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November 9, 2020

Statement by Mr. Chodos, Mr. Lischinsky, and Mr. Morales on Spain (Preliminary) Executive Board Meeting November 11, 2020

We thank staff for the clear reports and Mr. Moreno, Mr. Lopez, and Ms. Moral Betere for their insightful Buff statement. Spain's economy has been hit especially hard by the COVID-19 pandemic. A large number of small and medium-sized enterprises (SMEs), particularly in the tourism sector, absorb a significant share of the labor force, making the economy vulnerable to sizable reductions in employment in the event of an exogenous shock. The authorities rightly introduced a gradual relaxation of confinement measures as the first wave of the pandemic appeared to phase out. However, the well-known difficulties in managing a novel virus became evident as a second wave hit, leading to new lockdown measures that triggered a reversal of the incipient recovery. For this reason, we agree with the authorities' plans to maintain policy support measures until the recovery is firmly ingrained, including income and liquidity measures, job-supporting work schemes, and public loan guarantees to support credit flows. The authorities also point out that the second wave was different, because it shows fewer deaths and lower hospital admission rates.

Following five years of strong growth and declining unemployment, Spain faces a major crisis because of the pandemic, with a projected decline in GDP of up to 12.8 percent for 2020. In this regard, we welcome the staff's update showing a more promising growth outlook. However, it is clear that there is no way to put the economy on the path of steady recovery without significant improvements in the capacity to contain new infections. Therefore, the authorities are rightly giving high priority to contain the spread of the virus and to mitigate the economic fallout of the pandemic. Although the continuation of targeted lockdown restrictions and social distancing will constrain the expected pickup in economic activity in the short run, it would facilitate a rebound in private consumption leading to a significant pickup in GDP growth in 2021. In addition, public investment financed by EU grants would further support the recovery, for which the preparation of investment plans is underway. We encourage the authorities to be ambitious in the adoption of sizable plans that could be implemented in the near term to help prevent the scarring effects of the pandemic.

We welcome the authorities' efforts to maximize the use of fiscal space to support the economy and the vulnerable population. We agree with staff and the authorities that fiscal support should remain in place given the risks of a deeper recession and a broader financial crisis. Temporary discretionary measures, especially to preserve employment linkages, combined with additional healthcare expenditure, support to families and business, and the full use of automatic stabilizers, constitute an adequate response to this unique crisis. These measures are expected to raise the deficit by around 10 percent of GDP in 2020, from a structural deficit already hovering around 3 percent of GDP prior to the crisis because of public salary increases and a decline in tax collection. In addition, public debt is expected to rise by about 25 percent of GDP in the next two years in the staff's baseline scenario, from around 90 percent prior to the crisis. As the authorities maintain the focus on high-priority expenditure, other expenditure should be contained to prevent an undue accumulation of fiscal risks.

As in most advanced countries, Spain's banking system has built sizable buffers following the global financial crisis. However, some borrowers appear over-indebted, in particular in sectors that have benefitted from growing financial inclusion such as SMEs and low-income households. Moreover, banks may start to face difficulties in recovering loans to vulnerable sectors such as accommodation and food, at the risk of a significant deterioration in their solvency. For the time being, public loan guarantees have been instrumental in supporting firms' cash flows. Likewise, flexibility in the application of liquidity and provisioning rules, combined with the use of the ECB's liquidity provisioning facilities, have also supported lending activity. However, cliff effects may arise as temporary measures are phased out, especially loan defaults.

To anticipate complications arising from rising insolvencies, staff proposes that the private debt resolution system should be enhanced to facilitate restructuring as opposed to liquidation when warranted, including for SMEs, while giving more scope for out-of-court restructuring arrangements. As we noted in the authorities' views, a new Insolvency Law came into force in September and preparation to incorporate the EU Directive on restructuring and insolvency is under way. *Staff's comments on the actions taken on this front are welcome.*

Looking ahead, the Spanish authorities should redouble their efforts to mitigate scarring effects on growth prospects to the extent possible. This may be a protracted and complicated process, as GDP is projected to reach its end-2019 level only in 2023, with a projected 4.5 percent of cumulative output loss over the medium term. Against this backdrop, shifting income policies from job retention schemes to an upgraded unemployment benefits framework appears advisable, combined with enhanced social assistance and an ambitious retraining program. We note that the authorities expect that implementation of the EU Recovery and Resilience Facility would contribute to raise GDP by 2-3 percent in 2021 and raise potential growth by ½ percent annually over the medium term. We agree with staff that an effective use of these facilities, under the authorities' Recovery, Transformation and Resilience Plan, should aim to upgrade the quality of investment in digital-friendly infrastructure that could promote a more integrated economy and encourage productivity gains.

The pandemic is likely to widen social inclusion gaps, and therefore enhancing employability of dislocated workers should also be given high priority. These efforts should be complemented by the integration of the minimum income scheme into existing support tools, with its financing fully incorporated into the medium-term budget framework. In this connection, the introduction of special training opportunities under the Expedientes de Regulación Temporal de Empleo (ERTE) is a step in the right direction, and we welcome the authorities' plans to refine the ERTE program for future use as an employment adjustment tool. In addition, we welcome the authorities' commitment to policies to tackle climate change, social cohesion, regional and intergenerational inequality, digital transformation, and gender disparities, as highlighted by Mr. Moreno, Mr. Lopez, and Ms. Moral Betere, including ambitious goals beyond the EU 2030 targets.

With these comments, we wish the authorities success in their policy endeavors in these difficult circumstances.