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SPAIN: STRONG REBOUND AHEAD BUT RISKS ARE LOOMING

Berenberg Macro View

Like other economies in Europe, Spain looks set to bounce back strongly once lockdowns can be eased. But risks remain tilted to the downside near-term. If Spain misses the crucial summer tourist season due to insufficient progress against the pandemic, economic growth could disappoint in 2021. Longer-term, we see a chance that Spain may raise its trend rate of growth if the EU uses the grants of EU money to nudge Spain towards pro-growth reforms. Whether the centre-left/left coalition will accept and implement such reforms remains an open question, though.

Pandemic receding again: After a rapid increase in the number of new daily SARS-CoV-2 cases in January, numbers keep falling. As of 9 March, the seven-day rolling average dropped below 8,000 recorded infections per day after a peak of more than 30,000 new cases one month ago. Restrictions on the Spanish economy are being lifted gradually on a region-by-region basis. The Madrid region has allowed bars and restaurants to stay open until 11pm and Castile and León, the largest region of Spain, has eased the lockdown of some of its provinces.

With the expected acceleration in the pace of vaccination and spring weather around the corner, the Spanish economy looks set for a major rebound once most of the restrictions have been lifted. After a drop of 11% last year, we project GDP growth to reach 6.2% this year - below the Spanish government's own estimate of 7.2%. However, the risks are tilted to the downside near-term. Though it is too early to really assess it as numbers are volatile, the seven-day average of recorded infections has crept up slightly in the last two days. A premature easing of restrictions so that new more contagious variants of the SARS-CoV-2 virus spread faster and risks related to corporate insolvencies could retard the economic recovery when government support will be wind down. We forecast unemployment (16% in January 2021 according to Eurostat) to average 16.5% in 2021 and 15.5% in 2022

Downside risks to the outlook: We identify two major risks that could hold back the economy recovery:

1. Virus variants associated with increased transmission and/or higher viral burden represent an increased share of new infections in Spain. The UK variant now accounts for more than half the cases in the country against 25% in mid-February and even makes up to 90% in some areas (such as the northern region of Asturias). According to the evidence available so far, the efficacy differs from vaccine to vaccine and variant to variant. If infection numbers continue to decline and the pace of vaccinations accelerates by June, the summer tourist season could be saved. But if the re-opening of tourist resorts and/or the return of foreign tourists is delayed to the end of the summer, the economy may suffer a great deal. Tourism contributes 12.4% to the country's GDP and accounts for 12.9% of all jobs

2. The uptake of government-guaranteed loans has been significant. As a result, far fewer companies went bankrupt in 2020 than in 2019 (-21% during the first three quarters of

2020 compared to the same period of 2019, according to the latest available data). While it makes sense to temporarily help solvent illiquid companies, the Bank of Spain warned in February that insolvent companies – those unlikely to survive the impact of the crisis in the medium term – are also being rescued. This could have detrimental consequences for creditors and the overall financial sector. Until now, the government has decided to postpone the problem by systematically extending the debt moratorium scheme when it is about to expire. That will be certainly the case with the current deadline set for 14 March, in our view. But it does not solve the problem and we believe that Spain cannot avoid a wave of bankruptcies when the support measures will come to an end. In light of this, we expect the unemployment rate to increase in 2021 to an average of 16.5% in 2020 from 15.6% in 2019.

Can EU money nudge Spain back onto the reform track? Before the pandemic, the ruling coalition between the centre-left Spanish Socialist Workers' Party (PSOE) and the leftist group Podemos committed to partial rollback of the 2012 labour market reforms which introduced further flexibility and transformed Spain into a more competitive market. The coalition aimed to revert to sector-level wage bargaining agreements with unions, instead of at the company level, which may have adverse effects on employment if implemented, in our view. With luck, the European Union will prevent reform reversals by imposing conditions on its hand-outs to Spain from the €750bn recovery fund. In absolute terms, Spain is expected to be the largest recipient of the funds, behind Italy, with more than €140bn (11% of GDP). Half of that (€72bn) will be in the form of grants – see chart 1. The first disbursement will happen at the earliest in June.

As for the use of funds, the Spanish government unveiled last autumn a list of investments aligned with the EU Green deal - see table: 37% of the funds will be allocated to green investments and 33% to the digital transition, with a focus on helping small and medium companies to move upmarket. Spain also plans to push forward with pro-startup legislation later this year with the objective of turning the country into an entrepreneurial nation by 2030. The new legislation is intended to simplify starting up in Spain and might include tax concessions and incentives for foreign investments. To this end, a new body, the high commissioner for Spain entrepreneurial nation, was created within the presidency to help coordinate the different ministries. This is a step in the right direction. But much more needs to be done.

In return for EU funds, the government will have to implement structural reforms to address deep-seated problems and to give up its intent to revert the 2012 labour market reforms. The European Commission has identified three major issues that will require further negotiations between Brussels and Madrid in the coming weeks:

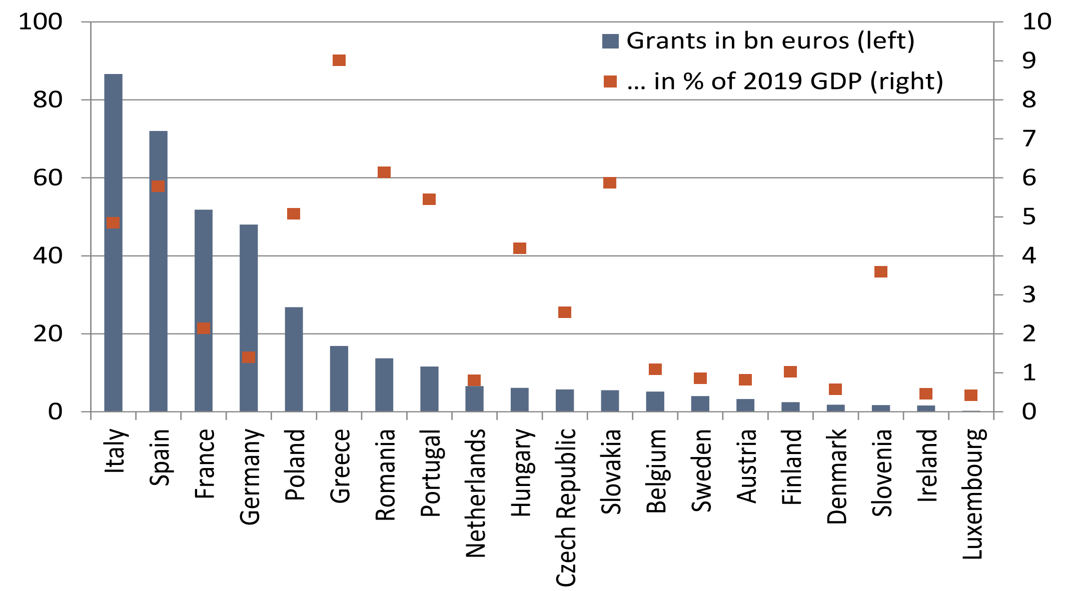
1. the **sustainability of the pension system** which has run a deficit for the past ten years. The legal retirement age is progressively raised from 65 to 67 years old in 2027 but further adjustments are needed, this time in relation to the replacement rate (the state pension payable as a portion of the final salary). In Spain, this ratio currently stands around 75% - one of the highest levels in the European Union. It will need to be lowered over time to improve the long term balance of the pension system.

2. the high share of **temporary contracts** which represent 25% of employment against 14% in the European Union as a whole and increase income volatility and lower job security.

3. the need to reduce the **fragmentation of regional regulation.** Companies wishing to do business in Spain are confronted with a patchwork of rules and regulations created by the country's 17 autonomous regions, which adds administrative burden to businesses.

Some of these reforms will be unpopular and politically sensitive. It may even generate serious tensions within the ruling coalition. The repeal of the 2012 labour reform is a landmark proposal of Podemos'electoral platform. But this is the only way for Spain to be on track for more trend growth after the pandemic, in our view. Under its current coalition, Spain has turned into a reform laggard. This time, it will have no other choice but to move forward with reforms in order to access the European Union funds. Whether Spain will deliver sufficient reforms and have the administrative capacity to adequately use the funds remains an open question.

Chart 1: Grants by major EU members



Source: European Commission, Bruegel, Berenberg

Table 1: Summary of the main investments identified by the Spanish government in Autumn 2020 which could be financed by the European Recovery Fund

Main investments	% of total
Digitalization of SME´s, measures to support the tourism sector and promotion of entrepreneurship	17.1%
Measures to help and reinforce the national health system	16.5%
Urban and rural agenda *Sustainable mobility plan, measures to support the use of electric vehicles, housing rehabilitation*	16%
Infrastructure and ecosystems *Measures to restore the ecosystem, coastal areas and water resources*	12.2%
Energy transition *Measures to boost renewable energy and invest in smart grids and support to innovative projects (especially for floating offshore wind)*	8.9%
Investments in the care economy	5.7%

Source: Spain's Recovery Transformation and Resilience plan, Berenberg

Also see our 2019 Euro Progress Monitor.

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