FOCUS

Quarterly Bulletin on Economic Situation and Prospects

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QUARTERLY BULLETIN ON ECONOMIC SITUATION AND PROSPECTS.

Executive summary.

The Spanish economy continues to profit from the strong competitiveness adjustments in recent years, the relative weakness of the euro, the moderation of the oil price and extremely low interest rates.

Macroeconomic data remain highly favourable, with growth in the first quarter once again above the annualised 3%. Also, job creation remains remarkably strong, **industrial production and exports were very positive in the first quarter**, confidence is at high levels, the PMI (Purchasing Managers Index) continues to show clear progress and the demand for credit continues increasing.

To this we must add the good condition of the tourism sector, partly due to the geopolitical tensions that affect some competing destinations and partly due to the competitiveness of the sector.

Prospects for the real estate sector are also clearly positive, albeit with significant differences by regions and areas.

Looking to the future, everything seems to indicate that this favourable dynamic will continue in the form of expansion throughout the year. **As a result, we have positively revised our forecasts for GDP growth for 2017 to 3.1%, compared to the 2.8% we anticipated in our previous quarterly bulletin.**

This strong pace of GDP growth, **well above the potential of the Spanish economy**, will bring with it significant reductions in the still high levels of idle capacity.

This reduction in idle capacity should, in turn, allow some acceleration in both underlying prices and wages.

The national accounting data for the first quarter confirmed that **the Spanish economy grew by 0.8% quarter-on-quarter in the first quarter of 2017**, reflecting the slight increase in the speed of GDP growth. **This has been due to the notable contribution of domestic demand but also of foreign demand.** This means that the Spanish economy still boasts a growth rate significantly higher than that in the Eurozone (+0.6%), which is also growing at rates not seen for six years.

With regard to domestic demand, **private consumption slowed its growth mainly due to the rebound in prices**. However, in recent months this has shown a slowdown as a result of the fall in the price of oil and in taxes and the demand accumulated throughout the crisis.

The lower growth of household consumption was more than offset by the increase in government spending and, especially, the significant increase in investment.

The strong growth of employment in the construction sector is due to the strong boost seen in residential investment. But more important is, if possible, the improvement in investment in capital goods and intellectual property products.

Part of the explanation could come from the unexpected increase in corporate tax payments required by the government in the second half of last year, which certainly motivated the noticeable deceleration observed in the capital goods investment of the second semester. This led many companies to postpone their investments, which were then made in the first quarter of this year, making them additional to those planned for the period, something which would help explain the magnitude of the advance.

With regard to the foreign sector, exports grew at a surprisingly high rate of 4% quarter-on-quarter, a rate not seen since the first quarter of 2007. Furthermore, **for the most part, this growth was not due to tourism, rather it stems from non-tourism goods and services**, driven by the notable improvement of the European economy and emerging countries, as well as our improved competitiveness.

In fact, **Spanish goods exports have grown significantly above the growth of world trade.**

Imports, given the strong increase in investment and exports, have also grown notably due to their high elasticity to said demand components. **However, imports have grown at a low rate than exports in such a way that the contribution of foreign trade to GDP growth is positive again.**

In short, **GDP is moving faster than in the previous quarter, with lower growth in private consumption, greater growth in investment in capital goods and a very positive contribution from the foreign sector, which, in turn, does not predominantly stem from tourism**. The significant efforts Spain has made to improve its competitiveness allow its economy to take greater advantage of the renewed momentum observed in the world economy in the first quarter of the year, something which facilitates and activates business investment, employment and, again, recovery in consumption, as is already being seen in the information available for the second quarter.

In the first quarter of 2017, according to quarterly national accounts, **the foreign sector contributed seven 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 four quarters. The contribution of domestic demand to growth was 2.3 percentage points, one tenth higher than the contribution from the fourth quarter of 2016. This has allowed **the Spanish economy to grow in a much more balanced way, 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 2.5% YoY in the first quarter of 2017, with the average annual growth balance being identical to that of the previous quarter (3%), bringing apparently productivity per worker up to 0.5%.**

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 would remain positive for GDP, which is estimated to grow at 3.1%. 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 three tenths improvement in our growth estimate for 2017 lies in the marked improvement in the performance of the world economy and the corresponding acceleration seen in international trade. Indeed, this significant revision reflects the better-than-expected behaviour of the foreign sector. International trade improves and the Spanish economy benefits as a consequence.** The growth of goods exports has accelerated thanks to the efforts made by companies to improve competitiveness in recent years. **Furthermore, the tourist season will once again be very good, both in terms of incoming tourists and their spending, to which exports of non-tourist services will be added. Despite the momentum of exports and a slight rebound in domestic demand compared to the previous forecast also boosting imports, the contribution to foreign sector growth would reach 0.6 points.**

Domestic or national demand, meanwhile, will slow down, but less than initially forecast, contributing 2.5 percentage points to GDP growth. Household consumption will increase somewhat more than expected due to the impact of higher employment creation on household disposable income, as well as the observed reduction in the savings rate. The improvement in incomes in both households and businesses will boost investment.

In June the price of oil in international markets dropped $10 to $45 per barrel and the euro appreciated. Meanwhile, **long-term interest rates referenced by Spain's 10-year bond will close the second quarter at their lowest of the year, below 1.4%, falling 27% since the beginning of the year**. Therefore, the deceleration through consumption and investment will be much lighter than expected at the beginning of the year, and the economy may even hold on to the growth rate seen in the last two years, given the strong GDP growth expected in the second trimester.

However, **second-quarter leading indicators, such as car sales or overnight stays in hotels, have shown a significant slowdown, both of which indicate that private consumption has lost strength in 2017.**

Employment will increase by 2.7% in 2017 and the unemployment rate will decrease to an annual average of 17.9%. The forecast for inflation is expected to reach 2.1% in 2017 as a result of the year-on-year rise in the price of oil, while underlying inflation will remains subdued. Part of the increase in inflation will shift to wages, which are forecast to increase by 1.2%.

Prices, in turn, stood at 1.9% in May, in a trend which showed the moderation of the significant growth which ran in parallel to the events related to the oil market. The weak euro, highly dynamic exports and strong growth favoured by low oil prices and low interest rates **allowed the Spanish economy to regain financing capacity in the first quarter of the year**, reaching around 2.1% of GDP, slightly higher than that already observed In the first quarter of 2016.

The Spanish economy's high dependence on external financing is worrying and adds greater vulnerability to markets tensions. Public debt is the main factor that explains a lack of decline in the external debt of the total economy in recent years, which in the first quarter of 2017 amounted to 100.4% of GDP. **Regarding the increase in public debt of 64 percentage points of GDP between 2007 and 2016, approximately half stems from non-residents**. But as long as the private sector of the economy is able to provide finance, the reduction of external debt will be faster and more likely. Low household savings relative to GDP and the recovery of residential investment will mean that financial tensions will not dissipate. The Spanish economy has no other way to reduce the aforementioned vulnerability than to save more than it invests, something which happens by having a very comfortable current account surplus.

Advanced indicators from the second quarter show signs of strong momentum in employment growth and 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.

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 the average inflation of the year at around 2%, with a similar general interpretation for the Eurozone. However, **inflationary tensions should probably be higher in the central euro countries**, especially in Germany, whose unemployment rate in the first quarter of 2017 fell to 3.9%. It should also be noted that **although the overall unemployment trend is clearly positive in the Eurozone (if the current rate of job creation holds steady, the unemployment rate in the Eurozone could fall to 8.5% by the beginning of 2018, which, although high compared to the US or Japanese economy, would place unemployment in the Eurozone at pre-crisis historical levels), the slack in labour markets is still noticeable** when measures which are broader than simply the underutilisation of labour are considered.

It is precisely for this reason that the European Central Bank (ECB) announced at its last monetary policy meeting 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 in order to achieve firm recovery of the Eurozone economy, as recently demonstrated by the ECB's survey of SME 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. Therefore, interest rates applicable to main financing operations, the marginal lending facility and the deposits facility will remain unchanged at 0%, 0.25% and -0.40%, respectively. Regarding non-conventional monetary policies, the ECB will continue to make purchases under the asset purchase program at a rhythm of €60 billion per month until the end of December 2017, or a later date if necessary. The ECB has recently updated its forecasts by projecting Eurozone GDP growth for 2017 of 1.9%, above its potential, but nevertheless it has admitted in a downward revision of price growth in the Eurozone that it is far from reaching the 2% target of the Central Bank. Prices are not expected to grow by 2% before 2019.

The **Federal Reserve continued with its rate hikes to between 1% and 1.25% at its last meeting in June.** The unemployment rate is stable and close to 4.3% as employment grows with the same intensity as the active population. Salaries have been growing for some time and underlying inflation is close to the target of 2%. Therefore, they will continue with their gradual normalisation process. The fact that the rate hike combines with the sale of debt could mean that the raising of rates is not so quick US 10-year public debt rates have stabilised close to 2.1%.

L**ong-term rates in Europe have rallied, especially in peripheral countries**. Yields have declined in a context of volatility, initially affected by the uncertainties associated with the French elections and subsequently by their outcome and the continuance of the ECB's stimulus program. Decreases of around one point of Portuguese and Greek debt are noteworthy. The 10-year Spanish bond stood at 1.44% in mid-June, the lowest of the year, as did the Italian bond, although the latter continues to trade at a premium 50 basis points higher than the Spanish one. And this in spite of the financial convulsions that led to public intervention in the Italian bank Monte dei Paschi and, especially, the bankruptcy of Banco Popular.

According to the ECB's latest biannual Survey on Access to Finance of Enterprises, the funding needs of Spanish SMEs have increased, thus increasing the demand for corporate credit, which has been weakened in recent semesters. In this sense, the amount of new loans and credits made to SMEs (using a proxy of less than one million euros) increased by 2.6% year-on-year in the twelve months leading up to April 2017. The amount of new loan and credit operations associated with large companies (amounts over one million euros) decreased by 27.6% year-on-year.

In 2018 GDP growth is expected to slow to 2.8%, partly explained by the lower contribution from the foreign sector. Exports of goods and services are likely to continue to gain market share, but at a slower pace, while imports are likely to gain some growth as domestic demand evolves. The contribution of national demand to growth is set to be similar to that of 2017, perhaps somewhat higher, since the slight expected slowdown in household consumption due to a certain slowdown in job creation could be offset by an increase in public consumption and investment stability.

A marked improvement in the public deficit is forecast. Taking Public Administrations as a whole, the deficit will be reduced in 2017 as a result of the freezing of the cost that comes with budgetary extension, of the fiscal measures taken at the end of 2016, and of the strong economic growth that is resulting in higher revenues. **The deficit will be at 3.3% of GDP, two tenths above the 2017 target. With public debt being so high, the process of consolidating public accounts becomes extremely important.** The Independent Fiscal Responsibility Authority has warned that compliance is unlikely, due to poor forecasts of state and social security revenues and expenditures as well as the cost of rescuing toll roads, close to €2,000 million. **The forecast for 2018 is a public deficit that reaches 2.9% of GDP, this time managing to meet the objective**.

Despite the Spanish economy finding itself in a good moment today, one of the risks that Spain faces would be to forget the **important long-term challenges that still lie ahead for the economy**. In this regard, it is still necessary to arbitrate measures to increase our low potential growth, such as increasing competition in certain sectors, promoting human capital or boosting technological innovation. It is equally important to keep our high external debt under control, as well as to mitigate the likely excessive increase in inequality.

As far as fiscal policy is concerned, and given what may be a scenario for the ECB's gradual normalisation of monetary policy, it is more relevant that the country meet the deficit targets during 2017 and 2018. **By the time a normalised monetary policy arrives, it would be desirable for the sovereign rating to have regained the ground lost throughout the crisis as to avoid a rebound in financing costs.** On an internal political level, and despite the fact that the situation seems to be stabilised, negative surprises cannot be ruled out. The "Catalan question" may continue to generate uncertainty.

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 risks still point towards a downturn. The main negative factors would include potential shocks caused by political and geopolitical uncertainty, such as the future relationship between the United Kingdom and the European Union, or the increased trade protectionism that is gaining momentum in advanced economies, led by protectionist threats of US President Donald Trump.

Among the **economic risks**, noteworthy are consumption and investment weakened by high debt levels, a rebound in inflation, a possible disorderly hardening of financial conditions at the global level, which could especially affect the most vulnerable emerging economies, generating undesirable financial tensions and possible disruptions associated with the process of reform, and the liberalisation of the Chinese economy, which has a heavily indebted private sector.

Global scenario.

The recovery of global trade

In the first quarter of 2017 **world exports continued to grow strongly**, just as in the second half of 2016. The engine of global growth is emerging countries, especially Asia, where imports grow more than exports. The main cause is the new Chinese growth model, where consumption grows at rates of 10% and industrial production at rates of 6%. This implies that Chinese imports grow more than exports and that its external position will gradually decline.

Asian peripherals are the ones that benefit most from the growth of Chinese domestic demand. **Eastern Europe is the area where exports have grown most in 2017**. The political instability in Poland and Hungary has not affected their economies at all, which are accelerating their rate of growth and job creation.

Latin America, with intense devaluations of its currencies in the last two years, also benefits from the growth in world trade and is being the main engine to recovering from recession. However, falling commodity prices have caused the region to return to external deficits, although at 2% of GDP, which is far from the levels that had caused severe balance of payments crises decades ago. The external debt against GDP is also lower and the fact is that these countries now have a comfortable buffer of foreign exchange. **This year the economic crisis is in decline but the political and social crisis will require several years of intense growth to strengthen institutions damaged by the crisis**.

The Eurozone is an economy where exports are very significant and the recovery of foreign trade explains the higher growth of GDP and employment. Worth mentioning in this regard is Portugal, who has benefited from fulfilling its deficit objectives, allowing it to end cuts in 2017 thanks to the reduction of its risk premium and the recovery of domestic demand in Spain, Portugal's main export client. Greece also grew in the first quarter of 2017. And France and Germany improved their expansion rate, reaching an annualised 2%.

Italy is still the country which is growing the least and with the second greatest amount of public debt, after Greece. With weak growth, when the ECB finishes its bond purchasing program, the

Italian economy will be the most vulnerable to financially unstable episodes due to having to release large amounts of debt into the market every year. Furthermore, there are doubt in the market regarding the solvency of their banking system and political uncertainty. Before long there will be elections and several parties are already raising the idea of abandoning the euro. Having surpassed the fear in France from Le Pen following Macron's victory, Italy has the most complicated financial prospects out of all Eurozone countries.

In the USA, market euphoria following Trump's victory is dissipating. Anticipating growth and inflation, the 10 year public debt bond rallied strongly following Trump's victory last November. In recent months, expectations have lessened and the 10 year bond's profitability has reduced to around 2%. The Fed keeps hiking rates and re-enforcing the profitability of the short term bonds, but the same is not true for long term bonds. The ongoing investigations into Russia's interference in the presidential elections are not translating, for the time being, into an increase in risk premiums that could negatively affect GDP growth or employment.

Growth prospects for the Spanish economy.

The expansionary phase of the Spanish economy that began in the third quarter of 2013 extended to the first quarter of 2017 and will continue at a good pace in the coming months.

First quarter data from the quarterly national accounts confirmed the strong performance of economic activity, experiencing quarter-on-quarter growth of 0.8%, one tenth greater than that seen in the third and fourth quarters.

Growth remains balanced with both domestic and foreign demand being positive. The momentum of foreign demand, contributing 0.1 percentage points QoQ, is added to the strong growth in domestic demand, which contributed 0.7 percentage points to annual GDP growth. In year-on-year terms, GDP growth was 3%, with domestic demand contributing 2.2 percentage points and foreign demand contributing 0.8, the same as what we found in the previous quarter.

The gradual and foreseeable deceleration of the Spanish economy did not happen in the end. At the moment, the first quarter has shown growth greater than that of the fourth quarter of 2016. The gradual disappearance of some tailwinds, such as the changes in the price of oil (currently in free fall but evidently more expensive in the first quarter when compared to the same period of the previous year), its effect on household spending following greater inflation, and the impact of a more restrictive fiscal policy have been compensated due to **foreign demand being better than expected**, thanks to improvements in international trade.

In any case, medium term prospects remain favourable. **Our projections for 2017 show economic progress of around 3.1%.**

In the first quarter, **domestic demand was established as being the prime driver for growth**, encouraged by private consumption (+0.4%), despite experiencing some slowdown, such as in investment demand (2%) and the public administrations' final consumption (+0.3%), accompanied by foreign demand which is still aiding net GDP growth due to the surprising rhythm of growth for goods and services exports (+4%) and goods and services imports (+3.8%).

The improvements to the labour market and financial conditions continue to favour the situation of households, which allows for the prolongation of the favourable pace of consumption growth and the process of household deleveraging, although at a lesser rate than that of the fourth quarter. The strength and momentum of domestic demand remains also thanks to investment demand, both in the construction sector and the in the case of capital goods investment.

Among those advanced indicators associated with private consumption, noteworthy is the increase in registrations of new cars of 7.3% in the January to May period, according to ANFAC, slightly less than that of 2016. With regard to the general retail sales index, calendar adjusted and deflated, year-on-year growth of 1.7% was registered in April, driven by the non-food component.

The increase in private consumption came accompanied by a strong increase in investment (2%), supported both by the increase in gross capital formation in housing construction (2.7%) and investment in capital goods (3.1%) which had previously been stagnant for two quarters.

Conditions are still favourable for investment decisions due to low interest rates, the good rhythm of domestic and foreign demand, the continued deleveraging of businesses, the utilisation of productive capacity and the improvement in forecasts.

Among those qualitative indicators, noteworthy is the rallying of Economic Sentiment Index of half a point in May up to 108.4 points, as published by the European Commission. This improvement was seen in all its components, with an important exception being retail, which worsened.

With regard to residential investment, economic indicators show growth in the sale and purchase of housing with increases in March of 21.2% YoY, although this is reduced to 2.4% YoY when we the quarter is considered in its entirety, compared to the fall of 0.1% in the fourth quarter of 2016. The increase in mortgages for housing was very high in March (20.2%). The free Housing Price Index, according to the appraised value statistics of the housing by the Ministry of Public Works, for its part, increased by 2.2% year-on-year in the first quarter of 2017, seven tenths more than in the previous quarter.

. In year-on-year terms, we see growth of 8.4%, explained by the drastic increase in exports to outside the European Union (13.3%) and the significance exports within the European Union (5.9%), according to calendar adjusted and deflated data from the Tax Agency.

In the first quarter of 2017, according to the available data on the Balance of Payments, the Spanish economy generated a funding capacity abroad of €1,896 million, compared to a funding need of €554 million in the same period of the previous year. The current account balance recorded a surplus in the fourth consecutive quarter with an amount of €1,506 million, compared to the €509 million deficit reached in the first quarter of 2016. Said results are due to a moderation of the deficit for first and second incomes, partially compensated by a reduction of the surplus of goods and services. The capital balance went from registering a deficit in the first quarter of 2016 to a surplus in the first quarter of 2017.

Total sales from large companies, taking calendar adjusted and deflated data and considering a constant population, registered a year-on-year increase of 2.4% in April, almost half that of the previous month (4.7%), due to the reduced momentum of both domestic sales and exports which grew 1.5% and 5.5% respectively, 1.2 and 6.1 points less than in the previous month. Imports, for their part, decreased 0.5% compared to the 0.3% improvement of the previous month.

But without a doubt, what gives hope to 2017 is the strong rhythm of job creation with which it has begun. Between January and March 2017, those registered as working in Social Security increased by a rate of 3.4%. This trend is explained by the acceleration of employment in all types of activity, especially construction, with an increase of close to 5% YoY.

The main indicators seem to suggest that **economic activity will remain strong in the second 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%. The PMI index made up of Global Activity, according to Markit, decreased a tenth in May to 57.2. Nevertheless, this is still four tenths higher than that of the Eurozone and the second highest in the monetary area after Germany.

The service activity PMI stood 57.3 points lower in May than in April, and one point higher than in the Eurozone (56.3), a result that is explained by the strong Increases in activity and new orders.

In terms of prices, the Consumer Price Index (CPI) decreased 0.1% in May compared to April and against the 0.5% increase in May 2016. In the year-on-year comparison, CPI grew 1.9%, a rate seven tenths lower than in April. The lower inflation in May is mainly explained by the moderation of growth in fuel prices, as well as by the slowdown in the price of tourist packages, after the upturn seen in April due to Easter. Underlying inflation fell by two-tenths in May to 1% as a result of the slowdown in the prices of services and, to a lesser extent, non-energy industrial goods, offset in part by the higher pace of growth in the prices of processed food.

With regard to the tourism sector, it is noteworthy that Spain received 19.9 million international tourists between January and April, an 11.6% increase when compared to 2016, according to provisional data published by INE from the Frontier Tourist Movement Survey (FRONTUR).

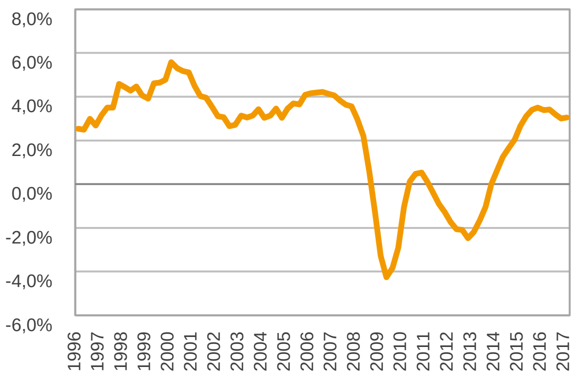
The inertia of private consumption stays strong, so this will remain a growth factor for GDP in the second quarter of 2017. The fall in the price of oil in the second quarter will join the still strong rhythm of employment creation and the credit facilities that drive household consumption.

Demand and production

According to the results of the Quarterly National Accounts (QNA), published by INE, real GDP, calendar and seasonally adjusted, recorded quarter-on-quarter growth of 0.8% in the first quarter of 2017, one tenth more than the fourth quarter of 2016, making 14 consecutive quarters with positive quarter-on-quarter growth. On a year-on-year basis, GDP grew by 3%, once again maintaining, therefore, the cruising speed with which 2016 ended. This is a continuation of the consolidation of the recovery process 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.

However, our forecasts point to a slight slowdown in GDP growth in 2017, falling to 3.1%. 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 depreciation of the euro and some budgetary stimuli. The weaker momentum of these factors should be offset, partially and in the medium term, by the gradual improvement of export markets, given the upturn seen in global trade and growth.

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

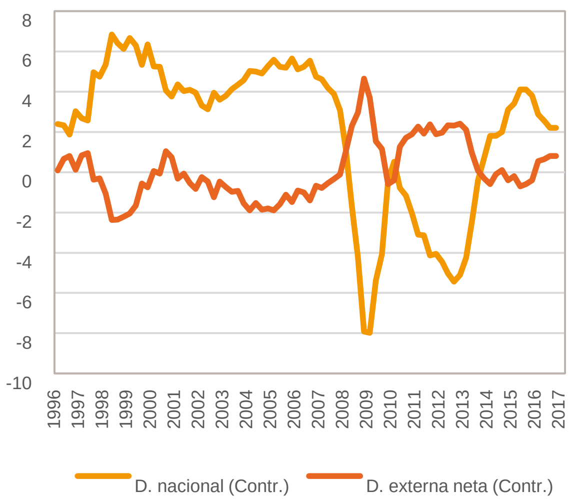


Source: QNA.

Taken in terms of its individual components, **economic growth continues to be driven by domestic demand, the main driver of growth**, with an increase of 2.3 percentage points, one tenth higher than in the fourth quarter of 2016, although slightly lower than the average contribution recorded in the whole of 2016. **The contribution of net foreign demand was positive**, as in the previous two quarters, reaching 0.7 percentage points. **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**, positively highlighting both the gradual moderation of the momentum found in private consumption and the strong recovery in investment demand.

With regard to employment, the good pace of job creation held true in the first quarter and demonstrated business vitality that has been progressing favourably for some quarters. According to data from the national accounts, full-time equivalent employment grew at 0.7% QoQ in the first quarter of 2017, the same as that of the previous quarter, placing year-on-year growth at 2.5%, representing **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**. Final real household expenditure and non-profit institutions serving households (NPISH), in volume, grew by 2.5%

YoY in the first quarter of 2017 (five tenths lower than in the fourth quarter). In quarter-on-quarter terms, the progression of private consumption (consumption of households and non-profit institutions serving households) stood at 0.4%, three tenths lower than in the previous quarter.

The good trends in private consumption are 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 second quarter of 2017, potentially even reaching higher growth rates.

Private consumption continued to grow in the first quarter, in nominal terms, at the same pace as the remuneration of those in paid work, which implies 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 is basically stagnant but grew 0.3% in comparison with the previous quarter.

Fixed capital investment, for its part, saw a year-on-year increase of 3.8% in the first quarter of 2017, compared to growth of 2.2% in the fourth quarter of 2016. And the pace of investment recovery in the first quarter of the year has been very strong. **In the fourth quarter, investment grew 2% quarter-on-quarter, four times the increase seen in the previous quarter**, with investment in capitals goods climbing to 3.1% quarter-on-quarter having previously fallen 0.5%. This is one of the most important changes of the Spanish economy seen in the first quarter, after half a year of decline in investment in capital goods.

Investment in construction, despite the decline in non-residential investment of 0.4% quarter-on-quarter, rose 1.1%, compared to 0.7% in the previous quarter, thanks to strong boost in residential investment of 2.7% QoQ.

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

Foreign demand

According to figures from the Quarterly National Accounts (QNA), **the foreign sector contributed one tenth to the quarter-on-quarter change in GDP in the first quarter of 2017**, the same as at the end of 2016, resulting in an increase in exports of goods and services greater than that of imports. Compared with the main economies of the European Union, the quarter-on-quarter rate for Spanish real exports (+4%) was higher than that for Italy (+2.7%), Germany (+1.3%) and France (-0.7%) and the United Kingdom (-1.6%). In terms of year-on-year growth, Spain is clearly situated above the largest economies in Europe with an increase of 8.4%.

In year-on-year terms, net foreign demand contributed eight tenths to the variation in GDP in the first quarter of 2017. **Therefore, both domestic and foreign demand showed positive growth in the first quarter.**

Exports of goods and services sped up in the first quarter of 2017 within an environment characterised by **clear improvements in the activity of the main trading partners and in the main emerging economies**.

On the other hand, in the first quarter of 2017, the competitiveness trend index based on consumer prices compared with developed countries recorded a boost in competitiveness of 0.3% year-on-year, due to a 1% depreciation of the nominal effective exchange rate which offset the 0.6% increase in relative prices. With regard to the European Union, competitiveness fell by 1.9% due to the appreciation of the nominal effective exchange rate of 1% and the increase in the consumer price index (0.9%). Finally, the competitiveness increase compared to BRICS nations was 4.2% due to the depreciation in the nominal exchange rate offsetting the slight increase in the relative price index.

In year-on-year terms, exports of goods and services increased 8.4%, double than in the fourth quarter of 2016, with advances of 8.4% in goods and 8.3% in services, rates much higher than those observed in the previous quarter, especially in the case of foreign sales of goods. On a quarter-on-quarter basis, exports rose by 4%, double that of the previous period, due to improvements in goods and services exports of 4.6% and 2.7%, respectively.

The year-on-year growth of exports has been much higher than that registered by world trade in goods, which grew by 3.9% according to the Central Planning Bureau of the Netherlands, with a real market share growth in the quarter of 4.3% year-on-year, to 1.99%. Growth of exports in the first quarter was generic for all products and improved significantly in those products destined for the European Union.

Non-resident household spending, according to data from the Quarterly National Accounts, slowed to 1.7% QoQ from 4.1% in the October-December 2016 period. The main indicators of foreign tourism, such as arrivals of tourist and overnight stays of foreigners in domestic hotels, improved in April with growth, respectively, of 16% and 19.8%.

Real exports of non-tourism services grew 3.3% in the first quarter of 2017 compared to the previous three months, 1.1 points more than in the fourth quarter of 2016. In year-on-year terms, growth was 8.2%.

Imports of goods and services increased by 3.8% in the first quarter of 2017 compared to the previous period. In terms of its individual components, **goods imports grew 5.4%** quarter-on-quarter while services fell by 2.4%. By product category, the increase of 6% for imports of intermediate goods stands out, showing the strong dependency between Spanish exports and imports. Real expenditure of overseas households, according to QNA figures, grew by 0.3% QoQ, following the 8.2% increase in the fourth quarter of 2016. Real exports of non-tourism services also fell by 3.4% QoQ, after a 0.6% decline in the previous quarter.

The balance of goods and services surplus, according to the QNA, was at 1.2% of quarterly GDP in the first quarter of 2017, four tenths lower than the previous year, due to the greater deficit of goods (-2.4% against -1.7% of GDP) which compensated the increase in the services surplus. Within the services sector, the net tourism revenue surplus (1.8% of GDP) remained stable with regard to the percentage registered in the first quarter of 2016. However, the surplus of non-tourism services increased by three tenths.

Productive activity

From the supply side, **the large sectors of activity show positive and expansionary behaviour**. Gross Value Added (GVA) grew by 4.4%. The primary sector grew by 4.4% and industry by 2.8%, while growth in the services sector fell three tenths, to 2.8%.

In quarter-on-quarter terms, the largest increase was in the construction sector, up 2.9%, following its stabilisation in previous quarters, followed by the services sector, with GVA accelerating by two-tenths to 0.7%.

The apparent productivity per employee, in terms of National Accounts, grew by 0.5% in the first quarter of the year as a result of the 3% increase in GDP and a 2.5% increase in full-time equivalent employment.

The provisional indicators for the industry show signs of greater business dynamism in the first months of 2017. The Industrial Production Index accelerated in April 2017, showing year-on-year growth of 0.6% with data adjusted for calendar effects. Finally, the manufacturing PMI advanced almost one point against the previous month in May, reaching 55.4, due to the acceleration of new orders and production.

The Industry New Orders Index, with a calendar-adjusted series, posted the highest year-on-year increase since 2006, reaching 10.8%, up 2.7 points from the previous month. The group of products that showed the greatest growth was that of capital goods (12.9%), 12 points higher than in February (0.8%).

In the construction sector, the areas designated for the construction of new-builds showed an increase of 21.2% in March, greater than that observed in February (11.5%), driven by the trends felt in the residential component.

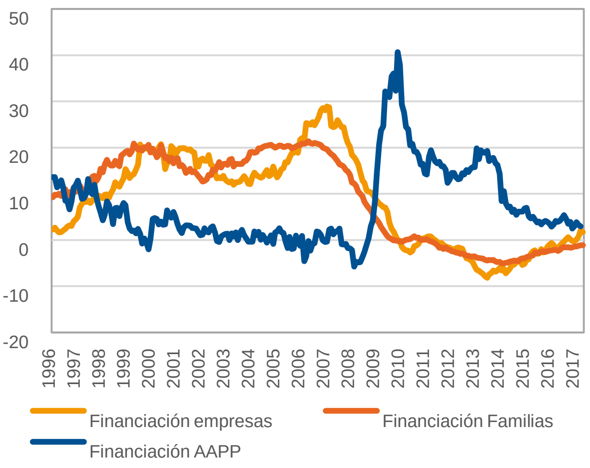
Looking to the Construction Production Index published by Eurostat, with corrected and deflated series, March saw a 5% year-on-year decrease, compared to a 4.9% increase in the previous month. With regard to areas designated for the construction of new-builds, this saw an increase of 13.8%in the first quarter.

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 services PMI, published by Markit, with increases in May reaching 57.3, half a point less than that reached in April, but one point higher than that of the Eurozone (56.3).

With this we must consider **the exceptional tourist season, which will probably break records again in 2017, having already broken them in 2016**. Between January and April, arrivals of tourists and tourist spending increased by 11.6% and 15.3%, respectively. Overnight stays in hotels went also up 6% year-on-year in both the resident and non-resident segments.

With regard to financing for productive activity, figure 3 shows the rate of variation of financing for the different productive agents. This good moment in the Spanish economy favours the expansion of credit, supported by the continuity of the ECB's expansionary monetary policy. Credit for the purchase of housing increased by 23.5% year-on-year, showing the recovery in demand in the sector, and consumer credit also showed very strong growth of 22.5% year-on-year. Credit to SMEs, for its part, increased by a remarkable 9.6% year-on-year. Large corporations, however, continue to be impacted by the effect of increased corporate issuance, albeit at a slower pace than in 2016.

Figure 3. Financing. Year-on-Year Rate



Source: Bank of Spain

From the supply side, improvements in the banking sector strengthened. The default rate of the banking sector, which was 9.2% at the end of the third quarter of 2016 and reached 9.11% at the end of the year, continues a downward trend that is supported by the improvement in economic activity and, especially, the labour market, which allowed the first quarter of 2017 to close with banking default of 8.83, the lowest since 2012.

Prices

CPI, as published by INE, fell 0.1% in May against April, notable next to the increase seen in May 2016 of 5%.

The CPI rose 1.9% year-on-year, seven tenths lower than in April. The lower inflation in May is mainly explained by the slowdown of fuel prices growth, as well as by the slowdown in the price of tourist packages, after the upturn seen in April due to Easter.

Energy product prices rose in May by 8.3% year-on-year, although this is still 3.7 points less than in April. The price of fuels and lubricants rose 11.5% year-on-year in April to 4.9% in May.

Underlying inflation, excluding unprocessed food and energy, which are more volatile in terms of CPI, fell by two-tenths in May to 1% due to the slowdown in prices of services and, to a lesser extent, non-energy industrial goods.

The fall in overall inflation in the Eurozone to 1.4% in May compared to April is mainly explained by the slowdown in prices of energy, services and, to a lesser extent, prices of unprocessed food and energy. Underlying inflation also decreased in May to 1%. The year-on-year rate of the Spanish Harmonised CPI stood at 2% in May, six decimal points lower than in April, resulting in a six-tenths difference in inflation in Spain compared to the Eurozone, after the seven-tenth difference observed in April. Lastly, there was no difference in underlying inflation, with it being the same as in April.

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

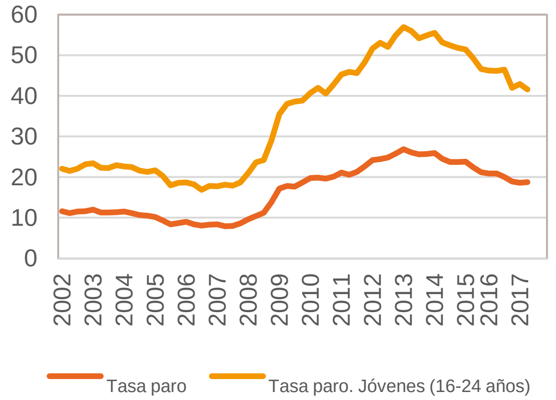
Labour market

The labour market was characterised in the first quarter of 2017 by an extension of the energy 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 April and May 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 0.9% in the first quarter, the same as in the previous quarter. In annual terms the number of those registered in Social Security rose a tenth to 3.4%.

According to QNA figures, full-time equivalent employment, with seasonally adjusted and calendar-adjusted series, increased by 0.7% QoQ in the first quarter, three tenths more than in the previous quarter, and 2.5% YoY, two tenths less than in the fourth quarter.

Figure 4. Unemployment rate. Active population percentage



Source: INE

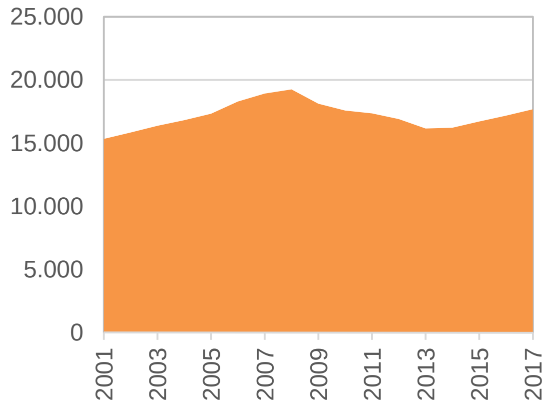
Growth in employment extended to all sections of activity in the first quarter. According to EAPS figures, and in terms of year-on-year, employment growth was widespread in all major sectors, mainly services, with an increase of 199,000 in work (1.4% annually); followed by industry, with 89,500 more in work (3.6%); agriculture, with 70,300 (9%); and construction, with 49,700 more in work (4.8%).

Looking at the professional situation of those in work, those in paid employment grew by 405,700, 2.7% YoY, compared to 2.6% in the fourth quarter. Meanwhile, the group of self-employed workers held steady, compared to the 0.5% advance of the fourth quarter.

If we look at the type of contract, the year-on-year increase in paid employment of 2.4% places net creation of paid employment at 48% of the total, while the 52% representing temporary employment grew at a year-on-year rate of 5.6%. As a result of this dynamic, the temporary employment rate stood at 25.8%, seven tenths higher than a year earlier.

By age, **all groups show declines in unemployment in the first quarter**. The youth unemployment rate stood at 41.7% in the first quarter, more than one point below that recorded in the fourth quarter of 2016.

Figure 5. Social Security Affiliates (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%, compared to -3.6% in the fourth quarter, which implies a continued fall in seasonally adjusted unemployment in the last sixteen quarters. In the last year, unemployment fell by almost 536,400 people, representing a year-on-year decline of 11.2%. The unemployment rate grew one tenth in the quarter and fell 2.2 points compared to a year earlier, standing at 18.8% of the working population.

Moderation in the growth of salaries and unit labour costs has continued. According to the Labour Cost Quarterly Survey for the first quarter of 2017, the average labour cost per worker and per month decreased did not change compared to the first quarter of 2016.

And, according to the QNA figures, remuneration per employee increased in the first quarter of 2017 by 0.4% YoY, three tenths higher than in the previous quarter. The apparent productivity of workers increased 0.5%, two tenths more than in the previous quarter. As a result, the unit labour cost decreased 0.1%, thus making seven consecutive quarters of declines. Finally, the Statistics of Employment Agreements prepared by the Ministry of Employment and Social Security points to an average increase up to May of 1.3%, two tenths higher than the wage increase agreed in 2016.

Balance of payments

In the first quarter of 2017, according to the available data on the Balance of Payments, the Spanish economy generated a funding capacity abroad of €1,896 million (2.1% of GDP), compared to a funding need of €554 million in the same period of the previous year.

The current account balance recorded a surplus of €1,506 million, compared to the €509 million deficit of the first quarter of 2016. Said results are due to a reduction of the deficit for first and second incomes, partially compensated by a reduction of the goods and services surplus. The capital balance went from registering a deficit in the first quarter of 2016 to a surplus one year later.

At the same time, the financial balance registered net capital inflows of €54 million compared to net inflows of €6,262 million one year earlier, due to an increase in the net debtor position of the Bank of Spain of €43,224 million, slightly higher than the net capital outflow, excluding the Bank of Spain (€43,172 million). This statistic can be subject to important oscillations.

Foreign trade of goods and services showed a surplus and improved the non-energy component of the trade balance. Tourism revenues sped up while payments thereof slowed down.

In the first quarter of 2017, the balance of tourist services reached a surplus of €6,104 million, 5.8% higher than in the same period of the previous year, which was strengthened by the 9.9% increase in income from tourism. According to the Tourism Expenditure Survey (EGATUR), spending by foreign tourists increased by 13.2% year-on-year, with tourist arrivals increasing by 9.3% year-on-year, 1.8 points lower than the previous quarter.

Payments from tourism as a result of Spanish outbound trips abroad grew 16.7% in the first quarter, a slowdown of almost more than four points compared to the last quarter of 2016.

On the other hand, the balance of primary and secondary incomes amounted to a deficit of €2,169 million in March, 54.6% lower than that of the equivalent period in 2016. This was made possible by an increase in revenues of 6.8% and a reduction in payments of 7.8%.

The financial account, on the other hand, recorded net capital inflows of €54 million in the first quarter of 2017, compared to net inflows of €6,262 million in the first quarter of 2016. Excluding the Bank of Spain, net capital outflows amounted to €43,172 million in March, compared to net outflows of €932 million recorded a year earlier, a result that includes positive balances (investments) in asset and liabilities transactions. Therefore, foreign investment in Spain has decreased while Spain's investment abroad has strengthened.

Finally, the Net International Investment Position (NIIP) reduced the debit balance in the fourth quarter of 2016 by €28,019 million compared to a year earlier, reaching €954,000 million, equivalent to 85.7% of GDP, 5.6 points to the fourth quarter of 2015. Gross external debt in the last quarter of 2016 amounted to €1.865 trillion (167.5% of GDP), with a year earlier being slightly higher (169.1% of GDP).

Public sector

The consolidated deficit of the Public Administrations, without taking Local Corporations into account, fell to 0.51% of GDP in the first quarter of the year, 29.7% lower than in the same period of 2016. This decrease is explained by a year-on-year increase in non-financial resources (3.4%), greater than the increase in jobs (0.5%).

The increase in income comes from the increase in social contributions (5.2%) and taxes (3.7%). In terms of non-financial jobs, the increase in intermediate consumption (4.6%), salaries of employees (1.6%) and subsidies (37.2%) offset the fall in interest rates (-9.8%) and the lower contributions to the EU General Budget (-35.2%).

In terms of national accounts, the state deficit up to April was 0.71% of GDP, representing a 41.6% year-on-year reduction. The smaller deficit was due to the year-on-year increase in non-financial resources (5.3%) and the decline in non-financial employment, which fell by 4.7%.

A marked improvement in the public deficit is forecast. Taking Public Administrations in their entirety, the deficit will be reduced in 2017 **as a result of the freezing of the cost that comes with budgetary extension of the fiscal measures taken at the end of 2016 and of the strong economic growth** that is resulting in higher revenues. The deficit will be at 3.3% of GDP, two tenths above the 2017 target. With public debt being so high, the process of consolidating public accounts becomes extremely important. The Independent Fiscal Responsibility Authority has warned that compliance is unlikely, due to poor forecasts of state and social security revenues and expenditures, as well as the cost of rescuing toll roads, close to €2,000 million. The forecast for 2018 is a public deficit that reaches 2.9% of GDP, this time managing to meet the objective agreed with Brussels.

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

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

According to the methodology of the Excessive Deficit Protocol (EDP), the debt of Public Administrations amounted to 100.4% of GDP in the first quarter of 2017, i.e. €1,129,378 million, a percentage lower than that of the same quarter last year.

State debt stood at 87.8% of GDP, nine tenths lower than the same period of 2016. The EDP debt ratio of the Autonomous Communities against GDP, in turn, increased three tenths in the first quarter of 2017, 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 2.8% of GDP in the first quarter of 2017, four tenths lower than the same quarter a year earlier.

2017-2018 scenario: sustained growth

Although the Spanish economy benefited from an extremely favourable environment in 2015 and 2016 which exceeded expectations quarter after quarter thanks to the good performance of companies, families and the public sector, **2017 will** most likely experience **a slight deceleration of GDP growth, which we estimate to be around 3.1%.**

At the start of the year, the expected deceleration of GDP was the result of several factors that not only were not going to favour, but could also contribute negatively to GDP growth in 2017. On the one hand, the **increasing 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. **Both of these factors, however, have lost momentum as the year has progressed**. In June the price of oil in international markets dropped $10 to $45 per barrel and the euro appreciated. Meanwhile, **long-term interest rates referenced by Spain's 10-year bond will close at the end of the second quarter at their lowest of the year** at less than 1.4%, falling 27% since the beginning of the year. Therefore, the deceleration through consumption and investment will be much lighter than expected at the beginning of the year, and the economy may even maintain the growth rate seen in the last two years, given the strong GDP growth experienced in the second quarter.

That said, second-quarter leading indicators, such as car sales or overnight stays in hotels, have shown a significant slowdown, both of which indicate that private consumption has lost strength in 2017.

The OPEC's efforts are being met by increased production of the main producing countries outside the Organisation and by the shale oil that has already become profitable in the United States, even with prices below $50 per barrel.

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 spare production 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**.

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 for the year at around 2%, with a similar general interpretation for the Eurozone despite inflationary tensions probably being higher in the central Eurozone countries in the medium term, especially in Germany, whose unemployment rate fell to 3.9% in the first quarter of 2017. It should also be noted that although the overall unemployment trend is clearly positive in the Eurozone (if the current rate of job creation holds steady, the unemployment rate in the Eurozone could fall to 8.5% by the beginning of 2018, which, would place unemployment in the Eurozone at pre-crisis levels), the slack in labour markets is still noticeable when measures which are broader than simply the underutilisation of labour are considered.

It is precisely for this reason that the European Central Bank (ECB) announced at its last monetary policy meeting in June 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, in order 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. Therefore, interest rates applicable to the main financing operations, the marginal lending facility and the deposits facility will remain unchanged at 0%, 0.25% and -040%, respectively. Regarding non-conventional monetary policies, the ECB will continue to make purchases of €60,000 million a month until the end of the December 2017 under the asset purchase program, or a later date if necessary. The ECB has recently updated its forecasts by projecting Eurozone GDP growth for 2017 of 1.9%, above its potential, but nevertheless, this downward revision of growth of prices in the Eurozone recognises that the bank's target of 2% remains a long way off. Prices are not expected to grow by 2% before 2019.

The Federal Reserve continued with its rate hikes to between 1% and 1.25% at its last meeting in June. The unemployment rate in the US is stable and close to 4.3% as employment grows with the same intensity as the active population. Salaries have been growing for some time and underlying inflation is close to the target of 2%. Therefore, they will continue with their gradual normalisation process**. The fact that the rate hike is combined with the sale of debt could mean that it does not happen as fast as expected at the beginning of the year.** US 10-year public debt rates have stabilised close to 2.1%.

Market euphoria following Trump's victory is dissipating. Anticipating growth and inflation, the 10 year public debt bond rallied strongly following Trump's victory last November. In recent months, expectations have lessened and the 10 year bond's profitability has reduced to around 2%. The Fed continues to raise rates and the yield of short-term bonds increase, but not so the long-term bonds.

Long-term rates in Europe have rallied, especially in peripheral countries. Yields have declined in a context of volatility, initially affected by the uncertainties associated with the French elections and subsequently by their outcome and the continuance of the ECB's stimulus program. Noteworthy are the falls of around one point in Portuguese and Greek debt. The 10-year Spanish bond stood at around 1.4% at the end of June, the lowest of the year, as did the Italian bond, although the latter continues to trade at a premium 50 basis points higher than the Spanish one. And this in spite of the financial convulsions that led to public intervention in the Italian bank Monte dei Paschi and the orderly liquidation of Veneto Banca and Banca Populare di Vicenza and, especially, the bankruptcy of Banco Popular

According to the ECB's latest biannual Survey on Access to Finance of Enterprises, the funding needs of Spanish SMEs have increased, thus increasing the demand for corporate credit, which has been weakened in recent semesters. The availability of credit and the associated cost are also increasing. In this sense, **the amount of new loans and credits made to SMEs (using a proxy of less than one million euros) increased by 2.6% year-on-year in the last twelve months leading up to April 2017**. The amount of new loan and credit operations associated with large companies (amounts over one million euros) decreased by 27.6% year-on-year.

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, while the gradual easing of deep recessions which are affecting some of the main raw materials exporters will support growth in emerging economies.

In 2018 Spanish GDP growth is expected to slow to 2.8%, partly explained by the lower contribution from the foreign sector. Exports of goods and services are likely to continue to gain market share, but at a slower pace, while imports are likely to gain some growth as domestic demand evolves. The contribution of national demand to growth is set to be similar to that of 2017, perhaps somewhat higher, since the slight expected slowdown in household consumption due to a certain slowdown in job creation could be offset by an increase in public consumption and investment stability.

However, uncertainty remains high due to a number of factors, including the design of the new US Administration's policies and their effects on the US economy, as well as potential contagion to global activity. To this we may add possible financial tensions in some emerging economies and the gradual realignment of the Chinese economy, given its high indebtedness, consumption and investment weakened by high debt levels, a possible rebound in inflation, increased protectionism, and the risk of a hard Brexit in the process of negotiating future relations between the UK and the European Union.

Indeed, an already long-lasting credit expansion, usually accompanied by real estate price increases, is a sign of overheating in some emerging economies. A faster-than-expected increase in US interest rates would negatively affect those emerging economies with larger dollar-denominated debt. In the case of advanced economies, the main concern in the medium term is the possible problems of addressing the imbalances in its financial system, especially in the Eurozone.

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 and maybe even increased said momentum in the first quarter of 2017.

In the first quarter of 2017 global exports continued to grow strongly, just as in the second half of 2016. Emerging countries are the engines of global growth, especially Asia, where imports grow more than exports. The main cause for this is the new Chinese growth model, where consumption grows at rates of 10% and industrial production at rates of 6%. This implies that Chinese imports grow more than exports and that its external position will gradually decline.

Asian peripherals are the ones that benefit most from the growth of Chinese domestic demand. Latin America, with intense devaluations of its currencies in the last two years, has also benefited from growth in world trade and has become the main engine for recovery from recession. However, falling commodity prices have caused the region to return to having an external deficit, although only at 2% of GDP, which is far from the levels that had caused severe balance of payments crises decades ago. Foreign debt over GDP is also lower. This year the economic crisis is in decline but the political and social crisis will require several years of intense growth to strengthen institutions damaged by the crisis.

The Eurozone, on the other hand, is an economy with a high share of exports and the recovery of foreign trade explains the higher growth of GDP and employment in the first quarter of 2017, with France and Germany raising their growth rate up to an annualised 2%. This, in turn, explains the excellent behaviour of Spanish exports of goods and services in the first quarter and the good prospects for the second quarter of 2017, although the data from the Tax Agency in April show a significant slowdown, falling 1% in the month-on-month comparison with respect to March.

In this foreign environment, the Eurozone's growth prospects are very favourable. With growth of around 1.7% in 2017 and 1.8% in 2018, the European Commission 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 economically dynamic Spanish exports both inside and outside the Eurozone. Additionally, in foreign exchange markets, the outcome of the French elections and the uncertainty over future economic policy decisions in the US have favoured the euro against the dollar despite the prospect of rate hikes by the Federal Reserve. Between the end of March and mid-June, the euro appreciated by 5% against the dollar, 4.6% against the yen and 2% against the pound sterling, with the nominal effective exchange rate appreciating against developed countries by 2.8%.

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 in 2018, something which could begin to be discounted by the markets in the in the second half of 2017.

While increases in the long-term interest rate will take some time to affect interest payments on public sector debt, **sooner or later they will have repercussions and, more immediately, they will affect companies. This is worrying given the high financial vulnerability of the Spanish economy**.

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

We could also include a third factor: the limited fiscal space in Spain which could result, at best, in a neutral fiscal policy**.** In fact, 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 the adjustment was seven tenths. 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 five and six tenths both in 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 light of what may be a scenario for the ECB's progressive normalisation of monetary policy, **it becomes more relevant that the country meet the deficit targets during 2017 and 2018**. By the time a normalised monetary policy arrives, it would be desirable for the sovereign rating to have regained ground lost throughout the crisis as to avoid a rebound in financing costs.

The intervention of the ECB is key in the expansion of the Spanish economy, both via lower interest rates and in its work on financial stability, although the inflation rate still remains well below 2%. Unconventional monetary policies have also been decisive in the significant depreciation of the euro and its stimulating effect on exports. 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 even in 2016 (-2.2%). 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, if the rise in the price of oil does not raise inflation as much as initially expected, the reduction of the current account surplus will be lower, reaching 1.3% in 2017 and 0.5% of GDP in 2018.

The ECB also made note of the uncertainty generated by political risk. This uncertainty stems from Brexit negotiations, the arrival of Donald Trump to the White House and the electoral processes that will take place in Europe throughout 2017 (Germany and 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. This political situation and its risk will be very much a focus point next year. **Polarisation and political instability are breeding grounds for less economic prosperity**.

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. The fiscal impulse, when it cannot come from the country itself due to its significant imbalances, must come from the community budget. But a more federal Europe and the political will towards a true political union is far from being forged as a real project. The arrival of Emmanuel Macron to the Elysee Palace can give a new impetus to the European integration project.

It is essential to redesign the EMU to correct the failures it presented at the outset. This redesign essentially involves deepening the European project through greater integration and greater powers for European institutions. The Commission's recent publication "Reflection Paper on the Deepening of Economic and Monetary Union" indicates the path towards a joint agreement:

- It establishes 2019 as the date to complete the **Banking Union**, which entails the creation of a common deposit insurance system and a common backing for the European Bank Resolution Fund (the mechanism that solved the Banco Popular problem). **This is key to preventing the problems of banks from being transferred to the States**.

- **Equally important is to break the vicious cycle, that is, that the bankruptcy or insolvency of the State triggers the bankruptcy of the banks**. In order to achieve a more diversified asset portfolio by banks and reduce their exposure to the country's public debt, the Commission proposes the creation of a new safe asset: securities backed by sovereign bonds, European Safe Bonds or "ESBies". **The existence of these assets would make the European financial system more robust as banks would have ESBies instead of the debt of their own government, avoiding panics by ensuring that a flight of the investors towards the safe assets would benefit all the member countries of the euro, not just Germany**. And all this would be achieved without the need to introduce joint liability, that is, without any country being responsible for the debts of another, increasing the political viability of the project, which traditionally counted on the German "no" under the argument of moral hazard.

- The publication confines itself to proposing a simplification of the rules for the Stability and Growth Pact when in reality it is necessary to abandon these rules that no one fulfils, both for political and economic reasons, and replace them with a new centralised mechanism that imposes discipline on national fiscal policies. This would involve **developing a sovereign bankruptcy procedure in the Eurozone which would facilitate an orderly renegotiation of sovereign debts with private creditors** (remember Greece). This mechanism would reintroduce market discipline, allowing the necessary flexibility in fiscal policy.

- The publication is also too unambitious in highlighting **the key importance of a genuine Eurozone budget,** with many more resources and a clearly stabilising role, capable of sharing economic risks and transferring income between countries. **This budget must include genuine European unemployment insurance with European standards based on the principles of flexicurity.** Such a scheme would not only be anti-cyclical but would contribute positively to the necessary structural changes in the Member States. It should not be forgotten that **unemployment is the area in which Europe can most positively affect the lives of citizens. An added benefit of this system would be the harmonisation of the tax bases of companies which are being eroded by fiscal engineering and competition between States.**

All these advances in the process of European integration would make the Spanish economy less vulnerable in light of withdrawal of stimulus in terms of monetary policy and would significantly strengthen market confidence in the Eurozone economy. However, **the Spanish economy has stronger fundamentals than in previous years, with the economy growing at a strong pace, driven by consumption, 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), strong job creation, favoured by these low labour costs, that in turn makes the improvement experienced by domestic demand that began in 2014 sustainable and, finally, the radical change in the availability of financing as well as in the conditions thereof since the European Central Bank decided to intervene and curb the risky episode of financial fragmentation and credit crunch that dominated the Eurozone.

There is no doubt that the greatest risk to the Spanish economy is still 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 and optimal financial conditions, very advanced financial sector sanitation), which allows us to gain necessary time and facilitates the task.

Annual forecasts for the Spanish economy.

Table 1. Annual forecasts.***(% annual average variation, unless otherwise indicated)***

	2017	2018
Real GDP	3.1	2.8
Final household consumption	2.2	2.0
Final Public Administration consumption	1.0	2.0
Gross Fixed Capital Formation	4.6	4.5
- Machinery and capital goods (1)	5.0	4.1
- Construction	4.3	4.9
Stock variation (contribution to GDP growth in pp)	0.0	0.0
National demand	2.5	2.6
Exports of goods and services	7.7	4.3
Imports of goods and services	6.1	4.0
Underlying CPI (annual average)	1.1	1.6
Total CPI (annual average)	2.1	1.8
Labour costs per worker (2)	1.2	1.5
Employment (National Accounts) (3)	2.7	2.4
Unemployment rate (EAPS, % of active population)	17.9	16.0
Balance of balance-of-payments current account (% GDP) (4)	1.3	0.5
Financing capacity (+) or necessity (-) Public Administrations **excluding aid to financial institutions** (% GDP)	-3.3	-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