Letter from the Editors

2020 started off on a positive note. Global recession risks had decreased relative to 2019 – supported by reduced trade tensions between the US and China, increased probabilities for an orderly Brexit, and accommodative monetary policy. In January, conditions were largely expected to improve this year, giving way to a modest recovery. By March, all of this had changed. The global expansion of the coronavirus outbreak, which had already prompted a downgrade in Chinese macroeconomic forecasts, coupled with declining oil prices, forced international organizations, rating agencies and financial institutions to notably revise downward world GDP forecasts. In its March interim forecasts, the OECD estimated that global GDP would be 2.4% this year, a 0.5% percentage point cut from its November forecast, but it now looks like we have already moved well beyond even the more severe scenario envisaged then.

At the time of publication of the March issue of *Spanish and International Economic & Financial Outlook (SEFO)*, several EU countries and the US had declared a state of emergency. This may further deteriorate growth expectations for a prolonged period of time, even heightening the risk of recession in some of these regions. At this stage we do not know the length that such emergency measures will remain in place, nor whether or not Covid-19 will be transient or a more longer-term shock. However, we think it is important to point out the emergence of these new significant downside risks and their potential implications, in particular for the Spanish economy and financial sector.

In this issue of *SEFO*, we start by assessing Spanish economic policy in response to Covid-19. The Covid-19 health crisis poses a major challenge for economic policy due to the unprecedented nature of the shock and because the repercussions will be significant. GDP is expected to drop sharply in the first half of the year, followed by a rebound in the second half, resulting in a contraction for the whole of 2020 of an estimated 3% – etching out a U-shaped recovery. Compared to other more alarmist predictions, that scenario is already playing out in countries hit by the virus earlier, such as China and South Korea. In 2021, the Spanish economy could grow by 2.8%. The emergency measures announced to date by the Spanish government and the ECB in response to the situation are a necessary first step; however, the authorities will have to continue to fine-tune the intensity of their stimuli depending on the duration of the crisis with the aim of safeguarding productive structures, preserving jobs at sustainable businesses and ensuring that the rebound materialises as anticipated.

As for the financial sector, 2019 was a challenging year for Spanish banks, as was the case for most European banks. The downward

revision to macroeconomic forecasts and the associated shift in monetary policy, prolonging the outlook for ultra-low rates, was largely responsible for the fact that Spain's six largest banks saw their aggregate net profit decline by 18.4% to 13.59 billion euros in 2019. That correction, which was in line with the dip observed in the rest of the eurozone, in conjunction with cross-cutting geopolitical and structural shocks (trade and technology tensions, respectively) and ad-hoc developments of an unforeseen magnitude (particularly the Covid-19 virus) are having a very adverse impact on the banking industry's market value. The large-scale measures approved by the Spanish government, particularly those related to an ambitious financing and public-private guarantee scheme, together with the measures announced by the ECB –a 750 billion euro asset purchase programme for the eurozone– are intended to mitigate this impact. The difficulties facing banks are not confined to the impact interest rates are having on asset prices, but also the issues being encountered in driving business volumes. On the one hand, regulatory pressure is considerable and loan approval policies are particularly cautious. On the other hand, demand for credit remains limited. That explains why, despite the low level of interest rates and NPL ratios of well below 5%, year-on-year growth in private sector financing remains stagnant. There are several potential drivers of bank profitability, such as improved efficiency/asset quality, as well as investor perceptions of undervaluation. However, it remains to be seen whether or not some of the recent, unforeseen shocks will prove transitory, potentially dissipating in the coming months.

We also look at the dominant role of European and Spanish banks as issuers in the primary debt markets ahead of compliance with regulatory capital requirements. Financial markets' propitious start to the year has led to the intensification of issuance in the European and Spanish primary fixed-income markets. Issuers' swift reactions to benign market conditions, coupled with strong investor take-up in light of ultra-low rates, has been even more apparent in the banking sector, which has been taking advantage of the momentum to address regulatory pressure deriving from the upcoming deadline for compliance with the resolution directive, specifically, the minimum requirement for own funds and eligible liabilities (MREL).Within this context, two trends have emerged. On the one hand, having maxed out the allowances for certain instruments (convertibles bonds, CoCos and subordinated debt) that dominated issuance volumes up until 2017, banks are switching to issuance of lower-cost liabilities, such as senior non-preferred debt, which qualifies for MREL purposes. In parallel, there has been a 'democratisation' trend in issuance, with smaller-sized entities tapping the markets more than before. According to our estimates, European and Spanish banks will need to raise another 250 billion and 50 billion euros of eligible instruments, respectively, to comply with the MREL deadline set for 2024. Thus, we anticipate banks to remain dominant players in the primary fixed-income markets for the coming years.

Covid aside, we then examine fiscal issues in Spain related to low corporate taxation. Tax revenue from corporate income tax has not recovered to pre-crisis levels in Spain. That is an anomaly in the European Union and comparable only to the situation in Italy. The government is contemplating the passage of measures this year which would increase annual corporate tax revenue by approximately 1.5 billion euros. Implementation of those measures depends on the ability of the minority government led by Pedro Sánchez to garner the support needed to pass the 2020 budget. The government is also assessing the possibility of enacting a new tax on BigTech which according to official estimates would generate annual tax revenue of around 1 billion euros. In any event, settlement of that tax has been postponed until the end of the year pending an agreement on a global minimum level of corporate tax on technology giants and other large multinationals which is currently under discussion at the OECD.

Lastly, we analyse the situation of a sector that has received increased attention from the

local media – the agricultural sector. Despite the emergence of some slightly negative trends in 2019, according to official data, the Spanish agricultural sector has enjoyed a favourable decade from a productive standpoint. Importantly, the sector's performance was resilient in the face of the Great Recession, when other significant productive sectors of the Spanish economy experienced a collapse. While last year's performance was further complicated by the introduction of US tariff hikes, which had a disproportionately adverse impact on certain agricultural sub-sectors, such as olive production, at the overall sector level, the recent trends in Spanish farming prices and salaries do not clearly explain the negative sentiment and rising social discontent within the sector at present. Within this context, it is plausible that the current tensions within the sector are more a product of other issues, such as uncertainty over EU agricultural support programs, as well as social issues, such as rural depopulation and ageing, the lack of business succession in certain communities, harsh working conditions and a lack of a healthy work-life balance. Although targeted public policies may contribute to improving the sector´s current conditions, a more meaningful solution to the sector's challenges calls on farmers themselves to conduct a critical assessment of the situation and, where necessary and possible, improve their business acumen.