Letter from the Editors

The October issue of *Spanish and International Economic & Financial Outlook (SEFO)* comes at an important political moment for Europe. For the region as a whole, with Germany's elections now concluded, uncertainty surrounding important elections in key EU countries has largely dissipated. At the same time, domestic political tensions in Spain remain high over Catalonia.

In this context, we begin this month's SEFO by looking at issues that affect Spain outside of its borders, firstly in Europe and secondly, in Latam. We assess the status of discussions over the eurobond proposal, which seems to be gaining little traction as regards its conversion into actual policy. The most recent proposals for a mutualized sovereign debt instrument contain both advantages and risks. On the positive side, such an instrument would provide increased legal clarity in the event of a restructuring, as well as create a large class of relatively risk-free assets. However, risks related to legal certainty, political control, financial liability and finally, moral hazard make it politically difficult to sell. No matter how strong political opposition may be, as long as crossborder capital markets are still inefficient at assessing sovereign risk and averting moral hazard, eurobonds will be necessary and the debate will persist.

This issue of SEFO also specifically takes a look at the growth strategy of Spanish international banking/finance in Latam over the last two decades. On the whole, the strategy has been positive, with the Spanish economic crisis having been, to some extent, cushioned by foreign investments made by the country's big firms in Latin America, including its two global banks. Going forward, structural conditions, such as good demographics, low rate of banked population, high intermediation rates, and low correlation with the domestic economy continue to favour Spanish banks/financial firms investing in Latin America. However, incredible divergence across political/business cycles in the countries within the region make Latin America a relatively high risk/high reward (or loss) proposition for investors.

Within Spain, the greatest political strain currently facing the Spanish economy is the situation in Catalonia. While there has been some observable market volatility, affecting both the stock market and country risk premium, at the fundamental level, Spain's economic recovery maintains its dynamism.

As for the country's financial sector, we look at two key aspects – digitalisation and the process of balance sheet clean-up. According to the most recent assessment by the European Commission, Spain ranks as a "medium performer" in the European context in terms of its performance on the so-called digital agenda (primarily in the area of financial digitalisation). However, European indicators reveal considerable progress in the last three years. Although lagging behind the European average overall, Funcas Observatory of Financial Digitalisation's projections indicate that Spain will continue to make progress on the financial digitalisation front in the coming years.

Our indicators predict that Spain's financial digitalisation will increase across a broad range of areas, whereas by 2020, 79.4% of Spaniards will use their computers to check their bank balances or conduct banking business. Frequency of online banking will also increase, with the percentage of Spaniards expected to check their balances or transfer money online at least once a week estimated to reach 59% over the same timeframe.

As regards progress on cleaning up banks' balance sheets, in the context of an already challenging earnings climate for the European financial sector, reducing the high volume of non-performing loans is of vital importance to banks. This has been recognised by European and international authorities. Spain's NPL ratio spiked during the recession, primarily due to the country's real estate crisis. However, there has been a notable improvement in credit quality since 2014, supported by better macroeconomic fundamentals, including reduced unemployment, which has notably slowed the pace of inflows of new NPLs. At 5.7%, Spain's NPL ratio stands just slightly above the 5.1% EU average. This, together with an improvement in recovery processes and the still relevant role played by foreclosures, has led to a significant reduction in the NPL ratio. However, there are signs of a slight slowdown in outflows, which looks set to continue in coming years, resulting from fewer foreclosures and write-offs. Thus, there is still much to be done both at the Spanish and European level in order to lower the close to 1 trillion euros of doubtful assets on bank balance sheets to more acceptable levels, which would be amenable to improved profitability.

While Spain's NPL ratios are improving, reflecting normalisation of the crisis in Spain's housing sector, there are still outstanding issues in the country's real estate market. A current snapshot of Spain's real estate sector reveals a prevailing trend in house prices – the sharp growth in rental prices, while prices in the buyers' market remain relatively stagnant. This phenomenon can be largely explained by looking at the key determinants of housing demand, which is not being efficiently transmitted to house price variables. Among the factors responsible for this is the lack of household access to financing, translating into weak demand in the buyers' market (which is why prices in this segment are not rising). In fact, access is proving to be concentrated in the rental segment, where prices are accelerating, altering the long-run equilibrium between the two price variables. Growth in the supply of units for rent or for sale could eliminate the prevailing price tension in Spain's residential markets.

Looking at the developments in the real economy, we study the recovery of consumption and its dependence on wages. As the financial health of households continues to improve, household consumption too is growing at an elevated rate. However, while GDP is now back at pre-crisis levels, household spending still remains below its 2008 peak. The short-term outlook for consumption is favourable and households look set to continue increasing their expenditures. However, household consumption remains dependent on income growth and confidence to sustain momentum. A deterioration in these fundamentals could endanger the medium-term sustainability of household consumption growth. At the same time, the drop in household savings rate, at its lowest level since 2006, puts Spanish households in a vulnerable position at a time of rising inflation and monetary policy normalisation.

On a related note, we close the issue by examining the links between wages, productivity and corporate management practices, using Spanish industrial SMEs as an empirical case. Companies which are better managed offer superior remuneration to their workers. In Spain, there is a notable and sizeable deficit in terms of the quality of corporate management among industrial SMEs which contributes significantly to their lower levels of productivity relative to their counterparts in other large European countries. Reducing this deficit should be an urgent priority, not just for the companies themselves, but also for business organisations and certainly for industrial policy.