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**AN INCOMPLETE RECOVERY AMID UNCERTAINTY: FROM THE PANDEMIC TO THE RISE IN INFLATION AND THE OUTBREAK OF WAR**



### 1 Introduction

**The supply chain disruptions, the pick-up in inflation and, in 2022, the war in Ukraine have hampered the global economic recovery that followed the most acute phase of the pandemic.** In the last two years, events on various levels with an impact on global economic activity have successively unfolded at a rapid pace. The restrictions on movement and contact, introduced to contain the pandemic, gave rise to a steep decline in activity in the spring of 2020 without precedent in recent history. The gradual lifting of those measures allowed a progressive recovery to begin in the summer of that year which was, nevertheless, stymied over the course of 2021 by a number of factors. These include the rise in the price of numerous commodities (mainly energy commodities) and the emergence of disruptions in global supply chains (bottlenecks), which have fuelled a sustained and sharp upturn in inflationary pressures. The Russian aggression against Ukraine in February 2022 has cast a dark shadow over the economic outlook and exacerbated price pressures in an environment marked by unusually high levels of uncertainty.

**The gradual path of recovery of activity throughout 2021 was, in any event, highly uneven across geographical areas and sectors of activity.** In the advanced economies, the swift roll-out of vaccines made it possible to cope with the successive waves of COVID-19 using only targeted restrictions rather than having to reintroduce pandemic containment measures with more adverse effects on economic activity. This gradual improvement in the epidemiological situation, together with the effectiveness of economic policies, has allowed many of these countries to reach their pre-crisis output levels. By contrast, in a large number of emerging economies the pandemic continued to hinder economic activity owing to the slow pace of vaccination. One factor that would explain the difference in progress, in both advanced and emerging market economies, is the sectoral composition of activity. Specifically, the countries that are lagging further behind tend to coincide with those where services in which personal interaction plays a major role (such as tourism-related services) account for a large share of the productive structure.

**At the global level, supply was not able to respond quickly enough to the recovery in demand.** The gradual lifting of the restrictions gave rise to a relatively swift revival of demand, aided by the broad support provided by macroeconomic policies. But global output did not react as quickly, largely because of the complexity of supply chains, which involve very distant providers in geographical terms that operate to order and with low stock levels. In particular, shortages of intermediate goods and the lack of means of transport disrupted these very fragmented supply

chains at different stages, highlighting their fragility. More recently, these difficulties have been compounded by some countries' zero-COVID policies.

**A salient feature of macroeconomic developments since the beginning of 2021 was the rise in commodity prices, particularly energy prices.** The ultimate causes of this rise are not easy to disentangle, as discussed in Chapter 3 of this report. As noted above, this is due partly to the rigidity of the supply of some intermediate goods (including energy) following the recovery in demand and partly to the role of gas both as a primary source of energy and in electricity generation, particularly in the European context. As the invasion of Ukraine has tragically highlighted, gas markets are subject to geopolitical vagaries in terms of both cost and security of supply.

**Since last year, this increase in commodity prices and the disruptions in supply chains have been leading to a surprisingly steep and persistent upturn in inflation across all geographical areas.** Given the a priori temporary nature of the phenomena that originated it, initial assessments of the rise in input costs underlined their probable transitory nature. However, as these cost increases have grown sharper and longer-lasting, firms have started passing them through to their final prices. Moreover, since energy is a direct part of households' consumption basket, the higher energy prices are leading to a decline in the purchasing power of these agents. A potential full pass-through of firms' costs to their final prices and of energy consumer prices to wage growth would set in motion a price-wage feedback loop that would prolong inflation, with the ensuing loss of well-being.

**Against this backdrop, the global macroeconomic outlook in early 2022 was moderately optimistic.** Now that the Omicron variant has been overcome, the course of the pandemic appears to be having less of an impact on economic activity, particularly in the advanced economies. And, although persistent inflation and bottlenecks were emerging as a growing risk for the sustainability of the recovery, it was still considered that these factors would lose steam over the course of the year.

**But Russia's aggression against Ukraine has drastically altered that scenario.** The invasion is a shock of major proportions, with adverse consequences in terms of weaker economic growth and greater inflationary pressures. The complex channels through which this global economic disruption could materialise can be grouped into four categories, although they are not strictly independent from each other.

**The most relevant channel is probably that related to the importance of Russia and Ukraine as global commodity producers.** Europe's dependence on some of these commodities, such as gas, is very high. And although Spain is less dependent on them, it cannot escape rising prices on global markets. Furthermore, the war has raised the possibility that gas supplies could be interrupted, in response to which it would be difficult to find alternative suppliers in the short term. In addition, the war is affecting the supply of some agricultural commodities that are key to feeding the

world's population and of some metals that play a central role in the production of certain goods, such as technological products and motor vehicles.

**Second, the war is having a highly significant adverse effect on economic activity through its impact on private agents' confidence.** Uncertainty about the duration and the actual course of the war and, therefore, about developments in household and corporate incomes tends to make these agents postpone their consumption and investment decisions.

**Third, world trade could be substantially impaired.** Spain's direct exposure to the two countries at war is small, but the indirect impact stemming from other more exposed economies and from the adverse effects that are arising in the production chains of some goods could be much more relevant than the direct effects. And there is a risk that these exposures will be exacerbated, in way that is not easy to anticipate, by the trade and financial sanctions introduced.

**Lastly, there is a potential financial channel that could transmit the shock to the real economy.** For the time being the financial effects, both globally and for Spain, have been small, in terms of both financial flows and their cost. However, the heightening of the inflationary process could have significant implications on monetary policy stance in the advanced economies, resulting in tighter financial conditions worldwide. Nor can it be ruled out that the effects will become more relevant in the future, particularly in the context of the possible implications of excluding Russia from global financial channels.

**This extraordinarily uncertain setting makes it difficult to formulate macroeconomic projections.** The most recent Banco de España projections, dating from early April, foresaw GDP growth of 4.5% in 2022 assuming no further escalation of the war, meaning that its biggest macroeconomic impact would be felt in 2022 Q2.<sup>1</sup> This high growth largely owed to the remarkable economic buoyancy at end-2021, which implied that the rate would remain high (at 3.1%) even if activity were to remain at its end-2021 level throughout 2022. Under this scenario, average inflation in 2022 would stand at 7.5%, the highest consumer price inflation rate in Spain since 1986.

**That baseline scenario is subject to downside risks to GDP growth and upside risks to inflation.** Part of those risks have already materialised, according to the information published after the projections cut-off date. Estimated GDP growth in 2022 Q1 has been lower than expected, automatically leading to a significant downward revision of average growth in 2022. Additionally, except for the energy component, consumer prices have recently recorded higher growth than anticipated by those projections. Besides the data already observed, the risks going forward

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<sup>1</sup> See Box 1, "Macroeconomic projections for the Spanish economy (2022-2024)" in the Quarterly Report on the Spanish Economy, *Economic Bulletin* 1/2022, Banco de España.

would be linked, above all, to the possibility that the fallout from the war could be more persistent and far-reaching, for example in terms of further commodity price increases or a complete halt in trade flows between the European Union and Russia. Moreover, activity and inflation would also perform more unfavourably in a scenario in which firms and workers tried to preserve their margins and wage levels in real terms, respectively, as this is not feasible in the face of a shock that entails a loss of income for the domestic economy vis-à-vis the rest of the world. An upside risk to activity would be the possibility that households will avoid reducing their consumption of goods and services in response to the lower disposable income by using the savings they accumulated during the pandemic. This possibility is moderated by the fact that lower-income households, where energy goods account for a larger share of the consumption basket and which are therefore more affected by energy price increases, were barely able to build up such savings buffers during the health crisis.

**In the current setting, economic policies have a crucial role to play.** Like other central banks, the European Central Bank (ECB) has begun a process of monetary policy normalisation. In an extraordinarily uncertain scenario, and provided that euro area medium-term inflation expectations remain anchored around its 2% target, the ECB has emphasised that its monetary policy response will depend on the performance of economic indicators, in addition to being gradual and maintaining all of the optionality and flexibility provided by its various instruments. In particular, the ECB Governing Council has insisted that it will take whatever action is needed to fulfil its price stability mandate and to safeguard financial stability.

**Fiscal policy in Spain must continue to cushion the effects of the successive shocks of the last two years, but must act selectively and through temporary measures, given the high government indebtedness and the resulting limited scope for action.** Following the increase in government debt in the wake of the pandemic, there is barely any budgetary room for manoeuvre. This calls for a very selective and temporary use of such measures, to avoid passing on an excessive burden to future generations and, more worryingly, compromising fiscal sustainability. This need to act in a selective manner makes it all the more advisable to rely on direct grants to support the agents most affected by the energy price increase rather than implement across-the-board price discounts, which are costlier and do not provide the right incentives to reduce consumption of these goods.

**The nature of the most recent shocks makes an incomes agreement between firms and workers a particularly appropriate instrument for addressing them.** As noted above, the rise in the cost of imported commodities entails a loss of income for the domestic economy, the sharing out of which should be agreed in the context of social dialogue. The agreement, whether explicit or tacit (as seems to have been the case so far), should be based on the premise that a wage-price spiral would entail an additional income loss for the domestic economy owing to the loss of external competitiveness and, therefore, a decline in net exports vis-à-vis the rest of the world.

**In addition, pan-European policies can make a very relevant contribution.** Current challenges obviously transcend national borders and can be more appropriately addressed through a joint European response. The war provides an opportunity to deepen integration in the continent, even if it has been partly missed due to the failure so far to mutualise the fiscal policy response.

**Lastly, the war makes an additional geopolitical argument for decarbonising the Spanish and European economy.** Far from pushing concerns about the consequences of climate into the background, the security of energy supply has made transitioning to renewable energy sources that reduce external dependence even more necessary. Chapter 4 of this Annual Report analyses the energy transition challenge for the Spanish economy.

## 2 The firming of the economic recovery and the rise in inflation at the global and euro area levels

**The recovery in global economic activity firmed in 2021 and over the first months of 2022, although growth in this period slowed temporarily and even more so after the invasion of Ukraine by the Russian army in late February.** World GDP rebounded by 6.1% in 2021 (see Chart 1.1.1), after the 3.1% decline in 2020, thanks to headway in the vaccination process (which enabled the health restrictions to be eased and bolstered consumer and business confidence) and to continued economic policy support. However, the recovery had a very volatile profile and lost some momentum from late 2021 onwards, as the pandemic worsened in some regions (owing to the emergence of new COVID-19 variants), bottlenecks in global supply chains persisted<sup>2</sup> and, as described in detail in Chapter 3 of this Annual Report, inflation picked up significantly mostly owing to higher energy and food prices.

**By geographical area, the pace of economic growth proved uneven.** Among the major economies, GDP growth in 2021 was 5.7% in the United States, 5.3% in the euro area and 7.4% in the United Kingdom. China grew by 8.1% in the year as a whole, although it experienced a marked deceleration in 2021 H2 as a result of the slowdown in the residential real estate sector and the imposition of strict health measures in response to fresh COVID-19 outbreaks. Among the emerging economies, the recovery was particularly strong in emerging Asia and Latin America,<sup>3</sup> with GDP growth rates of 7.3% and 6.8%, respectively. However, growth in the latter region's two largest economies (Brazil and Mexico) was dampened in 2021 H2 by the upsurge in inflation, the monetary policy tightening, the course of the pandemic and the persistence of bottlenecks.

<sup>2</sup> See Kataryniuk, Del Río and Sánchez-Carretero (2021) and Alonso, Kataryniuk and Martínez-Martín (2021).

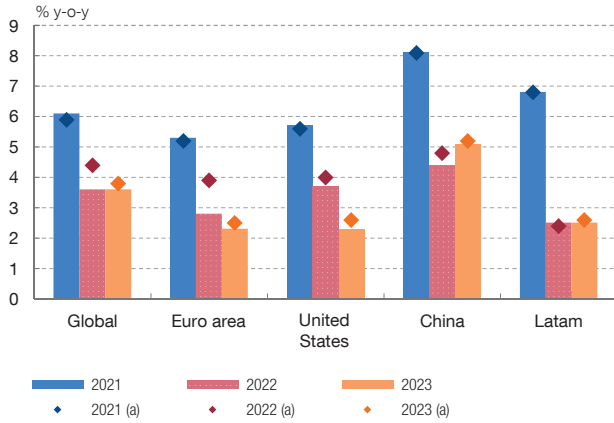
<sup>3</sup> See Reports on the Latin American economy at <https://www.bde.es/bde/en/areas/analisis-economi/enfoque/americalatina/>

Chart 1.1

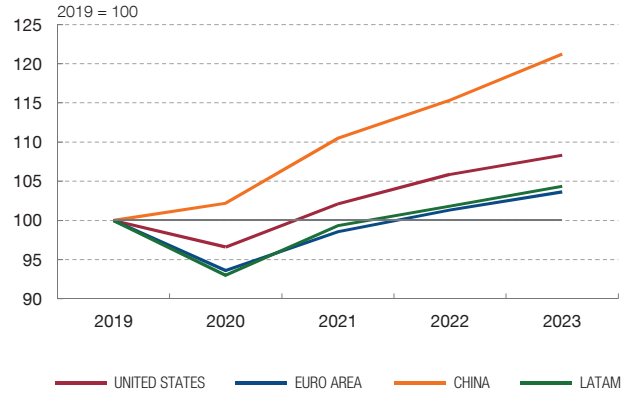
**THE FIRING OF THE GLOBAL ECONOMIC RECOVERY IN 2021**

The global economic recovery strengthened in 2021, although growth in activity slowed as the year progressed, even more so after the invasion of Ukraine and the imposition of sanctions against Russia. Growth in activity was uneven across geographical areas, economic sectors and demand components. The recovery is also heterogeneous across euro area countries.

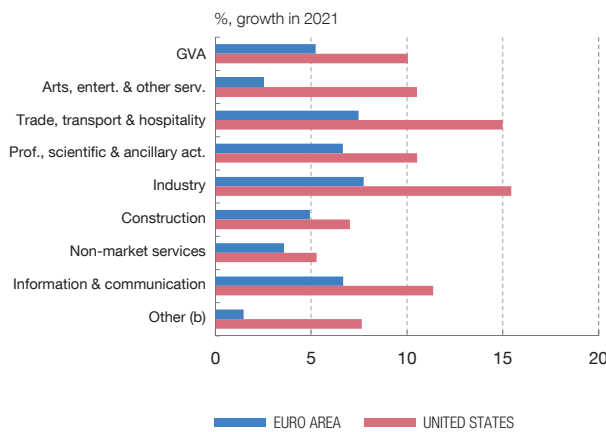
1 GDP GROWTH PROJECTED BY THE IMF IN THE APRIL 2022 WEO



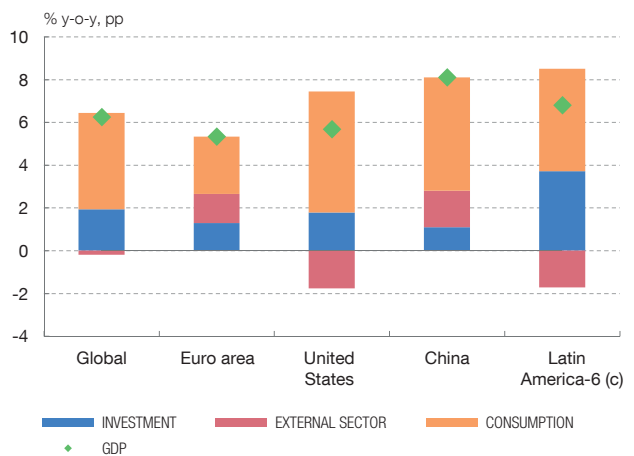
2 GDP LEVEL BY REGION: APRIL 2022 PROJECTIONS



3 GVA GROWTH BY SECTOR



4 BREAKDOWN OF 2021 GROWTH



SOURCES: Banco de España, national statistics, Eurostat, IMF (April 2022 World Economic Outlook) and Refinitiv.

- a October 2021 World Economic Outlook projections.
- b "Other" includes the primary sector and other market services (financial activities, insurance and real estate activities).
- c Aggregate of Argentina, Brazil, Chile, Colombia, Mexico and Peru.



**Cross-country differences in the extent to which pre-crisis levels of activity have been regained are largely explained by the productive structure (mainly in terms of the importance of the sectors most exposed to social interaction and to global supply chains), differential access to vaccines and the different capacity of economic policies to provide support.** Thus, while the United States had already exceeded such levels in 2021 H1, the euro area as a whole did not do so until the end of the year (see Chart 1.1.2). Among the largest economies of the area, only France and the Netherlands returned to their pre-pandemic levels in 2021. According to the latest International Monetary Fund (IMF) projections, Germany and Italy will regain those



levels in 2022 and Spain will not do so until 2023. Although the emerging economies have, on the whole, recouped their pre-COVID-19 levels, cumulative growth since late 2019 is considerably lower than it would have been had the pre-crisis growth trend held unchanged.

**The mixed pace of the recovery also affected the different economic sectors.**

The shift from demand for services (affected by the health restrictions) towards demand for goods drove a rapid recovery in the industrial sector initially (see Chart 1.1.3), leading to supply and demand mismatches against a backdrop of disruptions in global production and distribution chains.<sup>4</sup> From 2021 H2, however, headway in the vaccination campaign, particularly in the advanced economies, stimulated service sector activity as mobility increased due to the easing of the pandemic containment measures.

**The global recovery was mainly underpinned by private consumption** (see

Chart 1.1.4). The lifting of the restrictions on movement and public policies to support household income boosted private consumption, particularly in the United States. Nevertheless, the household saving ratio has remained above its pre-pandemic level, possibly owing to the increase in the precautionary component in an ongoing, highly uncertain context. Investment in capital goods, which had gained momentum in 2021 H1 fuelled by particularly favourable financing conditions, was weighed down in H2 by the persistence of bottlenecks, higher energy prices and the resurgence of the pandemic in the final months of the year. Similarly, the recovery in residential investment was also constrained by shortages of materials and, in some economies, of construction workers.

**The bottlenecks that emerged in global value chains slowed the recovery in international goods trade, which had already surpassed pre-pandemic levels at end-2020** (see Chart 1.2.1). The pick-up in demand for manufactured goods,

together with logistical difficulties in transport services and the health measures in Chinese manufacturing sites and ports associated with the zero-COVID policy implemented by several Asian countries, led to a significant increase in supplier delivery times (particularly for specific inputs such as semiconductors, electronic equipment and metal components), which disrupted international production chains and limited global goods trade growth.<sup>5</sup> Trade in services grew steadily throughout the year, reaching pre-health crisis levels only in Q4.

**Goods trade developments also showed cross-regional divergences and were marked in Europe by the United Kingdom's exit from the single market.** Trade growth was significant in the emerging economies overall, particularly in the Asian

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4 Chapter 3 of this report provides a detailed description of the bottlenecks in production chains and analyses their impact on inflation. See also [Attinasi, Bobasu and Gerinovics \(2021\)](#) and [Frohm et al. \(2021\)](#).

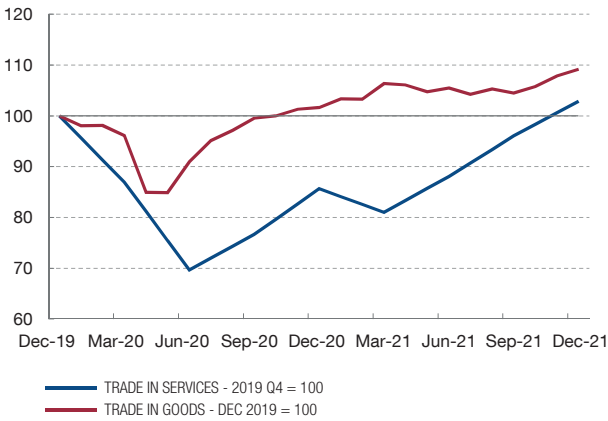
5 [Kataryniuk, Pérez and Viani \(2021\)](#) and [Di Stefano \(2021\)](#) analyse the impact of the health crisis on global value chains and conclude that, although it was very significant, there was no evidence at that time that multinational corporations were planning a significant relocation of their productive activity to their countries of origin owing to the pandemic.

Chart 1.2

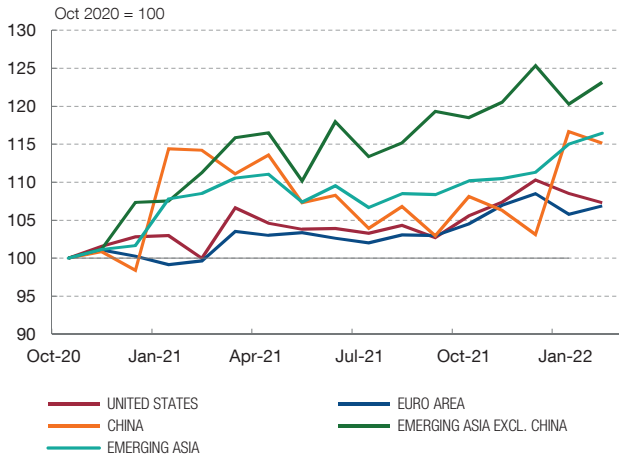
**THE RECOVERY IN WORLD TRADE HAS BEEN WEIGHED DOWN BY BOTTLENECKS AND FRESH OUTBREAKS OF THE PANDEMIC**

Prolonged bottlenecks in global production and distribution chains have slowed the recovery of international goods trade, which could be further severely affected by the war and the sanctions against Russia. Goods trade growth also showed some cross-regional divergences and was marked in Europe by the United Kingdom's exit from the single market.

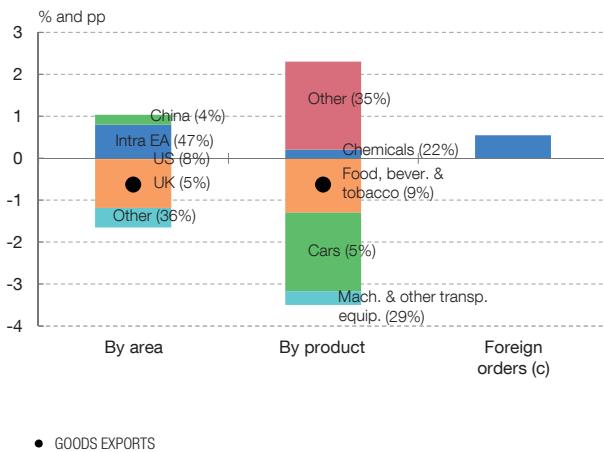
1 DEVELOPMENTS IN INTERNATIONAL TRADE (a)



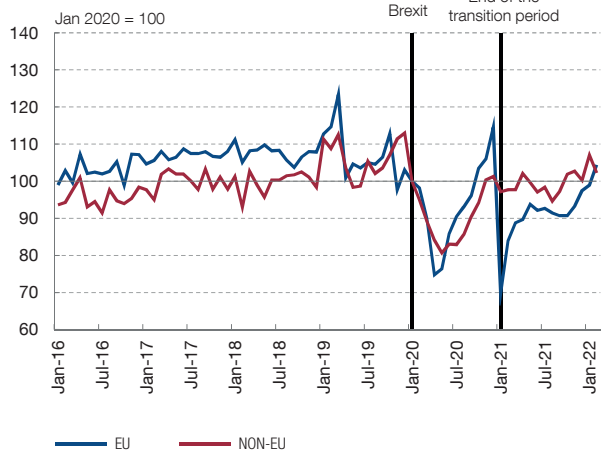
2 GOODS TRADE BY REGION



3 EURO AREA. VOLUME OF REAL GOODS EXPORTS GROWTH IN 2021 WITH RESPECT TO 2019 AND CONTRIBUTIONS (b)



4 UNITED KINGDOM: BILATERAL GOODS TRADE VOLUMES EU VS NON-EU



SOURCES: CPB, Office for National Statistics and OECD.

- a Trade in services data are nominal and published quarterly. The weighted average of the countries with available data is reported. Goods trade data are expressed in real terms.
- b The share of each product and destination in total euro area goods exports in 2021 is given in brackets.
- c European Commission business and consumer survey. Standardised series. Change in 2021 with respect to 2019.



region, but was more contained in the main advanced economies (see Chart 1.2.2), where the impact of the disruptions to global value chains was more marked due to the importance of the most affected industries in their productive structure and to severe input shortages.<sup>6</sup> In the case of the European countries, moreover, the end of

6 See Frohm et al. (2021).

the Brexit transition period in January 2021, which marked the United Kingdom's exit from the European single market and the subsequent entry into force of the Trade and Cooperation Agreement with the European Union, had a negative impact on euro area exports (see Chart 1.2.3). Thus, the end of the transition period coincided with a marked reduction in the merchandise trade volume between the United Kingdom and the European Union,<sup>7</sup> which only returned to pre-Brexit levels in February 2022 (see Chart 1.2.4). This limited recovery is partly explained by the fact that European firms with a higher exposure to the United Kingdom appear to have taken advantage of the transition period to gradually relocate their trade activities to other EU countries, as suggested by the evidence available for Spain.<sup>8</sup>

**In 2021 and in 2022 to date, inflation increased significantly worldwide to rates not seen for several decades** (see Chart 1.3.1). Among the advanced economies, consumer price tensions are particularly high in the United States, where the inflation rate reached 8.5% in March 2022, the highest level since 1982. But the upsurge has also been very marked in the euro area, where the harmonised index of consumer prices (HICP) posted a year-on-year increase of 7.5% in April, an unprecedented figure in the history of the monetary union. Among the emerging market economies, inflation rose especially in Latin America, reaching 9.3% in March for the region overall, while it was very moderate in China. Price increases, which are proving more intense and persistent than anticipated, have affected above all commodity prices, mainly energy and agricultural commodities, which were also hit in 2021 H2 by the geopolitical tensions that culminated in the outbreak of the war in Ukraine at the end of February 2022 and in the harsh sanctions imposed on Russia by the international community (see Chart 1.3.2). As discussed in Chapter 3, underlying inflation (which excludes energy and food) has also trended upwards, albeit in a more subdued manner, particularly in the euro area, where it rose by 3.5% in April (compared with 6.5% in March in the United States).

**Expectations of a faster-than-anticipated withdrawal of monetary stimuli in response to the uptick in inflation and higher risk aversion following the outbreak of the war in Ukraine have tightened global financial conditions since the beginning of 2022, particularly in the emerging markets** (see Chart 1.4.1). Long-term yields on higher-rated sovereign bonds, which had remained low throughout 2021, albeit with some volatility, picked up somewhat sharply since the beginning of this year (see Chart 1.4.2). Corporate credit risk premia (especially in the high-yield segment) and euro area sovereign spreads have also increased (see Chart 1.4.3) and are now higher than before the pandemic.

**The greater risk aversion has been reflected in increases in implied bond and equity market volatilities and rises in the systemic risk indices, which have been**

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<sup>7</sup> See [Buesa et al. \(2021\)](#).

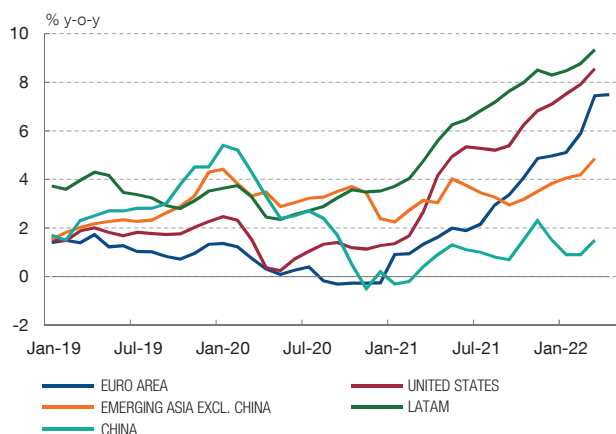
<sup>8</sup> See [Gutiérrez, Lacuesta and Martín Machuca \(2021\)](#).

Chart 1.3

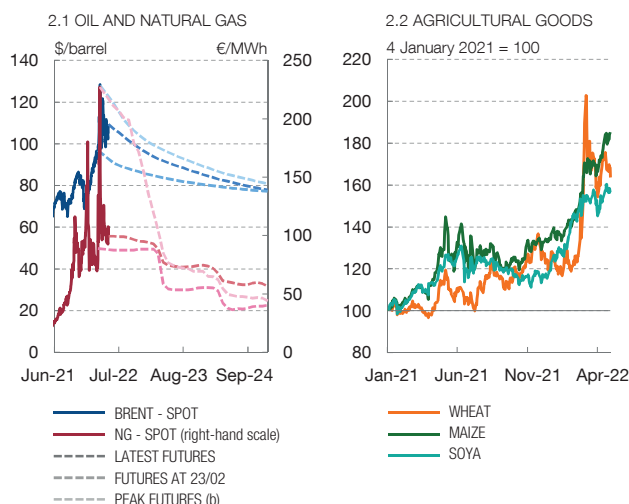
**THE PICK-UP IN INFLATION IS PROVING STRONGER AND MORE PERSISTENT THAN ANTICIPATED**

Inflation increased significantly worldwide to rates not seen for several decades, spurred by the rise in energy commodity and food prices and by the persistence of bottlenecks. The war in Ukraine has led to a further rise in the prices of energy and some agricultural products, and adds considerable uncertainty to the short and medium-term inflation outlook.

1 YEAR-ON-YEAR INFLATION (a)



2 COMMODITY PRICES



SOURCES: Bloomberg, Refinitiv and national statistics.

- a The Latam aggregate is the average of five Latin American countries (Brazil, Colombia, Chile, Peru and Mexico).
- b Oil prices peaked on 8 March and natural gas prices on 7 March.



**more significant in the euro area than in the United States** (see Chart 1.4.4). The main stock market indices, which remained on a rising trend in 2021 underpinned by better-than-expected corporate earnings and progress in the vaccination campaign worldwide, slipped at the beginning of 2022, influenced by the rise in interest rates and the invasion of Ukraine (see Chart 1.4.5). In foreign exchange markets, the euro continued to depreciate against the dollar and, to a lesser extent, against its other main trading partners (see Chart 1.4.6). The depreciation of the euro against the dollar appears to reflect the expectation of a widening divergence between monetary policy cycles in both areas and the fact that the dollar has acted as a safe-haven currency in the current setting of geopolitical tensions, which is comparatively worse for Europe.

**The war in Ukraine has worsened the global growth outlook for the coming quarters.** The war itself, and the international community’s response with harsh economic sanctions against Russia, have increased uncertainty, tightened financing conditions, exacerbated bottlenecks and pushed up energy and food prices (thus eroding households’ purchasing power and increasing firms’ production costs). These effects tend to be bigger in a geographical area, such as Europe, which depends to a greater extent on Ukraine and, above all, on Russia, for the supply of some commodities.<sup>9</sup>

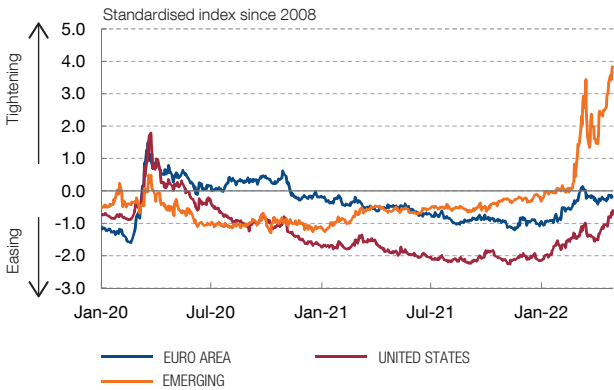
<sup>9</sup> See Alonso et al. (2022).

Chart 1.4

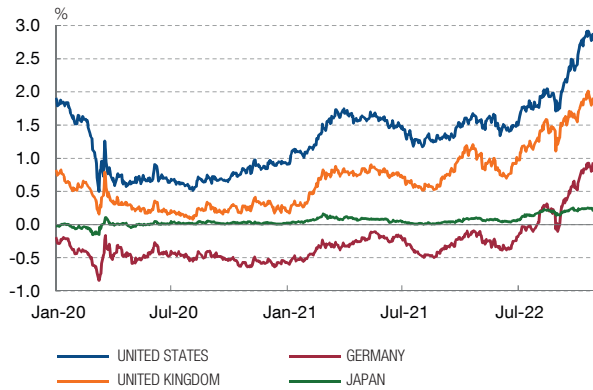
**GLOBAL FINANCIAL CONDITIONS HAVE TIGHTENED RECENTLY**

Financial conditions have tightened since early 2022, particularly in the emerging market economies. Long-term yields on higher-rated government bonds and euro area sovereign spreads picked up in 2022, on expectations of a faster-than-expected withdrawal of monetary stimuli in response to the uptick in inflation. Increased uncertainty and heightened risk aversion have been reflected in higher financial asset price volatility and rises in the systemic risk indices. These developments, together with the rise in long-term interest rates, have affected the performance of the major stock market indices and exchange rates.

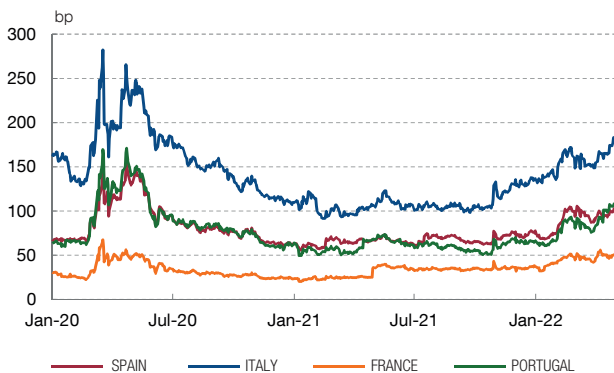
1 GOLDMAN SACHS FINANCIAL CONDITIONS INDICES



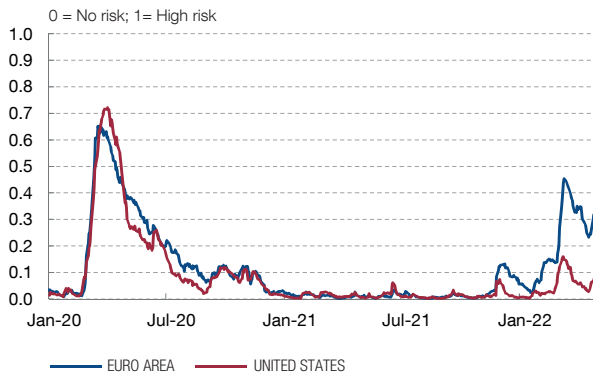
2 TEN-YEAR SOVEREIGN YIELDS



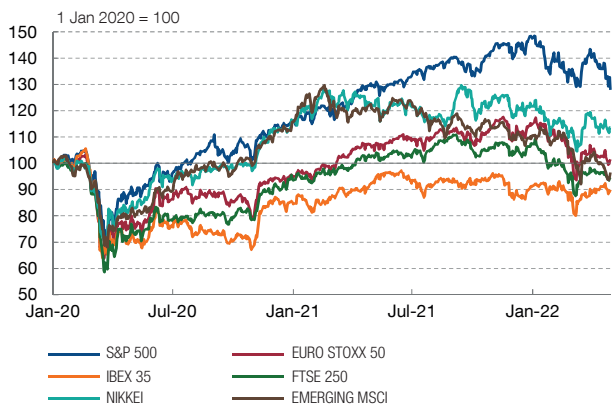
3 TEN-YEAR SOVEREIGN SPREADS VIS-À-VIS GERMANY



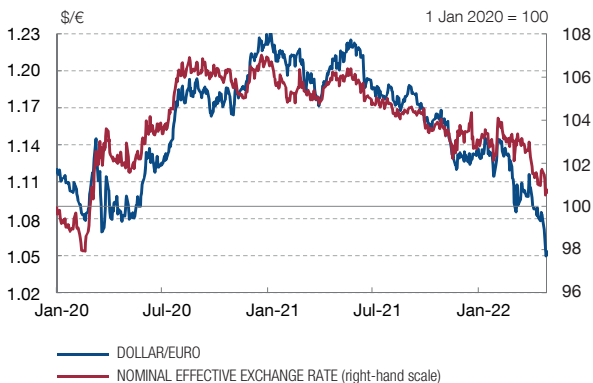
4 COMPOSITE INDICATOR OF SYSTEMIC RISK (a)



5 STOCK MARKET INDICES



6 EURO EXCHANGE RATES (b)



**SOURCES:** Refinitiv Datastream, Bloomberg Data License and ECB.

- a The ECB's Composite Indicator of Systemic Stress (CISS).
- b An increase (decrease) indicates an appreciation (depreciation) of the euro.



In general, the change in the relative price of exports and imports (the terms of trade) stemming from higher commodity prices will bear down on the economic activity of countries that are net importers and will benefit net exporters, particularly emerging market economies that are not highly integrated into global value chains, such as those in Latin America.

**Economic policies, which played a key role in the stabilisation phase of the health crisis, must also come to the fore in the current phase, where the extraordinary increase in uncertainty and inflationary pressures are jeopardising the continuity of the recovery.** As analysed in Section 4, and, more extensively, in Chapters 2 and 3 of this Annual Report, the growth outlook will largely depend on the proper calibration of the fiscal and monetary policy responses. These should maintain a medium-term orientation that ensures expectations are anchored around the price stability and fiscal sustainability targets, while retaining sufficient flexibility in the short term, which is necessary in the current climate of heightened uncertainty. Alongside these policies, structural reforms aiming to raise potential growth and enhance economies' flexibility to respond to future shocks are also particularly relevant in the current context. Beyond the consequences of the war for growth and inflation, the outlook for global activity is also influenced by the still uncertain course of the pandemic. The uneven pace of vaccination worldwide and the possible emergence of new COVID-19 variants mean that the health crisis has not yet been fully resolved. It is essential in this connection to reinforce multilateral collaborative initiatives, such as COVAX,<sup>10</sup> whose aim is to accelerate the manufacture of vaccines and to ensure fair and equitable access to all countries.

### 3 Positive and negative aspects of the recovery in Spain



**The gradual recovery of the Spanish economy over the course of 2021 lasted until the Russian invasion of Ukraine in early 2022.** Between the onset of the pandemic and the outbreak of the war, economic activity in Spain was influenced by epidemiological developments and the measures adopted to contain the disease (see Figure 1). The sharp fall in GDP in 2020 Q2, in the wake of the first lockdown, was followed by an equally sharp rebound in the summer months of that year. But the recovery stalled thereafter until 2021 Q2, when a phase of stronger output growth began as the toll of the pandemic on public health and economic activity weakened, thanks to the headway made in the vaccination campaign. Against the background of continued favourable financial conditions, these developments were initially supported almost exclusively by domestic demand, although net exports also made a significant contribution to output growth in 2021 H2. In any event, the strength of

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<sup>10</sup> COVAX is the vaccines pillar of the Access to COVID-19 Tools (ACT) Accelerator, a global collaboration initiative promoted by the World Health Organization to accelerate the development, production and equitable access to COVID19 tests, treatments and vaccines.

Figure 1.1

**THE SPANISH ECONOMY: BETWEEN OVERCOMING THE PANDEMIC AND THE UNCERTAINTY CAUSED BY THE WAR IN UKRAINE**

	 <b>KEY DEVELOPMENTS</b>	 <b>ECONOMIC POLICIES</b>
<b>2021 H1</b>	<p>Economic activity in Spain was influenced by epidemiological developments and the measures to contain the disease, which hindered its recovery, particularly in the services sector.</p> <p>Progress in the vaccination campaign raised hopes that the health crisis would be overcome and, therefore, that a more vigorous recovery in activity would be seen in the second half of the year, underpinned by favourable employment developments.</p>	<p>Monetary and fiscal policies provided crucial support to activity in the face of fresh waves of the pandemic, although the vaccine roll-out raised the prospect of their progressive normalisation.</p>
<b>2021 H2</b>	<p>The lifting of the containment measures was conducive to the sectoral shift of activity towards services. However, the supply chain disruptions and rising commodity prices, particularly of energy commodities, hampered the recovery in manufacturing.</p> <p>Uncertainty over the duration of the inflationary pressures and the bottlenecks, together with the new variant of the virus, threatened the recovery path in the final stages of the year. By contrast, expectations of a possible release of the built-up savings and of the rollout of NGEU funds suggested activity would be buttressed somewhat.</p>	<p>The process of monetary policy normalisation began, due to the increase in inflation, although the broadly expansionary stance remained.</p>
<b>2022 Q1</b>	<p>The recovery regained momentum in the initial weeks of the year thanks to the improving epidemiological situation and some timid signs of the bottlenecks clearing. However, the invasion of Ukraine has entailed, through various channels, a new shock to economic activity and prices: a fresh rise in commodity prices, private agents losing confidence and a slowdown in international trade.</p> <p>The war has generated considerable uncertainty, with risks to the downside for activity and to the upside for inflation.</p>	<p>Monetary policy must be guided by the price stability mandate and not overreact to developments in the more volatile components.</p> <p>Fiscal policy must mitigate the adverse effects of the new shock, but selectively given its scant room for manoeuvre (particularly in Spain). An incomes agreement would be highly desirable.</p>

SOURCE: Banco de España.

the recovery was increasingly dampened over the course of 2021 by disruptions in global supply chains and inflationary pressures. And, just as the first signs of an easing of these forces were beginning to emerge, the war broke out.

**Spanish GDP is returning to its pre-pandemic level slower than the euro area as a whole.** Specifically, the gap between GDP in 2022 Q1 and 2019 Q4 is still 3.4%. By contrast, the euro area had already surpassed pre-pandemic levels of activity at the beginning of this year. From the demand component standpoint, Spain's slower recovery is attributable to the less favourable behaviour of private consumption, housing investment and tourism exports. From the supply side, the relative delay in Spain's recovery can be explained by the comparatively higher share in GDP and employment of the sectors

requiring greater social interaction. Additionally, structural factors, such as Spanish firms' small size, may have amplified the adverse impact of the pandemic in Spain.

### 3.1 Bottlenecks and inflation, magnified by the war in Ukraine, are holding back the recovery

**The successive waves of the pandemic tended to have less consequences for public health as the vaccination process progressed.** The epidemiological situation deteriorated significantly in early 2021, but the improvement observed from March led to the end of the third state of alert on 9 May (see Chart 1.5.1). Two further outbreaks followed, although their severity was comparatively lower. The first of these episodes, which took place at the beginning of the summer, was more pronounced in Spain than in other European countries and had a negative impact on the tourist season. The second one, associated with the more contagious Omicron variant, caused an explosive increase in case numbers from December onwards to very high levels in mid-January 2022, both in Spain and in the rest of Europe. Since then the epidemiological situation has improved substantially.

**A crucial factor in explaining the gradual reduction in the severity of the disease over the successive waves is the growing proportion of fully vaccinated people.** Spain soon took the lead in the international vaccination process. By the end of the summer of 2022, 80% of the population was fully vaccinated (see Chart 1.5.2). In last year's successive outbreaks, vaccination reduced the severity of the disease and, therefore, the number of hospitalisations and deaths relative to the number of cases.

**This gradually diminished the impact of the pandemic on activity.** The improved health situation allowed the measures restricting contact to be gradually eased and mobility to be restored (see Chart 1.5.3). However, this process was incomplete – as was, therefore, the recovery in activity – since it has not allowed pre-crisis output levels to be regained nor has it reached all productive sectors equally.

**In 2021 overall, GDP grew by 5.1%.** Output growth was mainly underpinned by the contribution of domestic demand (4.7 percentage points (pp), including the 0.5 pp contribution of the change in inventories) (see Chart 1.5.4). Net external demand contributed almost 0.5 pp. In 2022 Q1 the consequences of the war resulted in GDP growth moderating significantly, to 0.3% quarter-on-quarter.

**Over the course of 2021 and in 2022 to date there has been an intense shift in the strength of activity across sectors.** The stringent restrictions in response to the pandemic remained in place in 2021 H1, leading to a sluggish performance of services requiring social interaction, with manufacturing showing greater buoyancy. But, as the year progressed, activity in the hospitality and leisure sectors became more dynamic as vaccination enabled the pandemic containment measures to be lifted (see Chart 1.6).

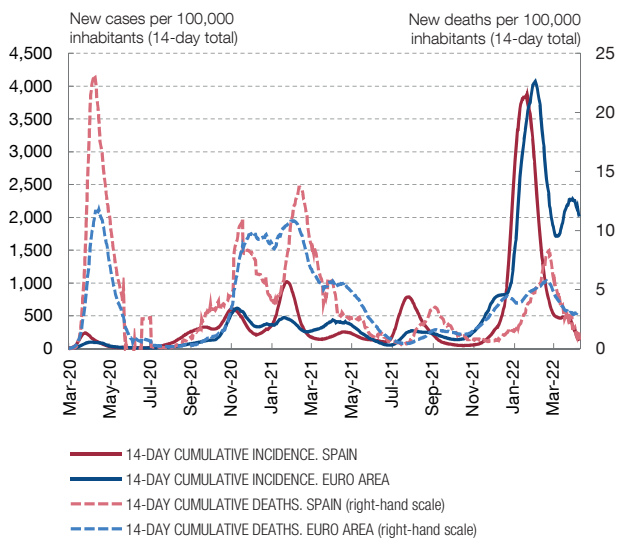


Chart 1.5

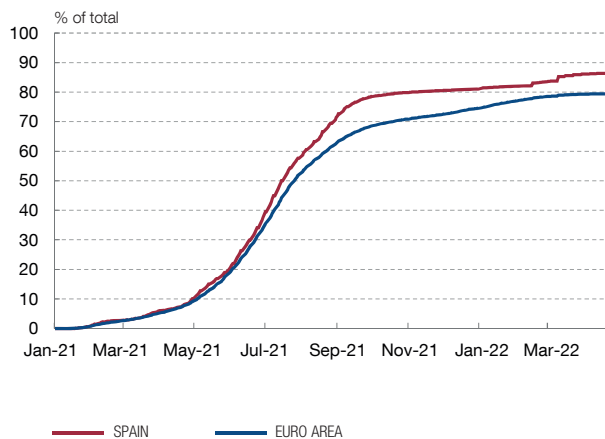
**IN SPAIN, ACTIVITY RECOVERED GRADUALLY ON THE BACK OF THE IMPROVED HEALTH SITUATION**

The Spanish economy recovered gradually in 2021, albeit incompletely, helped by the waning impact of the pandemic on activity thanks to the vaccination process.

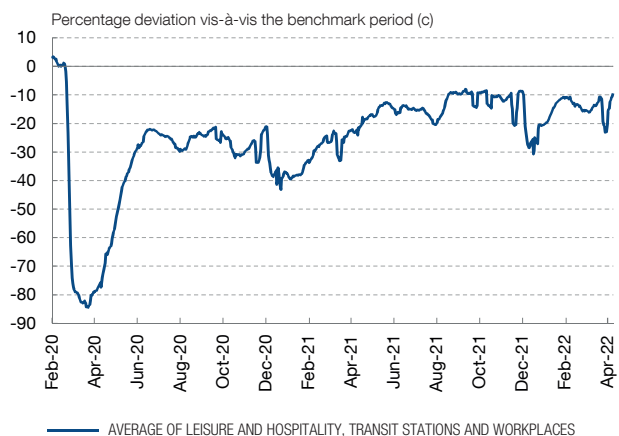
1 COURSE OF THE COVID-19 PANDEMIC IN SPAIN AND THE EURO AREA (a)



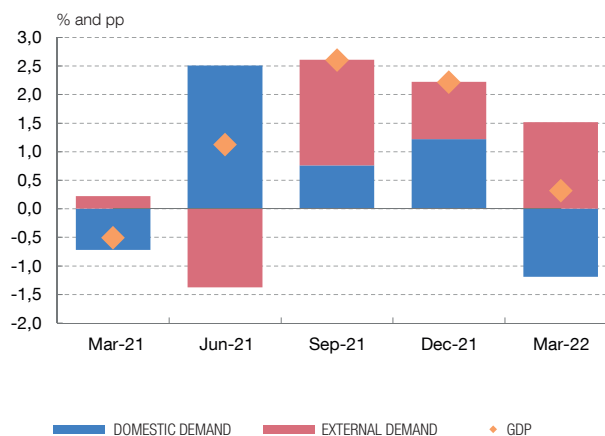
2 PERCENTAGE OF FULLY VACCINATED POPULATION (b)



3 GOOGLE MOBILITY INDICATOR



4 QUARTER-ON-QUARTER REAL GDP GROWTH AND CONTRIBUTIONS



**SOURCES:** Our World in Data, INE, Google and Banco de España.

a Latest data: 9 April.

b On information up to 27 April.

c Percentage deviation from the mobility observed during a pre-pandemic reference period (3 January - 6 February 2020). 7-day moving averages.



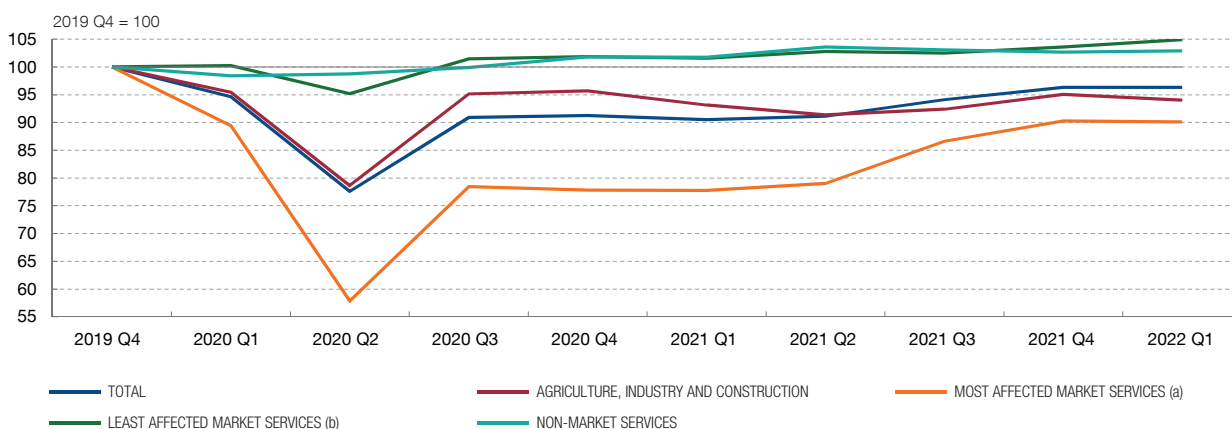
At the same time, disruptions in maritime transport, supply difficulties affecting certain inputs and their rising cost affected the recovery in the primary, industrial and construction sectors from mid-2021. Within the manufacturing sector, the production of transport equipment was particularly exposed to the disruptions in production processes, owing to the wide mismatches between supply and demand that emerged in the semiconductor and integrated circuit industry in the final stretch of 2020 and which intensified

Chart 1.6

### THE RECOVERY IN ACTIVITY HAS BEEN UNEVEN ACROSS THE SECTORS OF ACTIVITY

The sectors hardest hit by the pandemic are lagging behind the rest, many of which have reached pre-crisis levels.

1 CHANGE IN GROSS VALUE ADDED, BY SECTOR



SOURCES: INE, Ministerio de Inclusión, Seguridad Social y Migraciones and European Commission.

a Trade, transportation and hospitality, professional, scientific and administrative activities and arts and recreation services.  
 b Information and communication, financial and insurance activities and real estate activities.



progressively over the course of 2021. This has led to production cuts at numerous car factories in Spain and in the rest of Europe.<sup>11</sup> This activity is very sensitive to disruptions in international supply chains, since production is highly fragmented across different locations and it operates with low stock levels, based on the “just in time” model. It is also a very significant sector, not only because of its share in the economy as a whole (2.7% of total GVA in 2019, including the motor vehicle manufacturing and sale sectors), but also because of the significant spillover effects on the activity of other sectors.<sup>12</sup>

**As in other geographical areas, consumer prices have accelerated sharply.** The year-on-year rate of change has risen almost continuously between December 2021 and March 2022, going from -0.6% to 9.4%, its highest value since 1985.<sup>13,14</sup> For the most part, this increase in headline inflation is attributable to the rise in energy prices,

11 Industrial output indices in Spain for the car and other transport equipment (trains, aircraft, ships) manufacturing sectors are 21.5% and 6.6% below pre-pandemic levels, respectively.  
 12 Manufacture of motor vehicles is the sector which is most detracting from GDP due to the impact of global supply chain bottlenecks. Specifically, it is estimated that the shocks on this sector would have reduced the average GDP growth rate by 0.2 pp in 2021 and could lower it by another 0.5 pp in 2022 (see [Fernández-Cerezo, Montero and Prades \(2021\)](#)). The direct effects of the fall in production in the automotive sector would lie behind somewhat less than 30% of this downward revision, while the rest would be due to both domestic and international spillover effects.  
 13 The HICP series begins in 1997. For the period 1985-1996 the comparison is made against the consumer price index (CPI).  
 14 In April, the HICP decelerated to 8.3%, according to the leading indicator. However, at the cut-off date for this report, the breakdown by component is not yet available, making it difficult to evaluate the most recent data, although the partial information available suggests that the reduction in the rate is the result of the slowdown in the energy component, while the non-energy index continued to rise.

which accounts for almost two-thirds of the total increase (see Chart 1.7.1). However, food, services and non-energy industrial goods prices have also risen at a higher pace throughout this period. The underlying inflation indicator, which measures the change in prices in the latter two components, which typically show smaller swings, has rebounded between December 2020 and March 2022 from -0.1% to 3%. This increase can also be observed, albeit less intensely, when other alternative inflation measures are considered based on the exclusion of the most volatile components (see Chart 1.7.2).

**As described in further detail in Chapter 3 of this report, there are three factors behind this increase in inflation.**

The first, essentially mechanic in nature, is linked to the sharp slowdown in the price of numerous goods and services in the first months of the pandemic, which led to the emergence of powerful base effects on year-on-year inflation as of March 2021.<sup>15</sup> The second factor is linked to the response of supply to the recovery in demand once the worst of the health crisis had passed and to the changes in households' consumption patterns stemming from the pandemic containment measures and the pandemic itself. In this setting, as noted above, the imperfect adaptation of production processes to these demand developments, together with the proliferation of disruptions in international maritime transport, has altered global supply chains,<sup>16</sup> resulting in significant rises in the price of a wide range of intermediate goods. The third factor, partly related to the previous one, is the global increase in energy prices, as detailed below.

**Hydrocarbon and electricity prices have increased markedly since early 2021.**

Oil and gas prices have risen very sharply since the beginning of last year, partly due to the progressive escalation of geopolitical tensions. Further, the increase in the price of gas (a commodity used by combined cycle power plants) and, albeit to a lesser degree, of greenhouse gas emission allowances caused electricity prices on wholesale markets to surge, given the price-setting mechanisms in these markets.<sup>17</sup> This inflation has affected retail electricity prices in Spain significantly more than in other European countries (see Chart 1.7.3).<sup>18</sup>

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15 Base effect is the name given to the effect that arises when the year-on-year rate of change in a given month is affected by abnormally low or high month-on-month changes observed in the same month a year earlier. For a more detailed explanation of this effect, see [Banco de España \(2016\)](#).

16 See [Kataryniuk, Del Río and Sánchez Carretero \(2021\)](#) and [Attinasi et al. \(2021\)](#).

17 The wholesale electricity market operates under a marginal pricing model, whereby all power generators receive the market clearing price, which is set at the marginal generation costs of the most expensive technology. In Spain, developments in wholesale electricity markets mirrored those in other European countries, with prices increasing by 575% between end-2020 and March 2022. More than 80% of this increase owed to the rise in gas prices, while the higher price of emission allowances accounted for almost 10%. For more details on this estimate, see [Pacce, Sánchez and Suárez-Varela \(2021\)](#).

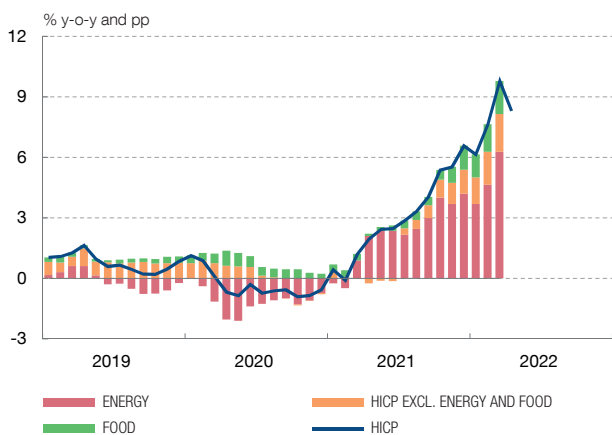
18 Retail prices have risen more sharply in Spain due to the differences in the price-setting mechanisms in each country, which mean wholesale market developments are passed through to retail prices at different speeds. This pass-through is particularly swift in Spain, while in other countries the spillover from the recent price rises in wholesale markets is yet to be observed.

Chart 1.7

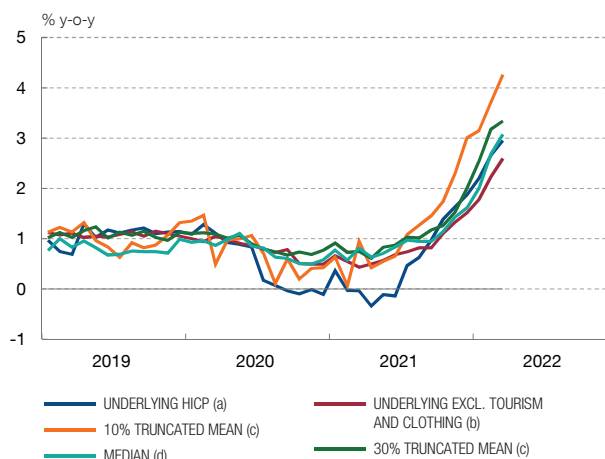
## THE INCREASE IN ENERGY PRICES EXPLAINS MUCH OF THE RISE IN INFLATION, BUT THE GROWTH IN OTHER CONSUMER PRICES HAS ALSO QUICKENED

Inflation has risen sharply since early 2021, driven essentially by the price of electricity and oil derivatives. However, the rate of price growth for other goods and services in the consumption basket has also risen to varying extents. This owes to a number of factors, including the recovery in demand following the gradual reopening of the economy, in step with the lifting of the pandemic containment restrictions, and the supply disruptions caused by production bottlenecks.

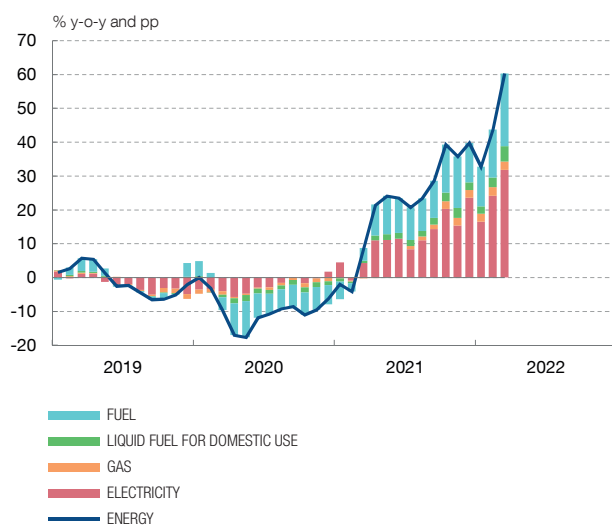
1 HEADLINE HICP. CHANGE AND CONTRIBUTIONS



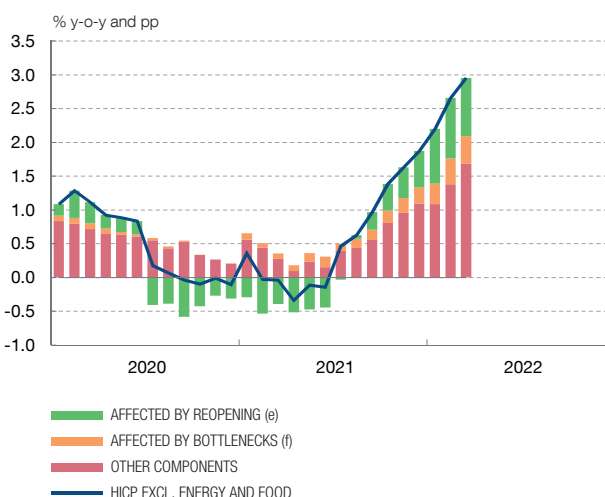
2 MEASURES OF UNDERLYING INFLATION



3 ENERGY HICP. CHANGE AND CONTRIBUTIONS



4 HICP EXCL. ENERGY AND FOOD. CHANGE AND CONTRIBUTIONS



SOURCES: INE and Banco de España.

- a HICP excluding energy and food.
- b HICP excluding energy, food, clothing and footwear, package holidays, accommodation services and air transport.
- c The trimmed mean is defined as the average rate of inflation after trimming out the components with the smallest and largest price change. For the 10% (30%) trimmed mean, the top and bottom 5% (15%) of components at each tail of the distribution of price changes are removed.
- d The median refers to the middle value in the distribution of price changes for all HICP components.
- e Includes: clothing and footwear, air transport, recreation and culture services and accommodation services.
- f Includes: vehicles, spare parts and accessories, and furniture and fittings.



**To date, the pass-through of the higher cost of inputs to the different components of the non-energy consumption basket has been partial.** Energy inflation has fed through quickly and in full to the corresponding consumer price components. However, the rise in input prices (energy and non-energy alike) has so far only partially fed through to the prices of the other consumption basket components (see Chart 1.7.4). This is consistent with the available empirical evidence, which suggests that the changes in input prices (those hit hardest by the bottlenecks) have a relatively small impact on the HICP and with a certain lag.<sup>19</sup> In the current episode, this is borne out by the results of various surveys of non-financial corporations (NFCs), such as the Purchasing Managers' Index (PMI) and the Banco de España Business Activity Survey (EBAE),<sup>20</sup> which indicate that since early 2021 firms have indeed only partially passed rising costs through to the final prices of their products. This would have narrowed profit margins somewhat, despite the recovery in demand.

**The war in Ukraine has further driven up energy prices and has exacerbated some of the distortions in global value chains.** At the start of the year, the tensions in global supply chains showed early signs of easing. However, once the war broke out, disruptions to supplies from Russia and Ukraine cast a shadow over those indications. Prices in hydrocarbon markets, and in some metal and agricultural commodity markets, have also tightened further. Thus, certain factors that were initially thought to be temporary are proving more persistent, driving up the likelihood of a widespread spillover to other nominal variables of the economy and the emergence of adverse effects on global activity. In particular, a protracted spell of high input costs means less scope for profit margins to continue to absorb these higher costs, thus translating into greater pass-through to final consumer prices. In a setting in which employees' real income is also declining, more persistent inflation could ultimately carry over to wage demands and, therefore, to labour costs, leading to the price-wage feedback loop known as second-round effects.

### 3.2 The limited recovery in household and business spending

**Financial conditions, which remained accommodating throughout 2021, began tightening in the early months of this year.** Over the course of 2021, the spending decisions of private agents in the economy benefited from the enduring period of favourable financing conditions. Interest rates on new lending declined across the board as the year progressed, reaching historical lows in all segments (see Chart 1.8.1). However, this trend came to an end in 2022. Although bank lending rates held at low levels in the early months of the year, the recent increase in interbank market yields suggests that

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19 In a simple correlation analysis for the period 2003-2021, the strongest correlation between the increase in producer prices for intermediate goods and underlying inflation occurs with a lag of six months. This is a shorter delay than identified for the euro area, where the feed-through of intermediate goods prices to non-energy industrial goods prices would take between 12 and 18 months (see Koester et al., (2021)).

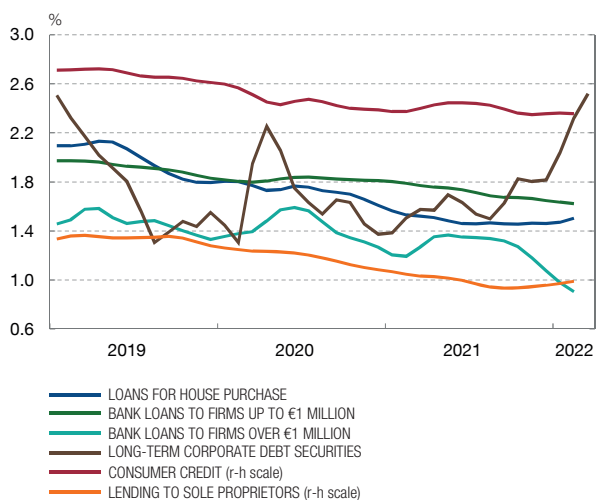
20 See Izquierdo (2022) (only available in Spanish).

Chart 1.8

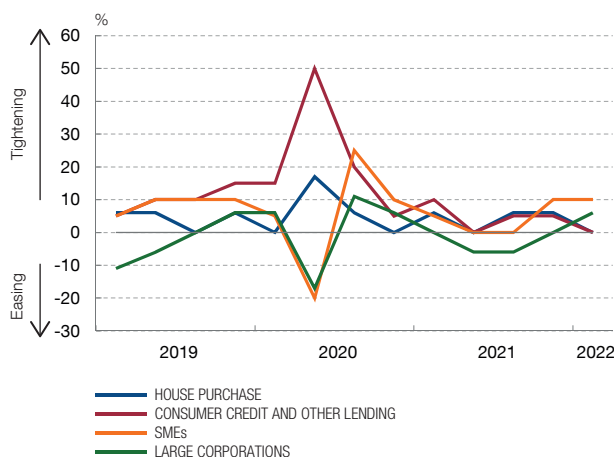
## FINANCIAL CONDITIONS REMAINED ACCOMMODATIVE IN 2021, WITH CREDIT SLUGGISH IN MOST SEGMENTS

Interest rates on new bank lending reached new historical lows, while the cost of debt security financing rose from the summer onwards. Credit standards in lending to households and firms tightened slightly over the course of 2021, while easing somewhat in lending to large corporations. However, in 2022 Q1 standards for lending to firms appear to have tightened somewhat. New lending to households for house purchase held at high levels, but new lending in other segments was lacklustre. The debt ratio of the non-financial private sector declined thanks to the rise in GDP.

1 COST OF FINANCING (a)

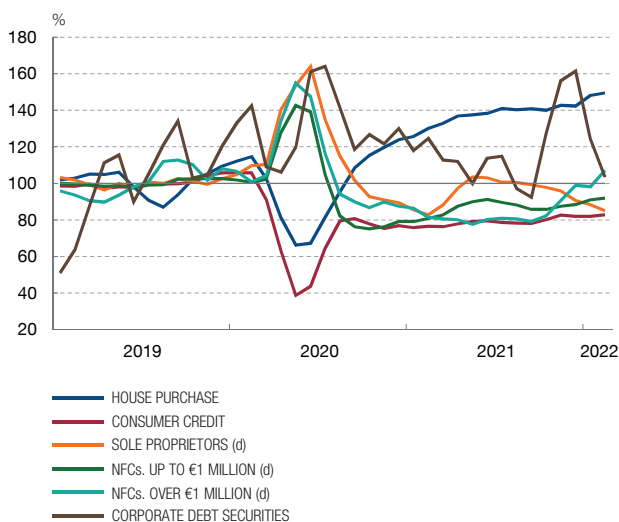


2 BLS: CHANGE IN CREDIT STANDARDS (b)

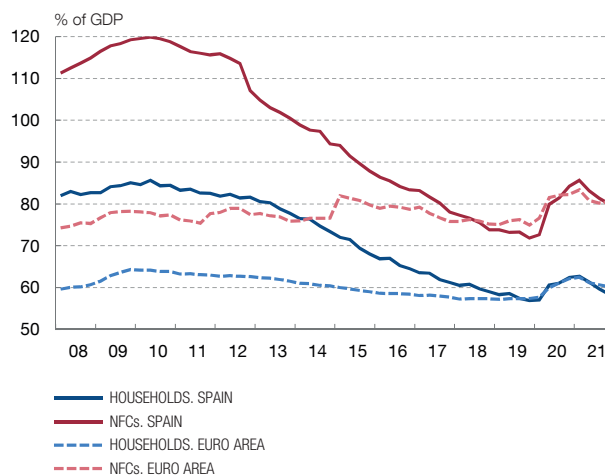


3 NEW LENDING (c)

3-month cumulative seasonally adjusted flows



4 NON-FINANCIAL PRIVATE SECTOR INDEBTEDNESS



SOURCES: Banco de España, ECB and Thomson Reuters.

- a Bank lending interest rates are narrowly defined effective rates (NDEs), i.e. they exclude related charges, such as repayment insurance premia and fees. They are also trend-cycle interest rates, i.e. they are adjusted for seasonal and irregular components (small changes in the series with no recognisable pattern in terms of periodicity or trend).
- b Bank Lending Survey. Indicator = percentage of banks that have tightened their credit standards considerably  $\times 1$  + percentage of banks that have tightened their credit standards somewhat  $\times 1/2$  - percentage of banks that have eased their credit standards considerably  $\times 1/2$  - percentage of banks that have eased their credit standards somewhat  $\times 1$ .
- c Bank financing series include financing granted by deposit institutions (DIs) and specialised lending institutions (SLIs).
- d Includes renegotiations of previous loans.



the cost of credit has also begun to rise. Long-term corporate financing gained momentum in the first few months of the year, as a result of rising long-term risk-free interest rates.

**According to the Bank Lending Survey (BLS), the supply of credit shrank slightly in some market segments over 2021 and in 2022 Q1** (see Chart 1.8.2). Over the course of last year, credit standards became slightly more restrictive in lending to households and SMEs; by contrast, standards in lending to large corporations eased slightly. In 2022 Q1, credit standards tightened somewhat for firms, irrespective of their size. Against the described background of favourable financial conditions and no credit supply constraints, the mixed developments in demand for financing across the segments was reflected in likewise uneven performances in the corresponding flows (see Chart 1.8.3). These credit flow developments, together with the favourable income trajectory, allowed household debt ratios to decline from mid-2021 (see Chart 1.8.4).

**Although significant, the recovery in consumption has not sufficed for this aggregate to return to pre-pandemic levels.** Consumption grew at an annual average rate of 4.6% in 2021. However, in 2022 Q1 it declined markedly (-3.6% quarter-on-quarter). Thus, the current level remains well short of the 9.7% recorded in 2019 Q4 (see Chart 1.9.1). Several factors have stymied the recovery in consumption. First, in 2021 gross disposable income failed to reach pre-health crisis levels in nominal terms, despite its relatively high growth rate in the year. Second, over the entirety of last year, concern regarding the health consequences of the pandemic continued to curb Spanish household spending on contact-intensive activities, such as tourism. However, consumption of those services partially normalised over the course of the year (see Chart 1.9.2). Third, supply difficulties for some inputs have caused production to decline in certain industries, limiting households' capacity to cover the demand for certain goods. This is particularly true of vehicles, whose sales continued to decline in 2021 and in 2022 Q1.<sup>21</sup> Fourth, inflation has been a very significant constraint, eroding households' purchasing power. Lastly, the outbreak of the war may have reinforced households' cautious attitude towards their spending decisions.

**In this context of a subdued recovery in real consumption, the saving rate declined over the course of 2021.** However, this variable held at comparatively high levels in historical terms (see Chart 1.9.3). Specifically, the saving rate was 11.4% of disposable income, 3.6 pp lower than in 2019 but 3.1 pp higher than in 2019. In nominal terms, consumption grew somewhat more robustly than income in 2021, which in part owed precisely to the rise in inflation in the second half of the

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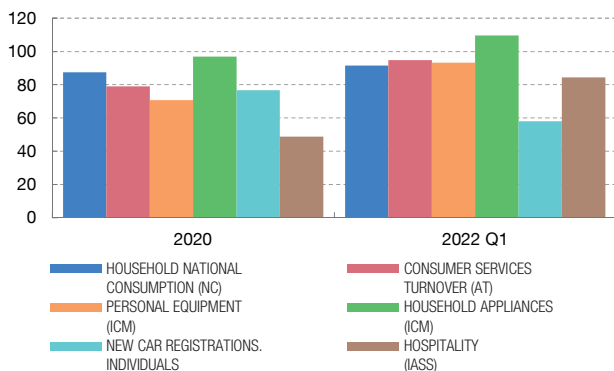
21 By contrast, turnover has been particularly buoyant in the electronic equipment industry, to which such inputs (particularly microchips) were redirected in the early stages of the pandemic when automotive firms scaled back their orders. Spending on this item comfortably outstripped pre-health crisis levels, possibly indicating a persistent shift in consumption patterns in favour of higher-tech goods, a process that the accelerated digitalisation prompted by the pandemic appears to have spurred. Spending on household appliances, which had shown marked resilience in 2020, grew robustly in 2021.

Chart 1.9

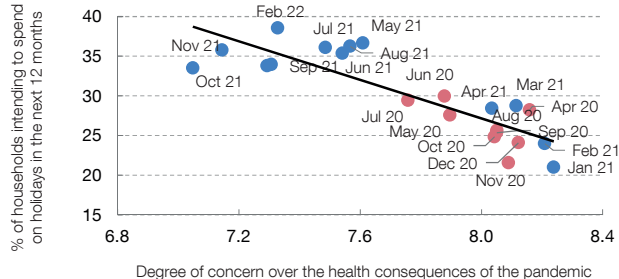
**AS COMPARED WITH PRE-PANDEMIC LEVELS, THE RECOVERY IN HOUSEHOLD CONSUMPTION HAS BEEN PARTIAL, WHILE IN AGGREGATE TERMS THE STOCK OF SAVINGS BUILT UP IN 2020 APPEARS NOT TO HAVE BEEN PUT TOWARDS CURRENT EXPENDITURE**

The increase in household consumption, which has been uneven across the spending items, was insufficient to reach pre-pandemic levels. The impetus in consumption was limited by the partial nature of the recovery in income, a persistent pandemic-induced adverse impact on the most contact-intensive spending items and the bottlenecks. The saving rate held at a high level, with higher-income households, which built up the bulk of the forced savings in 2020, not putting these funds towards consumption.

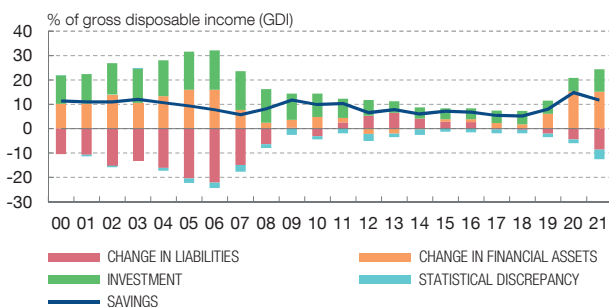
1 CHANGE IN HOUSEHOLD SPENDING (ANNUAL AVERAGE, VS LEVEL OBSERVED IN 2019 Q4) (a)



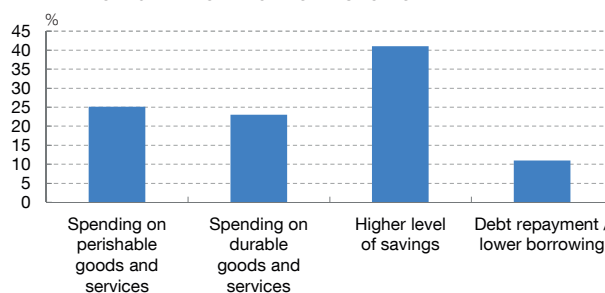
2 CONCERN OVER THE HEALTH CONSEQUENCES OF THE PANDEMIC VS INTENTION TO SPEND ON HOLIDAYS IN THE NEXT 12 MONTHS



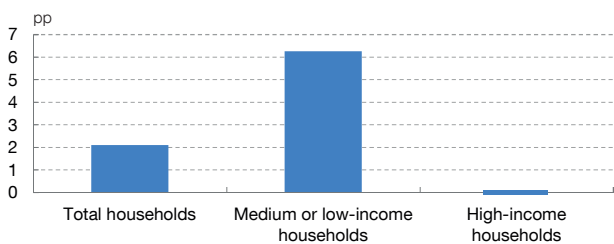
3 USE OF HOUSEHOLDS' GROSS SAVINGS (b)



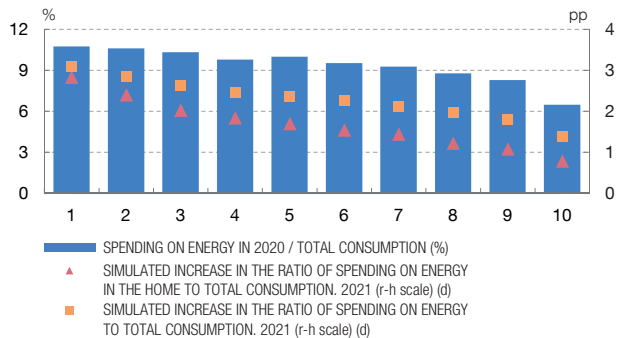
4 EXPECTED USE OF THE SAVINGS BUILT UP BETWEEN JANUARY 2020 AND MARCH 2021. PERCENTAGE DISTRIBUTION. SPAIN



5 MARGINAL IMPACT OF HAVING A STOCK OF SAVINGS ON THE PROBABILITY OF REPORTING A SPENDING INCREASE IN 2021 (c)



6 MEDIAN IMPACT OF THE ENERGY PRICE INCREASE (2021 AVERAGE VS 2020 AVERAGE). BREAKDOWN BY INCOME DECILE



SOURCES: INE, Agencia Tributaria, ANFAC, European Central Bank (Consumer Expectations Survey) and Banco de España.

- a Spending on personal equipment and household appliances is based on the retail trade index (ICM). The consumer services figure is based on the turnover of large corporations in this sector, drawn from information provided by the Spanish tax authority (Agencia Tributaria, AT). Activity in the hospitality sector is measured using the services business activity index (IASS). For the spending items based on AT and IASS data, no information is available for March, meaning the 2022 Q1 values are averages for January and February 2022 as compared with 2019 Q4.
- b Savings include capital transfers. Investment is gross capital formation plus acquisitions less disposals of non-produced, non-financial assets.
- c Results drawn from the ordered probit estimation. It captures the difference in the probability of reporting an increase in spending between households that had saved and those that had not, for total households and each income group.
- d Assuming stability in the quantities of energy consumed, and price increases equal to the average observed in 2021.





year. In any event, the partial recovery in consumption and the persistence of relatively high saving rates were in keeping with the weakness in consumer credit flows (down 22% on mid-2019 levels), despite the favourable financing conditions.

**These developments seem to indicate that, in aggregate terms, in 2021 households did not use the surplus savings built up since the onset of the pandemic to purchase consumer goods and services.** In 2020, households put a very large share of their income toward saving. This owed, first, to precautionary saving amid the widespread uncertainty caused by the health crisis, and, second, the impossibility of consuming certain services due to the pandemic containment restrictions.<sup>22</sup> Over the course of 2021, despite the gradually declining uncertainty over the health situation and the progressive lifting of restrictions, it appears that households continued to save more than their historical behaviour would suggest, meaning that this stock of savings might even have grown further, at least in aggregate terms.

**Information from surveys indicates that, around spring 2021, households expected to put a significant proportion of the savings built up since the start of the pandemic towards spending.** The ECB's Consumer Expectations Survey (CES) conducted in March 2021 points in this direction (see Chart 1.9.4). However, the information available suggests that, in practice and in aggregate terms, households did not use the savings built up in 2020 to purchase consumer goods and services over the course of 2021, as they had reported that spring. This does not rule out some groups of households having used a significant share of those savings in this way.

**Higher-income households, which accounted for the bulk of the surplus savings accumulated during the pandemic, appear not to have resorted to that stock of savings to increase their consumption.** Higher-income households built up a larger volume of funds, in proportion to their income, during the first year of the pandemic. However, in 2021 their spending remained well below pre-health crisis levels, suggesting they had not resorted to the savings built up in 2020, partly because the spending items that remained constrained by the pandemic in 2021 make up a comparatively larger share of their consumption basket (see Chart 1.9.5). By contrast, lower-income households had accumulated more modest surplus savings in 2020. This owed to (i) the crisis affecting their income more severely and (ii) the services whose consumption was limited by the pandemic accounting for a lower share of their consumption basket. However, those funds appear to have been released more freely in 2021.<sup>23</sup> Nonetheless, the use that this group of households

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22 [Cuenca, Martínez Carrascal and Del Río \(2021\)](#) includes an analysis of household saving developments in the first few quarters of the pandemic.

23 This appears to owe to a combination of factors. First, the labour market recovery, which would have benefited, precisely, lower-income households, may have allowed greater normalisation in their spending levels by reducing the need for precautionary saving. In addition, the lower share in their consumption basket of items that remained restricted by the pandemic would likewise have contributed towards this normalisation. Lastly, the lower-income households that built up a stock of surplus savings in 2020 probably used those funds to contend with the increase in energy prices in 2021, thus avoiding the need to reduce spending on other items.

has made of their stock of savings does not seem to have affected the aggregate saving rate sufficiently to return it to its pre-pandemic level.

**The rise in energy prices is having a significant impact on the purchasing power of household income.** Lower-income households are particularly affected by the upturn in prices, since energy bills account for a large proportion of their total spending. Specifically, the rising price of electricity, gas and other fuels observed in 2021 would have increased the share of these items in total nominal spending by 3.1 pp and 1.4 pp in the top and bottom deciles, respectively (see Chart 1.9.6).<sup>24</sup> That gap between income groups is even wider for energy consumed in the home. In addition, lower-income households have less scope to cushion the impact of this inflation on their consumption by reducing their savings, for two reasons: (i) they tend to have lower saving rates, and (ii) only a small proportion of these households were able to build up surplus savings during the pandemic.

**Housing starts fell sharply in the early months of the pandemic and have risen steadily since.** Building permits have reached levels similar to those seen prior to COVID19. However, the drastic fall-off in housing starts in 2020 Q2 and Q3 continued to weigh down on construction completion volumes over the course of 2021 and the first few months of 2022, and, therefore, on residential investment. More recently, the pace of new construction may have been adversely conditioned by a certain labour supply shortage in some construction sector trades. Supply difficulties affecting particular construction materials, reflected in a steady and marked increase in their cost, may also have begun to have an adverse impact on construction activity.

**House sales and purchases by households surged in 2021. In contrast with the sluggishness in construction, house sales were more buoyant than in the pre-pandemic period, with this performance extending into early 2022.** Housing transactions were particularly robust in the new build segment, where the volume of transactions in 2021 was high enough to more than offset the decline observed during the height of the pandemic restrictions (see Chart 1.10.1). As a result, the share of this market segment in the total has continued to rise, although the second-hand segment has accounted for the bulk of transactions. Various factors were behind the robust housing demand in 2021, including the improved general economic situation amid accommodative financial conditions, the materialisation of investment decisions postponed after the onset of the pandemic and the pandemic-induced shift in household preferences towards larger houses with outdoor space, such as single-family homes (see Chart 1.10.2).

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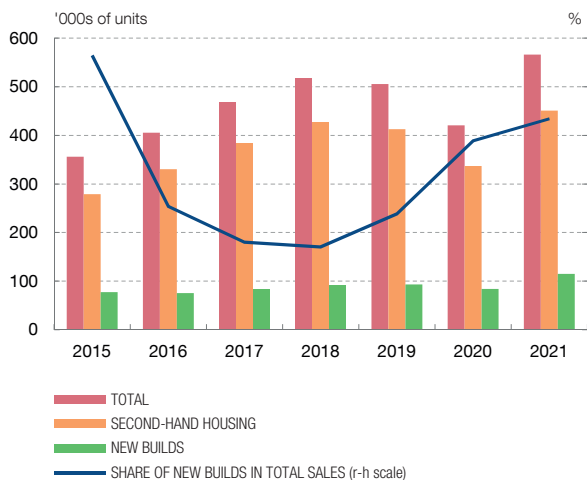
<sup>24</sup> These figures are the median impacts in each of these population groups. For a discussion of the macroeconomic effects of higher electricity prices, see Hurtado et al. (2022). Moreover, Chapter 3 sets out the specific inflation rates for the consumption baskets of each group of households, by level of income.

Chart 1.10

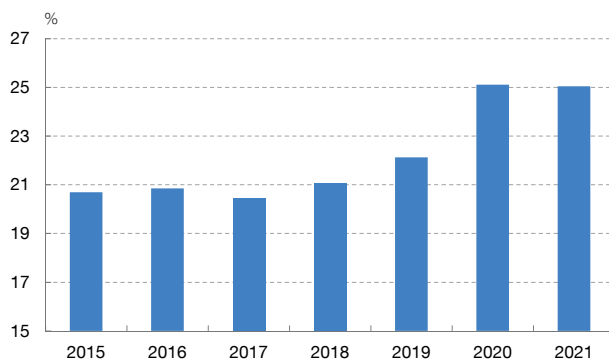
**HOUSE PURCHASES STOOD CLEARLY ABOVE PRE-PANDEMIC LEVELS IN 2021**

New builds continued to grow as a share of total sales, although they remain in the minority. Some of the pre-pandemic trends that accelerated once COVID-19 hit have slowed or partially reversed, as evidenced by the stabilising share of single-family homes in total purchases and the most populous capitals accounting for a larger share of sales within each province.

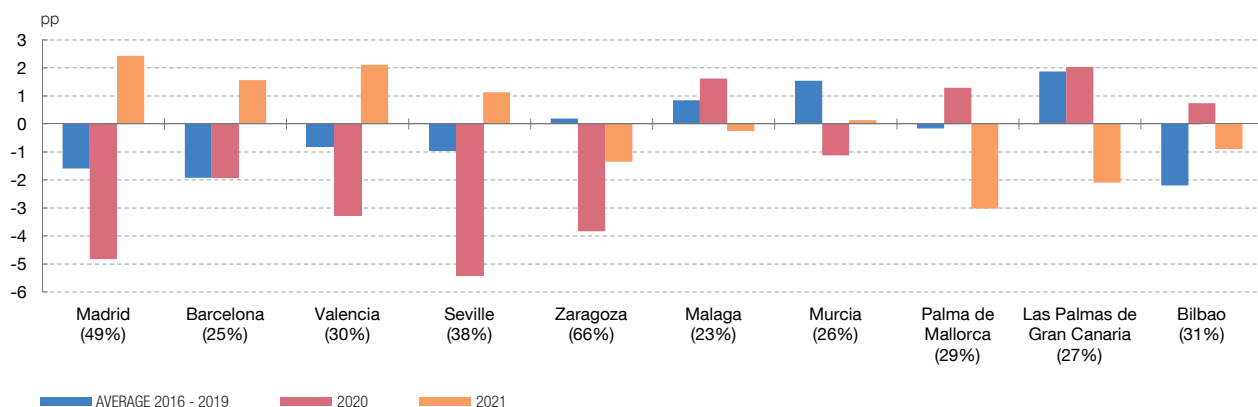
1 REGISTERED SALES



2 SINGLE-FAMILY HOUSING SALES: SHARE OF TOTAL SALES THROUGH PUBLIC DEEDS



3 HOUSE SALES THROUGH PUBLIC DEEDS IN THE CAPITAL: CHANGE IN SHARE OF TOTAL SALES IN THE PROVINCE (a)



SOURCES: Banco de España, Centro de Información Estadística del Notariado, INE and Ministerio de Transportes, Movilidad y Agenda Urbana.

a Beneath the name of each capital (in brackets) is its share in sales in each province in 2021. The ten most populous provincial capitals are selected.



**In the near future, residential investment will be fuelled by spending as part of the Next Generation EU (NGEU) programme.** Implementation of the Urban Rehabilitation and Regeneration Plan, under the Recovery, Transformation and Resilience Plan (RTRP), should provide very significant support for residential investment, given the large volume of funds earmarked to housing rehabilitation, particularly for energy efficiency improvements. Residential investment is also set to be galvanised by EU-funded RTRP projects aimed at rehabilitating residential environments and constructing social rental

housing in energy-efficient buildings. That said, implementation of these projects may be delayed by the persistent bottlenecks in the sector.

**However, it does not appear that the changes in household preferences will provide an additional impetus to residential investment.** Since mid-2021, demand for single-family homes, as a percentage of total sales, has stabilised. Moreover, in the more densely populated urban areas the shift in demand towards suburban locations, which was accelerated by the pandemic (due to remote working and housing supply better matching households' new preferences, with lower average prices than in city centres), tended to reverse in 2021 (see Chart 1.10.3).

**Private productive investment grew relatively robustly in 2021.** Specifically, this growth stood at an estimated 8.8% (see Chart 1.11.1). When assessing this performance, it should be borne in mind that business investment typically fluctuates far more than final demand. However, in 2021 the growth in the latter variable (7.1%) was not starkly different from that in private productive investment. Growth in this aggregate was fuelled by the effects of the pandemic, both in terms of spurring digitalisation and firms having to adapt to the pandemic containment measures. However, the modest momentum in investment was consistent with the persistent high uncertainty (albeit lower than in 2020) as to how the pandemic would unfold. Its recovery was also curbed by the sector's impaired financial situation as a result of the health crisis, the bottlenecks affecting production, rising energy costs and, in some sectors, the still partial recovery in capacity utilisation as compared with pre-pandemic levels. National Accounts information for Q1 points to investment in capital goods being more buoyant than investment in other construction.

**The flow of bank credit to firms showed scant momentum, compared with a stronger performance from funds raised on fixed income markets.** The lacklustre credit performance in 2021 owed in part to firms' relatively low external financing needs, after they built up considerable liquidity buffers in 2020. Further, this sluggishness in credit came in tandem with bank financing being substituted for debt security issuance, which held at historically high levels in 2021 (see Chart 1.8.3). The upshot was a moderate increase in firms' outstanding external financing in 2021, although GDP growth meant that the debt ratio declined by 4.3 pp to 79.9% (see Chart 1.8.4). However, firms operating in certain sectors have seen their balance sheet position deteriorate significantly following the pandemic, which may have stymied their investment.

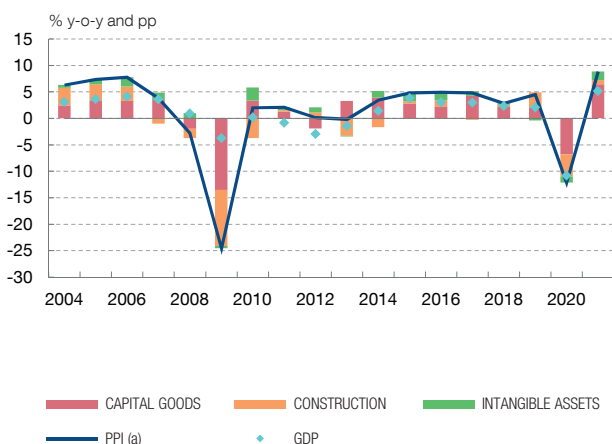
**Global value chain disruptions affected capital goods production.** The European Commission's business confidence surveys provide information on the factors that companies report as limiting their production. In the capital goods sectors, the proportion of firms reporting shortage of material as a constraint has grown steadily between 2021 Q1 and 2022 Q1, to become the main factor limiting their production (see Chart 1.11.2). The considerable impact of bottlenecks on capital goods sectors is consistent with the high proportion of imported inputs that they use.

Chart 1.11

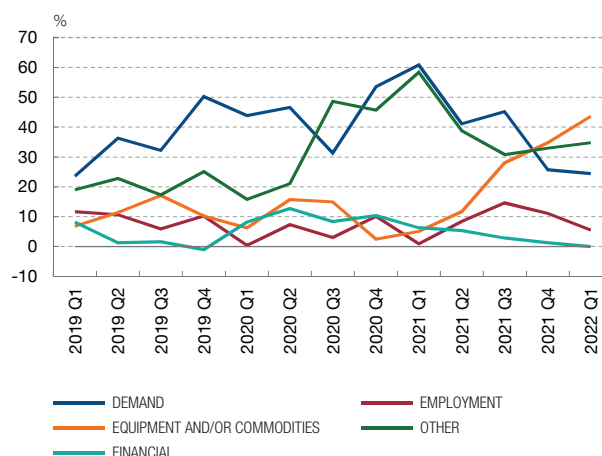
**BUSINESS INVESTMENT HAS SHOWN SOME BUOYANCY, BUT NOT ENOUGH TO RECOVER PRE-PANDEMIC LEVELS**

Private productive investment, which increased 8.8% in 2021, has not yet recovered pre-pandemic levels. Several factors limited its growth, such as the impairment of firms' financial situation as a result of the health crisis, bottlenecks and rising energy costs.

1 PRIVATE PRODUCTIVE INVESTMENT (PPI) AND GDP



2 LIMITING FACTORS IN THE INVESTMENT GOODS INDUSTRY



SOURCES: INE, Banco de España, European Commission and IHS Markit.

a PPI in real terms is estimated by deducting investment in housing and public sector investment from total investment. All of the information required for these calculations is provided by the INE, except for the public investment deflator which is estimated based on data for other deflators.



**The surge in energy costs limited the recovery in investment, albeit highly unevenly across sectors.** The cost of energy used in the production process as a percentage of turnover stood at around 2% in 2019, according to information from the Business Structure Survey conducted by the National Statistics Institute (INE).<sup>25</sup> However, this aggregate figure masks considerable disparity by sector of activity and by firm size, indicating a highly uneven impact of increased energy costs on total costs. Specifically, energy costs represent more than 12% of turnover in transportation and in manufacture of construction materials, and 6% in manufacture of certain mineral-derived products and in mining and quarrying. By contrast, these costs amount to less than 0.6% of turnover in manufacture of transport equipment; information and communication activities; professional, scientific and technical activities; administrative and support service activities; and in electricity, gas, steam and air conditioning supply. Moreover, the structure of energy spending also varies substantially by activity. For instance, for transportation and trade the largest

25 See Matea, Rosa, Martínez Casares and Vázquez Martínez (2021). The elasticity of activity in response to the rising price of an energy source may be broken down into two parts: (i) the parameter measuring the decrease in firms' energy consumption due to the increased cost of that energy source, and (ii) the parameter that proxies the fall in output associated with lower energy usage. For example, for the first of these parameters, and for electricity in Spain specifically, Labandeira, Labeaga and López (2016) find a value of around 0.3. The second parameter is proxied by the ratio between the cost of the energy and turnover (e.g. 0.002 for electricity). The product of these two parameters indicates that a 20 pp increase in the price of electricity could reduce the economy's aggregate output by 0.1 pp in the short term.

component in the energy bill is fuel (other than electricity) and natural gas, while for industry and services electricity is the main component. Lastly, a breakdown by firm size shows that, in the trade, transportation and services sectors, medium-sized enterprises (20 to 49 employees) consume somewhat more energy than other firms. Conversely, in industry no significant differences in energy consumption by firm size are observed.

**Capacity utilisation has only partially recovered following the decline in 2020.**

Capacity utilisation has increased most robustly in the consumer goods and intermediate goods sectors, where pre-pandemic levels were surpassed in early 2022. This explains why demand for investment goods is higher in these sectors.

**The cross-sector differences in activity developments were reflected in disparate performances from the various investment components in 2021.**

Investment in other construction and in transport equipment performed less favourably than investment in machinery and in intangible goods, both of which had already reached their pre-pandemic levels by end-2021. The uneven trajectories of the various investment components owe to the divergent activity developments across the sectors. These sectors invest in the various types of assets very differently and have been affected to varying extents by the health crisis and the global supply chain disruptions.

**The recovery in investment in machinery has been comparatively stronger.**

This is due to the pandemic containment measures having a lesser impact on manufacturing sectors, which account for a large proportion of such investment.<sup>26</sup> By contrast, in other sectors that were particularly hard hit by the pandemic, such as hospitality, investment in machinery accounts for a very small share of total gross capital formation in this asset.

**Investment in transport equipment has been hampered by developments in the transportation and storage sector.**

These sectors, which account for a larger relative share of this investment component,<sup>27</sup> have been severely affected both by the restrictions imposed to contain the pandemic and the disruptions in global supply chains. Both factors have constrained the renovation of plant capacity at firms in these sectors and, thus, their gross fixed capital formation in transport equipment. These developments appear to have been partly offset by increased investment in transport equipment by other industries, such as the trade sector, which have had to ramp up investment in such assets due to the pandemic prompting an increase in online sales. Lastly, the health crisis has also spurred the digitalisation of firms and, consequently, their investment in intangible assets.

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26 In 2019, the latest year for which a breakdown of investment by sector of activity is available, investment by the manufacturing sectors in machinery and other equipment accounted for 26% of the total investment in such assets. See [Pacce \(2022\)](#).

27 In 2019, the transportation and storage sector accounted for 34% of investment in transport equipment. Administrative and support service activities and retail and wholesale trade were the next two largest sectors in terms of investment in transport equipment (with shares of 26% and 16% of the total, respectively).

**To date, NGEU has provided a relatively modest boost to investment.** The information available suggests a relatively low volume of project implementation under the programme so far, although this should increase over the next two years. Further, there are reasons to expect investment in intangible assets to grow. These include the organisational changes prompted by the pandemic (the digitalisation of activity, the roll-out of remote working and online sales, among others) and the challenges associated with the changing geopolitical situation (e.g. cyber security). The persistence of international transport disruptions could also drive up investment in those sectors.

### 3.3 Developments in foreign trade: the recovery in tourism

**Net external demand contributed nearly 0.5 pp to GDP growth in 2021.** This contrasts with the robustly negative contribution of the previous year (-2.2 pp). Developments in the different flows – exports or imports, goods or services (both tourism and non-tourism) – were highly uneven. Specifically, at end-2021 trade in goods stood at levels only slightly higher than a year earlier, due to the growing impact of global bottlenecks. By contrast, exports of tourism services recovered vigorously over the course of the year, as a result of the improving health situation and the gradual lifting of the containment measures. These developments extended into early 2022, a period of continued sluggishness in trade flows of goods and buoyancy in inbound tourism.

**In 2021 total exports performed in line with the developments observed in destination markets** (see Chart 1.12.1). Price competitiveness contributed negatively to total export growth. The cumulative loss of competitiveness reflected (i) the positive differential, against the euro area, in industrial producer export price inflation and in domestic manufacturing producer price inflation, and (ii) the nominal effective exchange rate appreciation against other developed countries.

**The buoyancy of goods exports was hampered over the course of the year by global production chain disruptions.** Further, in early 2021 Brexit had something of an adverse impact on goods exports, although this was temporary and limited.<sup>28</sup>

**Developments in goods exports are uneven by geographical area and by product type.** In terms of geographical area, sales to the rest of the euro area have been more buoyant than non-EU sales (see Chart 1.12.2). By product type, supply disruptions are affecting car exports in particular. These have declined significantly

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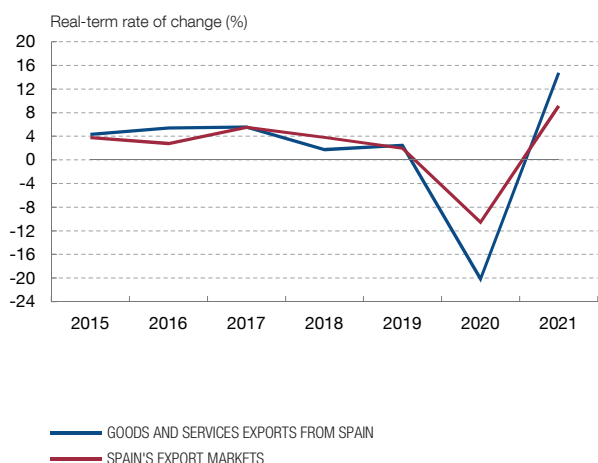
28 The United Kingdom's departure from the European Union and the frictions caused by new customs procedures hampered goods exports to the United Kingdom (which represented 6.8% of the total in 2019). In fact, as early as after the Brexit referendum Spanish trade began to be diverted towards other European markets due to uncertainty surrounding negotiations over the new framework for bilateral relations between the European Union and the United Kingdom (see [Gutiérrez, Lacuesta and Martín Machuca \(2021\)](#)).

Chart 1.12

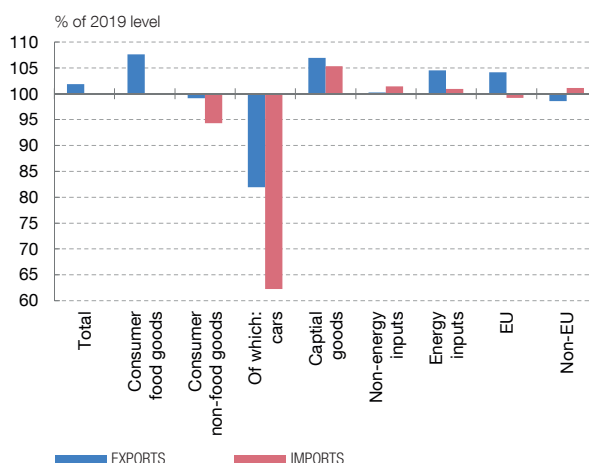
**NET EXTERNAL DEMAND MADE A POSITIVE CONTRIBUTION TO GDP IN 2021**

Net external demand added nearly 0.5 pp to GDP growth in 2021 thanks to the recovery in tourism exports. Within goods exports, the negative performance of car exports is noteworthy. The number of exporting firms increased in 2021, following a decline in the previous year.

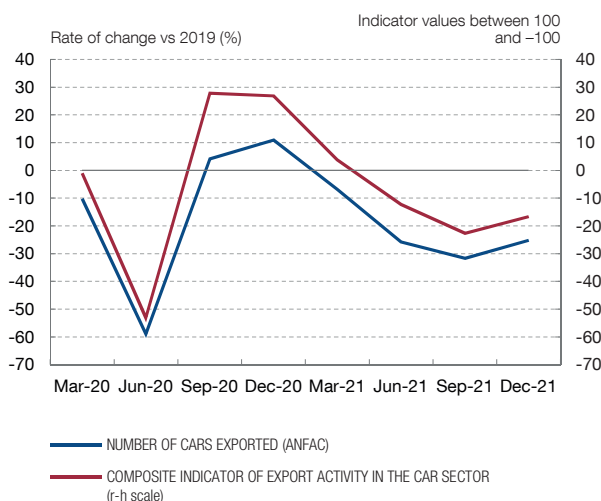
1 CHANGES IN EXPORTS



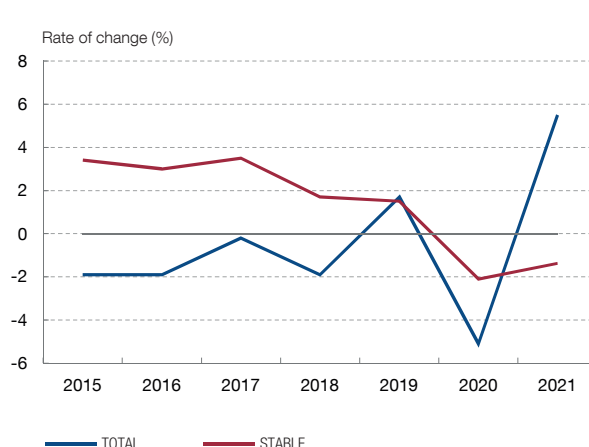
2 REAL GOODS EXPORTS AND IMPORTS 2021 (as a % of 2019 level)



3 CAR EXPORTS



5 NUMBER OF EXPORTERS (a)



SOURCES: ECB, Banco de España, Ministerio de Industria, Comercio y Turismo, Ministerio de Asuntos Económicos y Transformación Digital and INE.

a Excludes operators exporting less than €5,000. A stable exporter is a firm that has been exporting for at least four consecutive years.



(above all since mid-2021), reflecting this sector's strong level of integration in global value chains and, in particular, its reliance on certain electronic components, such as microchips, whose global production capacity has proven insufficient to satisfy demand. In 2021 as a whole, car exports were down by just over 20% on 2019 levels (see Chart 1.12.3). In 2022, the war in Ukraine has affected the global production of certain vehicle components, although Spanish manufacturers are less reliant than others on Ukraine-based suppliers.

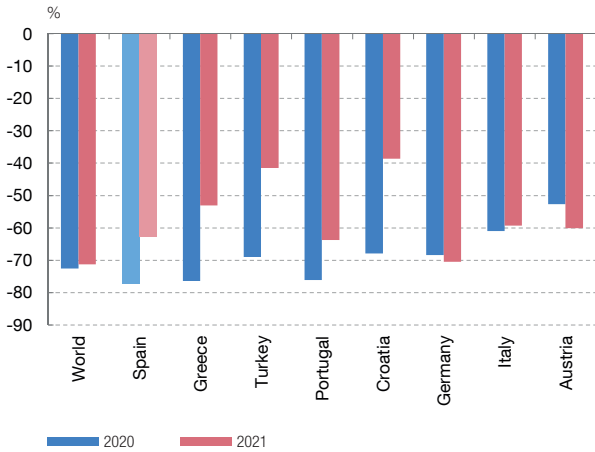


Chart 1.12

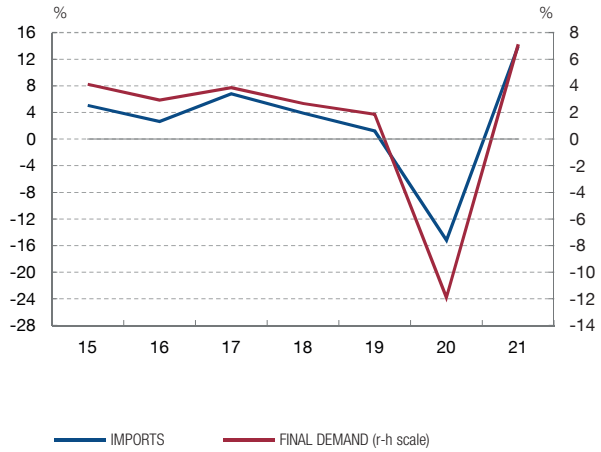
**NET EXTERNAL DEMAND MADE A POSITIVE CONTRIBUTION TO GDP IN 2021 (cont'd)**

The travel surplus stood at 1.4% of GDP (according to the Rest of World Account), compared with 0.7% of GDP in 2020. The recovery in tourism was, however, less robust than in other countries. The country's net lending capacity increased as a result of the recovery in the tourism services balance and the increase in capital transfers.

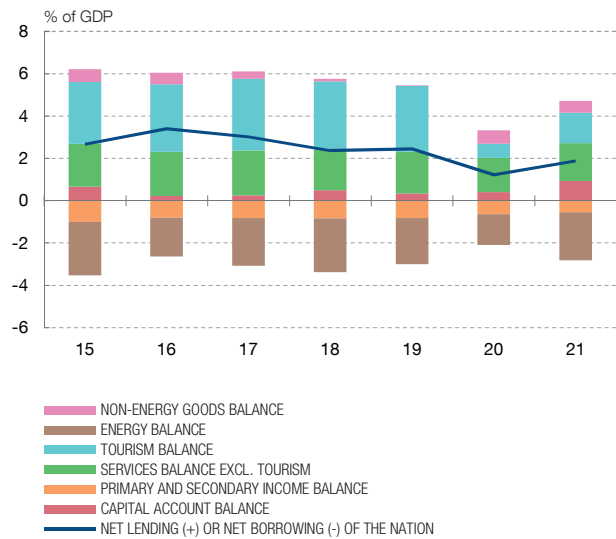
5 INTERNATIONAL TOURIST ARRIVALS  
Rate of change vs 2019



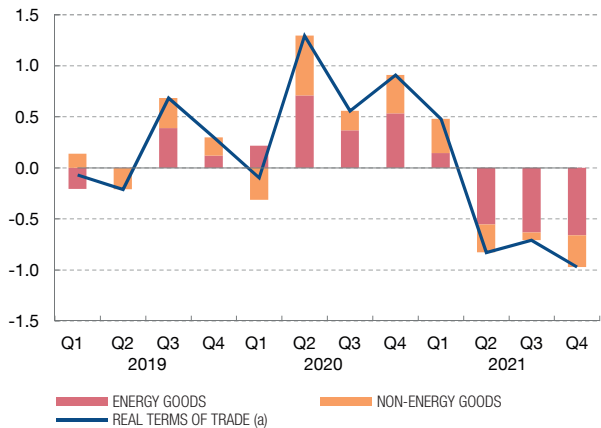
6 IMPORTS AND FINAL DEMAND  
Real-term rate of change



7 NET LENDING (+) OR NET BORROWING (-) OF THE NATION



8 INCOME EFFECT OF REAL TERMS OF TRADE  
(in pp of GDP)



**SOURCES:** ECB, Banco de España, Ministerio de Industria, Comercio y Turismo, Ministerio de Asuntos Económicos y Transformación Digital, INE and World Tourism Organization.

a Calculated as the difference between the year-on-year growth rates in the prices of export goods and import goods (according to the unit value index) weighted by the respective shares in GDP of export goods and import goods.



**The number of goods export companies recovered over the course of 2021.** The total number of exporters exceeded pre-pandemic levels by 5.5% (see Chart 1.12.4).<sup>29</sup> However, in 2021 the stable export base (firms that have

<sup>29</sup> Only exporters with sales abroad exceeding €5,000 are considered, given the particularities of firms whose exports fall below this threshold. In any event, the latter account for a negligible share of total exports.

been exporting for at least four consecutive years) was still 1.4% down on two years earlier.

**Real tourism exports recovered gradually but robustly over 2021, in keeping with the easing of international travel restrictions.** The recovery, in tandem with headway in the vaccination campaign, was partial and fluctuated in line with renewed outbreaks of the pandemic. In December 2020, tourist arrivals and expenditure were down to 15.5% and 13.9%, respectively, of their December 2019 levels. However, by February 2022 those figures had climbed to 72.1% and 80.6%, respectively. As compared with other international destinations, tourism activity in Spain has been stymied by (i) unfavourable epidemiological developments in the country at the beginning of the summer high season and (ii) reliance on British tourism, which has recovered more slowly than other tourism source markets (see Chart 1.12.5).<sup>30</sup> This is borne out by estimates using panel data of overnight stays by foreigners in a broad set of European countries.<sup>31</sup> Further, a particularly high share of tourist arrivals were by plane, a mode of travel that was hit harder by containment measures than overland transport.

**The growth in imports during 2021 was in keeping with the recovery in final demand** (see Chart 1.12.6). The buoyancy in imports was consistent with sizeable purchases of products with a high import content, such as medicines/pharmaceuticals, IT and telecommunications products and industrial machinery.<sup>32</sup> This countered, at least partially, the weakness in car purchases and paved the way for a more robust performance from goods imports over the course of the year, outstripping pre-crisis levels by just over 6.1% in 2021 Q4. Meanwhile, tourism imports recovered considerably more sluggishly than tourism receipts, reflecting the shift in the Spanish market towards domestic tourism.

**The Spanish economy's net lending capacity recovered slightly in 2021.** In the two years leading up to the pandemic, this variable stood at 2.4% of GDP (see Chart 1.12.7). However, in 2020 the health crisis halved this balance as a result of the deteriorating travel surplus, partly offset by the decline in the goods trade deficit, thanks above all to the lower cost of imports. These effects tended to reverse in 2021. On the one hand, the sharp rise in commodity import prices led to a marked deterioration in the real terms of trade (see Chart 1.12.8). Specifically, in 2021 the euro-denominated price of imported oil rose by 57% in annual average terms, significantly driving up the net energy import deficit. On the other hand, the improving

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30 Authorities in Britain (the largest tourism source market, accounting for around 20% of the total) maintained stringent restrictions on overseas travel until the end of June 2021 (see [García, Gómez Loscos and Martín \(2021\)](#)).

31 Specifically, according to an estimate based on monthly panel data of overnight hotel stays by foreigners between June 2020 and January 2022, the greater the incidence of the pandemic (compared with the euro area as a whole) and the greater the reliance on British tourism, the slower the recovery in overnight hotel stays in each country (compared with 2019 levels).

32 See [García, Martín and Viani \(2020\)](#) for a specific analysis of medical products.

health situation led to stronger inbound tourism flows. Likewise, the non-travel service balance and the primary and secondary income balance improved, albeit to a lesser degree. These developments, together with the expanding capital account surplus (driven by income from NGEU funds), saw lending capacity increase in 2021 by 0.7 pp to 1.9% of GDP. Despite the external surplus, the net debtor position vis-à-vis the rest of the world remains relatively high (70% of GDP at end-2021).

### 3.4 The partial correction of public finances

**Public finances continued to show a considerable imbalance in 2021.** The budget deficit corrected in 2021 from 10.3% to 6.9% of GDP (see Chart 1.13.1).<sup>33</sup> This improvement owed to both a slowdown in expenditure and to a robust income recovery. The relatively upbeat view of these developments is attenuated by certain underlying circumstances.

**A significant portion of the easing in expenditure growth owed to the marked reduction in pandemic-related spending.** The improvement in the health situation and, subsequently, in economic activity allowed the general government sector to somewhat reduce the support it had been providing to private agents since the onset of the crisis. According to the National Audit Office (IGAE), total pandemic-related spending declined by 19% between 2020 and 2021, falling from 3.9% of GDP to 3%.<sup>34</sup> In the main, this decline owed to the reduction in the number of furloughed workers and in the number of self-employed individuals whose activity has been suspended temporarily.

**By contrast, spending not linked to the health crisis remained buoyant, growing 6.9% on the previous year.** This includes NGEU-related spending, which generates an expansionary fiscal impulse but has zero impact on the deficit since it is EU funded. The IGAE has not reported what portion of 2021 spending and income was accounted for by NGEU. However, the information available on income from abroad suggests it was far lower than that initially budgeted (2.6% of GDP). The increase in non-pandemic-related spending also owes to the introduction of the Minimum Income Scheme and to the compensation provided to pensioners for the deviation between actual inflation and that forecast in the 2021 State budget. The changes in the various items, pandemic-related or otherwise, saw

33 The 2020 figure has been revised down by 0.7 pp from that published previously. This owes to the change regarding the date on which Sareb was reclassified as part of the general government sector. Although Sareb was initially only included in public finances from end-2020, a decision was later made to include it since its creation in 2012. As a result, public finance data from that year forward have been revised, the upshot being a larger deficit between 2012 and 2019 and a lower deficit in 2020.

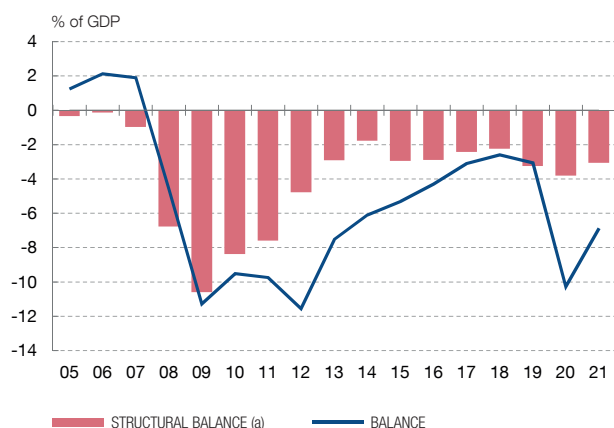
34 The items considered include social benefits for furloughed workers and the self-employed, other social benefits for temporary labour incapacity, waived social security contributions, spending on health and social care and subsidies and capital transfers to firms, including expected net losses on State-backed loans to firms, which were included for the first time in 2021 and were quantified at €4.4 billion. Excluding this item, the drop in pandemic-related spending would have been significantly larger (-29%).

Chart 1.13

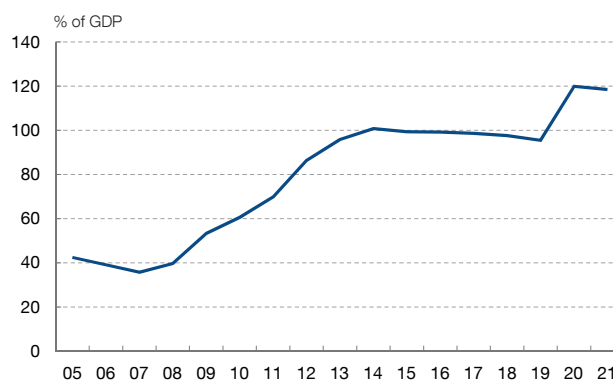
**PUBLIC FINANCES RECOVERED PARTIALLY IN 2021**

The general government deficit declined from 10.3% of GDP in 2020 to 6.9% in 2021, owing to strong revenue growth and the slowdown in expenditure. However, it remains at a very high level. The debt-to-GDP ratio ended the year at 118.4%, up 22.9 pp on the end-2019 level, which represents a considerable source of vulnerability for the Spanish economy going forward.

1 GENERAL GOVERNMENT TOTAL AND STRUCTURAL BALANCE



2 PUBLIC DEBT



3 GENERAL GOVERNMENT REVENUE AND EXPENDITURE

Percentages of GDP	2020	2021	2021-2020	Y-o-y rate (%)	Rate vs 2019 (%)
Revenue	41.5	43.7	2.2	13.2	7.9
Indirect taxes	11.3	12.1	0.9	15.6	2.2
Direct taxes	11.2	11.9	0.7	14.5	11.2
Social security contributions	14.5	14.3	-0.1	6.3	7.3
Other revenue (b)	4.6	5.4	0.8	25.9	16.3
Expenditure	51.8	50.6	-1.2	5.0	15.8
Compensation	12.5	12.2	-0.3	4.9	9.4
Other final consumption expenditure	8.9	8.9	0.0	7.0	9.9
Social benefits	20.4	18.9	-1.4	-0.2	15.9
Actual interest paid	2.2	2.2	-0.1	3.4	-8.0
Gross capital formation	2.6	2.7	0.0	8.2	21.3
Other (b)	5.0	5.7	0.7	21.7	61.2
Balance	-10.3	-6.9	3.4	-28.1	117.3
Debt	120.0	118.4	-1.5	6.1	20.1

**SOURCES:** Banco de España, IGAE and Ministerio de Hacienda.

**a** Banco de España estimate.

**b** Includes NGEU revenue/expenditure. By convention, the expenditure allocated to the programme must exactly match the revenue, meaning its effect on the balance is zero.



total expenditure increase by 5% last year, outstripping the spending in 2019 (the last year prior to the onset of the pandemic) by 16%.

**The tax amendments implemented in 2021 had a roughly neutral aggregate impact on the fiscal policy stance.** The low quantitative importance of the discretionary tax increases introduced in 2021 is consistent with the need to buttress

what is a partial recovery.<sup>35</sup> Over the course of 2021, the moderate tax increases established at the start of the year were partially offset, in terms of total tax revenue, by the tax cuts introduced to cushion the impact of the sharp increase in electricity prices on household purchasing power.<sup>36</sup>

**In 2021, government receipts recovered more robustly than the macroeconomic variables proxying its tax bases would suggest.** Total tax revenue grew very markedly as compared with 2020 (by 13%), with the items that had fallen furthest in 2020, such as indirect taxes, recording the sharpest gains. The notable revenue growth is consistent with the developments in the main tax bases (both on income and consumption) recorded by the Spanish tax authorities. These clearly exceeded pre-pandemic levels, in contrast to their National Accounts equivalents. In fact, the effective tax burden, including social security contributions, were, as a percentage of GDP, 3.7 pp higher in 2021 than in 2019.<sup>37</sup> It is worth pointing out that there is considerable uncertainty at present over the causes of the recently divergent performances of tax and National Accounts variables, which have historically been closely correlated. In particular, on the information available it is impossible to precisely quantify what portion of the relatively sharper increase in public revenue as compared with GDP observed in recent quarters owes to structural factors – e.g. associated with the growing digitalisation of activity prompted by the pandemic – or to essentially temporary factors – in which case public revenue could eventually be expected to perform less buoyantly than economic activity at some point over the coming quarters.

**Quantifying the general government structural balance is particularly complex in the current setting, although a prudent estimate would point to Spain's economy still maintaining a relatively high structural deficit in 2021.** Indeed, in addition to the difficulty in assessing the economy's potential output following the pandemic, there is the aforementioned uncertainty over the causes behind the considerable buoyancy of public revenue in recent quarters. The lessons of the expansionary spell enjoyed by the Spanish economy in the run-up to the global financial crisis suggest a prudent approach is advisable. In particular, during that expansionary period public revenue was also robustly buoyant; this was often treated as a structural phenomenon, but ultimately proved eminently temporary – and closely linked to real estate activity. In this connection, if, in the current context, a prudent approach is adopted, whereby a not insignificant portion of the recent increase in public revenue is deemed temporary, the Spanish economy's structural deficit at end-2021 would still be at high levels, above the average for the period 2013-2019 (see Chart 1.13.1).

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35 Specifically, new taxes were introduced on financial transactions and on certain digital services, the rate of VAT on sugary beverages and on insurance contracts was raised, income tax (IRPF) rates were raised in the highest income brackets, and corporate income tax deductions were reduced. Overall, these measures increased tax revenue, in ex ante terms, by 0.3% of GDP.

36 These measures lowered tax revenue by an estimated 0.2% of GDP.

37 These figures do not include funds received under the NGEU framework.

**The government debt ratio declined slightly in 2021.** The imbalance in public finances continued to drive up the debt ratio numerator. However, this ratio fell slightly (by 1.6 pp to 118.4%) thanks to the upturn in nominal GDP, whose growth rate was 7.2%. As a result, the correction to the sharp, pandemic-induced increase in the debt-to-GDP ratio (more than 20 pp) was minimal (see Chart 1.13.2).

### 3.5 The labour market proved highly robust until the outbreak of the war

**The recovery in employment was particularly vigorous in 2021, but it has shown some signs of waning in early 2022.** Robust job creation in 2021 meant that in November effective social security registrations – i.e. total registrations excluding furloughed employees – recovered their pre-pandemic level. These favourable developments have continued, albeit with some signs of reduced momentum, in the first months of this year. The effects of the war on net job creation in Spain were barely noticeable in the February data, given that the war broke out with just three business days left in the month. However, the March data were somewhat less encouraging. Specifically, the monthly rate of change in social security registrations in March was 0.7%, 0.1 pp below the average for the period 2016-2019, with the favourable performance of the services sectors (boosted by the elimination of the pandemic containment measures) standing in contrast to less encouraging developments in the manufacturing sectors most affected by the uncertainty induced by the war, the bottlenecks and higher commodity prices. As a result, effective social security registrations stood 2.1% above their level in February 2020, the month immediately before the outbreak of the pandemic.

**The pattern of the recovery displays notable cross-sector differences.** This unevenness is consistent with the developments observed in activity at sectoral level, which have been highly influenced by the different impact the containment measures have had on each productive sector (see Chart 1.14.1). In particular, the labour market recovery is weaker in some services, such as hospitality and recreation and leisure. This is consistent with their sensitivity to the restrictions on activity and movement and, especially, with the incomplete recovery in tourism flows. These sectors are still a long way off recovering their February 2020 employment levels. Conversely, employment is clearly above pre-crisis levels in information and communication activities (boosted by factors such as the e-commerce boom and remote working) and in non-market sectors (driven by hiring needs during the pandemic). In the public sector, employment is around 10 pp higher than the pre-pandemic level, while in the private sector the difference decreases to approximately 1.5 pp.

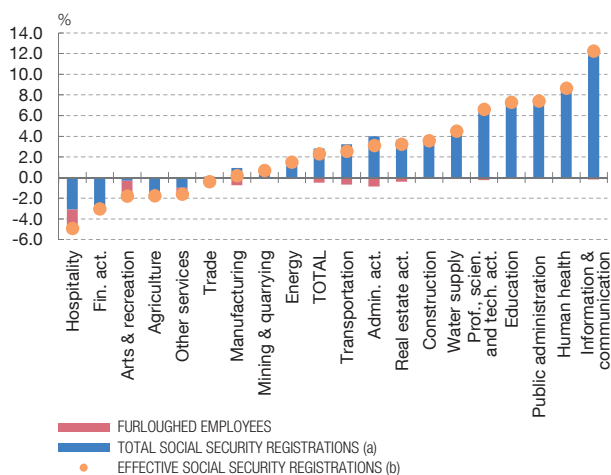
**Total hours worked in 2021 performed somewhat less favourably than the number of persons employed.** Other sources of quarterly data help flesh out the labour market performance over the last year. Specifically, both the Spanish Labour Force Survey (LFS) and the Quarterly National Accounts (QNA) confirm the labour market's vigorous

Chart 1.14

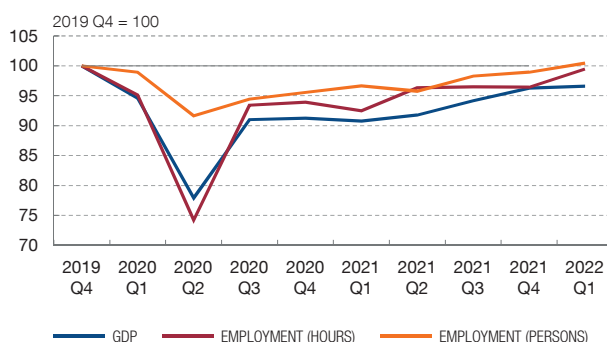
### EMPLOYMENT HAS SHOWN HIGH MOMENTUM

Employment has recovered more vigorously than GDP. The recovery in employment by productive sector is indicative of the different impact of the containment measures on each sector, which is reflected in the differences across regions and groups of workers.

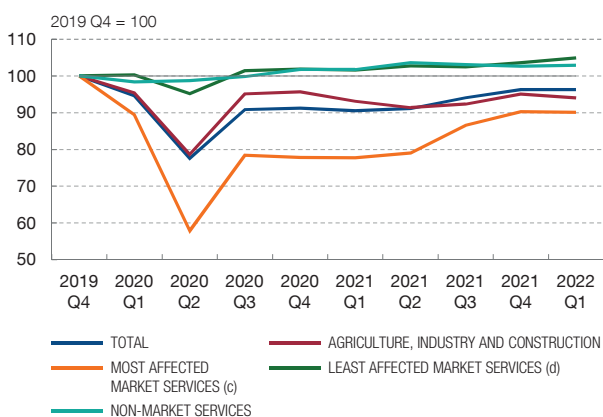
1 TOTAL SOCIAL SECURITY REGISTRATIONS, FURLOUGHED EMPLOYEES AND EFFECTIVE SOCIAL SECURITY REGISTRATIONS, BY SECTOR. CHANGE IN MARCH 2022 VERSUS FEBRUARY 2020



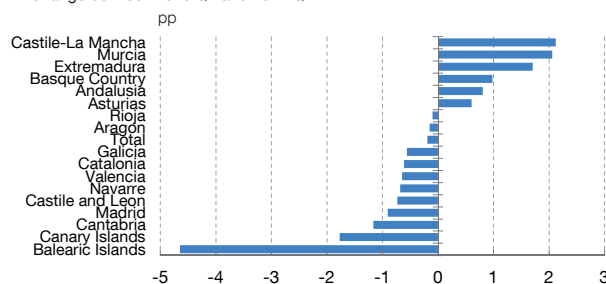
2 GDP AND EMPLOYMENT



3 GROSS VALUE ADDED, BY SECTOR



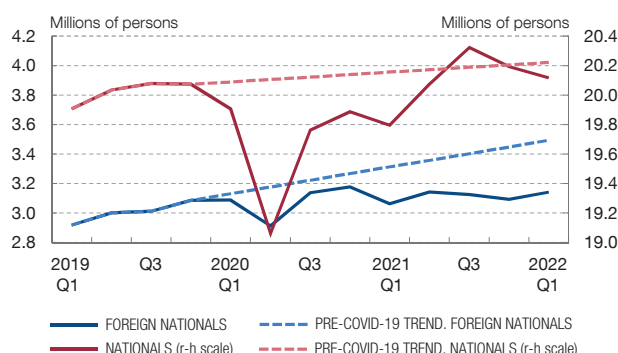
4 EFFECTIVE EMPLOYMENT RATE, BY REGION. Change between 2019 Q4 and 2021 Q4



5 CHANGE IN THE EFFECTIVE EMPLOYMENT RATE BETWEEN 2021 Q4 AND 2019 Q4 (e)



6 LABOUR FORCE



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

- a Seasonally adjusted series.
- b Effective social security registrations are defined as total registrations less furloughed employees.
- c Trade, transportation and hospitality; professional, scientific and technical activities and administrative activities; and arts and recreation.
- d Information and communication; financial and insurance activities; and real estate activities.
- e The effective employment rate is defined as persons employed as a percentage of the labour force, deducting from the total figure for persons employed in the LFS the furloughed employees in 2021 Q4, according to Ministry of Inclusion, Social Security and Migration data.



recovery throughout 2021, albeit at a somewhat slower pace than social security registrations. On both statistics, employment, measured in numbers of persons, was very close to its pre-crisis level in 2021 Q4 (see Chart 1.14.2). In terms of total hours worked, there was still a 4 pp gap in that period. However, it has narrowed significantly in 2022 Q1.

**One discernible characteristic since the crisis began is employment, measured in numbers of persons, performing markedly better than GDP.** Various explanations for this have been offered, none of which are easily verifiable. These include: the pandemic restrictions (e.g. limitations on capacity) forcing firms to maintain a higher volume of employment for a given level of activity; the public sector's greater hiring needs to deal with the fallout from the health crisis; and employees returning from furlough in droves in expectation of a recovery in activity that subsequently did not fully materialise. The discrepancy between GDP and hours worked since the recovery began was less stark and, in addition, decreased significantly in 2021 H2.

**The apparent discrepancy between the behaviour of activity and employment's more positive performance was particularly marked in some sectors.** In the aggregate of agriculture, industry and construction, effective social security registrations exceeded the pre-crisis level by 0.7 pp on average in 2022 Q1, while their overall GVA remained 6 pp below that level (see Chart 1.14.3). The divergence was particularly notable in construction: in 2022 Q1 employment in this sector was 3.8 pp above its pre-crisis level, but GVA remained 12.9 pp below that mark. These differences are not easy to interpret. They are perhaps attributable to GVA and employment adjusting to such a severe crisis at different speeds, such that the differences tend to disappear when observing the relationship between the two variables over a longer period.

**The uneven behaviour of employment across sectors is reflected in the performance of this variable at regional level.** According to the LFS, in 2021 Q4 effective employment in Spain as a whole was 0.2 pp below its 2019 Q4 level (see Chart 1.14.4). However, this figure conceals very high regional heterogeneity, which is the result of differences in the sectoral composition of economic activity. Specifically, the recovery in employment in the regions that are most reliant on tourism (above all inbound tourism, such as the island regions), lagged farther behind. In the Balearic Islands and the Canary Islands it stood 4.6 pp and 1.8 pp, respectively, below its pre-pandemic level. By contrast, in the regions with a lower share of inbound tourism and where the primary sectors and public employment are more important, such as Castile-La Mancha, Murcia and Extremadura, effective employment at end-2021 was approximately 2 pp above its pre-health crisis level. In the first few months of 2022, the most tourism-dependent regions were still lagging farthest behind in the employment recovery process.<sup>38</sup>

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38 The seasonality of these series prevents a consistent comparison between the situation in 2022 Q1 and 2019 Q4. Yet compared with 2019 Q1 the negative gap in terms of the employment rate remains wider in the island regions. However, this comparison also includes developments throughout 2019, a period unaffected by the pandemic.



**The significant disparity in the changes in the employment rate by gender and age group replicate the changes observed in participation rates.** At end-2021, the employment rate, i.e. the percentage of the persons employed within a population group, for both older workers and women exceeded that observed two years earlier.<sup>39</sup> Conversely, the employment rate of the under-30s had fallen steeply in that period. These changes are similar to those observed in the respective participation rates, i.e. the percentage of economically active persons within a population group (see Chart 1.14.5). As a result of the changes in economically active persons and persons employed being similar, the movements in unemployment rates are smaller, with a notable slight increase among the over-45s. Once again, developments in 2022 Q1 are in line with these patterns, with unemployment rates remaining similar to those of the pre-pandemic period and stronger labour-market participation developments among older workers.

**After the initial decline when the pandemic broke out, a recovery in labour supply has been observed recently.** This recovery has been confined to nationals (see Chart 1.14.6). Conversely, the migratory flows of foreign nationals are recovering considerably more slowly and, as a result, a notable gap with regard to the pre-crisis trend has opened up.<sup>40</sup> This could have important consequences for some productive sectors. Indeed, the information from the Banco de España Business Activity Survey (EBAE)<sup>41</sup> shows that labour supply shortages are reported more often as a constraint on economic activity in sectors characterised by a higher share of foreign employment, such as hospitality and construction.

### 3.6 A slower economic recovery than our peers

**GDP in Spain is further adrift of its pre-pandemic level than in the rest of the euro area.** All countries underwent a steep decline in activity at the onset of the pandemic, as a result of the first lockdowns, and a sharp subsequent rebound. However, the differences in terms of the gap between end-2021 GDP and its pre-crisis level are notable. Spain is the laggard of the main euro area countries (see Chart 1.15.1). Specifically, GDP in 2022 Q1 was 3.4% below its pre-pandemic level, whereas in the euro area taken as a whole it was already 0.4 pp above that level.

**From the sectoral standpoint, the gap between Spain and the rest of the euro area is indicative of the Spanish economy's specialisation in the sectors hardest hit by the pandemic.** Specifically, services sectors – in which social

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39 The rate's numerator is calculated as the difference between employment according to the LFS and furloughed employees.

40 See Cuadrado and Montero (2022)

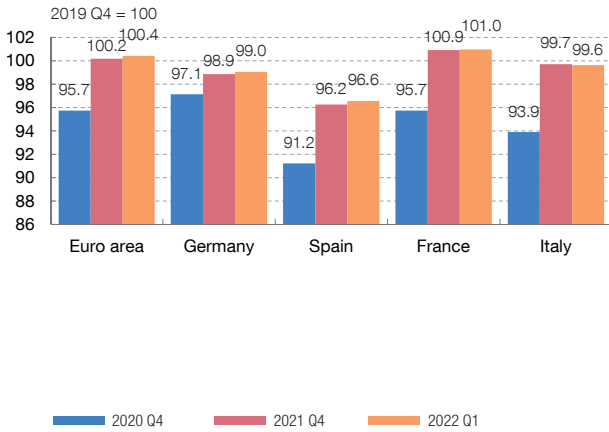
41 See Izquierdo (2022).

Chart 1.15

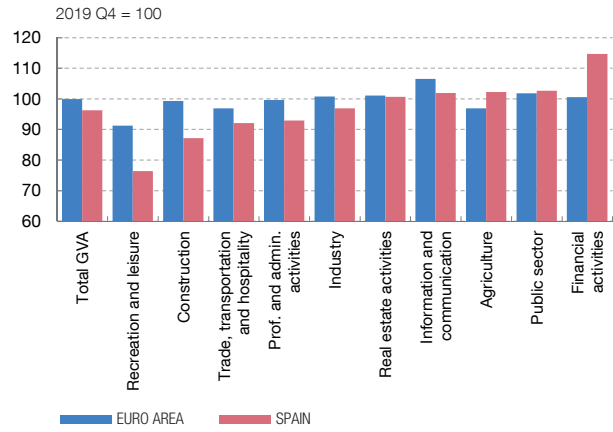
**THE PANDEMIC HAS HAD A PARTICULARLY SEVERE ECONOMIC IMPACT ON SPAIN, WHICH IS RELATED TO ITS PRODUCTIVE SYSTEM**

The gap between output and its pre-crisis level is wider in Spain than in the euro area as a whole. This is above all because the pandemic containment measures especially affected the services most dependent on mobility and social contact, whose share in Spain is comparatively higher. By demand component, the recovery in private consumption, residential investment and tourism exports is lagging farther behind than in the euro area.

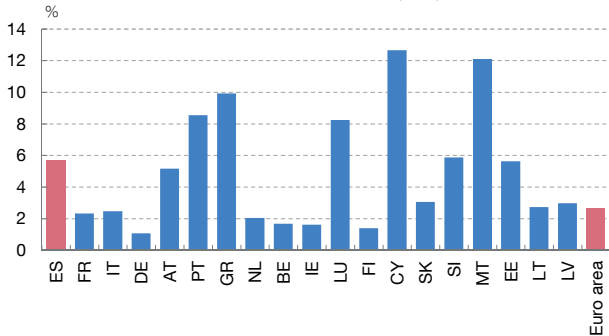
1 RETURN OF GDP TO PRE-PANDEMIC LEVELS



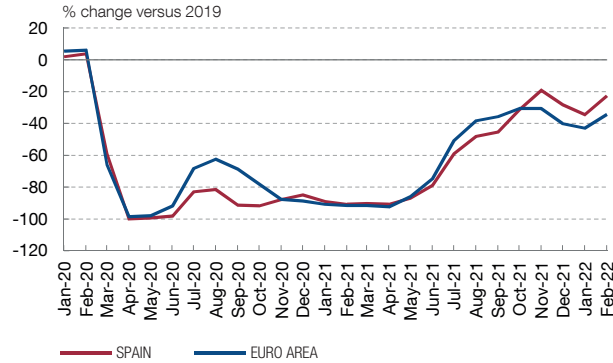
2 RETURN OF REAL GVA TO PRE-PANDEMIC LEVELS (2021 Q4)



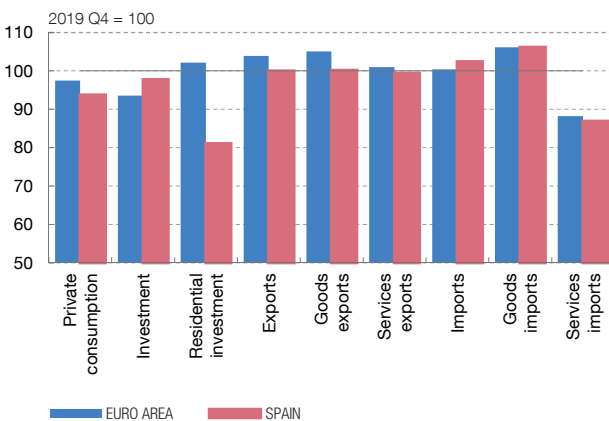
3 RELATIVE SHARE OF TOURISM EXPORTS IN GDP (2019)



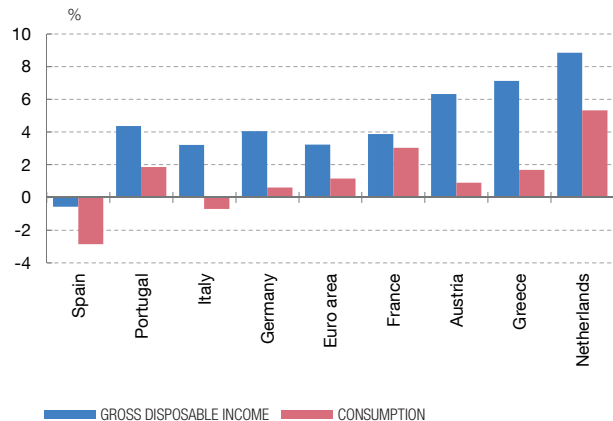
4 FOREIGN OVERNIGHT STAYS AT TOURIST ACCOMMODATION



5 RETURN OF DEMAND COMPONENTS TO PRE-PANDEMIC LEVELS (2021 Q4)



6 CHANGE IN HOUSEHOLDS' NOMINAL CONSUMPTION AND GROSS DISPOSABLE INCOME BETWEEN 2021 Q4 AND 2019 Q4 (a)



SOURCES: INE, Eurostat and Banco de España.

a The latest data on gross disposable income refer to 2021 Q3 in the case of France, Greece and the Netherlands.



interaction plays an important role – such as hospitality and tourism account for a particularly high share of Spain’s productive system.<sup>42</sup>

**In addition, these sectors have performed less favourably than in the euro area as a whole.** In Spain the sector whose level of activity (measured by GVA) was at end-2021 farthest from its pre-health crisis level was recreation and leisure, with an economic activity gap versus the pre-pandemic level of 23.6%, compared with just 8.9% in the euro area as a whole. Unlike in the euro area, in Spain there is also a significant gap between the current and 2019 Q4 activity levels in trade, transportation and hospitality, construction and professional and administrative activities (see Chart 1.15.2). Industry as whole has also performed worse in Spain, in part due to the importance of the automotive industry. Conversely, in the sectors that have led the recovery, such as financial activities and public administration, GVA has outstripped its pre-pandemic level in Spain more than in the euro area.

**From the standpoint of the components of demand, Spain’s straggling recovery is attributable to services exports, private consumption and residential investment.** Services exports are yet to return to their pre-crisis level in Spain (0.6% below that level), whereas in the euro area they already exceed it by 1%. Within services exports, the tourism component has, in all countries, performed less favourably than the non-tourism component. This is a direct consequence of the restrictions on social interaction and movement both domestically and internationally that resulted from the containment measures adopted to mitigate the health crisis.

**Spanish activity has been hit comparatively harder by the adverse impact of the pandemic on tourism exports.** First, tourism exports’ share of GDP is greater in Spain (5.7%, i.e. 3 pp higher than in the euro area as a whole) (see Chart 1.15.3). Second, inbound tourism recovered more slowly in Spain, due to dependence on the UK market and less favourable epidemiological developments than in alternative tourist destinations in the summers of 2020 and 2021 (see Chart 1.15.4).

**Private consumption has not recovered its pre-crisis level in either Spain or the euro area as a whole, but the gap is much narrower in the latter.** Thus, in Spain private consumption was 6.3% below its pre-crisis level at end-2021, compared with 2.5% in the euro area (see Chart 1.15.5). The poorer performance of this demand component in Spain is related to the less favourable behaviour of household disposable income (see Chart 1.15.6). This, in turn, is linked, among other factors, to the relative behaviour of employment, whose decline was steeper in Spain during the initial phase of the pandemic, owing partly to hospitality and tourism accounting for greater shares of Spain’s productive system. In 2021 Q4, in hours worked terms,

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42 *Gómez and Del Río* (2021) empirically quantify the impact of productive specialisation, of the severity of the pandemic and the stringency of the containment measures, and of other additional factors such as the prevalence of remote working. Their findings confirm that the health crisis has particularly afflicted economies like Spain that are more dependent on contact-intensive services.

employment was 3.6% below its pre-pandemic level in Spain, whereas in the euro area the gap was 1.8%.

**Lastly, residential investment has proven to be weaker in Spain.** The recovery in residential investment has been much slower in Spain, where this aggregate remains almost 20 pp below its pre-pandemic level, in contrast to the euro area, where it is already 2.1 pp higher.

### 3.7 The Spanish economy amid uncertainties

**Economic developments in the early months of 2022 have been marked by the persistence of the production bottlenecks, the surge in commodity and input prices and, above all, Russia's aggression against Ukraine.** In the first few months of the year, the course of the epidemic has gradually ceded centre stage to these three developments, which are not independent of each other and share the traits of a supply-side shock that undermines economic activity and pushes inflation up.

**Global supply chain disruptions are adversely impacting activity both via the direct effect on the most affected sectors and via the spillover to other sectors.** At the beginning of 2022, before the war broke out, it seemed as though the supply disruptions – which had become increasingly prominent throughout 2021 and were, as an immediate consequence, extending delivery times and raising the prices of domestically produced and imported inputs – were starting to ease somewhat (see Chart 1.16.1).<sup>43</sup> In any event, the sectoral spillover effects are above all responsible for the impact on aggregate growth.<sup>44</sup> The percentage of Spanish firms that, at the beginning of 2022, saw their production constrained by supply shortages (25%) was clearly above the historical average for the period 1995-2020 (see Chart 1.16.2). Nevertheless, the Spanish economy has been less affected by the bottlenecks than other euro area countries, such as Germany, where the impact has been particularly severe.<sup>45</sup>

**The current inflationary episode, which, as mentioned above, has largely centred around the energy component, is also affecting activity.** An important ingredient of the surge in inflation is the increase in the price of electricity, which has an adverse impact on economic output through various channels, including higher production costs and the erosion of household disposable income. The impact of such a shock can be assessed using the analytical tools available to the Banco de España. Specifically, it is estimated that a permanent increase of 10% in the price of electricity gives rise to a cumulative impact over three years of between 0.2 pp and 0.4 pp on prices and between -0.2 pp and -0.3 pp on GDP.<sup>46</sup>

43 See [Alonso et al. \(2021\)](#).

44 See [Fernández-Cerezo, Montero and Prades \(2021\)](#).

45 See [Kataryniuk, Del Río and Sánchez Carretero \(2021\)](#).

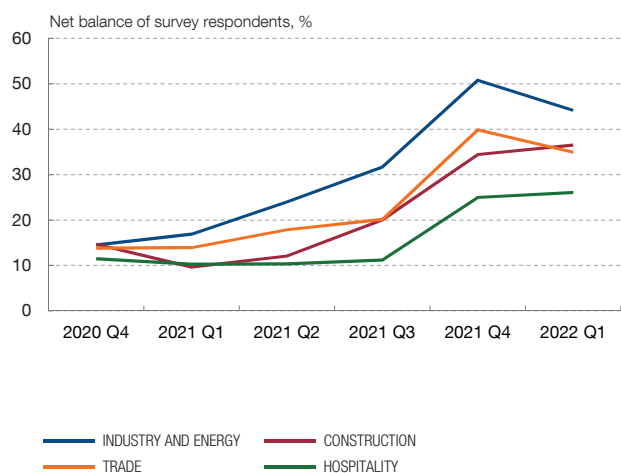
46 See [Hurtado et al. \(2022\)](#).

Chart 1.16

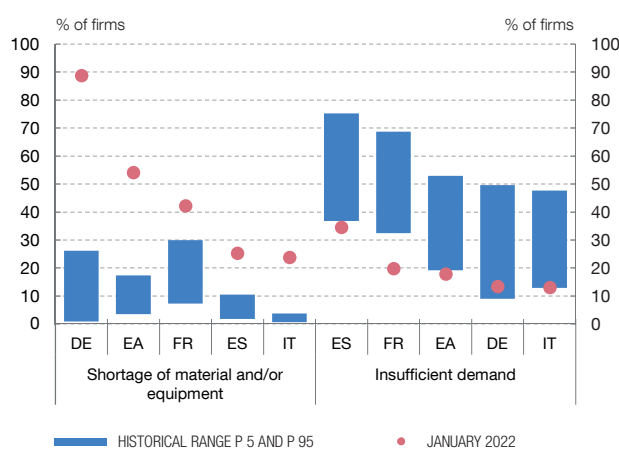
### THE BOTTLENECKS ARE AFFECTING THE RECOVERY

Supply chain disruptions have had an increasingly adverse effect on activity since mid-2021. The constraints associated with the lack of supplies have been greater in the manufacturing sectors.

1 SUPPLY PROBLEMS, BY SECTOR (a)



2 FACTORS LIMITING MANUFACTURING PRODUCTION



SOURCES: Banco de España and European Commission.

a EBAE.



### 3.7.1 The effects of the war on the Spanish economy

**The repercussions of the aggression against Ukraine are felt through multiple channels.** Much uncertainty surrounds the course and duration of the conflict. There are several transmission channels for the economic effects of the war. First, Russia and, to a lesser degree, Ukraine are major producers of certain energy and non-energy commodities. The outbreak of the war has given rise to a significant increase in many of their prices. A second channel through which the effects of the war spread is the direct trade exposure to the countries participating in the conflict, in addition to the indirect exposure via a fall in demand from other, more exposed countries. Additionally, there is the possibility of the global production chain disruptions being compounded, particularly amid the trade and financial sanctions imposed on Russia. A third channel is the potential effects of higher uncertainty on the future path of private agents' incomes, which will influence their consumer spending and investment decisions. The magnitude of the impact on economic activity through this channel is per se very difficult to measure. A final potential transmission channel for the effects of the war is the conflict's financial implications, insofar as escalating inflationary pressures result in a tightening of the monetary policy stance.

**The direct effects of the war on Spanish foreign trade will be moderate, as its bilateral trade flows with Russia are relatively limited.** Goods exports to the two countries at war accounted for around 0.9% of the total in 2019, while imports

represented around 1.6% (0.2% and 0.3% of GDP, respectively) (see Chart 1.17.1). Turning to tourism flows, in 2019, the year before the pandemic, Russia accounted for 1.6% of total foreign visitors (see Chart 1.17.2). However, after COVID-19, in a setting in which the farther away the country of origin the greater the reduction in tourism flows, this percentage fell to 0.4% in 2021. Russian tourists' spending per capita is higher than the average, such that they account for a higher share of total spending (2.2% in 2019 and 0.7% in 2021) than of overall tourists. In addition, it seems likely that the war will further weaken the flows of tourists from outside Europe to Spain. In 2021, non-European visitors accounted for almost 9.3% of tourists in Spain and 17.2% of their spending (around 15.3% and 25.7%, respectively, in 2019).<sup>47</sup> On the information available, just over two months after the conflict began, there are no indications that tourism in Spain has been significantly affected. For instance, air traffic at Spanish airports has continued to gradually improve.

**Although imports from Russia account for a small share of total imports, the share is somewhat higher in the case of energy goods.** Energy products imported from Russia accounted for 6% of the total in 2019. In any event, this figure was significantly lower than that of countries such as Germany (17%) and Italy (22%). Nevertheless, Spain is highly reliant on energy from the rest of the world and the war is having a severe impact on the cost of these energy goods on global markets regardless of their origin.<sup>48</sup> Accordingly, the rise in prices has represented a major negative shock to Spain's international purchasing power (which will foreseeably have an adverse impact on growth). Given the crucial role of these commodities in production processes and the limited capacity in the short term to substitute these energy inputs from Russia, a hypothetical interruption of the supply of energy products from Russia to Europe would have a significant impact on activity and inflation in the euro area. That impact would be more pronounced in the economies that are more dependent on Russian gas, with the consequent indirect effects on the Spanish economy.<sup>49</sup>

**The indirect effects of the war on economic activity, the magnitude of which will hinge on its duration and severity, will foreseeably be significant.** Aside from the impact via the deterioration of world trade, as mentioned above the war will have effects via its impact on uncertainty, which leads private agents to delay their spending decisions (see Chart 1.17.3). The decline in household confidence in March, after the conflict broke out, was the largest in the time series, which dates back to July 1986 (see Chart 1.17.4), and households' purchasing power is suffering from the additional rise in energy goods and food prices (see Chart 1.17.5). These effects are

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47 However, this adverse impact could be partially offset by an increase in European tourism flows to Spain to the detriment of non-European destinations (amid higher transport costs) and of competitor destinations close to the conflict zone, such as Turkey.

48 Oil and gas prices had already begun to rise in early 2021, before the outbreak of the war, as a result of growing geopolitical tensions in eastern Europe.

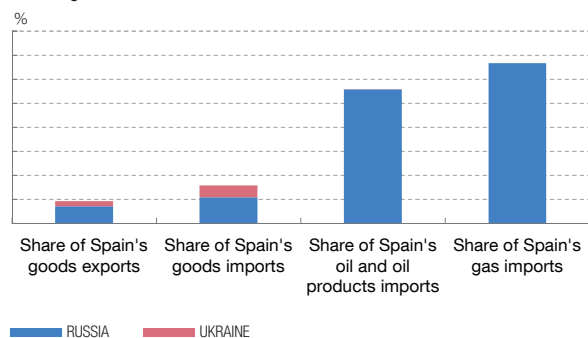
49 See Quintana (2022).

Chart 1.17

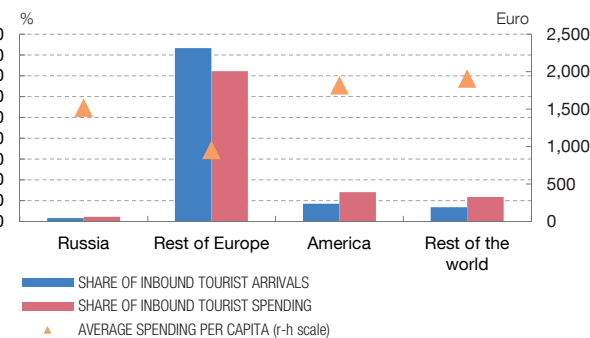
## THE EFFECTS OF THE WAR ON ECONOMIC GROWTH IN SPAIN WILL BE SIGNIFICANT, DESPITE THE LIMITED DIRECT EXPOSURE TO RUSSIA AND UKRAINE

The relative share of Russia in Spain's foreign trade of goods and services is moderate (although the dependence on imports of energy products from that country is greater). However, the war in Ukraine may have considerable adverse effects on the economy through various channels, such as the rise in commodity prices, the deterioration in confidence and higher uncertainty (which could weigh heavily on private economic agents' spending decisions), and the downturn in world trade.

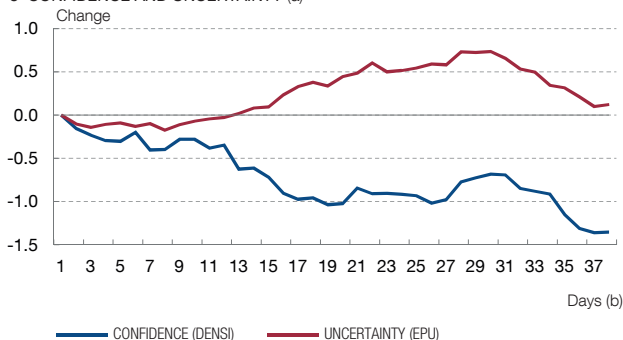
1 FOREIGN TRADE IN GOODS EXPOSURE TO RUSSIA AND UKRAINE  
% of foreign trade in 2019



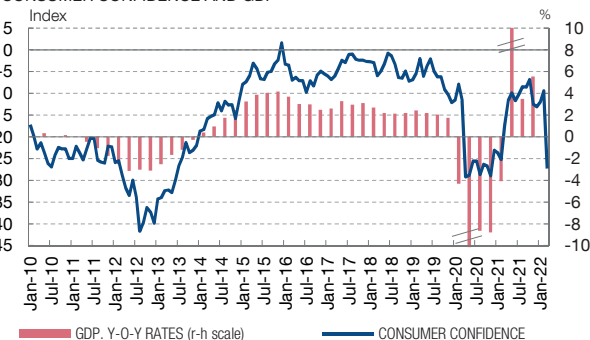
2 THE RUSSIAN SOURCE MARKET'S SHARE OF SPAIN'S INBOUND TOURISM 2019



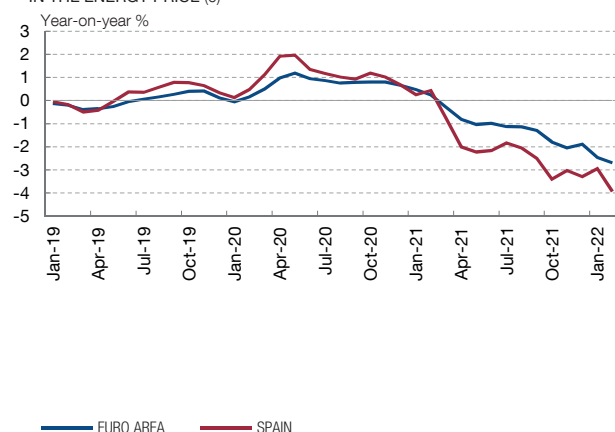
3 CONFIDENCE AND UNCERTAINTY (a)



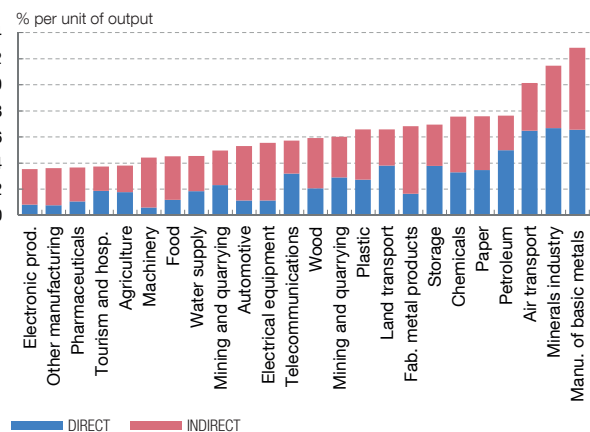
4 CONSUMER CONFIDENCE AND GDP



5 CHANGE IN PURCHASING POWER ASSOCIATED WITH CHANGES IN THE ENERGY PRICE (c)



6 THE MOST ELECTRICITY AND GAS-INTENSIVE SECTORS (d)



**SOURCES:** Departamento de Aduanas e Impuestos Especiales, INE, Geopolitical Risk Index, Economic Policy Uncertainty Index, Refinitiv, Factiva, European Commission, Eurostat, OECD (Inter-Country Input-Output: ICIO) and Banco de España.

- a The DENSI and the EPU Index are constructed drawing on the “economic sentiment” and the “economic policy uncertainty” contained in the articles published in Spain’s main newspapers. The DENSI takes into account the difference between the number of articles containing keywords related to potential upturns in economic activity in the short term and the number of those containing keywords related to potential downturns in economic activity in the short term, while the EPU Index is based on the number of articles on economic policy uncertainty.
- b Days since the start of the war in Ukraine (24 February).
- c The indicator proxies the year-on-year change in household purchasing power stemming from the changes in the price of energy if their gross disposable income grew at the same pace as the HICP.
- d Direct and indirect energy intensity calculated using the OECD Inter-Country Input-Output Tables (2021) with information for 2018. Direct energy intensity reflects the consumption of electricity and gas per unit of output, whereas indirect energy intensity considers the amount of energy needed to produce the inputs from other sectors required in the production process.



particularly significant in the case of low-income households, for whom these items account for a higher proportion of total spending. Turning to the impact on firms, a slowdown in their turnover and, above all, a rise in their production costs, which has been particularly sharp in the most electricity and gas-intensive sectors, is to be expected (see Chart 1.17.6). Some of the sectors (in particular, air transport, sea transport and the automotive industry) are, in addition, among those that were hardest hit by the health crisis and face this new shock without yet having recovered their pre-pandemic levels of activity.

**Consequently, as a result of the developments associated with the war, a delay in the gradual recovery that was under way in the Spanish economy should be expected.** This shock comes at a time when, as mentioned above, activity was yet to fully recover its pre-pandemic level and a set of households, firms and sectors remained in a relatively vulnerable position. Against this backdrop, the most important determinant of activity's buoyancy in the short and medium term is the uncertain course of Russia's aggression against Ukraine, with repercussions for activity and inflation whose magnitude is hard to predict. The war has compounded the global bottlenecks and the upward pressures on energy prices and production costs, factors that were already hindering the observed developments and clouding the future outlook. The persistence of the strains on prices and costs may tend to cause the feedback known as second-round effects, insofar as higher costs are more likely to be passed through to the final prices of goods and services and wages are more likely to reflect the higher inflation rate of the consumption basket.

### 3.7.2 The Spanish economy: outlook and risks

**According to the Banco de España April 2022 macroeconomic projections, GDP will grow by 4.5% in 2022, 2.9% in 2023 and 2.5% in 2024.**<sup>50</sup> This path is a continuation of the recovery, driven by the improved epidemiological situation, projects linked to NGEU, financing conditions that remain favourable and the measures adopted to combat the escalating energy prices. The implicit assumption in this scenario is that the war will not permanently affect the economy's productive capacity, which explains why at end-2024 activity will be at a level similar to that estimated in December 2021 (see Chart 1.18.1).

**A very high average inflation rate of 7.5% was projected for 2022.** While this sharp growth is explained, above all, by the energy component, other prices are also expected to accelerate temporarily (see Chart 1.18.2). Subsequently, the price growth rate will ease significantly to 2% in 2023 and 1.6% in 2024. However, this projection rests on two crucial assumptions: that the decline in energy prices signalled by the futures markets will bear out and that there will be no second-round effects.

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<sup>50</sup> See [Banco de España \(2022\)](#).

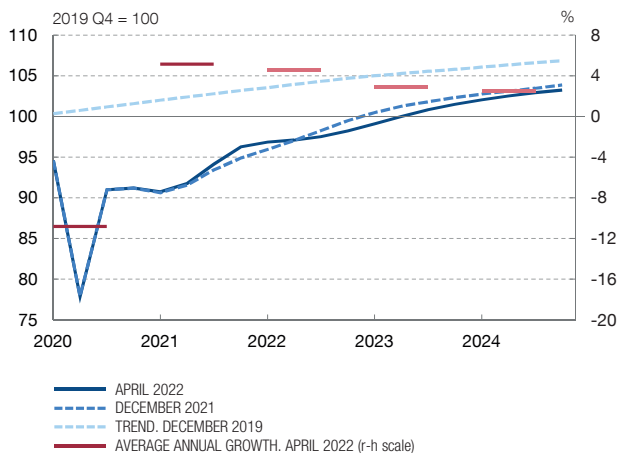


Chart 1.18

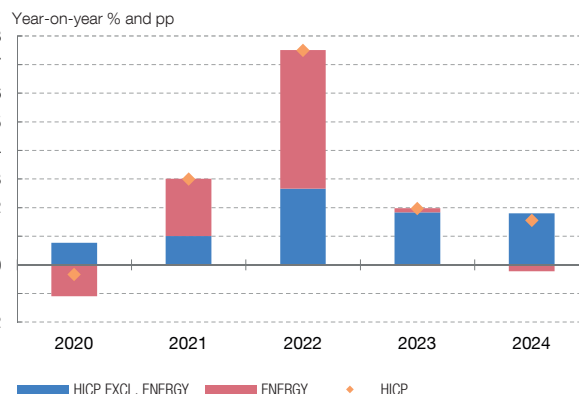
### THE CONSEQUENCES OF THE WAR AUGUR LOWER ECONOMIC GROWTH AMID HIGHER INFLATION

The war is a highly severe shock that will have a significant impact on activity (downwards) and inflation (upwards). The impact on inflation in 2022 will be significant. Yet if the paths of commodity prices on the futures markets bear out and second-round effects are limited, price growth will return to moderate rates in 2023. This outlook is, nevertheless, subject to a high level of uncertainty.

1 REAL GDP (a)



2 HICP: GROWTH AND CONTRIBUTIONS (a)



SOURCES: INE and Banco de España.

a The GDP projections are Banco de España projections prepared at different points in time (indicated in the legend), whereas the HICP projections were calculated in April 2022.



#### The war also represents an additional source of pressure on public finances.

If no corrective measures are implemented, the budget deficit will remain very high in 2024 (4.7% of GDP). Based on the paths projected for the general government budget balance and for nominal GDP, the government debt-to-GDP ratio will still be very high in 2024 (113.8%, 6.2 pp below the all-time high reached in 2020, but nearly 20 pp above the end-2019 level). This underscores the need to design a fiscal consolidation plan that ensures that government debt is sustainable.

**New information that has since become available has affected some of the projections' key figures.** Against such a changing backdrop, the macroeconomic projections are highly likely to fall quickly out of date. As a result of the war, GDP growth in Q1 was more moderate than that estimated in the Banco de España's latest projections. In the absence of any additional consideration, the figure would mechanically entail an approximately 0.5 pp lower average GDP growth rate for 2022. On the consumer prices front, information that has become available since the cut-off date for the projections points to the energy component growing slightly more moderately. Conversely, the indicator that excludes this component was stronger than expected.

**In acknowledgement of the high level of uncertainty, the baseline scenario of the April projections was supplemented by various sensitivity analyses.**

Specifically, four possible reasons for deviations from this baseline scenario were analysed. The first three were downside risks: (i) a stronger and more persistent increase in commodity prices; (ii) a complete suspension of bilateral trade flows between Russia and the EU; and (iii) the hypothetical emergence of second-round effects. The fourth, an upside risk to activity, was an increase in household demand, associated with a sharper reduction in the surplus saving built up during the pandemic.<sup>51</sup> These risks are not independent; two or more of them may materialise simultaneously (and possibly more or less severely than considered), in which case, the aggregate impact of these shocks would not be the mere sum of their individual effects.

**Overall, the risks are tilted to the downside in the case of activity and to the upside in that of inflation (pending the assessment of the impact of the Iberian mechanism to cap the price of gas and lower that of electricity which was recently approved in Spain and Portugal, in accordance with the European Commission, and which will foreseeably exert downward pressure on energy prices in Spain).** Under the alternative assumption about future energy price developments, GDP would fall by 0.7 pp in cumulative terms to 2024, while inflation would be 0.4 pp higher in 2022 and 2023 (see Chart 1.19.1). An interruption of bilateral trade with Russia, particularly one involving energy supply cut-offs, could have a severe impact on activity and prices. However, its magnitude is subject to a significant amount of uncertainty, since it is hard to judge the feasibility of substituting these supplies in the short term. Under plausible assumptions about this substitutability, after one year GDP could be 0.6-1.3 pp lower than its level were there to be no supply cut-offs, while consumer prices would be 1-1.5 pp higher (see Chart 1.19.2). Under the scenario in which profit margins and wages respond to the increase in energy prices, the cumulative adverse impact on activity and prices, compared with the current projections, could be approximately -1.5 pp and 3.2 pp, respectively, in 2024 (see Chart 1.19.3). Finally, households' greater use of the savings accumulated during the pandemic, in order to maintain their level of consumption following the loss of purchasing power, would raise GDP by 0.4 pp in 2022 and by a further 0.2 pp between 2023 and 2024 (see Chart 1.19.4).

**Lastly, other sources of uncertainty remain.** The probability of the pandemic having a direct adverse impact on economic activity in Spain in the future is lower thanks to the high vaccination rate. Yet the incidence of the virus remains high in other geographical areas where the share of the vaccinated population is lower. Accordingly, economic activity will continue to be affected in these locations.

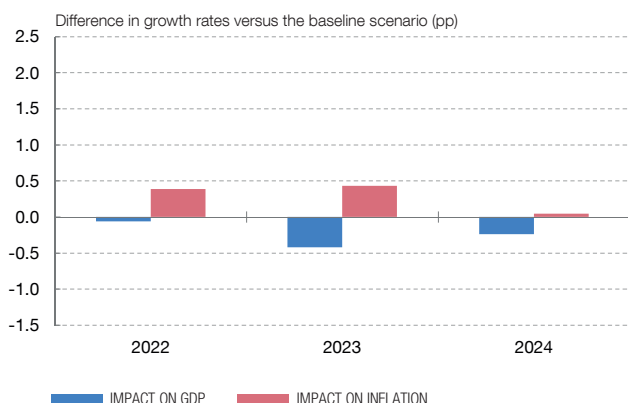
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51 The release of the surplus saving accumulated due to the pandemic may significantly underpin activity. This at a time when the decline in households' real disposable income triggered by rising energy prices, together with the indirect effects of such increase and the hypothetical second-round effects, is probably the main channel through which the war in Ukraine will affect the GDP growth outlook in 2022. Consumer Expectations Survey (CES) data for 2021 Q4 suggest that the accumulated savings could drive household spending in 2022. Specifically, the survey results reveal that the outlook for spending on goods and services in 2022, in particular on items such as holidays and cars, was more positive in the households that saved in 2020. In any event, a high degree of uncertainty continues to surround the pace at which the savings built up during the pandemic will be released.

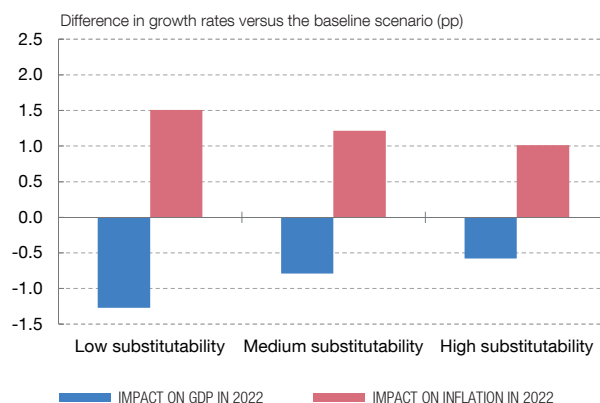
**SOURCES OF UNCERTAINTY AND THE ASSOCIATED RISKS**

The complexity of the repercussions of the war and the uncertainties surrounding its course complicate the assessment of its impact. One way of illustrating this uncertainty is by conducting different sensitivity analyses that enable the implications of the materialisation of different risks to be evaluated. Overall, the risks are tilted to the downside in the case of activity and to the upside in the case of inflation.

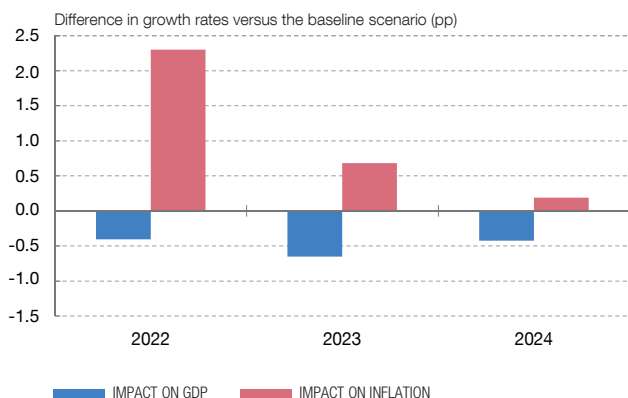
1 PERSISTENCE OF HIGH ENERGY PRICES (a)



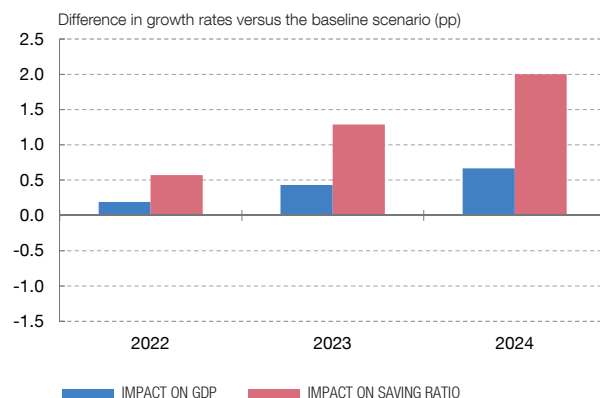
2 CUT-OFF OF TRADE WITH RUSSIA (b)



3 SECOND-ROUND EFFECTS (c)



4 HIGHER PRIVATE CONSUMPTION MOMENTUM (d)



**SOURCES:** INE, Google and Banco de España.

- a A future path for energy prices that levels off around the peak reached since the beginning of the war (observed at mid-March) is envisaged.
- b The cut-off of all bilateral trade, including energy commodities, between Russia and the EU is envisaged.
- c Business owners and employees seeking an increase in their prices and wages to nullify the initial impact of the energy shock on their incomes, which triggers second-round effects on prices and wages, is envisaged.
- d Households using two-thirds (one-third under the baseline scenario) of the savings they have built up since the onset of the pandemic in the period 2022-2024 is envisaged.



The virus being widespread in these regions also gives rise to the possibility of new, more vaccine-resistant variants emerging. Domestically, the pattern of the recovery in output will also depend on the pace, scope and effectiveness of the implementation of NGEU and on the path of the recovery in international tourism flows. A final source of uncertainty is the extent of the scarring that the pandemic may have left on employment and the productive system. However, the available evidence suggests, for the time being, that the scarring is relatively limited, as discussed in the following section.

## 4 Economic policies amid uncertainty

**Economic policies continued providing a very high level of support to activity in 2021.** The incomplete recovery, against the background of fresh waves of the virus, meant that monetary and fiscal policy remained particularly expansionary. On the monetary policy front, the reformulation of the US and euro area central banks' strategies afforded these institutions more flexibility amid uncertainty. The incomplete recovery meant that, overall, central banks were patient and avoided responding mechanically to the rise in inflation, as tightening the monetary policy stance prematurely could have jeopardised the continuity of the recovery. Fiscal policies continued to support the incomes and the financial position of the agents hardest hit by the pandemic. However, they did so more selectively due to (i) the measures to contain the health crisis becoming increasingly targeted and, therefore, tending to affect an ever smaller group of agents, and (ii) the limited fiscal space after the sharp rise in government debt in 2020.

**Yet the persistence and intensification of the upsurge in inflation meant that, over the course of the year, monetary policies began to normalise.** The monetary policy stance in many jurisdictions has gradually tightened in response to the threat of inflationary dynamics beginning to jeopardise inflation expectations remaining anchored around monetary policy targets.

**The war has made economic policy conduct even more complicated.** Even before the war broke out, economic policymakers faced a complex situation marked by intensifying inflationary pressures and the incomplete recovery in activity. The war has given rise to a downturn in economic activity, a further deterioration in the inflation outlook and a particularly marked increase in uncertainty. As a result, it has compounded the challenges of finding the right economic policy stance.

**Monetary policy should monitor the pass-through of higher prices to agents' inflation expectations.** The gradual rise in the medium-term inflation expectations, which in the case of the euro area are currently very close to the ECB's target of 2%, suggests that continuing with the normalisation of monetary policy is advisable. This should be a gradual process, given the great uncertainty associated with the current setting, as long as the medium-term inflation expectations remain anchored to the inflation target.

**The war has brought to the surface new needs that fiscal policies should try to address, within the limited fiscal space available.** The increase in inflation, a substantial proportion of which pre-dated the war and has affected energy prices above all, has a significant impact on lower-income households, who see their purchasing power squeezed more by rising energy prices, and on the firms operating in the most energy-intensive productive sectors. When resources are limited and inflation is high, budgetary policy should strictly target mitigating the impact on these hardest-hit agents via swiftly implemented measures of limited duration.

## 4.1 The role of global and euro area budgetary policies

**In 2021 fiscal policy remained expansionary in the advanced economies and retained its tighter stance in emerging market economies.** In the first case, maintaining the fiscal impulse in 2021, on the grounds of the persistence of the health crisis, resulted in many of the revenue and expenditure measures adopted in 2020 being renewed. The result of these two years of stimulus measures in these countries has been a marked increase in budget deficits and government debt (see Charts 1.20.1 and 1.20.2). This is in contrast to the more subdued growth of these two variables in the emerging market economies, whose fiscal space to contend with the fallout from the pandemic was smaller. In the specific case of the euro area, the activation of the general escape clause of the Stability and Growth Pact (SGP)<sup>52</sup> and the reform of the State aid framework<sup>53</sup> enabled a highly expansionary domestic fiscal policy stance in 2020 and 2021, which was also facilitated by the PEPP as a crucial tool for averting financial fragmentation. In addition, this expansionary stance has been supplemented by supranational policies, including most notably NGEU, whose implementation to date is analysed in Chapter 2.

**The invasion of Ukraine has upended the fiscal policy objectives for 2022, with fiscal policy instead being forced to address the economic fallout from the war.**

Energy prices had already risen markedly in 2021, with electricity prices increasing particularly sharply. Pressures on energy prices have intensified as a result of the war. Consequently, as detailed in Chapter 3 of this report, during the final stretch of 2021 and in early 2022 European countries adopted a raft of measures aimed at offsetting the higher electricity prices, such as reduced electricity charges and taxes, transfer programmes focused on the most vulnerable households and a temporary tax on the windfalls earned by non-CO<sub>2</sub>-emitting power plants as a result of rising gas prices. The war in Ukraine will also drive up government spending on other items to address the new needs that have emerged, such as accepting refugees from Ukraine and military spending. For example, Germany has announced that it will earmark €100 billion to increase its military spending to 2% of GDP.

**In the current circumstances, there are obstacles to implementing these new government spending needs.** Inflation rate surprises may be helping to contain government debt and budget deficit ratios in the short term. Yet, at the same time, these inflationary pressures involve a slight tightening of global financing conditions, which will tend to increase the public sector's borrowing costs. Furthermore, while to differing degrees, at domestic level there is generally limited elbow room for fiscal policy action given the pandemic-induced increase in debt. The NGEU's Recovery and Resilience Facility (RRF), funded via common European debt, provides some additional fiscal space, particularly to the countries with higher levels of government

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52 See [Alonso and Matea \(2021\)](#).

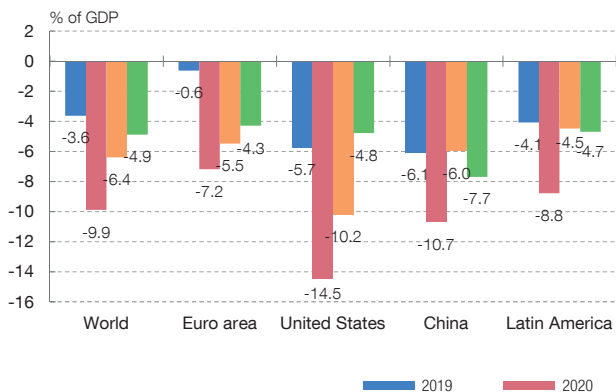
53 See [Alonso et al. \(2021\)](#)

Chart 1.20

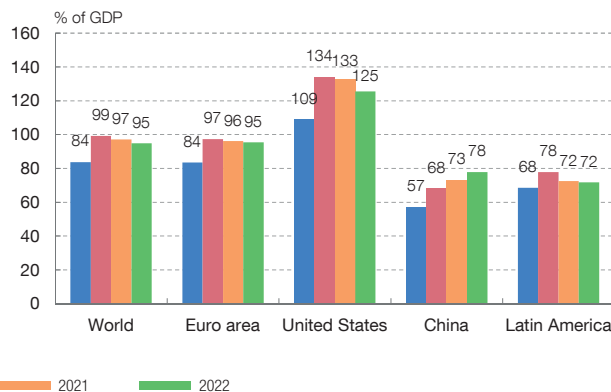
### FISCAL POLICY HAS REMAINED EXPANSIONARY IN THE ADVANCED ECONOMIES, IN CONTRAST TO THE TIGHTER STANCE IN THE EMERGING MARKET ECONOMIES

The persistence of the health crisis and the expiry of the fiscal measures adopted in 2020 justified the continuation of the fiscal impulse in 2021. This has resulted in sharp rises in budget deficits and government debt, in contrast to the more subdued increase in the emerging market economies. Looking ahead, the gradual reduction in the budgetary shortfalls caused by the crisis should be based on a determined shift towards a more growth-friendly composition of public finances and on structural reforms that increase the economies' potential growth. In this regard, in the European Union the RRF aims to boost government investment and may provide substantial support in this connection, in particular by speeding up the green and digital transitions.

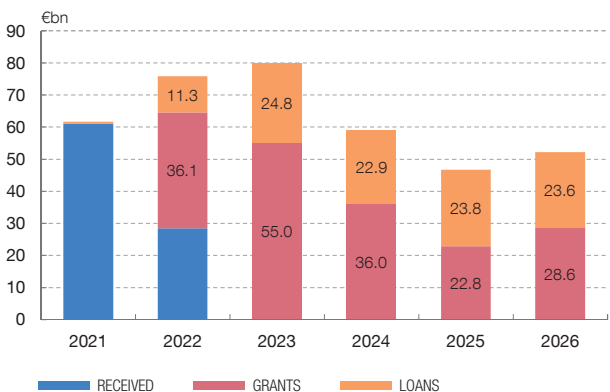
1 BUDGET DEFICIT



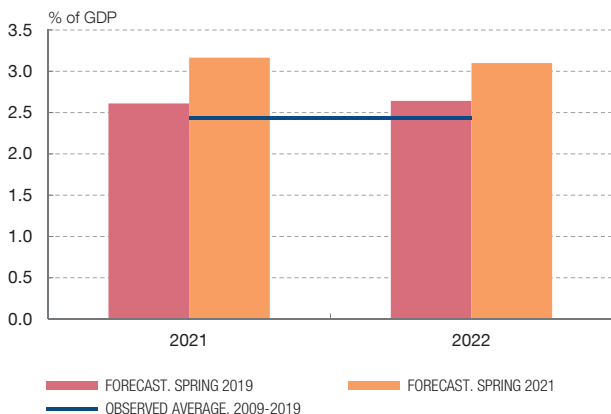
2 GOVERNMENT DEBT



3 RRF PAYMENT SCHEDULE (a)



4 GOVERNMENT INVESTMENT FORECAST IN THE STABILITY PROGRAMMES (b)



SOURCES: Banco de España, IMF (Fiscal Monitor, October 2021), European Commission (2021) and national stability programmes.

a France, Germany, Greece, Italy, Portugal and Spain.

b France, Germany, Italy and Spain. Forecasts made in the spring of each year (publication of the stability programmes) for the current and following years.



debt. The great challenge here is maximising the impact of these funds, €64.3 billion of which were disbursed in 2021 (see Chart 1.20.3).<sup>54</sup> Execution of the RRF is expected to gather pace in 2022, with the additional disbursement of around €76 billion. Going forward, one of the pillars of the gradual absorption of budgetary shortfalls must be a determined shift towards a more growth-friendly composition

54 Of this total for the EU as a whole, €57.5 billion is for the four main economies, Greece and Portugal. See European Commission (2022).

of public finances. Here, structural reforms must also play a part in boosting economic growth. In this regard, the main European countries' stability programmes envisage an increase in government investment, underpinned by the RRF funding (see Chart 1.20.4).<sup>55</sup>

**The current shocks could be tackled more appropriately by strengthening the coordination between countries.** The severity of the EU-wide supply shock (amplified after the outbreak of the war in Ukraine), its exogenous nature and the strong cross-border impact of domestic fiscal policies all warrant this coordination. First, in an integrated area such as the EU – and even more so in the case of the euro area – coordination boosts the effectiveness of the domestic fiscal policy measures implemented to mitigate, in the short term, the effects of the shock on growth and employment. Indeed, where the measures to support consumers and specific sectors and firms might interfere with the rules of the single market, coordination becomes a necessity. Second, one of the channels through which the war adversely affects the EU economies is the impact on them of the international community's severe sanctions against Russia. That said, while the expected benefits of these sanctions – in terms of their contribution to ensuring security in Europe – are common, their costs – in terms of lower growth and higher inflation – impact the different countries unevenly, depending on factors such as their trade exposure to Russia, their energy mix and the geographical origin of their oil and gas imports. Against this backdrop, the EU Member States' unified action would be boosted were the incentives better aligned via supranational financing and risk-sharing arrangements that help mitigate the unevenness of the costs borne. Lastly, it may also make sense to pool some of the costs associated with the measures required to increase Europe's strategic autonomy in key sectors. This is particularly true of energy generation, with the invasion of Ukraine underscoring the need to speed up the transition to the primary sources available in Europe so as to reduce dependence on third countries.

## 4.2 The contribution of monetary policies

**In response to sharply increasing inflation, the central banks of the advanced economies have begun to tighten their monetary policy stance.** In the United States, the Federal Reserve raised its policy interest rate by 25 basis points (bp) in March 2022 and again by 50 bp in May, to a target range of 0.75%-1%, aside from signalling further hikes for the remainder of 2022 and announcing that it will begin reducing its holdings of Treasury securities, agency debt and mortgage-backed assets. The Bank of England has raised its base rate by a cumulative 90 bp since December 2021, to 1%. The central banks of Canada and New Zealand (which had

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55 [ForteCampos and Rojas \(2021\)](#) describe the historical development of the European Structural and Investment Funds to contextualise the magnitude of the NGEU funds and the challenge of managing them. [Albrizio and Geli \(2021\)](#) assess the economic impact of the European Regional Development Fund, whose goals are similar to those of NGEU. Lastly, [Alonso et al. \(2022\)](#) detail NGEU's features and the keys to its success.

gradually been tapering their asset purchase programmes) have also raised their benchmark interest rates in recent months. For their part, except in the case of Asia, emerging market economies have prolonged the restrictive cycles of monetary policy initiated in 2021 (see Chart 1.21).

**The ECB has discontinued the emergency programmes that were launched during the pandemic and has announced that it will end net asset purchases under its regular asset purchase programme in Q3.** At end-2021, the ECB Governing Council announced the end of the net asset purchases under the PEPP in March 2022 and of the special conditions applicable to the third series of targeted longer-term refinancing operations (TLTRO III) in June. However, to address potential bouts of financial fragmentation which might affect the transmission of monetary policy, flexibility in the distribution of PEPP reinvestments is preserved at least until end-2024.<sup>56</sup> In March 2022, the ECB announced a gradual scaling down of net asset purchase volumes under the APP and in April it confirmed its plan to end net purchases in Q3.

**The ECB has reiterated its commitment to carry out any future interest rate adjustments gradually, provided that medium-term inflation expectations remain anchored at 2%.** The ECB Governing Council has indicated that any adjustment in its interest rates will occur some time after the end of net asset purchases and will be gradual. It has also maintained its forward guidance, according to which the first interest rate increase is dependent on three conditions being met: i) that expected inflation reaches 2% well before the end of its projection horizon; ii) that it remains at that level durably for the rest of the projection horizon; and, iii) that the progress observed in underlying inflation is deemed consistent with inflation stabilising at 2% over the medium term. In this connection, it is worth noting that these three conditions are now close to being met, since the different underlying inflation indicators are already above 2% and the medium-term inflation outlook is very close to that level.

**The ECB has also announced that it intends to use the instruments flexibly.** The pandemic has shown that, under financially stressed conditions, flexibility in the design and conduct of asset purchases has helped to counter the impaired transmission of monetary policy and made the Governing Council's efforts to achieve its goal more effective. Therefore, under stressed conditions, flexibility will remain an element of monetary policy whenever threats to a correct monetary policy transmission jeopardise the attainment of price stability. This setting frames the ECB Governing Council's commitment to flexibly reinvest (by jurisdiction, by asset type and over time) the principal payments from maturing securities under the PEPP in the event of a new financial market fragmentation related to the pandemic,

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<sup>56</sup> The importance of flexibility in the PEPP for monetary policy transmission is studied in [Costain, Nuño and Thomas \(2021\)](#) mimeo. For an analysis of the macroeconomic and financial effects of the PEPP, see [Aguilar et al. \(2020\)](#) and Banco de España ([2020](#) and [2021](#)).



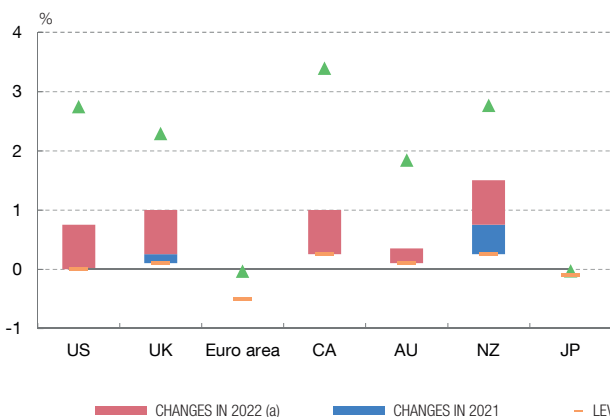
Chart 1.21

### POLICY INTEREST RATES HAVE INCREASED IN NUMEROUS JURISDICTIONS

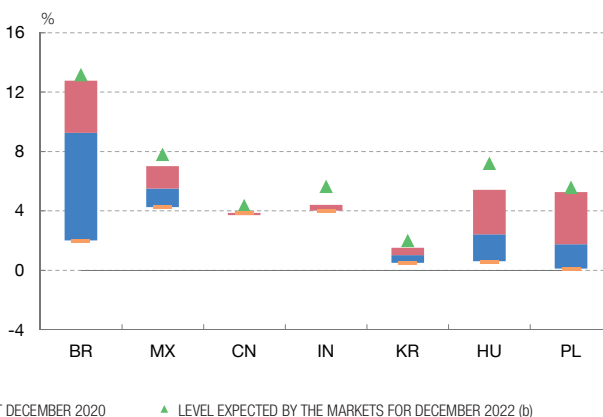
Central banks have tightened the monetary policy stance in response to the rise in inflation.

#### 1 POLICY INTEREST RATES

##### 1.1 ADVANCED ECONOMIES



##### 1.2 EMERGING MARKET ECONOMIES



SOURCE: National central banks.

a Includes changes to policy rates adopted before 13 May 2022.

b Based on futures for the interbank overnight rate, interest rate swaps and the OIS rate for the euro area, in April 2022.



and to adjust all its instruments to ensure that inflation stabilises at the 2% target in the medium term.

**The monetary policy decisions adopted by the ECB Governing Council since December 2021 have brought forward the expectations of policy interest rate hikes.** The upward shift in the risk-free interest rate curve from its level prior to the ECB Governing Council of December suggests that the markets expect a gradual normalisation of policy interest rates towards positive values (see Chart 1.22.1). As discussed in Section 2, this revision of expectations for short-term interest rates has been transferred to public-sector bonds' and other long-term debt instruments' yields. In addition, returns on these assets have been spurred both by domestic factors (the reduction of net asset purchases by the ECB) and external factors (the earlier-than-anticipated withdrawal of monetary stimuli also in the United States and the higher risk aversion owing to greater uncertainty linked to the war).<sup>57</sup> That said, private sector financing conditions have continued to be extraordinarily favourable in the euro area, and only recently has the pick-up in market financing costs started to be passed through, still relatively modestly, to the cost of bank financing. Thus, the cost of new loans to NFCs and households has remained, over recent quarters, at levels close to the all-time lows posted across all segments (see Chart 1.22.2).

**Looking forward, a hypothetical market interest rate hike would raise firms' net interest burden in a relatively quick and more intense manner than in the case**

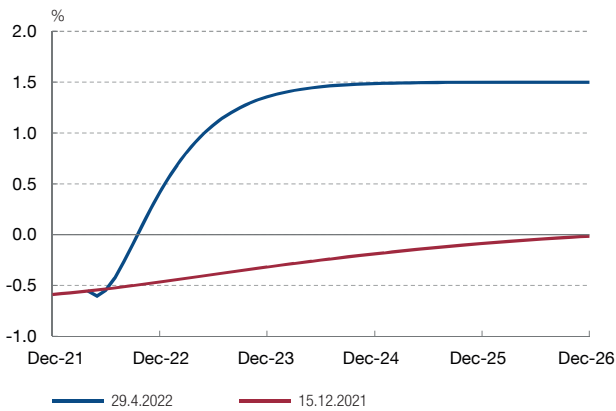
<sup>57</sup> See [Fuertes and MartínezMartín \(2022\)](#).

Chart 1.22

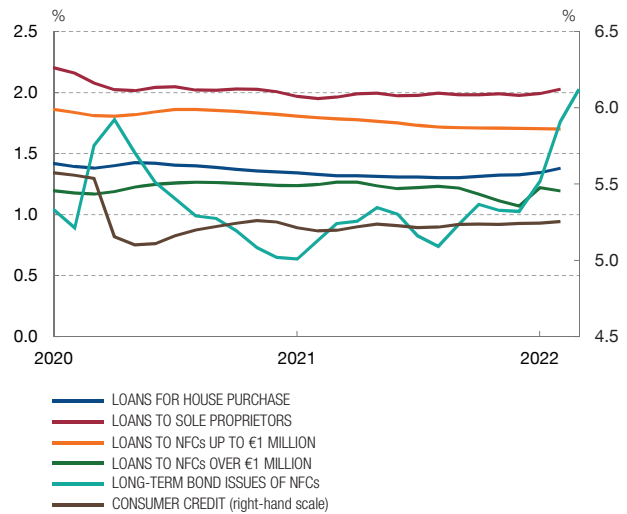
### INTEREST RATE EXPECTATIONS HAVE SHIFTED UPWARDS

Expectations of policy interest rate increases have been brought forward somewhat since December 2021. This has been passed through to long-term returns, but not yet to bank lending.

1 EURO AREA: €STR OIS INSTANTANEOUS FORWARD CURVE



2 FINANCING COSTS (a)



SOURCES: ECB and Refinitiv Datastream.

a Bank lending rates are narrowly defined effective rates (NDEs), i.e. excluding associated costs, such as mortgage protection insurance premiums, and fees and commissions. In addition, these rates are estimated on a trend-cycle basis, i.e. they are adjusted for seasonality and the irregular component.



**of households and general government.** Specifically, an increase of 100 bp in the short and long-term market interest rates would, after one year, lead to an increase of 1 pp in firms' net interest burden relative to their gross operating surplus (compared with a counterfactual scenario of interest rates remaining unchanged). For households, the aggregate effect would be much more moderate as a result of their lower, albeit highly uneven, net indebtedness (0.2 pp of their gross disposable income), and be concentrated in those segments whose level of income exceeds the median of the distribution and where the household reference person is in the younger age groups, since these are the ones who, on average, have greater net indebtedness. In the case of general government, the long-term effect would, as a result of high indebtedness, be more acute than in the past, but it would also be more gradual, owing to the extended average life of the outstanding debt and the fixed interest rate financing. Specifically, under the same assumptions the net interest burden would increase one year after the shock by 0.2% of GDP.

### 4.3 An assessment of public policies to tackle the consequences of the pandemic in Spain

**The last two years have been a period of major shocks to economic activity in Spain.** The pandemic posed an enormous challenge to economic policies, which

had to provide a forceful response to mitigate the consequences of the closing of significant parts of the economy. The recovery after the crisis has been incomplete, not so much on account of the persistence of restrictions on movement and economic activity, since these have mostly been lifted even though the pandemic is not entirely over, but rather of supply disruptions and the rise in inflation. In particular, the rise in prices and, especially in energy prices, has led to new economic policy challenges that have only intensified since the start of the war.

**It is therefore time to take stock of the economic policies implemented to combat the effects of the pandemic, as a starting point for assessing the new needs.** There is broad consensus on the important role played by monetary policy and macroprudential policies in combating the shock. In particular, the ECB's monetary policy has helped the different agents in the euro area enjoy favourable financing conditions to absorb such a severe shock. But the focus of the analysis conducted here is confined to three specific measures, probably the most important ones, which were implemented in Spain: more flexible furlough schemes, ICO credit facilities and direct assistance to firms. To conclude, protecting household income, preserving employment relationships and supporting NFCs appear to have helped economic output and employment recover. However, this favourable assessment is not an obstacle to recognising the existence of groups of households and firms whose situation has deteriorated with the health crisis, as analysed in detail in Chapter 2.

**The recovery of pre-pandemic employment levels suggests that furlough schemes have been effective in promoting the return to work.** The purpose of making furlough schemes more flexible was to temporarily suspend an employee's employment relationship with a firm while restrictions on activity were in place, enabling the employee to preserve an adequate level of income and the firm to reduce its labour costs. To this end, firms' Social Security contributions were waived and the unemployment benefit amount for employees subject to this scheme was raised. Now that the bulk of restrictions on activity have been lifted, it makes sense to assess whether these measures have been efficient in facilitating the return to effective employment. A sample of the effectiveness of the furlough schemes is the fact that the number of employees in this situation has declined from a high of more than 3.5 million in April 2020 to around 100,000 in March 2021. Also, effective employment in March 2021 exceeded by somewhat more than 400,000 persons its level in February 2020, immediately before the outbreak of the pandemic.

**Analysis of the flows of employees who have been subject to a furlough scheme helps to more appropriately study the effectiveness of this mechanism based on employee characteristics.** Individual data from the LFS have been used for this analysis covering from 2020 Q1 to 2021 Q4, and considering periods of between one and three quarters on furlough. The findings show that in the case of two persons with identical individual characteristics in terms of sex, age,

educational attainment level and type of occupation who differ in that, in a given quarter, one of them is on furlough and the other one is unemployed, the likelihood of subsequently returning to employment is greater in the former than in the latter.<sup>58</sup> However, the difference tapers off as the time on furlough lengthens. Specifically, the gap between the probability of returning to work for an individual on furlough for three quarters compared with the probability for an unemployed person is approximately one-half what it would be if the furlough lasted one quarter (see Chart 1.23.1). Additionally, this loss of effectiveness is more pronounced for some groups. In particular, for workers who are younger, have a temporary contract or are lower-skilled, the probability of returning to employment after three quarters on furlough does not differ significantly from that for a person who has been unemployed for the same length of time (see Chart 1.23.2).

**One of the most pressing needs following the onset of the pandemic was to mitigate the impact that restrictions on activity had on firms' liquidity. The ICO guarantee facilities were introduced for this purpose.** In 2020 the Government approved two public guarantee schemes for loans to firms and the self-employed which aimed to facilitate access to finance for the firms most affected by the COVID-19 crisis. These schemes, for an overall amount of €140 billion, allowed financial institutions to cover a high proportion of possible losses associated with the loans granted (up to 80% in the case of funding granted to SMEs and the self-employed and up to 70% for that provided to large firms). In February 2022 a volume of €104 billion of guarantees had been issued, 85% of which was formalised in 2020, giving rise to financing under these programmes amounting to €136 billion.

**These two public guarantee facilities met their goals effectively, insofar as they were able to cover a high proportion of firms' liquidity needs.** Specifically, the financing obtained with the loans that were channelled through the public guarantee facilities seems to have covered 30% of the non-financial corporate sector's liquidity needs (see Chart 1.24.1). The breakdown according to the firms' characteristics reveals that this percentage is comparatively higher for firms which, a priori, were facing greater difficulties in gaining access to funding, such as those in the sectors hardest hit by the crisis (38%, compared with 29% for sectors less affected) and, above all, SMEs (70%, compared with 20% for large firms). However, firms with no bank debt before the pandemic only covered 18% of their liquidity needs through bank loans. The scant contribution of the public guarantee scheme to mitigating the liquidity problems of these types of firms might have had an influence on the increase in bankruptcies in the segment of firms with high liquidity needs and no lending relationships at end-2019, which was substantially higher than that observed for firms in a similar situation but with relationships of this kind.<sup>59</sup>

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58 See Auciello, Izquierdo and Puente (2022).

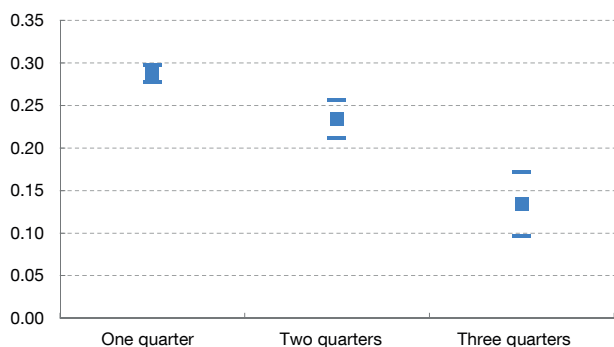
59 See Blanco and Mayordomo (2022).

Chart 1.23

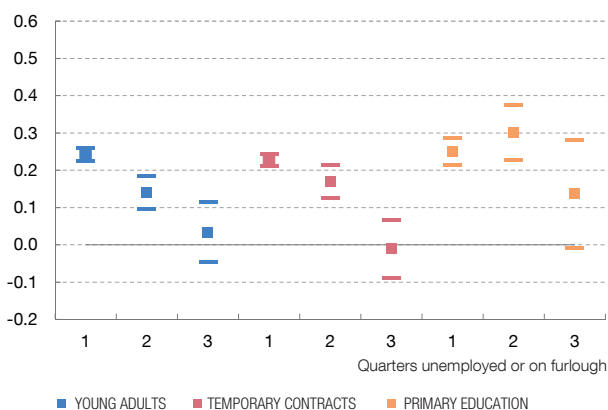
**FURLOUGH SCHEMES HAVE BEEN EFFECTIVE IN TERMS OF INCREASING THE PROBABILITY OF RETURNING TO WORK, ALTHOUGH THEIR POSITIVE EFFECTS DECREASE THE LONGER THE TIME ON FURLOUGH**

The probability of returning to work is higher for a furloughed employee than for an unemployed worker. However, the longer the furlough, the less effective the scheme is. For some groups, such as younger adults, employees with temporary contracts and lower-skilled workers, the relative benefit of the furlough schemes disappears after three quarters.

1 IMPACT ON THE PROBABILITY OF RETURNING TO WORK (FURLOUGH vs UNEMPLOYMENT) (a)



2 IMPACT ON THE PROBABILITY OF RETURNING TO WORK, BY INDIVIDUAL CHARACTERISTICS (FURLOUGH vs UNEMPLOYMENT) (a)



SOURCES: Microdata on EPA flows (INE) and Banco de España.

a The squares denote the point estimate of each coefficient, while the lines denote the 95% confidence interval.



**Also, the guarantee schemes appear to have fostered the supply of credit to SMEs and firms in the sectors hardest hit by the crisis.** As Chart 1.24.2 shows, financial institutions with lower capital buffers resorted more to public guarantees in new funding granted than those with a more comfortable capital position. Thus, public guarantees seem to have contributed to sustaining the supply of credit to these two groups of firms by financial institutions that started at lower solvency levels, thanks to the relief provided in consumption of own funds.

**A third block of actions to tackle the consequences of the pandemic was the solvency support measures for firms.** These included the creation of two recapitalisation funds,<sup>60</sup> with a maximum budget of €11 billion, and a direct assistance scheme, with a budget of €7 billion, mainly for sole proprietors and small firms. Overall, according to Banco de España estimates, funding for these three schemes could cover all the capital shortfalls of firms generated in 2020 as a result of the crisis, both in the case of SMEs and of large corporations (see Chart 1.25.1).

**As regards the recapitalisation funds, the criteria for granting assistance are based on an individual analysis of firms' economic and financial situation and**

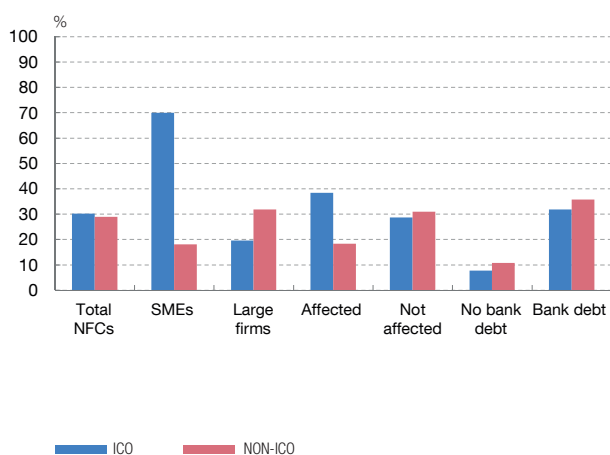
60 One is the Strategic Companies Solvency Support Fund, managed by SEPI (the State Industrial Holdings Corporation) and with an envelope of €10 billion, which aims to recapitalise strategic firms. The other one, managed by COFIDES (the Spanish Development Financing Company) and funded with €1 billion, is aimed at mid-cap companies.

Chart 1.24

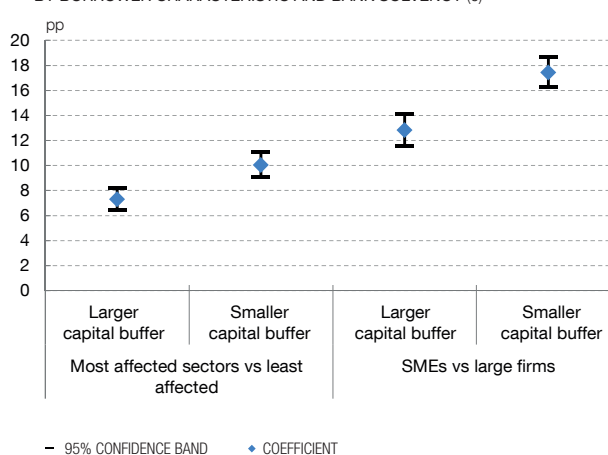
### THE PUBLIC GUARANTEE FACILITIES WERE ESSENTIAL IN UNDERPINNING THE SUPPLY OF CREDIT FOLLOWING THE PANDEMIC AND TO COVER SPANISH FIRMS' LIQUIDITY NEEDS

In 2020, 60% of Spanish NFCs' liquidity needs were covered through bank loans. In addition, loans that were channelled through the public guarantee facilities appear to have covered 30% of the liquidity needs. This percentage stood at 70% and 39% in the case of SMEs and the firms most affected by the pandemic, respectively. However, firms with no bank debt before the pandemic only covered 18% of their liquidity needs through bank loans. The banks with worse capital buffers made greater relative use of government-backed lending to these two groups of firms. Thus, such guarantees would have contributed to sustaining the supply of credit to these firms thanks to the relief provided in consumption of own funds.

1 COVERAGE OF FIRMS' LIQUIDITY NEEDS IN 2020 (a) (b)



2 PROPORTION OF NEW LENDING TRANSACTIONS WITH PUBLIC GUARANTEES, BY BORROWER CHARACTERISTIC AND BANK SOLVENCY (c)



SOURCE: Banco de España.

- a Includes new credit transactions drawn. Size is defined in line with the European Commission Recommendation. The sectors most affected by the health crisis are transportation, accommodation and food service activities, recreation and motor vehicles. The firms are classified as having bank debt or not based on whether they had bank loans on their balance sheet in December 2019.
- b Only credit transactions maturing after 2020 are considered, as those maturing within the year would have to be refinanced. Firms' liquidity needs are defined as the sum of debt maturities and the liquidity deficit generated both by the operating activity and by investment in fixed assets.
- c The diamonds are the coefficients estimated in a regression analysis in which: (i) the dependent variable is the amount of the new State-backed loans as a percentage of total credit obtained by a firm from a particular bank in a given month, and (ii) the explanatory variables of interest are firm characteristics that proxy their restrictions in terms of access to financing and their interaction with a dichotomous variable that takes the value of 1 for banks with smaller capital buffers (those whose capital buffers are below the average for Spanish banks as a whole) and zero otherwise (banks with larger capital buffers). The firm characteristics of interest are: (i) a dichotomous variable that is equal to 1 if the firm operates in one of the sectors most affected by the pandemic (see Note a), and (ii) an indicator of whether the firm is an SME (see Note a). The estimate is for a period between March and December 2020 and also uses firm-level controls and bank-time and province-time fixed effects. The vertical lines denote the 95% confidence bands.



**business outlook.** To date, the fund managed by SEPI has granted assistance amounting to €2.1 billion in 19 different operations, and that managed by COFIDES has done so for €329 million, in 26 operations. €8.6 billion of unused funds therefore remain.

**The direct assistance was aimed at reducing new debt built up by firms as a result of the pandemic.** In this case, the aid was not allocated on a case-by-case basis. Instead, objective criteria were established based on the sector of activity and the size of the fall in turnover.<sup>61</sup> The amount disbursed under this scheme is estimated

61 Specifically, direct assistance was aimed at firms with falls in turnover in excess of 30% in 2020 and which had recorded accounting profits in 2019. The regional governments, which managed the assistance, had some flexibility in the application of these criteria.

at around €5 billion, of which somewhat more than €4 billion were for business entities, mainly SMEs (91% of the total), and the rest was for sole proprietors.

**This assistance scheme seems to have contributed to reducing a small part of the SME solvency problems that arose as a result of the pandemic.** The percentage of firms of this type that went into a capital shortfall position after the crisis seems to have declined relatively modestly (from 6.4% of the total SMEs to 5.7%) and the overall capital shortfall of firms in this situation hardly declined by 9%, to 0.27% of GDP, according to Banco de España estimates (see Chart 1.25.2).<sup>62</sup> Such a low percentage is largely due to the fact that the fund allocation criteria did not include any requirement relating to firms' financial position. In particular, some firms that experienced solvency problems as a result of the crisis did not receive aid because they did not meet the standards set for receiving the aid. As noted earlier, it should be borne in mind that the funding was, according to the estimates made, sufficient to cover the total capital shortfall of SMEs, as shown in Chart 1.25.1.

**The analysis of the results of the successive editions of the EBAE supplements the assessment of the success of the measures.** A longitudinal analysis of the EBAE data is used to assess the strength of the recovery after the pandemic based on the level of use of public assistance schemes. In particular, firms that made a greater use of furlough schemes have recovered their turnover levels somewhat more markedly (see Chart 1.26.1). It is also interesting to note that the firms that resorted to ICO guarantee facilities at the onset of the pandemic appear to have re-optimised their investment plans in 2021, meaning that they simultaneously reduced total spending on investment and increased spending on digitalisation (see Chart 1.26.2).<sup>63</sup>

**Furthermore, the EBAE's longitudinal sample can be used to assess the magnitude, to date, of the consequences of the health crisis on the sample firms based on their characteristics.** These consequences are measured through the gap with respect to the pre-crisis turnover level. The characteristics considered include the extent of the fall in activity at the start of the crisis, the sector and region in which the firms operate, size, indebtedness, age and temporariness. Notably, in terms of size, a stronger recovery is not observed in 2021 among the smaller firms, which were the ones initially hardest hit by the effects of the crisis.<sup>64</sup> As was to be expected, the increase in turnover in 2021 was more pronounced among firms with higher levels of productivity and lower indebtedness.

**On the whole, the evidence available tends to suggest that the forceful public policy response seems to have helped reduce the long-term consequences of**

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62 For further details, see Blanco and Mayordomo (2022).

63 The firms that resorted more to remote working and e-commerce in 2020 were those that invested more in digitalisation in 2021.

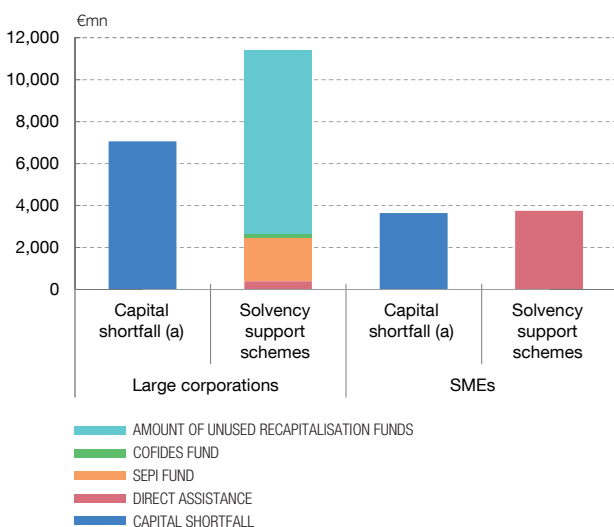
64 See Fernández-Cerezo et al. (2021).

Chart 1.25

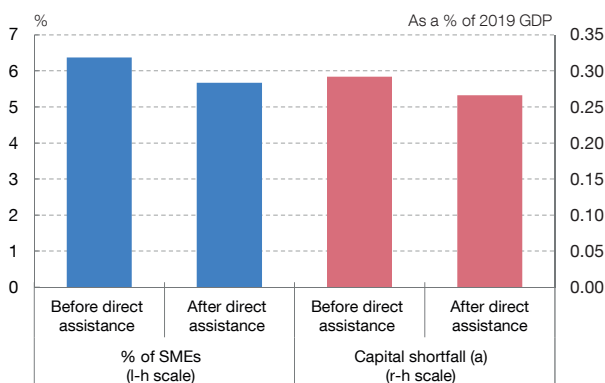
**THE DIRECT ASSISTANCE SCHEME HAS PARTIALLY MITIGATED THE DETERIORATION IN SMEs' SOLVENCY**

The funds under the corporate solvency support schemes were sufficient to cover all the capital shortfalls of firms caused by the crisis. It is estimated that, as a result of the direct assistance scheme, almost 1 pp fewer SMEs went into a capital shortfall position after the crisis and that the overall capital shortfall of firms in this situation declined by 9%.

1 CAPITAL SHORTFALL IN 2020 AND AMOUNT UNDER THE CORPORATE SOLVENCY SUPPORT SCHEMES



2 SMEs WITH A CAPITAL SHORTFALL IN 2020



SOURCE: Banco de España.

a Firms are deemed to have a capital shortfall when their capital ratio (Equity/Total assets) was positive in 2019 but fell in 2020 to stand below 15%. The amount of the capital shortfall is the volume required by firms with a shortfall to return to their 2019 capital ratio, with a 15% limit.



**the pandemic-induced crisis.** Massive employment losses and numerous firm closures have been observed in past recessions. A moderately paced closure of firms is essential for a fluid reassignment of resources towards their most productive uses (and, therefore, to boost the pace of growth of aggregate productivity). However, historically it has been observed that the episodes of very high rates of firm closures have given rise to prolonged periods of slow growth in total factor productivity. On this occasion, the measures implemented have managed, as a whole, to preserve most of the pre-pandemic employment and have avoided an increase in the rate of firm closure. In fact, according to data from the Central Business Register (DIRCE, by its Spanish acronym), the rate of business closures even decreased by 1 pp in 2020. This suggests that the long-term consequences of the health crisis will not be very significant.

**The cost in budgetary terms of the public finances absorbing the shock has been very high.** In particular, it is estimated that the different revenue and spending measures relating to the absorption of the shock triggered by the pandemic accounted for an amount equivalent to 4% of GDP in 2020.<sup>65</sup> This amount declined in 2021, owing to the lifting of restrictions on mobility, which made it possible to

65 Spending accounted for 3.9% of GDP and tax cuts for the remaining 0.1%.

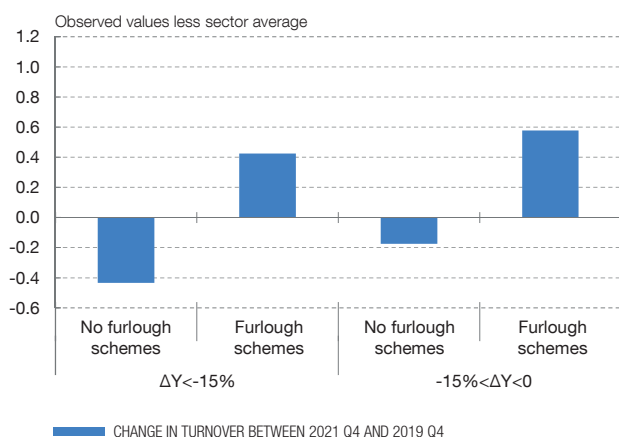


Chart 1.26

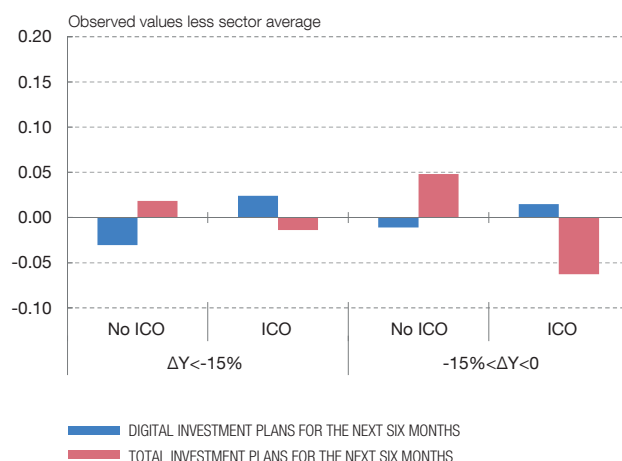
### THE DIFFERENT ASSISTANCE PROGRAMMES DEPLOYED IN 2020 SEEM TO HAVE CONTRIBUTED TO THE RECOVERY IN ACTIVITY IN 2021

Firms that used furlough schemes more in 2020 recovered more strongly over the course of 2021, once the characteristics of the firms are taken into account. Use of ICO-backed loans appears to have contributed to greater investment in digitalisation.

1 TURNOVER IN 2021 (a) (b)



2 DIGITAL INVESTMENT AND CHANGE IN INVESTMENT PLANS (a) (c) (d)



SOURCE: EBAE.

- a  $\Delta Y$  denotes the change in the firm's turnover between 2019 Q4 and 2020 Q4.
- b The variable "Furlough schemes" denotes those firms that in 2020 Q4 reported that such schemes were proving "important" or "very important", whereas "No furlough schemes" denotes those that reported that these schemes were proving "unimportant" or "of little importance".
- c The variable "ICO" denotes those firms that in 2020 Q4 reported that the ICO facilities were proving "important" or "very important", whereas "No ICO" denotes those that reported that the ICO facilities were proving "unimportant" or "of little importance".
- d A positive (negative) value denotes an increase in the probability of increasing (decreasing) digital or total investment in the next six months. Investment in new technologies and digitalisation is deemed digital investment. Total investment plans are calculated on the basis of the question on the likelihood of reducing pre-planned investments at the firm.



decrease spending on benefits for furloughed employees and the self-employed and on subsidies provided to firms in connection with these schemes, and to the use of European funds to finance part of these expenses. That said, the budgetary impact remained very high (2.7% of GDP).<sup>66</sup> The extraordinary fiscal stimulus deployed in response to the health crisis, together with the operation of the automatic stabilisers, led to a sharp increase in the level of government debt, reducing the room for manoeuvre in the face of new shocks, such as those linked to the rise in energy prices. In addition, there are other contingent costs of unknown magnitude associated with ICO-backed loans that might default. Together with the budgetary costs, other costs related to possible efficiency losses may arise, insofar as prolonging the actions entails the risk of discouraging the return of workers to effective employment and of hindering the closure of non-viable firms in the long term, where such closure would be beneficial from the standpoint of the allocation of resources of the economy as a whole.

<sup>66</sup> Spending represented 3% of GDP and tax cuts 0.1%. 0.4% of GDP, which was financed with a charge to the REACT-EU funds, is to be deducted from the sum.

**In a setting in which the pandemic appears to be receding, now would seem to be the time to roll back the bulk of the measures adopted to combat the health crisis in order to recover fiscal space.** This would allow for better, more targeted action to help the agents that are more vulnerable to the rise in energy costs and to mitigate the potential persistent effects of the pandemic on certain groups. It is also necessary to recover the fiscal headroom required to deal with longer-term challenges, such as population ageing or the energy transition. Chapter 2 analyses in depth the characteristics of a medium-term fiscal consolidation plan to restore fiscal policy leeway.

#### 4.4 Domestic economic policies in response to the war

**The domestic economic policy response to the war has two prongs: budgetary policy measures and the so-called incomes agreement.** Fiscal policies should aim to provide support to lower-income households, which are those that are hardest hit by inflation, and to the firms that are most vulnerable to this new shock. The incomes agreement between the different economic agents aims to share the costs of the crisis.

**In the fiscal policy area, the Government has approved the Emergency Action Plan in Response to the War.** The Plan has an envelope of €6 billion of public expenditure and also includes a corporate lending scheme backed by the ICO for €10 billion. The Plan also considers a series of additional actions with no direct budgetary cost.

**Public expenditure mostly takes the form of transfers to households and firms.** Subsidising the price of fuel is one of the measures. Actions aimed at households include raising the Minimum Income Scheme amount by 15%, increasing the scope of the social rebate on electricity to include a further 600,000 households and extending the energy bill tax cuts to 30 June 2022. In the case of firms, specific aid measures have been approved for agriculture and fishing, freight and passenger transport, and the electricity-intensive industry. Aside from the transfers to private agents, the Plan also includes public expenditure amounting to €1 billion, aimed at improving cyber security in Spain.

**Measures that have no direct budgetary cost affect the labour and energy markets.** Labour market initiatives include the prohibition of dismissal for economic reasons indemnified with 20 days' pay per year worked and a mandate to maintain employment for firms resorting to furlough schemes. As regards the energy markets, at the European Council meeting held on 24-25 March, the Member States were called on to apply emergency temporary measures to contain electricity prices. The Iberian exception – in terms of the Iberian Peninsula's interconnection with the rest of the EU being less than 3% – was also acknowledged at that meeting. This has

recently enabled Spain and Portugal to reach an agreement with the European Commission for a temporary (12-month) mechanism to cap the price of gas and lower that of electricity.<sup>67</sup> Also, an update of the tax regime for electricity generation from non-polluting sources has been proposed, together with some supplementary regulatory measures to accelerate the deployment of renewable energies and foster energy-saving.

**Support measures for households and firms against the energy price shock should be temporary, readily applicable and aimed at agents truly needing them.** Its temporary nature is based on the need to restructure public finances and on the transitory (in principle) nature of the increase in energy prices. From this perspective, although the increase in the Minimum Income Scheme serves to compensate the most vulnerable households for losing purchasing power as a result of the rise in energy prices, perhaps it would have been preferable to use transfers linked to level of income (a function which the social rebate on electricity performs to a certain point). The need to swiftly help the most affected agents is covered through the fuel price subsidy, but this is a very general measure which may even be regressive, since lower-income households will probably consume these products less. Also, the desirability of the targeted nature of the measures is based on the advisability of not fostering excess demand that would exacerbate bottlenecks and feed back into the inflationary process. Lastly, the temporary and selective nature of the assistance to firms is justified by the need to not hamper the reallocation of resources.

**The new type of furlough scheme called “RED” may help to mitigate the consequences of the war.** The recent labour reforms included the creation of this new type of furlough scheme for economic, technical, organisational or production reasons, which allows reducing working hours or suspending contracts with social security contribution rebates, in order to accommodate cyclical shocks to help bring about a sectoral transformation through employee re-skilling.

**The increase in imported commodity prices is equivalent to a loss of income for the domestic economy that should be shared among the different agents.** Spain does not produce a substantial portion of commodities, particularly energy ones, whose prices have risen since early 2021, and instead has to import them. Consequently, Spain must use a significant part of the income generated by its productive factors to pay for these goods. In sum, the remuneration of productive factors (capital and employment) must decrease overall.

**The agents must accept that, at aggregate level, all the economy’s incomes will inevitably lose purchasing power.** If businesses were to demand higher selling prices to offset their cost increases and employees were to demand wage increases

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<sup>67</sup> Not enough is known about this mechanism at the cut-off date for this report to accurately assess its implications on multiple fronts.

in an attempt to fully recoup the rising energy costs, the result would be a price-wage feedback loop where wages would end up being higher but the overall purchasing power would not. Also, should a similar process not occur in other euro area countries, the result would be a loss of competitiveness and, ultimately, of net exports, GDP and employment. The nature of the shock requires firms and employees to accept a moderation of their margins and some loss of the purchasing power of wages, respectively, in proportions to be determined through social dialogue. A hypothetical attempt by the two groups to maintain the purchasing power of their current income does not ensure success for either of them and, at aggregate level, entails the attendant costs of a high inflation rate, such as efficiency losses and higher inequality.

**To date, employees and firms are sharing costs tacitly.** The scant information that is available suggests that firms are only partially passing through the recent increase in their costs to their selling prices. Similarly, the information on collective bargaining indicates that the pass-through of the rise in inflation to wage increases is modest.

**Going forward, the distribution of the loss of income should abide by certain principles.** First, the uneven impact of the current shocks on employees, firms and sectors should be addressed. Given this unevenness, the necessary coordination at domestic level should be combined with mechanisms enabling the agreement to be adapted to the differences in productivity and activity existing across firms and sectors. Likewise, if there are segments of households whose living conditions have been especially adversely affected by higher energy prices, it would be desirable for the incomes agreement to entail a smaller loss of resources for these agents. Second, it would be advisable to avoid formulas that automatically index wages to past inflation or indexation clauses. It would also be desirable for the incomes agreement to envisage multi-annual commitments both to wage increases – where the nominal benchmarks for wage bargaining should exclude components associated with energy products and should be based on the projected trend in underlying inflation – and to job protection. Lastly, an explicit profit-margin moderation commitment would help to limit the pass-through of cost increases to final prices, while maximising the advantages of wage moderation in terms of business competitiveness.

**A factor to be taken into account when designing the incomes agreement is the inclusion of recipients of public transfers.** In particular, the commitment to revalue pensions in line with the HICP will have consequences on public expenditure in 2022 as a result of the compensation for inflation in 2022, and in 2023 and subsequent years owing to the consolidation of the higher current inflation in the pension amount. Beyond the need to complete the pension system reform in such a way that a decision is made as soon as possible about the sources of income that will finance this higher spending, maintaining the purchasing power of pensions raises certain equality issues against the backdrop of the current shock of loss of income compared with

the rest of the world. On the one hand, these considerations of equality justify ensuring the purchasing power of minimum pension recipients. But, on the other, outside of this particular group, the fact that some agents (pensioners as a whole) are excluded from the adjustments necessarily means that other domestic economic agents (recipients of income from work and capital) must assume a greater share of these costs.

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