

Spain Economic Outlook 3Q17

July 2017



Key messages

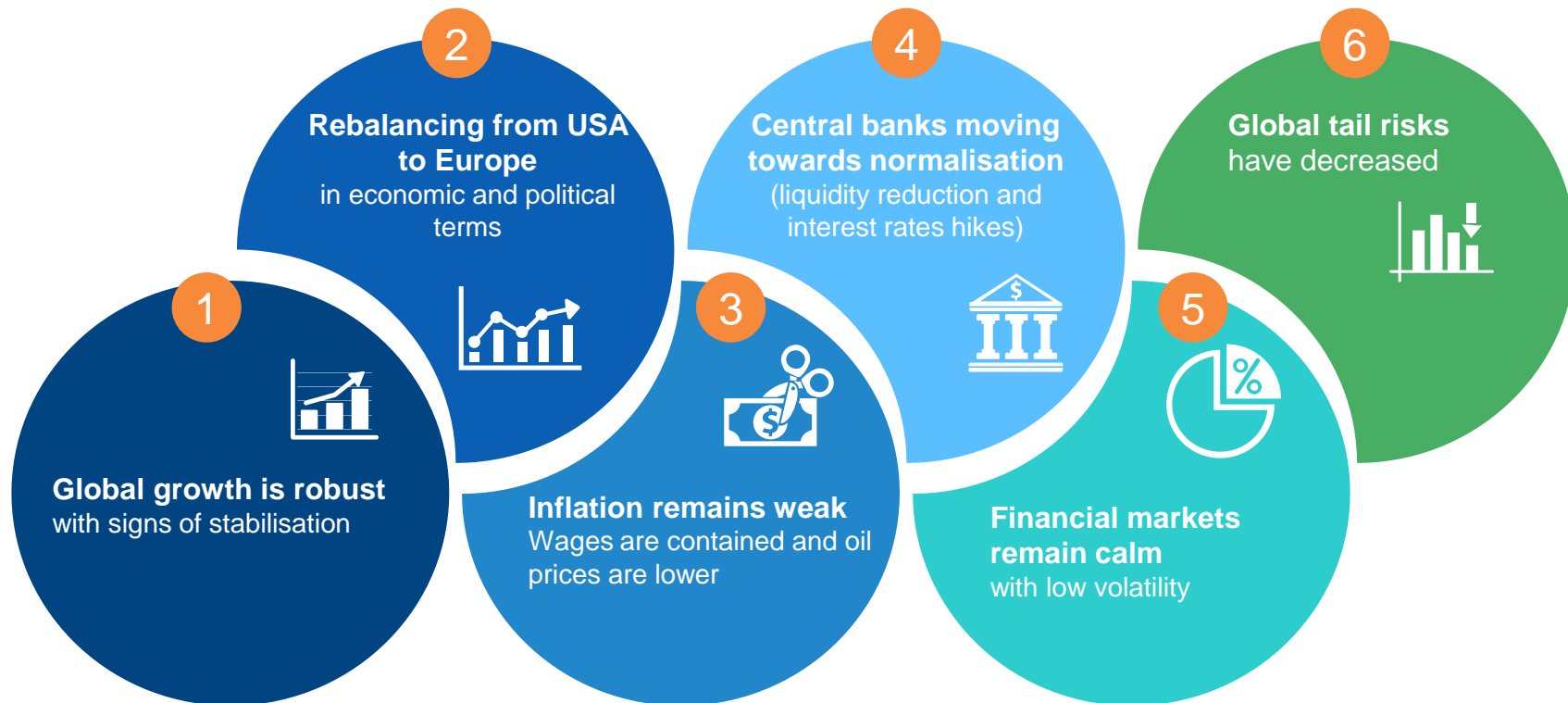
- Global growth continues but tends to stabilise. The slowdown in the USA is being offset by higher activity in Europe and China
- GDP growth forecasts for Spain are revised upwards to 3.3% in 2017 and 2.8% in 2018
- Based on these forecasts, the unemployment rate will fall by over 2pp on average per year, and more than one million jobs will be created over the two-year period
- The picture is not exempt from risks and long-term challenges remain, meaning further reforms are necessary



GLOBAL ECONOMIC OUTLOOK 3Q17



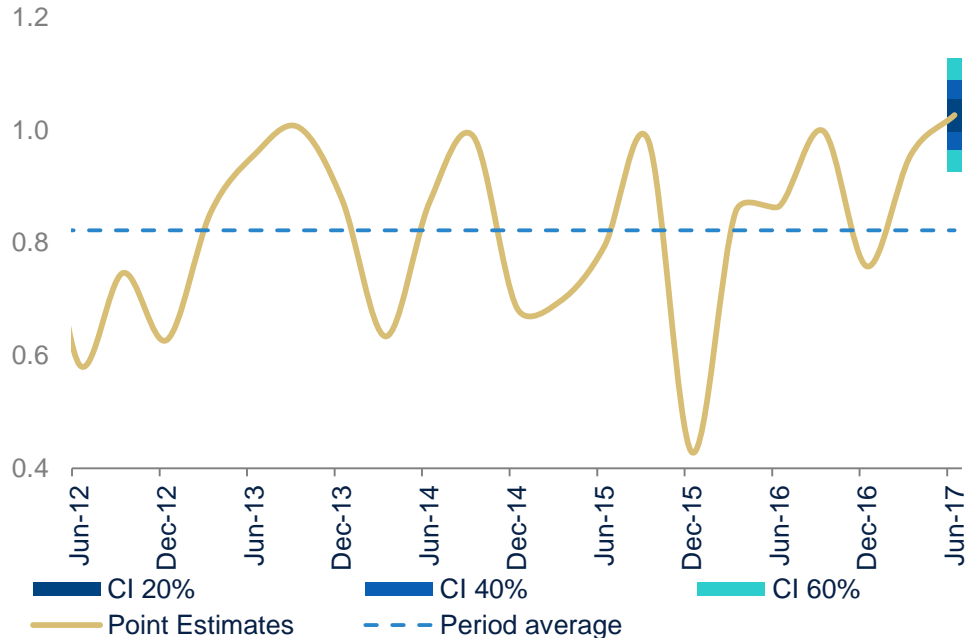
The positive environment remains



Global growth tends to stabilize

Global GDP growth

(Forecasts based on BBVA-GAIN (% QoQ))

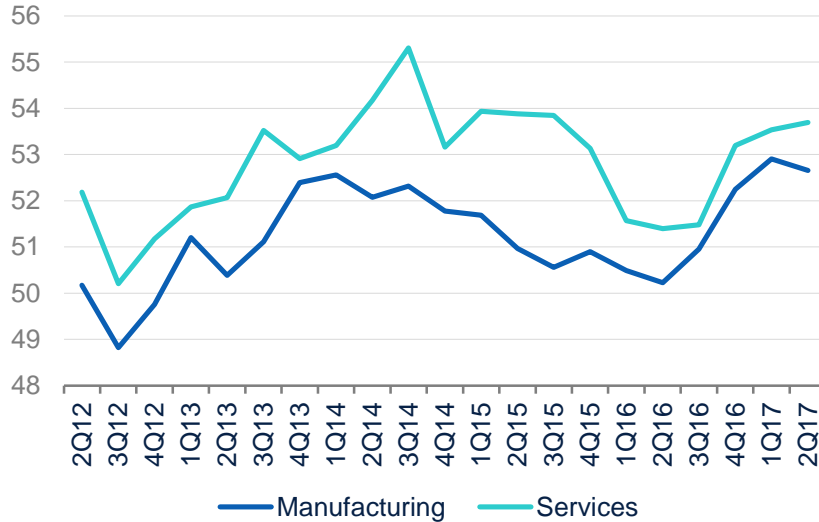


Source: BBVA Research

- ◆ Confidence indicators have stabilised at high levels
- ◆ Growth in world trade has slowed
- ◆ Momentum continues in the Eurozone but has slowed in China and Latam
- ◆ Modest rebound in the USA following weakness in 1Q17

Confidence and global trade remain at high levels

Confidence: Global PMIs (level)



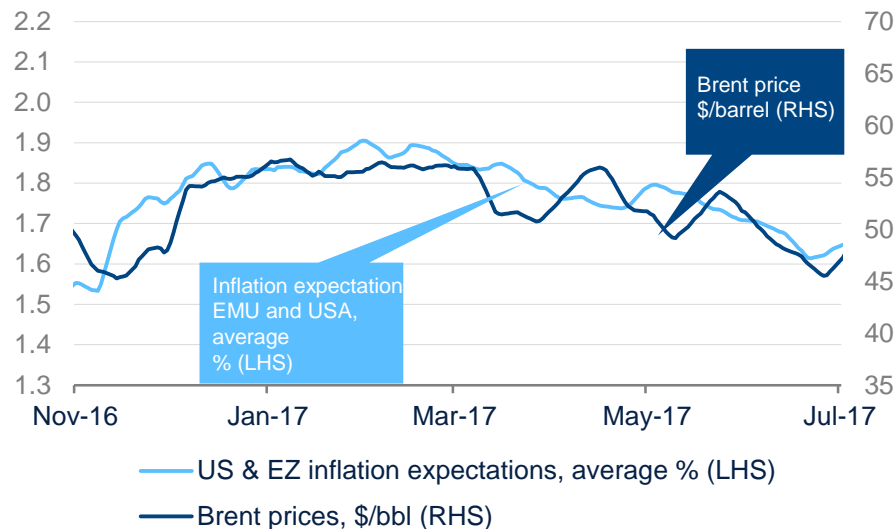
World exports of goods (YoY % at constant prices)



Lack of inflationary pressures

Inflation and oil price expectations


(moving average, % YoY, USD per barrel)

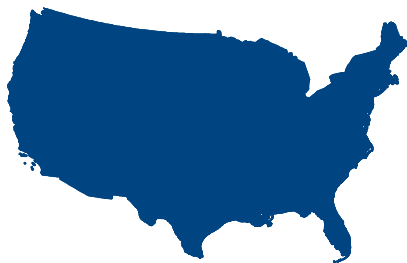


- ◆ Moderation in commodity prices has reduced inflation expectations
- ◆ Core inflation remains low
- ◆ Wage increases remain constrained, particularly in Europe

Rebalancing from the USA towards Europe, supporting the euro

USA

- 
- ◆ Economic performance slightly weaker than expected
 - ◆ Reduced likelihood of fiscal stimulus
 - ◆ Economic policy uncertainty



EUROZONE

- 
- 
- ◆ Larger than expected cyclical boost
 - ◆ Lower political risks, fostering inward capital flows
 - ◆ Potential progress in the European project following Brexit

Central banks towards normalisation, but there are challenges

It is expected that **interest rates will be increased** by another 75bp towards the end of 2018 while **balance sheet reduction** would start before the end of 2017

The **markets** are discounting a **much slower normalisation**



The **first steps towards normalisation** have been taken, by updating their forward guidance

A **reduction in bond purchases will be announced after the summer**; interest rates increases towards the end of 2018

An adequate communication is the key to **avoiding another taper tantrum**

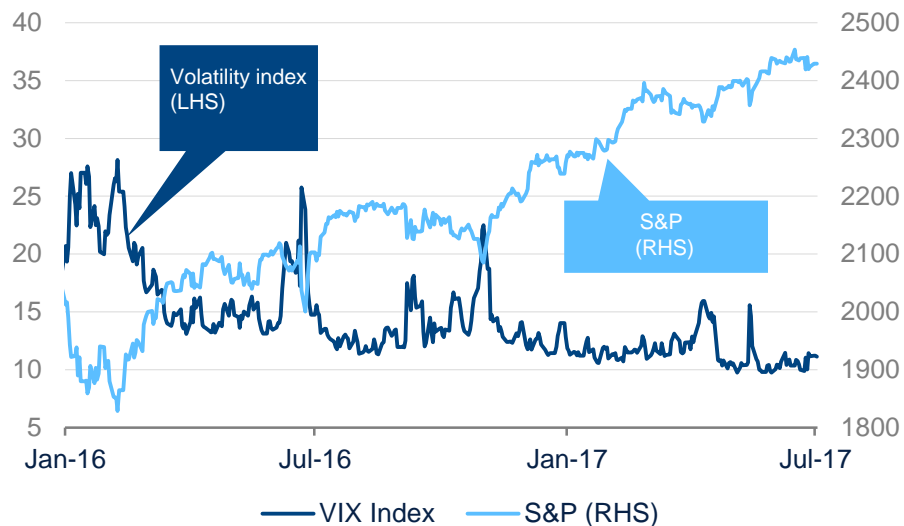


EUROPEAN CENTRAL BANK
EUROSYSTEM

Financial markets remain calm

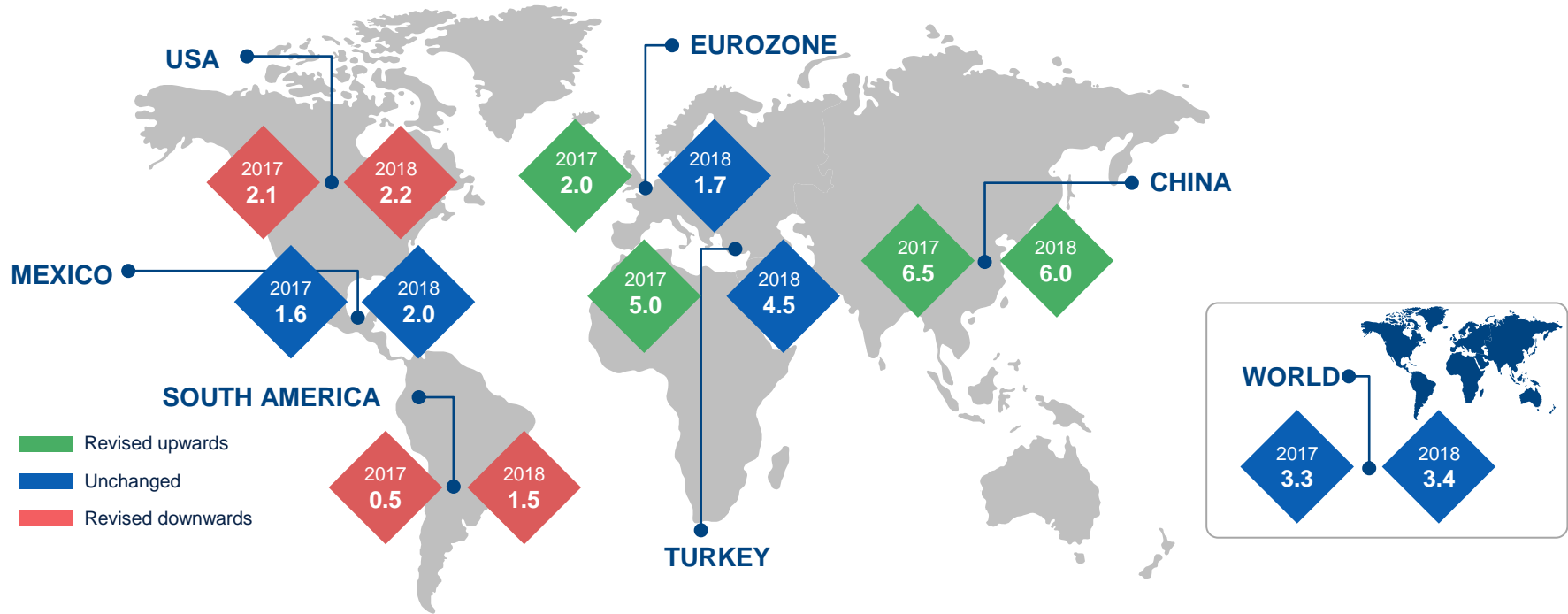
Volatility index (VIX) vs S&P

(index, points)



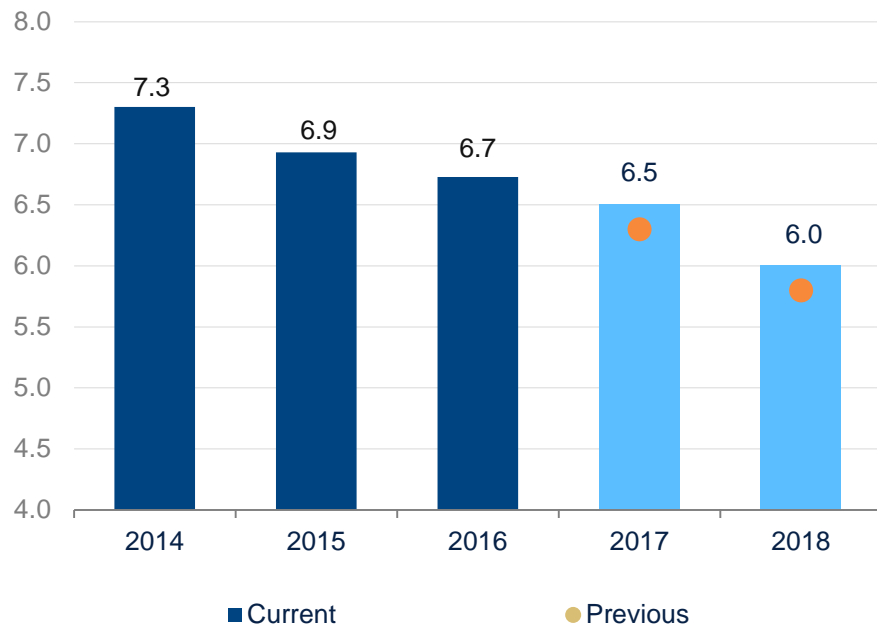
- ◆ The weakening of expectations of deflation in the USA has kept **long-term interest rates low**
- ◆ **Volatility and financial tensions** are very low
- ◆ **Capital inflows** in Europe and emerging markets
- ◆ There are **risks in the monetary normalisation process**

Upward revisions of growth for Europe and China



China: stimuli have borne fruit in the short term

China: GDP growth (YoY, %)



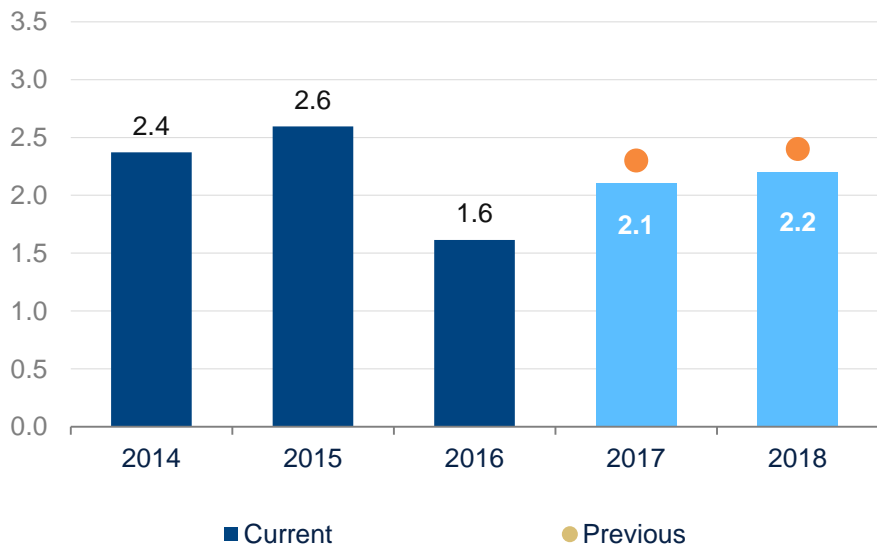
Source: BBVA Research and CEIC

- ◆ Fiscal stimuli and a prudent monetary policy will ensure **that growth objectives are met this year**
- ◆ The medium-term slowdown will continue and **significant risks remain**:
 - Domestic vulnerabilities (debt and shadow banking)
 - Depreciation and capital outflows
 - Risk of disorderly deleveraging

USA: few expectations of fiscal momentum

USA: GDP growth

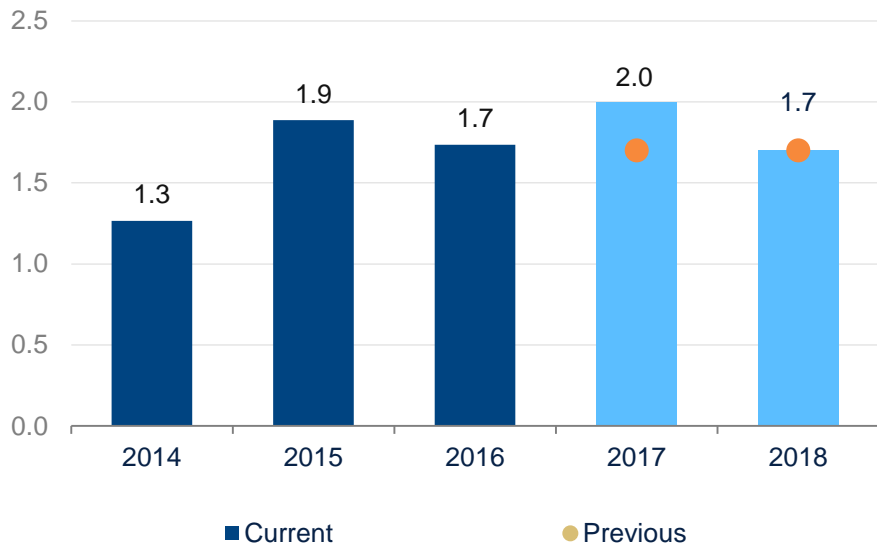
(YoY, %)



- ◆ Moderate growth and downward revision for 2017 and 2018, due to somewhat weaker figures
- ◆ Difficulties in passing economic policy measures, and delays in tax reform
- ◆ Risks of an erratic and protectionist economic policy remain, but have decreased

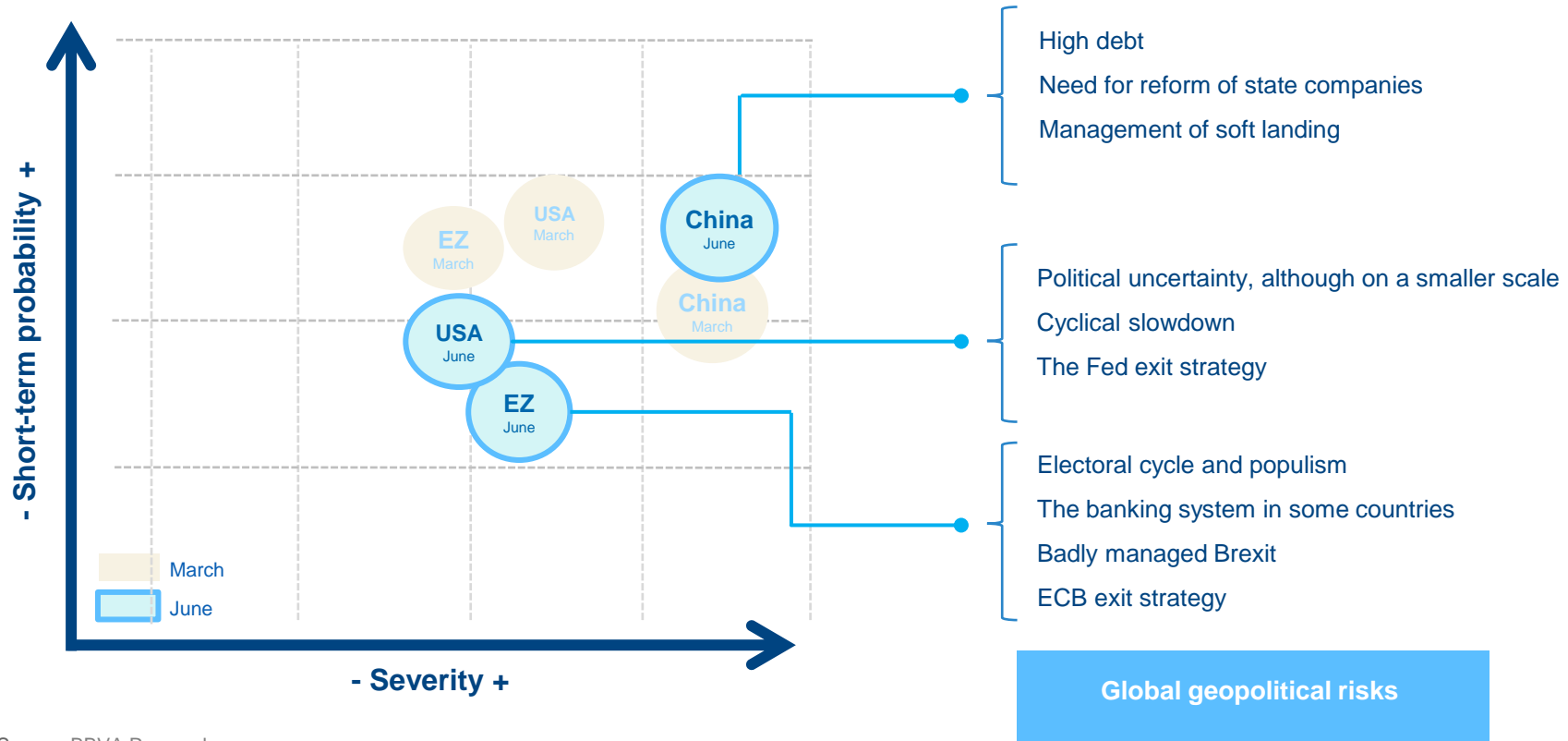
Eurozone: clear improvement, but with limits

Eurozone: GDP growth (YoY, %)



- ◆ Improved exports and investment, whilst consumption remain robust
- ◆ Economic confidence and expectations of reform in Europe are contributing to a positive climate
- ◆ Risks are shrinking, but have not disappeared (Italy, Brexit)

Risks: cyclical in the USA and more worrying in China



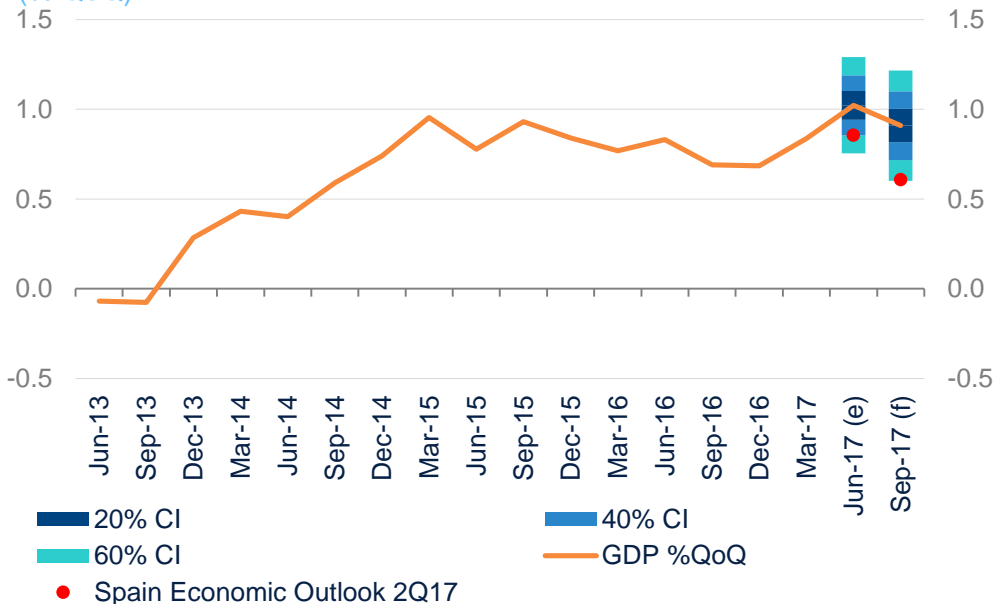
SPAIN ECONOMIC OUTLOOK 3Q17



Upward bias in GDP growth confirmed...

Spain: observed growth in GDP and MICA-BBVA model forecasts

(% QoQ)



(e): estimated

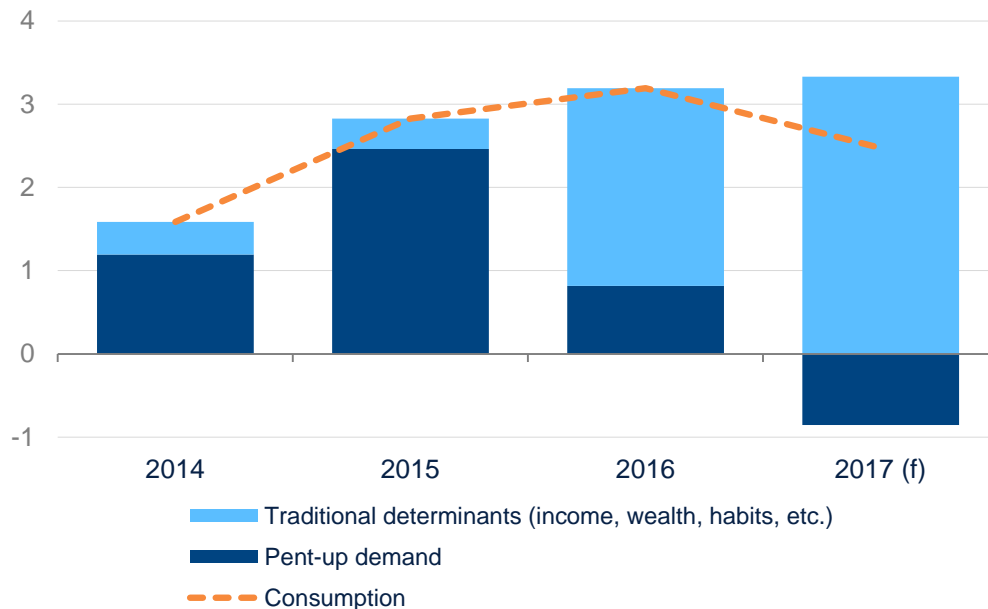
(f): forecast

Source: BBVA Research

- Recent figures (employment, exports, investment) point to the **economy growing faster than what was expected three months ago**
- Upward revision to growth in 2017 (0.3 pp to 3.3%) and in 2018 (0.1 pp to 2.8%)**

... with a healthy composition of demand

Spain: breakdown of growth in private consumption (%, YoY)



(f): forecast.

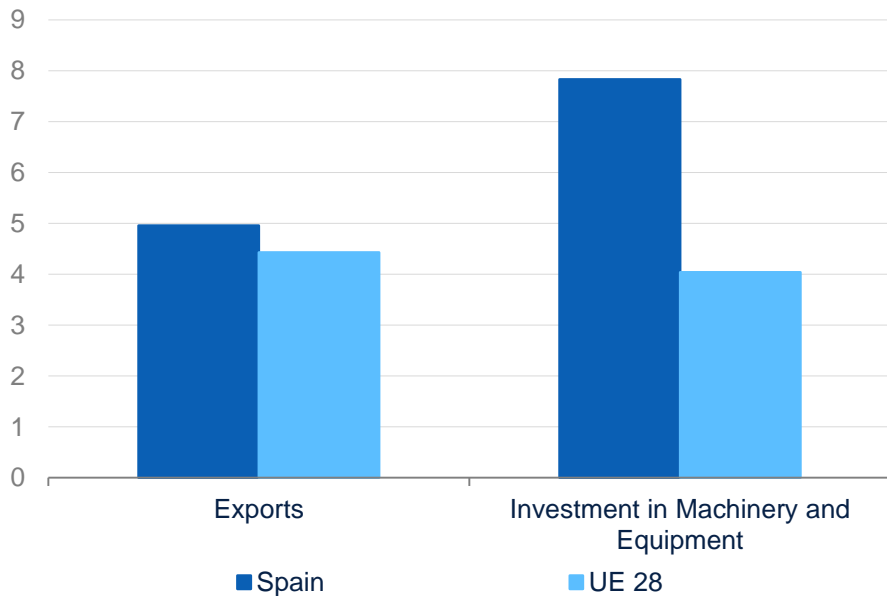
Source: BBVA Research based on INE

- ◆ Household consumption has slowed over the last year. This is due to:
- Exhaustion of temporary stimulus: tax cuts, pent-up demand, oil prices
 - Deterioration of some fundamentals (financial wealth) and economic policy uncertainty

... with a healthy composition of demand

Exports and investment in machinery and equipment

(% QoQ average on an annualised basis, 3Q13-1Q17)

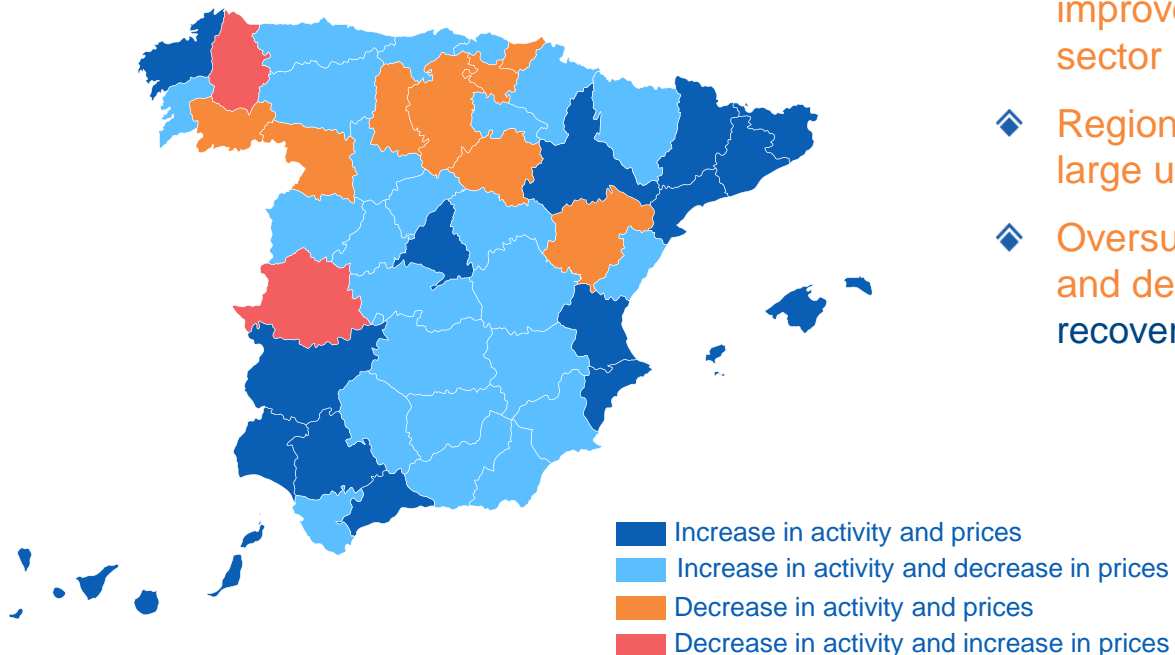


- ◆ The **slowdown in household spending** has been offset by:
- Growth in exports, which remain high despite Brexit
 - Increased investment in machinery and equipment, favored by exports momentum

... with a healthy composition of demand

Increasing social security affiliation and prices in the construction sector

(% YoY, 1Q14-1Q17)

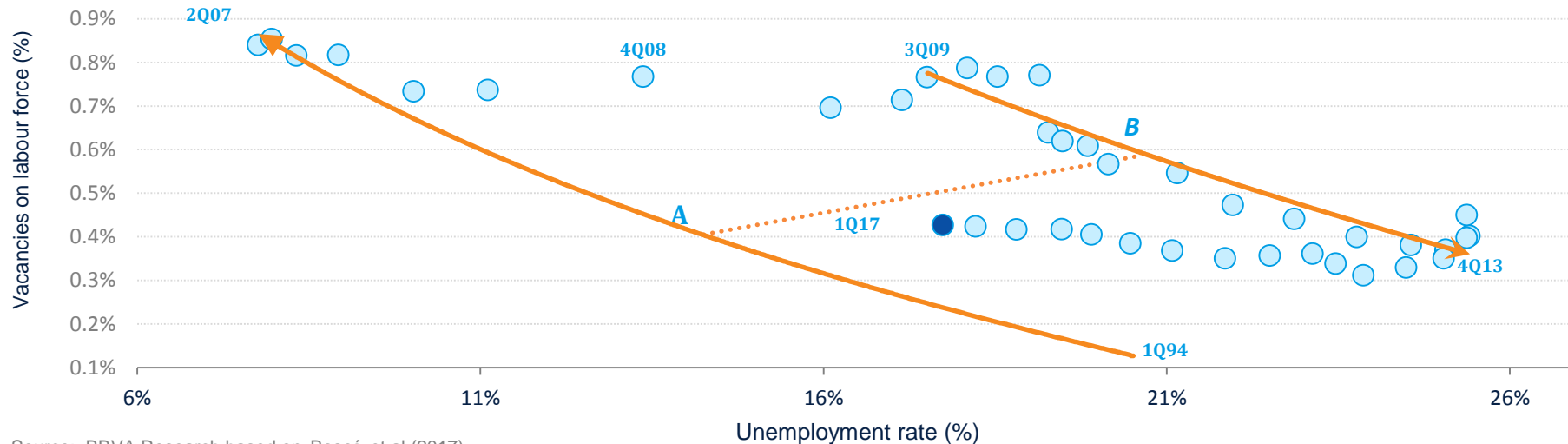


- ◆ Housing prices evolve in line with the improvement of activity in the real estate sector
- ◆ Regions with high external demand and large urban areas lead the momentum
- ◆ Oversupply, deleveraging of households and demographic stagnation will limit recovery in some regions

Improved labour market efficiency

Spain: Beveridge curve

(% of labour force)



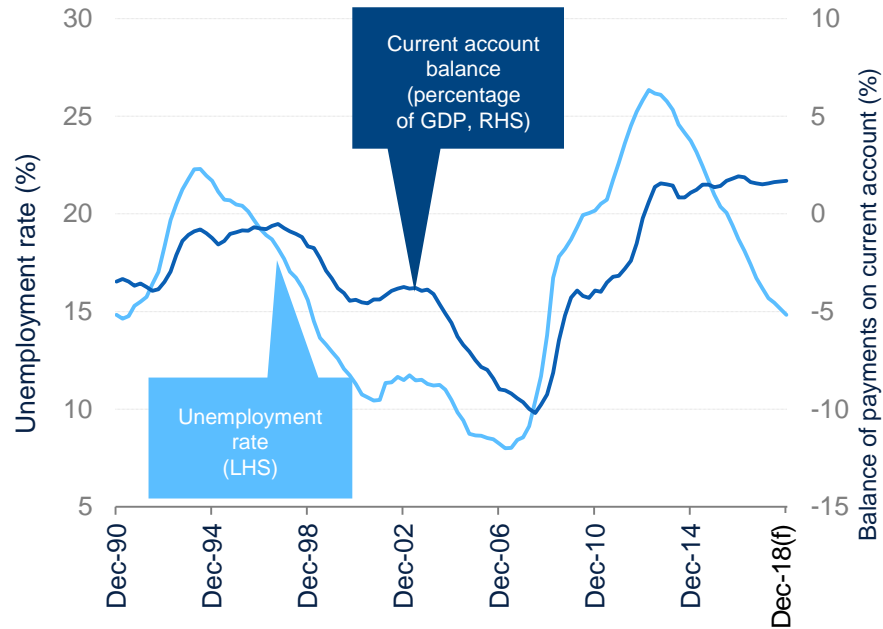
Source: BBVA Research based on Boscá et al (2017)

The economic recovery is taking place in the context of strong job creation and a labour market that is functioning more efficiently. This may, in part, be due to the reforms implemented

Deleveraging of the economy

Unemployment rate and current account balance

(%)



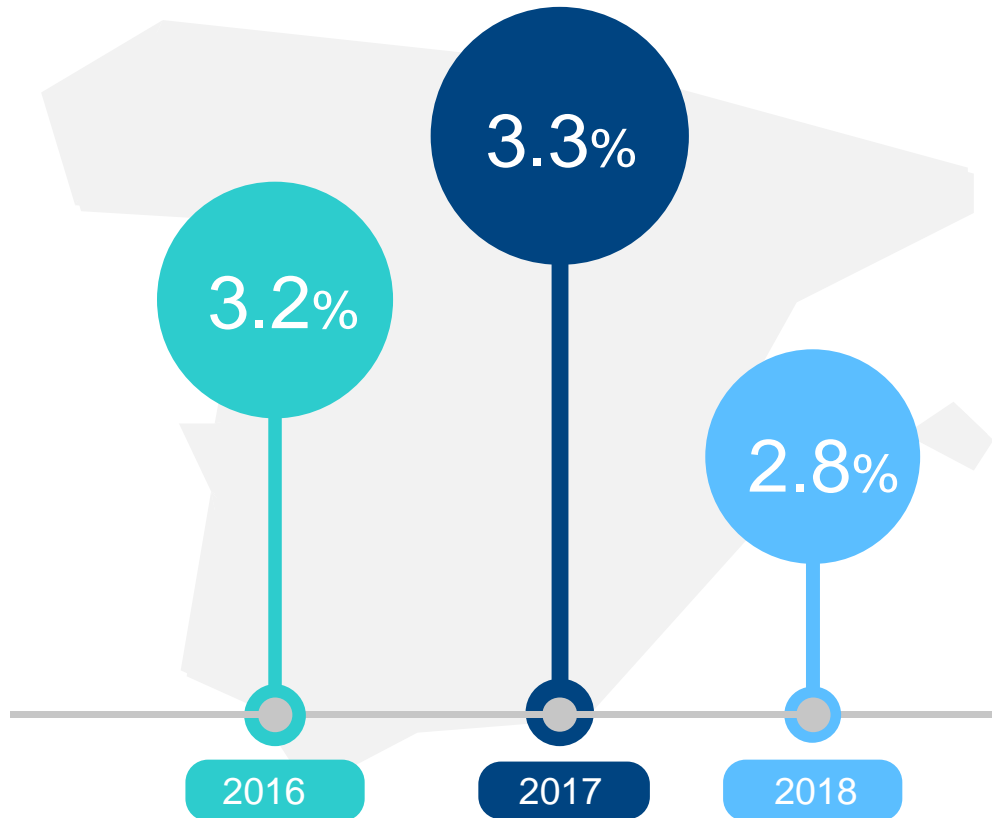
(f): forecast.

Source: BBVA Research based on INE and Banco de España

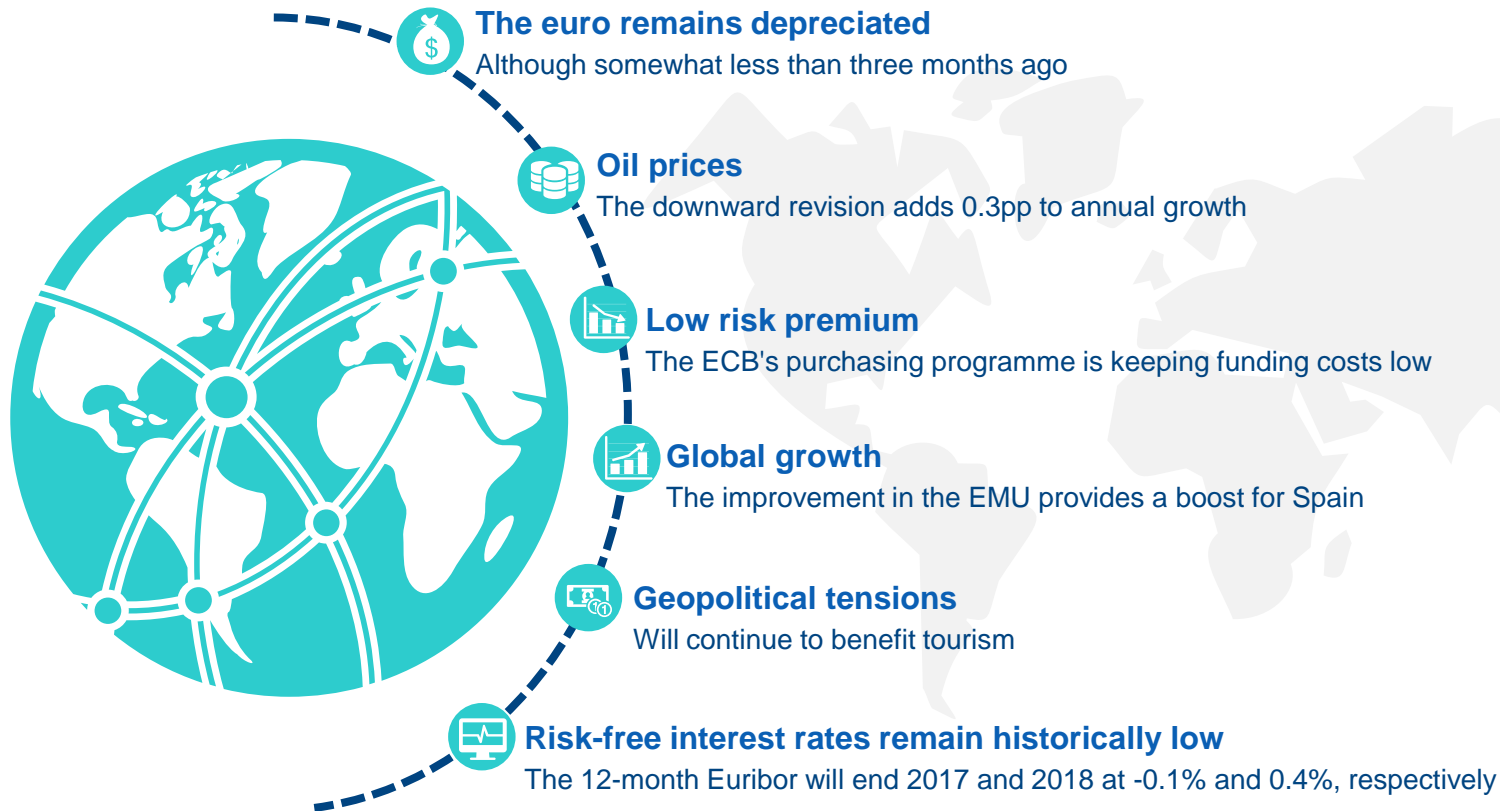
◆ The recovery remains compatible with **the correction of external imbalances:**

- At the end of 2018, 5 years of consecutive surplus in the current account will be met
- This is an unprecedented phenomenon at a time of expansion, when falling unemployment is usually accompanied by current account deficits

Upwards revision of growth in 2017 and 2018



The global context remains positive

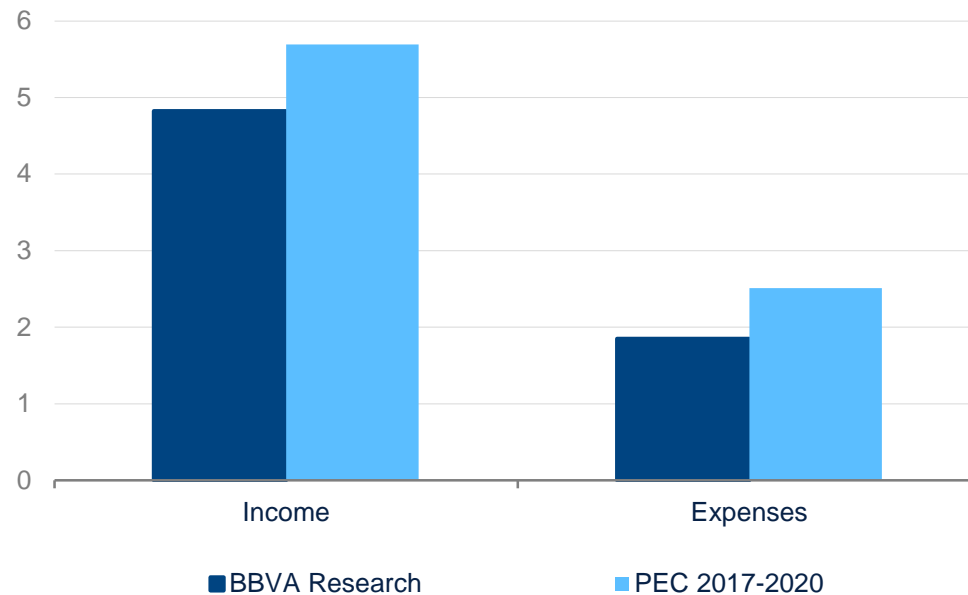


Feasible budget target

- ◆ The **public-sector deficit** is expected to shrink to **3.1% in 2017** and to **2.2% in 2018**, as a result of economic growth
- ◆ The upwards revisions of GDP increase the likelihood that the targets will be met. However, **controlling spending remains key**
- ◆ **Uncertainty about revenues continues** following the measures approved in December 2016

Spain: Expected growth in public spending and revenues for 2017

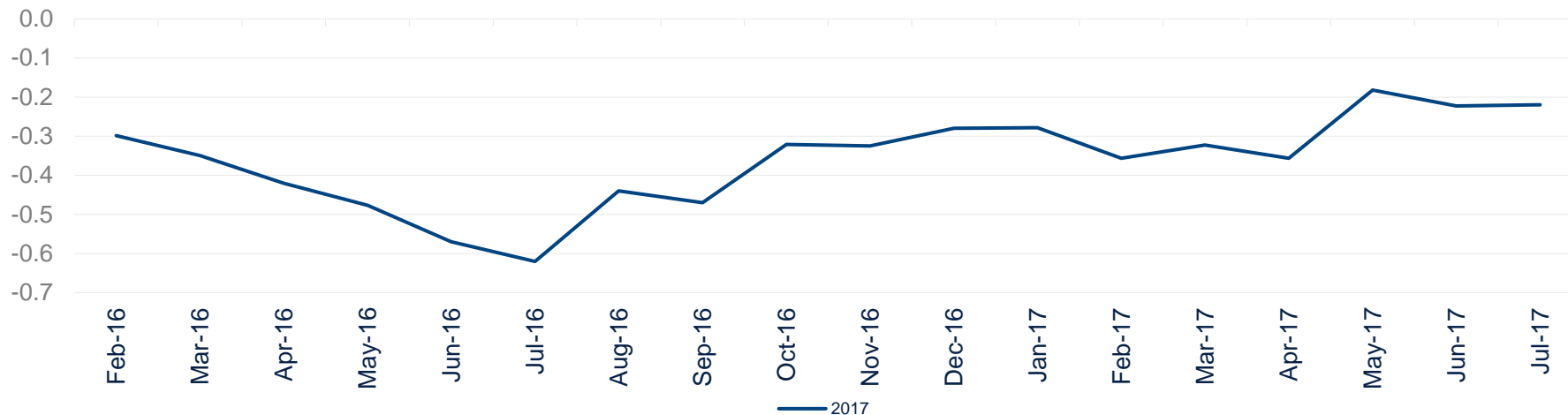
(%, YoY)



Risks: Economic policy uncertainty

Spain: Impact of economic policy uncertainty on GDP growth in 2017

(pp, YoY)



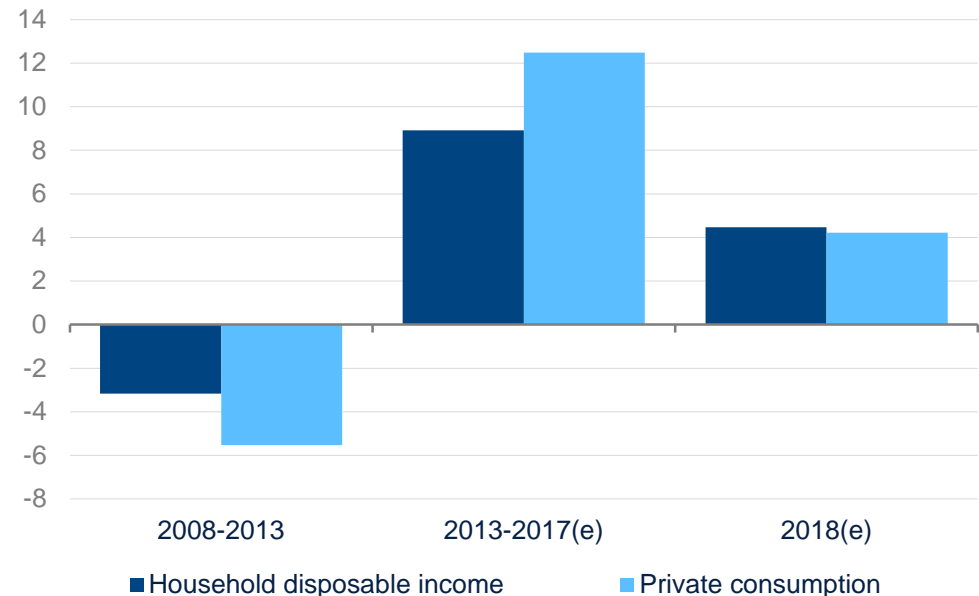
Source: BBVA Research from Baker et al (2015)

Factor such as the approval of the 2017 Spanish General Budget have reduced economic policy uncertainty which will be implemented over the coming quarters. However, existing imbalances (public deficit, unemployment rate, etc.) require additional reforms

Risks: sustainability of consumption growth

- ◆ The savings ratio for Spanish households has fallen to 8% of real disposable income, just 2 pp above the all time low
- ◆ This, together with the moderation of tailwinds, justifies a slowdown...
- ◆ ...however, the improvements in financing could continue fostering consumption

Spain: household disposable income and consumption
(accumulated % growth, nominal)



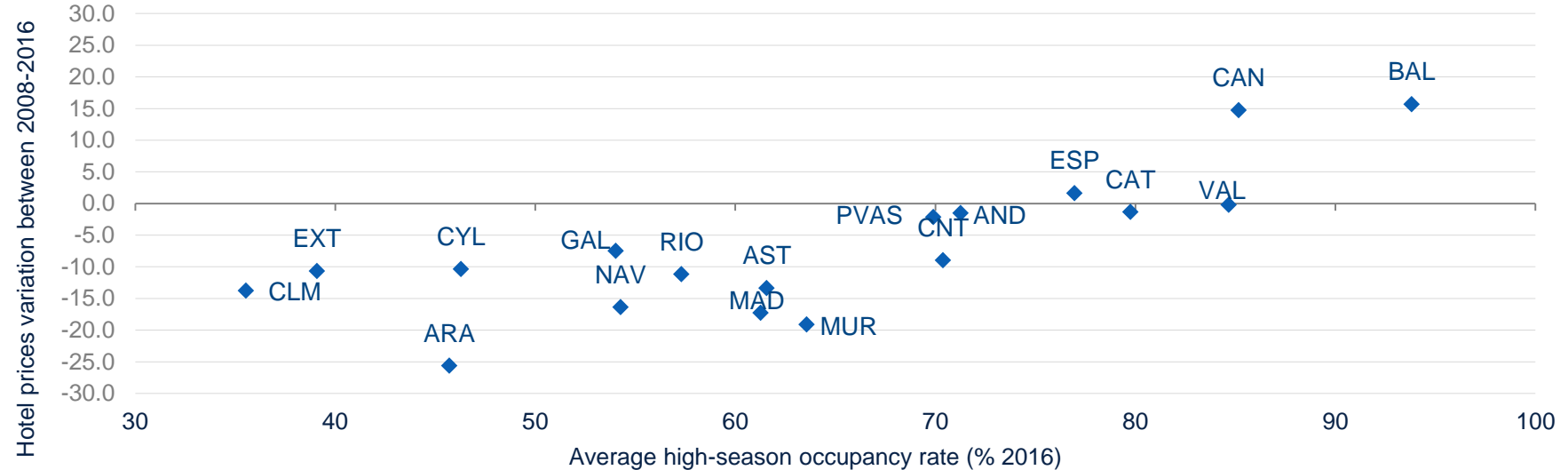
(e): estimated

Source: BBVA Research, based on INE figures

Risks: Tourism growth sustainability

Spain: average high-season occupancy rate and increases in hotel prices

(%, 2008 and 2016)



Source: BBVA Research, based on INE figures

The tourism sector's capacity for growth is not yet exhausted, but it is close to saturation in some regions (such as the Balearic Islands).

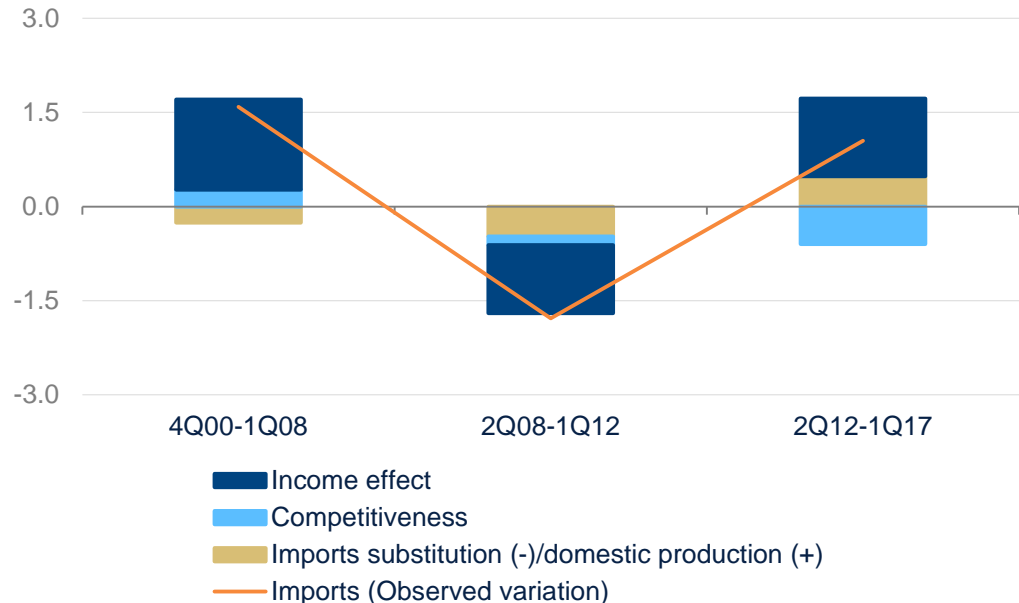
Moreover, it is needed to work on increasing the loyalty of foreign visitors which can be temporary

Risks: Import substitution?

- ◆ The crisis brought with it a reduction in imports due to the decline in income, competitiveness gains and an increase willingness to buy domestic goods
- ◆ Competitiveness gains have increased during the recovery, but the increase in income and a higher propensity to import have accelerated purchases from abroad

Spain: breakdown of changes in non-energy imports by long-term determinants

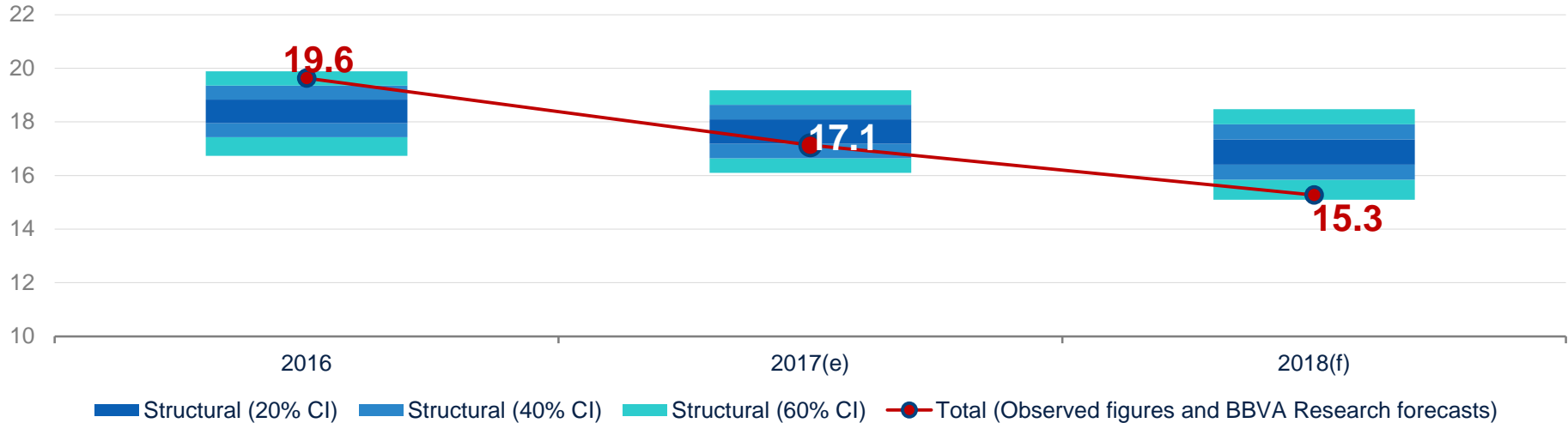
(pp of average quarterly growth rates)



Risks: the structural unemployment rate remains high

Spain: unemployment rate

(%)



(e): estimate, (f): forecast.

Source: BBVA Research

There is some uncertainty about the level of structural unemployment. If high, job creation could slow over the coming quarters, further increasing the inequality between the employed and the unemployed

Key messages

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- GDP growth forecasts for Spain are revised upwards to 3.3% in 2017 and 2.8% in 2018
- Based on these forecasts, the unemployment rate will fall by over 2pp on average per year, and more than one million jobs will be created over the two-year period
- The picture is not exempt from risks and long-term challenges remain, meaning further reforms are necessary



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ANNEX



Appendix 1

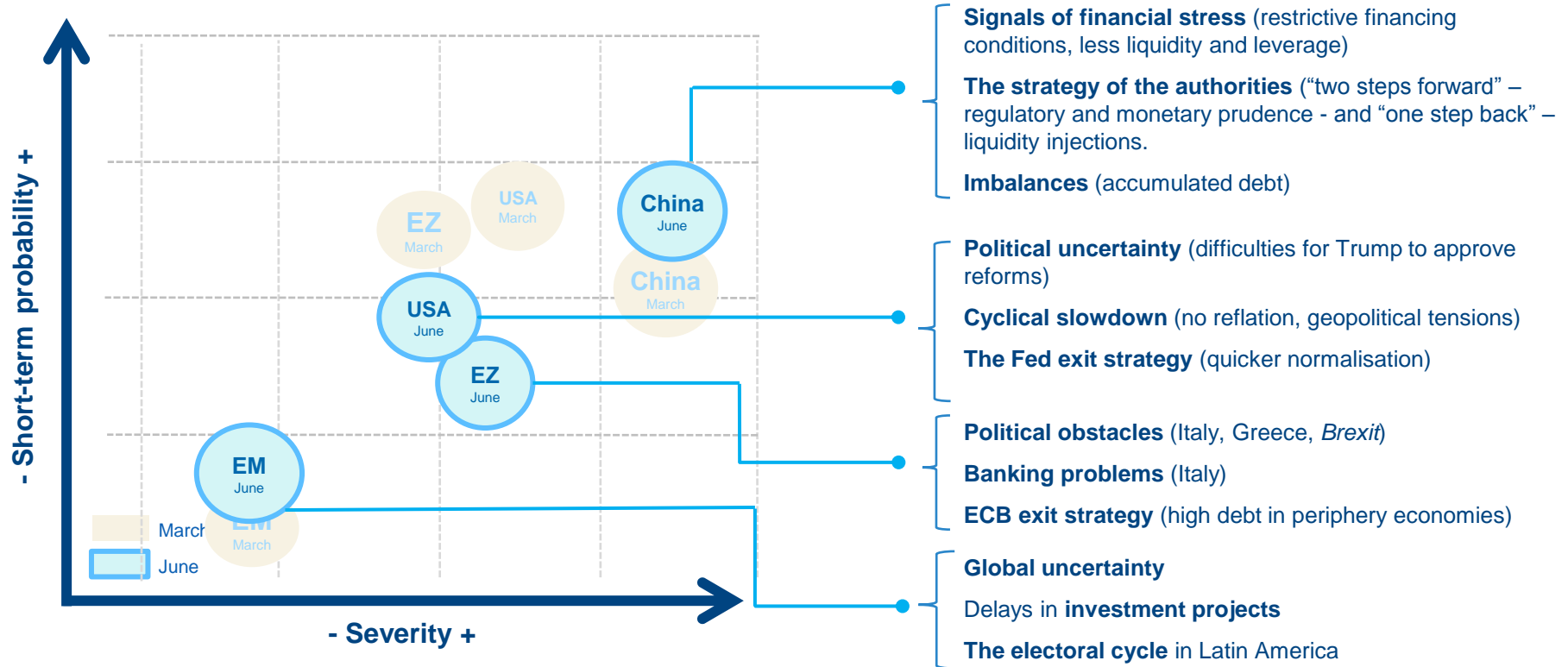
Gross domestic product

(YoY, avg. %)

	Jul-17				Mar-17				Difference	
	2015	2016	2017	2018	2015	2016	2017	2018	2017	2018
World	3,3	3,2	3,3	3,4	3,3	3,1	3,3	3,4	0,0	0,0
Advanced	2,2	1,7	1,9	1,8	2,2	1,6	1,9	1,9	0,0	-0,1
United States	2,6	1,6	2,1	2,2	2,6	1,6	2,3	2,4	-0,2	-0,2
Eurozone	1,9	1,7	2,0	1,7	1,9	1,7	1,7	1,7	0,3	0,0
Spain	3,2	3,2	3,3	2,8	3,2	3,2	3,0	2,7	0,3	0,1
Emerging	4,2	4,2	4,3	4,4	4,1	4,1	4,3	4,4	0,0	0,0
Latam	-0,4	-1,3	0,8	1,6	-0,3	-1,5	1,1	1,8	-0,3	-0,2
Mexico	2,7	2,0	1,6	2,0	2,6	2,1	1,6	2,0	0,0	0,0
South America	-1,5	-2,6	0,5	1,5	-1,4	-2,8	0,9	1,7	-0,4	-0,2
Brazil	-3,8	-3,6	0,6	1,5	-3,8	-3,6	0,9	1,8	-0,3	-0,3
South America (footprint)	1,1	-1,4	0,4	1,4	1,3	-1,9	0,8	1,6	-0,5	-0,2
Argentina	2,6	-2,2	2,8	3,0	2,6	-2,3	2,8	3,0	0,0	0,0
Chile	2,3	1,6	1,3	2,4	2,3	1,6	1,6	2,4	-0,3	0,0
Colombia	3,1	2,0	1,5	2,0	3,1	2,0	2,1	2,7	-0,7	-0,7
Peru	3,3	3,9	2,2	3,9	3,3	3,9	2,5	3,9	-0,3	0,0
Eagles	4,7	5,0	5,0	5,1	4,7	4,8	4,9	5,0	0,1	0,1
Turkey	6,1	2,9	5,0	4,5	6,1	2,9	3,0	4,5	2,0	0,0
Asia Pacific	5,6	5,6	5,2	5,2	5,6	5,5	5,2	5,1	0,0	0,0
Emerging Asia	6,7	6,7	6,2	6,0	6,7	6,6	6,1	5,9	0,1	0,1
China	6,9	6,7	6,5	6,0	6,9	6,7	6,3	5,8	0,2	0,2
Emerging Asia (ex. China)	6,4	6,5	5,7	6,1	6,3	6,3	5,8	6,1	0,0	0,0

Latam: Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela
 South America: Argentina, Brazil, Chile, Colombia, Peru and Venezuela
 South America (footprint): Argentina, Chile, Colombia, Peru and Venezuela

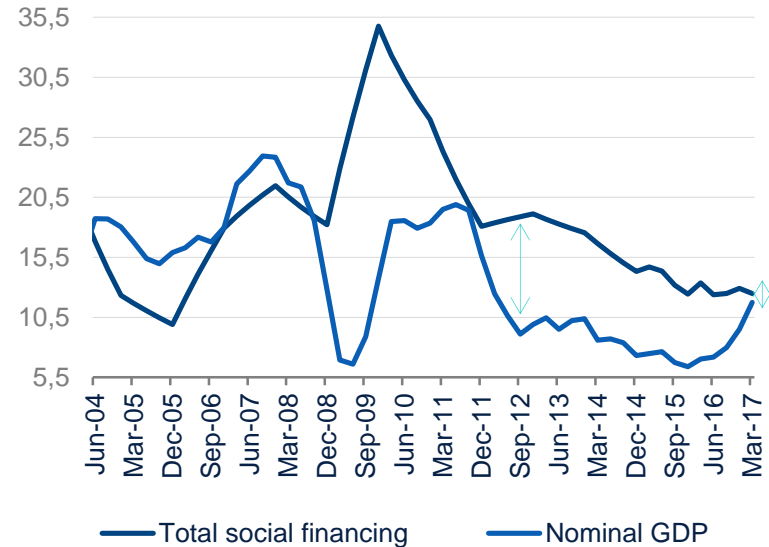
Risks: cyclical in the USA and more worrying in China



China: risk from lending growth

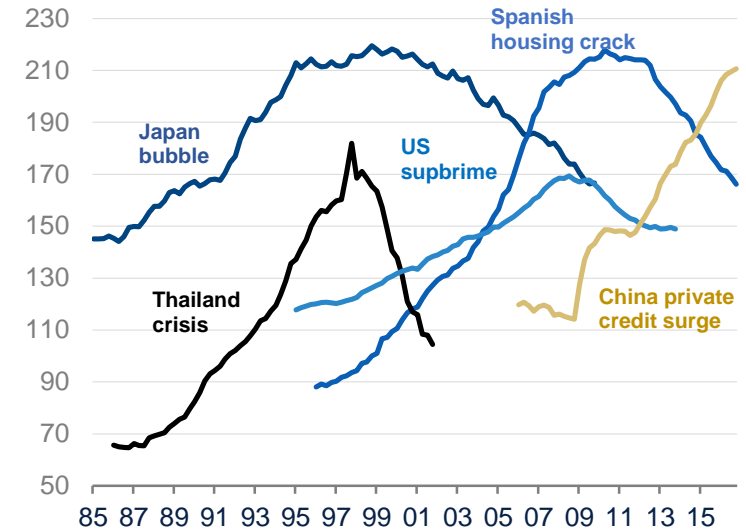
China: GDP and total funding to the real economy

(YoY % at constant prices)



Source: BBVA Research, Haver, BIS

Private non-financial debt (% GDP)



China: recent signs of stress

Warning signals

- ◆ Higher funding costs (*inter-bank rates*)
- ◆ Corporate bond issues delayed or cancelled (*refinancing risk*)
- ◆ Lower shadow banking activity
- ◆ Correction to stock markets and house prices
- ◆ Downward pressure on the RMB, reduction of flow of funds into the non-residents portfolio and fall in FX reserves
- ◆ Cut to sovereign rating
- ◆ The strategy of the authorities: “two steps forward” (regulatory and monetary prudence); and “one step back” (liquidity injections to cushion financial stress)

High risk of financial contagion

The scale of shadow banking
80% of GDP.

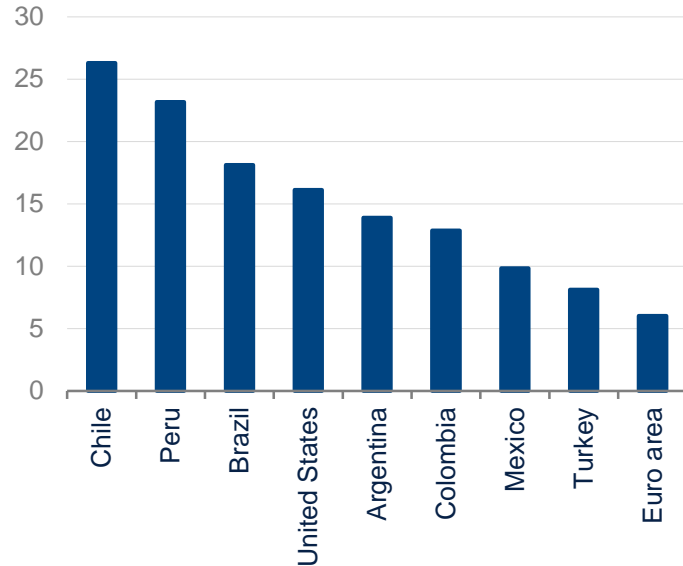
Exposure of formal banks
to shadow banking

10% of total assets

China: Impact in terms of trade with the country

Trade in goods with China

((exports + imports) / total, %, 2016)



Financial tension index

A higher level implies increased tension

