Annual Report: Digest

The spread of the virus

- The COVID-19 epidemic began in China, with the first cases detected in late 2019. It subsequently spread worldwide, turning into a pandemic.
- The number of infections and deaths has grown worldwide in recent months, although the virus's progression and impact have varied across countries.
- Most affected countries have adopted lockdown measures of varying severity. However, confinement at home and restrictions on movement have frequently been the norm.
- As the pandemic's intensity has subsided in some areas, the authorities have launched plans to normalise the social and economic situation.
- The virus continues to spread to several countries and regions. Arousing much concern are its spread (particularly to the least developed countries) and the possibility of fresh outbreaks where it is relatively under control.

The initial economic impact worldwide

- Global GDP grew by 2.9% in 2019, the lowest rate since the 2008 financial crisis. Yet there were signs of the world economy stabilising in late 2019, partly owing to the positive impact on activity of an initial US-China trade agreement.
- The expansion of the pandemic and the necessary containment measures have abruptly altered global economic developments. Activity and employment have declined sharply across all geographical areas, acutely so in the services sector.
- The scale of the economic disruption is still uncertain. There are different channels in play (supply, demand and financial), whose intensity and duration are as yet unknown.
- Even if the pandemic subsides in 2020 H2 and the lockdown measures are gradually eased, the IMF projects a sharp contraction in global GDP in 2020, by far exceeding that in 2009. Nonetheless, the impact will essentially be temporary; the IMF duly projects a recovery in activity from 2020 H2 and high growth rates throughout 2021.
- The outlook for the global economy is subject to significant downside risks. These may lead to a far slower recovery than is currently expected. A high level of uncertainty surrounds, inter alia, the pandemic's pathway and potential fresh outbreaks, the effectiveness of the economic measures adopted and the spillover effects associated with the real and financial interrelationships between countries (Box 2.1).
- Latin America is expected to be the emerging market region whose GDP most contracts in 2020, while the expected upturn for 2021 will also be smaller than that projected for the other main emerging market economies. Among other factors, this is due to the confluence of some of the region's structural characteristics, such as lower potential growth, the high rate of informal employment and the shortcomings of some institutions, combined with reduced economic policy response leeway.

The spread of the crisis in the euro area

- COVID-19 spread rapidly through the euro area countries, which introduced severe lockdown measures to contain it. These entailed a sudden, very severe fall in activity, with an uneven cross-country and cross-sectoral impact.
- Euro area GDP contracted by 3.6% in Q1, as compared with an expected increase pre-crisis of 0.1%. The decline in activity will foreseeably be much steeper in Q2.
- At this exceptionally uncertain juncture, the baseline scenario of the Eurosystem's June projections points to a severe contraction in activity in 2020.
- The contraction will be greater than that recorded in the global financial crisis and will be more acute in several of the main euro area economies, such as Spain, Italy and France. The crisis is also exerting downward pressure on the euro area inflation rate.
- A strong recovery is forecast for 2021, though there continues to be much uncertainty over how long the pandemic's effects will persist.

The main economic policy objectives in the current crisis

- A swift and forceful economic policy response is required to mitigate the short-term effects of the current health crisis and ensure a strong recovery.
- The world economy is tackling this crisis from a weaker position than in previous recessions. In recent years, global economic growth has essentially been underpinned by highly expansionary demand-side policies, against a setting in which the potential growth rate worldwide remained on a downward path.
- The nature of the crisis calls especially for multilateral cooperation to provide an internationally coordinated response to the pandemic and pave the way for a prompt and strong recovery.

The fiscal policy response

- To address the health emergency, virtually all countries have adopted fiscal policy measures to fund the increase in health spending and support households' and firms' income.
- The US fiscal policy package is particularly significant in quantitative terms and is essentially based on direct financial assistance to households, businesses and state and local governments.
- In euro area countries, governments have approved diverse fiscal packages, with varying budgetary impacts.
- At the European level, several EU instruments have been mobilised, via the EIB, ESM and in the form of SURE (the new temporary Support to mitigate Unemployment Risks in an Emergency), to uphold the measures adopted by national governments (Figure 3.1).
- The proposal with the greatest capacity to boost the European economy in the medium term is the European Commission's recovery plan for Europe, based on a supplementary budget of €750 billion for the EU between 2021 and 2027. The funds would be earmarked to finance investment and reforms bolstering European economies' growth capacity.

The multilateral response

- The IMF has swiftly deployed a broad battery of measures (Box 3.1). The main multilateral banks and fora have also responded to the crisis with various initiatives.
- Despite these multilateral actions, the magnitude and nature of this crisis evidence the need to refine the multilateral institutional structure, step up international cooperation and avoid the resurgence of protectionist policies.

The monetary policy response

- The monetary authorities of the main advanced and emerging economies have reacted swiftly and decisively to the COVID-19 crisis by cutting their key policy rates to record lows and, in many cases, by using unconventional instruments such as large-scale asset purchases.
- ECB measures:
  - — The ECB has, in general, reacted substantially more forcefully to the COVID-19 crisis than it did in the wake of the 2008 financial crisis.
  - — The ECB's main measures have focused on its asset purchase programmes and long-term funding provision. It has also temporarily expanded the set of assets eligible as collateral in the Eurosystem (Box 3.2).
  - — This raft of expansionary measures is aimed fundamentally at countering the risks a potential financial fragmentation of the euro area could pose to the smooth running of the monetary policy transmission mechanism and to the area's economic outlook.
  - — The ECB's measures appear to be helping maintain favourable financing conditions in the euro area (Box 3.3). However, the scale of the crisis evidences the importance of the monetary stimulus being accompanied by a broad fiscal policy response at the pan-European level (Box 3.4).

The response of the financial authorities

- On the prudential front, the ECB and the BCBS have boosted the use of capital and liquidity buffers by credit institutions. NCAs have also lowered some of the macroprudential capital requirements, such as the CCyB.
- Supervisors have promoted measures on operational, prudential and regulatory flexibility, while also adopting accounting measures to prevent an excessively mechanical application of provisioning standards from triggering a disproportionately contractionary effect on the supply of bank lending to the real economy.
- The ECB, EBA and the ESRB have recommended the temporary suspension of dividend payments and prudence in employee bonuses in order to channel income towards shoring up banks' solvency.

The health crisis in Spain

- In recent months, the COVID-19 pandemic has posed a major public health challenge in Spain.
- In March and April, as in most countries affected by the pandemic, severe restrictions were imposed on people's movement and on some economic activities to curb the rate of infection.
- Since early May, as the pandemic came more under control, there has been some lockdown easing, leading to a progressive reactivation of the economy.
- Yet while there is no vaccine or effective treatment for the virus, the Spanish economy remains very vulnerable to a fresh outbreak. On other countries' experience, a programme of rigorous protocols is needed to reduce this vulnerability. This should aim at a significant increase in the number of tests performed, to identify and isolate persons infected, and to closely monitor all those who may have been in contact with the positive cases detected.

The initial economic impact

- The measures adopted to contain the pandemic have markedly impacted economic activity in Spain.
- In 2020 Q1, Spanish GDP shrank 5.2%, its largest quarter-on-quarter contraction to date. All private spending items fell very considerably, as did exports, especially of tourism services.
- The latest economic indicators suggest the decline in GDP will be considerably steeper in Q2, albeit with a significant rebound in 2020 H2, assuming there are no further shocks.
- The impact of this crisis on employment is proving to be particularly severe:
  - in addition to the decline in social security registrations (of 752,000 between mid-March and end-May) are the employees subject to short-time work arrangements (ERTEs) and the self-employed who have temporarily ceased their activity (3 million and 1.4 million at end-May, respectively)
  - as is habitual in the Spanish labour market, temporary workers are bearing the brunt of the adjustment
  - the impact of the employment adjustment is highly uneven across sectors, with a more adverse effect on services, especially retail trade, recreation and hospitality, than on manufacturing or the primary sector

Economic policies adopted in Spain

- The Government's response has focused on four key areas:
  - strengthening the healthcare system
  - protecting employment
  - supporting vulnerable households
  - providing liquidity to firms and the self-employed
- One key aim is to prevent this eminently temporary health crisis from causing significant damage to the economy's growth potential, which would limit its capacity for subsequent recovery if viable firms were to close or jobs were to be permanently lost.
- The final cost of the measures adopted will be high, but will ultimately depend on their ability to achieve the objectives pursued. Further, the total cost of this crisis for public finances will depend not only on the expenditure associated with the discretionary measures approved, but also on the functioning of the automatic stabilisers and macroeconomic developments.

Economic outlook for the coming quarters

- The starting point
  - — The Spanish economy faces the economic crisis stemming from the pandemic after a long upturn that showed a more balanced growth pattern than in the past, helping to redress some of the economy's main macrofinancial imbalances.
  - — In recent years the Spanish economy has continuously run external surpluses, households and firms have deleveraged considerably, and the construction sector and financial system have undertaken extensive restructuring.
  - — Despite the progress, the Spanish economy still presented significant sources of vulnerability at end-2019, which have shaped the response to the COVID-19 crisis and the scale of the current downturn: the public finances shortfall has not been corrected, high unemployment rates and excessive duality between permanent and temporary workers still prevail in the labour market, and productivity growth remains lacklustre and inequality is relatively high.
- Looking ahead, the main sources of uncertainty include:
  - — How the pandemic unfolds and how quickly the different sectors of economic activity can resume some level of normality:
    - – fresh outbreaks of the disease in the future cannot be ruled out, which will weigh on the spending and investment decisions of households and firms.
    - – activity and movement will remain subject to certain restrictions, hindering a return to normality in some sectors.
    - – the sectors most affected by the restrictions account for a relatively large share of the Spanish economy and employ a higher proportion of women, young people and low-income workers than other sectors of the economy, which could have a bearing on the recovery's buoyancy (Boxes 4.1 and 4.2).
  - — The damage the health crisis has caused to the productive system and growth potential of the economy, despite the measures deployed to avert such damage:
    - – Employment: the ability of short-time work arrangements (ERTEs) to protect employment in the medium term will depend on the duration of the crisis and the specific growth conditions of the sectors and firms that employ the affected workers.
    - – Business sector: the severe contraction in activity in some industries in recent months has driven up the liquidity needs of businesses and the self-employed. Despite the Government's guarantee programme making substantial headway towards addressing these requirements (Box 4.3), there is a risk of some firms facing solvency difficulties as profitability deteriorates during this crisis.
  - — Developments in financial markets and their potential implications for the financing conditions of businesses and households.
- Macroeconomic scenarios for the medium term:
  - — The Banco de España's latest projections envisage various scenarios, drawing on different assumptions regarding how quickly some degree of normality may be restored both from the healthcare and the economic standpoint.
  - — All of the scenarios envisage a very severe contraction in Spanish GDP in 2020, followed by a substantial rebound in 2021, albeit subject to considerable uncertainty.
  - — However, this recovery, which would be compatible with relatively high quarter-on-quarter growth rates in 2020 H2, would only permit a return to activity levels close to those pre-crisis towards the end of 2022.
  - — The projections also point to a very significant and persistent increase in public debt, the budget deficit and the unemployment rate.

- Before the health crisis broke, the Spanish economy was facing major medium-term challenges: the need to increase growth potential, correct labour market dysfunctions, improve the sustainability of public finances and address the challenges associated with population ageing, inequality and climate change.
- The COVID-19 crisis has increased the scale of some of these challenges and posed new ones: it may ultimately have significant consequences for the ongoing globalisation and digitalisation under way in society and in the world and Spanish economy.
- The seriousness of the situation created by the pandemic has raised the need for and urgency of an appropriate response to these challenges.
- The economic policy response should include a comprehensive, ambitious and broadly agreed medium-term growth strategy, to be designed and implemented swiftly.
- National policies should be complemented by actions at the European level that include resolute advances in the institutional structure of the EU and the euro area.

Priority areas for attention in the Spanish economy

- Constraints on the Spanish economy's growth capacity
  - The depth of this crisis will probably cause some persistent damage to the Spanish economy's potential growth, which was already relatively low.
  - Low productivity growth is the main factor behind the Spanish economy's modest potential growth. Low productivity is in turn explained by, among other factors, the small size of Spanish companies and lower average levels of human and technological capital than our peer economies.
  - Further ahead, it will be necessary to delve into the various reasons why the Spanish business sector is so skewed towards small companies, and to have mechanisms at hand to promote business growth.
  - The relative disadvantage in the Spanish economy's human capital advises reconsidering the institutional design of the education system. It should include a far-reaching review of curriculum content and the very system of learning.
  - The most suitable financing arrangements to develop investments in innovation must be leveraged. It is also essential to reinforce the mechanisms supporting innovation and to improve the evaluation and selection of research-based further education.
- Labour market dysfunctions
  - For decades, the structural shortcomings in the Spanish labour market have explained why our economy has a significantly higher unemployment rate than any of our peers, even in expansionary periods.
  - Another differential aspect of the Spanish labour market is its high temporary employment ratio. This has negative structural implications in many other dimensions: it increases inequality; it adversely influences the formation and size of new households; and it has persistent effects on the careers of the workers most affected and on human-capital investment decisions.
  - Reducing the high duality in the Spanish labour market is an inescapable objective. Employment protection mechanisms should be reviewed to square the necessary protection of workers with flexibility requirements, but, above all, to achieve a fairer division of protection among workers with different contractual conditions.
  - It is imperative to strengthen active labour market policies in order to increase workers' human capital, reduce unemployment permanently and, in the current circumstances, increase the employability of the workers hardest hit by the crisis and smooth their transition to the sectors and businesses with a better growth outlook.

Priority areas for attention in the Spanish economy (cont'd)

- Restoring room for manoeuvre for fiscal policy
  - — There were considerable mismatches in the general government accounts before the COVID-19 crisis. Since 2015 there has been no appreciable headway in reducing the structural budget deficit; the public debt/GDP ratio stood at 95.5% at end-2019, only 5.2 pp below its 2014 peak.
  - — The fiscal measures adopted to alleviate the effects of the pandemic, the inevitable macroeconomic downturn and the operation of the automatic stabilisers will bear down most adversely on public finances.
  - — While in the short term the fiscal response to this crisis should be expansionary, in the medium term far-reaching reforms must be enacted to reduce public debt and restore fiscal policy leeway ahead of future negative shocks (Box 5.1).
  - — To bring general government debt back into compliance with SGP commitments, a multi-year fiscal consolidation programme encompassing all government tiers is needed.
  - — On the revenue side, there is room to re-define the basket of taxes to make it more conducive to economic growth. One distinctive feature of Spanish taxation susceptible to reconsideration is the high level of tax benefits.
  - — On the expenditure side, it would be advisable to increase the relative weight of those items relating to human and technological capital accumulation (Box 5.2). In tandem, it is necessary to set out a clear map of priorities, improve the efficiency of public spending under every heading and reduce resources for non-priority items in light of the Spanish economy's and society's more significant needs.
- Population ageing
  - — Demographic change will have a particular bearing on Spain: it will be the EU country undergoing the biggest increase in the dependency ratio (i.e. the over-65s in proportion to the population aged 15-64) in the next 25 years.
  - — Among the prominent determinants of population ageing in Spain are the increase in life expectancy and the decline in the fertility rate.
  - — Population ageing has notable implications in the fiscal policy arena. Specifically, demographic pressure poses the need for additional measures to strengthen the financial sustainability of the public pension system.
  - — Population ageing also poses key challenges in terms of the potential growth of the economy through its impact on the labour market and worker productivity. To avoid this downturn in the employability of workers as they age, it is vital to reinforce the role of active labour market policies and lifelong learning, and make some changes in working conditions.
- Inequality
  - — At the onset of this crisis, inequality levels in the Spanish economy were clearly higher than at the end of the expansionary cycle prior to the 2008 crisis.
  - — The crisis is bearing down more sharply on the most vulnerable groups, which will foreseeably entail a further increase in inequality levels.
  - — The employment protection and household income support measures enacted by the government in response to this crisis will contribute to lessening the vulnerability of the households most affected by it.
  - — The recently approved minimum income scheme (MI) may be useful for reducing the level of extreme poverty among groups with special structural difficulties. However, there should be close monitoring of whether this instrument may ultimately prompt unwanted effects, e.g. on the future income-generating capacity of beneficiaries or a possible switch from certain economic activities to informality.
  - — Reducing the adverse effects of inequality also requires action on numerous fronts, including the labour market and housing affordability.

Priority areas for attention in the Spanish economy (cont'd)	• The transition to a more sustainable economy — Climate change and the transition to a more sustainable economy are among the main challenges now facing our society. In recent years, both the EU and Spain have taken an active stance in combating climate change. — Attaining the established environmental goals will call for a comprehensive and internationally coordinated strategy. — Fiscal policy must be to the fore in this strategy, both to deter more environmentally damaging activities and to foster public and private investment in the development of cleaner technologies and to alleviate the social costs of the transition. — The financial sector is also called on to play a key role in the transition towards a more sustainable economy. It is crucial here that the sector incorporate into its decision-making process all climate change-associated risks and identify the opportunities opening up in this transformation. — Supervisors must ensure that banks correctly price the risks associated with climate change and incorporate them into the management of their portfolios.
New economic realities after COVID-19 (Figure 5.1)	• The COVID-19 crisis has highlighted some of the vulnerabilities associated with globalisation. The pandemic has prompted major disruptions in global supply chains, and in many countries major shortcomings have been observed in meeting minimal levels of domestic demand for specific essential consumer goods. • In light of these vulnerabilities, some countries and agents may develop strategies that contribute to slowing even further the process of globalisation in the world economy, in line with what has been observed in recent years as a result of the re-emergence of protectionist trends in some of the major world economies. • To contend with these dynamics, Spain, which has made very considerable efforts to internationalise its economy in recent years, must play a leading role in the defence of a global trade model, based on multilateral rules and free competition. • The pandemic might also significantly alter the process of digitalisation in which economies and societies worldwide have been immersed in recent years. During the lockdown the resort to teleworking, e-commerce and education through online channels has stepped up appreciably. Some of these trends might prove to be permanent and even accelerate in the medium term. • There is potential for teleworking becoming more widespread in Spain, but this option would not necessarily be equally accessible to all groups of workers (Box 5.3). The promotion of teleworking must, however, involve bolstering its positive aspects and seeking to alleviate its potential disadvantages. • Foreseeably, e-commerce will continue to gain in importance in the coming years, with very significant and multi-faceted consequences, e.g. in business competition and in pricing dynamics. It is necessary to prevent the eminently global and growing digitalisation of commercial transactions from putting the Spanish economy at a competitive disadvantage.

Challenges for the financial sector	• Spanish banks continued to improve the quality of their balance sheets and solvency levels in 2019, but profitability fell significantly. • The severe adverse impact of the COVID-19 crisis on economic activity is expected, with something of a lag, to worsen the quality of financial institutions' credit portfolios (Box 5.4). • As losses materialise on credit portfolios, additional downward pressure will be exerted on the banking sector's profitability. Improving the sector's profitability will therefore require efforts to cut operating costs, which may be achieved through efficiency gains. • Supervisory authorities must remain vigilant to head off the risks to financial stability stemming from this crisis and be ready to provide a forceful, pan-European response should they materialise. • Since the onset of the pandemic, there have been no signs of a general tightening of funding conditions for businesses. Support here has come from certain measures adopted as a result of the crisis, such as the Government's State guarantee scheme and the strengthening of the ECB's asset purchase and bank funding programmes. • The health crisis has brought into sharper relief the urgent need to address the challenges associated with digitalisation, cybersecurity risk management, the low interest rate environment, climate change and population ageing.

Europe's role: challenges and responses	• Many of the challenges facing the Spanish economy cannot be addressed from an exclusively domestic perspective. Where Spain is concerned, Europe is on many fronts the natural platform for taking strategic action. • In the short term, the nature of the current crisis warrants swift and unequivocal action by the EU to ensure economic recovery, preserve the Single Market and reaffirm the European project of social and economic progress. Many EU-approved measures are along these lines (SURE, ESM credit line and business loan support through the EIB) (Figure 5.2). • A common, investment-focused fiscal drive, such as that proposed by the European Commission in its recovery fund initiative, would help provide for a buoyant recovery and increase the EU's potential growth capacity (Box 5.2). • Nevertheless, further progress in the European project, beyond the measures adopted or proposals made in the context of this crisis, is required. Further deepening of the EU irrevocably entails setting greater store by the supranational risk-sharing mechanisms, including expanding the EU budget and making it more flexible. • All EU countries would reap the benefits of a common safe asset operating on a large enough scale: it would reduce the sovereign-bank nexus and enhance financial integration within the EU. • All Member States would benefit were the European Union to have greater weight in fiscal policy. However, this would also require increased fiscal responsibility at the domestic level. • In the financial realm, strengthening European governance by completing the Banking Union, through the creation of a European Deposit Insurance Scheme, and removing the impediments to the existence of a fully fledged Capital Markets Union in the EU is essential.