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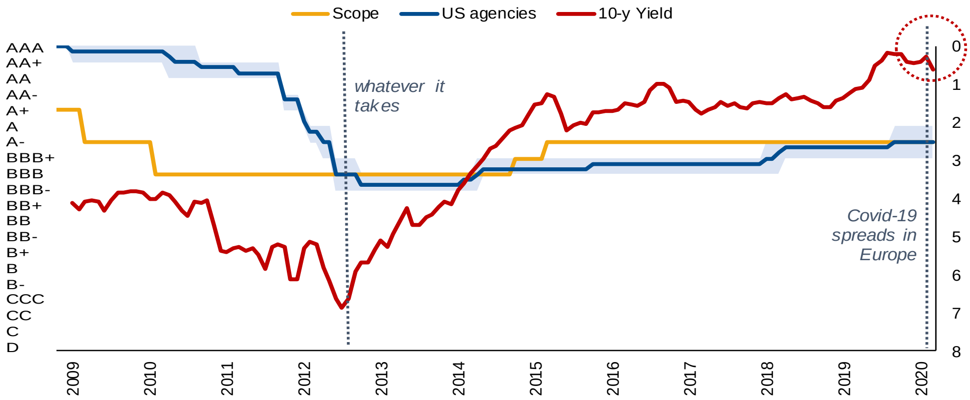
Spain's credit vulnerabilities to Covid-19: growth, labour market and public finances

Spain (A-/Stable) has been one of the worst-hit countries by the Covid-19 pandemic, both in terms of the healthcare emergency and the economic impact. The implications for growth, given the potential for widespread job losses, and public finances, considering the near inevitable large and lasting increases in the budget deficit and debt, are paramount in assessing the sovereign credit outlook.

The Covid-19 pandemic has triggered an unprecedented health and economic crisis in Spain. Several factors have made Spain particularly vulnerable to the crisis, including the structure of its economy, labour market rigidities resulting in widespread use of temporary contracts, as well as the lack of structural fiscal adjustments during the previous years of favourable economic conditions. The Covid-19 shock is thus exposing and exacerbating some of these underlying macro-economic and fiscal vulnerabilities, which governments have struggled to address in recent years given the country's political fragmentation – notably, a series of administrations led by parties without a parliamentary majority – and absence of reforms.

At the same time, the Covid-19 shock also highlights the strong European institutional support available to Spain. The ECB's actions are underpinning favourable market access for euro area countries which is crucial for avoiding a liquidity crisis in the short-term as well as for supporting debt sustainability in the medium term. So far, pressures on Spain's government financing costs have remained minor, when compared to the euro area crisis in 2012.

Figure 1: Spain's rating history versus its 10-year government bond yield



Source: Bloomberg, Scope Ratings GmbH

Spain's sovereign credit challenges from the Covid-19 shock thus depend more on the economic recovery than on the 2020 deficit and debt figures as the ECB keeps the costs of servicing public debt very low. Our credit analysis will focus on the materiality and reversibility of the impact of the shock on Spain's economic and fiscal outlook:

- **Economic growth**: The Spanish economy is particularly vulnerable to the pandemic and lockdown-related shocks given the structure of its economy as about 30% of economic activity and 40% of employment relates to tourism and recreation. We expect a recession of around 8% of GDP this year, followed by a strong rebound in 2021, assuming a gradual recovery of economic activity during H2 2020.
- **Labour market**: A high share of employment in the sectors most hit by the pandemic and a widespread use of temporary contracts (22% of all employed), will lead to a significant rise in unemployment, above 18% this year. In addition, this is likely to amplify second-round economic effects, in terms of growth and fiscal spending.
- **Public finances**: The combination of the announced stimulus measures of about 1.4% of GDP and the significant cyclical deterioration in Spain's budget deficit will increase the deficit to around 8% of GDP, from about 2.5% prior to the shock, raising the public-debt-to-GDP ratio by around 15pp this year to around 110% of GDP.

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Spain’s economic structure more vulnerable to lockdown effects

Covid-19-related shocks to abruptly reverse Spain’s robust economic performance

Spain has been one of the worst hit countries by the Covid-19 pandemic, not only in terms of its healthcare system but also regarding the economic impact. When the epidemic was mostly confined in China, economic indicators for January and February still suggested the Q1 economic performance would be in line with the 2% real GDP growth of 2019, above the euro area average for the fifth consecutive year.

However, as the virus spread to Europe in late February, the government in Madrid declared a state of alert in mid-March, resulting in severe restrictions on people’s movements, as well as a halt to productive activities in service sectors (hotels, restaurants and retailers) and to the manufacturing of non-essential products. On top of activities closed in the lockdown, industries are set to face supply chain disruptions and frozen demand, which will constitute a demand-supply shock of unprecedented dimensions.

Scope forecasts 8% recession for 2020, followed by a rebound

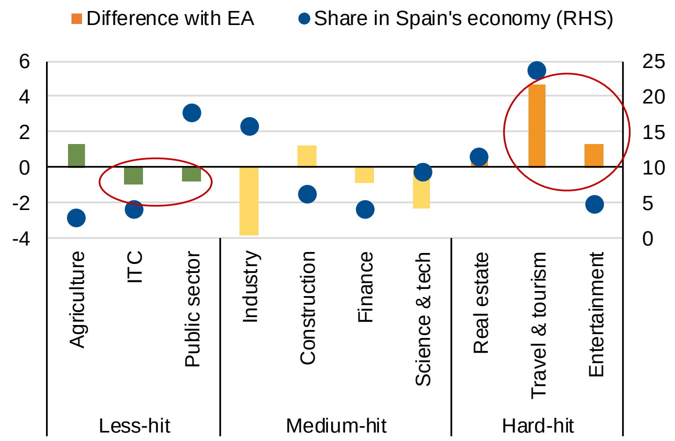
With the magnitude of the shock uncertain, we expect Spain’s GDP to fall by around 8% this year (**Fig.1** and **2**), depending on economic policy measures and, ultimately, on the virus’ spread in the coming weeks.

Figure 2: Scope’s economic outlook scenarios, real GDP, %

	Baseline	Lockdown until end-Q3	Lockdown until 2021	IMF forecasts
Germany	-5.2	-9.0	-11.2	-7.0
France	-6.3	-10.3	-13.5	-7.2
Italy	-7.5	-12.5	-17.5	-9.1
Spain	**-8.0**	**-13.0**	**-18.0**	-8.0
UK	-3.3	-6.0	-8.5	-6.5
US	-3.5	-8.0	-10.0	-5.9
China	4.0	2.0	0.5	1.2
World	-0.5	-3.5	-5.5	-3.0

Source: IMF, Scope Ratings GmbH, Q2 2020 Sovereign Update

Figure 3: Economy by sector, shares in real GVA, %, 2019



Source: Eurostat, Scope Ratings GmbH

Our baseline estimate assumes that the authorities relax containment gradually from May, with an economic recovery starting in Q3 2020. This scenario thus considers the shock to be temporary, followed by a rebound in 2021. Underlying assumptions include the effectiveness of measures not only to reduce the contagion but also to accommodate a prompt economic recovery once the emergency wanes. Still, we expect the recovery to bring GDP back to 2019 levels by the end of 2022 at the earliest.

Spain’s economy among most hit in the euro area: three scenarios

Two alternative scenarios (**Fig.2**) account for downside risks in the event measures prove less effective in halting the contagion, including a significantly longer period of lockdown. Under these scenarios, any economic policy is unlikely to prevent the temporary shock from becoming a long-lasting recession.

Large relevance of hard-hit sectors in Spanish economy

Finally, while the Covid-19 pandemic is a symmetric shock affecting all countries, we still expect Spain’s economy to be one of the most heavily affected in the euro area. The Spanish economy’s structure is particularly sensitive to this crisis. Sectors expected to be particularly hit, such as tourism and entertainment, occupy a large share in Spain’s economy, more than in many other euro area economies (**Fig.3**).

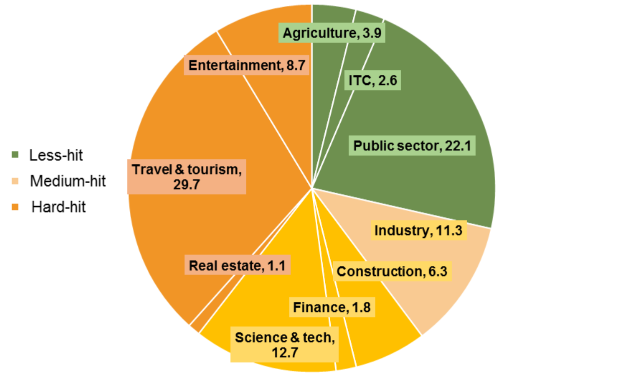
At the same time, sectors more likely to continue producing output during the pandemic, such as the public sector and information and communications, capture a smaller share in Spain’s economy, also relative to the euro area.

Pre-existing labour market rigidities to amplify the recession

Labour market structurally weak before the crisis

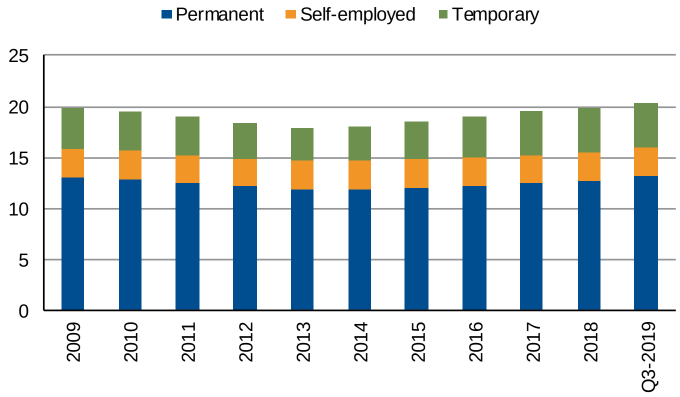
Despite Spain’s unemployment rate recovering after the global financial and euro area crises, from 26% in 2013 to 14% in 2019, it remains around twice the euro area average. Spain’s structural unemployment is also the highest in Europe, a consequence of persistent labour market rigidities.

Figure 4: Employment by sector, 2019, %



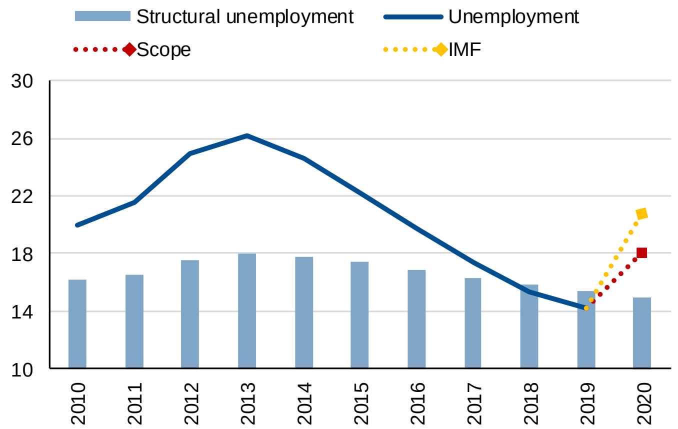
Source: Eurostat, Scope Ratings GmbH

Figure 5: Employment by contract type, Mn



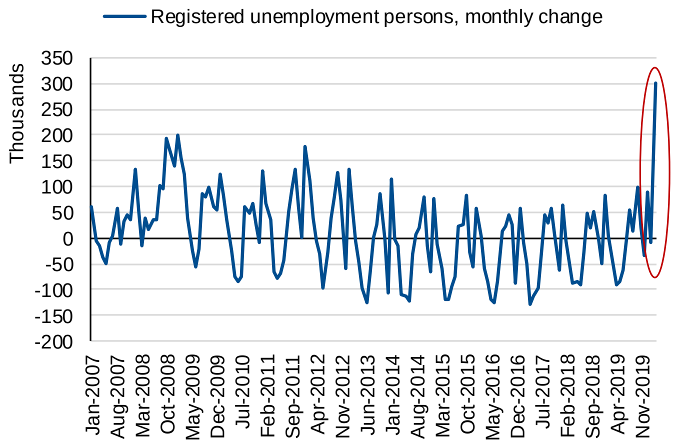
Source: Eurostat, Scope Ratings GmbH

Figure 6: Unemployment rate, %, including forecasts



Source: AMECO, IMF, Scope Ratings GmbH

Figure 7: Unemployment claims



Source: SEPE, Scope Ratings GmbH

Unemployment to rise due to sectoral composition and large share of temporary contracts

Now, as a result of the Covid-19 shock, we expect the unemployment rate to rise to around 18% this year. There are two key reasons behind a sizeable rise in unemployment:

i) The Spanish economy is particularly reliant on sectors hit hardest by the shock, such as travel, tourism and entertainment which are responsible for almost 40% of Spanish jobs in (**Fig.4**);

ii) Temporary contracts are widely used in Spain which means many workers can lose their jobs almost instantly. Temporary contracts make up more than 20% of all employment (Fig.5), compared with the euro area average of less than 14%, which also reflects the fact that sectors such as tourism or construction are more suited to such employment arrangements.

Government initiatives can partially cushion unemployment rate increase

Unemployment is already rising fast. People registered as unemployed jumping by 9% (more than 300,000 new claims) between February and March, a far greater increase than any seen during the global financial crisis. Job losses associated with the countrywide lockdown may aggravate the virus’ impact on growth through second-round effects, such as lower household incomes which would further weaken private consumption. This is likely to have knock-on effects on the strength of the economic recovery in 2021 and beyond.

Government measures to protect jobs as a result of this shock will help somewhat alleviate the pandemic's effect on the labour market, in particular, the temporary lay-off scheme (*ERTE*) allowing companies to suspend jobs until normality is re-established. So far, more than 100,000 workers have benefitted from the scheme.

Proposed labour market reforms prior to the Covid-19 shock credit negative

However, we note with concern that before the Covid-19 shock, the new PSOE-UP government announced its intention to reform the labour market with measures that may harm competitiveness and job creation. Two key measures discussed were i) the reversal of part of the 2012 labour market reform, strengthening workers' rights and reverting to wage negotiations being conducted at sector rather than company level; and ii) a further increase in the minimum wage to EUR 1,200 a month (around 60% of the median salary), after 22% and 5% increases implemented in 2019 and 2020, in the context of negative productivity growth and already very high unemployment. It remains to be seen whether these policy initiatives will still be pursued once the Covid-19 crisis abates.

Limited budgetary buffers, but solid market access amid ECB's support

Limited fiscal buffers to face the shock

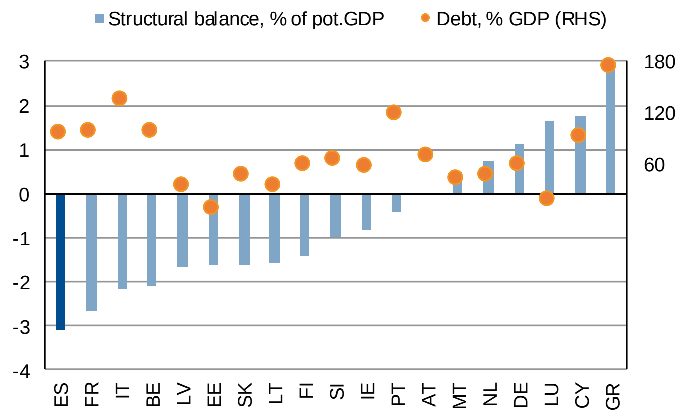
Spain has undergone important fiscal adjustments in the past 10 years, and its fiscal deficit has dropped from 11% of GDP to around 2% in 2019. However, in recent years the consolidation relied mostly on cyclical factors, while the structural deficit, close to 3% of potential GDP – the largest in the euro area (**Fig.6**) – even deteriorated since 2015.

As a result, the public debt has fallen only modestly, still standing at 96% of GDP by end-2019. Spanish governments have not built up fiscal buffers during the years of robust economic growth, leaving public finances vulnerable to a downturn as has materialised.

Spain's fiscal stimulus package

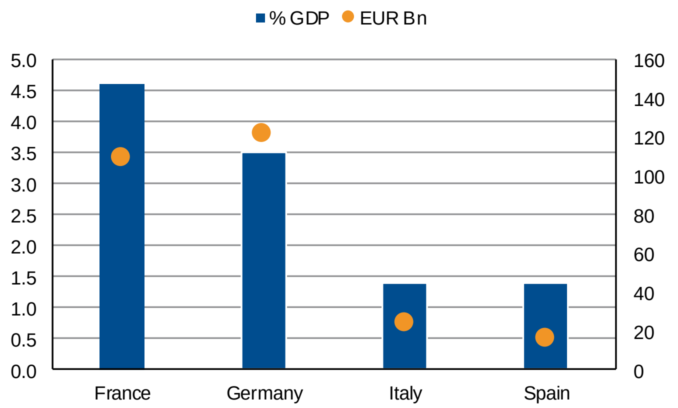
With public finances stretched, the government has intervened more modestly compared to other euro area sovereigns to combat the healthcare emergency and protect the economy. The fiscal package's budgetary impact, at EUR 17bn or 1.4% of GDP, reflects Spain's more limited fiscal space entering the crisis (**Fig.7**).

Figure 8: Public finances pre-shock



Source: AMECO, Scope Ratings GmbH

Figure 9: Fiscal stimulus, budget impact



Source: Government announcements, Scope Ratings GmbH

The government has focused support on : i) healthcare, with EUR 3.8bn allocated at the regional as well as central government level; ii) social protection, by easing access to unemployment benefits and allocating funds to vulnerable households; iii) businesses, with subsidies for labour costs, including the above-mentioned temporary layoff scheme, and cuts to social security contributions; iv) businesses' liquidity, with moratoria on tax liabilities for small companies, a credit line with the public development bank ICO for SMEs and companies in hard-hit sectors, and a EUR 100bn (8% of GDP) public guarantee to facilitate loans to non-financial corporations, and EUR 2bn in guarantees for export companies.

Public debt to remain structurally higher in the medium term

We expect a deficit of around 8% of GDP for this year, accounting for the reduction in economic growth, the announced fiscal stimulus and the cyclical component of the budget. Assuming a gradual improvement in fiscal flow variables and a gradual convergence of growth to Spain's medium-term potential (1.5%) after the initial rebound, we expect public debt to stabilise at around 110% of GDP over a five-year period. (**Fig.8**).

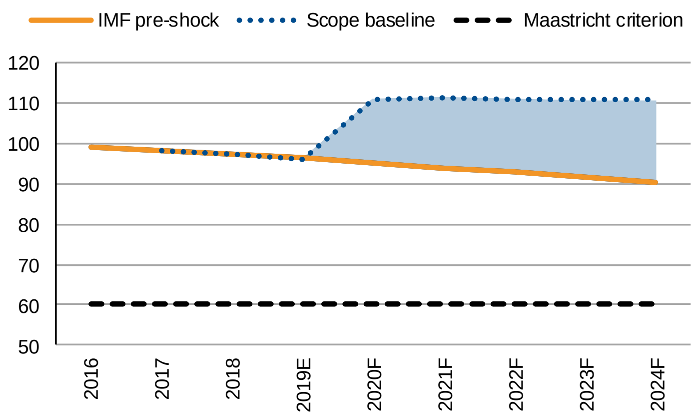
Resilient market access on the back of ECB actions

We note that despite the structural deterioration in fiscal flow and stock variables, Spain's market access remains solid, clearly aided by the ECB's interventions which are supporting the country's debt sustainability. A key feature of the ECB's EUR 750bn Pandemic Emergency Purchase Programme (PEPP) is that is allows asset purchases to be conducted more flexibly across jurisdictions, rather than strictly in line with its capital key.

This flexibility has already been displayed in March, with ECB's acquisitions targeted at countries with stretched finances, especially Italy, France and Spain, whose shares of total net acquisitions for the month clearly deviate from their respective shares in the ECB's capital (**Fig.9**). As a result, financing rates for Spain have remained so far favourable, with the 10-year government bond yield below 1%.

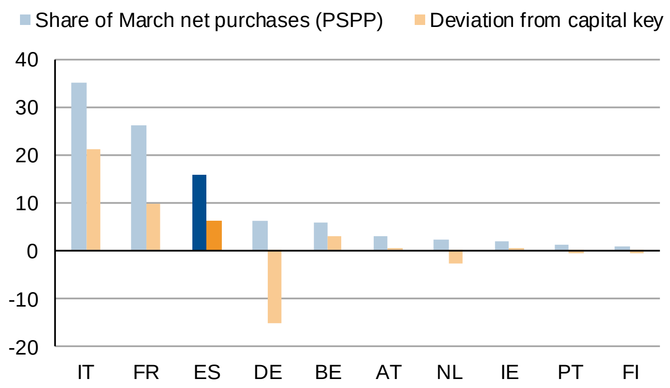
This is a fundamental difference, in terms of the severity and timing for credit-implications, compared with developments during the euro area crisis in 2012, when the return on Spanish government securities with the same maturity rose above 7%. The importance of the euro area architecture in supporting countries' market access is a fundamental credit strength, especially during this crisis.

Figure 10: Government debt to GDP, %



Source: IMF, Scope Ratings GmbH

Figure 11: ECB PSPP acquisitions in March, shares, %



Source: ECB, Scope Ratings GmbH

Annex: Methodological assumptions overview

Forecasting assumptions for 2020 economic growth

For 2020, we use a model based on a gross value-added calculation of GDP and run three scenarios (baseline, stress and worst-case) defined by the timing of "normality" resuming across industry sectors. We classify industry sectors into categories as operating over the crisis either at (i) near-full capacity, (ii) medium capacity or (iii) low industry capacity by assessing the severity of the impact of synchronised demand/supply shock across sectors:

Impact of demand/supply shock		
Low	**Medium**	**High**
• Agriculture, forestry and fishing • Information and communication • Public administration, education and social work	• Industry • Construction • Financial and insurance • Real estate • Professional, science and technology	• Trade, travel, accommodation and food • Arts, entertainment and recreation

We make assumptions about monthly levels of productive output compared to pre-crisis levels for each of the three classifications and consider fiscal countermeasures as announced to date by the government.

In our baseline scenario, we expect a gradual relaxation of containment measures as of May and a gradual return to broad "normality" by July 2020. We assume declines in economic activity of around 10% for low-hit sectors, 25-30% for medium-hit sectors, and 50% drop for hard-hit sectors in productive capacities, which we adjust on a country-specific basis. We then adjust for the impact of announced fiscal stimulus measures, differentiating between various types of government spending and liquidity assistance.

Finally, we have also developed two downside scenarios, which consider the cases of a slower relaxation of the lockdown, namely a scenario with return to "normality" by end-Q3 and a worst-case scenario, in which lockdown measures are maintained until the end of the year.

Debt sustainability analysis (DSA) assumptions

Scenario	Time Period	Real GDP growth (%)	Primary bal. (% of GDP)	Real eff. int. rate (%)	Debt end period (% of GDP)
History	2014-2018	2.8	-1.7	2.0	97.1
IMF Baseline	2019-2024	1.8	0.1	0.6	90.5
Scope Baseline		0.9	-3.0	0.9	110.7

Source: Scope Ratings

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