

QUARTERLY REPORT ON THE SPANISH ECONOMY

Economic activity worldwide is picking up again in Q3, after falling back sharply in Q2. The lockdown measures implemented to contain the pandemic have been largely lifted in most geographical areas. This has led to a notable surge in global GDP, although the large-scale losses of activity observed while the measures were in force have only been partially recovered.

Not only is it incomplete, but the recovery has two additional characteristics that urge caution with regard to the future outlook. The first is its degree of heterogeneity. The cross-country differences are caused by a set of factors, which include the level of stringency of the restrictions that remain in place and the structural characteristics of the different economies. The cross-sector differences are caused by the differing impact of the lockdown measures on each productive activity, with service activities in which social interaction plays a key part being the hardest hit. The second additional characteristic is the fragility of the recovery, since as the lockdown measures have been eased infections have increased. In certain cases, some measures have had to be reimposed, to limit the speed of the spread of infections at the expense of restricting activity.

The scale of the economic policy measures taken has successfully contained the impact of the sharp contraction in economic activity on private agents. The main aim of central banks has been to preserve a very high degree of monetary accommodation, seeking to prevent disruption to the economy's financing flows and to keep the cost of these flows low. In addition, the communication policy of the different monetary authorities has sought to reinforce expectations that such an expansionary stance will be maintained for as long as necessary. Monetary policy measures have been complemented by the actions of national governments, which have adopted a broad range of measures, two of which stand out on account of their scope. First, the public guarantees for financing provided by credit institutions to firms, to support the viability of solvent non-financial corporations whose liquidity has been adversely affected by the crisis. Second, the temporary employment adjustment schemes introduced for firms, which enabled them to reduce their staff expenses at times when they were barely able to operate and which ensure that the employment relationships may be restored once the measures limiting activity and personal movement are lifted.

The resurgence in activity and the continued economic policy support have given rise, throughout the summer, to increased risk appetite in the financial markets. Thus, stock market indices have risen, sovereign and corporate credit spreads have narrowed, oil and other commodity prices have increased and the dollar has depreciated, especially against the euro. The latter development is

Table 1

MAIN SPANISH MACROECONOMIC AGGREGATES (a)

	2018	2019	2019				2020			
			Q1	Q2	Q3	Q4	Q1	Q2	Q3	
National Accounts									SCN. 1	SCN. 2
Quarter-on-quarter rate of change, unless otherwise indicated										
Gross domestic product (GDP)	2.4	2.0	0.6	0.4	0.4	0.4	-5.2	-18.5	16.6	13.0
Contribution of national demand (b)	2.6	1.5	0.5	0.0	0.8	-0.1	-4.4	-16.1	22.7	19.2
Contribution of net external demand (b)	-0.3	0.5	0.1	0.4	-0.4	0.5	-0.8	-2.3	3.1	1.2
Year-on-year rate of change										
Employment: working hours	2.6	1.5	2.5	1.3	0.8	1.4	-4.2	-24.8	-10.5	-12.9
Price indicators										
Harmonised index of consumer prices (HICP)	1.7	0.8	1.1	1.1	0.4	0.5	0.7	-0.6	-0.6	-0.6
Harmonised index of consumer prices excluding energy and food	1.0	1.1	0.8	1.2	1.2	1.1	1.2	0.9	0.2	0.1

SOURCES: INE and Banco de España.

a Information available to 10 September 2020. The grey-shaded cells are Banco de España projections under scenarios 1 and 2.

b Contribution to the quarter-on-quarter rate of change of GDP, in percentage points.

probably also due to two additional factors. First, monetary easing appears to have been greater in relative terms in the United States than in the euro area, in keeping with the greater headroom available prior to the onset of the pandemic. Second, more recently the euro exchange rate has been buoyed by the agreement on the Next Generation EU (NGEU) European recovery plan, which appears to have helped reduce the perception that COVID-19 might damage cohesion in the euro area due to its harsher and longer lasting impact in some euro area countries than in others.

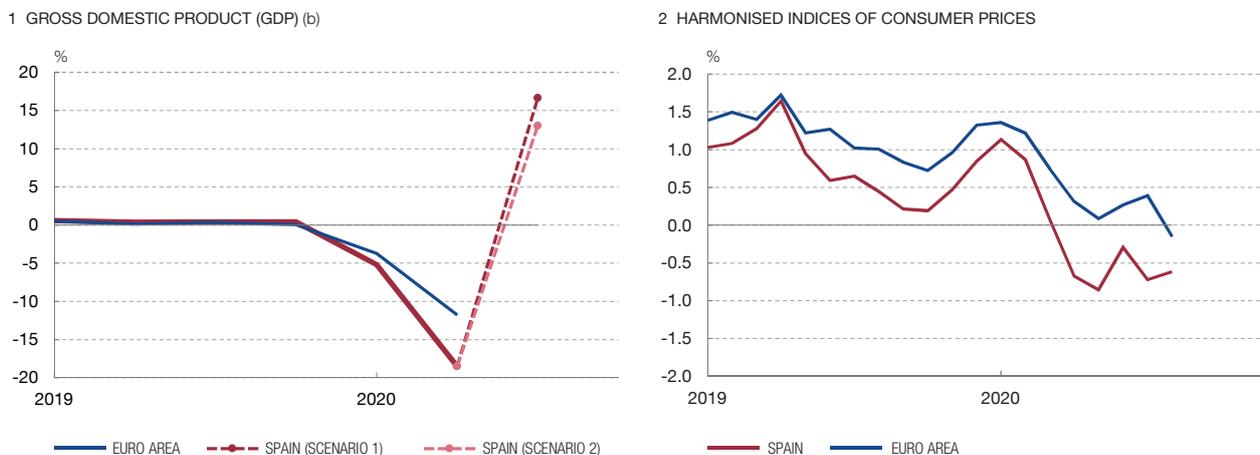
The latest ECB staff projections underline the incomplete nature of the present recovery in activity in the euro area. Under the baseline scenario, the improvement observed since May is expected to continue in the coming quarters: it is assumed that the epidemiological situation does not worsen in that period, so that the adverse impact of the pandemic on activity gradually decreases. However, euro area GDP at the end of 2022 is still expected to be nearly 4 percentage points (pp) below the figure projected in December 2019 (the last projections published before the onset of COVID-19). Given the exceptional level of uncertainty surrounding future developments insofar as the pandemic is concerned, this baseline scenario is accompanied by two alternative scenarios: one more favourable scenario, under which at the end of the projection horizon euro area GDP would be slightly higher than the level projected in December 2019, and another more adverse scenario under which it would be some 9 pp lower.

In Spain, as in many other economies, the lifting of the bulk of the lockdown measures prompted a swift but only partial recovery in the level of activity. The

Chart 1

INCOMPLETE RECOVERY IN ACTIVITY FOLLOWING THE LIFTING OF LOCKDOWN MEASURES (a)

The gradual resurgence in activity that began as the lockdown measures were eased is expected to have given rise to significant growth in GDP in Q3. But it will not be sufficient to recover the pre-pandemic levels; indeed, over the summer, signs of weakening were observed. Regarding consumer prices, core inflation has decelerated significantly, especially affecting the services sectors that have been hardest hit by COVID-19.



SOURCES: Eurostat, INE and Banco de España.

- a Quarter-on-quarter rates of change based on the seasonally-adjusted series in the case of GDP, and year-on-year rates of change based on the original series in the case of the consumer price indices.
- b The Q3 data are Banco de España projections.



improvement observed since May could take the rate of growth of Spanish GDP to between 13% and 16.6% in quarterly terms in Q3. Even so, activity levels in the quarter would still be 12.3 pp and 9.5 pp, respectively, below those observed in 2019 Q3. In any event, these figures are subject to a high level of uncertainty, given the difficulty involved in interpreting the conjunctural data available, the virtual non-existence of data for August on the more conventional economic indicators, and the fact that the quarter has still more than two weeks to run.

The most pronounced improvement in Spanish GDP was observed, roughly speaking, in the second half of Q2. The change in high-frequency indicators in this period is consistent with the gradual easing of the lockdown measures that took place between early May and 21 June when the “new normal” phase began. The resurgent activity throughout Q2 was not sufficient to prevent a very marked fall in the rate of growth of GDP in the quarter as a whole (–18.5% in quarterly terms), given the intensity of the production losses in the lockdown period and, especially, in April when the restrictions associated with the state of alert were at their peak. At end-June it is estimated that the level of activity may have been approximately 10% lower than in the same period a year earlier.

Throughout Q3 there have been signs appearing of a certain loss of momentum in the gradual improvement in the Spanish economy’s output. Since the

lockdown measures were the main cause of the recession, when the bulk of these measures were lifted (which occurred, as indicated above, at the end of June) it was only natural that the rate of achieving additional gains should begin to decline significantly. However, one set of high-frequency indicators seems to suggest that, rather than having slowed, further progress may in some cases have actually ceased. Thus, for example, the mobility indicators devised by Google and Apple, which improved continuously between mid-April and mid-July, have tended to steady since then and in some cases have even declined.¹ Since the start of confinement, these indicators have recorded lower mobility and activity levels in Spain than in the other three large euro area economies (whether because the restrictions imposed in Spain were stricter or because individuals decided to reduce their movements to a greater extent in view of the greater severity of the pandemic). But in addition, since mid-July, this gap has tended to widen. Likewise, the declines in the year-on-year decreases in other mobility indicators, to approximate air and road traffic, have also come to a halt.

This apparent slowdown in the recovery of activity has coincided with a resurgence in COVID-19 infections. The numbers of new cases began to increase in early July and this pattern has continued to intensify. International comparisons show that, at 10 September, Spain had a significantly higher number of new infections than the main European economies. The worsening situation throughout the summer underlines the importance – both from a public health and an economic standpoint – of continuing to improve the mechanisms in place to detect new cases and isolate and trace the contacts of the persons concerned.

As the epidemiological situation has worsened, some social distancing measures have been reinforced. To date the new restrictions are limited, both in terms of the activities and the geographical areas affected, with the main effects being borne by certain leisure activities. Nevertheless, these restrictions will probably have heightened the uneven nature of the recovery both by sector and geographical area. And, most importantly, they will have had a negative impact on the tourist industry over the summer, which is its busiest period in Spain.

The authorities of numerous source countries for tourists, including the main European markets, have introduced measures discouraging their citizens from travelling to Spain. These measures have taken various forms, such as recommendations advising people not to travel to Spain or the obligation to quarantine upon their return. External borders remained closed until the end of June, so after the declaration of the state of alert tourism flows virtually disappeared until then. Of the hotels that had opened in July 2019, only 70% did so in July 2020, the first complete month of the “new normal”, and only one-third of the beds available were occupied.

¹ Google's mobility indicator measures the time people carrying mobile phones spend in different places (the workplace, retail and recreation outlets, etc.); Apple's mobility indicator measures travel time by various means.

Moreover, the total number of overnight hotel stays fell by almost 75% year-on-year, and by 86% in the case of foreign visitors. In August, it seems the tourism business continued to perform poorly, according to the high levels of cancellations of previous bookings, the ever larger year-on-year declines in the number of international passenger arrivals at Spanish airports and the interruption in the relative improvement observed in July in spending using cards issued by non-residents.

The crisis is having a very severe impact on labour utilisation. Apart from the net loss of employment, the decline in labour utilisation has largely materialised in the recourse had to temporary lay-offs and short-time work schemes (ERTEs, by their Spanish abbreviation). The actual Social Security registrations series, which subtracts the number of workers subject to ERTEs from total registrations, still posted a 7.4% year-on-year decline in August on monthly average data, despite the recovery observed since June. It also showed a high level of heterogeneity by productive sectors, with particularly sharp falls in activities, such as accommodation and food services, that have been most affected by the social distancing measures.²

The outlook for the Spanish economy is surrounded by great uncertainty, linked essentially to the course of the pandemic. To reflect this uncertainty, alternative scenarios have been constructed, according to the assumptions as to how the epidemiological situation evolves. Box 1 of this report presents two scenarios, which differ even in the short term, since the information available on Q3 is still limited and, in particular, does not permit a precise assessment of the impact on activity of the recent resurgence in infections. Specifically, projected GDP growth for Q3 under scenarios 1 and 2 is 16.6% and 13% respectively, these being the upper and lower bounds of the quarterly growth rates indicated earlier. Beyond the short term, under scenario 1 fresh outbreaks of infection will require less stringent lockdown measures than under scenario 2, both in terms of their severity and the productive sectors directly affected (which would be confined to leisure and accommodation and food service activities). In consequence, the adverse effects on output and employment would also be lower, not only because the restrictions on activity would be less stringent, but also because the lower level of uncertainty would have a smaller impact on households' and businesses' spending decisions. In any event, under both scenarios it is assumed that no containment measures will be required after mid-2021, once an effective medical solution to the virus has been made widely available to the general population.

The decline in Spanish GDP in 2020 would be very high under either scenario. In annual average terms, GDP would decline by 10.5% in scenario 1 and by 12.6% in scenario 2. At the end of 2022, under scenario 1 GDP would be approximately 6.5 pp below the level projected in December 2019, and 10 pp below that level under scenario 2. These figures highlight the persistence of the consequences of the crisis.

² See Box 7 (The recovery of employment in recent months from a provincial and sectoral standpoint).

Under both scenarios, inflation is expected to maintain moderate rates of growth over the projection horizon. Core inflation has decelerated significantly since the onset of COVID-19, although this was not fully visible until the lockdown measures were lifted and direct collection of the data on the prices of goods and services that were not available during lockdown became possible. Looking ahead, the persistently high level of cyclical slack will mean that non-energy industrial goods and services inflation, despite continuing to rise, will remain relatively low up to the end of 2022.

The possibility that more adverse scenarios than the two considered might materialise cannot be ruled out. First, the course taken by the pandemic in Spain in the summer months underlines the difficulty of controlling the number of infections exclusively by means of voluntary measures to combat the spread of the disease. This would suggest that there is a risk that even stricter lockdown measures than those envisaged in scenario 2 may be required. Second, there is currently great uncertainty surrounding the time needed for a safe and effective vaccine to be developed and made widely available. Lastly, the damage that the pandemic may cause in the medium and long term, as a result of the destruction of the productive system, may possibly be more severe than that considered in the most adverse of our two scenarios. Moreover, in addition to the risks deriving from the pandemic, there are also others stemming from the external environment, such as the possibility of a no-deal Brexit and a possible heightening of China-US trade tensions.

By contrast, the funds that Spain could receive from the NGEU European recovery fund represent an opportunity for a significant improvement in the outlook for the Spanish economy, especially in the second half of the projection horizon. The European fund aims to mitigate the differences in the impact of the crisis across the European countries. In this respect, Spain would be one of the Member States to benefit the most, given that COVID-19 has had a comparatively harsher impact on the Spanish economy to date and that the consequences will very likely be more persistent. However, making available such a large volume of funds to the Spanish State poses a huge challenge in terms of designing a coherent set of projects geared towards promoting long-term growth and, in particular, improving Spain's human and technological capital.

Description of the scenarios

This box describes the most notable features of the latest update to the Banco de España's macroeconomic scenarios for the Spanish economy. Compared with the previous scenarios published on 8 June,¹ the current scenarios incorporate the new information that has since become available; this includes the preliminary estimates of the Quarterly National Accounts (QNA) for 2020 Q2 and the changes observed in the technical assumptions underlying the construction of the scenarios (see Annex 1).²

The COVID-19 pandemic and the measures put in place by the authorities to contain the health emergency resulted in a deep contraction in activity in the different world economies in 2020 H1. Among the advanced economies, Spain has seen one of the sharpest drops in GDP, falling by 22.7% in cumulative terms during that period. The gradual easing of the limitations on movement and restrictions on activity in many productive sectors between early May and late June (until reaching the so-called "new normal") led to the Spanish economy's output showing a pattern of recovery over the course of Q2. However, this did not prevent GDP from recording a most marked decline over the quarter as a whole (18.5% in quarter-on-quarter terms), according to preliminary estimates of the National Statistics Institute (INE by its Spanish abbreviation). This rate stood at around the mid-point in the interval estimated by the Banco de España in the two scenarios published in June, termed the "early recovery" (ER) scenario and "gradual recovery" (GR) scenario.³

Under the latter scenario, it was projected that, at the end of lockdown-easing (late June), activity would have gradually improved to stand approximately 12% below the level that would have been observed at that time in the absence of COVID-19. The information available suggests that the economy's performance was somewhat more favourable at the end of Q2, giving a slightly more positive

starting point for Q3 than that envisaged under the gradual recovery scenario in June.

Nevertheless, as described in Section 4 of this Report, the information available points to some weakening in the pace of recovery in activity over the summer months, coinciding with the adverse epidemiological developments observed in that period. These have required the re-introduction of certain lockdown measures and, in particular, have had adverse consequences for activity in sectors linked to tourism.⁴

The Q3 GDP projections are formulated based on the available conjunctural information on the performance of activity in the different productive sectors (including, in particular, data on actual Social Security registrations up to end-August,⁵ together with data from a set of high frequency indicators). In the specific case of retail trade, activity has been calibrated drawing on the changes in card payments. In tourism-related sectors, together with the usual monthly data sources available up to July, information from the sector itself on the developments observed during the other summer months and the outlook for the end of the quarter has been used.

However, at the cut-off date of this Report, the limited information available is insufficient to provide a precise quantification of the magnitude of the recent weakening. This, combined with the uncertainty about epidemiological developments in late September, makes it advisable to formulate two alternative scenarios for Q3 (each constituting the starting point for a distinct scenario over the projection horizon). These two alternative scenarios provide a range for GDP growth in Q3 from -9.5% to -12.3% in year-on-year terms (corresponding to quarter-on-quarter growth of 16.6% and 13%, respectively).⁶

Beyond the short term, both scenarios assume that the need to apply measures to contain the pandemic will

1 Macroeconomic projections for the Spanish economy (2020-2022): the Banco de España's contribution to the Eurosystem's June 2020 joint forecasting exercise.

2 The June projections were based on the information available up to 25 May. The cut-off date for the latest exercise was 10 September, except for the data on export markets and the prices of competitors in their national currencies, which were taken from the ECB staff macroeconomic projections for the euro area, September 2020, which use information up to 27 August.

3 Specifically, those scenarios projected quarter-on-quarter declines of 16% and 21.8%, respectively, in GDP for Q2.

4 See Box 8 "Recent developments in inbound tourism in Spain" in this Report.

5 Actual Social Security registrations are defined as the difference between total registrations and workers on furlough schemes (ERTE by the Spanish abbreviation). See Box 4 "Exit from lockdown and the labour market: a provincial perspective", in the "Quarterly report on the Spanish economy", Economic Bulletin 2/2020, Banco de España.

6 Recent developments in both the epidemiological and economic activity indicators have ruled out the early recovery scenario materialising in 2020 Q3; this scenario projected a year-on-year decline in GDP of 7.3% for that quarter. Further, the latest developments seem to also rule out the epidemiological situation in Q4 being as favourable as that underlying that scenario, under which no further limitations would be required beyond those characterising the "new normal".

disappear towards mid-2021 owing to the possible distribution of an effective medical solution in the form of a vaccine or treatment. However, the difference in the assumptions as to the epidemiological developments until such a medical solution becomes available implies that GDP will follow distinct paths under the two scenarios envisaged in this projection exercise.

Specifically, the epidemiological assumptions underlying scenario 1 are similar to those of the gradual recovery scenario presented in June, insofar as they envisage the emergence of fresh outbreaks; nevertheless, such outbreaks would only require containment measures of limited scope, both from a geographical standpoint and in terms of the sectors affected, and would therefore cause relatively limited additional disruption to economic activity. In particular, the consequences of such lockdown measures are expected to directly affect sectors linked to leisure and accommodation and food service activities (and, on the demand side, tourism) and indirectly influence other productive sectors through spillover effects.

Scenario 2 envisages more intense fresh outbreaks of the pandemic; however, these would not require applying such strict and widespread confinement measures as those in force before lockdown began to be eased. Nevertheless, they would require restrictions that, in addition to having a more intense impact on activity in those services sectors where social interaction is a key element, would also directly affect other productive sectors. This would result in the health crisis having a sharper and longer-lasting contractionary impact on production than that envisaged under scenario 1, not only owing to the effects of the restrictions on activity, but also because of the greater uncertainty as to the course of the pandemic holding back households' and firms' spending decisions.

The availability of an effective medical solution for COVID-19 after 2021 Q2 would allow any containment measures in place at that time to be lifted. This would lead to a subsequent improvement in activity, more markedly so under scenario 2, in keeping with the greater intensity of the fresh outbreaks envisaged in this scenario until that time, which, in turn, would have prompted more pronounced losses in output.

Nevertheless, the definitive lifting of the limitations on the normal pursuit of economic activity would not entail an immediate return to pre-pandemic GDP levels in either of the two scenarios, given the lasting impression that the crisis is expected to leave on the economy's productive

potential. Available capital stock will be affected by the disappearance of that part of the business sector whose viability has been compromised by the crisis, with the measures put in place to foster business liquidity not being able, in certain cases, to prevent insolvencies. Moreover, at the same time, a long-term increase in unemployment may be expected, despite the resort to furlough schemes and benefit programmes for the suspension of self-employment. The impact of the crisis on total factor productivity is more uncertain, insofar as the possible adverse effects derived from disruptions in supply chains may be countered by the incentives that could stem from the crisis in terms of reallocating resources (both between firms of the same sector and among different sectors) and incorporating more advanced technologies into the productive process. In any event, the damage to the economy's productive capacity would be more marked under scenario 2, given the comparatively greater stringency of the measures restricting activity that, as has been detailed, would be in place until the middle of next year.

As a result, Spanish GDP will show a pronounced fall-off in 2020, closely linked to the lockdown imposed in March and, therefore, concentrated in H1. The rebound in activity beginning at the end of Q2 and extending throughout Q3 will make way for more moderate growth in output over the rest of the projection horizon. In any case, the normalisation of activity levels will be incomplete and therefore, under the two scenarios considered, activity at end-2022 is expected to stand below pre-pandemic levels.

Under scenario 1, the economy's output would decrease by -10.5% on average in 2020. This fall would increase to -12.6% if the more unfavourable epidemiological situation underlying the construction of scenario 2 were to arise (see Table 1). The robust recovery in activity in 2020 H2 will have a very powerful positive carry-over effect on the average GDP growth rate in 2021, which is expected to be high, especially under scenario 1 (7.3%). This growth would be more moderate under scenario 2 (4.1%) owing both to the smaller magnitude of the spillover effect and to the greater outbreak of the pandemic up to the middle of next year. The continuing recovery is expected to lead to more moderate growth in activity in 2022 (1.9% and 3.3%, respectively, under the two scenarios considered). At the end of the projection period, GDP would be around 2 pp down on its pre-crisis level under scenario 1, a gap that would widen to somewhat more than 6 pp under scenario 2 (see Chart 1).

Box 1

MACROECONOMIC SCENARIOS FOR THE SPANISH ECONOMY (2020-2022) (cont'd)

Table 1
PROJECTIONS FOR THE MAIN MACROECONOMIC AGGREGATES OF THE SPANISH ECONOMY (a)

Annual rate of change in volume terms and % of GDP

	September 2020 projections							June 2020 projections		
	2019	Scenario 1			Scenario 2			Gradual recovery		
		2020	2021	2022	2020	2021	2022	2020	2021	2022
GDP	2.0	-10.5	7.3	1.9	-12.6	4.1	3.3	-11.6	9.1	2.1
Private consumption	1.1	-11.2	9.4	1.7	-13.1	5.5	3.2	-11.2	11.2	1.6
Government consumption	2.3	5.4	-1.3	-0.1	5.6	-1.2	-0.5	4.6	-1.5	0.8
Gross fixed capital formation	1.8	-19.5	6.0	5.3	-21.9	2.4	6.5	-26.5	7.4	7.1
Exports of goods and services	2.6	-20.7	11.5	6.2	-25.2	7.4	8.0	-21.9	18.5	7.7
Imports of goods and services	1.2	-18.7	8.4	6.6	-22.0	4.9	7.3	-21.5	14.0	9.1
National demand (contribution to growth)	1.5	-9.3	6.2	1.8	-10.9	3.3	2.9	-10.8	7.4	2.2
Net external demand (contribution to growth)	0.5	-1.2	1.1	0.1	-1.7	0.8	0.4	-0.8	1.7	-0.1
Harmonised index of consumer prices (HICP)	0.8	-0.2	1.0	1.2	-0.3	0.8	1.1	-0.2	1.2	1.5
HICP excluding energy and food	1.1	0.7	0.8	1.0	0.6	0.5	0.8	0.8	1.0	1.1
Employment (hours worked)	1.5	-11.9	7.0	1.6	-14.1	3.8	2.7	-12.6	8.5	2.3
Unemployment rate (% of labour force) (b)	14.1	17.1	19.4	18.2	18.6	22.1	20.2	19.6	18.8	17.4
National net lending (+)/net borrowing (-) (% of GDP)	2.3	1.7	2.1	2.1	1.1	1.3	1.5	2.3	3.5	3.0
General government net lending (+)/net borrowing (-) (% of GDP)	-2.8	-10.8	-7.0	-5.8	-12.1	-9.9	-8.2	-11.2	-6.8	-6.1
General government debt (% of GDP)	95.5	116.8	115.4	118.0	120.6	125.6	128.7	119.3	115.9	118.7

SOURCES: Banco de España and INE.

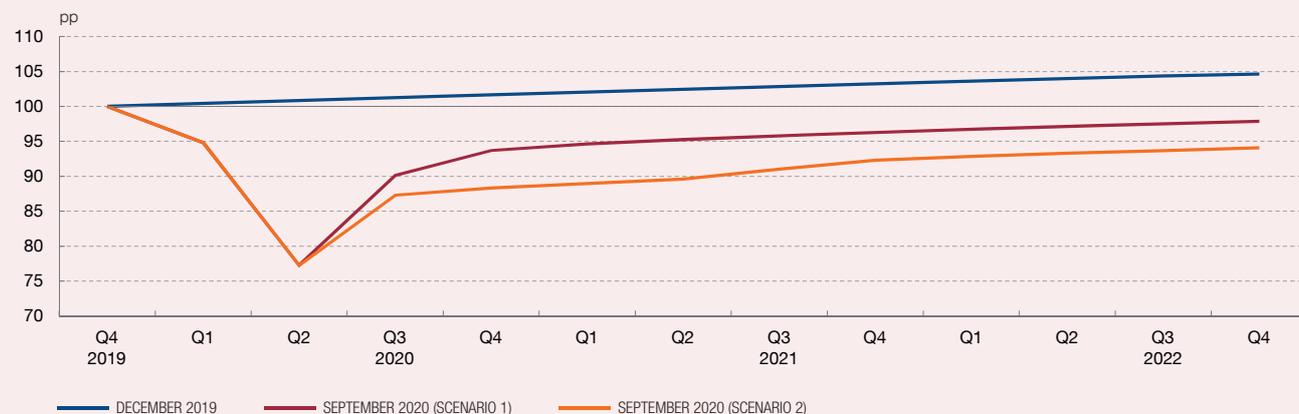
NOTE: Latest QNA figure published: 2020 Q2.

a Projections cut-off date: 10 September 2020.

b Annual average.

Chart 1
GDP UNDER THE DIFFERENT SCENARIOS

REAL GDP. LEVEL. (2019 Q4 = 100)



SOURCE: Banco de España and INE.

It should be highlighted that these scenarios do not incorporate the effects of the European recovery programme, Next Generation EU (NGEU), which could potentially be significant depending on the answers to some of the questions as to its practical implementation. Specifically, with no clearly defined details regarding the programme's application, these effects are currently shrouded in a very high degree of uncertainty, both in terms of their scale and in their timing, thus warranting their omission from the two scenarios presented in this box.⁷

In comparison with the gradual recovery scenario considered in June, the changes in the external assumptions have an overall negative effect on GDP growth projections. This is chiefly the result of rising oil prices, the appreciation of the euro and the somewhat less favourable trends in foreign markets in 2021 and 2022 (particularly under scenario 2).⁸ Conversely, the new economic policy measures introduced since the publication of the June scenarios are by themselves expected to result in an upward revision of the outlook for activity. These new measures specifically include the extension of furlough scheme regulations until 2020 Q3 and the recalibration of the ECB's Pandemic Emergency Purchase Programme (PEPP).⁹ Moreover, the provisional QNA data for Q2 mechanically give rise to an increase in average GDP growth in 2020.

The combination of all these opposing factors, together with the assumptions as to the course of the pandemic (which are more unfavourable under scenario 2 than under scenario 1), means that the overall revision of GDP growth this year with respect to the gradual recovery scenario in June presents a different sign in each case, standing at 1.1 pp and -1 pp, respectively. In the two remaining years of the projection horizon, the changes in the average GDP growth rates as compared with the foregoing gradual recovery scenario stand at -1.8 pp and -0.2 pp in the case of scenario 1 and -5 pp and 1.2 pp in the case of scenario 2.

The information provided by the comparisons between the average GDP growth rates in 2020 in the June scenarios

and in the present ones is reduced by the interplay between, on one hand, the fact that the preliminary estimate of GDP growth in Q2 (-18.5% in quarter-on-quarter terms) lies between the estimates of the early recovery and gradual recovery scenarios of three months ago (-16% and -21.8%, respectively) and, on the other, the deterioration in the outlook for the final quarter of the year. To clarify this comparison, it is useful to analyse the complete paths of the year-on-year rates of the various quarters.

As seen in Chart 2, the June ER scenario has already been ruled out, both because the year-on-year loss of output in Q2 was greater than then projected and because of the less favourable developments in Q3 and the deterioration of the outlook for Q4.

As regards the June GR scenario, the year-on-year decline in GDP in Q2 was smaller, which provides a more favourable starting point. That said, as a result of the information available on Q3, the improvement in the year-on-year rate is smaller than expected in June.¹⁰ That is to say, between Q2 and Q3 of this year, the slope of the solid blue line in the chart (GR scenario) is greater than that of the dotted and solid red lines (current scenarios 1 and 2, respectively). As a result, the year-on-year rate projected in June in the GR scenario in Q3 (-11.2%) now lies within the interval defined by the two current scenarios (-9.5% and -12.3%, respectively).

For Q4, the improvement in the projected year-on-year rate in the two current scenarios is again smaller than that under the June GR scenario, given the recent deterioration in the outlook. The result is that the year-on-year loss of output in Q4 in the current more favourable scenario (i.e. scenario 1) is similar to that expected in June in the GR scenario (while it is clearly higher in scenario 2).

This worse end-2020 starting point means that, under both of the two current scenarios, expected average growth in 2021 is lower than that envisaged in the June GR scenario.

7 Box 9 ("The macroeconomic impact of the Next Generation EU programme under various alternative scenarios") of this Report details the different sources of uncertainty as to the precise definition of the different elements of the programme and assesses, with help from the Quarterly Macroeconomic Model of the Banco de España, the possible final impact of the programme on activity depending on the answers to such questions.

8 The performance of Spain's export markets under each of the scenarios has been constructed taking as reference the scenarios formulated by the ECB as part of its September projections.

9 At its meeting on 3-4 June, the ECB Governing Council agreed to increase the size of the PEPP by €600 billion, extend the net purchase horizon to at least the end of June 2021 and announce that maturing principal payments from securities would be reinvested until at least the end of 2022.

10 Specifically, in the GR scenario an improvement was projected in the year-on-year rate between Q2 and Q3 of 14.1 pp (from -25.3% to -11.2%). In the current scenario 1, the improvement is 12.6 pp (from -22.1% to -9.5%), while in scenario 2 it is 9.8 pp (from -22.1% to -12.3%).

Developments in the main aggregates

The crisis is having an intense impact on the various components of both national and external demand (with the exception of government consumption and investment), which will lead to very marked declines in these aggregates in 2020 as a whole (see Table 1). This average annual performance stems from the partial nature of the recovery in the different variables during H2, following the deep contraction observed in H1.

Private consumption fell very sharply during the state of alert, with spending down notably in the items most directly affected by the containment measures, such as those associated with accommodation and food service activities and leisure, but also consumer durables (particularly vehicles). In any event, the decline in household spending was not solely caused by the difficulties in purchasing non-essential goods and services as a result of the lockdown, but also due to greater uncertainty regarding the economic outlook, reflected in a deep fall-off in consumer confidence. In a setting in which economic policies have helped shore up household income (particularly through furlough schemes), both factors – restrictions on movement and the greater uncertainty – prompted a sharp increase in the saving rate in Q2 (forced, in the case of the first factor, and as a precautionary measure, in the case of the second factor).

Since end-Q2, private consumption has been driven by the implementation of purchase decisions that had been postponed during the confinement, along with certain measures such as the assistance provided to vulnerable households or for car purchases. Looking ahead, household spending will tend to be supported by the gradual decline in uncertainty regarding how the health situation will unfold, particularly in scenario 1. However, drawing on the assumptions included in the exercise, spending increases will be limited by the gradual and incomplete nature of the labour market recovery and the decrease in support provided by general government to household income. Against this backdrop, in the medium term households are expected to maintain higher levels of precautionary savings than those observed prior to the crisis, albeit substantially below the levels reached in 2020 Q2.

Residential investment has been hit hard by the impact of COVID-19 through various channels. First, the lockdown between March and June imposed restrictions on both construction activity and property sales. Second, housing demand appears to have been more enduringly affected by the increased uncertainty and, in particular, by the weakening of households' future income expectations, stemming from the worsened outlook for the labour market. Residential investment is expected to increase in H2, associated with the gradual normalisation of the figures for property sales and housing starts after the easing of the restrictions on movement, and likewise

Chart 2
COMPARISON OF THE CURRENT SCENARIOS FOR 2020 WITH THE JUNE ONES



SOURCE: Banco de España and INE.

owing to the implementation of certain purchase decisions that had been postponed as a result of the confinement. However, the recovery will remain incomplete, particularly while the current climate of uncertainty persists.

Investment of non-financial corporations will shrink more sharply than GDP in 2020. This decline, which is likely to be highly heterogeneous across the sectors of activity, would be consistent with the steep fall-off in final demand and with the climate of uncertainty as to future changes in this variable, the considerable slack in current capacity utilisation, and the deterioration in the sector's liquidity position. In recent months, the latter factor has necessitated significant recourse to debt, which is expected to result in the corporate sector emerging from the crisis with a significantly impaired financial position. However, a part of the increase in debt has not been earmarked for covering the most immediate liquidity needs, instead being used to accumulate assets for addressing hypothetical future needs given the climate of uncertainty. To the extent that this uncertainty begins to dissipate in mid-2021, the indebtedness of firms will, in aggregate terms, represent a somewhat less significant impediment to their investment spending. Given that the pandemic containment measures are comparatively more stringent and protracted under scenario 2, the recovery in business investment under this scenario will be more sluggish and incomplete. At the end of the projection horizon, business investment is expected to remain below pre-health crisis levels in both scenarios.

The difficulties in transporting goods during lockdown and, especially, the restrictions on the movement of people prompted by the pandemic will lead to a very severe adjustment in exports of goods and services in 2020. This will be particularly marked for the tourism and transport services components, which were directly affected by the constraints on movement. Accordingly, the upsurge in infections in Spain over the summer, along with the restrictions on travel to the country imposed by numerous source countries for tourism, including the main European markets, are setting back the prospects of recovery in tourism exports. This is particularly true under scenario 2, which is consistent with the more adverse course of the pandemic and subsequent stricter containment measures considered in this scenario compared to scenario 1. Neither scenario envisages a full

recovery of tourist flows until the final stages of the projection horizon.

The disruption to international trade flows of goods and services will likewise affect imports, which are expected to present a slightly steeper decline than exports to the rest of the world, particularly in the first half of the projection horizon. This is due to the comparatively more adverse performance of demand in Spain relative to its main trading partners, particularly the rest of the euro area. The sharp drop in imports also owes to an especially heavy decline in those components of final demand with a higher import content, such as investment in capital goods and exports. Further, in line with the developments observed on the export side, the flow of Spanish tourists to the rest of the world will likewise be constrained by the health crisis and, especially in the near term, the restrictions that certain countries have imposed on travellers from Spain.

The pandemic is having a particularly significant impact on the labour market, especially on employment in those industries hardest hit by social distancing measures. Job destruction has been attenuated by widespread use of furlough schemes and the suspension of self-employment. Therefore, total hours worked is a more appropriate variable than the number of persons in employment for faithfully reflecting how this factor of production is being used and for projecting future developments. In Q2, hours worked contracted faster than employment, since many workers remained recorded as such but worked far fewer hours, or even none at all. This trend appears to have subsequently reversed as a growing proportion of workers have gradually resumed normal work schedules. The start of the recovery in total hours worked from Q3¹¹ will not prevent this variable from showing a marked decline on average over 2020 as a whole, falling by -11.9% and -14.1%, respectively, under scenarios 1 and 2. The upturn in hours worked is set to continue over the rest of the projection horizon. Despite this, at end-2022 the number of total hours worked is expected to still stand 4.5% and 8.3% below pre-COVID-19 levels under scenarios 1 and 2, respectively.

In terms of actual employment numbers, the year-on-year decline in Social Security registrations has eased significantly over the summer months, while the number of workers on furlough has fallen markedly from the highs reached in April, as detailed in Section 4 of this Report. Over

11 Monthly data, if they were available, would actually show that the recovery in hours worked began in May, when the lockdown easing started.

the coming quarters, the employment gains are set to slow in step with the projected activity trends. In any event, the pace of improvement will be highly heterogeneous across the different economic sectors.¹² Moreover, hysteresis phenomena in the labour market will be attenuated (particularly in scenario 1) by the effects of government policy, both in terms of the schemes to preserve employment in the near term and measures aimed at providing liquidity to firms.

In 2020 Q2, the unemployment rate rose less markedly than might have been expected based on the performance of registered unemployment. This came against the backdrop of a significant decline in the labour force, very likely owing to a statistical effect that saw a large contingent of the workers who had lost their jobs being classified as inactive, given the absence of active job search opportunities during the lockdown. In the projection horizon, it is assumed that this drop in the active population is gradually reversed. Given the projected paths for this variable and for employment, the unemployment rate is set to rise significantly this year (to 17.1% of the labour force under scenario 1 and 18.6% under scenario 2) and likewise in 2021, before beginning to decline in 2022 (when the annual average is expected to stand at 18.2% and 20.2% in the respective scenarios).

The pandemic has been accompanied by significant disruptions in consumer price trends. The HICP has slowed markedly, which at first was mainly associated with the energy component, as a result of falling oil prices, but later became highly visible in terms of core components. This suggests the prevalence of demand weakness as the key determinant behind the recent inflation trend (rather than supply difficulties, which would have only temporarily materialised as price increases in the food component). Specifically, the decline in core inflation has been shaped very significantly by the slowdown in items linked to the tourism activity, where the fall-off in demand has been particularly pronounced. Some stabilisation is projected over the rest of the year, both for the overall and core indicators, at rates not far from current levels, i.e. slightly negative for the former and just above zero for the latter.

Core inflation is subsequently expected to continue to experience very moderate, albeit rising, rates of change,

against a backdrop of a slow and gradual recovery in demand. This recovery will not be homogeneous across all productive activities. In particular, the more sluggish and incomplete recovery in accommodation and food service activities and leisure will foreseeably cause inflation for these services to hold at very moderate levels until the final stages of the projection horizon. In any event, considerable cyclical slack will remain in both scenarios. Consequently, there is no significant difference between the core inflation paths for the overall period under analysis in the two scenarios. Specifically, the rate of change in the HICP excluding food and energy would be 0.7% and 0.6% on average in 2020 under each of the two scenarios, before rallying moderately to 1% and 0.8%, respectively, in 2022.

Meanwhile, overall HICP would begin to record positive rates in early 2021. This would be triggered by the significant acceleration anticipated in the energy component, owing to the base effects derived from the year-on-year rate of change beginning to be calculated against a lower level owing to the steep drop in oil prices recorded in the first part of the current year. In terms of annual average rates, overall HICP is expected to increase from -0.2% in 2020 to 1.2% in 2022 under scenario 1 and from -0.3% to 1.1% under scenario 2.

The health crisis is likewise having a very severe impact on public finances. The forceful measures implemented to counter the pandemic's impact on public health and economic activity combined with the automatic stabilisers will drive up the general government deficit in 2020, which is expected to stand at -10.8% and -12.1% of GDP in each of the two scenarios under consideration, representing approximate increases of between 8 pp and 9.3 pp on 2019.¹³ The discretionary measures implemented are, in part, temporary in nature. Therefore, their reversal in 2021, together with the cyclical improvement, will result in an appreciable reduction of the general government deficit next year. Despite this decline, and the more modest additional drop in 2022, the budget deficit will remain at very high levels in the final year of the projection horizon. Accordingly, public debt would increase in 2020 by more than 20 pp in scenario 1 and some 25 pp in scenario 2, to stand at 116.8% and 120.6% of GDP,

¹² See Box 7 ("The recovery of employment in recent months from a provincial and sectoral standpoint") of this Report.

¹³ Annex 1 describes the budget measures included in these scenarios, along with the other fiscal assumptions underlying their construction (particularly as compared with those used in the scenarios formulated in June).

respectively. This ratio would continue to increase, in cumulative terms, in the next two years, especially under scenario 2.

Risks surrounding the scenarios presented

The scenarios described are subject to a high level of uncertainty, primarily owing to the course that the pandemic may take both in Spain and in the rest of the world. The risks to economic growth are on the downside throughout the entire projection horizon.

Over the coming quarters, how events unfold will be highly shaped by the intensity of the outbreaks of the pandemic and, therefore, by the stringency of the measures that may potentially be required to contain them. The developments observed in the summer months suggest that restrictions associated with the “new normal”, which are largely based on voluntary social distancing, have not by themselves been effective in suppressing the pandemic; instead additional restrictions of limited geographical and sectoral scope have had to be imposed. In this projection exercise, this uncertainty has been reflected in the preparation of two alternative scenarios, which differ on the basis of whether the future course of the pandemic is relatively similar to that observed towards the end of the summer or whether it is more adverse, but not to such a degree as to lead to very stringent lockdown measures. Nevertheless, the materialisation of potentially very unfavourable scenarios that require the implementation of more substantial restrictions cannot be ruled out, after the strategies adopted to date to contain the disease have been found to be less than fully effective. This risk is heightened by the start of the academic year.

Beyond the short term, the scenarios constructed are founded on the assumption, which at present seems plausible, that the discovery and distribution of an effective solution for COVID-19 will render the application of lockdown measures beyond next summer unnecessary. Nevertheless, experts are emphasising the uncertainty as to this timeframe, as the possibility of obstacles delaying the timeframe for developing and distributing an effective remedy cannot be ruled out.

The second large source of uncertainty is associated with the scale of the pandemic’s economic consequences. This source of risk is clearly not independent of the course of the disease: more intense and longer-lasting lockdown measures would result in deeper damage to the productive system. All things considered, in each of the two

epidemiological scenarios that have been set out, the extent to which the economic policy measures undertaken will successfully prevent such enduring damage is uncertain. Specifically, the high level of debt incurred by many non-financial corporations, owing to the drop in income triggered by the pandemic, could potentially result in higher levels of corporate insolvency in the future. In turn, a high number of business insolvencies would lead to an increase in loan defaults, with adverse implications for financial institutions’ intermediation capacity. Furthermore, the notable increase in public debt that general government has had to incur as a result of the pandemic could, under certain circumstances, affect future capacity for growth in activity.

Beyond the direct and indirect implications of the pandemic, there are two further downside risks from the external environment: the possibility of no agreement being reached when the Brexit transition period ends, and US-China trade tensions.

By contrast, a very significant upward risk derives from the different pan-European initiatives put in place to tackle the crisis, in particular the NGEU recovery programme approved at the end of July. As explained in Box 9, this programme could have significant implications for the outlook of economies, such as Spain’s, that have been intensely affected by both COVID-19 and the related economic consequences.

The risks surrounding inflation are also predominantly on the downside, owing to the hypothetical materialisation of a scenario that is more adverse for economic activity leading to greater weakness in demand and, therefore, a larger degree of cyclical slack. Moreover, changes in the different indicators of inflation expectations mean that the possibility of their potential deanchoring cannot be ruled out. Conversely, the cost increases for firms associated with introducing hygienic and sanitary measures might ultimately push up their prices.

ANNEX 1

Projection assumptions

As compared with the June projections, several of the assumptions underlying the projections have undergone significant change. Noteworthy is the significant appreciation of the euro, both against the dollar and in nominal effective terms (see Table 2). There are various reasons for this performance, particularly against the dollar. First, the decline in risk perception has fostered the outflow of some of the capital flows that had taken

MACROECONOMIC SCENARIOS FOR THE SPANISH ECONOMY (2020-2022) (cont'd)

refuge in the dollar at the height of the pandemic. Further, the relative tone of monetary policy in the United States as compared with the euro area appears to have likewise contributed to these developments, against a backdrop in which the Federal Reserve has had greater leeway to address the crisis. Finally, in the most recent period, the strength of the euro has been supported by the European Council agreement in late July regarding the NGEU programme, which appears to have bolstered the euro area's macroeconomic prospects and the institutional strength of this common project.¹⁴

The amplitude of the fluctuations in Spain's export markets has decreased in the current cycle relative to the June scenarios, in keeping with the tentative evidence that global trade has been less affected by the crisis than anticipated at that time. This has led to an upward revision of the projected growth in demand for Spanish exports,

particularly in scenario 1, and a downward revision in 2020 and 2021, especially in scenario 2.

In recent months, oil prices have risen markedly both on spot and futures markets. This has been prompted by increased demand stemming from improved global economic prospects and the production cuts agreed by OPEC in May. On public debt markets, a decline in the Spanish 10-year bond yield is envisaged over the projection horizon. The path of interest rates on the interbank market remains unchanged.

The assumptions regarding fiscal policy in the projection horizon now factor in, as compared with the June scenarios, the new measures adopted by the government to respond to the course of crisis prompted by the pandemic. In particular, in June the Council of Ministers resolved to extend until 30 September the support

Table 2
INTERNATIONAL ENVIRONMENT AND MONETARY AND FINANCIAL CONDITIONS (a)

Annual rates of change unless otherwise indicated

	September 2020 projections				Difference between current projections and the June 2020 gradual recovery scenario (b)		
	2019	2020	2021	2022	2020	2021	2022
International environment							
World GDP	2.8	-4.2	6.1	3.7	0.3	0.2	-0.1
Spain's export markets (c)	1.5	-13.1	7.3	4.3	1.0	-1.0	-0.5
Oil price in US dollar/barrel (level)	64.0	42.1	45.9	48.5	6.1	8.7	7.8
Monetary and financial conditions							
US dollar/euro exchange rate (level)	1.12	1.14	1.19	1.19	0.05	0.10	0.10
Nominal effective exchange rate against non-euro area (d) (2000 = 100)	116.4	117.7	121.4	121.4	4.3	8.4	8.4
Short-term interest rates (3-month EURIBOR) (e)	-0.4	-0.4	-0.5	-0.5	-0.1	-0.1	-0.1
Long-term interest rate (10-year bond yield) (e)	0.7	0.4	0.4	0.6	-0.3	-0.6	-0.6

SOURCES: Banco de España and ECB.

- a Cut-off date for assumptions: 10 September 2020. Figures expressed as levels are annual averages. Figures expressed as rates are calculated based on the relevant annual averages.
- b Differences between rates for world output and export markets and between levels for oil prices and the dollar/euro exchange rate. Percentage differences for the effective nominal exchange rate and percentage point differences for interest rates.
- c The assumptions for the performance of Spain's export markets in the table are obtained from the *September 2020 ECB staff macroeconomic projections for the euro area*. These assumptions have been adapted to the two scenarios prepared by the Banco de España.
- d A positive percentage change in the nominal effective exchange rate denotes an appreciation of the euro.
- e For the projection period, the figures in the table are technical assumptions, prepared using the Eurosystem's methodology. These assumptions are based on futures market prices or on proxies thereof and should not be interpreted as a Eurosystem prediction as to the course of these variables.

14 For a detailed description of the programme, see Box 5 ("Next Generation EU: Main characteristics and impact of its announcement on financial conditions") in this Quarterly Report.

measures for employment (furlough schemes and the suspension of self-employment benefit)¹⁵ and to set up an extraordinary fund of €16 billion to help regional governments finance their expenditure deriving from the COVID-19 crisis, which led to an upward revision of the government consumption and investment forecasts for both 2020 and 2021. Further, in July the government approved a €40 billion increase in the public guarantee scheme for loans to non-financial corporations, on this occasion geared to financing the productive investments of viable firms.¹⁶ Moreover, in late May the government approved the launch of a minimum living income scheme, at an estimated annual budgetary cost of some €3 billion.¹⁷

At the cut-off date of this Report, two relevant aspects of economic policy remain under discussion. First, the government is negotiating with various parliamentary groups, seeking the required support to pass the draft 2021 State budgets, which could be submitted over the coming weeks. Second, the government is in talks with social partners over the details of a hypothetical further extension to the employment support measures, through furlough schemes, which currently run until 30 September. The scenarios discussed in this box do not include either of these two items of economic policy, given that the negotiations are ongoing and the outcome is unknown.

Further, to project the expected paths of certain budget items in the period 2021-2022, similar technical assumptions to those employed in the June scenarios have been used. First, it is assumed that those items subject to greater discretion – particularly, given their volume, government investment and procurement – will

move in line with the growth potential of the Spanish economy, with the exception of the increased regional government funding described above. Second, in the absence of additional measures, the trajectory of the remaining items of the general government accounts is assumed to be governed by their usual determinants. Specifically, it is assumed that government revenue will grow in line with tax bases, which essentially depend on the macroeconomic context. Similar assumptions are made for those less discretionary expenditure items. This is the case for pension expenditure (determined by pension revaluation based on CPI growth and population ageing), unemployment benefits (which depend mainly on developments in unemployment) and interest payments (the changes in which reflect developments in public debt and interest rates).

Finally, it is worth reiterating that the projections do not include the potential budgetary and macroeconomic consequences of the funds that Spain may receive under the framework of the NGEU programme. These are not included owing to the high level of uncertainty regarding some of their more relevant aspects, such as the total amount receivable, the timeline for receiving the funds and the composition of the expenditure that they might finance.

The fiscal policy stance will be clearly expansionary in 2020, judging by the available information – including the measures adopted and the various assumptions used for the set of fiscal variables – and by the output gap estimated in a manner consistent with the other macroeconomic projections.

15 Royal Decree-Law 22/2020 of 16 June 2020.

16 Royal Decree-Law 25/2020 of 3 July 2020.

17 Royal Decree-Law 20/2020 of 29 May 2020.

This early-release box was published on 15 September

Over 2019 and the first half of 2020, the Federal Reserve (the Fed) carried out its first-ever comprehensive and public review of the monetary policy framework (strategy, tools and communication practices) it employs to achieve its dual mandate of maximum employment and price stability (the latter being interpreted as a level of annual inflation of 2%). According to the Fed, two structural transformations that have taken place in recent years stand out among the reasons for this strategy review. First, the flattening of the Phillips curve, i.e. the reduced sensitivity of prices to the degree of economic slack, which weakens the link between inflation and unemployment.¹ And second, the decline in the natural rate of interest,² as a result of structural changes, such as population ageing and low productivity growth, which makes it more likely that interest rate cuts in recessions may be constrained by the existence of an effective lower bound (ELB).

The review of the Fed's monetary policy framework was based on three pillars. First, a discussion of possible changes to the monetary policy strategy to make it more robust to the problem of the ELB. Second, an analysis of the effectiveness of the unconventional instruments employed since the 2008 global financial crisis (essentially large-scale asset purchase programmes and forward guidance), and also a comparison with international experience with other unconventional measures. Third, an assessment of the communication policy and innovations made over the last decade.

On 27 August, at the annual monetary policy meeting organised by the Federal Reserve Bank of Kansas City, the Chairman of the Fed, Jerome Powell, presented the conclusions of the first pillar, i.e. the monetary policy strategy review. These conclusions were incorporated into the "Statement on Longer Run Goals and Monetary Policy Strategy".³ First, average inflation targeting was adopted, with the aim of achieving inflation that averages 2% over

time. Thus, following a period in which inflation runs persistently below 2%, the Fed has committed itself to temporarily pushing inflation rates moderately above this threshold. The new inflation target has been described as flexible, insofar as no specific system for calculating average inflation has been defined: key aspects, such as the time period over which the average is calculated and the order of magnitude of the inflation deviations that will be tolerated, have yet to be specified. Accordingly, the Fed has modified its monetary policy strategy in line with proposals⁴ advocating make-up strategies, under which periods of persistently below-target inflation, like the present one, are made up for (hence the name) by subsequent periods in which monetary policy remains accommodative for some time in order to provide monetary stimulus to raise inflation rates above the target.

A higher incidence of episodes in which the ELB is reached entails a risk that inflation expectations will become deanchored: if inflation remains persistently below 2%, the fall in its average level may lead to a downward revision in the inflation expectations of economic agents and lower actual inflation rates, since the latter incorporate inflation expectations. In a setting in which the scope to reduce interest rates is constrained by the lower bound, the deanchoring of inflation expectations may therefore push up real interest rates (defined as the difference between the nominal interest rate and expected inflation), thus reducing the capacity of monetary policy to stimulate aggregate demand and prices.

The new average inflation target adopted by the Fed tolerates inflation running temporarily slightly above 2% to keep average inflation at its target level, the aim being to reduce the risk of a deanchoring of inflation expectations and the consequent loss of scope for monetary policy stimulus. Yet some quantitative analyses based on dynamic general equilibrium models warn that this type of make-up strategy may generate an excessive increase in

1 J. Powell (2020), "New Economic Challenges and the Fed's Monetary Policy Review", presented at the conference *Navigating the Decade Ahead: Implications for Monetary Policy*, Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, 27 August.

2 The natural or neutral interest rate is defined as that which would prevail in an equilibrium scenario with perfectly flexible prices and wages. Its relevance to monetary policy derives from the fact that when the real interest rate stands below its natural level, excess aggregate demand ensues, which generates inflationary pressures (the opposite occurs when the real rate stands above the natural rate).

3 The "Statement on Longer-Run Goals and Monetary Policy Strategy" is the formal document describing how the US central bank interprets its dual mandate and its decision-making framework. It was introduced in January 2012. The changes to the *Statement* made on 27 August were approved unanimously by the Federal Open Market Committee (FOMC).

4 A summary of the various proposals discussed in the Federal Reserve's strategy review can be found in S. Párraga, P. del Río and J. L. Vega (2019), "The Federal Reserve Review of its Monetary Policy Framework", Analytical Articles, *Economic Bulletin*, 4/2019, Banco de España. See, also, the 2018 *Annual Report*, Banco de España.

inflation in the medium term, especially if agents have adaptive expectations or the central bank's credibility is imperfect.⁵ The Fed attempts to mitigate this problem by pointing out that inflation rates will only be pushed moderately above 2% and only temporarily.

The Fed has also changed its formulation of the maximum employment objective, emphasising that this is a broad-based and inclusive goal. The new definition stresses the importance of access to the labour market, especially for low-income groups, and how low aggregate unemployment rates encourage the participation of such groups in the labour market.⁶ Given the recent evidence that high employment rates do not lead to marked inflationary pressures, even when the economy has little slack and unemployment rates are very low, the Fed has committed itself not to raise interest rates or withdraw monetary stimulus as long as inflation remains moderate, provided that no other risks compromising the achievement of its objectives emerge. Specifically, following this review, the Fed has indicated that it will assess "shortfalls" from its maximum employment objective, rather than "deviations" as previously.

Other notable changes in the new Statement include confirmation that the federal funds rate is the main monetary policy tool, and the commitment to adjust the monetary policy strategy and its long-term objectives each year. Lastly, following the example of other central banks,⁷ the Fed will carry out comprehensive reviews of the monetary policy framework every five years.

The impact on the financial markets of the announcement of this review of the Fed's strategy is analysed below using "event study" methodology. This methodology is based on calculating the change in the financial indicators

of interest within a short time window around the event in question, in order to isolate the impact of the event from that of other factors, such as economic or, in the current context, epidemiological news. These studies are regularly carried out to assess monetary policy announcements by central banks, such as those affecting their asset purchase programmes or reference interest rates.⁸

Chairman Powell's speech, in which, as mentioned above, he announced the conclusions of the first pillar of the monetary policy strategy review, began at 15:10 CET on 27 August, at the same time as a press release was published setting out the content of the new strategy. Accordingly, the start of the time window for this exercise is set at 15:00 CET, while the end of the window is set at close of trading on each market on 27 August. The size of the window selected represents a reasonable balance between two considerations. First, the need for the narrowest possible window around the event analysed, to avoid the influence of other factors on the financial indicators of interest. Second, the fact that, for an announcement of this type, on such a complex question as a change in monetary policy strategy, investors may have needed more time to process the implications for market valuations than is normally the case for specific monetary policy measures.⁹

Chart 1 shows the intraday changes in the yields on different US sovereign debt maturities (normalised to zero at 15:00 CET). Following a brief initial dip, US Treasury bond yields increased substantially over the rest of the session, mainly at the longest maturities. This climb in yields appears to have been driven by the increase in the inflation risk premium, which would be consistent with the greater impact observed on yields at the longest maturities.¹⁰ The difference in behaviour

5 See, for example, B. S. Bernanke, M. T. Kiley and J. M. Roberts (2019), "Monetary Policy Strategies for a Low-Rate Environment", *American Economic Association – Papers and Proceedings*, Vol. 109, pp. 421-426.

6 S. Aaronson, M. C. Daly, W. L. Wascher and D. W. Wilcox (2019). "Okun revisited: who benefits most from a strong economy", *Finance and Economics Discussion Series*, 2019-072, Board of Governors of the Federal Reserve System.

7 The Bank of Canada, for example, reviews its inflation targeting framework every five years. The European Central Bank (ECB) reviewed its strategy in 2003, after five years of experience following the introduction of the euro and the common monetary policy, and in January 2020 it initiated a new review which it expects to conclude in mid-2021.

8 For the United States, see, for example, J. Gagnon, M. Raski, J. Remache and B. Sack (2011), "The Financial Market Effects of the Federal Reserve's Large-Scale Asset Purchases", *International Journal of Central Banking*, Vol. 7(1), pp. 3-43. For the euro area, see C. Altavilla, G. Carboni and R. Motto (2015), "Asset purchase programmes and financial markets: lessons from the euro area", *ECB Working Paper Series*, No 1864, and M. Ampudia and S. Van den Heuvel (2018), "Monetary Policy and Bank Equity Values in a Time of Low Interest Rates", *ECB Working Paper Series*, No 2199.

9 In the literature on event studies of the effects of monetary policy measures it is normal to use windows of less than one hour. For example, in their analysis of the ECB's monetary policy measures, M. Ampudia and S. Van den Heuvel (2018) use a window starting 10 minutes before and ending 20 minutes after the usual ECB press release (announcing the measures), i.e. a 30-minute window.

10 From an investor's standpoint, the inflation risk premium is the additional return demanded for the possible loss of purchasing power owing to an increase in consumer prices when holding long-term debt instead of purchasing short-term debt and rolling it over. See J. C. Berganza and A. Fuertes (2018), "The flattening of the yield curve in the United States", *Analytical Articles, Economic Bulletin*, 1/2018, Banco de España.

across maturities can also be seen in Chart 2, which shows the change in the various yields between the start and end of the time window considered, the bonds with the longest maturities being those with the largest increases in yields. Even 2-year bond yields, which are more sensitive to reference interest rates and less sensitive to the term premium, rose slightly.

Another market segment in which the announcement of the Fed's new strategy may have had some impact is inflation swaps.¹¹ These financial instruments capture agents' expectations of future inflation developments up until their maturity, as well as a risk premium linked to the

possibility that inflation may actually be higher than expected. Accordingly, they can be used to assess the approximate effectiveness of the announcement in terms of raising investors' inflation expectations. Chart 3 shows the change in inflation swap rates during the time window considered. The increase in swap rates observed is smaller than in the case of government debt. One possible explanation for the more limited impact on inflation swaps is that investors may have doubts about the effectiveness of the change in strategy in terms of increasing the inflation rate in the medium and long term. This would mean that, insofar as increases in actual inflation

Chart 1
US GOVERNMENT DEBT INTEREST RATES
(NORMALISED TO ZERO AT 15:00 CET)

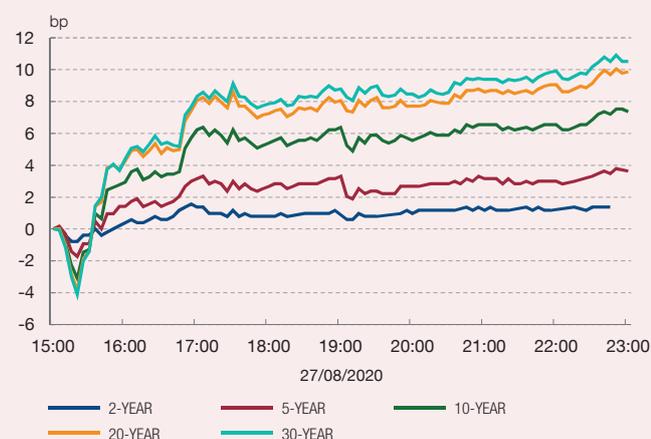


Chart 2
US GOVERNMENT DEBT INTEREST RATES
CHANGE FROM 15:00 CET ON 27 AUGUST TO CLOSE

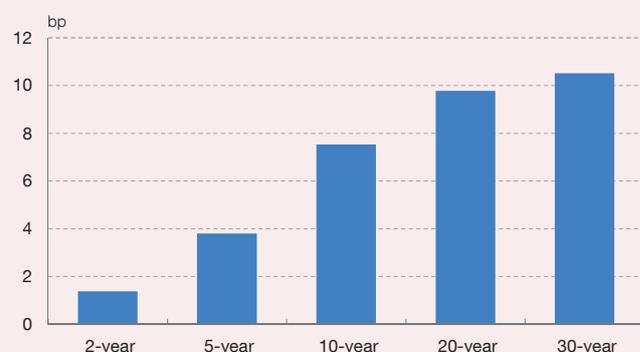


Chart 3
US INFLATION SWAP RATES
CHANGE FROM 15:00 CET ON 27 AUGUST TO CLOSE

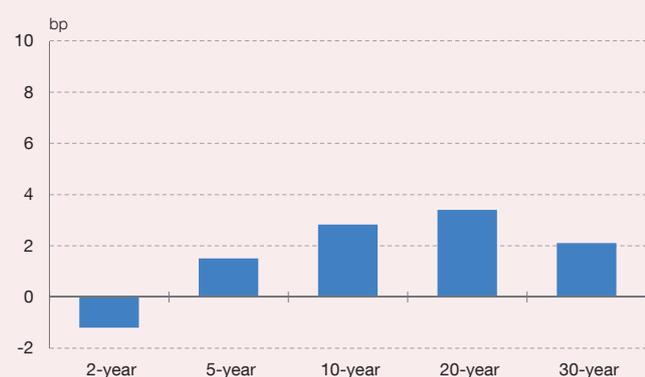
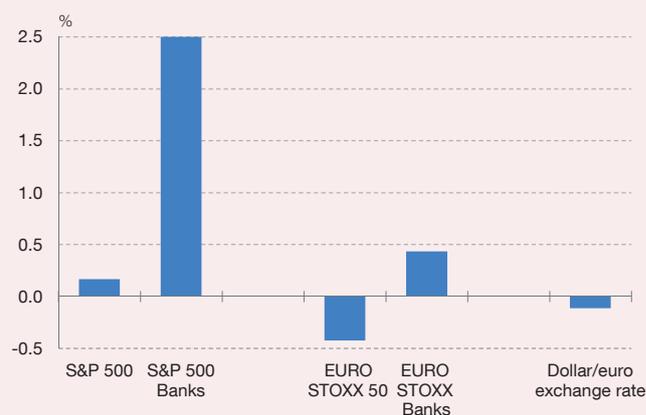


Chart 4
STOCK MARKET INDICES AND EXCHANGE RATE
CHANGE FROM 15:00 CET ON 27 AUGUST TO CLOSE



SOURCE: Thomson Reuters Eikon.

11 In an inflation swap, party A agrees to pay party B a fixed rate as consideration for receiving payments indexed to the level of inflation.

confirming the effectiveness of the new strategy are not observed, swap rates (and in particular, the genuine inflation expectations component implicit in these rates) may be barely affected.¹² Another possible explanation is that the Fed's announcement had already been partly discounted by investors, since the monetary policy strategy review was a lengthy, public and highly transparent process.¹³

Lastly, stock market developments in the United States and the euro area – with a particular focus on the banking industry – are analysed, along with the dollar/euro exchange rate. Chart 4 shows the percentage change in these variables during the time window considered.¹⁴ No significant changes occurred in the S&P 500 and EURO

STOXX 50 indices, which would suggest that investors did not envisage that the Fed's new strategy might have a significant effect on corporate profits or on its discount rate. However, the banking industry indices did rise significantly, especially in the United States. This would be consistent with a steeper yield curve resulting from higher longer-term government debt yields, and, therefore, an improved profit outlook for the banking industry.¹⁵ As regards the exchange rate, the dollar appreciated slightly, in line with the higher US government debt yields, although this movement was very small. Nonetheless, the more accommodative stance of the Fed's new strategy was reflected in a depreciation of the dollar during the days immediately following the announcement.

12 When the same analysis is carried out using Treasury Inflation Protected Securities (TIPS) similar results are obtained. TIPS are inflation-indexed bonds with returns that, when compared with those on unindexed bonds of the same maturity, give an alternative estimate of inflation expectations at different horizons.

13 In addition, the greater impact on sovereign bonds may have been due to the lack of detail regarding implementation of the Fed's new strategy, which would increase the uncertainty over future interest rates and also the term premium.

14 In the case of the US stock market indices, as the session began at 15:30 CET, the change reflects the difference between close of business on 26 August and 27 August.

15 The banking industry is sensitive to the slope of the yield curve due to its intermediation business, which is based on the transformation of returns on assets and liabilities according to their maturities. Thus, banks' liabilities, mainly deposits, are remunerated at short-term interest rates, while their assets, mainly loans, are remunerated in line with longer-term interest rates.

THE COVID-19 PANDEMIC IN LATIN AMERICA AND ITS ECONOMIC EFFECTS

This early-release box was published on 8 September

The COVID-19 pandemic reached Latin America¹ somewhat later than it reached Europe and the United States and, in general, the region has still not managed to contain its spread. Indeed, since June, Latin America has become the global epicentre of the pandemic, recording almost half of all COVID-19 daily deaths worldwide (see Chart 1). In total, since the onset of the pandemic, there have been approximately 260,000 COVID-19 deaths in the region, 32% of the world total, when it accounts for just 8% of the global population.² And this, despite the fact that, when the number of infections was still low, several Latin American countries adopted confinement and social distancing measures similar to those implemented in other parts of the world in an endeavour to contain the spread of the virus (see Charts 2 and 3). Some of the region's structural characteristics – such as high poverty levels, lower institutional quality compared with other emerging economic areas, high informal employment rates, the relative fragility of health systems (and the difficulties the lower income groups have accessing these systems) and the high proportion of the population living in urban areas – have heightened the region's vulnerability to the pandemic.

The data on the real number of COVID-19 cases in Latin America present the usual limitations of international statistics, exacerbated in the region by the low level of testing being done in some countries.³ Brazil and Mexico, which are the two countries with the highest population in the region, have the highest numbers of infection, verging on 3.9 million and 600,000 cases, respectively. They also have the highest number of COVID-19 deaths: over 121,000 in Brazil, second only to the United States, and over 64,000 in Mexico, behind only the United States, Brazil and India (see Charts 4 and 5). However, in per capita terms, Peru has the highest ratio worldwide with almost 87 deaths per 100,000 inhabitants, while the ratio is between 50 and 60 per 100,000 in Chile, Brazil and Mexico (see Chart 6). The situation is less negative in Colombia (around 38 deaths per 100,000 inhabitants) and

especially in Argentina where the ratio is under 20, although this is still above the overall figure worldwide (11 deaths per 100,000 inhabitants).

The negative economic effects of the pandemic in the region arise through different channels,⁴ the most important of which, on account of their scale, are the lockdown measures. As Chart 7 shows, economic activity began to fall sharply in March and continued to do so until April or May, according to the country considered. Peru, where activity contracted by more than 35% in April compared with February, was particularly hard hit, whereas at the other end of the scale, activity in Brazil declined by just 15% compared with February. The main reason for these differences between countries is the different level of stringency of the national lockdown measures. Indeed, Charts 8 and 9 show a high and significant negative correlation between economic activity and the lockdown indices, in terms of mobility restrictions and the stringency of the confinement measures.

The national accounts figures for 2020 H1, and especially for Q2,⁵ also reflect the extent of the economic contraction in the region (see Chart 10). The main reason for this is the change in consumption and private investment, which resulted in large negative output gaps that only began to narrow very slowly from May or June as lockdown measures were eased. For LATAM-6 overall, the quarterly rate of decline of GDP in Q2 was more than 14%, higher than that observed in almost all regions worldwide, albeit as indicated above with considerable cross-country differences. Thus, for example, GDP in Peru contracted by more than 27% while in Brazil it did so by 9.7%.

This collapse in activity occurred despite the economic authorities' rapid and robust response to the pandemic, both from a fiscal and a monetary standpoint. In most cases these responses were larger than those observed during the 2008-09 financial crisis. The governments of Brazil, Chile, Colombia and Peru, for example,

1 The box focuses mainly on the sub-group of economies with the highest GDP in the region – known as LATAM-6 – comprising Brazil, Mexico, Argentina, Colombia, Chile and Peru.

2 In per capita terms, since the start of the pandemic there have been 41 COVID-19 deaths per 100,000 inhabitants in Latin America, well above the 11 per 100,000 recorded at global level.

3 In accordance with www.worldometers.info which collects data from national and international statistical sources (such as, for example, Johns Hopkins University), only Chile ranks among the 50 countries in the world that are doing the most testing per capita (125 tests per 1,000 inhabitants). The situation in Mexico is particularly delicate, where the figure is only 10 tests per 1,000 inhabitants.

4 For a detailed description of the different channels, see "Report on the Latin American Economy. First half of 2020", Analytical Articles, *Economic Bulletin 2/2020*, Banco de España..

5 All the countries analysed recorded negative quarter-on-quarter growth rates in 2020 Q1, with the exception of Chile. Activity recovered in Q1 in Chile, but this was mainly on account of the decline recorded in 2019 Q4 as a consequence of the increase in social unrest.

THE COVID-19 PANDEMIC IN LATIN AMERICA AND ITS ECONOMIC EFFECTS (cont'd)

Chart 1
DAILY COVID-19 DEATHS

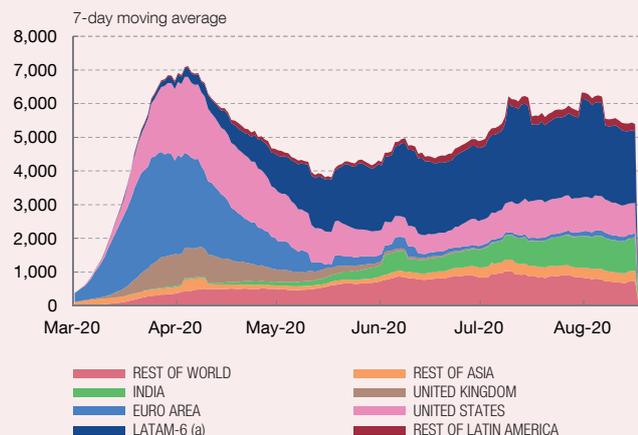


Chart 2
MOBILITY INDICATORS. CONSUMPTION (b)

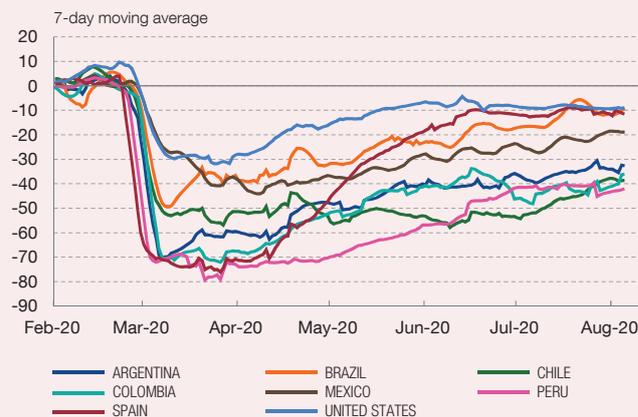


Chart 3
GOVERNMENT RESPONSE STRINGENCY INDEX (c)

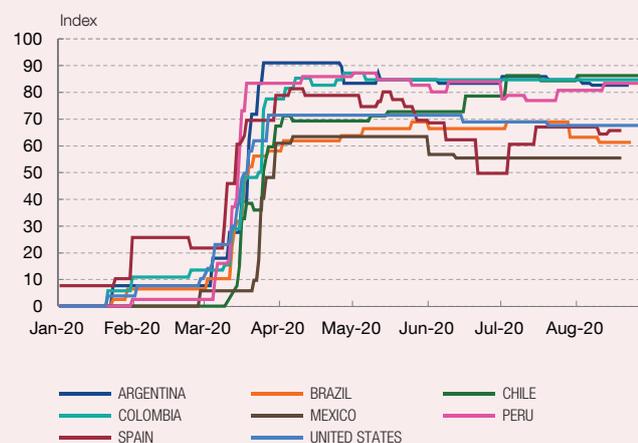


Chart 4
COVID-19 DEATHS IN LATIN AMERICA

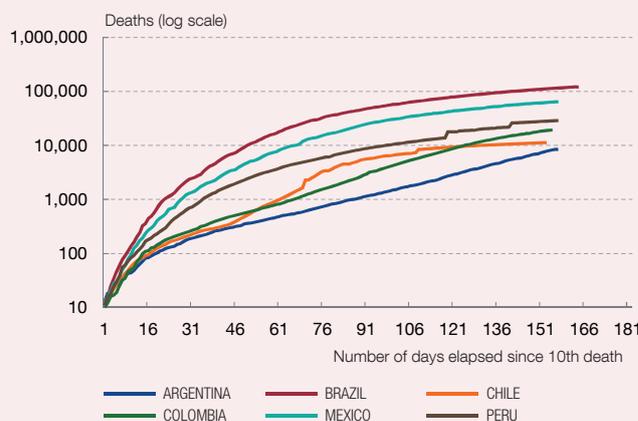


Chart 5
COVID-19 MORTALITY RATE IN LATIN AMERICA

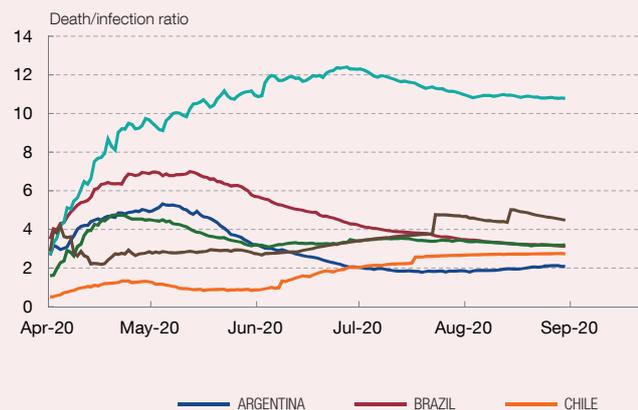
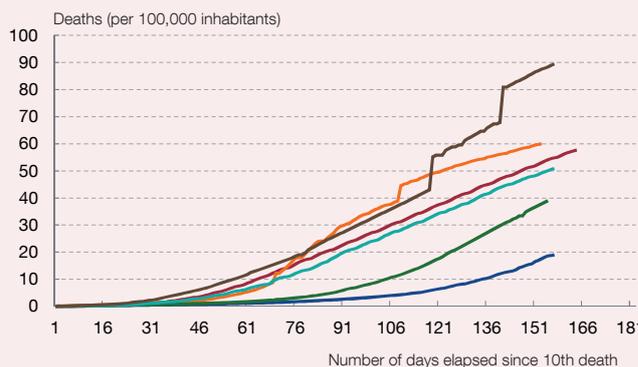


Chart 6
COVID-19 DEATHS IN LATIN AMERICA



SOURCES: Johns Hopkins University, Google (Global Mobility Report) and University of Oxford.

- a LATAM-6 is a sub-group of the economies with the highest GDP in the region, comprising Brazil, Mexico, Argentina, Colombia, Chile and Peru.
- b Consumption-related mobility indicators, with consumption the average of “retail and recreation” and “grocery and pharmacy”.
- c Synthetic index devised by the University of Oxford, which assesses the degree of stringency of the lockdown measures adopted by each country in response to the COVID-19 pandemic.

Box 3

THE COVID-19 PANDEMIC IN LATIN AMERICA AND ITS ECONOMIC EFFECTS (cont'd)

Chart 7
ECONOMIC ACTIVITY INDICES

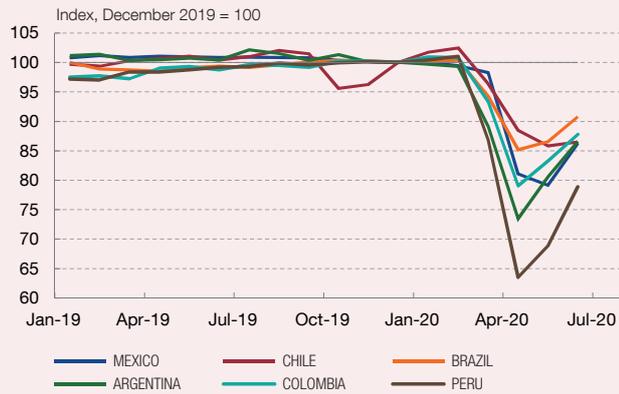


Chart 8
ECONOMIC ACTIVITY AND STRINGENCY INDEX (a)

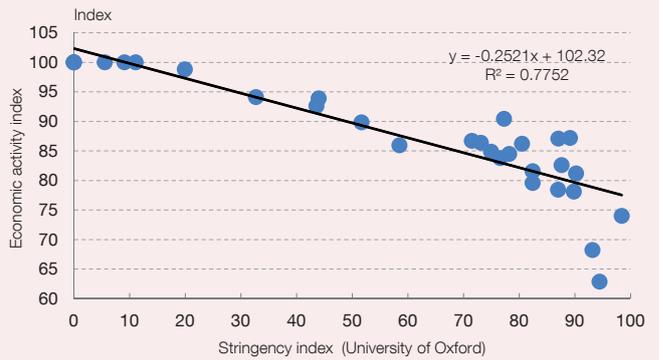


Chart 9
ECONOMIC ACTIVITY INDEX AND MOBILITY INDICATORS (a)

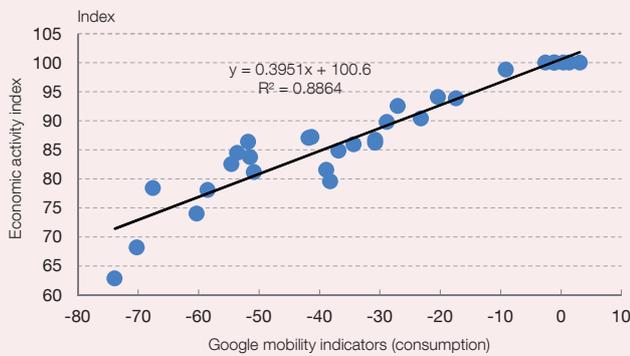


Chart 10
GDP, RATES OF CHANGE



Chart 11
SIZE OF STIMULUS PACKAGES

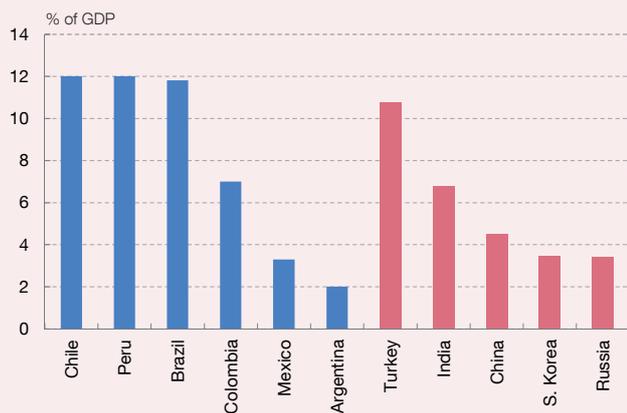


Chart 12
OFFICIAL INTEREST RATES



SOURCES: Thomson Reuters, University of Oxford, Google (Global Mobility Report), IMF and national statistics.

- a Feb-June 2020 data for Argentina, Brazil, Chile, Colombia, Mexico and Peru.
- b Estimated Q2 figure for Argentina drawing on monthly activity indices.

THE COVID-19 PANDEMIC IN LATIN AMERICA AND ITS ECONOMIC EFFECTS (cont'd)

implemented fiscal measures⁶ that amounted to between 7% and 12% of their GDP,⁷ while Argentina and Mexico also used such measures albeit to a lesser extent (see Chart 11).⁸ As regards monetary policy, the region's

central banks cut interest rates to all-time lows (see Chart 12), adopted support measures for bank lending, provided local and foreign currency (dollar) liquidity and established asset purchase programmes.

Chart 13
PORTFOLIO CAPITAL FLOWS TO EMERGING MARKETS (\$bn)

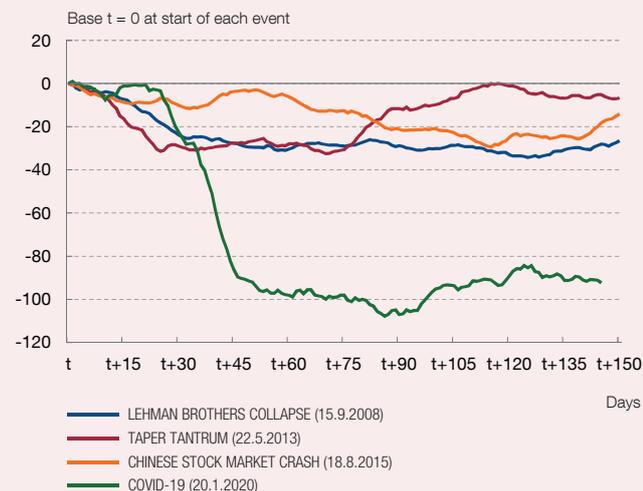


Chart 14
EXCHANGE RATES AGAINST THE DOLLAR



Chart 15
LATAM-6 REAL GDP GROWTH

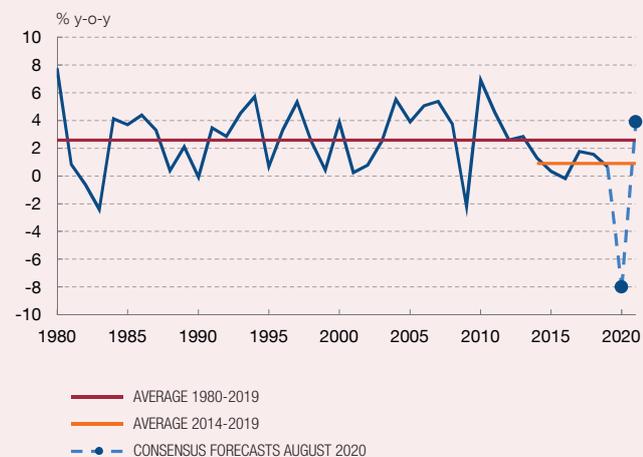


Chart 16
GDP LEVELS COMPARED WITH 2019. CONSENSUS FORECASTS AUGUST 2020



SOURCES: Thomson Reuters, IMF and Consensus Forecasts.

a Emerging Markets Currency Index, an aggregate index of exchange rates against the dollar for emerging markets devised by JP Morgan.

6 These measures focused mainly on providing support to businesses and households, expanding healthcare capacity and issuing guarantees for credit and capitalisation.
 7 Comparing different countries' fiscal stimulus programmes poses significant difficulties. This box draws on the figures supplied by the IMF (<https://www.imf.org/en/Topics/imf-and-covid19/Policy-Responses-to-COVID-19>).
 8 In Argentina this may be due to the limited public funding options, whereas in Mexico it may be related to different economic policy priorities (for instance, maintaining a balanced budget and pre-crisis large-scale infrastructure and social policy projects).

The negative effects of the pandemic on activity were not reflected to the same extent on the financial markets. Between mid-February and mid-March, the markets recorded high capital outflows (see Chart 13), exchange rate depreciation (see Chart 14), widening sovereign spreads and stock market declines. Yet these developments subsequently reversed, albeit not completely, as governments and central banks introduced accommodative policies both in these countries and in other developed economies.⁹ In consequence, in recent months, there has been a certain degree of decoupling between the region's financial markets, which have improved somewhat, and the real economy, which is still very weak.

To conclude, the COVID-19 pandemic has had an extremely negative impact on economic activity in Latin America in recent months. This has led analysts to project for 2020 the largest contraction in GDP since figures

became available (see Chart 15). As the rate of spread of the pandemic appears to have steadied recently, authorities in some countries of the region have begun to ease lockdown measures. In consequence, the main Latin American economies are expected to record positive growth rates in coming quarters. However, in general, they will likely continue on a fragile and very gradual recovery path, given their structural limitations and the scant room available for adoption of further stimulus policies. Accordingly, on the most recent forecasts and for most of the region's economies, the activity levels recorded before the health crisis are not expected to be restored until 2022 (see Chart 16). In addition, these forecasts are subject to a substantial degree of uncertainty, which largely depends on the future course of the pandemic, in Latin America and in the rest of the world, and on the stringency of any lockdown measures that may have to be reintroduced in the different economies.

⁹ In addition, in May the IMF approved a Flexible Credit Line (FCL) arrangement for Chile and for Peru. It also renewed the FCL arrangement for Colombia. Mexico also has a two-year FCL arrangement in place following the renewal approved in November 2019.

THE CAPITAL MARKETS UNION: NEW DEVELOPMENTS

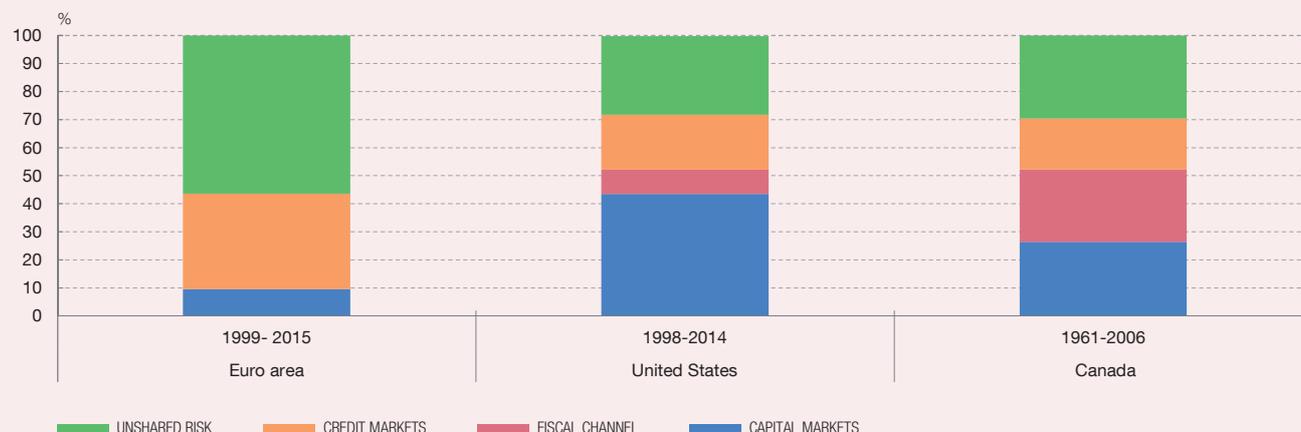
This early-release box was published on 4 September

The Economic and Monetary Union (EMU) project, launched in Europe in the 1990s, did not envisage a fully fledged monetary union from the outset, leaving important aspects to be fleshed out at a later stage. More than two decades later, there are still significant shortcomings in the euro area's institutional arrangements, among them scant headway in the development of sufficiently deep and integrated European capital markets. Given its significance, the European Commission continues to hold the Capital Markets Union (CMU) among its main priorities and has already taken significant steps in this direction. Following completion of the initial action plan launched in 2015, the Commission is working on a second package of measures that will be unveiled this autumn. The smooth functioning of European capital markets is all the more important in light of the withdrawal of the United Kingdom - home to Europe's largest capital market - from the European Union (EU), the situation prompted by the COVID-19 health crisis and the attendant need for economic reconstruction.

The benefits of a fully fledged CMU are significant. In the United States, the presence of deep and integrated capital markets allow shocks affecting one state in the union to be absorbed to a high degree on an aggregate basis.¹ This constitutes a risk-sharing channel and brings stability to the currency area as a whole. By contrast, the fragmentation that is characteristic of the euro area's financial markets means less capacity to share and diversify risks (see Chart 1). In the United States, this capacity stems from the size of the capital markets themselves - far larger in terms of GDP than those of the EU-27 (see Chart 2)² - and the high geographical diversification of portfolios, compared to the home bias that predominates in Europe.³

Further, the CMU is a necessary complement to the Banking Union within the EMU.⁴ More developed capital markets allow the real sector of the economy to achieve greater diversification in its funding sources and support the financing of activities that are important for economic growth, such as sustainable investment and investment in

Chart 1
CAPACITY OF RISK SHARING CHANNELS. AN INTERNATIONAL COMPARISON (a)



SOURCES: Banco de España, "Regional redistribution and stabilization by the center in Canada, France, the UK and the US: A reassessment and new tests", J. Méltz and F. Zumer, *Journal of Public Economics*, Vol. 86, November 2002, and "Interstate risk sharing in Germany: 1970-2006", R. Hepp and J. von Hagen, *Oxford Economic Papers*, Vol. 65, January 2013.

a Estimated using the methodology of "Channels of Interstate Risk Sharing: United States 1963-1990", P. Asdrubali *et al.*, *The Quarterly Journal of Economics*, vol. 111, 19962, which approximates the percentage of shocks to an economy's GDP transmitted to the income and consumption decisions of that economy's residents.

1 Specifically, risk sharing refers to the degree to which shocks to the GDP of a country or region affect the consumption of its agents. Risk sharing is considered full where consumption is unaffected by a shock and nil where all shocks are transmitted to consumption unsmoothed.

2 See Balta and Delgado (2008), *Home Bias and Market Integration in the EU*, CESifo Economic Studies, Vol. 55, 12009, 110-144.

3 See Pablo Hernández de Cos, *Thoughts on global financial stability and the European Capital Markets Union*, Annual Spanish Capital Markets Conference/AFME (Association for Financial Markets in Europe) and AEB (Spanish Banking Association), 13.02.2020.

4 See M. Hoffmann, E. Maslov, B.E. Sørensen and I. Stewen (2019), *Channels of Risk Sharing in the Eurozone - What Can Banking and Capital Market Union Achieve*, University of Houston.

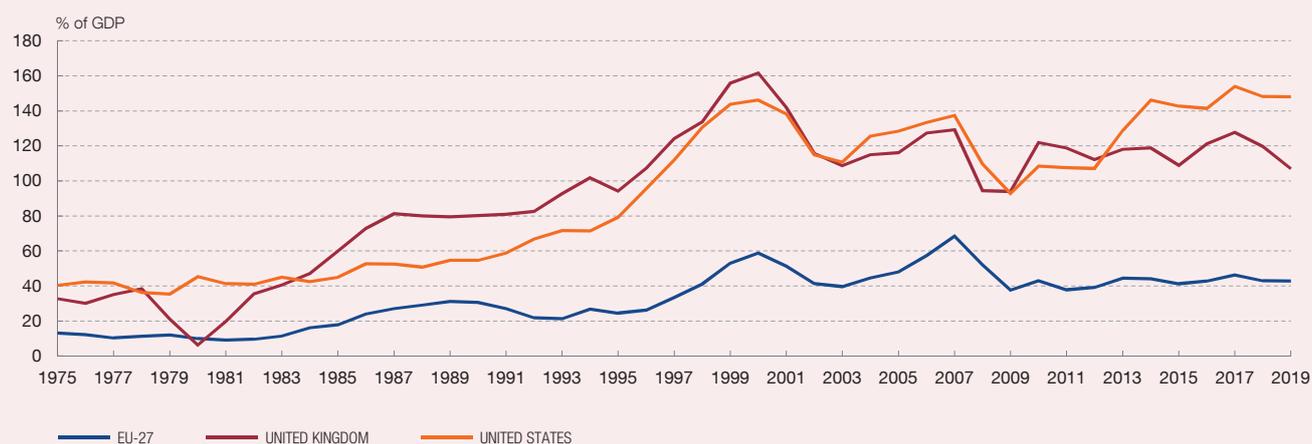
THE CAPITAL MARKETS UNION: NEW DEVELOPMENTS (cont'd)

innovation, where raising finance through the bank channel is sometimes difficult.⁵ Furthermore, in the context of the Banking Union, there is evidence that the presence of integrated capital markets is necessary to achieve efficient risk sharing when the economy faces supply shocks. Broadly speaking, these shocks have a first-order effect on the market value of assets, which can be better shared through cross-border ownership of private capital.⁶

With a view to achieving fully fledged capital markets in Europe, the European Commission's 2015 action plan was articulated around a series of priorities: supporting the financing of firms, particularly SMEs; fostering investment in sustainable projects and infrastructure; removing barriers to cross-border investment; and creating additional opportunities for savers and attracting

capital from outside the EU. Although the measures adopted under the plan represent a step towards building the CMU, this is a long-term objective and a long road lies ahead.⁷ The available indicators show that the EU's capital markets remain fragmented at the national level;⁸ the European non-financial sector is still considerably dependent on bank funding;⁹ and there is no robust upward trend in the proportion of mergers and acquisitions between firms in different EU member states, which remain below the levels seen prior to the financial crisis.¹⁰ In practice, financial integration in the euro area has faced its ups and downs, the latter chiefly being linked to the impact of the global financial crisis and the European sovereign debt crisis, as evidenced by the composite indicators formulated by the European Central Bank (see Chart 3).¹¹

Chart 2
STOCK MARKET CAPITALISATION-TO-GDP RATIO



SOURCES: ECB, Eurostat, World Bank and CEIC.

5 The differential aspects of such investment - including highly uncertain expected returns, a very protracted time horizon before projects are completed, and the predominance of intangible assets in the returns of these - mean that debt is often not the most suitable instrument for financing these initiatives and that innovative firms that exhaust their internal sources of financing have to resort to the capital markets to obtain the funds necessary to pursue these projects. For further details on the importance of capital markets in the financing of such projects, see Guindos (2020), *Capital markets union: the role of equity markets and sustainable finance*.

6 See J. Martínez, T. Philippon and M. Sihvonen (2019), *Does a Currency Union Need a Capital Market Union? Risk Sharing Via Banks and Markets*, NBER Working Paper No 26026.

7 See The Next CMU High-Level Group (2019). *Savings and Sustainable Investment Union*; CEPS-ECMI (2019). *Rebranding Capital Markets Union. A market finance action plan*; and New Financial (2019). *A New Sense of Urgency: The Future of Capital Markets Union*.

8 Capital market integration in the EU, measured using the composite cross-border finance indicator, barely improved in 2018. See AFME (2019). *Capital Markets Union – Key Performance Indicators*, second edition.

9 In 2018, 88% of non-financial corporations' new borrowing in the EU was raised from credit institutions and just 12% from capital markets. See AFME (2019).

10 See AFME (2019).

11 See ECB (2020). *Financial Integration and Structure in the Euro Area*.

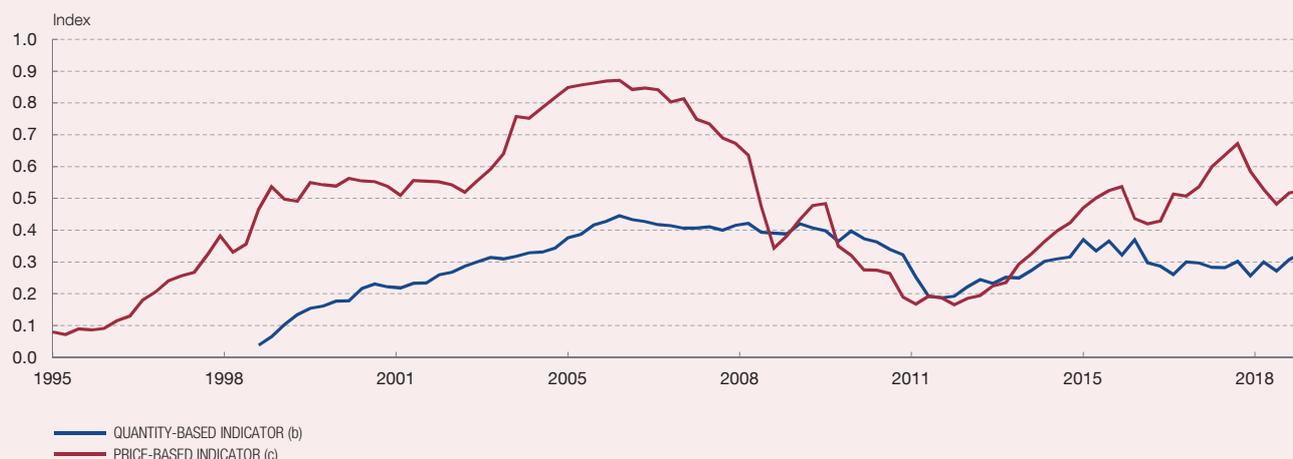
THE CAPITAL MARKETS UNION: NEW DEVELOPMENTS (cont'd)

Against this background, in late 2019 the Commission launched a High Level Forum with the aim of providing an up-to-date diagnosis and defining a set of key proposals to give new impetus to the CMU project. The Forum was composed of a broad group of experts whose recommendations were published in June 2020.¹² The report identifies 17 sets of measures - defined in a specific and granular approach - grouped into four clusters, as detailed in Figure 1: (i) channelling the supply of funds towards the capital markets, fostering saving and the engagement of end savers in the markets; (ii) satisfying demand for financing among firms, particularly SMEs, and facilitating their engagement in capital markets; (iii) developing pan-European market infrastructure; and (iv) driving cross-border integration, which includes some of the more controversial initiatives, such as harmonising withholding tax and insolvency

procedures, and shoring up Europe-wide financial market supervision.

The Commission plans to launch a new CMU action plan in the autumn of 2020, drawing largely on the recommendations of the High Level Forum.¹³ Some of the levers that can and must drive the CMU project forward are clearly identified in these recommendations:¹⁴ supervisory convergence and the eventual establishment of a single European supervisor; a focus on sustainable finance to cement Europe's global leadership in a segment with strong potential; improving securitisation regulations to boost banks' lending capacity; and supporting SME market-based funding and developing risk capital markets. Further, creating a European safe asset is essential to provide euro-denominated markets with the necessary depth. However, such an instrument, which would likewise be important in other dimensions, remains

Chart 3
INDICATORS OF FINANCIAL INTEGRATION IN THE EURO AREA (a)



SOURCE: ECB.

- a The integration indicators formulated by the ECB are composite indicators constructed using various indicators. Their value is limited to between zero (no integration) and one (full integration). For further details see P. Hoffmann, M. Kremer and S. Zaharia (2019), *Financial integration in Europe through the lens of composite indicators*, Working Paper Series, No 2319, ECB, September.
- b The quantity-based indicator is formulated using five indicators covering money, bond and equity markets.
- c The price-based indicator is formulated using ten indicators for money, bond, equity and retail banking markets.

12 See Final Report of the High Level Forum on the Capital Markets Union (2020). *A new Vision for Europe's capital markets*.

13 In the context of the response to the crisis stemming from the COVID-19 pandemic, in late July the Commission proposed to adopt a package of initiatives geared to facilitating the recapitalisation of firms, channelling investor funds towards the real sector and fostering securitisations by institutions. See *Coronavirus response: How the Capital Markets Union can support Europe's recovery*.

14 See K. Janse and R. Strauch, European Stability Mechanism Blog (22 June 2020). *Momentum builds for Europe's capital markets union*.

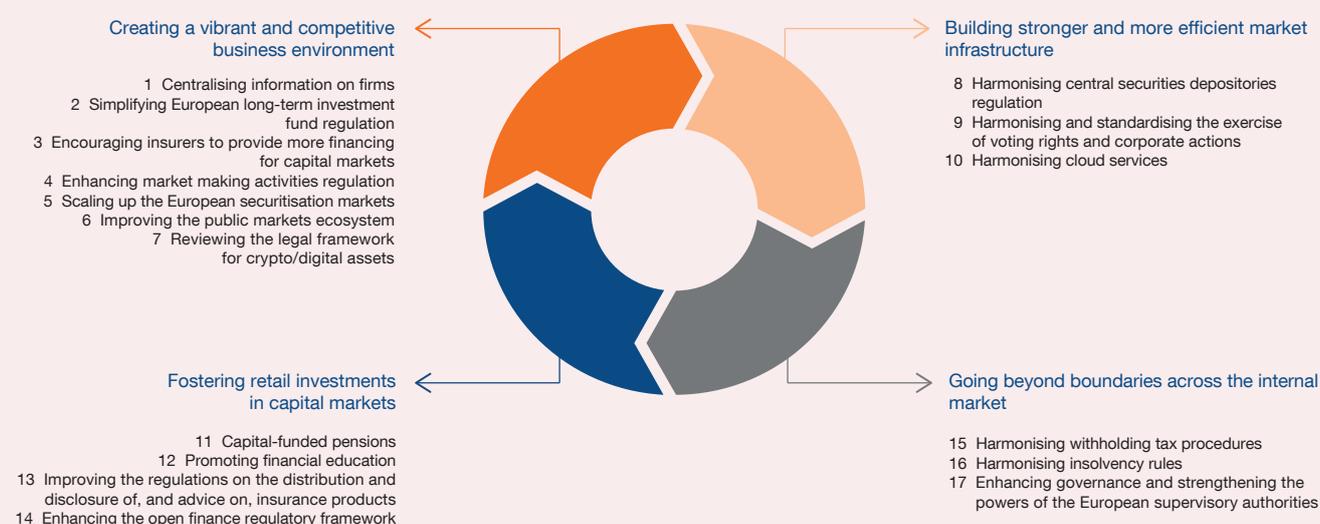
THE CAPITAL MARKETS UNION: NEW DEVELOPMENTS (cont'd)

beyond the scope of the Commission's project for the time being.¹⁵

More generally, it is important to note that building the CMU is a complex project that requires the adoption of measures and regulatory amendments in a wide variety of areas, and entails responsibilities not only at the EU level, but also - and critically - for each individual Member State. It is crucial that the various authorities concerned have the

political will to implement the required measures, transfer responsibilities and do away with red lines. The plan must also be ambitious enough to tackle the more controversial aspects and ensure that the proposed initiatives are clearly interconnected. In short, to avoid a piecemeal approach and the loss of momentum, the utmost political ambition must be mobilised to overcome the barriers that have blocked the CMU's construction for decades.

Figure 1
SUMMARY OF THE RECOMMENDATIONS OF THE HIGH LEVEL FORUM ON THE CAPITAL MARKETS UNION (a)



SOURCE: Banco de España.

a Based on the final report of the High Level Forum on the Capital Markets Union, *A new vision for Europe's capital markets*.

¹⁵ See Pablo Hernández de Cos (2019), *The EMU at 20: from divergence to resilience*, Welcome address, Third Annual Research Conference of the Banco de España.

NEXT GENERATION EU: MAIN CHARACTERISTICS AND IMPACT OF ITS ANNOUNCEMENT ON FINANCIAL CONDITIONS

This early-release box was published on 3 September

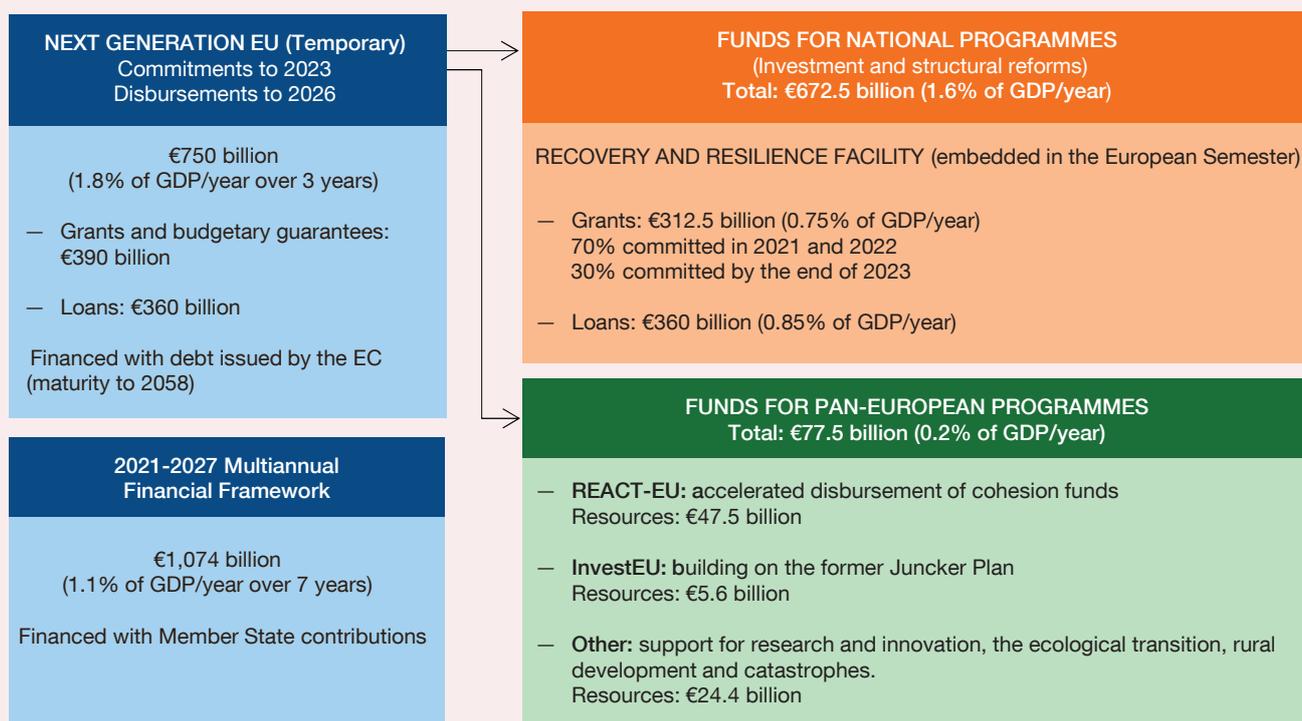
At its meeting of 17-21 July, the European Council agreed to create Next Generation EU, a temporary recovery fund additional to the multiannual budget of the European Union (EU) for 2021-2027. Unlike the multiannual budget, which is funded through contributions by Member States and some common taxes, the new fund will be financed through debt issuance on capital markets by the European Commission (EC). Up to €750 billion will be issuable between 2021 and 2026. The funds will be used to tackle the consequences of the COVID-19 crisis and to accelerate the digital and green transitions of the European economy (see Figure 1). It is envisaged that the fund will grant direct transfers to the Member States (42% of the total), finance pan-European programmes (around 10% of the total) and, if necessary, grant bilateral loans to countries (the remaining 48%). Debt issued by the EC under the framework of this fund will be repaid from 2028 and up to 2058. To this end, the possibility of providing the Commission with a number of new own

resources is envisaged (in particular, through digital and environmental taxes).

To access these resources, Member States will be required to design “recovery and resilience plans” that will be evaluated by the EC. These plans must be in compliance with the specific recommendations drawn up by the EC for each country in the context of the European Semester.¹ Also, investments included in these plans must follow the general EU budget criteria. Thus, in aggregate terms, 30% of the funds are to be allocated to environmental sustainability enhancement projects.

In accordance with the draft agreement available, the legal expenditure commitments relating to the projects included in Next Generation EU are to be made by 31 December 2023 and related payments will be made by 31 December 2026.² Specifically, 70% of direct transfers to Member States must be committed in 2021-2022, with an

Figure 1
MAIN CHARACTERISTICS OF THE EU'S RECOVERY PLAN



SOURCES: European Council and devised by authors.

1 See P. García-Perea, A. Millaruelo, V. Mora-Bajén and M. Sánchez Carretero (2020), “The 2020 European Semester and the specific recommendations for Spain”, Economic Notes, 3/2020, Banco de España.

2 The EC estimates that most transfers will be made between 2022 and 2025 (see COM (2020) 408 final).

NEXT GENERATION EU: MAIN CHARACTERISTICS AND IMPACT OF ITS ANNOUNCEMENT ON FINANCIAL CONDITIONS (cont'd)

allocation key between countries that depends on the unemployment rate recorded between 2015 and 2019, population and per capita income. The remaining 30% must be committed by end-2023. The allocation key will be amended to incorporate more directly the uneven impact of the health crisis. Thus, the unemployment rate will be replaced by a variable that will weigh, in equal proportion, the fall in GDP in 2020 and the cumulative loss in GDP in 2020-2021.

This instrument, which expands supra-national debt and incorporates a fiscal risk-sharing element, is a very important step in European integration. According to the historical experience available, the steps taken to press ahead institutionally both in the EU and in the euro area tend to bring about positive effects on the financial markets and, in particular, on the sovereign risk premia,³ which tend to decline as these agreements are perceived as a guarantee of continuity and further strengthening of the European project. Also, in the long term, a more extensive supra-national debt market could promote greater banking and capital markets integration at

European level, as there is a common and secure reference for all countries.

To quantify the impact of the various announcements linked to the new recovery fund on the euro area's financial markets, we present an event-study exercise, focusing on the stock and sovereign debt markets. This methodology consists of calculating the variation experienced by certain financial indicators within narrow time windows around the time a specific event is announced or takes place. Thus, the intention is to isolate the impact of the event from other possible factors that might also influence the financial indicators, such as economic or, in the current setting, epidemiological news. Specifically, the three most important milestones linked to the discussions leading up to the agreement to set up the recovery fund are considered for this exercise, namely: i) The Franco-German proposal of 18 May, ii) the EC proposal of 27 May, and iii) the announcement of the European Council agreement on 21 July. For these three events, time windows of a few hours around the moment when each announcement was made are set and intraday

Chart 1
CHANGE IN STOCK MARKET INDICES AND IMPLIED VOLATILITY (a)

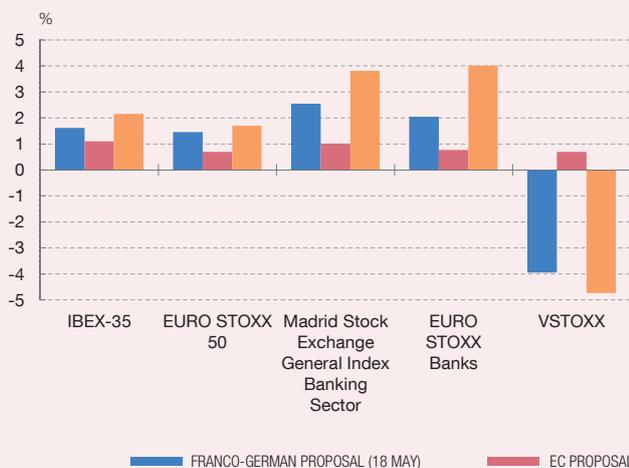
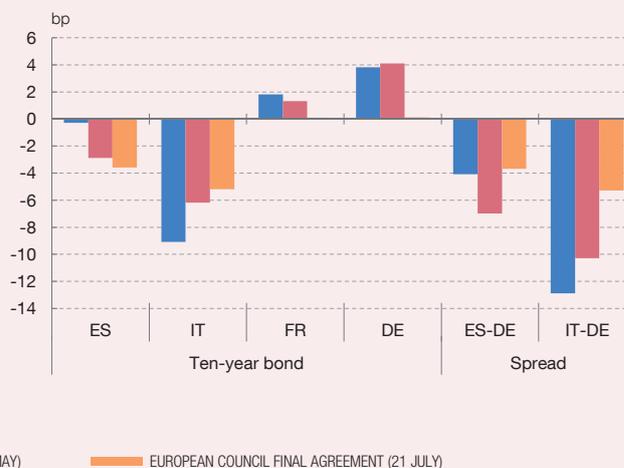


Chart 2
CHANGE IN YIELD ON SOVEREIGN DEBT (a)



SOURCE: Thomson Reuters Eikon.

a For the 18 May event, the window's starting time was set 30 minutes prior to the meeting between the French and German leaders at 15:30, which was followed by a press conference at which they announced their joint proposal. The close of the bond markets (19:00) on the same day was set as the end of window. The window for the 27 May event, lasting 4 hours, starts at 11:00, a few minutes before some details of the European Commission's proposal were published by a media outlet. The 21 July agreement was announced in the early hours of the morning. Therefore, the window used runs from the close of the markets on 20 July to 12:00 the following day.

3 See I. Kataryniuk, V. Mora-Bajén and J.J. Pérez. (2020), "EU deepening and sovereign debt spreads: how relevant is the "political space"?", Working Paper, Banco de España, forthcoming.

data are used to calculate the variation in the financial indicators within such windows.⁴

Charts 1 and 2 contain the results of this exercise. According to Chart 1, the three announcements had a positive impact on the European stock markets, somewhat higher on the Spanish index (IBEX-35) than on the European index (EURO STOXX 50). The increases were higher for the respective bank sub-indices than for the general indices. The European Council's final agreement prompted the highest stock market appreciations, as regards both bank sub-indices (3.8% and 4% in the Spanish banks index and in EURO STOXX Banks, respectively) and in the general indices (2.2% and 1.7% in the IBEX-35 and EURO STOXX 50 indices, respectively) followed closely by the Franco-German proposal. The effect of the EC proposal was more limited. Also, stock market volatility in the euro area, measured with the VSTOXX index, declined substantially as a result of both the final agreement and the Franco-German proposal (down 4.8% and 4%, respectively), while it hardly changed with the EC proposal.

The three events also had a significant impact on the sovereign debt markets (see Chart 2). In the case of Spain, the ten-year sovereign bond yield and its spread over the German ten-year Bund yield decreased appreciably following the European Council's final agreement (with

declines of nearly 4 basis points (bp) in the two variables) and the EC proposal (3 bp and 7 bp, respectively). The Franco-German proposal reduced the spread by 4 bp but had a negligible effect on the yield. In the case of Italy, the Franco-German proposal was the event with the greatest impact on the ten-year bond yield and on its spread over the German bond (down 9 bp and 13 bp, respectively), followed by the EC proposal (with falls of 6 bp and 10 bp, respectively); the effect of the European Council's final agreement was somewhat more limited (a decline of 5 bp in both variables). The yields on German and French bonds increased slightly in response to the EC proposal (by 1 bp and 4 bp, respectively) and to the Franco-German proposal (by almost 4 bp and 2 bp, respectively),⁵ while the effect of the final agreement on the two indicators was negligible.

In short, based on the analysis conducted in this box, the most relevant milestones leading to the European Council agreement of 21 July for the creation of the recovery fund Next Generation EU have had a positive effect on the euro area stock markets and have led to an easing of the financing conditions of the Italian and Spanish Treasuries. This positive reaction of the financial markets suggests that investors interpreted that the creation of a fund with such characteristics would boost growth in the euro area and strengthen the common European project.

4 See the footnote to Charts 1 and 2 for further information on the time windows chosen. The difficulty in establishing the exact moment when the information was sufficiently disseminated in the financial markets suggests the need to use several-hour windows, so as to capture market reaction to the event. However, this implies that market performance might also be affected by other contemporaneous events.

5 The increase in the yield on the French and, mainly German, sovereign bonds could be due to investors' higher appetite for risk a result of the announcements, in line with the stock market price appreciations.

THE SPANISH CORPORATE DEBT MARKET DURING THE COVID-19 CRISIS

This early-release box was published on 7 September

The COVID-19 crisis has triggered substantial macrofinancial effects, both globally and on the Spanish economy. These have had a considerable impact on the supply and demand conditions in funding markets, especially in those to which non-financial corporations (NFCs) resort. For instance, demand for funds in these markets has risen owing to the increase in liquidity shortages arising as a result of the sharp drop in corporations' revenue. On the supply side, risk perception is higher. This tends to result in a tightening of the conditions to access these markets, although this effect could be mitigated by the various measures implemented by the economic authorities geared towards encouraging the supply of funding. These include the state funding guarantee schemes, asset purchases and the extraordinary provision of financing by central banks.¹

This box analyses developments in the Spanish corporate debt market during the COVID-19 crisis in order to identify the degree to which Spanish firms are covering their financing needs in these markets and the conditions under which they have raised these funds.² In this connection, it bears clarifying that, broadly speaking, firms can cover their financing needs by resorting to bank credit or by issuing debt securities in capital markets. The latter, which is mainly used by larger firms, has gained in relative importance in Spain and in other countries over recent years.³

Chart 1 shows that between end-February and end-March the financing costs of Spanish NFCs in capital markets surged. This was a widespread phenomenon across international financial markets. This development

Chart 1
INTEREST RATES ON NFCs' BONDS (a)



Chart 2
DISTRIBUTION OF OUTSTANDING AMOUNTS AS AT 31 JULY 2020 OF DEBT SECURITIES ISSUED BY NFCs BY CREDIT RATING



SOURCES: Banco de España, Dealogic and Bloomberg Data License.

- a To calculate the yields on bonds, a daily average of the yields on these securities was calculated, weighted by outstanding balance (distinguishing between investment grade and high yield). The analysis was also confined to securities with a maturity of between 3 and 10 years in order to use a relatively consistent group of assets. Further limiting the range of maturities would result in a very short list of high-yield bonds. This would lead to a sample with scant prices that is highly sensitive to the inclusion of newly issued securities or to the exclusion of those that mature. Nonetheless, the chart shows a sharp drop in the return on high-yield bonds at end-2019, as this series is obtained using just over 30 securities, owing to their low weight in the Spanish corporate debt market.
- b Corresponding to the transport and storage, accommodation and food services, entertainment and motor vehicle sectors.

1 For further information on these measures, see Banco de España (2020), Annual Report 2019, Chapter 3, "The role of economic policies internationally in the face of the pandemic". In the case of the euro area, noteworthy among the measures adopted is the launch of the ECB's pandemic emergency purchase programme, with an initial envelope of up to €750 billion, subsequently increased to €1,350 billion.

2 For an analysis of bank finance granted to firms during the COVID-19 crisis, see Banco de España (2020), Annual Report 2019, Box 4.3, "Developments in bank finance for productive activities in the context of the COVID-19 crisis".

3 See Banco de España (2017), Annual Report 2016, Chapter 2, "Financing and investment decisions of Spanish non-financial corporations".

THE SPANISH CORPORATE DEBT MARKET DURING THE COVID-19 CRISIS (cont'd)

was the result of investors' reduced willingness to invest in this type of asset amid growing concern for default risks. As tends to be the case in these episodes, the tightening of financial conditions was more pronounced in the high-yield bond segment (which includes issues by firms with poor creditworthiness) than in the investment-grade bond segment (better creditworthiness). During the subsequent months, the conditions for access to financing in these markets gradually improved, in both Spain and the international markets. This was driven by the economic authorities' swift action. Despite this improvement, in mid-August financing costs still stood above the pre-COVID-19 crisis levels, around 25 bp higher in the case of investment-grade bonds and around 300 bp in the case of high-yield bonds.

Chart 2 shows the distribution of the outstanding amounts⁴ of the debt securities issued by Spanish NFCs by credit rating before and after the outbreak of the pandemic (28 February and 31 July, respectively).⁵ In the chart, a slight shift towards poorer credit ratings can be observed (in particular, the increased weight of the BBB category). Downgrades have affected 9.4% of the outstanding amount. Of this change, 5.6 pp related to downgrades within the investment-grade category (BBB- or higher), 2.8 pp to downgrades within the high-yield category and 1 pp to a downgrade from investment grade to high yield. In the sectors most affected by the epidemic, the downgrades were concentrated within the high-yield category, whereas in the other sectors the downgrades affected to a greater degree securities that were initially assigned to the investment-grade category.

Following these changes, the bulk of the outstanding amount remains in the investment-grade category (80%, 1 pp less than pre-pandemic). Yet the weight of the two categories closest to the high-yield group (BBB and BBB-) has risen 5 pp to account for 64% of the total at end-July. This increase is explained mainly by the rating downgrades of firms operating in sectors least affected by the pandemic since, as stated above, among the firms operating in the most affected sectors the downgrades were concentrated in securities that were already categorised as high yield

pre-health crisis. Naturally, the securities in the BBB and BBB- categories are potentially the most exposed to additional future downgrades that would leave them in the high-yield category. This change usually entails a potentially substantial worsening of the conditions under which their issuers can access funding in these markets owing to, among other factors, many investors (such as some investment funds or the Eurosystem itself under its asset purchase programmes) not being authorised to purchase assets rated below investment grade.

Chart 3 shows the trend in volumes issued by Spanish NFCs in debt securities markets since January 2019. In March 2020, in line with the tightening of financial conditions in these markets, a sharp drop in gross issuance was recorded. Thus, in March net issuance (gross issuance less redemptions) was negative, totalling the lowest amount since February 2014. However, in line with the improvement in financing conditions in recent months, from April there was a substantial recovery in activity in primary markets for corporate bonds. As a result, net issuance was once again positive, although the volumes issued had decreased at the end of the period analysed. In cumulative terms, gross issuance between March and July amounted to more than €39 billion, giving rise to net fund-raising of €4 billion. These figures are lower than the €43 billion and €11 billion, respectively, recorded in the same period of 2019.

The breakdown of gross issuance by security (see Chart 4) also reveals the trend in the corporate debt market during the pandemic. Initially, in March practically all transactions related to commercial paper (almost €3 billion), which generally poses lower credit risk to holders since it is a short-term financial asset. Subsequently, the situation in the market normalised thanks to the implementation of various measures geared towards improving corporate financing and from April NFCs replaced short-term financing (via commercial paper) with longer-term financing (via medium- and long-term bonds). This change arose despite the support for the issuance of commercial paper provided by the additional state funding guarantee scheme⁶ and the inclusion of non-financial commercial

4 To prepare this chart the outstanding amounts of each firm's debt securities were considered at a set date (31 July 2020) in order to ensure that changes in the distribution of the issuers' creditworthiness reflected changes in their ratings rather than in the issues or redemptions potentially realised between the two dates considered.

5 The sectors most affected by the health crisis are: transport and storage, accommodation and food service activities, entertainment and motor vehicles. Each firm is assigned to the sector of the financial group to which it belongs.

6 At its meeting on 5 May 2020, the Council of Ministers approved additional resources of €4 billion charged to the ICO guarantee facility to guarantee commercial paper issued by NFCs based in Spain in the alternative fixed income market (MARF by its Spanish abbreviation).

THE SPANISH CORPORATE DEBT MARKET DURING THE COVID-19 CRISIS (cont'd)

paper of sufficient credit quality in the list of eligible assets under the ECB’s corporate sector purchase programme. The increase in the relative weight of medium- and long-term securities during recent months, which has also resulted in a slight increase in the weighted average maturity of the issues, is a positive development since these securities have a lower refinancing risk for the issuers compared with commercial paper as repayment takes place over a longer period. Nonetheless, between March and July 2020, the amount issued via medium- and long-term bonds (around €16 billion) was

somewhat lower than that recorded in the same period of 2019 (€17 billion).

Chart 5 shows the breakdown of gross issuance by distinguishing between firms operating in the sectors most or least affected by the COVID-19 crisis. First, we observe that the resort to debt securities markets by the firms most affected by the pandemic was already comparatively very low pre-outbreak (barely accounting for 14% of gross issuance between January 2019 and February 2020). This is because the firms most affected

Chart 3
ISSUANCE AND REDEMPTIONS OF DEBT SECURITIES BY NFCs (a)

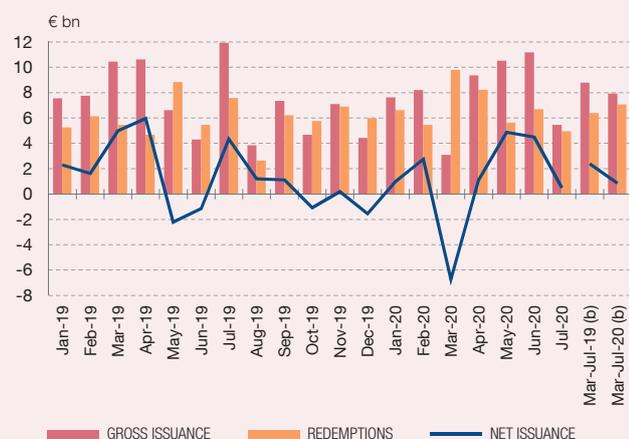


Chart 4
GROSS ISSUANCE. BREAKDOWN BY SECURITY (a)

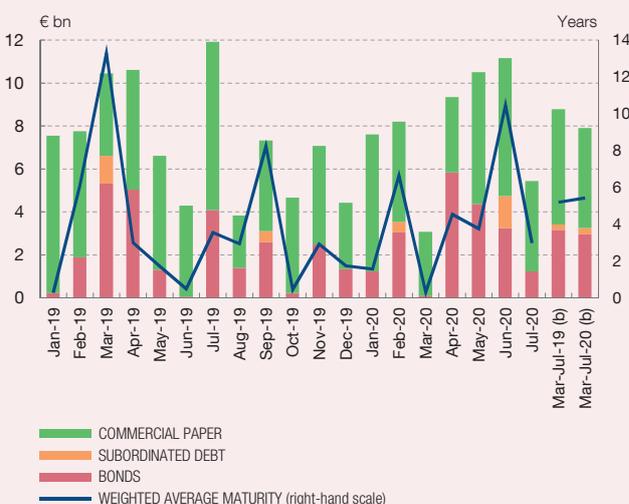


Chart 5
GROSS ISSUANCE. BREAKDOWN BY SECTOR (a)

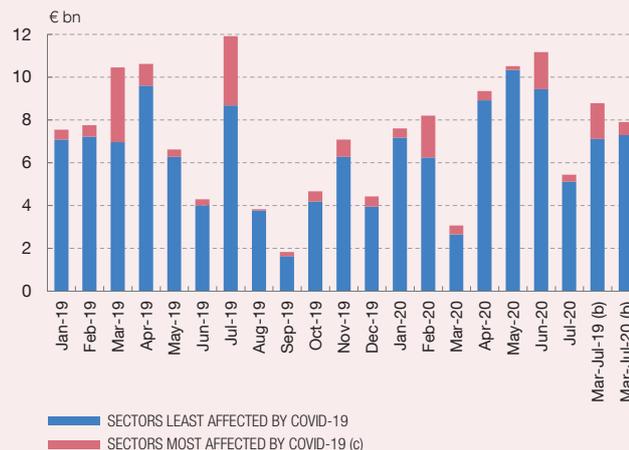


Chart 6
GROSS ISSUANCE. BREAKDOWN BY SIZE OF FIRM (a)



SOURCES: Banco de España, Dealogic and Bloomberg Data License.

- a Including issues abroad by non-resident subsidiaries.
- b Monthly averages for the period.
- c Corresponding to the transport and storage, accommodation and food services, entertainment and motor vehicle sectors.
- d A firm is deemed large if the outstanding amount of the total of its issues is above the 75th percentile of this variable’s distribution.

by this shock are on average comparatively smaller than the others are. This limits their possibilities of accessing capital markets, even in normal conditions. In the wake of the pandemic, the relative weight of the issues completed by firms operating in the most affected sectors has fallen to represent less than 8% of the total. In terms of volume, the cumulative issues by these firms between March and July 2020 decreased 63% compared with the same period of 2019, versus a 2.5% increase in the issues by the other firms. The most affected firms' reduced resort to the debt securities markets during recent months, despite the more pronounced relative increase in their financing needs,⁷ would partially reflect these firms having replaced somewhat their sources of financing, against a backdrop in which the conditions for accessing these markets tightened. In particular, these firms were able to access bank financing under more favourable conditions because of the government's state funding guarantee scheme for a maximum amount of €140 billion. Indeed, the smallest firms and those from the most affected sectors are those that have used this scheme the most.⁸

Lastly, Chart 6 shows the breakdown of the issues by firm size, approximated by the outstanding amount of the debt issued. In the wake of the pandemic, the relative weight of completed issues by larger firms (approximated as the 25% of firms with the largest outstanding amount) has risen by more than 4 pp compared with the same period of 2019. These firms also accumulate 78% of the completed issues. This outcome, which has also been observed in other international markets,⁹ could be a result of smaller firms' conditions for accessing these

markets worsening to a greater extent due to them being perceived as riskier because they are less diversified owing to their smaller size or are concentrated to a greater degree in the sectors most affected by the pandemic. In addition, these firms tend to provide less financial information to potential investors. Indeed, a larger proportion of completed issues by these firms lacks a credit rating. Amid a high level of uncertainty, this could have discouraged investors from acquiring these securities. Furthermore, the lower relative weight of completed issues by smaller firms could also reflect the replacement of their sources of financing, owing to more favourable conditions for accessing bank credit thanks to the state funding guarantee scheme.

In summary, the evidence presented in this box shows that, following the sharp initial tightening of the conditions for Spanish NFCs to access debt securities markets at the outbreak of the COVID-19 pandemic, financing costs tended to decline gradually. This prompted an increase in issuance. However, funding raised by firms in these markets in the months since the outbreak of the health crisis is somewhat lower than pre-pandemic levels. The credit rating of the outstanding amount of these issues also appears to have been downgraded slightly. These developments, together with a strong pick-up in bank credit extended to NFCs, indicate that although the resort to debt securities markets appears to have continued to contribute to covering Spanish firms' financing needs, it has done so less than in the past. This is especially so in the case of those firms operating in the sectors most affected by the pandemic.

7 See R. Blanco, S. Mayordomo, A. Menéndez and M. Mulino (2020), *Spanish non-financial corporations' liquidity needs and solvency after the COVID-19 shock*, Occasional Paper No 2020, Banco de España.

8 For more details on the loans benefiting from the state guarantees, see Banco de España (2020), *Annual Report 2019*, Box 4.3, "Developments in bank finance for productive activities in the context of the COVID-19 crisis".

9 See T. Goel and J.M. Serena (2020), "Bonds and syndicated loans during the Covid-19 crisis: decoupled again?" *BIS Bulletin* No 29.

THE RECOVERY OF EMPLOYMENT IN RECENT MONTHS FROM A PROVINCIAL AND SECTORAL STANDPOINT

This early-release box was published on 10 September

By August, average Social Security registrations had increased by somewhat more than 330,000 (around 1.8%) from the low recorded in April. Although job creation has been higher than usual in these months (for instance, Social Security registrations rose by 0.3% during the same period in 2019), only 42% of the employment lost between February and April has been recovered.¹ Thus, in August registrations were still 2.4% lower than in February, and 2.8% below the level a year earlier.

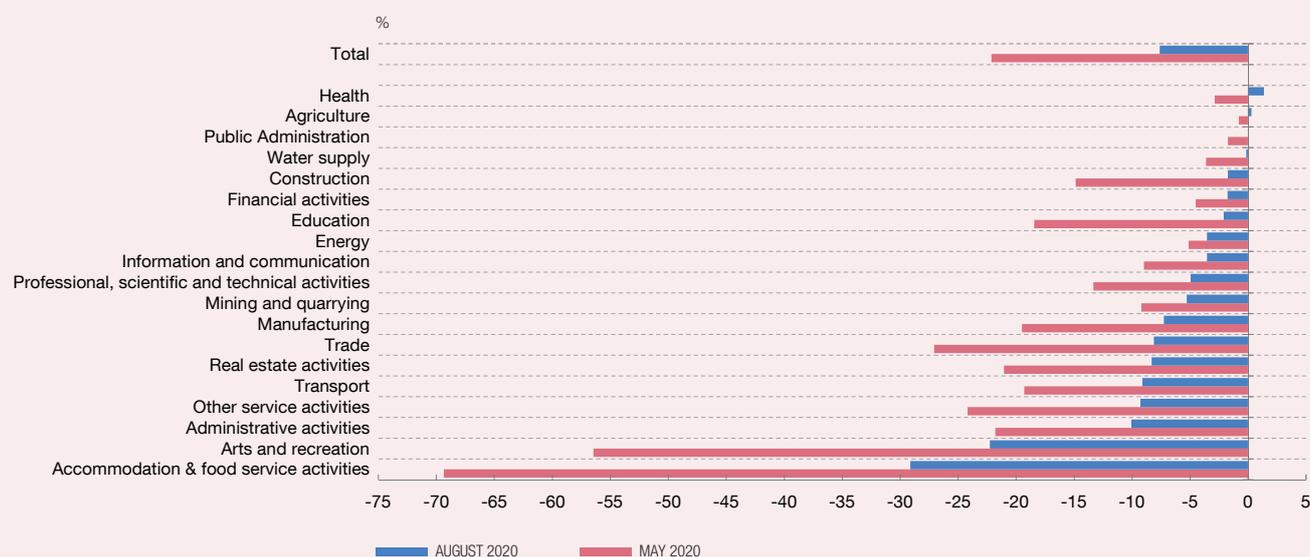
The intensity of the adjustment of employment during the months of lockdown and the subsequent recovery are more clearly seen when recent changes in the number of workers on furlough are considered. This number has declined from the almost 3.2 million recorded on average in May (somewhat more than 17% of total Social Security registrations) to 894,478 on average in August. As a result of this decline of more than 70%, actual registrations (calculated as total registrations minus the number of workers on furlough) recovered sharply during the summer months, from a year-on-year decrease of more than 20% in May to a drop of 7.4% in August.

The monthly Social Security registrations profile evidences that most of the recovery in employment from the record lows of April was concentrated in July and August, once the vast majority of the restrictions in force during the different stages of the lockdown easing plan implemented in May and June were lifted. However, according to daily Social Security registration data for the second half of August, the recovery path is petering out somewhat. This could be related to the different measures adopted in certain regions owing to the worsening of the health crisis.

In recent months, the recovery of employment has, however, been very uneven by sector and province. Chart 1 shows the year-on-year rate of change in actual Social Security registrations by activity. Although the recovery from the record lows posted in May is across the board, sectoral dispersion is high. In general in August, market services were farther from their level of employment a year earlier than the industrial sector and, especially, construction.

Although employment in market services has recovered considerably in recent months, actual Social Security

Chart 1
ACTUAL SOCIAL SECURITY REGISTRATIONS BY SECTOR OF ACTIVITY
Year-on-year rate of change in actual Social Security registrations (a)



SOURCES: Banco de España and Ministerio de Inclusión, Seguridad Social y Migraciones.

a Actual Social Security registrations: total registrations less workers on furlough.

1 Using average monthly data.

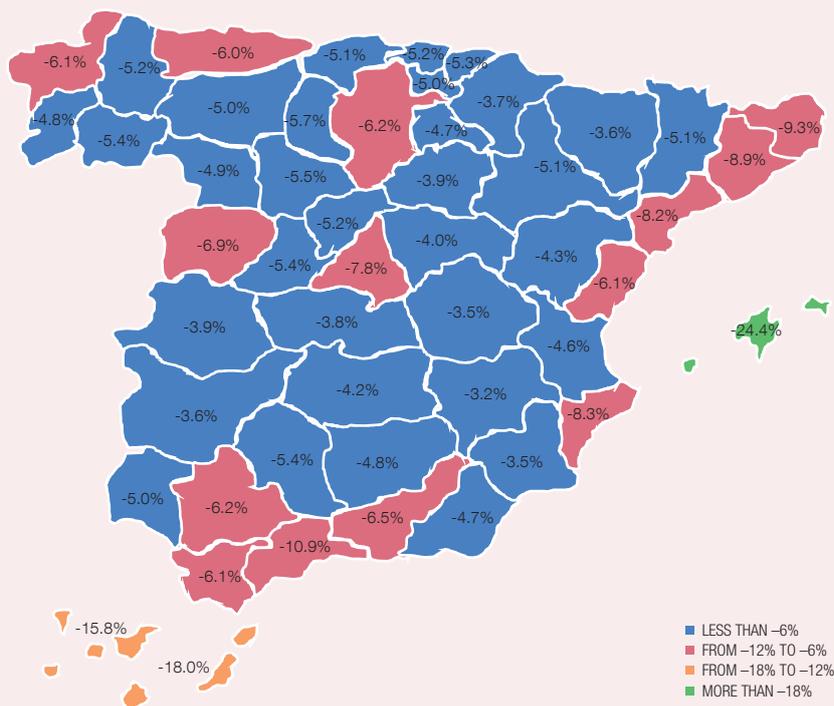
THE RECOVERY OF EMPLOYMENT IN RECENT MONTHS FROM A PROVINCIAL AND SECTORAL STANDPOINT (cont'd)

registrations in August were still nearly 12% below the level a year earlier. In this segment, the steepest year-on-year declines in August were observed in accommodation and food services (-29.1%). However, this sector has recovered sharply since May, when the year-on-year decline in employment was nearly 70%, owing to the closure of many activities in the sector as a result of the measures deployed to contain the pandemic. At a more disaggregated level, it is noteworthy that the level of employment in some of the activities more directly related to tourism, such as travel agency activities, accommodation services and air transport services, was around half that posted a year earlier.² In all other market services, the difference from the level of employment in August 2019 remained at around 10% in certain main sub-sectors, such as retail trade and transport. Only in some of the sectors less affected by the fall in employment in the spring, such as financial activities, was actual

employment in August closer to the level observed in the same period in 2019 (-1.8%). Lastly, in the case of non-market services, only in education was job destruction in March and April comparable to that observed in market services. Employment in education was down 18.4% in May, but following a recent sharp recovery it was down just 2.1% in August. Also in August, Social Security registrations in health services and public administration were both slightly higher than a year earlier.

Industrial sector employment has generally performed more favourably than services sector employment, but it has also been considerably uneven across sectors. Thus, for example, in recent months employment has been quite dynamic in motor vehicle manufacturing, where actual Social Security registrations fell by 7.3% in August compared with -35% in May, and in pharmaceutical products manufacturing, where employment was not

Chart 2
YEAR-ON-YEAR RATES OF CHANGE IN ACTUAL SOCIAL SECURITY REGISTRATIONS IN AUGUST 2020 (a)



SOURCES: Banco de España and Ministerio de Inclusión, Seguridad Social y Migraciones.

a Actual Social Security registrations: total registrations less workers on furlough.

2 For further details on the performance of the tourism sector in Spain in recent months, see Box 8, "Recent developments in inbound tourism in Spain".

THE RECOVERY OF EMPLOYMENT IN RECENT MONTHS FROM A PROVINCIAL AND SECTORAL STANDPOINT (cont'd)

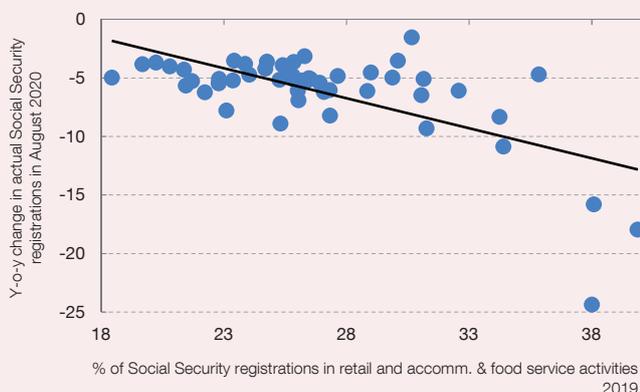
affected by the months of lockdown and in August stood 0.8% above its August 2019 level. By contrast, in other sectors such as clothing manufacturing or the leather industry, employment in August was still more than 15% below its level a year earlier.

Chart 2 shows that, in recent months, employment has also been very uneven across provinces. In general, in the provinces along Spain’s Mediterranean coast, in Madrid, and especially in the Balearic and Canary Islands, the contraction in employment in year-on-year terms was much higher in August than that seen in the inland

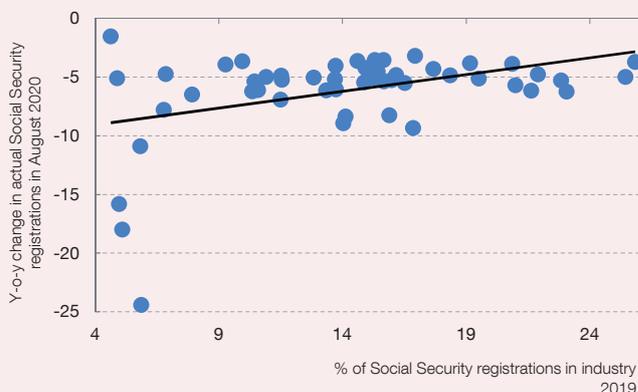
provinces. Accordingly, despite the recovery observed following the lows recorded in May, when employment fell in year-on-year terms by more than 40% in the Balearic Islands and by more than 30% in the two provinces of the Canary Islands, in August actual Social Security registrations were still below their August 2019 levels (24.4% lower in the Balearic Islands and 18% and 15.8% lower, respectively, in Las Palmas and Santa Cruz de Tenerife). The year-on-year declines are lower – albeit close to 10% – in other Mediterranean provinces such as Málaga, Gerona, Barcelona and Alicante. By contrast, in some of the inland provinces such as Cuenca, Albacete,

Chart 3
ACTUAL SOCIAL SECURITY REGISTRATIONS AND SECTORIAL STRUCTURE BY PROVINCE

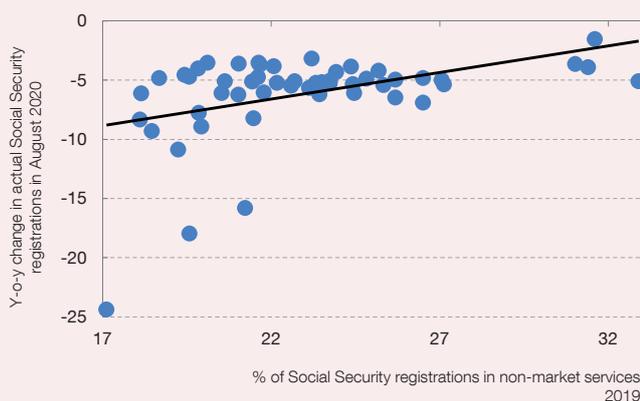
1 RELATIONSHIP BETWEEN ACTUAL SOCIAL SECURITY REGISTRATIONS AND SPECIALISATION IN RETAIL AND ACCOMM. & FOOD SERVICE ACTIVITIES (a) (b)



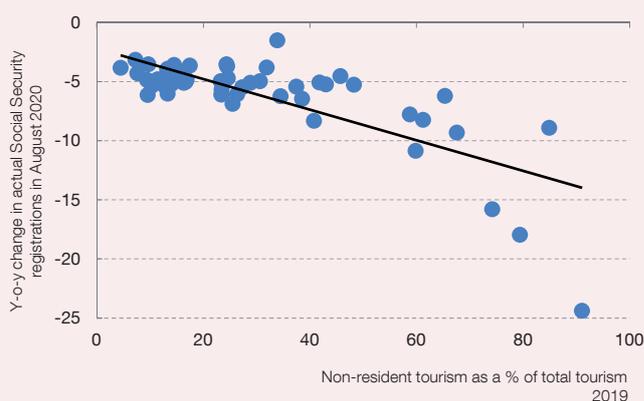
2 RELATIONSHIP BETWEEN ACTUAL SOCIAL SECURITY REGISTRATIONS AND SPECIALISATION IN INDUSTRY (a) (b)



3 RELATIONSHIP BETWEEN ACTUAL SOCIAL SECURITY REGISTRATIONS AND SPECIALISATION IN NON-MARKET SERVICES (a) (b)



4 RELATIONSHIP BETWEEN ACTUAL SOCIAL SECURITY REGISTRATIONS AND WEIGHT OF NON-RESIDENT TOURISM (a) (c)



SOURCES: Banco de España and Ministerio de Inclusión, Seguridad Social y Migraciones.

- a Actual Social Security registrations: total registrations less workers on furlough.
- b Specialisation in each sector is measured as the weight of the corresponding sector in the average total employment in each province in 2019.
- c The weight of non-resident tourism is calculated as overnight stays by non-residents as a percentage of total overnight stays in each province in August 2019, drawing on the Hotel Occupancy Survey (INE).

THE RECOVERY OF EMPLOYMENT IN RECENT MONTHS FROM A PROVINCIAL AND SECTORAL STANDPOINT (cont'd)

Badajoz or Huesca, actual Social Security registrations fell by around 3% year-on-year in August.

This heterogeneity in employment patterns across provinces is largely explained by cross-provincial differences in sectoral structure. Thus, as Chart 3 shows, in August the year-on-year decline in employment was greater in the provinces in which both retail and

accommodation and food services – sectors that were severely affected by the restrictions on mobility during lockdown and whose activity levels have still not been able to recover to the same extent as in other productive sectors – as well as non-resident tourism account for a higher share of their total tourist activity,³ with a lower share of activity for both the industrial sector and non-market services.

³ Calculated as overnight stays by non-residents in August 2020 as a percentage of total overnight stays registered in the month, on data from the Hotel Occupancy Survey of the Spanish National Statistics Institute (INE).

RECENT DEVELOPMENTS IN INBOUND TOURISM IN SPAIN

This early-release box was published on 9 September

In Spain, exports of travel services accounted for 5.6% of GDP and 16% of total exports of goods and services in 2018. These percentages are much higher than those observed in the main euro area economies, except for Portugal and Greece (see Chart 1). The Spanish economy is therefore particularly sensitive to this sector's performance, in terms of both activity and net external balance (within which the travel surplus exceeded 3% of GDP in 2019).

This box describes the latest developments in inbound tourism in Spain,¹ after the historic collapse recorded in 2020 Q2 as a result of the COVID-19 pandemic.² Naturally, they have been heavily influenced by the health crisis's course and by the measures deployed to contain it, with two clearly distinct phases in recent months.

At end-June and in early July, after a few weeks where the epidemiological situation in Spain and in most other European countries had shown clear signs of improvement, the restrictions imposed on international movement when the virus's incidence was at its highest were eased.³ This enabled the gradual resumption of inbound tourism in Spain. The foregoing is evidenced by various high frequency indicators including most notably those approximating passenger traffic at Spanish airports, spending in Spain using credit cards issued abroad, and internet searches for holidays in Spain from our main inbound tourism markets,⁴ such as the United Kingdom (see Charts 2-4).

The monthly frequency indicators typically used to monitor inbound tourism's situation, only available to July, also point to an improvement in activity levels in that month. However, they still remained very low (see Charts 5 and 6). For instance, drawing on data from the Inbound Tourism Survey (Frontur by its Spanish abbreviation), the year-on-year rate of contraction in foreign tourist arrivals moderated to 75% in July, compared with a rate of almost

98% in June. As expected, this recovery in tourist arrivals was underpinned mainly by tourists from neighbouring countries (who can enter the country more readily by road, without needing to resort to shared means of transport in order to travel) and by those with their own residence in Spain (or, more generally, those who do not pay monetary consideration for their accommodation).⁵ Indeed, while arrivals of French tourists diminished 58% year-on-year, those of tourists from the United Kingdom, who are more dependent on air transport, declined by 83%.

Similarly, the Hotel Occupancy Survey recorded a smaller year-on-year contraction in overnight hotel stays by non-residents in July (-86%) than in the three previous months (in which practically no overnight stays were recorded). However, the decline was still very significant. Across the main inbound tourism markets, the drops were, once again, steepest in the case of tourists from the United Kingdom (-91.4%). Lastly, the Tourism Expenditure Survey (Egatur by its Spanish abbreviation) points to a similar trend, with a decline in expenditure by inbound tourists of close to 80% year-on-year in July, following a drop of -98.6% in June. This contraction reflected both the aforementioned fall in tourist arrivals and the drop in their average daily expenditure (23.3%), countering the slight increase (of 0.6 days, to 8.1 days) in average stay.

Consequently, the gradual recovery of inbound tourism following the reopening of borders has been very limited. Moreover, as the summer progressed, this trend was curtailed by the worsening of the health crisis in our country. Thus, in response to the steady rise in the number of COVID-19 infections detected in Spain from mid-July, many countries established new restrictions for individuals travelling from Spain or from one of its regions. The limitations imposed by our main inbound tourism markets notably included the quarantine established on 26 July by the United Kingdom for all individuals travelling from

1 In this box, inbound tourism refers to tourism by non-residents in Spain. This box does not address developments in recent months in domestic tourism, i.e. that by residents in Spain. Nonetheless, according to the latest available information, the performance of this segment of the sector in this period appears to have been more favourable than that observed for inbound tourism. For instance, in July overnight hotel stays by residents declined year-on-year by 50%, versus an 85.7% drop in the case of non-residents.

2 For further details, see Banco de España (2020), *Annual Report 2019*, Box 4.1, "The Spanish tourism sector: recent performance, outlook and implications for the economy".

3 For instance, Spain reopened its borders to the 26 Schengen countries on 21 June (except for Portugal, the reopening was delayed until 1 July) and to another 12 countries (Australia, Canada, South Korea, Japan, Georgia, Montenegro, New Zealand, Rwanda, Serbia, Thailand, Tunisia and Uruguay) on 4 July.

4 It is necessary to state that the more flexible cancellation policies adopted by travel agencies and hotels, amid a high level of uncertainty surrounding the pandemic's course, mean that internet travel searches and bookings are not as sound a leading indicator of tourism activity as pre-epidemic.

5 While tourist arrivals by road fell 52.8% year-on-year in July, arrivals by air contracted 79.7%. In turn, arrivals of tourists using non-market accommodation performed better than those of tourists staying at hotels (year-on-year drops of 50.2% and 82.3%, respectively).

RECENT DEVELOPMENTS IN INBOUND TOURISM IN SPAIN (cont'd)

Chart 1
WEIGHT OF INBOUND TOURISM (2018)



Chart 2
AIR TRAFFIC AT SPANISH AIRPORTS
Year-on-year rates of change (seven-day moving average)



Chart 3
FOREIGN CREDIT CARD SPENDING
Year-on-year rates of change (seven-day moving average)



Chart 4
TOURISM SEARCHES ON GOOGLE FOR HOLIDAYS IN SPAIN
Inbound market: United Kingdom

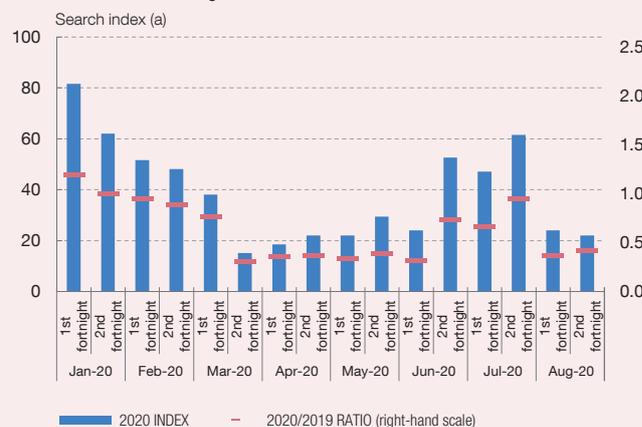


Chart 5
SPAIN: INBOUND TOURISM INDICATORS BY MAIN INBOUND MARKETS
Year-on-year rates in June 2020

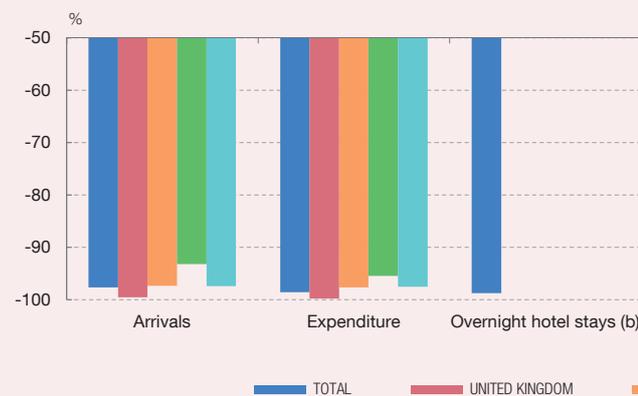
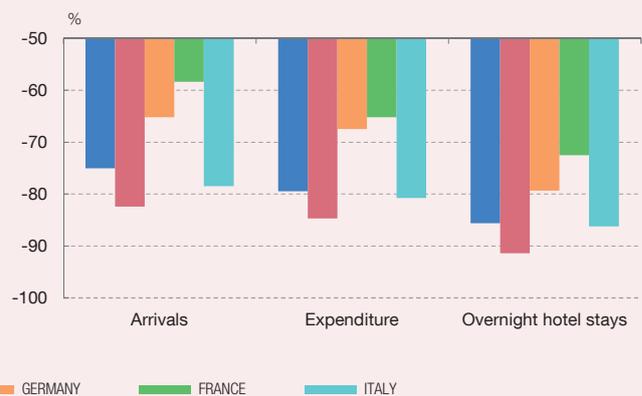


Chart 6
SPAIN: INBOUND TOURISM INDICATORS BY MAIN INBOUND MARKETS
Year-on-year rates in July 2020



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

- a A value of 100 indicates the searches' peak popularity.
- b Owing to the exceptional situation triggered by the COVID-19 pandemic, the Hotel Occupancy Survey did not provide an international breakdown of the overnight stays in its data for June.

RECENT DEVELOPMENTS IN INBOUND TOURISM IN SPAIN (cont'd)

Spain, and the mandatory testing imposed by Germany on all those arriving in the country from a large number of Spanish regions, with the obligation to remain in quarantine at least until they had received the results of such tests.⁶ In any event, according to the latest information provided by the Ministry of Foreign Affairs, European Union and Cooperation, the majority of EU and non-EU countries have established some movement restrictions on individuals travelling from Spain.⁷

Naturally, these new restrictions (and the recommendations not to travel to Spain) have had, and will foreseeably continue to have, a severe impact on the flows of inbound visitors. In addition, the fact that the Spanish authorities have again imposed certain limitations on capacity and activity in the leisure and food service sectors (of varying degree depending on the region and its epidemiological situation) could have an additional deterrent effect on tourism demand. In any case, it has already been observed that, in response to the new restrictions adopted by the countries providing tourists, some of the main tour operators have cancelled their scheduled trips to Spain, mainly those involving air travel. Moreover, the same high frequency indicators that evidenced some recovery of inbound tourism to Spain at end-June and in early July, showed a stagnating (and in some cases, reversed) trend from end-July (see Charts 2-4). In this connection, tourist industry sources have pointed to a decline in international bookings and an increase in cancellations in recent weeks, which would confirm the changing trend in this sector. These negative developments are causing a

substantial proportion of hotels to close before the end of the season, mostly in destinations that rely heavily on inbound tourism, and have led to a further worsening of the outlook for the Spanish tourism sector.⁸

In summary, inbound tourism's incipient recovery in Spain at end-June and the beginning of July appears to have been cut short in August, the month when inbound tourism expenditure typically records its annual peak, as a result of the worsening of the health crisis in recent weeks. Taking into account inbound tourism's importance to the Spanish economy and that, according to the latest World Tourism Organization scenarios,⁹ international tourist numbers returning to pre-health crisis levels before 2022 does not seem feasible, it would be desirable for the economic policies adopted in relation to this sector to combine elements mitigating the pronounced loss of income in the short term with stimuli encouraging the structural changes whose need had already been identified pre-COVID-19. Among other matters, the sector's digitalisation and human capital must be strengthened and the sustainability of tourism destinations, especially coastal destinations, boosted in order to improve the tourism experience through a more varied and less crowded offering, thereby providing better quality services. Such progress would help consolidate inbound tourism's diversification towards markets – such as the US, China and the Scandinavian countries – and segments – e.g. urban tourism and business tourism – with higher average expenditure. This diversification process was already under way before the health crisis.

6 On 8 August, Germany imposed these measures on individuals travelling from Catalonia, Aragon and Navarre, extending them to people travelling from Madrid and the Basque Country four days later, and subsequently, to other regions. The last region to which this measure was applied was the Canary Islands, on 2 September. Additionally, from mid-September, the German authorities will no longer provide tests for returning tourists, who will be subject to a mandatory quarantine.

7 Within the EU, the only countries that have not imposed such restrictions are France, Croatia, Bulgaria, Portugal, Sweden and Luxembourg. However, France has issued a recommendation not to travel to Catalonia and Aragon.

8 See Exceltur (2020), *Revisión del impacto del Covid 19 sobre el sector turístico español*, August.

9 See <https://www.unwto.org/news/covid-19-international-tourist-numbers-could-fall-60-80-in-2020>.

THE MACROECONOMIC IMPACT OF THE NEXT GENERATION EU PROGRAMME UNDER VARIOUS ALTERNATIVE SCENARIOS

In late July, the European Council agreed to create Next Generation EU (NGEU), a temporary recovery fund to address the consequences of the COVID-19 crisis and accelerate the digital and green transition of the European economy.¹ The fund will be financed through debt issuances by the European Commission (EC). Drawing on the government's preliminary estimates, the maximum volume of resources that Spain might receive from the fund between 2021 and 2026 would amount to €140 billion (12.6% of GDP estimated for 2020),² of which 47% would be in the form of direct grants and the remainder via loans. To access these resources, the Government will have to submit, before the end of the year, a "recovery and resilience plan" whose coherence with the EC's specific recommendations for Spain will have to be assessed by the EC.

The European Council agreement does not explicitly define certain important aspects of the new stimulus programme, such as the composition of the expenditure that each country will be able to undertake using the resources obtained, the timing of project implementation and fund disbursement or the conditions of the loans. The specifics of these aspects are not inconsequential, as the scale of the programme's macroeconomic effects will rely crucially on their final form.

This box presents an initial approximation of the potential effects on the Spanish economy based on various assumptions regarding the main determinants of that impact. These main determinants largely coincide with those aspects of the programme that are yet to be clarified and over which there is considerable uncertainty. Specifically, four sources of uncertainty are considered: the amount of funds to be disbursed, the schedule for project implementation (and how this corresponds to the schedule for receipt of the funds), how the resources received will be distributed between grants and loans, and the type of projects to which the resources will be allocated.

Moreover, even if precise details of the foregoing aspects were available, there is an additional important source of uncertainty in terms of how the scale of the macroeconomic impact of the stimulus will be measured. This is because the economic literature, to date, has only been able to estimate with considerable imprecision the "fiscal multiplier" of each public expenditure category (consumption, investment or benefits), defined as the percentage increase of GDP obtained from an increment of 1 pp of GDP in each of these expenditure items.

A further element of uncertainty as to the magnitude of the effects - not covered in this box - is the lack of any recent historical precedents for programmes entailing such a large-scale mobilisation of resources within the EU. This makes it harder to quantify the possible synergies deriving from the simultaneous implementation of a very extensive series of major projects in the various Member States, as it appears will happen as a result of NGEU.³ One notable aspect in this connection is the favourable impact to be expected on the functioning of European capital markets, stemming from the very significant increase in the volume of high credit quality assets available in the EU owing to the supranational issuances made under the framework of the various European programmes launched in response to COVID-19.⁴

Regarding the first of the above-mentioned four aspects of the fund that are yet to be clearly defined - the amount to be disbursed - it is important to set in context the sheer scale of the resources that the NGEU programme could potentially make available to Spain. Specifically, the portion taking the form of grants would alone approximately triple the entire general government's capital expenditure in 2019. Given the large scale of the funds and the short time frame allowed to the various national governments to set out their projects, it is possible that some countries will not mobilise all the funds potentially allocated to them. In view of this first source of uncertainty, the simulation exercises

1 The details of the programme are described in Box 5 ("Next Generation EU: Main characteristics and impact of its announcement on financial conditions").

2 The 2020 GDP estimate has been calculated as the average of the estimates under the two scenarios considered in Box 1 of this report.

3 For analysis of the potential synergies between expansionary monetary and budgetary policies and structural reforms in respect of a monetary union, see O. Arce, S. Hurtado and C. Thomas (2016) "Policy Spillovers and Synergies in a Monetary Union", *International Journal of Central Banking*, vol 12 No. 3: 219-277.

4 Overall, if the full resources envisaged in the European programmes launched in the wake of the COVID-19 crisis are brought to bear, supranational debt could increase over the next five years by some €1,300 billion, doubling the outstanding debt of European organisations. From the standpoint of total safe assets, including national sovereign debt, the increase would be of approximately one third. See M. Delgado-Téllez, I. Kataryniuk, F. López-Vicente and J. J. Pérez (2020). "Supranational debt and financing needs in the European Union", Occasional Papers No 2021, Banco de España.

THE MACROECONOMIC IMPACT OF THE NEXT GENERATION EU PROGRAMME UNDER VARIOUS ALTERNATIVE SCENARIOS (cont'd)

show the macroeconomic impact of a fiscal impulse of a standardised amount, which is identical in all cases. Specifically, for illustrative purposes, the simulations presented in this box are based on a stimulus of a size arbitrarily set at €10 billion (0.9% of GDP forecast for 2020).

Regarding the second of the aforementioned aspects, concerning the schedule for project implementation and receipt of the funds, the programme establishes that, once the projects are submitted and approved, the fund disbursement commitments shall be made before end-2023, whereas the payments would be made with a lag and in phases through to the end of 2026. Bearing this in mind, the simulation exercises performed in this box factor in two different assumptions regarding the project implementation schedule.

On the one hand, the scenarios constructed based on the “early implementation” assumption envisage the impetus to activity deriving from the NGEU programme being concentrated over the next three years (2021-2023), in keeping with the stipulation in the agreement that 70% of the resources be committed before the end of 2022 and the remaining 30% in 2023. Therefore, in the early implementation simulations, it is assumed that 70% of the standardised expenditure amount is implemented in equal parts in 2021 and 2022 (i.e. €3.5 billion each year). Applying the commitments schedule is equivalent to assuming that the Spanish general government will advance a portion of the allocated resources, as is often the case with existing European structural and investment funds (one example being the ERDF), meaning that project implementation and its impact on agents’ expenditure decisions would approximate the commitments schedule.

Conversely, in the scenarios that include the “late implementation” assumption, it is assumed that project implementation follows the payments schedule for the EU as a whole included in the EC proposal of 27 May. Assuming a consistent schedule for all countries, Spain would receive

approximately 6% of the funds in 2021 and an identical percentage in 2026, 18% in 2022 and 2025, and 26% in 2023 and 2024. Based on the standardised amount of €10 billion, this means expenditure would amount to €0.6 billion in 2021 and €1.8 billion in 2022 (peaking at just over €2.5 billion in each of the subsequent two years).

As for the third aspect - the distribution of the funds between direct grants and loans - it should be noted that direct grants have a greater impact on activity. Looking ahead, Spain will have to repay all the amounts that it receives in the form of loans. In the case of grants, it will have to contribute towards funding the European debt generated by the grants received by all the countries, in a proportion equal to its contribution to the resources that the EU allocates in European budgets to the repayment of that debt.⁵ That said, Spain would benefit in net terms from the portion of funds provided as grants, since its share in these would exceed its future contribution. In the near term, the expenditure financed through grants would be balanced in books by an income item of a matching amount, meaning the impact on the deficit is nil. By contrast, the balancing entry of expenditure financed with loans is an increase in debt, which would lead to a deficit increase.

In any event, even if the loans are less attractive than the grants as a result, they are nevertheless useful insofar as the related cost is lower than that of Spanish sovereign debt issuances with the same term.⁶ In light of these considerations regarding the macroeconomic impact of the funds provided via the two instruments, and given the uncertainty about how they will be distributed, the simulations envisage two alternative assumptions as to the form in which the funds will be received (“grants” and “loans”), assuming that Spain receives a normalised amount of €10 billion in either one form or the other.

Lastly, there is considerable uncertainty as to the type of projects that will qualify for the European funds,⁷ in addition, as mentioned, to the uncertainty over the fiscal

5 The envisaged time frame for debt repayment is between 2028 and 2058. In any event, it is not clear what portion of that debt that will have to be financed through national contributions (which, in theory, would have to be based on the gross national income of each country), since the European Council has urged the European Commission to establish new pan-European taxes, which might be used to repay the debt. Consequently, Spain’s participation in the EU budget multiplied by the volume of the grants received by all of the countries gives a higher amount than Spain will have to finance in the 30-year period that begins in 2028.

6 No indications as to the terms and conditions of the loans have been announced. That said, if the applicable interest rate were that used for issuances by the EU, the cost, based on historical experience, could be approximately 50 bp below the issuance costs of the Spanish Treasury. See M. Delgado-Téllez, I. Kataryniuk, F. López-Vicente and J. J. Pérez (2020). *Supranational debt and financing needs in the European Union*, Occasional Papers No 2021, Banco de España.

7 Although one of the objectives of the NGEU agreement signed by the European Council is to foster medium and long-term growth, no restriction has been set as to the type of spending to be carried out.

THE MACROECONOMIC IMPACT OF THE NEXT GENERATION EU PROGRAMME UNDER VARIOUS ALTERNATIVE SCENARIOS (cont'd)

multiplier to be applied to the amount used in each case. Both the theoretical models and the empirical evidence available suggest that public investment expenditure has a larger and more enduring impact on activity than that of spending in other areas, such as government consumption or transfers to households.⁸ This is, inter alia, because in addition to increasing demand for goods in the short term (as occurs in other cases), public investment also helps to expand the economy's productive capital stock and, therefore, to support medium and long-term growth.⁹ In any event, the timing of the impact of public investment on activity hinges on the nature of the projects receiving the investment. For instance, although the effects of R&D expenditure are higher over a sufficiently lengthy time frame, they may take longer to materialise than with other public investment projects.

To incorporate these sources of uncertainty, a scenario has been considered whereby the normalised amount of €10 billion is used entirely for public investment projects ("public investment" scenario), together with another in which these funds are used to finance current expenditure on government consumption and benefits ("current expenditure" scenario). Moreover, in each of these scenarios, the estimated impact is presented in the form of a range, in recognition of the uncertainty over the size of the fiscal multiplier for each type of project.

Given all these considerations, Table 1 shows, using the Quarterly Macroeconometric Model of the Banco de España,¹⁰ the impact on the Spanish economy (in terms of GDP and public debt) that would derive from a fiscal stimulus equivalent to €10 billion under the different

Table 1
MACROECONOMIC EFFECTS OF THE NEXT GENERATION EU PROGRAMME UNDER VARIOUS ALTERNATIVE ASSUMPTIONS
Impact on GDP and public debt in 2021-2022 of a standardised fiscal impulse of €10 billion (a)

Percentage differences in level

	GDP		Public debt	
	2021	2022	2021	2022
Exercise 1: "early implementation" + "grants" + "public investment"	0.19 – 0.3	0.21 – 0.35	-0.22 – -0.35	-0.35 – -0.57
Exercise 2: "late implementation" + "grants" + "public investment"	0.02 – 0.04	0.08 – 0.13	-0.03 – -0.05	-0.1 – -0.18
Exercise 3: "early implementation" + "loans" + "public investment"	0.14 – 0.27	0.15 – 0.29	-0.1 – -0.2	-0.09 – -0.18
Exercise 4: "early implementation" + "grants" + "current expenditure"	0.06 – 0.09	0.12 – 0.19	-0.07 – -0.11	-0.18 – -0.29

SOURCE: Banco de España.

a Range of intervals under two alternative assumptions on the multiplier effect of public investment expenditure (0.8 and 1.3) and of expenditure on grants and public consumption (0.4 and 0.7). Under the early implementation assumption, the €10 billion fiscal impulse would consist of increased expenditure of €3.5 billion in 2021 and 2022 and of €3 billion in 2023, whereas under the late implementation assumption it would consist of increased expenditure of €0.6 billion in 2021 and 2026, of €1.8 billion in 2022 and 2025 and of €2.6 billion in 2023 and 2024.

8 Indeed, the consensus reached by virtually all empirical evidence is that the medium-term public investment multiplier effect would be higher than 1, whereas that of spending on government consumption or benefits would be less than 1. See V. Ramey (2019), *Ten Years After the Financial Crisis: What Have We Learned from the Renaissance in Fiscal Research?*, Journal of Economic Perspectives, Vol. 33(2), pp 89-114, for a review of the existing evidence. Nevertheless, the estimates are subject to a particularly high degree of uncertainty. Thus, for instance, A. Abiad et al. (2016), *The macroeconomic effects of public investment: Evidence from advanced economies*, Journal of Macroeconomics 50: 224-240, estimates a public investment multiplier of 1.4 after four years for a group of advanced economies. Further, the estimated value could nearly double if the investment is made in highly efficient projects or during periods of low economic growth. Conversely, other studies find that, in the short term, the public investment multiplier may possibly not exceed a value of 0.6, especially in the case of short-run fiscal stimuli (see M. Alloza and C. Sanz (2020), *Jobs Multipliers: Evidence from a Large Fiscal Stimulus in Spain*, forthcoming in the Scandinavian Journal of Economics).

9 This multiplier effect largely depends on the degree of complementarity between public and private investment. See Box 5.2 of the Annual Report 2020 of the Banco de España for a detailed analysis of the channels through which public investment supports medium and long-term growth. One of the channels accounting for the high public investment multiplier, even in the short term, rests on the idea that, as it is more powerful in the medium and long term, rational agents consider it in their decisions.

10 See A. Arencibia, S. Hurtado, M. de Luis and E. Ortega (2017), *New version of the Quarterly Model of Banco de España (MTBE)*, Occasional Paper No 1709, Banco de España. In this exercise, it is assumed that public investment has a multiplier effect on GDP of between 0.8 and 1.3 after three years, compared with between 0.4 and 0.7 in the case of other expenditure items.

THE MACROECONOMIC IMPACT OF THE NEXT GENERATION EU PROGRAMME UNDER VARIOUS ALTERNATIVE SCENARIOS (cont'd)

scenarios described above. These scenarios have been constructed by combining different assumptions on the various sources of uncertainty set out. The findings are presented up to 2022, which is the last year in the horizon of the macroeconomic scenarios included in Box 1 of this report. In any event, the effects would also extend to subsequent years, more so naturally in the simulation using the “late implementation” assumption, as in that case spending would continue until 2026.

Exercise 1 considers the scenario in which the ingredients of the NGEU result in the combination most conducive to economic growth over the projection horizon: “early implementation”, “grants” and “public investment”. Specifically, as explained previously, the “early implementation” assumption is based on applying the commitments schedule, resulting in 35% of the normalised amount of spending (i.e. €3.5 billion) being made in 2021, with an identical amount in 2022. Considering this assumption, together with those relating to the form in which the funds are received (grants) and the use thereof (public investment), the fiscal stimulus would increase Spanish GDP by between 0.2 pp and 0.3 pp on average over the coming two years. This increased growth would also lead to a significant improvement in public finances.

Exercise 2 is the same as exercise 1, except in that it considers a more protracted implementation of the projects (“late implementation” scenario). As mentioned, the payment schedule is used in this assumption, with the result that 6% of the normalised amount of spending (€0.6 billion) is made in 2021, followed by a further 18% (€1.8 billion) in 2022. In this case, and assuming the full implementation timetable, the maximum effect on GDP of the fiscal impulse considered would not arise until 2024; consequently, the total cumulative impact of the stimulus on growth and improvement in public finances in the 2021-2022 horizon would be much lower than that estimated in exercise 1.

Exercise 3 shows the macroeconomic impact of the loan facilities included in the NGEU programme. This is

founded on the same assumptions as those in exercise 1, but considering the European funds in the form of loans rather than grants. According to the corresponding simulation, the impact on GDP of this stimulus would only be slightly lower than that obtained using the assumptions for exercise 1. However, as the additional spending would be recorded as general government deficit, the improvement in public finances would be considerably more modest.

Lastly, exercise 4 illustrates the importance of selecting projects that have a greater expansionary effect on the economy. In particular, the assumptions considered in this exercise are the same as those used in exercise 1 except, in this case, that the funds would not be used to finance productive public investment projects, but rather for other spending (“current expenditure” scenario). Under these assumptions, the rise in GDP would be less than half of that under exercise 1. As a result, the improvement in public finances would also be more modest.

In short, drawing on the analysis set out in this box, given the potential volume of funds that could be mobilised, the NGEU programme has the capacity to become a major element of support for Spanish economic recovery in the aftermath of the impact of COVID-19. As the exercises above show, maximising these effects hinges on a relatively broad set of factors. On the one hand, the capacity to carry out new projects must be developed to ensure that - ideally - the bulk of the programme’s funds are not used to finance expenditure that would have been incurred in any event. Moreover, early design and implementation of these projects would have a greater effect on activity in the short term, which should be conducive to a more robust recovery of the Spanish economy, following the harsh impact of the pandemic in 2020 as a whole. However, it is also crucial that the selection of these projects maximises their impact on economic activity and public finances; this would be fostered by structuring the distribution of the funds around a plan designed to strengthen the long-term growth of the Spanish economy.

2 INTERNATIONAL FINANCIAL MARKETS

International financial market performance has been generally positive in Q3 to date, albeit with a certain degree of heterogeneity across countries and segments, depending on the course of the health crisis

International financial markets have been influenced by various factors in Q3.

Economic policies introduced to mitigate the impact of the COVID-19 pandemic on activity and boost economic recovery have continued to support financial asset valuations. Monetary policy has remained accommodative in the main areas, reinforced in the case of the United States by the change in the strategy of the Federal Reserve that will permit temporary inflation deviations over the average 2% target (see Box 2). In addition, in the fiscal sphere, in July the European Council approved the launch of the European recovery plan that will mobilise funds totalling €750 billion. The announcement of this measure had a positive impact on valuations in the main financial markets (see Box 5). Also, global capital markets were influenced by the release of various economic activity indicators (which gave mixed signals on the recovery under way), by developments in the health crisis (with significant fresh outbreaks of infection in some countries and different expectations regarding the possibility of a vaccine), and more sporadically by certain geopolitical factors (such as the tension between China and the United States and the growing uncertainty surrounding Brexit).

Global stock markets have risen in general, most notably in the United States

(see Chart 2.1). The S&P 500 posted new all-time highs in Q3, up 7.7% compared with end-June at the cut-off date of this report. In Europe, stock prices have risen more moderately, influenced among other factors by the worsening of the health crisis in recent weeks. At the cut-off date, the EURO STOXX 50 was up 2.4% compared with end-June, but the performance was very uneven across countries. Thus, while in Spain the IBEX-35 fell 3.2% in the period, in Germany the DAX rose by 7.3%.

The overall stock market performance conceals high cross-sectoral differences.

In the case of the EURO STOXX 50, the sectors posting the highest gains since end-June are automobiles (13.5%) and tourism (8.4%).³ The gains on the S&P 500 have been led by stock prices in more cyclical sectors, such as consumer discretionary and, until their recent correction, by the big tech stocks. The banking sector has continued to underperform in all areas, affected by expectations of

³ Stock prices in these sectors have recovered, after falling sharply in previous months. In any event, high cross-country differences are observed. Thus, for example, the Madrid Stock Exchange tourism sector index is down in Q3 to date.

Chart 2

RIISING STOCK MARKETS, RELATIVELY STABLE HIGH-QUALITY SOVEREIGN YIELDS, FALLING EURO AREA SOVEREIGN RISK PREMIA AND US DOLLAR DEPRECIATION

In the quarter to date, global stock markets have risen in general, most notably in the United States, but stock price moves have been very uneven across countries and sectors. High-quality sovereign yields tended to decline, especially in the United States, until early August when this pattern began to reverse. Sovereign debt risk premia in the euro area have continued to fall and the US dollar has depreciated.

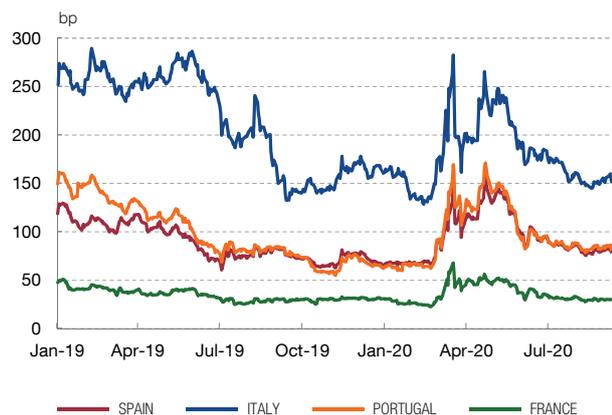
1 STOCK MARKET INDICES



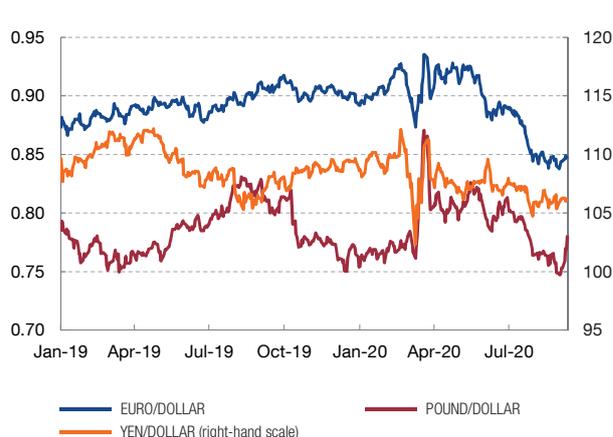
2 10-YEAR SOVEREIGN BOND YIELDS



3 EURO AREA SOVEREIGN SPREADS



4 BILATERAL EXCHANGE RATES AGAINST THE DOLLAR



SOURCE: Refinitiv Datastream.

interest rates remaining lower for longer and by the negative market perception of the impact the pandemic could have on banks' asset quality.

High-quality sovereign bond yields declined until early August and then rose again, while both euro area sovereign risk and corporate risk premia fell throughout the quarter. On 4 August, US 5-year sovereign bond yields reached an all-time low (0.5%), while 10-year sovereign yields recorded their second ever lowest value. Since then, both have recovered, overtaking the levels recorded at end-June

(see Chart 2.2). German sovereign debt yields have performed similarly, albeit without reaching all-time lows, falling in July and then subsequently recovering. In turn, Spanish and Italian 10-year sovereign spreads over the German benchmark have narrowed in Q3 to date, by 15 and 29 basis points (bp) respectively, to 12 bp and 22 bp above the low recorded at the start of the year (see Chart 2.3), supported among other factors by the monetary stimulus measures (in particular, the PEPP) and by the agreement on the EU recovery fund. Corporate credit risk spreads have also narrowed in Q3, in a setting in which investors have shown greater risk tolerance and central banks have continued to make large-scale corporate debt purchases.

In the foreign exchange markets, the dollar has depreciated considerably (see Chart 2.4), against a backdrop of high exchange rate volatility, while the price of gold has reached all-time highs. The US dollar depreciation was concentrated in July and may, among other factors, have been due to the accommodative monetary policy stance in the United States and declining market concern for global risks. In August dollar depreciation moderated, although it increased again after the Federal Reserve announced a change in strategy on 27 August and has moved more erratically since then. Against this backdrop, the price of gold reached all-time highs in early August, possibly influenced by the weakness of the US dollar and by the lower yields on other safe assets such as US and German sovereign debt.

3 EXTERNAL ENVIRONMENT OF THE SPANISH ECONOMY

3.1 External environment of the euro area

The gradual recovery in global activity has been uneven across regions and sectors, influenced by the trade-off between reactivating the economy and controlling the pandemic. Recently, the number of infections has risen in several countries and some indicators point to activity being less buoyant than the trends observed at the end of Q2

The pandemic continues to spread globally, although the easing of containment measures in the vast majority of countries has prompted a slight recovery in global economic activity. As countries began to lift the lockdowns in May, global economic activity rebounded somewhat, albeit from very low levels and unevenly across regions and productive sectors. Moreover, the pace of recovery has been influenced by the trade-off between reactivating the economy and controlling the spread of infections, in a setting of heightened uncertainty. In Q3, the number of infections has risen in various countries, mainly in Asian (South Korea and Japan) and European countries, while the pandemic has continued to spread in certain emerging economies, such as India. In the Americas, especially in the United States and Brazil, a gradual drop in new infections has been observed since end-July, although the numbers remain high (See Charts 3.1 and 3.2).

The latest economic indicators have shown a very slight recovery of consumption and investment in the main advanced economies. After several months in which the restrictions on movement led to a decrease in household spending, the easing of such measures has prompted a rise in the demand for goods, especially durables such as vehicles and small household appliances. That said, private consumption has only rebounded partially, in the absence of a full recovery of the labour markets. In the case of services, progress has been even more limited, given the high degree of uncertainty undermining consumer confidence and the continued social distancing measures. A high degree of uncertainty has also influenced firms' investment and employment decisions. In this respect, the rising number of infections in some economies since July has curtailed the recovery of purchasing managers' indices (particularly in the services sector), which had returned to close to pre-health crisis levels (see Chart 3.3).

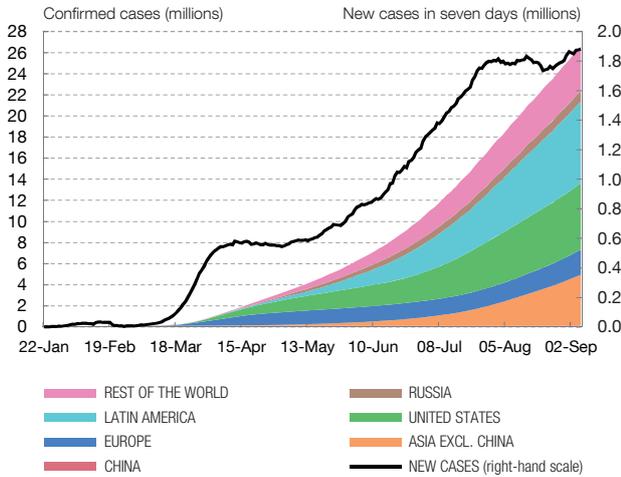
The GDP data released for Q2 show historic declines in most countries, reflecting the far-reaching economic effects of the pandemic (see Chart 3.4). In the United States, GDP fell by 9.5% in quarter-on-quarter terms and, although the

Chart 3

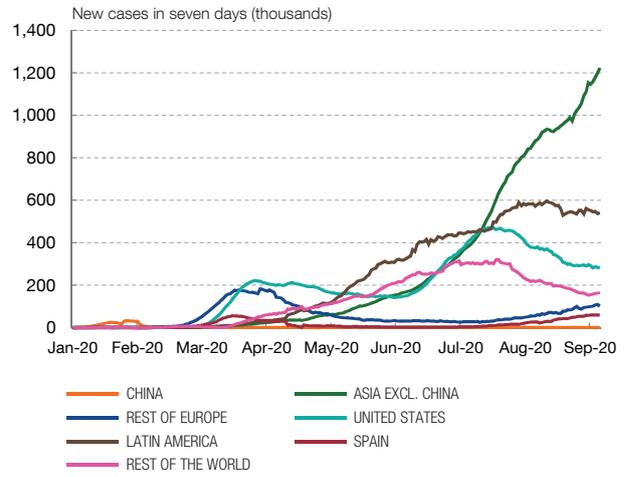
THE IMPACT OF COVID-19 ON INTERNATIONAL ECONOMIC ACTIVITY

Even though the pandemic continues to spread worldwide, the easing of confinement measures in most countries has prompted a gradual recovery in global economic activity.

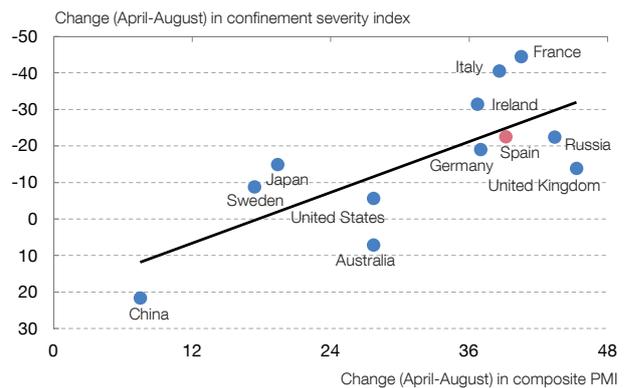
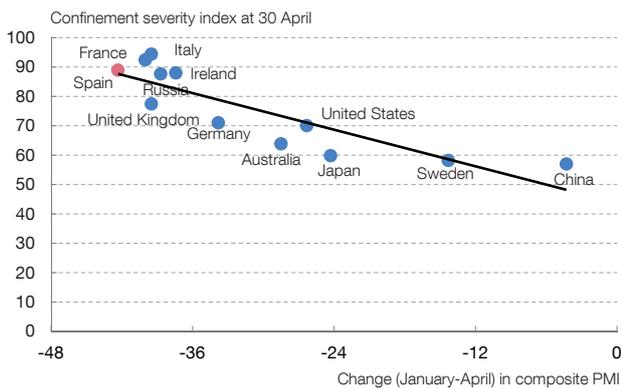
1 TOTAL INFECTIONS AND NEW WEEKLY INFECTIONS



2 PANDEMIC PATH: NEW WEEKLY INFECTIONS



3 CONFINEMENT SEVERITY AND PURCHASING MANAGERS' INDEX (PMI)



SOURCE: IHS Markit, Johns Hopkins University - Coronavirus Resource Center and Oxford COVID-19 Government Response Tracker.



resumption of economic activity in May led to a pick-up in job creation, the marked deterioration in the labour market remains, with the unemployment rate still standing at 8.4% (see Chart 3.5). GDP in Q2 plummeted by 20.4% quarter-on-quarter in the United Kingdom and fell by 7.9% quarter-on-quarter in Japan, declining for the third consecutive quarter.

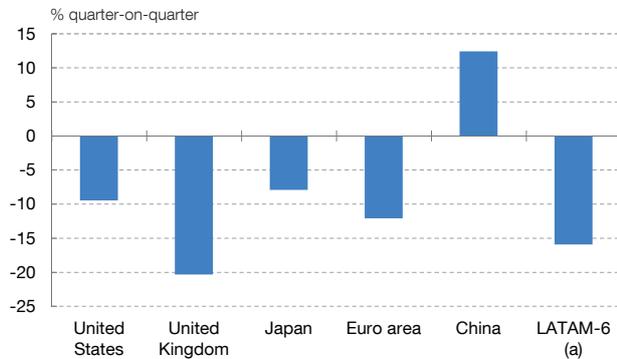
In China, the first economy to be affected by the pandemic and to show signs of recovery, the data for Q2 indicate a substantial improvement in activity. Specifically, in this period, the country's GDP growth exceeded 11% in quarter-on-

Chart 3

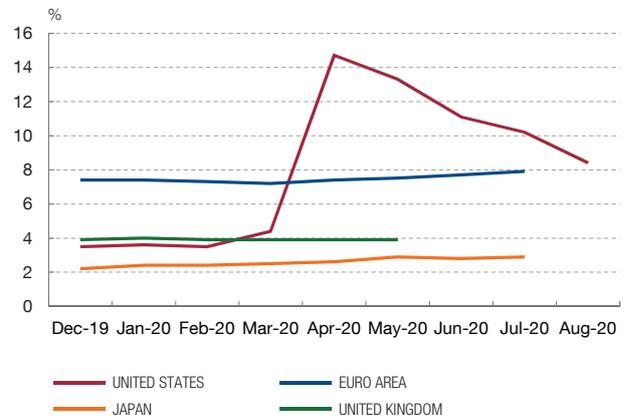
THE IMPACT OF COVID-19 ON INTERNATIONAL ECONOMIC ACTIVITY (cont'd)

The Q2 GDP data confirmed the far-reaching economic effects of the health crisis. The recent rise in energy prices has not fully offset the weakness of inflation, which possibly reflects the predominance of disinflationary elements associated with the collapse in aggregate demand.

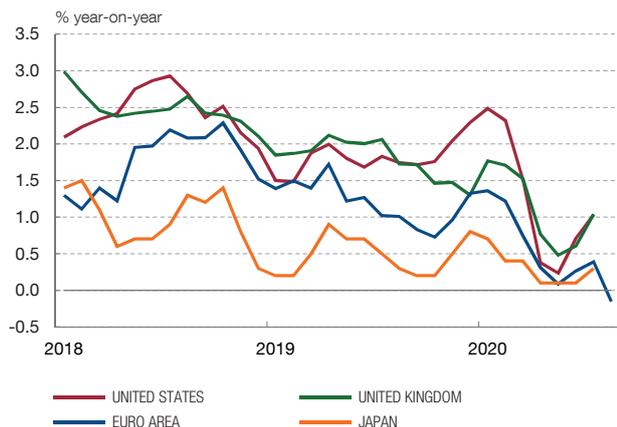
4 GDP GROWTH IN 2020 Q2



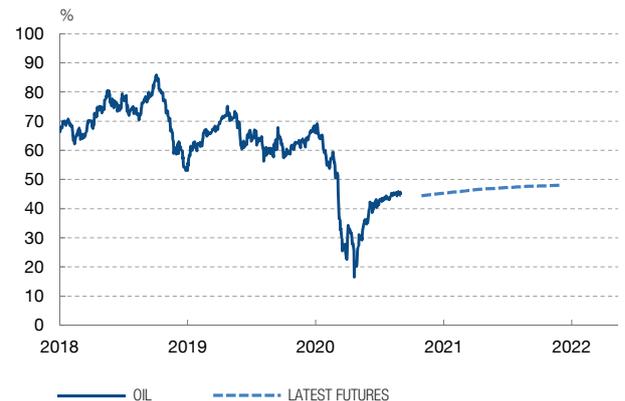
5 UNEMPLOYMENT RATES IN ADVANCED ECONOMIES



6 INFLATION IN DEVELOPED ECONOMIES



7 OIL PRICE (BRENT CRUDE)



SOURCES: Refinitiv and national statistics.

a Aggregate consisting of Argentina, Brazil, Chile, Colombia, Mexico and Peru. The data for Argentina are estimated on the basis of monthly indicators.



quarter terms, in contrast with the historic contraction of 10% posted in the previous quarter. The latest indicators suggest that China has made a full economic recovery as far as industrial activity is concerned, surpassing pre-health crisis levels, but it has still to complete that of consumption and services.

Turning to other emerging economies, the spread of the virus and the measures implemented to contain it also led to a sharp slump in activity in Q2, mainly in Latin America (see Box 3 on the course of the pandemic in this region and its

economic effects). However, the performance of financial markets in the emerging economies has remained positive since end-March, particularly that of equity markets. There are some exceptions, such as Turkey, where strong downward pressures on the exchange rate have been observed. The muted recovery of capital inflows has continued, without being sufficient to reverse the substantial outflows recorded in March and April.

World trade data also reflected a strong contraction in Q2, in a setting of great uncertainty.

In Q2, the volume of global trade in goods decreased by 12.5% in quarter-on-quarter terms, with significant contractions in almost all regions. This slump is similar to that recorded in the worst period of the 2008 global financial crisis (-13% quarter-on-quarter). However, the monthly data for June show some signs of a widespread recovery for the first time since the outbreak of the pandemic. In addition to the uncertainty associated with the health crisis, trade tensions between the United States and other countries have increased notably of late. The conflict with China was stoked up again at end-June, when the US authorities revoked Hong Kong's special status as a customs territory separate from China, and when the prohibitions to restrict Chinese telecom firms' access to the US market were strengthened. Moreover, the United States reinstated the tariffs on Canadian aluminium products in August, with Canada responding by announcing retaliatory measures. In July, the Trump administration announced the introduction of tariffs on certain French imports in response to the digital tax approved by the French government in 2019, the implementation of which has been delayed until the end of 2020 pending the outcome of the multilateral negotiations under way on digital taxation. By contrast, on a more positive note, the United States and the European Union agreed, in an isolated decision, to eliminate the tariffs on US seafood exports and to reduce the tariffs on some European products (mainly construction materials). Lastly, trade talks between the European Union and the United Kingdom continued, aimed at shaping the future EU-UK trade relationship once the current transition period, in force until 31 December 2020, ends. However, these negotiations have made no significant progress to date.

Inflation rates rose slightly in June and July, although they remain at very low levels, in a context of recovering commodities prices, most notably oil prices

(see Charts 3.6 and 3.7). In recent months, the price per barrel of Brent has gradually increased, from the low of \$17 observed in April to range from \$40 to \$50 per barrel for most of Q3, mainly as a result of the greater than anticipated cuts in oil production and the gradual recovery of demand. Core inflation rates have remained relatively moderate, possibly reflecting the predominance of disinflationary elements associated with the slump in demand. However, in June and July, price rises were observed in some of the components most exposed to the fall-off in demand resulting from the health crisis, such as clothing, footwear and leisure. Fresh outbreaks of the pandemic pose a downside risk for demand expectations and, consequently, for the pick-up in inflation.

As regards economic policies, the Federal Reserve introduced major changes to its monetary policy strategy in August, affecting its dual mandate of price stability and maximum employment. Specifically, the Federal Reserve adopted an inflation target that averages 2% over time and has also changed its formulation of the maximum employment objective, emphasising that it must be broad-based and inclusive (see Box 2). Most countries have maintained the fiscal policy measures aimed at providing liquidity and guarantees to economic agents and at supporting their income, extending, in some cases, the temporary measures adopted in the early stages of the pandemic given the context of widespread economic weakness and the uncertainty as to how the health situation will unfold.⁴ However, a number of countries are withdrawing some of these measures gradually or fully, as in the case of the federal supplement to unemployment benefits in the United States, which was almost halved in August.

3.2 The euro area

Activity in the euro area has rebounded with relative intensity in Q3, although without managing to offset the contraction in Q2. Inflation has moderated markedly, in part due to temporary factors

Euro area GDP fell by 11.8% in 2020 Q2, slightly less than the 13% decline forecast in the Eurosystem projection exercise conducted in June. The lockdown measures deployed in March and April, which were only eased gradually from early May, triggered a historic contraction of activity in the euro area in 2020 Q2. The decline in output was uneven across countries depending on the stringency of the lockdown, the spread of the virus and the differences in productive structure. The contraction in GDP was especially sharp in Spain (shrinking by 18.5%), followed by France and Italy, where it dropped by close to 13%. In turn, activity fell by around 10% in Germany, the Netherlands and Austria. By component, euro area GDP was hampered by the contraction in private consumption and gross fixed capital formation, while the external sector made a negative contribution to growth in all countries, especially those in which tourism plays a more prominent role (see Chart 4).

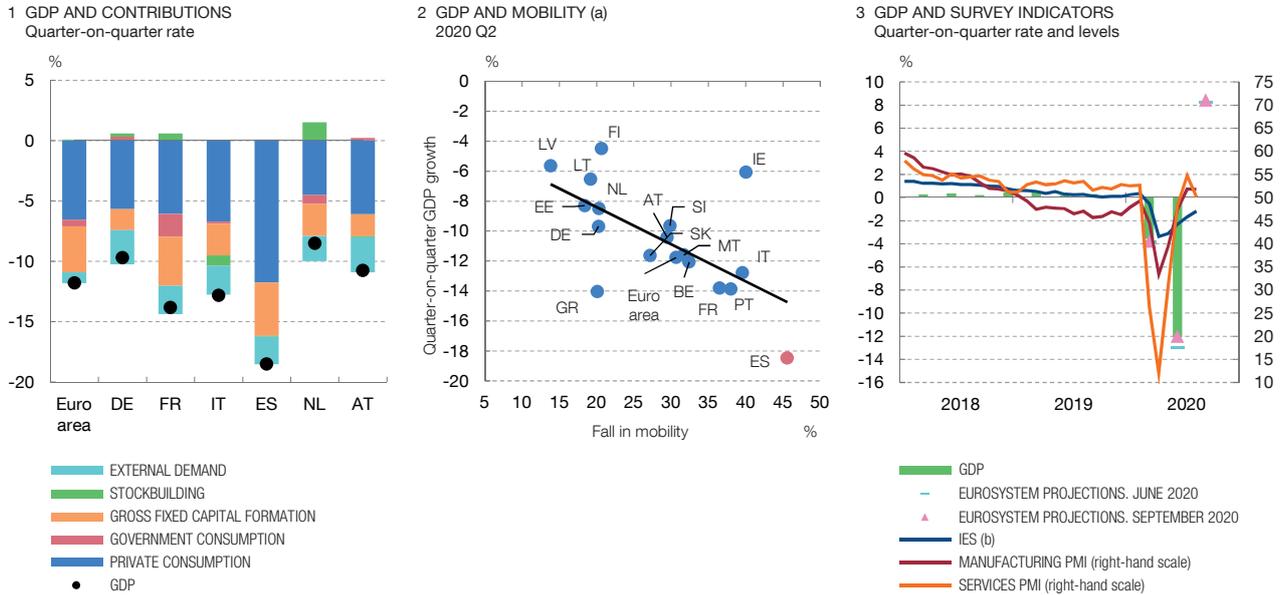
Activity rallied somewhat in the early stages of Q3, but it slowed as the summer unfolded amid rising pandemic infections. Growth in 2020 Q3 will be particularly marked by the comparison with the sharp contraction in Q2. However, available activity indicators, such as the PMI or the European Commission's economic sentiment indicator, reflected that activity had slowed somewhat in August following July's pick-up. Retail sales by major item (food and non-food) slipped in July to a level slightly lower than that recorded in February. That said, activity in 2020 Q3 is expected to recover some of the sharp drop in output in Q2, with euro area growth projected at around 8.4%.

⁴ See Cuadro-Sáez et al, "Fiscal policy measures in response to the health crisis in the main euro area economies, the United States and the United Kingdom", Occasional Paper 2019, Banco de España, 2020.

Chart 4

HISTORIC CONTRACTION OF ACTIVITY IN THE EURO AREA AS A RESULT OF PANDEMIC-RELATED RESTRICTIONS

Euro area GDP fell by 11.8% in 2020 Q2, with sharp declines in Spain, France and Italy. By component, private consumption posted the steepest decline, mainly weighed down by the stringency of the measures implemented to contain the pandemic. The latest data point to a partial recovery in 2020 Q3.



SOURCES: Eurostat, European Commission, Markit Economics, ECB and Google Community Mobility Reports.

- a Google mobility index. Average mobility to food, retail and leisure establishments, pharmacies and workplaces. The change is calculated in relation to the median value of the series in the period from 3 January to 4 February 2020.
- b The European Commission's economic sentiment indicator. Standardised series.



Latent uncertainty over the possible worsening of the pandemic is affecting households' and firms' spending decisions, with an uneven impact across economic sectors. Some sectors – such as certain services sector activities on which the lockdown had a low impact – returned to pre-pandemic activity levels in June. Yet other sectors – such as automobiles, tourism and recreation – suffered more. Employment fell by 2.8% in 2020 Q2. While this drop was less steep than the decline in GDP, thanks to the widespread adoption of government schemes to preserve employment, a significant recovery in Q3 is not expected. Against this background, marked by the uncertainty surrounding the course of the health crisis and its impact on the labour market, consumers' intention to make major purchases in the next 12 months fell in July.

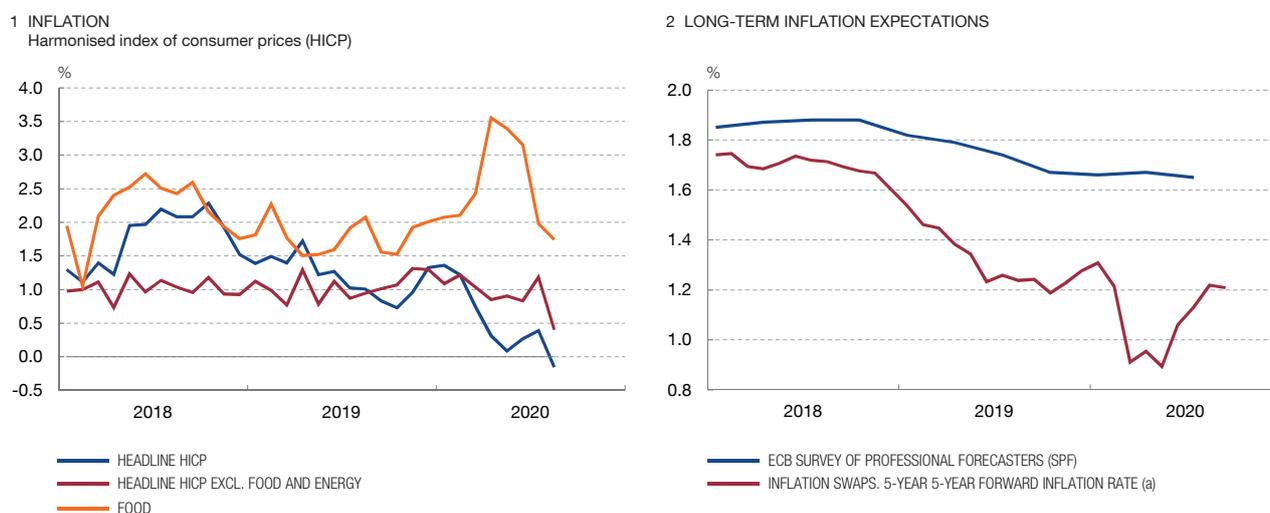
According to the September 2020 ECB staff macroeconomic projections,⁵ activity will contract sharply in 2020 due to the drop in 2020 H1. The baseline scenario assumes that the pandemic will be partially contained in the coming months, that foreign demand will perform somewhat better than forecast in June,

5 See [ECB staff macroeconomic projections for the euro area, September 2020](#).

Chart 5

EURO AREA INFLATION TURNS NEGATIVE

Inflation fell to -0.2% in August, breaking out of the upward path of the two previous months. Excluding energy and food, inflation stood at 0.4% . Expectations of low inflationary pressure continue, against a backdrop of falling energy prices and weak aggregate demand. Longer-term inflation expectations make up the ground lost during the pandemic.



SOURCES: Bloomberg, Eurostat and ECB.

a Monthly average of daily data.



and that monetary, fiscal and labour market policy measures will continue supporting agents' income, thereby reducing the impact of the crisis on employment and bankruptcies and containing adverse real-financial feedback loops. In this scenario, GDP is projected to fall by 8.0% in 2020 (0.7 pp less steep than the decline projected in June). The economy is expected to recover from 2020 Q3, with growth of 5% in 2021 and 3.2% in 2022, although GDP is not expected to reach its pre-crisis level by the end of the projection horizon. In any event, uncertainty over the pandemic's course, the possibility of a no-deal Brexit, and the possibility that unemployment and business creation and destruction may react more adversely after the withdrawal of the support measures all skew the risks to economic growth to the downside.

Inflation decreased amid weak demand and the appreciation of the euro

In August headline inflation fell by 0.6 pp to -0.2% in the euro area and core inflation by 0.8 pp to a historical low of 0.4% (see Chart 5.1). The drop in non-energy industrial goods prices and the deceleration in services and food prices – items which were partially offset by a more moderate fall in energy prices – lay behind the decline in inflation in August. The appreciation of the euro, the temporary VAT rate cut in Germany and the late start to seasonal sales in France and Italy would all explain, at least partially, the sharp adjustment to core inflation. Inflationary

Table 2

FORECASTS FOR EURO AREA GDP AND HICP GROWTH (a)

	2020		2021		2022	
	GDP	HICP	GDP	HICP	GDP	HICP
ECB (September 2020)	-8 (0.7)	0.3 (0)	5 (-0.1)	1 (0.2)	3.2 (0)	1.3 (0)
European Commission (July 2020) (b)	-8.7 (-1)	0.3 (0.1)	6.1 (-0.2)	1.1 (0)		
OECD (June 2020)						
Single-hit scenario	-9.1 (-9.9)	0.4 (...)	6.5 (5.3)	0.5 (...)		
Double-hit scenario	-11.5 (-12.3)	0.4 (...)	3.5 (2.3)	0.2 (...)		
IMF (June 2020) (b)	-10.2 (-2.7)	0.2 (...)	6 (1.3)	1 (...)		
Consensus Forecast (August 2020)	-7.9 (0.2)	0.4 (0)	5.7 (-0.2)	1.1 (0.1)		

SOURCES: ECB, European Commission, Consensus Forecast, IMF and OECD.

a In brackets, change with respect to the previous forecast, which was March 2020 for the ECB, May 2020 for the European Commission, March 2020 for the OECD, April 2020 for the IMF and July 2020 for Consensus Forecast.

b European Commission and IMF data are presented without adjusting for business days. The estimated effect for 2020 is 0.2 pp.

pressures are expected to remain very subdued in the medium term as a result of the degree of cyclical slack and the limited upward pressure from energy prices (see Chart 5.2).

In this setting, the ECB's latest forecasting exercise points to average inflation of 0.3% in 2020, which would reach 1.3% in 2022. These figures are unchanged from the June forecasts. Core inflation is projected to rise slightly, reaching 0.8% in 2020 and increasing gradually to 1.1% in 2022, against a background of a gradual decline in overcapacity over the projection horizon (see Table 2).

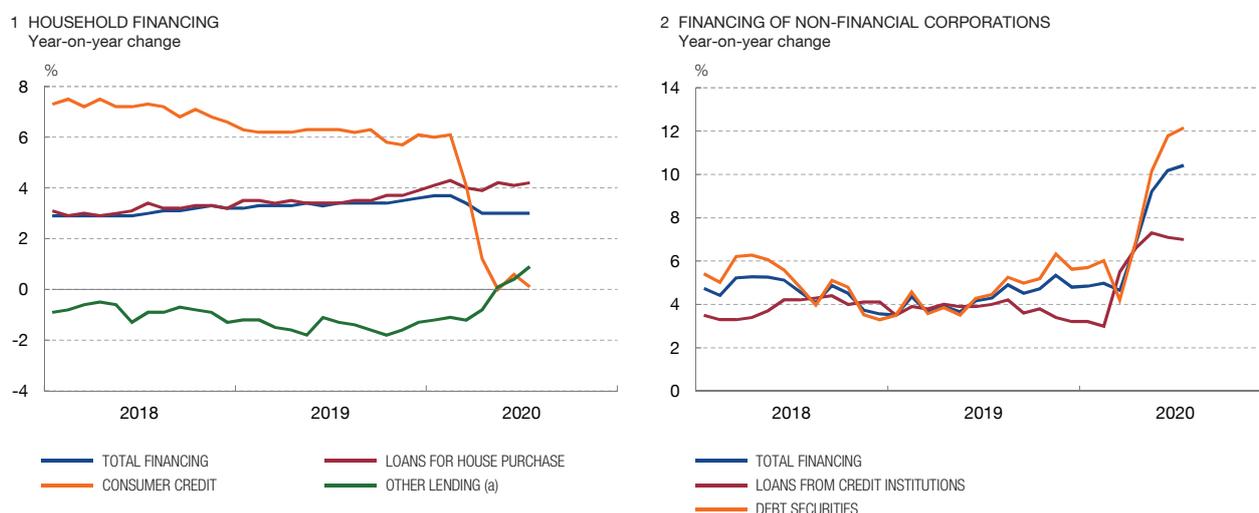
Bank lending conditions for households and non-financial corporations (NFCs) tightened slightly in recent months, while those for issuing corporate debt improved. There has been a fairly widespread slight increase in average interest rates on new bank loans to households and NFCs since April. However, they remain at historically low levels. Should the financial institutions' expectations contained in June's Bank Lending Survey bear out, credit standards for all types of lending would have tightened in 2020 Q3 as a result of lenders' increased concern for default risk. By contrast, long-term financing costs in corporate debt markets, which had surged at the onset of the pandemic, have decreased considerably since April, largely driven by the launch of the ECB's new pandemic emergency purchase programme (PEPP) in mid-March and the subsequent increase of its initial envelope in early June. Nonetheless, at end-August the average long-term interest rate on these transactions was still around 20 bp higher than the pre-health crisis level.

The latest available information on funding raised by the private sector shows that, in general, its momentum has remained somewhat stable

Chart 6

CREDIT TO THE NON-FINANCIAL PRIVATE SECTOR IS HOLDING QUITE STEADY, FOLLOWING THE MAJOR CHANGES OBSERVED DURING THE EARLY MONTHS OF THE HEALTH CRISIS

Credit to non-financial corporations has eased somewhat since May, following the sharp acceleration observed in the previous months. By contrast, the year-on-year rate of growth of corporate funding raised on the debt securities markets has increased in recent months. In turn, the year-on-year rate of growth of lending to households has held steady since April as a result of the uneven performance of its components. Thus, while consumer credit has continued to decelerate, the rate of growth of loans for house purchase, and particularly of other lending, has risen.



SOURCE: ECB.

a Includes loans granted to the self-employed.



following the substantial changes observed during the early months of the health crisis (see Chart 6). The rate of growth of the outstanding amount of bank loans extended to NFCs has decelerated slightly since May, after a marked increase in the preceding months, reaching 7% year-on-year in July. By contrast, the year-on-year rate of growth of corporate funding raised on the debt securities markets increased to 12.2% in July, 5.3 pp more than in April. The year-on-year rate of growth of lending to households has held steady at 3% since April as a result of the uneven performance of its components. Thus, while consumer credit has continued to decelerate (year-on-year growth of 0.1% in July), the rate of growth of loans for house purchase and, particularly, of other lending has risen (to 4.2% and 0.9%, respectively). In the case of other lending, the greater momentum appears to have been driven by funds raised by the self-employed, which are included under this heading.

Liquid assets held by the private sector have continued to increase. The broad monetary aggregate (M3) grew at a year-on-year rate of 10.2% in July, 2 pp more than in April, while the narrow monetary aggregate (M1), covering the most liquid forms of money, grew at 13.5% year-on-year in July (1.6 pp more than in April). This trend is consistent with the current setting of high uncertainty, which would have led economic agents to hoard liquidity for precautionary reasons.

The European fiscal response is key to driving a vigorous recovery that is sustainable over time

At its last two monetary policy meetings, in July and September, the ECB Governing Council resolved to leave its key policy rates unchanged and no additional measures were announced. The refinancing operations and asset purchase programmes were also left unchanged. The Governing Council explicitly indicated that purchases under the PEPP will continue to be conducted in a flexible manner over time, across asset classes and among jurisdictions. It also stated that it will continue to conduct net asset purchases under the PEPP until at least the end of June 2021 and, in any case, until it judges that the COVID-19 crisis is over. In the introductory statement following the last meeting of the Governing Council, ECB President Lagarde indicated that they will continue to carefully assess all information available, including developments in the exchange rate, with regard to its possible implications for the medium-term inflation outlook. The market is not expecting any change in key policy rates in the coming months.

The European Council, at its meeting of 17 to 21 July, resolved to create Next Generation EU, a temporary recovery fund for pooled funding of the economic recovery of the euro area. The new fund will be financed through debt issuance of up to €750 billion by the European Commission between 2021 and 2026. A new EU Multiannual Financial Framework (MFF) was also approved for 2021-2027, with funds of €1,074 billion.

The new fund will allow potential differences in economic recovery across the European partners to be mitigated, harnessing the positive externalities arising from joint action. The debt issued by the European Commission will benefit from the low interest rate environment and will mean that it will not have to be assumed, individually and asymmetrically, by Member States. It will also significantly boost the supply of common safe assets compared with the present volume of supranational European issuance. Lastly, the European Council's resolution is a positive sign of Member States' joint willingness to move the European project forward. This was reflected in the positive response of the financial markets to the main milestones in the approval of this new fund (see Box 5).

The sheer volume of the funds to be made available to Member States poses a challenge insofar as the design of projects eligible for funding under the recovery plan is concerned. The new fund provides an opportunity to steer the economic recovery towards a regeneration of the productive system to address the challenges of the coming years. It would, therefore, seem advisable to prioritise investment in technological innovation, in education and training, and in projects that contribute to the transition to a more sustainable economy, in accordance with the priorities identified in the 2020 European Semester.⁶

⁶ See P. García Perea, A. Millaruelo, V. M. Mora Bajén and M. Sánchez Carretero (2020). "The 2020 European Semester and the specific recommendations for Spain", Economic Notes 3/2020, Banco de España.

Given the medium-term approach of the new fund, in the near term Member States will have to continue to make considerable budgetary efforts to combat the effects of the pandemic. In consequence, it remains necessary to equip the EU with a permanent institutional framework to address the asymmetrical effect of shocks, through greater resource and risk-sharing in the budgetary sphere. Strengthening the European economy against future shocks also requires that the banking union be completed and, as indicated in Box 4, that continued new impetus be given to moving towards the capital markets union.

In recent months financing conditions for the private sector of the Spanish economy appear to have tightened slightly, while those for the public sector seem to have improved somewhat

In Q3 to date Spanish companies' stock prices have, overall, performed less favourably than companies listed in the main international markets, while the Spanish sovereign debt risk premium continued to decline. Between June and the cut-off date of this Report, the IBEX-35 has fallen by 3.2%, compared with the EURO STOXX 50's gain of 2.4%. The drop in stock prices has been particularly large in the banking and tourism sectors (10.4% and 8.1%, respectively). By contrast, in the government bond market, the yield spread between the Spanish and German ten-year bond decreased by 15 bp in Q3 to date, to 78 bp, on the back of the ECB's asset purchase programmes and the announcement of the launch of the EU recovery fund. Lastly, the 12M EURIBOR has declined by 18 bp, to -0.4%, influenced by the easing of strains in the interbank market.

Bank lending conditions tightened slightly in recent months, while those for issuing corporate debt improved. Thus, there was a slight, although fairly widespread, rise in the cost of bank credit. This increase was somewhat sharper in the segment of loans to sole proprietors (19°bp between April and July), which could be related to the lower proportion of new loans with State guarantee.⁷ The increase in the cost of financing was also appreciable in the case of loans to non-financial corporations (NFC's) in excess of €1 million (17 bp), mainly associated with lending to large firms, having reached its highest level since June 2017 (see Chart 7). Should the financial institutions' expectations contained in the latest Bank Lending Survey bear out, credit standards for lending would have tightened in 2020 Q3 in all segments.⁸ By contrast, the average cost of corporate debt issues, which had surged at the onset of the pandemic, has decreased considerably since April. This was largely driven by the launch of the ECB's new asset purchase programme in mid-March and the subsequent increase of its initial envelope in early June. However, in August it was still standing around 25 bp above the pre-pandemic level (see Box 6).

7 For further details, see Box 1 of Analytical Article "Recent developments in financing and bank lending to the non-financial private sector", *Economic Bulletin*, 3/2020, Banco de España.

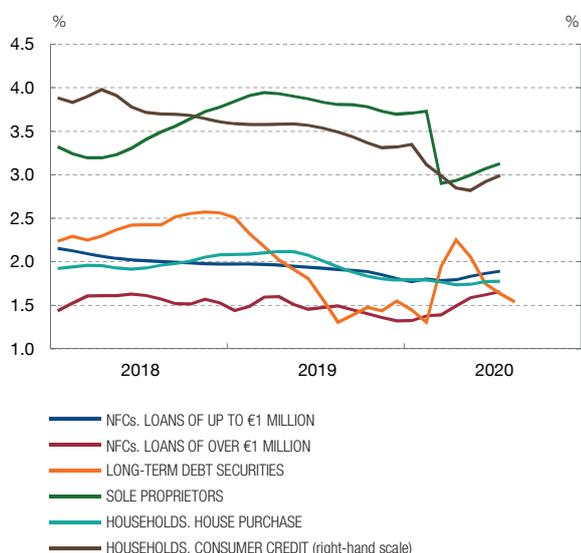
8 When the survey was conducted (between 5 and 23 June), the creation of a new guarantee scheme, for a maximum of €40 billion, to promote the granting of loans linked to the development of new investment projects by firms, had not yet been approved (see RDL 25/2020). This could have influenced banks' responses to the survey, against a backdrop of exhaustion of the State guarantees linked to the first guarantee programme approved by the Government (see RDL 8/2020).

Chart 7

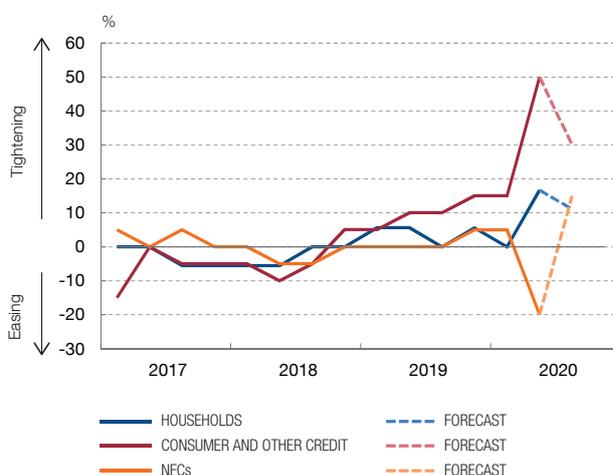
THE COST OF BANK LOANS HAS RISEN SLIGHTLY IN RECENT MONTHS AND CREDIT STANDARDS APPEAR TO HAVE TIGHTENED

A slight widespread increase in interest rates on new loans has been observed in recent months. Should the financial institutions' expectations contained in the latest Bank Lending Survey bear out, credit standards for loans across all segments would also have tightened. The cost of corporate debt issues has decreased, largely driven by the ECB's asset purchase programmes.

1 COST OF FINANCING (a)



2 BLS: CHANGE IN CREDIT STANDARDS (b)



SOURCES: Thomson Reuters and Banco de España.

- a Bank lending rates are NDER (narrowly defined effective rate), i.e. excluding the related charges and fees, and are adjusted seasonally and for the irregular component.
- b Bank Lending Survey. Indicator = percentage of institutions that have tightened credit standards considerably \times 1 + percentage of institutions that have tightened credit standards somewhat \times 1/2 – percentage of institutions that have eased credit standards somewhat \times 1/2 – percentage of institutions that have eased credit standards considerably \times 1.



Economic activity in Spain fell sharply in 2020 Q2, affected by the lockdown measures adopted to curb the pandemic's expansion

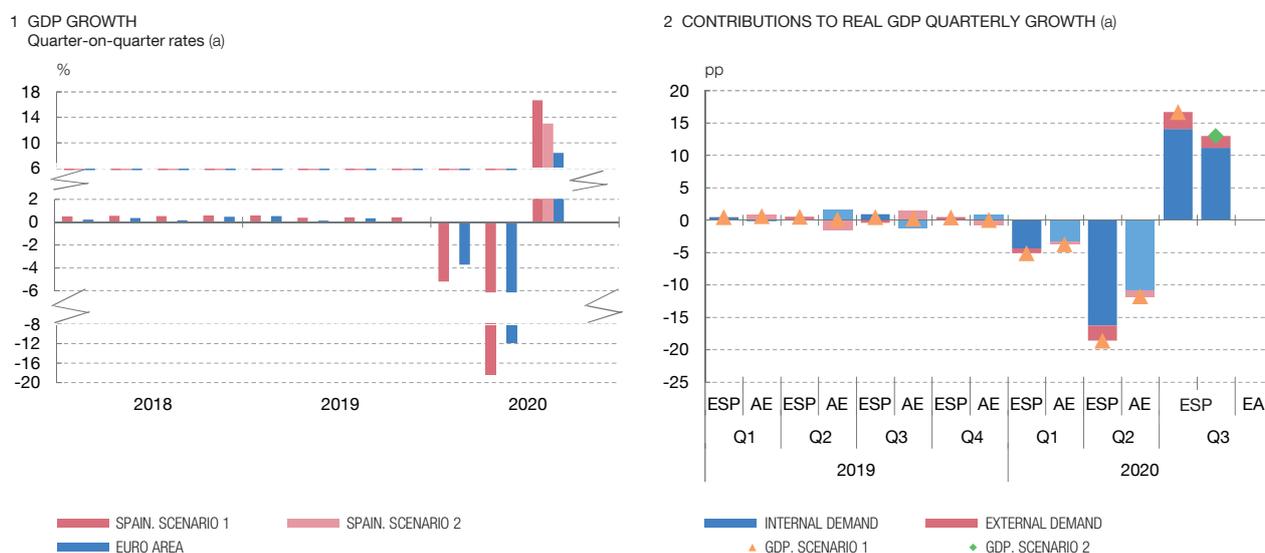
The impact of the health crisis on the Spanish economy was substantially more pronounced in Q2, when the sharpest downturn in GDP ever recorded in peace-time took place. The decline in activity, which had already been seriously affected in Q1, having fallen by 5.2% in seasonally adjusted quarter-on-quarter terms, was exacerbated in Q2, contracting by 18.5%. This reflects the high short-term economic cost of the measures implemented to contain the pandemic aimed at curbing the spread of the infection and preventing the healthcare system's collapse. The drop in GDP posted in Q2 was halfway between the early recovery and the gradual recovery scenarios drawn up in the Banco de España's June forecasting exercise.⁹

9 See [Macroeconomic projections for the Spanish economy \(2020-2022\): the Banco de España's contribution to the Eurosystem's June 2020 joint forecasting exercise](#).

Chart 8

ECONOMIC ACTIVITY WILL RECOVER PARTIALLY IN Q3

Following the unprecedented contraction recorded in Q2, economic activity appears to have recovered partially in Q3, although unevenly across sectors. The projected improvement stems mainly from domestic demand, following the strong contraction recorded by this aggregate in the two previous quarters.



SOURCES: INE, ECB and Banco de España.

a Projections of the Banco de España for the Spanish economy and of the ECB for the euro area for 2020 Q3.



The sharp drop in GDP in Q2 mainly reflected the downturn in domestic demand, which deducted 16.1 pp from GDP growth (see Chart 8). This decrease was concentrated in private-sector spending and was substantially more marked than in Q1 across all its components. Conversely, amid an increase in healthcare expenditure to withstand the pandemic, government consumption rose once again, although less sharply than in Q1, when it increased significantly. As regards the external sector, the negative contribution of external demand was also substantially more pronounced in Q2 than in the January-March period, reaching 2.3 pp. This was the result of a sharper fall in exports (largely conditioned by the collapse in inbound tourism) than in imports.

By productive sector, activity in 2020 Q2 contracted across the board (except in agriculture and fishing). However, the severity of the downturn was highly uneven across sectors, mainly depending on the difference in the impact of the lockdown measures on each sector. Market-related services contracted by 25%, with particularly sharp decreases (of up to 40% in some cases) in the retail trade, entertainment, restaurant and accommodation and food service activities sectors, which were greatly affected by the restriction on movement and social distancing measures in force during most of the quarter. Construction also shrank by nearly 25%, affected, among other factors, by the shutdown in non-essential

activities between 29 March and 9 April and by heightened uncertainty. The decline in manufacturing activity, around 21%, was also substantial, albeit less steep than in the foregoing sectors. Disruptions to the global supply chains continued affecting the sectors most highly integrated in cross-border supply chains, such as the automotive sector, mainly during the early part of the quarter. Non-market services declined slightly (around 1%).

The impact of the health crisis has been more severe on the Spanish economy than on the euro area as a whole, owing to a combination of factors. The negative growth differential between Spain and the euro area in 2020 Q1 (with respective contractions of 5.2% and 3.7%) widened substantially in Q2, with GDP declining by 11.8% in the euro area as a whole and by 18.5% in Spain. The Spanish economy's poorer performance appears to be the result of the convergence of a variety of factors. First, the lockdown measures adopted in Spain during the state of alert were among the strictest internationally. Second, the sectoral composition of the Spanish economy, with a greater relative weight of the sectors most affected by the measures to contain the pandemic (such as retail and wholesale trade, and accommodation and food service activities) also helps to explain a relatively more severe impact of the pandemic on Spain. Other structural characteristics of the Spanish economy also point in this direction. In particular, the Spanish business sector has a larger proportion of small and medium-sized enterprises than the other main euro area economies. These firms generally encounter more difficulties to mitigate liquidity problems triggered by adverse macrofinancial shocks or, in this case, the health crisis. Also, the temporary employment ratio in the labour market is substantially higher in Spain than in the euro area. In the face of an unfavourable shock this commonly leads the labour market adjustment to have a disproportionate impact on workers with temporary contracts, also resulting in a more severe impact on household demand.¹⁰

In Q3, economic activity appears to have remained on a path of gradual recovery, losing some momentum as the quarter progressed as a result of the worsening health crisis

The gradual easing of lockdown measures in Q2, which culminated on 21 June with the end of the state of alert, prompted a gradual rebound in activity. However, the recovery was partial and uneven across sectors, and began to slow at end-July, with the spread of fresh outbreaks of the epidemic. A broad range of indicators suggest that the low levels of activity reached in early April, when the most stringent lockdown measures were imposed, were followed by a path of gradual recovery, which was more pronounced in manufacturing than in services.

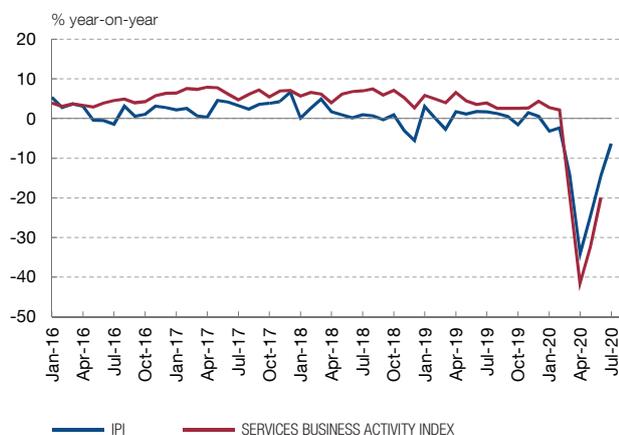
¹⁰ For further details, see Martínez-Carrascal (2020), "The relationship between consumption and the composition of household income", Analytical Article, Banco de España, forthcoming.

Chart 9

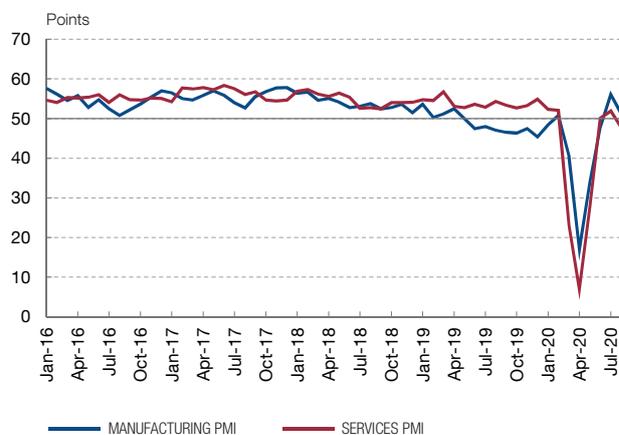
SERVICES WILL CONTINUE TO BE HARDER HIT BY THE EFFECTS OF THE PANDEMIC THAN MANUFACTURING

The services sector, harder hit by the social distancing measures adopted, posted a sharper decline in activity in Q2 than the manufacturing sector, and the recovery is also expected to be weaker in Q3, as reflected by both qualitative and quantitative indicators.

1 SERVICES BUSINESS ACTIVITY INDEX AND INDUSTRIAL PRODUCTION INDEX



2 PURCHASING MANAGERS' INDICES



SOURCES: INE, Markit Economics and Banco de España.



However, since end-July, the same indicators show emerging signs of a slowdown in this recovery, chiefly linked to the steady rise in the number of COVID-19 infections in Spain during the summer, which has resulted in certain social distancing measures being reinstated (in terms of productive sectors, these measures have mainly affected those relating to leisure activities) and in the authorities of numerous countries implementing various types of restrictions on individuals travelling from Spain (with a significant impact on tourism).

These two distinct phases in the recent behaviour of economic activity in Spain can be observed in a number of indicators. Specifically, the recently diminished strength of the recovery can be seen both in the monthly frequency indicators typically used to monitor activity, and in those of a higher frequency, whose use has gained prominence in this crisis. The former notably include purchasing managers' indices (PMIs), which posted a record low in April, picked up sharply until July (particularly in manufacturing) and fell again in August (see Chart 9). The latest available data on the industrial production index (IPI) and the services business activity index (IASS by its Spanish initials), corresponding to June, also point to a partial recovery until then, with a wider gap with respect to pre-crisis levels in services (especially in transport and accommodation and food services) than in manufacturing. The divergence between manufacturing and services can be explained by the fact that many activities relating to the services sector (leisure and accommodation and food services) generally require a high degree of personal interaction, and have thus been particularly affected not only by the social distancing

measures reinstated over the summer but also by the possible drop in demand owing to health concerns. The European Commission's economic sentiment indicator shows a partial recovery of agents' confidence in the May-July period, which was curtailed in August by a new, widespread decline across components (except in manufacturing), contrasting with the improvement observed in the euro area as a whole. Turning to high-frequency indicators, recent developments in various indicators relating to mobility (for example, mobile phone location data, air and road traffic and fuel sales) and electricity consumption are consistent with the partial recovery in economic activity in Spain in the final stretch of Q2 and the beginning of Q3, followed by a slowdown from end-July which has not been observed in other European countries (see Chart 10).

This information suggests that the loss of activity in 2020 Q3 compared with the levels recorded in the same period a year earlier could amount to between 9.5% and 12.3%. This would be consistent with GDP growth ranging from 16.9% to 13.0%,¹¹ quarter-on-quarter. As mentioned above, in recent weeks, activity seems to have levelled off, or even declined somewhat. However, the greater buoyancy observed at the beginning of the quarter, and the very low average level of production in the preceding quarter resulting from the lockdown (base effect), explains why the quarter-on-quarter rate is so high. The relatively broad range of GDP growth estimates in the quarter can be accounted for both by the difficulties in accurately interpreting the information available and by the uncertainty as to how the pandemic will unfold in the remaining stretch of the quarter, and its economic effects. By component, GDP growth will be underpinned by increased domestic demand, following the sharp contraction accumulated in the two previous quarters, with significant quarter-on-quarter growth in private consumption and gross fixed capital formation.

Employment continued to rebound in the summer months, but showed some signs of petering out in the second half of August

In terms of average social security registrations, improvements in the labour market allowed for the creation of 332,000 jobs between April and August, compared with the 56,000 jobs created in the same period in 2019. Specifically, average social security registrations increased by somewhat more than 160,000 in July (0.9%), and rose again slightly in August (by 6,800), contrasting with the usual seasonal behaviour in that month. Thus, the year-on-year rate of change in social security registrations, calculated on the basis of monthly average levels, stood at -2.8% in August, compared with -4.3% in April (see Chart 11.1). However, according to daily social security registration data, this recovery process was showing signs of

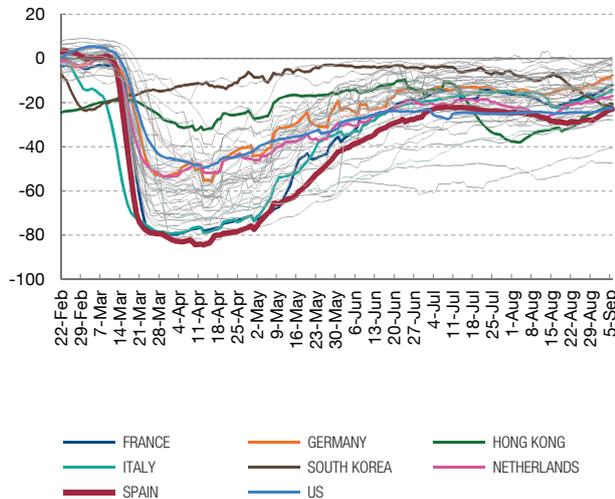
¹¹ For more details about these estimates, see Box 1 of this report, "Macroeconomic scenarios for the Spanish economy (2020-2022)".

Chart 10

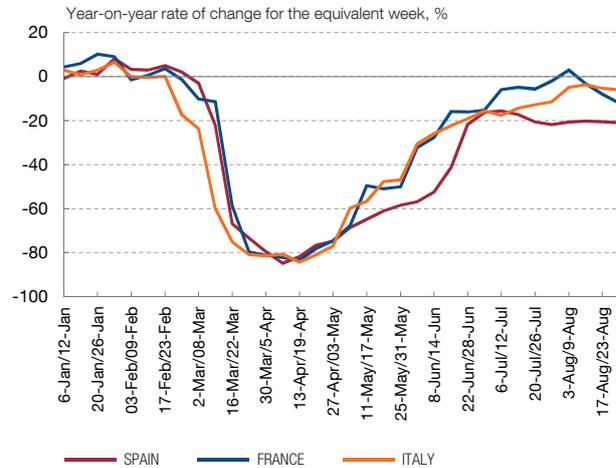
THE UPWARD TREND IN ACTIVITY INITIATED IN MAY HAS STABILISED

The gradual rebound in activity prompted by the easing of lockdown measures has tended to stabilise since July, with the spread of fresh outbreaks of the pandemic.

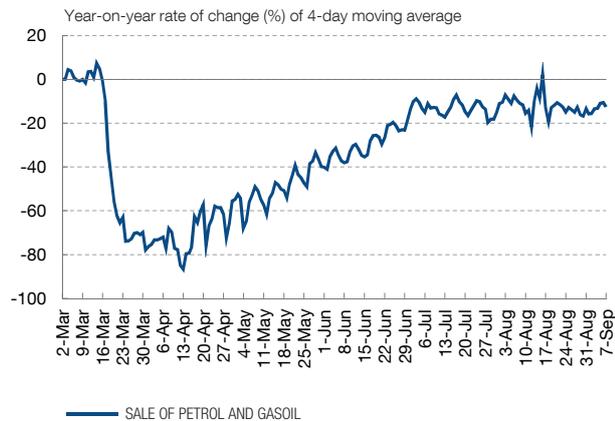
1 LOCAL MOBILITY INDICATORS. RETAIL AND RECREATION OUTLETS, PUBLIC TRANSPORT STATIONS AND WORKPLACES (7-day moving average)



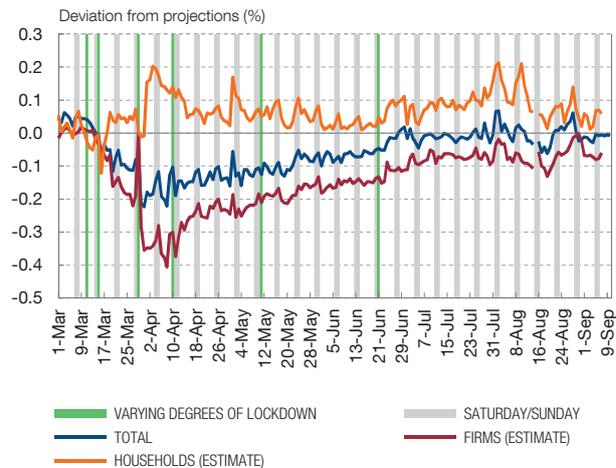
2 MOTORWAY TRAFFIC



3 SALE OF PETROL AND GASOIL



4 ESTIMATED IMPACT OF DIFFERENT LOCKDOWN MEASURES ON ELECTRICITY CONSUMPTION (a)



SOURCES: Google, Atlantia Group, Repsol Research Division, Red Eléctrica de España and Banco de España.

a The estimation period runs from 1 January 2019 to 10 September 2020. The regression's dependent variable is the logarithm of hourly electricity consumption over indicators for the year, month, day of the week and time of day, distinguishing between three time slots (super-off-peak from 1 a.m. to 7 a.m., off-peak from 7 a.m. to 1 p.m. and peak from 1 p.m. to 1 a.m.). Maximum temperature, maximum temperature squared and dummy variables for national and regional holidays, weighted by electricity consumption per region, are also included.



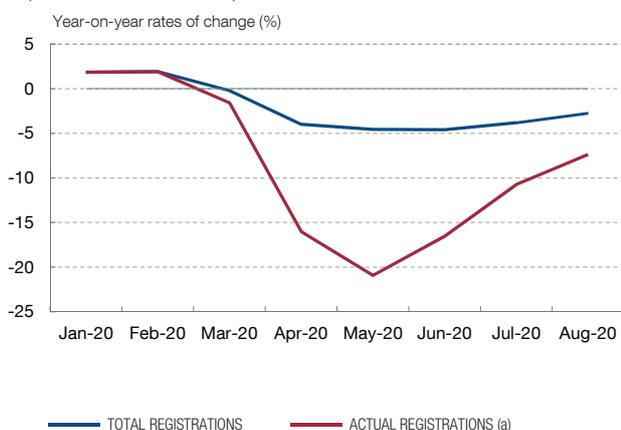
petering out in the second half of August, possibly reflecting the consequences of the fresh outbreaks of the pandemic in Spain and the response of the different authorities concerned, including those of the countries providing tourists (see Chart 11.2). By activity, the recovery of employment was particularly strong in

Chart 11

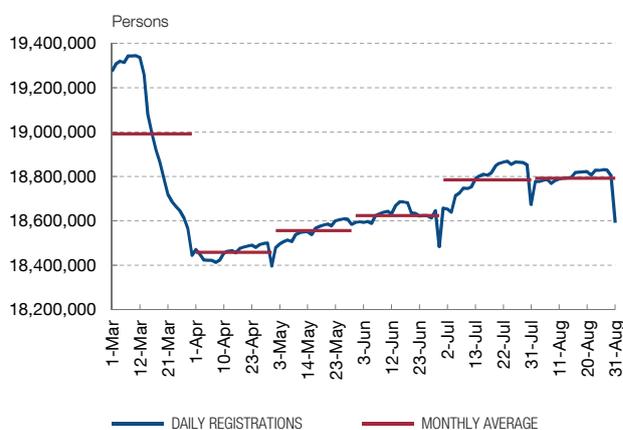
RECENT DEVELOPMENTS IN EMPLOYMENT

After the sharp declines observed from mid-March, social security registrations picked up gradually in the summer months, although in August they were still 2.4% lower than in February. The number of workers on furlough also fell significantly during the summer, as a result of which actual registrations recovered, from a year-on-year decrease of more than 20 % in May to a drop of 7.4 % in August.

1 YEAR-ON-YEAR RATE OF CHANGE IN TOTAL AND ACTUAL REGISTRATIONS (AVERAGE MONTHLY DATA)



2 DAILY SOCIAL SECURITY REGISTRATIONS SINCE MARCH



SOURCE: Ministerio de Inclusión, Seguridad Social y Migraciones.

a Actual registrations are calculated as total registrations minus the number of workers on furlough.



construction where, after the sharp adjustment in employment during the most stringent period of lockdown, the level in August was already close to that observed a year earlier. By contrast, in market services employment was still, on average in August, 4.7% below the level a year earlier, while in the industrial sector, the year-on-year decline was reduced by 1 pp between April and August to -2.4%.¹²

The rebound in social security registrations until August was accompanied by a steep decline in the use of furlough schemes (ERTE) as a means of temporarily laying off workers. At the end of August, somewhat more than 800,000 workers were on furlough, a decline of 76% with respect to the highs reached in April. Again, this decline was slightly sharper in July (-38.9% monthly) than in August (-27.4%), and remained very uneven by activity. Specifically, in certain services sectors, such as accommodation and food services, slightly more than 18% of workers remained on furlough at the end of August, while in manufacturing or construction, the proportion of furloughed workers was much lower (4.8% and 1.7%, respectively). As a result of the decline in the number of workers on furlough, actual registrations recovered sharply during the summer months, from a year-on-year decrease of more than 20% in May to a drop of 7.4 % in August.

¹² For further details on the behaviour of employment in recent months, by activity and province, see Box 7 of this report, “The recovery of employment in recent months from a provincial and sectoral standpoint”.

Overall, measured in terms of hours worked, the year-on-year decline in employment in Q3 is estimated to be slightly higher than 10%, similar to that anticipated for economic activity. Nevertheless, this figure represents a sharp recovery in the number of hours worked, compared with the drop of 24.8% observed in Q2. Meanwhile, the unemployment rate is expected to increase fairly sharply in Q3, following the rise of 15.3% in Q2. In this connection, it is worth noting that, despite the marked decline in employment observed in Q2, the increase in the unemployment rate in the same period was relatively moderate (1 pp), mitigated both by the widespread use of furlough schemes and by the difficulties encountered by job-seekers who lost their job during the state of alert, and who were considered economically inactive since they were unable to actively search for a job. In Q3, a large proportion of these economically inactive persons are expected to resume their job search, and this will exert upward pressure on the unemployment rate.

All components of private domestic demand and foreign trade flows of goods and services will record a pick-up in 2020 Q3, after steep drops in the preceding quarters

The gradual reopening of the economy has enabled private consumption to rebound in Q3, although it appears to remain below pre-pandemic levels. Following the sharp declines recorded in 2020 H1, purchases of durable and semi-durable goods and spending on services have increased markedly of late. In particular, new private car registrations increased by 6.9% year-on-year in July. This would reflect, to some extent, the positive impact of the implementation of the plans to assist new car purchases and the gradual absorption of pent-up demand from the lockdown. Nonetheless, this variable fell by 9.6% in August in year-on-year terms, pointing to a possible petering out of these factors (see Chart 12). Other indicators for July performed favourably during that month, in step with it being again possible to consume certain goods and services. First, in July the retail trade index displayed an especially pronounced recovery of sales of clothing and footwear, and household appliances. Likewise, spending on services rallied considerably once accommodation and food service activities resumed, although it remained below pre-pandemic levels. For example, overnight hotel stays by residents in Spain increased substantially, with the year-on-year decline moderating to 50% (compared with the 95% fall recorded between April and June). The year-on-year drop in the flow of consumer credit has also moderated since May, although its performance remains noticeably weak amid continuing high levels of uncertainty. In this regard, the confidence indicators, which picked up considerably at the end of Q2, lost momentum in July and even fell in August.

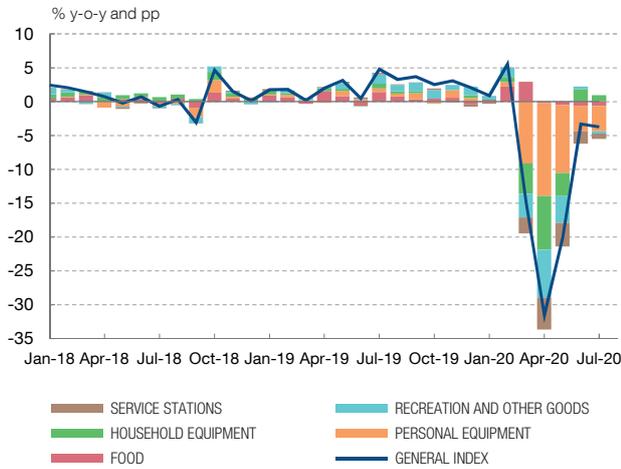
The household saving rate appears to have declined in Q3 as a result of the recovery of consumption. However, the high level of uncertainty and the labour market situation kept the saving rate above pre-pandemic levels. As regards the

Chart 12

THE COVID-19 CRISIS HAS HAD A MAJOR IMPACT ON HOUSEHOLD SPENDING

Household consumption seems to have rallied in Q3 to date, doing so with particular intensity in terms of spending on durables, which had contracted sharply in 2020 Q2. Nonetheless, it remains below pre-pandemic levels. Confidence indicators recovered somewhat in recent months, although they remain at low levels.

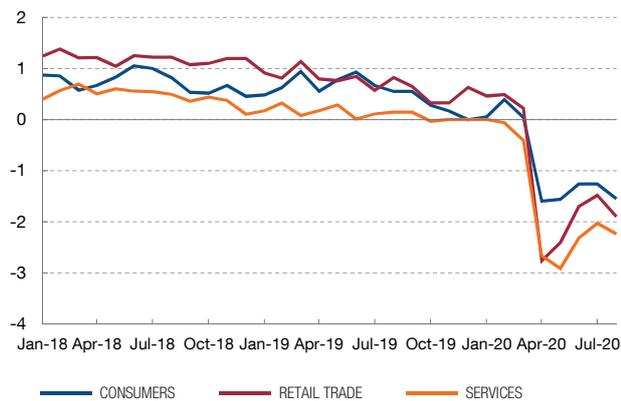
1 RETAIL TRADE INDEX
Y-o-y growth and contributions



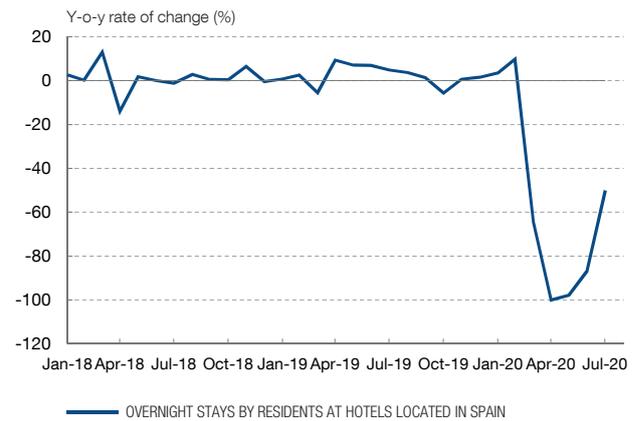
2 PRIVATE VEHICLE REGISTRATIONS



3 CONFIDENCE INDICATORS
Standardised data (a)



4 OVERNIGHT STAYS BY RESIDENTS AT HOTELS LOCATED IN SPAIN



SOURCES: INE, ANFAC, European Commission and Banco de España.

a Series computed by subtracting the average and dividing by the standard deviation.



financial position of households, it bears highlighting that, although this sector's volume of debt has not increased in the wake of the pandemic, its ability to repay could be undermined in the medium term due to the drop in income, especially in those population segments hardest hit by the crisis.¹³

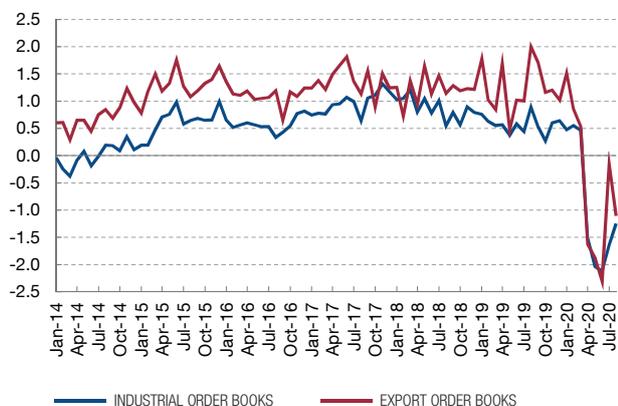
13 In the short term, these effects have been softened somewhat by the debt moratoria and the measures to protect income adopted to withstand the economic effects of the pandemic.

Chart 13

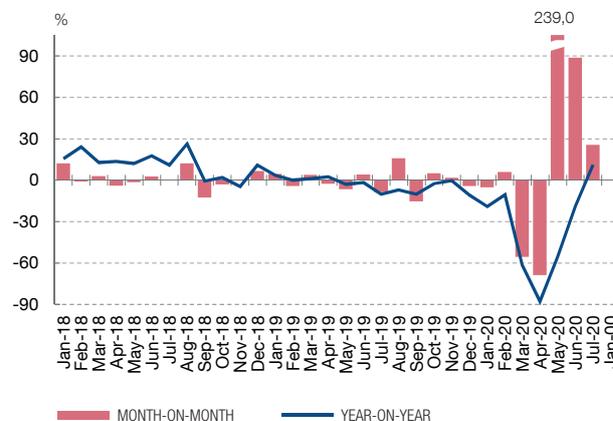
BUSINESS INVESTMENT WILL RALLY IN Q3

Investment in capital goods and intangibles will recover between July and September, after the unprecedented collapse in 2020 Q2, as suggested by the recent trend in the confidence and activity indicators related to this component of demand.

1 INDUSTRIAL ORDER BOOKS
Standardised data (a)



2 COMMERCIAL VEHICLE REGISTRATIONS



SOURCES: European Commission and Ministerio del Interior (Spanish Road Transport Department).

a Series computed by subtracting the average and dividing by the standard deviation.



All components of gross fixed capital formation appear to have rallied intensely in quarter-on-quarter terms in Q3, although they clearly remain below pre-pandemic levels. In the case of residential investment, which fell sharply in Q2, the projected increase would be explained by sales and purchases, and building starts gradually returning to normal once the restrictions on movement had been lifted and by the materialisation of purchase decisions postponed during the lockdown. In this setting, the year-on-year growth of flows of loans for house purchase was positive in July for the first time since the outbreak of the pandemic, although in cumulative three-month terms it remained in negative territory. With regard to business investment, the short-term indicators appear to suggest a quarter-on-quarter increase in Q3. However, this would only partially offset the collapse recorded in Q2. In particular, the latest readings of the industrial confidence indicators, the order book in this sector, the PMIs for activity, the investment goods production expectations in the Ministry of Industry, Trade and Tourism’s monthly business survey and commercial vehicle registrations would all be consistent with a partial recovery of business investment in Q3 (see Chart 13).

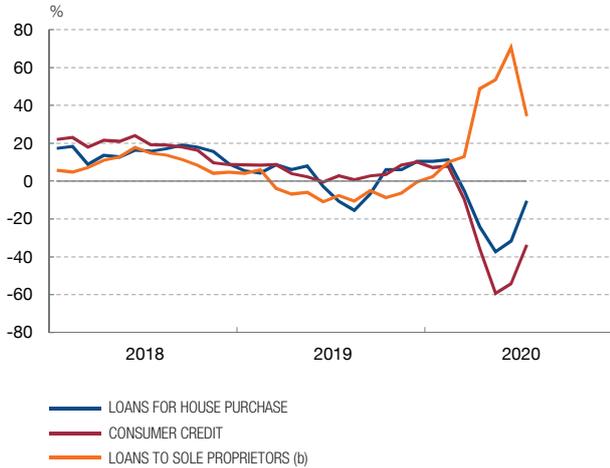
As regards the financing of investment decisions, new loans granted to NFCs and, to a lesser extent, to the self-employed have slowed since May after high growth in the preceding months (see Charts 14.1 and 14.2). This loss of momentum would in part be related to the exceptional volume of funds raised by these sectors between March and May, largely explained by the first State guarantee facility

Chart 14

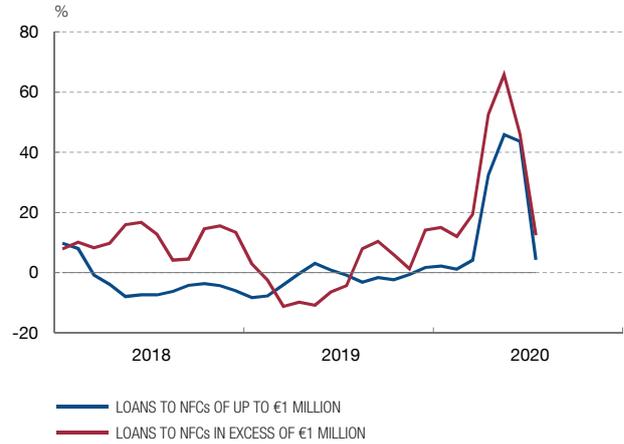
THE TRENDS OBSERVED IN NEW LOANS IN RECENT MONTHS HAVE MODERATED

The contraction in new loans to households for house purchase and consumer credit has moderated, while the flow of financing to productive activities (NFCs and sole proprietors) has lost considerable momentum since May, after high growth in the preceding months. The amount of lending to households for house purchase and consumer credit continues declining, while bank lending to productive activities continues growing at high year-on-year rates, albeit more moderately than in the preceding months. Corporate finance raised via the issuance of debt securities lost momentum in July, after the acceleration of the two preceding months.

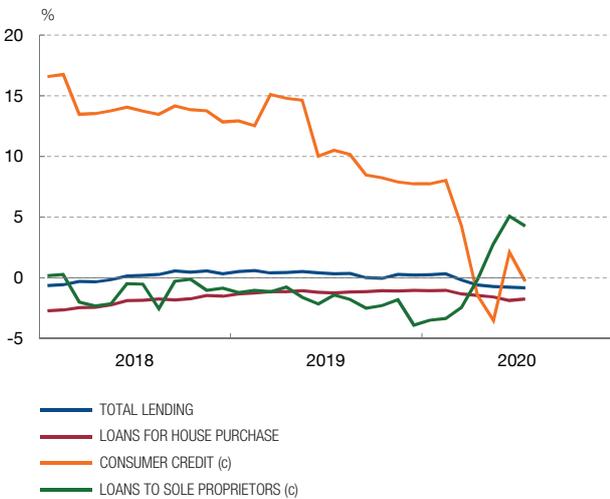
1 NEW LOANS TO HOUSEHOLDS
Y-o-y change (a)



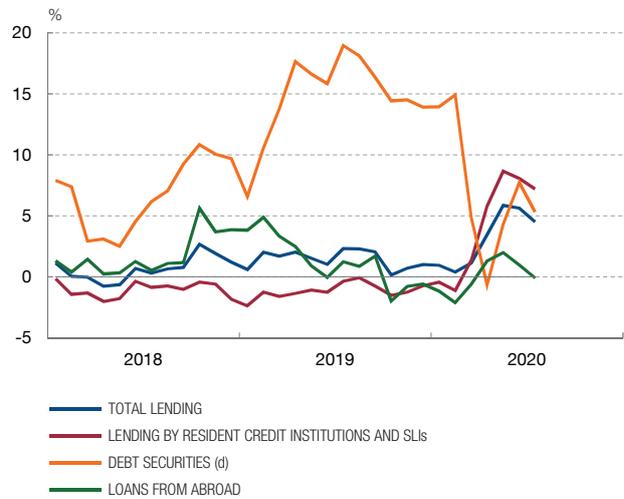
2 NEW LOANS TO NFCs
Y-o-y change (a)



3 LENDING TO HOUSEHOLDS
Y-o-y change



4 LENDING TO NFCs
Y-o-y change



SOURCE: Banco de España.

- a Three-month cumulative flow.
- b Includes renegotiations of previous loans.
- c Excludes securitised lending.
- d Includes issues by resident subsidiaries of non-financial corporations.



managed by the Official Credit Institute amounting to close to €100 billion, which at this point in time has been practically depleted. The new State guarantee facility for a maximum amount of €40 billion approved in July will foreseeably help to encourage

lending to these sectors over the coming months. As a result of these financing flows, the amount of lending by resident institutions to productive activities has decelerated in recent months, although the year-on-year rates of growth remained high in July (7.2% in the case of NFCs and 4.3% in the case of sole proprietors (see Charts 14.3 and 14.4)). Corporate finance raised on the debt securities markets also lost momentum in July, recording year-on-year growth of 5.3%, after the acceleration of the two preceding months. Drawing on provisional data, the corporate sector's aggregate financial position appears to have continued to worsen in Q2 following the downturn in Q1. Specifically, the debt-to-GDP¹⁴ ratio of the NFC segment appears to have risen by almost 9 pp to 82% (the highest level since early 2017) as a result of both the increase in the numerator and the decrease in the denominator. This has also resulted in an increase in the sector's debt burden ratio.

Exports and imports of goods and services remain noticeably lower than the pre-health crisis levels, especially tourism flows

After the unprecedented collapse in Q2, external trade in goods and services in Q3 appears to have picked up significantly. Nonetheless, this has not prevented the levels of these variables from remaining considerably below those observed pre-health crisis. The increase in foreign trade appears to cover both exports and imports, with across-the-board rises in goods and services transactions in each case.

The net external balance deducted 2.3 pp from GDP growth in Q2. In that period, goods and services transactions with the rest of the world dropped very sharply (see Chart 15.1). Specifically, between April and June aggregate exports diminished by 33.5%, while imports fell by 28.8%. In the case of goods, the decline in sales to the rest of the world was somewhat less steep than that in purchases abroad, in a context of markedly weak domestic demand. By contrast, the fall in exports of services, influenced by the adverse performance of both tourism and other services, was quite sharper than that in imports.

However, the available information appears to suggest that the contribution of net exports has changed sign in Q3, entering positive territory. This shift in the external sector's contribution to GDP growth would reflect the existing evidence of the quarter-on-quarter increase being more pronounced in exports than in imports. That said, in the current setting, which is particularly influenced by the course of the pandemic and its impact on the Spanish and global economy, a high level of uncertainty surrounds the sign and size of the external sector's contribution to quarter-on-quarter GDP growth in Q3.

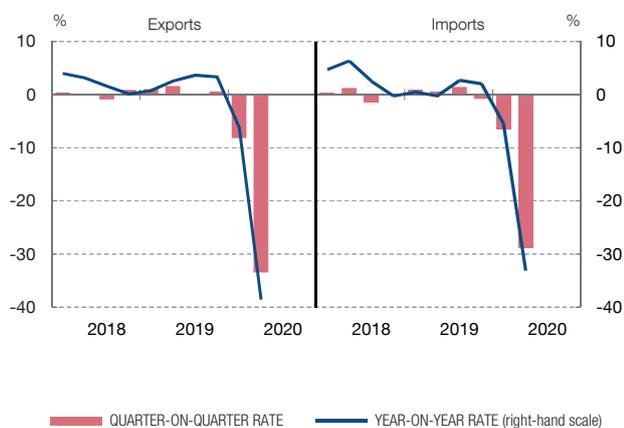
¹⁴ This ratio was calculated using the flash estimate of GDP in Q2 (in cumulative four-quarter terms) published by INE.

Chart 15

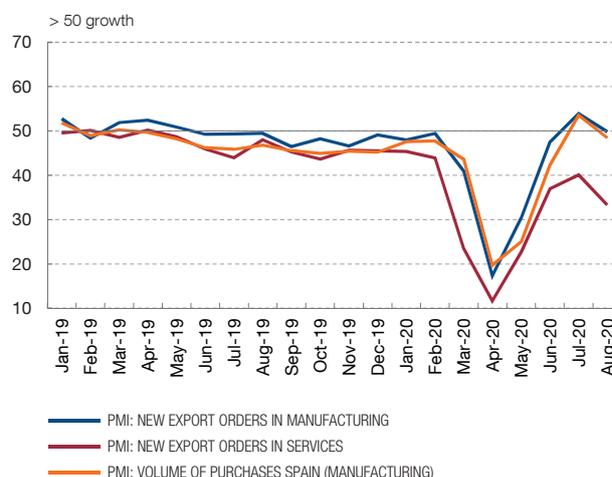
EXTERNAL TRADE FLOWS APPEAR TO HAVE RECOVERED IN RECENT MONTHS, WITHOUT YET REACHING PRE-HEALTH CRISIS LEVELS

Transactions with the rest of the world started to recover gradually as the measures adopted in Spain and internationally to contain the pandemic were eased. This improvement was stronger in goods trade than in services, the latter being influenced by fresh outbreaks of the pandemic in Spain, which cut short the path of gradual recovery of tourism and international passenger transport observed in early June.

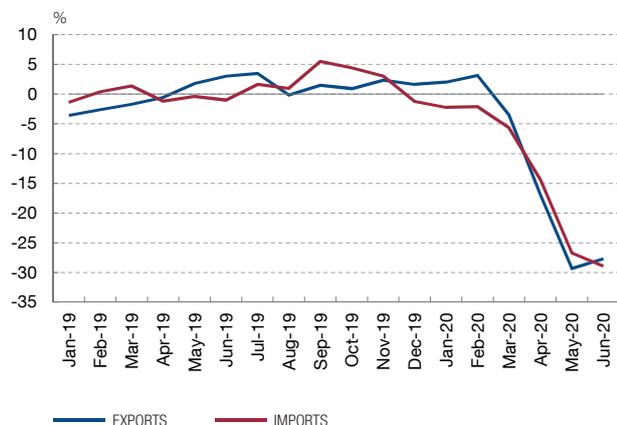
1 EXPORTS AND IMPORTS OF GOODS AND SERVICES (a)



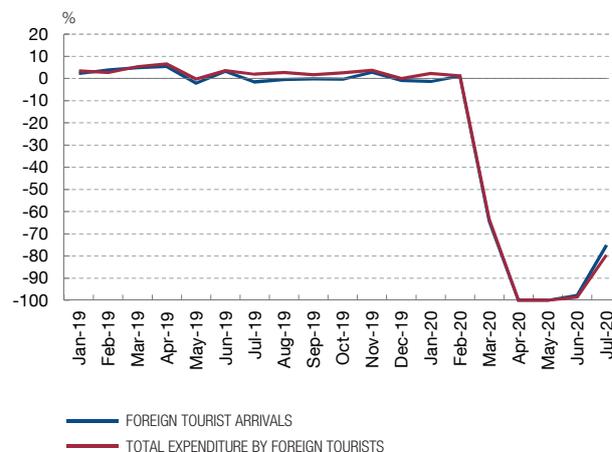
2 CONFIDENCE INDICATORS



3 REAL EXPORTS AND IMPORTS OF GOODS
(Deflated data from Customs)
Year-on-year rate from 3-month moving average



4 INDICATORS OF FOREIGN TOURISM
Year-on-year rate of change



SOURCES: INE, Departamento de Aduanas, Ministerio de Asuntos Económicos y Transformación Digital, and Markit.

a QNA data at constant prices. Seasonally adjusted series.



Goods transactions with the rest of the world have followed a path of gradual recovery, which is more pronounced in the case of exports. The latest leading qualitative data are the new export orders according to Spain’s manufacturing PMI. These levelled off in August after an increase in July (see Chart 15.2). This change arose amid a revival of global trade (drawing on information available up to July), yet it remains at levels considerably lower than those of the same period of 2019. The

inputs purchases component of the manufacturing PMI, which bears an indirect relationship to imports, performed weaker than the export orders indicator. This supports the evidence that the recovery of sales to the rest of the world has been more intense than the recovery in purchases.

The Customs data to June, the latest data available, afford quantitative corroboration of the information provided by the qualitative indicators to August. According to Customs, in the period to June, goods transactions showed a trend of gradual recovery, especially on the exports side (see Chart 15.3). During Q2, the year-on-year rates of decline of imports and, especially, of exports slowed, to 18.6% and 9.1%, respectively, in June, as compared with declines of more than 30% in the two preceding months. The gradual improvement in sales of goods to the rest of the world is broad-based by type of product, with notable improvements in capital goods and food, which in June had already returned to positive growth rates. That said, exports of non-energy intermediate products have recovered less strongly, as a result of the gradual resumption of activity, the disruption to global production chains during the health crisis and manufacturing inventory levels that remain relatively high. By geographical area, the improvement in real exports to the EU is proving to be somewhat stronger than in those to extra-EU markets.

The recovery in imports has been weaker. The behaviour of purchases from the rest of the world, in real terms, is explained by the extreme weakness that continues to be seen in purchases of energy and consumer durables and, from a more general standpoint, the fact that the marked lack of vigour in Spanish private demand is even more acute than in the case of Spain's trading partners. This ultimately means that the goods balance will contribute to the expected positive contribution of net external demand to GDP growth.

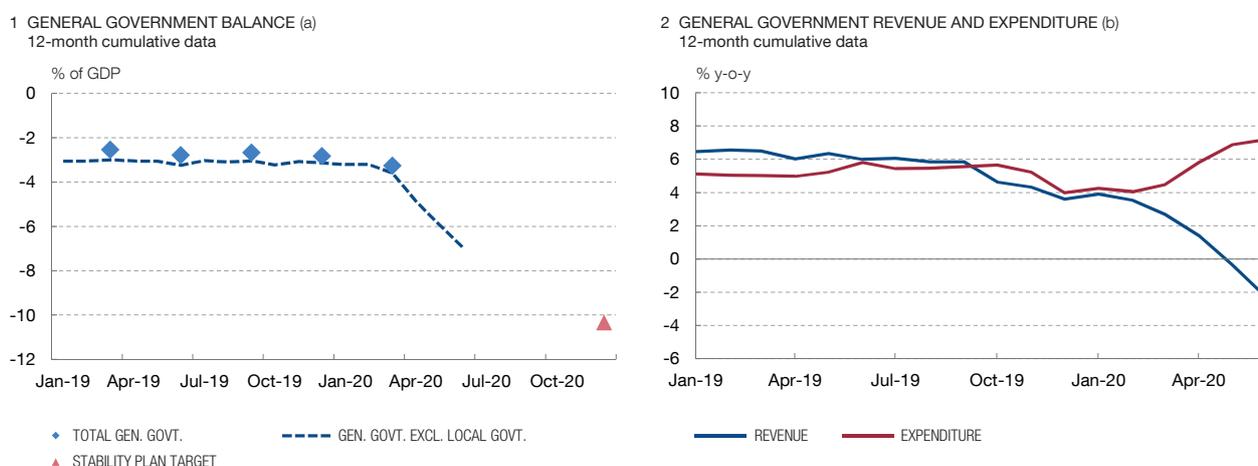
Turning to foreign trade in services, the prospects for a gradual recovery in tourism and international transport at the beginning of Q3 were cut short by the spread of outbreaks of COVID-19. The latest qualitative indicators, such as the PMI, are compatible with an improvement in services exports in Q3 that was less pronounced than the improvement in goods trade. In the case of tourism, whose activity came to a complete halt in Q2, exports followed a path of gradual recovery in the first weeks of July, once the state of alert had ended and international travel to and from a large number of countries had restarted (see Chart 15.4). However, since the end of that month, the outlook has been clouded by the negative impact of the fresh outbreaks of the pandemic in Spain, which have led to the reintroduction of restrictions on travel to Spain by the main countries that provide it with tourists.¹⁵

15 For further details on tourism in Spain in recent months, see Box 8 of this report, "Recent developments in inbound tourism in Spain".

Chart 16

PUBLIC FINANCES POSTED A STRONG DETERIORATION IN H1

The impact of the health crisis, of the measures adopted to contain it and of the fiscal policy measures implemented to counter its effects are clearly reflected in the budget outturn data to June. The deterioration of the budget balance will foreseeably continue over the course of the year.



SOURCE: IGAE, Stability Programme Update 2020.

- a The IGAE only provides quarterly information on general government as a whole. It publishes the data on the total, excluding local government, on a monthly basis.
b Relating to the aggregate for general government, excluding local government and transfers within general government.



The latest developments in general government finances reflect the profound effects of the epidemiological crisis and of the measures adopted to mitigate its impact on public finances

In recent months, the Government has continued to adapt the economic policy measures deployed since the outbreak of the health crisis to the course of such crisis. In relation to the labour market, at the end of June, the Council of Ministers approved an extension of the employment protection measures to 30 September, albeit amending the conditions applied.^{16, 17} Also, in July, the Government approved the creation of a new guarantee facility, with a maximum amount of €40 billion, the main aim of which is to finance investment by companies and the self-employed.¹⁸

The latest developments in public finances reflect the impact of the crisis and of the measures approved since March. The general government deficit, excluding local government, in 12-month cumulative terms, stood in the first half of 2020 at 7% of GDP, up 3.8 pp from December 2019 (see Chart 16). This figure reflects an increase

¹⁶ See Royal Decree-Law 24/2020.

¹⁷ As at the date of this report going to press, the Government is negotiating a new extension of these measures with the social agents.

¹⁸ See Royal Decree-Law 25/2020.

in expenditure of 7.2% year-on-year and a slowdown in revenue to -2.3% (following the increase of 3.6% in 2019 as a whole). According to the IGAE (National Audit Office), more than 70% of the increase in spending recorded to June appears to be directly related to the COVID-19 pandemic. As indicated in the box on the projections, these dynamics will translate into a very substantial increase in the general government budget deficit for 2020 as a whole, from 2.8% of GDP at the end of 2019 to between 10.8% and 12.1%, according to the two scenarios considered by the Banco de España.

At its meeting held between 17 and 21 July, the Council of the European Union approved a broad package of fiscal measures to support the European economies most affected by the impact of the COVID-19 crisis (see Box 5). In terms of the total amount, Spain would be one of the main beneficiaries of this programme (second only to Italy), and might receive over the period 2021-2026 a volume of funds representing up to 8% of its GDP in 2019. As at the date of this report going to press, many dimensions of this stimulus package have yet to be defined, including its total amount, the timing of distributions and its budgetary composition. In any event, its large size suggests that, under certain assumptions regarding its composition and duration, this programme may entail a very significant fiscal stimulus for our country over the next few years (see Box 9).

In recent months, the behaviour of consumer prices has been driven by the pick-up in energy prices and by the moderation of non-energy components, in a context of weak demand

The rate of decline of inflation, as measured by the harmonised index of consumer prices (HICP), has moderated slightly in recent months to stand at -0.6% in August (see Chart 17.1). These developments resulted from the pick-up in energy prices, partially offset by the easing of food prices and core inflation (see Charts 17.2 and 17.3). The energy component accelerated to a year-on-year rate of almost -9.3% in August, in line with the recovery of oil prices, which almost doubled between April and July, in terms of their average monthly level, stabilising in August at around \$45/barrel (see Chart 17.4). Among non-energy components, food prices, the growth rate of which doubled between February and April, owing mainly to the behaviour of fresh food, subsequently slowed to a rate similar to that recorded before the pandemic.

Core inflation decelerated sharply in July and marginally in August to a year-on-year rate of 0.1%, its lowest level for five years. The various components of core inflation followed divergent paths. On the one hand, there was an abrupt deceleration in services prices in July, their year-on-year rate remaining at 0.1% in August, in line with the markedly lower-than-usual dynamism of tourism-related items at this time of year. On the other hand, non-energy industrial goods prices

Chart 17

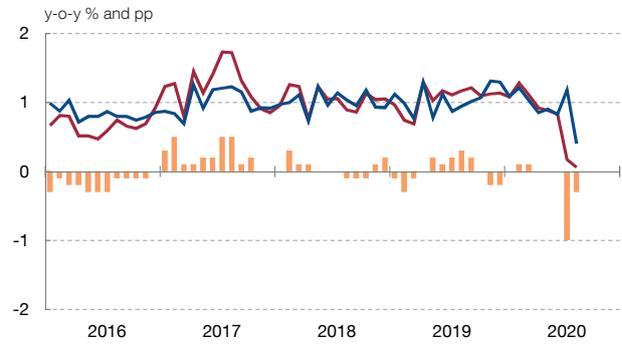
DECLINE IN INFLATION AND MODERATION IN WAGE INCREASES

Inflation has risen somewhat more intensely in the euro area than in Spain, in a setting in which oil prices have recovered and food price inflation between May and August moderated similarly in both areas, while core inflation performed rather more differently. In the domestic sphere, wage rates remain relatively steady, against a backdrop of scant progress in collective bargaining negotiations.

1 HEADLINE HICP

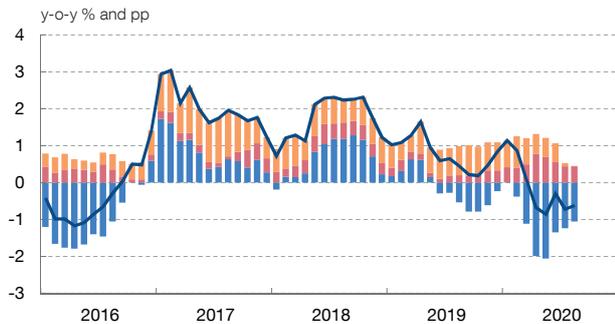


2 HICP EXCLUDING ENERGY AND FOOD



DIFFERENTIAL SPAIN EURO AREA

3 HICP: CHANGE AND CONTRIBUTIONS



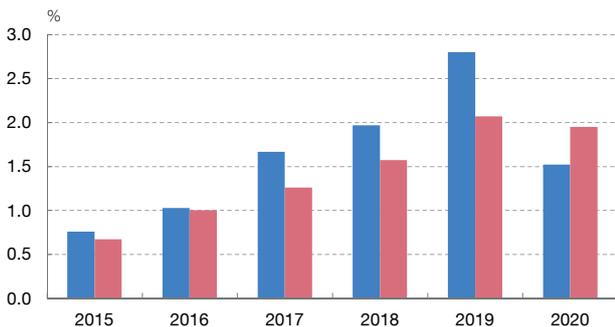
HICP EXCLUDING ENERGY AND FOOD FOOD ENERGY HEADLINE HICP

4 SPOT OIL PRICES AND FUTURES MARKET



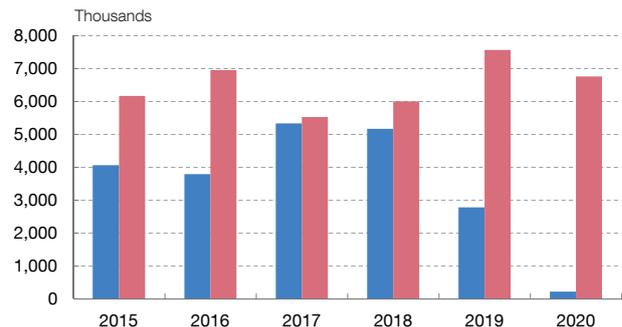
CURRENT PROJECTION

5 AGREED WAGE INCREASES (a)



NEWLY SIGNED WAGE AGREEMENTS REVISED WAGE AGREEMENTS

6 WORKERS COVERED BY COLLECTIVE BARGAINING



SOURCES: INE, Eurostat, Reuters, Ministerio de Trabajo, Migraciones y Seguridad Social and Banco de España.

a On data up to August 2020. The revised wage agreements are agreements signed in previous years; the newly signed agreements are those signed in 2020.



gathered pace to a year-on-year rate of 0.2% in August as a result of the more expansionary course followed by some items, such as those related to household appliances. The core inflation differential with euro area countries was -0.3 pp in August.¹⁹

In the coming months, the inflation rate is expected to remain negative, albeit close to zero. This would be a consequence of the waning negative contribution of energy prices, while core inflation will likely remain very moderate as a result of the modest increases expected in services prices, particularly those related to tourism, in a context where elements continue to push price developments in opposite directions. First, the downward pressures stemming from weak demand could grow stronger in the coming months if more stringent containment measures were to be required to curb the recent spread of the pandemic. However, some upward pressure cannot be ruled out due to rising costs for firms associated with the introduction of hygiene and health measures.

Collective bargaining agreements have led to wage rates remaining somewhat stable, in a context of scant progress in negotiations, although the labour costs of businesses increased in Q2 (see Charts 17.5 and 17.6). Wage rates under collective bargaining agreements, on data to August, rose by an average of 1.9%, slightly lower than the 2.3% agreed the previous year. These rises, which already affect a very large number of workers (almost 7 million), basically reflect what was agreed in collective bargaining agreements signed in previous years, as there are still very few newly signed agreements. These wage increases are therefore not yet reflecting the impact of the current crisis on the labour market. On Quarterly National Accounts data, compensation per employee increased by 3.1% in the market economy in Q2, up from 1.2% in Q1. Given the stability of wage rates, this acceleration in compensation per employee appears to be associated mainly with composition effects arising from the intense labour shedding that took place in Spain after the outbreak of the health crisis.

10.9.2020.

¹⁹ At the cut-off date for this report, the only inflation data available for the euro area as a whole were provisional preliminary estimates for August.