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The economic economic outlook of Portugal and Spain, and their long-term ageing challenge

Rafael Doménech

The 10th anniversary of the BBVA Pension Institute in Portugal

BBVA, Lisbon, 18th of June 2024

Creating Opportunities

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01

Global economy

Main messages

	World economy	Spain and Portugal
Growth perspectives	Slight slowdown in the US and China, albeit less than expected, and slight acceleration in EMU.	In 2024 GDP may grow as in 2024, thanks to tourism, immigration and other factors
Perspectives Inflation and rates	Inflation will come down more slowly, creating the conditions for the Fed and ECB to cut rates.	Slowdown in prices, as in Europe. Higher growth than in the EU moderates the risk premium.
Risks	Geopolitical uncertainty, supply disruptions, pressure on inflation, elections in the US and other regions, and fiscal consolidation.	Fiscal adjustment, weakness of private investment and productivity, filling of vacancies, NGEU execution, and economic policy uncertainty

A very soft landing: growth and inflation remain resilient, reducing the room for central banks cutting interest rates

Recent scenario drivers

Tight monetary conditions are hitting demand with long lags and through the traditional channels; tightening effects softened by monetary easing prospects

Expansionary fiscal policy has been favoring activity, partially offsetting the impact of monetary tightening

Supply "normalization": moderated input prices and bottlenecks, favored also by oversupply in China; despite geopolitics, trade tariffs, US elections...

Recent macro trends

Resilient growth, mainly in the US and service sector; recovery signs in Europe and China as well as in manufacturing

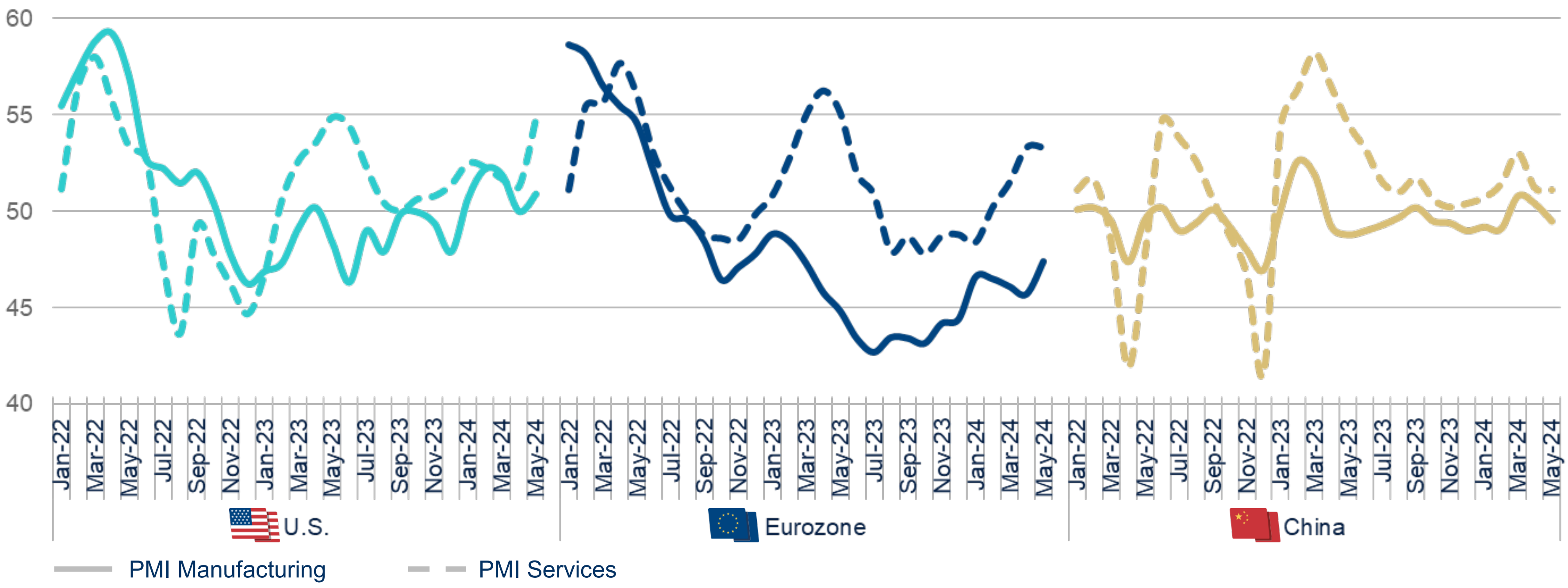
Inflation has surprised upwards; it has stopped falling lately on more persistent services inflation

Limited financial volatility as positive growth view prevails, despite prospects of delayed monetary easing by the Fed

Growth is holding up better than expected, mainly due to service dynamism, and there are now some signs of recovery, in particular in manufacturing

PMI INDICATORS

(MORE THAN 50: EXPANSION; LESS THAN 50: CONTRACTION)

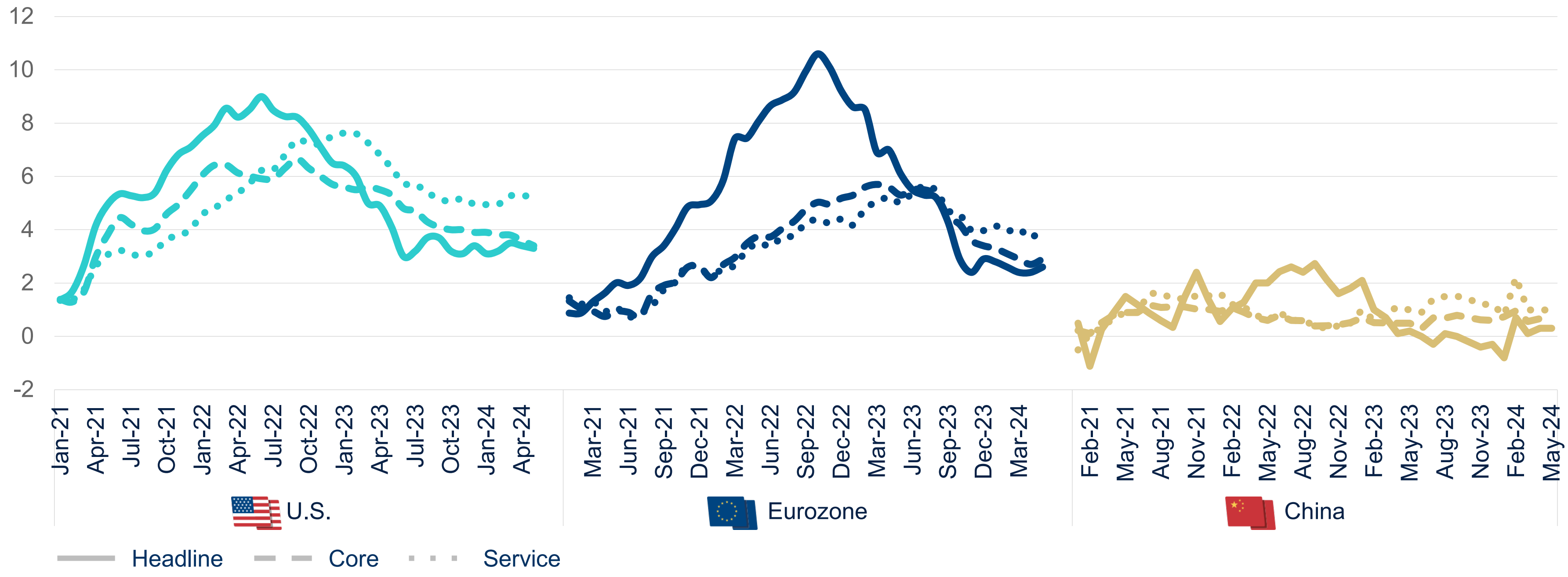


Source: BBVA Research based on data from Haver.

Headline inflation has been moving sideways lately, to a large extent due lo higher than expected service inflation persistence

CPI INFLATION: HEADLINE, CORE AND SERVICE

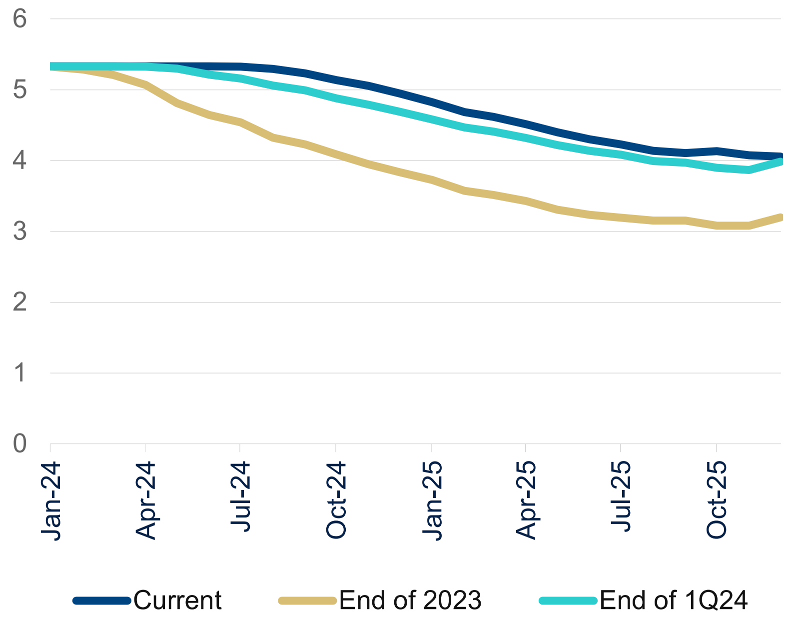
(Y/Y %)



Source: BBVA Research based on data from Haver.

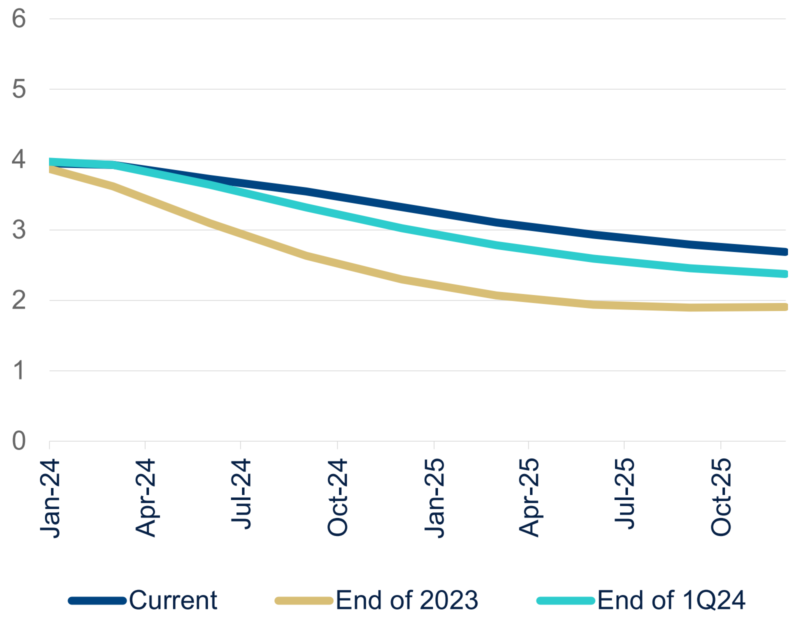
Markets have raised again their interest rate expectations as the Fed's easing cycle is delayed and the ECB remains cautious despite the recent 25 bps cut

US: IMPLICIT RATE IN FED FUND FUTURES (%)



Source: BBVA Research based on Bloomberg.

EZ: IMPLICIT RATE IN 3-MONTH EURIBOR FUTURES (*) (%)

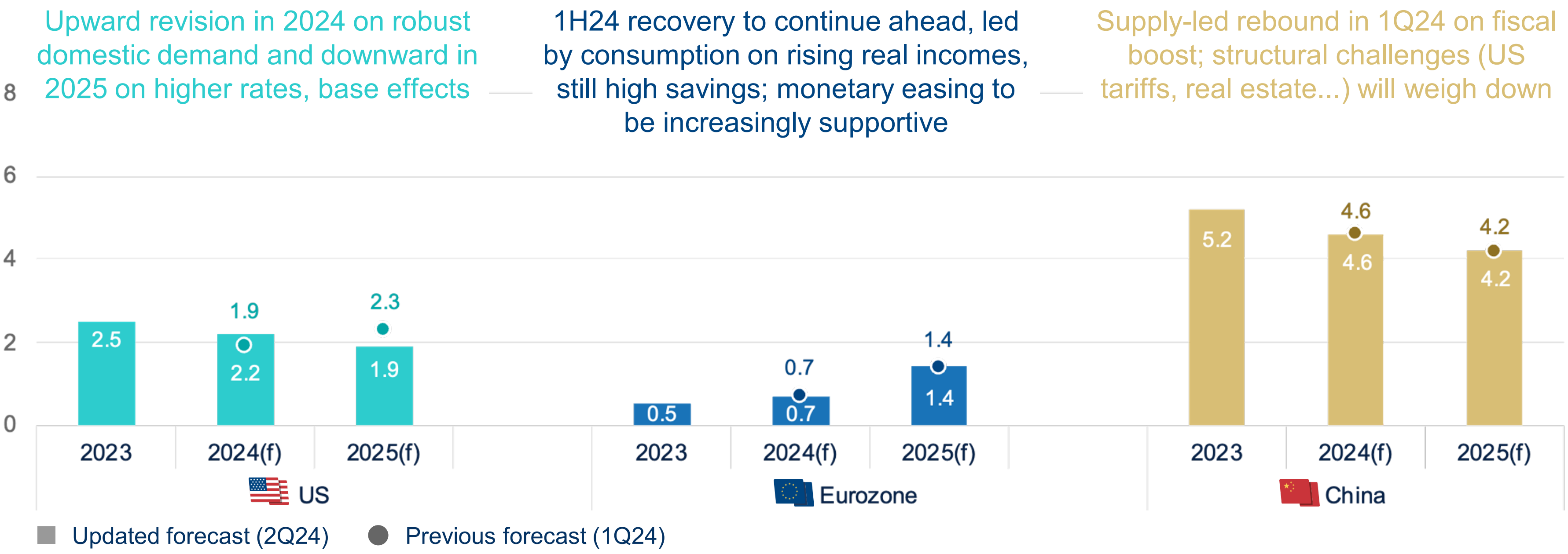


(*) Depo interest rates.
Source: BBVA Research based on Bloomberg.

GDP growth prospects: a softer landing in the US, a cyclical recovery in the Eurozone and a structural deceleration in China

GDP GROWTH (*)

(%)

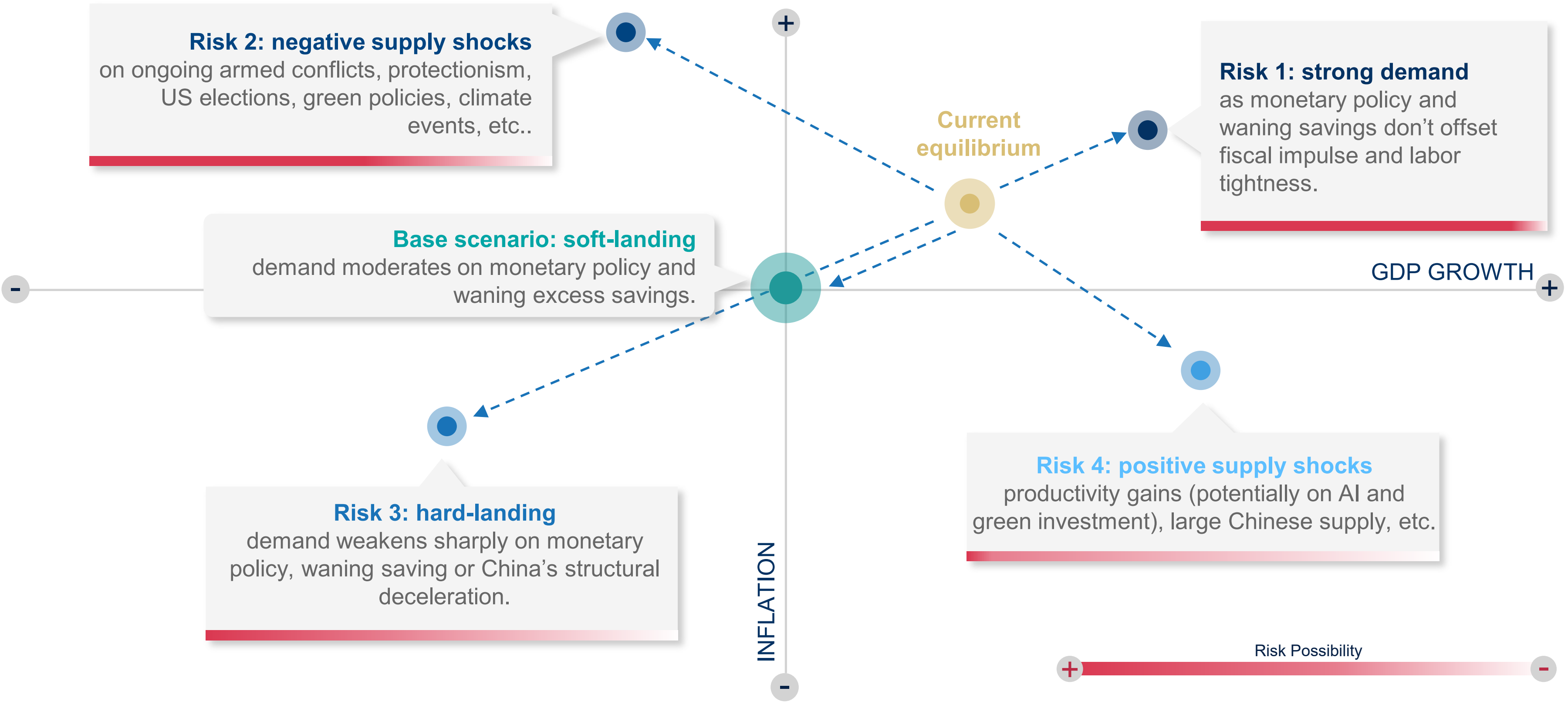


(f): forecast.

(*) Global GDP growth: 3.2% in 2023, 3.1% (+0.0 pp in comparison to previous forecast) in 2024 and 3.3% (+0.0 pp) in 2025.

Source: BBVA Research.

Risks: demand strength, protectionism, geopolitics, among other factors, could prevent inflation and interest rates from declining ahead



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Short-term forecasts for Spain and Portugal

Short-term upward revisions

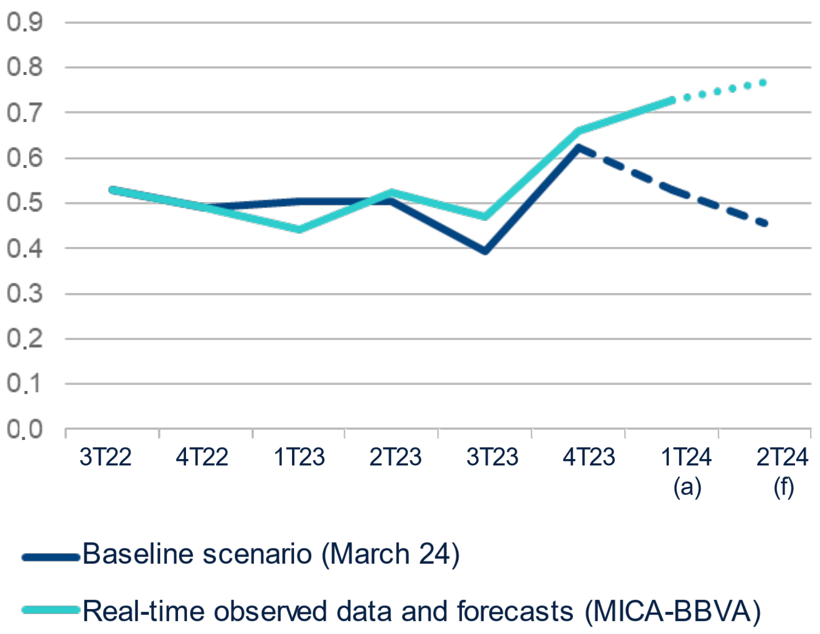
	2023 (a)	2024 (p)	2025 (p)
Spain	2,5%	2,5%	2,1%
Portugal	2,3%	2,2%	2,2%

(a): Advance. (P): Forecasting.
Source: BBVA Research based on INE.

Further improvement in growth prospects

Favourable performance of exports of services

QUARTERLY GDP GROWTH (%)



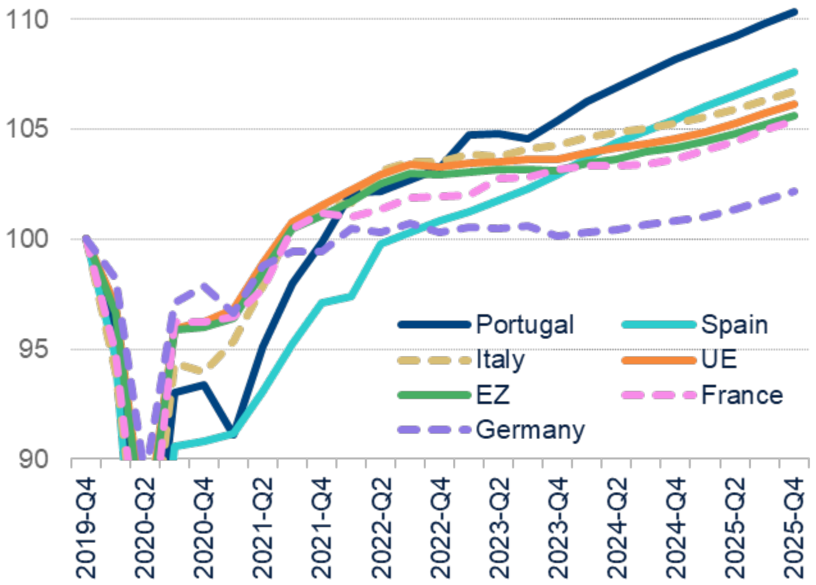
(a): advance; (f): Forecasting.
Source: BBVA Research based on INE.

- Available information indicates that production has performed better than expected three months ago.
- The INE has revised GDP growth for the second half of 2023 upwards, adding one tenth to the 2024 forecast.
- In addition, preliminary data for 1Q24 show higher-than-expected growth (0.7% QoQ/Q vs. 0.6%).
- Real-time data suggest that GDP growth will remain at similar levels during 2Q24 (0.7%), adding another three tenths of a percentage point to this year's growth.

Upward bias in GDP growth forecasts in 2024

Since 1Q22, Portugal and Spain have grown more than EMU

EU: GDP
(SA DATA, CHAINED VOLUMES 4Q19 = 100)



Source: BBVA Research based on Eurostat.

- Portugal and Spain have shown a differential performance compared to the rest of the eurozone since the start of the Russian invasion of Ukraine.
- The convergence in the post-COVID-19 recovery is due to higher consumption growth (both public and private) and the acceleration in exports of services (both tourism and non-tourism).
- Immigration, gains in price competitiveness, European funds and lower energy prices explain the relative improvement.

Challenges and uncertainty from 2025 onwards

Fiscal policy

The new fiscal rules in Europe will require significant and sustained adjustments over time from 2025 onwards.

Rising tax pressure

Productivity

Investment weakness

Weak productivity growth

Tightening of the labour market, filling vacancies and wage developments

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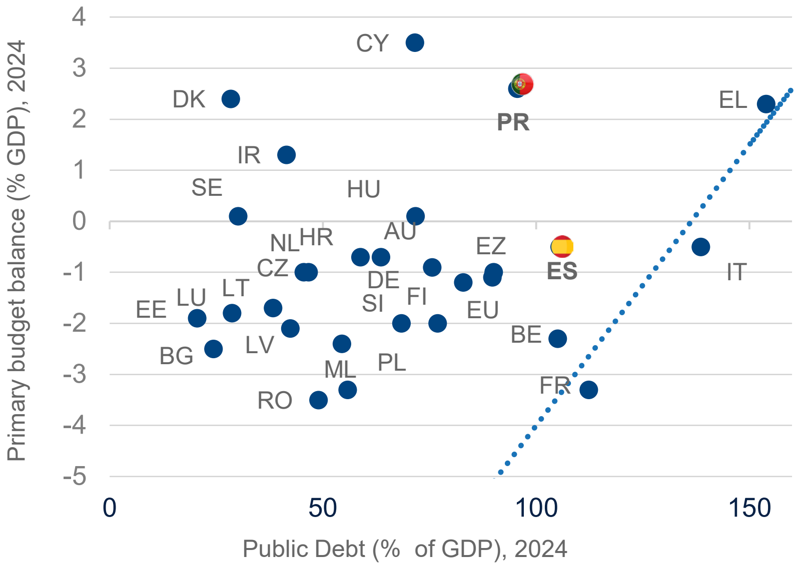
Economic policy

Political uncertainty, which affects economic policy

NGEU Implementation

Challenges and uncertainty from 2025 onwards

PUBLIC DEBT AND PRIMARY BUDGET BALANCE FORECAST FOR 2024 (AS % OF GDP)



The line with a negative slope represents the combinations of debt and budget balance with the same fiscal space

Source: BBVA Research based on the European Commission (May 2024) and Doménech and Gonzalez-Páramo (2017)

- Unlike Portugal, it is estimated that Spain needs an improvement of about 2.5 pp of GDP in the primary structural balance to comply with the fiscal rules.
- These objectives are demanding and could have a negative impact on activity, especially if economic conditions are less favourable than expected and the adjustment is intended to increase the tax burden.
- The negative impact would be less if inefficient expenditures are eliminated and indirect taxes are increased.

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03

The challenges of the public pension system in Europe

The challenges of the public pension system in Europe

The main challenge facing the pay-as-you-go pillar of the European public pension systems is the result of two excellent pieces of news:16

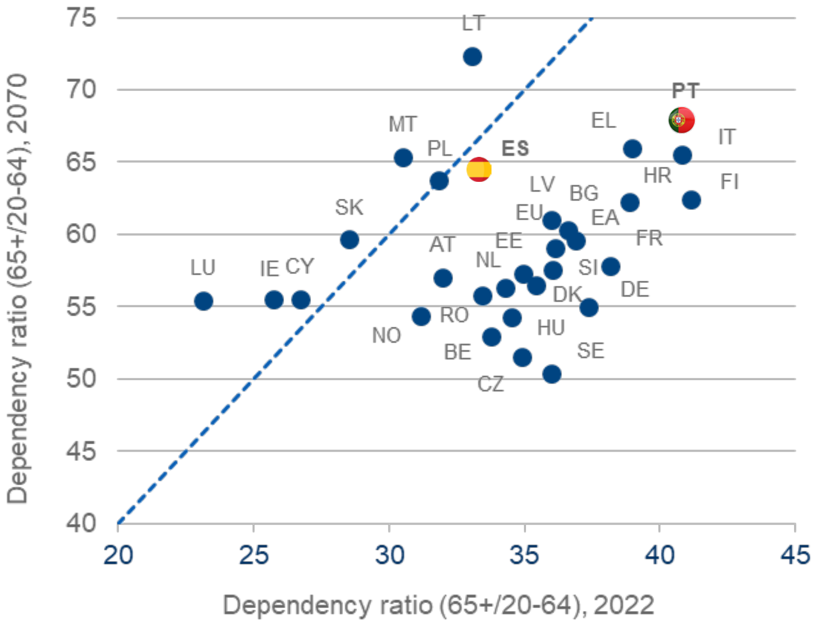
1. People are living longer due to the increase in life expectancy after reaching 65 years. For example, in Spain life expectancy from the age of 65 increases approximately 16 months every 10 years, but the average retirement age does so at a rate of 6 months per decade.

2. The baby boom generations have begun to retire or will do so in the coming years, and they will do so with increasing life expectancy...

… but without such numerous young generations replacing them.

The dependency ratio will practically double in the next decades

DEPENDENCY RATIO PROJECTIONS, EUROPE
(%)



Source: BBVA Research based on European Commission (2024)

- Although there is considerable uncertainty in population projections, all of them point to an increase in the dependency ratio of 64% in European countries between 2022 and 2070.
- In Portugal, the increase will be 66%, lower than in Spain (94%)

What factors determine pension spending as a percentage of GDP?

- Pension spending as a percentage of GDP can be broken down as follows:

$$\frac{Pension\ expenditure}{GDP} = \underbrace{\frac{Pop\ 65+}{Pop\ 20-64}}_{\text{Dependency ratio}} \underbrace{\frac{Pensionists}{Pop\ 65+}}_{\text{Coverage rate}} \underbrace{\frac{Average\ pension}{GDP/Employment}}_{\text{Benefit rate}} \underbrace{\frac{Pop\ 20-64}{Employment}}_{\text{Inverse of employment rate}}$$

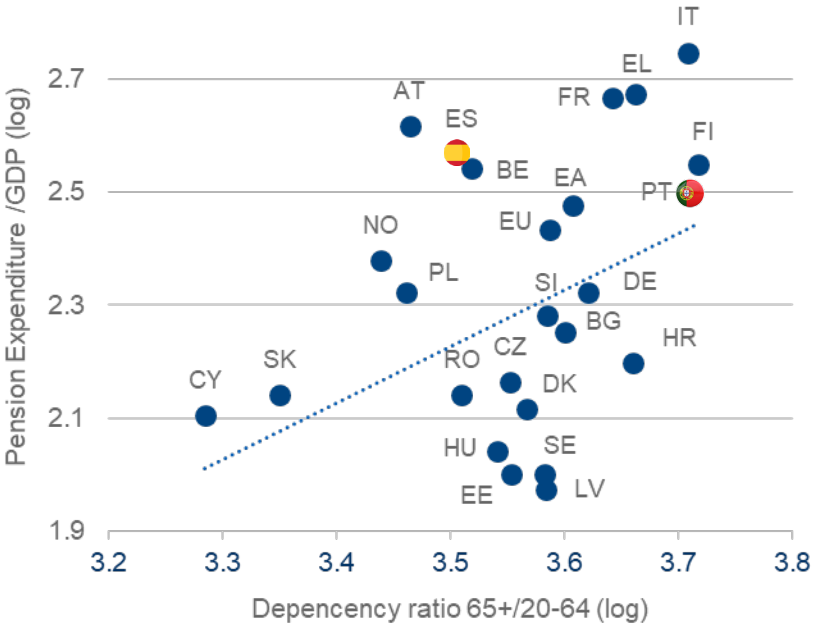
- By construction, these components enter the decomposition with a unitary elasticity: pension spending as a percentage of GDP increases in the same proportion as each component.

- The evidence for 2019, before the COVID crisis, shows huge differences in these four components between European countries.

What factors determine pension spending as a percentage of GDP?

1. The dependency ratio

DEPENDENCY RATIO AND PENSION EXPENDITURE OVER GDP, EU, 2022



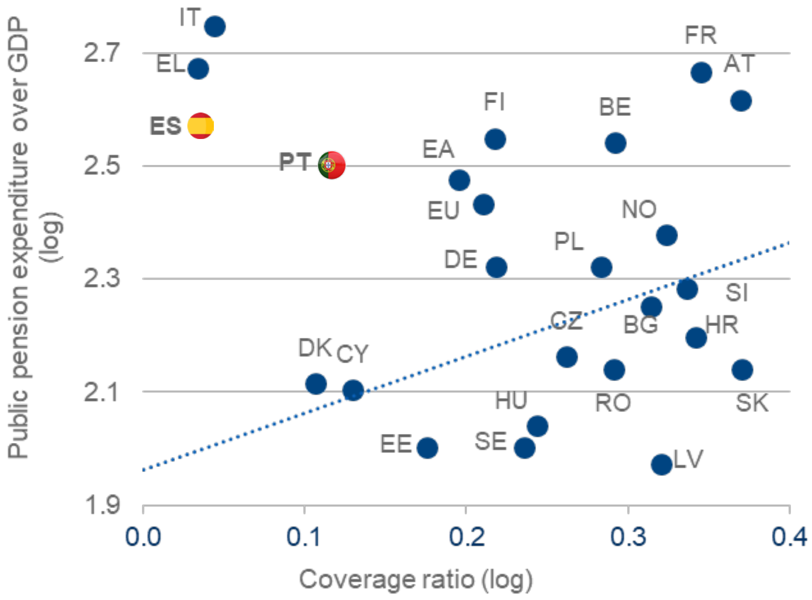
The slope of the straight line imposes a unitary elasticity
Source: BBVA Research based on Comisión Europea (2024).

- European countries show enormous heterogeneity in pension spending over GDP: from 6.8% in the Netherlands to 15.7 in Greece (2022).
- The dependency ratio explains a part of these differences (19%). The rest is explained by the other components
- Discounting the effect of the dependency ratio, Spain is one of the countries with the highest expenditure on pensions as a percentage of GDP, only surpassed by Austria, France, Italy and Greece.
- Portugal is close to the EU average, and the Nordic countries are below average.

What factors determine pension spending as a percentage of GDP?

2. The coverage rate

PENSION COVERAGE AND EXPENDITURE RATE OVER GDP, EU, 2022



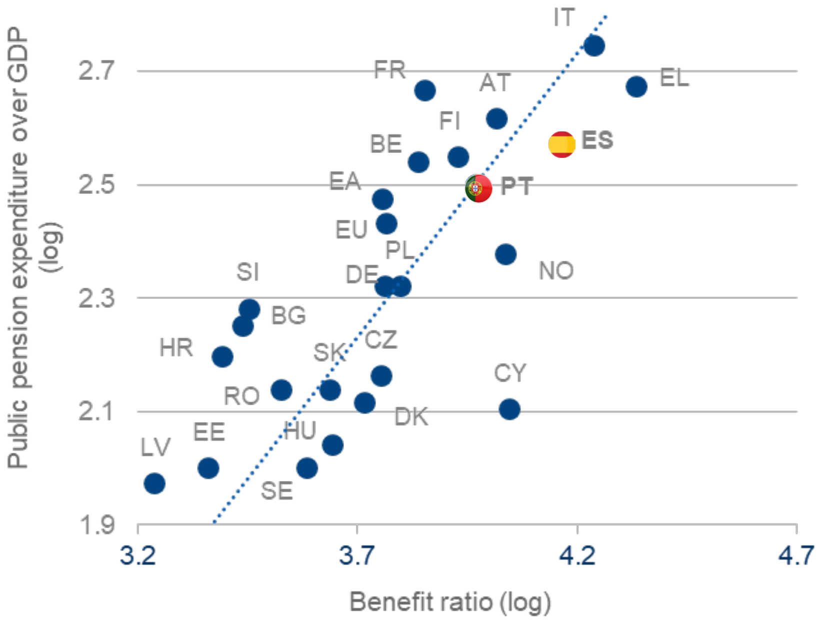
The slope of the straight line imposes a unitary elasticity
Source: BBVA Research based on Comisión Europea (2024).

- The coverage rate (pensions/population 65+) explains 2% of the differences in pension spending over GDP between the EU countries.
- Countries like Greece, Italy, Portugal or Spain have a coverage rate below the EU average, but with much higher spending on pensions as a percentage of GDP.

What factors determine pension spending as a percentage of GDP?

3. The benefit ratio

BENEFIT RATIO AND PENSION EXPENDITURE OVER GDP, EU, 2022



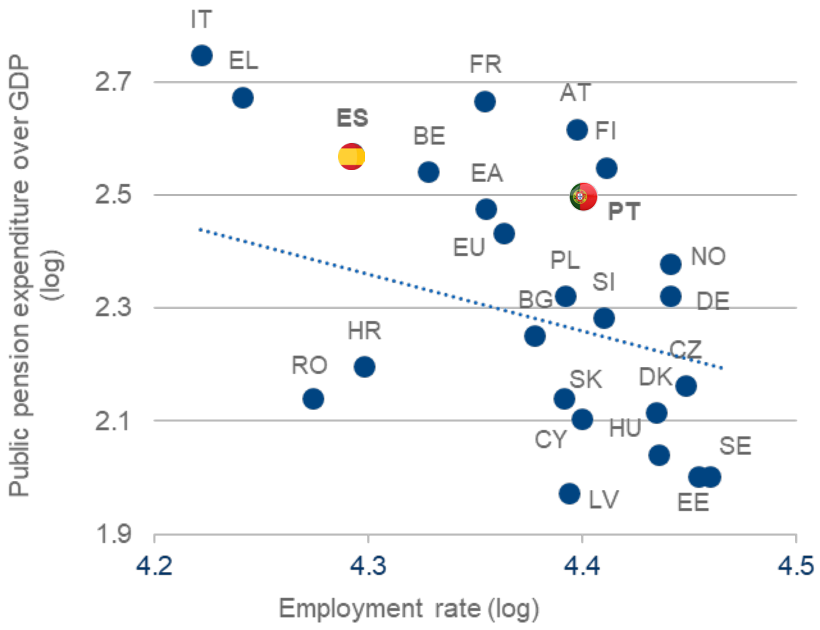
The slope of the straight line imposes a unitary elasticity
Source: BBVA Research based on Comisión Europea (2024).

- The benefit ratio (average pension over GDP per employee) explains 35% of the differences in pension spending over GDP.
- The countries with the highest Benefit ratio in Europe are Greece (74,4%), Italy (69,3%) and Spain (64,1%) … with a significant sustainability challenge. In Portugal is 52,9%.
- Differences in the benefit ratio reflect heterogeneity in the design of public pension systems and differences in productivity growth.

What factors determine pension spending as a percentage of GDP?

4. The employment rate

RATE OF EMPLOYMENT AND PENSION EXPENDITURE OVER GDP, EU, 2022

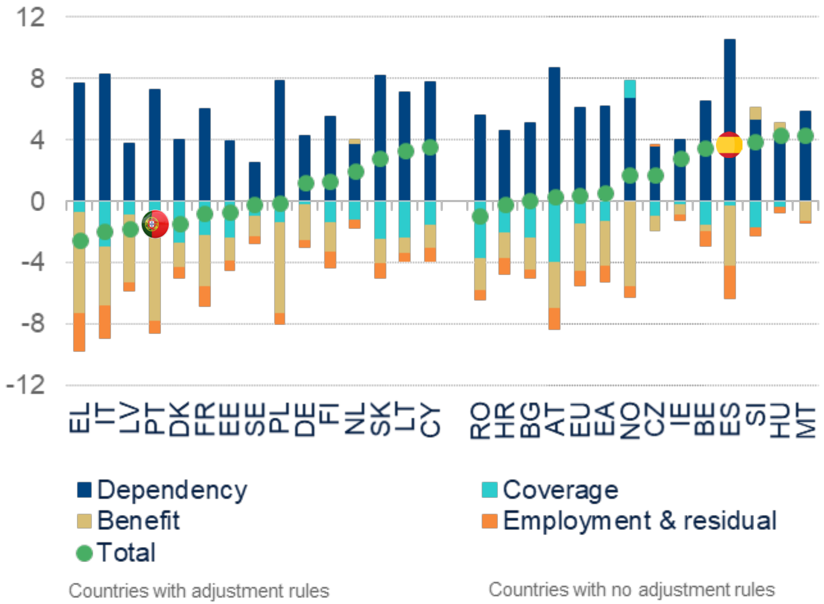


The regression line imposes unit elasticity with negative sign.
Source: BBVA Research based on [Comisión Europea (2021)](#).

- The employment rate (employment over the population between 20 and 64 years of age) is the second most important determinant: it explains 38% of the differences in pension spending over GDP.
- Differences of more than 20 points are observed in employment rates, from 66% in Greece to 82% in Sweden.
- An increase of 13 points in the employment rate in Spain, to reach the level of Sweden, would reduce spending on pensions as a percentage of GDP by almost 2 percentage points.

The increase in pension spending by 2070

INCREASE IN PENSION EXPENDITURE FROM 2022 TO 2070, AS A PERCENTAGE OF GDP



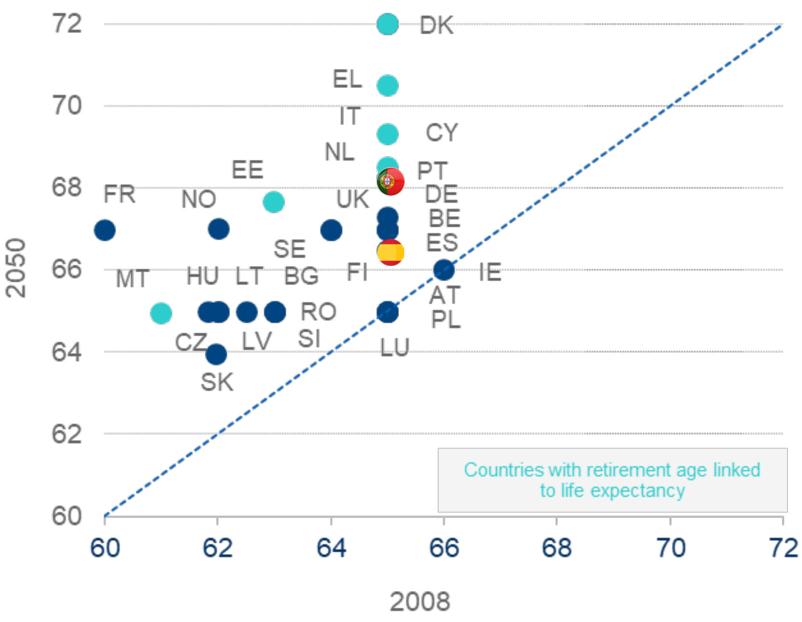
- Projections suggest that pension spending as a percentage of GDP will increase in Spain and fall in Portugal in the coming decades.
- Devesa and Doménech (2023): greater increase in countries without automatic adjustment mechanisms.
- The increase due to the dependency ratio is partially offset by the reduction in the benefit rate, the coverage rate, and the increase in the employment rate.
- Spain: revocation of the IRP and the FS increases pension spending by more than 3.5 pp.

Source: BBVA Research based on Comisión Europea (2024) and Devesa and Doménech (2023).

Measures in favour of the sustainability of the public system

1. Increase in retirement age

PLANNED INCREASE IN THE STATUTORY RETIREMENT AGE, 2008 TO 2050



Source: BBVA Research based on Fouejieu et al (2021), and Comisión Europea (2021) (2009, 2021).

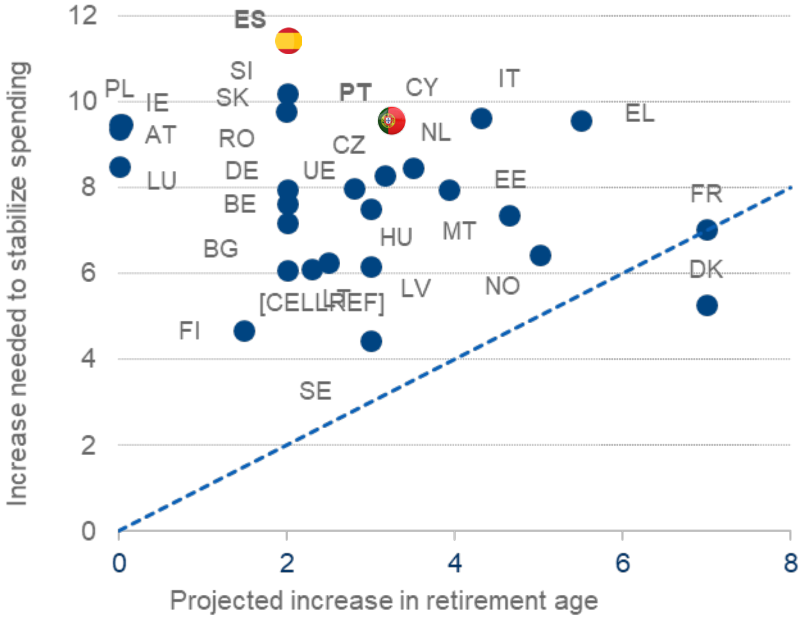
- In the last two decades, European countries have undertaken reforms to gradually increase the retirement age until 2050, especially in those that link it to life expectancy.
- Denmark plans to raise the statutory retirement age to 72 by 2050.
- This can be (depending on its design) one of the most effective measures to ensure sustainability...

... But the planned increases are generally not sufficient, without other measures.

Measures to promote the sustainability of the public system

1. Raising the retirement age

PROJECTED INCREASE IN THE STATUTORY RETIREMENT AGE COMPARED TO THAT NEEDED TO MAINTAIN THE DEPENDENCY RATIO, 2015-2050



Source: BBVA Research based on a [Boulhol y Geppert (2018)]() and [Comisión Europea (2021)]().

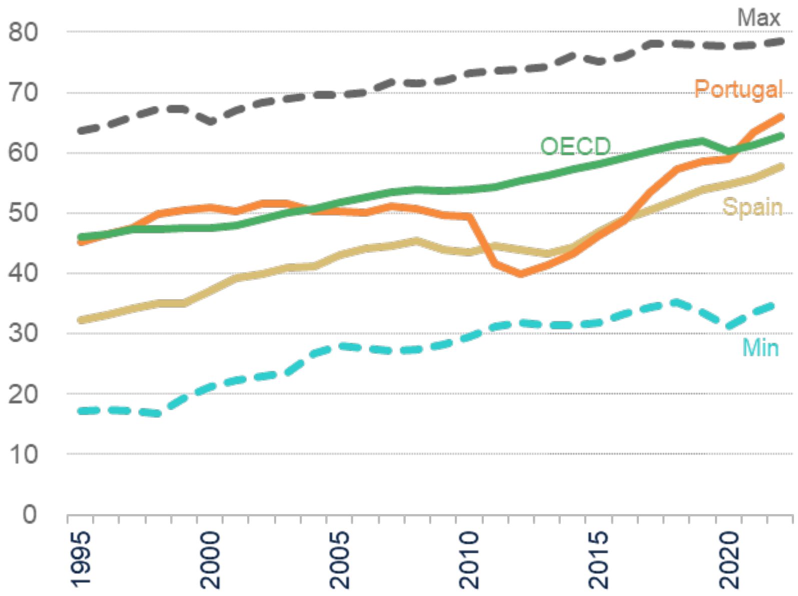
- Despite the measures taken, the planned increase in the retirement age will generally be insufficient to contain the increase in the dependency ratio.
- Only in France and Denmark does the planned increase coincide with the necessary increase.
- At the other extreme, in Spain, Poland, Ireland or Austria, the difference between the planned increase in the retirement age with that needed to maintain the dependency ratio is, on average, 9 years lower.

Measures to promote the sustainability of the public system

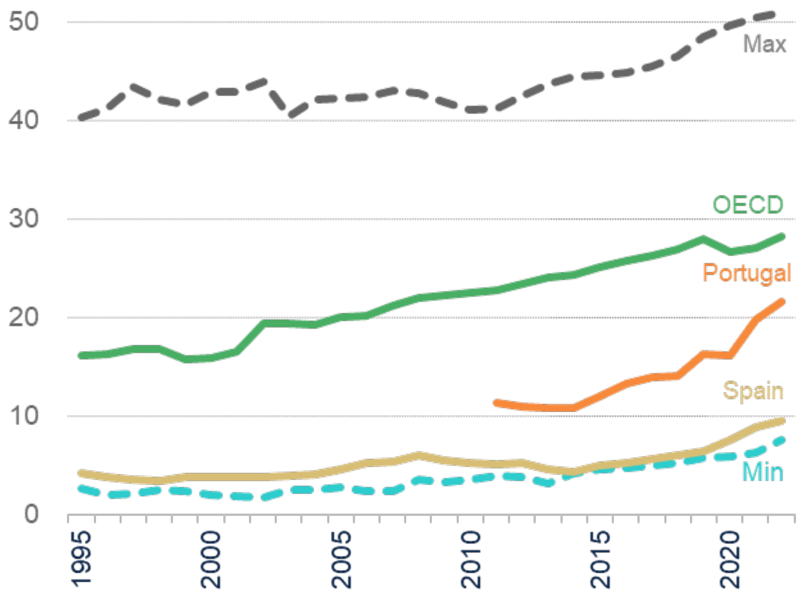
2. Measures to encourage longer working lives

EMPLOYMENT RATE, 1995-2022 (%)

POPULATION BETWEEN 55 AND 64 YEARS OLD



POPULATION BETWEEN 65 AND 69 YEARS OLD

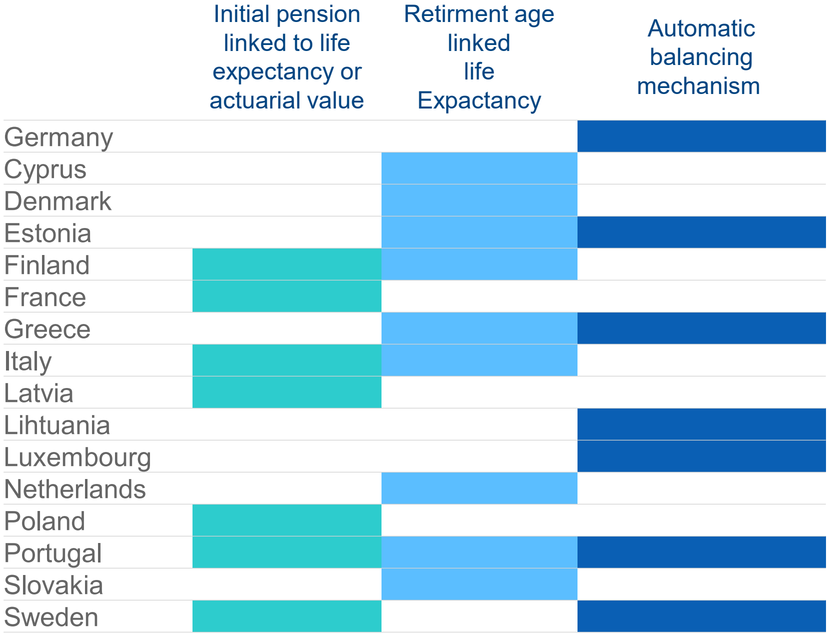


* Excluding Iceland.
Source: BBVA Research based on OECD. See [Arellano, Doménech and García (2022)]

Measures to promote the sustainability of the public system

3. Application of automatic adjustment mechanisms

AUTOMATIC ADJUSTMENT MECHANISMS AND SUSTAINABILITY FACTORS LINKED TO LIFE EXPECTANCY



Source: BBVA Research based on Devesa and Doménech (2022).

- Half of the countries in the EU use one or more adjustment mechanisms that:
  - They link the initial pension to life expectancy or the current value of a life annuity.
  - They link the retirement age to life expectancy.
  - Pensions are revalued based on demographics or economic variables.

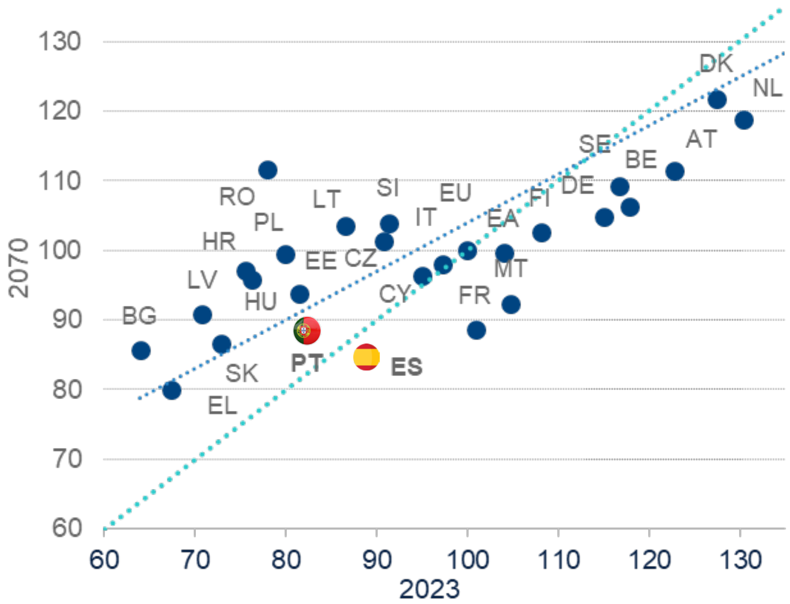
- In Spain, the Sustainability Factor (which adjusted the initial pension for differences in life expectancy between generations, at constant retirement age) has been replaced by the MEI, which increases social contributions.

Measures to promote the sustainability of the public system

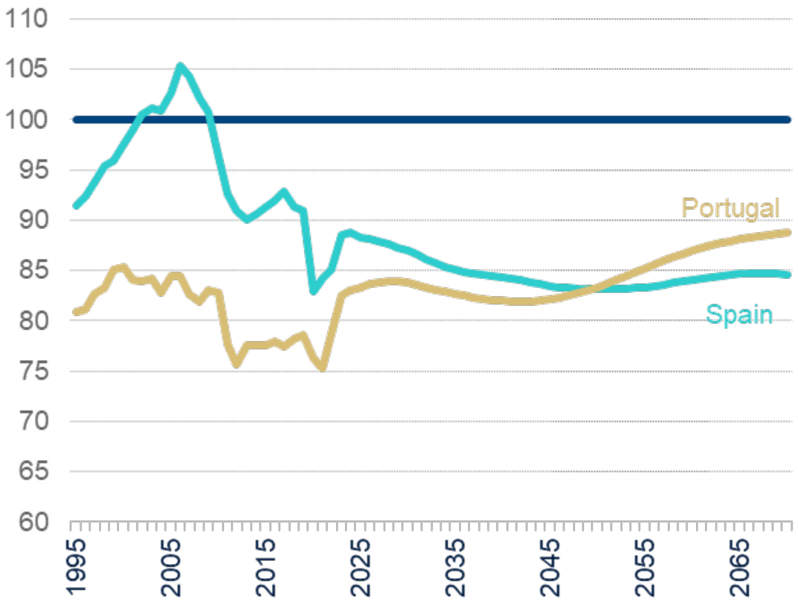
4. Structural reforms to increase the employment rate and productivity

GDP PER CAPITA, 1995-2070 (%)

2070 vs 2023



1995 TO 2070



Source: BBVA Research based on AMECO database (HVGDPR) and Ageing Report 2024.

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