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Creating Opportunities

Spain Economic Outlook

3Q20

Expected evolution of the Spanish economy in light of the COVID-19 crisis

July 2020

Spanish GDP could contract by 11.5% in 2020 and grow by 7% in 2021. The fall in activity levels may have exceeded 20% in the first half of the year with respect to the end of 2019. The lockdown and social distancing measures implemented have managed to control the spread of COVID-19. However, the impact on economic activity has been significant. Restrictions on mobility and trade caused output to plummet by more than 30% during the last two weeks of March. The contraction was even greater in the first half of April (around 50%), when activity was limited to those sectors considered essential. The reduction in infections and the easing of restrictions have given way to a vigorous recovery. The expectation that this will continue is reinforced by ambitious policy announcements across Europe and by a significant fiscal boost within Spain. This opens up the possibility of more positive scenarios going forward. In any case, uncertainty is still high and most risks remain on the downside.

The downward revision of growth in 2020 is explained by the prolongation of the containment measures for a longer period than expected; by the greater impact of the restrictions on domestic demand; by a greater concentration of the reduction in expenditure on domestically produced goods and services; and by the contraction of the tourism sector. Greater caution in expenditure decisions as a result of increased uncertainty and supply constraints explain much of the fall in consumption. In particular, concerns about health and employment status, together with the longer duration of confinement and social distancing measures, led to an adjustment estimated to be in the order of 25% in household consumption expenditure during the first six months of the year. This focused, above all, on service-related sectors and, among these, on those where consumption takes place in a social context. Examples of this are in the restaurant, leisure and tourism sectors. On the other hand, the need to spend on consumption from home, together with the redirection of resources toward basic products needed to face the epidemic, increased the sale of goods, particularly food and health protection products, which resulted in a significant change in relative prices. One of the consequences of this was that the adjustment in household expenditure was more concentrated on domestically produced goods rather than on imports, resulting in a greater fall in GDP. At the same time, rules to prevent travel reached a global scale, which adversely affected the arrival of foreign tourists and, therefore, non-resident consumption in Spain, which plummeted by 90–100% compared to the end of 2019.

Falls in investment and exports have been severe, but somewhat less than expected at the onset of the crisis, while public consumption accelerated, acting as a stabilizer. As expected, the uncertainty has had a significant effect on gross fixed-capital formation, but lower than the one that could be inferred given the fall in GDP. Reductions in investment on machinery and equipment and housing have been particularly important, as the adjustment could have exceeded 30% in the first half of the year. Although the magnitude of these falls is noteworthy, they may have been softened by the inertia brought about by some projects and the costs of stopping them. Meanwhile, exports of goods have evolved relatively in line with GDP, despite frictions in value chains worldwide, the reduction in global demand and the negative impact that the crisis is having on strategic sectors for Spain, such as the automotive industry. Lastly, public consumption expenditure has accelerated considerably over the last six months. This consolidates a trend that has been noticeable since the end of last year, but which has been reinforced by the need for a response to the pandemic from public administrations.

The impact of the crisis, in addition to being significant, has been heterogeneous and different from the crisis observed in 2008. An example of this is the behavior of the labor market, in particular with regard to the typology of the workers affected. Unlike the 2008 crisis, where a large number of those who lost their jobs were men, this time around the occupations most affected have a greater presence of women. Similarly, although the fall in employment continues to be greater among young people, demographic change has meant that those over the age of 35 now account for more than half of those who have lost their jobs (compared to one fifth in 2008–2009). Another example is the construction sector, which for the first time in a long time is not one of the triggers of the crisis. For its part, the restaurant and tourism industry, traditionally a refuge sector in other times of uncertainty, is suffering considerably from the impact of the epidemic. It is worth noting here the relatively successful position of employment in companies whose activities can be carried out from home, unlike in others where the physical presence of the worker, employer or consumer is essential.

The containment of the epidemic has allowed for the easing of restrictions and a particularly intense economic recovery since the middle of the second quarter of the year which, if continued without major setbacks, could lead to a 10% quarterly increase in GDP in the third quarter. Since early May, a number of indicators point to an economic upturn, as limitations on movement and the opening of businesses have relaxed. In particular, those provinces that started to ease restrictions earlier have shown more premature expenditure recoveries.[1] Furthermore, each phase overrun has been accompanied by an extra consumption improvement. Ultimately, the restrictions have not affected all sectors equally: those that lifted confinement measures earlier are the ones that rebounded more quickly. In some sectors, it can already be seen that expenditure has exceeded levels observed before the onset of the crisis. All of the above could lead to an increase in household consumption of nearly 20% per quarter in 3Q20. Meanwhile, the changes in virus containment policies have also been adopted in many of Spain's main trading partners, which has allowed a recovery in trade flows of goods and services, although to varying degrees. While exports of goods could increase by 13.3% per quarter during the summer period, consumption by non-residents could triple, which in any case, given the extremely low starting levels, implies a demand equivalent to 30% of the level expected in the absence of coronavirus.

The European economy has reached a turning point, policies are becoming more expansionary and the possibility of more positive scenarios is opening up, as long as the epidemic remains under control. In much of the EMU, the health emergency appears to be on track, although with higher levels of infection than in Asian countries. In addition, governments such as Germany have continued to announce measures aimed at supporting domestic demand growth. In the United States, the discussion of a new fiscal stimulus continues. We can add two further positive announcements to this. On the one hand, the initiative of the Next Generation EU recovery fund. The budget (750 billion euros, equivalent to 5.4% of the EU's GDP) seems adequate for the size of the crisis. In addition, the option of beginning the program early in the last quarter of the year would allow it to coincide with the exhaustion of a number of measures introduced by countries with limited fiscal space. Its composition, oriented toward direct transfers (440 billion) and less focused on guarantees (310 billion), would maximize the effect on activity in the beneficiary economies. By significantly delaying the repayment of funds collected (from 2027), the risks of focusing attention on countercyclical policies, rather than structural measures that boost potential growth are avoided. The objectives set for the use of resources also seem appropriate (health emergency, boosting investment, strengthening the single market, digital and ecological transition). Finally, in practice, the joint financing and payment of these resources will be an important step toward further fiscal integration in Europe. Although there are still doubts about the details of the plan (for example, under what criteria the funds will be distributed, how the use of resources and the fulfillment of objectives will be monitored) and some uncertainty about its approval, the initiative led by Germany and France is already a strong endorsement of the recovery. It would be advisable for the Spanish government to complement these efforts with measures that will boost resilience and increase potential growth in Spain. In addition, the ECB has continued to expand its balance sheet, consolidating a strong increase in liquidity (TLTRO III) and ensuring the proper transmission of monetary policy in the Eurozone (expansion of the PEPP program). This, along with public credit guarantee programs, has allowed business loans to increase notably in the second quarter of the year.

[1] The expenditure is made on credit cards issued by BBVA and on BBVA's POS terminals.

Public expenditure in Spain is increasing and the deficit could reach almost 15% of GDP this year. Discretionary measures to boost domestic demand are estimated to reach at least 3% of GDP in 2020. The main measures announced in the last three months include the approval of the Minimum Living Income, several sector programs (automotive, tourism), a higher-than-expected growth in expenditure relating to the health and education system, the provision of liquidity to the most affected companies, as well as the extension of income protection measures until September 2020 that includes incentives to use Temporary Employment Regulation Schemes (ERTE by its acronym in Spanish) and benefits for self-employed workers that have ceased to operate. This is occurring in an environment where revenues are affected both by the policies announced (mainly in terms of social security collection) and by the impact of the crisis. In this context, public finances will deteriorate significantly. By 2021, both economic recovery and the end of numerous temporary measures will help pave the way for slowly reducing imbalances. Any additional stimuli that may be considered must take into account the limited fiscal space remaining, especially since the ECB's support will not be indefinite. It is therefore increasingly necessary to assess the efficiency of the resources used and to design measures in such a way that they have the maximum possible impact on economic activity, job retention and reducing inequality. In some cases, this may mean that aid to certain sectors must be synchronized with recovering demand.

The design of the Minimum Living Income (IMV for its Spanish acronym) meets many of the conditions necessary to reduce the rate of extreme poverty and increase the employability and occupational inclusion of the people it benefits. Firstly, IMV is compatible with employment. It acts as a wage supplement when the recipient finds a job, but gradually decreases as their salary increases. Due to the requirement to participate in training programs and the way in which training and employment itineraries are designed, collecting IMV would improve the employability of its recipients. Secondly, the way in which IMV is designed aims to prevent its recipients from falling into a poverty trap. The amount received is small enough that supplementing the salary with IMV is more attractive in monetary terms than receiving the amount indefinitely. Thirdly, it complements the insertion income schemes managed by the Autonomous Communities. In order to contain its budgetary impact—estimated at 3 billion euros per year—implementing this supplement should be accompanied by a thorough review of the aid, benefits and social allowances adopted by the various public administrations. Much of the success of IMV will depend on its periodic evaluation so as to avoid any possible problems that may arise. Furthermore, it is advisable to align this aid more closely with similar benefits provided by the various autonomous communities. Lastly, the coexistence of this type of policy with others with which it may share some objectives, such as the minimum wage, and its modification to encourage occupational mobility between regions, should be reviewed.

Extending the Temporary Employment Regulation Schemes until September 30 is a necessary measure to protect jobs. The gradual introduction of income protection measures for employees and the self-employed will encourage workers to return to work and will help to lessen the impact of the crisis on employment, at least during the third quarter of this year. Indeed, the unemployment rate is expected to increase relatively little compared to the fall in GDP in 2020 and to remain relatively constant in 2021. This represents a milestone in Spain's management of the crisis by breaking the historical relationship between activity and unemployment. Moreover, although the extension puts further pressure on public finances, its final cost could be limited given the benefits resulting from the preservation of employment once sectoral activity resumes. However, the new measures introduced do not address some of the shortcomings of current regulations that make the Temporary Employment Regulation Schemes less effective. Firstly, the contribution exemption scheme uses the company, not the workplace, as the basis for calculating incentives, which could result in a penalty for partial resumption of activity. Secondly, it would be desirable for the requirement to maintain employment to be limited to the absence of redundancies declared unlawful or invalid, and for the refund of contributions exempted in the event of non-compliance to be limited to each worker so dismissed rather than to all employees covered. Thirdly, initiatives are needed to help boost the training of workers who remain in the Temporary Employment Regulation Schemes, so as to facilitate their transition to sectors or companies where recovery is stronger. Finally, while the extension is welcome, it should not continue indefinitely. There are sectors where the adjustment is permanent, both in negative and positive terms.

Public policies should encourage workers to be quickly transferred to the most productive and most expanding sectors.

Providing guarantees, together with the action of the ECB and the banking sector, managed to prevent a further fall in GDP in 2Q20 (4.5 percentage points). The amount of bank credit lent to non-financial companies increased in May at the highest year-on-year rate since the end of 2008. This growth in financing has resulted from a whole host of factors. The main one has been the coordination between the monetary authority, public administrations, the banking sector and businesses. The increase in credit has made it possible to build bridges so that businesses can move toward more favorable environments, maintain employment, and even maintain investment, during the height of the crisis. Moving forward, it will be important for discussions regarding the use of public resources to move from the necessary provision of liquidity during the first few months of the pandemic, to boosting the growth of private investment, reducing any obstacles that the crisis may have left in its wake. As such, the ICO (*Instituto de Crédito Oficial* — Spanish official credit institution) credit line of 40 billion euros to encourage investment in digitalization and environmental sustainability, together with the 10 billion euros allocated to the Support Fund for the Solvency of Strategic Companies, can be useful instruments in ensuring that companies stay afloat. For example, potential capital injections would improve companies' financial structure, reduce their leverage and allow the taxpayer to share not only the risks, but also the potential revaluation of the company. At the same time, potential drawbacks require special care when designing and implementing such instruments. For large companies, the risk mainly resides in political interference and reduced competition, so implementing proper governance and having an exit strategy are crucial. For small businesses, the key problem is being able to reach them in order to decide which ones should receive support and under which criteria investment should be made.

The balance of risks continues to be skewed to the downside, in an environment of persistent high uncertainty. The main obstacle to recovery continues to be doubts surrounding the evolution of the pandemic and the effectiveness of the measures taken to continuously limit the spread of the disease. Increasing the healthcare system's ability to handle potential outbreaks and developing effective treatments and a vaccine that definitively eliminates the risk of infection are therefore a priority. It is also crucial to work on containment strategies that learn from both our own experience and that of the rest of the world, using the most advanced technologies and the advantages provided by real-time information. There is evidence that uncertainty is limiting household expenditure: although consumption has resumed, it has experienced a slowdown with each phase of easing restrictions. Although people have begun to consume again in social settings, expenditure in restaurants, on leisure or accommodation still remains below the levels observed this time last year. This is not only due to the fear of infection and the restrictions still in place on supply, but also to the situation on the labor market. A high percentage of the workforce is in a relatively precarious situation: still a lot of people are either on a temporary contract, are part of a Temporary Redundancy Plan (ERTE), have ceased activity as a self-employed person or are unemployed. Uncertainty also affects businesses, which in turn could have a negative impact on investment. The effects of the pandemic on the cost structure and the uncertainties it may create in terms of changing household preferences will be of particular importance. All of the above will mean that expenditure recovery to levels observed at the end of the previous year may be delayed. In this environment, the scope and effectiveness of public expenditure policies in Spain is diminishing.

However, there is also room for somewhat more positive scenarios in the coming quarters, but these will require the good direction that some policies have taken at the European level to be consolidated and a national consensus on the measures needed to boost growth capacity. The Recovery Fund is a unique opportunity for the country to finance investment projects that help accelerate the transformation of the productive model in Spain. In any event, the highest returns could come from the policies that must be adopted to access resources. Reforms that help ensure the sustainability of public finances in the medium term, reduce the precariousness of the labor market, allow for more efficient adjustments at companies and increase competition and productivity can be a more appealing reward.

Tables

Table 1.1. **GROSS DOMESTIC PRODUCT** (ANNUAL AVERAGE, %

	2017	2018	2019	2020	2021
US	2.4	2.9	3.7	-5.1	3.5
Eurozone	2.7	1.9	1.2	-8.5	5.8
China	6.9	6.7	6.1	2.2	5.5
World	4.0	3.7	3.0	-3.1	5.1

* Argentina, Brazil, Chile, Colombia, México, Paraguay, Perú and Uruguay.
Forecast closing date: July 9, 2020.
Source: BBVA Research & FMI

Table 1.2. **INFLATION** (ANNUAL AVERAGE, %)

	2017	2018	2019	2020	2021
US	2.1	2.4	1.8	0.2	0.7
Eurozone	1.5	1.8	1.2	0.3	0.7
China	1.5	2.1	2.9	3.1	2.5
World	3.2	3.9	3.7	3.1	3.2

* Argentina, Brazil, Chile, Colombia, México, Paraguay, Perú and Uruguay.
Forecast closing date: July 9, 2020.
Source: BBVA Research & FMI

Table 1.3. **INTEREST RATE ON TEN-YEAR PUBLIC DEBT** (ANNUAL AVERAGE, %)

	2017	2018	2019	2020	2021
US	2.33	2.91	2.14	0.87	0.89
Germany	0.37	0.46	-0.21	-0.41	-0.20

Forecast closing date: July 9, 2020.
Source: BBVA Research & FMI

Table 1.4. **EXCHANGE RATES** (ANNUAL AVERAGE)

	2017	2018	2019	2020	2021
EUR-USD	0.89	0.85	0.89	0.90	0.88
USD-EUR	1.13	1.18	1.12	1.11	1.14
CNY-USD	6.76	6.61	6.91	7.02	6.87

Forecast closing date: July 9, 2020.
Source: BBVA Research y FMI

Table 1.5. **OFFICIAL INTEREST RATES** (END OF PERIOD, %)

	2017	2018	2019	2020	2021
US	1.50	2.50	1.75	0.25	0.25
Eurozone	0.00	0.00	0.00	0.00	0.00
China	4.35	4.35	4.35	3.65	3.50

Forecast closing date: July 9, 2020.
Source: BBVA Research & FMI

Table 1.6. **EMU: MACROECONOMIC FORECASTS** (YoY) (ANNUAL AVERAGE, %)

	2017	2018	2019	2020	2021
GDP at constant prices	**2.7**	**1.9**	**1.2**	**-8.5**	**5.8**
Private consumption	1.9	1.4	1.3	-9.7	7.7
Public consumption	1.3	1.1	1.8	1.0	2.4
Gross fixed capital formation	3.8	2.3	5.8	-11.3	7.4
Inventories (*)	0.2	0.1	-0.5	0.0	0.0
Domestic demand (*)	**2.2**	**1.5**	**1.8**	**-7.5**	**6.2**
Exports (goods and services)	5.8	3.5	2.5	-11.1	8.9
Imports (goods and services)	5.3	3.0	4.0	-9.8	10.3
External demand (*)	**0.5**	**0.4**	**-0.5**	**-1.0**	**-0.4**
Prices					
CPI	1.5	1.8	1.2	0.3	0.7
Underlying CPI	1.1	1.2	1.2	1.0	0.9
Labor market					
Employment	1.6	1.5	1.2	-2.3	0.3
Unemployment rate (% of active population)	9.1	8.2	7.6	9.4	9.5
Public sector					
Deficit (% of GDP)	-1.0	-0.5	-0.6	-8.9	-4.5
Debt (% of GDP)	87.8	85.8	84.1	99.9	97.8
Foreign sector					
Balance of payments on current account (% of GDP)	3.1	3.1	2.7	2.5	2.6

Annual rate change in %, unless expressly indicated.
Forecast closing date: July 9, 2020.
(*) Excluding financial aid for Spanish banks.
Source: BBVA Research

Table 1.7. **SPAIN: MACROECONOMIC FORECASTS**
(ANNUAL RATES OF CHANGE IN %, UNLESS OTHERWISE INDICATED)

(Annual average, %)	2017	2018	2019	2020	2021
Activity					
Real GDP	2.9	2.4	2.0	-11.5	7.0
Private Consumption	3.0	1.8	1.1	-12.9	7.8
Public Consumption	1.0	1.9	2.3	6.0	0.0
Gross Fixed Capital Formation	5.9	5.3	1.8	-17.2	5.3
Equipment and machinery	8.5	5.7	2.6	-18.4	9.2
Construction	5.9	6.6	0.8	-19.5	1.1
Housing	11.5	7.7	2.9	-23.1	1.3
Domestic Demand (contribution to growth)	3.0	2.6	1.5	-9.9	6.1
Exports	5.6	2.2	2.6	-18.1	12.2
Imports	6.6	3.3	1.2	-14.6	8.6
External Demand (contribution to growth)	-0.1	-0.3	0.5	-1.6	0.9
GDP at current prices	4.3	3.5	3.6	-12.1	7.9
(Billions of Euros)	1161.9	1202.2	1245.3	1094.2	1180.4
Labour market					
Employment, Labour Force Survey	2.6	2.7	2.3	-3.5	0.6
Unemployment rate (% Labour force)	17.2	15.3	14.1	17.4	17.1
Employment, full time equivalent	2.8	2.5	2.3	-5.1	0.6
Productivity	0.0	-0.2	-0.3	-6.5	6.4
Prices and Costs					
CPI (average)	2.0	1.7	0.7	-0.1	0.7
CPI (end of period)	1.1	1.2	0.8	0.2	0.5
GDP deflator	1.4	1.1	1.6	-0.6	0.9
Compensation per employee	0.7	1.0	2.0	1.4	0.2
Unit Labour Cost (ULC)	0.7	1.2	2.3	7.9	-6.2
External sector					
Current Account Balance (% GDP)	2.5	1.8	1.9	-0.4	1.5
Public sector					
Debt (% GDP)	98.6	97.6	95.5	123.0	122.4
Deficit (% GDP) (*)	-3.0	-2.5	-2.8	-14.4	-8.4
Households					
Nominal disposable income	2.9	3.7	3.9	-3.1	2.1
Savings rate (% nominal disposable income)	5.9	6.3	7.7	16.8	11.7

Annual rate change in %, unless expressly indicated.
Forecast closing date: July 9, 2020.
(*) Excluding financial aid for Spanish banks.
Source: BBVA Research

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