Letter from the Editors

Spain's fiscal outlook is at the core of the January issue of *SEFO*. Following the recent coming into power of Spain's first ever coalition government since the country's transition to democracy in the late 1970s, we start out by taking stock of Spain's recent economic performance and presenting our medium-term forecasts – drawing attention to the country's main challenge of reigning in public expenditures. Drilling down on fiscal issues, we then measure recent progress on deficit reduction and provide some insights on the expected consolidation path.

The Spanish economy registered growth of 1.9% in 2019, in line with October forecasts. The forecast for growth in 2020 is 1.5%, shaped by a slowdown in housing investment, public consumption and exports, the latter marked by a climate of heightened trade tensions and a slowdown in trade in manufactured products. Based on an improved global backdrop (*i.e.,* relaxation of US/China trade tensions, expansionary monetary –and in some cases fiscal– policies), the slowdown in Spain could hit bottom during the second half of the year, facilitating a modest rebound in 2021 and 2022 to 1.7%. Under those conditions, Spain would create close to 800,000 jobs over the next three years, fuelling a drop in the unemployment rate to 11.1% in 2022. A key concern lies with the public deficit, which, pending specification of the new government's economic policy, is barely expected to come down during the projection period, at an estimated 2.2% of GDP in 2022. In any event, these forecasts may be subject to revisions once the 2020 budget is approved and there is more clarity over the new government's economic policy agenda. However, the biggest downside risk lies abroad, particularly with the prevailing trade tensions which, if they were to intensify, could hurt the economic outlook.

Due to both economic and political pressures, Spain has repeatedly pushed back its deficit targets. Unfortunately, the total public deficit will not come down substantially in 2019 compared to 2018, as expenditure has continued to grow. Moreover, although the government failed to pass its general state budget for 2019, it did push through increases in public sector wages, pensions and unemployment benefits by way of decree. To put the situation into context, with a public debt-to-GDP ratio of 98.9%, Spain is the seventh most indebted European nation, well above the eurozone (86.4%) and EU-27 (80.5%) averages. Looking forward, the 2020 state budget has yet to take shape. However, initial estimates show that while announced tax increases could boost revenue between 0.3% to 0.4% of GDP, implementation of the expenditure measures contained in the coalition agreement will require paring back other spending initiatives or additional measures on the revenue-generation front.

As regards Spain's financial sector, the January *SEFO* provides a snapshot of the landscape for the FinTech sector in Spain, as well as an analysis of the recent changes in households' financial asset allocation and risk preferences.

The FinTech sector has sustained considerable growth in Spain in recent years, measured by both the number of players and the private investment it has attracted. In fact, FinTech firms raised 192.93 million euros in 2019, equivalent to an average of over 4 million euros per round of financing. Most firms are the result of entrepreneurial activity based in Spain's largest cities, such as Madrid, Barcelona and Valencia. Specifically, 93% of existing FinTech firms were established by groups of entrepreneurs, with just under 7% founded within an existing enterprise. The sector is primarily concentrated around four segments: credit, payments, investments and personal finance management. Many of these offerings are B2B solutions, with FinTech firms supporting the digitalisation of Spain's SMEs. While the initial expectation was that the Fintech players and banks would compete, there has been a marked shift towards collaboration among these two types of firms. Most notably, the banking sector frequently invests in FinTech start-ups and sponsors accelerators or incubators to support these firms in the early stages of their development.

The growth in the volume of retail customer funds managed by Spain's financial institutions has accelerated in the last year from the scant 1% observed in prior years to nearly 4%. This development has occurred in tandem with a two-percentage point increase in the savings rate. Of particular note is the shift from mutual funds to demand deposits. While the former attracted increased capital after 2012 thanks to the strong performance of equity markets and ultra-lax monetary policy, this trend has lost steam over the past year in both Spain and other main EU markets. Specifically, assets under management contracted by around 4 billion euros in Spain with bank deposits growing by 37 billion euros. Such a reversal is curious given the continued decline in demand deposit interest rates, indicating growing caution among households due to global uncertainty as well as increasing sensitivity to swings in the value of holdings. Importantly, these changes in risk appetite could lead to greater volatility in households' financial asset allocation decisions, with potential implications for financial stability.

We then focus on an intensifying debate at the global, European and Spanish level – climate change. This year's World Economic Forum (WEF) in Davos towards the end of January essentially approximated a climate conference. According to the latest WEF global risk report, all five of the top risks in terms of likelihood touched on climate and the environment. In this issue of *SEFO,* we explore potential to address the climate change challenge from the European standpoint and through a somewhat unconventional lens – evaluating the capacity for greening the ECB. We also assess how Spain is addressing the climate change challenge at the country level and progress on transitioning to a greener economy.

Incoming ECB President Christine Lagarde has signalled a commitment to 'green' the ECB. In this regard, the ECB could potentially support efforts to adapt to climate change through changes to supervisory requirements, credit rating agencies' methodologies, and/or its own formulas for macro-prudential supervision. It could even intervene in financial markets under a 'green' asset purchase program, however this could potentially create distortions, while effectiveness would be conditioned on the timing of such programs. The institution could even consider the use of its own investment portfolio to meet such objectives, creating a signalling effect. Nevertheless, to date, former ECB presidents have interpreted this dual mandate as prioritizing price stability over any economic policy objective. Thus, critics have expressed concern that going beyond that, *i.e.,* with the ECB's foray into climate change activism, could undermine the political independence of the central bank.

Preliminary estimates of the European Environment Agency (EEA) show greenhouse gas emissions in the European Union decreased

by 2% in 2018, having edged 0.6% higher in 2017. Although a positive trend, scenarios envisioned by the European Environment Agency indicate the EU would still miss its stated target of a 40% reduction by 2030. The advancement of climate change will involve structural shocks with effects in the medium and long-term. However, climate change and the actions taken to stall it are bound to have a growing impact on macroeconomic performance, too. In Spain, the government estimates that emissions decreased by 2.2% year-on-year in 2018, thanks to reduced emissions by the electricity sector, partially offset by growth in emissions in transport. Similarly, there has been an increase in the share of renewable energy and a decrease in the intensity of energy usage. Nevertheless, Spain's agricultural, energy, and tourism sectors remain highly exposed to climate change. Thus, it is imperative that the country make further advancements by taking advantage of its relative abundance of renewable sources, which will also mitigate the economic cost of its dependence on imported oil and gas.

Finally, we close with an assessment of the real estate market, taking a look at the broad transnational differences in this still-significant segment of the economy. House prices in Spain have recovered significantly over the past years and currently stand at a little over 80% of pre-crisis peak levels. Nevertheless, noteworthy variation exists across Spain's regions. While nine provinces have outperformed the national average, 22 of Spain's provinces have achieved a price recovery equivalent to just 65% of peak levels. Furthermore, the rebound in transaction volumes has lagged the recovery in prices. Volumes currently stand at just over 60% of peak levels but present considerable differences across provinces. It is worth highlighting the weak new housing construction figures. These statistics suggest Spain's housing market is still digesting the legacy stock of unsold housing from the previous construction boom. Lastly, housing affordability has improved in all regions, even those in which the price recovery has been most dynamic, putting prices at close to pre-crisis levels. Looking forward, the data suggest the housing market is likely to experience a soft landing rather than another crash. That said, the varying degrees of recovery draw attention to important structural dynamics, which could pose future challenges.