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BBVA Research

# Spain

# Economic Outlook

## 4Q18

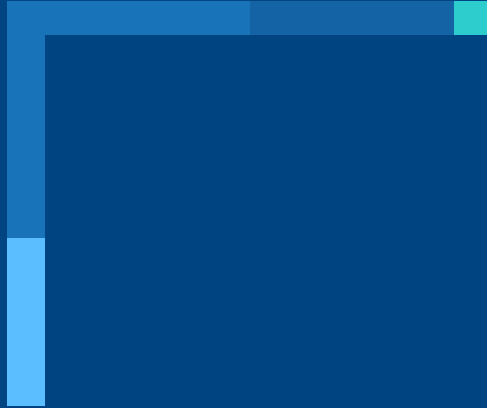
October 2018

Creating Opportunities

# Key messages



- The positive global environment is maintained, although growth is moderating in emerging economies and the Eurozone. The impact of protectionism is limited at the moment, but it remains the main risk along with the exit of the Fed and political uncertainty in Europe
- In Spain, growth is revised downwards to 2.6% in 2018 and 2.4% in 2019, due to the negative surprises registered in the first half, when the slowdown was focused on consumption and exports. The rebound of some uncertainties, external and internal, skews the forecasts downwards
- Nonetheless, the advance of economic activity will continue. Economic policy remains accommodative. It is also expected that oil prices will reverse current trends, and that external demand will continue to grow
- Uncertainty about economic policy and its possible impact remains high. It is necessary to advance measures that reduce the vulnerability of the Spanish economy in less favorable environments.



01

# Global Economic Outlook 4Q18

# Positive global inertia continues, although risks are intensifying



The global expansion remains at a steady pace, but more moderated and less synchronized

The strength of the US economy contrasts with moderation in China and Europe



Divergent monetary policy between the US and Europe from 2019

The Fed ends the cycle of increases, while the ECB initiates the increases and prepares the withdrawal of liquidity



Greater financial tensions in emerging markets

With evident differentiation between countries, the most financially vulnerable face sudden adjustments of their economies



Intensification of the commercial war between the US and China

Impact still limited, but could increase if new measures are taken. At the moment, the conflict between the US and other areas decrease



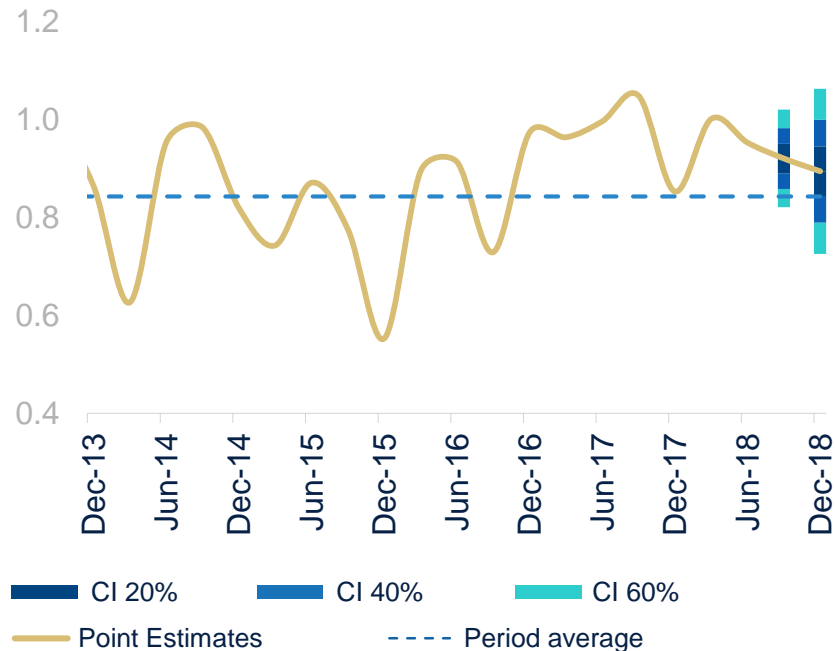
Global risks intensify

Protectionism and the normalization of the Fed are joined by the increase in tensions in emerging countries, and the greater uncertainty in Europe

# Moderation of global growth

## World GDP growth

(Forecasts based on BBVA-GAIN, % QoQ)



Source: BBVA Research

- Slight moderation of global growth towards rates slightly below 1% QoQ in 2S18
- Activity data remain strong, but have lost momentum, since protectionism weighs on confidence, trade and investment
- Beyond volatility, world trade has improved and stabilized after the slowdown at the beginning of the year

# Monetary policy continues to normalize and will diverge between the Fed and the ECB from 2019



## Balance

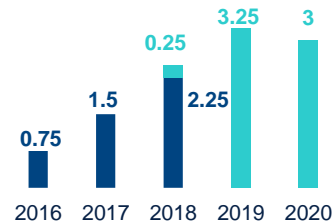


## Interest rates



**Continues the reduction of the balance** (450mM dollars in 2018)

**More rate hikes in 2019, but the cycle ends** (natural interest rate)

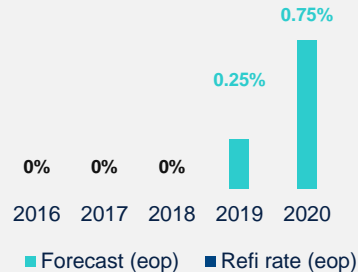


**End of QE** (December 2018)

**Total reinvestment** at least until December 2020

**Repayment of TLTROs** from June 2020

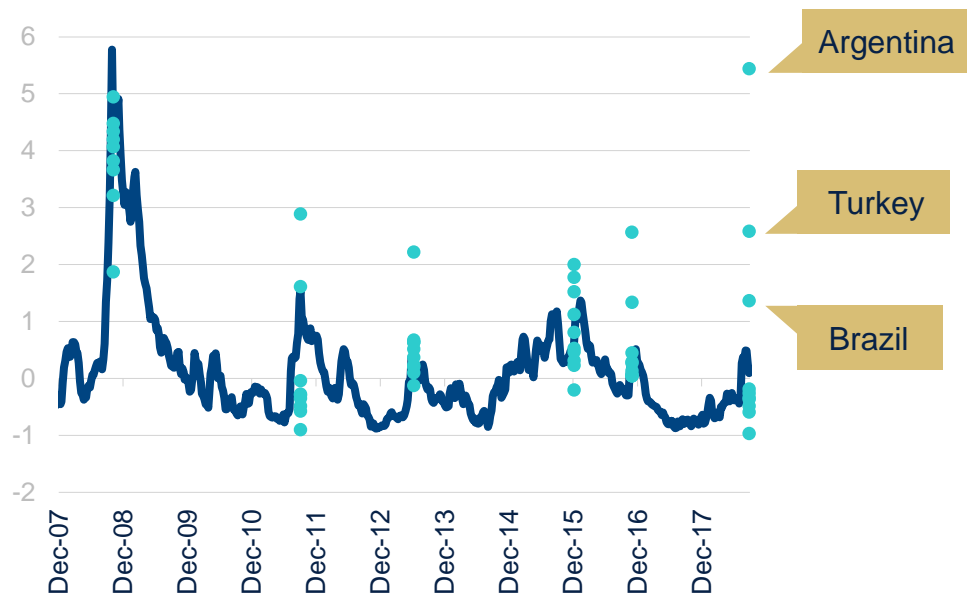
Anchored expectations of low rates for a prolonged period. **No increases are expected until September 2019**



# Financial tensions rebound in emerging markets, but less synchronized than in previous episodes

## BBVA index of financial stress in emerging markets

(Standardized index)



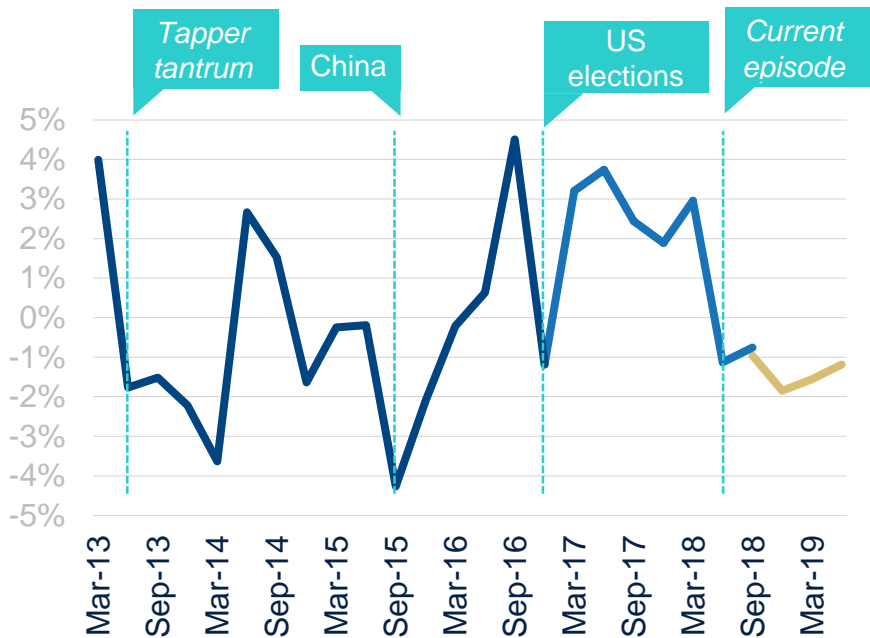
Source: BBVA Research

- The emerging markets are being subjected to greater stress which results in a depreciation of their currencies and an increase in their risk premium
- There is heterogeneity: tensions have concentrated especially on the most vulnerable economies. We are not facing a systemic crisis
- The adoption of economic policy measures (monetary and fiscal) are allowing some stabilization

# The outflows of emerging economies are still persistent, but we are far from a typical episode of sudden-stop

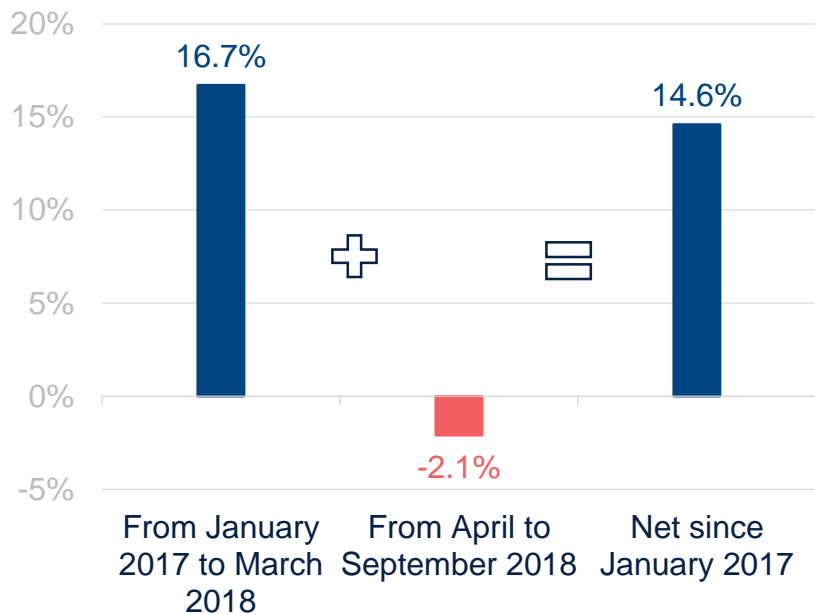
## Portfolio flows to emerging economies

(% of total assets, monthly data)



## Accumulation of flows in the last 5 quarters

(% of accumulated since January 2017)

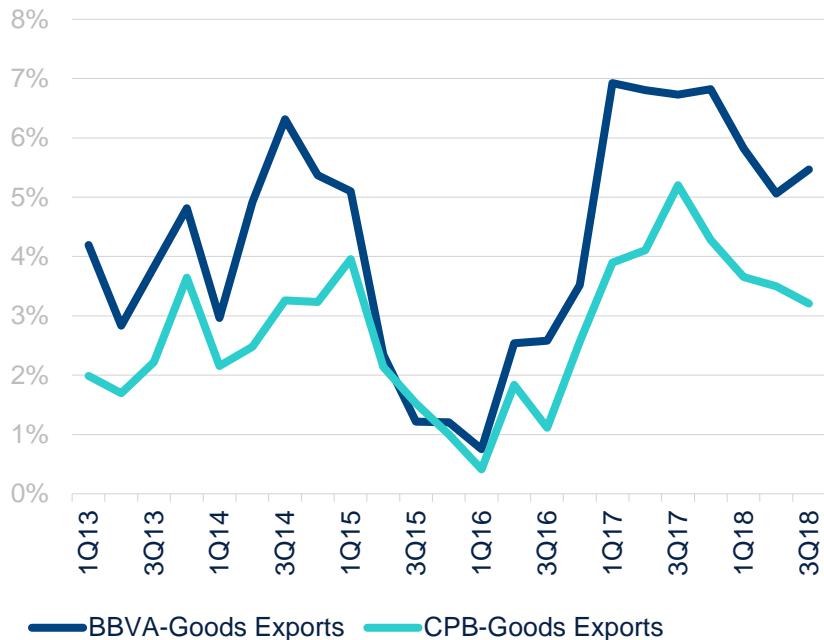




# Trade loses momentum after the strength of 2017, but will continue to support global growth

## Global export of goods

(% QoQ, constant prices)



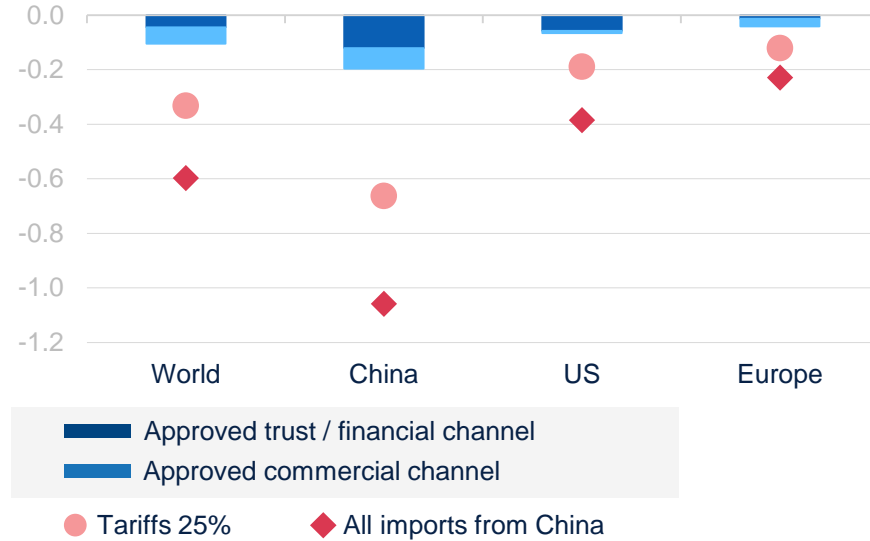
Source: BBVA Research based on CPB World Trade Monitor

- So far, the **trade war has had a limited impact**. Export flows may be ahead of the possibility of a worse scenario
- **Increases the volatility of trade flows** as a result of uncertainty...
- ... due to commercial tensions, the political situation and the depreciation of the currencies of emerging economies

# USA and China have announced higher tariffs, but with an estimated effect on limited global GDP

## Effect on GDP growth of US tariff increases and the response of other countries

(2018-20, pp)



Approved tariff increase: USA (25% steel, 10% aluminum, 25% Chinese imports worth 50,000 million dollars and 10% worth 200,000 million); China (25% to US imports worth 50,000 million dollars and 10% to 60,000 million).

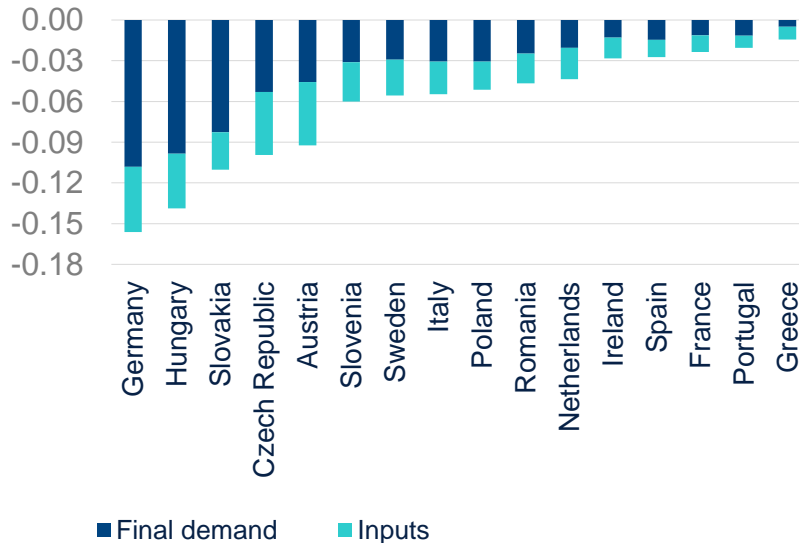
Source: BBVA Research

- The **impact** on growth of the measures approved so far through the **commercial channel could be limited**, but the **indirect effects could be considerable**, especially for China and emerging economies
- The **signature of the USMCA** reduces the uncertainty with Mexico and Canada
- In **Europe**, the increase of **tariffs on cars is currently frozen**, although it will be negotiated again from November

# The risk of an increase in US tariffs to the European automotive sector continues, with a limited and different effect per country

## Effect on GDP growth of US tariff increases to the European automotive sector

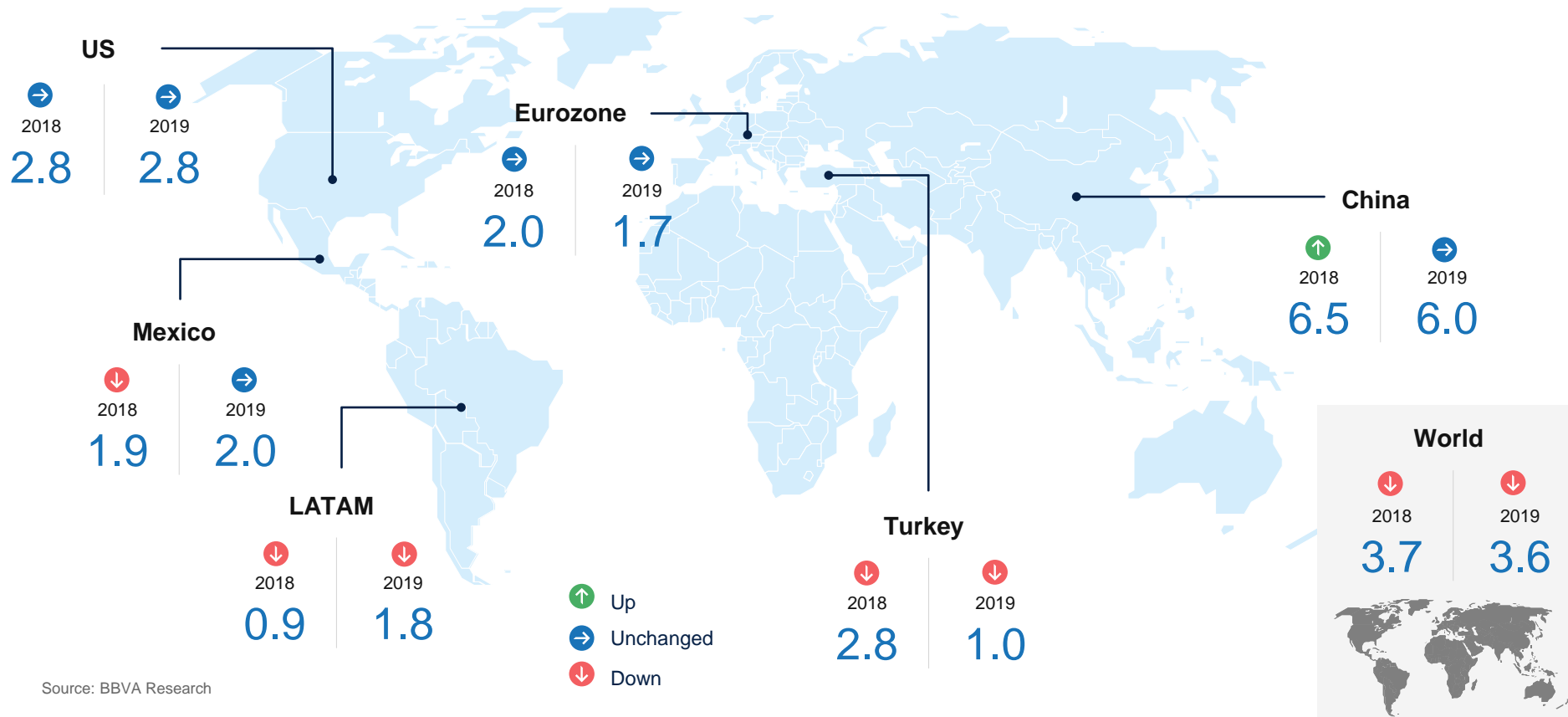
(2018-20, pp)



Simulation: increase of tariffs to 20% to the European automotive sector, Japan and Korea in addition to the measures approved so far  
Source: BBVA Research

- An increase of the tariff to the European automotive sector up to 20% (current 2.5%) could subtract between one and two tenths of the growth of Germany and the northern European countries
- Greater impact in Korea and Japan, but also in the US
- There is uncertainty about the effect of the hardening the amount of inputs produced in North America (75%) in the USMCA by European car companies, but the impact should be smaller

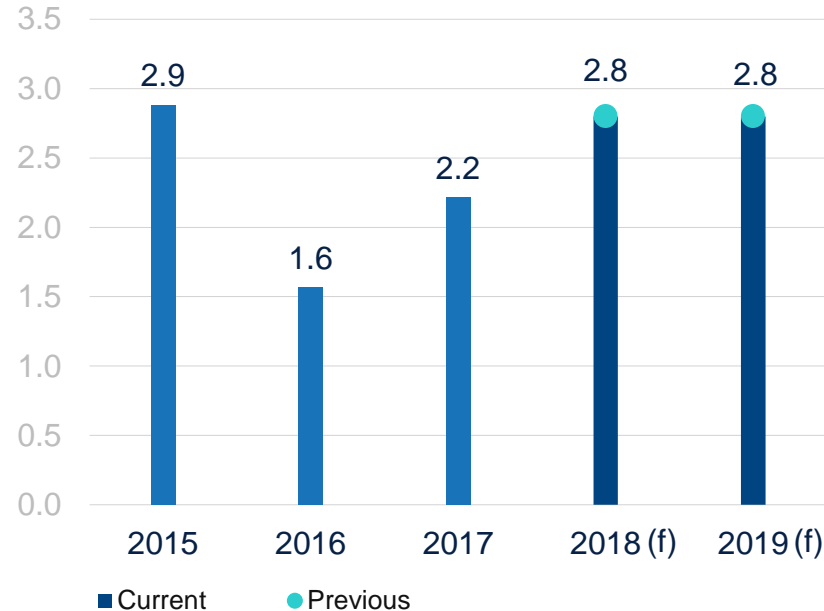
# The downward revision of growth in emerging economies explains the expected moderation of global growth in 2019



# USA: The increase of consumption and the solidity of investment support the greater growth, but with signs of stabilization

## USA: GDP growth

(% YoY)

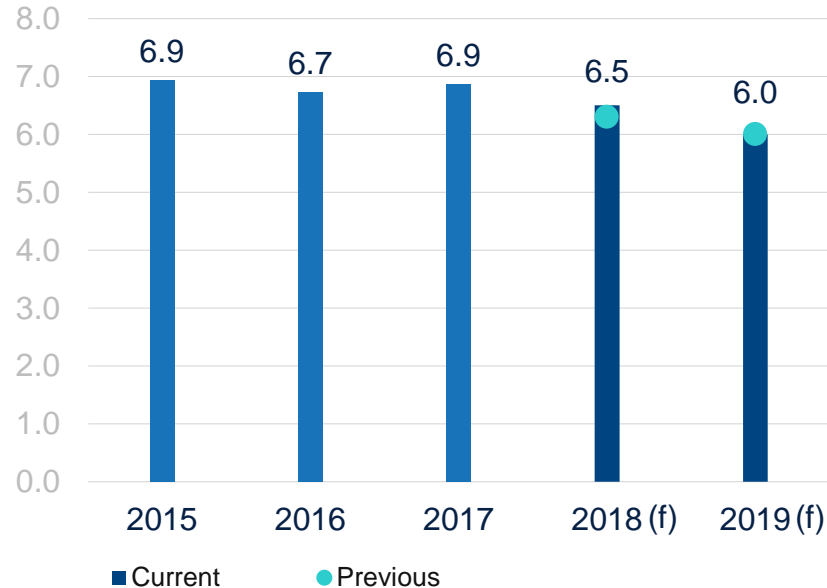


(f) Forecast.  
Source: BBVA Research based on BEA

- The **acceleration in 2Q18** of the economy seems **transitory** after the **strong momentum** of the foreign sector and some **moderation** is expected in the coming quarters
- General inflation is moderating and the core inflation remains stable at around 2%, which **reduces the likelihood** of a **high inflation scenario**
- **Imbalances are increasing.** Uncertainties increase for 2020 due to Fed rate hikes and fiscal stimulus depletion

# China: More accommodative policies to alleviate the headwinds

**China: GDP growth**  
(% YoY)



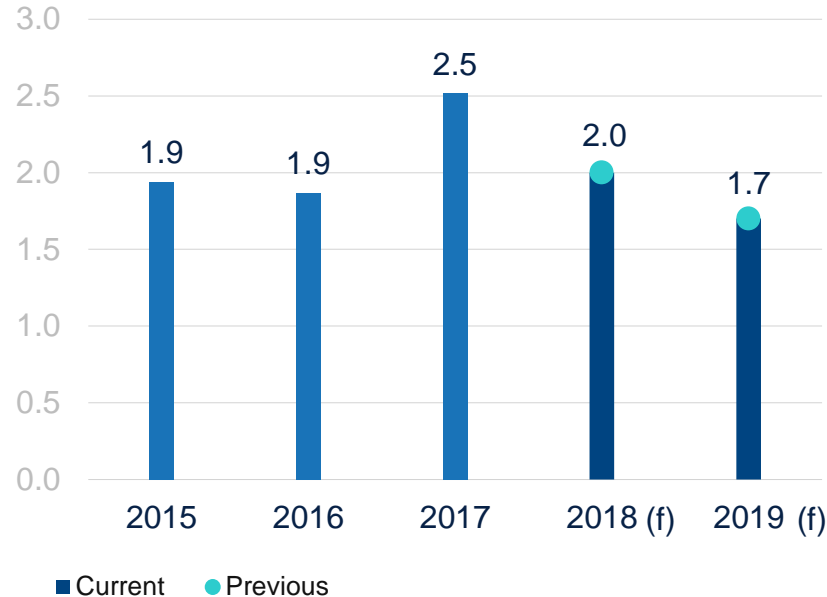
(f) Forecast.  
Source: BBVA Research based on CEIC

- Upward revision of growth in 2018 (+ 0.2pp) for the better performance in 1S18, but clear signs of forward moderation
- Fiscal and monetary stimulus measures are being implemented to support growth, but at the moment moderate, so as not to worsen financial vulnerabilities
- Protectionism is still the main risk, especially if it slows down the deleveraging of the economy or allows a strong depreciation of the exchange rate

# Eurozone: The strength of domestic demand compensates for the greater uncertainty and the moderation of global demand

## Eurozone: GDP growth

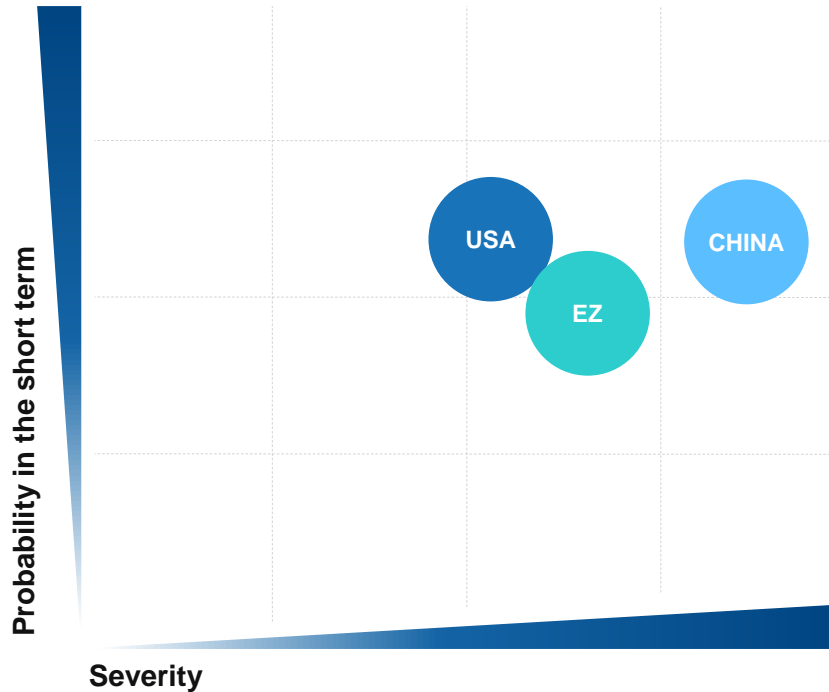
(% YoY)



(f) Forecast.  
Source: BBVA Research based on Eurostat

- The growth forecast is maintained, but with greater support from private consumption and investment
- Monetary and fiscal policy remain accommodative in a context of greater political uncertainty
- Despite the recent rebound in inflation, the core rate will only increase gradually, especially in 2019
- Trade tensions with the United States have relaxed for the moment, but can weigh on confidence and investment
- Political risk has increased (Italy)

# Global risks: protectionism and the exit of the Fed remain the most relevant, but political uncertainty in Europe increases



## CHINA

- **Protectionism**: upward (new tariffs and reprisals) with an impact on domestic policies (financial stability, reforms)
- **High indebtedness**: more content in the short-term, but higher in the medium term (private debt continues to rise)

## USA

- **Fed exit**: rises of higher than expected rates
  - Differential impact on emerging markets
- **Protectionism**: upward and concentrated in China
- **Economic recession**: low probability, but rising
- **Signs of financial instability** in some assets

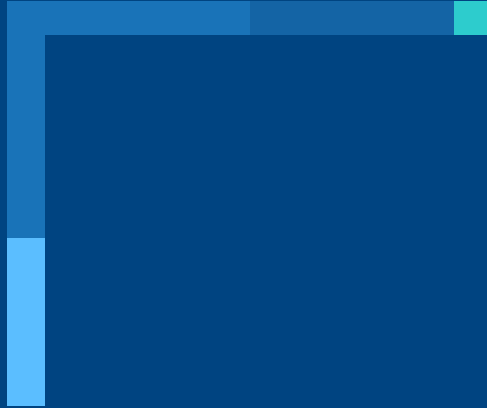
## EUROZONE

- **Political uncertainty**: upwards, led by **tensions in Italy** and Brexit
- **Protectionism**: more restrained with focus on the automotive sector
- **ECB's exit**: downward



Tensions in emerging economies can amplify the impacts of the aforementioned global risks (effects of "second round" on global growth)





# 02

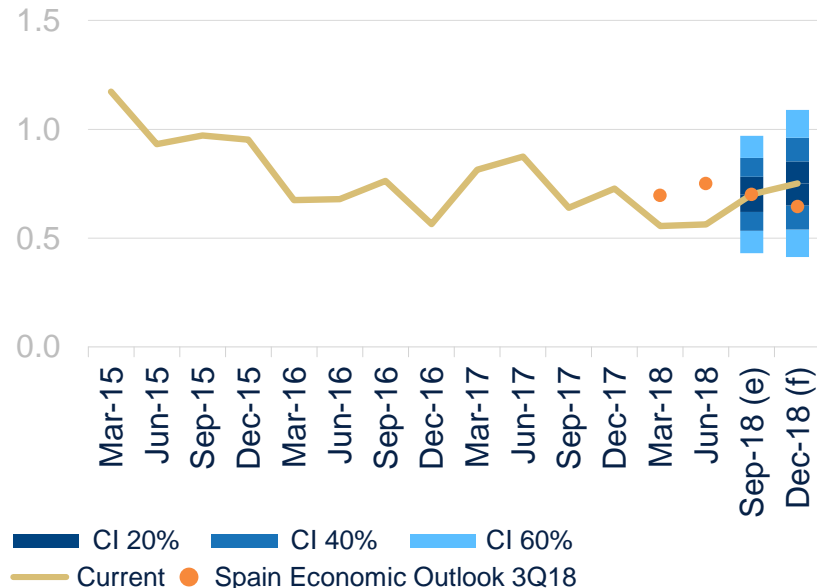
## Spain Economic Outlook

# GDP forecasts: downward revision



# GDP growth remains strong, although recent data surprises to the downside

Spain: GDP growth observed and forecasted using MICA-BBVA model (% QoQ)



CI: confidence interval; (e) Estimation; (f) Forecast.  
Source: BBVA Research based on national sources

- Recent economic data indicate lower growth than was estimated three months ago, especially in 1S18
- The deceleration trend is smooth and does not show an advance towards recession
- If these trends are confirmed, a decoupling would remain with respect to the rest of EMU (0.4% QoQ on average)

# Consumption and exports slow down, while investment remains strong

Spain: Demand components average growth rate (% QoQ)



Private consumption

2017	1S18
0.7	0.5



Investment in M&E

2017	1S18
1.8	3.3



Exports

2017	1S18
1.0	0.4



Construction investment

2017	1S18
1.8	2.2

Source: BBVA Research based on INE

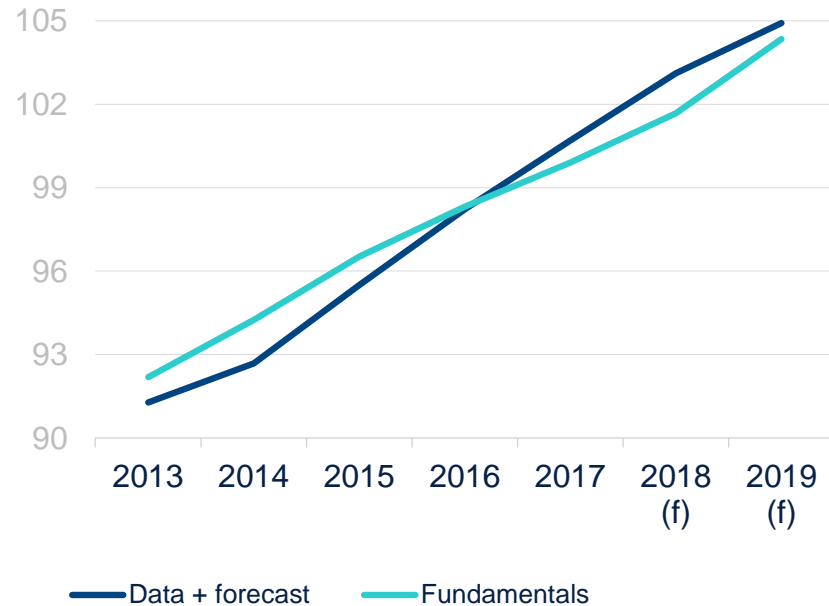
The composition of growth changes, keeping moderation in the growth of household spending, exports slow down, while investment accelerates

# What's behind the slowdown?

## Factors that will remain: Pent-up demand goes away

### Private consumption gap

(Index in base 2010)



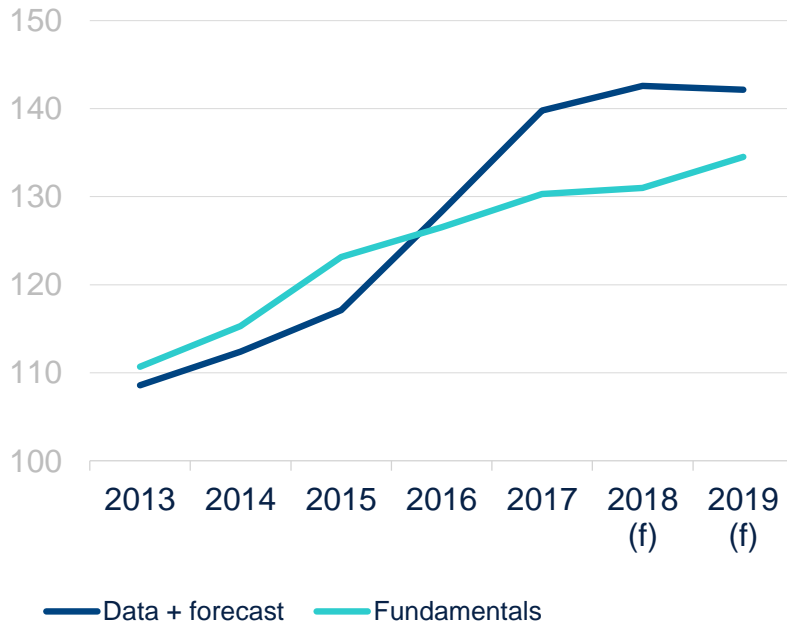
- Absorption of pent-up demand (spending postponed during the crisis) of durable goods ceased to contribute to economic growth in 2017
- Since then, consumer spending *has grown below what is consistent with the evolution of its fundamentals* (disposable income, financial wealth, etc.)
- The correction has already begun and *it is expected that it will continue gradually* during the coming quarters

# What's behind the slowdown?

## Factors that will remain: tourism slowdown

### Exports of touristic services gap

(Index in base 2010)



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

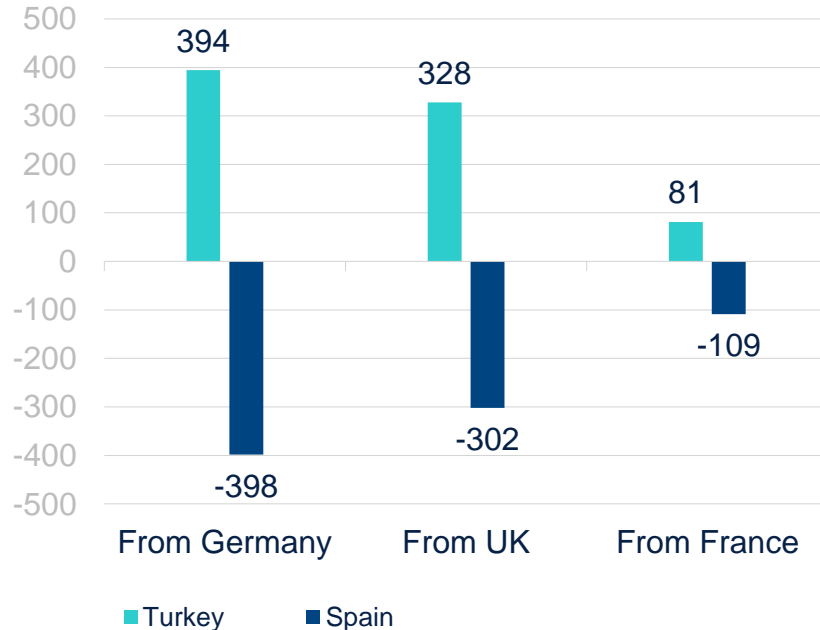
- The deceleration of tourism could be prolonged. A gap close to 10% persists between the observed tourist flows and what is explained by fundamentals
- Part of the expansion during the last years could be explained by non-traditional factors, such as the deterioration in the perception of safety in competing destinations
- These "borrowed tourists" could continue to change their holiday destination during the next months

# What's behind the slowdown?

## Factors that will remain: tourism slowdown

### Tourist arrivals in Spain and Turkey

(Change YoY in thousands, Jan-July 18)



Source: BBVA Research based on Tukestat and INE



- The redirection to other destinations is especially noticeable in tourists of European origin
- The moderation in the growth of consumption does not explain the fall observed in visitors from Germany, the United Kingdom and France
- Tourists especially sensitive to the price can continue to change their holiday destination due to the reduction in the price of some emerging currencies



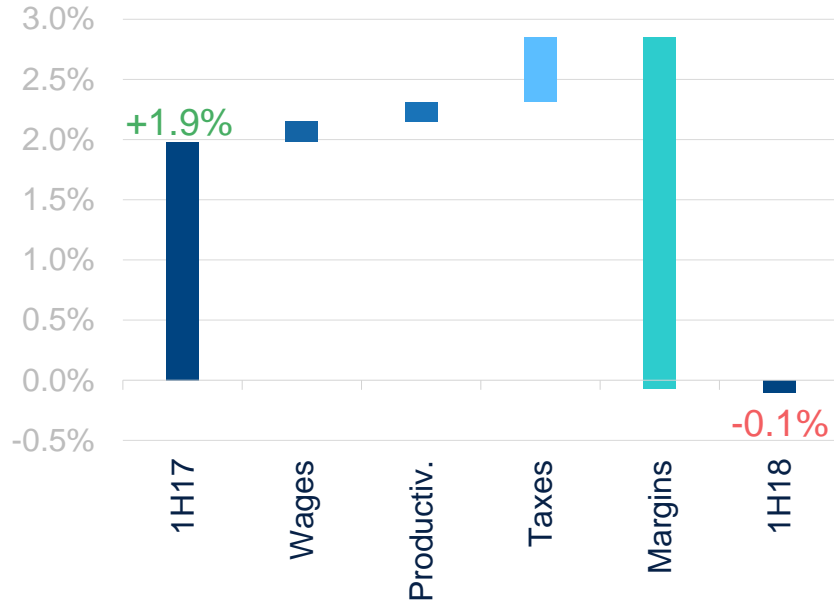


# What's behind the slowdown?

## Factors that may be temporary: oil price increases

### Spain: GDP Deflator

(% average annualized, QoQ growth rate and contributions)



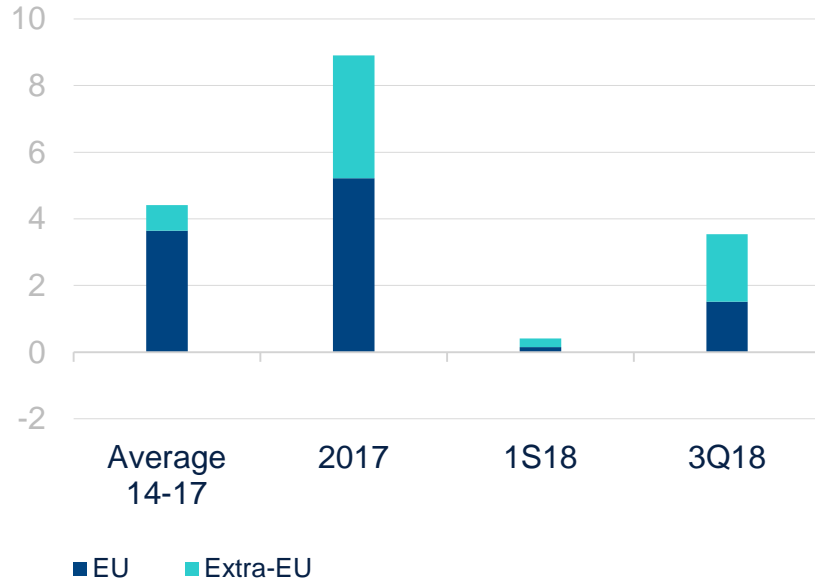
1H: First half of the year  
Source: BBVA Research based on INE

- Despite the increase in the price of oil, the prices of domestic production have fallen in 1H18
- However, there has been no drop in wages, indirect taxes or employment.
- Everything indicates that companies are moderating their margins, in an environment of lower growth in demand, expected to be temporary
- In particular, higher imported inflation is not being passed through to export prices as strongly as in previous episodes

# What's behind the slowdown?

## Factors that may be temporary: EMU demand

### Spain: Contribution to average growth of exports of goods (YoY average growth rate, %)



3Q18 based on forecasts with data up until July.  
Source: BBVA Research, based on Ministry of Economy

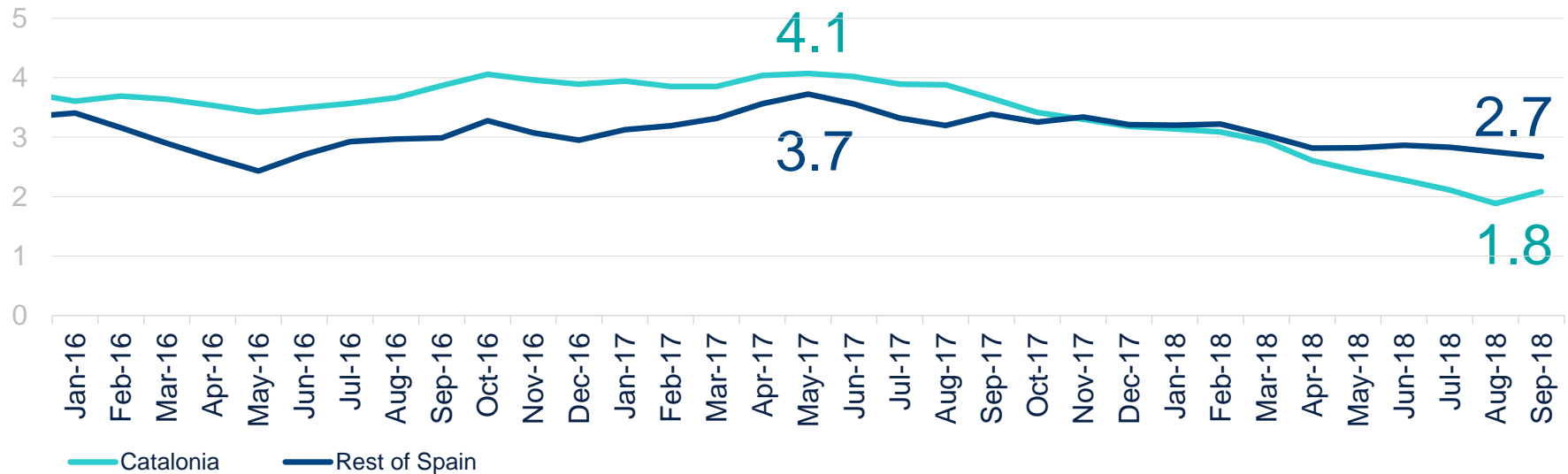
- The weakening of the growth of exports of goods is a **general phenomenon by destination and type of good**
- Exports lose traction due to the appreciation of the exchange rate, the slowdown in Europe and the strong increase at the end of last year
- 3Q18 data point to an **upward correction** in an environment of continued global growth

# What's behind the slowdown?

## Factors that may be temporary: political uncertainty

### Social Security Affiliation in private sector

(YoY %)



 The slowdown in employment has been particularly sharp in Catalonia

# 2018-2019 Outlook: we're still a long way from a recession



## The global expansion remains at a steady pace

Exports of goods should pick up soon, and the drop in tourism flows could also be contained



## Monetary policy should remain accommodative

For the next year, interest rates will remain low, supporting credit demand



## Oil prices

We are expecting a reversion of recent trends that should help firms' competitiveness



## A more expansive fiscal policy

It should boost growth in the second half of 2018 as we approach regional and local elections

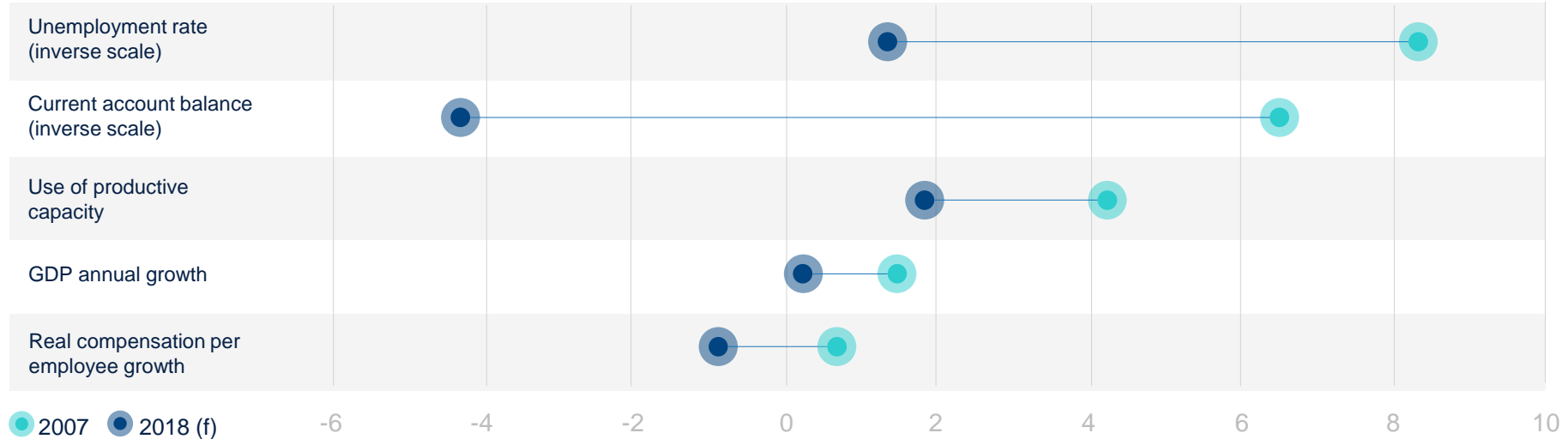


## Still a lot of unused capacity

Real sector should boost job creation, while wage growth remains subdued

# 2018-2019 Outlook: we're still a long way from a stagnation

## Spain: evolution of macroeconomic indicators during the maximum pre-crisis and the present (Deviation from the 1988-2008 average)



(f) Forecast.

Source: BBVA Research based on INE, CE and BdE

**Although some sectors show signs of moderation, there is room to continue growing steadily in the medium term**

# 2018-2019: The tail winds weaken in an environment of greater uncertainty

## Global

01

### Lower EMU Growth

Already included in the performance, worse than expected, of exports of goods during the first half of 2018

02

### Higher oil prices

It is expected that most of the increase will reflect supply restrictions, which should generate a stronger negative impact

03

### Protectionism

At the moment, the direct impact in Spain is insignificant, but it could reduce investment expectations

## Idiosyncratic

04

### Political uncertainty

The approval of the PGE 2018 reduces uncertainty about economic policy, but it remains high

05

### Tourism slowdown

It is expected to continue, but the impact will be limited, while the sector concentrates in segments of greater value added

# Risks: Tourism moderation and impact on job creation

## Social Security Affiliation in construction and tourism

(Annual growth, thousands)



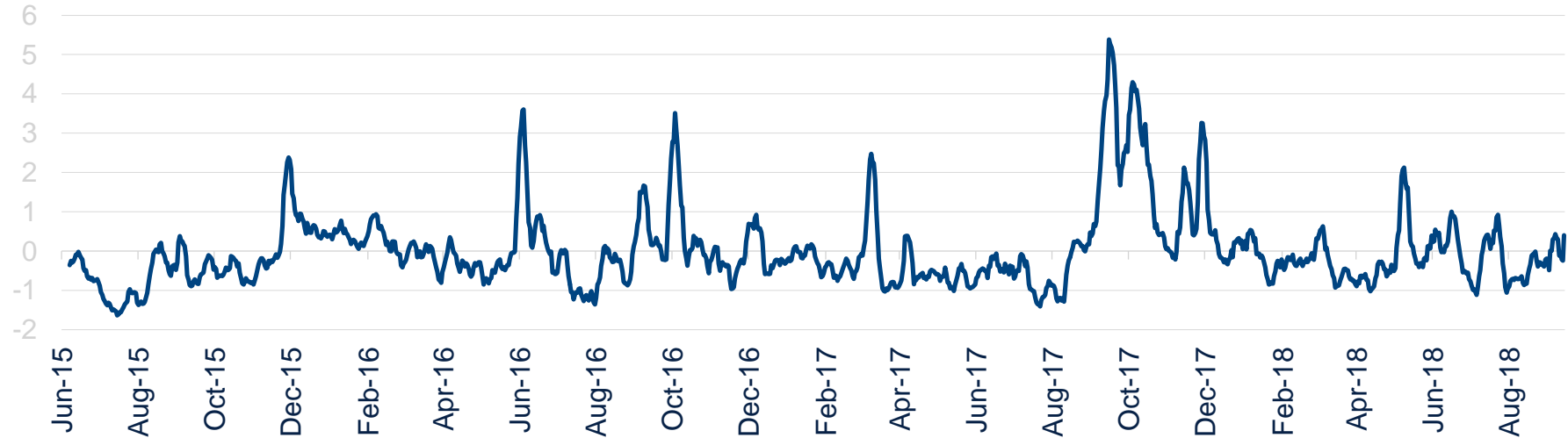
(f) Forecast.  
Source: BBVA Research based on MFOM and INE

- In 2014 -2017 the growth of affiliates in tourism was 321,600 people, 17% of total job creation
- There are doubts about the capacity of other sectors to compensate for the deceleration that is already observed
- Going forward, sectors such as construction still have a long way to go to replace tourism as a source of job creation

# Risks: Uncertainty regarding economic policy

## Spain: indicator of economic policy uncertainty

(Standardized data)



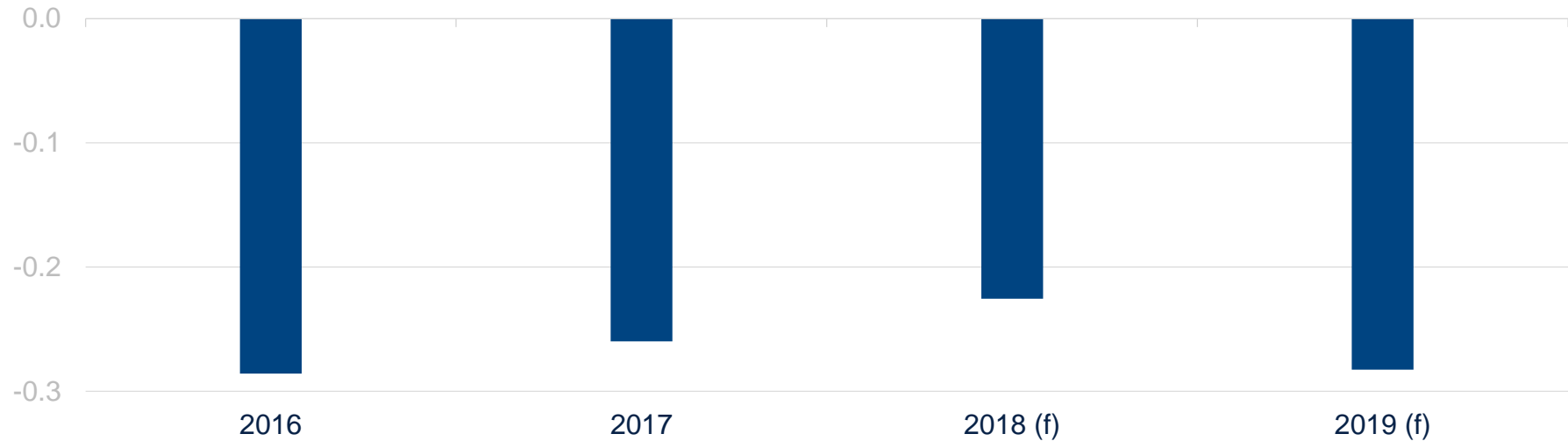
Source: BBVA Research using GDELT

**Uncertainty went up in 2Q18. The approval of the PGE18 would have helped to moderate it, but doubts still remain about the measures that will be implemented in the future**



# Risks: Uncertainty regarding economic policy

## Impact of uncertainty on annual GDP growth (%)



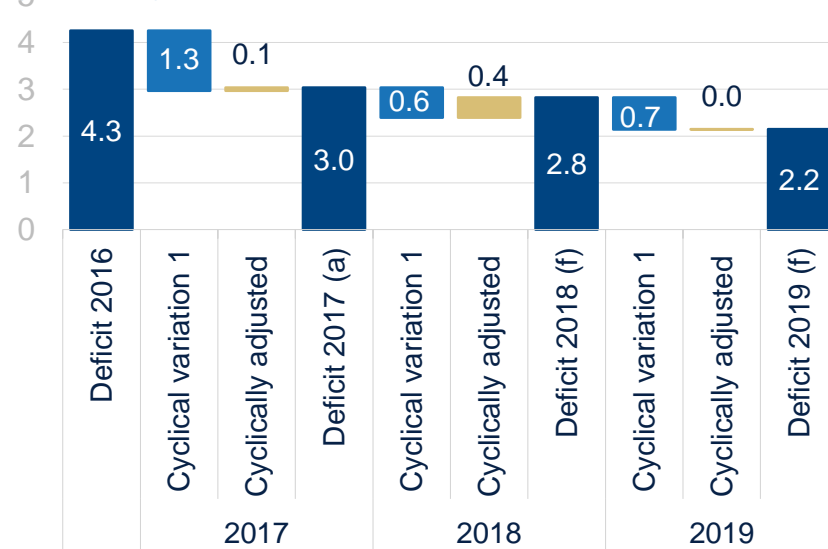
(f) Forecast.  
Source: BBVA Research based on GDELT

**Uncertainty went up in 2Q18. The approval of the PGE18 would have helped to moderate it, but doubts still remain about the measures that will be implemented in the future**

# Risks: Uncertainty regarding economic policy

## Spain: Public sector net borrowing\* and fiscal adjustment

(% of GDP)



(\*) Excluding assistance to the financial sector

(1) Includes changes in interest charges

(a) Advance (f) Forecast

Source: BBVA Research based on Ministry of Finance and Public Administration and INE

- The approval of the PGE2018 introduced an expansive bias in the fiscal policy for the second half of the year
- For 2019, uncertainty persists with respect to economic policy, especially regarding the approval of the Budget, which at the earliest, will occur during the first quarter of 2019
- Given the expected economic slowdown, we estimate that the government should include additional adjustment measures to reduce the deficit towards the goal of 1.8% of GDP

# 2018-2019: Inflation and labor market forecasts



## Employment growth (LFS)

2018	2019
2.6	2.2



## Inflation

2018	2019
1.8	1.6



## Unemployment rate

2018	2019
15.3	13.7



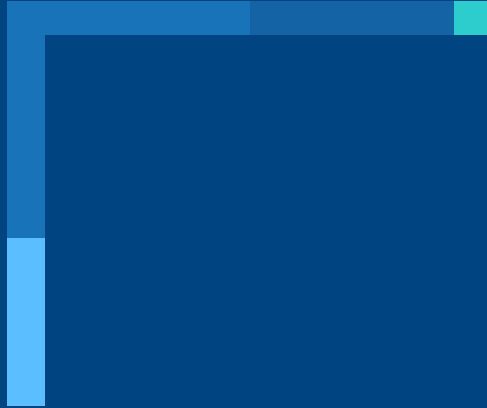
## Compensation per employee

2018	2019
0.9	2.1

# Key messages



- The positive global environment is maintained, although growth is moderating in emerging economies and the Eurozone. The impact of protectionism is limited at the moment, but it remains the main risk along with the exit of the Fed and political uncertainty in Europe
- In Spain, growth is revised downwards to 2.6% in 2018 and 2.4% in 2019, due to the negative surprises registered in the first half, when the slowdown was focused on consumption and exports. The rebound of some uncertainties, external and internal, skews the forecasts downwards
- Nonetheless, the advance of economic activity will continue. Economic policy remains accommodative. It is also expected that oil prices will reverse current trends, and that external demand will continue to grow
- Uncertainty about economic policy and its possible impact remains high. It is necessary to advance measures that reduce the vulnerability of the Spanish economy in less favorable environments.



# 03

## Forecasts

## Changes in our forecasts

# The fundamentals continue to support a relatively strong recovery

% YoY	2017	2018 (f)	2019 (f)
Final consumption expenditure	2.4	2.4	1.9
F.C.E. Households	2.5	2.4	1.8
General government	1.9	2.3	2.3
Gross fixed capital formation	4.8	6.0	5.0
Equipment and machinery	6.0	7.4	5.0
Construction	4.6	6.1	5.0
Housing	9.0	6.8	6.0
Other constructions	0.6	5.5	4.0
<b>Domestic demand (*)</b>	<b>2.9</b>	<b>3.1</b>	<b>2.5</b>
<b>Exports</b>	5.2	2.8	5.7
Exports of goods	4.7	2.8	6.2
Exports of services	6.3	2.9	4.5
Non-touristic services	4.5	3.5	7.0
F.C.E. by non-residents in the economic territory	8.9	2.1	1.1
<b>Imports</b>	5.6	4.7	6.2
<b>External demand (*)</b>	<b>0.1</b>	<b>-0.5</b>	<b>0.0</b>
<b>GDP mp</b>	<b>3.0</b>	<b>2.6</b>	<b>2.4</b>

(\*) Contribution to GDP growth.

(f) Forecast.

Source: BBVA Research based on INE and BdE

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# Economic Outlook

## 4Q18

October 2018

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