BBVA Research

Spain Economic Outlook

1st Quarter 2019

Contents

Closing date: **1 February 2019**

1. Editorial

The recovery continued in the final part of 2018, allowing GDP to grow by 2.5% over the year as a whole, consolidating an environment of moderate growth. Although during the fourth quarter of the year, activity growth (0.7% QoQ) was slightly higher than forecast three months ago (0.6% QoQ), the Spanish economy has grown 0.5pp less than in 2017. The key factors accounting for this deceleration were the lower contribution made by external demand, the loss of momentum in private consumption and the increase in uncertainty, both at the global and national level. Thus, growth in sales of goods and services abroad moderated, affected by losses in competitiveness (oil, the exchange rate), by the reduction in the growth of European demand and by factors that had negative impacts on specific sectors (tourism, automotive industry). Furthermore, the growth in household expenditure has weakened as the pent up demand has been exhausted, and in line with the fall in the savings rate of households (as a proportion of their income), which has reached historically low levels. Finally, sustainable global growth looks more doubtful than it did a year ago, and the lack of consensus in Spain about economic policy, as a consequence of the high level of parliamentary fragmentation, continues to have a negative impact on activity.

Growth accelerated at the end of last year (0.7% QoQ), although this may be temporary. Exports of goods appear to have moved beyond the sluggishness seen during a good part of 2018 and have performed better in all geographical markets. This reflects that the slowdown in certain sectors affected by supply-side factors is temporary, and also shows the positive effects on competitiveness of greater investment in machinery and equipment. Tourism from abroad, meanwhile, did not materialize its recovery and uncertainty about the structural factors that are pushing it downward advises caution about the forecasts for the coming quarters. Finally, fiscal stimulus has continued to contribute to growth through public-sector demand, despite the deceleration in private-sector consumption that will continue, principally in household consumption.

Looking ahead, the recovery is expected to continue and job creation to remain steady, while wages may begin to rise consistently above the rate of inflation. Therefore, GDP could grow by 2.4% in 2019 and 2.0% in 2020. If this scenario is realised, the economy could create around 800 thousand jobs over the two-year period, with the unemployment rate falling from 15.3% in 2018 down to 12.6% by 2020. Furthermore, the extended recovery in the labour market could begin to put pressure on the compensation per employee, which will rise by an average of 1.9% and 2.2% a year in 2019 and 2020. In principle, this would take place in a context of deleveraging with the rest of the world, with which the economy will run a current account surplus of around 1% of GDP.

The viability of the macroeconomic scenario presented in this publication depends on the world's major economies experiencing a "soft landing", conditioned on the favourable resolution of a number of different risk factors, and on the support of central banks. In the last few months, doubts have grown about the sustainability of growth in some of the major economic areas. This is the result of the depletion of the fiscal stimulus in the US, tensions related to trade conflicts, the Chinese economy's slowdown and the recent correction in financial markets. Importantly, forecasts are expected to improve gradually as negotiations between the US and China start to produce results that leave tariffs between both the two economies unchanged. Similarly, the uncertainty around political issues in Europe should taper downwards. This is conditional on the United Kingdom leaving the European Union in an orderly fashion and on the tension between the Italian government and the rest of the European Monetary Union continuing to de-escalate. Finally, central banks are expected to respond to this less positive environment and, in consequence, to change their monetary policy strategy. This means that the interest rate hikes will stop at 3% in the USA, not reaching the levels forecast three months ago. The ECB, meanwhile, will not start to increase its benchmark rates until May 2020, six months later than previously anticipated.

Spain's growth will remain above its potential, thanks to the new stimulus coming from both the adjustment to the downside in oil prices and to an economic policy which is somewhat more expansionary than forecast a few months ago. The fall in fuel costs may be particularly positive for the export sector, which will gain competitiveness when transport costs fall. Moreover, the resulting improvement in households' disposable incomes is expected to support consumer spending over the next few months. Thus, given that the lower value of a barrel of crude will be the principal outcome of a rise in supply, the positive contribution to growth in Spain will be significant, reaching around 0.4pp on average per year. The expectation of low interest rates for a longer period, meanwhile, will intensify the expansionary tone of monetary policy. It is expected that in 2019 and 2020 the cost of long-term financing may be more than 50 and 25 bps lower, on average, than anticipated 3 months ago. Finally, some of the measures passed in the last six months by the Spanish government will continue to underpin growth in short-term domestic demand, although with costs in the long term. This is the case with the approved increases in public spending on salaries and pensions for 2019, included in the forecasts presented in this publication (as opposed to other measures announced but not approved). Furthermore, the increase in the national statutory minimum wage (SMW) will bolster the incomes of 9% of waged workers: those with an SMW-linked contract who retain their job.

In any event, the risks are rising and the likelihood of an accident that might push the economy in a less positive direction is increasing. As we have already emphasised, the continuity of the worldwide recovery depends on the expectation that much of the uncertainty generated in the last few months will dissipate. On the domestic front, the impact that some of the policies implemented may have is uncertain. For example, although the increase in the minimum wage, referred to above, is expected to reduce wage inequality, it could exacerbate the disparities in income as a result of the foreseeable job destruction it will entail. In particular, we anticipate a negative impact on net job creation of between 20,000 and 75,000 jobs during 2019; in the medium term, in the absence of productivity gains to offset it, the impact could be greater and destroy more than 160,000 jobs. This would affect particularly vulnerable groups, as well as sectors and regions where the incidence of minimum wage-related contracts is higher.

Likewise, uncertainty about economic policy remains high. BBVA Research estimates that this uncertainty has been shaving an average of 0.3pp off GDP annually since 2016. Recent data confirm that in the final quarter of last year there was a deterioration in home-buying investment that coincided with certain regulatory changes affecting the real estate sector. Among these we should highlight the Supreme Court ruling on stamp duty on legal documents relating to housing purchases, together with changes in rental law. In addition, the decision to re-link the increase in pension with the CPI, without including alternatives to guarantee the sustainability of the system, introduces uncertainty about its future. All this in an environment where there is no certainty about the approval of the 2019 budget. Even if the latter are implemented, the announced measures, both by the central government and other public administrations, will not be sufficient to comply with the deficit target of 1.3% of GDP by the end of this year. This does not even take into account the current sharp growth in public spending which could intensify as elections draw closer. So, depending on the approval of the national budget, the gap in the public accounts will stay at between 2.0 and 2.3% of GDP. This, together with the fragmentation and lack of consensus that persists in the Spanish parliament about the policies needed to boost growth, and about how it can be inclusive, represents a focal point of vulnerability in an increasingly uncertain environment.

2. Global environment: Smooth adjustment of world growth, but with high uncertainty

The global environment has deteriorated over recent months, due to worse economic data in the industry and trade sectors and to the strong increase in financial tensions, particularly in developed economies. The downturn of activity indicators is partly due to temporary factors and, to a certain extent, the markets could be overreacting. However, there have also been contributing fundamental factors, such as signs of deceleration in the US and Chinese economies -where the uncertainty regarding protectionism is a key factor- in particular the uncertainty regarding protectionism-, signs from the Federal Reserve (subsequently reverted) suggesting that the normalisation of monetary policy would continue as expected, and the UK’s lack of progress in agreeing its departure from the European Union. These risks are mainly of a political nature and have contributed to render the world scenario more uncertain. Although many of these concerns are expected to disappear in the second half of the year, the widespread downturn in world growth forecasts further highlights the economic slowdown in developed countries.

Sharp deterioration of the world economy, but with signs of stabilisation at a still solid pace

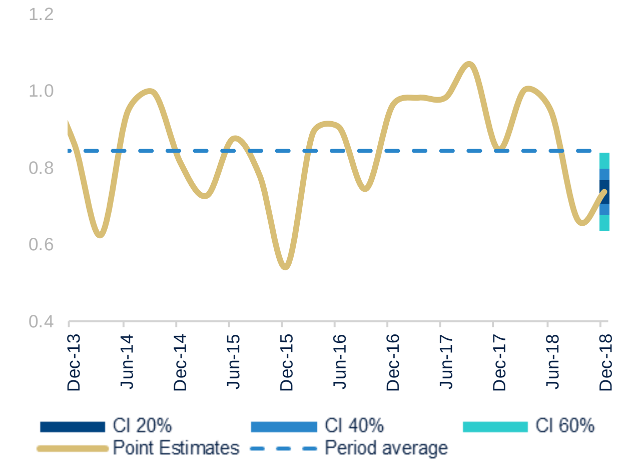
Available data up to December indicate that **world growth stabilised at 0.7% QoQ** by the end of 2018, in the aftermath of the strong moderation observed in the middle of the year (see Graph 2.1). The **difficulties in resuming the steady rate of progress** of around 1% QoQ **in previous years** have therefore become more evident. To the worse economic performance in Europe and China, are now added the Asian countries and the US cyclical downturn, although activity seems to be regaining momentum in other economies like India and Russia.

A large share of the deterioration is due to the **more pronounced and widespread downturn in global trade and the industrial sector since mid-2018**, undermined by the deceleration in China and the **effects of the rise in protectionism**, both in terms of trade and reduced confidence regarding whether the trade disputes will be resolved. Nevertheless, the **direct effect of the measures approved to date appears to be limited** (around one or two tenths of GDP) **and both trade and the industrial sector showed some signs of stabilisation towards the end of the year**.

Sharp increase in risk aversion in developed economies.

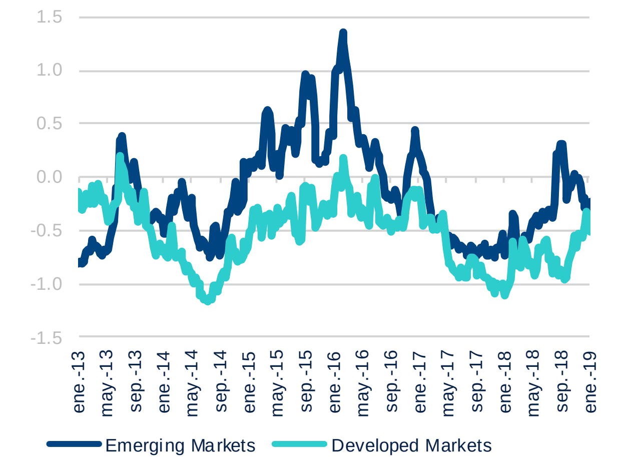
The diminished strength observed in recent economic data in the main areas underscored the **risks threatening world growth.** These risks stemmed from the negative effect of a potential escalation of trade tension and increased likelihood of a recession in the United States once the tax stimulus has disappeared, **amid a context of greater political uncertainty**. This, added to a scenario of **high asset prices and the normalisation of monetary policies, led to a sharp increase in risk aversion and exacerbated financial tensions in developed markets**, particularly in the United States (see Graph 2.2). Specifically, the Federal Reserve increased interest rates in December by 25 basis points, to 2.50%, resulting in a cumulative increase in 2018 of 100 points. Meanwhile, the ECB completed the asset purchase programme, although it confirmed that interest rates will remain low at least until the summer. The increase in political uncertainty was then added: the partial government shutdown in the US, and the the prolongation of the blockade of the UK's exit from the EU, along with doubts regarding the Italian budget (which now seemed to have been dispelled) increased investor cautiousness.

Figure 2.1 World GDP growth (QoQ, %)



Source: BBVA Research

Figure 2.2 BBVA index of financial tensions for emerging economies (normalized index)



Source: BBVA Research

Against this backdrop, there were sharp adjustments in the stock and credit markets, which led to further caution in the markets and an increase in volatility. Investors sought refuge in sovereign bonds, which resulted in sharp decreases in long term interest rates in the United States and Germany. Nonetheless, given that the decline in the Federal Reserve interest rate rise expectations was offset by flows seeking protection against greater risk aversion, the dollar exchange rate remained stable. On its part, the euro exchange rate did not capitalise the end of the ECB asset purchase programme and remained under pressure by the decelerated growth and political uncertainty in the UK and Italy.

On the other hand, and unlike what was observed throughout most of 2018, the downwards adjustments of emerging assets were more contained in this episode, going as far as showing a certain improvement following the adoption of measures. However, the drop in commodities prices, particularly in oil, due to both demand and supply factors, penalised Latin American currencies relative to the Asian ones.

The Federal Reserve timeout has helped to restrain financial tensions, although these are expected to remain high until the uncertainty on various political fronts has been dispelled

The **prudence displayed by the central banks** in the face of the worsening economic data and the sharp increase in financial tensions has affected market expectations regarding the Federal Reserve, which assign some probability to **interest rates cuts in 2019**. Recent comments made by Federal Reserve members, as well as the minutes of the last meeting, suggest that the Fed will be patient and that **the rise in rates will depend on the performance of the economy**. In this context, we expect a **pause during the first semester of this year before resuming the cycle of increases in federal fund interest rates in June** (25 basis points) **up to 3% in December 2019, putting an end to the current cycle of increases** (see Graph 2.3).

In Europe, following the end of the asset purchase program at the end of 2018, **the ECB will continue to be present in the debt market via the total reinvestment of maturing assets for an estimated two-year period** (beyond the start of the interest rate rise). As for official interest rates, the Central Bank has not made any changes in its communication (interest rates will remain at current levels at least until the summer), but could do so in the coming months. In particular, in the face of the economic downturn in the Eurozone and the increase of risks, the

ECB is expected to exercise extreme caution and delay the rate hikes, **with a first rise of 10 basis points in deposit rates in December of 2019** (three months later than expected) **and of 25 basis points in the official rate in June 2020** (six months later than previously expected) (see Graph 2.3). In terms of liquidity, a new auction is likely to be announced in the coming months to ensure a smooth transition of the maturities of the targeted longer-term refinancing operations (TLTROs).

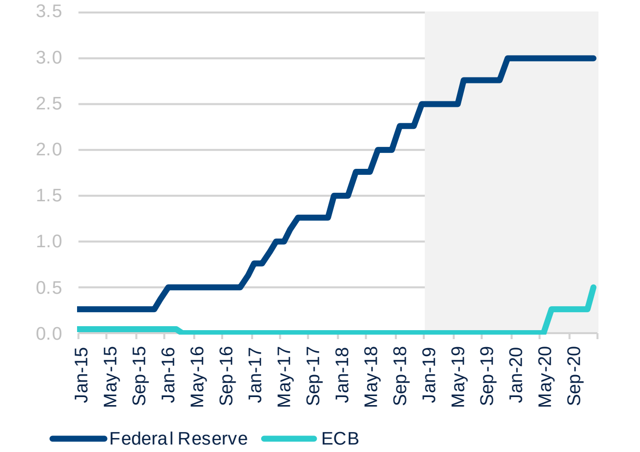
The Federal Reserve's pause in the rate hikes cycle was key in containing the sharp rise in financial tensions in recent months, but volatility will continue to be high during the first quarter, affected by the progress of the **US-China trade negotiations**. The signs appear to be positive, with the commitment by the latter to purchase more US products and to try to meet demands regarding technology transfer and intellectual property rights. The resolution of the conflict on these more structural areas will prolong in time, but the clearer evidence of the negative impact of protectionism on the activity and turbulence in the financial markets make more likely **reaching some sort of agreement by the end of March, thus avoiding the additional increase in US trade tariffs for China**.

In Europe, the final outcome of the UK's exit from the European Union will play a key role. For the time being, the process continues at a standstill due to the strong opposition of the British Parliament to the deal reached between the UK government and the European Union. Although there is no clear alternative, most of the Parliament is against a no deal exit and it seems that article 50 (deferral of Brexit) will extend it well beyond March. In this context, all scenarios are still open, from an agreement to stay within the customs union to an abrupt exit, as well as the possibility of holding an early general election or a second referendum. However, **the chance of a disorderly exit of the UK from the European Union continues to be low**.

The other source of concern at the global level is the economic slowdown in China. In this regard, **the Chinese authorities continue to implement measures** designed to support growth. Such measures range from tax cuts and more investments in infrastructure to supporting the monetary policy designed to boost lending to small and medium sized business. All this **should result in a slight adjustment of growth** in China without neglecting the target to reduce excessive debt.

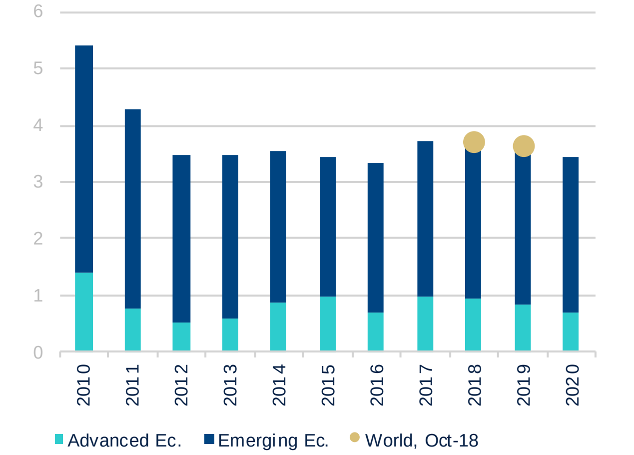
The **satisfactory resolution of these events of an eminently political nature during the first half of the year, along with the patience and caution of the main central banks, is key to achieving a smooth adjustment of the world economy.**

Figure 2.3 Official interest rates in USA and EMU (%)



Source: BBVA Research

Figure 2.4 Forecasts of world GDP growth (% YoY)



Source: BBVA Research

General downward revision of growth, with a more evident moderation in developed countries and emerging Asian economies.

Although 2018 might have closed with annual growth having stabilised at around 3.7%, moving forward **the slower progress observed in the second half of the year** is expected to be consolidated. Consequently, **the growth rate forecast for 2019 is revised downwards from 3.6% to 3.5%** (see Graph 2.4), amid a context of greater uncertainty which, at any rate, will continue during the first half of this year. This moderation of growth rates is general to all areas, although **the slowdown in activity is expected to be more pronounced in developed countries and emerging Asian economies**. Latin American countries meanwhile will continue to recover, albeit at a slower pace than expected three months ago. **For 2020, the soft landing pattern of the world economy is expected to continue, reaching a growth rate of 3.4%**.

In the **Eurozone**, **growth slowed down more than expected in the second half of 2018** due **partly to temporary factors. These include** the regulatory change on vehicle emissions, which could have temporarily affected production and domestic and foreign sales in the sector, - and the protests in France. Likewise, **an adverse effect on the European economy due to the reduction on global demand, particularly in China, cannot be ruled out.** Nevertheless, **the macroeconomic scenario of BBVA Research considers a smooth adjustment of global demand which, along with the depreciation of the euro exchange rate** over last year, should prevent a sharp drop in activity. **The domestic fundamentals continue to be strong,** with an improvement in the employment market which, added to the moderation of inflation, will continue to support the rise in private expenditure. At the same time, the favourable financial conditions (due to the delay in interest rate rises) and the absorption of idle capacity will continue to sustain the recovery of investment. Lastly, the reduced support from the external sector and the decline in confidence could be partly offset by an increase in public spending **stemming from a somewhat more expansive tax policy.** In light of this, we now expect **a faster moderation in GDP growth towards its potential, from 1.9% in 2018 to around 1.4% in 2019-2020.**

Inflation will be significantly reduced over the coming months as a result of lower oil prices to rates of around 1.4% in the second half of the year (1.8% in 2018, 1.6% in 2019-20), **whereas we continue to expect a very gradual increase in underlying inflation** (1.2% in 2018, 1.4% in 2019 and 1.6% in 2020).

Protectionism, a higher likelihood of a recession in the United States and greater adjustment of growth in China are the most significant risks on the forecast horizon

The **global scenario continues to be subject to largely negative risks and is becoming increasingly uncertain**, given the political nature of many such risks. On the one hand, **the risk of a trade war is still there**, particularly between the United States and China, although the threats over strategic sectors, such as the auto industry, could also significantly affect Europe and Japan. An additional increase in trade tensions **could undermine confidence, increase market risk aversion and hold back global direct investment flows**, with the ensuing impact on global growth potential.

In the United States, the risk of recession on the forecast horizon has increased considerably, as a result of several factors. On the one hand, the sharp adjustment of the financial markets amid a context of overvaluation of certain assets, and the increase in corporate spreads, in a highly indebted sector. On the other hand, the earlier than expected removal of the tax stimulus, and the many political controversies – which seem to have been exacerbated following the congressional elections (such as the Government shutdown or the difficulties in approving the spending ceiling this year) – could also prevent the adoption of further support measures (such as infrastructures). On a global level, the negative impact of a recession in the United States would be significant.

In China, the slowdown of the economy in the second half of last year has increased the risk of a **sharper adjustment of growth in the event of an escalation in the trade war**. Despite having scope to implement more stimuli, doubts raises about the economic policies transmission mechanism worsening; moreover, additional expansive policies could **delay the adjustment of the significant indebtedness** of the economy, thus increasing the risk in the medium term as well.

Finally, **political risks in Europe continue to be high**. The most immediate risk is still Brexit, where the standstill continues and where a **potential no-deal exit by the UK** from the European Union cannot be ruled out. The **political uncertainty in Italy is still** high despite the recent agreement on the budget reached with the European Commission and doubts about the sustainability of public debt and of the banking sector could be raised, with potential contagion to the periphery. Nevertheless, these risks should be dispelled over the coming months, once the orderly exit of the UK has been resolved and the doubts as to the public debt in Italy do not increase. In short, political polarisation in most of the countries makes it hard to conceive of a giving a greater boost to the European project after the spring elections.

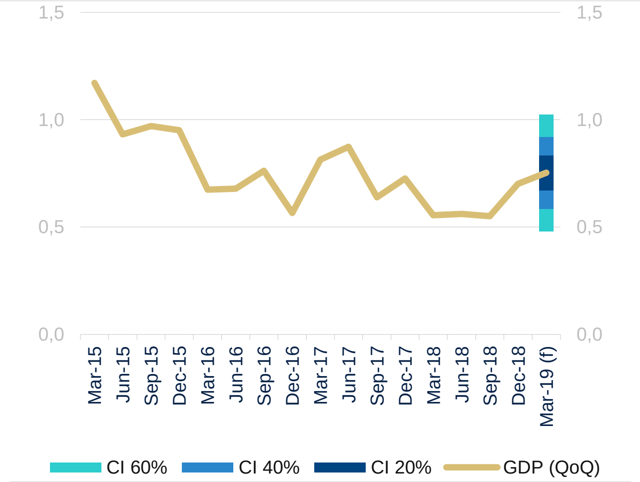
3. Growth outlook for the Spanish economy

The recovery lost momentum throughout 2018, in an environment of increasing uncertainty

The flash estimate of the Quarterly National Accounts (QNA), published by the National Statistics Institute (INE), indicates that the **Spanish economy may have grown by 0.7% QoQ (2.4% YoY)[1] in 4Q18, in line with expectations (MICA-BBVA[2]: between 0.7% QoQ and 0.8% QoQ)**. This means that GDP growth decelerated by 0.5pp down to 2.5% in 2018, which is slightly below the level forecast three months ago. In any event, this figure is near the historical average of annual growth.[3]

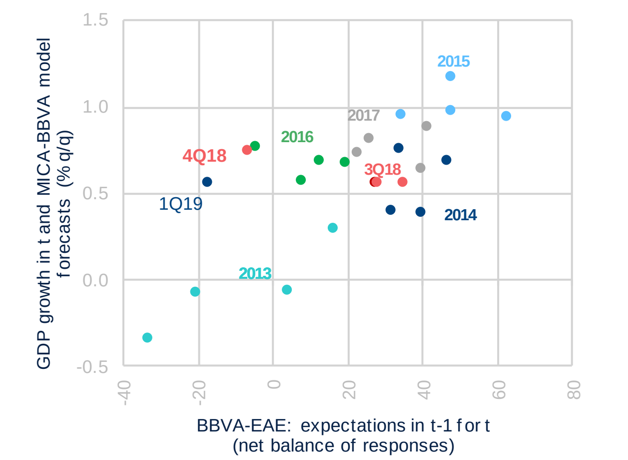
For the first quarter of 2019, the real-time estimates of BBVA Research suggest that GDP growth remains at healthy levels (forecast of MICA-BBVA model: between 0.6% and 0.8% QoQ, see Figure 3.1). However, uncertainty about the pace of growth has increased, as shown by the less favourable view suggested by the results of the BBVA Economic Activity Survey (EAE-BBVA)[4] (see Figure 3.2).

Figure 3.1 Spain: observed growth in GDP and forecasts of the MICA-BBVA Model (% QoQ)



(f) Forecast.
Source: BBVA Research based on INE (Spanish National Institute of Statistics) data

Figure 3.2 Spain: economic growth and expectations of participants in the EAE-BBVA in the previous quarter



Source: BBVA

1: SWDA: Seasonally and working day-adjusted data
2 For more details on the MICA-BBVA model, see M. Camacho, M. and Domenech, R. (2010): "MICA-BBVA: A Factor Model of Economic and Financial Indicators for Short-Term GDP Forecasting" BBVA WP 10/21, available at: https://bit.ly/2OTgtI1
3: Average annual growth between 1971 and 2017 was about 2.5%.
4: For details on the BBVA Economic Activity Survey (EAE-BBVA), see Box 1 of the Spain Economic Outlook for the second quarter of 2014, available at: https://bit.ly/2pKEh31

Domestic demand consolidated its position as the driver of economic growth over the past year

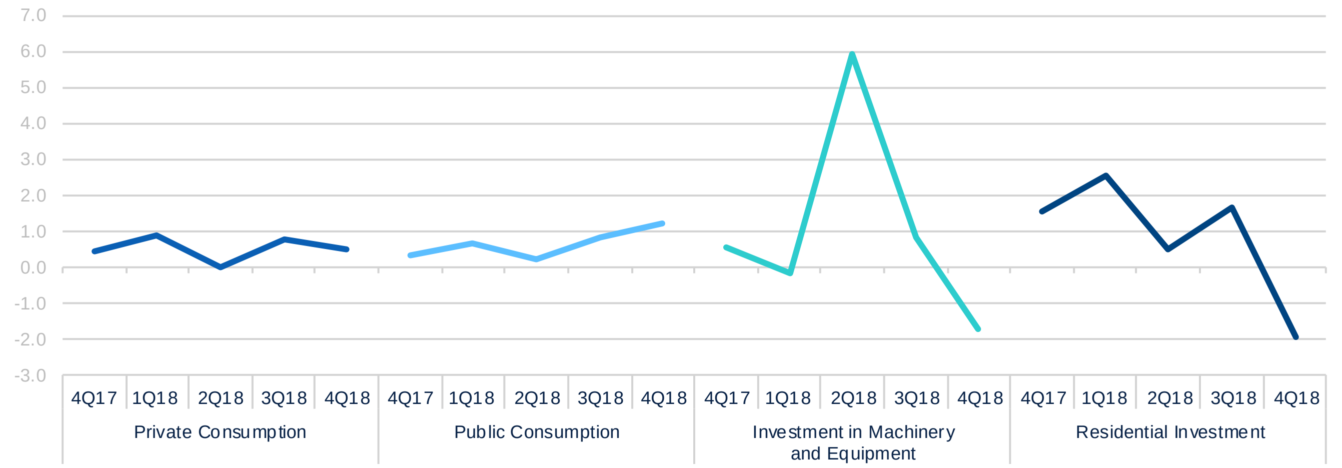
The INE's flash estimate suggests that **private consumption increased by about 0.5% QoQ (2.1% YoY) in 4Q18.**[5] If this estimate is confirmed, it means that **2018 closed with an average annual increase of 2.4% YoY, 0.1 pp below that observed in the previous year**. For its part, it is estimated that public demand gained traction in the closing period of 2018. Thus, the final consumption expenditure of public administrations increased by 1.2% QoQ (3.0% YoY) in 4Q18. That would mean that **the year closed with an average increase of 2.3% in public consumption, 0.4 pp higher than that of 2017**.

In terms of **investment in machinery and equipment,** the QNA flash estimate points to a downward correction in 4Q18 (-1.7% QoQ; 4.8% YoY), following the strong data seen in the central part of the year (5.9% QoQ in 2Q18 and 0.8% QoQ in 3Q18).[6] This demand component appears to have closed the year **with an average growth of 6.0%, similar to that of 2017.**

Data released by the INE indicate that **housing investment** decreased by 1.9% QoQ (2.7% YoY) in 4Q18. As a result, this component of investment **gained a further 6.2% in 2018, continuing with the recovery begun in 2016** (7% in 2016 and 9% in 2017). With respect to investment in other constructions, BBVA Research estimates a growth of 2.3% QoQ (7.0% YoY) in 4Q18, with which 2018 will have ended with an average growth of 4.8% (0.6% in 2017).

In short, domestic demand in 4Q18 contributed 0.4 pp to quarterly GDP growth thanks to the strength of consumption. With this ending to the year, **domestic demand will have contributed 2.9 pp to average GDP growth in 2018, comparable to its contribution in 2017.**

Figure 3.3 Spain: observed growth and forecasts for the major components of domestic demand (% QoQ)



Source: BBVA Research based on INE (Spanish National Institute of Statistics) data

5: Spending indicators are showing mixed signs. Retail sales were boosted by increasing durable goods demand. Interior sales of large companies and revenues of the service sector also grew in 4Q18, albeit at a slower pace than in the previous quarter. However, vehicle registrations decreased owing to the base effect caused by the entry into force in August of the new Worldwide Harmonized Light-Duty Vehicles Test Procedures (WLTP) and consequent rise of early demand. Financial position indicators show an upturn in real wage incomes, a mild increase of new consumer lending and a decrease of household confidence and of share prices.
6: The indicators mainly show a reduction in sales of industrial vehicles and a contraction in industrial confidence. Capital goods orders also shrank, but less than in the previous quarter. For its part, the IPI of capital goods increased, but less than in 3Q18, and imports of capital goods stagnated.

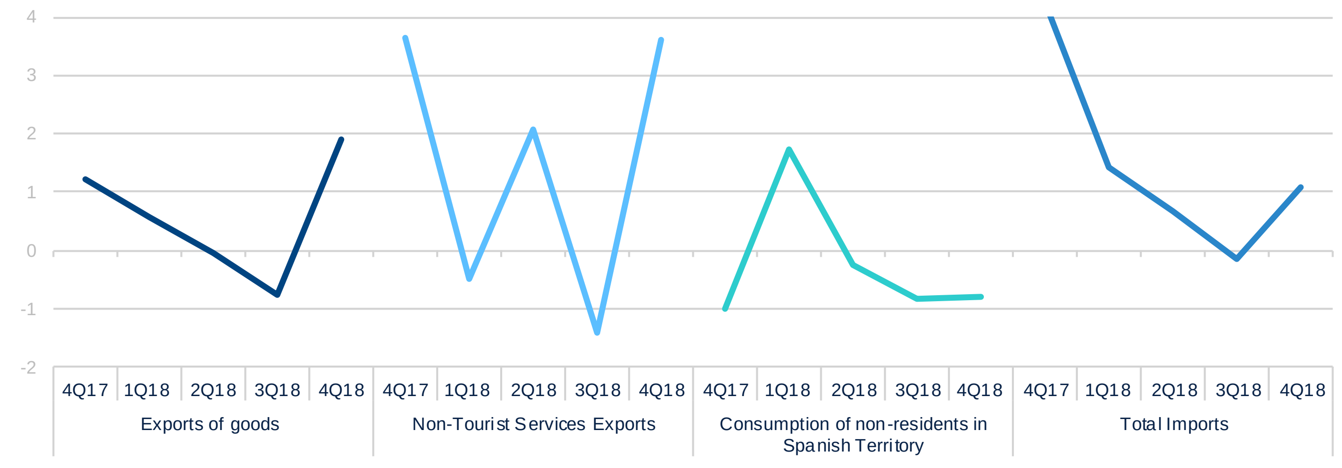
The recovery of external demand towards year-end 2018 was insufficient to prevent a slowdown for the year as a whole

The flash estimate of the CNTR suggests that, following the sluggishness throughout most of 2018, **exports of goods and services may have regained traction in 4Q18**, reaching 1.9% QoQ (1.8% YoY), as shown in Figure 3.4. Specifically, **goods exports appear to have** broken the downward trend seen since the start of 2018, with growth **of 1.9% QoQ (1.6% YoY) in 4Q18.**[7] Also, **exports of services were back in positive territory (1.8% QoQ, 2.1% YoY),** led by the sales of non-touristic services (3.6% QoQ; 3.8% YoY). However, those corresponding to the consumption of non-residents in the national territory remained negative (-0.8% QoQ; -0.2% YoY), despite the positive signs of the partial indicators.[8]

In any case, the recovery observed in the last quarter **of 2018 would not have prevented the economic year from ending with the lowest annual growth in the past five years (2.2% compared with 4.6% on average in 2013 and 2017)**. Sales of goods abroad slowed by 2.9 pp down to 1.8%, and of services by 3.3 pp down to 3.0%. In services, it is estimated that exports of non-touristic services increased by 4.1%, while consumption of non-residents by 1.3%, 0.4 pp and 7.6 pp less than in 2017, respectively.

In line with the growth of final demand, available information indicates that **imports increased by 1.1% QoQ (3.1% YoY) in 4Q18 and ended 2018 with an annual growth below that of 2017 (3.6% compared with 5.6%)**. Such performance, combined with that expected of exports, would have resulted in a positive contribution of net external demand to growth in 4Q18 (of 0.3 pp QoQ; -0.3 pp YoY) and a marginal contribution to growth for the year as a whole (0.1 pp).

Figure 3.4 Spain: observed growth and forecasts of the major components of external demand (% QoQ)



Source: BBVA Research based on INE (Spanish National Institute of Statistics) data.

7: Partial indicators of sales abroad gave conflicting signals. While available information on the balance of trade points to a slight upturn in goods exports during the quarter, exports by large companies slowed and the order books of exports stagnated.
8: Overnight stays by non-resident tourists in hotels increased by an average of 1.0% MoM CVEC in October and December. On the other hand, the number of foreigners entering the border grew by an average of 1.4%. Finally, tourism receipts from the balance of payments increased by an average of 1.3% between October and November.

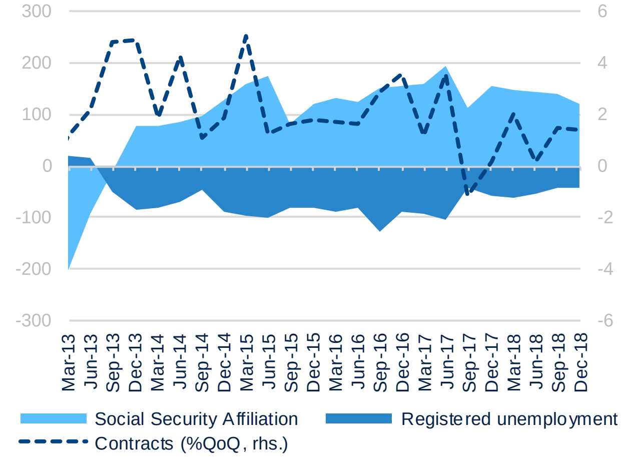
Job creation gained traction towards the end of 2018

Correcting for seasonal variations, **Social Security affiliations increased by 0.8% QoQ in the fourth quarter of 2018 (3.0% YoY), 0.2 pp more than in the third quarter, and surpassed 19,000,000 contributors in December** (see Figure 3.5). The decline in registered unemployment, which was widespread by sectors, also gained momentum between October and December. Thus, the number of unemployed persons decreased by -1.7% QoQ SWDA (-6.2% YoY), 0.4 pp more than in the previous quarter. Since mid-2013, Social Security affiliation has grown by 17.3% SWDA, but is still 2.0% below the pre-crisis peak reached in early 2008. Although unemployment has fallen by 34.9% in the last five years, it is 60.7% higher than in mid-2007.

The dynamism of job creation contrasts with the sluggishness of hiring. Having increased by 1.2% QoQ SWDA (3.5% YoY) in 3Q18, growth in the number of contracts slowed to 0.8% QoQ SWDA (4.1% YoY) due to the first decrease in open-ended hiring since mid-2015 (-3.2% QoQ, 14.6% YoY). Combined with the increase in the number of temporary contracts (1.3% QoQ SWDA, 3.1% YoY), this triggered an increase of 0.4 pp in the ratio of temporary contracts, up to 89.6% SWDA. However, the percentage of temporary contracts has fallen by 3 pp since 2013, as shown in Figure 3.6.

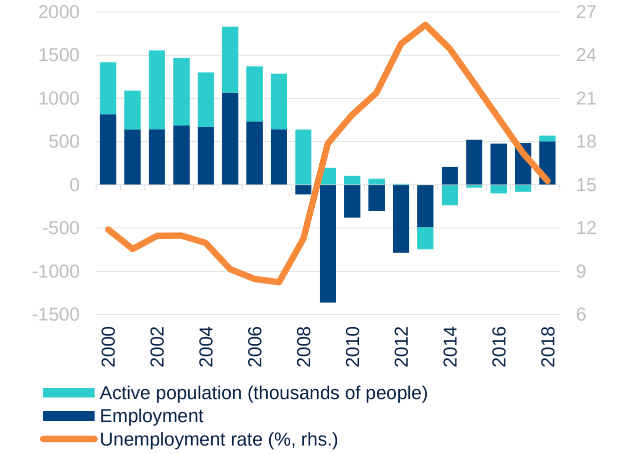
The Labour Force Survey (LFS) for 4Q18 confirmed the trend suggested by Social Security affiliation and unemployment figures. Employment appears to have increased by about 0.9% QoQ SWDA (3.0 % YoY) in the fourth quarter, 0.3 pp more than in the third. If the active population barely grows, as expected, the employment increase would bring about a fall of 0.6 pp in the unemployment rate, down to 14.5% SWDA. **The 4Q18 figure brought to a close the fifth consecutive year of job creation**. On average, employment increased by approximately 502,900 people in 2018, 19,700 more than in the previous year. Even if the active population should increase by 65,100 people following a decline over the past five years, unemployment would stand at about 15.3%, two points less than in 2017.

Figure 3.5 Spain: labour market indicators
(SWDA data. Quarterly change in thousands of people, except where indicated otherwise)



Source: BBVA Research based on Ministry of Labour, Migration and Social Security data

Figure 3.6 Spain: trend in recruitment
(SWDA data)



Source: BBVA Research based on Ministry of Labour, Migration and Social Security data

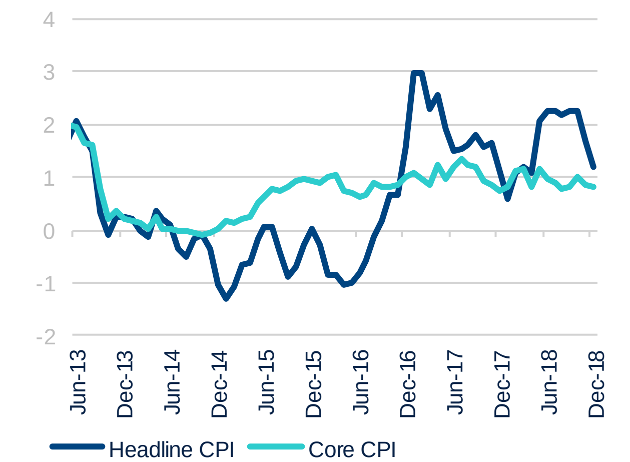
Prices slowed while wage demands have been mounting

Headline inflation eased during the fourth quarter of 2018 to 1.2% YoY in December (1.7% as the average for the year). Underlying this figure is the downward correction of energy prices, which fell by 10 pp between September and December down to 2.3% YoY (6.2% as the average for the year). For its part, **core inflation remained broadly stable throughout the last quarter of the year** (0.8% YoY in December; 0.9% as the average for the year).

In this context, **the headline inflation differential versus that of the eurozone became favourable to Spain by year-end 2018 (-0.4 pp YoY in December; 0.0 pp as the annual average)**. In addition, the estimates of BBVA Research would suggest that, using core inflation as the reference, the inflation differential stood at about -0.2% YoY in December (-0.1 pp as the annual average).

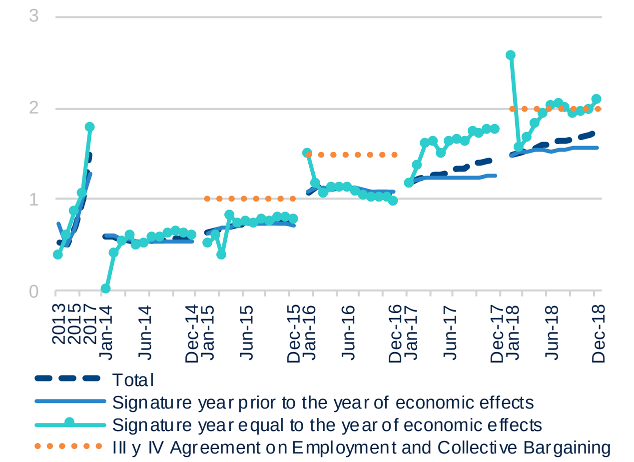
Wage demands rebounded in the fourth quarter. The average wage growth agreed in collective bargaining agreements up to December reached 1.8%, 0.1 pp more than at the end of 3Q18. In line with developments since early 2017, the agreed increase in remuneration in the revised multi-year agreements (1.6%) was lower than the increase in those signed during the current year (2.1%), which relate to 3,173,000 workers[9]. As can be seen in Figure 3.8, the wage increase provided in the agreements signed up to December exceeds by 0.1 pp the minimum recommended in the 4th Agreement for Employment and Collective Bargaining (AENC).[10]

Figure 3.7 Headline and core inflation (% YoY)



Source: BBVA Research based on INE data

Figure 3.8 Spain: average agreed wage increase in collective agreements (% YoY)



Annual data include agreements registered after December each year and incorporate the revision using the wage guarantee clause.
(*) Data for 2017 and 2018 are provisional.
Source: BBVA Research based on Ministry of Labour, Migration and Social Security data

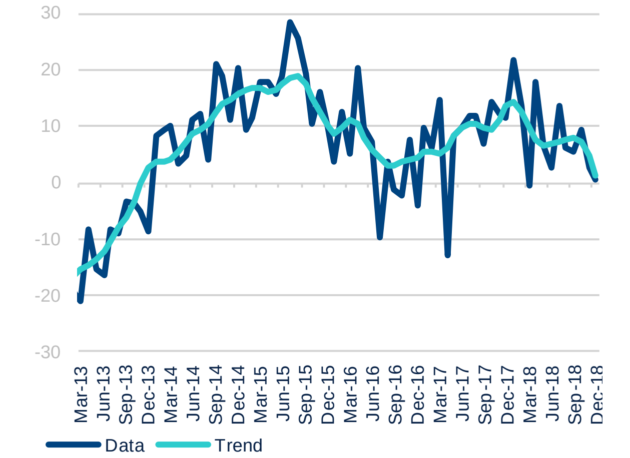
9 Up to December, the number of workers covered by collective bargaining agreements was close to 8,841,000 million, including those bound by agreements signed before 2018 (5,667,000), 25.1% more than in 2017.
10 The 4th AENC, which was signed in early July 2018 by the CEOE, CEPYME and CC.OO, recommends wage increases of around 2% in 2018, 2019 and 2020, plus a variable portion that will depend, among other factors, on productivity, the company's earnings and levels of unjustified absenteeism.

New lending slightly slowed in the closing months of 2018

The stock of credit to the private sector slightly softened its fall to -2.8% YoY in November 2018. However, new lending remained at strong levels and grew by 9.0% in 2018, even if they lost some traction in the last part of the year. The pace of financing transactions to companies for amounts of more than €1 million was erratic in recent months, while they did not hinder growth of 10.9% for 2018 as a whole. On the other hand, transactions with companies of less than €1 million were less volatile in the last part of the year, but only increased by 5.3% in the accumulated for the year. New lending to households kept up a strong flow of credit, with a 13.5% increase in 2018. This strong performance is based on transactions to finance consumer goods and home purchases, which was sufficient to counteract the lack of momentum seen in other types of household finance.

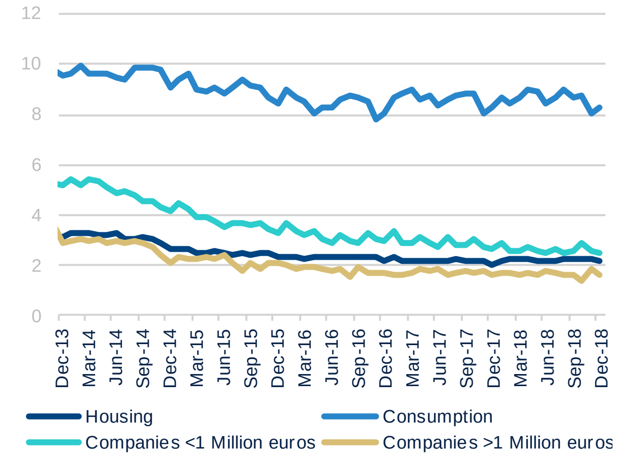
The price of new credit remained low, favoured by low interest rates, good liquidity conditions for banks, the containment of sovereign risk and the lower credit risk faced by banks. However, some portfolios are showing signs of reaching a minimum threshold, in an environment of narrowing interest income and changes in the term structure. Such is the case with interest rates set for home purchase transactions (2.18% average APR in November, 13 bp more than the previous year), which are showing clear resistance to further decreases, given the growing importance of fixed interest rate mortgages (35% of mortgage loans in 2018, vs. 31% in 2017) and because the 12-month Euribor has begun to slightly rebound (6 bp more than the previous year) from levels below zero.

Figure 3.9 Spain: new credit transactions to the retail sector (% YoY of the gross figure and its trend)



Source: BBVA Research, based on Banco de España figures

Figure 3.10 Spain: interest rates on new lending transactions (% APR)

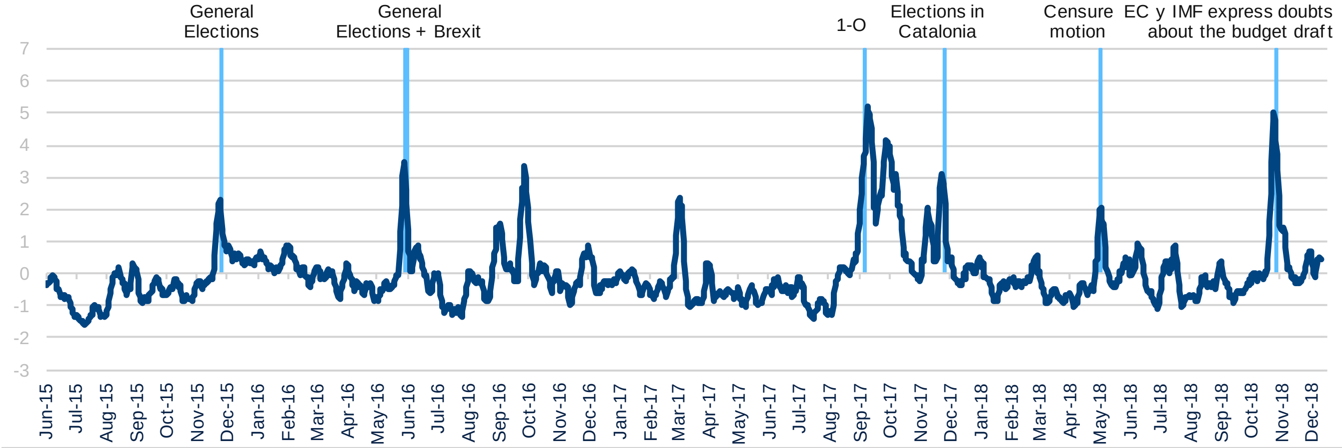


Source: BBVA Research, based on Banco de España figures

2019-2020 scenario: GDP growth near 2.0%

The fundamentals of the Spanish economy will drive continued growth over the coming years, although at a lower rate than that observed at the beginning of the recovery. These expectations of a slowdown are based on both external and internal factors. The former include the weaker stimulus provided by monetary policy, and the moderation of global growth. This is further combined with the exhaustion of tourism flows, which is likely to be gradual, and dependent upon lower geopolitical tensions of some competing countries. Internally, it is estimated that domestic pent-up demand during the economic recovery has been taken up, which will lead to an expansion of spending that is smaller and in line with fundamentals during this biennium. All this together with the negative effects derived from the persistent uncertainty about economic policy (see Figure 3.11) and of some measures adopted recently, notably the increase of the statutory minimum wage (SMW) (see more on page 21). Even so, some factors will contribute to reining in the slowdown in the economy. External factors include the downward revision in oil prices, and internal ones include an expansive fiscal policy.

Figure 3.11 Spain: index of economic policy uncertainty (Deviations from historical average, pp)



Source: BBVA Research based on GDELT data

Thus, the current year will result in annual growth of 2.4%, while in 2020 the economy will grow by 2.0%, 0.6 pp lower on average than growth seen during the previous biennium (see Table 3.1). Despite the slowdown, internal demand will continue to be the main support for growth (2.5 pp on average) while the contribution of net external demand will again be negative (-0.3 pp on average). Even so, if this scenario comes to pass, the increase in activity will be sufficient to create nearly 800,000 jobs over the two-year period and reduce the unemployment rate to around 12,6% on average in 2020[11].

Table 3.1 Spain: macroeconomic forecasts (% YoY unless otherwise indicated)

(% YoY unless otherwise indicated)	3Q18	4Q18	2017	2018	2019 (f)	2020 (f)
National Final Consumption Expenditure	2.1	2.3	2.4	2.4	2.1	1.8
Private FCE	2.1	2.1	2.5	2.4	2.1	1.8
FCE Public Admins.	2.1	3.0	1.9	2.3	2.4	1.7
Gross Fixed Capital Formation	5.5	4.6	4.8	5.2	4.6	4.6
Equipment and Machinery	7.2	4.8	6.0	6.0	3.9	4.2
Construction	5.5	4.8	4.6	5.5	4.9	4.7
Housing	6.4	2.7	9.0	6.2	5.5	5.6
Other Buildings and Structures	4.5	7.0	0.6	4.8	4.3	3.6
Domestic demand (*)	**2.8**	**2.7**	**2.9**	**2.9**	**2.6**	**2.4**
Exports	1.3	1.8	5.2	2.2	5.2	4.5
Imports	2.5	3.1	5.6	3.6	6.2	5.7
External balance (*)	**-0.4**	**-0.3**	**0.1**	**-0.4**	**-0.3**	**-0.3**
Real GDP at market prices	**2.4**	**2.4**	**3.0**	**2.5**	**2.4**	**2.0**
Nominal GDP at market prices	**3.4**	**3.2**	**4.2**	**3.5**	**4.2**	**3.7**
Total employment (LFS)	2.5	3.0	2.6	2.7	2.1	1.8
Unemployment rate (% of labour force)	14.6	14.4	17.2	15.3	13.8	12.6
Full-time equivalent employment (Quarterly National Accounts)	2.5	2.6	2.8	2.5	2.2	1.7

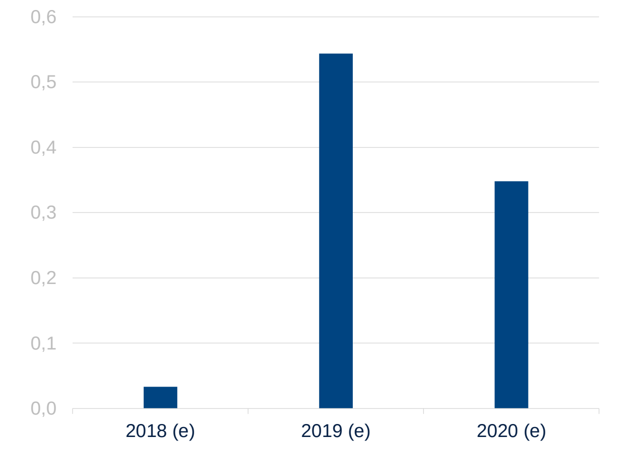
(*) Contributions to growth. (f) Forecast.
Source: BBVA Research based on INE (Spanish Office of National Statistics) and Banco de España data

11: Employment will increase by 700,000 people between 4Q18 and 4Q20 and the unemployment rate will be slightly above 12%.

In spite of the uncertainty, global demand, the price of oil and monetary policy will continue to support growth

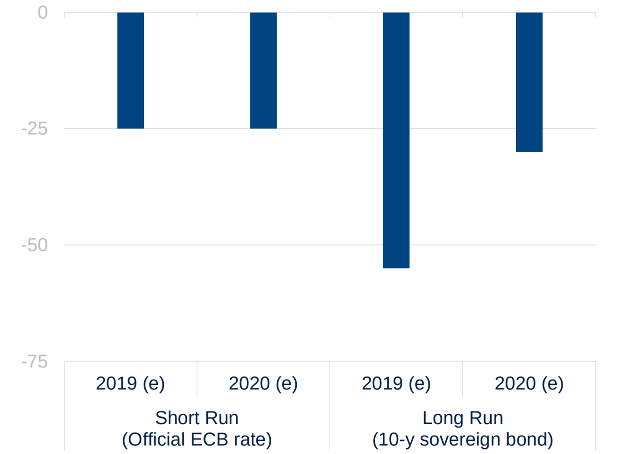
Although the global economy will continue to slow down in the current biennium (to 3.5% in 2019 and 3.4% in 2020), **especially in the case of the Eurozone, the external environment will remain favourable for the growth of the Spanish economy** (see section 1), if the numerous risks don't materialise. In this context, of special significance is the relief provided by the **downward correction in oil prices** which, according to BBVA Research forecasts, could be close to 60 dollars per barrel on average over the next two years, which is 15% below the level estimated three months ago. Although the fall in energy prices is partly due to the slowdown in activity at a global level, supply factors are also playing a role and, consequently, a net positive effect is estimated for business margins, household disposable income and economic activity in Spain (see Figure 3.12).[12]

Figure 3.12 Spain: GDP response to the downward revision of oil prices (pp of annual growth)



(e) Estimate.
Source: BBVA Research based on INE (Spanish Office of National Statistics) data

3.13 Spain: Change in benchmark interest rates for Spanish economy (bp, end-of-period forecast)



(e) Estimate.
Source: BBVA Research based on INE (Spanish Office of National Statistics) data

In Europe, growth expectations point to a sharper slowdown (1.4% in 2019 and 1.4% in 2020) that will moderate, but not truncate, the recovery of Spanish demand. In this regard, the **delay in the process of normalising ECB monetary policy** is expected to keep financing costs at low levels for a more prolonged period of time (see Figure 3.13), which will favour the growth of a majority of the components of aggregate demand. In addition, the monetary policy strategy of the Fed will help the euro/dollar exchange rate to remain favourable[13].

In summary, **lower oil prices, along with the accommodative tone of monetary policy, will at least partially offset the impact of headwinds** coming from the slowdown of the global and European economies. However, the scenario is not free of external risks, notably the growing global protectionism, China's economy deceleration and the uncertainty relating to economic policy in Europe.

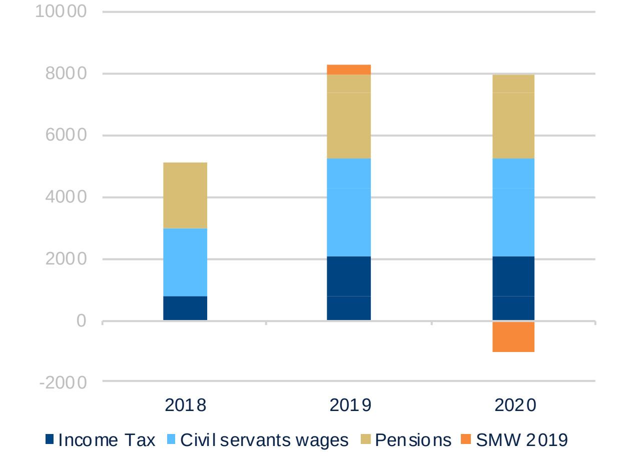
12: For further details on estimating the effects of oil prices on activity and prices in the Spanish economy by type of shock, see Box 1 of the Spain Economic Outlook journal for the second quarter of 2011, available at: https://goo.gl/6DM3cE
13: BBVA Research estimates indicate that a permanent 5% appreciation of the euro-dollar exchange rate implies an appreciation of the nominal effective exchange rate equivalent to 1.7%. The estimated effect on GDP growth during the first year is between 0.2 pp and 0.3 pp, and the pressure on the annual increase of exports is estimated at 1.3 pp.

Internal demand will continue to lead growth

Private consumption will lose momentum during the 2019-2020 biennium. BBVA Research forecasts that the growth in household spending will moderate to 2.1% in 2019 and 1.8% in 2020. What factors explain the loss of traction in private consumption? Firstly, the disappearance of the transitory elements that encouraged spending in previous years, such as pent-up demand for durable goods[14]. Secondly, the lower dynamism of some of the determinants of consumption, such as net financial wealth, which has been affected, among other things, by the decline in stock prices and the end of the deleveraging process of households. Lastly, the impact of uncertainty, which limits the downward trend in the savings rate[15].

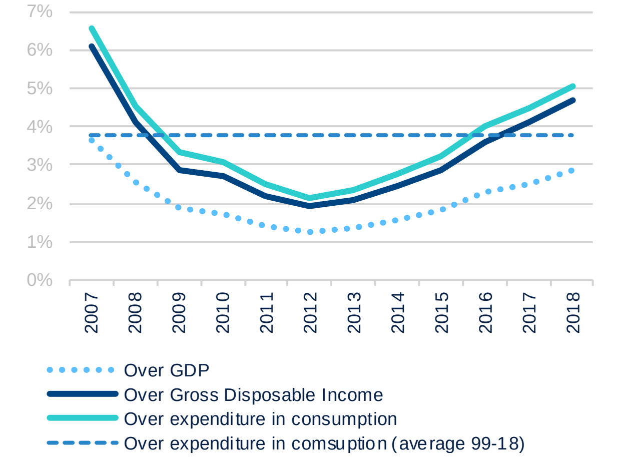
In contrast, the permanent tax stimulus included in the Spanish National Budget of 2018 and the increase in the statutory minimum wage (see page 22), in pensions and in the remuneration of public employees for 2019 will contribute to growth in household incomes (see Figure 3.14). Similarly, the uninterrupted increase in real estate wealth and the complementarity that exists between the demand for housing and the consumption of certain goods and services will encourage spending.[16] Lastly, financing will continue to grow over the coming quarters and help sustain more intensive consumption of credit. As shown in Figure 3.15, about 5% of the nominal spending of households in 2018 was financed, three points more than in 2012, but still 1.5 points less than the peak of 2007.

Figure 3.14 Spain: impact on disposable income of fiscal stimulus measures* and increase in minimum wage
(Millions of euros)



* 2018 Spanish National Budget and 2019 budget plan.
Source: BBVA Research based on Ministry of the Treasury data

Figure 3.15 Spain: new consumer financing
(% GDP, disposable income and consumer spending)*



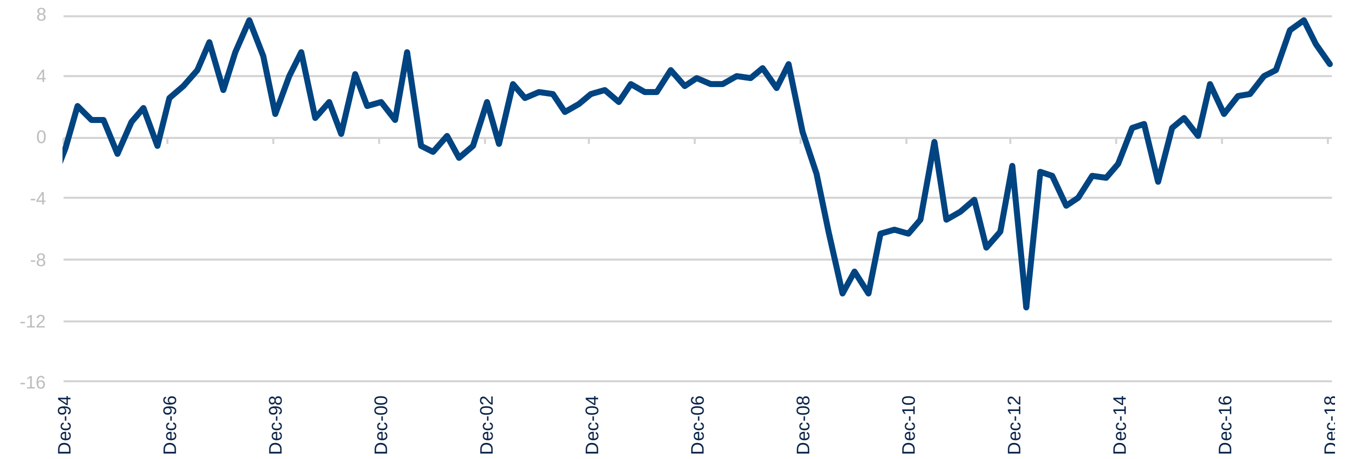
* New consumer financing data linked up to 2010.
Source: BBVA Research, based on Banco de España figures

The growth of investment in machinery and equipment will also moderate in the 2019-2020 period, and will fall below the levels of the past six years. The domestic factors underlying the slowdown include the lower pent-up demand for machinery and equipment, the expected slowdown of some demand components and the uncertainty about economic policy. Internationally, the slowdown of the global and European economies has led to a downward revision of Spanish exports, which will also probably make itself felt in this investment item. On the

14: Between 2013 and 2016, household consumption grew faster than its long-term fundamentals (disposable income, wealth and interest rates) as a result of the absorption of pent-up demand for durable goods during the crisis. This factor ceased to contribute to household expenditure growth in 2017 as pent-up demand disappeared.
15: Having fallen to 4.5% SWDA of disposable income in 1Q18, the savings rate of households increased by 0.7 pp up to 5.2% SWDA in 3Q18.
16: A household's consumer spending rises by around 20% when buying a home, regardless of any changes that may occur in the size of the family unit, the income or employment status of its members. The "property effect" reaches 35% in the case of furniture and household appliances. See Box 2 of the Spain Economic Outlook review for the second half of 2017, available at:
https://www.bbvaresearch.com/public-compuesta/situacion-consumo-segundo-semestre-2017/

other hand, the forecast of lower oil prices than in the previous quarter, and the possibility that the interest rate hike will be delayed, may broaden the margins for business and alleviate part of the impact of the above factors. However, the overall balance of demand fundamentals is favourable for increasing the economy's productive capacity (see Figure 3.16) and this investment item is expected to grow by 3.9% in 2019 (1.1 pp less than forecasted in the previous quarter) and 4.2% in 2020.

Figure 3.16 Spain: use of productive capacity in machinery and equipment (Deviations from the historical average, pp)



Source: BBVA Research based on Ministry of the Economy data

Housing investment will once again be one of the most dynamic demand items in the current biennium. The economy's capacity to continue creating jobs and the persistence of a scenario of low interest rates are expected to continue supporting the growth of residential demand, albeit at more moderate growth rates than between 2014 and 2017, when sales of dwellings grew at an annual average of about 15%. In any event, following several years of scant housing starts, the amount of stock has fallen significantly, which constitutes an incentive for the construction of new housing to meet current needs and requirements. Accordingly, construction activity is expected to continue to perform soundly, although uncertainty about economic policy, in general, and housing policy[17], in particular, could condition the undertaking of new projects. In summary, investment in housing is expected to increase by 5.5% in 2019, and to grow by 5.6% in 2020.

Public demand is expected to once again contribute positively to the growth of activity, boosted by the expansionary measures recently approved by the central government[18] and due to the electoral cycle. In any case, the political uncertainty and difficulties in achieving passage of the Spanish National Budget will condition the evolution of expenditure. Even so, an acceleration is expected in the final consumption of public administrations, up to 2.4% YoY in 2019, while it would moderate to 1.7% YoY in 2020 in a scenario with no changes in fiscal policy. For its part, **in the current conjuncture of budgetary extension, a slight moderation is expected in public investment**, which would mean that investment in other constructions would grow at an average rate of 4.0% in real terms in the current biennium.

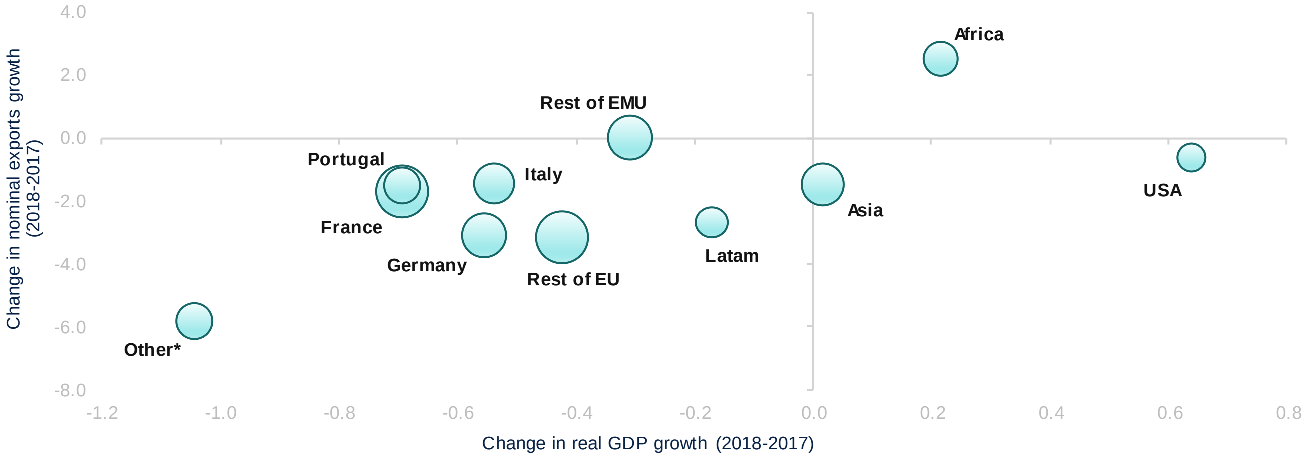
17: In recent months, a number of events have augmented uncertainty in the sector: mainly controversies relating to the Spanish Supreme Court decision on payment of stamp duty and measures approved for the rental market. As a consequence, residential sales in October and November 2018 performed worse than expected, with 11,000 fewer transactions than forecast three months ago.
18: Specifically, the 2.25% increase in remuneration of public employees (Royal Decree-Law 24/2018, of 21 December).

Trade flows will continue to grow throughout the biennium, but their contribution to growth will be negative

In spite of the **expected slowdown of global growth (3.5% in 2019 and 3.4% in 2020) and the moderate appreciation of the real effective exchange rate** for the Spanish economy (0.4 pp on average for the biennium), market conditions remain relatively favourable for Spanish exports. Along with lower oil prices, these conditions will provide **a conducive external environment for total sales abroad to grow by 5.2% this year** (0.5 pp below the forecast made three months ago), **and for them to increase by 4.5% during the next year**, a still-robust figure, even if lower than in the last five years (4.2% on average).

In particular, **it is expected that following the across-the-board slowdown seen in the main destinations in 2018** (see Figure 3.17), **sales of goods abroad should regain traction** and increase by 5.4% in 2019 (-0.8 pp less than previously estimated) and 4.9% in 2020. In contrast, it is estimated that exports of services will grow at an average annual rate of 4.1% during the current biennium, which is slightly below that seen in the previous one (4.7% as an annual average). In this regard, the forecasts of BBVA Research would suggest that **the slowdown of consumption of no-residents will continue**, with growth of 1.3% in 2018 (0.2 pp more than expected in the previous quarter) and of 1.6% in 2020, which contrasts with the vigorous rebound seen between 2013 and 2017 (5.9% on average). Behind this expected slowdown lie some structural factors that have been mentioned in previous editions of this publication. Domestically, doubts remain about restrictions on the growth of supply at destinations.[19] Externally, it cannot rule out that the recovery of some competing markets, burdened in recent years by geopolitical tensions, could lead to a reversal of part of the flows diverted towards the Spanish market.[20]

Figure 3.17 Spain: slowdown of activity and nominal exports by export market (pp change)



(*) Norway, Russia, Switzerland and Turkey and other minor trade partners.
The size of the bubble represents the market's contribution to Spain's total exports.
Source: BBVA Research based on Turkstat and INE data

In spite of the foregoing, the expected composition of growth of final demand will lead to **an increase in imports of around 6% on average** during the current two-year period which will result in a negative contribution of net external demand to growth (-0.2 pp in 2019 and -0.3 pp in 2020). This performance of the external balance is consistent with a slowdown of the current account balance to 0.9% of GDP in 2019 and 0.7% in 2020.

19: Evidence suggests that the sector may be approaching saturation levels, especially in traditional beach destinations, and that, going forward, will increase the likelihood that increases in demand will be passed on to higher prices and wages, instead of boosting growth and employment in the sector.
20: The estimates of BBVA Research would suggest that nearly 10 pp of tourism growth is not due to traditional fundamentals. For more information on this aspect, see the BBVA Research Economic Watch: "Are geopolitical tensions in competing markets affecting Spanish tourism?", available at: https://bit.ly/2pQHhul

The recovery of the labour market will lose momentum due to the increase in the statutory minimum wage

In line with the trend in economic activity, **job creation will slow down in 2019 and 2020**. Employment is expected to grow by 2.1% this year, 0.6 pp less than in the previous year. Given that the increase in the labour force will be modest, the increase in employment will result in a decrease of 1.5 pp in the unemployment rate to 13.8%. The increase in employment and the fall in the unemployment rate will continue in 2020, but at a slower pace, to 1.8% and 12.6%, respectively.

The notable increase in the statutory minimum wage for 2019 may condition trends in the economy and employment, in both the long and short term, unless the bases are laid for a significant increase in productivity.[21] The 22.3% increase in SMW, with no precedents since the 1970s, may raise by more than 6 pp the percentage of workers receiving remuneration lower or equal to this level, up to more than 9% of full-time equivalent wage earners, which would be equal to 3.5% of the total wage bill.[22] As a consequence, the repercussions on economic growth and job creation may be significant and affect especially vulnerable groups. In the short term (in the first year), the estimates of BBVA Research would suggest that GDP would be between 0.1 pp and 0.3 pp lower than in the baseline scenario and that employment would be between 0.1 pp and 0.4 pp lower, depending on whether companies absorb the wage increase or pass it on to prices.[23] That is, the economy would create between 75,000 and 195,000 fewer jobs in the 2019-2020 biennium than in the absence of the minimum wage increase. The effect would be concentrated among the most vulnerable workers: women, young people, foreigners, the less qualified, part-time workers, temporary workers and those working in smaller and less competitive enterprises. In the long term, the impact would depend on policies to help boost the productivity of these workers. In the absence of such measures, the increase in the minimum wage would reduce GDP by between 0.7 pp and 1.2 pp below the level expected in the baseline scenario and employment by between 0.9 pp and 1.6 pp (see Figure 3.18).[24]

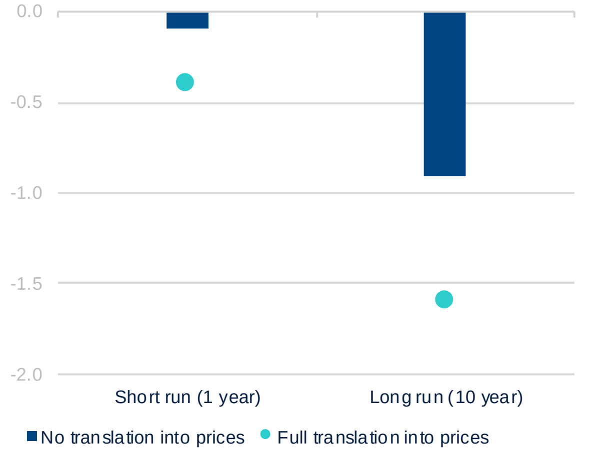
In spite of its impact on employment, the minimum wage increase could increase wage earner remuneration in the short term and, consequently, their spending levels. In particular, if companies absorb the increase, the effect on the total wage bill would be positive in 2019 and 2020 (between 0.1 pp and 0.2 pp). It might also contribute to reducing inequality in so far as the increase brings the minimum wage closer to the mean.[25] However, the long-term impact would unequivocally be negative.

If the forecasts of BBVA Research prove to be accurate, the number of employed people would exceed 20.2 million by the end of 2020 and the unemployment rate would be about 12%, still far from pre-crisis levels. As Figure 3.19 illustrates, in 4Q20 the level of employment will be around 2.6% below that existing at the beginning of 2008, while the unemployment rate will be three points higher. In addition, the expected trend in activity and full-time equivalent employment (FTE), which will increase by around 2% on average in the 2019-2020 period, point towards a limited contribution to growth of apparent productivity of labour.

21: Royal Decree 1462/2018, of 21 December, setting the statutory minimum wage for 2019. https://www.boe.es/boe/dias/2018/12/27/pdfs/BOE-A-2018-17773.pdf. On an annual basis the legal minimum wage amounts to €12,600.
22: The details of the calculation of the coverage of the minimum wage and the possible macroeconomic effects of it being increased can be found in Archondo, I., García, J. R. and Ulloa, C. A. (2017): "Repercusiones del aumento del salario mínimo en España" BBVA Economic Watch. Available at: https://www.bbvaresearch.com/publicaciones/repercusiones-del-aumento-del-salario-minimo-en-espana/
23: To estimate the repercussions of the increase in the statutory minimum wage, we used the model proposed in Doménech, R., García J. R. and Ulloa C. (2018): "The effects of wage flexibility on activity and employment in Spain", Journal of Policy Modeling, Vol. 40 (6), 1200-1220.
24: The impact would be more severe if the minimum wage increase is conveyed to the rest of the wage distribution without a proportional increase of productivity. .
25: The estimates of BBVA Research would suggest that the minimum wage will come near 50% of the average private sector wage in 2019, nearly ten points more than in 2018.

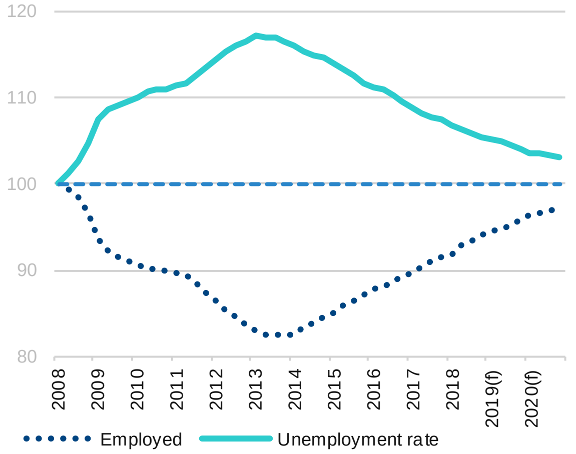
To mitigate the negative effects of the increase in the minimum wage, it should be accompanied by improvements in the efficiency of active labour market policies. It would be advisable to adopt stimulus strategies aimed at strengthening the employability of groups that may be most affected by the wage increase, particularly those whose qualifications would hinder achieving a level of productivity that is commensurate with the new threshold.

Figure 3.18 Spain: impact of 2019 minimum wage increase (Deviation from baseline scenario in pp)



Source: BBVA Research

Figure 3.19 Spain: level of employment and unemployment rate (1Q08 = 100. SWDA data)



(f) Forecast.
Source: BBVA Research based on INE (Spanish Office of National Statistics) data

Inflation will remain at moderate levels during the current biennium

The start of 2019 will continue to be marked by the slowdown in consumer prices. Headline inflation will probably stabilise in the second quarter of the year and close with an annual average of about 1.3% YoY (0.3 pp below that estimated three months ago, due to the downward revision in the price of oil). On the other hand, core inflation will remain virtually unchanged (1.0% YoY on average for 2019), supported by the expected fall in the unemployment rate and the stimuli still being supplied by monetary policy. In 2020 core inflation will continue to rise very gradually (1.2% on average per year) which, together with energy prices, will place headline inflation at 1.5% YoY.

If these estimates prove correct, the differential of headline inflation against the eurozone would become slightly favourable to Spain during the 2019-2020 biennium (-0.1 pp on average), having closed the gap in 2018.

The expansionary of fiscal policy stance leads to non-compliance with fiscal targets

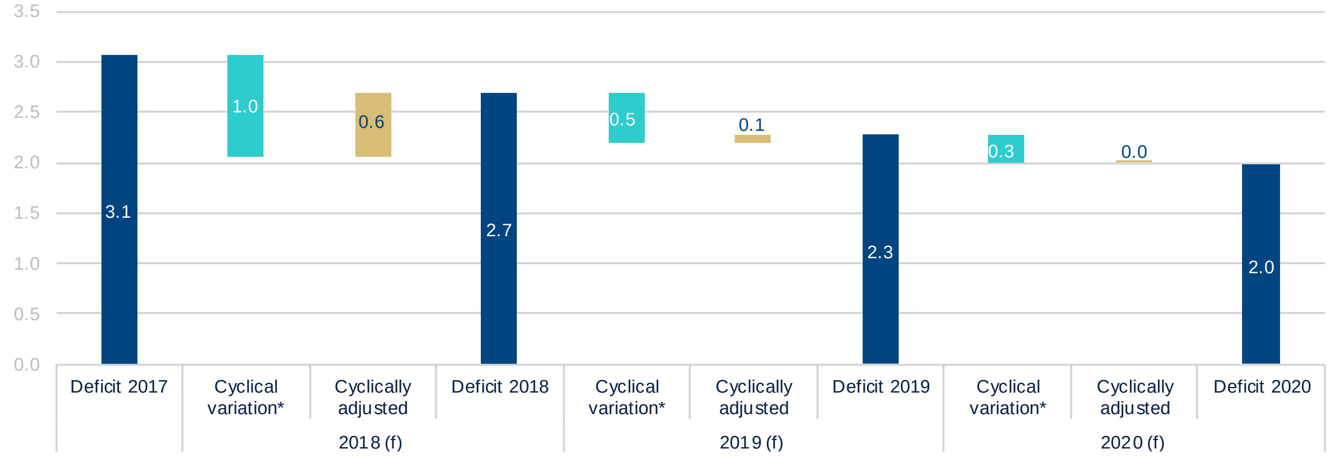
Available information on budgetary execution to November 2018 confirms the expansive stance of fiscal policy. The discretionary measures[26] approved in the 2018 Spanish National Budget, coupled with the acceleration of public expenditure in the second half of the year, increased the public expenditure to GDP ratio by about 0.6 pp, thus offsetting the positive impact of the upturn in the labour market and the lower costs of financing.

26: Among the measures approved, the following stand out due to their impact on activity: the rise in salaries for public sector employees, the increase in pensions, the partial reduction of income tax, and the authorisation to reinvest the surplus of the autonomous regions in 2017 in financially sustainable investments. All this amounts to a figure of €7.000 millions in 2018. It is expected that these pro-cyclical fiscal measures will give a boost to growth in the short term of between 0.3 pp and 0.8 pp over the 2018-2019 biennium.

On the contrary, tax revenue as a whole appears to have risen by more than expected at the start of the year, which facilitated a deficit reduction of 0.3 pp of the GDP. Hence, it is estimated that the public deficit stood at about 2.7% of the GDP at year-end 2018, above the target of budgetary stability (-2.2%) but in line with the forecasts of the Government.

Throughout the 2019-2020 biennium, the economic cycle will continue to reduce the deficit, both due to the effect of automatic stabilisers and the reduction of unemployment benefits, which will be accompanied by a lower interest burden arising from favourable financing conditions. However, this cyclical upturn will be partially offset by the impact of the measures approved towards the end of last year, all without taking into account the measures announced in the proposed National Budget for 2019.[27] As a result, the aggregate deficit of public administrations will decrease by only 0.4 pp in 2019, to 2.3% of GDP. For 2020, in a scenario with no changes in fiscal policy, a new cyclical correction of public accounts to 2.0% of GDP is expected (see Figure 3.20).

Figure 3.20. Public administration: breakdown of fiscal adjustment, excluding bail-outs of financial institutions (% of GDP)



(f) Forecast.
(1) Includes changes in interest charges.
Source: BBVA Research based on Ministry of the Treasury and INE (Spanish Office of National Statistics) data

In this scenario, we estimate that the structural primary balance will have deteriorated by around 0.6 pp of GDP in 2018, while for 2019 and 2020 we foresee a stabilisation of around -0.6% of GDP. Accordingly, Spain could have exited the excessive deficit protocol in 2018, but while failing to comply with the stability targets and the pace of structural adjustment required by the Commission (0.65 pp a year) to significantly reduce the high level of public debt (which is estimated to stand at around 97% in 2017).

The risks are mounting and could place a downward bias on growth in the coming biennium

Although the forecasts set out in this publication do not significantly differ from those presented three months ago, several elements of risk have gained in intensity and, if they materialise, could give rise to a major slowdown of activity during the current biennium. Internationally, a high degree of uncertainty remains regarding economic policy. First of all, trade tensions between the US and China persist and continue to place at

27 The forecasts made for this publication only take account the measures of fiscal policy that are in force. It should be noted that, in addition to the aforementioned 2.25% increase in the wages of public employees, on 28 December 2018 the Spanish Cabinet approved a 1.6% increase in contributory pensions and a 3% increase in non-contributory pensions (Royal Decree-Law 28/2018, of 28 December).

risk the future of global trade. Differences remain on structural questions, such as intellectual property rights, and the negative indirect effects on growth could worsen, such as upward pressure on costs, lower investment, and so on. Second of all, **changes in the US monetary policy strategy continue to condition the restructuring of investment portfolios and increased volatility in flows towards emerging markets**, some of which have exacerbated the reaction with economic policy errors. Lastly, in Europe, the probability of failure to reach an agreement on the United Kingdom's exit from the European Union has increased. Further, although uncertainty about the reduction of the public deficit in Italy is subsiding, tensions related to social unrest in France and other European countries have increased.

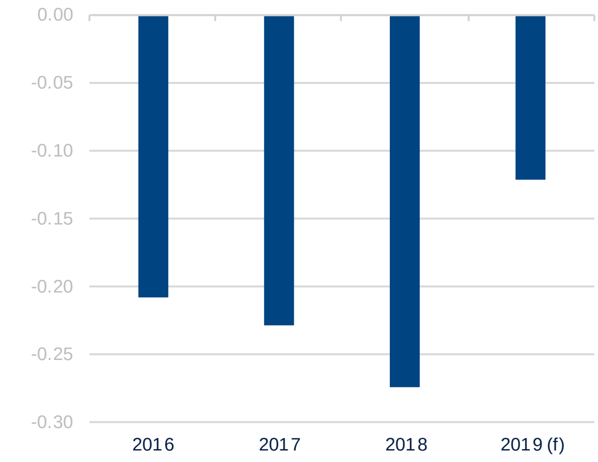
Domestically as well, the risks remain. First, **uncertainty about economic policy continues to be elevated**. For example, **in fiscal policy, there is no certainty regarding the approval of the 2019 Spanish National Budget**. The draft budget presented to the parliament by the Government on 14 January introduces few new features on what was announced in the budget plan of October 2018. One exception is the change in the deficit target to 1.3% of GDP, instead of 1.8% in the plan. This new target seems very ambitious, as it depends on the timely approval of new taxes on financial transactions and on digital services. To this we must add the upward pressure on public expenditure arising from the upcoming municipal and regional elections in 2019, and one-off outlays to bail out certain toll motorways and the cancellation of the concession of Aigües Ter-Llobregat. Lastly, forecasts on the impact of the economic cycle on revenues, particularly those of the Social Security, would appear to be optimistic. In the longer term, the challenges focus on improving the efficiency of public expenditure, ensuring the sustainability of public accounts and undertaking a comprehensive reform of territorial financing.

In this regard, the parliamentary fragmentation and, above all, the lack of consensus on the necessary measures to address the imbalances and limitations still shown by the Spanish economy, are a cause for concern. This had led to reversal of some of the reforms implemented in recent years, such as that of the pension system. Linking its increases to the CPI may endanger the sufficiency and sustainability of the system in the medium term, thus making additional measures necessary. Also, the increases in the cost of housing requires policies to incentivise the growth of supply. Here, several factors have added uncertainty in the real estate market, which could negatively affect investment decisions by enterprises and households. Among these are the ups and downs regarding the Supreme Court decision on payment of stamp duty and the measures announced to regulate the rental market. Beyond the one-off effect of some of these actions, uncertainty regarding economic policy has already been affecting activity for several years now: BBVA Research estimates that the impact on GDP growth has reached, on average per year, -0.2 pp since 2016 and, if it does not ease, it may continue to reduce GDP growth by more than 0.1 pp during the current year[28] (see Figure 3.21).

Further, **risks related to a possible exhaustion in the pace of job creation have increased** due, at least in part, to some economic policy measures adopted recently. Specifically, the sharp increase in the minimum wage should be accompanied by measures to boost productivity growth, so that labour demand is not negatively affected. Even further, in the present scenario, where the unemployment rate is gradually approaching its structural level and capacity restrictions or lack of skilled labour may begin to arise in specific sectors. In this regard, BBVA Research estimates indicate that the increase in compensation per employee for the economy as a whole should not exceed around 2% per year in the biennium for the unemployment rate to moderate in line with the forecasts presented in this publication[29] (see Figure 3.22).

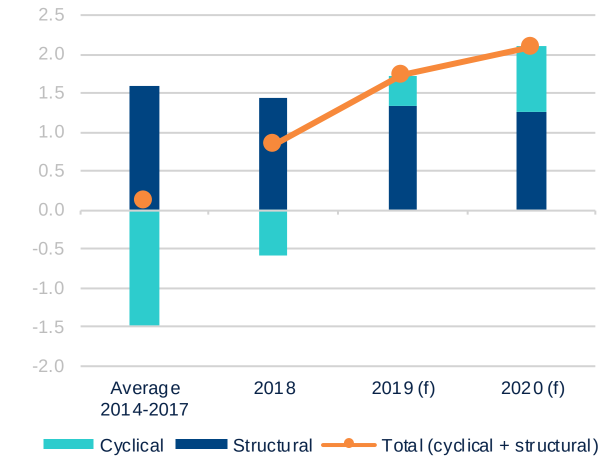
28: BBVA Research estimates indicate that increases in economic policy uncertainty since January 2016 drained nearly 0.3 pp from growth in 2016 and 2017. For more details on the estimate of the effects of economic policy uncertainty on activity in the Spanish economy, see Box 1 of the Spain Economic Outlook for the first quarter of 2016, available at: https://bit.ly/2NwxUZO
29: This threshold is the principle of agreement signed by the social partners to renew the State Collective Bargaining Agreement until 2020, which recommends a salary increase of 2% per year plus a variable 1%, which will be conditioned by the trend in productivity, business results and absenteeism, among other factors.

Figure 3.21 Spain: impact of economic policy uncertainty on GDP (Deviation from scenario level in absence of uncertainty)



(f) Forecast.
Source: BBVA Research based on INE (National Statistics Institute) data

Figure 3.22 Spain: breakdown of expected growth in remuneration per wage earner (%, YoY)



(f) Forecast.
Source: BBVA Research based on INE (Spanish National Institute of Statistics) data

4. Tables

Table 4.1 Macroeconomic forecasts Gross domestic product (Annual average %)

	2016	2017	2018	2019	2020
US	1.6	2.2	2.9	2.5	2.0
Eurozone	1.9	2.5	1.8	1.4	1.4
Germany	2.2	2.5	1.5	1.3	1.4
France	1.1	2.3	1.5	1.6	1.5
Italy	1.3	1.6	0.9	0.4	0.9
Spain	3.2	3.0	2.5	2.4	2.0
United Kingdom	1.8	1.8	1.4	1.5	1.7
Latin America*	-0.2	1.9	1.6	2.1	2.4
Mexico	2.7	2.3	2.2	2.0	2.2
Brazil	-3.3	1.1	1.2	2.2	1.8
Eagles**	5.3	5.4	5.2	5.0	5.0
Turkey	3.2	7.4	3.0	1.0	2.5
Asia and Pacific	5.6	5.6	5.5	5.3	5.2
Japan	0.6	1.9	0.9	1.0	0.6
China	6.7	6.8	6.6	6.0	5.8
Asia (ex. China)	4.6	4.6	4.5	4.7	4.6
World	3.3	3.7	3.6	3.5	3.4

* Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.
** Bangladesh, Brazil, China, Egypt, Philippines, India, Indonesia, Iran, Malaysia, Mexico, Nigeria, Pakistan, Russia, Turkey and Vietnam.
Forecast closing date: 1 February 2019.
Source: BBVA Research

Table 4.2 Inflation (Annual average %)

	2016	2017	2018	2019	2020
US	1.3	2.1	2.4	2.2	2.1
Eurozone	0.2	1.5	1.7	1.6	1.6
Germany	0.4	1.7	1.9	1.7	1.7
France	0.3	1.2	2.1	1.5	1.6
Italy	-0.1	1.3	1.2	1.3	1.5
Spain	-0.2	2.0	1.7	1.3	1.5
United Kingdom	0.7	2.7	2.5	1.9	1.8
Latin America*	9.6	6.5	7.3	7.6	5.8
Mexico	2.8	6.0	4.9	4.2	3.8
Brazil	8.2	3.3	3.9	4.1	5.0
Eagles**	4.4	4.0	4.7	5.1	4.7
Turkey	7.8	11.1	16.3	18.4	13.4
Asia and Pacific	2.3	2.0	2.3	2.6	2.9
Japan	-0.1	0.5	1.0	1.2	1.6
China	2.1	1.5	1.9	2.3	2.5
Asia (ex. China)	2.5	2.4	2.7	2.8	3.2
World	3.2	3.3	3.9	3.9	3.6

* Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.
** Bangladesh, Brazil, China, Egypt, Philippines, India, Indonesia, Iran, Malaysia, Mexico, Nigeria, Pakistan, Russia, Turkey and Vietnam.
Forecast closing date: 1 February 2019.
Source: BBVA Research

Table 4.3 Macroeconomic Forecasts: 10-year government bond yield (Annual average %)

	2016	2017	2018	2019	2020
US	1.84	2.33	2.91	3.09	3.43
Germany	0.13	0.37	0.46	0.48	1.11

Forecast closing date: 1 February 2019.
Source: BBVA Research

Table 4.4 Macroeconomic forecasts: exchange rates (Annual average %)

	2016	2017	2018	2019	2020
EUR-USD	0.90	0.89	0.85	0.86	0.81
USD-EUR	1.11	1.13	1.18	1.17	1.23
USD-GBP	1.35	1.29	1.33	1.41	1.49
JPY-USD	108.82	112.20	110.47	116.25	111.75
CNY-USD	6.64	6.76	6.61	6.78	6.68

Forecast closing date: 1 February 2019.
Source: BBVA Research

Table 4.5 Macroeconomic forecasts: official interest rates (End of period, %)

	2016	2017	2018	2019	2020
US	0.75	1.50	2.50	3.00	3.00
Eurozone	0.00	0.00	0.00	0.00	0.50
China	4.35	4.35	4.35	3.85	3.60

Forecast closing date: 1 February 2019.
Source: BBVA Research

Table 4.5 EMU: macroeconomic forecasts (YoY change. %. unless otherwise indicated)

	2016	2017	2018	2019	2020
GDP at constant prices	1.9	2.5	1.8	1.4	1.4
Private consumption	1.9	1.7	1.3	1.5	1.5
Public consumption	1.8	1.2	1.0	1.4	1.2
Gross fixed capital formation	4.0	2.9	3.3	2.9	2.4
Inventories (*)	0.1	-0.1	0.1	0.0	0.0
Internal demand (*)	2.3	1.7	1.8	1.7	1.6
Exports (goods and services)	3.0	5.4	3.0	3.1	3.0
Imports (goods and services)	4.2	4.1	3.1	4.0	3.6
External demand (*)	-0.4	0.8	0.1	-0.3	-0.2
Prices					
CPI	0.2	1.5	1.7	1.6	1.6
Core CPI	0.8	1.1	1.2	1.4	1.6
Labour market					
Employment	1.4	1.6	1.4	1.0	0.6
Unemployment rate (% of active population)	10.0	9.1	8.3	7.8	7.6
Public sector					
Deficit (% GDP)	-1.6	-1.0	-0.6	-0.9	-0.9
Debt (% GDP)	89.1	86.8	84.1	82.0	80.0
External sector					
Current account balance (% of GDP)	3.2	3.1	2.9	2.7	2.5

Forecast closing date: 1 February 2019.
Source: BBVA Research

Table 4.6 Spain: macroeconomic forecasts (Annual rates of change in %, unless otherwise indicated)

(Annual average, %)	2016	2017	2018	2019	2020
Activity					
Real GDP	3.2	3.0	2.5	2.4	2.0
Private consumption	2.8	2.5	2.4	2.1	1.8
Public consumption	1.0	1.9	2.3	2.4	1.7
Gross Fixed Capital Formation	2.9	4.8	5.2	4.6	4.6
Equipment and machinery	5.2	6.0	6.0	3.9	4.2
Construction	1.1	4.6	5.5	4.9	4.7
Housing	7.0	9.0	6.2	5.5	5.6
Domestic Demand (contribution to growth)	2.4	2.9	2.9	2.6	2.4
Exports	5.2	5.2	2.2	5.2	4.5
Imports	2.9	5.6	3.6	6.2	5.7
External Demand (contribution to growth)	0.8	0.1	-0.4	-0.2	-0.3
Nominal GDP	3.5	4.2	3.5	4.2	3.7
(Billions of euros)	1118.7	1166.3	1206.9	1257.3	1304.4
Labour market					
Employment, LFS (Labour Force Survey)	2.7	2.6	2.7	2.1	1.8
Unemployment rate (% of labour force)	19.6	17.2	15.3	13.8	12.6
Employment, FTE (Full Time Equivalent)	3.1	2.8	2.5	2.2	1.7
Productivity	0.1	0.1	0.0	0.2	0.3
Prices and costs					
CPI (annual average)	-0.2	2.0	1.7	1.3	1.5
CPI (end of period)	1.6	1.1	1.8	1.4	1.5
GDP deflator	0.3	1.2	0.9	1.8	1.7
Compensation per employee	-0.5	0.3	1.0	1.9	2.2
Unit labour cost	-0.6	0.2	1.0	1.7	1.9
External sector					
Current Account Balance (% GDP)	1.9	1.9	1.2	0.9	0.7
Public sector (*)					
Debt (% GDP)	99.0	98.1	97.5	95.9	94.4
Balance Public Admin. (% GDP)	-4.3	-3.1	-2.7	-2.3	-2.0
Households					
Nominal disposable income	1.8	1.6	3.7	4.7	5.2
Savings rate (% nominal disposable income)	8.0	5.7	5.4	6.6	8.0

Annual change in %, unless expressly indicated.
Forecast closing day: 1 February 2019.
(*) Excluding aid to Spanish banks.
Source: BBVA Research

5. Glossary

Initials

- AA. PP: Public Administrations
- AECB: Agreement for Employment and Collective Bargaining
- BBVA: Banco Bilbao Viscera Argentaria
- BBVA‐GAIN: BBVA's overall index of economic activity
- ECB: European Central Bank
- BOE: Spanish Official Gazette
- CC. OO: The Comisiones Obreras trade union
- CEOE: Confederación Española de Organizaciones Empresariales (“Spanish Confederation of Employers' Organisations”)
- CEPYME: Confederación Española de la Pequeña y Mediana Empresa
- (“Spanish Confederation of SMEs”)
- CG: Governing Council
- QNA: Quarterly National Accounts
- SCA Seasonally and calendar-adjusted data
- EAE‐BBVA: BBVA Economic Activity Survey
- EAGLES: Emerging and Growth-Leading Economies
- LFS: Labour Force Survey
- e.t.c / FTE: Employment (full-time equivalent)
- Euríbor: Euro Interbank Offered Rate
- FED: US Federal Reserve System
- NFCE: National Final Consumption Expenditure
- GDELT: The Global Database of Events, Language and Tone
- CPI: Consumer Price Index
- JPY: Japanese yen
- LATAM: Latin American countries. Includes Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.
- INE: Instituto Nacional de Estadística (Spanish Office of National Statistics)
- ME&SS Ministry of Employment and Social Security
- MICA-BBVA: BBVA Coinciding Activity Indicators Model
- MFPA Ministry of Finance and Public Administration
- GDP: Gross domestic product
- SME: Small and medium enterprise
- QE: Quantitative Easing
- RDL: Royal Decree-Law
- SMI: Salario mínimo interprofesional (legal minimum wage)
- APR: Annual Percentage Rate
- TPV/POS: POS terminal
- EU: European Union
- EMU: Economic and Monetary Union
- UGT: The Unión General de Trabajadores trade union
- USD: US dollar

Abbreviations

- YoY: Year-on-year change
- CI: Confidence Interval
- mM: Billions
- bps: Basis points
- MP: Market price
- pp: Percentage points
- QoQ: Quarterly change

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