Letter from the Editors

The Spanish recovery is gaining strength, supported by external demand, as shown by the latest data for the fourth quarter of 2013 and for the first few months of 2014. That said, global risks, such as heightened instability arising from the moderation of US expansionary monetary policy and increased tensions in the Ukraine, have increased. If global threats do not materialize, we forecast growth in 2014 at 1.2%, two tenths higher than previously, and that for 2015 at 1.8%, supported by the impact of the electoral cycle on fiscal adjustment, as well as tourism.

In light of these recent developments, the March SEFO also examines the possible implications for Spain and other euro area countries from a slowdown in emerging economies. Although it is true that Spanish exposure to emerging markets has increased in recent years, most obviously through the trade channel, fortunately, Spain´s trade exposure is weighted towards emerging economies that are not likely to be the focal point of renewed financial stress. Therefore, growth prospects for Spain will remain intact even if the crisis in emerging markets escalates further.

Nevertheless, the recovery continues to be sluggish and the high level of public debt remains a significant cause for concern for future growth. The crisis has had important implications for Spain´s public debt levels, elevating public debt to GDP ratios from 36.3% in 2007 to 93.9% in 2013, the seventh highest level among the EU. The situation is further complicated by Spain´s debt sustainability equation, as nominal growth rates are set to be below interest rates for the medium term, demanding a permanent fiscal effort.

Spain´s net external debt, or net international investment position, has also deteriorated, making it the fourth most heavily indebted country in the EU and placing additional pressure on borrowing rates.

That said, Spain is not alone among European economies in having a debt overhang problem, and recent correction in the current account balance and a reduction of sovereign spreads are helping the country to improve its currently high net international investment position and reduce the growth of the stock of public debt.

In this context, we highlight the recently released Experts´ Committee report on fiscal reform, commissioned by the Government. The report contains numerous proposals for improving the current tax system with the aim of simplifying it and making it more efficient, facilitate growth friendly fiscal adjustment, and employment creation. Although the proposal is not the Government´s official proposal, it likely anticipates some of the debates that will take place throughout the legislative approval process. Moreover, it represents a step forward in that it attempts to tackle some of the difficult issues facing the Spanish fiscal system. The Experts´ proposal is now under discussion in the Council of Ministers, which expects to present its own reform proposal for Parliamentary deliberation in June, with the hope that it will enter into force by January 1st, 2015. We will revisit this topic in upcoming issues of the SEFO once there are more details regarding the Government´s proposal and the legislative process.

In this number, we also take a look at the health of the Spanish banking sector ahead of the ECB/EBA balance sheet assessments and stress tests, scheduled for November of this year. All in all, our analysis of a representative sample of Spanish banks on the basis of end 2013 data reveals continued improvement in profitability and solvency, with the main challenge still the reactivation of lending to the private sector. More importantly, our simulation exercise reveals that a transformation is becoming evident within the Spanish banking sector. We add a word of caution, however, that there are two outstanding issues, which could affect Spain´s performance on the upcoming EU Comprehensive Assessment - the holdings of debt and some loan exposures. The ECB´s decision regarding the treatment of these issues, which remains to be finalized, could ultimately affect Spanish banking sector results.

Finally, we analyze the latest reform of Spain´s electricity sector. Including the expected 2013 tariff deficit, the accumulated electricity debt is anticipated to rise to above 30 billion euros. In an effort to correct this imbalance, the Government is preparing a new Royal Decree primarily focused on adjusting the remuneration for renewable energies, together with a toll on self-consumption and modifications for the current energy pricing auctions system. While it is true that further efforts are needed to end the revenue deficit, with the new reform, Spain has moved away from a predictable system to a more flexible model that will generate uncertainty over Spain´s investment climate.