

ACTIVITY

Spain: the economy maintains its cruising speed in Q3, although risks remain

Spain Unit

The trend in the variables observed indicates that the **recovery of the Spanish economy is continuing on from the start of the second half-year**. With nearly 50% of the information available for 3Q16, the MICA-BBVA¹ model estimates that **quarterly GDP growth (QoQ) could string together five consecutive quarters at the level of 0.8% (see Figure 1)**.

Given this, growth forecasts referred to in the BBVA Research scenario remain unchanged (3.1% for 2016 and 2.3% for 2017)², but the valuation regarding downside risks for next year remains in force.

Private domestic demand continues to lead growth

In the second quarter of 2016, it was domestic demand that continued to support activity. In particular, once again standing out was the progress both in household consumption (0.7% QoQ) and in investment in machinery and equipment (2.3% QoQ). By contrast, the negative surprise came from the virtual stagnation of housing construction (-0.1% QoQ), which was offset by the upward trend in non-residential construction (1.7% QoQ).

Looking to the third quarter, the available information does not advance major changes in the composition of growth. This is suggested by both spending, household expectations and the labour market, pointing to a 0.7% QoQ growth in consumption, similar to that recorded in the previous quarter (see Figure 2). Similarly, partial indicators of investment in machinery and equipment indicate an increase close to 1.2% QoQ, which, in any event would be lower than that recorded between April and June (see Figure 3). Finally, housing investment indicators are showing signs of recovery, which could lead to an increase of around 1.0% QoQ after stagnating in the second quarter (see Figure 4).

Public demand would increase again in 3Q16

The Quarterly National Accounts (QNA) for **2Q16 revealed an unexpected drop in real public consumption (-1.6% QoQ)**, which contrasted with the progress observed since early 2015 (on average 0.9% QoQ). However, data from the State budget execution until July indicate that the decline could be temporary (see Figure 5). Thus, it is estimated that **the actual final consumption expenditure of the public administrations could close the third quarter growing at around 0.7% QoQ**, an increase similar to that recorded until the first quarter of the year (average 2Q15-1Q16: 0.6% QoQ).

Exports maintain their positive tone, despite the global environment

As for external demand, the second quarter was marked by a significant recovery in exports of goods (4.8% QoQ SWDA) and the good performance of services (3.3% QoQ SWDA), which together offset more than the increase in imports (2.7% QoQ SWDA). **Thus, net external demand contributed 0.6pp to quarterly GDP growth, the highest since the last quarter of 2012.**

1: See Camacho, M. and Doménech, 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>

2: The BBVA Research description of the economic scenario for the 2016-2017 biennium is at the end of this observatory

For the third quarter, available indicators show that sales of goods abroad would be maintaining positive growth (1.0% QoQ SWDA), albeit at a slower rate than observed in 2Q16 (see Figure 6). With regard to services, the indicators related to foreign tourism allow expectations that consumption growth of non-residents will maintain its positive tone due, at least in part, to the geopolitical challenges still facing some of the main competitive markets.

The pace of job creation is slowing, at least temporarily

The growth in Social Security affiliation was disappointing in August (15,000 MoM SWDA³ according to BBVA Research estimates). However, if the improving trend observed until July is taken up during the current month (43,000 MoM SWDA on average since January), the number of affiliations could increase 0.7% QoQ SWDA in 3Q16, which, in any event, would imply a slight **slowdown in job creation** (0.8% QoQ SWDA in 2Q16). Meanwhile, **unemployment continued its downward trend last month** (-34,000 people SWDA according to BBVA Research estimates), and, if this continues in September, it will lead to **a bigger fall in registered unemployment** than that observed at the close of the first quarter of the year (-3.0% QoQ SWDA as against -2.4% in 2Q16).

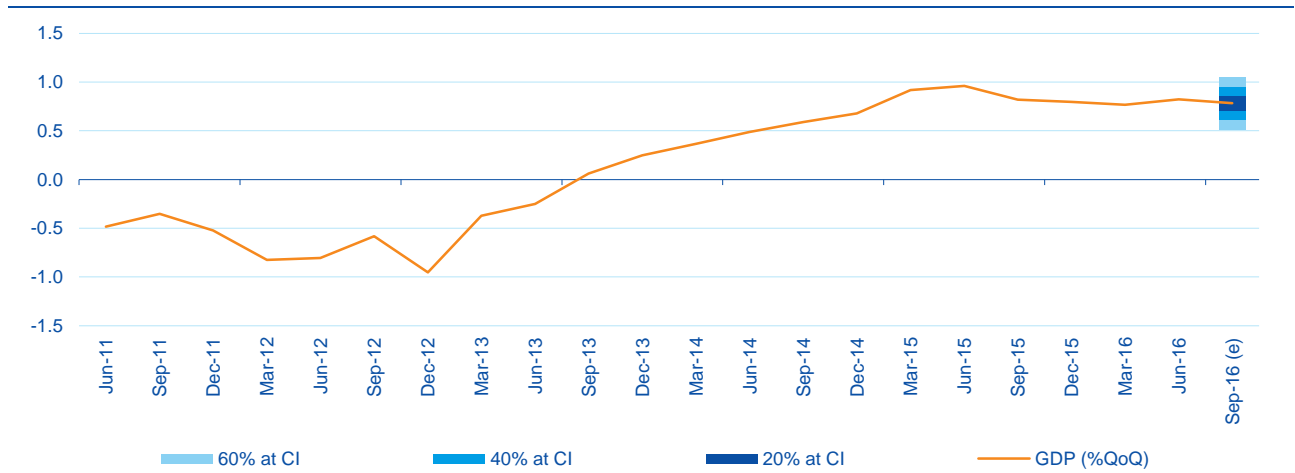
Headline inflation is near to stagnation, and core inflation remains stable in positive territory

The leading indicator signalled that consumer prices slowed their rate of decline in August 0.5 pp to -0.1% YoY (see Figure 8). In this regard, BBVA Research estimates suggest that downward pressure on energy prices continues to moderate, while **core inflation remains positive (at around 0.7%)**. However, **the context of low and stable inflation in Europe persists and, consequently, limits the gains in price competitiveness of the Spanish economy**. Thus, although it remains favourable, the differential in trend inflation relative to the euro zone fell by 0.4 pp over the course of last year to -0.2 pp in July⁴.

3: The seasonal and working day adjustments (SWDA) made by BBVA Research are based on statistical univariate time series methods. Consequently, SWDA series estimates are subject to uncertainty; they may differ from estimates by other agencies, and may subsequently be adjusted without prior warning.

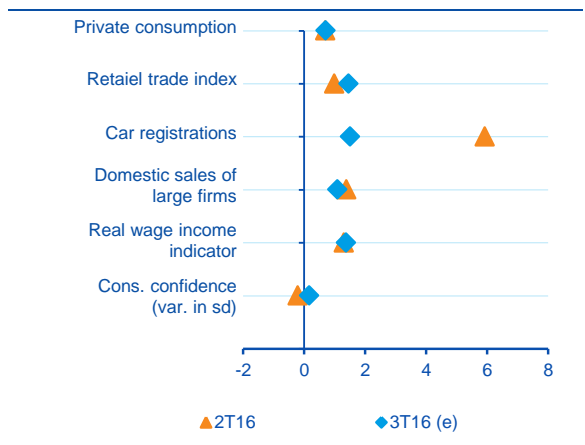
4: For more details on the calculation of trend inflation using the trimmed mean method, see Box 1 of the Spain Economic Outlook review for the first quarter of 2014, available at: <http://goo.gl/j0rIT8>

Figure 1
Spain: observed growth in GDP and forecasts of the MICA-BBVA Model (% QoQ)



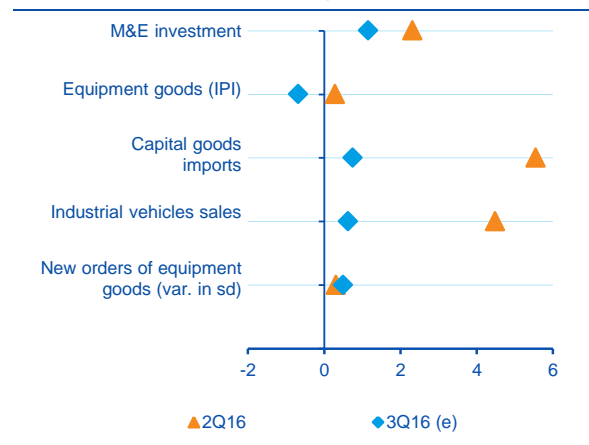
(e): estimate.
Source: BBVA Research

Figure 2
Spain: selection of indicators related to household consumption (% QoQ SWDA, unless otherwise indicated)



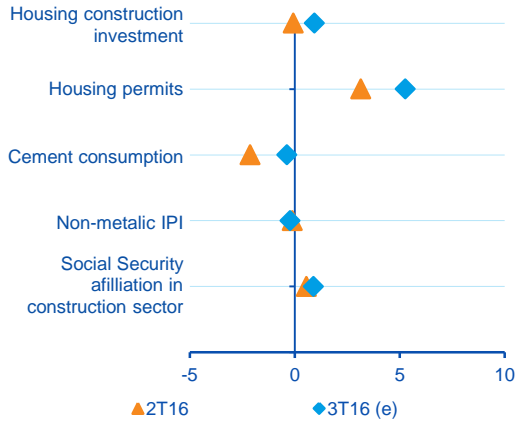
(e): estimate.
Source: BBVA Research based on data from official bodies

Figure 3
Spain: selection of indicators linked to investment in equipment and machinery (% QoQ)



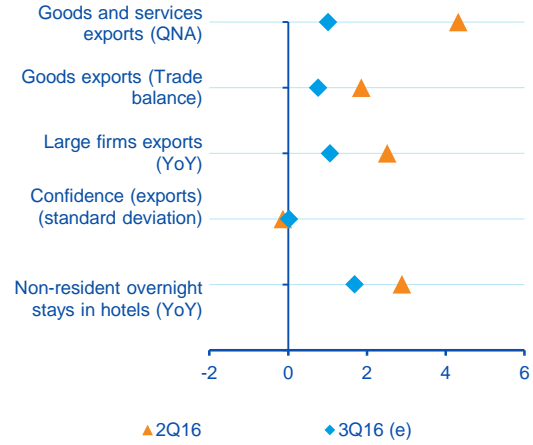
(e): estimate.
Source: BBVA Research based on data from official bodies

Figure 4
Spain: selection of indicators linked to investment in housing construction (% QoQ)



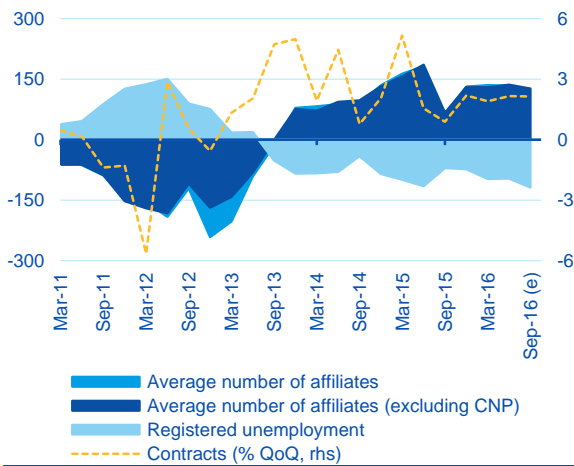
(e): estimate.
Source: BBVA Research based on data from official bodies

Figure 5
Spain: selection of indicators linked to exports (% QoQ, unless otherwise indicated)



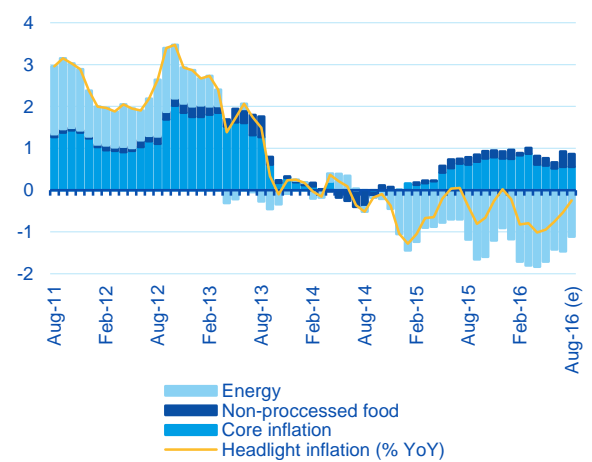
(e): estimate.
Source: BBVA Research based on data from official bodies

Figure 6
Spain: figures from the labour market (quarterly change in thousands of people unless otherwise indicated, SWDA data)



(e): estimate.
Source: BBVA Research based on data from official bodies

Figure 8
Spain: contribution to CPI growth (percentage points YoY)



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

Scenario 2016-2017

As advanced in the 3Q16 Spain Economic Outlook, the rate of progress observed throughout the year **improved the expected growth in early May 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) require 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. Similarly, domestic demand will be driven by the recovery of its fundamentals, progress in correcting imbalances and expansionary fiscal and monetary policies. The increase in final demand will accomplish an increase in imports, which in the most likely scenario, will result in **virtually no contribution of net external demand to growth**.

Low oil prices are conducive to growth, but less than expected earlier this year

During the first half of the year oil prices began to correct their downward trajectory. 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 at the beginning of the year⁵.

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 particular, 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.

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

Public administrations continue to take advantage of the recovery in activity and improved financing costs to once again undertake **a slightly expansionary fiscal policy**⁶. BBVA Research forecasts suggest that already adopted discretionary policies offset part of the cyclical improvement in public finances, so that **the 2016 deficit will decline only 0.6 pp to 4.4% GDP**, slightly below the new stability target (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% GDP**, and would exceed the budgetary target set at 3.1%. In line with the above, it is expected that public consumption will

5: The available information indicates that the bulk of accumulated energy cheapening corresponds to an increase in supply among which the following stand out: the production of unconventional oil in the United States (shale oil) and OPEC's failure to act on production quotas. Consequently, it has a net positive impact on activity: it increases the disposable income of households and improves business margins, which encourages both demand and aggregate supply. For 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/ijivP>

6: Among the measures approved, both rebates in personal income tax and corporate tax are included, as are refunds of part of the bonus withdrawn in December 2012, and a 1% increase in public salaries, etc.

grow 0.8% in 2016 and 1.8% in 2017, while investment in non-residential construction (affected by public works) will do so at around 2.0% and 2.7%, respectively.

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 punish 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 could compensate part of the effect of the fiscal stimulus measures in this year⁷. However, reducing the deficit to 3.1% in 2017 will require further adjustments to ensure a durable correction⁸.

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 years⁹. 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 goods¹⁰. As a result, **private consumption will increase by about 3.3% in 2016**, six tenths more than forecast in May.

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 consumption¹¹ in 2017.

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 (up to 7.0%), some of the basics are somewhat less favourable for 2017. Although the growth of final demand supports the expansion of production capacity, the remaining high level of economic policy uncertainty, along with that derived from Brexit, may condition the implementation of new investment projects. Although 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 this justifies a slowdown in this item of demand of up to 3.9% in 2017.**

7: 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 the collection of the tax (tax reduction, withdrawal of temporary measures on instalment payments, etc.). On 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.

8: European Commission resolutions are available at <http://goo.gl/u4QN2x> and <http://goo.gl/nd4Qxs>

9: The envisaged trend in stock market prices will reduce the weight of direct shareholdings and units in investment funds, which have accounted for almost 70% of the increase in net financial wealth of households since 2012

10: See Boxes 3 and 4 of the Spain Economic Outlook review for the first quarter of 2016, available at <https://www.bbvaesearch.com/public-compuesta/situacion-consumo-primer-semestre-2016/>

11: For more details, see Box 1 of the Consumption Outlook review for the first quarter of 2016.

The recovery of the real estate sector will continue in the next biennium. 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 biennium¹². 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 housing projects. In short, **it is expected that housing investment experience an annual growth of 2.8% in 2016 and 3.3% in 2017.**

Export growth is moderating, but remains healthy

Although the recovery in the second quarter has improved the forecast of total exports in 2016 (to 5.6%), **the international situation has become less favourable over the coming quarters.** The sluggishness already exhibited in global demand, is added to by the higher than expected oil prices and, above all, by the downward pressure derived from the Brexit result. 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), forced a **downward revision in the estimate of growth of total exports in 2017 (by 1.2 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 demand¹³. 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 that observed in the EU27, where exports of goods reached 2.3% and services, only 0.8%. The relative difference is explained by the importance of tourism within Spanish exports and by the revealed preference of British tourists for destinations in Spain¹⁴. 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%.

In the light of the above, **increasing geopolitical tensions in some of the competitors in the Maghreb and Turkey¹⁵ could stimulate demand for Spanish tourist destinations,** partially mitigating the potential effect of Brexit on the flow of British tourists. BBVA estimates indicate that this factor accounts for between a 25% and 30% increase in overnight stays by tourists between 2010 and 2015 (between 11 and 13 million).

12 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.

13: 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>

14: 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>

15: For a more detailed analysis, see the economic observatory: "Geo-World: Conflict & Social Unrest – July Update" available at <https://goo.gl/gkujGm>

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	0.8	1.8
Gross Capital Formation	-3.6	4.8	7.0	4.3	3.3
Equipment and Machinery	4.0	10.6	10.2	7.0	3.9
Construction	-7.1	-0.2	5.3	2.3	3.0
Housing	-7.2	-1.4	2.4	2.8	3.3
Internal Demand (contribution to growth)	-3.1	1.6	3.7	2.9	2.1
Exports	4.3	5.1	5.4	5.6	4.5
Imports	-0.3	6.4	7.5	5.3	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	3.9	4.5
(Billions of euros)	1031.3	1041.2	1081.2	1123.4	1174.2
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	0.7	2.2
Compensation of employees	1.7	-0.6	0.5	1.0	1.5
Unit labour cost	-0.1	-0.8	0.3	0.7	1.2
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	9.5

Annual change in %, unless indicated expressly
 (f): forecast.

Forecast closing date: 8 September 2016

(*): Excluding aid to Spanish banks

Source: BBVA Research

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