FOCUS

Quarterly Bulletin on Economic Situation and Prospects

No. 6 / December / 2016

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QUARTERLY BULLTIN ON ECONOMIC SITUATION AND PROSPECTS.

Executive Summary.

The national accounting data confirm **that the Spanish economy experienced Quarter-on-Quarter (QoQ) growth of 0.7% in the second quarter of 2016**, thanks to the notable contribution of domestic and foreign demand. This means that the Spanish economy boasts a growth rate doubling that of the Eurozone. GDP experienced Year-on-Year (YoY) growth of 3.2%.

It is worth mentioning the **dynamism** of the **private consumption** indicator (+0.6% QoQ), which has been benefiting from the increase in purchasing power of domestic economies and job creation, falling energy prices, and improved financial conditions for months. In the third quarter, public consumption joined private consumption with a rise of 1% QoQ, an increase far superior to that of the second quarter.

Domestic demand was also boosted by **equipment investment**, which grew a modest 0.1% QoQ, showing a significant slowdown after its enormous strength in the first half of the year, especially in the second quarter and via the investment in capital goods.

In the third quarter of 2016, according to the quarterly national accounting statistics, **the foreign sector contributed 6 tenths to the interannual variation of GDP,** while the contribution of domestic demand was 2.6 percentage points.

In line with GDP growth, **the number of those in work**, in terms of full-time equivalent employment, **grew 2.9% YoY in the third quarter of 2016.**

In 2016 our central scenario showed that the domestic demand continued expanding, albeit at a more moderate rate, and that net foreign demand was increasingly more positive for GDP growth, which is estimated at 3.2%. In contrast with the second quarter, when growth was more balanced, the slowdown of domestic demand growth was compensated with a greater contribution from the foreign sector.

The good behaviour of exports in the first semester was not continued in the third quarter, fundamentally due to the stagnation seen on a global scale. The value of the euro fell by 1.1% against the dollar and 6.5% against the yen in the first eleven months of the year, although its value grew 15.8% against the pound sterling, a circumstance very much influenced by Brexit.

The statistics of the Spanish economy gain even greater value when compared to the slowdown of the Eurozone economy (0.6% in the first quarter against 0.3% in the second and third). The slowdown of GDP growth in France and Germany (0.2%) in the third quarter is worrying, as it is 0.5 and 0.4 percentage points lower than at the beginning of the year.

The risks for the perspective growth in the Eurozone remain downwardly biased due to, among others reasons, the result of the referendum in the United Kingdom (a result which adds further uncertainty to the European project) and to other geopolitical uncertainties such as those derived from the "no" to the reform of the Italian constitution and the elevated political uncertainty regarding the French elections in April and those in Germany in September. Regarding the Spanish economy, the situation in Catalonia should also be taken into account.

Private consumption should continue growing at a notable rate in the fourth quarter of 2016 thanks to the steady rhythm of job creation shown by the statistics from the Social Security office in October regarding those in employment. Although the figures from November are disappointing, it is true that, on the whole, the number of those in regular employment is far greater than in the equivalent period in 2015. To this we can add the still relatively low price of petrol (although this experienced strong growth in December), price containment and lax financial conditions.

Household final consumption expenditure kept growing in the third quarter, in nominal terms, at a lower rate than that of salaries, something which could suggest an increase in household savings.

Households have continued with the deleveraging process which began in 2010, shifting from representing 70.9% of GDP in the second quarter of 2015 to 66.7% in the same period of 2016.

Following a 2015 year marked by contribution to investment, and a seemingly contradictory start to the year, investment, having maintained a strong growth rate in the second quarter, barely grew in the third (0.1%). This is partially compensated by the increase in public consumption, which grew 1% YoY, a rate at which it hadn't grown since the first quarter of 2015.

The investment downturn is more evident in investment in capital goods than in investment in construction. Furthermore, in terms of capital goods, it is worth distinguishing, after two quarters of very similar QoQ growth, the fall in machinery (-0.6%) against the acceleration in the growth of capital goods related to transport (2.3%).

Advanced indicators from the fourth quarter show signs of a return to growth in business investment, as we will explain in the *Growth forecasts for the Spanish Economy* section, **but this is yet to be confirmed**. This is key to maintaining the virtuous cycle seen with exports, investment, job creation and the increase in private consumption in areas which boost improvements in productivity and reduce foreign debt.

Productivity is practically stagnant. The Spanish economy has suffered a greater salary adjustment since the beginning of the crisis, which means that the increase of 0.8% in the third quarter is permissible for some businesses whose productivity increases are not proportional, since business margins have been more generous in recent quarters.

After consolidating its slow recovery in the first semester of 2016 with a growth of 20% in terms of sales and an increase in prices of 4%, slightly stimulating the construction of new homes and the creation of employment in the sector, the Real Estate market remained active in the third quarter, although the price of houses contracted slightly (-0.4% YoY), so, in this regard, its improvement slowed to 1.6% (2% in the second quarter). In October, the buying and selling of housing fell 1.7% YoY against the strong 13% increase thereof in September. The average price shows a growth of 1.5% in October, according to the General Council of Public Notaries.

Regarding the tourism sector, it is noteworthy that Spain received 7.1 million international tourists in October, an 11% increase when compared to 2015, according to provisional data from the Frontier Tourist Movement Survey (FRONTUR) published by the Spanish national statistics office (INE).

The inertia of private consumption remained strong, so this will remain a growth factor for GDP in the fourth quarter of 2016. The still strong rhythm of job creation, the fall in prices and the easy access to credit facilitate household consumption. Consumption also remains resistant thanks to the stabilising of the price of petrol. However, this will lose strength throughout 2016 and 2017, after the strong growth recorded in December.

On the other hand, both the strong increase in the price of crude oil seen in December and the policies brought in by the ECB diminish, practically definitively, any deflationary risks. As long as the economic growth in Europe continues, as expected, above its potential, the economy is most likely to tend to a progressive upturn of the underlying inflation over the next months.

At the same time, **the increase and stabilising of the price of crude oil should contribute to the tendency of general inflation, approaching the underlying inflation in coming months**. In certain countries of the Eurozone with low unemployment, the vibrancy of wages should put upward pressure on prices. Even in Spain, and with the improvements in the income statements of a large number of companies, the increases in salaries, although slow and progressive, should contribute to the greater distribution of wealth generated, involving workers in this strong growth period. Companies, once having decided on the optimal distribution of these profits and their investment needs to strengthen technology, equipment and human capital, should also have available funds to compensate the effort made by their workers throughout the crisis. This increase in inflation due to costs will also facilitate the deleveraging process of the Spanish economy. For the moment, **the Consumer Price Index (CPI) increased in October and November by 0.7% YoY,** following the 0.2% registered in September, according to data published by INE. This year-on-year increase in CPI is due to the behaviour of the price of energy products, which grew for the first time since June 2014. On a month-on-month basis, CPI increased 1.1% in October, 5 tenths more than the same month in 2015.

The following conditions have continued being very favourable for investment decisions: a more advanced deleveraging process, good trends in demand, low interest rates, and the use of productive capacity.

Nonetheless, in relation to businesses, note should be made to **the lower growth in credit in the SME segment in the third quarter** (taking as a proxy these credits being less than one million euros) which experienced a slight rise of 0.2% YoY, while YTD growth as of October was 2.8%. **Among possible explanations there is the lower demand for credit, as seen in the Survey of banking loans elaborated by the ECB**, but also the means of self-financing for SMEs due to accumulated savings from previous periods and interests to reduce financing from banks after having experience how painful it can be for a business to lose its financing from the bank in hard times. In the case of new operations greater than one million euros (those pertaining to large companies), the fall in credit for these companies was 40.9% in the third quarter, an event which coincided with the pivotal moment of the issuance of corporate bonds by these companies, especially after the news that the ECB was going to include corporate bonds in its Quantitative Easing scheme. Lastly, and within the public sphere, the debt of Public Administrations, according to the Excessive Deficit Procedure (EDP), was situated at 99.5% of GDP in October, having previously decreased 0.39% from 100.3% at the end of the third quarter. Everything appears to indicate that the Government, following the measures taken, will meet its public deficit objective in 2016.

At the end of October and the beginning of November, two new governments came into power in both Spain and the United States. In the case of Spain, **the government represents a minority where decision making will be slower and require negotiation and dialogue.** And this at a time when it is all the more necessary to push through changes and reforms which need high-mindedness and with questions on the table such as that of Catalonia. And there is the real risk that all this could lead to a very short or extremely inefficient legislature.

The Republican victory in the United States elections raises political risk, at least in the short-term, due to the existence of many important contradictory and disjointed proposals in Donald Trump's economic plan, mixing a Keynesian increase in public spending with a more liberal reduction in taxes, His clearly protectionist ideas with regard to relations with the rest of the world may be the element which introduces greater vulnerability to the weak and slow recovery of the global economy, as highlighted by the European Central Bank (ECB). This **protectionist threat** will serve, therefore, to ballast yet further the already difficult moment in which international trade finds itself and could mean **a turning point in the globalisation process** which the world economy has experienced during the last 40 years.

The problem is that greater uncertainty for the global economy will negatively influence the prospects of consumers and investors. The expansive fiscal policy would eventually have expansive effects which, albeit short-term, could set off a strong correction in the bonds market, as has already happened, due to its potential effects on inflation and public debt. **The correction in the bonds market on an international level has been fast and important.** In the case of the 10 year Spanish bond, it has gone up by 30 basis points, in line with those levels reached in June following Brexit, conditioning, in this way, the cost of financing the Treasury; **nonetheless, 2016 will close with an average interest rate for public debt at its lowest in history, less than 3% for the first time.**

Furthermore, the increase in profitability responds to the growing expectations for price increases which could oblige the Federal Reserve to normalise their monetary policy at a faster rate than desired, negatively influencing global financial stability, especially that of numerous emerging economies, above all those which have taken loans in dollars, since the American dollar has appreciated continuously against any other currency and it is likely to carry on in this fashion. In the December Federal Reserve meeting, the decision was taken to raise the interest rate to 0.75% and the euro fell to annual minimums against the dollar, depreciating more than 4% since the Republican victory, almost reaching parity.

This took place when, for the first time in recent years, the deterioration of prospects for developed countries was being compensated by an improvement in the prospects of emerging economies**.** The delay in the raising of interest rates in the USA and the recent stabilising of the prices of raw materials have allowed for certain optimism with regard to the emerging world throughout 2016, something which should be confirmed in the next few months in accordance with those agreements reached by the Organization of the Petroleum Exporting Countries (OPEC). Furthermore, with a growth greater than that expected in China and India and a slowing down of the falling GDP of Brazil and Russia.

The greatest risk for the Spanish economy is still complacency, given that long term challenges for the economy and Spanish companies remain. It is still necessary to introduce forms of reducing its short-term nature and drive employability in the labour market, policies which foment the creation of quality job roles and help to reduce inequality, something which has been amplified in Spain by years of crisis. Similarly, policies which drive productivity growth and a greater average company size are essential, just as a greater competition in the goods and services market and improved human capital. Finally, the reduction in net foreign debt, the advancements in the process of consolidating public accounts and the creation of employment are essential improvements to the macroeconomic picture.

Spain has a unique opportunity to face urgent political and economic reforms. The moment is favourable due to having a more competitive economy, which is growing well and has the enormous temporary support of the European Central Bank (ECB), which allows them to make time and facilitates the task.

In their last meeting, the president of the **ECB** hinted that, regarding non-conventional monetary policy measures, **it is foreseen that monthly bond buying will continue until the end of December 2017, or until a later date should it be necessary.**

The international context is more unpredictable (protectionist pressures, a new US president, Brexit, rejection of the constitutional reform in Italy, elections in 2017 in France, the Netherlands and Germany) and political risk increases, as we pointed out in the second part of the report on the *2016-2017 Scenario*, and requires greater prominence of the internal means for the economic recovery. The forecasts point to weak growth in the European markets, the main destination for Spanish exports. In any case, Spanish companies have improved their competitive positioning in terms of salary. In recent years, salaries have been reduced in comparison to other countries in the Eurozone, minimising the gap created during the real estate bubble. The average wage per hour worked is situated at around 10 euros whereas this reaches 15 euros in the Eurozone.

Ultimately, the problem with the Spanish economy is still, therefore, low productivity and low salaries because they make it more difficult to reduce the deficit and public debt.

The pact agreed upon to increase the interprofessional minimum wage 8% by 2017, to reach just over €707 per month, will slightly reduce inequality, the major imbalance of the Spanish economy, something which is mainly rooted in Spain's high unemployment. The impact of an increase to the minimum wage on employment remains to be seen; it may not even be significant, and arrives, on the contrary, at an opportune moment given the need to compensate for the probable fall in foreign demand, in light of the difficult international environment, with greater domestic demand, both by the creation of employment as well as the remuneration thereof. However, the empirical evidence suggests that an increase to minimum wage is unlikely to significantly translate to the rest of salaries.

The latest available economic indicators anticipate GDP growth of 0.6% in the fourth quarter, which will close 2016 with year-on-year growth of 3.2%, as we have anticipated for some months. Nonetheless, this does not contemplate a lowering of personal income tax to increase the disposable income of families and thus increasing private consumption in 2016, and includes an expected rise in alcohol, tobacco, soft drinks and gasoline taxes in 2017, which will drain 0.1% of GDP, to which we also add expected inflation of close to 2% and meagre nominal wage increases, close to 1% with real wages losing about 1% of their purchasing power. If the year-on-year growth rate of private consumption began its progress in the first quarter by expanding to 3.4%, this could end 2017 growing at 2% YoY. This fall in domestic demand will translate to a slower rate of job creation and less investor enthusiasm on the part of companies, which will decelerate GDP growth in 2017.

And the risk is financial, due to Spain's elevated foreign debt. What will happen when the ECB stops buying Spanish public debt, foreseeable at the end of 2017?

The risk thus lies more in 2018. 2017 should give rise to deceleration which could start to be noticed in the second half of the year. Nevertheless, the growth in investment and exports, as well as the still positive trends for private consumption, consolidate the growth inertia of the Spanish economy, which, despite slowing in 2017, could grow in the region of 2.5%, as explained in the last part of the report.

Global scenario

2017 outlook

2016 began with fear of a recession in the USA and the world and a severe financial crisis in China which affected global stock markets. The USA grew around 3% again in that quarter and created 200,000 jobs per month in the fourth quarter, steering clear of the threat of recession. In China, the uncertainty regarding the sustainability of the change of the growth model and its effects on the solvency of the banking system continues but the perception of risk for international investors has diminished.

For 2017, forecasts anticipate growth for the world economy of around 3%, similar to that of 2016. And the outlook is that world trade will growth less than GDP due to the process of globalisation and trade integration having stopped making progress. Russia and Mexico have joined the OPEC production cut-off agreement and in 2017 will put 1.5 million barrels a day less on the market. Forecasts predict oil prices to be at $60, significantly above the 2016 average.

But the main uncertainty in the world is the new president of the United States. He has not yet fully taken the helm and has already divided American society in a way not known since 2001. He has called into question Barack Obama's eight year search for new global consensus, provoking several diplomatic crises, mainly with China, Mexico, and Asia by rejecting the TPP, and with Europe, stopping the TTIP. Donald Trump has nominated three Wall Street bankers for positions of responsibility that call into question the current financial regulation, an Energy official opposed to the thesis of climate change, and a Secretary of State linked to the oil sector and with connections to Russian President, Vladimir Putin; he also has suggested that the Federal Reserve acts for political interests and has declared that the zero-rate policy has caused a big bubble in stock markets.

The investment plan promised by Trump requires private participation, like the Juncker Plan, and is not expected to have much impact on GDP. The Fed will continue to raise rates throughout 2017 and the ECB will continue buying €60 billion of bonds per month until at least December 2017. Therefore, it is most likely that the dollar will continue to appreciate and we will see it trading below parity against the euro.

In the Eurozone, with weak world trade and the highest oil price, the most likely scenario is lower GDP and employment growth than in 2016. The Commission presented a public investment plan of 50 billion, 0.5% of GDP, supported by the ECB and the IMF, but rejected by the Eurogroup. But the biggest uncertainty will be political, with elections in France in the spring and fears of a victory by Le Pen, who aims to get France out of the euro. The instability in Italy with a weak government and a banking system without sanitation. And elections in Germany in autumn with the re-election of Merkel uncertain due to the advance of the xenophobic party, Alternative for Germany. The most likely scenario is that Le Pen does not win the election, but the uncertainty is still high.

The ECB holding in place its bond buying scheme is an assurance of financial stability for Spain, whose economy has high levels of foreign debt and where GDP and employment will continue to rise. But with the Eurozone growing less and world trade being weak, exports will suffer. And with the higher oil and a contractionary fiscal policy, tax increases and spending cuts, especially in public investment, the growth of domestic demand will also be lower.

Growth prospects for the Spanish economy.

The expansionary phase of the Spanish economy that began in the third quarter of 2013 will continue at a good pace in the coming months.

Third quarter national quarterly data confirmed the strong performance of economic activity, experiencing quarter-on-quarter growth of 0.7%, slightly lower than in the second quarter, as anticipated in our previous bulletin. Growth was much more balanced than in previous quarters, with the contribution of both domestic demand and positive foreign demand. Due to the strong growth in domestic demand, which contributed 2.6 percentage points to annual GDP growth, the dynamism of foreign demand in the third quarter increased by 0.6 percentage points, with the contribution of the foreign sector being positive for the second consecutive quarter following three quarters of negative contributions.

According to our forecasts, the Spanish economy will grow by 3.2% in 2016, matching the good record of 2015, a behaviour typical of a consolidated phase of the cycle, although, as we were warning, **the economy will show a gradual deceleration during the second semester (which will continue throughout 2017) due mainly to the slowdown in international trade and the gradual disappearance of some tailwinds, such as the drop in the price of oil, which seems to have stabilised slightly at over $50 after OPEC intervention and the impact of a more restrictive fiscal policy.** In any case, the medium-term outlook remains favourable and, by 2017, the progress of the economic activity is likely to be around 2.5%.

In the third quarter, domestic demand strengthened its position as the main driver of growth, thanks to private and public consumption, taking over investment, an element that had been decisive in the second quarter.

Private consumption grew 0.6% QoQ in the third quarter of the year, slowing its growth by one-tenth compared to the second quarter and dropping two tenths when compared to the growth rate at the beginning of the year.

The improvements to the labour market and financial conditions continue to favour the situation of households, which, in turn, allows for the prolongation of the favourable pace of consumption growth and the process of household deleveraging.

We must add the almost **stagnant investment (0.1% QoQ)**, all of which was partially offset by the increase in public consumption, which grew at 1% QoQ, a rate at which it had not grown since the first quarter of 2015.

The investment downturn is more evident in investment in capital goods than in investment in construction. Furthermore, in terms of capital goods, it is worth distinguishing, after two quarters of very similar QoQ growth, the fall in machinery (-0.6%) against the acceleration in the growth of capital goods related to transport (2.3%).

The real estate market, meanwhile, remains active, although in the third quarter housing prices contracted slightly in quarter-on-quarter terms (-0.4%), thus, in year-on-year terms, its development slowed to 1.6 % (2% in the second quarter). In October, the buying and selling of housing fell 1.7% YoY against the strong 13% increase thereof in September. The average price grew in October by 1.5%, according to the General Council of Public Notaries.

Exports stopped growing in the third quarter (3.1% QoQ in the second quarter), dropping by 1.3% QoQ, with services more affected than goods by the halt in international trade. This growth is not homogeneous because, while sales outside the European Union, according to data from the Tax Agency, fell by 0.4% YoY in the period up to October, sales to partner countries of the Union grew by 3.2%.

The current account balance accumulated a surplus of €14,046 million, significantly higher than that reached in the first half of 2015 (€7,690 million). This has been possible thanks to the increase in the surplus of goods and services and to the moderation of the deficit of primary and secondary incomes.

In the fourth quarter, leading indicators, such as the foreign sales of large companies in October, seasonally adjusted, deflated and calendar-adjusted, show a 1.1% increase in September, whereas foreign sales throughout the third quarter in relation to the previous quarter fell 0.5% and grew 0.1% in September.

Also in positive terms, it should be noted that, once again, the good performance of **the sales of capital goods and software of large companies,** seasonally adjusted, deflated and calendar-adjusted, grew in October at the fastest rate seen in the last fourteen months (3.3 %). This is an indication of a possible improvement for this variable in the fourth quarter and a very positive sign of the dynamism of the sale of these types of products abroad by Spanish companies.

However, there are other indicators that generally point to a less expansive tone in the last quarter of the year. The qualitative indicator of the investment goods climate registered a positive balance in the period October-November, although this was 3.2 points lower than in the third quarter, and the degree of utilization of the productive capacity of investment goods gained almost two points to 81.7% in the fourth quarter.

With regard to employment, its good pace of job creation held true in the third quarter and showed a business vitality that has been progressing favourably for some quarters. According to national accounting data, full-time equivalent employment growth was 0.8% QoQ in the third quarter, a year-on-year increase of 2.9%. During the month of November, there were about 3.8 million unemployed people, that is, 24,800 more than in the previous month. Unemployment rose in seasonally adjusted terms. During October, its progression was very positive. It is too soon, therefore, to determine whether the bad data for November will lead to a change in trends. In any case, the greatest impact has been observed on those under 25 years old. From the analysis of those registered in the Social Security office, it can be concluded that November was also a bad month.

The main indicators seem to suggest that economic activity will continue strong in the fourth quarter and that Spain will continue to lead growth in the Eurozone, aiming at quarter-on-quarter GDP growth of around 0.6%. The PMI Composite Index of Global Activity, according to Markit, increased in October and November by 0.3 and 0.8 points, respectively. The manufacturing PMI index for Spain stood at 54.5 in November, higher to that of the Eurozone and 1.2 points higher than in the previous month.

The improvement is mainly explained by the acceleration of new orders, causing the hastening of pending orders to meet demand, which in turn generated a slight decrease in stocks of finished products. Meanwhile, the Business Confidence Index, prepared by INE, increased 0.2% in the fourth quarter, compared to 0.5% in the third quarter.

Among the qualitative indicators for the Spanish economy, the Economic Sentiment Index, which is produced by the European Commission, advanced eight tenths in November compared to October, to 108.4, the highest so far this year. This result includes improving confidence in all its components, except in retail, where it has worsened. The favourable differential for Spain increased one tenth in November to stand at seven tenths.

Among **the indicators related to private consumption,** it is worth noting the increase in car registrations in November, according to ANFAC, of 13.5%, insisting on the fact that it is resuming the path of double-digit progress interrupted in October and that was the best November since 2007. In the first eleven months of the year, an average annual increase of 11.1% was accumulated, compared to a growth recorded in 2015 of 20.9%. With regard to the general retail sales index, calendar corrected and deflated, it held month-on-month negative growth of -0.1% in October, following the increase of 0.5% in September.

Regarding the **tourism sector**, it is noteworthy that Spain received 7.1 million international tourists in October, an 11% increase when compared to 2015, according to the provisional data from the Frontier Tourist Movement Survey (FRONTUR) published by INE.

After moving to positive ground last September, inflation accumulated increases of 0.7% YoY in October and November, strongly influenced by the rise in oil prices. The accumulated fall in the first eleven months of the year was 0.4%.

The inertia of private consumption remained strong, so this will remain a growth factor for GDP in the fourth quarter of 2016. The still strong rhythm of job creation, the fall in prices and the easy access to credit facilitate household consumption. Consumption also remains resistant thanks to the stabilisation of the price of petrol. However, this will lose strength throughout 2016 and 2017 following to the strong growth recorded in December.

Lastly, and within the public sphere, the debt of Public Administrations, according to the Excessive Deficit Procedure (EDP), was situated at 99.5% of GDP in October, having previously decreased 0.39% from 100.3% at the end of the third quarter.

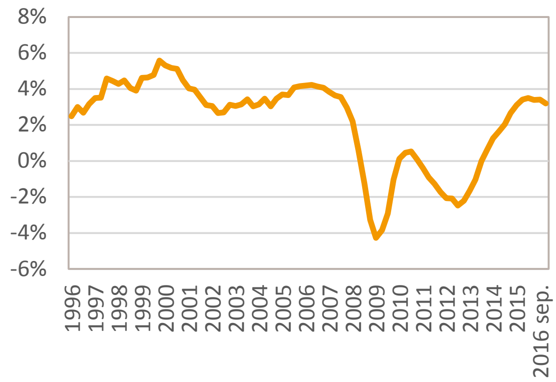
Demand is essential to boost business investment and, thus, prop up recovery. The situation is favourable with respect to the other main investment determinants (business surplus and access to credit under favourable conditions). So far companies have invested nearly €39,000 million abroad. That is 11 billion more than foreign investment in Spain.

Demand and production

According to the results of the National Quarterly Accounts (NQA), published by INE, real GDP, calendar and seasonally adjusted, recorded quarter-on-quarter growth of 0.7% in the third quarter of 2016, four tenths more than the Eurozone and one tenth lower than in the previous three quarters. On a year-on-year basis, GDP grew by 3.2%, two tenths less than in the first and second quarters of 2016. This is a continuation of the consolidation of the Spanish economy's recovery process, which closed 2015 with annual growth of 3.2%, more than double that of 2014 (1.4%) and the highest since 2007.

Nevertheless, our forecasts point to a progressive slowdown in GDP growth, down to 2.5% in 2017, although we expect that the slowdown will not affect 2016, with the GDP growth estimate holding at 3.2%, equal to the growth experienced in 2015. This 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 drop in the price of oil, the depreciation of the euro, or some budgetary stimuli. The lower momentum of these factors should be offset, partially and in the medium term, with the gradual improvement of export markets, as happened in the second quarter of 2016, a task that seems arduous and complicated for the coming quarters, resulting mainly from the stagnation in international trade.

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

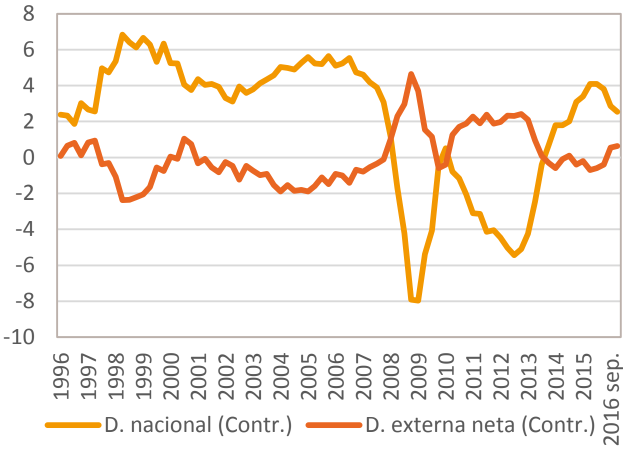


Source: QNA.

By components, economic growth continues to be supported by domestic demand, the main driver of growth, although its contribution to year-on-year GDP growth was reduced for the third consecutive quarter, standing at 2.6 percentage points, three tenths less than the previous quarter. The contribution of net foreign demand was positive, as it was in the second quarter, reaching 0.6 percentage points, one tenth more than in the previous quarter, after three quarters of negative contributions. This is a more balanced composition of growth, with greater importance on net foreign demand and a lesser contribution to the growth of domestic demand, highlighting, on the one hand and positively, the gradual moderation of the energy of private consumption and, on the other hand and negatively, the weak growth of business investment and the increase in public consumption in quarter-on-quarter terms.

With regard to employment, its good pace of job creation held true in the third quarter and showed a business vitality that has been progressing favourably for some quarters. According to national accounting data, full-time equivalent employment growth was 0.8% QoQ in the third quarter, a year-on-year increase of 2.9%.

Figure 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, driven by strong job creation. Real expenditure on final consumption of households and non-profit institutions serving households (NPISH), in volume, grew by 2.8% YoY in the third quarter, four tenths lower than in the previous quarter. **In quarter-on-quarter terms, the progression of private consumption (consumption of households and non-profit institutions serving households) stood at 0.6%, one tenth lower than in the previous quarter.**

The favourable evolution of private consumption can be explained by strong job creation, price moderation and improved access and conditions of financing.

The most relevant indicators, both qualitative and quantitative, signal to the expansionary path of private consumption growth being maintained in the fourth quarter of 2016, albeit at a more moderate rate.

Private consumption continued to grow in the third quarter, in nominal terms, at a slower rate than employee remuneration. Failing to have the full accounts of the institutional sectors, this could be pointing to an increase in household savings.

Also noteworthy is the behaviour of public sector final consumption expenditure, both in volume and year-on-year terms, with acceleration of six tenths in the third quarter of 2016 to 1.4% YoY, while quarter-on-quarter growth for public consumption was 1%, after the 0.6% fall observed in the second quarter.

Fixed capital investment, on the other hand, saw a year-on-year increase of 3.1% in the third quarter of 2016 thanks to the energy of capital goods investment (4.9%) and growth in investment, both in construction and in intellectual property products, with respective year-on-year growth of 2% and 2.6%. In the second quarter, investment grew by 0.3% QoQ, four points lower than the previous quarter. This slowdown is due to the loss of energy in the investment in machinery and equipment, which recorded a fall in the quarter of 0.3%, as opposed to transportation capital goods that grew strongly by 2.3% QoQ.

Construction investment maintained its pace in the third quarter, situating itself at a year-on-year rate of 2%, and 0.2% QoQ, both in residential and other construction segments.

The relevant indicators related to residential investment provided mixed signals. Thus, the number of sales and purchases of housing continued to grow strongly in September, although more moderately than the previous month, noting a year-on-year increase of 13.2%, 7 points lower than in August. The number of housing mortgages accelerated in September by 3.6 points compared to the previous month, with a year-on-year variation of 10%. Finally, according to statistics from the Ministry of Public Works, the price of housing continued the trend of year-on-year growth which started at the beginning of last year, with a price rise in the private housing market of 1.6% YoY in the third quarter, reaching 1.8% in real terms.

The following conditions are still very favourable for investment decisions: a more advanced deleveraging process, good trends in demand, low interest rates, and the use of productive capacity.

Foreign demand

In the third quarter of 2016, according to figures from the National Quarterly Accounts (QNA), the foreign sector contributed a tenth to the quarter-on-quarter change in GDP, after having contributed six tenths in the previous quarter, as a result of a fall in the exportation of goods and services (-1.3% QoQ) to less than that of imports (-1.8%), all of which after registering positive flows of 3.1% and 2%, respectively, in the second quarter of 2016. Compared with the main economies of the European Union, the quarter-on-quarter rate for Spanish real exports was lower than that for Germany (-0.4%), France (0.6%) and the United Kingdom (0.7%). In year-on-year terms, it is clearly above those of Germany (1.5%) and France (1.1%), yet lower than that of the United Kingdom (4.1%).

On a year-on-year basis, net foreign demand contributed six-tenths to GDP growth in the third quarter of 2016, one tenth more than in the second quarter, as exports decelerated less than imports.

Exports of goods and services slowed down in the third quarter of 2016, following the acceleration observed in the second quarter, in an environment where there is no clear and widespread recovery of activity in the main trading partners or in the largest emerging economies.

Nor did it help the performance of price competitiveness, since it deteriorated 1% YoY compared to the community partners - after eleven months of profit, due to the appreciation of the nominal effective exchange rate (1.7%), partially offset by the decline in the relative consumer price index (-0.7%) - and 0.8% in comparison with the BRICS countries resulting from a considerable appreciation in the nominal exchange rate index (4.7%), which contrasts with the depreciation of 2.8% in the third quarter of 2015, partially offset by the decline in relative prices of 3.7%. Only the economy is more competitive than the 1% strengthening of the nominal effective exchange rate. The Spanish economy, however, gained competitiveness, compared to developed countries (0.8% YoY) due to a decline in relative prices (-0.9%), partially offset by the appreciation of the nominal effective exchange rate.

In year-on-year terms, exports of goods and services increased by 2.8% in the third quarter of 2016 compared to 6.4% in the second quarter, with a growth of 2.5% in goods and 3.3% in services, rates which are 3.4 and 4.3 points lower than those of the previous period. On a quarter-on-quarter basis, exports fell 1.3%, compared to a 3.1% increase in the previous period, due to declines in goods and services exports of 0.6% and 2.8%, respectively, following growth of 3.8% and 1.5% in the previous quarter.

The quarter-on-quarter growth in goods exports in the third quarter (2.5%) contrasts sharply with the sluggishness of global trade in goods, which grew by 0.8% according to the Netherlands' Central Planning Bureau, producing an increase of real market share in the first months of the year to 1.95%. The slowdown of exports in the third quarter is widespread in all geographic areas (the correction being more intense in European markets as they had previous experienced significant growth rates) and by products (with the only exception being energy intermediates, which moderated its fall by more than 10 percentage points).

Non-resident household expenditure decreased by 0.5% QoQ in the third quarter, compared to a 2.7% increase in the previous quarter, and increased by 8.2% year-on-year, 1.5 percentage points lower than in the previous quarter, according to figures from the National Accounts. For the fourth quarter, the main indicators of foreign tourism, such as tourist arrivals and overnight stays of foreigners in domestic hotels, offer favourable signs, growing respectively by 11% and 7.2% in October.

Real exports of non-tourism services also fell by 4.3% QoQ, after a 0.7% increase in the second quarter. In year-on-year terms, they recorded a slight increase of 0.1%, six points lower than in the previous quarter. According to INE's International Trade in Services Survey, referring to the second quarter of 2016, services with the greatest contribution to nominal export growth were business and transportation.

Imports declined by 1.8% in the third quarter of 2016 against the previous quarter, compared to a 2% increase in the second quarter. By components, goods imports fell 3.3% compared to the previous quarter and services grew by 5%. Real spending by households residing abroad, according to QNA figures, grew by 11.5%, after 0.7% and 12.9% in the second and first quarters, rates which include, at least in part, the Easter effect as an explanation of this great difference. Spending in the third quarter, therefore, returned to double-digit growth rates. Imports of non-tourism services, on the other hand, increased by 2.8% QoQ, after a 0.7% increase on the previous quarter.

According to the QNA, the balance of goods and services surplus stood at 4.3% of quarterly GDP in the second quarter of 2016, half a point higher than in the previous year due to the lower goods deficit (-1.6% of GDP, compared to -2.6% a year earlier), partially offset by the lower services surplus (5.9% of GDP, five tenths lower than in the same period in the previous year) Within services, the net tourism revenue surplus (4.1%

of GDP) fell by one tenth with regard to the percentage recorded in the third quarter of 2015, while non-tourism services (1.9% Of GDP) decreased by three tenths.

Productive activity

From the supply side, the large sectors of activity show a mixed performance in the third quarter of the year. The Gross Value Added (GVA) of the construction industry grew by 1.1 points to 2.7% YoY, while in industry and services the GVA moderated the pace of growth by 1.2 points and two tenths, respectively, to 1.9% and 3.4%. Finally, the GVA of agriculture, livestock, forestry and fishing increased by 2.5%, one tenth more than in the previous quarter. In terms of the quarter-on-quarter rate, the largest increase was in the services sector (0.8% as in the previous quarter), followed by construction, with a growth of 0.5%, half that of the previous quarter. The GVA of industry stabilised (0.1%), after growth of 1% in the previous quarter, and that of agriculture grew slightly, 0.2%, after a reduction of nearly 2% in the second quarter.

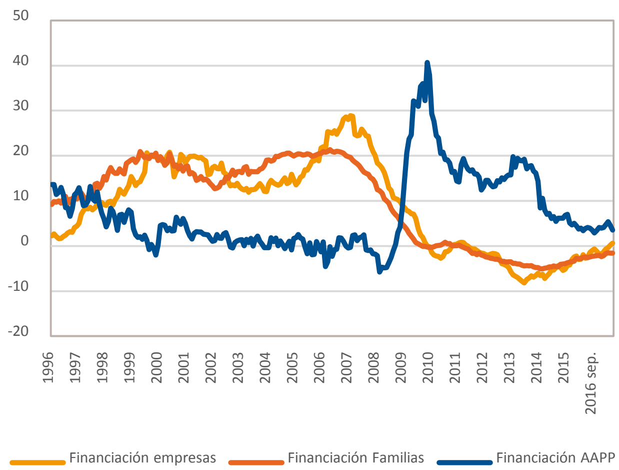
The apparent productivity per employee, in terms of National Accounts, grew by 0.3% in the third quarter of the year, as a result of the 3.2% increase in GDP and a 2.9% increase in full-time equivalent employment.

The leading indicators for the industry show mixed signals in the month of October. Although the Industrial Production Index shows a slowdown mainly explained by the poor performance of intermediate goods, capital goods slowed down while consumer goods remained unchanged at 0.4% growth. Finally, the PMI for manufacturing continued in November the upward trend started in September, reaching 54.5, the highest in the last ten months.

Without clear signs from construction, the Construction Production (volume) Index, published by Eurostat, registered a 3.9% YoY increase in September, compared to the 4.3% fall noted in the previous month. The increase in this index is explained by the improvement of the building component as well as by civil works. For the year as a whole, this index showed an average annual increase of 6%, compared to the 1.8% increase registered in 2015. Other indicators are less favourable, such as the apparent consumption of cement in October or the area to be developed into new building projects, according to works management visas, which slowed its growth in September. The services sector, on the other hand, showed, in general, favourable indicators, such as the service trust indicator, published by the European Commission, and the PMI of services, published by Markit, with increases in November. To this we must add the exceptional tourism season, characterized by an October that adds even more momentum to the sector, with year-on-year growth of 11% in tourists, 16.3% in total spending and 4.8% in average spending per person, and with overnight hotel stays also growing at a very good pace (6.5% YoY), a point and a half more than in September.

In relation to financing for productive activity, figure 3 shows the rate of variation of financing for the different productive agents. The fall in credit to companies and families lost momentum in the first nine months of the year, favouring productive activity, but continued to decline in annual terms, although corporate financing finally showed positive growth after a long time.

Figure 3. Financing YoY Rate



Source: Bank of Spain

With regard to companies, it is noteworthy a slower growth of credit in the third quarter in the SME segment (taking as a proxy those credits less than one million euros), where a slight increase of 0.2% YoY can be seen and the accumulate for the year until October shows a growth of 2.8%. Among possible explanations there is the lower demand for credit, as seen in the Survey of banking loans elaborated by the ECB, but also the means of self-financing for SMEs due to accumulated savings from previous periods and interests to reduce financing from banks after having experience how painful it can be for a business to lose its financing from the bank in times of hardship.

In the case of new operations greater than one million euros (those pertaining to large companies), the fall in credit for these companies was 40.9% in the third quarter, an event which coincided with the pivotal moment of the issuance of corporate bonds by these companies, especially after the news that the ECB was going to include corporate bonds in its Quantitative Easing scheme.

From the supply side, the improvement of the banking sector consolidated. The banking sector's non-performing loan ratio, which was 9.2% in September (1.5 percentage points lower than last year and 4.4 percentage points below the December 2013 high), continues with its downward trend supported by improvements to economic activity and, particularly important, improvements to the labour market. The slight upturn in October to 9.27% should be considered as stabilisation of the bank default rate whilst we await developments in the coming months. In any case, it shows some difficulty to get beneath 9%.

Prices

Inflation continues as expected. The CPI recorded a year-on-year change of 0.7% in November. The variation up to October shows that the recovery in inflation can be explained by the rise in electricity prices, compared to the decline in 2015, and by the increase in the prices of fuels, both gasoil and petrol. The annual rate of change of the latter (in euros) has been recovering since August 2015, and will continue to pull up the CPI until mid-2017.

Underlying inflation (excluding unprocessed food and energy products) rose by 0.8% YoY in October, following a mild upward trend supported by the vibrancy of private consumption. However, the impact of the negative incidence of the food and leisure and culture groups led to the October findings staying below those of August and September.

Labour market

In the third quarter of 2016, labour market statistics show acceleration in employment, both in the case of the Active Population Survey (EAPS) and Social Security affiliations, with a rate of growth of around 3% YoY. The joint balance of October and November shows an increase in the pace of job creation, according those figures published by the Social Security office regarding employment.

In the third quarter of 2016, according to the EAPS, employment in the Spanish economy increased by 226,500 (182,200 in the same period of the previous year), with a total figure of 18.5 million. In the seasonally adjusted series by the INE employment increased by four tenths QoQ, recording a rate of 0.8%. On a year-on-year basis, EAPS employment increased by 478,800 people in the third quarter, representing a rate of change of 2.7%, three tenths above that of the second quarter.

The favourable development of private consumption can be explained by job creation, price moderation and improved financing access and conditions.

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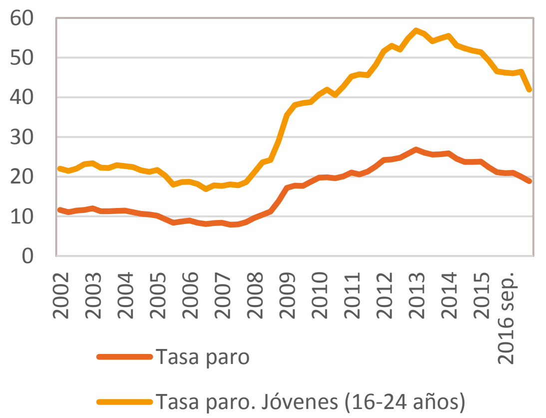
Similar conclusions are drawn from the analysis of the other two statistical sources of the labour market. Thus, according to the Quarterly National Accounts (QNA), full-time equivalent employment grew by 0.8% QoQ, with seasonally adjusted and calendar adjusted series, one tenth more than in the previous quarter and, in year-on-year terms and with gross series, rose 2.9%, one tenth higher than in the second quarter.

If we look at the affiliations, with seasonally adjusted series, these increased by 0.7% QoQ in the third quarter of 2016, two tenths less than in the second. In year-on-year terms, the number of affiliates shows acceleration of three tenths, registering a rate of 3% in the third quarter.

According to figures published by the EAPS, the year-on-year increase in employment was widespread in all major branches of activity, mainly in services, with an increase of 407,600 employed people (3% YoY), followed by agriculture, with 34,300 (4.8%), construction, with 24,600 (2.3%) and industry, with 12,400 (0.5%).

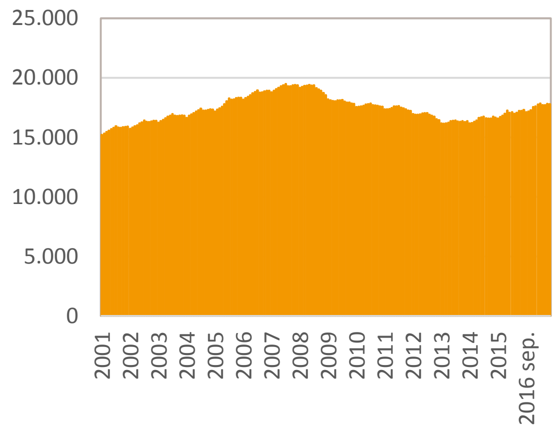
Figure 4. Unemployment rate. Active population percentage



Source: INE

With regard to age, all groups experienced declines in unemployment in the third quarter, with the largest decreases being concentrated in the 25-54 age group (199,800 fewer unemployed) and among young people aged 20-24 (43,900 fewer). The youth unemployment rate fell 4 points in one quarter, from 46.4% in the second quarter to 41.9% in the third, an even more significant figure given that it stood at 51.4% only a year before.

Figure 5. Social Security Affiliates (monthly average). Thousands



Source: Social Security.

Moderation in the growth of salaries and unit labour costs has continued. Compensation per employee increased by 0.1% YoY, two tenths less than in the second quarter, so unit labour costs (ULC) continued to fall slightly by 0.1% in the third quarter, compared to the 0.3% fall of the second quarter.

According to the Statistics of Collective Agreements prepared by the Ministry of Employment and Social Security with information collected up to October, the average agreed salary increase held at 1.1%. It should be remembered that the maximum increase established for 2016 is 1.5%. By sector, salary increases were 1.1% in services and industry and 0.9% in agriculture and construction.

Balance of payments

In the first nine months of 2016, the Spanish economy developed an external financing capacity of €16,418 million (2% of GDP), compared to an external financing capacity of €11,355 million (1.4% of GDP) in the same period of the previous year.

The current account balance accumulated a surplus of €14,046 million, significantly higher than that reached in the first half of 2015 (€7,690 million). This has been possible thanks to the increase in the surplus of goods and services and to the moderation of the deficit of primary and secondary incomes. Finally, the capital surplus fell by 35.2%.

At the same time, the financial balance registered net outflows of €7,531 million, compared to net outflows of €20,858 million a year earlier, as a result of an increase in the Bank of Spain's net debit position of €49,081 million, partially offset by an increase in net capital outflows excluding the Bank of Spain, which stood at €56,614 million.

The improvement in the trade balance from to the reduction of the energy deficit allowed for the surplus of goods and services to increase in the first months of 2016 to €27,022 million, 25.6% higher than in the same period of the previous year. In nominal terms, exports grew by 2.7% and imports by 0.6% YoY. According to Customs figures, in the first nine months of 2016 the commercial deficit of energy goods decreased by 29.8%, in line with the evolution of the imported price, which, measured in euros, fell by an average of 29.3% in said period, while the surplus of the non-energy balance decreased by 34.8%.

Both revenues and payments from tourism grew. Thus, the balance of tourism services accumulated a surplus between January and September 2016 of €28,755 million, 0.8% higher than the same period of 2015. The excellent momentum of the tourism industry in Spain is reflected in the 6.3% increase in tourism revenues, 7.6% in spending by foreign tourists and 10.2% in tourist arrivals in Spain, with figures in year-on-year terms for the first nine months of 2016. However, tourism payments, an indicator of the good shape of the consumption of Spanish families and that includes travel by Spaniards abroad, grew by 19.8% in the first nine months of the year.

Finally, the primary and secondary incomes deficit declined by 6.2% YoY for the first six months of the year, as a result of a much higher increase in income than in payments (3.1% vs. 1%), so the deficit amounted to €12,976 million. The decrease in the income deficit is mainly due to the ECB's purchase of public debt, which has allowed the cost of debt to fall. Lastly, the capital account surplus between January and September was reduced by 35.2%, with a surplus of €2,372 million, although the irregularity of this income must be highlighted given the multi-annual nature of many of the stocks that they finance.

The average cost of outstanding liabilities has declined for the first time by a rate of 3%. As of 30th November, average aggregate debt interest stood at 2.8%, down from the 3.21% at the end of 2015 and 3.94% at the end of 2014.

The fact that investors are paying the State for having treasury bills from the Kingdom of Spain has taken the average interest of the debt issued in the first eleven months of this year to 0.63%, below the minimum of 0.84% of 2015, with an estimated saving of €2,000 million in interest with regard to what was budgeted.

Current capital and financial operations generated a decrease of €49,081 million in the net assets of the Bank of Spain, an amount which makes up an increase of €8,006 million in reserves, a reduction (increase in the net debit position) of €54,005 million of assets against the Eurosystem and a decrease of €3,082 million for the rest of net assets.

The Net International Investment Position (NIIP) improved in the second quarter of 2016, reducing its debit balance in the second quarter by 21,403 million compared to the first half of 2015, reaching €969,800 million. The debtor NIIP accounted for 88.5% of GDP in the second quarter of 2016, 5.5 points less than a year earlier. Gross foreign debt in the second quarter of 2016 amounted to 171.5% of GDP, compared to 170.4% of GDP in the first half of 2015.

The Bank of Spain increased its debit balance by €55,139 million in the second quarter of 2016 from a year earlier to €153,279 million, equivalent to 14% of GDP. This rise is explained by the increase of €67,228 million in the debit balance of the Bank of Spain against the Eurosystem, whilst, on the other hand, reserves increased by €5,324 million and the balance of other net assets went from -1,911 million to 4,854 million.

Public sector

The consolidated deficit of the Public Administrations, without Local Corporations, reached 3.31% of GDP up to September. In consolidated terms, the Central Administration, the Regional Administration and the Social Security Funds showed a deficit of €36,869 million (3,31% of GDP) up to September 2016, 1.5% higher than the same period of 2015 (3.38% of GDP). This increase in the deficit, including aid, is explained by a year-on-year increase in non-financial employment (3,570 million, equivalent to a 1.1% increase) higher than that experienced by non-financial resources (3,019 million, also equivalent to one Increase of 1.1%). The increase in non-financial resources is mainly due to the rise of taxes on production and imports (2.1%) and social contributions (3%), partially offset by the drop in current taxes on income and wealth (-3.9%), taxes on capital (-2.6%) and transfers from other public administrations (-5.3%). Non-financial employment rose mainly due to increases in social benefits which were not transfers in kind (1.9%), social transfers in kind from market producers (3%), transfers to other public administrations (4.8%) and the remuneration of employees (2.5%). Among those items which decreased, intermediate consumption (-1%), interest (-6%), subsidies (-13.5%) and gross fixed capital formation (-36.1%) all stood out. The Central Administration closed the first nine months of the year with a deficit of €28,522 million (2.56% of GDP), 28.8% higher than in the same period of 2015 (22,141 million, equivalent to 2.06% of GDP), as a result of a decline in non-financial resources and an increase in non-financial employment. The non-financial resources of the Central Administration decreased by 4.1%, mainly due to the fall in current taxes on income and wealth (-12.7%), the effect of the final settlement of the system of financing autonomous communities of 2014, the impact of the tax reform, and the disappearance of some transitory measures that affected the split payments of the Corporation Tax in 2016.

The Regional Administration accumulated, until September 2016, a deficit of €2,132 million (equivalent to 0.19% of GDP), 81.5% less than the same period in 2015 (11,494 million, equivalent to 1.07% of GDP). Social Security Funds closed the first nine months of the year with a deficit of €6,215 million (0.56% of GDP), compared to the deficit of €2,683 million in the same period of 2015 (0.25% of GDP). This increase in the deficit is due to a decline in non-financial resources (-1.6%, despite a 3.3% increase in social contributions), which is explained by the decrease in transfers received from other public administrations (-22.6%), as well as an increase in non-financial employment (1.5%). This performance is due to worse results of the System, which has increased its deficit by 16.9%, as well as the lower surplus at the State Public Employment Service, which has almost halved to reach 2,486 million, mainly through the small transfers received from the State.

The State deficit, in terms of National Accounts, stood at 1.94% of GDP up to October. The budget execution of the State, up to October, closed with a deficit, in terms of National Accounts, of €21,656 million (1.94% of GDP), 1.2% lower than that accumulated up to October in 2015. This lower deficit is explained by a year-on-year decline in non-financial employment (-1.3%), partially offset by a decline in non-financial resources (-1.3%). **In terms of Cash,** the State registered a deficit of €9,588 million up to October 2016, 6,901 million higher than the same period in 2015 (2,687 million). Non-financial income decreased by 5.7% YoY to €115,974 million, while non-financial payments fell by 0.1% to €125,562 million. Total tax revenues increased by 1.9% up to October, in homogeneous terms. Total tax revenues (including the participation of local authorities) showed an increase of 3.4% up to October, compared to the non-existent variation accumulated up to September. This is due to tax revenues in October increasing by 18.5%, mainly driven by the extraordinary increase in the second split payment of Corporate Income Tax. In homogeneous terms, that is to say, correcting the different rate of making returns in both years, the returns of the Tax on the Retail Sales of Certain Hydrocarbons (IVMDH) and the deferrals of public entities, tax revenues increased by 1.9%. Without including the territorial entities and in non-homogeneous terms, they decreased by 1.3%. Within total taxes, income from personal income tax, including the participation of local authorities, fell by 0.4% in the period up to October, mainly due to the impact of the reform on the withholdings applied to labour and capital. Nonetheless, income from personal income tax in the period up to October has moderated the year-on-year rate of decline by seven tenths of a percentage point compared to the accumulated income up to September, due to revenues from 2015 already reflecting the total effects of the approved rate reduction in September In RDL 9/2015. In homogeneous terms, the decline is 0.7%.

Revenue from Corporate Income Tax in the period up to October stood at 19,063 million, compared to 17,001 million a year earlier (a 12.1% increase), mainly due to the application of RDL 2/2016, which approves a change in the method of calculating split payments for large companies and consolidated groups, which meant a 43.4% increase in the second payment on account, compared to the 48.7% decrease in the first payment. In homogeneous terms, collection increased by 6.2%. VAT collections, including the participation of local authorities, increased by 4.6% YoY up to October. In homogeneous terms, correcting for the different rate of making returns, the increase stands at 3.4%. The collection of Special Taxes, including the participation of territorial entities, increased by 3.7% compared to the same period of 2015, mainly due to the increase in the Tax on Hydrocarbons (8.6%, which in homogeneous terms, correcting the repayments of the sanitary cent, was 3.1%). The Tobacco Tax increased by 1%.

In terms of expenditure, total non-financial payments decreased by 0.1% up to October compared to the same period in 2015 due to the fall in personnel costs (-2.2%), current transfers (-5.4%), real investments (-31.8%) and capital transfers (-27.9%). On the contrary, current expenditure on goods and services increased by 8% and financial expenses increased by 31%. Debt needs up to October 2016 reached a figure of €27,367 million, compared to €53,123 million in the same period of 2015. This trend is explained by the lower net increase of financial assets (17,779 million, compared to 50,436 million a year earlier), which in turn is mainly due to the decline in the position of other deposits in the Bank of Spain, partially offset by the larger cash deficit (9,588 million, compared to 2,687 million a year earlier). The need for indebtedness has been mainly financed through medium- and long-term domestic debt (24,750 million).

Social contributions increased by 2.8% YoY up to October. The Social Security System (Management Entities, General Treasury and Mutual Funds) registered a deficit, in terms of Cash, of €6,301 million up to October 2016, 18.1% higher than that registered in the same period of 2015 (5,337 million). Revenues fell by 0.5%, mainly due to the decline in capital transfers (-76.4%) and, to a lesser extent, the fall in wealth income (-6.9%), partially offset with the increase in social contributions (2.9%) and current State transfers (0.5%). Payments increased by 0.4%, mainly as a result of the increase in pensions (3%), temporary incapacity (11.1%) and personnel expenses (0.3%). Finally, with regard to management expenses incurred by Social Security, current expenditure on goods and services fell by 5.1%.

Our forecasts point to an annual growth of 3.2% for 2016.

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The EDP Debt of Public Administrations slowed its growth in September. According to figures from the Bank of Spain, the debt of Public Administrations, according to the methodology of the Excessive Deficit Protocol (EDP), slowed by 1.1 points in September compared to August, to register a year-on-year rate of 3.5%, reaching the figure of €1,104,936 million (100.3% of GDP). By subsectors, the State EDP Debt stood at €949.352 million, which is an increase of 4.1% compared to the same period of 2015. On the other hand, the EDP Debt of the Autonomous Communities reached €271,173 million, 6.9% higher than that registered in the same month of 2015. With regard to Social Security Administrations, EDP Debt stood at €17,174 million (17,197 in September 2015). Finally, the Local Corporations registered in September an EDP Debt of €34,756 million, 5.7% less than a year earlier.

2016-2017 scenario: sustained growth

Although in 2015 and 2016 the Spanish economy benefited from an extremely favourable environment which exceeded expectations quarter after quarter thanks to the good performance of companies, families and the public sector, **2017 will**, with a high probability, experience **a deceleration of GDP growth, which we estimate to be around 2.5%.**

The expected deceleration of GDP is the result of several factors that not only will not favour, but could contribute negatively to GDP growth in 2017. On the one hand, the **strong price of oil** will raise the costs of the Spanish economy and reduce income for consumption or savings. On the other hand, **the sharp and rapid rise in interest rates observed in November and December** will raise the price of funding. The impact of both elements may go beyond simply depleting the momentum, becoming a genuine slowdown to the economy.

The agreement to reduce oil production recently reached by OPEC countries, coupled with the fall of the euro caused by the rate hike in the United States, has caused the price in euros of this raw material to shoot up and it will end the year around 60% above the average price of the first quarter. This is the highest oil price increase since the end of 2009.

The increase in the price of energy will have a significant impact on the inflation rate, which will rise above 2% during the first half of 2017, given that the first half of 2016 was the most unfavourable moment when compared to the reduced energy prices enjoyed a year earlier. **This will lead to a loss of purchasing power for consumers and an increase in costs for businesses.**

2017 will likely see a mix of contractionary monetary policy and a strong expansionary fiscal policy following the Republican victory in the US elections, which has already had effects on long-term interest rates in the country. A rise that has spread to Europe and we expect will continue in 2017.

In fact, **in December the US Federal Reserve raised interest rates to 0.75%.** With full employment and underlying inflation above 2%, the Federal Reserve will continue to raise interest rates gradually to at least 2% so that real interest rates, without contemplating inflation, will no longer be negative.

While short-term interest rates in the Eurozone have not undergone major changes thanks to the ECB continuing with its policy of negative rates, this policy is likely to be withdrawn by 2018, which could begin to be discounted by the markets in the in the second half of 2017.

Firstly, long-term interest rate increases, although they will take some time to affect interest payments on government debt, will end up affecting them and, more immediately, companies. This is worrisome given the high financial vulnerability of the Spanish economy.

Secondly, short-term interest rate hikes will impact the Spanish economy as it is especially sensitive to increases in the Euribor, given the high debt held by households, thus affecting the Spanish families' waterline.

We could also include a third factor, given the limited fiscal space in Spain that could end, at best, in a neutral fiscal policy**. 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 decimals, to 5% of GDP (excluding losses from supporting banks), but in 2016, if the target of 4.6% of GDP is met, the adjustment will be lower, 4 tenths lower. 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 is practically neutral if the deficit is reduced at a slightly higher rate than in the last two years and stands close to the target agreed with Brussels. In this regard, the Government has presented new budgetary measures to meet the deficit target of 3.1% of GDP in 2017. Most of the measures focus on corporate tax reform, which limits tax advantages and is expected to generate a revenue increase of €4,300 million. It also highlights the increase in excise taxes and a new tax on sweetened beverages.

For its part, the government deficit target of 4.6% of GDP in 2016 seems achievable. The AIReF (Independent Fiscal Responsibility Authority) has reached this conclusion. Until September, the Public Administrations' deficit (excluding local corporations) stood at 3.1% of GDP, two tenths below the August figure (this figure does not include losses from financial aid). By administrations, the state deficit improved markedly and stood at 1.9% of GDP in October, one tenth lower than a year ago. This improvement in the last month is explained by the recent restitution of split corporation tax payments, which should allow the 4.6% deficit target to be met by 2016. Likewise, the autonomous communities recorded a deficit of 0.2% of GDP, improving the September figure by nine tenths.

In the scope of **monetary policy**, the Governing Council of the **European Central Bank**, at its meeting on 8th December, decided not to alter interest rates applicable to the main refinancing operations, the marginal lending facility and the deposits facility, keeping them at 0.00%, 0.25% and -0.40%, respectively. The Council envisages that the ECB's official interest rates will remain at current levels, or at lower levels, for an extended period. Regarding unconventional monetary policy measures, the Governing Council has decided to keep purchases of its quantitative easing scheme at its current level of €80,000 million per month until the end of March next year. From April 2017, net purchases will amount to €60,000 million until the end of December 2017, or until a later date if necessary and, in any case, until the Governing Council observes a sustained adjustment to the inflation consistent with its target.

To ensure a correct implementation of quantitative easing, the Governing Council has decided to adjust the parameters of the program from 2017. On the one hand, the ECB will extend the maturity range of the public debt purchasing program, reducing the minimum maturities of eligible assets from the current two years to one year; and, on the other hand, the program will allow for, to the necessary extent, the acquisition of assets with a profitability lower than that offered by the deposit facility, currently set at -0.40%.

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. Indeed, **the ECB's expansionary monetary policy and the start of monetary normalization in the US led to a significant depreciation of the euro** whose effects in the form of a decline in the real effective exchange rate were noted in 2014 (-2.9%), 2015 (-2.8%) and still in 2016 (-1% between January and October). Given that the impact of the exchange rate on exports is not immediate, rather the maximum effect normally occurs after approximately a year and a half, **the positive effect on the Spanish foreign sector could be of some importance even throughout 2017**, although it seems complicated that it compensates for the stagnation or slowdown in exports caused by the stagnation in global trade.

International trade will grow at a rate below that of world GDP in 2016, a new phenomenon in the international economic context and one that will almost certainly be repeated in 2017. But the stagnation of global trade negatively affects Spanish exports of goods and services, which in turn affects the investment decisions of companies in such a way that if the investment stimulus is slowed down, job creation slows down and, with that, the growth of private consumption. Reflecting the weak momentum experienced by exports, we can point out that a nominal increase of 1% in exports in the third quarter is equivalent to the amount of exports to Morocco**. And in an economy with high foreign debt and low productivity such as Spain, the positive contribution to the growth of net foreign demand seems crucial.**

Finally, with regard to the foreign sector, the expected increase in the price of oil will raise inflation and reduce the current account surplus from the 1.9% of GDP forecast for 2016 to 0.5% of GDP in 2017.

At its recent meeting, the ECB also clearly pointed to the **uncertainty generated by political risk**. Brexit negotiations, the arrival of Donald Trump to the White House and the electoral processes that will take place in Europe throughout 2017 (France, Holland, Germany, perhaps Italy), which will undoubtedly be marked by the rise of populism and even stronger nationalism after the recent terrorist attack in Germany, all make politics and its risks a factor to be taken into account next year. Polarization and political instability are breeding grounds for less economic prosperity.

The latest available economic indicators anticipate GDP growth of 0.6% in the fourth quarter, which will close 2016 with year-on-year growth of 3.2%, as we have anticipated for some months. However, in 2017 private consumption could lose a percentage point over the growth experienced in 2016, given that the following factors will be seen: predictably, there will be no reduction in income tax equivalent to that of 2016, which has allowed for an increase in the disposable income of households by 0.5% of GDP and thus expanded private consumption; there will be an expected rise in taxes on alcohol, tobacco, soft drinks and petrol in 2017, which will drain another 0.1 percent of GDP; inflation will be close to 2%; nominal wages increases will be meagre, close to 1%, and real wages will lose around 1% of their purchasing power.

Although the year-on-year growth rate of private consumption began in the first quarter growing at 3.4%, it could end 2017 growing at 2% YoY. This fall in domestic demand will result in a lower rate of job creation and less investment enthusiasm on the part of companies. The increase in the minimum wage of 8% will improve low incomes in this context and reduce inequality, but it is very unlikely that these effects will carry over to other wages.

At a European level, Spain needs to, little by little, assume part of the leadership that corresponds to it and to work with a firm step in an increasingly fragile, albeit necessary, European project.

Recently, **the European Commission formally acknowledged the need for a more expansive fiscal policy for the Eurozone**. It has done so in a document, *"Towards a positive fiscal stance for the Euro Area"*, in which it recognises weak growth in which new factors generating uncertainty are threatening the recovery of the area (Brexit, Trump...). Furthermore, the Commission's change of attitude regarding the need for fiscal stimuli, equivalent to at least 0.5% of average GDP in the Eurozone, which the ECB has long insisted on and which Germany and other countries rejected in the last meeting of the Eurogroup, has played an important role in the forthcoming electoral consultations in some countries of the Eurozone and the presumable rise of political forces which do not favour the strengthening of the dynamics of European integration.

From the above, it follows that the Juncker Plan remains the only fiscal stimuli in Europe, although it may be that what has not been achieved in the form of fiscal expansion with the formal support of governments will happen regardless, given the relationship between increasing public spending and holding elections, which is contrasted by the empirical evidence. In 2017 national electoral processes will take place in France, the Netherlands, Germany and, perhaps, Italy. Increases in demand in the Eurozone would benefit Spanish exports.

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 the good investment data we could highlight the competitiveness achieved after the significant adjustment effort made by the companies in their unit labour costs, significantly lower than the average of our Eurozone partners, and which have also allowed for strong job creation. This, in turn, makes the improvement experienced by domestic demand, which began in 2014 also encouraged by the fall in prices, sustainable and, finally, the radical change in available financing as well as in the financing conditions since the European Central Bank decided to intervene and to curb the risky episode of financial fragmentation and credit restriction that the Eurozone lived.

The greatest 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 to cost reductions via the 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 offers a unique opportunity to face urgent political and economic reforms. The time to do so is today, when many (if not all) winds blow in our favour (more competitive economy, ECB debt buying, optimal financial conditions, very advanced financial sector sanitation), which allows us to gain necessary time and facilitates the task.

Annual forecast for the Spanish economy.

Table 1. ANNUAL FORECASTS

% annual average change, unless otherwise indicated

	2016	2017
Real GDP	3.2	2.5
Final household consumption	3.0	2.2
Final Public Administration consumption	1.2	0.3
Gross Fixed Capital Formation	3.6	2.5
- Machinery and capital goods (1)	5.9	4.5
- Construction	2.3	1.8
Stock variation (contribution to GDP growth in pp)	0.0	0.0
National demand	2.8	1.9
Exports of goods and services	4.1	3.4
Imports of goods and services	2.9	1.3
Underlying CPI (annual average)	1.0	1.4
Total CPI (annual average)	-0.2	2.4
Labour costs per worker (2)	0.5	1.3
Employment (National Accounts) (3)	2.6	2.0
Unemployment rate (EAPS, % of active population)	20.1	18.4
Balance of balance-of-payments current account (% GDP) (4)	1.9	0.5
Financing capacity (+) or needs (-). Public Administrations **excluding aid to financial institutions** (% GDP)	-4.5	-3.8

(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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