Economic, business and regulatory environment

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The global economy posted the slowest growth since the financial crisis and inflation was contained.

The leading economies' central banks resumed monetary stimulus measures.

Economic and financial background

The global economy weakened on the back of trade tensions, Brexit uncertainty and China's economic slowdown. Against this backdrop, the leading economies' central banks resumed monetary stimulus policies.

The US-China trade war was one of the main focuses of attention and uncertainty. Over the course of the year, several attempts to bring the two countries' positions closer proved unsuccessful, and were followed by tariff increases. Moreover, the conflict continues to affect not only trade but other spheres, such as technology (sanctions on Huawei and other Chinese tech companies) and the currency markets (the United States officially designated China a currency manipulator). Nevertheless, 2019 ended with news of a trade deal between the two superpowers, which included concessions from China in return for a reduction in tariffs.

The trade tensions generated by the Trump Administration also affected the EU, albeit to a lesser extent. The main event was the decision to impose 7.5 billion dollars in tariffs on EU goods in response to illegal subsidies to Airbus, after the World Trade Organization (WTO) ruled in the US's favour. However, the US eventually opted not to impose tariffs on the European automotive industry, a threat that loomed large for most of the year.

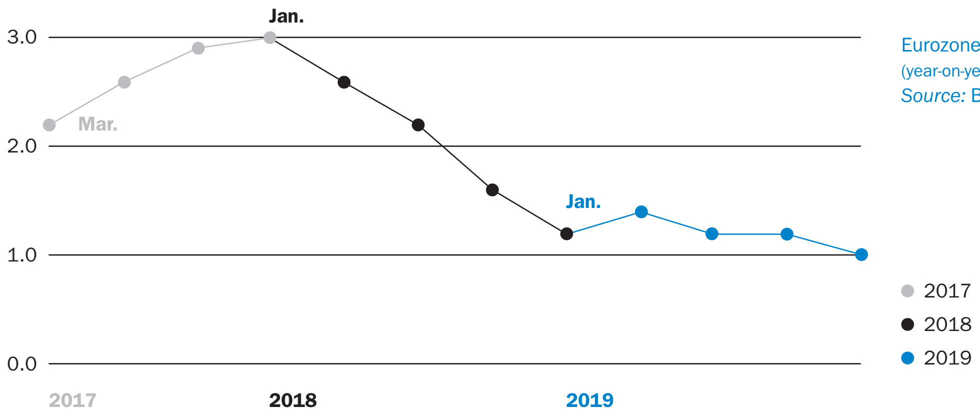
With regard to Mexico, over the summer the Trump Administration unleashed further shock waves of uncertainty after threatening to hit all Mexican imports with tariffs unless the country took steps to curb migrant flows. Days later, the authorities of the two countries reached a deal on migration that ruled out those tariffs. Meanwhile, despite some progress in the US regarding Congressional approval of the new trade deal that will replace NAFTA, its final approval remains pending.

Brexit and the successive postponements of Britain's exit from the EU shaped the UK economy and politics in the year. Theresa May's failure to persuade the House of Commons to approve her withdrawal agreement with the EU culminated in her resignation, and Boris Johnson's rise to power. Johnson managed to renegotiate the agreement with the EU and, with Parliament deadlocked, he called an election in December with a view to getting his deal through. Johnson's landslide election victory paved the way for the UK to leave the EU on 31 January 2020. That marked the beginning of a transition period and talks to shape the UK's future relationship with the European Union.

Also on the political front, the US House of Representatives voted to impeach Donald Trump. The Democrats' case stems from a phone call in which Trump asked the president of Ukraine to dig up information concerning the business dealings of Joe Biden's son (Biden is one of the front-runners in the Democratic primaries) in exchange for authorising military aid to the country. For the process to end in the president's removal, a two-thirds majority is required in the Senate, which is controlled by the Republicans. In Europe, in the wake of the parliamentary elections, the new President of the European Council established as the priorities of his mandate ensuring EU sovereignty (including in the industrial and digital spheres), leading the fight against climate change and upholding European values. In Italy, the Five-Star Movement and the Democratic Party formed a coalition government that is more pro-European than its predecessor.

With regard to economic activity, in 2019 global GDP logged its slowest growth since the financial crisis. The manufacturing sector, business investment and international trade were the worst hit by the trade war, while services proved more resilient. Meanwhile, positive labour market dynamics were maintained, supporting consumer spending.

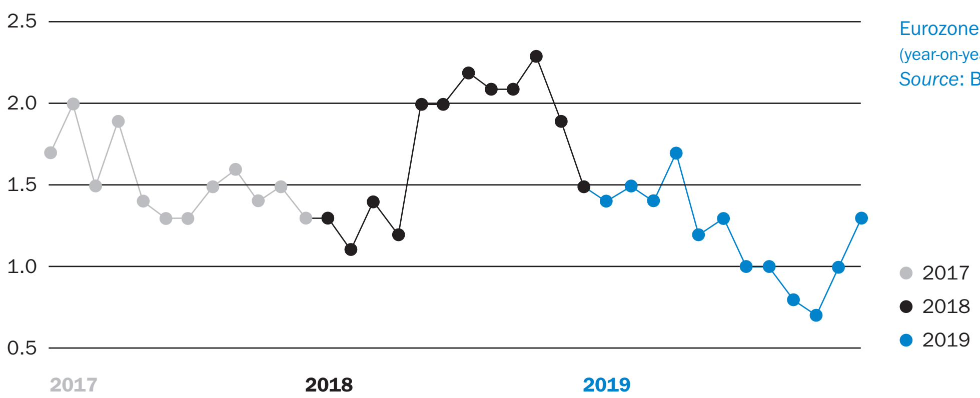
In the developed economies, the Eurozone showed vulnerability to the global context (trade tensions and Brexit) and continued to decelerate, hampered by export performance. The European economy was also weighed down by the conjunction of certain idiosyncratic elements, such as the new environmental regulations in the automotive sector. In the UK, economic growth was constrained by Brexit uncertainty and global trade tensions. UK companies replaced investment with labour, keeping the unemployment rate close to record lows. In the United States, economic growth gradually eased, but remained at reasonable levels in the year as a whole. Consumer spending was the mainstay of the economy, buoyed by a strong labour market. In Japan, growth in activity was constrained by the decline in the foreign sector.



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

As for emerging economies, Chinese growth was hampered by the trade war with the US, which forced the authorities to adopt measures to mitigate the impact. In any event, these measures were restrained and aimed at shoring up consumer spending, SMEs, the private sector and, to a lesser extent, infrastructure investment. It is notable that, excluding China and India, economic growth in emerging economies still barely exceeds that of developed countries. In Mexico, the economy stagnated, impacted by uncertainty on domestic policies and sluggish expenditure by Andrés Manuel López Obrador's government. Moreover, the government's shift towards a more interventionist energy policy triggered downgrades in the sovereign rating and the rating of state-owned oil company Pemex. With regard to Brazil, Jair Bolsonaro's new government managed to approve a pension reform needed to ensure fiscal sustainability. In Argentina, Peronist leader Alberto Fernández won the presidential election at the end of October, and appointed former president Cristina Kirchner his vice-president. The result was not welcomed by financial markets, given their interventionist, anti-IMF stance. The government's precarious financial situation led it to postpone Treasury bill repayments. The government also commenced the process to perform a general restructuring of government debt. In Turkey, some imbalances were redressed and the economy improved somewhat. However, the recovery remains closely linked to stimulus policies, while external leverage and dollarisation levels of the Turkish economy remain high. Erdogan's foreign policy has also remained in the spotlight after he acquired Russian missiles and ordered a military incursion into Syria, sparking tensions with the US government.

Inflation remained contained in the main developed economies and is below central banks' targets, especially in the Eurozone.

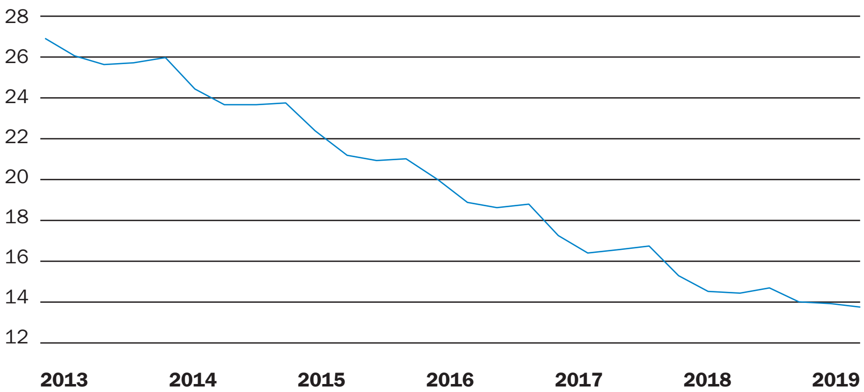


Eurozone HICP
(year-on-year change, %)
Source: Bloomberg

Spain logged growth in line with that of the previous year, of around 2% year-on-year.

Oil prices fluctuated to the tune of developments in the trade war and geopolitical tensions. The accommodative shift by central banks, the decision by OPEC and other oil producers to extend the production cuts, and disruptions in the supply of oil from countries like Venezuela and Iran were significant factors shoring up Brent crude prices, which ended the year about 20% higher. The increase in crude oil supply in the United States and the reduction in demand projections curbed the rise of crude oil prices.

The Spanish economy logged growth in line with that of the previous year, of around 2% year-on-year. As in the rest of Europe, the manufacturing sector was hampered by global trade tensions, Brexit and the introduction of new environmental regulations in the automotive sector. On the labour market front, the trend was less positive than in the previous year, although unemployment continued to fall. As for real estate, house prices remained very dynamic despite flagging sale transactions, which were impacted, among other things, by new legislation. On the external front, the current account balance registered a surplus for the eighth consecutive year, despite global trade tensions, trade partners' more sluggish economic growth and the absence of growth in foreign tourist arrivals. Several rating agencies took positive steps regarding Spain's sovereign rating, and the country held two general elections (in April and November) resulting in an especially fragmented parliament and an agreement between the Socialist Party (PSOE) and Unidas Podemos on a programme for government.



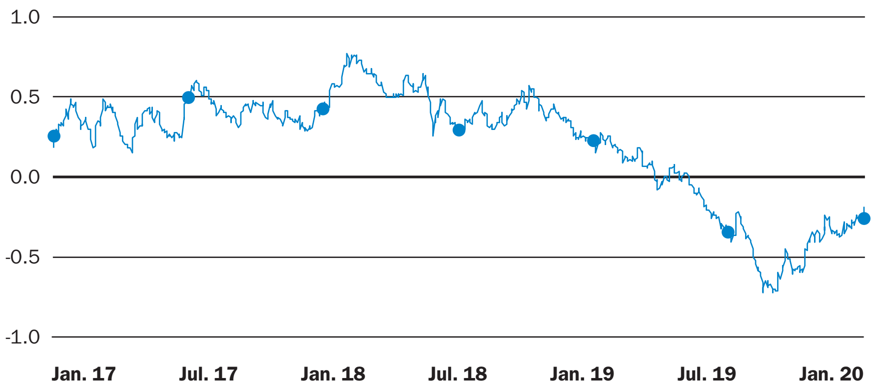
Unemployment rate in Spain (% of labour force)
Source: INE

The leading economies' central banks resumed a clearly accommodative stance, in a context of economic deceleration without inflationary pressures. In September, the ECB approved a 10bp cut in the deposit facility rate to -0.50%, the first cut since 2016, to a level never previously seen. The ECB also resumed its asset purchase programme without establishing a date for its conclusion, and improved the previously established conditions for short-term liquidity operations (TLTRO III). It also introduced a new tiering system for remunerating banks' surplus liquidity reserves. In the US, the Fed cut interest rates for the first time in a decade, with three consecutive cuts since the summer, to the 1.50%-1.75% range, as insurance against global risks. Towards the end of the year, the Fed opted to wait and see how developed economies would perform. The Fed also completed its balance sheet normalisation process ahead of schedule, and, in light of the tightening of the money market in dollars, it then began to expand its balance sheet by means of liquidity auctions in the repo market and the purchase of Treasury bills. During the year, Trump repeatedly criticised the Fed in a bid to pressure the bank to adopt a laxer monetary policy. The Bank of Japan extended the period in which it will keep interest rates low.

Global financial markets were buoyed by the shift at developed countries' central banks towards a more accommodative monetary policy. Risk assets such as equities and corporate debt performed very strongly and showed less volatility than in the previous year. This was the case despite ongoing trade tensions and deepening liquidity problems in some markets, such as the US repo market. Overall, funding conditions remained lax for most of the year, which led to a sharp increase in funding via capital markets. International institutions have warned that the growing importance of funding via capital markets is one of the main risks to financial stability.

Yields on German and US long-term government debt declined over the course of the year, ending at -0.19% and 1.92%, respectively. The yield on the German 10-year bond moved back into negative territory for the first time since 2016, and reached record lows. The yield on the US 10-year bond hit its lowest since 2016. The decline in the yields of both bonds were influenced by uncertainty regarding trade talks between the US and China and in connection with Brexit, the global economic slowdown, the absence of inflationary pressures, the reversal of market inflation expectations in the Eurozone and the new, more accommodative measures by central banks. At the end of the year, the easing of trade tensions between the US and China exerted upward pressure on both economies' sovereign debt yields.

The trade war and Brexit continued to shape the global economic and financial context.



German government bond yield (%)
Source: Bloomberg

Sovereign risk premiums in non-core Europe tightened due to the ECB's latest accommodative measures, the election of a more pro-European government in Italy and positive rating actions by the rating agencies with respect to Spain and Portugal. The improved market mood was also evidenced in Greece, where the Treasury issued the country's first long-term bond since exiting the international bailout.

With regard to currencies, the euro depreciated against the dollar. Sluggish macroeconomic performance in the Eurozone was among the key factors in this trend. Trade talks between the US and China generated volatility in the exchange rate, and this may have been a factor underpinning the dollar. Sterling remained exposed to Brexit developments and, in particular, the fluctuating risk of a no-deal exit from the EU. The repeated rejection by MPs of a no-deal Brexit and the change of tone by Boris Johnson, who eventually worked to ensure a deal, helped shore up sterling against the euro. The yen remained at similar levels to the previous year, although it did experience volatility against the dollar, impacted by the uncertainty linked to trade tensions.

Equities logged a very strong performance, bolstered by the accommodative tone of central banks. Developments in connection with the trade war had only a temporary effect on share prices.

The shift by developed economies' central banks towards a laxer stance supported emerging countries' financial markets and enabled some emerging countries to cut benchmark interest rates. In any event, trade tensions triggered volatility spikes over the course of the year. Once again, the countries with the greatest idiosyncratic vulnerabilities, such as Argentina and Turkey, suffered the most.

Banking sector

Eurozone banks strengthened their capital position and asset quality. Profitability is still under pressure in a context of low interest rates.

Europe's banking system maintained its strong capital position in 2019, and continued to reduce non-performing exposures. Accordingly, the average fully loaded CET1 ratio stood at 14.4% in September 2019, compared with 14.5% in September 2018. Meanwhile, the average loan loss ratio at EU banks continued to decrease, reaching 2.9% in June 2019 (vs 3.4% a year previously), the lowest level since the definition of non-performing loan was harmonised in Europe. This decrease was underpinned by enhanced management of this kind of assets, as well as by the favourable economic context and low interest rates. However, the prolonged period of low interest rates continued to burden profitability, which averaged 6.6% in September 2019, 0.6 points less than a year previously and still below the average cost of capital.

The liquidity stress test in the Eurozone banking system revealed a robust liquidity position, although global and systemic banks, more dependent on wholesale funding, would be worst hit in an adverse scenario.

According to various European authorities, the main risks to financial stability in the EU are: (i) tight asset valuations that could lead to sharp market corrections; (ii) challenges posed to financial entities' profitability; (iii) growing acceptance of risk by non-bank financial institutions; and (iv) in the longer term, the sustainability of business models in the transition towards a sustainable economy.

In Spain, the banking industry's profitability decreased year-on-year, to 7.3% in September 2019, although it remained clearly higher than the European average. Wholesale sales of stage 3 asset portfolios by some banks pushed the loan loss ratio down to 3.4% in September 2019, 0.7 points lower than a year earlier. As for capital, the CET1 ratio (11.6% in September 2019) is clearly above regulatory minimum requirements, but still below the European average.

Regulatory environment

The impact of climate change on the banking sector increasingly captured the attention of central banks and supervisors.

Banking Union

Over the course of 2019 there was little progress on completion of the Banking Union due to the electoral calendar in the EU. The main milestone was approval of the single rulebook through which the penultimate changes to Basel III are enshrined in European legislation. All of this was instrumented by amending the Capital Requirement Regulation (CRR) and the Capital Requirements and Bank Recovery and Resolution Directives (CRD IV and BRRD). Most of these new rules come into force in mid-2021.
On an institutional level, no agreement was reached to establish a European Deposit Insurance Scheme, although a high-level working group was created to make headway in political negotiations and a German proposal made at the end of the year will serve as the basis for subsequent discussions.

With regard to the resolution framework, it was agreed that the European Stability Mechanism (ESM) would act as a backstop for the Single Resolution Fund (SRF). Accordingly, in situations in which the SRF is stretched for resources to tackle a resolution event, the ESM will grant it a credit facility to cover any deficit. The ESM will commence its new functions in 2024, although there is scope to bring that date forward.

Capital Markets Union

Concrete progress in connection with the Capital Markets Union (CMU) was limited, due to the European elections in May.

On the one hand, negotiations are ongoing to devise regulations governing crowdfunding platforms in the EU. Some headway was also made in the creation of a pan-European voluntary individual pension product and measures were established to remove obstacles to the cross-border distribution of mutual funds. There were discussions concerning the possibility of resuming work on the project to create a risk-free asset for the Eurozone, which met with reluctance from various countries. The new Commission, for which the CMU is one of its priorities, created a high-level experts forum to strengthen the project with new strategic measures.

There was more progress with regard to sustainable finances, since the work focused on rolling out the Action Plan on Financing Sustainable Growth unveiled in 2018. Entry into force of the common classification of environmentally sustainable activities will be complete at the end of 2021 for two of the six categories defined, while the other four must be implemented one year later.

Macroprudential framework

Countries have intensified their use of macroprudential policies in 2019, due to the accumulation of financial vulnerabilities in a context of accommodative monetary policy in the last few years. All this is aimed at preventing and mitigating cyclical systemic risks that can be caused by excessive growth in aggregate lending.

Discussions concerning macroprudential policies focused on quantitative models underestimating financial risks, the need to complete macroprudential policy for the non-banking sector and to incorporate the macroprudential angle in stress tests in the banking sector.

Several economies, like Germany, activated or announced activation of the countercyclical capital buffer (CCyB). Others, like France and the United Kingdom, decided to increase it due to persistent vulnerabilities. For its part, the Bank of Spain expressed a willingness to activate this instrument if its macroeconomic forecasts are confirmed. All of this in a context in which the ECB has been calling for greater use of the CCyB.

Moreover, the European authorities warned of significant growth in non-bank financial intermediation. Regulation of this part of the financial sector is less developed than that of the banking sector, enabling the non-banking sector to assume greater risks. All of this makes it necessary to develop a specific macroprudential framework for the non-bank sector, strengthen the identification and monitoring of its risks and properly quantify the relationship between the banking and non-banking sectors.

Regulatory and supervisory framework

In 2019, the authorities continued to work on reforms already underway. Europe agreed to reform the European System of Financial Supervision (ESFS), comprising the EBA (banks), EIOPA (insurers and pension funds), ESMA (markets) and ESRB (macroprudential). The reform will aim to increase supervisory efficiency, coherency and transparency. The EBA is now the supervisor of activities relating to money-laundering throughout the financial sector.

Work continued in several regions to reform benchmark indices. In Europe, the ECB began publishing the replacement for Eonia, the Euro Short Term Rate (€STR). Although the two indices will coexist until the end of 2021, Eonia is now calculated as a fixed premium over €STR, set by the ECB. Moreover, the competent authorities confirmed that the reform of Euribor towards a hybrid methodology is compliant with the European Benchmarks Regulation (BMR), so it may be used in new and existing contracts and instruments. In the United Kingdom the first financial products linked to the index replacing Sonia were launched.

As for climate change, its impact on the banking sector captured growing attention from central banks and supervisors, who are working on supervisory expectations and the incorporation of climate risks into stress tests. With regard to Brexit, European and British authorities took contingency measures to avoid disruption in financial markets in the event of a no-deal exit. These measures, which focus on derivative transactions, will remain in place for part of the transition period. The future relationship between the UK and EU in connection with financial services will be based on existing regulatory equivalence rules.

Outlook for 2020

In the absence of additional escalations in trade tensions, the global economy should gain some traction as 2020 progresses.

Nevertheless, growth is likely to stay modest in light of the persistent sources of uncertainty: geopolitical environment, Brexit ramifications, US presidential election, etc.

To combat this uncertainty, monetary policy will likely seek to maintain lax funding conditions, while fiscal policy may be somewhat less focused on austerity.

Countries with more dynamic domestic demand and less reliance on the foreign sector look set to have some advantage over the rest.

Executive summary

- Political and geopolitical matters shaped the international economic and financial context once again.
- The trade war between the United States and China led to an increase in tariffs. Tensions also surfaced in technology.
- Brexit did not happen in 2019. Boris Johnson's landslide election victory paved the way for the UK to leave the EU on 31 January 2020.
- The global economy weakened in this context of uncertainty, posting the slowest growth since the financial crisis.
- The manufacturing sector and business investment were the worst hit by the trade war, while services have proven more resilient.
- Spain logged growth in line with that of the previous year, of around 2% year-on-year.
- Economic growth in the UK was constrained by Brexit uncertainty.
- In Mexico, the economy stagnated, impacted by uncertainty on domestic policies and slow execution of government expenditure.
- Risk assets performed well, buoyed by the shift at developed economies' central banks towards a more accommodative monetary policy.
- In September, the ECB approved a packet of stimulus measures (it cut the deposit facility rate, resumed the asset purchase programme, etc.).
- The Fed cut interest rates as insurance against global risks, auctioned liquidity, and commenced a programme to purchase Treasury bills as a means of combating money market tensions.
- The yield on German long-term debt moved back into negative territory for the first time since 2016, impacted by the context of uncertainty and by the ECB's policy.
- Sovereign risk premiums in non-core Europe have tightened, influenced by the ECB's latest accommodative measures and the change of government in Italy.
- The euro depreciated against the US dollar due to economic weakness in the Eurozone and trade tensions.
- Sterling remained sensitive to Brexit and appreciated against the euro when the UK parliament blocked a no-deal exit and Boris Johnson sought a new deal.
- The shift by developed economies' central banks towards a laxer stance lent support to emerging countries' financial markets.
- Europe's banking system maintained its strong capital position and continued to reduce non-performing exposures.
- There was little progress on the Banking Union and Capital Markets Union due to the electoral calendar in the EU. The main milestones were the approval of the reformed single rulebook, the agreement on the resolution framework and the rollout of the Action Plan on Sustainable Finance.
- Countries intensified their use of macroprudential policies in light of the accumulation of financial vulnerabilities in a context of accommodative monetary policy.
- In the regulatory and supervisory frameworks, work was done to reform benchmark indices and central banks and supervisors focused increasingly on the impact of climate change on the banking sector.