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Spain: NGEU opportunities and risks

Key take aways

- Covid-19 heavily impacted the Spanish economy, with GDP declining by 10.8% in 2020. The arrival of vaccines has allowed a gradual recovery in activity during 2021, albeit with less momentum than expected. We forecast close to 5% GDP growth in 2021, accelerating to 6.3% in 2022.
- Spain is eligible to access EUR152bn from the EU's Next Generation EU (NGEU) scheme between 2021-26. Access to NGEU funds is conditional on economic reforms. The labour market, pension system funding and a complete modernization of the public sectors are probably the main reforms which need to be addressed in the future.
- The arrival of the funds from the NGEU presents an opportunity to correct imbalances inherited from the past and prepare the economy for the future. But if this does not happen, then Spain may increase only a one-off period of higher growth without permanent necessary changes to its economic model.

01

Covid-19 heavily impacted Spanish economy, probably due to the significant importance of sectors most affected by the decline in mobility (tourism accounts for around 12% of GDP). As a result, GDP declined by 10.8% in 2020, with the second quarter suffering the biggest YoY decline (-21.5%).

A major response to the crisis (equivalent to approximately 20% of GDP in 2020), mainly through loans and guarantees, as well as direct aid, like short-term employment schemes (ERTEs is the Spanish acronym) and benefits to self-employed workers, has preserved an important percentage of jobs. As a result, and unlike during previous crises, there has been much less job destruction, with the unemployment rate remaining on average around 15.5% (it is currently below 15%).

The arrival of vaccines has also allowed a gradual recovery in activity during 2021, albeit with less momentum than expected. The 1.1% QoQ rise in Q2 2021 GDP has been followed, according to the national statistical office's estimates, by a 2% QoQ increase in Q3. At the domestic level, household consumption is leading the recovery, but the industrial sector is suffering, as in the rest of the Eurozone, from bottlenecks in production inputs, as well as higher costs for raw materials, with some companies even stopping production due to lack of supplies. In the case of the external sector, the partial recovery of tourism since the summer has allowed a positive contribution from it in Q3.

Unfortunately, the first indicators for Q4 have been showing signs of some stagnation in economic activity during October/November. Higher electricity prices, high CPI figures and the persistent problems on the global trade (bottleneck in the supply channel) have weighed on Spanish economic activity. The lack of activity in the public sector is another factor that has put a brake on growth. In any case, the current year is likely to end with annual GDP growth close to 5% and we forecast an acceleration of economic activity during 2022 (CIO forecast: +6.3%), thanks to higher consumption (the household savings rate is currently near 10% of disposable income, a figure not seen in 20 years) and the arrival of funds from NGEU. These factors will allow the return to pre-crisis levels of activity over the second half of 2022.

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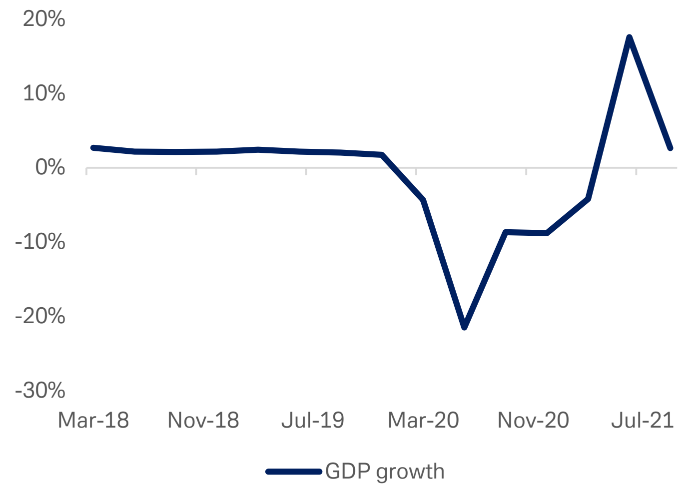
Figure 1: GDP growth rates (YoY)



Source: INE. Data as of November 12, 2021.

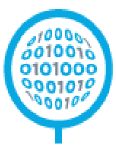
02 NGEU: a unique opportunity

The economic crisis generated by the Covid-19 pandemic has forced the EU to agree on an unprecedented response: the Next Generation EU (NGEU) fund. This involves not only the mobilization of a large volume of funds by the European authorities, but also, for the first time in the history of the EU, the issuance of common debt.

Spain is eligible to access to EUR152bn from the NGEU between 2021-26, split between React-EU for 2021-22 (short-term financing) and EUR140bn from the Recovery and Resilience Facility (RRF) – this one is equally split between grants and loans. Spain's Recovery, Transformation and Resilience Plan (RTRP) commits the Spanish government to use all grants received (EUR 70bn) over the period 2021-23, while the use of loans will not begin until 2023.

The Plan is divided into four pillars, aligned with 10 "lever policies". These policies are generally linked to the whole economy, however, some of them are specific for different sectors (trade, tourism, agri-food, health and automotive industries).

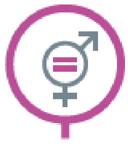
Pillar I: Green transition (40.29% of investment). The Plan includes the commitment to the transformation of the Spanish economy to promote sustainable investment in line with the priorities of the European Green Deal and the National Integrated Energy and Climate Plan.



Pillar II: Digital transformation (29.58%). Investment and reforms to improve digital infrastructures, guaranteeing universal access to digital services (Spain Digital Agenda 2025).

Digital is also included in the other three pillars of the Plan.

Pillar III: Social and territorial cohesion. The Plan looks to design specific measures to improve life quality in depopulated areas of Spain with the focus on creating better connectivity, maintaining the rural population, and supporting a green and digital transformation of the agri-food and fisheries industries, highly important for these regions. Education is also a key factor of this pillar, in order to provide opportunities for the next generations.

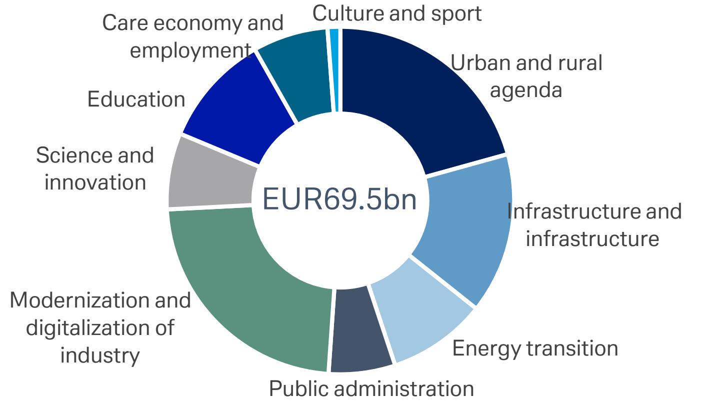


Pillar IV: Gender equality. Females and young people have been the most affected by the pandemic crisis. The gender wage gap and the structural barriers around women's access to employment are traditional problems of the Spanish economy.

Ten "lever policies" aligned with these four pillars:

1. Urban and rural agenda, agricultural development and the fight against depopulation
2. Resilient infrastructures and ecosystems
3. A fair and inclusive energy transition
4. A public administration for the 21st century
5. Modernization and digitalization of industry and SMEs, entrepreneurship and business environment, recovery and transformation of tourism and other strategic sectors
6. Promotion of science and innovation and bolstering the capabilities of the National Health System
7. Education and knowledge, lifelong learning and capacity building,
8. The new care economy and employment policies. Need to build a stronger care economy, encompassing services for dependents or vulnerable individuals. Reduce the duality of the labour market.
9. Promotion of the culture and sports industries
10. Modernization of the tax system for inclusive and sustainable growth. Spain's tax revenue to GDP ratio is lower than the European average. There is a heavy tax burden on employment income and insufficient development of environmental taxes.

Figure 2: Total costs of the 10 "lever policies"



Source: Ministry of Economy. Data as of October 2021.

03 The key stands on structural reforms

Access to NGEU funds is conditional on economic reforms. Labour market, pension funding system and complete modernization of the public sectors are probably the main reforms to be addressed in the future, in line with the European Commission Country Specific Recommendations (CSRs) for Spain published in 2019-20 (see chart 3). The government has taken the first steps on two of these key reforms: the pension reform and the labour reform, both of which are currently under negotiation with the social forces to reach a final draft.

In the case of the labour reform, the goal must be to put an end to the current duality of the labour market, with an excessive weight of temporary contracts (25% of the total number of employees). The use of active employment policies must also be strengthened, to really improve the capacity of employment agencies to link job seekers with available jobs. The current proposal announced by the government questions some key factors of the 2012 reforms, such as the abolition of sectoral or regional agreements in favor of company-level bargaining. However, this last point is being strongly questioned by employers who believe that the elimination of this measure will lead to higher labour costs.

As for the pension reform, the goal is to guarantee the sustainability of the current system in the medium term. To do so, the reform would adjust the incentives for early retirement to bring the actual retirement age to the legal retirement age, separate financing sources, modify maximum pension contributions and develop alternative long-term savings vehicles. At the same time, it plans to reverse the previous reform and re-link pension payments to inflation automatically. This factor, however, is finding with some opposition from the European Commission, as this controversial proposal has been introduced at a time of historically high inflation rates (5.4% YoY in October).

The government has also abolished the so-called sustainability factor, designed in the last pension reform of 2012 in order to introduce an intergenerational equality factor. The rationale for it was that people of different generations with the same job career should receive the same pension amount now and in the future. The current government proposals, now under discussion with social organisations, are for an increase in Social Security contributions from 2022 to 2032 by 0.6 percentage points per year in order to increase current Social Security Reserve Basket. This is another very controversial measure that has been criticized both trade unions and firms.

04 Where do we go from here?

The arrival of NGEU financing has presented an opportunity to correct imbalances inherited from the past and prepare the economy for the future. Environmental transition, digitalization, demographic changes, a more balanced labour market and regional depopulation are some problems which must be addressed in order to generate a new economic model, based on improved productivity and efficiency. If the NGEU projects are properly implemented, and the pending structural reforms are put in place, Spain should be able to achieve key policy and social objectives, with a more digitalized economy offering higher potential GDP growth.

But if this does not happen, then Spain will experience a period of stronger one-off growth (thanks to the fiscal and monetary impulses), but not achieved permanent changes to its growth model. That is the biggest risk at present.

In fact, the draft budget bill for 2022 recently passed by the Spanish government seems to be based on optimistic assumptions on economic growth (GDP growth is expected to exceed 6% in 2022). Public finances will remain under scrutiny. Although EU fiscal rules are currently suspended, these rules will reintroduced in the future, and it will be difficult to justify a wider deficit. (The European Commission will allow just a limited deficit reduction next year to assist economic recovery, but this is a transitory situation: deficit reduction will be needed..

Figure 3: European Commission's Country Specific Recommendations (CSRs), Spain

	2019	2020
Public Finances	Strengthening public finances Use windfalls gains to consolidate public finances	Take all necessary measures to address the pandemic When possible, pursue consolidation of public finances
Pension system	Relinking of pension increases to inflation and derogation (i.e. abandonment) of the sustainability factor would require compensatory measures to ensure the sustainability of the system in the long term	
Labour market	Reduce high percentage of fixed-term contract Address coverage gaps in unemployment assistance and minimum income schemes Higher cooperation between education and businesses	Support employment through arrangements to preserve jobs Reinforce unemployment protection, notably for atypical workers
Public investment & Business environment	Focus investment on fostering innovation and energy efficiency Upgrading rail freight infrastructure Strengthen competition in business services and regulated professions	Promote private investment. Focus investment on the green and digital transition, digital infrastructure, on clean and efficient production Measures supporting the liquidity of firms
Health system		Strengthen the resilience of the health system

Source: Deutsche Bank AG, European Commission, 2019, 2020

Moreover, the current proposal of increasing public wages according to changes in the CPI can be used by workers' unions as an argument for introducing such linked increases in collective bargaining for private employees. As a result, we could see second-round effects from the current surge of energy and gas prices – creating more lasting effects that could weigh on future growth and job creation.

Finally, although current vaccination rates are among the highest in Europe (near 90% of the population), the current surge of new cases in some European countries is causing new concerns. The existence of new mutations of the virus that could be more contagious or resilient to current vaccines is an additional risk.

05 Investment implications

The relative performance of the Spanish Ibex 35 index has been below its European peers. In 2020, the index fell by 15.5% largely as a result of declines in stocks linked to tourism and financial sectors. The improved economic outlook and generally positive sentiment towards risky assets has helped the Ibex to show gains so far in 2021 (it is up around 11% TYTD), albeit lower than the rest of Europe. The acceleration of economic growth expected for 2022 and the expected arrival of European funds might allow this positive performance to be sustained.

The majority of the funds from the NGEU will be focused on digitalization, sustainability, education and healthcare. Given recent statements from government officials, digital infrastructure will be a major issue in coming years.

Green transition is also a key pillar. Laws and bills regarding the electrification of transport have already been approved and a lot of effort has been put on the expansion of the electric grid and the charging infrastructure. The main utilities are already deploying charging stations in public and private areas and the government is encouraging alliances between industries to advance smart mobility, clean energy projects and the green economy in general. The problem is that the electric sector is sceptical around the government initiatives due to the latest legislation that will have a negative impact on their profits.

The government is also focusing its attention on using the impulse from R&D to prevent and partially reverse the "brain drain" of talented Spanish workers to elsewhere in the world. Education will be key to improve competitiveness and to develop an efficient environment for big companies and entrepreneurs.

The ultimate goal is promoting some Spanish cities as European "Silicon Valleys" and to use public capital to support start-ups on every technological field.

The global footprint and the prestige of the big Spanish construction and public works firms makes them attractive due to the huge amount of investment that is likely to be routed to infrastructure around the world.

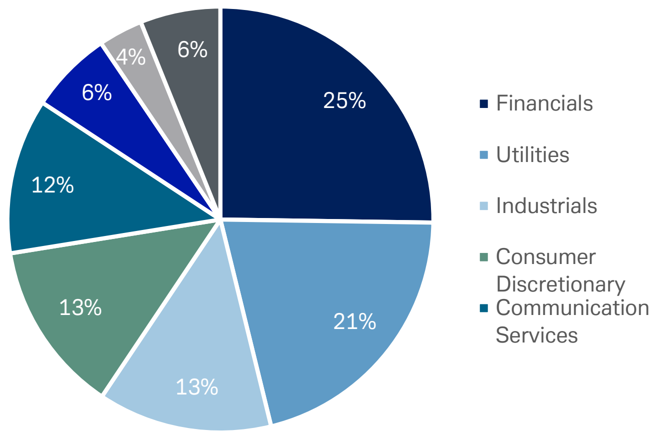
Further GDP growth should help ensure better control of public finances and, in particular, achieve debt level targets that make possible market stability and further growth. As previously mentioned, the main risk is that the NGEU funds will not be used as efficiently as they should, and the changes to the Spanish economic model will not be as successful or permanent as expected. Public finance challenges are thus linked to big questions about the future direction of the Spanish economy.

Figure 4: European Commission forecasts

	2020	2021	2022	2023
GDP	-10,8%	4.6%	5.5%	4.4%
Inflation	-0.3%	2.8%	2.1%	0.7%
Unemployment rate	15.5%	15.2%	14.3%	13.9%
Public balance	-11.0%	-8.1%	-5.2%	-4.2%
Gross Public debt	120%	120.6%	118.2%	116.9%
CA Balance	0.8%	0.3%	0.8%	1.0%

Source: European Commission. Data as of November 2021.

Figure 5: Ibex 35 sector weightings



Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of November 2021.

Glossary

The consumer price index (CPI) measures the price of a basket of products and services that is based on the typical consumption of a private household.

EUR is the currency code for the euro, the currency of the Eurozone.

The Eurozone is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

The Recovery and Resilience Facility (RRF) is a temporary recovery instrument, and the aim is to mitigate the economic and social impact of the coronavirus pandemic and make European economies and societies more sustainable, resilient and better prepared for the challenges and opportunities of the green and digital transitions.

The Recovery, Transformation and Resilience Plan (RTRP) is the key instrument for the development of the Next Generation EU recovery funds. It lays out the roadmap for the modernisation of the Spanish economy, the recovery of economic growth and job creation, following the COVID-19 crisis, as well as preparing the country to face the challenges of the future.

Research and Development (R&D) represents the activities companies undertake to innovate and introduce new products and services or to improve their existing offerings.

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