

MACROECONOMIC PROJECTIONS FOR THE SPANISH ECONOMY (2020-2022): THE BANCO DE ESPAÑA'S CONTRIBUTION TO THE EUROSISTEM'S JUNE 2020 JOINT FORECASTING EXERCISE

Introduction and summary

This note describes the macroeconomic projections for the Spanish economy for the period 2020-2022. They are part of the projections for the euro area as a whole that were submitted to the ECB's Governing Council and published on this institution's website on 4 June.¹ The cut-off date for the technical assumptions used (detailed in Box 1) was 18 May, and the preparation of the projections concluded on 25 May.

The COVID-19 pandemic has given rise to much uncertainty over the outlook both for the Spanish economy and the euro area. Usually, the Eurosystem's projections comprise a baseline scenario, accompanied by an assessment of the nature and sign of the risks surrounding it. In order to reflect the extraordinary level of uncertainty at present, the Eurosystem has opted on this occasion to alter its usual practice. Instead, several alternative scenarios have been formulated, in line with the approach followed in the wake of the crisis by other institutions (including the Banco de España, in its publication on 20 April of its reference macroeconomic scenarios).²

The uncertainty currently afoot reflects widely differing factors over the different projection horizons. The procedure used to estimate the decline in GDP in the current quarter is based on estimates of the percentage reduction in output in each sector as a result of the introduction of social distancing and measures restricting movement and, therefore, activity. It offers – in the current and highly unusual episode – a relatively high degree of reliability set against the traditional approaches based essentially on the analysis of a series of conjunctural indicators, but also evidences some shortcomings. For example, the difficulties of estimating the volume of forgone production are exacerbated in the current setting, in which the partial reopening of certain sectors takes place unevenly from a geographical standpoint and, frequently, includes certain restrictions (e.g. permitted numbers of customers) in the provision of a broad range of services.

As the projection horizon unfolds, two sources of uncertainty may be highlighted because of their intensity. The first stems from how COVID-19 may evolve, given the possibility that new infectious outbreaks may arise, necessitating the reintroduction

1 See the [Eurosystem staff macroeconomic projections for the euro area. June 2020](#).

2 The methodological approach used to prepare these projections differs in some respects from those that the Banco de España used in its publication [Reference macroeconomic scenarios for the Spanish economy after Covid-19](#), meaning that the comparability of both exercises is limited.

of certain social distancing measures until a vaccine or effective treatment for the disease becomes available. This possibility, according to the common methodology of the Eurosystem's projections, is considered significant until mid-2021.

The second factor of uncertainty relates to the possibility that any normalisation of the health situation may not, in parallel, entail a full restoration of the economy to its pre-crisis state. Such persistent harm might stem, for instance, from the possibility that the measures enacted to provide liquidity to firms does not manage to prevent the insolvency of a portion of them. A further possibility is that the loss of income incurred by these agents at the height of the crisis may translate into a lower volume of funds to address their investment. Such possibilities would give rise to losses in employment, probably leading to the emergence of a significant long-term unemployment component, with the subsequent loss of employability for some workers.

This note considers, in particular, several scenarios. They include a so-called “early recovery” scenario, and another “gradual recovery” scenario. They differ in terms of how the above-mentioned uncertainties are resolved. The decline in GDP is more marked in 2020 in both scenarios, but in one of the scenarios the exit from recession is swifter and the loss in output in the medium term is smaller. This more benign scenario is that of the early recovery, in which the improvement in economic activity from its trough begins at a somewhat higher rate as early as in Q2, and continues subsequently without the scale of the potential obstacles that might arise in the coming quarters (of both a health-related and economic or financial nature) becoming significant. Under both scenarios, sectoral activity in Q2 is defined by the restrictions contained in the various legal provisions that have been regulating the state of alert and, in particular, from May, by the lockdown-easing schedule set out by the authorities on 28 April. This schedule provides for approximate intervals for the move from one phase to another. The main difference in the short term is that, under the early recovery scenario, there is an assumption that economic agents will be adapting their operations more nimbly to the successive situations posed during the state of alert, which will allow the reductions in sectoral activity to be somewhat smaller in Q2 than under the gradual recovery scenario.

Under the early recovery scenario, moreover, it is considered that, after the lifting of the state of alert, it is possible to avoid further significant outbreaks of the disease, meaning it is not necessary to reintroduce containment measures. In addition, there is an assumption that the economic policy measures are highly effective in avoiding the destruction of firms and, therefore, of the capital stock; accordingly, the downturn in the labour market is also temporary and an increase in long-term unemployment is avoided.

The second scenario, that of a gradual recovery, departs from the assumption of a greater impact of the shutdown of sectors in Q2. Moreover, this scenario includes

the possibility that, during the period no vaccine or effective treatment against the virus is available, there are fresh epidemic outbreaks. These would, however, be less virulent than the original episode, meaning that the economic cost of the containment measures would also be lower. Lastly, this scenario considers that there is some persistent harm to the productive system, concentrated in the sectors most exposed to social interaction. It is here that the full recovery of normal activity will take longer.

The declaration of the state of alert in mid-March led, in Q1, to an unprecedented quarter-on-quarter rate of decline in GDP of 5.2%. In Q2, the period affected by the pandemic containment measures is notably longer. As a result, and despite the fact that since early May the lockdown has begun to be gradually eased, the fall in output in the Spanish economy will be significantly higher, at quarter-on-quarter rates of -16% under the rapid recovery scenario, and -21.8% under the gradual recovery scenario.

After the strong decline in activity in the first half of the year, there is expected to be a rebound in the second half. This will arise as a result of the gradual lifting of the pandemic containment measures (which, in any event, will not be complete as regards the activities entailing greater social interaction), the lesser intensity of any subsequent outbreaks and the effects of the fiscal, monetary and prudential measures pursued, which are expected to restrict any potential channels of financial amplification of the crisis. In this respect, the crisis has given rise to a drastic reduction in the income of many firms and, consequently, to a significant liquidity shortfall, which the various policies implemented (such as the granting of public guarantees on loans to non-financial corporations and the moratoria on the payment of taxes and social security contributions) are attempting to alleviate. One assumption underlying the projections of the early recovery scenario is that these policies are highly effective when it comes to preventing severe damage to the business sector. There would be damage under the gradual recovery scenario, but it would be relatively confined.

In any event, the uncertainty over the course the illness takes, which will likely remain in place until early next year, will check household and corporate spending. As a result of all these considerations, Spanish GDP would decline under the early recovery scenario by 9% this year, before rebounding by 7.7% and 2.4%, respectively, in 2021 and 2022 (see Table 1 and Chart 1.1). Under the gradual recovery scenario, the rebound in the economy would be later, meaning that the decline in output this year would be 11.6%. The rates of change for each of the two following years would be 9.1% and 2.1%. At the end of the projection period, GDP would be about 0.5 pp up on its pre-crisis level under the rapid recovery scenario, while it would still be 1.6 pp lower under the gradual recovery scenario (see Chart 1.2). Relative to the level projected in December 2019, these gaps would be -3.9 pp and -5.9 pp, respectively.

Table 1

PROJECTIONS FOR THE MAIN MACROECONOMIC AGGREGATES OF THE SPANISH ECONOMY (a)

Annual rate of change in volume terms and % of GDP

	2019	June 2020 projections								
		Early recovery			Gradual recovery			Risk scenario		
		2020	2021	2022	2020	2021	2022	2020	2021	2022
GDP	2.0	-9.0	7.7	2.4	-11.6	9.1	2.1	-15.1	6.9	4.0
Harmonised index of consumer prices (HICP)	0.8	-0.1	1.3	1.6	-0.2	1.2	1.5	-0.3	0.9	1.2
HICP excluding energy and food	1.1	0.9	1.1	1.3	0.8	1.0	1.1	0.6	0.5	0.7
Unemployment rate (% of labour force) (b)	14.1	18.1	18.4	17.1	19.6	18.8	17.4	23.6	24.7	22.2

SOURCES: Banco de España and INE.

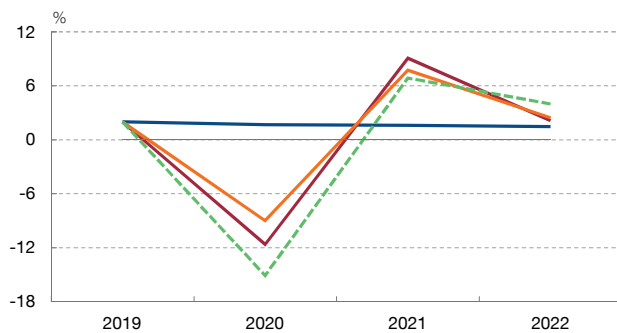
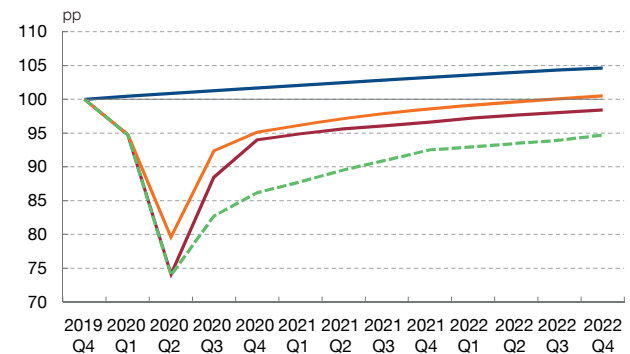
NOTE: Latest QNA figure published: 2020 Q1.

a Projections cut-off date: 25 May 2020.**b** Annual average.

Chart 1

GDP UNDER THE DIFFERENT FORECASTING SCENARIOS

1 REAL GDP. RATES OF CHANGE

2 REAL GDP. LEVEL
(2019 Q4 = 100)

— DECEMBER 2019 — JUNE 2020 (EARLY RECOVERY) — JUNE 2020 (GRADUAL RECOVERY) - - - JUNE 2020 (RISK SCENARIO)

SOURCES: INE and Banco de España.

The effects of COVID-19 are asymmetrical across countries in terms not only of the severity of the outbreaks, but also of their economic impact. In particular, Spain is among the euro area countries that will presumably be most affected, as a result both of the stricter confinement measures deployed to date and of certain structural characteristics of its economy. For one thing, services involving high social interaction, such as those relating to tourism, which the crisis has dented with particular severity, have a comparatively higher weight in the Spanish economy. For another, Spain has a higher proportion of small firms, which face greater difficulties gaining access to effective tools with which to mitigate the reduction in liquidity caused by the decline in revenue associated with the pandemic and with the

measures to contain it. Consequently, the reduction in Spanish GDP in 2020 is expected to exceed, under both scenarios, that of the euro area by around 3 pp, although the subsequent recovery in the Spanish economy will be sharper than that in the euro area.

The enormous uncertainty prevailing at present does not allow more unfavourable risk scenarios to be ruled out. Specifically, while knowledge on how the disease is evolving has rapidly increased, there are still relatively unknown aspects that might lead to more adverse epidemiological developments. And that, in turn, would give rise to more persistent effects on economic activity. To capture these risks, a “very slow recovery” scenario has been constructed. It is characterised by acute new infection episodes, requiring additional strict confinement, and by the presence of financial channels, that amplify the real shock and cause its effect is to exert a notably higher degree of persistence. Under this risk scenario, the fall in GDP would be as much as –15.1%.

Assumptions about the path of the pandemic and the containment measures

The rapid spread of Covid-19 has, in order to check it, necessitated the introduction both in Spain and in many other countries of severe restrictions on people’s movements, with most adverse effects on economic activity. In Spain, the restrictions came into force across the board with the declaration, on 14 March, of the state of alert, although they had already begun, in some areas, in the previous days.

In any event, the severity of the confinement measures has differed from country to country. Among other factors, this has been due to the intensity that the spread of the disease had reached at the time the restrictions were introduced, which in most cases was, as in Spain, towards mid-March. Spain, where contagion was on a very high scale at that time, is also one of the countries where the scope of the restrictions is expected, according to some indicators, to be greater. Specifically, according to mobility indicators drawn from mobile phones, Spain is expected to have recorded, in comparative terms, a greater reduction in the number of visits by people to retail and recreational premises and to workplaces (see Chart 2).

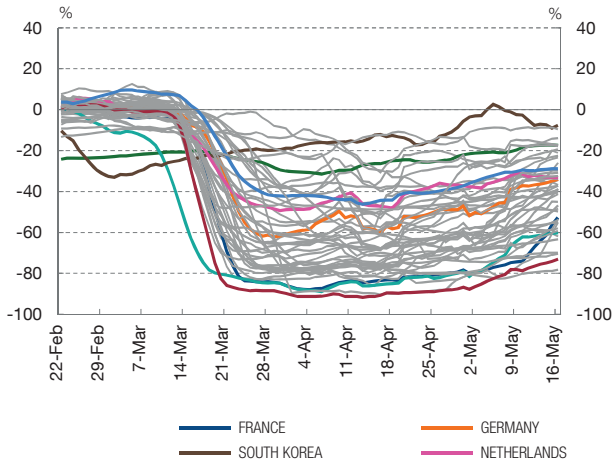
These restrictions on personal contact have been effective in containing the spread of the disease in Spain. Specifically, the figures for new infections and daily deaths, which in seven-day moving average terms reached peaks of 7,897 and 814 people on 31 March and 3 April, respectively, have since fallen to 370 and 5 people as at 2 June, according to the information provided by the Ministry of Health that day (see Chart 3.1).³ The measures broadly adopted in other countries in recent months appear to have been effective in controlling the pandemic, albeit to differing degrees of success depending on the time these measures were activated and on how severe they were (see Chart 3.2).

³ See Update no. 124. Illness due to coronavirus COVID-19. 02.06-2020. Situation in Spain. Centro de Coordinación de Alertas y emergencias Sanitarias. Ministerio de Sanidad. labour

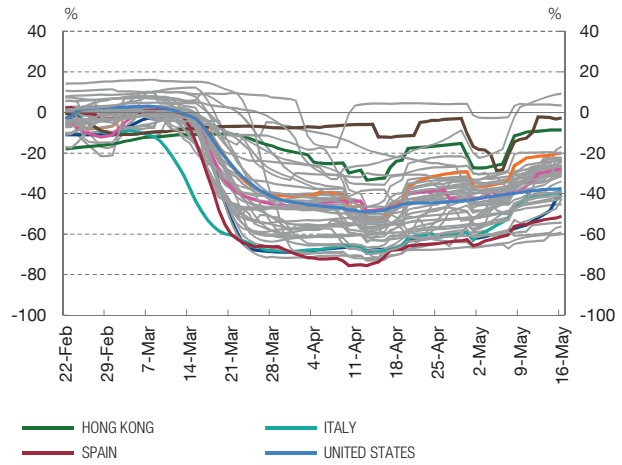
Chart 2

GOOGLE COVID-19 COMMUNITY MOBILITY REPORTS (7-DAY MOVING AVERAGE)

1 RETAIL AND RECREATION SITES (a)



2 WORKPLACES (a)



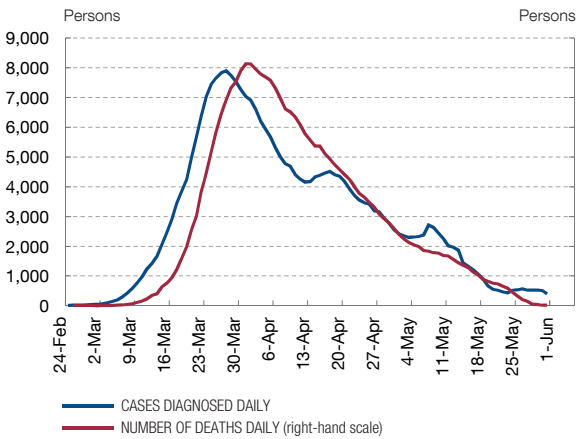
SOURCES: Banco de España and Google Mobility Report.

a Each grey line represents a different country.

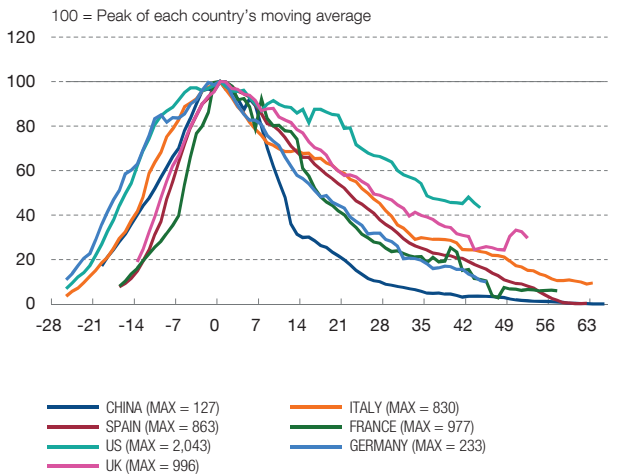
Chart 3

EPIDEMIOLOGY OF COVID-19 IN SPAIN AND IN THE MAIN COUNTRIES AFFECTED

1 CASES DIAGNOSED AND NUMBER OF DEATHS (7-DAY MOVING AVERAGE)



2 NUMBER OF DAILY DEATHS DUE TO COVID-19 (RE-SCALED) (a)
(T=0 AT THE PEAK OF THIS 7-DAY MOVING AVERAGE)



SOURCES: Ministerio de Sanidad and Banco de España.

a The figures next to the names of the countries relate to the peak of the 7-day moving average.

Controlling contagion has allowed for the start of the reversal of the confinement measures. In Spain, the guiding principles of this process were set out in a plan unveiled on 28 April. It comprises four successive phases into which the country's different regions are gradually moving, as certain health requirements of progressively met. Late June may

see the end of the process, entailing solely the maintenance of some restrictions on activities involving large numbers of people.

These extremely drastic measures have been an emergency solution to a health crisis that demanded a swift and categorical response. However, its costs in terms of economic activity are very heavy, as evidenced by the marked decline in GDP across different countries in Q1. In Spain's case the fall was 5.2%, despite the fact that the restrictions on movement were only in force during the second fortnight of March. The decline in Spanish GDP will, no doubt, be notably higher in Q2: on one hand, the period affected by restrictions of an intensity at least equal to that of the second fortnight in March will be longer; and, on the other, the restrictions – while slacker – will run practically to the end of the quarter. This gradual easing in the restrictions on movements (and, therefore, on economic activity) has begun to be reflected in some daily indicators (see Chart 4).

The emergency phase of the pandemic, in which governments had to act promptly and with indiscriminate measures, appears to be drawing to a close. But, hereafter, epidemiological developments will continue to exert enormous influence on global economic prospects for what may be a lengthy period. As different governments, including Spain's, wind back the confinement measures, they will face an uncertain environment in which they must assess the costs and benefits of different possible courses of action. At one extreme is a full return to pre-pandemic normality (which seems incompatible with controlling infection insofar as there is no effective medical remedy); and at the other, a hypothetical fresh resort to strict confinement (which should ideally only be a temporary measure, given its high economic cost). The adoption of an epidemiological monitoring strategy centred on early detection of new cases and tracing the contacts of recently infected people is, a priori, the means of navigating between both extremes that the governments of those countries at a more advanced stage of the pandemic are adopting.

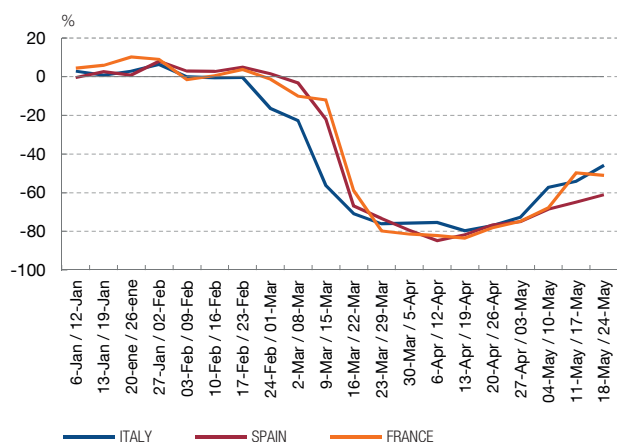
The Eurosystem's projections exercise rests on the formulation of specific assumptions about the course the pandemic will take. The early recovery scenario assumes that, even if no effective medical solution becomes available, a resurgence of the pandemic in the coming quarters will be avoided, making the application of further containment measures unnecessary.

Under the gradual recovery scenario, the progressive easing of the current lockdown might be followed by the emergence of new, one-off outbreaks in the coming quarters, until an effective vaccine or medical treatment is discovered (a possibility not foreseen until mid-2021). However, the intensity of these outbreaks would, in any event, be lower than that of the original episode, thanks to several factors: the greater preparedness of the health system; the application of voluntary social distancing measures; and the diminishing restrictions on certain activities where personal interaction is greater. On this last aspect, the gradual start-up in activity is taking place unevenly across sectors. Normalisation is earlier in manufacturing and certain

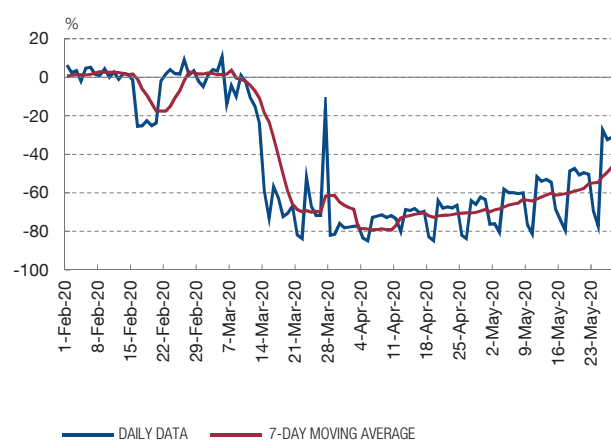
Chart 4

HIGH-FREQUENCY INDICATORS DURING COVID-19 IN SPAIN

1 TRAFFIC ON ATLANTIA GROUP MOTORWAYS (YEAR-ON-YEAR CHANGE, EQUIVALENT WEEK)



2 TRAFFIC ON M30, MADRID (a) (VEHICLES X KM TRAVELLED, % YEAR-ON-YEAR)



SOURCES: Grupo Atlantia, Madrid City Council and Banco de España calculations.

a Change compared with the same day of the week last year.

services, while in others, such as those relating to hotels and restaurants and leisure, full normalisation is not expected to be attained until the aforementioned effective medical solution is rolled out in mid-2021. The assumption that any new outbreaks will be appreciably less intense than that we are currently overcoming warrants the assumption that, even though new containment measures may need to be reintroduced, their economic cost will be lower than that of the recent lockdown.

Finally, the risk scenario that envisages a very slow recovery would be characterised, in fact, by its implicit inclusion of a significant resurgence of the disease, which would require the reintroduction of social distancing measures with a significant impact on economic activity.⁴

Calibration of the decline in GDP in Q2.

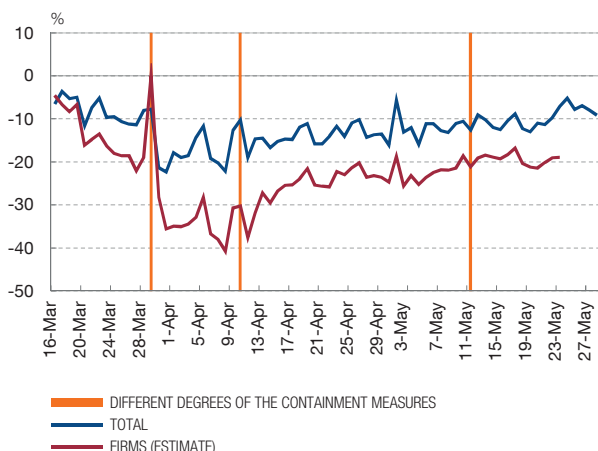
The assessment of the magnitude of the decline in GDP in Q2 is based on procedures similar to those used in the Analytical Article **Reference macroeconomic scenarios for the Spanish economy after Covid-19**. These involve estimating the level of activity by productive sector in light of the restrictions resulting from the various legal provisions enacted under the state of alert. Specifically, the estimates made rest on a set of assumptions relating to three different facets.

4 Moreover, from a non-epidemiological standpoint, the severe scenario includes, as an additional ingredient, pronounced adverse effects on agents' financial position, as a result of the prolonged contraction in activity.

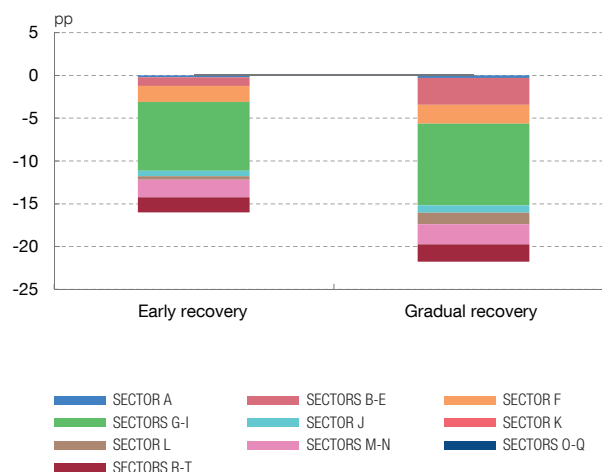
Chart 5

CALIBRATION OF THE RATE OF CHANGE IN GDP IN Q2

1 ESTIMATION OF THE IMPACT OF THE DIFFERENT PHASES OF THE PANDEMIC CONTAINMENT MEASURES ON ELECTRICITY CONSUMPTION (a)



2 CONTRIBUTIONS BY SECTOR TO GDP GROWTH IN Q2 (b)



SOURCES: ENTSO-E Transparency Platform, REE and own calculations.

- a See Bover, O., N.Fabra, S. García-Uribe, A.Lacuesta and R.Ramos “Lockdowns, electricity consumption and activity”, currently in progress. The chart shows the result of two regressions with different dependent variables: the logarithm of total hourly electricity consumption (ENTSO-E Transparency Platform) and the logarithm of hourly electricity consumption estimated by the authors for firms (REE). Estimation period: 1 January 2019 to 28 May 2020. The regressions are based on indicators of peak, off-peak and super-off-peak times, day of the week, month and year. Also included for the regressions are maximum temperature, maximum temperature squared and dummy variables for national and regional holidays, weighted by electricity consumption per region. The points for each series estimate as per-unit values the decline in the demand for electricity relative to a comparable day bearing in mind the foregoing variables.
- b Agriculture, forestry and fishing (A) Manufacturing (B-E) Construction (F) Wholesale and retail trade, transport, and accommodation and food services activities sector (G-I) Information and communications (J) Financial and insurance activities (K) Real estate activities (L) Professional, scientific, and technical and other activities (M-N) General government, education and health care (O-Q) Artistic and recreational activities and other services (R-T).

The first of these facets refers to the formulation of assumptions about the weekly loss of activity, in each of the 10 sectors considered, during the pre-lockdown easing period, i.e. between 1 April and 4 May. One pointer for the calibration of the reduction in activity in this period is given by the behaviour of certain daily indicators, including electricity consumption by firms (see Chart 5.1), the series of Social Security registrations and credit card payments. Interpreting the information from these daily series generally poses some difficulties which, in this case, are exacerbated by the fact the period of the shutdown in non-essential activities coincides with Easter week, which raises uncertainty.

The calibration is completed by means of the resort to certain additional assumptions. Specifically, it was considered under the gradual recovery scenario that, for the period after 9 April, the reductions in sectoral activity are similar to those in the last fortnight of March which, in turn, were calibrated on the basis of the QNA results for Q1. The outcome is a reduction in value added which, in aggregate terms, is approximately 30% compared with a non-pandemic situation. Moreover, for the first nine days of April, during which the aforementioned shutdown in non-essential activities was in force, the loss of value added for the economy as a whole resulting from aggregating the reductions estimated in each of the ten sectors is slightly over 50%.

The early recovery scenario takes into account the fact that the high-frequency indicators for the period of the quarter elapsed might be consistent with somewhat smaller losses of activity than those suggested by the evidence for the second fortnight of March. That might be associated with the capacity shown by firms to adapt their activity, by various means, to the new circumstances imposed by the COVID-19 containment measures. Such means include, for example, the adoption of protection measures for the workers in the industry, teleworking in certain services activities and home deliveries in the case of restaurants and some retail trade sectors. This results in reductions in value added which, on average for the weeks of the quarter concerned, are around 5 pp lower than those observed under the gradual recovery scenario.

The two remaining facets take into consideration a possible timetable for lockdown-easing process by sector and province. Specifically, on one hand, information is included about the territories changing phase in each of the weeks included between 4 May and 25 May (projections cut-off date), and working hypotheses are formulated about the changes in phase in each of the remaining weeks until 30 June. According to the assumptions made, which are the same under both scenarios, the end of the quarter would see a series of territories representing somewhat over 40% of the country's overall value added moving into the "new normality", while the remaining territories would be in phase 3 of lockdown-easing.⁵

On the other hand, assumptions are made about the percentage of activity recovered in each sector and phase as from 4 May. Under the early recovery scenario, this leads the level of value added to stand, at the end of the quarter, approximately 7% below what would have been observed in the absence of the pandemic. And under the gradual recovery scenario, the related figure would be 12%. That would be compatible with levels in the last week of the month 50% and 70% lower, respectively, in the activities relating to hotels and restaurants, tourism and leisure which, along with the wholesale and retail trade and transport sectors, are those that, over the quarter as a whole, contribute most to the loss of output (see Chart 5.2). The resulting quarter-on-quarter GDP growth would be -16% and -21.8%, respectively, depending on whether the rapid exit or gradual exit scenario is considered.

Macroeconomic developments beyond the short term

The decline in GDP, which is directly linked to the lockdown, is concentrated in the first half of 2020. During the summer months, a continuation of the ongoing gradual normalisation of activity that began in the final stretch of Q2 will be observed under both scenarios. This will be the result both of the easing in the restrictions on

⁵ Specifically, the assumption made is that territories change phase two weeks after beginning the previous one. Accordingly, the entire national territory will be in the «new normal» by 6 July. The latest developments suggest, in any event, the possibility that the process may accelerate to some extent.

production associated with the pandemic containment measures and of the materialisation of some of the spending decisions postponed by households and firms in the first of the year. However, the rebound in the level of activity will be incomplete, as a result of the effects (which will be sharper under the gradual recovery scenario) on agents' behaviour of the uncertainty over the possibility of fresh outbreaks of the disease requiring the reintroduction or reinforcement of containment measures. In particular, the uncertainty will lead households to increase their precautionary saving and firms to delay their investment and employment decisions. That said, the earlier fading of the uncertainty under the early recovery scenario leads to a more pronounced reversal of household precautionary saving as from the summer months. In a similar fashion, firms will resume their investment decisions under this scenario in the final stretch of the year.

Accordingly, under both scenarios, the end-2020 level of GDP will be notably lower than would have been the case according to the Banco de España's December 2019 projections (see Chart 1.2). The uncertainty will very gradually lift up to the moment when a definitive solution to the health crisis is found in mid-2021. The recovery in GDP in the final stretch of the projection horizon will not prevent the level of this aggregate in late 2022 from being only 0.6 pp higher under the early recovery scenario than in 2019 Q4, before the pandemic struck, and from being 1.6 pp lower under the gradual recovery scenario.

With the exception of government consumption and public investment, all the demand components are being profoundly affected by the crisis (see Table 2). Private consumption has contracted strongly in the first half of the year, as a result of the sum of two factors. First, the shutdown in sectoral activity has, perforce, given rise to a decline in spending on many categories of goods and services other than staples. Further, the extraordinary increase in uncertainty over the economic outlook has prompted households to be more cautious regarding their spending decisions. Both factors are translating into a very sharp increase in the saving rate, against a background in which public policies have helped limit the negative impact of the crisis on the sector's income. In the future, under both scenarios, the easing of the pandemic containment measures, the progressive materialisation of spending decisions postponed since mid-March and the gradual reduction in uncertainty are expected to lead to a gradual rise in private consumption. Several factors will be tempering this, however. They include the gradual and incomplete nature of the return to pre-crisis employment levels, the lower support given by general government to household income and, especially under the gradual recovery scenario, the persistence of uncertainty over how the health situation may evolve.

The decline in non-financial corporations' investment in 2020 will be very sharp, but also significantly uneven across the productive sectors. The fall-off will be due to two types of reasons. On one hand, firms will tend to delay undertaking new investment projects in a setting of high uncertainty over their future sales and of a

Table 2

PROJECTIONS FOR THE MAIN MACROECONOMIC AGGREGATES OF THE SPANISH ECONOMY (a)

Annual rate of change in volume terms and % of GDP

	2019	June 2020 projections					
		Early recovery			Gradual recovery		
		2020	2021	2022	2020	2021	2022
GDP	2.0	-9.0	7.7	2.4	-11.6	9.1	2.1
Private consumption	1.1	-9.1	9.0	1.8	-11.2	11.2	1.6
Government consumption	2.3	4.4	-1.5	0.8	4.6	-1.5	0.8
Gross fixed capital formation	1.8	-20.6	9.7	8.8	-26.5	7.4	7.1
Exports of goods and services	2.6	-16.7	21.8	8.7	-21.9	18.5	7.7
Imports of goods and services	1.2	-16.6	19.6	10.6	-21.5	14.0	9.1
National demand (contribution to growth)	1.5	-8.5	6.5	2.7	-10.8	7.4	2.2
Net external demand (contribution to growth)	0.5	-0.5	1.2	-0.3	-0.8	1.7	-0.1
Harmonised index of consumer prices (HICP)	0.8	-0.1	1.3	1.6	-0.2	1.2	1.5
HICP excluding energy and food	1.1	0.9	1.1	1.3	0.8	1.0	1.1
Employment (hours worked)	1.5	-10.1	7.3	2.3	-12.6	8.5	2.3
Employment (EPA, no. of persons)	2.3	-3.9	0.6	2.3	-5.7	1.8	2.6
Unemployment rate (% of labour force) (b)	14.1	18.1	18.4	17.1	19.6	18.8	17.4
Net lending (+)/net borrowing (-) of general government (% of GDP)	2.3	2.5	3.3	3.0	2.3	3.5	3.0
General government net lending (+)/net borrowing (-) (% of GDP)	-2.8	-9.5	-5.8	-4.8	-11.2	-6.8	-6.1
General government debt (% of GDP)	95.5	114.5	111.7	112.5	119.3	115.9	118.7

SOURCES: Banco de España and INE.

NOTE: Latest QNA figure published: 2020 Q1.

a Projections cut-off date: 25 May 2020.**b** End-of-period data.

significant decline in their current capacity utilisation. On the other, the pandemic containment measures have made for a most significant reduction in firms' revenues, entailing a decline in the funds they have available to commit to investment spending. This does not only affect the short term, but also the period after the lifting of restrictions on activity, insofar as firms will have to service the debt they are currently incurring. Since, under the gradual recovery scenario, the containment measures will be in force for longer, the loss of income for firms and the increase in their debt will also be greater. And that, along with comparatively more unfavourable financial conditions (manifest in higher interest rates on bank lending) and the high uncertainty facing the return of possible investment projects, causes a greater delay in the improvement of this aggregate. The improvement finally comes about towards the end of the projection horizon, assisted by the persistence of very benign financial conditions. This is particularly so under the gradual recovery scenario, as uncertainty progressively wanes.

As a consequence of the interruption of movements in goods and, above all, of people caused by the pandemic, the Spanish economy's external demand has shrunk forcefully. This has simultaneously affected all its external markets. The outcome is a strong fall in exports of goods and services, one which is deeper in the case of the gradual recovery scenario, given that it is characterised by a sharper and more

durable unfavourable performance of external markets. Under both scenarios, the persistence of the downturn in exports is exacerbated by some additional factors. These include, in the case of manufactures trade, the possible damage to global supply chains as a result of the crisis. And, in the case of tourist services, there is the fact that this is an activity liable to be durably affected by social distancing measures, both directly while these measures are in force and indirectly insofar as potential tourists perceive agglomerations of people to be a source of health risk.

The disruption of international goods and services flows will also affect imports, which in any event will experience a somewhat greater fall-off than exports given the comparatively more unfavourable performance of the Spanish economy vis-à-vis its euro area trading partners. In any case, the scale of the shocks endured means there is much uncertainty over what the net impact will be on the Spanish economy's foreign trade and, ultimately, its external balance. After having run a surplus since the start of the latest expansionary phase, the crisis is affecting the goods and services balance through forces that are operating in different directions, such as the decline in the energy bill and the reduction in inbound tourism, whose net effect is difficult to predict.⁶

The pandemic has dramatically changed the Spanish labour market, which had been notably expansionary since early 2014, the start of the previous recovery. Job destruction, which was at its most acute in the second half of March, has been alleviated by the considerable resort to the so-called ERTes (temporary layoff and short-time working arrangements) and to stand-down facilities for the self-employed, as well as to the measures aimed at promoting business liquidity. All these public measures are geared to helping employment activity resume on as normal a footing as possible as the restrictions on production as a result of the lockdown are lifted. Yet whereas under the early recovery scenario it is assumed that the measures are fully effective when it comes to achieving this objective, this is not the case under the gradual recovery scenario. That is particularly so in the sectors exposed most directly to the impact of the social distancing measures and among the most vulnerable groups of workers (including, especially, those on a temporary contract), where the loss of jobs might be more persistent. Probably, compared with other euro area countries, this phenomenon is more acute owing to the productive specialisation of the Spanish economy and to the high prevalence of temporary contracts. The unemployment rate increases sharply this year (up to 18.1% of the labour force, under the early recovery scenario, and to 19.6%, under the gradual recovery scenario), and will remain above 17% in 2022.

⁶ The March 2020 balance of payments figure attests to the sizeable scale of the impact of COVID-19 on the various headings of foreign trade in goods and services and on its net balance. Specifically, March saw a decline of over 60% in tourist revenues, which led to an external current account deficit for the first time in this particular month of the year since 2012.

Turning to inflation, the monthly HICP information, available to April, reveals there has been a significant slowdown in consumer prices since the onset of the pandemic, accompanied by substantial changes in the pattern of the different components. Specifically, food prices have risen, in step with increased demand and with the cost increases to which disruption in the provision of these goods has given rise. Conversely, April saw a reduction in the growth rate of core inflation, since the restrictions on people's movements and activity led to a weakening in the demand for a broad set of goods and services. Finally, the decline in energy prices has stepped up as a result of much cheaper oil.

Over the course of the projection horizon, the HICP, excluding food and energy, is expected to remain very subdued, against a background of sluggish demand. While demand will be weak across the board, it will be especially so for those categories of goods and services directly affected by the pandemic containment measures. The downward pressures resulting from the fragility of demand will be partly offset by the increased cost of providing certain services owing to the social distancing measures. Moreover, over the course of the projection horizon, the indirect effects of the rises in oil prices assumed in the projection exercise are expected to contribute also to the moderate acceleration in the core HICP. In any event, the path of this aggregate does not differ significantly under the two scenarios, owing to the high degree of cyclical slack existing in both cases. Specifically, the rate of change of the prices of this component will be 0.9% and 0.8%, respectively, in 2020 on average under the early and gradual recovery scenarios, before rising moderately to 1.3% and 1.1% in 2022.

The overall HICP will continue to post negative rates of increase until early 2021, when the energy component is expected to undergo a strong rise owing to the base effect when the year-on-year rate of change begins to be calculated against a lower level, given the sharp fall in oil prices recorded in early 2020. In terms of annual average rates, the overall HICP is expected to rise from -0.1% in 2020 to 1.6% in 2022, under the early recovery scenario, and from -0.2% to 1.5% under the gradual recovery scenario.

The crisis will most severely impact public finances. The general government deficit, which was 2.8% of GDP in 2019, will rise this year to 9.5% under the early recovery scenario and to 11.2% under the gradual recovery scenario. The worsening of the budget deficit will be the outcome both of the operation of the automatic stabilisers and of the discretionary fiscal measures introduced in recent months. The rebound in economic activity in 2021, along with the tailing off of the impact of the transitory measures adopted in response to the pandemic, will prompt a reduction in the deficit to 5.8% and 6.8% of GDP respectively, in the two scenarios. The modest declining trajectory on which the debt ratio had been moving since the start of the past expansionary phase will be abruptly interrupted in 2020 as a result of the high budget deficit this year. Specifically, public debt will increase

by approximately 20 pp and 25 pp of GDP to close to 115% under the early recovery scenario and 120% under the gradual recovery scenario, and will remain at very high levels in the following two years.

The risks surrounding the recovery scenarios.

The scenarios described above are subject to important downside risks. In particular, the knowledge of COVID-19 is in many respects highly incomplete, so it is not possible to rule out the reintroduction of containment measures, with the consequent adverse impact on activity. This would be necessary if the measures of voluntary social distancing and epidemiological monitoring, based on the performance of virus and antibody tests and contact tracing, prove to be insufficient to avoid fresh outbreaks of the disease of a certain intensity. Specifically, fresh outbreaks would increase the probability of the liquidity strains associated with the confinement leading to solvency problems, which would be more pronounced in the case of more heavily indebted businesses. The resulting business insolvencies would give rise to two types of adverse effects. On one hand, there would be an increase in loan defaults, which would make the financial system's credit intermediation task more difficult, thereby making it more difficult for private agents to access financing, which would be more expensive. On the other hand, the destruction of businesses would lead to a loss in the capital stock, increasing the probability of hysteresis effects in the labour market. Both these channels would make the effects on economic activity more persistent.

One factor that might limit the intensity of the effects of the crisis is the various European initiatives launched in response. While these have the backing of the Eurogroup, they have not been included in the projections since they are not sufficiently defined or have not yet been formally approved.⁷ Ultimately to be added to these initiatives would be the European Recovery Plan proposed by the European Commission, the shape of which is less defined so far. A common European instrument of this nature would help to avoid hindrance of the recovery in those euro area economies, such as Spain, where the epidemic and its economic consequences have been more severe and, simultaneously, the circumstances have been less favourable for combating them, given the comparatively limited budgetary scope available. However, in the light of the timetables currently being considered, this upside risk would only begin to operate towards the end of the projection horizon.

The inflation risks are also predominantly on the downside. This is because of hypothetically greater demand weakness, associated with the adverse epidemiological

⁷ These initiatives, this total volume amounts to €540 billion, including the support mechanism to mitigate unemployment risks in an emergency (SURE), the strengthening of the European Investment Bank's activities and the recourse to the European Stability Mechanism's credit lines.

developments just described, and the risk of a deanchoring of inflation expectations suggested by the various indicators available.

As a way of illustrating the possible impact of these downside risks, a “very slow recovery,” scenario has been constructed. This scenario considers that some increases in infection rates will occur over the coming quarters, which will require the reintroduction of relatively severe measures to contain the disease. This would trigger a number of economic and financial effects that would feed off each other.

Specifically, in this hypothetical scenario, the closure of various areas of economic activity is considered to result in lower household and business incomes. Economic policy would attempt to alleviate this effect, but, given the circumstances, with decreasing scope and effectiveness. The uncertainty surrounding the development of the health and economic crisis would lead households and businesses to refrain from implementing some of their spending decisions. Moreover, since fresh outbreaks of COVID-19 are assumed to occur simultaneously in other geographical areas, the contraction of external demand is more pronounced and persistent than in the two scenarios described above, which contributes to delaying the recovery in Spain.

In this risk scenario, the damage to the productive capacity of the economy would likewise be more lasting. In particular, although public guarantees mitigate the risk of loan defaults and limit their impact on bank capital, there would be a greater volume of business insolvencies, which would lead to a reduction in the economy’s capital stock and more persistent labour market deterioration. The effect of all this would be a decline in GDP of 15.1% in 2020, while the level of output the end of the projection horizon would still be more than 5 pp lower than at the end of 2019.

8.6.2020.

THE PROJECTION ASSUMPTIONS

The assumptions regarding the paths of interest rates and the prices of oil and other commodities are based on their respective market levels during the 10 business days preceding the cut-off date (which for this forecasting exercise was 18 May 2020). As regards the oil price, the marked decline seen in the first half of the year, against the background of a slump in the demand for this commodity as a consequence of the sharp fall in world activity, is expected to be partially reversed from the middle of the year (in line with the expected recovery in production). In annual average terms, following a fall of 44% in 2020, to \$36 per barrel, the oil price is expected to rise thereafter to \$37.2 per barrel in 2021 and to \$40.7 in 2022.

In the case of the euro exchange rate, its movement since the outbreak of COVID-19 has been limited, despite the enormous impact of the pandemic on the world economy. Specifically, the nominal effective exchange rate of the euro over the projection horizon, which corresponds, according to the methodology used, to the spot price quoted on currency markets during the days immediately preceding the cut-off date for the assumptions, is 2.9% lower than the average rate observed in 2019. Against the dollar, the depreciation of the euro exchange rate is similar (3.3%).

Turning to interest rates, the resolute monetary policy action taken since March has contributed significantly to limiting the steepening of yield curves in the euro area since the outbreak of the pandemic. The rates negotiated on futures markets suggest that in the three-year period 2020-2022 three-month EURIBOR will stand at levels in line with those observed on average in 2019 (-0.4%).

The assumptions regarding 10-year government debt yields vary according to the scenario considered. This variable, which followed a downward path in 2019, is assumed to rise over the projection horizon, more sharply the more unfavourable the scenario. Under the gradual recovery scenario, in which the projected path is in line with market expectations, the increase will mean that on average the debt yield will remain in 2020 at the same level as in 2019 (0.7%) and will stand at somewhat higher levels over the following two years (1% in 2021 and 1.2% in 2022). Under the early recovery scenario, with lower public debt issuance requirements, the increase is somewhat lower than under the gradual recovery scenario. In contrast, under the risk scenario of very slow recovery,

the greater public-sector borrowing requirements result in a sharper rise in the cost of 10-year debt, which reaches 1.6% in 2022. Meanwhile, the cost of borrowing for households and businesses rises slightly with respect to the end of 2019, against a background of somewhat higher levels of credit risk. The magnitude of this increase also depends on the severity of the scenario; it is more marked under the gradual recovery scenario than under the early recovery one (and even more so under the risk scenario of slow recovery).

The collapse in activity and global demand as a result of the measures taken to contain the epidemic will result in a contraction of the world economy in 2020 as a whole. The fall in world trade will be even more pronounced, since international trade flows tend to respond more strongly to recessions than economic activity itself, a pattern that will have been exacerbated in the current health crisis by the restrictions imposed on personal mobility, which have stopped all tourist flows, and by the disruption to global production chains. As a result, Spain's export markets will contract sharply in 2020, although they are expected to recover from Q3 onwards, except under the risk scenario, which envisages that the shocks will be more persistent. Under the gradual recovery scenario, export markets will contract substantially in 2020 (-14%), before growing at high rates over the following two years (8.3% in 2021 and 4.7% in 2022). Under the early recovery scenario, the swifter recovery in export markets means that their decline is smaller in 2020 and that they grow more strongly over the following two years.

In the fiscal policy sphere, some of the assumptions used in the projections precede the outbreak of COVID-19. First, the general government budgets for this year are incorporated, including the extensions for the second consecutive year of the 2018 central government and social security budgets and the 2020 budgets approved by regional and local governments. Second, the spending measures approved in January 2019 are taken into account. These include a 0.9% rise in pensions, in line with the growth in the CPI that was then expected for 2020, and a 2% increase in public sector wages, in line with the settlement reached with the unions in 2018.¹

Also, the projections include the new measures approved by the government since mid-March to combat the health

1 See Royal Decree-Law 1/2020 of 14 January 2020 and Royal Decree-Law 2/2020 of 21 January 2020.

THE PROJECTION ASSUMPTIONS (cont'd)

crisis and mitigate its economic effect on households and businesses.² The measures are in four areas: support for the health system, employment protection, the provision of liquidity to viable businesses and support for households made vulnerable by the crisis. The ex-ante impact of this set of measures on government finances cannot be immediately determined. On one hand, the measures taken to supply liquidity to non-financial corporations (such as the granting of government guarantees for bank loans to businesses and a six-month moratorium for tax payments that expires before the end of the year) do not have an explicit direct impact on the budget deficit for 2020. On the other hand, among those measures that do have an explicit direct impact on government finances this year, this impact is clearly defined in some cases, such as the increase in funding for expenditure on health (€4.4 billion or 0.4% of GDP), but not in others, where the budgetary cost depends on certain assumptions that are subject to considerable

uncertainty. In particular, among the measures designed to protect employment, the budgetary impact of layoffs or short-time work arrangements due to force majeure, the benefit for the cessation of activity for the self-employed and the extraordinary subsidy for certain groups will depend on the number of workers affected and the duration of the effects. The two scenarios include the same discretionary measures (as also does the risk scenario). The difference lies in the size of those linked directly to economic activity, as is the case of the measures to protect employment income. In terms of the risk analysis, the approval of new measures cannot be ruled out, depending on how the crisis develops.

The total ex-ante impact of the measures on the budget deficit is estimated to be around 2.5% of GDP and is expected to fall basically in the first half of 2020. Of all the measures, those to protect employment are estimated to have the largest budgetary cost (more than 1.5% of GDP).

² These measures were approved by means of four royal decree-laws (RDL 7/2020, RDL 8/2020, RDL 11/2020 and RDL 15/2020).

Table 1
INTERNATIONAL ENVIRONMENT AND MONETARY AND FINANCIAL CONDITIONS (a)

Annual rates of change unless otherwise indicated

	2019	June 2020 projections								
		Early recovery			Gradual recovery			Risk scenario		
		2020	2021	2022	2020	2021	2022	2020	2021	2022
International environment										
World GDP	2.8	-2.4	7.8	4.1	-4.5	6.0	3.8	-7.8	5.2	3.7
Spain's export markets	1.5	-9.3	11.2	4.5	-14.0	8.3	4.7	-21.0	6.8	4.8
Oil price in US dollar/barrel (level)	64.0	36.0	37.2	40.7	36.0	37.2	40.7	36.0	37.2	40.7
Monetary and financial conditions										
US dollar/euro exchange rate (level)	1.12	1.09	1.08	1.08	1.09	1.08	1.08	1.09	1.08	1.08
Nominal effective exchange rate against non-euro area (b) (2000 = 100)	116.4	113.4	113.0	113.0	113.4	113.0	113.0	113.4	113.0	113.0
Short-term interest rates (three-month EURIBOR) (c)	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4
Long-term interest rates (10-year bond yield) (c)	0.7	0.6	0.9	1.1	0.7	1.0	1.2	1.0	1.4	1.6

SOURCES: Banco de España y Banco Central Europeo.

- a** Cut-off date for assumptions: 18 May 2020. Figures expressed as levels are annual averages. Figures expressed as rates are calculated based on the relevant annual averages.
- b** A positive percentage change in the nominal effective exchange rate denotes an appreciation of the euro.
- c** For the projection period, the figures in the table are technical assumptions, prepared using the Eurosystem's methodology. These assumptions are based on futures market prices or on proxies thereof and should not be interpreted as a Eurosystem prediction as to the course of these variables.

THE PROJECTION ASSUMPTIONS (cont'd)

For the rest of the horizon considered (2021 and 2022), the fiscal projections are based on the usual technical assumptions. First, the more discretionary items (the largest of which are public procurement and investment) are projected to evolve in line with the potential growth of the Spanish economy. Second, it is assumed that, in the absence of other measures, the paths of the other items that make up the general government accounts will be governed by their usual determinants. Specifically, government revenue is assumed to grow in line with the tax bases, which mainly depend on the macroeconomic environment. Similar assumptions are made for less discretionary items of expenditure. This is the case

of expenditure on pensions (which is determined by demographic trends and the expected indexation of pensions to the CPI), unemployment benefits (which mainly depend on how unemployment behaves) and interest payments (determined by government debt levels and interest rates).

On these assumptions, the fiscal policy stance will be clearly expansionary in 2020, reverting in 2021 owing to the temporary nature of this year's measures. It will become neutral in 2022, on the usual assumption that no further measures will be taken other than those already approved or that have a high probability of being approved.³

3 The projections do not incorporate the effects of the introduction of the minimum living income since it was approved after the cut-off date of this report.