

The logo for BBVA Research, featuring the word "BBVA" in a bold, white, sans-serif font, followed by the word "Research" in a smaller, lighter weight of the same font. A small teal square is positioned to the right of the word "Research".

BBVA Research

Spain

Economic Outlook

3Q18

July 2018

Creating Opportunities

Key messages

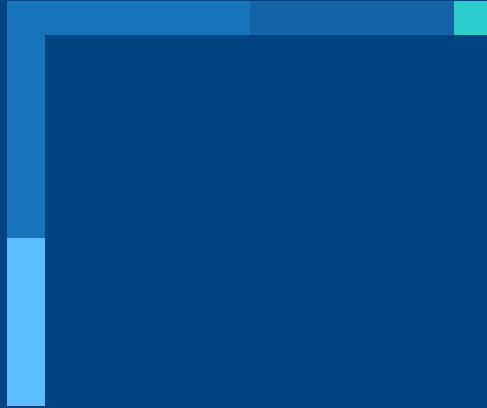
- Global recovery continues, with signs of moderation and differences among large areas. Risks related to political uncertainty, vulnerabilities in emerging economies, with a small deceleration in China, and trade protectionism
- In Spain, growth remains stable, but with a less virtuous composition: exports of goods and investment in M&E are adversely affected by headwinds, but consumption keeps growing and investment in construction accelerates
- The expansive tone of monetary and fiscal policy counteracts the rising price of oil, the slowdown in the EMU, the depletion of certain sectors or the negative impact of economic policy uncertainty
- GDP growth forecasts are maintained (2.9% and 2.5% in 2018 and 2019). At the same time, more risks are perceived, with higher probability of occurrence, which urges a more ambitious reform agenda

Contents

01 Global Economic Outlook

02 Spain Economic Outlook

03 Annexes



01

Global Economic Outlook

Global growth remains but risks intensify

01



The global expansion remains at a steady pace, but less synchronized
Growth is strong in the US due to fiscal stimulus, and stable in China, but it is slowing in Europe

04



Monetary normalization at different speed in the Fed and the ECB.

Strengthening the dollar and tightening global financial conditions

02



Increasing protectionism

The impact on growth is limited at the moment, but it may be larger if the announced measures were implemented and / or spread through confidence or the financial markets

05



More volatility in emerging markets

Higher financial tensions due to the increase in financing costs and protectionist threats

03



Higher oil prices

Upward pressure on inflation and a brake on growth in crude importing countries

06



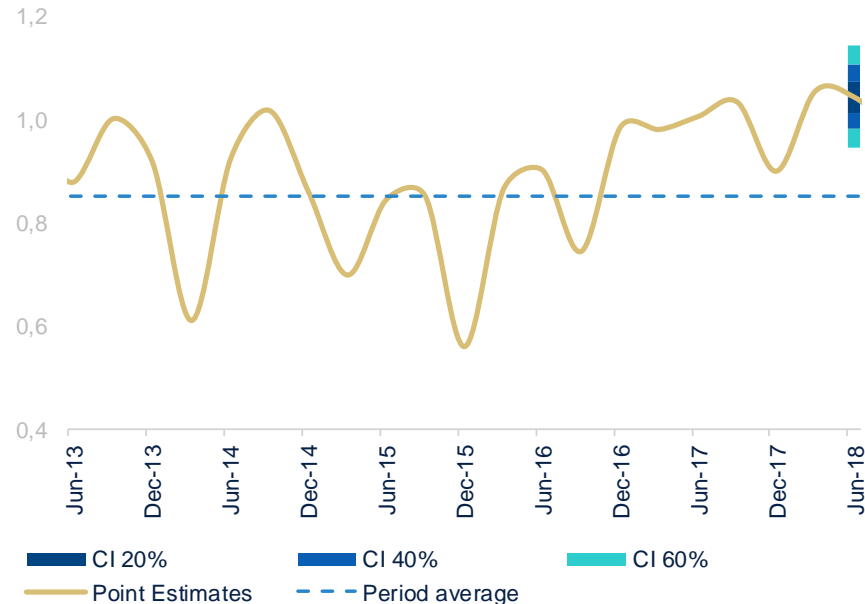
Global risks intensify

The possibility of a trade war comes together with greater risks in emerging economies and in Europe

Robust global economy despite growing uncertainty

World GDP growth

(Forecasts based on BBVA-GAIN, % QoQ)

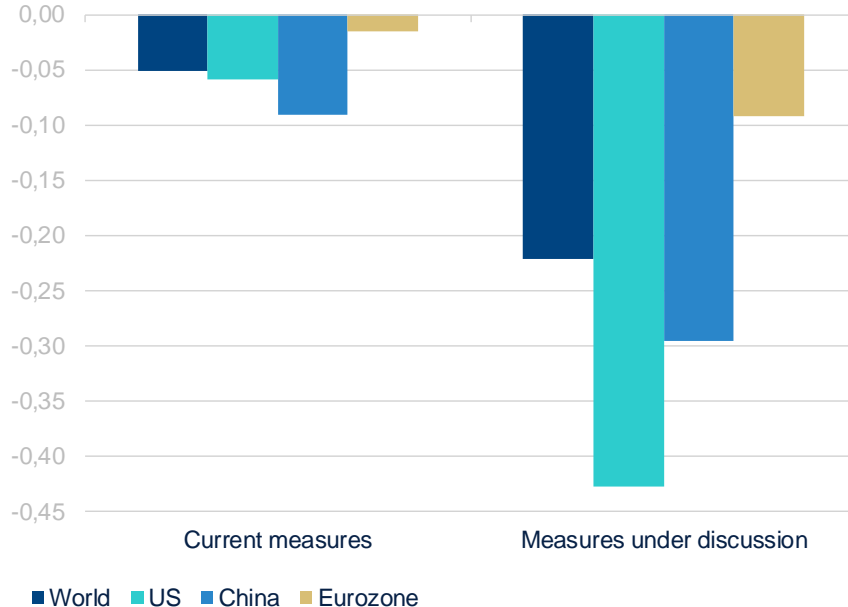


- Global growth continues, supported by private consumption and investment, but with growing differences among regions
- World trade continues to show a positive trend, although it loses momentum, and still does not reflect the protectionist escalation
- Confidence indicators show some moderation, but remain at high levels

Limited effect of approved tariff increases, but significant if those discussed are implemented

Effect on GDP growth of higher US tariffs and retaliation from affected countries

(2018-19, pp)



Measures announced: tariffs increase to 25% for steel, 10% for aluminum and 25% to Chinese imports for USD50mM

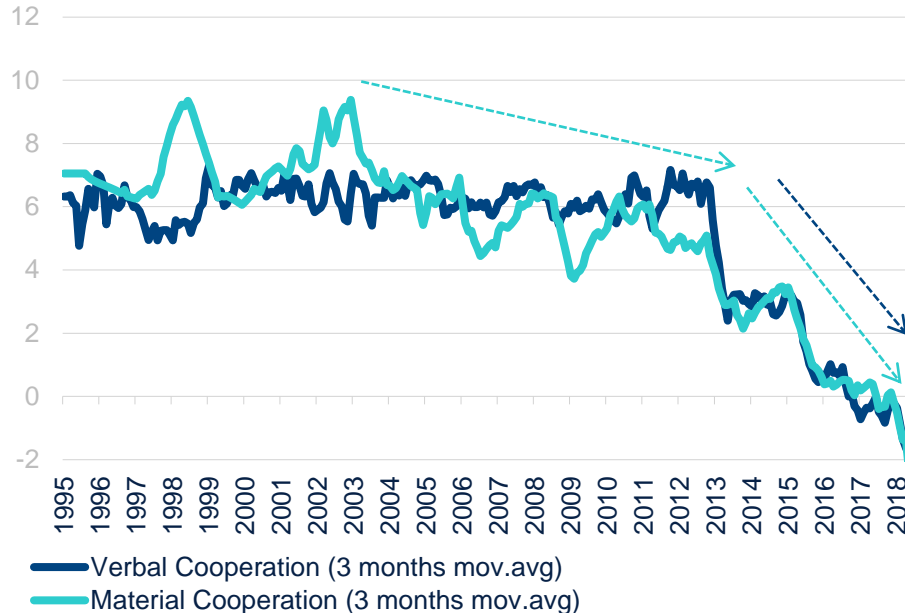
Measures under discussion: Tariffs increase up to 20% for Chinese cars and imports worth USD200mM.

Source: BBVA Research

- The tariffs increase approved by the US would have a reduced direct impact. The indirect effects, via economic confidence and financial channel, could emerge in 2S18
- If protectionism escalated, the negative effect on growth would also be significant in the US
- The effect, lower in Europe, would differ by country, and would affect mainly Germany and the Eastern countries
- Global GDP growth could be reduced around 0,2pp due to the trade channel

The trade material cooperation index as an early warning signal of the global trade slowdown

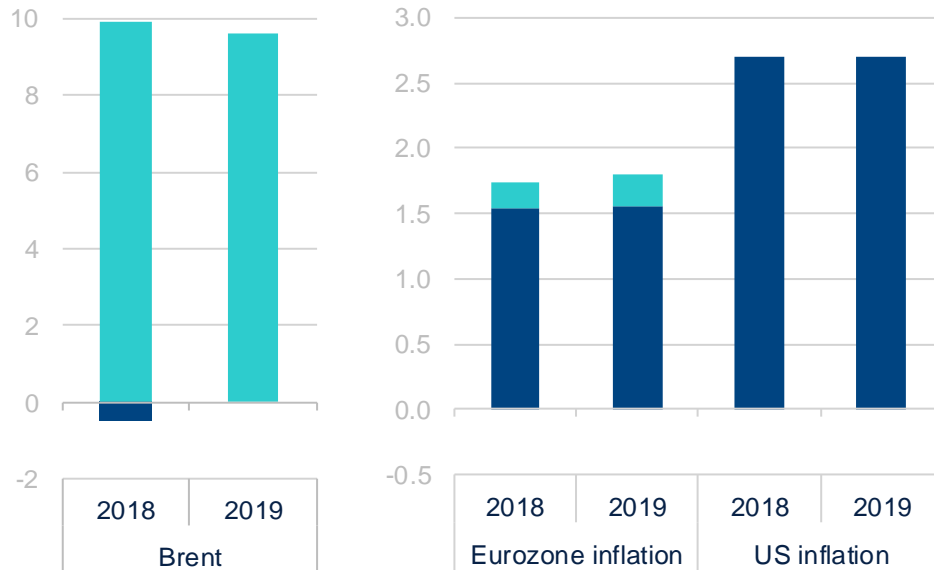
BBVA Research Trade Support Sentiment Index



- The BBVA Research material cooperation index shows since 2002 some early warning signals of global trade stagnation
- International Trade has maintained historically a positive tone or sentiment on the media. However, nowadays sentiment turns to negative
- The trade support material cooperation sentiment index started to deteriorate gradually since 2003 and accelerated its drop in 2012

The rise in the price of oil will push inflation upward and could weigh on growth

Upward revision of Brent prices and inflation (%)



- The price increase responds to a supply drop, and it will remain relatively stable in 2018 and 2019
- Higher inflation in the euro zone, but below the target, whereas core inflation will gradually increase from very low levels
- In the US the impact will be lower, but inflation will remain above the target in 2018-19
- The exit strategy of the Fed and the ECB is reinforced

The Fed and the ECB return to conventional monetary policy at different pace



Balance

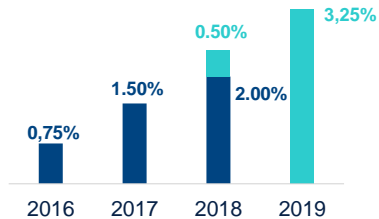


Interest rates



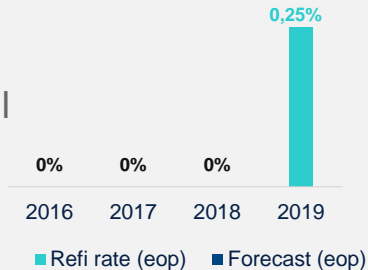
■ A USD450bn cut in 2018

■ Rate hikes accelerate in 2018



■ Gradual end of the QE between September and December 2018

■ Rate hikes delayed until September 2019



The strength of the dollar and higher interest rates lead to an adjustment in emerging markets

EURUSD and BBVA index of financial stress in emerging markets

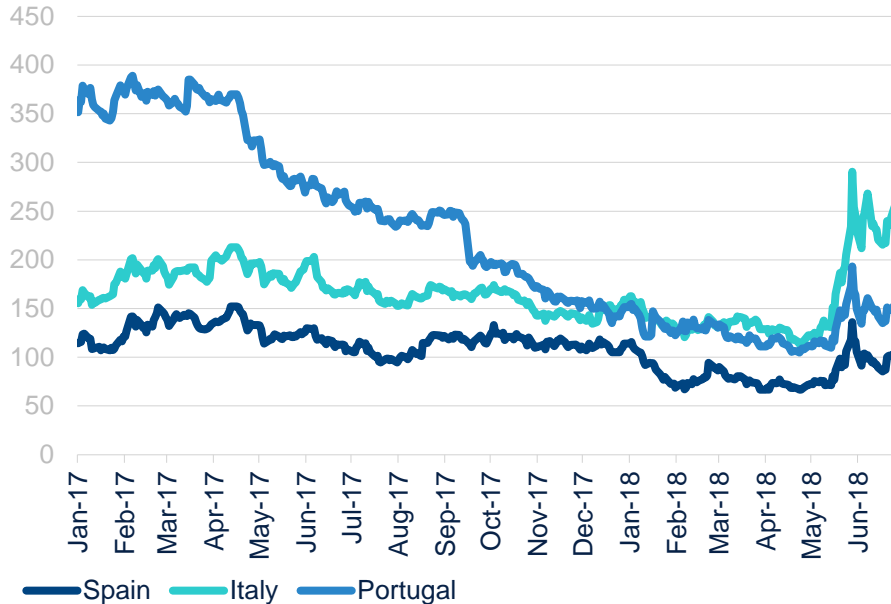


- The most vulnerable countries are those with the largest trade deficit and the largest external financing needs
- Turning towards a tightening of monetary policy in emerging countries (except China) to avoid further depreciation of their currencies
- The increase in financial tensions also reflects the intensification of the trade dispute

Political uncertainty in Italy and Germany weakens the euro and widens peripheral risk premiums

Risk premium in Italy, Spain and Portugal

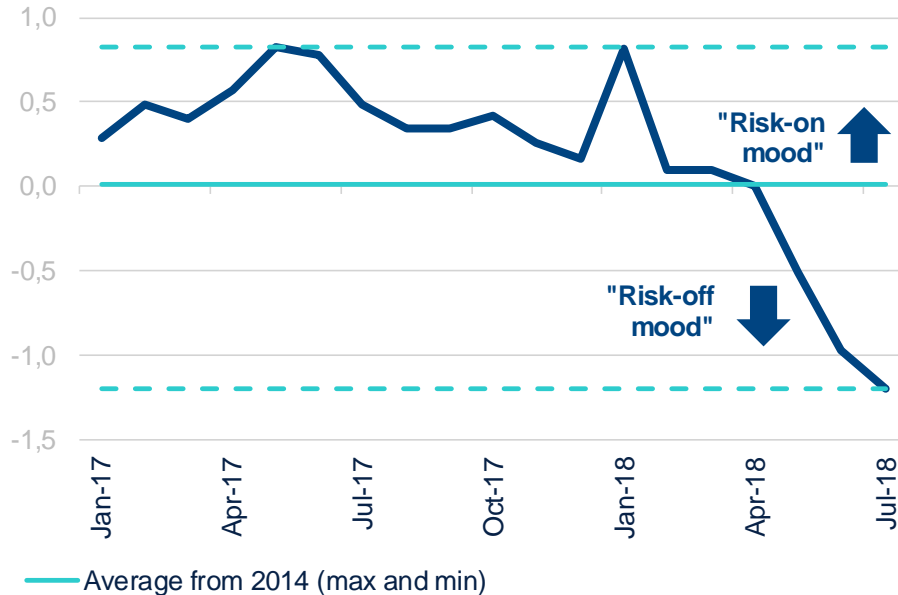
(bp)



- The reappearance of risks in the periphery is linked mainly to political uncertainty in Italy, with negative effects on European integration
- Although Italian risk premium was significantly increased, the contagion to the rest of the countries in the periphery was moderate...
- ...which did not prevent a refuge effect on German and US bonds and a strong depreciation of the euro

Protectionism and political factors lead to a growing aversion to risk

Index of risk-on/risk-off mood*
(normalized data)

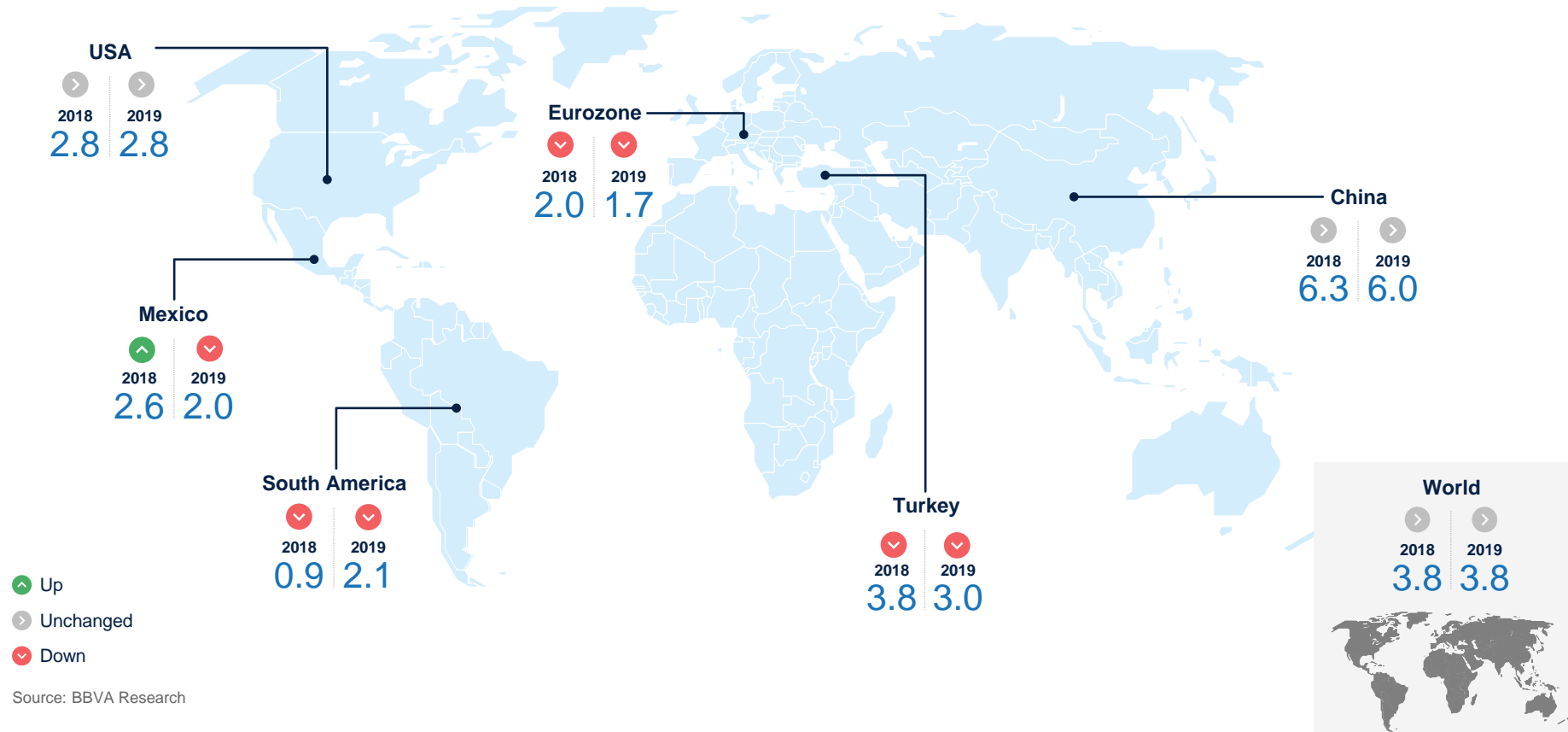


Note: * Institutional investors decrease / increase flows to safe haven funds above average. And retailers increase / reduce flows to Emerging funds above average

Source: BBVA Research

- Investor sentiment has gone from a regime of risk taking (even a certain complacency) to one of risk aversion
- The change is causing a rotation of flows between assets: from emerging to developed markets, and from equities to fixed income
- Trade tensions can lead to an environment of flight towards quality

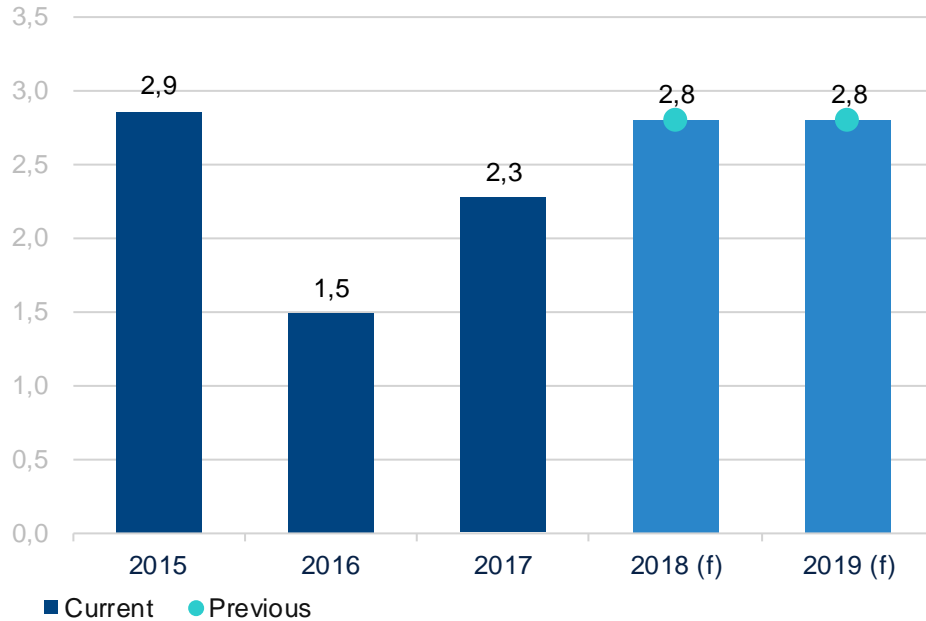
Steady growth in the US, but slowdown in other areas



US: Growth supported by fiscal stimulus, but entering the final stage of expansion

US: GDP growth forecast

(% YoY)

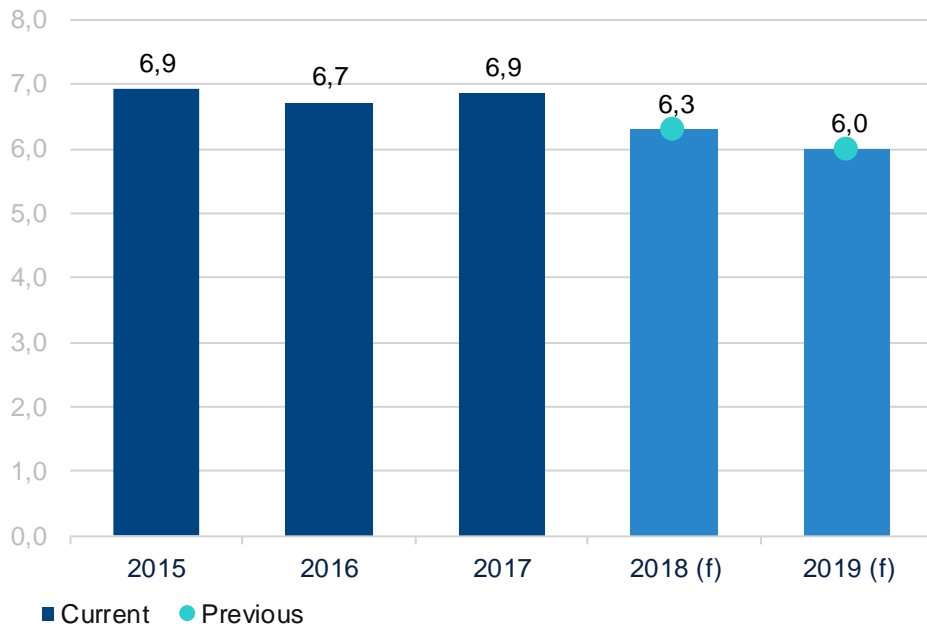


(f) Forecast.
Source: BBVA Research based on BEA

- Growth has accelerated in the first half of the year, favored by fiscal stimulus and the improvement of the labour market
- Commercial tensions could affect production and global demand
- The absorption of the idle capacity of the economy anticipates the end of the expansive phase of the cycle
- Inflation will temporarily exceed the Fed's target due to higher energy prices, but inflation expectations will remain anchored

China: Mild moderation in growth thanks to more stimulus

China: GDP growth forecast (% YoY)



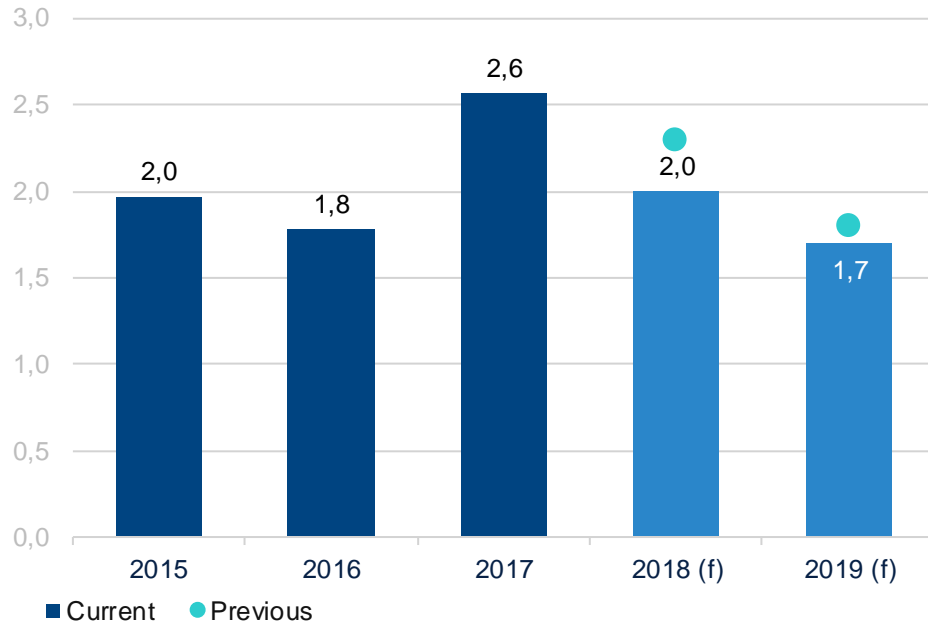
(f) Forecast.
Source: BBVA Research based on CEIC

- Growth moderation will continue in the second half of the year, although incoming data is somewhat more positive than expected
- Policies continue to tackle financial vulnerabilities, but smoothed by **fiscal and monetary stimulus measures** to sustain growth
- **Protectionism** threatens the sustainability of **exports**, as well as the **restructuring of the economy**

Eurozone: Rapid transition towards more moderate growth rates but above its potential

Eurozone: GDP growth forecast

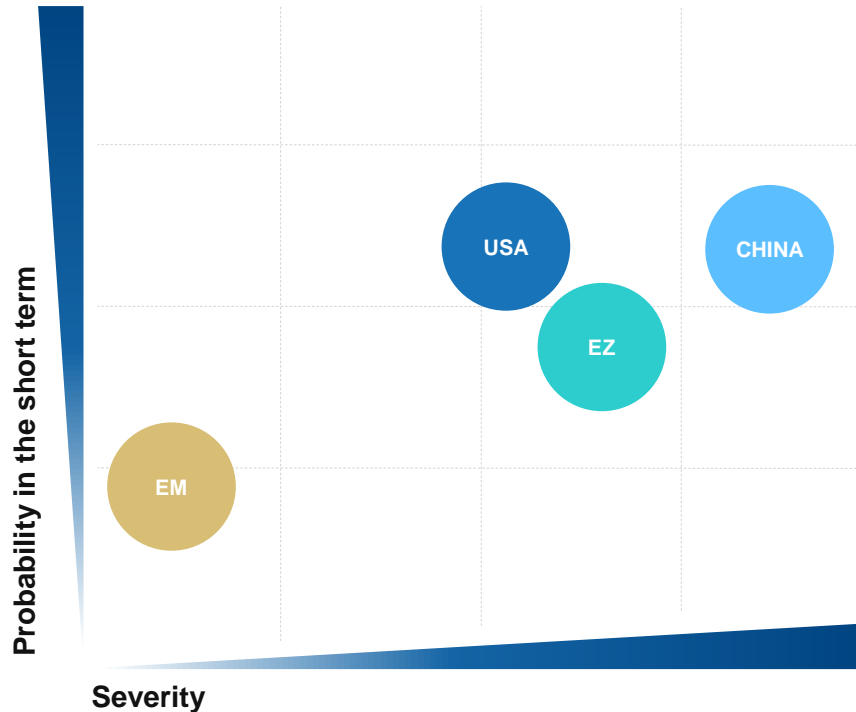
(% YoY)



(f) Forecast.
Source: BBVA Research based on Eurostat

- The increase in uncertainty and higher oil prices are weighing on activity, but domestic demand remains strong
- The depreciation of the euro and the global demand will continue to support exports
- Economic policies will be more accommodative: lower rates for longer and more fiscal loosening in some countries
- Despite the rebound of inflation in the short term, the core inflation will only increase gradually, especially in 2019

Global risks: The most important one is the trade war, but also those associated with emerging economies and Europe



CHINA

- **High indebtedness:** more content but still high
- **Protectionism:** upward (retaliation) with possible impact on domestic policies (financial stability, reforms)

USA

- **Protectionism:** upward
- **Fed exit:** high. Aggressive rate hikes in the face of a temporary increase in inflation
- **Signs of overvaluation** in some financial assets

EUROZONE

- **Political uncertainty:** upwards, led by Italy. Brexit: risk of a sudden departure
- **Protectionism:** upward with focus on the automotive sector
- **ECB's exit:** downward (delay of rate hikes)

EMERGING ECONOMIES

- Upward. Global risks and domestic vulnerabilities in some countries raise the risk of a systemic crisis



02

Spain Economic Outlook

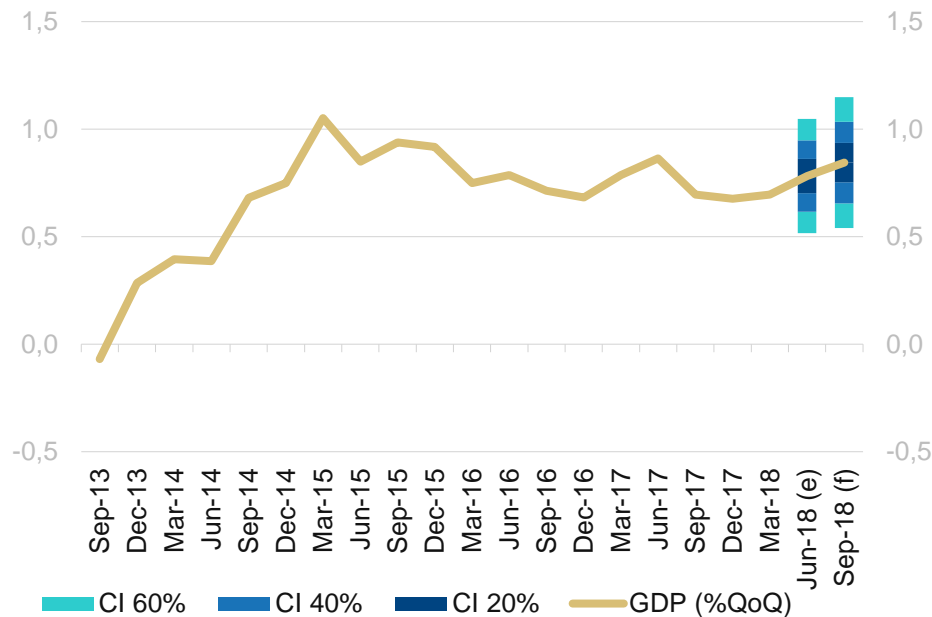
GDP forecasts: Unchanged



GDP growth remains strong, with no signs of a slowdown

Spain: GDP growth observed and forecasted using MICA-BBVA model

(% QoQ)



CI: confidence interval; (e) Estimation; (f) Forecast.

Source: BBVA Research based on national sources

- Recent economic data (employment, private and public consumption) point out to a solid growth (0.8% Q/Q) in 2Q18 and 3Q18
- The economy grows around the average observed since the beginning of the recovery
- If these trends were confirmed, there would be a decoupling with respect to the European economies (0.4% t/t on average)

A less virtuous composition of demand in 1S18

Spain: Demand components average growth rate

(% QoQ)

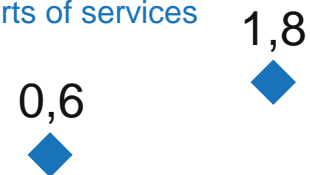
Private consumption



Exports of goods



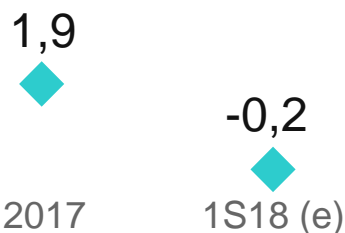
Exports of services



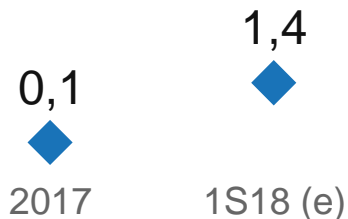
Residential investment



Investment in M&E



Investment in other constructions



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

Consumption remains stable in the short run. Investment leans towards construction while exports to services, highlighting tourism

Private consumption remains dynamic

Profile of households that take on consumer debt*

2017

- Male
- Between 30 and 50 years
- Spanish
- Cohabit
- Resident in the Mediterranean Coast
- Employed

- Household spending has shown great strength. The increase of the demand and supply of credit explains part of the consumption upturn
- The profile of the household that finances its consumption is headed by a man, between 30 and 50 years old, Spanish, who lives as a couple, employed and resident on the Mediterranean coast

* For more information, see, Situación Consumo 1S18 available here: <https://www.bbvaresearch.com/publicaciones/situacion-consumo-primer-semester-2018>
Source: BBVA Research from BBVA Consumer Finance data

Private consumption remains dynamic

Profile of households that take on consumer debt*

2017

- Male
- Between 30 and 50 years
- Spanish
- Cohabit
- Resident in the Mediterranean Coast
- Employed

Variation 2015-2017

- Female
- Younger than 30, older than 60 years old
- Foreigner
- Cohabit
- Resident in the Center and South of Spain
- Employed or retired

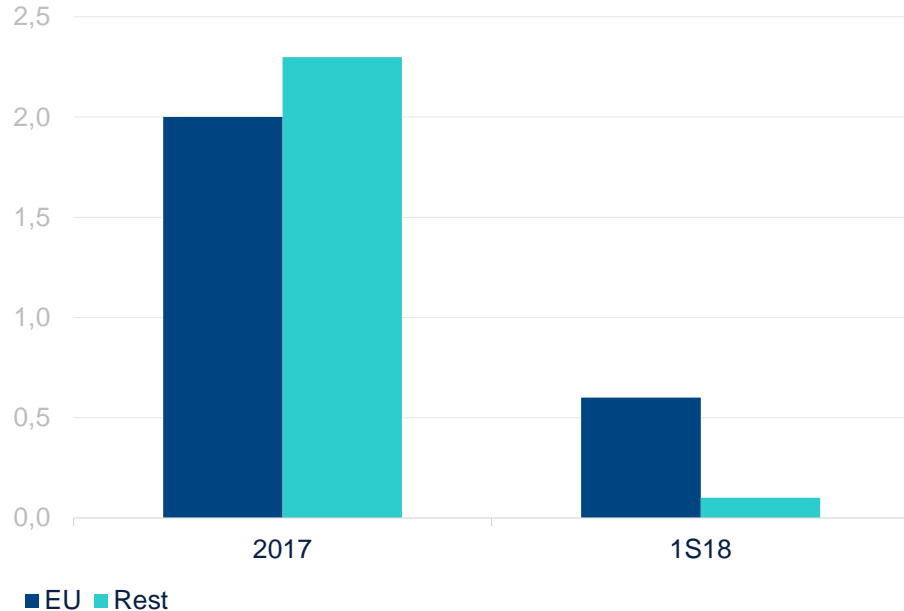
- Credit growth is higher for:
 - women
 - those under 30 and over 60
 - foreigners
 - those who live as a couple,
 - those employed and retired
 - residents in the center and south of the peninsula

* For more information, see, Situación Consumo 1S18 available here: <https://www.bbvarsearch.com/publicaciones/situacion-consumo-primer-semestre-2018/>
Source: BBVA Research from BBVA Consumer Finance data

What's behind the slowdown in the exports of goods?

Spain: Average growth of nominal exports of goods by destination

(% QoQ, average growth rate)



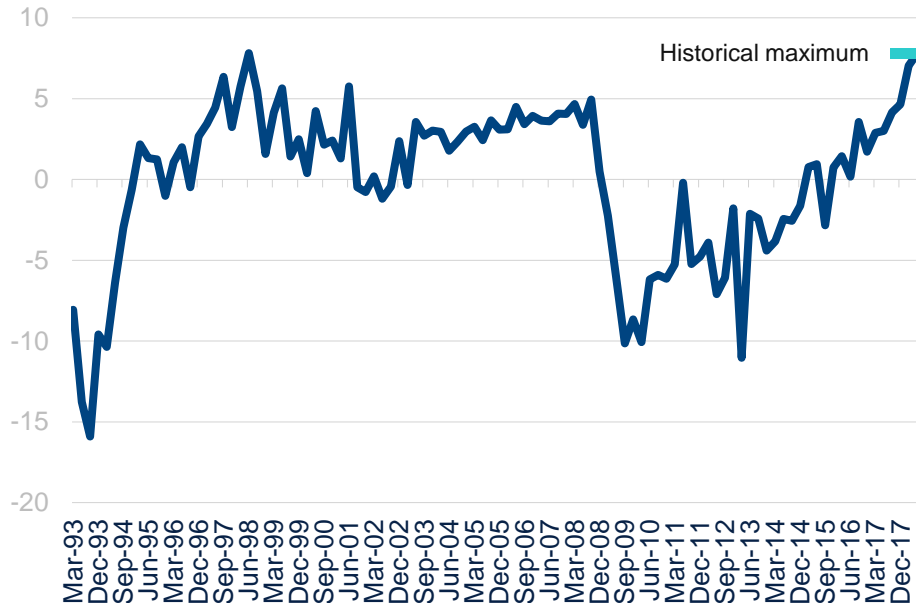
Source: BBVA Research, based on Ministry of Economy

- The weakening of the growth of exports of goods in 1S18 is a general phenomenon by destination and type of good
- Determinants of the loss of traction of exports: appreciation of the exchange rate, deceleration in Europe, rising oil prices and supply constraints

Weak investment in machinery and equipment is temporary

Spain: Capacity utilization in M&E

(Deviation from the historical average in pp)



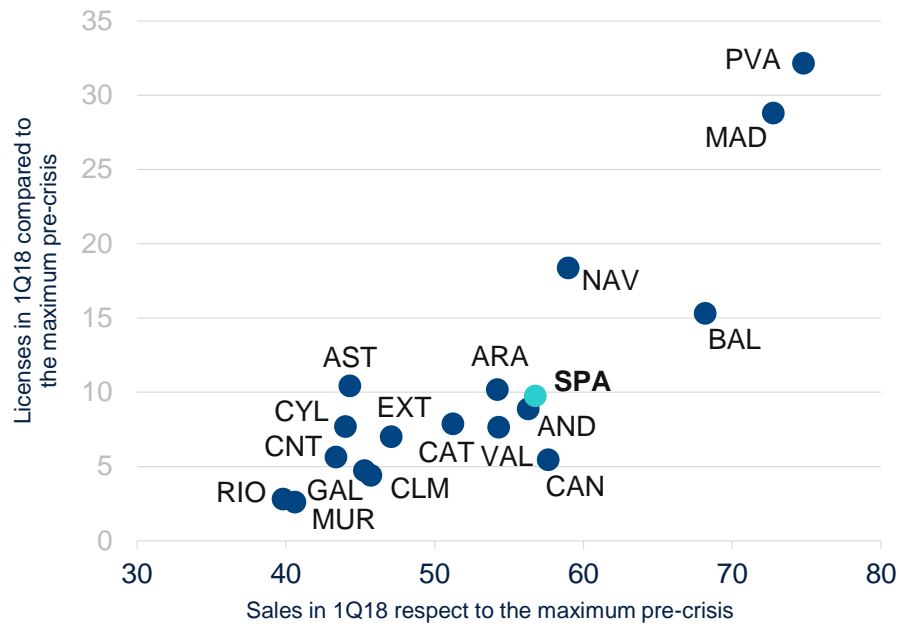
Source: BBVA Research based on ECI

- The fundamentals will continue to support the growth of investment in M&E, especially the low cost of financing, the evolution of exports and the reforms implemented
- The high use of the productive capacity allows to advance a rebound in sectors such as the production of M&E to meet the demand

Real estate market shows a great deal of heterogeneity

Spain and regions: Housing sales and licenses

(% Deviation from 1Q18 with respect to the maximum pre-crisis)






- The recovery in construction is accelerating, although at an uneven pace between regions.
- In any case, all regions are still far from the maximum levels reached during the previous expansive cycle...
- ...especially when looking at the level of variables related to the offer, such as licenses

2018-2019: The tone of economic policy will be expansive

Spain: Impact of the downward revision of the euro exchange rate*

(Deviation from the base scenario levels in pp)

		2018		2019
 GDP	>	0.1	>	0.2
 Exports	>	0.7	>	1.1
 Nominal effective exchange rate	>	-0.9	>	-1.5



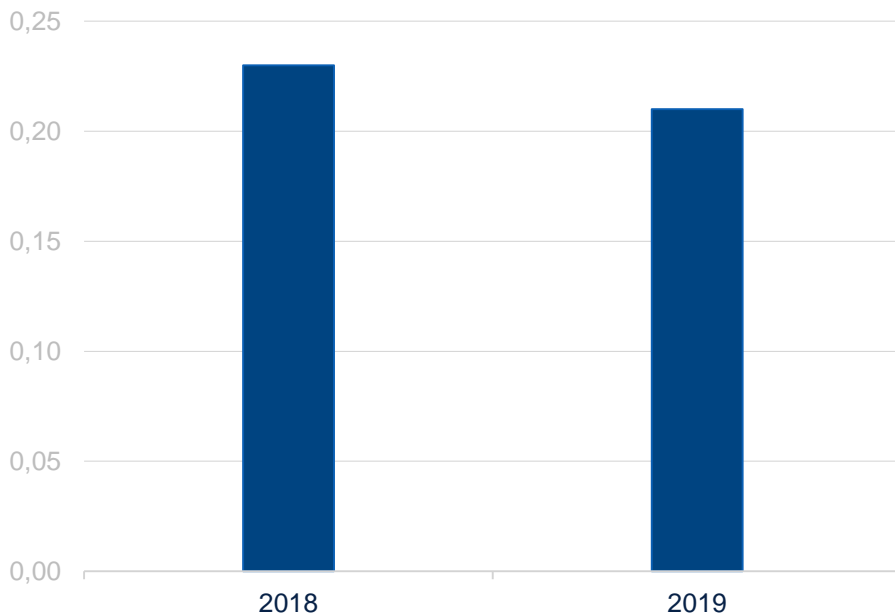
The delay in the increase of the interest rates, together with a more depreciated euro, would facilitate a greater growth of the exports during the next months

(*) The scenario of BBVA Research considers that the appreciation of the euro-dollar will be 2.5% lower than that previously estimated for 2018 (-4.5% in 2019).

2018-2019: The tone of economic policy will be expansive

Impact of the fiscal stimulus on the growth of private consumption

(pp)



Source: BBVA Research based on INE y GSB2018

- The GSB2018 includes a permanent fiscal impulse of 11 billion € in disposable income for 2018-2019 ...
- ... which will increase private consumption by 0.4 pp in the biennium
- Additionally, public investment is expected to increase, as a percentage of GDP, for the second consecutive year

2018-2019: The tail winds weaken in an environment of greater uncertainty



Global

01

Lower EMU Growth

Already included in the performance, worse than expected, of exports of goods during the first half of 2018

02

Higher oil prices

It is expected that most of the increase will reflect supply restrictions, which should generate a stronger negative impact

03

Protectionism

At the moment, the direct impact in Spain is insignificant, but it could reduce investment expectations



Idiosyncratic

04

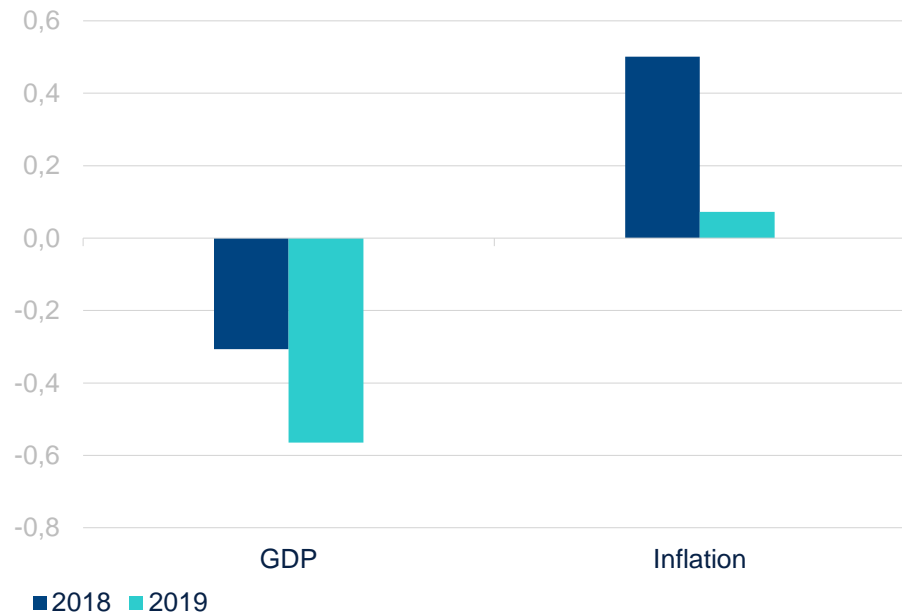
Change of government

The approval of the PGE 2018 reduces uncertainty about economic policy, but it remains high

2018-2019: Increased uncertainty, due to the impact of the increase in the price of oil

Spain: Responses to the change in oil price forecasts

(Percentage variation YoY)

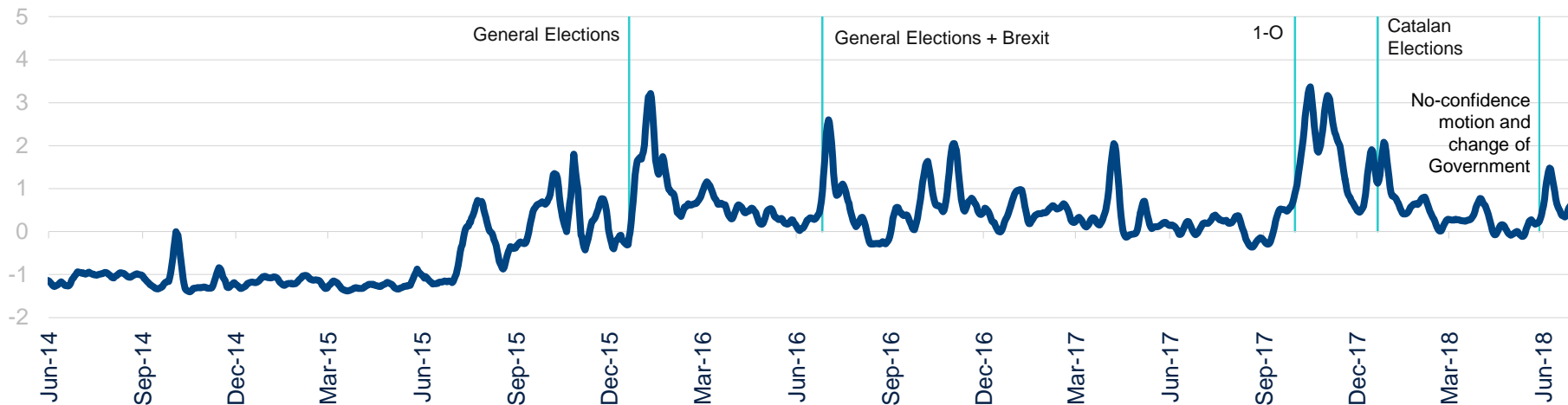


- It is assumed that 75% of the shock is related to supply constraints (OPEC, Iran, Venezuela, etc.). The rest is explained by increasing demand due to the continuation of strong global growth

2018-2019: Increased uncertainty, regarding economic policy

Economic Policy Uncertainty (EPU)

(Rolling weekly average, standard deviations)



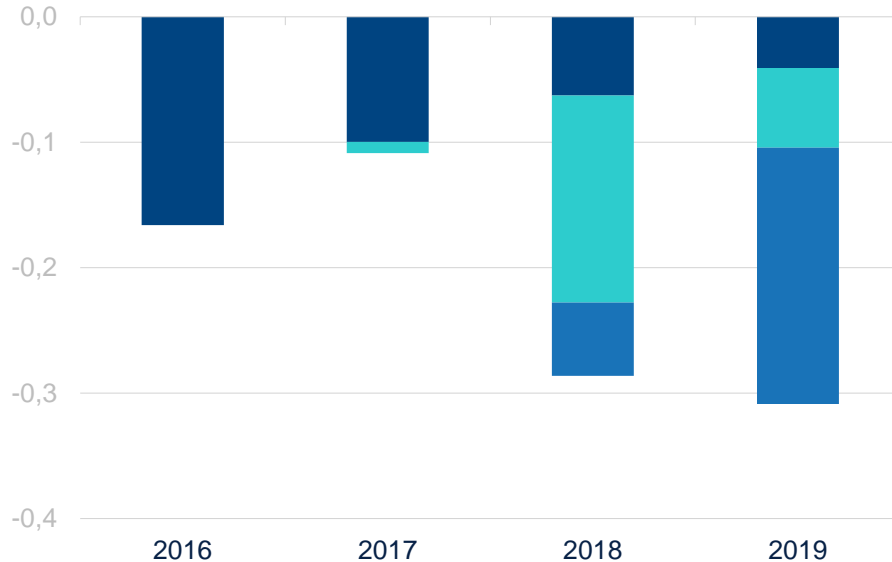
Source: BBVA Research using GDELT

Uncertainty went up in 2Q18. The approval of the PGE18 would have helped to moderate it, but doubts still remain about the measures that will be implemented in the future

2018-2019: Increased uncertainty, regarding economic policy

Spain: Responses to the increases in economic policy uncertainty

(% YoY, deviation from the baseline scenario)



■ Jan-16 to Oct-16 ■ Oct-17 to Apr-18 ■ From May-18

Source: BBVA Research

- The process of change of government resulted in an **increase in the uncertainty of economic policy**
- Although this **rebound is predictably temporary**, it adds to the uncertainty already existing in the Spanish economy
- The increase in uncertainty **can subtract between two and three tenths of the average annual growth** during the current biennium

2018-2019: Increased uncertainty, regarding economic policy

Spain: Tone of fiscal policy*

Procyclical	Neutral	Countercyclical
-	-	2008
-	-	2009
2010	-	-
2011	-	-
2012	-	-
2013	-	-
-	2014	-
2015	-	-
2016	-	-
-	2017	-
2018	-	-

* The tone of fiscal policy is understood as the role played by the discretionary measures of fiscal policy with respect to the economy

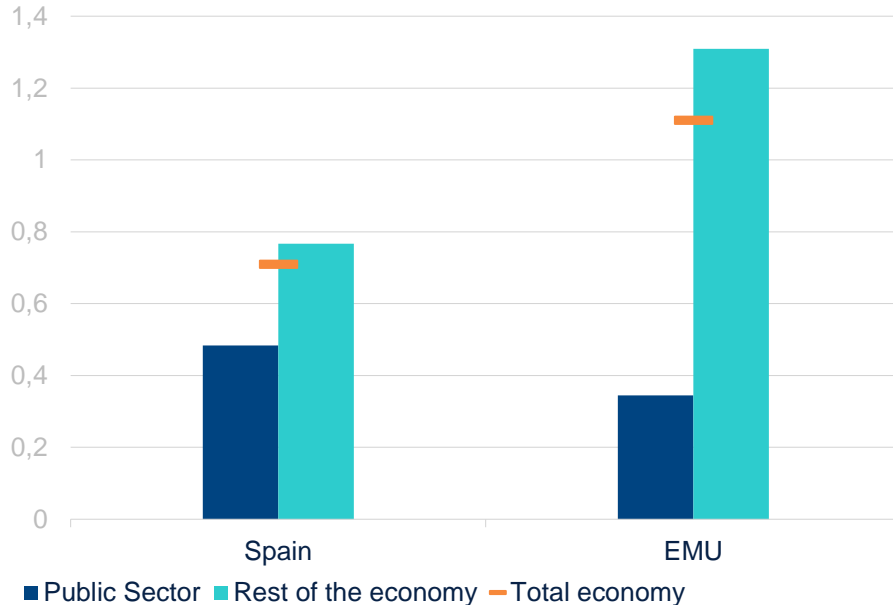
Source: BBVA Research based on MINHAP

- Fiscal policy in Spain will be **procyclical**, in line with what has happened during a good part of the past decade
- Moreover, the **risks associated with the electoral cycle** persist, which could lead to further increases in spending
- Although these measures would boost activity in the short term, **they increase the volatility of the economy and reduce the available space** that would be necessary in a less favorable environment

An ambitious reform agenda is needed that increases productivity, both in the public and private sectors

Spain and EMU: Apparent productivity growth of the labor factor by sector

(% YoY, annual average 1996-2017)



See: Observatory "Productivity and efficiency of the Spanish public sector"

<https://www.bbvarresearch.com/wp-content/uploads/2018/07/Observatorio-productividad-sector-publico-1.pdf>

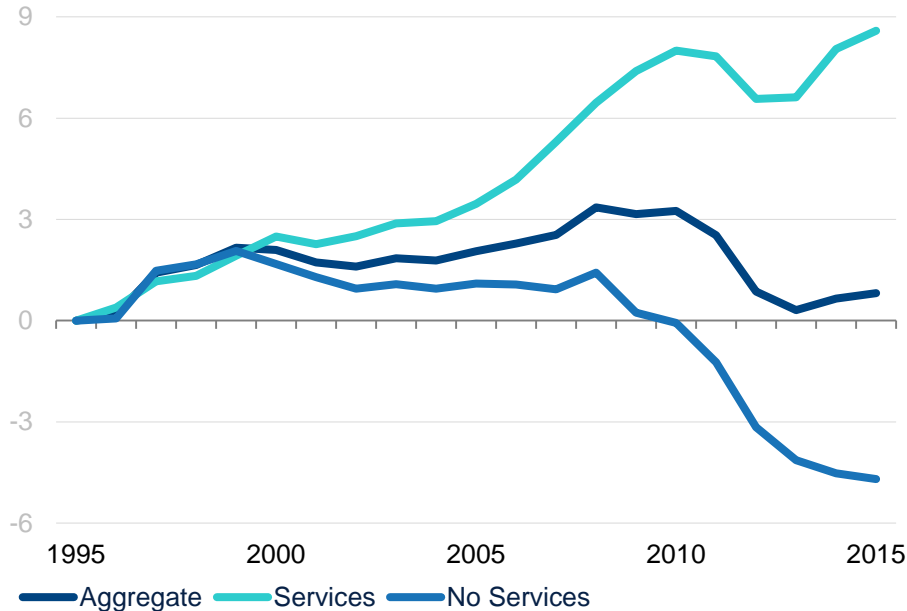
Source: BBVA Research based on INE and Eurostat

- The growth of total productivity in Spain was lower than in the EMU in the last 20 years
- The differential is explained by the lower progress of the private sector, while the public sector has experienced higher growth
- Despite this, Spanish public sector still has a wide margin for improvement
- The adoption of new technologies is key to increase the productivity and efficiency of the sector

An ambitious reform agenda is needed, allowing for inclusive growth

Spain: Wages share in income

(Percentage points, 1995=0)

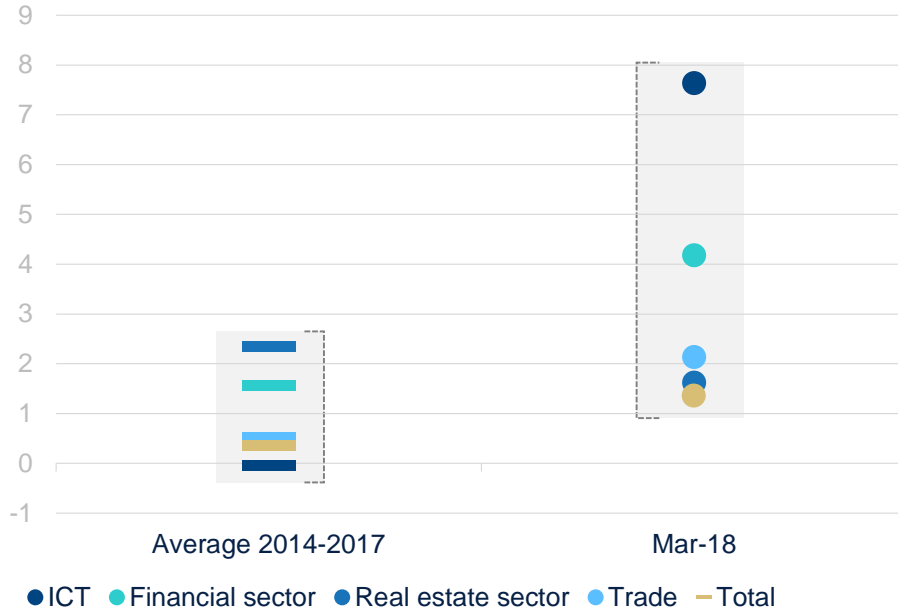


See Díez-Catalán, L (2018): "The Labor Share in the Service Economy," WP 18/09, BBVA Research.
<https://www.bbvarresearch.com/en/publicaciones/the-labor-share-in-the-service-economy/>
 Source: BBVA Research based on INE and Eurostat

- Divergence of the share of wages in income between services and the rest of the economy
- The long-term trend: the fall focuses on more capital-intensive sectors where technological progress has had a greater impact
- Not only observed in Spain: also in the US and in other large European countries

An ambitious reform agenda is needed, allowing for inclusive growth

Spain: Wage cost per worker (% YoY)



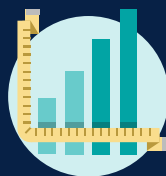
- ▲ Data point to a slight rebound in wage growth...
- ▲ ... but with greater heterogeneity than in the recent past, which possibly reflects differences between sectors, companies and some degree of decoupling between the demand and supply of human capital

2018-2019: Inflation and labor market forecasts



**Employment
growth (LFS)**

2018	2019
2.3%	2.3%



**Unemployment
rate**

2018	2019
15.2%	13.5%



Inflation

2018	2019
1.8%	1.7%

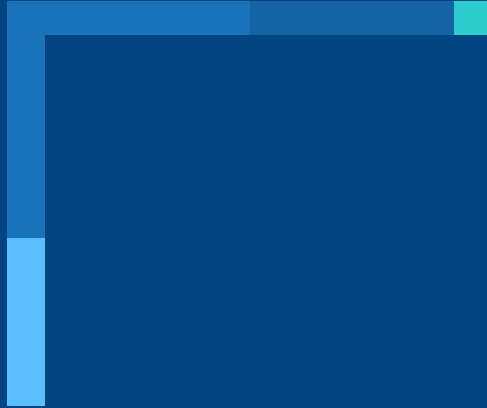


**Compensation
per employee**

2018	2019
1.0%	2.6%

Key messages

- **Global recovery continues, with signs of moderation and differences among large areas.** Risks related to political uncertainty, vulnerabilities in emerging economies, with a small deceleration in China, and trade protectionism
- **In Spain, growth remains stable, but with a less virtuous composition:** exports of goods and investment in M&E are adversely affected by headwinds, but consumption keeps growing and investment in construction accelerates
- **The expansive tone of monetary and fiscal policy** counteracts the rising price of oil, the slowdown in the EMU, the depletion of certain sectors or the negative impact of economic policy uncertainty
- **GDP growth forecasts are maintained (2.9% and 2.5% in 2018 and 2019).** At the same time, more risks are perceived, with higher probability of occurrence, which urges a more ambitious reform agenda



03

Forecasts

Changes in our forecasts

The fundamentals continue to support a relatively strong recovery

% YoY	2017	2018 (f)	2019 (f)
Final consumption expenditure	2.2	2.5	2.1
F.C.E. Households	2.4	2.6	2.1
General government	1.6	2.0	2.0
Gross fixed capital formation	5.0	4.3	5.6
Equipment and machinery	6.2	2.3	5.7
Construction	4.6	5.9	5.5
Housing	8.3	7.8	5.5
Other constructions	1.5	4.1	5.5
Domestic demand (*)	2.8	2.8	2.8
Exports	5.0	3.5	6.0
Exports of goods	5.0	3.0	6.5
Exports of services	5.1	4.7	4.7
Non-touristic services	2.8	5.2	6.0
F.C.E. by non-residents in the economic territory	8.5	4.0	3.0
Imports	4.7	3.7	7.1
External demand (*)	0.3	0.0	-0.2
GDP mp	3.1	2.9	2.5

(*) Contribution to GDP growth; (f) Forecast.
Source: BBVA Research based on INE and BdE



BBVA Research

Spain

Economic Outlook

3Q18

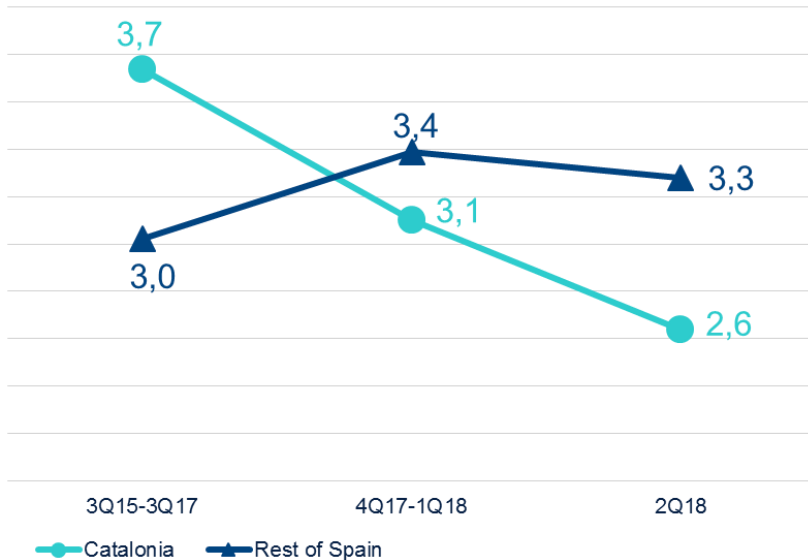
July 2018

Creating Opportunities

2018-2019: Increased uncertainty,... which particularly affects the Catalan economy

Social Security Affiliation

(annualized data, %, SWDA)



- **Political uncertainty** seems to keep having a negative impact on domestic demand (consumption and investment) in Catalonia. Moreover, after a rebound in 1Q18, tourism flows remain weak
- Adding to that is **the slowdown in the exports of goods**, particularly important for such an open economy, like Catalonia

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