Letter from the Editors

The COVID-19 pandemic has been a tremendous hit for the Spanish economy, essentially eliminating prospects of economic growth in 2020 and generating a severe financing gap in the public accounts. The OECD and the IMF have both recently warned that Spain will be among the economies hardest hit by the pandemic – in terms of growth, but also in terms of deficit and debt. Within this context, the September issue of *Spanish and International Economic & Financial Outlook (SEFO)* takes a snapshot of the current situation and provides perspectives on the evolution of Spain's economy, financial sector, and public finances.

We first present our latest set of forecasts for the Spanish economy, revised downwards substantially since July, largely a result of the surge in case numbers and the dissuasive effect it has had on foreign tourist arrivals. According to provisional data, Spanish GDP fell by 18.5% in the second quarter. Even after taking into consideration the weight of vulnerable sectors, such as tourism, Spain's contraction would still exceed that of Germany's. Looking forward, the economic recovery will be both unequal and surrounded by uncertainty. Assuming controlled growth in COVID-19 cases, an avoidance of lockdown, as well as the prolongation of expansionary macroeconomic policies, GDP is expected to contract by 13% in 2020, which is 3.2 percentage points below the last set of forecasts. Although GDP is forecast to grow by 7.9% in 2021, the economy will not fully recover to pre-COVID GDP levels until at least 2023. The ongoing crisis will adversely impact the number of hours worked, but the furlough scheme and redistribution of work will cushion the blow in terms of jobs. Significantly, Spain could receive almost 140 billion euros from the European recovery fund. However, the impact of these funds will depend largely on reforms in areas such as the labour market, education, the digital and energy transition, and in general measures that help close Spain's productivity gap with the EU. Moreover, there are upside and downside risks that could either support or undermine Spain's recovery, such as the rollout of a vaccine or a rise in NPLs that could reduce banks' lending capacities.

Relatedly, we assess the recent performance of two important sectors of the Spanish economy – real estate and exports. The health crisis is affecting the real estate sector, albeit moderately considering the scale of the economic shock. According to the most recent data available at the time of writing this article, home purchases are 33% below pre-COVID levels. Prices have also been affected, falling by close to 1.2% in August. Nevertheless, all signs suggest that unless the economy is once again locked down in response to the second wave of contagions, the market is not on the verge of collapse. Demand is being underpinned by current and anticipated low interest rates and the scarcity of attractive investment alternatives for buyers. Another factor pointing to a limited correction in prices in Spain is their relatively low level by comparison with other European countries and the rest of the world. In 2020 as a whole, average prices are expected to contract by between 5% and 8% (considerably

less than the contraction anticipated for the overall economy - 13%), going on to stabilise in the first half of 2021 and start to recover thereafter. The trend is, however, likely to be uneven across regions and types of property.

Next, we assess the performance of Spanish exports in the context of the pandemic, and on a comparative basis with the last financial crisis. Export markets have been hit hard by COVID-19, which necessitated lockdown measures across numerous countries. In this context, it is useful to analyse the specific effects on Spain's export industry and compare them to those experienced in the financial crisis, or Great Recession. From March through June 2020, total exports as well as the number of exporting firms fell. However, closer analysis shows that while the collapse in Spanish exports was widespread, it was primarily driven by a drop in the value of goods exported by Spain's most active exporters. This group includes the nearly 27,000 firms that exported in any of the 12 months prior to both the lockdown and financial crisis. Notably, in both periods, the intensive margin explains more of the contraction in exports, though it is slightly less significant in explaining the lockdown contraction (91% during the lockdown *vs*. 100% during the financial crisis). During the lockdown, product and destination mixes were hurt more and there has been a higher number of exiting firms than during the financial crisis. This suggests Spain will experience a tougher recovery this time relative to that observed in the wake of the previous crisis, if the current health crisis causes a prolonged period of uncertainty.

The September issue of *SEFO* then highlights key developments within the financial sector and perspectives for the fall. While COVID-19 spurred the Fed's decision to adopt an average inflation targeting regime, the ECB is more constrained in the way it can support the emergence of dynamic business growth. That said, it did launch the 1.35 trillion-euro Pandemic Emergency Purchase Programme (PEPP) and has extended its targeted long-term refinancing operations (TLTROs). This lax monetary environment enabled the Spanish banks to increase their use of the ECB's long-term financing facilities by 113.66 billion euros between March and July. In parallel, under specific schemes, such as the state-backed guarantees for business loans, corporate financing increased from a year-on-year rate of 1.1% in March to 6.1% in June. One of the most complex issues facing Spain is how long its extraordinary financing flows should continue so as not to significantly impair overall asset quality. Although non-performance has held steady at around 4.7%, this metric is expected to deteriorate throughout the rest of 2020 and much of 2021, with the magnitude of the rise in NPLs dependent on the continuation of the furlough scheme, speed of the economic recovery, and lingering uncertainty regarding COVID-19. Nevertheless, the crisis could prove an opportunity for Spain if public and financial intervention results in higher levels of business dynamism.

Taking into account the already challenging operating climate for the banks, as well as the high degree of uncertainty generated by COVID-19, we analyse the existing issues surrounding the EBA's stress tests, taking into considerations lessons learned from the recent US experience, as well as methodological challenges that need to be addressed. The COVID-19 crisis has emerged as a critical event that affects all aspects of bank management and supervision, including the design and execution of the stress tests — a key oversight tool with a forward-looking approach. In March, the EBA postponed the biennial stress tests originally scheduled for 2020 due to the banks' operational challenges brought on by the pandemic. Notably, this decision took place in the context of a growing debate regarding the EBA's stress testing methodology, especially in light of the failure of two banks in Italy and one in Spain. Unlike the EBA, the Fed went ahead with its stress tests, layering in sensitivity analyses designed to model the various economic scenarios the pandemic could leave in its wake, providing potential insight into how the EBA could improve its 2021 stress tests. The EBA could also adopt a \`top down´ approach like the Fed, instead of its 'bottom up' method, which makes it harder to discriminate between healthy and weak entities. Whatever the outcome, the stress tests' impact on the alignment of capital with the risk assumed by the banks has been critical and the continuity of the tests must be assured in the medium- and long-term.

Lastly, for the financial sector, this *SEFO* focuses on the particularly acute issue of household

resilience to the economic impact of COVID-19. At first glance, it appears Spain entered the COVID-19 crisis in a relatively good position. The household leverage rate had fallen below the eurozone average, reducing the amount of income Spanish households earmarked for debt service payments from 11.7% of their disposable income in 2008 to 6.1% at the end of 2019. Yet, 33.9% of Spanish households would be unable to deal with an unexpected expense of only 700 euros, which is higher than the EU-27 average. When analysed based on metrics such as age, gender, household composition, and geography, it becomes clear that there are certain groups particularly vulnerable to the economic effects of COVID-19. For example, among those with a lower secondary education, 47.8% of individuals would be unable to deal with an unexpected expense. Similarly, 53.7% of households headed by a single adult and 46% of households composed of a single woman would struggle. Notably, those aged between 16 and 24 present the highest percentage of an inability to deal with an unexpected expense, while 31.7% of this group are 'at risk of poverty or social exclusion', 6.4 percentage points above the overall average. For these reasons, targeted government measures that rely on intergenerational generosity would be required to successfully exit this crisis.

The next two *SEFO* articles drill down on fiscal issues. First, we assess the impact of the pandemic on public finances. COVID-19 has upended the government's spring forecasts, which included a projected deficit of 10.3% of GDP in 2020. The sharp economic contraction sustained in the second quarter, coupled with the spike in social spending and the automatic drop in tax revenue, have placed significant burdens on the government's finances and necessitated several downward revisions of spring forecasts. The most recent forecasts available, which date to September, fall within a very wide band, ranging from a contraction of 9% to one of 14%. Although Spain is set to receive the equivalent of 11% of its GDP from the EU recovery fund, the first round of transfers in 1Q2021 will support structural reforms instead of stimulating the economy in the short-term. Worryingly, the AIReF estimates that it could take Spain until at least 2050 to bring public debt below 60% of GDP. In order to improve its debt sustainability outlook, Spain will need to enact necessary reforms, such as lowering corporate and personal income tax rates, as well as recalibrating the tax basket to lean more heavily on consumption. The overarching goal must be to preserve the economy's productive fabric and lock in greater tax revenue over the long-term.

We conclude with a broader assessment and state of play of one of the government's recently proposed tax measures – the financial transaction tax (FTT). The notion of a financial transaction tax gained popularity in the aftermath of the 2008 crisis as a way of curtailing excessive risk and financial market volatility. Such a tax targets transactions involved in the trading of several types of securities. Interestingly, the idea first appeared during the Great Depression in the work published by J. M. Keynes, and subsequently in the form of the so-called 'Tobin Tax', theorized by James Tobin in 1978. In 2011, the European Commission promoted the adoption of an EU-wide FTT. However, the proposal has attracted numerous criticisms relating to its unintended consequences on transaction volumes and market liquidity, the role of normal hedging activities, and the potential impact on the cost of capital. In the absence of a unilateral agreement across Member States, Spain has sent a draft law for an FTT to Parliament in February. The Spanish FTT proposal would impose a 0.2% tax rate on transactions that covers securities issued by around 60 Spanish firms. However, to be successful, this initiative requires the voluntary cooperation of international parties and other countries. Moreover, as currently conceived, the Spanish FTT would impose a greater tax burden on the financial sector, which already pays a higher tax rate than the corporate sector. For all these reasons, if an FTT is to eventually be enacted, an EU-level FTT would be preferable to those enacted unilaterally by EU Members States.