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BBVA Research

Spain Economic Outlook

1Q19

February 2019

Creating Opportunities

Key messages



- The global environment has deteriorated and is more uncertain, but we are still expecting a mild slowdown. The impact of protectionism is more evident and remains the main risk, along with an intense adjustment of growth in China and the US, and increased uncertainty in Europe
- In Spain, the advance of economic activity remains positive. However, in 2018, a deceleration in annual GDP growth of 0.5pp down to 2.5% was consolidated, as a result of a loss of tone in private consumption, a slowdown in external demand and greater uncertainty
- The global context, accommodative monetary policy, low oil prices and fiscal stimulus will continue to support growth, albeit less than in 2017-2018. GDP growth will remain around 2.4% in 2019 and moderate down to 2.0% in 2020. Risks are on the downside
- However, it is necessary to promote measures that improve the Spanish economy's capacity to respond to ongoing challenges and generate inclusive growth. Uncertainty regarding the sustainability of external growth increases, and doubts over economic policy and the effects of some measures already taken continue



01

Global Economic Outlook 1Q19

Towards a still smooth adjustment of global growth, but with a lot of uncertainty



Slowdown in global growth, but still robust

Strong adjustment in trade and in the manufacturing sector while investment and consumption remained contained against a worsening confidence



Lower inflation after the fall in oil prices

Less pressure on central banks and more support for oil-importing economies



Increased financial tensions in developed countries

Strong asset price adjustment and outflows from investment, but not in emerging economies, where there is differentiation.



Central banks more cautious and patient

The normalization of monetary policy will depend on economic developments and is key to containing market concerns.



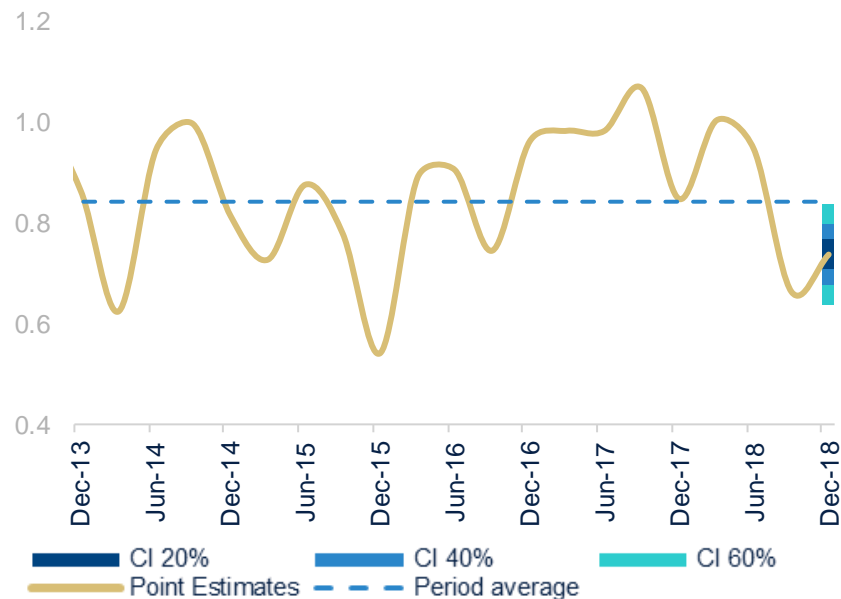
Global risks intensify

Protectionism is coupled with a possible further slowdown in China and the US, and increased uncertainty in Europe.

Clear downward trend in global growth, but with signs of some stabilization

World GDP growth

(Forecasts based on BBVA-GAIN, % t/t)

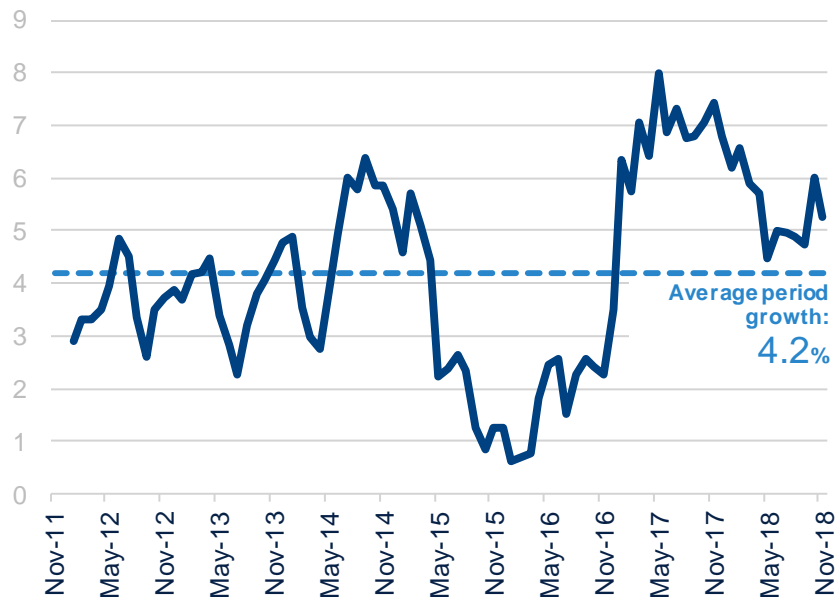


- Global growth has entered into the **slowdown phase**, but it is still strong
- The widespread deterioration of industrial production and trade suggests a **more evident impact of protectionism**
- Strong moderation in industrial confidence extends to other sectors, **but growth in private spending continues**
- **High uncertainty** continues at the beginning of the year and will continue to weigh on growth

Global trade: more evident effect of higher tariffs and uncertainty on trade negotiations

BBVA indicator of world exports of goods

(% YoY, 3-period moving average)



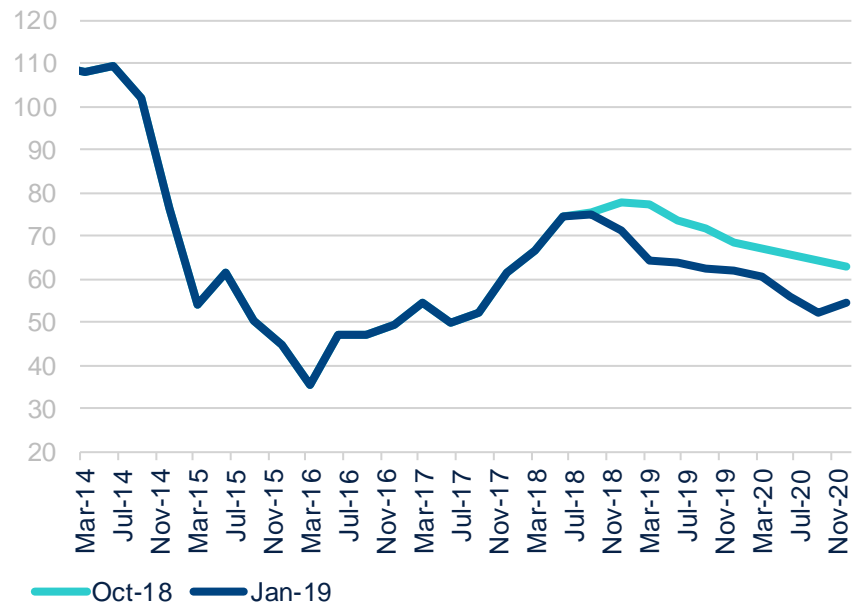
Source: BBVA Research

- World trade has shown **strong volatility** due to **uncertainty about trade disputes**
- China's recent poor export performance is due, in part, to the advancement of trade ahead of **further tariff increases**. **Nevertheless, the sharper than expected downward trend in exports performance is cause for concern**
- Poor export performance has **also been observed in the rest of Asia and Germany**

Lower oil prices will support growth and ease inflationary pressures

Crude oil price

(Brent, USD per barrel)

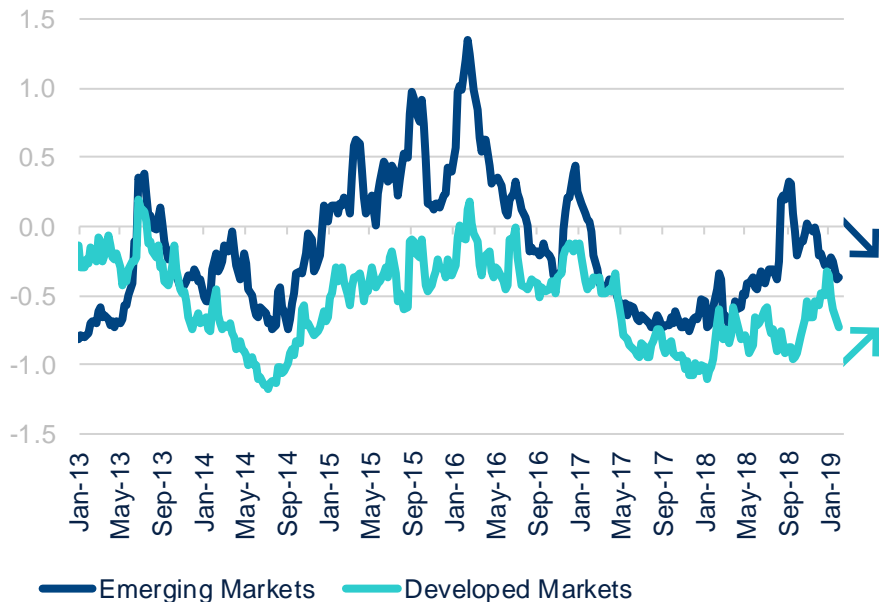


- Oil prices may recover somewhat in the short term due to production cut announcements
- Decline in supply offset by higher U.S. production and lower global demand
- Beyond their short-term volatility, crude oil prices should remain close to their long-term equilibrium level (60 USD per barrel) in 2019-20
- This could stimulate global growth between one and two tenths in 2019-20

Recent turmoil in the financial markets in face of the risk of an abrupt adjustment in global growth

BBVA financial tension index

(Normalized index)



Source: BBVA Research

01



Developed markets (USA)

are at the center of the episode. Flows remain cautious as they enter Europe

02



Emerging markets remained relatively resilient despite the global mood and the fall in oil prices

03



Investors adjust their portfolios: outflows of riskier assets and inflows into more liquid funds

04

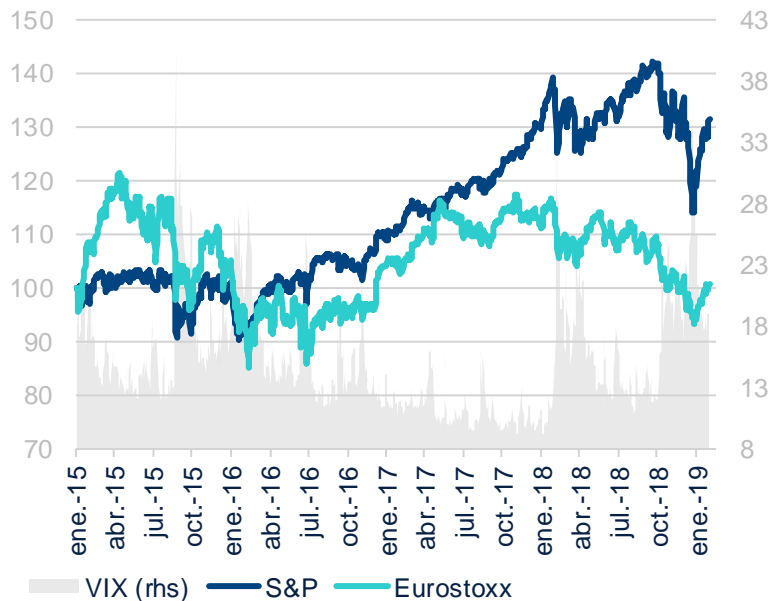


The response of central banks, (Fed) has been key, once again, to halt tensions

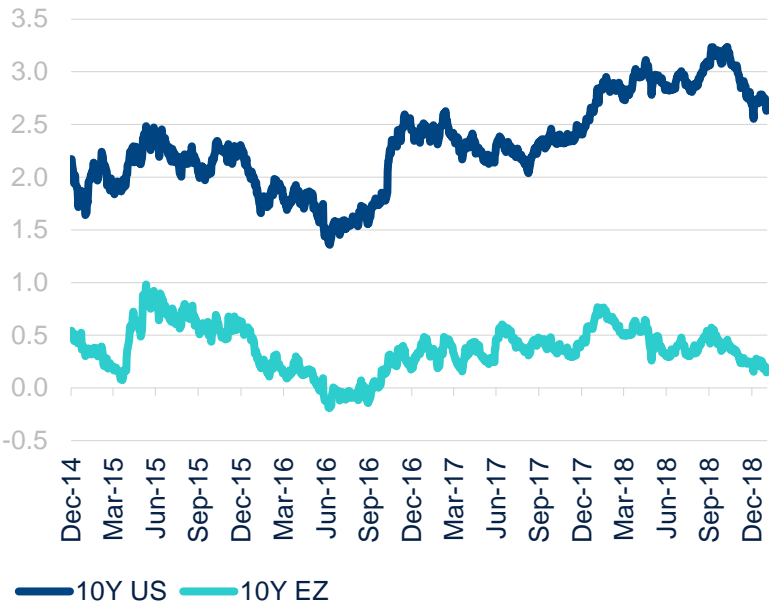
Tensions were concentrated in developed markets. Interest rates fall again

Developed equity index and VIX (%)

(Base 100: January 2015 and %)

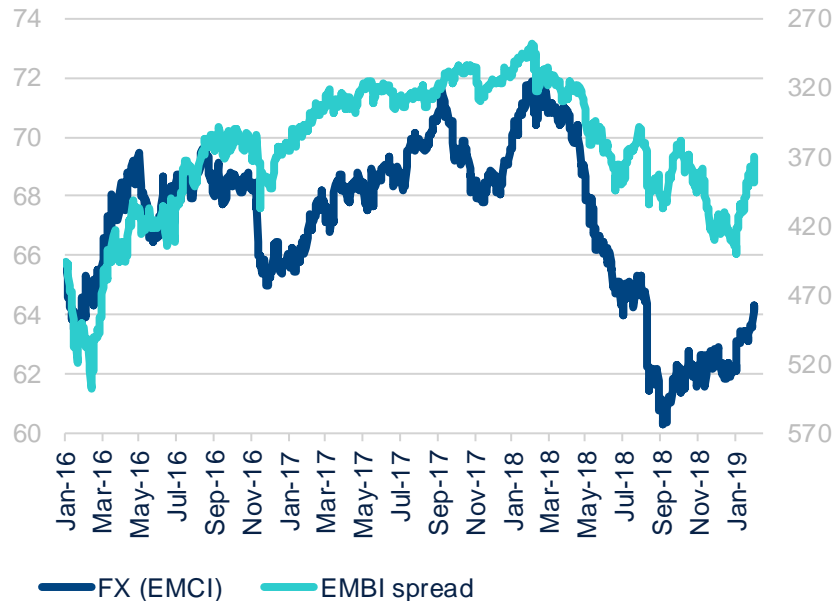


Sovereign debt yields in developed countries (%)



Emerging markets, after a strong adjustment in 2018, remain on the sidelines during this episode

Currencies and bonds of emerging markets (Indexes)



Economic policy reaction in the most vulnerable countries (Argentina, Turkey)



Economic stimuli (China)

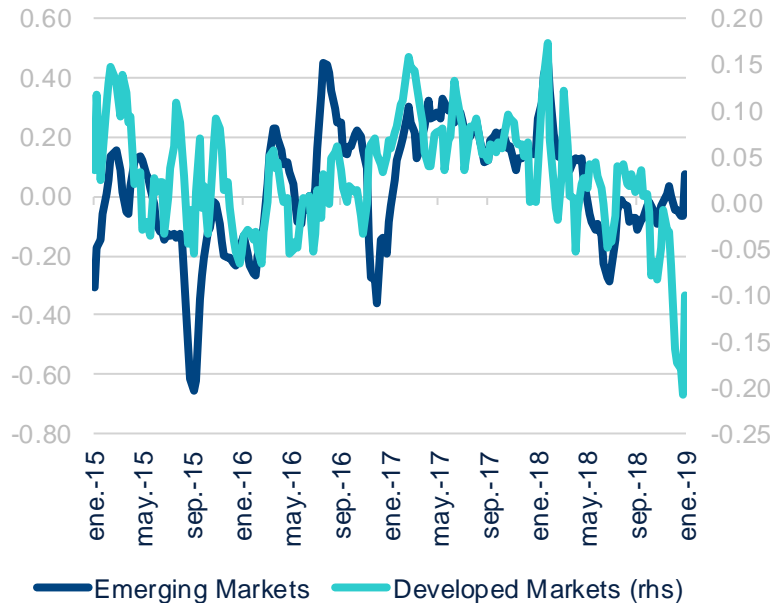


Asymmetrical effect of falling oil prices (exporters vs. importers)

The environment of risk aversion is being seen in the recomposition of capital flows, refuge in debt and liquidity

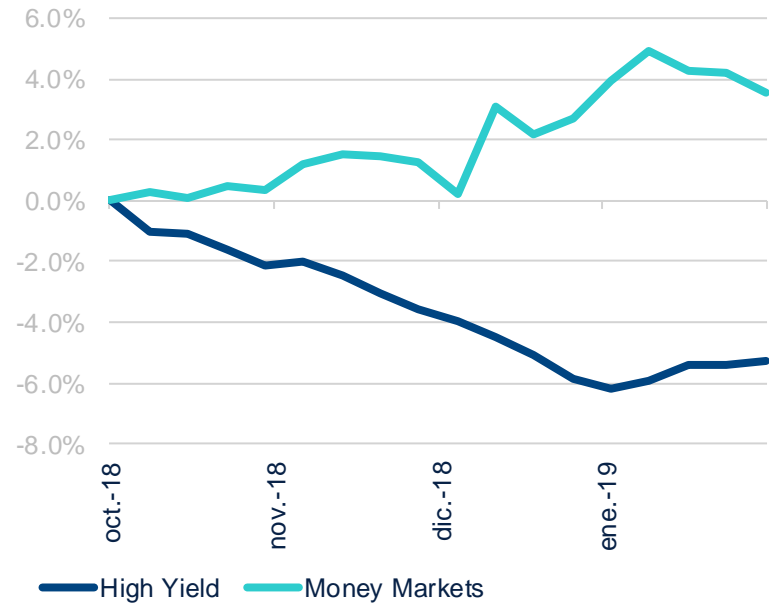
Portfolios flows by regions

(4 weeks avg, % assets under management)



Portfolio flows: types of assets

(%, assets under management accumulated since October)



Central banks are sensitive to increasing risks, and the process of monetary normalization is slowing down



Balance



- **Ongoing reduction of the size of the balance sheet** (USD500bn in 2019)



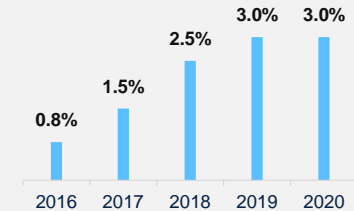
- **End of the QE** (in Dec 2018)
- **Total reinvestment of QE** beyond the start of rate hike
- **Very likely a new LTRO** before June 2019

Source: BBVA Research

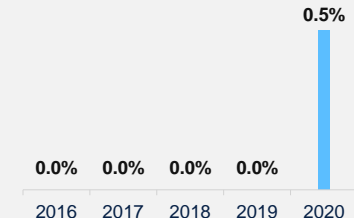


Interest Rates

- **The end of the hiking cycle is near** (two more rate hikes of about 25pbs in 2019, but there's a risk that they'll be less)



- **Delay in the rate hike path** due to a less supportive global outlook and higher risks. **Not expected until June 2020**



Global growth still mildly adjusted, but more uncertain due to dependence on economic policies

Worse macro outcomes

Faster slowdown than expected

(Protectionism + China)

Evidence that the impact from the US fiscal stimulus will fade earlier than expected



Higher financial stress

Risks of a strong global growth deceleration

Tougher financial conditions



Three key assumptions for not to derail the smooth global adjustment:



01

Reduction of trade tensions between the U.S. and China, and no change in the automotive sector



02

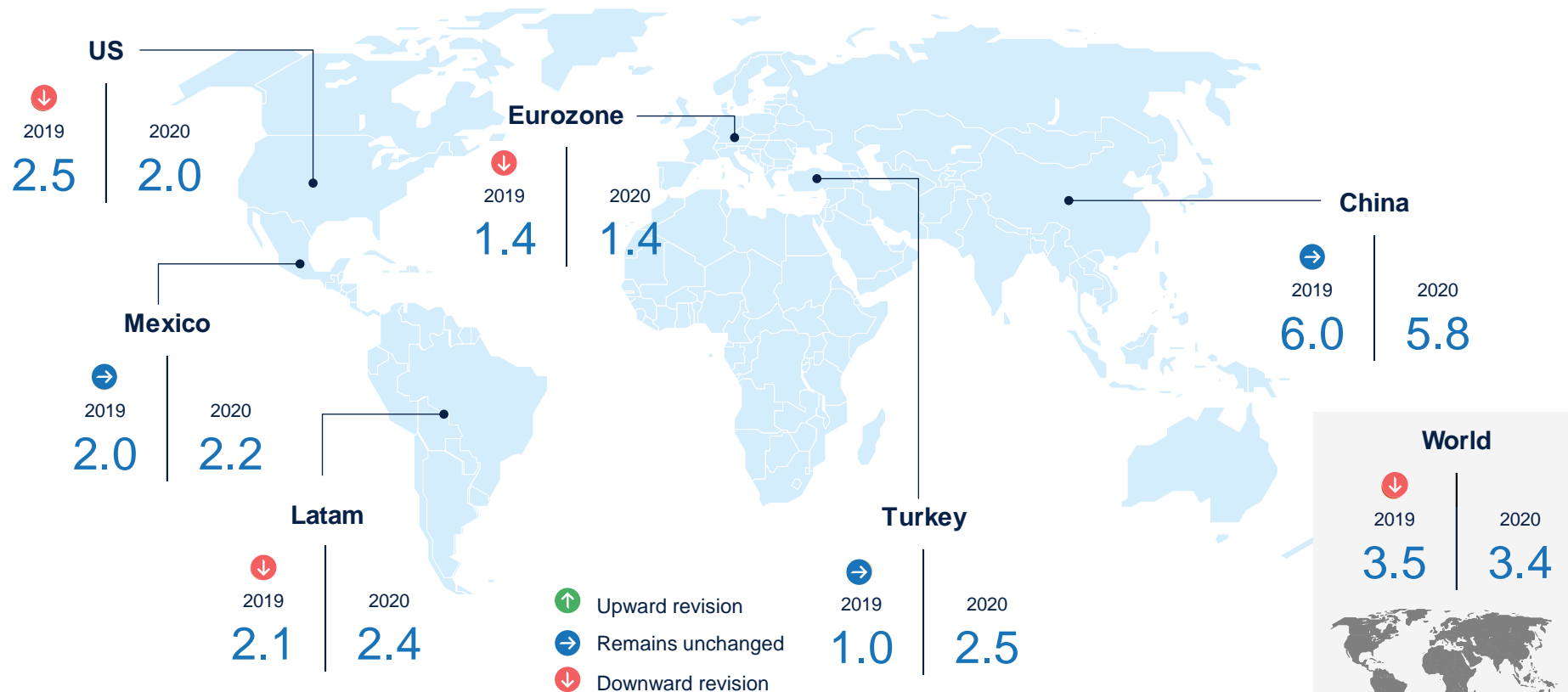
UK's orderly exit from the EU



03

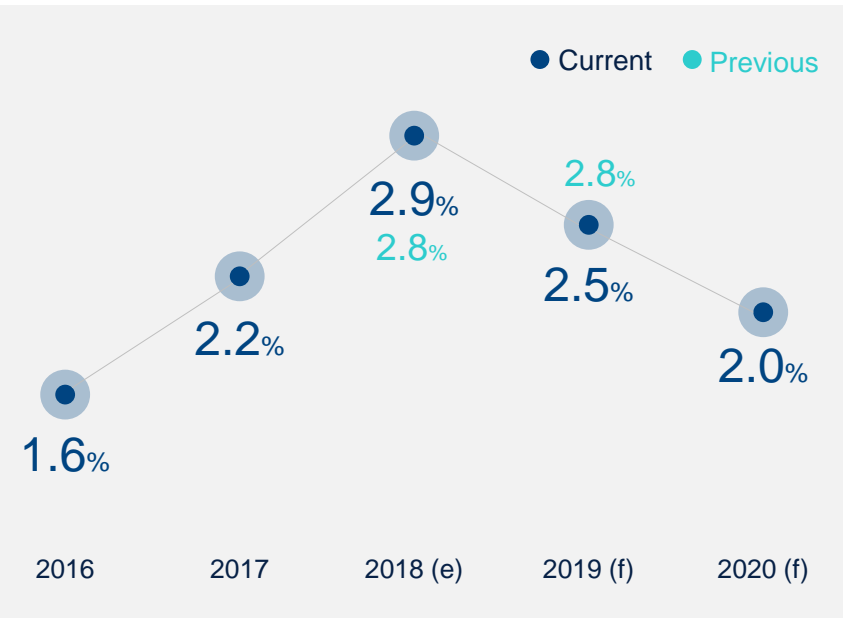
Fed and ECB more cautious on monetary policy normalization

Widespread downward revision of growth, with moderation more evident in developed countries and emerging Asian countries



U.S.: further slowdown in growth due to fading fiscal stimulus and financial volatility

U.S.: GDP Growth (% a/a)



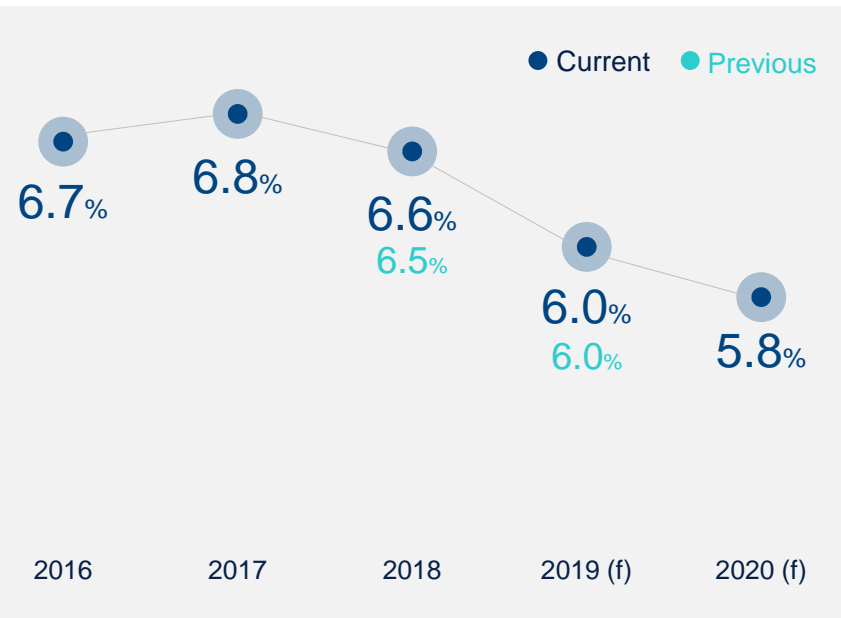
(e) Estimation. (f) Forecast.
Source: BBVA Research as of BEA

- GDP downward revision due to less optimistic prospects for private investment and public expenditure
- Private consumption will moderate as the impulse of the tax cut disappears, despite the strength of the labour market
- Inflation remains above target, but will be gradually reduced to somewhat below target in 2020
- Downside risks have increased due to the deterioration of the global environment, and there is also a greater risk of recession over the two-year horizon

China: authorities' priority is to avoid abrupt adjustment of growth

China: GDP Growth

(% a/a)

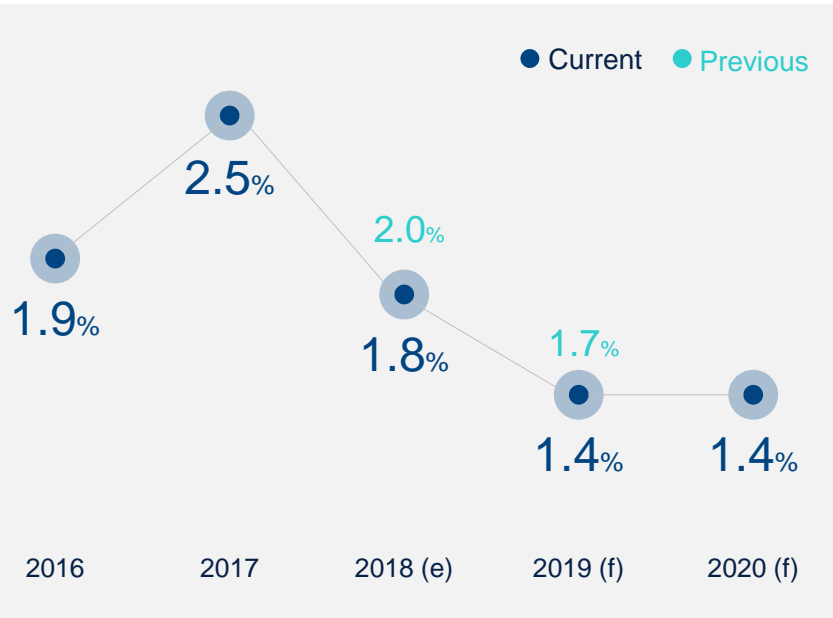


(f) Forecast.
Source: BBVA Research as of CEIC

- Growth forecasts remain unchanged, due to the implementation of greater stimuli to halt the intensification of the slowdown
- Support measures, both fiscal and monetary, are spreading, but attempts are being made not to worsen existing financial vulnerabilities
- Protectionism remains the main risk. If it has to be compensated with more stimuli, the necessary deleveraging could stop, which could lead to a sharp depreciation of the exchange rate

Eurozone: rapid deceleration towards potential growth due to less support from the global environment

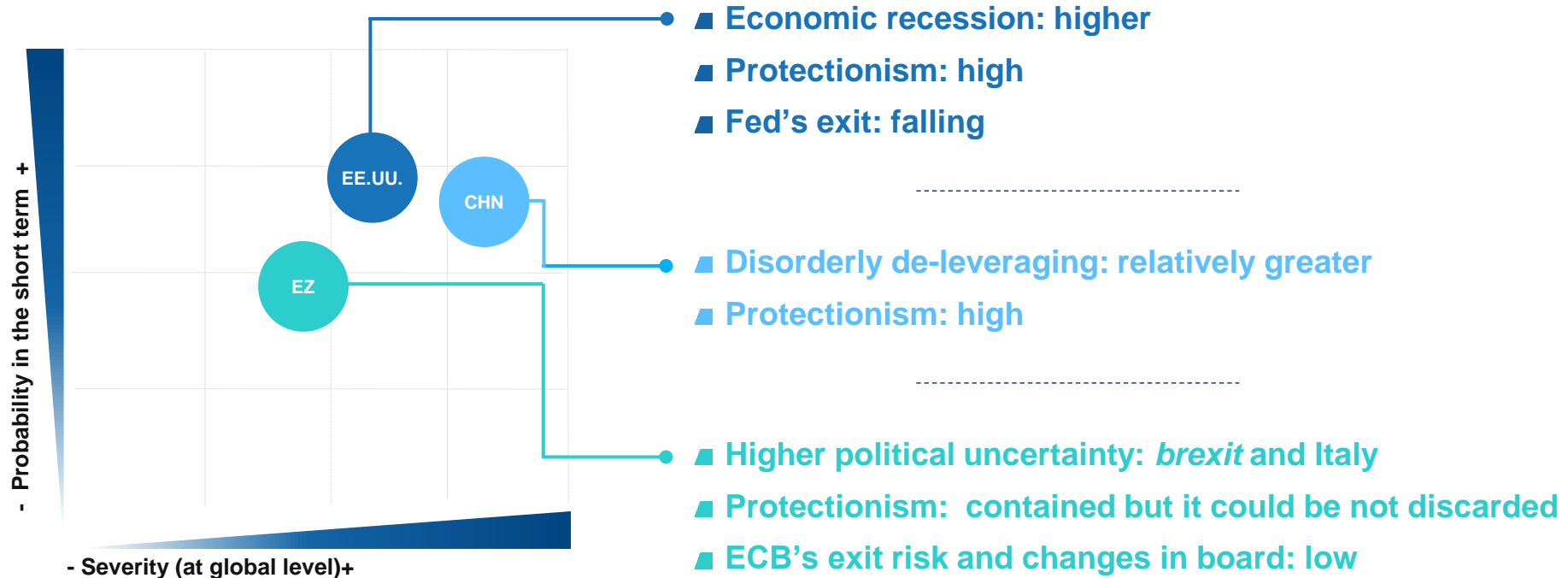
Eurozone: GDP Growth (% y/y)



(e) Estimation. (f) Forecast.
Source: BBVA Research as of Eurostat

- The fall in oil prices reinforces the **strength of domestic factors**, but not enough to compensate for lower global demand
- A somewhat **more accommodative monetary and fiscal policy** could offset the effect of worsening confidence on private spending
- Rapid **fall in inflation**, but core inflation should gradually rise
- **Political risk** has increased (Brexit and more uncertainty in several countries)

Global risks tilted to the downside. US recession fears, trade war and China’s debt are key concerns





02

Spain Economic Outlook 1Q19

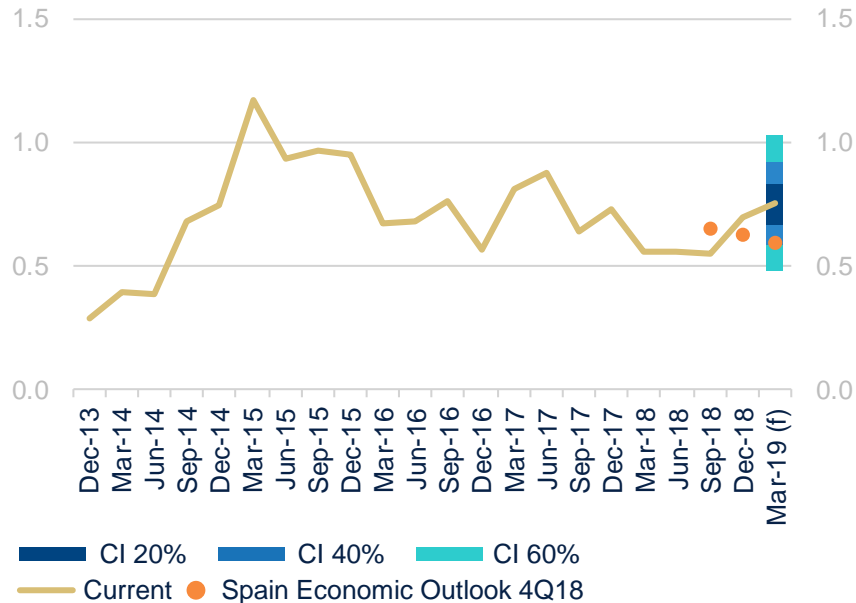
Economic activity will continue to decelerate throughout the biennium



GDP growth surprised downwards in 2018, but remains solid and away from stagnation

Spain: GDP growth

(MICA-BBVA model forecasts, % QoQ)



(CI) Confidence interval. (f) Forecast.

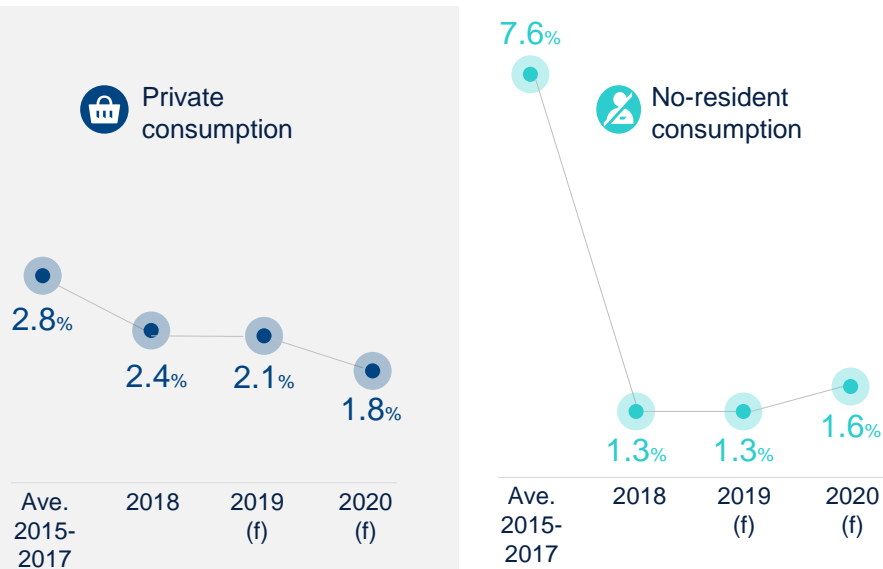
Source: BBVA Research based on national sources

- The slowdown could revert temporarily in the short term. GDP grew 0,7% in 4Q18, in line with our forecasts
- In addition, BBVA Research estimates indicate that GDP growth could be between 0.6% QoQ and 0.8% QoQ in 1Q19
- Recent data confirm that the Spanish economy grows faster than the rest of the EMU (0.4% QoQ on average)

Factors behind the slowdown: exhaustion of some tail winds

Spain: evolution of resident and non-resident consumption

(% YoY)



(f) Forecast.

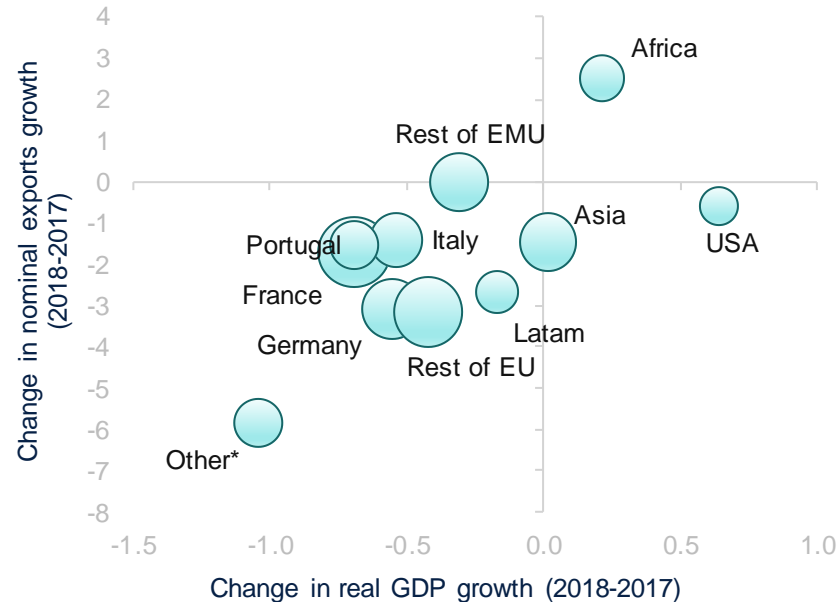
Source: BBVA Research based on INE

- Absorption of pent-up demand of consumption goods ceased to contribute to economic growth in 2017
- Moderation of geopolitical tensions in some competing countries reduces the influx of non-resident tourists
- Spending on resident and non-resident private consumption will probably continue to loose traction

Factors behind the slowdown: lower global demand

Nominal exports of goods

(pp QoQ annualized)



Source: BBVA Research

(*) It includes, Norway, Russia, Switzerland, Turkey and other small trading partners.

The size of the circles represents the weight of the country on Spanish exports of goods

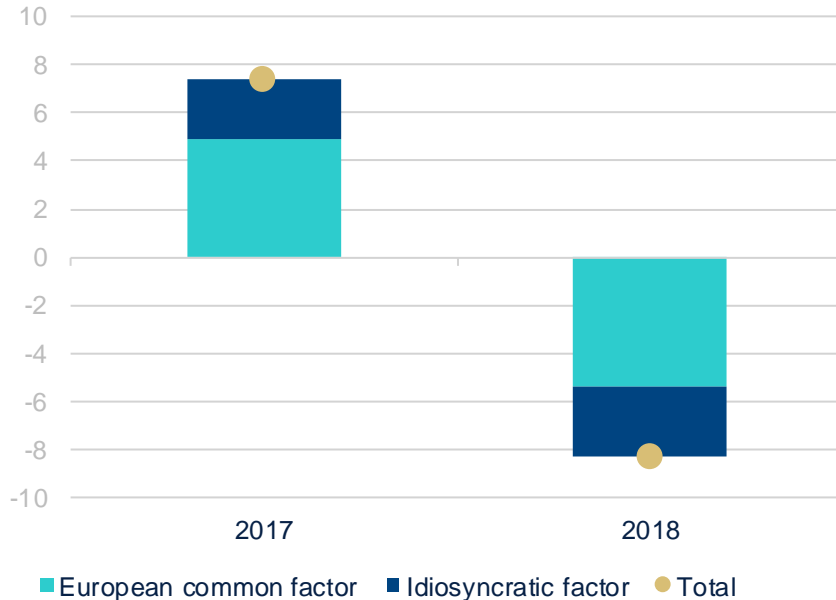
Exports of goods slowed down in 2018:

- The lower dynamism of global demand and the increase in oil prices during most of the year had a negative impact on trade flows
- The atony was widespread among the main export markets of the Spanish economy

Factors behind the slowdown : increase in internal and external uncertainty

Evolution of industrial confidence

(Annual change in standardized data)



- The confidence of the agents and, therefore, their consumption, savings and investment decisions have been conditioned by different sources of uncertainty
 - Protectionism increases and, in Europe, political risk and doubts about the final outcome of brexit persists
 - At domestic level, parliamentary fragmentation and its effects on economic and territorial policy decisions stand out

Outlook 2019-2020: recovery will continue, although growth moderates



Global demand grows

Despite its slowdown, it guarantees a healthy expansion of Spanish exports



Monetary policy will remain accommodative

Although demand moderates, low interest rates and the euro exchange rate will continue to drive economic activity



Oil prices

They are revised downward, which lowers the cost of transport for exports, while favors spending on consumption and investment of companies and families



Fiscal policy will be slightly expansive

In any case, the impact of the political cycle raises doubts about the evolution of public expenditure and the fulfilment of deficit targets



There is uncertainty about the effects of some economic policies implemented

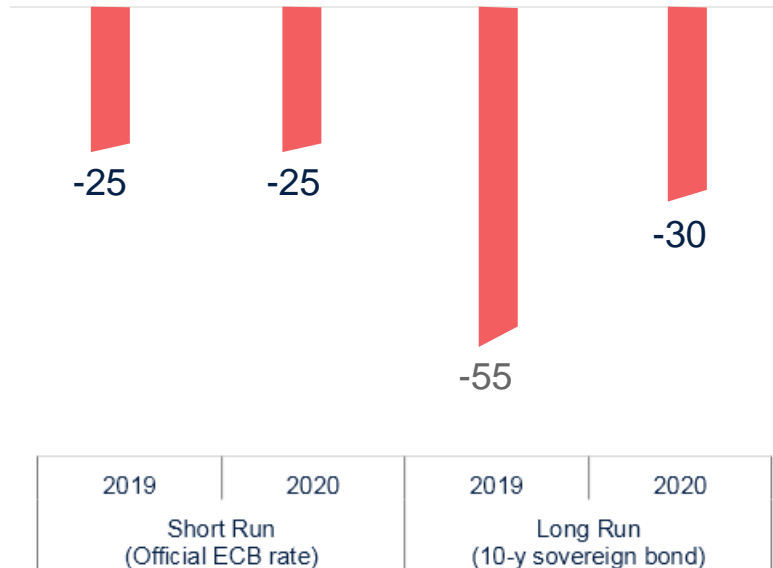
The increase in the statutory minimum wage (SMW) favors income and consumption in the short term, but will have negative effects on growth and job creation in the long term

Recovery will continue, although growth moderates

Monetary policy will remain accommodative

Change in reference interest rates for the Spanish economy

(bp, forecast end of period)



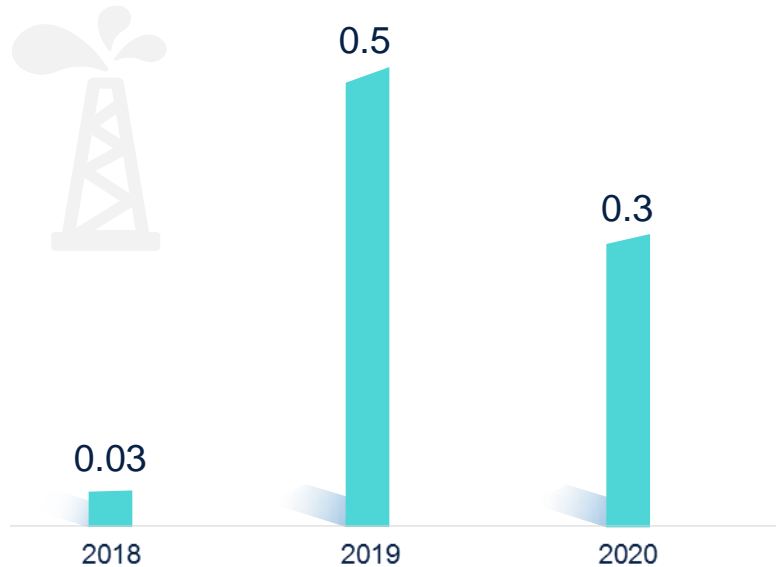
- Financial conditions will continue being favourable for consumption and investment decisions
 - The increase in the official interest rate is postponed to 2Q20. In addition, long-term interest rates are expected to be somewhat lower than in the previous scenario
 - The euro is expected to depreciate slightly more against the dollar than three months ago (1.20 vs 1.23 €/ \$ in 2019), which will favor competitiveness against other countries

Recovery will continue, although growth moderates

The lower price of oil will offset some headwinds

Spain: impact of the oil prices downward revision on GDP growth

(% YoY, deviation from base scenario)



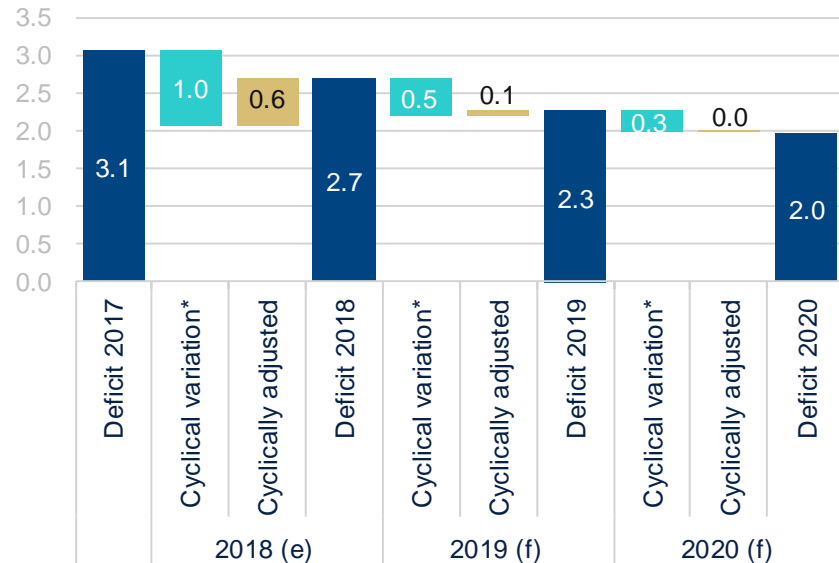
- The price of a barrel will be around 60 dollars on average during the current biennium, 15% less than expected three months ago.
- This will mean significant savings for businesses and families
- In the absence of the downward revision of the energy cost, the Spanish economy would grow, on average, 0.4pp less per year during the current biennium

Recovery will continue, although growth moderates

Fiscal policy will maintain a slightly expansive tone

Spain: Public sector net borrowing* and fiscal adjustment

(% of the GDP)



*Excluding assistance to the financial sector.

(1) Includes changes in interest charges

(e) Estimation. (f) Forecast.

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

- Revenues have exceeded expectations during 2S18, which has helped the government to reduce the deficit down to 2.7% of GDP, despite higher expenditures.
- In the last part of 2018 and the beginning of 2019 the Government has adopted expansive measures, the impact of which will be reduced throughout the year...
- ...however, and until the approval of the PGE by 2019, the economic cycle is expected to help the public deficit to be moderately reduced in 2019 and 2020

The risks in the scenario urge measures to improve the response capacity of the Spanish economy

Global

01

Protectionism and global deceleration

Protectionist tensions at the international level are a stumbling block to trade relations and condition investment decisions.

Europe

02

Political uncertainty

Open fronts could lead to a further slowdown in the European economy and therefore affect Spanish exports.

03

Brexit

It is not yet clear how the UK's exit from the European Union will materialize and this adds instability to the European economic context.

Idiosyncratic

04

Political uncertainty

Parliamentary fragmentation could increase and, with it, the conditioning factors on economic and territorial policy decisions.

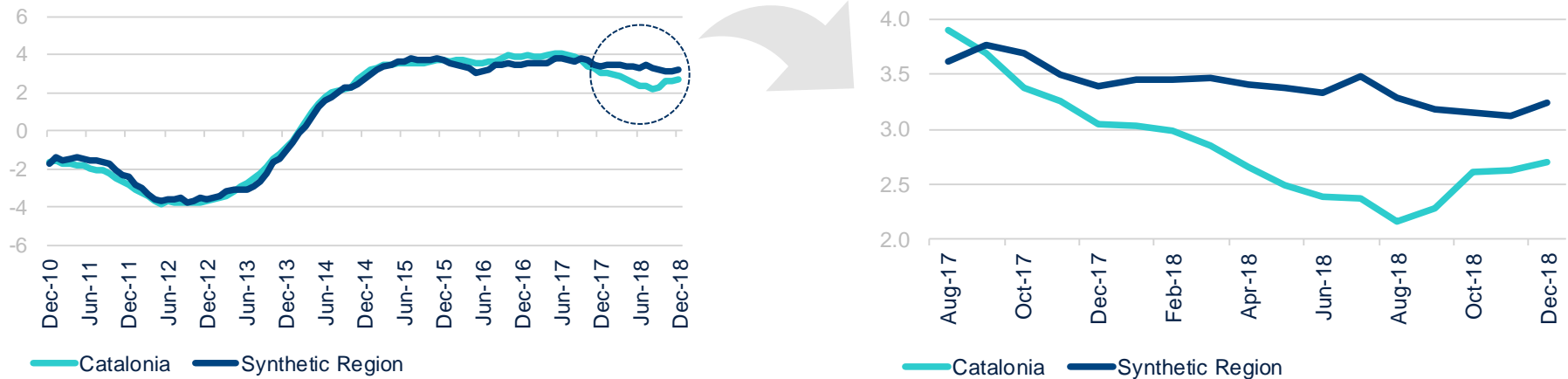
05

Limitations of growth capacity

Wage pressures can limit job creation and economic growth, especially if the slowdown in economic activity and the high unemployment rate partly reflect capacity constraints.

Idiosyncratic risks: uncertainty related to the political environment in Catalonia

Social Security affiliation in the private sector (% YoY)



To establish a counterfactual we use a synthetic control methodology, as Abadie and Gardeazábal (2004)
 Fuente: BBVA Research based on Social Security data
 An analysis of the effect of uncertainty is available at <https://goo.gl/K9zkjJ>

The slowdown in employment is more intense in Catalonia

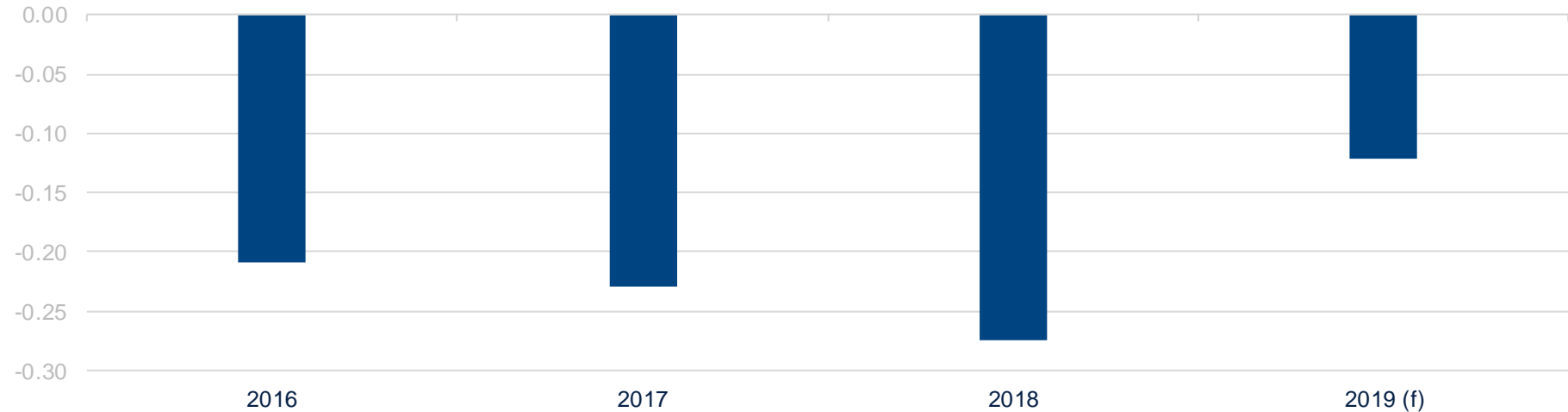
Job creation from Aug-17 to Dec-18 was 0.6 p.p. lower than in the counterfactual

This means that Catalonia today has **25,000 less people affiliated than the equivalent synthetic region would have** (around 1% of total employment)

Idiosyncratic risks: uncertainty regarding economic policy

Impact of uncertainty on annual GDP growth

(Deviation from levels in pp)

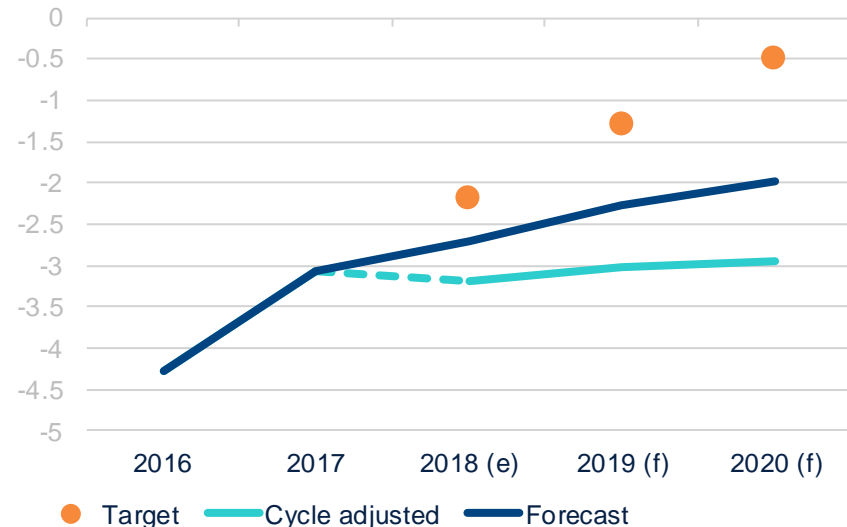


(f) Forecast.
Source: BBVA Research

The uncertainty does not go away and it could not be ruled out that it will increase in a year of intense electoral activity and given the fragmentation of the Spanish Parliament

Idiosyncratic risks: uncertainty regarding fiscal policy

Spain: Public sector net borrowing* and fiscal adjustment including the measures announced in the PGE 2019 project (% of the GDP)



* Excluding assistance to the financial sector

(1) Increases in corporate tax, personal income tax, wealth tax, green taxation, creation of new taxes (financial transactions and digital services), and fight against fraud are not included.

(e) Estimation. (f) Forecast.

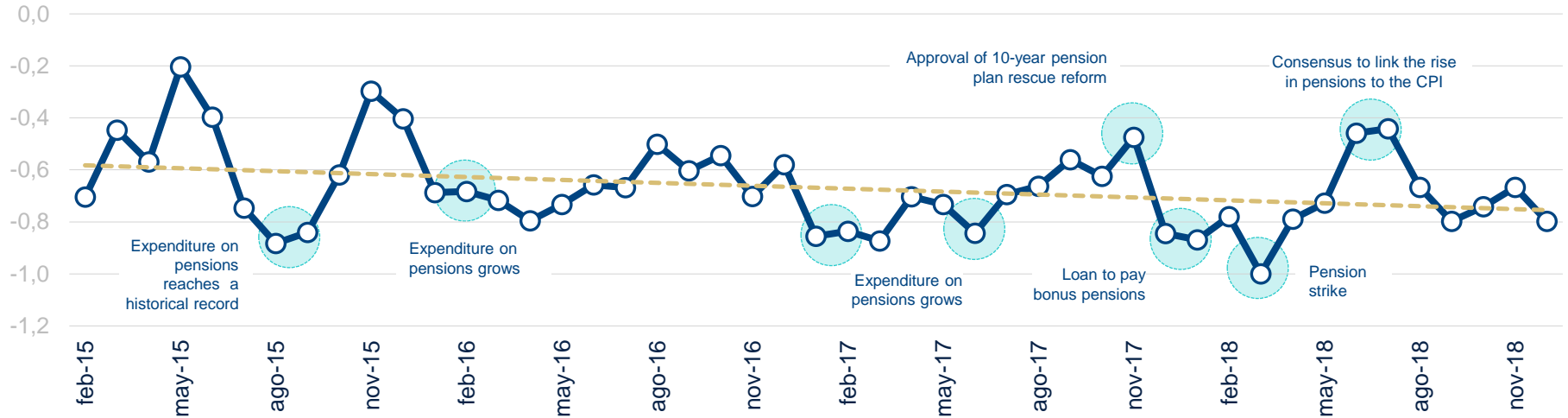
Source: BBVA Research based on BBVA Research based on Ministry of Finance and Public Administration and INE

- There are doubts about the impact that the political cycle could have on public spending and on the approval of the 2019 budget
- To achieve the current budgetary targets (1.3% and 0.5% of GDP in 2019 and 2020) would require a sizable adjustment. Even with the measures announced in the 2019 budget, the deficit would be around 2%
- In a favourable economic environment, not reducing the gap between public revenues and expenditures to below 2% of GDP would represent a missed opportunity to accumulate fiscal space

Idiosyncratic risks: uncertainty regarding economic policy

Perception of the pension system in the media (%)

(%)

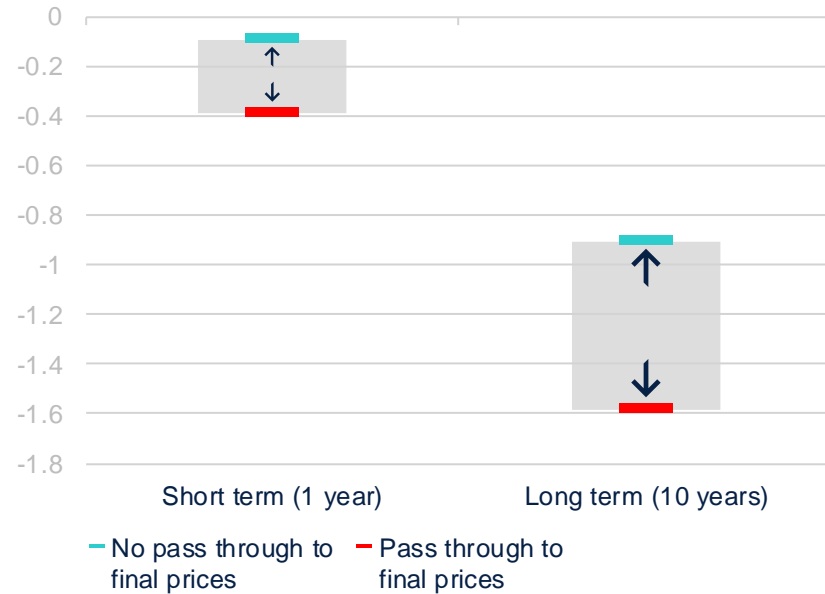


In the short term, the mechanism for revaluing pensions through the CPI will boost income and consumption. However, there is a need for an action plan aimed at improving the perception of sustainability and equity of the system in the long term

Idiosyncratic risks: an unprecedented increase in the statutory minimum wage (SMW)

FTE employment: impact of the increase in the SMW

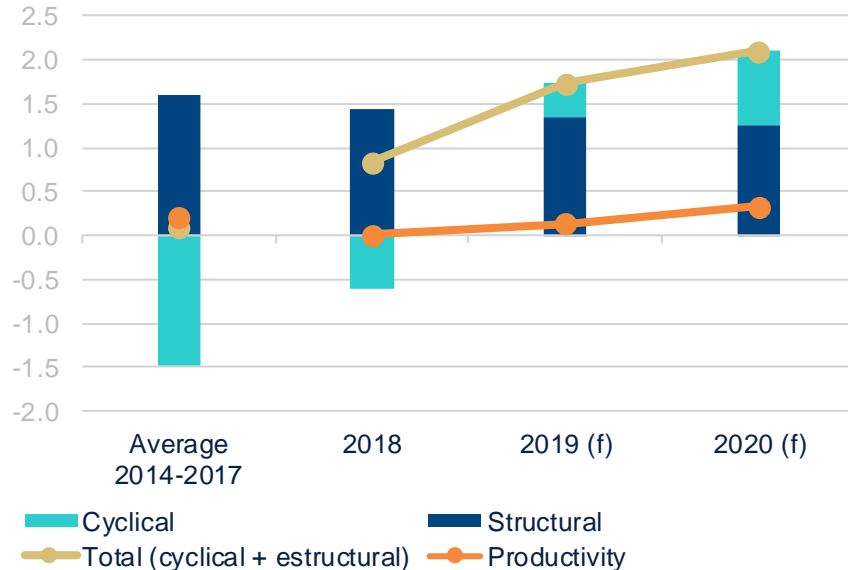
(% Deviation from the scenario without SMW increase)



- The increase in SMW could boost the income and short-term spending of affected employees, which would exceed 9%
- However, BBVA Research's estimates suggest that it would have a negative impact on economic activity and employment
- In the long term, the impact could be between -0.9pp and -1.6pp of employment, depending on whether firms absorb the wage increase or pass it on to prices

Idiosyncratic risks: limitations on growth capacity and job creation

Spain: decomposition of nominal compensation per employee (% , Y/Y)

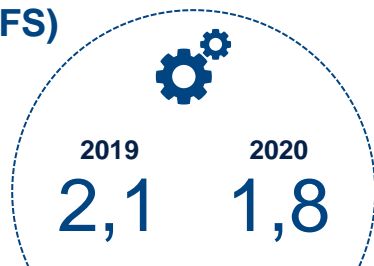


(f) Forecast
 Source: BBVA Research based on INE
 An analysis of the SMW is available at <https://bit.ly/2ExYjHR>

- Since mid-2018 there has been an increase in real wages and a fall in productivity, which may limit job creation capacity and economic growth
- The increase in inequality is an element to watch out
- Wage improvements are welcome if they are accompanied by productivity gains

2019-2020: Inflation and labour market forecasts

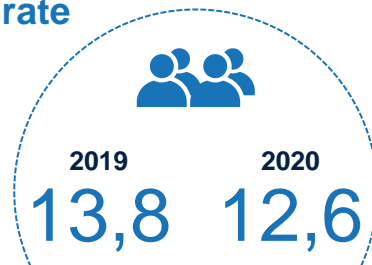
Employment growth (LFS)



Inflation



Unemployment rate



Compensation per employee



Key messages



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- In Spain, the advance of economic activity remains positive. However, in 2018, a deceleration in annual GDP growth of 0.5pp down to 2.5% was consolidated, as a result of a loss of tone in private consumption, a slowdown in external demand and greater uncertainty
- The global context, accommodative monetary policy, low oil prices and fiscal stimulus will continue to support growth, albeit less than in 2017-2018. GDP growth will remain around 2.4% in 2019 and moderate down to 2.0% in 2020. Risks are on the downside
- However, it is necessary to promote measures that improve the Spanish economy's capacity to respond to ongoing challenges and generate inclusive growth. Uncertainty regarding the sustainability of external growth increases, and doubts over economic policy and the effects of some measures already taken continue



03

Forecasts

Changes in our forecasts

The fundamentals continue to support a relatively strong recovery

% YoY	2018 (e)	2019 (f)	2020 (f)
Final consumption expenditure	2,4	2,1	1,8
F.C.E. Households	2,4	2,1	1,8
General government	2,4	2,4	1,7
Gross fixed capital formation	5,2	4,6	4,6
Equipment and machinery	6,0	3,9	4,2
Construction	5,5	4,9	4,7
Housing	6,2	5,5	5,6
Other constructions	4,8	4,3	3,6
Domestic demand (*)	2,9	2,6	2,4
Exports	2,2	5,2	4,5
Exports of goods	1,8	5,4	4,9
Exports of services	3,0	4,6	3,6
Non-touristic services	4,1	6,9	5,0
F.C.E. by non-residents in the economic territory	1,3	1,3	1,6
Imports	3,6	6,2	5,7
External demand (*)	-0,4	-0,3	-0,3
GDP mp	2,5	2,4	2,0

(*) Contribution to GDP growth.

(e) Estimation. (f) Forecast.

Source: BBVA Research based on de INE and BdE

Idiosyncratic risks: limitations on growth capacity and job creation

Typology of SMW beneficiaries



- The **new SMW** may hinder access to employment for the most vulnerable groups
- The effect may be more severe if the upturn is transmitted to the rest of the **wage distribution** and is not accompanied by a proportional increase in productivity.
- **Active labour market policies**, key to counteract possible negative effects

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