1

RISKS LINKED TO THE MACROFINANCIAL ENVIRONMENT

The expansion of the COVID-19 health crisis in the opening months of 2020 and the necessary containment measures implemented have abruptly altered global economic developments. Spain is one of the countries which the pandemic has impacted most and earliest. As in other countries, the impact of this – in principle transitory – shock on economic activity is proving very severe, and the authorities are adopting measures to mitigate its impact both on households and on firms. This chapter reviews the effects the pandemic is having both on systemic and materially significant countries and on Spain. It further summarises how national and international financial markets have reacted to date and how the various non-financial sectors of the Spanish economy are positioned to face this shock. Finally, it reviews the main measures adopted by the economic authorities.

1.1 Macroeconomic environment

1.1.1 Systemic and materially significant countries

The expansion of COVID-19 and the necessary measures adopted to curb it have strongly impacted the international economic situation in the past quarter. The level of uncertainty over the scale of the pandemic's adverse impact on activity and international trade is very high, though it is in any event expected to be very pronounced.[1] Consequently, analysts' and international organisations' growth forecasts for this year have begun to be revised substantially downwards, with an unusually high dispersion. The IMF forecasts that all global regions are expected, in the short term, to go into recession (see Chart 1.1). It also anticipates that the impact of COVID-19 will be transitory, whereby its forecasts, like those of most analysts, incorporate a pick-up in activity as from the second half of this year that will run at relatively high growth rates over the course of 2021. However, the uncertainty surrounding the pandemic is also extensive to expectations about the duration and intensity of its effects, with even more adverse scenarios not being ruled out. Against this background, the resolute response of fiscal, monetary and prudential policies, in the advanced and emerging economies alike, is cushioning the adverse impact of the coronavirus shock, and should be stepped up where necessary (see Box 1.1).

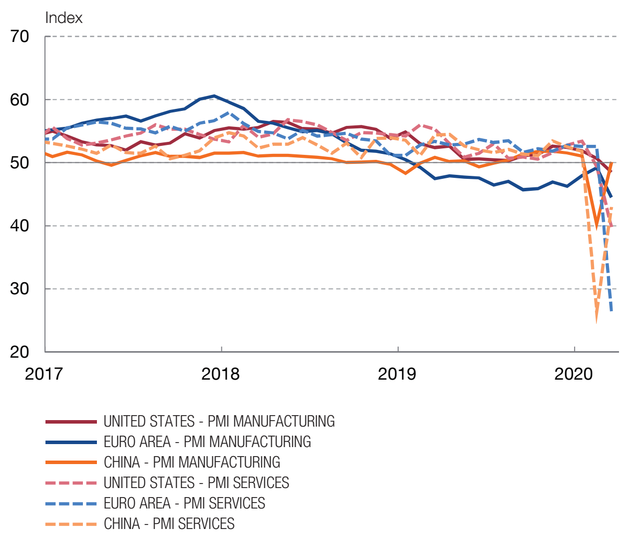
1 See Banco de España (2020) "The impact of the coronavirus pandemic", Analytical Articles, *Economic Bulletin* 2/2020, forthcoming.

Chart 1.1

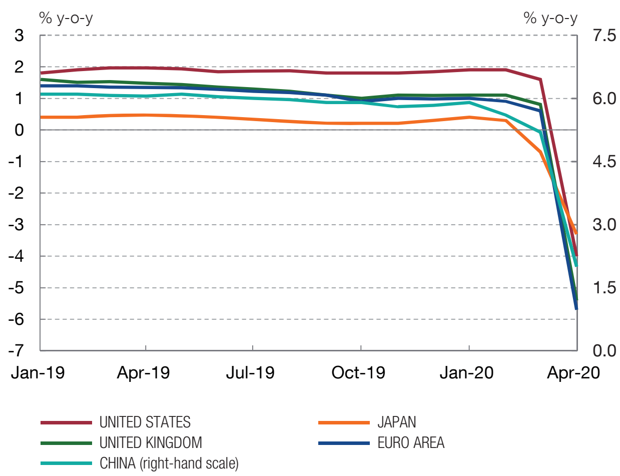
GLOBAL GROWTH IN 2020 WILL BE GREATLY IMPACTED BY COVID-19

Global economic developments have been severely influenced by the worldwide spread of the COVID-19 pandemic. The level of uncertainty over the scale of the adverse impact on activity and international trade is very high, although the impact is expected to be most pronounced. Consequently, analysts' growth forecasts for this year have begun to be revised substantially down, although most anticipate that the impact will be transitory.

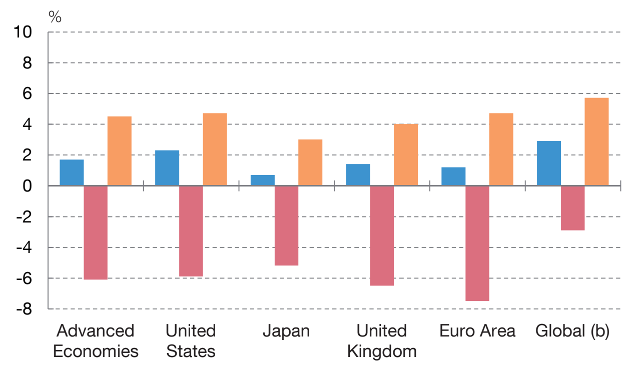
1 PMI MANUFACTURING AND SERVICES



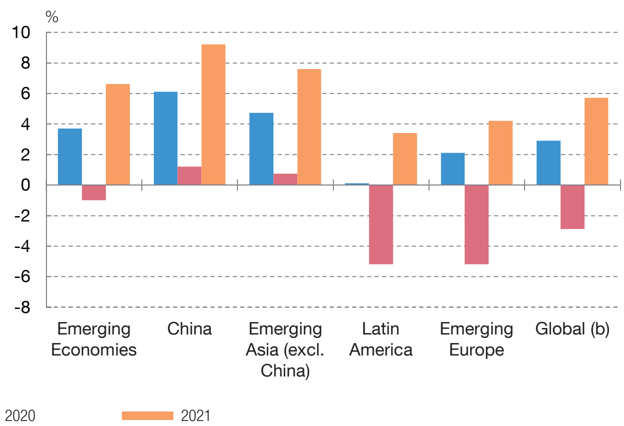
2 *CONSENSUS FORECASTS* FOR 2020



3 REAL GDP GROWTH PROJECTIONS. IMF (WEO) APRIL 2020: ADVANCED ECONOMIES



4 REAL GDP GROWTH PROJECTIONS. IMF (WEO) APRIL 2020: EMERGING MARKET ECONOMIES



SOURCES: IMF (WEO April 2020), IHS Markit, *Consensus Forecast.*

a Provisional figure.

b For comparison purposes, world economic outlook growth projections.

The indicators of activity becoming known broadly reflect a most significant impact of the expansion of the health crisis in the short term. Generally, in the main advanced economies, the PMI activity indices fell drastically in March, especially for services, with most components evidencing reductions on a large scale and historical lows, adding to the significant declines already observed for China in January and February. In the Chinese economy, the first affected, the available indicators of activity for Q1 show a quarter-on-quarter fall in GDP of 9.8%

(–6.8% year-on-year, compared with 6% in 2019 Q4) with declines in industrial production, retail sales and investment of between 15% and 25% in January and February; in March, however, some of these indicators have already begun to recover. The evidence thus becoming available on global economic activity, which is mainly partial in nature, augurs a most pronounced and across-the-board worsening of the economic situation, and one particularly acute in those countries which, having undergone the sharpest virus outbreaks, have been forced to introduce more drastic containment measures.

The risks the world economy is facing have shifted significantly upwards compared with previous FSR editions. As mentioned, these include most notably a prolongation of the coronavirus pandemic and a step-up in its geographical expansion. The bouts of geopolitical and social tension present in some regions prior to the health crisis,[2] or the new risks that may arise, might be exacerbated or activated owing to the impact of the pandemic. And that might have marked economic effects. Conversely, the recovery under way in China might partly soften the impact of the crisis on the global economy, given China's weight and its growing interrelatedness with the rest of the world.[3] Further, a more robust response of economic policies globally might also exert mitigating effects.

In the short run, the economic outlook for the euro area has worsened abruptly and sharply following the spread of the COVID-19 pandemic in Europe (see Chart 1.2). The population confinement measures, needed to halt the transmission of the disease, are adversely affecting the economy. They are doing so both through supply-side channels, given the disruption of productive chains (globally and locally), and demand-side channels, by prompting deep cuts in household and corporate spending, set against a heightening in uncertainty to unprecedented levels. That said, while the euro area economy is evidently facing a very deep shock at present, there is much underlying uncertainty over the scale of the economic impact of the pandemic, and how persistent it may prove. In these exceptionally uncertain circumstances, both private analysts and official agencies are revising the growth outlook for the euro area notably downwards, especially for 2020; however, as is the case globally, a growth rebound is expected in 2021. On mid-April IMF forecasts, euro area GDP might shrink by 7.5% in 2020, a revision of almost 9 pp on the on the forecasts prior to COVID-19. In 2021, GDP is expected to grow by 4.7%, under the assumption that the pandemic fades in the second half of 2020 and incorporating the effect of the economic policies approved.

The global expansion of the coronavirus pandemic has also significantly affected emerging markets. Generally, the emerging economies' degree of

2 See Banco de España (2020) "Social tensions in Latin America", Box 1 of the "Report on the Latin American economy. First half of 2020", Analytical Articles, *Economic Bulletin 2/2020.*

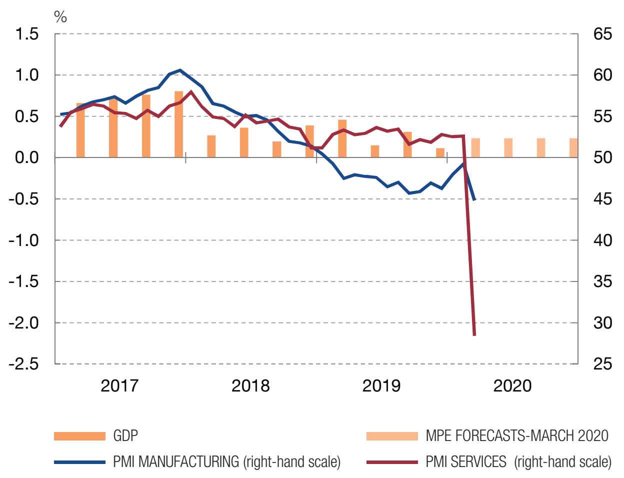
3 See Bing, Roth and Santabárbara (2019). "Global impact of a slowdown in China", Analytical Articles, *Economic Bulletin 4/2019,* Banco de España.

Chart 1.2

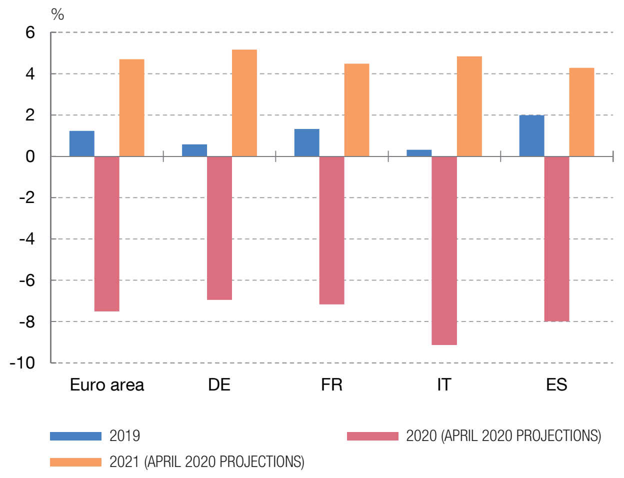
THE EURO AREA ECONOMY, WHICH WAS SHOWING WEAK GROWTH AS AT END-2019, WILL BE SIGNIFICANTLY IMPACTED IN THE SHORT RUN

In the short run, the euro area economic outlook has worsened most abruptly and sharply further to the spread of the COVID-19 epidemic in Europe, with significant revisions expected to the MPE-March 2020 projections. The euro area GDP is projected to contract by 7.5% in 2020, according to IMF WEO, April 2020. In 2021, euro area GDP is expected to rebound 4.7% under the assumption that the pandemic fades in the second half of 2020 and taking into account policy actions undertaken.

1 EURO AREA: GDP AND PMI INDICATORS
Quarter-on-quarter growth, diffusion index



2 EURO AREA GDP GROWTH AND PROJECTIONS (IMF WEO). APRIL 2020



SOURCES: Eurostat, Markit, IMF and ECB.

financial vulnerability has increased; their currencies have depreciated, their levels of sovereign risk have increased and portfolio investment flows have collapsed, according to the high-frequency partial data. Their vulnerability is much more acute than in previous episodes of financial stress, including the global financial crisis (see Chart 1.3).

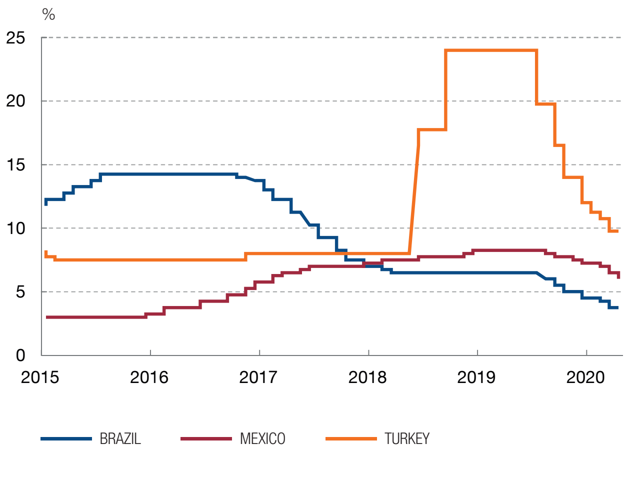
Considerable risks, associated mainly with the spread of the pandemic but also with domestic factors, persist in the emerging markets with a significant Spanish banking presence. In Mexico, growth forecasts have been revised substantially downwards, and there may be most pronounced declines in GDP owing to the containment measures, the tightening of financing conditions, the fall in oil prices and the adjustment of activity in the United States. On the domestic front, there is continuing concern about the State-owned company Petróleos Mexicanos (PEMEX), which is overburdened with high debt. This partly explains the greater depreciation of the Mexican peso than that posted by other emerging currencies, following the collapse of oil prices. Brazil is subject to pandemic-related effects similar to those of Mexico, although its economy is more closed than Mexico's. On the Brazilian home front, the reform of the pensions system and the government's intention to adopt other structural reforms (affecting taxation and the privatisation of public corporations) in the period prior to the health crisis provided some leeway

Chart 1.3

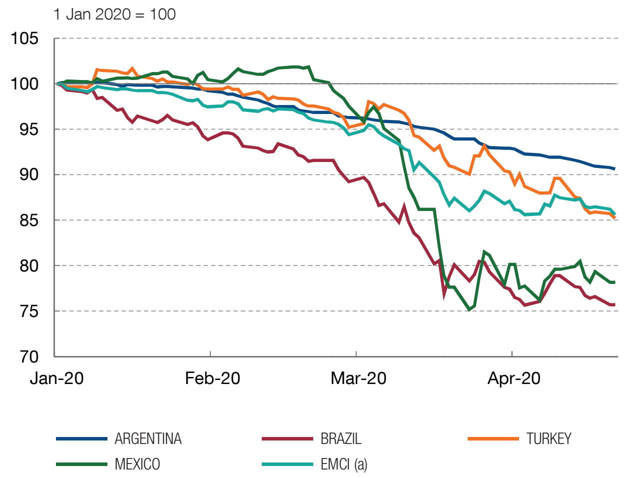
THE EMERGING ECONOMIES HAVE BEEN GREATLY AFFECTED BY THE EXPANSION OF COVID-19

Financial markets in the emerging economies also felt most keenly the effects of the expansion of the pandemic. The episode has given rise to flight to safe-haven assets which has translated into stock market declines, higher risk premia and currency depreciations, all the greater in the case of the Mexican peso owing to the collapse of oil prices and the ensuing effects on PEMEX. Nonetheless, central banks in the emerging economies cut policy interest rates across the board and adopted other monetary easing measures to mitigate the sharp declines in economic activity.

1 POLICY INTEREST RATES



2 EXCHANGE RATE AGAINST THE DOLLAR



SOURCE: Reuters.

a Aggregate index of emerging economies' exchange rates against the dollar. A decline denotes a depreciation.

for monetary policy, whereby the policy interest rate stood at historical lows in the final stretch of 2019. That has not prevented a further cut to this rate in response to the crisis. Nonetheless, the Brazilian real is performed relatively worse than other emerging currencies, given its lesser attractiveness owing to lower interest rates and the worsening current account balance. In Turkey, likewise affected by the global pandemic, the central bank has steepened the path of monetary policy easing in a setting in which, however, a high degree of external vulnerability remains.

1.1.2 Spain

Economic activity in Spain has also been abruptly affected by the necessary adoption of measures to contain the expansion of the virus. In 2019 Q4, quarter-on-quarter GDP growth was 0.4%. The most representative conjunctural indicators of activity suggest that GDP moved on a similar trajectory in the first two months of the year to that observed in late 2019.[4] However, the expansion of the COVID-19

4 For further details, see Box 1 "The Spanish economy before the spread of the coronavirus epidemic", in the Quarterly report on the Spanish economy, Economic Bulletin 1/2020, Banco de España.

health crisis to Spain and other European countries since then has abruptly changed the dynamics of economic activity. In particular, the rapid rise in March in the number of people infected necessitated the approval of the state of alert,[5] which has drastically restricted people's movements and practically brought to a standstill activity in some sectors.

The decline in activity is estimated to have affected certain specific sectors more than proportionately. These include some services sectors that have been more directly harmed by the restrictions on movement, such as tourism, air transport, accommodation and food service activities, significant retail trade segments and entertainment. Moreover, some manufacturing sectors have also ground to a halt because of the reduction in demand and the interruption of supply chains. The car industry is a case in point, where these value chains are of greater importance in the production of final goods.

Some indicators, including most notably the statistic on Social Security registrations, are already reflecting the extraordinarily acute impact of the COVID-19 crisis. The March figures on Social Security registrations reveal the biggest monthly decline in employment in the time series. The size of the fall, concentrated in the second fortnight, was 4.3% (833,979 workers) compared with the end-February level (see Chart 1.4). In terms of sectors, the most pronounced decline in employment in percentage terms was in accommodation and food service activities (–11.9%) and construction (–11.3%). The application of temporary layoff arrangements (ERTEs) has restricted the decline in Social Security registrations in all sectors. By type of contract, the decline in employment in the second half of the month was centred on temporary employees (–17.3%), while the impact on permanent employment was on a much lesser scale (–1.9%), partly owing to the application of ERTEs, which predominantly affect the second of these two sets of workers. In this regard, the Labour Force Survey of the first quarter showed an increase of the unemployment rate, reaching a level of 14.4%.

The qualitative indicators of activity and the high-frequency quantitative indicators also fell markedly in March. The manufacturing PMI, which have moved on an improving trend to February, fell sharply in March below 50 points. The decline in the services PMI was much steeper and shrank from 52.5 points in February to under 25 in March this year. The business sentiment indicator posted a reduction of 3.4 points in March which, however, reflects only partially the consequences of the pandemic containment measures, given that the surveys had been conducted in the main beforehand. Apart from the indicators of employment and new car registrations, which evidenced a very pronounced decline, the other quantitative indicators

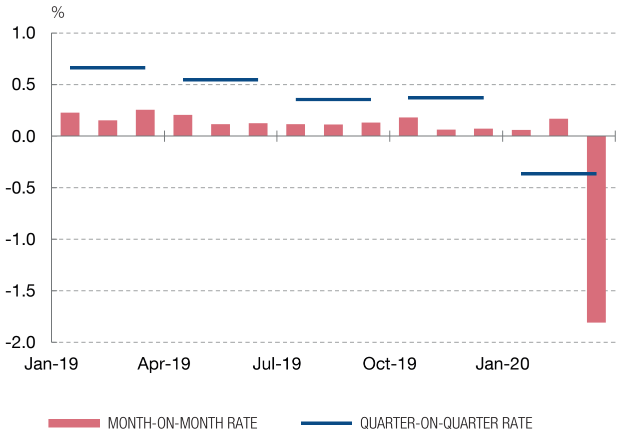
5 The state of alert was decreed en 14 March and, since then, it has been extended on three occasions. Within this period non-essential economic activities, such as construction and manufacturing not geared to the supply of food or staple goods or that had not been adapted to the manufacture of health-related equipment, were suspended between 31 March and 9 April.

Chart 1.4

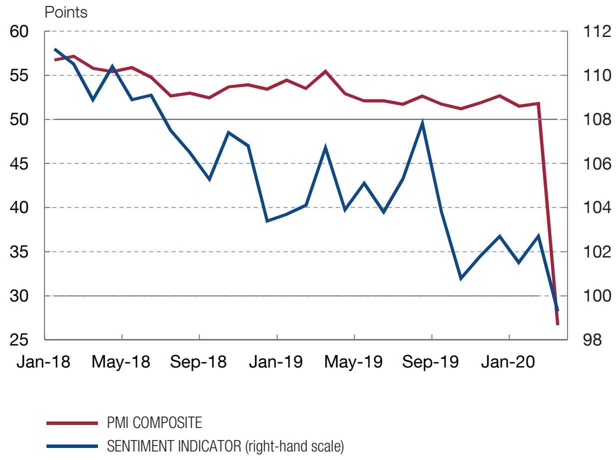
ECONOMIC ACTIVITY IN SPAIN HAS BEEN SERIOUSLY DISRUPTED BY THE COVID-19 PANDEMIC (a)

Economic activity in Spain has been sharply affected by the spread of the coronavirus health crisis, and some indicators, including most notably Social Security registrations, and consumer and business confidence surveys, are already capturing the extraordinarily severe impact of this crisis.

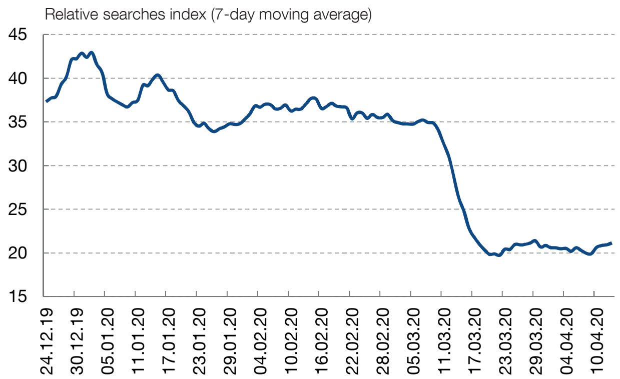
1 SOCIAL SECURITY REGISTRATIONS (EXCL. CARERS) (b)



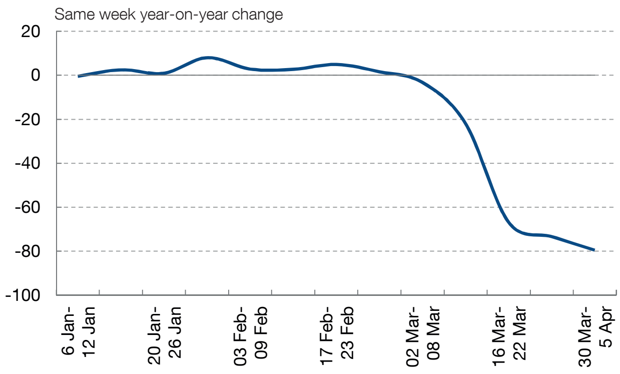
2 SURVEY-BASED INDICATORS



3 SYNTHETIC CONSUMPTION INDICATOR (c)



4 MOTORWAY TRAFFIC



SOURCES: Ministerio de Trabajo, Migraciones y Seguridad Social, European Commission, Markit Economics, Google Trends and Grupo Atlantia.

a Latest observations: March 2020 (Social Security registrations and survey-based indicators), 13 April 2020 (synthetic consumption indicator based on daily Google searches) and 5 April 2020 (weekly volumen of motorway traffic).

b Royal Decree-Law 6/2019 of 1 March 2019 restored the right of non-professional carers of dependents to enter into a special agreement with the Social Security authorities under which the State assumes the social security contributions payable. This legal amendment has increased the number of non-professional carers from 7,300 in March 2019 to 57,600 in February 2020.

c Indicator compiled on the basis of Google Trends searches.

for March usually used for economic analysis are not available. Other, higher-frequency quantitative indicators, less used in monitoring economic developments, also suggest a most pronounced contraction in activity. Thus, for instance, the figures for international travellers entering Spain by air and of flights from or to Spanish airports are estimated to have fallen to practically zero since mid-March. Along these same lines, and in accordance with an indicator of Internet searches relating to spending on consumer goods and services, this item is expected to have fallen heavily in the days prior to the announcement of the state of alert. The sharp fall-off in activity is also discernible in the decline in traffic on Spanish motorways.

These developments will translate into significant declines in GDP in the first half of the year.[6] Despite the fact that, as indicated, the information for March is incomplete, the preliminary estimates of the National Statistical Institute point to a quarterly GDP decline of 5.2% in the first quarter, even though the shock affected it mainly only in the last fortnight of the quarter. This fall exceeds in 2.6pp the biggest quarter-on quarter decline that the Spanish economy has posted in its recent history, namely in 2009 Q1. In 2020 Q2, the decline in output is expected to be appreciably higher, given that the number of weeks of confinement will be higher compared with Q1. This fall will have exceeded the biggest quarter-on-quarter decline that the Spanish economy has posted in its recent history, namely in 2009 Q1. In 2020 Q2, the decline in output is expected to be appreciably higher, given that the number of weeks of confinement will be higher compared with Q1.

The outlook for economic activity beyond the confinement period is shrouded in high uncertainty. First, there is a considerable lack of certainty over the duration and intensity of the current health crisis from an epidemiological standpoint. Second it is difficult to assess to what extent productive processes may return relatively rapidly to normality once the health alert is behind us. The time the resumption of normality takes will be all the shorter the more effective the domestic and international economic policy measures recently approved to prevent this shock leading to company closures and permanent job losses.[7]

These uncertainties hinder the preparation of medium-term macroeconomic projections using the habitual methodologies. Accordingly, on 20 April the Banco de España released a set of illustrative reference scenarios, using various analytical tools.[8] To construct the scenarios, two alternative – supply-side and demand-side – approaches were used. The supply-side perspective has as its starting point the calibration of the scale of the decline in output in the economy's various sectors as a result of the containment measures. The demand-side approach is based on simulations of different scenarios with a macroeconometric model drawing on a characterisation of the different shocks associated with the pandemic (see Chart 1.5). Evidently, given the pace of events, all these scenarios are subject to potentially frequent and large-scale revisions.

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6 For further details, see Banco de España (2020). "Reference macroeconomic scenarios for the Spanish economy after COVID-19", Analytical Articles, *Economic Bulletin 2/20200,* Banco de España.

7 See Box 1.1 in this chapter. For further details on some of these measures, see Section 5 of the Quarterly report on the Spanish economy, *Economic Bulletin 1/2020,* Banco de España.

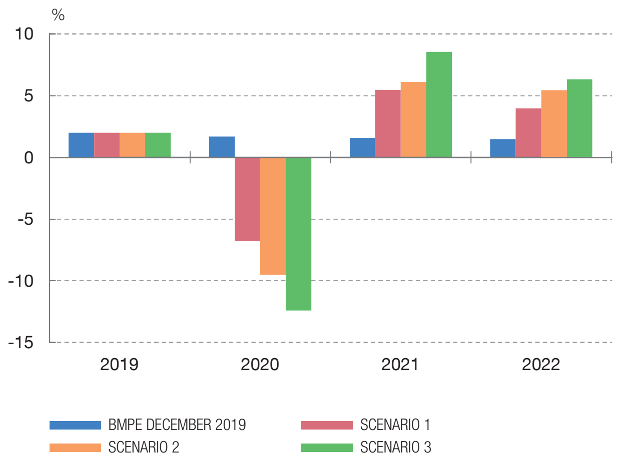
8 See Banco de España (2020) "Reference macroeconomic scenarios for the Spanish economy after COVID-19", Analytical Articles, *Economic Bulletin 2/20200,* Banco de España.

Chart 1.5

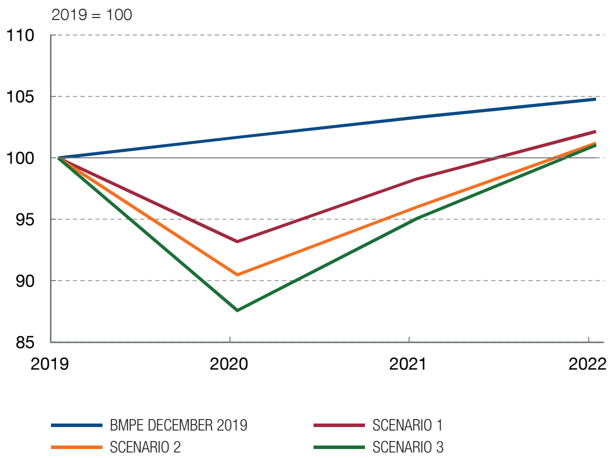
GIVEN THE UNCERTANTY SURROUNDING THE ECONOMIC IMPACT OF COVID-19, MULTIPLE SCENARIOS MUST BE CONSIDERED. HOWEVER THEY ALL FORESEE A SEVERE REDUCTION IN ACTIVITY DURING 2020 (a)

As in other countries, the Spanish economy faces a shock that is unprecedented in its recent history, the intensity and persistence of which are very uncertain; in any event, however, its effects are expected to be very marked. The specific impact on GDP will depend on the degree of success of the confinement measures in containing the pandemic and of the economic policy measures in preventing lasting damage to the economy and the financial position of agents.

1 ANNUAL RATES OF CHANGE IN GDP



2 ANNUAL GDP



SOURCES: Instituto Nacional de Estadística and Banco de España.

a Three GDP scenarios are simulated up to 2022, based on the scale of the impact of COVID-19 on activity and employment. Scenario 1 assumes that the health crisis is overcome rapidly, resulting in a confinement of the population lasting eight weeks, and that the measures approved by the authorities mitigate the destruction of firms and jobs. Scenario 3 considers a somewhat longer duration of the health crisis, with confinement lasting 12 weeks, and more persistent consequences on the loss of activity and employment. Specifically, in this scenario, activity would cease at certain percentage of firms due to liquidity problems. Scenario 2 lies between the two foregoing scenarios, combining the shorter duration of the confinement in scenario 1 with the business solvency problems of scenario 3, with a smaller proportion of firms affected. For more details, see "Reference macroeconomic scenarios for the Spanish economy after COVID-19", Analytical Article, *Economic Bulletin 2/2020,* Banco de España.

The scenarios currently available point to a decline in GDP in 2020 of between 6.6% and 13.6%. Where the Spanish economy lies in this range will depend on the duration of the confinement period, the persistence of the shocks and the extent to which private agents' liquidity problems may ultimately give rise to patrimonial difficulties. In any event, the scale of the decline will foreseeably and substantially exceed that recorded in the Spanish economy in 2009.

The simulations suggest that in 2021 there will be a rise of some intensity. However, there are factors that might detract from the momentum of such a recovery. First, it cannot be ruled out that, from a health standpoint, the pandemic may run, with some intensity, beyond the period covered in the simulations. Second, despite the economic policy measures implemented to mitigate its adverse effects, the health crisis might inflict persistent damage on the economy's productive structure (e.g. owing to permanent company closures) or a persistent reduction in aggregate demand (if households' permanent income expectations were to significantly worsen beyond what is considered even in the most unfavourable reference scenarios.

Hence, the authorities should be prepared to adopt further measures if necessary. These would include those that contribute to strengthening the European authorities' responsiveness to the crisis and to the financial needs that may arise as a result.

1.2 Financial markets and real estate sector

1.2.1 Financial markets

The expansion of the COVID-19 health crisis has impacted developments on financial markets since late February, with historical falls on stock market indices. The favourable market performance at the turn of the year, which had led the main stock market indices to post historical highs in the United States (S&P 500, Dow Jones and Nasdaq) and Europe (Stoxx Europe 600), was sharply reversed following the outbreak of COVID-19 outside China. Investors' concern over the macroeconomic effects of the health crisis coupled with the context of high uncertainty prompted flight by investors from risky assets.

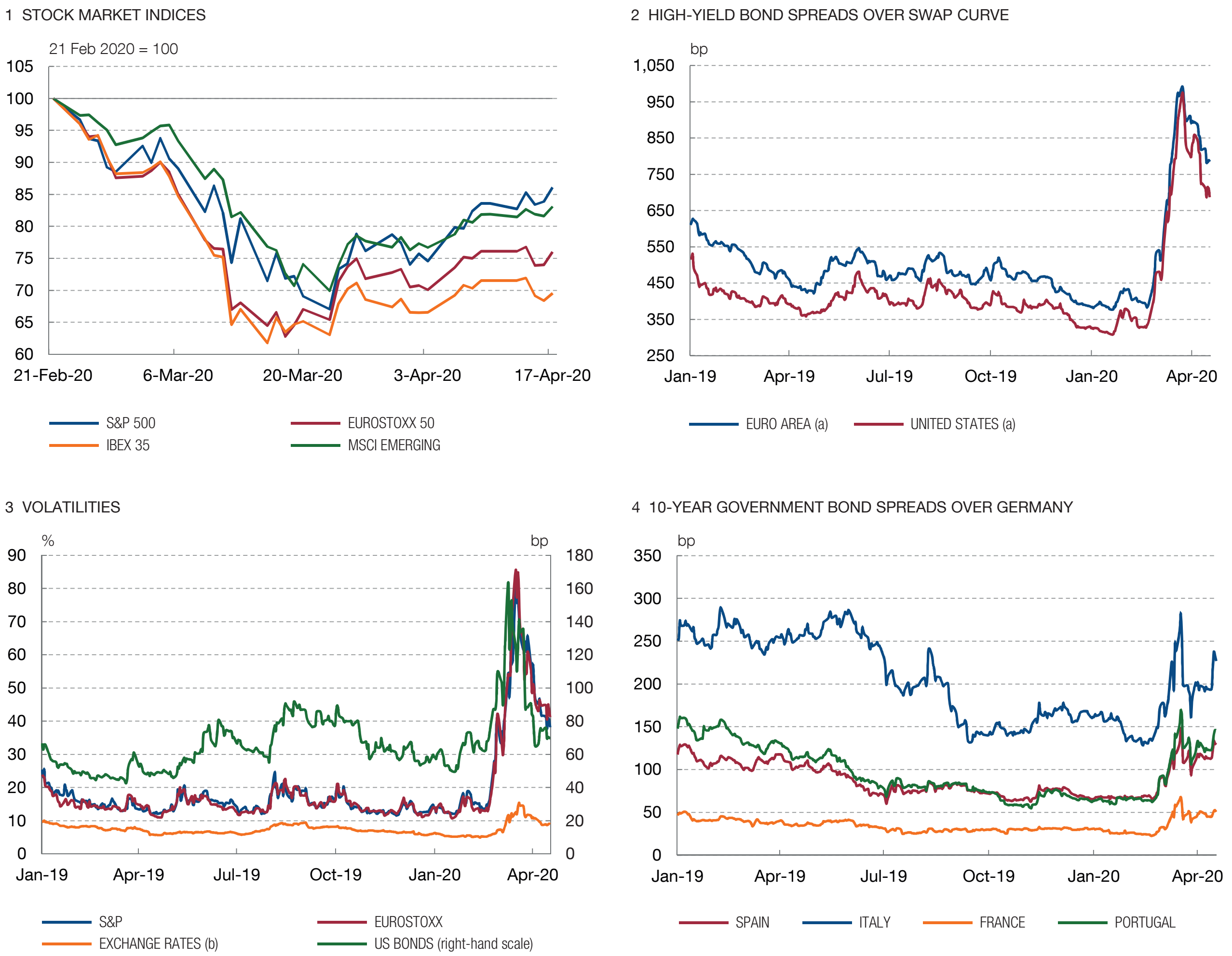
Despite the economic authorities' measures to contain the adverse effects of the health crisis have managed to stabilise the markets to some extent since late March, the cumulative declines the prices of risky assets are most significant. From 21 February to the cut-off date for this Report, the indices of the main global stock markets posted losses of over 13%, with the Ibex 35 falling back 30%, the EuroStoxx 50 24% and the S&P 500 14% (see Chart 1.6). Corporate credit risk premia have increased sharply, especially in the high-yield segments, with an increase over the same period of 348 bp in the case of the United States and of 397 bp in the euro area. Further reflecting the high uncertainty was the most significant rise in the volatilities of prices on equity and bond markets, reaching historical highs in some cases.

On the euro area financial markets, sovereign risk premia widened, albeit moderately owing to the ECB's measures. The widening reflects the outlook concerning the adverse impact of the health crisis on budget deficits (via both the automatic stabilisers and discretionary measures), and also the general climate of uncertainty and of investors' greater risk aversion. Pressure on these spreads eased first, following the approval on 18 March of new expansionary measures by the ECB, including purchases of assets worth €750 billion over the rest of 2020; and further, after the confirmation on 26 March that the limits on asset purchases set in previous programmes would not be applied. From 21 February to the cut-off date for this FSR, the cumulative increase in 10-year yield spreads over the German benchmark was 64 bp in Spain, 93 bp in Italy and 28 bp in France.

Chart 1.6

FOLLOWING THE SPREAD OF THE HEALTH CRISIS, RISKY ASSET PRICES FELL SHARPLY AND THE ASSOCIATED VOLATILITIES ROSE

Marked fall-off in stock market indices and a rise in risk premia on both corporate and sovereign debt. In the case of the latter, the measures adopted by the ECB managed to reduce the related premium in the final weeks of March. The high uncertainty globally prompted an increase in the volatility of financial asset prices.



SOURCE: Thomson Reuters Datastream.

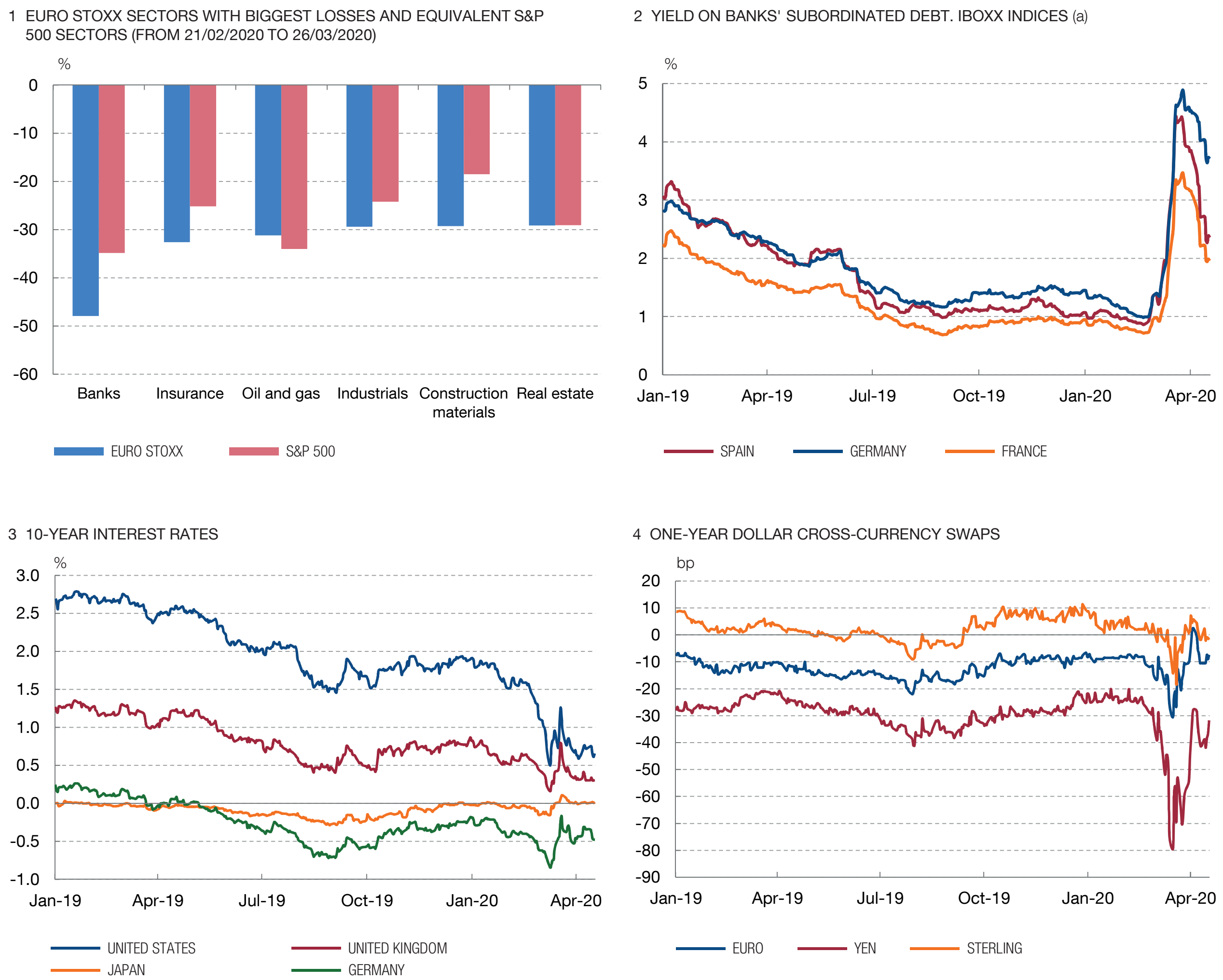
a ICE Bank Of America Merrill Lynch Single-B High Yield Index.
b Average of 3-month volatilities for USD/EUR, USD/GBP and JPY/USD.

Prices of assets issued by banks and companies in the insurance and oil and gas sectors fell to a greater extent than the market on average. Euro area banks' share prices are among those most affected by the correction in stock market prices, in line with what has been seen on other international markets, such as the United States (see Chart 1.7). The cost of debt issued by banks has also risen, markedly so in the case of subordinated debt. The share prices of firms in the insurance and oil and gas sectors have fallen to a greater extent than overall indices. That reflects the greater impact the health crisis is expected to have on these companies' profits.

Chart 1.7

THE TENSIONS ON FINANCIAL MARKETS ALSO AFFECTED THE PRICES OF ASSETS ISSUED BY BANKS AND DOLLAR FINANCING

The stock market capitalisation of the banking sector has fallen by over 30% both in the United States and in the euro area since the spread of the coronavirus from China. Moreover, the cost of banks' subordinated debt also rose. Top-quality sovereign yields initially fell, but this movement was subsequently reversed owing to investors' search for liquidity and the expected increase in issuance. The cost of financing in dollars rose considerably, prompting coordinated action by central banks to increase their currency swap operations.



SOURCE: Thomson Reuters Datastream.

a The Iboxx subordinated debt index tracks the prices of these instruments for a representative sample of banks.

The search for safe and liquid assets, expectations of expansionary monetary policies and the fiscal packages announced influenced the course of yields on higher-quality sovereign debt. The demand for safe-haven assets along with expectations of more accommodative monetary policies led to a decline in higher-rated sovereign debt yields. In the case of the US and German 10-year benchmarks, such yields fell to historical lows. However, in recent months there have also been temporary rises in these yields that might be linked to the announcement of fiscal stimulus programmes by many countries' governments and the increased demand for liquid assets, which also prompted a fall in the price of assets – such as gold – deemed to be safe.

There have also been tensions on foreign exchange markets, with periods of heavy depreciation of the US dollar followed by a reversal of this trend. The initial depreciation of the US dollar was influenced by the unwinding of carry-trade positions, while its subsequent appreciation against the euro and the yen reveals the growing demand for this currency globally by banks and non-financial corporations that are seeking to remain operational. This is reflected in higher dollar borrowing costs in currency swaps. Coordinated action on 15 March by the Fed, the ECB and the Canadian, UK, Japanese and Swiss central banks duly ensued to raise the numbers of participating central banks and the frequency of dollar swap facility operations. These decisions managed to reverse, in part, higher dollar borrowing costs (see also the section on liquidity and financing conditions in Chapter 2). More recently, the Fed has launched a temporary lending facility that will allow foreign central banks with accounts at the Fed to convert their holdings of US Treasuries into dollars using repos.

Energy and non-energy commodities prices have collapsed in the wake of the pandemic. The decline in oil prices, by close to 50% since late February in the case of the Brent reference price, was initially due to the disagreement between OPEC and other oil producer countries over production quotas. This was accompanied by the contraction in demand, especially in the transport sector, owing to the confinement measures adopted in the face of the pandemic. Following the agreement reached between OPEC and other partners to reduce supply by around 10 million barrels per day in May and June (and by a progressively smaller amount until April 2022), prices have scarcely reacted, suggesting a notable collapse in the demand for crude oil. Moreover, in the case of the United States, the fall in oil prices is estimated to have prompted significant downward revisions of the creditworthiness of those companies most exposed to oil extraction activities.[9]

1.2.2 The real estate market in Spain

The impact of the health crisis on the real estate market will also be significant, at least in the short run. Prior to the current shock, this market was in a slowing phase both in terms of activity and transactions and prices, following the notable expansion in the previous years (see Chart 1.8). The declaration of the state of alert owing to the COVID-19 crisis did not initially entail a closedown in the construction sector. Later, activity came to a halt, as a result of the suspension of non-essential economic activities between 29 March and 9 April. In any event, the confinement of

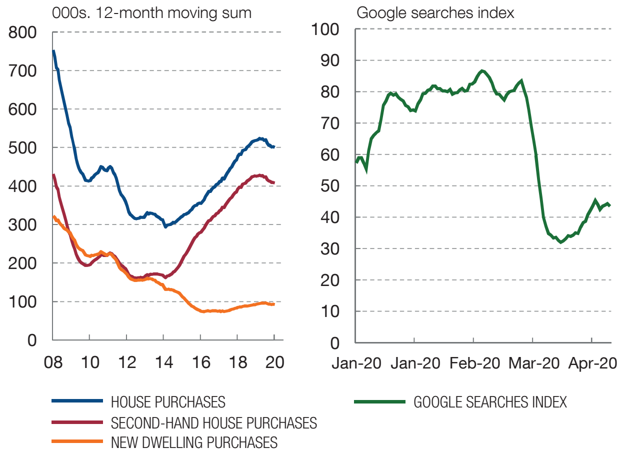
9 Thus, for example, the rating agency S&P downgraded companies such as Anadarko Petroleum, Occidental Petroleum and Exxon Mobil in March.

Chart 1.8

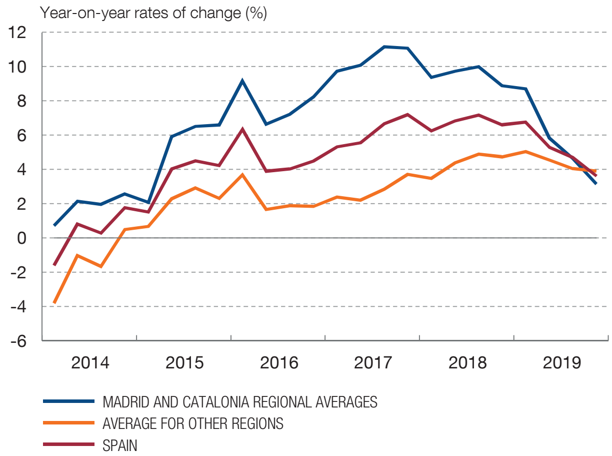
THE HOUSING MARKET WAS SLOWING BEFORE THE CORONAVIRUS CRISIS, WHICH WILL PROMPT DOWNWARD ADJUSTMENTS, AT LEAST IN THE SHORT TERM (a)

Residential activity was slowing before the coronavirus health crisis shock. House purchases contracted in 2019 in both the newly built and, to a greater extent, second-hand housing segments. In turn, growth in the average housing price moderated, and the level of geographical heterogeneity remained high. Unlike the situation prior to the last crisis, at the end of 2019 there were no major imbalances in the housing market in terms of either volumes or prices.

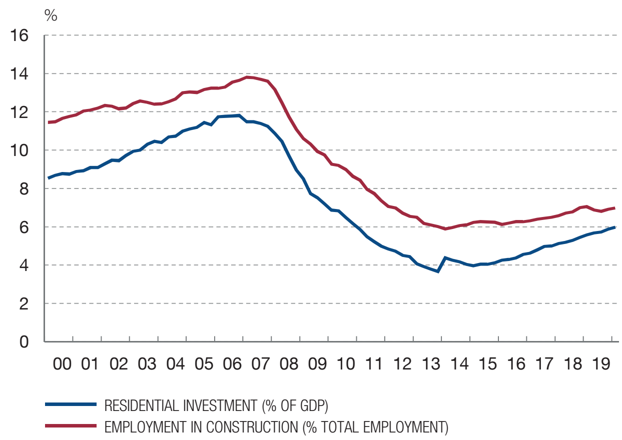
1 TRANSACTIONS AND GOOGLE SEARCHES (b)



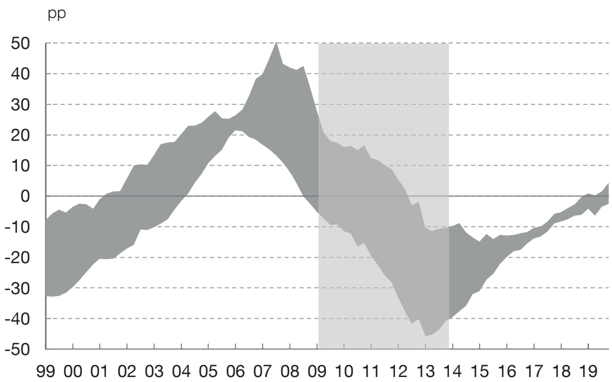
2 HOUSE PRICES PER REGION



3 RESIDENTIAL INVESTMENT AND EMPLOYMENT IN CONSTRUCTION



4 HOUSE PRICES IMBALANCES INDICATORS (c)



SOURCES: Google Trends, ECB, Eurostat, INE and Banco de España.

a Latest observation: 2019 Q4 (house prices), January 2020 (house purchases). 2020 Q1 (residential investment and employment in construction) and 13 April 2020 (Google searches index).

b The left-hand chart shows the number of purchases as a 12-month moving sum; the right-hand chart shows the Google housing search index.

c The vertical shaded area shows the last systemic banking crisis period (2009 Q1 to 2013 Q4). The shaded strip depicts the minimum and maximum values of a set of four indicators of price developments in the real estate sector relative to their long-term trends: i) housing prices gap relative to the long-term trend calculated using a Hodrick-Prescott filter with a smoothing parameter equal to 400,000; ii) the gap between the house prices-tohousehold-disposable-income ratio and the long-term trend calculated using a Hodrick-Prescott filter with a smoothing parameter equal to 400,000; iii) disequilibrium econometric model of house prices explained by long-term trends of disposable income and mortgage rates; and iv) long-term disequilibrium econometric model of house prices explained by prices from previous periods, disposable income, new mortgage rates and fiscal variables.

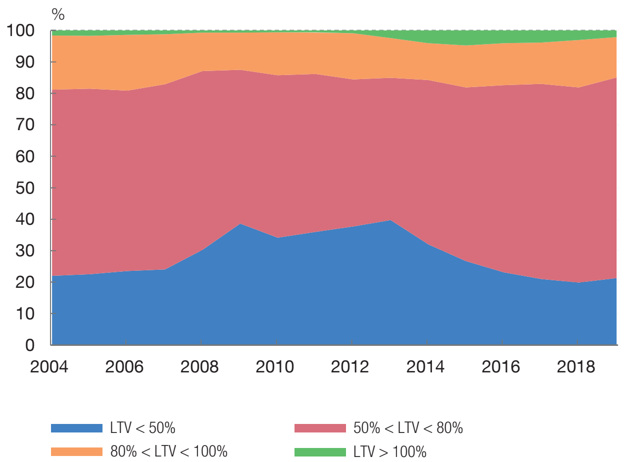
the population and the difficulty in concluding some of the tasks associated with the house sale process are estimated to have most significantly impacted demand. This can be inferred, for instance, from the indicators based on Internet searches for real estate sector-related terms, which reveal a sharp fall.

Chart 1.9

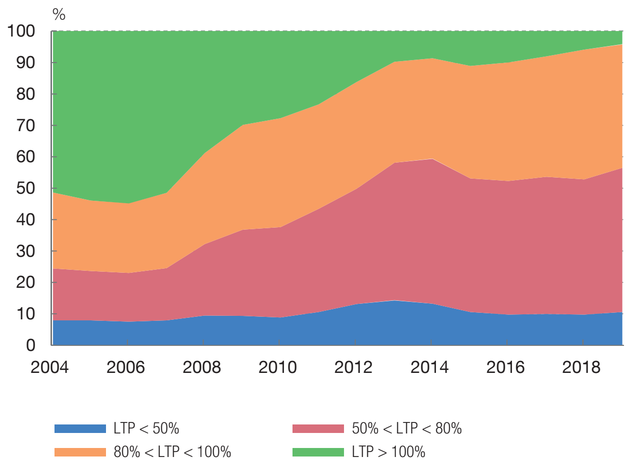
REAL ESTATE LENDING STANDARDS PRIOR TO THE OUTBREAK OF THE CORONAVIRUS CRISIS WERE MUCH MORE CONSERVATIVE THAN IN 2008

The weight of mortgages with high leverage in terms of LTP lessened substantially after the international financial crisis. Since then, much more conservative lending standards have remained in place. The empirical evidence available shows that this considerably reduces the probability of default when there is the decline in the borrower's income.

1 LTV RATIO. DISTRIBUTION (a)



2 LTP RATIO. DISTRIBUTION (a)



SOURCES: Datastream, ECB, Association of Registrars and Banco de España.

a Loans in which the collateral is a dwelling and the borrower an individual are included. In the distributions, the principal of the loans accumulates (by period) to define each segment within the distribution. The loan-to-value (LTV) ratio captures the relationship between the principal of the mortgage loan and the appraised value of the dwelling, while the loan-to-price (LTP) ratio, calculated for a sample of mortgages, uses the registered price of the dwelling as its denominator.

The extent of the recovery in real estate market activity once the health crisis is over will depend on how persistent the economic and financial effects of this shock prove to be. In any event, the absence of significant imbalances in terms of prices and volumes in this market prior to the outbreak of the health crisis is a factor that mitigates the scope of the possible risks to economic and financial stability more generally. Indeed, unlike at the onset of the previous crisis in 2008, on this occasion other factors were at play: the sector does not appear to be oversized; real estate activity-linked debt and financing to households for house purchases were contracting, even though they account for a significant fraction of bank lending to the private sector; and there were no widespread signs of housing overvaluation (see Chart 1.8). It should also be borne in mind that the weight of highly leveraged transactions in the granting of mortgages has been much lower in the post-2008 period (see Chart 1.9) and that the mortgage loans which survived the international financial crisis generally have prudent financing conditions and are much closer to maturing. The empirical evidence available shows that these factors are associated with a lesser likelihood of loan non-performance.

1.3 The non-financial sectors

1.3.1 Households and non-financial corporations

In the face of the coronavirus, which is a significant adverse shock to incomes, Spanish households are in a sounder financial position than they were before the 2008 financial crisis. In the past decade households have substantially deleveraged, with their debt declining by close to 23% since end-2008, when it peaked. This led the debt ratio to stand at 91% of gross disposable income (GDI) in 2019 Q4, a level not seen since early 2004 (see Chart 1.10). This level is almost 4 pp down on the euro area average. The reduction in debt has been accompanied by a significant decline in financing costs in recent years, which has translated into a strong reduction in the proportion of income earmarked for financial debt repayment. This percentage fell to 11.1% of GDI at end-2019, the lowest level for the past 20 years.

The volume of households' liquid assets relative to their income is also higher than before the last crisis. On the latest available data, for 2019 Q4, households' cash and deposits amounted to 118% of GDI, 8 pp up on 2007. If other readily realisable assets such as investment fund shares, listed shares and debt securities are added to these, households' liquid assets account for 181% of GDI, 11 pp up on 2007. However, the value of a portion of these latter assets has fallen in recent weeks as a result of the effects of the health crisis on financial market developments.

At the aggregate level, households' financial position, prior to the outbreak of the pandemic, was relatively sound. But there are population segments in a position of particular vulnerability. According to the latest wave of the Spanish Household Financial Survey (EFF by its Spanish name)[10], 10% of households were assigning more than 40% of their income to debt service, a percentage which is in any event at its lowest since 2005. However, the proportion of households earmarking over 30% of their income to rental payments has increased significantly, particularly among the under-35s (14%, compared with 8% in 2008). As regards the holding of financial assets, the EFF reveals that whereas in 2017 the median household had €10,500 in financial assets, €4,500 of which were in current accounts and sight deposits, households below the 25th percentile of net wealth had only €1,500 in financial assets, of which approximately half were in current accounts and sight deposits.

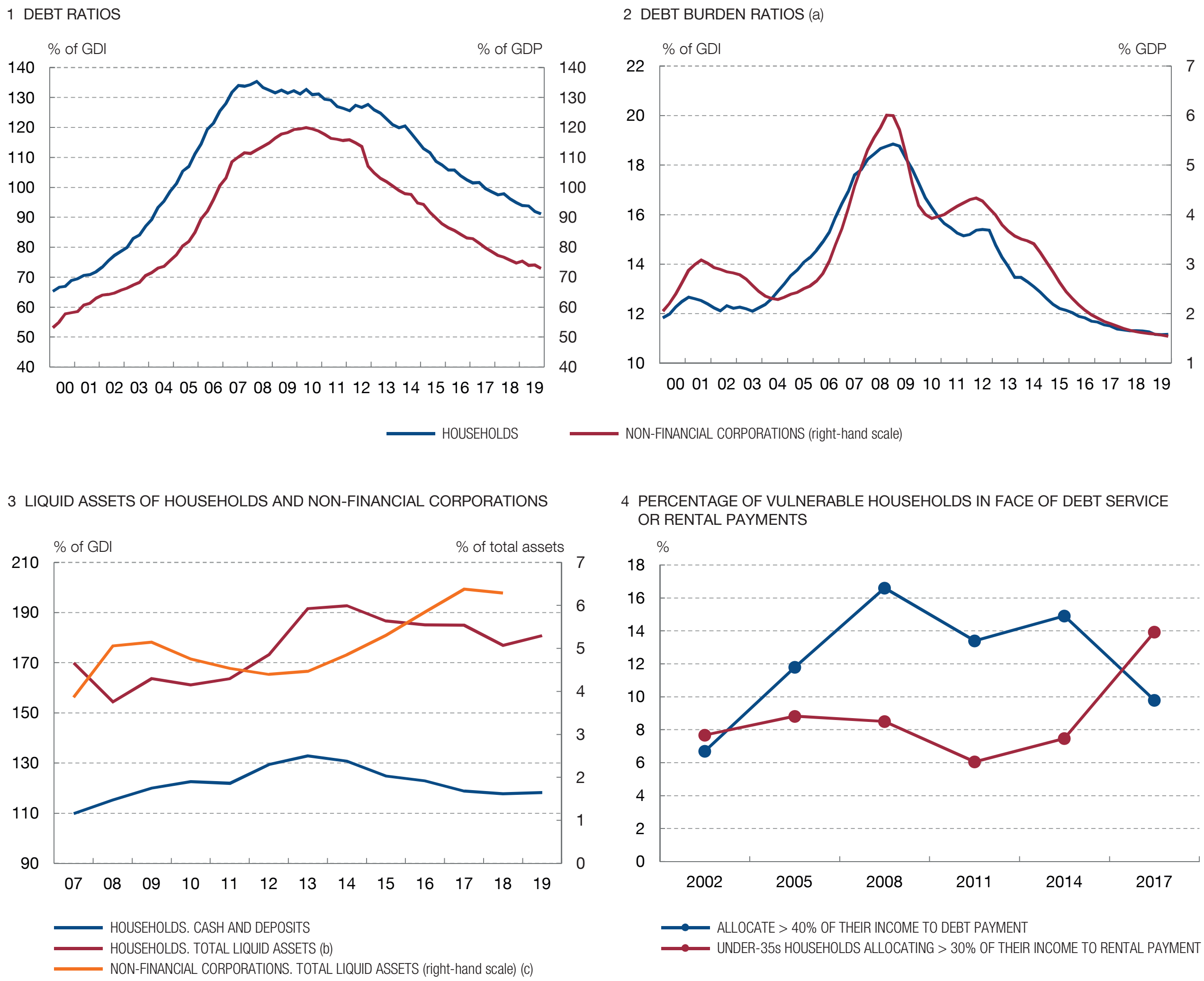
The support programmes for households affected by the economic effects of the health crisis should contribute to mitigating its impact on this sector's

10 For further details see the article "Survey of household finances (EFF) 2017: methods, results and changes since 2014", Analytical Articles, *Economic Bulletin 4/2019*, Banco de España.

Chart 1.10

THE NON-FINANCIAL PRIVATE SECTOR'S CURRENT FINANCIAL POSITION IS SOUNDER THAN IN 2007

Households and non-financial corporations have deleveraged intensely in the past decade. This, combined with the low cost of financing, has placed the debt burden at levels very close to historical lows. However, some household segments are in a position of some vulnerability. Thus, for example, the percentage of households allocating a high proportion of their income to rental payments has increased, particularly in the younger population segments. Liquidity ratios are at higher levels than those prevailing before the previous crisis, but household liquidity will be subject to valuation adjustments.



SOURCES: ECB, INE and Banco de España.

a The household financial burden comprises the debt principal and interest repayments they make, while in the case of firms only interest is considered, given the difficulty of reliably estimating the amount of repayment instalments.
b Comprises: cash, deposits, investment fund shares, listed shares and debt securities.
c Asset-weighted average.

economic and financial situation. Among the measures approved, the moratorium on mortgage loan instalment payments, and on other personal loans to the unemployed and self-employed who have seen their incomes substantially cut as a result of the health crisis, will ease the financial pressure on the groups availing themselves of this measure. Also, the possibility of deferring rental payments and the guarantee that basics will be provided also contributes to limiting the impact of the crisis on these groups. Access to contributory unemployment benefits for those workers laid off who lack the contribution period needed or the extension of benefits to temporary employees will alleviate the decline in incomes. The possibility of drawing down amounts from pension funds without penalisation will also contribute to providing liquidity to those households most affected by the crisis. Further, the government has announced the forthcoming introduction of a subsidy for households with hardly any income. Box 1.2 analyses whether households establish priorities in terms of the potential default on their financial obligations when there is a substantial loss of income or job loss.

Non-financial corporations are also facing the economic effects of the health crisis with a starting financial position that had improved substantially since 2008. The business debt ratio stood at 73% of GDP at end-2019, 5 pp down on the euro area average. This is the lowest level since early 2004 and is 47 pp below the June 2010 peak. This, combined with the decline in the cost of debt in recent years, has translated into a substantial reduction in interest payments relative to GDP, which have reached their lowest level of the past 20 years. The average return on assets for non-financial corporations had also grown in recent years and stood at similar levels to those pre-crisis.

In any case, some firms, concentrated among the smallest, were showing signs of vulnerability. The magnitude of the shock is very significant and there were in 2019 certain segments of the Spanish corporate sector with a weaker financial situation. Besides, the effect of the crisis will be heterogeneous across economic sectors. In particular, some areas of activity, such as hotels and restaurants, commerce and car manufacturing, will be impacted more adversely.

Non-financial corporations' liquidity reserves have also improved in recent years. Notwithstanding, the foreseeable scale of the decline in revenue will hamper the coverage of their needs, although the public guarantee programme will help alleviate this problem. Firms' liquidity has increased in recent years and the latest individual firm data, for end-2018, evidence higher levels of liquid assets than those in place before the previous crisis (see Chart 1.10). The position is, however, not uniform across firms. Financing available in the form of credit facilities, in proportion to the total outstanding balance of credit granted, has risen in recent years; however, at end-2019 the related levels were lower than those prior to the 2008 crisis, and they were moreover concentrated in the segment of larger firms. The government-approved guarantees programme will smooth the resort to bank financing in order to provide liquidity to firms so they may face existing financial obligations and those that may arise during this period.

1.3.2 General government

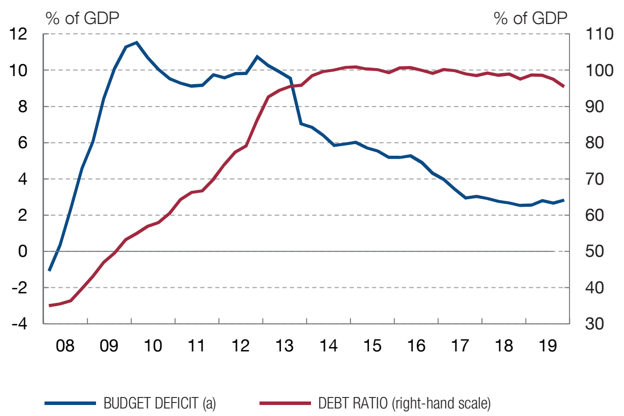
Following the worsening of the Spanish general government deficit in 2019, the structural position of public finances remained in deficit and public debt high. After six consecutive years of reductions in the Spanish general government deficit

Chart 1.11

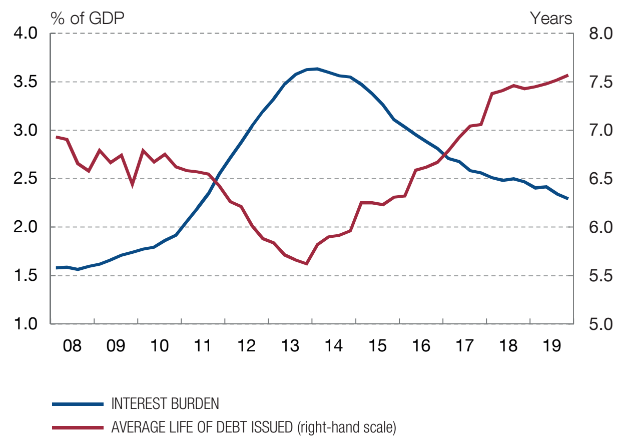
PUBLIC SECTOR DEBT REMAINS VERY HIGH AND WILL INCREASE SIGNIFICANTLY WITH THE CRISIS

In the different scenarios considered for the evolution of the Spanish economy, the general government debt is expected to rise considerably, on a potentially higher scale in the scenarios with a bigger downturn in activity. In any case, the risks to public debt sustainability are mitigated by the favourable financing conditions of recent years, although the risk premium has increased to some extent with the crisis, owing to the lengthening of the average life of outstanding debt, which reduces the volume of forborne exposures.

1 GENERAL GOVERNMENT FINANCIAL POSITION



2 GENERAL GOVERNMENT DEBT BURDEN AND AVERAGE LIFE OF DEBT ISSUED



SOURCES: Public Treasury and Banco de España.

a Four-quarter cumulative data.

as a percentage of GDP, in 2019 it rose by 0.3 pp to 2.8% (see Chart 1.11). This was due to the expansionary fiscal policy stance that year, reflected in significant increases in spending on social benefits and public-sector employees' remuneration. The positive effect of low financing costs and of the economic expansion – which while lower than in 2018, still exceeded the Spanish economy's estimated potential growth – was more than offset by the extra expenditure. In fact, since the start of the recovery in 2014, the entire correction of the public finances shortfall in Spain in recent years is estimated to have been due to the two effects mentioned (expansionary cycle and low interest rates). Accordingly, the general government structural balance and primary structural balance[11] are expected to have stood, at end-2019, at even higher levels, of around –3% and –0.8% of GDP, respectively, on Banco de España estimates. Public debt, for its part, stood at 95.5% of GDP, marking a reduction of 2.1 pp since last year. As a result, there has been a 5.2 pp reduction in this ratio from its 2014 peak of 100.7%, thanks to the increase in nominal GDP and the decline in the interest burden.

Against this background, the health crisis will have notable consequences for public finances, both in Spain and in many other countries. In the three scenarios

11 The structural balance attempts to correct the transitory effects that the economy cyclical position has on public revenue and spending. The primary structural balance excludes the public debt interest burden.

set out in Section 1.1.2, Spanish general government debt is expected to rise considerably, on a potentially higher scale in the scenarios with a bigger downturn in activity. In the first of these, public debt might rise to around 110% of GDP in late 2020. This scenario is characterised by an eight-week confinement period and the absence of financial frictions that may cause durable damage to the productive structure. Approximately half the almost 15 pp increase, compared with the end-2019 position, would be due to the public finances shortfall, equitable to around 7% of GDP. This would be as a consequence of the combined effect of the automatic stabilisers and the discretionary measures approved. The remainder would be attributable to the estimated decline in nominal GDP, plus a residual impact arising from flow-stock adjustments.[12] In the second, more unfavourable scenario, where it is assumed that private agents' liquidity problems may give rise to certain solvency difficulties, debt might rise in 2020 to 115% of GDP. These financial difficulties open the way for a sharper decline in activity and a somewhat slower recovery. If, moreover, the confinement measures run for a total of 12 weeks, as in the third scenario, debt might exceed 120% of GDP. In the three cases public debt would tend to fall in 2021, under the different scenarios. This is a consequence of the rise in nominal GDP growth, since the budget balance is expected to continue running a deficit.

The economic downturn prompted by the pandemic will give rise to a persistent increase in the vulnerability of the Spanish public finances position. The foreseeably temporary nature of the COVID-19 shock means that the expected downturn will not, in principle, be predominantly structural. For this to be so, however, a time-limited and forceful fiscal response is required. That said, the high starting position of the structural deficit and the increases in public debt which will foreseeably ensue, combined with the challenges arising from population ageing[13], highlight the vulnerability of Spanish public finances to further possible shocks to economic activity, to financing costs and to investor sentiment. In the short term, the bolstering of the ECB's asset purchase programmes is helping ensure the absence of general government financing tensions, and the decisions by the European institutions should smooth to a greater extent the financing of public sector requirements. Into the medium term, when normality resumes, a fiscal consolidation and structural reform programme should be implemented to reduce the imbalances in the economy and raised its potential growth.

The measures approved by the national authorities and by the ECB should be complemented by a broad-based European response. The pandemic and its economic impact are affecting all euro area countries and, by extension, the European Union. To tackle this situation calls for resolute and ambitious action by the Community authorities and institutions using the financial and budgetary

12 These reflect changes in debt not attributable to the balance of general government non-financial revenue and spending. Accordingly, they include the change in financial assets and liabilities and valuation adjustments.

13 The latest estimates already augured a significant increase in public spending on pensions, health and long-term care further to population ageing, but also to the latest measures adopted in the case of the pension system.

instruments already in place, along with possible new tools. In this respect, on 9 April the Eurogroup resolved to set in train a range of support measures. These included most notably a credit facility from the European Stability Mechanism (ESM) to provide financing to the Member States, a European Investment Bank (EIB) programme to smooth the funding of SMEs and a fund to defray a portion of the costs associated with employee furlough-like arrangements. In addition, the European Council supported on April 23th the creation of a Recovery Fund at the proposal of the European Commission, to be funded with the 2021-2027 multiyear European budget. Among other possible new instruments that may be required, priority should be given to those that strengthen the capacity of the EU as a whole to set in place conditions conducive to appropriate funding with which to defray the heavy costs of repairing the damage inflicted by the pandemic on all the Member States' growth capacity. In the current crisis it is more urgent than ever step up efforts to move resolutely towards completing the institutional architecture of the euro area.

1.3.3 The international investment position and external debt

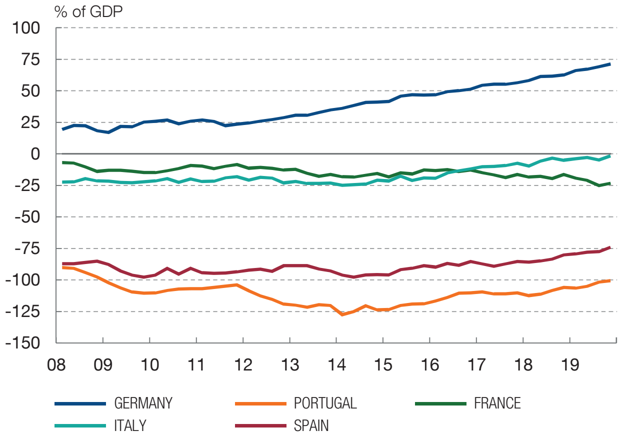
The Spanish economy has a high negative external position (IIP). This is a source of vulnerability given the current situation, steeped in uncertainty

Chart 1.12

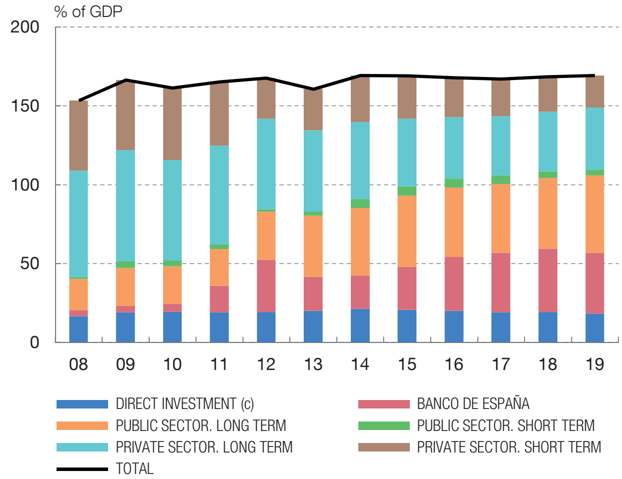
SPAIN'S NET DEBTOR INTERNATIONAL INVESTMENT POSITION HAS DECLINED BUT REMAINS HIGH

The Spanish economy's net debtor international investment position has fallen in recent years, but is still high from an international perspective. The refinancing risks of this debt are mitigated by the prevalence of long-dated issuance for public sector debt and for that denominated in euro.

1 NET INTERNATIONAL INVESTMENT POSITION BY COUNTRY (a)



2 GROSS EXTERNAL DEBT STRUCTURE BY INSTITUTIONAL SECTOR AND MATURITY (b)



SOURCE: Banco de España.

a The net IIP is the difference between the value of the resident sectors' external assets and that of liabilities vis-à-vis the rest of the world.
b External debt comprises the stock of all liabilities that give rise to future payments of principal, interest or both (i.e. all financial instruments except own funds, financial derivatives and monetary gold bullion).
c Includes only direct investment in the form of debt.

and with tensions on international financial markets. The Spanish economy's net debtor IIP has been falling in recent years, but is still at high levels in historical terms and compared with other advanced economies (see Chart 1.12). Specifically, at end-2019 it stood at 74% of GDP (in absolute terms), its lowest level since 2007 and 24 pp below its June 2014 peak. Gross external debt stood at end-2019 at 169% of GDP, 6.2 pp below its 2015 Q1 peak and in an intermediate position relative to the other advanced economies. The refinancing risks in relation to this debt are somewhat mitigated by the prevalence of debt issued long-term by the public sector, and debt denominated in euro, along with the active presence of the Eurosystem in sovereign debt markets by means of its asset purchase programmes. However, the reduction of the Spanish economy's NIIP to levels comparable with peer countries requires that the gains in competitiveness built up after the financial crisis be maintained. In that way, positive external current account balances may continue to be run recurrently.