Letter from the Editors

The July issue of *Spanish and International Economic & Financial Outlook (SEFO)* follows the European Parliamentary elections, which took place at the end of May. With voter participation among the highest in two decades, the results were deemed among the most significant in years. While voters still largely backed pro-EU parties, with the Social Democrats and the People's Party still dominant, these traditional centrist blocks appear to have lost their absolute majorities for the first time since European Parliamentary elections were held back in 1979.

Given current political uncertainty, together with heightened concerns over the regions' economic slowdown, this month's *SEFO* examines the EU's macro outlook and takes stock of its key financial sector metrics. Specifically, on this latter point, we present an alternative analytical approach in efforts to challenge the popular notion that Europe is overbanked. On both the macro and financial sector issues covered in this number, as always, we pay special attention to where Spain fits into the EU narrative.

On the macro level, the European Central Bank has recently cut its growth forecasts, projecting the eurozone will expand by just 1.2% in 2019. Although, to some degree, temporary factors play a role in the region's slowdown, an alternative explanation for such lacklustre performance is the tendency within Europe to rely on export markets in order to compensate for a chronic weakness of domestic growth factors. Prior to the financial crisis, domestic demand increased by 1.9%, annually. However, since the start of the crisis, this growth record has deteriorated dramatically across even the core eurozone countries. Thus, the eurozone's recovery is largely due to the opportunities in export markets, which have compensated for sluggish domestic demand. This is illustrated by the fact that the bloc's external surplus stood at 400 billion euros, the largest in the world. Significantly, recent trends show domestic demand is not responding in the face of declining exports, nor have rising national savings coincided with increased investment in the eurozone's productive capacity. Unfortunately, European macroeconomic policy has limited tools to address these trends and support an expansion of domestic demand.

As regards the monetary policy toolkit, while negative interest rates serve a purpose for the ECB in the face of the eurozone's slowdown, they have both direct and indirect effects on the region's banks. As of April 2019, the eurozone banking sector had excess reserves of 1.87 trillion euros, which implied costs of 7.5 billion euros a year. Given the unlikelihood of a rate increase, a tiered system for the deposit facility rate could reduce these direct costs. However, the indirect effect of negative interest rates is also problematic, specifically the influence they have on the yield curve, which is used as the benchmark for customer lending and deposit operations. For instance, 12-month EURIBOR, the main benchmark rate for bank lending, had fallen by over 70 basis points, from 0.60% in 2014 to -0.11% by April 2019. Until now, Spanish banks have withstood the adverse effects of negative rates better than the other major European systems. However, a prolongation of negative interest rates is expected to add further downward pressures on Spanish banks' profitability going forward. More generally, as long as interest rates remain negative, the eurozone banking sector's return on equity will remain low.

Apart from the profitability challenge facing banks operating in a persistent low/negative interest rate environment, growing trade protectionism has triggered a scramble for international technological leadership. The US government's decision to restrict Huawei's operations in the US and their partnership with US firms could have implications not only for Huawei, but also for innovation in general and 5G technology in particular. More broadly, trade tensions are occurring alongside Big Tech's foray into the banking sector, with Facebook's plans to launch Libra, a new cryptocurrency, just the latest development. Looking at these trends, it becomes clear that there are three potential outcomes. First, the `Super App´ model that dominates in China could emerge as a paradigm for global interaction. This would involve considerable concentration of financial and payment services, which could undermine competition. Second, Big Tech could help expand financial inclusion. Third, the combination of trade protectionism and market disruption could result in regulatory and technological fragmentation. While Big Tech's scale could give it an edge over traditional financial institutions, the future interaction between banks and Big Tech will be determined by the latter's ability (and willingness) to diversify into different financial services.

The July *SEFO* also takes a look at the relative importance of banking systems, both in terms of their relative weight in the economy and in employment creation, as well as in financial intermediation.

Spanish banking services generate 2.7% of the Spanish economy's gross value added and 1.1% of its jobs. Those percentages are below the eurozone averages of 3% and 1.4%, respectively. In the wake of the crisis, the banking sector's contribution to the economy has fallen in both Spain and the eurozone, albeit more intensely in the former. Despite growth in financial disintermediation, the banks remain at the core of the Spanish financial system, accounting for 70% of its GVA and 61% of the employment generated. It is worth highlighting the growing importance of auxiliary activities to financial services, which contributed 12% of the income and 24% of the employment generated by the Spanish financial system in 2017. This can be explained by the growth in fund management, which in the context of low interest rates, has made bank deposits less attractive. Although the Spanish economy continues to rely on bank credit relatively more than the rest of Europe, the intense private sector deleveraging observed has drastically narrowed this difference–measured in terms of credit/GDP, this statistic stands at 101% in Spain *versus* 98% in the eurozone.

Comparative economic literature differentiates between market-oriented and bank-oriented financial systems, with the former generally associated with the US. Moreover, ECB President Mario Draghi has described the European banking system as 'overcrowded'. This tendency towards black-and-white categorisation relies on the comparison of 'stock' metrics, such as the weight of bank assets and the market value of listed securities (stocks and bonds) in GDP. Specifically, the ratio of bank assets to GDP in the US and Europe is 80% and 250%, respectively. However, such analysis can be flawed. For instance, due to the nature of the US mortgage market, these assets are frequently excluded from US banks' balance sheets. It is also worth noting that the US banking sector includes twice as many institutions as those regulated by Europe's Single Supervisory Mechanism. Furthermore, so-called 'flow' metrics challenge the prevailing assumption that Europe is less market-oriented than the US. Over the last decade, European bond and stock markets have channelled around 80 billion euros, net, to the corporate sector a year, whereas the net flows via the US bond and stock markets have been negative by nearly 100 billion euros.

Related to the topic of financing, we analyse the progress and outstanding challenges for Spain's regional governments' funding model. The Regional Government Financing Fund, initially introduced as a temporary measure, has allowed regional governments to borrow at lower costs, but has also gone hand in hand with historically high levels of regional government debt in Spain. In many ways, this conundrum is mirrored at the EU level, with the eurozone debate on fiscal and financial reform centred on both 'risk mitigation' and 'risk sharing'. In the case of Spain, there are three possible funding models under consideration. Spain could extend the current financing scheme based on a single issuer of public debt instruments, divide regional debt into tranches, or rely on direct participation by the regional governments in capital markets. However, tapping capital markets would imply risks due to fluctuations in borrowing costs. While compliance with fiscal rules could limit this risk, it could take decades to reduce debt to a level that effectively minimizes it and would require abandoning regional fiscal policy as a counter-cyclical stabilization tool. It is for these reasons that observers have started to discuss the possibility of a redemption fund as an alternative solution.

We round out this *SEFO* by looking at firm-level issues, specifically, the latest figures on business dynamism in Spain, as well as analysing the link between corporate taxation and firm productivity.

Spanish companies face the challenge of improving their competitiveness in an environment which, in the medium- to longer-term, could face rising interest rates. Against this backdrop, it is important to assess the level of business dynamism to anticipate forward-looking scenarios. Data from Spain's central corporate database show that, although the rate of business creation now exceeds the rate of closure, it has not fully recovered to pre-crisis levels. Moreover, there has been a shift in the types of companies created in Spain. Prior to the crisis, LLCs were the most common form of corporation, but since 2014, self-employment has made the biggest contribution to new business creation. The reduction in medium-sized companies is also worth noting, with larger and smaller firms showing lower levels of decline. Lastly, data also indicate a gender gap when it comes to self-employment, where the percentage of men as employers with employees in relation to all men in work (6.3%) is twice that of women (3.2%).

Lastly, one of the most comprehensive measures of corporate productivity is total factor productivity (TFP), which quantifies the efficiency with which inputs are used in production. One factor that affects TFP is the corporate tax rate. In fact, data show that a 10-point reduction in the statutory rate of corporate income tax would increase national growth rates between 1% and 2%. A recurring debate among both economists and policymakers relates to the nature of the relationship between business size and productivity. Interestingly, in Spain, large companies with at least 250 employees account for 39.1% of gross value added (GVA). However, while policymakers may be tempted to prioritize an increase in average company size to improve productivity, such initiatives overlook other determinants of this variable. As well, the evidence indicates that productivity shocks lead to increases in company size but that this relationship does not function in reverse. However, data do show that corporate tax rates, through their impact on investment, do undermine productivity for companies of all sizes, with a particularly negative effect on smaller companies due to their lower technological intensity and productivity.

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