Box 1.1

SPAIN'S MACROECONOMIC AND FINANCIAL EXPOSURE TO THE UNITED KINGDOM IN THE EVENT OF A NO-DEAL BREXIT

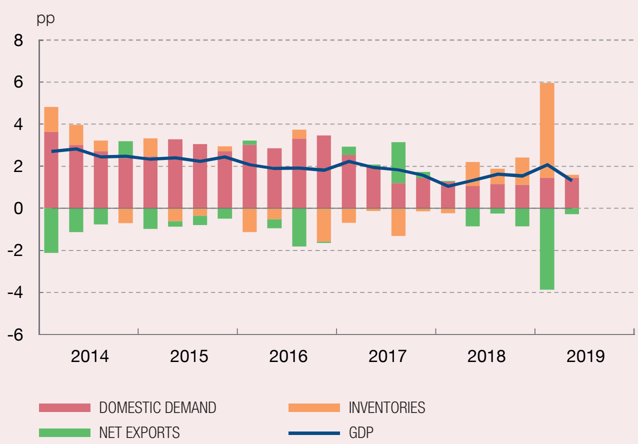
Uncertainty related to the form and date of the United Kingdom's departure from the European Union (Brexit) continues at the time of this report going to press (see Chart 1). Against this backdrop, this Box describes how the climate of uncertainty associated with the Brexit negotiations is affecting the country's economic situation and analyses the exposure of Spain's economy and banking sector to the United Kingdom. It also describes the contingency measures adopted by the European Commission and the Spanish government in relation to the financial system in the event of a no-deal Brexit.

The extension agreed by the European Council in April 2019 managed to delay the risk of a disorderly exit of the United Kingdom from the EU until 31 October 2019 in view of the British Parliament's failure to ratify the withdrawal deal negotiated with the previous government. More recently, on 17 October 2019, the European Union and the current British Government, led by Boris Johnson, signed a new agreement obviating a customs and regulatory border between the Republic of Ireland and Northern Ireland. At the cut-off date for this report, however, persisting difficulties over the timely ratification of the agreement have led the European Council to adopt, as requested by the British Government at the behest of Parliament, an additional extension. In this case the extension will be flexible, running to 31 January 2020 at the latest. This extension should, in principle, enhance the possibility of an agreement between the parties. But it cannot be ruled out that the ultimate terms of the future relationship between the United Kingdom and the European Union may involve a lesser degree of integration between both economies than the previous agreement.

The prolonged period of uncertainty following the 2016 Brexit referendum has affected the British economy, which has worsened notably in recent months. As Chart 2 shows, the UK maintained relatively high GDP growth rates after the referendum, while monetary and fiscal policy decisions were able to sustain domestic demand and exports. However, high uncertainty impacted corporate investment, which weakened significantly (see Chart 3) and remained virtually flat as a percentage of GDP, in contrast with other cycles. Also, some British firms have directed their investments towards EU-27 countries, setting up subsidiaries that allow them to keep accessing this market. By contrast,

Chart 1
UNITED KINGDOM. ECONOMIC POLICY UNCERTAINTY INDEX

Chart 2
UNITED KINGDOM. GDP AND CONTRIBUTIONS BY COMPONENT
Year-on-year growth



SOURCES: Eurostat, EPU, ONS and Bank of England.

1 H. Breinlichy, E. Leromainz, D. Novyx and T. Sampson (2019), Voting with their Money: Brexit and Outward Investment by UK Firms, with survey information available until March 2019, find that the number of FDI transactions of the United Kingdom in the EU27 rose by 17% since the referendum, while FDI transactions aimed at other non-EU OECD countries hardly changed. Conversely, FDI transactions from EU27 declined by 9%. See also N. Bloom, P. Bunn, S. Chen, P. Mizen, P. Smietanka and G. Thwaites (2019), Bank of England, Staff Working Paper 818, The Impact of Brexit on UK Firms.

the number of investment projects of EU-27 countries in the United Kingdom decreased by 9% after the referéndum.[1]

More recently, GDP growth figures available for 2019 H1 show some volatility associated with the inventory build-up process which took place in Q1 in view of the proximity of the first exit date agreed (31 March). However, the fall in industrial production, the decrease in corporate and consumer confidence to record lows and the recent slowdown in retail sales point to a gradual weakening of the British economy. European economies are already affected by lower demand from the United Kingdom, especially those with a greater commercial exposure to this economy (see Chart 4). In addition to the above-mentioned fall in direct foreign investment flows, euro area exports to the United Kingdom post negative rates since mid-2016, with a cumulative decline of nearly 10% in real terms up to July 2019. But the effects of a possible no-deal Brexit would be much more disruptive for both parties, given their strong current commercial and financial links and the potential impact of this scenario on the financial markets. In particular, according to the latest Bank of England estimates, in the event of a no-deal Brexit, the United Kingdom's GDP would drop to 5.5% over 5 years below the baseline scenario from 2020 H1, while the unemployment rate and inflation would rise to 7% and 5.3%, respectively.

The Spanish economy's exposure to the United Kingdom is significant. Therefore, a no-deal departure would have notable consequences. The volume of goods trade with the United Kingdom, which would be negatively affected by the increase in tariffs to the levels currently in force for third countries, is not particularly high, but is significant. Spanish exports of goods to the United Kingdom account for 1.7% of GDP, a percentage that is lower than the average for the euro area (2.6%), although the agri-food sector's exposure is higher. In services, the exposure of Spain's economy to the United Kingdom (1.6% of GDP) is higher. In this case, some specific areas, such as the tourism sector, could be especially affected. The United Kingdom is the main country of origin of tourist flows to Spain, representing around 20% of tourist inflows and of total spending. This is compounded by the exposure of financial services and telecommunications export firms.[2] As a whole, it is estimated that the cost through these channels of a disorderly exit of the United Kingdom for the Spanish economy may be substantial (around 0.7 pp of GDP in 5 years).[3]

Chart 3
UNITED KINGDOM. PRODUCTIVE INVESTMENT FOLLOWING PREVIOUS RECESSIONS

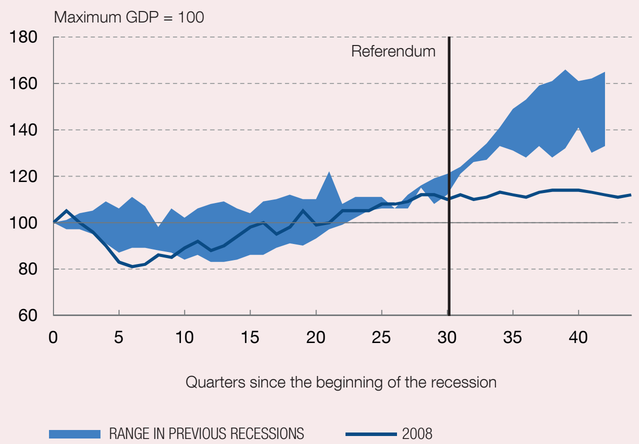
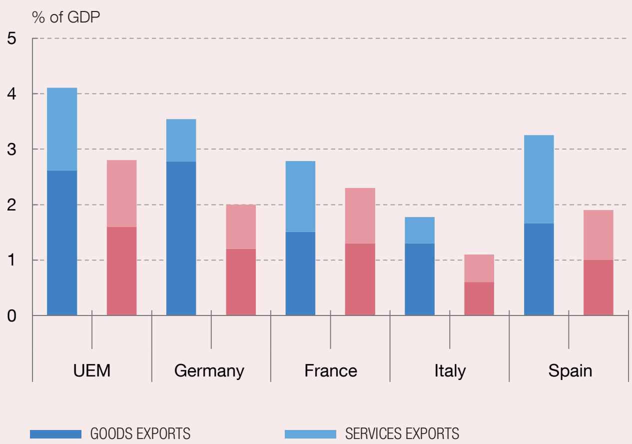


Chart 4
GOODS AND SERVICES TRADE WITH THE UNITED KINGDOM (2017)



SOURCES: Eurostat, EPU, ONS and Bank of England.

2 The second-home market, which traditionally attracted many British citizens, particularly in the Mediterranean provinces, is one of the most exposed sectors to a no-deal Brexit.

3 See Vega (2019), Brexit: current situation and outlook, Occasional Paper No 1905 of the Banco de España.

Box 1.1

SPAIN'S MACROECONOMIC AND FINANCIAL EXPOSURE TO THE UNITED KINGDOM IN THE EVENT OF A NO-DEAL BREXIT (cont'd)

As regards the banking sector's exposure, the foreign banks with the greatest weight in the British financial system are the Spanish, US, German and French banks. As a whole, they exceed 50% of the exposures of foreign banks in the United Kingdom, according to the latest available the data published by the Bank for International Settlements (BIS), which related to June 2019.[4] Spain has the highest exposure (16.1%), followed by the United States (15.9%). As regards other European countries, Germany (10.6%), France (8.2%) and the Netherlands (4%) have the greatest exposures (see Chart 5).

However, from the perspective of each of these countries, the importance of these exposures will depend on the size of their respective banking sectors. Thus, according to data published by the European Banking Authority (EBA), in the latest transparency exercise relating to June 2018, Irish banks appear to be the ones most exposed in relative terms, followed by Spanish banks (23.8% and 14%, respectively, of exposure to the United Kingdom as a percentage of total exposure). The exposure of Germany, France and the Netherlands to the United Kingdom was below 5% of the total exposure (see Chart 6).[5] In absolute terms, Spain, together with France and Germany, were the countries with the highest volume.

The exposure of Spanish banks is mainly concentrated in loans, accounting for more than 85% of their financial assets in the United Kingdom as at June 2019. Household loans (54.9%) and, more specifically, mortgage loans, have the highest weight in total exposure (see Chart 7).

Over a longer time frame, an increase is observed in the volume of loans of Spanish banks in the United Kingdom from the levels of December 2014. Also, the NPL ratio decreased from 1.6% in December 2014 to below 1% in June 2019 (see Chart 8).

In any event, in order to assess the potential impact of a no-deal Brexit on Spanish credit institutions, it should be taken into account that these exposures arise from the activity of subsidiaries with financial autonomy and a retail-oriented business model. This means that the main risk would be the potential deterioration of the British economy, which would entail a significant increase in NPL ratios and the possible depreciation of the pound sterling.

Chart 5
FOREIGN BANKS' EXPOSURE TO THE UNITED KINGDOM (a)
June 2019

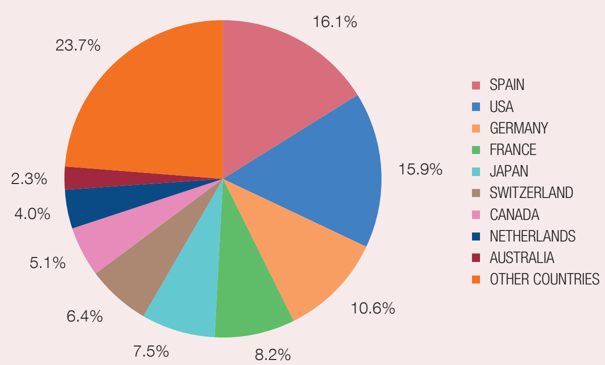
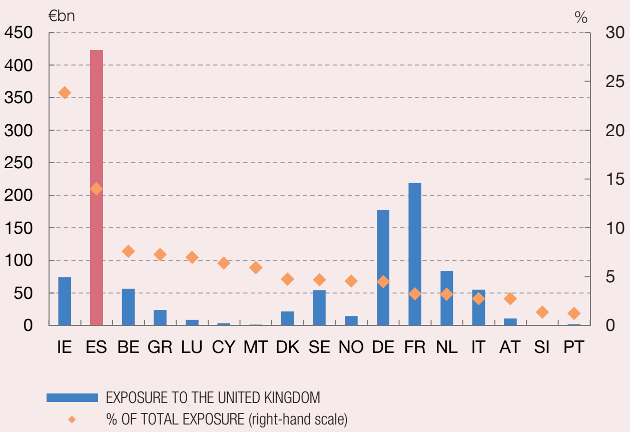


Chart 6
SIGNIFICANCE OF EXPOSURE TO THE UNITED KINGDOM (b)



SOURCES: BIS, EBA and Banco de España.

a Chart 5 shows the outstanding balance of loans based on the direct counterparty according to the consolidated banking statistics (CBS) of the BIS.
b Chart 6 shows the credit exposure to the United Kingdom of the main banks in EU countries (other than the United Kingdom), and the weight in total exposure.

4 See CBS (2019) of the BIS.

5 See transparency exercise (2018) of the EBA.

Box 1.1

SPAIN'S MACROECONOMIC AND FINANCIAL EXPOSURE TO THE UNITED KINGDOM IN THE EVENT OF A NO-DEAL BREXIT (cont'd)

Chart 7
SPANISH BANKS' EXPOSURE TO THE UNITED KINGDOM
June 2019

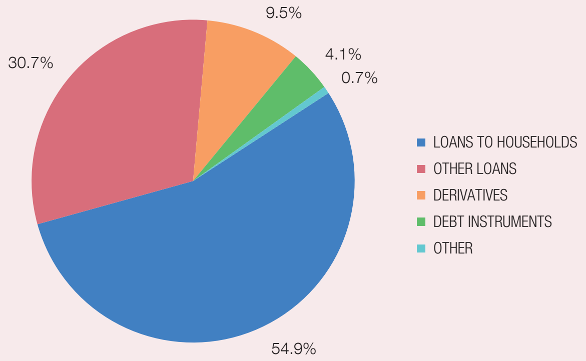
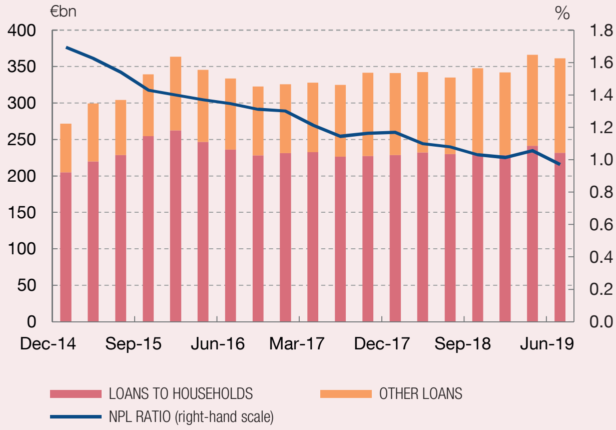


Chart 8
SPANISH BANKS' LOANS IN THE UNITED KINGDOM
June 2019



SOURCES: BIS, EBA and Banco de España.

In terms of financial institutions' operations, a disorderly Brexit could also give rise to financial market turbulence and to risks to Central Counterparty Clearing House (CCP) operations. In the latter case, mitigating measures have been adopted both in Europe and in Spain. The European Commission has expanded its consideration of CCPs that are eligible to operate with European financial institutions.[6]

In Spain, the government approved Royal Decree-Law 5/2019 of 1 March 2019 to ensure the continuity of financial contracts in case of a no-deal Brexit, including a requirement for British financial institutions operating in Spain to adapt their operations to national regulations as well as a transitional arrangement to facilitate this adaptation without disrupting operations.[7]

6 In December 2018 the European Commission issued an implementing decision determining, for a limited period of time, that the regulatory framework applicable to CCPs in the United Kingdom is equivalent to that existing for CCPs within the European Union in accordance with Regulation (EU) No 648/2012. The expiration date is 30 March 2020. A decision on equivalence, temporary and conditional, of the framework applicable to central securities depositories (CSDs) was also adopted. It expires on 30 March 2021.

7 See Royal Decree-Law 5/2019 and briefing note of the Banco de España.