FOCUS

Quarterly Bulletin on Economic Situation and Prospects

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QUARTERLY BULLETIN ON ECONOMIC SITUATION AND PROSPECTS.

Executive summary.

The Spanish economy continued to register strong growth in the third quarter, prolonging the expansionary path that began at the end of 2013 - making it four consecutive years of positive quarter-on-quarter growth.

To put the excellent performance of the Spanish economy **in the last three years** into context, **growths of above 3% per annum have allowed for an accumulated growth of 9.8%** (compared to 6.2% and 5.7% of the Eurozone and the United States, respectively) **as well as for the creation of more than one and a half million jobs.**

GDP grew by 0.8% in the third quarter. Economic growth has continued to be supported by the momentum found in the investment in equipment and private consumption, reflecting the prolongation of the improvement in the labour market and the favourable financing conditions, as well as the strength of external demand. This consolidates a new, more solid and balanced economic cycle than in the previous expansive phase and in which the foreign sector takes on a greater role. The economy has managed to grow with regard to the correction of macroeconomic imbalances in a context of maintaining the ECB's expansive monetary policy, the recovery of global demand and increases in oil prices.

The slight moderation of growth in the third quarter is explained by the more contained progress of external demand offset, in part, by domestic demand and, in particular, by the strong rebound of investment in capital goods, which rose 2.5% quarterly compared to the slight fall of 0.1% in the second quarter. Private consumption is managing to continue in its progress despite the increase in the price of oil. But it is at the cost of saving, which is still falling.

The improvement in the current account balance in September is explained by the improvement in income, the increase in the tourist surplus and by the new fall in unit labour costs, showing that wages rise less than productivity. If we add to this the momentum seen in the Eurozone's economy, it is foreseeable that the financing capacity of the Spanish economy will be maintained and that the contribution to the growth of external demand will increase or be maintained, thus compensating for the possible deceleration of some components of domestic demand in the latter part of the year. This could once again put **quarterly growth in the fourth quarter at 0.8% and close 2017 with an average growth of 3.1%**, above 3% for the third consecutive year.

The slight improvement in productivity observed in previous quarters is explained, in part, by the higher growth in employment in sectors of higher than average productivity. To this we must add the closure of the least productive companies in all sectors. This has also allowed companies that are able to withstand the challenges of the crisis to be strengthened by less competition and by the strict adjustment of costs that has been carried out, which, in turn, boosts their profits in a greater proportion when compared to their increase in sales, thanks to the favourable effect of operating leverage. The gross operating surplus of companies increased in the third quarter at a nominal year-on-year rate of 5.1%, the highest so far this year and almost two percentage points above the advance observed in the remuneration of employees, 3.3% nominally in the third quarter. The importance of investment income with regard to the total income generated reaches a maximum in recent years in the third quarter, rising to 42.5%, with income from wages standing at 47.2% of the total. **In the coming quarters the increase in salaries should be accompanied by the improvement of profits in all those companies where advances in productivity allow for it.**

The main indicators seem to suggest that economic activity will remain strong in the fourth quarter of 2017 and that the Spanish economy will continue to lead growth in the Eurozone, pointing to quarter-on-quarter GDP growth of around 0.8%. The PMI Index composed of Global Activity, according to Markit, shows a positive trend for October and November. The number of people registered as working in Social Security in the construction sector is growing at annual rates close to 6%. Industry is also accelerating and generating employment at high rates, following the decline seen in the third quarter.

Beyond employment, **prices in Spain registered a one tenth rise in November as a result of the rise in the price of oil**, with the annual inflation rate at 1.7%. The underlying inflation rate fell, however, by one tenth of a percentage point to 0.8% year-on-year, due to the slowdown in the prices of services and the further fall in the prices of non-energy industrial goods. A degree of saturation in the labour market lower than suggested by the unemployment rate could explain, in part, the resistance to rising wages, especially applicable in those countries that present frictional unemployment rates. The absence of demand for credit, despite the very low interest rates, does not contribute to generating greater tensions in prices.

Among the leading indicators linked to private consumption in the fourth quarter, **we should note, positively, the good performance of Social Security registrations.** Indeed, job creation advanced at a year-on-year rate of 3.6% and 3.7% in October and November, which is indicative of a rebound in job creation in the final part of the year. We may add to this the strong increase in vehicle registrations in the months of October and November, a remarkable figure compared to what was observed in the third quarter, since the growth rate of this indicator has doubled. The continuation of the escalation in consumer credit also favours the increase in consumption, well above the rate at which this indicator is progressing in the Eurozone average. With regard to negative factors, however, retail sales and domestic sales of consumer goods and services of large companies both experienced slight year-on-year falls in November and October respectively. And to this we may add the worsening of consumer confidence which was witnessed in November. The stagnation of wages and the low savings rate could have an effect on household spending, although the Christmas season and a normalisation of the situation in Catalonia could maintain the pace of consumption at the high levels observed, especially in the second and third quarter of 2017.

To the growth of private consumption we must add the quarter-on-quarter improvement of 1.3% of investment in the third quarter, seven tenths higher than the previous quarter. This was **possible thanks to the increase seen with regard to capital goods**, which increased by 2.5% compared to the slight decrease seen in the previous quarter (-0.1%) and, to a lesser extent, to the higher growth rate of the investment in intellectual property products, 1.9%, compared to 0.8% in the second quarter. Finally, investment in construction reduced the growth rate by seven tenths, up to 0.3%.

The conditions are still favourable for investment decisions, due to very low interest rates, the good rhythm of domestic and foreign demand, the continuation of the deleveraging of companies and the use of productive capacity. However, **the expectations of businessmen worsened in the fourth quarter, breaking the positive trend and increases seen in recent months. Everything seems to indicate that part of the explanation would be found in the Catalan crisis.**

The most recent indicators of investment in equipment show, however, mixed signals in the fourth quarter. Lower business confidence and a decrease in the internal sales of equipment and software of large companies suggest that investment in equipment has had a worse performance in the quarter that closed the year. But the indicators for the situation and prospects relative to the residential sector are truly dynamic. The number of home sold rose 25.7% in October, almost fifteen points more than in the previous month, boosted both by the operations of used housing, which advanced at a rate of 24.8%, and of new housing, which increased 29.8%.

On the other hand, **the expenditure on final consumption by Public Administrations, in volume, and with calendar and seasonally corrected data, decelerated one tenth in the third quarter in year-on-year terms, up to 1%, according to figures from the Quarterly National Accounts, while in quarter-on-quarter terms the growth rate remained unchanged at 0.4%.**

Exports of goods and services, on the other hand, increased by 4.9% in real terms in the third quarter of 2017, compared to 4.4% in the second quarter, with advances of 4.7% in goods and 5.2% in services. In quarter-on-quarter terms, exports showed zero growth, compared to the slight progress of the previous quarter, due to being offset by a 0.3% increase in the exports of goods with a fall of 0.8% in services (-1.1% and 3%, respectively, in the previous quarter). The October data from the Tax Agency show an annualised growth of exports of goods and services of 8.1%, indicating that they continued to progress at a moderate pace, avoiding the observed drop in domestic sales, but losing strength with respect to September, when they grew twice as much as the rest of the world.

Our forecasts for the Spanish economy in 2018 point to a growth of 2.5% such that the expansionary path initiated in 2013 will continue, despite the foreseeable slowdown compared to previous years, following the creation of employment at a good rhythm, while the main macroeconomic imbalances continue to be corrected: the public deficit will be reduced to below 3%, agents will continue their deleveraging process and **a current account surplus will be maintained for the fifth consecutive year**, the latter being a totally favourable characteristic and a new feature of the current expansive cycle of the Spanish economy.

The contribution to the growth of domestic demand will be somewhat lower (2.1% compared to the 2.6% forecast for 2017) due to the lower growth in private consumption as a result of the expected slowdown in job creation, stagnation or very weak wage rises and a slightly higher price of oil. However, this could be partially offset by an increase in public consumption, slightly higher than the forecast for 2017 (1.6% vs. 1.2%), facilitated by the sharp adjustment of the deficit in recent years and for a considerable increase in the tax revenues of an economy that in 2017 boasted three consecutive years of growth above 3%.

Finally**, we also expect investment to slow down in 2018 to 2.6% per year from the almost 4% expected in 2017**, mainly due to the slowdown in the growth of investment in machinery and capital goods. The worse behaviour forecast with regard to investment in capital goods can largely be explained by both the end of the worst of the stagnant demand for investment, which came about during the long period with no government in 2017and was worsened by the Catalan crisis, and the lower demand expected in exports for 2018.

Net external demand, meanwhile, will continue to make a positive contribution, although slightly decreasing, mainly due to an increase in exports, somewhat lower than that observed in 2017, although this is also favoured by an even smaller increase in imports which results, in part, from the deceleration of the Spanish economy.

The good moment for the European and world economy should allow the effort of geographical diversification of exports carried out by Spanish companies in recent years to continue contributing to the growth of the Spanish economy in 2018. Nevertheless, the expected good performance of the foreign sector will not compensate for the expected slowdown in domestic demand, due, among other reasons, to the increase in the price of oil, the absence of tax cuts and the exhaustion of the recent impetus due to the materialisation of certain purchasing decisions with regard to durable goods and investment decisions which were postponed during the crisis.

Therefore, **the expected progress of the Spanish economy in 2018 of 2.5% would place the unemployment rate at 15%, the lowest figure seen in the last ten years.**

In the international arena, for the first time in a long time, risks are balanced out, according to the IMF, and are no longer "downwards". However, and despite the fact that the balance of risks has become more well-adjusted, the sources of uncertainty in the world economy must not be lost sight of. On the one hand, a category of risks that can condition the strong global expansion from the financial point of view is **the accumulation of debt as an outstanding protagonist**, a particularly vulnerable element in a context of tightening global financial conditions, which would have a greater impact more abruptly than expected. Also, throughout 2018, we will add other risks to the recent rise in interest rates of the Federal Reserve. Furthermore, **the process of reducing the balance of both the Federal Reserve and the European Central Bank will affect long-term interest rates**, especially in the North American case due to its greater intensity. This monetary tightening could make the euro and the dollar more expensive compared to the currencies of emerging countries, hindering the progress of certain exports. However, low inflation in both economies shows the absence of significant wage tensions, which affords the monetary authorities discretion when accommodating the monetary tightening. On the other hand, a series of risks of a political nature are also present, covering a wide spectrum of circumstances, from purely geopolitical ones (fundamentally the conflict with North Korea) to a supposed protectionist boom.

To all of the above we must add the impact of the uncertainty related to the internal political context, which is much more complex at present. Assessing how the increase in political uncertainty in Spain can affect the consumption and investment decisions of economic agents and, therefore, the forecast of growth, is not easy. It suffices to recall that the most recent experience during the ten months of the Government in office demonstrated the difficulty involved in incorporating this type of effect into macroeconomic forecasts. Most forecasts were erroneous and, except for the slight negative impact on capital equipment investment observed, the economy has continued to grow at a strong pace.

Global scenario.

Recovery of world trade

The biggest change in 2017 has undoubtedly been the intense recovery in world trade that is already growing at the same rate as GDP. The year 2016 began with a financial crisis due to the fear of a recession in China. However, the Asian dragon kept its cruising speed in 2017 with growth close to 7%, but with a very significant change in its growth model. Exports and industrial production have ceased to be the engine, which now is private consumption and investment, especially in energy and the fight against pollution and climate change.

This change is noticeably reflected in their current account. In 2007, China had an external surplus of 10% of GDP and financed the US deficit, which was equivalent to 5% of GDP. What was called at that time as a savings glut created the environment conducive to the international credit bubble that led to the Great Recession. China will end 2017 with an external surplus close to 1% of GDP and shortly will have a deficit. Therefore, China has gone from being the factory of the world to one of its main demand engines.

However, the greatest recovery in world demand has occurred in Europe and the US. The Eurozone economy, thanks to the ECB's aggressive monetary policy, has recovered the level of employment it boasted before the crisis and will register the highest growth rate since 2007. Spain concentrates two thirds of its exports in Europe, something which helps explain the recovery thereof, despite the fact that the Brexit has caused a drop in imports of Spanish cars of 13% per annum.

In the US, the uncertainty generated by Trump's victory has not materialised in risks. The Treaty with Mexico and Canada remains unchanged, the wall with Mexico will be smaller and will be paid by US taxpayers and the replacement of Janet Yellen at the head of the Fed will be Jerome Powell, who was already part of the Council, which guarantees the continuity of the monetary policy. Investors have assumed this and 10-year American Treasury rates are trading at 2.5%, anticipating gradualism.

What has gone up with Trump is the Stock Exchange. This rise is partially explained by the recovery of global activity, which benefits multinationals, especially technology companies, and partly because the investors correctly anticipated Trump's tax reduction. The reduction for families will be much lower than that announced in the campaign, but the corporate tax cut will meet expectations. Most of that adjustment is likely to end up in the repurchase of shares of companies, which is inflating the prices thereof.

The US maintains a structural public deficit close to 4% of GDP and, according to the forecasts of the CBO, Congressional Budget Office, the deficit before Trump's reduction would increase in the next decade to 5% of GDP. **The downgrade will increase the structural deficit by at least one point of GDP, raise the external deficit and make the US economy more dependent on external financing, in turn worsening global vulnerability and financial instability**. The story is reminiscent of what happened with the Reagan Administration and the twin deficits (fiscal and current account), which forced George Bush Sr. to raise taxes in breach of his campaign promise. Now the public debt of the US is at historic highs above 100% of GDP and is more than double that of the Reagan era, although the effects do not have to be felt in the short term.

In conclusion, the outlook for 2018 is positive, although there are still risks. Namely, globally, the conflict with North Korea and, domestically, the crisis in Catalonia are the two main issues that can put the economic recovery at risk.

Growth prospects for the Spanish economy.

The expansive phase of the Spanish economy that began in the third quarter of 2013 continued in the third quarter of 2017 and will continue apace in the coming months.

The data of the quarterly national accounts of the third quarter confirmed the robust progress of the economic activity, observing growth of 0.8% quarter-on-quarter, a rate one tenth lower than that seen in the previous quarter. This has allowed the country to overcome the real income levels experienced prior to the crisis, where the maximum was reached in the second quarter of 2008.

Growth continued to be balanced with positive contributions from both domestic and foreign demand. The strong growth of domestic demand, which contributed 2.7 percentage points to annual GDP growth, was added in the third quarter to the positive contribution of external demand for the seventh consecutive quarter. The contribution of net external demand was 0.4 percentage points in the year-on-year comparison, which represents a still positive contribution, but reduced by half of that observed in the second quarter due to imports growing faster than exports. In quarter-on-quarter terms, the contribution to GDP was zero, after a contribution of three tenths in the previous quarter, as a result of a stabilisation of both exports and imports of goods and services in real terms, after having observed quarter-on-quarter rates of 0.1% and -0.7%, respectively in the second quarter of 2017.

The gradual and predictable deceleration of the Spanish economy is still very weak. At the moment, the third quarter has shown a strong growth, equalling the record of the first quarter.

The strong progress seen in national demand is the result of the prolongation of the momentum found in private consumption and the acceleration of investment, while external demand was reduced by four tenths. The medium-term outlook remains favourable and, for 2017, our forecast is for the final growth of economic activity to reach around 3.1%.

In the third quarter, domestic demand consolidated as the main driver of quarter-on-quarter growth, driven by private consumption (0.7%) and, to a greater extent with clear growth, by investment demand (1.3%), (mainly due to the equipment component) and the final consumption expenditure of public administrations (+0.4%).

The improvement of the labour market and consumer confidence, as well as financial conditions, continued to favour the situation of households, which, in turn, allowed the good growth rate of consumption to continue, equalling the growth seen in the second quarter (+0.7%), growth which is also driven by the better performance of the price of oil during the third quarter, showing some stability both in quarter-on-quarter and year-on-year terms.

The main indicators show signs that economic activity will continue to be strong in the fourth quarter of 2017 and that the Spanish economy will continue to lead growth in the Eurozone, with quarter-on-quarter GDP growth of around 0.8%. The PMI Index made up of Global Activity, according to Markit, which serves to predict the evolution of growth, was positive in October and November. The number of people registered in Social Security in the construction sector is growing at annual rates close to 6%. Industry is also accelerating and generating employment at a high rate, defying the threat of robotisation, after the decline observed in the third quarter.

Among the leading indicators linked to private consumption and for the fourth quarter, it is worth noting the increase in **car registrations**, according to ANFAC, of 12.4% and 12.3% in the months of October and November, an important upturn with respect to what was observed in the third quarter, since this indicator's growth rate has doubled. With regard to the **General Sales Index of Retail Trade**, when corrected for calendar effects and deflated, it registered a fall in October of 1.1% year-on-year, both due to the slowdown of the food component of 3.7 points to 0.1% year-on-year (compared to the 2.5% increase of the previous month) as well as the 2.4% decline in the non-food group (compared to the same amount in September).

The decrease in November of the **Consumer Confidence Index** prepared by the European Commission, together with the annualised fall of 0.9% of **domestic sales of goods and consumer services of large companies** collected by the Tax Agency, could anticipate greater weakening of consumption in the fourth quarter. The stagnation of wages and the low savings rate could have an effect on household spending, although the Christmas season could compensate for this dynamic and ensure that growth in consumption remains at the levels observed throughout 2017. Consumer credit, meanwhile, continued its strong growth, advancing 1% in October compared to the previous month, leaving the year-on-year rate at 14.3%, one tenth less than in September, although ten points above the growth of consumer credit experienced in Germany and more than eight points over the growth of consumer credit seen in the Economic and Monetary Union (EMU).

The growth in private consumption must be added to the quarter-on-quarter improvement of 1.3% of investment in the third quarter, seven tenths higher than the previous quarter. This has been possible thanks to the increase recorded in the capital goods component, which increased by 2.5% compared to the slight decrease of the previous quarter (-0.1%) and, to a lesser extent, to the higher growth rate of the investment in intellectual property products of 1.9% compared to 0.8% in the second quarter. Finally, investment in construction reduced the growth rate by seven tenths, up to 0.3%.

Conditions remain favourable for investment decisions due to very low interest rates, the good rhythm of domestic and external demand, the continuation of the deleveraging of companies, the use of productive capacity and the continuous improvement of expectations.

The most recent indicators of investment in equipment show, however, mixed signals. The perception of the current situation of their business by businessmen worsened in the fourth quarter, according to the **Business Confidence Indicator developed by the INE**. This index had six consecutive quarters with positive rates. In October, the **internal sales of equipment and software of the large companies** also fell sharply, with data corrected for calendar effects, deflated and a constant population, falling, compared to the 3.8% increase in September, by 4.2% in October. In view of the above, the **indicator of the industrial climate of investment goods** registered a balance of 11.2 points in the October-November 2017 period, 7.3 points higher than in the third quarter, while the degree of use of productive capacity of investment goods expanded by four tenths, reaching 84.6% in October. The **registrations of freight vehicles** accentuated the rate of progress in October, registering a year-on-year increase close to 20.9%, according to data from ANFAC, which represents an acceleration of 12.7 points over the previous quarter.

As for investment in construction, this moderated its quarter-on-quarter growth rate by seven tenths in the third quarter to 0.3%. By components, the residential segment and that of other construction projects recorded year-on-year variations of 0.7% and -0.2%, respectively, both of which are eight tenths lower compared to the previous quarter.

However, the indicators for the current situation related to the residential sector were truly dynamic. The number of purchases of homes grew 25.7% in October, almost fifteen points more than in the previous month, as a result of the greater momentum experienced in the purchases of second-hand homes, which advanced at a rate of 24.8, as well as sales of new housing, which increased 29.8%.

On the other hand, **the expenditure on final consumption of Public Administrations, in volume, and with data corrected for seasonality and calendar effects, decelerated in the third quarter by one tenth in year-on-year terms, up to 1%, according to figures from the Quarterly National Accounts (QNA), while in quarter-on-quarter terms the rate of advancement remained unchanged at 0.4%.**

Exports of goods and services, on the other hand, increased by 4.9% in the third quarter of 2017, compared to 4.4% in the second quarter, with advances of 4.7% in goods and 5.2% in services. In quarter-on-quarter terms, exports showed zero growth compared to the slight advance of the previous quarter due to the 0.3% increase in exports of goods being offset by a 0.8% fall in the exports of services (-1.1% and 3%, respectively, in the previous quarter). The October data of the Tax Agency show an annualised growth of exports of goods and services of 8.1%, an indication that they continue to advance at a moderate pace, avoiding the observed fall in domestic sales, but losing strength in comparison with September, when they grew twice as much as the rest of the world.

In the first nine months of 2017, and according to the available data of the Balance of Payments, the Spanish economy generated a foreign financing capacity of 13,787 million euros (1.6%) compared to a financing capacity of 15,081 million (1.8%) in the same period of the previous year.

The labour market was characterised in the third quarter of 2017 by a renewed dynamism in the creation of employment following the excellent trend of previous quarters, both in response to the data provided by the Economically Active Population Survey (EAPS) and by new registrations in Social Security.

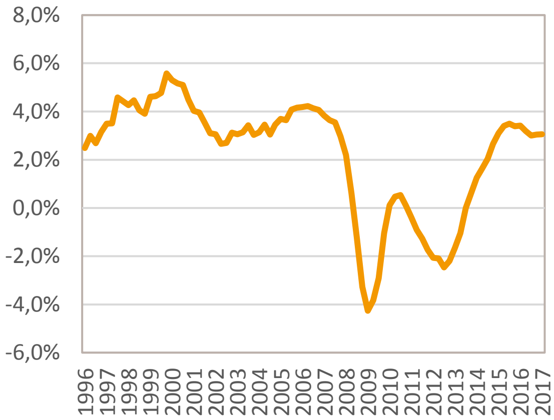
With series corrected for seasonality, the quarter-on-quarter variation in the number of people registered as working grew by 0.4% quarter-on-quarter in the third quarter, eight tenths less than in the previous quarter. In year-on-year terms, the number of people in employment slowed down by three tenths to 3.5% in the third quarter. However, data for October and November, with year-on-year increases of 3.6% and 3.7% respectively, point to a new acceleration of employment in the fourth quarter, according to the figures from Social Security.

Demand and production

According to the results of the QNA published by the INE, the real GDP, corrected for calendar effects and seasonality, recorded a quarter-on-quarter growth of 0.8% in the third quarter of 2017, exactly the same as the previous quarter. In year-on-year terms, GDP grew by 3.1%, the same rate as the previous quarter.

However, our forecasts point to a very slight slowdown of up to 3.1% for GDP growth in 2017, mainly due to a slight deceleration of one tenth in the second half. This slight deceleration profile is explained by the loss of strength of some factors that would have driven the activity in a transitory way, such as the fall in the price of oil, the depreciation of the euro and some budgetary stimuli. The weakened impulse stemming from these factors should be partially offset in the medium term by the gradual improvement in export markets, given the strong upturn in trade and world growth.

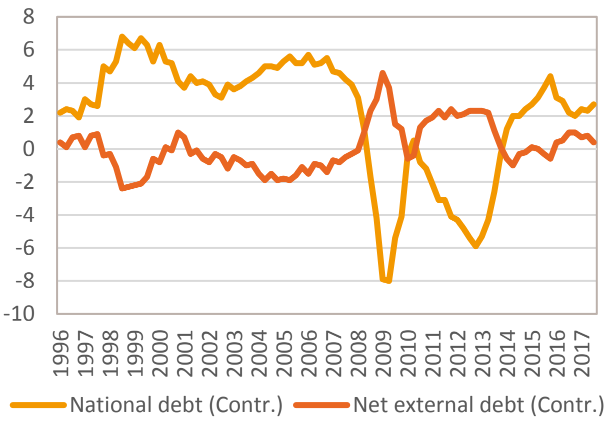
Graph 1. GDP (year-on-year change in %)



Source: QNA.

By components, economic growth continues to be supported by domestic demand, the main driver of growth, with 2.7 percentage points, three tenths higher than that observed in the second quarter of 2017, although slightly lower than the average contribution recorded in 2016. The contribution of net foreign demand was positive, as in the previous three quarters, reaching 0.4 percentage points. It is a growth composition somewhat less balanced than that observed in the second quarter.

Graph 2. National and foreign demand (Contribution to growth %)



Source: INE.

National demand aggregates

The main components have contributed to the growth of domestic demand. Particularly noteworthy was the favourable behaviour of private consumption which was driven by strong job creation as well as low interest rates and improved financing conditions. The real expenditure on final consumption of households and non-profit institutions serving households (NPISH) in volume showed year-on-year growth of 2.4% in the third quarter of 2017 (one tenth less than in the first quarter). However, in quarter-on-quarter terms, growth of private consumption (consumption of households and non-profit institutions at the service of households) accelerated by up to 0.7%, the same growth rate as in the previous quarter.

The good trends seen in private consumption are explained by the strong creation of employment, the improvement of access to and conditions of financing and the moderation of prices, with the latter being to thank for the stabilising of the price of oil registered on average throughout the third quarter.

The most recent indicators of the economic situation, both qualitative and quantitative, indicate that the expansionary path of private consumption growth is maintained in the fourth quarter of 2017.

Private consumption continued to grow in the third quarter, in nominal terms, at the same pace as the remuneration of employees, which implies that **household savings have stopped growing**.

Conditions continue to be very favourable for investment decisions, a more advanced deleveraging process, good behaviour of demand, low interest rates and the use of productive capacity. It is precisely the demand for investment that advanced the most in the third quarter, led by the good performance of investment in equipment.

External demand

According to figures from the QNA, in the third quarter of 2017 the foreign sector contributed four tenths of a percentage point to the year-on-year change in GDP, half as much as in the second quarter, due to the fact that exports accelerated less than imports in the year-on-year comparison.

Spanish real exports did not change in quarter-on-quarter terms which, although better than the case of the United Kingdom (-0.7%), is worse than other large European economies such as Germany (1.7%), Italy (1.6%) or France (1.1%). However, compared to the previous year's quarter, growth of exports is 4.9%, a notable figure and higher than that observed in France (3.9%), but lower than that of British, German and Italian exports.

Exports of goods and services have accelerated despite the worsening of competitiveness compared to developed countries and emerging economies. According to the competitiveness trend index based on consumer prices compared to developed countries, in the third quarter we see a loss of competitiveness of 2.7% year-on-year, following the slight fall experienced in the previous quarter (0.3%). This is explained by the 2.8% appreciation of the nominal effective exchange rate in the period, nevertheless relative prices barely varied. The loss of competitiveness with respect to the European Union was 0.5%, explained by the increase in the index of relative prices of consumption (0.2%) and the appreciation of the nominal effective exchange rate (0.3%). **It is the fifth consecutive month in which competitiveness has worsened**. Finally, with respect to the BRICS countries, a loss of competitiveness of 3.3% was observed as a consequence of the appreciation of the nominal exchange rate of 3.4%, very slightly offset by a slight decrease in the relative price index.

Despite the loss of competitiveness indicated, real exports of goods have managed to maintain their market share (1.94%) thanks to the advance of exports of 4.7% year-on-year, a rate similar to the observed growth of world trade of 5.1%, according to the Central Planning Bureau of the Netherlands.

The expenditure of non-resident households, according to QNA figures, increased in the third quarter of the year by 2.1% QoQ, compared to the increase of 4% in the previous quarter, and 10.3% YoY, 1.4 percentage points more than in the April-June period. The main indicators of foreign tourism, such as tourist arrivals, overnight stays by foreigners in domestic hotels and the total expenditure of international tourists, offer favourable signs but with a tendency to more moderate growth, with year-on-year rates in October of 1.8%, 2.6% and 5.9%, respectively.

Real exports of non-tourism services fell by 2.9% in the third quarter of 2017, after the increase of 3.6% in the second quarter. In year-on-year terms, growth was 1.8%, down by 5.6 points from the previous quarter.

The moderation in the growth of exports to the European market observed in the third quarter continued in October, according to the foreign sales of the large companies published by the Tax Agency.

Real imports of goods and services, meanwhile, remained stable in the third quarter, compared to a 0.7% drop in the second quarter. By components, imports of goods increased by 0.9% compared to the previous quarter while those of services fell by 4% compared to the respective rates of -0.9% and 0.5% in the previous quarter.

The real expenditure of resident households abroad, according to QNA figures, increased by 3.8% quarter-on-quarter following the 2.1% increase observed in the second quarter. On the other hand, imports of non-tourist services fell by 6.6% quarter-on-quarter after having remained stable in the previous quarter.

The surplus of the balance of goods and services at current prices, always according to data from the QNA, stood at 4.4% of the quarterly GDP in the third quarter, one tenth less than the previous year, due to the greater deficit of goods (-2.6% compared to -1.8% of GDP) which was almost completely compensated for by the higher service surplus (7% of GDP, seven tenths higher than in the same period of 2016). Within services, the surplus of the net income of tourism grew by 4 tenths (4.7% of the GDP) and the non-tourist services by 3 tenths (2.4% of the GDP) in relation to the percentage registered in the third quarter of 2016.

Productive activity

In terms of supply, the large sectors of activity showed a mixed performance in the third quarter of the year. The construction sector is particularly noteworthy: the Gross Value Added (GVA), in volume and with series corrected for seasonality and calendar effects, grew by 4.9% in this sector, equalling the growth of the previous quarter, while the GVA of the industry improved by 0.7% - that of the service sector, 2.7%, and agriculture, livestock, forestry and fishing accelerated seven tenths compared to the same period of the previous year.

In quarter-on-quarter terms, the GVA of the services sector and the construction sector accelerated by 1.1% and 0.8% respectively in the third quarter, with agriculture both registering the greatest expansion (1.2%) and recording a greater deceleration as it fell by half a point to 0.4%.

Apparent productivity per employee grew by 0.3% in the third quarter of the year, as a result of an increase of 3.1% of GDP and a 2.9% increase in full-time equivalent employment.

Leading indicators for the industry show signs of returning to a more expansionary state. The Industrial Production Index, with series corrected for calendar effects and seasonality, accelerated eight tenths in October to boast 4.2% year-on-year growth, mainly due to the acceleration of the main groups (consumption, equipment and intermediate goods).

The New Industrial Order Index in the Industry, with corrected series for calendar effects and advanced data of the activity of the sector, registered high annual growth of 15.7% in September, the highest of the historical series thanks to the favourable evolution of all its components.

In the construction sector, dynamism continues. The surface area where new builds will be constructed, according to building permits, registered a year-on-year increase of 25.1% in September, much higher than the previous month (5.7%), accumulating average annual growth of 20.8% in the first nine months of the year, compared to 19.6% observed in the same period of 2016. This significant acceleration was due to the non-residential component, which rose 29.6% year-on-year, after the decrease of 48.4% in the previous month, while the residential component slowed by 15.5 points, reaching a year-on-year rate of 23.5%.

The Construction Industry Production Index, published by Eurostat, rebounded in September, reaching a year-on-year rate of 5.9% with calendar corrected data, 4.8 points more than in the previous month. This improvement was due to growth in its two components, building and civil works. However, in the accumulated index of the year up to September, this indicator registered a fall of 0.2%.

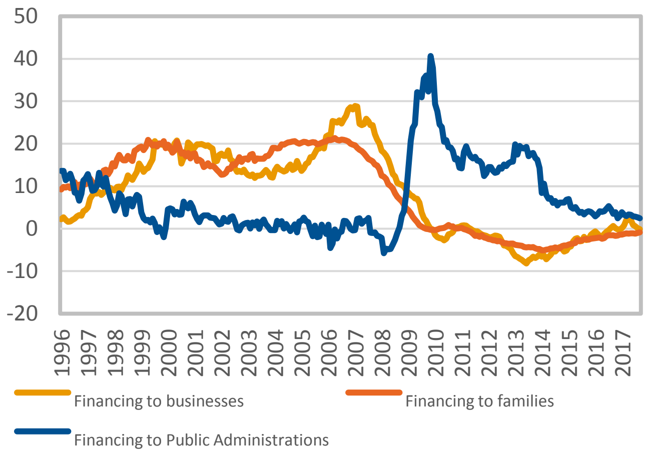
The services sector, on the other hand, generally shows favourable indicators, although the tourism sector has moderated its progress somewhat. Indicators such as confidence in services published by the European Commission and the PMI showed growth in November, which, although indicative of a solid increase in activity, are more moderate than in previous quarters.

Furthermore, to this we must add the exceptional tourist season, which broke records in 2016 and will probably also do so in 2017. However, activity moderated slightly in October. This lower dynamism (a fall of ten points) in October is explained by the decrease observed in the arrival of tourists to Catalonia, which fell by 4.7%.

The favourable performance of private consumption is explained by the creation of employment and the improved access to financing and financing conditions

With regard to financing for productive activity, graph 3 shows the rate of variation of financing for the different productive agents. In Spain, the balance of credit to households and companies remained stable in October, compared to the slight advance of the previous month. The year-on-year rate reflects the fall of 1.8% recorded in October, while in the Eurozone credit grew in year-on-year terms by 1.6%, the highest rate in six years. The good moment that the Spanish economy is going through favours the expansion of credit, supported by the continuation of the expansive monetary policy of the European Central Bank (ECB). However, according to the Survey on access to financing for SMEs of the central entity, **it is the low demand for credit that is responsible for credit not flowing at a greater speed in Spain**. The public sector, on the other hand, did contribute to the growth of financing, although the process of slowing down in growth continues.

Graph 3. Financing Year-on-Year rate



Source: Bank of Spain.

In the year-on-year comparison in September, and according to the different types of agents, financing for companies and households fell by 0.1% and 0.8%, respectively. The funding destined for Public Administrations increased by 2.5%.

In terms of supply, the improvement of the banking sector strengthened. **The default rate of the banking sector stood at 8.22% in the month of October, the lowest figure since March 2012**.

Prices

The Consumer Price Index (CPI) for the month of November, published by the INE, rose to 1.7% year-on-year, due to the rebound of energy while containing services and food.

The prices of energy products increased 6% year-on-year in November in 2017, 2.1 points more than in October. This trend is mainly associated with the fast growth of fuel prices. Food inflation stood at 2.2% annually in November, one tenth below that observed in October.

Underlying inflation (which excludes unprocessed food and energy products, the most volatile elements of the CPI) fell one tenth in November to 0.8% due to the slowdown in the prices of services and the greater fall in the prices of non-energy industrial goods.

The harmonised CPI for November stood at 1.8%, one tenth higher than in October. For its part, the advanced rate from Eurostat for the whole of the Eurozone was 1.5% in November, also one tenth higher than in October.

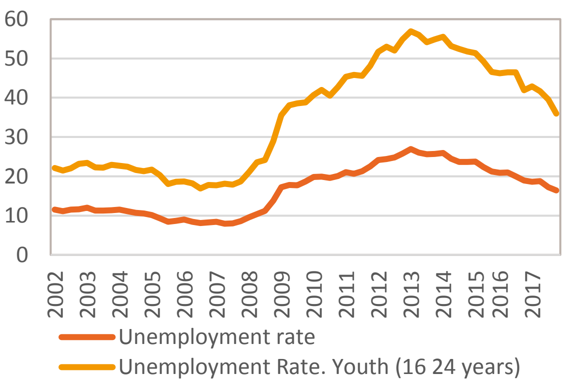
Labour market

The labour market was characterised in the third quarter of 2017 by a renewed dynamism in the creation of employment following the excellent trend of previous quarters, both attending to the data provided by the Economically Active Population Survey (EAPS) and registrations in Social Security.

With series corrected for seasonality, the quarter-on-quarter variation in the number of those in work grew by 0.4% in the third quarter, eight tenths less than in the previous quarter. In year-on-year terms, the number of people in employment slowed by three tenths, to 3.5%, in the third quarter. However, data for October and November, with year-on-year increases of 3.6% and 3.7% respectively, point to a new acceleration of employment in the fourth quarter, according to the figures from Social Security.

Based on the QNA data, full-time equivalent employment, with seasonally and calendar adjusted series, grew by 0.4% quarter-on-quarter in the third quarter, eight tenths less than in the previous quarter and, in year-on-year terms, slowed three tenths, to 3.5%.

Graph 4. Unemployment rate. Active population percentage



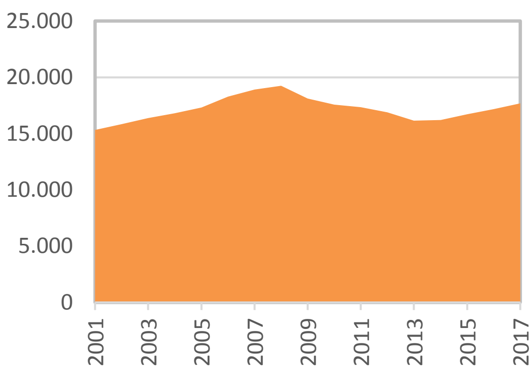
Source: INE

If we look at the type of employment contracts, the year-on-year increase in paid employment of 3.3% places the net creation of undefined paid employment at 60% of the total, while 40% of the increase in paid employment was temporary. As a result of this dynamic**, the temporary employment rate stood at 27.4%**.

The total number of unemployed stood at 3,731,700, below four million for the second consecutive quarter. In the last year, unemployment has fallen by 589,100 people, an annual decrease of 13.6%. **The unemployment rate fell to 16.4% of the active population, the lowest since the fourth quarter of 2008**.

Considering age, it is worth highlighting the decrease of youth unemployment of 10.5% year-on-year, with the youth unemployment rate standing at 36%, 5.9 points lower than that of a year earlier.

Graph 5. Workers registered with Social Security (monthly average). Thousands



Source: Social Security.

Long-term unemployment, defined as the number of people who have been unemployed for more than a year, fell by 21.7% year-on-year in the third quarter of 2017, according to Eurostat figures, standing at 43.6% of total unemployment.

Moderation in the growth of salaries and unit labour costs has continued. Figures from the QNA show that remuneration per employee increased 0.1% in the third quarter, after the decrease of 0.2% in the second quarter, and the apparent productivity of work increased one tenth more than in the previous period, such that the unit labour cost decreased 0.2% year-on-year, prolonging the downward trend of the last two years.

Finally, the Statistics of Labour Agreements drawn up by the Ministry of Employment and Social Security point to an average wage increase agreed until the end of November of 1.4%, four tenths higher than that agreed in 2016.

Balance of payments

In the first nine months of 2017, and according to the available data of the Balance of Payments, the Spanish economy generated a foreign financing capacity of 13,787 million euros (1.6%) compared to a financing capacity of 15,081 million euros (1.8%) in the same period of the previous year.

The accumulated surplus of the current account balance amounted to 12,702 million euros, compared to 13,361 million reached in the same period of 2016. This result is due to the decrease in the surplus of goods and services, partially offset by the reduction of the primary and secondary income deficit. Additionally, the capital surplus was reduced by 36.9%.

At the same time, the financial balance registered net capital outflows of 22,731 million euros, compared to the net outflows of 12,709 million a year earlier, due to net capital outflows, excluding the Bank of Spain, of 60,270 million of euros, which more than offset the increase in net debit position of the Bank of Spain, which reached 37,542 million.

The commercial balance has worsened due to the increase in the energy deficit. The trade deficit of energy goods increased by 32.1%, in line with the evolution of the price of imported oil, which, measured in euros, increased by 33.2% on average in the first nine months of the year, while the surplus of the non-energy balance decreased by 24.3%. **As a result, the increase in the trade deficit was 40.3%.**

The balance of tourism services reached a surplus of 33,314 million in the first nine months of 2017, 11.2% above the same period of the previous year and that is possible thanks to the 11.8% growth in tourism revenues, while the expenditure made by foreign tourists, according to the Tourism Expenditure Survey (EGATUR), increased by 13.9% year-on-year with tourist arrivals growing 9.2% year-on-year, eight tenths less than the previous quarter.

Payment entries for tourism as a result of the outflow of Spaniards abroad grew by 13.1% in the first nine months of 2017, a rate that represents an acceleration of 3 points compared to that recorded in the same period of 2016.

Meanwhile, the balance of primary and secondary incomes accumulated a deficit of 12,650 million euros in the first three quarters of the year, 8% lower than that recorded in the equivalent period in 2016. And this was possible thanks to the 0.5% increase in revenues and the 1.4% drop in payments for this concept.

The financial account, on the other hand, accounted for net capital outflows of 22,731 million euros in the first nine months of 2017, compared to net outflows of 1,230 million in the same period of 2016. Excluding the Bank of Spain, there were net capital outflows of 60,270 million euros in the months up to September, representing 7% of GDP, compared to the net outflows of 43,020 million registered a year earlier, a result that includes positive balances (investments) in asset and liability operations. This increases both foreign investment in Spain and Spanish investment abroad.

Finally, the net debit position of the Bank of Spain increased compared to the Eurosystem (mainly due to the reduction of 34,433 million euros in assets compared to the Eurosystem) and the debit balance of the Net International Investment Position (NIIP) increased by 19,067 million euros up to 983,100 million euros, equivalent to 86.2% of GDP, a percentage 1.5 points lower than in the second quarter of 2016. On the other hand, gross external debt rose to 1,925 billion euros (168.6% of GDP) in the second quarter of 2017, compared to 1,880 billion euros in the same period of 2016 (170.9% of GDP), although it increased with respect to that recorded at the end of 2016 (167.5% of GDP).

Public sector

The deficit of the Public Administrations as a whole in September reached 2% of GDP if local corporations are excluded. This implies that there is a high probability of meeting the deficit target at the end of the year.

In the months up to September, the Public Administrations accumulated an adjustment of 1.2 percentage points of the total of 1.3 percentage points needed to reach the deficit target of 3.1% in 2017.

By administrations, the State deficit, with data up to October, decreased to 1.1% of GDP compared to 2% in the same month of the previous year. The balance of the Autonomous Communities also improved, with a surplus of 0.1% of GDP in September, compared to a deficit of 0.2% in the same month of the previous year. Social Security, meanwhile, registered a deficit of 0.6% of GDP in September, equal to that seen in September 2016.

Despite the improvement in the adjustment of the public balance, public debt remains high. Thus, in the third quarter it stood at 98.6%, close to the maximum of 100.7% in the third quarter of 2016 and well above pre-crisis levels and the historical average of the Spanish economy. This forces us to avoid complacency and continue making fiscal consolidation efforts.

As the Independent Authority of Spanish Fiscal Responsibility (AIRef) states, the good performance of tax collection, both taxes and contributions and, above all, the containment of public expenditure, have increased the probability of ending 2017 with a deficit of 3.1% of GDP, in line with the target set by the Government.

In terms of fiscal policy, and in light of what may be a scenario of progressive normalisation of monetary policy by the ECB, it becomes more important for the country to meet the deficit targets during 2017 and 2018. By the time monetary normalisation arrives, it would be desirable for the sovereign rating to have regained some of the ground lost during the crisis as to avoid a rebound in financing costs.

Our forecasts point to annual growth of 3.1% for 2017.

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2017-2018 scenario: sustained growth

The Spanish economy will experience a gradual deceleration in the coming quarters that will lead it to register growth of 2.5% in 2018, more than half a percentage point below the growth with which it will probably close 2017.

At the beginning of the year the expected deceleration of GDP was the result of several factors that are not favourable and could contribute negatively to GDP growth in 2017. On the one hand, the rising price of oil would raise the costs of the Spanish economy and reduce income for consumption or savings. The gradual rise since June has been 42% and this month has reached annual maximums, reaching an average of 18.5% above the levels reached a year ago. However, its effect has been partially neutralised by the strength of the euro, which appreciated by 14.5% since the beginning of the year. Since September the euro has depreciated close to 1%. Despite the gradual rise in the price of oil, much more on average in the fourth quarter, private consumption has grown at a good pace, which should favour a slightly higher increase in household spending.

On the other hand, the sharp and rapid rise in interest rates did not occur in the end. The long-term interest rates referenced by the Spanish 10-year bond will end the year at around 1.5%, a very low level in historical terms, convenient to manage and facilitating growth.

The Spanish economy continues to benefit from the strong competitiveness adjustments of recent years, the extraordinarily low interest rates and the still relatively low oil price. With annualised growth that could be around 3% in the fourth quarter, the macroeconomic data are very positive. Thus, confidence data are at high levels, industrial production, the services sector, tourism and exports have been giving positive surprises and PMIs are again showing positive behaviour. Prospects for the real estate sector are equally clearly positive.

Furthermore, the leading indicators of the fourth quarter, such as car sales or overnight stays of residents in hotels maintain a high rate of growth. With regard to investment in equipment, these indicate a continuation of the expansive state, although less intense than in the third quarter. The confidence of employers also decreased in the last quarter of the year.

All this would allow growth to reach 3.1% in 2017, with the importance of domestic demand being slightly lower than that observed in 2016, offset by the greater contribution of external demand, which would reach a contribution to growth of 0.5%. A slightly lower rate of job creation and a higher average price per barrel of oil in 2017 will be the main factors responsible for slowing the progress of private consumption. The opposite is true in the case of investment, which we expect to increase up to 4%, almost one percentage point more than in 2016. The stagnant demand for investment pending the formation of government, the favourable financial conditions and the good performance of GDP and employment will allow business investment in both capital goods and construction to advance faster than it did in 2016. Public consumption, on the other hand, has also moved up by around 1.1% year-on-year, three tenths above the previous year, and its growth will probably be even higher in 2018. The strong rate at which tax collection grows, especially VAT and IRPF, should allow for the target of the public deficit in 2017 of 3.1% of GDP to be reached.

The recent rise in oil and other commodity prices is expected to sustain overall short-term inflation. Subsequently, the slow decline in unused global production capacity should, to some extent, boost underlying inflation in the medium term. However, as the current oil futures curve anticipates that oil prices will remain very stable, we expect the future contribution of energy prices to inflation to be very limited.

The Consumer Price Index (CPI), published by the INE, rose in November to 1.7% albeit maintaining a level that is far from the figures seen at the beginning of the year. In any case, the price increase in Spain at the beginning of 2017 was, as we mentioned in previous reports, on top of a temporary increase in prices that would have more effect in the first half of 2017, with this being less in the second half of the year, although with the capacity to place the average inflation of the year at around 2%. There is a similar interpretation for the euro area in general, even though inflationary tensions should probably be higher in the central euro countries in the medium term, with much lower unemployment rates. It should also be considered that although the general trend of unemployment is clearly positive in the European Community (if the current pace of job creation is maintained, the unemployment rate in the euro area could fall to 8.5% by the beginning of 2018, which, despite being high compared to the US or Japanese economy, would put unemployment in the Eurozone at the pre-crisis average historical levels), the slack in labour markets is still noticeable when considering broader measures of underutilisation of labour.

According to the forecasts of major international organisations, the global economy will accelerate its growth by over 3% in 2017, 2018 and 2019. World trade has gained momentum since the summer and maintains a good inertia that favours, for the time being, the growth of the world economy. The intense recovery of world trade, which is already growing at the same rate as GDP, is probably the biggest change in 2017. It is appropriate to remember that 2016 began with a financial crisis due to the fear of a recession in China.

Over the last few months**,** increased global growth has translated into better performance in terms of business results. And, what's more, fixed income has been favoured by the moderation of inflation and, therefore, central banks have perceived it as being highly prudent.

However, it is not easy for this scenario of high growth and low inflation to be sustained over time. As idle capacity of the global economy continues to decline, wage and price pressures are bound to increase. This, in turn, will require a progressive reaction on the part of central banks in the form of a gradual rise in interest rates (nominal and real) and a reduction, also gradual, in the sizes of their respective balance sheets. This gradualism could be affected, in the case of the United States, by the impact of fiscal stimulus via tax cuts in an economy in a phase of solid growth.

In line with the above, the Federal Reserve has decided to gradually put an end to the process of quantitative expansion (QE). Furthermore, there was a rate hike in December of a quarter of a point, placing it above 1%. This is the fourth consecutive increase in a process of gradual tightening of monetary policy. The unemployment rate is at its lowest levels in the last 16 years. The historic tax decrease will be a new stimulus to the economy and has led the Federal Reserve to raise its growth forecast for 2018 to 2.5%.

The result of the low unemployment rate and of a fiscal stimulus plan of this magnitude should bring about a progressive acceleration of wages which would also tend to translate into progressive price pressures. Furthermore, the recent weakness of the dollar will tend to generate additional price pressures. If we add to this the protectionist profile of the current United States Government, everything seems to indicate that prices should rise in the world's leading economy, motivating successive new increases in the price of money.

The United States economy can expect solid economic performance for the coming quarters. The fundamentals of private consumption are still strong and corporate investment looks positive. The real estate sector, for its part, still has a significant margin for further expansion and the external sector should benefit from a weaker dollar, despite the likely appreciation following the withdrawal of stimulus announced by the Federal Reserve.

Unlike previous historical episodes, the tightening of monetary policy by the Federal Reserve should not affect emerging economies so severely. First of all, the implementation of stimuli withdrawal will be very gradual. Secondly, the macroeconomic fundamentals of most emerging economies are stronger than in previous periods. Finally, and recognising the high debt that these economies have held in a historical perspective, these countries are less vulnerable to the appreciation of the dollar due to the stability offered by both the general price levels, the result of the correct monetary policies implemented, and the prices of raw materials which are an important export asset. To this we should add the greater use seen in recent quarters of the local currency debt market, especially by foreign multinationals, which makes these emerging economies less dependent on dollar-denominated debt to finance their current account deficits.

Among the emerging economies, it is noteworthy the Chinese authorities' efforts to keep in order their banking system, where the threat of a major financial crisis is losing strength, despite the high levels of debt. However, private debt is at record highs and continues to grow. China maintained cruising speed in 2017 with growth close to 7%, but with a very significant change in its growth model. Exports and industrial production have ceased to be the engine, which is now private consumption and investment, especially in energy and the fight against pollution and climate change.

This change is especially reflected in their current account. In 2007, China had an external surplus of 10% of GDP and financed the US deficit (5% of its GDP). This is well-known as the superabundant savings that created the favourable environment for the international credit bubble which led to the Great Recession. In contrast, China will close 2017 with an external surplus close to 1% of GDP and shortly will have a deficit. Therefore, China has gone from being the factory of the world to one of its main demand engines.

On a European level, and with less political uncertainty within the European Union, the macro data in the Eurozone are really positive: growth almost doubles its potential, expansion benefits practically all countries and good news proliferates both in terms of domestic demand and exports.

Although in the euro area there are still appreciable levels of idle capacity, it has been rapidly decreasing. Unemployment decreasing at the same rate as last year is enough to make mid-2018 levels reach around 8%. This rate, in spite of being high in comparison with America, is below the average of unemployment in the area in the period previous to the crisis and is, therefore, a reasonable estimate of what could be the natural rate of unemployment of the European continent. And this, despite the fact that the unemployment rate most likely underestimates the levels of idle capacity in the Eurozone. Nonetheless, what is certain is that whatever the idle capacity may be, it is difficult to not see the output gap of the Eurozone closing in about a year and a half (knowing, moreover, that there are already countries like Germany boasting positive output gaps). This could have effects on the rise of underlying inflation to levels higher than expected today by the market.

The ECB, for its part, has revised downwards its inflation forecasts due to the appreciation of the euro. Monetary policy remains intact. Thus, a significant degree of monetary accommodation remains necessary for underlying inflationary pressures to increase and support general inflation in the medium term.

The perception is, therefore, that the underlying inflationary pressures are very contained. This explains why the favourable financing conditions are maintained in order to achieve their transmission to the financing conditions of households and companies and thus stimulate the demand of credit, which is insufficient given the current financial conditions, for the firm recovery of the economy of the Eurozone, as recently shown by the ECB survey of SMEs access of to financing. In recent months the deflationary component of the appreciation of the euro has been added, which with high probability has already conditioned the optimum moment for the withdrawal of stimuli. The euro has appreciated over the dollar more than 15% since the beginning of the year.

In order to ensure a sustained return of inflation rates to close to 2%, the Governing Council of the ECB has decided to keep the ECB's official interest rates unchanged and expects them to remain at current levels or lower for the foreseeable future, a timeline which will far exceed the horizon of net purchases of assets.

Our central scenario continues to be one of moderate reflation for the global economy, with central banks gradually normalising their monetary policies. Whether the correction of the yield curve is more gradual or more abrupt, whilst probably still remaining very flat, will depend on the level of prudence in relation to the needs of the economy. The probability of a significant overshooting of inflation targets will increase as monetary policies are relaxed in relation to observed price tensions. Should this occur, long-term interest rates may take longer to rebound but they will do so more strongly than currently discounted by the market.

In 2018 a deceleration of the GDP growth of the Spanish economy is expected to reach 2.5%, which is explained by a lower contribution of domestic demand and external demand, with the slowdown expected in the former being more intense. Exports of goods and services are likely to continue gaining market share but at a more leisurely pace, while imports would slow some growth in line with the lower expected growth in domestic demand. The contribution of national demand to growth would be lower than in 2017 (2.1% vs. 2.6%), given that the expected slowdown in household consumption by a somewhat slower pace than in job creation will not be offset by an increase in public consumption and by lower investment demand. In any case, the expected growth, although lower than in previous years, would bring the unemployment rate to levels not seen since the beginning of the crisis, specifically at 15.2%.

However, **uncertainty remains high due to various factors, including the design of US Administration policies and their effects on the economy of this country, as well as the effects of possible contagion on global activity**. To this should be added the possible financial tensions in some emerging economies and the gradual readjustment of the Chinese economy, given its high indebtedness, consumption and investment weakened by high levels of debt, a possible rapid rebound in inflation or the rise of protectionism.

In effect, a rather long-lasting credit expansion, usually accompanied by real estate price increases, points towards financial overheating in some emerging economies. A faster-than-expected rise in US interest rates would negatively affect those emerging economies with larger dollar-denominated debt. Meanwhile, in advanced economies, the main concern is in the medium term with the possible problems regarding fixing the imbalances of its financial system, especially in the Eurozone.

A protectionist drift in the coming years would affect the dynamism of current European exports. New episodes of appreciation of the euro are also a risk to consider as they would slow down the growth of the Eurozone.

The vulnerability of the Spanish economy to future rate hikes is another of the great risks that hang over the economy. The ECB's speed in stimulus withdrawal will condition the impact of monetary policy measures on the real economy. Although short term interest rates in the Eurozone have not suffered significant variations due to the European Central Bank (ECB) maintaining its policy of negative rates, this policy will probably be withdrawn in 2018.

The first impact will come in the form of long-term interest rate rises. It will affect companies more immediately, and this is worrying given the high financial vulnerability of the Spanish economy. At the same time, although it will take some time to affect interest payments on Public Administration debt, it will also end up affecting them.

Short-term interest rate increases will impact the Spanish economy because it is especially sensitive to increases in the Euribor given the high debt held by households, thus affecting the waterline of Spanish families.

To the aforementioned, we could also add a neutral fiscal policy as a third factor, something which derives from the limited fiscal margin in Spain. Fiscal policy has been another element that has decisively boosted GDP growth in the last two years. In 2015, the public deficit was reduced by 8 tenths to 5% of GDP (excluding losses from financial aid to banks), but in 2016, there was a seven-tenth adjustment. In both years, improving the overall economy would have entailed a larger reduction in the deficit had the fiscal policy been neutral. This fiscal boost to GDP growth of between 5 and 6 tenths in both 2015 and 2016 will not occur in 2017 because the fiscal policy will be practically neutral and the deficit will be reduced at a slightly higher rate than in the last two years and stand close to the target agreed with Brussels.

As far as fiscal policy is concerned, and given what may be a scenario for the ECB's gradual normalisation of monetary policy, the country meeting deficit targets will become more relevant during 2017 and 2018. By the time monetary normalisation arrives, it would be desirable for the sovereign rating to have regained some of the ground lost during the crisis as to avoid a rebound in financing costs.

The intervention of the ECB is key in the expansion of the Spanish economy, both via lower interest rates and in its work on financial stability, although the inflation rate still remains well below 2%. Unconventional monetary policies have also been decisive in the significant depreciation of the euro and its stimulating effect on exports in 2015 and 2016. Given that the impact of the exchange rate on the evolution of exports is not immediate, but rather the maximum effect normally takes place after approximately a year and a half, the significant appreciation of the single currency in 2017 could still affect the Spanish export sector in the first half of 2018 in all foreign sales directed outside the Eurozone.

Further progress in the process of European integration would make the Spanish economy less vulnerable when the withdrawal of monetary stimuli arrives and would significantly strengthen market confidence in the euro area economy.

The Spanish economy has more solid foundations than in previous years, with the economy growing at a strong pace, driven by both consumption and investment and exports.

Among the reasons for optimism in the future performance of the Spanish economy we could highlight the competitiveness achieved after the significant adjustment effort made by the companies in their unit labour costs (notably lower than the average of our partners in the Eurozone and which also have allowed for strong job creation), job creation that, in turn, makes the improvement experienced by the internal demand that began in 2014 sustainable and, finally, the radical change in the financing available as well as in the financing conditions since the European Central Bank decided to intervene and stop the risky episode of financial fragmentation and credit restriction that was being experienced in the Eurozone.

At the national level, attention must be drawn to the situation in Catalonia. After the celebration of elections on 21 December, the Catalan question remains unresolved. It is necessary to reach a political agreement that gives rise to a stable government in Catalonia and normalises the situation, otherwise it could generate a real risk of greater financial and economic instability.

Another risk for the Spanish economy is still complacency, given that long term challenges for both the economy and Spanish companies remain.

In the same way, policies which boost productivity growth are crucial, bearing in mind that having larger companies gives access to better financing instruments and conditions, as well as to foreign markets and cost reductions through better use of economies of scale. Finally, achieving high rates of GDP growth requires greater competition in the goods and services markets, the design of independent and inclusive institutions, and the improvement of human capital and the consensus on essential aspects of education in order to cope with global education revolution.

The economy has a unique opportunity to face unforeseeable political and economic reforms. The time to do so is today when many (if not all) winds blow in favour (a more competitive economy, debt buying by the ECB and optimal financial conditions, advanced financial rehabilitation), allowing the necessary time to be gained to facilitate the task.

Annual forecast for the Spanish economy.

Table 1. Annual forecasts.

(% annual average change, unless otherwise indicated)

	2017	2018
Real GDP	3.1	2.5
Final household consumption	2.5	2.0
Final Public Administration consumption	1.2	1.6
Gross Fixed Capital Formation	3.9	2.6
- Machinery and capital goods (1)	4.9	2.0
- Construction	3.3	3.2
Stock variation (contribution to GDP growth in pp)	0.0	0.0
National demand	2.6	2.1
Exports of goods and services	6.1	4.4
Imports of goods and services	4.6	3.1
Underlying CPI (annual average)	1.2	1.5
Total CPI (annual average)	2.1	1.4
Labour costs per worker (2)	1.0	1.2
Employment (National Accounts) (3)	2.7	2.0
Unemployment rate (EAPS, % of active population)	17.0	15.2
Balance of payments current account balance (% GDP) (4)	1.5	1.0
Financing capacity (+) or requirements (-) Public Administrations **excluding aid to financial institutions** (% GDP)	-3.1	-2.6

(1) Includes GFCF regarding transportation and other machinery and capital goods. (2) Average remuneration per employee in equivalent to full-time employment. Comprises gross wages received by employees and contributions to Social Security. (3) Full-time equivalent jobs. (4) According to estimates of the Bank of Spain.

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