Letter from the Editors

We initiate this month's *SEFO* with the first time ever publication of Funcas' eurozone forecasts. The eurozone economy has improved significantly. Recent indicators point to a recovery in both domestic demand and exports. This is due to the continuation of the low interest rate environment, stemming from ultra-expansive ECB policy, the recovery in international markets and increased optimism among consumers and companies. Funcas' projections are for GDP growth of 2% this year and 1.9% in 2018, making a significant dent in the unemployment rate. Even so, by 2018 the economy is still likely to be 1.7 million jobs short of the pre-crisis employment situation. Furthermore, there continues to be significant divergence across eurozone economies, weakening the sustainability of the single currency.

Spain continues to be one of the fastest growing European economies. Spain's economic growth in 2017 is exceeding expectations and the outlook for next year remains positive. Stronger exports are supported by the global recovery and the favourable competitive position of Spanish firms, while the slowdown in domestic demand is proving milder than initially foreseen. In short, the economy, which had lost steam in the second half of 2016, is gathering momentum once again. Growth is forecast at 3.2% in 2017 and 2.8% in 2018.

Nevertheless, the legacy of the crisis still weighs down on overall results, the main risks to the recovery being the stock of public debt and long-term unemployment. Public debt is expected to reach 98.1% of GDP in 2017 – high in comparison with other European countries and almost three times the pre-crisis level. And although the drop in unemployment keeps accelerating, reforms are needed to address outstanding labour market issues. It will be crucial to tackle these two main weaknesses, and in parallel reinforce the eurozone's institutional framework, before the ECB scales down its exceptional arsenal of stimulus measures.

In this context, the July *SEFO* provides an assessment of the outlook for fiscal consolidation in Spain. Following several upward revisions, the Spanish government closed 2016 with a public deficit of 4.3% of GDP,[1] or below the 4.6% of GDP official objective. Target compliance was achieved with the help of the surplus recorded at the local government level, which compensated for slippage by Social Security and the slowdown in consolidation at the central government level.

[1] Excluding aid to the financial system.

Most analysts believe Spain will come close to reaching the deficit target of 3.1% of GDP for this year. Optimism is underpinned by the growth outlook, together with scope for additional discretionary spending cuts in the event of 2017 targets coming under pressure. However, as evidenced by the latest (April) version of the 2017-2020 Stability Plan: i) the consolidation effort will come 80% from expenditure adjustment and 20% from revenues; ii) progress remains systematically slow and the current level of structural deficit needs to be further reduced; and, iii) spending cuts must be taken carefully to avoid a scenario where the quality of Spain's public services falls below that of its peers.

Furthermore, the 2017 budget reveals a dependence primarily on favourable cyclical developments. The strong performance of tax revenues in the first part of the year, together with stagnation in discretionary departmental spending, bode well for a significant reduction in the deficit, bringing it mostly in line with the official target for this year. However, the lack of substantive reforms foreshadows difficulties in fully delivering on deficit targets over the longer-term.

While the public sector strives to reign in deficit and debt ratios, the private sector has made notable progress on reducing its outstanding debt burden. The significant deleveraging effort by Spanish households and companies since 2010 has successfully reduced the weight of debt in GDP by 50 percentage points (pp), allowing for a reduction of the gap relative to the eurozone average to 3.4pp, albeit remaining 13.4pp above the average for the EU-28. Deleveraging, together with an improvement in corporate earnings and household gross income, has significantly improvement debt sustainability. The combination of deleveraging, rebounding profitability and lower funding costs has also helped bring about a reduction in debt servicing costs for Spanish households and firms. Consolidation of the current economic recovery and a continuation of existing benign financing conditions are crucial prerequisites for the continued reduction in financial vulnerability.

The July *SEFO* also analyses progress on tackling Spain's other main outstanding risk – shortcomings of the labour market. The Spanish labour market is gradually emerging from the crisis, with over half of the jobs destroyed having been recovered. The new jobs created since 2014, however, are substantially different from those of the pre-crisis period. In general, the Spanish labour market is paying less than it used to for the same kind of work. This wage moderation reflects the new labour market conditions, where most of the burden is being shouldered by those workers who had to change jobs and young people just joining the labour market.

Finally, as regards developments in the financial sector, we explore the contrast in the performance of Spanish banks versus insurers. The recent crisis has significantly altered the behaviour and relative positioning of Spanish insurance companies and banks. The former have performed much more strongly, reducing the gap to the banking sector in terms of size, solvency and profitability. Meanwhile, both sectors have substantially improved their solvency levels at the cost of lower returns to shareholders. But there is a noteworthy difference: insurance companies are sustaining double-digit profitability, while the returns offered by banks are much more limited.

Also, we assess developments in shadow banking. In Spain, shadow banking scarcely accounts for 0.7% of the global total. Even so, the combined non-banking sector managed 1.34 trillion euros in assets in 2016, a decline from 1.53 billion euros in 2010 – primarily because of a downturn in securitisation fund assets. However, growth in shadow banking in the euro area and potential contagion risks make it an issue worth monitoring. To this end, regulatory and supervisory authorities coordinate internationally to try to reduce contagion from a business that continues to experience rapid growth.