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Economic and financial developments in Spain over the COVID-19 crisis

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Let me first thank the organisers for allowing me to address this distinguished virtual audience. In my talk today, I will first elaborate on the impact of the health crisis on the Spanish economy and briefly discuss the macroeconomic outlook. Next, I will turn to the assessment of the economic policy responses put in place to limit the impact of the crisis. Lastly, I shall set out what I consider to be the most pressing policy challenges for the Spanish economy.

The impact of the health crisis on the Spanish economy

You will hardly need convincing of how deeply the spread of the COVID-19 pandemic has changed economic dynamics around the world since early 2020. The impact of the health crisis has been even more marked in Spain, with a fall in GDP of 11% last year, among the deepest in the group of advanced economies. This decline in activity was not only more pronounced, but also far steeper than in the previous recessions.

This time around, the drop was concentrated in the first half of the year, with historical contractions in quarter-on-quarter terms of 5.3% and 17.9%, respectively, in Q1 and Q2. As in other countries, these developments were the result of the adoption of extraordinary containment measures, which disrupted many productive activities and limited people's movements. However, even if the measures were similar in nature, their comparatively greater stringency in Spain helps explain the deeper GDP contraction in relation to other countries during the first half of last year.

Since late Spring, the progressive easing of the lockdown measures allowed for a recovery in economic activity. As a result, GDP rebounded significantly in Q3, rising 16.4% on the previous quarter. The fresh outbreaks of the virus in the final stretch of the year have since led to a renewed tightening of containment measures and thus to a near levelling-off of economic activity in Q4 (0.4% q-o-q growth). As a result, the level of activity by end-2020 was still 9.1% below that a year earlier. This last figure underlines the incomplete nature of the recent recovery, a feature that is shared with the other euro area countries, where the gap to the pre-crisis level of GDP is, however, smaller (currently estimated at around 5.1% for the euro area aggregate). Aside from being incomplete, the recovery is also characterised by its unevenness across a number of dimensions. This is perhaps most importantly the case from a sectoral perspective, since the restrictions have had a far bigger impact on those services that require a higher degree of social interaction.

The pandemic has also affected the labour market most adversely, although the extensive use of furlough schemes (ERTEs by their Spanish acronym) has significantly mitigated the impact of the crisis on workers' incomes. In particular, by end-January 2021, the employment of almost 739,000 workers, or 3.9% of total employees, had been fully or partly suspended. That is still a very high figure, but far below the peak recorded in April (3.5 million people on average for the month). The resort to furlough schemes has helped contain the increase in the unemployment rate; but, in the fourth quarter of 2020, joblessness nevertheless stood at 16.1% of the labour force, i.e. 2.3 pp up on the end-2019 figure.

Yet these aggregate figures mask a very uneven impact of unemployment across different sectors, as evidenced by the data on "actual" Social Security registrations (i.e. after taking into account the incidence of furlough schemes). In the hospitality sector, actual registrations fell by 38.1% year-on-year in January, whereas the decrease was just 4,4% in manufacturing. On the other hand, actual registrations have remained stable in agriculture and education, and have even increased by more than 4% in healthcare activities.

The crisis has also unevenly impacted the various layers of workers and households, since the proportion of young workers and low wage earners in the sectors most affected by the pandemic is relatively high. As a consequence, inequality is likely to have increased in Spain on account of COVID-19.

The economic outlook

Vaccine approvals have cascaded since November and they are now being distributed. This has raised hopes of us eventually overcoming the pandemic. However, fresh outbreaks and the emergence of new strains of the virus keep clouding the economic outlook, at least in the short run. Under these conditions, a robust economic recovery is unlikely to take hold until an effective and widespread medical solution is finally reached.

The central scenario of our latest macroeconomic projections for the Spanish economy, published last December, is founded on the expectation that the progressive resolution of the health crisis, together with substantial support from monetary and fiscal policies, should allow for a significant rebound in activity as from the second half of the year. However, the extent of that recovery will depend on the structural damage the pandemic is causing to the economy.

Under our baseline scenario, GDP would rebound at a rate of 6.8% in 2021, although pre-pandemic levels of activity would not be attained until mid-2023, about one year later than in the euro area as a whole. Several reasons account for the longer-lasting impact of the crisis in Spain. First, the shock was initially larger in this country, given also the higher degree of contagion during the initial stages of the pandemic. A second factor is the comparatively greater weight in Spain of those sectors in which the impact of the pandemic is expected to be more persistent. This is certainly the case of those sectors involving closer social interaction, in particular, tourism-related activities. Indeed, prior to the crisis, tourism exports accounted for nearly 6 % of GDP in Spain, against, for instance, around 2.5% in France and Italy, or 1.8% in the UK. And third, small and medium-sized firms, which are less well equipped to deal with the consequences of the crisis, are over-represented in the Spanish productive system.

The economic policy response

The response to the crisis provided by the authorities, both at the national and international levels, has been broad-based, resolute and largely coordinated, encompassing significant measures in the fiscal, monetary, labour market and financial sector areas. The measures taken have eased the downturn in real activity and have so far headed off the materialisation of financial systemic risks.

In the eurozone, the monetary policy implemented by the European Central Bank has been pivotal to avoiding systemic risks through a wide range of measures. These have included the provision of financing to banks on very favourable terms, the relaxation of the collateral framework and a significant increase in asset purchases through the Pandemic Emergency Purchase Program (PEPP). The measures have stabilised financial markets throughout the euro area, avoiding financial fragmentation across countries, and have supported the flow of bank lending which, in the euro area, is so relevant for financing households, SMEs and the self-employed.

Also, at the supranational European level, various instruments have been put in place to support the measures adopted by national governments. Member States have been allowed to make use of the flexibility clause of the Stability and Growth Pact, which in practice enables them to deviate temporarily from the existing fiscal rules. The European Commission approved the SURE, a programme of loans to Member States covering the cost of temporary lay-off schemes. However, the programme with the largest capacity is Next Generation EU (NGEU), which has been set up not only to address the consequences of the crisis, but also to speed up the digital and ecological transition of EU economies. In any case, the final impact of the NGEU will be highly dependent on a number of factors, including the ability to channel such a large amount of funds in a very short time span to projects with a high and persistent impact on economic growth.

National fiscal policy –the first line of defence in this crisis- has acted on a number of fronts. As in other countries, measures aimed at mitigating the impact of the crisis on employment and on households' and firms' income and liquidity have been a priority for the Spanish authorities. Among these measures, two stand out: the implementation of the ERTEs I mentioned and the setting-up of public guarantees for bank loans given to firms, to which I shall turn later.

Against the background of the high uncertainty we still face, economic policies should retain a strongly expansionary stance until the recovery has taken hold. At the same time, it is becoming increasingly necessary to adapt the policy response to how the crisis is unfolding. Here, I share the view that it is now time to step up the emphasis on polices aimed at fostering medium and long-term growth.

In this respect, as far as labour market policies are concerned, there is no doubt that furlough schemes have enabled a high number of labour relations to be maintained during this crisis. However, their suitability for safeguarding sustainable employment may be limited as the crisis drags on and restructuring is required at the sector and/or firm level. In these circumstances, it is crucial to avoid a loss of furloughed-worker skills. To this end, these workers should be considered as a priority group for access to training. A comprehensive review of the catalogue of active labour market policies is also warranted, with a view to increasing their effectiveness and efficiency. At the same time, we must be watchful of some elements in current policies that might eventually hamper the need for resource reallocation that is likely to arise as a result of the crisis. Here, preserving an adequate degree of flexibility in labour market regulations should be a priority in the context of any future revision of the legal framework in this area.

Let me now turn my attention to the policies deployed to protect the financial situation of corporates. In the initial phase of the crisis, corporate liquidity risks were the main area of concern. The significant fall in firms' turnover, mainly due to the restrictions on mobility, gave rise to a sharp increase in firms' liquidity needs. In spite of a significant improvement in the sector's overall liquidity situation in previous years, many companies did not have enough buffers to cover these liquidity shortfalls and had to rely on external funding.

National and supranational authorities reacted quickly to tackle these corporate liquidity risks. The policies enacted aimed at both reducing firms' liquidity shortfalls, including fiscal measures such as tax deferrals, and at supporting the flow of new credit to firms. The non-conventional monetary policies of the ECB I described and the public loan guarantee programme approved by the Spanish government can be included in this second group of policies.

As a result of this set of policy actions, firms' financing conditions significantly eased. The results of the Eurosystem Bank Lending Survey show that, in the second quarter of 2020, Spanish banks eased their corporate credit standards. This stands in sharp contrast to the significant tightening of credit standards in the wake of the Lehman bankruptcy in September 2008.

In fixed-income markets, the significant tightening in conditions between end-February and mid-March reversed quickly after the announcement of the introduction of the PEPP on 18 March.

Spanish firms have taken advantage of the improvement in financing conditions in both bank lending markets and fixed-income markets to cover a large portion of their liquidity needs. Between February and May, the stock of corporate debt increased by 6%, and has remained relatively stable since.

The public loan guarantee programme has played an important role in improving the access of firms to bank loans. Up to the end of December, this programme was used to extend loans to almost 600,000 firms and self-employed, for an amount of nearly EUR 115 billion. Recent research by the Banco de España reveals that reliance on public guarantees was particularly intense among firms facing potentially more difficult access to external funding in the current juncture, such as SMEs, riskier firms and companies operating in those sectors more exposed to the shock.

However, the prolongation of the crisis has increased firms' solvency risks. In particular, increased indebtedness and the reduction in earnings have worsened the financial position of many firms. Therefore, in the current phase of the crisis, economic policies in this area should focus on dealing with these solvency problems.

The Spanish government has already set up a special-purpose fund to inject capital in large and strategic firms. However, in the case of smaller firms there are fewer available tools to inject public capital, or at least to inject it efficiently. One option that could be explored is to set up vehicles investing in firms' capital using both public and private resources. In parallel, direct investments could be considered in firms that are under financial pressure yet remain viable, sponsored by the public sector using hybrid instruments such as participative loans or subordinated debt. In the case of small firms, providing support in the form of grants to viable companies may also be a sensible alternative.

In some cases, dealing with solvency problems will require debt-restructuring at insolvent firms with viable business projects. The current insolvency mechanisms should be improved to make them more efficient and to minimise the risk that these firms may end up being inefficiently liquidated. In this context, out-of-court insolvency procedures should be prioritised since they are generally more flexible and quicker than in-court insolvency processes.

The role of fiscal policy in the recovery

Public finances have deteriorated severely as a result of the pandemic's direct impact on health spending, the normal functioning of automatic stabilisers and the fiscal response aimed at supporting household and corporate incomes. The budget deficit might have exceeded 10% of GDP in 2020 and public debt would have climbed towards near 120% of GDP.

Yet despite these stark figures, in the short run it will be necessary to prolong the fiscal stimulus. At this stage, the costs of not doing so outweigh the benefits. But, at the same time, it is imperative to avoid poorly targeted expenses, especially when these are of a structural nature.

Also, we need a strong commitment to a gradual consolidation path once the crisis is behind us. This requires designing an ambitious multi-year fiscal consolidation programme, with a detailed description of the action plan put forward to achieve a gradual path of correction of the disequilibria that have built up. In other words, it is imperative to avoid unjustified delays in rebuilding fiscal buffers that may be needed in adverse future situations. An early announcement of the consolidation plan would maximise its credibility and its positive impact on agents' confidence.

In parallel with fiscal consolidation, the design of an ambitious structural reform agenda to raise our relatively modest growth potential would help revert the path of public debt over a medium and long-term horizon.

Challenges for the Spanish economy after the pandemic

Moving to my final points, let me briefly describe the main challenges to the Spanish economy ahead of the post-pandemic world. Actually, our economy was already beset by a number of significant challenges prior to COVID-19. However, the pandemic has increased the scale of those pre-existing challenges and posed some new ones. Let me focus, in what follows, on a few of those I deem most relevant: a high temporary employment ratio; a relatively low level of human capital; and a small average firm size.

Duality in the labour market

One differential aspect of the Spanish economy that has conditioned the developments observed since the start of the pandemic is the high temporary employment ratio, which stands at almost 25%, the highest in the euro area.

Reducing the high segmentation in the labour market should be a priority. During recessions, temporary employment usually absorbs the bulk of the adjustment in the labour market (and this has certainly been the case again in the current crisis). As a result, a large number of temporary employees, usually belonging to particularly vulnerable groups, such as the young – with less work experience – and the lesser skilled, are expelled from the labour market. This pattern of adjustment has the perverse effect of increasing income inequality significantly during crisis periods.

In addition, duality in the labour market has a substantial negative effect on efficiency, as it reduces the incentives for temporary workers to accumulate human capital and for permanent workers to increase their productivity. Instability of temporary contracts among the young also leads to a delay in decisions related to leaving the family home and fertility. All these aspects indicate the need to revise employment protection mechanisms in order to achieve more equal and fairer protection among workers. In addition, as I said earlier, firms' internal flexibility mechanisms should be favoured as an alternative to employment adjustment, especially in times of high uncertainty.

Human capital accumulation

In terms of the second challenge I mentioned, that of human capital accumulation, there has been a substantial improvement in recent decades in terms of closing the gap in educational levels with the EU average. However, a significant shortfall remains, affecting both Spanish workers and employers. And these comparatively low levels of human capital contribute to explaining the negative productivity gap with other more dynamic economies.

A comprehensive overhaul of the Spanish education system, at all levels, is needed in order to close that gap. Action in this field is all the more pressing in view of the challenges posed by globalisation, digitalisation and technological progress. This calls for rethinking the curriculum content, both at compulsory education stages and at university. Likewise, the apprenticeship system should also be reviewed, taking as an example those European countries, such as Germany, that have attained better results in this field.

Firm size

The final challenge I want to mention is that of increasing firm size. Indeed, the Spanish business sector is skewed towards small (or even very small) companies to a larger extent than in other euro area countries. For example, in 2019 the share of companies with fewer than five employees was 78% in Spain, 9 pp above the euro area. This contributes to explaining the Spanish economy's low aggregate productivity when compared with the euro area, since it is precisely in smaller Spanish companies where the negative productivity difference in relation to their European counterparts is wider.

Given its negative impact on productivity growth, factors that favour the relative smaller average size of Spanish firms should be addressed. For example, there are some regulations which are contingent upon corporate size and may inhibit business growth. In particular, some regulations increase the corporate burden once companies have more than 50 employees. Therefore, some firms might opt to remain small to avoid the costs of exceeding this threshold. Also, closer convergence of regulatory standards across Spanish regions towards best practices would be conducive to a more competitive plateau within the country and make it easier for companies to expand their businesses.

Concluding remarks

Let me conclude on a cautiously optimistic note. I believe it is fair to say that the policy response to the current shock has been far more timely and ambitious than it was during the past global financial crisis. This applies to the main relevant policy levers -fiscal and monetary, among others- and, in the case of the EU, important and unprecedented steps have been taken. On the side of economic agents, we have witnessed a gradual process of adjustment, in which individuals and corporates have changed their habits and their way of working, consuming and producing, adapting themselves to the dire circumstances.

But the pandemic is still part of our daily life and its economic consequences will still be felt in the years to come. Spain shares many of the challenges faced by other advanced economies, which can be summarised as follows. First, while we are still in the crisis-management mood, it is essential to maintain the impetus of the mitigating actions put in place over the last year, but adapting them to the evolving nature of the crisis. Second, we must prepare our economy for the post-pandemic world, even if some of its facets are still unknown. This implies addressing the new threats and opportunities that will emerge after the pandemic, while also fixing the main areas of vulnerability and inefficiency that were already present before COVID-19.

True, this is like doubling our homework. But this time we have an important extra tool to hand: the European programme NGEU. It is a considerable opportunity, but is also comes with an equally considerable responsibility: to make the best possible use of these resources. This will determine the capacity of the Spanish economy to prepare itself in order to cope successfully with the coming challenges in the decades ahead. And, at the EU-level, the outcome of NGEU, as I see it, will set an important landmark on the road towards more European integration, including the necessary establishment of a permanent common macrofinancial stabilisation capacity. Much is at stake and, hence, there is little room for complacency.

Thank you.