BBVA Research

Creating Opportunities

Spain Economic Outlook

3Q22

Situation and outlook for the Spanish Economy in 3Q22

July 2022

The GDP growth forecast for 2022 is maintained at 4.1%, but revised downwards from 3.3% to 1.8% in 2023. It is possible that there will be stagnation or even some occasional falls in activity over the coming quarters. The deterioration in the outlook is related to the increasingly likely shortage of some raw materials, the increase in their price and the observed pass-through of this increase in the cost of production to inflation. Moreover, the financial burden on firms and households is expected to pick up as the European Central Bank (ECB) accelerates the withdrawal of monetary stimulus. Against this backdrop, the Spanish economy is better prepared than in other recent recessionary periods and continues its recovery, which favors sectors that have a significant weight in GDP and are labor-intensive. Inflation has become the greatest risk, so decisions must be made to help distribute costs evenly and prevent it from becoming entrenched, which would increase the risk of recession.

Spain's GDP slowed during the first six months of the year. Both in the first quarter of 2022 (+0.2% quarter-on-quarter) and in the second quarter (BBVA Research: +0.6% quarter-on-quarter) the growth in GDP would have been considerably lower than that observed during the second half of 2021 (+2.6% and +2.2% quarter-on-quarter in the third and fourth quarters of 2021). Among the demand components, the slowdown in demand has been widespread, although the fall in Spanish household consumption and the moderation of exports of tourism services stand out. In any case, the slowdown in the central part of the year will be less than expected three months ago (shortly after the outbreak of the war in Ukraine), which will partially offset some of the headwinds to come.

Household spending has been negatively affected by several factors. The increase in the price of raw materials and intermediate goods continues to reduce the purchasing power of household income. Of particular importance has been the increase in both fuel and electricity prices. To this has been added, after a period of containment between 2020 and the end of 2021, a greater pass-through of this increase in the cost of production to final prices as companies have come to perceive that the rise in input prices will last longer than initially anticipated. In addition, supply problems continue to limit car purchases. Lastly, households are not using the wealth accumulated during lockdown to consume. The increase in demand seen in some service sectors appears to be being offset by a decline in spending on other goods. The latter would be the result of the loss of momentum that certain components of the consumption basket would have had during the pandemic. Savings, as a percentage of disposable income, remain near their historical average. In this regard, it is possible that the uncertainty about the performance of the economy and the increase in inflation may be causing households to delay making some decisions or providing an incentive to invest in housing.

Low growth in productivity levels per worker persists. In recent months, employment indicators such as registration with the Social Security system have advanced at rates that on other occasions have implied a higher rate of GDP growth. This may be partly a direct consequence of increased job creation in the service sector, both private and public. Progress in activities where the return on human capital is traditionally lower could explain this change. Another possible reason is the low unemployment rate that has been reached, the lowest since September 2008. As the availability of workers decreases, it is possible that the productivity of new hires will be lower than that of existing employees. After the labor reform, job creation may be continuing but with a lower intensity of hours worked. One of the consequences of the reform has been the increase in the percentage of indefinite-term contracts and, particularly, of discontinuous fixed-term contracts. This has come about both through legal imperative and due to an increase in the cost of temporary hiring, which, with all else being constant, has raised the cost of hiring in general. One of the risks associated with the latter was lower job creation. Although the number of people in work continues to increase, the conversion of temporary contracts to discontinuous fixed-term contracts may be reducing the number of hours worked: since 2007, temporary employees have been working three hours more per week, on average, than discontinuous fixed-term employees. This relationship has remained the same even during the first quarter of this year, when the increase in the second type of contract has been outstanding.

The revised growth of GDP for 2023 is explained by the impact of a number of risks that have emerged or materialized over the past few months. Firstly, it increases the likelihood of a gas shortage scenario in Europe. This has led to continuous revisions in the outlook concerning its cost. The new upward revision in gas prices could deduct an additional 0.1pp to 0.2pp from GDP growth for 2023. Second, inflation continues to surprise on the high side, and is no longer limited to a few CPI components. The underlying, which includes 82% of the household basket of goods and services, could rise further and average almost 6% during the second half of the year. This has caused a reduction in the consumption of goods affected by the increase in the cost of energy. In addition, there are still disruptions in global value chains that limit supply. The lack of car availability in 2022 would, for example, account for up to a 50% drop in sales from 2019. More recently, companies have taken advantage of the recovery in spending on services to raise prices and recover margin declines of previous quarters. All of the above has led to a loss in household purchasing power that is having a detrimental effect on consumption.

The increase in inflation expectations has had an impact on the outlook for interest rates. As rising prices are a global phenomenon, central banks have been quick to signal their intention to withdraw the stimulus introduced over the past few years. In the United States, the monetary policy rate is expected to end the year at 350 basis points (bp), while in the Euro zone it is expected to end the year at 125 bp. Should this scenario occur, the increase with respect to the end of 2021 would be 325 and 125 bp, respectively. This will increase the financial burden on households and companies, reducing the resources available for consumption and investment. BBVA Research estimates point to a direct negative impact of 0.7% and 0.3% on Spain's economic growth in 2022 and 2023, respectively. In addition, lower European demand will reduce the growth of exports and, therefore, of activity in the Spanish economy (-0.8pp for the two-year period as a whole).

A more uncertain environment has affected private sector confidence, which may have a negative impact on spending. The possibility of a winter with restrictions on energy consumption in Europe cannot be ruled out. This would intensify bottlenecks in the industry and reduce the willingness of households to travel to Spain. Rising inflation and the response of central banks have led to a tightening in equity markets. The consequent decrease in the financial wealth of families and companies may translate into an increase in precautionary savings. In fact, it is estimated that the recent increase in financial volatility would result in lower GDP growth of 0.4 pp in the following year. Finally, it is to be expected that the positive impact of the effectiveness of the vaccines and the elimination of consumption restrictions may peter out once the summer is over. The possibility of a cliff effect in household spending during the tail-end of of 2022 or the first part of 2023 is high. In addition, it should be taken into account that a large part of the savings accumulated during the lockdown period is held by high-income households. The longer it goes unused, the more likely it will be kept as wealth.

In any case, the recovery is continuing for the time being and the momentum is positive for the third quarter of the year. Although data on activity indicators for the month of July are not yet available, GDP is expected to increase by 0.4% quarter-on-quarter in 3Q22, a level similar to that observed in the first half of the year. The trend in credit card spending by BBVA customers suggests that consumption will continue to grow in the services sector, mainly in the hotel, leisure, transportation and accommodation sectors. Spending on some goods is showing some signs of fatigue, such as home furnishings, technology and health-related goods. Others, such as those related to beauty or fashion, affected by the impact that the pandemic has had on the workplace or entertainment, have not been able to recover pre-crisis levels. Foreign tourism has returned with vigor, and the second quarter is expected to witness a return to late 2019 levels of spending by overseas residents. This favorable performance in labor-intensive sectors has led to employment and unemployment levels not seen in the last 15 years.

The trend in the export of goods and industry and the good performance of investment in machinery and equipment point to gains in competitiveness that will support activity. The rise in costs since the end of the previous year has not resulted in the decline in foreign sales or manufacturing predicted three months ago. In fact, industrial production would have recovered back to 2019 levels despite the fact that different sectors continue to face supply constraints. For example, the production of transportation vehicles, whether automobiles, trains, or aircraft, continues to be about 25% below 2019 levels and with no clear short-term trend in sight. The same is true of other sectors affected by the rise in raw material prices, such as the manufacture of oils, metal products (iron, steel, etc.), or paper and cardboard. Finally, there are those that suffer from the changes in individual preferences brought about by the pandemic, such as footwear. At the opposite end of the spectrum are the sectors that are increasing their importance in the Spanish economy and have offset these declines. Some have aided the post-pandemic recovery, such as the manufacturing of pharmaceuticals, cleaning products or processed foods. Others have taken advantage of the investment boost from companies that have needed to reduce their dependence on fossil fuels or increase their digitalization. In fact, capital accumulation has already reached pre-crisis levels, driven by investment in machinery and equipment that is 17% above what was seen in 2019. This is despite the fact that spending on transportation equipment is still 30% below that observed before the onset of the COVID crisis. All of the above leads to gains in market share, improvements in company productivity and a more sustainable production model.

The slowdown in activity is expected to be limited and short-lived, thanks to several factors. The first is related to the wealth accumulated during the lockdown. According to BBVA Research, households would have around 80 billion euros invested in ready-to-use assets, which could sustain consumption during the coming quarters despite the risks surrounding the economy and would help soften the impact of several of the negative elements described above. In addition to consumption, these resources could be used to purchase housing, as has been the case in previous quarters. Despite the fact that interest rates have begun a process of normalization, credit conditions remain attractive, especially in an environment where real estate asset prices are expected to continue to rise. In this regard, housing prices could increase by 7.4% in 2022 and 3.6% in 2023.

The execution of Next Generation EU (NGEU) funds could accelerate over the next few quarters. The data available so far suggest that some €28 billion worth of calls for proposals and spending programs funded under the Plan would have been launched by June 2022 . Therefore, it is expected that in the second half of the year companies will begin to face greater demand related to the development of these projects.

The positive effects of the labor reform could help to sustain the trend in consumption, particularly among the youngest, as well as favor productivity. Hiring statistics show that changes in regulations are reducing the weight of temporary employment. It is particularly positive that it is those under 25 years of age who are benefiting from open-ended contracts. Increased job security could reduce precautionary savings among this type of worker or increase their willingness to take on debt. In addition, a more stable employment relationship could increase incentives to invest in the human capital of the people hired. This should boost productivity over the next few years.

The main risk moving forward is now inflation. BBVA Research forecasts that the variation in the CPI will remain high, reaching almost 8% on average during 2022 and 3% in 2023. More worrying still may be the underlying trend, which could reach 5% on average this year and 4% the following year. Various indicators show that the variation in the prices of most goods and services has continued to increase or has stabilized at high levels. This could lead to an adjustment in household consumption over the next few months, or could cause investment or business competitiveness to suffer. Future developments will depend on several factors in the international markets, such as the impact of the invasion of Ukraine on the price of raw materials or the continuation of supply chain problems. However, what will be decisive will be the effect on corporate margins, the outcome of collective bargaining negotiations and the impact of public policies. Regarding the former, companies did not pass on the increase in costs during the second part of the previous year to prices, as they perceived that the increase could be temporary. However, the decline in margins has been reversed as of the first quarter of 2022. With respect to the latter, the wage growth agreed in collective bargaining agreements has accelerated, but still shows increases well below inflation and what would be consistent with the variation in productivity per worker. Finally, the government has announced the capping of gas prices for electricity production and, more recently, the lowering of VAT. The impact of the first measure could reduce average inflation for the year by between 0.3 pp and 0.8 pp, whereas the second, by 0.1 pp. Of greater importance going forward will be the willingness of the various agents to enter into an income pact, and of the government to mediate between them. This will require the inclusion of as many groups as possible, so that the final result does not generate an unequal burden and, therefore, an environment of social discontent.

The increase in interest rates finds the Spanish economy better prepared, although still exposed to the risk of financial fragmentation within the Euro zone. Household and corporate debt has fallen sharply and is now at levels similar to the rest of the Euro zone. In addition, the last few years have helped the private sector accumulate assets that can help soften the impact of a greater financial burden. The situation of the public sector, with its high debt thresholds, may be more vulnerable. At the time of going to press, there are no details of the mechanism the ECB is preparing to avoid significant deviations of risk premia from levels consistent with the transmission of its monetary policy. The risk here is one of a liquidity crisis, where a perceived lack of commitment to these objectives would lead to an increase in the cost of sovereign debt financing. In turn, an increase in the financial burden of public administrations may deteriorate the perception of the sustainability of public finances or the commitment of countries to comply with the necessary adjustments and reforms. The resulting vicious circle could cause a new crisis in Europe. Incomplete progress in finalizing the banking union prevents this from being the first line of defense and forces imaginative but less impactful and protective solutions. In any case, even here one can find reasons for optimism. The Treasury has increased debt maturities, and the performance of revenues has managed to reduce the imbalance in public finances beyond what was expected. This will limit short-term liquidity needs and the impact of rising interest rates on the deficit.

Uncertainty about economic policy will increase as next year's municipal and regional elections draw nearer. The country still has a reform agenda to fulfill in order to continue accessing NGEU funds and, most likely, to receive support from the ECB in the debt markets. The measures implemented to reduce the impact of higher fuel and electricity prices may have to be sustained over time, as the cost of gasoline and gas is expected to remain high for at least the next year. This will slow the pace of reducing the deficit. It is therefore important to focus aid on the most vulnerable groups, to make it clear that the support will be temporary and to respect the price mechanism in order to encourage the transition to a more sustainable production model. In this sense, the increases in the Minimum Vital Income, in non-contributory pensions and the 200 euro assistance for those residing in households whose income in 2021 did not exceed 14,000 euros are welcome. More doubtful is the efficiency and progressiveness of the indiscriminate subsidy to fuel consumption, the reduction of taxes on electricity production and consumption or the limitation on rent increases.

In the State of the Nation Debate, the Government announced additional measures of different nature and effects, whose only common feature is that they have been presented as transitory. Temporary free travel on some public transport will help to alleviate the cost of inflation and reduce the demand for energy. Moreover, it is a more selective measure than the fuel subsidy. It seems a missed opportunity not to have eliminated this support for nonrenewable energy consumption and to use the resources to increase support for households, the self-employed and businesses particularly affected by the increase in the price of gasoline and electricity. Regarding the announcement of tax increases, it makes no sense to penalize specific sectors, such as the banking sector, which does not generate negative externalities in the rest of the economy, but quite the opposite: it facilitates the allocation of productive resources to the most dynamic and fastest growing sectors. Moreover, the expected rate hikes point to a normalization towards the natural rate of interest rates, after years of exceptionally low levels. Pending the specific details of this measure, BBVA Research estimates suggest that an increase in the tax burden on the banking sector, which aims to increase ex ante revenue by 0.1% of GDP, will result in a long-term decline of 0.09% of GDP, a 10 pp increase in lending rates, and a reduction in banking activity.

Moving forward, the necessary measures to guarantee the sustainability of the pension system, to improve the efficiency of the tax system and to re-evaluate the financing of the autonomous communities will be necessary. These policies will necessarily have winners and losers. The risk is that it will become increasingly difficult for governments to assume the costs associated with reforms as the climax of the political cycle approaches. In addition, the conditions that will be imposed by the European Central Bank to implement the "anti-fragmentation" mechanism that will allow the transmission of monetary policy across the euro area will have to be taken into account. Both access to NGEU funds and the stability of the cost of financing the Spanish economy could be jeopardized if the reforms agreed so far are not complied with..

Tables

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

	2019	2020	2021	2022	2023
United States	2.3	3.7	5.7	2.7	0.7
Eurozone	1.6	-6.5	5.3	2.7	0.6
China	6.0	2.2	8.1	4.5	5.2
World	2.9	-3.2	6.1	3.8	2.5

* Argentina, Brazil, Chile, Colombia, México, Paraguay, Perú and Uruguay.
Forecast closing date: July 11, 2022.
Source: BBVA Research & FMI.

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

	2019	2020	2021	2022	2023
United States	1.8	1.2	4.7	7.7	4.3
Eurozone	1.2	0.3	2.6	7.2	3.0
China	2.9	2.5	0.9	2.3	2.5
World	3.6	3.1	3.8	5.5	4.4

* Argentina, Brazil, Chile, Colombia, México, Paraguay, Perú and Uruguay.
Forecast closing date: July 11, 2022.
Source: BBVA Research & FMI.

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

	2019	2020	2021	2022	2023
United States	2.14	0.90	1.44	2.87	3.72
Germany	-0.21	-0.48	-0.31	1.21	2.17

Forecast closing date: July 11, 2022.
Source: BBVA Research & FMI.

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

	2019	2020	2021	2022	2023
EUR-USD	0.89	0.88	0.84	0.93	0.92
USD-EUR	1.12	1.14	1.18	1.08	1.09
CNY-USD	6.91	6.91	6.45	6.61	6.60

Forecast closing date: July 11, 2022.
Source: BBVA Research & FMI.

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

	2019	2020	2021	2022	2023
United States	1.75	0.25	0.25	3.50	4.00
Eurozone	0.00	0.00	0.00	1.25	2.00
China	4.35	4.35	4.35	3.70	3.70

Forecast closing date: July 11, 2022.
Source: BBVA Research & FMI.

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

	2019	2020	2021	2022	2023
GDP at constant prices	**1.6**	**-6.5**	**5.3**	**2.7**	**0.6**
Private consumption	1.4	-7.9	3.6	2.9	0.6
Public consumption	1.9	0.9	3.9	1.4	1.2
Gross fixed capital formation	6.8	-7.2	4.1	2.1	0.3
Inventories (*)	-0.1	-0.5	0.3	0.6	-0.1
Domestic demand (*)	**2.4**	**-6.1**	**4.1**	**2.9**	**0.5**
Exports (goods and services)	2.7	-9.5	10.8	4.6	1.1
Imports (goods and services)	4.8	-9.4	8.7	5.3	1.1
External demand (*)	**-0.8**	**-0.4**	**1.3**	**-0.2**	**0.0**
Prices and Costs					
CPI	1.2	0.3	2.6	7.2	3.0
CPI Core	1.0	0.7	1.5	3.3	2.7
Labour Market					
Employment	1.3	-1.5	1.2	1.9	0.2
Unemployment rate (% of labour force)	7.6	8.0	7.7	6.7	7.3
Public sector					
Surplus (+) / Deficit (-) (% GDP)*	-0.7	-7.1	-5.1	-4.3	-2.9
Public debt (% GDP)*	83.8	97.2	95.6	94.7	94.3
External Sector					
Current Account Balance (% GDP)	2.4	1.8	2.4	1.2	1.9

Annual rate change in %, unless expressly indicated.
Forecast closing date: July 11, 2022.
(*) 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, %)	2019	2020	2021	2022	2023
Activity					
Real GDP	**2.1**	**-10.8**	**5.1**	**4.1**	**1.8**
Private Consumption	1.0	-12.0	4.6	1.9	2.3
Public Consumption	2.0	3.3	3.1	-0.3	1.6
Gross Fixed Capital Formation	4.5	-9.5	4.3	9.8	6.9
Equipment and machinery	3.2	-12.9	16.0	17.2	4.4
Construction	7.1	-9.6	-2.8	4.5	8.7
Housing	6.6	-11.2	-5.3	5.6	3.2
Domestic Demand (contribution to growth)	**1.6**	**-8.6**	**4.7**	**3.0**	**3.1**
Exports	2.5	-20.1	14.7	14.4	3.1
Imports	1.2	-15.2	13.9	11.8	6.7
External Demand (contribution to growth)	**0.5**	**-2.2**	**0.4**	**1.1**	**-1.2**
GDP at current prices	3.4	-9.8	7.4	7.2	4.2
(Billions of Euros)	**1244.4**	**1121.9**	**1205.1**	**1292.0**	**1345.8**
Labour market					
Employment, Labour Force Survey	2.3	-2.9	3.0	3.5	0.8
Unemployment rate (% Labour force)	14.1	15.5	14.8	13.0	12.9
Employment, full time equivalent	2.6	-7.6	6.6	3.8	0.6
Productivity	-0.5	-3.3	-1.5	0.3	1.2
Prices and Costs					
CPI (average)	0.7	-0.3	3.1	7.9	3.2
CPI (end of period)	0.8	-0.5	5.8	6.4	3.4
GDP deflator	1.3	1.0	2.3	3.2	2.3
Compensation per employee	2.6	1.3	-0.7	3.6	5.0
Unit Labour Cost (ULC)	3.1	4.6	0.8	3.3	3.8
External sector (*)					
Current Account Balance (% GDP)	2.0	0.6	0.9	0.1	0.0
Public sector					
Debt (% GDP)	95.5	120.0	118.4	115.9	116.7
Deficit (% GDP) (*)	-2.9	-10.1	-6.8	-5.5	-5.4
Households					
Nominal disposable income	4.0	2.7	3.2	2.9	5.0
Savings rate (% nominal disposable income)	7.6	7.5	6.2	5.9	8.6

Annual rate change in %, unless expressly indicated.
Forecast closing date: July 11, 2022.
(*) Excluding financial aid for Spanish banks.
Source: BBVA Research.

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