6. SPAIN

The strict confinement measures put in place in Spain in response to the outbreak of the COVID-19 pandemic are expected to result in an unprecedented contraction in economic activity. Output should rebound strongly once restrictions are lifted, but the recovery will be uneven across sectors, and the lost output will not be fully recovered within the forecast horizon. Measures to limit job losses and support the corporate sector will cushion some of the impact of the crisis. Still, the unemployment rate is forecast to increase significantly this year, and only part of this increase will be reversed in 2021. The downturn is set to further deteriorate the general government balance.

An unprecedented downturn followed by a strong but uneven rebound

The Spanish economy was on a moderating growth path before the outbreak of the COVID-19 pandemic. GDP growth stood at 2.0% in 2019, and the 2020 winter forecast projected it to slow down to 1.6% this year. Soft and hard indicators for January and February pointed to an unchanged growth pace compared to the last quarter of 2019. However, the severe outbreak of the pandemic in the country in early March led to strict confinement measures, culminating in the suspension of all non-essential activities for two weeks. The ongoing restrictions are expected to take an unprecedented toll on economic activity, with a particularly severe impact on the services sector. Output is expected to have already declined substantially in the first quarter of 2020.

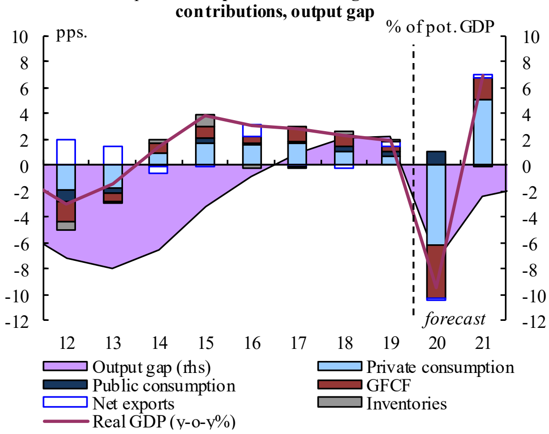
Under the assumption of a gradual and targeted lifting of the more severe restrictions beginning in mid-May, the economy is expected to experience an even sharper contraction in the second quarter, before undergoing a strong 'mechanical' rebound in the second half of 2020 as activity gradually resumes. For the year as whole, GDP is forecast to decline by almost 9½%. Activity in the manufacturing sector is expected to resume more quickly than in the services sector, where restrictions are expected to remain in place for longer, affecting in particular retail trade and tourism-related activities, such as transport, and food and accommodation services. Still, disruptions in global value chains, and weak demand may impede a normalisation of industrial activity before the end of the year.

If all productive restrictions are lifted by the start of 2021, activity should experience some rebound during the first half of the year, and then moderate gradually but remain above potential in the second half. This, together with a strong positive carry-over from the last quarters of 2020, would bring annual GDP growth to 7% in 2021, leaving output in 2021 about 3% below its 2019 level.

A protracted recovery for the labour market

Short-time work schemes (so called "ERTEs") are being used in high numbers, and should limit job losses and support household incomes during the downturn. Still, the widespread use of these schemes has not prevented a rapid fall in employment, affecting in particular temporary workers. The unemployment rate is expected to rise rapidly, amplifying the shock to the economy, although job losses should be partly reabsorbed as activity picks up again. However, the recovery in the labour market is expected to be slower amid high uncertainty, weak corporate balance-sheet positions, and the disproportionate impact of the crisis on labour intensive sectors, such as retail and hospitality. The lockdown should lead to a sharp contraction of private consumption in the first half of 2020, followed by a strong rebound in the second. The decline in private consumption this year will exceed that of household disposable incomes, resulting in a sizeable increase in the saving rate.

Graph II.6.1: **Spain - Real GDP growth and contributions, output gap**



Measures aimed at supporting the corporate sector may reduce the number of bankruptcies, but weak demand, high uncertainty, liquidity shortages, and impaired profitability are set to result in a sharp contraction in investment. Although capital expenditure should gain traction from 2020-Q3 onwards, investment in 2021 is expected to remain well below its 2019 level. Exports are also forecast to contract strongly this year due to sharp declines in export markets, production restrictions, and the severe impact of the crisis on the tourism sector. Goods exports should rebound in 2021, but the recovery of the tourist sector is projected to be slower owing to longer-lasting restrictions in activity and possibly increased aversion to travel. Imports are also likely to contract strongly this year and rebound in 2021, in line with final demand. The contribution of net exports to growth should be slightly negative this year, and turn positive in 2021. Owing to the marked drop in oil prices, the current account surplus is set to widen, while headline inflation is expected to decline from 0.7% in 2019 to 0% this year, before picking up to 1.0% in 2021, as base effects fade away.

Downturn to further worsen the fiscal balance

In 2019, the general government deficit increased for the first time since 2012, from 2.5% to 2.8% of GDP. The increase was driven by expenditure growth outstripping revenue growth, following increases in pensions and public sector pay.

In 2020, the downturn is expected to have a deeply negative impact on government finances. The contraction of tax bases is expected to lead to a significant drop in revenues, while the increase in unemployment and the extensive use of short-time work schemes (‘ERTEs’) should result in large increases in social transfers. In addition, health care expenditure is increasing significantly. These factors, together with the already-enacted increases in pensions and public sector pay, should push the deficit up to about 10% of GDP in 2020. The deficit should then narrow to below 7% of GDP in 2021 on a no-policy-change basis, as economic activity resumes and most of the measures put in place to respond to the COVID-19 crisis have a temporary effect.

Due to the large government deficit and the severe contraction in GDP, the general government debt-to-GDP ratio is expected to rise by around 20 pps., from 95% in 2019 to almost 116% by 2020, before decreasing to about 114% in 2021.

Table II.6.1:

Main features of country forecast - SPAIN

	2018			Annual percentage change					
	bn EUR Curr. prices	% GDP	00-15	2016	2017	2018	2019	2020	2021
GDP	1202.2	100.0	1.6	3.0	2.9	2.4	**2.0**	**-9.4**	**7.0**
Private Consumption	700.8	58.3	1.3	2.7	3.0	1.8	**1.1**	**-10.7**	**8.9**
Public Consumption	223.8	18.6	2.9	1.0	1.0	1.9	**2.3**	**5.8**	**-0.4**
Gross fixed capital formation	233.6	19.4	0.3	2.4	5.9	5.3	**1.8**	**-20.7**	**10.3**
of which: equipment	75.6	6.3	1.0	1.8	8.5	5.7	**2.6**	**-23.0**	**12.0**
Exports (goods and services)	422.2	35.1	3.5	5.4	5.6	2.2	**2.6**	**-19.8**	**11.9**
Imports (goods and services)	389.5	32.4	2.5	2.6	6.6	3.3	**1.2**	**-21.1**	**12.4**
GNI (GDP deflator)	1204.9	100.2	1.7	3.3	2.6	2.6	**2.0**	**-8.9**	**6.5**
Contribution to GDP growth: Domestic demand			1.4	2.2	3.0	2.4	**1.4**	**-9.2**	**6.7**
Inventories			0.0	-0.2	0.0	0.2	**0.1**	**0.0**	**0.0**
Net exports			0.2	1.0	-0.1	-0.3	**0.5**	**-0.1**	**0.3**
Employment			0.5	2.8	2.8	2.5	**2.3**	**-8.7**	**6.1**
Unemployment rate (a)			15.8	19.6	17.2	15.3	**14.1**	**18.9**	**17.0**
Compensation of employees / f.t.e.			2.7	-0.6	0.7	1.0	**2.0**	**0.5**	**0.7**
Unit labour costs whole economy			1.6	-0.8	0.7	1.2	**2.3**	**1.3**	**-0.2**
Real unit labour cost			-0.5	-1.1	-0.7	0.1	**0.7**	**1.1**	**-1.2**
Saving rate of households (b)			8.6	7.1	5.5	5.9	**7.4**	**14.0**	**10.5**
GDP deflator			2.1	0.3	1.4	1.1	**1.6**	**0.2**	**1.0**
Harmonised index of consumer prices			2.4	-0.3	2.0	1.7	**0.8**	**0.0**	**1.0**
Terms of trade goods			-0.1	0.1	-0.8	-2.2	**-0.6**	**2.6**	**-0.1**
Trade balance (goods) (c)			-5.2	-1.3	-1.9	-2.4	**-2.3**	**0.1**	**-0.4**
Current-account balance (c)			-3.8	3.2	2.7	1.9	**2.0**	**3.2**	**2.7**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-3.2	3.4	2.9	2.4	**2.3**	**3.5**	**3.0**
General government balance (c)			-3.8	-4.3	-3.0	-2.5	**-2.8**	**-10.1**	**-6.7**
Cyclically-adjusted budget balance (d)			-3.3	-3.8	-3.6	-3.8	**-4.2**	**-5.8**	**-5.2**
Structural budget balance (d)			-	-3.8	-3.5	-3.5	**-4.0**	**-5.6**	**-5.2**
General government gross debt (c)			61.2	99.2	98.6	97.6	**95.5**	**115.6**	**113.7**

(a) as % of total labour force. (b) gross saving divided by adjusted gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.