Letter from the Editors

The pervasiveness of supply bottlenecks, which are hitting the advanced economies particularly hard, along with escalating energy costs, are acting as a drain on the global economic recovery, while intensifying inflationary pressures. Another source of weakness is the bursting of the property bubble in China. All of which has prompted the IMF in its Autumn report to cut its growth forecasts and raise its inflation estimates for 2021. Indicators suggest that these trends will persist in the short-term.

The US economy is proving to be one of the hardest hit by these bottlenecks, with headline CPI increasing in October. However, the European economy is also suffering, with inflation up largely due to the rise in electricity and fuel prices.

Within this context, the November issue of *Spanish and International Economic & Financial Outlook (SEFO),* first gives an updated snapshot of: the status and prospects for the economic recovery in Spain; progress to date on the execution of Next Gen EU funds; and, a closer look into Spain's lagging productivity – affecting the country's recovery and putting a drag on GDP per capita.

Recent indicators point to a post-COVID-19 recovery in Spain, which is not as vigorous as predicted: growth is projected to reach 5.1% in 2021, compared to 6.3% in the Summer forecast. Leaving aside statistical oddities, under-performance mainly reflects weaker-than-expected domestic demand, which is only partially offset by stronger export growth. Inflation, which has eroded household and business purchasing power, is another key factor at work. The long delay in the implementation of investment projects funded from European transfers has also slowed the economic rebound *vis-à-vis* original expectations.

Spain's Recovery, Transformation and Resilience Plan (the Plan), approved by the European Commission in June, will mobilise up to 140 billion euros of funds. Spain is currently in the process of implementing the first tranche, in the amount of 69.53 billion euros – transfers from the Recovery and Resilience Facility (RRF). Although execution of the investments contemplated under the Plan will last until 2026, 70% of the RRF funds have to be committed in 2021–2023. That means there is little more than two years left for highly ambitious commitments to materialise. Based on the budget breakdown contemplated in the Plan for 2021 and the information gleaned from the tenders published up until October (inclusive), a significant volume of funds still needs to be executed before the end of the year. Furthermore, execution levels across the various Plan drivers and components are proving uneven. Nevertheless, any RRF funds that are not executed in 2021 will be rolled into next year's budget. The general state budget for 2022 contemplates 26.9 billion euros of investments under the Plan. That sum implies stepping up the pace of investments and reforms by over 10% by comparison with 2021.

For the past two decades, Spain's economic growth has been underpinned by the accumulation of factors of production, with productivity undermining growth. In fact, since 2000, total factor productivity (TFP) has fallen by 14.7%, which helps explain why GDP per capita in Spain trails the eurozone average by 18.5%, with productivity per hour worked also lagging by 14.1%. Behind that poor performance in productivity lies scant investment in its determinants, as is illustrated by the fact that Spain lags the European average in variables, such as its stock of technological capital relative to GDP (66.1% lower), its stock of human capital (4.2% lower), its stock of public capital (26.6% lower per capita) and its stock of productive capital per employee (29.9% lower), among others. The COVID-19 crisis has served to exacerbate Spain's productivity problem, with the loss of work and falling TFP contributing to the marked decline in 2020. In order to reverse this trend, structural reforms alongside the deployment of European recovery funds will be necessary. Among the investments contemplated, those aimed at boosting digitalisation are imperative given the productivity gains associated with digital transformation.

The financial issues addressed in the November *SEFO,* meanwhile, focus on the intensification of the debate around cryptoassets, more broadly their pros, cons, and the prospects for the advent of Central Bank Digital Currencies, or CBDCs. As well, we assess the recovery of the Spanish insurance sector in the aftermath of the pandemic.

Cryptoassets draw admirers and detractors in equal amounts. They are, nevertheless, here to stay and are destined to play a prominent role in the global financial system over the coming decades, as renowned institutional investors and central banks are already acknowledging. However, it is not yet clear which type of asset will prove most dominant. Moreover, there are questions regarding the intrinsic value of a broad number of these assets, with potential risks for their holders and for the stability of the financial system. Here, banks could play an important role. These institutions have a comparative advantage given their experience with financial regulation and would benefit as they transition towards digital service platforms. Central banks are also increasingly considering how they could influence the development of cryptoassets. For example, the ECB is examining a number of options including a system of citizen retail accounts. However, this would have consequences, such as banks' increased reliance on wholesale versus retail funding, with potentially adverse implications for their margins.

In 2020, the insurance sector sustained a real contraction in premium volumes of 1.3% compared to the pre-pandemic trendline growth of close to 3%, with much of this contraction concentrated in advanced economies. The decline in premium volumes in real terms was uneven across the various lines of business, with the life insurance segment falling by close to 4.5% in 2020. However, the non-life insurance business segment managed growth of 1.5%. As a result of this subsector divergence, the non-life insurance business now outweighs the life insurance business. So far this year, momentum in non-life insurance remains strong, with particularly robust growth in the health and multi-risk lines, while the contraction in motor insurance is slowing. Turning to the Spanish insurance sector, signs suggest it is riding out the pandemic's impact with relative ease, with the volumes for non-life recovering faster than initially expected. In this context, the trend in margins will be shaped by what happens to claims, which are expected to normalise. This is, however, based on the assumption that financial market stability continues.

Finally, this *SEFO* closes with an assessment of the 2022 general state budget, including a specific focus on the budget for the Social

Security, together with a discussion over the state of play of fiscal consolidation and the need for structural reforms to achieve budget stability in the medium-term.

There are three key aspects of Spain's state budget for 2022: the underlying macroeconomic forecasts; the public revenue and expenditure projections; and, the resulting deficit. The macroeconomic forecasts assume a 6.9% growth in private consumption, a 12.2% increase in investment, and export growth of 10.3%. However, other institutions have estimated GDP growth that is between 0.4 and 1.5 percentage points lower. In regards the second aspect, an unusually strong growth in revenue will be essential to delivering the forecasted deficit in 2021. The budget contemplates growth in non-financial income of 10.8% in 2022 to 279.32 billion euros. However, in the absence of the Next Generation-EU funds, that growth would narrow to 6.8%. Furthermore, various new taxes have yet to be approved and some of the temporary measures, such as the VAT cut on electricity, could be extended. Rising inflation is anticipated to increase structural spending by at least 8 billion euros in 2022. As for the level of public debt, the government is forecasting a reduction from 120% in 2020 to 119.5% in 2021 and 115.1% in 2022. In the absence of a credible fiscal consolidation plan, there are doubts about the feasibility of the deficit reduction path between 2021 and 2024.

The two main developments in the Social Security budget for 2022 are: (i) the implementation of a new method for revaluation of pensions based on prior-year inflation; and, (ii) growth in state transfers to finance the so-called "undue" expenses being funded by the Social Security and help balance its accounts. Despite the sharp growth in pension spending, the increase in contributions from the state via taxes and the forecast growth in contributors, underpinned by the anticipated economic recovery, are expected to drive a reduction in the nominal deficit to 0.5% of GDP in 2022. However, the shortfall in system contributory revenue relative to expenditure will remain at 1.5% of GDP. Correction of the Social Security's structural deficit in the medium- and long-term will, therefore, require new measures that will necessarily have to combine actions on the revenue side (even after the recently proposed increase in employer contributions) with others on the spending side, with contributory pensions the primary focus of any future reforms.

Spain's 2020 deficit came in at 10.1% of GDP, better than estimated but still topping the EU-27 ranking. Looking forward, there are reasons for optimism such as the Next Generation-EU funds, the recovery in tax collection, and extension of the Stability and Growth Pact escape clause, though these do come with notable downsides. While current forecasts for 2021's deficit are below the government's budgetary plan, the structural deficit could prove a weak spot in the coming years, as it is forecast to reach 4.5% in 2022. Regarding the Stability and Growth Pact, the most likely outcome is a reformist approach, with greater flexibility built around a medium-term debt anchor, a simple expenditure benchmark and a general escape clause. However, Spain cannot wait for the official rewriting of the EU's fiscal rules. As it stands, the country lacks a credible and ambitious medium-term budget strategy. Over the next five years, Spain's public deficit will not fall below 4.2% of GDP, while public debt will still be stuck at close to current levels. Curtailing spending will become even more difficult due to Spain's ageing society, with spending on dependency care, employment, education, health, science and innovation, government, and a fair transition likely to increase.