BFF BANKING GROUP

# Q2 2020: COVID-19 MACRO AND FISCAL ANALYSIS

Macro perspectives on Spain
and its regional governments' finances

## Executive Summary


### *Spain: The macro& fiscal scenarios in the COVID-19 pandemic era*

The declaration of the state of emergency in Spain in mid-March led, in Q1, to an unprecedented quarter-on-quarter rate of decline in GDP of 5.2%. In Q2, the period affected by the pandemic containment measures is notably longer. As a result, and despite the fact that since early May the lockdown has begun to be gradually eased, the fall in output in the Spanish economy will be significantly higher according to the Bank of Spain, at quarter-on-quarter rates of –16% under the rapid recovery scenario, and –21.8% under the gradual recovery scenario.

The effects of COVID-19 are asymmetrical across countries in terms not only of the severity of the outbreaks, but also of their economic impact. In particular, Spain is among the euro area countries that will presumably be most affected, as a result both of the stricter confinement measures deployed to date and of certain structural characteristics of its economy. For example, services involving high social interaction, such as those related to tourism, which the crisis has dented with particular severity, have a comparatively higher weight in the Spanish economy. The importance of the tourism sector, which exceeds 12% of GDP, and which carries more weight from associated services, such as hotels and restaurants and retail, diminishes the resilience of the economy in the face of a shock that implies policies of social distancing and restriction of social activities.

Moreover, Spain has a higher proportion of small firms, which face greater difficulties in gaining access to effective tools with which they can mitigate the reduction in liquidity caused by the decline in revenue associated with the pandemic and with the measures to contain it. Consequently, the reduction in Spanish GDP in 2020 is expected to exceed, under both scenarios, that of the euro area by around 3 pp, although the subsequent recovery in the Spanish economy will be sharper than that in the euro area.

Consensus macro and fiscal estimates for the Spanish economy in the 2020-201 period consider a decline of 8%-9%min GDP growth in 2020 with a recovery in the 4-5% area in 2021; in fiscal deficit terms, the consensus of forecasters expect a significant deterioration in the deficit figures both in 2020, which could even go below the 10% of GDP threshold in the most adverse scenario, followed by a still significant deficit figure in 2021, around the 6% level. The Spanish government's new official forecast for 2020-21 is aligned with this "asymmetrical V-shaped recovery", with an estimated GDP decline of 9.2% in 2020 and

public deficit of 10.3% of GDP followed by a positive 6.8% GDP growth in 2021. This would imply that the Spanish economy would not regain the output level of YE19, until well into 2022.

As a result, the Spanish debt to GDP ratio looks likely to increase from c.95.5% at the end of 2019 to the 115% area by YE20 and remain roughly stable at this level during 2021; bear in mind that Spain was in a fragile situation in terms of fiscal consolidation even before the COVID-19 outbreak, as the provisional final deficit for 2019, at 2.8%, was worse than the 2.5% reported in 2018. The Spanish independent Fiscal Monitor's (AIReF) debt projections consider an increase in the debt-to-GDP ratio of between 20 and 27 points in 2020, and another two points in 2021, placing the debt-to-GDP ratio in a range between 115%and 122% in 2020 and between 117% and 124% in 2021.

The previous figures are still subject to important downside risks. In particular, the knowledge of COVID-19 is in many respects highly incomplete, so it is not possible to rule out the reintroduction of containment measures, with the consequent adverse impact on activity. Specifically, fresh outbreaks would increase the probability of the liquidity strains associated with the confinement leading to solvency problems, which would be more pronounced in the case of more heavily indebted businesses. There is also the possibility that the measures enacted to provide liquidity to firms do not manage to prevent the insolvency of a portion of them.

## *The Spanish regions in the COVID-19 era: macro & fiscal implications*

Regarding the GDP growth estimates by Autonomous Community for this year, they will tend to vary according to the productive idiosyncrasy of each one. In accordance with the aforementioned structure, it is expected that those regions that concentrate more productive activities in the most affected sectors will suffer more.

The regions expected to contract less than the average are the ones favoured by the relevance of essential activities and the primary sector and/or by the rapid return to normality of the industrial sector. On the other hand, those ones where the higher GDP contraction is expected in 2020 are the ones affected either a) by a slower return to normality, due to dependence on tourism and social consumption activities and/or b) with restrictions on the capacity used, which affect social consumption activities.

Therefore, the regions with a preponderance of the activities described above are expected to show a greater impact in terms of GDP drop. The Balearics and the Canary Islands would concentrate the bulkiest economic contractions, with double-digit GDP declines in the 11-12% area range 2020, while Navarre and the Basque Country, with a heavier weight of industrial production and less dependence on tourism, would be at the other extreme, with estimated GDP declines slightly above the 7% threshold.

The 2021 outlook will be different, since the recovery will be more intense in the services most affected by the crisis this year, which will especially favor the Balearic and Canary Islands. Furthermore, those regions more responsive to a changing environment are expected to have better long-term results.

## *2019 Spanish regional deficit figures: a step backwards*

The provisional deficit figure of the autonomous regions in 2019 stood at

EUR6,795mn, or 0.55% of GDP, compared to 0.28% in 2018. If the impact of the 2017 VAT settlement is discounted, the 2019 deficit would be 0.34% of GDP, still well above the 0.1% deficit target.

Three regions (the Canary Islands, the Basque Country and Navarre) had budgetary surpluses in 2019 and three others, discounting the effect of the 2017 VAT settlement (SII), met the -0.1% target (Andalusia, Madrid and Galicia).

We estimate the increased healthcare expenditure to be around 0.5% of GDP, and the overall impact closer to 1% of GDP. The estimated impact on regional revenues would be around 0.5% of GDP. Roughly three quarters of the regional revenues in 2020 are already guaranteed through State transfers. Therefore, the combined impact would be 1.2-1.5% of GDP, which is broadly aligned with the new EUR 16bn non-reimbursable extraordinary fund for the regions announced on 2 May. Taking the EUR 16bn fund into account, the estimated regional deficit in 2020 would then range between 0.1-0.6% vs the 0.2% revised target.

## *Regional deficits up to March 2020 show the first hints of fiscal deterioration because of the pandemic*

The aggregate of Autonomous Communities registered a deficit of EUR 1,703mn in the first three months of the year, 0.15% of GDP, slightly above the EUR 1,578mn deficit registered in the first quarter of 2019. This evolution is explained by an increase in revenues of 5.1% YoY, slightly less than the increase in expenditure of 5.2% YoY, a situation that is mainly explained by the impact caused by the health emergency generated by the COVID-19.

The opposite dynamics between current/investment expenditure shown by the Spanish regions evidence the use of reprogramming spending as a way to finance the new financing needs generated by COVID-19, allocating to current expenditure such as personnel cost and purchase of goods and services, resources that, given mobility restrictions, would be difficult to execute in the investment budget of the regions.

## *The non-refundable EUR16bn fund comes to the rescue*

In order to offset the increase in health and social spending of the regions in 2020, estimated by the Ministry of Finance at an additional EUR 11bn (around 1% of GDP), the Spanish government announced, on 2 May, an extraordinary non-reimbursable fund, worth EUR 16bn, via direct transfers to the regions, for social and economic reconstruction. The enabling Royal Decree with all the details and structure of the Fund was enacted on June 16th, following the Cabinet meeting.

There is no financial cost for the regions and no impact on the regional deficits and debt metrics (the central administration will absorb all the impact and the funds will come from the Spanish Treasury).This fund is articulated as direct transfers to the regions, and therefore, will not generate an interest burden or higher financial debt.

In this regard, the central administration absorbs the lion's share of the deterioration in income by not adjusting the instalments on account to regions and local entities to realistic income forecasts, plus the impact of the EUR16bn non-reimbursable fund.

This policy of "centralization" of the deficit, with the direct consequence that the Autonomous Communities will not register significant increases of their financial debt levels in 2020. Bear in mind that the autonomous communities will receive in total

almost EUR 27,000 million (2.4% of GDP) more than the State transfers they received in 2019.

The regions will increase their deficits in 2021 and 2022, due to the decline of the on-account transfers and the negative liquidation of 2020, which will be accentuated by the announced EUR 16bn non-reimbursable fund.

### *COVID-19 could bring forward the update of the regional financing system*

The looming recession will again bring to the fore the deficiencies of the current model in terms of regional equalisation and the lack of fiscal responsibility. In this regard, we believe that the impact of the COVID-19 pandemic on healthcare expenditure and the growing pressure from the society about a strengthening of the regional healthcare system can move forward the reform of the normal-status regions that has been pending since 2015.
This new financing model in our view should pivot around two main points: a) a higher degree of fiscal responsibility by the regions linked to more available resources in the financing system and b) a clearer, simpler and fairer equalisation mechanism.

### *Regional debt stabilised further in 2019, but could mark new highs in 2020-21e*

Regional financial debt stood at EUR 295,077mn in YE19, a EUR 1,683mn YoY increase. In relative terms, the debt-to-GDP ratio has stabilised since 2015, to a level of 23.7% of GDP as of YE19.In terms of the distribution of regional debt by instruments, the loans granted through the extraordinary liquidity mechanisms (FFCA) represents 61% of regional debt, whose total volume amounted to EUR 180bn.

The newly created EUR 16bn non-reimbursable fund for the regions will absorb, to a large extent, the expected increase in the regional financial debt as a result of COVID-19. We therefore expect regional financial debt to increase to EUR 300bn by YE20 (26.5% of GDP), while the evolution in 2021 will largely depend on whether the government decides to set up a new extraordinary non-reimbursable fund and to what extent the State account transfers will reflect the new macro scenario.

### *The regional commercial/non-financial debt dynamics and average payment time to suppliers (PMP)*

Finally, the Average Period of Payment to Suppliers (PMP) of the Autonomous Communities declined by 4.87 days in March 2020, up to 34.98 days. The regional non-financial debt, which includes, among other items, the commercial debt, remained roughly flat in March 2020 vs the previous month, with an outstanding amount of EUR 11.83bn. Out of this amount, commercial debt amounts to EUR 4,575.56mn, where 73.7% of the total commercial debt is linked to the healthcare sector.

The multisectoral platform against delayed payments (PMcM), has warned that 500k small private companies could go into bankruptcy in the next months because of the growing delayed payments from private companies. Despite the liquidity lines put at a disposal of corporates in the last weeks, in some cases this liquidity is being used to increase the levels of available cash but not paying their suppliers. 70% of suppliers would have been affected by longer payment periods since the pandemic began, and this time it is not only the largest companies the one delaying the payments to suppliers, but particularly the SMEs are the ones delaying the most their payment to suppliers, potentially hinting to liquidity problems.

According to the PMcM data, the average payment time to suppliers from private companies would have been at 73 days in 2019, 13 days above the 60-days legal limit, and it has been consistently above the 70 days threshold since 2014. 3.1% of the bills were never repaid back, the highest figure since 2015.

Regarding the public sector and according to the PMcM data, the average payment time to suppliers increased to 70 days in 2019 from 68 days in 2018. The volume of unpaid bills from the public administration which would have exceed the 30 days legal limit increased to EUR 8,500mn by 2019YE.

BFF Banking Group | Paseo de la Castellana 81 - 9a planta | 28046 Madrid – Spain
Communications and Institutional Relations Office | +34 912 102 151 | newsroom@bffgroup.com

Author: Cristina Nogaledo
June 2020