3 Growth outlook for the Spanish economy

The recovery continues, in spite of the uncertainty

In 2015 the Spanish economy consolidated the recovery begun in mid-2013. Although the macroeconomic environment was not without risk, the positive trend in economic activity and employment was maintained, encouraged by significant tailwinds (such as the fall in oil prices**), the increased support from fiscal and monetary policies and the structural changes made in recent years**. Among the latter, we can highlight the correction of internal imbalances, some of the reforms set in train and changes in the structure of production, such as the reorientation of investment towards machinery and equipment and of aggregate demand towards exports.

In line with these developments, quarterly growth was at its fastest at the end of the first half of the year, with a rate of 1.0%, while during the second half it stabilised at 0.8% QoQ[2]. Consequently, **the Spanish economy ended 2015 with a higher growth in GDP than expected a year ago (3.2% vs 2.7%)**, which also marked the first annual growth above the historical average since 2007[3]. **As in 2014, the expansion of activity throughout the year was concentrated in domestic (mainly private) demand**. Firstly, it is worth noting the robust growth of consumption and productive investment, and secondly the recovery in residential investment which, despite being less vigorous than expected, resulted in the first annual increase in nine years. **By contrast, net external demand drained growth for the second consecutive year**, despite the fact that exports increased in an environment of slowdown among the emerging economies and gradual recovery in the developed economies. Thus, the balance of trade's negative contribution to growth is explained by the upturn in imports.

Going forward, the fundamentals of the Spanish economy support the continuation of the recovery over the next two years. BBVA Research estimates indicate that activity will grow by 2.7% in both 2016 and 2017, which will allow the creation of around one million jobs during the period as a whole and reduce the unemployment rate to around 17.5%[4].

In the international economic outlook, a global growth similar to that recorded in the previous year (3.2% in 2016 and 3.5% in 2017) is expected, which in the case of the European economy will mean increases in GDP of around 1.8% in 2016 and 2.0% in 2017. This factor, along with the geographical diversification of Spanish exports, will positively contribute to the development of export sales, despite the euro's appreciation against emerging markets' currencies. **Tailwind from the recent fall in oil prices** (more than 40% since the beginning of the third quarter of 2015) **is added to the external factors.** While BBVA Research estimates point to a gradual stabilisation of prices at around $45 per barrel on average for 2017, **the net impact of the downward revision in prices will be positive, and could contribute to economic growth by more than two points in the 2016-2017 two-year period.**

Domestically, we expect fiscal policy to remain slightly expansionary, contributing to growth in the short term, but leading to further failure to meet budgetary targets. In addition**, the gradual recovery of the labour market, the improvement in financing conditions for businesses and households** and the advanced stage of certain internal adjustment processes will support growth in domestic demand.

Nevertheless, there is a perceived higher probability of occurrence of certain risk events. Economic policy uncertainty in Spain has increased, and this could have significant consequences for households' and businesses' consumption and investment decisions. Although at the time of writing real activity and

2: All the figures mentioned regarding the quarterly national accounts have been seasonally and working days adjusted (SWDA).
3: The average annual growth between 1971 and 2014 stood at around 2.5%.
4: In average terms, employment will grow at an annual rate of 3.0% and the unemployment rate will be around 18.3% in 2017.

employment data do not show any deterioration as a result of the increased uncertainty, if it is not solved quickly and favourably, the impact could be negative and significant.

In addition, some external risks remain or have even increased their potential impact on the Spanish economy. In particular, **we are seeing increased risks associated with the slowdown in emerging economies, especially China and oil exporting countries.**

2015: the year in which Spain once again grew above its historical average

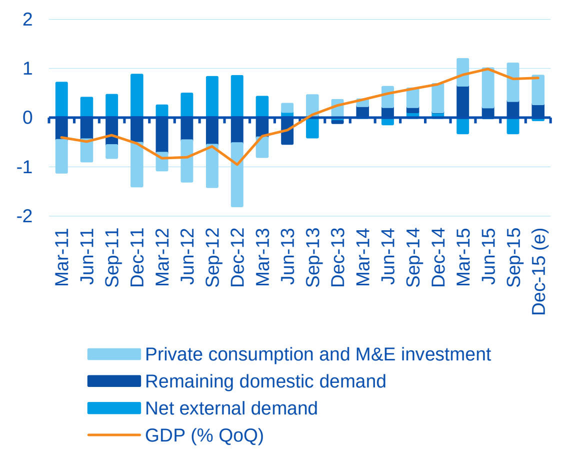
After the Spanish economy posted a positive average annual growth rate in 2014 (1.4%), expectations were that 2015 would be the year in which it would grow by more than its historical average (2.5% between 1971 and 2014) for the first time since 2007. Specifically, the recovery was expected to reach its top speed during the first half of the year, helped by tailwinds, giving way to a gradual slowdown in the latter part of the year. **Confirming the forecasts, the economy gained traction during the first half of 2015, but during the second half it experienced a slowdown that was less pronounced than anticipated.** Thus, in the absence of detailed results**, the GDP advance estimates published by the National Statistics Institute (INE) indicated that growth stabilised at 0.8% QoQ (3.5% YoY)[5] in 4Q15,**. A higher value than the one expected at the beginning of the quarter (BBVA Research: 0.7% QoQ). Thus, 2015 closed with an average annual GDP growth of 3.2%, an improvement of 0.5 pp on the rate estimated a year ago.

With regard to GDP breakdown, **partial short-run economic indicators show that, in 4Q15, activity was again underpinned by domestic demand,** (0.8 pp QoQ), primarily on private demand (see Figure 3.1). In contrast, **external demand made no contribution to growth**, since the increase in imports balanced out the increase in exports. At year-end, domestic demand contributed 3.6 pp to annual GDP growth, while net external demand drained growth for the second consecutive year (-0.4 pp on this occasion).

Looking ahead to the first quarter of 2016, the available information suggests that **the recovery trend of the Spanish economy is being extended (MICA-BBVA forecast[6]:0.8% QoQ)** (see Figure 3.2). However, uncertainty is high, as evidenced by the results of the BBVA Economic Activity Survey (EAE-BBVA)[7], which since mid-2015 have pointed to a slowdown in growth expectations (see Figures 3.3 and 3.4).

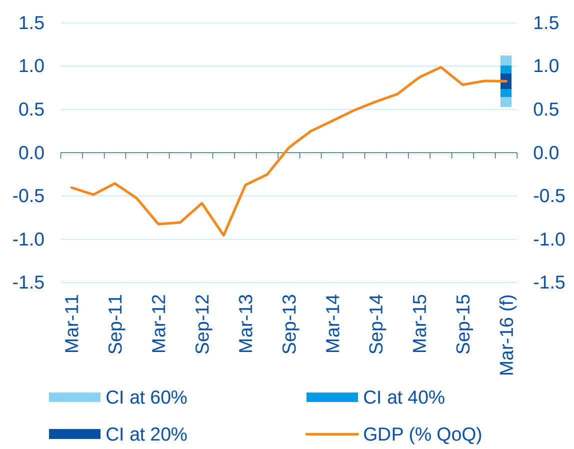
5: The details of the Quarterly National Accounts (CNTR) for 4Q15 are due to be released on 25 February 2016, with a possible revision of the advance estimate.
6: For more details on the MICA-BBVA model, see M. Camacho, and R. Domenech (2010):"MICA-BBVA: A Factor Model of Economic and Financial Indicators for Short-Term GDP Forecasting" BBVA WP 10/21, available at:http://goo.gl/zeJm7g
7: For more information on the BBVA Survey of Economic Activity (EAE-BBVA), see Box 1 of Spain Economic Outlook, Second quarter 2014, available at : http://goo.gl/epUinr

Figure 3.1
Spain: contributions to quarterly GDP growth (%)



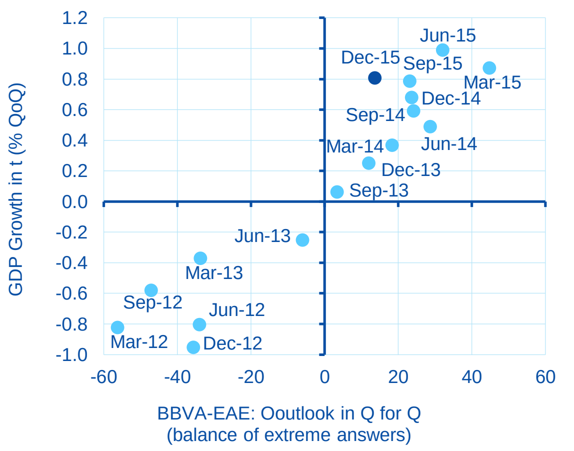
(e): estimate.
Source: BBVA Research based on INE

Figure 3.2
Spain: observed GDP growth and MICA-BBVA model estimates (% QoQ)



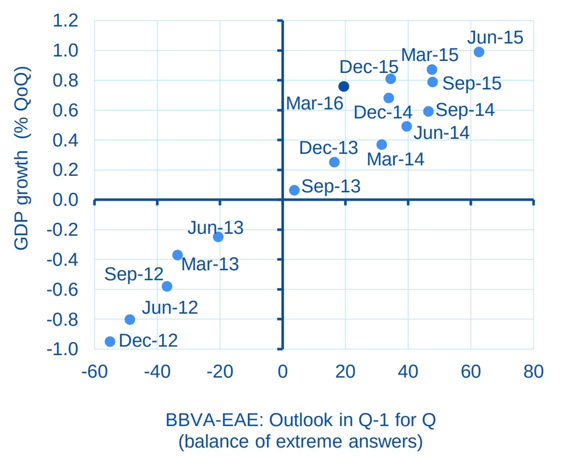
(e): estimate.
Source: BBVA Research based on INE

Figure 3.3
Spain: economic growth and view of respondents in the EAE-BBVA



Source: BBVA Research based on INE

Figure 3.4
Spain: economic growth and expectations of EAE-BBVA respondents in the previous quarter



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

Domestic demand contribution to growth doubled over the course of the year, although in 4Q15 it moderated its momentum

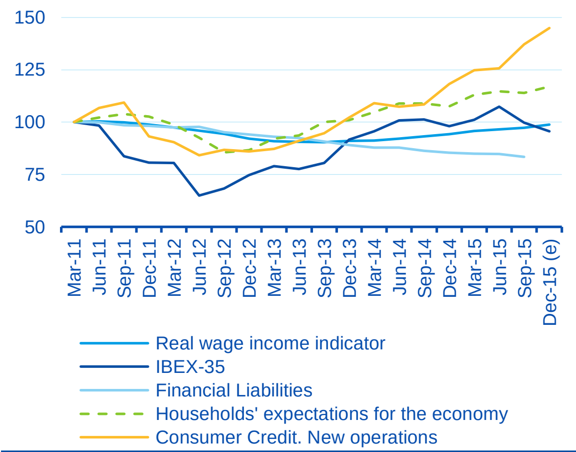
Indicators of household spending, for both goods and services[8], suggest that **household spending grew again in the fourth quarter, although at a slower pace than in the previous one.** Regarding recent developments in its fundamentals, family disposable income is expected to have increased between October and December, due as much to the effect of job creation on the wage component as to the bringing forward of the reduction in the income tax rate that was to have taken effect in 2016. In contrast, the fall in

8: A detailed analysis of the trend in household expenditure by product type can be found in the Consumption Outlook journal covering the second half of 2015, available at: https://goo.gl/VAKSbs.

equity prices was expected to have reduced the contribution of net wealth to the growth in spending, despite the expected reduction in financial liabilities and the increase in housing prices.

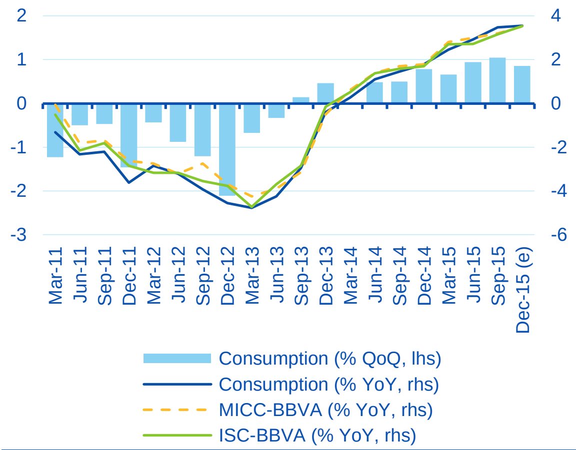
Household spending has also benefited from the rise in new lending transactions, while the view of households regarding the economic situation remained favourable at the end of the year (see Figure 3.5). In summary, both the composite consumption indicator (ISC-BBVA) and the coincident consumption indicators model (MICC-BBVA) suggest that household spending grew by around 0.9% QoQ in 4Q15, a tenth of a point less than in 3Q15 (see Figure 3.6). Thus, **household spending is expected to have increased by about 3.1% in 2015, almost two points more than in 2014.**

Figure 3.5
Spain: drivers of consumption (SWDA data. 1Q11 = 100)



(e): estimate.
Source: BBVA Research based on MINECO, Datastream, CE and Banco de España

Figure 3.6
Spain: observed data and real time estimates of household consumption

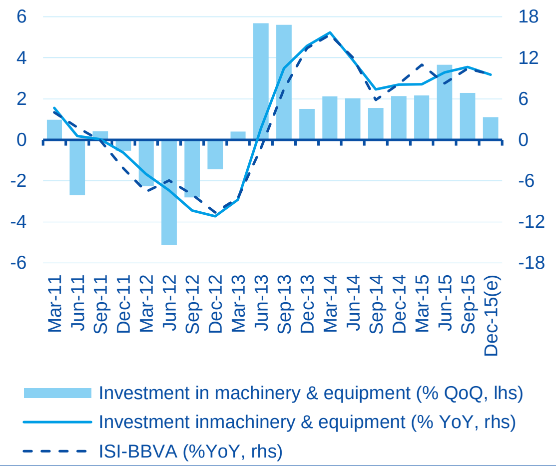


(e): estimate.
Source: BBVA Research based on INE

Machinery and equipment investment is likely to have seen slightly slower growth in 4Q15. Although financing conditions remained favourable at the end of the year, increased uncertainty - associated with emerging economies, volatility in capital markets and the domestic political context - could adversely affect the launching of investment projects.Thus, although some indicators of this demand component performed better than in 3Q15, such as industrial confidence and capital goods order-book, others slowed or even fell, such as industrial output and capital imports. However, **as shown in Figure 3.7, the composite investment indicator (ISI-BBVA) suggests an increase in machinery and equipment investment of 1.1% QoQ (9.5% YoY), 1.2 points less than in the previous quarter.** Thus, 2015 is estimated to have ended with an average annual increase in this component of demand of 9.6%, just one point below that recorded in 2014 (10.6%).

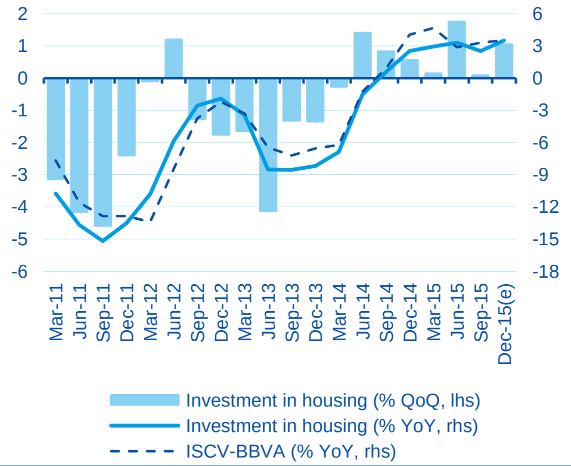
Despite the mixed signals coming from its indicators, **residential investment is expected to have returned to growth in 4Q15 after its virtual stagnation in the previous quarter.** During the fourth quarter, the trend in the construction sector was estimated to have been characterised by a further improvement in employment and a recovery in business confidence. However, the approval of building permits was estimated to have fallen from the previous quarter. All this in an environment in which home sales remained stable compared to 3Q15. As a result, **the composite housing construction investment indicator(ISCV-BBVA) points to an increase in 4Q15 of 1.1% QoQ (3.0% YoY),** and closes its seventh quarter of consecutive growth (see Figure 3.8). Thus, residential investment ended 2015 with an annual increase of 2.9%, the first positive average annual growth since 2007.

Figure 3.7
Spain: observed data and real-time estimates for machinery and equipment investment



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

Figure 3.8
Spain: observed data and real-time estimates for housing investment



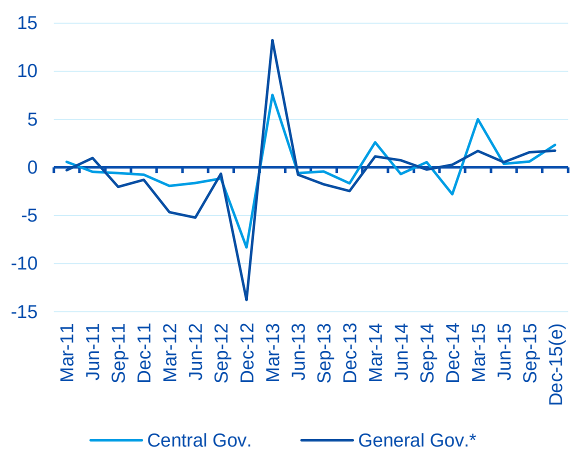
(e): estimate.
Source: BBVA Research based on INE

Public sector demand increased at the end of 2015, in line with the expansionary stance of fiscal policy

After the surprise increase recorded in the third quarter, it is estimated that public spending expanded again in the fourth quarter. Adjusted for season and working day variation (SWDA), the State's budget execution figures outturn to November show a slightly bigger **increase in nominal public sector consumption than in the previous quarter** (see Figure 3.9). Similarly, the trend in public employment according to the Labour Force Survey (EPA in Spanish), together with the return of a portion of the 2012 extra payment to civil servants suggest a **greater contribution of the wage component to public expenditure.** In fact, job creation in the public sector accelerated in the fourth quarter to 1.1% QoQ SWDA (see Figure 3.10). Consequently, it is estimated that the **real expenditure by the administrations taken as a whole grew by 1.0% (4.3% YoY) during the fourth quarter of 2015, 0.1 points more than in 3Q15.** Thus, public consumption is estimated to have closed the year with an increase of around 2.7% over the previous financial year, the first expansion of this component of demand since 2010.

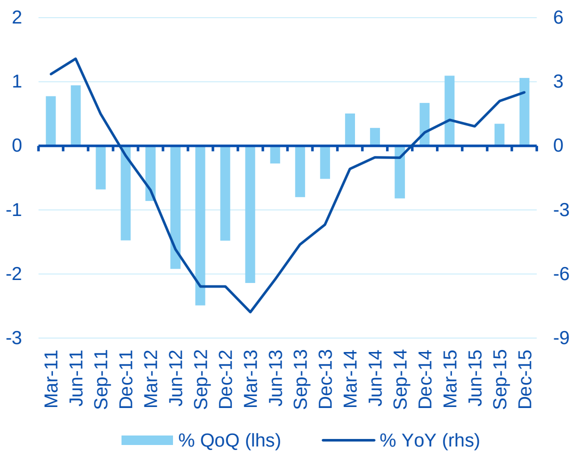
Meanwhile, the fall in official tendering processes registered up to November points to a moderation of public investment in 4Q15, following its upturn in the first half of the year. Consequently, it is estimated that **non-residential construction investment marginally slowed its momentum, with growth in the fourth quarter at around 0.7% QoQ** (6.6% YoY), three tenths of a point less than in 3Q15. Despite this slowdown, investment in other buildings is estimated to have increased by around 7.6% in 2015, almost seven points higher than in 2014.

Figure 3.9
Spain: observed data and estimates for nominal public sector consumption (% QoQ, swda)



(e) estimate.
(*)Among other items, this does not include fixed capital consumption.
Source: BBVA Research based on MINHAP and INE

Figure 3.10
Spain: salaried public sector employees (swda)

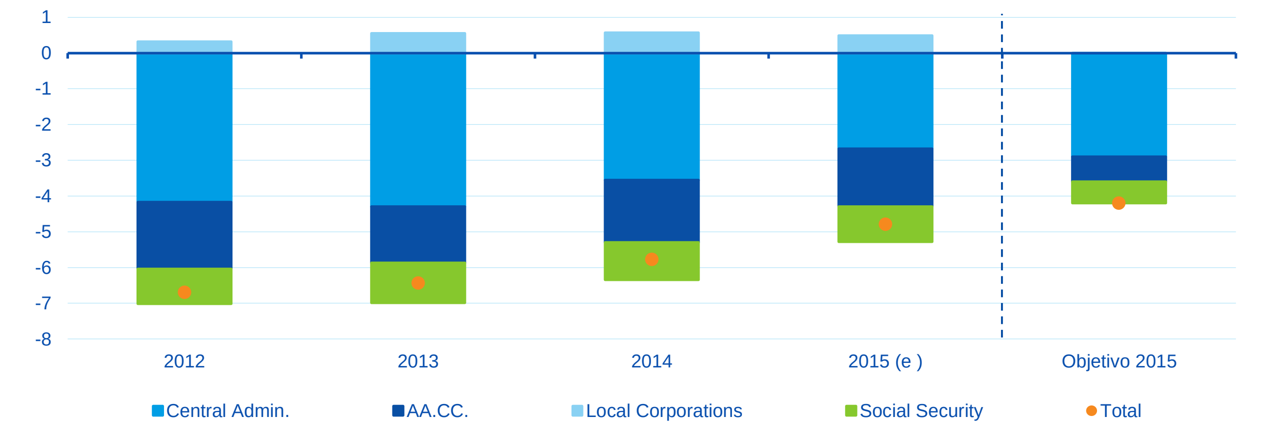


Source: BBVA Research based on INE

In this context, **the improvement in public accounts estimated for 2015 was apparently assisted by the cyclical recovery of the tax bases**, which supposedly offset the structural decline in revenue deriving from the tax cut. In addition, public spending was estimated to have been reduced again, largely due to improvements in the labour market, bringing down the amount of unemployment benefits, and to the reduction in financial costs.

Thus, **it is estimated that at year-end 2015, the public deficit stood at 4.8%**, a reduction of nearly one percentage point of GDP compared to 2014. However, **this would not be sufficient to meet the stability target (4.2%)**. In this regard, the known implementation data confirm a **failure to meet the target by the Autonomous Communities as a whole, although their 2015 deficit was lower than the one recorded in 2014.** Similarly, Social Security recorded a deviation from its target, closing the year with a similar deficit to 2014. These deviations were estimated to have been partly offset by the **good performance of local governments and, above all, of the central government**, which improved its figures from the previous year in 2015 (Figure 3.11).

Figure 3.11
Spain: net funding capacity (+) or requirement (-) of the Public Administrations by sub-sector (% GDP)



Source: BBVA Research based on MINHAP and INE

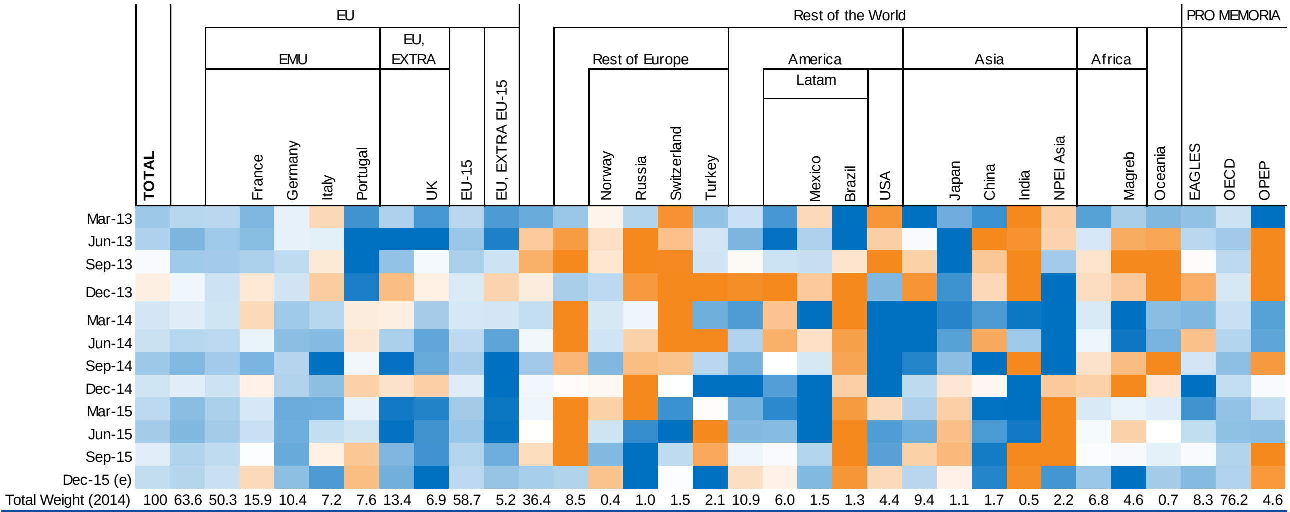
Trade flows slowed at the end of 2015, but this did not negatively affect the progress made over the whole year

The second half of 2015 was marked by **a global situation less favourable for Spanish exports than the one recorded in the first.** Although oil prices fell again and pushed down costs, the euro real effective exchange rate appreciated and the growth of emerging countries lost momentum. Accordingly, the foreign trade indicators available confirm the **fall in external demand for goods from some of the large emerging economies** (such as Brazil, India and Turkey)[9]. However, the positive trend in demand in most of the EU countries was estimated to have partially offset the weakness of non-EU countries, and gave way to a **modest expansion of the export of goods in 4Q15 (0.7% QoQ, 5.2% YoY)** (see Figure 3.12). All in all, sales of goods abroad were estimated to have closed 2015 with high growth (5.1%), slightly higher than the previous year (4.5%).

Also, **the growth in the exports of services during the last quarter of 2015 (0.9% QoQ, 8.5% YoY) was expected to be lower than in the previous quarter**. With regard to tourism, tourist inflows in 4Q15 maintained the positive trends for the major countries of origin (see Figure 3.13). Thus, it is estimated that **the growth rate of non-resident consumption in Spain reached 0.8% QoQ (3.2% YoY)**, which would mean an increase of 3.2% over the full year (4.3% in 2014). Meanwhile, **non-tourism services exports are likely to rise by 1.0% QoQ in the fourth quarter of 2015 (12.0% YoY)**, so that the financial year closed with an annual increase of 11.2%, exceeding the increase in 2014 (7.9%). **Overall, the increase in total exports was estimated to have slowed in 4Q15 to 0.8% QoQ (6.2% YoY)**, although growth for 2015 as a whole is likely to be solid (5.9%) and slightly higher than that recorded in 2014 (5.1%).

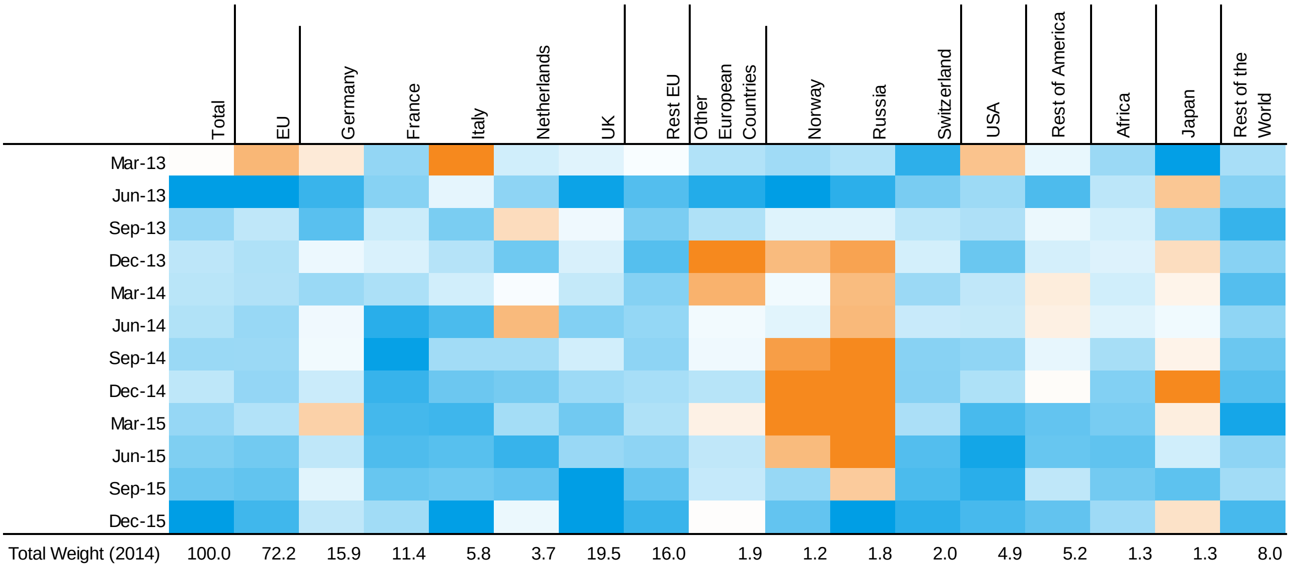
9: For greater detail regarding through which th activity shocks in China and Greece can be transmitted, see the Spain Economic Watch of September 2015, which is available at: https://goo.gl/qIgDn4

Figure 3.12
Spain: goods exports (% QoQ, swda)



(e) estimate.
(*): EAGLES: Emerging and Growth Leading Economies
Note: A deeper blue indicates a more positive value. A deeper orange indicates a more negative value.
Source: BBVA Research based on INE and the Customs Office

Figure 3.13
Spain: entry of foreign visitors in hotels (QoQ, % trend)



Note: A deeper blue indicates a more positive value. A deeper orange indicates a more negative value.
Source: BBVA Research based on IET and INE

In line with the trend for final demand, the information available as this Outlook goes to print suggests that import **growth slackened in the fourth quarter to 0.9% QoQ (8.8% YoY).** In 2015 as a whole, purchases of goods and services from abroad were estimated to have risen by 7.7%, 1.3 percentage points above the increase in the previous year.

In summary, the above elements suggest a non-existent **contribution by net external demand to growth in 4Q15** and a negative one for the year as a whole (-0.4 percentage points). However, developments in aggregate external sector did not prevent the **consolidation of the current account surplus which, supported by the gradual decrease of the structural deficit and the energy deficit, was estimated to have amounted to 1.8% of GDP at the end of 2015**, 0.8 pp more than in 2014.[10]

Job creation exceeded half a million jobs in 2015

In the fourth quarter of last year, the labour market regained the momentum it had lost in the third. Allowing for variations caused by seasonal factors, average Social Security affiliation increased by 0.8% QoQ, five tenths more than in 3Q15, and had its ninth successive quarter of growth. Hiring also picked up to reach 2.4% QoQ swda, driven by the increased in temporary work. By contrast, the decline in registered unemployment - for the tenth successive quarter - stayed at around 1.6% QoQ between October and December[11] (see Figure 3.14).

The 4Q15 Labour Force Survey (EPA) confirmed the employment pattern noted by the affiliation records. In gross terms, employment climbed by 48,800 people over October to December, in line with what was anticipated by BBVA Research[12]. Seasonally adjusting for the period, employment grew by around 0.7% QoQ, one tenth of a point more than in the third quarter. The private sector and, in particular, services led job creation.

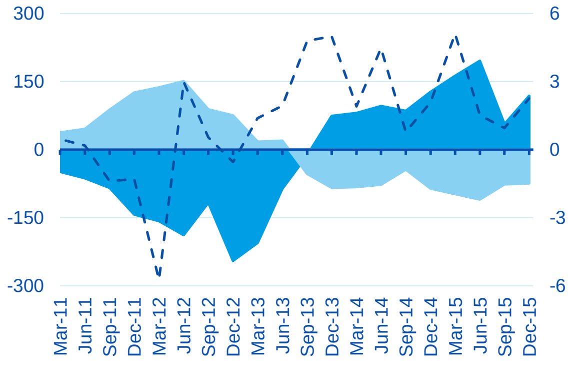
The rise in the number of salaried employees with a permanent contract (103,400 people) and the fall in recruitment under temporary contracts (63,600 people) caused a seasonal decline of 0.5 points in the temporary employment rate in 4Q15 to 25.7%. After seasonal adjustment, **the percentage of salaried personnel with a temporary contract has risen by three percentage points from its cyclical low of 1Q13**.

The rise in employment and the fall in the labour force (120,700 people), which was greater than expected, brought about a drop in **in the unemployment rate to 20.9%** (20.9% swda). Since its cyclical peak in 1Q13, the swda unemployment rate has declined by 5.4 percentage points (see Figure 3.15).

The 4Q15 figure ended the second consecutive year of job creation since 2007. Employment increased by 525,100 people during 2015 (521,900 in average terms), 64.9% of them in services and 54.7% in temporary work. These results led to a fall in the unemployment rate of nearly three points over the last year to 20.9% (annual average: -2.4 pp to 22.1%) despite the reduction in the active population (153,200 individuals at the close of the period; -32,600 as an annual average).

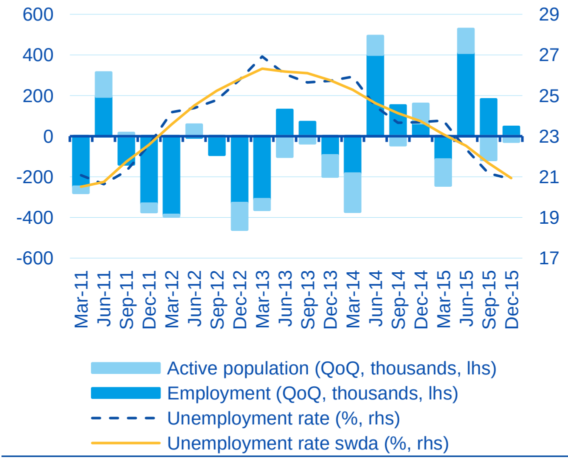
10: See Economic Watch: "Un análisis de la evolución y los determinantes del saldo por cuenta corriente en España" ("An analysis of the trend and determinants of the current account balance in Spain"), available at: https://goo.gl/UzNSeu
11: The January figures extended the positive trend of 2015. Adjusted for seasonality, BBVA Research estimates indicate that the increase in Social Security membership was around 35,000 people, while the fall in unemployment was 40,000. For more information, see https://goo.gl/bL2k4X
12: The detailed evaluation of the data from the EAPS of 4Q15 can be found at https://goo.gl/Shn4Pt

Figure 3.14
Spain: labour market figures (QoQ var. in thousands of persons, unless otherwise stated, swda)



Source: BBVA Research based on ME and SS

Figure 3.15
Spain: labour market indicators



Source: BBVA Research based on INE

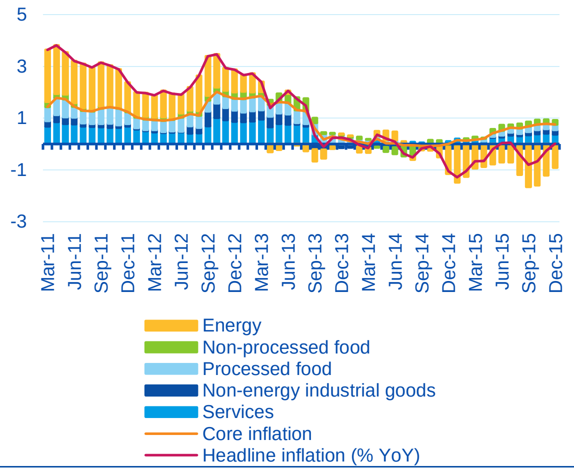
Core inflation was positive in 2015 despite the fall in oil prices

Headline consumer prices stopped falling in December 2015 (annual average: -0.5%), but they returned to negative territory in January 2016, according to the advance indicator published by the INE[13]. The downward pressure on prices is concentrated in the energy component (-13.6% YoY in December) mainly attributable to the decline in oil prices (down to around $35 a barrel as at the publication of this report). Despite the lower imported inflation, **core prices maintain a path of steady growth (0.9% YoY in 4Q15 and 0.6% as an annual average)**, to which improving domestic demand and the monetary policy measures implemented by the ECB will continue to contribute. Thus, core inflation's contribution to the YoY price growth stood at around 0.8 pp in December, while that of the residual component was at -0.8 pp (energy: -0.9 pp and non-processed food: 0.1 pp) (see Figure 3.16).

According to BBVA Research estimates, the increase in core prices in the Spanish economy continues to take place in an environment of low inflation in Europe, which is starting to moderate the price-competitiveness gains in Spain. Thus**, the inflation differential with respect to the euro area, as measured by the trend component has been reduced from -0.6 pp in December 2014 to -0.4 pp in the same month of 2015** (see Figure 3.17)[14].

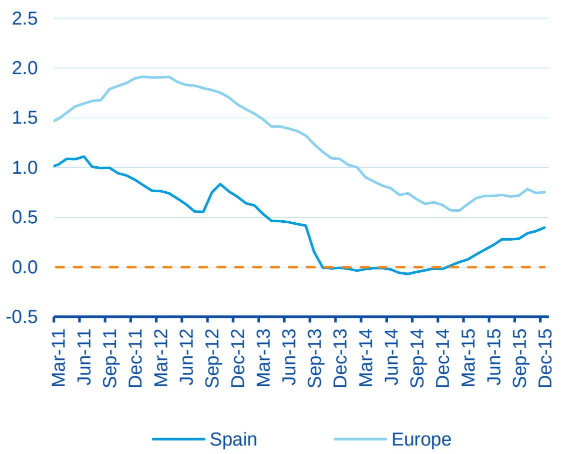
13: The advance CPI indicator showed a decline in overall inflation in January of -0.3% YoY due to the fall in fuel prices. Our estimates suggest that core inflation may have remained between 0.6% and 0.7% YoY. For more details , please see https://goo.gl/oLiIby
14: For more details on the calculation of trend inflation through the trimmed mean method, see Box 1 of the Spain Economic Outlook journal for the first quarter of 2014, available at: http://goo.gl/j0rlT8

Figure 3.16
Spain: contribution to CPI growth(pp YoY)



Source: BBVA Research based on INE

Figure 3.17
EMU: trend inflation (trimmed mean method, % YoY)



Source: BBVA Research based on INE and Eurostat

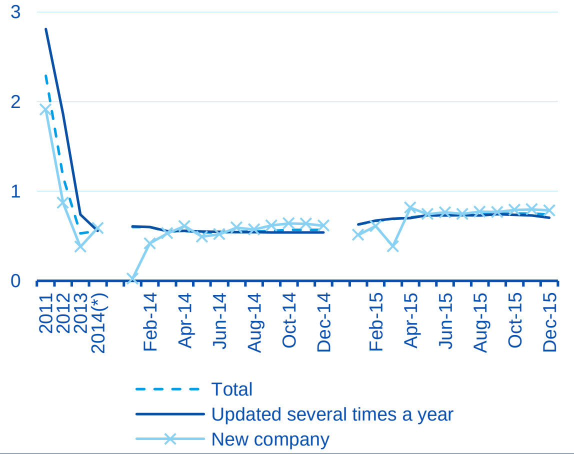
Wage demands remained stable during the fourth quarter despite the rise in core inflation. The average wage increase agreed in collective agreements increased by around 0.7% YoY over October to December for those agreements subjects to multi-year review process and 0.8% for those signed during the year, involving 2,487,000 workers[15] (see Figure 3.18). Therefore, the average wage rise agreed in 2015 was less than the 1% set as a maximum limit in the III Agreement on Employment and Collective Bargaining (AENC) for the full year[16].

As Figure 3.19 shows, wage moderation evidenced following the entry into force of the labour market reform in 1Q12 represents an accumulated gain of 5% in cost-competitiveness relative to the EMU.

15: The number of workers covered by collective agreements was around 6.5 million up to December when those affected by the agreements signed before 2015 were incorporated (3,998,000). This figure is 36.4% higher than that recorded up to December 2014.

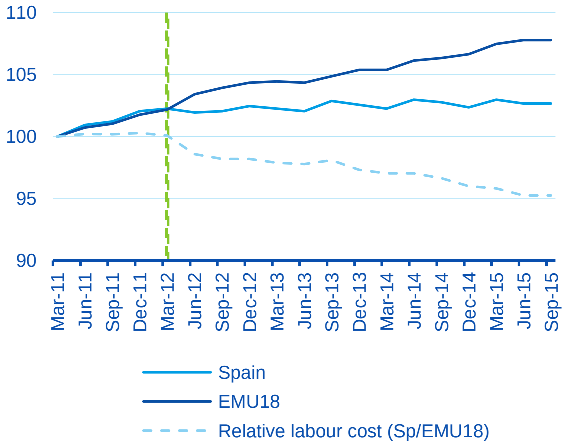
16: The III AENC, signed in early June 2015 by CEOE, CEPYME, Comisiones Obreras and UGT (employers associations and trade unions) establishes a set of recommendations to guide the negotiation of collective agreements over the next three years. Like its predecessor, the 3rd AENC sets limits on the wage increases agreed in the collective agreement. In 2015 they may not exceed 1% and in 2016 the figure is 1.5%. The increase in 2017 will depend on the development of GDP growth in 2016 and the Government's macroeconomic forecasts. Although the agreement does not expressly impose the inclusion of wage revision clauses, it does indicate that the wage growth agreed in the 2015-2016 two-year period must be greater than the sum of the inflation in both years.

Figure 3.18
Spain: average wage increase under collective bargaining agreements (%)



The annual data includes agreements registered after December each year and incorporates the review under the wage guarantee clause.
(*) Provisional data. The figures since 2013 are not comparable with years previous to this. See: http://goo.gl/WQkvNU
Source: BBVA Research based on ME and SS

Figure 3.19
EMU: labour cost per effective hour worked in the market economy (1Q11 = 100)



Source: BBVA Research based on Eurostat

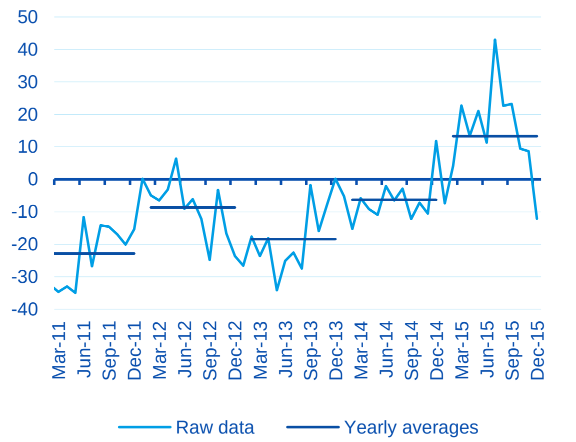
New credit flows grow 12.0% in 2015 after falling 5.9% in 2014

The stock of credit continued to fall during the second half of 2015, albeit at an ever slowing pace (-3.4% YoY in November). Meanwhile**, the inflow of credit (new lending transactions granted) increased by 12.0% in 2015**, although with a profile that declined throughout the year (see Figure 3.20). Thus, in the fourth quarter, new transactions slowed to match the levels of the same period in 2014, dragged down by lending to larger companies (transactions being classified as those of over one million euros). This portfolio, which is the most voluminous, managed to accumulate an increase of 7.7% in 2015. However, in the last quarter, the uncertainties in international markets, along with the ability to finance their credit needs in other non-bank markets at competitive rates, may have influenced businesses' demand for credit.

In contrast, **the pace of growth in lending retail transactions (households and SMEs) quickened during 2015 to 16.4%**, five percentage points higher than in the previous year, and relatively stable in the last quarter (see Figure 3.21). Transactions by SMEs (transactions classified as those of less than one million euros) increased by 12.8% in 2015, nearly four percentage points more than in the previous year. In addition, loans to households showed a marked growth in all categories during 2015, such that flows for mortgages rose by 33.4%, consumer credit by 20.1% and other loans by 17.2%.

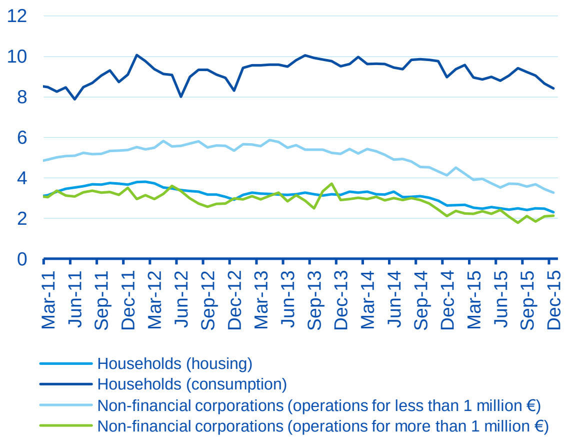
The cost of new credit has maintained its downward trend. For example, the APR on mortgage lending was 2.31% in December, some 33 basis points (bps) lower than a year ago, and those for consumer credit transactions at 8.43% (APR), approximately 55 bps below the same month in 2014. The average interest rate on new SME loans declined by 85 bps in the last twelve months to 3.28% (APR), and that of larger companies loans stood at 2.13% (APR), the same level as a year ago. This development has been favoured by the reduction in EURIBOR, the lower level in the sovereign risk premium and the lower credit risk faced by banks.

Figure 3.20
Spain: new lending transactions (% YoY)



Source: BBVA Research based on Banco de España

Figure 3.21
Spain: interest rates on new lending transactions (% APR)



Source: BBVA Research based on Banco de España

2016-2017 Scenario: the recovery continues

As previewed in the introduction to this section, **the elements incorporated in the updating of the macroeconomic scenario suggest keeping, at least for now, the growth forecasts for the Spanish economy** for the next two years. **Both in 2016 and in 2017 activity will grow by 2.7%**, a pace sufficient to accumulate net job creation of around a million jobs at the end of the period.

The expansion of activity will rest on both domestic and external factors. The global economy will continue to grow slightly above 3.0%, which together with the fall in oil prices will support the increase in Spanish exports, despite the exchange rate appreciation against emerging currencies. Similarly, the expansionary monetary policy will stimulate demand. Domestically, the continued recovery of fundamentals, the progress in correcting imbalances and a moderately expansionary fiscal policy will contribute to in the expansion of domestic demand (see Table 3.1). The increase in final demand will cause a notable upturn in imports, which is likely to result in a **negative contribution to growth from net external demand.**

However, the increased economic policy uncertainty in Spain does not allow us, at least for the time being, to improve the growth expectations for the current two-year period. Although a favourable trend of activity and employment has so far been maintained, if the uncertainty does not dissipate quickly and favourably, it could have a significant impact on the economic decisions of businesses and households (see Box 1).

Table 3.1
Spain: macroeconomic forecasts

(% YoY save indication to the contrary)	1Q15	2Q15	3Q15	4Q15(e)	2014	2015(e)	2016 (f)	2017 (f)
Domestic Final Consumption Expenditure	2.1	2.7	3.3	3.7	0.9	3.0	2.7	2.4
Private FCE	2.4	2.9	3.4	3.5	1.2	3.1	2.8	2.5
General Government FCE	1.3	2.1	3.0	4.3	0.0	2.7	2.5	1.9
Gross Fixed Capital Formation	6.0	6.3	6.5	6.1	3.5	6.2	4.2	5.6
Machinery & Equipment	8.1	9.9	10.7	9.5	10.6	9.6	4.8	5.0
Construction	6.2	5.5	5.5	5.0	-0.2	5.6	3.8	5.9
Housing	2.9	3.3	2.5	3.0	-1.4	2.9	4.2	8.2
Other Buildings and structures	8.8	7.3	7.8	6.6	0.8	7.6	3.5	4.2
Domestic demand (*)	2.9	3.3	3.9	4.2	1.6	3.6	2.9	3.0
Exports	5.9	6.2	5.6	6.2	5.1	5.9	4.8	5.7
Imports	7.2	7.0	7.7	8.9	6.4	7.7	5.8	6.8
External balance (*)	-0.2	-0.1	-0.5	-0.7	-0.2	-0.4	-0.2	-0.2
Real GDP at market prices (mp)	2.7	3.2	3.4	3.5	1.4	3.2	2.7	2.7
Nominal GDP (mp)	3.1	3.7	4.2	4.5	1.0	3.9	4.1	5.2
Memorandum items								
GDP ex housing investment	2.6	3.2	3.4	3.5	1.5	3.2	2.6	2.5
GDP ex construction	2.3	2.9	3.1	3.3	1.5	2.9	2.6	2.4
Total employment (LFS)	3.0	3.0	3.1	3.0	1.2	3.0	2.9	2.6
Unemployment rate (% labour force)	23.8	22.4	21.2	20.9	24.4	22.1	19.8	18.3
Total employment (fte)	2.9	3.0	3.1	3.1	1.1	3.0	2.5	2.2

(*) Contributions to growth.
(e): estimatef; (f): forecast.
Source: BBVA Research based on INE and Banco de España

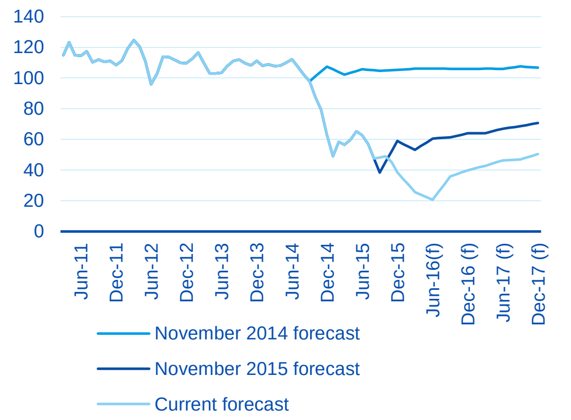
Low oil prices provide new impetus to activity

In recent months, **the oil price has resumed a downward path**, with Brent crude price falling to around US$35 a barrel at the time of writing, about 40% below the price at the beginning of the third quarter of 2015 (in euros, 43%) and 70% lower than the closing price of the first half of 2014 (in euros, 62%), when the first change in trend took place (see Figure 3.22). Although the uncertainty as to the nature of this disturbance still rides high**, the available information suggests that it mainly relates to supply factors**[17]**.** Among these are the increase in Iran's exports following the lifting of international economic sanctions, the unconventional oil production in the United States (shale oil) and the OPEC's decision not to cut production quotas.

Since it is mainly a supply side shock, a positive and significant effect on activity is to be expected: it will increase households' disposable income and reduce companies' production costs, thereby benefiting consumption, business margins, investment and trade flows. BBVA Research estimates point to a **gradual steadying of prices at around $30 and $45 per barrel in 2016 and 2017 respectively**, 30% and 20% lower than was expected three months ago. Given the high energy dependency of the Spanish economy**, the lifeline that this new drop in oil prices provides could mean, on average, more than one additional point to growth in the current two-year period** (see Figure 3.22)[18].

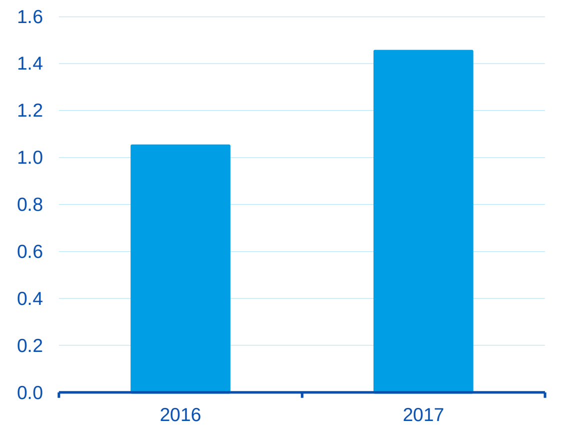
17: Falling oil prices also reflected some moderation in global growth prospects, especially in emerging countries. However, estimates by BBVA Research suggest that this factor has played a secondary role in the latest episode.
18: For greater details about on the estimation of the effects of oil prices by type of shock on activity and prices in the Spanish economy, please see Box 1 of the Spain Economic Outlook, second quarter of 2011, available at: http://goo.gl/42s7N9

Figure 3.22
Oil price scenario
(USD/bbl, Brent)



Source: BBVA Research based on Bloomberg

Figure 3.23
Spain: impact of the oil price slump
(pp of annual growth)



Source: BBVA Research

Monetary policy will continue to act as a support

Amid the increasing downside risks for growth and inflation in the European economy, **the ECB has confirmed its readiness to use all the stabilising instruments envisaged within its mandate, if necessary.** In December, the Governing Council (GC) of the monetary authority has already adopted a cut in the interest rate of the deposit facility by 10 bps to 0.3% and a six month extension of the asset purchase programme until March 2017 among other measures. More recently, the GC said that it will reconsider its monetary policy stance at the next meeting in March, which could lead to a further easing of unconventional measures, or even additional cuts in interest rates[19].

In the most likely scenario, it is expected that these measures - along with expectations that the Federal Reserve will continue the process of normalisation of monetary policy in the US - will help to keep the euro exchange rate against the dollar at a low level and contain the downside risks for growth and inflation in the euro zone.

The improvement of financing flows will be consolidated in the next two years

Facing 2016, the total of new transactions can be expected to continue to grow as long as uncertainties do not materialise and economic activity does not deteriorate. The trends suggest that new credit will exceed the flow of repayments and bad debts by the summer of 2016, meaning that outstandings will start to grow. New credit is expected to increase for reasons of both demand and supply. On the demand side, while waiting for economic uncertainties to dissipate, the improved financial situation of companies (especially exporters) and lower interest rates will encourage loan applications. On the supply side, the improvement experienced in liquidity conditions (thanks to the banking union and the ultra-expansionary policy of the ECB), the lower risk of portfolios and the progress made in bank restructuring will contribute positively.

19: For further details, please see the ECB Watch by BBVA Research that was published on December 3, 2015 and January 21, 2016. Available at https://goo.gl/GA306o and https://goo.gl/Etwfs0

Fiscal policy will remain moderately expansionary over the next two years

The latest available budget execution information confirms that **the government has made the most of the recovery of activity and the improvement in the cost of borrowing by implementing an expansive fiscal policy in the short term[20].** In a scenario with no change in economic policy, **the tone of fiscal policy will remain slightly expansionary during the coming two years.** Thus, real public sector consumption growth is expected to be 2.5% in 2016 and to slow to 1.9% in 2017, while non-residential construction investment will present growth rates of around 3.5% in 2016 and 4.2% in 2017.

In this context, the momentum of the improved economic environment will be offset in part by the combined effects of the expansionary policies implemented during 2015-2016. For this year it is expected that the economic cycle will benefit public finance again, both through the effect of automatic stabilisers such as a lower burden from interest and social benefits (pensions and unemployment, mainly). Some containment of the other items of expenditure, more intense in current expenditure than in capital expenditure (see Table 3.2) is also foreseen. However, the tax rate reduction will continue to adversely affect the structural revenue of the administrations. Thus, given the policies announced so far, **the deficit in 2016 would be reduced by around 1.3 pp to 3.4%, above the stability target (-2.8%).**

Looking forward, it is expected that the economic cycle will continue correcting the deterioration in public accounts, so that in a scenario with no change in fiscal policy**, the deficit would be reduced by 2017 and would be around 2.3% of GDP** (see Figure 3.24). If this scenario occurs, the cycle-adjusted public deficit will be around -1.7% in late 2017**. If interest payments are deducted, a primary structural surplus of around 1% would already be recorded, which would mean a correction of over 10 pp of GDP since 2009** (see Figure 3.25).

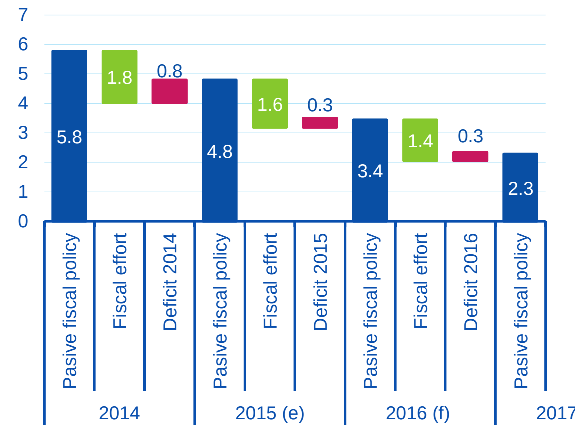
20: On the revenue side it is worth noting the tax cut (brought into force in two stages, in January and July 2015); and on the expenditure side, measures include the payment to public servants of part of the extra payment withdrawn in December 2012, and the stimulus in 2015 from capital spending.

Table 3.2
Genral government: net borrowing *

(% GDP)	2014	2015 (e)	2016 (f)	2017 (f)
Employee compensation	11.0	10.9	10.8	10.7
Intermediate consumption	5.3	5.2	4.9	4.8
Interest	3.4	3.1	2.8	2.6
Unemployment benefit	2.4	1.9	1.7	1.6
Other social benefits	14.0	14.0	13.8	13.6
Gross capital formation	2.2	2.4	2.3	2.4
Other expenditure	6.1	5.9	5.6	5.5
Non-financial expenditure	**44.4**	**43.4**	**42.0**	**41.3**
Taxes on production	11.5	11.8	11.8	12.0
Taxes on income, wealth, etc.	10.1	10.4	10.4	10.8
Social Secutiry contributions	12.5	12.2	12.2	12.1
Taxes on capital	0.5	0.6	0.6	0.6
Other income	4.0	3.5	3.5	3.5
Non-financial funding	**38.6**	**38.6**	**38.5**	**39.0**
Net borrowing	**-5.8**	**-4.8**	**-3.4**	**-2.3**
Stability target	-5.5	-4.2	-2.8	-1.4

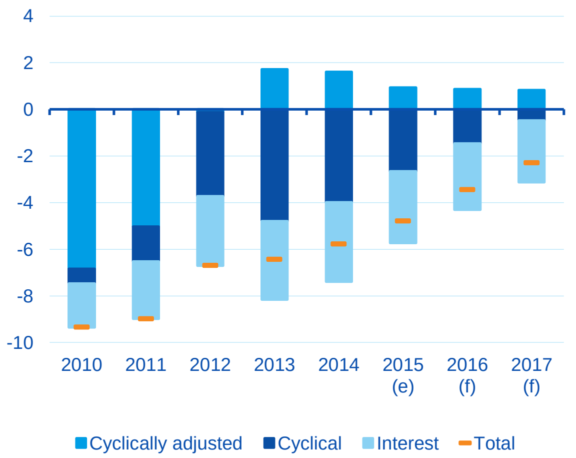
(*): Excluding aid to the financial sector.
(e): estimate; (f): forecast.
Source: BBVA Research based on MINHAP and INE

Figure 3.24
General Government.: breakdown of fiscal adjustment (pp of GDP)



(e): estimated; (p): forecast.
Source: BBVA Research based on MINHAP and INE

Figure 3.25
General Government.: funding capacity /requirement (% of GDP)



(e): estimated; (p): forecast.
Source: BBVA Research based on MINHAP and INE

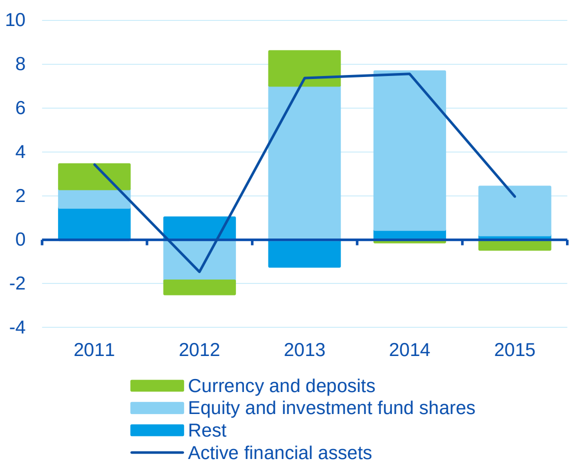
In short, it is expected that the slightly expansionary stance of fiscal will be maintained policy over the next few years. However, in the medium term, there is still uncertainty about the ability of the government sector to generate primary surpluses of sufficient magnitude to significantly reduce the high level of public debt reached (expected to have exceeded 100% of GDP in 2015). The continuation of policies to control public spending is therefore essential, but the implementation of measures to increase the growth capacity of the economy will be even more important.

Private domestic demand will continue to lead growth

Consumption outlook for households are favourable despite the expected trends in financial wealth and the decline of some temporary stimuli. Job creation, less tax pressure and the absence of inflation pressure will boost real disposable income in the coming quarters. The expected growth in real estate asset value and the expectation of official interest rates remaining at historic lows will also encourage private consumption. In addition, new consumer finance transactions will continue to increase and will sustain spending in the medium term, especially on durable goods.

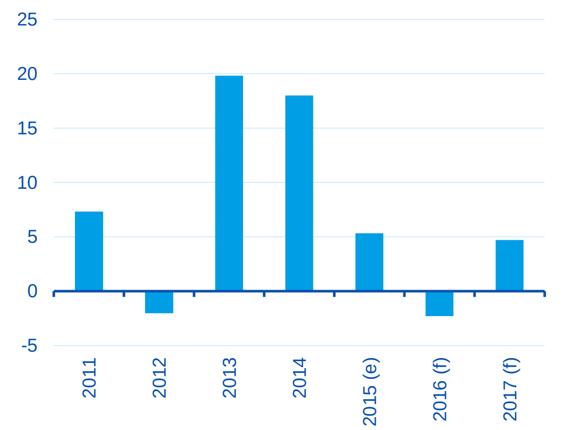
In contrast, the trend in share prices, which explained a significant part of the increase in financial assets held by households since 2013 (see Figure 3.26) - will be more modest than in recent years, thus reducing the contribution of financial wealth to consumption growth[21], mainly in 2016 (see Figure 3.27). As a result**, private consumption will increase by about 2.8% in 2016**, in line with the forecasts in the latest edition of the Consumption Outlook[22]. In 2017, some of the temporary factors favouring household spending during the current year, such as the tax cuts, will no longer be present. Consequently, **growth in private consumption will moderate back to 2.5%.**

Figure 3.26
Spain: contribution of financial assets held by households to growth in consumption (annual averages in %)



(*): Data to 3Q15
Source: BBVA Research based on Banco de España

Figure 3.27
Spain: real net financial wealth of households* (change in annual averages)



(*) Deflated using the private consumption deflator
Source: BBVA Research based on INE

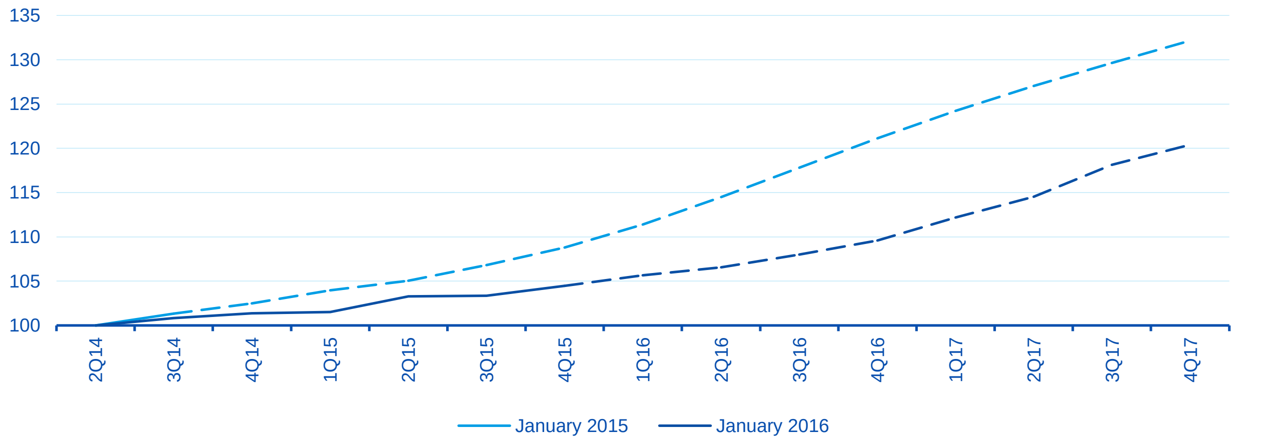
Several factors will continue to encourage the growth in machinery and equipment investment during the next two years. Firstly, the increase in both domestic demand and exports will continue to encourage the expansion of installed productive capacity. Secondly, the expansionary stance of monetary policy will ensure that financing cost remains at relatively low levels and that new credit increases. Finally, the latest drop in oil prices will lead to cost savings and thereby to increasing profit margins and the freeing up of additional resources that can be allocated to productive investment. However, the increased uncertainty envisaged in the macroeconomic scenario will have an adverse effect on investment decisions. Thus, after two years growing at an annual average of 10.1%, there is a **downward revision of the expected growth in machinery and equipment investment (by 1.5 pp) to 4.8% YoY in 2016. In 2017 this component of demand is expected to grow at an annual rate of 5.0%.**

21: Estimates by BBVA Research indicate that a quarterly reduction in real net financial wealth of 1% would cause a cumulative decline in private consumption by almost 0.1% over the next 4 quarters.
22: See: https://goo.gl/78uhh1

The real estate sector continues to make progress in its recovery, although investment is growing at a slower rate than expected a year ago (see Figure 3.28). Nevertheless, the fundamentals in the sector remain at healthy levels and are expected to evolve positively in the next two years. The recovery of the labour market and household income and the forecast for low interest rates will support growth in residential demand in the next two years. Thus, **construction activity will respond to increasingly strong demand**, with housing starts improving from the current rock-bottom levels.

However, given the sensitivity of the sector to economic policy uncertainty (which could be higher than in other sectors because of the high weight of regulation in the execution of building projects) and the fact that the start of the recovery is proving less vigorous than was expected a year ago, **growth in housing investment for 2016 has been revised downwards to 4.2%. Therefore, the significant rise in this component of investment is delayed until 2017, when an annual growth of 8.3% is expected.**

Figure 3.28
Spain: recovery scenarios for real investment in housing (2Q14 = 100)



Source: BBVA Research based on INE

Exports will continue to grow, but will be offset by increased imports

The downward revision of growth prospects in emerging economies, together with the appreciation of the euro against these countries' currencies **entails a somewhat less favourable environment for Spanish exports in the short-term.** However, the expected growth of the world economy for the period 2016-2017 and cheaper transport costs as a result of falling oil prices continue to support the outlook for strong demand for exports. Thus, **even if forecasts for export growth over the two years are revised downwards, they will remain favourable: the totals will increase at an average annual rate of 5.3%**, the goods component will grow an average of 4.9% and non-resident consumption will rise by around 2.3%.

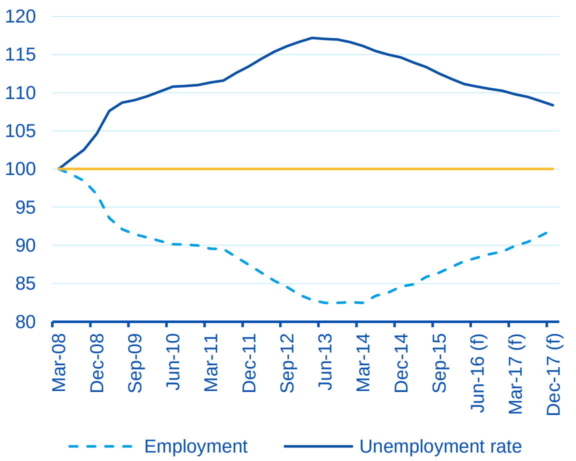
The growth in final demand will have a positive impact on imports (5.8% in 2016 and 6.8% in 2017), again surpassing the increase in exports. Thus, the **contribution to economic growth of net external demand will be slightly negative in both 2016 and 2017 (-0.2 pp in both cases).** Over the next two years cheaper oil prices will continue to alleviate the Spanish economy's energy import bills, which will help to **maintain positive current account balances (average:3.0% of GDP).**

The recovery of the labour market will continue, but pre-crisis levels are still a long way off

The economy will continue to drive job creation over the next two years. Given the expected economic growth, employment could rise by around 2.9% in 2016, while the unemployment rate would fall by 2.2 points to 19.8%, more than expected in November given the less favourable outlook for the recovery of the labour force. In 2017, job creation would be slightly lower (2.6%), while the unemployment rate would drop to 18.3%.

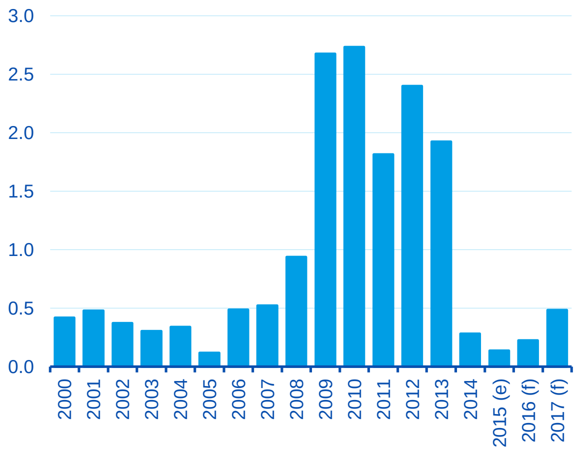
Although prospects for employment are positive, it will still be significantly below pre-crisis levels at the end of next year. As Figure 3.29 shows, in the fourth quarter of 2017 employment would be about 8% lower than at the beginning of 2008, while the unemployment rate would be more than 8 points higher. In addition, the expected development of activity and full-time equivalent employment – which will grow by more than 2% in 2016 and 2017 – **suggests a meagre rebound in the apparent labour productivity until it converges in 2017 with pre-crisis figures** (see Figure 3.30).

Figure 3.29
Spain: employment level and unemployment rate (1Q08 = 100. SWDA)



(f): forecast.
Source: BBVA Research based on INE

Figure 3.30
Spain: growth of apparent labour productivity (%)



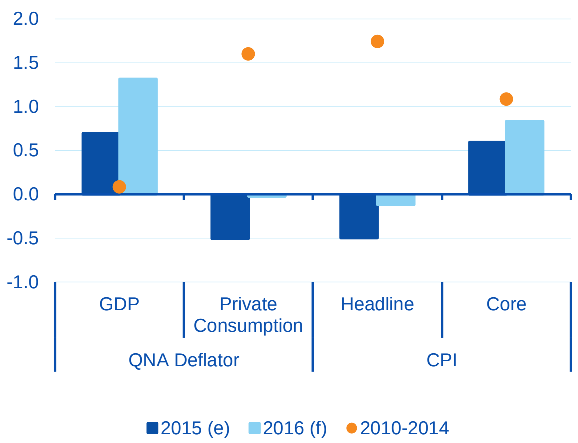
(f): forecast.
Source: BBVA Research based on INE

The oil price leads general inflation into negative territory in the short term, but core inflation will remain positive

Although the euro appreciation against the dollar will be somewhat less than expected three months ago, the downward revision of the oil price leads to lower **headline inflation for this year than previously anticipated (down by 1.3 points, to -0.1% as an annual average).** However, domestic determinants indicate that both core inflation and the implied GDP deflator will remain in positive territory this year (0.7% and 1.3% as an annual average, respectively) (see Figure 3.31).

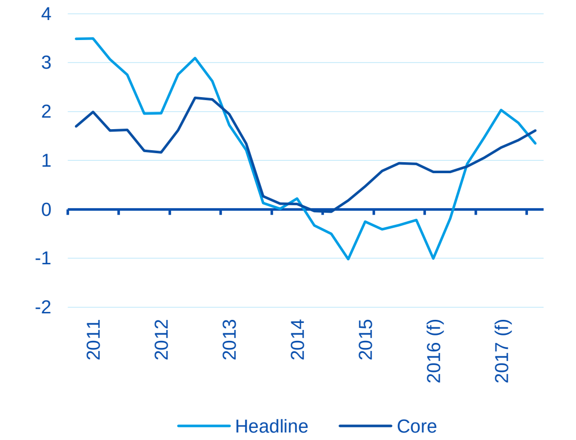
In 2017, both headline and core inflation will be clearly positive (1.7% and 1.3% as an annual average, respectively), but will still remain at relatively low levels (see Figure 3.32). As was previously said in earlier Outlooks, the expected improved trend in inflation is supported both by the recovery in domestic demand and the labour market, and by the **current monetary policy stimulus measures** (interest rate cuts, promoting the availability of credit, and quantitative easing).

Figure 3.31
Spain: price indicators (% YoY)



(e): estimate; (f): forecast.
Source: BBVA Research based on INE

Figure 3.32
Spain: observed data and expectations for inflation (% YoY)



(f): forecast.
Source: BBVA Research based on INE and Consensus Forecast Inc.

The scenario is not without risks

Although the Spanish economy is still growing at a healthy rate, some external and domestic risks remain or have even increased. Among the former, we note **those associated with the slowdown in emerging economies, especially China and oil exporting countries.**

In domestic terms, economic policy uncertainty has increased, and if it intensifies or persists, the possibility of its exerting greater pressure on the recovery cannot be ruled out. Finally, **it is estimated that the public deficit again exceeded the stability target in 2015** which, in the absence of measures, raises the probability of the target's being missed for the next two years. Maintaining credibility in the control of public finances affects the ability to contain the cost of financing of an economy with excessive external indebtedness.

DISCLAIMER

This report has been produced by the Spain Unit

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