Letter from the Editors

The March issue of *Spanish and International Economic & Financial Outlook (SEFO)* comes out just weeks after the ECB's surprise announcement to delay the start of its interest rate normalization cycle at least through the end of the year, relative to prior expectations of a rate hike sometime in the third quarter of 2019. The more dovish stance by the ECB –echoing a similar shift recently adopted by the Fed– underscores concerns over the deterioration in the eurozone growth outlook, on the back of the overall deterioration in global economic prospects. Within this context, yield curves are expected to stay relatively flat – implying intermediation remains a fairly non-profitable activity for banks. To assuage resulting concerns over a credit squeeze that could exacerbate the economic slowdown, the ECB has launched a new series of TLTROs. However, while liquidity should remain cheap, bank profitability will remain a challenge.

In this context, we start off this issue of *SEFO* with a comparative analysis of profitability of the European and US banking sectors, as well as an exploration of a potentially new area of financial sector systemic risk. Financial institutions in both the US and eurozone have had to contend with challenges including a flattening yield curve and more stringent capital requirements. Nevertheless, US banks have proven more resilient, with average RoE virtually twice that reported by EU financial institutions. These differences can be attributed to a multitude of factors including a more robust economic recovery in the US and an uptick in US banks' M&A activity, which has not been mirrored by EU banks. While European banks have improved their overall capital and NPL ratios, their lower levels of profitability should remain a concern. Going forward, with the next round of stress tests scheduled for this year, it remains to be seen whether new data will inspire greater confidence in the banking industry on either side of the Atlantic.

We then examine a new potential area of systemic risks in the financial sector on which European regulators have begun to focus their attention. Their concerns centre around the overlap of portfolios held by the four main types of financial sub sectors: banks, insurance corporations, investment funds and pension funds. European Central Bank data on the size and composition of these portfolios in both the eurozone and Spain reveal a high degree of interconnectedness in the securities held by these four actors, indicating a significant source of potential systemic risk. Nevertheless, there were some notable differences in the composition of these portfolios in Spain *versus* the eurozone as a whole. For example, Spanish banks are the major holders of securities in the country, whereas across the rest of the eurozone, this asset is primarily held by investment funds. Moreover, in Spain, the heightened risk profile in financial markets originates largely from investment funds. These entities may not pose a risk to the solvency of the financial system as a whole, but through responses by investors, have the potential to trigger sudden market swings.

Next, given recent legislative changes affecting the Spanish housing sector, we present an assessment of the current challenges in Spain's rental market. It is becoming rather fashionable to describe the dynamics in Spain's rental market as exhibiting characteristics of a "bubble", but close analysis casts doubt on this claim. First, it is necessary to highlight that any analysis of housing market dynamics is restricted both by the limited quality and breadth of available data. Second, while it is true that the financial crisis and subsequent recovery have coincided with a rise in the demand for rental properties, some indicators, such as the rate of severe housing deprivation, in Spain have remained below the EU-28 average, suggesting prices are still relatively affordable. Moreover, there is little empirical evidence to support popular misconceptions as regards the reasons for recent rental price increases, such as the growth of large-scale investors as landlords, as well as home sharing platforms. That said, previous public policy measures in this area have failed to adequately address problems in the rental market. Going forward, it will be important to carefully assess the impact of any measures adopted to ensure the incentivisation, rather than restriction, of rental supply, as well as to assess any potential impact on inequality.

The next two articles in this number center on the real economy. First, we analyze the resilience of the Spanish economy in the fairly unlikely event of potential adverse shocks. Second, we look at the recent weakness exhibited by Spain's external sector for the first time since the financial crisis.

The current baseline scenario is for positive, albeit slower, economic growth of 2.1% in 2019. However, given the risk of further international tensions, it is useful to consider how the economy might fare under a potential materialization of more adverse circumstances. In order to do so, two relatively low probability stress scenarios are modelled. The first consists of weaker global and European growth, as well as a sharp increase in oil prices, while the second amplifies these effects and adds a major financial shock of a similar magnitude to the one that triggered the sovereign debt crisis almost a decade ago. In the first risk scenario, it is estimated that Spanish growth would fall to 1.8% in 2019, resulting from weaker exports and a slower pace of job creation and consumer spending. While the economy would see a more dramatic reduction in growth in 2020, a tepid recovery would follow in 2021. In the extreme risk scenario, which adds to the previous one a financial shock, the economy would enter a recession in 2019. It would begin to stabilise in 2020, with moderate growth returning in 2021. Significantly, there would be a rise in public borrowings over the entire projection period, peaking at 105.7% of GDP, a record high. However, the overall impact would be less severe than experienced in the sovereign debt crisis, due to the stronger financial health of Spain's private sector and the absence of any evidence of a bubble nor of credit propping up present employment levels. Despite an overall improved resilience, Spain has reduced capacity to deploy fiscal stimulus in response to shocks. Another vulnerability is the high level of oil dependency under the current energy model.

Drilling down further, global trade growth expanded by just 3.3% last year, falling from 4.7% in 2017. However, the picture is somewhat worse for Spain, where the slowdown was more intense. Particularly noteworthy is the reduction in demand from the UK, which began in 2017 and failed to recover in 2018. From a sectoral performance, the automotive industry performed weakest with a 1.5% contraction in current prices. That said, the broad nature of the slowdown in Spain's external sector suggests that traditional factors relating to a specific export market, sector, unit labour costs or exchange rate movements alone cannot account for this downward trend. It therefore remains to be seen whether the recent figures point to a one-off event, or the start of a more prolonged period of weakness in Spain's export performance.

We close this *SEFO* with a status update on the progress of reform of the regional financing system. The regional financing system has been generating positive results (on an accrual basis) since 2014, in contrast with the prior period which, with the exception of 2010, was characterised by economic contraction. The improved performance, tied to the economic recovery, has had an even bigger impact in budgetary terms, given that the payments on account in 2014-2015 did not reflect the economy's real dynamism. The aggregate of the payments on account, coupled with the definitive settlements received in 2016 and 2017, registered year-on-year growth of 9.5% and 7%, respectively.

This improved regional fiscal performance has been particularly apparent in Catalonia, Murcia, Valencia, the Canary Islands, the Balearic Islands and Madrid. The recent positive fiscal dynamics –as evidenced by compliance with regional deficit targets– together with the difficulty for regional governments to reach agreement – has slowed reform momentum. Lastly, the panorama is further complicated by divisions on the delicate issue of potential regional debt restructuring, not only in the academic field but also within the regional governments themselves.