

Consumption Outlook

1H14

BBVA Research – Madrid, 17 June 2014

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Key Messages

- 1 **The global economic cycle is improving.** Expansion in developed economies is offsetting the slowdown in emerging markets. There are risks, but these are not systemic
- 2 **Spain: upside bias in growth**, which will be above 1% in 2014 and around 2% in 2015 ...
- 3 **... but reforms must continue**
- 4 **Private consumption is undoubtedly recovering, particularly durable goods.** Causes: better fundamentals, more financing, less uncertainty and the PIVE programme (incentivising purchase of energy-efficient cars)
- 5 **Substituting national products for imported goods**, as a result of changing preferences, accounts for 60% of the fall in consumption imports during the crisis
- 6 **Lower-income households are bearing higher inflation** because they concentrate their consumption on products whose prices are more rigid to the downside

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On Spanish households' consumption habits: import substitution and inflation differentials between households

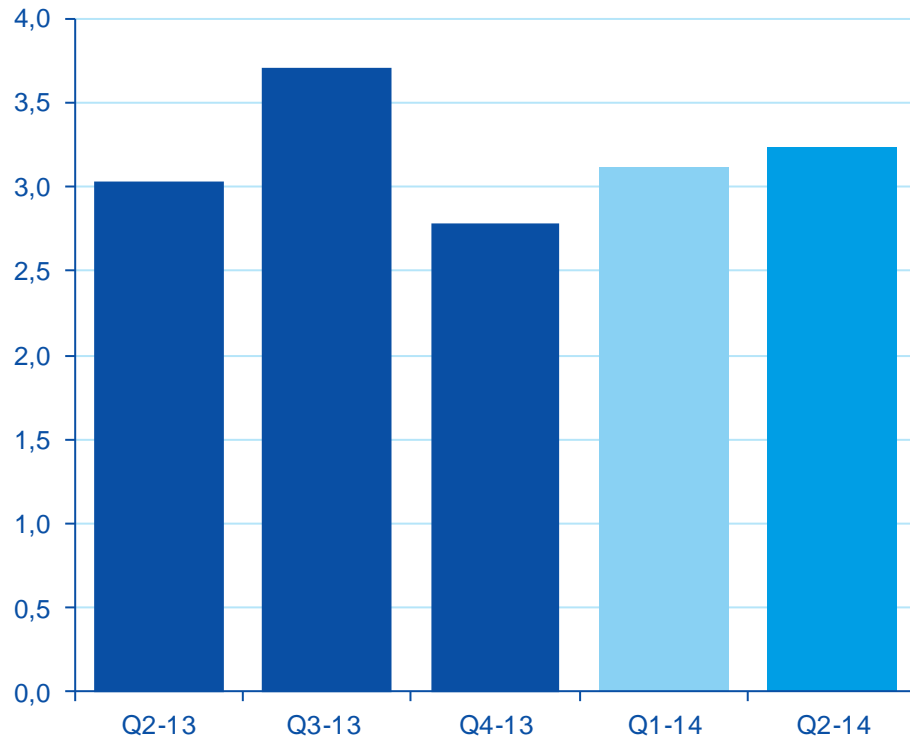
Section 1

The world economy improves

World GDP growth

(Annualised quarterly % rate based on BBVA-GAIN)

Source: BBVA Research



World economic growth remains at over 3%

The expansion of developed economies offsets the slowdown in emerging markets...

... despite the improvement in their financial conditions

Section 1

The world economy improves

US: growth in line with forecasts (2.5%)
The Fed will end tapering by the end of 2014 and will start to raise interest rates in the second half of 2015

Emerging economies: the end of QE in the US is an event with global impact in financial markets, but there will still be great differentiation between emerging markets

China: adjustment to the downside of growth outlook (7.2%) because of recent moderation and the shift in economic policy targets, although with room for manoeuvre

EMU: Domestic demand will contribute to recovery in 2014 (1.1%) and 2015 (1.9%), especially investment

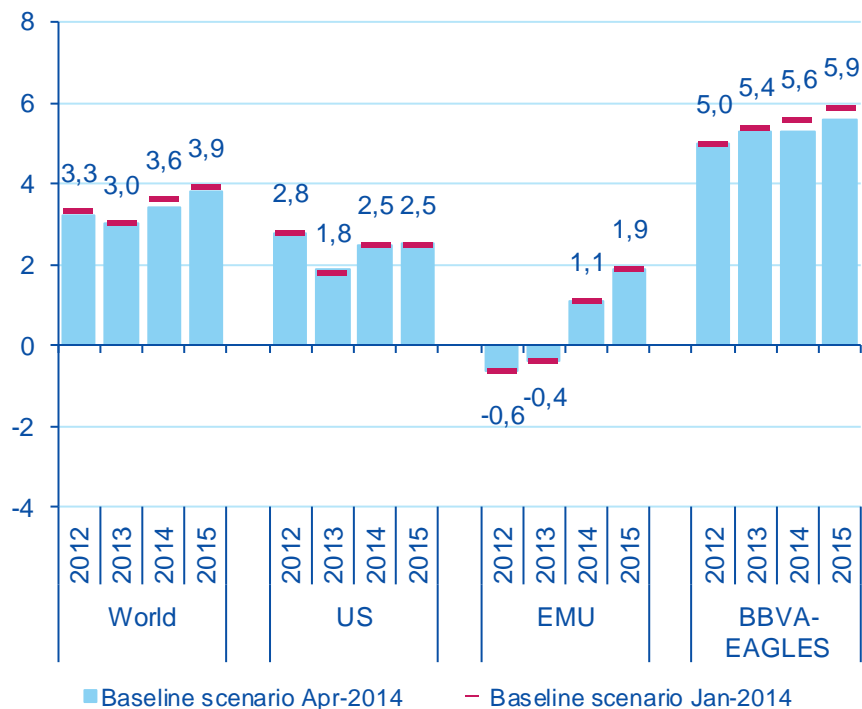
Banking Union should support credit recovery.
The strength of the euro and “too low inflation for too long” are dragging down on the recovery

Section 1

Favourable outlooks, pending risks

Economic growth (%)

Source: BBVA Research



Global expansion will continue, with some uncertainty but without immediate systemic risks

Risks on the horizon: tightening monetary policy by the Fed and slowdown in China

Heterogeneous impact on emerging markets

Section 1

Growth drivers in the eurozone

1. The available data are favourable, particularly confidence

2. The financial environment has improved, especially on the periphery

3. Fiscal policy is less restrictive

4. Unprecedented measures by the ECB to re-establish its monetary-policy's transmission mechanism. ECB ready to offer further support

5. In general terms, banking union is progressing

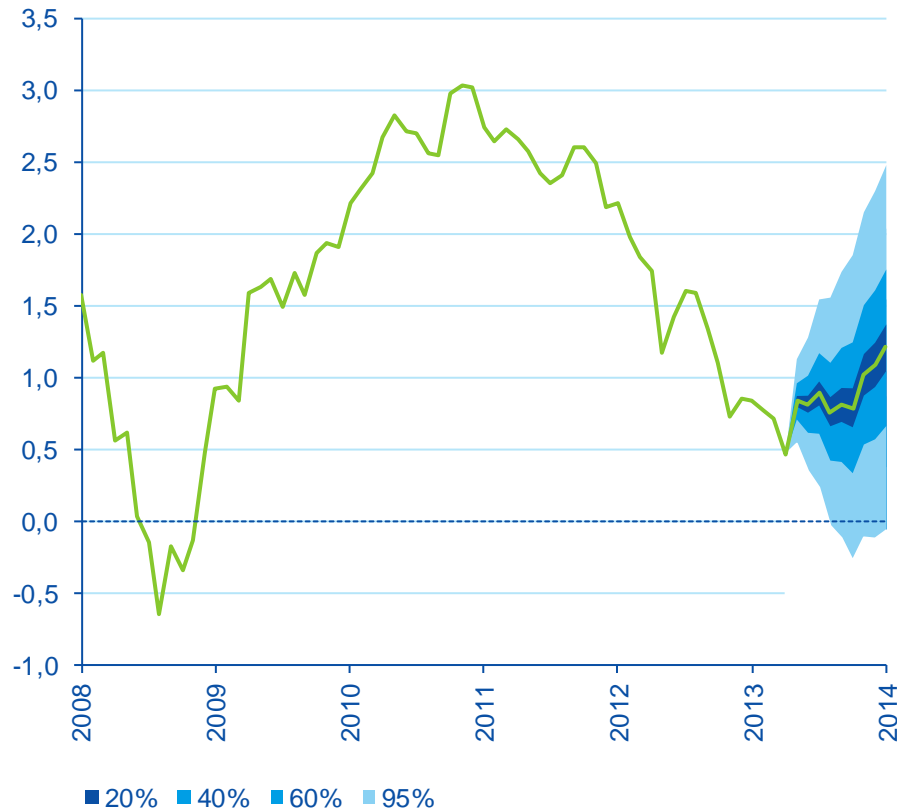
6. The external environment is favourable, but the euro is very strong

Section 1

Risks are bounded

Inflation in the eurozone (% YoY)

Source: BBVA Research



Surprises to the downside in inflation have increased the risk of unanchored expectations

The strength of the euro and the fall in prices of raw materials are exerting pressure to the downside on inflation ...

... but the recovery underway in demand and the improvement in the credit supply reduce the risk of deflation

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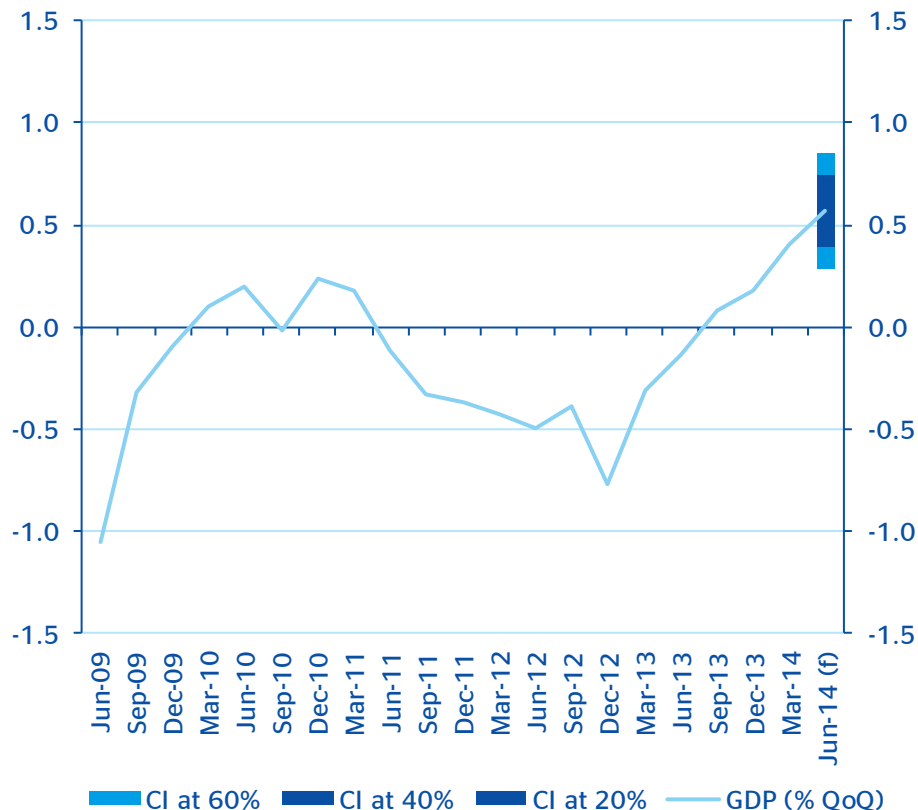
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On Spanish households' consumption habits: substituting imports and inflation differentials between households

The Spanish economy's recovery accelerates

Spain: GDP growth and MICA-BBVA forecasts (% QoQ)

Source: BBVA Research based on INE



The economy has grown for three consecutive quarters, and more strongly in 1Q14 (0.4% QoQ) ...

... thanks to better fundamentals, less need for fiscal adjustment, mitigation of some uncertainties and import substitution

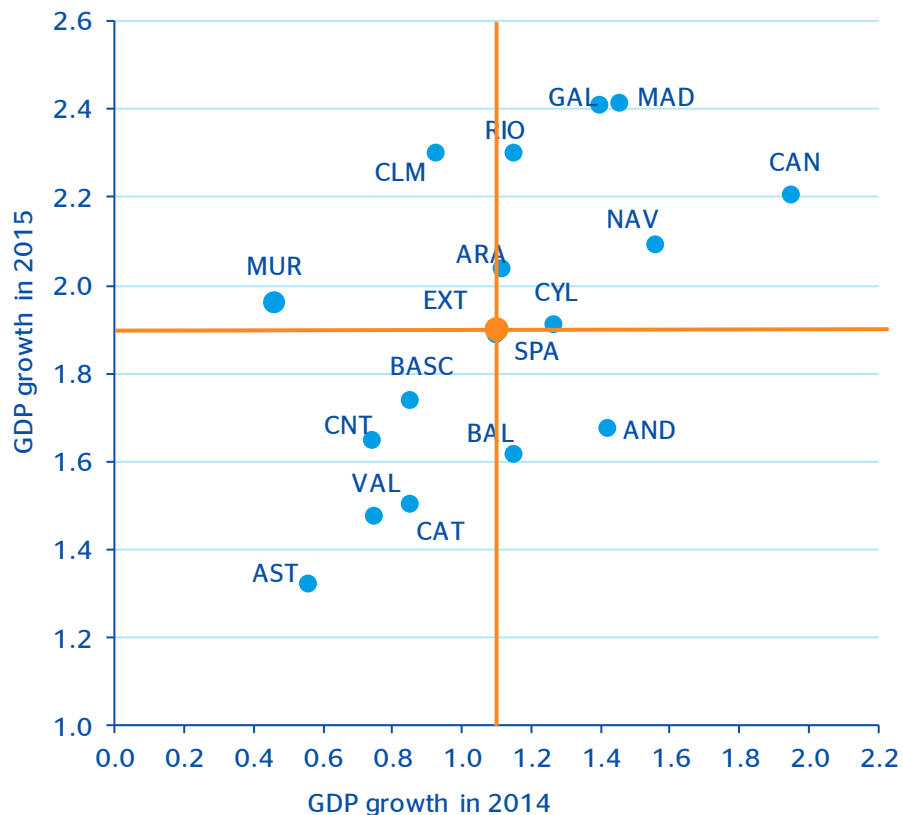
If the favourable start to 1Q14 were to consolidate in the next few months, growth could accelerate again, granting a rate above 1% in 2014

Section 2

The Spanish economy's recovery accelerates

Spain: GDP growth by region (%)

Source: BBVA Research



We have revised 2014 GDP growth upwards, from 0.9% to 1.1%, and we maintain our 1.9% forecast for 2015

Regional growth is heterogeneous. Progress in correcting imbalances and exposure to foreign demand ...

... are key to explaining the regions' different growth rates

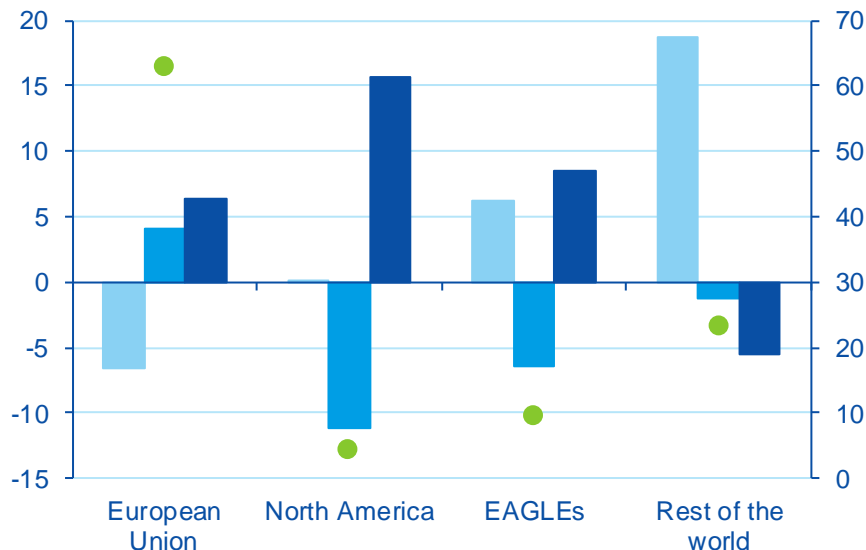
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Some uncertainties have been resolved

1 Exports continue to grow

Spain: growth and composition of goods exports by geography

Source: BBVA Research based on Datacomex



- Nominal growth, 1Q13 average % YoY (LHS)
- Nominal growth, 4Q13 average % YoY (LHS)
- Nominal growth, 1Q14 average % YoY (LHS)
- Exports share, % (RHS)

Declining activity in emerging markets accounts for the temporary slowdown in goods exports observed in the last two quarters

Competitiveness continues to improve through decreasing ULCs, which helps both exports and the process of import substitution

On average, three quarters of the export growth during the crisis is accounted for by geographic and product diversification

Section 2

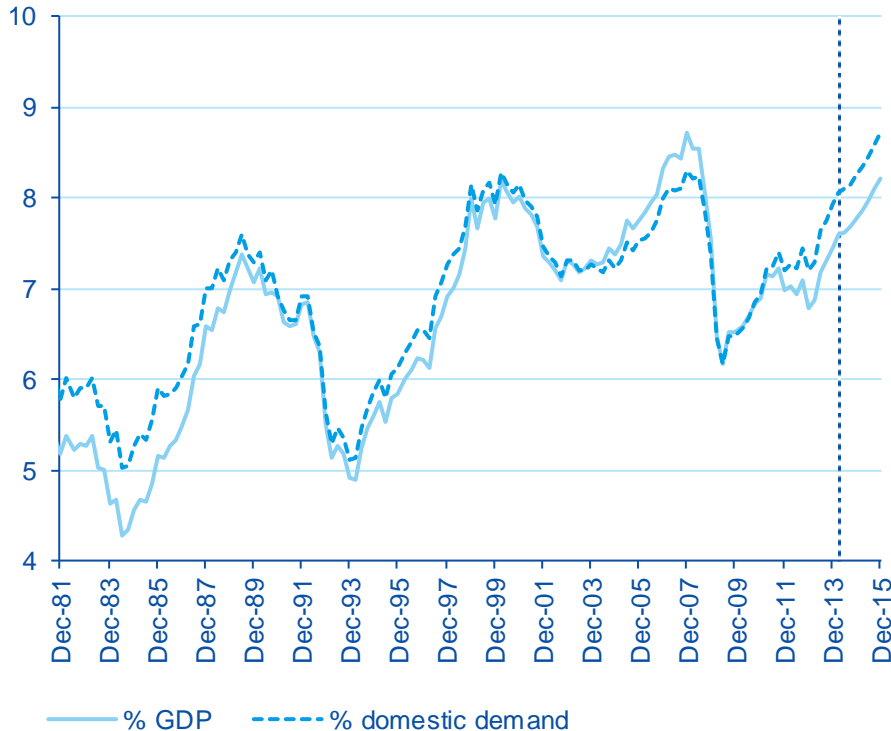
Some uncertainties have been resolved

2 Investment gathers pace

Spain: investment in machinery and equipment (M&E)

(Real ratios at 2008 prices)

Source: BBVA Research based on INE



Whereas in Europe as a whole investment in M&E has grown 8.3% since it bottomed-out in 2Q09, in Spain it has grown by 17.6%

Today M&E investment represents around 45% of the total and more than 8% of real domestic demand (all-time high)...

... which is consistent with the change in productive model oriented towards the external sector

Section 2

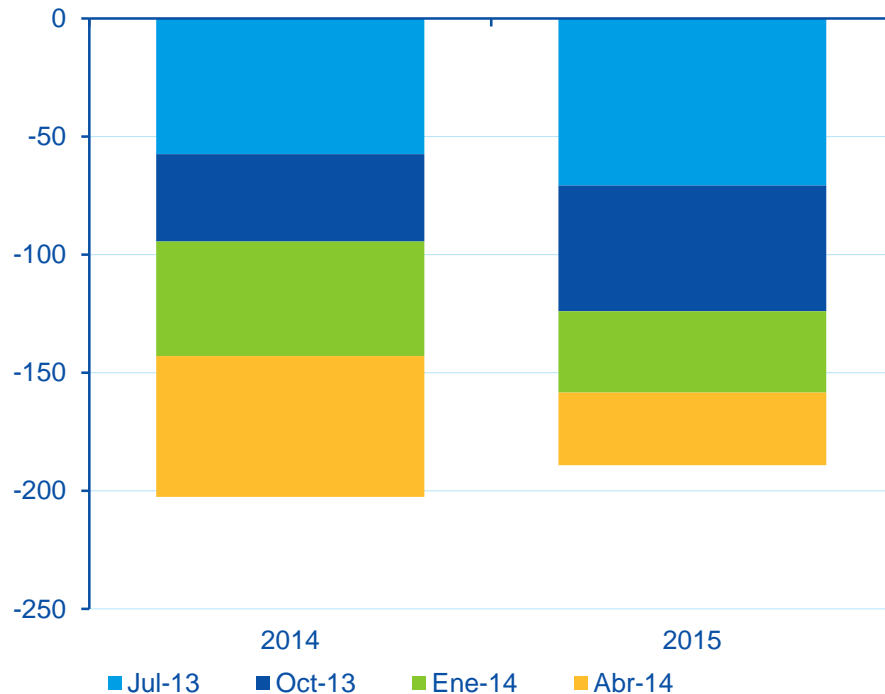
Some uncertainties have been resolved

3 Lower financial tensions

Spain: 10-year bond yield

(Difference vs. previous forecasts in bp)

Source: BBVA Research



Improved perceptions abroad have reduced dependence on the ECB and also improved access to wholesale markets for large companies

Lower financial tensions are felt in the economy with a six- to nine-month time lag

A permanent drop of 100bp in sovereign yields implies up to 1% more growth for the economy

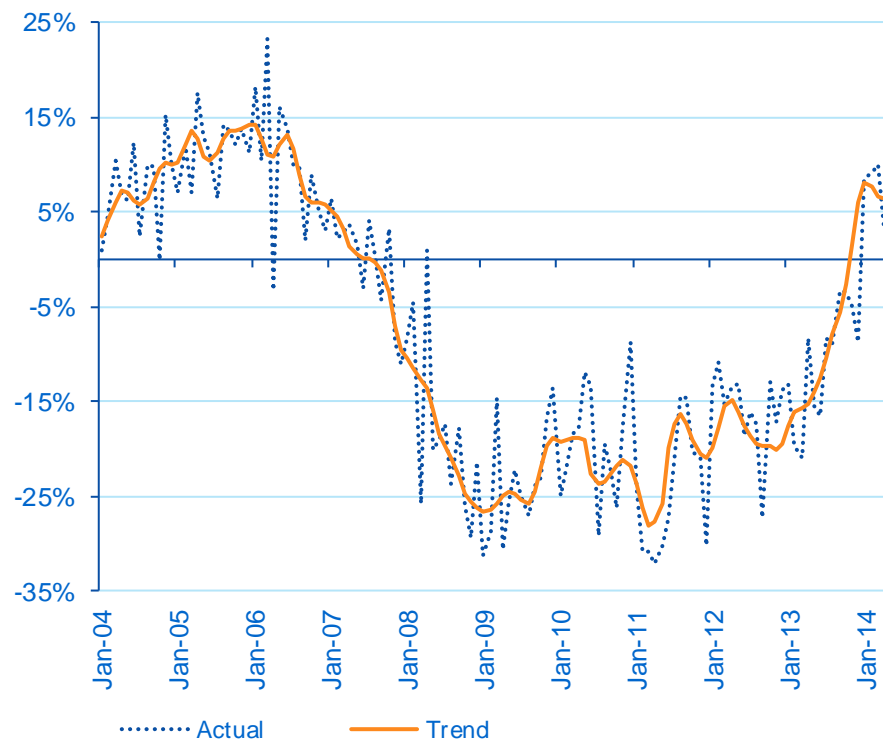
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4 New credit flows are improving

Spain: new retail credit operations (% YoY)

Source: BBVA Research based on Bank of Spain



The Spanish economy is going through an unavoidable deleveraging process ...

... which is compatible with credit availability for solvent projects

A turning point is already visible, together with an improvement in credit flows to households and SMEs, which will be strengthened throughout 2014

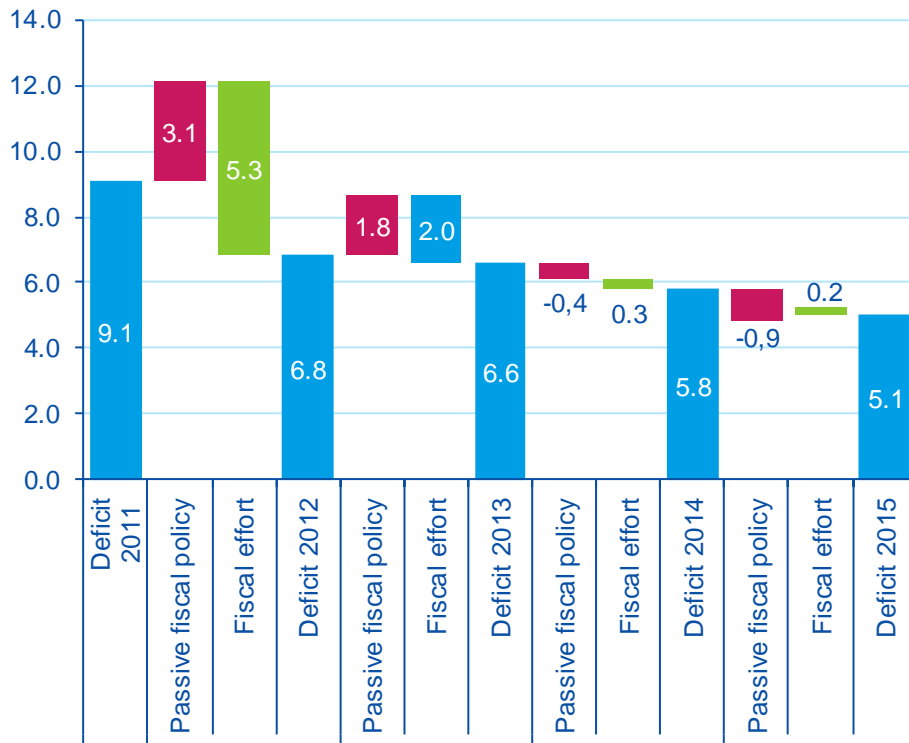
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Some uncertainties have been resolved

5 Meeting fiscal targets

Regions: breakdown of public deficit, excluding aid to the financial sector (% GDP)

Source: BBVA Research based on MINHAP



The fiscal effort made at the end of 2013 and the recovery both significantly increase the likelihood of meeting targets in 2014 ...

... although doubts remain over how public revenues will respond to economic growth and the impact of the reform of local corporations

Meeting the 2015 targets will depend on the impact of the tax reform and the measures passed with the official budget

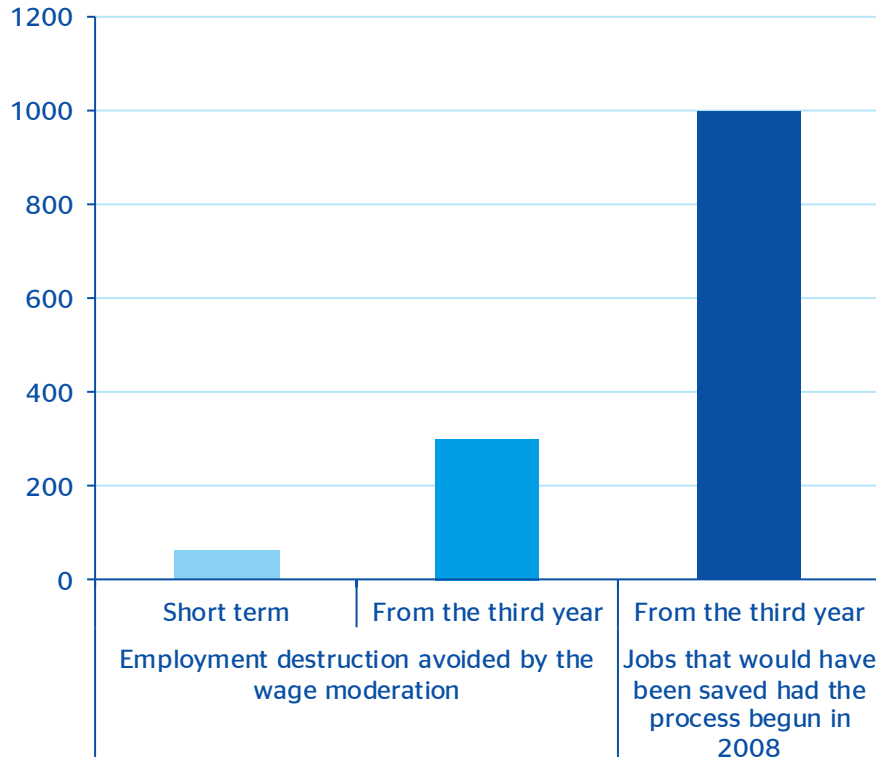
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6 Impact of reforms

Spain: impact of the wage restraint in 2012 on employment ('000s of full-time-equivalent jobs)

Source: BBVA Research



Some of the reforms introduced in the last few years are starting to have a positive impact ...

... such as labour reform. Job-creation has begun earlier than expected

Structural changes will imply that employment will respond more rapidly to economic recovery

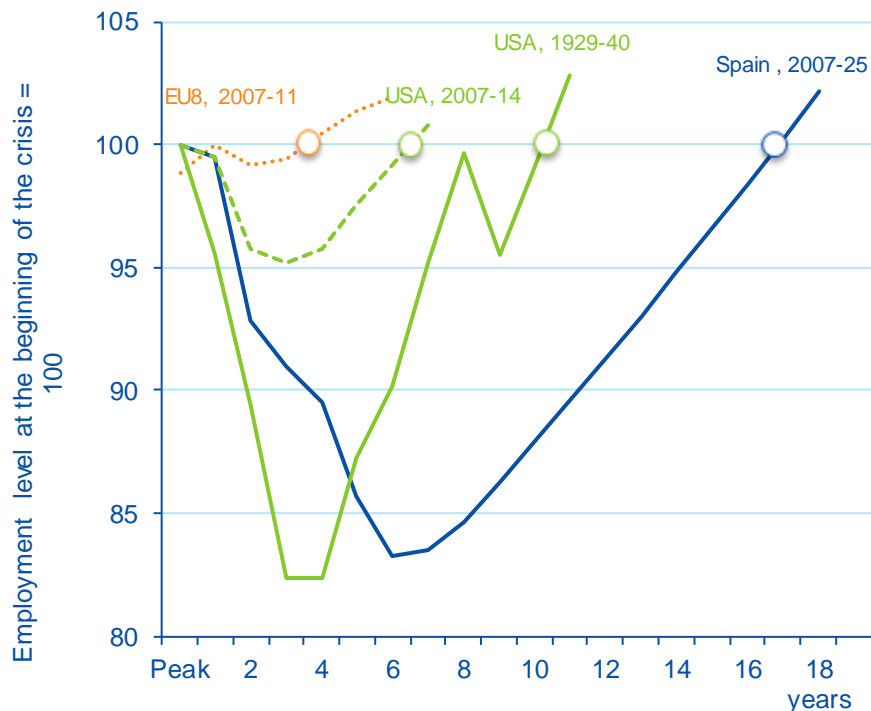
Section 2

The need to go further with the reforms

Employment performance

(Employment level at the beginning of each crisis = 100)

Source: BBVA Research based on Andrés and Doménech (2012)



Urgent short-term goal: reduce the unemployment rate

But the labour market's problems go deeper: collective bargaining, two-tier system and employment policies

Wage flexibility to win back productivity (Δ of employment and W) and more competition (margin reduction)

Target for GDP growth: 2.5% to 2025

Section 2

The need to go further with the reforms

1. Complete the restructuring of the financial sector and deleverage to improve financing in the Spanish economy and attract FDI

2. Public administration reform, fiscal consolidation and long-term sustainability of public finances, with an efficient fiscal system that incentivises growth and the creation of employment → Experts Committee report

3. Reforms to improve productivity, firm size, competitiveness and the attractiveness of Spain to foreign physical, human and technological capital

4. Going further with reforms that improve the effectiveness of active employment policies, reduce the two-tier nature of the labour market and make it work better → more employment, and of higher quality

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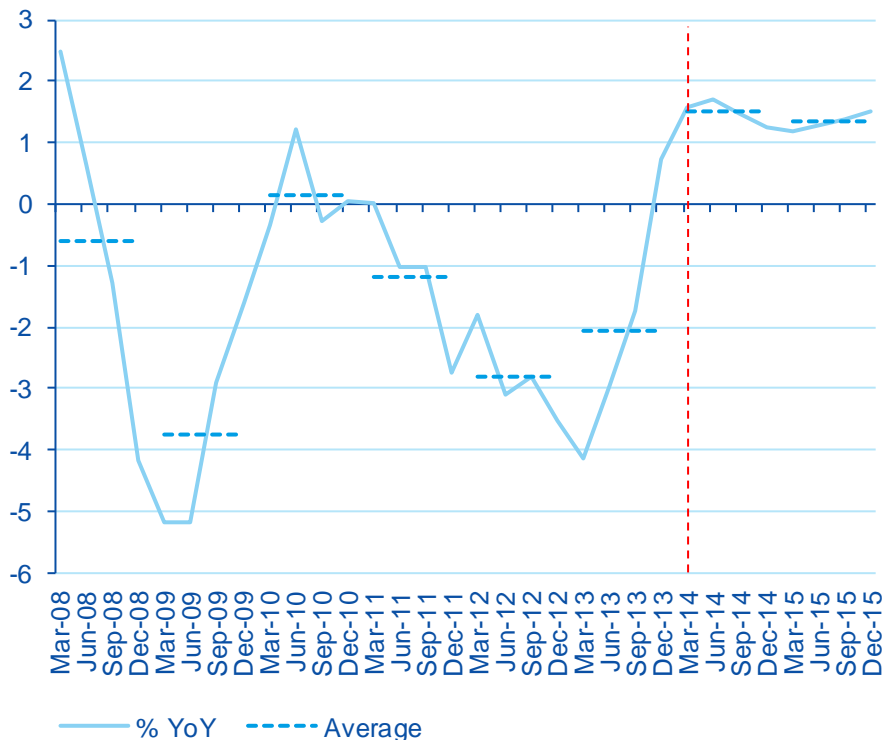
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Private consumption is undoubtedly recovering

Spain: growth in private consumption

(%)
Source: BBVA Research based on INE



What are the drivers of the improvement in consumption?

Disposable income:
change in the labour market cycle

Wealth:
Increase in financial wealth

Propensity to consume: less uncertainty

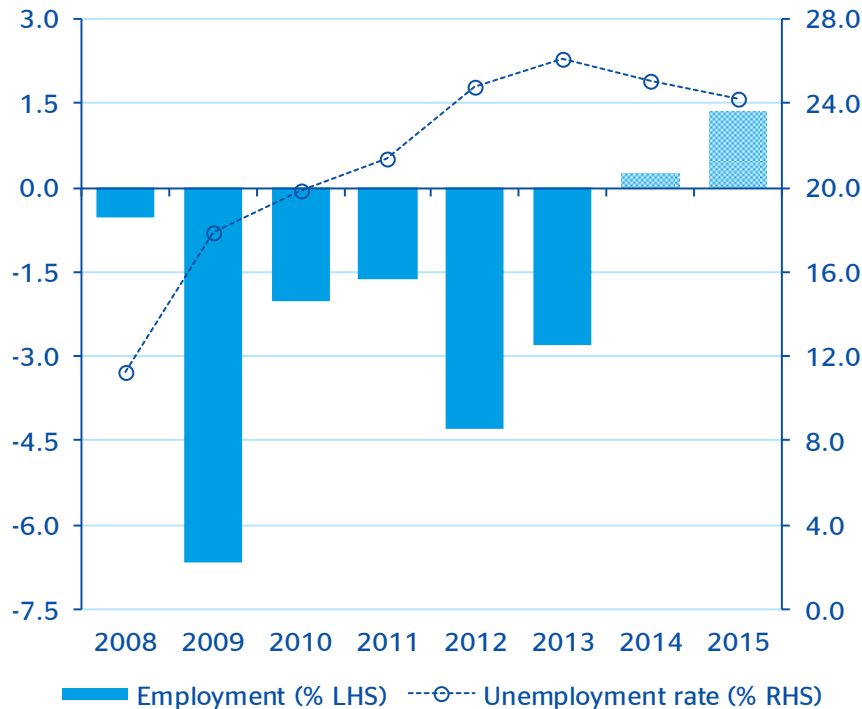
Borrowing capacity:
Household: increase in financing
Public sector: PIVE

Section 3

Private consumption is undoubtedly recovering

Spain: employment and unemployment rate

(%)
Source: BBVA Research based on INE



1. Cyclical change in the labour market

The labour market reform has enabled a readjustment of the balance between quantities (employment) and prices (wages)

The economy has started to create employment in 1H14

Sustained reduction in the unemployment rate will arrive in 2H14

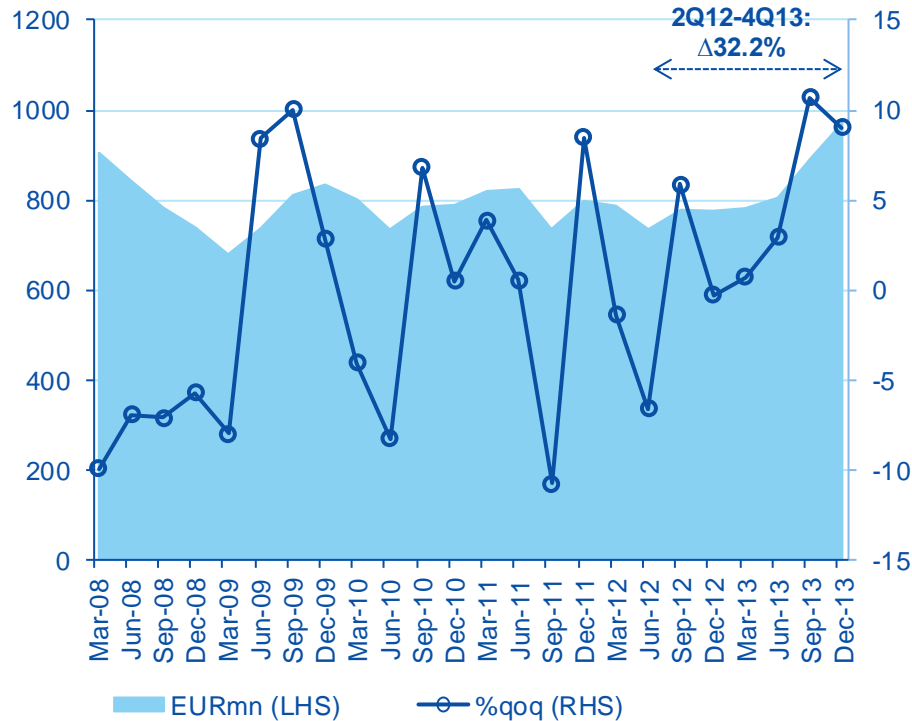
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Private consumption is undoubtedly recovering

Spain: real net financial wealth

(Deflated with the consumption deflator, swda data, %)

Source: BBVA Research based on Bank of Spain



2. Increase in net financial wealth

Reductions in financial tensions → recovery of share prices and reduction in borrowing costs → Δ in financial wealth

BBVA Research: Δ of 1% per quarter in real net financial wealth → accumulated Δ in private consumption of 0.2% over the following four quarters

Real net financial wealth: Δ32.2% since 2Q12 → Δ5.5pp of growth in consumption to 4Q14

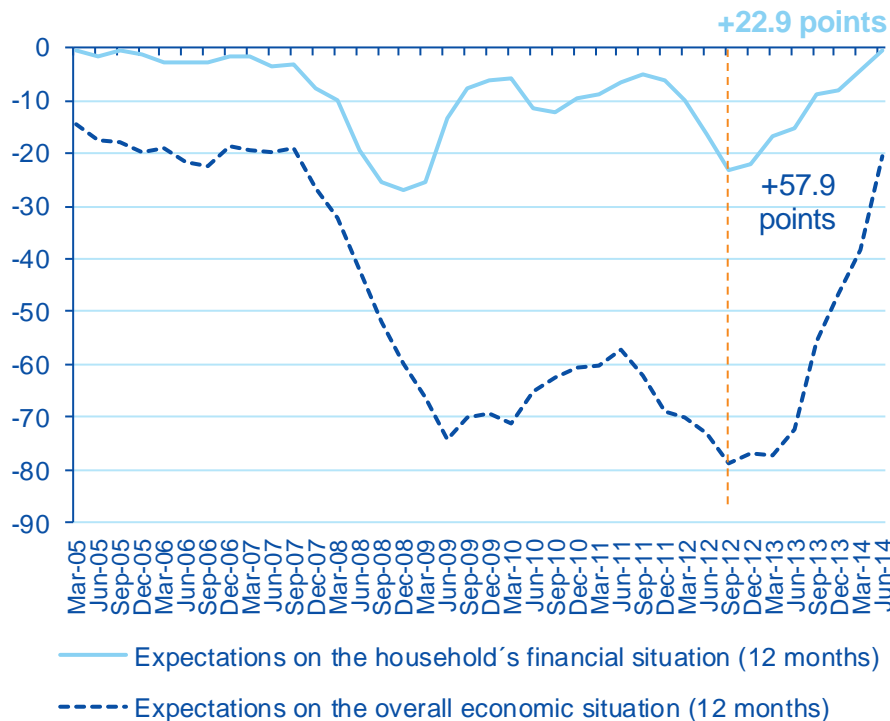
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Spain: household perceptions of the economic situation

(swda data, quarterly averages, balance of answers)

Source: BBVA Research based on EC



3. Less uncertainty

On the macroeconomy: the perception of the Spanish economy is at pre-crisis levels

On the microeconomy: perceptions of households' own financial situation is as high as it has been for the last decade

The reduction in uncertainty is an incentive to consume, at the expense of saving $\Delta 10$ points in confidence $\rightarrow \Delta 1.2$ points in consumption in the next 3 years

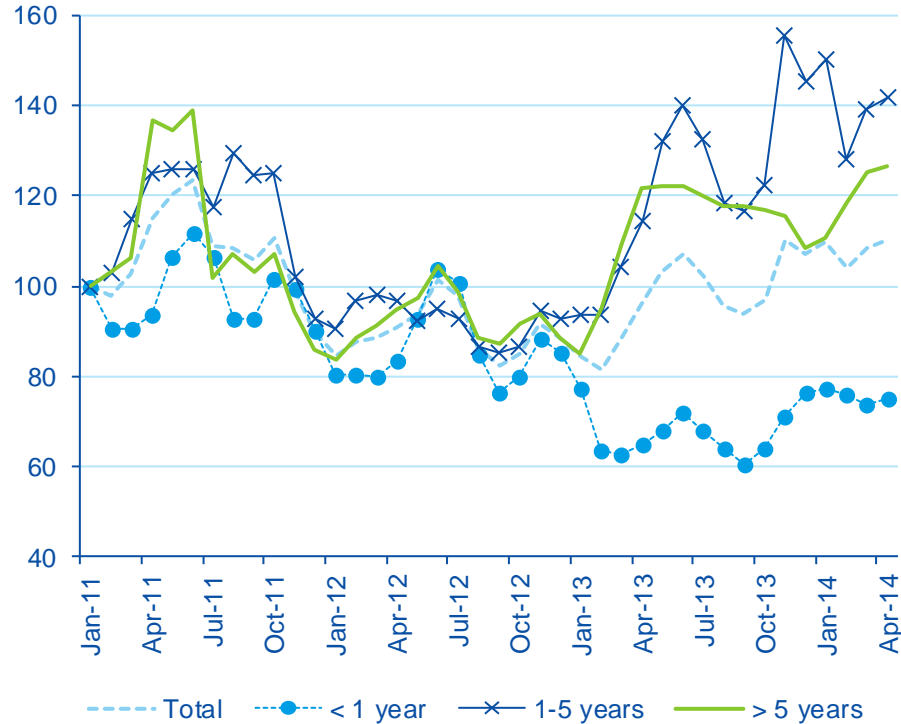
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Spain: new consumer financing operations

(3rd order centred moving average. Jan 11 = 100)

Source: BBVA Research based on Bank of Spain



4. Improvement in financing (I)

New consumer credit operations have grown at double-digit rates between January and April ...

... driven by the increase in short-, medium- and long-term financing

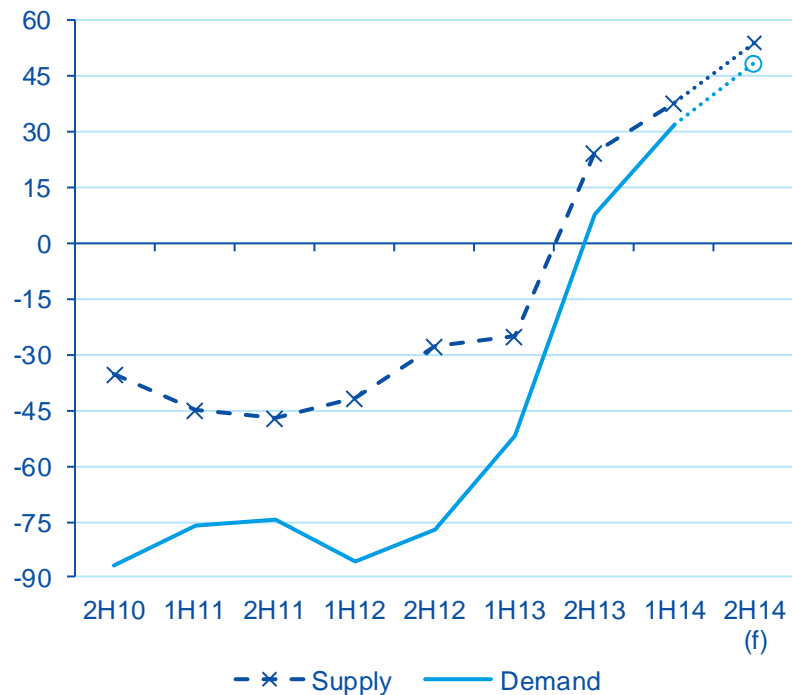
... in a context of decreasing outstanding credit and high interest rates
 Consumer credit/Spain GDP=5.9%=EMU

Section 3

Private consumption is undoubtedly recovering

BBVA business trends survey: perceptions of consumer credit supply and demand

(Balance of replies. A value <0 indicates deterioration)
 Source: BBVA Research



4. Improvement in financing (II)

The BBVA Business Trends Survey (BTS) in 2H13 already anticipated an increase in financing

BTS for 1H14: those surveyed think that credit has performed favourably in all retail trade activities...

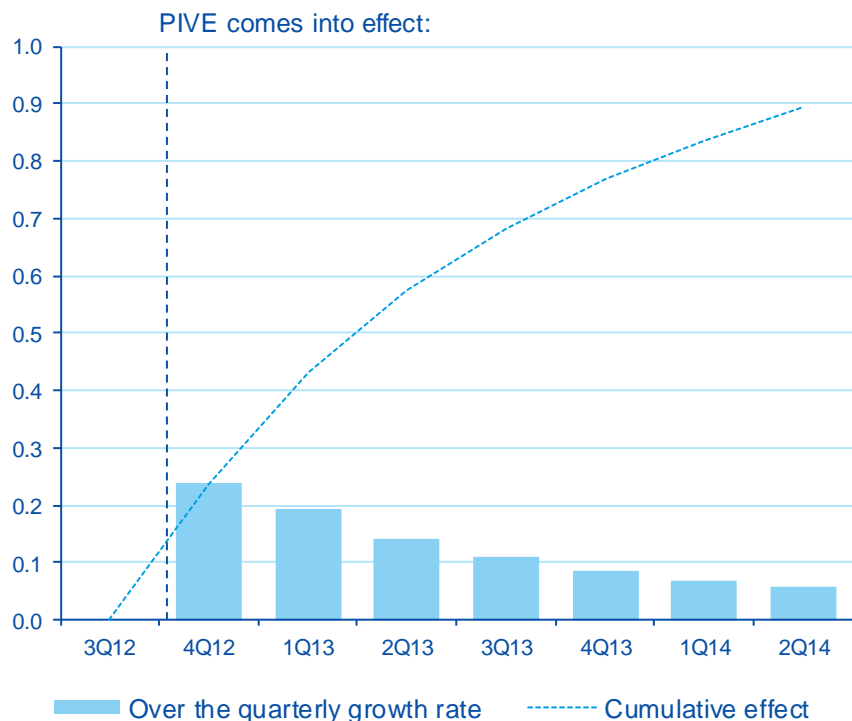
... and that it will continue to do so in the second half of the year

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Private consumption is undoubtedly recovering

Spain: effect of the PIVE car programme on private consumption

(pp of the quarterly growth rate)
Source: BBVA Research



5. Fiscal stimulus: PIVE

The PIVE programme has limited the negative and permanent effect on consumption caused by the increase in VAT in September 2012

Δ VAT \rightarrow a fall of 300k new car registrations between October 2012 and May 2014 if the PIVE plan had *not* been approved. The subsidy has meant this fall was restricted to 53k vehicles

The effect on private consumption is 0.9% since 4Q12

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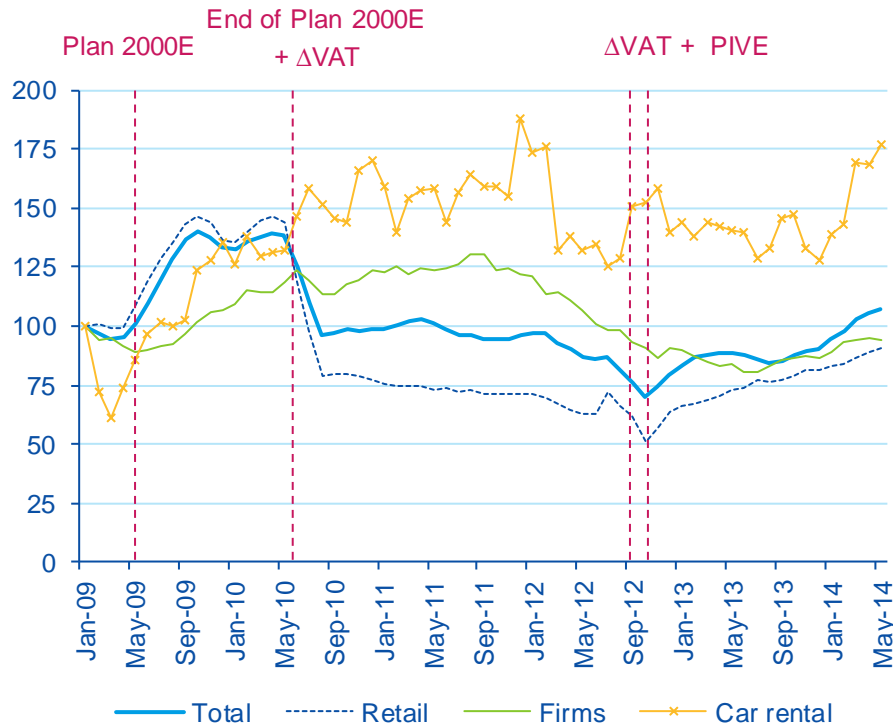
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Spending on durable goods takes off

Spain: new car registrations, by channel

(swda figures, MA3, Jan 09 = 100)
Source: BBVA Research based on ANFAC and GANVAM



Cars: sales are still driven by the PIVE programme

The private channel is the main responsible for the increase in registrations (2.3x since the 1st PIVE came into force)

...

...together with an increase in demand from car rental firms and, to a lesser extent, from companies (renting)

The second-hand/new vehicle ratio has fallen: 1.9 to May 2014 vs. 2.1 to May 2013

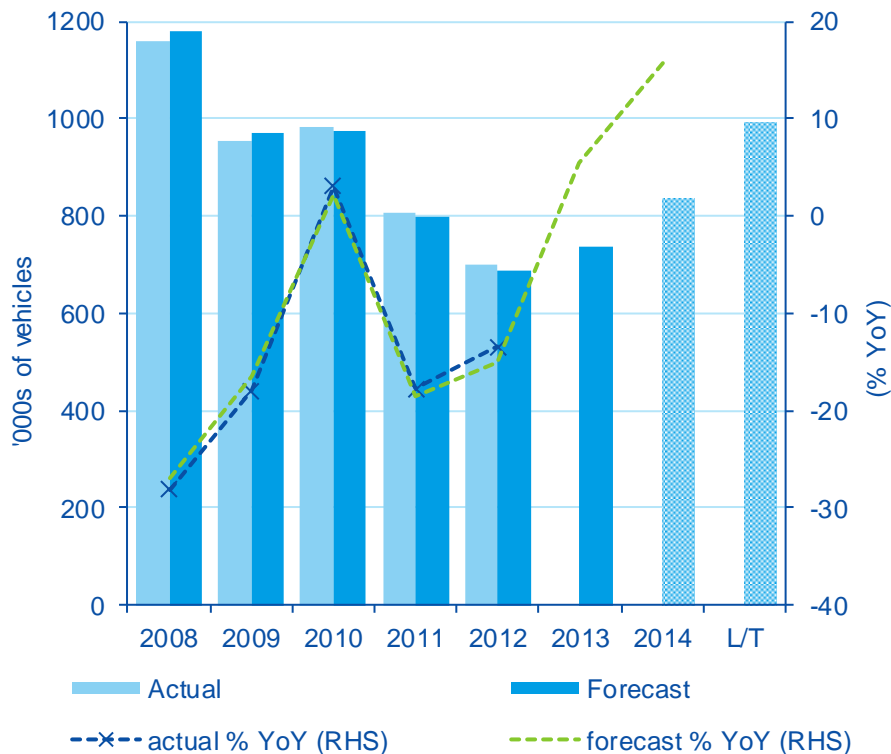
... but the country's total car fleet is still aging (51.7% of cars are 10+ years old); average age ≈ 11.3 years old

Section 4

Spending on durable goods takes off

Spain: forecast new car registrations

Source: BBVA Research



PIVE extension → rise in car registrations in 2014

2014: 840k units (15.5% more than in 2013)

2015: numbers will depend on whether the subsidy is continued or not
 $\Delta 2.5\%$ if current conditions are continued through to the first half of the year

Drivers (per capita income, unemployment, relative prices and interest rates) are now favourable

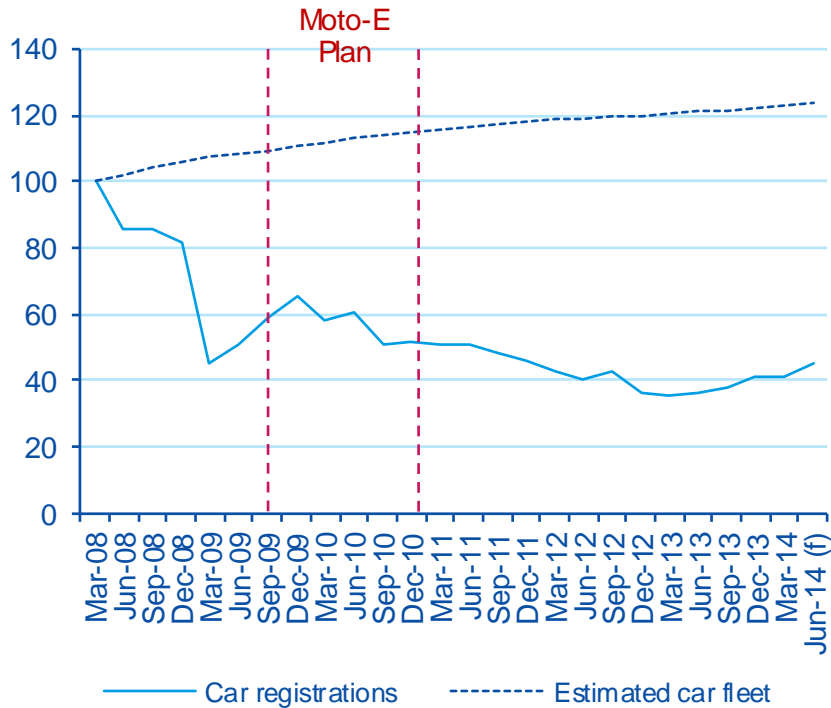
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Spending on durable goods takes off

Spain: new motorbike registrations and estimated fleet

(CVEC data, 1Q08 = 100)

Source: BBVA Research based on Bank of Spain Anesdor



Motorbikes: the recovery consolidates

1H14: double-digit growth

Drivers: improved expectations by potential buyers, increased availability of finance and the unavoidable renovation of the fleet

2014: 112k new motorbike registrations (Δ16.7%)

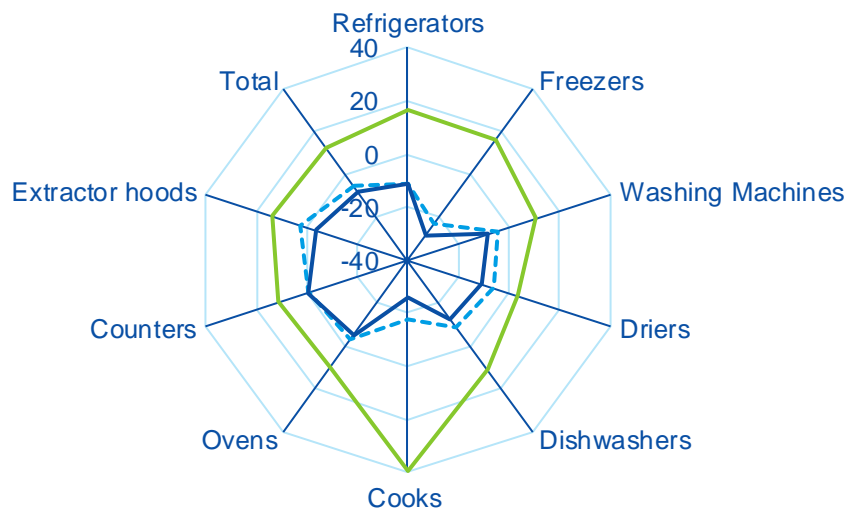
Section 4

Spending on durable goods takes off

Spain: white goods sales per household

(% YoY in unit terms)

Source: BBVA Research based on ANFEL



----- 2013 — Jan-May 2013 — Jan-May 2014

White goods: light at the end of the tunnel

The overall market has halved:
-5.2 million appliances since 2006
(-51.8%)

Sales Jan-May 2014: 12.4% YoY (-5.6% in 2013)
Downward trend in prices → more modest
Δ in turnover (6.1%)

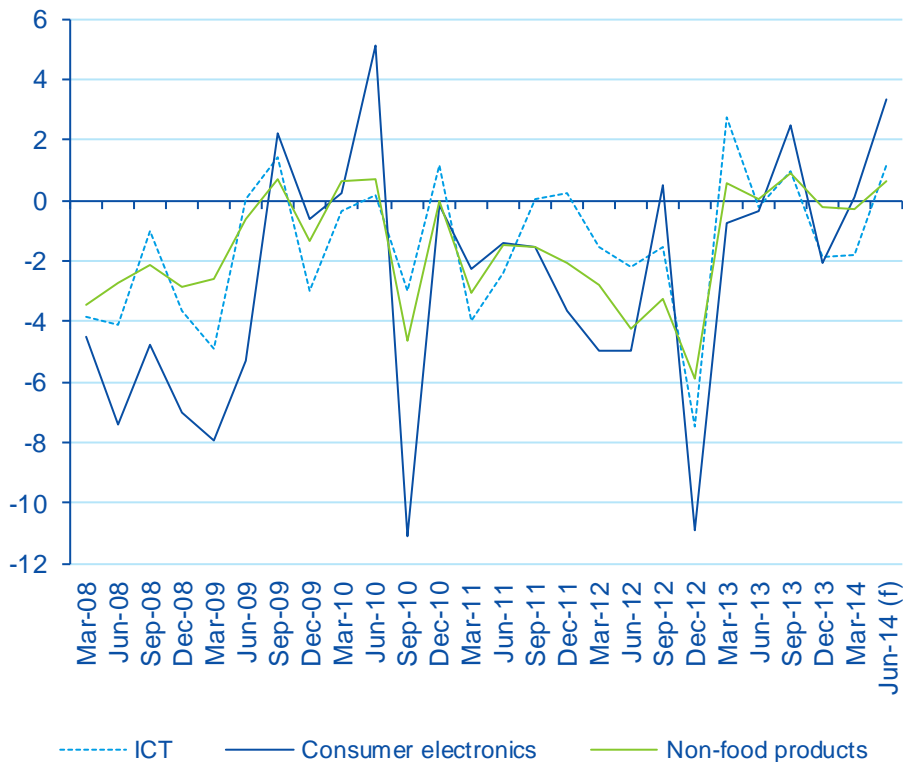
All electrical appliances saw positive YoY growth, the majority in double digits

Section 4

Spending on durable goods takes off

Spain: actual retail sales of brown goods

(swda data, 1Q08 = 100)
Source: BBVA Research based on INE



Brown goods: erratic performance

Sales have been weak since the VAT hike in September 2012 ...

2Q14: recovery in demand for consumer electronics related to the World Cup

Fall in relative prices and in penetration rates
Exceptions: tablets, laptops & mobile phones

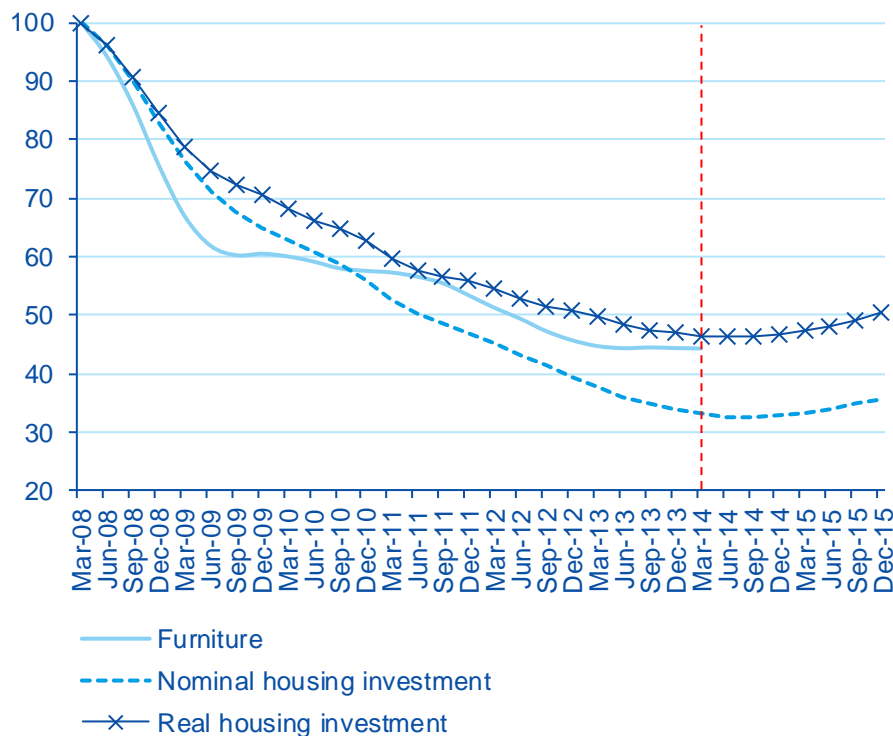
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Spending on durable goods takes off

Spain: turnover of the furniture sector vs. housing investment

(Trend. 1Q08 = 100)

Source: BBVA Research based on INE



Furniture: in a context of increasing demand for housing

Stable turnover, stable prices ... for the fourth consecutive quarter

BBVA Research estimates:
 Δ in nominal investment in housing at 1% QoQ \rightarrow 0.5% cumulative Δ in turnover

House purchases will start to recover over the course of 2014, which should drive consumer demand for furniture starting in 1H15

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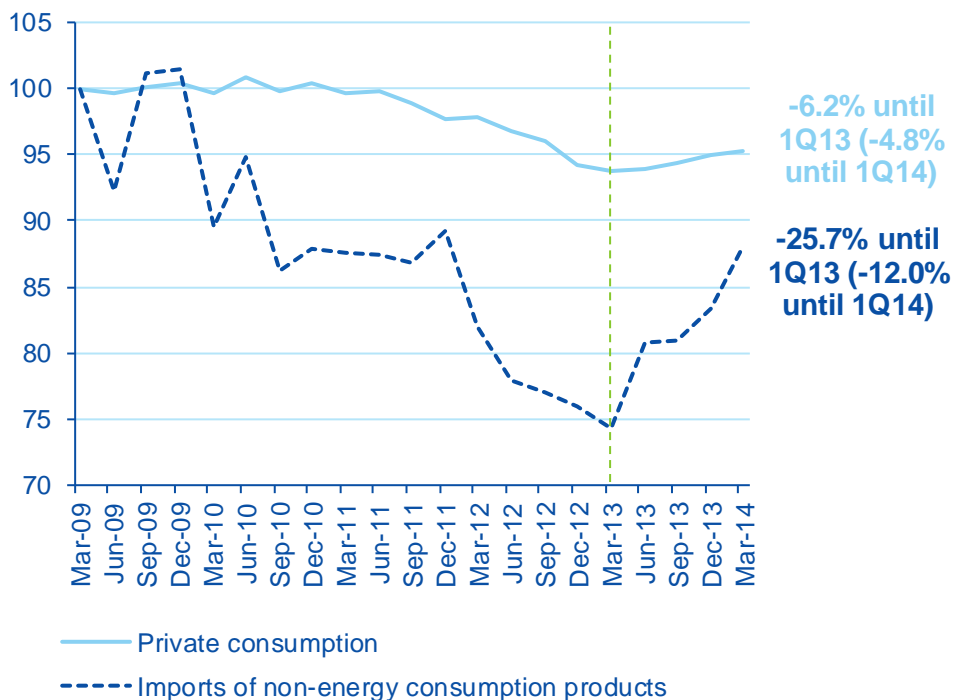
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Are consumer preferences for Spanish-made goods changing?

Spain: private consumption and imports of non-energy consumer goods (Deflated sa data, 1Q09 = 100)

Source: BBVA Research based on INE & Customs



Since the beginning of 2009, consumer goods imports have contracted 12%, more than twice as much as private consumption

Part of the correction is explained by reduced household spending (*income effect*)

And the rest? *Import substitution* by domestic output

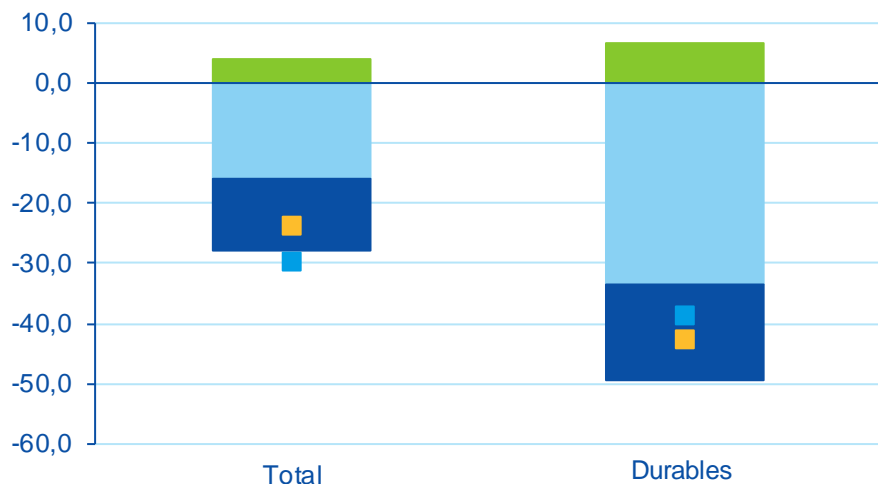
Box 1

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Are consumer preferences for Spanish-made goods changing? Yes, they are

Spain: breakdown of the variation in consumer goods imports into their long-term drivers

(1Q09-1Q13, pp)
 Source: BBVA Research



- Loss (-) / Gain (+) in competitiveness
- Income effect
- Change in preferences
- Total (actual)
- Total (LT explained)

Import substitution could be due to:

- Deterioration in competitiveness – price of foreign-made goods
- Change in households’ preferences towards Spanish-made goods

Results:

- Import sensitivity to income and, above all, to prices has increased during the recession
- Import substitution, cased by changes in preferences, explains two-thirds of the fall in consumer imports ...

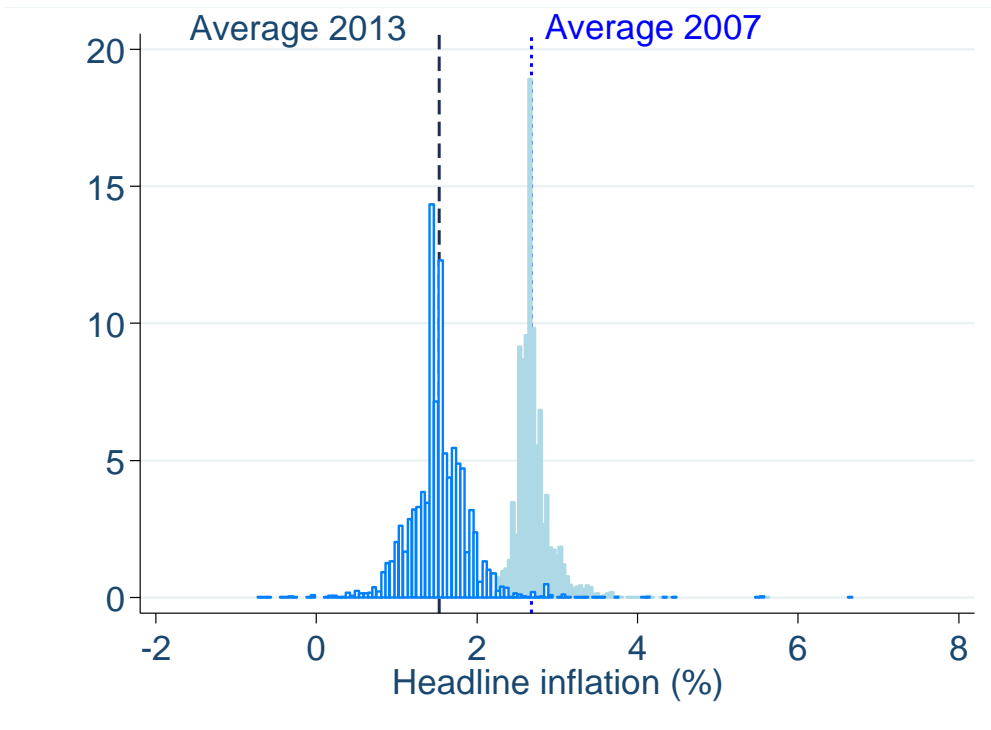
... particularly in durable goods (substitution effect : 70%)

Section 5
My CPI isn't like your CPI: inflation differentials by household

Spain: inflation distribution in 2007 & 2013

(% of households)

Source: BBVA Research based on INE



The apparent simplicity of CPI has facilitated its use as a mechanism for indexing numerous monetary variables (salaries, pensions, etc.)

Nonetheless, it aggregates prices for millions of household baskets → inflation is not the same for all households

Outcome: inflation dispersion is significant and has increased during the crisis

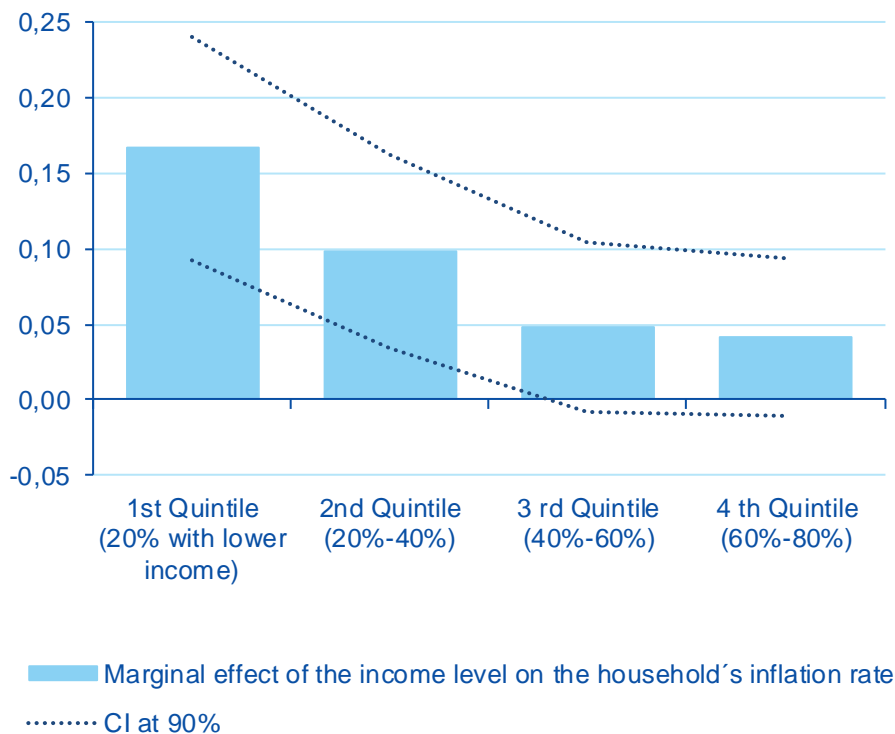
Box 2

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My CPI isn't like your CPI: inflation differentials by household

Spain: estimated inflation differentials by income level

(in pp vs. the 20% of households with higher equivalent income)

Source : BBVA Research



What household characteristics affect the rate of inflation for that household?

Lower-income households face higher inflation because their consumption is concentrated on products whose prices are more rigid to the downside:

- Basic goods (foodstuffs)
- Products subject to regulated prices (alcohol and tobacco)
- A combination of both factors (housing and supplies)

Key Messages

- 1 **The global economic cycle is improving**, supported by the expansion in developed economies
- 2 **Spain is not lagging behind.** Growth is accelerating, but more reforms are still needed
- 3 **Private consumption is undoubtedly recovering**, particularly durable goods
- 4 **Causes: better fundamentals, more financing, less uncertainty and the PIVE programme (incentivising purchase of energy-efficient cars)**
- 5 Lower preference by Spanish consumers for imported products. The role played by the price in purchase decision making has become more and more relevant
- 6 **Inflation differentials among household types is significant.** Lower-income families are bearing higher inflation

Appendix

Baseline Scenario

Spain & Europe: macroeconomic forecasts

Source: BBVA Research based on INE & Eurostat

(% YoY)	2012		2013		2014 (f)		2015 (f)	
	Spain	EMU	Spain	EMU	Spain	EMU	Spain	EMU
Households final consumption expenditure	-2,8	-1,4	-2,1	-0,7	1,4	0,8	1,3	1,3
General government final consumption exp.	-4,8	-0,6	-2,3	0,1	-1,6	0,3	1,4	0,7
Gross fixed capital formation (G.F.C.F.)	-7,0	-3,8	-5,1	-2,9	1,0	3,1	4,7	5,1
Equipment and machinery	-3,9	-4,3	2,2	-1,9	7,9	5,2	6,9	7,0
Housing	-8,7	-3,3	-8,0	-3,6	-3,4	1,1	4,9	3,9
Other constructions	-10,6	-4,7	-10,9	-4,3	-4,0	0,5	1,1	3,2
Changes in inventories (*)	0,0	-0,5	0,0	-0,1	0,0	0,0	0,0	0,0
Domestic Demand (*)	-4,1	-2,1	-2,7	-1,0	0,7	1,0	1,9	1,8
Exports	2,1	2,7	4,9	1,4	6,0	3,1	5,1	4,2
Imports	-5,7	-0,8	0,4	0,0	5,4	3,1	5,4	4,6
External Demand (*)	2,5	1,5	1,5	0,6	0,4	0,1	0,0	0,0
GDP mp	-1,6	-0,6	-1,2	-0,4	1,1	1,1	1,9	1,9
Pro-memoria								
GDP excluding housing	-1,2	-0,4	-0,9	-0,2	1,3	1,1	1,8	1,7
GDP excluding construction	-0,4	-0,2	-0,1	0,0	1,6	1,2	1,8	1,7
Total employment (LFS)	-4,3	-0,7	-2,8	-0,9	0,3	0,1	1,4	0,7
Unemployment rate (% Active pop.)	24,8	11,3	26,1	12,0	25,1	11,9	24,2	11,4
Current account balance (% GDP)	-1,2	1,2	0,8	2,3	1,3	2,2	1,5	2,1
Public debt (% GDP) (**)	86,0	93,0	93,9	95,2	98,4	95,9	100,4	95,5
Public deficit (% GDP)	-6,8	-3,7	-6,6	-3,0	-5,8	-2,6	-5,1	-2,1
CPI (average)	2,4	2,5	1,4	1,4	0,3	0,9	0,9	1,3
CPI (end of period)	2,9	2,3	0,3	0,8	0,5	1,1	1,2	1,4

(*) Contribution to GDP Growth

(**) Excluding aid to the banking sector in Spain

(f): forecast