Letter from the Editors

Global economic prospects seem brighter – the OECD has recently revised upwards its world economic growth forecast since November for this year and next. But 2018 also appears to be a year marked by heightened uncertainty and market volatility. As regards Spain, the economy's current growth cycle is the most balanced in recent economic history. In the past, growth had been accompanied by external imbalances, relatively high inflation and an erosion of competitiveness that ultimately triggered fresh recessions. Evidence suggests, however, that today's Spanish economy is significantly better positioned to withstand external shocks.

It is within this context that we open the March issue of *Spanish and International Economic & Financial Outlook (SEFO)* with an assessment of the robustness of Spain's current growth cycle under different scenarios – *i.e.,* in response to various potential macroeconomic shocks – both external and domestic, as well as negative and positive.

From the formulation of four scenarios for the period 2018-2020, we conclude that in all of them, the Spanish economy would continue to grow until 2020 and even under the most adverse scenario, would not fall into a prolonged recession. In the central scenario, activity would approach its non-inflationary potential by the end of 2020 and the unemployment rate would drop to around 10%. Some Autonomous Regions (Balearic Islands, Basque Country and Navarre) would be close to full employment. This increased resilience of the Spanish economy is due to a combination of factors, including: i) the improved financial position of non-financial enterprises; ii) a healthier post-crisis financial sector; and, iii) the country's favourable competitive position. Nevertheless, in all scenarios, public debt and unemployment remain the main medium-term challenges, highlighting the need for additional reform.

Next, we turn the focus to current trends and upcoming challenges for Spanish financial system actors by looking at bank profitability after the crisis and assessing the prospects of the digital opportunity in the years to come. While the latest quantitative indicators for the European banking sector largely show improvement in the ten years following the financial crisis, the sector has not been able to fully dispel doubts over asset quality. Moreover, banks still face important profitability challenges, with margins still significantly below pre-crisis levels. The five major Spanish banks posted a combined net profit of 13.44 billion euros in 2017, up 53.5% from 2016 and nearing the levels reported in 2008 - at the start of the crisis. Compared to the main European markets, Spanish banks perform relatively well in terms of profitability and efficiency, albeit still below average on capital adequacy. The restructuring forced by the crisis is ongoing, particularly as regards digitalisation. In this context, a more qualitative analysis of the situation reveals digitalisation as the best opportunity for lifting profitability, framed by the choice of a range of competitive alternatives. Spanish banks are relatively well positioned compared to their European counterparts for tackling the digital challenge, although we do not rule out that relevant changes in the competitive landscape and service channels may still materialise.

Other areas of Spain's financial landscape are also showing improvement. After experiencing a somewhat slow start from its origination in the mid-eighties, the Spanish private equity market has evolved substantially, achieving record levels of investment in 2017 and a recovery in fundraising activity since the crisis – with international funds playing an increasingly prominent role. Moreover, the existence of favourable financing conditions, on offer from banks and non traditional financiers alike, is helping to get transactions closed. Nevertheless, increased competition will present challenges for the sector going forward.

While the outlook for the country's financial sector appears to be improving, Spain's banks, alongside their European counterparts, having digested new capital requirements imposed under Basel III, are now facing requirements to have easily 'bail-inable' instruments for loss absorption purposes in the event of resolution under the so-called Minimum Requirement of Eligible Liabilities (MREL). In recent months, progress has been made on specifying MREL requirements for European banks, allowing for an estimation of Spanish banks' associated funding requirements for compliance. Based on year-end 2016 data, we estimate an issuance requirement of between 65 and 79 billion euros, over one-quarter of which was already covered in 2017 in a very propitious market for 'bail-inable' liability issues, principally for senior 'non-preferred' notes following recent regulatory changes. Going forward, strong investment appetite and constructive market conditions should underpin continued issuance at favourable terms of the remaining MREL requirements for Spain's significant banks in the coming year. However, the final levels of bail-inable capital needed for MREL compliance may still vary given that numerous regulatory parameters have yet to be defined, together with the entity-specific approach taken by European authorities.

The final topic addressed as regards financial issues looks at financing conditions as perceived from the demand side; specifically, banks financing for micro and small enterprises in Spain in the European context. In, Spain, the weight of micro and small enterprises is the most relevant to the productive landscape, accounting for 59.5% of all jobs (10pp above the EU average) and 44.0% of GDP (+5.3pp). Yet, the small size of Spanish companies serves as a barrier in terms of the ability to invest in the factors that drive productivity (R&D, human capital, international expansion, *etc.*), as well as in terms of their access to finance. The findings of the latest ECB survey addressing firms' access to finance show that micro and small enterprises face harsher financing conditions, particularly in the case of micro enterprises. Although these terms and conditions have improved substantially in recent years, firms with fewer than 50 employees are perceiving the improvement to a lesser degree. The good news is that the differences in spreads on bank loans by loan size have narrowed and that access to finance is now the key problem for only a very small percentage of Spanish companies (around 7%), irrespective of size. In addition, financing conditions have improved in terms of interest rates, but have gotten tighter in terms of commissions and collateral, more so for micro and small enterprises.