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November 5, 2020

Statement by the Staff Representative on Spain
Executive Board Meeting
November 11, 2020

This supplement provides information that became available after the staff report was issued on October 27, 2020. The thrust of the staff appraisal remains unchanged.

1. **Spain's rebound in the third quarter has beaten expectations, setting the stage for a smaller contraction in 2020 than projected by staff.** According to the preliminary data release, growth in the third quarter was 16.7 percent relative to the previous quarter. Despite the sharp rebound, the economy remains 8.7 percent below its level a year ago. The extent of the recovery has been more significant for private consumption and investment, and less so for external sector components, with tourist services holding back exports. In labor markets, effective hours worked also recovered substantially, increasing by about 25 percent relative to the previous quarter. Nevertheless, the unemployment rate rose further to 16.3 percent (up from 15.3 percent in Q2) due to a sizable flow of workers moving from being inactive to actively seeking a job. Given the strong GDP outcome in the third quarter, the drop in GDP for 2020 could be less severe than the 12.8 percent decline projected by staff, absent a material tightening in containment measures in the coming months.

2. **However, the virus resurgence and associated authorities' response needs pose risks for the near-term outlook.** Average daily new cases have doubled to about twenty thousand by end-October/early-November compared to the first half of October. Parliament has extended the state of emergency through May 9, 2021 (with an interim assessment by March 9). The decree empowers the government and regions to adopt measures that contain the spread of the COVID-19 virus. The scale of restrictions announced so far is still much milder than the fully fledged spring lockdown. Restrictions include a nationwide curfew (with regional variation on starting time), limits on social gatherings, and with a significant degree of regional variation: constraints to personal mobility at local levels, and limitations on hospitality and entertainment businesses in terms of closing time and capacity constraints as well as localized closures. There are no restrictions to most business activities including industry and trade, no home confinement restrictions, and schools and universities are to remain open. However, the situation remains fluid and risks are tilted toward further tightening.

3. **The macroeconomic outlook that underpins the government's draft budget is optimistic.** The government projects a recovery in activity of about 10 percent in 2021 compared to about 7 percent projected by staff. Discrepancies mainly arise from the use of

EU funds and the associated multiplier. The authorities aim to absorb 2.2 percent of GDP and assume a multiplier impact of around 1.2. Staff assumes a somewhat slower absorption of EU funds, with additional spending of 1¼ percent in 2021 and an average short-term multiplier for investment of 0.8, based on past experience. Staff assumptions were made prior to the publication of the budget, and further analysis will be needed once more detail on specific recovery plans is available. In addition to the EU funds impact, the evolution of the pandemic will shape the recovery. A weaker-than-projected fourth quarter GDP outturn would make the projected 2021 real GDP growth difficult to achieve.

4. **The Draft Budgetary Plan and the draft budget law envisage a narrowing of the fiscal deficit by 3.6 percent of GDP in 2021.** The anticipated deficit reduction in 2021 and over the medium term would be largely supported by the expected strong economic rebound and the expiration of some COVID-related measures. While the headline deficit for 2021 is broadly in line with the level projected by staff, the authorities' projections are underpinned by a stronger revenue forecast and a more expansionary spending plan. In particular, the government is planning to adopt a range of structural revenue measures (about 0.5 percent of GDP) that aim to improve the progressivity, equity, and efficiency of the tax system. The main proposals include the introduction of taxes on financial transactions and digital services, increases in income taxation targeted at high-income earners and large companies, measures to improve environmental taxation including new taxes on plastic bags and waste, as well as efforts to fight against tax fraud. On the expenditure side, the government is set to raise pensions and public wages by 0.9 percent in line with the projected inflation, and increase non-contributory pensions by 1.8 percent. Finally, the draft budget foresees using the entire budgeted amount of nearly €27 billion in grants under the EU Recovery and Resilience Facility for new government spending—of which about €21 billion is envisaged for investment—, thereby not changing the headline deficit in 2021.