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Creating Opportunities

Spain Economic Outlook

4Q20

Expected evolution of the Spanish economy

October 2020

Spanish GDP could contract by 11.5% in 2020 and grow by 6% in 2021. Although GDP fell by more than 20% in the first half of the year, it is estimated that recovery in the third quarter will have been somewhat more intense than expected. In particular, the contribution of net external demand was positive, as a result of a marked recovery in goods exports and thanks to growth in demand, which was concentrated on services produced at the national level. However, the last quarter of the year will experience a higher-than-expected slowdown, meaning that the forecast for 2020 will remain as is, and GDP growth forecast for 2021 will be revised downward by 1 percentage point (pp), primarily as a result of the deteriorating health situation both in Spain and in the EMU. At the same time, the effects of demand side policies may be beginning to weaken. This may be partially offset by the initial push of the Recovery, Transformation and Resilience Plan for the Spanish Economy. As such, reaching consensus on the adoption of measures that may advance the impact of resources from Europe and that maximize their short- and long-term effects is particularly important.

GDP in the third quarter of the year could increase by 14% quarter-on-quarter (QoQ), its biggest variation in real terms in the historical data. This recovery follows a historical drop in the second quarter (-17.8% QoQ), which is more or less in line with the level expected three months ago (-17.0%). The rebound is explained by the widespread reactivation of the various internal and external demand components, which have been bolstered by the easing of restrictions required to contain the pandemic and the policies implemented to sustain household income, maintain employment, and boost corporate credit and liquidity. In particular, household consumption may have shown an even higher growth than GDP growth (+17.0% QoQ). The same happened with goods exports (20.0% QoQ) and non-tourist services (25.0% QoQ), which would also have benefited from the recovery of the European economy. Public consumption showed weak progress during the second quarter of the year (+0.3%), but seems to have rebounded in the third quarter (+4.0% QoQ), thanks to the ongoing fiscal stimulus, especially as a result of the money spent on containing the pandemic and preparing for the start of the school year. Conversely, recovery in private investment seems to have shown signs of weakness (6.4% QoQ), after recording similar adjustments to those seen in private consumption in the second quarter.

The highest growth during the third quarter will be partly due to an atypical concentration of changes in expenditure on domestically produced goods. During the crisis, the decline in goods imports has been considerably lower than could have been expected given its historical relationship to final demand (domestic plus foreign sales). The adjustment has been relatively limited, especially in the purchase of intermediate goods, given the sharp decline in activity in industry and, particularly, in the automotive sector. However, the decline in activity has had more of an effect on non-tradable goods sectors, whose dependence on imported inputs is very low compared to the export sector. This has been particularly detrimental to services, especially those involving social interaction, which have been adversely affected by lockdown and social distancing measures. Finally, within these services, unlike previous crises, the decrease has been exacerbated by the decline in tourism activity, which, within sectors with exposure to external demand, is among the most intensive in terms of the use of domestic inputs. The consequence of the above is that, during the third quarter of the year, the situation has been reversed and much of the increase in demand has not flowed out of the country, but instead expenditure has been concentrated on domestically produced goods.

A considerable slowdown is expected going forward as a result of the impact that the second wave of infections may have on the European and Spanish economies. In particular, GDP could grow by 2% QoQ in the last quarter of the year. This would leave activity still almost 10% below the level observed at the end of 2019. The increase in COVID-19 cases over the past few weeks has resulted in increased uncertainty. This is particularly reflected by a turning point (for the worse) in surveys on economic activity in Europe. At the moment, this decline does not appear to affect other large areas such as the US or China. However, weak recovery in some emerging countries is concerning. In Spain, various indicators show that improvement may be slowing down. This is the case for BBVA's card or POS expenditure, which decreased from growing by a year-on-year average of 4.0% in August down to 2.1% in the first two weeks of October. This decline has been particularly significant in provinces with the highest number of infections, or in sectors especially exposed to the pandemic, such as tourism, leisure or hospitality. Other indicators, such as social security affiliation, car sales or confidence indicators, also show that momentum slowed down in August and September.

The same uncertainty that affects consumer expenditure could be behind a lower return on investment. The decline of the return on investment during the first part of the year was relatively limited given the impact on GDP. The inertia of many projects that were difficult to stop will have supported continued capital expenditure. However, the completion of the projects, the structural adjustment that is being observed in some sectors and the increase in uncertainty as a consequence of the outbreaks could be leading to a slower recovery than in other domestic demand aggregates. This slow progress in gross capital formation is likely to continue during the first part of 2021.

Domestic demand stimuli may be beginning to lose steam. The policy of the European Central Bank (ECB), the guarantees offered by the public sector through the ICO (*Instituto de Crédito Oficial* — Spanish official credit institution), together with the good starting position of companies and the banking sector, led to an increase in the amount of credit lent to companies. However, while much of the ICO funding between March and June was allocated to new operations, such new operations have fallen significantly since July compared to the same period last year. This may reflect the liquidity accumulated during the aforementioned months, so should not necessarily be a cause for concern. However, the ECB must maintain its willingness to extend the various asset purchase programs, both in terms of time and in size. If necessary, the ECB should also relax the conditions of its TLTROs (targeted longer-term refinancing operations) and those of the two-tier system for the remuneration of surplus liquidity so as to prevent any negative effect on the credit supply. This, making clear that the exchange rate is an important variable in the transmission of monetary policy and that its recent appreciation against the dollar does not support progress toward the medium-term inflation target. In any case, and within the scope of national policy, consideration must be given to the possibility of making the conditions for the grace periods and expiration periods of ICO loans more flexible should a less favorable environment continue to develop. Furthermore, given the high levels of uncertainty, extending the deadlines within which credit can be applied for should be considered. This would boost investment and would support liquidity if this demand exists in certain sectors that are more dependent on social contact.

Extending income protection measures was a necessary step in the ongoing attempt to protect job destruction. The Spanish Council of Ministers approved a Royal Decree-Law extending the benefits of Temporary Redundancy Plan (ERTE) forms until January 31 of 2021, providing for a relaxation of the requirements for submission, the exemption (total or partial) of Social Security contributions and the extension of benefit coverage for the workers concerned. The regulation also extends and broadens the measures for protecting the income of self-employed workers until the end of January. This step has been widely welcomed and will help to lessen the impact of the crisis on the job market in the short term. The fact that it has been adopted with the consensus of the social partners, which reduces uncertainties and increases the effectiveness of the measures, has also been widely welcomed.

However, the changes announced do not address some of the current regulatory shortcomings that decrease the effectiveness of ERTEs and could damage the business fabric and aggravate future job losses if companies that have submitted a form find that they need to restructure their workforce. For example, the clause prohibiting employees from being dismissed due to economic, productive, technical or organizational reasons relating to COVID-19 has not been relaxed, nor has the clause safeguarding employment.

On the grounds of proportionality, it would be preferable that the requirement to maintain employment 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 dismissed in this way rather than to all employees covered. Finally, it seems necessary to introduce more efficient training mechanisms that help workers placed on ERTEs to maintain their human capital or transform it in order to take advantage of any opportunities that may arise in other companies or sectors.

The number of people on ERTEs has been declining. In any case, the new type of ERTE covers a broad range of cases in the sector, which means that further significant reductions to its coverage are not expected, though this coverage will ultimately depend on the evolution of the pandemic. This has already been happening over the last few months, where the economic situation has allowed. The idea is for workers to be able to return to work and, where possible, to redirect them to sectors with better prospects. Furthermore, extending measures to protect the income of both employees and self-employed workers places new pressures on public finances. In any case, its final cost may be limited given the benefits inherent in supporting employment.

Bridges must be built to avoid a potential fiscal cliff edge Policies to support household income and maintain employment have been essential in terms of sustaining expenditure, reducing the impact of the health crisis on inequality and reducing uncertainty for families. However, more than six months on from their introduction, and from the reduction in their coverage, the impact could be beginning to weaken. This is important, because, although the fiscal stimulus announced for the next few years is estimated to be sufficient, once the resources of the Next Generation EU (NGEU) fund have been used, resources may be delayed. On the one hand, at the European level, a governance system has been created that may not be agile given the urgency of the situation. On the other hand, the prompt execution of the projects will crucially depend on the approval of the General State Budgets for 2021. Indeed, there is already a delay in the parliamentary process, which together with the lack of consensus in the Congress of Deputies may mean that it is not implemented on January 1. This may create a gap between the current fiscal impulse and the next one, and may further distance Spain from the rest of the EMU.

The Spanish Government estimates that the Recovery, Transformation and Resilience Plan will result in additional cumulative growth in GDP of between 7 and 8 pp over the next three years. This forecast is feasible if Spain is able to access available European funds with sound projects and to fully implement them, although it is in the optimistic range of BBVA Research's estimates (between 4.5 and 7.5pp). Our assessment, based on macroeconomic aggregates and prudent criteria, is subject to a high level of uncertainty and cannot possibly include significant but as-yet-unknown details. For example, no reports have been given of the projects that make up the plan's agenda or a timetable for its implementation. It is also not easy to know how many of these projects are totally separate from those that would have been carried out anyway without the NGEU. All this makes it difficult to assess both the final impact on the economy and the yearly impact. In principle, there are several factors that could maximize the consequences of the money to be spent. Interest rates are at historic lows and will not rise as the deficit increases, thanks to intervention by the ECB. Net subsidies involve a transfer to Spain from the EU at no future tax cost. In addition, public capital has depreciated for years and investment by public administrations is minimal. There may be significant carry-over effects on private investment at this time, and on consumption as well, since unfortunately there is a high percentage of people in uncertain circumstances, who will immediately spend any indirect benefits they reap from the plan, with its job creation effects. However, an extremely significant factor that could maximize the impact of the plan would be the structural reforms that will accompany said plan and how ambitious they are. Specific details of the measures to be taken in terms of improving the functioning of the job market, the goods and services market, productivity or the sustainability of public finances are therefore required.

Planning and governance will be key to the success or failure of the Recovery Plan. Its centralization within the Cabinet Office reflects the commitment and priority given to the Plan. Furthermore, the willingness to undertake a comprehensive legislative reform of the administration to expedite procedures and public procurement is welcome, given the theory that this could be one of the main obstacles for expenditure. Indeed, the forecasts presented herein suggest that significant effects of higher investment will only begin to be seen from the third quarter of 2021, and that the most significant impact will be seen in later years. Regardless, centralization and administrative changes should not be at the expense of transparency criteria and legal certainty. Furthermore, working closely with and cooperating with both local and regional governments will be essential when it comes to identifying the most effective projects and ensuring they are optimally implemented. Public-private collaboration will also be crucial to the Plan's success, which requires a strategic overview of the projects. Finally, those responsible for implementing these control mechanisms should also establish accountability processes, which assess the ex-ante and ex-post efficiency of expenditure and its performance, beyond any demands coming from Europe.

The risks on Spain's economic scenario remain centered around the evolution of the pandemic, the effect of the NGEU and the reforms that may be undertaken to tackle the economy's structural weaknesses, in addition to the impacts of the crisis. In the absence of a widely available vaccine, we must continue to invest in mechanisms that prevent and contain infections and minimize the economic impact. Here, the risk lies in having to go back into mass lockdowns, as well as the consequences they might have on production, especially in the services sector and particularly in tourism. Conversely, the government has decided to use the suspension of fiscal rules in the European Union to outline a public deficit reference level of around -11.3% and -7.7% of GDP in 2020 and 2021 respectively. Both targets seem optimistic, given recent developments in public accounts and economic activity. How rigid these targets will be, or how they will be shared among public administrations, will be essential in regaining some of the credibility that risks being lost when rules are temporarily suspended. Furthermore, the future of the Spanish economy depends partly on how pending European funds will be used. Using these resources inefficiently, besides creating an opportunity cost in terms of growth and recovery in Spain, would undermine potential future progress in European integration. What's more, if not used to implement structural reforms, this would result in a wasted opportunity to reduce the high rate of structural unemployment and increase the low level of productivity.

In any case, more positive scenarios are still possible. The number of vaccines in an advanced testing phase has increased the likelihood of having an effective remedy in the next year and a half. This report already assumes that growth will increase rapidly during the second half of next year, particularly so in investment, which could be fed back by the simultaneous nature of the stimulus throughout the European Union. Regardless, early approval of the Spanish National Budgets and the possibility that the impact of the fiscal stimulus on the economy is being underestimated could lead to much more positive environments than those presented here. Finally, there is the possibility of progress in measures that improve the growth capacity of the Spanish economy. If all of this were to occur, GDP growth next year could be much higher than predicted in this report.

Tables

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

	2017	2018	2019	2020	2021
United States	2.3	3.0	2.2	-4.6	3.8
Eurozone	2.8	1.8	1.3	-8.0	5.2
China	6.9	6.7	6.1	2.2	7.5
World	3.9	3.6	2.9	-2.9	5.4

* Argentina, Brazil, Chile, Colombia, México, Paraguay, Perú and Uruguay.
Forecast closing date: October 16, 2020.
Source: BBVA Research & FMI.

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

	2017	2018	2019	2020	2021
United States	2.1	2.4	1.8	1.3	2.6
Eurozone	1.5	1.8	1.2	0.3	0.8
China	1.5	2.1	2.9	3.0	2.3
World	3.2	3.8	3.6	3.5	3.4

* Argentina, Brazil, Chile, Colombia, México, Paraguay, Perú and Uruguay.
Forecast closing date: October 16, 2020.
Source: BBVA Research & FMI.

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

	2017	2018	2019	2020	2021
United States	2.33	2.91	2.14	0.84	0.75
Germany	0.37	0.46	-0.21	-0.45	-0.32

Forecast closing date: October 16, 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	0.88	0.83
USD-EUR	1.13	1.18	1.12	1.14	1.21
CNY-USD	6.76	6.61	6.91	6.95	6.80

Forecast closing date: October 16, 2020.
Source: BBVA Research & FMI.

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

	2017	2018	2019	2020	2021
United States	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	4.15	3.85	3.85

Forecast closing date: October 16, 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**	**1.3**	**-8.0**	**5.2**
Private consumption	1.9	1.4	1.3	-8.9	5.1
Public consumption	1.1	1.1	1.8	-0.2	3.3
Gross fixed capital formation	4.1	3.1	5.6	-10.8	6.7
Inventories (*)	0.2	0.0	-0.4	0.1	-0.2
Domestic demand (*)	**2.3**	**1.6**	**1.8**	**-7.1**	**4.7**
Exports (goods and services)	5.8	3.6	2.5	-10.7	8.0
Imports (goods and services)	5.3	3.5	4.0	-9.7	7.6
External demand (*)	**0.4**	**0.2**	**-0.5**	**-0.9**	**0.5**
Prices and Costs					
CPI	1.5	1.8	1.2	0.3	0.8
CPI Core	1.1	1.2	1.2	0.9	0.9
Labour Market					
Employment	1.6	1.5	1.2	-2.5	0.4
Unemployment rate (% of labour force)	9.1	8.2	7.6	8.3	9.4
Public sector					
Surplus (+) / Deficit (-) (% GDP)*	-1.0	-0.5	-0.6	-8.9	-5.1
Public debt (% GDP)*	87.8	85.8	84.1	100.6	100.0
External Sector					
Current Account Balance (% GDP)	3.1	2.9	2.3	2.1	2.3

Annual rate change in %, unless expressly indicated.
Forecast closing date: October 16, 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 av erage, %)	2017	2018	2019	2020	2021
Activity					
Real GDP	3.0	2.4	2.0	-11.5	6.0
Private Consumption	3.0	1.8	0.9	-14.2	7.0
Public Consumption	1.0	2.6	2.3	3.6	3.3
Gross Fixed Capital Formation	6.8	6.1	2.7	-17.8	7.7
Equipment and machinery	9.2	5.4	4.4	-25.9	4.9
Construction	6.7	9.3	1.6	-19.8	4.3
Housing	13.4	12.4	4.1	-23.7	0.3
Domestic Demand (contribution to growth)	3.1	3.0	1.4	-11.0	6.5
Exports	5.5	2.3	2.3	-21.4	11.9
Imports	6.8	4.2	0.7	-21.8	13.5
External Demand (contribution to growth)	-0.2	-0.5	0.6	-0.5	-0.5
GDP at current prices	4.3	3.6	3.4	-11.0	6.8
(Billions of Euros)	1,161.9	1,204.2	1,244.8	1,107.6	1,182.8
Labour market					
Employment, Labour Force Survey	2.6	2.7	2.3	-4.2	0.8
Unemployment rate (% Labour force)	17.2	15.3	14.1	17.0	17.5
Employment, full time equivalent	2.9	2.6	2.3	-8.8	3.6
Productivity	0.1	-0.2	-0.3	-2.7	2.4
Prices and Costs					
CPI (average)	2.0	1.7	0.7	-0.2	0.7
CPI (end of period)	1.1	1.2	0.8	-0.1	0.4
GDP deflator	1.3	1.2	1.4	0.5	0.8
Compensation per employee	0.7	1.0	2.1	-1.2	1.4
Unit Labour Cost (ULC)	0.6	1.2	2.4	1.5	-1.0
External sector (*)					
Current Account Balance (% GDP)	2.6	1.8	2.0	0.1	0.2
Public sector					
Debt (% GDP)	98.6	97.4	95.5	120.3	121.5
Deficit (% GDP) (*)	-3.0	-2.5	-2.8	-13.0	-8.9
Households					
Nominal disposable income	3.2	3.0	2.6	-5.1	5.0
Savings rate (% nominal disposable income)	6.2	6.0	6.6	15.1	13.1

Annual rate change in %, unless expressly indicated.
Forecast closing date: October 16, 2020.
(*) Excluding financial aid for Spanish banks.
Source: BBVA Research.

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