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FOR INFORMATION

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To: Members of the Executive Board

From: The Secretary

Subject: **Spain—Statement by the European Central Bank Representative**

Board Action:	Executive Directors' **information**
Additional Information:	For the Executive Board discussion on Spain to be held on Wednesday, November 11, 2020.

9 November 2020

Statement by Rasmus Rueffer (ECB Representative) and Dimitrios Rakitzis (Advisor) on Spain – 2020 Article IV Consultation
IMF Executive Board Meeting
11 November 2020

We would like to thank Mr. Moreno, Mr. Lopez, and Ms. Moral Betere for their informative Buff statement, and Staff for their report, which we view as balanced. We broadly agree with Staff and share many of the main findings, in particular those related to risks facing the Spanish economy and policy priorities ahead. However, we would also like to highlight a few items, including with respect to the importance of institutional frameworks and central bank mandates in the discussion of monetary policy.

We broadly share the IMF's views on the macroeconomic outlook. In line with IMF projections, ECB staff also forecasts a sharp contraction followed by a gradual recovery. Risks and vulnerabilities have increased and are still assessed to be very substantial, with the balance of risks being tilted to the downside. The COVID-19 pandemic has led to an unprecedented GDP decline in Spain, partly due to stricter containment measures, a large tourism sector and small average firm size. Policy measures have mitigated the impact of the crisis on households and firms. However, the growth outlook is surrounded by a large degree of two-way uncertainty related to the pandemic evolution, as highlighted by the most recent news on the availability of an effective vaccine.

While we agree with the inflation outlook, we view the projected outlook for unemployment as being somewhat on the optimistic side. Job retention schemes have been successful to contain unemployment so far; however, job losses have been more pronounced than in other countries due to the high reliance on temporary contracts, reflecting the dual labor market. Notwithstanding the strong focus of the Staff Report on structural issues in the labor market, particularly in the Special Issues Paper, the IMF projections assume no significant hysteresis effects.

We share the overall assessment contained in the Staff Report regarding the Spanish financial sector. In addition to entering the present crisis with stronger balance sheets than a decade ago, the Spanish banking system, like others in the euro area, has received a significant amount of additional supervisory capital relief and liquidity support from the ECB during this crisis. These elements, in combination with the large public loan guarantees and loan moratoria programmes, have allowed the banking system to continue to support the real economy during the pandemic.

Looking ahead, we believe that the most important short-term risks primarily relate to the materialisation of credit risk in H1 2021 when moratoria begin to expire and the first

repayments of guaranteed loans are due. So far, households' NPL ratios have risen only slightly and the NPL ratio for non-financial corporations has declined in the first semester of 2020. However, loans under moratoria (mainly mortgages) still account for around 7% of outstanding loans to households. Moreover, most of the guaranteed loans of non-financial corporations have been granted to micro enterprises working in those service sectors most affected by the pandemic. Banks' exposure to mortgages may also be vulnerable to weaker real estate market conditions. Although there were no signs of house price over-valuation before the pandemic, property transaction volumes have plummeted, potentially signalling an adjustment in house prices if the economic outlook continues to worsen.

Amidst the unfolding of a second pandemic wave, the policy priority remains to support solvent borrowers' ability to repay and safeguarding their access to credit, while also enhancing the debt resolution framework. This is also necessary in order to avoid that the economic recession evolves into a financial crisis. However, there is also a need for both authorities and banks to continue working on future exit strategies from support schemes in order to avoid "cliff-effects" and facilitate debt relief and debt restructurings of highly indebted but viable firms.

We agree with the positive assessment of the enhanced information sharing between AML/CFT and prudential supervisors. In this regard, we would like to note that following EU law amendments introduced in 2019, the resulting enhancements to the information shared between such supervisors will be integrated into prudential supervisory activities, where relevant as of the supervisory cycle following the transposition of CRD V into national law.

We concur on the importance of using fiscal policy to fight the pandemic and avert scarring, while also noting the need to strengthen debt sustainability. In more detail, we agree that fiscal policy should mobilise adequate resources to fight the pandemic and prevent as much as possible long-term scarring effects of the COVID crisis. With the intensification of the crisis the response should be scaled up accordingly. In the medium-term it is of utmost importance for Spain to utilise effectively the significant resources available from the Next Generation EU. These could be used as both a stabilisation tool as well as a means to reform the economy to reap the potential of digitalisation and environmental efficiency. The country should also undertake concrete steps to ensure sustainability of public finances without endangering the post-crisis recovery. In this context, the reduction of the high structural deficit is necessary for bringing down the stock of government debt.

Regarding monetary policy, we would like to make the general point that it is important to be mindful of existing institutional frameworks and central banks' mandates. The primary objective of the ECB is to maintain price stability and any policy measure has to be seen against this background. The Staff report calls for ECB policy support in view of Spain's severely strained public finances (paragraph 19). Especially in case of an adverse scenario, in which the public debt-to-GDP ratio is seen as increasing by 40pp, Staff sees the need for monetary policy to keep borrowing costs low. While the ECB's Governing Council currently considers an ample degree of monetary accommodation necessary this is clearly guided by the need to support economic activity and the robust convergence of inflation to levels that are below, but close to, 2 percent over the medium term. To that end, measures taken since early March are helping to preserve favourable financing conditions for all sectors and jurisdictions across the euro area. While ensuring favourable financing conditions is an important part of the monetary transmission mechanism at present, the report unduly focuses on sovereign borrowing costs and does not put this into the context of the ECB's overall price stability objective.

We agree with the structural policy priorities highlighted in the Staff report, and underscore the importance of aiming for a structural transformation in the economy. In the short term, measures are needed to control outbreaks of infection and save lives, while support needs to continue to employees and firms. However, we view that in the medium term, the EU Recovery and Resilience Facility is an opportunity to jump-start the structural transformation of the economy. More specifically, in the medium term, measures would need to be implemented to address labour market duality and tackle income inequality and social exclusion, improve active labour market policies and training systems to facilitate the transition from declining activities to expanding sectors, enhance private debt resolution systems and improve the effectiveness of policies supporting research, development and innovation. In addition to the IMF staff views, we would add as an important structural priority the need to tackle early school leaving and improve education outcomes. We also support the authorities' efforts to achieve carbon neutrality by 2050, and welcome staff's discussion of policies to ensure the consistency of recovery and resilience plans with climate goals.

In this context, we view that Next Generation EU funds could contribute to the implementation of various policy priorities. This includes (i) setting up a framework for active labour market policies and vocational training, and social housing policies; (ii) promoting private investment in the green economy; (iii) promoting investment in the digital economy by fostering research and innovation; and (iv) improving the coordination between different levels of government.