3Q2021

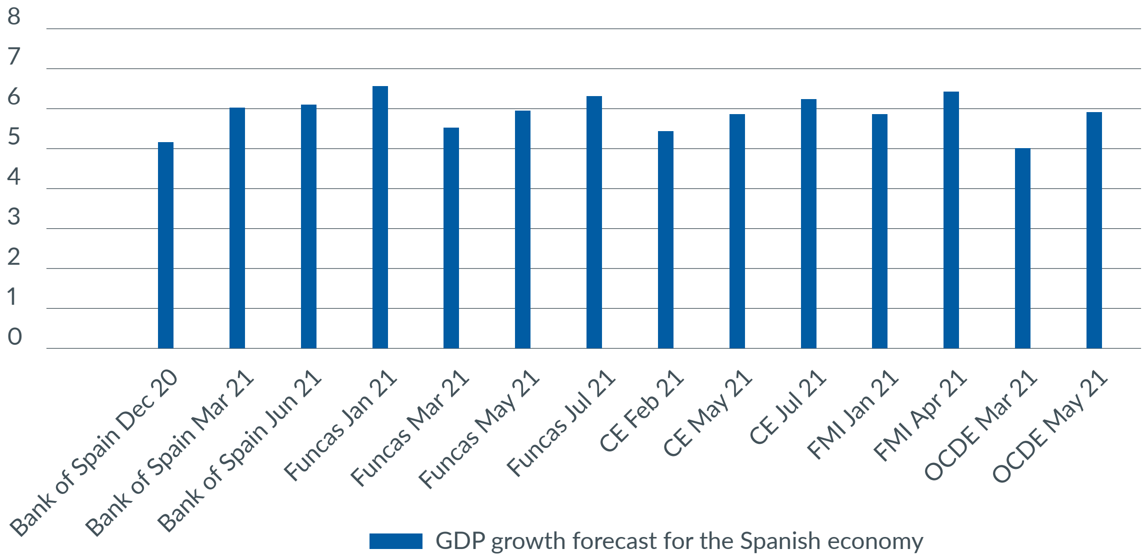
Spain moving towards recovery? Debt sustainability and inflation pose additional challenges

Executive Summary

Spain 2021-2022: macro scenario update

The publication of the most recent indicators has lead to an upward revision of the Spanish GDP growth forecast in 2021 by numerous analysts and international organizations, as we can see in Figures 1 and 2.

Figure 1. Evolution of GDP growth forecast for the Spanish economy.



Source: AIReF

Note: for the Bank of Spain we've used the Central Scenario

Figure 2. Macroeconomic scenario for the year 2021

Interannual variation rates	2020	May-21	Jul-21
Private national final consumption expenditure	-12.1	7.6	7.6
Final consumption expenditure of Public Administrations	3.8	2.6	1.8
GFCF Capital goods and cultivated assets	-12.2	16.6	17.8
GFCF Construction and intellectual property	-11.0	10.2	9.8
National Demand *	-8.8	7.3	7.1
Export of goods and services	-20.2	10.3	10.8
Import of goods and services	-15.8	13.2	13.2
External Balance	-2.0	-0.7	-0.6
Gross Domestic Product	-10.8	6.6	6.6
Nominal GDP	-9.9	8.2	8.1
GDP deflactor	1.1	1.5	1.4
Equivalent full-time employment	-7.5	4.6	4.6
Unit Labor Cost	5.3	-1.8	-1.7
Productivity per full-time employee	-3.6	1.9	1.9
Unemployment rate (% active population)	15.5	16.1	15.8
Household saving rate (% gross disponsable income)	14.8	10.2	10.2

Source: National Statistics Institute (INE) and AIReF 2021

** Contributions to GDP growth*

In this way, **the GDP growth forecast for Spain in 2021 would be between 6.1-6.5% and in a similar range, or even slightly higher, in 2022.** The control of the disease, the use of savings accumulated by families, the approval of the Recovery Plan, the arrival of NGEU funds, the ECB's impulse measures and a high unused productive capacity would be behind the rebound by 2022.

The improvement in health indicators, together with the easing of restrictions, have reduced uncertainty and allowed an **advance in private spending.** The recovery of household consumption is observed mainly in services and, within these, in those that are carried out in a social context. The good evolution of investment in machinery and equipment also continues.

Going forward, the conditions for recovery remain favorable given the speed of vaccination, the immunization of the most vulnerable groups and the demand policies in place, at the expense of the restrictions that the increase in infections associated with new variants of COVID-19 may introduce. The international environment will remain favorable, thanks to progress in vaccination and the implementation of demand policies in the main economies of the world. Immunization of the population is advancing in the US, Europe, and China.

With respect to 2022 and compared to 2021, a **weakening of domestic demand is expected,** as a result of lower growth in public and private consumption, which will be offset by **a greater contribution from the non-domestic sector.**

We believe it is important to highlight that our GDP growth scenario in 2021 and 2022 in the 6.1-6.5% range that we have commented above, is based on the fact that in the second half of 2021 and in the beginning of 2022, **public spending will take over from private spending thanks to the implemen-**

tation of resources related to the NGEU. In addition, it is assumed that the recovery of the tourism sector will progressively include foreign visitors. If either of these two assumptions does not occur, the economy could look off a cliff and suffer a severe slowdown. A deterioration in the external perception of health security in the country or a delay in the implementation of the plans related to the NGEU would have devastating effects on **a recovery that, for the moment, is based solely on the spending of Spanish households and that without major reforms, it seems cyclical.**

The inflation rate will remain above 3% until the end of 2021

The improvement in the economic outlook has been accompanied by an increase in the last few months in the prices of oil and other raw materials, which is beginning to pass on to consumer prices and inflation expectations. In the case of Spain, **in August the interannual variation rate of the consumer price index stood at 3.3% and at 3% in the Eurozone,** the highest rate in the last four years. A good part of this rise in inflation may be temporary, because of technical issues related to changes in the consumption basket or a temporary mismatch between supply and demand for certain raw materials. In any case, and even considering the foreseeable moderation of inflation since the beginning of 2022, **the "Normalization" of the inflation dynamics will be above the levels of 2010-19 due to a series of factors,** among which we would highlight: a) central banks that are more tolerant of inflation, b) more expansive fiscal policies, c) trade protectionism, d) energy transition and relative price changes, and e) structural reduction in labor supply.

The risks of the macro scenario are still relevant

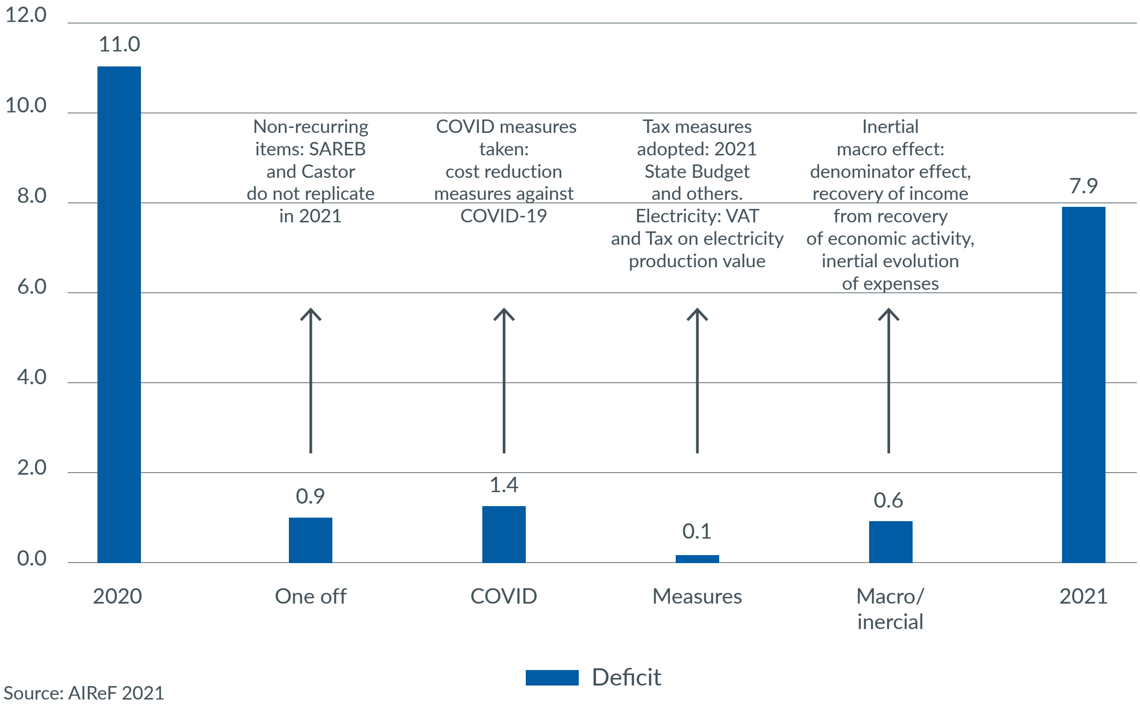
The medium-term risks center around the efficiency in the use of resources related to the Next Generation EU (NGEU) program and the reforms that will have to be implemented to access the transfers and, more importantly, reduce the vulnerabilities and transform the economy.
Other relevant risk factors would be:
- Rising inflation has a negative impact on consumption. An upturn in inflation that would have reduced the purchasing power of families and companies.
- Pension reform improves adequacy but does not yet address sustainability.
- With the suspension of fiscal rules, the public deficit will remain high. The "structural" primary deficit (without interest), which remains high at around 3% of GDP, and the significant level of indebtedness represent a fragile situation for the future stability of Spain's public finances.
- The employment gap between Spain vs EU widens again
- High regional indebtedness: In particular, in Valencia, but also Castille-La Mancha, Catalonia or Murcia, the high volume of financial debt could condition their margin of action going forward.
- Lack of ambition in the reform agenda. Without ambitious reforms, which remain over time, the high GDP growth will be temporary, and not consistent with the commitments made in digitization and environmental sustainability.

Ahead, **a period is coming with conditions that should be used to implement reforms that reduce unemployment and temporary employment, increase productivity, while transforming the economy towards a more digitized and sustainable one.**

Fiscal scenario of the Spanish Public Administrations in 2021-2022

AIReF estimates for its central scenario a combined deficit of the Spanish public administrations of 7.9% of GDP in 2021, below the 8.4% of GDP forecast by the government at the end of April. This still high public deficit figure is the result of the interaction of different factors, such as the adoption of new measures or the observed execution, largely offset by others that have acted in the opposite direction, such as the positive evolution of tax collection in the first half of the year.

Figure 12. The reduction in deficit of just over 3 points of GDP in 2021 is based on several factors (% GDP)



Source: AIReF 2021

We estimate that the Autonomous Communities can close 2021 with a deficit of 0.5% of GDP. This figure continues to be below the -0.7% rate forecast for the subsector by the government and the reference rate of -1.1% of GDP.At an individual level, **deficit estimates lower than the references of -1.1% and -0.7% are maintained in most of the Autonomous Communities.** In this way, we estimate that all the Autonomous Communities except the Murcia and Valencia could achieve a more favorable balance than the -1.1% reference set for the subsector, and only Castile-La Mancha and Extremadura would surpass the deficit of 0.7% of GDP forecast by the government for the aggregate regional subsector. Regarding the local entities, we maintain our previous surplus forecast **around 0.3% of GDP in 2021.**

Debt Sustainability Analysis of the Spanish Public Administrations

The debt-to-GDP ratio of the Spanish public administrations stood at 122,8% of GDP in 2Q21, the last reported data by the Bank of Spain, vs a ratio figure of 110,2% of GDP in the same period of 2020 (2Q20), which represents an increase of 10,6% of GDP in the last twelve months. In the medium term, under the macro-fiscal forecasts discussed in the previous sections, **a decrease in the debt-to-GDP ratio of 7.6 points is projected for the year 2024,** where the debt ratio would stand at 112 ,4%.

The high economic growth estimated for the coming years will be the main factor in the reduction and stabilization of the debt ratio. The strong rebound in economic activity expected in the next two years will drive the reduction of the debt ratio in the short term. On the other hand, the low interest rate environment will help contain the debt ratio, while the large primary deficits projected for the period will continue to push in the opposite direction.
The significant increase in the stock of public debt legacy of this crisis, added to a high starting level, **places the sustainability of public finances for the general government, as well as for the Autonomous Communities subsector in a position of great vulnerability.** The dependence on a low interest rate environment over a long timeframe has become one of the most prominent aspects linked to the dynamics of debt sustainability.

The increase in the debt ratio will be uneven in the different Autonomous Communities. Valencia, the Balearic Islands and the Region of Murcia, would be the territories that would see their debt increase the most in 2021 in relation to 2019, from previous levels already elevated. In 2021, no autonomous community will comply with the reference limit of 13%, with the Canary Islands, Madrid and the Basque Country being the regions that would be closest ones to the legal reference. **The containment and stabilization of the regional debt ratio will require a convergence to the budgetary balance in the future,** although it will be essential that the adjustment path is adequate so as not to compromise GDP growth in the short and long term.

The CFPP agrees to maintain the extraordinary support of the State to the regions in 2022

The last CPFF meeting in July approved additional revenues for both the Autonomous Communities and Local entities in 2022. With an impact in the current year, it was decided that the distribution criterion of the 13,486 million euros of non-reimbursable transfers for 2021 corresponding to the Covid Fund will be the **adjusted population.** In addition, the CPFF informed the Autonomous Communities of **an increase of about 6,690 million euros (+ 6.3% yoy) from the State account transfers for 2022, which will reach 112,213 million euros, the highest volume in the history of State account transfers to the regions.** The comparison of these record figure with the pre-pandemic volume of State account transfers in 2019 represents a cumulative increase of 9.2% yoy.

With an impact in 2022, **two unprecedented new transfers will be included in the Autonomous Financing System** aimed at offsetting negative settlements:

- **New formula to compensate the negative settlements** (EUR3,900 mn).
- **Solution to the 2017 VAT (SII) issue** (EUR3,100mn)

Moreover, and for the Spanish regions, the deficit target 2022 is 0.6% of GDP, 10 basis points below the revised benchmark rate established for 2021 (0.7%).

Average Payment Time (PMP) of the Autonomous Communities and Local Entities (June 2021)

The Average Payment Period to Suppliers **(PMP)** of the Autonomous Communities has once again registered in the month of June 2021 a figure lower than 30 days, with **23.19 days,** so that it once again presents a new historical minimum since the beginning of the publication of the series, in April 2018. In addition, the trend of previous months is maintained so that it is the first time that the PMP is below 30 days (maximum period established in the regulations) during six consecutive months.
No region shows in June a PMP higher than the 60-days threshold, the limit from which the Ministry of Finance begins to apply the measures provided for in the stability regulations. In addition, there are only two regions that fail to comply with the 30-days threshold.

Figure 4. Average payment time (PMP) by region (number of days)

CCAA	Ratio of paid operations	Ratio of operations pending payment	APP global
Andalusia	11.74	20.19	14.98
Aragón	25.00	34.76	29.37
Asturias	19.73	44.58	27.46
Balearic Islands	45.12	28.85	34.95
Canary Island	15.00	25.22	18.96
Cantabria	17.57	18.10	17.81
Castille-Leon	21.28	29.01	24.41
Castille La Mancha	14.02	22.30	16.51
Catalonia	30.99	36.06	33.41
Extremadura	8.07	20.27	11.93
Galicia	9.81	15.30	10.99
Madrid	15.28	40.53	23.51
Murcia	11.50	15.00	11.60
Navarre	21.40	19.79	20.82
Basque Country	23.02	15.45	20.47
La Rioja	18.93	17.28	18.55
Valencia	16.02	25.91	21.72
TOTAL	**19.01**	**29.38**	**23.19**

Source: Ministry of Finance 2021

The outstanding volume of commercial debt is estimated at 3,425.36 million euros, equivalent to 0.28% of the national GDP. This represents an increase of 669.58 million euros compared to the previous month, in line with the rebound in commercial debt that historically we usually see in the sixth month of the year. Despite the increase observed in June, the volume of total commercial debt remains close to the minimum value of the series published since April 2018. The main cause of this decrease is the establishment of liquidity measures that in favor of the Autonomous Communities have implemented the State. **This set of measures is allowing that the levels of commercial debt and PMP of the regions have not been affected by the health crisis.**

Regarding the PMP of local corporations, l**ocal entities show a PMP at 60.46 days in the sixth month of the year, 5.57 days less than with respect to the first quarter of 2021.** If those local entities with an excessive PMP are not taken into account (those with a PMP above 60 days), which would represent 9.87% of the entities that present information on the subsector, **the Average Payment Time would decline up to 20.50 days in the second quarter for the entire local entities' subsector,** a figure clearly well within the legal limit.

BFF Banking Group | Paseo de la Castellana 81 - 9ª planta | 28046 Madrid – Spain
Communications & Institutional Relations | +34 933 228 605 10 | newsroom@bff.com

Author: Cristina Nogaledo Castaño
September 2021