Letter from the Editors

Progress on the vaccination front, albeit highly uneven, has ushered in a change in global economic momentum that is already being foreshadowed by economic indicators. This wave of growth is reaching Europe and should be supported further by the upcoming disbursement of Next Generation EU funds. Economic indicators in Spain too are sending broadly positive signals, pointing to a recovery. Within this context, the publication of the May issue of *Spanish and International Economic & Financial Outlook (SEFO)* is marked by a more constructive backdrop.

As Spain heads into the second stage of the COVID-19 crisis, the recovery phase, this issue of *SEFO* takes a look at the asymmetrical impact of the crisis on Spain's business fabric, both in broad terms and for specific industry segments.

To frame our analysis, we start out this issue of *SEFO* by assessing the impact of the pandemic on households and corporates. Although the impact of COVID-19 on the Spanish economy was substantial, the extent to which it hit the household and corporate sectors' finances differed in several notable ways. Thanks to generous government protection measures, such as the furlough and income support schemes, households' gross disposable income (GDI) declined by just 3.3% in 2020, which is considerably lower than the contraction in GDP. Notably, Spain's household savings rate shot up to 14.7% of GDI in 2020 from 6.3% in 2019. That said, it is possible the drop in income was concentrated in low-income households, while the growth in savings occurred primarily in medium- and high-income households, which could have consequences for post-pandemic consumption and savings trends. Meanwhile, gross operating profit of the non-financial corporate sector declined by 18% in 2020 with the sector's net lending position deteriorating to 2.4% of GDP. This has contributed to a fall in the number of businesses operating in Spain. While the recently announced government support measures directed towards the business community were a welcome development, these data suggest that additional measures are needed in order to prevent even greater structural damage. That said, the increase in public indebtedness could leave the economy more vulnerable when the ECB eventually winds down asset purchases.

We then focus on Spain's business demographics as a consequence of the pandemic. Specifically, this *SEFO* places particular emphasis on the performance of the manufacturing sector – a sector that seems to have demonstrated resilience in the face of the COVID-19 crisis in terms of output, but may face a mixed outlook going forward, given the contraction in new businesses created and some deterioration in employment trends.

Although previous crises have had adverse effects on business volume indicators and corporate dynamism, the extent to which COVID-19 has impacted Spanish businesses is unprecedented. For example, business turnover in the first few months of the pandemic contracted by nearly twice as much as during the financial crisis. In terms of corporate dynamism, there was an average year-on-year reduction in the number of net new businesses of 72% in April 2020. However, closer analysis reveals that some sectors have been hit harder than others, with the subsequent recovery speeds also differing across industries. While the manufacturing industry contracted for 15 consecutive months during the financial crisis, it has sustained a relatively rapid recovery in turnover during the COVID-19 crisis. Conversely, turnover in the retail sector remains 10% below pre-crisis levels. Although it is difficult to be more precise, evidence suggests that the positive performance within the retail sector comes from the sale of food and everyday products, while the rest of the retail sector is still struggling with uncertainty and difficulties. That said, manufacturing fared less well in terms of business dynamism, where the number of net new businesses contracted by 20%, slightly less than the 22% registered by the hospitality sector (accommodation and food service activities). These data highlight the need to design economic support measures in accordance with each sector's trajectory, reality and reasonable outlook.

While Spain's GDP contracted by more than the other core EU countries in 2020, its manufacturing sector has proved surprisingly resilient. At 10.8%, the Spanish manufacturing sector's GVA posted the smallest contraction, with Germany's manufacturing GVA plunging by 11.3%, more than double its fall in GDP. Admittedly, part of this is explainable by the fact that tourism, a key sector for Spain, collapsed in 2020, weighing heavily on GDP. Also relevant is the fact that Spain entered the crisis after several years of stronger growth in output in the manufacturing sector compared to Germany, France and Italy. Notably, the recovery in Spanish manufacturing took longer to emerge due to the prolongation of lockdown measures compared with peer countries. However, by December 2020, Spanish manufacturing production was down just 2% year-on-year. In terms of manufacturing employment trends, Spanish firms had a strong record of job creation going into the crisis. However, by the second quarter of 2020, the number of hours worked in the manufacturing industry had fallen significantly, with job losses rising incrementally despite the temporary job protection scheme.

Apart from assessing the performance of Spain businesses to date, we look ahead at the outlook for business creation in Spain, taking into account the relevant policy considerations necessary to underpin a constructive environment. The Ministry of Economic Affairs and Digital Transformation has published a document titled "Measures for Fostering Business Creation and Growth" that argues in favour of increasing the average size of Spain's enterprises to close the productivity gap. But many studies show that it is not company size that determines productivity levels but productivity that determines size and that the breakdown of a country's enterprises by size segments is the result of market discipline, competition and management practices. Although the government argues that the minimum capital required for setting up an LLC is an impediment to business creation, reducing this amount could send a misleading message to start ups about the real financial needs of going into business. More attention should also be paid to the employer and management training market in Spain and the gap in formal education between the two. In terms of regulations relating to enterprise size thresholds, it may be necessary to review these but such a review should be approached from a broad perspective that takes general interest goals into account. Lastly, business creation policy underestimated the internal costs of growth. As a first step in taking them into consideration, the government could benefit from commissioning a white book on management practices in Spain.

The next section of the May *SEFO* shifts the attention back to the financial system. First, we analyse the performance of European bank stocks throughout the pandemic. As well, we look at the impact of the health crisis on payments trends in Spain. European and Spanish banks' share prices took a significant hit during the peak of the COVID-19 crisis. Measured using price-to-book value, Spanish and European banks were trading at a low of 0.3x (*i.e.* at a discount to their book value of 70%) in 2020. At the start of the crisis, some bank stocks lost more than 50% of their value, compared to average index correction of 20-25%. However, towards the end of 2020 and beginning of 2021, banks have been one of the best-performing sectors, significantly outperforming the broader indices. Although both European and Spanish banks' share prices have rebounded, the recovery has been more intense for the Spanish banking sector. These strong recoveries are due to monetary and fiscal measures as well as a rebound in M&A activity and progress on the vaccination front. Banks' shares also received a significant boost from the sizeable upward shift in rate curves. Notably, the experience of banks' CoCo bonds has highlighted the asymmetric nature of these instruments. Their prices contracted by less than ordinary bank shares yet went on to rebound more strongly.

COVID-19 has accelerated shifts in social and economic patterns that predate the crisis, including those in the retail payments sphere. Last year, there were 4.7 billion card transactions at the point of sale (PoS), up 4.4% from 2019. This is despite the overall drop in the volume of transactions due to strict lockdowns and social distancing requirements. Although the growth rate in card payments is lower than seen in previous years, the contraction in cash sales was considerably more pronounced in 2020. Evidence also shows an increased willingness of consumers to use alternative digital payment options. For example, the percentage of the population that made a payment from their mobile handset increased from 55.66% before the pandemic to 63.22 % during the final months of 2020. Meanwhile, the percentage of the population using P2P applications to transfer money increased from 62.79% to 75.26% over the same timeframe. Looking forward, QR codes and biometric payments are expected to grow in popularity due to their user-friendliness, security and speed. Nevertheless, it will not be possible to determine the extent of the shift in consumer preferences for payment technologies until some degree of normality returns.

Finally, we close the issue with an assessment of the health of public balances, as well as present the latest forecasts as regards the evolution of Spain's deficit and debt figures. Spain reported a public deficit of 10.1% of GDP in 2020, which ultimately rose to 11.0% following the assumption of the reclassified deficit of the SAREB, or Spain's so-called bad bank. Much of this was concentrated in the central government, whose deficit came in 0.89 percentage points of GDP higher than initially forecast due in large part to transfers made to sub-central governments. The deficit is the result of two primary factors: an increase in spending and a fall in revenue. Specifically, spending rose to finance furlough schemes, healthcare expenses and income support for the self-employed. While personal income tax receipts rose in 2020, VAT and corporate tax receipts plummeted. The 2021 General State Budget includes a deficit of 8.4% of GDP in 2021. Upward pressure on the deficit could come from solvency support for the corporate sector and the rollover of fiscal and bankruptcy protection. Downward pressure on the deficit could arise from a positive trend in corporate income tax, VAT revenue and the gradual withdrawal of the measures passed in 2020 to mitigate the effects of the pandemic. However, the uncertainty regarding the economy and, particularly, the absence of a medium-term consolidation plan, raises considerable doubts about the forecast trajectory in public debt over the coming years.