1 Economic and financial environment

1.1 International environment

World growth remained strong in 2018, although a slowdown was recorded in some economies and there was less synchrony among the different countries. According to IMF estimates, the world economy grew by 3.6% in 2018, 0.2 percentage points less than in 2017. Among advanced economies, the United States continued to lead the pace of growth, while among emerging economies, Asian countries recorded particularly strong growth, in many cases of over 5%. The year was marked by the presence of several sources of uncertainty, including doubts relating to restrictions to world trade, tensions in some emerging economies, such as Turkey and Brazil, Brexit and the initial lack of agreement between the Italian Government and the European Commission with regard to the Italian public accounts. In this context, the normalisation of monetary policy in the United States continued, with four interest-rate hikes in 2018, while in the United Kingdom, the Bank of England raised interest rates in August, with this being the second rate hike since the start of the financial crisis. In contrast, in Japan and in the euro area, the monetary policy stance remained unchanged with regard to interest rates, as they stayed at the same level, although the ECB ended its debt purchase programme at the end of the year.

International financial markets followed a somewhat unstable path over the year. Short-term rates in the advanced economies followed the path set by official rates, while yields on long-term sovereign bonds only recorded insignificant changes over the year except in the United States and in Italy, where they rose significantly. For their part, in equity markets, the aforementioned uncertainties gave rise to occasional falls in share prices and upturns in volatility, which did not prevent significant price gains in the United States and Japan for much of the year. However, in the final stretch of the year, the perception of a possible sharper-than-expected slowdown in world growth triggered a widespread fall in share prices in all geographical areas. This in turn led to annual losses of varied significance in the most important indices, which stood at over 10% in most cases.

The outlook for growth in 2019 is less favourable than in previous years (the IMF expects growth of 3.3%), as a significant part of the uncertainties of last year are still present this year. One of the most significant sources of risk is the possibility of a worsening of trade tensions between China and the United States, and the possibility of the United Kingdom leaving the European Union without a deal. Other sources of geopolitical risk in some emerging economies may also give rise to periods of instability.

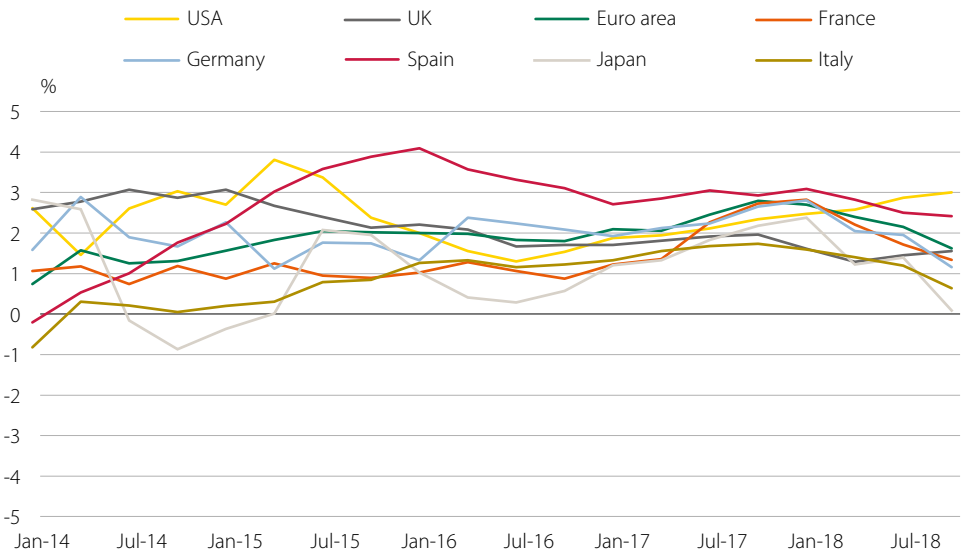
1.1.1 The world economy

World GDP grew by 3.6% in 2018, slightly down on the rate recorded in 2017

According to IMF estimates,[1] the world economy grew by 3.6% in 2018, 0.2 percentage points less than in 2017. Growth in the advanced economies stood at 2.2%, 0.2 percentage points lower than in 2017, while growth in the emerging economies stood at 4.5%, 0.3 percentage points down on the previous year. The political uncertainties present in the international economic and financial landscape, together with the restrictions on international trade and effects of the shift in monetary policy of the United States in some emerging economies, led to this slowdown, which was sharper in European economies.

Within the advanced economies, it is worth noting the progress in the United States, practically the only member of this group that recorded an acceleration in growth (from 2.2% in 2017 to 2.9% in 2018), which was driven by fiscal policy. This increased buoyancy offset a large part of the slowdown in growth of other advanced economies. In the euro area, GDP rose by 1.8% in 2018, 0.6 percentage points less than in 2017, with a significant slowdown in growth recorded in the larger economies (except Spain). Particularly noteworthy was the slowdown in GDP growth in Germany (from 2.5% to 1.5%). This was the result, among other factors, of the introduction of the Worldwide harmonized Light-duty vehicles Test Procedure (WLTP) and restrictions to world trade; in France (from 2.2% to 1.5%), as a result of the so-called "yellow vests" and in Italy (from 1.6% to 0.9%), which was affected by the increase in financial risks. Growth in Spain was also lower than in the previous year (2.6% compared with 3% in 2017), although the slowdown was less intense than in other European economies. In the United Kingdom, GDP grew by 1.4% (1.8% in 2017).

GDP: annual change FIGURE 1.1.1



Source: Thomson Datastream.

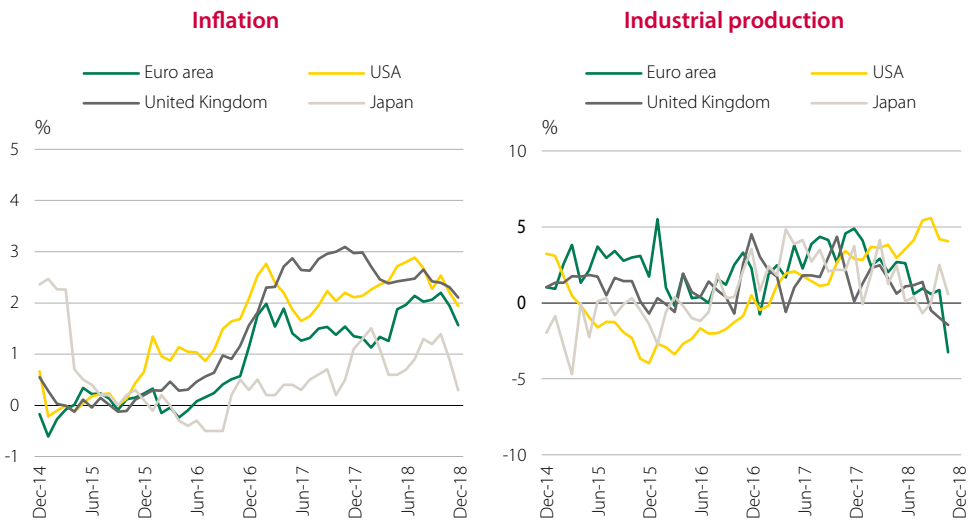
1 *World Economic Outlook* (April 2019).

Emerging and developing economies also recorded a slight slowdown, which was more intense in Eastern European countries. Overall, these countries recorded growth of 3.6% (6% in 2017), with the crisis in Turkey being a key factor. In contrast, the emerging Asian economies grew by 6.4% (6.6% in 2017), thanks to strong activity in India, which recorded annual growth of 7.1%, which offset the lower pace of growth in China (6.6% in 2018 compared with 6.8% in 2017).

Inflation rose around the middle four months of the year as a consequence of the increase in the price of oil in that period

Inflation rates in the euro area and the United States followed an upward trend over much of last year as a result of higher oil prices.[2] The highest rates of inflation were recorded in the second four-month period of the year and the start of the third, with year-on-year highs of 2.9% in the United States (July) and 2.2% in the euro area (October). In the final months of the year, these rates fell and inflation ended the year at 1.9% in the United States and at 1.6% in the euro area. Core inflation rates, which exclude changes in the most volatile elements of the index (fresh food and energy), were much more stable over 2018, although at a higher level in the United States. Core inflation in the United States stood at 2.2% in December, while in the euro area it stood at 1.0%.

Inflation and industrial production (% annual change) FIGURE 1.1.2

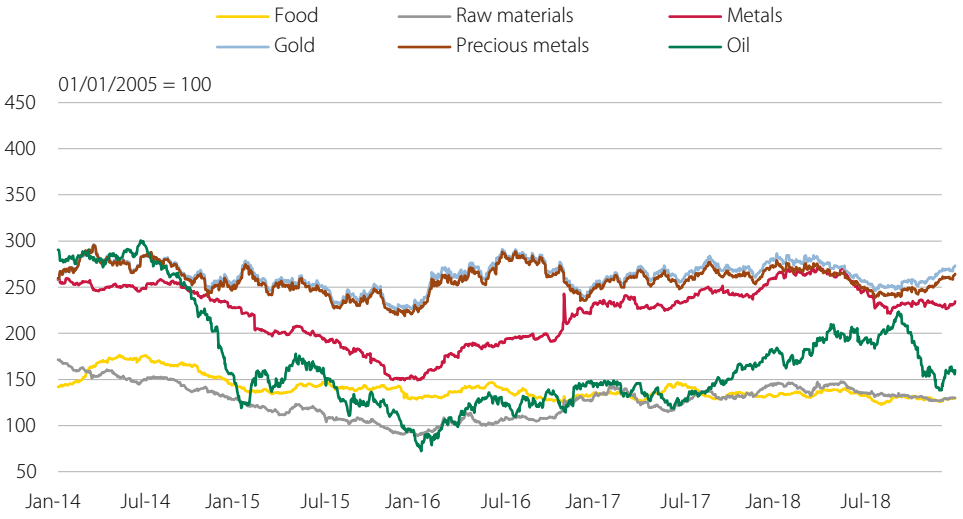


Source: Thomson Datastream.

The inflation rate in the United Kingdom began 2018 at levels close to 3% and then fell progressively, with occasional upturns in the third quarter, to end the year at a rate of 2.1% (see Figure 1.1.2). In turn, core inflation fell from 2.5% to 1.9%. Finally, inflation in Japan over 2018 ranged between 0.3% and 1.5%, without showing a clear trend in the year and with upturns in the first and third quarters.

2 Between February and October 2018, the price of oil in dollars rose by 28% and in euros by 36%.

Commodity prices FIGURE 1.1.3



Source: Thomson Datastream.

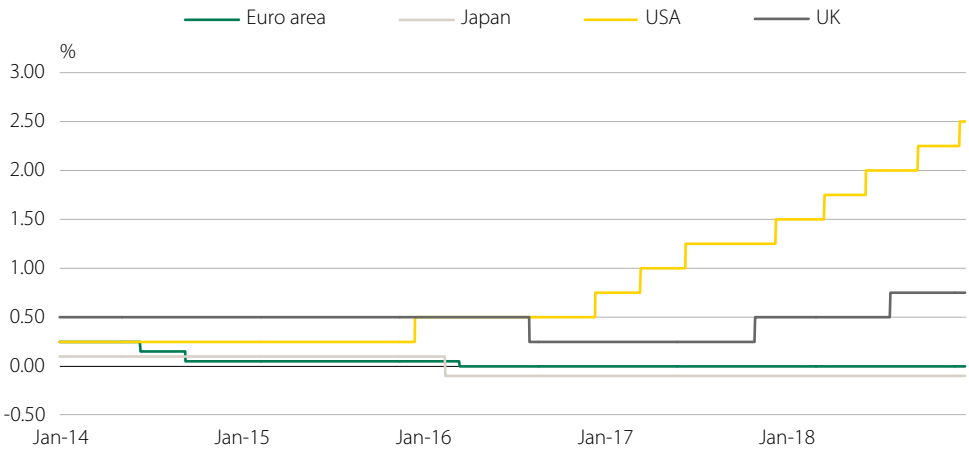
The monetary policy stance in the United States and in the euro area diverged further in 2018

The stance of the monetary policies applied on each side of the Atlantic remains divergent, as a result of the differences in movements in prices and economic activity in general in both areas. In the United States, the Federal Reserve decided to raise interest rates four times in the year based on the growth in economic activity, the conditions of its job market – close to full employment – and inflation. The last hike in the year in December left official interest rate in the range of 2.25-2.5%. The Federal Reserve also continued to reduce the size of its balance sheet.[3] In the United Kingdom, the Bank of England also raised interest rates to 0.75% in August (previously, in November 2017, it had raised its bank rate by 25 basis points (bp) to 0.50%, with these two hikes being the only rises since the start of the financial crisis). With this decision, the bank aimed to contain the rise in inflation, which at year-end 2018 stood at close to the 2% target, and to maintain economic growth and employment.

In contrast, the monetary policy stance in the euro area and in Japan remained accommodative. In all its meetings of the year, the ECB maintained the main refinancing rate, the deposit facility rate and the marginal lending rate unchanged at 0%, -0.4% and 0.25%, respectively. Nevertheless, the ECB announced in December, as the first stage of the planned shift in its monetary policy, that its asset purchase programme would end that same month, although it announced that it would reinvest the maturing debt for an extended period of time and, in any case for as long as necessary to maintain favourable liquidity conditions and a sufficiently accommodative monetary policy stance. For their part, official interest rates in Japan have remained at -0.1% since February 2016, with the central bank having expressed its intention to keep them unchanged for a long period of time as a result of the uncertainty relating to economic activity and price movements.

3 This has been reduced by approximately 8.4% since 2017.

Official interest rates FIGURE 1.1.4



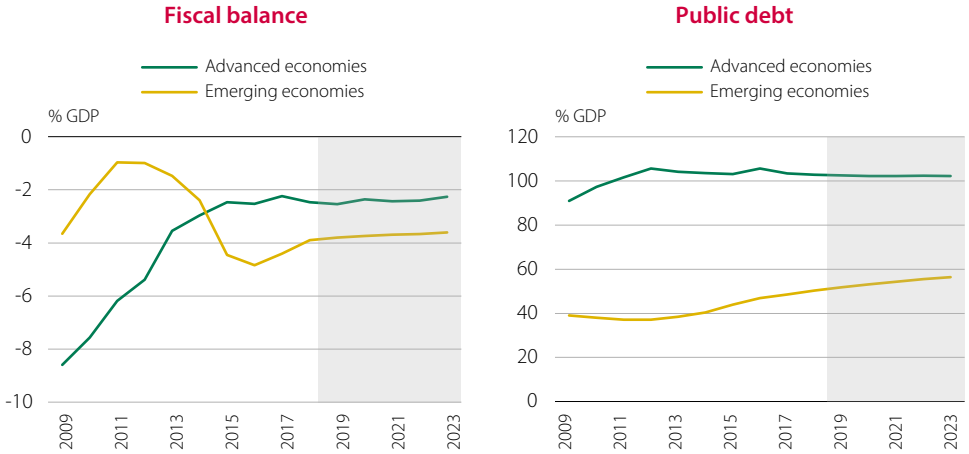
Source: Thomson Datastream.

In 2018, the public deficit rose slightly in advanced economies and fell by half a percentage point in emerging economies

According to IMF estimates, the aggregate government deficit of advanced economies rose slightly in 2018 to stand at 2.5% of GDP (2.2% in 2017), while that of emerging and developing economies decreased by 0.5 percentage points to 3.9% of GDP. In the case of the former, it was the expansive fiscal policy stance, particularly in the United States, that led to the slight increase in the public deficit. In the emerging economies as a whole, despite lower oil prices in the second half year, the downward trend in the public deficit recorded in 2017 continued in 2018. With regard to public debt, advanced economies recorded a slight fall in the aggregate ratio (from 104.5% of GDP in 2017 to 103.8% in 2018), while emerging economies recorded a slight increase of 2 points to 50.7% (see Figure 1.1.5).

The IMF forecasts a slight reduction in the public deficit of both advanced and emerging economies in the next 5 years, to 2.3% of GDP in the case of the former and to 3.6% in the case of the latter. The public debt in advanced economies would maintain the downward trend, albeit very slight, remaining at around 103% of GDP over the coming years. In contrast, the public debt of emerging economies would continue an upward trend to 57% of GDP.

Fiscal balance and public debt FIGURE 1.1.5



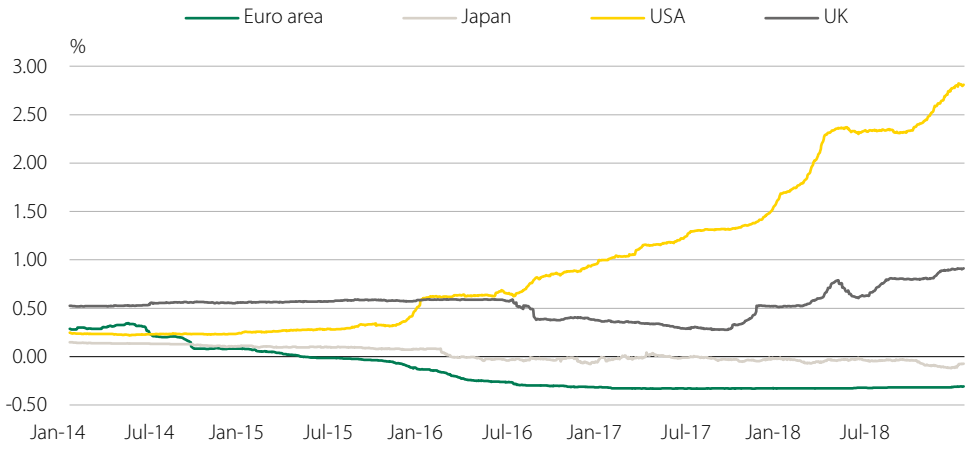
Source: IMF.

1.1.2 Developments in international financial markets

The difference between 3-month interest rates in the United States and the euro area exceeded 300 basis points

Short-term interest rates in the major advanced economies continued to drift apart over 2018, due to the different pace of the measures for normalising monetary policy applied by their central banks. In the United States, 3-month interest rates followed an upward trend throughout the year, standing at 2.81% in December, 111 bp up on year-end 2017, in line with the decisions of the Federal Reserve, which, as mentioned above, raised its benchmark interest rate four times in 2018. These levels of short-term rates were the highest from among the advanced economies, with a difference of over 300 bp compared with those in the euro area (see Figure 1.1.6). In the United Kingdom, 3-month interest rates also rose gradually in 2018, to 0.91% in December (39 bp more than at the beginning of the year).

Short-term interest rates[1] (3 months) FIGURE 1.1.6



Source: Thomson Datastream. (1) 3-month Libor.

For their part, 3-month interest rates in Japan followed a slightly downward path in 2018, which intensified in the final quarter, and they ended the year at around -0.07% (-0.02% in December 2017). In the euro area, 3-month interest rates remained stable at around -0.32% throughout the year, in line with decisions taken by the ECB.

As regards interest rate expectations, forward rates (FRAs) suggest that the differences in short-term rates in the euro area and the United States will tend to continue over 2019. In the euro area, stability in this aspect is expected throughout the year, which is in line with the ECB's intention to keep official interest rates at 0% at least through the summer of 2019 or even longer, in view of the slowdown in growth and the statements made by the bank itself. In the case of the United States, a period of few changes in rates in the short term is also expected, following the numerous rate hikes by the Federal Reserve since 2016.[4] This is due to the opening of a period of a certain slowdown in economic growth, which will delay or, at least, mitigate the pace and size of rate hikes in the short term.

Debt markets were characterised by stable bond yields and rising risk premiums

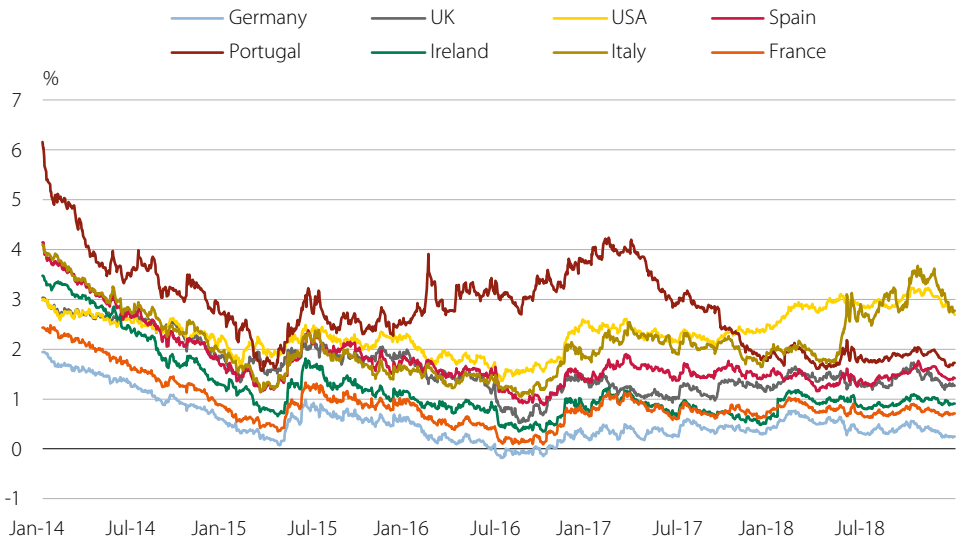
Long-term yields on sovereign bonds in most advanced economies remained relatively stable over 2018, with slight upturns in the early months of the year and falls between November and December. The performance in the last part of the year was the result of the worsening outlook for global growth and, in the case of Europe, also as a consequence of confirmation that the changes in the ECB's monetary policy would be slow and progressive.

Only the United States and, particularly, Italy recorded an increase in yields over the year as a whole, which rose by 28 bp in the case of the former (from 2.41% to 2.69%) and by 77 bp in the case of the latter (from 2.00% to 2.77%). In the United States, the rise in long-term yields was lower than the rise in short-term yields, which led to a marked flattening of the yield curve, which is compatible with inflation expectations that are, for the moment, relatively contained. There is some concern with regard to the slope of this curve as in the past very small values (sometimes negative) of the difference between the 10-year and 3-month yield have tended to precede periods of economic recession. In the case of the Italian bond, the significant increase in its long-term yield is mainly the result of the uncertainty relating to the public accounts of the Italian economy and the failure of the Italian Government and the European Commission to reach an agreement.

In the United Kingdom, the yield on the 10-year government bond stood at 1.27%, compared with 1.19% at the end of 2017. Long-term yields in the euro area, with the exception of Italy, recorded slight falls in 2018, which ranged between 8 bp in France and 21 bp in Portugal (14 bp in Spain), which led to them standing in December 2018 at 0.71% and 1.72%, respectively (1.42% in Spain). In the case of Germany, its debt status as a safe-haven asset may at least partially explain the fall in its yield. Accordingly, the long-term yield stood at 0.25% at the end of 2018 (18 bp down on 2017).

4 Since December 2016, the cumulative rise in the official interest rate is 2 pp.

10-year government bond yields FIGURE 1.1.7

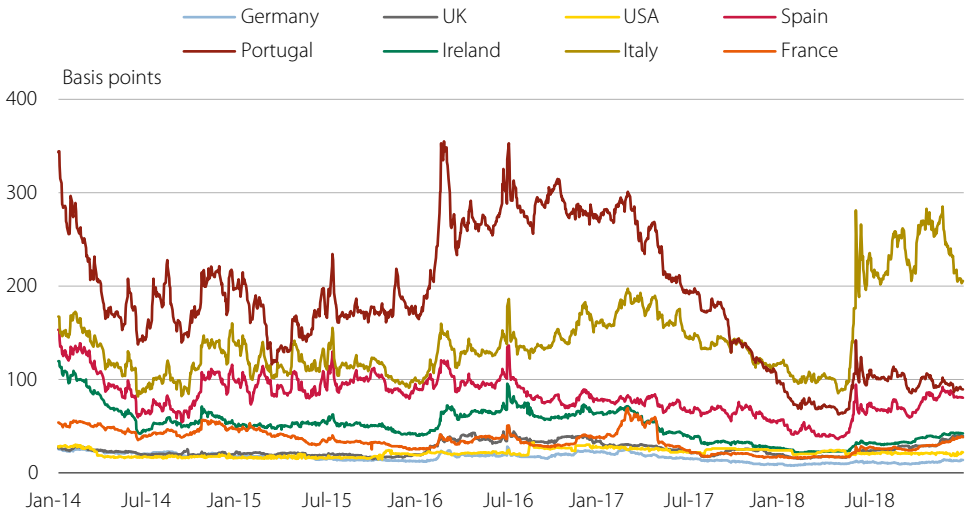


Source: Thomson Datastream.

Sovereign risk premiums (as gleaned from 5-year CDS contracts) of advanced economies grew, in general terms, throughout 2018, echoing the downward corrections to world growth forecasts. In the case of the peripheral euro area countries, this increase was exacerbated by the results of the elections in Italy in May. The Italian risk premium recorded a first upturn at the end of that month (to 281 bp, 163 up on the end of 2017) and then subsequently between October and November due to the failure of the Italian Government and the European Commission to reach an agreement with regard to the 2019 budget. Uncertainty in this area fell at the end of the year, which allowed the risk premium to drop to 205 bp. The risk premium in Spain rose by 23 bp, to 80 bp, and in Greece it reached 458 bp (76 bp up on year-end 2017). In Portugal, it rose by 47 bp in the first five months of the year to 142 bp, and fell in the following 7 months to 89 bp. In the other European economies, which were barely affected by the uncertainty in Italy, risk premiums edged up gradually over 2018. For example, risk premiums rose by 21 bp in France and by 4 bp and 20 bp, respectively, in Germany and the United Kingdom. In contrast, the US sovereign risk premium remained practically constant throughout the year and stood at 22 bp at the end of December, only 2 bp down on the figure for year-end 2017 (see Figure 1.1.8).

In line with the performance of sovereign debt, risk premiums of European banks rose over 2018 as they were affected by the same factors that contributed towards the increase in sovereign risk premiums: the outlook of lower growth, the rise in uncertainty relating to the public sector accounts in Italy and the delay in normalisation of the ECB's monetary policy. In this context, the spreads of the banking sector as a whole in the euro area rose from the lows of the end of January, close to 65 bp, to 155 bp at the end of December. In the United States, the risk premium of the banking sector also rose, from 33 bp to 72 bp, with practically all the growth concentrated in December, when doubts about the intensity of the economic slowdown grew.

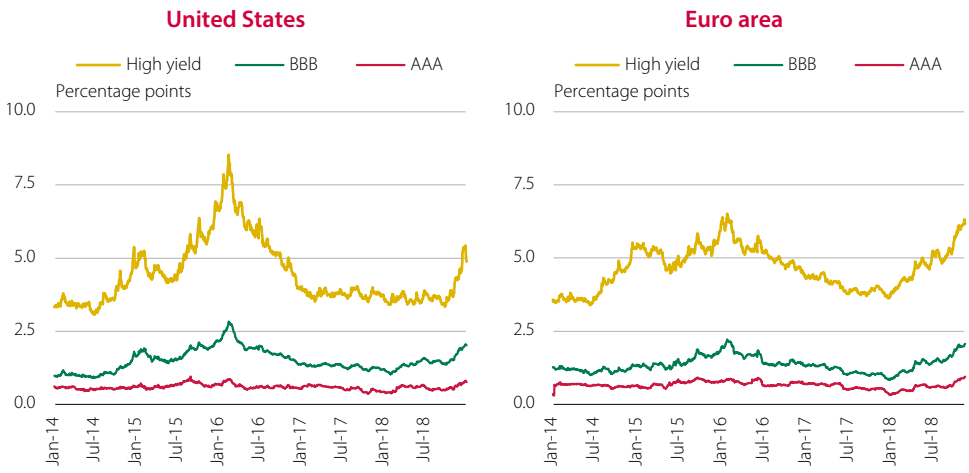
Sovereign CDS spreads FIGURE 1.1.8



Source: Thomson Datastream.

Spreads on corporate debt rose in 2018 in the major advanced economies, particularly in lower quality corporate bonds, after two years of continuous falls. These increases were more moderate in the United States, where spreads on high-yield bonds stood at 532 bp at the end of December, accumulating annual growth of 158 bp. Over the same period, the spread on corporate debt with the worst credit rating in the euro area recorded a much higher increase (227 bp), to stand at 618 bp, as a result of the aforementioned environment of uncertainty (see Figure 1.1.9).

Corporate bond spreads[1] FIGURE 1.1.9



Source: Thomson Datastream (BofA, Merrill Lynch and IBOXX indices). (1) Expressed as the difference between the IRR of the set of bonds belonging to a determined maturity and credit rating index and that of 10-year government bonds (the German bond is used in the case of the euro area).

Significant fall in net debt issuance in international markets in 2018

Net issuance on global debt markets amounted to 2.04 trillion dollars in 2018, 19.0% down on 2017. Debt issues fell in every sector except the financial sector, where they amounted to 846 billion dollars, 16.0% up on the figure for year-end 2017, as a result of the significant increase recorded in Europe (see Figure 1.1.10).

In the United States, net debt issuance fell significantly to 753 billion dollars (1.12 trillion dollars in 2017) against the backdrop of the interest-rate hikes by the Federal Reserve. While the fall took place both in the private sector and the public sector, it was much more dramatic in the former, where debt issuance shrank by 39.5% to 544 billion dollars in net terms. Of this amount, 327 billion corresponded to the financial sector, which issued 21.5% less than in 2017. Net issuance of government bonds amounted to 209 billion dollars in 2018, a very similar figure to that recorded in 2017 (only 8 billion dollars down).

In Europe, in contrast, net debt issuance grew by 24.8% over 2018 to 308 billion dollars. This growth was driven by the financial sector, whose net issues stood at 213 billion dollars, after 3 consecutive years at negative values, as many institutions took advantage of the good financing conditions in the context of the planned imminent end of the ECB's bank-specific longer-term refinancing operations. In contrast, issuance by non-financial companies fell significantly to 124 billion dollars, 18% down on 2017, while net issuance of government bonds was negative for the first time since the start of the crisis (-29 billion dollars), as gross issues, which fell by 5.8%, were less than the debt that matured during the year.

Net international debt issuances FIGURE 1.1.10

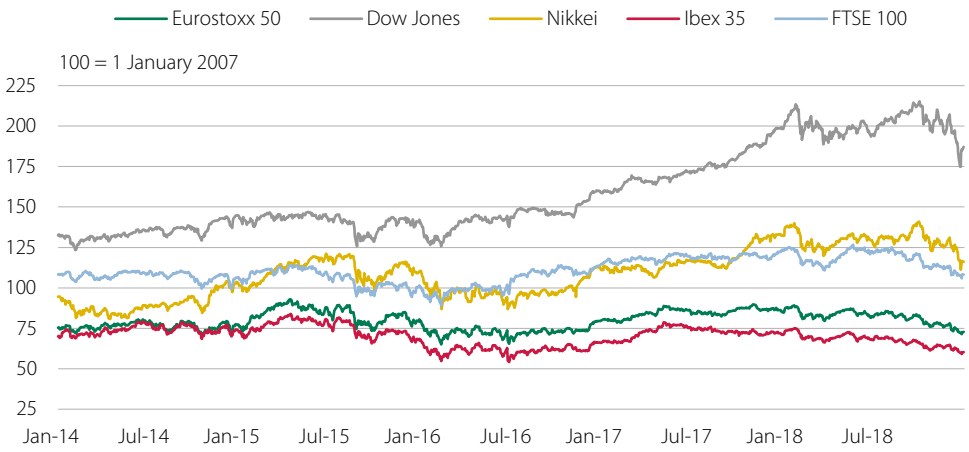
Source: Dealogic. Half-yearly data.

International stock markets fell significantly due to the presence of various types of uncertainties and there were occasional upturns in volatility

In the year as a whole, the leading stock indices recorded significant falls as a result of the aforementioned elements of uncertainty, such as the perception of an economic slowdown in the leading economies and the prolongation of trade tensions. The largest falls were recorded in European stock markets, which were particularly affected by doubts about Brexit and the lack of agreement between the European Union and the Italian Government relating to the latter's budget. The losses ranged between 11% and 18.3% (the Ibex 35 lost 15%). The falls in the United States were concentrated in the final part of the year and were more moderate, ranging between 3.9% and 6.2%, in a context characterised by the positive tone of economic activity and the job market, where unemployment levels are at lows not seen since 1969.

The falls recorded across the board by the major stock indices were accompanied by low levels of volatility, if the annual average is compared with historical averages. However, the market turmoil in the first and last quarters of the year gave rise to temporary upturns in volatility to levels lower than those recorded in other moments of uncertainty. For example, the historical volatility of the Dow Jones and Nikkei indices grew to values of close to 30% and 25% in February and December, compared with averages of 15% and 16.6%, respectively, during the year (see Figure 1.1.8). Volatility on European stock markets reached occasional highs of close to 20%, with annual averages slightly above 10%, which are low levels. Similarly, implied volatility indicators reached temporary highs during the same months, although the upturn in December was slightly higher, reaching levels of close to 40% in some indices (for example, the Japanese Nikkei).

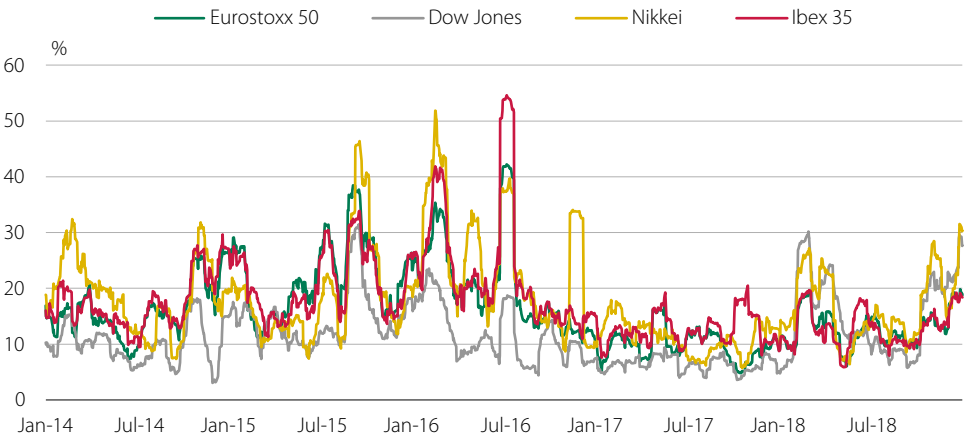
Performance of main world stock indices FIGURE 1.1.11



Source: Thomson Datastream.

Historical volatility[1] of main stock indices

FIGURE 1.1.12



Source: Thomson Datastream. (1) The index's historical volatility on day t is calculated as the standard deviation of daily index returns in the 20 preceding sessions.

Performance of main world equity markets

TABLE 1.1.1

		Change[1] (%)				
Stock market	**Contents**	**2014**	**2015**	**2016**	**2017**	**2018**
Developed countries						
United States	Dow Jones Ind. A.	7.5	-2.2	13.4	25.1	-5.6
United States	Nasdaq Composite	13.4	5.7	7.5	28.2	-3.9
United States	S&P 500	11.4	-0.7	9.5	19.4	-6.2
Japan	Nikkei	7.1	9.1	0.4	19.1	-12.1
United Kingdom	FTSE 100	-2.7	-4.9	14.4	7.6	-12.5
Euro area	Euro Stoxx 50	1.2	3.8	0.7	6.5	-14.3
Euronext	Euronext 100	3.6	8.0	3.0	10.6	-11.2
Germany	Dax 30	2.7	9.6	6.9	12.5	-18.3
Italy	Mib 30	0.2	12.7	-10.2	13.6	-16.1
Spain	Ibex 35	3.7	-7.2	-2.0	7.4	-15.0
Latin America, Asia and Eastern Europe						
Argentina	Merval	59.1	36.1	44.9	77.7	0.8
Brazil	Bovespa	-2.9	-13.3	38.9	26.9	15.0
Chile	IGPA	3.5	-3.8	14.2	35.0	-7.3
Mexico	IPC	1.0	-0.4	6.2	8.1	-15.6
Peru	IGBL	-6.1	-33.4	58.1	28.3	-3.1
South Korea	Korea Cmp Ex	-4.8	2.4	3.3	21.8	-17.3
Hong Kong	Hang Seng	1.3	-7.2	0.4	36.0	-13.6
China	Shanghai Composite	52.9	9.4	-12.3	6.6	-24.6
Russia	Russian RTS Index	-45.2	-4.3	52.2	0.2	-7.6

Source: Thomson Datastream. (1) In local currency.

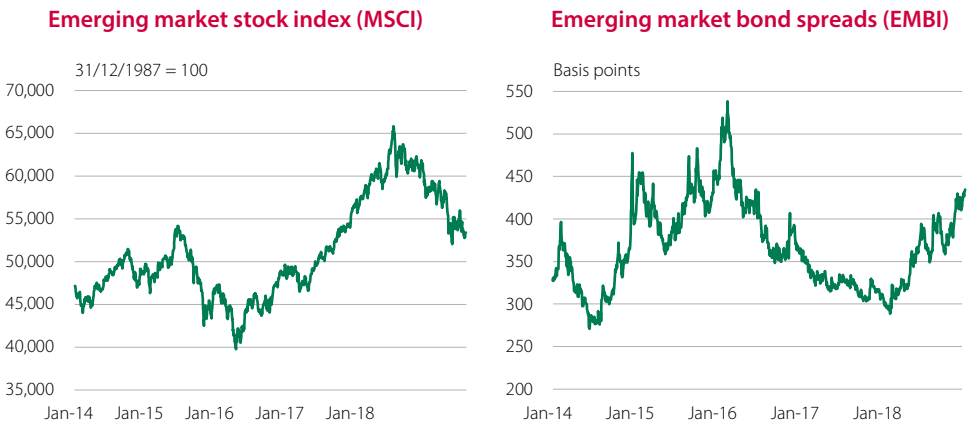
Throughout the year, the performance of emerging economies was marked by escalating trade tensions between China and the United States and the uncertainty seen in countries such as Turkey and Argentina. All of this led to notable rises in risk premiums and significant falls in stock market prices, particularly in the second half

of the year (the MSCI emerging market stock index fell by 8.7% over the third and fourth quarters). In 2018 as a whole, the MSCI index fell by 12.3% and the risk premium (EMBI) rose by 123 pb, to stand at 435 bp at the end of December (see Figure 1.1.13).

As shown in Table 1.1.1, the stock markets of emerging economies generally recorded significant falls in 2018. However, in Latin America, Brazil's Bovespa index gained 15% in the year, driven partly by the positive market reaction to Jair Bolsonaro's victory in the October general election. Particularly noteworthy in Asia, where significant losses were recorded in most stock indices, was the Shanghai Composite, which fell by 24.6% between January and December. The Russian RTS Index performed unevenly throughout the year. In the absence of major international economic sanctions, but with a drop in oil prices in the final stretch of the year, this index fell by 7.6% in 2018 as a whole.

According to figures published by the World Federation of Exchanges and the Federation of European Securities Exchanges, movements in trading volumes on leading stock markets and Multilateral Trading Facilities (MTFs) were uneven in the different geographical areas over 2018. In the United States, trading grew across the board, reaching a total of 45.6 trillion euros, approximately 35% up on 2017. Among the European platforms, the most notable increase was seen in the Deutsche Börse, with growth of 21.5% on the figure for 2017, followed by NYSE Euronext and Cboe Equities Europe, with growth of around 12%. Trading volumes in the markets of London and Japan also rose, but more moderately. At the opposite end was, once again, the Turquoise MTF, with a decline of over 23%, and BME, with a fall of approximately 9%.

Emerging economy financial markets FIGURE 1.1.13



Source: Thomson Datastream and Bloomberg.

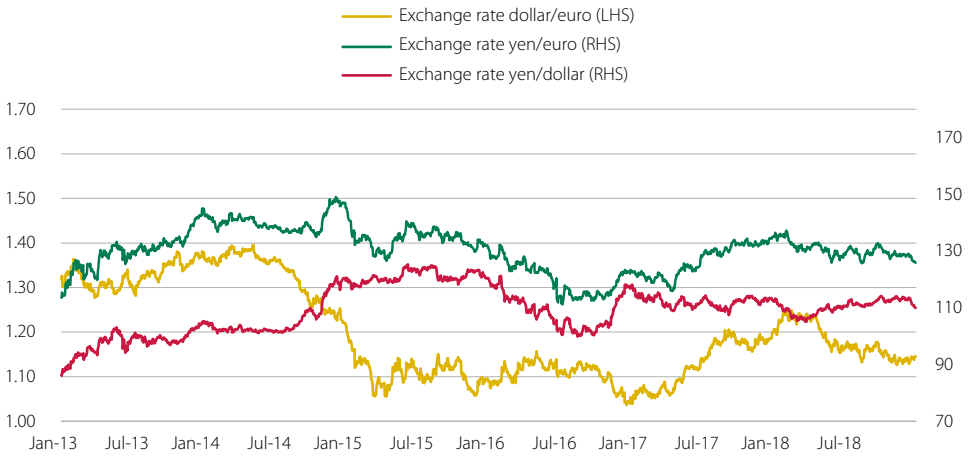
In the first few months of 2019, equity markets recovered a large part of the losses recorded in the previous year (in many cases, all the losses) after discovering the position of the ECB and the Federal Reserve, which are more willing to delay (in the case of the former) and to make more gradual (in the case of the latter) interest rate rises in the current context of a slowdown in growth. Certain progress in the negotiations on trade agreements between China and the United States and the fact that many companies recorded attractive share prices for a good number of investors, following the losses of 2018, also had a positive impact. In this context of rises

in equity prices, the leading stock markets generally recorded falls in trading volumes.[5] However, there are still various sources of uncertainty that make markets highly sensitive to the emergence of new information and occasional episodes of volatility cannot be ruled out, against a backdrop of a slowdown in global economic activity.

The rate hikes in the United States and uncertainties in Europe weigh on the price of the euro

In exchange markets, over the first few months of 2018, the euro appreciated against the major currencies, but it then mainly depreciated, although not very sharply. In relation to the US dollar, the exchange rate began the year at 1.20 dollars per euro and it remained above this figure for the first 4 months of the year, from when it began a downward trend to end the year at around 1.15. This change in the trend was influenced by, on the one hand, the appeal of the US dollar as a result of the higher yield of its assets and, on the other hand, the existence of various elements of uncertainty in Europe (Italy and Brexit), which weakened the price of the European currency. The euro/yen exchange rate followed a similar path to that of the dollar/euro rate over the year, with the consequent slight depreciation of the European currency. Between December 2017 and December 2018, the exchange rate dropped from 135 to 126 yen per euro.

Euro exchange rates against the dollar and the yen FIGURE 1.1.14



Source: Thomson Datastream.

1.1.3 Outlook and risks

According to the forecasts published in April 2019 by the IMF, global GDP growth will continue to slow this year and will stand at 3.3%, before rising slightly to 3.6% in 2020. Compared with its January report, the forecast for this year has been downgraded by 0.2 percentage points, while the forecast for 2020 remains the same. A large part of the slowdown in economic growth is due to trade restrictions, the loss of the impact of factors that had a positive effect in the past and the presence of

5 In some cases, the fall in trading in the first quarter of 2019 was over 15% year-on-year.

various sources of political and financial uncertainty. In the advanced economies, GDP is expected to grow by 1.8% this year (2.2% in 2018) with growth in the euro area of 1.3% (1.8% in 2018) and in the United States of 2.3% (2.9% in 2018). The emerging and developing economies are forecast to grow by 4.4% this year and by 4.8% next year (0.1 percentage points down on the previous forecast in both cases).

The most significant risks that loom over this scenario include the uncertainty about the future of trade negotiations between the United States and China, and the possibility that these might lead to an increase in global protectionism. There are also significant doubts about the development of some emerging economies. In Europe, there are still risks relating to the possibility that the United Kingdom might leave the European Union without a deal being reached between the two parties (hard Brexit) and risks resulting from the accumulation of financial imbalances in a prolonged environment of extremely low interest rates. These include the greater willingness of some participants to invest in higher risk assets and to raise their level of borrowing. These risks will continue in the short term, given the likely delay in the process of interest-rate rises by the ECB.

1.2 Spanish environment

The Spanish macroeconomic environment was favourable in 2018 as a whole. Although at a slower rate than in previous years, GDP and employment continued to grow, inflation remained under 2% for almost all the year (despite higher oil prices) and the public deficit fell below 3% of GDP. The different sources of uncertainty that were present in 2018, some of an economic or financial nature (trade agreements, problems of emerging economies and fiscal consolidation and energy) and others of a political nature (Brexit, Catalonia, etc.), had a relatively limited impact on Spanish economic activity, but they did have an effect on financial markets. Stock market indices were therefore affected by the falls in other global stock markets and risk premiums recorded slight temporary upturns.

Against this background, GDP grew by 2.6% in 2018 (3% in 2017), 0.7 percentage points more than in the euro area, in a year of economic slowdown and less synchrony among the leading economies. Despite the economic slowdown, the number of people in work rose by over 560,000 and therefore the average unemployment rate in 2018, although high, was almost 2 points down on 2017 and stood at 15.3% of the active population. The financial position of households continued to improve as a result of the increase in their incomes, the reduction in their debts and the increase in their wealth. However, their savings fell to historical lows, placing some of them in a vulnerable position in the event of a change in economic circumstances. Banks continued to face difficulties in increasing their profitability due to the low level of interest rates, although the rate of growth in lending was consolidated in some segments and there was a further fall in the NPL ratio.

In bond markets, yields remained relatively stable despite the prevailing uncertainties. Short-term yields underwent few changes, in line with the continuity of the monetary policy adopted by the ECB. The yields on longer-term government bonds, which benefited from the upgrades to their credit rating, fell in the early months of the year but then later recorded some rises at the times of greatest uncertainty in Italy, which also triggered temporary upturns in the risk premium. The balance for the year was practically neutral as yields ended December at very similar levels to those of 2017.

In equity markets, the Ibex 35 recorded a fall of 15%, similar to that reported in other leading European stock markets, in an environment of relatively low volatility and favourable liquidity conditions. The largest falls, although partially reversed during the early months of 2019 as a result of the good market performance across the board,[6] were recorded in the financial sector and in the consumer goods and services sector.

1.2.1 Economic environment

The Spanish economy grew by 2.6% in 2018 and widened the gap with the rest of the euro area

Spain's GDP grew by 2.6% in 2018, and therefore continued the growth that began in 2014, although at a somewhat lower rate than in previous years (3% in 2017 and 3.2% in 2016), in line with the environment of a slowdown in other economies. However, the slowdown in domestic growth was lower than in the euro area (where growth dropped from 2.5% to 1.8%, mainly as result of the poor performance of Germany), which raised the difference in growth from 0.5 percentage points (pp) to 0.7 pp.

Key variables of the Spanish economy (growth rates) TABLE 1.2.1

	2014	2015	2016	2017	2018
GDP	1.4	3.6	3.2	3.0	2.6
Private consumption	1.5	3.0	2.8	2.5	2.3
Government consumption	-0.3	2.0	1.0	1.9	2.1
Gross fixed capital formation, of which:	4.7	6.7	2.9	4.8	5.3
Capital goods	6.0	11.8	5.3	6.0	5.4
Exports	4.3	4.2	5.2	5.2	2.3
Imports	6.6	5.4	2.9	5.6	3.5
Net exports (contribution to growth, pp)	-0.5	-0.3	0.8	0.1	-0.4
Employment[1]	1.0	3.3	3.1	2.8	2.5
Unemployment rate (% of active population)	24.4	22.1	19.6	17.2	15.3
Consumer price index	-0.1	-0.5	-0.2	2.0	1.7
Current account balance (% GDP)	1.1	1.2	2.3	1.8	0.8
Public authority balance (% GDP)[2]	-6.0	-5.3	-4.5	-3.1	-2.5

Source: Ministry of Economy and Competitiveness, European Commission and Thomson Datastream. Annual change unless otherwise stated. (1) Full-time equivalent jobs. (2) Figures for 2015, 2016, 2017 and 2018 include government aid to credit institutions amounting to 0.1%, 0.2%, 0.04% and 0.01% of GDP, respectively.

The contribution of domestic demand to GDP remained constant at 2.9 pp in 2018, while the contribution of the external sector, which had not ended the year in negative numbers since 2015, stood at -0.4 pp (0.5 pp less than in 2017). With regard to the components of domestic demand, growth in public consumption picked up speed between 2017 and 2018 (rising from 1.9% to 2.1%), as did gross fixed capital formation (from 4.8% to 5.3%), while the growth in private consumption recorded

6 The Ibex 35 gained 11.4% up to 29 April.

a slight slowdown (from 2.5% in 2017 to 2.3% to 2018). With regard to the components of the external sector, both exports and imports recorded a lower rate of growth, affected by the situation of international trade. Imports grew by 3.5% (5.6% in 2017) and exports by 2.3% (5.2% in 2017). The sharper slowdown of the latter meant that the contribution of the external sector to growth was negative throughout last year.

On the supply side of the economy, stronger growth was recorded in the construction sector, whose value added grew by 6.8% in 2018 (6.2% in 2017), while slower growth was recorded in the industrial sector (including the energy sector, which grew by 1.2% compared with 4.4% in 2017. For its part, the services sector and the primary sector recorded growth in the year as a whole, with a noteworthy increase in the value added of the primary sector, which changed from a fall of 0.9% in 2017 to positive figures in 2018 (annual average of 1.8%). In the case of services, value added rose by 2.6% (2.5% in 2017) with a noteworthy increase of 2.3% in financial and insurance activities (0.4% in 2017).

The rate of inflation, which exceeded 2% in the middle months of 2018 as a result of the upturn in energy prices, later fell as energy inflation returned to normal.[7] The average inflation rate for the year stood at 1.7% (1.2% in December), while the core rate – IPSEBENE, which excludes the more volatile elements of the index, such as energy and unprocessed food – remained at much lower levels throughout the period (between 0.8% and 1.2%), recording an annual average of 0.9% (the same rate as in December). The inflation gap versus the euro area fluctuated at values close to 0 during the whole year to end at a slightly negative figure of -0.3 pp. The annual average of this gap was negligible, compared with an average of 0.5 pp in 2017.

In the job market, the buoyancy of the economy allowed employment to grow significantly, by 2.5% on average in 2018, but at a slightly lower rate than in previous years (2.8% in 2017 and 3.1% in 2016). Information from the Labour Force Survey (EPA) indicates that last year the number of employed people rose by 566,200 (2.42 million in the last 5 years) and that the unemployment rate fell to 14.5% in the fourth quarter (16.6% at the end of 2017). Furthermore, year-on-year growth in unit labour costs was slightly positive in 2018, as the increase in the remuneration per employee was somewhat higher than the increase in apparent labour productivity.

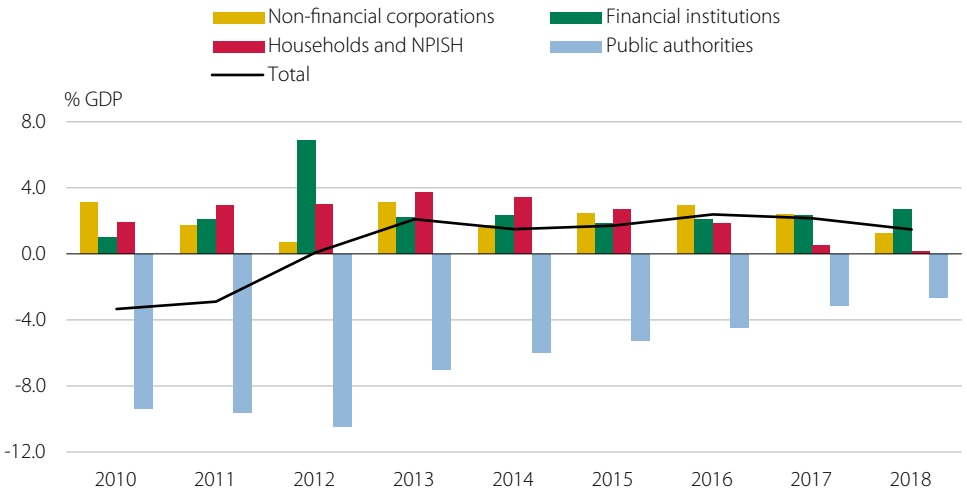
Public sector finances improved significantly in 2018 as a result of the growth in the economy and lower spending on servicing debt. The public deficit ended the year at a rate of close to 2.5% of GDP (3.1% in 2017), which is therefore compatible with Spain leaving the excessive deficit procedure which it has been subject to since 2009. All levels of public authorities that require financing reduced the amount borrowed. Particularly noteworthy was the fall in the deficit of the central government, which dropped from 1.9% in 2017 to 1.6% in 2018, and that of the regional governments, which stood at 0. 2% (0.4% in 2017). The deficit of the social security funds also fell, although to a lesser extent, dropping from 1.44% in 2017 to 1.41%. For their part, local authorities recorded a slight fall in their surplus, which slipped from 0.6% to 0.5% of GDP. Government debt stood at 97.1% of GDP (fourth-quarter data), recording very few changes since the middle of 2014.

7 The year-on-year rate of change in energy prices fell from 12.0% in September to 2.1% in December.

Net lending of the Spanish economy with regard to the rest of the world fell in 2018 to 1.5% of GDP

The recovery in the investment of the Spanish economy in a context of stable savings led to a slight fall in its lending, which stood at 1.5% of GDP in 2018 (2.2% of GDP in 2017). By sector, net borrowing by the public authorities fell, for the sixth consecutive year, in line with the fall in the public deficit. The non-financial sectors of the economy recorded a fall in lending, which in the case of households was due to the fall in their savings rate. Lending by non-financial companies fell from 2.4% to 1.3% of GDP, in line with the recovery in gross fixed capital formation.

Net lending (+) / Net borrowing (-) of the Spanish economy FIGURE 1.2.1



Source: Bank of Spain.

The improvement in the financial position of households continues, but their savings rates remain at record lows

The latest data on the financial position of households reveal that both their savings rates and their debt-to-income and debt burden ratios continued to fall in 2018. The fall in the savings rate, which dropped from 5.5% of gross disposable income (GDI) at the end of 2017 to 4.7% in the third quarter of 2018, is the result of buoyant aggregate consumption in a context of only a marginal increase in remuneration per employee. The debt-to-income ratio fell from 100.2% of GDI at year-end 2017 to 98.3% in September 2018 as a result of both a reduction in the level of debt and an increase in the level of disposable income. The debt burden ratio fell slightly (from 11.5% of GDI to 11.4%) given the stability of the average cost of debt, at low levels in the context of growing income. Net household wealth rose in 2018 (from 542.6% of GDP to 553.1%) mostly due to the increase in the value of real estate assets. Financial wealth fell slightly to 182% of GDP.

Households' net financial investments rose to 1.9% of GDP in 2018[8] (1.5% in 2017), maintaining the trend of previous years, but with amounts that were generally smaller. Households continued investing in payment instruments (4.2% of GDP)

8 Cumulative data from four quarters, up to the third quarter of 2018.

and reducing their investments in term deposits and bonds (3.5% of GDP) and in shares (1.4% of GDP). Households once again purchased units in mutual funds, although for a slightly lower amount than in previous years, probably as a result of market turmoil at the end of the year. In total, they invested in these products a volume of resources equivalent to 1.8% of GDP (2.4% in 2017).

Unit-holders in mutual funds continued to prefer higher-risk categories, thus following the trend of recent years, although volumes were much lower as the investor profile changed in the final part of the year, coinciding with the periods of sharp stock market falls, which led to higher risk aversion and greater preference for more conservative categories. In 2018 as a whole, these most conservative categories recorded net redemptions of close to 6.8 billion euros, while higher-risk categories received a significant inflow of investment (close to 17.6 billion euros in total). Among the latter category, there was significant investment in global funds (over 9.4 billion euros). Net subscriptions in equity funds (mixed, euro and international) ranged between 1.79 billion euros and 3.86 billion euros depending on the category.

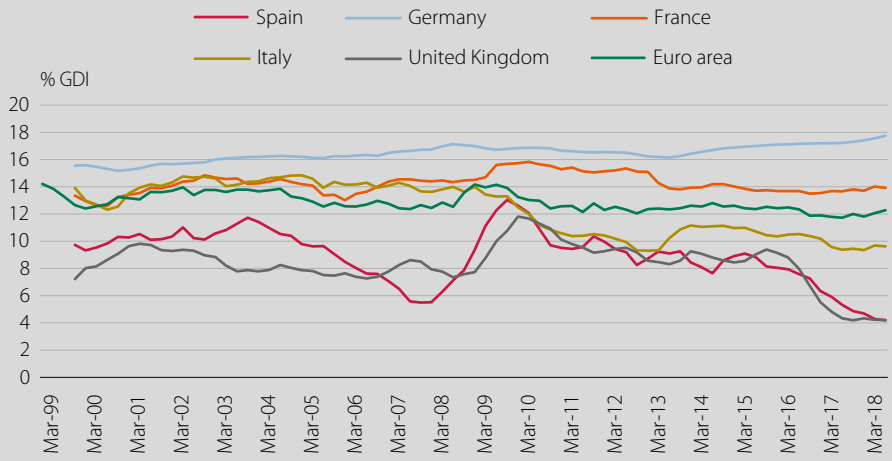
Latest trends in savings and investment decisions of Spanish households

EXHIBIT 1

The saving, borrowing and investment decisions of the agents of an economy are decisive for shaping a country's productive economy model and also the level of development of its financial markets. This Exhibit presents the most important trends of the decisions taken by Spanish households compared with those of comparable countries and suggests possible explanations for the differences found.

Savings rate

FIGURE E1.1



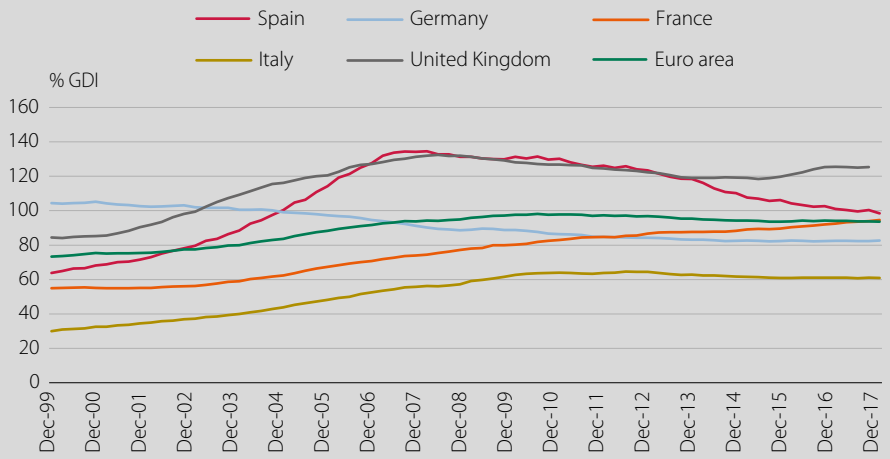
Source: Thomson Datastream.

As shown in Figure E1.1, in the time period under consideration (since 1999), the savings rate of Spanish households has been systematically lower than the average for the euro area and most of the European countries analysed. This trend has continued even at times of rises in precautionary savings following the financial crisis of 2008. Data for the third quarter of 2018 indicate

that savings stood at 4.2% of Gross Disposable Income (GDI), compared with 12.3% in the euro area. In parallel with this low level of saving, Spanish households borrowed significantly more than European households until the start of the crisis (see Figure E1.2), when the gap between both reached 40 pp of GDI (134% in Spain and 93% in the euro area). This borrowing was mainly used to acquire non-financial assets (in particular, housing) as opposed to other assets.

It may be argued that before the crisis there was a series of factors which allowed and even intensified these trends: i) the economy was growing strongly and rising incomes led to households making more ambitious investment decisions; ii) the fall in interest rates following Spain joining the euro area together with a sharp increase in the supply of credit significantly boosted borrowing by the private sector; and iii) the existing tax system encouraged the acquisition of housing rather than other assets and as opposed to the option of renting. Following the crisis, the bursting of the real estate bubble and the significant increase in unemployment, Spanish households began a sharp process of debt reduction, which now places the level of household debt at rates very close to the average for the euro area, while the saving rate has once again returned to historic lows. Part of the reduction in savings might be associated with the high number of low-income households, whose saving capacity is very limited. There may also be a significant number of households that had postponed the consumption of certain durable goods during the crisis that they can now afford.

Debt ratio FIGURE E1.2

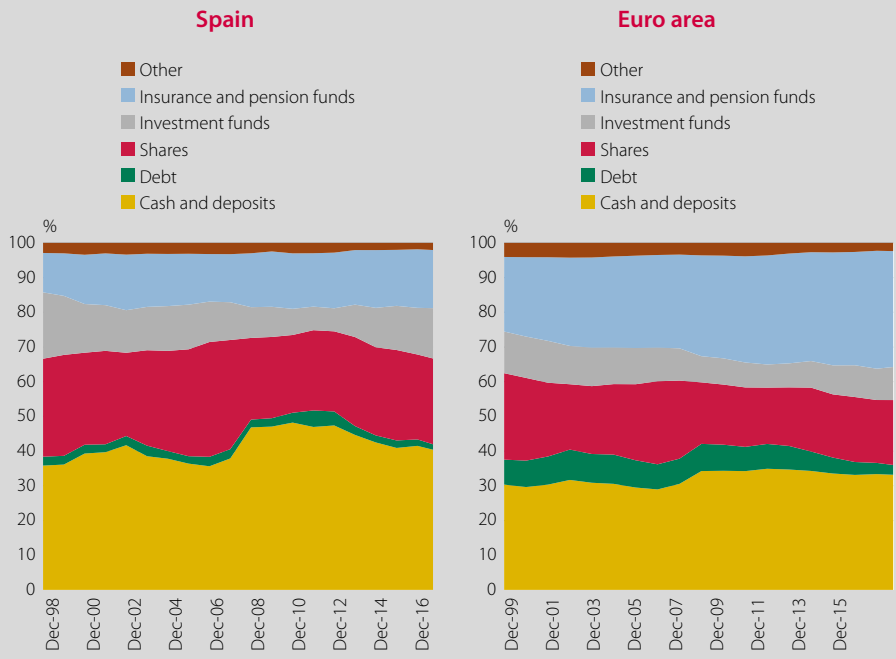


Source: Thomson Datastream.

It can be deduced from the behaviour of households that their resources have come from small domestic savings and larger debt, and that these have mainly been used to acquire real estate assets, while investment in financial assets has been much less significant. In aggregate terms, Spanish households have a level of wealth that is higher than the average in the euro area, but this is exclusively the result of the greater weight of real estate assets (453% of GDP in Spain compared with 271% in the euro area), with (net) financial assets accounting for 95% of GDP, compared with 130% in the euro area. With

regard to households' investment and financial assets, it is observed that the volume of investment by Spanish households in financial assets was lower than the euro area average throughout the period considered (between 25 and 30 pp of GDP). However, the composition of the financial assets is not significantly different, although the relative importance of cash and deposits and investment in shares and mutual funds is somewhat higher in Spain. In contrast, investment in insurance and fixed-income assets is lower (see the panels of Figure E1.3).

Breakdown of the balance of financial assets by asset class FIGURE E1.3



Source: ECB.

It is possible that an economy in which households systematically save little, borrow more and demonstrate a clear preference for real estate assets brings favourable consequences in the short term, generated by higher growth (based on the strength of consumption). However, there would be an imbalance between domestic and foreign demand and growth would be somewhat biased towards construction and real estate activities, which are less productive sectors. The consequences seem to be more unfavourable in the medium and long term to the extent that this context favours the accumulation of certain financial imbalances (excess leverage) and the formation of (real estate) asset price bubbles, which may be unsustainable at a particular time and generate negative effects on economic agents and growth. This preference for home ownership may also lead to a less mobile labour supply within the country itself. Finally, this model leads to less developed financial markets, which has clear effects on the economic development of any country.

Looking ahead, it would be desirable for Spanish households' savings to be somewhat higher and for their investments to be more balanced between real estate assets and financial assets. This would allow, *inter alia*, more developed financial markets and, in the medium term, higher economic growth.

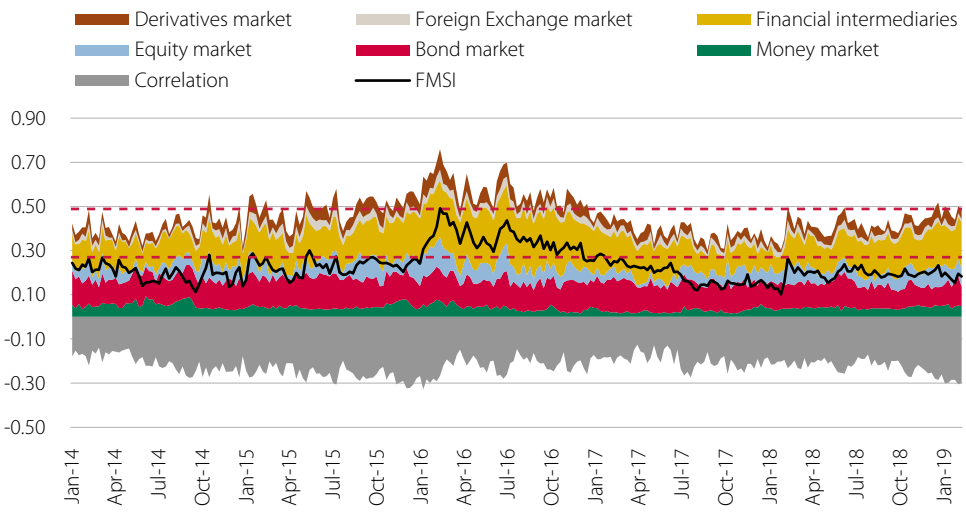
However, this process has at least two short-term limitations: i) the high proportion of low-income households, which are unable to increase their savings and are more vulnerable in financial terms and ii) the level of financial literacy of certain strata of the population, which is a decisive factor in their saving, borrowing and investment decisions. Finally, it is important to note the major challenge that is already present in society resulting from the ageing of the population in Spain. It may be assumed that this process will take on increasing importance in households' financial decisions and that it is likely to have a positive impact on capital markets.

1.2.2 Financial environment

The financial market stress index remained at very low levels, although with occasional small upturns throughout the year

The Spanish financial market stress index remained low throughout practically the whole year, standing at 0.18 at the end of December (stress is considered to be low at under 0.27). The indicator recorded small upturns throughout 2018, such as that recorded in February (to 0.27), due to the turmoil in US markets or, later on in the year, those of June and October (to 0.24 and 0.22, respectively), which were related to doubts about public finances in Italy and, to a lesser extent, other sources of uncertainty (the so-called "trade war", tensions in emerging economies and regulatory uncertainty). The highest stress level has generally been found in the financial intermediary segment, which was affected by the prolonged fall in share prices of banks, and in the fixed-income segment due to occasional upswings in volatility and the loss of liquidity of these instruments. This index, which the CNMV has published since 2017, is based on information on risk spreads, volatility, liquidity and, in addition, sharp falls in prices. It therefore measures the current stress in the market which, as in the rest of Europe, is very low, but it does not forecast future stress.

Stress index of Spanish financial markets[1] FIGURE 1.2.2



Source: CNMV. (1) For further information on the methodology of this index see Cambón M.I. and Estévez, L. (2016). "A Spanish Financial Market Stress Index (FMSI)". *Spanish Review of Financial Economics*, Vol. 14, No. 1, pp. 23-41, or as CNMV Working Paper No. 60 (http://www.cnmv.es/portal/Publicaciones/monografias.aspx).

Bond yields underwent few changes in the year with only an occasional temporary upturn in longer-term bonds as a result of the doubts about Italy

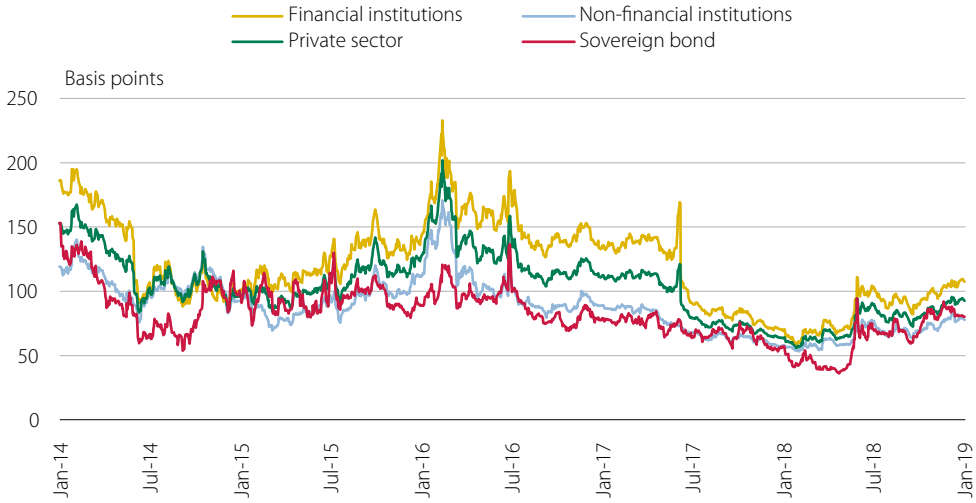
In domestic bond markets, short-term government bond yields recorded few changes in 2018, in line with the ultra-expansive monetary policy maintained by the ECB. These yields ended the year at figures that were slightly less negative than in 2017, although they remained close to historical lows. In particular, the 3-month, 6-month and 12-month yields on Spanish Treasury Bills stood at -0.55%, -0.42% and -0.37%, respectively, above the values for year-end 2017 (-0.62%, -0.54% and -0.47%, respectively). Medium and long-term yields recorded substantial falls in the early part of the year as a result of the improvement in the credit rating of the sovereign bond.[9] Subsequently, the times of greater uncertainty relating to the sustainability of the public accounts in Italy and the failure to reach an agreement with the European Union and, to a lesser extent, other events, led to small rises in the yield on the 10-year bond, which rose from lows of close to 1.15% in March to levels of over 1.6% at the end of May and to 1.75% in October. At the end of the year, the narrowing of the differences between Italy and the European Union and the outlook of a sharper-than-expected slowdown in the economy, with its likely effects on monetary policy, led to falls in the yields on long-term debt, which in the case of the 10-year bond closed the year at 1.42%, 15 bp below the figure for year-end 2017 (1.57%).

The sovereign credit risk premium recorded temporary upturns in 2018 as a result of the aforementioned uncertainties and recorded an annual high of 134 bp in May. It then dropped significantly to a low of under 90 bp in June and, in the final part of the year, after recording some ups and downs relating to doubts about Italy, ended the year at 118 bp, 4 bp up on year-and 2017. The performance of risk premiums in the private subsectors of the economy was more unfavourable than in the public sector, particularly the risk premium of financial institutions, which grew over practically the whole year. This indicator was negatively affected by some banks' exposure to emerging economies with problems (Turkey or Argentina), by the difficulties in increasing their net margin in the current context of low interest rates and by some regulatory and tax uncertainties. Thus, the average CDS of Spanish financial institutions at the end of December stood at 108 bp, above the 70 bp at the start of the year, and the average for non-financial companies stood at 78 bp, compared with 58 bp at the start of the year.

In a context that is favourable to fixed-income issues, and despite the efforts by the authorities and market infrastructures to facilitate and lower the cost of issues in national markets, companies have continued to replace their issues in Spain by issues abroad. Corporate bond issues registered with the CNMV fell by 8% over the year to 101.08 billion euros, while those performed abroad grew by 5.4% to 89.36 billion euros. However, issues registered with the CNMV recovered in the fourth quarter thanks to several issues of mortgage bonds and of asset-backed securities and, above all, to an issue of bonds of the SAREB (Asset Management Company for Assets Arising from Bank Restructuring) for an amount of close to 30 billion euros.

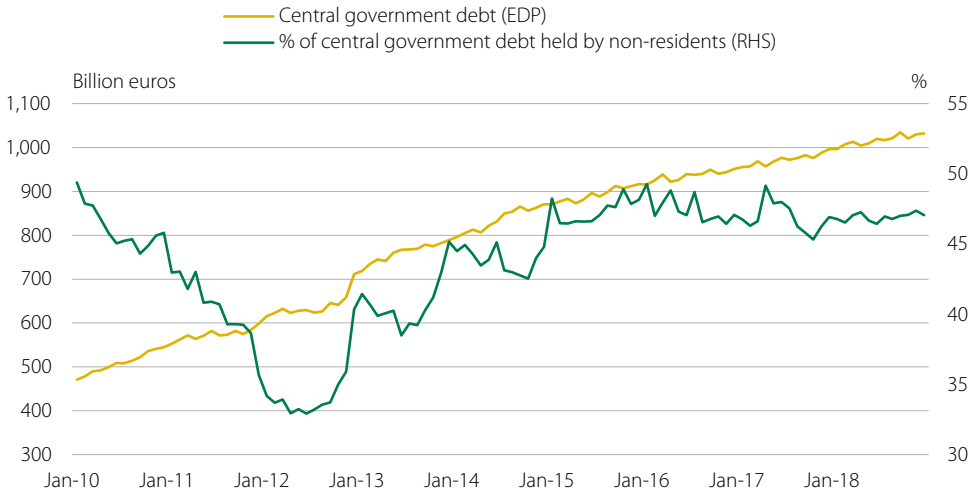
9 At the end of March, S&P upgraded the rating of the Spanish sovereign bond from BBB+ to A- (with a positive outlook) and, in April, Moody´s raised it from Baa2 to Baa1 (stable outlook).

Risk premium paid by Spanish issuers[1] FIGURE 1.2.3



Source: Thomson Datastream. (1) Credit derivatives market. 5-year maturity. Simple average, except for Spanish sovereign CDS.

Central government debt and non-resident holdings FIGURE 1.2.4



Source: Bank of Spain.

The Alternative Fixed-Income Market (MARF), which is mainly used for funding SMEs through the issuance of fixed-income securities and is focused on institutional investors, continued to grow in 2018. The nominal amount issued in 2018 stood over 6.37 billion euros, an increase of 60% on the previous year. Most of this amount corresponded to commercial paper issues (85%) made by 28 companies, including large companies such as El Corte Inglés, Elecnor, Grupo Barceló or Sacyr. Trading of securities listed on the MARF continued to primarily be carried out on a bilateral basis.

The low interest rate environment continued to weigh on bank profits, although the NPL ratio continued to fall

Pending increases in official interest rates (which are likely to be delayed in view of the slowdown in economic growth in the euro area), the bank sector continues to

operate in an environment of low interest rates which prevent significant improvements in the net interest margin and to face some structural changes, such as increasing competition from FinTech companies. On a positive note, it is important to highlight the fact that the buoyancy of the economy and the favourable performance of the job market continue to allow falls in the NPL ratio, which stood at 5.8% in December (7.8% at the end of 2017), where it stands at the lows recorded in March 2011.

Bank income statements show that their activities in Spain led to a profit of 12.38 billion euros in 2018 (losses of 3.92 billion euros in 2017, as a result of the losses of Banco Popular, which are estimated at 12 billion euros). As mentioned above, bank profits are still restricted by the context of low interest rates, which prevents them from improving their net interest margin, which stood at 23.28 billion euros in 2018 (23.23 billion euros in 2017). Operating expenses fell slightly to 25.99 billion euros in 2018 (26.67 billion in 2017). It was therefore the significant improvement in impairment of financial assets and other assets that marked the sharp growth in aggregate profit for the sector (which was the highest recorded since 2009).

Bank lending to the non-financial resident sector (companies and households) continued to grow slightly in 2018 and exceeded the rate of growth recorded in 2017. Lending to non-financial companies rose by 1.2% in December (0.4% in the same month of 2017), due to the growth in borrowing through securities other than shares (9.4%) and foreign loans (4.3%). In contrast, borrowing through loans from resident credit institutions fell by 2.0%. Lending to households rose by 0.15% in December, thus reversing the trend of recent years (-1.3% and -0.6% in 2016 and 2017, respectively). The expansion of consumer lending (4.8%) offset the fall in the outstanding balance of home purchase loans.

The size of the banking sector, in terms of the aggregate volume of assets from its activity in Spain, fell in 2018 to 2.58 trillion euros (2.65 trillion euros in 2017), thus resuming the downward trend that began in 2012 but was temporarily interrupted in 2017. Some of the most important sources of funding, such as deposits from resident households and companies or borrowing from the Eurosystem,[10] recorded falls. Bank equity recorded a slight fall in 2018, which was much sharper in the item that includes the provisions to cover impairment losses of both loans and other assets.

The profits of non-financial listed companies fell in 2018 as a result of the poor performance of a few companies

Non-financial listed companies obtained aggregate profit of 22.15 billion euros in 2018, 34% down on 2017. This performance was uneven between sectors and companies as, if the unfavourable performance of 4 companies[11] (out of a total of 119) is discounted, the total aggregate profit would have grown by 4.9%, which would be more in line with the buoyancy of the domestic economy. By sector, the largest

10 Borrowing from the Eurosystem (deducting the amount of the debt purchase programmes) at the end of 2018 amounted to 143 billion euros (164 billion in 2017).

11 Naturgy (energy), Abengoa (retail and services), OHL and Ferrovial (both from the construction and real estate services sector).

increases took place in industrial companies, whose profits grew by 8.4% in the year to over 5.7 billion euros and in companies from the retail and services sector (deducting the figures of Abengoa), which recorded profit growth of 7.8%. The consolidated profit for the year of energy sector companies grew by 4.2%.[12] Construction and real estate companies recorded a significant fall in aggregate profit that was also concentrated in a small number of companies,[13] although the performance of their accounts was more evenly spread (profits fell even after deducting those of the largest companies).

Profit by sector: non-financial listed companies TABLE 1.2.2

Million euros

	Operating profit		Profit before tax		(Consolidated) profit for the year	
	2017	**2018**	**2017**	**2018**	**2017**	**2018**
Energy	11,562	9,571	10,043	7,739	9,727	5,773
Industry	7,491	7,560	6,753	7,162	5,269	5,714
Retail and services	15,158	15,959	17,651	12,669	13,588	8,540
Construction and real estate	5,877	5,370	4,958	4,397	5,009	2,124
Aggregate total	**40,088**	**38,460**	**39,405**	**31,967**	**33,593**	**22,150**

Source: CNMV.

The aggregate debt of non-financial listed companies recorded very little change in 2018, with an increase of 0.7% to a little over 230 billion euros. This increase was the result of growth in the debts of retail and services companies, which rose from 81.19 billion euros in 2017 to 84.87 billion euros in 2018 and, to a lesser extent, industrial companies (from 19.71 billion euros to 21.13 billion euros). In contrast, the debt level of energy companies and construction and real estate services companies fell over the year a whole. The aggregate leverage ratio, measured as the debt to equity ratio, barely changed in 2018, rising from 0.97 to 0.98. At the end of the year, the lowest ratio corresponded to industrial companies (0.57) and those related to the energy business (0.73). Lastly, the debt coverage ratio, measured using the ratio of debt to operating profit, worsened slightly as a result of the aforementioned fall in margins.

The Ibex 35 fell by 15% in 2018, in line with other European stock markets, affected by several sources of international and domestic uncertainty

In domestic equity markets, the Ibex 35 ended the year with significant falls (15%, in line with the performance of most leading European markets, as indicated in Section 1.1) as a result of several uncertainties discussed above, including the exposure of Spanish companies to Italian debt assets and to several emerging economies with difficulties, the restrictions on global trade, doubts about the withdrawal agreement of the United Kingdom to leave the European Union and some fiscal and regulatory uncertainties. By sector, there were gains in the oil and energy sector, while the losses were concentrated in companies from the financial sector and from the services and consumer goods sectors.

12 Excluding Naturgy's losses, which were close to 2.6 billion euros in 2018.

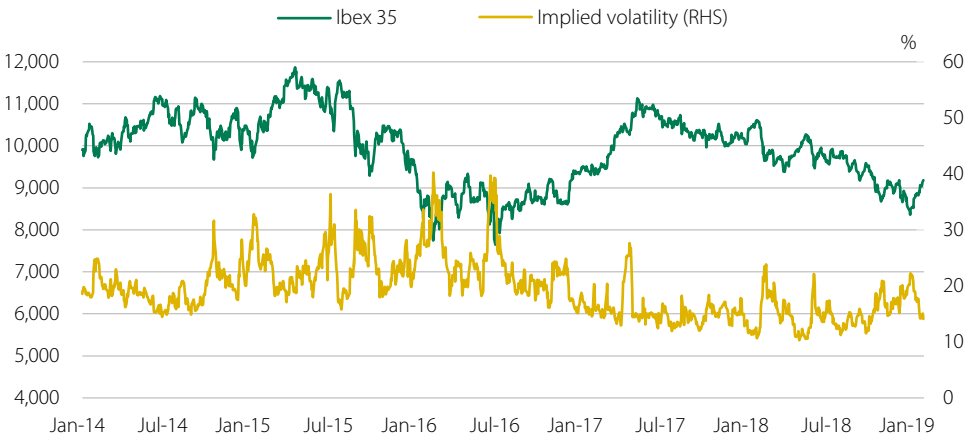
13 OHL, Ferrovial and Colonial.

Small-cap companies, which had performed well in the first half of the year, fell sharply and recorded losses for 2018 as a whole as a result of the possible repercussion that the slowdown in the Spanish economy might have on their accounts and the difficulty to offset this with business abroad. The indices representing Latin American shares that are listed in euros also recorded significant gains in 2018 in an environment of high volatility of some exchange rates of Latin American currencies with regard to the euro (the FTSE Latibex All-Share and FTSE Latibex Top indices gained 10.3% and 14.8%, respectively).

Stock market capitalisation fell for the first time following 6 straight years of growth to an amount of approximately 593 billion euros, 15% down on the previous year. The reduction was mainly due to the fall in share prices, supported by the lower amount of funds raised through capital increases (7.39 billion euros, 71% down on 2017).

As in other leading international stock markets, the volatility of the Ibex 35 remained low throughout the year. Despite market turmoil in the first and last quarters of the year, which gave rise to temporary upturns in volatility, the values reached were lower than those recorded at other times of uncertainty. At the end of the year, the implied volatility of the Ibex 35 stood at levels of slightly over 20%, in line with the average recorded between 2016 and 2017, but still below its historical average. Against this backdrop, trading of Spanish shares exceeded 930 billion euros in 2018 (0.2% down in year-on-year terms), of which almost 580 billion euros corresponded to the Spanish regulated market (8.5% down) and 351 billion euros corresponded to competing Multilateral Trading Facilities (MTFs) and regulated markets, which allowed them to reach a record market share (37.4%) of trading subject to market rules (28.1% and 31.7% in 2016 and 2017, respectively).[14]

Ibex 35 performance and implied volatility[1] FIGURE 1.2.5



Source: Thomson Datastream.

The Ibex 35, which had reached lows of under 8,400 points at the end of 2018, recovered to 9,500 in the early months of 2019.[15] Despite the prolongation of some sources of uncertainty and market sensitivity to the appearance of information that was not in line with analysts' expectations, many companies had attractive share

14 Data on trading subject to market rules (lit and dark).
15 Data to 29 April.

prices due to the sharp falls in the last quarter of the previous year and, therefore, purchases predominated. The rise in the index in the year (11.4%) was similar to that of the UK index (10.6%), but lower than that of other benchmark European indices, which gained between 16% and 18%.

Performance of Spanish stock market indices and sectors TABLE 1.2.3

%

	2014	2015	2016	2017	2018
Indices					
Ibex 35	3.7	-7.2	-2.0	7.4	-15.0
Madrid	3.0	-7.4	-2.2	7.6	-15.0
Ibex Medium Cap	-1.8	13.7	-6.6	4.0	-13.7
Ibex Small Cap	-11.6	6.4	8.9	31.4	-7.5
FTSE Latibex All-Share	-16.1	-39.2	71.0	9.0	10.3
FTSE Latibex Top	-11.1	-34.6	67.8	7.3	14.8
Sectors[1]					
Oil and gas	-9.8	-21.0	32.7	-11.9	-1.5
Chemical	-17.1	56.7	198.2	55.4	8.8
Basic materials	17.8	-8.5	24.0	26.1	-10.0
Construction and construction materials	9.9	6.3	-4.3	15.8	0.2
Industrial goods and services	-1.4	9.1	8.4	29.8	-12.8
Healthcare	1.1	23.9	-7.8	12.9	-3.6
Utilities	27.3	7.9	-0.7	3.1	12.0
Banks	8.1	-22.7	-1.1	11.9	-28.1
Insurance	-9.2	-5.1	15.5	0.1	-12.8
Real estate	46.3	12.6	-5.0	15.6	-8.3
Financial services	5.3	-2.7	-1.3	7.3	-7.5
Telecommunications and media	3.8	-8.2	-8.3	-3.2	-11.9
Consumer discretionary	-0.1	29.7	3.1	-9.5	-23.4
Consumer staples	-7.8	5.5	-6.0	-1.0	-35.7

Source: Thomson Datastream. (1) Thomson Datastream classification.

1.2.3 Outlook and risks

According to the IMF's forecast published in April this year, the GDP of the Spanish economy will grow by 2.1% in 2019 and by 1.9% in 2020. These forecasts were 0.1 percentage points down for 2019 and the same for 2020 compared with the previous forecasts published in January and, therefore, fell outside the IMF's generalised downgrades in growth forecasts for the most important economies. With these figures, the growth differential between Spain and the euro area would stand at 0.8 percentage points this year and 0.4 points next year (0.8 pp on average between 2016 and 2018).

The most significant risks to the national economic outlook relate to: i) the need to further consolidate the public accounts and, in particular, reduce the level of public debt; ii) the high, although falling, unemployment rate, together with the challenges resulting from the ageing population; iii) the possible prolongation of the political uncertainty resulting from both parliamentary fragmentation and the conflict in Catalonia; and iv) the negative impact on the business of Spanish exporters with greater exposure to markets with trade restrictions and also to those which are suffering a sharper slowdown in demand.

The most important financial risks include those relating to the maintenance of interest rates at low levels for longer than expected a few months ago, in view of the intensity of the economic slowdown in the euro area. This environment will continue, on the one hand, to apply downward pressure on bank profits and, on the other hand, to encourage borrowing by agents and the search for yield. Neither should the triggering of occasional episodes of turmoil in financial markets be ruled out as a result of any of the existing sources of uncertainty (for example, the possibility of a hard Brexit).

The creation of a macro-prudential authority in Spain (AMCESFI)

EXHIBIT 2

The aim of macro-prudential policy is to preserve the stability of the financial system as a whole by strengthening its resilience and mitigating systemic risks. Policies related to financial stability have traditionally been focused on the banking system, placing special emphasis on the size of banks. However, the last financial crisis revealed that other agents and activities performed outside the banking business might be a source or a channel for transmitting systemic risk in certain circumstances. Since then, and following the recommendations of the G20, national authorities and international institutions have been working on improving the resilience of activities and entities related to non-bank financial intermediation (previously known as shadow banking) and on building an institutional and regulatory framework for detecting and analysing systemic risks that will include all segments of the financial system. At a European level, this work resulted in the European Systemic Risk Board (ESRB) being set up in 2011, responsible for macro-prudential oversight of the European Union's financial system and for preventing and mitigating systemic risk.

In 2011, the ESRB issued a recommendation[1] that called on EU countries to designate an authority responsible for macro-prudential oversight. This recommendation was justified as a result of the improvement in the effectiveness of macro-prudential policy as the responsibility for taking measures to maintain financial stability was placed at a national level. In addition, in its latest review of the Spanish financial system,[2] the IMF also indicated, among other aspects, that Spain should establish a Systemic Risk Council for inter-agency coordination on systemic risk factors, surveillance, and system-wide financial sector policies. Following the recommendation by the ESRB, most Member States of the European Union (with the exception of Italy) have established their macro-prudential authorities in recent years. They have done this by creating a new authority with the participation of the pre-existing supervisory authorities or, in many cases, by designating the central bank as the authority, or by setting up an inter-agency cooperation structure with a leading role for the central bank or the pre-existing integrated supervisory authority.

Although the formal creation of an actual macro-prudential authority in Spain began in the final months of last year, there already was a committee with similar functions to those planned for the new macro-prudential authority. This precursor committee, which was called CESFI (Financial Stability Committee), was set up in 2006 and was made up of members representing

the Bank of Spain, the CNMV and the Directorate-General for Insurance and Pension Funds, and the Ministry of Economy. The CESFI met frequently during the most complicated years of the sovereign debt crisis in Europe but was then inactive for several years. The CESFI met again in June 2018 under the authority of the Minister for Economy and Business, and gave its full support for her initiative to set up a proper macro-prudential authority in Spain, following the recommendations of the ESRB and the IMF.

A draft Royal Decree creating the Macro-prudential Authority Financial Stability Board (AMCESFI) was published at the end of 2018. This draft Royal Decree was submitted to public consultation until 26 December and finally approved on 1 March.[3] According to the content of this Royal Decree, the AMCESFI, which has held its first meeting in April, seeks to improve the coordination of macro-prudential oversight at a national level and help to prevent or mitigate systemic risks, which should help the financial system to support rather than hamper economic growth. The Authority is made up of a Board, a Technical Committee as support body and the sub-committees that the Board decides to create. The Board is made up of the Minister for Economy and Business, who acts as chairperson, the Governor of the Bank of Spain, who takes on the vice-chair, the President of the CNMV, the Deputy Governor of the Bank of Spain, the Vice-President of the CNMV, the State Secretary for Economy and Support for Business, and the Director-General for Insurance and Pension Funds. The Deputy Governor of the Bank of Spain acts as chairperson and the Secretary-General for the Treasury and International Financing acts as vice-chairperson of the Technical Committee. All bodies are granted the possibility of inviting other public authorities to attend, such as the Fund for Orderly Bank Re-structuring (Spanish acronym: FROB) and the Independent Fiscal Responsibility Authority.

The AMCESFI's mission is, firstly, to monitor and analyse those factors that might affect systemic risk and, secondly, to issue the opinions, warnings and recommendations that it deems appropriate in view of its prior analyses. It may also make macro-prudential policy recommendations to supervisors for them to take specific measures. The recipients of the Authority's recommendations must explain how they will comply with them or provide appropriate justification, as the case may be, of the reasons why they deem it unnecessary or inappropriate to follow them. Supervisory powers are maintained by the competent national authorities that have exercised them to date, which have more information and experience in monitoring the supervised entities. Their independence is therefore respected.

In addition, sector supervisors must inform the AMCESFI in advance about their intention to activate, recalibrate or deactivate any of their macro-prudential tools. In particular, they must report on measures relating, for example, to capital buffer requirements, the establishment of limits to sectoral concentration, the setting of conditions for the granting of loans and other operations, or the application of higher risk weightings for real estate exposures. The measures falling under the remit of the CNMV include the suspension of redemptions of collective investment scheme units, decisions aimed at strengthening the level of liquidity of collective investment schemes and the banning or restriction of short selling. A few months before this,

Royal Decree-Law 22/2018, of 14 December, establishing macro-prudential tools, had granted additional powers to the Bank of Spain, the CNMV and the Directorate-General for Insurance and Pension Funds to address possible risks to the Spanish financial system from a macro-prudential perspective. In the specific case of investment funds, the CNMV is granted the power to set, in certain circumstances, liquidity requirements for collective investment schemes and undertakings.[4]

Finally, in order to contribute towards maintaining financial stability within the European Union, the requirement to cooperate with the macro-prudential authorities of other Member States as well as with the competent European institutions is regulated. The AMCESFI will be accountable through the preparation of an annual report and the appearance of the Authority's chairperson before the corresponding committee of the Lower House of Parliament.

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1 Recommendation of the European Systemic Risk Board of 22 December 2011 on the macro-prudential mandate of national authorities (ESRB/2011/3). https://www.esrb.europa.eu/pub/pdf/recommendations/ESRB_2011_3.en.pdf?da108dbb14efccdf98f4544534e2ef4e

2 Spain Financial System Stability Assessment. IMF Country Report No. 17/321. This assessment is part of bilateral surveillance under Article IV of the IMF's Articles of Agreement.

3 Royal Decree 102/2019, of 1 March, creating the Macro-prudential Authority Financial Stability Board, establishing its legal regime and implementing certain aspects relating to macro-prudential tools.

4 Royal Decree-Law 22/2018, of 14 December, establishing macro-prudential tools.