Letter from the Editors

In response to being one of the European countries hardest hit by COVID-19, Spain has implemented some of the strictest confinement measures not only in the EU, but in the world. Therefore, while forecasting must be made with a caveat given the dynamic nature of the pandemic, the country is expected to experience one of the most severe recessions this year within the EU, with equally negative consequences for jobs and public finances. Within this context, the May issue of *Spanish and International Economic & Financial Outlook (SEFO)* sets out to assess the myriad of recent public policy responses to COVID-19 –at the international, EU and national levels– aimed at supporting the real economy through channelling liquidity to households and businesses. We also provide a snapshot of how these measures may impact Spain's economic outlook, financial sector, and fiscal balances.

We start off this issue by analysing the impact of the lockdown measures on Spain's real economy. Economic restrictions imposed on March 13th, as well as broader global dynamics, will have a material impact on previously published forecasts. For this reason, Funcas has updated its economic projections. Our baseline scenario now predicts GDP will contract by 8.4% in 2020, with the public deficit and debt levels reaching over 10% and nearly 114% of GDP, respectively. Data indicate that retail, accommodation, food services, cultural and sports activities, and personal services sectors are the most directly affected by lockdown measures. The only sectors expected to end the year with a similar level of GDP prior to the COVID-19 crisis are the primary sector, the mining and energy industries, healthcare and education. As expected, employment levels have also deteriorated, though much less than in earlier crises thanks to short-time work arrangements. Indeed, 3.3 million employees are registered as part of a government sponsored furlough scheme. Although the external sector is expected to make a small positive contribution to GDP, tourism receipts and exports have fallen significantly. Importantly, the Spanish economy's ability to rebound will largely depend on the maintenance of jobs at sustainable enterprises, the rapid implementation of government programmes, and the Spanish Treasury's ability to capture financing at reasonable terms.

We then examine the numerous policy responses, the objective of which is to provide liquidity to Spanish corporates and households in the midst of the crisis: (i) through financial support measures (liquidity enhancement, state-guarantees, and supervisory relief); and, (ii) fiscal support mainly in the form of tax deferral schemes. Lastly, we take a look at the anticipated fiscal implications these measures will have for Spain's public finances.

First, we look at the timeliness and sufficiency of EU and Spanish financial support measures, as well as possible implications for banks. Financing policies are essential in the context of a public health pandemic that results in the paralysis of economic activity. However, the effectiveness of these policies will hinge on the duration of lockdown measures as well as the timely and effective disbursement of funds to the real economy. At present, the forcefulness and direct nature of US policy contrasts with the uneven and issue-ridden nature of the European response to the COVID-19 crisis, which could lead to greater divergence within Europe. EU member states have issued aid primarily in the form of state guarantees for loans provided by banks to companies facing difficulties. In Spain, 200 billion euros has been earmarked for public-private financing schemes, but the roll out has been gradual. While state guarantees are expected to cushion the effect of a rise in NPLs, there will be a time lag. In the EU, aid has also been mostly directed at stimulating bank lending, with the ECB having stepped up its buyback programme. Having rejected the idea of 'coronabonds', the EU is expected to announce a new reconstruction fund later this year. However, looking forward, it is possible that the bloc's uneven response will result in an asymmetric recovery across the EU.

Drilling down on financial support measures, first we focus on regulatory and supervisory relief for the banking sector in an efforts to achieve the effective transmission of these liquidity support measures to corporates. Regulatory and supervisory authorities have adopted temporary measures to shore up banks' in advance of the expected rise in defaults and in recognition of their key role in the transmission mechanism for financial aid. Banks will be able to operate below the capital conservation buffer (CCB), the Pillar 2 Guidance, and liquidity coverage ratio. In Spain, the sum of the CCB and average Pillar 2 Guidance would release around 58 billion euros for the Spanish banking system. Regulators have also relaxed collateral measures, such as lowering the minimum size threshold for domestic credit claims from 25,000 euros to zero. This will provide liquidity to support additional measures, such as public guarantees used to ensure credit flows to SMEs and the self-employed, which is especially important in Spain given that SMEs account for over 99.9% of all companies. Additionally, the ECB's decision to accept less than investment grade debt is significant given the potential for ratings downgrades and the fact that sovereign debt accounts for approximately 10% of the Spanish banks' total assets. However, since Spanish banks are predominately retail focused, regulatory loosening that targets market risk and volatility in financial markets will have less of an effect on the industry.

Apart from the supervisory support, we look at the state guarantee structures. The Spanish government has introduced a 100 billion euro guarantee scheme, dispersed across successive tranches that are being adjusted based on the experiences of previous disbursements. The first tranche (20 billion euros) was allocated evenly between SMEs (including the self-employed) and large enterprises, while the scheme's second tranche was earmarked in full to the SME segment (including self-employed individuals). Of the total guarantees extended as of early May, 66% had secured SME loans, while 34% supported large enterprise loans. A key novelty of the third tranche is the addition of 4 billion euros to underwrite fixed-income securities (commercial paper) issued by companies listed on Spain's alternative fixed-income exchange, the MARF. This initiative will be applicable to commercial paper with terms of maturity of up to 24 months. The guarantees provided for commercial paper issued on the MARF have a maximum size of 70%, implying a leverage effect of 143%, such that 4 billion euros of guarantees could drive total commercial paper issuance of around 5.7 billion euros.

To determine the ultimate efficacy of these measures and how they may impact the Spanish financial sector, as reference, we include a snapshot of Spanish banks' performance alongside EU peers on key metrics. With a capital adequacy level 4.2 percentage points higher than in 2008, Spanish banks appear better positioned to withstand the economic fallout from COVID-19 than during the previous financial crisis. Notably, Spanish banks boast above-average profitability and efficiency compared to their eurozone peers, their loan-to-deposit gap has improved, and they have a healthy buffer of liquid assets. That said, the IMF and the European Commission are forecasting a bigger contraction in GDP in Spain (8%-9.4%) than in the eurozone (7.5%-7.7%). Although government-backed guarantees, the aid rolled out to prop up business and household income and the easing of bank regulations may help cushion the impact of the crisis on the banks, a GDP contraction of that magnitude will drive non-performance higher and require the recognition of provisions. Moreover, although the Spanish banking sector's solvency ratio is significantly above regulatory requirements, it is 2.3 percentage points below the eurozone average. Furthermore, even though a deep restructuring effort has left Spanish banks among the most efficient in Europe, efficiency has deteriorated in recent years. As a result, Spain's banks will need to continue with their cost-cutting efforts and reduce their capacity even further in order to weather the COVID-19 crisis.

Next, we focus on a comparative assessment of fiscal support measures, essentially tax deferral schemes, across the EU to help boost liquidity for Spanish individuals and businesses. As stated previously, current forecasts for the Spanish economy suggest that the COVID-19 pandemic will result in a significant economic contraction in 2020. Faced with that scenario, the government has passed a raft of employment, fiscal and financial measures to mitigate the destruction of jobs and businesses. One of the most significant initiatives is the deferred payment of state taxes and social security contributions by six months. That deferral option is longer than the two to four months granted in some other European countries. However, the scale and reach of the initiative in Spain are significantly smaller than its equivalent in Germany, France, Italy, Denmark and Belgium, for example. In addition, these countries have offered direct grants or subsidies to firms, not just tax deferrals. One of the reasons for that difference is the fact that in Spain, taxes can only be deferred by companies with revenue of less than six million euros in 2019. For this reason, the authors of this article believe that the government may want to consider a more decisive commitment to prop up corporate liquidity and pre-empt job losses. While this would inevitably result in a higher deficit over the short-term, it could pay off in the long-run by providing the economy with a stronger foundation upon which to stage a recovery after the health crisis has abated.

Lastly, we close this *SEFO* exploring how the recently approved fiscal support measures may impact government finances. Economic figures published in April by Eurostat suggest that Spain's fiscal consolidation has experienced a setback. Unfortunately, this setback may become even greater given the economic paralysis caused by COVID-19. The uncertainty surrounding the COVID-19 crisis makes forecasting both growth and the deficit extremely difficult and has contributed to a wide range of forecasts published by the Bank of Spain, the IMF, BBVA and Funcas. These institutions have forecasted a GDP contraction of between 6.8% and 12.4% with the public deficit ranging from 7.2% to 11.0%. Though much of the deficit reflects the impact of the recession and the costs of one-off fiscal measures, there remains an important structural component. Indeed, Spain's structural deficit is among the highest in the European Union, with the EU Commission calculating a cyclically-adjusted budget deficit for Spain at slightly over 3% in 2020.