Letter from the Editors

EU bank's today are stronger and more resilient than they were prior to the crisis. However, they are still dealing with a difficult operating environment, both at the global/macro and sector levels. First, they must navigate several key global challenges, including an uncertain outlook for the world economy and the eurozone, as well as specific issues in Italy arising from tensions between the Italian administration and the European Commission over the budget and fiscal discipline. Second, increased regulatory pressures at the sector level continue to weigh on profitability.

In light of these complexities facing the EU financial sector, the November issue of *Spanish and International Economic & Financial Outlook (SEFO)* starts out with an analysis of the recent performance of EU banks on the European Banking Authority's latest EU-wide stress tests —published early this month. Looking more closely at the stress tests, it becomes apparent that most of the European banks, including those in Spain, are better capitalised to withstand potentially adverse macroeconomic scenarios. Specifically, of the 33 entities directly supervised by the ECB, an adverse scenario would result in a decrease in the fully-loaded CET1 ratio from 13.7% in 2017 to 9.9% by 2020, which is an improvement from the equivalent adverse scenario ratio of 8.8% in 2016. In the case of Spain, the percentage impact on fully-loaded CET1 estimated in the adverse scenario is below the European average. That said, both Italy and the UK were notable exceptions, suggesting that these banking systems may encounter difficulties in overcoming adverse economic conditions.

As referenced above, in light of the increased capital requirements demanded by regulators (and investors), many EU banks have pursued strategies of tapping the Additional Tier 1 Capital (AT1) markets to boost their Common Equity Tier 1 (CET1) ratios. Next in this SEFO, we explore banks' recent increased reliance on one such AT1 instrument —the contingent convertible bond, or CoCo— whose success can be attributed, in part, to higher yields, but not without risks.

We then assess how banks have responded to managing customer deposits within the context of the protracted, unusually low, interest rate environment and what we can expect as regards this segment of bank liabilities under an anticipated (gradual) ECB rate normalisation cycle. The persistence of abnormally low interest rates has had a significant impact on the structure of customer funds managed by the Spanish banking sector. That structural change has affected both the mix of off-balance sheet funds relative to deposits (with the former clearly predominating in recent years) and the breakdown between term and demand deposit. Over the last few years, the traditional mix of 60/40 in favour of term deposits has shifted towards demand deposits, which currently represent 80% of all deposits. The increased weight of demand deposits as a structural source of funding has significantly lowered banks' funding costs. However, cautious observation is necessary, especially in the, albeit unlikely, event of ECB monetary policy normalisation in the very near-term. In such a scenario, the expected margin recovery would be extraordinarily sensitive to how Spanish banks manage their pool of deposits.

In the remaining articles within this SEFO, we bring the focus back to macroeconomic analysis, in particular, looking at issues related to competitiveness –the performance of Spain's external sector and, on a related note, the outlook for the Spanish labour market.

Spain's external sector appears to be exhibiting signs of weakness in the current year. The slowdown in GDP growth over the first three quarters of 2018 can be largely attributed to the loss of dynamism of exports of both goods and services. Consensus forecasts already reflect a slight deterioration in the current account surplus for this year and the next –although with the balance still remaining in positive territory.

Against this backdrop, we look at the potential for sustainability of Spain's trade surplus under a continued economic expansion. By the end of 2017, the Spanish economy had experienced three years of GDP growth of at least 3%. This is highly unusual and has not occurred in more than three decades. Moreover, periods of high growth have typically corresponded with trade deficits, yet this most recent growth trend has occurred in the context of a positive current and capital account balance. Given that many companies have yet to maximize their exposure to foreign markets, there is still significant room for growth in exports. In terms of imports, their sensitivity to final demand growth has fallen. Therefore, despite some recent negative performance reflected by Spain's latest export figures, on the basis of an analysis of long-term import and export trends, if the Spanish economy continues its expansion, there is potential to do so without generating trade imbalances, thereby reducing the country's unemployment rate and foreign borrowings. It should be noted, however, that there are several downside risks in the current fragile international scenario –oil prices, an increase in exchange rates and lower global growth– which could negatively impact the trade surplus.

Next, we look at the role of cost competitiveness in export performance through an assessment of the situation in Spain relative to other EU countries by analysing the relationship between the changes in unit labour costs (ULCs) and the changes in the export market shares of the six biggest exporters of manufactured goods in the eurozone (Germany, France, Italy, Netherlands, Belgium and Spain). First, we analyse the different trends in unit labour costs in 2005-2010 versus 2010-2015 and in the components of ULCs (employee compensation and apparent labour productivity). Spain stands out as the country where the change in the ULC trend has been the most pronounced. During the first period analysed, Spain was the country where ULCs increased the most. Conversely, Spain saw the largest decease in ULCs in the second period analysed. Notably, Spain also experienced the largest decline in manufacturing jobs over both periods. As for the relationship between ULCs and export market shares, the figures analysed show that there is no clear correlation between the two variables at either the aggregate country level or at the product-country level for eight products within the manufacturing sector. Therefore, while ULCs are relevant to some key sectors in Spain, they are not the only factor that determines competitiveness. Consequently, it is important to move beyond the internal devaluation practices adopted to tackle the crisis, given that additional factors aside from cost competitiveness, such as R&D intensity and foreign demand, too have a significant impact on export success.

Finally, as regards the outlook for the Spanish labour market, since the start of the financial crisis, Spain's job market has exhibited a highly volatile employment trend. After shedding nearly 4 million jobs during the recession, the unemployment rate has steadily declined, with 30% of eurozone job creation occurring in Spain over the last 4 years. Interestingly, the labour force participation rate in Spain increased during the recession, the opposite of what would be expected. More recently, it has stagnated, while still remaining higher than in many other European countries, such as Belgium, France and Italy. On the other hand, the analysis of recent trends does not permit a clear-cut determination as to whether structural unemployment has increased as a result of the crisis: recent declines in long-term unemployment point to an optimistic picture; but prevailing education gaps, and regional differences in employment suggest a less favourable assessment, especially in view of the impacts of an increasingly digitised economy. Despite initial reform efforts already undertaken, the high correlation between the level of employment volatility and the rate of unemployment calls for policymakers to design initiatives that will address persistent imbalances in the Spanish labour market.