Letter from the Editors

This month's *Spanish Economic and Financial Outlook* (*SEFO*) confirms Spain´s economic recovery as a reality; yet, recent indicators point to the beginning of a slowdown to be felt over the course of the coming year, mostly driven by the slowdown in domestic demand, as well as external factors.

In Europe, banks remain immersed in a complicated scenario marked by macroeconomic and financial market uncertainty and an exceptionally expansionary monetary policy that has pushed interest rates into negative territory. The results of the stress tests have highlighted the difficulties of two of the most important European financial systems (German and Italian), casting doubts over the current governance of the banking union and the sector as a whole.

In the case of Spain's financial sector, profitability continues to decline as a consequence of lower interest margins, leaving the door open for additional restructuring. On the positive side, our analysis shows that non-performing loans continued to fall to stand at 9.48% and solvency increased, reaching a CET1 ratio of 11.8% as of June 2016.The European Banking Authority (EBA) stress tests have consolidated the longer-term vision of the improvement in the Spanish banking sector's solvency, although they have not been able to ascertain, to the extent that would have been desired, which banking sectors present the main problems and to what degree.

Against this backdrop, the September *SEFO* reflects on the limitations of the stress test exercise, which, even given its positive outcome, has not succeeded in reassuring financial markets. Despite shortfalls, the publication of the stress test results is a good start towards boosting transparency. However, making progress towards banking union and restoring confidence in the European banking sector will require implementation of more powerful disciplinary tools and greater, swifter adjustments in those financial entities and sectors where they are needed.

As regards the insurance sector, we highlight the uncertainty generated from the prolonged episode of low interest rates − one of the main issues affecting the insurance sectors in Spain and in the rest of Europe, particularly for insurers with guaranteed long-term commitments. Despite an overall increase in the volume of premiums, the contraction in investment income is exerting upward pressure on expectations for underwriting results. Insurance companies are taking action to adapt to this new environment through attempts to boost income and streamline pay-outs, including: portfolio reallocation towards higher risk, higher yield and longer duration assets; shifts in product offerings; cost cutting measures; and, geographic diversification.

In the medium term, in and of itself, the recovery will not be sufficient to address the main challenges facing the Spanish economy. Beyond 2017, specific policies aimed at job creation and public debt reduction will be needed if Spain is to tackle its key medium-term challenges. Moreover, although at present, political instability is not reflected in current growth, a prolonged period of political uncertainty is likely to affect future growth prospects. Political gridlock is already causing delays in the adoption of decisions and policies crucial to improving Spain's medium term outlook, such as the approval of a new budget and compliance with EU fiscal targets.

Related to the first medium-term challenge, given the importance of SMEs to job creation and their predominance and weight in Spain's business landscape, we explore recent regulatory developments in Spain aimed at overcoming some of the existing SME finance challenges (*i.e.* high degree of dependence on bank credit, lack of access to alternative financing sources and lack of transparency over banks' credit evaluation process). The new measures attempt to make bank finance more accessible and flexible, while at the same time increasing access to alternative financing sources, through the publication by finance providers of an *SME- Financial Information report* – designed to reduce SME information asymmetries. The report contemplates various aspects of the borrower's credit profile, with one of the most significant novelties being a borrower risk rating, comprised on the basis of both financial and qualitative variables. Additionally, the report provides information over the borrower's relative position in the sector. Although the measures will not come into effect until October, these regulatory developments already undeniably mark a milestone in terms of the transparency of financial institutions' decision-making process.

Related to the second challenge of public debt reduction, this *SEFO* takes a look at an important component of this process − fiscal performance at Spain´s regional government level. In general terms, the fiscal performance of local corporations has served to offset the deterioration of Spanish public finances at other levels of government, recording surpluses and reducing borrowing in nominal terms. But, the rapid increase of regional financial liabilities has become a source of concern, although some regions have done better than others at reining in spending with the objective of meeting targets. In any event, understanding and correcting the causes of regional fiscal slippage is a pre-requisite for designing on-target fiscal strategies to address this problem in the longer -term.

Finally, we close this number with a snapshot of recently adopted reforms in Spain´s electricity sector, designed to address some of its traditional shortcomings. The new measures have solved some of the operating problems related to the consumer price setting system in the retail segment. In addition, the regulation introduced to amend the renewable energy incentive regime has proven effective in controlling the tariff deficit. However, additional measures should be considered to increase competition and bring down retail prices. Looking ahead, the introduction of measures aimed at achieving the Energy Union will be the key determinant factor to form a clear perspective on the future of the energy market.