Letter from the Editors

The January issue of *Spanish and International Economic & Financial Outlook (SEFO)* comes at a time when most of Europe remains immersed in the coronavirus pandemic. While prospects have somewhat improved since our last issue, as vaccination campaigns have begun across many countries, the new wave of COVID-19 infections is putting economic recovery at risk. Within this context, this issue of *SEFO* sheds some light on both the fiscal and monetary implications of the current crisis at the European level as well as within Spain.

We begin by providing an update on the status of the debate over the deactivation of the EU's 'general escape clause'. This spring the European Commission will decide whether to deactivate the general escape clause that provided Member States with the fiscal room to combat the economic effects of COVID-19. The main reason for considering a deactivation of the general escape clause is medium-term debt sustainability. At the moment, that does not seem to be a pressing concern. Although debt levels are high as a share of national output, interest rates are at historic lows. The problem comes from the policies which underpin the current low interest rate environment – namely ECB asset purchases. Significantly, the ECB's pandemic emergency purchases do not have to be proportionate across countries except across the life of the program. As a result, they skew heavily toward sovereign debt issued by governments in Southern Europe. The challenge going forward is to balance the need for active fiscal stimulus in the short-term with the requirements for fiscal sustainability in the medium-term. The tension between these two goals was evidenced over the pandemic-related credit facility within the ESM. For Southern Europe, this pressure is particularly pressing given the difficulty of balancing the need for sustained, productive investment on the one hand, and the necessity of fiscal consolidation on the other.

We then look at how COVID-19 has shaped the Spanish General State Budget for 2021. In comparison with consensus forecasts, Spain's 2021 budget appears overly optimistic about the Spanish economy's growth prospects. The government is forecasting growth of 9.8% and a deficit of 7.7% in 2021, while other institutions' estimate lower growth and higher deficits. The government's favourable forecasts are based on key assumptions regarding global and eurozone growth levels, as well as Spain's export markets. Its expectations relating to the Next Generation EU programme may also prove overly confident given Spain's previous track record absorbing EU funds and the essentially political composition of the committee constructed to oversee the funds' use. Additionally, the government's deficit estimate was calculated before the extension of the furlough and income support schemes, which will put upward pressure on expenditures. As a result, in the absence of fiscal consolidation, Spain's public debt is set to rise in the years to come, and will be highly exposed to an upward trend in interest rates. In terms of the government's forecast for revenue growth of 14.53%, its dependence on GDP growth and revenue elasticities also raises concerns over exceedingly optimistic projections. Lastly, considering regional, local and central government spending, state expenditure will increase to 50.8% of GDP in 2021. The biggest government expenses forecast include pensions (35.8%), public debt service (6.9%) and unemployment benefits (5.4%).

Specifically, the current crisis has had an important impact on the budget for Spain's Social Security administration. While much of the budgeted Social Security expenditure is predetermined by the rules that govern it, both the 2020 and 2021 budgets contain financing and expenditure novelties. The preliminary budget outturn numbers for 2020 point to a deficit of 19.77 billion euros. Notably, this is not due to COVID-19 as the Spanish state stepped up its transfers in order to cover those effects. The consolidated Social Security budget for 2021 forecasts a deficit of 14.29 billion euros, with expenditure falling in some areas like income support for the self-employed and rising in categories such as contributory pensions. Somewhat unexpectedly, taxpayer contributions to the Social Security are expected to increase by 3.8%; however, this figure will likely change now that the furlough scheme has been extended. The Social Security budget for 2021 is also shaped by regulatory developments which provide for an annual state transfer. Stagnant at 1.5% of GDP since 2014, the deficit is undoubtedly the key issue facing the Social Security. Although the government has previously provided loans, this is not considered a sustainable approach. The government has built some noteworthy recommendations into its pension reform programme, but the current fiscal situation of the Social Security implies that measures are needed to ensure the sustainability of the pension system and, by extension, the Spanish public sector.

Apart from fiscal impact, the current pandemic is having noteworthy implications for monetary policy. While 2019 suggested that several central banks appeared to be moving towards monetary tightening, the threat of recession towards the end of the year, followed by the onset of the pandemic several months later, prompted many to leave rates at close to zero or at negative values. In 2020, the quantitative easing response was overwhelming. Since the scale of the pandemic became apparent, the four main central banks (Federal Reserve, ECB, Bank of England and Bank of Japan) have injected 3.8 trillion euros of liquidity, weighing heavily on long-term fixed-income rates and flattening or inverting yield curves.

Within this context, the next section of *SEFO* looks at the implications that this extraordinary monetary stimulus has had on interest rates and as a consequence on the banking business. On a related note, we then assess trends in the EURIBOR, which has surmounted a very challenging year under a new calculation methodology. Last, we consider how the COVID-19 pandemic has manifested itself with respect to inflation in Spain.

As regards interest rates, the pandemic has led monetary authorities to extend their expansionary policies and shaped the expectation that they will remain lax until at least 2022. Currently, some 45 central banks have introduced interest rates at or below 1%, and yet inflation has remained low. Moreover, the prolongation of ultra-low levels is generating considerable distortions in the financial intermediation business and in the financial markets. Monetary policy has staved off liquidity crunches and episodes of heightened uncertainty, but it has also facilitated the accumulation of credit risk and debt and placed downward pressure on retail banks' profitability. Additionally, there are concerns that the extraordinary levels of debt accumulated in recent years will make it harder for central banks to meet their inflation targets, thereby reducing their credibility. Looking to 2021 there are several possible scenarios that could emerge, including a continuation of current monetary policies as the economy recovers, a resurgence in inflation due to expansionary fiscal and monetary policies, or a delayed recovery requiring the extension of monetary stimulus measures. Regardless of which scenario develops, central banks can offer additional support to the banking sector through the creation of a ‘pandemic insurance policy’ that prevents the impairment of loan quality, a pan-European financing plan, reducing minimum reserve requirements, and raising the deposit facility rate.

On the topic of rates, the onset of the global financial crisis in 2008 forced regulators and supervisors to rethink the suitability of the IBORs as benchmark rates of interest. In Europe, the FSB’s recommendations affect two key benchmark rates – EURIBOR and EONIA – and have resulted in the creation of the euro short-term rate, or €STR, to replace the EONIA following a period during which the two indices will co-exist. Importantly, EURIBOR must at all times and in differing market conditions reflect the cost to banks’ of obtaining funding in the euro unsecured interbank lending market at different tenors. Despite the volatility wrought by COVID-19 in 2020, it is fair to say that the EURIBOR has surmounted a very challenging year, helped significantly by a new hybrid calculation methodology developed in the aftermath of the financial crisis. Specifically, the EURIBOR rates trended in a manner that was consistent with expectations for benchmark rates and perceived bank credit risk and captured the indirect effects of the dislocation sustained in the FX swap market as a result of the surge in global demand for dollar funding in the early stages of the COVID-19 crisis.

With respect to inflation, and in particular the situation in Spain, it was thought that, initially, the COVID-19 crisis would have an inflationary impact on the Spanish economy but the subsequent drop in GDP would cause prices to fall. However, in 2020, inflation averaged -0.3% in Spain. And yet, closer analysis shows that the only clear-cut, crisis-induced deflation is in energy products and some of the services most severely impacted by social distancing measures, such as hotels and air travel. In terms of the services sector, only one-fifth of its total subcategories sustained deflation, with negative year-on-year rates between July and November. Importantly, in those cases where price growth slowed but remained positive, the effect has been disinflation rather than deflation. Looking forward, these dynamics may well change. In 2020, energy products detracted one percentage point from the headline inflation rate. In 2021, they could boost it by a little over one percentage point. Furthermore, progress on vaccination rates and an easing of social distancing measures is expected to buoy demand. While the historic savings rate reached during the crisis implies a significant future upside for consumption, it is difficult to estimate to what extent and at what pace that surplus will translate into spending.