Letter from the Editors

As political tensions in Catalonia persist, we start the November issue of *Spanish and International Economic & Financial Outlook (SEFO)* with an in-depth outlook for the Spanish economy overall, together with a breakdown of perspectives for the regional dimension. Spain's GDP is expected to register a growth of 3.1% in 2017 and 2.6% in 2018. The slowdown next year is related to the weakening in domestic demand, together with the negative impact from the political tensions in Catalonia, expected to shave off 0.3 percentage points of national growth. In addition, there is significant divergence in performance across the autonomous regions, notably as regards unemployment, which remains one of the main challenges to territorial cohesion.

This SEFO also looks at progress by the Spanish government as a whole, but in particular the autonomous regions, on improving liability management. The ECB's unconventional monetary policy measures, namely its public debt purchase programs, have helped euro area governments reduce their average cost of debt, while increasing maturities. In the case of Spain, Treasury yields have come down from an average of 4.07% at the end of 2011 to 2.59% at present, while average maturity has increased from 6.3 years at the end of 2013 to 7 years today. Although average funding costs have gone down for all levels of the Spanish public administration, the autonomous regions have seen the largest reduction, primarily explained by the favourable financing arrangements set up by the State. However, autonomous regions should gradually return to market finance to support a constructive outlook for overall public debt sustainability.

Additionally, we present an external study of the resulting map of the Spanish banking system following the strong consolidation effort since the crisis. The author's objective is to measure bank concentration in Spain, building indicators at the provincial level, allowing for a comparison to the situation in 2016 with that of 2008 as well as to analyze the impact of the mergers and acquisitions that have taken place in 2017. The Spanish banking sector stands apart in the European context for the intensity of its consolidation since the start of the crisis in terms of both the reduction in the number of competitors (having declined by 43%, compared to 28% in the Eurozone) and the increase in market concentration – albeit from a starting point below the European average. Notwithstanding the intense restructuring, Spanish banks could still benefit from additional measures to increase efficiency amidst profitability pressures. And despite profound consolidation, the Spanish banking sector remains below the threshold level of a highly concentrated market, even in the wake of the two bank mergers of 2017 (although a provincial approach reveals higher levels of concentration). Recognizing that there is occasionally a trade-off between financial stability and competition, and that the latter may suffer in the interest of the former, there is scope for additional consolidation, including cross-border transactions, as welcomed by the ECB.

The next article explores additional issues that affect banks in Spain, as well as the rest of the EU. We focus on the regulatory and monetary environment for the EU banking sector, including progress and remaining challenges for the EU banking union, together with providing an update on the current state of play for the Spanish banking system. Europe's banks are approaching year-end offering the highest returns in a decade, albeit still below pre-crisis levels. But in 2018, EU financial institutions will face changes, both in the level of regulatory burden, as well as in the monetary policy environment, and will therefore be under renewed pressure to boost their profitability by increasing cost to efficiency ratios, in part by accelerating technological change. On the regulatory front, completion of Banking Union is running up against a set of challenges. And on the monetary front, quantitative easing is set to be gradually rolled back, albeit over an uncertain time horizon. There is also downside risk, particularly in the form of heightened political tensions in some countries (*i.e.,* the situation in Catalonia in Spain). In Spain, the six largest banks by asset volumes reported aggregate net profits of 11.78 billion in the first nine months of 2017, year-on-year growth of 11.6%. The return on equity (RoE) offered by Spanish banks is above the Eurozone average and their cost-to-income ratio is among the lowest in the region. As for the risks posed by the situation in Catalonia, it is worth noting that the measures taken by the financial institutions affected have proven an efficient backstop to mitigate risks that were reduced from the onset.

Apart from the banking sector, which has been one of the areas where we have seen most notable progress on reforms, we assess two other key areas where structural reform has been undertaken in Spain in recent years – the labour market and budgetary stability. 2012 marked a year of much–needed progress on Spain's structural reform agenda, particularly in the areas of budgetary stability and the functioning of the labour market. However, in the wake of the reforms, a current snapshot of the country's public finances and job market reveals outstanding issues that still need to be addressed. In terms of the sustainability of the country's public finances, the stability act, understood as the fiscal discipline rules, faces issues in terms of its ability to achieve stipulated outcomes which require attention. It is also important to control the increase in certain public liabilities that fall outside the scope of excessive deficit procedure (EDP) definitions. As for the labour market, future reforms need to pay more attention to certain key variables and trends. More specifically, action needs to be taken with respect to the ageing of the working population, the drop in the number of economically-active men and the rise in long-duration unemployment and the resulting shortfall in safety net.

Even given the need to address outstanding fiscal issues, Spain is largely on track to meet the deficit target of 3.1% of GDP for this year. The constructive fiscal outlook has been supported by macroeconomic improvement and the reduction in debt servicing costs on the back of lower interest rates. Not so positive, Spain's consolidation process depends too heavily on cyclical, rather than structural, improvements as the main adjustment mechanism. In addition, potential downside risk from extended political tensions in Catalonia also threatens the outlook for a more ambitious deficit reduction over the medium to longer term. For 2018, meeting official targets may be feasible, but will depend on the ability of the State and Social Security deviations to be offset by the local administrations and for a resolution to the Catalonia crisis before the end of that year. Overall, there is a clear and urgent need for approval of the 2018 Budget to help ensure target compliance. Going forward, Spain's fiscal system requires deep reforms, particularly on the revenues side, to be more sustainable, equitable, and efficient.

We close this SEFO with a micro-level assessment of how Spanish corporates are adapting their risk management strategies in the face of greater geographic diversification. Spanish companies have significantly increased their presence in international markets in recent years, not only through export activity but also through foreign investment in other economies. This international expansion has simultaneously been accompanied by greater geographical diversification into non-traditional markets. The result has been a growing complexity in the management of various types of exchange rate risks, such as: translation or conversion risk, transaction risk; and economic risk – all of which could potentially impact the company's financial statements through different channels. Effective exchange rate hedging strategies requires a company-by-company, dynamic assessment to ensure instruments are well suited to the underlying risks.