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Statement by Mr. Moreno, Mr. Lopez, and Ms. Moral Betere on Spain
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Staff has provided very useful feedback under the current highly uncertain economic scenario. On behalf of the Spanish authorities, we thank staff for the very constructive dialogue and well-focused analysis. The new coalition government that took office in January has adapted its policy strategy to address the new challenges posed by the COVID-19 crisis. The authorities have put in place forceful measures to sustain the economy, which have been complemented by decided European Union (EU) policies. Staff has usefully structured the report around a timeline distinguishing three main stages: fighting the pandemic, the recovery phase, and the longer-term challenges. There is broad agreement with staff on the diagnosis and the main policy recommendations on the need to maintain support measures to the economy through the pandemic, and to design a policy response for the recovery phase that, in line with the pre-covid policy agenda, is already guided towards addressing the structural challenges of the economy, including boosting productivity, ensuring fiscal sustainability, addressing gender inequality, and fostering social and environmental sustainability.

Economic outlook and fighting the pandemic

The Spanish economy has been especially hit by the COVID-19 crisis. After growing for more than five years well above its peers, unwinding in the process much of its previous imbalances, Spain has been especially hit by the COVID-19 crisis. The large economic impact in relative terms of the lockdown and social distancing needed to control the pandemic is mainly related to the stricter confinement measures adopted in Spain and to other idiosyncratic factors, including a larger weight of economic sectors most directly affected by the pandemic, such as tourism, an economic structure with a large weight of SMEs (the pandemic has impacted more significantly on smaller firm revenues), the higher share of temporary workers in the labor market, the high population density in big cities, and social standards of closer personal contact.

The authorities project a less depressed outlook than staff, albeit subject to high uncertainty. The authorities are projecting GDP growth rates of -11.2 percent, in 2020, mostly in line with consensus, up to +9.8 percent in 2021, after factoring in the effects of a full implementation of the Recovery and Resilience Plan, and a recovery of pre-covid GDP levels by 2022—these projections are above staff's growth estimates of -12.8 and +7.2 percent, respectively, and a recovery of GDP levels by 2023. The 2020 and 2021 forecasts have been endorsed by the independent fiscal authority (subject to the uncertain outlook) and are compatible with the positive surprise in 3Q20 (a GDP growth of 16.7 percent and employment growth of 3 percent, with 569.000 new jobs). The divergence with staff is mainly explained by differences in the pandemic scenario and the pace of implementation and the multiplier effect of the Recovery Plan—the authorities' estimation has been carried out using a detailed bottom-up approach, considering the heterogeneity of measures and reforms articulated in it. Nevertheless, the outlook is marked by high uncertainty and downside risks, which are the focus of staff's analysis, mainly associated with the evolution of the pandemic. There is, however, also the potential for upside risks, once the pandemic is under control and a medical solution (vaccine or treatment) is widely available. Spain is under a second wave of the pandemic with an earlier but similar evolution and intensity as in other European countries. The strengthened testing and tracing have resulted in a higher contagion incidence than the first wave, but its severity is lower, with lower hospitalization and death rates.

The authorities have undertaken decisive and timely actions to support the economy, cushioning the impact of the crisis, preserving jobs and incomes, and supporting the most vulnerable. The government decreed a strict national lockdown in March, and gradually reopened the economy since May. In parallel, it has put in place decisive policy actions to face the immediate consequences of the pandemic and support the economy through both, budgetary (5.3 percent of GDP), and liquidity measures (15.3 percent of GDP), including, among the main policy actions: (i) on health, measures amounting more than €20 billion oriented towards providing essential products, reinforcing the health care system, and R&D to fight the pandemic (including €16 billion in direct transfers to the regions through the Covid Fund, covering also expenditures for the adaptation of the education system); (ii) the introduction of the Minimum Income Schemes (MIS), focused on reducing inequality and poverty, while incentivizing labor force participation, that will benefit 850,000 households and lift 1.6 million people out of poverty; (iii) other measures to support households, such as the extension of public leases, moratoria on mortgage and rental payments, and the provision of basic supplies to vulnerable households; (iv) the reinforcement and flexibilization of the short-time work scheme (ERTEs), which has sustained 3.4 million jobs through the pandemic—in comparison, the 3 pp increase in unemployment is substantially lower than that of the Global Financial Crisis, when the unemployment rate rose 6.6 pp between 2008 and 2009; (v) a revision of the Spanish insolvency law and the introduction of temporary provisions to avoid insolvencies for viable companies, which will be further improved with the transposition of the EU Directive on insolvency; (vi) a temporary moratoria on taxes and on payments of employers' Social Security contributions focused on SMEs and the self-employed; and (vii) an initial program of €100 billion of public guarantees though the national promotional bank, ICO, to facilitate liquidity provision to firms, specially SMEs, which has successfully supported a total of 550,500 companies with more than 842,000 operations granted, as of 15th October 2020.

National measures have been complemented by determined EU support. The EU has forcefully responded to the pandemic by deploying a joint and coordinated package materialized in a broad set of economic and financial supranational measures to provide a safety net for firms, people, and sovereigns. The measures include: the decisive monetary policy by the ECB to sustain liquidity and prevent financial market fragmentation; the SURE instrument to cover the expenses of partial and temporary unemployment schemes; the pan-European guarantee fund to promote investment projects through the European Investment Bank; the new ESM Pandemic Crisis Support facility to support health related spending; and the Next Generation EU as a new temporary EU budgetary instrument to guide and finance the recovery.

The recovery phase

Containment policies and temporary support measures will continue until the pandemic is under control. The authorities work under the assumption that there is no trade-off between the economy and health, and therefore, the economy cannot recover a sustained growth path until the pandemic is under control. The uneven spread of the pandemic across regions in the second wave requires a focalized effort. In this respect, on October 25 the government approved a six-month state of emergency that provides the legal umbrella for the regions to display the necessary containment, social distancing and mobility restrictions to control the pandemic (some previous measures enacted until then had been rejected in courts, as they were not harbored in ordinary legislation). The government is also undertaking a more targeted design of the support measures including, for instance: in agreement with the social partners, an extension of the ERTEs until January 2021 with incentives to resume normal activity and focused on the most affected sectors of the economy such as tourism and self-employed workers; an additional ICO guarantee line of €40 billion, to cover not only liquidity and working capital needs but also investment ahead of the recovery phase; and an equity fund (the SEPI Fund equipped with €10 billion) to support the solvency of viable strategic companies. These measures are temporary (contingent on the evolution of the pandemic); the government rigorously monitors the epidemiological situation and does not rule out the extension of existing measures or the adoption of new targeted ones should the situation require it.

The 2021 Draft Budgetary Plan (DBP) aims at supporting the economic activity during the recovery phase and addressing structural challenges. The negative impact of the shock is aggravating some of the existing weaknesses that had already been identified for the government's term in office, such as raising productivity, underpinning fiscal sustainability, accelerating the green and digital transition, addressing gender equality, and social sustainability.

- **On the expenditure side, the DBP significantly boosts investment in health, education and social resilience, as well as R&D and infrastructure projects.** It envisages an increase of over 70 percent on health, education and social spending, including: additional €3 billion on health expenditures, largely oriented to reinforce primary care and buy vaccines; an increase in education and scholarship spending and a new plan for the modernization of vocational training; the consolidation of the MVI and additional social spending on dependency, child poverty and gender policies. The budget also reinforces horizontal policies on infrastructures (114 percent increase), R&D and innovation (80 percent increase), or support to SMEs (150 percent increase), as well as sectoral policies to decarbonize the industrial and energy sectors and support the tourism or retail sectors. Contributive pensions and public wages are increased by the expected inflation rate to sustain real purchasing power (0.9 percent).

- **On the revenue side, the DBP bolsters medium-term fiscal consolidation by increasing revenues through progressive taxation and new green taxes.** In line with the pre-COVID fiscal strategy, the authorities have taken steps towards increasing the tax collection bases and the progressivity of the tax system which shall move Spain's revenues closer to the EU average—at 41 percent of GDP, the revenue-to-GDP ratio in 2019 was 6 points below the EU average. New measures are expected to yield revenue increases over €6 billion. These measures include (i) an increase of the marginal rates of the personal income tax for the highest earning taxpayers—those with wage earnings above €300.000 and capital gains above €200,000 (affecting around 36,000 individuals, 0.17 percent of the total), and of the marginal rate of the wealth tax (for wealth over €10 million); (ii) for larger companies, a reduction from 100 to 95 percent in the tax credit applied to benefits from international subsidiaries, in line with the practice of other EU countries (it affects about 0.12 percent of the companies); (iii) reinforced green taxation, including new taxes on plastic packaging and waste; (iv) new taxes on financial transactions and digital services;

(v) an increase in the VAT rate for sugary drinks; and (vi) new measures to prevent tax evasion and reduced tax elusion.

The authorities' Recovery, Transformation and Resilience Plan is also aligned with the medium-term challenges of the economy. The Plan delineates the use of the Next Generation EU resources, which includes a financing pillar to member countries through lines such as the Recovery and Resilience Facility and React-EU—Spain is eligible for €140bn to finance public investment, including €72 billion in transfers, which are expected to be deployed in a period of six years, mobilizing up to €500 billion in private investment. It is structured around four axes: green transition, digitalization, gender equality and social and territorial cohesion, further detailed in ten traction policies with green and digital investment absorbing 37 and 33 percent of the resources, respectively. The use of EU funds will be accompanied by a structural reform agenda informed by the EU Semester recommendations. The authorities have designed a governance structure to ensure the efficiency, transparency and accountability in the use of funds, including a new office in charge of the strategic review in the Prime Minister's cabinet, a structure of commissions at ministerial, territorial and parliamentary levels, a set of expert and consultation committees with the private sector and social partners, and a reinforcement of public procurement and supervision procedures. The 2021 DBP includes €27 billion that can be subject to be financed with EU funds. Additionally, the React EU instrument will finance in 2021 up to €8 billion of initiatives to be included in the regional operational programs. The Recovery Plan is projected to create 800,000 new jobs, lift Spain's growth potential above 2 percent, and reduce by two thirds the inequality gap with respect to the EU average.

The authorities are closely monitoring the banking sector, which remains in sound grounds. The initial financial impact of the pandemic has been cushioned by the decisive economic policy response, in particular, credit support programs, the debt moratoria, and the expansionary monetary policy. Bank lending has shown positive growth since the end of March, financial conditions in the corporate sector have normalized, though they remain slightly tighter than before the COVID-19, and, so far, the volume of non-performing loans (NPLs) has increased only moderately. Solvency has improved slightly since 3Q19, supported in part by the flexibility introduced in the European banking regulation and supervision. In addition, there are significant capital buffers to absorb potential losses, and banks have undertaken extraordinary provisioning in anticipation of potential impairment losses, which has adversely affected income statements. The vulnerability analysis and the stress test performed by the ECB and Banco de España, respectively, show a high capacity to absorb losses under the central scenario. Nonetheless, given the severity of the macroeconomic scenarios, capital depletion can be expected to be significantly higher than in recent years and the supervisory authorities have reiterated that banks will have sufficient time to replenish capital buffers. In this scenario, consolidation processes in the banking sector, such as the ongoing merger of two banks into the largest bank measured by assets in Spain, might prove to be a useful response to the crisis, including cross border mergers. Going forward, the resilience of the euro area banking system can be improved with the completion of the Banking Union. We also support staff's recommendation to strengthen the European AML/CFT framework, currently coordinated by an ad hoc EBA Standing Committee.

Medium-term challenges

The COVID-19 crisis has heightened the need for social and economic transformation. The government took office in January 2020 with a coalition agreement that included among its medium-term economic objectives: increasing potential growth, ensuring fiscal sustainability, lowering unemployment and improving the quality of jobs, enhancing social and environmental sustainability and fostering gender equality. The COVID-19 crisis has made these objectives more urgent and there is political consensus on the need to strengthen the reform momentum in close coordination with social partners, including the opportunity of leveraging on the resources from Next Generation EU to accelerate the reform agenda.

The authorities are strongly committed to resume the fiscal consolidation strategy once the economic recovery stabilizes. Spain continues to enjoy a very strong market access and historic record-low levels in cost at issuance (0.21 percent) and record-high levels in average life of issued debt (7.82 years). The government projects reducing the fiscal deficit by 3.6 pp down to -7.7 percent of GDP in 2021 and is committed to resume fiscal consolidation and the pre-COVID downward trend in the debt-to-GDP ratio, once the recovery is firmly on track. The authorities have already taken steps in this direction by increasing the progressivity of the personal income tax and introducing new green, digital, and financial transactions taxes. Moving forward, they are already working on a complete review of the tax structure and of the public transfers system to enhance the progressivity and revenue collection capacity, and to better target spending. This process will be data-driven and informed by the expenditure and revenue reviews conducted by the independent fiscal authority. Measures in the pipeline include: a reform of the pension system—convergence of the different contribution regimes, sustaining purchasing power, incentivizing older effective retirement age, and encouraging the compatibility of work with the perception of pensions, while improving the complementary private pension system; and reordering non-contributory social benefits, with the MIS absorbing a series of non-contributory benefits to avoid duplications. Here, the authorities take note of the staff's recommendation to set an Earned Income Tax Credit program but prefer to continue working on the design of the MIS, which is already temporarily compatible with in-job earnings. In any case, the effects of the new MIS will be assessed in due course.

The new digitalization agenda plays a pivotal role in the strategy to raise productivity and improve social and regional equality. 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. The authorities are committed to devising a comprehensive regulatory and financing strategy in all these areas, which has already been strengthened in the 2021 DBP. The new digital strategy, Digital Spain 2025, is instrumental to increase productivity and reduce the carbon footprint, through the modernization of the productive structure, and to reduce social and regional inequalities, by leveling access and skills across society. It projects a public investment of €20 billion in the 2020–22 period and includes projects to ensure 100 percent connectivity and deployment of 5G, by 2025, and the digitalization of public administrations and companies, with a special focus on SMEs and start-ups. It will be articulated through public-private partnerships with the participation of social agents.

The authorities are undertaking a gradual reform of the labor market. They have implemented a number of measures to sustain jobs through the pandemic, most notably, the new provisions for ERTEs and the support program for the self-employed. Moving forward, the government will continue to tackle the main problems of the labor market such as duality, youth and long-term unemployment, gender gaps and facilitating resource allocation (staff has provided useful feedback on these issues, including in the SIPs). Reforms in the pipeline include: a reform of active labor market policies (reinforcing coordination between agents, enhancing profiling, fostering synergies with vocational training and evaluating and applying best practices); a review of the passive labor market policies to boost active job searching; and fostering open-ended contracts as the ordinary form of access to employment (increasing causality on the use of temporary contracts, fighting its abuse and enhancing the use of discontinuous fixed-term contracts). Additionally, the ERTEs have proven very effective, not only to limit the increase in unemployment, but also to provide added flexibility for companies, particularly for SMEs. In this respect, the authorities are working on the redesign of ERTEs to address some of the traditional problems of the labor market. For example, they can be used to reduce duality by providing stability and quality for temporary workers and seasonal activities, or by introducing elements of professional training to increase capabilities.

Social and environmental sustainability are guiding principles of the government's policy strategy. Tackling climate change and deploying policies to reduce inequality in all its dimensions, such as income, gender, intergenerational or regional, are guiding principles of government policies. These policies are not only key for achieving socially and environmentally sustainable growth, but they are also instrumental to improving productivity and long-term potential growth (staff has provided useful feedback, including in the SI on housing and gender policies). A key achievement in 2020 has been the approval of the draft bill on Climate Change and Energy Transition targets net zero GHG emissions by 2050, in line with EU targets. It concentrates on three major sectors: transport, housing and energy; and provides an institutional framework to achieve more ambitious goals than the EU 2030 targets on renewables and energy efficiency. Some of its main provisions include ensuring that almost all new vehicles are zero carbon by 2040; establishing low-emission areas in cities with more than 50,000 inhabitants by 2023; or the promotion of electric charging infrastructures throughout the national territory. The bill also focuses on ensuring that the energy transition succeeds with a "no one left behind" approach, articulated through policies such as transition agreements for the most affected areas, work-training programs for low-carbon jobs, or climate change education in schools. According to the government' estimates, the ecological transition could attract more than €200 billion in investments over the next decade and create up to 350,000 new jobs annually.