

1. Editorial

In 2017, the Spanish economy is expected to show growth above 3% for the third year in a row, and to continue to recover in 2018, albeit at a slower pace and in an environment of increased uncertainty. More specifically, the advance of GDP growth could be around 3.1% for 2017 and 2.5% in 2018, with both figures being lower than those forecast last July (3.3% and 2.8% respectively). The factors underpinning growth will be the positive inertia still observed in activity data and employment; a favourable international context that should support growing exports of goods; and, an expansive monetary policy. However, the increase in uncertainty and the possibility of its prolonged persistence pose a risk to the development of certain demand components, mainly investment and service exports.

Recent activity data for the second and third quarter revealed a GDP advance of 0.9% QoQ and 0.8% QoQ, indicating a somewhat more marked growth moderation than what was expected in July (1.0% and 0.9% respectively). The lower growth is explained by the **unexpected weakness of exports and capital expenditure on machinery and equipment** in the past few months, together with a somewhat slower increase in household consumption. In regards to the exports of goods, the practical stagnation of the last two quarters is partly due to the sharp increase seen at the end of last year and the beginning of the current one. Accordingly, this process of consolidation of the high levels of exports attained in the early part of the year could give way to a return to growth in the next few months. A greater source of concern is the persistent weakness of British demand, affected as it is by the uncertainty relating to Brexit. Also, the euro's recent appreciation against the dollar (and other currencies) may have hampered the competitiveness of some companies that are particularly sensitive to price changes due to their limited degree of integration in European production chains or due to their small size. Lastly, tourism is slowing, possibly as a consequence of structural factors. In particular, as pointed out three months ago, there are some tourist areas that are starting to show symptoms of over-occupation and exhaustion, given the constraints on increases in supply that exist in the sector. With regard to household consumption expenditure, the slowing trend has been observed since the second half of 2015 and simply seems to reflect the reduced effect of certain tailwinds that had boosted spending in previous years. **On the other side of the ledger, we should highlight the positive trend in residential investment, where growth has been exceeding its forecast for a year now.**

Looking ahead, we expect a favourable external environment and the ECB's monetary policy to underpin continued recovery. In particular, global growth seems to have had several above average quarters since 2008. The improvement in confidence indicators, together with the good performance of manufacturing activity, point to this continuing through next year. Moreover, this acceleration of the world economy seems more synchronised. Of particular importance for Spain is the growing dynamism observed in the EMU, where GDP growth, recently revised

upwards, should be around 2% on average during 2017 and 2018. In any case, job creation in developed economies is not accompanied by a sustained increase in inflation, which points towards monetary policies that will keep the cost of financing at historically low levels. Both factors should stimulate the rest of the world's demand for Spanish goods and services, while lending will continue to increase and support the growth of private consumption and investment.

During the fourth quarter, growth seems sustained at levels consistent with the trend of the past few years, despite the fact that uncertainty is once again the main risk facing economic activity. In particular, the latest activity data suggest GDP is increasing between 0.8% and 1.0% QoQ between October and December. In any case, various factors could slow the advance in activity. On the one hand, the terrorist attacks suffered in August in Catalonia could have an effect on foreign tourist arrivals. As shown in this publication, these events increased the attention given to Barcelona with the same intensity, duration and tone as in similar situations experienced by other cities such as Paris, Nice or London. Using these experiences as a reference, we calculate that the negative impact on foreign tourist overnight stays would reach a figure between 1.5% and 2.0% in the year following the attacks. In any case, several factors could moderate these numbers. For example, the effect on other cities may have been greater as a consequence of the recurrence of this kind of incident. Over the past few years one of Spain's comparative advantages had been the perception of safety relative to other destinations. If it is confirmed that the attacks were atypical events, the final effect could be moderate. Also, with the recovery, businesses in the sector had started to transfer the increase in demand into margins. This process could be reversed in the next few months, giving way to price reductions which could sustain growth in demand.

On the other hand, economic policy uncertainty has increased. The measures taken at the end of last year and over the course of this, together with the economic recovery, point towards the Public Administrations as a whole meeting the deficit target set for the end of 2017. However, 2018 is expected to begin with extended General State Budgets. This introduces uncertainty in various areas. Although it may help to continue the process of reducing the public deficit, it would be better for specific measures to be agreed to attain this goal - measures that would minimise the economic impact of fiscal consolidation.

There has also been an increase in the volatility of certain financial variables, mainly related to the political environment in Catalonia. In this regard, the indicators that seek to measure economic policy uncertainty have reached levels above those seen in 2016. Thus, there is a risk that this increased tension will have a negative influence on consumers' and businesses' future spending decisions. Estimating the impact on GDP of the current political situation in Catalonia is particularly difficult, since this uncertainty is of a different nature from that seen in the past. Moreover, it presents paths of contagion to other regions that may be unique due to the event faced by the Spanish economy. On the other hand, there are various factors that could moderate the effect on activity, such as the ECB's monetary policy and the redirecting of expenditure to other regions of Spain. Lastly, the repercussions for the

economy will depend crucially on the magnitude and length of the uncertainty currently experience. We therefore estimate a wide range of possible impacts. In particular, according to preliminary estimates, if the uncertainty seen in October lasts until the end of the year, GDP for 2018 could be between 0.2% and 1.1% less than it would have been in a stress-free scenario. In any case, in the most likely scenario we expect the impact to be limited and GDP growth for 2018 to be around 2.5% on average.

One of the main negative effects that the current environment could have is represented by opportunity cost.

In particular, significant reforms, such as those related to the financing of the autonomous regions, the pensions system and improvements to the functioning of the labour market have been postponed. This at a time when the ECB is moving closer to withdrawing the stimulus measures that have kept the Spanish economy's cost of financing at historically low levels. Towards the future, it will be essential to put these issues back at the top of the legislative agenda and to build the necessary consensus for consolidating the recovery, while at the same time seeking to reduce inequality.

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