# 1. Editorial

**The Spanish economy will continue to show a strong recovery, albeit less intense than in previous years and even so, it will be exposed to risks with potentially negative consequences if they materialise**. Both the trend in recent activity indicators and the expected continuation of most of the elements supporting the recovery so far point to a GDP growth at around 2.7% in 2017 and 2018. This is in spite of the worsening observed in some of the key factors behind the improvement in private domestic demand over the past two years, and in spite of the heightened worldwide uncertainty about economic policy.

**The last few quarters have seen the rate of growth settle at a somewhat lower level than that of previous years, due to a slowdown in domestic demand.** Growth in the fourth quarter of 2016 was 0.7% QoQ, nearly 3% in annualised terms. As expected, the lower growth during the last few quarters was due to the slowdown of two components of domestic demand: household consumption and investment in machinery and equipment. This is explained by the increasingly diluted effect of certain positive factors that had been supporting growth. These factors notably include the exhaustion of pent-up demand, the upward correction in oil prices trend and the monetary policy declining impact. Additionally, the construction investment performance (particularly of housing) has been weaker than anticipated. Lastly, it seems that the disappointing export figures seen in the third quarter of 2016 were transitory, and that exports are still on a positive and indeed encouraging trend. This is important, given the negative effect already being felt from sterling's depreciation against the euro and the potential impact of reduced growth in UK domestic demand.

**Looking ahead, growth is expected to remain slightly below 3%.** The trend in the latest data points to GDP growth in the first quarter of this year at around 0.8% QoQ, higher than anticipated three months ago. This, together with the continued positive environment for the Spanish economy, explains the upward revision of the growth forecast for 2017 up to 2.7% and even a moderate upward bias for this figure. In particular, the acceleration in global activity, especially in emerging markets, oil prices still below the last three years average, the monetary policy expansionary stance, the cyclical momentum we are seeing, and the impact of the reforms carried out in the past few years should be sufficient to continue reducing the imbalances that still remain in the Spanish economy. The outlook is therefore favourable.

**Nonetheless, the past few months have seen the accumulation of a number of risk factors that could be limiting the extent and speed of the recovery**. In the first place, uncertainty persists regarding the final outcome of Brexit and its effect on the various sectors and regions exposed to changes in UK demand. Added to this is the possible effect of the US administration change on economic policies, particularly on trade. Although neither of these doubts is likely to be resolved very soon, they may already be leading some exporters to delay investment plans. Secondly, the energy cost has risen considerably in the past few months, and this could have a negative effect on the growth of household and business spending. Specifically, we estimate that the 7% forecast upward revision on the oil barrel price (compared to what was expected three months ago), could subtract between 0.2 and 0.3 pp of growth in 2017. In the third place, although part of the increase in inflation is temporary and explained by increased energy costs, the next few months will give some idea of the extent to which price setting in the Spanish economy still reflects shifts in the headline index as opposed to the particular situation of businesses, consumers or the labour market. In this regard the behaviour of real wages will be especially significant. In a context of high unemployment, sustained increases above productivity gains could slow the recovery of employment and exacerbate inequality between those with a job and those without. An example to take into account is the 8% increase in the legal minimum wage that came into effect at the beginning of the year. In principle the aggregate effect on both GDP and employment is expected to be close to zero (assuming that other wages and salaries do not increase as a result of the increase in the legal minimum wage). However, there are nuances to this analysis. On the one hand the limited impact is due to the small weight the recipients or those affected by the rise have on employment and on total wage costs. On the other hand, this increase may make it even more difficult for certain groups to find a job (e.g. unskilled workers, young people without experience or people with temporary contracts).

**The increase in inflation in the EMU may lead to a turning point in monetary policy, which would be of particular significance for an economy such as Spain's, which still has high levels of external and public sector indebtedness**. The ECB is expected to continue its asset purchase programme during 2017, in line with its announcement of last December, but from the beginning of 2018 the stimulus measures will be tapered, and this could lead to an increase in interest rates in the last quarter of 2018. While the normalisation of monetary policy can be expected to be a slow process, with interest rates staying low for quite some time, the increase in financing costs may be particularly negative for the Spanish economy. For example the ECB's asset purchase programme is estimated to have reduced the risk premium on Spain's ten-year sovereign bonds by between 50 and 70 bps approximately. In the past, prolonged increases of this kind have reduced Spain's GDP in the same proportion (between 0.5 and 0.7 pp). What is more, we cannot rule out the possibility that the effect of the programme on financing costs was actually even greater than this, if for example it avoided increases during recent periods of uncertainty. This is a factor to be taken into account, since 2017 looks set to be another intense year on the geopolitical front.

**Fiscal policy will go from expansionary to neutral, and attaining targets will depend on the impact of measures announced on revenues**. In principle, the improvement in activity that BBVA Research foresees may have been sufficient to bring the imbalance in the public finances into line with the targets set, without the need for tax increases. Therefore, it is estimated that the measures designed to increase corporate tax collection will finance an increase in spending that would not otherwise be possible. Overall, we estimate that the impact of higher corporate taxes on activity will be marginal in the short term, given the fillip to domestic demand from increased public consumption and investment and an interest rate environment that will mitigate the negative effects of this policy on businesses. Additionally, as with any tax measure, there is uncertainty as to the effect it might have on revenues.

**Uncertainty regarding economic policy remains high**, and geopolitical events only add to this uncertainty. Furthermore, as far as Spain is concerned, the recent tax changes, the legal uncertainty that may arise as a result of various rulings, the doubts about both the approval of the national budget for 2017 and the path of economic reforms, all constitute sources of uncertainty that may have negative effects on investment and job creation. The reforms carried out in the past few years seem to have increased the Spanish economy's capacity for growth. Maintaining this trend will require a continued process of improvements that help to raise productivity and reduce unemployment.

# 5. Glossary

## Acronyms

- AENC: Bipartite Inter-Confederal Agreement on Employment and Collective Bargaining
- APP: Asset Purchase Programme
- APR: Annual Percentage Rate
- BBVA: Banco Bilbao Vizcaya Argentaria
- BBVA – EAE: BBVA Economic Activity Survey
- BBVA – GAIN: BBVA Global activity index
- CDS: Credit Default Swaps
- CEOE: Spanish Confederation of Employers' Organizations
- CEPYME: Spanish Confederation of Small and Medium sized Enterprises
- CC. OO: Trade Union Confederation of Workers' Commissions
- CPI: Consumer Price Index
- EAGLES: Emerging and Growth-Leading Economies
- ECB: European Central Bank
- EMU: European Economic and Monetary Union
- EPU: Economic Policy Uncertainty Index
- EU: European Union
- Euribor: Euro interbank Offered Rate
- FCE: Final Consumption Expenditure
- FED: Federal Reserve System
- FTE: Full time equivalent
- GC: Governing Council
- GDP: Gross Domestic Product
- IC37: Group of Industrial Countries comprising the 28 EU members plus the US, Canada, Japan, Switzerland, Norway, Australia, New Zealand, Mexico and Turkey
- INE: National Institute of Statistics
- LATAM: Latin America aggregated including Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela
- LFS: Labour Force Survey
- ME and SS: Ministry of labour and social security
- MICA-BBVA: Factor Model of Economic and Financial Indicators for Short-term GDP Forecasting
- MINHAP: Ministry of Finance and Public Administration
- NAFTA: North American Free Trade Agreement
- OPEC: Organization of the Petroleum Exporting Countries
- PA: Public Administration
- QE: Quantitative easing
- ULCs: Unit labour costs
- US: United States
- UK: United Kingdom
- SMEs: Small and medium-sized enterprises
- SWDA: Seasonally and working day adjusted
- UGT: General Workers Union

## Abbreviations

- Bps: Basic points
- CI: Confidence interval
- MoM: Month on month change
- Pp: Percentage points
- QoQ: Quarterly on quarter change
- YoY: Year on year change

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