## Letter from the Editors

In the context of the Eurozone recovery, Spain continues to outperform the rest of the single currency area. The March issue of *Spanish Economic and Financial Outlook (SEFO)* starts off by taking a look at outstanding structural obstacles to improving the Euro area's growth potential and the possible risks of failing to do so for the ongoing recoveries of the individual countries in the region, for Spain in particular and for the very existence of the common currency itself.

Despite the recent pick-up in economic activity, the Eurozone remains an area of relatively modest growth and high unemployment. Performance is also unequal across countries, leading to a process of ever-increasing divergence. This disappointing record reflects the systemic weaknesses which prevail since the construction of the Euro: Shortfalls in the ECB's capacity to act as lender of last resort, the strong exposure of banks to domestic shocks; and, the lack of instruments for macroeconomic stability. Reinforcing the architecture of the Eurozone will be critical for supporting the ongoing recovery in Spain, while making growth more socially inclusive.

In tandem with Spain's macroeconomic recovery, the country's banks too have now largely completed their post-crisis transition and have moved into the recovery phase. In this setting, we analyse the most recent data on the performance of the Spanish banking sector, in absolute terms and relative to the rest of the EU – their 'deleveraging' effort continues, but the prospects for credit are improving little by little, their cost-to-income ratios and income-generating capabilities also outperform those of the EU. And while Spanish banks' Tier 1 capital ratios remain somewhat below the Eurozone average, they rose from 11.87% to 14.96% between 2010 and 2016 – comfortably above regulatory requirements and demonstrating reinforced transparency. Going forward, both Spanish and Eurozone banks face a challenging international environment, mainly due to uncertainty surrounding Brexit implementation, potential spillover effects from US financial deregulation, and the upcoming stress test exercise – but compared to 2016, this year makes a greater case for renewed optimism.

We take our analysis of the EU financial sector a step further and examine how its adaptation to the crisis and post-crisis operating environment has been reflected in the business models of EU, and in particular Spanish banks, by looking at changes to their balance sheet activity and income structures. On the whole, the post-crisis environment of falling interest rates, deleveraging, regulatory requirements and increased competition has forced Euro area banks to adapt their

business models to maintain profitability. The structure of banks' balance sheets has changed, with the relative weight of non-interest sources of income increasing. In Spain, we point out that the retail banking model continues to dominate, although overall lending to the private sector fell largely due to deleveraging by non-financial corporations. Also, the weight of sovereign debt on Spanish banks' balance sheets has tripled, making it one of the countries with the fastest growth in sovereign debt holdings by banks within the Euro area.

Finally, on a related note, we look at room for further progress in Spain in the area of digital payments. Spaniards' payment habits are shifting in the expected direction but not at the expected speed. The fact that Spaniards still use cash more often than card-based payments, that one in four still only uses cash and that just 7% pay for their purchases only with cards, suggests that there is still a long way to go in terms of encouraging card usage– particularly among small retailers and, generally speaking, for micro payments. Whether this dynamic reflects current obstacles in the evolution of the card-based payment market, or simply Spaniards' payment habits, Spain currently lags behind its EU peers as regards use of cards relative to cash payments.

Moving on to the macroeconomic and fiscal analysis of the situation in Spain, we examine several areas where there has been progress in correcting imbalances, but where obstacles still persist: unemployment, the current account balance, and fiscal accounts.

As regards the issue of unemployment we assess empirical evidence to conclude Spain's current high rate of structural unemployment leaves little room for the unemployment rate to fall without distorting prices. Estimates for structural unemployment in Spain currently point to a range of between 15% and 19%, depending on the methodology employed. Lowering this high rate through structural reforms thus becomes an increasingly important priority to reduce potentially negative consequences for the Spanish labour market and overall economy.

We then study Spain's current account balance. Since 2013, the current account entered into surplus – reversing a recent history of deficits. Unlike the years prior to the crisis, an apparent rise in labour productivity across most sectors is presumably underpinning these recent favourable developments. Nevertheless, current account and productivity figures in Spain coexist with a rate of unemployment that is nearly three times that of other benchmark economies. Until the Spanish labour market begins to create jobs in the quantity and of the quality needed, the economy will not move towards effective recovery.

Related to the issue of improving Spain's external accounts, at the micro level, we look at the role of industrial policy in addressing some of Spain's aforementioned structural challenges. By helping to increase manufacturing exports, the right industrial policy mix could help to generate a more balanced growth without exacerbating external imbalances, and at the same time provide new opportunities for employment.

Finally, on the fiscal front, greater political stability, a more favourable economic climate, and substantial upward revisions

to original deficit targets means there is a high probability that Spain will meet its 2016 deficit objectives. Under current conditions, consensus expects slippage in 2017. Neither the social security system, nor the regions will be able to substantially bring down their deficits and local corporations' surpluses may even be reduced, forcing the central government to bear the brunt of the adjustment burden. Reaching agreed upon fiscal objectives this year may still be feasible, but unlikely without additional measures, particularly in the area of tax revenues.