1 Editorial

Developments in the Spanish economy have confirmed the expectations of three months ago and, in the absence of changes as regards the international scenario or in the policies to be implemented, the forecast of GDP growth of 3.2% for 2015 and 2.7% in 2016 is being maintained. Production in particular continues to increase rapidly at rates going over 3% in YoY terms. Much as expected, this implies a deceleration of activity compared to the figures seen in the first part of the year, when the economy was growing at around 4% YoY. The reasons behind this lower growth rate are several and include the loss of momentum of world demand, exhaustion of certain cyclical factors and increasing uncertainty, which is partly associated with the Spanish electoral cycle. Whatever the case, the tail winds driving the recovery are expected to prevail, and growth to hold at levels in the 2.5-3.0% range in the coming quarters. The risks to this scenario relate to slower growth of the world economy and the volatility which uncertainty over economic policy might inflict on domestic demand going forward.

Growth continues to exhibit relatively high rates, underpinned by the vigour of domestic demand, though by exports as well. Specifically, in the third quarter of the year GDP flipped up 0.8% with respect to the second, which implies that the economy is still growing at rates above 3.0% in YoY terms. The available information suggests that private consumption continues to be the mainstay of the strong performance by domestic demand. Moreover, the good performance shown by exports and by investment in machinery and equipment are signs that the larger share of both factors in aggregate demand is a trend that will be kept up over time. For example, although the fall in household and corporate spending partly explains the rise in exports throughout the crisis (around 40%), the impact seems to be asymmetric given that in the upswing the effect of greater domestic demand on sales abroad has not been significant (see Box 1). By the same token, the upsurge in machinery and equipment investment since 1Q13 has already gone past 30% and is three times bigger than that observed for the EMU as a whole over the same time. Part of this improvement can be explained by the increase in saving by companies which, through the use of an assortment of instruments and depending on their size, have managed to bring down their borrowings on differing scales and generate the funds required to be able to invest (see Box 2). This indicates that over the coming months the export capacity of the Spanish economy will continue to increase and that, in the absence of restrictions on demand, the internationalisation of companies will progress.

The deceleration in the second half of this year is as expected, while there appear to be several reasons for it. As was already announced in recent Spain Economic Outlooks, growth is likely to have hit its top speed in the first half of 2015. The causes of the slowdown in 2H15 range from weaker global demand or the loss of momentum of certain drivers, through the deferment of consumption and investment decisions associated with the hectic election timetable. For example, even though China's economy barely represents 2% of Spanish exports, this share has doubled over the crisis. Moreover, the indirect impact via the reliance exhibited by emerging economies, or certain key trading partners such as Germany, could be delaying goods export growth[1]. Similarly, certain boosts to the competitiveness of Spanish companies have not been as powerful as had been previously expected, notable here being the euro's exchange rate depreciation, mainly with respect to currencies in emerging markets, where greater uncertainty has led to inversion of the trend.

A portion of the rise in consumer spending by families during the recovery might have been triggered by pent-up demand that had built up over a long period of uncertainty. The double-digit increase that has been observed for certain items of private spending, such as car purchases, far overstates

1: For a more in-depth examination, please see Spain Economic Watch, September 2015 by BBVA Research, "Spain: Potential channels of contagion of economic shocks in China and Greece", available at https://goo.gl/DQFAvs the improvement that is suggested by gross disposable income or family wealth figures. Added to this, the upswing in consumption has been uneven, as this has risen among middle- or high-income households, while it has remained the same or even fallen back among the least well-off. As this pent-up demand, which is concentrated among a certain bracket of households, runs out of steam, it will mean that over the next few quarters these items of consumption will grow at rates that are more in keeping with their fundamentals.[2] Finally, although the situation has been partly turned round in the past few weeks, the relatively deterioration in risk perception of Spain's economy that has arisen from political uncertainty has led to a rise in what the Spanish Treasury has to pay on the debt it issues in comparison with its Italian counterpart. Were this situation to remain the case or worsen over the coming months, the Spanish economy could begin to count the cost in terms of growth and job creation.

The recovery is expected to progress further, and that the economy will continue growing at rates of 2-3% in YoY terms over the next few quarters. This is, first of all, based on a global setting that remains sufficiently conducive to the expansionary process moving ahead. To explain, although world growth will still hold at a level below its historical average in 2015 and 2016, it should pick up gently over the coming quarters. Crucial here will be the better relative performance expected of the developed economies, particularly Europe. Second, the oil price is still at a comparatively low level, which should help to keep Spanish firms competitive and support disposable household income. Finally, the shift in the emphasis of demand-side policy is consolidating, especially on the monetary front, where the European Central Bank could announce additional measures in December to ensure a firmer recovery of credit and domestic demand, as well as convergence towards target inflation. All of this is reflected in the fact that Spain's economy continues to show high growth rates, while on this point it is worth noting that GDP in 4Q15 is likely to have grown by 0.7% against the previous quarter.

Spain finds itself in a virtuous circle, where growth, low inflation and external deleveraging have all come together in a sort of "divine coincidence"[3]. Going forward, it is important to keep this triple set of factors in concert and recognise what part of this situation is temporary and derives from the muted oil price and low interest rates. It would, nonetheless, not be very advisable to ignore the fact that reaching this point has also been as the result of implementing structural measures which should be persevered with. For example, although the imbalance displayed by general government's saving is gradually decreasing, there is still a long way to go (see Section 3 and Box 3). Likewise, improvements in goods and services markets over the last few years explain the better performance of investment in relation to other neighbouring economies. Persisting with deficit and public debt reduction, as well as permanently decrease unemployment and nurturing the competitive advantage achieved via ambitious reforms represent the biggest challenges for next government.

2: For further information, please see BBVA Research (2015), Consumption Outlook, First half 2015, available at https://goo.gl/cKnbQF.
3: Blanchard & Galí (2007) employ this term in reference to those situations where the relationship between inflation and the welfare-relevant output gap is such that the latter can be stabilised through monetary policies that control inflation. See Blanchard, O., & J. Galí (2007). "Real Wage Rigidities and the New Keynesian Model". *Journal of Money, Credit, and Banking*, 39(1), pp. 35-65.

DISCLAIMER

This report has been produced by the Spain Unit:

Chief Economist for Developed Economies
Rafael Doménech
+34 91 537 36 72
r.domenech@bbva.com

Miguel Cardoso
miguel.cardoso@bbva.com
+34 91 374 39 61

Juan Ramón García
juanramon.gl@bbva.com
+34 91 374 33 39

Antonio Marín
antonio.marin.campos@bbva.com
+34 648 600 596

Juan Ruiz
juan.ruiz2@bbva.com
+34 646 825 405

Joseba Barandiaran
joseba.barandia@bbva.com
+34 94 487 67 39

Guillermo García
guillermo.garcia.alonso@bbva.com
+34 91 757 52 78

Myriam Montañez
+34 954 24 74 86
miriam.montanez@bbva.com

Pep Ruiz
ruiz.aguirre@bbva.com
+34 91 537 55 67

Alba Duchemin
alba.duchemin@bbva.com
+34 91 757 52 78

Félix Lores
felix.lores@bbva.com
+34 91 374 01 82

Virginia Pou
virginia.pou@bbva.com
+34 91 537 77 23

Camilo Andrés Ulloa
camiloandres.ulloa@bbva.com
+34 91 537 84 73

With the contribution:

Economic Scenarios
Julián Cubero
juan.cubero@bbva.com

Europe
Miguel Jiménez
mjimenezg@bbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

BBVA Research

Group Chief Economist
Jorge Sicilia Serrano

Developed Economies Area
Rafael Doménech
r.domenech@bbva.com

Spain
Miguel Cardoso
miguel.cardoso@bbva.com

Europe
Miguel Jiménez
mjimenezg@bbva.com

US
Nathaniel Karp
Nathaniel.Karp@bbva.com

Emerging Markets Area

Cross-Country Emerging Markets Analysis
Alvaro Ortiz
alvaro.ortiz@bbva.com

Asia
Le Xia
le.xia@bbva.com

Mexico
Carlos Serrano
carlos.serranoh@bbva.com

Turkey
Alvaro Ortiz
alvaro.ortiz@bbva.com

LATAM Coordination
Juan Manuel Ruiz
juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Jorge Selaive
jselaive@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Peru
Hugo Perea
hperea@bbva.com

Venezuela
Julio Pineda
juliocesar.pineda@bbva.com

Financial Systems and Regulation Area
Santiago Fernández de Lis
sfernandezdelis@bbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Financial Inclusion
David Tuesta
david.tuesta@bbva.com

Regulation and Public Policy
María Abascal
maria.abascal@bbva.com

Digital Regulation
Álvaro Martín
alvarojorge.martin@bbva.com

Global Areas

Economic Scenarios
Julián Cubero
juan.cubero@bbva.com

Financial Scenarios
Sonsoles Castillo
s.castillo@bbva.com

Innovation & Processes
Oscar de las Peñas
oscar.delaspenas@bbva.com

Contact details:

Azul Street, 4
La Vela Building - 4 and 5 floor
28050 Madrid (Spain)
Tel.: +34 91 374 60 00 and +34 91 537 70 00
Fax: +34 91 374 30 25
bbvaresearch@bbva.com
www.bbvaresearch.com
Legal Deposit: M-31254-2000