Letter from the Editors

In the first issue of *Spanish and International Economic & Financial Outlook (SEFO)* of this year, we take a look at prospects for the Spanish economy in 2019-2021 against the backdrop of a challenging global, not least European, economic environment. Recent indicators point to the cooling of the European economy. Italy has just entered into recession as a result of the pressure on its risk premium, the uncertainties surrounding its public deficit roadmap amidst high public borrowings, and the banks' still high non-performing loan ratios. In France, the economy has slumped as a result of the *gilets jaunes* movement. But the biggest surprise has come from the Germany economy, most exposed to trade tensions, which has contracted in the third quarter of 2018 and has failed to show significant signs of recovery since. Finally, the uncertainty surrounding Brexit is also weighing on the European economy, particularly the UK, one of Spain's main trading partners, which is registering very low growth.

Within this context, we point out that in recent years, the Spanish economy has grown by more than 3%, outpacing the EU average and most of its large European peers, while also managing to maintain a substantial current account surplus. However, this pattern of strong growth with external surplus is losing momentum, due in large part to the deteriorating international context. The Spanish economy is expected to register relatively strong growth in 2019. However, external shocks, such as trade tensions, the imbalances weighing on China's economy, a highly leveraged global economy and a surge in anti-European populist movements, could unleash a crisis of confidence and drain global growth more intensely than is currently anticipated. In such circumstances, Spain's high public deficit would leave scant room for deploying anti-cyclical fiscal policies. Domestically, maintaining momentum on the reform agenda will be necessary to support Spain's growth cycle, create jobs and remedy inequalities.

We then shift the focus to the financial sector, assessing first the prospects for the future of blockchain in the European banking system in the coming years and then providing an update on the status of NPL disposals at the EU level. Blockchain technology has sparked intense debate in recent years. In the financial industry, this debate has centred almost exclusively on the rise, and more recently on the relative decline, of cryptocurrencies and the risks of these instruments. However, blockchain technology has far wider implications for markets and banks. To get in front of emerging challenges, the European banking industry has spearheaded some key blockchain-based platforms, including for trade finance. These initiatives have recently been backed by the European Commission, which made the financial applications of blockchain technology a central part of its 2018 FinTech Action Plan.

As regards NPLs, since the European Commission approved its Action Plan on the Reduction of Non-Performing Loans in 2017, several institutional initiatives have emerged to achieve the Plan's goal. Among the most notable are the recently published EBA Guidelines on the management of non-performing and forborne exposures and a European Commission progress report, which includes an analysis of an ambitious proposal for an EU-wide transaction platform to boost non-performing asset sales. However, on-going pressure on banks from the European supervisor (SSM) suggests that the current pace of reductions is too slow and would fail to prevent some key economic risks from materialising down the road. Judging by the downward trend in NPLs in most European countries, it appears that this pressure has been effective and that Spain will continue to sell off non-performing assets.

On a related topic, we look at prevailing conditions in the Spanish mortgage market. Prior to the 2008 financial crisis, 20% of every 100 euros of housing loans extended in the eurozone were granted in Spain. Today, five years after the country's real estate bubble burst, that percentage stands at 5.2%. The housing market is recovering, however, with new housing loans registering double-digit year-on-year growth since April 2018. This has sparked renewed interest in how Spain's mortgage market compares to other eurozone economies, from business indicators to interest rates to borrowing terms and conditions, bank margins, rejection rates and household debt service ratios, among other indicators. While there has been a notable pick-up in Spain´s mortgage market, the volume of mortgages granted, the size of new mortgages and the financial burden for households are all well below the highs of the past and there are no clear signs pointing to the emergence of another property bubble.

We then look at recent regulatory changes and their anticipated impact in various areas. First, we provide details on the new accounting model, IFRS 16, which has established new criteria and fixed treatment for all types of leases regardless of whether the risks of ownership of the asset are transferred to the lessee. By standardising the way in which leases are accounted for, IFRS 16 seeks to ensure that reporting entities account for financing from operating leases on their balance sheets and that credit risk analysis is less biased. Some sectors —including airlines, retail and tourism/leisure— will be more affected by the new criteria than others and most market players had already taken steps to address associated challenges. Nonetheless, the broad implications of the new standard are only just beginning to be understood.

Second, we explore the possible impact of the increase to Spain's minimum wage. The recently approved increase in the minimum wage by 22.3%, to 900 euros per month in 2019 —forecast to reach 1,000 euros in 2020— will make Spain pass from being one of the countries with the lowest minimum wages to one of the highest. This decision could be in part justified given the country's low current wage level and the decoupling of wages from labour productivity, although there are broad differences across sectors. However, the scale of the increase may be disproportionate or, at the very least, risky. It is not clear that a minimum wage is the best tool for addressing growing household income inequality as there is no clear correlation between wage levels and household poverty. Furthermore, evidence shows that disproportionate increases in the minimum wage may significantly impact employment for low-wage earners, older workers, youth, and other already vulnerable groups.

Lastly, we analyse Spain's uncertain medium-term fiscal outlook. With a structural deficit incompatible with fiscal stability and substantially higher than those seen in the EU, the fiscal landscape is undoubtedly one of the Spanish economy's biggest weaknesses. Facing the very real possibility of interest rate hikes, international financial market tensions and lower economic growth, the government has recently proposed a new fiscal strategy that includes upward revisions to the deficit targets for 2019–2021. Additionally, receiving Parliamentary support for the recently presented 2019 GSB will be difficult and the revenue estimates included in the project to achieve an ambitious 1.3% of GDP

target initially agreed upon with the EU will too be difficult to achieve.

We close this *SEFO* with an assessment of a topic of critical importance not only for Spain, but for all EU member states – challenges surrounding the ECB's definition of price stability. By advocating monetary integration and through efforts to strengthen forward guidance, the ECB seeks to improve how Europe's economic and monetary union functions. However, the politics and economics of the ECB's unconventional monetary posture has bred confusion, much of which likely stems from the ambiguity surrounding the definition of price stability. Europe's unique economic and monetary union and member state diversity have spawned divergent policies and perspectives on price stability. To provide more clarity, the Governing Council could promote financial market integration within the euro area, encourage market-structure convergence and construct a narrative that explains how prices can be stable for the euro area as a whole despite obvious differences in national inflation rates. While the ECB may not be able to eliminate all the ambiguity surrounding price stability, its efforts to construct a more cohesive monetary union can produce more effective monetary policymaking, both in perception and reality.