2. The economy continues to recover more moderately and with more risks

The Spanish economy will continue to recover strongly, albeit less so than in previous years, and 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 different measures that have supported the recovery so far point to GDP growth remaining at around 2.7% in 2017 and 2018. This will be in spite of the deterioration observed in some of the key factors behind the improvement in private sector domestic demand over the past two years, and in spite of the heightened worldwide uncertainty about economic policy.

The global economy is improving in an environment of high uncertainty

Despite the acceleration experienced by the global economy in the latter part of 2016, the outlook for 2017 and 2018 is fraught with uncertainty. This is principally related with the economic policy of the new US administration, the direction of which remains largely to be seen.

The rise in inflation is putting pressure on monetary policy

The magnitude of inflationary pressures is another unknown factor opening up at a global level. The rising prices of raw materials along with the base effects of energy prices are pushing up expectations of inflation in the long term. This, oupled with quantitative easing programme and the prospects of fiscal stimulus, means that the deflation risks of a few quarters ago have been replaced by inflationary pressures, raising questions about monetary policy.

In principle, the Federal Reserve is maintaining a cautious attitude and is continuing to aim at a relatively slow normalisation of rates, forecasting two rate hikes this year and another two in 2018. Furthermore, the pressures by the ECB to bring forward the normalisation of monetary policy have already begun with increasing prices in Germany, and may well intensify in the coming months when inflation in the Eurozone approaches 2% owing to the effects of energy prices. Given the above, the ECB is expected to decide on the first interest rate hike at the end of that year.

The global scenario is not without risks

Overall, growth projections for 2017 are subject to greater uncertainty than usual. The base effect of increased growth at the end of 2016 and its inertial effect, together with the fiscal stimulus packages expected in the US, mean we need to revise the forecasts moderately upward for the US and Europe, and slightly more so for China, while the forecasts for Latin-American countries are being revised downward, principally due to idiosyncratic factors. The risks are mainly on the downside and are dominated by the aforementioned uncertainty associated with US economic policy. Also, an unexpected rise in inflation could lead to the tightening of monetary policy by the main central banks, with global consequences. In the long term, the risks of the accumulation of imbalances in China, together with the lack of structural reforms, could have an impact on its capital flows and currency and lead to a sudden slow-down in growth. Europe is subject to substantial political risks, in a year that is packed with elections, and where certain increasingly popular parties propose rolling back on structural reforms or measures to quit the euro zone or the European Union. And for their part, geopolitical risks remain significant.

Continued growth of the Spanish economy but at more moderate rates

The Spanish economy will grow by 2.7% in 2017.

In the next biennium, growth is expected to remain at around 2.7%. The trend in the latest data points to GDP growth in the first quarter of this year coming in at around 0.8% QoQ. This, together with the continuation of a positive environment for the Spanish economy, means there is even a warning of a moderate upward bias in this figure. In particular, the uptick in worldwide activity, oil prices still below the average for the last three years, the expansive tone of monetary policy, the cyclical impulse we are seeing, and the effects 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. Even so, this increase in activity will be sufficient to create nearly 920,000 jobs over the two-year period and reduce the unemployment rate to around 15.8% in 2018. However, the expected dynamism in the labour market will not be enough to return to pre-crisis levels (Figure 2.1).

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 change of administration in the US on public policies, particularly on trade. Secondly, the cost of energy has risen considerably in the past few months, and this could have a negative effect on the evolution of household and business spending. Thirdly, 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 the evolution of the general index as opposed to the particular situation of businesses, consumers or the labour market.

No rate hikes are expected until 2018

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, but from the beginning of 2018 the stimulus measures will be tapered off, and this could lead to an increase in interest rates in the last quarter of 2018. The increase in the cost of financing 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). On the other hand, fiscal policy will go from expansive to neutral, and attaining objectives will depend on what impact the announced measures have on 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.

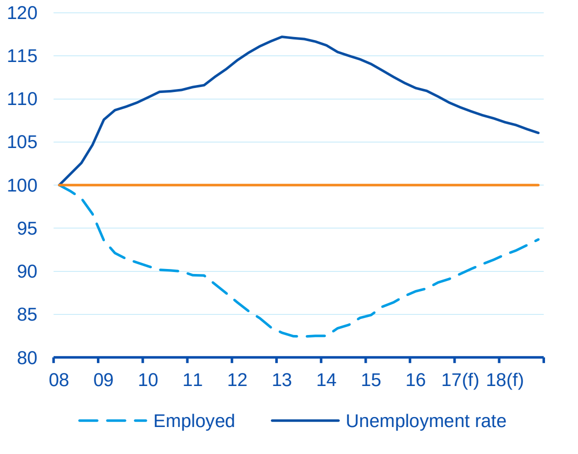
The scenario is not without risks

External and internal risks remain. On the external front, uncertainty remains about the possible protectionist measures that could curtail the incipient recovery in world trade. In this regard, we still do not know what shape US foreign trade policy will take or how the negotiations on the UK leaving the EU will progress and what the end result will be. Apart from this, upcoming elections in some of the euro zone's main economies (France in April and Germany in September) are additional unknown factors in the foreign panorama.

Uncertainty regarding economic policy remains high, and geopolitical events only add to this uncertainty (Figure 2.2). Moreover, in Spain, recent tax changes (based on corporation tax), legal uncertainty that could arise from different legal decisions, doubts about the approval of the State's 2017 Budget and on the path of reforms provide sources of economic insecurity that could adversely affect 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 evolution will require a continued process of improvements that help to raise productivity and reduce unemployment.

Figure 2.1

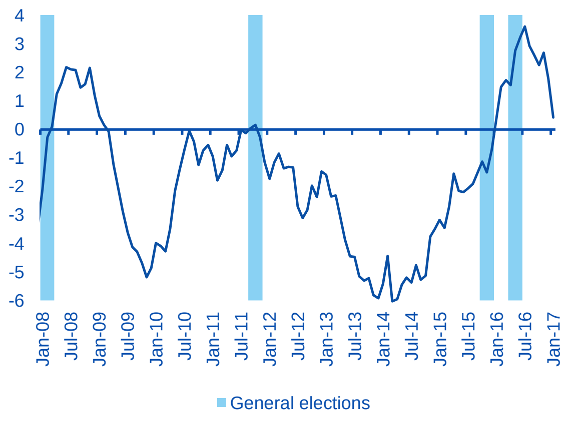
Spain: level of employment and unemployment rate (1Q08 = 100. SWDA data)



Source: BBVA Research based on INE figures

Figure 2.2

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



Source: BBVA Research

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