Letter from the Editors

The publication of the September issue of *Spanish and International Economic & Financial Outlook (SEFO)* coincides with an important turning point in the monetary policy stances of key global central banks, such as the ECB and the Fed, towards a renewed bout of monetary easing. As global headwinds persist and inflation falls below expectations, many of the world's central banks find themselves back on the path towards exceptionally low rates and accommodation as they struggle to meet their mandates. At the September meeting, the ECB cut rates for the first time since 2016 and announced that it will restart its QE scheme in November. The Fed applied its second rate cut (following the first in July) since 2008 in September and markets are increasing expectations of the return to some form of renewed QE in the near future, particularly after recent tensions in money markets.

In light of these developments, this month's *SEFO* pays tribute to the growing debate over the limits and potential impact of such ultra-low rate policies and exceptional measures – in particular on European and Spanish banks.

We start the debate over monetary policy at the European level. The deeper debate about the most recent decision to loosen European monetary policy centres around when monetary instruments should be used to respond to negative contingencies, how monetary policy decisions are transmitted to the real economy, and how other macroeconomic policy instruments can be brought into the mix. In terms of negative contingencies, the ECB's Governing Council has expressed concern that the negative deposit rates and asset purchases may be close to an inflection point beyond which the costs of the policy change would outweigh the benefits. This challenge is complicated by the fact that European private banks are not all equally exposed to central bank credit, which means that the costs and benefits of monetary accommodation are unevenly distributed. Lastly, there is the struggle to address the consequences of the monetary transmission mechanism that creates differences traced back to structural factors, which are more difficult to ignore in times of relative stress. Going forward, incoming ECB President Christine Lagarde will need to forge a new consensus on the timing and content of monetary policy and on the implications of Europe's existing monetary transmission mechanism. She will also need to encourage those national governments with fiscal space to become more active in their use of fiscal policy, and she will need to start a conversation about what are the alternatives that are available in the event that no consensus is reached within the eurozone countries on further policy actions and/or that national governments provide insufficient fiscal stimulus.

We then focus on what QE means for the European banking system overall, as well as for the case of Spanish banks. With the eurozone's Main Refinancing Operations rate having stagnated at zero percent, inflation has remained frustratingly below the ECB's target of 'below but close to 2%'. The situation has notable parallels with Japan, where interest rates have lingered at 0% and inflation below 2% for two decades. For this reason, it is pertinent to consider lessons that could be drawn from Japan and to gain insight into what might lie in store for Europe's banks. The persistence of ultra-low interest rates in Japan has exerted systemic downward pressure on banks' unit margins. Interestingly, European banks' net interest margins are currently the same as those achieved by Japanese banks in the early years of the century. Since then, however, Japanese banks' net interest margins have fallen to around 0.6-0.7%. Japanese banks do benefit from two advantages not shared by their European counterparts, namely lower NPL ratios and a far lighter cost structure. Turning to profitability levels, Japanese banks have achieved a reasonably low, but stable, ROE of between 5% and 7%. Meanwhile, capitalisation levels are below those of European banks, where ratios of capital to assets have increased by over 50%. This divergence could be due to the difficulty for Japanese banks to raise capital in light of offering such a low ROE, and/or less stringent regulatory capital requirements in the context of a low volatility/low risk climate.

In the case of Spain, the countries six largest banks posted earnings in the first half of 2019 that were down 11% from the same period in 2018. While the ECB lowered its deposit rate an additional 10 basis points further into negative territory in September 2019, the central bank also introduced a tiered-deposit rate with the goal of offsetting the pressure on banks' margins. However, this provides only partial support for bank profitability. Looking at the empirical evidence, it becomes clear that while asset non-performance improves when rates fall, the effect on net interest margins is greater, thereby reducing a bank's profitability. Negative rates can even have the opposite effect on stimulating credit than the one intended due to their influence on markets' expectations. More broadly, negative rates can distort yield curves, exacerbating debt accumulation and potentially impacting financial stability. Finally, they can impact exchange rates, which warrants careful consideration in the context of today's trade tensions.

Also, related to the banking sector, we discuss recent amendments to Europe's Bank Recovery and Resolution Directive (BRRD) in the face of implementation of the Minimum Requirement for own funds and Eligible Liabilities (MREL). With an eye to preventing the use of public funds to shore up weakened financial institutions, there is now an international consensus that entities must be equipped to 'bail in' their losses in an orderly manner. In this context, in 2015, the Financial Stability Board approved the total-loss absorbing capacity (TLAC) standard, endorsed by the G20. TLAC stipulates that global systemically important institutions (G-SIIs) must hold a minimum level of own funds and liabilities capable of absorbing losses. Following approval of the TLAC at the international level, the European Union has revised its bank resolution directive to adapt its equivalent concept, the MREL, accordingly. Significantly, MREL regulations capture more financial institutions than the TLAC, prioritise equity, subordinated debt and non-preferred senior debt instruments to meet the new capital requirements and set specific minimum thresholds for larger-sized entities. Consequently, this new regulation will influence the size and types of instruments entities issue.

While monetary measures are in the spotlight, outgoing President Draghi's remarks remind us that we should not underestimate the importance of fiscal policy. The next section of *SEFO* provides an in-depth analysis of Spain's near-term fiscal outlook and path towards fiscal target compliance, as well as an analysis of the very important issue of tax decentralisation as applied to the regional governments in Spain.

Having brought its fiscal deficit under the threshold of 3% of GDP, Spain exited the excessive deficit procedure in 2018. That target

was met following a decade's-long hard work in the context of a harsh economic crisis that saw a substantial increase in Spain's public debt. Indeed, between 2008 and 2012, the ratio of debt-to-GDP increased by a total of 46.2 percentage points, compared to the eurozone average of 21.2 points. Significantly, it took Spain ten years to rein in its deficit, twice the EU-28 and eurozone average. However, Spain has now set an ambitious target outlined in its Updated Stability Programme, which includes achieving a balanced budget in 2022. Spain's independent fiscal institution, the AIReF, believes the country will miss that mark, albeit narrowly, estimating a deficit of 0.5% for that year. Either way, Spain is currently facing two sources of instability in terms of attaining the sought-after fiscal equilibrium. The first is external, namely that generated by the global economic slowdown. The second is internal and relates to the political uncertainty prevailing in Spain since 2015, which is proving a serious obstacle to passing budgets and implementing targeted fiscal consolidation measures.

Like many other countries, the decentralisation process in Spain has made more progress in terms of granting its regions spending responsibility rather than revenue powers. However, ensuring fiscal autonomy at the sub-central level is important as it supports a regional government's political autonomy, strengthens political accountability among voters, and disincentivizes large public deficits. Nevertheless, Spain's current decentralised tax system compares favourably with other countries. According to the OECD, on the expense and revenue side, Spain ranks 5th and 6th, respectively. Furthermore, the OECD's effective measurement of tax autonomy places Spain first within the EU. This suggests that the focus should not be on increasing the extent of tax decentralisation in Spain but redesigning the context in which tax autonomy is exercised. To accomplish this, it is vital to tighten the so-called 'soft budget constraint' in the regional sphere and fine-tune most of the taxes transferred. Such action would involve reforming tax management and the partial alignment of environmental taxes collected by the regions with a nationwide green tax strategy.

Lastly, we close this issue of *SEFO* with a reflection over the impact of the great recession on income inequality and its relationship to consumption. The great recession has had a long-lasting impact on Spanish households, with consumption still below pre-crisis levels. Given the importance consumption plays in a country's GDP, it is necessary to go beyond the analysis of aggregated statistics to identify behavioural patterns across household groups, with the goal of gleaning insight into past patterns and future projections of consumption. Interestingly, the latest data show that while income inequality has fallen, it is still higher than in 2007. On the other hand, wealth is less unequally dispersed and those households in economic hardship have fallen. That said, with the exception of retirees, Spaniards' income levels have yet to fully re-bound. The combined effect of these developments means consumption remains lower than in 2007. Interestingly, there has been a slowdown in the improvement in consumption this year despite an increase in gross disposable income. This suggests household spending could be influenced by factors such as uncertainty emanating from global trade disputes and other factors that are remnants from the crisis still observable today.