INTERNATIONAL MONETARY FUND

IMF Country Report No. 12/202

SPAIN

2012 ARTICLE IV CONSULTATION

July 2012

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2012 Article IV consultation with Spain, the following documents have been released and are included in this package:

- **Staff Supplement** of July 20, 2012 updating information on recent developments.
- **Staff Report** for the 2012 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 14, 2012, with the officials of Spain on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 9, 2012. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- **Informational Annex**.
- **Public Information Notice** (PIN) summarizing the views of the Executive Board as expressed during its July 25, 2012 discussion of the staff report that concluded the Article IV consultation.
- **Statement by the Executive Director and Senior Advisor** for Spain.

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INTERNATIONAL MONETARY FUND

SPAIN

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—SUPPLEMENTARY INFORMATION

July 20, 2012

Approved by Rodrigo Valdés and Martin Mühleisen

This supplement provides an update on major financial and fiscal sector policy initiatives that occurred after the staff report was issued to the Board. The initiatives are in line with staff recommendations and significantly alter the thrust of the staff appraisal.

Financial Sector: Policies to Accompany the Financial Assistance

1. The key policies incorporated in the Memorandum of Understanding (MoU) to accompany the EFSF financial support, which was approved on July 20, are: (1) identifying individual bank capital needs based on a comprehensive asset quality review and an independent bank-by-bank stress test; (2) recapitalizing, restructuring and/or resolving weak banks; (3) segregating legacy assets of weak banks into an asset management company; (4) burden sharing from hybrid/subordinated-debt holders in banks receiving public capital; and (5) strengthening supervision and regulation.

2. The financial assistance will cover estimated capital requirements with an additional safety margin, estimated as summing up to €100 billion in total, to be disbursed in several tranches over the 18-month duration of the program, with an average maturity of 12½ years. A first tranche of €30 billion is expected to be pre-funded and kept by EFSF as a contingency in case of urgent needs. The European Commission, in liaison with the ECB and EBA, will verify at regular intervals that the policy conditions are fulfilled. The Spanish authorities have also requested technical assistance from the Fund to support the monitoring of the financial assistance with regular reporting**.**

3. In staff's view, the policies envisaged in the MoU are strong and in line with recommendations of the FSAP and staff report. In particular, weak but viable banks are to be supported and non-viable banks are to be resolved, a comprehensive strategy to deal

with legacy assets is developed, and supervision and crisis management and the resolution framework are upgraded. If fully implemented, and in combination with the European financial assistance, these policies would substantially complete the needed restructuring of the sector. It remains important to sever the adverse loop between the sovereign and the banks and help mitigate short-term risks by a timely transformation of the European support into direct recapitalization.

Fiscal Sector: A Smoother Deficit Path and Additional Measures

4. On July 10, the Council of the European Union issued a recommendation giving Spain another year (until 2014) to reduce its deficit below 3 percent of GDP and loosening the targets for 2012–14. The new path for the overall deficit is: 2012, 6.3 percent of GDP (previously 5.3); 2013, 4.5 percent of GDP (previously 3.0); and 2014, 2.8 percent of GDP (previously 2.2). To achieve this path, the Council called for an average annual improvement of the structural balance of almost 2½ percent of GDP over this period. The new path is in line with staff recommendations and is similar to the recommended "smoother" adjustment scenario in Box 5 of the staff report.

5. On July 11, Prime Minister Rajoy announced a significant package of additional fiscal measures. Key measures include:

- VAT: the standard rate was raised from 18 to 21 percent and the reduced rate from 8 to 10 (the super-reduced rate was left unchanged at 4 percent). A number of products have also been moved from lower to higher rates. Other indirect taxes will also be raised.

- The extra payment in December to civil servants was suspended for 2012 — equivalent to nearly a monthly wage.

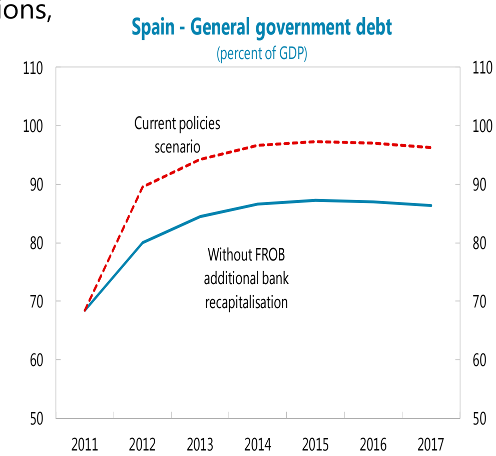
- The mortgage income tax deduction will be removed.

- Unemployment benefit was reduced (with the replacement rate after six months falling from 60 to 50 percent).

- Social security contributions are reduced by one percentage point in 2013 and a further point in 2014.

6. At the Fiscal Policy Council meeting of July 12, the central government initiated for several regions the first step in the warning procedure established in the new budget stability law (Appendix III). Regions will also begin monthly budgetary reporting from October and a centralized fund was established to support regional financing. On July 14, measures were also taken to liberalize retail opening hours and promotion periods, and to reduce the electricity deficit.

7. The new fiscal package, regional government actions, and structural measures, are broadly in line with staff recommendations. Staff's preliminary estimate is that the cumulative size of the package between 2012–14, as currently planned, is about 2 percent of GDP. This should lead to deficits in 2012 and 2013 close to the revised targets, though more measures (for example, on the VAT) would be needed for 2014 and beyond. Medium-term debt sustainability would improve with government debt[1] reaching 97 percent of GDP in 2015, but declining slightly thereafter. Implementation will be key and challenging, with the risk of slippage, in particular by the regions, warranting close attention.



Source: IMF Staff estimates.

8. Staff expects the new fiscal consolidation measures to have a significant impact on growth, especially in 2013. While the large role of indirect taxes should lead to a relatively low multiplier, preliminary estimates suggest that the level of output would be lowered by about 1 percent by 2014. Unemployment would also increase, although this might be mitigated by the effect of lower social security contributions and unemployment benefits, as well as the recent labor market reform. The VAT increase, combined with electricity price increases, will also lead to temporarily higher inflation. Lower domestic demand would further improve the current account, which would reach a larger surplus over the medium term, putting the net IIP on a downward path.

Spain: Staff Medium Term Outlook--Baseline Scenario

(percent, unless otherwise indicated)

	2011	2012	2013	2014	2015	2016	2017
Real GDP	0.7	-1.7	-1.2	0.9	1.6	1.7	1.7
HICP (period average)	3.1	2.1	2.2	1.2	1.4	1.4	1.4
Unemployment rate (period average)	21.7	24.9	24.7	24.3	23.3	22.1	20.5
Current account balance (percent of GDP)	-3.5	-1.8	-0.6	0.1	0.9	1.5	2.1
Overall balance (percent of GDP)	-8.9	-6.3	-4.7	-3.6	-3.3	-2.6	-2.1
Primary balance (percent of GDP)	-6.4	-3.1	-1.0	0.4	0.9	1.8	2.5
Structural balance (percent of GDP)	-7.6	-4.7	-2.8	-1.8	-2.0	-1.8	-1.7
Government debt (percent of GDP)	68.5	89.6	94.3	96.6	97.3	97.0	96.3

Sources: Eurostat; and IMF staff projections.

[1] Including, for the sake of prudence and pending further details, the full Eurogroup commitment of up to €100 billion (9.4 percent of GDP).

INTERNATIONAL MONETARY FUND

SPAIN

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION

July 9, 2012

KEY ISSUES[1]

Context: Spain is facing mounting market pressure and costly market access, with possibly negative repercussions for the rest of the Europe, amid the longer-term challenge of unwinding imbalances that built up during several years of excess private sector spending. The economy is in the midst of an unprecedented double-dip recession with unemployment already unacceptably high, public debt increasing rapidly, and segments of the financial sector lacking capital and market access. Headwinds from household and corporate deleveraging, combined with unavoidable fiscal consolidation and persistent capital outflows, will likely translate into output contractions this year and next.

Risks: Downside risks dominate. While the recently announced Euro area financial assistance for banks and the Euro area summit statement help to mitigate short-term risks, market tensions could intensify further, threatening market access, particularly if policies fail to stem capital outflows or due to further stress elsewhere in the Euro area. Private sector deleveraging could be faster than envisaged, and the fiscal consolidation may have larger than expected output costs.

Policies and staff views: Many major policy actions have been taken in recent months on several fronts. These include: significant efforts to further strengthen the financial sector, an important labor market reform which should facilitate gains in competitiveness which are critical, fiscal adjustment measures and improvements in the fiscal framework. But market confidence remains weak and the outlook is very difficult. This calls for a commensurately ambitious policy response and communicating it within a comprehensive medium-term strategy. This strategy should be based around concrete measures to deliver the needed medium-term fiscal consolidation, a clear

[1] Significant policy developments occurred after this Staff Report had been issued to the Board, which are discussed in the attached Staff Supplement.

roadmap for restructuring the weak segments of the financial sector, and structural reforms to support relative price adjustments and boost growth. In the short-term, the main priority is securing market financing for both public and private sectors at affordable rates. The prospective Euro area financial sector support is an important plank in this strategy, with the recent Euro area summit decisions rightly aiming to address market concerns on the implication of bank sector losses for the sovereign balance sheet. Spain's prospects for lowering borrowing costs would be critically helped by a timely implementation of the summit decisions and continued progress toward a banking and fiscal union at the European level.

Authorities' views: The authorities viewed the renewed market tensions as reflecting not only domestically generated imbalances but also the flaws in Euro area frameworks. The authorities broadly shared the assessment of the ongoing adjustment of macroeconomic imbalances, the near-term outlook, and the medium-term potential of the recent reforms. They also broadly shared staff's view on the financial sector, and expressed their willingness to implement recommendations of the FSAP and concurred that the Euro area backstop gives the opportunity to clean up Spain's financial sector once and for all. The government recognized the challenges of the envisaged fiscal consolidation, but pointed to the substantial revisions in the fiscal framework, and underscored their commitment to take additional measures as needed. The government also argued that the labor market reform is profound, introducing significant labor flexibility to provide adjustment mechanisms alternative to job destruction, and that structural reforms would continue on several fronts.

Approved By
Rodrigo Valdés and Martin Mühleisen

A staff team comprising J. Daniel (Head), P. Lopez-Murphy, P.Sodsriwiboon, J. Vacher, I. Yakadina (all EUR), A. Buffa di Perrero, A. Giustiniani (both MCM), E. Vidon (SPR), R. Romeu (FAD), J. Guajardo (RES), A. Gaviria (EXR) visited Madrid on June 4–14, 2012 to conduct the 2012 Article IV Consultation discussions. The mission also visited Valencia and Sevilla. Mr Valdés (EUR), Ms. Balsa and Ms. Aparici from the Executive Director's office for Spain, joined the discussions in Madrid. The mission met with Economy and Competitiveness Minister De Guindos, Finance and Public Administrations Minister Montoro, Bank of Spain Governor(s) Ordonez and Linde, other senior officials, and financial, industry, academic, parliament, and trade union representatives.

CONTENTS

CONTEXT AND OUTLOOK **5**
A. Outlook 10
B. Authorities' Views 13

THE POLICY AGENDA **14**
A. Financial 14
B. Fiscal Policy 18
C. Structural reforms 27

STAFF APPRAISAL 32

FIGURES
1. Activity 35
2. Inflation 36
3. High Frequency Indicators 37
4. Competitiveness 38
5. Imbalances and Adjustments 39
6. Financial Market Indicators 40
7. Labor Markets 41

TABLES
1. Main Economic Indicators 42

2. Selected Financial Soundness Indicators 43
3. General Government Operations 44
4. General Government Balance Sheet 45
5. Outstanding Liabilities of the Public Sector 46
6. Regional Fiscal Operations 47
7. Balance of Payments 48
8. International Investment Position 49
9. Monetary Survey 50
10. Risk Assessment Matrix 51
11. Authorities' Response to Past IMF Policy Recommendations 52

BOXES

1. External Financing 6
2. Spain's request for Euro Area Financial Assistance to Recapitalize the Banking Sector 7
3. Structural Reforms and Medium-term Growth 12
4. FSAP Main Recommendations 18
5. What is the Right Deficit Path 22
6. The Challenge of Regional Fiscal Adjustment 25
7. Unemployment Volatility and Labor Market Rigidities 28

ANNEXES

I. Fiscal And External Sustainability 53
II. Main Elements Of The Labor Market Reform Of February 2012 60
III. Organic Law For Budget Stability And Financial Sustainability 64
IV. Cleaning-Up Banks' Balance Sheets 67
V. External Sector Assessment 69

CONTEXT AND OUTLOOK

1. **Imbalances accumulated over the long boom years are gradually being unwound while the economy faces considerable stress.** Spain is facing mounting market pressure and costly market access, with possibly negative repercussions for the rest of the Europe, amid the longer-term challenge of unwinding imbalances that built up during several years of excess private sector spending. This unwinding is occurring as the economy enters an unprecedented double-dip recession with unemployment already unacceptably high, public debt increasing rapidly, and segments of the financial sector lacking capital and market access. The center-right Popular Party won an overall majority in the November general election and took office in late December with a strong mandate for consolidation and reform.

2. **The new government has taken prompt action on a range of fronts.** Facing an intensification of the euro area debt crisis, the economy falling back into recession, unemployment rising even further, bank wholesale funding drying up, and the news that the fiscal deficit for 2011 would be at least 8 percent of GDP rather than the 6 percent of GDP targeted, the government responded with a number of major policy actions:

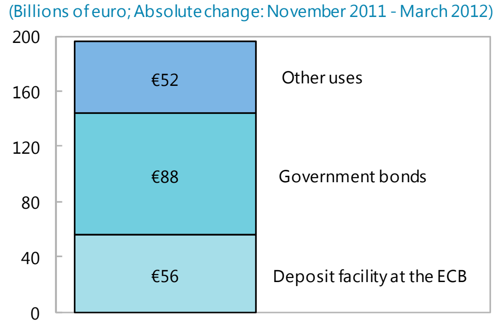
- ***Banks.*** Provisions and capital requirements have been raised, independent valuations commissioned, the fourth largest bank is being restructured, and a credible backstop provided with support from Spain's European partners. The government adopted a pro active approach to the FSAP and committed to draw on its findings rapidly.
- ***Fiscal.*** A package of measures was introduced in December, an ambitious 2012 budget was introduced, the fiscal framework significantly improved, and sub-national arrears are being cleared.
- ***Labor.*** A profound labor reform was enacted in February.

3. **After an LTRO-led respite, market tensions re-emerged in the Spring and the government sought euro area financial support:**

- Successive 3-year refinancing operations by the ECB in December and February saw a particularly large take up by Spanish banks, which helped relieve concerns about bank funding and allowed them to increase their purchases of government bonds. However, banks access to capital markets remained virtually shut and gross ECB borrowing rose to €343 billion (around 9 percent of total assets) as of end May. Including staff estimates of SMP purchases, the Eurosystem held claims on Spain of close to 40 percent of Spanish GDP as of end May.

Spain: Uses of 3-Year LTROs

(Billions of euro; Absolute change: November 2011 - March 2012)



Sources: Banco de España; Ministerio de Economia y Competitividad; J. P. Morgan; and IMF staff estimates.

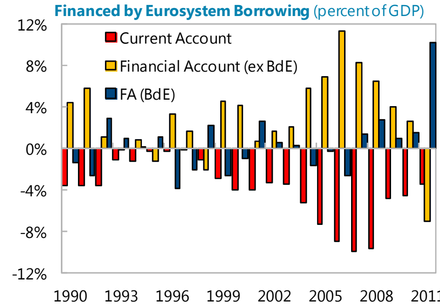
- Spain has suffered a sharp reversal of private external financing flows in the second half of 2011 and early 2012 (Box 1). Once the LTRO effects subsided, this pressure was reflected in spread over German bunds hit euro era highs. The 10-year bond yield differential with Italy also reversed, moving from a peak of almost 200 bps in December in Spain's favor above 90 bps in Italy's favor as of early July, although correlations remained high. The sovereign and banks also have suffered multiple-notch downgrades from rating agencies and LCH Clearnet has increased the margin requirements on banks using Spanish government debt as collateral in repo operations. Downgrades and increased spreads have also led to much costlier market access for large corporates.

In early June, the government announced its intention to request European financing for bank recapitalization, which was welcomed by the Eurogroup, for up to €100 billion, with further strengthening of the planned financial assistance at the Euro area summit of June 29 (Box 2).

Box 1. Spain's External Financing

Over the past decade, Spain's current account deficits had been financed by private capital inflows: this came to a sudden stop in 2011. While recent years had witnessed increased reliance on Eurosystem refinancing, private flows had remained the dominant source of funding. Even in 2010, the spike in ECB borrowing had been mostly temporary, and portfolio repatriation by residents had played a key role. By contrast, in the second half of 2011 and early 2012, net private capital outflows have been persistent. The resulting financing needs, which greatly surpass current account financing needs, have been covered for a limited part by ECB intervention in the bond market (through the SMP), and to a larger extent by a surge in bank refinancing with the Eurosystem.

2011 Current Account Deficit and Private Outflows Financed by Eurosystem Borrowing (percent of GDP)



Source: Bank of Spain.

At the end of 2011, both gross external debt and the net IIP were broadly unchanged in magnitude compared to a year before. However their composition had shifted significantly toward less portfolio assets and liabilities, and increased Bank of Spain liabilities to the Eurosystem.

Staff projects a gradual decline in reliance on ECB financing. In the central scenario, ECB financing would not drop markedly before maturity of the 3 year LTROs and would still amount in 2015 to about half current levels. A moderate decline in private sector reliance on external financing would be compensated by external asset drawdown. Alternative scenarios include:

- A resumption of private capital inflows combined with continued foreign asset drawdown, would allow ECB refinancing to be paid down by 2015.
- If foreign investors were not to rollover any of their portfolio holdings of Spanish government and bank debt as they mature, reliance on ECB financing would increase and foreign asset drawdown would accelerate.
- If private capital outflows were to continue at the same pace that was seen over the second half of 2011, non-resident holdings of Spanish government debt could soon drop to zero. ECB refinancing would further rise.

Box 2. Spain's request for Euro Area Financial Assistance to Recapitalize the Banking Sector

Purpose. On June 25, the Spanish Government formally requested financing from euro-area Member States for the recapitalization of its weakest financial institutions. The Eurogroup has welcomed the request. Financial assistance will be provided by the EFSF until the ESM becomes available, and would then be transferred to the ESM without gaining seniority status. The assistance is intended to backstop all possible capital needs estimated by the diagnostic exercise commissioned by the Spanish authorities from external evaluators. The envelope of up to €100 billion defined by the Eurogroup is intended to cover currently estimated capital requirements with an additional safety margin.

Process. Following the formal request, an assessment that eligibility conditions for access to an EFSF/ESM financial assistance for the re-capitalisation of financial institutions were satisfied was provided by the European Commission. In liaison with the ECB, EBA and the IMF, the Commission has also prepared proposals for financial sector policy conditionality that will accompany the assistance. Once agreed, a MoU will be signed by the Spanish Government.

- *Amount:* The specific amount will be determined based on the ongoing bottom-up assessment of individual institutions.

- *Conditionality*: The Eurogroup considers that the policy conditionality of the financial assistance should be focused on specific reforms targeting the financial sector, including restructuring plans in line with EU state-aid rules and horizontal structural reforms of the domestic financial sector.

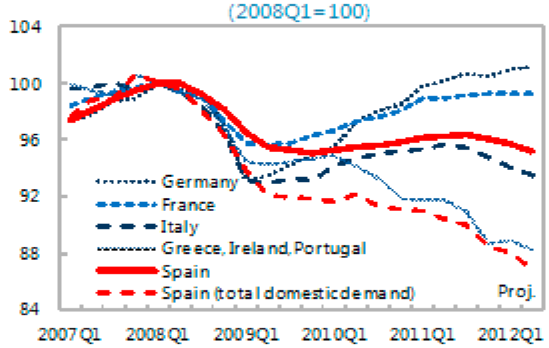
- *Commitments*: Spain's European commitments under the excessive deficit procedure and with regard to structural reforms, with a view to correcting any macroeconomic imbalances as identified within the framework of the European semester. Progress in these areas will be closely and regularly reviewed in parallel with financial assistance.

- *Disbursement*: The FROB, acting as agent of the Spanish government, would receive the funds and use them to recapitalize the financial institutions concerned. The Spanish Government will retain the full responsibility of the financial assistance. Assistance provided as a loan, as opposed to direct equity stakes, will increase Spain's general government debt in gross terms. When a single supervisory mechanism for banks in the euro area, involving the ECB, is established, the ESM could have the possibility to recapitalise the banks directly via a new instrument.

Role of the Fund. As indicated by the Eurogroup, the Commission will continue to liaise with IMF (as well as the ECB and EBA) for the preparation of the forthcoming assessment of capital needs. The Eurogroup has also invited the IMF to support the monitoring of the financial assistance with regular reporting. To that effect, Spain will request technical assistance from the IMF.

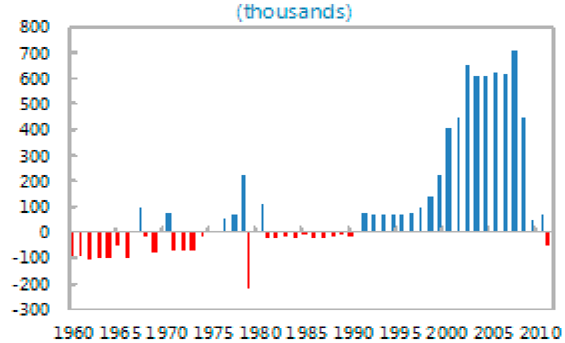
4. **The economy has entered an unprecedented double-dip recession with unemployment surging over 24 percent.** The modest recovery from the 2008–09 crisis gave way to a new slowdown in the second half of 2011 as financial tensions rose. By the end of the first quarter of 2012, real output was some 3 percent below its 2008 peak, similar to Italy. Unlike France and especially Germany, output has not recovered its pre-crisis level (though it has when excluding construction). Private consumption and investment led the downturn and domestic demand is almost 13 percent below its 2007 peak. Recent wage moderation proved insufficient to arrest the pace of job losses, and Spain has net emigration for the first time since the early 1990s. Credit is declining and house prices are falling at an increasing rate. An inflation differential with the euro area has opened up while net exports are cushioning the fall in activity.

Real GDP for Selected European Countries
(2008Q1=100)



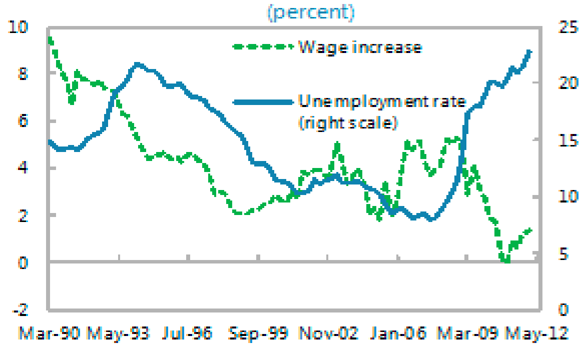
Source: IMF, *World Economic Outlook*.

Net Migration Flows in Spain, 1960-2011
(thousands)

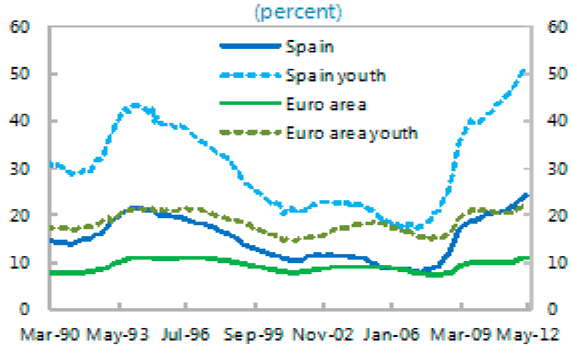


Source: FEDEA.

Wage Costs and Unemployment
(percent)



Unemployment Rates
(percent)

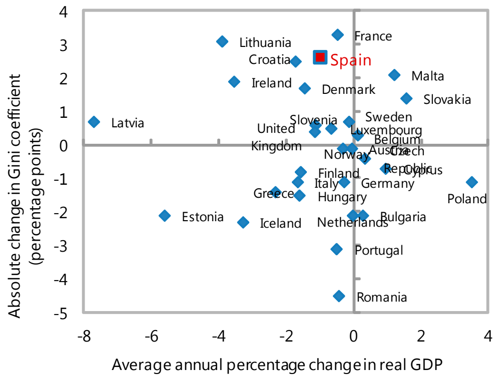


Sources: Ministry of Labor and Immigration; Eurostat; and INE.

5. **Income inequality and poverty are on the rise, especially among the young, reflecting labor market developments.** Spain suffered one of the worst absolute deteriorations in income distributions since the crisis, mainly due to unemployment, though additional income support provided by informal occupations may have provided a limited buffer. In a dual labor market, the

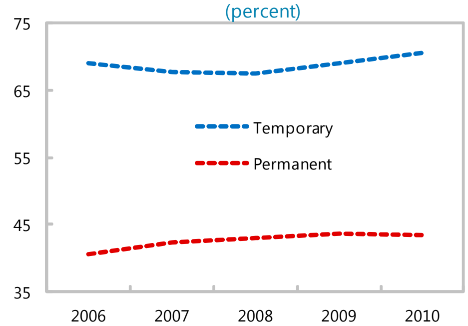
income gap between workers with permanent and temporary contracts further widened, with now close to three quarters of temporary workers in the bottom half of the income distribution. Around half of all youth are unemployed, a third has dropped out of school, and those who have jobs are largely on temporary contracts.

Impact of Financial Crisis on Income Inequality, 2007-2010



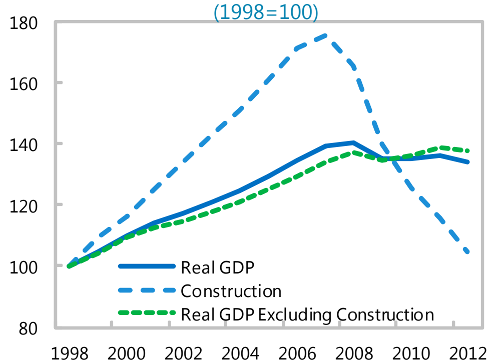
Sources: INE, Eurostat, and IMF staff estimates.

Share of Workers in Lower Half of Income Distribution by Type of Contract
(percent)

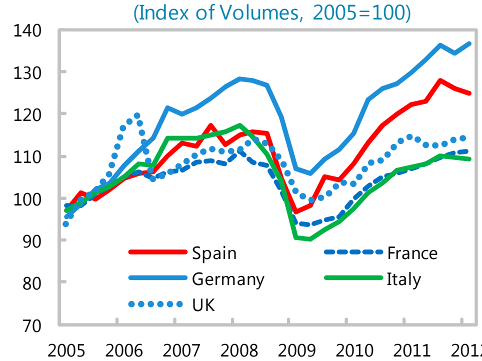


6. **Private sector imbalances are large but diminishing with deleveraging underway.** The trade balance was a bright spot. In 2011, exports were higher than their pre-crisis level at 30 percent above trough. Imports fell more than domestic demand, helping the current account deficit narrow to 3 ½ percent of GDP. The household savings ratio declined back towards pre-crisis levels in 2011 amidst weakening disposable income and housing investment. Nonfinancial corporate sector balance sheets continued to strengthen and the sector is now a net lender to the economy. However, this also reflects the lack of investment and access to finance of many businesses. Large corporations that had access to the financial markets now find it increasingly difficult and SMEs are constrained in their access to bank finance. House prices have fallen by some 30 percent since the peak and construction investment is back to its 2000 level, representing 10 percent of total value added.

Real GDP and Construction
(1998=100)



Exports of Goods and Services
(Index of Volumes, 2005=100)



Source: Eurostat; IMF, *World Economic Outlook*.

7. **But stock problems are little improved.** While the current account deficit has narrowed sharply, the net external position has only stabilized at a very high level. Private sector debt remains high. House prices are still overvalued, potentially by a significant margin. The large stock of unsold housing has little diminished, which suggest that while investment in construction may be at historical norms, a substantial period of "undershooting" may be necessary, as inventory effects are poorly captured by traditional models of overvaluation.

Spain: Estimates of House Price Overvaluation 1/

(Percent)

Source	2011 Estimates	2010 Estimates
ECB	18	20
European Commission	n.a.	24
Deutsche Bank	33	n.a.
Goldman Sachs	20	n.a.
Economist	32	39

1/ Average of house price measures, i.e. house price-to-rent ratio, house price-to-income ratio, affordability index, etc.

A. Outlook[2]

8. **The outlook is very difficult.** Large fiscal consolidation is planned and unavoidable. Coupled with high unemployment and household and corporate deleveraging, this will continuously drag domestic demand and dampen underlying inflation. Output will likely decline this year and next, and over the medium term the effects of fiscal consolidation will have to be fully factored in. Potential output growth is also projected to turn negative reflecting high structural unemployment and a permanent decline in capital accumulation. But with an assumed gradual easing in financial conditions and an eventual improvement in the labor market (aided by the labor market reform), employment, private consumption and fixed investment are likely to recover modestly. Net exports are expected to continue to contribute positively to growth, with exports projected to maintain their world market share and the current account moving into surplus over the medium term. By 2017, however, real GDP would have only just surpassed its 2007 level (real domestic demand would be some 9 percent lower) and unemployment only have fallen to 20 percent.

Spain: Real GDP Growth Projections

(Percent)

	2012	2013	2014	2015
IMF	-1.5	-0.6	1.1	1.5
MoF (April 2012 SGP update)	-1.7	0.2	1.4	1.8
Bank of Spain (February 2012)	-1.5	0.2	...	...
EC (May 2012)	-1.8	-0.3	...	...
OECD (May 2012)	-1.6	-0.8	...	...
Consensus (April 2012)	-1.6	...	...	...
FUNCAS (April 2012)	-1.7	-1.5	...	...

Spain: Staff Medium Term Outlook--Baseline Scenario

(percent, unless otherwise indicated)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Real GDP	3.5	0.9	-3.7	-0.1	0.7	-1.5	-0.6	1.1	1.5	1.6	1.6
Total domestic demand	4.1	-0.5	-6.2	-1.0	-1.7	-3.9	-1.4	0.4	0.7	0.9	1.0
Private consumption	3.5	-0.6	-4.3	0.8	-0.1	-1.5	-0.1	0.9	1.0	1.1	1.1
Public consumption	5.6	5.9	3.7	0.2	-2.2	-6.9	-5.5	-1.2	-0.4	-0.2	-0.1
Fixed investment	4.5	-4.7	-16.6	-6.3	-5.1	-7.5	-1.1	0.6	1.0	1.4	1.8
Net exports 1/	-0.8	1.5	2.8	0.9	2.5	2.4	0.7	0.7	0.7	0.7	0.6
Exports	6.7	-1.0	-10.4	13.5	9.0	1.7	4.6	4.5	4.9	4.9	4.9
Imports	8.0	-5.2	-17.2	8.9	-0.1	-6.2	2.4	2.8	3.0	3.4	3.7
HICP inflation (period average)	2.8	4.1	-0.2	2.0	3.1	1.6	1.0	1.2	1.3	1.4	1.4
GDP deflator	3.3	2.4	0.1	0.4	1.4	0.6	0.8	1.1	1.2	1.3	1.2
Unemployment rate (period average)	8.3	11.3	18.0	20.1	21.6	24.7	24.4	23.8	22.9	21.7	20.3
Trend output growth	2.5	2.3	1.3	0.6	0.5	-0.4	-0.4	-0.1	0.2	0.6	0.8
Output gap 2/	3.8	2.3	-2.8	-3.4	-3.2	-4.3	-4.4	-3.3	-2.1	-1.2	-0.4
Current account balance (%GDP)	-10.0	-9.6	-4.8	-4.5	-3.5	-2.0	-1.1	-0.6	0.0	0.8	1.4

Sources: Eurostat; and IMF staff projections.
1/ Contribution to growth.
2/ As percent of potential GDP.

[2] Significant policy developments occurred after this Staff Report had been issued to the Board, which are discussed in the attached Staff Supplement.

9. **Private sector credit will likely contract further for the next few years.** Although ECB liquidity support has alleviated bank funding pressure, private sector credit is expected to shrink by about 5 percent in 2012 and continue to decline until 2014. By 2017, the deleveraging process would bring down private sector credit to about 140 percent of GDP. Deposits would decline gradually in 2012–13, in the wake of a weak economy. The loan-to-deposit ratio would be lower-decreasing only marginally wholesale financing needs—but at a high level while it converges to the euro area average.

10. **Structural reforms could lead to a much improved medium-term scenario (Box 3)**. If properly implemented and accompanied by other measures, the recent labor market reform could lead to a substantial reallocation of resources towards more dynamic sectors. This could boost the level of potential output by 4–5 percent by 2017 and bring unemployment down by an additional 3–4 percentage points by 2017 (though at above 15 percent would remain high). New jobs would center in more knowledge-based and tradable sectors.

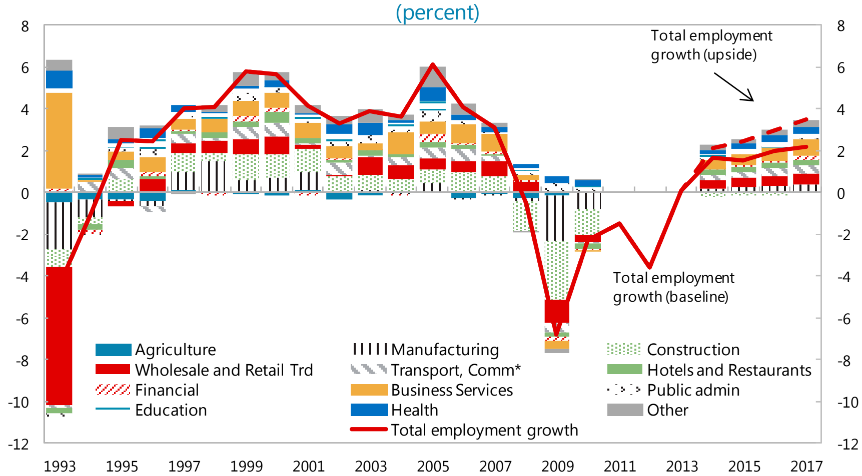
Box 3. Structural Reforms and Medium-term Growth

Structural reforms focusing on the supply side and leading to labor reallocation could boost potential growth and employment by 4 percent over 4 years. This upside scenario builds on the announced reforms (centered on the recent labor market reform) for 2014 and beyond. Reallocation towards more productive and profitable sectors is assumed to bring about a moderate increase in the capital-labor ratios of the targeted sectors and the entire economy, boosting growth potential even without any additional positive contribution from TFP.

The upside scenario for employment reverts price misalignments accumulated during the boom years. Construction, real estate activities, and the housing-related part of financial intermediation contributed over a third of 2001–07 growth but their contribution will shrink or disappear in 2014–17. The upside scenario mimics a sectoral pattern of recovery after the early 1990s recession resuming the pre-crisis long-term trends in agriculture and business services. Estimates from the literature on the degree of reallocation and frictionless (or intrinsic) employment are used to project sectoral growth. The sectors that would make the largest contribution to employment growth would be business services, wholesale and retail trade, and transport and communications.

Employment growth and sectoral contribution: Baseline and Upside Scenarios

(percent)



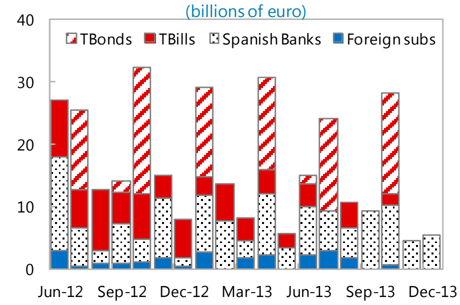
Sources: Eurostat; and IMF staff calculations.

To support job creation and bridge the gap between the baseline and the upside scenarios, policies should support the expansion of the tradable sector. Policies needed for this necessary reallocation include wage moderation, improved job search assistance and incentives, better integrated employment services, and more competitive domestic markets. Further reforms at the European level would increase even more Spain's potential (IMF SDN/12/07 "Fostering Growth in Europe").

11. **But downside risks greatly dominate the outlook.** Macroeconomic risks include a faster than expected private sector deleveraging and fiscal consolidation having greater than envisaged output costs. Tail risks are significant and potentially extremely costly both for Spain and Europe (Table 9).

- Immediate homegrown risks primarily relate to a repetition of a large fiscal slippage and debt accumulation, accelerated by the recognition of contingent liabilities and higher than expected capital needs in the banking sector, and intensified funding pressure on weak banks.
- External risks are dominated by the threat of continued capital outflows amid renewed financial market stress, focusing on sovereign/bank spillovers. Direct recapitalization of banks as envisaged by the euro area summit could mitigate these adverse effects.
- Although both the sovereign and banks have significant buffers, materialization of these risks could threaten sovereign market access. Financing needs of the sovereign are large at 11 percent of GDP for the remainder of this year and 23 percent of GDP for next year. Given Spain's size, financing needs and external indebtedness, potential spillovers can be large. German and French banks have considerable exposures while market correlations suggest other southern European countries could be affected.

Spanish Treasury and Bank Debt Amortization
(billions of euro)



Sources: Tesoro; and Bloomberg.

B. Authorities' Views

12. **The authorities viewed the renewed market tensions as reflecting the imbalances of the Spanish economy but also flaws in Euro area frameworks.** They emphasized the extent and depth of reforms adopted since the beginning of the year, their comprehensive approach to government finances and noted that although the economy has been adjusting, unwinding the accumulated imbalances would take time. They noted that the Spanish economy is becoming more competitive. The authorities saw the market risks faced by Spain as having a major Euro-area dimension and thus requiring, along with national policy actions, a Euro-area response to mitigate. They stressed that the solution to current tensions is more Europe, and that although Spain is ready to play an active part and will continue on its reform path, additional measures by Spain in isolation risk losing traction in the short term if significant Euro area-wide measures are not forthcoming.

13. **The authorities broadly shared the assessment of the ongoing adjustment of macroeconomic imbalances, near-term prospects, and medium-term potential of the recent reforms.** The authorities also concurred with the analysis of the challenges facing the economy over the medium-term. However, the government saw a stronger recovery starting from mid-2013 with much lower output costs of fiscal consolidation. Even in the absence of any immediate growth employment gains from reforms, the government reiterated its strong commitment to maintaining the reform momentum.

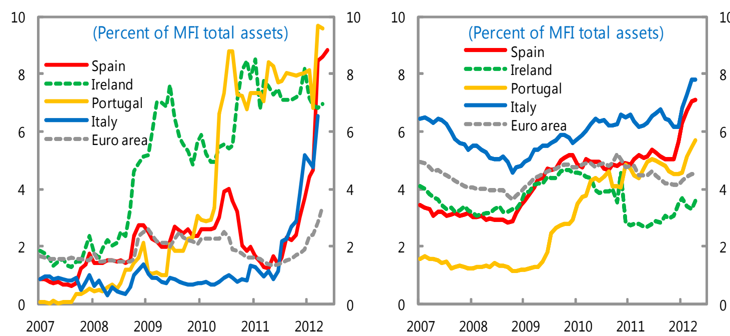
THE POLICY AGENDA

14. **Continued strong implementation of a comprehensive strategy is needed to restore confidence so that imbalances can be unwound smoothly and jobs and growth fostered.** This strategy should include strengthening the finances of the government and finalizing the banking reform. The financial sector backstop allows the financing of the clean-up, restructuring, and recapitalization of the weak segments of Spain's banking sector once and for all. But the policy plan also should include better functioning labor and product markets to support household incomes, fiscal consolidation, banks' asset quality, and social backing for reform. The recent labor market reform offers a good stepping stone to intensify the ongoing reversal of the large misalignment in prices and wages. Gains in employment and external competitiveness will be gradual but should also be at the center of this agenda. It will be important to communicate such a package clearly and cohesively.

15. **It is critical that Spain's prospects be helped by decisive progress at the European level.** There is an immediate need at the euro area level to ensure adequate bank funding and mitigate contagion. But a lasting resolution to the Euro area crisis will require a convincing and concerted move toward a complete and robust EMU, as discussed in the Euro area Article IV staff report. At their summit meeting on June 28–29, European leaders agreed upon significant positive steps to address the immediate crisis. The agreement, if implemented in full, will help break the adverse links between sovereigns and banks. These initiatives are in the right direction and will need to be complemented, as envisaged, by more progress toward deeper fiscal integration and a full-fledged banking union. A clear commitment to implement steps in this direction, in particular through an area-wide deposit insurance and resolution authority, and greater fiscal integration, with risk sharing supported by stronger governance, is essential to chart a credible path ahead.

A. Financial[3]

Spain: Banks' ECB Borrowing and Sovereign Bond Holdings



Sources: European Central Bank; Bundesbank; Banco de España; Banco de Portugal; Central Bank and Financial Services Authority of Ireland; and Banca d'Italia.

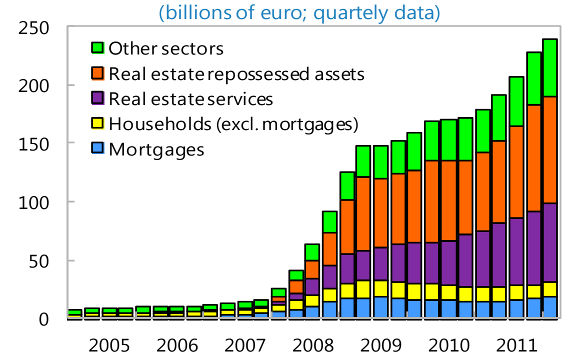
16. **Spanish banks remain under pressure, though the 3-year LTROs provided some temporary relief.** Bank issuance virtually stopped since mid-2011, spreads soared, and interbank tension rose. Against this backdrop, Spanish banks drew heavily from the ECB 3-year LTRO operations. Following an ECB Council decision in December 2011, the BdE, like other euro-area national banks, widened the range of collateral eligible for repo-operations; to date the use of this additional collateral remains marginal. Domestic retail deposits have somewhat declined

[3] Significant policy developments occurred after this Staff Report had been issued to the Board, which are discussed in the attached Staff Supplement.

reflecting, besides macroeconomic factors, portfolio reallocation towards more remunerative banks' commercial papers and government securities.

17. **Amid continuing asset deterioration and declining profitability, banks have strengthened capital and provisioning buffers.** Nonperforming loans reached 8.7 percent of gross loans in April. Including assets repossessed from developers and households, impaired loans amount to about 12 percent of gross loans. Declining net interest income and rising cost of risk curbed banks' profitability, despite cost-reducing policies. Spanish banks buttressed their core capital ratio from less than 7 percent in mid-2008 to about 9 percent (including state support). Most of the recapitalization has been achieved through retained profits, conversion into equity of hybrid instruments, and below-par debt pre-payments. Some de-risking of banks' total assets has also taken place, partially reflecting the decline in credit to the private sector. Provision and specific capital buffer requirements against real estate were further increased in February and May, amounting to about 7 percent of GDP. This would bring the coverage of the total problematic portfolio to about 70 percent. In addition, banks were required to transfer real estate foreclosed assets into asset management subsidiaries.

Spain: Nonperforming Loans; Breakdown by Activity
(billions of euro; quartely data)



Sources: Banco de España; R.R. de Acuña & Asociados; and IMF staff estimates.

18. **The restructuring of the banking sector has continued apace.** By end-2012, ten institutions will have been resolved since 2008, with most of the costs borne by the banking industry, and the number of former savings banks reduced to 8 (from 45 at the beginning of the crisis). The number of bank employees has been reduced by 11 percent and branches by 13 percent. The authorities and the industry (via the Deposit Guarantee Fund) have outstanding funding and capital support amounting to about 9 percent of GDP. In early May, the FROB intervened the holding company of the fourth largest bank, thereby taking a 46 percent ownership in the latter.

Spain: Financial Sector Support Measures
(As of March 2012)

	in EUR bn	in % GDP
Bond guarantee	50.8	4.7
FROB	13.9	1.3
Preference shares	9.3	0.9
Equity capital	4.2	0.4
Asset protection scheme	0.4	0.0
Deposit Guarantee Fund	31.3	2.9
Recapitalization	7.5	0.7
Asset protection scheme	23.5	2.2 1/
Other	0.4	0.0 2/

1/ Includes EUR 2.5 billion granted for the takeover of CCM and 80 percent of total ring-fenced portfolio net of accumulated provisions granted for the takeover of CAM and Unnim (maximum possible disbursement).
2/ Bridge loan granted for the takeover of CCM.

19. **The outlook for banks remains highly challenging.** Further significant deterioration in asset quality is likely given the projected recession and further rises in unemployment. Deleveraging and low credit demand will sustain margin pressure, despite the benefits of LTRO related carry-trade, while the need to increase loan loss provisioning will absorb a very large share of banks' pre-provision income. These factors will significantly reduce banks' capacity to internally generate capital, while regulatory and especially market solvency pressure has intensified. The inter-reliance of banks and the sovereign has increased. Assuming the stability of domestic deposits, liquidity

buffers appear sufficient at the system level, but collateral posted at the ECB for repo purposes is vulnerable to ratings downgrades and margin calls while asset encumbrance for some banks is high and the capacity to generate new collateral is weakening. Spanish banks also face €158 billion (medium- and long-term) debt redemption in 2012–13. Although the LTROs have provided a sizeable cushion, the phasing-out of ECB funding will likely prove problematic if market access does not improve and reliance on wholesale funding is not reduced. Indeed, liquidity stress tests in the context of the FSAP show that liquidity risk can potentially become the biggest risk should ECB support not be renewed.

20. **Stress tests in the context of the recent FSAP show that while the core of the system appears resilient, vulnerabilities remain in some segments.** Under the adverse scenario, the largest banks would be sufficiently capitalized to withstand further deterioration of economic conditions, while several banks would need to increase capital buffers by about 4 percent of GDP to comply with the Basel III transition schedule (core tier 1 capital of 7 percent). Important caveats are attached to these stress test results. In particular, feedbacks between banking system distress and economic performance cannot be fully captured and capital needs in these banks would be larger than this, as they would also include restructuring costs and reclassification of loans that may be identified in the recently launched independent valuations of assets. For a core tier 1 of 10 percent in the baseline scenario, the recapitalization needs would be around 5 percent of GDP. Stress tests by independent consultants hired by the authorities reported in June a potential capital need under an adverse scenario of around 5–6 percentage points of GDP. A more definitive estimate will need to await the results of the independent valuations.[4]

21. **Recent reforms need to be followed through by a comprehensive strategy to decisively clean up the system taking advantage of the European backstop.** Reforms to date, while substantial and increasingly well-designed and comprehensive, have yet to decisively clean up the system and to convince markets. The recent FSAP identifies some key reform areas, many of which are along the lines envisaged by the government. A final phase of the reforms should involve:

- ***Independent valuation.*** The quality and transparency of the independent valuations and stress tests should be assured (the inclusion of staff of independent institutions to advise on the process is encouraging).
- ***Triage.*** Banks should quickly be required to meet any resulting additional need for higher provisions and capital, drawing on the backstop as needed. Banks should be triaged into: (1) those that do not need support (2) viable banks that need government support, which will be provided subject to tightly-monitored restructuring plans, and (3) non-viable banks.
- ***Dealing with intervened banks.*** The new management of the fourth largest bank should quickly present their detailed restructuring strategy and timetable. The strategy for the other

[4] While the Eurogroup's commitment of up to €100 billion (9.4 percent of GDP) includes an additional safety margin, staff, to be prudent and pending further details on implementation, assumed this amount for the analysis in this report, for example, in the debt sustainability analysis.

intervened banks should be announced, including their restructuring plans and estimated cost of government support. Consideration should also be given to strengthening the state's ability to manage its large stakes in a substantial share of the banking system, and to enhance its ability to eventually exit, and ideally benefit, from the sale of such stakes.

- ***Using the backstop.*** The exact cost to the government will depend on many factors, including the results of the valuation exercise, the costs of restructuring intervened banks, and the specific strategy adopted. Even if the cost were to reach the full Eurogroup commitment of €100 billion, this would remain manageable from a debt sustainability perspective, provided the envisaged fiscal adjustment is undertaken.
- ***Legacy assets.*** A goal of dealing comprehensively with legacy real estate assets should be announced, with options to be finalized after the independent valuations.
- ***Liquidity.*** Banks should take full advantage of the new rules widening the range of collateral eligible for repo-operations. The BdE should streamline and expedite current procedures to facilitate the prepositioning of collateral by banks.

22. **In this context, an upgrade of the banking supervision and crisis management resolution frameworks is key (Box 4).** The BdE's gradual approach in taking corrective action has allowed weak banks to continue to operate and requires, inter alia, measures to improve the timeliness and cost-effectiveness of remedial action. To this end, amendments should be introduced to allow overriding shareholders rights, the partial transfer of assets and liabilities, the allocation of losses to (left behind) creditors, the conversion of some categories of bank debt into equities, and special administrative bank insolvency and liquidation procedures. In addition, FROB should be allowed to use mechanisms more rapid and flexible than the current auction procedures to dispose of an intervened bank if systemic considerations arise.

Authorities' views

23. **The authorities largely concurred with staff's analysis.** They shared staff's view that the Euro area backstop is a unique opportunity to clean up Spain's financial sector once and for all. However, they expressed their preference, shared by staff, for direct recapitalization with European funds to help break the adverse feedback loops between sovereign and banking stress at the national level. In this respect, in follow up discussions after the mission, they strongly welcomed the Euro area summit statement and the possibility of direct recapitalizations once a single supervisory mechanism is in place. Regarding the practical implications of greater bail-in, while this would be in line with the burden sharing principles outlined in the recent European Commission directive, the authorities observed that since in Spain a high share of hybrid capital is held by retail customers, a too strict bail-in could risk triggering undesirable reactions. A large bail in program could undermine banks' market access, including for larger institutions. The authorities also argued that ECB collateral policies are more important than Bank of Spain procedures in alleviating eventual needs for greater pools of collateral.

Box 4. FSAP Main Recommendations

The economic environment increases the risks to corporate and household balance sheets and consequently, the soundness of the banking sector. However, vulnerabilities are unevenly distributed across credit institutions. Most banks appear resilient and the results of the stress test and the diagnostic analysis confirm the need to address segments of the system

Spain's financial oversight framework is largely compliant with international standards. However, it needs to be further enhanced in some aspects; in particular, by:

- strengthening remedial actions and sanctioning powers of the banking and securities regulators—currently shared with the Ministry of the Economy—so as to address preemptively the build-up of risks in the system;
- providing operational and regulatory independence to the banking and securities regulators and financial-budgetary independence to the insurance and securities regulators; establishing a risk-based regulatory framework for the insurance sector and monitoring potential risk build-up in the system;
- developing regular testing and contingency plans to further strengthening the resilience of financial market infrastructures to liquidity shocks.

Although the BdE has flexible powers to deal with weak banks, the framework should be further strengthened by putting in place a more forward-looking approach. The crisis management framework should be buttressed by widening the array of resolution tools, in line with recent international practices. And while significant progress have been made in reforming and consolidating the savings bank sector, a clear long-term strategy on governance structures needs to be designed to transform of savings banks into minority institutional investors over the medium-term.

B. Fiscal Policy[5]

24. **The 2011 fiscal slippage was much worse than expected, underlining the challenges of fiscal consolidation at all levels of government.** The 6 percent of GDP target was missed by almost 3 percent of GDP and the adjustment in 2011 was only 0.4 percent of GDP—even less adjustment than in 2010 and not due to worse macro conditions. The slippage is mainly (two-thirds) at the regional level, which did not adjust at all in 2011. But the central government and social security systems also slipped

Fiscal Performance by Level of Government 1/

	2010			2011		
	Target	Outturn	Diff.	Target	Outturn	Diff.
Gen. Govt.	-9.3	-9.3	0.0	-6.0	-8.9	-2.9
Cen. Govt.	-6.7	-5.7	1.0	-4.8	-5.1	-0.3
Regions	-2.4	-2.8	-0.4	-1.3	-3.3	-2.0
Local Govt.	-0.4	-0.5	-0.1	-0.3	-0.4	-0.1
Social Sec.	0.2	-0.2	-0.4	0.4	-0.1	-0.5

Source: MHAP.
1/ These data do not include the effect of the financing system settlement.

[5] Significant policy developments occurred after this Staff Report had been issued to the Board, which are discussed in the attached Staff Supplement.

substantially. The slippage was largely revenue related, pointing to a rapid deterioration of the tax base and higher than usual elasticities, in particular for indirect taxes.

25. **The government reacted by announcing at the end of December a package of measures of about 1½ percent of GDP**. This was an emergency package effective immediately while the 2011 budget was prolonged and until the full 2012 budget was presented to Parliament in April. The package was two-thirds expenditure based with a broad-based freeze on expenditure authorizations and wages, and one-third revenue based, with marginal tax rates on personal and capital income and real estate raised progressively. New revenue measures for 0.8 percent of GDP are predominantly from corporate taxation and temporary increases in personal income tax rates. However, the package was closer to 1 percent of GDP when considering offsetting measures (such as a reinstated mortgage deduction for housing, the extension of a lower VAT rate on housing transactions and a small pension increase). Some of the measures are temporary, covering the first two years of the legislature—such as the increase in personal income tax and a revaluation of property taxes.

General Government Revenues and Expenditures (percent of GDP)

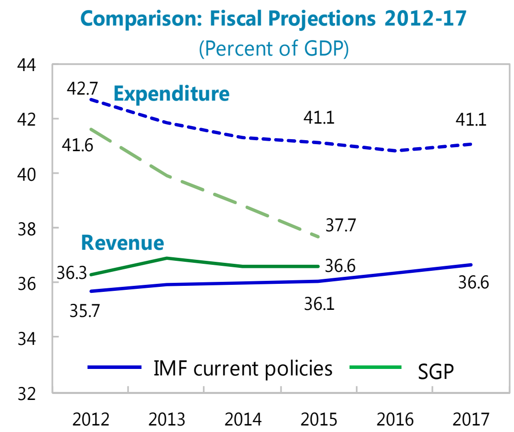
	2010	2011		
	Actual	SGP	Actual	Slippage
Total revenues	36.3	36.7	35.1	-1.6
Of which:				
Indirect taxes	10.3	10.6	9.8	-0.8
Direct taxes	9.5	9.7	9.5	-0.2
Social contributions	13.3	13.1	13.0	-0.1
Total expenditures	45.6	42.7	44.0	1.3
Of which:				
Goods and services	5.6	5.1	5.8	0.7
Wages	11.9	11.2	11.5	0.3
Interest payments	1.9	2.2	2.4	0.2
Social transfers	18.3	17.9	18.0	0.1
Gross fixed capital formation	3.8	2.9	2.8	-0.1
Subsidies	1.2	1.0	1.1	0.1

Source: Ministry of Finance.

26. **These emergency measures were included in the draft 2012 budget, which aims for very ambitious consolidation**. The initial target in the 2011 SGP for 2012 was set at 4.4 percent of GDP, but rested on unrealistic growth forecasts and the assumption of no slippage in 2011. The revised target of 5.3 percent of GDP remains highly ambitious (involving a structural improvement of some 4 percent of GDP) and could have accommodated more fully the effects of the cycle. A tax regularization program was introduced and expected to bring 0.2 percent of GDP. The expenditure adjustment entailed ministerial cuts of 17 percent on average, and is designed to be achieved through lower capital expenditures, and goods and services. In addition, the government introduced measures to cut health and education expenditures by about 1 percent of GDP, and with an impact mostly at the subnational level. The clearing of arrears at the subnational government level through the creation of a special fund, financed by bank borrowing, implies a debt increase of around 3½ percent of GDP.

27. **Further substantial slippage is likely in 2012, though the adjustment could still be significant**.

- The macroeconomic framework is largely in line with staff's, but underlying revenue weakness could be stronger than expected. Items such as social security contributions, pensions or unemployment are likely to respond more negatively to the economic outlook.



Tax revenues over the first five months have been weak, in particular for VAT. The timeframe for the adjustment is short: though some measures have been implemented at the beginning of 2012, the rest of the adjustment rests on just seven months. The adjustment is very dependent on relatively large expenditure cuts at the central government level, resting essentially on capital expenditures and goods and services, with the underlying measures not fully specified. The international experience with tax repatriation programs in particular suggests significant risks of underperformance. The adjustment at the regional level seems optimistic given the very high deficits in some regions, the difficulty of adjusting their expenditure (mainly health and education) and their poor track record.

- Staff expects an overall deficit of around 7 percent of GDP, a deviation with respect to target of around 1 ½ percent of GDP. Structural slippage should be resisted, but given the weak growth outlook, it should not be made up in a compressed timeframe. This could imply, for example, immediately taking additional measures of at least 1 percent of GDP on a full year basis to reach a 2012 deficit of about 6 ¼ to 6 ½ percent of GDP. The additional measures could usefully include eliminating some VAT exemptions, raising VAT rates (especially reduced rates) and other indirect taxes, taxing the thirteenth salary, and cutting fourth quarter capital expenditure.

28. **Achieving the medium term fiscal targets will also be very challenging, but critical for debt sustainability.** Reaching a primary surplus of about 2-3 percent of GDP should allow maintaining debt at manageable levels. However, the bulk of the planned consolidation from 2013 is based on expenditure savings, many of which are yet to be specified.

- The revenue to GDP ratio is projected in the SGP to barely rise over the period, though indirect taxes are projected to grow and social security contributions to fall after an initial increase in 2012.

- Primary spending is projected to fall by almost 4 percent of GDP. Only a part of this reduction has been linked to specific measures (such as raising co-payments on prescription drugs and increasing class size); the bulk is to come from reviews of current spending at all levels of government and rationalization of spending responsibilities across different levels of government. The evolution of the wage bill in particular is underpinned only in part by measures that would allow a significant nominal decline over time.

- Interest expenditure is projected to fall by 2015 as the yield on 10-year Spanish government debt is projected by the government to decline gradually to 3.7 percent. Under staff's framework, growth would also be significantly lower than the government's were the deficit targets to be achieved.

- Under staff's baseline, deficits remain high. Given the lack of detailed measures, staff projects the deficit to substantially overshoot targets and to fall gradually to only about 4 percent of GDP in the medium term. This, plus debt from bank recapitalization and financing regional arrears, would lead to debt surpassing 100 percent of GDP in the medium term.

29. **Staff believes that the medium-term fiscal plan should be strengthened around three dimensions:**

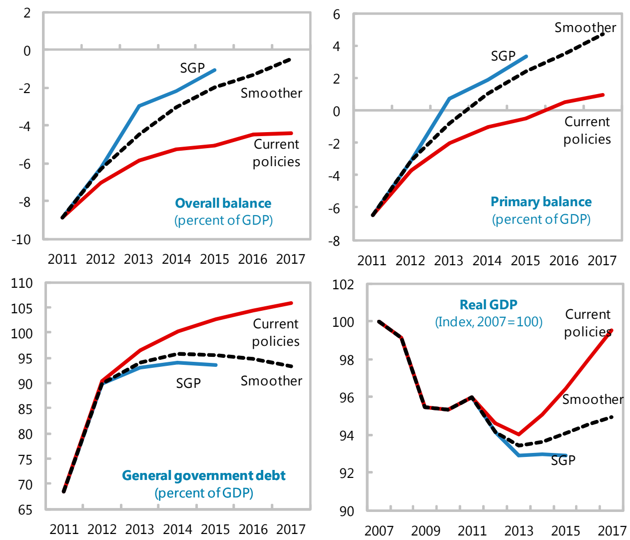
- ***Path.*** The deficit path envisaged in the SGP should be less front-loaded, in agreement with European partners. The medium-term targets are broadly appropriate, but a smoother path would be more desirable during a period of extreme weakness, when multipliers are likely to be particularly large and the tax base soft, to reduce the risk of creating a negative feedback loop with growth and NPLs, which may also undermine market confidence, especially if targets are missed (Box 5). Such a smoother path should also be embedded in a prudent macroeconomic framework.

- ***Composition.*** Given the size of the needed consolidation, no options should be ruled out. Revenue measures should play a larger role. In particular, there is considerable scope to reduce tax expenditures and increase indirect tax revenue by broadening the base and raising and unifying rates, especially on VAT and excises—actions that should be taken now. Reducing social security contributions to induce an internal devaluation is desirable, but should be contingent on first reducing the deficit (to, say, below 3 percent of GDP). The reintroduced deduction for mortgage payments should be eliminated. It is also important that the measures deliver permanent and not one-off gains (for example, there should be no further amnesties or transitory rate increases). Spending on the most vulnerable should be protected.

- ***Certainty.*** Spending reductions are planned for the right areas. But they will take time to identify, be difficult to implement, and their yields uncertain. To give assurance that the envisaged savings will materialize, future public wage cuts to reduce the wage bill and VAT/excise increases could be legislated now and only cancelled if the revised targets are hit. Spain has privatized extensively in the past, but privatization on remaining assets should be more aggressively pursued to give upside risk to debt projections.

Box 5. What is the Right Deficit Path?

The needed medium-term consolidation can either be achieved by a front-loaded adjustment or a smoother reduction over time (a third approach of a back-loaded adjustment would very likely not be considered credible by the market). Both have pros and cons. On balance, staff recommends a less front-loaded strategy than envisaged in the government's Stability Program.



Source: IMF Staff estimates.

- **Front-loaded adjustment.** The medium-term targets under the Stability Program imply a front-loaded adjustment path, as the deficit target for 2011 was significantly overshot, and despite the loosening of the target in 2012 to 5.3 percent of GDP (in both scenarios a slippage of 1 percent of GDP to a 6.3 percent deficit in 2012 is assumed). Based on Staff's macroeconomic assumptions, the total improvement of the primary balance from 2011 to 2015 would be almost 10 percent of GDP, of which over 3 percentage points would be achieved in 2012. Debt would peak at 94 percent of GDP in 2014.

- **Smoother adjustment.** Spreading the same primary balance adjustment more smoothly would imply higher deficits in the near term and higher debt. To stabilize debt from 2014 onwards, some degree of frontloading would still be needed, but the target of a 3 percent deficit would be pushed back by one year (a completely smooth adjustment towards the primary balance of 1 percent of GDP/year by 2014 would not allow for a stabilization of the debt). A strong adjustment of the structural primary balance of more than 2 percent in 2013 (instead of 4 percent), 2 percent in 2014 and then ¾ percent every year until 2017 would allow a smoother profile, while still ensuring debt stabilization. Debt would peak in 2014, at about 96 percent of GDP and would fall back to 93 percent of GDP in 2017. In both scenarios, and although staff made a conservative assumption to include the Eurogroup's commitment up to €100 billion that includes an additional safety margin, there are downside risks to the debt path, through for instance the recognition of contingent liabilities.

Pros and cons. Compared to a smooth adjustment, the front-loaded strategy has the advantages of: (1) improving the deficit and debt faster, which should boost market confidence and reduce borrowing needs; and (2) possibly being more politically feasible as adjustment measures, especially if permanent, could be more easily introduced early in the legislature. The main disadvantage is that the front-loaded strategy would imply most contraction when the economy is weakest, compounding the headwinds of de-leveraging and labor market adjustment. This would likely lower significantly growth compared to the baseline (using a multiplier of ½ in the first year and ¼ in the second) and raise

Box 5. What is the Right Deficit Path? (continued)

unemployment and non-performing loans. This could create a negative feedback loop with adjustment. This would likely lower significantly growth compared to the baseline (using a multiplier of ½ in the first year and ¼ in the second) and raise unemployment and non-performing loans. This could create a negative feedback loop with fiscal consolidation, especially if multipliers are even larger and tax bases weaker than envisaged. The benefits of a front-loaded strategy would also be lost if the targets are missed by significant margins. The smooth path could also be compatible with establishing credibility by: (1) pre-announcing fiscal measures and with the path still being front-loaded in structural terms; (2) strong action in other areas, such as labor markets (already undertaken) and banks that would allow to compensate for the drag on growth in outer years; and (3) the implementation of institutional fiscal reforms.

Fiscal paths

(percent of GDP, unless otherwise indicated)

	2011	2012	2013	2014	2015	2016	2017
Overall balance							
SGP	-8.9	-6.3	-3.0	-2.2	-1.1		
Current policies	-8.9	-7.0	-5.9	-5.3	-5.1	-4.5	-4.4
Smooth(er)	-8.9	-6.3	-4.5	-3.0	-2.0	-1.3	-0.5
Primary balance							
SGP	-6.4	-3.1	0.7	1.9	3.4		
Current policies	-6.4	-3.7	-2.0	-1.0	-0.5	0.5	1.0
Smooth(er)	-6.4	-3.1	-0.8	1.1	2.4	3.5	4.7
Structural balance							
SGP	-7.6	-4.7	-1.4	-0.8	-0.2		
Current policies	-7.6	-5.4	-4.2	-3.9	-4.1	-4.0	-4.3
Smooth(er)	-7.6	-4.7	-2.8	-1.6	-1.1	-0.8	-0.3
Structural primary balance							
SGP	-5.2	-1.5	2.4	3.3	4.3		
Current policies	-5.2	-2.2	-0.4	0.4	0.4	1.0	1.1
Smooth(er)	-5.2	-1.5	0.9	2.5	3.3	4.0	4.9
General government debt							
SGP	68.5	89.8	93.1	94.1	93.6		
Current policies	68.5	90.3	96.5	100.2	102.7	104.4	105.9
Smooth(er)	68.5	89.8	94.1	95.8	95.5	94.7	93.3
GDP growth							
SGP	0.7	-2.0	-1.3	0.1	0.0		
Current policies	0.7	-1.5	-0.6	1.1	1.5	1.6	1.6
Smooth(er)	0.7	-2.0	-0.8	0.2	0.5	0.5	0.4

Source: IMF Staff estimates.

30. **The fiscal framework has been significantly strengthened.** A constitutional balanced budget amendment was passed in September, supported by the Budget Stability Law in February and a draft Transparency, Access to Public Information and Good Governance Law. The laws apply to all levels of government and stipulate a structural balanced budget and a debt ratio of 60 percent of GDP by 2020, with transitional requirements in the interim, and limits expenditure growth to below that of GDP. Monitoring and transparency requirements on subnational governments are enhanced, as are tools to sanction non-compliance. For example, fines can be levied, transfers withheld and, ultimately, sub-national financial autonomy removed (see Annex I). Public officials that deliberately fail to comply with the fiscal targets in the organic law can also be directly sanctioned, including removal and ineligibility for public office and loss of pensions. The center is also giving financing to sub-national governments, in return for greater conditionality (Box 6).

31. **While the recent legislation has many promising elements, implementation will be key and further improvements in the fiscal framework are still necessary.** It is important that the new provisions in the Budget Stability Law be fully implemented (for example, immediately warning some regions and quickly intervening if they fail to respond promptly). But the framework could benefit from further improvement, and the stronger the framework, the more likely markets would accept a smoother consolidation path.

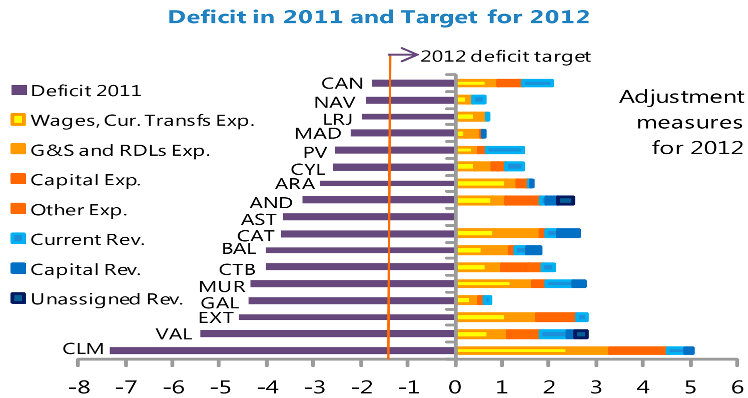
- While significant progress has been made in recent months, including publishing quarterly regional government outturns in national accounting terms for the first time, greater fiscal transparency is essential. For example, providing monthly consolidated general government accounts on a cash basis within six weeks. Regional budgets, fiscal plans and reporting should be made more homogenous and user-friendly. A durable framework for funding regional governments also needs to be established.

- Moving to a fully-fledged medium-term budget framework with expenditure ceilings and detailing measures covering at least 2013 and 2014, alongside measures that would aid sub-national consolidation (for example by introducing savings in health spending).

- Creating an independent fiscal council. This could, for example, analyze budgets and provide their key macroeconomic assumptions, develop comparative regional performance indicators, and conduct nationwide expenditure reviews of major programs.

Box 6. The Challenge of Regional Fiscal Adjustment

Spain's regions have recently failed to meet their fiscal targets. Poor fiscal reporting and transparency have made taking timely corrective measures difficult. Before 2012, enforcement of agreed fiscal targets was non-credible and penalties for regions that violated agreed targets or flaunted procedure went unused. Cyclical revenues (including linked to real estate) have failed since the crisis but expenditure, which is over two-thirds related to structural social categories (e.g. education and health), is yet to be significantly consolidated.



Even with strong efforts at the regional level and help from the central government, achieving the 1.5 percent of GDP regional 2012 deficit target is challenging. Regions began 2012 with a weighted average consolidation need of 2 percent of GDP (and some much more). Rebalancing plans were finished only in May, leaving little time for execution. Moreover, the adjustment is tilted towards current expenditure consolidation, which may be difficult given the structural nature of regional public spending. Some regions showed difficulties already in Q1 2012, for example, Navarra and Murcia reported Q1 outturns close to the 1.5 percent of GDP full-year target while Asturias had not agreed on a rebalancing plan as of mid June.

The central government is reducing structural expenditure mandates on health, education and other areas, to improve the likelihood of consolidation through two Royal Decree Laws. In health, pharmaceutical copayment has been linked to income, and a raft of rationalization measures have been introduced, e.g. requiring generics or limiting prescriptions. In education, class sizes and tuition have increased, and in both sectors, working weeks have been extended, replacement rates limited, and benefits reduced. Other measures, such as changing the public television requirements or eliminating duplicate public services and entities are in progress.

The central government has also introduced and used a number of "carrots" to induce fiscal cooperation, increase monitoring, and reach consensus on fiscal targets. The central government has taken action on its declaration that no region would default, and raised the possibility of mutualizing issuance via, for example, "hispanobonos" (central-government guaranteed debt to cover regional amortizations). Liquidity pressures were reduced by advancing transfers and extending the

Box 6. The Challenge of Regional Fiscal Adjustment (continued)

repayment of past revenue overpayment from five to ten years. Two financing facilities were created with favorable terms, also to be used for repaying suppliers and rolling over maturing debt. The deficit target was also relaxed from 1.3 percent in 2011 (and 2012) to 1.5 percent of GDP under the 2012 SGP.

Sticks		Carrots	
Econ.-Finan. Quart. Monitoring	✓	No regional defaults allowed	✓
Long-term credit restriction	✓	A region is bailed out	✓
Short-term credit restriction		Transfers brought forward	✓
Warning/no-credit decree		ICO credit line	✓
Deposit taken		FFPP Arrears credit line	✓
Deposit stops earning interest		Revenue repayment extended	✓
Delegation of experts sent		Deficit target relaxed	✓
Regional control assumed		Hispanobonos, credit	
Public official dismissed			

Check mark indicates the envisioned measure has been utilized.

But the government has also range of "sticks" which it has used less actively. The Constitutional Amendment passed in September of 2011, the Organic Law for Fiscal Sustainability and Financial Stability, and the Transparency and Good Governance Law provide several tools to increase fiscal discipline. Expenditure and debt ceilings are extended to the regions and fiscal reporting is greatly increased (including rebalancing plans, the standardization and increased content of budgets, and improved reporting fiscal outturn, including in national accounting). Deviating regions must adjust within one year instead of three and monitoring by the central government is quarterly. Warnings, penalties and the possibility for taking a region into national administration are envisioned in the law as progressive penalties for persistently deviating regions. Officials proven to have intentionally failed to comply with mandates or disregarded implementation of measures face penalties including dismissal, ineligibility for public service and loss of pension.

These sticks need to be used. In the short-run, establishing the legal mechanisms which ensure transparency and deliver consolidations is critical to ensuring success. The rebalancing plans were reportedly reviewed more stringently in 2012, which is promising. The functionality and credibility of new tools, such as warnings, non-disposition of credit decrees, and dismissal of public officials should be quickly and convincingly established. Stronger measures, such as imposing the recommendations of a delegation of experts and taking a region into national administration, should also be executed as promptly as the law permits. Ultimately, all options must be tabled to ensure the fiscal sustainability of the regions, which are now more intertwined than ever with each other and the sovereign.

Authorities' views

32. **The government recognized that the envisaged fiscal consolidation is very ambitious and challenging.** They concurred with staff that a smoother path of consolidation would have been preferable given the rapid deterioration of the economy. They assessed that a traditional approach to fiscal multipliers might not be warranted, as the inter-temporal effects of fiscal consolidation might differ between time periods. They concurred with the view that Spain has a low level of tax revenue and the need to take revenue measures along the path of fiscal consolidation, although they considered that legislating measures for the medium term was difficult in the current constitutional framework of Spain.

33. **The authorities pointed to the significant changes in their fiscal framework and underscored their willingness to take additional measures as needed.** The authorities agreed with the pressing need to bring greater certainty and transparency to fiscal outcomes at all levels of government, and particularly at the regional level. They viewed initiatives including the Fund to Pay Suppliers, the Organic Budget Stability Law and the Fiscal Transparency and Good Governance Law as strengthening transparency and fiscal control in all levels of government. The authorities, however, did not agree that an independent fiscal council would be useful, noting for example, the risk of undermining existing institutions.

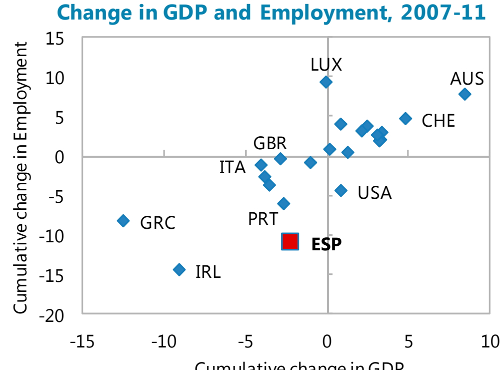
C. Structural reforms

34. **Spain urgently needs job-rich growth and further gains in competitiveness.** Domestic demand is likely to be structurally weak for the foreseeable future and the current account deficit needs to improve further. This means focusing on policies to expand the tradable sector, raise productivity and lower costs by addressing wage-price misalignments that have developed with a decade long, credit-fuelled, boom. Though product markets require significant improvement, Spain's main structural problems are its labor market rigidities and high unemployment, with adverse effects both on aggregate demand and potential output.

35. **Spain's labor market rigidities have resulted in highly cyclical and volatile employment.** Spain suffered one of the largest falls in employment in the OECD, even though its GDP loss was mild. The negative performance of the Spanish labor market can be attributed to the following structural rigidities (Box 7):

- ***Wage rigidity*:** Wages react little to unemployment and are more correlated to past inflation than in other OECD economies. Spain's wage rigidity is due to collective wage agreements that are automatically extended to the whole province/industry, with very restrictive opt-out clauses and widespread wage indexation.

Change in GDP and Employment, 2007-11



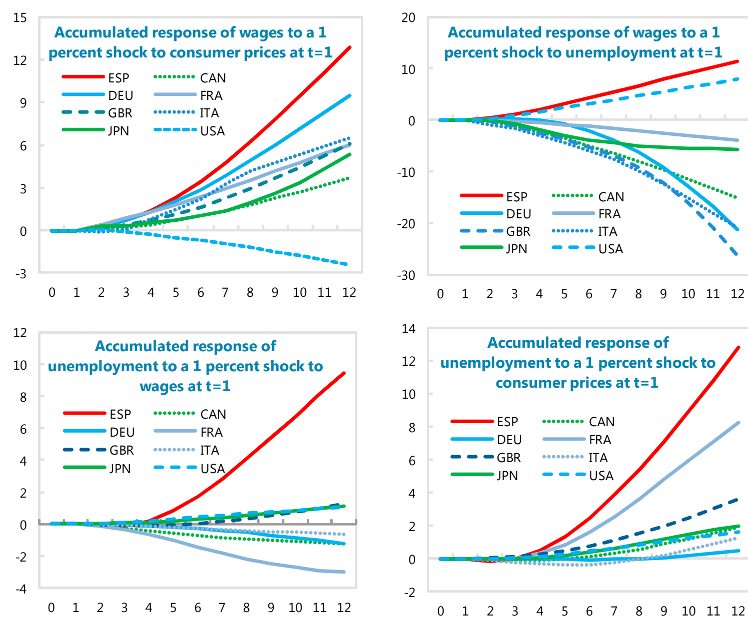
Source: INE.

- ***Insufficient flexibility of working conditions*****:** Industry or region wide collective agreements restrict the ability of firms to modify working arrangements to adjust to shocks. For example, Spain's hours worked per employee increased since 2007, when unemployment was rising, while they fell in most OECD countries.

- ***High labor market duality*****:** Spain has the largest share of temporary workers in the OECD. Workers on open-ended contracts enjoy high protection and job stability, while workers on temporary contracts have low protection and face job instability. Given the rigidity of wages and working conditions, and the high dismissal costs of workers on open-ended contracts, Spanish firms keep a large share of temporary workers and adjust to negative shocks by dismissing them. For example, temporary employment has fallen by 34 percent since end-2007 while employment in open-ended contracts has fallen only by 6 percent.

Box 7. Unemployment Volatility and Labor Market Rigidities

Empirical analysis indicates that Spain's labor market rigidities play a large role in explaining the cyclical behavior of unemployment. A wage Phillips curve vector autocorrection equation with five variables (labor compensation, prices, labor productivity, unemployment and work hours), is used with the G7 economies as a benchmark. In comparison to the G7 economies, Spain's labor compensation stands out for its high inertia (high responsiveness of labor compensation to a 1 percent increase in labor compensation) , high responsiveness to inflation (a high increase of labor compensation in response to a 1 percent increase in inflation), and low sensitivity to unemployment (labor compensation does not fall when the unemployment rate increases by 1 percent). In addition, Spain's work hours react little to labor market shocks. These rigidities result in large increases in unemployment in response to shocks to wages or inflation.



The recent labor market reform can significantly improve the performance of Spain's labor market over the medium-term. This reform aims at reducing wage and working time rigidity, and if properly implemented, can substantially increase the sensitivity of labor costs to economic conditions.

36. **The recent reform promises a significant improvement in the functioning of the labor market.** This reform, enacted as a decree on February 2012, introduced measures that can importantly reduce labor market duality, wage rigidity and firms' internal inflexibility. These should boost job creation over time by making wages more responsive to economic conditions, allowing firms to agree wages and working conditions according to their needs, and making firms more willing to offer open-ended contracts and step up in-job training. Most Spanish labor market academics shared the view that this is a potentially major reform. The main elements of the reform are:

- Duality is reduced by lowering the dismissal costs of permanent workers for unfair dismissals. More importantly, the reform eases and clarifies the use of fair dismissals for firms in distress (those firms facing current or prospective losses, or a persistent decline in sales). It also reduces procedural costs and eliminates the need for prior administrative approval for fair dismissals. The goal is to make fair dismissals the regular channel to dismiss workers with permanent contracts in distressed firms, thus significantly reducing dismissal costs.

- Wage rigidity and firms' internal inflexibility are reduced by giving priority to firm level agreements over wider collective agreements. The reform also allows distressed firms to change working conditions, temporarily suspend contracts, and reduce working time. The goal is to allow distressed firms to adjust wages and working time instead of dismissing workers. In addition, the reform limits the automatic extension of expired collective agreements to one year.

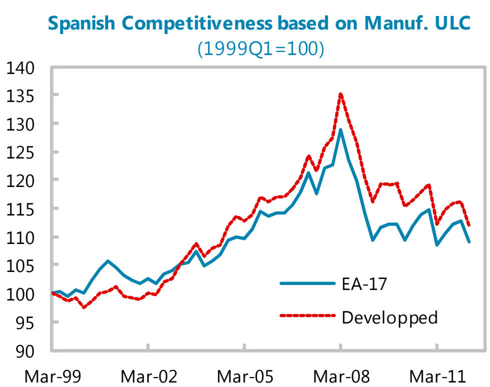
37. **The reform also introduces more targeted measures to foster employment and training, although some may have potentially limited effectiveness.** The reform includes a number of measures aimed at fostering job creation for the youth and long-term unemployed, and in-job training. However, some of these measures are based on subsidies and tax breaks, which have been used in the past with little success. The measures that do seem more likely to foster job creation are the authorization for temporary employment agencies to act as private placement agencies, and the enhanced flexibility of part-time work and telework.

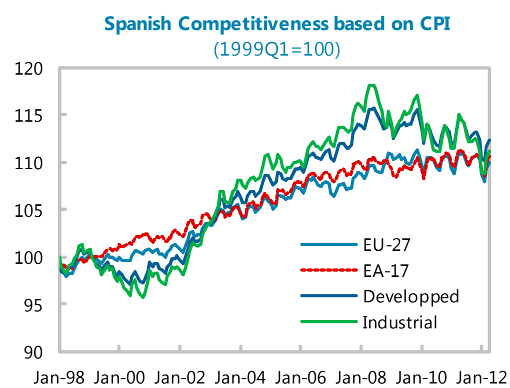
38. **The reform's success hinges on its implementation and further strengthening labor policies should be considered.** Previous reforms have not been successful, largely as the changes were marginal and not widely used, in part, due to interpretation by the courts. The reform could also be strengthened, for example, by reducing the difference between protection for open-ended and temporary contracts to make the labor market more inclusive and by eliminating the practice of indexation and "ultra-activity". The new flexibility options could also be better communicated to firms. And if sufficient firm-level flexibility is not quickly forthcoming (which should be transparently monitored), policymakers should prepare contingency plans, for example, by moving to an opt-in system for collective bargaining. The planned review of active employment policies is welcome and should carefully consider whether the unemployed are being given sufficient training and incentive to secure employment and whether the use of subsidies (that has proven inefficient and expensive in the past) offers the best alternative. Recent measures on fighting fraud, including on

unemployment benefits, should also contribute to decreasing the size of the grey economy and strengthening labor policies.

39. **Further improvement in labor productivity will be needed to increase trend growth.** Since the beginning of the crisis, productivity per employee rose by 11 percent, largely reflecting labor shedding, and the working week increased by almost 3 percent. Wage growth slowed helping deflate unit labor costs. Yet, more progress will be needed for Spain to fully regain competitiveness lost during the boom years and to sustain the needed export-led recovery. Further improvement in labor productivity will have to be achieved not by means of additional layoffs but rather through the better use of resources.

40. **The external position remains considerably weaker than would be consistent with medium term fundamentals and appropriate policy settings.** The current account has improved significantly on the back of resilient export market shares, and Spain now has a trade surplus with the euro area. Yet because the ongoing improvement partly reflects domestic demand compression, a sizeable output gap, and labor shedding attaining full employment and strong and sustainable growth would require a significantly weaker real effective exchange rate.





Source: Bank of Spain.

- Competitiveness indicators based on either consumption prices or unit labor costs show that the large gaps that opened up vis-à-vis trading partners since euro entry (when the current account deficit was already 3 percent of GDP) have only partly corrected since 2008. EBA and CGER model estimates still point to REER overvaluation of 10 to 15 percent (Annex V). Recent competitiveness improvements significantly reflect cyclical productivity gains from labor shedding, and a change in relative prices is the primary way to improve the external balance while closing the output gap.

- Further structural improvement bringing about a persistent current account surplus would be appropriate to help improve the net IIP position, which would still remain very negative for many years. External debt is also too high, and is to be further increased in gross terms to the extent that the European financial assistance to bank recapitalization would take the form of a loan rather than direct equity stakes. Although projected to gradually decline over time, external debt remains a major source of external vulnerability as it generates large financing needs.

- To improve the external position, an effective implementation of the labor market reform should bring down labor costs, while financial sector restructuring should help banks reduce reliance on the ECB. Delivering fiscal consolidation will also contribute significantly to external adjustment.

41. **Other structural reforms are necessary to support the labor reform with decisive changes in the product and service markets.** The growth challenge is such that Spain should be aiming to be have one of the most business-friendly internal markets in the world. Reforms to the goods and service markets not only would help Spain to raise its growth potential, but also to accelerate its employment recovery. Reforms aimed at increasing overall competitiveness in the economy can help strengthen labor demand across all sectors, but may not be sufficient to absorb the workers shed by the labor-intensive construction sector since 2007. A cooperative solution, where workers accept greater wage moderation, employers pass on the cost savings to prices and hire, and banks recapitalize, could result in a faster reallocation of resources to dynamic sectors and a better outcome for all.

42. **The government's reform agenda is promising and needs to be rapidly implemented.** Retail licensing has already been eased and the government's reform agenda appropriately targets a common regulatory framework in all regions, boosting the rental market, liberalizing retail hours and professional services, and eliminating the tariff deficit. It would be important that these reforms are rapidly and effectively implemented – a detailed and ambitious timetable would help structure and communicate the efforts. Further reforms, such as policies to help small firms grow, deregulating the fuel sector and postal services and supporting intellectual property rights, also seem necessary to foster inclusive and job-rich growth. Establishing a clear goal, such as getting Spain into the "Top 10" list of global indices of competitiveness and business environment could help focus policy and popular understanding.

Authorities' views

43. **The government argued that the labor market reform is profound, introducing significant flexibility.** They acknowledged that the reform needs time to take effect and it is too soon to assess whether it is working as planned. Still, they noted that there are some early indications that the reform is producing results. Notably, partial data for the first 3–4 months of 2012 show that wage increases in collective agreements signed during 2012 are low, the number of opt outs from industry or sectoral level collective agreements has increased, and the severance payments for collective dismissals has fallen. The authorities viewed their structural reform agenda as comprehensive, already underway, and helping to revive growth in the medium-term. They already enacted a reform removing the license requirement to start small retail businesses, a process which previously took more than six months. The authorities agreed that ongoing competitiveness gains were not sufficient, and that persistent current account surpluses would be needed to reduce external vulnerabilities.

STAFF APPRAISAL[6]

44. **Faced with great challenges on several fronts, the government reform momentum has been strong, with many major actions initiated in recent months.** In the financial sector, provisions and capital requirements have been raised, independent valuations commissioned, and a large backstop provided with support from Spain's European partners. In the fiscal sector, a package of measures was introduced in December, the 2012 budget is ambitious and the new organic budget and transparency laws provide for greater transparency and control over regional finances. A profound labor reform was also introduced.

45. **The outlook is very difficult.** The economy is falling into an unprecedented double-dip recession, with unemployment already at 24 percent, persistent capital outflows and risks of losing market access. Large-scale fiscal consolidation is beginning, private sector de-leveraging has far to go, credit is contracting, and banks rely heavily on the ECB. On the positive side, imbalances are unwinding, especially the current account deficit, inflation and unit labor costs. Wage and price realignment should be supported by the recent labor market reform. While upside risk exists, especially related to a successful implementation of the labor reform, downside risks largely dominate at this juncture. In particular, while the Euro area financial backstop and the end June Euro area summit decisions help mitigate short-term risks, market tensions could further intensify. Private sector deleveraging could also be faster than envisaged, and the fiscal consolidation may have larger than envisaged output costs.

46. **Continued strong reform momentum and a clear medium-term vision are critical to restore confidence so that imbalances can be unwound smoothly and jobs and growth fostered.** This strategy should be based around concrete measures to deliver the needed medium-term fiscal consolidation, and a clear roadmap for restructuring the weak segments of the financial sector. It also means better functioning labor and product markets to support household incomes, fiscal consolidation, banks' asset quality, and social backing for reform. Intensifying the ongoing reversal of the large misalignment in prices and wages should be at the center of this agenda. A cooperative approach, where workers accept greater wage moderation, employers pass on the cost savings to prices and hire, and banks recapitalize, could result in a faster reallocation of resources to

[6] Significant policy development occurred after this Staff Report had been issued to the Board. The Staff Supplement attached to this report provides the staff's appraisal of these developments, reproduced here for convenience. On the financial sector and policies to accompany the financial assistance: "*In staff's view, the policies envisaged in the MoU are strong and in line with recommendations of the FSAP and staff report. In particular, weak but viable banks are to be supported and non-viable banks are to be resolved, a comprehensive strategy to deal with legacy assets is developed, and supervision and crisis management and the resolution framework are upgraded. If fully implemented, and in combination with the European financial assistance, these policies would substantially complete the needed restructuring of the sector. It remains important to sever the adverse loop between the sovereign and the banks and help mitigate short-term risks by a timely transformation of the European support into direct recapitalization*." On the fiscal sector and the smoother deficit path recommended by the Council of the European Union:

(continued)

dynamic sectors and a better outcome for all. The prospective Euro area financial sector support is an important plank in this comprehensive strategy, and the recent Euro area summit decisions rightly aim to address market concerns on the implication of bank sector losses for the sovereign balance sheet, Spain's prospects for lowering borrowing costs would be critically helped by a timely implementation of the summit decisions and continued progress towards a banking and fiscal union at the European level, and actions to support and revive growth.

47. **The recent progress in the financial sector needs to be built upon to complete the restructuring**. The recent FSAP helps identify some key reform areas, which include ensuring the quality of the independent valuations, supporting viable but weak banks while resolving the non-viable, and developing a comprehensive strategy to deal with legacy real estate assets. Banking supervision and the crisis management and resolution framework also needs to be upgraded in key areas. The government is to be commended for ensuring a backstop for the financial sector, which is an opportunity to help complete this task.

48. **Significant consolidation efforts are in train for this year.** Despite the considerable effort, the very ambitious deficit target for 2012 will likely be missed by a substantial margin. Given the weak growth outlook, however, slippage should not be made up in a compressed timeframe. Given also the lack of detailed measures after 2012, the deficit will likely fall only gradually over the medium term. This, plus debt from bank recapitalization and financing regional arrears, requires achieving the medium-term targets to maintain debt at manageable levels.

49. **The medium-term fiscal plan should be strengthened.** The deficit reduction path envisaged should be made less front loaded and contain specific measures. Revenue should play a larger role in the adjustment, especially indirect taxes—action in this area should be taken immediately. Greater certainty could be given to the plans by legislating now measures to take effect in the future, though the application of some could be contingent.

50. **An improved fiscal framework would facilitate the envisaged adjustment.** Full and proactive use should be made of new provisions to control regional government finances and the transparency of their accounts greatly improved. The budget should also become more medium-term oriented and an independent fiscal council considered.

"The new path is in line with staff recommendations and is similar to the recommended "smoother" adjustment scenario in Box 5 of the staff report". On the fiscal sector and additional adjustment measures: "*The new fiscal package, regional government actions, and structural measures, are broadly in line with staff recommendations. Staff's preliminary estimate is that the cumulative size of the package between 2012–14, as currently planned, is about 2 percent of GDP. This should lead to deficits in 2012 and 2013 close to the revised targets, though more measures (for example, on the VAT) would be needed for 2014 and beyond. Medium-term debt sustainability would improve with government debt reaching 97 percent of GDP in 2015, but declining slightly thereafter. Implementation will be key and challenging, with the risk of slippage, in particular by the regions, warranting close attention."*

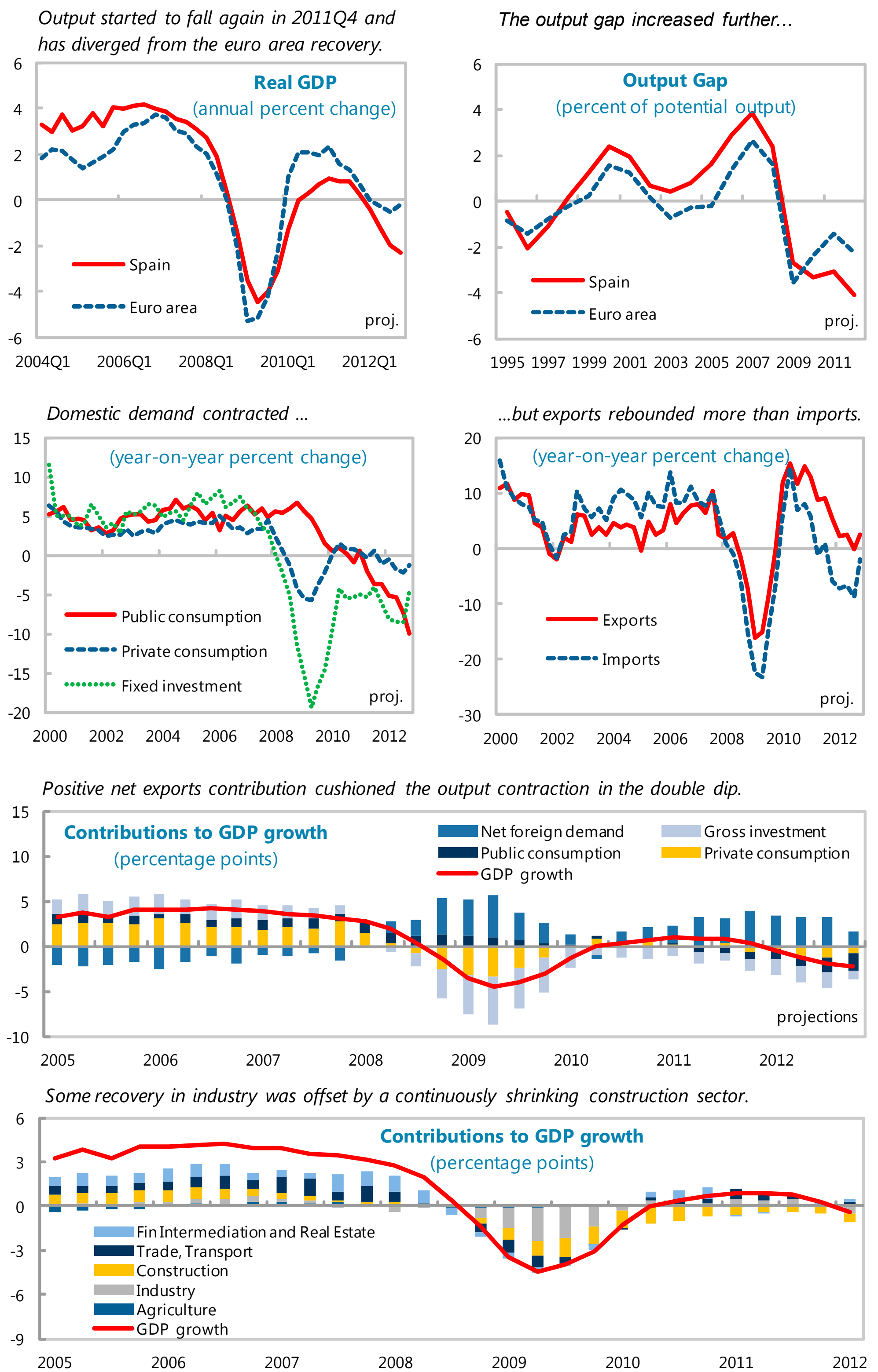
(continued)

51. **Spain urgently needs job-rich growth and further gains in competitiveness.** This means focusing policies to facilitate reallocation of resources towards the tradable sector and lower costs. The recent labor reform is most welcome as it has the potential to substantially improve the functioning of the labor market. The reform's success hinges on its implementation and it could usefully be strengthened, including by improving active labor market policies. Labor reform should be complemented by delivering on the structural reform agenda in other areas—a detailed and ambitious timetable would help structure and communicate the efforts.

52. It is proposed to hold the next Article IV consultation on the regular 12-month cycle.

On the economic outlook: "*Staff expects the new fiscal consolidation measures to have a significant impact on growth, especially in 2013. While the large role of indirect taxes should lead to a relatively low multiplier, preliminary estimates suggest that the level of output would be lowered by about 1 percent by 2014. Unemployment would also increase, although this might be mitigated by the effect of lower social security contributions and unemployment benefits, as well as the recent labor market reform. The VAT increase, combined with electricity price increases, will also lead to temporarily higher inflation. Lower domestic demand would further improve the current account, which would reach a larger surplus over the medium term, putting the net IIP on a downward path*".

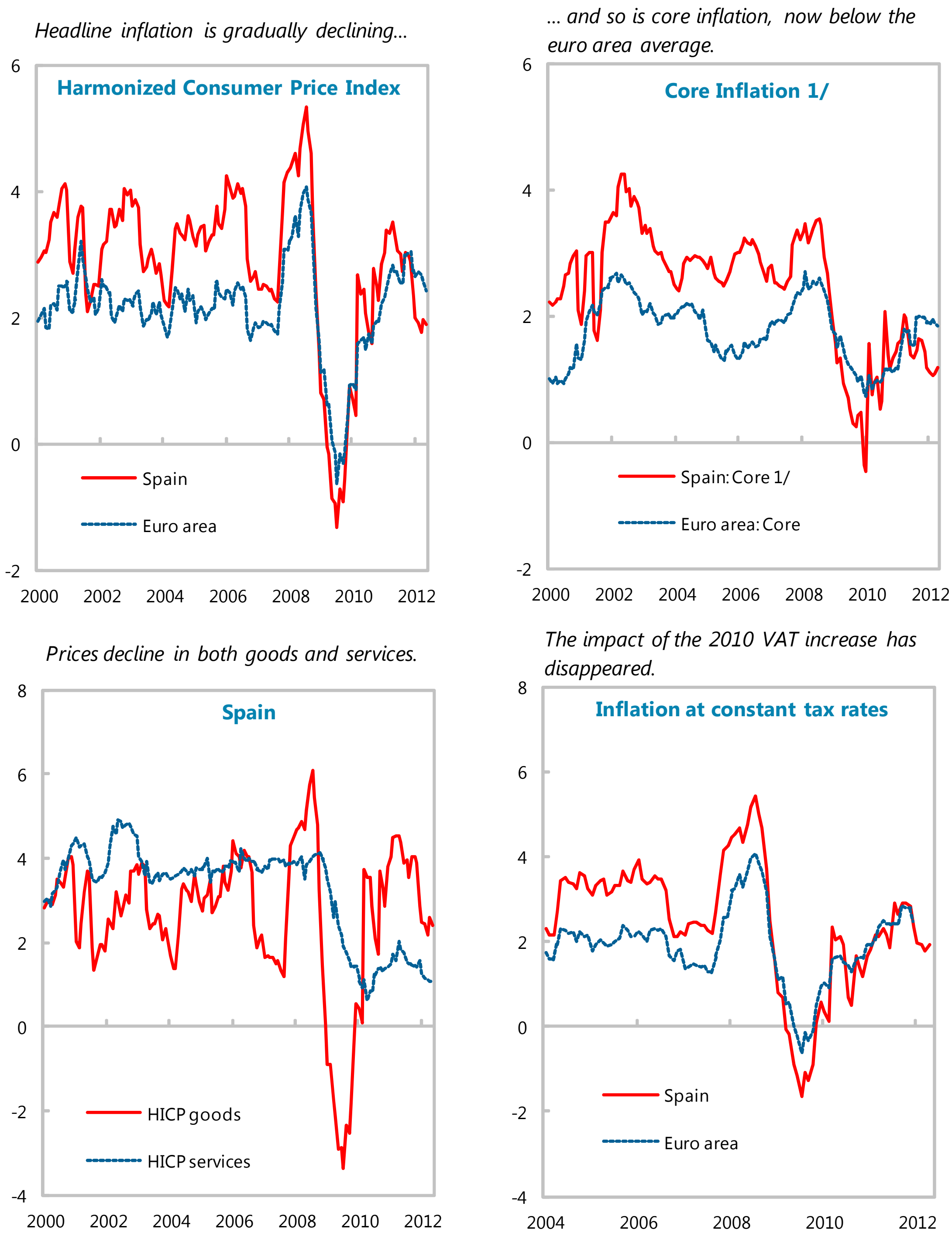
Figure 1. Spain: Activity



Sources: Bank of Spain; Eurostat; WEO; and IMF staff calculations.

Figure 2. Spain: Inflation

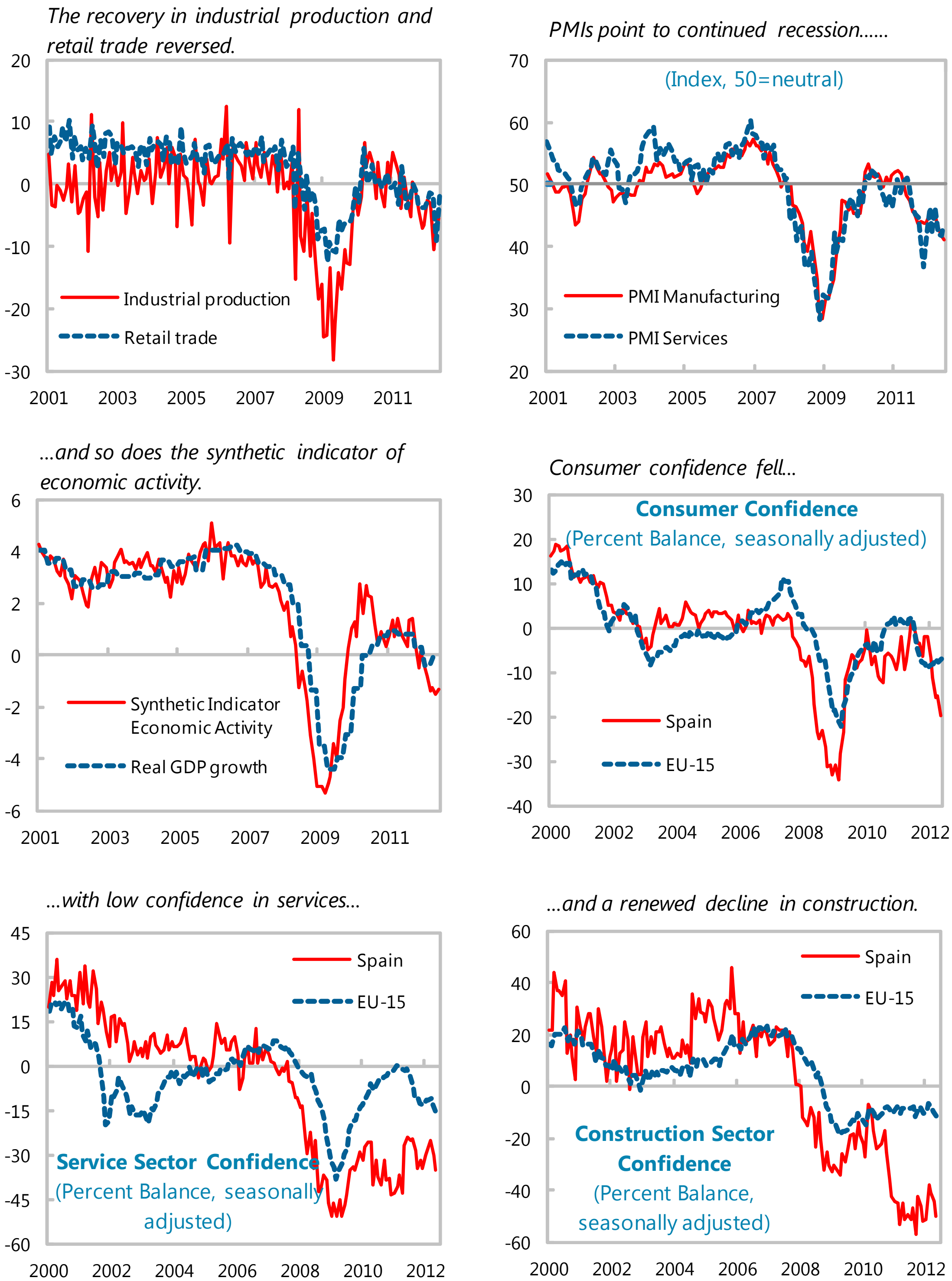
(year-on-year percent change, unless otherwise indicated)



Sources: Eurostat; IMF staff projections based on data provided by the authorities; and WEO.
1/ Excludes nonprocessed foods and energy products.

Figure 3. Spain: High Frequency Indicators

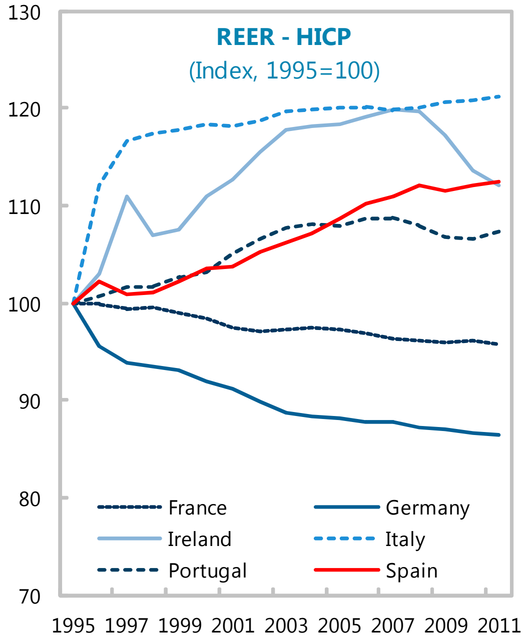
(Year-on-year percent change, unless otherwise indicated)

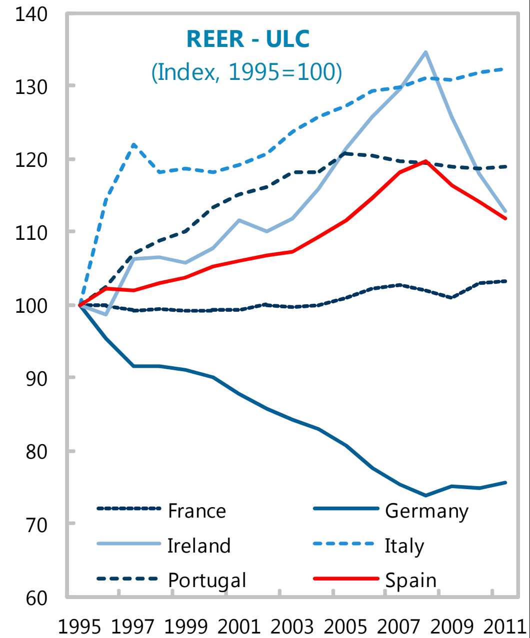


Sources: Eurostat; and IMF staff calculations based on data provided by the authorities.

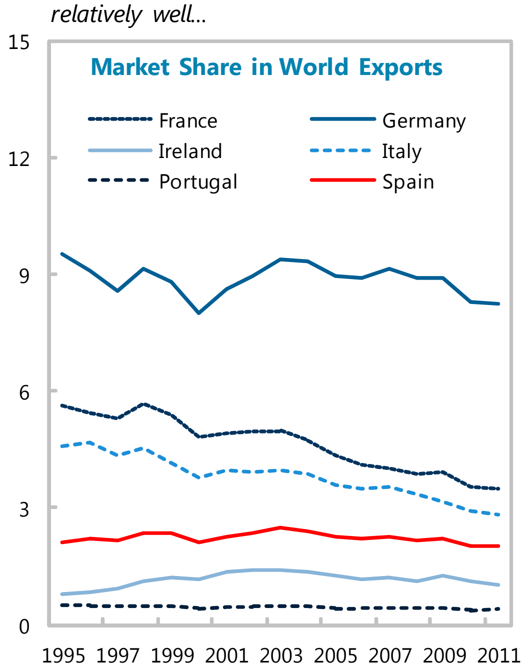
Figure 4. Spain: Competitiveness

Real effective exchange rates show a sustained appreciation since euro adoption and some correction with the recession.

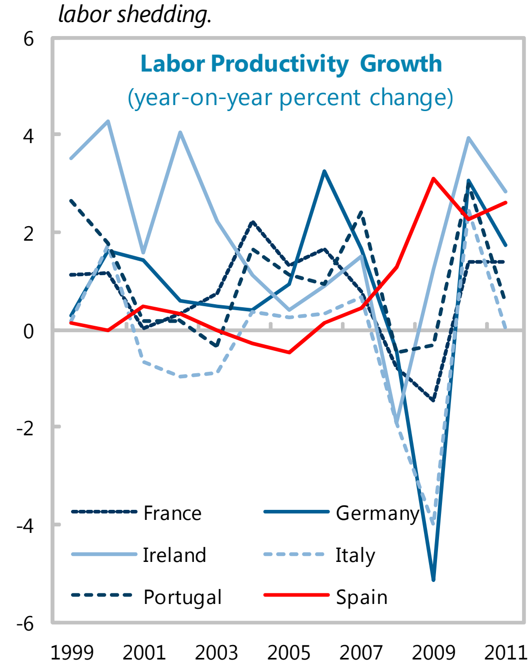




The export market share has held up relatively well...

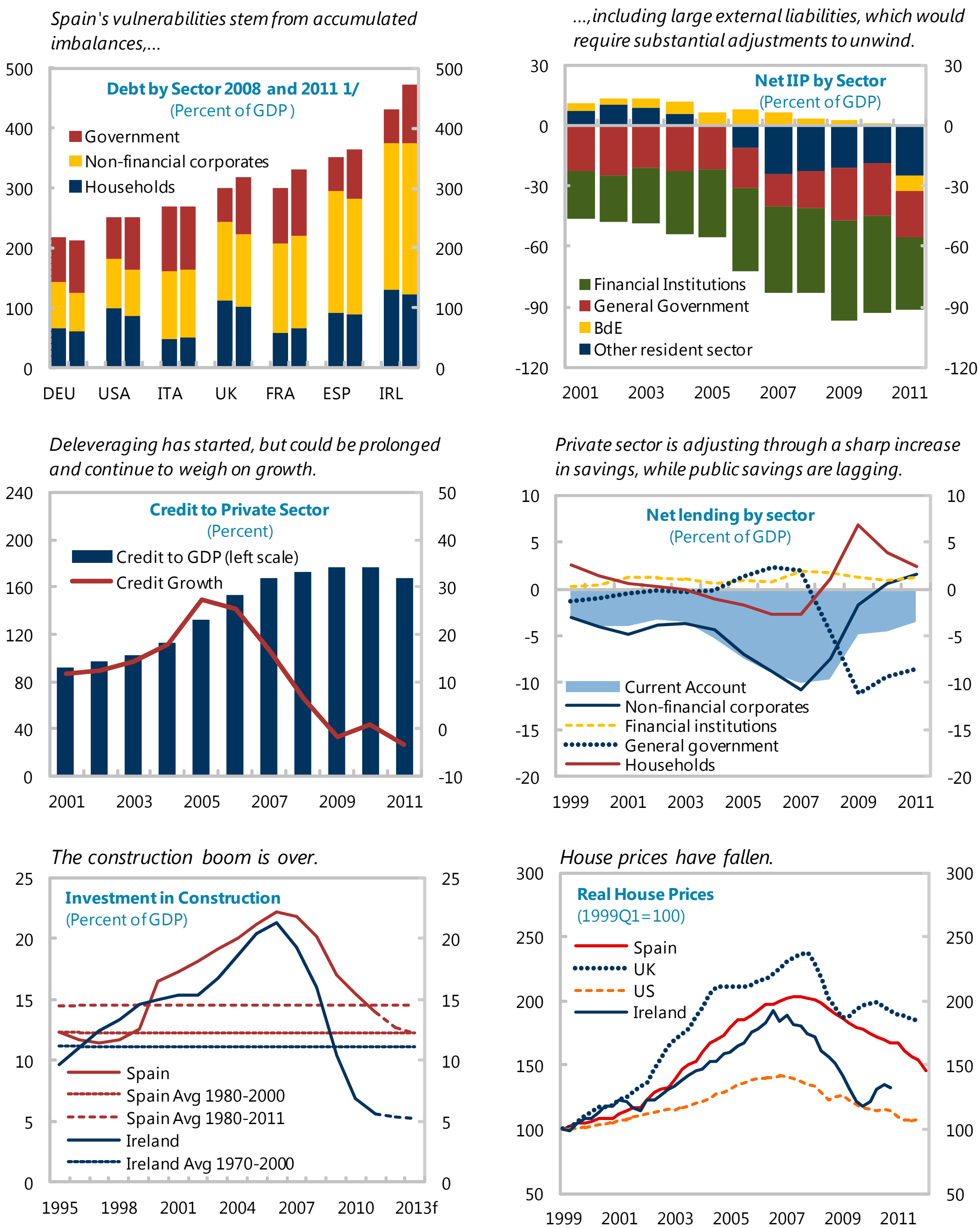


...with productivity growth supported by labor shedding.



Sources: Direction of Trade; Eurostat; and WEO.

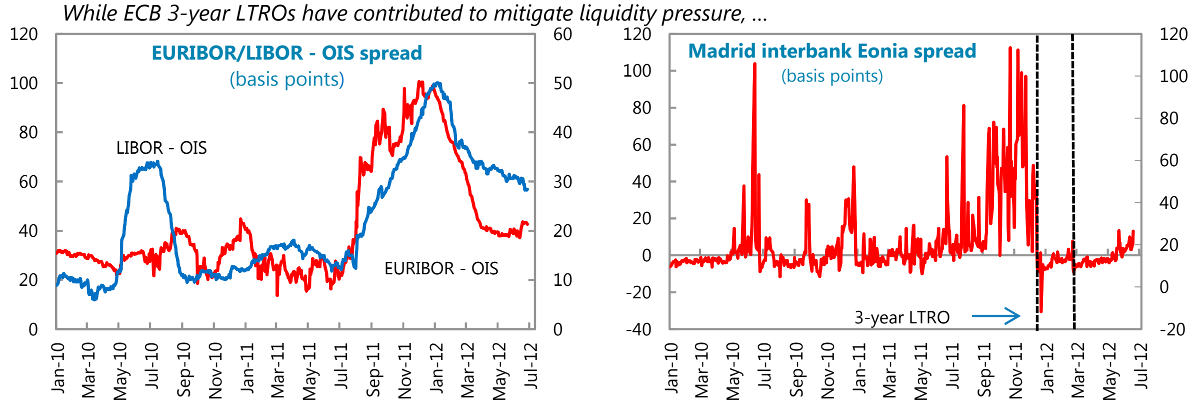
Figure 5. Spain: Imbalances and Adjustments



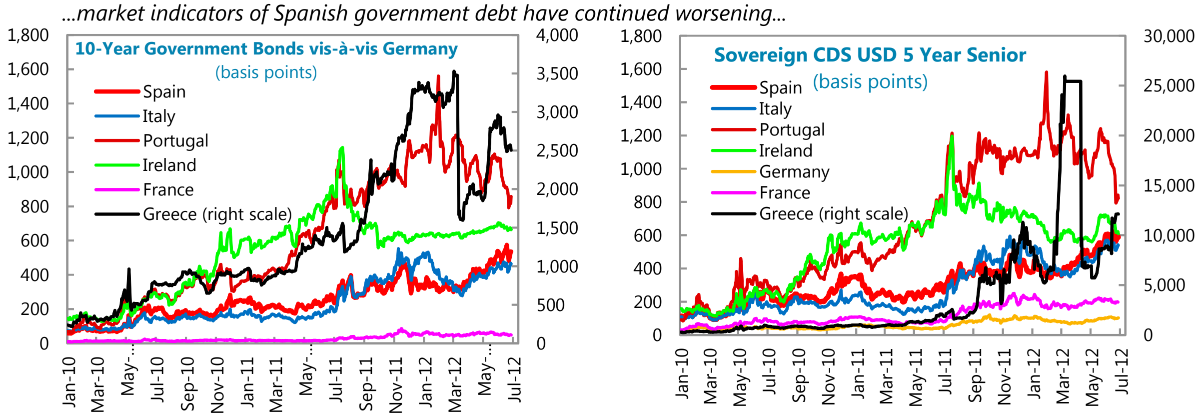
Sources: Banco de España; Instituto Nacional de Estadistica; MVIV; CSO; WEO; and IMF staff calculations.
1/ For each country, the left column refers to 2008, and the right column to 2011.

Figure 6. Spain: Financial Market Indicators, 2010-11

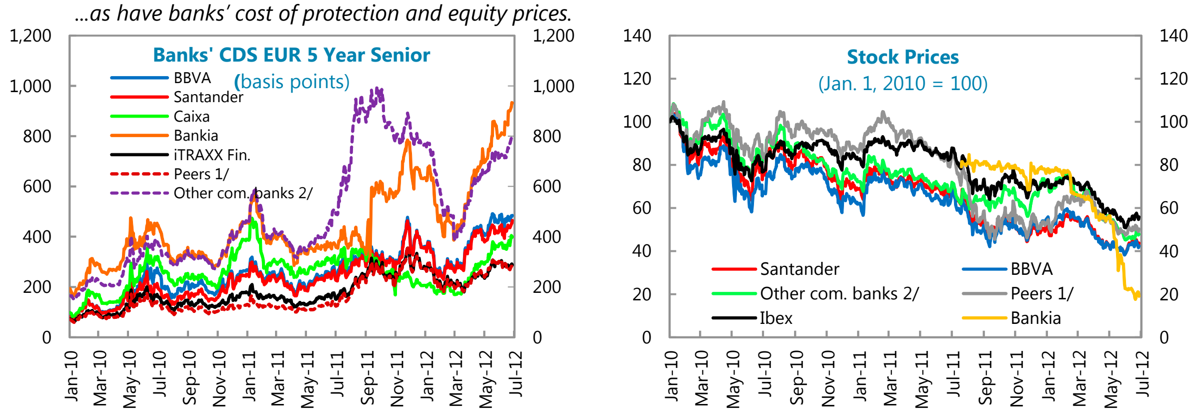
While ECB 3-year LTROs have contributed to mitigate liquidity pressure, …



…market indicators of Spanish government debt have continued worsening…



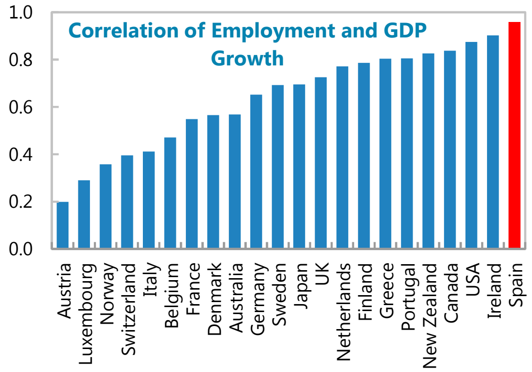
…as have banks' cost of protection and equity prices.



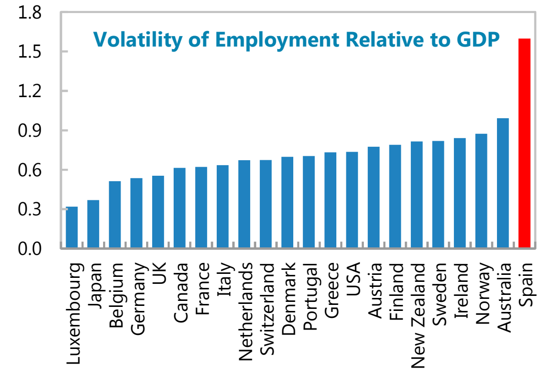
Sources: Bank of Spain; Bloomberg; and IMF staff estimates.
1/ Peers include Unicredit, Intesa-San Paolo, Commerzbank, Deutsche Bank, HSBC, Barclays, UBS, Credit Suisse, Societe Generale, BNP, and ING.
2/ Includes Banco Popular, Bankinter, Banco Sabadell, and Banco Pastor.

Figure 7. Spain: Labor Markets, 1990-2011

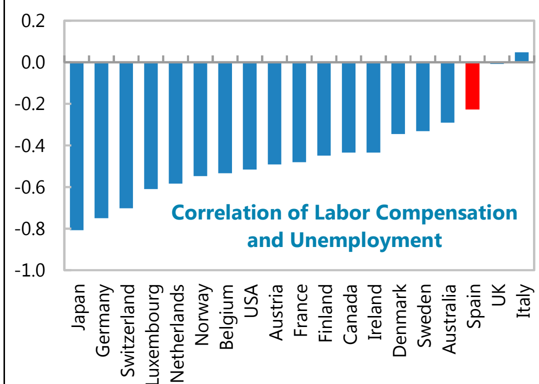
Spain's employment is the most procyclical among the OECD economies...



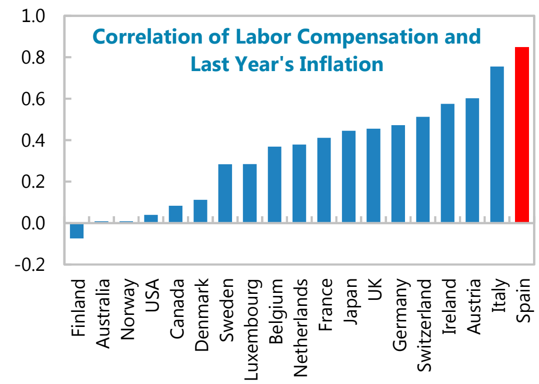
...and the most volatile relative to GDP.



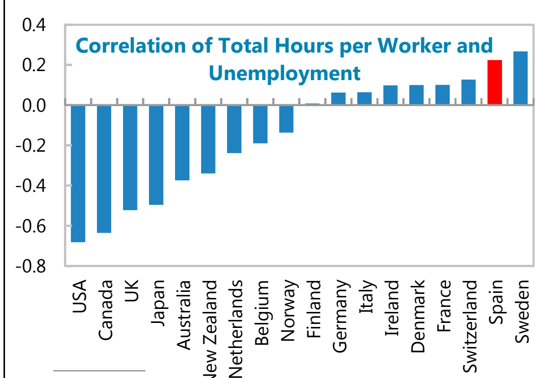
Spain's labor compensation falls little when unemployment increases...



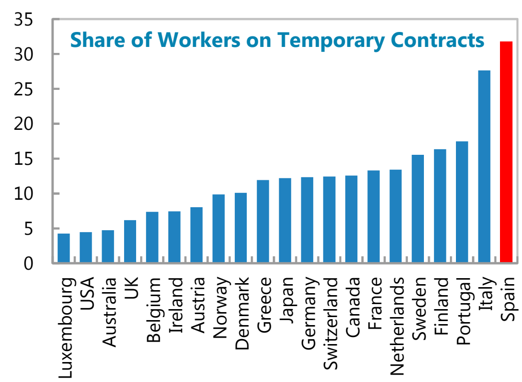
... and is the most correlated to past inflation due to wage indexation.



Spain's total hours worked per employee do not fall when unemployment raises.



Spain has the largest share of temporary workers among the OECD economies.



Sources: OECD; and IMF staff estimates.

Table 1. Spain: Main Economic Indicators 1/
(Percent change unless otherwise indicated)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
								Projections					
Demand and supply in constant prices													
Gross domestic product	3.6	4.1	3.5	0.9	-3.7	-0.1	0.7	-1.5	-0.6	1.1	1.5	1.6	1.6
Private consumption	4.1	4.0	3.5	-0.6	-4.3	0.8	-0.1	-1.5	-0.1	0.9	1.0	1.1	1.1
Public consumption	5.5	4.6	5.6	5.9	3.7	0.2	-2.2	-6.9	-5.5	-1.2	-0.4	-0.2	-0.1
Gross fixed investment	7.1	7.1	4.5	-4.7	-16.6	-6.3	-5.1	-7.5	-1.1	0.6	1.0	1.4	1.8
Construction investment	6.7	6.7	2.4	-5.8	-15.4	-10.1	-8.1	-9.4	-1.9	0.3	0.9	1.2	1.6
Other	7.8	7.0	10.5	-0.8	-15.2	1.0	0.8	-1.9	0.1	1.0	1.2	1.6	2.1
Stockbuilding (contribution to growth)	-0.1	0.3	-0.1	0.2	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Total domestic demand	5.0	5.2	4.1	-0.5	-6.2	-1.0	-1.7	-3.9	-1.4	0.4	0.7	0.9	1.0
Net exports (contribution to growth)	-1.7	-1.4	-0.8	1.5	2.8	0.9	2.5	2.4	0.7	0.7	0.7	0.7	0.6
Exports of goods and services	2.5	6.7	6.7	-1.0	-10.4	13.5	9.0	1.7	4.6	4.5	4.9	4.9	4.9
Imports of goods and services	7.7	10.2	8.0	-5.2	-17.2	8.9	-0.1	-6.2	2.4	2.8	3.0	3.4	3.7
Potential output growth	2.7	2.8	2.5	2.3	1.3	0.6	0.5	-0.4	-0.4	-0.1	0.2	0.6	0.8
Output gap (percent of potential)	1.5	2.8	3.8	2.3	-2.8	-3.4	-3.2	-4.3	-4.4	-3.3	-2.1	-1.2	-0.4
Credit to private sector	27.2	25.4	16.7	6.4	-1.6	0.8	-3.2	-5.4	-5.2	-1.6	2.1	2.5	2.7
Private sector debt (percent of GDP)	245	273	286	286	289	294	273	267	263	258	254	250	247
Household savings (percent of disposable income)	10.8	10.2	10.4	13.6	18.5	13.9	11.6	10.5	10.8	11.0	11.2	11.5	12.2
Prices													
GDP deflator	4.3	4.1	3.3	2.4	0.1	0.4	1.4	0.6	0.8	1.1	1.2	1.3	1.2
HICP (average)	3.4	3.6	2.8	4.1	-0.2	2.0	3.1	1.6	1.0	1.2	1.3	1.4	1.4
HICP (end of period)	3.7	2.7	4.3	1.5	0.9	2.9	2.4	1.1	1.2	1.2	1.4	1.4	1.4
Differential with euro area average	1.2	1.4	0.7	0.8	-0.5	0.4	0.3	-0.4	-0.6	-0.4	-0.4	-0.3	-0.4
Employment and wages													
Unemployment rate (in percent)	9.2	8.5	8.3	11.3	18.0	20.1	21.6	24.7	24.4	23.8	22.9	21.7	20.3
Unit labor cost in manufacturing	2.5	2.8	4.1	6.9	2.8	-4.6	-2.3	-2.4	-2.5	-1.7	-0.9	-0.7	-0.7
Labor cost in manufacturing	4.3	4.1	3.7	4.8	5.0	1.4	1.0	0.4	0.0	0.4	0.8	1.0	1.0
Employment growth	4.1	3.9	3.0	-0.4	-6.6	-3.8	-1.9	-4.1	0.5	0.9	1.5	2.0	2.2
Labor force growth (in percent) 2/	2.0	3.2	2.7	3.0	1.0	-1.3	0.1	-0.2	0.0	0.2	0.3	0.4	0.4
Balance of payments (percent of GDP)													
Trade balance (goods)	-7.5	-8.4	-8.7	-7.9	-4.0	-4.5	-3.7	-2.4	-1.8	-1.2	-0.6	-0.2	0.2
Current account balance	-7.4	-9.0	-10.0	-9.6	-4.8	-4.5	-3.5	-2.0	-1.1	-0.6	0.0	0.8	1.4
Net international investment position	-56	-66	-78	-79	-94	-89	-92	-95	-95	-93	-90	-87	-83
Nominal effective rate (2005=100) 3/	99	101	103	104	105	101	102	101	...	...	...	...	...
Real effective rate (2005=100, CPI-based) 3/	100	102	105	107	107	103	103	102	...	...	...	...	...
Public finance (percent of GDP)													
General government balance	1.3	2.4	1.9	-4.5	-11.2	-9.3	-8.9	-7.0	-5.9	-5.3	-5.1	-4.5	-4.4
Primary balance	3.1	4.0	3.5	-2.9	-9.4	-7.4	-6.4	-3.7	-2.0	-1.0	-0.5	0.5	1.0
Structural balance	-1.6	-1.2	-1.1	-4.9	-9.3	-7.6	-7.6	-5.4	-4.2	-3.9	-4.1	-4.0	-4.3
General government debt	43.2	39.7	36.3	40.2	53.9	61.2	68.5	90.3	96.5	100.2	102.7	104.4	105.9

Sources: IMF, *World Economic Outlook;* data provided by the authorities; and IMF staff estimates.
1/ Significant policy developments occurred after this Staff Report had been issued to the Board, which are discussed in the attached Staff Supplement.
2/ Based on national definition (i.e., the labor force is defined as people older than 16 and younger than 65).
3/ Based on data from IMF, *International Financial Statistics*. Data for 2012 refer to April 2012.

Table 2. Spain: Selected Financial Soundness Indicators
(Percent or otherwise indicated)

	2006	2007	2008	2009	2010	2011
Solvency						
Regulatory capital to risk-weighted assets 1/	11.9	11.4	11.3	12.2	11.9	12.4
Tier 1 capital to risk-weighted assets 1/	7.5	7.9	8.2	9.4	9.7	10.6
Capital to total assets	6.0	6.3	5.5	6.1	5.8	5.9
Returns on average assets	1.0	1.1	0.7	0.5	0.5	0.2
Profitability						
Returns on average equity	19.5	19.5	12.0	8.8	7.2	2.8
Interest margin to gross income	53.3	54.8	62.8	65.6	64.2	65.2
Operating expenses to gross income	47.0	44.4	45.7	42.7	46.7	49.8
Asset quality						
Non performing loans (billions of euro)	10.9	16.3	63.1	93.3	107.2	135.8
Non-performing to total loans	0.7	0.9	3.4	5.1	5.8	7.6
Provisions to non-performing loans	272.2	214.6	70.8	58.6	66.9	58.3
Exposure to construction sector (billions of euro) 2/	378.4	457.0	469.9	453.4	430.3	396.8
of which : Non-performing	0.3	0.6	5.7	9.6	13.5	20.1
Households - House purchase (billions of euro)	523.6	595.9	626.6	624.8	632.4	626.6
of which : Non-performing	0.4	0.7	2.4	2.9	2.4	2.8
Households - Other spending (billions of euro)	213.4	221.2	226.3	220.9	226.4	212.2
of which : Non-performing	1.7	2.3	4.8	6.1	5.4	5.4
Liquidity						
Use of ECB refinancing (billions of euro) 3/	21.2	52.3	92.8	81.4	69.7	132.8
in percent of total ECB refin. operations	4.9	11.6	11.6	12.5	13.5	21.0
in percent of total assets of Spanish MFI	0.8	1.7	2.7	2.4	2.0	3.7
Loan-to-deposit ratio 4/	165.0	168.2	158.0	151.5	149.2	150.0
Market indicators (end-period)						
Stock market (percent changes)						
IBEX 35	31.8	7.3	-39.4	29.8	-17.4	-13.4
Santander	26.8	4.6	-51.0	73.0	-30.5	-26.3
BBVA	21.0	-8.1	-48.3	49.4	-38.2	-12.1
CDS (spread in basis points) 5/						
Spain	2.7	12.7	90.8	103.8	284.3	466.3
Santander	8.7	45.4	103.5	81.7	252.8	393.1
BBVA	8.8	40.8	98.3	83.8	267.9	407.1

Sources: Bank of Spain; ECB; WEO; Bloomberg; and IMF staff estimates.
1/ Starting 2008, solvency ratios are calculated according to CBE 3/2008 transposing EU Directives 2006/48/EC and 2006/49/EC (based on Basel II). In particular, the Tier 1 ratio takes into account the deductions from Tier 1 and the part of the new general deductions from total own funds which are attributable to Tier 1.
2/ Including real estate developers.
3/ Sum of main and long-term refinancing operations and marginal facility.
4/ Ratio between loans to and deposits from other resident sectors.
5/ Senior 5 years in euro.

Table 3. General Government Operations 1/

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
							Projections			
					(Billions of euro)					
Revenue	**402**	**365**	**379**	**377**	**380**	**383**	**392**	**404**	**418**	**433**
Taxes	228	197	213	210	215	215	217	224	233	243
Indirect taxes	107	92	109	105	105	105	108	111	114	117
Direct taxes	117	101	100	102	107	106	106	110	116	122
Capital tax	5	4	4	3	3	3	3	3	3	4
Social contributions	143	140	140	140	136	137	138	142	146	151
Grants	4	6	6	6	6	6	6	6	6	6
Other revenue	27	23	21	21	22	26	31	32	33	33
Expenditure	**451**	**483**	**478**	**472**	**454**	**446**	**450**	**460**	**470**	**486**
Expense	**425**	**454**	**456**	**462**	**455**	**449**	**454**	**463**	**474**	**489**
Compensation of employees	119	125	124	124	120	117	115	115	115	115
Use of goods and services	60	61	58	62	48	43	42	43	44	45
Consumption of fixed capital	19	19	20	19	19	19	20	20	21	21
Interest	17	19	20	26	35	41	46	51	57	64
Subsidies	12	12	12	12	10	8	8	8	8	11
Grants	10	11	11	11	11	11	11	12	12	12
Social benefits	165	184	193	193	203	203	205	207	210	212
Other expense	23	23	18	15	9	6	6	7	7	8
Net acquisition of nonfinancial assets	26	29	22	10	-1	-3	-4	-3	-4	-3
Gross operating balance	**-23**	**-88**	**-77**	**-85**	**-76**	**-65**	**-62**	**-59**	**-56**	**-56**
Net lending / borrowing	**-49**	**-117**	**-98**	**-95**	**-75**	**-62**	**-58**	**-57**	**-52**	**-53**
					(Percent of GDP)					
Revenue	**37.0**	**34.9**	**36.1**	**35.1**	**35.7**	**35.9**	**36.0**	**36.1**	**36.3**	**36.6**
Taxes	21.0	18.8	20.2	19.6	20.2	20.2	19.9	20.0	20.3	20.5
Social contributions	13.2	13.4	13.3	13.0	12.8	12.8	12.7	12.7	12.7	12.7
Grants	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Other revenue	2.5	2.1	2.0	2.0	2.1	2.4	2.8	2.8	2.8	2.8
Expenditure	**41.5**	**46.1**	**45.4**	**44.0**	**42.7**	**41.8**	**41.3**	**41.1**	**40.8**	**41.1**
Expense	**39.0**	**43.3**	**43.4**	**43.0**	**42.8**	**42.1**	**41.6**	**41.4**	**41.2**	**41.3**
Compensation of employees	10.9	11.9	11.8	11.5	11.3	11.0	10.6	10.3	10.0	9.7
Use of goods and services	5.5	5.8	5.5	5.8	4.6	4.1	3.9	3.8	3.8	3.8
Consumption of fixed capital	1.7	1.8	1.9	1.8	1.8	1.8	1.8	1.8	1.8	1.8
Interest	1.6	1.8	1.9	2.4	3.3	3.9	4.3	4.6	5.0	5.4
Subsidies	1.1	1.1	1.1	1.1	0.9	0.7	0.7	0.7	0.7	0.9
Grants	0.9	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1
Social benefits	15.2	17.6	18.3	18.0	19.1	19.0	18.8	18.5	18.2	17.9
Other expense	2.1	2.2	1.7	1.4	0.8	0.6	0.6	0.6	0.6	0.7
Net acquisition of nonfinancial assets	2.4	2.8	2.1	1.0	-0.1	-0.3	-0.4	-0.2	-0.4	-0.3
Gross operating balance	**-2.1**	**-8.4**	**-7.3**	**-7.9**	**-7.1**	**-6.1**	**-5.7**	**-5.3**	**-4.9**	**-4.7**
Net lending / borrowing	**-4.5**	**-11.2**	**-9.3**	**-8.9**	**-7.0**	**-5.9**	**-5.3**	**-5.1**	**-4.5**	**-4.4**
Memorandum items:										
Primary balance	-2.9	-9.4	-7.4	-6.4	-3.7	-2.0	-1.0	-0.5	0.5	1.0
Primary structural balance	-3.6	-7.5	-5.6	-5.2	-2.2	-0.4	0.4	0.4	1.0	1.1
Structural balance	-5.2	-9.3	-7.6	-7.6	-5.4	-4.2	-3.9	-4.1	-4.0	-4.3
Change in structural balance	-4.2	-4.0	1.7	-0.1	2.2	1.2	0.4	-0.3	0.2	-0.3
General government gross debt (Maastricht)	40.2	53.9	61.2	68.5	90.3	96.5	100.2	102.7	104.4	105.9

Sources: Ministry of Finance; Eurostat; and IMF staff estimates and projections.
1/ Significant policy developments occurred after this Staff Report had been issued to the Board, which are discussed in the attached Staff Supplement.

Table 4. General Government: Balance Sheet

	2004	2005	2006	2007	2008	2009	2010	2011
				(billions of euro)				
Net financial worth	**-287.7**	**-264.6**	**-220.9**	**-187.0**	**-245.8**	**-359.5**	**-422.8**	**-521.2**
Financial assets	**161.9**	**196.8**	**234.4**	**259.0**	**273.0**	**299.2**	**282.2**	**286.9**
Currency and deposits	64.2	75.6	88.9	101.1	101.9	119.7	95.1	77.5
Securities other than shares	1.4	6.1	16.7	22.8	34.4	28.0	31.4	24.0
Loans	15.5	17.4	19.1	21.3	23.4	30.8	36.2	47.1
Shares and other equity	61.5	75.3	82.7	87.5	88.3	91.9	93.8	100.5
Other accounts receivable	19.4	22.4	27.0	26.2	24.9	28.7	25.7	37.7
Financial liabilities	**449.6**	**461.4**	**455.3**	**446.0**	**518.8**	**658.7**	**705.0**	**808.1**
Currency and deposits	2.5	2.8	3.1	3.3	3.4	3.5	3.6	3.7
Securities other than shares	351.8	357.1	340.9	323.4	378.3	498.1	526.4	609.0
Loans	66.5	66.3	66.5	65.7	78.0	89.8	106.2	121.4
Other accounts payable	28.8	35.3	44.8	53.6	59.1	67.4	68.8	74.0
				(percent of GDP)				
Financial Net worth	**-34.2**	**-29.1**	**-22.4**	**-17.8**	**-22.6**	**-34.3**	**-40.2**	**-48.6**
Financial assets	**19.2**	**21.6**	**23.8**	**24.6**	**25.1**	**28.6**	**26.8**	**26.7**
Currency and deposits	7.6	8.3	9.0	9.6	9.4	11.4	9.0	9.0
Securities other than shares	0.2	0.7	1.7	2.2	3.2	2.7	3.0	3.0
Loans	1.8	1.9	1.9	2.0	2.2	2.9	3.4	3.4
Shares and other equity	7.3	8.3	8.4	8.3	8.1	8.8	8.9	8.9
Other accounts receivable	2.3	2.5	2.7	2.5	2.3	2.7	2.4	2.4
Financial liabilities	**53.4**	**50.7**	**46.2**	**42.3**	**47.7**	**62.9**	**67.1**	**75.3**
Currency and deposits	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Securities other than shares	41.8	39.3	34.6	30.7	34.8	47.5	50.1	56.7
Loans	7.9	7.3	6.8	6.2	7.2	8.6	10.1	10.1
Other accounts payable	3.4	3.9	4.5	5.1	5.4	6.4	6.5	6.5
Memorandum items (billions of euro):								
Public debt	389.1	392.5	391.1	382.3	437.0	565.1	643.1	735.0
Net lending/borrowing	-2.9	11.5	23.3	20.2	-48.9	-117.3	-98.2	-95.0
Change in public debt	7.1	3.4	-1.4	-8.7	54.7	128.1	78.1	91.8
Stock flow adjustment	4.2	14.9	21.9	11.5	5.8	10.8	-20.2	-3.2
GDP	841.3	909.3	985.5	1053.2	1087.7	1047.8	1051.3	1073.4

Sources: Eurostat; IMF GFS; and IMF staff estimates.

Table 5. Spain: Outstanding Liabilities of the Public Sector

	2004	2005	2006	2007	2008	2009	2010 8/	2011 8/
	Percent of GDP							
Fiscal Balances in National Accounting								
Central Government	-1.0	0.6	1.0	1.1	-3.0	-9.4	-5.0	-2.9
Autonomous Communities	-0.1	-0.3	0.0	-0.2	-1.7	-2.0	-3.5	-5.1
Municipalities	0.0	-0.1	0.1	-0.3	-0.5	-0.6	-0.6	-0.8
Social Security	1.0	1.1	1.3	1.3	0.7	0.8	-0.2	-0.1
General Government	-0.1	1.3	2.4	1.9	-4.5	-11.2	-9.3	-8.9
Non-Financial Enterprises 1/	0.2	-0.1	-0.1	-0.5	-0.8	-0.6	...	...
Financial Enterprises 2/	0.0	-0.1	-0.1	-0.3	-0.1	0.0	...	...
Combined Public Sector (excluding BdE)	**-0.1**	**0.8**	**1.8**	**1.1**	**-5.0**	**-11.8**	**...**	**...**
Debt and Other Outstanding Liabilities								
General Government Debt								
Central Government	37.1	33.9	30.8	27.7	30.6	41.9	46.4	52.1
Autonomous Communities	6.2	6.4	6.0	5.8	6.7	8.7	11.4	13.1
Municipalities	2.9	2.8	2.8	2.8	2.9	3.3	3.4	3.3
Social Security	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Public Administrations	46.3	43.2	39.7	36.3	40.2	53.9	61.2	68.5
General Government Liabilities 3/								
Central Government	6.8	7.2	5.5	4.8	7.1	9.4	7.7	6.7
Autonomous Communities	1.7	2.0	2.2	2.4	2.6	2.8	3.0	2.3
Municipalities	1.3	1.5	1.5	1.6	1.7	1.9	2.2	2.0
Social Security	3.4	3.1	2.8	2.7	2.6	2.6	2.6	2.5
Public Administrations	13.1	13.7	12.0	11.6	14.0	16.8	15.6	13.5
Public Entities Outside the General Government 4/								
Central Government	1.1	1.3	1.4	1.7	2.0	2.4	2.8	3.0
Autonomous Communities	0.8	0.7	0.8	0.9	1.0	1.2	1.4	1.3
Municipalities	0.4	0.4	0.4	0.5	0.5	0.7	0.9	0.9
Social Security	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Public Administrations	0.0	2.4	2.6	3.1	3.5	4.3	5.1	5.2
Government Guaranteed Debt 5/	0.9	3.5	3.7	4.1	5.4	11.1	14.1	17.6
Financial Sector 6/	...	...	...	...	...	4.6	5.7	6.1
Other	0.9	0.7	0.6	0.6	0.7	1.0	1.3	3.1
ICO Liabilities 7/	...	2.8	3.1	3.5	4.6	5.5	7.1	8.5

Sources: MHAP, BdE, IGAE, Staff estimates. Shading indicates estimate, as last IGAE update of enterprises was in 2008.
1/ Financially independent non-financial entities controlled by public administrations, projected for 2010-11.
2/ Financially independent financial entities controlled by the public administrations excluding the Bank of Spain (BdE),proj. 2010-11.
3/ Liabilities of the general government (AAPP, public administrations). Includes outstanding payments due in good standing and float.
4/ Debt of Financially independent entities controlled by the general government.
5/ Guarantees issued by the Central Government, includes guarantees to the financial sector.
6/ Liabilities in accordance Laws 2/2008, 9/2009 on banking restructuring and strengthening own resources of credit entities.
7/ Reflects central government guarantees of the liabilities of the Instituto de Credito Oficial (ICO).
8/ 2010 preliminary, 2011 advanced, and include 2011 liquidation effect.

Table 6. Spain: Regional Fiscal Operations 2010-2017 1/
(percent of GDP, budget accounting except where specified)

	2010	2011	2012					2013	2014	2015	2016	2017
	Preliminary		Bud. 2/	Mea. 3/	PEF 4/	Q1	Proj.	Projections				
1. Direct taxes	2.8	3.8	3.6	0.0	3.9	0.9	3.8	3.8	3.9	4.0	4.1	4.2
Inheritance and gift tax	0.3	0.2	0.2	...	...	0.1	0.2	0.2	0.3	0.3	0.4	0.4
Personal income tax	2.5	3.4	3.4	...	...	0.8	3.6	3.6	3.6	3.7	3.7	3.8
2. Indirect taxes	3.2	4.4	4.8	0.1	4.8	1.0	4.4	4.5	4.6	4.8	4.9	5.1
Capital gains & transfers	0.8	0.6	0.7	...	...	0.1	0.6	0.6	0.7	0.7	0.8	0.8
Value added tax	1.3	2.3	2.6	...	...	0.5	2.3	2.3	2.4	2.4	2.5	2.5
Excise duties	1.1	1.4	1.4	...	...	0.3	1.5	1.5	1.6	1.6	1.7	1.7
3. Fees, public prices	0.5	1.2	0.4	0.0	0.4	0.1	0.4	0.4	0.5	0.5	0.6	0.6
4. Current transfers	5.5	2.8	3.2	0.1	3.0	1.0	2.9	2.9	2.9	2.9	2.9	2.9
5. Property income	0.0	0.0	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Current Revenue	**12.1**	**12.2**	**12.1**	**0.3**	**12.3**	**3.0**	**11.5**	**11.6**	**11.9**	**12.2**	**12.5**	**12.8**
6. Divestment	0.0	0.0	0.1	0.1	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
7. Capital transfers	0.7	0.5	0.6	0.0	0.6	0.1	0.5	0.5	0.5	0.5	0.5	0.5
Compensation fund	0.1	0.1	0.1	...	...	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Other	0.5	0.4	0.5	...	...	0.0	0.4	0.4	0.4	0.4	0.4	0.4
Capital Revenue	**0.7**	**0.6**	**0.7**	**0.2**	**0.7**	**0.1**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Revenue	**12.8**	**12.8**	**12.9**	**0.4**	**13.0**	**3.1**	**12.0**	**12.2**	**12.5**	**12.8**	**13.0**	**13.3**
1. Wages	5.6	5.3	5.3	0.3	5.0	1.2	5.1	5.0	5.0	5.0	5.0	5.0
2. Goods and Services	2.7	2.6	2.5	0.4	3.2	0.6	2.5	2.4	2.4	2.4	2.4	2.4
3. Interest expenditure	0.3	0.4	0.6	0.0	0.6	0.1	0.6	0.7	0.8	0.8	0.9	0.9
4. Current transfers	4.3	5.0	3.9	0.3	4.7	0.9	4.9	4.8	4.8	4.8	4.8	4.8
5. Contingency fund	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Current Expenditure	**12.8**	**13.4**	**12.3**	**1.1**	**13.6**	**2.8**	**13.1**	**12.9**	**12.9**	**13.0**	**13.0**	**13.1**
6. Capital investment	0.9	0.6	0.8	0.1	0.7	0.1	0.8	0.8	0.8	0.8	0.8	0.8
7. Capital transfers	1.2	1.0	1.0	0.2	0.9	0.1	1.0	0.9	0.9	0.9	0.9	0.9
Capital Expenditure	**2.1**	**1.6**	**1.8**	**0.3**	**1.6**	**0.2**	**1.8**	**1.7**	**1.7**	**1.7**	**1.7**	**1.7**
Expenditure	**15.0**	**15.0**	**14.2**	**1.3**	**15.2**	**3.0**	**14.9**	**14.6**	**14.6**	**14.7**	**14.7**	**14.8**
Balance (budget accounting)	**-2.2**	**-2.2**	**-1.3**	**1.8**	**-2.2**	**0.1**	**-2.9**	**-2.4**	**-2.2**	**-1.9**	**-1.7**	**-1.4**
National Accounting Adj. 5/	**-0.8**	**-1.1**	**...**	**...**	**0.7**	**-0.1**	**0.7**	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**-0.1**
Balance (national accounting)	**-2.9**	**-3.3**	**...**	**...**	**-1.5**	**0.0**	**-2.2**	**-2.5**	**-2.3**	**-2.0**	**-1.8**	**-1.5**
Primary balance	-2.7	-2.8 #	...	...	-0.9	0.1	-1.6	-1.8	-1.5	-1.2	-0.9	-0.6
Memorandum:												
Debt	11.4	13.0	...	...	...	...	16.8	19.2	21.1	22.5	23.7	24.5
Real regional GDP growth	-0.1	0.7	...	...	...	...	-1.5	-0.5	1.1	1.5	1.6	1.6

Sources: Spanish authorities; and IMF staff estimates.
1/ Significant policy developments occurred after this Staff Report had been issued to the Board, which are discussed in the attached Staff Supplement.
2/ Consolidated 2012 regional budgets presented in budget accounting, corrected by measures presented in PEFs for 2012.
3/ Measures in Financial-Economic Plans (PEFs) in 2012 as reported by MHAP; includes measures presented by Asturias but not accepted by the MHAP, and approximately €2.6 billion in health and education from RDLs 14/2012 and 16/2012.
4/ Financial-Economic Plans for 2012, includes expenditure amounts reflecting accounting entries in goods and services or transfers that are accounting offsets for national accounting adjustment in 2011 related to Suppliers Payments Financing Facility (FFPP).
5/ Adjustment to bring budget accounting to ESA95 national accounting, for 2012 assumes a one-off positive adjustment in PEFs.

Table 7. Spain: Balance of Payments 1/

				Projections					
	2009	2010	2011	2012	2013	2014	2015	2016	2017
				(Billions of euro)					
Current Account	-51	-47	-38	-21	-12	-7	0	9	17
Trade Balance of goods and services	-17	-20	-6	15	24	34	45	54	63
Exports of goods and services	253	288	325	337	357	378	403	430	459
Exports of goods	164	194	223	231	245	260	277	296	316
Exports of services	89	94	102	105	111	118	126	134	143
Imports of goods and services	-269	-308	-330	-322	-332	-344	-358	-375	-395
Imports of goods	-206	-241	-262	-257	-265	-274	-284	-297	-313
Imports of services	-64	-66	-68	-65	-67	-71	-74	-78	-82
Balance of factor income	-26	-20	-26	-30	-31	-35	-39	-39	-40
Balance of current transfers	-8	-7	-6	-6	-6	-6	-6	-6	-7
Capital Account	4	6	5	4	4	4	4	4	5
Financial Account	52	43	34	19	8	2	-4	-13	-21
Foreign Direct Investment	-2	2	-6	16	14	15	15	15	16
Portfolio Investment	51	34	-29	-157	28	27	37	-4	-10
Other Investment	10	-1	76	155	-35	-39	-56	-24	-27
of which EFSF/ESM	…	…	…	100	0	0	0	0	0
Financial Derivatives	-6	9	2	5	0	0	0	0	0
Reserves In(+)/Outflows(-)	-2	-1	-10	0	0	0	0	0	0
Errors and Omissions	-6	-2	-2	-1	0	0	0	0	0
				(Percent of GDP)					
Current Account	-4.8	-4.5	-3.5	-2.0	-1.1	-0.6	0.0	0.8	1.4
Trade Balance of goods and services	-1.6	-1.9	-0.5	1.4	2.3	3.1	4.0	4.7	5.4
Exports of goods and services	24.1	27.3	30.2	31.6	33.5	34.7	36.0	37.3	38.8
Exports of goods	15.7	18.4	20.7	21.8	23.0	23.9	24.8	25.7	26.7
Exports of services	8.5	8.9	9.5	9.9	10.5	10.8	11.3	11.7	12.1
Imports of goods and services	-25.7	-29.3	-30.8	-30.3	-31.2	-31.6	-32.0	-32.6	-33.4
Imports of goods	-19.6	-23.0	-24.4	-24.2	-24.8	-25.1	-25.4	-25.8	-26.4
Imports of services	-6.1	-6.3	-6.3	-6.1	-6.3	-6.5	-6.6	-6.8	-7.0
Balance of factor income	-2.5	-1.9	-2.4	-2.8	-2.9	-3.2	-3.4	-3.4	-3.4
Balance of current transfers	-0.8	-0.7	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6
Capital Account	0.4	0.6	0.5	0.4	0.4	0.4	0.4	0.4	0.4
Financial Account	5.0	4.1	3.2	1.7	0.7	0.2	-0.4	-1.1	-1.8
Foreign Direct Investment	-0.2	0.2	-0.6	1.5	1.4	1.3	1.3	1.3	1.3
Portfolio Investment	4.8	3.3	-2.7	-14.8	2.7	2.5	3.3	-0.4	-0.8
Other Investment	1.0	-0.1	7.1	14.6	-3.3	-3.6	-5.0	-2.1	-2.3
of which EFSF/ESM	…	…	…	9.4	0.0	0.0	0.0	0.0	0.0
Financial Derivatives	-0.5	0.8	0.2	0.5	0.0	0.0	0.0	0.0	0.0
Reserves In(+)/Outflows(-)	-0.1	-0.1	-0.9	0.0	0.0	0.0	0.0	0.0	0.0
Errors and Omissions	-0.5	-0.2	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
Net International Investment Position	-93.7	-89.4	-92.1	-94.6	-95.1	-93.3	-90.5	-86.8	-82.7

Sources: Bank of Spain; and IMF staff projections.
1/ Significant policy developments occurred after this Staff Report had been issued to the Board, which are discussed in the attached Staff Supplement.

Table 8. Spain: International Investment Position, 2005-11

	2005	2006	2007	2008	2009	2010	2011
				(Billions of euro)			
International Investment Position	-505	-648	-823	-863	-982	-940	-989
Direct Investment	-67	-19	-3	1	-4	21	16
Assets	259	331	395	424	434	491	496
Liabilities	326	350	398	423	439	469	480
Portfolio Investment	-274	-509	-649	-604	-694	-648	-616
Assets	455	456	438	354	374	313	258
Liabilities	728	965	1087	958	1068	960	874
Financial Derivatives	0	-10	-19	-6	-1	3	6
Other Investment	-237	-206	-232	-305	-327	-346	-314
Assets	268	325	379	387	370	373	399
Liabilities	505	531	611	692	697	719	713
Bank of Spain	72	96	79	51	44	30	-81
o/w Reserve Assets	15	15	13	15	20	24	36
				(Percent of GDP)			
International Investment Position	-55.6	-65.8	-78.1	-79.3	-93.7	-89.4	-92.1
Direct Investment	-7.4	-2.0	-0.2	0.1	-0.4	2.0	1.5
Assets	28.5	33.6	37.5	39.0	41.5	46.7	46.2
Liabilities	35.8	35.6	37.8	38.9	41.9	44.6	44.7
Portfolio Investment	-30.1	-51.6	-61.6	-55.5	-66.2	-61.6	-57.4
Assets	50.0	46.2	41.6	32.6	35.7	29.8	24.0
Liabilities	80.1	97.9	103.2	88.1	101.9	91.4	81.4
Financial Derivatives	0.0	-1.0	-1.8	-0.6	-0.1	0.3	0.6
Other Investment	-26.0	-20.9	-22.0	-28.1	-31.2	-32.9	-29.3
Assets	29.5	33.0	36.0	35.5	35.3	35.4	37.2
Liabilities	55.5	53.9	58.0	63.6	66.5	68.4	66.5
Bank of Spain	7.9	9.7	7.5	4.7	4.2	2.9	-7.5
o/w Reserve Assets	1.6	1.5	1.2	1.3	1.9	2.3	3.4
Memorandum Item:							
Nominal GDP (Euro billions)	909	986	1053	1088	1048	1051	1073

Source: Bank of Spain.

Table 9. Spain: Monetary Survey, 2008-2017 1/

(Billions of euros, unless otherwise indicated; end of period)

					Projections					
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Aggregated Balance Sheet of Monetary Financial Institutions (MFIs) 2/										
Assets	3,409	3,447	3,471	3,621	3,724	3,623	3,581	3,561	3,578	3,601
Cash	9	9	8	7	7	7	7	7	8	8
Deposits at the ECB	54	35	27	51	34	32	31	15	13	11
Claims on other MFIs	218	217	211	203	212	207	200	188	184	174
Claims on non MFIs	1,924	1,906	1,936	1,887	1,797	1,712	1,690	1,720	1,761	1,808
General government	53	64	79	89	96	101	106	104	105	107
Private sector 3/	1,871	1,842	1,857	1,797	1,700	1,611	1,584	1,616	1,656	1,701
Corporates	952	915	896	840	781	736	721	739	761	786
Households and NPISH	880	873	876	857	823	783	771	785	802	821
Shares and other equity	93	99	103	163	172	164	159	153	149	146
Securities other than shares	412	515	520	544	605	597	590	589	585	581
Claims on non-residents	421	420	374	386	405	398	395	393	394	396
Other assets	278	245	293	381	492	506	510	496	484	478
Liabilities	3,409	3,447	3,471	3,621	3,724	3,623	3,581	3,561	3,578	3,601
Capital and reserves	242	270	283	367	476	473	469	467	468	472
Borrowing from the ECB	102	91	62	172	339	322	305	146	131	113
Liabilities to other MFIs	220	217	211	201	211	206	200	188	183	174
Deposits of non MFIs	1,656	1,694	1,728	1,650	1,558	1,522	1,526	1,563	1,608	1,664
General government	76	82	79	70	64	63	64	65	67	69
Private sector	1,580	1,612	1,648	1,581	1,494	1,458	1,462	1,498	1,541	1,595
Corporates	213	216	219	197	167	154	153	155	160	169
Households and NPISH	680	704	727	727	713	711	714	732	756	785
Debt securities issued	399	440	433	435	410	390	378	430	422	414
Deposits of non-residents	505	508	512	493	422	408	401	465	461	458
Other liabilities	286	228	244	302	306	301	302	304	304	306
Money and Credit										
Broad Money 4/	1,181	1,163	1,140	1,121	1,106	1,104	1,123	1,148	1,176	1,203
Intermediate money	1,013	1,035	1,031	977	964	962	979	1,001	1,025	1,049
Narrow money	478	528	515	506	499	498	507	518	530	543
Monetary base	134	127	122	152	150	149	152	155	159	163
(Percent of GDP)										
Broad Money	108.6	111.0	108.4	104.5	104.0	103.5	103.1	102.6	102.1	101.7
Private sector credit	172.0	175.8	176.7	167.4	159.8	151.1	145.3	144.4	143.9	143.7
Corporates	87.5	87.3	85.2	78.3	73.4	69.0	66.1	66.0	66.1	66.4
Households and NPISH	80.9	83.4	83.4	79.8	77.3	73.5	70.8	70.2	69.7	69.4
Public sector credit	4.9	6.2	7.5	8.3	9.1	9.5	9.8	9.3	9.1	9.1
(Percentage change)										
Broad Money	10.1	-1.5	-2.0	-1.6	-1.3	-0.3	1.8	2.2	2.4	2.3
Private sector credit	6.4	-1.6	0.8	-3.2	-5.4	-5.2	-1.7	2.1	2.5	2.7
Corporates	6.6	-3.9	-2.1	-6.2	-7.1	-5.8	-2.0	2.5	3.0	3.2
Households and NPISH	4.8	-0.8	0.3	-2.2	-4.0	-4.8	-1.5	1.8	2.2	2.4
Public sector credit	23.5	22.1	21.9	13.6	8.0	5.0	5.0	-2.0	1.0	2.0
Memo items:										
Loans to deposits (%, other resident sector) 5/	158.0	151.5	149.2	150.0	150.2	145.8	142.9	142.4	141.8	140.7
Deposits (% change, private sector)	14.3	2.0	2.3	-4.1	-5.5	-2.4	0.3	2.4	2.9	3.5
Wholesale market funding (% change)	4.6	6.0	-8.8	-1.4	-9.5	-4.3	-2.5	14.7	-1.4	-1.4
Wholesale market funding (% assets)	23.8	24.9	22.6	21.3	18.8	18.5	18.2	21.0	20.6	20.2
Capital and reserves (% total assets)	7.1	7.8	8.1	10.1	12.8	13.1	13.1	13.1	13.1	13.1

Sources: Bank of Spain; and IMF staff estimates.

1/ Significant policy developments occurred after this Staff Report had been issued to the Board, which are discussed in the attached Staff Supplement.

2/ Monetary financial institutions (MFIs) excluding Bank of Spain.

3/ Loans to other resident sector, including non monetary financial institutions, insurance corporations and pension funds, non-financial corporations, NPISH and households.

4/ Broad money includes currency in circulation, deposits at the central bank, sight deposits, deposits redeemable at notice of up to three months, deposits with agreed maturity of up to two years, repos, shares in money market funds and money market instruments.

5/ Of which credit institutions, other resident sectors. Data are from supervisory return. The ratio of lending to other resident sectors to overnight, saving and agreed maturity deposits in both euro and foreign currency.

Table 10. Spain: Risk Assessment Matrix[1 2]

Source of Risks	Relative Likelihood[3]	Impact if Realized
1. Strong intensification of the euro area crisis	**Medium** • Market stress could intensify. • Deleveraging and fiscal drag could affect the outlook for the euro area, with potential knock on effects on the financial sector and increased volatility.	**High** • Direct effects through lower export demand and inward financial spillovers, indirect effects through deleveraging and uncertainty.
2. Fiscal slippage, and public debt build-up	**High** • Implementation of Spanish fiscal adjustment plans may falter as fiscal targets remain ambitious amid recession. Regional fiscal slippages could re-occur. • Debt could be further increased by contingent liabilities.	**High** • Exacerbate ongoing non-resident outflows. • Further widen sovereign borrowing costs and impair market access.
3. Banking sector funding risks and recapitalization	**High** • Banks' market financing may not be regained quickly. • Following cleanup of balance sheets, capital needs could be larger than expected. • Real estate price decline could intensify and corporate and mortgage NPLs further rise.	**High** • The ECB's LTROs have addressed immediate bank funding pressures. • However, further ratings downgrades and margin calls could worsen liquidity situation of certain banks, potentially requiring ELA. • The impact of capital needs is mitigated by the mobilization of a large backstop. Impact on debt would however be muted if the ESM implements direct recapitalization.
4. Structural reform slippage	**Medium** • Social impact of austerity could be high, with fading support for reform.	**High** • Implementation of structural reforms could stall, undermining confidence. • Durable drag on potential growth.
5. Protracted balance-sheet recession	**High** • High private sector debt may give rise to a prolonged deleveraging cycle.	**High** • Dampen activity in the short and medium-term. • Could lead to deflation and worsen debt sustainability for both private and public sectors.

1/The RAM shows relatively low probability events that could materially alter the baseline discussed in this report. The relative likelihood of risks listed is the staff's subjective assessment of risks surrounding this baseline.
2/Significant policy developments occurred after this Staff Report had been issued to the Board, which are discussed in the attached Staff Supplement.
3/ In case the baseline does not materialize.

Table 11. Authorities' Response to Past IMF Policy Recommendations[1]

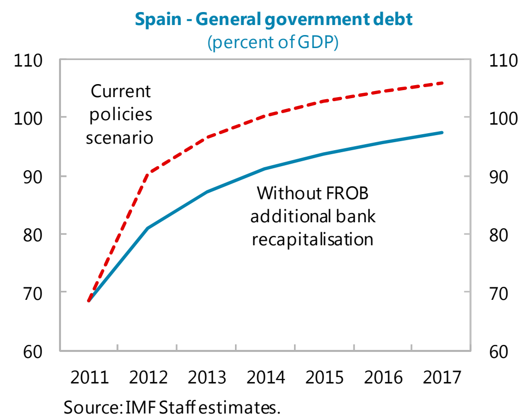
(Scale-fully consistent, broadly consistent, or marginally consistent)

IMF 2011 Article IV Recommendations	Authorities' Response
Fiscal policy I Take additional measures, if near-term risks to outlook materialize, to ensure the targets will be achieved. These include further cuts in current and investment spending, as well as an increase in VAT and excise rates especially on petroleum products.	**Marginally consistent** A package of additional measures was introduced in December, including a broad-based freeze on expenditure authorizations, an extension of the wage freeze, and a progressive increase of marginal tax rates on personal and capital income as well as real estate. An ambitious 2012 budget was also presented.
Fiscal policy II Improve fiscal frameworks to underpin the fiscal consolidation targets. The frameworks should aim at enhancing transparency, strengthening mechanisms to ensure subnational compliance, establishing an independent fiscal council, and institutionalizing periodic public-sector-wide review of major spending programs.	**Broadly consistent** The fiscal framework was significantly improved. A constitutional balanced budget amendment was passed in September 2011 and the government introduced an organic law for budget stability and financial sustainability as well as the Transparency, Access to Public Information and Good Governance Law.
Financial sector policy The financial sector reform needs to be decisively completed. The reform should address carefully the viability of weak banks based on deliberately conservative assumptions, boost capital and provision buffers above the minimum requirements, and perform a review of estimates of loan losses by a leading independent firm.	**Broadly consistent** Provisions and capital requirements have been raised. The fourth largest bank was intervened. Independent valuations are being conducted.
Labor market reform A bold strengthening of labor market reform to substantially reduce unemployment. This calls for effectively decentralizing collective bargaining to the firm level, eliminating inflation indexation, and lowering severance payments further to at least EU average levels. These measures should be supported by broader reforms, including further improving the retraining of workers with mismatched skills, supporting youth employment, and ensuring that the sufficient incentives to return to work.	**Broadly consistent** A royal decree law on labor market reform was enacted in February 2012, which introduced significant improvement to the functioning of the labor market. The reform gives priority to firm-level agreements over higher level collective bargaining, reduces severance pay for unfair dismissal and makes fair dismissal easier. It also introduces more targeted measures to foster job creation for the young and long-term unemployed, and in-job training.

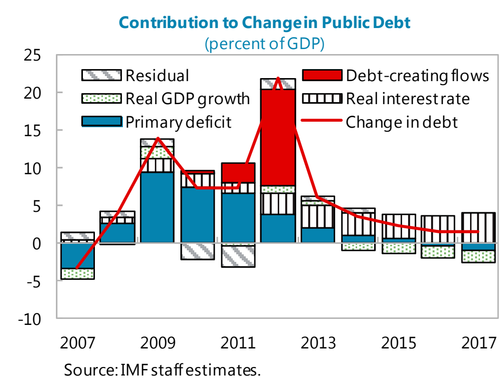
1/Significant policy developments occurred after this Staff Report had been issued to the Board, which are discussed in the attached Staff Supplement.

ANNEX I. FISCAL AND EXTERNAL SUSTAINABILITY[7]

Spain has large public sector and external funding needs for the next few years. Gross general government debt financing needs would exceed 20 percent of GDP in 2012 and 2013. The government's funding pressure arises largely from amortization payments, with redemption of outstanding securities alone amounting for 7.5 percent of GDP in the second half of 2012, and 11 percent in 2013. As of early July, the central government had raised 65 percent of projected gross medium and long term debt issuance for 2012, in advance compared to previous years and taking advantage of the positive effect of the ECB's LTRO. Relative to its European peers the public sector debt-to-GDP ratio remains relatively low, but growing rapidly absent any significant fiscal adjustment. Stock flow adjustments are also substantial, for example the plan to clear arrears at the subnational level that is potentially leading to an increase of debt by 3 ½ percent of GDP in 2012. Debt rollover is a limited portion of central government debt—though the average maturity has slightly declined to 6 ½ years, and the average maturity at the subnational level has decreased significantly in some instances. There is a risk that depending on conditions for market access, the maturity structure of debt may decline further. Market scrutiny of its ability to meet its financing needs is high and interest costs on newly-issued debt have risen with 10 year spreads with respect to the German Bund at above 570 basis points as of early July. The European financial assistance for weak segments of the financial sector has been agreed by the Eurogroup for an amount of up to €100 billion (9.4 percent of GDP). This assistance is to be channeled through the FROB and as long as it is provided as a loan, rather than direct equity stakes, would result in an increase of public and external debt. While the Eurogroup's commitment of up to €100 billion (9.4 percent of GDP) includes an additional safety margin, staff, to be prudent and pending further details on implementation, assumed this amount for the debt sustainability analysis.



While the standard debt sustainability analysis (DSA) framework is limited by its medium term horizon and relatively mechanistic assumptions, it provides a useful assessment that can be complemented by longer-term analysis. Under unchanged policies, and assuming that European financial assistance provided as a loan via the FROB reached the full €100 billion committed by the Eurogroup, the public debt DSA for Spain projects further increase in the debt-to-GDP ratio



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[7] Significant policy developments occurred after this Staff Report had been issued to the Board, which are discussed in the attached Staff Supplement.

over the medium term, to 106 percent of GDP in 2017. Although expected additional measures would contribute to stabilize that ratio, stress scenarios could result in further significant increases. This is also highly dependent on the potential realization of contingent liabilities. Regarding external debt, a large portion of financing needs is accounted for by non-resident deposits, with 2012 maturities estimated to about one third of GDP (including interbank deposits), as well as the growing share of Eurosystem financing. Beyond the impact of the EFSF loan for this year, the external debt sustainability analysis projects gross external debt to start declining significantly over the medium term as external deleveraging proceeds.

A. Baseline Scenarios

In the *current policies scenario* for the fiscal sustainability assessment, the underlying fiscal position is projected to improve slowly over the medium-term, and is based on current policies. Gross government financing needs are expected to remain large. On the external side, while external liabilities are to be impacted in 2012 by European financial support, projections of further current account improvement, together with substantial foreign asset drawdown, contribute to putting Spain's external debt on a downward path.

B. Alternative Scenarios for Fiscal Sustainability

Interest rate. Real interest rates in the current policies scenario are assumed to average 3.3 percent over the projection period, and assume a gradual but not complete decline from current levels of spreads (to 300 basis points in 2017). The impact of an increase in interest rate is expected to have a non negligible effect on interest expenditure, which has already increased rapidly at the general government level in 2011. There are also large downside risks should debt dynamics foster further market concerns. Should real interest rates increase above the historical average of 1.4 percent (the historical average is depressed in large part by relatively high GDP deflators in the mid 2000s) and reach 5.5 percent (representing an extreme and tail 2 standard deviation shock), debt would increase to 123 percent of GDP by 2017, about 17 percentage points of GDP above the current policies scenario. The overall gradual impact on interest payment reflects the long average life of central government debt, whose average maturity is 6 ½ years in 2011. As a result, debt rollover over the forecasting period is expected to be relatively modest.

Growth. Relative to interest rates, Spain's public debt profile is more sensitive to shocks to growth. Should growth fall by about a little over 1 percentage point over the forecasting period, the debt-to-GDP ratio could reach 124 percent by 2017, about 18 percentage points higher relative to the current policies scenario.

Euro depreciation and contingent liabilities. In the case of a 30 percent nominal depreciation of the euro, after adjusting for domestic inflation, and an additional contingent liability shock of 10 percent of GDP, the debt-to-GDP trajectory is expected to increase to 117 percent. It is notable that the portion of the government's liabilities denominated in foreign currencies is small, at less than 2 percent. Thus, all else being equal, the impact of a sudden depreciation in the euro exchange rate on the debt profile would be modest but not the impact of contingent liabilities.

C. Alternative Scenarios for External Sustainability

Interest rate. The impact of a permanent ½ standard deviation shock to the interest rate for all outstanding external debt— close to a 40 basis point increase from the baseline—would increase debt compared to the baseline by more than 5 percentage points of GDP by 2017.

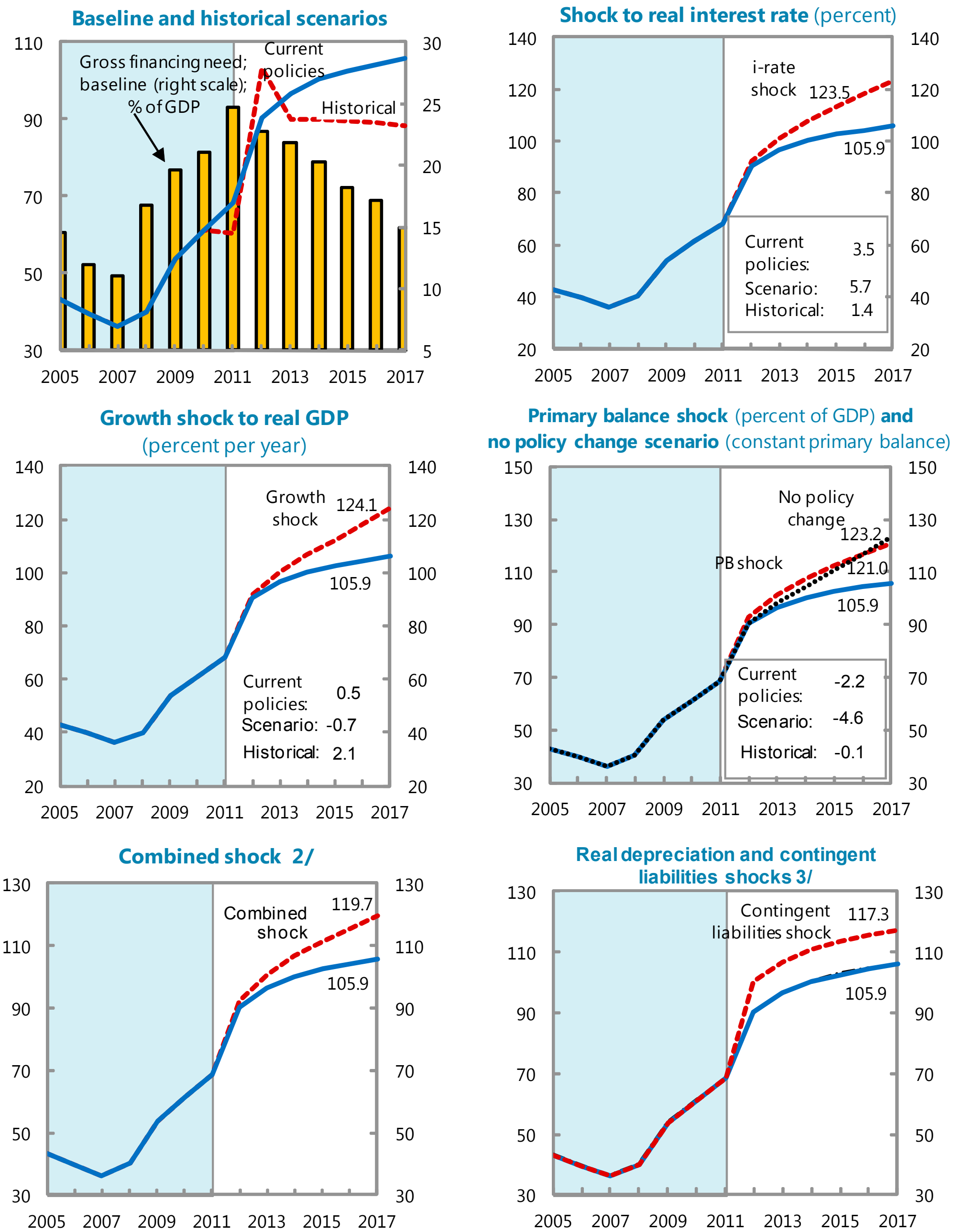
Growth shock. A permanent ½ standard deviation shock to the projected real growth rate—corresponding to a continuing recession in 2013, no growth in 2014, and an anemic recovery of growth to just 0.4 percent by 17—would increase debt compared to the baseline by close to 12 percentage points of GDP at the projection horizon.

Current account shock. A permanent ½ standard deviation shock to the projected non-interest current account balance—corresponding to a slower return to overall balance—would increase debt compared to the baseline by close to 8 percentage points of GDP at the projection horizon.

Standard combined shock. A permanent ¼ standard deviation shock applied to the projected interest rate, real growth rate and current account balance would increase debt compared to the baseline by about 11 percentage points of GDP by 2017.

Under all these alternative scenarios, gross external debt ratio to GDP would however remain on a downward path at the projection horizon.

Figure A1. Spain : Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: International Monetary Fund; country desk data; and IMF staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one standard deviation shocks except for the interest rate shock (two standard deviations). Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/2 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2012, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table A1. Spain : Public Sector Debt Sustainability Framework, 2006-2017 1/

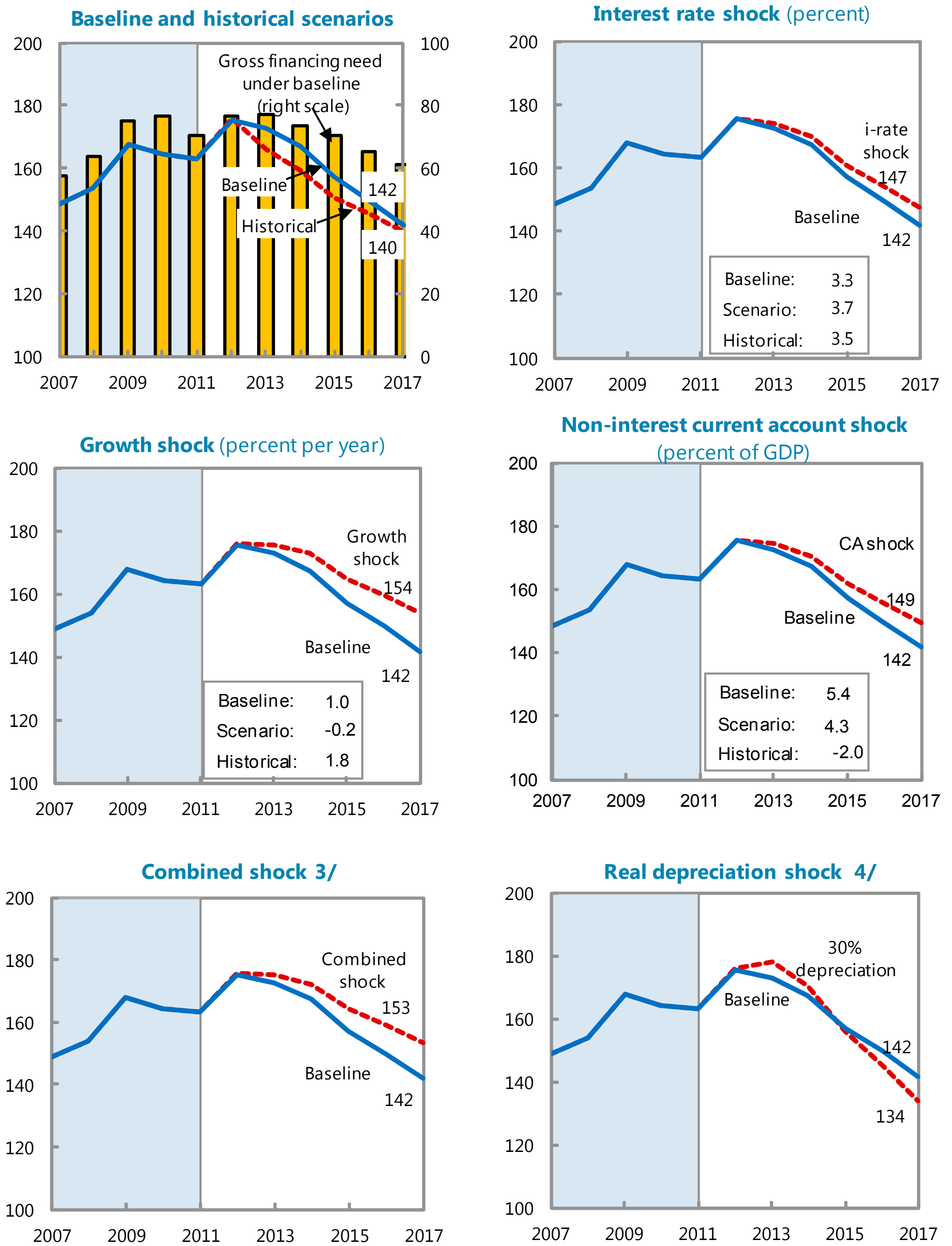
(Percent of GDP, unless otherwise indicated)

							Projections					
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Baseline: Public sector debt 2/	39.7	36.3	40.2	53.9	61.2	68.5	90.3	96.5	100.2	102.7	104.4	105.9
o/w foreign-currency denominated	0.4	0.3	0.5	0.6	0.8	0.7	0.8	0.8	0.7	0.7	0.7	0.7
Change in public sector debt	-3.5	-3.4	3.9	13.8	7.2	7.3	21.8	6.2	3.7	2.4	1.7	1.6
Identified debt-creating flows (4+7+12)	-5.3	-4.4	3.0	12.7	9.4	10.2	20.3	5.7	3.2	2.4	1.7	1.6
Primary deficit	-3.7	-3.5	2.6	9.4	7.4	6.4	3.7	2.0	1.0	0.5	-0.5	-1.0
Revenue and grants	40.4	41.1	37.1	34.9	36.1	35.1	35.7	35.9	36.0	36.1	36.3	36.6
Primary (noninterest) expenditure	36.7	37.6	39.7	44.3	43.5	41.6	39.4	37.9	37.0	36.6	35.9	35.7
Automatic debt dynamics 3/	-1.7	-0.9	0.5	3.3	1.8	1.1	3.9	3.7	2.1	2.0	2.1	2.6
Contribution from interest rate/growth differential 4/	-1.7	-0.9	0.4	3.3	1.8	1.1	3.9	3.7	2.1	2.0	2.1	2.6
Of which contribution from real interest rate	-0.1	0.4	0.7	1.8	1.7	1.6	2.9	3.1	3.2	3.4	3.7	4.2
Of which contribution from real GDP growth	-1.6	-1.3	-0.3	1.6	0.0	-0.4	1.0	0.5	-1.0	-1.4	-1.6	-1.6
Contribution from exchange rate depreciation 5/	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...	...
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.3	2.6	12.7	0.0	0.0	0.0	0.0	0.0
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	1.3	3.3	0.0	0.0	0.0	0.0	0.0
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.3	1.3	9.4	0.0	0.0	0.0	0.0	0.0
Residual, including asset changes (2-3) 6/	1.9	1.0	0.8	1.0	-2.2	-2.9	1.5	0.5	0.6	0.0	0.0	0.0
Public sector debt-to-revenue ratio 2/	98.3	88.3	108.1	154.7	169.5	194.9	253.1	268.5	278.6	284.6	287.2	289.3
Gross financing need 7/	12.0	11.0	16.8	19.6	21.1	24.8	22.7	21.9	20.3	18.2	17.2	14.9
(billions of U.S. dollars)	148.3	158.8	268.3	286.7	293.9	375.9	341.7	327.2	307.8	280.2	270.9	241.2
Scenario with key variables at their historical averages 8/						68.5	90.3	90.2	90.1	89.6	89.0	88.5
Scenario with no policy change (constant primary balance) in 2012-2017						68.5	90.3	98.2	104.7	110.5	116.6	123.2
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	4.1	3.5	0.9	-3.7	-0.1	0.7	-1.5	-0.6	1.1	1.5	1.6	1.6
Average nominal interest rate on public debt (percent) 9/	4.1	4.3	4.5	4.3	3.6	4.0	4.7	4.3	4.5	4.7	5.0	5.3
Average real interest rate (nominal rate minus change in GDP deflator, percent)	0.0	1.1	2.1	4.2	3.2	2.6	4.1	3.5	3.4	3.5	3.7	4.2
Nominal appreciation (increase in US dollar value of local currency, percent)	-1.9	-8.5	-7.0	0.4	0.2	...	...	...	...	...	...	...
Inflation rate (GDP deflator, percent)	4.1	3.3	2.4	0.1	0.4	1.4	0.6	0.8	1.1	1.2	1.3	1.2
Growth of real primary spending (deflated by GDP deflator, percent)	4.3	6.0	6.6	7.3	-1.8	-3.7	-6.6	-4.3	-1.4	0.2	-0.4	1.1
Primary deficit	-3.7	-3.5	2.6	9.4	7.4	6.4	3.7	2.0	1.0	0.5	-0.5	-1.0
Overall balance	2.0	1.9	-4.2	-11.1	-9.2	-8.9	-7.0	-5.9	-5.3	-5.1	-4.5	-4.4
Revenue to GDP ratio	40.4	41.1	37.1	34.9	36.1	35.1	35.7	35.9	36.0	36.1	36.3	36.6
A2. No policy change (constant primary balance)						68.5	90.3	98.2	104.7	110.5	116.6	123.2
B. Bound Tests												
B1. Real interest rate is at historical average plus two standard deviations						68.5	92.2	101.1	107.8	113.3	118.3	123.5
B2. Real GDP growth is at historical average minus one standard deviation						68.5	91.9	100.3	106.8	112.5	118.0	124.1
B3. Primary balance is at historical average minus one standard deviation						68.5	92.6	101.3	107.5	112.5	116.7	121.0
B4. Combination of B1-B3 using 1/2 standard deviation shocks						68.5	92.2	100.7	106.7	111.4	115.5	119.7
B5. One time 30 percent real depreciation						68.5	90.7	97.0	100.7	103.1	104.8	106.4
B6. 10 percent of GDP increase in other debt-creating flows in 2012						68.5	100.3	106.9	110.9	113.5	115.4	117.3

1/ Significant policy developments occurred after this Staff Report had been issued to the Board, which are discussed in the attached Staff Supplement.
2/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.
3/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate;
a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
4/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.
5/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).
6/ For projections, this line includes exchange rate changes.
7/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
8/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
9/ Derived as nominal interest expenditure divided by previous period debt stock.

Figure A2. Spain: External Debt Sustainability: Bound Tests 1/ 2/

(External debt in percent of GDP)



Sources: International Monetary Fund; National authorities data; and IMF staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

4/ One-time real depreciation of 30 percent occurs in 2013.

Table A2. Spain: External Debt Sustainability Framework, 2007-2017 1/
(percent of GDP, unless otherwise indicated)

	Actual							Projections					
	2007	2008	2009	2010	2011			2012	2013	2014	2015	2016	2017
Baseline: External debt	148.5	153.7	167.7	164.3	163.1			**175.3**	**172.6**	**167.2**	**157.0**	**149.6**	**141.8**
Change in external debt	9.4	5.2	14.0	-3.4	-1.2			12.2	-2.7	-5.4	-10.2	-7.4	-7.8
Identified external debt-creating flows (4+8+9)	3.2	3.1	11.1	4.6	-0.8			2.7	-0.5	-3.5	-5.1	-5.9	-6.5
Current account deficit, excluding interest payments	4.6	3.7	0.4	0.4	-0.6			-2.6	-3.9	-4.5	-5.3	-6.1	-6.9
Deficit in balance of goods and services	6.5	5.5	1.6	1.9	0.5			-1.4	-2.3	-3.1	-4.0	-4.7	-5.4
Exports	27.2	26.7	24.1	27.3	30.2			31.6	33.5	34.7	36.0	37.3	38.8
Imports	33.6	32.2	25.7	29.3	30.8			30.3	31.2	31.6	32.0	32.6	33.4
Net non-debt creating capital inflows (negative)	3.5	-0.5	-0.8	-0.4	-0.2			-1.9	-2.7	-2.2	-2.7	-2.7	-2.7
Automatic debt dynamics 2/	-4.9	-0.1	11.6	4.6	0.0			7.2	6.1	3.3	2.9	3.0	3.1
Contribution from nominal interest rate	5.4	5.9	4.4	4.1	4.2			4.6	5.0	5.2	5.3	5.4	5.5
Contribution from real GDP growth	-4.1	-1.2	6.3	0.1	-1.1			2.6	1.1	-1.8	-2.4	-2.4	-2.4
Contribution from price and exchange rate changes 3/	-6.1	-4.8	0.8	0.4	-3.0			-0.1	-1.2	-1.9	-1.9	-1.9	-1.7
Residual, incl. change in gross foreign assets (2-3) 4/	6.2	2.2	2.9	-8.0	-0.5			9.7	-1.0	0.0	-3.1	0.4	0.3
External debt-to-exports ratio (in percent)	546.8	575.3	695.1	600.8	539.3			554.2	515.6	481.7	436.1	400.6	365.7
Gross external financing need (in billions of US dollars) 5/	831.4	1019.2	1091.9	1069.5	1052.5			1045.8	1036.9	1003.8	982.8	932.8	899.7
in percent of GDP	57.6	63.7	74.8	76.7	70.5	10-Year	10-Year	76.6	77.1	73.2	70.1	65.0	61.3
Scenario with key variables at their historical averages 6/								**175.7**	**165.7**	**159.3**	**150.6**	**145.2**	**139.9**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation						
Real GDP growth (in percent)	3.5	0.9	-3.7	-0.1	0.7	1.8	2.4	-1.5	-0.6	1.1	1.5	1.6	1.6
GDP deflator in US dollars (change in percent)	12.7	9.9	-5.3	-4.3	6.3	7.8	8.8	-7.3	-0.9	0.8	0.8	0.8	0.7
Nominal external interest rate (in percent)	4.5	4.4	2.6	2.3	2.7	3.5	0.8	2.6	2.8	3.0	3.2	3.5	3.8
Growth of exports (US dollar terms, in percent)	19.8	9.1	-17.7	8.3	18.4	10.7	11.5	-4.4	4.3	5.7	6.1	6.2	6.2
Growth of imports (US dollar terms, in percent)	20.2	6.3	-27.2	8.8	12.5	10.5	14.8	-10.2	1.5	3.2	3.7	4.3	4.8
Current account balance, excluding interest payments	-4.6	-3.7	-0.4	-0.4	0.6	-2.0	2.1	2.6	3.9	4.5	5.3	6.1	6.9
Net non-debt creating capital inflows	-3.5	0.5	0.8	0.4	0.2	-1.4	2.8	1.9	2.7	2.2	2.7	2.7	2.7

1/ Significant policy developments occurred after this Staff Report had been issued to the Board, which are discussed in the attached Staff Supplement.
2/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate,
ε = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.
3/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).
4/ For projection, line includes the impact of price and exchange rate changes.
5/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
6/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

ANNEX II. MAIN ELEMENTS OF THE LABOR MARKET REFORM OF FEBRUARY 2012

A labor market reform was enacted as a decree law on February 10, 2012, entering into force immediately. It has now completed its way through Parliament with only minor changes. This reform has the following objectives: (1) to enhance market efficiency and reduce duality; (2) to foster firms' internal flexibility and avoid employment destruction; (3) to promote permanent employment and employment creation in small firms; and (4) to make the workers more employable and fungible. The detailed measures are as follows:

1. Measures to enhance labor market efficiency and reduce duality:

   a. Compensation for unfair dismissals of permanent workers is reduced from 45 days per year worked, with a maximum of 42 months, to 33 days per year worked, with a maximum of 24 months. Existing contracts keep their cumulated compensation of up to 42 months, but new compensation days are cumulated at the rate of 33 per year and only until they reach the new maximum of 24 months. New permanent contracts abide by the new rule.

   b. Compensation for fair dismissals of permanent workers remains at 20 days per year worked, with a maximum of 12 months. But fair dismissals for unfavorable economic conditions are made easier. The causes are clarified to avoid excessive judicialization and to make fair dismissals the regular channel to dismiss permanent workers. The objective reasons that justify fair dismissals are defined as follows:

      i) Economic: At least when the company faces current or prospective losses, or a persistent decline on its revenue or sales (for three consecutive quarters compared to the same period of previous year).

      ii) Technical: Changes in the means or instruments of production.

      iii) Organizational: Changes in the system of work or the organization of production.

      iv) Productive: Changes in the demand for products or services that the company wants to sell in the market.

   c. Compensation for fair dismissals of permanent workers by small firms (less than 25 workers) is reduced, with 8 of the 20 days of compensation paid with public funds (the wage guarantee fund). Thus, duality is practically eliminated for small firms given the gradual increase of compensation for temporary workers to 12 days. However, there is still a significant difference between permanent and fixed term contracts if the dismissal is considered unfair by a judge.

d. Public administrations can also use fair dismissals for objective economic, technical, or organizational reasons. Economic reasons are defined as a persistently insufficient budget (3 consecutive quarters), while technical and organizational are as in b.

e. Reform of procedures to lower dismissal costs and increase efficiency in the use of fair dismissal. Removal of processing wages (wages paid during the legal process) for all fair dismissals, and removal of the administrative authorization required for collective dismissals, which de facto was not granted without the unions' agreement.

f. The renewal of temporary contracts is limited to a maximum of two years starting in 2013. The cost of termination of a temporary contract remains as established in the 2010 reform, at 9 days per year worked from January 2012, increasing by one year every year until reaching 12 days per year worked January 2015.

2. Measures to foster firms' internal flexibility and avoid employment destruction:

a. Firm level agreements are given priority over regional or industry level collective agreements on wages, working time, professional classification, type of contracts, and measures to reconcile work and life balance.

b. Opt-out clauses from provincial or industry wide collective agreements for objective economic, technical, organizational or productive reasons are eased and clarified. In the case of a lack of agreement in the application of an opt out clause, a decision will be made by a commission including employers, employees and the government. These opt-clauses can be applied in areas such as wages, working time, shifts, and working functions. The objective reasons are defined as follows:

i) Economic: When the company faces current or prospective losses, or a persistent decline on its revenue or sales (for two consecutive quarters).

ii) Technical: Changes in the means or instruments of production.

iii) Organizational: Changes in the system of work or the organization of production.

iv) Productive: Changes in the demand for products or services that the company wants to sell in the market.

c. Changes to working conditions for objective economic, technical, organizational or productive reasons are eased and clarified. Working conditions are defined as wages, working time, working system, and functional mobility. These modifications can affect the workers' conditions recognized in the contract or in collective agreements. In the case conditions recognized in the contract are above those in collective agreements, the modification might be done unilaterally by the employer.

d. Higher internal flexibility promoted by collective agreements. Unless otherwise specified 10 percent of the time schedule could be irregularly distributed over the year. Additionally, occupations are defined in a broader manner, providing incentives for occupational mobility within the firm.

e. Temporary contract suspension or working time reduction for objective economic, technical, organizational or productive reasons are eased and clarified. Working time can be reduced 10–70 percent and contracts can be suspended temporarily. Affected workers are encouraged to take training to make them more employable. Firms are entitled to 50 percent of the social security contributions for workers they suspend or reduce their working time for a maximum of 240 days, and only if they keep the worker for at least a year after the suspension or working time reduction expires.

f. The automatic extension of expired collective agreements (ultra-activity) is limited to a maximum of one year. Previously this extension was unlimited.

3. Measures to promote permanent employment and job creation in small firms:

a. New permanent contract for small firms (less than 50 workers) with a trial period of one year. A deduction from tax payments by € 3000 if the first contract is with a youth (16–30 years old), and an additional deduction of 50 percent of the worker's unemployment benefit for up to 12 months if the worker was unemployed.

b. Bonus for small firms (less than 50 workers) that hire youth unemployed (16–30 years old) with permanent contracts: €3300 for males and €3600 for females. The worker must be employed for at least three years.

c. Bonus for small firms (less than 50 workers) that hire long-term unemployed (over 45 years old) with permanent contracts: €3900 for males and €4500 for females. The worker must be employed for at least three years.

d. Bonus for small firms (less than 50 workers) to convert internship, replacement or substitution contracts into permanent contracts: deduction from their social security payments of €500 for males and €700 per for females, during three years.

e. Reform to the current permanent part-time contract to allow overtime and make it more flexible. Tele-work is promoted and regulated for the first time.

4. Measures to make the workers more employable and fungible:

a. New individual right to professional training of 20 hours per year. Increased supply of professional training by allowing direct participation of private agents. New training account associated to each worker to improve training itinerary in case of unemployment.

b. New training contract for youth 16–25 years old, allowing for theoretical training within the firm, with a bonus to encourage the use of the contract.

i. Minimum contract duration is 1 year and the maximum 3 years. No limit in the number of training contracts as long as they are in different professional areas.

ii. Firms of less than 250 workers signing this contract with an unemployed are exempt of social security contributions for the worker for the full duration of the contract. Firms of 250 workers or more are exempt of 75 percent.

iii. Firms transforming the training contract into a permanent contract can deduct from its social security payments €1500 per year during three years for males, and €1800 per year during three years for females.

5. Temporary Employment Agencies are authorized to act as private placement agencies. Previously, only the public employment service and a few private agencies were involved in job intermediation.

ANNEX III. ORGANIC LAW FOR BUDGET STABILITY AND FINANCIAL SUSTAINABILITY

The Organic Law for Budget Stability and Financial Sustainability, which implements Spain's Balanced Budget Constitutional Amendment of September 2011, represents another important step towards strengthening fiscal control. The law was the first in Europe to comply with Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. The amendment passed in September 2011, and the organic law was approved by the cabinet in January 2012, ahead of the March 2012 signing of the Fiscal Compact Treaty, and then passed the lower house of Spain's Parliament in April. The Amendment and the Organic Law meet the Treaty's requirement for a balanced budget rule at the highest legally binding level, which is also critical to ensure compliance by Spain's autonomous subnational governments. More broadly, the law represents an important step in Spain's broader reform of the fiscal framework. This ongoing effort strengthens transparency, coordination, rationalization and sustainability through linked fiscal legislation, including the pension reform and the transparency law.

Spain: Legislation Revamping the Fiscal Framework

Law	Passed	Fiscal Framework Improvement
Pension Reform	Jul-11	Quinquennial pension sustainability adjustments
Central/Municipal Expenditure Ceilings	Jul-11	Restrain spending to below EU mandates
Balanced Budget Constitutional Amendment	Sep-11	Structural balance at most binding legal level
European Fiscal Compact	Mar-12	Supports multilateral fiscal coordination
Transparency, Information Accessibility *	Mar-12	Budget and transparency and enforcement by officials
Financial Fund to Pay Suppliers	Mar-12	Subnational arrears financing exchanged for greater monitoring
Budget Stability and Financial Sustainability	Apr-12	Debt, deficit and expenditure limits on all government levels
Introduce financing ("hispanobonos") *	Jul-12	Rationalize financing costs of de facto Spanish fiscal union

Source: Government of Spain.
* Transparency law in draft form, regional financing facility expected in summer/fall 2012.

The Organic Law introduced fundamental improvements in Spain's fiscal framework, including in mandating fiscal targets, strengthening enforcement, and improving transparency.

The legislation introduced a debt ceiling, expenditure level and growth ceilings, and a deficit limit, with the most binding of the four dominating the others in a given year. An escape clause is introduced for catastrophes, negative annual real GDP growth, or emergencies, and requires a vote by an absolute parliamentary majority. The law also prohibits subnational bailouts from the center to the regions and municipalities, and from regions to the municipalities they control.

The law included a number of improvements to facilitate enforcement. Current penalties are kept, including the threat of not authorizing financing long-term and short-term financing operations and de-authorizing co-financing of joint projects for deviating regions. In addition, the law authorizes the creation of financing mechanisms which can embargo shared revenues if a region deviates from an agreed plan. Three year "rebalancing plans" for regions that deviate from targets have been replaced with one-year "economic-financial" rebalancing plans (Table A1). Most critically, the law explicitly links persistent fiscal deviation with intervention by central government into a subnational administration and the de-authorization of subnational governance competencies. In this connection, a region can be intervened by the central government within one year of detecting a persistent deviation from the legal limits, and the law introduces "warnings" from the Ministry to regions that could compel some corrective fiscal actions in an even shorter time period.

Transparency and monitoring are improved through increases in publication mandates. Quarterly reviews, quarterly fiscal outturns at all levels of government, economic-financial rebalancing plans and related reports are to be centralized and published by the Central Government. Economic-financial rebalancing plans must include explanations of the causes of deviations from fiscal targets, projections based on existing and corrective policies, a calendar and quantification of corrective policies, multi-year budgeting and debt sustainability and macroeconomics sensitivity analyses. Finally, regions and municipalities that participate in the new financing facilities, such as those for arrears, report detailed financial positions, including amortization schedules and borrowing requirements.

A transitional regime is introduced to help manage the fiscal consolidation necessary to meet debt targets set for 2020 and to accommodate the current recession, and includes a minimum annual adjustment in the structural balance, the enactment of the escape clause for the crisis, and a review of the minimum adjustment during the period as part of the strategy to reach the debt target of 60 percent of GDP by 2020.

Table A1. Enforcement Scheme of the Organic Law for Budget Stability and Financial Sustainability in 2012 1/

DATE		ARTICLE
01- September - 2012 (as an example 2/)	Automatic preventive measures: warning issued: the Autonomous Community should adopt the measures needed to correct the situation within one month	18 y 19
01 - October - 2012 option 1	If the Autonomous Commmunity has not adopted any measure or they are insufficient: articles 20, 21 y 25.1.a) will be applied: - 20: automatic corrective measures (authorisation of all regional government borrowing) - 21: Economic and Financial Plan - 25.1.a): Coercive measures (approval of non-availability of credit agreement within 15 days and possible exercise of regulatory authority on taxes granted by Central Government)	19
01 - November - 2012 option 2	Deadline to present the Economic and Financial Plan	23
01 - January - 2013	- Approval of the Plan - The Economic and Financial Plan becomes binding	23
OPTION 1: THE NON AVAILABILITY AGREEMENT IS NOT ADOPTED BY THE AUTONOMOUS COMMUNITY		
16 - October - 2012	If the measures of article 25.1.a) are not adopted, the Ministry of Finance and Public Administration will send an delegation of experts to the Autonomous Community.	25.2
Delegation actions within seven days	The measures proposed by the delegation of experts are published seven days after they are identified.	25.2
OPTION 2: THE ECONOMIC AND FINANCIAL PLAN IS NOT PRESENTED OR IT IS NOT APPROVED 3/		
01 - October - 2012	If the Plan is not presented, article 25.1 is applied:	25.1
01 - October - 2012	Possible exercise of regulatory authority on taxes granted by Central Government (25.1 a)) Interest bearing deposit in the Bank of Spain equivalent to 0.2% of nominal GDP (art. 25.1 b))	
15 - October - 2012	Approval of a non-availability of credit agreement (25.1 a))	25.1
16-October-2012	If the measures of article 25.1.a) are not adopted, the Ministry of Finance and Public Administration will send an delegation of experts to the Autonomous Community.	25.2
Delegation actions within seven days	The measures proposed by the delegation of experts are published seven days after they are identified.	25.2
01-April- 2013	If the measures included in the plan are not adopted, the deposit turns into a fine (within six months)	25.1 b)
OPTION 3: THE MONITORING REPORTS REVEAL DEVIATIONS IN THE IMPLEMENTATION OF THE MEASURES		
1 March 2013/01-June-2013	A pre-existing plan's quarterly report can be issued on 1 March, on the basis of the new monthly reporting (referred to January 2013 execution under the new plan) and pre-existing measures. A new plan's quarterly monitoring report in June will reflect one quarter budget execution after the plan is in place. These reports are written and published by Ministry of Finance and Public Administration (two months- lag). If these reports reveal the existence of deviations, the Autonomous Community has to justify the deviation, apply the measures included in the plan, or apply new measures.	24.3
01-September-2013 option A	The monitoring report is adequate	24.3
01-September-2013 option B	The non-compliance continues: coercive measures of article 25.1.a) are applied	24.3
01-September-2013	Possible exercise of regulatory authority on taxes granted by Central Government (25.1 a)) Interest bearing deposit in the Bank of Spain equivalent to 0.2% of nominal GDP (art. 25.1 b))	
15-September-2013	Approval of a non-availability of credit agreement (25.1 a))	25.1
16-September-2013	If the measures of article 25.1.a) are not adopted, the Ministry of Finance and Public Administration will send an delegation of experts to the Autonomous Community.	25.2
Delegation actions + 7 days	The measures proposed by the delegation of experts are published seven days after they are identified.	25.2
01 - March - 2014	If the measures included in the plan are not adopted, the deposit turns into a fine (within six months)	25.1 b)
OPTION 4: THERE ARE NO MORE DEVIATIONS During THE YEAR **The Autonomous Community fulfills the Economic and Financial Plan and returns to the stability path**		
1 March 2013/01 - June - 2013	The Ministry of Finance and Public Administration publishes on 1 June the monitoring report of the first quarter (1 January - 31 March) and presents it to the Council on Fiscal and Financial Policy. Also monthly reports will be used for monitoring when available.	24
01-September-2013	The Ministry of Finance and Public Administration publishes the monitoring report of the second quarter (1 April - 30 June) and presents it to the Council on Fiscal and Financial Policy	24
1-Dec-13	The Ministry of Finance and Public Administration publishes the monitoring report of the third quarter (1 July - 30 September) and presents it to the Council on Fiscal and Financial Policy	24
1-Mar-14	The Ministry of Finance and Public Administration publishes the monitoring report of the fourth quarter (1 October - 31 December) and presents it to the Council on Fiscal and Financial Policy	24

Source: MHAP.
1/ As presented by the Spanish authorities.
2/ Warning issued when a risk of non-compliance is detected this can be done at any time of the year
3/ If the Plan is not approved, these actions begin two months later, in December.

ANNEX IV. CLEANING-UP BANKS' BALANCE SHEETS

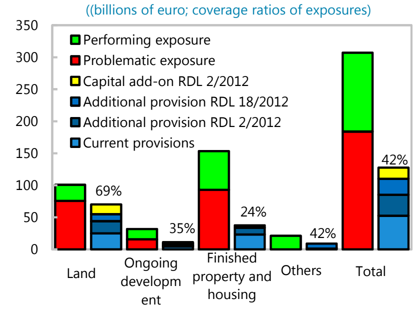
In February 2012 and May 2012, the authorities introduced higher provisions and specific capital buffers for banks' outstanding real estate exposure as of end-2011 (RDL 2/2012 and RDL 18/2012). The objective is to bring balance sheet valuation of troubled assets closer to market value and force banks to recognize losses.

The measures are based on three complementary pillars:

- ***Specific provisions*** to realize incurred losses in problematic assets; the new one-off requirements are:
    - *Land* — 60 percent of the loans classified as substandard and doubtful;
    - *Housing under development* —50 percent of the loans classified as doubtful and substandard, and 24 percent of the loans classified as substandard but where development is ongoing;
    - *Finished housing and other real estate collateral*— the exceptions for minimum provisioning requirements for doubtful and substandard loans (25 and 20 percent, respectively) are eliminated.
- ***General provision*** to take into account potential migration from normal to problematic portfolio. To this end, banks are requested to charge one-off general provisioning for exposures against construction and real estate developers classified as standard, namely 52 percent for land, 29 percent on housing under developments, 14 percent on finished property and housing, and 52 percent on personal guarantee and second mortgages.

Provisions of Real Estate Exposures

((billions of euro; coverage ratios of exposures)



Sources: Ministerio de Economia y Competitividad; and IMF staff estimates.

- ***Capital add-on*** to allow for valuation uncertainties regarding land and housing under development. Capital add-on of 20 and 15 percent is computed, respectively, for land and housing under development classified in the problematic portfolio.

The impact of these measures is estimated to amount to about €75 billion, thus bringing the coverage of total problematic portfolio – which includes doubtful and substandard loans as well as repossessed real estate assets and is estimated to be about €184 billion—from 29 percent to 70 percent.

The amortization schedule for foreclosed assets has been also revised as follows:

	1 year	2 years	3 years	4 years
Finished Housing	10% → 25%	20% → 30%	30% → 40%	50%
Housing under development	50%	50%	50%	50%
Housing from households (first residence)—minimum requirements	10% (unch.)	20% (unch.)	30% (unch.)	40%
Land	60%	60%	60%	60%

To better gauge the extent of asset quality deterioration, an independent third party valuation on all loan books (including residential mortgage and SMEs) will be performed on each bank by two reputable auditor firms over the next two-three months.

In the meantime, banks have been required to segregate foreclosed assets into dedicated asset management subsidiaries. Further refinement of the strategy to deal with legacy assets will be determined on the basis of the results of the independent valuation.

The measures also included incentives for banks to merge. In particular, for banks that present a merger plan by end-May 2012, the deadline to comply with the new rules is set 12 months after the approval of the mergers. To foster the solvency of consolidating groups, FROB has been allowed to purchase contingent capital securities issued by merging institutions.

ANNEX V. EXTERNAL SECTOR ASSESSMENT[8]

Despite recent improvement in the current account, staff assesses Spain's external position as substantially weaker than one consistent with fundamentals and desirable policy settings. In particular, net external liabilities are too high and indicators point to real effective exchange rate overvaluation.

Negative Net International Investment Position and Capital Outflows

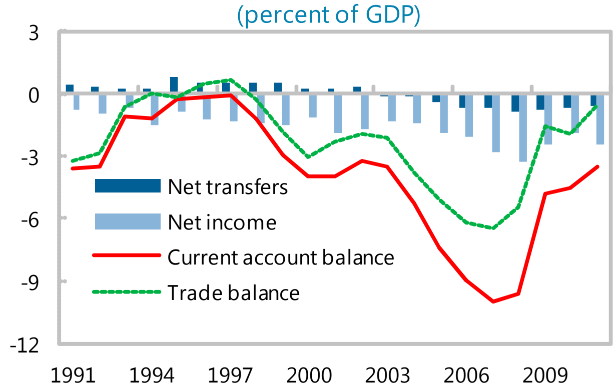
1. Spain's large negative net international investment position has remained around 90 percent of GDP since 2009. High gross external debt has also stabilized close to 170 percent of GDP since 2010. Over 2010–11, portfolio liabilities have declined, while Eurosystem-related liabilities have surged. Large portfolio outflows by non-residents took place in 2010–11 and early 2012, adding external financing needs to the current account deficit. Despite residents' portfolio repatriation, a private financial account deficit opened up in 2011 and early 2012, with large private "other investment" outflows over the recent period. Net private outflows were compensated to a limited extent by ECB purchases of Spanish securities in the second half of 2011, and to a larger extent by increased ECB refinancing of Spanish banks (reflected in TARGET imbalances).

2. The negative IIP and large gross financing needs from external debt are major sources of external vulnerability. Vulnerabilities have been materializing in relation with concerns about growth, banking sector restructuring, and the viability of the fiscal path, amid volatile market conditions. A further large improvement in the cyclically adjusted current account would be needed to reduce net liabilities, and thereby address vulnerabilities stemming from a weak external position.

Current Account Improvement

3. Since reaching 10 percent of GDP in 2007 as a result of a domestic demand boom, the current account deficit has been adjusting. In 2011, the current account deficit dropped to 3.5 percent of GDP, with a cyclically adjusted deficit close to the actual deficit. The current account balance continues to improve as the economy switches away from non-tradable sectors and the output gap widens.

Trade and Current Account Balance
(percent of GDP)



Sources: Eurostat; and Bank of Spain.

4. Current account norm. The External Balance Assessment analysis of current accounts points to a current account deficit norm of 2.5 percent of GDP for Spain in 2011. Relative to that

[8] Significant policy developments occurred after this Staff Report had been issued to the Board, which are discussed in the attached Staff Supplement.

model estimate, the larger current account deficit is largely explained by the contribution of the fiscal policy gap. Beyond the regression results however, the overriding need to improve the net international investment position suggests that a significant decline in the cyclically adjusted current account would be appropriate. Taking this into account, the 2011 cyclically adjusted current account appears to be 3 to 5 percentage points of GDP weaker that the value implied by fundamentals and desirable policy settings.

Real Exchange Rate Assessment

5. Competitiveness indicators based on either consumption prices or unit labor costs show that the large gaps that have opened up between Spain and its trading partners since euro entry have only partly corrected since 2008. Export market shares have been resilient. However, recent improvements in unit labor costs significantly reflect cyclical productivity gains from labor shedding.

6. Alternative competitiveness indicators exhibit a range of uncertainty, but suggest a real effective exchange rate 10–15 percent above the level consistent with underlying fundamentals and desirable policies. REER values as of the Spring 2012 WEO reference period resulted in a gap of 11 percent under the EBA analysis, and 18 percent under the CGER analysis of the real effective exchange rate. Spain's REER depreciated by about 4 percent between the reference period and the time of the Article IV consultation.

Policy Implications

7. Because the current account improvement expected in the near-term partly reflects domestic demand compression and a sizeable output gap, attaining full employment and strong and sustainable growth would require a significantly weaker real effective exchange rate.

- An effective implementation of the labor market reform should bring down labor costs, contributing to reduce both external and domestic imbalances.
- Financial sector restructuring should help banks regain market access and reduce reliance on the ECB, addressing vulnerabilities from the composition of the external position.
- Delivering fiscal consolidation will also contribute to external adjustment.

INTERNATIONAL MONETARY FUND

SPAIN

July 9, 2012

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

European Department
(In Consultation with Other Departments)

CONTENTS

I. FUND RELATIONS..2

II. STATISTICAL ISSUES...4

SPAIN—FUND RELATIONS

(As of May 31, 2012)

I. **Membership Status**: Joined September 15, 1958.

II. **General Resources Account**:

	SDR Million	Percent of Quota
Quota	4,023.40	100.00
Fund holdings of currency	2,742.06	68.15
Reserve position in Fund	1,281.35	31.85
Lending to the Fund		
New Arrangements to Borrow	765.30	

III. **SDR Department**:

	SDR Million	Percent of Allocation
Net cumulative allocation	2,827.56	100.00
Holdings	2,666.85	94.32

IV. **Outstanding Purchases and Loans:** None

V. **Latest Financial Arrangements:** None

VI. **Projected Payments to Fund**

(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2012	2013	2014	2015	2016
Principal					
Charges/Interest	0.11	0.24	0.24	0.24	0.24
Total	0.11	0.24	0.24	0.24	0.24

VII. **2012 Article IV Consultation**: A staff team comprising J. Daniel (Head), P. Lopez-Murphy, P.Sodsriwiboon, J. Vacher, I. Yakadina (all EUR), A. Buffa di Perrero, A. Giustiniani (MCM), E. Vidon (SPR), R. Romeu (FAD), J. Guajardo (RES), Ms. Gaviria (EXR) and Mr. Valdés (EUR) visited Madrid on June 4–14, 2012 to conduct the 2012 Article IV Consultation discussions. Ms. Balsa and Ms. Aparici from the Spanish Executive Director's office, joined the discussions. The mission met with Economy and Competitiveness Minister De Guindos, Finance and Public Administrations Minister Montoro, Bank of Spain Governor(s) Ordonez and Linde, other senior officials, and financial, industry, academic, parliament, and trade union representatives. The concluding statement was published and the staff report is expected to be published as well. The consultation includes an annex on Spain's Main Elements of the Labor Market Reform of February 2012, Organic Law for Budget Stability and Financial Stability, Cleaning-up Banks' Balance Sheets, Fiscal and External Sustainability and External Sector Assessment. Spain is on a standard 12-month cycle. The last Article IV consultation discussions were concluded on July 22, 2011 (EBM/11/81-1). A Financial Sector Assessment Program (FSAP) Update was conducted in two missions (February 1–21 and April 12–25, 2012). On June 8, 2012, the FSAP discussions were concluded and the documents published.

VIII. **Exchange Rate Arrangements and Restrictions**: Spain's currency is the euro, which floats freely and independently against other currencies. Spain has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange rate system free of restrictions on payments and transfers for current international transactions, other than restrictions notified to the Fund under Decision No. 144 (52/51).

SPAIN—STATISTICAL ISSUES

(As of June 29, 2012)

I. Assessment of Data Adequacy for Surveillance	
General: Data provision is adequate for surveillance.	
Fiscal sector:. Greater progress on improving the timeliness of general government outturns is needed. The fiscal accounts of the central government and social security on a cash and national accounts basis are reported with a lag of less than two months. The consolidated fiscal accounts of the general government on a cash and national accounts basis are reported quarterly with a lag of more than three months. The government is, however, taking steps to address the lack of consolidated general government consolidated fiscal data on a timely basis and recently announced that it plans to report monthly consolidated general government accounts reported in cash basis six weeks after each month.	
II. Data Standards and Quality	
Subscriber to the Fund's Special Data Dissemination Standard (SDDS) since September 1996.	No data ROSC available.

Table 1. Common Indicators Required for Surveillance

(As of June 29, 2012)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items: Data Quality – Methodological soundness[8]	Memo Items: Data Quality – Accuracy and reliability[9]
Exchange Rates	June 2012	June 2012	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	May 2012	May 2012	M	M	M		
Reserve/Base Money	May 2012	May 2012	M	M	M	O,O,LO,LO	O,O,O,O,LO
Broad Money	May 2012	May 2012	M	M	M		
Central Bank Balance Sheet	May 2012	May 2012	M	M	M		
Consolidated Balance Sheet of the Banking System	May 2012	May 2012	M	M	M		
Interest Rates[2]	June 2012	June 2012	D	D	D		
Consumer Price Index	May 2012	May 2012	M	M	M	O,O,O,O	LO,O,LO,O,O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q1 2012	May 2012	Q	Q	Q	LO,O,LO,O	LO,O,O,O,LO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	April 2012	June 2012	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	May 2012	June 2012	M	M	M		
External Current Account Balance	April 2012	June 2012	M	M	M	O,LO,LO,O	LO,O,LO,O
Exports and Imports of Goods and Services	Q1 2012	May 2012	Q	Q	Q		
GDP/GNP	Q1 2012	May 2012	Q	Q	Q	O,O,O,O	LO,LO,O,O,O
Gross External Debt	Q1 2012	June 2012	Q	Q	Q		
International Investment position[6]	Q1 2012	June 2012	Q	Q	Q		

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

[3] Foreign, domestic bank, and domestic nonbank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

[5] Including currency and maturity composition.

[6] Includes external gross financial asset and liability positions vis a vis nonresidents.

[7] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

[8] Reflects the assessment provided in the data ROSC or the Substantive Update for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).

[9] Same as footnote 7, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment, and revisions.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 12/xx
FOR IMMEDIATE RELEASE
July xx, 2012

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2012 Article IV Consultation with Spain

On July 25, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Spain.[1]

Background

The economy has entered an unprecedented double-dip recession with unemployment already very high and public debt increasing rapidly. On the positive side, imbalances are improving, especially the current account deficit, inflation, and unit labor costs, and deleveraging is underway. But market confidence remains weak. Spain has suffered a sharp reversal of private external financing flows in the second half of 2011 and early 2012. After an LTRO-induced respite, market tensions re-emerged in the spring. Yields and spreads on Spanish government bonds remain high and banks unable to tap private unsecured financing.

Many major policy actions have been taken in recent months on several fronts. On banks, provisions and capital requirements have been raised, independent valuations commissioned, and a backstop provided with support from Spain's European partners. The key policies incorporated to accompany this backstop are: (1) identifying individual bank capital needs based on a comprehensive asset quality review and an independent bank-by-bank stress test; (2) recapitalizing, restructuring and/or resolving weak banks; (3) segregating legacy assets of weak banks into an asset management company; (4) burden sharing from hybrid/subordinated-debt holders in banks receiving

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summing up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

public capital; (5) strengthening supervision and regulation. The financial assistance will cover estimated capital requirements with an additional safety margin, estimated as summing up to €100 billion in total, to be disbursed in several tranches over the 18-month duration of the program.

On fiscal policy, the 2011 fiscal slippage was about 3 percent of GDP, much worse than expected, underlining the challenges of fiscal consolidation at all levels of government**.** The new government introduced a first package of measures in December, an ambitious 2012 budget was adopted in June, the fiscal framework was improved, and a scheme for clearing sub-national arrears was put in place. In July, the Council of the European Union recommended another year (until 2014) for Spain to reduce its deficit below 3 percent of GDP and loosened the targets for 2012–14. To help achieve the new targets, the government recently announced a series of measures—including increases in VAT and reductions in civil service remuneration and unemployment benefits. Regarding regional governments, the government initiated the first step in the warning process for several regions at risk of missing targets, monthly reporting from October, and a new funding mechanism.

On labor market policy, a profound labor reform was introduced in February with measures to reduce labor market duality (by lowering the dismissal costs of permanent workers for unfair dismissals) and wage rigidity and to increase firms' internal inflexibility (by giving priority to firm level agreements over wider collective agreements).

Executive Board Assessment

Executive Directors commended the Spanish authorities for taking decisive actions on many fronts. Nevertheless, in light of the ongoing private sector's deleveraging, heightened market tensions, fiscal retrenchment, and the high unemployment, Directors noted that the economic outlook remains very difficult and vulnerable to significant downside risks. Accordingly, they emphasized the critical importance of sustained efforts and a clear, credible medium-term strategy for fiscal consolidation, financial sector restructuring, and structural reforms. Directors agreed that the success of this strategy in restoring confidence, jobs, and growth depends critically also on progress at the European level in strengthening the currency union.

Directors commended the Spanish authorities for the measures taken to restructure the financial sector in a challenging environment. They welcomed the European financial assistance for the recapitalization of Spanish financial institutions and the accompanying policies, as well as the envisaged role of the Fund in monitoring progress. Directors stressed the need to continue providing official support for weak but viable banks, resolve non-viable banks, and implement a comprehensive strategy to deal with legacy assets. Further efforts are also needed to upgrade supervision, crisis management, and the resolution framework. Directors considered that allowing direct recapitalization for Spanish banks through the European Stability Mechanism would help break the adverse feedback loops between the sovereign and banks, and have positive spillover effects for the wider euro area. Faster progress toward establishing a common supervisory mechanism for euro area banks would also boost market confidence.

Directors welcomed the new fiscal package that supports a smoother path of consolidation in the context of weaker growth, although a few saw scope for a less front-loaded adjustment. Directors urged the authorities to adhere strictly to the agreed fiscal path, stressing the need for a credible medium-term budget strategy to reduce deficits and safeguard debt sustainability, while protecting the most vulnerable. In this context, they called on the authorities to take additional measures as necessary, especially on the revenue side, as well as use the available tools to enhance fiscal discipline, particularly at the sub-national level. Directors welcomed significant progress in strengthening the fiscal framework and looked forward to further improvements.

Directors underlined the urgency of additional progress in boosting competitiveness and jobs, given the high level of unemployment in particular among the youth. They welcomed the recent labor market measures, aimed at reducing market duality and wage rigidity, and increasing firms' internal flexibility. These efforts should be complemented with further steps to improve the product and service markets, and the business environment. More broadly, Directors encouraged a rapid implementation of the government's structural reform agenda.

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Spain: Selected Economic Indicators, 2007–2012

	2007	2008	2009	2010	2011	2012 1/
Real economy (change in percent)						
Real GDP	3.5	0.9	-3.7	-0.1	0.7	-1.7
Domestic demand	4.1	-0.5	-6.2	-1.0	-1.7	-4.1
Harmonized index of consumer prices (HICP)	2.8	4.1	-0.2	2.0	3.1	2.1
Unemployment rate (in percent)	8.3	11.3	18.0	20.1	21.7	24.9
Public finance (in percent of GDP)						
General government balance	1.9	-4.2	-11.2	-9.3	-8.9	-6.3
General government structural balance	-1.1	-4.9	-9.3	-7.6	-7.6	-4.7
Primary Balance	3.5	-2.6	-9.4	-7.4	-6.4	-3.1
General government debt 2/	36.3	40.2	53.9	61.2	68.5	89.6
Interest rates (in percent)						
Short term deposit rate	3.8	1.0	0.8	1.7	2.2	2.2
Government bond yield 3/	4.3	4.4	4.0	4.3	5.5	7.1
Balance of payments (in percent of GDP, unless otherwise noted)						
Trade balance (goods and services)	-6.5	-5.5	-1.6	-1.9	-0.5	1.6
Current account balance	-10.0	-9.6	-4.8	-4.5	-3.5	-1.8
Fund position (May 31, 2012)						
Holdings of currency (percent of quota)						68.2
Holdings of SDRs (percent of allocation)						94.3
Quota (millions of SDRs)						4,023.4
Exchange rate						
Exchange rate regime		Euro Area Member				
Euro per U.S. dollar (June 18, 2012)						0.80
Nominal effective rate (2005=100) 4/5/	101.6	104.1	104.7	102.6	102.6	100.5
Real effective rate (2005=100, ULC-based) 4/	108.9	113.9	110.3	107.2	106.2	101.8

Sources: Bank of Spain; National Institute of Statistics (INE); Eurostat; and IMF staff estimates.

1/ IMF staff projections, unless otherwise noted.

2/ While the Eurogroup's commitment of up to €100 billion (9.4 percent of GDP) includes an additional safety margin, staff, to be prudent and pending further details on implementation, assumed this amount for its projections.

3/ Data refer to 10-year government bond yields. Data for 2012 are as of July 20, 2012.

4/ Data from IMF, *International Financial Statistics*. Data for 2012 are as of May 2012.

5/ Corresponding to the ULC-based real effective rate.

Statement by Carlos Perez-Verdia, Executive Director for Spain and Carmen Balsa, Senior Advisor to Executive Director
July 25, 2012

We thank staff for their work and their comprehensive set of papers. This Article IV, together with the recent FSAP, comes at a decisive moment for Spain. Authorities are fully aware of this situation and are acting decisively to reduce the uncertainty in the financial sector, strengthen the fiscal accounts, boost growth, and fight unemployment. Consequently, most of the recommendations in the Article IV report are already being implemented, as noted in the staff's supplement (SM/12/183 sup.2) that describes the most recent measures and significantly alters the staff's appraisal. This notwithstanding, authorities will stand ready to adopt additional measures as necessary. Moreover, they are working hand in hand with their European partners to face both domestic and Euro Area challenges.

The imbalances of the Spanish economy—mainly the debt overhang of the household and corporate sectors associated to the real estate bubble—accumulated over a long period of high domestic demand and credit growth, were crudely exposed by the crisis. Throughout the last months, the Spanish government has embarked on a comprehensive plan that encompasses a very intense fiscal adjustment program and bold financial and structural reform processes.

The outlook is certainly challenging, as the correction of imbalances is hindered by an economic context defined by global economic risks and uncertainties, acute market stress, and widespread lack of growth. Nevertheless, the current strategy, together with appropriate actions at the European level, has the potential to rebuild trust and get the Spanish economy back on a sustainable growth path—supported by the dynamism of the external sector.

The strategy mentioned above relies on three main areas: financial sector, fiscal accounts, and structural reforms. To address one of the main sources of uncertainty, the government has acted decisively to **reform and reinforce the financial sector**. Over the last five months, two Royal Decree Laws were enacted raising regulatory demands on banks' provisions and capital buffers. Beyond that, the measures included in the recently signed Memorandum of Understanding on Financial Sector Policy Conditionality (MoU), in the context of the financial assistance granted to Spain by its European partners, will constitute the backbone of the Spanish financial sector reform program until its completion (as explained in the supplement). Fully in line with the recommendations of the recent FSAP and the Art. IV report, the policies contained in the MoU have the overarching goal of restoring confidence in the financial sector by strengthening the resilience of individual institutions and the soundness of the general framework.

In dealing with institutions, the first step is the evaluation of their individual capital needs to be finalized in September. This stress test assessment, together with an asset quality review, is being conducted by independent consultants—whose work is being monitored by the Spanish authorities, the European Commission, the ECB, the EBA and the IMF. All entities in need of more capital will have to present recapitalization plans to be jointly approved by the Spanish authorities and the EC. In the case of banks requiring public funds, this approval —and the launching of the subsequent recapitalization or resolution processes—will have to be ready by year-end. Banks that do not need public support will have, as a maximum deadline, until June 30, 2013 to raise the necessary capital from private sources. All institutions requiring public funds will have to (i) remove impaired assets from their balance sheets by transferring them to an external Asset Management Company that will be operational by November, and (ii) require burden sharing from hybrid capital and subordinated debt holders after allocating losses to shareholders.

In order to increase the soundness of the regulatory framework, Spanish authorities will request, from December 31, 2012 onwards, a minimum Common Equity Tier 1 ratio of 9 percent for all credit institutions. At the same time, the regulatory framework will be reviewed and improved in the areas of loan-loss provisioning, credit concentration, governance (mainly of former saving banks and the commercial banks controlled by them), and transparency. Regarding the supervisory framework, the internal procedures and operational independence of BdE will be strengthened by acquiring the sanctioning and licensing powers currently held by the Ministry of Economy.

The above description of tasks, to which the Spanish authorities are fully committed, is not exhaustive but provides an idea of its comprehensiveness and the importance attached to the culmination of the financial sector clean-up process. The latter will not only contribute to regaining confidence, but will also facilitate the restoration of the normal flow of credit to profitable enterprises and, therefore, contribute to the return to growth and the reduction of unemployment.

Turning to the **fiscal area**, last December authorities reacted to the 2011 slippage by announcing a package aimed at yielding a 1.5 percent of GDP consolidation—8.9 billion euros in expenditure reductions, and 6.2 billion euros from increased revenues. However, as for the financial sector, last few weeks have witnessed the adoption of very important measures in the fiscal front that have altered staff's original appraisal. First, on July 10th, the Council of the European Union issued a set of recommendations to which Spain is fully committed. Again along the lines of the IMF's advice, the essential elements of the current fiscal strategy are the new extended deadline (2014) for the correction of the excessive deficit and the corresponding smoother deficit reduction path—expressed both in overall targets (6.3 percent of GDP in 2012, 4.5 in 2013, and 2.8 in 2014) and in terms of structural yearly improvements (2.7, 2.5, and 1.9). In order to achieve these targets, Spain will also adopt a detailed multi-annual budget plan for the foreseen period.

Second, the government has recently adopted a substantial set of additional fiscal consolidation measures. Once again in line with the suggestions included in the report, the main building blocks are (i) the increase in VAT—by substantially raising rates and widening the basket of goods to which the highest rates are applicable—and the tobacco excise tax; (ii) the elimination of the mortgage income tax deduction; and, (iii) the reduction in the public sector wage bill. Additional measures include a further cut in ministerial spending of one billion euros, a 20 percent additional reduction in the financing of political parties, unions, and business organizations, the streamlining of active labor market policies, and steps aimed at guaranteeing the sustainability of the social security and dependency long-term care systems. Moreover, the Budget Stability Law enacted in February enshrines the principle of budget balance and sustainability at all levels of government. This normative instrument contains new powerful instruments to control budgets and its forceful implementation will be crucial. In applying this Law, the Ministry of Finance has recently set in motion the warning procedure for those regions in risk of breaching annual targets. At the same time, the Council of Ministers approved, on July 13th, a centralized fund to support the financing of regions, subject to reinforced fiscal conditionality.

The reform of the public sector is also being boosted by a large number of measures that are already being carried out. Their goal is to increase the efficiency and to streamline the range of services provided. The main lines of action include the elimination of overlaps and duplicities, clear definition of responsibilities and allocation of functions among government levels, budget control, reduction in the number of elected public officials and capping of their wages.

All these fiscal initiatives will have a significant impact on public debt trajectory, as analyzed in the supplement. The public debt level will stabilize within the forecast period, even if the total amount of the European assistance for the financial sector is included, as staff conservatively assumes.

The Spanish authorities are also very aware of the need and importance of **structural measures**. They will play a key role in fostering sustainable growth, correcting internal and external imbalances, and boosting the competitiveness and flexibility of the economy. We broadly share the staff´s analysis of the well documented problems of the Spanish labor market. We also concur with the positive assessment of the February labor reform and its potential to reduce the excessively high rate of unemployment. This will be done by addressing the two main factors that make this market dysfunctional: duality and rigidity in wages and employment conditions. Implementation is of the essence. Preliminary data on the latter is positive: collective agreements signed in 2012 have led to wage moderation, opt-out clauses are increasingly being used, and severance payments for collective dismissals have decreased.

On other structural fields, authorities are also introducing improvements. The recently announced measures include, beyond labor market reform, a number of actions that will contribute to making the Spanish economy more flexible and competitive. Among others, reforms are focused on the energy sector, the service sector—particularly professional services—shopping hours, commercial distribution, and the transport sector.

All in all, the Spanish authorities have been proactive in the adoption of measures throughout the crisis, with a significant intensification in recent months. The actions already taken and the ones to be adopted in the future will decisively contribute to the improvement of the economic situation. The Spanish authorities remain committed to their forceful implementation. Nevertheless, ultimate success will hinge also on continued progress at the European level in strengthening the currency union and in reducing stress in sovereign debt markets.