Letter from the Editors

2015 was a key year for the global economy. The slowdown in China led to a collapse in commodity prices, dragging down many emerging markets (EM) exporters. The Federal Reserve began its interest rate hike cycle, with implications for the dollar and additional downside risks for EM, while the ECB continued on a path of quantitative easing. The divergent EU and US monetary policy stance, together with continued uncertainty over the situation in China and other EM, will be the main factors to watch in 2016.

Spain's economy grew dynamically in 2015, the highest among the main Euro area economies. The growth outlook will remain constructive, although somewhat slower, as some of the temporary exogenous shocks (such as lower oil prices, lower financial costs and lower income taxes) begin to wear off. However, December´s historic, yet inconclusive, general elections have created a climate where economic growth and financial stability coexist with political uncertainty.

It is within this unique context that we present you with the January issue of *Spanish Economic and Financial outlook (SEFO),* with a focus on Spain´s economy and financial sector: What to expect in the new legislative term.

We start out by taking a look at the macro situation, as well as that of the Spanish financial sector and the fiscal consolidation process, in addition to providing a more medium to longer-term perspective in these areas.

As mentioned above, Spain´s near-term macroeconomic outlook remains positive. However, the slower potential GDP growth rate, due to the damage caused by the length of the crisis, will substantially limit GDP growth unless economic policy reforms are enacted to raise its potential. We believe these limiting factors are not expected to prevent the Spanish economy from growing between 2.5% and 3% over the medium-term.

Assessing the Spanish financial sector, we find no grounds for concern over financial stability. The reforms, restructuring, write-downs and recapitalisations that the Spanish financial sector has undergone over the last four years ensure its foundation. A gradual return to positive year-on-year credit growth is expected between 2016 and 2019. The default rate is projected to drop from 8% in 2016 to around 3% by 2019. At the same time, a protracted political vacuum will no doubt have some negative implications on investment and funding flows, at least in the near to medium term. Moreover, the sector will still need to confront several major challenges over the next four years, including reactivating lending, raising profitability, privatising nationalised institutions, adapting to increased regulatory pressure and embracing technological innovation.

On a related note, we look at the recent decline in EM and its possible implications for listed Spanish corporates, including banks. Increased internationalisation by Spanish firms has generally proven

to be a successful strategy, particularly to counteract the negative performance of the domestic market throughout the crisis. Recently, however, in the face of deteriorating EM performance in 2015 and a negative outlook for the year ahead, internationalisation could transform into a significant vulnerability for some IBEX 35 members with heightened exposure to EM, specifically to Latam. On the whole, the performance of the IBEX 35 should not be significantly affected by deteriorating conditions in emerging markets. However, those Spanish corporates with greater earnings exposure to Latam will likely see their share prices come under pressure, which could have a considerable impact on the performance of the index.

On the fiscal front, while the government continues on the path of fiscal consolidation, there will likely be some deviation from 2015 targets, further complicating the outlook for 2016. Improving the fiscal outlook should entail a debate over the regional funding model, as well as social security revenues.

In terms of additional considerations for the Spanish economy, we assess the economic impact of ageing and the recent performance and outlook for the services sector.

There is often times a negative perception of population ageing in Spain and many other countries. Indeed, increased longevity in Spain will have important implications for society and the economy, specifically in the realm of labour markets, healthcare and pensions. In Spain, these dynamics could result in a shortfall in labour supply in the medium term, especially in the under 44 age categories. In contrast, life expectancy increases alone should not necessarily put upward pressure on healthcare spending in Spain, as expenditure is also influenced by a host of other factors. Lastly, pensions in Spain do face a sustainability and sufficiency challenge in the context of growing life expectancies, which will call for further reform efforts in addition to the meaningful measures already undertaken. In short, the effects of ageing will only be problematic if accompanied by a failure to adapt economic, social and savings systems to the new reality.

Finally, we examine how the Spanish services sector is adapting after the crisis and find that there is still scope for significant improvement. In the case of Spain´s services economy, the decline of manufacturing decreases the possibilities of advancing in “servitization,” the process by which manufacturing companies begin to provide related services to third parties. The Spanish “pure” service sector must also undergo significant changes if it is to follow the trends of the largest, most advanced EU economies – in particular, in the areas of ICT consultancy and private employment services. Private sector investment, together with progress on previously initiated, but stalled reform efforts, will be needed to liberalises and modernizes the sector.