# Letter from the Editors

With lockdown measures having eased, the Spanish economy is beginning to show signs of incipient recovery. Activity levels hit bottom in April and began to recover in May, a process which gathered pace in June, as the 'easing' measures accelerated. Recovery is expected to continue into 2021, albeit not reaching pre-pandemic levels; however, current forecasts remain subject to an unusually high degree of uncertainty, not only because of the possibility of a second wave requiring new restrictions, but also regarding the behaviour of certain key macroeconomic variables, such as the savings rate and international tourism. Given the impact of COVID-19 on the Spanish economy and the country's fiscal constraints, the ability to access the EU Recovery Plan will be critical to Spain's recovery, alongside tapping already available EU-level emergency programs.

Within this context, the July issue of *Spanish and International Economic and Financial Outlook (SEFO)* first assesses the EU-level response to COVID-19, as well as how the pandemic has impacted the Spanish economy overall, as well as the impact across the key sectors of the economy.

OECD forecasts indicate that Spain is one of the countries most impacted by COVID-19. However, its fiscal stimulus measures are small in comparison with other countries, such as the UK and Germany. For this reason, Spain's recovery will rely heavily on support from EU funds. Given the time-sensitive nature of responding to the pandemic's economic consequences and the schedule of European Recovery Plan payments, it is essential that Spain accesses other EU funding initiatives. The Spanish government has already expressed its desire to use the SURE scheme, which will be available until the end of 2022, and may also use the ESM credit line, which would provide Spain with 10-year financing on more attractive terms than those offered by the financial markets. However, the ability to tap these EU initiatives will depend on Spain's capacity to demonstrate the allocation of funds to support the EU's twin green and digital transition objectives.

COVID-19 is forecast to have contributed to an 18% quarter-on-quarter decline in GDP in 2Q2020. While lockdown measures have eased, the economy is not expected to reach pre-pandemic levels until at least 2023. From a sectoral perspective, the automotive industry was particularly hard hit, with a contraction of nearly 90% in April and May. Likewise, the services sector's turnover index in April declined by 42%. However, job losses in the construction sector exceeded those of the services industry. International trade has been strongly affected, too. April figures show exports declined by 32% in real terms compared with February, and imports dropped by 29%. COVID-19 also contributed to a significant expansion of government debt by more than 24 billion euros in 1Q2020. While the Spanish economy should experience a rebound in 3Q2020, it will not make up for the ground lost during the state of emergency. In general, projections are subject to significant uncertainty due to potential new outbreaks, the increase in savings rates, and the fate of furloughed workers once the employment support scheme expires.

As regards the Spanish financial system, the COVID-19 pandemic has disrupted Spain's credit markets and payments methods. In regard to the former, it has triggered the need for financial aid programmes, including state guarantees of business loans. Notably, the volume of outstanding business loans in Spain, which had registered year-on-year growth of 1% in January and 0.4% in February, accelerated to 1.1% in March and to 3.1% in April. As for origination, while new loans amounted to 55.12 billion euros in January and February, the aggregate amount for March and April rose to 89.91 billion euros, providing a glimpse of the extra effort made by Spain's banks to extend financing during the pandemic. Turning to payments, ATM cash withdrawals contracted by 9.3% year on-year in April, having registered growth of 0.3% in 2019. Meanwhile, point-of-sale card payments, which had sustained growth of 9.4% in 2019, increased by a much lower 2.3% in the first quarter of 2020. That said, this does not foretell the death of cash, with certain segments of the Spanish economy still displaying strong preferences for this form of payment.

Relatedly, as is the case with equities across a broad range of sectors, bank stocks have also been disrupted. COVID-19 issued a substantial blow to banks' share prices across the globe but especially in Europe. Notably, this occurred in the context of a three-year-long sector valuation slump despite an improvement in banks' capital and liquidity levels. Analysis of banks' equity prices and COVID-19 incidents shows the intensity of the equity market contractions sustained by the national banking systems is somewhat correlated with the incidence of the pandemic. Looking more deeply at the impact, data show these market corrections have sharply eroded banks' price-to-book ratios. However, the industry has broadly seen a recovery since the lows of March, due to fiscal and monetary stimulus, the possibility of a vaccine, and effectiveness of lockdown measurements. Interestingly, those banks that have made the greatest loss provisions have also been the institutions to perform most strongly during the recovery.

The next section of the July *SEFO* provides an analysis of various key sectors of the Spanish economy, and their recent performance/resilience both in the face of COVID-19 as well as more broadly in the context of addressing existing challenges. We start off by examining trends in the services sector, in particular, the tourism sector, among the most crucial to Spain's GDP. We then look at the manufacturing sector more generally, to be followed by a more in-depth analysis of Spain's performance in high-tech exports, as well as within the automotive industry.

COVID-19 resulted in a sudden interruption in global tourism after years of sustained growth. In Spain, the tourism sector accounted for 12.3% of GDP and 12.7% of employment in 2018. Both the European Commission and Spanish government have unveiled plans to support the tourism sector. Taking into account the furlough scheme and business stoppage benefits, the state guarantee lines, and the deferral of taxes, the government estimates it has earmarked 19.54 billion euros to the tourism sector. Nevertheless, some sector representatives have argued that these funds are moderate in size compared with the losses the sector faces in 2020. Specifically, tourism export receipts could fall to around 33.6 billion euros, representing more than a 50% decline from 2019. While a diversion of residents' expenditure abroad could cushion the pandemic's impact on the tourism sector's GDP and on the balance of payments in 2020, the forecast for 2021 is less optimistic. As oil prices rebound and a rise in internal demand leads to an increase in imports, the strong current account dynamics observed since 2013 may weaken.

COVID-19 has unleashed a massive shock on Spain's industrial sector before it had achieved the production levels of 2008, prior to the Great Recession. The impact of the pandemic on the manufacturing sector is the result of a dual supply and demand shock. The direct contraction in the manufacturing industry's GVA is estimated at 11.1%, solely due to transport and electrical equipment. This figure rises to 24.2% when the knock-on effect on the rest of the economy's sectors is considered. Spanish manufacturers are particularly sensitive to foreign demand considering that 40% of their output is exported, which means the anticipated drop in world exports could have a major impact on industry.

While data show that the competitiveness of the Spanish manufacturing industry is relatively strong, productivity is lower than that of Germany, Italy and France. This underperformance is attributable to human and technological capital, two factors which Spanish companies include on their balance sheets under intangible assets. These challenges could be more surmountable through the adoption of more robust technology and industrial policy coordinated by the Spanish government in concert with private industry.

The COVID-19 crisis highlights the importance of a robust science and technology base in a country. One way of measuring this is by analysing exports of high-tech products. Looking at export intensity of high-tech products, Spain ranks 25th out of the 27 EU member states and in terms of net trade, it is the country with the highest deficit in this product category among the four major EU economies. From 2008 to 2013, high-tech imports fell by close to 30% (in a context of rising exports). However, between 2013 until 2018, this category of imports increased by 45%, pointing to certain shortcomings in the national high-tech product manufacturing sector. While it is tempting to draw a connection between investment in R&D and export intensity in high-tech products, data analysis indicates there is no linear relationship between the two variables. Unsurprisingly, Spain trades more with its EU than its non-EU partners. By sector, Spanish high-tech exports are dominated by the aerospace and chemistry industries, while electronics and telecommunications dominate on the import side. Given the importance of high-tech exports for national science and knowledge, it is crucial that Spain improves these indicators.

The Spanish automotive sector is a key part of the country's industrial sector, accounting for 9% of GDP and nearly 8% of employment. Notably, export growth between 2013 to 2019 was equivalent to a constant annual rate of 2.6%, just shy of growth in Germany (2.9%) but ahead of Italy (2.4%) and France, where annual average growth in exports has been just 0.5%. However, export growth has been slowing, a concern given that historically eight out of every ten vehicles produced in Spain are exported. This slowdown in exports has also occurred in countries, such as Germany, Italy and France, leading to a deterioration of trade balances in the automotive sector. Unfortunately, the arrival of COVID-19 interrupted a recovery in car exports, leading to an annual export contraction of 87.9% in April. That said, there are longer term challenges other than COVID-19 that threaten the future growth of the industry, including significant competition from abroad, slower growth in new car registrations in Europe, and uncertainty regarding the cleanest alternative technology for cars. The latter is of particular importance and will call for the design of transitional measures that address the reorganisation of the production of diesel cars, which, in any case, are less environmentally harmful than previous diesel models.