BBVA Research

Creating Opportunities

Spain Economic Outlook

1Q20

Contents

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1. Editorial

The Spanish economic growth slowdown could bottom out in 2020. However, future developments will crucially depend on the resolution of various sources of uncertainty and the policies implemented. Thus, the scenario published three months ago is maintained in which GDP growth could slow to 1.6% in 2020 from the 1.9% in 2019. For 2021, the slight improvement expected in the international environment would explain a moderate acceleration, which would allow growth to return to levels close to 1.9%. In any case, the balance of risks is still biased downward.

GDP growth appears to have stabilized during the second half of 2019. In particular, GDP growth is estimated to have remained at 0.4% QoQ during the last quarter of the year, in line with the first nine months of 2019. Likewise, the trend of the data known so far suggests that this rate of expansion will be sustained in the early months of 2020.

The slowdown in domestic spending may have reached a turning point during the second half of the year, while the export sector holds its ground. In particular, household consumption may have moved past the sluggishness shown during the first part of 2019, when the savings rate increased, possibly affected by the loss of confidence related both to the external and internal environment. In addition, investment in machinery and equipment remains surprisingly strong, despite the weakness of the export sector over the past year. This positive evolution of fixed capital accumulation, together with the first signs of recovery in foreign sales, support a stabilization of growth moving forward. Finally, the fiscal policy has been moderately expansionary, which, even though it is bad news for the objectives of reducing the imbalance in public accounts, is a support for domestic demand.

However, certain sectors continue to negatively reflect the implementation of regulatory changes. The above is mainly observed in car purchases, in indicators related to the real estate sector and job creation in those regions, companies or collectives most exposed to the increase of the statutory minimum wage. Additionally, the beach tourism sector continues to show a weakness that seems to go beyond what may be explained by the slowdown in external demand. Despite this, it seems that the contagion from these sectors to the rest of the economy remains limited.

Despite the resurgence of geopolitical tensions in the Middle East, uncertainty related to the international environment has diminished due to greater clarity in trade issues. For example, the outcome of the UK elections seems to have reduced the likelihood of a disorderly exit from the European Union. In addition, although some sectors and companies have been negatively affected by the increase in tariffs imposed by the US, on the Eurozone, the items affected account for a relatively small share of Spanish exports. Moreover, there are signs of reduced tension between major economic areas, as evidenced by the tentative agreement that the US and China might have reached. The expectation of a moderately more expansionary fiscal policy in the EMU is also consolidated, especially in Germany. Although the momentum does not seem sufficient to raise inflation expectations throughout the Eurozone, it will allow the ECB to maintain interest rates at their current levels, without further action. In any case, the tensions between the US and Iran must be taken into account, as well as their effects on the price of oil, particularly important in a fuel-importing economy such as Spain.

Spain is at a crossroads: The future speed of recovery will depend on the policies implemented over the next few months. Uncertainty about economic policy remains high given the lack of consensus on key issues. The workers' strike and the various episodes of tension observed in Catalonia during the month of October seem to have had a negative impact on the activity in the regional economy, but less than what was observed two years ago. The trend change that has been observed in the evolution of the Catalan economy since the second half of 2017 has been a limiting factor for the growth of Spain as a whole.

Of particular importance will be the changes that the new government can make in important areas, like the labor market or the pensions system. Before moving forward with a total reversal of the reforms implemented in previous years, it would be desirable to review the various assessments that have been made on the effects of the measures introduced and to maintain those aspects that have been valued positively. This spirit of public policy evaluation should be extended to all areas. In this regard, a detailed analysis of the costs and benefits of recent changes in the housing sector or increases in the statutory minimum wage should guide future actions.

Reducing the imbalance in public accounts should remain a priority, minimizing the impact of fiscal consolidation on growth. In this regard, the new Government's commitment to fiscal responsibility and improving the efficiency of the use of resources through strengthening public policy evaluation systems is welcome. In any case, uncertainty remains about the speed of adjustment and the net impact that tax increases, approved to finance the announced spending policies, may have on activity. Moreover, the starting point is not the best, since in 2019 the deficit reduction was almost zero, failing to meet the targets set despite an environment of economic recovery and low interest rates. Indeed, last year would have been the fifth consecutive year with a pro-cyclical fiscal policy. With regard to the expected tax increases, it is necessary to move toward efficient taxation, which limits the negative effects on growth, innovation and employment, provides certainty on tax capacity, encourages investment, takes into account inter-generational justice and does not jeopardize the competitiveness of enterprises in general, or certain sectors in particular. These criteria must guide not only fiscal policy, but also economic policy as a whole.

In the absence of efficient reforms, the trend growth of the Spanish economy would be converging at significantly lower levels than those observed at the beginning of the recovery. Different strengths can be highlighted from the recent evolution of the Spanish economy. On the one hand, GDP growth has remained on average almost one percentage point above that of the EMU. In addition, this has been achieved at the same time as significant increases in investment in machinery and equipment have been maintained, without any further reduction in indebtedness to the rest of the world. The population is also increasing again, as a result of immigration, which rises the growth capacity of the Spanish economy. Finally, many of the imbalances that fed back the effects of the crisis and made it more virulent have been mitigated.

All of this points to the fact that the Spanish economy is now better prepared to face an environment of higher uncertainty. In any case, lower growth is expected in the international context. Internally, unemployment and the use of temporary contracts remain structurally high, which has a particularly negative effect on inequality. In addition, the aging population will be a major challenge for activity over the next few years. Finally, productivity continues to show worrying stagnation. These latter factors indicate that Spain will hardly achieve growth rates similar to those observed in recent years, which highlights the importance of pushing for reforms that efficiently tackle these challenges, maintain a favorable investment climate, and enable the challenges of the technological revolution and the energy transition to be successfully addressed.

2. Decreased uncertainty paves the way for stabilizing global growth

The easing of trade tensions between the US and China, and the disappearance of the risk of a disorderly Brexit in the short term (though still existing for late 2020) have contributed to a fall in economic uncertainty. This has paved the way to curb the slowdown in growth and stabilize the global economy, even though protectionism will continue to affect world trade, and the geopolitical and structural risks remain high. In addition, the stabilization prospects for global growth have been bolstered by the relative strength of activity in the US and by the upward surprises in growth data in China and in the Eurozone. Similarly**, economic policy has continued to support activity, and will continue to do so in the coming quarters, at least in the major world economies**. After recent monetary stimulus measures, both the US Federal Reserve and the ECB are expected to keep interest rates at current low levels for a prolonged period of time, while China will take additional fiscal and monetary stimulus steps. Greater optimism about the global environment has also led to a clear improvement of the financial markets. As a result, following a steady worsening in the outlook for the global economy throughout 2019, **growth forecasts for China and the Eurozone are now being revised slightly upward, while prospects for gentle moderation in the US continue.**

Global environment: a more positive tone in recent months, following the decline seen in much of 2019

2019 was a year marked by a slowdown in growth worldwide. According to BBVA Research estimates, the world economy grew by 3.2% over the year, the lowest rate since 2009 (between 2010 and 2018, the average expansion of global GDP was 3.8%), and 0.4 percentage points below 2018 growth.

The decrease in growth in 2019 was largely due to the structural slowdown of the Chinese economy and the cyclical moderation in the US, especially after the effects of the fiscal stimulus adopted in 2018 faded. The escalating protectionism added to these factors and helped to drive global growth downwards. Investments and exports weakened, in contrast to the relatively strong performance of private consumption, bolstered by the relative strength of labor markets, low inflation and counter-cyclical policies adopted in the main regions.

Economic policy has played a key role in mitigating risks. The fiscal stimulus launched in China and, to a lesser extent, in the Eurozone and, above all, the Fed's monetary stimulus prevented further moderation of growth in 2019. In addition, these measures were fundamental to limiting volatility in financial markets.

Despite the complexity of the economic and geopolitical context, some positive news in recent months has helped to clarify the picture. Notably, they include an **improvement in the tone of conversations between the US and China, which have reached "phase one" trade deal.** The US has agreed not to impose new tariffs and to halve those introduced in September of last year (on USD 120 billion of Chinese exports), while China has agreed to increase purchases of goods produced by the US (mainly agricultural products) and has promised better protection of intellectual property rights, among other measures.

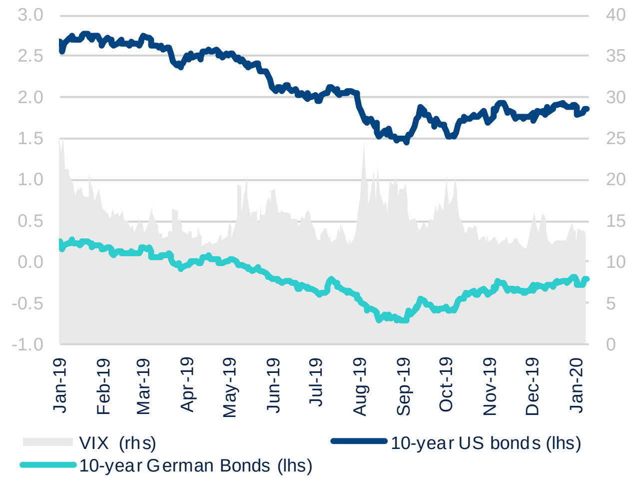
The agreement itself does not significantly reduce tariffs. China's average import rate for US products will remain at around 21% (compared to 8% at the start of 2018), while the average tariff levied by the US on Chinese products will only fall from 21% to about 19% (compared to around 3% just two years ago). **In addition, there are**

risks related to the implementation of the announced measures, and a permanent solution to the structural and technological issues still seems far off. However, it is good news that, at least temporarily, changes the negative dynamics of relations between the two countries and can strengthen the confidence of economic agents.

The trade agreement between the US and China, the progress made toward resolving Brexit , the US economic data, and the upward surprises in growth in China and the Eurozone have generated some optimism in financial markets, despite recent concerns about the rise in geopolitical tensions between the US, Iran, and Iraq. Thus, financial volatility has declined, sovereign debt yields have rebounded (see Figure 2.1), the stock markets are trending upwards, and the appetite for risk has grown, which in turn has favored some emerging markets' assets.

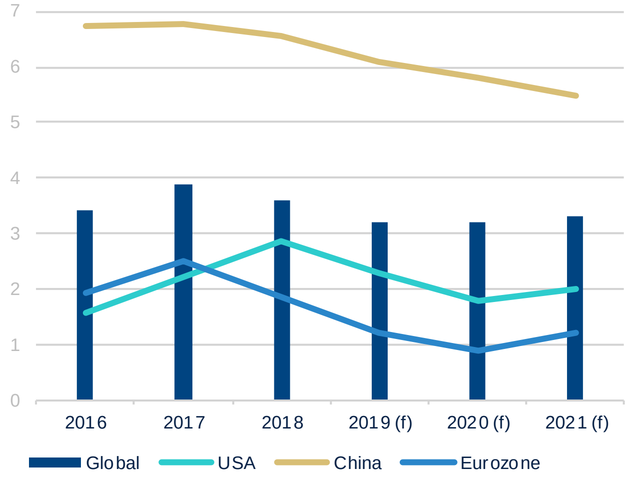
Recent developments have also **prompted both the Fed and the ECB to keep their benchmark interest rates steady in recent months** (at 1.75%, and -0.50%, respectively), rather than announcing additional cuts.

Figure 2.1. **SOVEREIGN DEBT YIELDS AND STOCK VOLATILITY** (%)



Source: BBVA Research based on Haver

Figure 2.2. **GLOBAL GDP GROWTH: 2016-2021** (%)



(f) Forecast.
Source: BBVA Research

After growing at 3.2% in 2019, the global economy will expand by 3.2% in 2020 and by 3.3% in 2021, less than in previous years

After slowing its pace in 2019, global growth is likely to remain at 3.2% in 2020 and to gradually accelerate to around 3.3% in 2021. **While the strategic rivalry between the US and China will continue to generate tensions, and other regions may be affected by new protectionist measures, global uncertainty is expected to remain lower than in 2019**, enabling the global slowdown process to end. **These growth forecasts are also dependent upon keeping geopolitical tensions in check, in addition to other risks threatening the world economy.** Specifically, the BBVA Research scenario assumes that recent tensions between the US, Iran, and Iraq will have no permanent negative impact on the global environment. In particular, oil prices are expected to stabilize at about USD 61 per barrel over the next two years, below the average value recorded in 2019 (USD 64) or the current price (USD 68). This expected reduction in crude oil prices is based on gradual improvement in global demand and a forecast increase in supply from non-OPEC countries. Should an escalation of instability in the Middle East drive oil prices up to USD 70 a barrel and keep them at these levels throughout 2020, global growth over the next biennium could be undermined by between one and two tenths, with Europe suffering the greatest impact.

The prospects for stabilization are likewise backed by the view that economic policy will continue to support activity in most regions. Specifically, in a setting of limited inflationary pressures, **both the Federal Reserve and the ECB are expected to maintain current rates throughout 2020 and 2021**, although additional stimulus measures cannot be not ruled out in either case in the event of further decline of the outlook, nor are rate hikes out of the question in the US if inflation rises more than expected. Furthermore, fiscal policy will act as a stimulus in the Eurozone and, primarily, in China, where there will be more public investment in infrastructure than expected three months ago. In addition, the Chinese central bank's monetary expansion measures will be limited by the recent, largely temporary, surge in inflation. Thus, official interest rates are forecast to drop in the coming months, from 4.1% to 3.9% and bank reserve requirements are expected to fall again.

In the US, prospects remain for a slight slowdown toward near-potential growth rates: after the 2.9% growth in 2018, the economy grew by 2.3% in 2019 and will expand by about 1.8% in 2020 and 2.0% in 2021 (see Figure 2.2). Thus, the growth cycle that began in 2010 will continue, in a setting in which political upheaval could increase with the November 2020 presidential elections, despite the risk of recession, which, in any case, has shrunk in recent months.

In China, the economy will continue to progress at a moderate pace, albeit with less intensity than previously expected. Specifically, forecasts point to a growth of around 5.8% in 2020 in that country, three tenths lower than in 2019, and by 5.5% in 2021. The improvement in the forecast for 2019 (+0.1pp) is due to the fact that growth slowed somewhat less than expected in recent months, while the adjustment to the 2020 forecast (+0.2pp) was prompted by the agreement with the US and the improved outlook for the future relationship between the two economies, as well as the decision to intensify the use of fiscal policy as a stimulus tool for activity. In any case, the risks associated with a disorganized deleveraging of the economy continue to exist.

Growth forecasts for 2019 and 2020 have been revised slightly in the Eurozone. After ending 2019 with a 1.2% (+0.1pp) increase, growth is expected to reach 0.9% (+0.1pp) in 2020 and 1.2% in 2021. The positive surprises in activity indicators in recent months, as well as the eliminated risk of a no-deal Brexit at the end of January, have contributed to the upward revisions, although this risk could increase by the end of 2020.

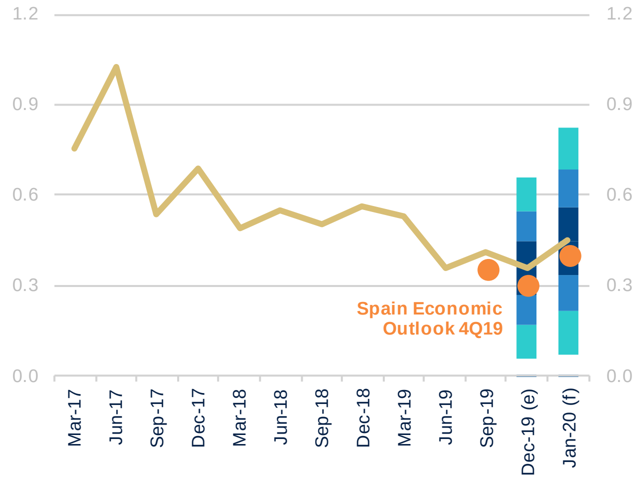
3. Growth Outlook for the Spanish Economy

GDP growth in the short term: stable at around 0.4%

The current information known at the closing date of this report indicates that **the Spanish economy could have moderately grown once again in the fourth quarter of 2019,** slightly above what was anticipated three months ago (see Figure 3.1). The increase in activity between October and December would have been around 0.4% QoQ (1.7% YoY)[1], in line with the two preceding quarters and below the average quarterly growth since the start of the recovery (0.7% QoQ). Therefore, annual GDP growth in 2019 would have decelerated to 1.9%, 0.5pp lower than in 2018.

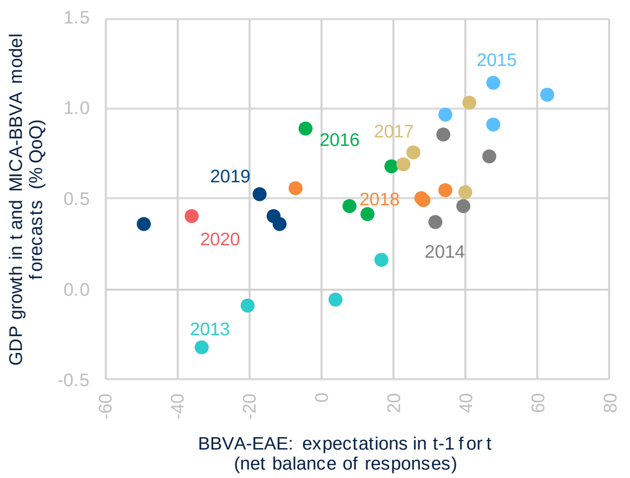
For the first quarter of 2020, the real-time estimates of BBVA Research indicate that the increase in GDP remains stable (the MICA-BBVA model forecast: between 0.3% and 0.5% QoQ). However, uncertainty about the pace of growth has increased, as shown by the less favorable view suggested by the results of the BBVA Economic Activity Survey (EAE-BBVA) (see Figure 3.2).

Figure 3.1. **SPAIN: OBSERVED GDP GROWTH AND FORECASTING RANGE** (% QoQ).



(e) Estimate. (f) Forecast.
Source: BBVA Research based on INE data

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



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

1: SWDA: seasonally and working day adjusted data.

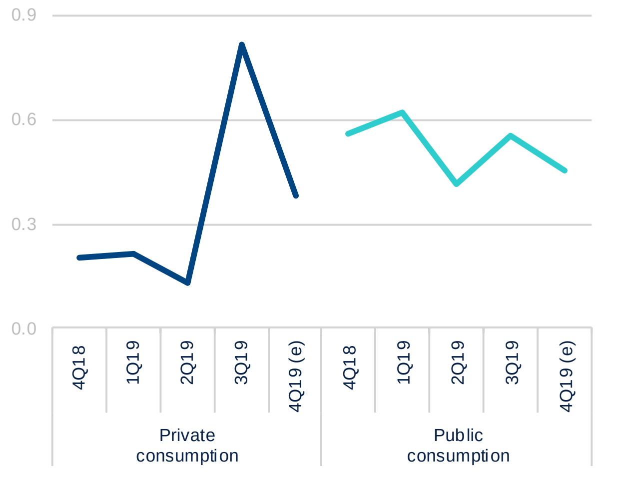
Domestic demand: on positive ground thanks to the increase in consumption

The information available regarding the fourth quarter points to a slight increase in both private and public consumption (see Figure 3.3). The signals from spending indicators[2] suggest that household consumption growth could have slowed to 0.4% QoQ (1.6% YoY) in the fourth quarter, following the strong progress observed between July and September (0.8% QoQ). If this forecast is met, the year 2019 would have closed with an average annual increase in household spending of 1.2% YoY, six pp below that observed in the previous year. Likewise, budgetary execution data points to the fact that the government consumption would have lost some traction to 0.5% QoQ (2.1% YoY) in the fourth quarter of last year, after accelerating to 0.6% QoQ in the third quarter. As a result, the past financial year would have ended with an average increase in public consumption of 2.2% YoY (1.9% in 2018).

Investment could have slowed the growth in domestic demand between October and December (see Figure 3.4). Following a significant increase in the third quarter (4.9% QoQ), the partial economic performance indicators point to the fact that investment in machinery and equipment would have decreased by -0.9% QoQ (6.0% YoY) in the fourth quarter.[3] Therefore, this investment item would end 2019 with an annual increase of 3.9%, 1.8pp below the previous year. Residential investment, on the other hand, would have stagnated in the fourth quarter (1.8% YoY) after the slight decline observed in the third quarter (-0.1% QoQ).[4] As a result, this demand component would have ended the year with an average expansion well below that recorded in the last triennium (2.6% YoY versus 9.4% on average since 2016).

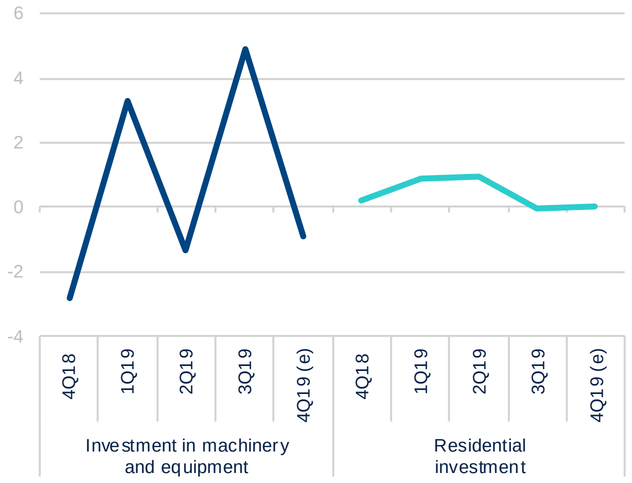
The increase in consumption would have offset the decline in investment, so domestic demand would have contributed positively to GDP growth in the fourth quarter (a quarterly increase of 0.3pp and a year-on-year increase of 1.9pp). In the year as a whole, the domestic demand contribution was 1.7pp, 0.9pp less than in 2018.

Figure 3.3. **SPAIN: OBSERVED GROWTH AND CONSUMPTION ESTIMATES** (% QoQ).



(e) Estimate.
Source: BBVA Research based on INE data

Figure 3.4. **SPAIN: OBSERVED GROWTH AND INVESTMENT ESTIMATES** (% QoQ)



(e) Estimate.
Source: BBVA Research based on INE data

2: Fourth quarter 2019 indicators anticipate lower growth in private consumption. Private-sector registrations fell between October and December and retail turnover, consumer-goods imports and domestic sales in large companies lost traction. On the other hand, resource indicators and expectations show mixed signals. While progress in real wage income slowed and household expectations on their own financial situation and that of the economy worsened, stock prices and consumer finance increased.
3: The partial indicators of economic conditions linked to investment in machinery and equipment reflected different behaviors. While the IPI of capital goods and sales of industrial vehicles showed better development than in 3Q19, industrial confidence and capital goods orders, as well as capital goods imports, decreased.
4: Most of the indicators related to residential investment performed slightly worse in 3Q19. Moderation in job creation in the construction sector and the slight progress in unemployment once again stood out. On the contrary, visa signature improved after the bad data from the previous quarter.

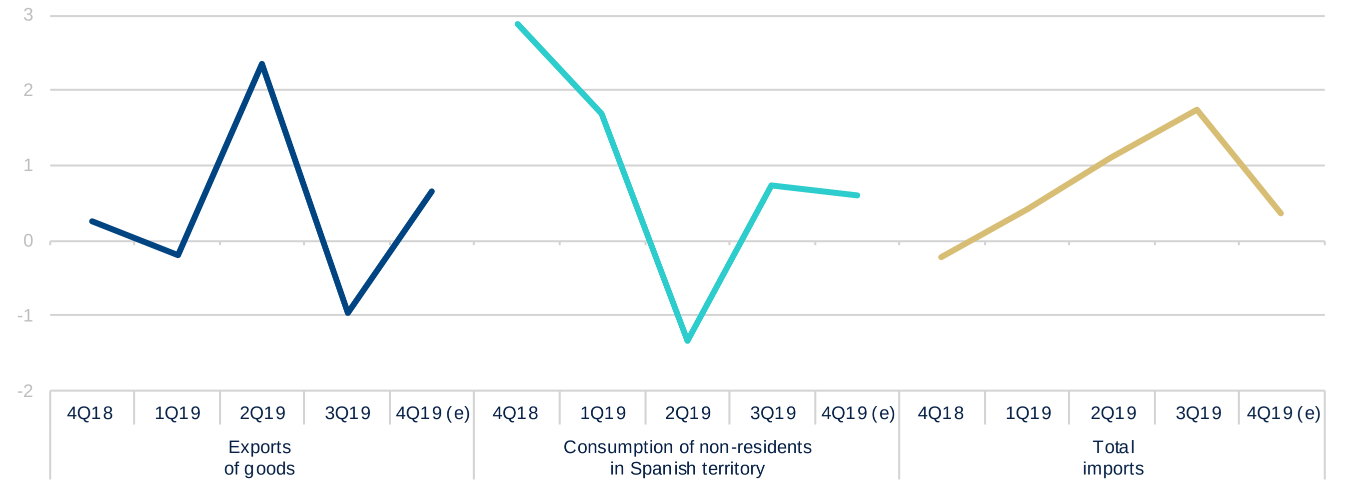
External demand: Exports recovered slightly at the end of 2019

Following the stagnation observed between July and September last year, exports of goods and services gained some traction in the fourth quarter (0.6% QoQ; 2.7% YoY), which would have led to an average expansion in 2019 slightly lower than that recorded in 2018 (2.0% vs 2.2%). In particular, the available indicators suggest that sales of goods abroad[5] would return to positive territory (0.7% QoQ; 1.8% YoY) between October and December and close in 2019 with an average growth of 0.5%, 1.6pp less than in 2018 (see Figure 3.5).

In contrast to goods exports, services exports[6] would have slowed in the fourth quarter of last year (0.3% QoQ; 4.6% YoY), which would, in any case, imply an increase of 5.3% for the whole of 2019 (2.3% in 2018). This evolution of external sales of services is due, at least in part, to the high levels of consumption amongst non-residents in Spain (0.8% QoQ between October and December; 1.8% YoY), which resulted in an increase of 3.1% at the end of 2019 (1.7% in 2018).

Finally, imports would have also increased in the fourth quarter of the year (0.4% QoQ; 3.7% YoY) and would have ended the fiscal year with an increase of 1.6% (3.3% in 2018). This, coupled with the expected behavior of total exports, **would have resulted in a net external demand having a positive impact on the growth of the Spanish economy (0.1pp QoQ; -0.2pp YoY) in the fourth quarter of 2019** and 0.2pp in the year as a whole (-0.3pp in 2018).

Figure 3.5. **SPAIN: OBSERVED GROWTH AND FORECASTS OF THE MAJOR COMPONENTS OF EXTERNAL DEMAND (% QoQ)**



(e) Estimate.
Source: BBVA Research based on INE data

5: Partial indicators of exports are showing conflicting trends. Available trade balance information points to a recovery in sales in the fourth quarter of 2019 (0.7% MoM SWDA in October). However, exports from large companies grew by only 0.2% MoM SWDA in October and the export order portfolio returned to negative territory following the rally observed during the summer months.

6: Partial consumption indicators of non-residents also show mixed signals. Overnight stays in non-resident tourist hotels grew by 0.6% MoM SWDA on average in October and November. At the same time, visitor border arrivals increased on average by 0.5% MoM SWDA in the same period. Nevertheless, balance of payments from tourism revenue fell by -0.4% MoM SWDA in October.

Labor market: Job creation remains weak, while unemployment is growing for the first time since 2013

Once seasonal and calendar effects are accounted for, **Social Security affiliation increased by 0.4% QoQ in the fourth quarter of 2019 (2.2% YoY)**, in line with the third quarter, and exceeded 19,420,000 contributors in December, slightly below the historical peak reached in early 2008 (19,430,000 SWDA affiliates).[7] On the contrary, **registered unemployment interrupted the downward trend that started in the second half of 2013** and grew by 0.1% QoQ SWDA (-1.8% YoY) between October and December (see Figure 3.6). Although unemployment has fallen by 35.9% in the last five years, it is still 59.6% higher than in mid-2007 (1,973,000 unemployed people SWDA).

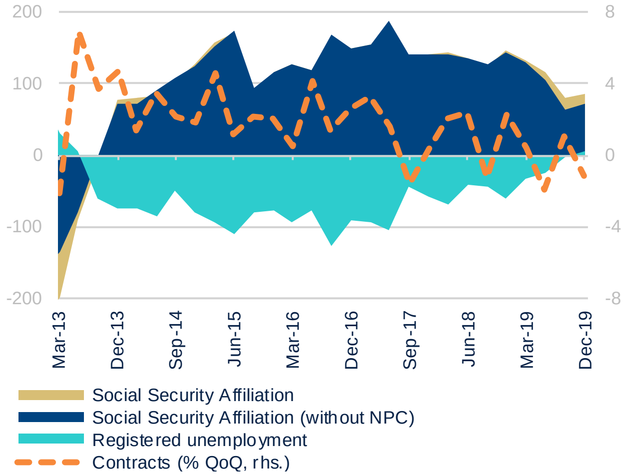
The impact of the minimum wage increase on employment remains limited. The information from 2019 shows slightly less favorable performance of Social Security registration among young people, those employed in traditionally low-paid service activities such as retail or hospitality, and the residents of Andalusia, the Canary Islands, Extremadura and the Region of Murcia. In the groups with greater minimum wage coverage, the number of contributors increased by 2.8% in 2019, a point lower than the average of 2017-2018. In other groups, the slowdown in registration growth was lower (around six tenths).

Records show a comparatively high adjustment in General Social Security Regime affiliation among workers who are potentially affected the most by the rise in the minimum wage. This result suggests that the increase in wage costs would have driven a flow from salaried employment to self-employment. In this respect, Figure 3.7 shows that the differential of growth in Social Security affiliation between the groups with the highest minimum wage coverage and the rest of the employed population is greater in the general regime (seven tenths) than in the total (four tenths).

The Labor Force Survey (LFS) corresponding to the fourth quarter is expected to confirm the sluggishness suggested by Social Security registration and unemployment figures. Employment would have increased by around 0.3% QoQ SWDA (1.3% YoY) between October and December, following the practical stagnation observed in the third quarter. If the labor force follows the growth trajectory observed in the preceding quarters (see Box 1), the unemployment rate would remain virtually stable at around 14.2% SWDA, in line with the gross figure. If the forecasts for the fourth quarter are met, **2019 would have been the sixth consecutive year of job creation.** On average, employment would have increased by around 413,000 people, 90,000 fewer than in the previous year. Despite the increase in the working population of more than 200,000 people, the unemployment rate fell by about one point to 14.2%.

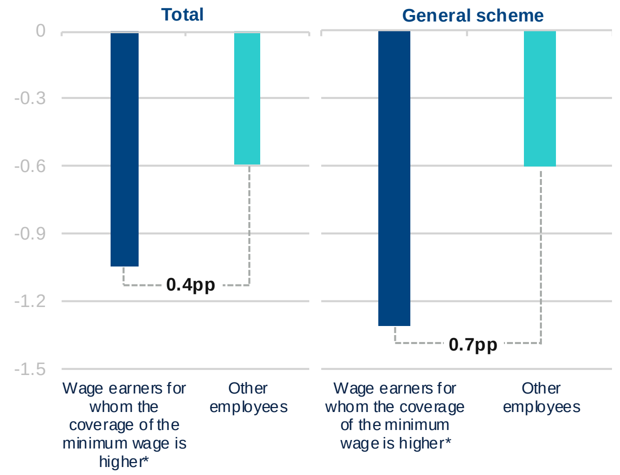
7: From April 1, the Social Security contributions of the special agreement for non-professional care providers of dependent persons have been paid again by the General State Administration, which has boosted the Social Security registration of this group to 54,400 people in December. Excluding non-professional careers, the increase in the fourth quarter's number of contributors would have been similar to the total (0.4% QoQ SWDA; 2.0% YoY).

Figure 3.6. **SPAIN: LABOR MARKET INDICATORS** (SWDA DATA. QUARTERLY CHANGE IN THOUSANDS OF PEOPLE, EXCEPT WHERE INDICATED OTHERWISE)



Source: BBVA Research based on MITRAMISS (Spanish Ministry of Labor, Migrations and Social Security) data

Figure 3.7. **SPAIN: VARIATION IN SOCIAL SECURITY AFFILIATION** (DIFFERENCE BETWEEN VARIATION IN 2019 AND 2017-2018 AVERAGE, %)



(*) Adults under the age of 30; Trade, hospitality, real estate activities, professional, administrative and artistic activities and other services; Canary Islands, Extremadura, Andalusia, and Murcia.
Source: BBVA Research based on MITRAMISS (Spanish Ministry of Labor, Migrations and Social Security) data

Prices and wages: headline inflation increases, while wage demands remain stable

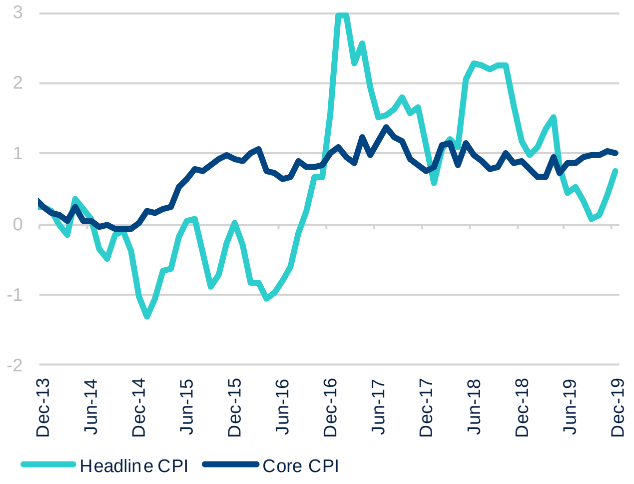
During the fourth quarter of 2019, headline inflation accelerated to 0.8% YoY in December, according to the INE flash estimate (a yearly average of 0.7%) (see Figure 3.9). Behind this trend, the evolution of energy prices - mainly fuel and gas - stood out. The prices reduced their year-on-year fall due to the absorption of the base effect resulting from declines at the end of 2018. For its part, core inflation remained virtually stable between October and December last year (Forecast BBVA Research: 1.0% YoY in December; a yearly average of 0.9%).

In this context, BBVA Research estimates indicate that the headline inflation differential with respect to the euro area remained favorable to the Spanish economy throughout the year (-0.5 pp YoY in December; an annual average of -0.4pp). Similarly, using core inflation as a reference, the price growth differential would have returned to negative territory (-0.3pp YoY in December; an annual average of -0.2pp) after temporarily closing itself between July and September.

Wage demands remained stable in the fourth quarter of 2019. The average wage growth agreed in collective bargaining last year was 2.3% YoY, in line with the levels recorded at the end of the third quarter but three tenths higher than the minimum recommended in the IV Agreement for Employment and Collective Bargaining (AENC in Spanish).[8] The increase in remuneration in the revised multi-year agreements increased by barely half a tenth compared to the agreements signed up to September (to 2.1%), while in the data for the whole year, it decreased by four tenths to 3.1%, as seen in Figure 3.9.[9]

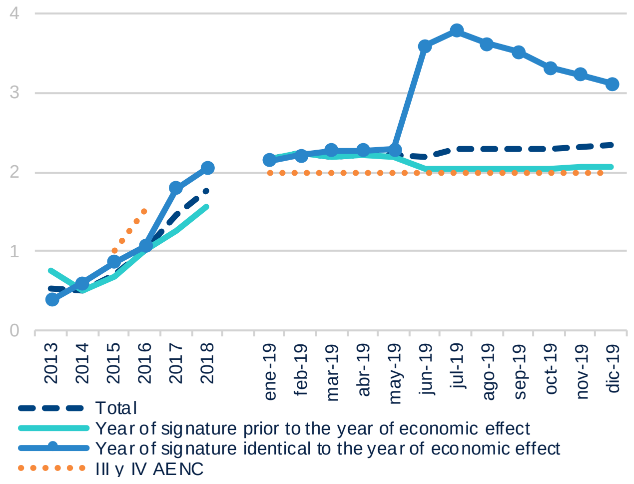
8: The 4th AENC, which was signed in early July 2018 by the CEOE, CEPYME, CC.OO and UGT recommended wage increases of around 2% in 2018, 2019 and 2020, plus a variable portion that depends, among other factors, on the evolution of productivity, the company's earnings and levels of unjustified absenteeism.
9: The number of workers covered by collective agreements signed during 2019 stood at 2,382,000. This represents 24.2% of the total number of workers affected by collective bargaining agreements (9,850,000).

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



Source: BBVA Research based on INE data

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



Annual data include agreements registered after December each year and incorporate the review using the wage guarantee clause.
Source: BBVA Research based on MITRAMISS (Spanish Ministry of Labor, Migrations and Social Security) data

2020-2021 Scenario: GDP growth will remain below 2.0%

The fundamentals of the Spanish economy guarantee the continuity of the expansion during the present biennium. However, the rate of growth will be significantly lower than that recorded since the beginning of the recovery (an average of 2.6% between 2014 and 2019), and around the trend (see Box 2). Therefore, **GDP growth is estimated to slow down once again in 2020 (by 0.3pp to 1.6%), but will recover some traction in 2021, to around 1.9%** (see Table 3.1). This increase in activity will support the creation of more than 600,000 jobs in 2020 and 2021—34% less than those created in the previous two-year period—and will reduce the unemployment rate to an average of around 12.5% next year.[10] However, these expectations for improvement are conditional upon the various sources of uncertainty affecting the economy being resolved, the risks facing the scenario not materializing (see page 19) and the economic policy adopted in the coming years not adversely affecting activity or employment.

Although in this scenario, activity is expected to increase throughout the forecast horizon, **the majority of the domestic demand components will grow with less momentum than the rate observed in recent years**. This is largely due to the depletion of the various tailwinds that have driven the Spanish economy so far. However, domestic demand is expected to continue to explain the majority of GDP growth, **with a contribution of 1.9pp on average for the two-year period.**

For its part, **the contribution of net external demand will once again enter in negative territory during the two-year period** (-0.2pp on average). The gradual traction gain of global trade flows and the reduction of uncertainty will drive imports more strongly than exports.

10: Employment levels will increase by around 650,000 people between 4Q19 and 4Q21 and the unemployment rate will fall to levels near to 12.2%.

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

					Changes with regard to the previous publication	
	2018	2019 (e)	2020 (f)	2021 (f*)	2019	2020
National Final Consumption Expenditure	1.9	1.4	1.5	1.6	0.4	0.1
Private FCE	1.8	1.2	1.4	1.6	0.4	0.1
Public Administration FCE	1.9	2.2	1.7	1.8	0.2	0.0
Gross Fixed Capital Formation	5.3	2.7	2.6	4.5	0.4	-0.4
Equipment and Machinery	5.7	3.9	3.2	5.1	2.3	0.6
Construction	6.6	1.7	1.4	3.8	-1.2	-1.3
Housing	7.7	2.6	2.4	5.0	-0.9	-1.5
Domestic demand (*)	**2.6**	**1.7**	**1.7**	**2.1**	**0.4**	**0.0**
Exports	2.2	2.0	2.6	3.4	0.0	-0.3
Imports	3.3	1.6	3.0	4.5	1.4	-0.4
External balance (*)	**-0.3**	**0.2**	**-0.1**	**-0.3**	**-0.5**	**0.0**
Real GDP at market prices	**2.4**	**1.9**	**1.6**	**1.9**	**0.0**	**0.0**
Nominal GDP at market prices	**3.5**	**3.4**	**2.7**	**3.6**	**0.2**	**0.2**
Total employment (LFS)	2.7	2.1	1.4	1.7	-0.1	0.0
Unemployment rate (% of labor force)	15.3	14.2	13.5	12.5	0.1	0.2
Full-time equivalent employment (Quarterly National Accounts)	2.5	2.1	1.4	1.6	0.0	0.0

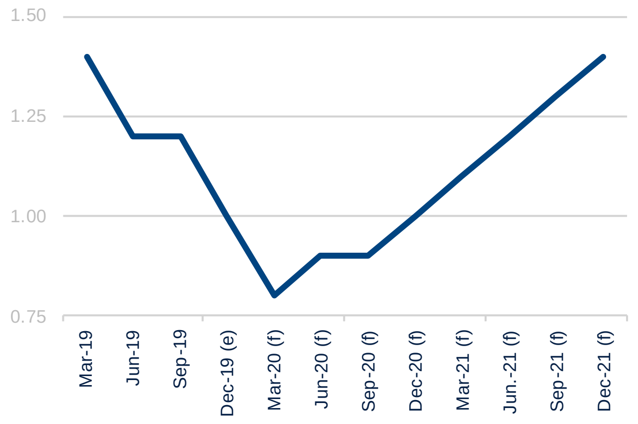
(*) Contributions to growth.
(e) Estimate. (f) Forecast. (f*) First-time forecast.
Source: BBVA Research based on INE and Banco de España data

External determinants will continue to drive activity

The annual growth rate of the global economy will once again be slightly above 3.0% in 2020 and therefore below the rate observed in the last decade (3.8% on average). However, a reduction in some of the most relevant pockets of uncertainty, (in particular, Brexit and the trade tensions between the US and China) has been envisaged, thus representing a turning point that will conclude with a surge in activity in the most developed economies in 2021. Of particular importance to Spain will be the growth acceleration of the European economy for that year (see Figure 3.10) which, according to BBVA Research estimates, could move practically one-to-one with the Spanish GDP. In this context, **the action from the central banks will continue to help contain financial tensions and prevent the US and Europe from entering into a recession**. While the marginal impact of the ECB's expansionary monetary policy is declining, the stabilization of interest rates at minimum levels will lead to a continuation of generous financing conditions (see Figure 3.12), which favors consumption and investment. In addition, interest rate differentials related to the US will continue to provide a euro exchange rate against the dollar that will boost Spanish exports.

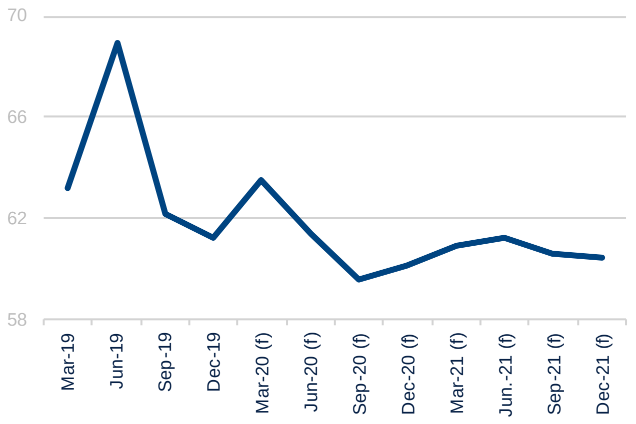
Increased tensions between Iran and the US have led to a surge in oil prices over recent weeks, which poses a risk to the Spanish economy given its high dependence on fuel imports. In any case, if uncertainty is temporary, the fundamentals of demand and supply of this raw material support a gradual stabilization of the value of a barrel of oil at around $60, according to BBVA Research estimates (see Figure 3.11).

Figure 3.10. **EMU: OBSERVED GDP GROWTH** (% YoY)



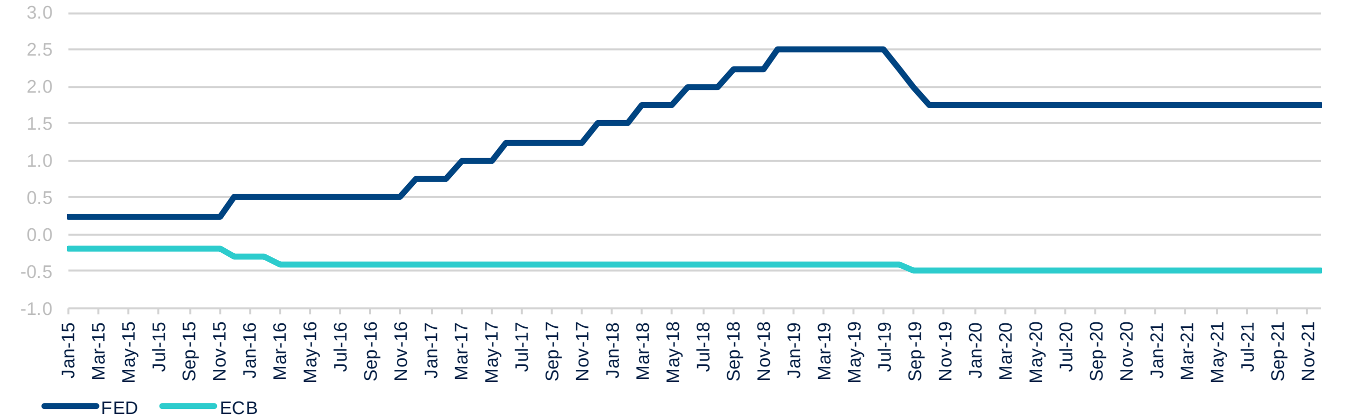
(e) Estimate. (f) Forecast.
Source: BBVA Research

Figure 3.11. **OIL PRICES** (US$ PER BARREL)



(f) Forecast.
Source: BBVA Research

Figure 3.12. **FED AND ECB: OFFICIAL INTEREST RATES*** (END OF PERIOD %)



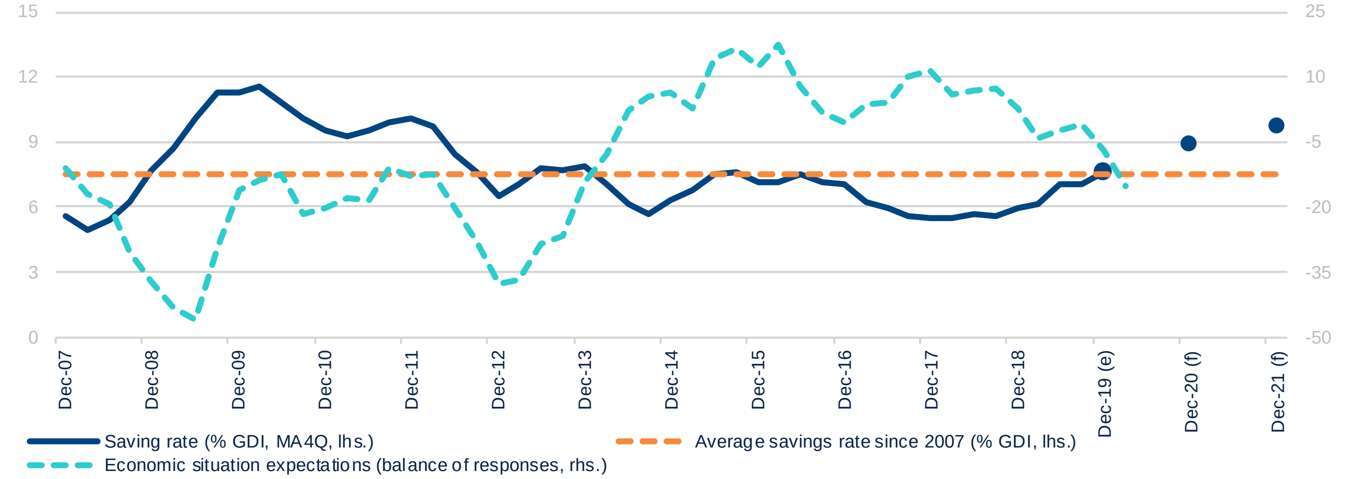
* Deposit interest rates in the case of the ECB. Forecast from January 2020.
Source: BBVA Research

Domestic demand: from least to most over the two-year period

After the sluggishness of 2019, the growth of private consumption will recover some traction next year. BBVA Research forecasts that the increase in household spending will rebound by two tenths both in 2020, to 1.4%, and in 2021, to 1.6%. What factors explain the expected dynamism of private consumption? Firstly, the evolution of spending in the second half of last year exceeded expectations in October, which introduced an upward bias on projected consumption in 2020. Secondly, the strength of the determinants of household spending is expected to extend over the next few quarters. Although job creation is losing momentum, income will keep pace with growth due to sustained wage increases, positive developments in social benefits (particularly pensions), and price containment. In addition, the rebound in financial wealth since mid-2019, favored by the reorientation of saving toward safer assets, the prolonged dynamism of real-estate wealth and consumer finance will boost spending throughout 2020.[11] On the contrary, uncertainty, reflected in the deterioration of consumers' prospects for the economic situation, will decrease spending expansion and contribute to the increase in the savings rate (see Figure 3.13).[12]

11: The volume of new consumer financing operations will continue to increase in the coming quarters at a rate consistent with last year (4.9% year-on-year up to November 2019), after growing by 17.0% in 2018.
12: In addition to uncertainty about the economic situation, there may be other reasons behind the upturn in the household savings rate, such as changes in the composition of the population or regulatory uncertainty in some markets, such as the automotive market.

Figure 3.13. **SPAIN: HOUSEHOLD EXPECTATIONS ABOUT THE ECONOMIC SITUATION AND SAVINGS RATE**



(e) Estimate. (f) Forecast. 4QMA: four-quarter moving average.
Source: BBVA Research, based on INE and EC data.

The growth in investment in machinery and equipment will increase during the two-year period. Therefore, this investment item is expected to moderate its progress to 3.2% in 2020 (0.6pp above three months ago) and to pick up some momentum in 2021 to 5.1%. The slowdown this year is explained by the domestic demand loss of traction, as well as by the downward correction in machinery purchases after the positive records in the second half of 2019, especially in the transport equipment component. The slowdown in the global and European economies will also have a negative impact in 2020. On the contrary, lower interest rates will continue to support their expansion. In line with aggregate activity, growth in machinery and equipment investment will accelerate in 2021, leaving three years of moderation behind. The expected increase in domestic demand and the best economic growth forecasts of major trading partners will boost investment next year, in a context where pockets of uncertainty could decrease, thereby limiting the risks of undertaking new investment projects.

Investment in housing will also lose traction in the current year and recover in the following one. The sluggishness that has been afflicting the residential sector in 2019 will be evident again in 2020. Therefore, investment in housing is expected to increase by 2.4% in 2020 (1.5pp less than the figures published in the last edition of this publication) and by 5.0% in 2021. Uncertainty over economic policy in general and the implementation of new regulatory changes in the sector, in particular, could further determine producers' and consumers' investment decisions. Furthermore, so far, there has been no clear reactivation of transactions following decreases caused by regulatory changes over the past year. As the pockets of uncertainty dissipate, housing investment is expected to recover in 2021, as its determinants are positive: the economy will continue to create jobs, financing costs will remain low, and low interest rates will place housing as an alternative investment asset with competitive rates of return. In turn, the recovery of the EMU economies in 2021 could lead to a boost in foreigners' demand for housing.

Pending the details of the fiscal policy measures to be adopted by the new Government, **the contribution of public demand to growth is estimated to decrease**. Therefore, public consumption will decelerate during the next two-year period to 1.7% YoY in 2020 and 1.8% YoY in 2021. Likewise, public investment will remain anemic this year, which will affect the dynamism of investment in other construction projects, and will only recover over the next year.

External sector: The recovery of demand and the reduction of uncertainty support a gradual recovery

The moderation of trade tensions following the principle of agreement reached between the US and China, together with **slightly lower negative growth expectations for Europe and the rest of the developed economies**, will support a **gradual improvement in Spain's sales abroad**. Likewise, oil prices and the real effective exchange rate will remain favorable to trade, despite their slight upward revision. Therefore, total exports are expected to increase by 2.6% YoY on average in 2020 (0.3pp less than previously estimated) and 3.4% YoY in 2021. This implies a rate of progress higher than that of the last two-year period (2.1% YoY on average for 2018-2019), although this is almost two points lower than the rate observed since the beginning of the recovery (4.4% YoY on average since 2014).

Looking at the breakdown of exports, **sales of goods abroad in the next two years are expected to recover some of the traction that was lost in 2019**. Therefore, growth will be around 2.5% in 2020, and 3.7% in 2021 (0.5% in 2019 and 3.8% on average since 2014). In any case, this implies a downward revision of 0.8pp in 2020 compared to the figures published in the previous edition of this publication, justified by the disappointing data from the second half of 2019. The progressive recovery of goods exports during the two-year period would be conditional on the consolidation of decreased trade tensions and the progressive improvement of the economies of Spain's main trading partners. Moreover, competitiveness gains from a relatively low cost of financing are expected to continue. **Service exports are also expected to remain positive** and grow by 2.9% in 2020 (nine tenths more than previously estimated) and 2.7% in 2021, which, in any case, would represent a progress rate almost three points below the average annual increase observed since 2014.

With regards to foreign tourism, BBVA Research's forecasts suggest that **consumption amongst non-residents in the national territory will once again grow moderately. It will increase by 1.7% in 2020 and by 2.0% in 2021**. While this represents 1.0pp more than expected three months ago for 2020, it compares negatively with the growth observed since 2014 (a yearly average of 5.8%). Behind this slowdown lie some structural factors, which have been mentioned in previous editions of this publication. For example, the main source markets continue to have an influence on economic apathy (Germany, the United Kingdom, France and Italy account for just over half of total border inflows), as well as the recovery of some of the competing markets, which were negatively affected by geopolitical tensions in the last five-year period. [13]

The expected composition of final demand growth will lead to an **increase in imports of 3.0% in 2020 and 4.5% in 2021**, which will, therefore, amount to a negative contribution of net foreign demand to growth in 2020 (-0.1 pp) and 2021 (-0.3pp). These figures are consistent with a slowdown of the current account balance to 1.2% of GDP in 2020 and 0.9% in 2021.

Labor market: Job creation will lose traction, in line with economic activity

The slowdown in economic growth expected in 2020 will determine the evolution of job creation. Therefore, **employment will increase by 1.4% this year**, in line with what was expected three months ago and around seven tenths less than in 2019. **In 2021, the upturn in economic activity will result in a slight acceleration in job creation to 1.7%**.

13: In this regard, BBVA Research estimates suggest that around 10pp of tourism growth in recent years cannot be explained by traditional fundamentals such as trends in global demand or the real effective exchange rate. For a more detailed explanation of the structural factors that are determining the levels of 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

The increase in employment will result in a decrease in the unemployment rate to 13.5% in 2020—two tenths more than anticipated in the previous edition of this publication—**and 12.3% in 2021, despite the increase in the labor force**. In line with what has happened since the end of 2017, the foreign population of working age will continue to grow throughout the two-year period and will boost the increase in the working population, even though the propensity to participate in the labor market continues to decline.[14]

If the forecasts of BBVA Research prove to be accurate, **the number of employed people would approach 20.5 million by the end of 2021 and the unemployment rate would be about 12%, still far from pre-crisis levels**. As Figure 3.14 illustrates, in 4Q21 the employment level will be around 1.4% below that 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 1.5% on average over the 2020-2021 two-year period, point toward a meager contribution to GDP growth by labor productivity.

These forecasts are consistent with a limited impact of the 2019 increase in the minimum wage on economic activity and employment in the short and medium term. The BBVA Research estimates, included in the Spain Outlook publication for the first quarter of 2019,[15] indicated that the level of FTE employment in 2019 could have been between one and four tenths higher without wage appreciation. In 2020 and 2021, the differences from the base scenario would be between -0.5% and -1.2%, depending on whether companies absorb wage pressure or move it to prices. In this context, further increases in the minimum wage, unrelated to productivity developments during the two-year period could hinder the employability of workers who would potentially be most affected, such as young people, foreigners or less skilled workers.

Inflation will remain below the ECB's target for the Eurozone

In 2020, headline inflation will increase by 0.3pp on average to around 1.0% YoY (two tenths lower than the levels estimated three months ago). The gradual reduction in the unemployment rate and weak monetary stimulus will lead to core inflation also fluctuating around 1.0% (1.1% YoY on average for 2020), while also minimizing the downward pressure on energy prices in 2019. In 2021, the underlying prices will continue to grow gradually (a yearly average of 1.2% YoY), which, along with the energy component, will place headline inflation at 1.5% YoY.

If these estimates prove to be correct, **the differential of headline inflation against the Eurozone would remain in territory that is slightly favorable to Spain during the 2019-2020 two-year period** (-0.1pp on average).

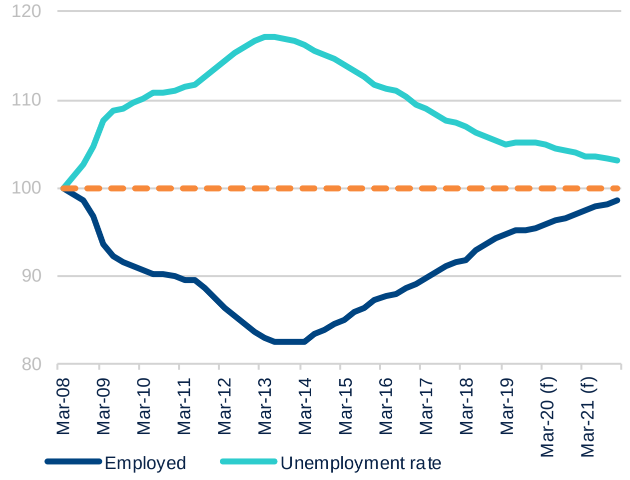
Fiscal policy: pending new budgetary policies

Despite the political uncertainty that has prevailed throughout the year, 2019 is estimated to have ended with a fiscal boost of around four tenths of GDP. This impulse came primarily from the impact of some of the expansionary measures adopted at the end of 2018 and during the first months of 2019.[16] However, some of this would have been offset by the effect of the economic cycle and the lower cost of debt. Nevertheless, the deficit would have been around 2.4% of GDP by the end of 2019, which was slightly worse than the forecast made three months ago, moving away from both the stability target (-1.3%) and the government's forecasts (-2.0% of GDP).

Looking ahead, given the persistence of uncertainty over economic policy and moderation in activity growth, the cyclical correction will decrease, and fiscal adjustment will come almost exclusively from lower debt costs. Therefore, under no-policy-change scenario, the deficit would fall to 2.2% of GDP in 2020 and 2.0% in 2021 (see Figure 3.15). Without knowing the details of the measures proposed by the new Government in its budget program, these figures would certify that the tone of fiscal policy could change to neutral during the next two-year period.

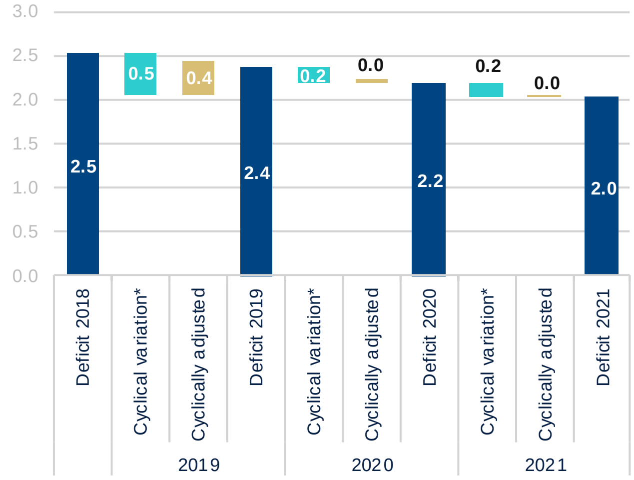
14: The activity rate of the Spanish population has decreased by almost two points since 2012. The activity rate of the foreign population has increased by around six points since 2010.
15: Available at https://www.bbvaresearch.com/en/publicaciones/spain-economic-outlook-first-quarter-2019/
16: In particular, the 2.25% increase in the salary of public employees (RDL 24/2018, December 21), the 1.6% increase in contributory pensions and 3% increase in non-contributory pensions (RDL 28/2018, December 28), as well as measures to extend paternity leave (RDL 6/2019, of March 1), or to restore unemployment allowance for persons over 52 years of age and to approve a new bonus for long-term unemployed contracts (RDL 8/2019, of March 8).

Figure 3.14. **SPAIN: LEVEL OF EMPLOYMENT AND UNEMPLOYMENT RATE** (1Q08 = 100. SWDA DATA)



(f) Forecast
Source: BBVA Research based on INE data

Figure 3.15. **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 the Ministry of the Treasury and INE data

Risks: the downward bias remains

At the external level, doubts over growth prospects in large economic areas and the impact of the different pockets of uncertainty that have harmed trade and investment have been partially moderated. On the one hand, the outcome of the British Parliament election seems to have reduced the possibility of a disorderly Brexit. There are also signs of a decrease in trade tensions between the US and China, as shown by the provisional principle of agreement that seems to have been reached. Moreover, the probability of recession is lower for both the American and European economies and the latter has consolidated expectations for a slightly more expansionary fiscal policy, especially in Germany. However, the risk associated with higher production and transport costs has increased as a result of higher volatility in the crude oil market, following increased tensions between Iran and the US. The futures markets discounted that the price of oil could be up to 10% higher in 2020 than they were discounting a month ago. If this happens, it could lead to a decrease of between 0.3pp and 0.5pp of the Spanish economy's growth.[17]

At the domestic level, regulatory and economic policy uncertainty remains high and is one of the main sources of instability. This is particularly evident in the automotive and real estate sectors where sales remain below the figures from 2018 and in job creation in those regions, companies or collectives most exposed to contracts linked to the minimum wage. With regard to the latter, it should be noted that the impact of possible future revaluations will again depend not only on the number of employees who are affected by additional increases but also the effect of the other wage demands on the economy and the response from business margins.[18] Likewise, the changes that the new government can make in important areas such as the labor market or pensions will be of particular importance for growth in investment and employment.

17: For further details on estimating the effects of oil prices by type of 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://bit.ly/2GaFeeG
18: BBVA Research estimates of the potential impacts of the 2019 increase in economic growth and job creation are available in the Spanish economic outlook publication for the first quarter of 2019, https://www.bbvaresearch.com/en/publicaciones/spain-economic-outlook-first-quarter-2019/

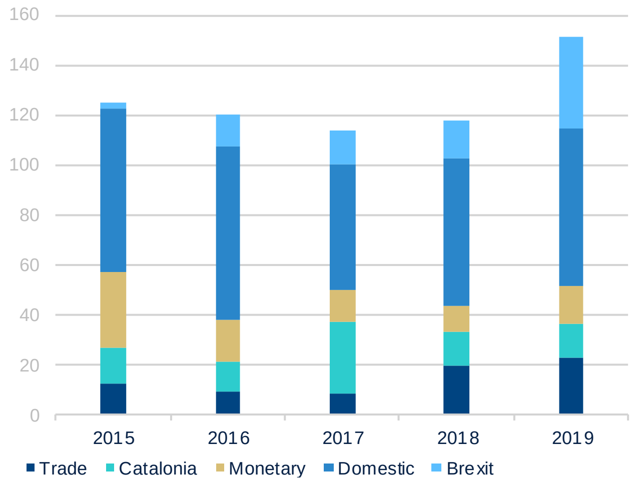
Similarly, the one-day strike and the various episodes of tension that took place in Catalonia in October seem to have had a negative impact on regional economic activity. Although the effect has been less than it was two years ago, political uncertainty continues to diminish the Catalan economy's evolution and, therefore, the growth capacity of Spain as a whole.[19]

In this respect, **the BBVA economic policy uncertainty index increased in 2019 and therefore remains at historically high levels, despite the moderation recorded in the fourth quarter of last year** (see Figures 3.16 and 3.17). It is estimated that increases in uncertainty in the final stretch of 2019 have been lower than the level recorded during other incidents linked to electoral processes. Furthermore, the decrease in uncertainty over Brexit and, to a lesser extent, over trade disputes has offset the increase in uncertainty related to Catalonia, which explains the downward correction between October and December.[20]

The risks associated with the fulfillment of budgetary objectives also continue to be relevant. In this regard, the new Government's commitment to fiscal responsibility is welcome. In any case, the starting point is not the best: Over the past year, the deficit reduction was virtually zero in an environment of ample growth and low interest rates. In fact, 2019 would have been the fifth consecutive year with a pro-cyclical fiscal policy. For the next two-year period, **commitment to reducing the imbalance in public accounts should be a priority. Although monetary policy is helping to keep the cost of financing public debt at relatively low levels, fiscal consolidation must continue** with the aim of improving the efficiency of spending and the tax system.

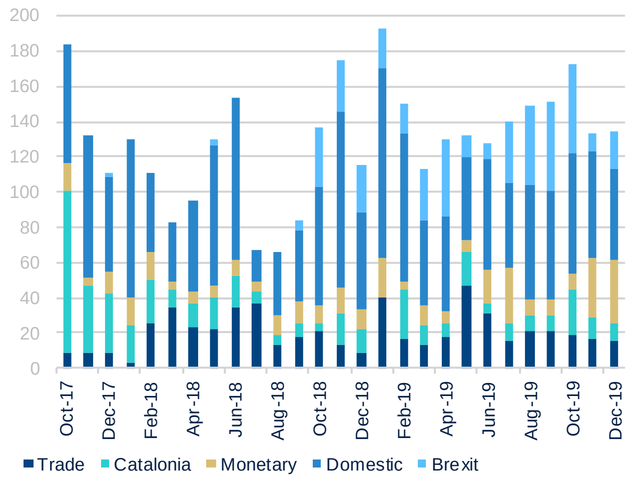
However, the long-term challenges remain for the Spanish economy. **Unemployment and the use of temporary contracts are structurally high. Similarly, the aging population is putting stress on the pension system's sustainability in a context where productivity is showing worrying levels of stagnation** (see Box 3). These factors point to the fact that in the medium term, the Spanish economy will exhibit a slower rate of progress than that observed in recent years if reforms that boost growth potential are not implemented (see Box 2).

Figure 3.16. **SPAIN: UNCERTAINTY OF ECONOMIC POLICY** (INDEX 100 = AVERAGE 1997-2008)



Source: BBVA Research based on press articles

Figure 3.17. **SPAIN: POLITICAL AND ECONOMIC UNCERTAINTY** (INDEX 100 = AVERAGE 1997-2008)



Source: BBVA Research based on press articles

19: For more details see the Catalonia Economic Outlook for the second half of 2019, available at: https://www.bbvaresearch.com/en/publicaciones/catalonia-economic-outlook-second-half-2019/
20: For more information on the BBVA uncertainty index, see BBVA Research observatory: "Understanding the causes of economic policy uncertainty using machine learning" available at https://www.bbvaresearch.com/en/publicaciones/spain-understanding-the-causes-of-economic-policy-uncertainty-using-machine-learning/

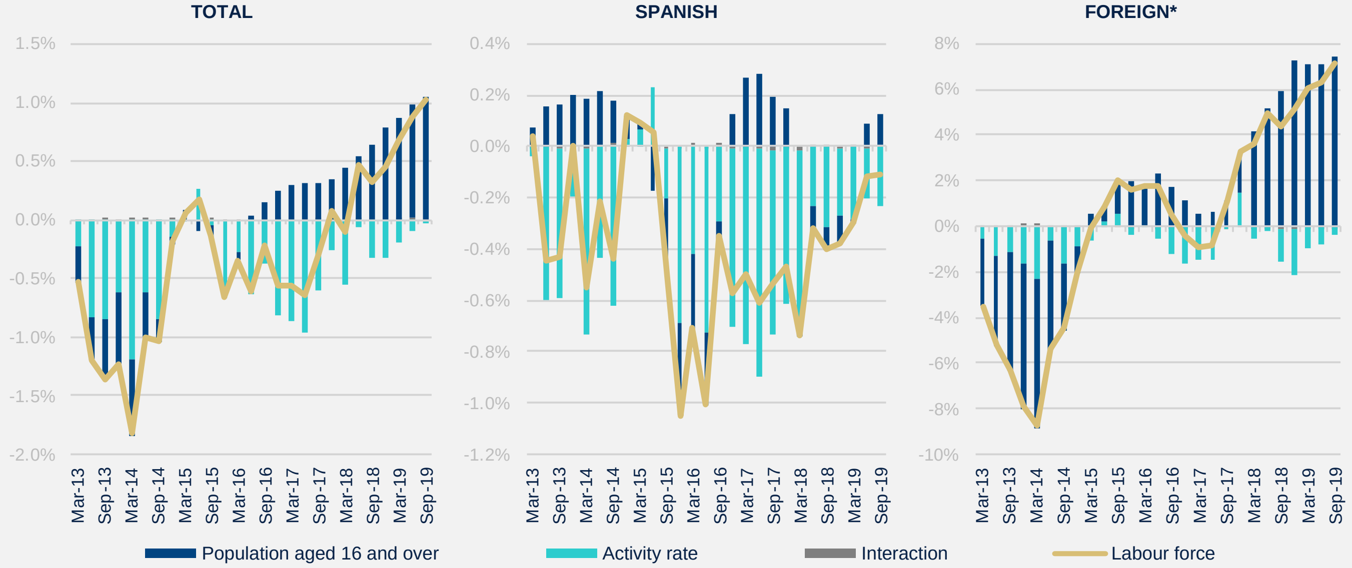
Box 1
Immigration and the growth of the labor force

Spain's labor force has grown since the second half of 2017, after falling almost continuously during the previous four years. Since the third quarter of 2017, the number of active people has increased by more than 300,000 (1.4%) to exceed 23,000,000 people in the period July to September 2019.

Population growth explains the increase. As Figure R.1.1 illustrates, the positive evolution of the working-age population since early 2016 is entirely responsible for the increase in the number of active people, given that the propensity to participate in the labor market – represented by the activity rate – has fallen by almost two percentage points throughout the recovery to stand at 58.7% in the third quarter of last year.

The change in the labor force differs by nationality. Since mid-2017, the number of active foreign people[21] has increased by around 400,000 (11.8%) due to the increase in the adult population, while the number of active Spaniards has declined by almost 100,000 (-0.5%). Therefore, **immigrants are the ultimate cause of the recovery**.[22]

Figure R.1.1. **CONTRIBUTIONS TO THE YEAR-ON-YEAR GROWTH OF THE LABOR FORCE BY NATIONALITY (% AND PP)**



* Includes dual nationality.
Source: BBVA Research, based on INE data (LFS)

Where do the foreign members of the labor force come from? Figure R.1.2 shows that people from Latin America account for almost half of the growth in the foreign active population since the second half of 2017. 31% come from South America and 17% from Central America. Africans and Asians account for 25% and Europeans for the remaining 27%. Among the latter, the nationalities that stand out are the Italians, French and British, as well as those from Eastern Europe (Romania, Russia, Moldova, and Armenia, essentially).

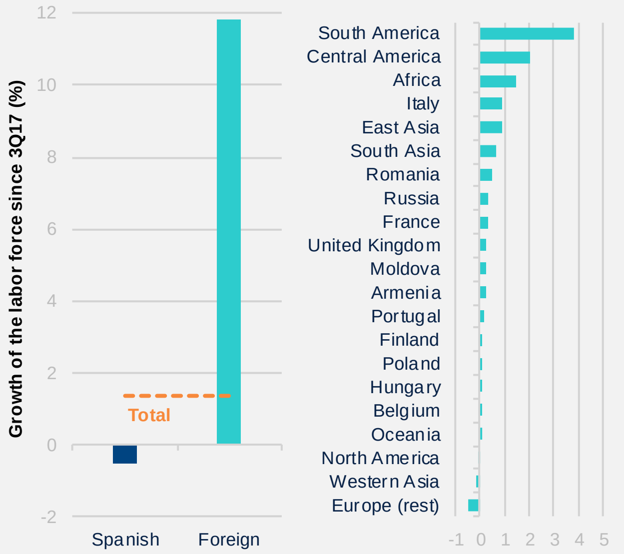
21: Includes the population with dual nationality.
22: The foreign population aged 16 and over has grown by 650,000 in the last two years. By contrast, its activity rate has fallen by 1.3 points to 70.8% in the third quarter of 2019.

In contrast to the situation during the crisis period, the steady growth in the labor force should boost the potential growth of the Spanish economy, as well as job creation and increased productivity. As Box 2 shows, the fall in labor participation between 2012 and 2017, fueled by the reduction in migratory flows, contributed to the slowdown in the potential growth of the Spanish economy. Moreover, as the increase in the active population is the result of immigration, it can help to keep inflation delimited, as it did during the previous expansionary phase.[23]

Although its economic impact in the medium and long term is positive, in the short term the increase in the labor force will slow down the reductions seen in the unemployment rate. Figure R.1.3 shows the contributions of job creation and the increase in the active population to the change in the unemployment rate.[24] The results indicate that the unemployment rate would have fallen by an additional 1.5 points since the third quarter of 2017 if the active population had not grown. In this case, the unemployment rate would have been around 12.5% in the period July to September 2019, instead of the actual figure of 13.9%.

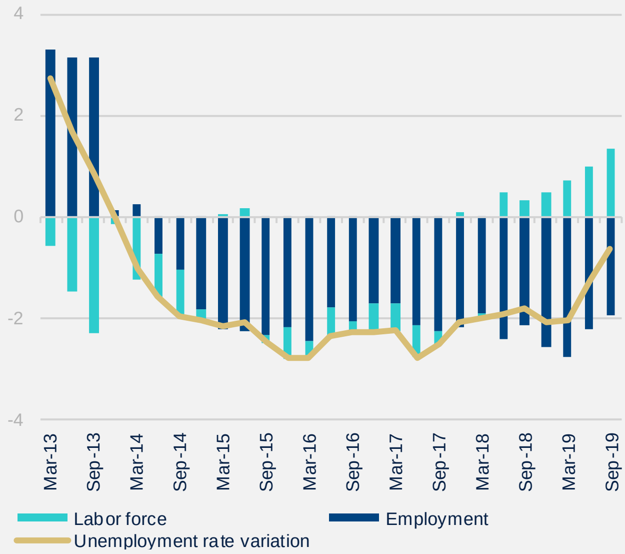
BBVA Research forecasts indicate that the labor force will continue to grow in 2020 and 2021, although probably at a slower rate than in 2019. While a reversal of the migratory flows is not anticipated, the pro-cyclical nature of labor participation could slow the increase to around 0.5% per year in that two-year period.

Figure R.1.2. **CONTRIBUTIONS TO THE GROWTH OF THE FOREIGN LABOR FORCE POPULATION* BETWEEN 3Q17 AND 3Q19** (% AND PP)



* Includes members of the active population with dual nationality.
Source: BBVA Research, based on INE data (LFS)

Figure R.1.3. **CONTRIBUTIONS TO THE YEAR-ON-YEAR CHANGE IN THE UNEMPLOYMENT RATE** (% AND PP)



Source: BBVA Research, based on INE data (LFS)

23: Bentolila, Dolado and Jimeno (2008) show that the reduction in the unemployment rate between 1995 and 2006 would have resulted in an annual increase in inflation of 2.5% had it not been offset by downward pressure on wage costs caused by immigration. More details at Bentolila, S., Dolado, J. J. and Jimeno, J. F. (2008): “Does immigration affect the Phillips curve? Some evidence for Spain,” *European Economic Review*, Vol.52 (8), 1398-1423.
24: The variation in the unemployment rate is distributed in proportion to the change in the number of unemployed persons caused by the behavior of employment and the active population.

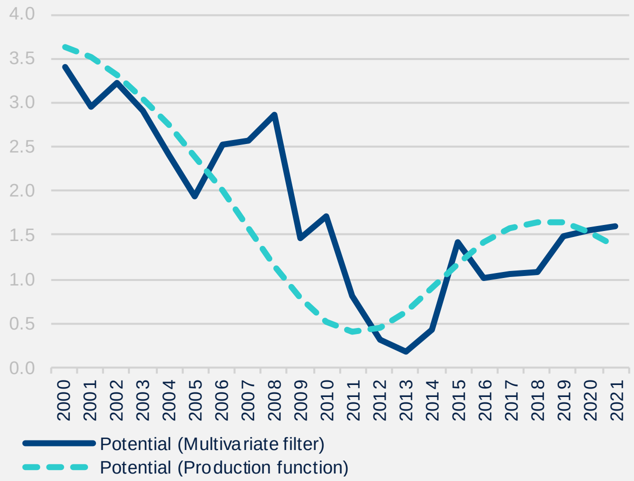
Box 2

Potential growth in Spain: Future opportunities

The increase in "potential" or "trend" GDP helps to assess the growth rate that an economy can sustain indefinitely in the absence of stimuli and without generating significant imbalances. If observed growth deviates from this estimated growth, are used as an argument for implementing demand policies that can help smooth out the cycle's fluctuations. In addition, a slowdown in this potential growth rate may point to a lower capacity of the economy to improve the living standard of its citizens and thus highlight the need for structural reforms.

According to BBVA Research estimates, potential GDP growth in Spain is currently between 1.25% and 1.75%, considerably lower than that observed in the years prior to the crisis. This loss of traction is the conclusion of the BBVA Research analysis, which is based on two standard methodologies found in the literature (see Figure R.2.1).[25] This view is broadly in line with the estimates produced by institutions such as the European Commission and Banco de España (BdE). Thus, while potential GDP is what is known as a "non-observable" variable and the estimate produced may depend on the method used, the consensus appears to be that the numbers are relatively low and lower than those estimated at the beginning of the century (see Table R.2.1).

Figure R.2.1. **SPAIN: POTENTIAL GDP ESTIMATES PREPARED BY BBVA RESEARCH** (%)



Source: BBVA Research

Figure R.2.1. **SPAIN: POTENTIAL GDP ESTIMATES PREPARED BY BBVA RESEARCH** (%)

	Averages	
	2000-2005	2015-2020
BBVA Research (a)	3.1	1.5
BBVA Research (b)	2.8	1.3
Banco de España (c)	3.0	1.0
European Commission (d)	3.4	1.0
OECD (e)	3.1	0.7

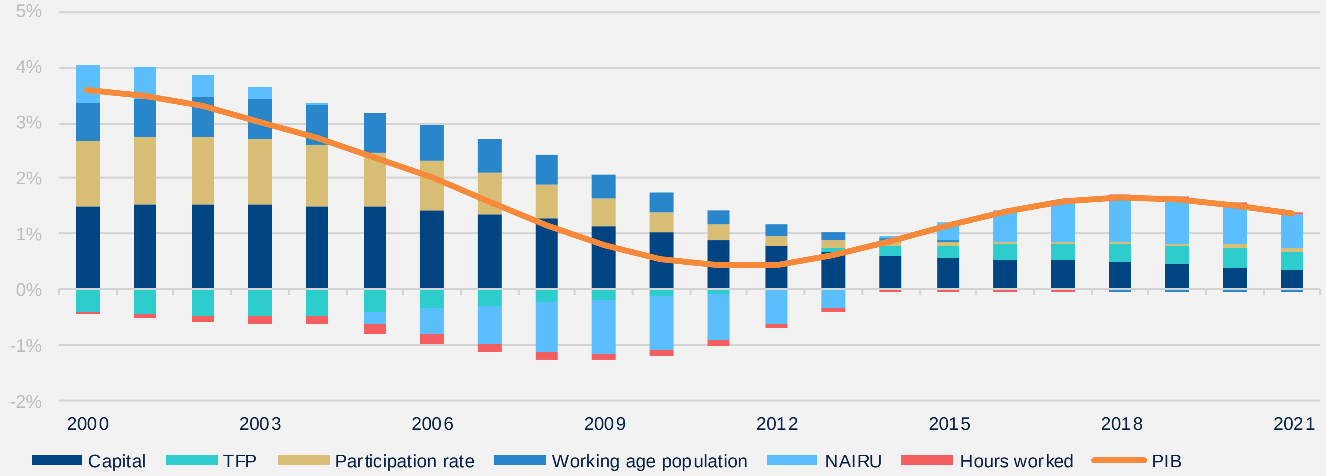
(a) estimate from the production function; (b) estimate from the multivariate filter; (c) approximate data from figure 1 in box 6 in the Economic Bulletin 1/2018 Quarterly Report on the Spanish Economy ; (d) data from AMECO; (e) Economic Outlook, Nov 19.
Source: BBVA Research based on BdE, European Commission and OECD data

Spain is not alone: the slowdown in potential growth is widespread across the advanced economies. Thus, the post-crisis period has led to a structural slowdown in activity in the US and the EMU.[26] A number of factors have been identified in the economic literature to explain the above. Among the most important are the exhaustion of the gains from the globalization process and the European integration, population aging, stabilization of labor market participation, changes in the composition of investment (from tangible to intangible) and lower productivity growth.[27]

25: In particular, estimates are developed based on a production function similar to that included in Doménech and Gómez (2006), and on a multivariate filter. The latter breaks down the observed growth into a cyclical component and a trend component using a model of non-observable components in which an expectations-augmented Phillips curve and Okun's law are also inferred. The model makes use of the Kalman filter and is estimated through maximum likelihood.
26: See, for example, Chen and Papanyan (2016) or World Bank (2018).
27: See Box 3 and the Observatory "(Un)productivity: The Spanish disease?," to be published soon.

In any case, Spain has its own specific factors. Unlike in other developed economies, total factor productivity (TFP) has not made a significant contribution to the slowdown in potential GDP growth (see Figure R.2.2). In particular, the stagnation observed in this variable is instead structural. The elements making the greatest contribution to the decline in growth are related to social factors (exhaustion of the participation rate following weaker migratory flows during the crisis), demographic factors (stagnation of the working-age population) and reduced capital accumulation. Finally, structural unemployment (NAIRU) has been falling over the past few years, although we should note that its contribution is cyclical.

Figure R.2.2. **SPAIN: CONTRIBUTIONS TO THE ANNUAL GROWTH OF POTENTIAL GDP** (PP)*



* Estimates obtained from the production function.
Source: BBVA Research

Overall, Spain has more room than other countries to improve its prospects for potential growth in the future. The country shows significant differences from the average position in the EMU in terms of unemployment and temporary employment rates. If corrected, these could contribute to a significant increase in the contribution of employment and productivity to potential growth.[28] This does not take into account the efforts that can be made to increase the profitability of investment projects in other sectors of the economy through ambitious reforms.

28: Although the temporary employment rate of the population aged between 15 and 64 years fell in Spain by 5.5pp between 2000 and 2018, it remains 10.7pp higher than the average for the EMU. Similarly, and despite the economic recovery seen at the end of 2013, the unemployment rate for that age range reached 15.4% in Spain in 2018, 10.1pp above the figure for the EMU.

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Box 3

Un(productivity): The Spanish disease?[29]

Labor productivity[30] in Spain is low compared to the average for the Eurozone. In 1995, real gross value added (GVA) was just over €27 per hour worked, 14% lower than in the EMU as a whole. Although the growth in Spanish labor productivity was comparatively high during the crisis, the gap with Europe has widened since the beginning of the recovery, to 22% in 2019.

The modest increase in GVA per hour worked in Spain has taken place in a context of a widespread slowdown in the developed economies.[31] But beyond the factors that explain the trend for weaker productivity growth, the economic cycle plays an important role, especially in the case of the Spanish economy. Along with the US, **Spain is the only country among the developed economies to exhibit a negative correlation between labor productivity and economic growth**.

From a sector-based perspective, there are two reasons for the counter-cyclical behavior of labor productivity. First, the *internal productivity* of each sector may be negatively related to the growth of the economy. Second, this may be due to a composition effect across sectors.[32] For example, it would be positive if during recessions, labor is redirected to the most productive sectors.

As shown in Figure R.1.1, changes in productive efficiency within each sector account for around 90% of the behavior of labor productivity in Spain. In contrast, the role played by variations in the composition of employment between business sectors has been minimal, except since 2013. In the Eurozone, although **labor productivity is pro-cyclical, its growth is also due to the intra-sector component**, and, in keeping with Spain, the composition effects between sectors have very little impact on the behavior of GVA per hour worked.

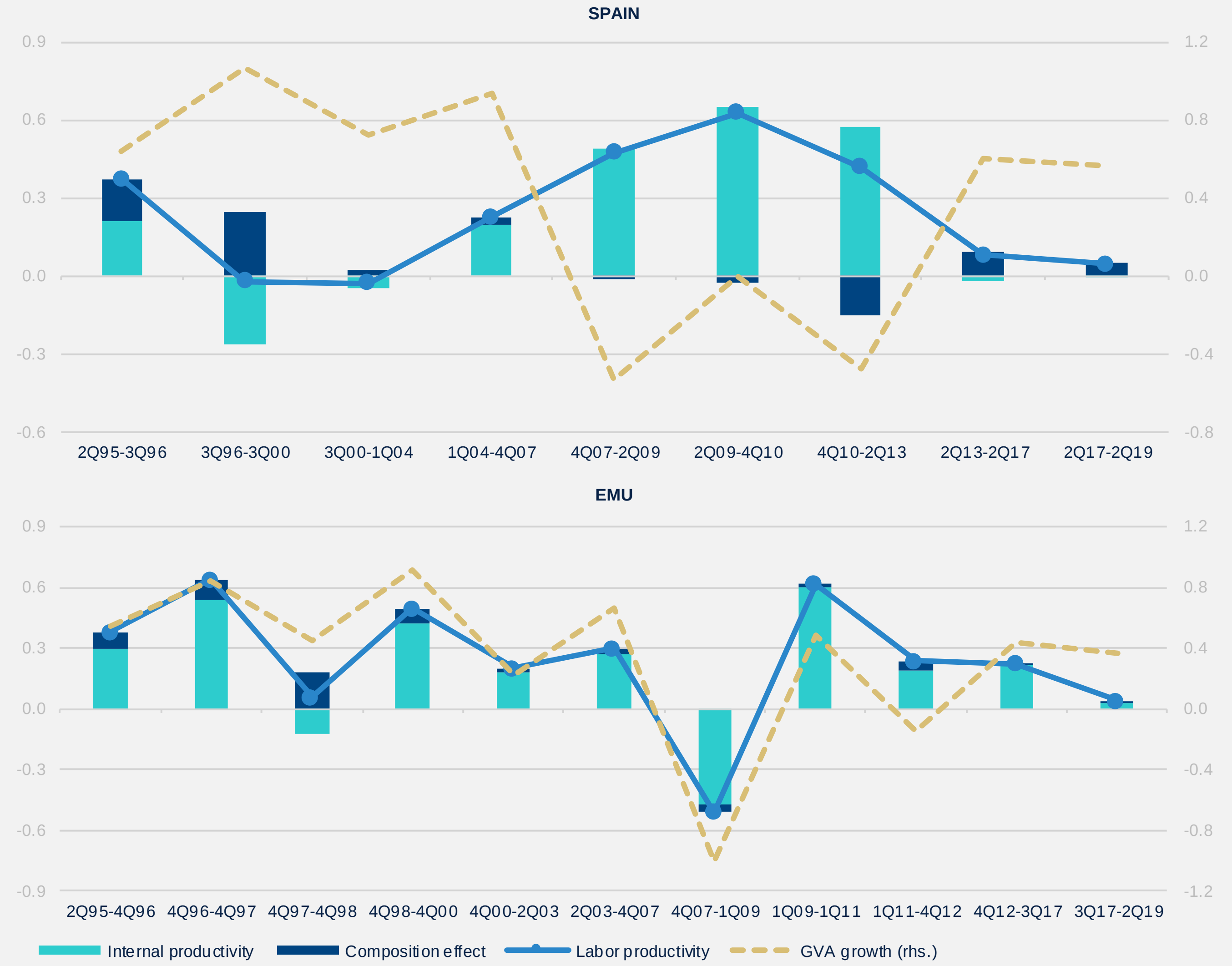
What is behind the exceptional behavior of labor productivity in Spain? It is mainly due to the poor performance of labor market institutions. Substantial differences in the degree of labor protection between contracts for temporary and permanent workers have exacerbated the cyclical volatility of employment. The upturn in productivity in recessions and downturn in expansionary phases, caused by fluctuations in employment, are intensified by the lower productivity of temporary employment, caused, among other factors, by low investment in specific human capital and less workplace training.

Moreover, **a biased corporate demography toward small and medium-sized enterprises** has also helped explain the countercyclical behavior of labor productivity. To avoid being driven out of the market during periods of economic slowdown, smaller companies tend to adopt the technological innovations generated by the leading companies in the expansionary phase. The result is an increase in the GVA per hour worked for the SMEs that survive, boosting average productivity.

These results highlight the pressing **need for structural reforms to boost sustained labor productivity growth.** In the context of adverse demographic forecasts and ever-greater challenges linked to the digitization of the economy, productivity becomes the main source of economic growth in the medium to long-term, capable of ensuring, among other aspects, the sustainability of the welfare state.

29: This box is a summary of the BBVA Research Observatory to be published shortly: "Un(productivity): The Spanish disease?."
30: Understood as real gross value added per hour worked.
31: The key factors explaining the slowdown in labor productivity include: the growth of the service economy, reduced growth of TFP, innovations being adopted more slowly, declining returns on ICT and falling real interest rates.
32: The Composition effect combines three components. The first quantifies the growth in labor productivity caused by the readjustment of employment between sectors (extensive margin). The second indicates how GVA per hour worked would have performed if only the relative working day had changed (intensive margin). Finally, the third measures the change in labor productivity as a result of redirecting production toward higher quality goods and services, which comes through as a relative price increase.

Figure R.3.1. **SPAIN AND THE EMU: BREAKDOWN OF QUARTERLY LABOR PRODUCTIVITY GROWTH** (AVERAGE FOR EACH PERIOD, PP AND %)



Source: BBVA Research, based on INE and Eurostat data

4. Tables

Table 4.1. **MACROECONOMIC FORECASTS GROSS DOMESTIC PRODUCT** (ANNUAL AVERAGE %)

	2017	2018	2019 (e)	2020 (f)	2021 (f)
US	2.4	2.9	3.7	1.8	2.0
Eurozone	2.7	1.9	1.2	0.9	1.2
Germany	2.8	1.5	0.6	0.7	1.2
France	2.4	1.7	1.3	1.2	1.1
Italy	1.8	0.7	0.2	0.4	0.7
Spain	2.9	2.4	1.9	1.6	1.9
United Kingdom	1.9	1.4	1.3	1.0	1.3
Latin America*	1.8	1.6	0.6	1.4	2.1
Mexico	2.4	2.1	0.0	1.5	2.0
Brazil	1.3	1.3	1.1	1.9	2.0
Eagles**	5.8	5.2	4.6	4.8	4.9
Turkey	7.5	2.8	0.8	4.0	4.5
Asia and Pacific	6.0	5.6	5.2	4.9	4.9
Japan	1.9	0.8	0.9	0.3	0.8
China	6.8	6.6	6.1	5.8	5.5
Asia (ex. China)	5.3	4.7	4.3	4.0	4.4
World	3.9	3.6	3.2	3.2	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.
(f) Forecast. Forecast closing date: 11 January 2020.
Source: BBVA Research

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

	2017	2018	2019	2020 (f)	2021 (f)
US	2.1	2.4	1.8	2.0	2.2
Eurozone	1.5	1.8	1.2	1.1	1.5
Germany	1.6	2.0	1.3	1.2	1.7
France	1.2	2.1	1.3	1.1	1.4
Italy	1.3	1.2	0.7	0.7	1.1
Spain	2.0	1.7	0.8	1.3	1.7
United Kingdom	2.7	2.5	1.8	1.7	2.0
Latin America*	6.7	7.1	8.7	8.7	8.2
Mexico	6.0	4.9	3.6	3.4	3.5
Brazil	3.4	3.7	3.7	4.1	4.3
Eagles**	3.9	4.9	4.9	4.7	4.2
Turkey	11.1	16.3	15.2	10.0	8.6
Asia and Pacific	1.8	2.6	2.5	2.9	2.6
Japan	0.5	1.0	0.7	1.0	0.8
China	1.5	2.1	2.9	3.4	2.5
Asia (ex. China)	2.1	3.0	2.2	2.4	2.7
World	3.2	3.9	3.7	3.7	3.5

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela.
** Bangladesh, Brazil, China, Egypt, Philippines, India, Indonesia, Iran, Malaysia, Mexico, Nigeria, Pakistan, Russia, Turkey and Vietnam.
(f) Forecast. Forecast closing date: 11 January 2020.
Source: BBVA Research

Table 4.3. **MACROECONOMIC FORECASTS: 10-YEAR GOVERNMENT BOND YIELD** (ANNUAL AVERAGE %)

	2017	2018	2019	2020 (f)	2021 (f)
US	2.33	2.91	2.13	1.94	2.08
Germany	0.37	0.46	-0.21	-0.18	0.23

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela.
** Bangladesh, Brazil, China, Egypt, Philippines, India, Indonesia, Iran, Malaysia, Mexico, Nigeria, Pakistan, Russia, Turkey and Vietnam.
(f) Forecast. Forecast closing date: 11 January 2020.
Source: BBVA Research

Table 4.4. **MACROECONOMIC FORECASTS: EXCHANGE RATES** (ANNUAL AVERAGE %)

	2017	2018	2019	2020 (f)	2021 (f)
EUR-USD	0.89	0.85	0.89	0.87	0.83
USD-EUR	1.13	1.18	1.12	1.14	1.20
USD-GBP	1.29	1.33	1.28	1.35	0.70
JPY-USD	112.20	110.47	109.00	109.00	104.92
CNY-USD	6.76	6.61	6.91	6.94	6.86

(f) Forecast. Forecast closing date: 11 January 2020.
Source: BBVA Research

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

	2017	2018	2019	2020 (f)	2021 (f)
US	1.50	2.50	1.75	1.75	1.75
Eurozone	0.00	0.00	0.00	0.00	0.00
China	4.35	4.35	4.35	3.90	3.90

(f) Forecast. Forecast closing date: 11 January 2020.
Source: BBVA Research

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

	2017	2018	2019 (e)	2020 (f)	2021 (f)
GDP at constant prices	**2.7**	**1.9**	**1.2**	**0.9**	**1.2**
Private consumption	1.8	1.4	1.3	1.2	1.2
Public consumption	1.3	1.1	1.5	1.5	1.3
Gross fixed capital formation	3.7	2.4	6.9	1.9	2.0
Inventories (*)	0.2	0.0	-0.4	-0.1	0.0
Internal demand (*)	**2.2**	**1.5**	**2.0**	**1.3**	**1.3**
Exports (goods and services)	5.8	3.3	2.4	2.1	2.7
Imports (goods and services)	5.2	2.7	4.6	3.3	3.1
External demand (*)	**0.5**	**0.4**	**-0.8**	**-0.4**	**-0.1**
Prices					
CPI	1.5	1.8	1.2	1.1	1.5
Core CPI	1.1	1.2	1.2	1.3	1.4
Labour market					
Employment	1.6	1.5	1.1	0.5	0.4
Unemployment rate (% of active population)	9.1	8.2	7.6	7.6	7.5
Public sector					
Deficit (% GDP)	-0.9	-0.5	-0.8	-1.0	-1.1
Debt (% GDP)	87.8	85.9	83.9	82.5	81.2
External sector					
Current account balance (% of GDP)	3.1	3.1	2.6	2.4	2.3

Annual change in %, unless expressly indicated.
(e) Estimate. (f) Forecast. Forecast closing day: 11 January 2020.
(*) Excluding aid to Spanish banks.
Source: BBVA Research

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

	2017	2018	2019 (e)	2020 (f)	2021 (f)
Activity					
Real GDP	2.9	2.4	1.9	1.6	1.9
Private consumption	3.0	1.8	1.2	1.4	1.6
Public consumption	1.0	1.9	2.2	1.7	1.8
Gross Fixed Capital Formation	5.9	5.3	2.7	2.6	4.5
Equipment and machinery	8.5	5.7	3.9	3.2	5.1
Construction	5.9	6.6	1.7	1.4	3.8
Housing	11.5	7.7	2.6	2.4	5.0
Domestic Demand (contribution to growth)	3.0	2.6	1.7	1.7	2.1
Exports	5.6	2.2	2.0	2.6	3.4
Imports	6.6	3.3	1.6	3.0	4.5
External Demand (contribution to growth)	-0.1	-0.3	0.2	-0.1	-0.3
Nominal GDP	4.3	3.5	3.4	2.7	3.6
(Billions of euros)	1161.9	1202.2	1242.5	1275.9	1322.1
Labour market					
Employment, LFS (Labour Force Survey)	2.6	2.7	2.1	1.4	1.7
Unemployment rate (% of labour force)	17.2	15.3	14.2	13.5	12.5
Employment, FTE (Full Time Equivalent)	2.8	2.5	2.1	1.4	1.6
Productivity	0.0	-0.2	-0.2	0.3	0.3
Prices and costs					
CPI (annual average)	2.0	1.7	0.7	1.0	1.5
CPI (end of period)	1.1	1.2	0.7	1.2	1.7
GDP deflator	1.4	1.1	1.4	1.0	1.7
Compensation per employee	0.7	1.0	2.2	2.0	1.7
Unit labour cost	0.7	1.2	2.4	1.8	1.5
External sector					
Current Account Balance (% GDP)	2.5	1.8	1.7	1.2	0.9
Public sector (*)					
Debt (% GDP)	98.6	97.6	96.8	96.5	95.1
Balance Public Admin. (% GDP)	-3.0	-2.5	-2.4	-2.2	-2.0
Households					
Nominal disposable income	2.9	3.7	3.9	3.8	4.2
Savings rate (% nominal disposable income)	5.9	6.3	7.7	8.9	9.8

Annual change in %, unless expressly indicated.
(e) Estimate. (f) Forecast. Forecast closing day: 11 January 2020.
(*) Excluding aid to Spanish banks.
Source: BBVA Research

5. Glossary

Acronyms

- AA. PP: Public Administrations
- AECB: Agreement for Employment and Collective Bargaining
- BBVA: Banco Bilbao Vizcaya Argentaria
- BBVA – GAIN: BBVA's overall index of economic activity
- ECB: European Central Bank
- BOE: Boletín Oficial del Estado (Spanish Official Gazette)
- CC. OO: Workers' commissions (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
- 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 (statutory minimum wage)
- APR: Annual Percentage Rate
- TPV/POS: POS terminal
- EU: European Union
- EMU: Economic and Monetary Union
- UGT: Unión General de Trabajadores (Trade Union)
- USD: US dollar

Abbreviations

- a 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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