BBVA Research

Creating Opportunities

Spain Economic Outlook

3Q19

Contents

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1. Editorial

The Spanish GDP could grow 2.3% in 2019 and 1.9% in 2020. The forecast for 2019 is slightly revised upwards, while 2020 remains unchanged. This level of growth would lead to the creation of around 810,000 jobs over the course of these two years and to the unemployment rate falling to around 12.2% by the end of the following year. This recovery is also expected to help reduce the public deficit to 1.9% of the GDP by the end of 2020. Although the growth composition is likely to reduce the current account balance, the surplus will continue.

Both in the first and second quarter of the year, the GDP growth has remained at around 0.7% QoQ. This shows an acceleration over what had been observed in the last 6 months of 2018 (0.5% QoQ), as well as a slight improvement of the levels forecast by BBVA Research last April (0.6%). This situation is due to an atypical growth composition, where the dynamism of both domestic demand and exports has dropped a little over what had been expected. A large share of the worse performance of domestic spending and sales abroad has reduced import growth, limiting its impact on domestic production and, therefore, on growth.

The negative performance of domestic demand was particularly significant in private consumption and public spending. The acceleration in household spending that had been expected in the short term has not come to fruition. Specifically, the rise of gross disposable income has been somewhat below the level forecast, and the increase that has actually taken place has had a diminishing impact on consumption. The first of these has been surprising in light of the increase in the minimum wage and measures such as the increase in pensions and civil servant wage rises, offset by the increase in the Social Security contribution base. The second one could be the consequence of a number of factors. For instance, the rise in income is becoming increasingly concentrated in sectors that are less likely to consume. In addition, the growing uncertainty with regard to economic policy could have affected household confidence. An example of the above is the decline observed in car purchases, which remains below the levels seen a year ago. In connection with this, a moderation in the growth of consumer loans has also been observed. As for fiscal policy, it has been less expansionary than predicted, particularly in light of the performance of consumption and the investment made by public administrations in the context of an election. Neither one has shown an important acceleration, having diverted from the patterns observed in other similar years.

The weakness of the flow of trade of goods overseas continues to be higher than expected. The sale of goods to other countries appears to have reached a turning point after declining last year. However, growth has not been as strong as had been expected. Among the good news is the recovery of exports to European economies, as well as the fact that the automotive sector shows signs of recovering. Nevertheless, a number of factors continue to have a negative impact on industrial production. On the one hand, regulatory issues and the uncertainty regarding potential tariff increases are having a disruptive effect on value chains worldwide. On the other, the higher market volatility and adjustments observed in emerging economies are causing a drop in sales tothose countries. Lastly, the doubts regarding Brexit continue to have a negative impact on the manufacturing sector.

Among the more positive trends of the first half of the year is the strong growth observed in several components of investment and the unexpected resilience of the tourism sector. The increase in spending on machinery and equipment in a context of high uncertainty has been particularly significant, insofar as it indicates gains in market share on a global level over the coming quarters. In addition, the increase in housing investment remains steady as a result of the strong adjustment of previous years and the improvement in a number of fundamentals which help support the performance of both businesses and buyers. On the other hand, the resilience of non-resident consumption has been surprising, having left behind the negative impact of certain factors affecting it over the previous year. Such factors include a worse perception of safety associated with the terrorist attacks of August 2017 and the political uncertainty in Catalonia. Moreover, the sector has managed to halt the decline that had been observed in competitiveness indicators, additionally showing signs of a change of focus towards higher value added tourism.

This atypical growth pattern could be due to temporary causes. The trend points towards a slowdown, in the absence of a stronger recovery of the global economy and particularly of the Eurozone. With regard to household expenditure, the growth moderation trend will become more entrenched. A number of the stimuli of previous quarters, such as increased transfers from public administrations and the rise in the minimum wage, will diminish. Moreover, there are structural factors that indicate a downturn in dynamism in the coming quarters. Among those not yet mentioned is the exhaustion of pent-up demand during the crisis and medium-term factors such as the aging population. As for fiscal policy, the likelihood of approving the General State Budget for 2019 is dwindling, whereas the swearing-in of the new governments could slow down decision-making. This may lead to a change in the fiscal stance during the second half of the year. In addition, although housing investment is expected to continue to grow, its performance has been less positive than the levels suggested by its fundamentals. This could be due to factors related to the regulatory uncertainty surrounding the sector. With regard to all other areas of investment, their response to the decline observed in business margins over recent quarters is yet to be seen. In addition, there are concerns that despite the strength displayed by the sector, the accumulation of machinery and equipment has not translated into sustained growth in productivity. Lastly, no definitive resolution to the widespread uncertainty regarding international trade is expected to come about. Furthermore, the EMU continues to show relatively low growth rates, reducing the room for further growth of Spanish exports. Moreover, the sharp adjustment of imports appears to be more of a one-off situation, related to specific sectors, as opposed to a sustained process of increased competitiveness.

The most likely scenario is that the recovery will continue, with monetary policy becoming its main source of support. The growing trade tensions between the US, China and the EMU, along with the slowdown of their economies, have led the central banks to rethink their strategy for the future. In the case of the Federal Reserve, the prevention of risk scenarios has led to a change in interest rate expectations. From the potential increases in the second half of the year, a drop in rates is now expected. As for the ECB, a number of factors indicate imminent monetary stimulus measures. Among these are the need to maintain a competitive exchange rate with the US dollar, the low growth currently experienced by the European economy and, above all, the fall in inflation expectations, well below the ECB target. Among the announcements that could be expected are making the rise in interest rates contingent upon the improvement of such expectations instead of setting them for a specific period of time, additional drops in interest rates on deposits towards a more negative range or even the reactivation of the asset purchase program. As the market has been putting such measures in place, the historically low financing costs for the Spanish economy have been consolidated, particularly for longer periods. This will help support spending, by releasing income for consumption and public spending, improving the expected returns from investment projects and boosting credit offerings. On the other hand, the tensions that have adversely affected trade flows over the year are expected to gradually die down. This would help stabilize the value chains worldwide and reactivate domestic exports. Moreover, oil prices have returned to levels below the average observed in the previous year. Insofar as this is largely transferred to the cost of energy and fuel paid by Spanish companies, it should help drive competitiveness.

At a domestic level, the greater level of uncertainty regarding economic policy seems to be having a limited effect on activity. However, there is a clear need for reforms designed to help reverse the trend towards slowdown, to reduce structural unemployment and increase potential growth, which are key to reducing inequality. The election has confirmed the increased fragmentation of the Spanish parliament. This is a problem insofar as it decreases the likelihood that the consensus required to implement reforms to boost growth and render it inclusive will be achieved. It can also become an area of concern if the only pacts possible lead to a decline in fiscal balance or measures that discourage saving and investment. In any event, the current context of growth and low interest rates still make it possible to advance in reforms that help reduce the imbalances still in existence in the Spanish economy. In addition, the impact of the monetary policy is diminishing, and therefore the reversal of the current trends will depend on the action taken by the national governments. In this regard, the assessment process of a part of public spending carried out by the AIReF appears hopeful, although it is necessary for the results to be used to review public policies and improve their efficiency. The ideal situation would be the consolidation in Spain of a culture of generalized assessment of public policies, enabling the population to be informed of the costs and benefits of implementing certain measures. This would have been useful with regard to the debates on the effect of policies such as the minimum wage increase or the changes in the regulation of housing rentals. In addition, it would play a key role in the design of the demanding challenges still faced by the Spanish economy, such as the structurally high unemployment rate, the level of temporary employment, the low growth in productivity (and wages), inequality, the fiscal deficit and the consequences of an aging population.

2. Global environment: trade tensions and the reaction of central banks condition global growth

In recent months, the rise of protectionism has intensified and trade tensions have increased. **Although the USA and China announced a truce during the last G20 summit that provided an opportunity to resume negotiations, doubts about a final agreement will not go away easily and will continue to slow down global growth**. In this context, with continued low inflation and prominent growth risks, **the central banks have changed their stance and seem to be inclined to reduce interest rates again**. This shift by monetary authorities is expected to offset the negative effect of increased trade tensions and stabilise global growth, although at lower levels than in previous years.

The escalation of protectionism remains a source of uncertainty, even after the latest trade truce between the USA and China

Over the past few months, we have seen how trade disputes have intensified, which has been further exacerbated by tensions regarding technology. The US government announced new tariff increases from 10% to 25% on imports from China worth USD 200 billion, and threatened to extend them to all other imports (an additional USD 230 billion). It also added Huawei to a blacklist of companies, thereby blocking business transactions. For its part, China responded with tariffs of 25% on imports from the USA worth USD 60 billion. However, **at the most recent G20 summit, a truce was declared** (although tariff increases have not been rolled back), thereby cooling tensions and allowing negotiations to be resumed. In any case, although the worst-case scenario has been avoided, the intensity and extent of the issues being disputed suggest that it won't be easy to come to a trade agreement, and that tensions between the two countries will continue in the future.

Despite new monetary stimuli, there is a strong safe-haven effect in the financial markets

The high uncertainty generated by trade tensions strongly increased risk aversion in the markets, in such a way that the VIX rose significantly to around 20 (+7 bp) during the first half of May, triggering an adjustment in world stock markets of an average of 6%. All of this increased the safe-haven demand and, together with the more accommodating attitude of the central banks, caused the ten-year German bond yield to reach a historic low, and the ten-year US bond yield to fall to lows seen in 2016 (see Graph 2.1). However, the reduced level of safe-haven asset yields and the confidence that the action from central banks will sustain growth have generated a search for alternative yields, which has resulted in both an increase in the stock markets (the S&P 500 has once again reached historically high levels) and in the bonds of emerging countries and peripheral European countries. In any case, the lack of a generalized risk appetite continues to be felt.

In a context of high uncertainty and low inflation, trade tensions have led central banks to reassess their policy

To counter the negative effects of increased protectionism and the concern on the global markets, **the Federal Reserve and the ECB (in this order) have indicated their intention to adopt new stimulus measures** as insurance against increasingly likely risk scenarios and to counteract the continued decline in long-term inflation expectations. The Federal Reserve made changes to its 19 June meeting statement that set the stage for the start of interest rate cuts. It warned that inflation could fall below the 2% target, changed the description of its growth rating from 'solid' to 'moderate' and, faced with trade threats and political uncertainty, changed its approach from patience to close monitoring. For its part, the ECB has reinforced its accommodating stance on monetary policy, approving a new liquidity provision programme (LTRO-III) and delaying its commitment to maintain interest rates at current levels from the end of 2019 to the middle of 2020. In addition, it has noted that it has a range of instruments to combat the risks of low growth and inflation, including reducing deposit rates and revitalising the bond purchase programme (QE), which is a development on previous communications.

For its part, **China announced that it had a lot of room to adjust its monetary policy if the trade conflict intensified.** In fact, cuts to loan rates and the banks' required reserve ratio (RRR) are expected. It also announced that it will use USD 43 billion in rediscount quotas and standing lending facilities (SLFs), and that it will begin accepting interbank certificates of deposits and bank certificates as collateral for small banks to support liquidity. **As regards fiscal policy,** there will be increased debt issuance by local governments and a USD 14.5 billion training plan for those individuals who have lost their jobs due to the slowdown.

World growth continues in a slight downwards trend

In the second half of 2018, world growth was below the average of previous years. This is due, in large part, to the poor performance of exports, which have remained virtually stagnant since the middle of last year and have mainly affected the manufacturing industry. **Activity data shows how the manufacturing sector has continued to slow down during the first four months of 2019,** despite a good March. **This trend will most likely continue,** as manufacturing PMIs continued to fall in May and June, tumbling into contraction territory. Overall, however, **growth in the first quarter of 2019 regained some momentum**, although it remained below average.

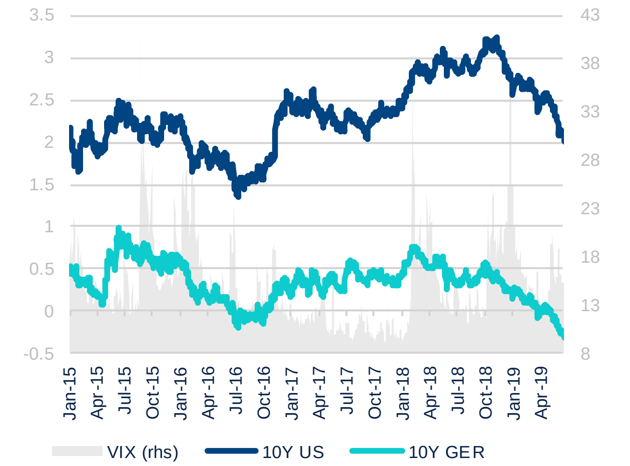
For the rest of the year, there is a risk that weak manufacturing and exports will end up infecting the services sector, which remains relatively robust, supported by the strength of employment growth and low inflation. In this regard, **our BBVA-GAIN model suggests a stable quarterly growth of around 0.8% at the global level,** in line with our forecast (3.3%) for 2019 annual growth.

The scenario for growth remains almost unchanged, but downside risks are rising

The base scenario incorporates the **assumption that the USA and China will eventually come to a trade agreement, possibly towards the end of the year**, thus cooling trade tensions, although not eliminating them. It is also expected that there will be no significant increase in tensions between the USA and Europe (the US threat to increase automobile tariffs still looms). **In principle, the UK leaving the EU should not have any significant impact** on the global economy. In addition, with regard to the crude oil market, a slight reduction in the Brent price is anticipated (from around USD 68 per barrel in the second quarter of the year to around USD 62 and USD 55 at the close of 2019 and 2020, respectively) owing to the increase in supply from the USA and the fall in demand, which more than offsets the OPEC production cuts.

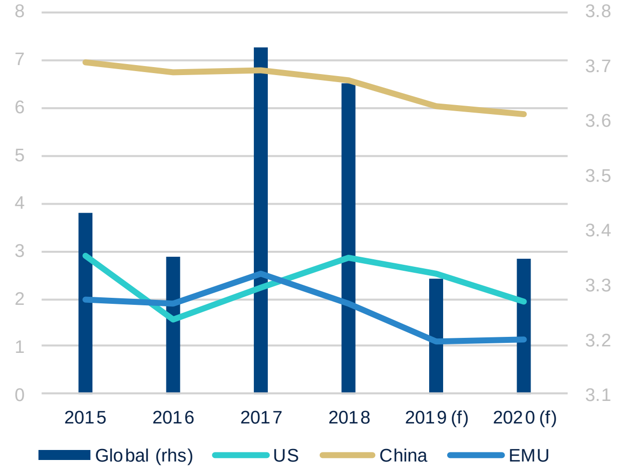
Lastly, **it is expected that monetary stimuli will offset the effects of prolonged trade tensions and potential future shocks**, although both factors operate through different channels, with trading uncertainty being a negative supply factor and monetary stimuli being a positive demand stimulus. Global growth would therefore stabilize at lower levels than in previous years. We therefore maintain the forecast **that global GDP, which climbed 3.7% in 2018, will grow by 3.3% in 2019 and in 2020** (see Graph 2.2).

Figure 2.1. **SOVEREIGN DEBT YIELDS**



Source: Bloomberg and BBVA Research

Figure 2.2. **ANNUAL GDP GROWTH 2015–2020 (*) (%)**



(f) Forecast
Source: BBVA Research

In the USA, growth should gradually lose momentum, moving towards its potential growth rates. In particular, **US GDP is estimated to grow by 2.5% in 2019 and by 2.0% in 2020, after the 2.9% growth recorded in 2018.** In order to sustain the economic expansion in a context of risks of lower growth and low inflation, the **Federal Reserve is in a position to start an expansion cycle in 3Q19**, **reducing its rates by up to 75 bp** over the next few quarters, and then keeping them stable until 2022.

In Europe, growth will be more modest owing to a weak manufacturing industry and high uncertainty (trade and Brexit). It is therefore expected that **the ECB will strengthen its forward guidance and further reduce deposit rates (-10 bp in 3Q19),** leaving them unchanged until the end of 2021. In addition, it is anticipated that a staggered deposit system will be adopted, and, if the situation worsens, that quantitative easing (QE) measures will be re-implemented. Therefore, **the scenario for Europe remains the same with very few changes**. With the strong data from the first quarter, **growth has been revised upwards in 2019 by one tenth to 1.1%** and, owing to the persistent weakness of the industrial sector and the greater uncertainty, there has been a **slight downwards revision for 2020 of one tenth to 1.2%.**

In China, more fiscal stimulus measures are expected (tax cuts and growth of regional government debt) that, along with loan interest rate cuts, bank swaps and specific medium-term credit, among other measures, can sustain the country's growth, therefore countering the negative effect of the trade war. These stimulus measures **will help GDP to grow by 6.0% in 2019 and 5.8% in 2020, in line with previous forecasts.**

Although the view of the global economy does not differ much from what was published in the previous edition of this report, the risks to this global scenario are relatively higher due to the escalation of protectionism and its potential impact at the global level. An expansion in trade tensions to other sectors and countries is also not to be ruled out, as US tariff threats to the automobile sector are still pending. There is also an increased risk that the USA will enter an economic downturn, while political risks in Europe remain relevant (Brexit and fiscal policy in Italy). Lastly, China's stimuli stop the country's deleveraging process and therefore increase its vulnerability in the medium and long term.

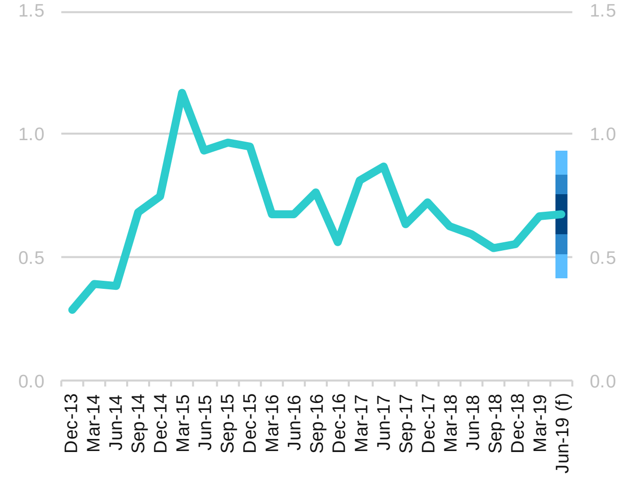
3. Growth outlook for the Spanish economy

Activity maintains a high rate of growth

The data available at the time of writing suggests that **the Spanish economy may have grown between 0.6% and 0.7% QoQ SWDA[1] (between 2.3% and 2.4% YoY) in 2Q19** (forecast using the MICA-BBVA model).[2] Should this estimate be confirmed, the growth of economic activity between April and June would be in line with the forecasts made at the beginning of the quarter (MICA-BBVA: between 0.6% and 0.8% QoQ) and the data observed in the previous quarter (0.7% QoQ in 1Q19).

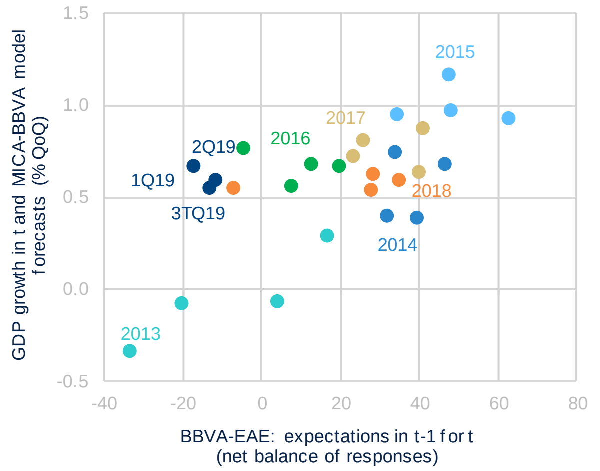
Looking ahead to the third quarter, BBVA Research's real-time estimates suggest that GDP growth could slow slightly (MICA-BBVA model forecast: between 0.5% and 0.7% QoQ). Furthermore, uncertainty regarding the pace of progress remains significant, as illustrated by the results of the BBVA Economic Activity Survey[3] (EAE-BBVA), which are yet to indicate any rolling back of the deterioration seen in expectations during the last year (see Figure 3.2).

Figure 3.1. **SPAIN: OBSERVED GROWTH IN GDP AND FORECASTS OF THE MICA-BBVA MODEL** (% QoQ)



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

Figure 3.2. **SPAIN: ECONOMIC GROWTH AND EXPECTATIONS OF PARTICIPANTS IN THE EAE-BBVA IN THE PREVIOUS QUARTER**



Net balance between positive and negative responses.
Source: BBVA Research

1 SWDA: Seasonally- and working day-adjusted data.
2 For more details on the MICA-BBVA model, see M. Camacho and R. Doménech (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 For details on the BBVA Economic Activity Survey (EAE-BBVA), see Box 1 of the Spain Economic Outlook (Situación España) journal for the second quarter of 2014, available at: https://bit.ly/2pKEh31

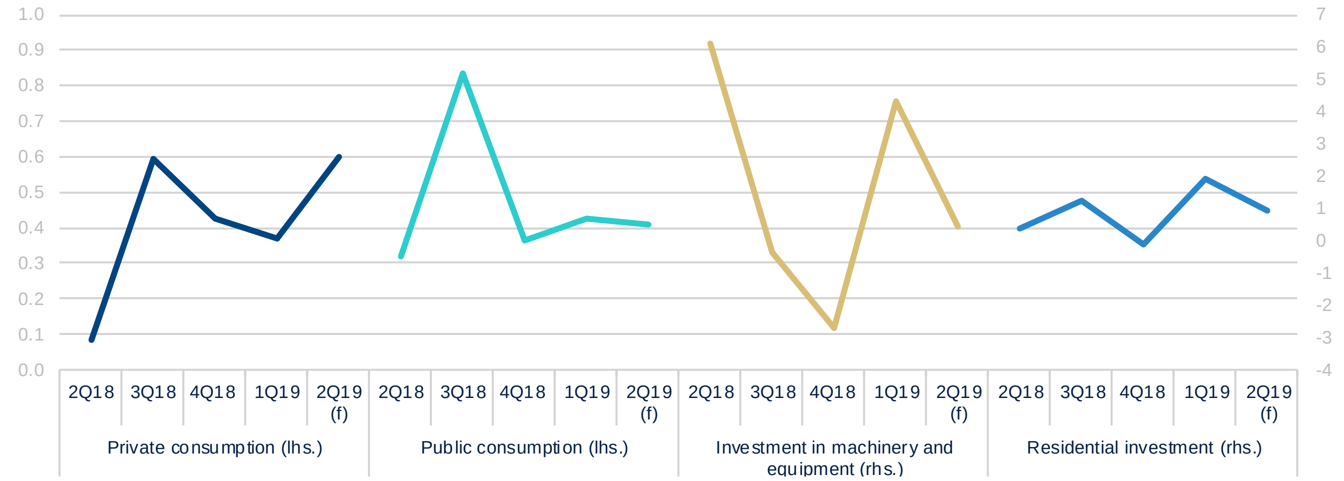
Domestic demand leads growth, boosted by consumption and residential investment

Private consumption expenditure could recover some of the buoyancy lost in the first quarter, while public consumption is expected to grow at a stable pace. Thus, spending indicators[4] suggest that household consumption may have increased by around 0.6% QoQ (2.0% YoY) in the second quarter, after a slowdown in growth at the end of last quarter (0.4% QoQ, 1.5% YoY in 1Q19). Meanwhile, the available budget execution data indicates that consumption expenditure by the public administration may have grown by 0.4% QoQ (2.1% YoY) in 2Q19, in line with the growth posted in the previous two quarters.

Albeit its lower pace, investment should continue to support domestic demand growth. Partial short-term indicators suggest that investment in machinery and equipment grow at a moderate pace (0.5% QoQ; 1.6% YoY), sustaining robust activity growth after the strong recovery observed in 1Q19 (4.3% QoQ; 7.3% YoY).[5] Similarly, residential investment is estimated to have eased to 0.9% QoQ (4.0% YoY), following the recovery observed last quarter (1.9% QoQ, 3.4% YoY in 1Q19).[6] Finally, quarterly growth in investment in other construction is thought to be recovering (0.6% QoQ; 1.7% YoY), after the decline registered in the first quarter (-1.5% QoQ; 5.1% YoY).

In summary, partial short-term indicators suggest that **domestic demand would account for 0.6 pp of GDP growth in 2Q19** (2.0 pp YoY), driven by an improvement in all items (see Figure 3.3).

Figure 3.3. **SPAIN: OBSERVED GROWTH AND ESTIMATES FOR THE MAJOR COMPONENTS OF DOMESTIC DEMAND (% QoQ)**



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

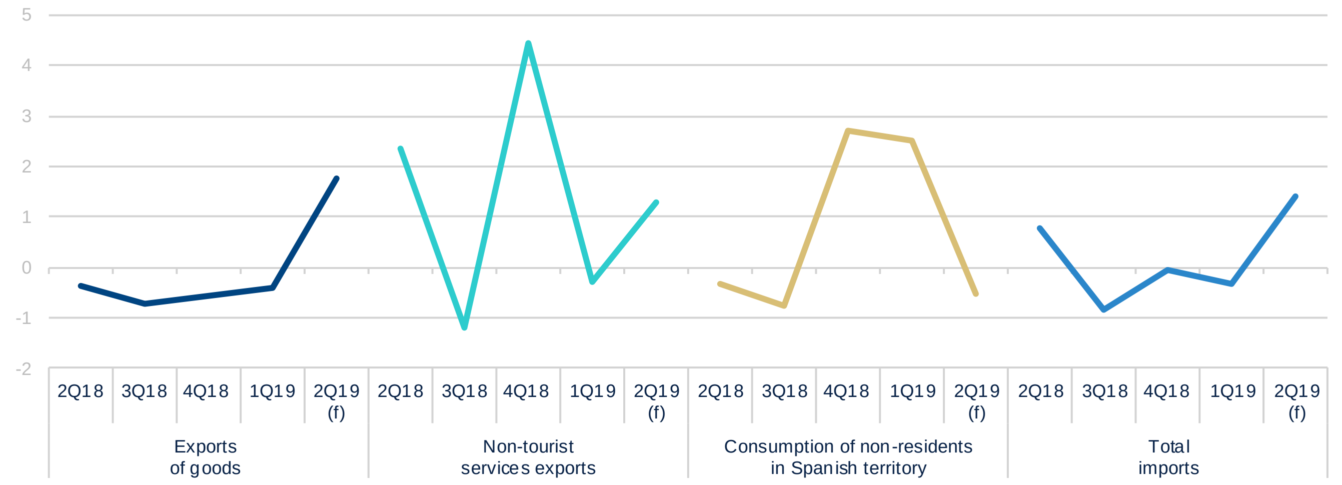
4 As last quarter, spending indicators are showing mixed signs. Car registrations grew at a similar rate to that of the first quarter, despite the negative contribution of the private channel. Activity in the service sector also remained buoyant. However, domestic sales of consumer goods by large companies and retail sales would have lost traction in the second quarter. With regard to resource indicators, there was a slowdown in the growth of real wage income, due to the slowdown in job creation and consumer finance, but a rise in stock prices. Although households' perception of the economy is deteriorating, their intentions to purchase durable goods remain.
5 Many indicators for investment in machinery and equipment point to a negative trend in 2Q19. Only the industrial goods order portfolio suggests a recovery compared to the previous quarter. Industrial confidence again deteriorated for the third consecutive quarter. In addition, both the sale of industrial vehicles and imports of capital goods shrank compared to 1Q19. Finally, data for the first two months of 2Q19 indicates that the IPI remained stagnant compared to the previous quarter.
6 Most residential investment indicators showed positive trends in 2Q19, although somewhat more moderate than in previous periods. Thus, employment grew less than in the previous quarter. In turn, permits remain on the rise. Finally, the sentiment index for entrepreneurs in the sector deteriorated considerably compared to the previous quarter.

Trade flows recover some traction in the second quarter, although future trends remain a concern

Exports of goods and services are likely to have grown 1.4% QoQ (1.3% YoY) in the second quarter, following a disappointing start to 2019 (see Figure 3.4). In particular, despite high levels of uncertainty, exports of goods may have grown by 1.8% QoQ (0.0% YoY) in 2Q19, after showing declines in the previous four quarters.[7] On the other hand, exports of services remained in positive territory (0.5% QoQ, 4.1% YoY), spearheaded by services not linked to foreign tourism (1.3% QoQ; 4.2% YoY), while consumption of non-residents in the domestic territory shrank (-0.5% QoQ; 4.0% YoY), following strong gains in 4Q18 and 1Q19.[8]

In line with the performance of final demand, data available at the time of writing suggests that imports expanded 1.4% QoQ (0.1% YoY) in the second quarter of the year, recovering some dynamism following a dip in 1Q19 (-0.3% QoQ; -0.5% YoY). This, together with the expected performance of total exports, would mean that **net external demand contributed 0.0 pp QoQ (0.4 pp YoY) to growth of the Spanish economy in the second quarter**.

Figure 3.4. **SPAIN: OBSERVED GROWTH AND ESTIMATES OF THE MAJOR COMPONENTS OF EXTERNAL DEMAND (% QoQ)**



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

The pace of job creation also remained stable

Seasonally adjusted Social Security affiliation increased by 0.6% QoQ in the second quarter of 2019 (2.8% YoY), one-tenth down with respect to the first quarter, standing at 19,550,000 contributors in June (see Figure 3.5).[9] The decline in registered unemployment, which was present across all sectors, also lost further momentum between April and June. Thus, the number of unemployed individuals shrank by -0.8% QoQ SWDA (-5.0% YoY), four tenths less than in the previous quarter.[10]

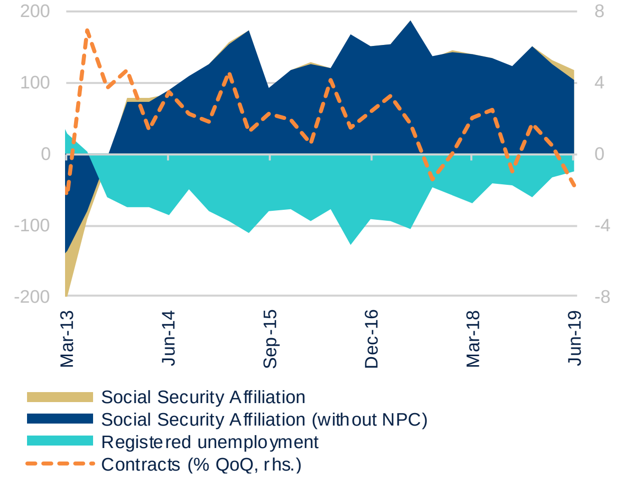
7 Partial indicators for overseas sales showed mixed signals. On the one hand, the available balance of trade information points to a strong surge in exports during 2Q19 (3.5% MoM SWDA in April). However, exports from major companies grew by only 0.3% MoM SWDA in April, while the order-book exports continued the negative trend that began at the start of the year.
8 Overnight hotel stays from non-resident tourists dropped by 0.9% MoM SWDA on average in April and May. Tourist arrivals at the border were down by 2.6% MoM during the same period. Tourism revenue on the balance of payments grew by 0.7% MoM SWDA in April.
9 As of April 1, the central state resumed Social Security payments under the special agreement for non-professional carers of dependent individuals, driving up numbers in this group by 32,800 persons in May. Excluding non-professional carers, the rally in affiliation during the second quarter would have been somewhat more modest (0.5% QoQ SWDA; 2.7% YoY).
10 Since mid-2013, Social Security affiliation has grown by 19% SWDA, but is still 1% below the pre-crisis peak reached in early 2008. Although unemployment has fallen by 36% in the last five years, it remains 59% higher than in mid-2007.

The statutory minimum wage (SMI) hike, in effect since January, is having a limited impact on employment. The data available through to June suggests a worse performance in Social Security registrations among young people, those engaged in traditionally low-wage service activities (such as retail or hospitality) and residents of Andalusia, the Canary Islands, Extremadura and the Region of Murcia. As Figure 3.7 illustrates, the number of employees under 30 declined in the first half of 2019 by 0.8% compared to the second half of 2018, four tenths below the first half of both 2017 and 2018. A similar trend can be seen when comparing affiliation in sectors or regions with higher minimum wage levels in the first half of the current year compared to the same period in previous years. There is no evidence of a shift from salaried employment to self-employment as a result of the minimum wage hike. In fact, the trend in terms of social security registrations in the general category, which would potentially be the most affected by the higher minimum wage, is in line with overall affiliation data.

In contrast with Social Security registrations and unemployment data, the number of contracts declined in the second quarter. Having expanded 0.5% QoQ SWDA (4.0% YoY) in 1Q19, hiring was down 1.7% QoQ (-0.6% YoY) between April and June, both due to a slide in permanent recruitment (-1.6% QoQ SWDA; -8.5% YoY) and, above all, a drop in temporary hiring (-1.8% QoQ SWDA; 0.2% YoY). As a result, the temporary employment rate fell by one tenth to 90.5% SWDA. As illustrated in Figure 3.6. the percentage of temporary contracts stands two points lower than the figure at the end of 2013.

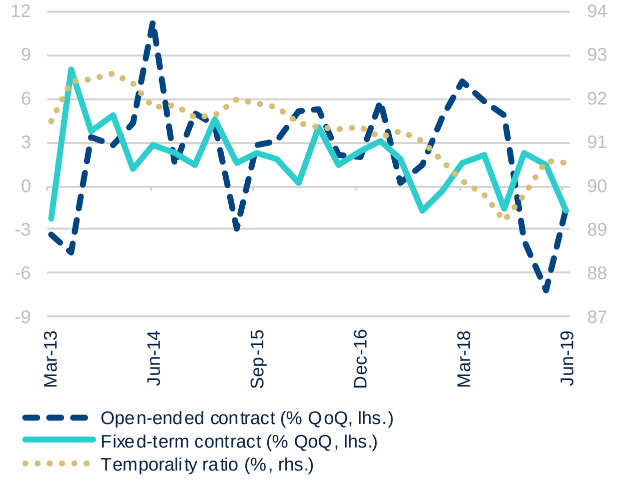
The Labor Force Survey (LFS) for 2Q19 is expected to confirm the trend indicated by Social Security affiliation and unemployment figures. Employment seems to have increased by around 0.6% QoQ SWDA (2.7% YoY), about one tenth less than in 1Q19. If the active population barely grows, as expected, the rise in employment would bring about a four-tenth drop in the unemployment rate, down to 13.6% SWDA. [11]

Figure 3.5. **SPAIN: LABOR MARKET INDICATORS (SWDA DATA QUARTERLY CHANGE IN THOUSANDS OF PEOPLE, EXCEPT WHERE INDICATED OTHERWISE)**



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

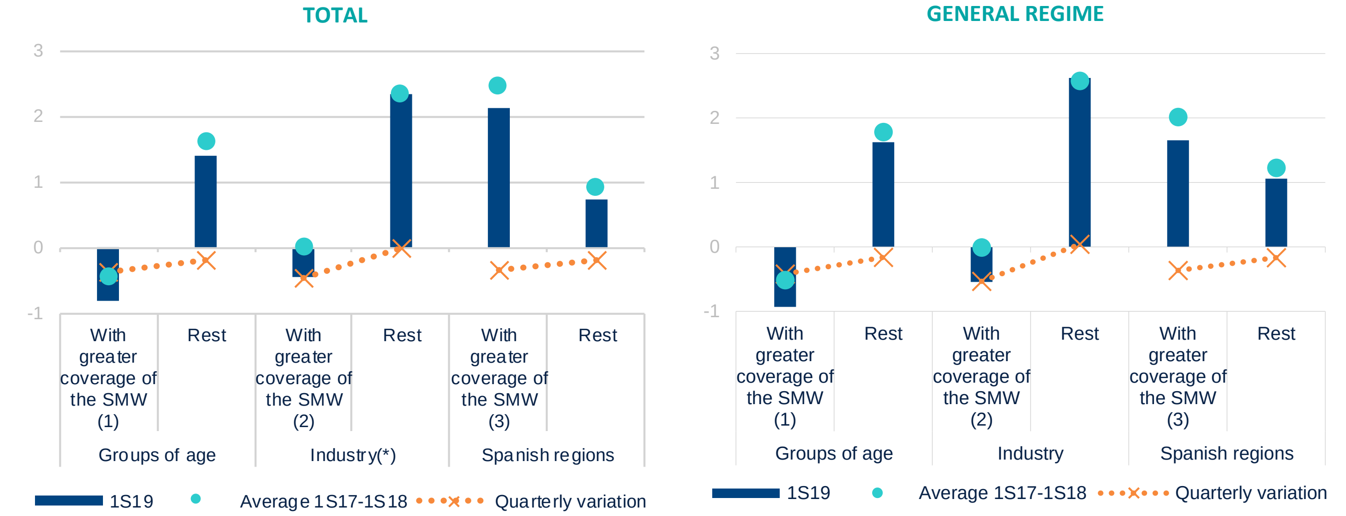
Figure 3.6. **SPAIN: TREND IN RECRUITMENT (SWDA DATA)**



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

11 Given the positive seasonality of the period, the gross unemployment rate would stand at 13.4% in 2Q19.

Figure 3.7. **SPAIN: VARIATION IN SOCIAL SECURITY AFFILIATION IN THE FIRST SEMESTER** (1S VS 2S, %)



(*) General regime and self-employment regime.
(1) People under 30.
(2) Commerce, hospitality, real estate activities, professional, administrative and artistic activities and other services.
(3) Canary Islands, Extremadura, Andalusia and Murcia.
Source: BBVA Research based on Ministry of Labor, Migration and Social Security data

Prices ease, while wage demands stabilize

Following the rebound observed during the first quarter of the year, headline inflation eased between April and June to 0.4% YoY (see Figure 3.8). This trend was affected by a downward correction to energy prices, which slowed 8.0 pp between April and June to -2.6% YoY, due to the base effect of price growth a year ago and declining fuel and electricity prices. Core inflation remained stable throughout 2Q19 and ended June at 0.9% YoY.

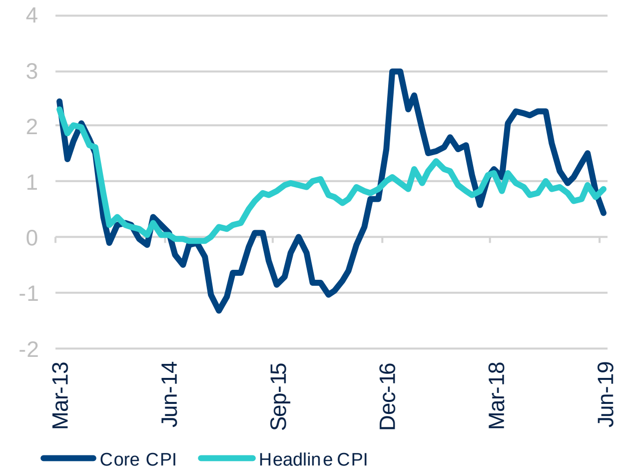
In this context, the headline inflation differential with the Eurozone was again in Spain's favor during 2Q19 (-0.6 pp YoY in June). BBVA Research estimates, which take core inflation as a reference, suggest that the price growth differential stood at -0.5% YoY in June.

Wage demands stabilized during the second quarter. The average wage growth agreed in collective bargaining agreements in the year through May stood at over 2.2% YoY, in line with the figure at the end of the first quarter. Compensation growth agreed in revised multi-year agreements was slightly lower than that for the current year (2.3%), which is applicable to just 380,400 workers.[12] As seen in Figure 3.9, the wage increase established in the agreements signed up to May exceeds by 0.2 pp the minimum level recommended in the 4th Agreement for Employment and Collective Bargaining (AENC).[13]

Sluggish inflation suggests that wage growth - in particular, the minimum wage hike of 2019 - has not yet been passed on to final prices. As Figure 3.10 illustrates, although the contribution made by compensation of employees to GDP deflator growth has increased during the current year, companies have narrowed their margins down, meaning price hikes have been moderate.

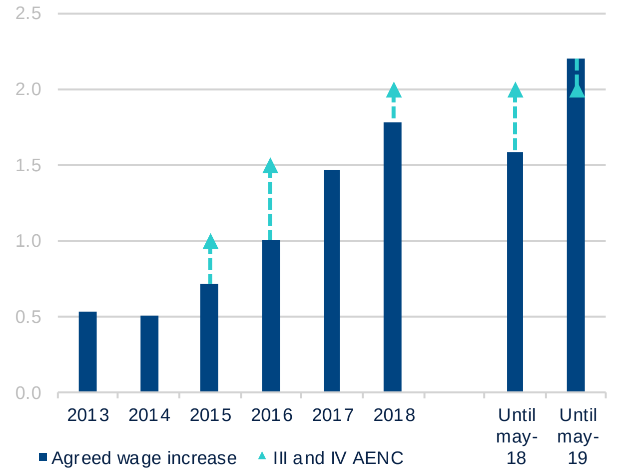
12 The number of employees included in collective bargaining agreements stood at over 7,450,000 through to May, when those affected by agreements signed before 2019 (7,070,000) were included, up 30% compared to the first five months of last year.
13 The 4th AENC, which was signed in early July 2018 by the CEOE, CEPYME, Workers' Commissions (Comisiones Obreras) and UGT, recommends wage increases of around 2% in 2018, 2019 and 2020, plus a variable portion that depends, among other factors, on productivity, the company's earnings and levels of unjustified absenteeism.

Figure 3.8. **SPAIN: HEADLINE AND CORE INFLATION** (% YoY)



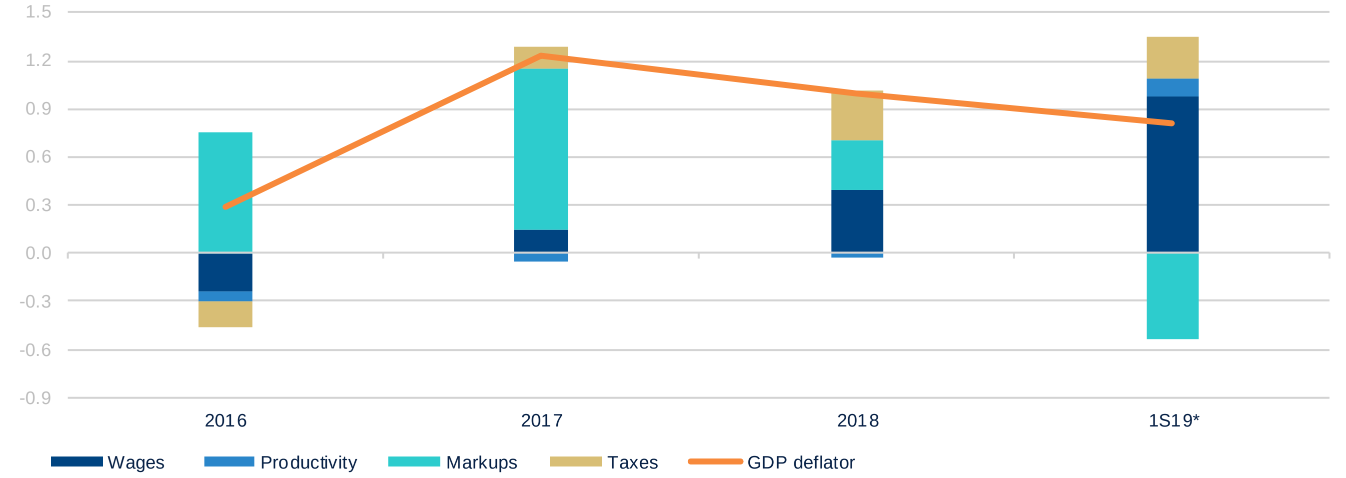
Source: BBVA Research, based on INE (Spanish National Statistics Institute) data.

Figure 3.9. **SPAIN: AVERAGE WAGE INCREASE AGREED IN COLLECTIVE AGREEMENTS** (% YoY)



Annual data includes agreements registered after December of each year and incorporates the review using the wage guarantee clause.
(*) Data since 2017 is provisional.
Source: BBVA Research based on Ministry of Labor, Migration and Social Security data

Figure 3.10. **SPAIN: CONTRIBUTIONS TO GDP DEFLATOR GROWTH** (QUARTERLY AVERAGE)



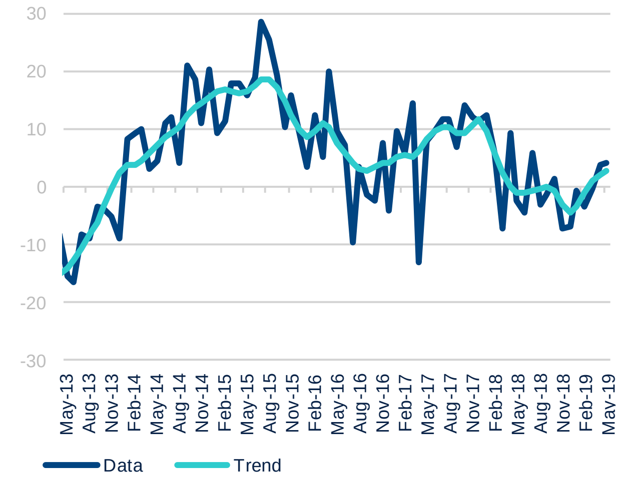
* Data up to 1Q19; forecasts for 2Q19.
Source: BBVA Research, based on INE (Spanish National Statistics Institute) data.

The decline in new credit slows in 2019

The drop in the stock of credit to the private sector halved, sliding -1.6% YoY in April. Meanwhile, new operations were also in negative territory during the first few months of the year, down -3.4% YoY in the cumulative figure through to May (see Figure 3.11). By operation type, lending to companies showed a negative trend during the first five months of the year. Financing operations in excess of one million euro fell -10.0% YoY in cumulative terms in the period January-May 2019, while company financing operations of less than one million declined by -0.6% YoY. Lending to households has exhibited some fatigue year-to-date, albeit sustaining a growth of 3.5% YoY in cumulative terms in the year to May, supported by financing for consumer goods and property, but undermined by other household financing items.

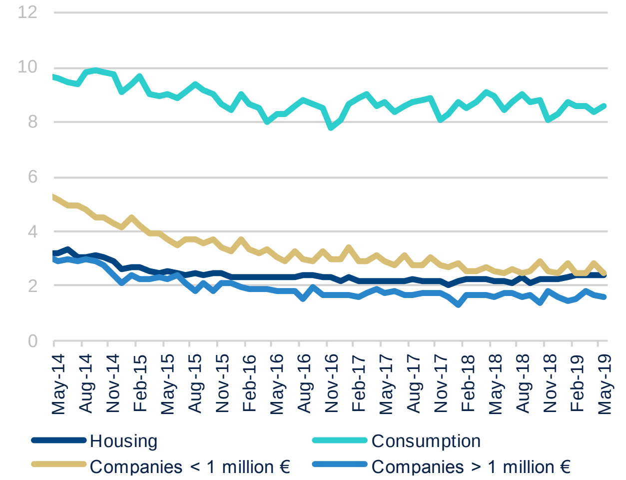
The price of new lending remains at low levels, underpinned by depressed interest rates, good liquidity conditions for banks, stable sovereign risk and lower credit risk premia for banks (see Figure 3.12). However, some portfolios show evidence of bottoming out amid narrowing interest margins and changes to the term structure. This is true of housing purchase operations (2.40% average APR in May, 22 basis points more than a year ago), indicating real resistance to further declines and even early signs of a slight rally. This is due to the growing use of fixed interest mortgages (37% of new mortgage loans up to May vs. 35% in 2018) and because the 12-month Euribor rose slightly year-on-year (5 basis points more than a year ago) although it remains in negative territory. In this regard, there is still no clear evidence that the fact that banks have to pay stamp duty is having any impact on mortgage rates.

Figure 3.11. **SPAIN: NEW LENDING TO THE RETAIL SECTOR** (% YOY GROSS FIGURE AND TREND)



Source: BBVA Research, based on BdE data

Figure 3.12. **SPAIN: INTEREST RATES ON NEW LENDING OPERATIONS** (% APR)



Source: BBVA Research, based on BdE data

Economic scenario: slight slowdown in 2019, to be intensified in 2020

The Spanish economic recovery will continue during the 2019-2020 period. Despite the continued risks, GDP growth expectations are revised up by one tenth to 2.3% in 2019 and are left unchanged at 1.9% in 2020 (see Table 3.1). Although growth is expected to slow in consumption and investment compared to the previous two-year period, domestic demand will still be the main support for growth (2.0 pp on average). Meanwhile, the contribution made by net external demand will return to positive territory (0.1 pp on average; -0.3 pp in 2018), supported by a gradual recovery in exports, more accommodating monetary policy and lower oil prices. Should this scenario be confirm, the growth in economic activity would create 810,000 jobs and cut the unemployment rate to around 12.7% on average in 2020.[14]

14 Employment will increase by 740,000 people between 4Q18 and 4Q20 and the unemployment rate will fall to levels of around 12%.

Table 3.1 **SPAIN: MACROECONOMIC FORECASTS** (% YoY UNLESS STATED OTHERWISE)

(% YoY unless stated otherwise)	1Q19	2Q19 (e)	2017	2018	2019 (f)	2020 (f)
National Final Consumption Expenditure	1.6	2.0	2.4	2.3	1.8	1.7
Private FCE	1.5	2.0	2.5	2.3	1.8	1.7
FCE Public Authorities	2.0	2.1	1.9	2.1	1.8	1.7
Gross Fixed Capital Formation	4.7	2.1	4.8	5.3	3.1	3.4
Equipment and Machinery	7.3	1.6	6.0	5.4	3.9	3.0
Construction	4.3	2.9	4.6	6.2	3.1	3.5
Housing	3.4	3.9	9.0	6.9	3.9	3.8
Other Buildings and Structures	5.1	1.7	0.6	5.5	2.3	3.0
Domestic demand (*)	**2.2**	**2.0**	**2.9**	**2.9**	**2.0**	**2.1**
Exports	0.0	1.3	5.2	2.3	1.7	3.5
Imports	-0.5	0.1	5.6	3.5	0.8	4.1
External balance (*)	**0.2**	**0.4**	**0.1**	**-0.3**	**0.3**	**-0.1**
Real GDP at market prices	**2.4**	**2.4**	**3.0**	**2.6**	**2.3**	**1.9**
Nominal GDP at market prices	**3.3**	**3.1**	**4.2**	**3.6**	**3.2**	**3.6**
Total employment (LFS)	3.2	2.7	2.6	2.7	2.4	1.7
Unemployment rate (% of labor force)	14.7	13.4	17.2	15.3	13.7	12.7
Full-time equivalent employment (Quarterly National Accounts)	2.8	2.4	2.8	2.5	2.2	1.6

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

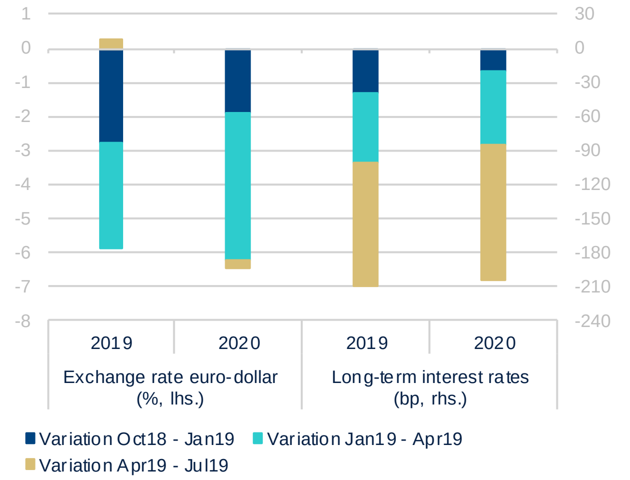
The shifting monetary policy stance will soften the effect of escalating trade tensions

Although global growth remains steady (3.3% in 2019 and 2020), it is expected to stabilize below the levels achieved in previous years (see Section 1). For the next two-year period, **additional monetary policy measures are expected to offset the effects of heightened trade tensions between the US, China and EMU. As these tensions eventually subside**, confidence should improve and a more positive climate for Spanish activity growth take shape.

In Europe, growth expectations remain virtually constant (the forecast for 2019 is increased by one tenth of a percentage point to 1.1%, but the forecast for 2020 is revised downwards by the same amount to 1.2%), which together with **a lower cost of financing** due to new measures anticipated from the ECB (cut in deposit rates, tiered deposit rate system and a boost in forward guidance) and a relatively favorable **exchange rate**, should help drive activity growth (see Figure 3.13). Finally, **oil prices** should continue to provide some relief; BBVA Research forecasts indicate that prices could ease from 68 dollars per barrel in 2018 to 62 dollars in 2019 and 55 dollars in 2020 (see Figure 3.14).[15]

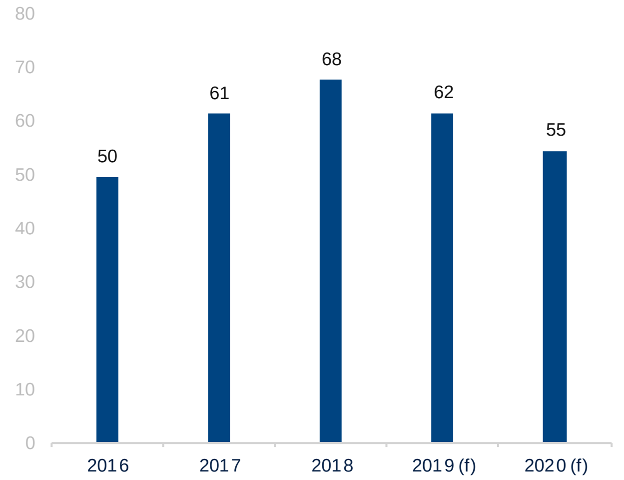
15 Although the fall in energy prices is due to the slowdown in activity at a global level, supply factors are also playing a role and, consequently, a net positive effect is estimated for business margins, household disposable income and economic activity in Spain. For further details on estimating the effects of oil prices by type of

Figure 3.13. **SPAIN: EXCHANGE RATE AND LONG-TERM INTEREST RATE** (% & PP)



Source: BBVA Research

Figure 3.14. **SPAIN: OIL PRICE** (DOLLARS PER BARREL)



Forecast (f).
Source: BBVA Research

Domestic demand will slow down, but will continue to underpin activity growth

Private consumption will lose traction in the 2019-2020 period due to the waning of certain tailwinds. BBVA Research expects growth in household spending to ease to 1.8% in 2019, two tenths less than expected in the previous edition of this publication, and 1.7% in 2020. Average growth will therefore stand six tenths below that posted in the 2017-2018 period. What factors explain the loss of buoyancy anticipated for private consumption? First, the dissipation of certain transitory elements that had stimulated spending in previous years, such as pent-up demand for durable goods[16] and the impact of expansionary monetary policy on household financial burdens. Second, less impetus from some of the factors shaping consumption, such as net financial wealth, which is affected by the volatility of stock prices, and the shift in savings towards more secure but less profitable assets. Thirdly, more modest growth in consumer financing, in line with trends registered during the first five months of the current year.[17] Finally, uncertainty results in a deterioration of household sentiment regarding the economic scenario, which has helped drive the savings rate to 5.4% of disposable income (see Figure 3.15).[18]

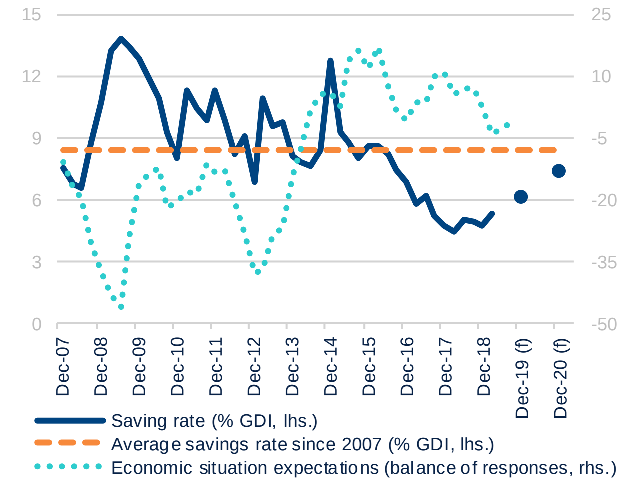
In contrast, the fiscal stimulus included in the 2018 General State Budget and additional measures approved in recent months (including higher pensions, civil servant wages and minimum wage) will continue to drive household income, especially if companies continue to absorb the cost of higher wages rather than transfer them onto prices.[19] Similarly, spending will be driven by the non-stop growth in real estate wealth and the complementary nature of demand for housing and the consumption of certain goods and services.[20]

shock on activity and prices in the Spanish economy, see Box 1 of the Spain Economic Outlook journal for the second quarter of 2011, available at: https://goo.gl/6DM3cE
16 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 add to household expenditure growth in early 2018.
17 The volume of new consumer financing operations increased 5.1% YoY through to May, having expanded 17.0% in 2018.
18 Having eased to 4.5% SWDA of disposable income in 1Q18, the household savings rate rose by nearly one point to 5.4% SWDA in 1Q19.
19 BBVA Research estimates indicate that the impact of the minimum wage hike on the total wage bill would be positive during the two-year period should companies not transfer the effect onto final prices. As of mid-2021 the negative impact on employment levels would outweigh the positive impact on wages, unless productivity growth outweighs the upturn in labor costs. Details can be found in the Spain Economic Outlook journal for the first quarter of 2019, available at: https://www.bbvaresearch.com/publicaciones/situacion-espana-primer-trimestre-2019/
20 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 journal for the second half of 2017, available at: https://www.bbvaresearch.com/public-compuesta/situacion-consumo-segundo-semestre-2017/

In the 2019-20 two-year period, investment in machinery and equipment will grow at an average annual rate of 3.5%, supported by monetary policy but hit by uncertainty regarding foreign trade flows. In particular, this demand item is expected to rise 4.0% in 2019 and 3.0% in 2020 (1.0 pp more and 0.7 pp less than the figures stated in the last edition of this publication), shaped by the strong growth observed in the first quarter of the year. Investment in machinery and equipment will significantly be driven by goods exports and, in particular, how these might be affected by ongoing trade tensions and weak growth among key trading partners. In any case, lower financing costs will have a positive but limited effect, starting at already low levels. All this while two significant aspects of uncertainty remain in place: how the automobile sector will be affected by regulatory change and the consequences of real parliamentary fragmentation on decisions made by agents.

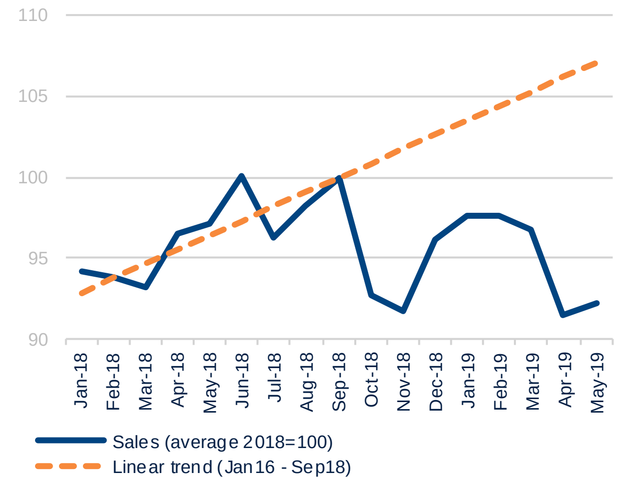
On the other hand, investment in housing will continue to expand faster than GDP growth in 2019 and 2020, although at a more moderate rate than expected a few months ago, due to greater regulatory uncertainty. Industry fundamentals support this positive trend. Employment will continue to make progress more robustly than initially expected, which should support growth of household income. In addition, expectations of further interest rate cuts should benefit buyers who require financing, although the benefits of new stimuli are likely to be less robust than in the past. However, some aspects could have a negative effect on residential investment in the coming quarters. On the one hand, legal uncertainty at the end of last year and regulatory changes affecting rental contracts could be behind the deterioration of residential sales since the end of 2018. On top of this is the short-term impact of a new law regulating real estate credit contracts coming into force on June 16 (see Figure 3.16). In this scenario, there is a slight downward revision of housing investment in the current two-year period, as growth is cut by 0.7 pp in 2019 to 3.9% and 0.4 pp in 2020 to 3.9%. However, it will remain one of the most dynamic components of domestic demand.

Figure 3.15. **SPAIN: HOUSEHOLD EXPECTATIONS REGARDING THE ECONOMIC SITUATION AND THE SAVINGS RATE** (SWDA DATA)



Source: BBVA Research based on INE (Spanish National Statistics Institute) and European Commission data

Figure 3.16. **SPAIN: HOUSING SALES** (SWDA DATA, Sept.18=100)



Source: BBVA Research, based on CIEN data

Assuming a scenario of no changes to economic policy, fiscal policy is expected to be slightly expansionary in 2019 and neutral in 2020. In any case, the electoral cycle and slow progress establishing new governments, both at the state level and for some regional governments, indicate **an easing of public expenditure in the second half of the year**. Thus, the rise in spending on final consumption by public administrations will be limited, standing at around 1.8% YoY in 2019 and 1.7% YoY in 2020. Similarly, growth in investment in other buildings will be restrained in the current two-year period (YoY 2.3% in 2019 and 3.0% in 2020), affected by the gradual slowdown in public investment.

Lower growth in developed economies and trade tensions hinder trade flows

Mounting trade tensions between China, USA, and EMU, together with economic slowdowns in said countries, will affect the performance of Spain's sales abroad and are consistent with slowing growth rates over the next two-year period. However, robust global economic growth, a relatively favorable real effective exchange rate, along with lower oil prices, should be sufficient to keep foreign demand growth in positive territory. **Thus, total exports are expected to expand 1.7% YoY this year and 3.5% next year, 1.1 pp and 0.3 pp less than expected three months ago respectively**.

In particular, **the sluggishness of exports of goods last year is expected to continue in 2019, and recover somewhat in 2020**. Exports growth is expected to be around 0.5% in 2019 and 3.6% in 2020. This is 1.5 pp and 0.5 pp below the forecasts published three months ago. The anticipated growth in goods exports in 2020 should be supported by easing trade tensions, a recovery in the automotive sector and a progressive improvement in the Eurozone. In addition, moderate competitiveness gains are expected to add additional impetus, via declining oil prices and a lower cost of financing.

Meanwhile, exports of services are expected to be the driver behind foreign sales, growing 4.5% in 2019, 0.1 pp faster than estimated in the previous quarter, and 3.0% in 2020. In any case, this would stand almost two points below the average annual growth observed since 2014. As for foreign tourism, BBVA Research's forecasts suggest that non-resident consumption in the domestic territory, which expanded just 1.8% during 2018, would return to growth rates observed early in the recovery, rising 4.1% in 2019 and 2.1% in 2020. This represents 2.6 pp and 1.1 pp more than estimated in the last edition of this publication. Thus, the slowdown continues in terms of foreign tourism compared to the growth posted in the 2016-2017 two-year period (9.2% annual average), but not as sharply as expected three months ago. Nonetheless, some of the structural factors already mentioned in previous editions of this publication remain in place. There are still concerns over restrictions on supply growth at some destinations and a diminishing flow of tourists diverted toward the Spanish market from competing markets hit by geopolitical tensions.[21] Finally, overseas sales of non-tourism services are expected to grow 4.8% in 2019 and 3.7% in 2020, 1.7 pp and 0.7 pp less than estimated last quarter, and slightly below the average for the last two years (4.5% on average).

The expected composition of final demand growth will lead to imports growth of around 2.4% on average during the current two-year period, which will result in a negative contribution from net external demand to growth (0.3 pp in 2019 and -0.1 pp in 2020). This performance is consistent with a moderate decline of the current account balance to 0.7% of GDP in 2019 and 0.4% in 2020.

The labor market recovery will continue at a slower pace

Although the economy and the labor market performed better in the first half of the year than was expected three months ago, **job creation will lose traction in 2019**. In line with easing growth, employment will rise by 2.4% this year, three tenths less than in 2018, but four more than expected in early April. Given that the labor force expansion will be modest, rising employment will result in a decrease of 1.5 pp in the unemployment rate to 13.7%.

These forecasts are consistent with a limited impact of the statutory minimum wage increase on growth and employment in the short term. BBVA Research estimates, included in the Spain Outlook edition for the first quarter of 2019, indicate that employment levels (measured in full-time equivalent jobs) in 2019 would stand

21 In this regard, the estimates of BBVA Research would suggest that nearly 10 pp of tourism growth over recent years is not due to traditional fundamentals such as the evolution of global demand or the real effective exchange rate. For a more detailed explanation of the structural factors that are slowing foreign tourism, see the BBVA Research Economic Watch: "Foreign tourism in Spain: Loss of traction pending improvements in competitiveness", available at https://bit.ly/2FuOVl9

between one and four tenths lower than in the baseline scenario, depending on whether companies absorb the wage increase or transfer it onto prices. Data for the first quarter suggests that the effect of the higher minimum wage would be close to the lower end of the range, provided that investment plans remain largely unaffected by the narrowing of business margins. In the long term, the effect will depend on the adoption of policies that contribute to increasing the productivity of the workers likely to be most affected, including young people, foreigners and low-skilled workers. Should their productivity not improve, the higher minimum wage could drop occupation to between 0.9 pp and 1.6 pp below the baseline scenario level.

The increase in employment and shrinking unemployment rate will continue in 2020, albeit at a slower pace, easing to 1.7% and 12.7%, respectively. If the forecasts of BBVA Research prove accurate, the number of employed people would stand close to 20.3 million by the end of 2020, while the unemployment rate would be about 12.2%, still well above pre-crisis levels. As Figure 3.17 illustrates, in 4Q20 employment will be around 2.2% below the level observed at the beginning of 2008, while the unemployment rate will be three points higher. In addition, the expected trends in terms of activity and full-time equivalent employment (FTE), which is set to grow by around 2% on average in the 2019-2020 period, point to a limited contribution from labor productivity to GDP growth.

Inflation will remain at moderate levels during the current two-year period

The slowdown in consumer prices is expected to continue, given the easing in domestic growth, an expected drop in fuel prices, and a global environment that is unlikely to exert upward pressure on the costs of imported goods. Thus, inflation is expected to end 2019 at an annual average of around 0.8% YoY (0.3 pp below the estimate three months ago), while core inflation should remain virtually stable (0.8% YoY annual average in 2019). In 2020 core inflation will continue to rise very gradually (1.0% YoY annual average), which, together with easing energy prices, should put headline inflation at 1.3% YoY (0.1 pp below the previous forecast).

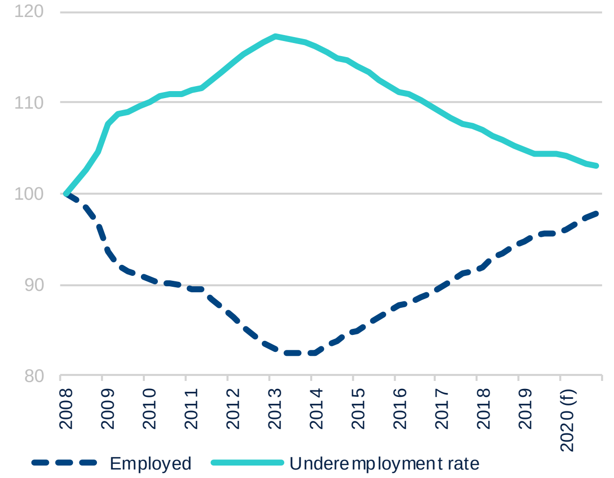
Should these estimates prove correct, **the headline inflation differential against the Eurozone would shift slightly in Spain's favor during the 2019-2020 period** (-0.2 pp on average), after the gap narrowed in 2018.

During the 2019-2020 period the pace of public deficit adjustment will slow

The budget execution information available through to April 2019 indicates a somewhat more dynamic recovery of public revenue than expected three months ago, due to the impact of the minimum wage hike and higher Social Security contribution bases. Meanwhile, there has been a boost in public expenditure, especially for items such as social transfers, which added almost one tenth to the deficit through to March 2019, but had a diminishing effect on activity.

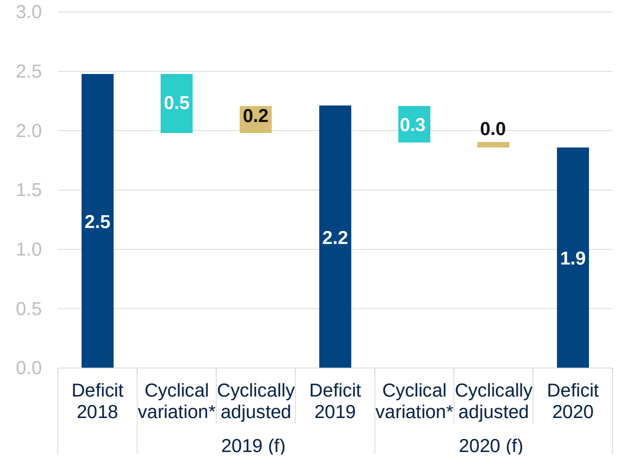
In this context, both the economic cycle and more favorable financing conditions are expected to lead to a decline in the public deficit during the 2019-2020 period. This cyclical improvement will be partly offset by measures adopted late last year and during the first months of this year. As a result, **the aggregate public administration deficit will shrink by just 0.4 pp in 2019 to 2.2% of GDP**, again standing above the stability target (-1.3%). **In 2020, assuming no changes to fiscal policy, a cyclical correction of the fiscal balance to 1.9% of GDP is expected** (see Figure 3.18), meaning further deviation from the stability target (-0.5%) and government forecasts (-1.1%).

Figure 3.17. **SPAIN: LEVEL OF EMPLOYMENT AND UNEMPLOYMENT RATE** (1Q08 = 100. SWDA DATA)



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

Figure 3.18. **PUBLIC ADMINISTRATIONS: BREAKDOWN OF FISCAL ADJUSTMENT, EXCLUDING BAIL-OUTS FOR FINANCIAL INSTITUTIONS** (% OF GDP)



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

Pending final confirmation from the European Council, Spain will withdraw from the excessive deficit protocol in 2019, but is expected to deviate from the structural deficit reduction path due to a high level of public debt (98.7% of GDP in March 2019). Should the BBVA Research scenario be confirmed, the structural primary balance will stabilize at around -0.5% of GDP, consistent with a virtually neutral fiscal policy stance during the 2019-2020 two-year period. All this shows that, **despite marginal progress, there is still insufficient fiscal leeway to address the long-term sustainability challenges facing public accounts** (high public debt, aging population, tax system efficiency improvements, etc.).

The likelihood of any of the risks materializing continues to rise

Although BBVA Research's scenario includes a slight upward revision of the forecast of economic activity for 2019, the economy remains highly vulnerable. Growth continues to be particularly dependent on domestic demand, while there is still uncertainty regarding global trade. In addition, the diminishing impact of monetary policy and the absence of leeway for fresh fiscal stimulus, reduces the ability of the Spanish economy to respond to the current risks.

At the external level, there is uncertainty regarding the performance of global growth. The slowdown affecting the Chinese and American economies, coupled with the lack of dynamism of the EMU, indicates **increasing difficulties for developed economies**. In addition, there is uncertainty generated by the multiple international issues currently ongoing. Among the most troubling for the Spanish economy are **trade tensions between the USA, China and EMU, as well as a disorderly exit of the UK from the EU**. Furthermore, despite the announcement of fresh monetary stimuli, economic weakness in Europe is a matter for concern. This may be materializing as structural problems, which would require reforms to drive European integration and create a climate more conducive to growth. The results of the May European elections and the limited gains by Eurosceptic parties offer some relief.

Domestic risks are also significant. On the one hand, uncertainty regarding economic policy remains high and is still one of the main sources of instability. The recent general, regional and local elections increased the fragmentation of the political spectrum, making it difficult to reach agreements over measures necessary to continue the recovery and improve the long-term functioning of the economy.

Moreover, the near impossibility of achieving consensus is particularly significant now that **the effects of monetary policy are diminishing**. So far, the European Central Bank has been able to underpin domestic demand growth amid unusually low interest rates. However, there is decreasing scope for the tools implemented to date to be effective. Therefore, it will become increasingly evident that other policies will be required to help boost, in particular, investment expenditure. In Spain there is limited ability to make use of fiscal policy, meaning the economy might be bolstered via measures aimed at driving competitiveness or making the labor market operate more efficiently.

Meanwhile, although the minimum wage increase seems to have had a limited impact, in line with the BBVA Research baseline scenario, the medium and long term effect remains uncertain. At present, there has been no transfer to final consumer prices or a significant dent in job creation, although these more adverse scenarios cannot yet be ruled out.[22] This is particularly important in the current context, with the unemployment rate gradually approaching its structural level. In this scenario, we may witness binding capacity constraints and shortages of skilled labor, which could lead to greater wage pressure.

In addition to the short-term risks, **the Spanish economy also faces structural challenges**. The **low growth in real productivity during the recovery is a prominent one.** In contrast with the previous upturn (2003-2007), recent productivity improvements, defined as gross value added per hour worked, are due to *changes to the sectorial composition* of employment and hours worked, as well as different price trends in each branch of activity, rather than real productivity improvements. For example, the aggregate productivity of the economy could expand due to a sector with a comparatively high gross value added per hour accounting for a larger share of employment. This productivity improvement would be driven by a composition effect, but not the economy's ability to produce more with the same resources. This has been the case during the recovery, as Figure 3.19 illustrates. The increase in gross value added per hour worked since early 2014 is exclusively due to a positive composition effect. Figure 3.20 illustrates that during the recovery some of the more productive sectors, such as real estate and ICT, accounted for a greater percentage of employment, while those with lower gross value added per hour, such as artistic activities, commerce, hospitality and transport, saw their role decline.[23] Reforms are needed to boost real productivity growth both in the educational-training field and in the labor and product market, seeking to drive the qualification levels of workers and entrepreneurs and foster lifelong training, reduce labor segmentation, and encourage stronger growth of enterprises.[24]

Finally, longer-term trends must also be monitored, as these will undoubtedly have an impact on the Spanish economy in the coming years. Particularly important among these is the **gradually aging of the population**. According to INE population forecasts, people over 65 will account for 26% of the total population by 2033 (said group now represents 20%). This may affect growth both by exerting downward pressure on potential growth[25] and also through lower demand. In particular, older individuals have lower per capita consumption levels. Policies that target the consequences of population aging should into account these demand-side effects.[26]

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22 BBVA Research estimates 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 the same on to prices. That is, the economy would create between 75,000 and 195,000 fewer jobs in the 2019-2020 period than in the absence of the minimum wage increase. To estimate the repercussions of the increase in the legal 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

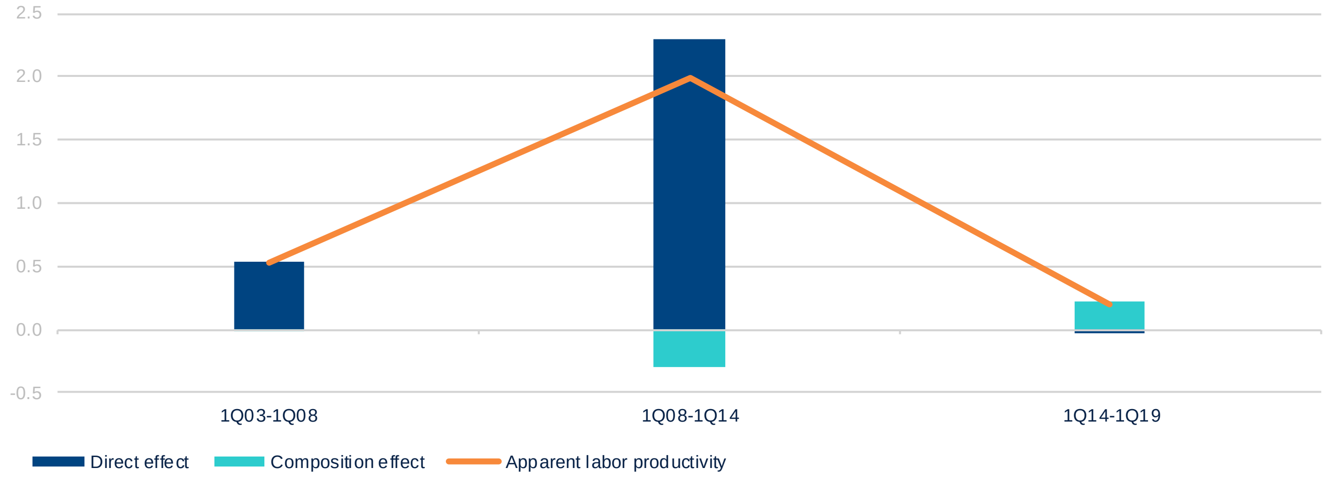
23 A detailed explanation of the factors behind productivity trends in Spain can be found in the BBVA Research Economic Watch report: "Causes of productivity trends in Spain: 2002-2019", soon to be published on the BBVA Research website.

24 For a more detailed analysis of policies that could help improve productivity, see Cardoso, M., Doménech, R., García, J. R., Sicilia, J. and Ulloa, C. A. (2016): "Toward a more efficient and equitable labor market", available https://bit.ly/2LceHA3

25 For example, see Chapter 4: "Economic consequences of demographic changes" in the Banco de España Annual Report (2018).

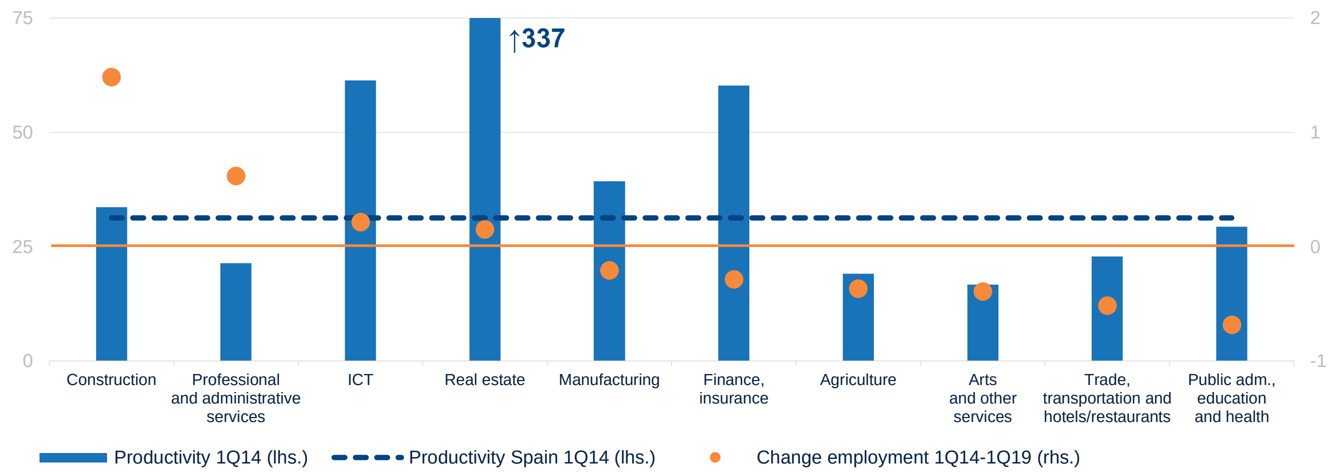
26 For further details, see Box 2: "Consumption habits and the challenge of population aging" in Situación Consumo for the first half of 2019.

Figure 3.19. **SPAIN: AVERAGE ANNUAL PRODUCTIVITY GROWTH PER HOUR***(%)



*GVA per hour worked.
Source: BBVA Research, based on INE (Spanish National Statistics Institute) data.

Figure 3.20. **SPAIN: PRODUCTIVITY PER HOUR IN 1Q14 AND CHANGE IN EMPLOYMENT BETWEEN 1Q14 AND 1Q19*** (EUROS PER HOUR AND PP)



*Productivity: GVA per hour worked. Employment: percentage of total hours worked
Source: BBVA Research, based on INE (Spanish National Statistics Institute) 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	1.9	1.1	1.2
Germany	2.2	2.5	1.5	0.8	1.2
France	1.0	2.4	1.7	1.3	1.5
Italy	1.2	1.8	0.7	0.0	0.4
Spain	3.2	3.0	2.6	2.3	1.9
United Kingdom	1.8	1.8	1.4	1.1	1.2
Latin America*	-0.2	1.8	1.5	1.0	2.2
Mexico	2.6	2.4	2.0	0.7	1.8
Brazil	-3.3	1.1	1.1	0.9	1.8
Eagles**	5.3	5.4	5.2	4.7	4.9
Turkey	3.2	7.4	2.6	0.3	2.5
Asia and Pacific	5.6	5.6	5.6	5.3	5.1
Japan	0.6	1.9	0.8	0.7	0.4
China	6.7	6.8	6.6	6.0	5.8
Asia (ex. China)	4.7	4.6	4.7	4.6	4.4
World	3.4	3.7	3.7	3.3	3.3

* 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: 12 July 2019.
Source: BBVA Research

Table 4.2. **INFLATION** (ANNUAL AVERAGE %)

	2016	2017	2018	2019	2020
US	1.3	2.1	2.4	1.8	2.0
Eurozone	0.2	1.5	1.8	1.2	1.4
Germany	0.4	1.7	1.9	1.4	1.5
France	0.3	1.2	2.1	1.1	1.3
Italy	-0.1	1.3	1.2	0.8	0.9
Spain	-0.2	2.0	1.7	0.8	1.3
United Kingdom	0.7	2.7	2.5	1.9	1.8
Latin America*	9.8	6.7	7.1	8.4	6.6
Mexico	2.8	6.0	4.9	3.9	3.8
Brazil	8.8	3.5	3.7	3.9	4.1
Eagles**	4.4	4.0	4.7	4.9	4.6
Turkey	7.8	11.1	16.3	16.2	13.1
Asia and Pacific	2.3	2.0	2.3	2.4	2.6
Japan	-0.1	0.5	1.0	0.7	1.0
China	2.1	1.5	1.9	2.3	2.5
Asia (ex. China)	2.5	2.4	2.7	2.6	2.9
World	3.2	3.3	3.8	3.7	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: 12 July 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	2.26	1.73
Germany	0.13	0.37	0.46	-0.14	-0.16

* 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: 12 July 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	0.88	0.84
USD-EUR	1.11	1.13	1.18	1.14	1.19
USD-GBP	1.35	1.29	1.33	1.29	1.41
JPY-USD	108.82	112.20	110.47	110.31	110.58
CNY-USD	6.64	6.76	6.61	6.75	6.71

Forecast closing date: 12 July 2019.
Source: BBVA Research

Table 4.5. **MACROECONOMIC FORECASTS: OFFICIAL INTEREST RATES** (END OF PERIOD. %)

	2015	2016	2017	2018	2019
US	0.75	1.50	2.50	2.00	1.75
Eurozone	0.00	0.00	0.00	0.00	0.00
China	4.35	4.35	4.35	3.85	3.85

Forecast closing date: 12 July 2019.
Source: BBVA Research

Table 4.6. **EMU: MACROECONOMIC FORECASTS** (YOY CHANGE. %. UNLESS OTHERWISE INDICATED)

	2016	2017	2018	2019	2020
GDP at constant prices	**1.9**	**2.5**	**1.9**	**1.1**	**1.2**
Private consumption	1.8	1.8	1.3	1.5	1.5
Public consumption	1.8	1.3	1.0	1.2	1.3
Gross fixed capital formation	3.9	3.0	3.3	3.0	2.1
Inventories (*)	0.1	-0.1	0.1	-0.2	0.0
Internal demand (*)	**2.3**	**1.8**	**1.7**	**1.4**	**1.5**
Exports (goods and services)	3.0	5.4	3.2	2.5	2.3
Imports (goods and services)	4.2	4.1	3.2	3.4	3.3
External demand (*)	**-0.4**	**0.8**	**0.1**	**-0.3**	**-0.3**
Prices					
CPI	0.2	1.5	1.8	1.2	1.4
Core CPI	0.8	1.1	1.2	1.1	1.4
Labour market					
Employment	1.4	1.6	1.5	0.9	0.6
Unemployment rate (% of active population)	10.0	9.1	8.2	7.7	7.6
Public sector					
Deficit (% GDP)	-1.6	-1.0	-0.5	-0.9	-1.1
Debt (% GDP)	89.2	87.1	85.1	83.4	81.9
External sector					
Current account balance (% of GDP)	3.1	3.2	2.9	2.6	2.4

Annual change in %. unless expressly indicated.
Forecast closing day: 12 July 2019.
(*) Excluding aid to Spanish banks.
Source: BBVA Research

Table 4.7. **SPAIN: MACROECONOMIC FORECASTS**
(ANNUAL RATES OF CHANGE IN %. UNLESS OTHERWISE INDICATED)

	2016	2017	2018	2019	2020
Activity					
Real GDP	3.2	3.0	2.6	2.3	1.9
Private consumption	2.9	2.5	2.3	1.8	1.7
Public consumption	1.0	1.9	2.1	1.8	1.7
Gross Fixed Capital Formation	2.9	4.8	5.3	3.1	3.4
Equipment and machinery	5.2	6.0	5.4	3.9	3.0
Construction	1.1	4.6	6.2	3.1	3.5
Housing	7.0	9.0	6.9	3.9	3.8
Domestic Demand (contribution to growth)	2.4	2.9	2.9	2.0	2.1
Exports	5.2	5.2	2.3	1.7	3.5
Imports	2.9	5.6	3.5	0.8	4.1
External Demand (contribution to growth)	0.8	0.1	-0.3	0.3	-0.1
Nominal GDP	3.5	4.2	3.6	3.2	3.6
(Billions of euros)	1118.7	1166.3	1208.2	1247.5	1291.8
Labour market					
Employment. LFS (Labour Force Survey)	2.7	2.6	2.7	2.4	1.7
Unemployment rate (% of labour force)	19.6	17.2	15.3	13.7	12.7
Employment. FTE (Full Time Equivalent)	3.1	2.8	2.5	2.2	1.6
Productivity	0.1	0.1	0.1	0.1	0.3
Prices and costs					
CPI (annual average)	-0.2	2.0	1.7	0.8	1.3
CPI (end of period)	1.6	1.1	1.7	0.6	1.5
GDP deflator	0.3	1.3	1.0	0.9	1.6
Compensation per employee	-0.5	0.3	0.8	2.6	2.5
Unit labour cost	-0.6	0.2	0.8	2.5	2.2
External sector					
Current Account Balance (% GDP)	2.1	1.8	0.9	0.7	0.4
Public sector (*)					
Debt (% GDP)	99.0	98.1	97.1	96.2	94.8
Balance Public Admin. (% GDP)	-4.3	-3.0	-2.5	-2.2	-1.9
Households					
Nominal disposable income	1.8	1.6	3.2	3.8	4.6
Savings rate (% nominal disposable income)	8.0	5.7	5.0	6.1	7.3

Annual change in %. unless expressly indicated.
Forecast closing day: 12 July 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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Creating Opportunities

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