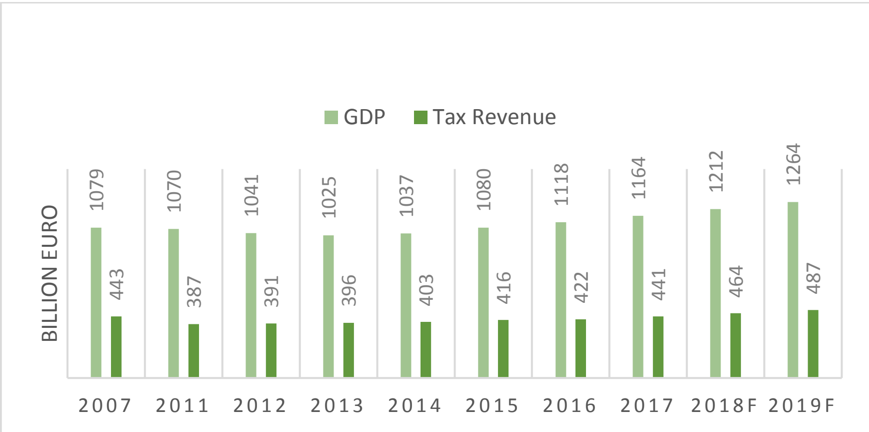
When Spanish public finances and the Spanish banking system are noted, it is usually in less flattering terms. In the light of recent years of corruption scandals, there is a strong contempt for government and financial institutions.
The phenomena itself is easy to understand, but there are obvious disadvantages of unilaterally focusing on the scandals.
Blinded by contempt, you risk losing what takes place. Households, companies and many good politicians have in strong headwind achieved something that few other countries have managed.
In terms of volume in the economic activity, the turnaround was in 2013, since then nominal GDP grew by 13.5%, which amounted to 139 billion euros. The volume has long ago exceeded the previous 'All Time High'.

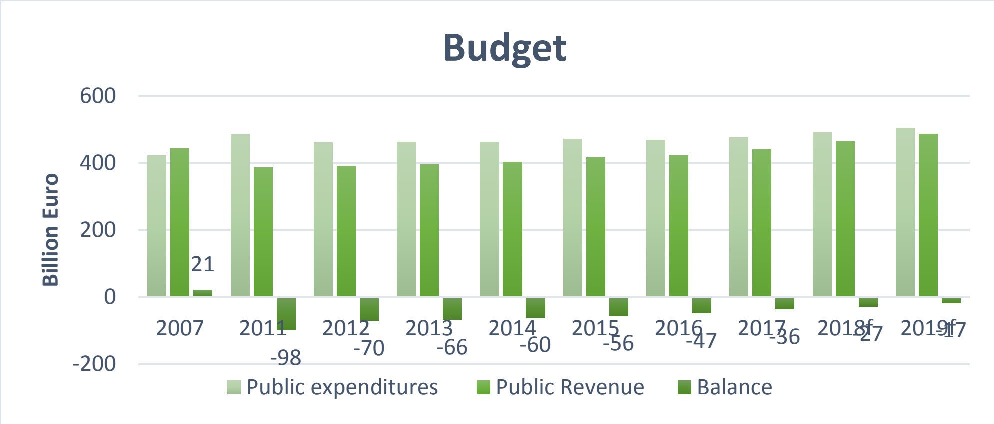
In order to curb a huge budget deficit, different aggressive reforms were implemented. These included reforms in the labor market, pension reforms and shrinking a vulgar public sector. Many of these were political suicide, but thanks to bold politicians, these painful reforms were implemented.
So, how is Spanish public finances doing?
Below I have compiled data from national accounts, national budget and some figures from regional level.
From 2007 to 2011, tax revenues decreased by 56 billion euros. This as a result of fewer taxable transactions between households and companies.



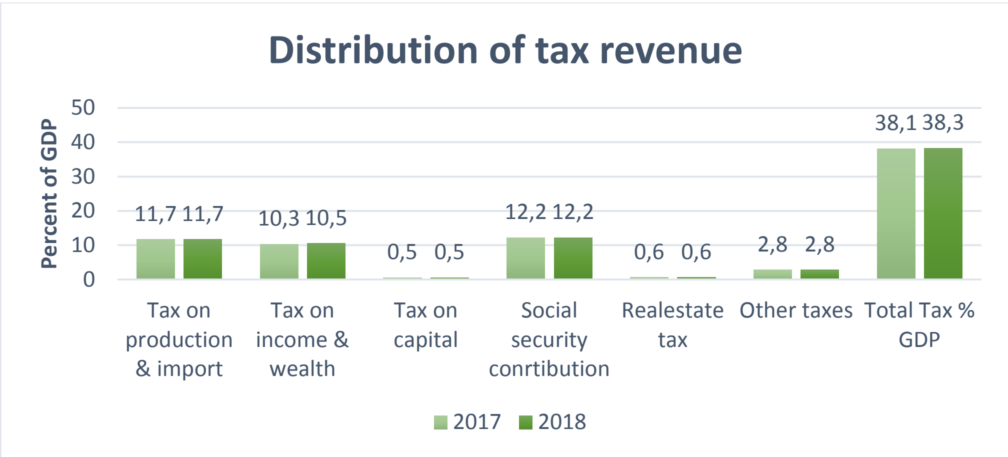
The figures for 2018 and 2020 are forecasts based on the growth rate below.

Year	2018f	2019f	2020f
Real GDP growth	2,7 %	2,2 %	1,9 %
GDP deflator (inflation)	1,8 %	1,7 %	1,6 %
Nominal GDP growth	4,1 %	3,9 %	3,5 %

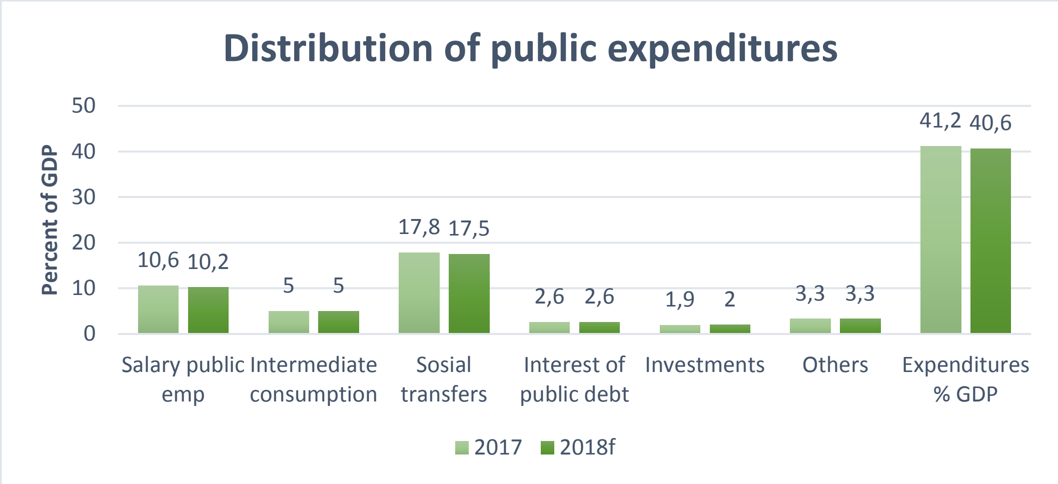
In 2011, the total deficit was 98 billion euros, almost 10% of GDP. Last year, the deficit had shrunk to 36 billion. Considering the circumstances, Spain has had an impressive journey.



Despite lower taxes, public revenue have increased. The explanation is the increasing volume of transactions between households and producers. An increase in taxable transactions provide a larger tax base and higher income.

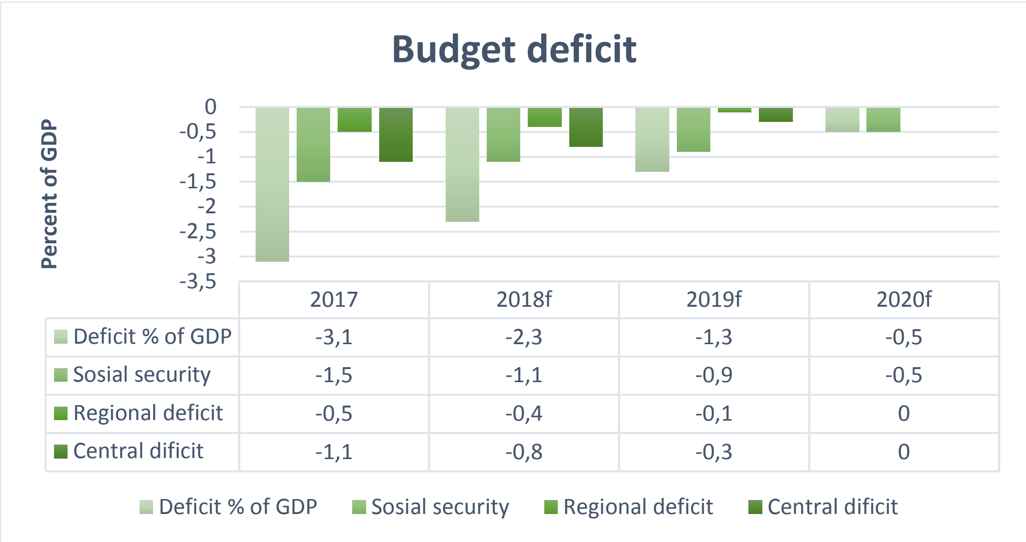


Regarding the distribution of public expenditure, the largest increase is pension costs. Despite lower costs for unemployment benefits (1.4% of GDP) and social welfare, pension expenditures increases aggressively. The explanation is a demographic headwind and an unsustainable pensions system called PAY AS YOU GO. This means that our children have to pay for the uninhabited pension benefits this generation have granted themselves.



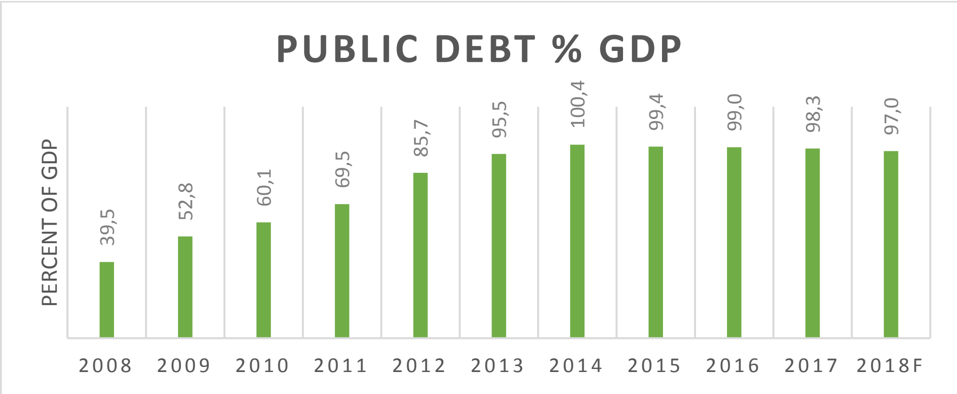
Forecasts for the budget are based on the current fiscal policy. It also assumes that the job creation in recent years will continue with the same annual volume of 500,000 full-time jobs. However the growth rate will shrink slightly.

The Spanish pension system is financed by employers' fees. In periods of high employment, the surplus goes to the reserve fund. In periods of high unemployment, funds are collected from the fund to cover the deficit. As we speak the reserve fund is almost empty.

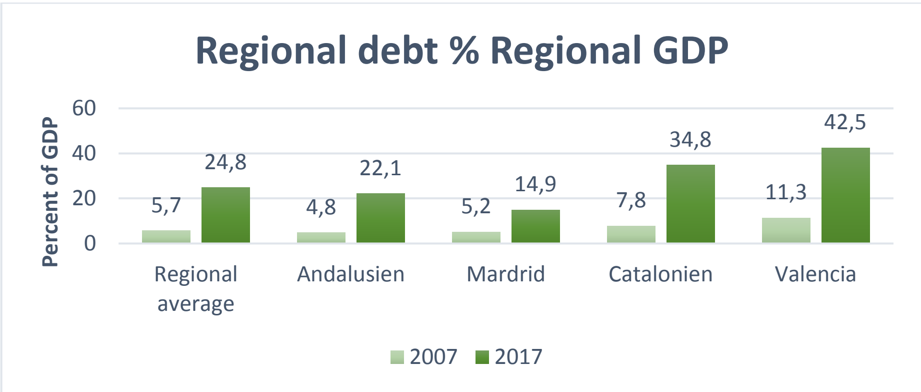


	2017	2018f	2019f	2020f
Deficit % of GDP	-3,1	-2,3	-1,3	-0,5
Sosial security	-1,5	-1,1	-0,9	-0,5
Regional deficit	-0,5	-0,4	-0,1	0
Central dificit	-1,1	-0,8	-0,3	0

Years of massive budget deficits have increased the public debt from 39, 5 % of GDP to over 100 % in only 6 years. With a nominal GDP growth of 4 % and the effect of structural reforms, the debt is expected to shrink to 91% by the end of 2020. The bulk of the loans, more than 90% has a maturity around 6 years.



If we break out the debts of some regions and compered them with regional GDP, the pile of debt has increased rapidly. Surprisingly, Andalusia is below the regional average for both years (2007 - 2017). Equally surprising is the indebtedness in Catalonia and Valencia, which is well above the regional average.



Looking at regional budget balance as a percentage of regional GDP, Andalusia is below the regional average. Again we find the largest deficits in Catalonia and Valencia.

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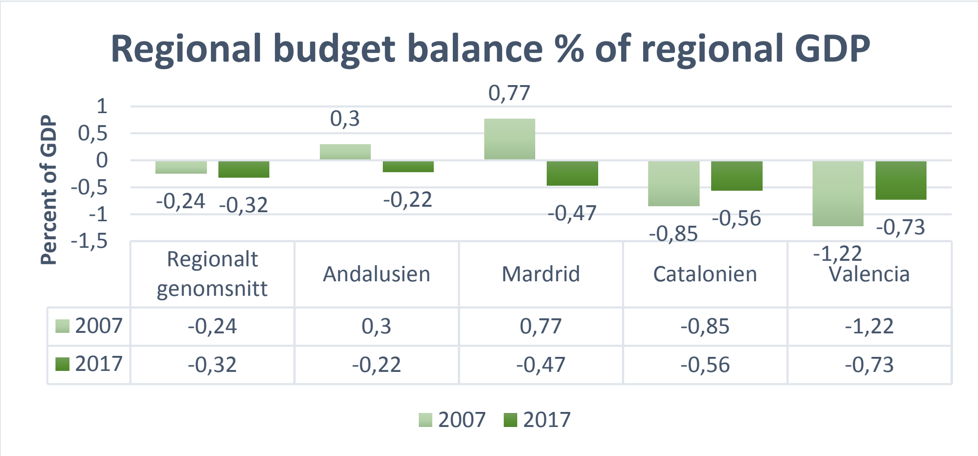
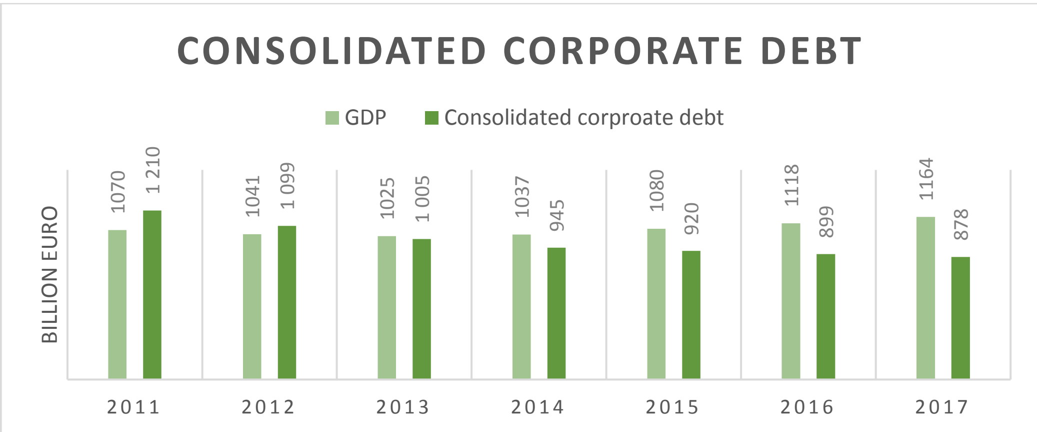


When the European Commission describes household debt and corporate debt in Southern Europe, the term "private debts" has consistently been used. The problem of aggregating household debt and corporate debt is that it is not clear whether the corporate debt is consolidated or not. However, this is a very simple exercise, Eurostat publish consolidated and non-consolidated corporate debt. If you are looking at corporate debt you have to consider intragroup financing. This is always done with public debt, and you get a more accurate picture of total borrowing. If we have two companies (A and B) who borrow 50 euros each, the total debt is 100 Euro. ‘A’ will have a stronger balance sheet and therefore better terms. ‘A’ borrows 100 euros and then lends 50 euros to the subsidiary, the total loan will be 150 Euro. (Consolidated & unconsolidated liabilities)

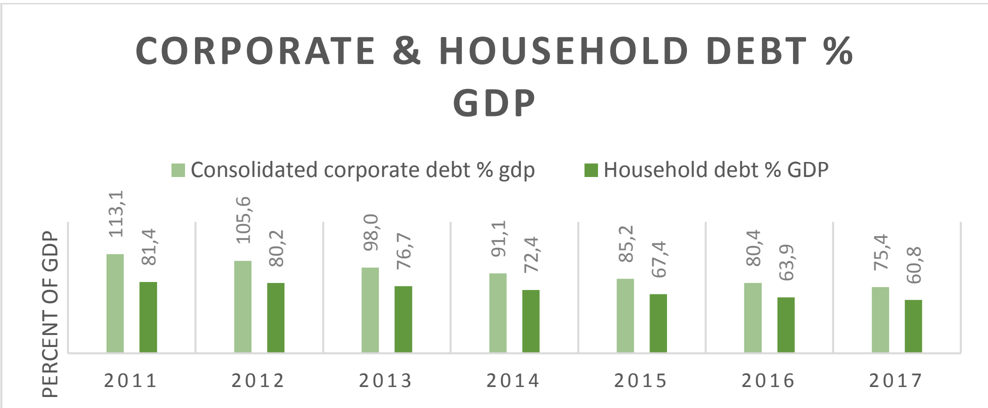


The last 6 years' reduction of private debt has been of a dignity that historically lacks its opposite. Debt continues to shrink rapidly, and it seems that amortization has become the new national sport in Spain.
Lower costs for debt as a result of low interest rates and aggressive amortization have released enormous resources for saving and consumption. Households' financial savings, which basically consist of bank funds, have increased from around 50% of GDP in 2008 to around 120% of GDP. As house prices have begun to move upwards. Subsequent lower loan to value ratios have strengthened household wealth and improved banks' balance sheets.
The effect of debt reduction on GDP growth is underestimated. To highlight the phenomena, I have broken the volume of household consumption for the years 2008 and 2016. Furthermore, I compared the change in employment, wage reductions, savings and new credits

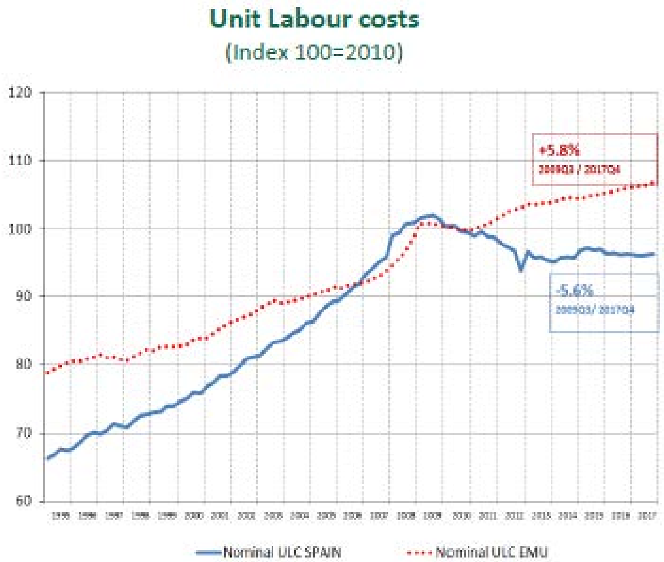
Year	2008	2016
Household consumption MRD Euro	623	649
Employed persons	20,5 millions	18,3 millions
Average salary	100	97
Saving	4	8,5
New credits	3	0
Netto purchasing power	99	88,5

Household consumption in 2016 was 25 MRD higher than in 2008. How can this be explained when wages have decreased by 3% and 2.2 million fewer had jobs? The savings have been doubled and no one lends. How could the volume in consumption be 4% higher on net wages (after savings), which was 11.5% lower? The answer is consistently lower costs for non-GDP driving transactions as credit costs. These have generated a sharp surplus for the purchase of newly produced goods and services, as well as increased savings. The increase in demand creates capacity pressure for producers, new jobs are created which, in turn, generate new consumers. An increase in taxable transactions arise and public finances can be repaired.

This is the engine behind the real economy growth I Southern Europa.



Lower wages have reduced production costs in Spain. Compared with the rest of the EU, Spain have competitive advantages. Because of Lower ULC Spanish industry absorbs large production volumes for exports.



<u>Spanish Banks</u>

Spanish banks have had a rough time in recent years. Low inflation and periods of deflation have led to a zero interest rate environment with subsequent low margins. Furthermore, the total loan volume has shrunk as everybody amortizes and no one borrows. High volume of bad loans, depreciation and major losses have hit profitability and capital adequacy hard.

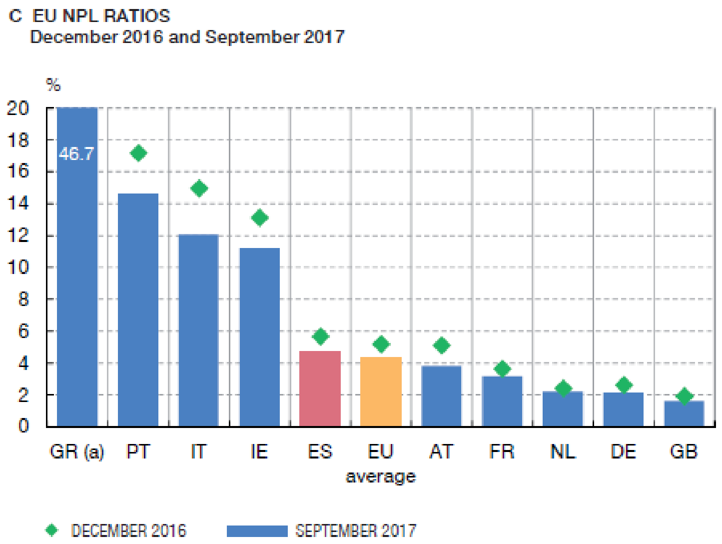
Recent years' borrowing behavior must be seen in the light of the theoretical assumptions on which modern monetary policy is based. The central banks' main mission is to stimulate the demand for goods and services to a level slightly larger than supply. If this occurs, supply shortages are expected to generate price increases, which in the Western world has a target of 2% year-on-year

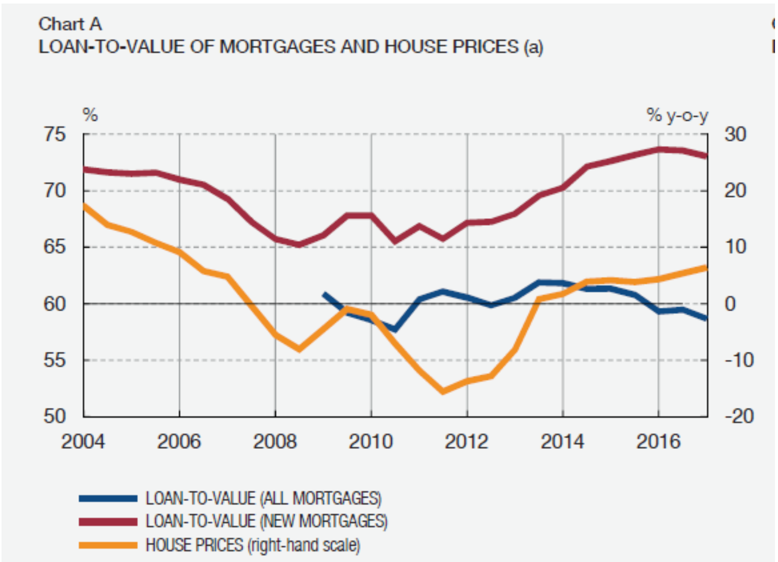
If the opposite occurs and the supply would be greater than demand, then prices are expected to decline. Under this scenario, consumers are assumed to postpone their purchases as it becomes cheaper to wait. Such a phenomenon would lead to mass unemployment and economic collapse, since no one purchases goods and services while they wait for lower prices. Deflation came with the 2008 collapse and central banks used the big canon, they lowered the interest rate to zero. Enormous resources that previously went to lenders was now in the wallets of households, companies and states.

These resources are now expected to be used for consumption. This assumption is based on the assumption that the central bank's monetary policy can be used to manipulate consumer purchasing decisions. This time, the theory was wrong. It took more than five years before consumers gently went back to the shops. In late 2013 demand slowly started to increase and in some areas prices are moving up. This can be seen as an expression that demand is about to pass the supply in volume. With inflation back, Interest rate margins will increase and contribute to higher profitability. Furthermore an increase in credit volume is observed. Although the total volume still shrinks, as time passes households and corporates will forget their misery and start borrowing again. The future debt reductions will be driven by nominal GDP growth. If we compare southern European banks with their Northern Europe counterparts regarding sales of financial products to consumers and businesses. They have not made the same journey. In the coming years this will contribute to banks profit growth. According to the latest stability report from BDE (Spanish Central Bank), Spanish banks' consolidated earnings were 15.6 MRD for 2017. This is about 44% higher than 2016. These figures does not includes the Banco Popular event.

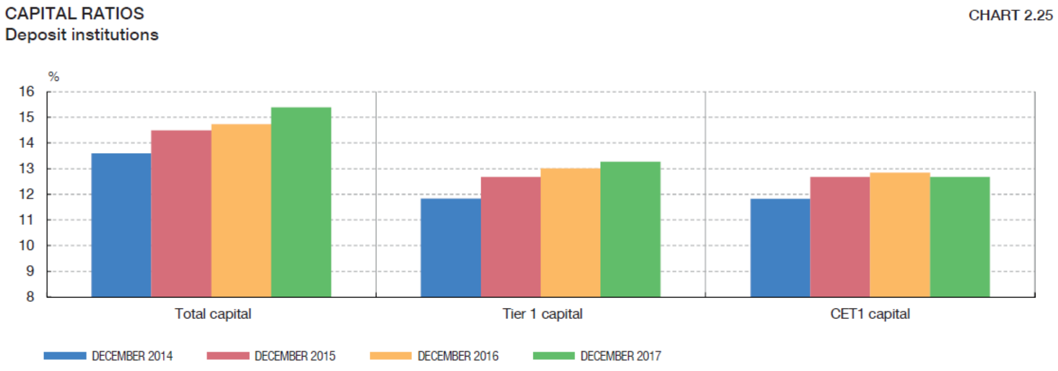
ROA increased from 0.3% to 0.43% and ROE increased from 4.3% to 6%

The amount of bad loans has fallen sharply and is largely in line with the EU average





The banks 'capital ratio has gradually improved. In light of recent years' massive regulatory and public interest for financial companies, particular regarding southern European players, it is highly unlikely that these are under-analyzed.

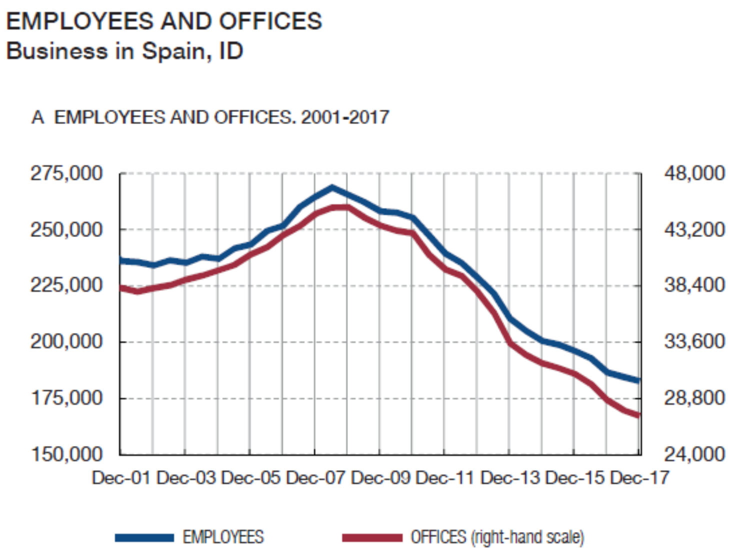


SOURCE: Banco de España.

Analysts argues that the Southern European retail banking market is over-established, but the recent years of rationalization gains gets little or no attention. Why economists continue to argue for something that was true ten years ago without highlighting the change is hard to explain.

<u>Perhaps it`s convenient to have someone to point finger at.</u>

<u>Again, blinded by contempt and their own excellence, they might miss the opportunity.</u>



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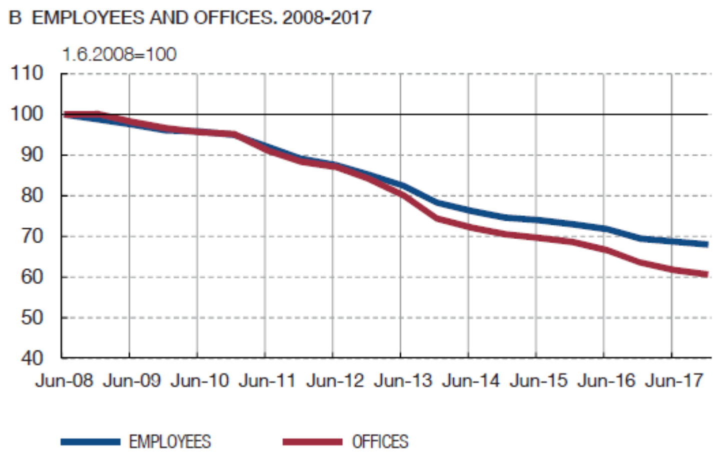

From a cyclical perspective, the global growth has come a long way, all major economies show growth. In my opinion we're to approaching the middle of the cycle. But we have some credit expansion to do before we reach the next peak. When households and businesses have forgot about the years of misery they will start borrowing again, eventually we will have a new era of casino economy. During this period, bank shares will be a profitable story.

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