1

RISKS LINKED TO THE MACROFINANCIAL ENVIRONMENT

The global economy continued to decelerate in 2019 against a background of high geopolitical uncertainty (trade disputes, possibility of a no-deal Brexit, tension in the Middle East, etc.), with Europe and the emerging economies the most affected. This has led to a downward revision of the growth outlook, and the Spanish economy has been no exception to this pattern. The slowdown in activity and the absence of inflationary pressures have led to an easing of monetary policy in the United States and in the euro area. There has been some upturn in volatility on the financial markets, but asset prices have held at historically high levels, especially following the monetary policy reaction. Activity in the Spanish real estate market has slowed to some extent in 2019 while mortgage lending conditions have tightened slightly. There has also been a deceleration in the flow of financing to the non-financial sector, whose net asset position continued to improve, albeit at a slower pace and with certain household and corporate sectors in a more fragile position.

1.1 Macroeconomic environment

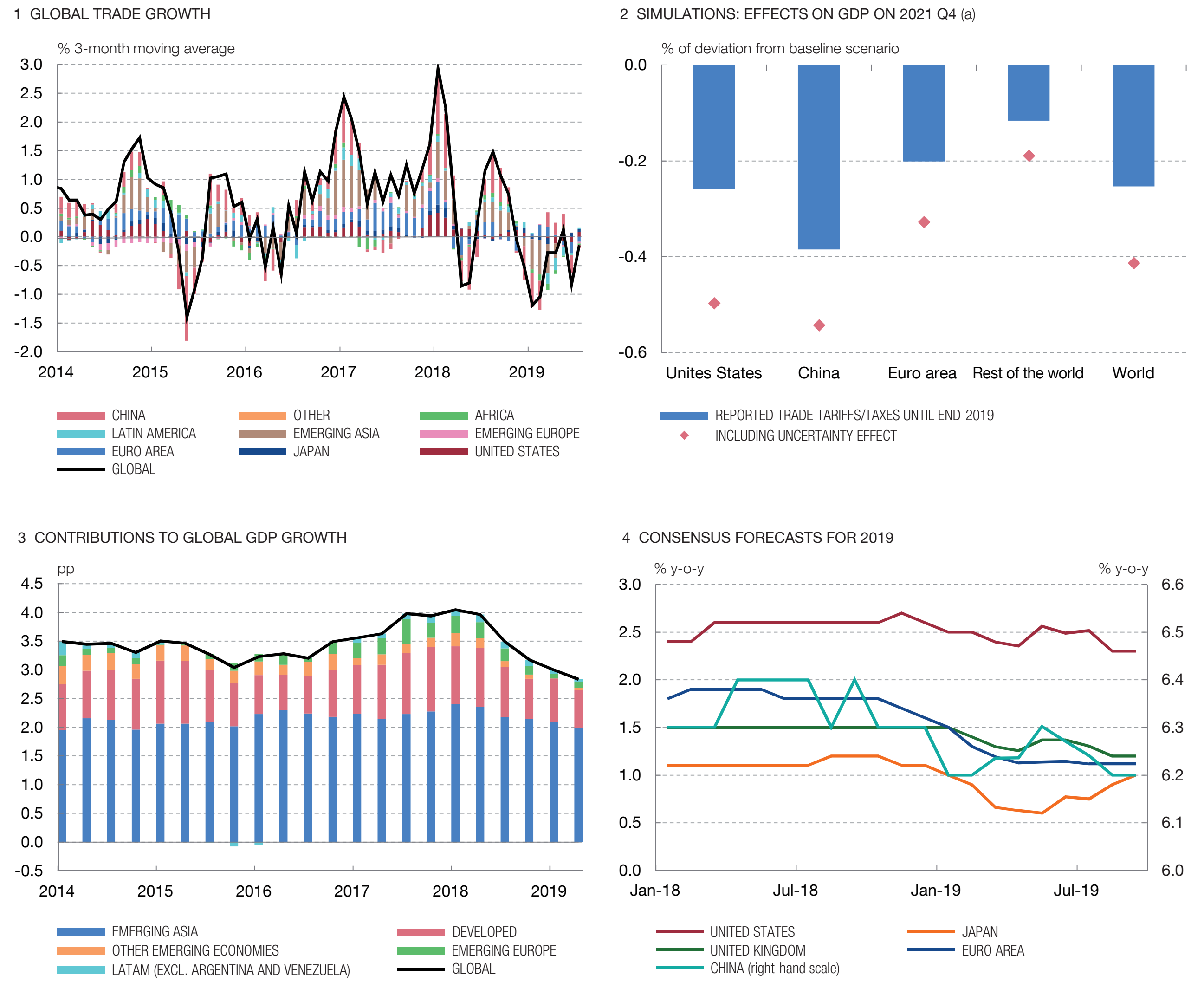
1.1.1 Key systemic countries

The contraction in global trade deepened against the backdrop of growing trade tensions, which are one of the main risks to the world economy. Global trade in goods contracted in Q2 more sharply than in Q1, declining at a quarterly rate of 0.8% and weighed down by the worsening of the trade disputes between the United States and China (Chart 1.1). The US imposition of additional tariffs on European products is also raising trade tensions. Uncertainty over the course of the conflict remains very high, but should the measures announced become effective, the impact on global growth could be substantial. Other geopolitical risks have played a greater role in recent months, in particular the likelihood of a disorderly withdrawal by the United Kingdom from the European Union (Box 1.1). Tensions in the Middle East also intensified, prompting a notable but temporary rise in oil prices in September.

In this setting the global economy continued to move on a slowing path, in a highly uncertain setting. Global GDP growth eased further in 2019 Q2 to a year-on-year rate of 2.8%, more than 1 pp down on a year earlier (Chart 1.1). The downturn was particularly manifest in manufacturing and in the wholesale and retail trade, while the remaining services initially trended more favourably. By type of expenditure, investment weakened compared with the greater resilience of consumption. The US economy remained somewhat more robust than other advanced economies, although it too

Chart 1.1
GLOBAL TRADE AND OUTPUT GROWTH

The slowdown in the world economy has continued. Analysts have duly revised their growth forecasts for 2019 downwards for the main economies, in a setting characterised by the US-China trade tensions, which have shrunk global trade and may have significant effects on global activity.



SOURCES: National statistics, Consensus, CPB, Thomson Reuters and Banco de España.

a The simulation considers two scenarios: that affecting EU-China bilateral relations and the subsequent reduction in global demand; and another in which, moreover, a decline in confidence and an increase in uncertainty come about.

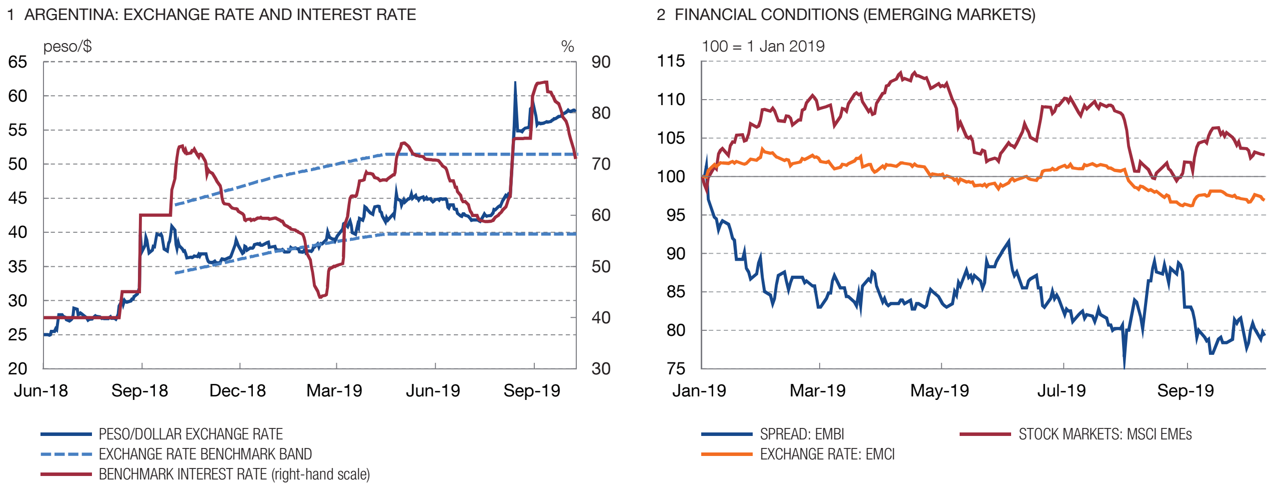
slowed. Among the emerging economies, economic activity in China decelerated once more in Q2. All in all this has given rise to across-the-board downward revisions of growth forecasts for 2019.

In the emerging markets with a significant Spanish banking presence, considerable risks associated with the global uncertainty and with various idiosyncratic events persist. In *Mexico,* the economic outlook has worsened, which will result in fresh challenges in the fiscal realm. These compound the delicate situation of the State-held company Petróleos Mexicanos (PEMEX), which has recently received a $5 billion capital injection from the government and has lengthened debt maturities

Chart 1.2

EMERGING ECONOMIES

Emerging countries' financial instruments lost value during the summer as a result of the trade war and of the elections in Argentina, but they have recently stabilised, but for Argentina itself.



SOURCES: JP Morgan and Thomson Reuters.

by repaying short-term bonds and issuing long-term debt securities. The current risks the economy is facing in *Brazil* might be relieved somewhat by the pension system reform (a key element for ensuring the sustainability of public finances). Congress approved the reform and the Senate is shortly expected to follow suit. Finally, in *Turkey,* whose economy has experienced a recession, uncertainty also remains high. This is even after the recent GDP and inflation figures, which were better than expected.

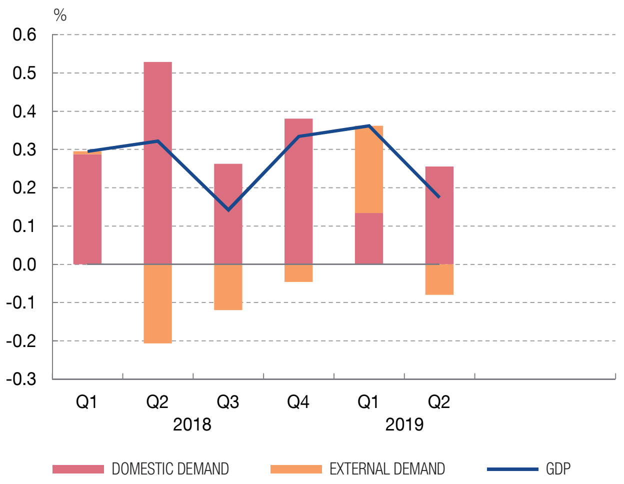
The other emerging financial markets have also been affected. Although its relative weight is small, *Argentina* is the most notable case. The primary election results in August had a strong adverse impact on financial markets and increased doubts over the sustainability of public debt (Chart 1.2). Set against the heavy depreciation of the peso, the central bank decided to considerably tighten its monetary policy stance. The government, meantime, announced its intention to reschedule debt payments, obligatorily lengthening the maturity of Treasury bills held by institutional investors and, voluntarily, that of longer-dated debt held both by residents and non-residents. The government likewise requested a change in the debt payment schedule arranged with the International Monetary Fund. This process culminated in early September in the introduction of capital controls and limits on dollar purchases by residents, which have tightened following the elections last Sunday, on 27 October. So far, the financial markets have not reacted significantly to the results of these elections.

In the euro area, the increase in economic activity was very moderate in Q2. The indicators available suggest this pattern has extended into Q3. GDP slowed in 2019 Q2 owing largely to the fall-off in exports and the slackness of investment (Chart 1.3). Growth was particularly modest in economies where the industrial sector has a greater weight, such as Germany and also Italy. The indicators available for Q3 suggest a

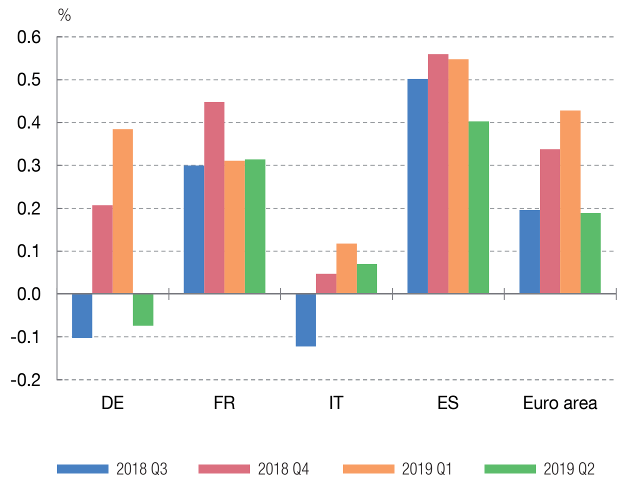
Chart 1.3
ECONOMIC GROWTH IN THE EURO AREA

Euro area GDP growth slowed notably in Q2 owing largely to the fall-off in exports. Economic activity was particularly sluggish in the economies with a greater industrial specialisation, particularly Germany and Italy.

1 EURO AREA QUARTER-ON-QUARTER GDP GROWTH AND CONTRIBUTIONS (a)



2 GDP BY COUNTRY
Quarter-on-quarter rate



SOURCE: Eurostat.

a Excluding Ireland.

further downturn in manufacturing activities and a more moderate services performance. In this setting, the Eurosystem's September forecast revised GDP growth downwards to 1.1% and to 1.2% for 2019 and 2020, respectively, compared with the June projection.

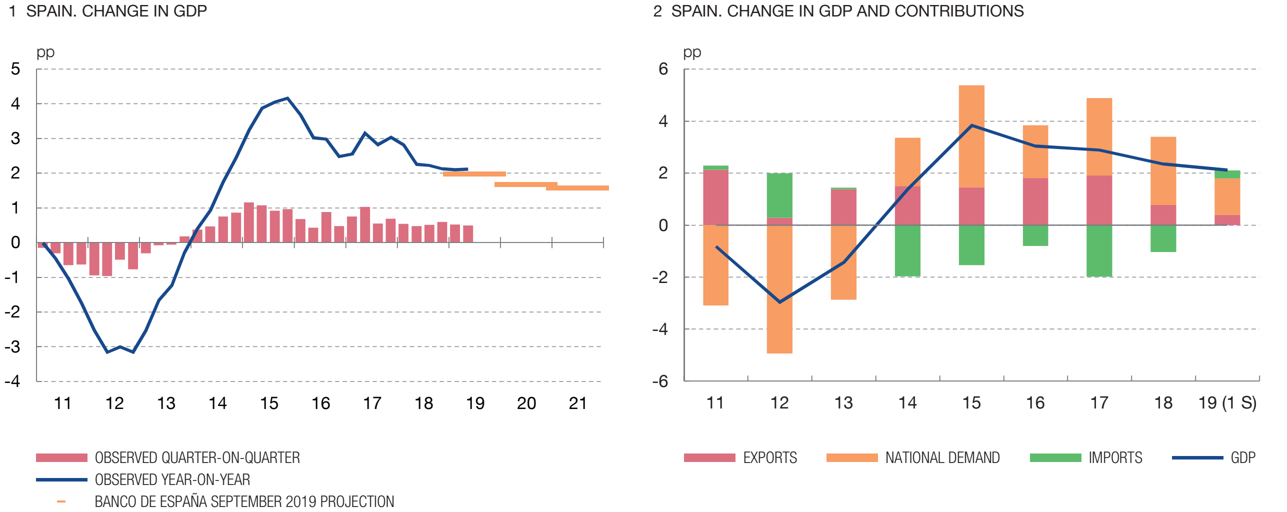
The downturn in the global growth outlook and the absence of inflationary pressures have led to a fresh easing in monetary policies in the main advanced economies. The US Federal Reserve cut its policy interest rate in July, September and October to a range between 1.5% and 1.75%, as a preventive measure against global risks. The ECB, at its September Governing Council meeting, agreed to introduce a package of measures with a clear accommodative stance. Among others, it approved a 10 bp cut in the deposit facility interest rate, placing it at –0.50%, reinforced its forward guidance on interest rates, and improved the lending conditions governing quarterly TLTRO. The ECB also agreed to resume net purchases under its asset purchase programme, at a monthly rate of €20 billion as from 1 November and with no defined time limit (Box 1.2). Moreover, a large number of central banks in other advanced and emerging economies cut their policy interest rates.

1.1.2 Spain

On the Banco de España's projections, GDP in 2019 Q3 grew at 0.4%, a similar pace to that of Q2 (Chart 1.4). The growth rates of the various demand components

Chart 1.4
SPANISH GDP

The expansion is projected to continue during the 2019-2021 period, albeit with lower growth rates than in previous years and with downside risks. In the recent period GDP is estimated to have once again been underpinned by domestic demand growth, though this latter variable would have been affected by the build-up of external and domestic uncertainties.



SOURCES: INE and Banco de España.

moderated in 2019 H1. In particular, the loss of momentum in the global environment and the rise in uncertainty impacted in the first half of the year the different domestic demand components. Indicators available for 2019 Q3 suggest a more dynamic behavior of household expenditures and firms in that quarter. The slowdown in activity has been apparent in employment, where the moderation has been somewhat sharper than that in output, according to the Social Security registration figures and the last Spanish Labour Force Survey (EPA). That points to a loss of dynamism in private-sector employment which, while across the board, may be more acute in construction.

The medium-term baseline scenario envisages a continuation of the expansionary phase, albeit at a more moderate rate and with downside risks. The latest Banco de España macroeconomic projections, published in September, point to a continuation of the expansion over the 2019-2021 period (Chart 1.4).[1] Under this baseline scenario, however, the pace of GDP growth would be somewhat less than that of previous years, in step with the persistence of the uncertainty linked mainly to the external setting. Further, this baseline path will be subject to downside risks, associated with a potential worsening of trade tensions and with the materialisation of specific geopolitical risks (such as a no-deal Brexit). That would

1 For further details, see Box 1 "Macroeconomic projections for Spain (2019-2021)", Quarterly report on the Spanish economy, Economic Bulletin 3/2019, Banco de España.

give rise to lower-than-expected growth in the Spanish economy. On the domestic side, it cannot be ruled out that the persistence of uncertainty over the future course of economic policies and the recent events in Catalonia may affect output developments.

1.2 Financial markets and real estate sector

1.2.1 Financial markets

Geopolitical risks, trade tensions, the global macroeconomic outlook and central banks' accommodative monetary policies have all influenced developments on international financial markets. In two specific episodes, in May and in August, negative sentiment on the markets prevailed regarding the outcome of trade negotiations between China and the United States, other geopolitical risks and, in general, the outlook for economic activity. This was reflected in across-the-board declines in higher-risk asset prices, such as equities and high-yield corporate bonds, and increases in those considered safer, such as sovereign debt (Chart 1.5). Additional downward pressure on the long-term yields on these securities was exerted by the expectations of more accommodative monetary policies, leading to historical lows in most euro area countries and in the United States. The growing uncertainty on markets also entailed a rise in price volatility, markedly so in the case of sovereign debt.

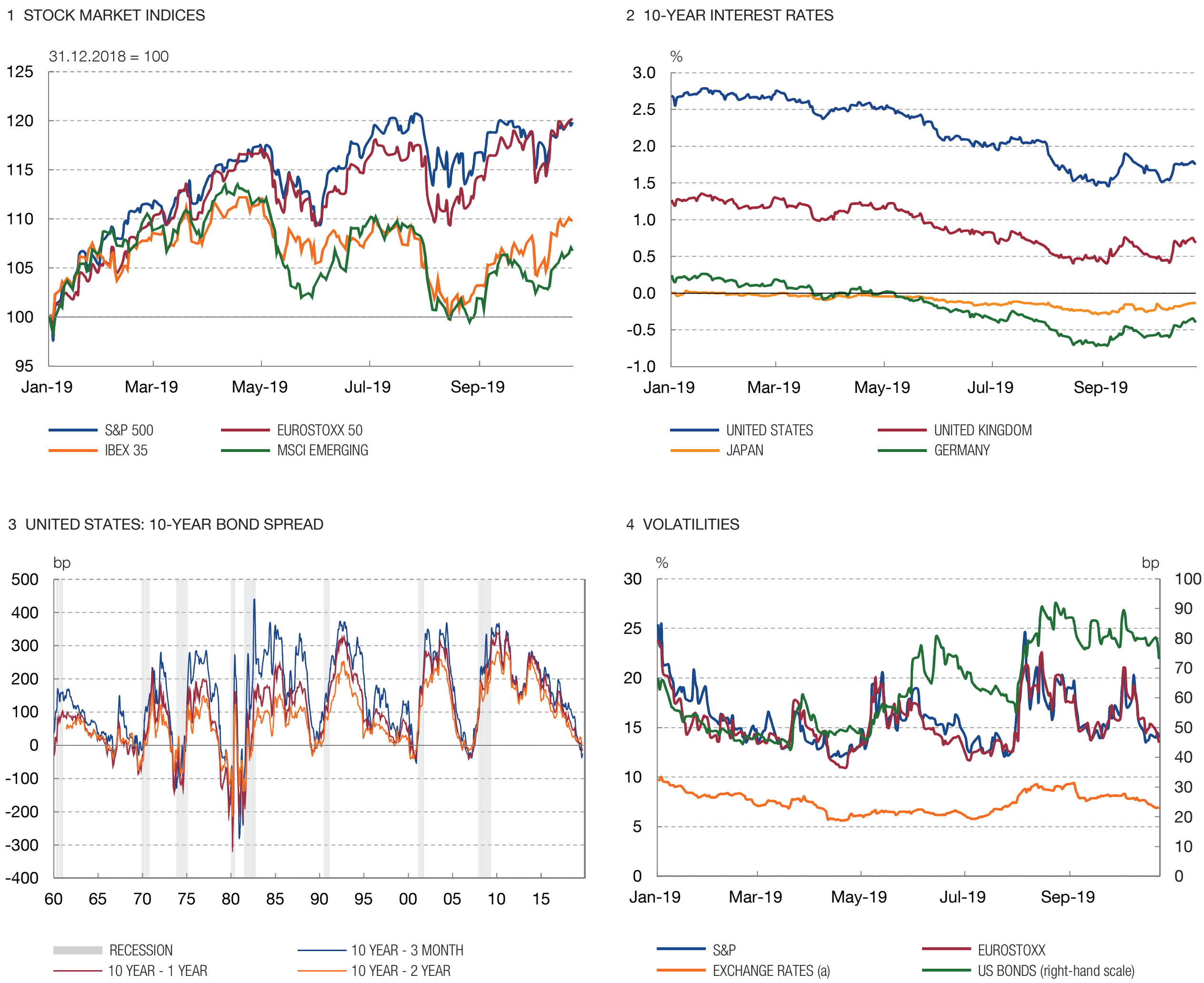
Since late August, sentiment on the financial markets has improved across the board, against a background of apparent progress in US-China trade negotiations. This has translated into a rise in sovereign debt yields and a recovery in higher-risk asset prices. As a result, the main stock market indices in the developed countries are, at the cut-off date for this FSR, above the levels reached at the related cut-off date for the previous FSR and, in the case of the United States, very close to their historical high. Their cyclically adjusted PER, which is an indicator of the degree of alignment between stock market prices and economic fundamentals, evidences somewhat high levels compared with corporate profits, given the historical relationship between the two variables (Chart 1.6). By contrast, on Spanish and euro area markets, this ratio has been below its average level since 1997, which suggests the absence of signs of overvaluation.

Of note on euro area financial markets is the compression of sovereign risk premia since June 2019, along with the worse performance of bank stock market indices in relative terms. In Spain, the 10-year sovereign debt yield spread over the German benchmark has fallen by around 45 bp, while in Italy it has declined by around 120 bp (Chart 1.6). Behind these developments have been both the announced resumption of the ECB's asset purchase programmes and a lower perception of risk. In Italy, a key factor has been the formation of a new, more European-oriented

Chart 1.5

FINANCIAL MARKET INDICATORS

Following certain episodes in which negative sentiment prevailed on the markets, higher-risk asset prices have picked up somewhat since end-August. Long-term sovereign debt yields also recovered, after having posted historical lows in most euro area countries and in the United States in August. The slope of the US yield curve inverted in August in the 2-10-year tranche for the first time since 2007. Excepting a brief episode in early October, market volatility has tended to decline since late August.



SOURCES: Thomson Reuters Datastream.

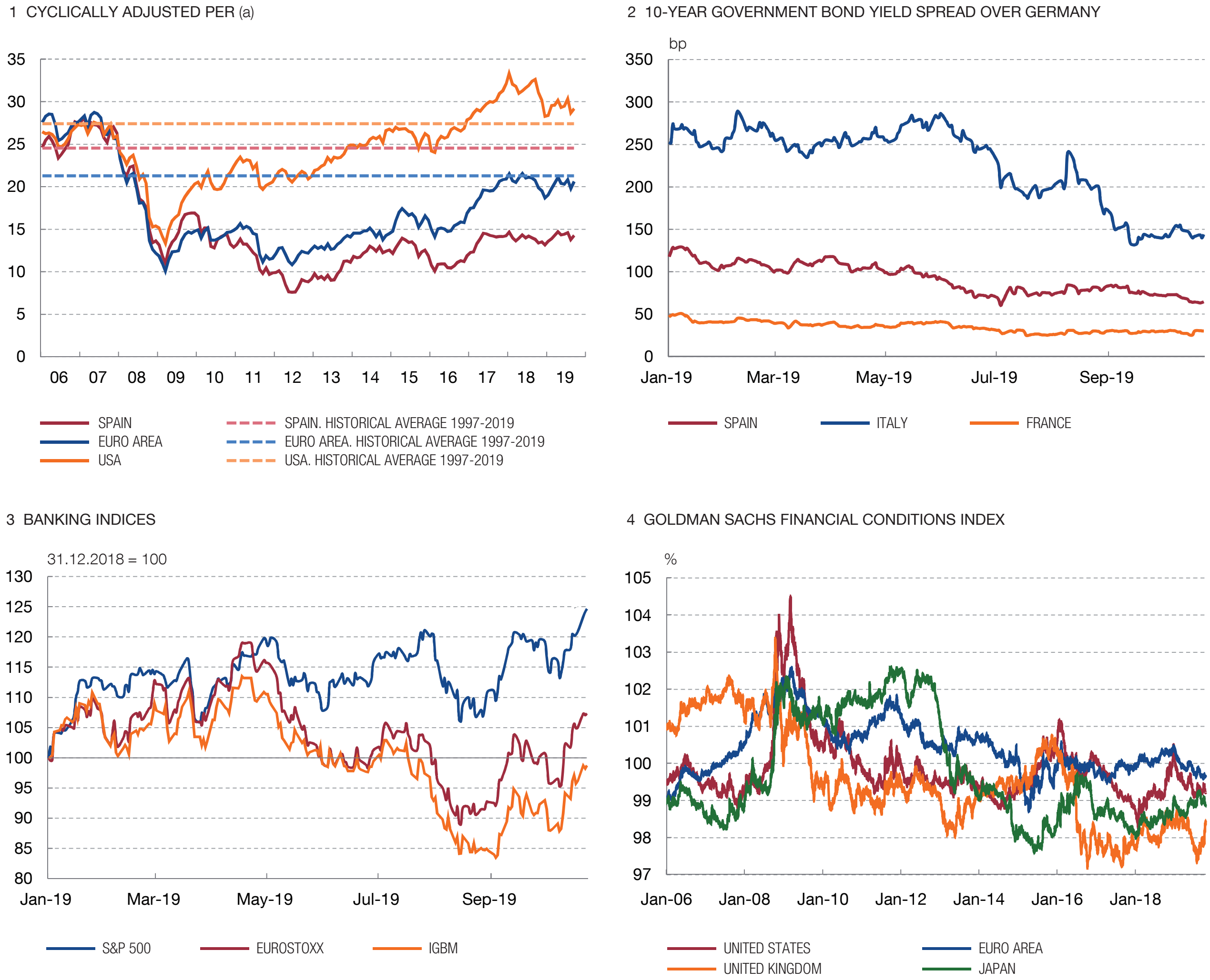
a Average of 3-month volatiities for USD/EUR, USD/GBP and JPY/USD.

government, while in Spain both the improved credit rating granted by Standard & Poor's (from "A" to "A+") in late September and the DBRS upgrade of the outlook (from stable to positive) have been pivotal. The European bank stock market indices have posted further declines, since the publication of the previous FSR, of 7% in the case of the EuroStoxx Banks sub-index and 10% in that of the Madrid Stock Exchange listed banks (Chart 1.6). These declines in bank prices are due to the worsening in the macroeconomic outlook, which bears down on expected profits in the banking sector both through the effect on the diminished quality of their credit portfolios and the lesser demand for banking services, and through the possible

Chart 1.6

OTHER FINANCIAL MARKET INDICATORS

The price-earnings ratio (PER), in cyclically adjusted terms, stands somewhat above its historical average in the United States, and below this average in the euro area and in Spain. Of note in the euro area financial markets is the compression in sovereign risk premia and the poorer relative performance of the banking stock market indices. The financial conditions indices show that such conditions continue to be relatively easy in the advanced economies.



SOURCES: Robert J. Shiller, Thomson Reuters Datastream and Bloomberg Data License.

a The cyclically adjusted PER is calculated as the ratio of share prices to the ten-year moving average of profits.

narrowing of the unit net interest margin associated with expectations that interest rates will hold at very low or even negative levels for a longer period.

Spanish stock market indices have performed more poorly than the related indicators on the main European markets. This is due mainly to the greater decline in banking sector share prices in Spain and to the relatively greater weight of this sector in national indices.

The materialisation of some of the risks described in Section 1.1 might lead to fresh periods of tension on international financial markets, with potentially

adverse consequences for financial stability. A new episode of this type, accompanied by strong rises in risk premia, would entail a tightening of financial conditions that would interrupt a long period over which these conditions had remained loose (Chart 1.6). These developments might affect to a greater extent the more vulnerable segments such as that of debt with impaired credit quality, including leveraged loans and CLOs,[2] and markets with high valuations, and they could spread to other assets. That would amplify the direct effect of the economic growth shock associated with agents' lower confidence and other real factors, impairing not only the credit quality of banks' portfolios but also reducing the value of other securities on their balance sheets.

In the medium term, the extension over time of easy financial conditions characterised by very low interest rates also poses some challenges for financial stability. Against this background, macro- and microprudential supervisors should monitor closely the behaviour of bank and non-bank intermediaries and use the instruments available to curb any excessive risk-taking with systemic implications or to build up buffers with which to counter future adverse shocks.

1.2.2 The real estate market in Spain

The information available points to a slowdown in activity in the real estate market in 2019 up to the cut-off date of this report. Since late 2018, a growing number of housing market indicators, on both the supply and demand sides, have slowed. This has been in spite of easy borrowing conditions holding and of continuing employment creation, albeit at lower rates. The uncertainty stemming from the external environment might have begun to feed through, as in the case of other domestic demand components, to residential investment. As regards sale/purchase transactions, the slowdown has been sharper in the second-hand housing market (Chart 1.7). This recent loss of momentum in housing transactions will be largely attributable to the slowdown in the national component of housing demand, since the non-national component (resident and non-resident alike) is holding stable around late-2018 levels, which marked a peak. The construction of new housing, proxied by the number of building permits, decelerated notably in year-on-year terms until July. In cumulative 12-month terms, the figure for building permits in July accounted for just over 12% of the pre-crisis peak.

Second-hand house prices have recently slowed, while the growth rate of new house prices has risen. In the first half of 2019, average house prices posted year-on-year growth of 6%, compared with 6.7% in 2018 as a whole. The slowdown

2 CLOs are leveraged loan securitisations. See "Financial Stability Report", Federal Reserve Board, May 2019, and Banco de España FSR, Spring 2019. The presence of CLOs in the Spanish financial system is very low compared with other European countries and the United States.

was due to the developments in the second-hand housing market, which increased by 5.6%, 1.2 pp lower than in 2018. Conversely, the prices of new houses continued to accelerate in the first half of the year (8.8% year-on-year, above the 2018 figure of 6.4%). As a result, they have continued to draw closer to their 2008 Q3 peak level, standing 7 pp below. Although, in real terms they are still 18% below their historical high.[3] In aggregate and real terms, house prices are still around 30% below their 2007 Q3 high (Chart 1.7). The indicators and models available, based on aggregate data and subject to a high degree of uncertainty, would suggest that prices are already around their equilibrium level (Chart 1.7).

Real estate market activity and prices continue to show high heterogeneity across regions and segments. In the past 12 months, the increase in prices for new and second-hand housing alike has tended to ease in those areas where prices had grown to a greater extent from their post-crisis low. Conversely, the rate of increase of prices has held up and, in some cases, steepened in those areas where prices had recovered more slowly. In terms of the volume of housing transactions, the slowdown has been generalised across the regions; that said, those that have been most dynamic since the recovery have shown greater weakness over the past year in relative terms (Chart 1.7). That is to say, some convergence and rebalancing in the rates of change of prices and volume of transactions is under way.

The percentage of households paying rentals continued growing in 2018, although there continues to be notable heterogeneity between types of households and geographical areas. In 2018, the weight of residential rentals in Spain held on the growing trend dating back to the mid-2000s, especially among those households in which the age of the reference person is between 30 and 44 years. The weight of rentals in 2018 grew across the board in Spain’s regions, albeit maintaining notable disparity.

In line with the slowdown in real estate market activity, new lending to households for house purchase has lost momentum. Since June, the volume of new lending under this heading has been contracting in year-on-year terms. This had not occurred since early 2014 (Chart 1.8). In this respect, the Bank Lending Survey (BLS) suggested that during the first half of the year there had been some tightening in lending standards, while loan applications had remained rather flat. The developments in new lending have meant that the rate of contraction of the outstanding balance of credit in this segment has ceased to ease in recent months (–1.1% in August), breaking the trend recorded in 2018.

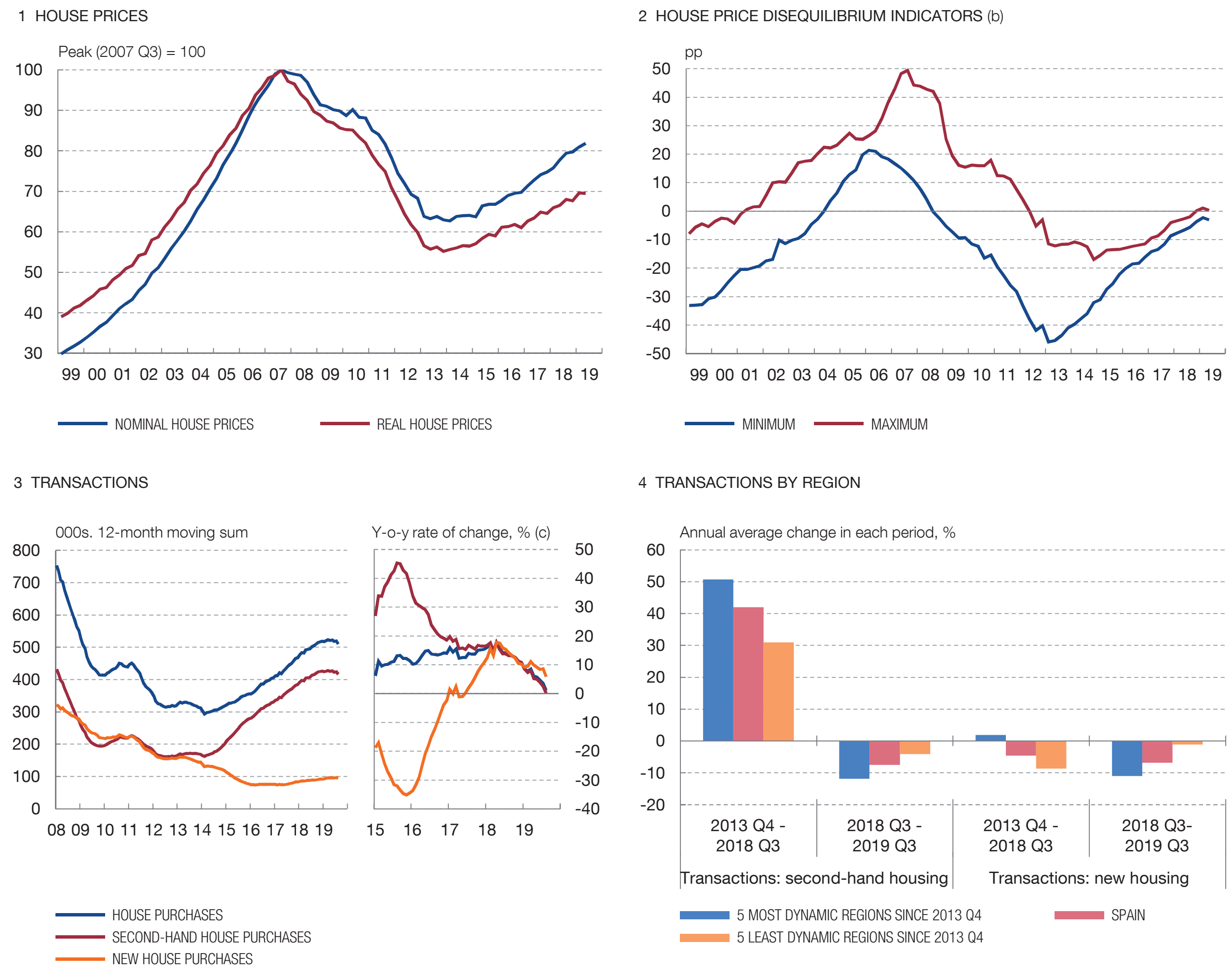
The interest rates on new loans for house purchase fell by around 20 bp, in cumulative terms, from May to August (Chart 1.8). This decline is mainly linked

3 In the same period, second-hand house prices stood 38% below their respective high.

Chart 1.7

HOUSING MARKET ACTIVITY INDICATORS (a)

Real estate activity has slowed in the course of 2019, influenced by the slowdown in demand by national purchasers but also by agents' adaptation to the latest regulatory changes in the mortgage market. Housing supply has also slowed and continues to be far off its precrisis peak volume. Second-hand house prices have recently decelerated, while new house prices are drawing closer to their historical high.



SOURCES: Banco de España, ECB, Eurostat and INE.

a Latest observation: 2019 Q2 (house prices) and August (house purchases). Real house prices are deflated using the consumer price index.

b The maximum and minimum of four imbalance indicators are shown. The first two are gaps calculated as the difference between the value of the variable of interest in each period and its long-term trend for: (i) house prices in real terms and (ii) the house prices/household disposable income ratio. The last two indicators are based on econometric models. The first of these is based on an Ordinary Least Squares (OLS) estimation of house prices, in real terms, in respect of household disposable income and mortgage interest rates. The second is based on an Error Correction Model (ECM) in which, in the long term, real-terms house prices depend on household disposable income and mortgage interest rates. In all cases, longterm trends are obtained using a one-tailed Hodrick-Prescott filter with a smoothing parameter equal to 400,000.

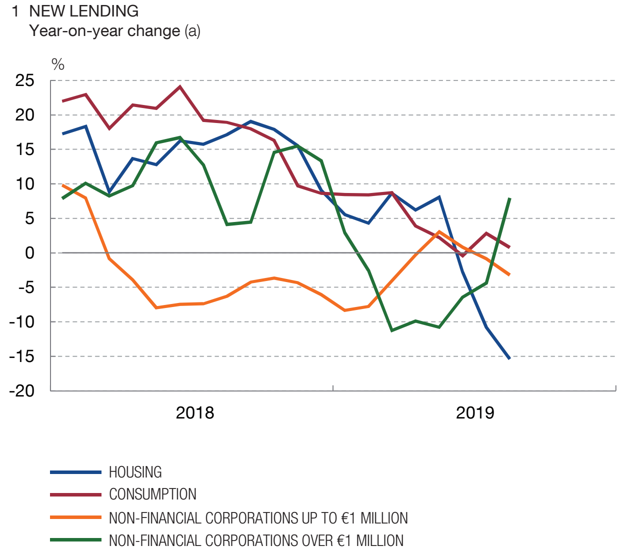
c Year-on-year rate of change taking the cumulative 12-month flow.

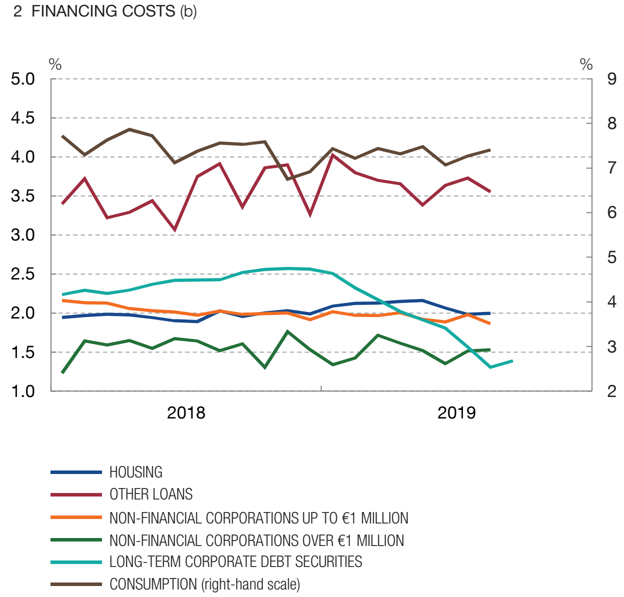
to the fall in wholesale funding costs since April. Thus, for example, the 12-month EURIBOR, the usual benchmark rate for these transactions, fell by 17 bp from April to July.

The loan-to-value (LTV) and loan-to-price (LTP) ratios also suggest some tightening in mortgage lending standards. Chart 1.9 displays the distribution of these two indicators for new mortgages, obtained from the databases of the

Chart 1.8
NON-FINANCIAL PRIVATE SECTOR FINANCING CONDITIONS

New credit flows to the non-financial private sector have gradually slowed in 2019 and, in recent months, they have contracted in practically all segments. The cost for companies of financing with fixed-income securities have fallen sharply, and companies have taken advantage of this to increase their resort to corporate bond financing.





SOURCE: Banco de España.

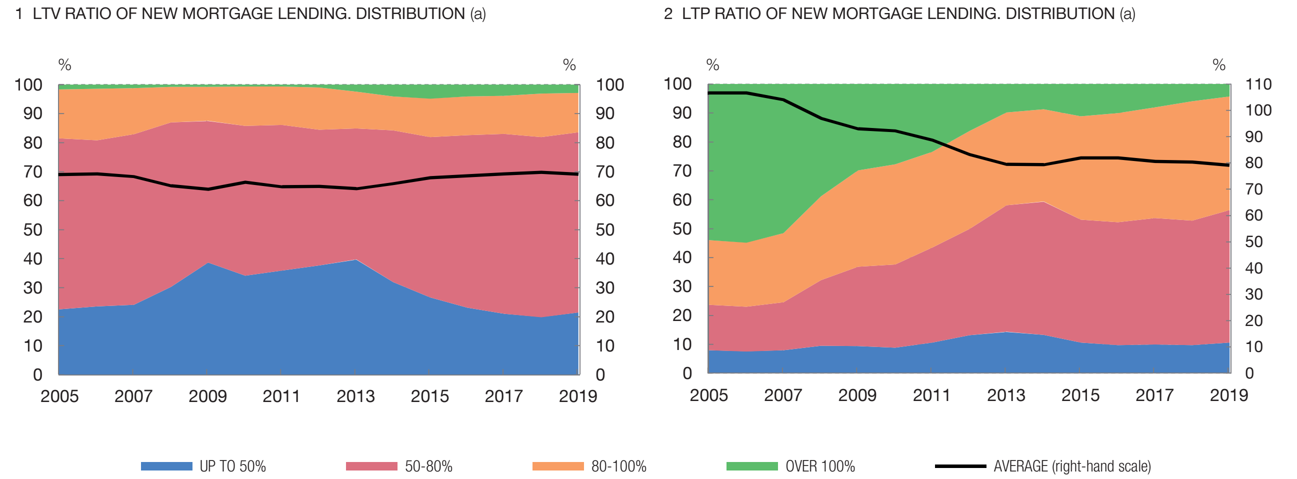
a Calculated taking 3-month cumulative flows.
b The interest rates on bank loans are NDER (narrowly defined effective rate).

Spanish Association of Registrars. In both cases, the amount lent is related to the collateral value of the mortgage, whereby an increase (reduction) in the proportion of loans with a high LTV/LTP would denote an easing (tightening) of lending standards. In this respect, the weight of more leveraged loans (those with an LTV or an LTP of over 80%), is lower in new mortgage financing. Moreover, the average LTV on new lending stabilised in the first half of 2019, while the average LTP diminished again. The average amount of mortgages fell in regions with a higher income level and grew less sharply in the other geographical regions. This suggests that the loan-income ratio of individuals or households with mortgages, another relevant factor for assessing mortgage conditions, might also have improved.

The LTV and LTP figures are highly stable. Despite the fact that the weight of transactions with a low LTV has fallen significantly in recent years, the average LTV is only slightly higher at present. By contrast, in the case of the LTP, there has been a reduction in the weight of the most leveraged transactions (with an LTP of over 80%) compared with the crisis years. Moreover, the average LTP is also lower. Box 1.3 analyses in detail the consequences of these new lending standards for the risk institutions take on in the mortgage market.

Chart 1.9
MORTGAGE LENDING STANDARDS

There has been some tightening of mortgage lending standards, as the weight of more leveraged mortgages (with an LTV and LTP of over 80%) has fallen, and the average LTV/LTP of the new mortgages has also declined.



SOURCE: Spanish Association of Registrars.

a In the distributions, the principal of the loans (by period) is accumulated to define each segment within the distribution. The average of the LTV and of the LTP is weighted in accordance with the capital of each mortgage.

The reduction in the outstanding balance of bank credit has been maintained in construction and real estate development activities. The year-on-year rate of decline was 12.5% in June 2019, entailing a more moderate fall-off than that observed at end-2018 (18.7%). This would be mainly due to the still-high volume of repayments and the sale of non-performing loan portfolios by credit institutions.

1.3 The non-financial sectors

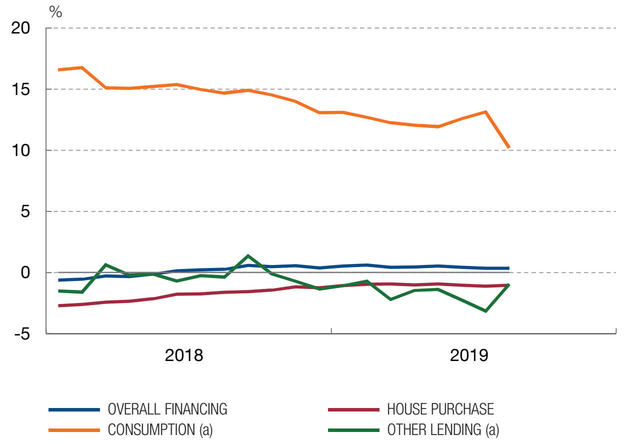
1.3.1 Financial position and credit developments

New lending flows to the non-financial private sector decelerated gradually during 2019, having shrunk in practically all segments in recent months (see Chart 1.8). As the BLS suggests, this would be due both to supply-side factors, especially in the case of mortgages, and demand-side factors. Despite the tightening in lending standards, bank financing costs for households and firms generally held at very low levels and without significant changes. In the case of firms, the cost of fixed-income securities issues has fallen sharply since the start of the year, thereby raising their attractiveness relative to bank loans.

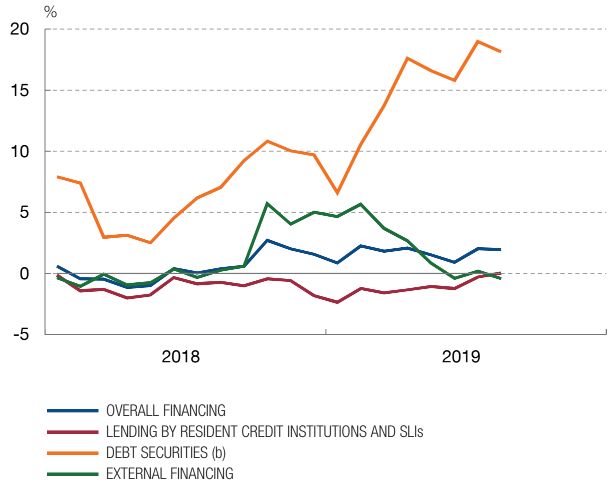
Chart 1.10
FINANCING TO HOUSEHOLDS AND NON-FINANCIAL CORPORATIONS

Of note in terms of financing is the buoyancy of consumer credit for households and the financing obtained through debt issuance for firms.

1 FINANCING TO HOUSEHOLDS
Year-on-year change



2 FINANCING TO NON-FINANCIAL CORPORATIONS
Year-on-year change



SOURCES: Banco de España and Datastream.

a Excluding securitisation.
b Includes issues by resident subsidiaries.

The outstanding balance of financing raised by households continued to expand at a very contained rate (0.3% in August). The consumer credit segment has been the most dynamic to date, with a year-on-year growth rate of 10.2% in August (see Chart 1.10). According to the BLS, banks perceive less creditworthiness in this segment, which should also be consistent with the increase in NPLs recently observed.

In this setting, households' financial position has continued to strengthen in recent months, albeit at a lesser pace. Gross household disposable income increased by over 4% year-on-year in the first half of the year, boosted by the rise in wages and the fall in unemployment. The household debt-GDP ratio fell by 0.4 pp to 58.6%, scarcely 0.6 pp above the euro area average. The interest burden associated with debt has also diminished during this period. Lastly, net household wealth continued to expand owing both to the increase in the financial and the real estate components.

In the first half of 2019, there was a step-up in the rise the household saving rate had begun to show in late 2018. The moderation in the growth of consumption and the rise in income led the household saving rate, in proportion to household gross disposable income, to stand at 8.7%, 1.8 pp above the end-2018 level. As a result, the rate of saving not earmarked for debt service is expected to be close to zero, after having been in negative figures over recent years.

Overall external funding by non-financial corporations continued to expand at a year-on-year rate of close to 2%. In terms of components, corporate bond financing has been growing strongly (see Chart 1.10), assisted by the declines in market interest rates, particularly in the medium and long-term tranches (see Chart 1.8). This would partly explain the fall-off observed since the start of the year in new bank lending to non-financial corporations. However, repayment dynamics enabled the outstanding balance of credit provided to firms by resident banks to actually increase slightly, in year-on-year terms, in August. Lastly, the financing obtained abroad by firms has contracted slightly in the most recent period; however, this behaviour has been much influenced by one-off operations.

The financial position of non-financial corporations has continued to improve, but signs of a downturn in profitability are beginning to be discernible. In the first six months of the year, the corporate debt ratio continued to fall. This decline took the ratio to 73.4% of GDP, 1.1 pp less than in December 2018, and 4.3 pp below the euro area average. Combined with the low cost of debt, these developments have prompted a fresh decline in the sector's debt burden, marking another historical low. However, the ordinary profits of the non-financial corporations drawn from the Banco de España Central Balance Sheet Data Office sample increased by scarcely 1.4% in the first half of the year, far down on the same period the previous year (8.4%), while the return on assets declined by 0.2 pp to 4%.

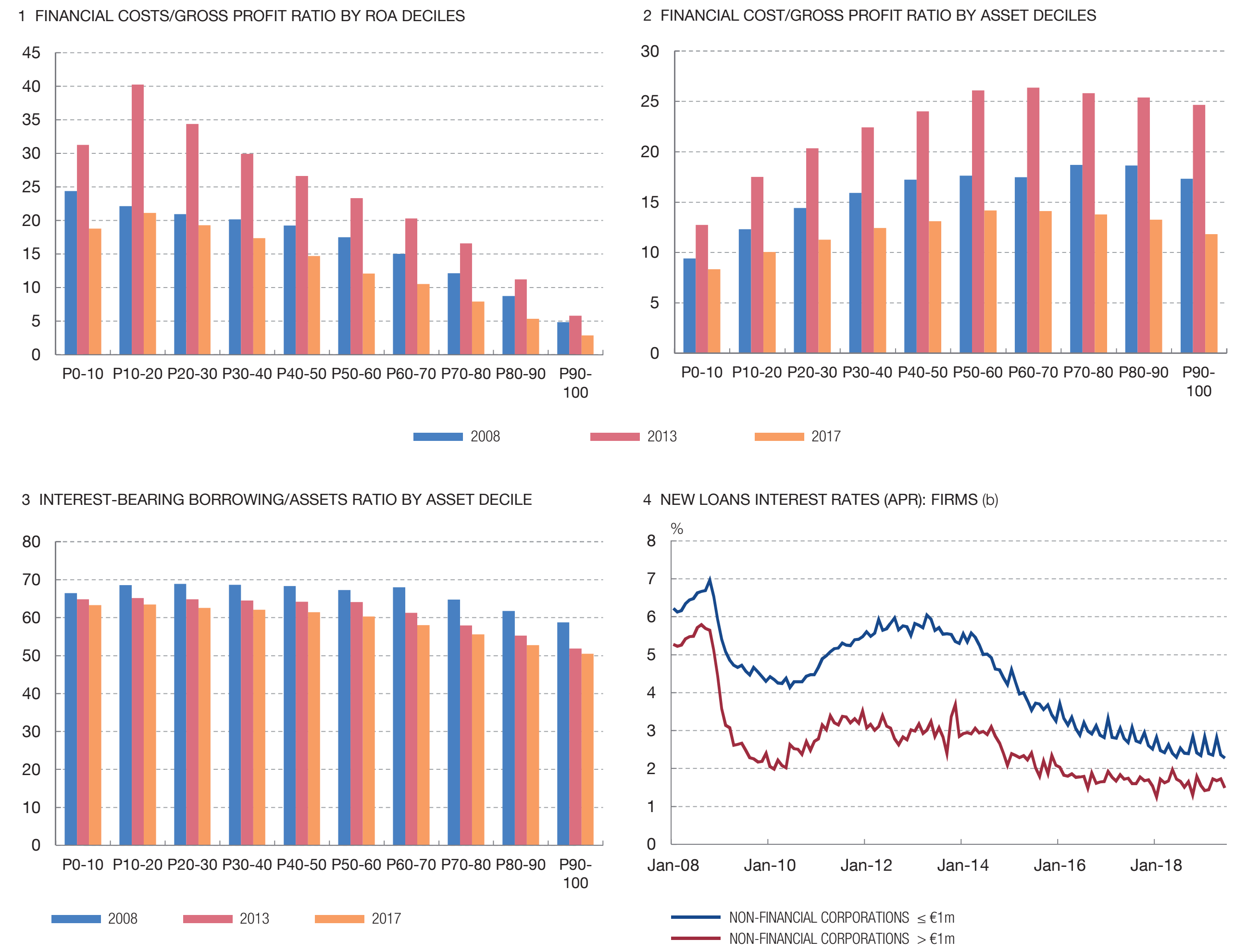
Firms' debt burden declines as their profitability increases. In fact, it stands at close to 20% for firms in the lowest three deciles (see Chart 1.11). By firm size, an inverted U relationship is obtained, with medium-sized firms those that have to make most effort to meet their financial obligations. Chart 1.11 also highlights the fact that the debt burden increased significantly for all firms during the last crisis. This increase came about even though deleveraging had commenced some years earlier. Behind this behaviour are, above all, the decline in gross operating profit during the crisis and the rise in interest rates. This latter element underscores the potential sensitivity of firms' financial position to a downturn in profits and a rise in rates.

In recent months, public-sector financing costs have fallen significantly (see Chart 1.12). Spanish sovereign debt returns posted historical lows in August, standing at 0.04% for the 10-year maturity. In this context, the Treasury followed a strategy in which the issue of long-term instruments was to the fore. That allowed a further lengthening of the average life of overall outstanding debt, which stood at 7.5 years in September. Moreover, net Treasury issuance in 2019 has declined, posting its lowest level since 2007.

Chart 1.11

FIRMS' FINANCIAL POSITION (a)

The interest burden of debt is diminishing as firms' profitability rises. In terms of corporate size, an inverted U relationship is obtained, with medium-sized corporations those that have to make the greatest effort to meet their financial obligations. The interest burden of debt increased significantly for all firms until 2013, despite deleveraging, being in 2017 lower than in 2008.



SOURCE: Banco de España.

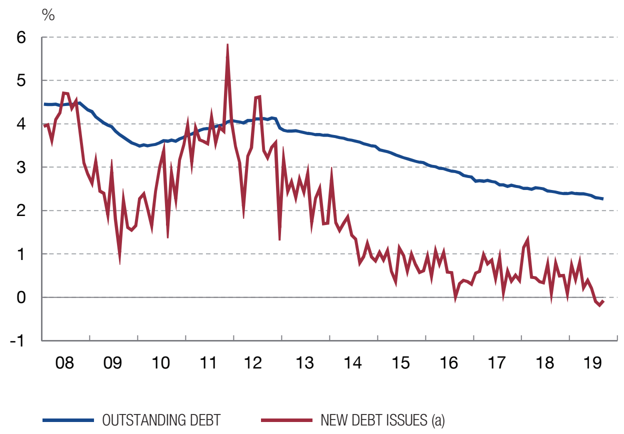
a Firms' balance sheet and income statement information is drawn from the Banco de España Central Balance Sheet Data Office. Financial firms and companies from the construction and real estate development sector are excluded.

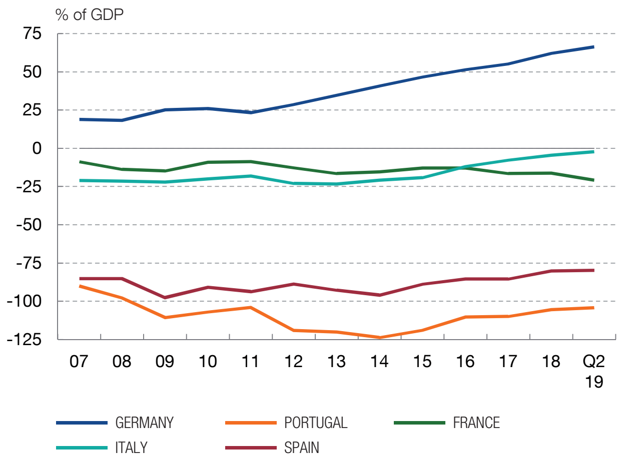
b The new loans of a period are defined as all the first-time loans arranged with customers and all the contracts existing in earlier periods whose amount, interest rate, maturity or other significant financial conditions in relation to interest rates have been renegotiated with customers in the month in question.

The public sector's high debt continues to be a major source of vulnerability for the Spanish economy. True, the general government deficit has fallen in recent years, thanks essentially to the economic pick-up; but it was still at 2.5% of GDP in 2018, ranking second-highest in the euro area. Also, in June 2019 the public debt/GDP ratio stood at 98.9%, a level still 13 pp higher than the euro area average. While this high level of indebtedness does not translate into a burgeoning debt burden owing to low financing costs, it is a significant factor of vulnerability for the Spanish economy ahead of potential increases in funding costs on markets or of a

Chart 1.12
PUBLIC DEBT FINANCING COST AND INTERNATIONAL INVESTMENT POSITION

General government financing costs have fallen significantly, while the Spanish economy's net debtor position remains at high levels from both a historical and international perspective.





SOURCES: Banco de España, Spanish Treasury and ECB.

a Average interest rate on issues made during the month.

macroeconomic downturn. The lengthening of public debt maturities seen since 2013 might partly mitigate this risk by reducing refinancing requirements.

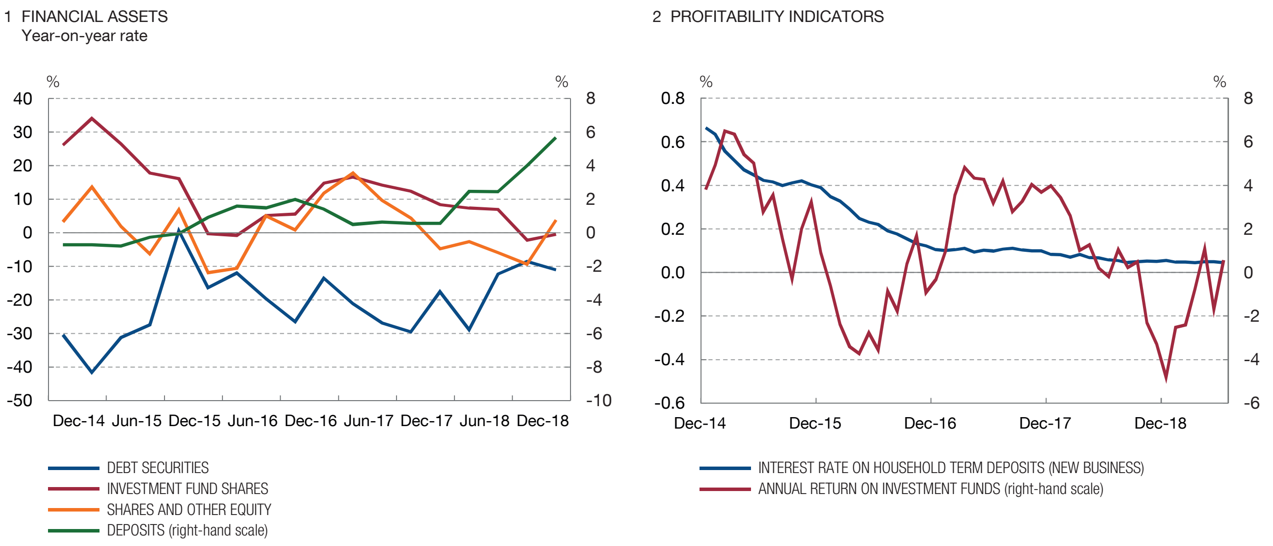
Likewise, the high negative net international investment position (IIP) is another major vulnerability for the Spanish economy in the face of potential changes in international financial market sentiment. The Spanish economy's negative net IIP, as a percentage of GDP, has declined by around 18 pp since 2014. However, in June 2019 it still stood at over 79.9% of GDP, far above the euro area average (see Chart 1.12). Gross external debt amounted to 171.6% of GDP in 2019 Q2, only 3.9 pp below the high recorded in 2015 Q1, though similar to that of other comparable countries. The fact that most of this gross external debt has a lengthy maturity, is denominated in euro and is issued by general government would alleviate, to some extent, refinancing risk.

1.3.2 Other interconnections with the financial sector

The main financial assets in which households invest their gross wealth are deposits (38.2% of the total in March 2019). Post-2015, deposits had been diminishing in significance in household portfolios relative to investment funds. Specifically, households' holdings in investment funds grew in cumulative terms by 40.2%, while deposits increased by only 7.9% over these five years, due in part to the progressive reduction in the return on them in an environment of very low interest

Chart 1.13
HOUSEHOLDS' FINANCIAL POSITION

Households' financial assets have increased in the past five years by close to 10% to €2.2 trillion as at March 2019. While the composition of the financial assets portfolio has held stable in this period, investment funds and, to a lesser extent, deposits have grown notably, set against the reduction in cash and fixed-income.



SOURCE: Banco de España.

rates. However, a significant rebound can be seen in the volume of deposits in 2019 (5.7% year-on-year), despite the fact that the return on them is practically zero. The increase has been far above the rates of change recorded for other financial assets (see Chart 1.13). It is estimated that the low returns on fixed-income securities have lessened the interest in investing in assets linked to such securities, whereas the volatility of equities has discouraged direct and indirect investment in these instruments in a setting of high uncertainty (see Chart 1.5).