BBVA Research

Creating Opportunities

Spain Economic Outlook

October 2022

Situation and outlook for the Spanish Economy in Q422

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The estimate of GDP growth for 2022 has been revised upward to 4.4%, but the outlook for 2023 has deteriorated as growth could reach only 1.0%. Recent economic developments provide a better starting point for the slowdown already seen in the data. As expected three months ago, various factors are now having a negative impact on household spending. The end of health restrictions has had a positive effect that is now diminishing, the widespread increase in prices, the reaction of the European Central Bank to inflation, and the revision of the investment series by the National Institute of Statistics (INE), which has deteriorated the outlook for future productivity developments. Nevertheless, it is still widely believed that, in the most likely scenario, the slowdown will only result in a moderate decrease in activity. Facing the challenge of stagflation, public policies should focus on preserving market signals, ensuring the sustainability of public finances, and targeting support for vulnerable households and businesses.

According to reports, GDP growth accelerated in the second quarter of the year. The generalized vaccination against COVID-19 has had a greater impact on services consumption, especially in the tourism sector. For example, according to data published by INE, non-resident consumption was 46% higher in Q222 than in Q419. Nominal card spending by BBVA customers outside their province of residence was 18% higher than before the pandemic. Sectors such as catering, transport, leisure and entertainment also benefited from greater health security. Purchases of some goods such as clothing and footwear also recovered as social conditions returned to normality. Although there was a significant increase in construction investment, it is premature to believe that this is due to an acceleration in the implementation of the Next Generation EU (NGEU) funds. Finally, merchandise exports continued to show some strength, despite the increase in production costs and the obstacles associated with interruptions in the production chain.

However, data from recent months suggests that the recovery is losing momentum. It is likely that activity has stagnated in the third quarter due to the end of the tourist season, whichwill explain the slowdown in employment growth seen in recent months. In addition, the deterioration of Spain's terms of trade has had a direct impact on the competitiveness of companies and the purchasing power of households. To the extent that sanctions against Russia last, gas cuts from this country increase and the rise in the price of energy becomes more permanent, and the more likely it is that decisions will be made to cut spending. Moreover, the investment outlook has worsened due to increased uncertainty and the potential for rising financing costs, together withthe partial recovery in margins. INE's statistical revision of the historical series on machinery and equipment expenditure points to a worse evolution during the last two years. It also remains unclear when NGEU funds will begin to flow more rapidly into the economy. Finally, the supply of new housing is not keeping up with the strong demand. And in terms of exports, European households may well be cutting back on spending, while the underlying supply problems within the export sector are not yet fully resolved.

The economy may largely stagnate or even experience a moderate contraction over the next few quarters as uncertainty increases, inflation expectations rise and interest rates increase. The sanctions against Russia and its gas cuts confirm that further reductions in energy consumption and the procurement of alternative sources at higher prices will be necessary to survive a winter without rationing on the continent. Although the latter was already part of the scenario presented in July, gas costs have risen more than expected. This will have a negative impact on economic activity, especially in industry and some energy-intensive services. Confidence indicators in Germany are starting to reach levels consistent with a recession. In Spain, the deterioration observed in recent months could lead to a 0.6 percentage point decline in household consumption in the fourth quarter of the year. Moreover, as the increase in costs is expected to be permanent, companies are starting to pass some of it on to prices. Workers, for their part, have begun to negotiate higher wages. These two dynamics suggest that inflation will be higher than expected in the coming months and will take longer to normalize.

The ECB has moved to raise interest rates sooner than expected, with markets now anticipating a higher end-point than was forecasted just a few months ago. Central banks in developed economies continue to fight inflation by making money more expensive. Together with the general appreciation of the dollar, this points to an environment of global monetary tightening. In the Eurozone, the monetary policy rate has increased by 125 basis points (bps) since June, and could potentially increase by another 125 bps by the end of the year. This would approach neutral or even slightly restrictive territory. It is debatable whether the ECB needs to take further measures to control inflation, especially if weak economic activity is a contributing factor. Moreover, unlike in the US, the rise in prices is largely explained by supply-side factors, without a full pass-through to margins and wages so far. In any case, the rise in interest rates is expected to dampen the growth of domestic demand. In particular, it is estimated that the rise in real interest rates could reduce private consumption growth by about 2.2 percentage points in 2023.

Economic policy uncertainty increases as the peak of the election cycle approaches. The government has approved a new aid to support households by reducing the Value Added Tax (VAT) rate on gas from 21 to 5%. In light of sharp price increases, the measure will help modestly to limit the impact on households. Discriminatory measures like this will only slow down the progress we need to make in transitioning to more efficient energy use. Although it has been announced as temporary (like other subsidies), its duration is uncertain given that prices are likely to remain high beyond the end of the year. As far as fiscal policy is concerned, the negotiations on the budgets for the coming year are discussing several measures which, apart from the uncertainty about their duration, do not seem to be consistent with maintaining the pace at which the public deficit has fallen or are not compatible with a comprehensive reform toward a tax system that also supports job creation and boosts investment. A more refined assessment will be possible once the complete set of proposed fiscal measures is approved.

The period of stagnation is expected to be short-lived, with recovery picking up again in the first months of next year. There are several factors that will help to soften the impact of higher interest rates on consumption and investment. Households and businesses are in a stronger position than in the previous cycle of increases, having built up their assets and reduced their liabilities. Financing conditions have improved since then, based on historically low interest rates. A large percentage of loans negotiated recently have fixed payments, and a large proportion of balances have existed for some time (meaning that more capital is being repaid). In addition, the economy is not anticipated to experience a large impact on employment due to the slowdown in GDP growth andwages will continue to increase, but at a slower rate than inflation. Finally, the lockdown period has resulted in increased savings for households (around 130 billion euros), which will help to offset the impact of price increases on household spending. This will lead to an average increase in private consumption of about 1.0% in 2022 and 2023.

It is expected that rising interest rates and the economic slowdown will further contribute (on top of other factors) to the slowing of growth in housing investment. There has been an increase in house purchases as households take advantage of low financing costs and savings accumulated during lockdown. However, the increase in demand and corresponding price pressure have not been enough to boost supply. Furthermore, increasing interest rates and declining employment growth could discourage investment decisions in the sector. It is important to note that imbalances have not accumulated after a prolonged low interest rate environment. In fact, inventory levels seem to be decreasing. Moreover, household and corporate sector debt ratios are significantly lower than in 2008. The banking system has also reduced its exposure to the sector. Finally, the rise in prices follows significant and prolonged declines, so that, unlike in other Eurozone countries, there is no perceived divergence between the actual value and the fundamentals. As a result, residential investment is expected to grow by an average of only 2.7% in 2022 and 1.3% in 2023, which is still more than 12% lower than in 2019.

The sustainability of investments in other construction and machinery and equipment depends on the effective execution of NGEU funds. The value of public works tenders is estimated to have reached almost EUR 16 billion by August, 30% above the level observed by August 2021 and more than double the level accumulated in the same period of 2019. The acceleration would be largely due to the boost in resources from the NGEU. Up to the second quarter of this year, investment in other construction barely increased by 6% compared to last year. Meanwhile, the accumulation of machinery and equipment (excluding transport) remains at the same level as it was twelve months ago. It is clear that the process of digitization and transformation towards a more sustainable economy is not progressing as quickly as hoped. This can be partly explained by the disconnection between tenders and the whole process that follows until the projects are launched and the companies actually invest. Although lending to businesses appears to have increased significantly in recent months, this may be more related to businesses' short-term need for working capital in the face of cost increases associated with higher inflation. The lack of evidence that the funds will materialize in the economy has led BBVA Research to again revise downward its estimation for the execution of the NGEU funds and now expects expenditure related to these projects to be between EUR 9.0 billion and €15.0 billion by the end of 2022. In 2023, EUR 21 billion could be delivered.

Foreign demand will make a negative contribution to growth in the coming quarters. In particular, Eurozone GDP could fall by 0.1% in 2023, following growth of 3.1% in 2022. It is possible that this environment could negatively impact foreign tourism, as the exhaustion effect described above has reduced spending by European households. The decline may be limited by several factors, however. First, as the value of the euro decreases and transportation costs increase, alternative beach destinations will become less appealing. The second factor is that Spain is much further away from the Russian invasion than other countries, and its population is also largely vaccinated. Finally, the trade in goods is expected to improve during the year as bottlenecks are gradually removed from production chains. This could have a particularly positive impact on the automotive sector.

Inflation appears to be nearing a peak, although it will likely remain high. The price of oil has decreased due to the expectation of lower global activity, while the Chinese economy's weakness has contributed to slower growth in gas prices. The measures announced in Spain and at the European level to limit the pass-through of fuel price increases to electricity have also been crucial. Additionally, lower trade barriers at the global level have resulted from reductions in transportation costs, increased availability of containers, and improved waiting times for industrial inputs. Domestically, leading indicators suggest that prices for some goods and services have already peaked. In addition to the cooling pace in imported inflation, slower growth in expenditure is also a contributing factor. As companies' expectations of stagnation strengthen, they may decide to correct some of the price increases observed over the past two years. In light of recent upward surprises in energy prices and their effects on other items in the CPI basket, the forecast for the average change in CPI have been revised upward for 2022 from 7.9% to 9.3%, and for 2023 from 3.2% to 4.9%.

The containment of inflation will depend on how the costs of higher import prices are shared. The evidence shows that increased energy costs have not been significantly passed on to consumers in the form of higher prices, thanks to higher wages and profit margins. The public sector has benefited from the increased tax revenue caused by higher inflation. It should be noted that this cost sharing has been implicit, so that the so-called "income agreement" is really being applied. However, this is no guarantee that it will continue in the future. The various public administrations should avoid measures that appear to exclude certain groups from the agreement. Furthermore, they must ensure that the support they provide is compatible with the need to reduce the public deficit, preserve market signals (which are necessary in order to make resources more efficient) and protect the most vulnerable. Businesses and unions should be able to negotiate wages that are appropriate for the conditions in each sector. Otherwise, if the loss of purchasing power and increase in costs become entrenched, it could jeopardize employment, the survival of companies, and social peace. One way to limit the loss of workers' purchasing power and prevent wage growth from fueling inflation is for companies to pay a one-off, non-consolidated bonus.

Barriers to investment could hamper efforts to improve competitiveness, increase the availability of affordable housing and maximize the impact of NGEU funds. The observed slowdown in new housing starts is difficult to explain. It is hypothesized that there are several factors influencing the current housing market situation, including a lack of developable land, delayed permitting, uncertainty related to the negotiation of the new Housing Law in Congress, a lack of skilled labor, or rising input costs and high uncertainty about future developments. The risk is that, in an environment of still low interest rates and high inflation, demand will continue to rise as soon as the economic recovery returns. This could lead to increased house prices relative to household incomes, which could disproportionately impact vulnerable groups such as young people. Housing construction can be promoted by making land available, streamlining and speeding up the license process, and encouraging public-private collaboration. An increase in profitability or legal certainty could end up bringing unused real estate assets onto the market: Spaniards have 76% of their wealth invested in real estate assets, so there is potential to attract this unused stock and improve conditions for growth. Urban planning could also be reconsidered by promoting higher building density, a different use in some areas of major cities, or better transport links to areas outside urban centers. In this case, it would be interesting to take advantage of the influx of NGEU funds, some of which are earmarked for neighborhood regeneration. It is essential to have a comprehensive plan for the management of public housing stock, which includes involvement from the private sector, as is common in other countries.

The structural imbalance in the public accounts remains high, so that any reduction in the tax burden or increase in spending must be accompanied by a corresponding measure to ensure at least a neutral impact on the balance sheet. There are several reasons why the current budget deficit is not having as negative of an effect as it did during the years following the global financial crisis. Firstly, revenue from direct taxes has not collapsed, thanks to measures taken to protect employment and productivity. The subsidies and credits provided helped to improve consumption and investment, which in turn increased indirect tax revenues. In addition, spending on goods reduces informality, which has increased with the digitalization of payment methods. Finally, inflation has resulted in an increment in the tax burden. It is important to remember that some of the driving factors may be temporary. The primary structural imbalance (permanent over the cycle, excluding interest on debt) would be between 1 and 2% of GDP. Therefore, any changes to the tax system or increases in spending should be matched with measures to ensure the sustainability of public finances. It is also desirable to take steps to safeguard pensions, especially at a time when the financing costs of the economy depend on the implementation of the monetary policy transmission protection instrument of the ECB. Although the NGEU program offers financial assistance, it is important to remember that this assistance is contingent on meeting various milestones. One of these milestones is the long-term sustainability of public finances.

The reform process needs to be further advanced to reduce unemployment and precarity. Labor reform has resulted in more stable jobs by simplifying the types of temporary contracts, limiting their use and making permanent contracts more flexible (especially fixed-term contracts). This has led to a significant decline in temporary contracts, which is welcome. However, implementation of the reform presents several challenges that will need to be overcome in the coming years. One of the problems is that people who are on fixed-term contracts work fewer hours than people who are on regular permanent contracts, regardless of their personal and professional characteristics or those of the company where they work. So far, the labor market reform has not changed this state of affairs. For increasingemployment intensity, it would be more advisable to switch from temporary work to regular permanent contracts, especially for part-time jobs, rather than toward fixed-term contracts.

The shift to a new production model requires a more effective training system that better prepares workers for the jobs required by the most productive companies. While unemployment is falling, it is taking longer and longer to fill openings. This is a major concern in an economy that still has such a high unemployment rate. The education system needs to be more interactive with businesses so that they can communicate their needs and students can make decisions that are beneficial to both parties. This process can take some time, so another part will have to be covered by increased immigration. The upcoming Foreigners' Reform is a step in the right direction to relieve some of the economic pressure that will be caused by the projected decline in the working-age population. The reform will help to match the supply and demand in the labor market, making it more efficient. Other potential measures to explore include encouraging later retirement (en la presentación creo recordar que se citaba el trabajo de Rafael Domenech, Juan Ramon García y Alfonso Arellano). The participation and employment rates of the Spanish population aged 55 still lag behind those of the leading OECD economies. This is partly due to differences in human capital. To remedy this situation, it must become easier to balance work and retirement. One way is to remove barriers that prevent older workers from being hired or retaining their jobs. Another is to improve their employability and productivity.

One of the most pressing issues facing the Spanish economy is its low productivity growth. Here the constraints are the small size of businesses and the low level of entrepreneurship. **So the implementation of the "Crea y Crece" law is good news.** It has several useful amendments aimed at reducing the cost of setting up a business, such as reducing the minimum share capital for setting up a limited liability company from 3,000 to 1 euro. The digitalization of company set-up processes in line with the European directive is a positive development. Young people and people with greater digital skills stand to gain the most from this measure. In order for these changes to be successful, accompanying training processes must be put in place to allow less technologically-minded entrepreneurs to access these services. The changes announced to improve the unity of the market are not expected to lead to a significant reduction in the operating costs of businesses. Institutions created to monitor the unity of the market will have a positive but limited effect. However, since they do not have the power to force regional governments to comply with harmonization of regulations, their impact will be moderate. The measures taken simply incorporate the emerging jurisprudence into law, and although they impose some restriction on the autonomous communities in regulating professional services, they do not appear to represent significant changes. The use of electronic invoicing, which can boost the formalization of companies and their digitalization, and the willingness to evaluate the measures to be implemented, are positively valued. Finally, it is disappointing that the recent measures do not seem to address the review of regulatory thresholds for tax and labor obligations, andcertain recent measures even represent a step backwards.

Tables

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

	2019	2020	2021	2022	2023
United States	2.3	3.7	5.7	1.7	0.5
Eurozone	1.6	-6.2	5.2	3.1	-0.1
China	6.0	2.2	8.1	3.6	5.2
World	3.0	-3.0	6.2	3.2	2.4

* Argentina, Brazil, Chile, Colombia, México, Paraguay, Perú and Uruguay.
Forecast closing date: October 3, 2022.
Source: BBVA Research & FMI.

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

	2019	2020	2021	2022	2023
United States	1.8	1.2	4.7	8.0	4.1
Eurozone	1.2	0.3	2.6	8.1	4.5
China	2.9	2.5	0.9	2.3	2.5
World	3.6	3.1	4.5	7.8	5.7

* Argentina, Brazil, Chile, Colombia, México, Paraguay, Perú and Uruguay.
Forecast closing date: October 3, 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	2.95	4.28
Germany	-0.21	-0.48	-0.31	1.18	2.30

Forecast closing date: October 3, 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	0.96	0.98
USD-EUR	1.12	1.14	1.18	1.05	1.02
CNY-USD	6.91	6.91	6.45	6.67	6.81

Forecast closing date: October 3, 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	4.50	4.75
Eurozone	0.00	0.00	0.00	2.50	2.75
China	4.35	4.35	4.35	3.60	3.60

Forecast closing date: October 3, 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**	**-6.2**	**5.2**	**3.1**	**-0.1**
Private consumption	1.4	-7.8	3.7	3.8	0.1
Public consumption	1.8	1.0	4.2	1.8	0.9
Gross fixed capital formation	6.7	-6.6	4.1	2.5	0.5
Inventories (*)	-0.1	-0.3	0.1	0.2	0.0
Domestic demand (*)	**2.4**	**-5.7**	**3.9**	**3.2**	**0.3**
Exports (goods and services)	2.9	-9.3	10.3	5.7	1.0
Imports (goods and services)	4.9	-8.8	8.0	6.4	2.1
External demand (*)	**-0.8**	**-0.5**	**1.4**	**-0.1**	**-0.4**
Prices and Costs					
CPI	1.2	0.3	2.6	8.1	4.5
CPI Core	1.0	0.7	1.5	3.8	3.5
Labour Market					
Employment	1.3	-1.5	1.3	2.2	0.0
Unemployment rate (% of labour force)	7.6	8.0	7.7	6.8	7.4
Public sector					
Surplus (+) / Deficit (-) (% GDP)*	-0.7	-7.1	-5.1	-4.5	-3.5
Public debt (% GDP)*	83.8	97.2	95.6	94.6	95.2
External Sector					
Current Account Balance (% GDP)	2.4	1.8	2.4	0.8	1.2

Annual rate change in %, unless expressly indicated.
Forecast closing date: October 3, 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	**2.0**	**-11.3**	**5.5**	**4.4**	**1.0**
Private Consumption	1.1	-12.2	6.0	1.0	0.9
Public Consumption	1.9	3.5	2.9	-1.5	1.5
Gross Fixed Capital Formation	4.5	-9.7	0.9	4.5	5.1
Equipment and machinery	2.0	-13.3	6.3	4.9	3.8
Construction	7.2	-10.2	-3.7	3.8	4.3
Housing	5.2	-11.4	-4.8	2.7	1.3
Domestic Demand (contribution to growth)	**1.6**	**-9.1**	**5.2**	**0.8**	**1.8**
Exports	2.2	-19.9	14.4	16.5	-1.5
Imports	1.3	-14.9	13.9	6.5	0.3
External Demand (contribution to growth)	**0.4**	**-2.2**	**0.3**	**3.6**	**-0.8**
GDP at current prices	3.5	-10.2	7.9	7.2	2.5
(Billions of Euros)	1245.5	1118.0	1206.8	1294.3	1326.5
Labour market					
Employment, Labour Force Survey	2.3	-2.9	3.0	3.1	0.6
Unemployment rate (% Labour force)	14.1	15.5	14.8	13.0	13.3
Employment, full time equivalent	3.3	-6.8	6.6	3.3	0.8
Productivity	-1.3	-4.5	-1.1	1.1	0.2
Prices and Costs					
CPI (average)	0.7	-0.3	3.1	9.3	4.9
CPI (end of period)	0.8	-0.5	5.8	9.3	3.5
GDP deflator	1.5	1.1	2.4	2.8	1.5
Compensation per employee	2.4	2.5	-0.8	2.4	5.4
Unit Labour Cost (ULC)	3.8	7.0	0.3	1.4	5.2
External sector (*)					
Current Account Balance (% GDP)	2.0	0.4	0.9	1.1	-1.2
Public sector					
Debt (% GDP)	98.2	120.4	118.3	114.5	116.1
Deficit (% GDP) (*)	-2.9	-9.9	-6.8	-4.2	-4.4
Households					
Nominal disposable income	5.0	-2.0	3.1	3.3	4.5
Savings rate (% nominal disposable income)	8.1	17.6	13.7	7.9	6.9

Annual rate change in %, unless expressly indicated.
Forecast closing date: October 3, 2022.
(*) Excluding financial aid for Spanish banks.
Source: BBVA Research.

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