Letter from the Editors

May's *Spanish and International Economic & Financial Outlook (SEFO)* ushers in a recently elected Socialist government for an upcoming four-year term. In this context, we see it an appropriate time to assess Spain's medium-term economic outlook and key risks the country may face while under the current administration.

Available information for the first quarter of 2019 indicates that the Spanish economy performed stronger than many analysts had predicted, with GDP growing by 2.4% and employment extending its strong expansion. Forecasts suggest that unemployment will continue to decline, eventually falling to 11.4% in 2021. However, GDP growth is likely to decelerate from 2.2% in 2019 to 1.8% for both 2020 and 2021, due to less robust domestic demand and the potential prolongation of trade tensions –one of the main risks to these projections. Moreover, it is also unlikely that the public deficit will come down substantially. In this context, public debt would also not decline much, falling to 94.5% by 2021, around 2.6 percentage points below the 2018 figure. Finally, in Spain, an additional drop in the household savings rate or an increase in household leverage (developments not currently contemplated in these estimates) would entail a cost in terms of financial vulnerability and the sustainability of the ongoing expansion over the medium term.

With this in mind, we next focus on deconstructing Spain's net borrowing/lending position by institutional sectors. The return of the household sector to a net borrowing position after eight years in surplus constitutes one of the most significant developments in the Spanish economy. Notably, the sector registered growth in gross disposable income (GDI) of 3.2% in 2018, the highest rate since 2008. However, this was accompanied by a decline in the household savings rate to 4.9% of GDI, the lowest level since the statistic was first published in 1999. This downward trend in savings could be attributed to factors such as an ageing population and low interest rates, among others; however, these dynamics have been present in other European economies where the savings rate has moved along a different trajectory. Turning to the non-financial corporate sector, a net financial surplus of 2.5% was recorded in 2018. Similarly positive was the reduction in the public sector's deficit to 2.48% of GDP. Nevertheless, with Spain's households and the public sector presenting a net borrowing requirement, the country's non-financial corporations are bearing the full weight of propping up the economy's overall surplus, which is necessary if the country is to reduce its high NIIP deficit and shore up confidence in its solvency.

We then drill down specifically on the issue of the public sector's fiscal performance –current state of play and perspectives– and

consequently, Spain's public debt, providing a detailed picture of the country's creditors and how they have evolved over time, as a function of both global financial conditions, monetary policy decisions, and risk appetites.

Spain's public deficit had fallen to 2.5% in 2018. While a welcome reduction, the result still fell short of the 2.2% target, placing the country two percentage points above the EU average. Moreover, Spain ranks as one of three countries with the highest structural deficits in the EU. This, coupled with a high debt-to-GDP ratio, leaves the Spanish economy vulnerable to potential scenarios of economic slowdown, interest rate hikes and financial turbulence. Unfortunately, future forecasts suggest the country is unlikely to see any significant improvement. The IMF estimates the deficit will remain above 2.5% for another four years with public debt exceeding 92% in 2024. Looking at the underlying causes reveals that Spain suffers more from a shortfall of revenue rather than a spending problem, and any potential strategy to address this will need to consider the available financial tools, institutional framework and political will. The latter point is a particular challenge given that latest polls show that Spanish citizens on average do not prioritize addressing the country's fiscal problems.

As regards the public debt, essentially, we find that the composition of the investor base for holders of Spain's sovereign debt has evolved significantly over the past 15 years and can be divided into three distinct periods. The most recent period began in 2012 and has been heavily influenced by the ECB's public sector purchase programme (PSPP), which initiated a shift in demand for Spanish bonds from the domestic private sector to the Bank of Spain, encharged with implementation of the PSPP. In a reversal of the observable trend during the crisis, non-resident holdings of Spanish public debt have increased since 2012, while the proportion of German, French and Dutch bonds held by foreign investors has diminished. This largely corresponds with data that show a correlation between non-resident holdings of sovereign bonds and the difference in borrowing costs between Spain and Germany. Also noteworthy is the increased appetite for Spanish bonds among Asian, and in particular, Japanese, investors, who tend to be risk-averse, thereby suggesting renewed confidence in the Spanish economy. Finally, it is also important to highlight that while Spain's Target2 balances have widened as public debt has increased, these balances are merely accounting adjustments that reflect the decentralised implementation of monetary policy. Going forward, it will be necessary to continue to reduce Spain's public debt levels and ring-fence the economy from the ongoing instability emanating from Italy's financial markets.

Shifting to the financial sector, we look broadly at how the ECB's recent decisions to push pack its rate increases and implement a new round of extraordinary liquidity measures may further complicate banks' ability to boost profitability. In March 2019, the ECB announced it would halt the dismantling of its quantitative easing program, leaving the interest rates for the main refinancing operations, marginal lending facility and deposit facility unchanged at 0.00%, 0.25% and -0.40%, respectively. Additionally, the ECB has announced the launch of a new round of its targeted longer-term refinancing operations programme (TLTRO). This decision represents a marked shift from autumn 2018 when the ECB indicated it was ready to adopt a more hawkish stance. However, stagnant economic data and a tightening of credit mean interest rates are now unlikely to rise before 2020. This prolongation of exceptional monetary policy has put downward pressure on eurozone banks' margins, leading some analysts to argue in favour of a tiered deposit facility rate to ease the burden on banks. Notably, the ECB remains unconvinced of this measure's merit as it would undermine its forward guidance. Nevertheless, the ECB is likely to provide greater clarity on these issues as economic developments play out in the US and additional details over its new TLTRO-III programme are disclosed later this year.

Lastly, we estimate the impact thus far of banks' capacity adjustment efforts in response to the downward pressures on profitability from the

protracted period of exceptional monetary policy. Since 2009, Spanish banks have made a concerted effort to cut capacity through both a reduction in employees and branches, with capacity cuts far greater in intensity than in most other major eurozone economies. This has occurred over three distinct periods, with mergers, recapitalisation requirements, the need to increase efficiency, and the recalibration of banks' distribution models providing the impetus for the banks' restructuring efforts. This downsizing trend was also initiated to increase productivity at a time of declining business volumes. Given that the reduction in the number of branches and employees exceeded the contraction in business volumes, productivity, measured by employee and branch, has improved considerably. However, due to the combination of the volume effect and the unit margin effect, banks have experienced a significant drop in margin, thereby constraining any productivity measured in terms of the margin generated per employee and branch. Significantly, this occurred alongside an increase in per employee and branch unit costs, which has reduced banks' efficiency. This is explained by the fact that headcount cuts have focused more on branch staff than central service staff, which exhibit higher ULCs, and the way in which banks account for the costs associated with their workforce restructuring efforts.