Letter from the Editors

Since the publication of the previous issue of *Spanish Economic and Financial Outlook* in November 2013, we continue to see improvement in Spain´s real economy and financial sector.

In the January publication of the *SEFO*, we assess Spain´s economic performance and the forecasts for the year ahead. In many ways, 2013 marked a turning point for the global economy, including Spain, although significant risks lie ahead, such as the potential instability arising from the Fed´s change in monetary policy stance, concerns over the stability of China´s financial system, and a possible resurgence of the European debt crisis. If these risks do not materialize, 2014 could be the year in which we will see stability in Spain´s property market, a moderate recovery in credit conditions, and net job creation.

We also take a closer look at recent performance of the Spanish financial sector. Spanish banks continue to demonstrate positive momentum, both in absolute and relative terms compared to other European peers. Overall, the latest review reports from the Troika present a positive evaluation of Spain´s financial reform and considered the implementation process finished, although some long term challenges related to macroeconomic downside risks, and regulatory and supervisory issues remain. Meanwhile, the ECB´s latest available consolidated banking data reveal that the restructuring and recapitalization efforts undertaken within the Spanish banking sector are beginning to show results, with Spanish banks showing improvement in liquidity, solvency, and efficiency ratios compared to their European peers.

In this context, we examine how these more favorable developments in Spain´s real economy and financial sector have helped to increase foreign investor confidence in Spain, as demonstrated by the increase in direct exposure to Spain by foreign banks from mid-2012 to mid-2013 relative to the previous period. Foreign banks have increased their holdings of public and bank debt, while corporate debt exposure continues to decrease, an obvious consequence of the on-going deleveraging process in this sector. Nevertheless, the fact that overall foreign holdings have gone down means additional effort is needed in Spain on an orderly, deleveraging process. To consolidate this incipient recovery, Spanish financial fragmentation must be decreased through progress on the European banking union.

Advances in financial regulation will have additional implications for the Spanish banking sector this year. 2014 marks the year of implementation in many countries of new, greater and more stringent international capital requirements under Basel III, and its subsequent introduction at the EU level. This *SEFO* examines how the transposition to Spain under Spanish law of the new standards should help consolidate the recent positive momentum of the Spanish financial sector by leading to a new Spanish Banking code, which will systematize and unify Spain´s overarching legislation on credit institutions, simplifying the regulatory burden and thus helping to enhance compliance.

On a related note, we highlight that in order to adapt to these new capital requirements and in the context of current deleveraging, many banks are going back to more conservative, traditional banking models. While this trend may improve the liabilities side of banks' balance sheets, Spanish banks, as well as banks in other countries, will have to transform their business models to face a more difficult post crisis operating environment. This will mean that Spanish banks must continue to boost cost and revenue efficiency to improve profitability, including through alternative channels alongside traditional efforts.

Despite the aforementioned advances in the real economy and financial sector, we analyze recent developments in two areas of the Spanish economy which are still experiencing significant problems– the housing and labor markets. New measures have been approved to address the devastating impact of the economic crisis on households through the protection of mortgagors. The main measures include the approval of the Code of Good Practices, the two year moratorium on evictions for particularly vulnerable households, and the creation of a Social Housing Fund for households that have lost their residence in a foreclosure process. Given the high eligibility requirements, there has been little recourse to the measures as a percentage of the outstanding problem. That said, softening these criteria would have adverse implications on banks´ balance sheets.

As regards the Spanish labor market, we study the impact of the 2012 Labor reform two years after its approval. We are finally starting to see some progress in net job creation, supported by wage moderation mostly in the construction and services sector and the decrease in active population. Nevertheless, on the whole, there has been little advancement on tackling the key issues of labor market duality, youth unemployment, and long term unemployment. In order to move forward, further efforts must be aimed at productivity gains through improving Spain's education system, as well as better active labor market policies.