Letter from the Editors

Although the global economic environment remains unfavourable on the whole, there is a sense of cautious optimism over the outlook for the global economy in the months ahead, as vaccination campaigns progress, setting the tone for improvement. This optimism is clearly biased towards the US, where the vaccination effort is making fast progress, restrictions are gradually being lifted and President Biden has announced a massive new fiscal stimulus package. In Europe, despite a weak start to the year, the recovery is also on the horizon, albeit less certain.

Within this context, we kick off the March issue of *Spanish and International Economic & Financial Outlook (SEFO)* by providing our latest set of forecasts for the Spanish economy, as well as an in-depth snapshot of Spain's fiscal outlook two years into the pandemic, with a focus at the sub-central level.

Based on provisional figures, Spain's GDP contracted by 11% in 2020, with 70% of the decline concentrated in sectors most dependent on human contact — retail, transport, hospitality and artistic and leisure activities. Available indicators suggest that the economy weakened again in early 2021, with a markedly uneven impact across sectors. In light of restrictions on mobility and businesses, as well as the slow progress on the vaccination front, our growth forecasts have been cut to 5.7% in 2021, one point less than in previous projections. In 2022, growth should reach 6.3%, a 0.1 percentage point increase from the last set of forecasts. However, there are downside risks relating to insolvency rates and corporate debt levels. In addition, although the combination of investments and reforms is crucial for transformation purposes in the medium- and long-term, in the short-term the recovery depends more on the plight of Spain's tourism sector. Baseline assumptions see the tourism sector staging a gradual recovery from the second quarter on, such that tourism receipts this summer come close to last year's levels (which were less than a quarter of pre-crisis levels). By 2022, tourism should have made up 75% of the ground lost due to the crisis.

Next, we assess the performance of one of Spain's key sectors – the real estate sector – throughout this crisis relative to the previous one, as well as provide some insights as to the future outlook for the housing market. Many market observers have expressed concerns that the COVID-19 crisis could create vulnerabilities within the Spanish housing sector, leading to negative knock-on effects for the wider economy. However, Spain's housing sector has performed better than many had initially anticipated. For example, in December 2020, new mortgages topped €5.4 billion, the highest reading since mid-2010. This favourable performance can largely

be explained by government policies, such as furlough schemes and mortgage moratoria, that have protected Spanish consumers' income, while ultra-low interest rates have ensured demand for housing has remained strong. Imbalances and market dislocations observed in the past appear to have corrected. Residential investment currently accounts for 5.4% of nominal GDP in Spain, which contrasts with the highs of 2006, when residential investment reached 11.8% of nominal GDP. Also, the spread between the gross rental yield and the 10-year sovereign bond yield is at a high, indicating that the presence of speculative demand in the rental market is much lower than it was in 2006-2013. Lastly, the debt burden and housing affordability indicators also look much better than in 2008. Going forward, bigger corrections in volumes than prices are expected. However, the prospect of ongoing government support and European recovery funds suggest that the sector is more likely to evolve than collapse as a result of the current crisis.

We then analyze the impact of the pandemic on Spain's fiscal performance. The pandemic has had the dual effect of raising public deficit levels and reducing government revenue. In Spain, deficit increases differ across the various levels of government, with the central government's deficit rising to 7.82% against the regional governments' surplus of 0.29% up to the end of November 2020. This divergence is due to the extraordinary level of financial support provided by the federal government to the sub-central governments. However, updated data from December is expected to show that the regional governments dropped back into deficit by year-end. Some regions like the Basque region and Navarre are forecast to run a deficit of 2% or more while the Canary Islands should record a surplus. The deficit outlook for 2021 is clouded by uncertainty and will be influenced by Spain's sensitivity to changes in GDP, the scale of discretionary measures, and the extent to which loans channelled by ICO become non-performing. Spain's independent fiscal authority (AIReF) is forecasting an increase in the regional government deficit from 0.6% to 0.8%, with differences across regions persisting into 2021. Notably, Spain's regions also differ in terms of their debt levels, with Valencia presenting a leverage ratio of 46.7%, triple that of the Canary Islands. These divergences mean solutions that involve debt forgiveness or risk-pooling would likely prove divisive.

Relatedly, we look at healthcare spending in Spain, pre and post the COVID-19 crisis, providing a country-level international comparison as well as taking a look at the breakdown of health spending across the regions. With EU fiscal rules frozen due to the COVID-19 crisis, the Spanish government has some scope to increase spending on health services, which has been low compared to peer countries. However, upward pressure on healthcare expenditure will likely extend beyond the pandemic. Analysis of healthcare spending patterns per capita by age and gender categories alongside demographic projections shows Spain's healthcare spending will grow by over 10.83 billion euros between 2018 and 2030. However, this spending will not be evenly dispersed across Spain's regions. One source of increased spending will be investment in healthcare technology, which will translate into constant average annual spending growth of 2.2%. Despite its already high ranking for health digitalisation initiatives, Spain is expected to allocate additional spending to enhance system interconnectivity, improve patient empowerment and prevent and monitor chronic conditions. Such e-Health initiatives imply a 1.5% increase in estimated health expenditure. Other areas requiring additional spending include recruiting and retaining healthcare workers as well as the expansion and upgrading of healthcare technology. The likely consolidation of those higher spending levels in the future needs to be framed by criteria related to efficiency, value creation and programme assessments (spending reviews). An independent assessment is the only way to ensure that the additional funds injected help to build a more favourable position for responding to potential future health emergencies.

As regards the financial sector, we explore the phenomenon of popular capitalism, a rising

trend evidenced by the latest events taking place in the GameStop/Robinhood/Reddit scheme, and its potential implications. In the wake of the financial crisis, new financial market trends have emerged such as the disconnect between financial signals and the real economy, the accumulation of bargaining power in certain investment arenas, and the impact of shareholder activism on corporate governance and valuations. Although shareholder activism has traditionally been more prolific in the US, the percentage of campaigns launched in Europe has been on the rise, prompting responses by both governments and corporations. More recently, a novel form of shareholder activism has developed, coined 'populist activism', which differs from traditional shareholder activism in terms of liquidity and suitability for retail investors. Perhaps the best example of this new investment activity is the purchase of GameStop shares by retail investors coordinating over Reddit. These actions had unforeseen consequences for both the retail investors who may have lacked the knowledge to properly assess their risk-taking as well as for institutional investment funds.

We close this issue with an analysis of Spain's corporate sector. Among the factors that will have a significant impact on the speed and intensity of Spain's economic recovery are economic policy measures, including both those which provide direct aid for viable companies at risk of insolvency, as well as those that incentivize Spain's commitment to a digital, green and social transition.

Along these lines, first, we provide an assessment of the impact of the pandemic on Spain's corporates and what has and still needs to be done to help viable Spanish companies. The protracted length and intensity of the COVID-19 crisis means that the initial measures designed to ensure the flow of financing to the corporate sector are no longer sufficient. In response to the first wave of COVID-19, the Spanish government provided loan guarantees to nearly one million enterprises, most of which are SMEs. While these loans involved attractive conditions, they nonetheless count as debt and have reversed a decade's long deleveraging effort in the Spanish corporate sector. A wave of bankruptcies would have a deleterious effect on Spain's productive fabric at a time when the economy's recovery is highly vulnerable to shocks. However, any response to this potential risk must look beyond a rise in insolvency filings. Instead, efforts should also be made to reinforce the corporate sector's financial structure so as to support investments in digitalisation and sustainability. Spain should consider adopting the highly targeted approach of other countries that utilise a wide variety of instruments and bolster the role of the private sector. Within this context, the Spanish government's recent approval of a new 11 billion-euro aid package for SMEs and the self-employed, comprised of a direct aid fund, debt restructuring, and business recapitalization is a welcome development.

Finally, we examine one of the key factors that firms need to consider if they want to maintain competitive advantage — investment in intangible assets and its important implications for digitalisation. Digitalisation has become a key focus of the EU, as evidenced by the allocation of Next Generation EU funds to support the digital transformation of the EU economy. This is because of its potential to boost growth, and by extension, social welfare. However, the digitalisation of Europe's economy will be dependent on investments in intangible assets, which in some cases are considered 'expenses' rather than investments according to national accounting systems. Examples of intangible assets include design, market research, specific human capital training and organisational capital. Unfortunately, Spain lags behind when it comes to investing in intangible assets, standing second last in the EU and significantly behind the EU average. Importantly, investment in intangible assets is rarely financed through bank loans, with firms instead relying on own funds or private equity. However, policy shifts could help channel more bank credit to investments in intangibles. For example, governments could issue guarantees for these loans so as to reduce the potential risks

faced by banks. As well, the introduction of a supporting factor for banks' risk weighted asset (RWA) calculations along the lines of what is used for loans to SMEs and infrastructure investments could also help increase bank lending.