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BBVA Research

Spain Economic Outlook 2Q18

April 2018

Creating Opportunities

Key messages

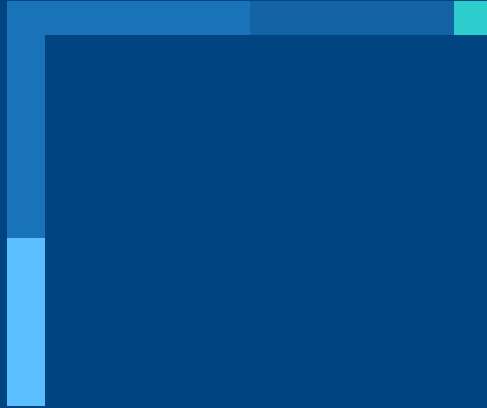
- Global growth remains robust, but uncertainty increases. The US fiscal stimulus may underpin progress in other areas too, but the protectionist measures pose a risk
- In Spain, recent data confirms the upward biases noted three months ago. Exports and investment are picking up, while consumption is easing off
- The uncertainty in Catalonia is high, but has waned, and its impact is in line with what was expected: temporary (4Q17), confined to the region and with effects on specific sectors (tourism)
- The growth forecasts in Spain have been revised upwards, to 2.9% in 2018 and 2.5% in 2019, on the improvement in fundamentals (promising external environment, fiscal policy, etc.)
- Domestic risks include the political environment, a relaxation of fiscal adjustment and an uneven recovery

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Global Economic Outlook 2Q18

Global growth remains but risks intensify

01

Steady global momentum remains

Supported by the recovery of trade and investment

02

Economic policies underpin the cyclical recovery

The US fiscal stimulus can support other areas

03

Greater financial volatility

The unusual low-volatility environment is now past

04

Normalization of central banks' monetary policy

Somewhat faster than expected in the Fed, while the ECB has already taken its first steps

05

Uncertain effect of US protectionist measures

The direct effect of approved measures is not very large, but it may presage more aggressive measures

06

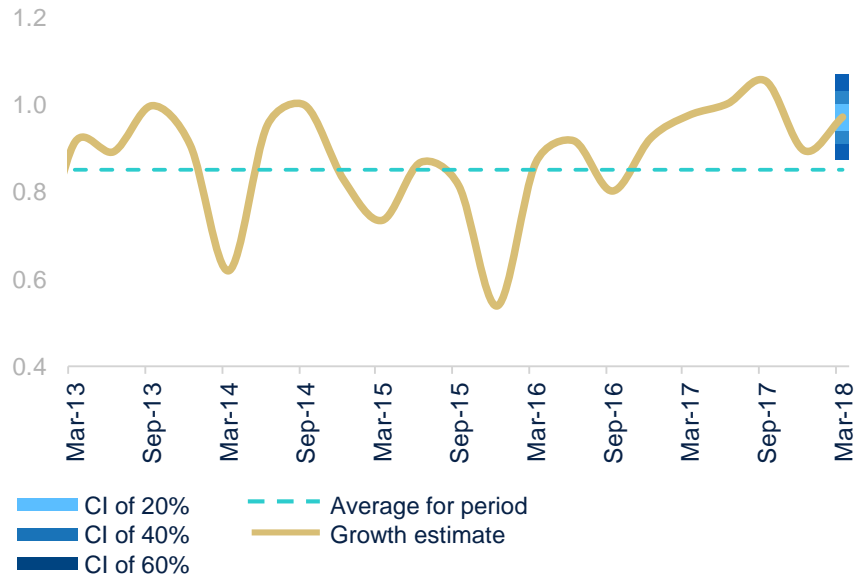
Global risks

Increasing in the short-run by a possible escalation of protectionist measures

The global economy is expected to grow firmly in 1Q18, at rates similar to those of most of last year (1% quarterly)

World GDP growth

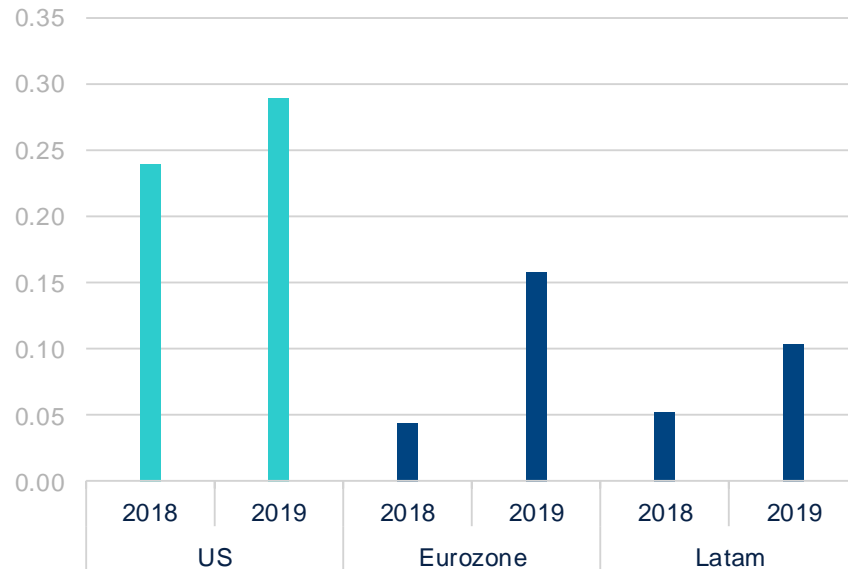
(Forecasts based on BBVA-GAIN, % QoQ)



- Global growth is continuing, buoyed by the recovery in investment and trade
- Private consumption is softening, but remains a positive factor for the advanced economies and is gaining momentum in emerging economies
- Confidence indicators remain at high levels, but show signs of dampening

The upward revision of US growth forecasts, due to fiscal stimulus, could add further support to the recovery in other areas

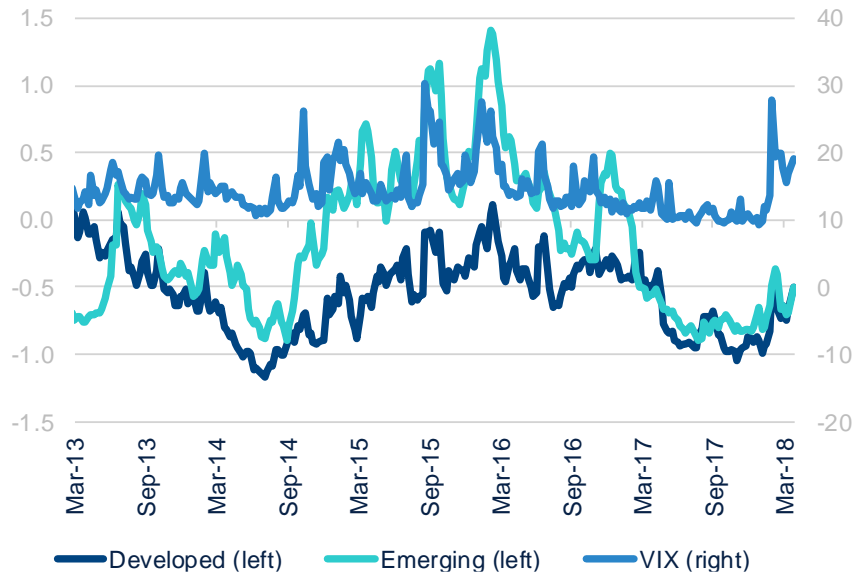
Impact of the fiscal stimulus in the US on growth (pp)



- The larger effect would be in 2019, especially in the eurozone
- This support could offset some headwinds in other areas (political uncertainty in Latam or higher global volatility)
- The weakness of the dollar could mitigate the positive impact of higher US demand

Financial tensions are beginning to reflect a less accommodating environment

VIX and BBVA Research financial tension (%)

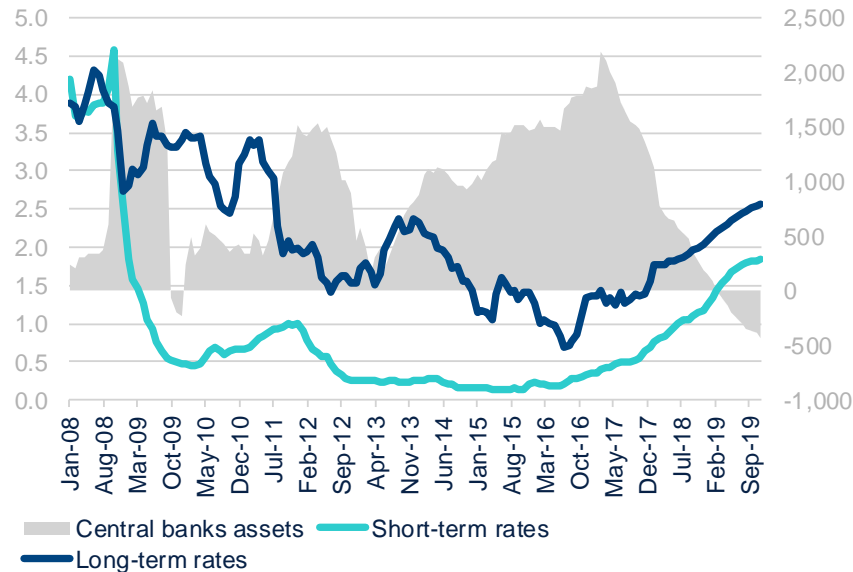


- Concerns about inflation (US) and protectionism have led to higher volatility and stock market correction
- The contagion effect is limited, but it will depend on the persistence of the current shock
- Markets are unlikely to be as complacent with uncertainty as in 2017

Financial conditions will be less accommodating

Global financial conditions*

(% and change in billion dollars)



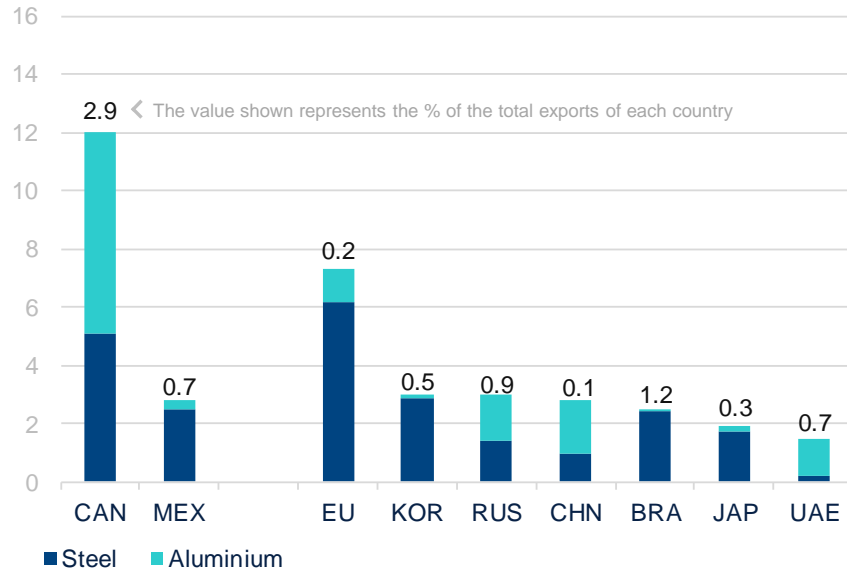
- As central banks will reduce their balance sheets and interest rates gradually increase...
- ... volatility shocks could be more frequent and persistent
- More cautious investor mood

(*) Short and long term interest rates, average yield of German and US bonds over 3 months and 10 years. Includes assets on the balance sheets of the Fed, ECB, BoE and the BoJ
Source: BBVA Research based on Fed, ECB, BoE and BoJ

The risk of protectionist escalation creates uncertainty about the global economic outlook

US imports of steel and aluminium and export share by country

(billion USD, % of total exports)

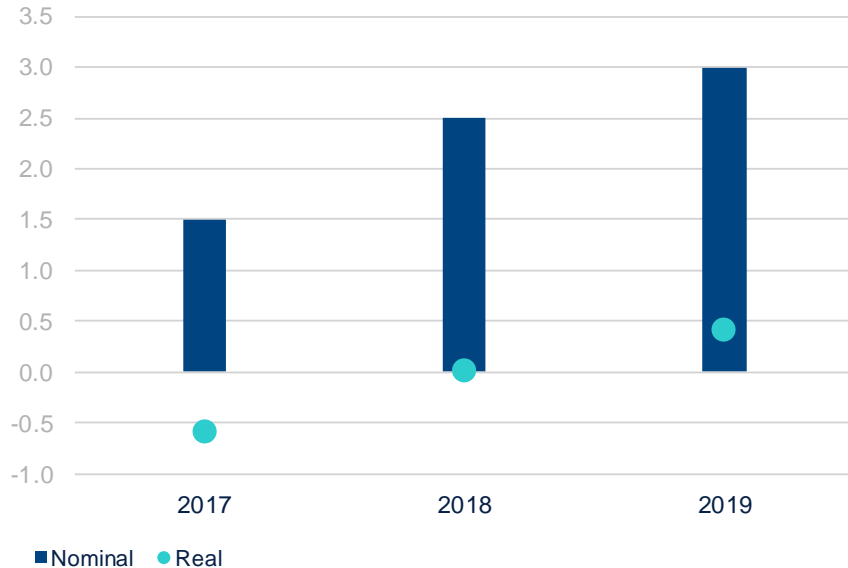


Source: BBVA Research

- US tariffs on steel and aluminum have a small direct impact on activity:
 - They represent only a small share of total exports
 - Exemption for many countries until May
 - The greatest negative impact may come from indirect effects and possible reaction of the countries concerned
- The mutual tariff increase between the US and China (25%, 50bn USD in 2017):
 - Larger effect: 38% exports to China (3% of the total US exports) and 11% of exports to the US (2% of the total chinese exports)
 - They can only be the beginning of a major escalation

Further Fed rate hikes due to better economic outlook

USA: Intervention rate (%)



- Fed is likely to increase rates by further 75bp this year and 50bp in 2019
- Monetary conditions will remain accommodative, with real interest rates close to zero

ECB is making progress to QE without causing any strain



The QE will end in 2018

Monthly purchases of assets
(30bn EUR) up to September

Purchases withdrawal between
September and December

Interest Rates



As we approach the end of QE, the **focus shifts** to the rate hikes: when and at what pace

But the **ECB will remain in debt markets:**
reinvestment of maturities

The **challenge** for the ECB is to **manage the interest rate expectations** (*forward guidance*)

Key points in crisis exit:



Long rates and risk premiums

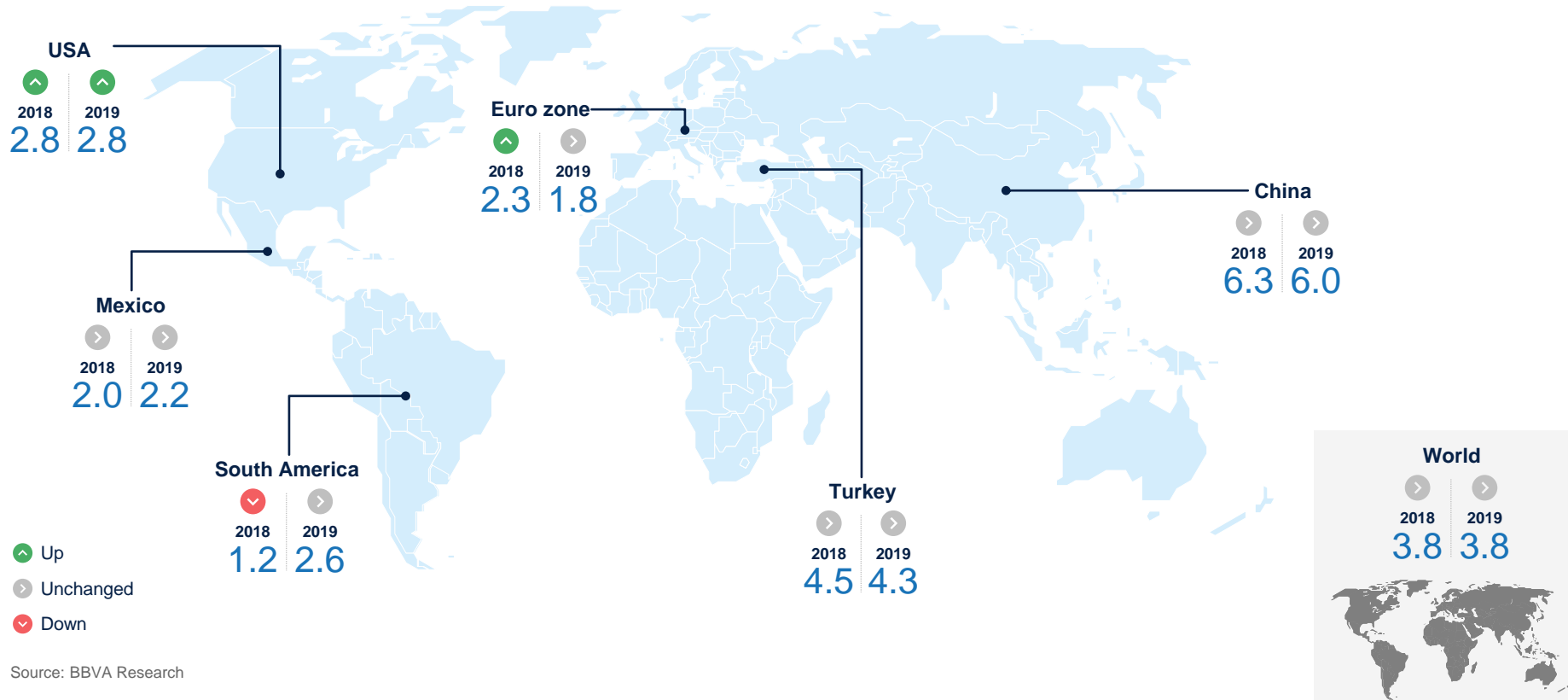


Exchange rate (EUR)



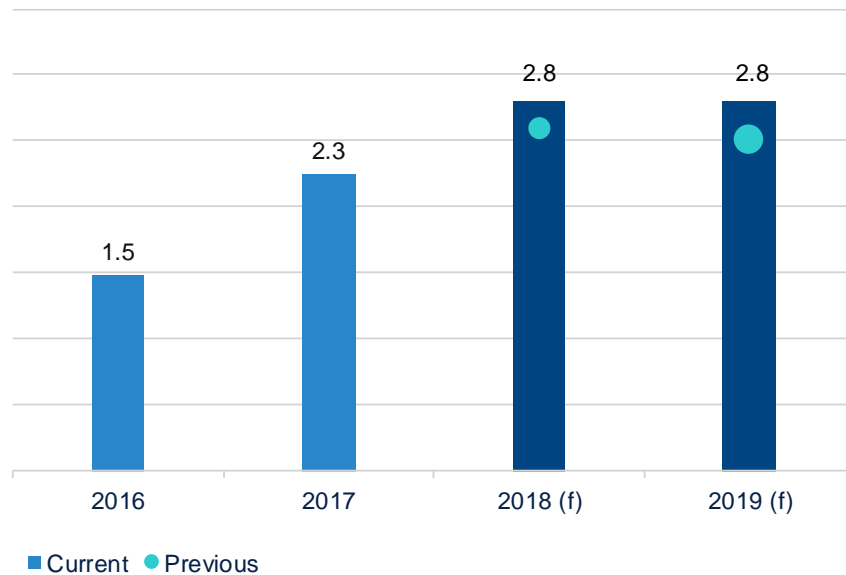
Rate hike expectations

Revised upwards in the USA and downwards in South America



USA: Higher growth on new budget deal

USA: GDP growth (% YoY)



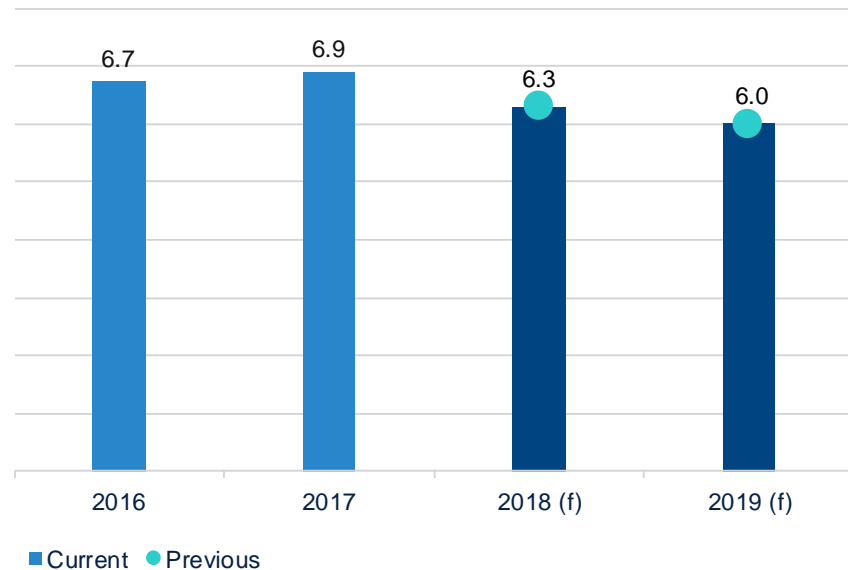
(f) Forecast

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

- Moderate impact of the new fiscal stimulus in the short term as the economy approached full employment without measures to support a significant increase in potential growth
- The favourable global environment and strong domestic demand complement the positive impact of higher public spending (upward revision 0.2 and 0.3pp in 2018-19)
- Inflation is likely to temporarily exceed the Fed's target, but will remain contained

China: Growth holds well while policy uncertainty abates

China: GDP growth (% YoY)



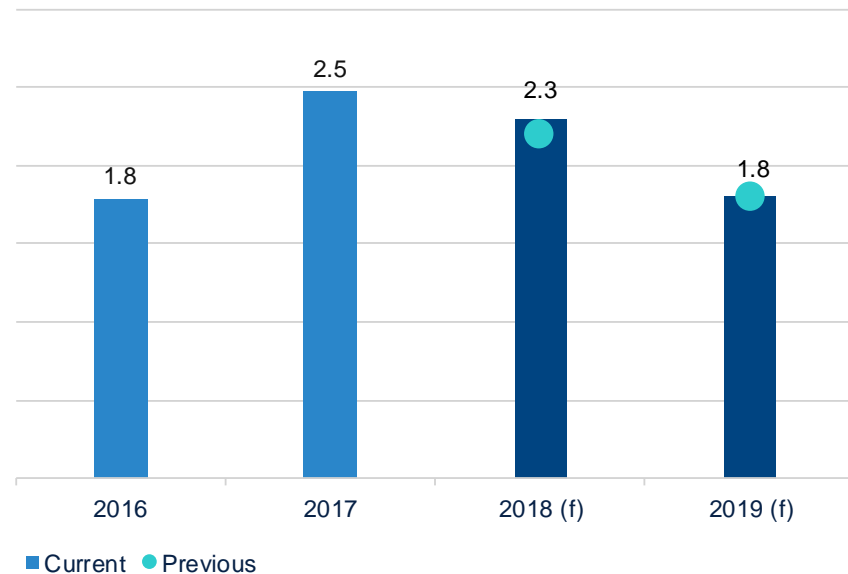
(f) Forecast
Source: BBVA Research based on CEIC

- The strength of credit and exports allowed the economy to stabilize in 1Q18
- Forecast unchanged: growth moderation in 2018 due to more prudent economic policy
- Increasing probability of implementing structural reforms in the medium term and addressing financial vulnerabilities
- Increasing protectionism threatens the sustainability of exports

Eurozone: Small upward revision for 2018 despite recent softer data

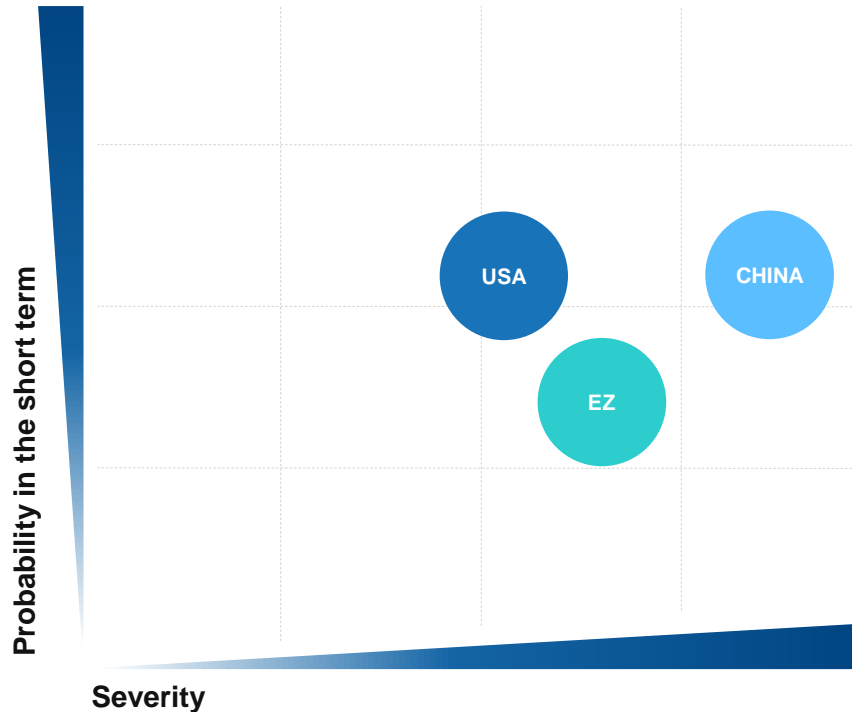
Eurozone: GDP growth

(% YoY)



- Stronger exports, supported by increased global demand, help maintain momentum in 2018
- Lower domestic demand contribution, although domestic fundamentals remain strong
- Core inflation will continue to rise gradually, but clearly below 2%.
- Recovery is widespread in most countries, but the problem of low potential growth persists

Global risks: Turning again towards the US. The protectionism threat (with potential global range) joins to the Fed's exit risk



CHINA

- Deleveraging risk more contained in the short term, coexisting with a slower than expected GDP moderation
- Potential negative outcome derived from increased protectionist rhetoric

USA

- Protectionism risk increases after recent measures
- Political controversy risk despite fiscal stimulus
- Signs of overvaluation in certain assets
- Fed exit risks: tighter monetary policy in response to a transitory spike in inflation (without demand support). Risk of sell-off in bonds

EUROZONE

- Political concerns increase following Italian elections outcome
 - Italy: uncertainty on the Government formation, and risk of a populist / heterodox government contrarian to European project
 - *Brexit*: uncertainty on negotiations outcome
- ECB's exit risk is low, but will require monitoring the risk of a faster normalization



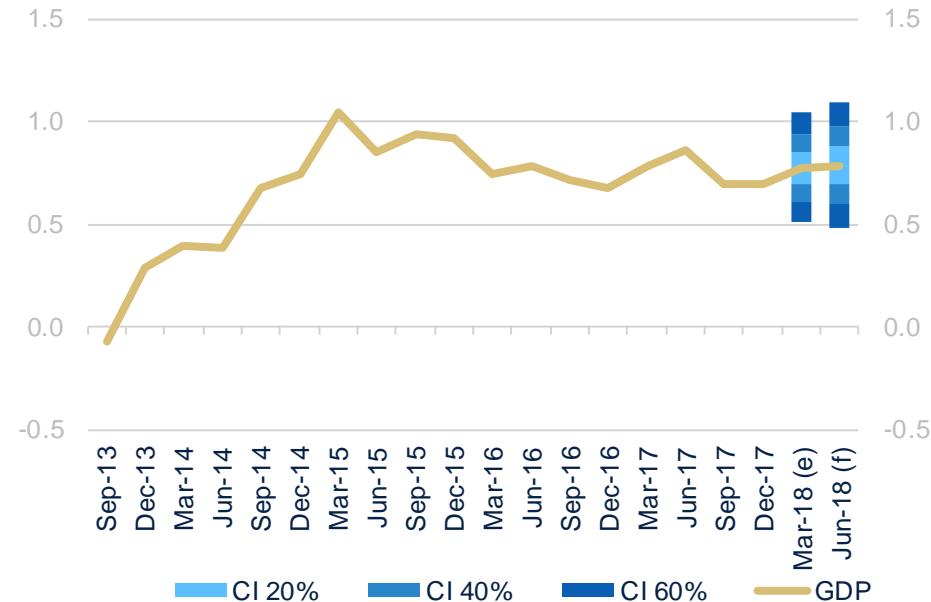
02

Spain Economic Outlook 2Q18

Upward biases in the short term

GDP growth

Forecast from the MICA-BBVA model (% QoQ)



(e) Estimate

(f) Forecast

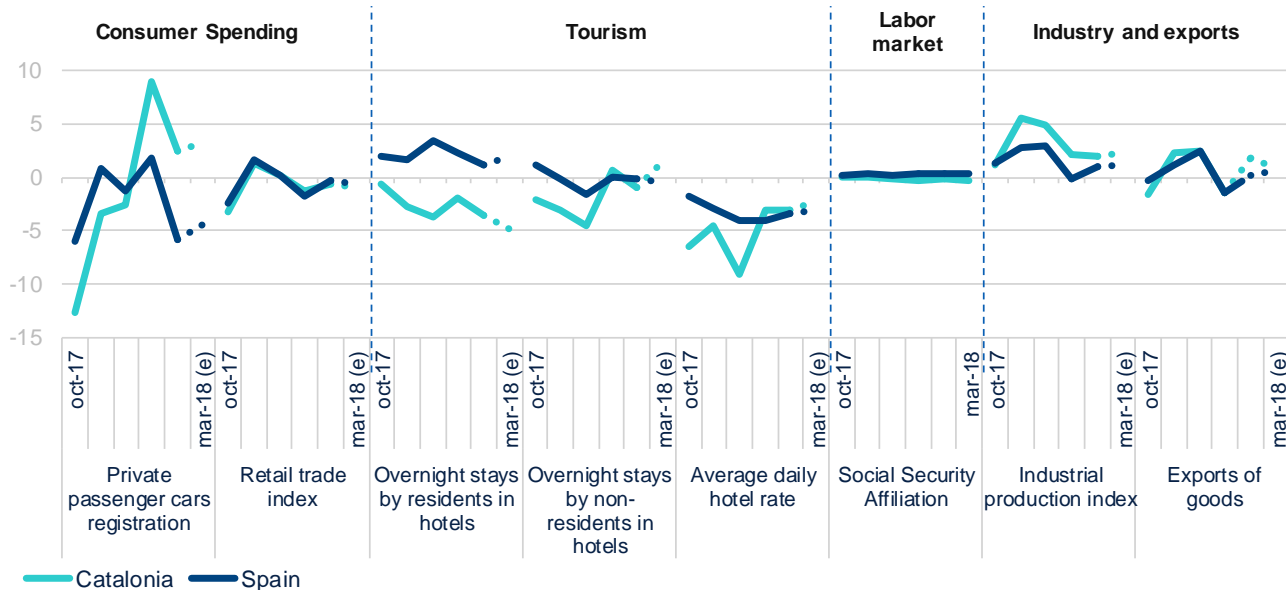
Source: BBVA Research based on INE

- Estimates indicate that GDP growth is likely to have accelerated, and should improve the forecasts that were made three months ago
- Despite the economic policy uncertainty, the economy could grow by around **0.8% QoQ** on average during 1H18

Catalonia: Impact of uncertainty in line with expectations

Observed data and forecasts in a scenario without uncertainty

Monthly difference between the observed raw data and expected figure with information until September-17 (pp)



Substantial, but temporary

Increased precautionary saving and negative impact in some sectors

Geographically limited

Mainly in Catalonia

More significant in tourism

Activity has recovered, but prices have yet to do so

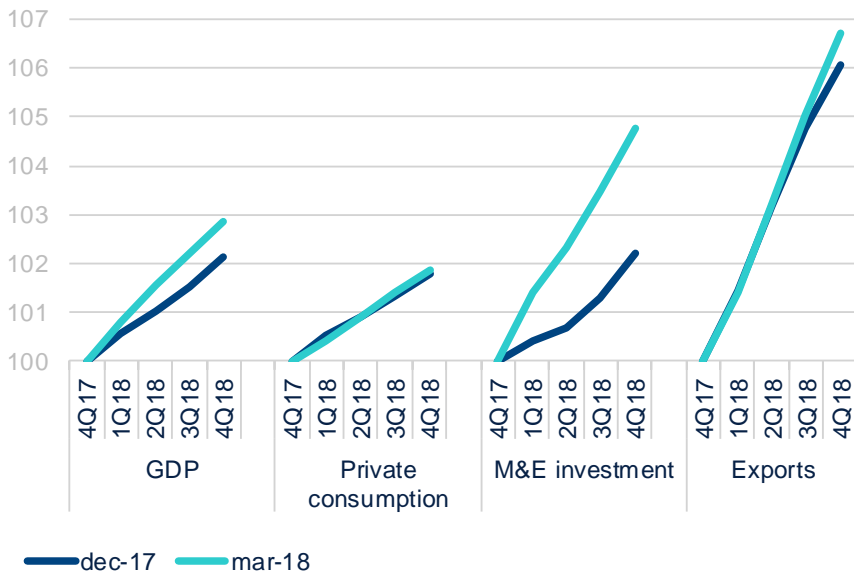
Partially offset by external demand

The increase in industrial production and exports is due to higher growth in the rest of the world

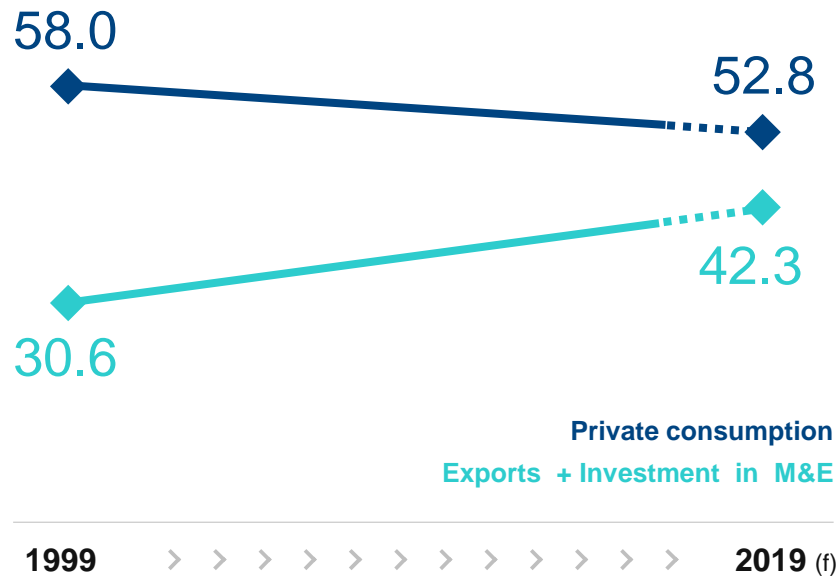
(e) Estimate
Source: BBVA Research based on INE, DGT, Datacomex and Social Security

Exports and investment are spearheading growth

Projected trends in demand components (4Q17=100)



Changes in the structure of demand (% of GDP)

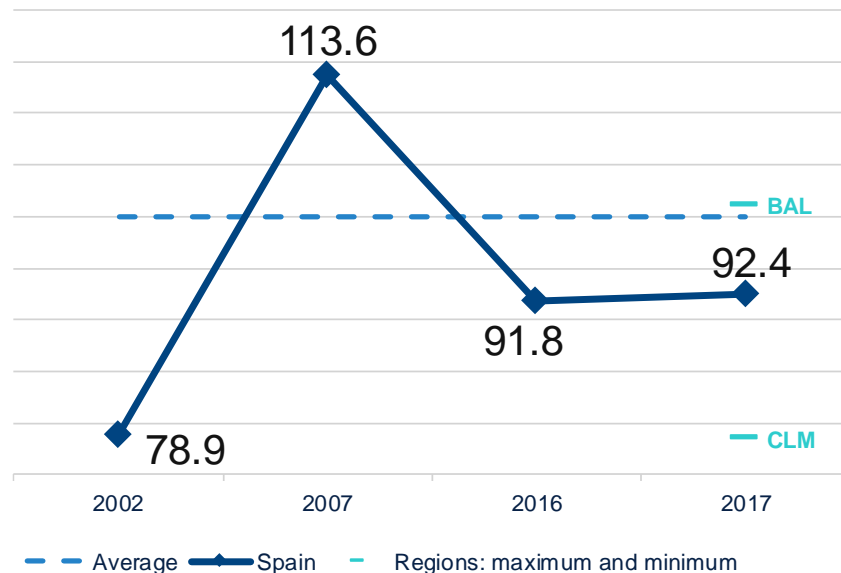


(f) Forecast
Source: BBVA Research based on INE

The real estate market recovery continues

Ratio between house prices and wage income per household

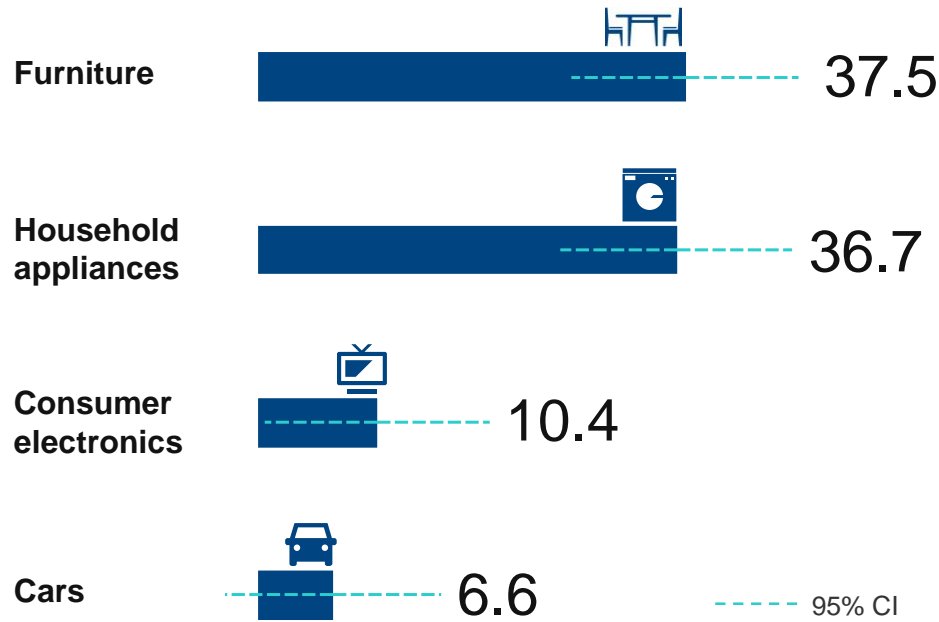
(Average 2002-2017=100)



- Despite economic policy uncertainty and the recent slowdown, the outlook for the sector is positive
- Prices are starting to rise in line with the average income of families, but they are still far from pre-crisis levels
- Lending conditions will remain favourable and construction will boost job creation, while tourism will lose steam

The impetus of the real estate sector should support the growth of spending on certain goods within a context of a slowdown in consumption

Effect of home-buying on consumption (%)



- A household's spending rises by around 20% when buying a home, regardless of the changes that take place in the size of the family unit, income or employment status of its members
- The “property effect” reaches 35% in the case of furniture and household appliances
- The recovery of the real estate sector will contribute to the increase in purchases of furniture and appliances

Upward revision in the growth forecasts for 2018 and 2019



2018-2019: The external environment will bolster growth



Oil prices

Still low (compared with 2014), despite the upward trend



Exchange rate

The appreciation will have a limited impact for Spain, but may affect some regions, sectors and companies



Global growth

Improved prospects for Europe and the US
A more synchronised global recovery is positive for Spain, given the diversification of its exports



Monetary policy

Very gradual exit by the ECB
Low long term interest rates



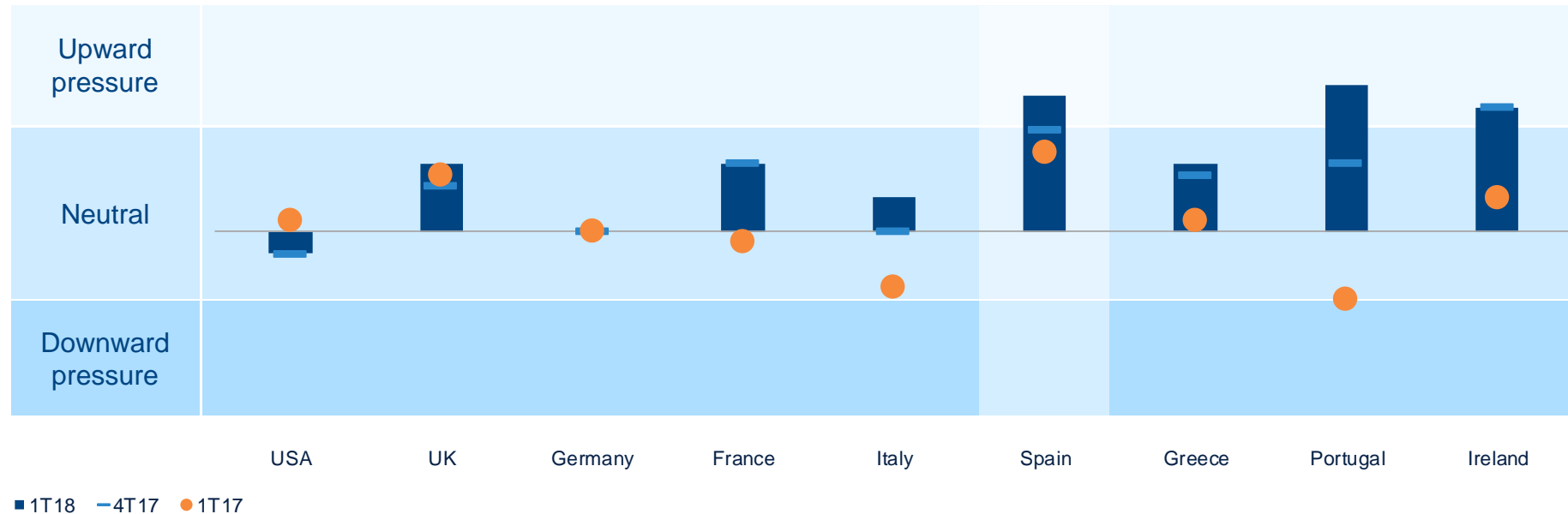
Risk premium

Downward revision in the cost of long-term financing

A better than expected overall performance has been key

Indicator of market pressure on the sovereign rating

(Gap between the implied CDS rating and the sovereign rating by class, quarterly average)

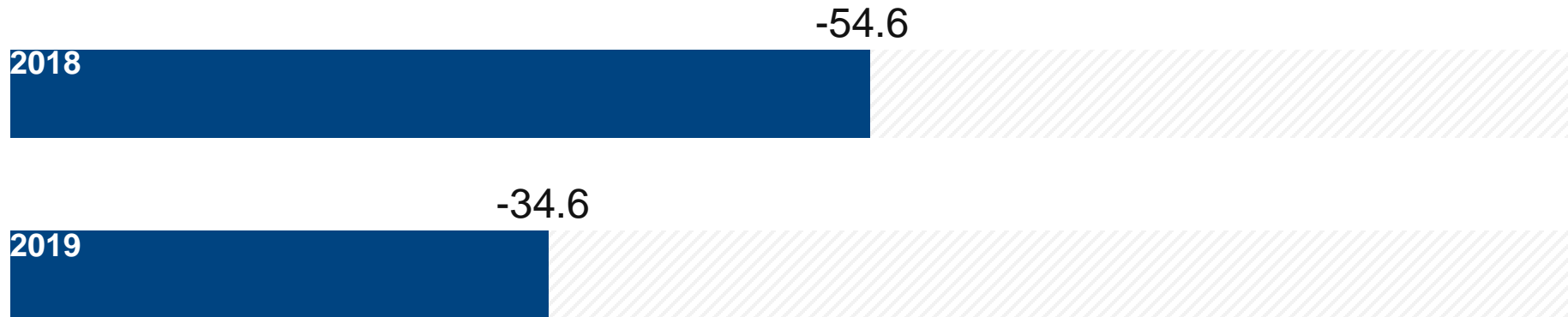


Monetary policy will continue to be expansive

Downward revision of the risk premium

(Deviation compared to baseline scenario in bps)

Lower cost of long-term financing



Modest impact of the appreciation of the euro exchange rate

Spain: Simulation of a 10% appreciation in the EUR-USD exchange rate*

(Deviation from baseline scenario levels in pp during the first year)

 GDP	>	-0.6
 Exports	>	-2.6
 Nominal effective exchange rate	>	3.6



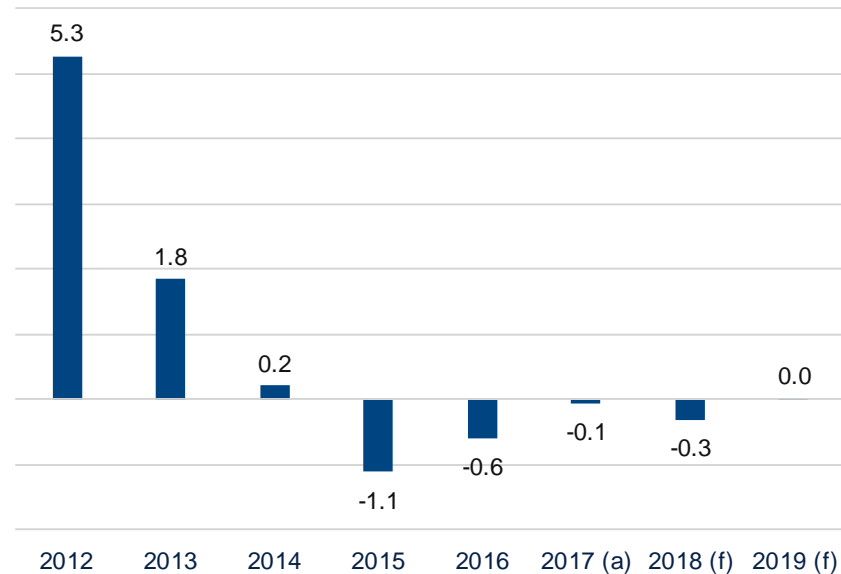
Companies, sectors and regions with greater exposure to the rest of the world may be more affected by expectations of a stronger euro (€)

(*) The BBVA Research scenario assumes an average appreciation of the EUR-USD exchange rate of 9.0% in 2018 and 2.5% in 2019
Source: BBVA Research

Fiscal policy will be mildly expansive

Changes in the primary structural balance*

(Excluding assistance to the financial sector, pp of GDP)



(a) Advance

(f) Forecast

(*) The measures that could be approved in the Spanish National Budget for 2018 are not included

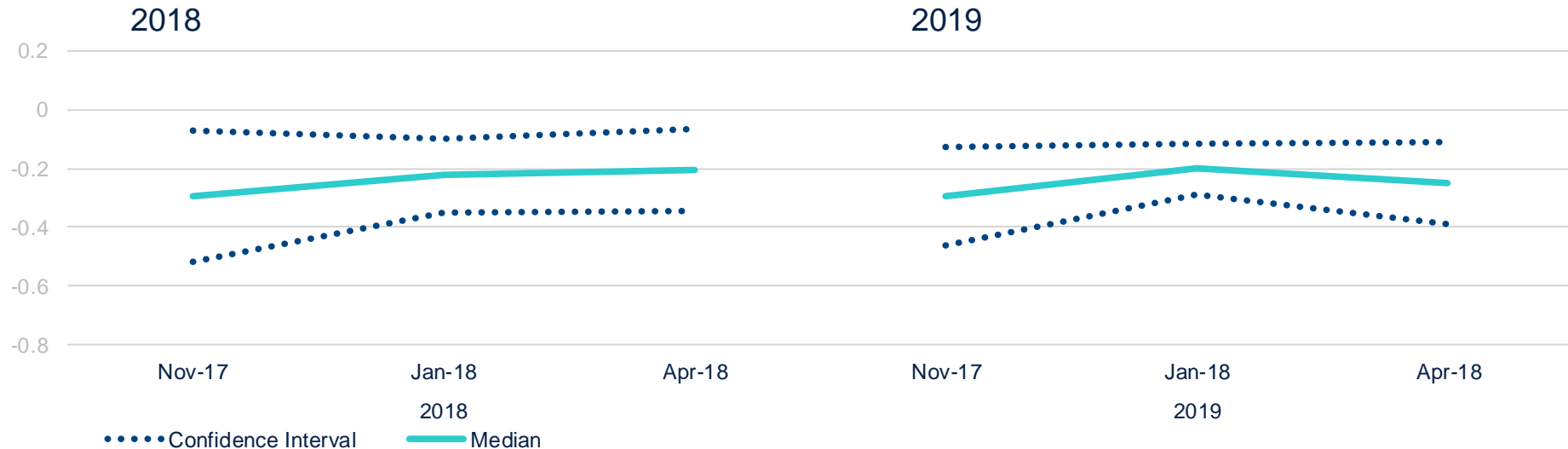
Source: BBVA Research, based on Ministry of Finance and Public Administration and INE

- The recovery in economic activity may not be sufficient to reach the stability objectives, given the new measures to expand investment spending
- If approved, the measures included in the Spanish National Budget 2018 presented by the Government would increase the fiscal stimulus and the probability of failing to hit budget targets, and could lead to growth of more than 2.9% in 2018

Domestic risks: Uncertainty of economic policy

GDP response to the current economic policy uncertainty shocks

(% YoY, deviation from baseline scenario)



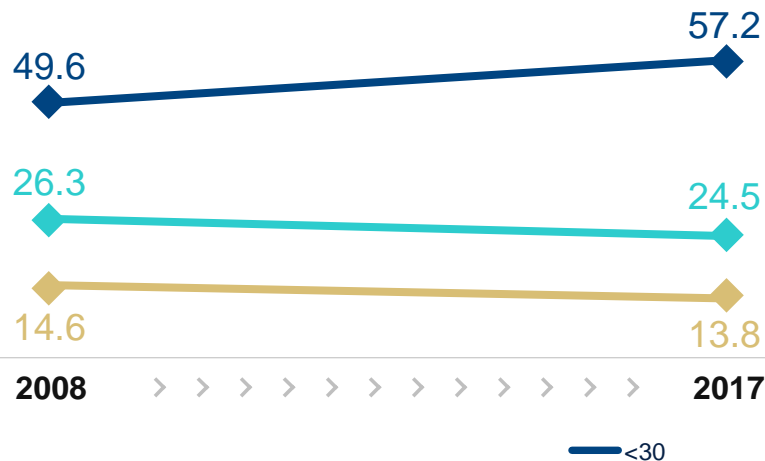
Source: BBVA Research

Uncertainty, although still high, has decreased, as was expected in November. Its impact has also been in line with the estimates by BBVA Research

Challenges: Progressing towards a more inclusive labour market

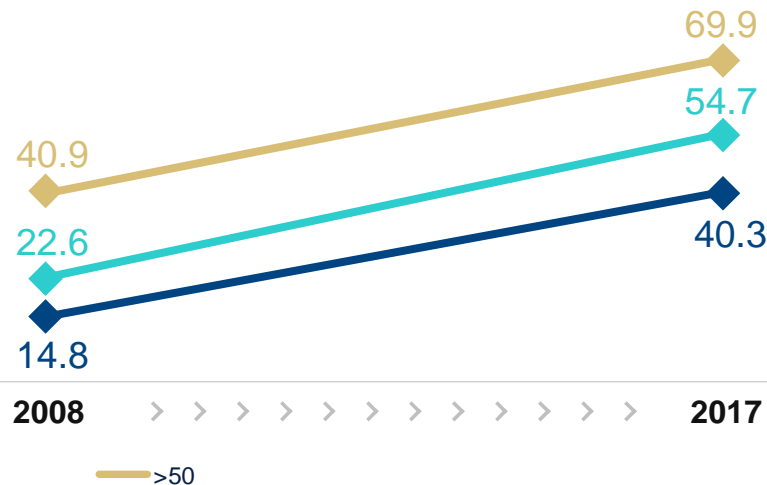
Temporary employment rate by age group

(% of employees)



Incidence of long-term unemployment by age group

(Unemployed for at least 12 months/total unemployed, %)



Source: BBVA Research based on INE

The flexibility of the Spanish labour market increased after the reforms adopted since 2012, but the degree of job security has not improved significantly. Younger workers and older workers have benefited the least from the recovery



03

Forecasts

Changes in our forecasts

The fundamentals continue to support a relatively strong recovery

% YoY	2017	2018 (f)	2019 (f)
National Final Consumption Expenditure	2.2	2.1	2.0
Private consumption	2.4	2.2	2.0
Public consumption	1.6	1.7	1.9
Gross Fixed Capital Formation	5.0	4.8	5.4
Equipment and Machinery	6.2	5.2	5.3
Construction	4.6	4.7	5.4
Housing	8.3	6.1	5.6
Other Buildings and Structures	1.5	3.4	5.2
Domestic demand (*)	2.8	2.6	2.6
Exports	5.0	4.8	6.1
Exports of goods	5.0	5.4	6.4
Exports of services	5.1	3.6	5.3
Services other than tourism	2.8	3.8	6.8
Final consumption of non-residents in Spain	8.5	3.4	3.1
Imports	4.7	4.2	6.9
External demand (*)	0.3	0.3	-0.1
Real GDP at market prices	3.1	2.9	2.5

(*) Contributions to GDP growth

(f) Forecast

Source: BBVA Research based on INE and Bank of Spain

2018-2019: Inflation and labour market forecasts



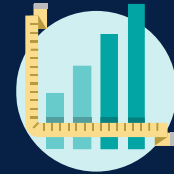
Inflation

2018	2019
1.5%	1.6%



Growth in employment (Labour Force Survey)

2018	2019
2.6%	2.3%



Unemployment rate

2018	2019
15.3%	13.7%

Key messages

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- In Spain, recent data confirms the upward biases noted three months ago. Exports and investment are picking up, while consumption is easing off
- The uncertainty in Catalonia is high, but has waned, and its impact is in line with what was expected: temporary (4Q17), confined to the region and with effects on specific sectors (tourism)
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Spain Economic Outlook 2Q18

April 2018

Creating Opportunities

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Spain Economic Outlook 2Q18 (Annex)

April 2018

Creating Opportunities

European demand, favourable

Spain: Effect on GDP of the EMU demand shock

(Deviation compared to baseline scenario in pp)

2018

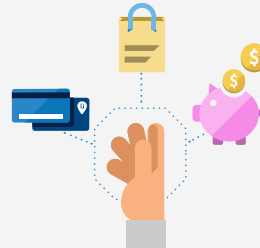
0.2

Exports



0.1

Domestic demand



0.1

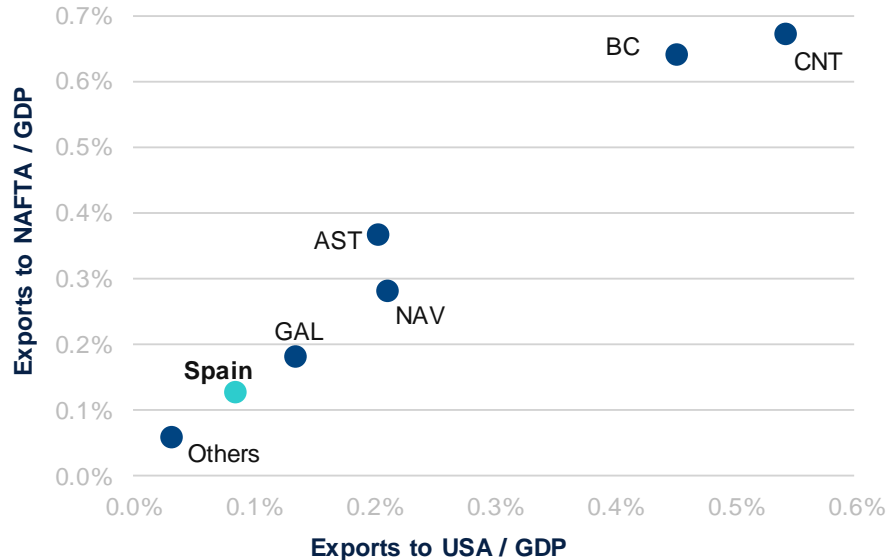
GDP



External risk: The greatest impact could come from the indirect channel

Autonomous Regions Exports of steel, aluminium and their manufactures

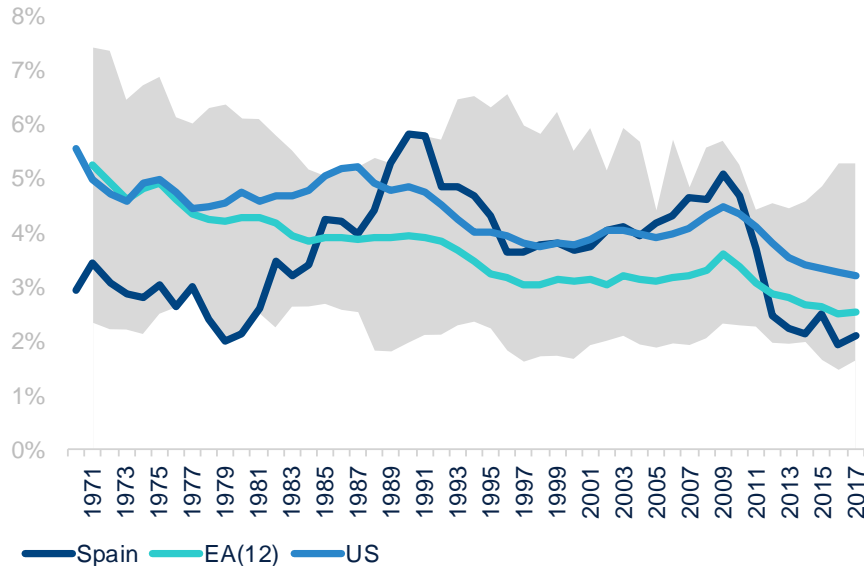
(% Regional GDP)



- If US tariffs were applied on steel, aluminium and their manufactures, they would not have a significant direct impact on Spanish exports
- In 2017, the USA imported those goods from Spain to a percentage equivalent to 0.1% of Spanish GDP
- The shock is asymmetric in regional terms, with a greater effect on the Basque Country and Cantabria (0.5% of the regional GDP)

A more efficient consolidation effort is needed

Government investment (% of GDP)



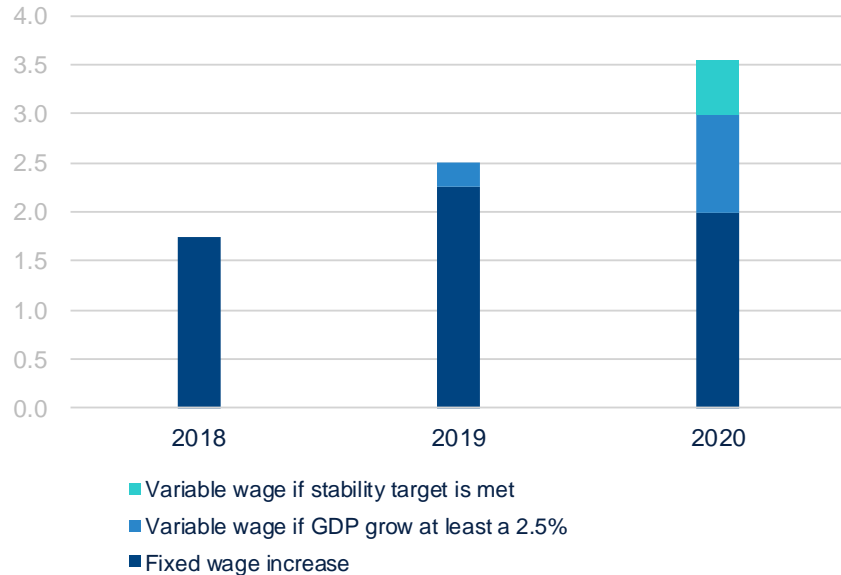
- Part of the reduction of the public deficit was made at the **cost of lower investment**
- Beyond the cyclical situation, this **trend is also present in other developed economies** as a result of:
 - Decreasing returns to scale
 - Changes in the types of investment
 - Lower private investment
 - Lower productivity (absence of reforms)
- **Competitiveness could be adversely affected.** Institutions that allow efficient use of scarce resources are needed

(*) Developed economies: Belgium, Denmark, Germany, Ireland, Greece, Spain, France, Italy, Netherlands, Austria, Portugal, Finland, Sweden, United Kingdom, Norway, USA and Japan

Source: BBVA Research based on Eurostat

Impact of the agreement on public sector salaries on the private sector

Salary growth agreed in the public sector (2018-2020, %)

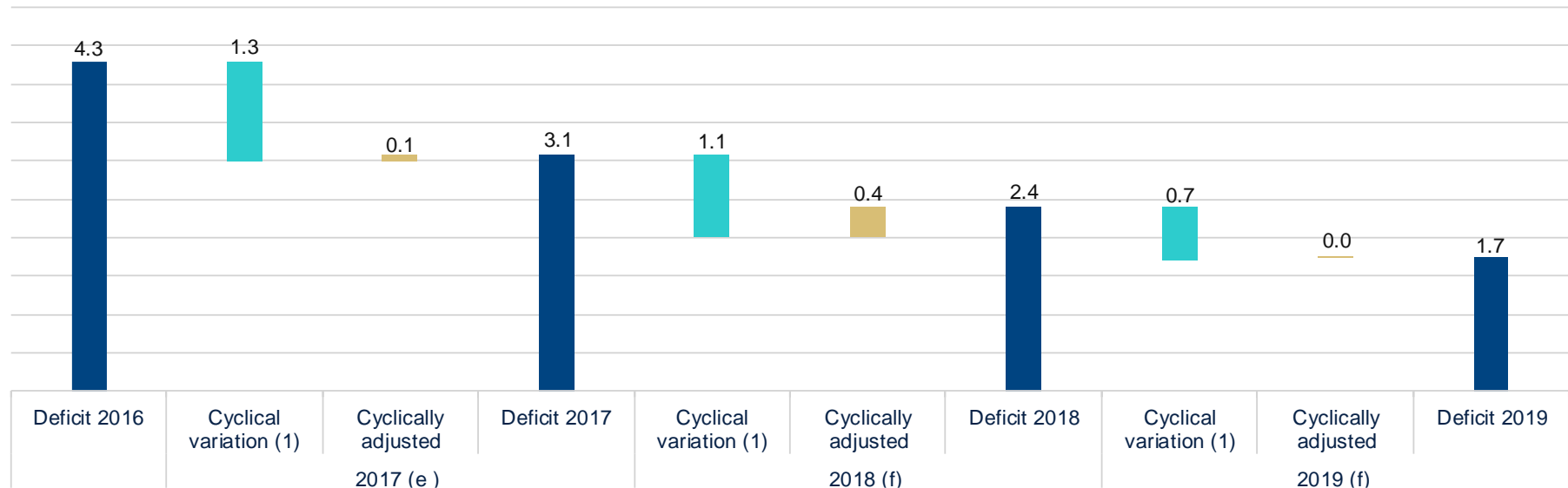


- It is likely that the salary growth agreed between the Government and the trade unions regarding public service for the 2018-2020 triennium will not have a significant impact on the remuneration of private sector workers
- The empirical evidence shows that in the vast majority of developed economies the knock-on effect of public sector salaries is limited, compared to that of the private sector...
- ...and will be even more so due to the effects of globalisation, the lower degree of unionisation and the down-scaling of the public sector

The budgetary objectives would be achievable with a greater cost containment effort

Spain: Net borrowing and fiscal adjustment*

(% of GDP)



(*) Excluding assistance to the financial sector

(1) Includes changes in interest charges

(a) Advance (f) Forecast

Source: BBVA Research based on Ministry of Finance and Public Administration and INE figures

The budget targets are achievable

Public administrations: net borrowing, excluding assistance to the financial sector

(2018-2020, %)

% of GDP	2016	2017 (a)	2018 (f)	2019 (f)
Employee pay	10.8	10.6	10.5	10.4
Intermediate consumption	5.1	5.0	4.9	4.9
Interest	2.8	2.6	2.4	2.3
Unemployment benefit	1.7	1.5	1.3	1.2
Pensions	10.9	10.7	10.6	10.5
Other welfare benefits	3.0	3.1	3.0	3.0
Gross capital formation	2.0	2.1	2.3	2.4
Other expenditure	5.7	5.5	5.5	5.5
Non-financial expenditure	42.0	41.0	40.6	40.2
Taxes on production	11.6	11.6	11.8	11.8
Taxes on income, wealth, etc.	9.9	10.2	10.4	10.5
Social security contributions	12.2	12.3	12.3	12.3
Taxes on capital	0.6	0.5	0.5	0.5
Other revenue	3.5	3.3	3.3	3.3
Non-financial revenue	37.7	37.9	38.2	38.5
Net borrowing	-4.3	-3.1	-2.4	-1.7
Stability target	-4.2	-3.1	-2.2	-1.3

(a) Advance (f) Forecast

Source: BBVA Research based on MINHAP data