Letter from the Editors

In the March issue of SEFO, we assess the impact of the Spanish recovery on foreign banks´ exposure to Spain. In contrast to the outflows observed during the crisis years, our analysis shows that the economic recovery has restored confidence in Spanish debt among foreign banks. Since 2012, these banks have increased their exposure to both Spanish bank and public debt, up 13.7% and 30.9%, respectively. At the same time, the decline in exposure to Spanish corporate debt should not be seen as capital flight, but rather a logical consequence of the strong deleveraging efforts underway in Spain´s non-financial corporate sector. Simultaneously, Spanish banks have increased their outward exposure, particularly to countries such as the UK, U.S., Brazil, Mexico, and Italy, while prudently maintaining low exposure to high geopolitical/default risk countries, such as Greece and Russia.

In this context, this SEFO highlights the considerable improvement in the overall short-term outlook for the Spanish economy, paying particular attention to recent evidence of normalization in Spain´s real estate market and financial sector. Spain´s recovery continues to gain speed, prompting us to once again revise upwards our 2015 growth forecast to 3.0%. The strength of this recovery is due in part to the continued correction of imbalances built up during the growth phase, supported by structural reform, together with favorable transitory factors, such as falling oil prices and interest rates. On the downside, the effects of these factors will wear off over time, resulting in lower growth from 2016 onwards. In the meantime, the recovery is exacerbating the deterioration in the balance of payments, which, for the time being, remains in positive territory mainly as a result of the drop in oil prices.

Furthermore, there are signs that point to a gradual comeback of Spain´s real estate market. After six-years of adjustment, the average of leading house price indicators shows an estimated fall from peak to trough prices of between 35%-40%. Recent transactions data, as well as the growth in the amount loaned in the form of mortgages, can be interpreted as improvement. Nevertheless, recovery remains uneven across the regions, and the high level of unemployment and outstanding household debt mitigate the prospects for anything other than a modest recovery, at least over the medium-term.

There is also room for optimism as regards the evolution of the financial sector. The strong provisioning effort undertaken in 2012 and 2013, mostly aimed at covering real-estate exposure, and the economic recovery underway, is helping narrow banks´ cost of risk. In 2014, favorable economic conditions, alongside the drop in non-performing loans, resulted in a narrowing of the cost of risk by 19 basis points. If this trend continues and the cost of risk were to gradually return to 2000-2007 levels, banks could see a noteworthy increase in profitability – helping them to address one of their key remaining challenges.

On a related note, the March SEFO takes a deeper look at some of the recent structural reforms undertaken that have helped to support Spain´s emergence from the crisis, as well as what remains to be done on the reform agenda – whether this be adopting new reforms, or improving those that have already been implemented.

As we show in this SEFO, the Spanish government has pursued an active reform agenda since 2012. Significant improvements have been made to Spain´s insolvency regime, addressing one of the strongest recommendations from international organizations, which now better distributes risks between debtors and creditors. Progress has been limited and/or mixed in other key areas, such as professional services, competition, entrepreneurship, and regulated markets such as transport and the electricity sector. As regards to the latter, the Law on the Electric Sector can already probably be viewed as insufficient to tackle the problems of the electricity tariff system. Moreover, as regards to the renewable energy regime in particular, the reduction in legal certainty and clarity over the remuneration regime in this sector has already had a negative impact on profitability and is increasing the level of returns demanded by investors.

Finally, we take a look at recent changes to Spain´s fiscal regime, starting with 2012 legislation to increase budgetary stability through the Organic Law on Budgetary Stability and Financial Sustainability (LOEPSF), which aimed at strengthening Spain´s public finances with particular attention to the regional level. While the measure was clearly a positive first step, recent empirical evidence is already revealing deficiencies and weaknesses in the current legislation and raising the possibility of the need for further modifications to achieve more feasible regional deficit and debt targets, structural deficit targets, and overall debt consolidation path. On a related note, this SEFO presents the results of a survey of tax advisors´ opinions on some of the recent tax reforms enacted in Spain to arrive at a similar view – while the changes indicate a step in the right direction in terms of eliminating distortions, mitigating tax planning, and reducing complexity, additional efforts will be needed. To conclude, we provide a brief analysis of the anticipated impact of changes to the economic cycle on Spanish tax revenue. Our findings suggest that given the sensitivity of Spain´s income and consumption taxes (VAT and excise duties) to the economic recovery, it is likely that revenues from these taxes will rise significantly in the immediate future.