BANCO DE ESPAÑA
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SPANISH COVID-19 RECOVERY, POLICY RESPONSE AND WIDER EUROPEAN REFORMS

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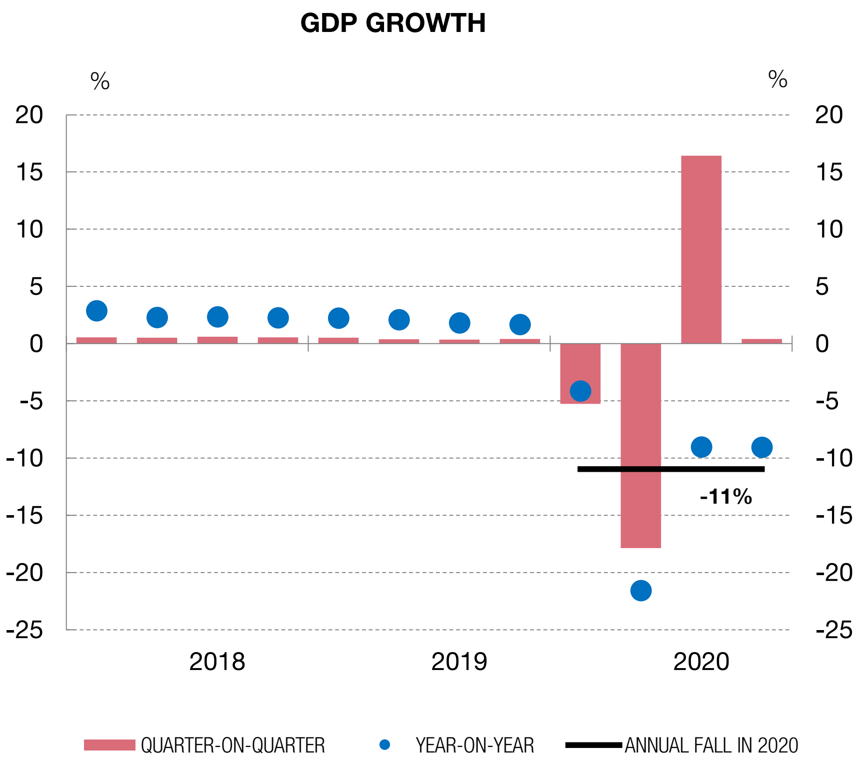
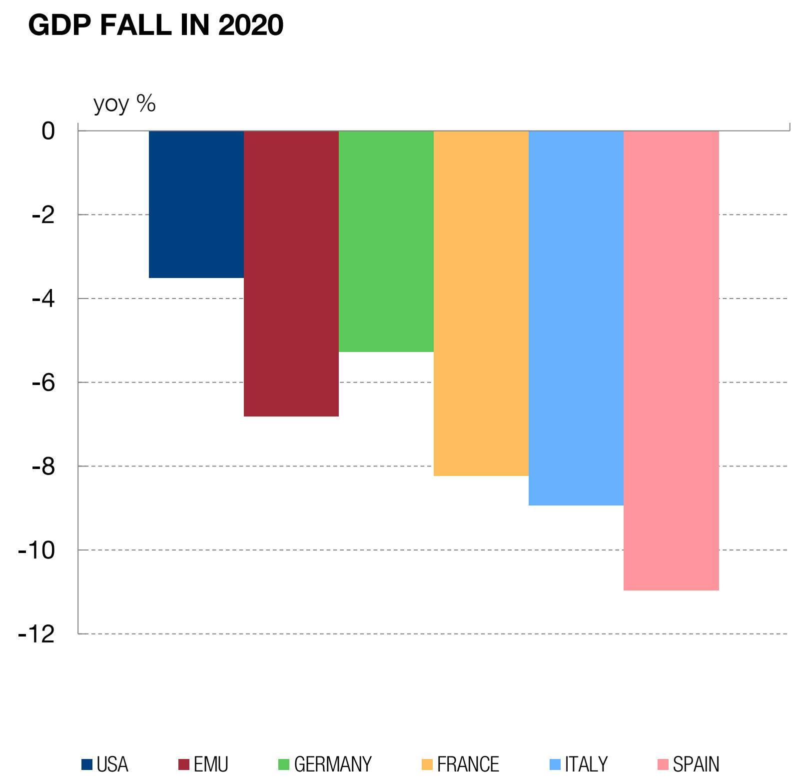
Online

8 March 2021

A CRISIS LIKE NONE BEFORE, WITH SPAIN HARDER HIT THAN MOST OTHER ADVANCED ECONOMIES

- **A fall in GDP without precedents in living memory at peace time**
- **And a recovery which is incomplete and fragile**
- **At end 2020, the GDP level was still 9.1% below 2019q4 (against 5.1% in the euro area)**





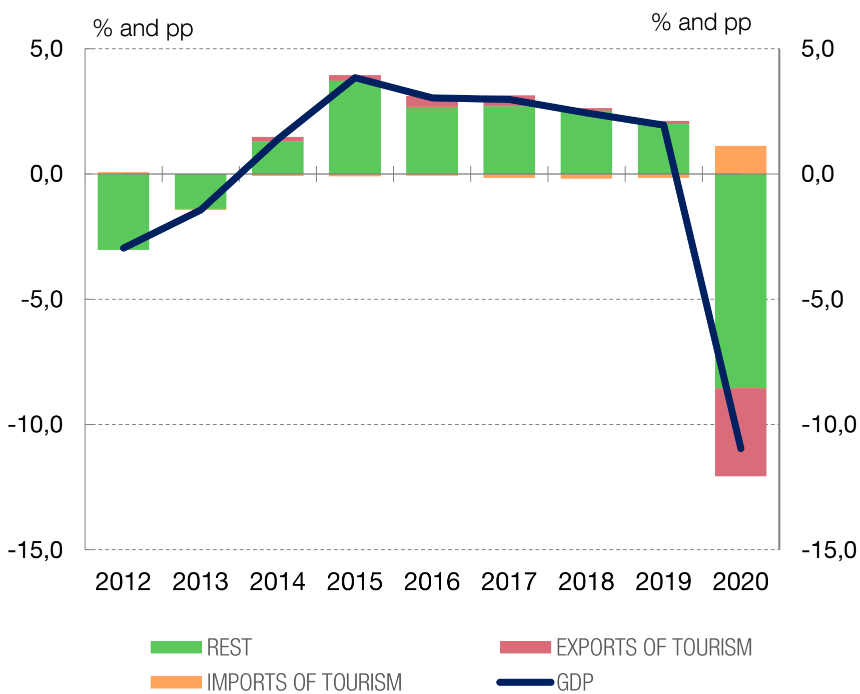
Source: Instituto Nacional de Estadística. Lastest observation: fourth quarter 2020.

Source: Bureau of Economic Analysis (US Department of Commerce) and Eurostat. Lastest observation: fourth quarter 2020.

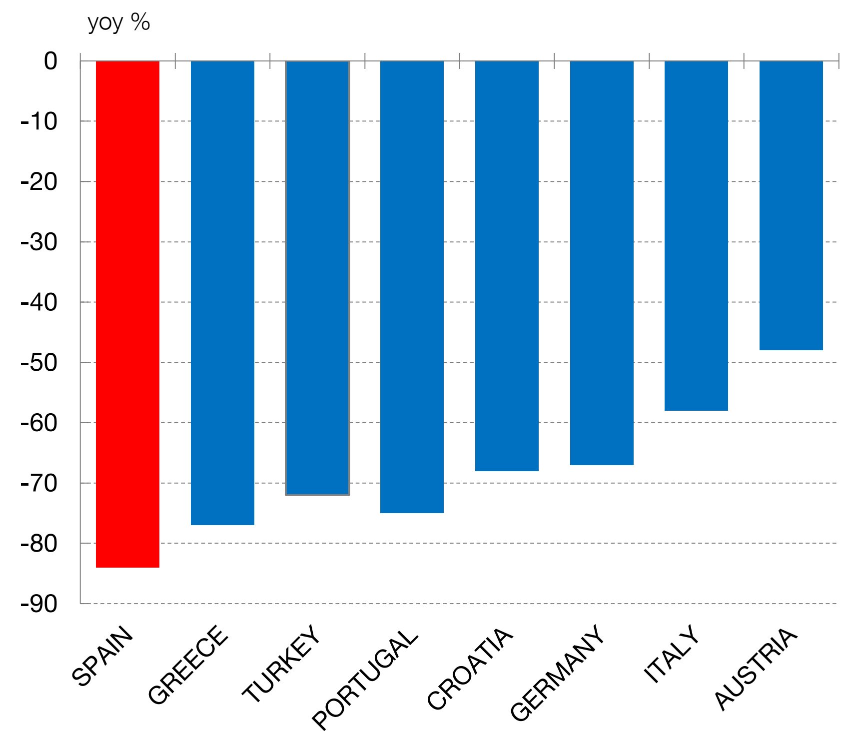
WHY A HIGHER IMPACT OF COVID-19 IN SPAIN (1): THE WEIGHT OF THE TOURISM INDUSTRY

- **The weight of tourism activities is larger in Spain than nearly anywhere else (exports tourism ES: 6% GDP vs FR, IT: 2,5%, UK: 1,8%)**
- **Moreover, the tourist industry has been harder hit in Spain than in other destination countries**

GDP. Y-O-Y GROWTH RATES AND CONTRIBUTIONS



INTERNATIONAL TOURISTS ARRIVALS IN 2020



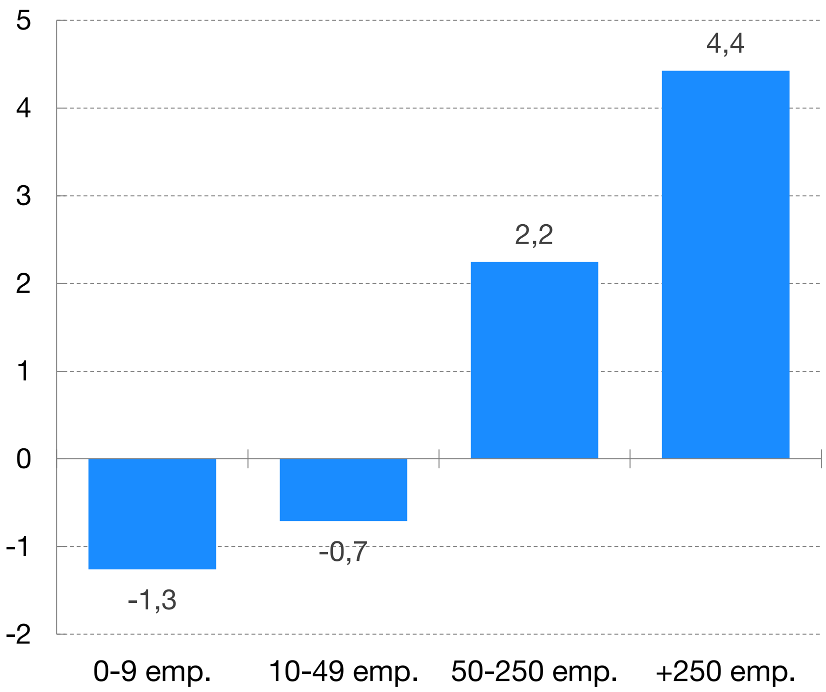
Source: Instituto Nacional de Estadística and Banco de España.

WHY A HIGHER IMPACT OF COVID-19 IN SPAIN (2): THE ROLE OF SMEs

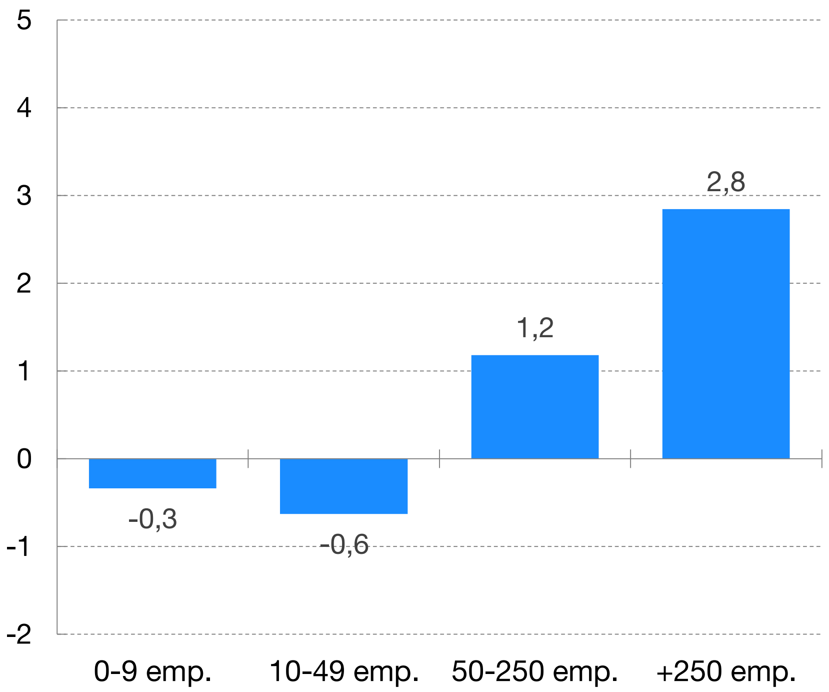
- **SMEs have a larger weight in the Spanish productive fabric than in other countries (share of companies with less than 5 employees is 78%, 9 pp above the euro area)**
- **SMEs have disproportionately suffered the impact of the crisis, as a recent BdE survey shows: the fall in sales and employment was larger in SMEs, even after controlling by sector.**

Y-O-Y GROWTH RATES OF TURNOVER AND EMPLOYMENT
(deviation respect to sector average)

TURNOVER



EFFECTIVE EMPLOYMENT

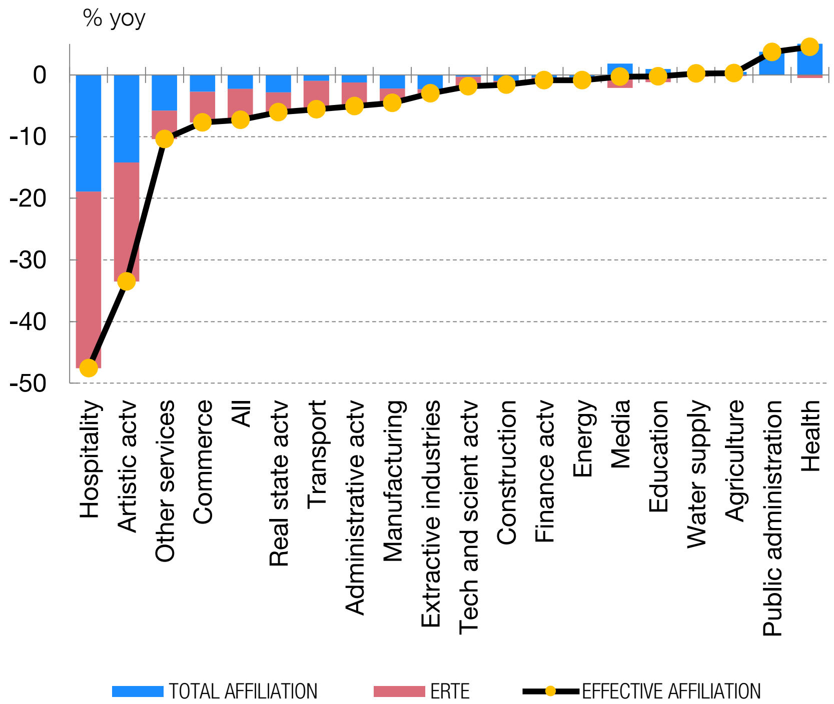


Source: EBAE (Encuesta del Banco de España sobre la Actividad Empresarial), carried out in November 2020 over a sample of 4.004 valid answers.

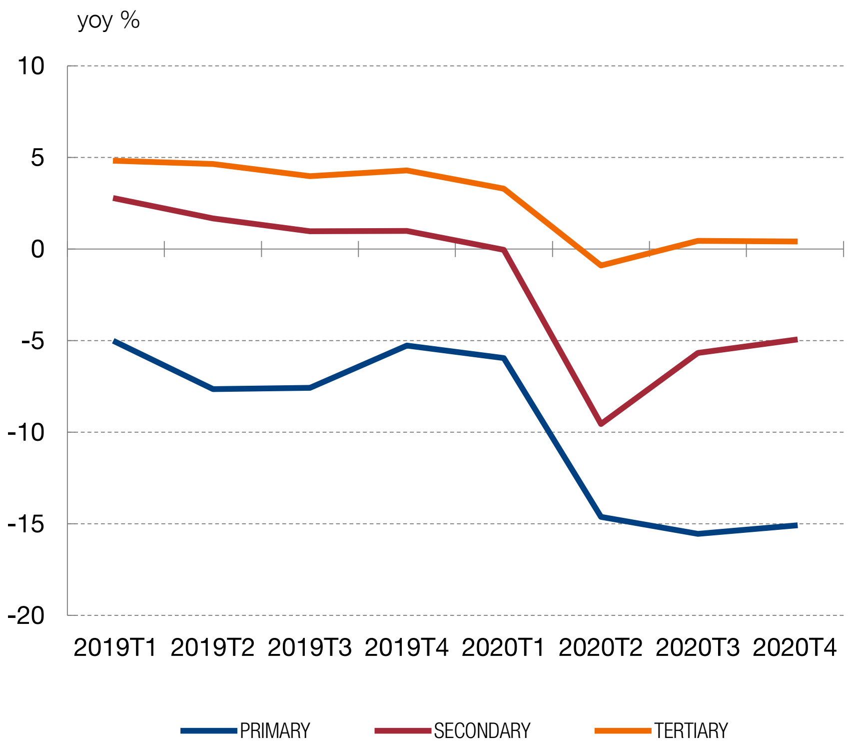
THE IMPACT OF THE CRISIS IS HIGHLY HETEROGENEOUS (1): EMPLOYMENT

- **The impact of the shock is strongly asymmetric from a sectoral perspective, and this is highly visible in terms of “effective” Social Security registration figures**
- **Also, the impact is larger among those employees with low educational attainment levels**

EFFECTIVE SOCIAL SECURITY AFFILIATION (FEBRUARY, % YOY)



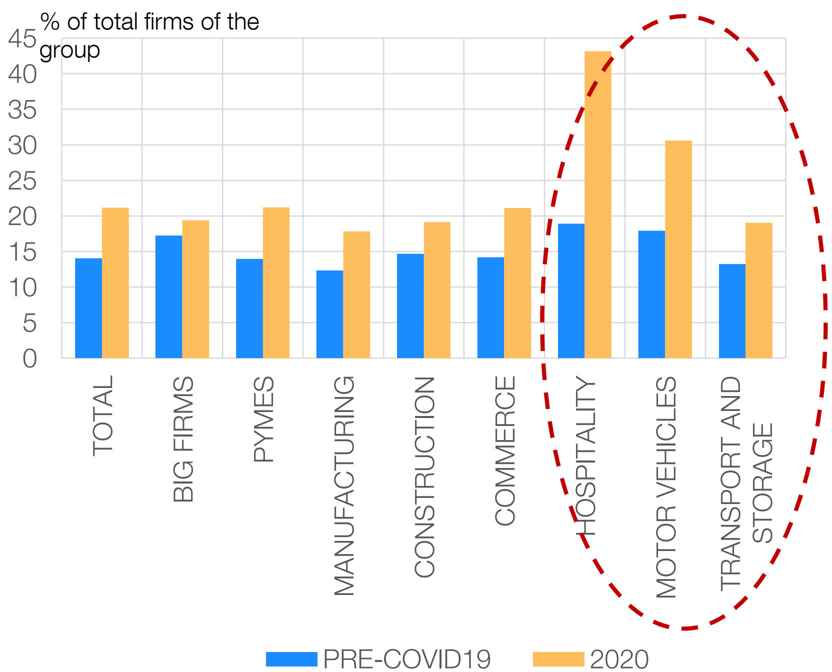
EMPLOYEE BY EDUCATIONAL LEVEL (YOY, %)



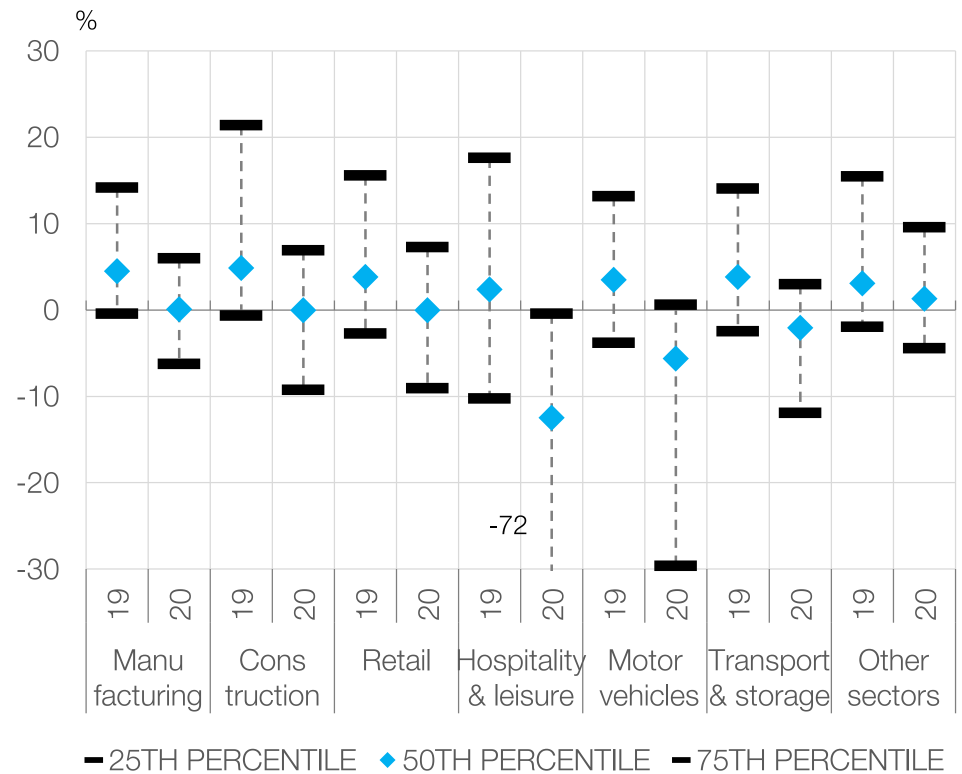
Source: Ministerio de Inclusión, Seguridad Social y Migraciones (left) and Instituto Nacional de Estadística, EPA (right). Lastest observation: February 2021 (left panel) and fourth quarter 2020 (right panel).

- **Again, NFCs operating in sectors most affected by the pandemic have suffered a larger deterioration in their financial position in terms of both indebtedness and profits**

VULNERABLE FIRMS ACCORDING TO THE RATIO OF NET DEBT OVER NET ASSETS (a)



DISTRIBUTION OF RETURN ON ASSETS BREAKDOWN BY SECTOR



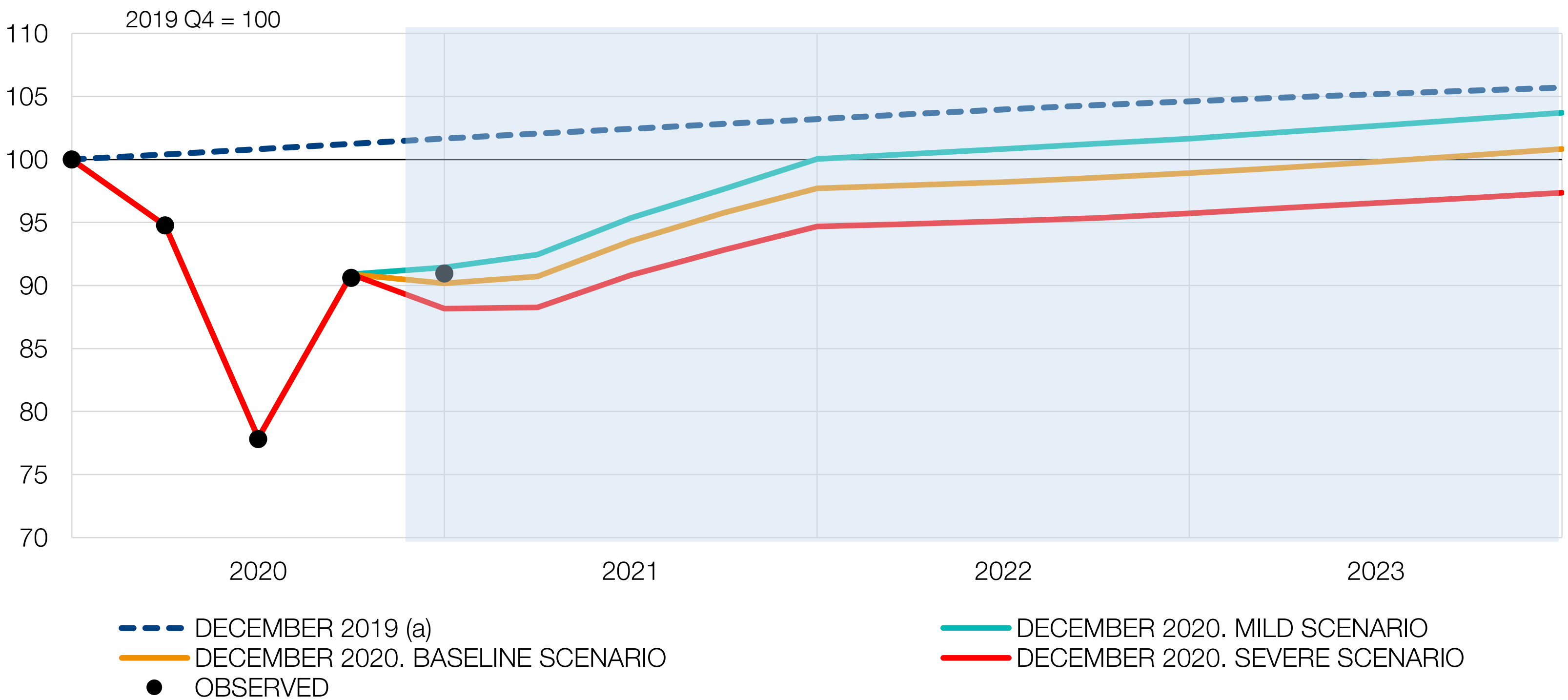
Source: Banco de España.

a. Vulnerable firm is defined as the one whose indebtedness ratio is higher or equal to 0.75. Net assets: total assets net of debt without financial cost.

EVEN IF TRANSITORY, THE SHOCK IS EXPECTED TO HAVE RATHER PERSISTENT EFFECTS

- **Economic prospects are still highly dependent on epidemiological developments and a solution to the health crisis**

GROSS DOMESTIC PRODUCT
(Chained volume index)

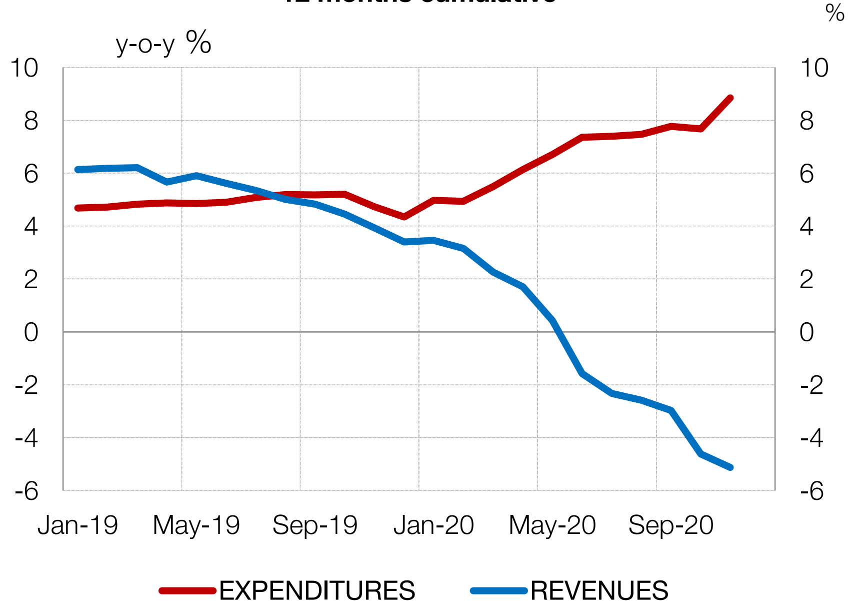


SOURCES: Banco de España and Instituto Nacional de Estadística. The graph reflects the various scenarios prepared for December 2020 macroeconomic projection exercise.
a) For 2023, trend projection of the path.

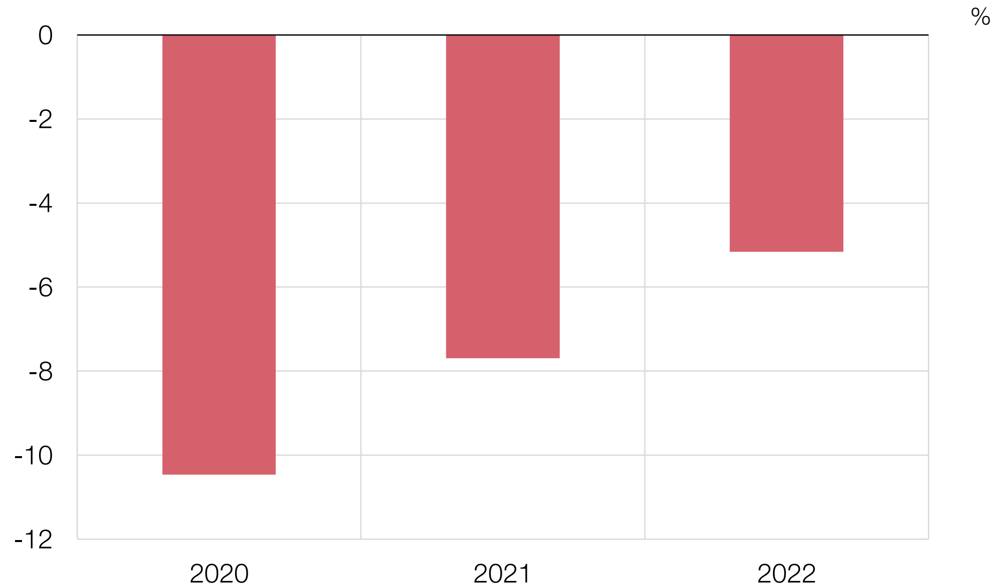
A RESPONSE OF FISCAL POLICY OF AN UNPRECEDENTED SIZE…

- **A significant increase in expenditure due to automatic stabilizers, measures to mitigate the fall in households and NFCs incomes, and health expenditure**
- **A significant deceleration in revenues (less marked, though, in personal taxation)**
- **As a consequence, the public deficit climbed above 10% of GDP in 2020 and the public debt ratio reached 117,1% of GDP**

PUBLIC REVENUES AND EXPENDITURES (a) (b)
12 months cumulative



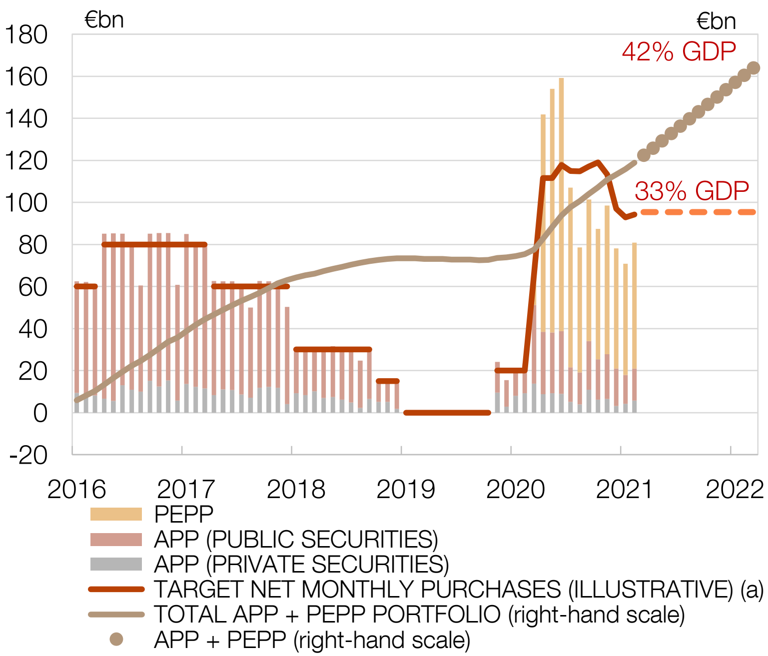
PUBLIC DEFICIT (% GDP)



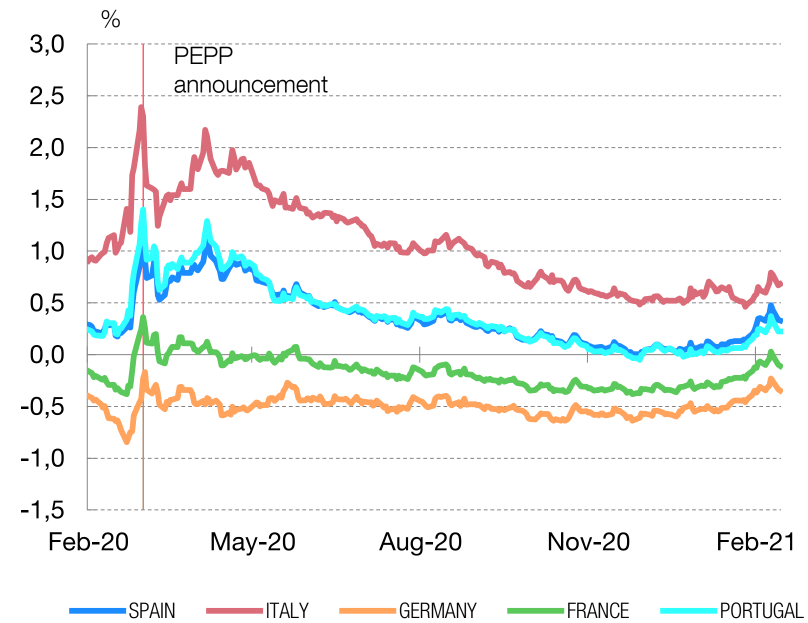
Sources: IGAE and Banco de España. Lastest observation: November 2020 (left panel). Right panel reflect December 2020 BE projections.
(a) IGAE only provides quarterly information for the whole public sector. Monthly data are estimated using information for the whole sector excluding Local Corporations.
(b) Data are adjusted from monthly outliers by distributing them along the year.

- **A very sizeable increase in asset purchases (APP and, especially, PEPP) has contributed to stabilize financial markets, loosen financial conditions and avoid the fragmentation of capital markets in the euro area**
- **Monetary policy actions have been crucial in order to provide margin of manoeuvre for fiscal authorities to put in place the necessary measures of support for NFCs and households**

ASSET PURCHASE PROGRAMMES (APP+PEPP)



10 YEARS BOND YIELDS



Fuentes: BCE, Thomson Reuters Datastream. Latest observation: February 2021 (left panel), 02/03/2021 (right panel).

a. The monthly net purchase target as from March 2021 (broken blue line) includes, in addition to the €20 billion per month approved last year and ratified at the Governing Council in December 2020, the unused portion of the maximum amount of €1,850 billion under the new Pandemic Emergency Purchase Programme (PEPP, approved on 18 March and extended and increased on 4 June and 10 December), assuming, for illustrative purposes, that the purchases will be distributed uniformly until March 2022 (in practice, they may be distributed flexibly over time) and that full use will be made of said maximum amount (in practice, it is possible that this maximum amount will not be used in full).

FISCAL POLICY SHOULD KEEP SUPPORTING EMPLOYMENT AND ACTIVITY, ALTHOUGH MORE FOCUSED AND ADAPTING ITS INSTRUMENTS

- In the short term, it remains essential to keep the support measures as long as there is no final solution to the health crisis, avoiding an early withdrawal
- Yet, measures should become more focused on sectors and firms most affected
- At this stage, identifying possible structural changes is crucial, as economic policy should place an increasing weight in fostering an efficient resource allocation across firms/sectors

- Consider the need to rethink the instruments and/or complement them with new ones:
  - *Support to firms:*
    - focus has moved from liquidity to solvency issues, which suggests the need to deploy subsidies and instruments to reinforce firms' own resources (recapitalization, debt restructuring)
    - prolonging the activity of viable firms and facilitating the exit of those which are not would be facilitated by a more agile functioning of judicial and extrajudicial insolvency procedures
  - *Employment:*
    - the need to avoid human capital losses and long-term unemployment suggest to bring into the limelight an improvement in active labour market policies.
    - firms should use flexibility mechanisms embedded in current legal labour market framework to ease their adjustment to the postpandemic environment

- **The consequence of the fiscal stimulus: a large increase in public debt**
- **Hence, current stimulus should be accompanied by the design of a fiscal consolidation strategy that:**
  - defines a multiannual path of gradual reduction in public debt
  - describes in detail the actions to be adopted in each period
  - includes a review of the composition of public expenditure and revenue aiming both at:
    - *ensure that the reduction in debt takes place*
    - *foster economic growth*
  - is preannounced as early as possible in order to maximize its credibility and its positive effects on agents' confidence
- **In the medium and long run, the path for public debt depends on the fiscal policy decisions and on the structural reforms oriented towards increasing potential growth**

NEXT GENERATION EU: A FIRST ORDER OPPORTUNITY AND CHALLENGE

- **The Next Generation EU (NGEU) programme has two aims and one instrument for each of them:**
    - ➢ help recovery from Covid-19 -> REACT-EU, to fight the socioeconomic consequences of the pandemic in the short and medium run
    - ➢ help accelerate the digital and energy transition -> Recovery and Resilience Facility, oriented towards financing reforms and investment in order to transform the economy in the medium and long run
- **Spain would receive €140mm (12,6% of GDP), approximately equally split between grants and loans**
- **The State Budget for 2021 incorporates expenditure financed by the NGEU up to an amount of 26,6 bn, with an impact of 2.6 pp on GDP in 2021, according to Government estimates**
- **However, the final economic impact will crucially depend on various factors:**
    - ➢ the ability to absorb such a large volume of funds
    - ➢ the extent to which the funds are directed towards new expenditure instead of replacing that already existing
    - ➢ their materialization on current expenditure vs investment
    - ➢ the form of finance: grants vs loans

NGEU: A NECESSARY TOOL THAT SHOULD BE PART OF A WIDER EUROPEAN PERMANENT FISCAL- MACRO ESTABILISATION PACK

- **Accumulation of national debt: SGP unable to induce fiscal buffers - pro-cyclical fiscal bias**
  - Too big shocks for national governments?
- **Sovereign debt market fragmentation (beyond ECB):**
  - Weak national fundamentals…
  - … and/or re-denomination risks (common)?
- **Economic divergence within the EA**
  - Countries lose MP/FX, no supra-EU tool against idiosyncratic shocks/impacts
- **A challenging new world**
  - **Tails shocks:** too large for national governments, too strong for ad-hoc decisions (no automaticity)
  - **Structural (global) forces**
    - *r^* - reduced (conventional) MP space*
    - *Demographic trends, productivity, digitalisaton, etc.*

Most large countries in EMU currently lack the necessary fiscal buffer to confront a recession in the next 10 years even if following SGP rules

	Debt over GDP forecast for 2030 fullfiling SGP rules	Average historical change of Debt 5 years after a recession (% of GDP)	Debt after a recession in the next 10 years (%GDP)
Germany	51.8	12.8	64.6
France	109.2	16.5	125.7
Italy	155.0	21.0	176.0
Spain	105.7	23.7	129.4

NEW LOGIC: FISCAL POLICY FIT FOR NEW MACRO CONTEXT

Supranational fiscal policy

- **Reaction to tail events:** increase firepower, more automatic (risk sharing mechanisms)
- **Make space for MP:** hinge on r*, by focusing on growth-enhancing composition
- **EA fiscal stance:** permanent fiscal capacity

National fiscal policies

- **Shared medium-term guiding goals of** public finances: social, environment, competitiveness…
- **“Prudent” national fiscal policies:** simplify current fiscal rules
- **National commitments, supra-national monitoring**

INSTRUMENTS OF THE NEW LOGIC

- **An enlarged, permanent NGEU (a European Treasury, Arce et al., 2020), with an automatic stabilisation capacity, drawing lessons of fiscal-federal systems (Burriel et al, 2020), allowing for**
    - Increase in r*
    - Closer interaction of monetary and fiscal policies (Andrés et al, 2020) to facilitate consolidation
    - Full use of fiscal spillovers (Alloza et al, 2020)
- **A guide for the composition of public finances**
    - Improving supranational monitoring: shared standards?
    - Facilitating the green and digital transitions
    - Avoiding at the supranational level the social dominance and the procyclical consolidation of public investment (Delgado-Tellez et al, 2020)
- **Complete the EMU: Banking Union, Capital Markets Union**
    - in order to avoid financial fragmentation (Kataryniuk et al, 2021) and free resources for monetary policy action

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THANKS FOR YOU ATTENTION