

Spain Economic Outlook 4Q17

November 2017



Key messages

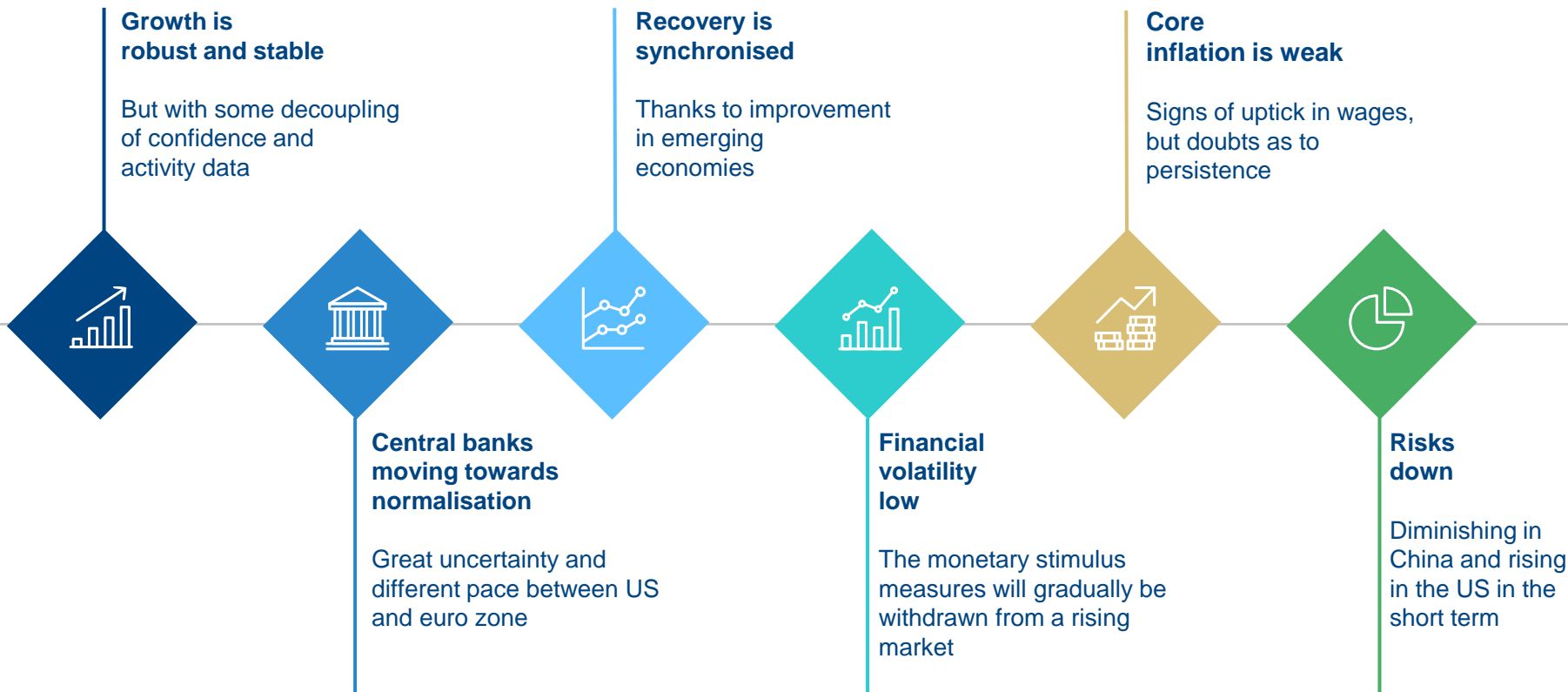
- ◆ Global recovery continues and is more synchronised than in the past. Upward revision for Europe and China
- ◆ In Spain, data for the third quarter and the increase in uncertainty bias growth expectations downwards. However, the external environment continues to underpin the recovery, which is showing strong resistance in 4Q17
- ◆ Forecasts for GDP growth have been revised downwards to 3.1% for 2017 and 2.5% for 2018
- ◆ The more uncertain environment and the long-term challenges call for new reforms to reduce the vulnerabilities of the Spanish economy



GLOBAL ECONOMIC OUTLOOK 4Q17

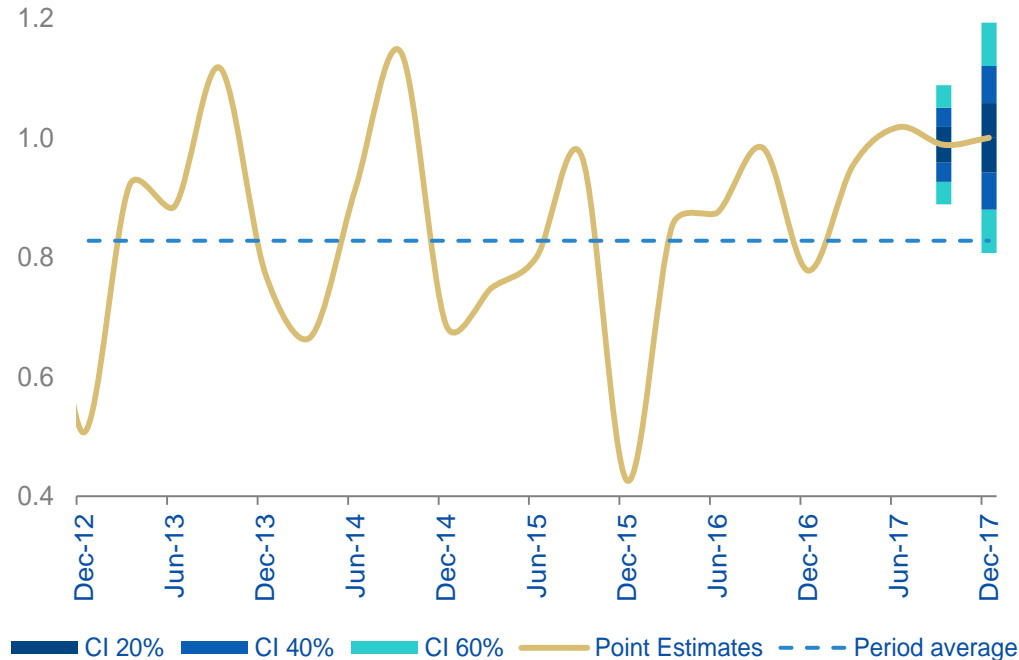


The positive global environment is consolidating



Global growth: robust and stable in 2H17

World GDP growth
(Forecasts based on BBVA-GAIN (% QoQ))

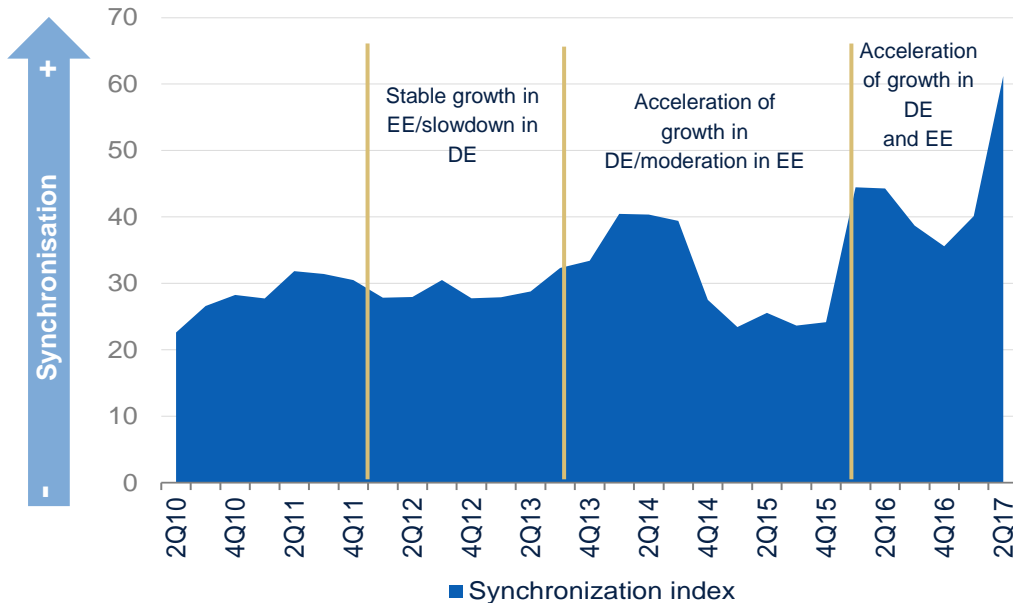


- ◆ Confidence indicators are improving appreciably, and point to a more positive panorama than activity indicators do
- ◆ Solid growth in world trade and continuation of the manufacturing sector recovery
- ◆ Signs of strength in private consumption despite slacker tailwinds

(e): estimated
Source: BBVA Research

Recovery: more synchronisation among the different areas

Index of synchronisation of growth between developed economies (DE) and emerging economies (EE)



Inverse index of the standard deviation of quarterly growth observed in countries
Source: BBVA Research based on data from national sources and Markit Economics

◆ Developed economies:

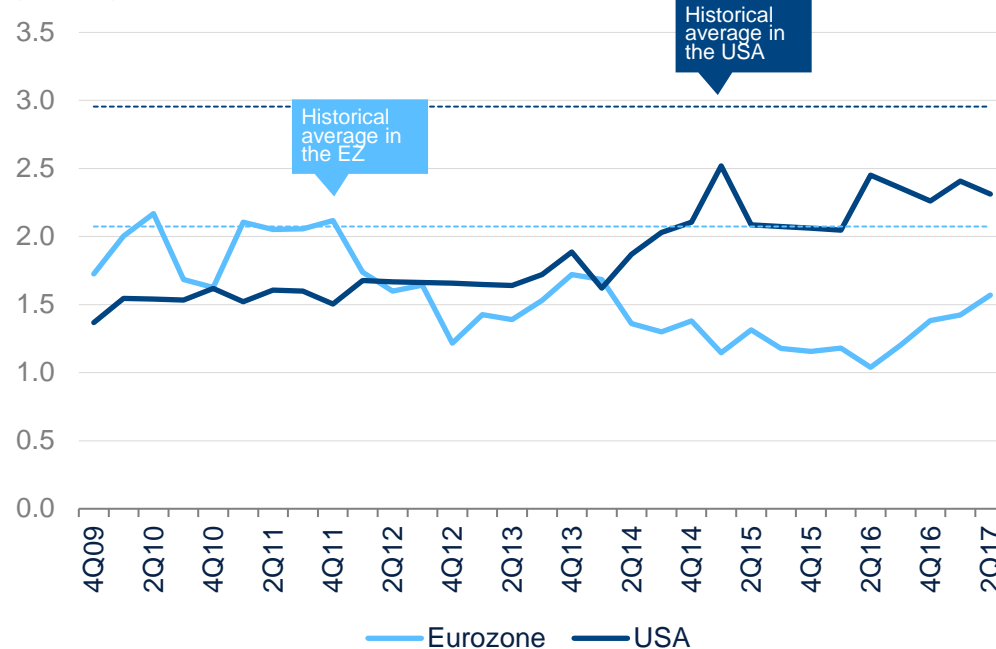
- Strong rally in the US
- Positive surprise in Europe

◆ Emerging economies:

- Slight slowdown in China, although less than expected. China continues to underpin the rest of Asia
- Recovery in Russia and Brazil, which are no longer holding world growth back.
- Growth is gaining traction in Latin America

Core inflation remains weak

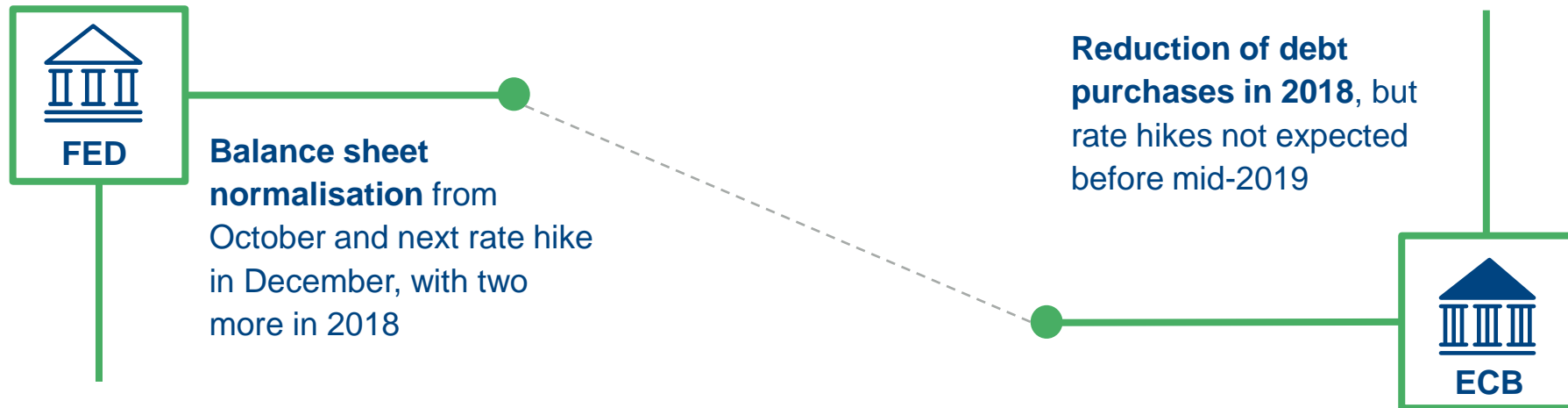
Euro zone and US: wages compared with historical average
(% YoY)



- ◆ Despite economic growth and the improvement in the labour market, **core inflation remains low**
- ◆ Doubts about the consolidation of the incipient upticks in wages. **Inflationary pressures contained**
- ◆ **Uncertainty** about the determinants: are changes transitory or permanent?
- ◆ **Cautious stance of central banks**, especially in the developed countries. More margin for monetary policy in the emerging economies thanks to the reduction in inflationary pressures

Source: BBVA Research, based on Eurostat and BEA (Bureau of Economic Analysis)

Central banks are moving towards a very gradual normalisation



Great uncertainty:

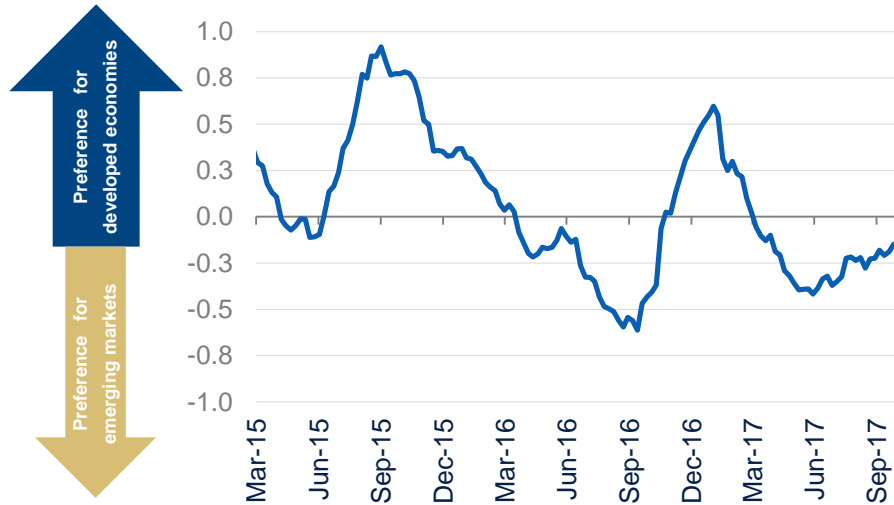
- In the **United States** due to slowing inflation and the expected change to the FOMC in 2018



- In the **euro zone**, bias towards more gradual tapering (euro strength) and a delay in the rate hike cycle (low inflation)

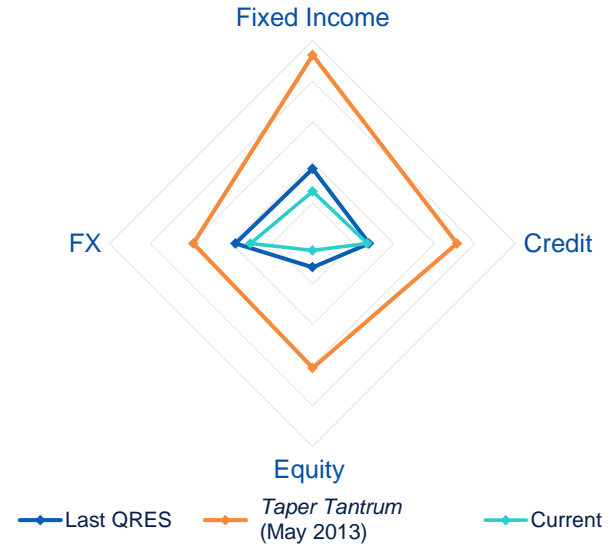
The financial markets still favour the emerging economies

Regional asset reallocation indicator
(Standard deviation from the historical average)



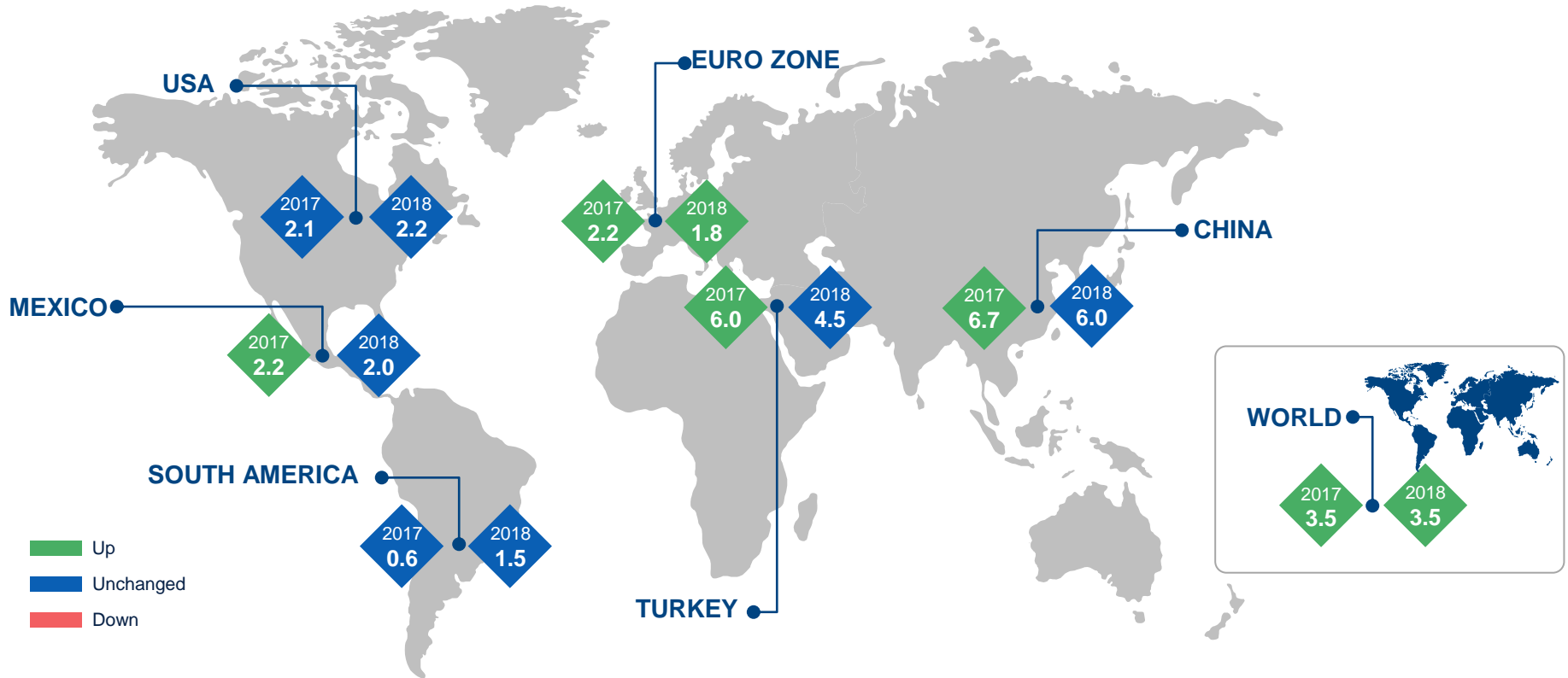
Source: BBVA Research based on Bloomberg

BBVA volatility indicator by type of asset
(Standardised data)



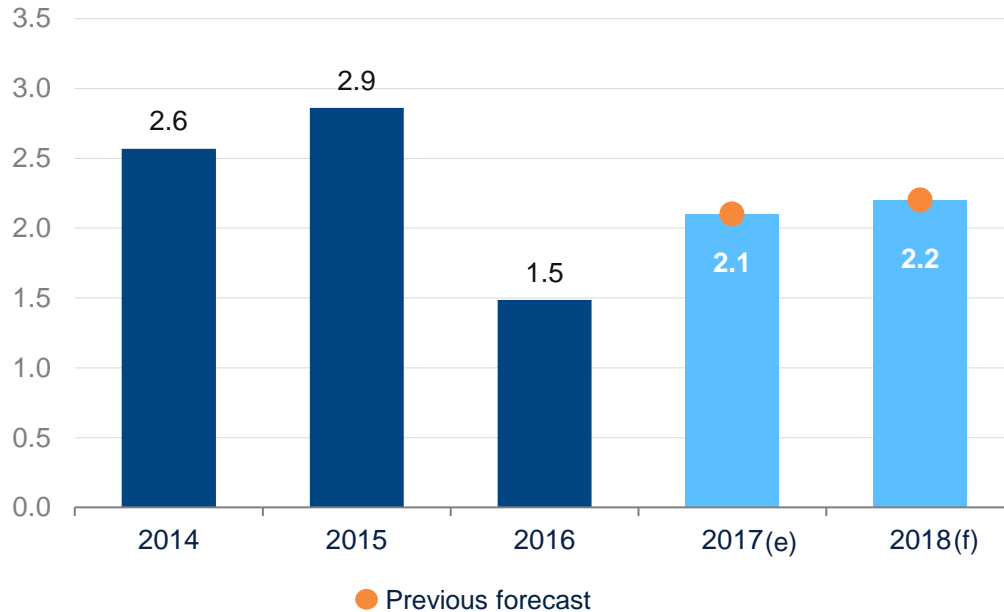
The dollar's weakness and the low yields on US Treasuries drive the quest for yield and underpin emerging market assets

Upward revision of global growth in 2017



USA: sustained recovery despite the uncertainty

USA: GDP growth (% YoY)



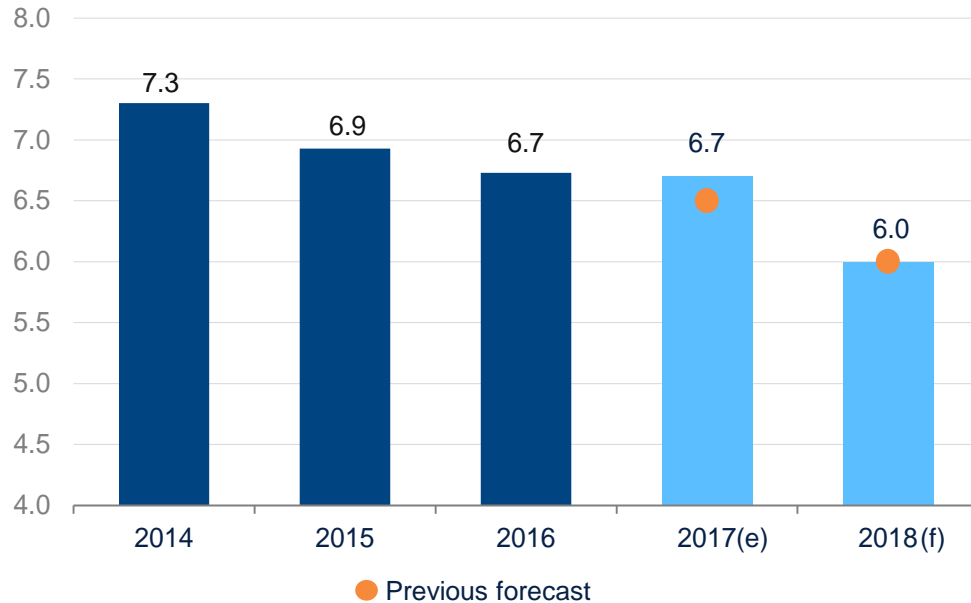
(e): estimated; (p): projected.

Source: BBVA Research based on BEA (Bureau of Economic Analysis)

- ◆ The hurricanes will have a moderate impact on activity, so we are maintaining our growth forecasts for 2017 and 2018
- ◆ Among outstanding issues are:
 - Tax reform, which has yet to be spelt out and approved
 - Economic policy uncertainty
 - Certain signs of financial vulnerability
 - Greater geopolitical risks

China: a more favourable panorama in the short term

China: GDP growth (% YoY)



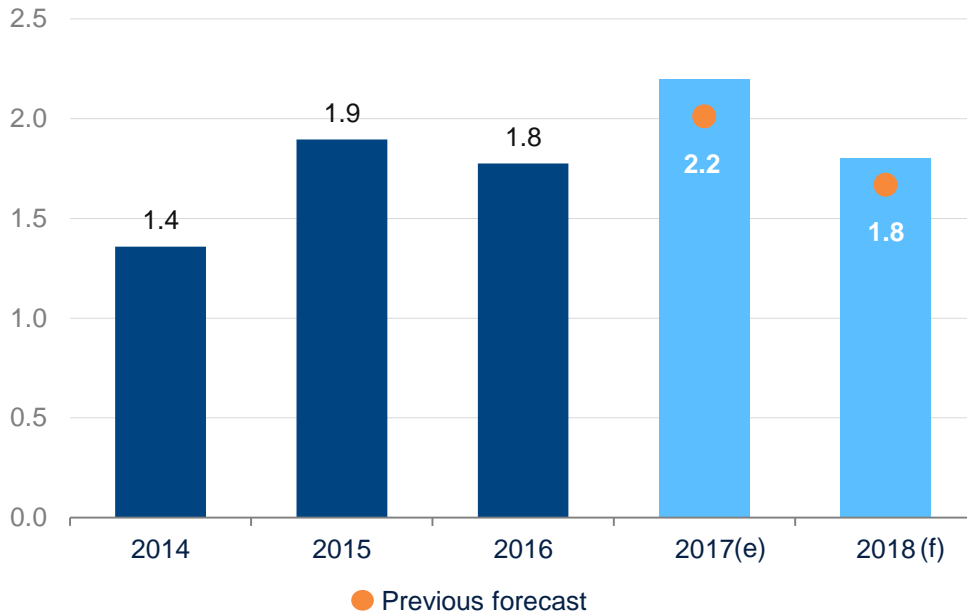
(e): estimated; (p): projected.

Source: BBVA Research based on CEIC data

- ◆ Slight upward revision of growth for 2017 in view of improved performance in 1H17
- ◆ Slowdown in 2018 due to reduced support from economic policies and the appreciation of the currency
- ◆ After the Communist Party Congress there will be more political margin for focusing on qualitative rather than quantitative growth objectives
- ◆ In the long term, doubts persist, although financial vulnerabilities have eased thanks to regulatory measures

Euro zone: increased growth due to strong domestic demand

Euro zone: GDP growth (% YoY)

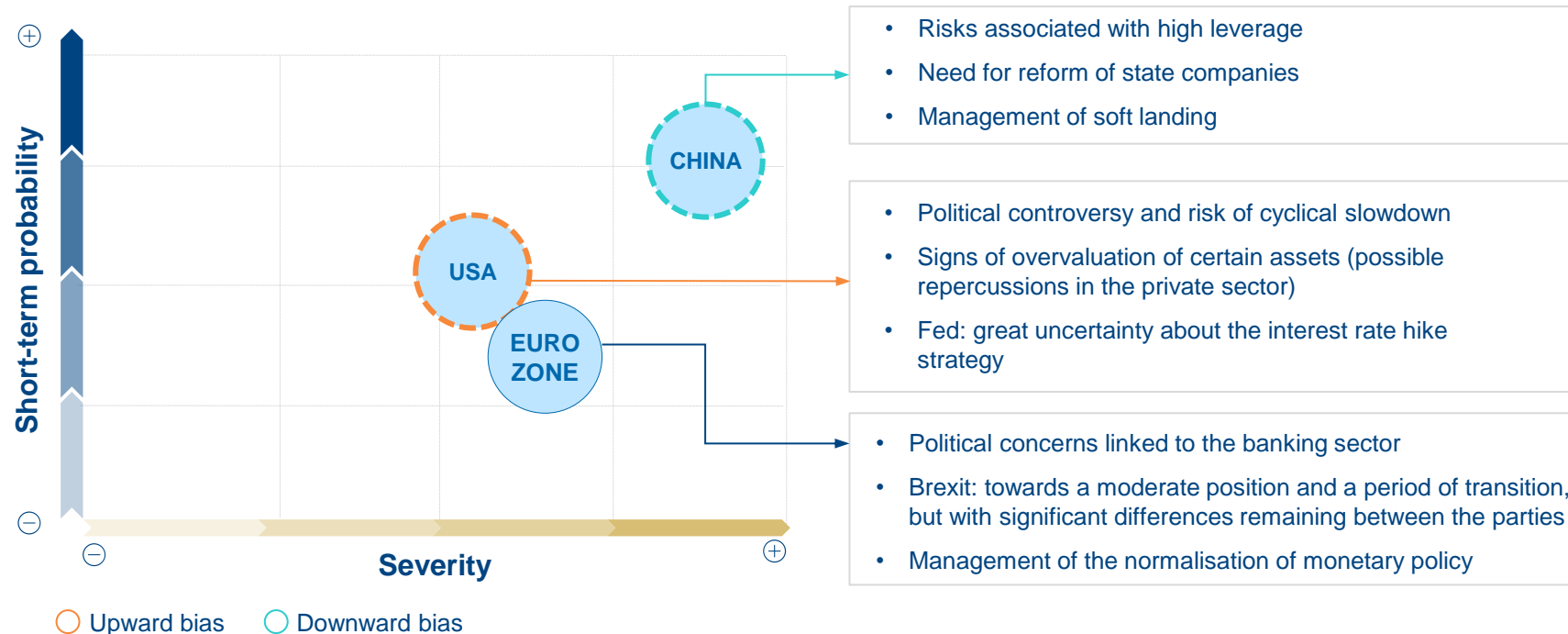


(e): estimated; (p): projected.

Source: BBVA Research based on Eurostat

- ◆ Improved performance of consumption and investment, with limited impact from the appreciation of the euro
- ◆ Very gradual increase in inflation towards the ECB's target
- ◆ The normalisation of monetary policy will allow it to continue to support growth
- ◆ Political and banking risks remain (Spain, Italy, support for the European project, Brexit)

Global risks: rebalancing from China to the US in the short term



SPAIN ECONOMIC OUTLOOK 4Q17



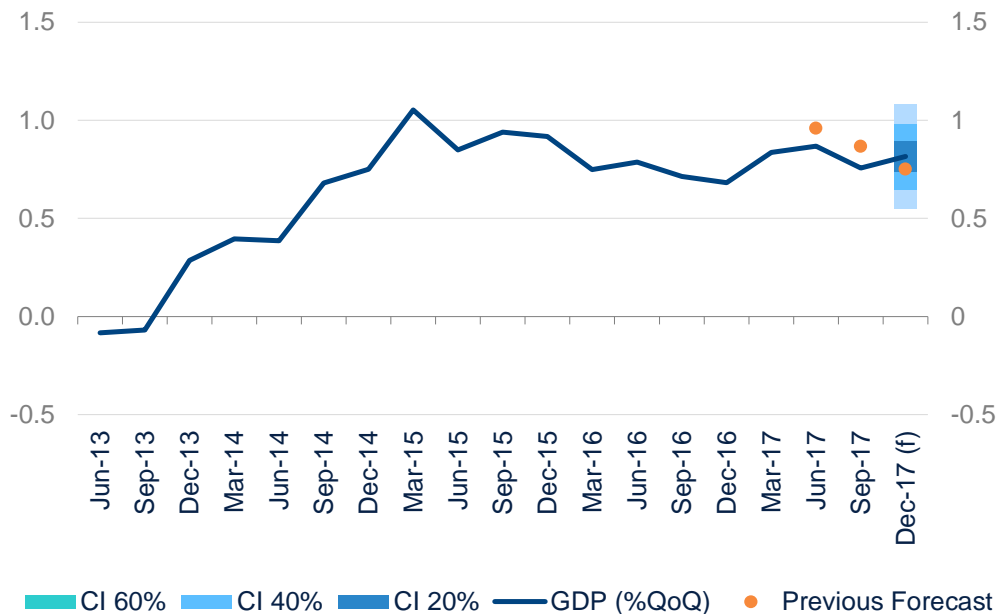
Economic activity is slowing slightly



Downward bias to growth in the short term

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

(% QoQ)



- ◆ Economic growth in 2Q and 3Q was lower than estimated three months ago
- ◆ This, together with the risks to the scenario, obliges us to moderate growth expectations:
 - We have revised the forecast downwards for 2017 (by 0.2pp to 3.1%) and for 2018 (by 0.3 pp to 2.5%)
- ◆ However, the external environment will continue to support growth, which is showing strong momentum in 4Q

(e): estimated.
Source: BBVA Research

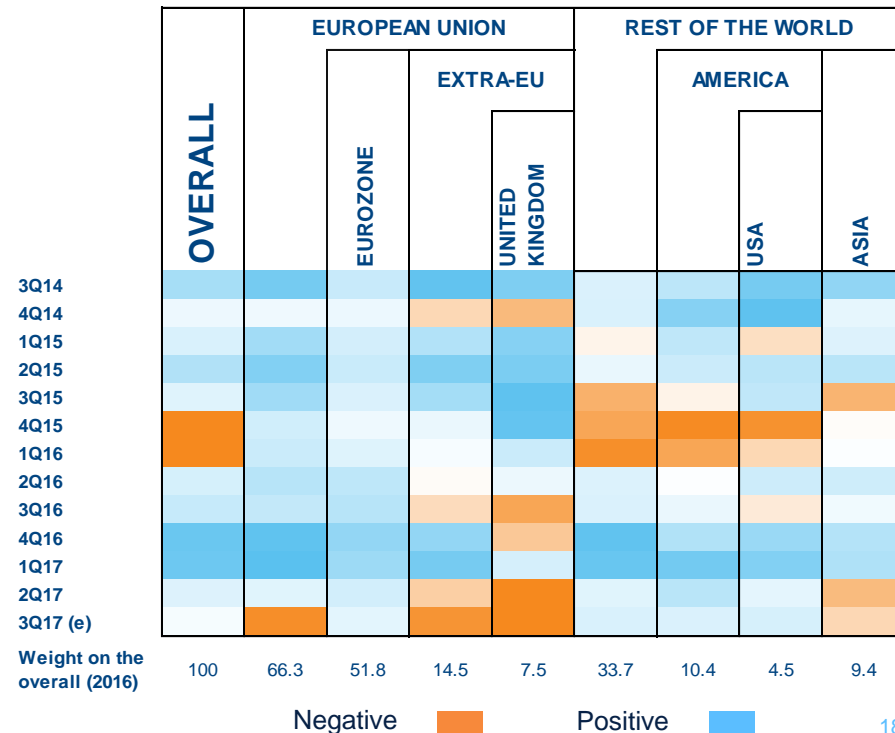
Exports of goods are flagging, albeit temporarily

Exports of goods performed disappointingly in 2Q and could do so again in 3Q, due to:

- the weakness of UK demand;
- the euro's appreciation;
- and the increase in oil prices.

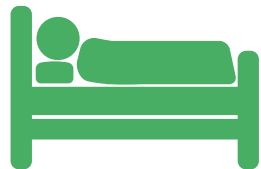
The negative trend will probably reverse, given growth in global demand and investments made in certain sectors

Spain: export of goods
(% QoQ, nominal trend)



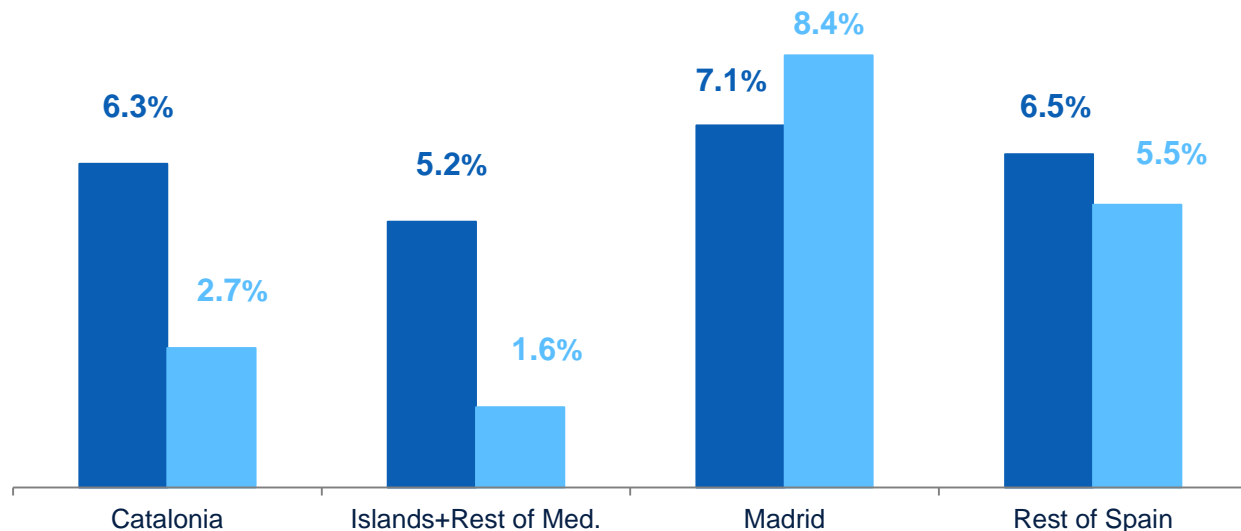
Tourism is slowing, possibly due to structural factors

Overnight stays of non-residents in Spanish hotels (SWDA, average for the period)



1Q13-2Q16

3Q16-3Q17



Source: BBVA Research based on INE

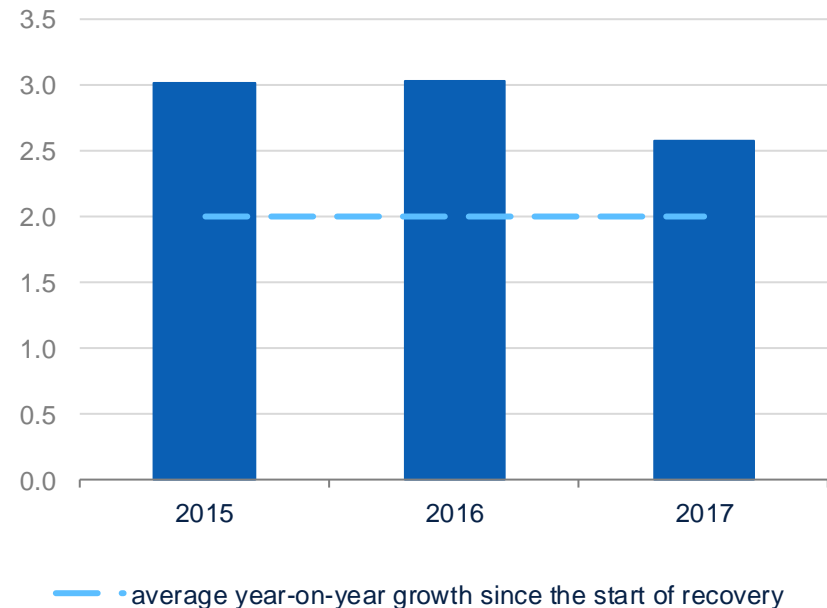
The tourism sector could be nearing saturation levels, particularly in the traditional seaside resorts

Going forward, increased demand will be more and more likely to translate into higher prices and wages rather than job creation → challenge: to enhance quality

Growth in private consumption has been moderating since 2S16

- ◆ The trend is caused by the **end of temporary stimulus measures and tailwinds** such as tax cuts, falling oil prices and the flatness of certain fundamentals (financial wealth and the impact of political uncertainty)
- ◆ **Recent data suggest that the slowdown will continue during 2H17**, in line with the expectations from six months ago

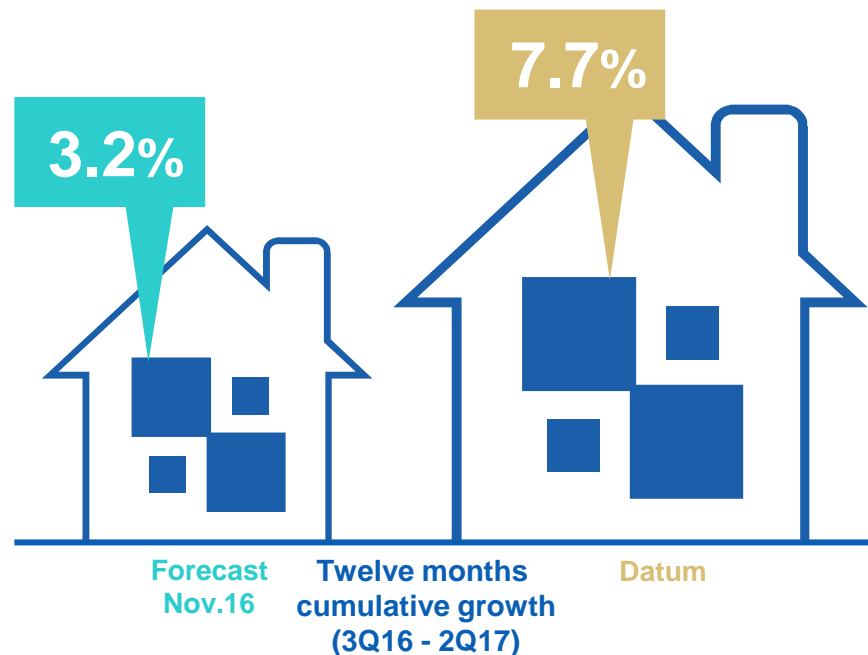
Private consumption
(Average year-on-year growth, %)



Residential investment continues to surprise positively

- ◆ A rising trend that **has been repeated in the past three quarters**
- ◆ The **positive tone** is explained by the **good performance of the sector's fundamentals** (trends in prices, household incomes and the availability and cost of credit)

Growth in investment in housing (%)



2018: recovery will continue to be supported by a favourable external environment



Global growth

The improvement in emerging economies and above all in the EMU will boost external demand



Oil prices

Slight upward revision of the forecast for 2017, but they remain low relative to previous years



Risk-free interest rates

historically low

Expectations of increases postponed.
12-Month EURIBOR will end 2017 at -0.2 and 2018 at -0.1



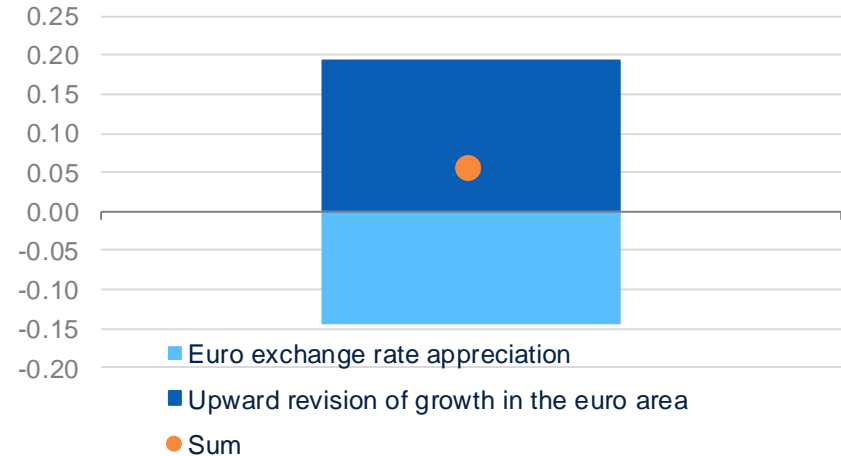
Reduced risk premium

The ECB's purchases will keep the Spanish economy's cost of financing low

2018: recovery will continue to be supported by a favourable external environment

- ◆ The negative impact of the **euro's appreciation** may be considerable on exports in the short term, although moderate on GDP growth
- ◆ In any case, the **expected increase in demand in the EMU** will offset the effects of the stronger currency on growth

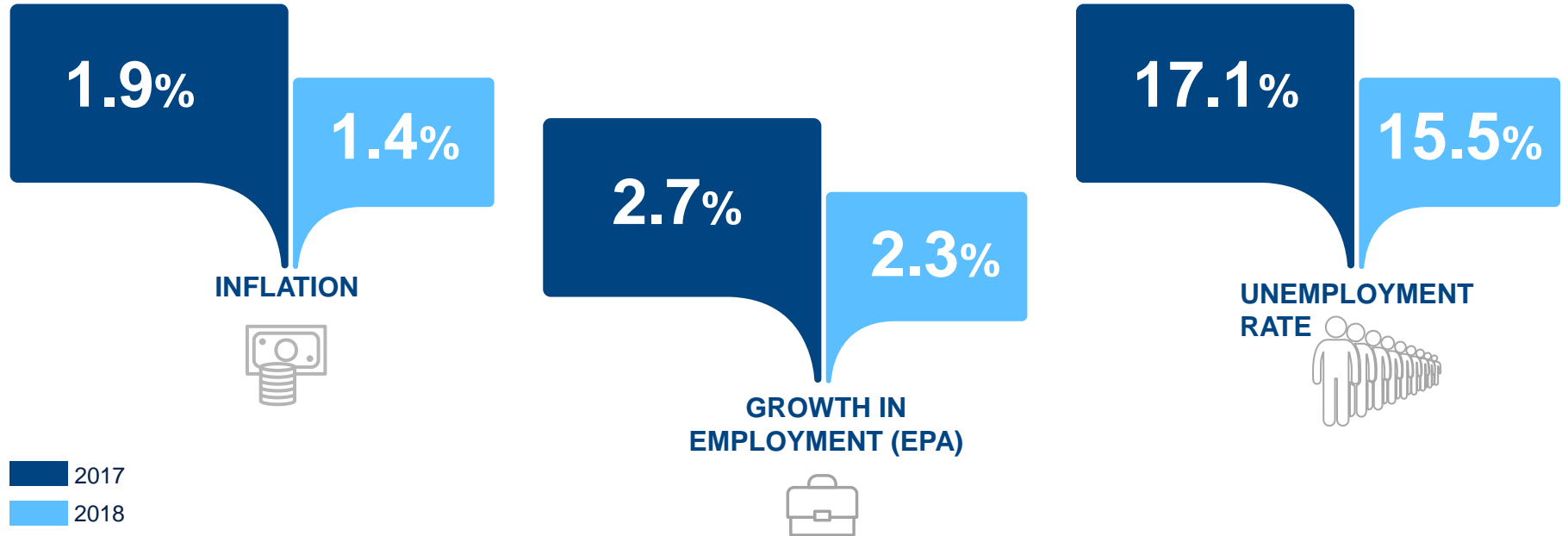
Spain: impact on GDP of the change of scenario in the European economy
(Cumulative pp in 2017 and 2018)



Source: BBVA Research

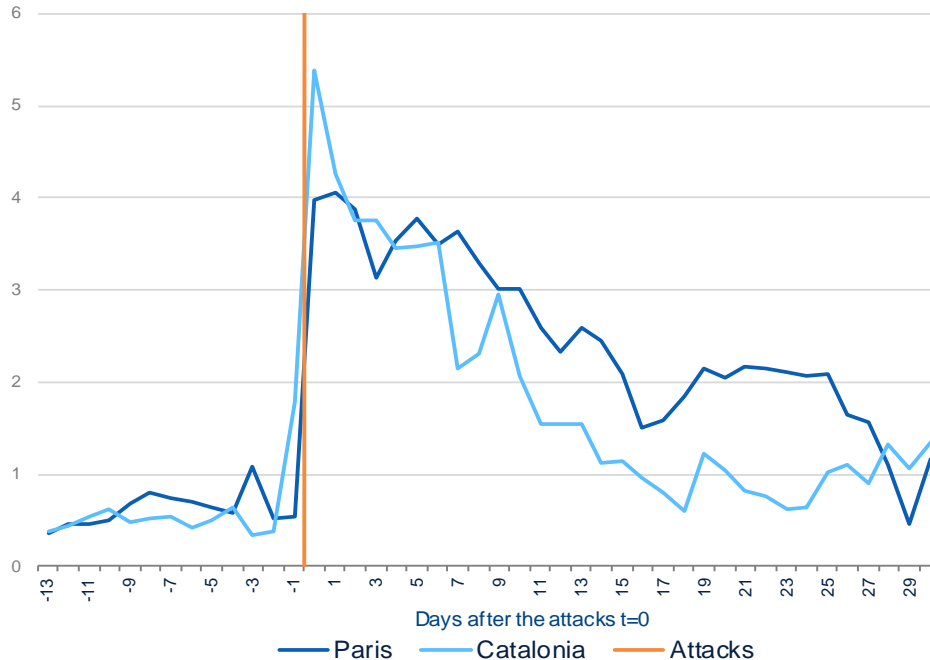
The increased growth in the EMU will mitigate the effect of the euro's appreciation

Summary of forecasts with the main magnitudes



Domestic risks: uncertainty after the terrorist attacks in Catalonia

Instability index (Frequency: every 15 minutes)



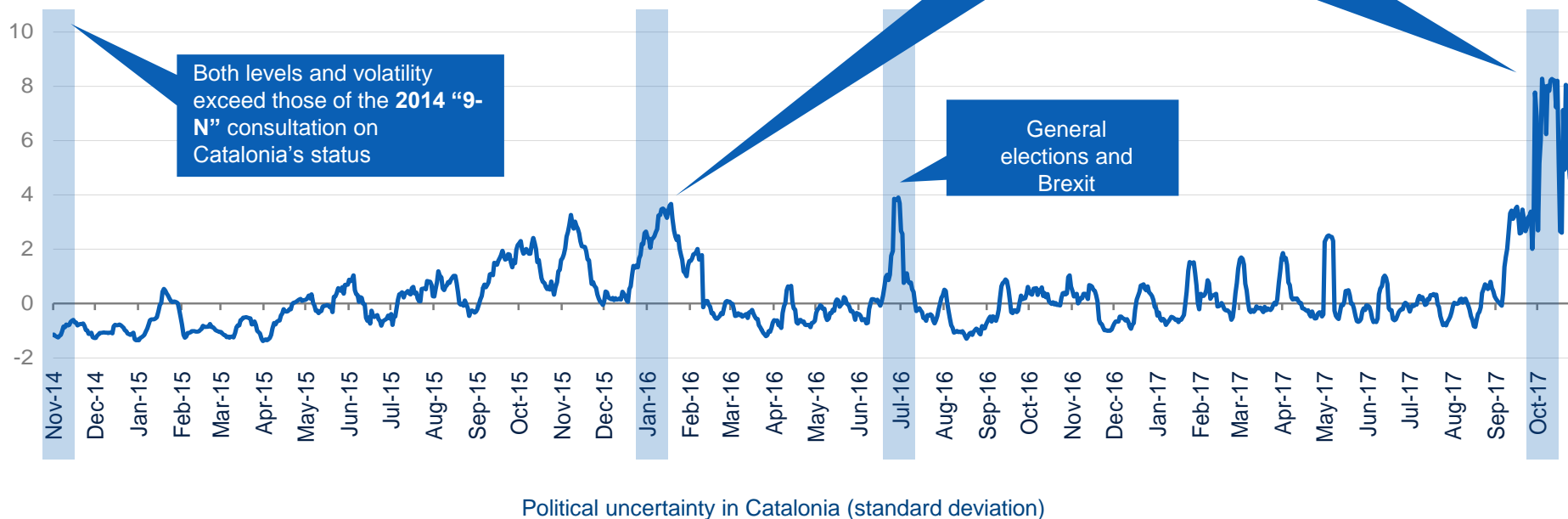
Paris: 13 November 2015, Catalonia: 17 August 2017

Source: BBVA Research based on GDELT

- ◆ Following the attacks in Barcelona, the perception of risk increased as in other European cities
- ◆ After two weeks, tensions eased. A similar period of time to the one observed in Paris, Nice and London
- ◆ The impact will be negative but probably temporary on sectors such as tourism and real estate
- ◆ Foreigners' overnight stays could be 2% lower during the next few months compared with a stress-free scenario

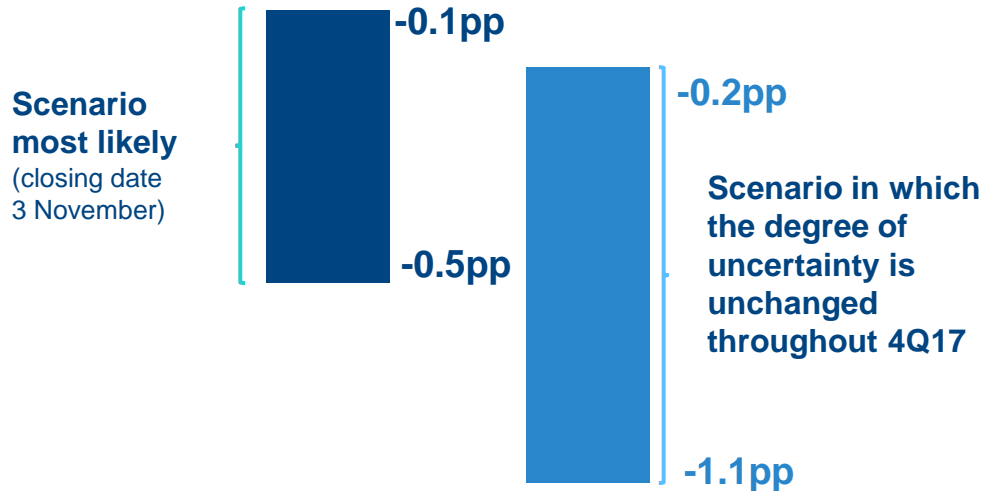
Domestic risks: political tension in Catalonia

Spain: index of economic policy uncertainty (EPU)



Domestic risks: political tension in Catalonia

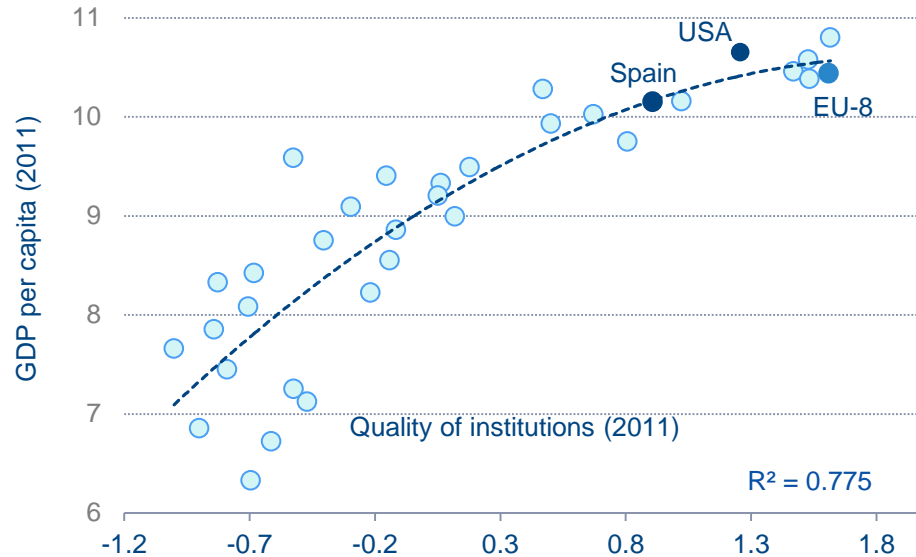
Uncertainty about the impact on Spain's GDP growth in 2018 (pp)



- ◆ The impact on GDP is difficult to estimate and will depend on the intensity of the increase in uncertainty, how long it lasts and its effects on the rest of Spain
- ◆ Factors such as the ECB's monetary policy could mitigate the impact on the economy

Long-term challenges: more efficient institutions

Quality of institutions and income per capita

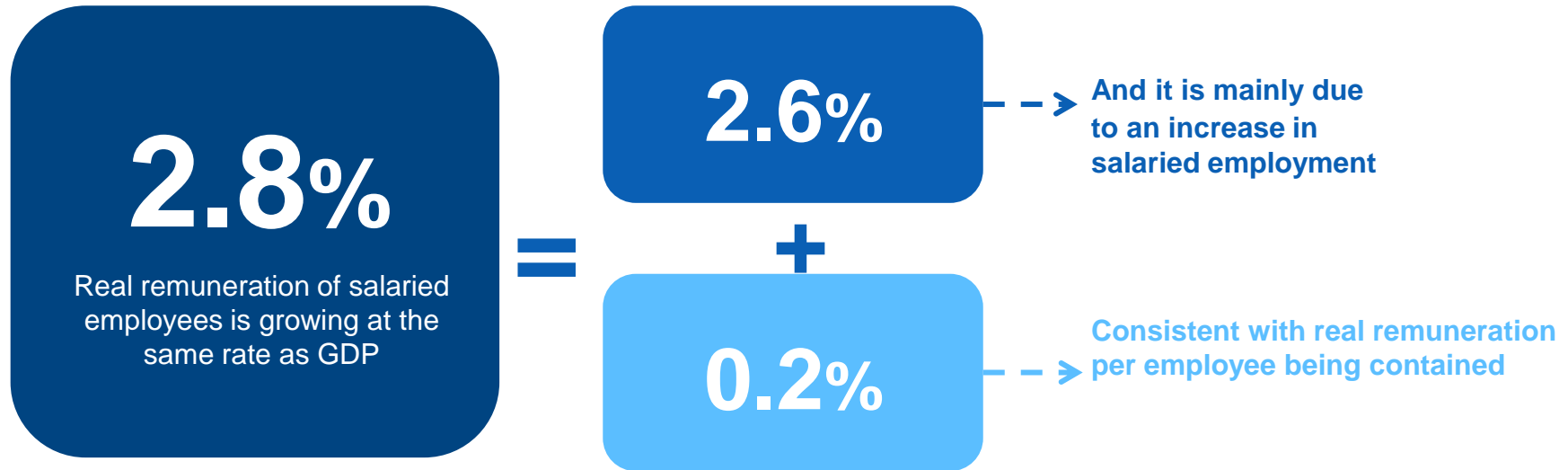


- ◆ Growth increases, and progress becomes more equitable, with improvements in the functioning of institutions (political, economic and legal), with legal certainty and the rule of law, with clear rules followed by all
- ◆ Spain is in the upper part of the ranking, but there is room for improving the efficiency of its institutions
- ◆ Progress towards best international practices could increase the rate of growth in GDP per capita by 0.5 pp a year

Source: own research based on PWT and WGI. Each point represents the average of five countries in a sample of 156 economies other than Spain, USA and the EU-8 (Austria, Belgium, Denmark, Finland, Germany, the Netherlands, Sweden and the UK)

Long-term challenges: consolidating the recovery in employment

Average growth rates for the period 2014-2018



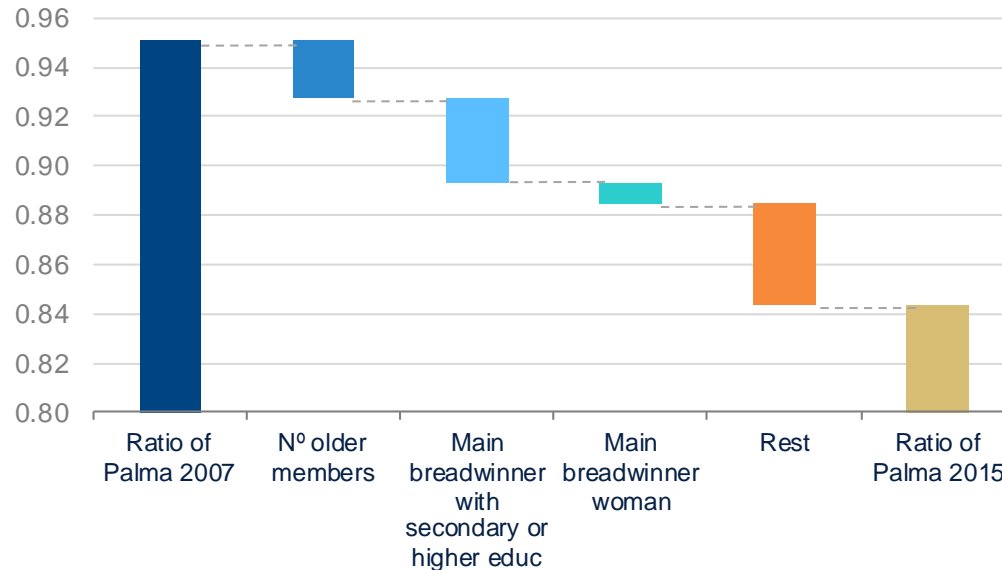
Source: BBVA Research

Wage growth continues to be consistent with strong job creation. Looking ahead, the main priority for fostering an equitable recovery must be to reduce the unemployment rate

Long-term challenges: a more inclusive economic recovery

Factors determining inequality in Spanish households' consumption

(Contribution to the variation between 2007 and 2015 (pp))



◆ Despite the growing inequality in incomes, inequity in terms of consumption diminished by 9.7% between 2007 and 2015 due to:

- families reuniting;
- improved level of education of families with relatively low consumption;
- and a greater proportion of households headed by women in those with relatively high consumption.

◆ Some of these changes have undesirable social and economic consequences (reunification) and others may have a temporary effect due to cyclical conditions

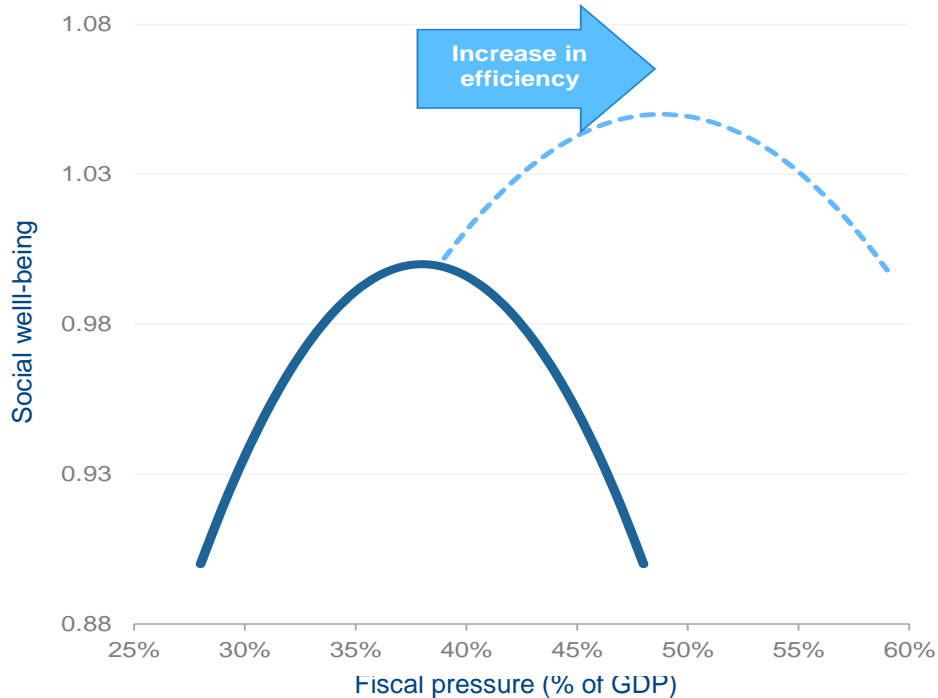
Source: BBVA Research based on EPF (INE)

For further details, see “Caída de la desigualdad en consumo: El caso de España durante la crisis”, available (in Spanish only) at:

<https://www.bbvarresearch.com/publicaciones/caida-de-la-desigualdad-en-consumo-el-caso-de-espana-durante-la-crisis/>

Long-term challenges: more efficient tax system

Fiscal pressure and wellbeing



Source: Boscá, Doménech and Ferri (2017)

- ◆ **Non-linear correlation between wellbeing and the size of the public sector:** depends on whether the positive effects of increased spending on utility and inequality outweigh the negative effects of the distortions caused by increased fiscal pressure
- ◆ **Increasing the public sector's efficiency** allows for improved resource management and favours society's wellbeing and its predisposition to accept greater fiscal pressure
- ◆ It is essential to **make the most** of the opportunities presented by the **process of technological and digital transformation** that is under way

Key messages

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- ◆ In Spain, data for the third quarter and the increase in uncertainty bias growth expectations downwards. However, the external environment continues to underpin the recovery, which is showing strong resistance in 4Q17
- ◆ Forecasts for GDP growth have been revised downwards to 3.1% for 2017 and 2.5% for 2018
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DATE	TIME	DISTANCE (MILES)	PACE (TIME / MILE)	NOTES
4/1/14	20m 0s	2.00	10m 0s	
4/2/14	25m 18s	2.25	11m 15s	
			12m 0s	

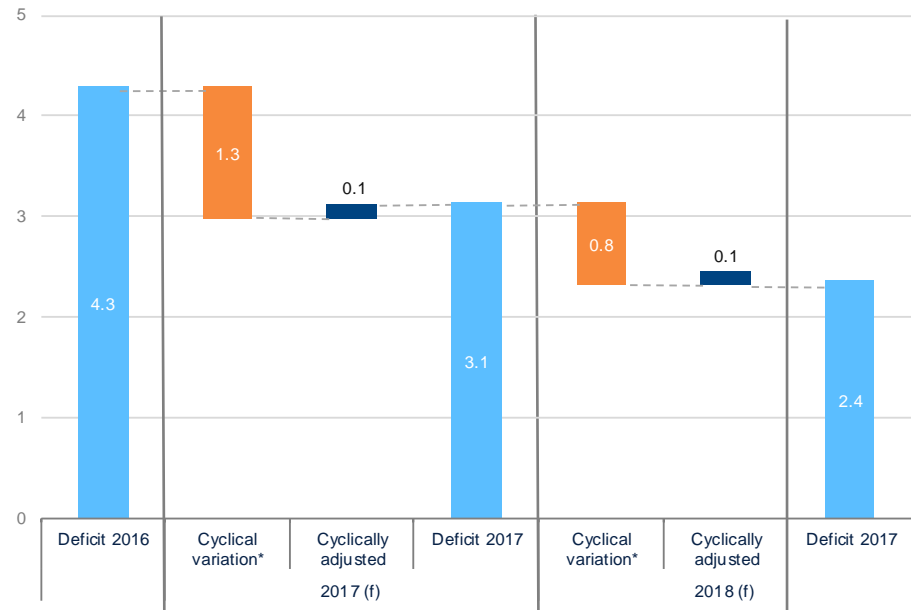
APPENDICES



Fiscal policy will be neutral and in line with budgetary objectives

- ◆ The 2016 deficit (meeting expectations), the recovery and the General State Budgets for 2017 make the **stability target viable**
- ◆ Although there is some uncertainty regarding the forecast revenues, the increased growth in **GDP** and the measures taken at the end of last year will facilitate the reduction of the deficit

Spain: fiscal adjustment
(%, YoY)



(f): forecast.
Source: BBVA Research

Changes in our forecasts

The fundamentals continue to support a relatively strong recovery

% YoY	2016	2017 (f)	2018 (f)
National final consumption expenditure	2.5	2.3	2.0
Private consumption	3.0	2.6	2.1
Public consumption	0.8	1.3	1.8
Gross fixed capital formation	3.3	4.7	3.6
Equipment and machinery	5.0	5.6	2.8
Construction	2.4	4.5	3.8
Housing	4.4	8.2	5.9
Other constructions	0.9	1.2	1.9
Domestic Demand (*)	2.5	2.6	2.3
Exports	4.8	5.0	4.3
Exports of goods	3.1	4.7	4.6
Exports of services	8.8	5.8	3.7
Non-turist services	8.2	4.8	5.5
Final consumption of non-residents in the economic territory	9.7	7.3	1.2
Imports	2.7	3.8	3.8
External Demand (*)	0.7	0.5	0.3
GDP mp	3.3	3.1	2.5

(*) Contribution to GDP growth

Source: BBVA Research based on INE and Banco de España

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