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# Post-Programme Surveillance Report

Spain, Spring 2023

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European Commission  
Directorate-General for Economic and Financial Affairs

## **Post-Programme Surveillance Report**

Spain, Spring 2023

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The Post-Programme Surveillance assessment was prepared in liaison with staff from the European Central Bank (ECB) <sup>(2)</sup>. The European Stability Mechanism (ESM) was consulted.

This report reflects information available and policy developments that have taken place until 28 April 2023. Therefore, the macroeconomic and budgetary projections, including those underlying the debt sustainability analysis, are in line with the Commission 2023 spring forecast released on 15 May 2023 (with cut-off date 28 April 2023).

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(1) The executive summary of this report was adopted as Commission Communication C(2023)4004 on 22 May 2023. The rest of the report is the Staff Working Document SWD(2023)653 accompanying this Communication.

(2) ECB Staff participated in this mission, and in the drafting of this report, in accordance with the ECB's competences and thus provided expertise on financial sector policies and macro-critical issues, such as headline fiscal targets and sustainability and financing needs.

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## ABBREVIATIONS

BdE	Banco de España, Bank of Spain
CET1	Common Equity Tier 1
DSA	Debt Sustainability Analysis
EBA	European Banking Authority
ECB	European Central Bank
EFSF	European Financial Stability Facility
EFSM	European Financial Stabilisation Mechanism
ESM	European Stability Mechanism
FROB	Fondo de Reestructuración Ordenada Bancaria
GDP	Gross Domestic Product
HICP	Recovery and Resilience Plan
ICO	Instituto de Crédito Oficial
IFRS	International Financial Reporting Standards
LSIs	Less Significant credit Institutions
LTD	Loan-To-Deposit ratio
MREL	Minimum Requirement for Own funds and Eligible Liabilities
NPL	Non-Performing Loan
RED	Real Estate Developments loans
REOs	Real Estate Owned assets
RRP	Recovery and Resilience Plan
RWA	Risk-Weighted Assets
Sareb	Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria S.A.
SIs	Significant credit Institutions
SRB	Single Resolution Board
TLTRO	Targeted Long-Term Refinancing Operation

## EXECUTIVE SUMMARY

**This nineteenth post-programme surveillance mission to Spain took place from 15 to 16 March 2023.** The meetings involved staff from the European Commission, in liaison with European Central Bank staff<sup>(3)</sup>. The European Stability Mechanism (ESM) participated on aspects related to the ESM's Early Warning System.

**The Spanish economy is projected to close the gap with the pre-pandemic output level and continue its expansion in 2023, although at a slower pace than last year in a context of global downside risks.** Spain weathered well the economic fallout stemming from the Russian aggression against Ukraine in 2022. Real GDP expanded by 5.5%. The strong outturn reported in 2022 was underpinned by a markedly positive first half of the year, particularly the second quarter, on the back of strong external demand, including significant rebound in tourism activity and revived private consumption. Positive labour market developments throughout the year and government income support measures also sustained the resilience of the economy, despite the pronounced slowdown of domestic demand experienced in the second half of the year. Economic activity is expected to keep growing in 2023, although at a more moderate pace than last year. Real GDP growth is projected to reach 1.9% this year, according to the Commission's spring forecast. Bolstered consumer confidence, labour market resilience and lower expected inflation from lower energy prices are set to uphold consumption growth. The full recovery of international tourism, the strong carry-over from 2022 and the implementation of funds under the Recovery and Resilience Plan (RRP) are also expected to contribute to economic expansion. The gap with the pre-pandemic output level is set to be closed between the second and the third quarter of 2023. Downside risks to the outlook relate to the materialisation of additional disruptions in global commodities market, uncertainty related to the unfolding geo-political events and to the financial environment. Moreover, further tightening of financial conditions would adversely impact consumption and investment decisions by economic agents, thereby weighting negatively on aggregate demand over the forecast horizon.

**Headline inflation, which averaged 8.3% in 2022 fuelled by the surge in energy prices, is expected to decelerate in 2023.** HICP inflation peaked during the summer last year before easing towards year-end, also on the back of the policy response taken by the authorities to protect households and firms' disposable income. However, the pass-through from energy prices to other products in the inflation basket, notably food and services, accelerated considerably as from the third quarter of the year. This is set to slow the easing of core inflation in 2023, particularly in the first half of the year. The headline indicator is expected to moderate further on the back of lower price pressure from the energy component, reaching 4.0% on average this year. Second-round effects stemming from the pick-up in inflation on wages were very limited in 2022, but nominal wage growth is expected to pick-up this year.

**The private sector debt-to-GDP ratio continued decreasing and the external net debtor position strongly improved over the course of 2022<sup>(4)</sup>.** The debt ratio of the non-financial private sector decreased to 125% of GDP in the fourth quarter of last year, down by 14pps compared to the end of 2021 and below pre-pandemic levels, in a context of strong nominal GDP growth and a relatively stable outstanding amount of loans. The housing market has followed a generalised orderly slowdown over the course of 2022 after strong growth of activity and prices in the previous years. Spain's negative net international investment position (NIIP) declined to -60% of GDP in the fourth quarter of 2022 from -71% of GDP at the end of 2021, supported by the surplus in both the current and capital accounts, and valuation effects.

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<sup>(3)</sup> European Central Bank (ECB) Staff participated in this mission, and in the drafting of this report, in accordance with the ECB's competences and thus provided expertise on financial sector policies and macro-critical issues, such as headline fiscal targets and sustainability and financing needs.

<sup>(4)</sup> The evolution of external and internal indebtedness position is also monitored in the context of the In-Depth Review (IDR), aimed at identifying and assessing the severity of macroeconomic imbalances.



**Tax revenue dynamism has offset the cost of the different packages of measures to fight inflation, but the headline government deficit and public debt, while in a downward path, remain high.** The general government deficit reduced in 2022 to 4.8% of GDP, driven by strong revenues and the phase-out of COVID-19 measures, and is expected to decrease further throughout the forecast horizon, but more gradually, reaching 4.1% in 2023. All the major tax revenue headings grew with double digits in 2022, explained by the relatively good performance of the labour market, sustained private consumption, a robust recovery in corporate profits and the effect of high inflation. However, it is still not clear to what extent this dynamism will continue and the data of the first months of 2023 point to a deceleration. The government passed several packages of measures to fight the impact of high inflation. They had an estimated cost of 1.6% of GDP in 2022 and are projected to have a reduced budgetary impact (by 1.0% of GDP) in 2023, driving the improvement of the general government balance. Despite certain reforms included in the RRP that could help improve the fiscal outlook, the general government deficit is likely to stay above 3% of GDP over the forecast horizon. Rising interest payments will add to the strain on public finances in view of the high government debt ratio (113.2% of GDP in 2022). The still pending tax reform has, however, the potential to enhance the efficiency of the system and reduce the sizeable structural deficit.

**Despite the slowdown in economic growth, the higher inflation and interest rates, the banking sector remains resilient.** The slowdown in lending activity continued in 2022 and in the beginning of 2023. Supported *inter alia* by the decrease in the stock of impaired assets, in particular due to sales of NPLs by banks <sup>(5)</sup>, the NPL ratio declined to 3.5% at the end of 2022, which is the lowest level since March 2009. The asset quality has continued to improve. However, the tightening of monetary policy coupled with the higher inflation may impact adversely the debt repayment capacity of borrowers, in particular of those more vulnerable. After the repayment of a significant part of the TLTRO funding, the liquidity position of banks has remained reassuring. The cost of deposit funding has increased only moderately for Spanish banks, as the pass through of the increase in interest rates to deposits has been rather low. Banking sector profitability improved markedly in 2021 and 2022, supported by the increase in net interest income and commissions, lower loan-loss provisions and the good results from operations in Latin America and United Kingdom. For the largest banks, in particular those mainly operating on the Spanish market, profitability will be also impacted by the temporary bank levy introduced in 2022, which banks have to pay in 2023 based on the 2022 financial results. The capital ratios of Spanish banks continue to be lower than EU peers and warrant close monitoring as credit quality may deteriorate in the near future. In 2022, SAREB proceeded with the implementation of its new legal framework and introduced a new operating model. SAREB has disposed of roughly 48% of its assets and redeemed 38% of the issued senior debt. Due to the negative valuation adjustments of over EUR 8.5 billion up to 2021, the losses posted in 2022 and the negative own resources, the negative equity of SAREB as of YE 2022 is expected to deteriorate further.

**Spain retains the capacity to service its debt.** Spain's economic activity is expected to continue to expand, its fiscal situation to improve and its financial situation to remain resilient amid tighter monetary policy and still elevated inflation in the short run. Spain's debt-to-GDP ratio is gradually declining and expected to reach around 110% of GDP in 2024. According to the debt sustainability analysis, Spain is considered to face low risks in the short term, but medium-term fiscal sustainability risks appear high. Government gross financing needs are stable at 20% of GDP level annually. After several voluntary repayments in 2014-2018, Spain made a scheduled repayment of the ESM loan in 2022. According to the agreed repayment schedule, the payments will continue annually until 2027. Despite a limited widening of sovereign spreads in 2022, financing conditions for Spain are considered to remain favourable.

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<sup>(5)</sup> Non-performing loan (NPL)



# 1. INTRODUCTION

**1. Spain received financial assistance for the recapitalisation of financial institutions in July 2012 and successfully exited the related programme in January 2014.** The financial assistance programme was agreed by the Eurogroup on 9 July 2012 for a period of 18 months and provided financing by the euro area Member States of up to EUR 100 bn, to be lent by the European Stability Mechanism (ESM). Eventually, Spain used EUR 41.0 bn for bank recapitalisation, under restructuring and resolution plans approved by the European Commission consistently with State aid rules, and around EUR 2.2 bn for capitalising SAREB, the Spanish asset management company.

**2. This report presents the main findings from the 19<sup>th</sup> PPS mission.** Staff from the European Commission, in liaison with staff from the ECB, participated in the mission to Spain. Staff from the European Stability Mechanism (ESM) also attended the meetings on aspects related to the ESM's Early Warning System. Under the PPS, the Commission carries out regular review missions to EU Member States that have had an EU-supported financial assistance programme. The objective of the PPS mission is to assess the economic, fiscal and financial situation to ensure the Member State maintains its capacity to service its debt to the European Stability Mechanism (ESM) and the European Financial Stability Facility (EFSF).

**3. This report reflects information available and policy developments that have taken place until 28 April 2023.** The macroeconomic and budgetary projections, including those underlying the debt sustainability analysis, are in line with the Commission 2023 spring forecast released on 15 May 2023 (with cut-off date 28 April 2023).

## 2. MACROECONOMIC DEVELOPMENTS

**4. The Spanish economy weathered well the negative shocks unleashed by Russia's war of aggression against Ukraine and real GDP posted a growth of 5.5% in 2022.** The relatively favourable position compared to other EU countries in terms of supply exposure to Russia contributed to mitigate the impact of the war. The strong outturn reported in 2022 stemmed from a markedly positive first half of the year, particularly 2022-Q2, on the back of revived private consumption and the impetus provided by the rebound of tourism over the summer season. In the second half of the year, real GDP growth slowed down significantly as investment recorded a negative contribution to growth and private consumption declined sharply in the last quarter. The weakening of the outlook was due to increased uncertainty, higher energy costs and widespread price pressures, as well as the impact of the tightening of financial conditions on households and firms. The stock of savings accumulated during the pandemic contributed to sustain consumption in an environment of high inflation and limited wage growth.

**5. Economic activity in 2023 is expected to reach 1.9% amid reduced uncertainties and supported by the implementation of the Recovery and Resilience Plan (RRP) <sup>(6)</sup>.** Real GDP growth is expected to gradually pick up in the first half of this year and to gain further momentum in the second half, according to the Commission's spring forecast. Bolstered consumer confidence, labour market resilience and lower expected inflation are projected to underpin consumption growth, also supported by real income gains for pensioners and workers earning the minimum wage. The acceleration in RRP funds reaching final beneficiaries is set to boost investment, notably in construction and equipment. The full recovery of international tourism and the carry-over effect from 2022, are also expected to contribute to economic growth this year. The gap with the pre-pandemic output level, standing at

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<sup>(6)</sup> In addition to EUR 69,5 bn in grants allocated to Spain under the Recovery and Resilience Facility (RRF), EUR 84bn in the form of loans will be made available upon request from Spain in the context of the addendum to the Plan, as well as an additional EUR 7.7 bn in grants due to the revision of the calculation of the financial contribution and EUR 2.6 bn as part of the REPowerEU envelope to be channelled through the RRP.

0.9% in Q4-2022 relative to Q4-2019, is now set to be closed between the second and the third quarter of 2023. The unemployment rate reached 12.9% in 2022 and is projected to remain at elevated levels and above the euro area average, albeit on a declining trend, over the forecast horizon (12.7% and 12.4% in 2023 and 2024 respectively).

**6. Driven by the spike in energy prices, headline inflation averaged 8.3% in 2022.** The energy shock was mainly channelled through import prices, given the large external dependence on international markets shown by Spain despite low direct exposure to supply disruptions. Energy prices declined markedly as from the third quarter of last year, also underpinned by government measures to protect firms and households' disposable income <sup>(7)</sup>. Despite the slowdown of overall inflation from peak levels in the summer, the pass-through from energy prices to other goods and services in the inflation basket accelerated considerably as from the third quarter of the year. This pushed core inflation to reach 6.4% at the end of 2022 (averaging an annual rate of 5.2%) which increased further in the first quarter of this year.

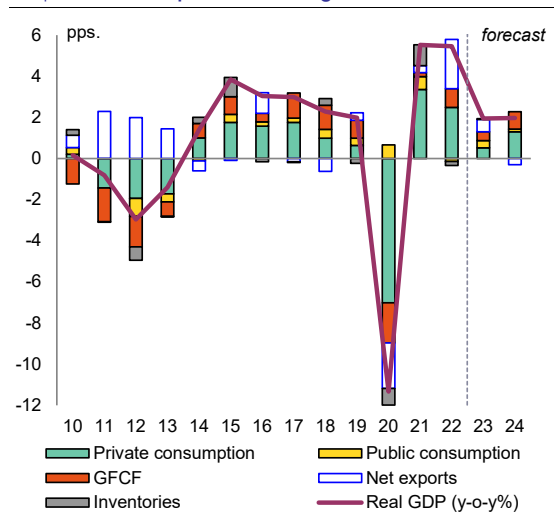
**7. Annual headline inflation is expected to decelerate in 2023 to 4.0%.** Inflationary pressures this year are set to be partially eased by the further decline in energy prices, as well as by the extension until end-2023 of most government measures adopted last year and additional ones, including the VAT reduction on several food products. Nonetheless, core inflation is projected to moderate gradually, remaining at elevated levels in 2023, particularly in the first half of the year amid lingering pressure especially from food and services prices. Second-round effects stemming from the pick-up in inflation on wages were

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<sup>(7)</sup> The government successively extended in 2022 the reduction of VAT on electricity (from 21% to 5%), the reduction of the special tax on electricity (from 5.5% to 0.5%) and the suspension of the tax on the value of electricity production, which have been in place since 2021. The reduction of VAT was extended to gas starting in October 2022. Moreover, the so-called 'Iberian mechanism' was deployed in June 2022, introducing until the end of 2023 a cap on the price of gas used for electricity generation in the Iberian market.

contained in 2022, but nominal wage growth is expected to pick-up this year <sup>(8)</sup>.

Graph 2.1: **Composition of GDP growth**



GFCF: gross fixed capital formation

Source: INE, European Commission Economic Forecast, spring 2023.

**8. Downside risks to the outlook relate to the materialisation of further disruptions in energy markets and a prolonged tightening of financial conditions.** The potential persisting high levels of commodity prices, as well as pressure from core components might result in a more sluggish slowdown of inflation. Further, a prolonged period of monetary policy normalisation and the consequent tightening of financial conditions could adversely affect households' and firms' financial positions. The materialisation of these risks would hamper consumption and investment decisions by economic agents, weighing negatively on the dynamism of aggregate demand. These developments may also impact the implementation of the RRP, as shortages of inputs in sectors receiving a large share of these funds (e.g.,

<sup>(8)</sup> Collective agreements signed up to March 2023 show an average wage growth of 3.1% for this year, although higher figures in newly signed agreements, the extension of inflation clauses and the 8% increase in the minimum wage could anticipate some upward pressures. In the public sector, the budget set a 2.5% wage increase that could be upwardly adjusted by 1pp depending on inflation and nominal GDP developments.

construction <sup>(9)</sup>) could affect the timely delivery of some investments envisaged in the Plan.

**9. The growth of activity and prices in the housing market moderated over the course of 2022.** Moderate credit growth, limited increases in housing valuation gaps and the resilience of the labour market have supported an orderly slowdown. The push of demand by accumulated savings during the pandemic would have by now been to a large extent absorbed, while buyers face a more negative economic outlook, a significant loss of purchasing power due to high inflation, and the tightening of monetary and financial conditions. House sales increased by 14.7% in 2022, slowing down from 34.6% growth in 2021, a trend that intensified in the second half of last year, particularly for new dwellings (-8.9% y-o-y in the fourth quarter). These developments were generalised across Autonomous Communities, although with significant heterogeneity. House prices increased by 7.4% in 2022, accelerating from 3.7% in 2021 but below annual CPI-inflation of 8.4%. The acceleration observed during 2021 extended in the first quarter of last year, when growth of house prices peaked at 8.5% y-o-y. The subsequent slowdown has been progressive in both new and second-hand segments (6.2% y-o-y and 5.3% y-o-y in the fourth quarter of 2022, respectively), as well as quite synchronised across Autonomous Communities.

**10. The private sector debt-to-GDP ratio continued decreasing in 2022.** The debt ratio of the non-financial private sector decreased to 125% of GDP in the fourth quarter of last year, down by 14 pps compared to the end of 2021 and below pre-pandemic levels <sup>(10)</sup>. The stock of debt accumulated by non-financial corporations (NFCs) accounted to 72% in terms of GDP, while total household liabilities amounted to 53%. The decline of the debt ratio for both segments has been mainly driven by a significant acceleration of nominal GDP growth in 2022 due to strong economic activity and higher inflation rates. In a context of economic slowdown after the summer and higher interest rates, the outstanding amount of loans remained relatively stable at year-end,

<sup>(9)</sup> In addition, (Bank of Spain, 2022) highlights that the risk of employment shortages in some sectors may dampen the estimated macroeconomic impact of the Plan.

<sup>(10)</sup> Data are expressed in consolidated terms.

slightly contracting for NFCs (-0.3% y-o-y) and mildly increasing for households (0.6% y-o-y). The weakening of the economic outlook for 2023 and the tightening in financial conditions anticipate an extension of this trend.

**11. Spain's external net debtor position in terms of GDP strongly improved over the course of 2022.** Spain's negative net international investment position (NIIP) declined to -60% of GDP in the fourth quarter of 2022 from -71% of GDP at the end of 2021. These developments were supported by strong nominal GDP growth, as well as by the surplus in both the current and capital accounts, and valuation effects. The strong rebound of international tourism revenues offset the increase in trade deficit due to the high level of energy prices, while Spain received EUR 12 bn in capital transfers under RRF grants. A key driver of the reduction of the negative NIIP has been the devaluation of debt instruments in a context of rising interest rates, particularly affecting the value of outstanding public debt in the hands of foreign investors. The current account surplus reached 0.6% in 2022 and it is expected to grow further in 2023 and 2024 to 1.6% and 1.5% respectively, helped by the gradual reduction of energy prices and the expected improvement in the terms of trade.

## 3. PUBLIC FINANCE DEVELOPMENTS

### 3.1. FISCAL PERFORMANCE

#### 12. Spain's public finances keep improving but the general government deficit remains high.

The positive developments on the revenue side (8.1% increase in 2022) along with the phase-out of COVID-19 measures supported the improvement of the public deficit. Several packages of measures to protect firms' and households' income were approved, weighing on the general government balance. All in all, the public deficit continued to decrease in 2022 by 2.1 pps. to 4.8% of GDP, outperforming by 0.2 pps. the government's budget projection (5.0% of GDP) and narrowing by half in a period of two years (from 10.1% in 2020).

#### 13. Tax revenues are maintaining momentum, but uncertainty on their structural nature calls for fiscal prudence.

Total revenues grew by 8.1% in 2022, with tax revenues showing continued strength throughout the year. Revenues from corporate income tax grew by 11.1%, reflecting the recovery of profits after the pandemic, while strong job creation supported the solid performance of revenues from personal income tax, which posted growth of 16.2%. As for VAT, the rise of private consumption, the recovery of international tourism, the dynamism of the housing sector and the strong increase in nominal imports were the main drivers behind its sustained growth throughout the year (13.1%). The tax revenue-to-GDP ratio reached 24.9% at the end of 2022, having increased by 2.6 pps. since 2019 and halving the initial gap of 5 pps. with the EU weighted average. However, it is still unclear what part of this recent rise in revenues has a structural or temporary nature. On the back of this strong performance among the main taxation headings, there are substantial deviations from their structural elasticities. Multiple factors may explain this divergence of tax revenues from their traditional macroeconomic fundamentals, some can be statistical, such as a potential underestimation of the nominal GDP figures or the decoupling between the GDP and the final demand deflators; and some can be policy-driven factors, such as the effect of income support policies (reinforced short-time work schemes reducing the pro-cyclicality of unemployment during the crisis), a possible decrease in the capacity to engage in tax

avoidance and tax fraud practices as a result of reinforced antifraud policies, changes in consumption patterns involving lower cash payments, or the non-adjustment of tax brackets with inflation, resulting in salaries being subject to higher tax rates. Recent studies<sup>(1)</sup> suggest that inflation has progressively become a major contributor to the rise in revenues over the course of 2022, while there is a substantial part that cannot be explained by developments in macroeconomic aggregates. These conclusions would call for a prudent expenditure strategy, also in face of recent developments in tax revenues at the beginning of 2023, which suggest some deceleration within the main taxation figures, with a lower growth mainly in VAT (1.7% y-o-y until February), but also to some extent in personal income tax (10.6%).

#### 14. The government passed several sets of measures to help cope with the effects of inflation.

Overall public expenditure was mostly in line with the budget projections for 2022, despite a growing interest cost. The phasing out of COVID-19 measures reduced their budgetary cost to approximately 0.3% of GDP in 2022 from around 3% of GDP in 2021. The reduction of short-term working schemes subsidies and social contribution waivers were the main drivers as well as the lower impact of contingent liabilities on the deficit. Part of the remaining cost may however become permanent, particularly certain social transfers to regions for health expenditure. In turn, the government passed several packages to ease the impact of energy price inflation on households and firms throughout the year, weighing on higher expenditure. The overall estimated cost of the different sets of measures amounted to 1.6% of GDP. They included, among others, the reduction of VAT on electricity and gas, the reduction of the special tax on electricity, the suspension of the tax on the value of electricity production, a generalised fuel rebate of 20 cents per litre, subsidies for public transport and direct support for households (notably, the energy voucher) and companies in the transport, primary, gas-intensive, and electro-intensive sectors. The 2023 Country Report for Spain includes a box that provides a

<sup>(1)</sup> [Los ingresos públicos tras la pandemia. Residuos fiscales e inflación. BOLETÍN ECONÓMICO 2023/T1. Artículo 16 \(bde.es\)](#)

comprehensive overview of the measures taken in response to the energy crisis, together with an assessment of whether they are targeted towards the most vulnerable and preserve the price signal, as well as the government's intentions for their withdrawal.

### 3.2. FISCAL OUTLOOK

**15. The headline deficit is expected to decrease, but more gradually, while public debt remains high** (see also Section 5). According to the latest Stability Programme submitted by Spain on 28 April 2023, the general government deficit is forecast to drop to 3.9% of GDP in 2023. The Commission's 2023 Spring Forecast also expects the public deficit to narrow, by 0.7 pp to 4.1%, helped by the reduced cost of energy support measures (by 1.0% of GDP) and decrease further in 2024 to 3.3%. A swifter implementation of the Recovery and Resilience Plan is expected for 2023 and 2024, which should spur economic growth particularly through investment. Many projects in the pipeline are starting to materialise in the first months of the year, and the effective expenditure financed by the Recovery and Resilience Facility may double compared to 2022, according to the Commission's projections. The implementation of reforms also continues and the effects of further measures agreed on pensions should be increasingly visible within the forecast horizon. The still pending tax reform, that aims to make the Spanish tax system more effective by increasing revenue, supporting the green transition, and promoting fairness has the potential, if sufficiently ambitious, to have a positive impact on fiscal progressivity, support vulnerable households and reduce the sizeable structural deficit. Some new revenue measures in place since the beginning of the year, will help improve the general government balance. In particular, the newly created taxes to energy companies and financial institutions (see Section 4 for more information) are projected to add EUR 6 bn to the budget until the end of 2024, and the solidarity wealth tax EUR 3 bn. In addition, the temporary measure to limit the deductible business losses incurred by large companies may bring some extra EUR 2.4 bn in the next two years. On the expenditure side, the government passed a package of measures to fight inflation on 27 December 2022 whose budgetary impact will mainly occur in 2023. The overall cost

of the package amounts to 0.6% of GDP and includes the extension of higher benefits under the social heat voucher until the end of 2023, additional VAT reductions for several food products until 30 June 2023, a more targeted fuel rebate, also until the end of June, and direct support to the primary and gas-intensive sectors until the end of the year. The interest payments are likely to keep growing (see Section 5) and the indexation of pensions to inflation, with an estimated cost of 1.0% of GDP in 2023, will add to the strain on public finances. Overall, the general government deficit is likely to stay above 3% of GDP throughout the forecast horizon and the public debt, even if gradually decreasing thanks to the immediate impact of high nominal in terms of higher nominal GDP growth, is still elevated. Additional steps on fiscal consolidation would help to anchor the investors' expectations in a context of uncertainty.



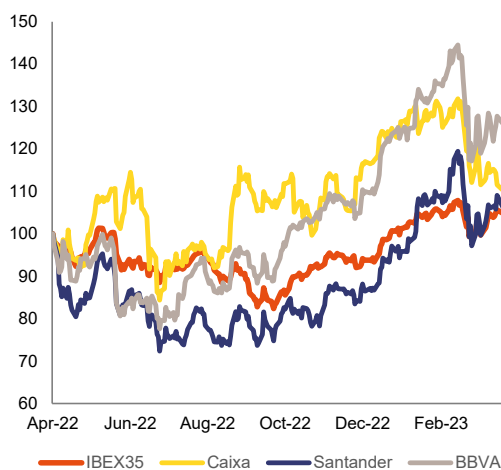
## 4. FINANCIAL SECTOR DEVELOPMENTS

### 4.1. RECENT TRENDS

#### 16. Despite the slowdown in economic growth, the higher inflation and interest rates, the banking sector has maintained its resilience.

After the upward trend in 2021, the share prices of Spanish banks have faced increased volatility after the onset of Russia's aggression against Ukraine, but recovered to some extent in the second half of 2022 and the beginning of 2023, despite the risks from higher inflation and the moderation in the economic outlook. The heightened market volatility triggered by the developments related to the Silicon Valley Bank and Credit Suisse has temporarily put renewed strain on the share prices of Spanish banks. Overall, the share prices of most of the large Spanish banks have rebounded following the tightening of monetary policy by the ECB and have performed positively compared to the IBEX 35 and Stoxx® Europe 600 banking sub-index.

Graph 4.1: IBEX35 and selected Spanish banks stocks



(1) Indexed at 21/04/2022=100.

Source: Madrid Stock Exchange, own calculations.

#### 17. After the repayment of a significant part of the TLTRO funding, the liquidity position of banks has remained reassuring.

The Spanish banks' borrowing from the ECB has declined markedly in recent months, on the back of the partial repayment of the TLTRO funding. The ECB funding went down by roughly EUR 171 bn since February 2022 and stood at EUR 118.5 bn in February 2023, the lowest level since March

2020<sup>(12)</sup>. The pace of increase in deposit funding slowed down gradually in 2022. Total domestic bank deposits from households and non-financial corporations remained in positive territory, but increased by just 0.2% year-on-year (y-o-y) in January 2023. While non-financial corporations had mainly driven the increase in total deposits in the first nine months of 2022, the increase in the deposits of non-financial corporations slowed down in the last quarter of 2022. The deposits of non-financial corporations contracted by 1.4% year-on-year (y-o-y) in January 2023. Meanwhile, the deposits of households continued to expand, albeit at a slower pace by 3.1% y-o-y in January 2023<sup>(14)</sup> (Graph 4.2). The loan-to-deposit ratio (LTD) decreased to 100.8% in the third quarter of 2022 compared to 101.21% in the third quarter of 2022. This is one of the lowest levels since 2017<sup>(13)</sup>. The cost of deposit funding has increased only moderately for Spanish banks, as the pass through of the increase in interest rates to deposits has been rather low. Meanwhile, the conditions for retail and wholesale market access have slightly deteriorated. Despite the more operating environment and the increase in the cost of funding, the Spanish banks have continued to issue MREL compliant debt securities.<sup>(14)</sup> Banks have mainly issued senior preferred and senior non-preferred bonds and to a much lesser extent T2 and AT1 instruments. According to Bank of Spain, the significant credit institutions issued MREL compliant debt instruments of roughly EUR 36 bn in 2022 and already a significant amount in January 2023 (i.e. EUR 9.3 bn). Meanwhile, the cost of debt issuances has increased since mid-2022. Based on the latest available data, Spanish banks do not have difficulties to comply with MREL targets.

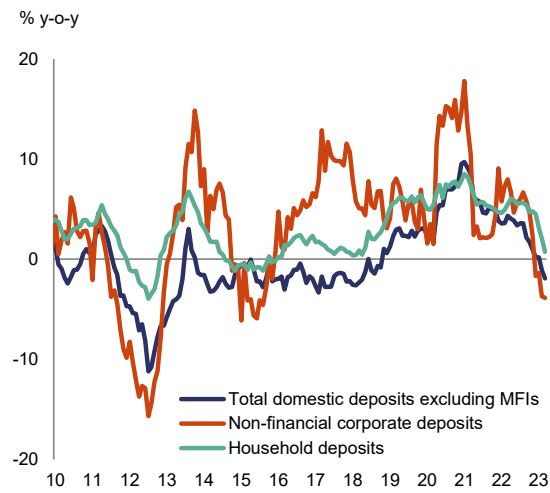
<sup>(12)</sup> <https://www.bde.es/webbde/es/estadis/infoest/a0199.pdf>

<sup>(13)</sup> Bank of Spain, *Nota de prensa estadística*, 20 January 2023. [El Banco de España publica las estadísticas supervisoras de las entidades de crédito correspondientes al tercer trimestre de 2022 \(bde.es\)](https://www.bde.es/webbde/es/estadis/infoest/a0199.pdf)

<sup>(14)</sup> Minimum Requirement for own funds and Eligible Liabilities (MREL)



Graph 4.2: **Bank deposits**



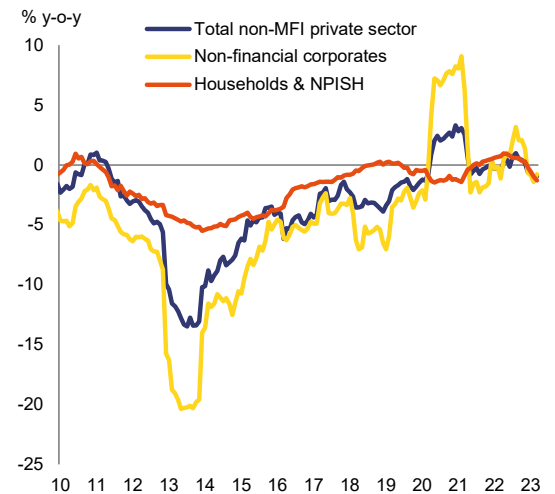
Source: BdE.

**18. The slowdown in lending activity continued in 2022 and at the beginning of 2023.**

Following a more positive evolution from June to August 2022, total lending to the private sector (excluding interbank lending) lost momentum again in the last part of 2022 and contracted further by -0.6% y-o-y in February 2023. Lending to non-financial corporations expanded at a higher pace than lending to households from May until November 2022. Due to the tightening of credit standards and the increase in interest rates, lending to corporates contracted by -0.3% y-o-y in December 2022 and -0.5% in January and -0.9% in February 2023. The support to lending to non-financial corporations provided by the ICO) guaranteed loans has been less pronounced in 2022. Following the enactment of the Royal Decree Law 34/2020, many companies have extended the maturity of their ICO guaranteed loans. Lending to households has been more sluggish in 2022 and contracted by -0.2% in February 2023. Lending to the government has been decreasing in y-o-y terms since May 2022. The cost of lending gradually increased during 2022. The one-year Euribor®, which is used as main reference to set the interest rate on the mortgage loans granted by banks, rose to 3.647% in March 2023. Taking the last twelve months as reference, the one-year Euribor® increased by 3.884 percentage points since March 2022. The total volume of loans granted by the Spanish banks (on an individual basis) decreased by roughly -4.4% in February 2023 (provisional data)

compared to February 2022 and stood at roughly EUR 1.992 tn <sup>(15)</sup>.

Graph 4.3: **Bank loans to the private sector**



The decrease in the stock of loans in late 2012 and early 2013 was due to the transfer of assets to SAREB.

Source: BdE, own calculations.

**19. The Bank Lending Survey for the fourth quarter of 2022 indicated a further tightening of credit standards for loans in Spain and the euro area.**

This tightening has been the most pronounced observed since 2011. Credit standards for loans to non-financial corporations and households in Spain tightened due to the lower risk tolerance by banks, the increase in risk perception linked to the worsening macroeconomic outlook and the increase in financing costs <sup>(16)</sup>. Overall, terms and conditions on new loans tightened for all categories of loans. Loan demand by non-financial corporations and households decreased further in the fourth quarter of 2022. The increase in interest rates and a reduction in fixed investments dampened loan demand by non-financial corporations. The demand for working capital contributed positively to loan demand although to a lesser extent than in the previous quarters of 2022. Regarding lending to households, loan demand for house purchases decreased further in the fourth quarter of 2022 due to declining consumer confidence, the increase in interest rates

<sup>(15)</sup> Source: Banco de España (BdE), <https://www.bde.es/webbde/es/estadis/infoest/a0802e.pdf>

<sup>(16)</sup> For further details see BdE, [Banco de España - Publications - Economic analysis and research - Economic Bulletin \(bde.es\)](https://www.bde.es/webbde/es/estadis/infoest/a0802e.pdf)

and the worsening outlook for the housing market. For the first quarter of 2023, Spanish banks expect credit standards to tighten further for loans to corporates and households, while loan demand from corporates and households, in particular for consumption purposes is expected to decline. Although asset quality and the level of NPLs had a rather neutral impact on credit standards in 2022, especially in the first half of the year, banks expect that asset quality will contribute to the tightening of credit standards and lending conditions in the first half of 2023.

**20. The improvement in asset quality of Spanish banks continued in 2022.** Supported by the decrease in the stock of impaired assets in particular due to sales of NPLs by banks <sup>(17)</sup>, the system-wide NPL ratio went down to 3.5% at the end of 2022, the lowest level since March 2009 and down from 4.3% at the end of 2021. (Graph 4.4). The construction sector continued to have the highest share of NPLs. However, the NPL ratio for the construction sector declined to 7.6% at the end of September 2022, by 0.9 percentage points lower than at the end of 2021. Since March 2022, the NPL ratios for real estate declined steadily and stood at just below 4% at the end of 2022. Meanwhile, the NPL ratio for productive activities fell to 4.4% at the end of September 2022 (down from 4.8% at the end of 2021), the lowest level since March 2009. Loans to households continue to have the lowest level of impairment, with the NPL ratio declining to almost 3.2% at end of September 2022, by roughly 0.6 percentage points lower than at the end of 2021. The NPL ratio on mortgage loans also continued to decline to below 2.9% at the end of September 2022, the lowest level since September 2011. After the increase in 2021, Stage 2 loans (according to IFRS 9 <sup>(18)</sup>) at consolidated level declined in the first three quarters of 2022. According to the latest data by the European Banking Authority (EBA), the share of Stage 2 loans as percentage of total loans and advances stood at 6.6% at the end of September 2022, below the EU average of 9.5%, and by 0.6 percentage points lower than in September 2021. According to Bank of Spain, Stage 2 loans increased again in the last quarter of 2022. While asset quality has continued to

improve, the tightening of monetary policy coupled with the higher inflation may impact adversely the debt repayment capacity of borrowers, in particular, of those more vulnerable. According to estimations by the Bank of Spain, the increase in interest rates is expected to affect predominately households in the 20 - 60 percentiles of the income distribution. While the bulk of new mortgage loans are granted with fixed interest rates, roughly 70% of the total stock mortgage loans have variable rates. Regarding the portfolio which benefitted from relief measures after the onset of the COVID-19 pandemic, roughly 99% of granted loan moratoria expired. <sup>(19)</sup> Meanwhile, refinanced loans, in particular those backed by ICO guarantees warrant close oversight <sup>(20)</sup>. According to the latest EBA data (consolidated data), the loans subject to public guaranteed loans classified as Stage 2 loans declined by 1.8 percentage points in the third quarter of 2022 compared to the second quarter and stood at 20.2%, below the EU average of 23.1%. The NPL ratio for the loans subject to public guarantee schemes increased to 5.9% in the third quarter of 2022, up from 5.2% in the second quarter and stood above the EU average of 4.2%. <sup>(21)</sup> Meanwhile, the NPL ratio for already expired EBA-compliant moratoria remained broadly flat in the third quarter of 2022 and stood at 8.5%, slightly lower than in the second quarter. However, the impairment of loans with expired

<sup>(19)</sup> The volume of loans and advances covered by non-expired EBA compliant moratoria granted by significant credit institutions (SIs) declined to roughly EUR 105 mn at the end of September 2022 compared to EUR 110 mn at the end of June 2022. For further information, see Bank of Spain, *Nota de prensa estadística*, 20 January 2023. [El Banco de España publica las estadísticas supervisoras de las entidades de crédito correspondientes al tercer trimestre de 2022 \(bde.es\)](https://www.bde.es/estadisticas/estadisticas-supervisoras-de-las-entidades-de-credito-correspondientes-al-tercer-trimestre-de-2022)

<sup>(20)</sup> The increase in refinanced loans is basically due to a group of ICO operations that according to RDL 34/2020, need not to be considered as proper refinanced loans. For prudential reasons though, they have been classified as refinanced operations.

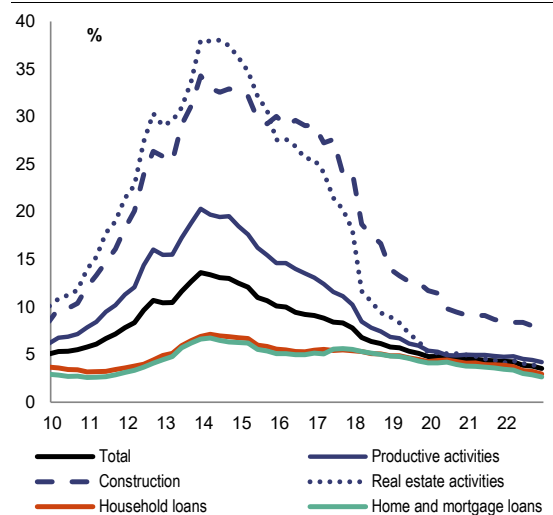
<sup>(21)</sup> When assessing the NPLs for the loan portfolios supported by public guarantees, it is necessary to take into account the fact that the ICO backed loan portfolio is closed (i.e. no origination of new loans since June 2022). NPL ratios are usually measured for open portfolios for which new loans are included in the denominator on a continuous basis. Unless the ICO backed loan portfolio NPL ratio is controlled for its closed nature, the NPL ratio will increase continuously as redemptions accumulate and the outstanding debt (i.e. the NPL ratio denominator) decreases.

<sup>(17)</sup> Non-performing loan (NPL)

<sup>(18)</sup> International Financial Reporting Standards (IFRS)

moratoria has continued to be higher than the EU average (i.e. 6.4%).

Graph 4.4: Ratio of non-performing loans



(1) The scope of non-performing loans covered in these figures overlap with BdE's definition of doubtful loans.  
(2) Home loans comprise also loans that are not mortgages  
**Source:** BdE, own calculations.

**21. Banking sector profitability improved markedly in 2021 and 2022.** Banking sector profitability benefitted from the increase in net interest income and commissions coupled with lower loan-loss provisions. (Graph 4.5) The profitability of banking groups with international footprint benefitted from the increase in interest rates and the good results obtained by their subsidiaries abroad, in particular in Latin America and United Kingdom. According to Bank of Spain data <sup>(22)</sup>, the operating profit reached roughly EUR 29 bn in the third quarter of 2022 compared to EUR 25 bn in the third quarter of 2021, while the return on equity (consolidated basis) stood at 10.09%. However, when comparing the return on equity in 2022 and 2021, it has to be taken into account that the profitability in the first quarter of 2021 was influenced by a one-off item stemming from a merger. Meanwhile, the cost of risk decreased marginally in the third quarter of 2022 compared to the previous quarter and stood at 0.94% (slightly below the level at the end of

<sup>(22)</sup> Bank of Spain, Nota de prensa estadística, 20 January 2023. [El Banco de España publica las estadísticas supervisoras de las entidades de crédito correspondientes al tercer trimestre de 2022 \(bde.es\)](https://www.bde.es/estadisticas/supervisoras-de-las-entidades-de-credito-correspondientes-al-tercer-trimestre-de-2022)

2021), but by 1.2 percentage points lower than in the third quarter of 2021. Interest income has continued to remain the main source of income for Spanish banks. As the balance sheets of the Spanish banks are sensitive to changes in interest rates, the tightening of monetary policy led to an increase in interest income. The net interest income as percentage of total income stood at 69.2% (the sixth highest in the EU and the third highest in the euro area) in the third quarter of 2022, up from 66.4% in the third quarter of 2021 and markedly above the EU average of 58% (ECB data). After the phasing out of restrictions on the distribution of dividends, banks have resumed the distribution of dividends to their shareholders. Overall, Spanish banks are among the most efficient banks in the EU. After a slight decrease in efficiency after the onset of the Covid-19 pandemic, the cost rationalisation brought about *inter alia* by the recent banking mergers has been gradually kicking in. According to ECB data, the cost-to-income ratio of Spanish credit institutions stood at 48.2% in the third quarter of 2022, down from 52.9% in the third quarter of 2021 and markedly below the EU average of 60.6%. For the largest banks, in particular those mainly operating on the Spanish market, profitability will be also impacted by the temporary bank levy introduced in 2022, which banks have to pay in 2023 on the basis of the 2022 financial results. <sup>(23)</sup>.

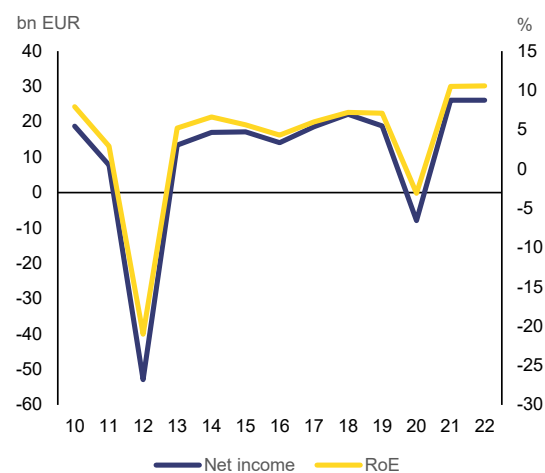
**22. Banking sector capitalisation declined slightly in 2022.** According to the latest data by Bank of Spain, the solvency ratio at banking system level remained broadly flat in the third quarter of 2022 and stood at 16.55% at the end of June 2022, by roughly 1 percentage point lower than at the end of 2021. Less significant credit institutions (LSIs) continued to have higher capital ratios than significant credit institutions (SI). The total capital of LSIs declined slightly in the third quarter of 2022 and stood at 21.52%, while the total capital of SIs reached 16.25%, marginally lower than the system-wide solvency ratio <sup>(24)</sup>. Meanwhile, the Common Equity Tier 1 (CET1)

<sup>(23)</sup> For further details on the bank levy, see Section 4.2 on Reforms and policy.

<sup>(24)</sup> Bank of Spain, Nota de prensa estadística, 20 January 2023. [El Banco de España publica las estadísticas supervisoras de las entidades de crédito correspondientes al tercer trimestre de 2022 \(bde.es\)](https://www.bde.es/estadisticas/supervisoras-de-las-entidades-de-credito-correspondientes-al-tercer-trimestre-de-2022)

ratio at system level decreased to 13.05% at the end of September 2022, down from 13.51% at the end of 2021. In the first three quarters of 2022, banking sector capitalisation declined due to increase in the risk-weighted assets (RWA). The CET1 capital increased slightly, but could not compensate the growth in RWA. Overall, the capitalisation of Spanish banks continues to be lower than that of EU peers, with the CET1 ratio being the second lowest in the EU after the CET1 ratio of Greek banks. Since the higher inflation and the increase in interest rates is likely to put strain on the debt repayment capacity of some borrowers, the capitalisation of Spanish banks continues to warrant close oversight. Furthermore, since the bank levy will be also taking a toll on the profit of banks that are subject to this levy, the potential for the organic generation of capital in the future is also more limited.

Graph 4.5: Bank sector profitability (consolidated basis)



Since 2019, return on equity (RoE) is calculated dividing Net income by the average of total own funds, while before that year RoE was calculated according to the market standards, this means dividing the income attributable to the controlling entity by the average of shareholders' equity.  
**Source:** BdE, Financial Stability Report.

## 4.2. REFORMS AND POLICY

**23. According to Bank of Spain, the credit and housing market developments have not required a change in the macro-prudential policy stance.** The Bank of Spain decided to keep the countercyclical capital buffer applicable to banks for their credit exposures in Spain at 0% in the first quarter of 2023. The credit-to-GDP gap,

which has remained above the warning threshold since the start of the pandemic, has continued to decline driven by the recovery in economic activity in 2021 and developments in 2022. The latest data indicate that housing purchases have moderated, but the price growth, which decelerated in the second half of 2022, is still in positive territory. The real estate market indicators still show some signs of overvaluation, although much more contained and lower than in the EU Member States that activated macro prudential measures for real estate market exposures. Going forward, the higher inflation, the tightening of monetary policy and the increase in uncertainty will dampen the economic outlook which will weigh upon the correction in the credit-GDP-gap.

**24. The cycle of resolution planning has continued for all credit institutions.** Ten significant institutions under the resolution remit of the Single Resolution Board (SRB) and all less significant institutions have a resolution plan. For the 2021 cycle, the MREL decisions for the two significant institutions with a resolution college and the eight significant institutions without a resolution college were communicated in 2022. For the 2022 cycle, the MREL decisions for the banks with a resolution college are expected to be communicated in the second quarter of 2023. For the banks without a resolution college, four MREL decisions were communicated in January 2023, while the pending ones are expected by the end of the first quarter of 2023. Regarding the less significant institutions, the MREL decisions for the 2021 cycle were communicated in 2022. In January 2023, the MREL decisions for the 2022 cycle were communicated to 25 banks with liquidation strategies. The rest of the MREL decisions including for the banks with resolution strategy are expected in the second quarter of 2023. Meanwhile, the compliance of Spanish banks with MREL targets does not entail difficulties for the Spanish banks (significant and less significant) as well as for the host institutions and cross-border entities. Most credit institutions have met their MREL targets for January 2024.

**25. In 2022, the authorities introduced a temporary levy on banks.** The bank levy amounts to 4.8% of banks' net interest and fee income accrued in Spain and is applicable only to banks operating in Spain with an interest and income fee equal to or above EUR 800 mn in 2019

pursuant to the applicable accounting rules. The levy will be paid in 2023 and 2024 based on the 2022 and 2023 financial results and is expected to generate revenues of EUR 1.3 bn per year. The bank levy is not deductible from corporate tax, which increases the fiscal pressure on banks. Furthermore, the levy contains a prohibition on banks passing on the cost of the bank levy to their clients. The impact of the levy on the profitability of individual banks depends on cost efficiency and the share of domestic business in total earnings. Several banks have already opened judicial litigations to challenge the bank levy or announced their intention to do so.

**26. The authorities approved in November 2022 borrower relief measures aimed at mitigating the impact of higher interest rates on borrowers with mortgage loans.**

The package of measures modifies a program introduced in 2012, which allows vulnerable borrowers to obtain more favourable mortgage conditions. In line with the new provisions, vulnerable borrowers (annual income below EUR 25,200 and a debt-to-income ratio above 50%) are eligible for a principal grace period of five years during which the interest rate is reduced to Euribor® minus 0.10%. Borrowers can also obtain an extension of the loan maturity (i.e. to 40 years) and apply for a second restructuring at the end of the initial grace period. The new provisions also provide support for two years to vulnerable families (annual income below EUR 29,400, a debt-to-income ratio above 30% and loan instalments that went up by at least 20%). These borrowers are eligible for a one-year instalment freeze, a lower interest rate and a loan maturity extension of up to seven years. The borrower relief measures have been used to a limited extent so far (roughly 9,000 transactions), but more borrowers may apply after the full repricing of the mortgage loan book with the current higher interest rates. Moreover, the package facilitates the conversion of floating rate mortgage loans into fixed rate loans and the early redemption (partial or full) of loans.

**27. The FROB has maintained its investment in CaixaBank<sup>(25)</sup>.** According to the divestment

<sup>(25)</sup> *Fondo de Reestructuración Ordenada Bancaria* (FROB) was created in 2009 to provide public support for the consolidation of the Spanish banking sector by, inter alia, strengthening the capital buffers of credit institutions.

strategy of FROB and with a view to maximising the recovery of public funds, the conditions needed to execute the sale of FROB's stake (17.32%)<sup>(26)</sup> in CaixaBank have still not been met. However, as the bank is well managed and further improvements in CaixaBank's shareholder value may be expected in the future, FROB should be able to maximise the recovery of public funds. Bank share prices are expected to pick up once the uncertainties in the macroeconomic outlook will start to dissipate and banking sector fundamentals will be appropriately priced in. Currently, the deadline for FROB to divest from CaixaBank is set at the end of 2025, after it was postponed at the end of 2022 by a decision of the Council of Ministers.

**28. SAREB has continued the process of asset disposal.**

After 10 years out of its total envisaged lifetime of 15 years (until 2027), SAREB sold roughly 48% of its asset portfolio. Since its creation, the asset composition has tilted towards real-estate owned assets (REOs). Currently, 41% of total assets are Real Estate Developments loans (RED, mostly being non-performing) and 59% REOs. Roughly 80% of the RED assets have a cost to value of above 100% and a very slow repossession of collateral. In 2022, roughly 35% of the REO assets were published for sale, 19% in preparation for sale, 19% in development and 23% not for sale. SAREB focuses on divesting an appropriate asset mix to maximise the cash flow generation during its remaining lifetime.

**29. SAREB has continued to accumulate losses and achieved the redemption of 38% of its senior debt.**

SAREB has been able to operate with negative equity, due to the legal changes which waived SAREB from the general corporate law obligations related to compulsory winding-up and capital reduction. After posting losses of EUR 1.5 bn in 2022, SAREB's total own resources were of – EUR 2.5 bn at the end of 2022. Due to negative valuation adjustments of EUR 8.6 bn from the impairment on assets and the negative own resources posted in 2022, the total losses of SAREB accumulated since its setting up in 2012 amount to just over EUR 11 bn. SAREB

<sup>(26)</sup> FROB's stake after the cancellation of the shares bought back by CaixaBank within the 2022 share-buyback programme.



performed below its business plan in 2022, as it managed to generate 90% of the income estimated in the 2022 budget and roughly 82% of the budgeted cash. However, the net margin exceeded the budget while the operating expenses were below the budget due to lower expenses with asset renovation and transformation.

**30. In 2022, SAREB proceeded with the implementation of its new legal framework and introduced a new operating model.** In June 2022, SAREB approved a new organisational structure, by appointing a new CEO and changing the nature of the chairman to non-executive. Furthermore, it reduced the size of its board of directors (i.e. from 14 directors to 9). SAREB selected two asset servicers to manage the retail portfolio of loans and real estate assets and also completed the migration of assets to the new servicers. However, the migration of assets impacted negatively the 2022 revenues for the REO assets. The full implementation of the “sustainability principle” is still subject to the approval of the updated Business Plan. According to this “sustainability principle”, which was included in the recent reform, SAREB can transfer assets to develop social housing policies, incorporating therefore a social dimension to its objective of maximising the value of its asset portfolio.

## 5. SOVEREIGN FINANCING AND CAPACITY TO REPAY

**31. Spain retains the capacity to service its public debt. In the short run, public debt is forecast to decline, but this trend is expected to reverse in the medium term and the debt-to-GDP ratio is projected at 106% of GDP in 2033 in a baseline scenario of the debt sustainability analysis (DSA) <sup>(27)</sup>.** Based on data validated by Eurostat, general government debt stood at 113.2% of GDP in 2022, 15 pps of GDP higher than in 2019. The general government debt-to-GDP ratio is expected to decrease to 110.6% in 2023 and 109.1% in 2024 according to the Commission 2023 spring forecast. Based on the Commission's DSA baseline scenario, the debt ratio is projected to decline to 104.5% 2029-2030 but thereafter the positive trend is projected to reverse and the debt ratio is expected to rise gradually to 106% of GDP in 2033. In a scenario where the structural primary balance (SPB) converges to a deficit of 1.1% of GDP (its historical average), the debt ratio in 2033 is projected at about 2 pps. of GDP higher than in the baseline scenario. In an adverse interest—growth rate differential scenario, government debt in relation to GDP is projected at around 115% of GDP in 2033 (see Annex B for the debt sustainability analysis).

**32. Structural features of outstanding Spanish government debt in terms of average maturity and investor base remain favourable despite a shift in monetary policy.** Central government debt accounted for 70% of total public debt in the fourth quarter of 2022. The debt issued by regional governments (Autonomous Communities) accounted for 21% while the remaining 9% was issued by local governments and social security funds. The average interest rate of the outstanding regional government debt and the average maturity were estimated at 1.1% and 5.6 years, respectively at the end of 2022. As regards the structure of central government outstanding debt, the largest category of debt corresponds to long-term government bonds (*bonos*), which accounted for about 72% at the end of 2022. The maturities of long-term bonds range from 10 to 50 years and roughly 55% of these outstanding bonds are 10-year bonds. In 2022, the stock of bonds with maturities of 20 years or more grew by 12.9%

while stock of 10-year bonds grew by 10.3%. The largest group of holders of the central government debt were non-resident investors (40% in December 2022), and their share has been on a declining trend over the past two years. The second largest holder was the Bank of Spain (33%). Other resident holders increased their share in 2022, particularly credit institutions (up to 14%) while it remained broadly stable for insurance companies (7%). The stock of central government debt held by resident financial institutions (excluding the Bank of Spain) was on an increasing trend in the second half of 2022. As part of the path of monetary policy normalisation, the ECB has announced that it will start the reduction of the portfolio under the Asset Purchase Programme (APP) at an average pace of EUR 15 bn per month from March to June 2023. Partial reinvestments of principal amounts will be allocated proportionally to the share of redemptions across each constituent of the APP. <sup>(28)</sup> As the principal payments would be invested only partially under the planned reduction of asset purchase programme holdings, the importance of the Bank of Spain as a holder of Spanish debt could gradually decline.

**33. At the beginning of 2023, financing conditions for the government appear broadly favourable but the cost of financing is increasing.** According to the Treasury's funding strategy for 2023, the total net-financing planned for the current year is EUR 70 bn. In 2022, the redemptions of maturing debt were EUR 162.5 bn. In 2023, the redemptions are expected to increase by about 15% to EUR 187 bn as the redemptions of medium and long-term debt increase from previous year. Up to early March this year, the Treasury had already issued about one quarter of the planned gross issuance in 2023 issuing more medium and longer-term maturity debt. The Treasury's funding strategy envisages an increase in the amount of outstanding medium and long-

<sup>(27)</sup> For a more detailed debt sustainability analysis, see Annex B.

<sup>(28)</sup> The constituent programmes of the APP are the public sector purchase programme (PSPP), the asset-backed securities purchase programme (ABSPP), the third covered bond purchase programme (CBPP3) and the corporate sector purchase programme (CSPP). The ECB published details about the modalities for reducing asset purchase programme holdings on 2 February 2023. See: <https://www.ecb.europa.eu/press/pr/date/2023/html/ecb.pr230202~1a4ecbe398.en.html>

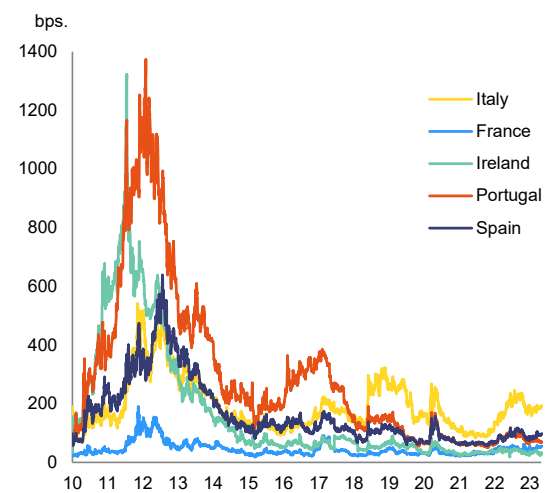


term government bonds and a reduction in the amount of outstanding T-bills. The average maturity of the debt stock overall rose above 8 years in early 2022 and has since then slightly declined to remain narrowly below 8 years. Recently the stock of longer maturity bonds (10 years and above) has grown faster than the overall debt stock. This is expected to support the average maturity to remain close to recent levels in 2023. The central government average interest rate of outstanding debt declined to 1.5% in early 2022. Since then the interest rate started to rise and reached 1.7% at the end of 2022. In the course of 2022, the yield at issuance increased from 0.75% (average nominal interest rate for 10-year bond issued in January) to 2.9% reflecting the monetary policy decisions taken in the euro area. In March 2023, the yield at issuance on 10-year bond was 3.4%.

**34. Since 2022, sovereign spreads have increased following similar developments in peer economies.** The expected slowdown in economic growth, the higher inflation and the less accommodative monetary policy stance led to an increase in spreads from March until the last week of October 2022, when spreads have started to decline again. On the back of improved financial market conditions, sovereign spreads stabilised towards the end of 2022 and the beginning of 2023 at around 100 basis points (Graph 5.1). Overall, in line with the developments registered in recent years, sovereign spreads have continued to remain below the spreads of Italy, but above those of France, Ireland and Portugal. In March 2022, Standard & Poor's changed Spain's sovereign credit rating outlook from negative to stable and affirmed the credit rating grade at A, while in July 2022, Moody's affirmed Spain's Baa1 rating and maintained a stable outlook <sup>(29)</sup>.

<sup>(29)</sup> Spain's credit rating by the main rating agencies is A (stable outlook by Standard & Poor's, stable outlook by DBRS), A- with stable outlook by Fitch and Baa1 with stable outlook by Moody's.

Graph 5.1: **Sovereign spreads to the 10-year German bund**



Source: IHS Markit, own calculations.

**35. The outstanding amount of the ESM loan stands at EUR 20.1 bn, which represents 49% of the total amount disbursed to Spain under the programme.** The repayment of the loan principal by the Spanish Government started in July 2014. Between July 2014 and October 2018, Spain made nine voluntary early repayments. In December 2022 – in accordance with the agreed repayment schedule – Spain made a repayment worth EUR 3.6 bn. In 2023, Spain will repay a similar amount to reduce its ESM loan and the last repayment will be done in 2027.

**36. While the structural features of government debt reduce the vulnerabilities arising from the elevated debt levels and rising market interest rates, a high ratio of public debt warrants the monitoring of financing conditions.** Spain's public debt remains well above the pre-pandemic level and in 2023, the gross financing needs will be higher than in the previous year. Assuming that non-resident investors' and the Eurosystem's holdings of Spanish debt would not increase based on recent trends, resident investors' role will gain in importance going forward. Given the high overall debt stock, short-term financing needs and increased market rates will gradually result in an increase in actual interest expenditure. On the positive side, the increases in the average costs of financing come from low levels and the spread with respect to German bonds has stabilised. Additionally, there are currently no signs of

investors seeking less risky, shorter maturity bonds. Owing to high average maturity, the Treasury is considered to have a buffer against possible shifts in investors' demand towards higher yield. As regards other government sector debt, the current situation is considered stable. Overall, therefore, risks concerning Spain's public debt are currently sufficiently contained to ensure the capacity to service its debt.

# ANNEX A

## Main macroeconomic and financial indicators

Table A.1: Main macroeconomic and financial indicators

	2000 -2007	2008 -2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023 (f)	2024 (f)
<b>Core indicators</b>													
GDP growth rate	3.7	-1.3	1.4	3.8	3.0	3.0	2.3	2.0	-11.3	5.5	5.5	1.9	2.0
of which domestic demand incl. stocks	4.5	-3.1	1.9	3.9	2.0	3.1	2.9	1.6	-9.1	5.2	3.1	1.4	2.3
Private consumption (annual % change)	3.7	-2.1	1.7	2.9	2.7	3.0	1.7	1.1	-12.2	6.0	4.4	0.9	2.3
Public consumption (annual % change)	5.0	0.9	-0.6	2.0	1.0	1.0	2.3	1.9	3.5	2.9	-0.7	1.7	0.6
HICP (annual % change)	3.2	2.2	-0.2	-0.6	-0.3	2.0	1.7	0.8	-0.3	3.0	8.3	4.0	2.7
Unemployment rate (% of labour force)	10.6	20.2	24.5	22.1	19.6	17.2	15.3	14.1	15.5	14.8	12.9	12.7	12.4
Gross fixed capital formation (% of GDP)	27.7	21.4	17.8	18.0	18.0	18.7	19.4	20.0	20.4	19.8	20.1	20.3	20.8
Gross national saving (% of GDP)	22.3	18.8	19.6	21.0	21.9	22.2	22.3	22.9	21.0	21.8	21.6	22.9	23.2
<b>General Government (% of GDP)</b>													
Balance (g)	0.4	-9.0	-6.1	-5.3	-4.3	-3.1	-2.6	-3.1	-10.1	-6.9	-4.8	-4.1	-3.3
Gross debt	46.7	69.0	105.1	103.3	102.7	101.8	100.4	98.2	120.4	118.3	113.2	110.6	109.1
Interest expenditure	2.2	2.4	3.5	3.0	2.8	2.5	2.4	2.3	2.2	2.2	2.4	2.5	2.4
<b>Households</b>													
Households saving rate	8.9	8.9	6.3	7.2	7.1	5.8	5.6	8.2	17.7	13.8	7.2	7.0	6.6
<b>Rest of the world (% of GDP)</b>													
Trade balance	-3.7	-0.1	3.1	3.0	4.0	3.6	2.7	2.9	1.5	1.5	1.4	2.3	2.1
Trade balance, goods	-6.8	-4.1	-2.1	-1.9	-1.3	-1.9	-2.4	-2.1	-0.8	-1.6	-4.4	-4.1	-4.1
Trade balance, services	3.1	4.0	5.2	5.0	5.3	5.5	5.1	5.1	2.2	3.1	5.8	6.4	6.3
Current account balance	-5.9	-2.9	1.7	2.0	3.2	2.8	1.9	2.1	0.6	1.0	0.6	1.6	1.5
Net financial assets	-55.3	-91.6	-95.4	-88.3	-84.7	-85.3	-77.3	-72.5	-83.9	-70.0	n.a.		
Net international investment position (h)	-56.5	-91.6	-95.9	-88.9	-85.4	-85.5	-79.1	-73.7	-85.7	-71.5	-60.5		
<b>Competitiveness (index, 2015=100)</b>													
Real effective exchange rate relative to the rest of the euro area	104.6	107.9	100.4	100.0	98.3	98.1	97.7	99.7	102.4	102.4	99.3	98.2	98.0
Real effective exchange rate relative to the rest of the European Union	104.8	107.7	100.3	100.0	98.1	97.6	97.2	99.0	101.8	101.9	98.6	97.2	96.7
Real effective exchange rate relative to the rest of 37 industrialised countries	104.4	111.7	104.2	100.0	99.0	99.8	101.0	101.6	105.0	n.a.	n.a.		
<b>Banking sector</b>													
Assets (% of GDP)	214.9	325.0	287.9	262.4	244.8	234.3	219.7	214.9	258.8	248.8	224.1		
Private domestic credit (y-o-y %)	15.7	-3.0	-6.5	-4.2	-4.1	-2.0	-3.9	-1.5	3.3	-0.2	-0.6		
Non-performing loans (NPLs), total (%) (i)	1.0	7.7	12.5	10.1	9.1	7.8	5.8	4.8	4.5	4.3	3.5		
NPLs, productive activities (%)	1.0	10.8	18.5	14.6	13.1	10.3	6.9	5.4	5.0	4.8	4.2		
* of which, construction, and (%)	0.9	17.3	32.6	30.0	29.1	24.1	14.0	11.7	9.2	8.5	8.1		
* real estate activities (%)	0.5	19.8	36.2	27.5	25.5	18.1	9.0	5.2	5.0	4.1	3.8		
NPLs, residential mortgages (%)	0.4	3.7	6.3	5.1	5.2	5.6	4.9	4.1	3.8	3.5	2.7		
<b>ECB ratios (%) (j)</b>													
NPL (domestic and controlled foreign branches and banks)	n.a.	n.a.	8.1	6.3	5.7	4.4	3.7	3.1	2.8	2.9	n.a.		
* of which non-financial corporations	n.a.	n.a.	16.4	12.8	10.9	7.9	5.9	4.7	4.6	4.8	n.a.		
* of which households	n.a.	n.a.	5.3	4.5	4.5	4.4	4.0	3.6	3.4	3.8	n.a.		
Coverage	n.a.	61.7	46.4	46.8	45.0	42.7	43.7	43.7	45.6	41.7	n.a.		
Return on equity (k)	n.a.	1.8	6.7	6.6	5.0	7.0	8.2	6.7	-3.5	10.2	n.a.		
Return on assets (k)	n.a.	0.1	0.5	0.5	0.4	0.5	0.6	0.5	-0.2	0.7	n.a.		
Total capital	n.a.	12.1	13.6	14.5	14.7	15.4	15.4	15.7	16.8	17.3	n.a.		
CET 1	n.a.	n.a.	11.8	12.7	12.8	12.6	12.2	12.5	13.2	13.3	n.a.		
Tier 1	n.a.	9.8	11.8	12.7	13.0	13.2	13.5	13.8	14.7	15.0	n.a.		
Loan-to-deposit	n.a.	n.a.	90.3	91.7	92.5	89.3	90.6	92.6	85.5	82.8	n.a.		
<b>Interest rates</b>													
10 year spread vis-à-vis the Bund (%)	0.1	2.1	1.5	1.2	1.3	1.2	1.0	0.9	0.9	0.6	0.9		
CDS 5 year (basis points)	n.a.	221.5	90.3	84.1	82.0	67.4	62.6	52.0	68.0	33.6	48.8		

Updated on 28 April 2023.

(f) forecast

(g) General government balances include capital transfers related to support of banks

(h) ESA2010 and BPM6, latest quarter divided by a 4 quarters rolling GDP

(i) NPLs: ratios, in % of total loans, end-of-period, source: BdE

(j) ECB ratios, end-of-period

(k) annualised

**Source:** Ameco, BdE, Boursorama, ECB, Eurostat, IHS Datainsight.

## ANNEX B

### Debt sustainability analysis

**This Annex assesses fiscal sustainability risks for Spain over the short-, medium- and long-term.** It follows the same multi-dimensional approach as the European Commission's 2022 Debt Sustainability Monitor, updated based on the Commission 2023 spring forecast.

**1 - Short-term risks to fiscal sustainability are low overall.** The Commission's early-detection indicator (S0) does not signal major short-term fiscal risks (Table B.2).<sup>(30)</sup> Government gross financing needs are expected to remain large at around 20.5% of GDP in the short-term (i.e. over 2023-2024), although declining compared with the recent peak in 2020 (Table B.1). Financial markets' perceptions of sovereign risk are investment grade, as confirmed by the main rating agencies.

**2 - Medium-term risks to fiscal sustainability are high overall.**

**The DSA for Spain shows that, under the baseline, the government debt ratio is projected to remain at a high level over the medium term (at 106% of GDP in 2033), despite a decline until 2029 (Table B.1)**<sup>(31)</sup><sup>(32)</sup>. The assumed structural primary balance (a deficit of 0.8% of GDP) contributes to these developments. It appears plausible compared with past fiscal

performance, indicating that the country has room for corrective action. At the same time, the baseline projection benefits until 2031 from a still favourable (although declining) nominal interest-growth rate differential, notably thanks to the favourable impact of NextGenerationEU, with real GDP growth at around 1.0% over 2025-2033. This differential is projected to turn slightly unfavourable in 2032. Government gross financing needs are expected to remain large over the projection period, reaching around 20% of GDP in 2033, close to the level forecast for 2024.

**The baseline projection is stress-tested against four alternative scenarios to assess the impact of changes in key assumptions (Graph 1).** For Spain, reverting to a historical fiscal position under the 'historical structural primary balance (SPB)' scenario would slightly worsen the government debt trajectory. If the SPB gradually converged its historical 15-year average (-1.1% of GDP), the projected debt-to-GDP ratio would be about 2 pps. higher than in the baseline by 2033. A permanent worsening of the macro-financial conditions, as reflected under the 'adverse interest-growth rate differential' scenario (with a differential 1 pp. higher than the baseline) would result in a persistently higher debt ratio, by around 9 pps. of GDP by 2033, as compared with the baseline. A temporary worsening of financial conditions, as reflected in the 'financial stress' scenario (with a temporary increase of interest rates by 2.4 pps.), would also lead to a higher public debt-to-GDP ratio (+2 pps. by 2033) compared with the baseline. The 'lower structural primary balance' scenario (with the SPB level permanently 0.4 pp. lower than in the baseline) would also lead to a higher government debt-to-GDP ratio (+4 pps. by 2033) compared with the baseline.

**Additionally, stochastic debt projections point to high risk.**<sup>(33)</sup> These projections point to 32% probability of the debt ratio in 2027 being greater than in 2022, entailing high risk given the initial high debt level (Graph 2). In addition, such shocks point to significant uncertainty (as measured by the difference between the 10th and 90th debt

<sup>(30)</sup> The S0 is a composite indicator of short-term risk of fiscal stress. It is based on a wide range of macro-financial and fiscal variables that have proven to perform well in the past in detecting situations of upcoming fiscal stress.

<sup>(31)</sup> The assumptions underlying the Commission's 'no-fiscal-policy-change' baseline notably comprise: (i) a structural primary deficit, before ageing costs, of 0.8% of GDP as of 2024; (ii) inflation converging linearly towards the 10-year forward inflation-linked swap rate 10 years ahead (which refers to the 10-year inflation expectations 10 years from now); (iii) the nominal short- and long-term interest rates on new and rolled over debt converging linearly from current values to market-based forward nominal rates by T+10 (as for all Member States); (iv) real GDP growth rates from the Commission 2023 spring forecast until 2024, followed by EPC/OGWG 'T+10 methodology' projections between T+3 and T+10, i.e. for 2025-2033 (on average 1.0%); (v) ageing costs in line with the 2021 Ageing Report (European Commission, Institutional Paper 142, November 2020). For information on the methodology, see the 2022 Debt Sustainability Monitor (European Commission, Institutional Paper 199, April 2023).

<sup>(32)</sup> Table 1 shows the baseline debt projection and its breakdown into the primary balance, the snowball effect (the combined impact of interest payments and nominal GDP growth on the debt dynamics) and the stock-flow adjustment.

<sup>(33)</sup> These projections show the impact on debt of 2000 different shocks affecting the government's primary balance, economic growth, interest rates and exchange rates. The cone covers 80% of all simulated debt paths, therefore excluding tail events.

distribution percentiles) surrounding the baseline debt projections.

### **3 - Long-term risks to fiscal sustainability for Spain are medium overall<sup>(34)</sup>.**

**The S2 sustainability gap indicator (at 0.7 pp. of GDP) points to low risk.** This suggests that Spain would need to improve its structural primary balance only by a limited amount to ensure debt stabilisation over the long term. This result is underpinned by the projected decrease in ageing-related costs (contribution of -0.6 pp. of GDP) while the initial budgetary position is unfavourable (contribution of +1.3 pps. of GDP) (Table B.2). Developments in ageing costs are primarily driven by the projected decrease in public pension expenditure (contribution of -2.0 pps. of GDP). However, pension spending will first increase to reach a peak of 13.5% of GDP in 2045 before starting to decrease (the impact of the recently adopted pension reform under the RRP is not included in this projection). On the other hand, health and long-term care spending is projected to increase over the projection period (joint contribution of 1.7 pps. of GDP). As a result, while a number of investments and reforms in the RRP contribute to supporting the efficiency of the Spanish health system, additional measures may be required to further improve its efficiency and its fiscal sustainability.

**Yet, combined with debt vulnerabilities highlighted by the S1 indicator, overall long-term risks are assessed as medium.** Indeed, the S1 sustainability gap indicator signals that a significant consolidation effort of 2.2 pps. of GDP would be needed to reduce debt to 60% of GDP by 2070 (Table B.2). This result is mainly driven by

the high level of the Spanish government debt ratio and deficit (contributing 1.0 pp. and 0.8 pp. of GDP, respectively).

**Finally, several additional risk factors need to be considered in the assessment.** On the one hand, risk-increasing factors relate the recent increase in interest rates and the elevated level of external and private debt, which may amplify the adverse impact of the tightening of financial conditions on households' and firms' financial position. On the other hand, risk-mitigating factors include the lengthening of debt maturity in recent years, relatively stable financing sources featuring a well-diversified and large investor base, and the currency denomination of debt. In addition, the structural reforms under the NGEU/RRF, if fully implemented, could have a further positive impact on GDP growth in the coming years, and therefore further mitigate the debt sustainability risks.

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<sup>(34)</sup> The S2 fiscal sustainability indicator measures the permanent SPB adjustment in 2024 that would be required to stabilise public debt over the long term. It is complemented by the S1 indicator, which measures the fiscal gap in 2024 to bring the debt-to-GDP ratio to 60% in the long term. For both the S1 and S2 indicators, the risk assessment depends on the amount of fiscal consolidation needed: 'high risk' if the required effort exceeds 6 pps. of GDP, 'medium risk' if it lies between 2 pps. and 6 pps. of GDP, and 'low risk' if the effort is negative or below 2 pps. of GDP. The overall long-term risk classification brings together the risk categories derived from S1 and S2. S1 may notch up the risk category derived from S2 when it signals a higher risk than S2. See the 2022 Debt Sustainability Monitor for further details.

Table B.1: Debt sustainability analysis - Spain

Table 1. Baseline debt projections	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033
Gross debt ratio (% of GDP)	120.4	118.3	113.2	110.6	109.1	107.7	106.5	105.4	104.8	104.5	104.5	104.8	105.5	106.0
Changes in the ratio	22.2	-2.1	-5.0	-2.6	-1.5	-1.4	-1.2	-1.0	-0.6	-0.3	0.0	0.3	0.7	0.5
of which														
Primary deficit	7.9	4.7	2.4	1.6	0.9	0.8	0.6	0.5	0.4	0.4	0.4	0.4	0.5	0.5
Snowball effect	13.5	-6.7	-8.3	-4.4	-2.8	-2.2	-1.8	-1.5	-1.0	-0.7	-0.4	-0.1	0.2	0.0
Stock-flow adjustments	0.8	-0.1	0.9	0.1	0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross financing needs (% of GDP)	27.8	24.7	21.7	20.2	19.6	19.1	18.9	18.8	18.9	19.0	19.1	19.4	19.7	20.0

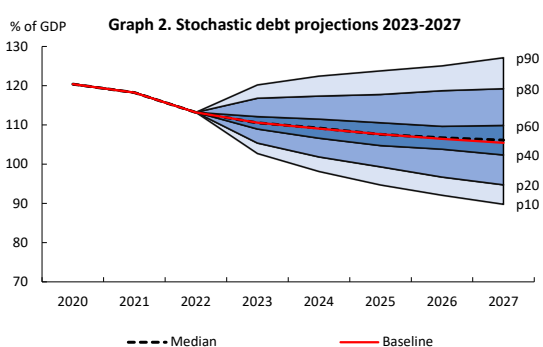
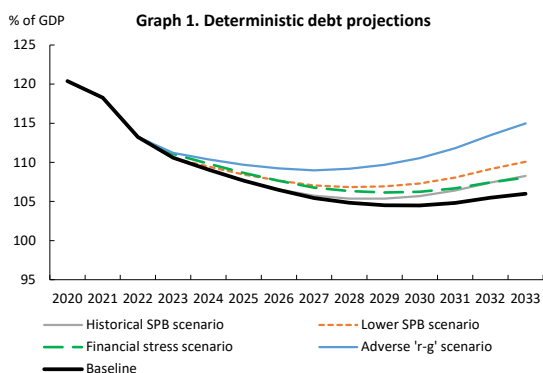


Table 2. Breakdown of the S1 and S2 sustainability gap indicators

	S1	S2
Overall index (pps. of GDP)	2.2	0.7
of which		
Initial budgetary position	0.8	1.3
Debt requirement	1.0	
Ageing costs	0.4	-0.6
of which		
Pensions	-0.5	-2.0
Health care	0.9	1.1
Long-term care	0.4	0.6
Others	-0.4	-0.4

Source: Commission services.

Table B.2: Heat map of fiscal sustainability risks - Spain

Short term	Medium term - Debt sustainability analysis (DSA)						Long term				
	Overall (S0)	Overall	Deterministic scenarios					S2	S1	Overall (S1 + S2)	
		Baseline	Historical SPB	Lower SPB	Adverse 'r-g'	Financial stress	Stochastic projections				
LOW	HIGH	Overall	MEDIUM	MEDIUM	MEDIUM	HIGH	MEDIUM	HIGH	LOW	MEDIUM	MEDIUM
		Debt level (2033), % GDP	106.0	108.3	110.1	115.0	108.0				
		Debt peak year	2022	2022	2022	2033	2022				
		Fiscal consolidation space	63%	69%	73%	63%	63%				
		Probability of debt ratio exceeding in 2027 its 2022 level						32%			
						37.4					

(1) Debt level in 2033. Green: below 60% of GDP. Yellow: between 60% and 90%. Red: above 90%. (2) The debt peak year indicates whether debt is projected to increase overall over the next decade. Green: debt peaks early. Yellow: peak towards the middle of the projection period. Red: late peak. (3) Fiscal consolidation space measures the share of past fiscal positions in the country that were more stringent than the one assumed in the baseline. Green: high value, i.e. the assumed fiscal position is plausible by historical standards and leaves room for corrective measures if needed. Yellow: intermediate. Red: low. (4) Probability of debt ratio exceeding in 2027 its 2022 level. Green: low probability. Yellow: intermediate. Red: high (also reflecting the initial debt level). (5) the difference between the 90th and 10th percentiles measures uncertainty, based on the debt distribution under 2000 different shocks. Green, yellow and red cells indicate increasing uncertainty.

Source: Commission services.

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