

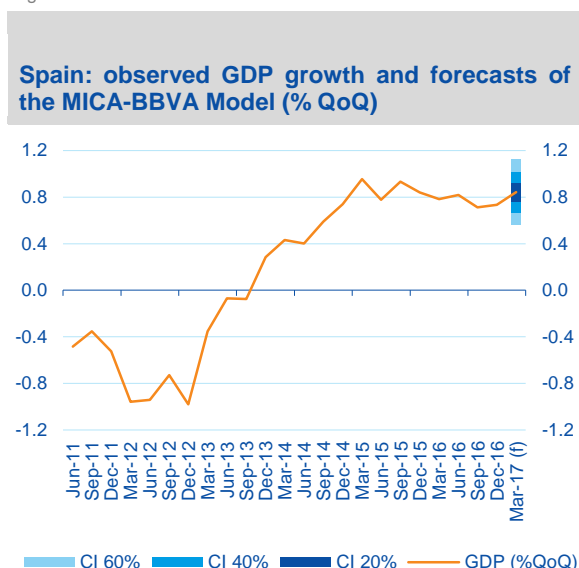
3. Growth outlook for the Spanish economy

Recovery continues, despite uncertainty

GDP flash estimates published by the National Statistics Institute (INE) indicated that **growth stabilised at 0.7% QoQ (3.0% YoY) in 4Q16¹**. If this estimate is confirmed, the increase in activity between October and December would have been in line with the expectations at the beginning of the quarter (between 0.7% and 0.8% QoQ), but below BBVA Research real-time estimates (MICA-BBVA: between 0.8% and 0.9% QoQ)². This would bring Spain's 2016 GDP growth to 3.2%, which surpasses the forecast made a year ago (2.7%) and exceed the historical average for the second time since 2007³.

Turning to the first quarter of 2017, the information known at the closing date of this report suggests that the **recovery continues at a slightly higher pace than that recorded in 4Q16 (forecast from the MICA-BBVA model: 0.8%)** (see Figure 3.1). This rate of growth would be in line with the results of the BBVA Economic Activity Survey⁴, which evidence an improvement in growth expectations compared to the last quarters of 2016. (see Figure 3.2).

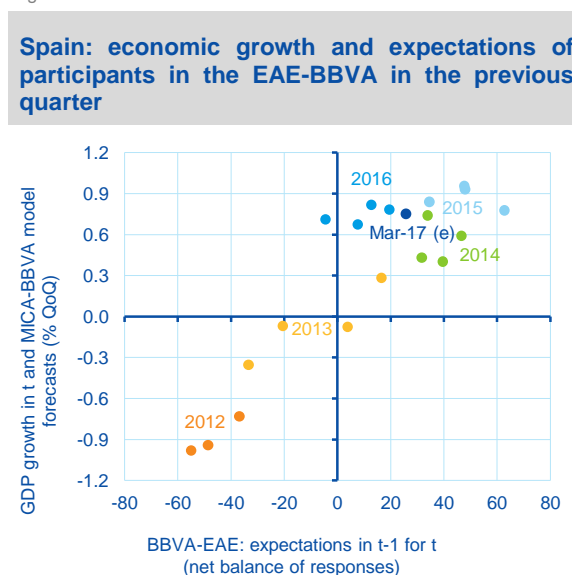
Figure 3.1



(e): estimated.

Source: BBVA Research based on INE figures

Figure 3.2



(e): estimated.

Source: BBVA Research based on INE figures

1: The Quarterly National Accounts for 3Q16 will be published on 25 November, possibly with a revision of the flash estimate.

2: See Spain Economic Watch, January 2017, available at https://www.bbvarresearch.com/wp-content/uploads/2017/01/Observatorio-de-Actividad-ene17_EN.pdf

3: The average annual growth between 1971 and 2015 stood at around 2.5%.

4: For details on the BBVA Economic Activity Survey, see Box 1 of the Spain Economic Outlook journal for the second quarter of 2014, available at: https://www.bbvarresearch.com/wp-content/uploads/2014/05/1405_Spain_Economic_Outlook.pdf

The increase in domestic demand in 4Q16 was modest, but balanced

While income growth and lending to households slowed in the fourth quarter, on balance the partial indicators of spending⁵ and household expectations suggest that growth in **private consumption stabilised at around 0.6% QoQ (2.7% YoY) in 4Q16** (see Figure 3.3). If this is confirmed, 2016 may have closed with an annual average increase in household spending of 3.0%, similar to that seen in the previous year (2.9%).

Regarding public demand, available data on budget execution suggest that **actual final consumption of all Public Administrations may have increased by 0.3% QoQ (1.1% YoY)**, 0.6 pp less than in 3Q16. In consequence the past year would have ended with an increase of 1.3% in public consumption, 0.5 pp less than the increase seen in 2015.

On the side of **investment in machinery and equipment**, partial economic indicators⁶ suggest that it would have grown by **0.7% QoQ (4.1% YoY) in 4Q16**. Although this figure is slightly higher than the one recorded in 3Q16 (0.3% QoQ), it would still be significantly below to that posted over the course of the recovery (2.2% QoQ on average between 1Q13 and 2Q16). Thus 2016 would close with a slowdown in productive investment of 3.2 pp to 5.7% average for the year.

As for **residential investment**, available information⁷ indicates that after practically stagnating in 3Q16, it **grew by 0.7% QoQ (2.6% YoY) in the last quarter of 2016**, which in any case implies that the recovery rate continues to be moderate. With regard to **investment in non-residential construction**, BBVA Research estimates that it **will have grown by 0.4% QoQ (1.8% YoY) in 4Q16**. Thus, 2016 may have ended with a stabilisation in annual growth of investment in home building (at around 3.1%) and a slowdown of investment in non-residential construction (by 4.7 pp to 1.7%).

The major part of the growth in 2016 was due to domestic spending

In summary, partial indicators point to **domestic demand having once again contributed 0.6 pp to quarterly GDP growth** in 4Q16, albeit with a more balanced composition than that observed in the previous quarter. If the year closes like this, domestic demand will have contributed 2.8 pp to the average economic growth of 2016.

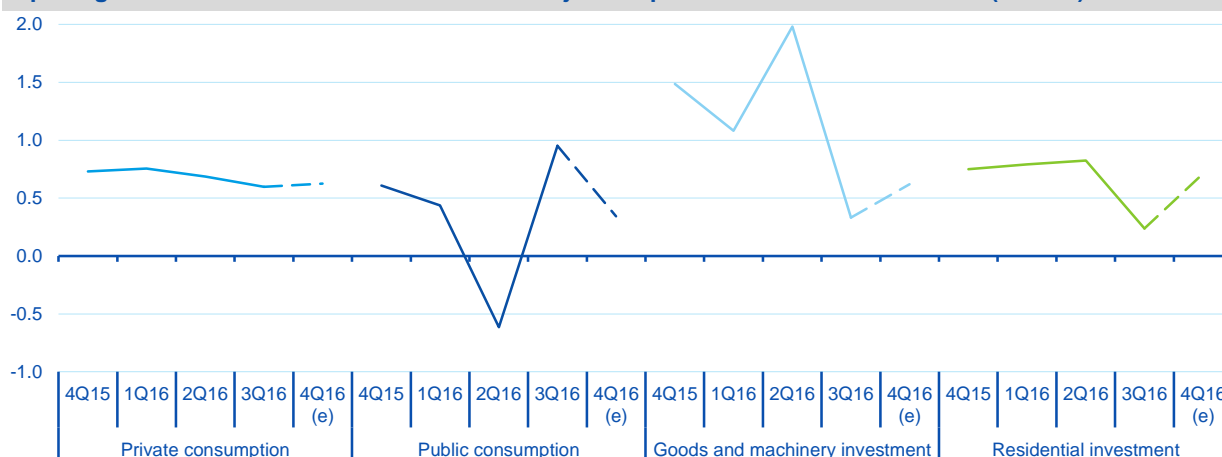
5: Consumption of services and domestic sales of major corporates showed considerable dynamism at year-end, while retail sales slowed somewhat and private individuals' new car registrations were down.

6: Business confidence and sales of industrial vehicles increased in the last quarter of the year. On the other hand orders of capital goods and the industrial output index both fell relative to the previous quarter.

7: Both new housing permits and social security affiliations in the construction sector stood out as performing better than in the previous quarter.

Figure 3.3

Spain: growth observed and forecasts of the major components of domestic demand (% QoQ)



(e): estimated.

Source: BBVA Research based on INE

Exports recovered at year-end

External demand would have contributed 0.5 pp to GDP growth in 2016

During the last quarter of 2016 external demand increased strongly, confirming that the disappointing performance in 3Q16 was of a temporary nature. In this regard, available indicators point to **an uptick of 2.0% QoQ (4.9% YoY) in exports of goods⁸ in 4Q16, to end the year with average growth slightly less than that recorded in 2015 (4.0% compared with 4.4%).** Available information also suggests that service exports recovered. On the one hand inbound tourism remains healthy⁹, suggesting that **non-residents' consumption in Spain may have grown by 1.5% QoQ (6.5% YoY) in 4Q16 and by 8.1% for the whole of 2016 (4.1% in 2015).** On the other hand, exports of non-tourism services apparently increased by 1.6% QoQ in the last quarter of 2016 (although they were down 0.3% YoY) and ended the year with an average increase of nearly 3.2% (4.1 pp below the growth registered in 2015). Thus **total exports grew by 4.3% in 2016, slightly less than in 2015 (4.9%).**

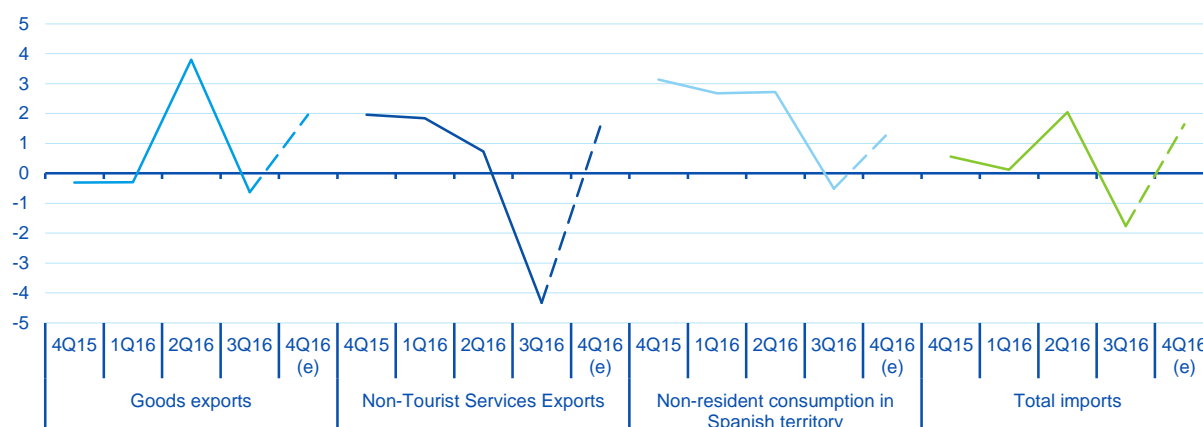
In line with the behaviour of final demand, the information available at the time of writing suggests that **growth in imports during 4Q16 was 1.6% QoQ (2.0% YoY) and that imports for the whole year would be up by 3.2% on the previous year (5.6% in 2015).** This behaviour, along with the expected for total exports, would indicate that **net external demand contributed 0.1 pp to Spain's GDP growth in 4Q16 and 0.5 pp for the whole year (-0.1 pp in 2015).**

8: Both exports by large companies and the backlog of export orders grew in 4Q16, while information available on the balance of trade points to a sharp increase in exports of goods in the last quarter of 2016.

9: Both arrivals and hotel overnight stays of non-resident tourists grew by around 2.6% SWDA in 4Q16. Balance of payments revenues from tourism grew by 0.4% MoM SWDA on average in October and November 2016.

Figure 3.4

Spain: growth observed and forecasts of the main components of external demand (% QoQ)



(e): estimated.

Source: BBVA Research based on INE

Labour market: mixed signals regarding growth in employment

The labour market continued to recover in the fourth quarter. Allowing for variations caused by seasonal factors, average Social Security affiliation increased by 1.0% QoQ, 0.2 pp more than in the third quarter. Hiring also gained in strength, increasing by 2.9% QoQ, while registered unemployment fell by 2.3% QoQ SWDA between October and December, half a point less than in 3Q16¹⁰.

However, the Labour Force Survey (LFS) for 4Q16 revealed a weaker improvement in employment than that suggested by the Social security registration (see Figure 3.5). Employment declined by 19,400 people between October and December due to the negative seasonality of the period. Discounting this factor, the number of people in employment will have grown by around 80,000 (0.4% QoQ SWDA), 50,000 fewer than in 3Q16 (0.7% QoQ SWDA)¹¹.

The decline in employment was concentrated in the service sector and in temporary workers. This fact, together with the uptick in the number of employees with indefinite contracts, led to a reduction of half a point in the proportion of employees on temporary contracts to 26.5%. However, when the effect of the negative seasonality of the period is discounted, the growing trend in temporary employment remains in place. As shown in Figure 3.6, the percentage of employees with temporary contracts increased by 0.2 pp to 26.4% SWDA, 3.7 pp above its cyclical trough reached in the first quarter of 2013.

Despite the fall in the number of people in employment, the unemployment rate declined by 0.3 pp to 18.6% due to the unforeseen decrease of 102,400 in the labour force. The seasonally adjusted figures suggest that the unemployment rate fell by 0.7 pp to 18.7%, being now at the same level as it was at the end of 2009 (Figure 3.5).

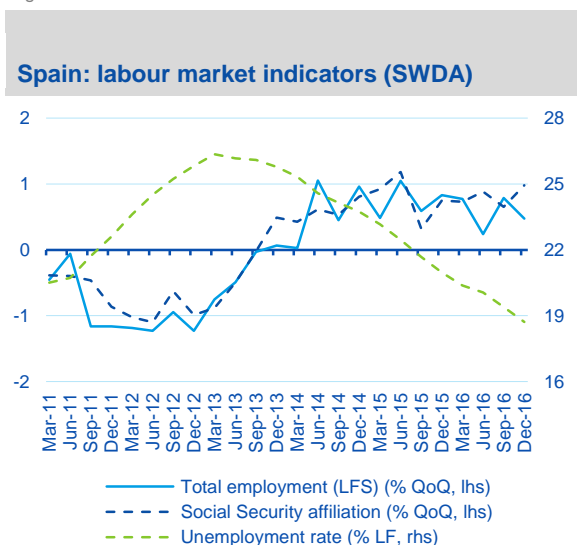
10: January figures extended the positive trend of the fourth quarter. Adjusted for seasonality, BBVA Research estimates indicate that the increase in social security affiliation was around 60,000 people, while the fall in unemployment was 33,000. For more information (in Spanish), see <https://goo.gl/VZeiqd>

11: A detailed evaluation of the data from the labour force for 4Q16 can be found (in Spanish) at: https://www.bbva.com/wp-content/uploads/2017/01/flash_epa4T16.pdf

The recovery of the labour market flagged somewhat in 2016

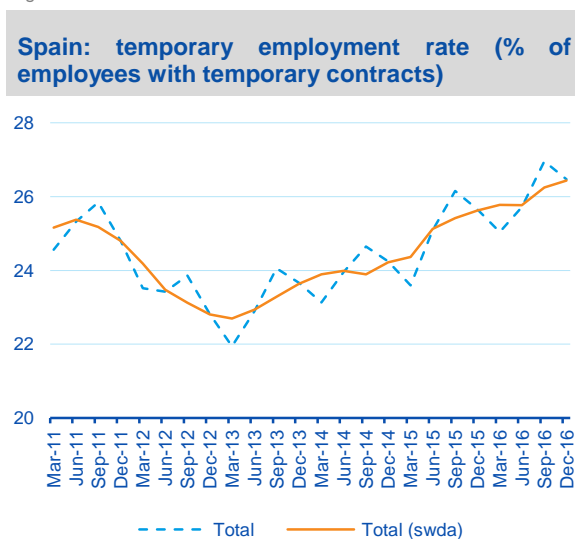
The 4Q16 figure ended the third consecutive year of job creation since 2007. On average, employment increased by 475,500 in 2016, 46,400 fewer than in 2015. The increase in the number of people in employment was concentrated in the service sector (eight out of ten new jobs) and in temporary contracts. These results contributed to a decline of 2.4 pp in the unemployment rate to 19.6% (end of period: -2.3 pp to 18.6%).

Figure 3.5



Source: BBVA Research based on INE

Figure 3.6



(e): estimated.

Source: BBVA Research based on INE

Headline inflation is increasing, while core inflation is holding steady

Headline consumer goods prices have increased strongly in the past few months, leaving behind the period of deflation in which the Spanish economy had been immersed since mid-2014. Having ended 2016 with headline inflation of 1.6% YoY in December (-0.2%YoY for the average for the year), the flash CPI indicator pointed to an increase of 1.4 pp to 3.0% in January. **Behind this behaviour is mainly the uptick in energy prices**, (nearly 17% YoY in January), which is in turn due to three factors: the base effect generated by the fall recorded one year ago (-8.4% between November 2015 and January 2016), the upward correction in commodity prices (13% cumulative in the case of Brent crude in the past two months) and lastly the upward pressure on the price of electricity (11.9% between November and January), largely caused by adverse weather conditions.

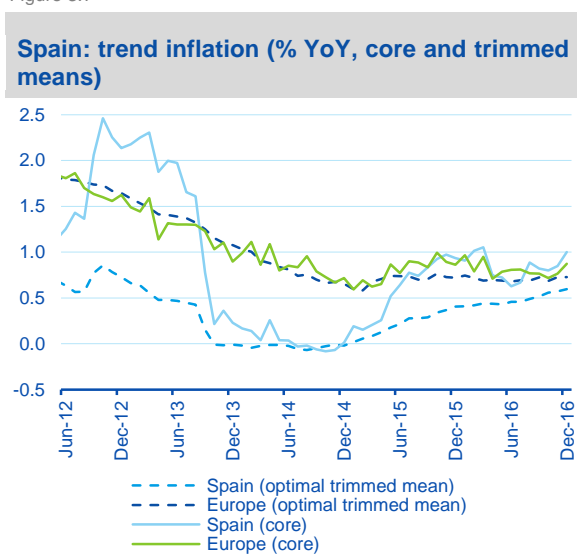
The recent uptick in prices was due to energy

In contrast, core inflation has held practically steady at around 1.0% YoY (0.8% YoY on average in 2016), which in any case implies pressure on the Spanish economy's gains in price competitiveness, given the context of low core inflation in Europe. Thus BBVA Research estimates indicate that **the differential in**

trend inflation relative to the euro zone as a whole has decreased by one point from its peak in October 2013 to 0.1 pp in December (see Figure 3.7)¹².

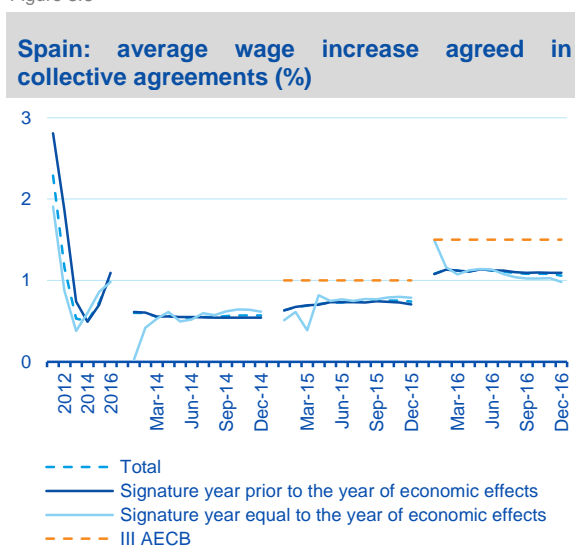
Wage demands remained steady during the fourth quarter, in line with core inflation. The average wage increase agreed in collective bargaining stood at 1.1% YoY from October to December for the revised multi-year agreements and 1.0% for agreements signed during the current year, involving 1,994,000 workers. As can be seen in Figure 3.8, increases in wages in the fourth quarter were similar to those recorded in the first three, but less than the 1.5% set as a maximum limit in the 3rd Agreement for Employment and Collective Bargaining (AENC from its Spanish initials) for the whole year of 2016¹³.

Figure 3.7



Source: BBVA Research based on INE

Figure 3.8



Annual data include agreements registered after December each year and incorporate the review using the wage guarantee clause. (*) Data for 2015 and 2016 are provisional. The figures from 2013 onwards are not strictly comparable with those of previous years. Source: BBVA Research based on ME and SS

The new credit to households and SMEs ended 2016 on a positive stance

The stock of credit to the private sector continued to decline in 4Q16, at a similar pace to the third quarter (down 4.5% YoY in November). Similarly, **new lending continued its downward trend** (falling by 13.9% YoY cumulative in 2016), mainly because of the decline in financing transactions of more than €1 million for companies (down 32.8% YoY cumulative for the year). This lower demand for bank borrowing by major companies is due at least in part to the climate of uncertainty (national and international) and to the growing tendency to meet financing requirements from other sources (own savings and debt issues). Cheaper debt issuance

The price of new lending has maintained its downward trend

12: For more details on the calculation of trend inflation using the trimmed mean method, see chart 1 of the Spain Economic Outlook review for the first quarter of 2014, available at: <http://goo.gl/j0rIT8>

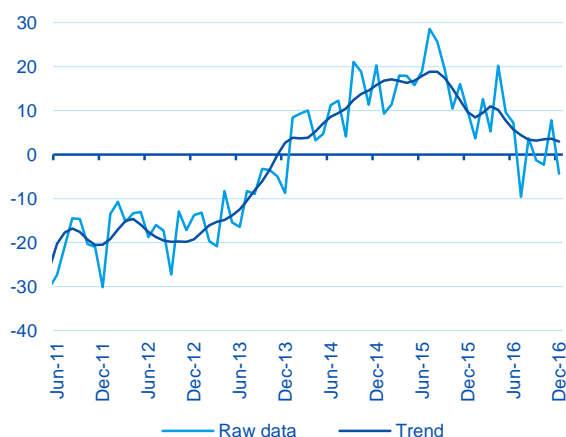
13: The 3rd AENC, signed in early June 2015 by CEOE, CEPYME, CCOO and UGT, sets limits on wage increases agreed in collective agreements. In 2015 they were not allowed to exceed 1%, and in 2016 the figure is 1.5%. The increase in 2017, which should be agreed on in the next few weeks, will depend on the development of GDP growth in 2016 and the government's macroeconomic forecasts.

thanks to the ECB's asset purchasing programme (APP) have contributed to this. **As for the retail sectors (households and SMEs), growth in lending slowed throughout the year**, although an increase of 3.8% YoY was accumulated in 2016.

The price of new credit has maintained its downward trend, favoured by the reduction in EURIBOR, improved liquidity conditions for banks, lower sovereign risk and lower credit risk faced by banks. However, in some portfolios there is evidence of having reached a minimum threshold in an environment of narrowing interest margins and changes in the structure of the class of loan. On the other hand, the rates for housing acquisition (2.19% APR in December, 12 bps less than a year ago), show a clear resistance to continuing decline given the growing importance of fixed-rate mortgage loans. According to this indicator, which includes commissions, Spanish mortgage loans continue to be cheaper than those of many other European countries such as France and Ireland.

Figure 3.9

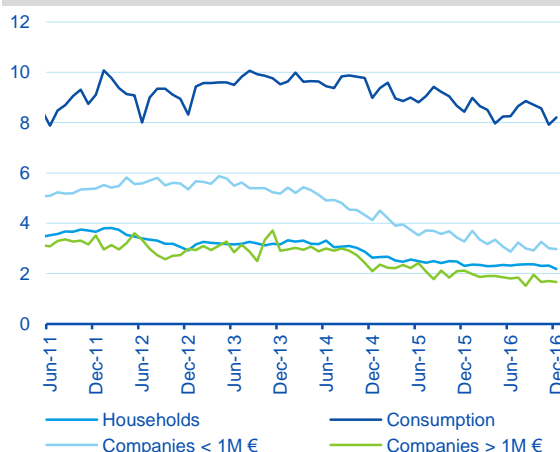
Spain: new lending transactions to the retail sector (% YoY)



Source: BBVA Research based on Banco de España data

Figure 3.10

Spain: interest rates on new lending (% APR)



Source: BBVA Research based on Banco de España data

Scenario for 2017-2018: growth will moderate to 2.7%

The fundamentals of the Spanish economy support continued recovery over the next few years. However, expectations persist of a

slowdown in the short term, given the environment of uncertainty, both internal and external, the change in the fiscal policy stance, which will turn neutral this year, and the exhaustion of the momentum so far provided by low oil prices¹⁴ and expansive monetary policies. Thus **the current biennium will end up with average annual growth of 2.7%, which implies a moderation of half a percentage point relative to the previous biennium** (see Table 3.1). Even so, this increase in activity

Tailwinds slacken

14: Forecasts by BBVA Research indicate that oil prices will be around \$57 and \$58.70 per barrel in 2017 and 2018 respectively, 7% and 0.7% higher than was expected three months ago as a result of the correction to supply. Given the Spanish economy's high degree of energy dependence, higher oil prices could lead on average to 0.2 or 0.3 pp less growth over the two-year period.

will be sufficient to create nearly 920,000 jobs over the biennium and reduce the unemployment rate to around 15.8% in 2018¹⁵.

Table 3.1

Spain: macroeconomic forecasts						
(% YoY unless otherwise indicated)	3Q16	4Q16(e)	2015	2016 (p)	2017 (p)	2018 (p)
National Final Consumption Expenditure	2.4	2.3	2.6	2.6	2.3	2.2
Private Consumption	2.8	2.7	2.9	3.0	2.5	2.4
Public. Consumption	1.4	1.1	2.0	1.3	1.8	1.9
Gross Fixed Capital Formation	3.1	2.9	6.0	3.6	3.3	4.4
Equipment and Machinery	5.0	4.1	8.9	5.7	4.1	4.3
Construction	2.0	2.1	4.9	2.3	2.5	4.2
Housing	2.6	2.6	3.1	3.1	3.2	5.8
Other Buildings and Constructions	1.4	1.8	6.4	1.7	1.9	2.8
Domestic demand (*)	2.6	2.3	3.3	2.8	2.4	2.6
Exports	2.8	4.1	4.9	4.3	4.5	5.2
Imports	0.9	2.0	5.6	3.2	4.1	5.5
External demand (*)	0.6	0.7	-0.1	0.5	0.2	0.1
Real GDP at market prices	3.2	3.0	3.2	3.2	2.7	2.7
Nominal GDP at market prices	3.5	3.9	3.7	3.7	4.8	5.2
Total employment (LFS)	2.7	2.3	3.0	2.7	2.5	2.5
Unemployment rate (% Labour Force)	18.9	18.6	22.1	19.6	17.5	15.8
Full time equivalent employment (FTE)	2.9	2.9	3.0	2.9	2.3	2.1

(*) Contributions to growth.

(e): estimated; (p): projected.

Source: BBVA Research based on INE and Banco de España

Despite the forecast slowdown, **expectations of growth for 2017 have improved slightly compared from those presented in the previous edition of this publication (by 0.2 pp)**. The upward revision of growth forecasts for Spain's major trading partners (by 0.1 pp in the case of the euro zone), together with the prospect of recovery in certain emerging economies (mainly in Latin America) bodes well for **increased demand for exports, although uncertainty remains regarding the impact of the exit of the UK from the European Union (Brexit) and the future of US foreign trade policy**. This export momentum will also favour domestic demand (especially investment) which will also continue to be driven by the improvement in its fundamentals and the progress being made on correcting imbalances. The increase in final demand will bring about an increase in imports, which in any case will not prevent the current biennium from ending with a slightly positive contribution to growth from net external demand.

15: By the end of the period, the number of people in employment will have increased by 950,000 and the unemployment rate will have declined to around 15.1%.

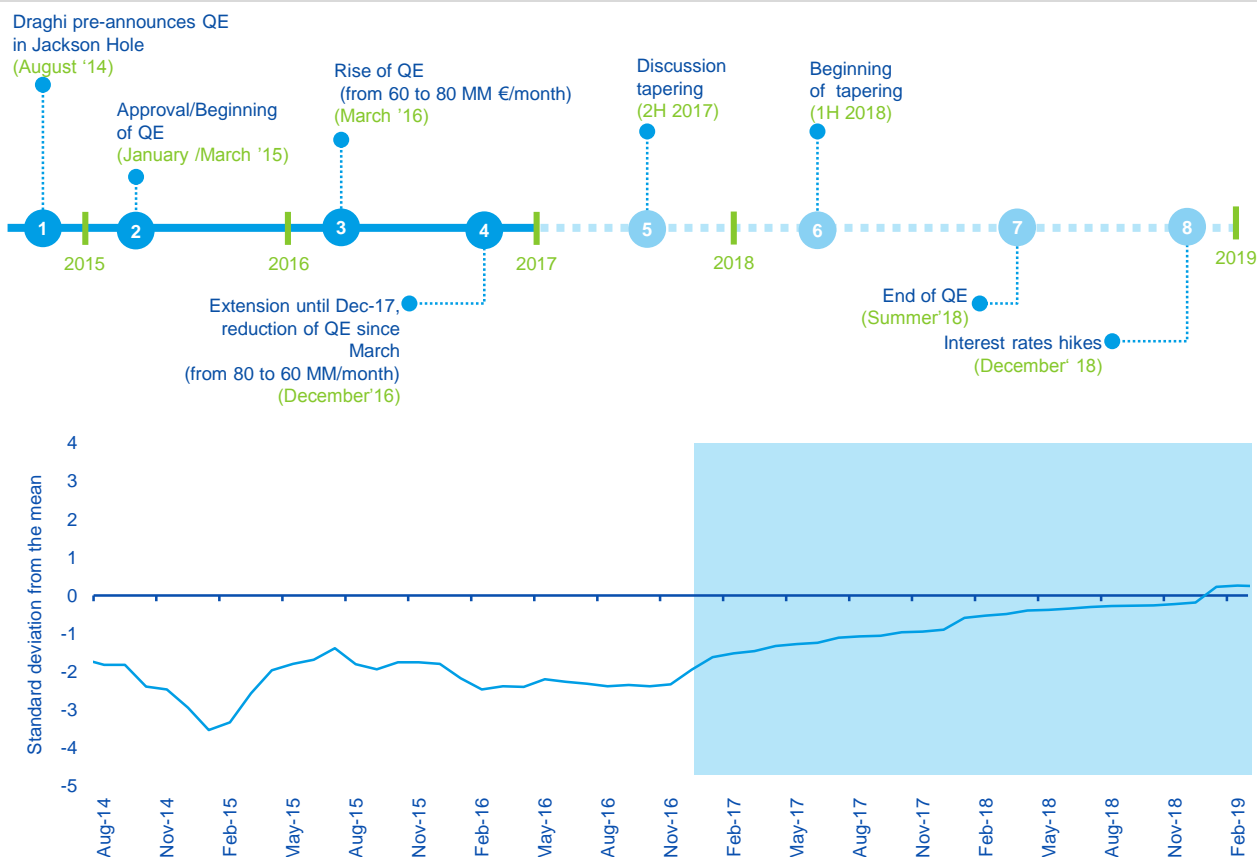
The expansive stance of the ECB's monetary policy will moderate gradually over the current biennium

The ECB has reaffirmed its commitment to using all the stabilising instruments available to it under its mandate if necessary. In December, the ECB's Governing Council (GC) approved an expansion of the ECB's monthly asset purchase programme (APP) at least until December 2017 or until sustained recovery in inflation is observed. However, in line with the improvement in economic conditions in the euro zone, the ECB will reduce the amount of monthly purchases from €80 billion to €60 billion from March this year. The ECB's president stressed that this measure did not mean a gradual withdrawal of QE (tapering), being merely an adjustment to the programme consistent with the more favourable environment in which the risk of deflation had practically disappeared. Ultimately, the ECB's discourse remains dovish if one bears in mind the continuing threats to growth posed by the global environment and the fact that the recent uptick in inflation, due mainly to energy prices, is not yet considered permanent. All the same, the decision to extend QE was not unanimous; some distinguished GC members were highly critical of it. The criticisms started when Germany's inflation picked up and it seems likely to rise further in the coming months, while prices in the euro zone look set to rise by as much as 1.8% YoY due to the energy effect. And this despite the likelihood of it subsequently easing slightly, since in principle second round effects are not expected to have a significant effect on core inflation in the euro zone as a whole.

Looking ahead, the ECB is expected to keep its monetary policy unchanged in the shortest term, given the persistent external and internal uncertainty -mainly associated with the electoral calendar in Europe-. Starting in the summer, as it becomes clearer that inflation is sustained and downside risks ease, the debate about withdrawing QE will no doubt come to the fore, possibly leading to some volatility in debt markets. As early as 2018 the ECB is expected to set a gradual withdrawal process in train, sticking to the roadmap it has followed so far. Thus, during the first half of 2018 there would be a gradual reduction in asset purchases, and later, towards the end of 2018, we would see the first interest rate hike (see Figure 3.11).

Figure 3.11

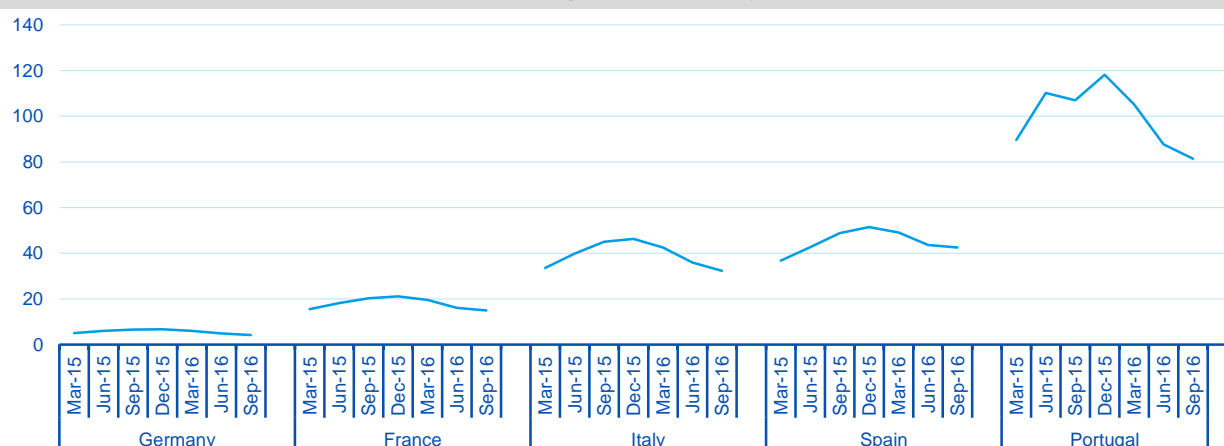
Calendar for the ECB's asset purchase programme and euro zone inflation monitor (*)



Source: BBVA Research

The end of the APP will bring some volatility in the debt markets causing a direct effect on EMU's members cost of financing in the medium and long term. As shown in Figure 3.12, this programme contributed to lowering the perceived risk of default in 2015 and 2016 (45 bps on CDS at 5 years).

Figure 3.12

Estimated impact of the ecb's asset purchase programme on five years cds

Source: BBVA Research

The retail sector will underpin growth in new lending by banks

Going forward, we expect total new lending to halt its retreat, for reasons of both demand and supply. On the demand side, the retail sector will continue to show a positive trend and will play a leading role in new lending (it already accounts for 62% of the total accumulated in 2016). Also, companies' improved financial situation and lower borrowing costs will favour the recovery, albeit gradual, in lending to major corporates, which will continue to be influenced by the extension of the ECB's corporate bonds purchase programme to the end of 2017. On the supply side, positive contributions will be felt because of improvements in liquidity conditions (thanks to the banking union and the ultra-expansionary policy of the ECB) and lower portfolio risk. The revival in new lending transactions should support the continuing recovery, with banks attending to solvent demand, especially to the retail sector, which is more reliant on bank financing.

Fiscal policy will be practically neutral during this biennium

In a non-changing economic policy scenario, **the fiscal policy stance is likely to be practically neutral in 2017 and 2018 (see below).** Given the increased tax revenues envisaged following the tax rate increases approved in December, this will mean an increase of 1.9% in real terms in public consumption over the current biennium. Apart from this, investment in construction other than housing will grow by more than 2% in spite of the prospect of public works levelling off, driven by private sector non-residential investment.

Private domestic demand will slow

Household consumption will slacken somewhat in 2017 and 2018, but the outlook remains favourable. The uptick in inflation will restrain growth of disposable income and property wealth in real terms, despite the recovery in employment and housing prices. On the other hand net financial wealth is expected to contribute more to the increase in household spending than it did in 2016, since new consumer finance transactions

continue to grow, supported by some still reduced official interest rates. Consequently, private consumption is expected to increase by 2.5% this year, 0.5 pp less than in 2016, and by 2.4% next year.

The growth forecasts of investment in machinery and equipment for 2017 and 2018 will remain at a high rate over the current biennium, although this growth will probably be slower than that seen since the beginning of the recovery. Contributory factors to this slowdown will be the decline in pent-up demand for machinery and

Productive investment
will continue to grow,
but at a lower rate

equipment and the expected slowdown in other domestic spending. Also, the gradual normalisation of oil prices and interest rates from their historical lows will make self-financing and borrowing to finance new capital expenditure projects marginally more expensive in the coming years. On the other hand, the expected growth in demand for exports will continue to support the expansion of installed capacity just as intensely. On balance, after three years growing at an annual average of 7.6%, we expect that investment in machinery and equipment will increase at rates of 4.1% and 4.3% in 2017 and 2018 respectively.

The real estate market will continue to recover over the next few years, underpinned by its healthy fundamentals. Both growth in employment and the positive but less dynamic trend in households' gross income will continue to support residential investment. And all this with financing terms which, despite the expected increase in the cost of medium- and long-term borrowing, will remain relatively favourable. Also, agents' expectations of housing prices increases continue to consolidate, and the regions with the greatest economic activity are starting to feel the need for new housing. In summary, the outlook for **residential investment** remains practically unchanged from the **scenario described in the previous edition of this publication**. **Growth in this component of demand in 2017 will be 3.2%**, and in **2018 it will increase to 5.8%**. In this way residential investment will contribute 0.14 pp to GDP growth in 2017 and 0.26 pp in 2018.

Exports will keep up their rate of growth during the biennium (2017-2018)

The global environment has undergone some changes relative to the scenario presented by BBVA Research in November. On the one hand, expectations regarding oil prices have been slightly revised upwards, while expectations about the euro's real exchange rate point to additional depreciation in the short term. On the other hand, expected growth for the major economies has been revised marginally upwards. This, together with the expected recovery of emerging markets (mainly in Latin America) bodes well for solid demand for Spanish exports; despite the uncertainty surrounding Brexit and the future path of US foreign trade policy.

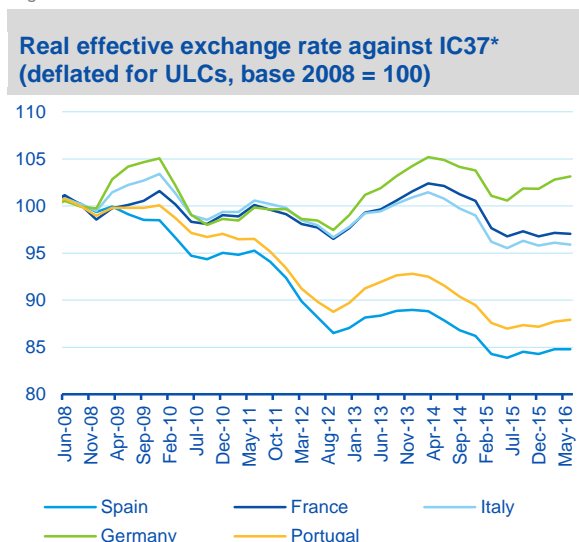
In line with this, **the forecast of total exports have been revised slightly upwards for 2017 and 2018. The totals will increase at an average annual rate of 4.9%**, exports of goods will grow at an average of 4.8%, and consumption by non-residents will increase by around 4.1%. The expected pace of

Spain's exports will continue
to show great dynamism
compared with the rest of
Europe

growth suggests that **Spain's exports will continue to perform more dynamically than those of the rest of Europe**, as has been the case in the past few years. This differential behaviour is explained, at least in

part, by the Spanish economy's greater gains in competitiveness: since the onset of the crisis, adjustments to unit labour costs (ULCs) have been greater in Spain than in many other European countries, and this has translated into a bigger fall in the real effective exchange rate (see Figure 3.13). At the same time, Spain has increased the degree of penetration of non-EU markets, which accounted for 37% of total exports in 2013 (see Figure 3.14). Although this percentage has declined in recent years because of the slowdown suffered by emerging markets, it is still well above pre-crisis levels. In conclusion, **the greater diversification of export destinations** leads us to believe that, given the good economic prospects for developing countries, **non-EU markets will again be a growth driver for Spanish exports**.

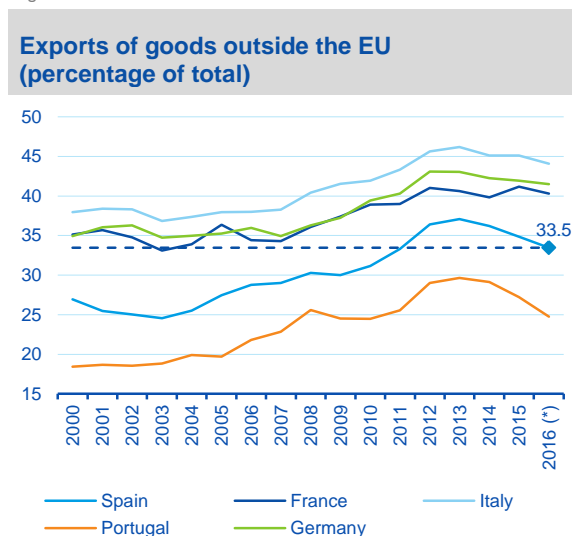
Figure 3.13



(*) IC37 is a group of Industrial Countries comprising the 28 EU members plus the US, Canada, Japan, Switzerland, Norway, Australia, New Zealand, Mexico and Turkey.

Source: BBVA Research based on European Commission

Figure 3.14



(*) Data for 2016 to November.

Source: BBVA Research based on European Commission

The expected evolution of final demand will lead to a **big increase in imports during the current biennium (average for the two years: 4.8%)** which will not however compensate the increase in exports. Thus, **the contribution of net external demand to growth will be slightly positive in 2017 and 2018 (0.2 pp and 0.1 pp respectively)**. This, together with persistently low oil prices, will contribute to keep **current account balances positive (average: 1.8% of GDP)**.

The labour market recovery continues

Expectations of a slowdown in the economy for 2017 and 2018 are pushing expected job creation down. The number of people in employment is expected to increase on average by 2.5% this year, 0.2 pp less than in 2016. Given the expected flatness of the labour force¹⁶, growth in employment will translate into a fall of 2.2 points in the unemployment rate, to 17.5%. Employment will continue to increase in 2018, by 2.5%, and the unemployment rate will decrease to 15.8%.

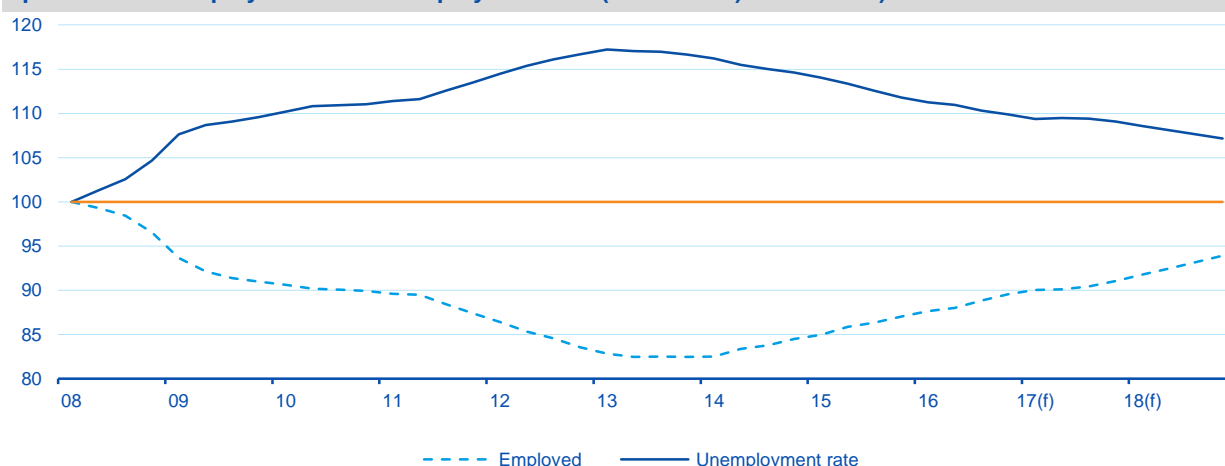
16: The rate of decline in the Labour Force is expected to slow to 0.2% in 2017, and in 2018 the Labour Force is expected to grow by 0.4% in spite of the fall in the number of people of working age. The increase in the Labour Force projected for the last part of the forecast period corresponds to an uptick in propensity to participate in the labour market. In any case, projected growth is very little compared with the historical average of 1.4% or with the 2.8% seen in the previous growth phase from 1995 to 2007.

But the labour market expected dynamism will not be enough to return to pre-crisis levels. As Figure 3.15 shows, in the fourth quarter of 2018 employment would be about 6% lower than at the beginning of 2008, while the unemployment rate would be six points higher. In addition, the expected development of activity and full-time equivalent employment – which will increase by around 2.2% on average in the 2017-2018 periods – suggests a very slight rebound in the apparent productivity of labour to 0.6% in 2018.

At the end of the current biennium the labour market will still not have returned to its pre-crisis level

Figure 3.15

Spain: level of employment and unemployment rate (1Q08 = 100) SWDA data)



(f): forecast.

Source: BBVA Research based on INE figures

The recent increase in the legal minimum wage¹⁷ makes hardly any difference to the outlook for the labour market, but it does potentially make it harder for certain groups to find work. From the Wage Structure Survey it is possible to estimate the proportion of workers in manufacturing, construction and services in receipt of annual wages equivalent to or less than full-time minimum wage. The data indicate that people receiving the legal minimum wage account for 2.3% of non-farm workers after the increase, equivalent to 0.7% of the total payroll¹⁸.

Given the small number of people to whom it applies, **the impact of the increase in the legal minimum wage on employment and GDP will be limited.** Our estimates¹⁹ indicate that the wage disruption would have imperceptible effects in the short term. In the long term, the level of employment would be between 0.1

17: Royal Decree 742/2016 of 30 December establishes an increase of 8% in the legal minimum wage for 2017. On an annual basis the legal minimum wage reaches €9,907.80.

18: The details of the calculation in the minimum wage coverage and the possible macroeconomic effects of its increase will be available in a forthcoming Economic Observatory.

19: To estimate the macroeconomic impact of the increase in the legal minimum wage, we used the model proposed in Doménech, R., García J. R. and Ulloa C. (2016): "Los efectos de la flexibilidad salarial sobre el crecimiento y el empleo" (The effects of wage flexibility on growth and employment), BBVA WP 16/05, which allows us to break down the changes in the main macroeconomic aggregates into the distinct types of structural disturbances faced by the Spanish economy. More details (in Spanish) at <https://www.bbva.com/publicaciones/los-efectos-de-la-flexibilidad-salarial-sobre-el-crecimiento-y-el-empleo/>

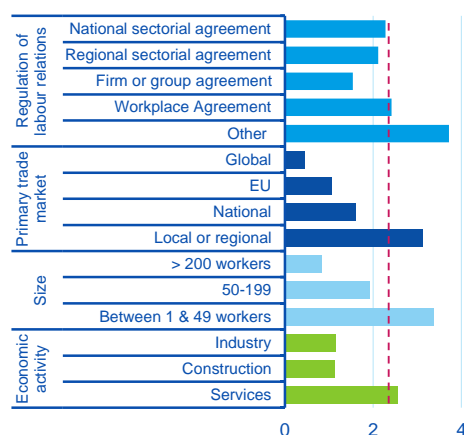
pp and 0.2 pp less than if there had been no increase, while GDP growth would be about 0.1 pp lower²⁰. Nonetheless, the repercussions could be greater **if the increase in the legal minimum wage exerts upward pressure on wage demands of workers as a whole**²¹.

In any case, the impact may be significant for the most vulnerable workers. Empirical evidence for Spain²² indicates that employability of young people, those over 45 years of age, women and the least qualified would be particularly affected by the increase in the legal minimum wage. As can be seen from Figure 3.14, the proportion of people on minimum wage is comparatively high among women, young people, foreigners, those least qualified, part-time workers, temporary workers and those who have been working for a company for the shortest length of time. We also observe some disparities depending on the characteristics of the workplace. The percentage of workers receiving the legal minimum wage or less is greater in the service sector, in very small companies and in companies with no collective agreement.

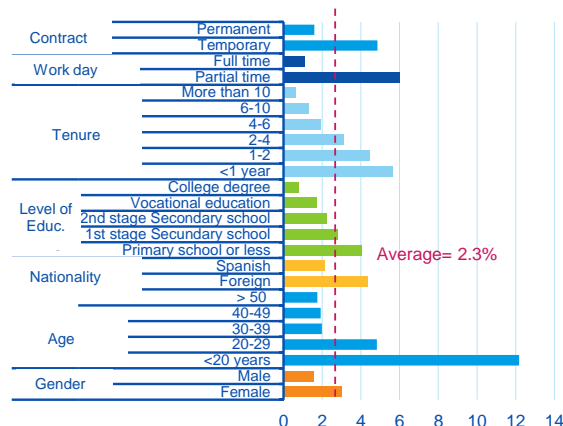
Figure 3.16

Types of workers receiving, in 2016, wages equal to or less than the minimum legal wage for 2017 (Percentage of employees in manufacturing, construction and services)

Characteristics of the firm



Characteristics of the worker



Source: BBVA Research based on INE figures

20: These figures assume that the proportion of people affected by the minimum wage in the primary sector is similar to the average of the other sectors. A complementary exercise assumes that all primary sector workers receive the minimum wage or less. In this case, the effects of the wage disruption would be greater: from 0.1 pp to 0.2 pp on employment and GDP in the short term and from 0.2 pp to 0.4 pp in the long term.

21: According to our estimates, a wage shock equivalent to an increase of 1% in real wages in the long term would lead to the level of employment falling by 1.9% relative to the baseline scenario.

22: See, *inter alios*, Dolado, J. J. and F. Felgueroso (1997): "Los efectos de salario mínimo: evidencia empírica para el caso español", *Moneda y Crédito*, 204, 213-263; Dolado, J., Kramarz, F., Machin, S., Manning, A. and Teulings, C. (1996): "The Economic Impact of Minimum Wages in Europe", *Economic Policy*, vol. 11(23), 317-372; Galán, S. and Puente, S. (2012): "Una estimación del impacto de las variaciones del salario mínimo sobre el empleo", *Banco de España, Boletín Económico*, Dec-12, 19-25.

Both headline and core inflation will remain in positive territory during the current biennium

Although the start of 2017 continues to be marked by the uptick in energy prices, headline inflation will slow from the second quarter. Thus **the year will close with average annual inflation of around 2.1%**, 0.4 pp more than the estimated three months ago, due to the upward revision of commodity prices and the uptick in the price of electricity. Core inflation for its part will maintain its gradual upward trend (1.2% annual average for 2017), supported by the improvement in the domestic determinants and the stimulus measure provided up to now by monetary policy (low interest rates, pushing loan availability, and quantitative easing).

In 2018 underlying prices will continue to increase (1.6% p.a. on average) and this, together with the absorption of the base effect on energy prices, will bring headline inflation to 1.9%, 0.1 pp below the target set by the ECB for the euro zone as a whole.

Gains in price-competitiveness are nearly exhausted

If these estimates prove correct, Spain's headline inflation would be higher than that of the euro zone as a whole during the current biennium (0.4 pp on average), after three years below it (average 0.5 pp). However there will be practically no difference in core inflation.

Although the high level of inflation is of a transitory nature, it could lead to increased pressure on wage demands given the current context of recovering demand and employment. The direct effects of the increase in the legal minimum wage on the general price levels would be limited, even if companies transfer the labour cost increase to final prices in full. However, any second round indirect effects could be significant in the medium term.

Economic recovery will help in meeting the public deficit targets for 2017 and 2018

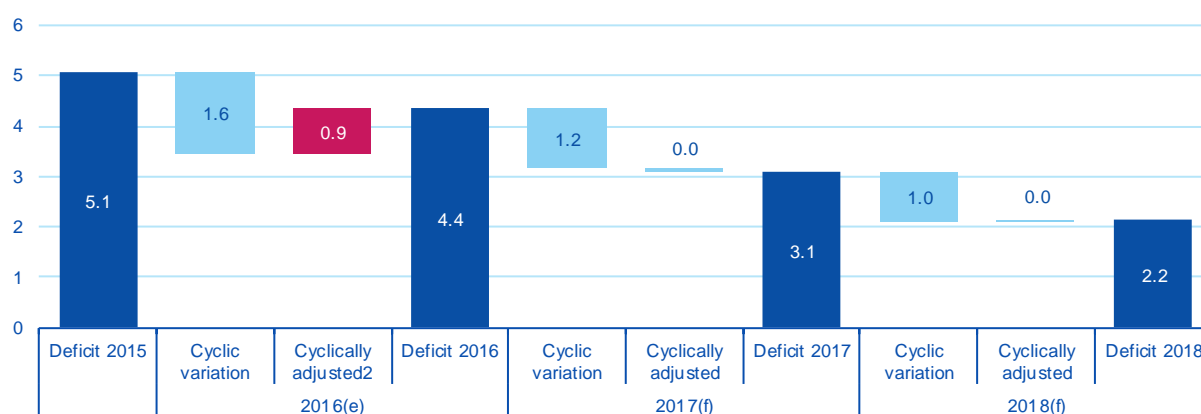
Available information on budget execution of the public administrations as a whole confirms that **fiscal policy stance in 2016 proved to be more expansive than the anticipated at the beginning of the year.** Although we expect the ratio of spending to GDP to have fallen slightly in 2016 (1.3 pp less than that observed in 2015) this will be due to lower unemployment benefits thanks to the improved labour market, lower financing costs and adjustments to public sector investment in the second half of the year. On the revenue side, the measures adopted in the last quarter of the year offset the structural reduction in direct tax revenues deriving from the tax rate cuts of 2015 and 2016. As a result, 2016 will have closed with a deficit of around 4.4% of GDP (excluding aid to financial institutions), representing a reduction of 0.7 pp of GDP and adding to the nearly six percentage point fall of the past five years.

Over the current biennium, the economic cycle will continue to reduce the deficit, both through the effect of the automatic stabilisers and through the reduced interest burden, given the decrease in rates in the past few years, and lower social benefits (basically pensions and unemployment). The tax rate increases will have a positive effect on government bodies' structural revenues. Thus, given the policies announced so far, **the**

deficit would be reduced to around 3.1% of GDP in 2017 and 2.2% of GDP in 2018; in line with the stability objectives required by the European Commission (see Figure 3.12).

Figure 3.17

Public Administration: breakdown of fiscal adjustment, excluding aid to Spanish financial institutions (pp of GDP)



(e) estimated; (f): forecast.

(1) Includes changes in interest charges

(2) 2016: 0.4 pp structural deterioration + 1.2 pp expansive policies – 0.7 pp fiscal adjustment measures; 2017: includes 0.5 pp from adjustment measures approved in December 2016.

Source: BBVA Research based on MINHAP and INE

In this scenario, we estimate that the structural primary balance will have deteriorated by around 0.9 pp of GDP in 2016, while for 2017 and 2018 we foresee an improvement of 0.1 pp each year. In this way, the structural correction of the public accounts would allow debt objectives to be achieved, but this rate of adjustment is far away from the recommended by the Commission (0.5 pp a year) in order to bring a significant reduction in the high level of public debt, which is estimated to have exceeded 100% of GDP in 2016.

The deficit will be in line with the stability targets for 2017 and 2018

If this scenario were to be confirmed, Spain would emerge from the excessive deficit protocol in 2018, but there would continue to be significant challenges in addition to those deriving from the deficit and public debt, which would require the reforming agenda to be retained. In terms of the public accounts, the medium- and long-term challenges are focused on improving the efficiency of public expenditure, ensuring the sustainability of the public accounts and embarking on a reform of regional financing so as to balance autonomy in spending against shared fiscal responsibility.

The scenario is not without risks

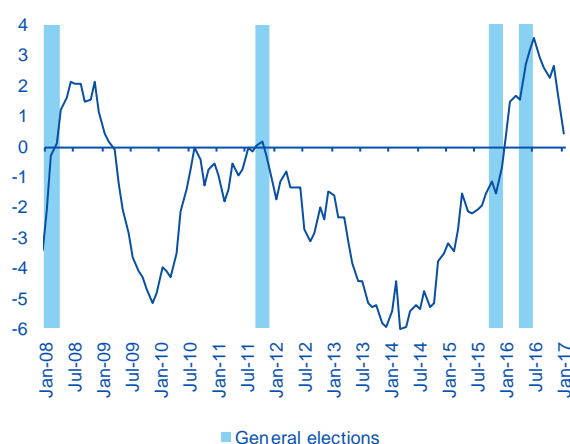
Although the forecasts for 2017 have been corrected upwards relative to those described in the previous edition of this publication, external and internal risks persist. On the external front, uncertainty remains about the possible protectionist measures that might curtail the incipient recovery in world trade. In this regard, it is still unknown what shape US foreign trade policy will take or how the negotiations on the UK leaving the EU will evolve and what the end result will be. Apart from this, upcoming

elections in some of the euro zone's main economies (the Netherlands in March, France in April and Germany in September) are additional unknown factors in the external panorama.

On the domestic front, uncertainty regarding economic policy diminished over the course of 2016. However, according to BBVA Research estimates, it could continue to shave around 0.3 pp off growth in 2017 (Figures 3.17 and 3.18). What is more, uncertainty could increase during the current administration, depending on what measures are adopted. In this regard, the latest changes to corporate tax, which in some respects reverse changes that had been approved in the last few years, increase the lack of trust in the stability of tax policy and therefore could affect long-term investment decisions. Although, it is estimated that the impact of the increase in the legal minimum wage on employment and GDP will initially be limited, it will test the wage flexibility achieved following the labour law reform of 2012. In particular, it cannot be rule out the possibility of the measure exerting upward pressure on wage demands of workers in general, which would affect the price-competitiveness of the Spanish economy and ultimately economic growth.²³

Figure 3.18

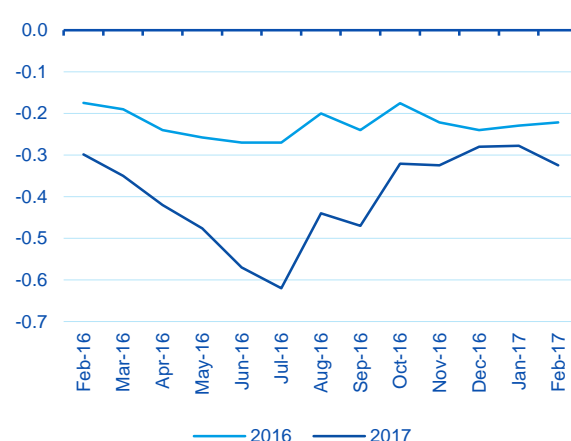
Spain: Economic Policy Uncertainty (SM12 of the idiosyncratic component in standard deviations)



The shading corresponds to a period of three months surrounding the general elections
Source: BBVA Research based on the EPU index produced by *Baker et al.* (2015)

Figure 3.19

Spain: estimated impact of economic policy uncertainty in GDP by forecast date (pp)



Source: BBVA Research

23: For details about estimating the effects of economic policy uncertainty on the Spanish economy, see Box 1 of the Spain Economic Outlook journal for the first quarter of 2016, available at: https://www.bbva.com/wp-content/uploads/2016/03/Spain_Economic_Outlook_1Q16.pdf

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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