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Letter from the Editors

The September issue of *Spanish and International Economic & Financial Outlook (SEFO)* comes at a time when Spain's fiscal outlook takes centre stage. In this context, we start off this issue with an assessment of the budget debate and its implications not only for fiscal deficit targets for this year, but also for consolidation over the medium-term. Moreover, this year's budget negotiations for the 2019 exercise will be particularly significant, given that the results of the complex political dialogue will shed some light onto the current administration's deficit reduction strategy, with subsequent implications for financing Spain's already high stock of public debt. At approximately 98% of GDP – only four eurozone countries have a higher debt-to-GDP ratio. Reducing this outstanding stock of public debt will become an even greater challenge in the face of expected ECB interest rate hikes, but also due to the reduced appetite for holding public debt securities from the banks.

The first article explores the uncertainties over Spain's fiscal outlook, which became apparent earlier this year when the previous administration, under the Popular Party (PP), struggled to pass its 2018 general state budget (GSB). After coming to power in the wake of winning a no-confidence vote against former PP president Rajoy, the new minority government reversed its previous opposition to the budget and oversaw its passage through parliament in June. Since then, a consensus has formed amongst the AIReF, Bank of Spain, and European Commission that Spain is expected to miss its initial 2018 deficit target of 2.2% by half a percentage point. The fiscal situation is especially worrying as Spain's deficit has remained the highest in the EU, even with a rapid improvement in the country's output gap. Looking forward, the government faces an uphill battle in its attempt to get the 2019 general state budget approved by the Lower House. With just 85 of the 350 seats, the government will need to engage in complicated negotiations with several national and regional parties that hold widely different positions on budgetary and fiscal policies.

Spain is among several EU countries that are still experiencing considerable strain on public finances. We next review the state of play of EU national fiscal policies coordination and the outlook for its much-needed reform. The creation of a monetary union by definition entails the loss of national monetary sovereignty. As a result, eurozone member states have to rely on budgetary tools in order to tackle macroeconomic shocks. In practice, however, these countries face serious constraints in implementing counter-cyclical fiscal policies at the national level. This is due, firstly, to the fiscal rules undertaken in response to the financial crisis. Indeed, under the current coordination system, fiscal policies tend to be pro-cyclical, which exacerbates business-cycle imbalances, limits growth potential and hinders the scope for

debt relief. Secondly, Europe lacks the kind of supra-national instruments which would help counteract the inability of national fiscal policy to mitigate shocks. This conundrum has spurred a debate over potential eurozone reforms that could include: i) changes in the rules that coordinate national fiscal policy; and, ii) stronger European-wide fiscal instruments, such as an EU-level investment fund or unemployment benefit, a "rainy-day", fund or the creation of a eurozone treasury capable of enacting counter-cyclical policies similar to those seen in the United States.

Concerns in the fiscal realm translate to a more challenging public debt outlook, in part due to the recent evolution of the nexus between banks and sovereigns. In this issue of *SEFO,* we present the second part of our two-part series on Spain's bank-sovereign feedback loop – this time analysing the relationship from the perspective of the Spanish banks. The banks' investments in fixed-income securities (particularly Spanish sovereign debt) occurred at a time when there was a steep decrease in the demand for credit amongst Spanish companies and households. These securities' earnings, which took the form of interest income and capital gains, propped up the banks' income statements during times of financial stress. Recently, the flattening of the yield curve, coupled with a gradual normalisation in lending activity, has prompted the banks to pare back their public debt holdings considerably, a trend that is bound to accelerate in the years to come. Nevertheless, concerns have been raised over the feedback-loop between banks and sovereign risk, sparking debate about the regulatory treatment of government bond holdings. However, we believe that if there are ultimately any amendments introduced to the regulatory treatment of banks' sovereign exposures, these should be analysed in the context of reforms undertaken to build the Banking Union. In any event, such amendments are unlikely to be adopted anytime soon.

In continuation, we cover issues related to the financial sector, such as the outlook for the real estate market, the expansion of consumer credit in Spain in the European context and the outlook for the insurance sector, with reference to the situation in Spain.

The real estate market in Europe, including in Spain, has clear and significant implications for banks, as well as the overall economy. The European housing market has undergone an uneven recovery across the EU since the recent financial crisis. In countries, such as Spain and Ireland, the data indicate that a gradual recovery in housing prices began in 2014. However, other countries like the UK have experienced a much swifter market recovery. This has contributed to the impression that the Spanish and many EU housing sectors are on the rebound again. This situation has led to a deterioration in housing affordability. One explanation for this is the concentration of real estate investment activity in large cities, which has been driven by low interest rates and a lack of other investment opportunities. This activity has put pressure on both housing sales and rental prices in densely populated markets. It is also worth noting that price increases have occurred alongside the emergence of new online tourist accommodation platforms. While their impact is probably more pronounced in the hotel sector, in the case of Spain, these platforms have nonetheless initiated a confrontation between local governments and anti-trust authorities over their effect on housing affordability and the extent to which they should be regulated.

Since emerging from recession, Spain has experienced significant growth in consumer lending to households. This expansion of credit can be attributed to demand side factors such as the consolidation of the economic recovery (*e.g.,* the decline in the unemployment rate), improvement in consumer confidence and a decline in interest rates. Supply-side factors have also contributed to consumer credit growth, including the easing of approval standards and the corresponding terms and conditions associated with these loans. While it is true that the growth in Spanish consumer credit has outpaced the eurozone average and should continue to be monitored, close analysis suggests this does not, at present, appear to be a significant

source of concern. Higher interest rates on Spanish consumer loans are in line with the risks posed by lending to Spanish households, which are more highly leveraged than their Eurozone peers. Additionally, these loans represent just 11.8% of total household borrowings and 7.1% of total credit extended to the non-financial sector by monetary financial institutions, are largely undertaken to finance house purchases and have low rates of non-performance. Furthermore, it is likely that the demand for consumer credit will decrease as pent-up household expenditure is exhausted, GDP growth rates slow and savings rates normalise.

Of late, growth in the insurance business has become sluggish in the developed world with earned premiums having stagnated in real terms. This trend has been shaped by the recent financial crisis and a prolonged period of low interest rates. However, these developments have been offset by dynamic earnings growth in the emerging markets, particularly China, which is currently the second-largest insurance market after the US. The significantly higher GDP growth rates in emerging economies, together with their low levels of GDP per capita, are driving substantial growth in the insurance business. Nevertheless, it is conceivable that advanced economies' earned premiums in the life insurance segment will improve as interest rates are gradually normalised. Furthermore, it is expected that the insurance industry will benefit from a rise in retirement savings as public pension systems fail to cope with rapidly aging populations. Of particular note are the promising conditions in Spain, where the life insurance segment has room to grow.

Finally, we close this issue with a micro level snapshot of the Spanish economy by looking at the recent evolution and outlook for the growth and competitiveness of Spanish firms. In order to draw conclusions about the competitiveness of the Spanish economy, we analyse Bank of Spain data on Spanish firms prior, during and after the recession. Our analysis reveals that economic growth during the first period was based on decreasing costs of inputs, as total factor productivity was also decreasing. During the recession, many firms disappeared and both employment and output dropped. However, since 2015, the Spanish economy has overcome the worst phase of the crisis that took place from 2009 to 2014. Activity growth is recovering and exports and manufacturing are growing strongly, productivity increasing and incomes growing in real terms. Currently, the corporate sector has reduced its debt ratio to pre-recession levels and has experienced moderate growth and earnings momentum. Also worth noting is the fact that the growth impetus has shifted in recent years towards the manufacturing sector. But the sustainability of this growth may be called into question as labour and capital costs, at historically low levels, begin to increase. Going forward, in an environment of increasing real wages and interest rates, sustainable corporate growth may only be achieved through efficiency gains.