Letter from the Editors

The outlook for the global economy has become more unclear since the March edition of *Spanish and International Economic & Financial outlook (SEFO)*. The invasion of Ukraine has heightened existing tensions in the energy and commodities markets. The situation has been exacerbated by the Chinese government's zero COVID policy, which has triggered further supply chain disruptions. Geopolitical turbulence and supply chain friction are aggravating inflationary pressures, foreshadowing monetary policy tightening. The Federal Reserve has already initiated interest rate tightening, which has had ripple effects on the financial markets, and the ECB will likely not be far behind.

The confluence of these factors is clouding the prospects for economic recovery, as evidenced by the IMF´s recent downward revisions for global growth and the European Commission´s downward revisions for the European growth outlook.

Within this uncertain context, the May issue of *SEFO* is marked by the conflict in Ukraine and begins with an assessment of the return of geopolitical risk and its near-term impacts, as well as potential long-term, structural implications. The invasion of Ukraine by Russian forces implies a shift in the international paradigm impacting global geopolitical dynamics prevailing since the fall of the Berlin Wall. An event of such magnitude (a black swan in financial terminology) will not only have effects on the economic cycle in the short-term but may also alter the underlying trends that have defined the economy's performance in recent decades. In the near-term, the increase in political risk will impact the economy via multiple channels, such as commodity prices, commercial ties, uncertainty and financial stability. At the same time, the return of policies articulated around blocks of geopolitical influence could imply a threat to the globalisation that has been intact since China joined the global production chain. Specifically, this may occur through triggering structural changes in the global economy, particularly on the supply side. Making this transition in Europe will require reconfiguring economic, foreign, defence and energy policy, potentially providing the long-awaited impetus for European integration.

We then look more closely at policy responses to the conflict from key eurozone countries. The global shortage of fossil fuels, which developed in the middle of last year and gained momentum in the aftermath of the invasion of Ukraine, has had a strong macroeconomic impact. The most visible effects are higher inflation and slower economic growth, moving Europe to the brink of stagflation. In this context, this article compares the responses to the energy crisis of Germany, France, Italy and Spain. All four countries carried out similar measures, with a view to: i) cushion the impact of higher energy costs on vulnerable households and enterprises (especially in Germany and France); ii) directly curb inflation via oil price subsidies (all four countries) or electricity price caps (notably France and Spain); and iii) tackle windfall profits (in particular in Italy). These initiatives may help attenuate consumer price trends, while also reducing the burden of the crisis on disadvantaged groups and sectors. However, they are temporary in nature, so they are not necessarily adapted to a long-lasting crisis – not to mention the fact that their cost to the public accounts ranges from 15 to nearly 30 billion euros over the next few months. Moreover, the measures leave entirely open their consistency with energy transition goals.

We then look at the evolution of several key areas affecting the Spanish economy two years after the pandemic. We begin by studying the behaviour of Spanish non-financial accounts, with a view to determining the health of the household and corporate sectors. Although the recovery in Spanish GDP was somewhat less intense than initially expected in 2021, the recovery in employment was noteworthy and stronger than anticipated. Against that backdrop, the recovery in household income was more intense than that of the corporate segment that year. Household GDI ended 2021 2.8% below that of 2019, whereas corporate income remained 9.7% lower. The more pronounced recovery in the former was driven largely by public sector wages, as well as social benefits, which both rose above 2019 levels. Spain's households once again registered excess savings in 2021, albeit below 2020 levels, earmarking nearly the entire volume of surplus savings towards housing investment. Despite that, household debt levels increased for the first time since 2008, albeit by a far lesser degree than the increase in Spanish corporate debt. That said, Spain's companies too increased their leverage, despite generating, on aggregate, a sizeable net lending position, with companies most affected by the pandemic taking on additional borrowings largely to fund current expenses and ultimately, to some extent, eroding their overall financial health.

We then examine the performance of Spanish tax revenues, and the factors that have influenced receipts throughout the health crisis. The revenue managed by Spain's tax authority, the AEAT, over the past decade has registered average annual growth of 2%. Tax revenue peaked in 2021 at 223.39 billion euros, rebounding by 15.1% from 2020, when receipts contracted. This contrasts with the slower and more gradual recovery etched out from 2010 onwards in the wake of the 2008 crisis. The two most noteworthy aspects of the trend in tax revenue in 2021 include the fact that: (i) the correction lasted for just one year; and (ii) it was followed by a strong recovery to above pre-pandemic levels in the span of just one year. The differential performance of the recovery in tax revenues during the two crises can be largely attributed to the different institutional measures implemented to mitigate their consequences and the healthy pace of recovery in the tax bases of each of the main taxes, both those related with income and, especially, those associated with consumption. That last factor bodes well for continued healthy tax collection dynamics in 2022, shaped by economic growth, albeit with more moderate growth than initially anticipated on account of the war in Europe and, above all, ongoing high inflation. These favourable tax dynamics, however, rest on the assumption that the measures passed to tackle the crisis unleashed by the war thus far, including the associated tax breaks, do not remain in place for an extended period.

As regards the financial sector, we analyse how COVID-19 has accelerated the trend in financial digitalisation and specifically, for the case of Spain, we examine the details of the state guarantee program in light of its recent extension to take into effect the damaging impact of geopolitical tensions on various sectors, as well as the potential factors that could impact loan non-performance for the business sector going forward, once the program comes to an end.

In the wake of the pandemic, we are seeing considerable changes in how Spaniards are using banking services. The pandemic has given significant impetus to the process of financial digitalisation. According to the Observatory of Financial Digitalisation (ODF in its Spanish acronym)-Funcas online survey from December 2021, 36.4% of banking service users are currently using their online banking applications daily or almost daily, compared to 17.3% before the pandemic. That said, although the digital divide in online banking has narrowed, physical branches, despite being used less, continue to play an important role for some segments of the population. Another significant change relates to Spaniards´ methods of payment. Digital payments, especially from mobile phones, have displaced cash as the main payment method. Indeed, 69.1% of purchases are being settled using non-cash instruments and just 18% of those surveyed said they continued to use cash as their main payment method. There is also growing interest in crypto-assets, although so far their usage is concentrated within the younger population. According to survey results, the typical crypto-asset investor is young (and male), studies or works, generates a high monthly income and lives in a big city. Finally, in light of the cyber-risks ushered in by online banking, Spaniards stand out for their use of basic security measures in accessing those services. Over 80% of the population follows their banks' security recommendations when banking online, with the sole exception of installing antivirus software on their mobile phones, where the percentage is a much lower 44.2%.

One of the most noteworthy measures taken by the government to mitigate the effects of the war in Ukraine is the approval of a new state guarantee programme and extension of the maturities of the loans awarded under the pandemic guarantee scheme in an attempt to prevent geopolitical tensions from having compounding adverse effects on top of the toll taken by the pandemic. Extension of outstanding state guaranteed loans will come as a lifeline for the sectors and businesses most affected by the two crises. In the case of the banks, it will contain the materialisation of associated non-performance. Nonetheless, the increase in riskier stages of public guarantee scheme (PGS) exposures could translate into growth in non-performance in the business loan segment, with the potential impact substantially higher in Spain than in Europe due to the higher weight of PGS exposures in total outstanding business loans. The possible increase in non-performance is highly sensitive to both the level of impairment of stage-2 exposures, which determines the spillover to stage-3 classification, and the multiplier effect derived from pre-existing customer-level exposure. Depending on the combination of estimates for these two factors, analysis shows that the increase in the non-performance ratio could be upwards of one percentage point. However, given the high degree of uncertainty characterizing the current economic climate, including over the path of interest rate increases, the impact on non-performance is difficult to quantify. In any event, non-performance should not translate into a significant increase in NPL coverage for two main reasons: (i) cautious front-loading of impairment provisioning by the banks in 2020 and 2021; and, (ii) the impact of the guarantees on the amount of losses incurred, as the banks' exposure is ultimately limited to the percentage not covered by those public guarantees.

Finally, we assess business creation and destruction dynamics in Spain throughout the pandemic. In 2020, Spain created over 100,000 fewer businesses than in 2019, a reduction of close to 24% to levels not seen since the aftermath of the crisis of 2008. Business creation fell across all main forms of incorporation –public limited and limited liability companies– albeit somewhat less intensely in the case of the self-employed. However, based on the available data, the number of businesses closed also decreased, albeit much less intensely (less than 2%) in 2020. Looking at the intensity of business creation and destruction between 2019 and 2020, on the creation side, financial services, postal and courier activities and certain transport segments were more dynamic, while on the destruction side, travel agencies and retail establishments stand out. If we break down the analysis by both business activity and legal form of incorporation, the data point to a degree of business reorganisation in some activities related with construction, with the number of incorporated enterprises declining and the number of self-employed professionals increasing. More broadly, in addition to pandemic-related factors, the figures reveal the continuation of a trend observed before the pandemic – 2008 marked a shift in the most dynamic type of business format, away from limited liability companies to individuals, a trend that continued in 2020.