Economic, business and regulatory environment

Europe's banking system continued to reduce non-performing exposures in a context of persisting headwinds to profitability.

Brexit has been shrouded in considerable uncertainty.

The Spanish economy continued to post robust growth—outperforming the eurozone—albeit somewhat more moderate than in previous years.

Global economic environment

Political and geopolitical events were back centre-stage in 2018. They events had an increasing impact on financial markets over the course of the year, in a context in which the main central banks continued to reduce monetary stimuli.

Some of the main political events were the Brexit negotiations, the new Italian government's stance regarding European fiscal rules, President Trump's protectionist policies, and election outcomes in some emerging countries.

In the UK, the political scene was dominated by the complexities of Brexit, both negotiations with the EU and on the domestic front, given the divisions it has generated within the cabinet and in the main parties. The main obstacle in talks with the EU has been the quest for a solution to avoid a hard border in the island of Ireland. Eventually, Theresa May's government reached a deal with the EU that envisages a transition period until the end of 2020—extendible to the end of 2022—during which the new bilateral relationship would be negotiated. The House of Commons vote on the deal was postponed until early 2019.

In Italy, the 4 March election saw the traditional parties punished and resulted in a fragmented parliament. After several months of complex talks, which almost culminated in an institutional crisis, the Five Star Movement and League eventually agreed a coalition deal. The new government then unveiled a budget with government deficit targets in breach of European rules. This resulted in the European Commission rejecting a country's national budget for the first time. The discipline imposed by financial markets and the negative impact of the political turmoil on the country's economic performance ultimately persuaded the Italian government to adopt a more conciliatory tone with the European Commission and to reduce the deficit target for 2019.

In the United States, Trump took an increasingly aggressive tone in foreign policy. The US imposed trade tariffs on more than half of goods imported from China and has threatened to raise those tariffs and apply them to all Chinese imports. The technology sector was another bone of contention between the two countries. The trade truce between the US and the EU, agreed in May, averted protectionist measures. NAFTA member countries eventually agreed to renegotiate (and rename) the agreement on more favourable terms for the US.

As a result of its more assertive foreign policy tone, the US also: (i) called the EU a "strategic competitor", in contrast to decades of transatlantic cooperation; (ii) imposed sanctions on Iran, in defiance of the rest of major powers; and (iii) raised the tension with specific countries, such as Turkey and North Korea.

The November mid-term elections in the US saw the Democrats regain control of the House of Representatives, although Trump's Republican Party retained its Senate majority. The Democrats have expressed their intention to use their House majority to ramp up the legal pressure on Trump and limit some of his domestic policies.

In Latin America, elections in countries such as Mexico and Brazil shifted the political landscape. In Mexico, Andrés Manuel López Obrador's victory in the July presidential and parliamentary elections added uncertainty to the country's economic and institutional environment. In this connection, the use of popular suffrages outside the legal framework for major economic decision-making has undermined investor confidence. In Brazil, meanwhile, the victory of former military officer Jair Bolsonaro was seen as a clear rejection by voters of the violence and corruption that are rife in the country.

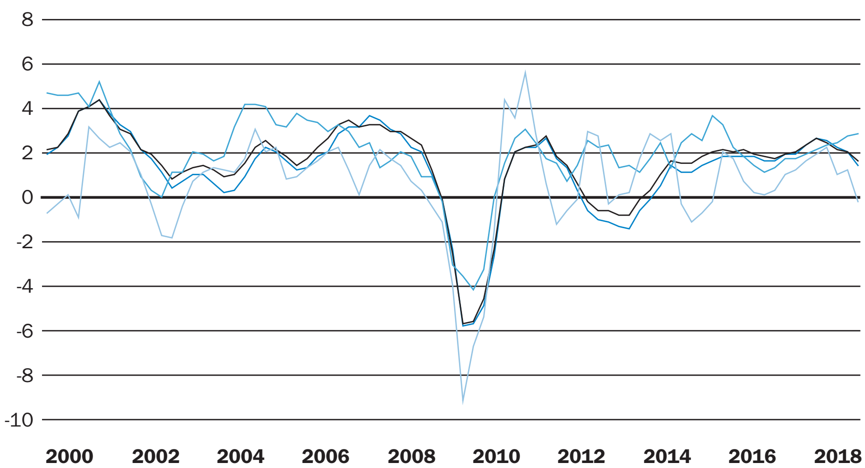
As for economic activity, global GDP growth stayed relatively high, underpinned by factors such as expansive fiscal policies in countries such as the US and China, and the still-accommodative monetary policy in regions such as the eurozone (G1).

Economic activity in the eurozone continued to grow, albeit at a somewhat slower pace than in 2017, which was an exceptionally good year. Growth trends were hampered by more sluggish external demand, against a backdrop of somewhat weakened international trade. Some one-off factors also had a negative impact, such as new emissions standards, which hit production in the autos industry. In the UK, the economy expanded at a moderate pace, constrained by the uncertainty surrounding Brexit. This uncertainty has taken a particular toll on investment and on sectors such as real estate. The United States economy was dynamic, buoyed by the expansive fiscal policies that have benefited consumer spending, in particular. In this context, unemployment has continued to fall and remains at record low levels. In Japan, the economy continued to experience moderate growth, underpinned by lax funding conditions and government spending.

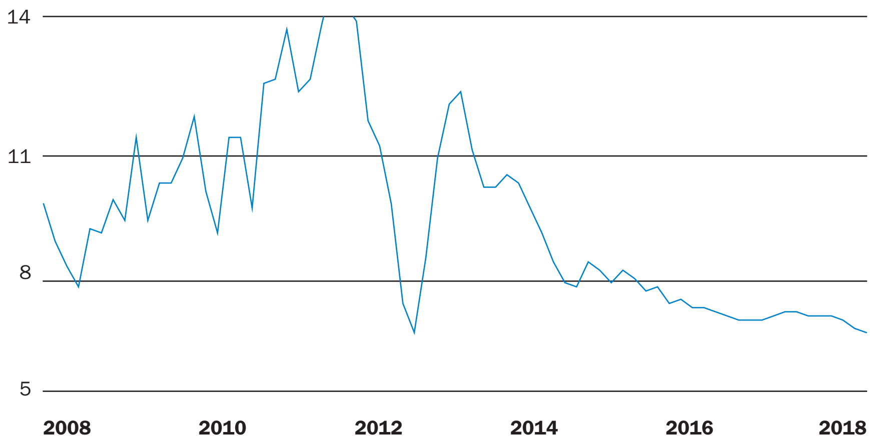
In the emerging economies, China's economic growth, while still high, eased somewhat, impacted by regulatory efforts in the financial sphere (G2). This effect was heightened by the repercussions of the trade war unleashed by the US. Nevertheless, measures aimed at economic expansion helped offset these negative effects. Elsewhere, the focus was on the most vulnerable economies, like Argentina and Turkey, whose financial markets slumped against a backdrop of tightening international funding standards. The Mexican economy continued to log relatively stable moderate growth, albeit hampered by the uncertainty surrounding the NAFTA negotiations and domestic politics.

In the eurozone, core inflation, which excludes energy and food, remained low and with no clear trend (G3). UK inflation eased as the effects of sterling's slump in the wake of the Brexit referendum dissipated, and by year-end it was near the monetary policy target. In the US, core inflation rose to near the Federal Reserve's target. Wage trends also improved and have practically normalised. Inflation remained contained in Japan.

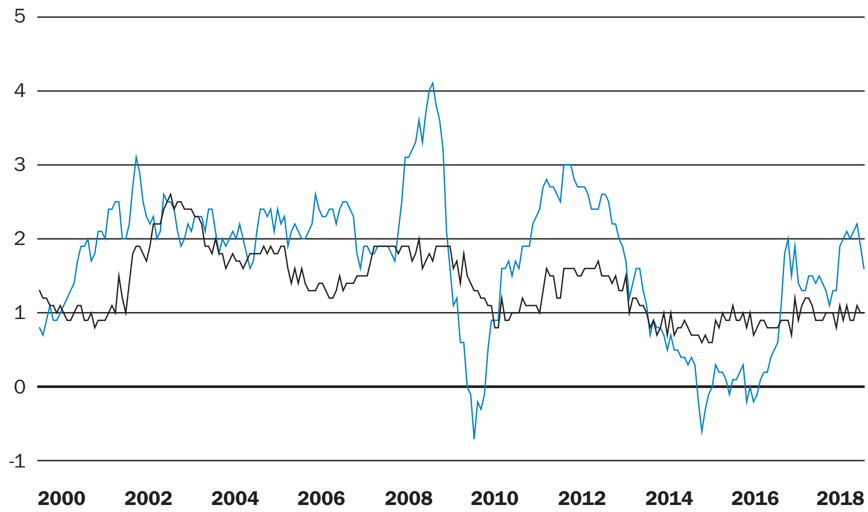
Crude oil prices reached their highest since 2014, hit by OPEC production cuts, bottlenecks in US production and the Trump Administration's announcement of renewed sanctions on Iranian oil exports. Oil prices subsequently eased amid financial tensions, temporary US authorisations to import oil from Iran, and the increase in production by Saudi Arabia, Russia and the United States (G4).



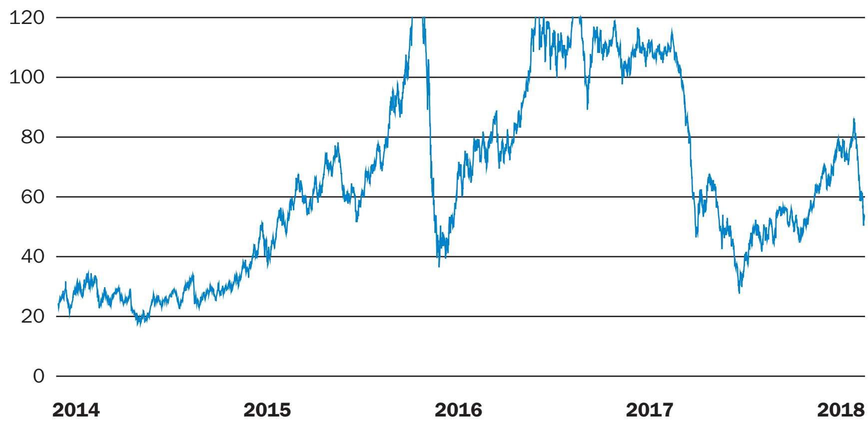
G1 GDP growth in the main developed economies
(year-on-year change, %)
Source: Bloomberg



G2 GDP growth in China (year-on-year change, %)
Source: Bloomberg



G3 Eurozone HICP (year-on-year change, %)
Source: Bloomberg



G4 Brent price (dollars/barrel)
Source: Bloomberg

Spanish economy

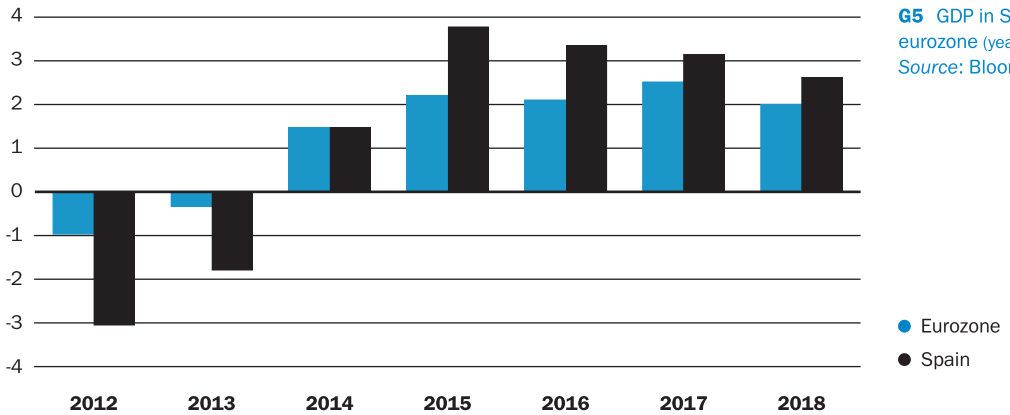
The Spanish economy continued to post robust growth—outperforming the eurozone again in 2018—albeit somewhat more moderate than in previous years (G5). The economy continued to be buoyed by low interest rates and a more robust financial situation in the private sector. On the labour market front, unemployment continued to fall, having reached the 2008 year-end low. On the external stage, tourism has lost some momentum as tourists have started to return to rival Mediterranean destinations. Because of this, combined with higher oil prices in the year as a whole, though Spain registered a current account surplus for the sixth consecutive year, it was lower than the previous year. In the real estate market, both house prices and sales transactions were dynamic. New loan production to both enterprises and households increased. Published data indicate that the budget deficit was below 3.0% of GDP. On the Spanish political scene, a successful no-confidence motion presented by the Socialist Party (PSOE) led to a change of government.

Monetary policy and financial markets

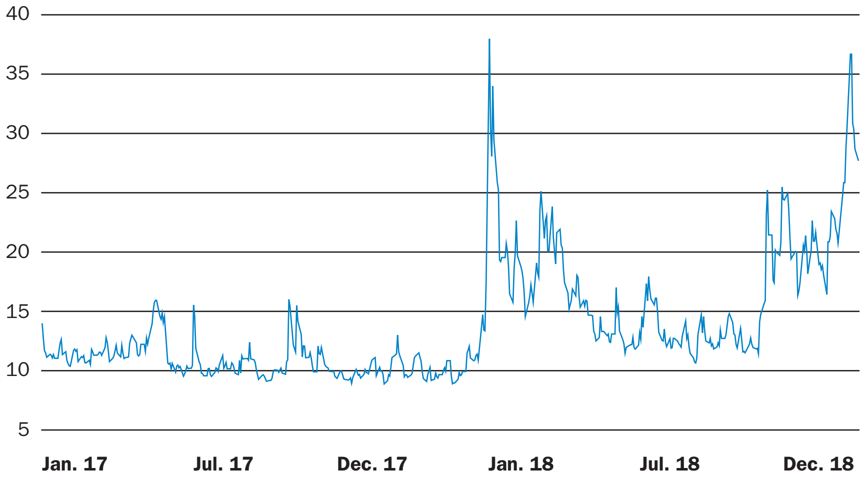
Global financial markets

Financial markets saw increasing volatility. Global risk assets logged losses almost across the board, although the sharpest declines came in those assets, such as corporate debt, that had benefited most from the search for yields. Accordingly, financial conditions became tighter, especially towards the end of the year, and market liquidity difficulties were compounded. All the main international bodies continued to warn of the mounting risks that the financial markets for financial stability (G6 & G7).

Central banks continued to take steps to normalise their monetary policies. After tapering the monthly pace of asset purchases, the ECB ended its asset purchase programme at the end of the year, although it said it will continue to reinvest as assets mature over a prolonged period. The ECB also indicated that interest rates would



G5 GDP in Spain and the eurozone (year-on-year change, %)
Source: Bloomberg



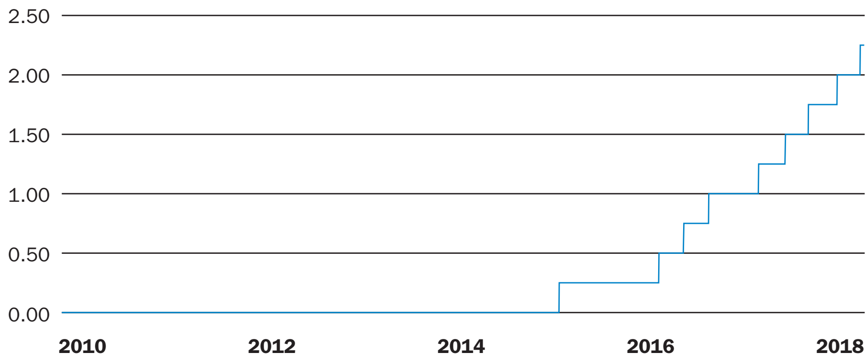
G6 Equity market volatility (VIX)
Source: Bloomberg

remain unchanged at least until the summer of 2019. The Bank of England raised its base rate to 0.75% at its August meeting, confirming the gradual, limited monetary normalisation that it had announced. Meanwhile, the Fed continued along its path of gradual interest rate increases, in a context of strong economic performance, inflation around the monetary policy target and a normalisation of the labour market. The benchmark interest rate ended the year at 2.25-2.50%, compared with 1.25-1.50% at the end of 2017 (G8). The Bank of Japan kept its base rate unchanged at -0.10%, and gradually reduced its government bond purchases, although not as part of an explicit policy move. In July, it introduced more flexibility in its government bond purchases, allowing a wider range (up to 0.20%) around its target yield for the Japanese government 10-year bond (0.00%).

Long-term government debt yields logged uneven performance in the US and Germany (G9). US government debt yields ended the year above 2017 year-end levels. This was due to factors such factors as the interest hikes implemented by the Fed, the expansive fiscal policy, the robust economy and the buoyant labour market. Yields were pushed down towards the end of the year, hampered by the poor performance by risk assets and by falling oil prices. Yields on German government debt fell from 2017 year-end to very low levels. This performance was driven by the political situation in Italy and the status of the financial markets at the end of the year. As a result, the German/US 10-year bond yield spread reached its widest since the European Monetary Union was created.

Sovereign risk premiums in Spain and Portugal ended the year in line with the previous year. Rating upgrades

G7 Corporate debt in euro (spread against sovereign, bp)
Source: ICE



G8 Fed benchmark interest rate (low end of range, %)
Source: Bloomberg

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

and the expansive cycle in the two economies exerted downside pressure on their risk premiums. Conversely, trade tensions and the considerable political uncertainty in Italy exerted upside pressure. In Italy, the political context triggered a significant increase in the risk premium, which hit its highest level since 2013, despite falling towards the end of the year after the Italian government made a commitment to greater fiscal discipline (G10).

With regard to currencies, the dollar appreciated against the euro, after slumping at the beginning of the year to levels not seen since late 2014. The dollar was underpinned by the widening interest rate spread, political rumblings in Italy, Brexit uncertainties and growing risk aversion amid the trade dispute (G11). Sterling, meanwhile, did not show a clear trend against the euro and stayed mainly in the 0.87-0.90 range. In addition to Brexit, sterling was sensitive to Bank of England rates expectations and domestic political wrangling (G12). The yen gained against the dollar in the year. Towards year-end, increasing volatility and instability in financial markets spelled some support for the Japanese currency.

Share performance was hampered, not just by tightening global lending standards, but also by the trade war, especially in those sectors most exposed to it, such as autos and technology. A number of international companies issued profit warnings as a result of the impact of the trade hostilities. In the eurozone, the political instability in Italy and the sharp increase in the country's risk premium

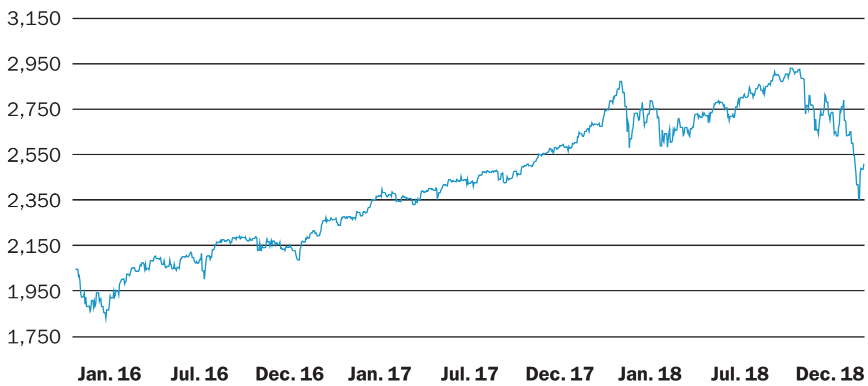
G10 Risk premiums on Spanish and Italian 10-year bonds (basis points)
Source: Bloomberg

● Spain
● Italy

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

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

weighed heavily on the banking sector. Spain's IBEX 35 and Italy's MIB underperformed in this context, as did Germany's DAX, which was affected by the vital automobile industry (G13).



G13 S&P 500
Source: Bloomberg

Financial markets in emerging economies

Financial markets in emerging countries proved especially sensitive to episodes of risk aversion linked to Argentine and Turkey. In the case of Turkey, sharp depreciation by the lira and the sharp increase in the corporate risk premium in August actually impacted on financial assets in developed economies, though only temporarily. Other factors that burdened emerging markets were: (i) domestic political instability in some economies; (ii) a policy shift on the part of developed countries' central banks; and (iii) Trump-driven protectionism. In this context, the aggregate risk premium for emerging economies reached its highest level since early 2016. In the specific case of Mexico, the peso saw considerable volatility and downside pressure as a result of the political uncertainty. Consequently, and with inflation above the monetary policy target, the central bank continued to raise the official interest rate (G14).

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

Banking sector

Europe's banking system improved its capital strength in 2018, increasing profitability and reducing non-performing exposures. The fully-loaded CET1 ratio (referring to capital of the highest quality) averaged 14.5% in September 2018, up from 14.3% in September 2017. Banks' improved capital levels were evidenced in the results of the European Banking Authority (EBA) stress tests, in which all banks scrutinised exceeded the regulatory capital requirements even in the most adverse scenario. Moreover, the average NPL ratio at EU banks continued to decrease, reaching 3.4% in September 2018 (vs. 4.2% a year previously), the lowest level since the definition of non-performing loan was harmonised in 2014.

Profitability improved in a slightly more favourable context, but the authorities warn there are ongoing risks relating to the sustainability of business models. On average, ROE remained below the cost of capital, although it increased by 1.2 percentage points over 2018, to 7.2% in September. These improvements varied between regions and institutions. Moreover, a number of authorities indicate that political and geopolitical uncertainty could compound the risks of a sudden increase in risk premiums and volatility, which they see as the main vulnerability for the European banking sector.

On the domestic front, Spanish banks' profitability was buoyed by the reduction in asset impairment losses. Problem exposures have decreased by more than 60% from their 2013 high, with the NPL ratio at 6.4% in June 2018, down 7.5 percentage points from the peak. However, low interest rates continue to squeeze margins. As for capital, the Spanish banks averaged a CET1 ratio of 11.4% in June 2018, well above the minimum regulatory requirement.

Regulatory environment

Banking Union

Over the course of 2018, progress was made in completing Banking Union, with preparatory discussions for establishing the remaining pillar—the European Deposit Insurance Scheme (EDIS)—and proposals on setting up a common support mechanism for the Single Resolution Fund (SRF).

With regard to EDIS, during the year various European authorities came out in favour of greater risk sharing in the wake of the progress made in derisking the European banking system. In April, the ECB published a report in support of the European Commission's 2015 proposal for a fully-mutualised EDIS, which it sees as adequate in terms of the amount of funds it would need and the system of risk-based contributions by banks. Progress on this front has been confined to the creation of working groups by the authorities, which will continue to debate and prepare the workings of EDIS in the first half of 2019.

The European Stability Mechanism (ESM) would act as a backstop by means of a credit line to the SRF. Accordingly, in the event of a resolution, the ESM would inject the necessary funds to restore a bank's stability after: (i) the absorption of losses by a percentage of the bank's instruments; and (ii) an injection of funds by the SRF.

The December European Council meeting finalised details of the SRF support mechanism and agreed on its early implementation (before 2024), subject to there being sufficient progress in risk reduction by 2020. It also approved a proposal to broaden the ESM's role in financial assistance programmes and placed its supervisory remit (focused on risk analysis and access to financial markets) on the same level as that of the European Commission and the ECB (more focused on macroeconomic analysis and fiscal sustainability).

Going forward, the European Council has identified the following as priority areas for completing Banking Union: (i) measures to reduce risk (non-performing exposures and defaults); (ii) anti-money laundering measures; and (iii) a framework for liquidity in resolution. With regard to the final point, it is hoped an institutional agreement can be reached, although there is no set time frame; regarding anti-money laundering, the European Commission has proposed granting the EBA powers in that sphere and harmonising the existing national regulations.

Capital Markets Union

The European authorities have made little progress on the implementation of measures under the Capital Markets Union (CMU), which was initially expected to be complete by March 2019.

The main measures that are adopted were confined to the publication of the European Commission's action plans on sustainable finance and on FinTech. With regard to sustainable finance, the Commission aims to involve the financial sector in funding the necessary investments to comply with the Paris Agreement (more than 1.0% of EU GDP each year over the next decade), for which purpose it has undertaken to establish a regulatory framework and clear definitions on sustainability by the third quarter of 2019. As for FinTech, the European Commission hopes to make Europe a global centre for financial technology, and has therefore undertaken to set up regulatory sandboxes, increase cybersecurity and nurture new technologies. The plan also contains rules for boosting the growth of crowdfunding platforms in the Single Market.

The scant progress on the CMU in 2018 led eight EU countries (Denmark, Estonia, Finland, Ireland, Latvia, Lithuania, Sweden and the Netherlands) to call for the completion of several areas: (i) the review of standards applicable to investment banks and brokers; (ii) a drive to create a pan-European covered bonds market; and (iii) support for FinTech companies and sustainable finance.

The urgent need to advance towards CMU in 2018 is due to the proximity of the UK's withdrawal from the EU (the UK is the EU's main capital market) and the European Parliament elections in May 2019, which will hamstring legislative development.

Macroprudential framework

Countries have continued to wield macroprudential policies in 2018 to complement monetary policy in a context of tightening financial conditions. In the eurozone, which has a common monetary policy, macroprudential policy also offers countries greater wiggle room, enabling them to tackle the risks linked to the domestic financial cycle. Several economies have activated or announced plans to activate the anti-cyclical capital buffer and measures aimed at highly indebted sectors (enterprises in France and households in Portugal). All this is aimed at preventing and mitigating cyclical systemic risks that can be caused by excess growth in aggregate credit.

After several years developing the macroprudential framework for the banking sector, the authorities shifted the focus to the non-banking sector, in which they consider it is necessary to broaden the macroprudential instruments and adapt them to those agents' specific risks.

Meanwhile, in Spain the macroprudential framework was reinforced, with progress in establishing the Macroprudential Authority Financial Stability Council (AMCES-FI), to comprise the Ministry of Economy and Business, the Bank of Spain and the CNMV, and with the entry into force of new macroprudential tools for sector-specific financial supervisors. In this way, Spain responded to the recommendations of various international bodies to create an independent macroprudential authority.

Regulatory and supervisory framework

In 2018, various new regulatory requirements entered into force, such as IFRS 9 and the investor protection directive (MiFID II/MiFIR). Furthermore, the Single Supervisory Mechanism (SSM), the EBA and the European Council presented proposals to reduce non-performing assets, in terms of both stock and flow.

There was also work in several regions to reform benchmark indices. In Europe, the Benchmarks Regulation (BMR), published in 2016 and in force since early 2018 (with a transition period until the end of 2019), meant undertaking a reform of Eonia and the Euribor curves and establishing backup indices for both cases. The European Money Markets Institute (EMMI), the agency responsible for devising and publishing Euribor, is developing a hybrid methodology to make Euribor valid under the BMR. Meanwhile, EMMI's inability to modify Eonia led the ECB to decide to publish an alternative index (ESTER). In parallel, it created a working group in partnership with the industry, which adopted ESTER to replace Eonia. At the same time, it began developing ESTER's term structures and preparing a seamless transition. The complexity of the process and the risks it entails led the industry to ask for an extension of the BMR transition period, a move that was supported by the European Commission and the European Parliament.

European financial institutions have continued to gear up for the regulatory requirements of the next few years, for example, issuing debt with loss-absorbing capacity (MREL) and analysing the maturities structure of their liabilities to adapt it to the net stable funding ratio (NSFR), which will likely come into force formally in 2021.

Meanwhile, the United States continued the process of financial deregulation announced by President Trump. The post-crisis easing of financial regulation focused on banks of up to average size and was aimed at reducing the frequency of stress tests, making capital computation models more flexible, and adopting more favourable liquidity requirements, among others.

Outlook for 2019

Looking into 2019, (geo)politics is expected to continue to have a considerable influence on the economy and financial markets, given the lower support from central banks.

The world can be expected to continue advancing towards a global order characterised by less multilateral cooperation. This transition, accompanied and strengthened by the digital revolution and new means of communication, will likely not be free of international conflicts (trade wars, currency wars, fiscal competition, etc.). It is fair to expect greater arbitrariness in economic policy, which will be less focused on efficiency.

In this context, governments are expected to focus on sustaining growth—applying expansive and pro-cyclical fiscal policies—over macroeconomic stability, which could increase vulnerabilities in the medium and long term. The growth environment and greater use of resources, along with protectionism, is a combination conducive to core inflation rising to somewhat higher levels than in recent years.

Turbulence can be expected to persist in financial markets as central banks continue their policy shift. This will contribute to even tighter lending standards than in previous years. The environment is especially complex for the assets that had benefited most from the search for yields.

Furthermore, it is to be hoped that the UK's withdrawal from the EU is orderly, that China and Europe manage to maintain healthy economic growth despite the trade war, that Italy maintains some fiscal discipline, and that the tightening of lending standards is orderly.

With regard to Spain, the economy can be expected to continue to perform relatively well, driven mainly by domestic demand. The UK economy will continue to be shaped by the consequences of Brexit, even if it leaves in an orderly manner. In Mexico, economic growth is expected to ease compared with 2018, due to the higher uncertainty regarding economic policy.

On banking regulation, the major post-crisis reforms are expected to continue their process of recalibration. The main priorities of legislators and supervisors from the various regions are expected to include proportionality in regulation, the financial impact of climate change, cybersecurity, transparency, consumer protection, anti-money laundering and competitiveness in domestic markets.