

SPAIN Economic Outlook

2ND QUARTER 2017



Main messages

- The world economy continues to improve, albeit within an environment in which risks are still present
- In Spain, current figures confirm the upward bias. Thus 2017 GDP growth forecast has been revised to 3%, while we have maintained unchanged the 2.7% for 2018
- There are no major changes in the fundamentals of growth, nor have there been second-round effects regarding inflation so far
- Although reforms have had a positive impact, there are still significant imbalances



Global Economic Outlook

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The positive dynamic takes hold

The main trends continue...

Recovery of
industrial activity and
international trade is confirmed

Financial markets stable
amidst growing geopolitical tension

Headline inflation continues to rise,
while core inflation remains stable

...while uncertainties take shape

A substantial growth stimulus
in the US seems less likely...

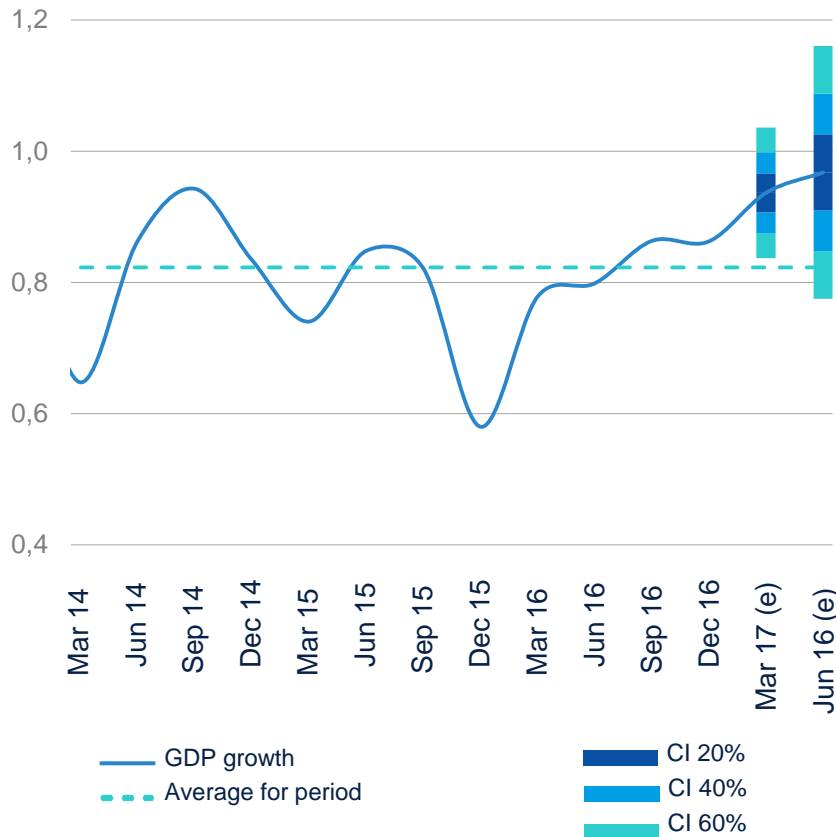
...although more protectionist
scenarios too

Central banks move
towards normalisation

The world's economy continues to accelerate in early 2017

Global GDP growth

Forecasts based on BBVA-GAIN (% QoQ)

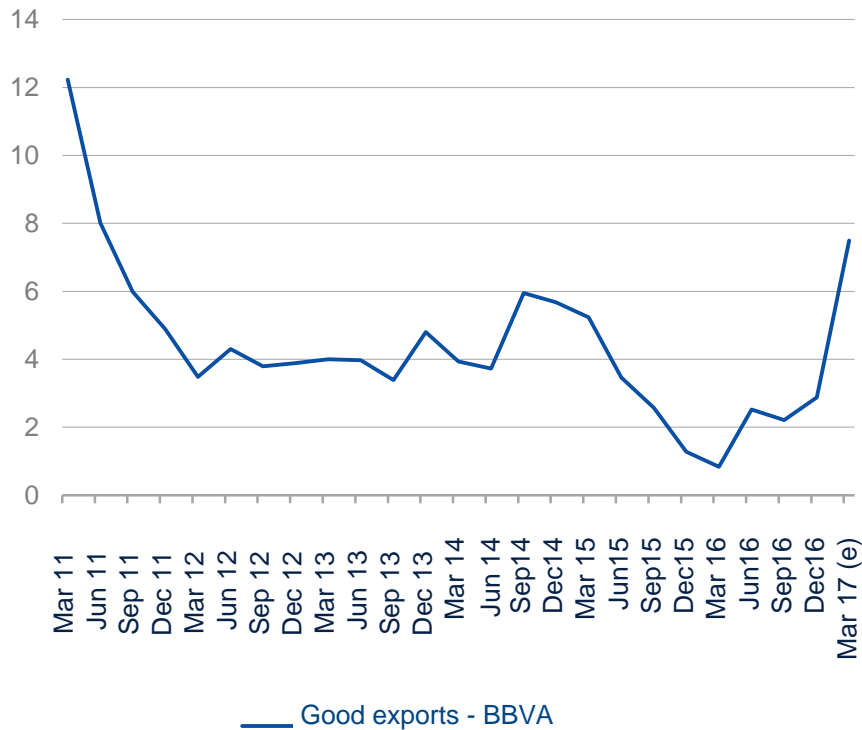


- ◆ Confidence indicators are at very high levels, but hard indicators only partially reflect that improvement
- ◆ China and advanced economies show signs of strength. However, the emerging economies are performing more irregularly

(e): estimated
Source: BBVA Research

Exports improve around the world

**World exports of goods
(constant prices)**
(YoY, %)

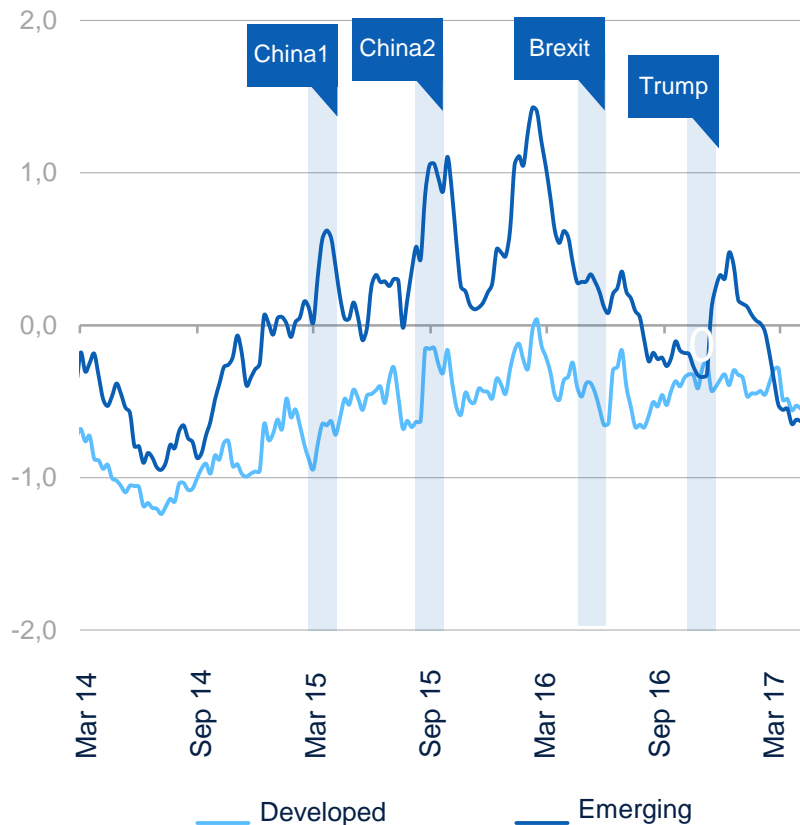


- ◆ **World trade** shows signs of acceleration, driven by investment in China
- ◆ **Industrial activity** partially reflects this improvement
- ◆ **Consumer indicators** show some signs of slowing down

(e): estimated
Based on BBVA-Trade Index figures
Source: BBVA Research and CPB

Financial tension remains low

BBVA financial tension index
(normalised index)



- ◆ **Volatility has shrunk** despite the economic policy uncertainty
- ◆ **Fiscal and Monetary stimulus** mask substantives concerns
- ◆ **Europe** has been the exception, with **sovereign spreads increasing**, due to forthcoming French elections and the overall political scenario

Inflation shows no signs of second round effects so far

Headline and core inflation

(YoY, %)

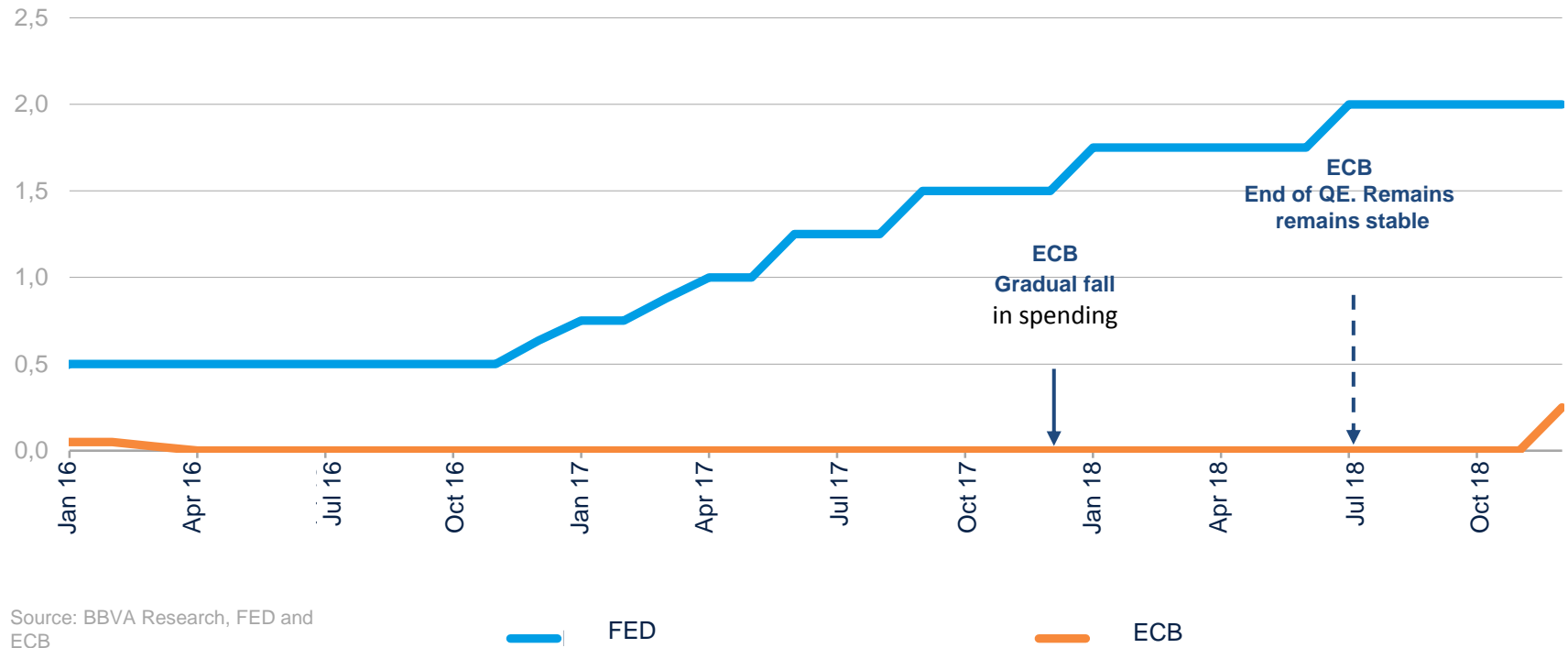


- ◆ The effect of commodity prices on inflation is reaching its maximum level
- ◆ Core inflation remains low, without apparent second-round effects
- ◆ As a result, inflation forecasts have been lowered

Central banks move towards a normalisation of their policies

FED and ECB interest rates

(bp)



Source: BBVA Research, FED and ECB

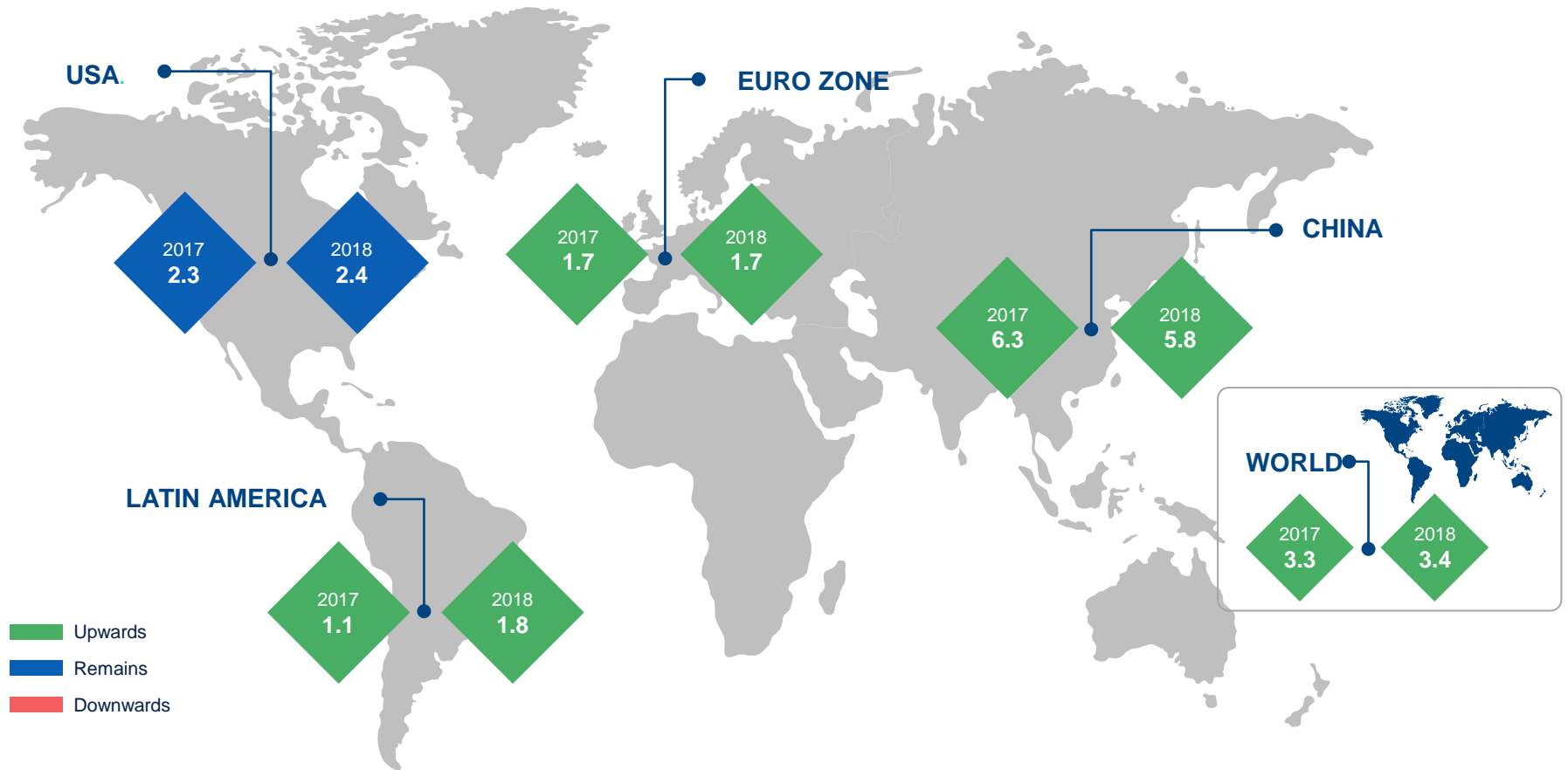
— FED

— ECB

The Federal Reserve continues to raise interest rates, although it remains cautious about the economic

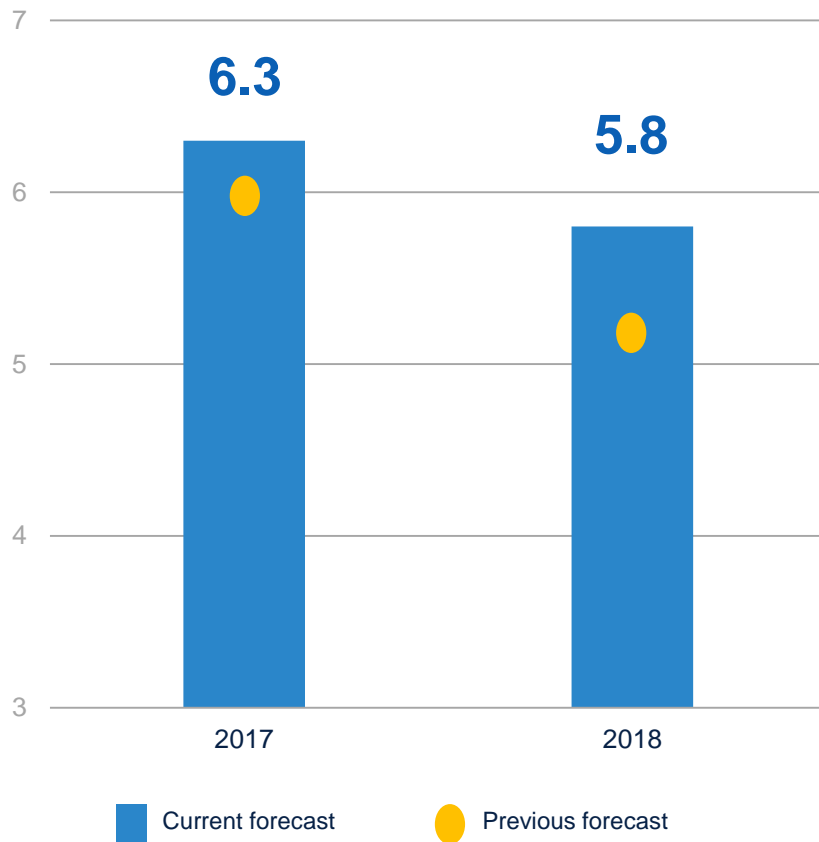
The ECB is increasingly looking at an exit strategy for monetary policy

Upward revision in China and the eurozone, slightly higher in Latin America. Unchanged in the US.



China: a new impulse from old engines

GDP growth (YoY, %)

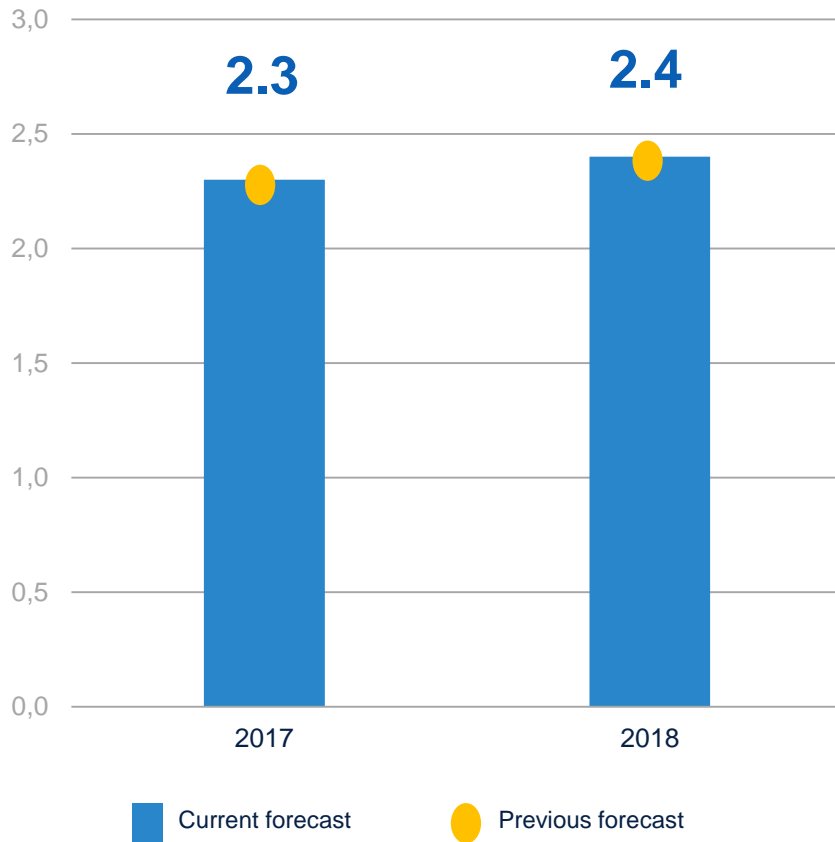


◆ We have revised our forecasts for 2017 and 2018 upwards, due to recent figures that mainly reflect the fiscal impulse

- ◆ Nevertheless, mid-term risks remain considerable:
- The rebalancing process toward services and consumption has stagnated
 - Economic policy mistakes may lead to disorderly deleveraging process

USA: expected fiscal stimulus delayed

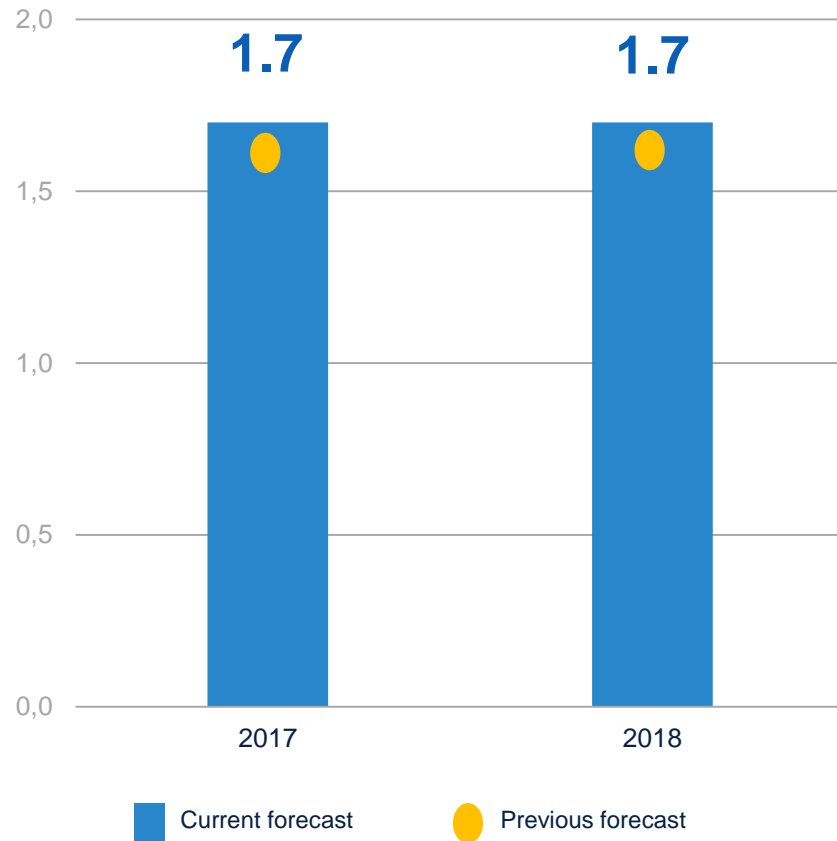
GDP growth
(YoY, %)



- ◆ Activity will accelerate in 2017 due to improving investment. However, consumption is somewhat less dynamic
- ◆ Economic policy risks continue despite the more optimistic tone in recent months

The eurozone: a more positive panorama, although risks remain

GDP growth (YoY, %)



- ◆ Slight upward growth revision in 2017 and 2018, which may drive inflation. Exports are behind this improved scenario
- ◆ Risks are mainly political in nature, but there are still many sources of uncertainty (electoral cycle, hard Brexit, Greece, the geopolitical prospect etc.)

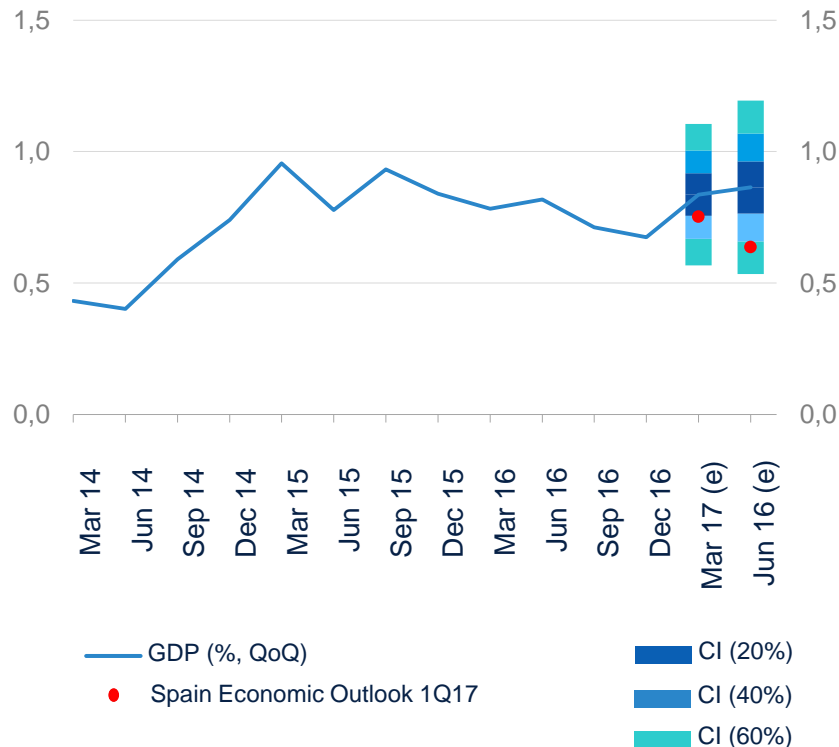
Spain Economic Outlook

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Upward bias confirmed

Spain: Observed GDP growth and forecasts of the MICA-BBVA Model*
(% QoQ.)



- ◆ Recent economic figures (e.g. employment and exports) point to a **slightly better than expected short-term outlook**
- ◆ Upward revision of 0.3pp in the **growth forecast, which now stands at 3% for 2017**

(e): estimated

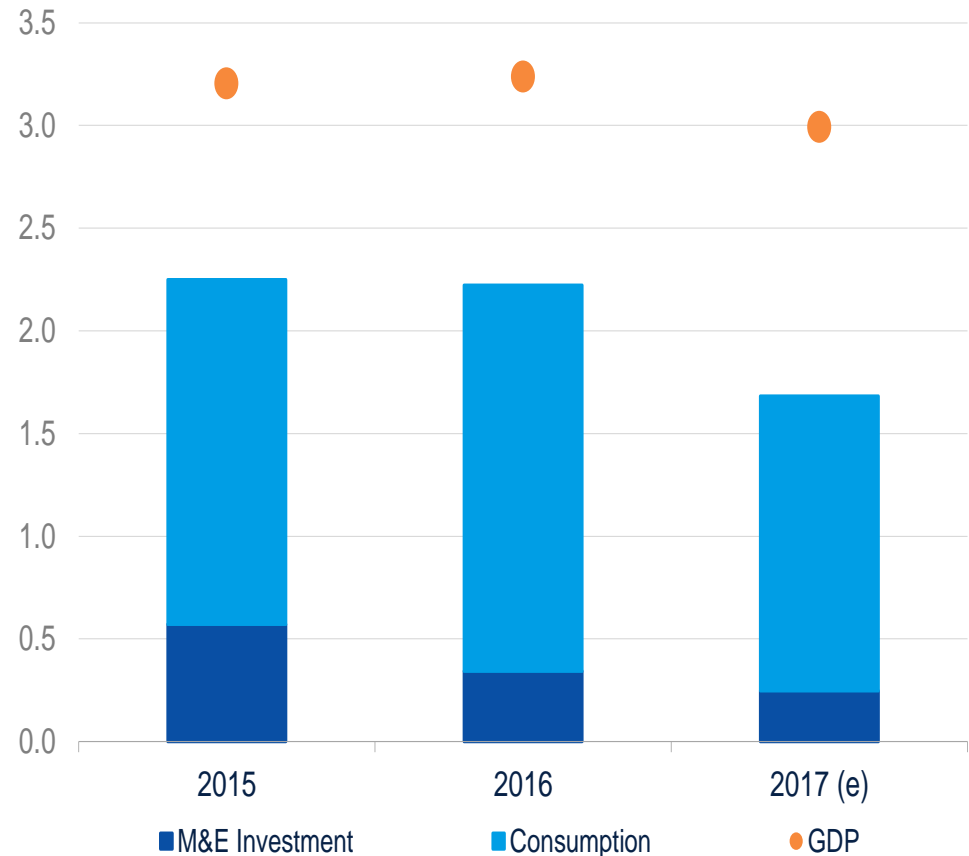
Source: BBVA Research

(*) Camacho, M. and R. Doménech (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>

...despite the slowdown in internal demand

- ◆ We have seen slower growth in household consumption, private investment in machinery and equipment
- ◆ Some cyclical stimulus may have run out (pent-up demand), while uncertainty may have seen growth clipped

Spain: contributions to YoY GDP growth (%)



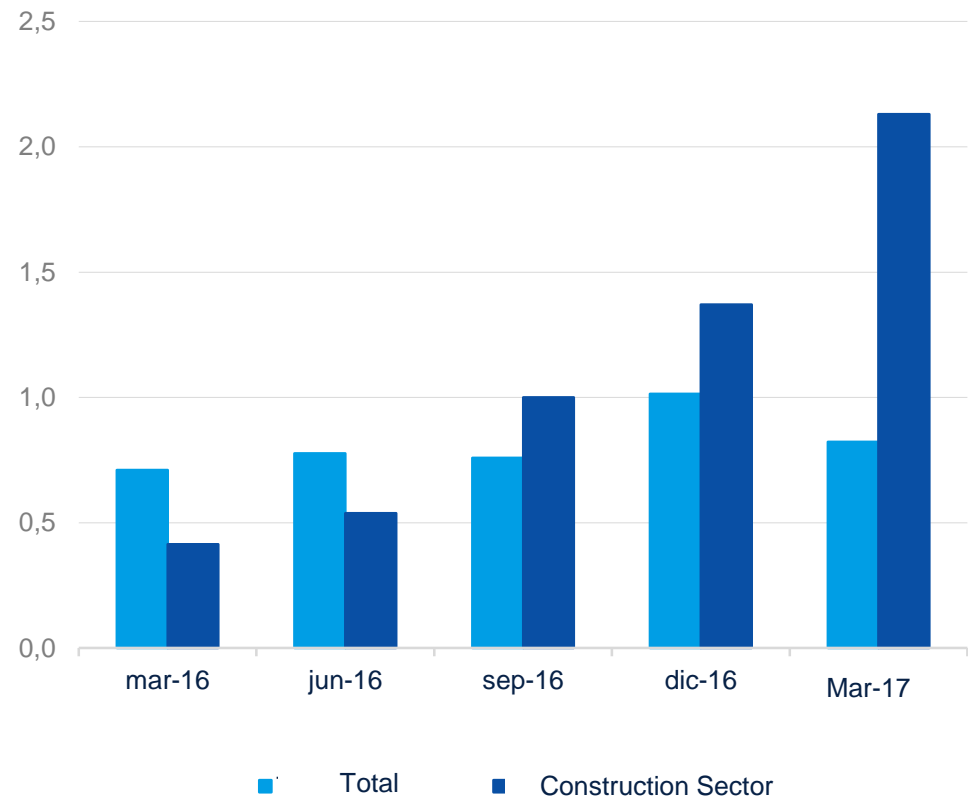
(e): estimated

Source: BBVA Research based on INE (National Statistics Institute) figures

Residential investment gains momentum

- Recent figures point to the long-awaited **acceleration in the real estate sector**
- Demand, along with a reduction in oversupply, have been the causes of the **price increases and the uptick in activity** in certain urban areas

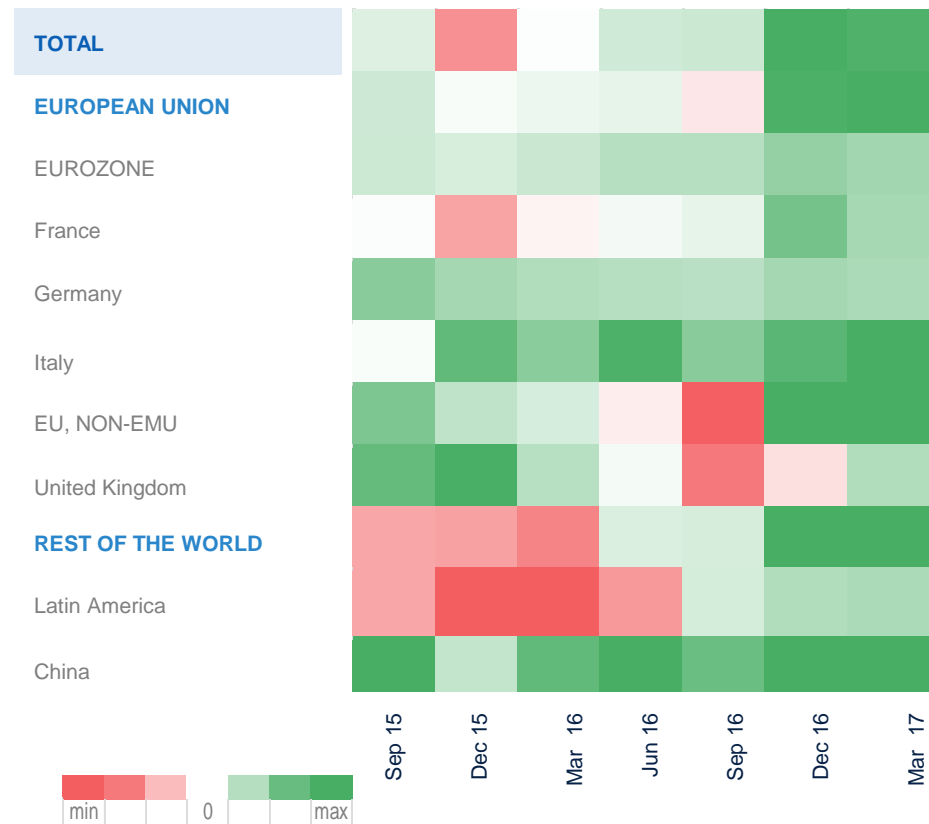
Spain: Social Security affiliation growth
(SCA, % QoQ)



Exports of goods recover, despite Brexit

- ◆ The recovery in goods exports can be explained partly by **improved performance in emerging markets**
- ◆ **The euro zone continues to bolster growth in exports, while lower sales to the United Kingdom has had a relatively small impact**

Spain: Exports per country
(trend, %YoY)



(e): estimated

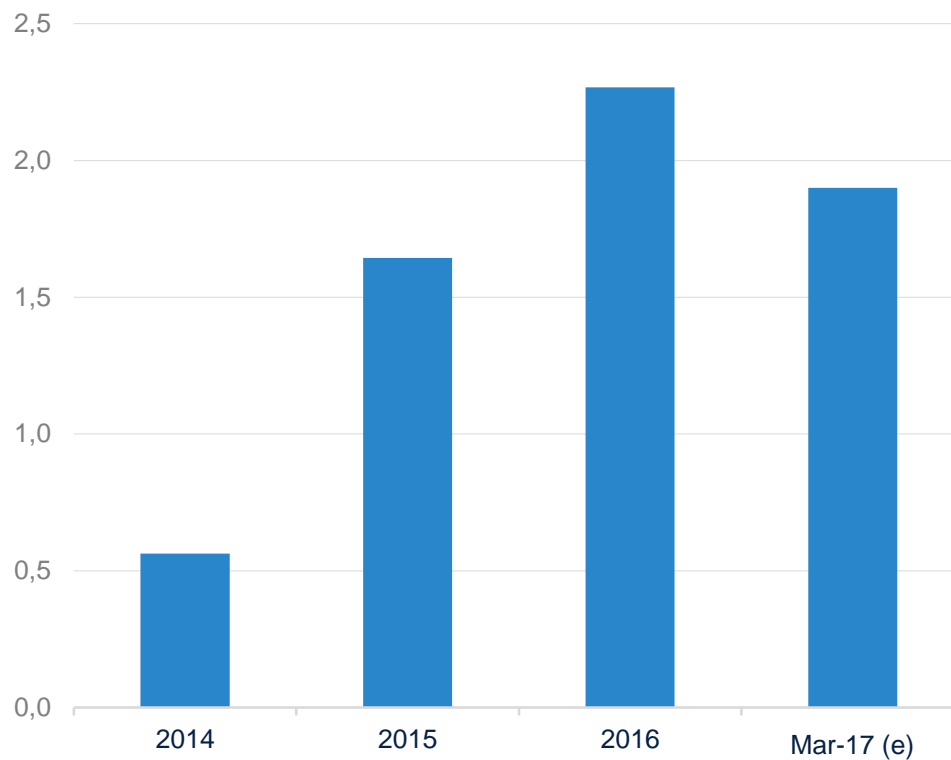
*Red and green respectively indicate negative and positive quarterly trend variations
Source: BBVA Research based on INE figures

Foreign service sales remain strong

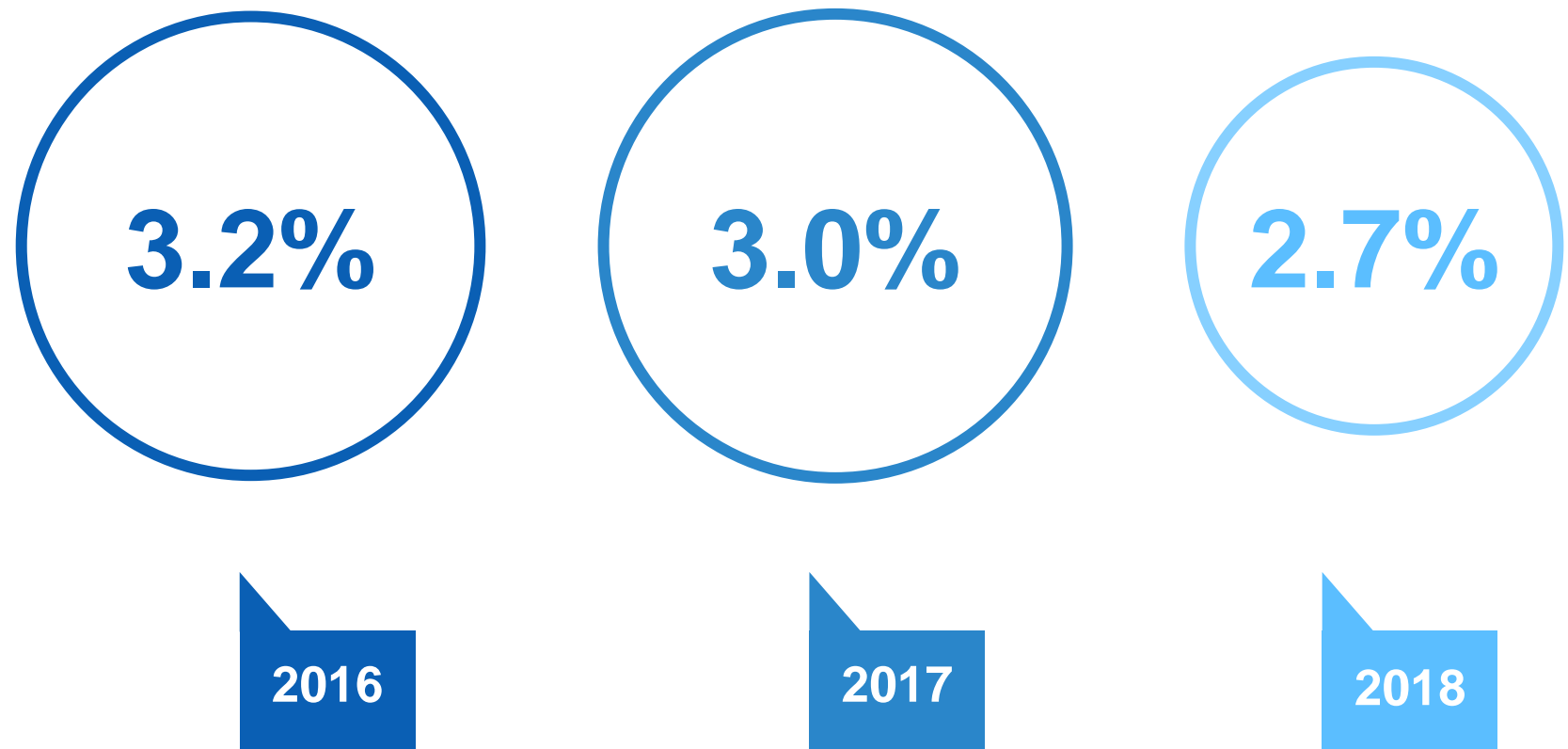
- ◆ Non-tourism service exports continue to grow at a healthy rate (an average of 6.8% per year, 2014 to 2018)
- ◆ Geopolitical tension in competing countries continues to bolster growth in tourism

Spain: Tourism services exports

(annual average of quarterly growth rates)



We revise our 2017 GDP growth forecast to 3%



The global context, positive for Spain

1



Global demand

Positive perspectives, especially in the euro zone and in emerging markets, will drive the exports

2



Oil price

Despite increases in recent months, prices stay 40% below 2014 levels

3



Geopolitical tension

Tourism in Spain will continue to benefit from the perception of insecurity in competing destinations

4



Euro exchange rate

The euro is still depreciated against the dollar in 2017, but with an upward trend for 2018

5



Official Interest rates

At historical lowest levels, with expectations of moderate increases in the short term interest rates in late 2018

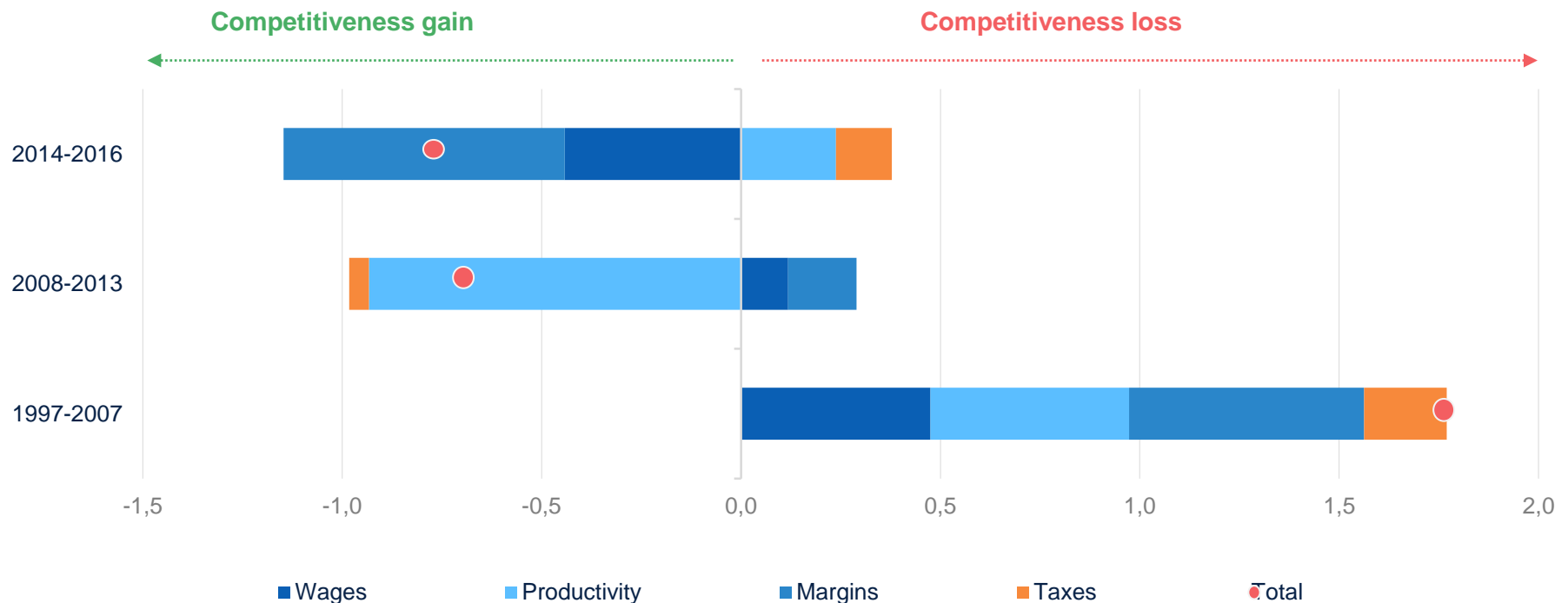


Risk premium

Still low as a result of the ECB's Asset Purchase Programme

Inflation: gains from competitiveness

Spain: breakdown of the inflation differential with respect to the EMU 12 based on the GDP deflator (average annual growth)



Source: BBVA Research based on AMECO figures

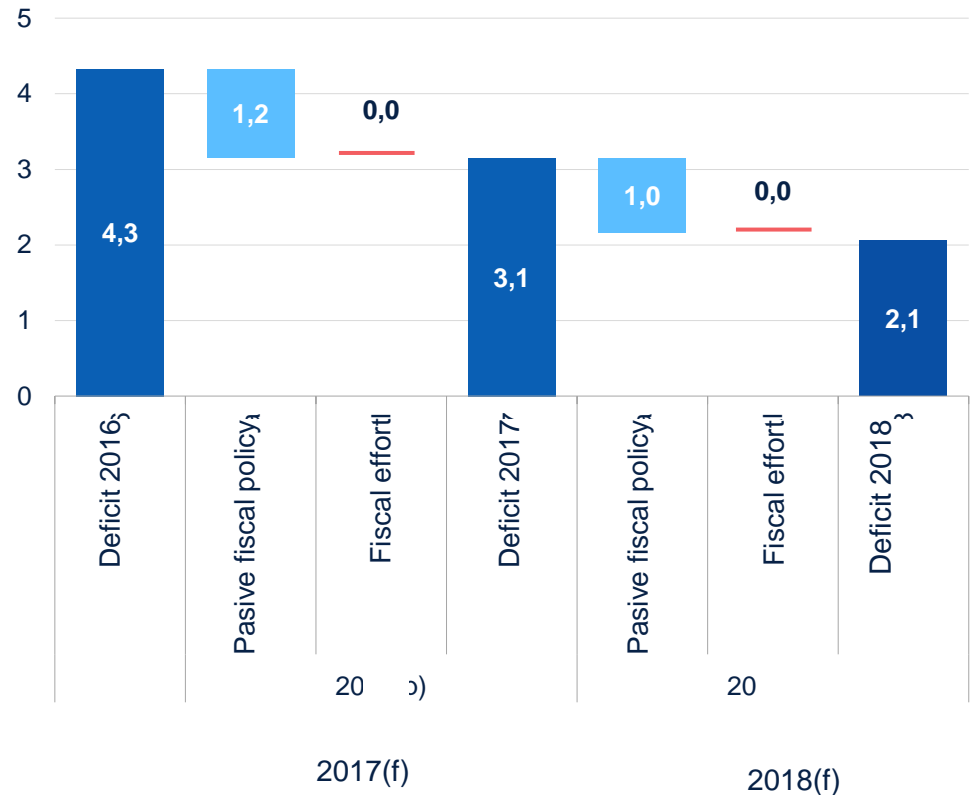
During recovery, competitiveness gains have remained stable, thanks to the contribution of both margins and wages

This distribution has been consistent with the creation of employment, the growth of investment and the increase in exports. Maintaining this level will be key

Fiscal policy in line with targets

- ◆ The 2016 deficit (in line with expectations), recovery and Central Government Budget for 2017 make the stability target viable
- ◆ Although there is some uncertainty regarding expected revenues, the higher GDP and prices growth will facilitate a reduction of the deficit

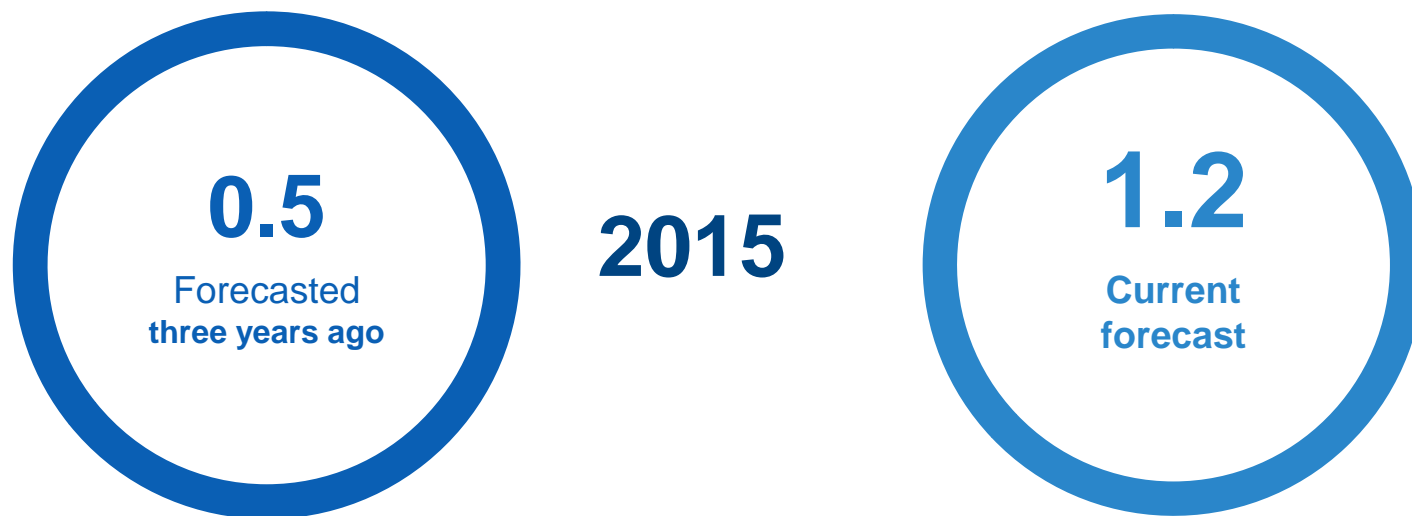
Spain: Fiscal adjustment
(%, YoY)



(f): forecast.
Source: BBVA Research

Economic performance highlights structural improvements

Spain: Potential 2015 GDP growth by forecast date
(%)



Source: BBVA Research based on INE and CF INC

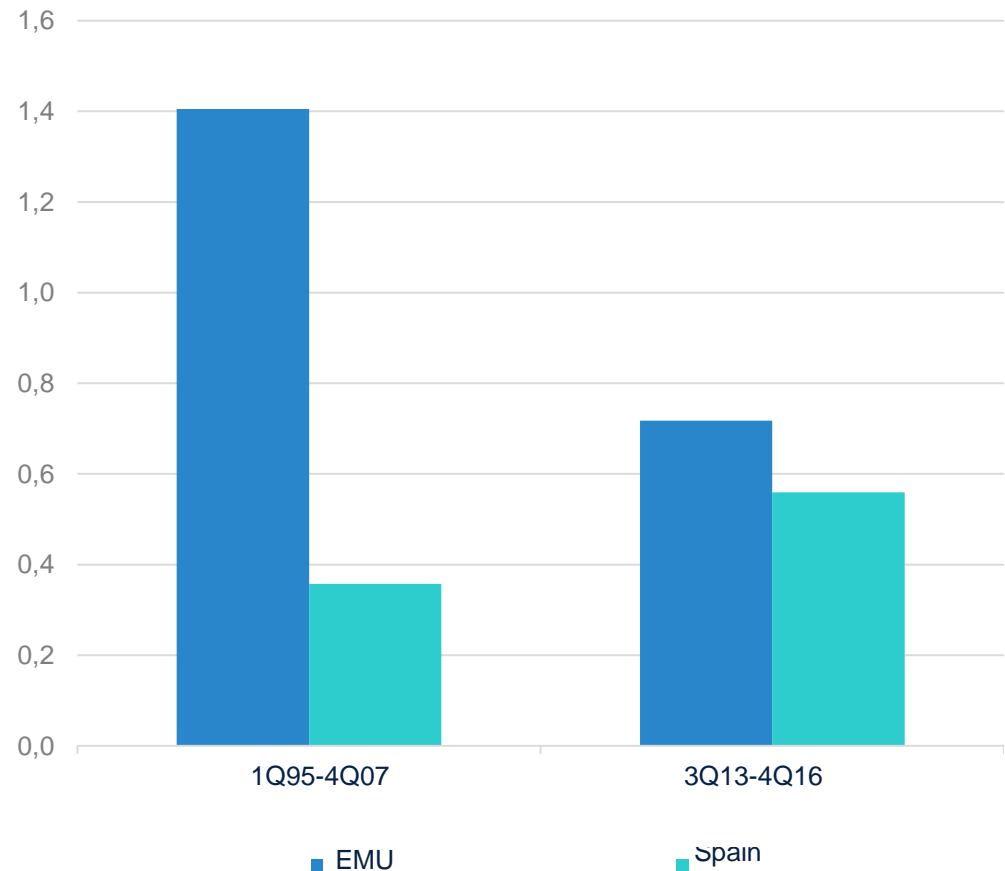
The ongoing upward revision of GDP growth forecasts suggests an underestimation of both structural and cyclical factors

Deleveraging efforts would appear to have been underestimated, as has reorientation towards external demand and the impact of reforms

In the medium term, improved productivity will be a key factor

- ◆ The **gap** between Spain and the EMU in **productivity growth** has **decreased** in recent years
- ◆ **Productivity growth** is still low, although in part this might be the result of global factors
- ◆ There are some signs of **structural improvement**

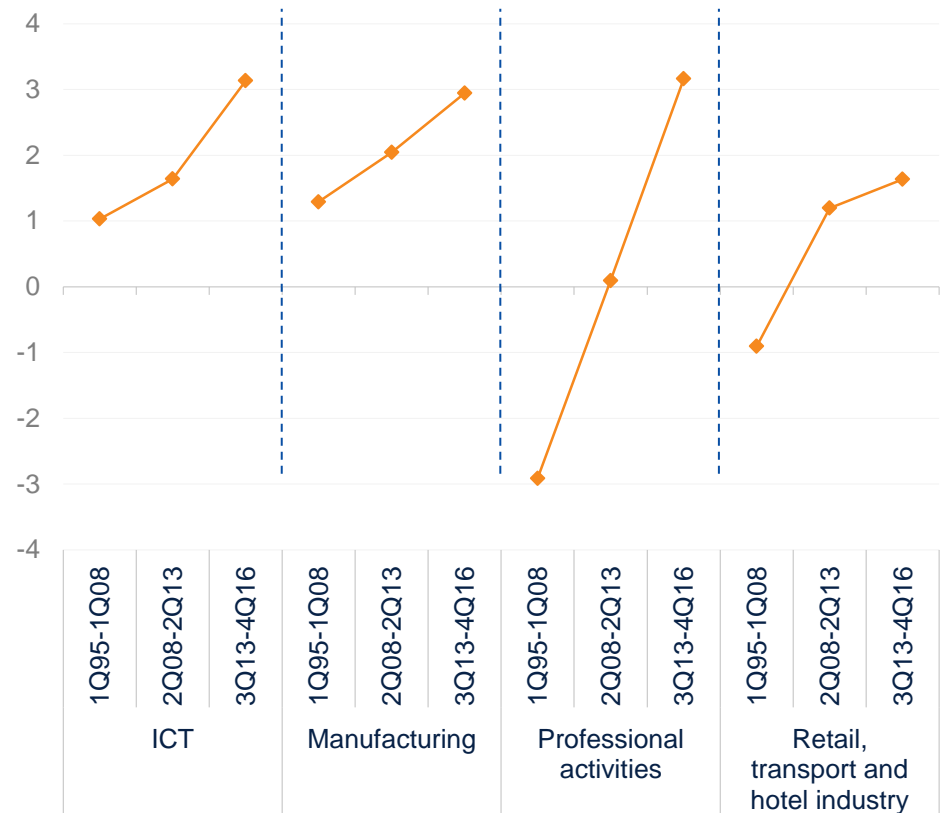
Spain: Labour factor productivity
(GVA per hour worked % QoQ, annualised average)



Sectoral composition shows some reasons for optimism

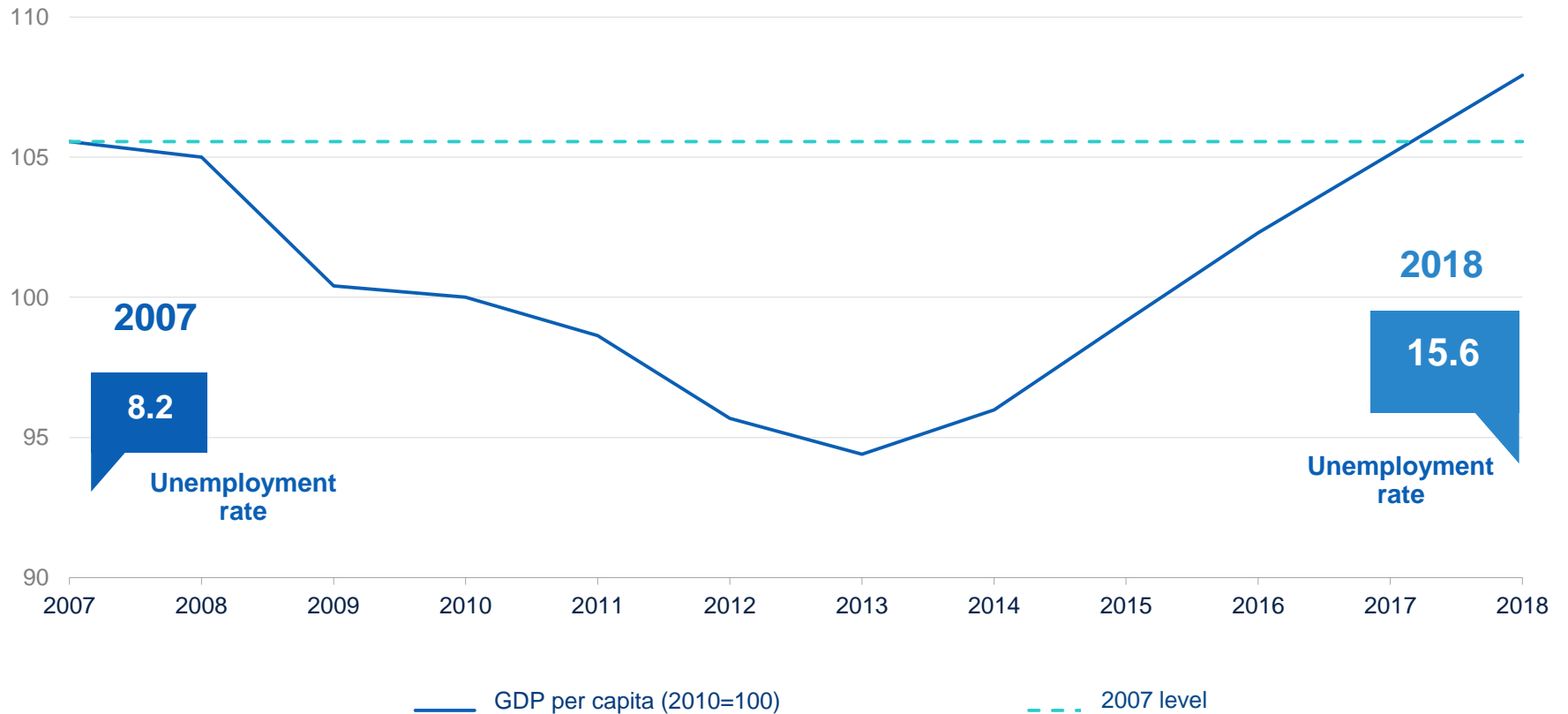
- ◆ Productivity performance is influenced by **traditionally leading sectors, such as ICT and Manufacturing**
- ◆ Recently, **other labour intensive sectors** have increased productivity, as well as creating employment

Spain: Labour productivity factor
GVA per hour worked (% QoQ, average annualised)



In any event, there is still much to be done

Spain: GDP per capita
(2010=100)

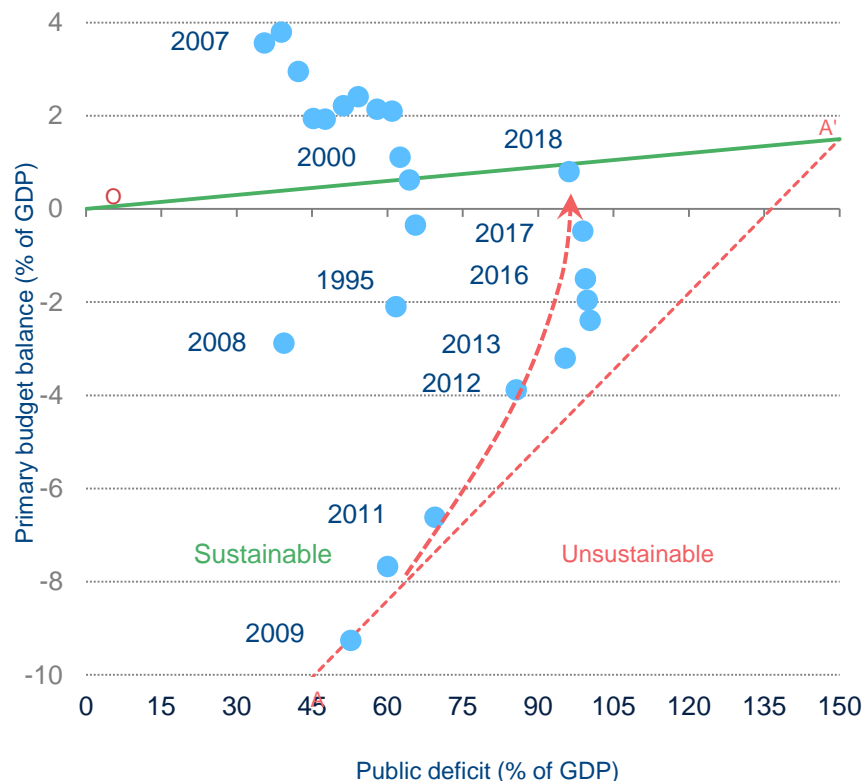


In any event, there is still much to be done

Intelligent fiscal consolidation

- ◆ The primary budget balance and public debt showed clear signs of public account unsustainability between 2009 and 2011
- ◆ Significant costs to GDP (>5pp) and employment (>3pp) of maintaining high debt levels after the recession
- ◆ Reducing structural unemployment would allow to bring down public debt, deficit levels and the tax burden, as well as increasing per capita public expenditure

Primary budget balance and public debt. Spain, 1995 - 2018
(% of GDP)



Source: BBVA Research, based on Doménech and González-Páramo (2017, published in press)

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