Letter from the Editors

The March *Spanish and International Economic & Financial Outlook (SEFO)* comes out at a time of global uncertainty. On the positive front, for the time being, the global economy is holding up better than expected against the impact of inflation. Since the beginning of the year, economic indicators have picked up. The energy markets have continued to moderate, while geopolitical risk is perceived to be lower, giving the economy some breathing space. The resilience of labour markets is another favourable factor. In its latest outlook for 2023, the OECD revised its projection for global growth to 2.6% (0.4 points higher than in the November outlook) and to 0.8% in the case of the eurozone (0.3 points higher).

Nonetheless, several factors cloud the economic outlook. The first is the persistence of inflation and its potential impact on consumption and GDP once surplus savings have been exhausted. As well, the tightening of monetary policy has brought vulnerabilities in the financial system to the surface. The bankruptcy of SVB was followed by a liquidity crisis at Credit Suisse, unleashing severe turbulence in the financial markets, the full consequences of which remain to be seen.

We note that the bulk of the analysis contained in this issue of *SEFO* was performed prior to the collapse of SVB, thus may not reflect recent volatility in financial markets, in particular within the banking sector.

Within this context, we first look at the recent evolution of the Euribor, the key reference rate for the European financial markets, in terms of its impact on banking sector profitability. Long-term interest rates are a function of three major factors: real interest rates, the structure of supply and demand, taking into consideration the central bank's balance sheet, and long-term inflation expectations. Thus, based on the information provided by the nominal yield curves (spot and forward rates), inflation expectations, gleaned from the market and surveys, and estimated real rates, the new interest rate levels are etched out in the eurozone. Results show that there is a possibility that following the significant upward shift in short-term rates observed since the summer of 2021, long-term rates may have stabilised in real terms such that, going forward, the curve will pivot around them. Under this scenario, as short-term rates keep increasing, the stabilisation of longer-term rates could generate a downward sloping yield curve.

An interesting dimension of the impact of these increases in benchmark rates is the differentiated way in which they are affecting banks across regions. In the context of extraordinary market volatility, triggered by the war in Ukraine and its consequences in terms of exacerbating the energy crisis and inflationary pressures, we have seen significant shifts in relative valuations across different asset classes and/or sectors,

some of which breaking from patterns that had become entrenched for many years. After years of US outperformance, last year marked an inflexion point in the relative performances of the European and US banks in terms of both their market values and earnings, particularly in the second half. The search for a factor that explains the banks' outperformance relative to other sectors and within the banking sector the European sector's outperformance relative to that of the US yields one obvious answer: the recent trend in interest rates against the backdrop of monetary policy tightening. The scant sensitivity of the US banks to the increase in dollar rates contrasts sharply with the high correlation observed in Europe and Spain, largely explaining the stock market performances of the European and Spanish banking sectors relative to the remaining sectors and by comparison with the US banks. But there are also structural factors underpinning EU banks' outperformance. Indeed, the improvement registered in the Spanish and European banks' ROEs is being driven by a more stable provisioning profile. There is still a profitability and valuation gap between the two systems but the distance has narrowed considerably by comparison with that prevailing systematically for nearly a decade. [1]

Some of the impacts of the aforementioned increases in Euribor are already being reflected in banks' results. Indeed, the Spanish banks announced record earnings growth in 2022, in tandem with the ongoing process of financial normalisation, in which interest rates increased, after years in negative territory. Spain's top three banks reported aggregate net profit of 19.17 billion euros last year, up 6.1%. Looking at the six largest banks, that figure rises to 20.85 billion euros. Although the absolute figures are eye-catching, it is important to note that they remain below 2007 levels. More importantly, this solid performance comes a time when the Spanish banks, along with their European peers, continue to face difficulties in increasing their earnings per share. The European Stoxx Bank Index contracted by 7% in 2022 with the vast majority of the banks trading at P/BV multiples of under 1x. Moreover, the banking business is facing challenges on the demand side. Household borrowings increased by just 0.3% year-on-year in January 2023, while corporate borrowings contracted by 0.7%. Fundamentals for 2023 do not point to significantly higher credit growth. Going forward, it will be key to consider a broader spectrum of factors in order to bring more perspective to the interpretation of banks' profitability. Those factors include the considerable structural changes unfolding in recent years, such as complex mergers, sometimes taking place over a brief time span. As well, the balance between the volume of financing extended and deposits captured has improved relative to during the financial crisis, with the loan-to-deposit ratio at around 1x today, compared to 1.6x in 2007. Finally, solvency too has improved, with capitalisation substantially higher than prior to the financial crisis. Within this context, it is important to highlight the essential role banks play in underpinning a country's business and social fabric. They must remain profitable and solvent on account of their systemic importance and relevance at critical times, such as during the pandemic, while pushing ahead with the necessary cost-cutting and transformational digitalisation.

As well, the next article in the section on Euribor and banks focuses on an area sometimes overlooked but with a high degree of significance for financial stability, the shadow banking sector. Since the onset of the financial crisis in the US in 2007, what has become known as the shadow banking system has attracted the attention of analysts, sparking growing concern about its role as a destabilising force. In the meantime, international financial system globalisation and innovation, coupled with regulatory trends across the world's main regions, particularly in the area of bank solvency, have only increased the relative importance of the shadow banking system, particularly in the US and eurozone. Yet, it is noteworthy to examine the diverse factors underpinning the extension of shadow banking within these two regions. In the eurozone, although there are limitations given the lack of available financial literature on

this topic, according to empirical analysis, the expansion of shadow banking is mainly being driven by regulatory pressure, whereas in the US, the profitability of financial intermediation more broadly is the main impetus for shadow banking growth. Going forward, ongoing interest rate tightening, coupled with restrictive monetary policies, will drain financial system liquidity. At the same time, modified capital requirements for private equity and investment funds will entail high capital requirements for these types of vehicles. The combination of these two factors will foreseeably slow shadow banking growth.

Relatedly, we look at how changes in the Euribor have impacted the mortgage market in Spain. The impact of the rise in Euribor on mortgage payments depends primarily on households' outstanding principal. Although the average size of a new mortgage stands at close to 145,000 euros, the average balance on outstanding mortgages is lower, at 82,700 euros. Circumstances therefore vary significantly depending on the age of the loan, just as a household's vulnerability depends on its income levels. Overall, the rise in Euribor has cooled the housing market –transaction volumes have slowed and the price curve is beginning to bend. For now, however, the situation cannot be said to pose a major recessionary risk to the Spanish economy. Longer-term, the key will lie with the trend in employment, the main determinant of households' ability to service their debts. Nevertheless, households that have taken out floating-rate mortgages more recently with low- or medium-low income levels are set to face a sharp increase in financial burden relative to their disposable income, highlighting the importance of policy measures targeted at those most at-risk.

Furthermore, as mentioned, one of the key determinants of the capacity of households to service outstanding mortgages as interest rate pressures increase will be the employment market. For this reason, the next article focuses on the resilience of the Spanish labour market. The recent performance of the Spanish labour market has been favourable as regards employment (in both *Labour Force Survey -LFS-* and contributor terms), which has already surpassed pre-pandemic levels and continued to grow in 2022 despite a challenging economic and geopolitical context. The reduction in temporary contracts since the passage of the most recent labour reforms is another positive development. Indeed, the incidence of temporary workers in total contributors stood at 15% (the lowest level in the historical series) by the end of 2022, compared to 27% in previous years, evidencing the favourable impact of labour reforms in terms of job quality. However, the rationale behind the evolution of some labour market data remains uncertain and the performance of other indicators remains mixed, complicating a straightforward interpretation. Firstly, it is not clear why Social Security contributor growth has been so intense, outpacing both GDP and *LFS* employment growth. Part of the explanation could be attributable to the formalisation of the informal economy, a testament to labour market resilience in the context of extreme economic uncertainty. Lastly, despite some of these favourable trends, there was a sharp drop in actual hours worked per job holder, in line with the trend across the eurozone, adding to the mixed picture. Given the somewhat ambiguous nature of recent trends, it may simply be too early to come to a definitive conclusion over the evolution of Spain´s labour market and the extent to which it may have undergone structural changes.

Lastly, in the context of rising rates, we analyse a key area of vulnerability for the Spanish economy, the regional debt market. Following nearly two decades of legislative action, Spain's fiscal rule framework is among the most advanced and rigid within Europe, systematically placing the country among the top quartile of the EU-27 in terms of fiscal governance. Nevertheless, data on regional governments' deficit and indebtedness reveal a significantly weaker commitment to budget stability. Strong regional debt growth has largely been underpinned by collapsing revenues and high, rigid public spending in key public services, such as healthcare and education. Yet, debt levels differ significantly across regions,

with just two regions, Catalonia and Valencia, accounting for 44.1% of the growth in regional debt stock between 2007 and 2022. Beyond the debate about exit strategies for the extraordinary financing mechanisms implemented since 2012, it is important to think about adapting the current fiscal stability framework to layer in the requirements that will come into force under the new European rules and the need to address identified shortcomings.

Notes

[1] All of the analyses contained in this article refer to financial developments in 2022 and stock market valuations up to mid-February. Valuations have been greatly affected by events at some regional American banks and a large Swiss bank.