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Economic Outlook

March 2022

SPECIAL REPORT: "The Russia-Ukraine conflict: channels of transmission to the Spanish economy"

Overview

- **Change in the global economic outlook due to the conflict between Russia and Ukraine, which affects a wide range of areas such as energy, the economy, trade relations and inflation, among others.**
- **Central banks speed up the tightening of their monetary policies in response to rising inflation.**
- **Commodity prices, mainly energy and food, rebound amid high volatility.**
- **The conflict's impact in Spain can be felt mainly through the increase in the price of energy products and production costs, which are pushing inflation to record highs.**
- **GDP growth forecasts are revised downwards by around half a percentage point to 4.7% for 2022.**
- **Activity is expected to slow down in Q1 due to the sixth wave, high inflation, and increased uncertainty.**
- **Job creation slows down in the first months of 2022. CEOE's estimations indicate that seasonally adjusted effective registrations with the Social Security will increase by around 1.1% quarter-on-quarter in Q1 2022, almost half in comparison to the 2.1% recorded in Q4 2021.**
- **In the first months of 2022, inflation has reached rates that had not been seen in decades, and its evolution over the coming months will be strongly conditioned by the duration of the conflict between Russia and Ukraine and by the economic policy measures implemented as a result.**

SPECIAL REPORT
• **The Russia-Ukraine conflict: channels of transmission to the Spanish economy**

The International Scenario

The Russian invasion of Ukraine puts upward pressure on inflation and hurts global growth, while central banks tighten their monetary policy

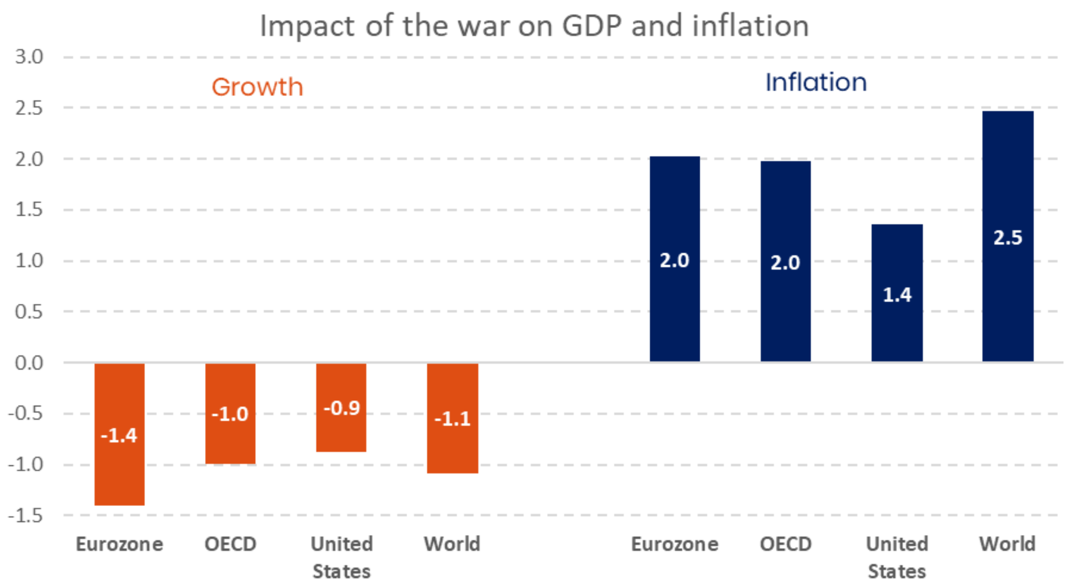
The year started out with high inflation rates due to existing bottlenecks and a generalized slowdown in global growth, partly as a consequence of the restrictions imposed by the pandemic. This situation has been further aggravated by the Russian invasion of Ukraine. In addition to the loss of lives and the very substantial economic and infrastructure damage this event will cause, it will have repercussions on inflation, which will remain high for longer, and also on global growth, which will suffer, especially in Europe.

The war in Ukraine and the subsequent sanctions are leading to very significant increases in the price of energy products. After the war broke out, gas prices reached record highs and oil traded above $130/barrel, the highest since 2008, although over the last few days, despite still being quite high, these prices have eased somewhat. However, there are also other commodities whose prices are rising sharply, such as wheat and other cereals, due to Russia and Ukraine being major producers. The effects of these price increases will be felt globally, with a greater impact on lower-income households, where food and energy account for a larger spending share.

In addition to the direct and short-term effects, there will be other effects such as those derived from the sanctions against Russia and the countersanctions that the latter may, in turn, impose. Moreover, there will be significant changes in worldwide trade relations. The effects will also be felt through financial channels, with widespread stock market declines and high volatility.

In the case of Russia, the repercussions are already particularly significant, with a sharp plunge in its stock market and the temporary closure of stock market trading. In addition, the EU excluded several Russian banks from the SWIFT payment system. Moreover, the rouble has depreciated sharply and is trading at record lows against the dollar, which has led its central bank to raise interest rates from 9.5% to 20% to contain the currency's decline and try to curb rising inflation. The Russian economy is facing a severe recession, while rating agencies are downgrading its debt to junk bond level, reflecting the likelihood of defaults.

Thus, in light of the existing high uncertainty, and with the sharp downturn that the Russian and Ukrainian economies will experience, coupled with the increase in prices worldwide that will also have negative impact on activity, the main international organizations have indicated that they will revise their growth forecasts downwards for 2022. However, most of them have not yet provided specific figures on the extent of these revisions, which will be conditioned by the evolution and duration of the war and the sanctions adopted. The effects will be uneven across regions and sectors of activity, with greater impacts for those countries that have closer trade relations with Russia and Ukraine, and also for the ones that are most dependent on imports of commodities whose prices are being affected the most by the conflict. The OECD has been the first to offer initial figures by region, pointing out that the consequences of the war will lead to a reduction in global growth of almost 1.1 percentage points, while inflation will increase by almost 2.5 percentage points.



Source: OECD

What seems clear is that the effects of the war in Ukraine are going to interrupt the recovery that was being anticipated by the February PMI indices for the United States and Europe, and which do not yet reflect the consequences of the war. The February Global Composite Index increased by two points compared to January, with the improvement concentrated on the United States, the United Kingdom, and the EU, as a result of a stronger momentum in manufacturing and, most of all, in the services sector, after the slowdown triggered by the pandemic in December and January. In contrast, activity in Asia is now being the hardest hit on the back of the advance of the omicron variant. The composite PMI in China remained unchanged at just 50.1 points, showing very weak growth, while Japan's continued to decelerate and posted 45.8 points, the worst reading since August 2021 and clearly pointing to a contraction in activity. The Japanese economy was affected by border closures and higher energy imports, while its domestic demand remains very subdued, and its exports are affected by the slower pace of growth of the Chinese economy.

In the Eurozone, the consequences of the war are already being felt, especially in inflation, which is heavily impacted by energy prices. These continued to rise in February to a year-on-year rate of 5.9%, eight tenths higher than in January and marking a new high in its historical series. Core inflation, although also on the rise and reaching new highs, still stands at the relatively modest level of 2.9%. As for the effects on growth, the European Commission has indicated that the forecasts issued in February, when it expected growth of 4.0% for the Eurozone as a whole this year, are no longer valid and will have to be revised downwards, although it has not yet specified the extent of the adjustment. Meanwhile, the OECD estimates that growth will suffer a 1.4-point impact and inflation around 2 points.

The European Central Bank, at its March meeting, also revised its growth and inflation forecasts. Highlighting the enormous uncertainty, it set out three scenarios: a central one, based on the war in Ukraine ending soon, and two additional ones with more adverse outcomes. Thus, growth for 2022 was lowered from the 4.2% previously estimated to 3.7%, i.e., by five tenths, in the most benign scenario, and to 2.3%, i.e., by almost two points, in the most pessimistic scenario.

In addition, the ECB also tightened its monetary policy by accelerating the pace at which it will reduce bond purchases. Thus, net purchases could be concluded by Q3, although it will continue to reinvest the principal. Official interest rates remained unchanged, and the ECB does not intend to touch them until the net bond purchases have been completed. In this regard, if net bond purchases are, in fact, concluded by Q3, and inflation expectations are far from the 2% target, the ECB could implement its first rate hike at the end of this year or at, the latest, in Q1 2023.

In the United Kingdom, with inflation standing at 5.5% in January, the Bank of England raised its interest rates again, for the third consecutive meeting, to 0.75%, justifying the move on the grounds that the invasion of Ukraine has led to a rise in the price of energy and other basic products, such as food. In addition, there is the risk that problems in global supply chains will intensify, which, together with greater uncertainty, could weaken growth, especially in a net energy-importing economy such as the United Kingdom.

In the United States, inflation also continued to rise, standing at 7.9% in February, four tenths higher than in January and the highest level since January 1982. Although fuels and energy products account for a large part of the rise in inflation, the increase in prices is widespread and has pushed core inflation up to 6.4%, the highest level since August 1982. As for the labour market, it continued to gain momentum in February with the creation of 678,000 non-farm jobs, following 481,000 in January, and it has already recovered more than 90% of the employment lost during the pandemic. The unemployment rate fell by two tenths to 3.8%, which is also very close to pre-crisis levels.

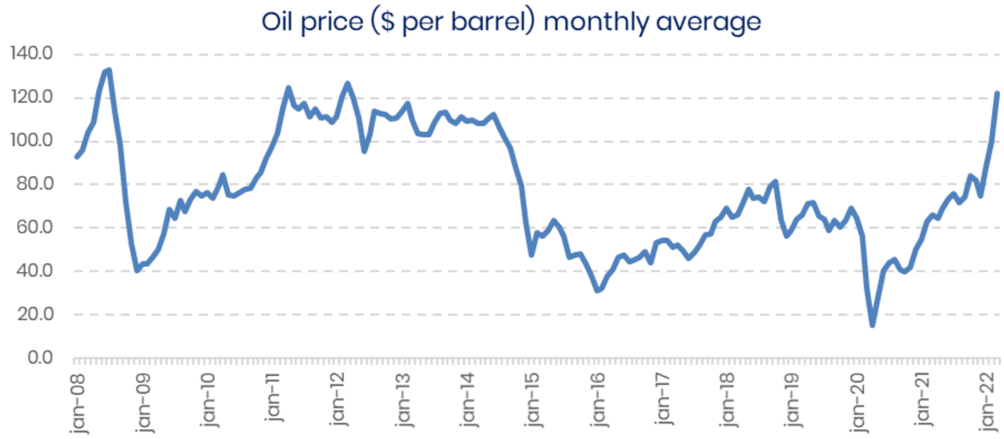
The good performance of the labour market and the high inflation figures, which are aggravated by the energy price tensions derived from the conflict in Ukraine, have led to a more aggressive economic policy by the Federal Reserve. Thus, at its March meeting, the Fed raised its interest rates by a quarter of a point to the 0.25% to 0.50% range, the first increase since 2018. Furthermore, to prevent the economy from overheating, six additional hikes are expected throughout the current year, with rates expected to end 2022 in the 1.75% to 2.0% range. In 2023, the institution anticipates three to four additional hikes, in order to contain the second-round effects that are being felt in both wages and product prices.

On the growth front, the Federal Reserve has revised down its estimates for this year, from 4% to 2.8%, as a result of the war in Ukraine and the high inflation levels. Its forecasts of 2.2% for 2023 and 2% for 2024 remain unchanged. As for inflation, it expects it to slow down in the second half of the year despite the current tensions, foreseeing the annual average at 4.3% vs. 2.6% in their previous estimates. In 2023, price moderation is expected to continue, with inflation averaging 2.7%, also a few tenths of a percentage point higher than the 2.3% previously foreseen.

As for China, the PMI indices show a certain weakness of its economy, which is being affected by the restrictions on activity resulting from its zero tolerance COVID policy aimed at containing the advance of the pandemic, currently most prevalent in Asian countries. Specifically, China is experiencing the biggest wave of infections in two years. The measures adopted include the confinement of several cities affecting more than 30 million people, among them Shenzhen, one of the country's main technological metropolises. In addition, they are still dealing with the problems of an oversized real estate sector, high indebtedness, and the concern that the difficulties being experienced by some of the country's main developers could spill over to other sectors and affect consumer confidence.

With regard to the consequences of the war in Ukraine, apart from the increase in energy prices, which does not favour growth, trade relations between Russia and China are not expected to suffer. In fact, it could have the opposite effect, given that the Asian country may end up absorbing a large part of Russia's lower sales to Europe.

As a result of the war in Ukraine, energy and other commodity prices, most notably food, are experiencing high volatility and a considerable increase. The price of Brent crude oil, which had already been on an upward trend due to a faster recovery of demand over supply, reached a monthly average of $99.8/barrel in February, the highest level since August 2014. In the days following the start of the war, it rose to over $130/barrel and, although it has subsequently eased due to the possibility of increased production in Venezuela and Iran, the average price in March is fluctuating around $122/barrel, which, if sustained, would be the highest since March 2012.



Source: Prepared in-house based on data from the Ministry of Economic Affairs and Digital Transformation

The Spanish Economy

Change of scenario in view of the war in Eastern Europe without having recovered to pre-crisis levels

The war between Russia and Ukraine is affecting the Spanish economy, causing higher uncertainty, additional increases in costs and inflation (with some figures at record highs) and, foreseeably, lower GDP growth. All this is happening at a time when activity had not yet recovered pre-pandemic levels, especially in those sectors that were most affected by the restrictions on activity and mobility. The channels of transmission of the Eastern European crisis to the Spanish economy are discussed in detail in the report box below titled "The Russia-Ukraine conflict: channels of transmission to the Spanish economy".

Although it is very difficult to quantify the real impact of the conflict on each of the economic parameters, given that it will depend on its duration and intensity, it's clear that the economic scenario for 2022 is characterised, to a certain extent, by the return of the "*old*" macroeconomic imbalances (high inflation, possible current account deficit), in addition to those that had not yet been corrected (high levels of public deficit, public debt and unemployment).

Therefore, growth will be lower than anticipated just a month ago, and it will be very difficult for GDP to exceed 5% this year, which means that the forecast for 2023 will also be lower unless the crisis situation is resolved in the short term and there is a significant rebound in activity and a notable reduction in costs. A feasible scenario would be GDP growth of between 4 and 5% in 2022 (CEOE estimates 4.7%) if the conflict does not extend over time. In fact, the OECD has pointed out that Spain is among the European countries with least exposure to this conflict.

There is no doubt that the main weakness of the Spanish economy continues to be our high external debt due to the public debt levels (118.7% of GDP at the end of 2021). Any change in the sentiment of the financial markets regarding the Spanish economy's ability to repay its debt could lead to an increase in the risk premium, which would significantly raise our financing costs.

Demand and Activity

Q1 is weighed down by the sixth wave and rising inflation and uncertainty

At the beginning of 2022, a slowdown was already expected in the first quarter due to the factors that had been limiting activity since the end of last year. Specifically, the sixth wave of the pandemic, the increase in the prices of raw materials, the difficulties in supplying materials and components or the rise in transport costs continue to limit the activity of many industries.

The outbreak of the war in Ukraine at the end of February has posed an additional risk factor, which has become the most worrying for the current year and could weigh on the recovery forecast for 2022, just when it seemed that the pandemic was beginning to subside.

Among the effects of the conflict, one of the most notable ones is the additional increase in energy prices, which were already rising at very significant rates. This increase in energy costs is having such an impact on certain economic activities that for some it is almost impossible to function normally, causing the shutdown of certain production centres.

On the other hand, uncertainty about the duration, intensity or consequences of the conflict will cause confidence to deteriorate to some degree, although this is not yet reflected in the figures up to February. In fact, during the first two months, consumer and sectoral confidence showed an improvement compared to last year's final months on the back of a better economic outlook and the positive prospects for the pandemic's evolution. The services PMI had also improved significantly in February after its decline in January, when it had fallen back below the 50 level. The manufacturing PMI has changed very little since December, but it had already been showing a gradual deterioration in previous months due to the factors mentioned above.

In the first few months of 2022, household consumption is expected to continue to rise, although high inflation will weigh down since it reduces purchasing power. In this respect, the domestic sales of large companies in January showed positive advances in goods, but a decline in services. The retail trade indices also recorded significant growth during January in nominal terms but, when deflated, they show a slight fall. Car registrations rose by 6.6% year-on-year in February, boosted by private purchases, although this still represents a weak pace of recovery and is 40% below pre-pandemic levels. Production difficulties due to component shortages, which may be further aggravated by the war in Ukraine, and weakened demand continue to result in very restrained registration figures, similar to those recorded in 2021.

In terms of the foreign sector, the information available for the month of January shows a much more dynamic evolution of imports over exports in nominal terms, due to the increase in import prices. Thus, exports increased by 24.6% year-on-year (7.4% in volume) and imports by 42.2% year-on-year (16.7% in volume). The result of these flows was a trade deficit for the month of €-6.1229 billion, compared to €-1.7691 billion in January 2021. According to the Balance of Payments data published by the Bank of Spain, for the whole of 2021, the accumulated surplus of the current account balance was 8.4 billion in 2021, lower than the 9.3 billion accumulated in the previous 12 months. The improvement in the tourism balance (11.3 billion) was offset by the decline in the balance of non-tourism goods and services (10.7 billion) and of primary and secondary income (-1.4 billion).

The latest available data for the tourism sector shows that tourist inflows slowed their recovery in January due to the increased incidence of the sixth wave, falling back from December's record, which had already shown some weakness. In January, international tourist arrivals stood at 2.5 million tourists, 4.7 times the previous year's figure, although still -39% below the number of tourists in January 2020, before the start of the pandemic. The evolution of tourist inflows since November represents a step back in the sector's recovery process, which had reached figures of tourist inflows of around 70% of pre-crisis levels and has now receded to around 60%. Similarly, total spending by international tourists in January reached €3.027 billion, which is still a 36.6% decrease compared to 2020.

The Labour Market

Employment recovery continues in 2022, albeit with less intensity than in 2021

In the first months of 2022, job creation has lost intensity compared with the dynamism observed in 2021. According to the evolution of the number of people registered with the Social Security, the labour market is showing some normalization following 2021, a year in which employment grew notably and recorded surprisingly positive figures for certain months. However, this does not prevent current registration figures, even in effective terms, from consolidating above those recorded before the outbreak of Covid.

Looking at the upcoming months, the previous factors that called for caution regarding the performance of the labour market this year, such as an uneven recovery by sector, a high number of people unemployed, more than 100,000 workers still furloughed or the uncertainty about the evolution of the pandemic, have now been coupled with the impact that the conflict in Ukraine may have on our country's economy and labour market.

At the beginning of the year, estimations pointed to less intense job creation in 2022 compared to 2021 and also in comparison to the expected GDP growth for the year. Following the outbreak of the war between Russia and Ukraine, CEOE has revised down its economic growth and employment forecasts. Thus, it now expects employment in LFS terms to increase by an annual average of 2.1% in 2022 and 1.8% in 2023, which is five tenths and one tenth lower than the previous forecast, respectively. Meanwhile, the unemployment rate will continue to fall, albeit more slowly than foreseen a few weeks ago, to 13.9% in 2022 and 13.1% in 2023. However, these forecasts are subject to a high degree of uncertainty, depending on how the evolution of the conflict in Ukraine.

In February, Social Security registrations increased by a monthly average of 67,111 jobs, a very similar figure to the average increase recorded in this month over the 2014-2021 period. Thus, it seems that employment is returning to a certain normality in monthly variations following 2021, a year in which several months saw employment growth rates that were record highs. Social Security registrations increased in February in the public and the private sectors, by 21,185 and 45,926 workers, respectively. In seasonally adjusted terms, the number of workers registered with the Social Security increased for the tenth consecutive month. Specifically, in February it grew by 37,726 jobs, thus extending the trend of more moderate growth initiated at the end of 2021. Moreover, the preliminary estimates of the Ministry of Inclusion, Social Security and Migration point to an increase in seasonally-adjusted Social Security registrations of 30,520 persons in March, thus confirming the slowdown in job creation (in adjusted terms) of recent months.

The number of workers still under furlough schemes (in terms of registration date) fell again in February, although the pace of decline has slowed in the last three months compared with the rate recorded over the course of 2021. Specifically, in February, 8,941 workers came out of furlough, setting the total figure at a monthly average of 119,028 people. According to data recently published by the Ministry of Inclusion, Social Security and Migration, in the first half of March the number of workers furloughed may have fallen by almost 13,000 in comparison to the end of February. Meanwhile, the number of self-employed workers receiving extraordinary benefits increased in February for the fourth consecutive month, reaching a total of 111,331 people as of 21 February, the last date for which data were published.

The number of people registered with the Social Security increased by 2,3% vs. February 2020, just before the outbreak of the pandemic. Discounting the 119,028 individuals who remain under furlough schemes, effective registrations are 1.7% higher than two years ago, which means there are 325,015 more people employed. However, the results differ between the public and private sectors. Public sector registrations are 9.7% higher than in February 2020 (+249,884 jobs). Meanwhile, actual registrations in the private sector are 0.5% higher than two years ago, or 75,130 additional jobs.

Registered unemployment performed favourably in February, with a decrease of 11,394 persons, the largest fall in this month since 2015. Thus, the total number of people unemployed stands at 3,111,684. At the same time, it is worth highlighting the notable upturn in permanent contracts, which accounted for 21.9% of the total number of contracts signed in February, compared with an average of around 10% for the same month in previous years, and it represents an all-time high in this respect.

According to estimates by CEOE's Department of Economic Affairs, based on the preliminary data for March from the Ministry of Inclusion, Social Security and Migration, the employment balance in Q1 2022 will be positive, although job creation will be significantly less intense than in Q4 2021. Specifically, seasonally adjusted effective registrations (excluding those under furlough) are estimated to increase by around 1.1% quarter-on-quarter in Q1, practically half of the 2.1% increase recorded in Q4 of last year.

Inflation

February CPI stood at 7.6% due to higher energy prices

In February, inflation rebounded again to 7.6%, the highest rate since December 1986. The rise in energy prices continues to be the main driver of the increase. There is still a significant "base effect" component in this CPI figure, as inflation in February 2021 was zero (0.0%).

Core inflation increased by six tenths, setting the year-on-year rate at 3.0% in February, more than 4.5 points below the general CPI. Within the core component, Services prices increased their year-on-year rate by three tenths to 2.0%; prices of Industrial Goods excluding energy products increased by six tenths to 3.0%; and Processed Food, beverages and tobacco accelerated their year-on-year rate by 1.3 points to 5.3%, with a notable increase in oils and fats (28.1%).

Non-processed food prices decreased by two tenths to stand at 5.0% year-on-year. It is worth highlighting the increase in the prices of all types of meat and most especially lamb (9.5%), as well as cereals (8.2%) and milk (8.8%).

Energy product prices reached a year-on-year rate of 44.3% in February, up from 33.0% in January, driven by higher energy commodity prices. In February, the price of crude oil averaged $99.8/barrel, an increase of 59% year-on-year. After the Russian invasion of Ukraine, prices reached over $130/barrel, but in recent days they are softening due to Russia's and OPEC's pledges to guarantee the agreed supply.

In 2022, inflation will be strongly influenced by the evolution and duration of the conflict between Russia and Ukraine and the economic sanctions imposed by the European Union on Russia, which may have a significant impact on the price of some commodities, including gas, crude oil, cereals, and oils. This will be coupled with other factors that were already driving inflation, such as the base effects caused by the pandemic, supply difficulties or the strong increase in the price of some intermediate goods. All these factors will keep inflation high in the coming months, but it is expected to gradually ease by the end of the year.

The Public Sector

The public deficit could close 2021 at around -7% of GDP

Up to the end of November, the overall general government deficit, excluding local government, was 37.9% lower than in the same period for 2020. The deficit-to-GDP ratio stood at -4.6%, significantly lower than in the same period of the previous year (-8.0% of GDP). In 2021, the public deficit could close at around -7% of GDP.

The primary balance (net of accrued interest) remains negative, with a deficit equivalent to -2.7% of GDP, a significant decline compared to 2020 (-6% of GDP).

The different government levels have performed unevenly, although they have followed the same trend as in 2020. The central government is the one with the greatest imbalance due to the transfers made by the State to the Autonomous Regions, which were in addition to those related to the financing system. Thus, while the deficit of the former stands at -5.4% of GDP in the first eleven months of 2021, the Regional Government has achieved a surplus of 0.7% of GDP, while the Social Security stands at 0.1% of GDP.

Expenditure shows some containment, increasing by 2.7%. According to the General Comptroller of the State Administration (IGAE), expenditure associated with COVID-19 stands at around €28 billion at the end of November 2021, which implies a decrease of just over 25.0% with respect to the same period in 2020. Among the expenditure increases, it is worth highlighting intermediate consumption (5.8%), which includes vaccines, compensation of employees (5.7%) and also Gross Fixed Capital Formation (11.1%).

This explains part of the reduction of the fiscal imbalance during this period, although one must also take into account the dynamism on the revenue side. In fact, at all government levels, it is worth noting the strength of revenues linked to the economic recovery, the increase in funds from the EU, from taxes, and also from contributions in the case of the Social Security system. Of total non-financial resources, tax revenues have increased by 15.6%, which is 5.3% more compared to tax revenues in the same period of 2019.

Forecasts

Economic forecasts for Spain (last update: March 2022)						
Annual rates of change, unless otherwise indicated						
	2018	2019	2020	2021	2022	2023
GDP	2.3	2.1	-10.8	5.0	4.7	3.9
Private consumption expenditure	1.8	0.9	-12.2	4.7	3.6	3.2
Government consumption expenditure	2.3	2.0	3.3	3.0	3.0	1.3
Gross fixed capital formation	6.3	4.5	-9.5	4.1	7.0	6.0
-Tangible fixed assets	7.5	5.8	-10.5	3.8	6.7	6.5
Construction	9.5	7.1	-9.6	-3.0	3.4	5.0
Equipment and cultivated assets	4.6	3.7	-12.1	15.2	11.0	8.4
-Intangible fixed assets	1.1	-1.5	-4.3	5.6	8.5	4.1
Domestic demand (*)	2.9	1.6	-8.6	4.7	3.8	3.4
Exports	1.7	2.5	-20.1	13.4	11.1	6.7
Imports	3.9	1.2	-15.2	12.8	8.9	5.4
External demand (*)	-0.6	0.5	-2.2	0.3	0.8	0.5
GDP current prices	3.5	3.4	-9.7	7.1	8.2	4.9
GDP deflator	1.2	1.3	1.1	2.2	3.5	1.0
CPI (average annual rate)	1.7	0.7	-0.3	3.1	5.9	1.0
CPI (Dec/Dec)	1.2	0.8	-0.5	6.5	2.8	1.0
Core CPI (average annual rate)	0.9	0.9	0.7	0.8	2.8	1.6
Employment (Quarterly National Accounts)(**)	2.2	2.6	-7.6	6.7	3.6	2.2
Employment (LFS)	2.7	2.3	-2.9	3.0	2.1	1.8
Unemployment rate (LFS) (% active population)	15.3	14.1	15.5	14.8	13.9	13.1
Productivity	0.1	-0.5	-3.5	-1.7	1.0	1.7
Compensation per employee	1.8	2.6	1.3	-0.6	2.0	1.8
Unit labour cost (ULC)	1.7	3.1	5.0	1.1	1.0	0.1
Current Account Balance (% of GDP)	1.9	2.0	0.8	0.7	0.0	0.5
General government net lending (+) / net borrowing (–) (% of GDP)	-2.5	-2.9	-11.0	-7.3	-6.3	-4.8
Interest rates USA (Dec)	2.50	1.75	0.25	0.25	2.00	2.75
Interest rates Eurozone (Dec)	0.00	0.00	0.00	0.00	0.00	0.50
Brent Oil ($)	52.1	43.3	54.3	70.9	112.8	95.5

Source: CEOE, INE (National Statistics Institute), Banco de España, Eurostat

(*) Contribution to GDP growth

(**) Full-time equivalent jobs

The Russia-Ukraine conflict: channels of transmission to the Spanish economy

The geopolitical tension between Russia and Ukraine is having repercussions on the global economy and, unsurprisingly, also on the Spanish economy, by introducing greater uncertainty, additional and significant increases in energy costs and, foreseeably, lower GDP growth.

At the time of writing this report, it is very difficult to quantify the economic consequences, given that they will depend on the duration and intensity of the conflict and the repercussions that this situation may have on economic policy in general, including international trade and energy policies. This special report, therefore, outlines the possible channels of transmission of the events taking place in eastern Europe, and offers estimates of the potential impact on different macroeconomic variables in Spain, distinguishing between its short- and medium-term effects.

Transmission channels of the conflict in the short term:

1. **Inflation**, which is rising at historic rates, mainly due to higher prices in energy, commodities and transport.

   Russia's conflict with Ukraine poses a clear additional upside risk to inflation in 2022 if it extends over time. Although the fundamentals suggest that high inflation rates will correct, there is a risk that this upturn will not be temporary. Thus, if the war is prolonged, higher energy commodity prices may lead to an even greater spillover to final prices.

   Inflation in Spain could stay between 5% and 7%, peaking in the spring months. Once the crisis subsides and energy and commodity prices return to normal, its base effects will fade, and inflation should start to ease substantially. Thus, forecasts for 2023 point to growth of around 1-2%.

   One of the keys at the moment is not to start a price-wage spiral. The responsibility for avoiding second-round effects in the economy lies with the social partners through collective wage bargaining, where moderation and caution will play a key role. Such a spiral would clearly be detrimental to the welfare of workers, the viability of enterprises and the manoeuvrability of the public sector. Overall, there would be a loss of competitiveness of the Spanish economy, which would be detrimental to economic recovery in the short term and to the sustainability of growth in the medium and long term. We would then face a scenario of lower growth, lower job creation and higher inflation.

2. **Confidence levels.** The situation of increased uncertainty in the economy will undermine the confidence of consumers and of businesses, leading agents to delay or cancel their investment and consumption decisions. This will lead to a slower increase in domestic demand and, thus, to lower economic growth.

3. **The foreign sector**. In terms of trade, Spain's relations with Russia and Ukraine are limited. Total exports of Spanish products to Russia account for 0.7% of overall exports and Spanish exports to Ukraine account for only 0.2% of the total, so the direct impact on the balance of goods would be fairly small.

   However, the higher increase in energy prices due to the conflict will have a very significant impact on our balance of energy goods, with the subsequent deterioration in the trade balance. Spain is characterised by its high intensity as an importer of energy products and, in particular, of crude oil. In other words, it requires a higher net import of energy products for each unit of GDP produced. This is reflected in a more severe deterioration of the current account balance as a result of increases in energy prices. Although we have witnessed an improvement in energy efficiency over the past decades, which has reduced the impact of price increases on our current account, it is still significant.

   The impact on the trade balance this year and in the coming years will depend heavily on prices remaining at current levels. In a scenario in which energy prices (oil, gas, and electricity) were to be 50% higher on average than in 2021, the direct impact on the trade balance would be approximately 1 GDP point. This would mean that the Spanish economy would practically stop registering surpluses in its current account balance after having posted positive figures for the past 9 years.

4. **Tourism**. In 2019, tourists from Russia accounted for 1.6% of the 83 million tourists who came to Spain. The direct impact of these issuing markets is not relevant for the tourism sector in our country, but the situation of tension and uncertainty may slow down international passenger movements and thus interrupt the recovery of the sector, which was already slower than expected in 2021 and could behave similarly in 2022. Nevertheless, Spain has the advantage of being considered a safe destination and this may, to some extent, favour the arrival of tourists from our European partners.

5. **Production restrictions in the industrial sector.** In addition to high energy prices, supply shortages and transport problems are creating bottlenecks in many industries, causing delays and even shutdowns in some sectors. Experts point out that this situation could extend into the first half of 2022, but it also depends on the situation in Eastern Europe. According to the Bank of Spain, disruptions in global supply chains could reduce Spain's GDP growth rate by five to nine tenths in 2022.

Transmission channels of the conflict in the long term:

6. **Rising costs of financing public debt**. The ECB is modifying its monetary policy with the aim of reducing the push it had been providing since the outbreak of the pandemic. In terms of public sector financing costs, this means that, in contrast to the past two years, in which the ECB bought practically all issued debt, these purchases could be much lower in 2022, making it necessary to turn to international markets more often, with rates are on the rise. This could increase the country risk premium and increase public sector financing costs.

7. **For fiscal rules to be resumed**, although given the current situation of uncertainty over the conflict, the most likely scenario is to delay the escape clause of the Stability and Growth Pact. In this way, the implementation of expansionary fiscal policies could continue in order to cushion the effects of the war. If the fiscal rules were to come into force at a time of incomplete recovery of the Spanish economy, the adjustment that the public sector would have to make would be very sharp, given the Spanish high levels of deficit and public debt.

In conclusion, the downward impact on growth is clear in the short term, although it is still very difficult to quantify. Most analysts point to a growth reduction of 3-4 tenths in 2022 but, if the conflict lasts longer, the impact could be 1 percentage point. Our central scenario of a 5.3% forecast for 2022 has been revised down by about half a percentage point to 4.7% for 2022 and 3.9% for 2023. However, we should not lose sight of the fact that growth levers remain in place and could cushion downward biases. These include the implementation of European funds, expansionary policies (fiscal and monetary), accumulated household savings and a certain recovery in tourism, given that Spain is considered a safe destination. Another key factor is the magnitude of macroeconomic imbalances (and their degree of deviation from what is considered macroeconomic stability), which could lead to changes in economic policies with the aim of getting them back on track, within a context of slow recovery, high indebtedness, and high unemployment for the Spanish economy.