

Spain Economic Outlook

November 2014

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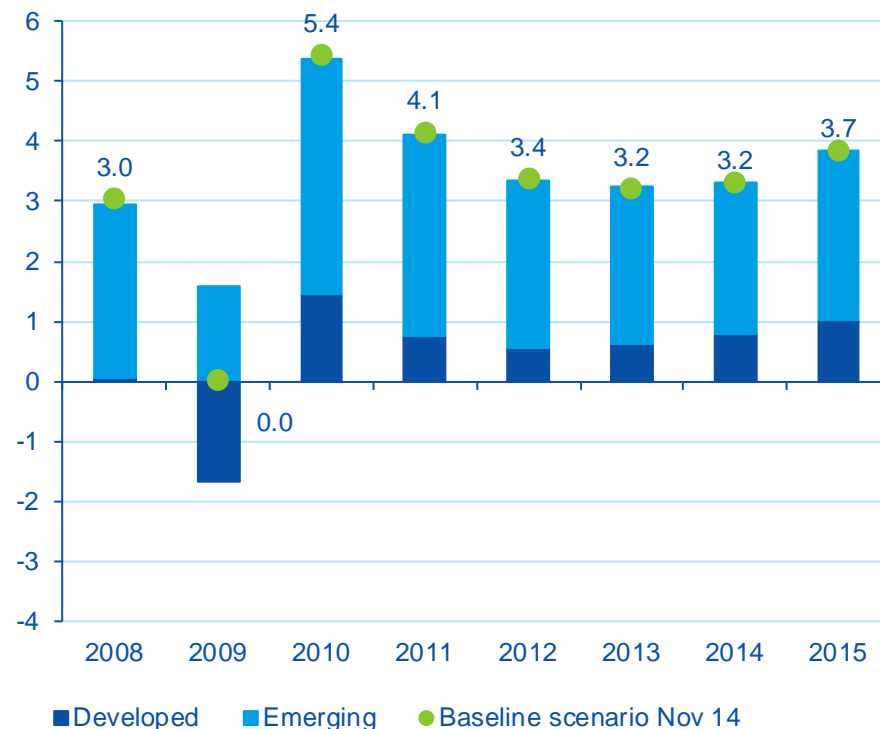
Section 1

World economy: baseline scenario

- 1 **Global growth will accelerate in 2015** despite the downward correction of Eurozone GDP and lower growth in LatAm
- 2 The risk of a hard landing in China is low and the Fed is managing the recovery skilfully, but **geopolitical risks are rising, as are those associated with activity in the EMU**
- 3 The **correction of imbalances among agents is still hindering recovery**

GDP, global growth (%)

Source: BBVA Research



Section 1

World economy: current outlook and risk map

World economy (3.6%)

- Signs of acceleration in international trade
- Asia: No shocks. Mixed data in China. Deceleration in Japan
- Latin America: downward correction in all countries, apart from Mexico (=) and Colombia (↑)
- Risks: geopolitics in the Middle East, the Fed, correction in China, EMU stagnation

USA (2.5%)

- 3Q consistent with our baseline scenario, unemployment under 6%
- *Forward guidance*: rate hike in mid-2015
- Risks: fiscal (high public debt) and long-term stagnation

EMU (<1.5%)

- GDP stagnation in 2Q and 3Q, low inflation expectations for the long term
- Interest rates and premia going downwards, EURUSD depreciation < 1.22? QE in public debt?
- Risks: geopolitical in Ukraine and sanctions on Russia, exhaustion of demand-side policies
- AQR/ST: major progress in transparency and SSM. Solvency is not a problem

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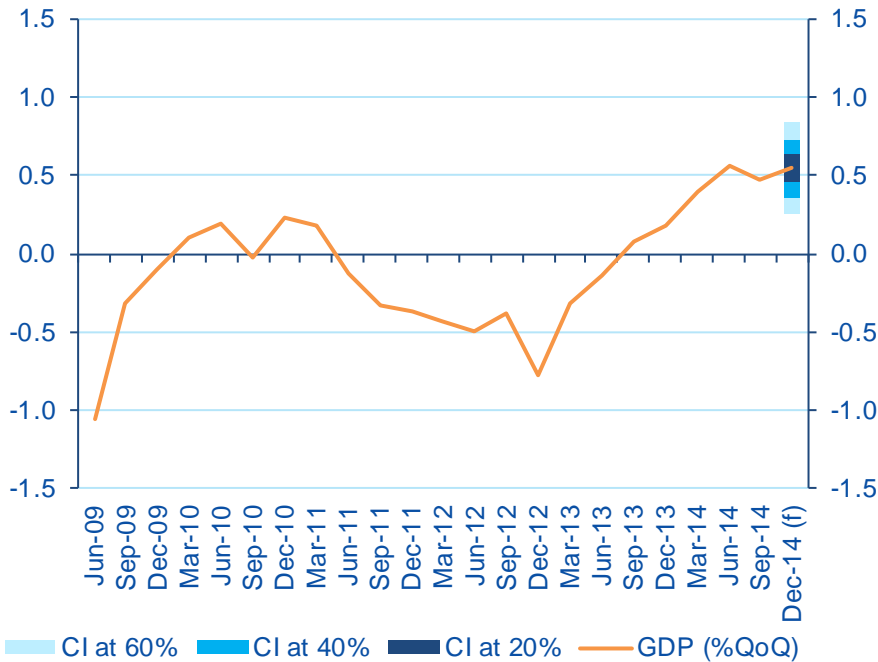
It is crucial to carry on with the reform drive

Section 2

Expansion continues as expected

Spain: GDP growth and MICA-BBVA forecasts

Source: BBVA Research



GDP has already clocked up five consecutive quarters of growth (0.5% in 3Q14) ...

... because of the improvement in domestic demand, particularly from the private sector, and in spite of virtual stagnation in net exports

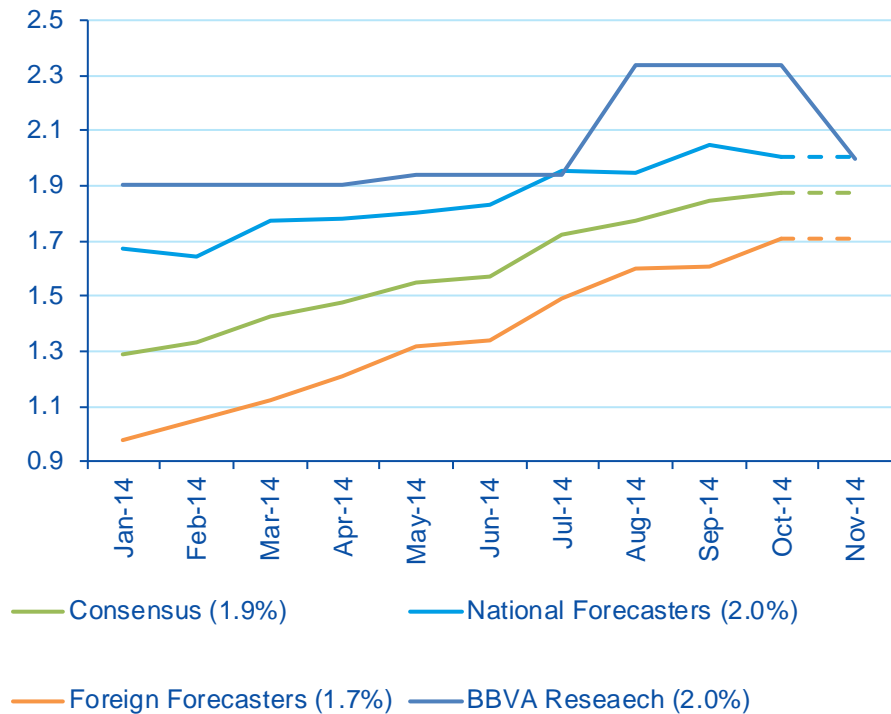
The trend in 4Q14 data is bending towards a stabilization of the rate of expansion at 0.5%

Section 2

Although 2015 growth forecasts have been corrected to the downside ...

Spain: 2015 growth forecasts (%)

Source: BBVA Research based on Consensus Forecasts



Given the sound long-term economic performance, we are keeping to our GDP growth forecast of 1.3%

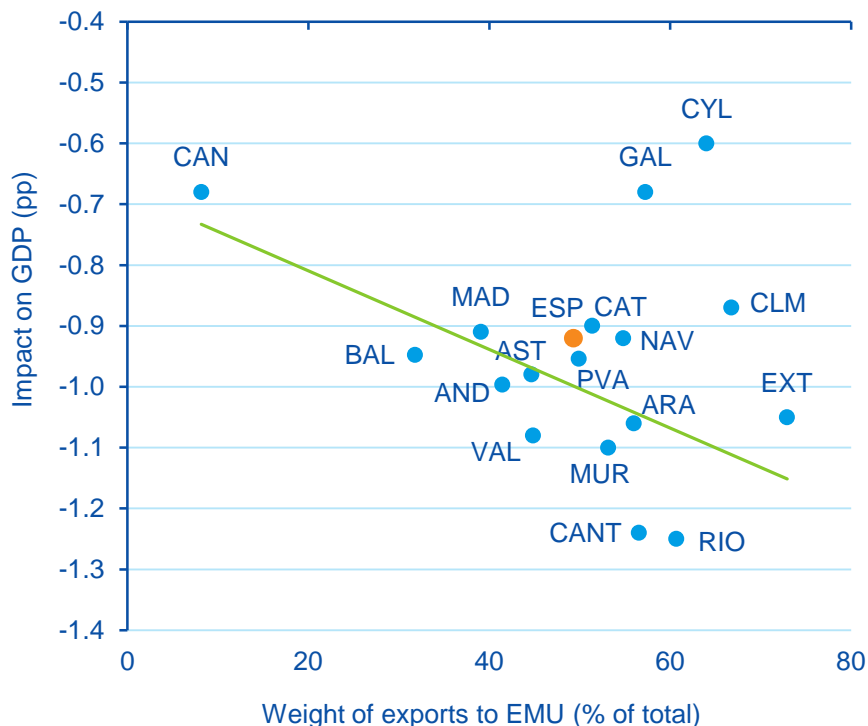
However, the 2015 forecast has been reduced from 2.3% to 2.0%

The principal reason for the revision is lower-than-expected growth in the EMU

Section 2
 ... because of the weakness in the EMU's recovery ...

Spain: estimated impact on GDP of a 1% fall in the EMU's GDP (pp)

Source: BBVA Research



Box 1

In the past, a 1% reduction in the EMU's GDP passed through to Spanish GDP almost entirely

The trade channel (exports) will be the main vehicle for transmission, but others cannot be ruled out (investment, financial etc.)

This time, the impact may be lower

... GDP will accelerate in 2015 as a result of diverse factors

Baseline scenario in which risk factors do not materialise

Exports (>5%)

- Euro depreciation
- Improvement in international trade
- Slight acceleration in the eurozone, helped by the reduction in oil prices and other factors

Investment M & E (>7%)

- Investment in machinery and equipment now represents 45% of total real investment and more than 8% of real internal demand (all-time record)
- Consistent with the change in production model to target the external sector

ECB and credit

- More expansive monetary policy, which has brought interest rates to historic lows
- Increase in demand for credit (EUR50bn) over the next few years and in GDP (+0.5% in 2015)
- New credit flows (YoY 7M 2014): +12.4% (corporate<EUR1m) +12.1% (individuals)

Fiscal policy

- The tax cuts will cost EUR9bn between 2015 and 2016
- This will increase domestic demand and imports, attenuating the effect on GDP: +0.3% (2015)
- The cyclical improvement and compliance with 2014 targets make fiscal consolidation easier to achieve

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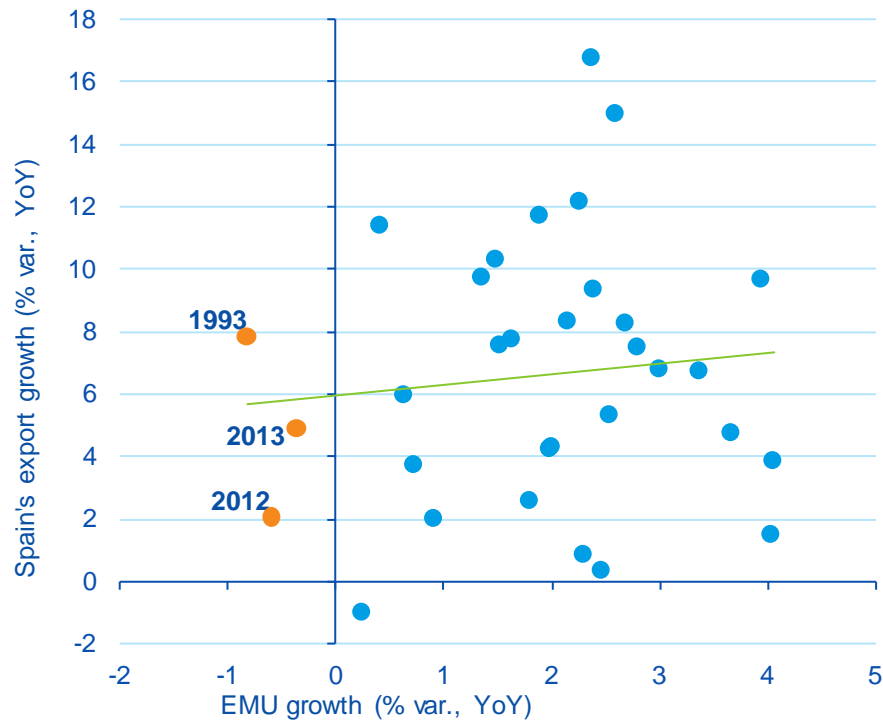
Factors which will keep the economy growing

A. Greater diversification and competitiveness of exports

Spain: exports and GDP in the EMU

(% var., YoY)

Source: BBVA Research



Exports continue to grow: average growth of 1.4% QoQ is expected in 2Q14 and 3Q14

In the past, other factors have enabled exports to continue to grow despite a recession in the EMU

Greater diversification, competitiveness gains and increased investment in recent quarters will support exports

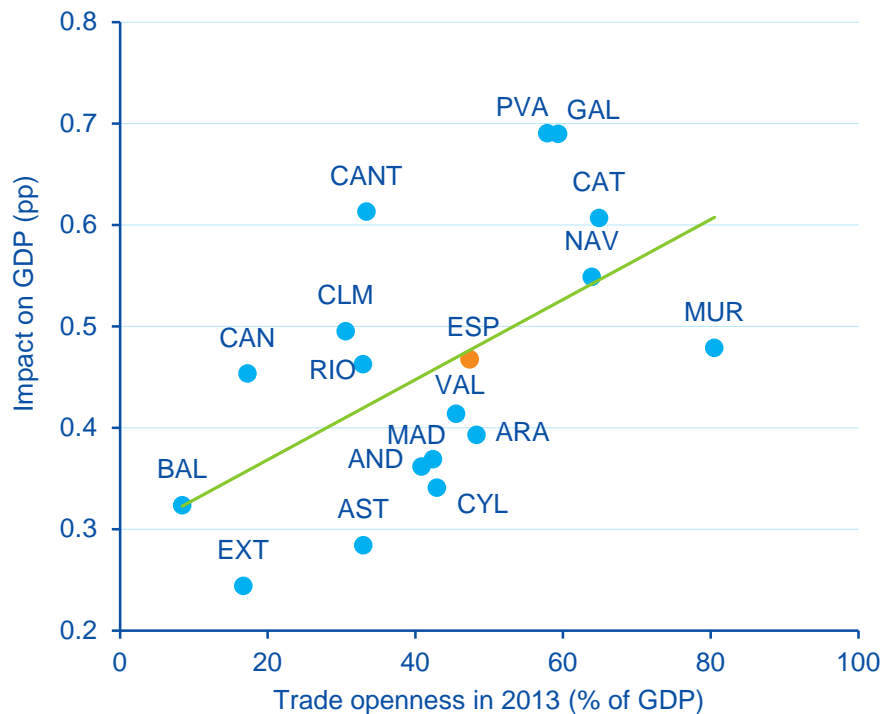
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Factors which will keep the economy growing

B. Looser monetary policy: euro depreciation

Spain: impact on GDP of a 10% depreciation in the euro over the dollar (pp)

Source: BBVA Research



Box 1

Another factor which will help competitiveness will be a greater-than-expected depreciation of the euro

We expect an exchange rate of around USD/EUR 1.2 next year, 10% below the 2014 average

This will strengthen the increase in exports and imports substitution

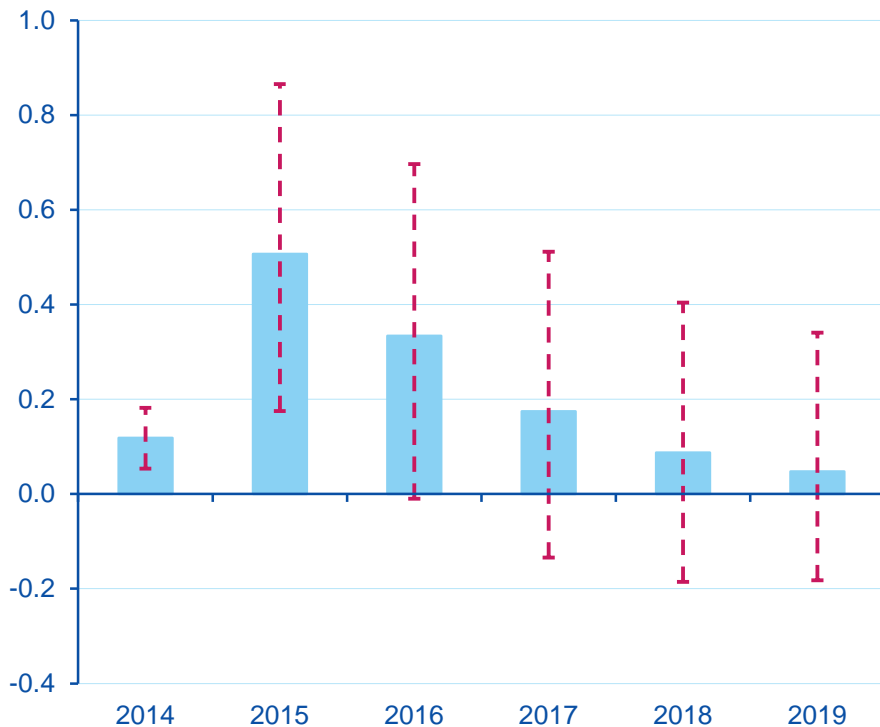
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Factors which will keep the economy growing

B. Looser monetary policy: lower interest rates

Spain: forecast impact on GDP of a 100bp fall in banking credit spread as a result of the TLTRO (pp)

Source: BBVA Research



Box 3

The ECB's actions are designed to reduce the cost of bank lending, conditional on an increase in credit

In Spain, lower rates could contribute to GDP growth of around 0.5pp in 2015 ...

... although the uncertainty is large

Section 2

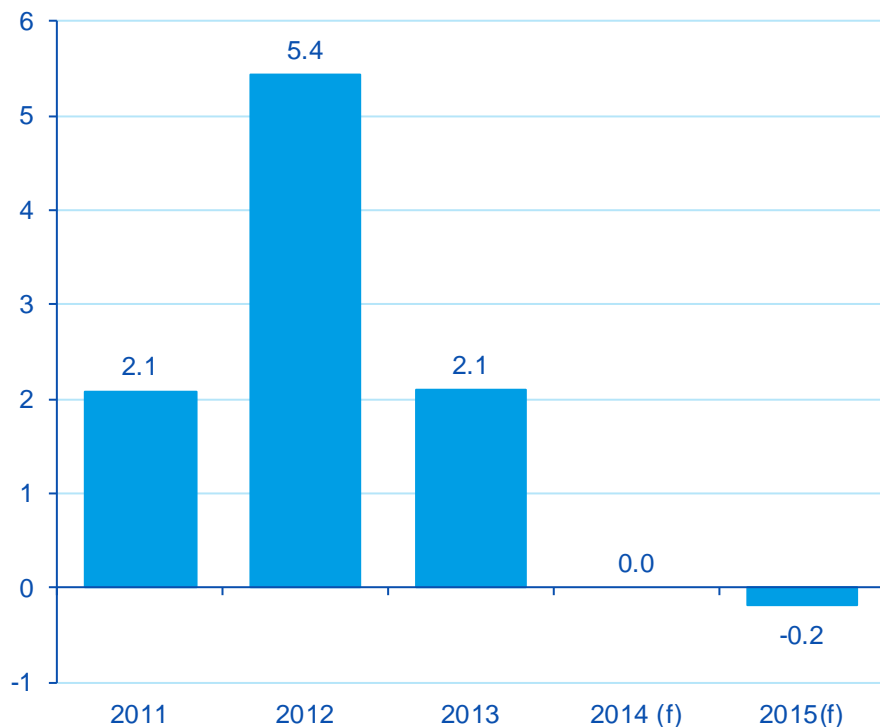
Factors which will keep the economy growing

C. The improvement in the cycle means less fiscal tightening is needed ...

Spain: discretionary fiscal measures

(pp of GDP)

Source: BBVA Research



Between 2011 and 2013, reducing the public deficit from 9.2 to 6.3% of GDP required measures of about 7% of GDP, given the cyclical position

In 2014, there has been an improvement in the cycle and greater responsiveness of revenues and expenditure to that recovery

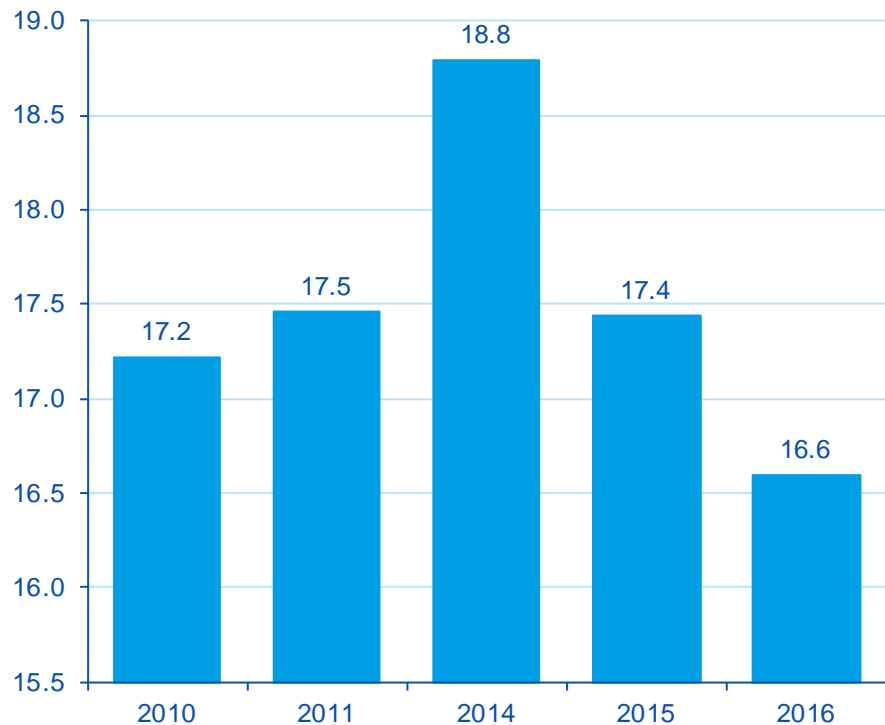
This will give the public sector room to introduce expansionary policies and still meet its budgetary targets

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Factors which will keep the economy growing C. ... and make more expansive measures possible

Spain: Income tax, expected effective average rate over the net tax base (pp)

Source: BBVA Research



Box 2

The tax reform can reduce effective average rates to a significant degree

This ought to help underpin domestic demand, at a time when certain incentives are winding down

We estimate the tax reduction could add around 0.3pp to GDP in 2015

Section 2

Factors which will keep the economy growing

E. Progress in reducing imbalances

Box 4

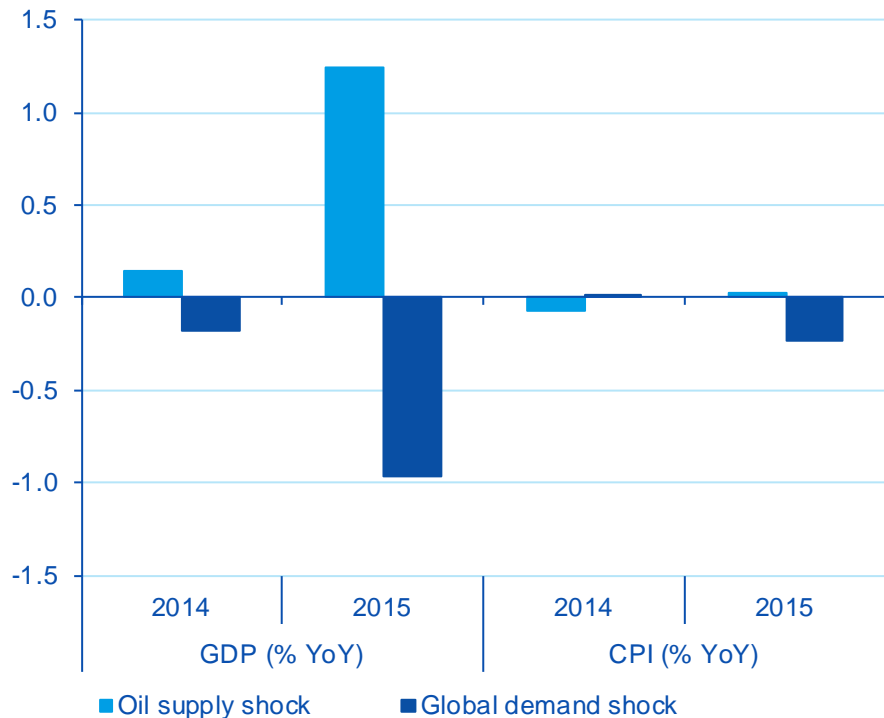
Variables that lead the recovery	Real interest rate	✓	-330bp since 3Q12
	Financial wealth	✓	+38% since 2Q12
	Building permits	✓	+15.5% since 2Q13
=	Prices	=	Around zero in 2Q14
	Residential investment		Around zero in 2Q14
	Lagging variables		
	External demand	✓	+72% since 1Q10

Section 2

Bias to the upside: lower oil prices

Spain: estimated impact on GDP and CPI of a 20% fall in the oil price (pp)

Source: BBVA Research



The reduction in trade costs could be an important factor for exports competitiveness

Likewise, as the price reduction is transferred to households, this may boost private consumption

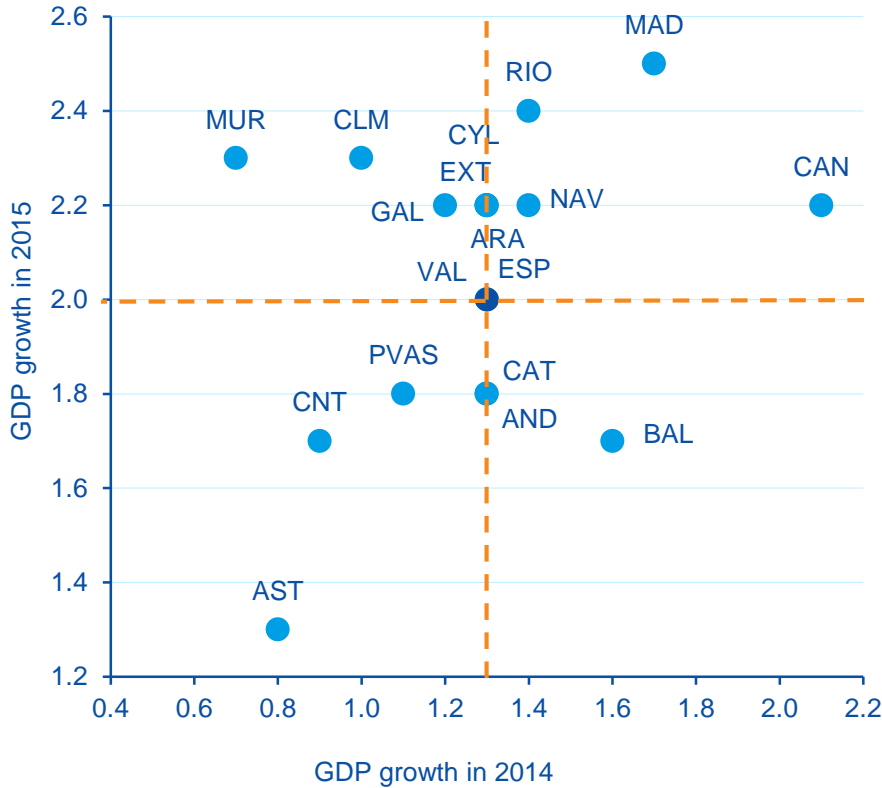
It is critical to diagnose the factors behind the downward pressure: if it is a response to increased supply and is permanent, the impact may be relevant

Section 2

Forecasts by Spanish regions

Spain: GDP growth forecast by region

Source: BBVA Research based on NSI



Growth forecasts remain heterogeneous by region

Each region's different level of exposure to external demand ...

... and the progress made in fiscal consolidation continue to be the main factors accounting for growth differentials

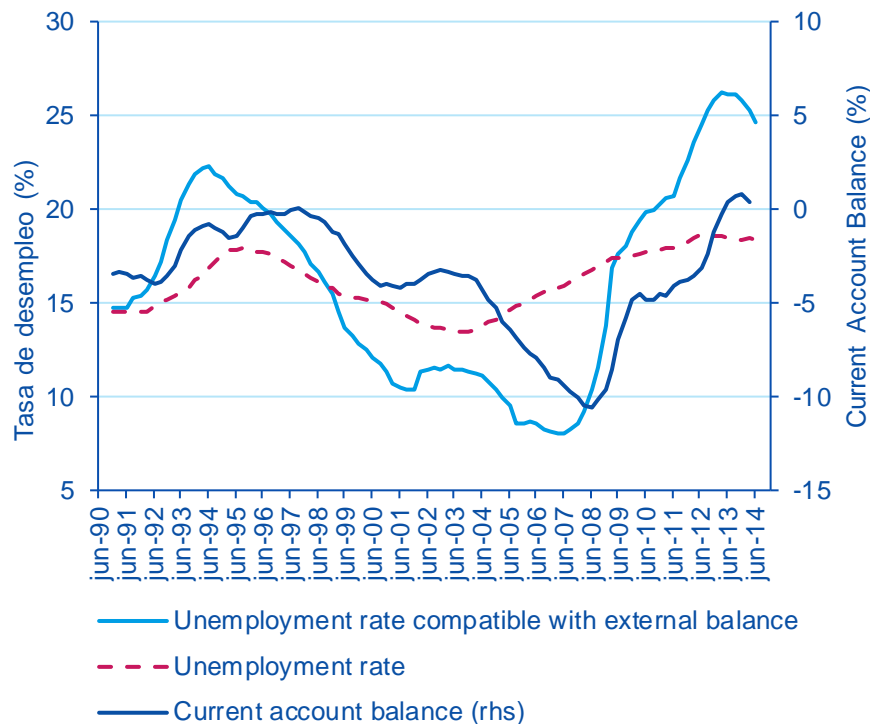
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Internal risks: correction in the current account

Spain: current account and unemployment rate

(% of GDP and %)

Source: BBVA Research



Although major progress has been made in improving competitiveness and exports ...

... the increase in job creation has brought with it a deterioration in the current account balance ...

... which has to be avoided in the medium and long-term by continuing the reform drive

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The need to go deeper with reforms

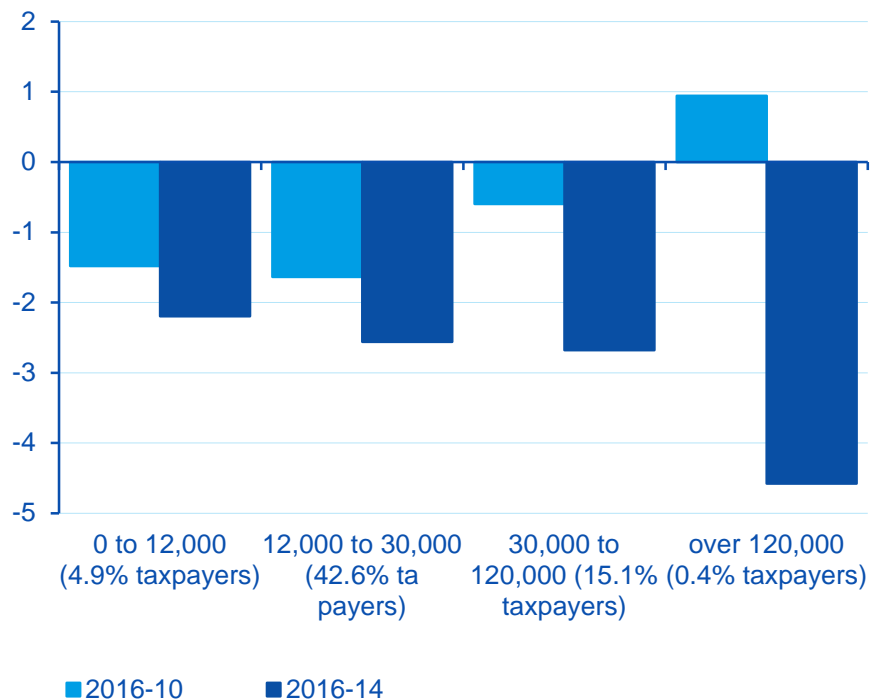
1. To reduce debt, improve the Spanish economy's financing capacity and attract foreign direct investment
2. Reform of the public sector, fiscal consolidation and long-term sustainability of public finances, with an efficient fiscal system to incentivise growth and job creation -> experts committee
3. Reforms to improve productivity, the size of companies and the Spanish's external competitiveness and attractiveness: its physical, human and technological capital
4. Building on reforms to improve the efficacy of active employment policies, reduce duality in the labour market and improve how it works -> more and better employment

Section 3

The need to go further with reforms

Spain: income tax, expected variation in the effective average rate, by income bracket (pp)

Source: BBVA Research



Box 2

The reform isn't comprehensive and it's far away from what had been proposed by the experts committee

However, the system might become more transparent and efficient...

... and progressive than in 2010

Macroeconomic Forecasts

Spain and Europe: macroeconomic forecasts

Source: BBVA Research based on NSI, Eurostat, central bank and ECB

(% YoY)	2013		2014 (f)		2015 (f)	
	Spain	EMU	Spain	EMU	Spain	EMU
Households final consumption expenditure	-2.3	-0.6	2.1	0.7	1.8	1.3
General government final consumption exp.	-2.9	0.2	1.0	0.9	0.9	0.4
Gross fixed capital formation (G.F.C.F.)	-3.8	-2.4	0.6	0.6	4.3	1.8
Changes in inventories (*)	0.0	-0.1	0.0	0.1	0.0	0.0
Domestic Demand (*)	-2.7	-0.8	1.6	0.8	2.0	1.1
Exports	4.3	2.1	3.7	3.7	5.3	5.1
Imports	-0.5	1.2	4.8	4.1	5.5	5.2
External Demand (*)	1.4	0.4	-0.3	0.0	0.1	0.2
GDP mp	-1.2	-0.4	1.3	0.8	2.0	1.3
Pro-memoria						
Total employment (LFS)	-2.8	-0.8	1.0	0.5	1.8	0.6
Unemployment rate (% Active pop.)	26.1	11.9	24.4	11.6	23.1	11.4
Current account balance (% GDP)	1.4	2.3	1.2	2.2	2.1	2.1
Public debt (% GDP) (**)	92.1	90.9	98.2	94.5	99.8	94.4
Public deficit (% GDP)	-6.3	-2.9	-5.5	-2.8	-4.2	-2.6
CPI (average)	1.4	1.4	0.0	0.5	1.0	1.0
CPI (end of period)	0.3	0.8	0.3	0.6	1.2	1.1

(*) Contribution to GDP Growth

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

(f): forecast

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