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Letter from the Editors

The July issue of *Spanish and International Economic & Financial Outlook (SEFO)* is the first to be published following the recent, and wholly unexpected, transition to power of Spain's Socialist Party after winning a parliamentary no-confidence vote against former Popular Party President Rajoy last June. The smooth transition by new Socialist President Pedro Sánchez, followed by his appointment of a pro-European cabinet, allowed for a relative calm to ensue in financial markets, despite the dramatic changes. This can be largely attributable to market perceptions of policy continuity and the potential for some normalisation of the impasse between the outgoing government and Catalan leaders over the independence conflict in Catalonia – albeit the outlook for resolution of the conflict remains challenging.

While the political environment in Spain marks a sharp contrast to existing political uncertainty in Italy, the recent moves in both countries nevertheless draw attention not only to the changing dynamics of Europe's political landscape, but also to imminent shifts in monetary and financial conditions across the continent.

Against this backdrop, the July *SEFO* focuses on the relationship between EU financial conditions and the banks. We examine not only the transmission mechanism of ECB monetary policy to financial conditions and the resulting implications for the European banking sector, but also the feedback loop between EU sovereigns and banks – the situation in Spain in particular – to determine the evolution of this link before, during and after the crisis.

Financial stability in the eurozone appears to be headed in the right direction, moving away from the fears and circumstances that unleashed the sovereign debt crisis in 2012. As a result, the eurozone is facing a shift in monetary policy conditions as the ECB recently signalled that it would end its historic bond-buying program next year and that interest rates would likely rise in late summer 2019. Despite the ECB's decision to prioritise the end of QE, while delaying rate hikes, banks could still benefit through the normalisation of yield curves. However, the financial sector continues to face risks including hostile US trade policies and solvency concerns in Italy. These factors could delay the implementation of the ECB's policy decisions, even though the eurozone banking sector is now less vulnerable to negative shocks. Specifically, recent data show that the link between sovereign and bank risk has eased significantly in recent years and that eurozone banks have reduced their cross-border exposures, particularly to Italy.

Elaborating more on the sovereign-bank nexus, we note that concerns over this link between bank risk and sovereign risk, which intensified during the sovereign debt crisis of 2010-2012, have returned to the forefront

in recent months due to: i) concerns over Italy's borrowing costs, ii) the spill-over effect this can have on the country's banking sector; and, iii) the attendant need for eurozone reform. It is against this backdrop that an analysis of the bank-sovereign nexus is undertaken using Spain as the primary case study. As part of a two-part series, in the July *SEFO* we focus on the public debt part of the relationship. (The second article to be published in September will be from the perspective of the banks.) We demonstrate that while foreign investors reacted more volatilely during times of sovereign bond stress by dramatically reducing their holding of Spanish sovereign bonds, domestic banks helped stabilise Spain's public debt market by increasing their share of Spanish government debt.

Finally, on the financial sector, we provide a brief recap of the roadmap of Spanish Savings Banks consolidation and reform – looking at the pre- and post-crisis evolution of the sector. Coupled with an extraordinary contraction in the number of entities, the most profound change in the Spanish financial system during the last decade has taken place in the savings banks segment. This segment was characterised by a large number of entities, had no shareholders, entrenched local roots, a commitment to giving back to society and represented half of the Spanish banking system prior to the crisis. The fact that the financial crisis hit this sector particularly hard, in part led to the introduction of regulation that significantly reformed the savings banks segment. Specifically, this involved a contraction in the absolute number of entities and a change in their legal form –from savings banks or *cajas* to banks and foundations– with clear implications for their ownership and management structures (corporate governance).

In the next section of *SEFO*, we look at the macroeconomic situation in Spain. While the solid recovery continued in recent months, Spain's economic growth is expected to slowdown in 2018 and 2019 to 2.8% and 2.4%, respectively. This is primarily due to weaker domestic demand, but also to the expected normalisation of ECB policy, a slowdown in external demand and an increase in energy prices. Looking forward, Spain's relatively high unemployment and public debt levels are also key sources of potential vulnerability. Between 2000 and 2017, unemployment in Spain averaged 16%, compared to 9% in the European Union and 6.1% in the US, with the main source of job market volatility being the high incidence of temporary jobs created. As for debt levels, private sector deleveraging has been accompanied by the opposite trend in government borrowing, which reached 98.3% of GDP by end 2017, compared to 35.6% in 2007. If policymakers do not take advantage of the current economic expansion to address these issues, they will weigh disproportionately on future generations.

As regards Spain's economic prospects, we analyse the evolution, since the crisis, of two factors that will be decisive in determining the country's medium to longer term performance: i) The potential for the continuation of Spain's strong export performance – Spain's *so-called export miracle*; and, ii) The not so promising situation of investment in R&D.

On this first point, we examine key aspects of the Spanish export story, pre- and post-crisis, to determine whether export growth since 2009 can really be called a 'miracle'. We find that, since 2009, Spanish exporters have made a great effort to diversify into new markets and offer new products. While talk of a miracle may seem exaggerated, if this broader exporting base becomes entrenched, Spain will achieve a permanent increase in the value of its exports. Spain could thus transition from a growth model based on its domestic market, particularly the construction sector, to one that capitalizes on the country's competitive edge in the international marketplace.

On the second point, recent data indicate that there has been a decrease in Spain of public sector R&D investment, while the private sector has increased its expenditure. In fact, the crisis has had very different impacts on the four main eurozone economies in terms of investment in R&D. Whereas investment was scaled back very significantly in Spain, the other three economies

continued to step up their expenditure on R&D. Spain is one of just three eurozone member states in the OECD to have invested less in R&D in 2016 than in 2008. As for budget execution by the general state administration, the percentage of the R&D budget actually executed began to plummet in 2008, dropping to a low of 30% in 2017 from nearly 90% in 2007. As for the innovative drive amongst Spain's enterprises, despite a slight upturn in activity by firms engaged in non-technological innovation since 2014, it is concerning that the number of Spanish firms engaged in technological innovation has been in freefall since 2008. As a result, it will be necessary to promote political support for R&D in Spain so as to effectively halt the divergence in innovation with the rest of the EU.

We close with a recap of the situation in Italy, a peripheral economy like Spain, but with notable differences in the recent evolution of its political situation as well as its financial sector. While the new Italy struggles to find a balance under an unexpected political coalition, expectations of political tensions internally and with the EU may have significant implications for the financial sector, sovereign debt markets and much needed-progress on strengthening the EU's institutional framework and governance reform.

Italy's recent election surprised many observers who were caught off guard by the success of the right-wing Lega and the populist Five Star Movement (M5S). This outcome can be attributed to an increasingly volatile Italian electorate and a shift in political dynamics brought about by the economic and financial crisis. As the protracted coalition negotiations demonstrated, the Lega and M5S are not natural political allies and maintaining a united front may prove difficult. Nevertheless, this unexpected political partnership has an ambitious and disruptive domestic policy agenda, as well as a clear vision on shaping EU macroeconomic governance reform. Thus, it ought not to be written-off by European partners. Finding ways to interact with Italy's new government poses a considerable challenge to EU leaders and, subsequently, the outlook for EU macroeconomic governance reforms and financial markets' stability. However, such efforts will be necessary to stabilize the eurozone and contain anti-EU sentiment.

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