Letter from the Editors

The publication of the November issue of *Spanish and International Economic & Financial Outlook (SEFO)* follows Spain's recent general election – the fourth in a four-year period. As the winning Socialist party seeks to form a stable coalition amid investor uncertainty, doubts have resurfaced over the country's ability to withstand internal and external shocks in the context of a likely slowdown.

Against this backdrop, this month's *SEFO* starts off by assessing the situation and outlook for two key historical sources of imbalances that have raised concerns in the lead up to an economic slowdown – the real estate market and the credit market. As regards both types of risks, we find that the potential impact from these on the broader economy is estimated to be significantly reduced compared to that observed in the last financial crisis.

Several years into the post-crisis recovery, the Spanish housing market is showing signs of a slowdown. This has sparked debate among analysts as to whether Spain is set to experience the bursting of another housing bubble. An examination of a broad set of indicators to assess the state of the housing sector reveals that a property bubble has not formed in Spain. Moreover, the data suggest that any fallout from the prospective slowdown in the real estate sector on the broader economy will probably be moderate. While both real estate prices and transaction volumes are likely to ease in the coming years, especially in certain urban areas where prices have grown at particularly high rates, we do not expect a significant correction. This outlook is based on the fact that prices, household borrowing and housing affordability indicators are still at reasonable levels. Lastly, in a low-probability scenario where there is a market overcorrection, the end of the real estate cycle would still have a limited impact on the Spanish economy.

In its *World Economic Outlook* report in October 2019, the IMF noted a considerable slowdown in the eurozone, with growth in Spain expected to ease to 1.8% in 2020. While there is no indication that a recession is looming, emerging economic dynamics suggest credit and real estate risks should be watched closely. Typically, growth in both these risks has accompanied financial crises in Spain. For example, the estimated probability of default in 1977 and 2009 was 20% and 13.8%, respectively, while the correction in house prices from peak levels stood at 33.3% and 45% for both those years. Interestingly, contemporary data show moderate price level growth in Spanish real estate compared to the run-up to the recent financial crisis, suggesting the real estate market does not pose a risk of amplification in the face of the anticipated cyclical slowdown of the Spanish economy. Furthermore, lending to both businesses and households has remained timid since 2017. Still, concerns have focused on Spain's public debt, which is equivalent to 98% of GDP. Taken together, these data suggest Spain is headed for a soft landing alongside that of the global economy.

We then take a step back and evaluate the implications of current financial conditions and regulatory requirements on the Spanish debt market, *i.e.,* spurring issuance of diverse fixed income instruments, including sustainable, social, green bonds, and finally contingent convertible bonds (CoCos), a tool many banks have used to fulfil more stringent capital requirements in recent years.

After muted activity in 2018, this year has seen intense growth in private fixed-income issuance by Spanish issuers. Specifically, bond issuance by the Spanish private sector during the first 10 months of 2019 is 23% higher year-on-year and already above the volume issued in all of 2018. This can be attributed to several factors, including the collapse in sovereign yields and the persistence of record-low credit spreads. The banking sector is spearheading the growth in issuance and a shift in the types of debt instruments issued. Non-financial corporate debt issuance is growing at a slower pace, albeit faster than in 2018, in an environment that continues to be shaped by diversification of sources of financing, interest rate refinancing and term lengthening. Particularly noteworthy is the expansion of foreign bond issuance among this segment and the fact that almost all bonds issued this year had maturities of at least 5 years. Lastly, data show the gradual maturing of the fixed-income market for medium-sized enterprises (known as MARF) and sharp growth in the issuance of green, social and sustainable bonds, segments in which the Spanish issuers are emerging as global pioneers.

CoCos have emerged as one of the most popular instruments for recapitalisation in the European banking sector. In Spain alone, the 22 billion euros of CoCos issued over the last five years account for around 60% of Spanish banks' capital-raising efforts. From the banks' perspective, CoCos are an attractive funding instrument given their tier 1 status. For investors, these bonds' appeal is undoubtedly driven by the fact that they have substantially outperformed issuers' ordinary shares. That said, CoCos stand out for their dichotomous nature, underpinned by the two financial options they provide for issuers –prepayment and conversion. These options offer a distinctly asymmetric performance for investors depending on the issuer's financial health. Under normal conditions, the bonds generate attractive returns for investors; however, in the event of recapitalisation, CoCo buyers stand to lose their entire investment. In analysing the main factors behind a CoCo's coupon value, it was determined that this value is correlated to measures of financial health, such as Tier 1 capital adequacy (CET1), risk profiles (RWA/TA) and banks' price-to-book values (PBV), with the combination of the latter two variables increasing in statistical significance.

The last section of the November *SEFO* deals with the topic of internationalisation. As the global economy faces challenges to overcome the current bout of rising protectionism, and its subsequent negative spill-over effects on economic expansion and trade, we analyse how banks' internationalisation and geographic diversification strategy's have helped them compensate for periods of domestic market weakness. We also look at Spain's internationalisation process on a broader scale, focusing on key risks and challenges facing a further deepening of this trend for the Spanish economy, and specifically for Spanish companies.

The profitability of geographically-diversified Spanish banking groups is 43%

higher than that of their domestic business, evidencing the advantages of an international strategy. The key factor explaining the profitability premium is the high net interest margin earned by Spanish banks' subsidiaries in third country places of business. This feature has become all the more impactful given the decline in eurozone interest rates. For example, consolidated groups' net interest margin is more than twice (2.01%) that of the Spanish banking business (0.93%). While the level of international expansion of the Spanish banking system is high relative to that of many other systems (overseas investments accounted for 44% of the total), their geographic diversification is lower by comparison with the major European economies and the US. Notably, there are some ad-hoc risks to consider in countries where Spanish banks are active, such as Turkey and Argentina. Nevertheless, analysis shows that diversification has mitigated banks' overall risk exposure. However, the benefits associated with diversification will remain limited within the eurozone until the EU completes its Banking Union.

The international expansion of Spanish companies as well as the broader Spanish economy between 2000 and 2018 is generally viewed as a success. In relative terms, Spanish exports kept pace with the growth in German exports over the same period, while significantly outperforming export growth in Italy and France. Data also indicate that the Spanish economy is now more open than either the Italian or French economies. Nevertheless, there are risks and challenges associated with the internationalisation of Spain's economy. Some challenges, such as the deficit in the balance of trade in goods and the tendency for micro-enterprises (fewer than 10 employees) to dominate the export market, have been longstanding. However, new risks have also recently emerged. While export indicators are slowing sharply, many of the world's largest economies are turning inwards and questioning the pre-existing model of international trade based on predefined and predictable rules. It is in this context that it becomes essential for Spain's companies to improve their level of competitiveness and overcome barriers to further international expansion.