Economic, sectoral, and regulatory environment

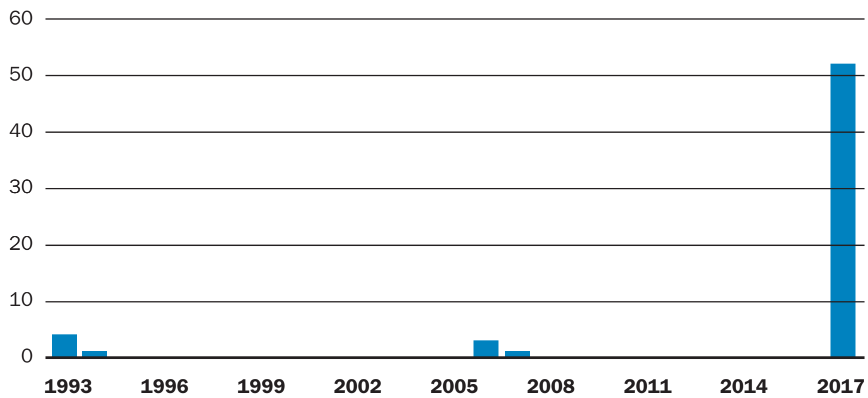
The year 2017 was marked by political and geopolitical developments and moves toward monetary normalization by the main central banks.

Growth in the developed economies was more robust and more synchronised.

The Spanish economy grew strongly and again compared well with other eurozone economies.

Global economy

The year 2017 saw key developments on the political and geopolitical fronts and moves towards monetary normalisation by the main central banks. After a change of government in the USA at the beginning of the year, the focus shifted to Europe with the start of negotiations on Brexit and elections in France, the UK and Germany. With the global economy gathering strength and inflation rates somewhat higher than in the preceding years, central banks in the main developed economies were able to confirm their intention to start or continue a gradual reversal of the highly accommodative policies adopted in earlier years. Against this backdrop, financial markets continued to show upward movement throughout the year in a context of growing investor complacency as reflected by the VIX index (Figure G1), which plots the volatility of the S&P 500 stock market index. A VIX that stays below 10 is significant as an indicator of investor complacency and, therefore, of low market volatility.



G1 Number of days on which the VIX was below 10 in the year
Source: Bloomberg

Political events in different regions of the world were a cause of concern in the financial markets but had only limited, short-term impacts.

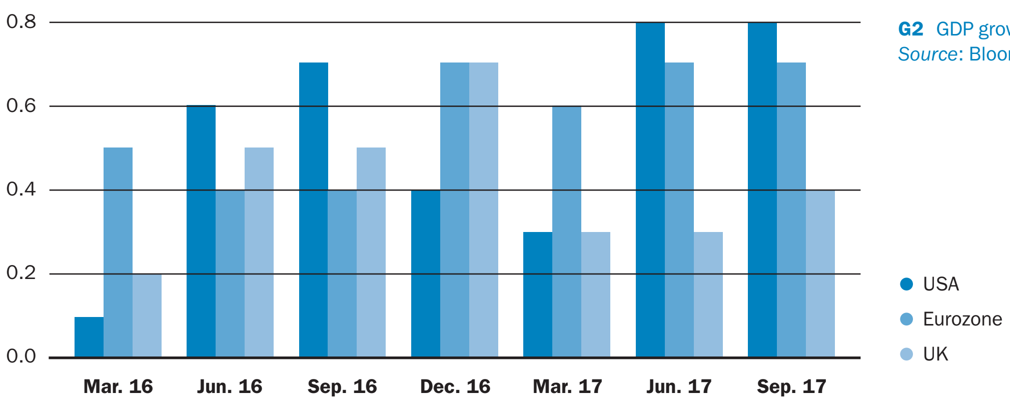
In March, the government of the United Kingdom gave formal notice of its intention to leave the European Union (EU) by invoking Article 50. The "Brexit" negotiations started in June with widely divergent positions, although the United Kingdom did agree to follow the procedure laid down by the EU. Accordingly, it was agreed that the exit agreement would be discussed first, after which, in a second phase, the nature of the new trade agreement between the UK and the EU would be discussed. The British government gradually softened its stance on the three priority areas in the first phase of the negotiations: the exit bill, the rights of expatriate citizens, and the Irish border. This led to an outline exit agreement being reached and the way being cleared for a start on the second phase of negotiation. On the domestic front, Prime Minister Theresa May saw her ability to lead the country being called into question by the loss of her absolute majority in the June general election, limited support in her party and her cabinet, the resignation of three of her ministers for breaches of the ministerial code and the growing popularity of the Labour party leader, Jeremy Corbyn.

Elsewhere in Europe, elections were held in France and Germany. The French presidential elections were preceded by a political row over corruption scandals surrounding one of the main candidates and the possibility of victory for Marine Le Pen, the candidate of the Eurosceptic National Front. In the end it was the liberal Emmanuel Macron who won, fighting on a pro-Europe platform. In the case of Germany, Angela Merkel's party won the largest number of votes in the general election but failed to obtain an absolute majority, making it difficult for her to form a government. In Spain, politics entered a more complex phase as a result of the upsurge of a pro-independence movement in Catalonia. In regional elections held in December, the Ciudadanos party won the largest number of seats in parliament but pro-independence parties held on to their parliamentary majority.

In the USA, Donald Trump showed a less aggressive and more pragmatic stance than before his inauguration, declining to label China a currency manipulator and delaying in taking his country out of NAFTA. Some of the more controversial policies that he had been proposing to implement were held up by a lack of agreement within his own party or by the judiciary and his main achievement has been getting his tax reforms passed. At the same time, internal divisions grew within the Republican party and, in November, the party suffered major defeats in elections held in a number of states, reducing its already narrow majority in the Senate. The political noise was increased by investigations into Russia's links with the Trump campaign, resulting in the resignation of several political appointees and advisors. In the world political arena, there was a strong upsurge of tension between the USA and North Korea in the second half of the year although this had only a limited impact on the financial markets and mainly affected Asian assets.

With regard to world economic activity, growth in the main developed economies became more robust and more synchronised as the year progressed. The eurozone economy showed high rates of growth, with different eurozone countries showing more uniformity in their performance than in the preceding years: in the USA, activity continued to be solid, with sound consumer spending and more dynamic capital expenditure (G2). As a result, unemployment fell to its lowest level since early 2000. The Japanese economy also continued to do well, helped by a surging economy in Asia. In the United Kingdom, economic growth was modest, constrained by uncertainty surrounding the Brexit negotiations.

Emerging markets have emerged from the worst period of economic adjustment of recent years. Growth in China exceeded government targets and the authorities shifted the focus towards regulatory improvements and reducing financial risk. Trump did not carry out his threat of a trade war against China; in fact, he showed a certain softening in his attitude to the country in exchange for cooperation on the conflict with North Korea. In Brazil, a programme of reforms provided support for the start of an economic recovery. In Mexico, GDP growth was higher than expected in the aftermath of the Trump election, thanks in large measure to strong export performance. Meanwhile, the USA, Canada and Mexico started talks

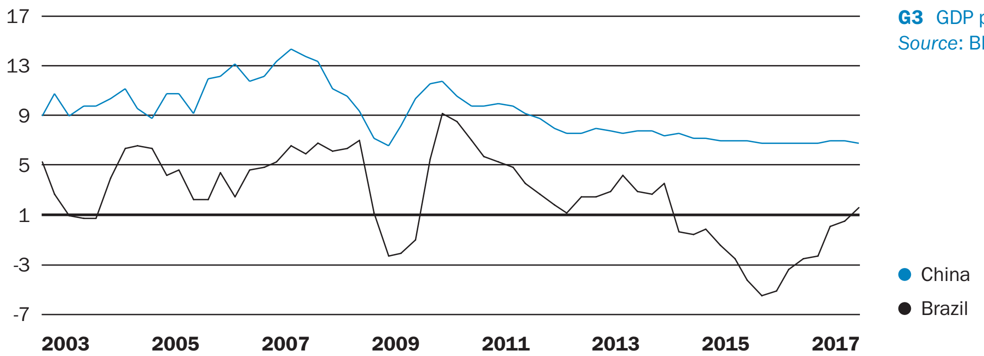


G2 GDP growth (%)
Source: Bloomberg

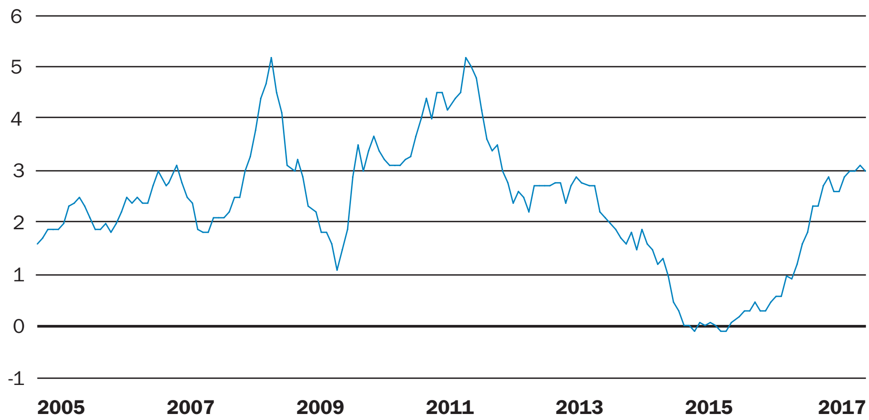
to renegotiate NAFTA, with the intention of reaching an agreement by March 2018 (G3).

Rates of inflation in the main developed economies were above those of 2016, although they remained below monetary policy targets except in the United Kingdom, where they were significantly higher. Inflation increased in all economies in the early months of the year, supported by a favourable baseline effect in the oil price, reaching their highest levels since 2012-2013. Since then, performance has been uneven. Inflation eased in the eurozone while, in the USA, it was constrained by a number of short-term factors. In the United Kingdom, on the other hand, inflation continued to increase significantly on the back of a falling pound caused by concerns over the Brexit negotiations and Theresa May's political weakness (G4).

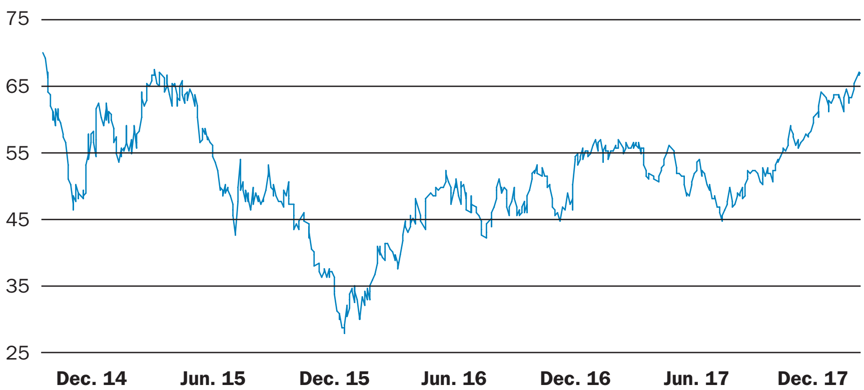
Oil prices reached their highest levels since mid-2015, supported by the decision of OPEC and other oil-producing countries to extend oil production cutbacks up to the end of 2018. The effect of this was augmented by a slowdown in the growth of oil supplies from the United States, robust demand, and geopolitical instability in the Middle East (G5).



G3 GDP performance (%)
Source: Bloomberg



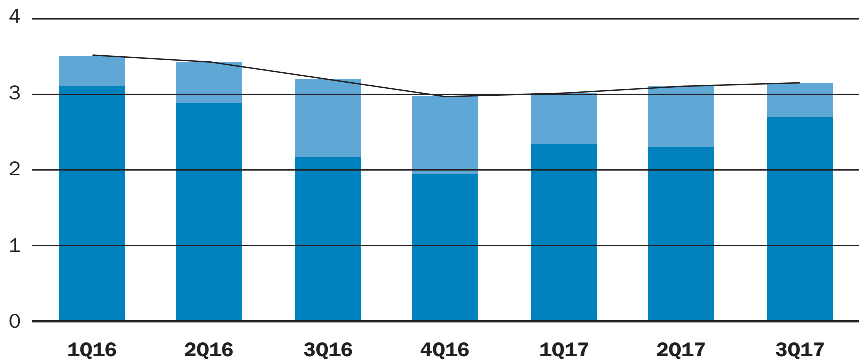
G4 UK inflation (HICP)
(year-on-year, %)
Source: Bloomberg



G5 Brent price
(dollars/barrel)
Source: Bloomberg

Spanish economy

The Spanish economy continued to show a strong performance and again outpaced other eurozone countries, with growth in the region of 3.0% for the third consecutive year (G6). On the labour market front, employment fell to the lowest level since the end of 2008. In the area of export performance, the current account ended the year in surplus for the fifth year in a row. The country's performance in terms of public accounts is consistent with achieving its deficit target. A revival of the real estate market was confirmed, although with large inter-regional variations. Finally, concerns over the domestic political situation caused the government to revise down its growth forecast for 2018.



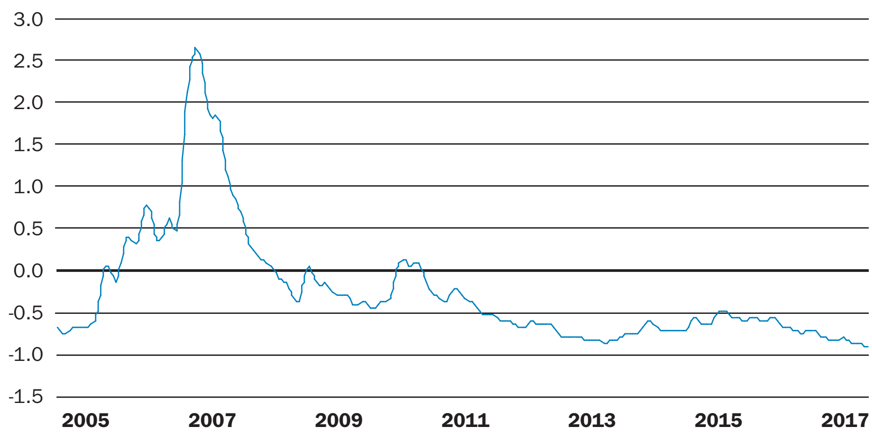
G6 Spain GDP (%)
Source: Bank of Spain

Monetary policy and financial markets

Global financial markets

The global financial markets showed a positive evolution during the year against a backdrop of growing investor complacency, with only short-term setbacks resulting from events of a political or geopolitical nature. Volatility levels for most assets fell to historic lows. Funding conditions remained lax, despite the rise in the Fed's benchmark rate. However, a number of international organizations have warned of growing risks, particularly in the non-bank financial services sector (G7).

Central banks in the main developed economies have been moving towards a normalisation of their monetary policies. In June, the European Central Bank (ECB) initiated a change of direction in its monetary policy, ruling out further cuts in its benchmark rate and appearing to be less concerned over risks to economic activity. In October, it changed its asset purchase programme. It extended the duration of the programme, at least until September 2018, while reducing the rate of purchases from 60 to 30 million euro per month from January 2018 onwards. The ECB emphasized that it would leave interest rates unchanged for a prolonged period and well past the end of the asset purchase programme. In the United Kingdom, the Bank of England increased its base rate to 0.50% in November, thus cancelling the rate reduction adopted just after the Brexit referendum. To explain its decision, the Bank cited high inflation and historically low unemployment rates. In the USA, the Fed increased its benchmark interest rate on three occasions to 1.25-1.50%, and indicated its intention to raise it three more times in



G7 Financial conditions index
Source: Bloomberg

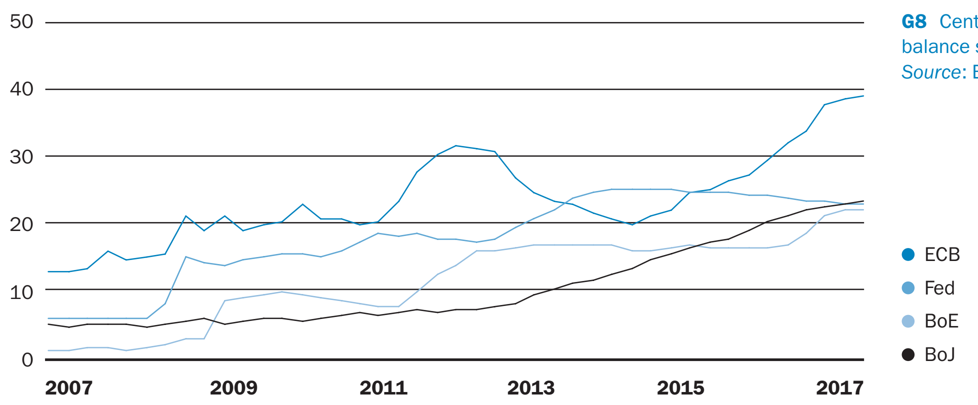
2018. In October, it started to reduce its balance sheet in line with the plan it had published several months earlier. It was also announced that Jerome Powell, a member of the Federal Reserve Board, will become the new governor when Janet Yellen steps down as Chairman and member of the Board in February 2018. Finally, the Bank of Japan has been gradually reducing its purchases of government bonds, albeit without any formal announcement of a change in policy (G8).

Long-term government bond yields in the main developed economies remained at low levels without showing any clear trend. During the year, political events, the actions of central banks and inflation were the primary determinants of bond market returns. In the USA, political noise together with President Trump's difficulties in implementing his electoral programme, combined with lower-than-expected inflation, were the most influential factors. In the last quarter of the year, the passing of the tax reform bill gave yields a boost. In Germany, government bond yields were affected by the political noise surrounding the election in France in the first half of the year, and by early steps being taken by the ECB in the direction of monetary policy normalisation (G9).

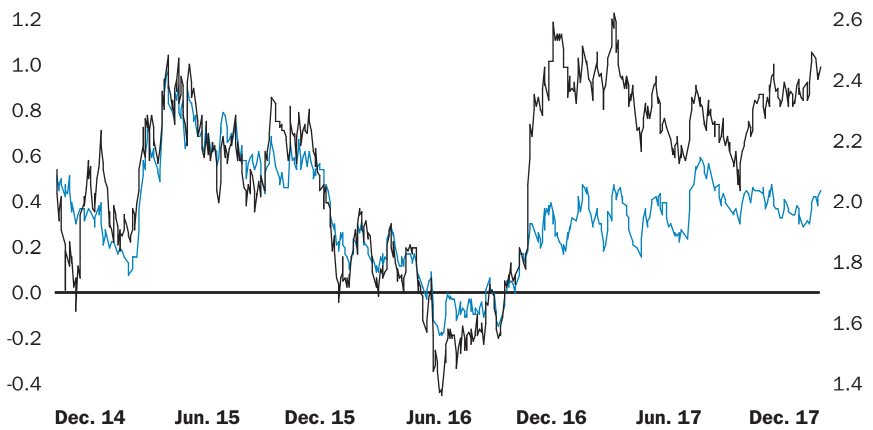
Risk premiums in countries on the European periphery continued to be supported by the ECB's accommodative policy, particularly its asset purchase programme. Spanish and Italian risk premiums rose in the second half of the year under the influence of political noise surrounding the French elections. Once the election excitement had subsided, the Italian risk premium dropped, helped by an improvement in the rating of Italian government debt. The risk premium on Spanish government debt was affected by volatility fuelled by domestic political concerns. Portuguese and Greek risk premiums fell sharply thanks to improved ratings for both countries' government debt, favourable economic conditions and, in the case of Greece, by positive news related to the country's bailout programme. This made it possible for Greece to carry out its first issue of long-term government bonds since 2014. Portugal saw its debt regain investment grade status from Standard & Poor's and Fitch (G10).

On the currency markets, the year saw a notable appreciation by the euro against the dollar and the pound sterling. The euro/dollar rate rose to highs not seen since the end of 2014, after breaking out of the range in which it had been trading for the previous two and a half years (G11). The euro found support, primarily, in political noise in the USA and a strengthening economic recovery in the eurozone. The pound sterling fell to its lowest level against the euro since 2011, as political upheavals related to Brexit and domestic politics took their toll. Monetary policy measures by the Bank of England sought to curtail sterling weakness (G12). The yen showed a high degree of volatility against the dollar. The Japanese currency was helped by the country's strong economic performance, political noise in the USA and rising geopolitical tension over North Korea during the summer.

As for equities, stock exchanges in the main developed economies appreciated strongly, reaching all-time highs in some cases. In Italy and Spain, solid performance by



G8 Central banks' balance sheets (% of GDP)
Source: Bloomberg

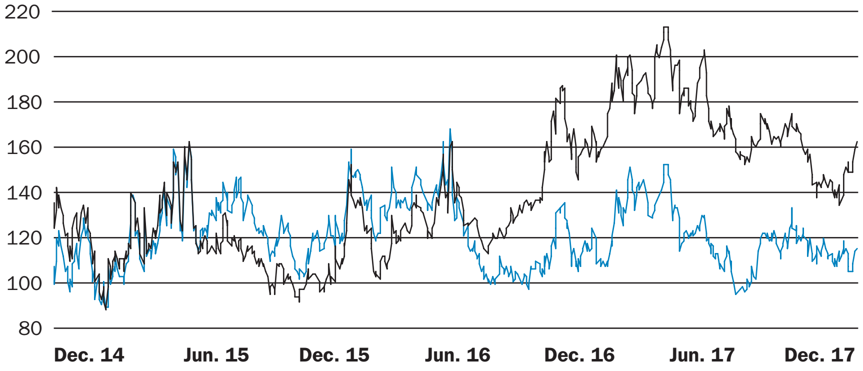


G9 German and US 10-year bond yields (%)
Source: Bloomberg

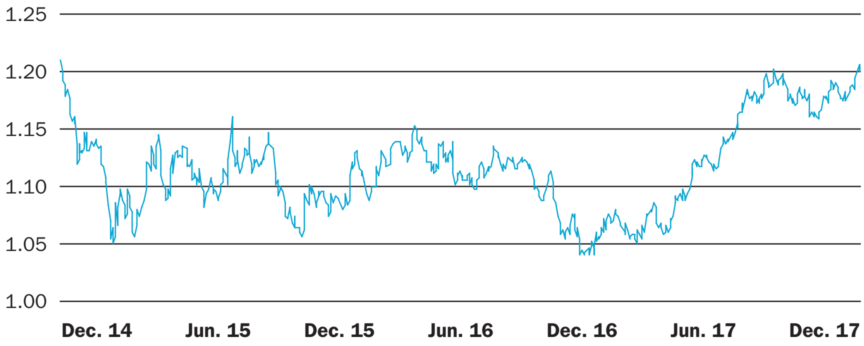
the banking sector spurred this growth. Political and geopolitical upheavals caused only temporary setbacks in surging asset markets (G13).

Financial markets in emerging economies

Financial markets in the emerging countries showed a generally encouraging picture. A fall in risk premiums was helped by the easing of anxieties over economic activity in China; a less aggressive discourse from president Trump; the fall in the dollar; the prospect of a gradual return to monetary policy normality in the developed countries; and an oil price that reached its highest levels in more than two years (G14). In this context, the Mexican peso looked especially vulnerable to political developments, but appreciated over the year as a whole.

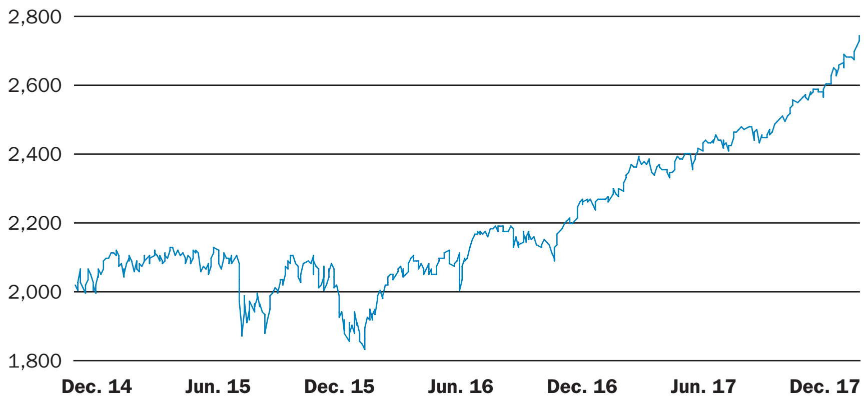


G10 Risk premiums on Spanish and Italian 10-year bonds (basis points)
Source: Bloomberg

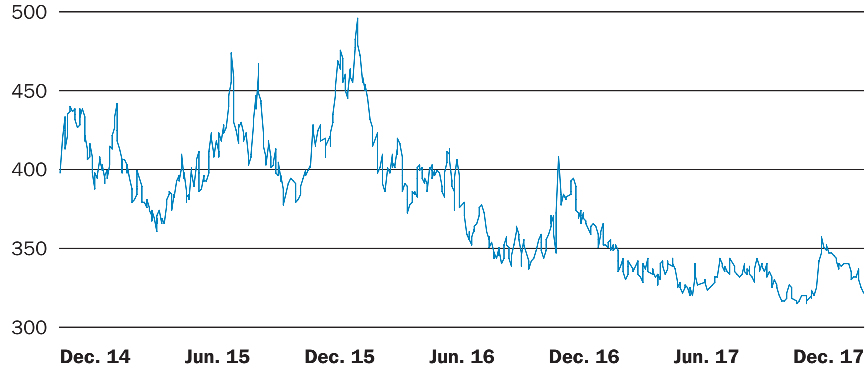


G11 Dollar/euro exchange rate (dollars per euro)
Source: Bloomberg

G12 Sterling/euro exchange rate
(pounds per euro)
Source: Bloomberg



G13 S&P 500
Source: Bloomberg



G14 Emerging market risk premiums
(EMBI+ index, basis points)
Source: Bloomberg

Banking sector

Europe's banking system saw its capital strength improve during the year, with increases both in asset quality and in profitability. In September 2017, the average fully-loaded CET1 ratio (referring to capital of the highest quality) stood at 14.3%, up from 13,6% in September 2016. The average loan-loss ratio for EU banks fell to 4.2%, down from 5.4% in September 2016, a reflection of the progress made by EU banks in strengthening their balance sheets. Profitability was up thanks to an improved operating environment, but continued to be a major challenge for EU banks. As of September 2016, the average ROE stood at 7.1%, up 170bp year-on-year and the highest figure since 2014. Progress was uneven, however, with divergences among jurisdictions and institutions; reducing the overall level of non-performing loans and improving long-term profitability thus remain key challenges for the sector as a whole.

In Spain, low returns on the banking business continue to be an issue, as is the volume of non-performing assets which, through declining, is still high.

Regulatory environment

Banking Union

During 2017, the Single Supervisory Mechanism (SSM) continued to consolidate its supervisory role of ensuring high standards of regulation in line with international best practice. In its second full year of operation, the Single Resolution Mechanism (whose purpose is to ensure the orderly resolution of failing banks) continued to perform its functions of approving resolution plans, setting Minimum Requirements for Own Funds and Eligible Liabilities (MREL) and standardising the process for contributions to the Single Resolution Fund. In addition, the Single Resolution Board took its first resolution decisions in relation to the Spanish and Italian banking systems.

In October, the European Commission (EC) called on the European Parliament and Member States to accelerate the processes in order to bring Banking Union (BU) to completion by 2019. The EC set out an ambitious path to culminate BU based on commitments already made by the Council. The proposed measures are: to move with all speed to adopt the legislative measures proposed in November 2016 for the reduction of risk within the banking sector; to give the BU a common fiscal backstop, i.e. transform the European Stability Mechanism (ESM) into a European Monetary Fund; possible measures for sovereign bond-backed securities; a package of measures to reduce non-performing loans; to maintain a high standard of supervision (to include large corporate investors carrying on bank-like activities under the SSM), and a new proposal to establish a European Deposit Insurance Scheme (EDIS).

The new EDIS proposal aims to address the diverging views and concerns raised in the European Parliament and the Council and proposes a more gradual introduction than under the Commission's 2015 proposal. Instead of three phases, there would be only two: a more limited reinsurance phase, and then a coinsurance phase (conditional on the progress made in reducing risks). In the reinsurance phase, EDIS would only provide temporary liquidity coverage to national deposit insurance schemes. in the coinsurance phase, EDIS would also progressively cover losses.

Capital Markets Union

In mid-June the EC published a mid-term review of the Capital Markets Union (CMU), a key priority within Commission President Juncker's Investment Plan for Europe. The CMU is designed to supplement bank financing by helping to unlock more investment from the EU and the rest of the world; to connect financing more effectively to investment projects across the EU; to make the financial system more stable by opening up a wider range of funding sources; and to deepen financial integration and increase competition.

The review has come at the right time to take stock of what has been achieved so far and to discuss future challenges arising from recent developments such as Brexit and fintech. The revised action plan has been drawn up following a public consultation process and a public hearing to gauge industry opinion. The review is being conducted around a new set of priorities focused on more effective supervision by the European Securities and Markets Authority (ESMA), ensuring a more proportionate regulatory environment for SMEs, simplifying cross-border investment and developing capital market ecosystems throughout the EU. It will also explore ways to harness the transformative power of fintech and shift private capital towards sustainable investment.

In 2017 macroprudential policies continued to play an important role as a complement to monetary and microprudential policies. These policies serve to address national or sectoral imbalances and thus help to reduce disparities between the financial and business cycles. A number of European countries have implemented or announced the implementation of anticyclical capital buffer requirements with the aim of preventing and mitigating the cycle-related systemic risks that can be caused by excessive growth in aggregate credit.

As systemic risks become more severe in less well-regulated sectors, the authorities are emphasizing the need for a set of set of macroprudential tools to be deployed in the non-bank sector, where these are not currently available.

Regulatory and supervisory framework

The summer of 2017 marked the tenth anniversary of the onset of the global financial crisis, which shook the EU to its foundations and required drastic measures to stabilize the economy and the financial system. At the international level, agreement was finally reached on establishing the Basel III post-crisis regulatory framework, whose aims are to ensure greater risk awareness, simplicity and comparability with regard to solvency.

Many of these measures are now at the stage of implementation or legislative approval within the EU. The legislative package produced by the EC in November 2016 has seen progress in some areas — transitory measures for IFRS9 and the approval of a ranking of claims in insolvency — although most of them are the subject of tripartite negotiations being conducted with the Council and the European Parliament.

Other regulatory areas under discussion in 2017 and likely to remain so include: reducing non-productive assets (the European Council has launched an action plan with supervisory and regulatory initiatives for a Europe-wide approach); a review of benchmark interest rates (to make them more robust and representative), and the regulation of digital technologies (fintech, cybersecurity) to provide a level playing field, enhance security and encourage innovation.

The financial services sector is also preparing itself for a number of new regulations that will be coming into effect and will directly or indirectly affect the sector. These include changes to the IFRS9 financial reporting standard, which will bring in a new classification of financial assets and new provisioning rules based on expected loss (instead of loss incurred, as at present). Also ongoing are preparations for new regulations on investor and consumer protection (MiFID III, PRIIPs, PSD2 and new rules on mortgage lending), involving requirements for greater disclosure to customers and and markets, products and services better suited to customers' needs, and procedures for handling conflicts of interest.

Outlook for 2018

In 2018, the balance of growth and inflation is likely to be benign. As a result, growth should be more evenly distributed, both in the developed and the emerging economies, while surplus capacity will continue to be reduced. Economic growth will find support in continued low rates of interest and, in some countries, tax reductions. In such a scenario, economic risks are likely to be balanced. Inflation is expected to be positive but muted, with domestic market pressures being offset by ongoing global trends (technology, globalisation, etc.).

Central banks in the main developed economies are expected to move further in the direction of monetary policy normalisation. 2018 could therefore be the first year since the crisis in which the balance sheets of the main central banks do not increase in size. In fact, the year could see some tightening of financial conditions in an environment of increasing market volatility.

The emerging economies, in all probability, will prove resilient to the normalization of monetary policy by central banks in the developed economies as long as economic growth is favourable and increases in the Fed's benchmark rate are implemented gradually.

Policy is likely to be conditioned by the after-effects of the political and geopolitical events of the last few years, particularly in connection with Brexit, Trump and NAFTA. Markets could be exposed to these developments to the extent that the associated risks have not been priced in and central banks may prove to be less supportive than in the last few years.

With regard to bank regulation, a slowdown is likely in the pace of regulatory change seen in the last few years, to be followed by a period of recalibration of the measures that have been adopted, possibly with a slight bias towards deregulation.