Letter from the Editors

Although financial market tensions have eased since the start of the year, doubts remain about the situation in China and other emerging markets, as well as a possibility of a new global recession. In response to financial market volatility, falling oil prices, and the deteriorating outlook for the global economy, in its latest monetary policy meeting on March 10th, the ECB announced a larger than expected stimulus package, which included interest rate cuts and an expansion of its quantitative easing asset-buying program. Market reactions to the initial announcement were positive, but Draghi´s comments that interest rates probably would not fall any further amid concerns over the impact for European banks raised concerns over the possible limits of ECB policy.

In this context, the March SEFO takes a detailed look at the role of the ECB during the latest crisis and post-crisis period, together with the additional actions that will be needed from European institutions to construct a more united and resilient Europe. The ECB has been critical to Europe´s emergence from the crisis. In addition to consolidating its traditional role of guaranteeing price stability, it took on new tasks, such as guaranteeing financial stability and banking supervision. But the ECB cannot act alone to secure the integrity of the European project. This will require further strengthening of European institutions. In the immediate future, the objective will be the completion of banking union. Over the longer term, progress on fiscal and political union will also need to be considered.

We then assess the economic outlook for Spain over the short and medium term, as well as present considerations on how to improve longer term growth perspectives. After growing at a rate of 3.2% in 2015, the impact of the one-off factors that stimulated growth last year is wearing off. This, together with worsening global economic conditions, at least in 2016, has led us to expect slower GDP growth in Spain this year and next, 2.7% and 2.3%, respectively. On the fiscal front, the 2015 deficit target of 4.2% will be surpassed. For the economy as a whole, downside risks are considerable, deriving from the possibility of renewed tensions in financial markets and the possible negative impact of prolonged domestic political uncertainty on investment and employment decisions.

While Spain´s economic recovery currently outperforms that of the EU, restoring growth potential and modernising the Spanish economy remain key objectives. Increasing competitive advantage of sectors towards a knowledge-based economy will require building up technological and human capital, creating the right incentives for entrepreneurship, and improving institutional quality and social inclusion. Taking advantage of attractive investment opportunities for infrastructure projects and SMEs arising from the recent creation of the European Fund for Strategic Investments (EFSI), or the Juncker plan, should form a part of

Spain´s efforts to change its productive model and foster sustained job creation in the wake of the crisis.

Our financial sector analysis starts off with a broad snapshot of the key challenges for banks´ operating climate and their implications for banks in general and, in particular, in the case of Spain. A prolonged period of low (in some cases zero or negative) interest rates, pressing regulation mainly based on higher capital requirements and technology-related disruptive change are the main actual and forthcoming challenges for the banking industry. In Spain, low interest rates pose a more intense threat, given Spanish banks´ high degree of reliance on the traditional banking model. Increased capital requirements, however, appear to be more manageable for most Spanish banks, which have improved their levels of capitalisation and typically have lower risk profiles. Both global and Spanish banks´ adaptation strategies in response to these challenges will likely forge a new industry structure and financial innovation technologies should be an important part of it.

Focusing in greater detail on Spanish banks, despite the financial market turbulence in early 2016, they have increased their profitability and solvency. Joint profits of the six largest Spanish banks increased in 2015 by 8.1% relative to the previous year. Solvency has improved – banks' fully-loaded core tier 1 capital (CET1) ratio rose from 10.9% in 2014 to 12.2% in 2015. Private sector credit growth is expected to return to positive figures in 2016. Finally, Spanish banks may benefit in the medium-term relative to their peers elsewhere thanks to the enhanced transparency exercises undertaken. Nevertheless, as we stated previously, the outlook remains challenging.

For example, we examine the effects of a potential new challenge - the inclusion of government debt within banks´ risk-weighted assets, in the leverage ratio and in the large exposure limit, which all represent alternatives currently forming part of the EU regulatory debate. The significant weight of government debt on banks' balance sheets in several European countries, including Spain, has been fuelling ongoing debate about the regulatory treatment of these bond holdings. A reduction in sovereign bond holdings could weaken the link between banks and sovereigns and free up funds for private sector lending. However, penalising these holdings would also reduce banks' ability to stabilise the sovereign bond markets and could exacerbate financial fragmentation in the event of stress in the EMU. Banks' returns are currently being eroded by increased regulatory requirements and negative rates. Before introducing limits or haircuts on sovereign bond holdings, it might be advisable to make progress on banking union to prevent further erosion of banks' profitability from causing financial stability issues.

Finally, we look at progress on two areas related to the financial sector restructuring process: regional concentration of the Spanish banking sector and clean-up of bank exposure to the real-estate market. The deep restructuring of the Spanish banking sector has led to significant branch reduction, largely as a consequence of mergers within the sector. In parallel, there has been a notable increase in market concentration – now much higher than the European average. Concentration varies greatly across the provinces, although increasing substantially during the crisis and almost across all of Spain. The increase in concentration has been so intense that in some provinces it may warrant assessment of potential implications for competition.

Various property market indicators point to a recovery in 2015, although below pre-crisis levels – in line with the correction of the sector´s imbalances. As in the case of the Spanish economy´s overall recovery, the property sector’s future remains highly sensitive to global and domestic conditions. The recovery of the Spanish economy in 2015 allowed the financial sector to significantly reduce its volume of troubled assets, although the reduction needs to factor into account the transfer of assets to SAREB. A closer look reveals that the reduction in troubled assets has been due to the fall of NPLs, whereas progress on reducing foreclosed assets has been going very slowly, with the net effect being an accumulation on financial institutions’ balance sheets. As regards SAREB, latest data reveal a significant reduction in its portfolio of financial assets; however, the value of its real-estate assets has remained largely unchanged since the initial transfer.