Letter from the Editors

As the pandemic drags on, the spike in inflation has emerged as one of the key threats facing not only the Spanish, but also the global economy. Inflation is running the highest it has this century, prompting decoupling across monetary authorities in the US and Europe. Geopolitical factors, including the Russia-Ukraine conflict, together with the emergence of new variants and their potential to exacerbate business restrictions and spark fresh supply chain disruptions, remain legitimate downside risks.

Within this uncertain context, the January issue of *Spanish and International Economic & Financial Outlook (SEFO)* starts off with an analysis of the performance of the Spanish economy after two years of pandemic. The economy is expected to have grown by 5.1% in 2021, lower than initial expectations. The shortfall is stemming mainly from a weaker than projected recovery in consumption –as higher prices eroded purchasing power– and adverse investment trends in construction, together with a slower than anticipated execution of NGEU funds. In general, rising inflation has become one of the main threats facing the Spanish economy. The emergence of bottlenecks in 2021 drove production costs higher, curbing the rebound in economic activity. Going forward, although the reconfiguration of global supply chains should offset price increases, other inflationary pressures could last throughout the projection horizon. Of particular concern are developments in the energy markets as well as second-round effects. Our central scenario is still for strong GDP growth of 5.6% in 2022, fuelled primarily by both domestic demand, notably investment in construction and capital goods, and favourable export performance. Although this rebound is likely to lose momentum in 2023, growth is still forecast to reach 3.5%, which would put GDP back at pre-pandemic levels by the first quarter of that year. That said, this scenario rests on the evolution of inflation trends. Indeed, higher than projected prices would have a significant negative effect on real incomes and the strength of the recovery.

We then look more broadly at the European response to the pandemic crisis and the outstanding challenges faced by policy coordination in an uncharted economic context. European policymakers learned important lessons about the need for monetary and fiscal policy coordination from the Global Financial Crisis, which they applied at the start of the pandemic. The resulting recovery has been faster than expected, despite successive waves of variants. However, learning these policy lessons has not eliminated the many barriers to policy coordination, especially when there is disagreement among policymakers over macroeconomic performance, assignment of policy instruments to economic targets and concerns about policy interaction.

Unfortunately, the pandemic economic recovery has fostered such a context, as have efforts to respond to demographic change, global warming and digital innovation. Under this scenario, successful policy coordination will require both careful analysis of what is clearly an unfamiliar economic situation and strong political agreement on what European policymakers should do about it.

This issue of *SEFO* then assesses the outlook for monetary policy in 2022 and the resultant considerations for the Spanish banking sector. Monetary decoupling is already here in 2022. The Federal Reserve has set an end date for its asset purchase programme –the end of March– and signalled that rate hikes over the course of the year are likely. The European Central Bank (ECB), however, plans to continue to support liquidity until at least 2023 and does not expect to raise rates in 2022. That decoupling will have different impacts on both sides of the Atlantic, including on the ability of banks to generate margins, as well as on bond yields, exchange rates and the relative attractiveness of different monetary regions for investment. While Spanish banks have been able to increase lending capacity during the crisis on the back of state guarantee schemes and other support programs, as well as to shore up solvency, both profitability and solvency will remain key challenges in 2022, especially if rates remain ultra-low or negative and support measures are rolled back. Going forward, banks´ profitability will continue to rely to a significant degree on efficiency gains, however, after years of consolidation and structural adjustments, such gains may be achieved through greater adoption of digitalisation and the shift towards platform-based models, with implications for employee/branch rationalisation and increased investment in digitally-savvy talent.

Relatedly, we dive into the impact that the current monetary policy climate has had on banks´ net interest margins. The trend in the Spanish and European banks' net interest margin (NIM) is proving highly volatile in year-on-year and earnings contribution terms. One reason for this volatility is the "volume effect" associated with the trend in the outstanding balance of credit. That balance sustained sharp growth in 2020 (breaking a decade-long downtrend) thanks to the state guarantees rolled out to mitigate the economic ramifications of the COVID-19 pandemic before losing steam at the start of 2021. In this context of stagnant (or contracting) credit, the trend in the margin is highly sensitive to the ability to increasingly layer a negative component into funding costs. One such source is the widespread application of negative rates to a growing proportion of deposits, particularly those held by businesses and high net worth individuals. However, the banks' net interest margin is most sensitive to the use of the ECB's liquidity facilities in the form of targeted longer-term refinancing operations (TLTROs) and compliance with the related eligibility benchmarks which determine whether the (negative) rate applicable by the ECB is -1% or -0.5%. This will be especially important in the case of Spanish banks, which have used the facility heavily, and where NIM is particularly sensitive to benchmark compliance.

The final section of the January *SEFO* is dedicated to the corporate sphere. First, we look at the impact of policy support measures aimed to keep credit flowing during the crisis and the potential impact the phasing out of these measures may have on so-called "zombie firms". Subsequently, we shed some light on an emergent form of financing flowing from established companies towards start-ups referred to as corporate venturing, resulting in quantitative and qualitative gains for both sides.

The COVID-19 pandemic is wreaking financial and economic havoc on many sectors. The businesses operating in the sectors squeezed most by the crisis, such as those related to the provision of services, particularly tourism, hospitality, leisure, retail, passenger transportation and professional services, have been hit particularly hard. The measures rolled out to mitigate the adverse effects of the pandemic have helped keep money flowing to the real economy, mainly in the form of credit, containing unemployment and staving off the demise of a significant number of businesses. That aid brings its own risks, however. Namely, that a considerable number of companies that were in precarious positions before COVID-19 may have used the pandemic support measures to survive, and lax financing conditions may be masking business models that are, in reality, not viable from an economic perspective. The survival or failure of such companies, known as "zombie firms", has implications for the outlook of the global economy and the financial sector. In the case of Spain, such firms currently account for around 2.0% of the total. In line with the estimated European average, this share is high enough to raise the risk of loan non-performance in the Spanish banking sector. As well, over 62% of Spain's zombie firms are small or microenterprises, which are more vulnerable to today's economic and financial frictions. Thus, risks could increase should a new variant trigger fresh lockdowns and business restrictions necessary to contain transmission.

Intense competition in developed markets has pushed companies to innovate and add value to their offerings. They need to focus their efforts on bringing something new to market, improving their productive processes, enhancing their services and honing their management style. In this environment, corporate venturing provides a tool that ticks all those boxes for investors, while also fostering business initiative. Corporate venturing entails investment by established companies in high-tech or otherwise ground-breaking start-ups. However, it is more than just financing. Corporate venturing provided by enterprises constitutes a formula for innovation articulated around financial and strategic criteria. The two principles converge around the search for returns in the context of new technologies, business models, talent and sources of innovation. In short, corporate venturing does not simply seek returns driven by multiple expansion or M&A-driven returns, as may be the case with private equity or venture capital funds; it also strives to acquire knowledge and know-how and foster collaboration. It is, in sum, a new way of tapping innovation. From the standpoint of entrepreneurs, this formula offers clear-cut advantages in terms of access to the business ecosystem, the corporates' management experience and contacts, while giving them the ability to scale up their projects, share know-how and tap into growth opportunities. In Spain, the number of start-up investment rounds reached 385 in 2021, which is 78 transactions more than closed in 2020 with a record level of funds raised totalling €4.21 billion. Going forward, the outlook appears bright for this form of corporate cooperation and development.