Independent Authority for Fiscal Responsibility

Debt Monitor, June 2018

I. EXECUTIVE SUMMARY

The general government (GG) debt-to-GDP ratio stood at 98.8% in the first quarter of 2018, increasing 0.5 percentage points compared to the end of 2017, reaching 1.16 billion euros, a new historic high. The data published by the Bank of Spain for the first quarter of 2018 as well as the Quarterly Spanish National Accounts (QSNA) by the National Statistics Institute (INE) put the debt-to-GDP ratio for the GG at 98.8% (€1,160.6 billion), which represents an increase of half a point of GDP with respect to the last quarter of 2018 and a new historic high in euros. On a year-to-year basis, the outstanding debt has increased €34.3 billion, while the debt-to-GDP ratio has fallen 0.9 percentage points.

When disaggregating the quarter-to-quarter debt evolution by sub-sector, it can be observed that the debt-to-GDP ratio has decreased in the Central Administration (CA), decreased slightly in the Autonomous Regions and remained stable in the Local Governments (LGs) and Social Security Funds (SSF). In the first quarter of 2018, the CA and the SSF reached a debt-to-GDP ratio of 71.7% (€842.06 billion), 0.6 percentage points above the previous quarter. For the LG sub-sector, the ratio is maintained at 2.5% GDP (€28.88 billion), while for all Regions the debt-to-GDP ratio increased 0.1 percentage points compared to the previous quarter and remains virtually unchanged on a year-to-year basis, standing at 24.7% GDP (€289.67 billion). In the case of the Regions, the quarterly increase in the debt of Extremadura (+0.8 p.p.), Galicia and Basque Country (+0.7 p.p.) stand out, and on the opposite end the reductions observed in Valencia (1.1 pp.), Cantabria and Navarre (0.5 pp.) are worth noting.

The debt reduction dynamics associated with a scenario of compliance with the framework of fiscal rules implies the achievement of the benchmark of 60% GDP around the year 2034. An alternative scenario, which would maintain the structural deficit unchanged, would stabilise the debt-to-GDP ratio in the medium term at around 90% GDP. In the baseline debt scenario, which supposes the continuity of the fiscal consolidation process and compliance with fiscal rules, it is projected that there will be a slightly declining trend, which would delay the GG's achievement of the reference value of 60% GDP until 2034. However, in a "no policy change" scenario, which implies a relaxation in the rate of correction of the structural deficit (i.e. if the current policies were maintained), the debt-to-GDP ratio would stabilise around 90%, becoming more vulnerable to negative shocks (i.e. decreases in the growth rate, increase in interest rates, etc.). Although the situation is very heterogeneous among the Regions, under the assumptions of the baseline scenario it is projected that in the next 30 years all the Regions, except Valencia, will reach the reference value. Conversely, in the "no policy change" scenario, the number of Regions where this target will be achieved over the next 30 years drops to six (Balearic Islands, Canary Islands, Galicia, Madrid, Navarre and

Basque Country). In the latter case, as well as for the GG, the debt path would return to growth in many Regions.

Despite the recent positive macroeconomic trends and highly favourable conditions in the financial markets, the decline in the debt-to-GDP ratio continues to be limited. Although the year-on-year growth until the first quarter of 2018 amounts to 3.1%, the debt-to-GDP ratio has been corrected by just 0.9% GDP in the last four quarters, which implies a limited reduction rate given the high level of current debt. The LG sub-sector has been the only one to reach the reference value (3% GDP) of the Stability Law. At the regional level, the best placed are Canary Islands, Madrid and Basque Country, which will reach a level close to the reference value, set at 13% of GDP, within the next 3 years. The rest of the Regions and sub-sectors will not reach the reference values in the medium term under any of the scenarios considered. As has been mentioned on several occasions, the impossibility of compliance with the time frames and reference levels laid down in the law calls for its review, so that demanding but realistic paths may be established.

The General Government's debt-to-GDP path projected by the government is still considered to be likely in the medium term. After including the latest data published relating to the GG accounts, National Accounts and interest rate trends, the materialization of the 2018-2021 debt projections contained in the Stability Programme Update (SPU) presented last April are still deemed as likely, according to the confidence interval of AIReF's baseline scenario. The path of the debt-to-GDP ratio is in the middle of the confidence interval in the first two years, but as the time horizon extends the probability of materialisation declines, becoming unlikely in 2021. An analysis of the sensitivity of debt dynamics in relation to changes in the main determinants identifies the main risks in the medium term as the correction of the structural deficit and the maintenance of primary surpluses.

In parallel to the improvement in the credit rating of the debt issued by the Spanish Treasury, and supported by a dynamic growth and a progressive correction of its deficit path, there is a general improvement in the credit rating of the Regions. The credit rating of the Spanish Treasury debt carried out by the agencies S&P and Fitch is maintained in the category of middle-upper grade investment. With respect to the last update of the Monitor, in the case of the Regions there has been a generalised improvement in the rating, mainly due to the improvement experienced by the Treasury debt. Moody's has improved the rating of all Regions analysed except for Catalonia due to its "unresolved political instability".

At the regional level, there are slightly high sustainability risks that are distributed very uniformly across the different Regions. For all Regions it is expected that the macroeconomic and financial indicators will contribute to reducing sustainability risk in the short term, while in the long term, one of the main challenges remains the high debt-to-GDP ratio, which is almost double the reference level of 13% included in the Stability Law and determines a slightly high-risk level. With respect to the last quarter of 2018, there are no major changes in the sustainability risk indicator in any of the Regions. The composite sustainability risk indicator does not present any important changes in any of the Regions that would justify a change in their rating. In this sense, there continues to be a very high sustainability risk in Catalonia, Castile-La Mancha, Murcia and Valencia. Under current conditions, the return to market discipline for these Regions does not seem feasible. Andalusia and Extremadura stand in the middle of the classification, which present a risk slightly high, alongside Aragon with medium risk. Finally, the available information indicates that in nine Regions the sustainability risk is slightly low (Cantabria, Castile and León, Asturias and Galicia) or low (Navarre, Rioja, Canary Islands, Madrid and Basque Country). In this edition of the Monitor, AIReF has enriched its risk assessment methodology with the aim of facilitating historical comparison (between various editions of the Monitor) and horizontal comparison (both between Regions in the same scenario and between scenarios).

Access to state funding continues to increase in general, including for the Regions with low sustainability risk, which reflects a system that does not incentivise the progressive return to market discipline. The extraordinary financing mechanisms for the Regions have continued to rise both in absolute terms (reaching €168.5 billion in the first quarter of 2018) and in relative terms (representing almost 60% of the total debt of the regional sub-sector). In the first quarter of 2018 extraordinary financing mechanisms represent over three quarters of the regional debt of five Regions (Valencia, Murcia, Andalusia, Balearic Islands and Castile-La Mancha). In absolute terms, the use of the mechanisms by the Regions remains uneven, as 70% of the total loans granted to the Regions belongs to three Regions, Catalonia (32% of the total), Valencia (22%) and Andalusia (16%). With respect to the 2017 total, in the first half of 2018 the funding of the Financial Facility compartment has already been doubled, a reflection of a framework that limits incentives to reincorporation into market discipline. Currently, three Regions cover their long-term financing needs in the capital markets (Navarre, Basque Country and Madrid), a further seven are financed in the Financial Facility compartment (Andalusia, Asturias, Balearic Islands, Canary Islands, Castile and León, Galicia and Rioja) and the remaining seven exclusively use the Regional Liquidity Fund (RLF).

The gross debt-to-GDP ratio of the LG sub-sector stands at historic lows and net debt is around 0% GDP, with accumulated total deposits of around €25 billion. Since the beginning of 2013, the debt-to-GDP in the LG sub-sector has fallen steadily, reaching the reference level of 3% in mid-2016. In early 2018, the debt of the sub-sector already represented approximately 2.5% GDP and is expected to continue to decline in the medium term. Although since 2013 the accumulated primary balance for the sub-sector exceeds 3% GDP, in many city councils the debt has been fully erased or they chose to not amortise the remaining capital in advance, generating an accumulation of financial assets that represent 2.1% GDP (€24,391 billion) in the first quarter of 2018. The above would imply a net financial assets debt of close to zero and a debt to cash and deposits ratio of over 80% in the first quarter of 2018 (historic high). However, although both the gross and net debt-to-GDP ratios are at historic lows since 1995, it must be noted that there are still individual cases with medium or high financial sustainability risk, where the debt is greater than 75% Consolidated Current assets (Malaga, Murcia, Valencia, etc.). In part due to the number of LGs in Spain and the dispersal of the information needed for the sustainability analysis, AIReF recently published the Local Government Monitor, providing all the relevant public with the information in one place and in an interactive and friendly manner.

TABLE 1. DEBT AND DERIVED INDICATORS. GENERAL GOVERNMENT SUB-SECTORS AND DETAIL OF REGIONS (% GDP)

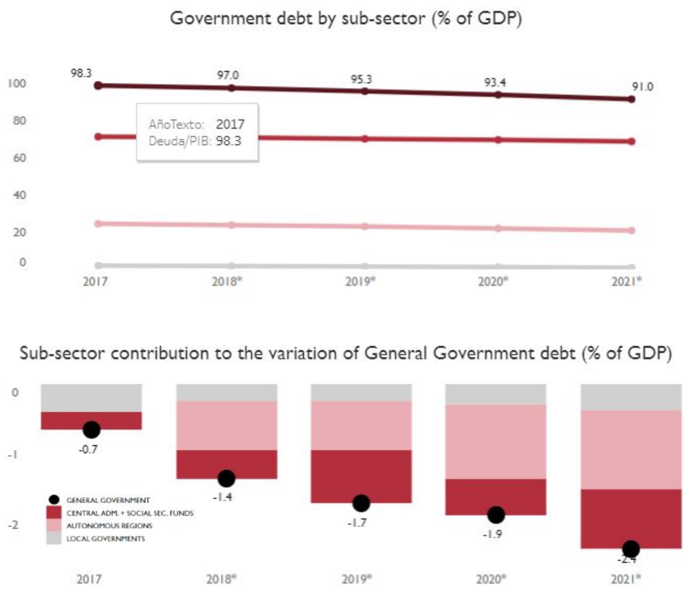
Debt			Projections				Necessary days per person to repay debt [3] 2018				Rating [4]			Debt cost 2016		Public financing mechanisms (% debt)	Debt per capita (€)	Debt / Current Revenue (%) [5]	GFN / Current Revenue (%) [6]	Fiscal effort indicator S1 [7]
	2007	2017	2018	2019	2020	2021	2018 regional	2018 common	2018 total	Δ 07-18 total	Moody's	S&P	Fitch	Implicit rate	%GDP	2018 -I	2018	2017	2018	2018
General Government [1]	35,6	98,3	97,0	95,3	93,4	91,0	-	-	-	-	-	-	-	2,4	2,6	-	25380	262,5	-	-
Central Adm+SSF	27,2	71,1	70,7	69,9	69,4	68,6	-	-	-	-	Baa2 (4) ↔	A- (3) ↗	A- (3) ↗	2,6	2,1	-	-	408,3	-	-
Local Corporations	2,7	2,5	2,3	2,0	1,7	1,3	-	-	-	-	-	-	-	2,0	0,1	20,4	-	41,5	-	-
Total Regions [2]	5,7	24,8	24,0	23,3	22,3	21,1	-	-	-	-	-	-	-	1,6	0,4	58,2	6294	176,2	24,6	-
ANDALUCIA	4,8	22,1	21,4	20,5	19,2	17,9	78	362	441	282	Baa2 (4) ↗	BBB+ (4) ↔	BBB- (4) ↔	1,3	0,3	77,7	4118	133,4	22,2	-0,2
ARAG□N	3,4	22,1	21,5	21,2	21,0	20,7	78	240	318	206	-	BBB (4) ↗	-	2,1	0,4	44,9	6237	168,4	24,0	0,1
P. DE ASTURIAS	3,2	18,7	18,2	17,8	16,9	15,9	67	302	368	237	Baa1 (4)	-	-	1,1	0,2	36,4	4212	109,1	14,9	-0,2
ILLES BALEARS	6,9	29,4	27,6	26,1	24,0	22,0	101	259	360	233	-	BBB+ (4) ↗	-	1,3	0,4	75,5	7416	182,0	15,6	0,0
CANARIAS	3,7	15,9	14,9	13,4	10,9	8,4	54	327	381	244	-	A- (3) ↗	BBB (4) ↔	1,2	0,2	70,6	3175	93,6	2,6	-0,8
CANTABRIA	3,4	23,2	22,6	22,4	22,0	21,6	82	296	378	250	-	-	BBB (4) ↔	1,6	0,4	73,1	5327	129,0	17,2	0,1
CASTILLA Y LE□N	3,4	20,8	20,7	20,4	20,0	19,4	76	283	359	228	Baa1 (4) ↗	-	-	1,9	0,4	25,0	5095	140,4	19,0	-0,1
CASTILLA –LA MANCHA	4,7	36,0	35,2	34,6	33,3	32,0	128	340	468	316	Ba1 (5) ↗	-	BBB- (4) ↔	1,4	0,5	75,0	7209	228,6	28,0	0,8
CATALU□A	7,8	34,8	33,9	32,9	31,8	30,6	124	222	346	225	Ba3 (5) ↔	B+ (6) ↔	BB (5) ↔	1,6	0,5	70,2	10620	262,2	46,0	0,6
EXTREMADURA	4,5	23,8	23,8	23,9	23,8	23,3	87	387	474	295	Baa2 (4) ↗	BBB (4) ↔	-	1,6	0,3	53,1	4280	105,0	12,7	0,2
GALICIA	6,6	18,4	17,8	17,3	16,1	14,9	65	294	359	208	Baa1 (4) ↗	A- (3) ↗	-	1,8	0,3	51,0	4216	116,9	13,0	-0,2
COMUNIDAD DE MADRID	5,2	14,9	14,5	14,2	13,5	12,6	53	197	250	147	Baa1 (4) ↗	BBB+ (4) ↔	BBB (4) ↔	2,4	0,3	5,0	5139	136,1	14,7	-0,2
REGI□N DE MURCIA	2,3	29,0	29,3	29,4	29,3	29,2	107	325	432	293	Ba1 (5) ↗	-	BBB- (4) ↔	1,5	0,4	80,6	6275	188,2	29,3	0,8
C. FORAL DE NAVARRA	3,6	18,3	17,4	16,4	15,6	14,7	64	215	278	177	-	A+ (3) ↗	-	2,9	0,5	-	5651	92,6	6,9	-0,2
PA□S VASCO	1,0	14,1	13,3	12,4	11,4	10,3	49	200	249	159	A3 (3) ↗	A+ (3) ↗	A- (3) ↗	1,7	0,2	-	4628	88,6	7,6	-0,4
LA RIOJA	3,5	19,3	18,7	18,2	17,2	16,0	68	254	322	208	-	-	BBB (4) ↔	0,6	0,1	20,4	5142	127,6	27,5	-0,2
COMUNITAT VALENCIANA	11,3	42,5	41,3	40,4	38,9	37,5	151	301	451	289	Ba1 (5) ↗	BB (5) ↔	BBB- (4) ↔	1,0	0,4	81,4	9571	280,2	46,1	1,1

Source: INE, IGAE, Bank of Spain, DatosMacro.com and AIReF estimates (simulation corresponding to the baseline path).

Notes: 1) The debt-to-GDP ratios disseminated by the Bank of Spain are calculated with the nominal GDP estimated by the INE in the last Quarterly National Accounts. **2)** For the data published by the Bank of Spain relating to the debt-to-GDP ratio at market prices of each of the Regions, we took the corresponding regional GDP at market prices published by the INE, except for the last available data, where the regional structure of the Regional Accounts applies to the addition of the last four quarters of GDP at market prices. In the forecasts, the regional GDP at market prices estimate follows the METCAP-AIReF methodology. **3)** The person-days required to pay the debt by Region are derived by multiplying the respective regional debt-to-GDP ratio by 365. For the common debt (CA and SSF plus LG sub-sector) this is distributed regionally based on the size of the Region's population, so that the resulting regional debt-to-GDP ratio is multiplied by 365. **4)** (M) Moody's, Fitch (F) and (S) Standard and Poors. The quality can be (3) middle-upper, (4) middle-lower, (5) degree of non-speculative investment and (6) highly speculative. **5)** The income streams used are those published by IGAE, in accordance with the methodology of the ESA 2010. **6)** The current revenues correspond to 2016. **7)** Indicator S1 is defined as the average primary balance between 2017-2030 to achieve the goal of 13 per cent of GDP in 2030.

Cut-off date 15 June 2018.

FIGURE 1. CONTRIBUTION TO VARIATION OF GENERAL GOVERNMENT DEBT BY SUB-SECTOR (% GDP)



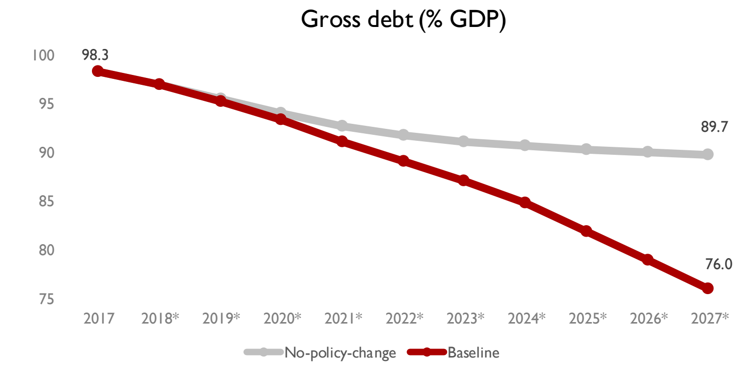
- The latest data published by the Bank of Spain put the debt at the end of 2018 at 98.8% GDP, 0.5 percentage points above the figure recorded in the previous quarter.
- In the first quarter of 2018, the CA and the SSF reached a debt-to-GDP ratio of 71.7%, 0.6 percentage points above the last quarter. For the Regions the debt-to-GDP ratio fell by 0.1 percentage point to stand at 24.7% GDP, while for the LG sub-sector, the ratio remained at 2.5% GDP, the lowest level of the past two decades.
- The AIReF baseline scenario envisages that the debt-to-GDP ratio will be reduced by 7.4 percentage points accumulated in the next 4 years, with half of this reduction corresponding to the Regions.

You can access the interactive version of the figure by clicking on the image

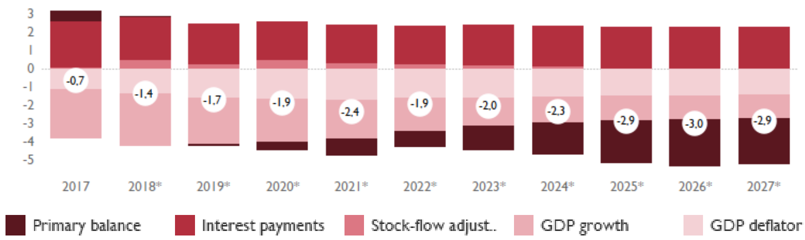
Source: INE, Bank of Spain and AIReF's estimates

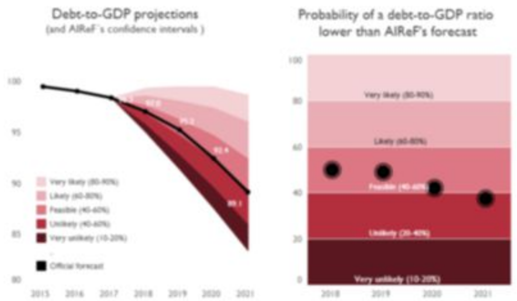
FIGURES 2, 3 AND 4. DEBT-TO-GDP RATIO PROJECTIONS AND SENSITIVITY ANALYSIS

DEBT DYNAMICS AND DETERMINANTS, BASELINE SCENARIO (% GDP)



CONTRIBUTIONS TO CHANGES IN DEBT-TO-GDP RATIO



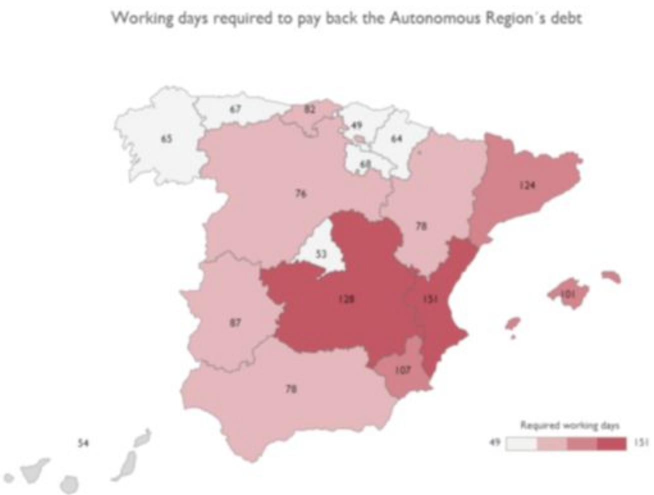


- The baseline scenario projects a mild but steady decline in the debt-to-GDP ratio over the next 10 years, remaining at the limit of 76% GDP in 2027. The GG's achievement of the reference value of 60% GDP is delayed until 2034.
- In the baseline scenario, the slowdown in economic growth is matched by a gradual improvement in the primary balance. For its part, the interest burden remains relatively stable, at slightly above 2% GDP.
- If the current structural deficit were maintained, the debt-to-GDP ratio would stabilise in the medium term around 90%, becoming more vulnerable to negative shocks.
- Debt forecasts contained in the 2018-2021 Stability Programme Update follow the same decreasing trend as the forecasts of the AIReF baseline scenario for the period,

You can access the interactive version of the figure by clicking on the image

Source: INE, MINECO, Bank of Spain and AIReF's estimates **Note**: Official forecast corresponds to 2018-2021 Spanish SPU

FIGURES 5 AND 6. INDICATORS OF REGIONAL PER CAPITA DEBT (NUMBER OF DAYS)

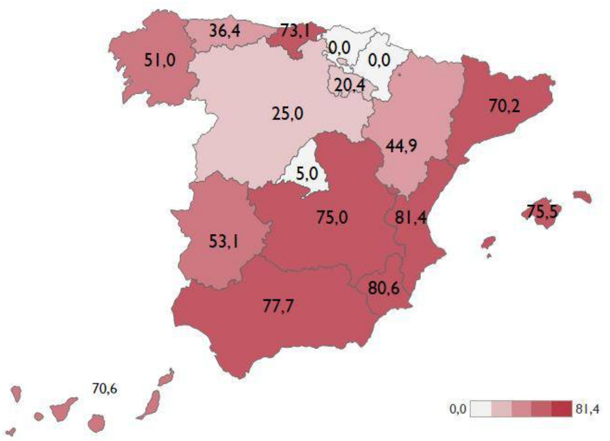


You can access the interactive version of the figure by clicking on the image

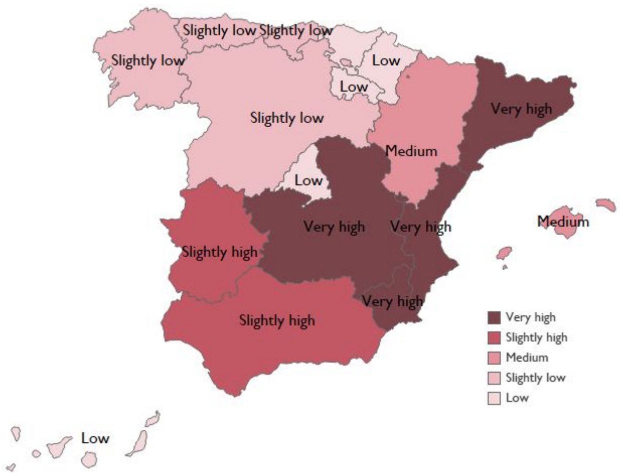
Source: AIReF **Note:** The person-days required to pay the debt in the regional case are derived by multiplying the regional debt-to-GDP ratio by 365. The common debt (CA and SFF plus LG) is distributed regionally based on the size of the population of the region, so that the resulting regional debt-to-GDP ratio is multiplied by 365.

FIGURES 7, 8 AND 9. DEPENDENCE ON STATE FUNDING AND ESTIMATED ARRIVAL AT REFERENCE LEVEL

Autonomous Regions' Total Debt and share held by the Central Government (FFCCAA)



Autonomous Region's Public Debt Sustainability Risk



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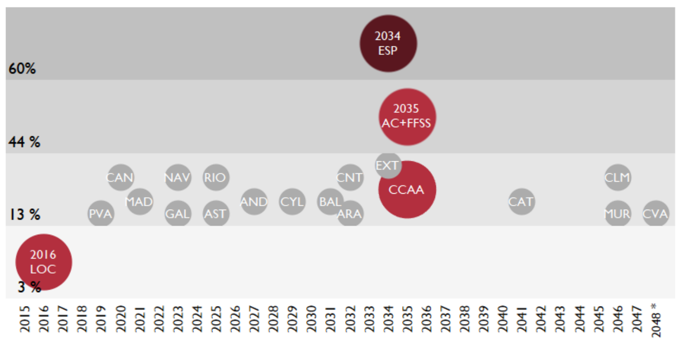
Source: Bank of Spain and AIReF's estimates

DEBT TARGET COMPLIANCE - PROJECTED YEAR



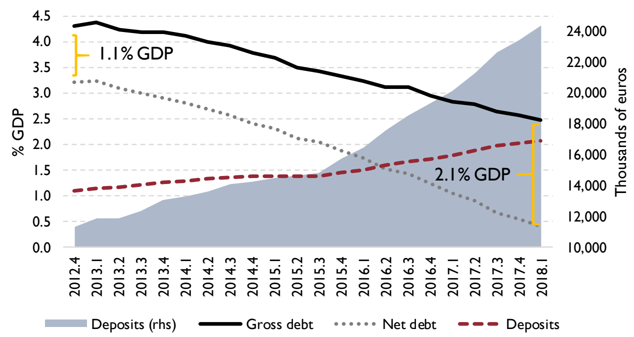
You can access the interactive version of the figure by clicking on the image

Source: INE, IGAE, Bank of Spain and AIReF's estimates

Note: * target is not met before 2048

- It is expected that, in 2018, the inhabitants of a Region would need to spend 88 days of work on average to repay the entire debt. In PVA or MAD that figure is around 50 days and is double this in BAL and MUR. This figure exceeds 120 days in CAT and CLM, reaching 151 in the case of CVA.
- The weight of regional funding has increased both in absolute terms (surpassing €168 billion) and in relative terms. three Regions cover their long-term financing needs in the capital markets (NAV, PVA and MAD), a further seven are financed in the Financial Facility compartment (AND, AST, BAL, CAN, CYL, GAL AND RIO) and the remaining seven exclusively use the RLF (ARA, CAT, CLM, CNT, CVA and MUR).
- 70% of the total regional funding in 2018 belongs to three Regions, CAT (32% of the total), CVA (22%) and AND (16%).
- The medium-term risks for regional debt sustainability are slightly high. The Regions present inconsistencies, which remain unchanged since last quarter, highlighting CAT, CLM, MUR and CVA with very high risk. At the other end, NAV and RIO have low sustainability risks, along with CAN, MAD and PVA.
- In the baseline scenario the regional sub-sector will not reach the reference value before 2035. However, in the "no policy change" scenario, only 6 Regions would reach 13% within the next 30 years (BAL, CAN, MAD, GAL, NAV and PVA).

FIGURE 10. LOCAL GOVERNMENT SUB-SECTOR DEBT



Source: Bank of Spain and AIReF's estimates

- In seasonally adjusted terms, the debt-to-GDP ratio continues to decline and is close to 2.5%, below the reference level of 3%.
- The accumulation of financial assets continues, representing 2.1%GDP (€24,391 billion) in the first quarter. This behaviour is due in part to obtaining positive budgetary balances in a structural way.
- Since 2012 the sub-sector's financial position has improved substantially, observing an increase in the debt to cash and deposits ratio from 25% to over 80% in the first quarter of 2018. Net financial assets debt stands at around 0.5% GDP.
- Both the gross and net debt-to-GDP ratios are at historic lows since.