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OVERVIEW

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Global economic dynamics have been sharply affected by the pandemic and very significant declines in activity are expected in 2020. Following several quarters in which activity had been weighed down, among other factors, by the US-China trade dispute and uncertainty over Brexit, the pick-up in global growth discernible in late 2019 was abruptly curtailed by the emergence of the disease and by the social distancing measures to contain it. As a result, the rate of increase of world GDP in 2020 has been revised substantially downwards in recent months. At the start of the year, global growth of over 3% was expected this year. But now the latest forecasts point to a contraction of close to 5%, sharper than that recorded during the global financial crisis.

The COVID-19 pandemic has caused practically unprecedented disruption to society and global economic activity in recent months. The high rates of contagion and mortality associated with this disease, and the lack of a vaccine or effective treatment, have stretched health systems in most of the countries affected by the pandemic to the limit and have given rise to an extraordinary high cost in human lives. To contain the rate at which the disease is spreading has necessitated the adoption of stringent restrictions on people's movement and on economic activity in a large number of productive sectors, with the subsequent adverse impact on household and corporate income and on jobs.

Insofar as this health shock is eminently temporary, economic activity might pick up relatively dynamically in the coming quarters, partly underpinned by the economic policy measures taken in recent months. Although there are still regions and countries where the incidence of the disease is high, the headway made in recent weeks in the lockdown-easing plans adopted by a growing number of countries has entailed a gradual pick-up in activity. If they hold, these dynamics would suggest that the most adverse effects of the pandemic on the global economy might be concentrated in Q2 this year. Activity could therefore pick up quite robustly in the second half of the year and continue expanding throughout 2021. However, at present it is not expected to resume pre-crisis levels of activity before 2022. The recovery would be supported by the recent economic policy measures rolled out relatively quickly and forcefully in numerous areas. Thus, in most of the countries affected, governments have implemented a wide range of measures aimed essentially at shoring up their health systems, protecting employment and household income, especially in the case of the most vulnerable, and providing liquidity to firms. Meantime, many central banks have cut their benchmark interest rates to record lows and, frequently, they have launched or bolstered non-conventional instruments that will expand their balance sheets most significantly. The overriding aim is to alleviate the tensions witnessed on financial markets in the early stages of the global spread of the disease and to ensure the appropriate functioning of monetary policy transmission so that credit may flow smoothly to the real economy. Along these same lines, the prudential authorities have allowed banks' regulatory requirements to be eased so that they may not have to reduce their balance sheets during the crisis and in order to promote buoyant credit flows to the private sector.

In any event, much uncertainty persists over how the pandemic health situation is evolving and the lasting damage it may already have caused to the productive system and growth capacity in the medium term. Until a vaccine or effective treatment is widely available, which will foreseeably not happen before late 2020, it cannot be ruled out that fresh outbreaks may call for some of the now-relaxed social distancing measures to be reintroduced. That will upset economic activity once again. Such disruption will be all the more limited the greater the capacity of the different national health systems to perform serological tests on the population to identify and isolate the infected, and to monitor those people who have already been in contact with those who have tested positive. In light of the experience of those countries that have pursued this type of disease-control strategy, that would help control fresh outbreaks without the need to deploy once more the most stringent and disruptive lockdown measures. Further, the economic policy measures approved to date in the fiscal, monetary and financial realms have been on a most extensive scale; however, the absence of comparable past references makes it especially complex at present to calibrate their effectiveness in preventing persistent damage to the growth capacity of economies, owing to the disappearance of solvent firms or to the permanent rupture of stable labour relations.

Worldwide, these challenges are being addressed from a relatively fragile starting position of the global economy and, in some cases, with less fiscal and monetary headroom than in the past. In recent years, the potential growth rate of the world economy has held on a clearly declining path. Notwithstanding, the main causes behind this secular weakness of the economy have generally not been tackled ambitiously enough. They include most notably, for instance, the consequences of population ageing, low investment rates and lacklustre productivity. Against this background, global economic growth in recent years, which has been relatively modest in historical terms, has been sustained essentially by extraordinarily expansionary demand-side policies. In some countries this has entailed less leeway with which to face the current crisis. This is so both in terms of fiscal policy, given the high levels of public debt, and of monetary policy, especially regarding the meagre space to make substantial new cuts to what were record-low interest rates before the pandemic.

The crisis is highlighting the current weakness of governance arrangements and of global economic relations. While a large number of multilateral measures have been taken, aimed especially at the poorest countries, this crisis has underscored the current fragility of governance arrangements and of global economic relations. Compared with the 2008 global financial crisis, in this pandemic there has been a notable lack of high-level political leadership in the international coordination of the health response. And at present, moreover, uncertainty persists over the extent to which the weakened spirit of international cooperation may prove significant in the recovery of the global economy.

In Europe, various and multi-faceted measures have been taken to tackle the economic effects of the pandemic, and the ECB has significantly increased the volume of its monetary stimulus. So far, however, the weight of the fiscal response to the crisis has fallen essentially on the measures independently implemented by the different Member States. Although the different national packages of measures show similar objectives and content, their volume and scope differ significantly from country to country. At the same time, at the European level several instruments have been launched to complement the measures adopted by national governments, and some notable headway has been made, especially with the European Commission's proposed and still-to-be-approved Recovery Fund (Next Generation EU). But there remains a significant gap between the sizeable financing requirements Member States will need in their budgetary drive to combat the effects of the pandemic and the volume of European funds mobilised.

In the realm of banking supervision, where the degree of international coordination has generally been greater than in other economic policy areas, numerous macroprudential, microprudential and accounting measures have been deployed. In particular, the Basel Committee on Banking Supervision and the ECB have boosted the use of the capital and liquidity buffers available to credit institutions, and the national authorities have released some of the macroprudential capital buffers available, namely the countercyclical and systemic risk buffers. At the microprudential level, the ECB, the European Banking Authority (EBA) and other supervisory authorities have promoted operational, prudential and regulatory measures of flexibility to support the proper functioning of the banking system and to smooth the flow of credit to the private sector. Specific measures have been adopted to prevent an excessively procyclical behaviour of provisions from prompting a disproportionate contractionary effect on the supply of bank lending. The EBA has also recommended that banks suspend dividend payments and exercise prudence in the payment of employee bonuses, in order to shore up their solvency.

The impact of this health crisis on the Spanish economy will be very severe. The growth path of the last six years was abruptly altered in March, in a setting in which the spread of the health crisis necessitated extraordinary lockdown measures, affecting people and productive activity alike. Although these restrictions mainly affected the second half of March, their intensity was such that Spanish GDP underwent in Q1 the biggest quarter-on-quarter contraction in its history, to date, with a decline of 5.2% (on preliminary National Accounts data). Insofar as the restrictions on activity and movement have been in force for much of Q2, the expected fall in GDP for this period is appreciably sharper.[1]

Economic activity has been picking up gradually in recent weeks, but that will not prevent a very marked decline in GDP in 2020 as a whole. In recent weeks, the headway in the lockdown-easing process provided for by the Government has allowed some recovery in activity and employment, which is expected to continue and accelerate in the coming quarters.[2] That said, the scale of decline in activity recorded in the first half of the year will entail a very sharp contraction in GDP over 2020 as a whole.

Despite the notable rebound in activity projected for 2021 and 2022, the crisis will have a persistent effect on employment and public finances. Both the latest Banco de España projections, and those of most analysts, point to a significant recovery in activity in the coming two years. However, the envisaged recovery in GDP will only allow activity levels to return close to those pre-crisis towards late 2022. These projections also auger a most notable and persistent increase in debt and the budget deficit, and in the unemployment rate. Specifically, this rate is estimated to increase sharply this year and will remain for several years at levels clearly above those posted before the pandemic. The general government deficit and debt will also rise most significantly over the current year and will only improve slightly at the end of the projection horizon when, even under the most favourable scenarios, public debt will exceed 110% of GDP.

The Spanish economy has faced this crisis after a long period of growth, which enabled some of its main imbalances to be corrected. Until the COVID-19 crisis broke, the Spanish economy had been in an uninterrupted growth phase dating back to late 2013. During those years, the growth pattern was more balanced than in other, previous expansions, which enabled some of the macrofinancial imbalances built up during the financial crisis and the expansionary phase that preceded it to be reduced. In recent years in particular, the economy ran successive surpluses on current account, households and firms deleveraged forcefully, and the construction sector and financial system undertook far-reaching restructuring that led to notable downsizing but also reduced their fragility.

However, a series of factors have contributed to the impact of this crisis being greater in Spain than in our European peers. First, the lockdown has been more prolonged and intense in Spain than in the euro area on average. Moreover, compared with other euro area economies, the Spanish economy's sectoral structure evidences a greater relative weight of sectors, such as tourism, that have overall been more

1 See Quarterly report on the Spanish economy 2/2020, June 2020.

2 See Macroeconomic projections for the Spanish economy 2020-2022.

affected by the social distancing measures that have had to be implemented. To the extent that temporary workers and SMEs are, generally, relatively more vulnerable to adverse macrofinancial shocks than employees with permanent contracts or larger companies, the high percentage of temporary employment in Spain and the substantial weight of SMEs in the national productive system are also expected to have influenced the greater negative impact of this crisis on the Spanish economy.

Looking ahead, the Spanish economy faces extraordinarily deep-seated challenges. Some of these were already present before the health crisis, while others have arisen as a result of it. Before the outbreak of the COVID-19 crisis, the Spanish economy was already facing major medium-term challenges. These included the need to increase growth potential, to redress labour market dysfunctions, to moderate public debt and to address the challenges associated with population ageing, inequality and environmental sustainability. The crisis has inflated these challenges and posed some new ones. In particular, it has revealed some of the vulnerabilities associated with the ongoing international fragmentation of production witnessed in recent decades with the intense development of global value chains. In light of these vulnerabilities, it is not to be ruled out that some economies or agents will pursue future strategies that may involve a sharper slowdown or even reversal of globalisation than that seen in recent years. At the same time, the lockdown measures to tackle the pandemic have strongly boosted activities such as teleworking, e-commerce and online classes. If these dynamics take root, it might mean a most significant acceleration in the ongoing digitalisation of society and the economy, globally and in Spain. This would involve new challenges, but also new opportunities that would be worth exploring.

The seriousness of the situation created by the pandemic has raised the need for and urgency of an appropriate response to these challenges. The extraordinarily complex circumstances facing the Spanish economy in the coming quarters, and the scale of the challenges ahead in the medium term, pose a considerable threat to present and future growth capacity and, therefore, to employment and well-being. Accordingly, an ambitious economic policy response is required.[3] In some cases, this response should take the form of new measures in the short term. In others, these measures should be applied once the current recessionary bout and its more adverse economic effects is behind us, although they should be designed and communicated without delay. This is the case, for example, with fiscal policy. Here, there is no place for a premature withdrawal of the stimulus measures deployed, since that would increase the risk of more lasting harm to economic growth; however, at the same time, it would be advisable to move towards the design and announcement of a sufficiently detailed medium-term fiscal consolidation plan to be implemented once the crisis has been overcome.

3 See the Governor's appearance before the Parliamentary Committee for the Social and Economic Reconstruction of Spain (Congress of Deputies), 23 June 2020.

The economic policy response should take the form of a comprehensive, ambitious and broadly agreed medium-term growth strategy. The challenges conditioning the Spanish economy's growth outlook and our society's well-being are closely interrelated. In this connection, a well-planned strategy is needed, in which the impact each economic policy decision may have on multiple facets is assessed, and balances are struck between different objectives that are not always simultaneously compatible. Further, the importance of the challenges that will mark the future of the Spanish economy in the coming decades requires an ambitious response in the form of an extensive package of deep-seated reforms. Lastly, the economic policy measures pursued to tackle the Spanish economy's challenges should be the outcome of a high degree of consensus on the part of the different political, economic and social agents. That would mean the underpinnings of our growth are stable and not subject to the vagaries of the political cycle.

On the financial front, Spanish and, generally, European credit institutions will be up against a more demanding environment in the coming years. Spanish credit institutions have improved the quality of their balance sheets and increased their solvency ratios significantly in recent years. Consequently, their starting position coming into this crisis, which did not originate in the financial field, is relatively sound. However, the scale of the adverse shock to households and firms in recent months is likely to impair, with something of a lag, the quality of financial institutions' credit portfolios. This deterioration will bear down on the sector's profitability ratios, which were already low previously. In a setting in which interest rates will probably hold at very low rates for a longer period than estimated just some months back, improving the sector's profitability will require efforts to cut costs and increase efficiency. In addition to this challenge, amplified by the current circumstances, Spanish banks will also have to address eminently global challenges, already in place before the pandemic struck. They include those associated with digital disruption, climate change and population ageing. Given the significant role the banking sector plays in the Spanish economy, how successfully they resolve these challenges will notably influence the intensity and sustainability of Spain's economic growth in the coming years.

Lastly, national policy should be complemented by actions at the European level that include resolute advances in the still inconclusive institutional structure of the EU and the euro area. This crisis has shown that, to the extent that the European economies' future challenges are essentially shared, successfully resolving them will necessarily involve a greater weight of supranational policies and institutions. In the fiscal realm this calls, among other measures, for an increase in and greater flexibility of the EU budget. Also, the launch of new, genuinely pan-European and permanent instruments will be needed, allowing for a greater pooling of risks among the Member States. Financially speaking, a full Banking Union in the euro area must be achieved. Its cornerstone, still pending approval, is a European Deposit Guarantee Scheme. Headway must also be made in reviewing those institutional and regulatory aspects hampering the development of an authentic Capital Markets Union in the region.