Letter from the Editors

In the January issue of *Spanish Economic and Financial Outlook (SEF0)*, we focus on how two highly significant events of 2016 – the election of Donald Trump and Brexit – may unfold in 2017 and what could be their possible implications for the Spanish economy and financial sector over the near to medium term.

Analysing Spain's recent macroeconomic performance, we find that growth has exceeded 3% in the last two years, outperforming the majority of forecasts and approximately doubling average eurozone growth. In contrast to earlier recovery episodes, growth has not generated external imbalances. For 2017, most of the main pillars of the economic recovery remain in place. However, tailwinds supporting the recovery – such as tax cuts, falling oil prices, and a renewed decline in interest rates – have run out of steam and the external environment has become more uncertain.

As regards possible impact from the new Trump administration, at this stage, Trump's policy announcements are both protectionist and fiscally expansive, which could have implications for global trade in the case of the former and translate to higher borrowing costs in the case of the latter. However, the details of his proposed programs remain unclear and it remains to be seen whether or not they will get sufficient political and/or social backing.

Against this backdrop, Spain's growth is expected to slow to 2.4% in 2017, slightly above the previous projection and still one percentage point above the eurozone average. Yet, unemployment and public debt will remain significantly above pre-crisis levels.

On a specific note, regarding the Spanish recovery, this SEFO analyses the current state of play and outlook for a sector that has traditionally made an important contribution to Spain's GDP growth –the construction sector. Recent data point to a slow but solid recovery in construction with demand factors driving increases in prices– specifically, in a few regions, associated with population mobility and rental access. The recovery has been more pronounced in non-residential markets, with a significant presence of foreign investment, which registered increased inflows in 2015. Despite improvement, housing prices are growing slowly due to the existence of barriers such as restrictive credit conditions, insufficient savings and labour market failures.

The current situation points to a sharp contrast to what we have seen in the past – which typically saw construction take off at the first sign of economic recovery. In fact, construction could still take some time to recovery to reach long term levels and thus increase its potential to generate spillover effects for the wider economy.

Nonetheless, the recovery in transactions, positive price growth and the presence of foreign investment are positive signs, which – all being equal – are expected to continue in the upcoming quarters.

Taking a closer look at the issue of US monetary policy normalisation, this month's SEFO provides details over the Federal Reserve's current tightening cycle, including current policy challenges and possible general spillover implications for the global economy overall. On balance, the Federal Reserve's current monetary policy normalisation cycle is expected to be among the slowest of all cycles analysed, complicated by: uncertainty in the actual level of US job market slack, difficulties in estimating the natural interest rate, a shift in supply and demand of 'safe' assets, official rates close to zero, and increased divergence in the economic cycles across the main developed economies. Evidence suggests that international transmission will also be unique. Central banking authorities in the rest of the world will respond to resulting circumstances in their domestic economies. But risks remain given the high degree of global economic uncertainty.

Next, we assess the outlook for the Spanish financial sector ahead of expected implementation of the other game changing event in 2016 – Brexit – set to begin in March 2017. Spain has considerable economic and financial ties to the UK, specifically as regards its banking sector. Direct investment by Spanish banks in the UK stands at over 16 billion euros, while their claims on the UK totalled 377.29 billion euros as of June 2016, made up mostly by claims on non-financial corporates. Despite large UK exposure, we expect the Spanish financial sector to be well prepared to face these upcoming challenges, in part due to the preservation of the EU passport, as well as its experience with international diversification.

Despite increased uncertainty in 2016, thanks to the stability provided by the ECB's asset purchase programs, there has been little contagion to sovereign debt markets. In fact, as we show in our next article, in 2016, both the State and some of Spain's Autonomous Regions have taken advantage of favourable market conditions to improve their liability management profiles, reducing debt servicing costs and extending maturities. For 2017, the State is expected to continue to cover the bulk of its financing needs through long-term debt issuance. Regional bond issuance has increased with financing conditions having also improved, but the majority of financing is still provided by the State through the special liquidity mechanism. The government should take advantage of the current climate to increase financial autonomy for those regions that have still been unable to return to capital markets. Doing so may help the government address other more urgent issues – such as the near depletion of the Social Security Reserve Fund – that may require, at least in the short-term, additional debt issuance.

Apart from the implications of recent political and monetary policy events, we close with an assessment of the potential impact from the entry into force in January 2018 of IFRS 9, the international financial reporting standard which contemplates a new model for provisioning for credit risk projected to have material effects on financial institutions' balance sheets. The new standard changes the current provisioning model, based on the recognition of actual, materialised losses to one based on expected losses at the time loans are granted. While the Basel

Committee on Banking Supervision is currently assessing various arrangements to smooth IFRS 9 implementation, the initial impact study carried out by the EBA points to significant increases in provisioning requirements and decreases in CET1 ratios at financial institutions.