Letter from the Editors

The Spanish recovery remains strong and growth on track for 2015 at 3.2%. We believe the impact of the worsening global outlook will be limited and offset by beneficial factors, such as the drop in oil prices and other commodities, together with income tax cuts being brought forward. Given that the effect of the positive transient factors will have worn off, growth in 2016 has been revised downward modestly by two tenths of a percent, to 2.8%. The main risks to Spain´s forecast scenario will be a worse than expected deterioration in the external context, or a possible intensification of domestic political uncertainties, related to the recent elections in Catalonia and the upcoming general elections before year-end.

In the context of this scenario, the September SEFO takes a detailed look at Spain´s property market: i) current situation and outlook for the sector; ii) progress on the clean-up of Spanish banks´ property market risk; and, iii) recent regulatory measures designed to safeguard homeowners and mortgage borrowers. While undergoing a much-needed correction, latest economic data suggest the Spanish property market has entered a phase of stabilisation, rather than recovery. House price increases have been erratic and uneven, and while the number of mortgage transactions is on the rise, new credit for housing purchases is substantially lower than pre-crisis levels.

The process of reducing the financial sector´s real estate risk is gaining momentum through the adoption of various deleveraging strategies, together with the help of new players in Spain´s property market. Banks are prudently reducing exposure to real estate and construction lending, down 21 points since its peak, to 29% of total lending to productive activities. Financial institutions are also moving forward on cleaning up their real estate assets. Initial risk reduction strategies have included loan refinancing and restructuring operations, together with foreclosures. Subsequent phases of deleveraging included the sale of non-strategic assets and businesses, such as real estate platforms, alongside the sale of loans and foreclosed assets themselves. At a later stage of the process, banks opted to reduce their stock of foreclosed properties through land development initiatives. Going forward, major players, like the SAREB, and new entrants, such as the Real Estate Investment Companies (the SOCIMIs in their Spanish initials), will also play a key role in the ultimate success of the reduction of Spanish banks´ property market exposure and risk.

The scale of households´ exposure to mortgage debt prompted a series of regulatory initiatives aimed to protect homeowners and borrowers from some of the harmful aspects of existing Spanish mortgage law, such as evictions proceedings and interest rate floor clauses. This SEFO explores how, in the case of changes to mortgage regulation, recent measures addressing these issues were adopted in response to key EU and Spanish court rulings.

The September SEFO also provides an analysis on recent financial markets developments with implications for Spanish and EU markets, such as the upcoming improvement in the Spanish futures market, as well as the ECB´s latest Expanded Asset Purchase Program (EAPP). The fact that Spanish debt has been trading wider to Italian debt in recent months, despite Spain´s favorable macro performance, reflects the impact of political concerns highlighted above. Nevertheless, the recent widening of Spain´s sovereign spreads is being driven by specific, technical factors apart from prevailing political uncertainty, such as the lack of a sufficiently liquid market for natural hedging instruments on the Spanish sovereign. The creation this October of a Eurex-traded futures contract with the Spanish sovereign as the underlying asset should benefit the Spanish debt market and reduce disincentives to invest in Spanish paper.

Recent developments for EU bond markets, such as the introduction of the ECB´s latest asset purchase program, have been unambiguously positive for Europe, and in particular for Spain. The ECB has bought about 5.5 billion euros per month of Spanish bonds, in line with its capital key share, with an average maturity of about 10 years, helping to bring about a sharp reduction in interest rates, stock market rally, and the decline of the euro, which have fueled growth. Because of QE, the softening of the fiscal stance since 2014, which has also supported growth, has not had any negative impact on Spain´s long term rates or sovereign ratings. On the whole, the program is well designed and calibrated for the characteristics of the euro zone bond market, and the ECB could easily relax some of the eligibility restrictions if needed.

In the final section of this month´s SEFO, we look at Spain´s expected fiscal consolidation path through an assessment of the recently presented 2016 General State Budget. Improving macroeconomic conditions support the government´s optimistic revenue forecasts in the face of tax cuts, while cost savings will come largely through reductions in unemployment benefits and debt service payments. Nonetheless, expenditure on general activities will grow by 4.5% to 118.6 billion euros in 2016, including transfers to the autonomous regions and local government bodies (48.79 billion euros), up 3.5%. According to the government´s forecasts, the general government deficit is projected at 2.8% of GDP – converging close to budgetary equilibrium in 2018.

The budgetary targets at the central government level are in line with the 2015-2018 Stability Programme, but budget implementation for the first half of 2015 anticipates the overall general government deficit will deviate slightly from the target. Once again, the autonomous regions emerge as the most disruptive factor, although the most recent deviations in the case of the social security system and the medium-to-long term demographic trends make it necessary to consider new funding mechanisms.

On a related note, we specifically look at regional fiscal consolidation in the area of healthcare spending – in terms of volume of expenditure, the largest function assigned to Spain’s regional governments. The autonomous regions´ healthcare spending cuts are a step in the right direction and reflect the central government´s decision to implement much-needed deficit reduction measures. Unfortunately, more could also have been done to improve the overall efficiency of national healthcare services.