BBVA | RESEARCH

Spain Economic Outlook

3RD QUARTER 2016 | SPAIN UNIT

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The Spanish economy will grow around 3.1% in 2016, which confirms the bias on economic scenario

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Worsening external outlook, linked mainly to Brexit, advocate a moderation in growth expectations for 2017 to 2.3%

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Closing Date: 5 August 2016

1 Editorial

The upward bias to Spain's GDP growth in 2016 is confirmed, but several elements point a downward bias for 2017. Growth is expected to reach 3.1% on average this year and 2.3% in 2017. This implies an upward revision of 0.4 pp of GDP for 2016 and a downward one of 0.4 pp for 2017 relative to the forecasts released three months ago. Although activity data show no slowing so far, the materialisation of certain external and domestic risks points to a slowdown in the next few quarters. In any case, we expect the recovery and job creation to continue, given the impetus from supports such as monetary policy. However, the Spanish economy is becoming increasingly vulnerable. The policies to be adopted in the next few years really ought to be defined as soon as possible.

GDP growth remains at annualised levels of around 3%, with hardly any signs of a slowdown and underpinned by domestic demand and service exports. In particular, during the second quarter of 2016, GDP posted an increase of 0.7% QoQ, exceeding the one envisaged in BBVA Research's May scenario (0.6%). Moreover, data available at the closing date of this publication increase the probability of this rate of growth being maintained or even surpassed in the third quarter (reaching 0.9% QoQ according to the MICA-BBVA model). The strength of domestic demand, mainly of household consumption, continues to be the determinant factor behind this trend, despite the high level of volatility, the downward correction of financial markets and the persistent economic policy uncertainty.

Also, everything points to the slowdown in private investment growth bottoming out, at least for the time being. On the one hand, residential investment look set to complete nine consecutive quarters of growth, performing appreciably better in the first half of 2016 than in the second half of 2015. Besides both capital expenditure on machinery and equipment and good exports seem to have picked up in the second quarter of the year. All in an ongoing environment that has been favouring the growth of tourism. The only component of demand that hampers the growth momentum is investment in non-residential construction, which is suffering from the effects of a fiscal policy that concentrates part of the adjustment to the public accounts in spending on infrastructure.

Recent trends in the US economy and the materialisation of risks in Europe have led to growth expectations in the developed countries being revised downwards and therefore to deterioration in the outlook for Spanish exports. In the US, disappointing first-quarter growth was accompanied by persistent weakness of non-residential investment, uncertainty surrounding the November elections, and in particular by the low increase in productivity. This confirmed that the recovery will attain growth rates of only about 2.0% in 2016 and 2017, against the 2.5% we expected for both three months ago. In the euro zone, activity indicators point to marginally better than expected performance and justify an upward revision of 0.1 pp to the 2016 growth forecast, to 1.6%. However, the result of the UK referendum on whether to leave the EU (Brexit) will have negative effects on GDP in the next few months, and this reduces our 2017 growth projection by 0.4 pp to 1.5%.

In the short term, the effect of Brexit on the Spanish economy will be limited (between 0.3 and 0.4 pp of GDP in 2017). In this regard, the two main channels of transmission will be trade and finance (volatility in the markets). Concerning trade, Spain's total exposure is not as high as that of other EU countries. However there are sectors (agrifood, automotive, chemical products and tourism) and regions (Aragón, the Balearic Islands, the Canary Islands, Valencia, La Rioja, Murcia and Navarre) which may be especially affected. In particular, the expected fall in UK demand and the depreciation of the pound against the euro will act as a drag on export growth in the next few months. Apart from this, Brexit has given rise to a new bout of volatility in the financial markets, albeit temporary for now and not having become systemic event like the Lehman Brothers crash in 2009 for example. Taken together, the two channels will have a negative impact on activity and mainly on Spanish exports, which will increase by 1.0% less in 2017 as a result of Brexit effects. The negative impact on GDP next year will also vary between 0.3 pp for the least exposed autonomous regions and 0.5 pp for the most exposed.

Added to the external risks is the materialisation of some internal ones and the slackening of the tailwinds. This will probably lead to a slowing of growth in the coming quarters. The imbalance in the public accounts remains constant at around 5% of GDP (12 months cumulative), and this has forced the authorities to reconsider the short- and medium-term objectives. The new deficit target for the end of 2016 (4.6% of GDP) is credible, given the fiscal measures taken so far and the growth prospects for the year. In any case, if the policies announced were strictly complied with, public spending would be adjusted in the second half of the year and would act as a drag on the growth of domestic demand. Apart from this, the growth in consumption and investment continue to reflect levels that are hard to explain in terms of the dynamic shown by employment and wage incomes. In this regard it may be that the demand pent up during the crisis period is nearly all used up by now.

Despite this, the recovery will continue, thanks in part to the expansive monetary policy being kept in place for a long time. The environment described has led central banks to reaffirm their commitment to supporting growth. In the case of the ECB, it is possible that in the next few months we will see changes in the asset purchasing programme and that this programme will be extended beyond March 2017. This should provide certainty to both the private and public sectors that interest rates will be held low for a long time, allowing Spanish economic agents to continue to deleverage or to borrow on advantageous terms if they have the capacity. Given the solvency of the Spanish financial sector, the monetary policy transmission mechanisms are not blocked, as they seem to be in other peripheral European countries. This is a comparative advantage that ought to be taken advantage of by Spanish companies that can access credit at low interest rates. Also, the price of oil will remain at relatively low levels, which together with the expected recovery in the growth of emerging countries next year and the increase in investment, should support exports despite the lower growth in developed countries. Lastly, increased geopolitical uncertainty continues to benefit the Spanish tourism sector, which will maintain its positive contribution to growth in the coming months.

All in all, the Spanish economy is becoming more vulnerable, and it has become necessary to attain certainty as soon as possible on the policies to be implemented in the coming years. Externally, there has been an increase in the frequency of negative events, whether related to the financial markets or of a geopolitical nature. In Spain, although the new deficit target agreed for 2016 is credible, its fulfilment in 2017 will require the implementation of measures to the extent of about 0.5% of GDP. Defining the composition of the adjustment will be crucial for assessing the impact on the economy and the sustainability of the public accounts in the long term. Apart from this, part of Spain's growth differential relative to other European economies is due to the reforms implemented in previous years. The exhaustion of the impetus see in the last few quarters may increase the vulnerability of Spain's economy given the failure to define the policies to be implemented in the next few years. Given the ever more limited leeway for fiscal and monetary policy, it may be that the only way to maintain growth and job creation in Spain is to continue with the Improvements process.

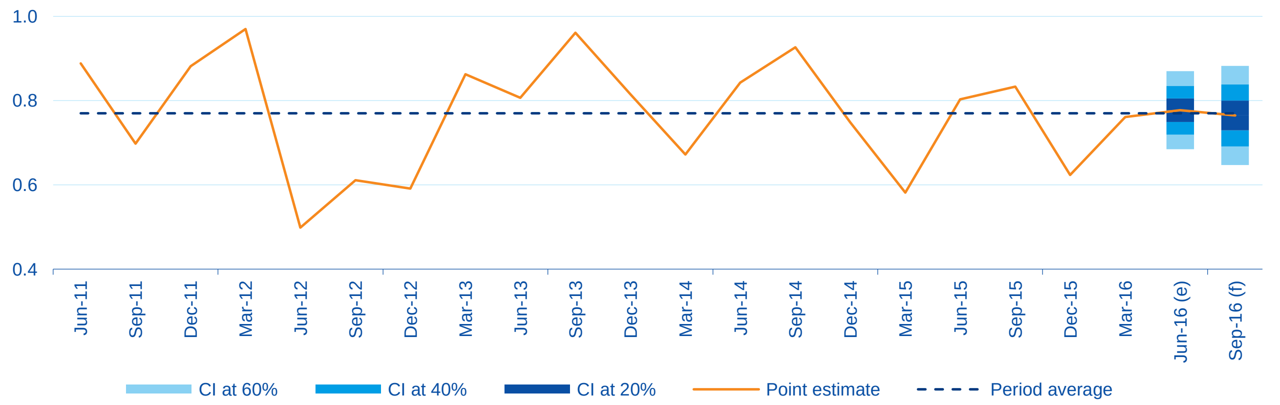
2 International environment

In the past three months the global economy continued its moderate expansion, with annualised growth rates of around 3%. However, one of the risks we referred to in the previous edition of this report - a vote in favour of "Brexit" in June - has materialised, and this leads us to revise our growth forecasts downwards, mainly in Europe. On the other hand, the quarter was also marked by the US Federal Reserve's decision to delay the process of normalising interest rates amid doubts about the short-term situation of the US economy, its long-term growth and global risks.

The global economic situation improved in the first half of the year

The BBVA-GAIN indicator suggests that global growth in the second quarter (0.8% QoQ) remained close to the average of the past five years. This lends weight to the view that the world economy is finding it difficult to achieve more than what is perceived as limited growth when compared with pre-crisis levels. Looking ahead, the most recent indicators seem to confirm the continuation of this trend. All the above, together with a reduction of financial stresses in both developed and emerging countries, points to a third quarter of 2016 quite similar to the first two (BBVA-GAIN 0.8% QoQ), which is consistent with overall growth of 3.1% for 2016 (see Figure 2.1).

Figure 2.1
Global GDP growth: data observed and forecasts of the BBVA-GAIN model (%, QoQ)



(e): estimated
Source: BBVA Research based on IMF data

Monetary policy will be influenced by the effects of Brexit on financial markets and activity

The uncertainty associated with the potential impact of Brexit and the strengthening of the dovish bias in the monetary policies of major central banks affected the dynamic of financial markets during the last quarter. **Brexit brought a substantial increase in financial volatility,** common to most asset classes, **and a particularly severe punishment for share prices in the European corporate sector**. **Its effect, however, was transient and non-systemic**: in the first weeks of July, the BBVA financial stress indices for developed and emerging economies corrected the entire decline observed between May and June. **The response of central banks, delaying the process of normalising interest rates** (in the case of the US Federal Reserve) or remaining ready to strengthen stimuli measures (ECB, BoE and BoJ) helped cushion the effect of the Brexit vote and was the main reason behind the sharp drop in yields on long-term sovereign bonds of countries such as the US and Germany, which reached their lowest levels in recent years in both cases.

This time around, unlike in earlier bouts of financial instability, **the emerging markets held up better.** The search for yield, in an environment of very low interest rates and the relief produced by the Federal Reserve's delaying its action on financing conditions, encouraged the redirection of capital flows to the emerging bloc. In fact, in the first weeks of July, emerging countries received their largest inflow of foreign capital since 2013. By contrast, equity markets, especially those of developed economies, continued to suffer doubts about the recovery of the corporate earnings cycle and the relative underperformance of the banking sector in regions such as Europe.

Nevertheless, the political shock in the UK was substantial. Its impact on confidence will probably lead to a short and mild recession in the British economy, but its estimated short-term effect over the rest of Europe will be relatively limited (three to four tenths of a percent lower growth in 2017), mainly through the trade channel. In the rest of the world the impact will be almost negligible. The greatest risk of an overall effect of the referendum is its potential political contagion to the rest of Europe, an effect which is still to be determined.

Growth revised downwards in the US and Federal Reserve's interest rate normalisation process put on hold

In the US, a number of factors lead us to revise our growth forecast for 2016 and 2017 downwards to around 2%. Among these factors are disappointing first quarter growth (1.1% annualised), persistent weakness in non-residential investment, uncertainty surrounding the November elections and global risks. **Additionally, in its latest meetings the US Federal Reserve expressed increased doubts about the US economy's potential for long-term growth in productivity and GDP**, which implies greater uncertainty as to where the equilibrium interest rate lies. This, coupled with the risks of the global economy, led it to put its interest rate normalisation process on hold. In this context, we now expect the US Federal Reserve to announce only one additional rate hike this year (probably in December, given the electoral calendar), and two in 2017, as opposed to the two and four, respectively, that we expected three months ago.

China continues to be marked by a slowdown and long-term risks

In China, fears of a sharp slowdown in the economy have partly dissipated following the stabilisation of GDP growth at 6.7% in the second quarter, somewhat better than expected, supported by strong consumption and an increase in lending. **Less encouraging signals come from weak investment,** especially by the private sector and in sectors with excess capacity, which might reflect the beginning of the awaited deleveraging process.

Monetary policy authorities will maintain an accommodative stance. It is possible that they will decide to reduce the reserve requirement ratio three more times and make a further cut in the benchmark interest rate in the remainder of the year. **However, we are maintaining our forecast of a moderate slowdown in growth to 6.4% in 2016** (from 6.9% in 2015) **and to 5.8% in 2017.** In any case, short-term risks persist regarding financial stability, while in the longer term doubts remain due to the slow progress of structural reforms in certain key areas.

The effect of Brexit on the euro zone will be limited, although numerous risks persist

In the euro zone, the strong growth posted in the first quarter was a response to temporary factors, so recovery continued at a moderate pace in the second quarter (0.3% QoQ). This improved performance of the economy during the first half of the year leads us to make a slight upward revision to the **GDP growth forecast for the whole of 2016, to 1.6%. However, the recent increase in oil prices, and above all the UK's vote to leave the EU justify a downward revision of 0.4 pp in the growth forecast for 2017, to 1.5%.**

The risks in Europe continue to show a downside bias and are predominantly political in nature: added to the uncertainty about Brexit is the **possible political contagion to other member states,** with elections in several countries in 2017 (the Netherlands, France and Germany), and above all a **constitutional referendum in Italy** in October. Added to this is the delicate situation of the Italian banking system. Risks, albeit it lesser ones, also persist in Greece.

As for monetary policy, the accommodative stance of the other central banks and the potential impact of Brexit on the euro zone economy have strengthened the **ECB's readiness to take further stimulus measures if necessary.** The fact that purchases of corporate bonds and the first TLTRO II auction did not take place until June gives the ECB some leeway to analyse their effects before considering any substantial change to its **quantitative easing (QE) programme. What cannot be ruled out is the extension of its duration until at least September 2017 (it expires in March of that year), and the introduction of some adjustments,** such as increasing the limits on purchases per issuer in the case of bonds without collective action clauses, to overcome the shortage of paper at terms which already offer negative yields. In principle, additional cuts in the marginal deposit facility (at -0.4%) are less likely.

3 Growth outlook for the Spanish economy

The recovery has not lost ground in 2016, but will slow in 2017

The recovery of the Spanish economy reached its third year at the end of the first half of 2016. Despite a economic conjuncture again marked by uncertainty, **the growth achieved in the middle quarters of the year is higher than was expected** at the beginning of this exercise**.** Among the factors that support this trend at domestic level are, the improving labour market and financing conditions, as well as expansionary fiscal policy and the progress of correcting internal imbalances[1]. Externally, contributory factors have been the expansionary monetary policy of the ECB, the gradual improvement in global demand and, despite their recent recovery, the still relatively low oil prices.

However, **the outlook for the external environment of the Spanish economy was overshadowed by the referendum result on the permanence of the UK in the European Union (Brexit) at the end of the second quarter**. In the short term, this event will have a negative effect on activity through direct channels (trade flows and volatility in financial markets) and indirect ones (lower global demand). On the other hand, the lack of reduction in the imbalance of public accounts has made the caretaker government take additional steps, which together with those announced last April, will involve a drag on economic activity. Moreover, the environment of high economic policy uncertainty remains, and it is particularly important to resolve it given the commitment to reduce the deficit to levels of around 3% of GDP by the end of next year.

In short, the fundamentals of the Spanish economy confirm the upward bias that rode ahead three months ago and endorse an **increase of GDP higher than previously estimated by BBVA Research for 2016 (3.1% vs. 2.7%)**. However, new elements in the economic scenario induce a downward revision **in expectations for 2017 (of -0.4 pp to 2.3%)**. This rate of growth will help to create about 800,000 jobs over the entire period and reduce the unemployment rate to around 18.2%[2]. Finally, although the scenario presented in this report includes downward revisions in growth forecasts for 2017, **there continue to be downward risks.**

The growth of the Spanish economy improved expectations in 2Q16

Pending on detailed results, **the GDP flash estimates published by the National Statistics Institute (INE) confirmed that growth slowed in 2Q16 (by up to 0.7% QoQ; 3.2% YoY), although less than expected at the beginning of the quarter**[3]. Thus, the economy witnessed three years of expanding activity, despite high levels of internal and external uncertainty.

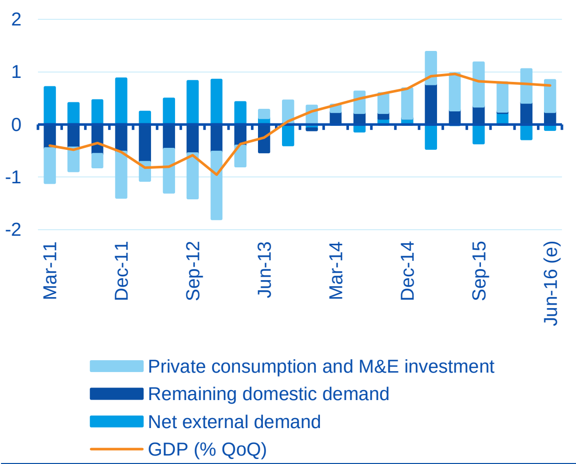
With regard to the composition of growth, **partial economic indicators show that the improvement in activity would again be underpinned by domestic demand** (0.8 pp QoQ) (see Figure 3.1). On the other hand, **net external demand would make a slightly negative contribution to growth** (-0.1 pp QoQ), since the recovery of exports would be more than offset by the rise in imports.

Looking ahead to the third quarter, the information known at the time of writing suggests that the **recovery of the Spanish economy continues without major upheavals (MICA-BBVA forecast**[4]: **0.9% QoQ)** (see Figure 3.2). However, uncertainty remains high, as evidenced by the results of the BBVA

1: For example, current account indebtedness or the real estate glut.
2: In average terms, employment will grow at an annual rate of 2.5% and the unemployment rate will be around 18.5% in 2017.
3: The Quarterly National Accounts (CNTR from its Spanish initials) for 2Q16 will be published on 25 August, possibly with a revision of the advance estimate.
4: For more details on the MICA-BBVA model, see M. Camacho, M. and Domenech, R. (2010): "MICA-BBVA: A Factor Model of Economic and Financial Indicators for Short-Term GDP Forecasting" BBVA WP 10/21, available at: http://goo.gl/zeJm7g

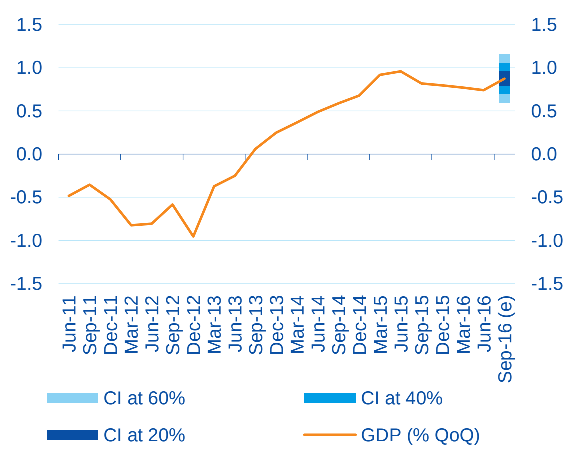
Economic Activity Survey (EAE-BBVA), which for a year has been reflecting less optimistic growth expectations (see Figures 3.3 and 3.4).

Figure 3.1
Spain: contributions to quarterly GDP growth (%)



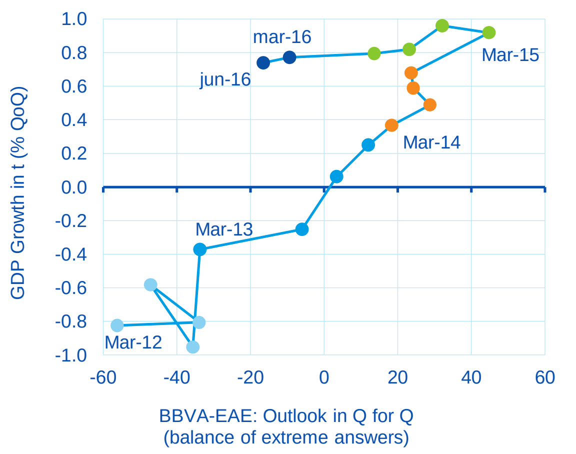
(e): estimated.
Source: BBVA Research based on INE

Figure 3.2
Spain: observed growth in GDP and MICA-BBVA Model forecast (% QoQ)



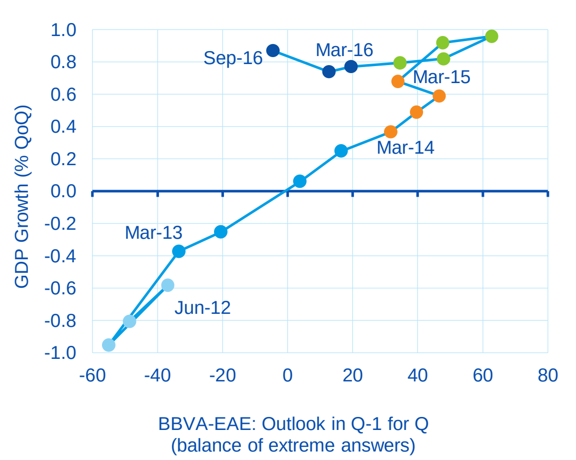
(p): projected.
Source: BBVA Research based on INE

Figure 3.3
Spain: economic growth and view of the respondents in the EAE-BBVA



Source: BBVA Research based on INE

Figure 3.4
Spain: economic growth and expectations of EAE-BBVA respondents in the previous quarter



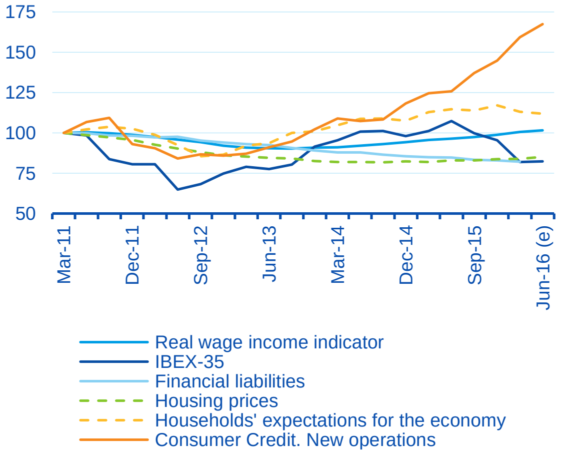
(e): estimated.
Source: BBVA Research based on INE

Private domestic demand dodged uncertainty

Private consumption would increase again in the second quarter. The dynamism of car registrations, large companies' domestic sales and retail sales of durable goods reveal that household spending continued to grow in the 2Q16, supported by the favourable performance of some of its determinants. As illustrated in Figure 3.5, job creation has driven the salary income of households between April and June, which has contributed to the recovery of their purchasing power. Similarly, new consumer credit operations have grown back to double-digit rates. By contrast, the weakness in equity prices would reduce the contribution of net wealth to spending growth, for the third quarter running, despite the expected reduction in financial liabilities and the increase in housing prices. Furthermore, households' perception of the economic situation deteriorated during 2Q16.

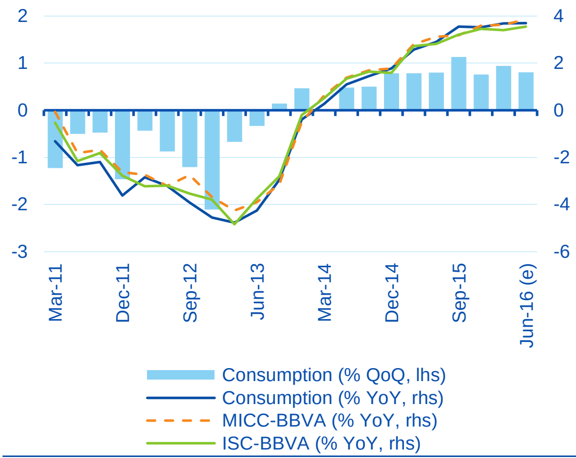
In summary, both the synthetic consumption indicator (ISC-BBVA) and the coincident consumption indicator model (MICC-BBVA) suggest that **household spending would grow by around 0.8% QoQ in the second quarter**, in line with that seen during the first quarter (see Figure 3.6).

Figure 3.5
Spain: determinants of consumption (SWDA data. 1Q11 = 100)



(e): estimated.
Source: BBVA Research based on MINECO, Datastream, CE and Banco de España

Figure 3.6
Spain: observed data and real time forecast of household consumption



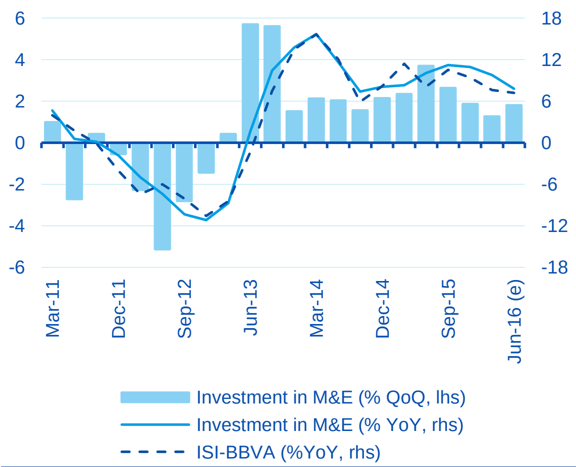
(e): estimated.
Source: BBVA Research based on INE

Investment in machinery and equipment would pick up in 2Q16 after three quarters of slowing growth. All partial indicators under this demand component improved between April and June, except industrial confidence. In particular, they highlighted the recovery in sales of industrial vehicles, following the downturn seen in the first three months of the year, the growth in equipment order books and the dynamism in capital goods imports. Thus **the synthetic investment indicator (ISI-BBVA) supports an increase of 1.8% QoQ (7.8% YoY) in investment in machinery and equipment in 2Q16** (see Figure 3.7).

Meanwhile, growth in housing investment would be slightly lower than in the first quarter. This is suggested by the drop in building permits compared to 1Q16, the lower consumption of cement (probably associated with the deterioration of public works) and the sharp deterioration in the confidence of producers in the second quarter. Nevertheless, the labour market in the sector continued to recover, even with a little more intensity than in the first three months of the year. Overall, **the synthetic indicator of investment in housing construction (ISCV-BBVA) suggests growth of 0.9% QoQ (3.2% YoY) in 2Q16** (see Figure 3.8).

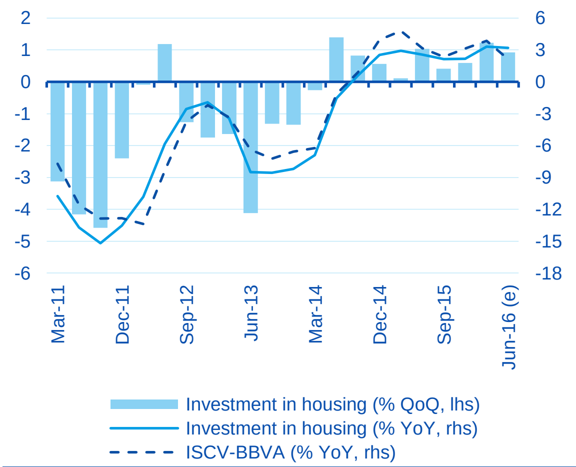
On the other hand, the good tone of non-residential permits for new buildings seen in the latter part of last year suggests that private investment would be leading the investment in non-residential construction. Thus, **it is estimated that investment in other constructions has grown by around 0.2% QoQ** (0.6% YoY) **in 2Q16**.

Figure 3.7
Spain: observed data and real-time estimates for machinery and equipment investment



(e): estimated.
Source: BBVA Research based on INE

Figure 3.8
Spain: observed data and real-time estimates of housing investment



(e): estimated.
Source: BBVA Research based on INE

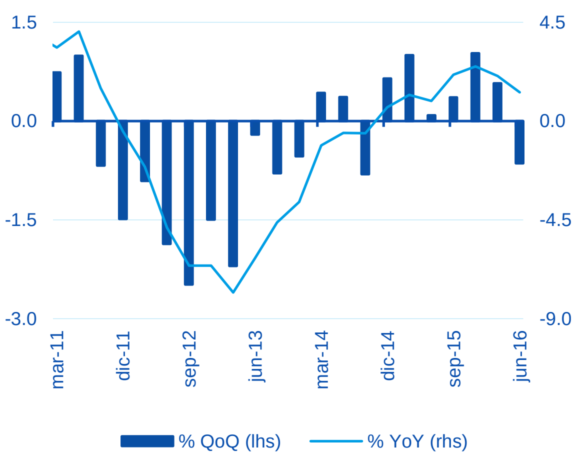
Public demand continued to rise throughout the first half of the year

After picking up more than expected in the first quarter, it is estimated that public demand continued to show strong growth during the second. Thus, budget execution data from public administrations until May (excluding local authorities) confirm that nominal spending on public consumption rose at a similar rate to that of previous months, even though the number of employees in the public sector fell by 0.6% QoQ SWDA in 2Q16 according to the Labor Force Survey (see Figure 3.9). On balance, the coincident indicators model of public consumption (MICG-BBVA)[5] points out that **the actual final consumption expenditure of public administrations would have closed the second quarter by growing at around 0.8% QoQ** (2.2% YoY), an increase similar to that of the previous quarter (see Figure 3.10).

In contrast, the reduction in official tenders recorded throughout the second half of 2015 points to a **moderation in public investment in the coming quarters.**

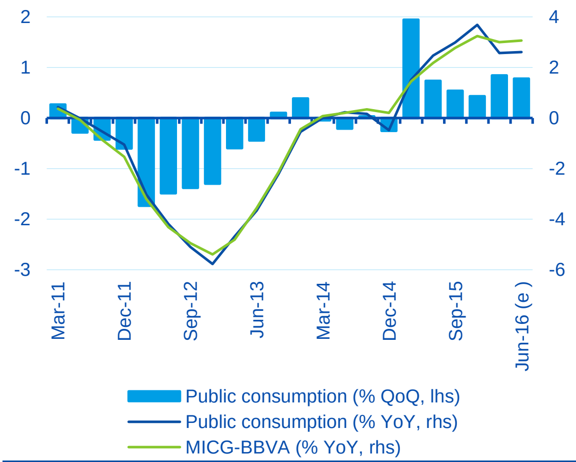
5: The MICG-BBVA model is a dynamic factor model developed by BBVA Research that provides real-time estimates of public consumption from its own history and the monthly and quarterly expenditure information from Public Administrations. (excluding Local Authorities), published by the Ministry of Finance and Public Administrations. In particular, spending on wages, intermediate consumption, transfers in kind and public production of goods and services.

Figure 3.9
Spain: salaried public sector employees (swda)



Source: BBVA Research based on INE

Figure 3.10
Spain: observed data and real-time estimates of Public Authority consumption

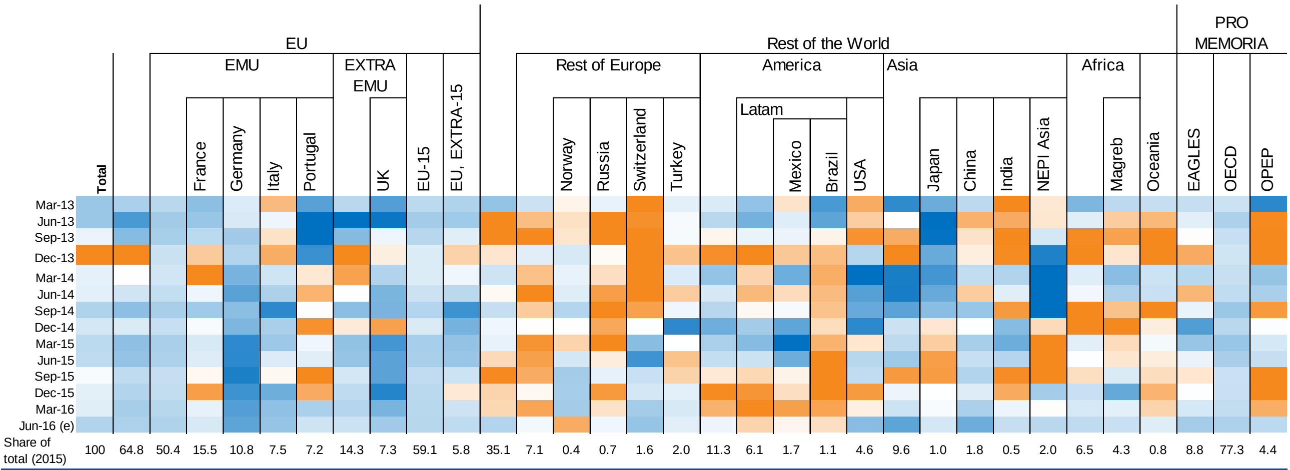


(e) Estimation.
Source: BBVA Research based on INE and the Ministry of Finance and Public Administrations

Trade flows picked up in 2Q16

During the second quarter, Spanish foreign trade experienced a global context marked by high uncertainty which, since late June, was exacerbated by uncertainties surrounding the future withdrawal of the United Kingdom from the European Union. **However, global growth remained positive and led to the recovery of Spanish exports** after a disappointing start to the year. In particular, available indicators for external trade signal a **high growth in goods exports in 2Q16 (2.3% QoQ, 3.9% YoY)** after the stagnation observed in 1Q16. By destination, Figure 3.11 shows that the upward trend in sales to most European countries, the US, and China would be offsetting lower non-EU demand (mainly from emerging countries such as Russia, Mexico and Brazil).

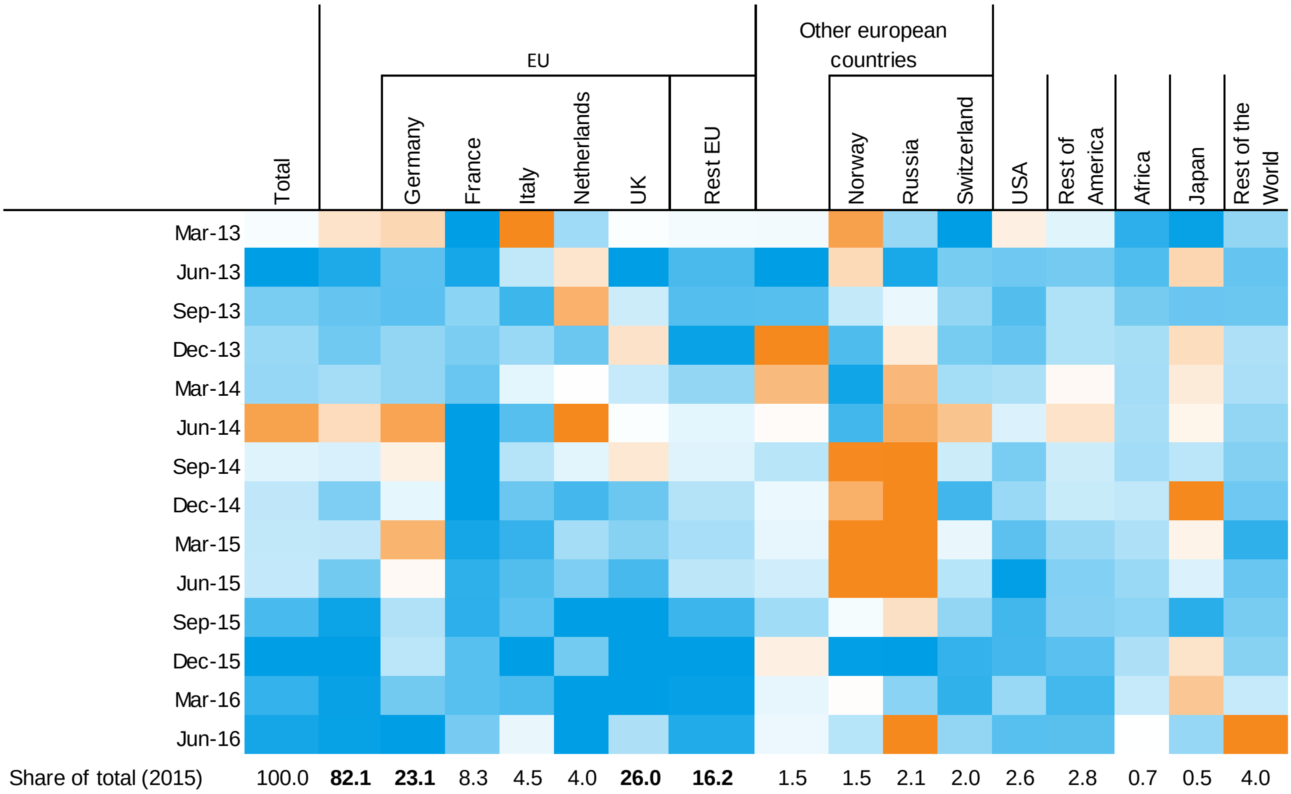
Figure 3.11
Spain: good exports (% QoQ, trend)



(e) = estimated.
Note: A brighter blue indicates a more positive value. A brighter orange indicates a more negative value.
Source: BBVA Research based on INE and the Customs Office

Regarding exports of total services, available information from the second-quarter points to a recovery (1.6% QoQ; 5.6% YoY) following the unexpected fall earlier this year (-1.7% QoQ). With regard to tourism, it is estimated that consumption of non-residents on national territory has returned to positive rates (1.1% QoQ; 4.9% YoY), leaving behind the temporary downward correction registered in 1Q16 (-1.0% QoQ). Overnight stays by foreign tourists in hotels went up by 2 points to 3.6% QoQ in 2Q16, maintaining the positive trend shown for the main countries of origin (see Figure 3.12). Similarly, a favourable trend in exports of non-tourist services (1.9% QoQ; 6.1% YoY) is estimated to partially reverse the decline observed in the first three months of the year (-2.2% QoQ).

Figure 3.12
Spain: overnight hotel stays by foreign tourists (%QoQ, trend)



Note: A brighter blue indicates a more positive value. A brighter orange indicates a more negative value.
Source: BBVA Research based on IET and INE

Despite the above, **the data for the second quarter anticipate a nil contribution of net external demand to growth.** While goods and services exports have grown strongly (2.1% QoQ; 4.3% YoY), their dynamism would have been offset by the acceleration of imports (from 2.1 pp to 2.4% QoQ; 6.3% YoY).

After three consecutive years of surplus in the current account balance, recent developments in external sector aggregates suggest that the consolidation of the positive balances continues to be underpinned by the gradual reduction in structural and energy deficits. Thus **the current account surplus may have reached 1.5% of cumulative annual GDP at the end of the first half-year** (1.4% of GDP in December 2015)[6].

6: See Economic Observatory "An analysis of the trend and determinants of the current account balance in Spain", available at: https://goo.gl/UzNSeu

The labour market recovery continued

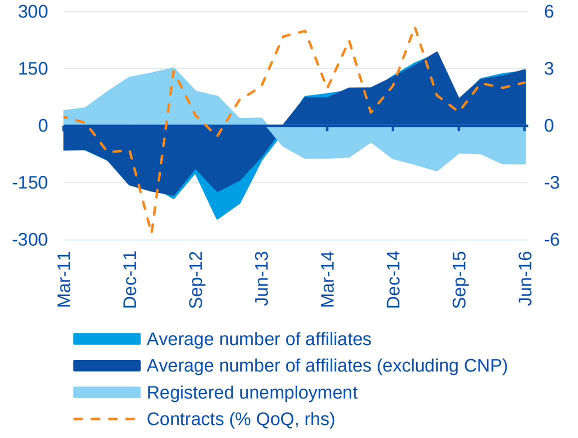
After controlling for seasonal variations, **the number of affilietes to Social Security increased again** by 0.8% QoQ swda between April and June, while **the dynamism of enrolment increased** to 2.3% QoQ, three tenths more than in the first quarter. Meanwhile, **registered unemployment fell** by 2.4% QoQ swda, in line with what happened until March, reaching its third straight year falling[7] (see Figure 3.13).

Overall, the Labor Force Survey (LFS) for 2Q16 confirmed the labour market developments pointed to by data for unemployment and Social Security afilliation. However, job creation was lower than expected. Employment increased by 271,400 people between April and June, 125,000 less than expected. Discounting the favourable seasonal period, it is estimated that employment grew by around 0.3% QoQ, five tenths less than in the previous quarter, which is the worst figure since 1Q14. Services disappointed, but still lead the rise in employment[8].

Job creation led to a drop in unemployment rate (of a point to 20.0%), **despite the timid growth in active population** (54,700 people). When the positive effect of seasonality is eliminated, it is estimated that the unemployment rate fell by four percentage points to 20% and stood at mid-2010 figures. Since its cyclical peak in 1Q13, the swda unemployment rate has declined by 6.3 percentage points (see Graph 3.14).

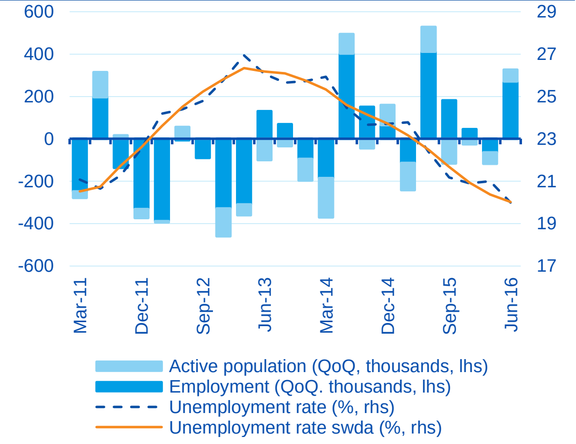
Although permanent employment grew for the third consecutive quarter (86,400 thousand), the increase of employees with temporary contracts (166,200 thousand) caused a **seasonal upturn of seven tenths in the temporary employment rate to 25.7%.** If this factor is corrected, the percentage of employees with temporary contracts stabilized at around 25.7%, 3.1 points above its cyclical trough reached in the first quarter of 2013.

Figure 3.13
Spain: labour market figures (QoQ var. in thousands of persons, unless otherwise indicated, swda)



Source: BBVA Research based on ME and SS

Figure 3.14
Spain: labour market indicators



Source: BBVA Research based on INE

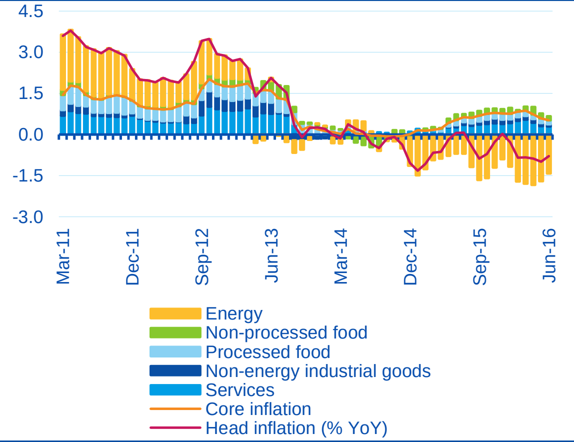
7: The July figures extended the positive trend of the first half-year. Adjusted for seasonality, BBVA Research estimates indicate that the increase in Social Security membership was around 52,000 people, while the fall in unemployment was 42,000. For more information, see https://goo.gl/ErGVdk
8: The detailed evaluation of the data from the EAPS of 2Q16 can be found at: https://www.bbvaresearch.com/publicaciones/epa-del-2t16-la-tasa-de-paro-cae-a-niveles-de-2010-pero-la-creacion-de-empleo-se-modera/

Core inflation limited the fall in consumer prices

The variation of overall consumer prices remained negative during 2Q16 (-0.8% YoY in June)[9]. The downward pressure on inflation continued to focus on the energy component (-11.6% YoY in June), explained by low oil prices (around $45 per barrel at the time of writing) and the falling price of gas and electricity (-11.6% YoY and -13.5% in June, respectively). In contrast, **core inflation remained positive, despite suffering a slowdown of four tenths between March and June (to 0.6% YoY).** Thus, its contribution to the year-on-year growth of prices stood in June at around 0.5 pp, while that of the residual component was at -1.3 pp (energy: -1.4 pp and non-processed food: 0.1 pp) (see Figure 3.15).

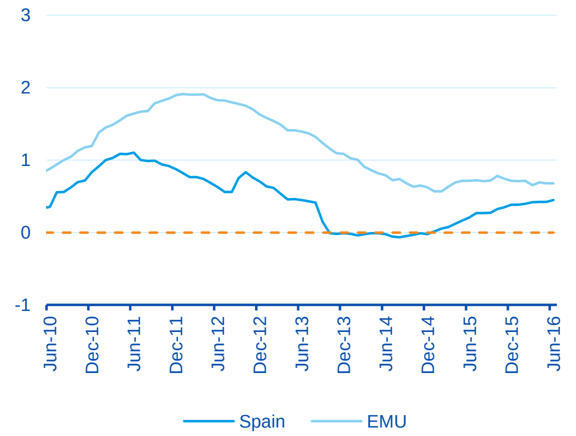
According to BBVA Research estimates, the increase in Spain's core inflation continues to take place in an environment of low and stable inflation in Europe, and consequently limits the Spanish economy's gains in price competitiveness. Thus, although it remains favourable, **the differential in trend inflation relative to the euro zone fell by 0.2 pp in June, almost a point lower than its peak in October 2013** (see Figure 3.16)[10].

Figure 3.15
Spain: contribution to CPI growth(pp YoY)



Source: BBVA Research based on INE

Figure 3.16
EMU: trend inflation (trimmed mean method, % YoY)



Source: BBVA Research based on INE and Eurostat

Wage demands remained stable during the second quarter. The average wage increase agreed in collective agreements was 1.1% YoY from April to June, both for the revised multi-year agreements and for agreements signed during the current year, involving 730,400 workers[11]. As can be seen in Figure 3.17, increases in wages in the second quarter were similar to those registered in the first, but less than the 1.5% set as a maximum limit in the 3rd Agreement for Employment and Collective Bargaining (AENC from its Spanish initials) for the full year[12].

As shown in Figure 3.18, the gain in cost competitiveness relative to the EMU driven by this process of wage moderation since 1Q12 seems to have stabilized at around 5%.

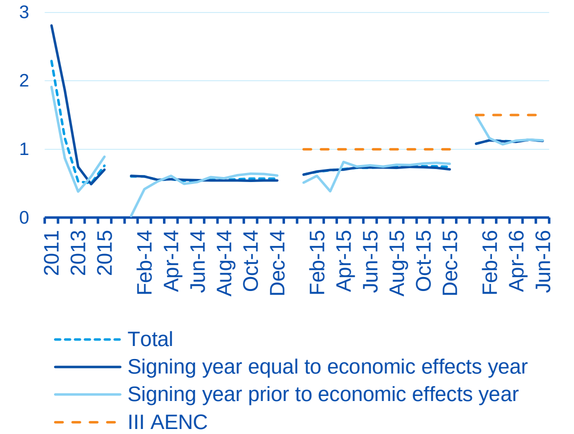
9: The CPI leading indicator pointed to a moderation of 0.2 pp in price decreases with overall inflation going down by 0.3 pp to -0.6% YoY in May, which corresponds to an increase in food price inflation. Our estimates suggest that core inflation may have remained stable at 0.6% YoY. For more details, see https://goo.gl/bJI0G5

10: For more details on the calculation of trend inflation using the trimmed mean method, see Box 1 of the Spain Economic Outlook review for the first quarter of 2014, available at: http://goo.gl/j0rlT8

11: The number of workers covered by collective agreements surpassed 5.5 million up to June including those affected by agreements signed before 2016 (4,841,000). Even though this figure is almost double that recorded to June 2015, it must not be interpreted as an increase in the number of workers covered by collective bargaining agreements, because since the beginning of the current year Collective Agreements Statistics have also included agreements signed but not yet registered.

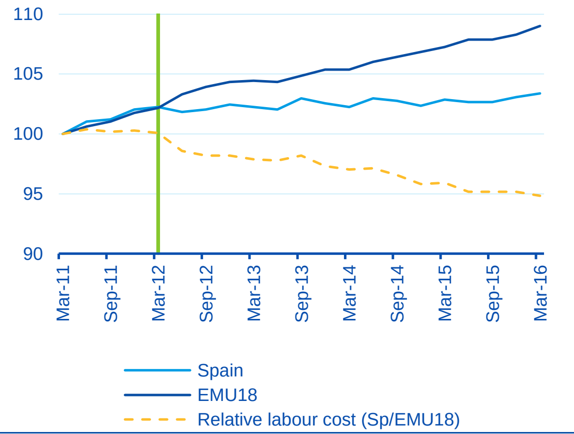
12: The III AENC, signed in early June 2015 by CEOE, CEPYME, Comisiones Obreras and UGT, sets limits on wage increases agreed in collective agreements. In 2015 they were not allowed to exceed 1%, and in 2016 the figure is 1.5%. The increase in 2017 will depend on the development of GDP growth in 2016 and the government's macroeconomic forecasts. Although the agreement does not expressly impose the inclusion of wage revision clauses, it does indicate that the wage growth agreed in the 2015-2016 two-year period must be greater than the sum of the inflation in both years.

Figure 3.17
Spain: average wage increase under collective bargaining agreements (%)



Annual data include agreements registered after December each year and incorporate the review using the wage guarantee clause.
(*) Data for 2015 and 2016 are provisional. The figures from 2013 onwards are not strictly comparable with those of previous years.
Source: BBVA Research based on ME and SS

Figure 3.18
EMU: labour cost per effective hour workedin the market economy (1Q11 = 100)



Source: BBVA Research based on Eurostat

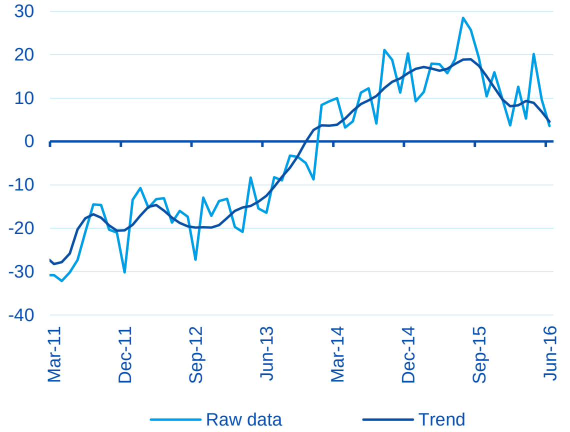
New credit flows are slowing, but lending to the retail sector remains robust

The stock of credit to the private sector continued to decline in the second quarter (-5.1% YoY in May). Likewise, the number of new lending transactions granted also continued to fall, ending the first half down by an average of 9.8% YoY (-15.9% YoY in June). Thus, financing has been dragged down by the decline in credit to companies that top 1 million euros (-40.2% YoY in the month and -31.5% YoY in that accumulated from January-June). The environment of national and international uncertainty, together with the growing tendency to finance their needs through other sources (private savings and, to a lesser extent, debt) is leading to less recourse to bank credit by large companies. In addition, the ECB's corporate debt purchase program could be helping to cheapen bond issues and thus moderate the demand for bank credit.

Unlike the aggregate, **lending to retail sectors (families and SMEs) shows robust growth** and accumulated a rise of 9.2% YoY in the first semester. The cumulative new financing for SMEs (credit roughly estimated at less than one million euros) increased by 4.5% YoY until June, but is showing some signs of slowing down (-1.2% YoY in June). Meanwhile, loans to households picked up and increased by 19.6% in the first semester (13.9% in June). Both new loans for house purchase and consumer loans increased to double-digit rates (31.0% and 33.2% YoY, respectively), while the starting point of the others decreased by -9.8% YoY. Looking ahead to the coming months, it is expected that current trends will be maintained. Financing for the retail sector, which already accounts for 60% of new loans granted in 2016, will continue to increase, while the downturn in loans to large enterprises will stabilize during the second half-year.

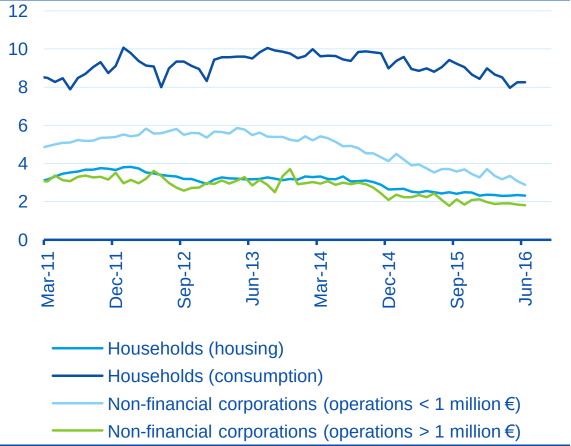
Moreover, the price of new credit continued its downward trend, although in some portfolios it seems that a minimum threshold has been reached, given the low levels of benchmark rates and reduced margins. For example, although the Annualized Percentage Rate (APR) of interes rates for housing acquisition in June stood at 2.32% (18 bp lower than a year ago), it is evidence of some downward resistance given the growing importance fixed rate mortgages are gaining. Meanwhile, interes rates for consumer credit stood at 8.26% APR, 56 bp below their level a year earlier. The interest rate on new loans to SMEs was reduced to 2.87% (APR, -65 bp in a year), while the interest rate on loans to larger companies stood at 1.81% (APR, -61 bp in a year). This trend has been helped by the reduction in EURIBOR and the reduced sovereign and credit risks faced by banks.

Figure 3.19
Spain: new lending transactions (% YoY)



Source: BBVA Research based on Banco de España data

Figure 3.20
Spain: interest rates on new lending transactions (% APR)



Source: BBVA Research based on Banco de España data

The biases within the scenario become reality: an upward revision in 2016 and a downward one in 2017

As advanced in the introduction to this section, the rate of progress observed throughout the year helps **improve the growth forecast for the Spanish economy for 2016 (by 0.4 pp to 3.1%).** However, some of the elements incorporated into the updated macroeconomic scenario (Brexit, fiscal measures, economic policy uncertainty) entail a **moderation in expectations for 2017 (by 0.4 pp to 2.3%).** In any case, this improved activity will be enough to build a net creation of employment of around eight hundred thousand jobs and reduce the unemployment rate to around 18.2% at the end of the period.

However, growth will continue to rely on both internal and external factors. Despite the revisions, the decline in global growth and the rise in the euro exchange rate and oil prices, the international environment will continue to support growth in export demand. Also, domestic demand will be driven by the recovery of its fundamentals, progress in correcting imbalances and expansionary fiscal and monetary policies (see Table 3.1). The increase in final demand will bring about an increase in imports, which in the most likely scenario, will result in **virtually no contribution of net external demand to growth**.

Table 3.1
Spain: macroeconomic forecasts

(% YoY unless otherwise indicated)	Q3 2015	Q4 2015	Q1 2016	2Q16 (e)	2015	2016 (f)	2017 (f)
National Final Consumption Expenditure	3.4	3.5	3.4	3.4	3.0	3.1	1.9
Private FCE	3.5	3.5	3.7	3.7	3.1	3.3	1.9
Public Admin. FCE	3.0	3.7	2.6	2.6	2.7	2.5	1.8
Gross Fixed Capital Formation	6.7	6.4	5.2	4.0	6.4	3.9	3.5
Equipment and Machinery	11.2	10.9	9.8	7.8	10.2	7.0	3.8
Construction	5.2	4.6	3.1	1.7	5.3	1.9	2.9
Housing	2.1	2.2	3.3	3.2	2.4	3.4	3.3
Other Buildings and Constructions	7.6	6.4	2.9	0.6	7.5	0.9	2.7
Domestic demand (*)	4.1	4.1	3.8	3.7	3.7	3.4	2.2
Exports	4.5	5.3	3.7	4.4	5.4	3.8	4.4
Imports	7.2	7.7	5.4	6.4	7.5	4.9	4.5
External balance (*)	-0.7	-0.6	-0.4	-0.5	-0.5	-0.2	0.1
Real GDP at market prices (mp)	3.4	3.5	3.4	3.2	3.2	3.1	2.3
Nominal GDP mp	4.1	4.3	3.2	3.4	3.8	3.6	4.5
Pro-memoria							
Total employment (EAPS)	3.1	3.0	3.3	2.4	3.0	2.9	2.1
Unemployment rate (% Active Population)	21.2	20.9	21.0	19.7	22.1	19.6	18.5
Total employment (FTE)	3.1	3.0	3.2	2.9	3.0	2.9	1.9

(*) Contributions to growth.
(e): estimated; (f): forecast.
Source: BBVA Research based on INE and Banco de España

Low oil prices will encourage growth, but less than what was expected at the beginning of the year

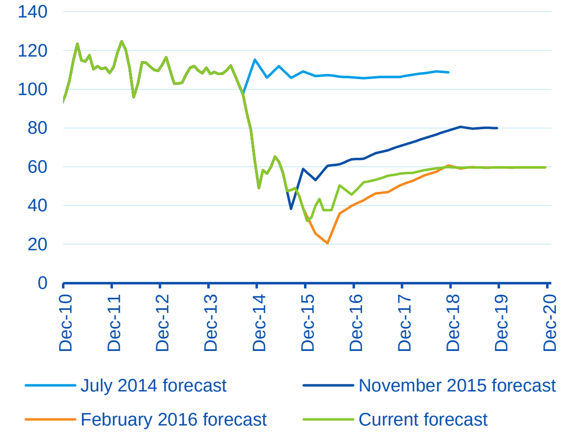
During the first half of the year the price of oil started to correct its falling trend, with Brent crude trading at around US$45 per barrel at the time of writing. Thus, since the downward trend began two years ago **the price of crude oil accumulated a fall of 58.5% until July (47.3% in euros) (see Figure 3.21)**.

The available information indicates that **the bulk of accumulated energy cheapening corresponds to an increase in supply** and, therefore, has a positive net impact on activity[13]: it increases the disposable income of households and improves business margins, which encourages both demand and aggregate supply.

However, BBVA Research forecasts point to an increase in **prices of up to 44 and 53 dollars per barrel in 2016 and 2017 as an annual average,** 11% and 8% above estimates from early 2016 (30 and 45 dollars per barrel, respectively). Consequently, **the support provided by low oil prices to growth could reach, on average, 0.6 pp during the present biennium**, about half that estimated six months ago (see Figure 3.22)[14].

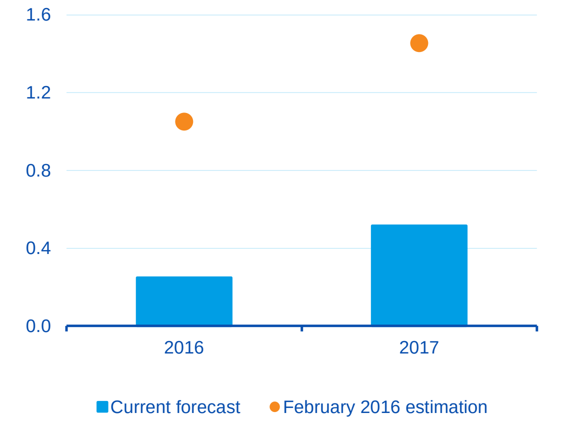
13: Prominent among the supply factors is the production of non-conventional crude in the United States. (shale oil) and OPEC's failure to act on production quotas. On the demand side too there have been pressures on the price of crude, linked to the moderation in expectations of world growth, mainly in the emerging markets. However, estimates by BBVA Research suggest that this factor has played a secondary role.
14: For further details about estimating the effects of oil prices by type of shock on activity and prices in the Spanish economy, see Box 1 of the Spain Economic Outlook journal for the second quarter of 2011, available at: https://goo.gl/iijivP

Figure 3.21
Oil price scenarios (USD/bbl, Brent)



Source: BBVA Research based on Bloomberg

Figure 3.22
Spain: impact of downward revision of the price of oil caused by increase in supply (deviation of annual growth in pp from base scenario of six months ago)



Source: BBVA Research

Monetary policy accompanies the recovery

In view of the risks that hang over growth and inflation, **the ECB has again confirmed its commitment to using all the stabilising instruments envisaged within its mandate, if necessary**. In July, the ECB's Governing Council (GC) maintained rates at all-time lows, the reference interest rate at 0.0%, the deposit rate at -0.4% and the marginal lending rate at 0.25%. With regard to unconventional measures, monthly asset purchases will remain at 80,000 million euros until the end of March 2017 or even later, if necessary. However, the ECB left the door open to implement additional easing measures in the months ahead, the most likely being to expand the program of asset purchases in combination with setting the parameters of the same. The easing of monetary policy in Europe - along with expectations that the Federal Reserve will continue the process of gradual normalization of monetary policy in the United States - helps mitigate the financial volatility stoked up after Brexit and, above all, to contain the risks to recovery.

Bank financing flows will return to the path of recovery

Going forward, we expect all new lending to halt its retreat in the coming quarters, for reasons of both demand and supply. At the expense of allaying the degree of internal and external uncertainty, it is expected that the improvement in the economic situation of businesses and low interest rates encourage the demand for credit. On the supply side, positive contributions will be felt because of improvements in liquidity conditions (thanks to the banking union and the ultra-expansionary policy of the ECB) and lower portfolio risk. The recovery of new credit operations should accompany the improvement in economic activity, so that the banking sector attends to solvent demand and especially to the retail sector, which is more dependent on bank financing.

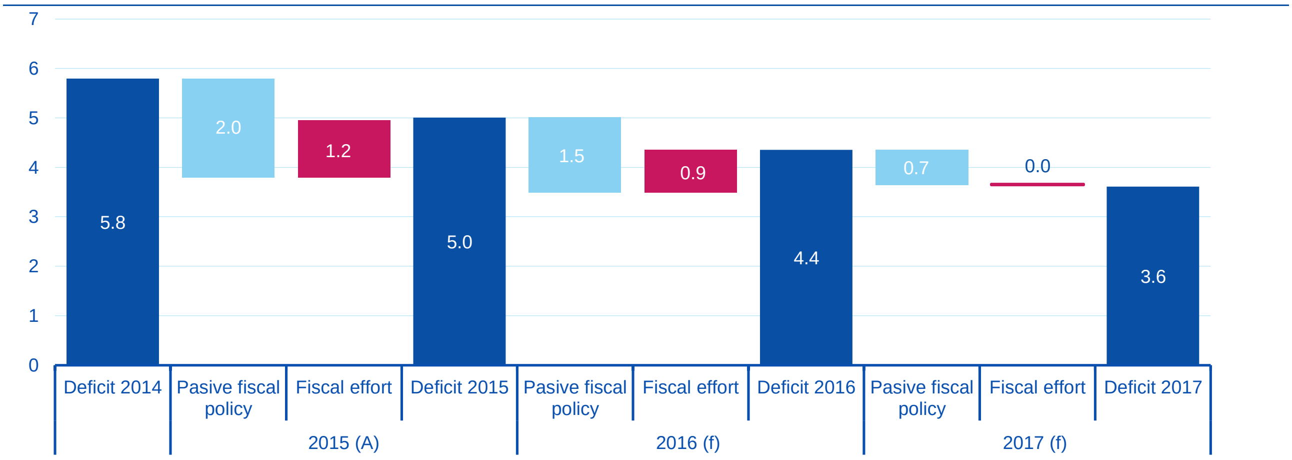
Fiscal policy will remain expansionary in 2016, but would have to change to meet budgetary targets in 2017

Following the trend begun in 2015, public administrations have taken advantage of the recovery in activity and improved financing costs to once again undertake **a slightly expansionary fiscal policy**. Thus, during 2016, public consumption is expected to grow by 2.3% in real terms, while investment in non-residential construction (affected by public works) does the same at around 0.9%. In an unchanging scenario regarding economic policy, **the fiscal policy stance will be broadly neutral in 2017**. Thus, real growth in spending on public consumption will slow to 1.8%, while investment in other construction will present a growth rate of around 2.7%, driven by private non-residential investment, which will compensate prospects of a slowdown in public works.

BBVA Research forecasts suggest that **the tax cuts of 2015 and 2016 have led to a structural fall in revenues, which in the short term will be partially offset by the recovery of tax bases**. Also, the economic cycle will continue to drive revenues, both taxes on production and social contributions. On the expenditure side, **the adjustment is expected to continue over the next two years**, largely due to the expected improvement in the labour market, which will reduce the amount of unemployment benefits, and due to the reduction in financial costs.

In short, **it is again expected that the business cycle supports the containment of the deficit in 2016, both through the effect of automatic stabilisers and thanks to the reduced burden of interest and social benefits.** However, discretionary policies already adopted compensate part of the cyclical improvement, so that the 2016 deficit will decline by only 0.6 pp to 4.4% of GDP, slightly below the new objective for stability (4.6 %). For 2017, the economic cycle is expected to continue correcting the deterioration in the public accounts, but in a scenario without changes in fiscal policy, the shortfall would decline only to 3.6% of GDP, and would exceed the budgetary target set at 3.1% (see Figure 3.23).

Figure 3.23
Regions. Pulbic. Admins.: breakdown of fiscal adjustment (pp of GDP)



(a): advance; (p): projected.
Source: BBVA Research based on MINHAP and INE

However, fiscal policy for the next biennium will be conditioned by the decision of the European Commission under the sanctioning procedure for non-compliance with the objectives for 2015. By virtue of the exceptional economic circumstances, the Commission decided not to fine Spain and give it one more year to correct its excessive deficit (to 2.2% of GDP in 2018). However, the decision was accompanied by the requirement for a new round of structural adjustments (0.5% of GDP in 2017 and 2018), which allows the permanent reduction of the deficit to follow the agreed path. On the other hand, although still pending resolution, the withholding of part of the European funds could be a limitation to the expansion of investment.

In this context, the adoption of measures proposed by the Government during the period of allegations will compensate part of the effect of the fiscal stimulus measures in this year[15]. However, reducing the deficit to 3.1% in 2017 will require further adjustments to ensure a durable correction[16].

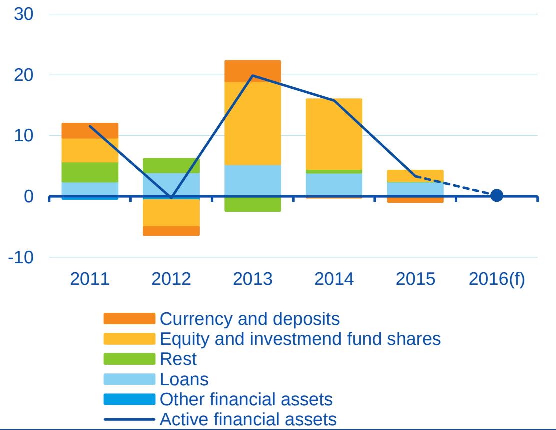
15: On the one hand, the establishment of a minimum rate for corporate tax instalment payments would offset the greatest negative impact that the measures approved in 2016 are having on on the collection of the tax (tax reduction, withdrawal of temporary measures on instalment payments, etc.). On

The momentum of private domestic demand in 2016 will give way to slower growth in 2017

Prospects for household consumption remain positive despite the increased uncertainty. The contribution of net financial wealth to growth in household spending will be more modest than in previous years. As illustrated in Figure 3.24, the envisaged trend in stock market prices will reduce the weight of direct shareholdings and units in investment funds that has explained nearly 70% of the increase in the net financial wealth of households since 2012. Conversely, job creation, lower tax pressure and the absence of inflationary pressures will boost real disposable income in the coming quarters. The expected growth in housing wealth and the expectation that official interest rates will remain at historically low levels will also encourage private consumption. In addition, new consumer finance transactions will continue to increase and will sustain spending in the short term, especially on durable goods[17]. As a result, **private consumption will increase by about 3.3% in 2016**, six tenths more than forecast three month ago.

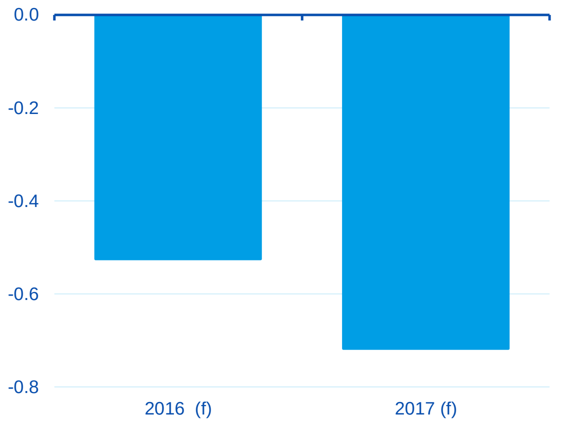
The deteriorating economic scenario undermines the prospects for household spending in 2017. Growth in consumption will touch 2% next year, four tenths less than expected in May. The downward revision is explained by the lower dynamism expected from some of the spending determinants, the exhaustion of transitory factors that spurred on consumption until 2016 (such as tax rebates), the recovery of energy costs and the impact of uncertainty. In this regard, increased uncertainty about the economic policy measures to be adopted in the coming years could subtract seven tenths from the growth in private consumption[18] in 2017 (Figure 3.25).

Figure 3.24
Spain: contributions to net growth in financial wealth of households (annual averages in %)



(f): forecast.
Source: BBVA Research based on Banco de España data

Figure 3.25
Spain: consumer response to increased economic policy uncertainty registered until July (Deviation of the growth rate against the baseline scenario in pp)



(f): forecast.
Source: BBVA Research based on Banco de España and Bloomberg data

the other hand, as shown in the Independent Authority on Fiscal Responsibility's (AIReF) report (see http://goo.gl/6ciGKw) the bringing forward of the closure of the State Budget to July 2016 would be seen to correct some of the non-execution of the entire agreement of announced unavailability.
16: European Commission resolutions are available at http://goo.gl/u4QN2x and http://goo.gl/nd4Qxs
17: See Boxes 3 and 4 of the Spain Economic Outlook review for the first quarter of 2016, available at https://www.bbvaresearch.com/public-compuesta/situacion-consumo-primer-semestre-2016/
18: Consumers alter their patterns of saving and spending, if they have doubts about how policy actions will influence their future income. For example, the possibility that the tax burden on a particular good or service might change, could motivate the bringing forward or deferral of demand. But in addition to its direct effect on purchase intentions, political uncertainty indirectly influences consumption through its impact on job creation. Specifically, companies can modify their investment plans, hiring and firing when the degree of uncertainty about economic policy changes, which sooner or later effects households' spending decisions. For more details, see Box 1 of the Consumption Outlook review for the first quarter of 2016.

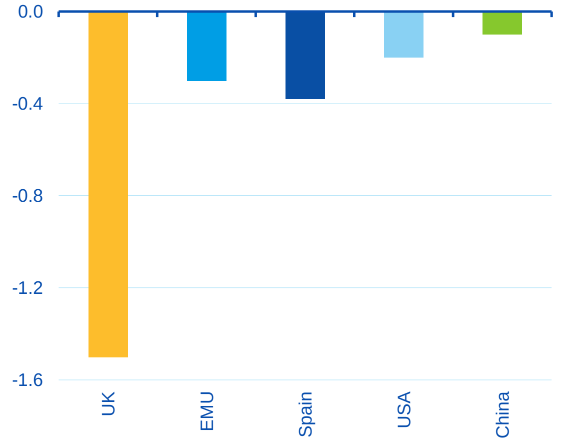
Similar to consumption, investment in machinery and equipment is revised upwards in 2016 and downwards in 2017. While the remarkable dynamism of the first half explains the change in 2016 (1.5 pp to 7.8%), some of the determinants are somewhat less favourable for 2017. Although the growth of domestic and external demand supports the expansion of production capacity, the remaining high level of economic policy ucnertainty, along with that derived from Brexit, may condition the implementation of new investment projects. Even though the expansive monetary policy will in turn continue to facilitate the financing of investment at low rates of interest over the short and long-term, the upward revision in oil prices will narrow savings on internally generated resources which could be used to finance new projects. **All the above justifies a slowdown in demand for this item of up to 6.0% in 2017**, 0.9 pp below the figure forecast three months ago

The recovery of the real estate sector will continue in the next biennium The positive surprise in residential investment in the first half of the year will melt away during the coming quarters. Internal uncertainty and new fronts of scepticism, such as that derived from the United Kingdom's exit from the European Union, may also affect the real estate sector in the next biennium. To date, the United Kingdom is the main source of foreign buyers of housing in Spain. The depreciation of the pound against the euro and economic decline will adversely impact on the income and wealth of British households, which could reduce their demand for housing in Spain. However, sales are expected to continue to grow, supported by favourable financing conditions. The gradual increase in demand in an environment of decreasing supply will favour construction activity and the emergence of new residential projects. In short, **it is expected that residential investment experience an annual growth of 3.4% in 2016** (0.4 pp more than that estimated three months ago) **and 3.3% in 2017** (1.1 pp less).

Export growth is revised downwards, but remains healthy

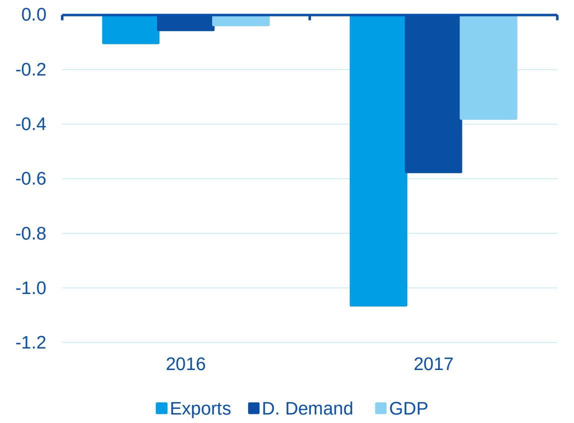
Despite the recovery in the second quarter, the international outlook has become distinctly less favourable for Spanish exports. The sluggishness already exhibited in the recovery of global demand, is acompanied now by the higher than expected oil prices and, above all, by the downward pressure derived from the Brexit result (see Figures 3.26 and 3.27). The consequent moderation of global growth expectations (from -0.4 pp to 1.5% in 2017 in the case of the EMU) and the appreciation of the real effective exchange rate for the Spanish economy (by nearly 2.0 pp in the biennium 2016-2017), has forced a **downward revision in the forecasted total exports growth (by 0.6 pp to 3.8% in 2016 and by 1.2 pp to 4.4% in 2017).**

Figure 3.26
Estimated impact of Brexit on the growth of GDP in 2017. (difference compared to baseline scenario in pp)



Source: BBVA Research

Figure 3.27
Spain: estimated impact of Brexit (difference compared to baseline scenario in pp)

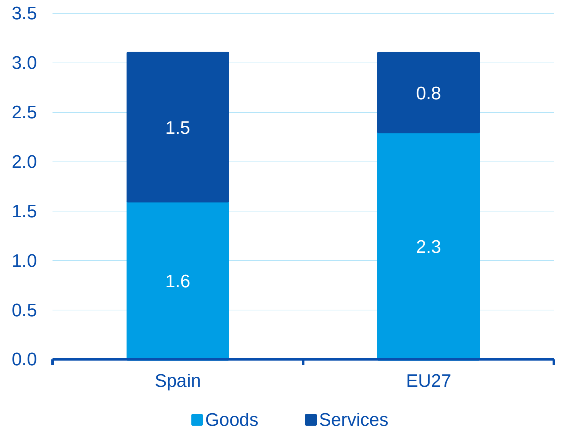


Source: BBVA Research

This revision focuses mainly on exports of services. In the case of non-tourist services, an average annual growth of 5.1% is estimated for the biennium 2016-2017, 2.9 pp below the expected three months ago. In the case of the consumption of non-residents, it is expected to slow from 4.0% in 2016 to 1.1% in 2017 (0.8 pp and 0.9 pp below the figure estimated in May). For its part, **the forecast for growth in exports of goods for 2016 remains unchanged (3.7%), but the expected acceleration is moderated for 2017** (by 0.8 pp to 4.5%).

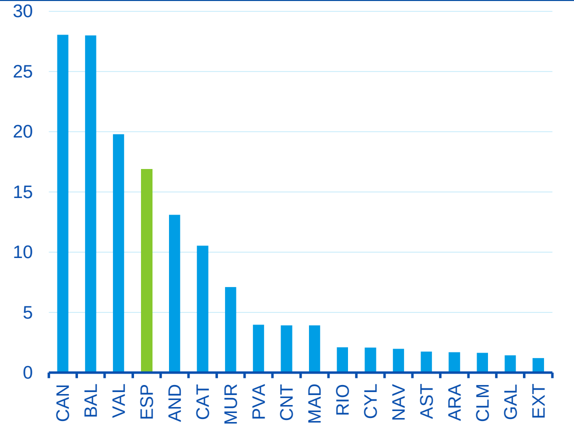
The estimated impact of Brexit on the Spanish economy is based on both direct exposure to the UK and indirect exposure through global demand[19]. In this regard it is noteworthy that Spanish exports to this country represent about 3.1% of GDP, with a similar relative weight between goods and services (1.5% and 1.6% in 2014, respectively). This distribution contrasts with the one observed in the EU27, where exports of goods reached 2.3% and services, only 0.8% (see Figure 3.28). The relative difference is explained by the importance of tourism within Spanish exports and by the revealed preference of British tourists for destinations in Spain[20]. As shown in Figure 3.29, in 2015, the British accounted for 17% of total overnight stays in Spain, with the Canary and the Balearic Island regions (28%) and Valencia (20%) highlighting. Equally important is the weight of the United Kingdom as a destination for Spanish exports of non-tourist services, on average for 2013-2015, it reached 10%.

Figure 3.28
Spain and the EU27: exports to United Kingdom (% of GDP, 2014)



Source: BBVA Research based on IMF

Figure 3.29
Spain: overnight stays of British tourists (% of total in 2015)

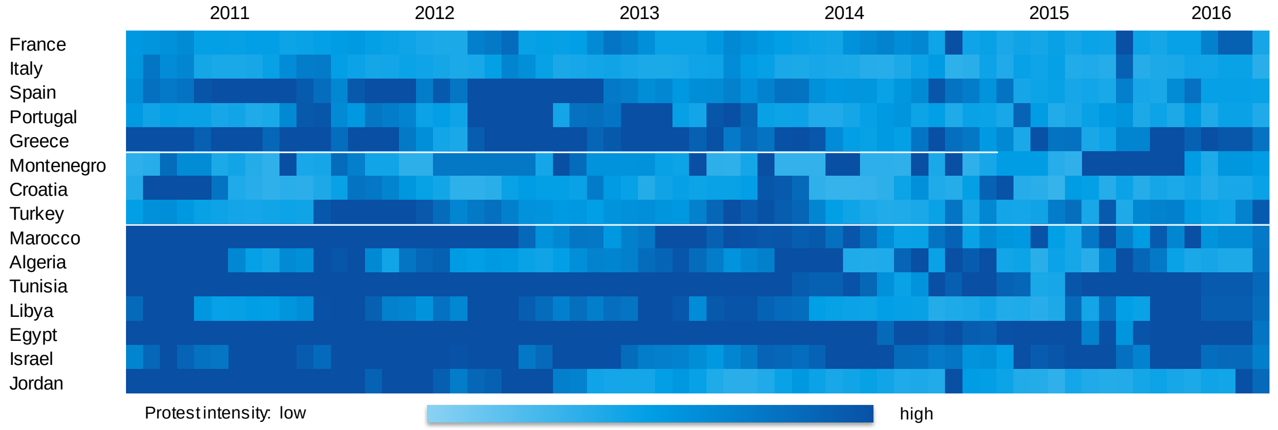


Source: BBVA Research based on INE

In the light of the above, **increasing geopolitical tensions in some competitors in the Maghreb and Turkey**[21] **(see Figure 3.30) could stimulate demand for Spanish tourist destinations,** partially mitigating the potential effect of Brexit on the flow of British tourists.

19: For further details, see BBVA Research publications: "Impact on Spain of the deterioration in growth prospects in the UK" and "Brexit raises uncertainty and skews global growth prospects downward", available at https://goo.gl/0LZuGL and https://goo.gl/mfQzlx
20: According to the United Kingdom's Office for National Statistics (ONS), Spain was the world's most chosen destination by the British and where they spent most money in 2015. See "*Travel trends 2015*" available at https://goo.gl/ptNHTr
21: For a more detailed analysis, see the economic observatory: "Geo-World: Conflict & Social Unrest - July Update" available at https://goo.gl/gkujGm

Figure 3.30
Map of intensity of protests BBVA-Research (number of protests/total events)



Source: BBVA Research based on Gdelt.org

The recovery of the labour market will continue, but pre-crisis levels are still a long way off

Job creation will continue during the next few quarters. Although the LFS 2Q16 disappointed, improving growth prospects for 2016 suggests that employment could increase by around 2.9% this year, one tenth more than expected three months ago. The unemployment rate would drop 2.5 points to 19.6% (19.8% in May). The deterioration of expectations for 2017 downward skews expected job creation to 2.1%. However, the poor growth of the active population would offset the smaller increase in employment, so the unemployment rate would continue to decline to 18.5%.

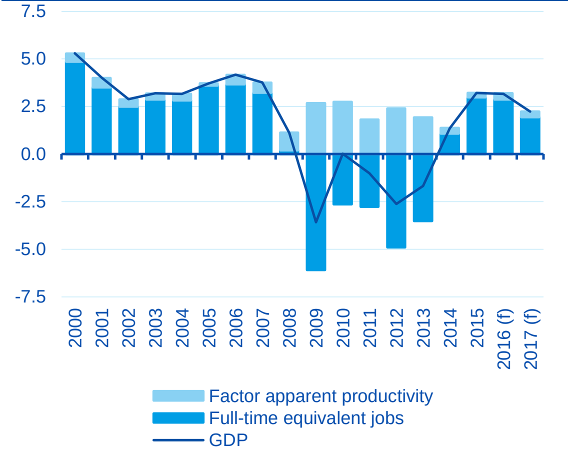
Although prospects for the labour market are positive, much still remains to be done[22]. As Figure 3.31 shows, in the fourth quarter of 2017 employment would be about 9% lower than at the beginning of 2008, while the unemployment rate would be more than 9 points higher. In addition, the expected development of activity and full-time equivalent employment – which will grow by around 2.4% on average in 2016 and 2017 – suggests a meagre rebound in the apparent productivity of labour until it converges in 2017 with pre-crisis figures (see Figure 3.32).

22: In order to strengthen the recovery in employment, BBVA Research proposes that a thorough reform of the labour market be undertaken, which includes a change in the system of job protection so as to encourage hiring on indefinite contracts, modernisation of the collective bargaining system and far-reaching changes to labour market policies. A proposal in this regard can be seen in BBVA Research (2016). BBVA Research (2016): *"Hacia un mercado de trabajo más eficiente y equitativo"* ("Towards a more efficient and fairer labour market"), *Observatorio Económico BBVA*, May. Available at: https://goo.gl/zcwmsn.

Figure 3.31
Spain: level of employment and unemployment rate (1Q08 = 100. swda)

(f): forecast.
Source: BBVA Research based on INE

Figure 3.32
Spain: contributions to annual GDP growth (%)



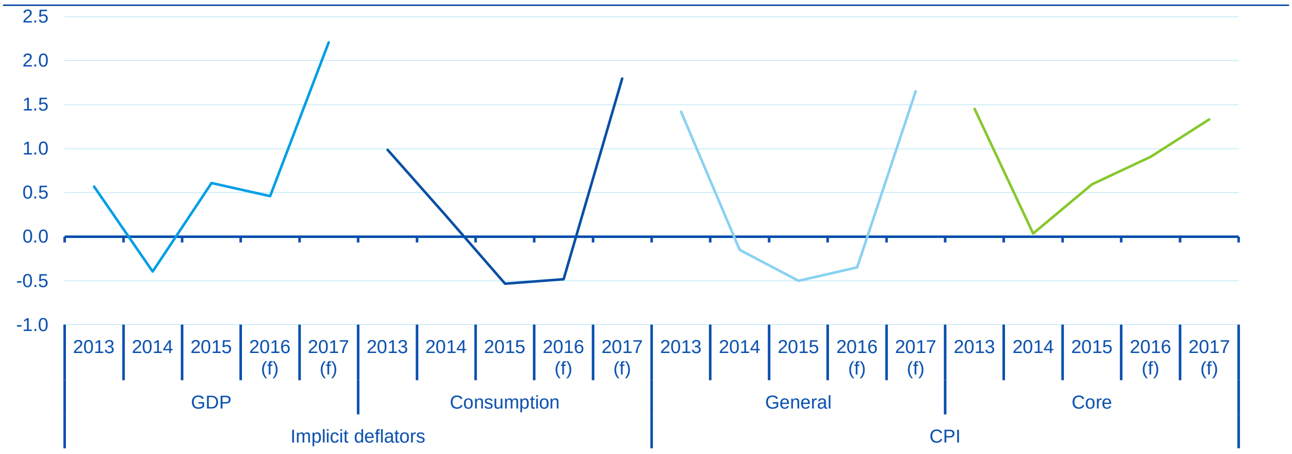
(f): forecast.
Source: BBVA Research based on INE

Inflation will resume a clearly positive trend

Despite the upward correction in oil prices and the slight appreciation of the exchange rate, the base effect resulting from the cumulative decline in energy prices will keep **headline inflation in negative territory for most of 2016 (-0.3% annual average)**. However, domestic determinants continue to sustain positive annual rates for both for core inflation and the implicit GDP deflator (0.8% and 0.5%, respectively) (see Figure 3.33).

In 2017, both headline and core inflation will maintain their positive trajectory (1.7% and 1.6% annual average respectively), but will not reach the inflation target set by the ECB for the euro zone as a whole. Both improved activity and employment, like **monetary policy stimulus measures** (low interest rates, promoting the availability of credit and quantitative easing) continue to contribute to this expected increase in inflation.

Figure 3.33
Spain: price indicators (% YoY)



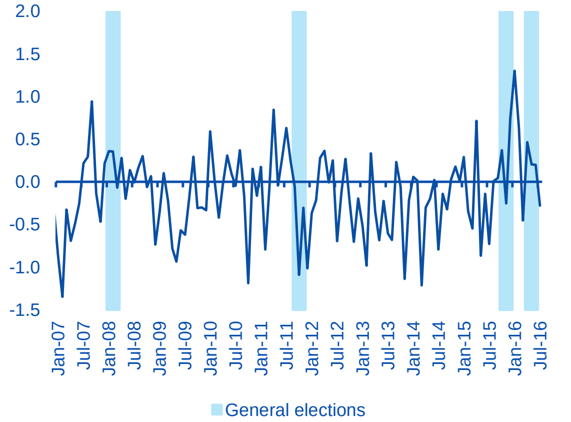
(f): forecast.
Source: BBVA Research based on INE

The persistence of external and internal risks which hang over the scenario

Externally, **there are still warnings of risks about the weakness of the global economy recovery.** Growth in some of the major developed economies (most notably in the US) was disappointing during the first half of the year. This combined with Brexit, adds more uncertainty to the international panorama, already limited by the slowdown in emerging economies (China and the oil exporting countries). As a result, markets have adjusted their expectations about the future of monetary policy in developed economies. The perception that interest rates will remain at their current levels for a prolonged period of time, points to downward pressure on the profitability of the banking system. This, together with the fragility observed in the balance sheets of some European financial institutions may hinder the proper functioning of monetary policy transmission mechanisms.

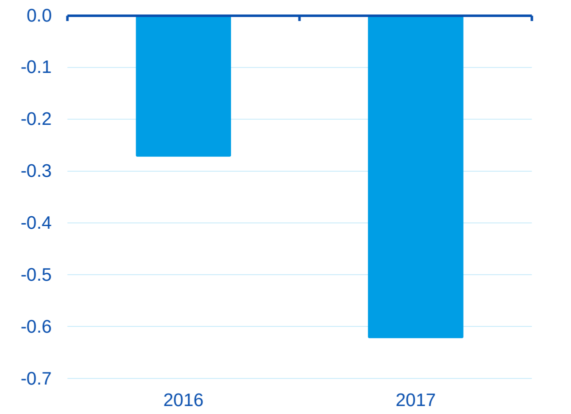
In the domestic environment, the continuing **economic policy uncertainty** is prominent (see Figure 3.34). Despite the resistance shown by growth during the first half of the year, BBVA Research estimates suggest that **this source of uncertainty could be subtracting just under 1 pp of growth from the 2016-2017 biennium** (Figure 3.35)[23]. Although in recent quarters investment could have been sustained by projects whose decisions to initiate were taken before the current period of uncertainty, a slowdown in the coming months cannot be ruled out. Reducing uncertainty is becoming more pressing because, for example, it determines the adoption of the fiscal adjustment measures necessary to meet the new fiscal targets agreed with the European Commission.

Figure 3.34
Spain: idiosyncratic component of the economic policy uncertainty (EPU) index (normalised data)



The shading corresponds to a period of three months surrounding each political event.
Source: BBVA Research based on the EPU by Baker *et al* (2015).

Figure 3.35
Spain: response of GDP to the increase in uncertainty about economic policy recorded since January



Source: BBVA Research

23: For further details about estimating the effects of economic policy uncertainty on the Spanish economy, see Box 1 of the Spain Economic Outlook journal for the first quarter of 2016, available at: https://goo.gl/nRnxi7

4 Tables

Table 4.1

Macroeconomic Forecasts: Gross Domestic Product

(Annual average, %)	2012	2013	2014	2015	2016	2017
United States	2.2	1.5	2.4	2.4	2.0	2.1
Eurozone	-0.9	-0.2	0.9	1.6	1.6	1.5
Germany	0.6	0.4	1.6	1.4	1.4	1.5
France	0.2	0.7	0.2	1.2	1.5	1.4
Italy	-2.8	-1.8	-0.3	0.6	1.0	1.1
Spain	-2.6	-1.7	1.4	3.2	3.1	2.3
United Kingdom	1.2	1.9	3.1	2.2	1.5	0.4
Latam *	2.9	2.7	0.6	-0.4	-0.9	1.8
Mexico	4.0	1.3	2.3	2.5	2.6	2.6
Brazil	1.9	3.0	0.1	-3.9	-3.0	0.9
Eagles **	5.8	5.6	5.2	4.5	4.7	4.8
Turkey	2.1	4.2	3.0	4.0	3.9	3.9
Asia Pacific	5.8	5.9	5.6	5.5	5.3	5.1
Japan	1.7	1.4	0.0	0.5	0.5	0.6
China	7.7	7.7	7.3	6.9	6.4	5.7
Asia (ex. China)	4.3	4.4	4.3	4.3	4.4	4.5
World	3.4	3.3	3.4	3.1	3.1	3.2

* Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.
** Bangladesh, Brazil, China, India, Indonesia, Iraq, Mexico, Nigeria, Pakistan, Philippines, Russia, Saudi Arabia, Thailand and Turkey.
Forecast closing date: 6 May 2016.
Source: BBVA Research and IMF

Table 4.2

Macroeconomic Forecasts: 10-year government bond yield

Annual Average, %	2012	2013	2014	2015	2016	2017
United States	1.79	2.34	2.53	2.14	1.72	1.86
Germany	1.57	1.63	1.25	0.63	0.06	0.20

Forecast closing date: 5 February 2016.
Source: BBVA Research and IMF

Table 4.3

Macroeconomic Forecasts: Exchange Rates

Annual Average	2012	2013	2014	2015	2016	2017
USD-EUR	0.78	0.75	0.75	0.90	0.91	0.90
EUR-USD	1.29	1.33	1.33	1.11	1.10	1.11
GBP-USD	1.59	1.56	1.65	1.53	1.34	1.30
USD-JPY	79.77	97.45	105.82	121.07	106.27	111.25
USD-CNY	6.31	6.20	6.14	6.23	6.66	6.99

Forecast closing date: 5 February 2016.
Source: BBVA Research and IMF

Table 4.4

Macroeconomic Forecasts: Official Interest Rates

End of period, %	2012	2013	2014	2015	2016	2017
United States	0.25	0.25	0.25	0.50	0.75	1.25
Eurozone	0.75	0.25	0.05	0.05	0.00	0.00
China	6.00	6.00	5.60	4.35	0.00	0.00

Forecast closing date: 6 May 2016.
Source: BBVA Research and IMF

Table 4.5

EMU: macroeconomic forecasts (YoY change, %, unless otherwise indicated)

	2010	2011	2012	2013	2014	2015 (f)	2016 (f)	2017 (f)
Real GDP	**-0.3**	**0.9**	**1.6**	**1.6**	**1.5**	**-0.3**	**0.9**	**1.6**
Private consumption	-0.6	0.8	1.7	1.7	1.4	-0.6	0.8	1.7
Public consumption	0.2	0.8	1.3	1.5	1.1	0.2	0.8	1.3
Gross fixed capital formation	-2.5	1.3	2.7	3.0	2.7	-2.5	1.3	2.7
Inventories (contribution to growth)	0.1	0.0	-0.1	0.2	0.0	0.1	0.0	-0.1
Domestic demand (contribution to growth)	**-0.7**	**0.9**	**1.7**	**2.0**	**1.5**	**-0.7**	**0.9**	**1.7**
Exports	2.2	4.1	5.1	2.9	3.0	2.2	4.1	5.1
Imports	1.3	4.5	5.9	4.1	3.4	1.3	4.5	5.9
Net exports (contribution to growth)	**0.4**	**0.0**	**-0.1**	**-0.4**	**-0.1**	**0.4**	**0.0**	**-0.1**
Prices								
CPI								
CPI core	1.4	0.4	0.0	0.2	1.4	1.4	0.4	0.0
Labour market	1.3	0.9	0.8	0.8	1.3	1.3	0.9	0.8
Employment								
Unemployment rate (% of labour force)								
Public sector	-0.6	0.6	1.1	1.2	0.8	-0.6	0.6	1.1
Budget balance (% GDP)	12.0	11.6	10.9	10.1	9.8	12.0	11.6	10.9
Debt (% GDP)								
External sector								
Current account balance (% GDP)	-3.0	-2.6	-2.1	-2.0	-1.9	-3.0	-2.6	-2.1

(f): forecast.
Forecast closing date: 6 May 2016.
Source: BBVA Research

Table 4.6

Spain: macroeconomic forecasts (Annual rate of change in %, unless otherwise indicated)

	2013	2014	2015	2016 (f)	2017 (f)
Activity					
Real GDP	-1.7	1.4	3.2	3.1	2.3
Private consumption	-3.1	1.2	3.1	3.3	1.9
Public consumption	-2.8	0.0	2.7	2.5	1.8
Gross Capital Formation	-3.6	4.8	7.0	4.8	3.5
Equipment and Machinery	4.0	10.6	10.2	7.0	3.8
Construction	-7.1	-0.2	5.3	1.9	2.9
Housing	-7.2	-1.4	2.4	3.4	3.3
Internal Demand (contribution to growth)	-3.1	1.6	3.7	3.4	2.2
Exports	4.3	5.1	5.4	3.8	4.4
Imports	-0.3	6.4	7.5	4.9	4.5
External Demand (contribution to growth)	1.4	-0.2	-0.5	-0.2	0.1
Nominal GDP	-1.1	1.0	3.8	3.6	4.5
(Billions of euros)	1031.3	1041.2	1081.2	1120.4	1171.0
GDP excluding housing investment	-1.4	1.5	3.2	3.1	2.2
GDP excluding construction	-1.0	1.5	3.0	3.3	2.2
Labour market					
Employment, EPA	-2.8	1.2	3.0	2.9	2.1
Unemployment rate (% of labour force)	26.1	24.4	22.1	19.6	18.5
CNTR Employment (full-time equivalent)	-3.5	1.1	3.0	2.9	1.9
Apparent productivity of labour factor	1.8	0.3	0.2	0.3	0.3
Prices and costs					
CPI (annual average)	1.4	-0.2	-0.5	-0.3	1.7
CPI (end of period)	0.3	-1.0	0.0	0.6	1.3
GDP deflator	0.6	-0.4	0.6	0.5	2.2
Compensation of employees	1.7	-0.6	0.5	1.1	1.5
Unit labour cost	-0.1	-0.8	0.3	0.8	1.1
Foreign sector					
Balance of payments on current account (% of GDP)	1.5	1.0	1.4	1.5	1.9
Public sector (*)					
Debt (% of GDP)	93.7	99.3	99.2	99.8	99.1
Balance Public Admin. (% GDP)	-6.6	-5.8	-5.0	-4.4	-3.6
Households					
Nominal disposable income	-0.8	0.9	2.3	2.9	3.4
Savings rate (% nominal income)	10.2	9.8	9.6	9.7	9.4

Annual change in %, unless indicated expressly
(f): forecast.
Forecast closing date: 6 May 2016
(*): Excluding aid to Spanish banks
Source: BBVA Research

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