

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.

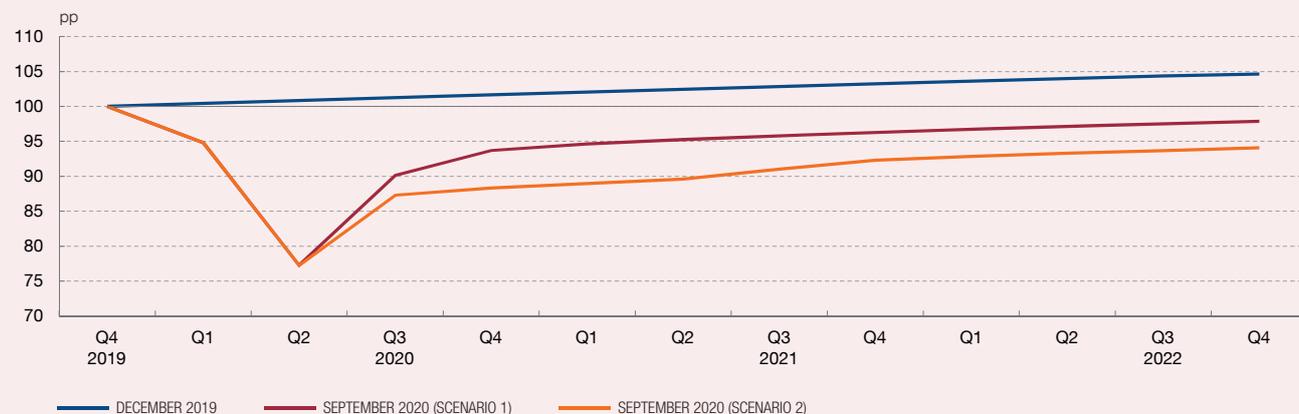
NOTE: Latest QNA figure published: 2020 Q2.

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

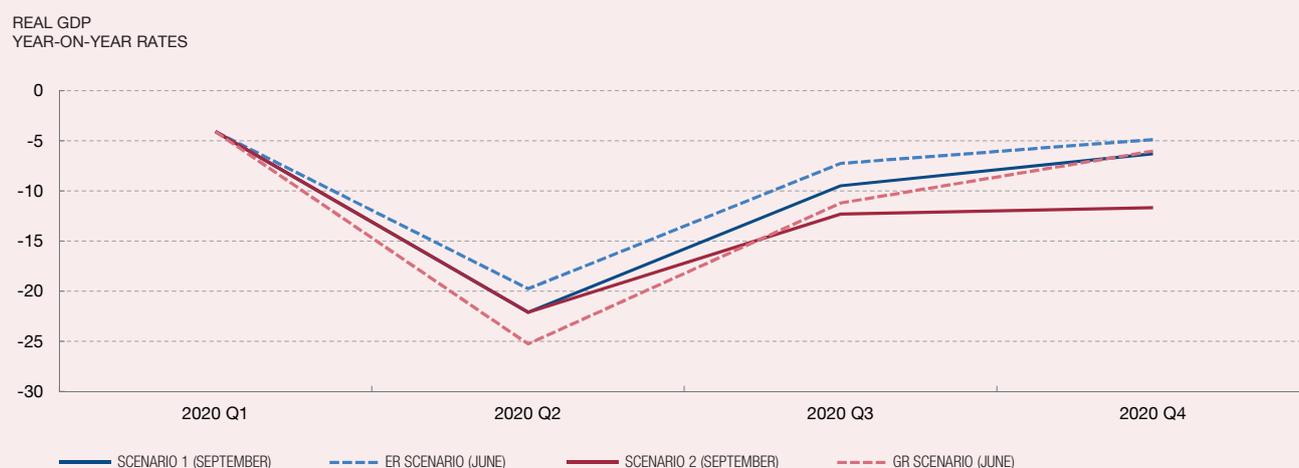
The crisis is having an intense impact on the various components of both national and external demand (with the exception of government consumption and investment), which will lead to very marked declines in these aggregates in 2020 as a whole (see Table 1). This average annual performance stems from 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 of 0.1 pp 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

	2019	September 2020 projections			Difference between current projections and the June 2020 gradual recovery scenario (b)		
		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.