Letter from the Editors

Since the publication of the previous issue of *Spanish Economic and Financial Outlook* (SEFO), the election of Donald Trump in the US this November is arguably the biggest game-changing event to hit the US (and the global) economy by recent historical standards. For the time being, there remains a high degree of uncertainty surrounding the details of Trump's economic policy and thus, logically, the implications it will have for the US and world economy and financial system. At present, Trump's main proposed growth drivers appear to be infrastructure and deregulation.

In short, Donald Trump's administration is expected to be fiscally expansionary, with massive tax cuts, and liberalization and public spending in civilian and military projects that may, in turn, raise growth and inflation. Markets are pricing in a faster than anticipated Fed rate hike cycle, beginning in December – although in the US, there has already been a de facto tightening. In Europe, while there has been a recent uptick in inflation, the ECB is expected to maintain its exceptional monetary easing stance, at least as far as into March of next year.

In the context of remaining policy uncertainty and the persistence of Europe's low interest rate environment, the November SEFO assesses the Spanish and European banking sectors today and their prospects for 2017. For Spanish banks, the intensity of the restructuring effort undertaken, together with the depth and transparency of the asset provisioning effort, appear to be paying off and have emerged as a competitive advantage. Non-performing assets in the Spanish banking system have contracted by 38% since December 2013. Their common equity tier 1 (CET1) capital ratio remains above 12%. This combined improvement in asset quality and solvency has placed Spanish banks in a better position to tackle the profitability challenge, as evidenced by Spanish bank's recent performance on profitability, as well as high price-to-book ratios, relative to their European peers. If the situation in the European financial sector stabilizes in 2017, we could see an increase of concentration within the sector, alongside some improvement in profitability, although still within the context of a challenging monetary environment. Moreover, uncertainty remains high for the EU banking sector, particularly ahead of Italy's upcoming referendum and the potential implications results may have as regards addressing the problems of the country's ailing banking sector.

We then take a look at just how the ECB's prolonged policy of low interest rates is affecting Spanish banks, in the context of the rest of the euro area. We find that, although these policies initially had a positive impact on increasing loan volumes and demand, maintaining them over a prolonged period may increase negative pressure on financial stability, compressing banks' margins by varying degrees across Europe. For the case of Spain, the result has been a decrease of the average income of the outstanding loan portfolio – in part a function of the high degree of floating rate loans. Increasing Spanish banks' profitability in the future will require increased efficiency and a further reduction in the still high volume of unproductive assets.

We then move on to the macroeconomic picture, this time, by taking a snapshot of Spanish economic performance at the regional level. In line with the Spanish economy's overall performance, regional activity indicators for the first half of 2016 confirm recovery across all regions, although at distinct speeds. We expect to see higher growth rates in those regions that have most benefitted from tourism flows and diversification of their productive structures. Despite the overall improvement, disparities in GDP per capita (inequality) across the regions have intensified since the crisis, with implications for productivity, population loss, and unemployment levels. Fiscal performance too has varied significantly across the regions, both in terms of deficit reduction and outstanding stock of public debt. Going forward, public policy should take into consideration measures to reduce regional inequalities, such as well-designed investment and redistribution policies, as well as to correct deficiencies in some regions' education levels.

A further analysis at the regional level attempts to explain away some of these difference in performance across regions by looking at variation in business climate regulation. In this issue of SEFO, we analyse the World Bank's *Doing Business in Spain 2015* report, concerning the business regulations affecting SMEs and their relation to variables representative of regional economic activity in Spain. The report reveals significant differences in regional regulations affecting business activity. On aggregate, the best performing region is La Rioja, followed by Madrid, while the worst-and second-worst ranked regions are Galicia and Aragon, respectively. Despite some limitations to estimating the impact of the reports' findings on economic variables, the study still highlights the need to further improve business regulation across all of Spain´s regions.

The November SEFO then explores a key issue affecting Spain at the national level - the strength of the country's external sector in the context of a deceleration in global trade. The Spanish trade balance is holding up in the midst of a competitive environment characterised by increased flows of goods at notably lower prices, together with low oil prices. Aside from maintaining price competitiveness, the Spanish export sector faces various challenges in the short and medium term. These include Sterling depreciation and weaker growth in some key trading partners, especially the Euro Area. The increase in non-tourism exports may well represent the most significant structural change in the Spanish economy during the last decade, adding a strong boost to the services surplus.

This SEFO also provides a more in-depth analysis of a specific area where there is room for improvement and increased efficiency: shortening commercial debt late payment terms.

Recent regulations designed to reduce the term of commercial debt late payments are deemed to have had a limited impact on shortening average payment periods. There exists room to introduce productive changes under a new regulatory push directed not at legally capping payment terms, but rather at supervising and overseeing compliance with the agreed-upon terms, vigorously upholding free competition and the effectiveness of the courts to impose justice and of the mediation mechanisms in the event of conflict.

Finally, we close this SEFO with a broader perspective with a debate as to whether or not there exists a single European business cycle. Our preliminary findings do reveal increased comovements during periods of European convergence as well as during the Great Recession. The analysis identifies the existence of just one cluster among the business cycles of European countries.