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Quarterly Bulletin on Economic Situation and Prospects

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QUARTERLY BULLETIN ON ECONOMIC SITUATION AND PROSPECTS

Executive Summary

National accounting data confirmed that **the Spanish economy grew by 0.7% quarter-on-quarter (QoQ) in the fourth quarter of 2016**, the same rate observed in the third quarter, totalling **thirteen quarters of sustained growth**.

This has been due to the notable contribution of domestic demand but also of 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% in the third quarter of 2016.

It is worth mentioning the **momentum** of the **private consumption** indicator (+0.8% QoQ and 3% YoY) which has been benefiting from the increase in purchasing power of domestic economies stemming from job creation, falling energy prices, and improved financial conditions throughout 2016. Public consumption, in turn, fell 0.2% quarter-on-quarter in the fourth quarter, closing the quarter with no year-on-year growth, although this aggregate increased by 0.8% when the year's average is taken into account.

Investment demand slowed as 2016 progressed, closing with a 3.1% year-on-year growth, half that of 2015, having advanced 2.6% QoQ and 0.5% YoY in the last quarter. Whereas construction investment saw its demand boom again in the last quarter, **investment in capital goods remained stagnant for the second consecutive quarter.**

In the fourth quarter of 2016, according to quarterly national accounts, **the foreign sector contributed eight tenths of a percentage point to the year-on-year change in GDP**, consolidating a trend of positive contributions from the foreign sector to the economy that had already lasted three quarters. The contribution of domestic demand to growth was 2.2 percentage points, the lowest it has been in the last two years. This has enabled the **growth of the Spanish economy in the fourth quarter and in the whole of 2016 to be much more balanced, with both components of demand contributing positively to GDP growth.**

In line with GDP growth, the number of those in work, in terms of full-time equivalent employment, **grew 2.7% YoY in the fourth quarter of 2016, with the average annual growth balance being nearly that of 2015 (2.9% compared to 3%).**

Prices, meanwhile, closed the year again in negative terms, with the average consumer price index at -0.2%. Nevertheless, the trend changed drastically in the last quarter of 2016 following the rise in the price of oil.

The weak Euro, the strong momentum of exports of the last part of the year and the strong growth favoured by a low oil price and by the low interest rates allowed **2016 to finish with a historical surplus in the current account balance (2% of GDP) and to place the public deficit, excluding aid to financial institutions, at 4.6% of GDP or slightly below.**

In 2017 our main scenario showed that domestic demand would continue expanding, albeit at a slightly more moderate rate than in previous quarters, and that net foreign demand is still positive for GDP growth, which is estimated at 2.7%. Contrary to the first two years of economic recovery, growth in 2017 will be, as it was in 2016, more balanced and with positive contributions to GDP growth both from domestic and foreign demand. **The improvement in our growth estimate for 2017 lies in the marked improvement in unemployment on a global level and the acceleration of world trade growth**, which is expected to grow at the same pace as economic activity in 2017.

Advanced indicators from the first quarter show signs of a great improvement in employment growth and a return to growth in business investment, as we will explain in the *Growth prospects for the Spanish economy* section; **however, this remains 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.

2017 will be characterised by the return of inflation to the Spanish economy, potentially **faster than expected**. In fact, inflation rose to 3% year-on-year in February as a result of higher oil, electricity and food prices. Underlying inflation, however, remained stable at 1% in February. Despite the growth in consumption and employment, prices and wages continue to show signs of weakness, as is often the case for an economy with an unemployment rate of 18.6%, as it stood in the fourth quarter of the year.

In the Eurozone prices rose to 2%, with underlying inflation falling at 0.9% in February, and there are differences that show the **greater ease with which the prices of services have risen when compared to industrial prices**, which are subject to international competition and virtually stagnant. Furthermore, the devaluation of the Chinese currency adds downward pressure to international industrial prices.

In any case, **the rise in prices in Spain seems more a transitory increase of prices that will be more felt in the first half of 2017, diminishing in the second half of the year**, albeit with the capacity to place average inflation of the year at around 2.5%, with a similar general interpretation for the Eurozone despite **inflationary tensions probably being higher in the central Eurozone countries**, especially in Germany, which has an unemployment rate of around 5.9%. It should also be considered that, **although the overall unemployment trend is clearly positive in the Eurozone, with job creation at a maximum and unemployment rates at the lowest since the beginning of the crisis, slack in the labour market continues to be noticeable when broader measures of under-employment are considered.**

It is precisely for this reason that the European Central Bank (ECB) announced at its last monetary policy meeting in March that a significant degree of monetary accommodation remains necessary in order for the underlying inflationary pressures to increase and support general inflation in the medium term. The perception is, therefore, that the underlying inflationary pressures are very much contained, making it possible to explain why financing conditions are maintained so favourably as to ensure their transmission to the financing conditions of households and companies and thus stimulate the demand for credit, which is insufficient given the current financial conditions, to achieve firm recovery of the Eurozone economy, as recently demonstrated by the ECB's survey of SMEs' access to finance. In order to ensure a sustained return of inflation rates inferior but close to 2%, the Governing Council of the ECB has decided to keep the ECB's official interest rates unchanged and expects them to stay at current levels, or at lower levels, for a long time, which will far exceed the horizon of net asset purchases.

Regarding non-conventional monetary policies, the ECB will continue to make purchases under the asset purchase program, although from April these purchases are expected to move from the current rate of €80 billion per month to €60 billion per month, until the end of December 2017, or a later date if necessary.

That said, if interest rate increases by the ECB appear to be unlikely to occur today, contrary to the recent behaviour of the Federal Reserve, the **increased global inflationary pressures** and expectations that prices may rise even more so, especially in the US economy, **have long been affecting longer-term interest rates in advanced and emerging economies.** Thus, in the case of Spain, the interest rate on the 10-year bond, which started at around 0.8% before the US elections, was almost a point higher in the middle of March 2017 (four and a half months later).

In fact, **the Federal Reserve continued its rate hikes and placed them between 0.75% and 1%.** The unemployment rate in the US is stable and close to 4.5% as employment grows with the same intensity as the active population. Wages are stable and underlying inflation is close to target of 2%. Therefore, they will continue with their gradual normalisation process. US 10-year public debt rates have stabilised close to 2.5%. Long-term rates in Europe have rebounded, especially in peripheral countries. The Italian bond continues to trade with a premium which is 50 basis points higher than the Spanish. Also, the German bond has rallied, but less so, despite the euro devaluing against the dollar, which has stabilised at close to 1.07.

Although it hardly affects underlying inflation and is unlikely to happen throughout the year, as wages are virtually stagnant and most companies cannot raise prices, the rise in prices at the beginning of the year means that **the rise in the price of oil will translate into revenues that will go out of Spain, having a negative impact on consumption and investment, slowing growth throughout 2017.**

Similarly, **higher overall inflation would have an impact on competitiveness if a generalised process of transferring price increases to wages was put in place**, so that the effects of the "second round" would be felt in the Spanish economy, something which is not likely to happen. Furthermore, **not every increase in inflation implies a loss of competitiveness**, not least because this is best measured with other indicators of the prices of goods, such as the GDP deflator or the export goods deflator. And finally, the competitiveness of the Spanish economy is not necessarily affected by the recent increases in prices from general inflation if the increase in inflation is transitory and largely due to a sharp rise in the price of oil.

However, the slowdown in the growth of consumption and investment as a result of the rise in prices could be partially offset by **the increase in credit**. The fall in credit to companies and households slowed down in 2016, especially in the fourth quarter, where the quarter-on-quarter rate fell to a meagre -0.13%, favouring productive activity, but it continued to decline year-on-year, nevertheless, **corporate finance stock showed quarter-on-quarter growth for the first time since the Great Recession**. In fact, total financing of non-financial corporations increased by 750 million euros in the fourth quarter. Finally, the growth of credit destined for the financing of Public Administrations continued to slow and in December was 3% YoY.

With regard to new credit, the importance of the strong growth in lending to households observed in January, 22% year-on-year, cannot be understated. Much of this increase was due to an extraordinary year-on-year increase of 28.4% in loans destined for the purchase of homes and 24.8% in loans for consumer goods, growth well above the variations observed in the economic activity. The fact is that price increases place real interest rates at levels that should also encourage greater demand for credit and greater indebtedness.

Regarding the state of public accounts, the public deficit is very likely to close at 4.6% of GDP or slightly below, with this being the highest in the European Union. In spite of what was foreseen weeks ago, the Government should be able to get the General State Budgets off the ground, something which should be approved in Parliament during the month of May in a vote that, a priori, looks to be very tight. Be that as it may, the Spanish Government must bear in mind that a very high percentage of the public deficit is of a structural nature and that only the cyclical position of the Spanish economy has made it possible to reduce that imbalance. **With public debt at 100%, financial vulnerability is high in the event of any adverse shock and it is urgent to reduce the high structural deficit to help make debt more sustainable**. Our forecast is that, without considering public subsidies, **Public Administrations will present a financing requirement of 3.8% in 2017.**

The positive trends found in the foreign sector in 2016 and the recovery of international trade in the last quarter of the year have allowed exports of goods and services in the month of January, deflated and adjusted for seasonality, to be placed at 7.6% greater than the previous year, while imports have improved by 3.2%. This, coupled with the recovery of world trade seen in European exports in the first quarter of the year, will help Spanish exports, as half of these are characterised as intra-industry trade by multinationals which manufacture a part of the product value chain in Spain. Therefore, **a large part of the raising of our GDP forecast for 2017 up to 2.7% comes from expected improvements regarding exports in 2017.**

Among the main risks we can highlight, along with the rise in interest rates and the lack of momentum in the investment in capital goods, the political risk associated with the Catalan question, which remains unresolved, and various external aspects.

Investment in capital goods has been stagnant for two quarters, which can be considered to be one of the main risks on the not so distant horizon for the Spanish economy. However, it can be argued that such poor behaviour may be predominantly due to the €8,000 million effort made by companies in the face of corporate tax breaks Additionally, there is evidence of some recovery in the first quarter of 2017 such as sales of capital goods and software by large companies and the results of the European Commission's survey of the first quarter of 2017, in which we find a reduction in the idea of demand in the Eurozone being a factor which is limiting the production of capital goods, a perception that is at its lowest level since the beginning of the Great Recession. Finally, the use of productive capacity also increased to above pre-crisis levels in the first quarter of 2017.

Weakness in investment coinciding with a reduced rate of job creation in the fourth quarter is significant, especially when it can be seen that it is in fact a reduced rate in the creation of hours worked, which better measures the activity and income of households. In the fourth quarter, hours worked, when considering seasonally-adjusted series, decreased, while in 2015 they grew close to 4% and ended 2016 with a positive year-on-year variation of 1.7%. In the medium term, total investment should be strengthened by the extraordinarily accommodative tone of the ECB's monetary policy. Investment in capital goods should also be boosted by favourable financing conditions, the significant improvements observed in the profits of many companies, which already have a high degree of liquidity, and the observed improvement in the price of many stocks and lower indebtedness. However, it should not be overlooked that this may continue to be constrained by long-term growth expectations, which are weaker than in the recent past, and the need to deleverage the public sector.

On the other hand, the corporate bond boom throughout 2016 following the ECB's announcement of the purchase of corporate bonds in March has not been matched by the observed growth in business investment, given that a large part of bonds were destined for the cancellation of debt held against financial institutions.

With regard to international **political risk**, it should be noted that the uncertainties surrounding the baseline projections related to world economic activity remain high and that **risks continue to point downwards**. The main international political risks would include possible disruptions caused by political and geopolitical uncertainty, such as future relations between the United Kingdom and the European Union; the disorderly tightening of financial conditions on the global scale, which could particularly affect the most vulnerable emerging economies; the instability associated with the process of reform and liberalisation of the Chinese economy, and, finally, greater trade protectionism that is gaining momentum in the advanced economies, led by the protectionist threats of the new president of the United States, something which will be discussed below.

Risk is thus transferred to 2018. 2017 should give rise to a deceleration, which could start to be felt 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 2.7%, as explained in the last part of the report.

Global scenario

Trump: maximum uncertainty

As was expected when he won the election, Donald Trump is a focus of uncertainty and instability for the world economy. His diplomatic confrontations, first with China and then with his European partners, have meant a radical change to the international policy of former President Barack Obama which sought the consensus and multi-polar and multicultural development of global institutions. So far, Trump has failed to pass any bills on his economic program with his own Republican colleagues in Congress not supporting his measures. Therefore, it is not possible to anticipate the impact of his measures until they are formalised in both chambers.

In Europe uncertainty is decreasing. Macron leads the polls in France and would gain a fair lead on Le Pen in the second round of the French presidential elections. Macron would be a Europeanist president, which would help to give impetus to the European project. In Germany Martin Schulz was named as a candidate against Merkel with 100% support in the SPD Congress. At the moment there is a technical tie as, in a few weeks, the Social Democrats have risen more than ten points in the polls thanks to the new leader. The best news for the world would be Europe advancing in its project and standing up to Trump in global institutions with an alternative model.

World trade rebounded strongly in the second half of 2016 and the Eurozone, with and undervalued Euro, benefited from strong export growth in the fourth quarter. Imports also increased with the same intensity and the Eurozone's GDP grew quarterly by 0.4%, the same growth as seen in the previous quarter. In France and Germany, GDP also increased by 0.4%, but in Germany most of the growth is explained by public investment and consumption in construction, as Angela Merkel is not certain of being re-elected in the impending elections.

Inflation in the Eurozone rose sharply to 2% as oil prices rose. However, **underlying inflation remains close to 1%, the same level as a year ago**. Germany and the ECB's hawks have begun talking about stopping the buying up of debt. But Draghi has made it clear that his 2% target for underlying inflation is still far from being achieved and it is necessary to continue with the 0% rates and debt buying scheme until at least the end of this year.

The Federal Reserve continued its rate hikes, placing them between 0.75% and 1%. The unemployment rate in the US is stable and close to 4.5% as employment grows with the same intensity as the active population. Wages are stable and underlying inflation is close to the 2% target. Therefore, the Fed will continue with their gradual normalisation process. US 10-year public debt rates have stabilised at around 2.5%. Long-term rates in Europe have rebounded, especially in peripheral countries. In Spain, the 10-year rate of public debt has gone from close to 1% to 1.8% in a few months. The Italian bond continues to trade with a premium which is 50 basis points higher. Also, the German bond has rallied, but less so, despite the euro devaluing against the dollar where the exchange rate stabilised at close to 1.07.

In China the exchange rate with the dollar remains at the same levels since the November elections in the US. Trump then accused China of manipulating its currency and Chinese authorities have decided to spend more reserves to avoid further depreciation. The fear of recession at the beginning of 2016 has been diluted and the outlook is that of strong growth, close to 7%, led by domestic private consumption.

Growth prospects for the Spanish economy

The expansionary phase of the Spanish economy that began in the third quarter of 2013 extended to the fourth quarter of 2016 and will continue at a good pace in the coming months.

Fourth quarter national quarterly data confirmed the strong performance of economic activity, experiencing quarter-on-quarter growth of 0.7%, the same growth rate experienced in the third quarter, as anticipated in our previous bulletin. Growth was much more balanced than in previous quarters, with contributions from both domestic demand and foreign demand being positive. Due to the strong growth in domestic demand, which contributed 2.2 percentage points to annual GDP growth, the dynamism of foreign demand in the fourth quarter added 0.8 percentage points to this, with the contribution of the foreign sector being positive for the second consecutive quarter following three quarters of negative contributions.

As we have mentioned, the Spanish economy closed 2016 with a growth of 3.2%, on a par with the good performance of 2015, a behaviour typical of a consolidated phase of the economic cycle. However, as we have also warned, **the economy will show a gradual deceleration throughout 2017**, mainly due to the gradual disappearance of some tailwinds, such as the fall in the price of oil, which seems to have strengthened slightly above the $50 a barrel after OPEC intervention, and the impact of a more restrictive fiscal policy. In any case, the medium-term outlook remains favourable and, for 2017, our new forecast shows economic growth of around 2.7%.

In the fourth quarter of 2016, **domestic demand** established itself as t**he main driver of growth**, driven especially by private consumption, which again gained momentum (0.8% QoQ) and, to a lesser extent, by gross fixed capital formation (0.5%).

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. Not only did household consumption not slow down its growth in the fourth quarter, but it also experienced a slight boost, with quarter-on-quarter growth reaching 0.7%.

According to the Spanish Association of Automobile and Truck Manufacturers (ANFAC), there was an increase of 4.8% with regard to the registration of new vehicles in the January-February period, an indicator which is directly linked to private consumption and a percentage which is not only far from the two-digit advances of months such as November but also from the 9% growth of the fourth quarter. With regard to the general retail sales index, calendar adjusted and deflated, negative growth of 1.3% was felt in January, following an increase of 2.8% in December.

The increase in private consumption came accompanied by a slight increase in investment (0.5%), supported only by the increase in gross capital formation in construction, with investment in capital goods for the second consecutive quarter.

In terms of residential investment, short-term indicators showed increases in the number of housing sales and increases in January of 18.1% YoY, substantially higher than those observed in December. The free market housing price index, published by the Spanish National Statistics Institute (INE), increased 4.5% YoY in the fourth quarter of 2016, half a point more than in the third quarter, ending the year with an average annual increase of 4.7%, slightly higher than in 2015.

Exports performed well in the fourth quarter, unlike in the third quarter, and grew 2% quarter on quarter. This growth is very homogeneous, unlike the previous quarter, when exports outside the European Union were falling, since while sales outside the European Union, according to data from the Tax Agency, increased by 5.3% year-on-year, sales to partner countries of the Union have grown by 5%.

In 2016, according to the available data on the Balance of Payments, the Spanish economy generated a financing capacity abroad of 2.4% of GDP, compared to a financing capacity of 2% of GDP in 2015. **The accumulated surplus of the current account balance amounts to €22,306 million and represents 2% of GDP, 6 decimals higher than the previous year and the highest in the historical series**. 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 first quarter of 2017, provisional indicators such as the foreign sales by large companies in January, seasonally adjusted, deflated, calendar adjusted and considering a constant population, show growth of 3.6% in year-on-year terms, due, in part, to a rise in exports of 9.1% YoY, partially offset by the slowdown of 0.7 points in domestic sales to 2.1% YoY.

Also as a positive aspect, we should point out the good trends, once again, of the sales of capital goods and software of large companies, seasonally adjusted, deflated and calendar adjusted, which grew in January by 2.5% compared to the previous month, following two falls in the months of November and December 2016

Additionally, the qualitative indicator of the investment goods climate is added to this improvement as it recorded a positive balance in the January-February period, 1.1 points greater than in the fourth quarter, and the productive capacity utilisation of investment goods gained almost two points to 82.9% in the first quarter of 2017.

But without a doubt, **what gives hope to 2017 is the strong rhythm of job creation with which it has begun**. The last quarter of 2016 registered the highest year-on-year growth in employment and the beginning of 2017 -January and February- shows job creation to be growing at the rate as that which was found at closing of the last quarter, 3.4%. This trend is explained by the acceleration of employment in all types of activity, especially construction, with an increase of nearly 5% YoY.

The main indicators seem to suggest that economic activity will remain strong in the first quarter of 2017 and that Spain will continue to lead growth in the Eurozone, aiming at quarter-on-quarter GDP growth of around 0.7%. According to Markit, the PMI Index of Global Activity increased in February by 2.3 points to 57 points driven by the PMI for services, which in February reached 57.7 points, even though the PMI for manufacturing fell in February by eight tenths of a percentage point against the previous month, to 54.8 points, as a result of the more moderate increase in both production and new orders.

As for prices, they grew in February at a rate of 3% year-on-year. The successive increases in fuel and electricity explain this significant rise, in an economy that closed 2016 with a fall in prices of 0.2%. Underlying inflation, however, did not only not grow, but fell by one tenth in February to 1% as a result of the slowdown in the prices of processed food and non-energy industrial goods, while prices of services held the rate of change steady.

Among the qualitative indicators for the Spanish economy, the Economic Sentiment Indicator, which is produced by the European Commission, advanced in February to 108.7, the highest value since December 2015. This result includes the improvement of confidence in all its components, except in retail, where it has worsened.

With regard to the tourism sector, it is noteworthy that Spain received 3.9 million international tourists in January, a 10.7% increase when compared to 2016, according to provisional data published by the INE and drawn from the Frontier Tourist Movement Survey (FRONTUR).

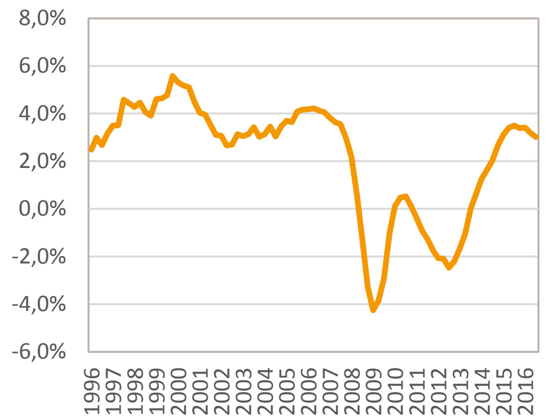
The inertia of private consumption remained strong, so this will remain a growth factor for GDP in the first quarter of 2017. The still strong rhythm of job creation and the easy access to credit facilitate household consumption.

Demand and production

According to the results of the Quarterly National Accounts (QNA) published by the INE, calendar and seasonally adjusted real GDP, recorded quarter-on-quarter growth of 0.7% in the fourth quarter of 2016, the same as that of the previous quarter, which means 13 consecutive quarters with positive quarter-on-quarter growth. On a year-on-year basis, GDP grew by 3%, two tenths less than in the third quarter and four tenths less than the first and second quarters of 2016. This is a continuation of the recovery process consolidation within the Spanish economy, which closed 2016 with annual growth of 3.2%, the same as that of 2015, more than double that of 2014 (1.4%) and the highest since 2007 (Figure 1).

However, our forecasts point to a progressive slowdown in GDP growth, falling to 2.7% in 2017. This deceleration profile is explained by the loss of strength of some factors that might have driven the activity in a transitory way, such as the fall 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, given the upturn seen in global trade and growth.

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

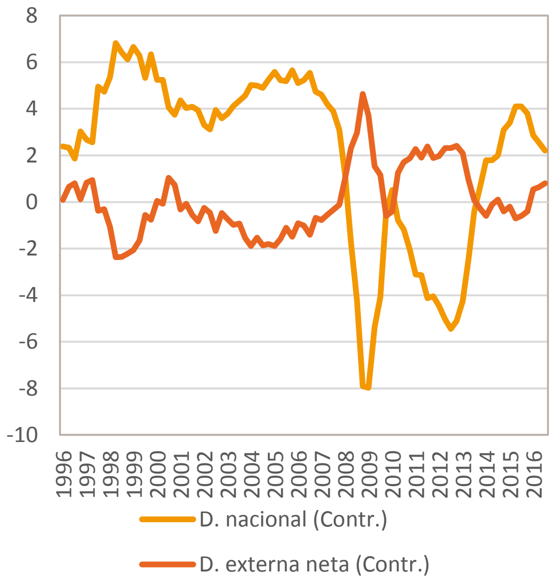


Source: QNA.

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 fourth consecutive quarter, standing at 2.2 percentage points, two tenths less than the previous quarter. The contribution of net foreign demand was positive, as in the previous two quarters, reaching 0.8 percentage points, which is the same as in the third quarter. 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 slowdown of private consumption and, on the other hand and negatively, the weak growth of quarterly business investment which has led this macroeconomic measure to grow at half the rate when compared to the beginning of the year.

With regard to employment, its good pace of job creation held true in the fourth quarter and demonstrated business vitality that has been progressing favourably for some quarters. According to national accounting data, full-time equivalent employment grew at 0.7% QoQ in the third quarter, a year-on-year increase of 2.7%, representing the creation of almost half a million full-time jobs in the last year.

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 performance of private consumption, driven by strong job creation, low interest rates and improved financing conditions. Real expenditure on final consumption by households and non-profit institutions serving households (NPISHs), by volume, grew 3% year-on-year in the fourth quarter (two tenths above the 2.8% of the third quarter), contributing 1.7 points to GDP growth and ending 2016 with average year-on-year growth of 3.2%, two tenths higher than in 2015. **In quarter-on-quarter terms, the progression of private consumption (consumption of households and non-profit institutions serving households) stood at 0.7%, one tenth higher than in the previous quarter (Figure 2).**

The favourable evolution of private consumption is explained by strong employment creation, improved access to finance and its conditions and price moderation, the latter being subject to an upward change in the first quarter of 2017 mainly due to the rise in the price of oil and electricity.

The most recent qualitative and quantitative economic indicators signal to the expansionary trajectory of private consumption growth being maintained in the first quarter of 2017, albeit at a more moderate rate.

Private consumption continued to grow in the fourth quarter, in nominal terms, at the same pace as the remuneration of those in paid work, which means that household savings have stopped growing.

Also noteworthy is the behaviour of the Public Administrations' expenditure on final consumption, in volume and year-on-year terms, which has not grown in year-on-year terms and fell two tenths in comparison with the previous quarter.

Fixed capital investment, for its part, saw a year-on-year increase of 2.2% in the fourth quarter of 2016, compared to an average growth of 3.1% throughout the year. In the fourth quarter, investment grew 0.5% quarter-on-quarter and **investment in capital goods stagnated, something which could become a major risk for the Spanish economy if this trend does not change as it has already been this way now for two quarters**.

Construction investment raised its pace in the fourth quarter, situating itself at a rate of 1.9% YoY and 0.7% QoQ, both in residential and other construction segments.

The relevant indicators related to residential investment provided mixed signals. Thus, the number of sales of houses continued to grow strongly in January (+18.1% YoY), which was 11.3 points higher than in December. The number of home mortgages taken out sped up in December to 6.9% YoY, against the previous month increase, so 2016 closed with an average annual increase of 14%, 6.8 points lower than that of 2015. Finally, according to statistics from the INE, the price of housing continued the trend of year-on-year growth which started at the beginning of last year with an increase in prices in the private housing market of 4.5% YoY in the fourth quarter, reaching 4.7% in real terms, 1.1 points higher than that seen 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 productive capacity utilisation.

Foreign demand

According to figures from the Quarterly National Accounts (QNA), the **foreign** sector contributed a tenth to the quarter-on-quarter change in GDP in the fourth quarter of 2016, after having contributed two tenths in the previous quarter, resulting in an increase in exports of goods and services being greater than that of imports. Compared with the main economies of the European Union, the quarter-on-quarter rate for Spanish real exports (+2%) was higher than that for Italy (+1.9%), Germany (+1.8%) and France (+1.3%) and less than that for the United Kingdom (+4.1%). In terms of year-on-year growth, Spain is clearly situated above the largest economies in Europe with an increase of 4.4%.

On a year-on-year basis, net foreign demand contributed five-tenths to GDP change in 2016, sixth-tenths more than in 2015 when it was slightly negative, as exports decelerated less than imports. **Both domestic and foreign demand showed positive growth in 2016**.

Exports of goods and services sped up in the fourth quarter of 2016 following the slowdown observed in the third quarter in an environment characterised by slight improvements in the main trading partners and in the main emerging economies.

Moreover, in the currency markets, the euro depreciated slightly in trade-weighted figures, with the nominal effective exchange rate of the euro falling by 1.4% since the beginning of December. In bilateral terms, the single currency depreciated 1.6% against the US dollar and 1.5% against the Japanese yen and appreciated 2.2% against the pound sterling. At the same time, the euro also depreciated against the currencies of most other EU Member States who have not adopted the single currency and against currencies of major emerging economies (including the Chinese renminbi).

In year-on-year terms, exports of goods and services increased by 4.4% in the fourth quarter of 2016 compared to 2.9% in the third quarter, with a growth of 3% in goods and 7.8% in services, rates which are 2 and 0.6 points higher than those of the previous period. On a quarter-on-quarter basis, exports rose by 2%, compared to a 1.2% increase in the previous period, due to improvements in goods and services exports of 1.6% and 3%, respectively.

The year-on-year growth in goods exports in the fourth quarter (3%) contrasts sharply with the sluggishness of global trade in goods, which grew by 1.5% according to the Netherlands' Central Planning Bureau, producing an increase of real market share in 2016 of 1.8%, 1.9% YoY. The growth of exports in the fourth quarter was generic by products (with the only exception being capital goods, which reduced their quarterly decline by 0.5 percentage points, down 5% YoY).

The expenditure by non-resident household in the economic territory, by volume and according to the QNA figures, increased by 4.1% QoQ in the fourth quarter compared to 0.7% in the previous quarter, and increased 9.3% YoY, one percentage point more than in the previous first quarter. For the first quarter of 2017, the main indicators for foreign tourism, such as arrivals of tourists and overnight stays by tourists in domestic hotels, offered favourable signs, growing respectively by 10.7% and 9.3% in January.

Imports grew by 1.8% in the fourth quarter of 2016 compared to the third quarter, when they suffered a slight decline. By components, goods imports grew 1.9% compared to the previous quarter and services grew by 1.6%. Real expenditure of overseas households, according to QNA figures, grew by 8.2% QoQ, following the 6.1% increase in the third quarter. Imports from non-tourism services, on the other hand, fell by 0.6% QoQ, after a 4.3% increase on the previous quarter. The services with the greatest positive contribution were business and intellectual property services.

The balance of goods and services surplus, according to the QNA, was at 2% of quarterly GDP in the fourth quarter of 2016, three tenths higher than the previous year, due to the smaller deficit of goods and a slight increase in the services surplus. Within services, the net tourism revenue surplus held stable with regard to the percentage recorded in the fourth quarter of 2015, however the surplus of non-tourism services grew by one tenth.

Productive activity

In the overall figure for the year, activity sped up in all sectors, with the exception of industry, where growth fell from 5.5% in 2015 to 2.4% in 2016. In this way, the Gross Value Added (GVA) of the primary sector increased by 3.4% in the last year (-2.9% in 2015), while construction increased by 2.5%, compared to 0.2% in 2015 and 3.4% in services, compared to 2.6% in 2015.

The apparent productivity per employee, in terms of National Accounts, grew by 0.3% in the fourth quarter of the year as a result of the 3.2% increase in GDP and a 2.7% increase in full-time equivalent employment.

The provisional indicators for the industry showed signs of greater business dynamism in the first months of 2017. However, the 2.5% increase (with calendar-adjusted data) of the industrial production index was mainly due to the strong boost in the energy sector (9.8% YoY) and, to a lesser extent, to the demand of capital goods experiencing a more moderate drop than usual (-0.1%). Finally, the PMI of manufacturing declined eight tenths in February from the previous month to 54.8, due to the more moderate increase in both production and new orders.

In the construction sector, looking at 2016 in its entirety, areas used for new constructions reached an average annual increase of 20%, compared to a 38% increase in 2015, mainly due to the evolution of the non-residential component which decreased by 2% compared to an increase of 27.4% in 2015, and, to a lesser extent, the deceleration of the residential component.

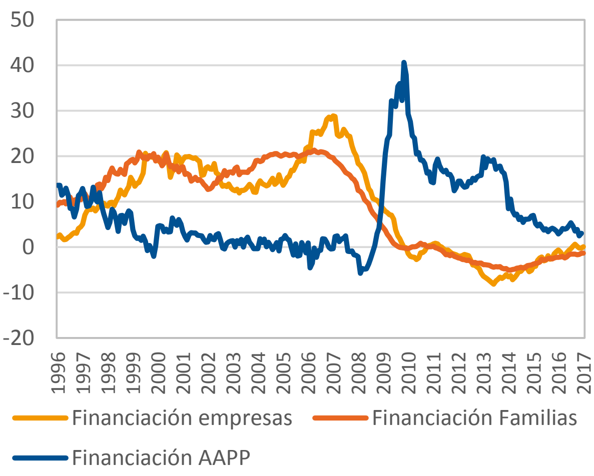
Following the Construction Production Index published by Eurostat, 2016 closed with average annual growth of the index of 5.1%, higher than the 1.8% of 2015, which is explained by the favourable trends in civil construction, which accelerated by 4.5 points to 13.5%, and building, which registered an increase of 3.5%

The service sector, on the other hand, showed, in general, favourable indicators such as the service trust indicator, published by the European Commission, and the services PMI, published by Markit, with increases in February reaching 57.7, 3.5 points higher than in January, and higher than that of the Eurozone (55.5). The increase in customer demand and greater commercial activity were the main factors that contributed to this expansion of activity. The exceptional tourist season must be added to this as it came characterised by the arrival of more than 75 million tourists, a historic record. In January 2017, indicators related to tourism continued to show very positive signs. Relevant here was the arrival to Spain of 3.9 million tourists in January 2016, 10.7% more than in January 2016, according to data from Frontur published by the INE. Total expenditure also rose by 13.8% YoY, which translated into an increase in average expenditure per person of 2.8%. In a less positive light, it is worth mentioning the slowdown in overnight stays in hotels in January to 3.5% from 4.2% in December due to the decline in overnight stays by Spanish nationals, a decline seen for the second consecutive month (-6.1% against -1.2% in December).

In relation to financing for productive activity, figure 3 shows the trends of the rate of variation of financing for the different productive agents. The fall in credit to companies and households lost momentum in 2016, especially in the fourth quarter, where it fell a meagre 0.13% QoQ, favouring productive activity. However, it is still declining in year-on-year terms even though corporate financing finally showed positive growth for the first time since the Great Recession. In fact, total financing of non-financial corporations increased by €750 million in the fourth quarter. Finally, the growth of credit destined for the financing of Public Administrations continued to slow, and in December it was 3% YoY.

With regard to new credit, the importance of the strong growth in lending to households observed in January, 22% year-on-year, cannot be understated. Much of this increase was due to an extraordinary year-on-year increase of 28.4% in loans destined for the purchase of homes and 24.8% in loans for consumer goods, growth well above the variations observed in the economic activity.

Figure 3. Financing YoY Rate



Source: Bank of Spain

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

From the supply side, improvements in the banking sector strengthened. The banking sector's non-performing loan ratio stood at 9.11% in December (1.01 percentage points lower than the previous year and 4.5 percentage points below the December 2013 high). This is a downward trend that is based on improving economic activity and, especially, the labour market. Although the NPL ratio increased slightly to 9.12% in January, due to the increase in the default rate of households, our forecasts point to further declines that could put the NPL ratio at 8.9% at the end of the first half 2017.

Prices

Despite the monthly decline in the Consumer Price Index (CPI) of -0.4% in February 2017, CPI grew by 3% YoY, a rate identical to that of the previous month. The stability of the year-on-year rate is mainly due to the fact that the deceleration of the prices of electricity, non-energy industrial goods and processed food has partly compensated for the rise in unprocessed food and fuel prices, while the prices of services held steady.

Prices of energy products rose 16.8% year-on-year in February, after a 17.5% increase in January. This trend is explained by the moderation in the increase in electricity prices, which rose from 26.2% year-on-year in January to 18.9% in February, partly offset by the rise in the price of fuels, which went from a growth of 13.9% to 16.4%.

Unprocessed food prices grew by 5.4%, a rate substantially higher than that of the previous month, highlighting the evolution of fresh fruit prices (which went from a fall of 0.3% year-on-year in January to growth of 7.6% in February) and fresh vegetables, whose prices rose by 4.3 points to 22.2%.

Underlying inflation, which excludes the more volatile elements of the general index (unprocessed food and energy), decreased by one tenth in February to 1% as a result of the slowdown in prices of processed food and non-energy industrial goods while the price of services held steady.

The increase in global inflation in the Eurozone to 2% in February compared to January is mainly explained by the growth of the prices of unprocessed food and energy. Underlying inflation remained unchanged in February at 0.9%. On the other hand, the year-on-year rate of the Spanish harmonised CPI stood at 3% in February, one tenth higher than in January, resulting in an inflation differential in Spain with respect to the Eurozone of one point, following the differential of 1.1 points in January. Finally, the underlying inflation differential was one tenth, with Spain's harmonised underlying inflation being at 1%.

Labour market

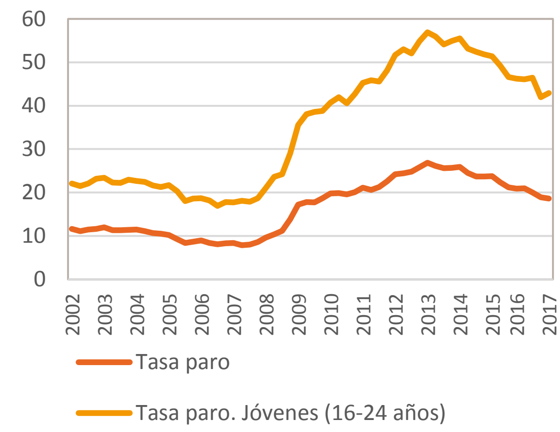
The labour market was characterised in the fourth quarter by an extension of the dynamism observed in the creation of employment in previous quarters, both in the case of the Economically Active Population Survey (EAPS) and new registrations in Social Security. **In the first two months of 2017 there was an increase in the pace of job creation, according to the figures of registrations in Social Security.**

With seasonally adjusted series, quarter-on-quarter variation was 0.4% in the fourth quarter, three tenths lower than in the previous quarter. Between the fourth quarter of 2016 and the fourth quarter of 2015, 413,900 net jobs were created, an increase of 2.3%.

According to QNA figures, full-time equivalent employment, with seasonally adjusted and calendar-adjusted series, increased by 0.4% QoQ, four tenths less than in the previous quarter, and 2,7% YoY, two tenths less than in the third quarter.

If we look at Social Security registrations, with seasonally adjusted series, these increased by 0.9% QoQ in the fourth quarter of 2016, two tenths more than in the third quarter. In year-on-year terms, the number of those in work showed an acceleration of three tenths, registering a rate of 3.3% in the fourth quarter.

Figure 4. Unemployment rate. Active population percentage



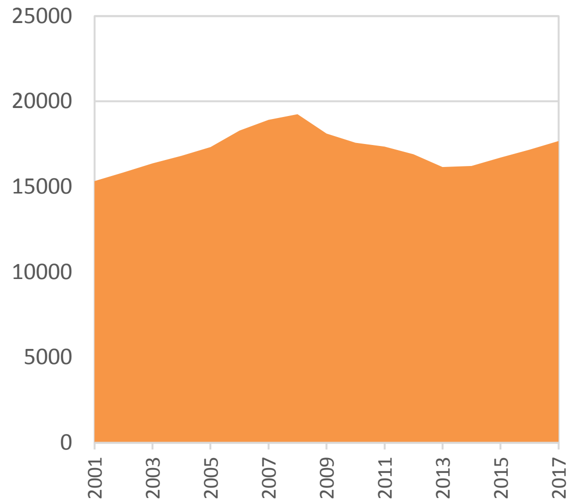
Source: INE

Looking at the professional situation of those in work, those in paid employment grew by 2.6% in the year-on-year comparison, compared to 3% in the third quarter. At the same time, the number of self-employed workers increased by 0.5%, two tenths less than in the third quarter.

If we look at the type of contract, the year-on-year increase in paid employment of 1.5% places the net creation of paid employment at 43% of the total, while the 57% representing temporary employment grew at a year-on-year rate of 5.9%. This results in the temporary employment rate growing to 26.5%, higher by almost a point to that of last year.

Looking at age groups, all groups showed declines in unemployment in the fourth quarter, except for those over 55 years old and those under 25 years old. The youth unemployment rate rose by one percentage point, from 41.9% to 42.9%.

Figure 5. People Registered in Social Security (monthly average). Thousands



Source: Social Security.

In the seasonally adjusted series provided by INE, the quarter-on-quarter change in the number of those unemployed was -3.8%, compared to -3.2% in the third quarter, which implies a continued fall in seasonally adjusted unemployment in the last fifteen quarters. In the last year, unemployment fell by almost 542,000 people, representing a year-on-year decline of 11.3%. The unemployment rate stood at 18.6% of the labour force at the end of 2016.

Finally, data from January-February point to an acceleration of job creation in the first quarter of 2017 - in particular, employment grew by one tenth to a year-on-year rate of 3.4%.

A slowdown with regard to the growth of salaries and unit labour costs has continued. According to the Labour Cost Quarterly Survey for the fourth quarter of 2016 the average labour cost per worker and per month decreased by 0.8% in relation to the same quarter of 2015, compared to 0.5% in the previous quarter. Thus, 2016 closed with an average annual fall in labour cost per worker of 0.4%, compared to the increase of 0.6% in 2015, and with a decrease in the wage cost of 0.3% compared to the 1.1% in the previous year.

And according to QNA figures, remuneration per employee increased in the fourth quarter of 2016 by 0.1% YoY, one tenth higher than in the previous quarter. Meanwhile the apparent labour productivity increased by 0.3%, as in the previous quarter, such that the unit labour cost decreased by 0.2%, thus accumulating six consecutive quarters of declines. Finally, the Statistics of Employment Agreements prepared by the Ministry of Employment and Social Security pointed to an average increase until February of 1.2%, one tenth higher than the wage increase agreed in 2016.

Balance of payments

In 2016, according to the available data on the Balance of Payments, the Spanish economy generated a funding capacity abroad of €26,859 million (2.4% of GDP), compared to a funding capacity of €21,786 million (2% of GDP) in 2015.

The accumulated surplus of the current account balance amounted to €22,306 million and represented 2% of GDP, 6 tenths higher than the previous year and the highest in the historical series. This increase was due to an improvement of more than €6,000 million in the goods and services surplus, 2.9% of GDP, and, to a lesser extent, to the reduction of the deficit in primary and secondary incomes, which stood at -0.9% of GDP. The smaller trade deficit in energy goods played a key role in the improvement of the current account, as it decreased by 25%, in line with the trends followed by the price of imported oil, which, measured in euros, fell by 21.5% on average during the year.

While income from tourism grew by 7.1% year-on-year in 2016, breaking all records regarding incoming tourists and their expenditure in the historical series, payments from tourism, as a result of travel abroad by Spaniards, grew by 18.1% in 2016 YoY, a rate that surpasses that of 2015 by 2.8 points.

The financial balance, for its part, recorded net capital outflows amounting to €34,000 million, compared to outflows of more than €25,000 million a year earlier. This trend was the result of an increase in net capital outflows excluding the Bank of Spain, of €87,600 million, partially offset by an increase in the Bank of Spain's net debt position of €53,600 million.

Public sector

Despite the fact that the data on the government deficit are not yet closed, it seems as though the public deficit will be below the target of 4.6%, excluding banking aid, in line with what we predicted in previous bulletins.

With data already closed and taken in consolidated terms, the Regional and Central Administration and Social Security Funds recorded up until November 2016, the last available data, a deficit of €39,579 million, equivalent to 3.5% of GDP, lower than the 3.8% of 2015 for the same dates. Excluding aid to financial institutions, the deficit stood at €37,243 million, or 3.33% of GDP, which was 8.7% less than in November 2015.

The increase in taxes on production and imports (0.3%), current taxes on income and wealth (0.5%) and social contributions (3.1%) explain the increase in non-financial resources, partially offset by the fall in capital taxes (-0.6%) and the transfers from other public administrations (-6.9%).

Increases in social benefits other than transfers in kind (1.9%), social transfers in kind from market producers (3.1%), transfers to other public administrations (4.2%) and the remuneration of employees (1.9%) can explain the increase in non-financial jobs. Among those which decreased, we can highlight gross fixed capital formation (-17.5%), subsidies (-14.6%), interests (-5.9%) and intermediate consumption (-1.4%).

Our forecasts point to annual growth of 2.7% for 2017.

According to the methodology of the Excessive Deficit Protocol (EDP), the debt of Public Administrations amounted to 99.3% of GDP in the fourth quarter of 2016, i.e. €1,105,627 million, a percentage lower than that of the previous quarter.

State debt stood at 85.4% of GDP, six tenths lower than in the third quarter, while debt of other organisms belonging to the Central Administration reached 3.5% of GDP. The EDP debt ratio of the Autonomous Communities on GDP, in turn, increased one tenth in the last quarter of 2016, when compared with the third quarter, to 24.8%. And finally, within Social Security Administrations, debt reached 1.5%, compared to 1.6% of GDP in the previous period. Local Corporations showed an EDP debt ratio of 2.9% of GDP in the fourth quarter, two tenths lower than the previous quarter.

2017-2018 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** most likely experience **a deceleration of GDP growth, which we estimate to be around 2.7%.**

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

Brent prices have fluctuated between $52 and $56 a barrel since late November when the OPEC reached an agreement to cut output. World crude oil production declined in January as a result of this intervention. While OPEC output registered one of the biggest cuts in its history, non-OPEC member countries who signed the agreement also contributed **to the sharpest year-on-year decline in world oil supplies since September 2008**. However, production in non-OPEC countries is expected to increase in 2017, driven mainly by countries that have not participated in the agreement (United States, Canada and Brazil), having already seen an increase in American production of non-conventional oil (shale oil) in December 2016.

As a result, **global inflation is expected to increase slowly**. 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, **given that the current oil futures curve anticipates that crude oil prices will remain very stable, we expect the future contribution of energy prices to inflation to be very limited**.

Even taking into account the above, it is necessary to add that global activity improved in the second half of last year and **growth is expected to remain the same in the first quarter of 2017**, albeit at a moderate pace if viewed from a historical perspective. Global inflation has also increased in recent months, following the rebound in oil prices.

Recent data confirm that the world growth rate was sustained in the last quarter of 2016. The composite PMI index of global production in early 2017 confirmed this trend. At the country level, quarterly PMI improved in all major advanced economies in the last quarter of 2016. Among emerging economies, quarterly data improved in China and Russia, but worsened in India (following its recent demonetisation policy) and in Brazil, remaining below the 50 threshold in both countries.

Looking ahead, both advanced and emerging economies are expected to contribute to growth and, in particular, **the stimulus provided by fiscal policy is expected to strengthen economic activity in the United States**, while the gradual easing of deep recessions which are affecting some of the main exporters of raw materials will support growth in emerging economies.

However, **uncertainty remains high due to a number of factors, including the design of the new US Administration's policies and its effects on the US economy**, as well as potential contagion to global activity. Furthermore, it is important to mention in this regard the strength of the recovery in commodity-exporting countries, the gradual realignment of the Chinese economy, and the future relations between the United Kingdom and the European Union.

Although, overall, financial conditions have remained favourable, they have become tougher in some emerging economies. Financial market volatility has remained subdued in recent weeks, and stock markets in the advanced economies have recorded new gains. US long-term government bond yields rose slightly, while long-term bonds remained at low levels in other advanced economies.

Financial conditions tightened in some emerging economies, as sovereign debt differentials widened and currencies depreciated, notably the Mexican peso and the Turkish lira. Overall, there was some decline in capital outflows in emerging economies, less persistent than in previous episodes of uncertainty. However, China's outflows were significant in December, and were only interrupted by strict control measures imposed by the authorities.

Much of this new buoyancy in the global economy, which is expected to accelerate growth by over 3% in 2017, 2018 and 2019, according to the forecasts of major international organisations, is due to the fact that world trade gained momentum in the second half of 2016 and, according to the available data, it seems that it has maintained this energy in the first quarter of 2017. Global import data, excluding the Eurozone, were revised as being slightly positive in the third quarter of 2016, confirming the upturn in the first half of the year, and available indicators point to positive outlook in the short term. According to data from the Dutch Planning and Analysis Centre, world imports of goods in real terms rose by 0.6% QoQ in December, slightly below the third quarter but still aiming for sustained growth. The overall PMI for new foreign orders has continued to increase in recent months, indicating an improvement in the vitality of world trade at the beginning of the year In the longer term, although prospects are subject to some degree of uncertainty related to future US trade policies, **world trade is expected to advance practically in line with global activity**.

In this foreign environment, t**he Eurozone's growth prospects are very favourable**. With growth of around 1.8% in 2017 and 1.7% in 2018, the ECB recently revised its forecasts slightly upward, precisely because of the good prospects presented by the world economy, which favours somewhat stronger foreign demand in the short term, weaker exchange rate and more a favourable economic sentiment. All this will have repercussions on the good performance seen in the Spanish economy, with it being beneficial for the more dynamic Spanish exports both inside and outside the Eurozone. Moreover, in the currency markets, the euro depreciated slightly in trade-weighted figures, with the nominal effective exchange rate of the euro falling by 1.4% since the beginning of December. In bilateral terms, the single currency depreciated 1.6% against the US dollar and 1.5% against the Japanese yen and appreciated 2.2% against the pound sterling. At the same time, the euro also depreciated against the currencies of most other EU Member States who have not adopted the single currency and against currencies of major emerging economies (including the Chinese renminbi).

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 that country. A rise**

that has spread to Europe and we expect will continue in 2017.

In fact, in March the US Federal Reserve raised interest rates up to between 0.75% and 1%. 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 European Central Bank (ECB) continuing with its policy of negative rates, this policy is likely to be withdrawn by 2018, something which could begin to be discounted by the markets in the in the second half of 2017.

The first effect will be the hiking of long term interest rates. **Although a hike will take some time to affect interest payments on the debt of Public Administrations, it will end up affecting them and, more immediately, companies. This is worrisome given the high financial vulnerability of the Spanish economy**.

The second effect, **short-term interest rate hikes, will impact the Spanish economy as it is especially sensitive to increases in the Euribor** due to the high debt held by households which thus affects the Spanish families' waterline.

We could also include a third factor, given the limited fiscal space in Spain, which 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 tenths to 5% of GDP (excluding losses from aid to banks), but in 2016, if the target of 4.6% of GDP is met, the adjustment will be 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 the scope of monetary policy, the Governing Council of the European Central Bank (ECB) decided not to alter interest rates applicable to the main financing 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 continue its asset purchase program, although from April onwards, net purchases will amount to €60,000 million until the end of December, or until a later date if necessary and, in any case, until the Governing Council observes a sustained adjustment of the inflation path compatible with its inflation target.

To ensure a correct implementation of quantitative easing, the Governing Council has decided to adjust the parameters of the program starting 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, to the necessary extent, the acquisition of assets with a profitability lower than that offered by the deposit facility, currently set at -0.4%.

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 normalisation 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, above all if the acceleration seen in international trade in the last quarter of 2016 continues. 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 1.8% of GDP forecast for 2016 to 1.1% of GDP in 2017 and to 0.2% in 2018.

In a recent statement, 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, Germany, perhaps Italy), which will undoubtedly be marked by the rise of even stronger populism and nationalism after the recent terrorist attacks in Germany and the United Kingdom, all make politics and its risks a factor to be taken into account next year. **Polarisation and political instability are breeding grounds for less economic prosperity**.

The latest available economic indicators anticipate a growth of 0.7% of GDP in the first quarter of 2017. That said, without an income tax cut that would increase household disposable income by 0.5% of GDP and thus continue the growth of private consumption experienced in 2016, and with the increase in taxes on alcohol, tobacco, soft drinks and gasoline, which will drain another 0.1% of GDP, slight nominal wage increases close to 1% and real wages that lose around 1% of their purchasing power, **2017 could see private consumption lose one percentage point of the observed growth in 2016**. 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 of 8% in the minimum wage will improve low incomes in this context and reduce inequality, but it is very unlikely that these effects will carry over to other wages and salaries.

At a European level, Spain needs to assume, little by little, 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. The fiscal impulse, when it cannot come from the country itself due to its significant imbalances, must come from the community budget. But, given the lack of political will towards a true political union, a more federal Europe is far from being forged as a real project.

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 anyway, given the relationship between increasing public spending and the holding of elections. Following the elections in the Netherlands, where the government agreement is still pending, national electoral processes will also take place in France, Germany and, perhaps, Italy. Increases in demand in the Eurozone would benefit Spanish exports.

The sixtieth anniversary of the European Union will be marked by the recognition that the European federalist project is not at its best and the Union will move forward in a two-speed model, since further integration would require adopting an immigration and asylum policy that is rejected by countries such as the Czech Republic, Poland, Hungary and Slovakia, which refuse to admit refugees. It would also require reforms and fiscal adjustments to be able to approve a fiscal and competitiveness policy opposed by countries such as Spain, Italy or France. **And more integration would also mean approving by majority the mutualisation of bank and debt risks that complete the monetary union and are consistent with the historic decision to surrender sovereignty which implied the birth of the euro**. But the latter is opposed by countries like Germany, Holland and Finland. The Eurozone is a monetary union without political union, that is, without a common budget of a dimension coherent with the size of the economy, without a common treasury and Eurobonds, and without common mechanisms to manage common risks (like common unemployment insurance). The Banking Union is still incomplete, since there is no common deposit guarantee fund and the Capital Market Union project is progressing too slowly.

And there seems to be no doubt that the post-Brexit European project will be a multi-Speed Europe. The question is whether the process will be controlled by governments or pivot on common institutions in Brussels.

The Spanish economy has stronger fundamentals 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 optimism in the future of the Spanish economy, we could highlight the competitiveness achieved after the significant adjustment effort made by companies in their unit labour costs (notably lower than the average of our Eurozone partners and having also allowed for strong job creation), job creation that in turn makes sustainable the improvement experienced by domestic demand that began in 2014 and, finally, the radical change in the availability of financing as well as in the financing conditions since the European Central Bank decided to intervene and curb the risky episode of financial fragmentation and credit crunch that dominated the Eurozone.

Part of the economic slowdown foreseen for 2018 (our initial estimate is 2.3% growth) is due to the fact that the Eurozone could already be immersed in a monetary tightening policy context, which will significantly affect the Spanish economy.

Likewise, we forecast that job creation will soften to around 2.3%, partly due to a loss of some momentum in household spending. Investment in construction and capital goods should positively contribute to accelerating growth somewhat more than expected in 2017. The current account surplus would be slightly positive (0.2% of GDP), compared to 1.8% in 2016.

There is no doubt that the greatest risk to the Spanish economy remains complacency as the long-term challenges for the Spanish economy and society remain unresolved.

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 the Spanish economy has ahead.

Annual forecasts for the Spanish economy.

Table 1. ANNUAL FORECASTS

% annual average change, unless otherwise indicated

	2017	2018
Real GDP	2.7	2.3
Final household consumption	2.2	1.8
Final Public Administration consumption	1.2	1.6
Gross Fixed Capital Formation	2.8	3.4
- Machinery and capital goods (1)	2.6	3.4
- Construction	2.6	3.0
Stock variation (contribution to GDP growth in pp)	0.0	0.0
National demand	2.2	2.2
Exports of goods and services	4.7	4.3
Imports of goods and services	3.6	4.1
Underlying CPI (annual average)	1.4	1.6
Total CPI (annual average)	2.5	2.1
Labour costs per worker (2)	1.6	1.7
Employment (National Accounts) (3)	2.3	2.0
Unemployment rate (EAPS, % of active population)	18.1	16.3
Balance of balance-of-payments current account (% GDP) (4)	1.1	0.2
Financing capacity (+) or necessity (-) Public Administrations **excluding aid to financial institutions** (% GDP)	-3.8	-2.9
(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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axesor {Primera Agencia de Rating española}

902 10 10 33
www.axesor.es
bccomunicacion@axesor.es