Letter from the Editors

Thirteen years after the Global Financial Crisis (GFC), Spain was confronted with a new and unexpected economic shock caused by the pandemic, which had brought the economy to a halt. While both crises represented scenarios that were extremely adverse, the starting points and toolkits necessary to face them were quite distinct. For example, contrary to the case of the previous crisis, the financial and real estate sectors seem to be holding up surprisingly well in response to COVID-19. Conversely, while Spain headed into the GFC in a relatively solid fiscal position, the government today has a much smaller margin to deal with the present crisis. Fortunately, the speed of the EU response relative to 2008 will help fill in this gap in discretionary fiscal support to underpin recovery.

Within this context, the July issue of *Spanish and International Economic & Financial Outlook (SEFO)* takes a look at the better than expected performance across some areas of Spain's public and private sectors throughout the pandemic, as well as highlights outstanding challenges.

This *SEFO* starts out with an assessment of the outlook for the Spanish recovery – first, broadly at the national level, and next, at the level of Spain's provinces. Spain's economy contracted by 0.4% in 1Q21, with all components of demand except investment in capital goods affected. However, second-quarter indicators released to date point to a sharp turnaround. Jobs registered strong growth in May and June, while the manufacturing and services PMI readings rose to near-record levels. Although tourism seemed to be headed towards recovery in May, rising infection rates appear to have weighed on tourist numbers in June. Also, inflation rose from negative rates at the end of last year to 2.7% in June and is expected to rise above 3% by the end of 2021. The forecast for GDP growth in 2021 stands at 6.3% and at 5.8% for 2022. This growth pattern reflects the fact that consumers are spending their precautionary savings faster than anticipated, which should benefit growth this year at the expense of 2022 (the pent-up demand effect). Conversely, the protracted negotiations over the NGEU mean that those funds will have a bigger impact next year (without fully offsetting the pent-up demand effect). Meanwhile, the budget deficit will reach 6.2% in 2022. And, in the absence of measures, debt is expected to increase to nearly 117% of GDP by 2022.

The economic crisis in Spain has been characterised by a triple asymmetric impact in terms of timing, sector and region. That asymmetry explains the differing impacts on the economic front and will also shape the varying speeds of recovery over the coming months. Regarding timing, the crisis began in 2Q20, resulting in a quarterly contraction of 17.8%, with a 17.1% recovery in the following

quarter. Customer-facing sectors most affected by the restrictions saw GVA contract at a quarterly rate of 41.4% in 2Q20. Due to their reliance on tourism, the Balearic and Canary Islands, along with certain provinces along the Mediterranean coast, were the regions hit hardest. Our nowcasting model points to quarterly growth of over 3% in 2Q21. Importantly, those sectors most exposed to the restrictions are very labour intensive. As a result, they require less growth than other sectors to increase employment. Specifically, those sectors need activity to grow by 0.24% year-on-year to create jobs, while all other sectors require growth of at least 0.33% year-on-year to increase employment. [1] Nevertheless, the economic and job recovery will continue to be characterised by disparity across sectors and regions.

As regards the financial sector, with the worst of the pandemic seemingly behind us, we take stock of the impact on the banking sector to date. In this respect, we analyse forbearance patterns at Spanish institutions, as well as the provisioning effort until the present, and what we can expect from banks going forward as they plan just how much of their capital will be tied up to secure solvency in the face of some anticipated uptick in loan non-performance.

Curiously, the COVID-19 crisis has yet to translate into an increase in Spanish banks' non-performing loan (NPL) ratio. This is due to government measures implemented to mitigate the impact of the crisis, such as the furlough scheme and payment moratoria. However, there are signs of a deterioration in asset quality. For example, the downward trend in forborne exposures (FBE) of recent years has ground to a halt. The fourth quarter 2020 data reveal an increase in the FBE ratio quarter-over-quarter, a trend worth monitoring in the coming months. A comparison of Spanish banks' forbearance rates to the rest of the eurozone also yields some notable insights. Prior to the crisis, Spanish banks' exposure to forbearance had been falling more intensely than in Europe in recent years, with the gap narrowing 2.9 percentage points since 2015. That said, this ratio was still 0.5 percentage points higher in Spain by year-end 2020. With a share of 20%, this puts Spain at the top of the list of eurozone banking systems in terms of FBEs. Finally, it is worth highlighting that in Spain the percentage of forborne exposures classified as non-performing is 11.5 percentage points above the eurozone average (50.2%) implying greater reliance on the refinancing route when borrowers run into trouble.

Also noteworthy was the significant provisioning effort made by Spanish banks even after the introduction of more accommodating regulation and accounting rules. However, provisioning started to slow in the first quarter of 2021 and there is a debate as to whether it ought to keep pace with 2020. Non-performing exposures should peak by early 2023, rising by around €40 billion between 2021 and 2022, with consumer credit hit especially hard in relative terms. If the provisioning effort of 1Q21 were maintained for all of 2021, the banks would recognise one-third of the estimated balance outstanding in the wake of the 2020 effort this year. Alternatively, the banks could step up their provisioning by 20-25% so that it is completed by the end of 2022.

We then drill down on another important sector where banks have exposures that has performed relatively well during the crisis – the real estate sector. Surprisingly, COVID-19's effect on the Spanish real estate market has been limited. The pandemic occurred during the "mature" housing cycle phase in terms of prices and transaction volumes. While GDP contracted by 17.8% year-on-year in the second quarter of 2020, the contractions in construction and property services amounted to 22.8% and 6.3%, respectively. Between June and September, both activities have recovered, registering growth of 24.8% and 6.4%, respectively. COVID-19 did, however, change the nature of the housing market, with rising demand for larger homes due to home working and declining demand for holiday homes thanks to mobility restrictions. Importantly, significant disparity in house prices exists across Spain's regions. As well, the pandemic had a greater adverse impact on prices of new builds compared to existing homes. That

said, COVID-19 had a more uniformly adverse effect on rental prices. In general, the pandemic has shone a spotlight on housing affordability issues.

Subsequently, we examine the challenging outlook for Spain's fiscal consolidation path, where, as in many countries, meaningful progress has been set back by the advent of the COVID-19 crisis, thus making achievement of fiscal targets all the more difficult over the near- to medium-term, particularly without much-needed fiscal reform.

Although Spain's deficit came in lower than expected in 2020, it still ranked highest among the EU-27. While the government's budget deficit forecast of 8.4% for 2021 is very similar to the Funcas consensus forecast of 8.2%, Spain faces a structural deficit in 2022 even higher than the 3.5% observed in 2019. This suggests the return to budget stability will be tough and requires a credible strategy for tackling the debt and deficit challenges to be defined in 2021. Such a strategy will need to cover until at least 2027 and will necessitate higher annual reductions than were being required of the country under the European fiscal rules before the pandemic (-0.65%). In the case of the regional authorities, the situation is more urgent as some of the income transferred in 2020 and 2021 to them by the central government will have to be returned in 2022 and 2023. Also, some regions will face significant financial stress and the reform of the regional financing regime needed to fix the problem remains bogged down. Lastly, the gradual ageing of the Spanish population will exert upward pressure on spending in health and social services, which between them account for over half of the regional budgets.

Finally, we close this issue on a more theoretical note, assessing Spain's institutional framework, taking into consideration current strengths, shortcomings, and the need to implement reforms in this space if the country is to tackle declining productivity.

Between 1996 and 2017, total factor productivity in Spain decreased by 10.5%. Some evidence suggests that certain institutional weaknesses could be a direct cause of the unsatisfactory trend in productivity. For example, the Global Competitiveness Report shows that Spain ranks 23rd on institutional quality compared to higher rankings in areas such as health and physical infrastructure. Notably, Spain is one of the EU countries in which institutional quality has deteriorated the most over the past two decades. This is likely due to the real estate boom and period of sustained growth in abundant and cheap credit during the run up to the financial crisis. Upon closer examination, it becomes apparent that Spain's institutional deficiencies are especially acute in areas such as transparency, the justice system, regulation, and coordination between government levels, which weigh on the country's economic growth. However, one bright spot for Spain is the quality of its democracy, with the country continuing to fall within the Economist Intelligence Unit's group of "full democracies". In light of the COVID-19 crisis and the transition to a digital/green economy, it is especially pressing that Spain address its institutional vulnerabilities. If left unaddressed, the absence of government efficiency could undermine Spain's response to the upcoming changes anticipated in the international economy.

Notes

[1] If the full-time equivalents (FTEs) metric were used, the employment threshold would be higher at an estimated 0.8%.