Robust domestic demand and a resilient external sector kept GDP growth well above the euro area average in 2016. Despite political uncertainty, the headline public deficit continued falling in 2016, mostly benefiting from cyclical improvement in activity. The Spanish treasury's market access remained healthy in 2016, and the country completed its funding programme successfully. The banking sector showed stability, although profitability remained lacklustre, as elsewhere in Europe.

Spanish GDP, on its third consecutive yearly expansion, grew 3.2% in 2016 (the same rate as in 2015), outperforming most forecasts. Domestic demand, supported by private consumption, drove growth. For the first time since the recovery began, the external sector also contributed positively. Despite weak global trade, exports grew robustly, while imports of goods and services slowed. Low oil prices helped to amplify the improvement in the trade balance, leading to an increase in the current account surplus to 2.0% of GDP. Spain's international debtor position, which remains high, fell during 2016 and is expected to continue declining given a sustained surplus in external accounts. Low energy prices kept inflation subdued in 2016 but it accelerated slightly to -0.3% from -0.6% in 2015. Due to rising energy prices, headline inflation has gained momentum since the end of 2016, while underlying inflation has remained subdued, with food prices offsetting the increase in services inflation.

The robust activity supported strong job creation, although the participation rate fell to a seven-year low. Still, employment growth remained solid at 2.7%, helping to cut the unemployment rate to 18.7% by year-end 2016. Despite substantial private non-financial sector deleveraging (50 percentage points since its peak), private debt-to-GDP continued above the euro area average. Looking forward, the economy is projected to slow as low oil prices and expansionary economic policies fade.

Fiscal performance improved in 2016. The general government deficit dropped to 4.5% of GDP in 2016, a reduction of 0.6 percentage points from 2015, below the new target of 4.6% under the Excessive Deficit Procedure.[6] The government deficit excluding one-off transactions amounted to 4.3% of GDP. Fiscal consolidation was driven by strong growth, savings related to favourable financing conditions, and the new measures introduced following the 2016

[6] On 12 July 2016, the Council of the European Union decided that Spain had not taken effective action to correct its excessive deficit. After the national authorities' response, the Council agreed to forego a fine. In addition, the Council granted Spain two additional years to correct its excessive deficit, setting 2018 as the deadline.

MICHEL SAPIN

Minister for the Economy and Finance of the French Republic, ESM Governor

“The euro is a long-term economic and political project like no other. It rapidly became the second most used reserve currency internationally and acquired a strong credibility worldwide as well as a robust domestic support. Despite significant economic shocks over the years, its main outcomes are tremendous. For our economies, it caters for the need of monetary stability and full price and cost transparency, which support trade and investments while avoiding uncooperative exchange rate policies within the Union. For our 340 million citizens, the euro is now one of the main concrete realisations of the European project, thanks to which one travels freely in 19 countries with the same coins in hand. Yet the euro remains a work in progress, with some way to go on financial, fiscal, and political integration, dealing with macroeconomic imbalances within the zone, and strengthening cohesion and democratic legitimacy. But these challenges should only fuel further our commitment to protect and strengthen this common public good.”

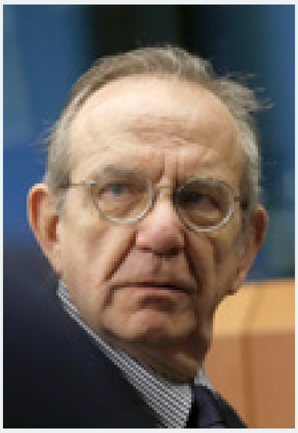
European Commission deficit recommendation.[7] The latter more than offset a tax revenue drop, related to the 2015–2016 fiscal reform. Public debt declined to 99.4% of GDP in 2016 from 99.8% in 2015.

The Spanish treasury successfully completed its 2016 funding programme in a low interest rate environment with both lowered funding costs and extended duration at issuance. The 10-year bond yield fell by 34 basis points in 2016, bucking a widespread sell-off in European sovereign bonds from September.

Spanish banks' financial condition was stable thanks to better asset quality, strong funding, satisfactory capitalisation, and its ongoing restructuring. As elsewhere in Europe, Spanish banks' profitability has remained weak due to the challenging environment. Banks' domestic net profits declined by one third in 2016, stemming from declining net interest income and increasing litigation costs that could not be offset by a drop in impairment charges. Although credit stock is decreasing, expanding bank lending to small and medium-sized enterprises and consumer credit supported the economy. Asset quality improved, albeit unevenly. NPL stock decreased by 13.4% year-on-year in 2016, which together with a fall in credit (-3.8%), led to a one percentage point decrease to 9.1% in the NPL ratio. Capital ratios remained slightly below the European average but above regulatory requirements, and banks performed satisfactorily in the 2016 EBA stress test. The government aims to merge the two state-owned banks to maximise the recovery of state investment.

Since the sixth post-programme mission in October 2016, economic and financial indicators have performed positively. Under its Early Warning System, the ESM continued to assess positively Spain's ability to honour its ESM loan service obligations. Additional early repayments of €3 billion are planned in 2017, leading to a total repayment of 23.3% of the programme by the end of 2017. Nevertheless, given high debt levels, a credible fiscal strategy and strong reform momentum are key to reducing vulnerabilities.

[7] On 9 March 2016, the European Commission issued its Recommendation regarding measures to be taken by Spain in order to ensure a timely correction of its excessive deficit.



PIER CARLO PADOAN

Minister of Economy and Finance of Italy, ESM Governor

"The euro has played a central role in European integration. Today the single currency continues to serve as a foundation of the euro area but the economic governance is falling short of the fundamental goals of fostering convergence among Member States and promoting growth, employment, and inclusion. Persisting fragmentations and a rapidly evolving international scenario require an urgent collective response based on credible reform efforts and effective risk sharing."