has advanced; property prices have started to recover; and even unemployment is declining gradually. In spite that, the unemployment rates are still almost unacceptably high, especially among the youth and the long-term unemployed.

I also commend the new administration for its commitment to continue to address the remaining vulnerabilities of the Spanish economy. However, it is understandable that some reform fatigue and the change in the political cycle may lead to some recalibration of the policies that have been adopted in response to the remaining imbalances of the Spanish economy.

I want to make one comment, which was already raised in my gray statement, and address an issue that some Directors have also touched on in their gray statements and even here in this meeting. The Fund needs to be careful when raising yellow or red flags. Every risk that is flagged should be well justified. In the report, the staff raised concerns that the profitability of Spanish global banks could suffer from weakening economic conditions in emerging economies.

Global Spanish banks operate on a standalone subsidiary model, especially in Latin America, which is the region that comprises the bulk of their international business. There is limited interdependence between a parent bank and its subsidiaries. Management is independent. Regulation and supervision are a responsibility of the host country authorities, even though they work in a coordinated way. This is a model that has worked very well for the last 20 years.

Globally, Spanish banks faced many real-life stress tests in the last two decades and performed very well. There were shocks both in Spain and in Latin America, and notwithstanding these shocks, the model proved effective in diversifying risks. If we look at the past—both historically in the recent years—a good chunk of the profitability of the global Spanish banks come from their subsidiaries abroad. I would recommend that staff be more cautious when referring to this specific issue in what is an overall very good report.

Mr. de Villeroché made the following statement:

I thank the staff for good report. I also thank Mr. Moreno, Mr. Montero, and Ms. Mulas, for their informative and useful buff statement.

We agree with the staff's assessment on the economic outlook and the improvement of fundamentals allowed by past reforms. The least we can say is that it delivered a lot in terms of fiscal consolidation, reduction of NPLs, rebalancing of the external position. Unemployment is declining as well, so it is a very strong achievement.

I would like to associate myself with the statement made by Mr. Ostros, and I will make a few additional comments.

First, on fiscal policy, some work could be done on the revenue side. I would like to insist on the improvement of taxation efficiency to keep public debt on a downward trajectory. I am in line with the staff's recommendation, that there could be some measures to expand VAT collection, raise excise duties, and environmental taxes. They would be less distortive than other measures to the short-term economic activity.

Second, on the fiscal side, we see the safeguarding of the pension system as a medium-term but important challenge going forward.

On the labor market—maybe the most important structural issue—we see the case to continue the structural policies to increase mobility across regions. We believe it is crucial to promote the convergence of unemployment rates at the national level and avoid the long-lasting effects of prolonged unemployment, especially with the youth and less qualified people. Everything that could be achieved to address the duality of the labor market will be fundamentally important.

We have a debate on whether increasing the minimum wage is the best policy when there is still a very high structural unemployment rate. We acknowledge the answer of the authorities, that it will not hurt and that it could even have a positive outcome on the labor market. But we still have some doubts. The case will be even stronger if it is associated with structural policies in the labor market to reduce duality and to increase regional mobility.

Maybe a last remark on structural reforms, we recognize that past structural reforms have helped improve productivity and narrow the country's gap against its European partners. As shown in the buff statement, the authorities are aware of the need to keep addressing this issue. We concur that more emphasis should be put on the rapid implementation of the Market Unity Law to remove barriers to free competition and make it easier for economic agents to settle and circulation among the national territory.

Mr. Merk made the following statement:

We thank the staff for their insightful, excellent report. Furthermore, we thank Mr. Moreno, Mr. Montero, and Ms. Mulas, for their insightful buff statement. We associate ourselves with the statement of Mr. Ostros and would like to add the following comments.

We commend the authorities on the strong, continued growth, reductions in unemployment, and favorable investment dynamics. Nevertheless, in an environment where external and domestic risks to the outlook are tilted to the downside, productivity growth is sluggish, unemployment is high, especially in regard to youth joblessness, and we echo staff's call to set public finances on a sustainable footing, to revitalize structural reform dynamics, and to further advance the resilience of the financial sector.

We agree with the staff that public debt vulnerabilities, as identified in the Debt Sustainability Analysis (DSA), are elevated, and more needs to be done to bring debt on a clear, downward trajectory. The deterioration of the structural balance since 2014 contrasts with the need to advance fiscal consolidation amid the strong economic tailwinds and favorable monetary conditions. We call on the authorities to rebuild sufficient fiscal buffers and to ensure full compliance with the European fiscal rules.

Mr. Just made the following statement:

We thank the staff for the well-prepared and balanced reports and answers to our technical questions and associate ourselves with Mr. Ostros' oral remarks.

The Spanish economy has experienced above-euro-area-average growth for several years, benefitting from a supporting external environment, but more importantly, from implementing much-needed reforms after the financial sector crisis. Yet despite this substantial progress, significant vulnerabilities remain, which the authorities will need to continue to address.

Given the high public debt level and the maturing economic cycle, we call on the authorities to intensify their fiscal consolidation efforts. We agree with the staff's advice that the measures for raising revenue should aim at streamlining existing tax exemptions, as well as reducing the budget policy gap. Introducing new taxes with relatively low yields usually creates a disproportionate additional burden for tax administration, while the potential yield may be subject to high uncertainty.

At the same time, we agree with the authorities that inequality is a growing concern and that the most vulnerable segments of society should be protected against the negative impacts from consolidation by well-targeted measures.

We recognize the improvements in the financial sector but not the remaining important crisis legacies, which should be addressed, guided by the swift implementation of the 2017 FSAP recommendations. Moreover, we call on the authorities to promptly implement the ECB's NPL guidance.

Like Mr. De Lannoy, Mr. Johnston, and others, we see that banks' resilience would benefit from higher capitalization levels, as well as increased profitability.

We agree with Mr. Tombini and Mr. Saraiva, that the international operations of Spanish banks are relatively robust, particularly due to following a subsidiary model abroad, which relies more on local funding. At the same time, we believe that a systemic risk council should be established, along the lines proposed in the 2017 FSAP, to ensure adequate oversight over the financial system, which should allow the authorities to make progress on macroprudential policies and manage liquidity and interest risks rigorously.

Last but not least, the authorities should build on the past structural reforms to further boost Spain's growth potential. We are concerned with the possible negative consequences of the proposed large increase in the minimum wage. This is especially against the background of the very small size of firms in Spain, as well as regional disparities, not least in productivity. In our view, the higher minimum wage will tend to decrease labor market flexibility, as well as mobility, and probably exacerbates the structural high youth unemployment rates. We, therefore, wonder whether the money would be better spent by modernizing education and investing in vocational training.

Mr. Feerick made the following statement:

We thank the staff for the report and the well-focused selected issues paper, and Mr. Moreno, Mr. Montero, and Ms. Mulas, for their helpful buff statement. We issued a gray statement, so I will touch on a few points.

The Spanish authorities undertook significant reforms in the aftermath of the crisis, which have sown the seeds for the recovery we have witnessed over recent years. Looking to the future, it is important that these reforms are not substantially unwound and that the structural reform agenda is pushed forward.

On fiscal policy, a balance will need to be struck between undertaking the necessary consolidation and generating fiscal space to help reduce elevated and persistent inequality. As the staff allude to, these objectives are not mutually exclusive.

On the consolidation piece, we welcome the specification measures in the 2019 budget, which lends credence to the authorities' willingness to implement consolidation.

As regards fiscal space, noting the low revenue-to-GDP ratio, there appears to be scope to generate policy room for maneuver. It would be important that measures are designed in such a way as to minimize negative drag on economic growth. A reprioritization of expenditures and showing greater value for money should also form part of the toolkit.

As I mentioned in my gray statement, the Spanish authorities' instruction on gender budgeting represents an important addition to the fiscal architecture.

Turning to the financial sector, the authorities must be commended for their progress across a number of fronts, probably best represented by the reduction in NPLs to below 5 percent. While capital and liquidity metrics are assessed as adequate, building buffers during good times is always a sensible call.

Finally, and as Mr. de Villeroché mentioned, perhaps the most important issue facing Spain is the labor market. Chronic inefficiencies are persistent there, including low rates of interregional mobility, labor market duality, which have resulted in persistently high structural unemployment, particularly for younger workers, and low productivity growth.

We agree wholeheartedly with Mr. Moreno, who stated that the authorities need to adopt a multifaceted approach to the issues in the labor market. There are no silver bullets here. The challenges ahead are substantial, but the authorities have a keen awareness of the scale of these challenges and have, in the past, displayed a resoluteness to implement the required policy actions.

We wish authorities well in their endeavors.

Mr. Trabinski made the following statement:

We thank the staff for insightful set of papers and Mr. Moreno and his colleagues for their informative buff statement. We broadly agree with the analysis, so we would like to raise only three points for emphasis.

Spain's economic recovery has been one of the strongest in the euro area since the crisis, reflecting its improved fundamentals in the areas of productivity growth, employment prospects, and enhanced bank asset quality. Within this overall positive context, Spain still faces economic challenges and downside risks. While we understand that not everything could be addressed and solved at once, we encourage the authorities to consider prioritizing and streamlining the reform agenda. Such a prioritization should focus on improving public finances and addressing labor market deficiencies in the first place, as suggested by Mr. Castets and Ms. Gilliot in their gray statement. Therefore, we underline the importance of further revenue-based fiscal consolidation and a buildup of fiscal buffers to strengthen the resilience of the Spanish economy.

Second, when it comes to the labor market, we take note of the authorities’ different views on some policy recommendations. While we encourage the authorities to tackle the longstanding rigidities, we commend them for their reform progress achieved so far. We also agree with staff, that the planned increase in the minimum wage could put at risk job opportunities for the young and low skilled.

Finally, we note a sizable reliance of the Spanish banks on ECB liquidity support. We would like to ask the staff, what is the banks’ exit strategy from this support, given the expected gradual normalization of the ECB policies?

Mr. Agung made the following statement:

We echo other Directors in supporting a more active fiscal adjustment to reduce the structural deficit and to bring down the public debt to a more sustainable level.

New revenue proposals in the 2019 budget seem to be one of the main ways to reduce the structural deficit, given the limited scope for expenditure adjustment. But we would encourage the authorities to consider the staff’s suggestion from the last Article IV consultation regarding less distortive revenue measures, including improving VAT collection, excise and environmental levies, and reducing some tax exemptions.

Structural unemployment and the productivity gap remain the key structural challenges for Spain, so we stress that the policies to improve labor quality and innovative capacities are necessary complements to other policies that reduce market rigidities.

A number of measures, such as the dual vocational training model, are in the government’s action plan to support the envisaged wage growth; but as the staff explains, the practical details are still being developed, and coordination with regional governments will be critical. In this regard, we would like to invite the staff’s comments on the adequacy of this program and the possible implementation challenges in the current context.

Mr. Jost made the following statement:

We thank the staff for the good report and the authorities for their buff statement.

We support the comments made by Mr. Ostros. In particular, we agree that strong efforts have been made by the Spanish authorities in the past few years and that they are paying off, and we believe that they should be continued. We welcome the commitment set out in the buff statement. We also agree that efforts remain necessary to further reduce the debt stock to increase their room for maneuver in case of future shocks.

Turning to the report, we welcome the staff's work on intergenerational equity, which we believe is a relevant issue not only in the case of Spain but in the EU or the membership more generally. Developments in the labor market, such as youth unemployment—in general, opportunities for the young, education, pensions, debt developments, or at-risk-of-poverty rates—are certainly important indicators in this context. We, therefore, welcome Box 4 in the report, and we welcome the Spanish authorities' commitment to reduce inequalities more generally.

Finally, we appreciate the staff's answer on intra-EU labor mobility, which we also deem relevant in the case of labor market developments in EU member states. Going forward, we encourage further work on this in staff reports within the EU.

Mr. Fanizza made the following statement:

We have issued a gray statement, and we fully share the position expressed by Mr. Ostros. For parsimony, I will not touch on any of the issues that have been raised and not even the many good points that have been already raised in the discussion.

While I like the staff report and the work done by the staff, I must say that the impression that I got from reading the staff report is that the policy advice given to this new government is: "Do not do anything new, please."

The staff appraisal says, "It is essential to preserve the thrust of past structural reforms," which maybe is absolutely true. But I wonder whether this is the most productive way to give policy advice.

This is a new government. It wants to do new things. We cannot tell them, “Do not roll back what has already been done.” Or say to them, “Look, they have done very well, keep doing what your predecessors have done.”

We have to encourage them to build on the success of the past reforms, and improve it. Then we will get the ear of the authorities.

If I were the minister, I would say, “That is interesting, but these people just liked the people who were in power before.”

We should pay attention to the way we present our policy advice in a constructive way, in a way to make it palatable and implementable for the authorities, because if we are perceived as just representing—and I am sure that is not the case, but the risk is there—support for the policies that have already been in place by the government, which is different, we are not going to get much traction there.

The staff representative from the European Department (Ms. Schaechter), in response to questions and comments from Executive Directors, made the following statement:[1]

I thank Directors for their thoughtful gray statements and the stimulating questions, most of which we have answered in writing. I will elaborate on two points, one of which was also raised in the Board.

The first question was about the prospects of the budget being adopted for 2019. What we know at this stage is that the government plans to submit the 2019 budget proposal to parliament in early December. Prime Minister Sánchez has today clarified that he would only do so if the budget stands a chance for adoption in parliament.

The government of Prime Minister Sánchez holds 84 seats of the 350 seats in parliament. He was voted into office with the support of the *Podemos* party and several regional parties. *Podemos* has expressed its general support for the budget, while the negotiations of the government with the regional parties are still ongoing. This includes the two pro-independence parties from Catalonia, and one of the pro-independence parties has said it would not vote for the budget.

[1] Prior to the Board meeting, SEC circulated the staff’s additional responses by email. For information, these are included in an annex to these minutes.

In addition, the government faces another hurdle in the budget process. The budget stability law from 2012 requires that Spain's second parliamentary chamber, the Senate, also support the budget law. In the Senate, the conservative *Partido Popular* holds an absolute majority. It has announced that it would vote against the budget proposed by the Sánchez government. The government is currently looking for options to change the budget process, with a view to eliminate the de facto veto power of the Senate. Overall, it is unclear if and when the government would obtain a parliamentary majority for its budget proposal.

The second question that I would like to elaborate on relates to the potential contingency actions that the staff advises to the government in case any of the revenue measures in the budget fall short of the projected yields. The staff can point to a range of options, but the ultimate policy choices should reflect the priorities of the government, and any contingency action should not be a stopgap measure but create permanent fiscal space.

The staff sees room for fiscal adjustments, including on contingency actions, primarily on the revenue side. In particular, more goods and services that currently qualify for the reduced VAT rate could be moved to the standard VAT rate. Moreover, the tax base, including on corporate income tax, could be broadened. There is also room to raise excise on alcohol, tobacco, as well as environmental taxes, and beyond the already planned increase in excise duty on diesel.

On the spending side, contingency actions would be best informed by the ongoing expenditure reviews that aim to identify room for savings; in particular, on subsidies and pharmaceutical spending. Moreover, the government should stand ready to revisit the increase in public employment that is embedded in the 2019 budget plan to ensure that it matches with the revenue developments.

Let me also respond to a few questions that were raised by Directors. One was about the role of the shadow economy for the productivity differences across regions. The estimates for the shadow economy in Spain, in the particular working paper that was referenced here, puts Spain above the euro area average. The estimates that were also recently published by a think tank in Spain have a broad range, so it is notoriously difficult to accurately capture those activities. Indeed, there is a puzzle between the high compliance, especially on VAT revenue collection, where the gap that can be observed in Spain is on the policy side. It is not on the compliance side. Many of the estimates for activities in the shadow economy use indicators such as unemployment. Given Spain's very high structural or long-term unemployment over the past, these might be reflected in the high estimates for the shadow economy.

For the selected issues paper, which aimed to identify the differences of regional productivity, we did not have time series data available to undertake that task. We have some crude estimates of the shadow economy also across regions. If one just looks at a correlation, one could see that there is a correlation between the efficiency in the way resources are being used and the estimated size of the shadow economy. But, clearly, there is room for further investigation.

Another question concerned the preparedness of Spanish banks in terms of their liquidity management ahead of the eventual exit or the end of the gradual reduction of the ECB's monetary accommodation. Spanish banks have a very high degree of liquidity ratios. They have strengthened their balance sheets also with a view to being in a strong position to access market funding, once the liquidity provision from the ECB becomes less accommodative.

There was one more question about the plans on vocational training. Unfortunately, I am not in a position to provide more detail. Our understanding is that these plans are at the initial stages and the details are still to be fully fleshed out. But one of the intentions of the government, as we understand it, is to focus this employment model on the future need of work, so especially jobs that require skills in terms of digitalization. But unfortunately, I do not have any more details to elaborate on this particular plan.

Mr. Moreno made the following statement:

I thank the staff for the useful report. During this Article IV cycle, there was a change in government, and they had to change their counterparts between the staff visit and the mission. They adapted the surveillance to take into account the priorities of the new government, most notably, on the consideration of inequality concerns. There was a good, and very constructive dialogue with the authorities.

I thank Ms. Schaechter, Ms. Liu, MR. Salas, and Mr. Stepanyan.

On the general assessment of the staff and the Board, we thank Directors for their acknowledgement of the progress made by Spain; notably, on reducing unemployment and private sector leverage and improving the economic fundamentals. But there are important challenges that remain, particularly related to fiscal discipline, reducing inequality, and fostering productivity. This is why the authorities have designed a new economic policy strategy, which is anchored on the three pillars that are developed in the buff statement: fiscal discipline, social inclusion, and sustainable growth.

I will now briefly turn to the policies.

First, on fiscal policy, the authorities fully share the staff's and Directors' view that there is a need to reduce public debt levels and rebuild fiscal buffers. There is no doubt about this. In this respect, the authorities are reversing—as a parenthesis I have to say that like the word "reverse" here, but not in other places of the Article IV report when the staff refers to structural reforms—the procyclicality of fiscal policy and are targeting a structural adjustment in the deficit. The draft budget is compliant with the European Union requirements, as it has been endorsed by the Spanish Independent Authority for Fiscal Responsibility. The authorities are committed to closely monitor budget execution throughout 2019.

It is also very important to stress that the draft budget has been agreed between the two major left-wing parties in parliament, so there is broad support to the strategy of consolidation. If the budget is not approved, it would be due to other political calculations, but it would not be related to the strong commitment to the consolidation. I think that it is important to make this point here.

As stressed by Ms. Schaechter, the budget is being scheduled for discussion in December. Political uncertainty in Spain is high, and one never knows if we are going to find an agreement or not. If not, the 2018 budget will be extended into 2019 and the authorities will retain some margin for policies, particularly on the revenue side.

In this respect, I would also like to thank Directors and the staff for their support of the fiscal strategy, which is based on increased revenues and better targeting spending. As Mr. Ostros pointed out, Spain has a large margin to increase revenues. It is eight points below the European Union average in revenue-to-GDP, so we welcome the recommendations of Directors in this respect. The authorities are also targeting better spending and there is an ongoing review by the Spanish Independent Authority for Fiscal Responsibility on expenditure efficiency.

I would also like to refer to the pension reform, which has been highlighted by many Directors. The authorities are well aware of the importance of long-term sustainability of pensions, but they also have to be socially viable. I would like to point out that there is unanimity across all political parties in parliament to ensure the purchasing power of pension benefits. This being said, there is a wide range of measures in the pension framework in Spain, which is called the *Pacto de Toledo,* and there are a number of other measures that can be tackled in order to reach the sustainability of the pension system. The staff has mentioned some in its responses.

Turning to the labor market, as stressed especially by Mr. de Villeroché and others, it is probably the main problem of the Spanish economy. The authorities have a wide perspective in the sense that it is not only an issue of overall unemployment; it is also an issue of youth unemployment, long-term unemployment, large duality, involuntary part-time work, share of workers at risk of poverty, and low wages, as well. The increase in wages in the last few years has been significantly below the increase in productivity.

Like most Directors, we agree that we need a multifaceted approach, including in education, active labor market policies, or research and development policies. I would like to stress that the staff has provided a useful analysis on the regional perspective for these policies.

I would also like to point out that there is a need to fine-tune labor market regulation. Our last reform is from 2012 and it was designed in the context of recession. I do not agree with the staff characterization as a reversal but would rather refer to a fine-tuning of the reform. Particularly, we have had some disagreement with the staff and with some Directors. We take note of their concerns on the increase in the minimum wage, but the authorities feel that the minimum wage is low compared to peers. The experience of Spain in the past is that increases in the minimum wage have been consistent not only with sustaining wage growth but with an acceleration in the creation of jobs, particularly in periods when the economy is growing.

I would also like to convey to Directors that I will make some deletions on the buff statement for publication because some of the regulations that we have included in the buff statement are still under negotiation, and we would not like to anticipate the results.

On other structural reforms, I will just stress the authorities' agreement with Directors. The authorities attach particular importance to environmental and gender issues, which fall under the emerging issues of the Fund. This is something that we are going to work on in the future. We believe that these objectives are not only good in and of themselves, but they are also instrumental for long-term potential growth.

On the financial sector, I welcome the acknowledgement of the reduction of NPLs, Spain is close to the euro area average now. Profitability is above the euro area average and solvency ratios are well above the regulatory standards, But there is no room for complacency. We totally agree with the staff and Directors on the need to continue strengthening bank capitalization to close the remaining gap to get to the levels of our European peers. The *Banco de España* has already stressed this message publicly a number of times.

Furthermore, we are stepping up the surveillance framework, creating a new financial stability authority in charge of macroprudential oversight. The project has already been announced publicly and it includes adding new borrower-based macroprudential toolkit for *Banco de España* as well,.

On the financial sector, I would also like to echo Mr. Saraiva's words. The subsidiary model has worked well. The Spanish banks are in for the long run in their investments abroad. This works both ways and investments facilitate the diversification of risk. Because of the subsidiary model, the subsidiaries are autonomous, and the main link is basically the profitability channel. As Mr. Saraiva has pointed out, we have already had some real-life experiences and the model has proven to work well.

Finally, I take note that many Directors described our buff statement as informative and detailed. I guess that, for some, this means extensive or long. Give the combination of a new government with new policies and a new economic strategy, and also a new team from Spain here at the Board, we were all excited to contribute to the debate, but I take note of it.

The Acting Chair (Mr. Furusawa) noted that Spain is an Article VIII member, and no decision was proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed Spain's continued strong economic growth and decline in unemployment, which reflects the economy's improved fundamentals.

However, Directors noted that notwithstanding the achievements, several downside risks are clouding the medium-term outlook. They encouraged the authorities to persevere with policies and reforms aimed at further enhancing economic resilience, reducing public debt, improving productivity, reducing inequality and increasing employment, especially raising long-term and youth employment.

Directors called for rebuilding fiscal buffers. Given the still high level of public debt, they stressed the need to resume structural fiscal consolidation and bring public debt down faster. They welcomed the authorities' fiscal deficit target for 2019. In this context, they encouraged the authorities to adopt a sound package of measures and plan for contingency actions in case of potential fiscal shortfalls.

Directors noted the government's intention to raise additional revenues, given the relatively low revenue-to-GDP ratio. They considered that revenue measures can bring the deficit down, help finance more social spending, and support the government's goal of lowering inequality. However, a careful design of tax measures is key to limit distortions and negative growth implications. Directors encouraged the authorities to consider gradually reducing the number of goods and services that qualify for reduced VAT rates, addressing tax system inefficiencies, and raising environmental taxes.

Directors stressed the need to safeguard the pension system's financial viability while enhancing its social acceptability. They noted that linking pension growth permanently to inflation, without offsetting measures, could put pension spending on a sharp upward trajectory. Directors called for a comprehensive, transparent, and equitable approach to pension reforms.

Directors welcomed the further strengthening of the banking system. They stressed the importance for banks to continue raising high-quality capital as a shield against shocks, including from potential spillovers related to market volatility. Directors underscored the need for rigorous management of liquidity and interest rate risks, in particular, ahead of the eventual gradual normalization of the ECB's accommodative policies. They welcomed the authorities' plan to create a macroprudential authority to better address potential financial stability risks and to swiftly expand the Bank of Spain's macroprudential toolkit.

Directors welcomed the strong job creation and underscored the need to make the labor market more inclusive. They called for preserving the thrust of past labor market reforms. Directors encouraged the authorities to continue to address labor market duality, strengthen active labor market policies, enhance incentives for greater labor mobility across regions, and ensure wage flexibility. They emphasized that wage increases should be aligned with productivity growth.

Directors underlined that raising productivity growth requires new impetus. They highlighted the need for policies that facilitate competition, foster innovation, address skills mismatches, and dismantle barriers for firms to grow. Directors also encouraged the authorities to improve regional coordination with a view to lower regional productivity disparities.

It is expected that the next Article IV consultation with Spain will be held on the standard 12-month cycle.

APPROVAL: April 14, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook, Risks

1. We would be interested in staff comments on the cyclical or structural nature of this slowdown linked somehow to the decline in tourism dynamism.

- A slowdown in GDP growth was expected as the economy has grown above its potential rate for several years. The cyclical recovery is now largely completed and external tailwinds are dissipating. Going forward, GDP growth is projected to gradually moderate to its potential rate of about 1.75 percent of GDP. Past strong growth rates in tourism reflect Spain's competitiveness related to cost and non-cost factors, such as the high-quality infrastructure. The slowdown in tourist arrivals in 2018 suggests in part a "saturation" in some popular destinations (e.g., Spanish islands) and the recovery of tourism in countries like Turkey and Tunisia. Given the sector's structural strengths it will continue to be an important industry for the Spanish economy.

2. The external debt sustainability analysis shows that under the staff's baseline scenario the external debt is projected to decline from 167 percent of GDP in 2017 to 144 percent in 2023. At the same time, gross external financing is expected to decrease throughout the projection period but would remain high at around 60 percent of GDP in 2023. Could staff comment on the risk implications of these projections?

- Risks are somewhat contained due to mitigating factors such as the current low cost of debt, the limited share of debt denominated in foreign currency, a favorable maturity structure, diversified exports, and the projected current account surplus over the medium term. That said, while the private sector has deleveraged since the crisis, the share of external debt accounted for by the general government has increased. Thus, fiscal policy should take full advantage of the current benign economic conditions (including the low level of Spanish bond yields) to bring down faster the high level of public debt and the large gross financing needs.

Fiscal Policy

3. More broadly, how staff is calibrating its policy recommendations to take into consideration Spain's particular circumstances? Specifically, what kind of

measures the authorities could undertake to rebuild fiscal buffers and reduce public debt if no new budget is approved?

- Staff's policy recommendations are based on the specific vulnerabilities that remain for the Spanish economy. These include the high level of public debt, of which a large share is held by foreign investors and domestic banks, high structural unemployment, which contributes to inequality, and low productivity growth. While environment is still favorable, measures should be taken to strengthen the economy's resilience and address the remaining structural challenges. While acknowledging the challenging political environment to implement new reforms, staff stresses the importance of preserving past achievements and sees room for reforms that could gather political consensus, particularly in the area of training and education.

- Regarding fiscal measures in the scenario where no new budget is approved, staff encourages the authorities to take adjustment measures that could be adopted outside the budget procedure. These include strict control on spending and revenue measures.

4. What are staff's view on prioritization and sequencing of fiscal adjustment?

- In staff's view, priority of fiscal adjustment should be given to measures that improve VAT collection, raise excise duties and environmental levies, and reduce inefficiencies in the tax system, as they tend to be less distortive to short-term economic activity and have lower multipliers relative to other revenue raising measures. Expenditure rationalization could contribute to adjustment, but the scope is limited. In terms of sequencing, staff does not have any particular recommendation, except that the proposed revenue measures should be accompanied with targeted spending for the most vulnerable.

5. Given that Spain's primary spending is already low, which additional measures would staff possibly recommend on the spending side to ensure sustainability of fiscal finances?

- Measures on the spending side will have to focus on improving the quality and efficiency of public service provision (see also IMF Country Reports No. 17/23 and 17/319). In this respect, the ongoing expenditure reviews, including for pharmaceutical spending and hiring subsidies, are crucial to assess expenditure needs and minimum provision standards against the availability of financing resources at all government levels. A more broad-based spending review, including on the public sector wage bill, would also be welcome.

6. Staff suggests a need for additional revenue measures, as well as spending cuts. Can staff elaborate on what measures would they recommend?

- Staff's recommendations on potential measures lie mostly on the revenue side, including measures that expand VAT collection—for example, by increasing VAT rates for products that are currently taxed at reduced rates—, raise excise duties and environmental levies, and reduce inefficiencies in the tax system. Reforms designed to improve the quality and efficiency of public expenditure could also help, although room is limited. See also response to question 4.

7. We noticed from the buff that the authorities will move forward to link the pension increase to inflation and noted the potential implication on budget, as well as significant funding needs caused by such decision. We welcome staff's elaboration on what additional measures should be taken to make such sharp increase in spending sustainable.

8. Additional measures that could be taken to maintain the sustainability of the pension system include: (i) supplementary parametric reforms to incentivize greater labor force participation and longer work lives (e.g., index the statutory retirement age to changes in life expectancy at retirement; adjust pension accrual rates, which are currently frontloaded, to encourage longer work lives; further restrict access to early retirement; extend the pensionable earnings reference period to a contributor's full career); (ii) increasing social security revenue without raising contribution rates (e.g., raise the ceiling for maximum contributions faster than the maximum pension); (iii) raising the minimum contribution for self-employed individuals; and (iv) promoting supplementary private saving (see IMF Country Report No. 17/320, Chapter 1). In addition, it is crucial to be fully transparent about the demographic pressures the contributory pension system faces and the tradeoffs inherent in safeguarding pension sustainability, so that future pensioners can make informed decisions on their work lives and savings.

9. Staff's comments would be appreciated whether the approach followed by the Portuguese authorities on addressing inequality while continuing with an overall restrictive fiscal policy and in particular the thoughtful communication by the Portuguese authorities could serve as an example for Spain.

- Spain's high level of structural unemployment, youth unemployment and pervasive labor market duality have contributed to the increase in inequality. This weakness in Spain's labor market compares unfavorably to European peers, including Portugal. In Portugal, inequality after tax-and-transfers has been stable throughout this decade, albeit with a small reduction in recent years, when, at the margin, tax changes have favored lower-income taxpayers. More significantly, that country did experience a rise in inequality before-tax-and-transfers in the wake of its crisis, and a subsequent reduction in that measure of inequality since 2014; these changes seem to be closely linked to the evolution of unemployment, which peaked in early 2013 at 17.5 percent and has fallen to under 7 percent, and other labor market variables, including the proportion of temporary jobs, which has been stable in the last few years.

- This experience suggests that a core element to tackle inequality in Spain should rest on making the labor market more inclusive. At the same time, there is room to raise more revenue, including for social and distributional objectives.

Labor Market

10. We would like however staff to comment if they disagree with authorities' perception about the strong and positive impact of relatively large increases in statutory minimum wages on employment?

- Spain's past experience with raising statutory minimum wages is not necessarily a good guide to judge the impact of the proposed increases for 2019 and 2020. Only a small share of workers were paid at the minimum wage level. Nevertheless, a Bank of Spain's 2015 study concluded that past minimum wage increases raised the probability of employment loss, although the impact on aggregate employment was limited. More generally, the empirical literature finds a wide range of estimates for the elasticity of minimum wage increase on employment, which center around -0.2. The literature also argues that the negative impact of minimum wage on employment rises with the level of the minimum wage and the share of affected workers. Both ratios will move significantly upward in Spain with the envisaged minimum wage increases in 2019 and 2020.

11. The authorities also note that the 20 percent increase in the minimum wage for 2019 is not likely to have a material impact on job creation. Could staff elaborate on this matter? How binding is the new minimum wage? How is the increase expected to impact wage dispersion, which is already low?

- See the response to question 10.

- On wage dispersion, the available information suggests that the share of workers earning the statutory minimum wage will increase from about 3 percent in 2018 to around 10 percent in 2019 with the minimum wage increase by 22 percent. Beyond this information on coverage, staff has not analyzed the potential impact on wage dispersion which will depend critically on the pass-through to general wages and require micro-level data on wage distribution.

12. Could staff provide some assessment on how much the proposed statutory minimum wage increase would impact employment opportunities for the low-skilled

and the young, as well as details and sequencing of the authorities' plan to improve labor quality in support of the envisaged wage growth?

- See the response to questions 10 and 11. Many details of the authorities plans to improve the labor quality are still being developed. The government has announced plans to develop a dual vocational training model and to enhance the digital and language skills of the youth. Some initiatives, especially on education and training policies, require coordination with the regional governments.

13. Wage increases must follow productivity growth, and in that, we share staff's cautious advice to preserve wage flexibility event if the impact on competitiveness and employment might be limited given the relatively low level of the minimum wage in Spain. Staff comments are welcome.

- See the response to question 10.

- Staff's analysis suggests that real wages across Spanish regions saw little movement between 2002 and 2016, and their regional dispersion was relatively small. In contrast, variations in the unemployment rate both across regions and across time were large. Indeed, the observed low degree of real wage dispersion suggests that Spain's region-specific wages do not adjust sufficiently to region-specific employment conditions, which is in line with the finding in the literature. One potential explanation for the lack of differentiation in wages across regions could be related to the past use of national and sector-level collective bargaining agreements, which limited the flexibility of wage setting.

14. We noticed the staff's recommendation to avoid a sharp increase in the annual statutory minimum wage and to allow greater minimum wage differentiations. We welcome staff's comment on whether the authorities' current plan meet their expectations.

- The authorities' proposal on the minimum increase in 2019 is currently not considering to differentiate the statutory minimum wage factors, such as region or age.

15. Additionally, could staff comment on the projected effects on the youth and long-term unemployed of the latest collective bargaining agreement? Concerning labor mobility, what policies has staff examined or recommended to incentivize labor movement, especially to overcome a strong "home bias"?

- The guideline of the latest collective bargaining agreement regarding a 2-3 percent general wage increase is broadly in line with the expected productivity growth and should generally not have negative implications for youth or long-term unemployed. For a thorough analysis of the potential effects of the latest collective bargaining agreement disaggregated data would need be needed, which are not readily available.

- Staff's current suggestions on incentivizing labor movement are mostly based on other countries' experience. For instance, the Mobility Assistance Program (MAP) adopted in Germany, which provides financial support to distant job search, such as subsidies for travel expenses of distant job interviews and cost of reallocation, has been found to be effective in encouraging distant job search and promoting regional labor mobility. For Spain specific policy design on incentivizing labor mobility, careful analysis will be needed to evaluate the potential benefit and cost of such proposals.

16. While staff argue that the proposed increase in the minimum wage would increase the ratio of the average wage to one of the highest rates in the EU, the authorities argued that the proposed increase would take this ratio to around the OECD average; how can these different assessments be reconciled?

- The difference comes from the fact that the authorities refer to the expected minimum-to- average wage ratio in 2019, while the staff report mentions the expected ratio in 2020, reflecting the proposed additional 11 percent increase of minimum wage in 2020.

17. We are wondering if staff could advice the authorities on how to device a monitoring system for the possible impact of minimum-wage levels on employment, so that, if confirmed, the measured could be rolled back.

- Disentangling the employment impact of minimum wage hikes from other factors on a real-time basis is notoriously difficult. Nevertheless, we would recommend the authorities to closely monitor employment and wage developments particularly in sectors and among groups that are most vulnerable to minimum wage hikes.

18. We take note of staff's assessment that low labor mobility across Spanish regions contribute to high structural unemployment, but wonder if the analysis would differ considering mobility at the provincial level, rather than on the regional level. Staff's comments are welcome. Also, given the importance of foreign nationals in the labor market, does staff consider the impact of economic factors on internal migration of foreigners the same as for Spanish nationals?

- Internal mobility rate at the provincial level is generally higher than that at the regional level, partially driven by the sizeable intra-regional migration flows. Given the limited availability of cross-country data on inter-provincial migration, staff have not done any benchmarking exercise to compare Spain's inter-province mobility with other countries and are also not aware of other studies on this topic. Nevertheless, previous studies generally found that dispersions in unemployment across provinces are also large. Similar to the findings of staff's analysis on regional labor mobility, housing prices, wages, and unemployment rate are the main factors explaining migration between provinces.

- Regarding the comparison between Spanish nationals and foreigners, staff's analysis in the forthcoming working paper indeed finds different impacts of economic factors. More specifically, the results suggest that that pull factors from the destination regions play a more important role in mobility among Spanish nationals, while push factors in the origin regions matter more for foreigners.

19. We appreciate staff's explanations of intra-national labor mobility. We would like to use the opportunity to inquire whether staff believes that intra-EU labor mobility has an impact on human capital development in Spain, and, in turn, might impact growth potential.

- Staff have not analyzed this topic as detailed intra-EU migration data by education or skill levels are not readily available. However, a 2015 study by the Bank of Spain could be used to shed some light on this issue. The paper shows that Spain experienced massive migration inflows before the crisis (1995-2007) and large migration outflows following the crisis (2008-12). Compared with the flows in the 1990s, inflows between 2002-12 saw an increasing share of foreigners with tertiary education, particularly among European immigrants. In contrast, foreign nationals leaving after 2008 were less highly educated, which is consistent with the fact that this is the population group that has been hardest hit by the crisis.

20. The report calls for increased inter-regional workers' mobility and goes as far as to suggest considering relocation benefits. We would caution in this regard, not only because of the cost implications, but also because of possible perverse effects. Shouldn't, instead, wages be left doing their job?

- We agree that promoting wage flexibility will be the key policy option to boost regional labor mobility. Nevertheless, staff analysis suggests that controlling for wage differentials and other economic and labor market variables, regional migration is still negatively affected by home region fixed effects, indicating a potential role played by cultural and other unknown institutional factors. To overcome these obstacles, there may be room for policies to provide additional incentives for workers to move.

21. ***While staff propose more coordinated and better-designed active labor market policies (ALMPs) to enhance employability, could staff elaborate more on some details/ examples of possible designs of ALMP measures?***

- Measures to deliver more coordinated and better designed ALMPs could include better-managed use of the EU's Youth Guarantee, refined collaboration with private job-placement agencies, and enhanced coordination between active and passive labor market policies. In addition, strengthening the Public Employment Services' capacity to offer individualized support; better targeting job measures, particularly demand-driven skills training, to increase the employability of low-skilled and long-term unemployed; and conducting regular evaluations could also improve the cost-effectiveness of existing ALMPs (see IMF Country Report No. 17/319, Annex I).

22. ***At the same time, we would put more emphasis than staff on the promotion of vocational education and training, which is in our view also highly relevant to address skill mismatches in the labor market against the backdrop of prevalent overqualification and newly created jobs often being found in the medium-skill segment. Staff comments welcome.***

- We agree that vocational education and training is an important avenue to address skills mismatch. Since these policies fall under the responsibility of Spain's regional governments a close coordination will be critical for broad-based implementation.

23. ***Could staff elaborate on its suggestion to provide targeted housing assistance and, in how far characteristics of the Spanish housing market (e.g. preference for owning vs. renting) might impede mobility?***

- Policies could be considered to provide temporary and targeted housing assistance, particularly in regions that face a high house price-income ratio or an underdeveloped rental market. These measures could help reduce reallocation cost and provide additional incentives for workers to move. Indeed, staff analysis finds that housing prices and home ownership play an important role in determining regional migration flows. The share of home ownership in Spain is relatively high (about 77 percent), indicating that on average Spaniards tend to have a preference toward owning a property rather than renting. This makes house prices particularly relevant for mobility decisions.

Structural Reforms

24. ***Could staff elaborate on the key reasons for the slow progress in the implementation of Market Unity Law?***

- The Market Unity Law has been challenged by some regions, which led the Constitutional Court to declare the principal of nation-wide effectiveness of licenses null and void. Nevertheless, the Court has endorsed the principle of necessity and proportionality and laid out ways to implement the law consistent with the constitution. However, it is a time-consuming process as it requires consensus building among 17 regions over many regulations in different sectors.

25. Can staff comment on whether the policy implications derived from the SIP are aligned with the authorities' priorities?

- The policy implications of the analysis presented in the SIP are aligned with the authorities' priorities. The policies derived from the SIP focus on two main areas: (i) measures to improve education outcomes and reduce mismatches between skill demand and supply; and (ii) policies to enhance regions' innovative capacity. The government has announced that these policies will be among the key pillars of its comprehensive strategy. This includes the aim to increase education and R&D spending in 2019. Additionally, the government intends to present a Law on Vocational Training to develop the dual system in cooperation with the private sector to incorporate new professional qualifications related to the digital economy.

26. Do SMEs play a big role in driving innovation in Spain?

- The small size of many Spanish firms often is mentioned as one of the main factors holding back research, development, and innovation activities. According to 2016 data, companies with 250 and more employees were responsible for 67 percent of all R&D spending.

27. Could staff give specific examples of impediments caused by undue regulatory disparities, preferably those for which a regulatory reform would seem realistic and/or those having a major detrimental impact?

- A few thousand regulatory barriers, most at the regional level, have been identified as inconsistent with the Market Unity Law. For example, a firm that wants to operate in multiple regions has to obtain separate licenses or permits for its activity from each affected region (this applies to many but not all cases and regions). Another example is differing regional requirements for obtaining licenses or permits. These create additional costs as firms must adapt their products to local requirements, such as labelling. There are also regulatory disparities that relate to the restrictions for establishment and expansion of hotels, including minimum distance requirements.
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Financial Sector

28. Could staff inform about the NPL incidence including prudential measures if any taken by the BdE in respect of banks' exposures to consumer loans?

- The NPL ratio of bank loans for purchases of consumer durables remained low at 3.2 percent in June 2018, unchanged with respect to a year earlier. However, both credit for the purchase of consumer durables and NPLs in that segment increased by over 20 percent between June 2017 and June 2018. Total consumer credit granted by deposit institutions accounts for about 5 percent of overall credit to the resident private sector.

- The BdE has not applied any prudential measures yet, but it has alerted banks to monitor the behavior of NPLs for consumer credit, provide adequate coverage for new NPLs, and avoid excessive risk taking by preserving adequate credit standards. While the current macroprudential toolkit in Spain comprises mainly capital-related tools, the government's recent proposal to establish a macroprudential authority envisages expanding that toolkit to include sectoral countercyclical capital buffers and other credit-related measures that could potentially be used to restrain credit growth in specific segments.

29. As for modernization of the institutional framework, we take note of the government announcement of the creation of a national macroprudential authority (ANESFI). We would appreciate it if staff could elaborate its details and share the staff's evaluation on it.

- The recent proposal for the creation of the new macroprudential authority (ANESFI) includes the key elements while details still have to be specified. Following the proposal, the new macroprudential authority (ANESFI) would comprise the Ministry of Economy, the Bank of Spain, and the National Securities Market Commission. Though not possessing regulatory powers in its own right, the new entity would be granted functional independence and authority to issue observations, warnings, and recommendations on emerging threats to financial stability and needed remedial actions. The designated authorities for exercising macroprudential powers would need to inform ANESFI in advance on their plans to apply macroprudential tools. ANESFI's Technical Committee would be chaired by the deputy governor of the Bank of Spain. While waiting to learn more details, staff has a broadly positive view of these announcements, noting several coincidences with suggestions formulated in the 2017 FSAP. Staff would welcome including a review clause requiring an evaluation on how the new authority is functioning after three years.

30. ***While we commend the creation of a national financial stability authority (ANESFI), we welcome staff's elaboration on the reasons why insurance regulation is not included in this institution.***

- Financial oversight of the insurance sector is currently carried out by the Directorate General for Insurance and Pension Funds, a department within the Ministry of Economy. According to the recent government proposal, the director of that department is expected to be a member of the new macroprudential authority's council, which suggests that–in line with staff's views–ANESFI will include insurance regulation in its financial stability analysis. To further upgrade the institutional framework for financial oversight, the government is working on the creation of an independent insurance and pension supervisor, which would no longer fall within the remit of the Ministry of Economy.

31. ***We noticed that the authorities are considering distributing the responsibilities of toolkits between the Bank of Spain and sectoral supervisors, rather than concentrating the responsibility with the Bank of Spain. Could staff comment on the pros and cons of these two options?***

- The 2017 FSAP did not find significant problems related to the existing distribution of macroprudential tools across the Bank of Spain and the National Securities Market Commission. The FSAP highlighted, however, that a national macroprudential authority had to be set up to improve inter-agency coordination linked to financial stability, including on systemic risk surveillance and prudential policies. It also noted that the role of the Bank of Spain in safeguarding financial stability should be further strengthened. Staff welcomes that both of these recommendations seem to be reflected in the authorities' plans on the new national macroprudential authority. While those plans already envisage granting broader macroprudential powers to the Bank of Spain, it would also be important to ensure that its expanded toolkit include borrower-based tools.

32. ***Further could staff inform about the risk management practices for market and credit risks in subsidiaries, and whether these are centralized within the parent banks?***

- Spanish banks' subsidiaries are generally perceived to operate under adequate risk management practices. This is related to the use of a Multiple Point of Entry (MPE) resolution strategy, by which Spanish parent banks set some risk and liquidity policy guidelines, but the subsidiaries are self-sufficient and responsible for managing their liquidity. The MPE model thus helps to limit the risk of contagion across the group, and it provides subsidiaries with market discipline and incentives to implement sound risk management practices.

33. Could staff share possible spillover effects on Spanish financial system from these emerging markets? In addition, we would like to know staff's view on how Spanish banks are reacting to the increased uncertainty in these areas, e.g. their stance on rolling over the current exposures.

- Some impact has materialized in the form of underperformance in share prices for those banks with the largest exposure to emerging markets. Further spillovers would be mainly transmitted through the profitability channel: a significant increase in NPL ratios at Spanish banks' subsidiaries would impact group-wide profits. Spillovers would be mitigated by the Spanish bank subsidiary model characterized by decentralized liquidity and funding management as well as a large share of subsidiaries' funding in local currency. Moreover, Spanish banks use exchange rate hedging strategies to mitigate the impact of currency fluctuations on group-wide profitability and solvency indicators. So far, Spanish banks have not made any announcements related to rolling over their current exposures to emerging markets.

34. Given the uncertainties related to emerging markets and Spanish banks' exposure to Latin America, could staff elaborate on potential consequences of adverse shocks for the banks' capitalization?

- The impact would be mainly through the profitability channel: a significant increase in NPL ratios at Spanish banks' subsidiaries would adversely affect group-wide profits. Spillovers on capitalization ratios would be limited by the Spanish bank subsidiary model and their use of a Multiple Point of Entry resolution strategy, characterized by decentralized liquidity and funding management. Under that business model, the risk to the parent bank is ultimately limited to the value of the investment in the subsidiary.

35. We would welcome staff comments on measures underway to address the issues arising from Sareb, an asset management company, which has been loss-making for quite some time.

- In 2017, Sareb continued to post net losses, though these were somewhat smaller than in 2016, and its operational margin improved. Its revised business strategy appears to be generally well designed, envisaging stronger engagement in the sale of its assets through joint ventures with real estate developers. Given the weight of real estate assets in Sareb's remaining asset portfolio, a key determinant of its financial results will be a geographically broader recovery of the Spanish property market that encompasses a larger number of provinces. Continued efforts are needed to optimize Sareb's business activity and ensure that its remaining liabilities remain manageable. Staff would welcome a closer involvement of the Bank of Spain in the review of

Sareb's business plan, to ensure the soundness of its cash-flow projections and related sensitivity analysis.

36. We note staff's recommendation on more rigorous management of liquidity risks: Can staff elaborate on what the authorities could do and provide views on whether there are challenges to Spanish banks' implementation of the net stable funding ratio?

- At the time of the 2017 FSAP, staff made the following specific recommendations on liquidity risk management: improve liquidity monitoring, including by closing reporting gaps; review funding structures and policies of banks with excessive reliance on ECB's liquidity support; and place a premium on effective liquidity risk management by banks. Staff welcomes that the Bank of Spain now conducts and reports liquidity stress tests on an annual basis. Concerning the net stable funding ratio (NSFR), a potential future challenge for some Spanish and European banks is that their current NSFR positions may turn less favorable once long-term ECB funding (which is considered as very stable in the NSFR calculation) becomes less plentiful and has to be replaced with other sources of funding.