Letter from the Editors

The November issue of the SEFO analyzes the latest available macroeconomic and financial sector data to assess the overall outlook for the Spanish economy and financial sector, in addition to the credibility of the 2015 draft General Budget.

Although the latest data point to a deceleration trend in growth over the last two quarters of the year, Spain´s recovery continues. The loss of momentum is probably just a temporary dip, given that in 2015, the growth rate will gain pace as a result of improvements in financial conditions, tax cuts, and falling oil prices. Provided the Eurozone manages to consolidate its recovery, Spain´s average annual growth will be around 2%. We see that the biggest risks to the world economy, and specifically to Spain, in the coming year derive from two factors: i) the possibility of the Eurozone's economy relapsing into recession–or at least becoming mired in a prolonged stagnation; and, ii) the uncertain impact of rising U.S. interest rates on world financial markets and on the emerging economies, in particular.

Longer-term growth prospects for Spain will remain favorable if the country improves innovation performance. In this issue, we show how fiscal consolidation and a suboptimal regulatory climate have left Spain not converging to the EU average R&D+I performance, but rather deviating from it. An immediate and radical change on both fronts −budget and reforms− is needed if Spain is to preserve the knowledge creation capacity that has been so costly to build in the past 20 years.

Looking at the financial sector, we examine the results of the ECB´s comprehensive assessment of the European banking sector, the precursor to the entry into force of the ECB as single banking supervisor of the European Union on November 4th. Spain's performance on the assessment was quite favourable, both in absolute and relative terms. Of the 15 Spanish banks subject to the assessment, 14 passed without any observations. The overall impact of the combination of the asset-quality-review (AQR) and the stress-test under the adverse scenario results in just a 1.6% correction on average in the solvency ratio CET1, compared with 3.5% for the average bank examined in the exercise.

On a related note, we also look at patterns of cross-border activity of the Spanish banking sector in the EU context. Latest ECB data reveal that the crisis led to a new scenario, which broke the European banking market´s trend towards greater openness, internationalisation, and financial integration. Despite this setback, EU cross-border activity in Spain and in Europe has, for the most part, recovered.

Profitability remains the main challenge for Eurozone banks. Moreover, given the regulatory pressures that banks face and the macroeconomic uncertainty, it will be difficult to restore credit growth in the short-term, although the upcoming liquidity programs of the ECB may have a positive impact.

In light of the still challenging liquidity climate, this SEFO explores the emergence of alternative, external financing channels for Spanish corporates. In an environment historically characterized by high likelihood of corporate default, a large share of Spanish companies have become more selective in granting loans to their clients. In addition, companies have been facing more and more roadblocks to discounting commercial notes in traditional banking channels. Although reliance on traditional bank finance remains high in Spain, current conditions are laying the groundwork for the growth of alternative financing sources, although they do not yet present a true opportunity for SMEs.

On the fiscal front, this issue highlights the main features of Spain's draft 2015 General State Budget and attempts to determine its reliability in addition to the probability of meeting fiscal targets agreed-upon with the EU. Although optimistic, the 2015 proposals seems to be a credible one, with revenue forecasts taking into account the expected improvement in economic conditions, together with the anticipated effects of the tax reform that will enter into force in January 2015, with changes applicable, for the most part, to the individual and corporate income tax. On the expenditure side, the Government anticipates an overall cut of 1.5% *versus* 2014, or 0.5% of GDP, supported by decreases in unemployment benefits and other benefits, together with a reduction in debt servicing costs. Uncertainties regarding economic conditions, together with major challenges at the regional level, will be key determinants for achieving the main objective of the budget – fiscal consolidation.

Finally, we take a closer look at what is really happening in the Spanish real estate market, a sector of vital importance for the economy. After seven years of contraction, the latest figures released point to an uptick in this sector, specifically, as regards the recovery in and growing importance of second home purchases, which account for 17.3% of the total in the first half of the year. The possible elimination of the amortisation coefficient in 2015, the chance to obtain a long-stay visa or residence permit by acquiring a home for over 500,000 euros and, above all, the improvement in the economic climate coupled with intense price corrections in the coastal markets could continue to prop up holiday-home transaction volumes in the months to come. This would not only help to absorb the huge overhang of unsold housing, but also to restore financial stability within the sector, for banks operating in these markets and the economy as a whole.