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Quarterly Bulletin on Economic Situation and Prospects

No. 9 / September / 2017

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QUARTERLY BULLETIN ON ECONOMIC SITUATION AND PROSPECTS.

Executive summary.

The Spanish economy continues to profit from the significant adjustments made to competitiveness in recent years as well as from the still relatively low oil price and extraordinarily low interest rates. With annualised growth that could reach around 4% in the second quarter, macroeconomic data are very positive. Thus, confidence indicators are at high levels, industrial production, services sector and exports are giving positive surprises and the PMI shows upward trends once again. What's more, the demand for credit continues to strengthen and tourism is at its best, with it being unlikely that the latter be excessively affected by the terrorist attack in Catalonia. Prospects for the real estate sector are equally positive.

Additionally**, leading indicators for the third quarter,** such as car sales and overnight stays in hotels, **maintained a remarkable growth rate.** Regarding equipment investments, expansion is seen to be continuing, even more intensely than in the first half of the year, improving businessmen's perception of the current situation of their businesses in the third quarter, according to the business confidence indicator. The degree of utilisation of the productive capacity of investment goods expanded by more than one point, reaching 84.2% in the third quarter and the qualitative indicator of investment goods in July-August registered a positive balance (0.5 points). Finally, the new registrations of freight vehicles accentuated the rate of growth in July, registering a year-on-year increase close to 18%, according to data provided by the Spanish Association of Manufacturers of Automobiles and Trucks (ANFAC).

This will allow for 3.1% growth in 2017, with a slightly lower contribution from domestic demand than in 2016, offset by the greater contribution of foreign demand. Looking ahead to 2018, we expect a correction of foreign demand, which in turn will reduce the GDP growth rate to 2.8%.

A slightly lower rate of job creation and a higher average price per barrel of oil in 2017 will be mainly responsible for slowing the progress of private consumption from 3.2% in 2016 to 2.5% in 2017. The strong rhythm of job creation and the lower price of oil during the second quarter explain the increase of three tenths in our forecast for final household consumption in 2017. However, in the third quarter private consumption will have begun to lose some of its dynamism due to the lower purchasing power of wage income.

Although the growth of household spending slows this year, the opposite will happen with investment, which we expect to increase to 4% in 2017, almost one percentage point more than in 2016. **The demand for stockpiled investment pending the formation of government and the confidence generated by the favourable financial conditions and the good behaviour of the GDP and of employment will allow business investment both in capital goods and in construction to grow faster than in 2016.** Public consumption, meanwhile, will also grow positively at around 1.1% year-on-year, three tenths above the previous year, due to the increase in procurement by public administrations. Furthermore, growth in Public Consumption will probably be even greater in 2018.

Regarding tax, the strong pace of tax collection, especially VAT and personal income tax (9.2% and 7% in the period up to July, respectively), and the containment of public expenditure **raise the probability of meeting the public deficit target of 3.1% of GDP in 2017.**

The Consumer Price Index (CPI), published by INE, rose 0.1% in August from July, to 1.6% year-on-year, after two consecutive months of stability at 1.5%. The upturn in August is mainly due to rising fuel prices and, to a lesser extent, processed food, partially offset by the lower growth rate of non-energy industrial goods and services prices. Nevertheless, underlying inflation, excluding unprocessed food and energy -elements with higher CPI volatility- fell by two-tenths in August to 1.2%, mainly due to the slower pace of the prices of services and, to a lesser extent, non-energy industrial goods.

In any case**, the rise in prices in Spain,** as we anticipated in the previous bulletin**, seems more a transitory increase of prices that will have a greater effect in the first half of 2017, decreasing somewhat in the second half of the year,** albeit with the capacity to place the year's average inflation at around 2% with the Eurozone bearing a similar interpretation, generally speaking, although **it is likely that inflationary pressures be higher in the central euro countries**, especially in Germany, whose unemployment rate fell in July to 3.7%.

To this, we must add **the good health of the tourism sector**, partly because of the competitiveness of the sector and also thanks to the geopolitical tensions that affect some competing destinations.

The **outlook** for the **real estate sector** is also **clearly positive**, albeit with significant differences by regions and areas, with double-digit year-on-year increases for housing prices in Madrid and Barcelona in the first half of the year.

Looking to the future, everything seems to indicate that this favourable dynamic will remain expansionary in terms of activity for the year as a whole.

The 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 relatively rapid reduction of idle capacity should, in turn, allow some acceleration in both underlying prices and wages**. Although, at the moment, the forecast for 2017 is that wages will grow less than prices, resulting in a reduction in purchasing power.**

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

If we focus on **the second quarter of 2017,** the national accounting data confirm that **the Spanish economy grew by 0.9% quarter-on-quarter,** reflecting a slight acceleration of GDP growth, a tenth more than the previous quarter. **And this has taken place thanks to the notable contribution of domestic as well as foreign demand**. This means that the Spanish economy boasts a growth rate significantly higher than that of the Eurozone (+0.6%), which is also growing at rates not seen for six years.

Regarding the **external sector**, **exports** returned to growth in the second quarter by 0.7%, which is even more significant considering the enormous growth registered in both the last quarter of 2016 and in the first quarter of 2017.

The contribution of foreign trade to GDP growth has once again been positive **because the good performance of exports came accompanied by a slight drop (-0.2%) in imports of goods and services in the second quarter.**

In short, **GDP is moving faster than in the previous quarter, with higher growth in private consumption, a slowdown in the rate of investment and a very positive contribution from the external sector which, in turn, does not stem from tourism for the most part**. The important efforts made by the country to improve its competitiveness allowed the Spanish economy to take greater advantage of the renewed momentum observed in the world economy in the first half of the year, something which facilitates and activates business investment, employment and, again, consumption. However, it remains to be seen if the expansion of the world economy maintains the same pace in the second half of the year.

In recent months**,** the greater global growth has translated in a better performance of business results. And, what's more, fixed income was favoured by moderate inflation and by what has come to be perceived as an extremely prudent attitude on the part of the central banks.

The world economy is progressing at a good pace and the absence of worrisome inflationary pressures (we have even seen declines in underlying inflation in the United States in recent months) **could lead to a prolonged low interest rate scenario.**

However, it is not easy for this scenario of high growth and low inflation to continue over time. As the idle capacity of the global economy continues to decline, wage and price pressures are bound to increase. This, in turn, will require a progressive reaction by the central banks in the form of a gradual rise in interest rates (nominal and real) and a reduction, also gradual, of the sizes of their respective balances.

In line with the above, **the Federal Reserve has decided to put an end to its process of quantitative easing (QE)** and has announced that it will begin to gradually shed its more than four trillion dollars in state and mortgage bonds in October. At first it will get rid of $6 billion in Treasury bonds and $4 billion in mortgage bonds every month for a quarter. Above this initial limit, the debt will be reinvested. After the first quarter, the threshold will gradually rise with a similar rate, financial and economic situation permitting.

The risks are well balanced so that, even if it keeps the short-term interest rate between 1% and 1.25% at the moment, it leaves the door open for a further increases in 2017 (which would be the third this year) and three more possible in 2018. This policy is in line with its forecasts of more robust growth of the US economy in the coming years and it has revised its projection upwards by two tenths for this year to 2.4% and has kept the 2018 projection at 2.1% and, with an unemployment rate of 4.4%, this marks the lowest level since March 2007.

The unemployment rate in the United States is already below the natural level and it is likely that in the coming months we will see further improvements in the American labour market. The result of this should be a progressive acceleration of wages which would also tend to translate into price pressures (thus demonstrating that the underlying fall in inflation that we have seen during the first months of this year has been due to fundamentally temporary factors, as Janet Yellen pointed out in her last appearance after the meeting of the Federal Open Market Committee). **Furthermore, the recent weakness of the dollar will tend to generate additional price pressures.**

The Federal Reserve has assumed that, after achieving 3% annualised growth in the second quarter, the US economy will show strong economic performance over the coming quarters. The fundamentals of private consumption remain strong and corporate investment continues to provide good signals. The real estate sector, for its part, still has a significant margin for further expansion and the external sector should benefit from a weaker dollar, despite the likely appreciation following the withdrawal of stimulus announced by the Federal Reserve.

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

Among the emerging economies, it is noteworthy the effort by the Chinese authorities to keep their banking system in order, where the threat of a major financial crisis, despite high levels of debt, is losing strength. However, private debt is at record highs and continues to grow. Among the negative news, the slowdown of the Indian economy is surprising, where everything indicates that a nation which has long been one of the emerging economies that has maintained a strong rate of growth will stop being so.

On a European level, and with **less political uncertainty within the heart of the European Union, the macro data in the Eurozone continue to be frankly positive**: growth almost doubles the potential, expansion benefits virtually all countries and we are witnessing good news both in terms of domestic demand and exports.

A good example of this is the return to GDP growth in Greece and the return of Portuguese debt to being investment grade, abandoning the levels of high risk or junk bond. The improvement in the Portuguese debt rating allowed the interest charged on its ten-year bond to register the largest daily fall in more than a year and a half in mid-September, placing the

Portuguese risk premium only just above the 200 basis points limit, which it will probably exceed.

Although there are still significant levels of idle capacity in the Eurozone, it is rapidly shrinking and not infinite. It is enough that unemployment maintains its current downward trend for it to reach 8% within a year. This rate, despite being high compared to America, is below where the average unemployment rate stood in the pre-crisis Eurozone and is therefore a reasonable estimate of what could be the natural unemployment level of our continent. This is despite the fact that the unemployment rate most probably underestimates the levels of idle capacity in the Eurozone. But what is certain is that the output gap, the difference between observed GDP and potential GDP in the Eurozone, should it keep following current trends, the gap could potentially close in the next year and a half.

The European Central Bank, for its part, **has revised its inflation forecasts downwards due to the appreciation of the euro and has postponed any new developments in its stimulus withdrawal schedule until autumn.**

Monetary policy remains intact. Thus, a significant degree of monetary accommodation remains necessary for underlying inflationary pressures to increase and support general inflation in the medium term.

The perception is, therefore, that the underlying inflationary pressures are very contained. This explains the financing conditions being kept so favourable in order to achieve their transmission to the financing conditions of households and companies and thus stimulating **demand for credit, which is insufficient given the current financial conditions for the firm recovery of the Eurozone economy**, as the ECB Survey on SMEs' access to finance recently showed. **In recent months the deflationary component of the appreciation of the euro has been added, potentially conditioning the final decision on the optimal moment for the withdrawal of stimuli.** The euro has appreciated against the dollar over 15% since the beginning of the year.

The ECB foresaw Eurozone GDP growth for 2017 at 2.2%, above its potential, and three tenths higher than the July forecast. **And it downscaled price growth** in the Eurozone as they are far from reaching the 2% target of the bank**. Prices are not expected to grow by 2% before 2019**. Inflation forecasts are 1.5%, 1.2% and 1.5% for 2017, 2018 and 2019, respectively.

Our central scenario continues to be one of moderate reflation for the world economy, with central banks gradually normalising their monetary policies. Whether the correction of the yield curve, which is probably still very flat, is more gradual or more abrupt will depend on the level of prudence in relation to the needs of the economy. The probability of more or less significant overshooting on inflation targets will increase as monetary policies become more relaxed according to observed price pressures. Should this occur, long-term interest rates may take a little longer to pick up, but they would do so more strongly than is currently the case.

In 2018, GDP growth in the Spanish economy is expected to slow down to 2.8%, partly as a result of the lower contribution from the external sector and a slower pace of job creation. Exports of goods and services are likely to continue to gain market share but at a slower pace, while imports would gain some growth as domestic demand grew. The contribution of national demand to growth would be similar to that of 2017, perhaps slightly higher, as the expected slight slowdown in the consumption of households by a somewhat lower rate of job creation could be offset by an increase in public consumption and the relative stability of investment.

The high dependence of the Spanish economy on external financing is an object of concern and one of greater vulnerability to market tensions. The main factor that explains why the foreign debt of the total economy has not declined in recent years is public debt, which in June beat a new record and stood, in terms of GDP, at 100.03%. Approximately half of the increase in public debt of 63 percentage points of GDP between 2007 and 2016 is owned by non-residents. But as long as the private sector of the economy is able to achieve financing, the reduction of foreign debt will be faster and more likely. Low family savings relative to GDP and the recovery of residential investment will keep financial tension. Nevertheless, the Spanish economy has no other way to reduce the aforementioned vulnerability than to save more than it invests, a consequence of keeping a current account surplus as comfortable as possible.

The leading indicators for the third quarter show signs of increased momentum in employment and business investment, although employment measured through Social Security data shows a marked slowdown in July and August, as explained in the section *Growth prospects for the Spanish economy*. 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.

According to the latest bi-annual ECB Survey on the access to finance of enterprises, Spanish SMEs' funding needs are increasing, thus increasing the demand for corporate credit, weakened in recent semesters.

The good moment in which the Spanish economy finds itself favours the expansion of credit, supported by the continuity of the expansive monetary policy of the European Central Bank (ECB). The amount of new loans and credit to households, in cumulative terms for the last twelve months, increased by 0.6% year-on-year in July, compared to the 2% decrease of the previous month.

Despite this good moment in which the Spanish economy finds itself, one of the risks in Spain would be to forget the **important long-term challenges that the economy still faces**. In this regard, it is still necessary to take measures which increase our low potential growth, such as increasing competition in certain sectors, promoting human capital and boosting technological innovation. It is equally important to keep our high foreign debt under control as well as to mitigate the 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 monetary normalisation arrives, it would be desirable for the sovereign rating to have regained some of the ground lost during the crisis as to avoid a rebound in financing costs. Our forecast is that of a public deficit of 2.6% in 2018, which would allow for the ending of the "excessive deficit procedure".**

At the internal analytical level, **the escalation of tension in Catalonia is the main political risk** and forces both parties to find a negotiated solution. The risk of financial instability, although very unlikely, exists and, although the situation seems stable, negative surprises cannot be ruled out. The "Catalan question" may continue to generate considerable uncertainty.

With regard to international **political risk**, it should be noted that the uncertainty surrounding baseline projections related to world economic activity remains high and risks continue to point downward. Among the main negative risks would be possible shocks caused by political and geopolitical uncertainties including: an increase in the escalation of tension with the North Korean regime, a worsening of future relations between the United Kingdom and the European Union, and greater trade protectionism that is gaining momentum in advanced economies, led by the protectionist threats of the President of the United States. On the other hand, the strong entry of the right-wing in the German parliament following the elections held on Sunday adds further uncertainty in terms of the euro's role in Europe.

Global economic risks include consumption and investment which have been weakened by high debt levels, a rebound in inflation, a possible disorderly tightening of global financial conditions which could particularly affect emerging or more heavily indebted developing economies by generating undesirable financial tensions, and potential disruptions associated with the process of reform and liberalisation of the Chinese economy, which has a heavily indebted private sector.

The pace of progress of the Spanish economy in the coming quarters will be conditioned both by its vulnerability to future interest rate hikes in 2018 due to high foreign debt and by an excessively strong single currency against the dollar.

Global scenario.

North Korea and the global geostrategy

Donald Trump has been in the White House for more than eight months and his protectionist threats during the campaign and against world trade have not been met. The president has failed in most laws that he has brought before

Congress and the US economy continues to grow steadily creating 180,000 jobs a month, an amount similar to that of 2016.

The Eurozone economy is also growing steadily and 180,000 jobs have been created every month since 2016. ECB debt purchases have achieved financial stability and reduced risk premiums. For that reason, employment in Spain, Portugal, Ireland and Greece (countries that suffered most from financial instability and the credit crunch) is now growing at a rate triple that found in France and Germany.

In China, GDP growth remains close to 7%. The Li Keqiang index, which is made up of 40% bank credit, 40% electricity consumption and 20% merchandise transported by freight rail, grew by 11%, its largest increase since 2012. Consumer confidence has risen sharply since the summer of 2016 and is at its highest since 2007, before the Great Recession. Private investment recovers and grows at a rate of 7% annually, twice as much as in 2016, but still very far from the 25% of 2013.

Underlying inflation in the main countries remains stable and below the central bank's price stability targets, which allows the global monetary policy to remain expansive and foster growth. The ECB has anticipated beginning to reduce its debt purchasing in October. The European monetary authority has been carrying out the same policy as the Fed since 2007, but slightly late. Therefore, the most likely scenario is that the withdrawal be gradual and not jeopardise the creation of employment.

The price of oil remains at an average of $50 even though OPEC extended its reduction in barrels production approved in 2016. **Technology allows for the production with renewable energies at increasingly competitive prices, forcing the growth of oil demand to slow down. Also, fracking has increased the available supply of oil, effectively depleting OPEC's oligopoly and pricing power.**

The main risk to the growth of the world economy is geopolitics. During the Cold War, Henry Kissinger accepted the failure of the US in the wars of Vietnam and Korea and agreed with the Chinese to leave Asia under its zone of influence on the condition that it not team up with Russia. Barack Obama tried to establish a multipolar and multicultural world and adapt global institutions to the new reality of the 21st century. Donald Trump has returned to the bipolar model but this time against China. The North Korean threat that has already fired two non-nuclear rockets over Japan has once again provoked a US reaction in Asia, breaking the status quo. Investors reacted by increasing risk aversion when the conflict began but their fear has gradually normalised. Although there are other problems, geopolitics is currently the main risk that can slow global growth. Once again, a black swan: low probability of occurrence but with very negative consequences if it occurs.

Growth prospects for the Spanish economy.

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

Second quarter national quarterly data confirmed the strong performance of economic activity, experiencing quarter-on-quarter growth of 0.9%, one tenth higher than that seen in the previous quarter. This has made it possible to return to pre-crisis real income levels from the peak reached in the second quarter of 2008.

Growth continued to be balanced with positive contributions from both domestic and foreign demand. 0.3 percentage points in quarter-on-quarter terms to net foreign demand in the second quarter added to the strong growth in domestic demand, which contributed 0.6 percentage points to annual GDP growth. In year-on-year terms, GDP growth stood at 3.1%, with domestic demand contributing 2.4 percentage points and foreign demand 0.7, as in the previous quarter and being positive for the fifth consecutive quarter, something which had not been observed since 1997.

The positive contribution of net foreign demand to annual GDP growth is due to the increase in exports being stronger than that in imports, with rates of 4.5% and 2.8%, respectively, substantially lower than those of the first quarter, a contribution characterised by exceptionally momentous importing and, even more so, exporting.

The gradual and predictable deceleration of the Spanish economy did not take place in the end. At the moment, the second quarter shows growth still higher than that observed in the first quarter of the year and two tenths higher than that recorded in the fourth quarter of 2016. The lower-than-expected increase in exports due to the loss of momentum in international trade and investment has been offset by the growth in consumption, favoured in the second quarter by the fall in oil prices.

In any case, the medium-term outlook remains favourable and, by 2017, the progress of the economic activity is likely to be around 3.1%.

In the second quarter, domestic demand was consolidated as the main driver of quarter-on-quarter growth, driven by private consumption (0.7%) and, to a lesser extent, by a sharp reversal in demand for investment (0.7%), (mainly by the equipment component) and the expenditure on final consumption by public administrations (+0.2%), accompanied by foreign demand which continues to bring net growth to GDP (+0.2%).

The improvement in the labour market and consumer confidence, as well as the financial conditions, continued to favour the situation of households which, in turn, allowed for the good pace of consumption growth, better still in the second quarter (+0.7%), which was also driven by better performance of the price of oil during the second quarter. This also allowed for the continuance of the household deleveraging process.

Among the leading indicators linked to private consumption, the increase in new car registrations, according to ANFAC, was 6.4% in July and August, one tenth lower than the increase seen in 2016. With regard to the general retail sales index, calendar adjusted and deflated, a slowdown was seen in July by almost two and a half points, until it recorded a year-on-year rate of 0.5% as a consequence of the less expansive tone of both the food and the non-food component.

The advance of private consumption was accompanied by a quarter-on-quarter increase of 0.8% of investment in the second quarter, 1.3 points lower than in the previous quarter. However, in the first half of the year, fixed investment increased by 3.6%, a rate half a point higher than in 2016, due to the strong dynamism of equipment investment and the clearly expansive profile of investment in construction and of intellectual property products.

The conditions remain favourable for investment decisions, due to low interest rates, the good rhythm of domestic and foreign demand, the continuation of corporate deleveraging, the utilisation of productive capacity and the continuous improvement of expectations.

The most recent indicators for equipment investment indicate a continuity of the expansionary tone, even more intense than in the first half of the year, improving the perception of the current situation of its business by the entrepreneurs in the third quarter, according to the indicator of business confidence. The degree of utilisation of the productive capacity of investment goods expanded by more than one point, reaching 84.2% in the third quarter, and the qualitative indicator of investment goods in July-August registered a positive balance (0.5 points), albeit lower than in the first quarter. Finally, the registrations of freight vehicles accentuated the rate of growth in July, registering a year-on-year increase close to 18%, according to data from the Spanish Association of Manufacturers of Automobiles and Trucks (ANFAC).

As for **investment in construction**, the quarter-on-quarter growth rate remained at 1.1% in the second quarter. By components, **the good moment that the residential segment is going through is noteworthy, with an increase of 2.4%,** according to data from the National Quarterly Accounting published by the INE, following a strong rebound of 2.7% observed in the previous quarter. Investment in other types of construction, on the other hand, moderated its rate of decline by four tenths to 0.1%.

Short-term indicators related to the real estate sector were truly dynamic. The number of new housing sales grew by 3.1% in the second quarter, seven tenths more than in the previous quarter, and the number of mortgages set up for home purchase increased by 5.2%. The index of free housing prices increased by 5.6% year-on-year in the second quarter, according to the INE, mainly due to the pull observed in the purchase of used housing (+5.8%), compared to the moderation shown by the price of new housing, which advanced by 4.4% year-on-year.

On the other hand, **the final consumption expenditure of Public Administrations, in volume, increased 0.2% in quarter-on-quarter terms in the second quarter of the year,** six tenths less than in the first quarter. In the year-on-year terms, this accelerated by eight tenths to 1.3%, closing the first half of the year with an average annual increase of 0.9%, similar to that for 2016 as a whole.

Exports of goods and services, for their part, have suffered a significant fall after the surprising and favourable performance during the first quarter, well above expectations. In quarter-on-quarter terms, growth is 0.7%, compared to 3% first trimester. However, the contribution to growth in net foreign demand is higher than in the first quarter (+0.3%), which is explained by the fall in imports of goods and services of 0.2%, compared to the increase of 3.1% felt in the first quarter. The overall figure for the first half of the year is positive both for exports destined for European markets and, especially, for exports outside the European Union. **The months of June and July showed a new push against the slowdown in the second quarter for foreign sales by large companies, with data deflated and corrected of calendar and published by the Tax Agency**, both in terms of sales from Europe and from the rest of the world.

In the first half of 2017, and according to the Balance of Payments data available, **the Spanish economy generated a foreign financing capacity of €4,561 million**, compared to the financing capacity of €6,346 million in the same period of the previous year.

The labour market has been characterised in the second quarter of 2017 by an extension of the performance observed in the creation of employment in previous quarters, both in the Labour Force Survey (LFS) and in Social Security data.

With seasonally adjusted series, quarter-on-quarter variation in the number of newly registered workers grew by 1.2% quarter-on-quarter in the second quarter, three tenths more than in the previous quarter. In year-on-year terms, the number of workers accelerated by four tenths to 3.8% in the second quarter. In July and August 2017, there was a slight slowdown in the rate of job creation, according to the figures of Social Security.

The main indicators seem to suggest that economic activity will remain strong in the third quarter of 2017 and that Spain will continue to lead growth in the Eurozone, aiming at quarter-on-quarter GDP growth of around 0.8%. The PMI Composite Index of Global Activity, according to Markit, points to an increase of 0.7% quarter-on-quarter in the third quarter. Following the same trends we see the Business Confidence Index as prepared by INE, whose quarter-on-quarter increase in the third quarter (2%) is higher than in the second (1.8%), and the economic sentiment index, which improved by two tenths in July-August compared to the second quarter, to 108.6, as a result of the increase in confidence.

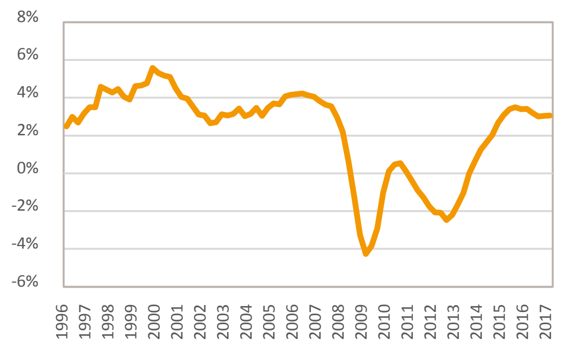
The inertia of private consumption is still strong, so this will remain a growth factor for GDP in the third quarter of 2017. To the still robust rate of job creation and the credit facilities that boost consumption by households, a new boost of business investment and public consumption will be added in the third quarter.

Demand and production

According to the results of the National Quarterly Accounts (NQA), published by INE, calendar and seasonally adjusted real GDP recorded quarter-on-quarter growth of 0.9% in the second quarter of 2017, one tenth more than the first quarter, making it fifteen consecutive quarters with positive rates. In year-on-year terms, GDP grew by another tenth to 3.1%, keeping it, therefore, at the rate it was at the end of 2016. This is a continuation of the consolidation of the Spanish economy's recovery process, which closed 2016 with annual growth of 3.2%, the same as in 2015, more than double that of 2014 (1.4%) and the highest since 2007.

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

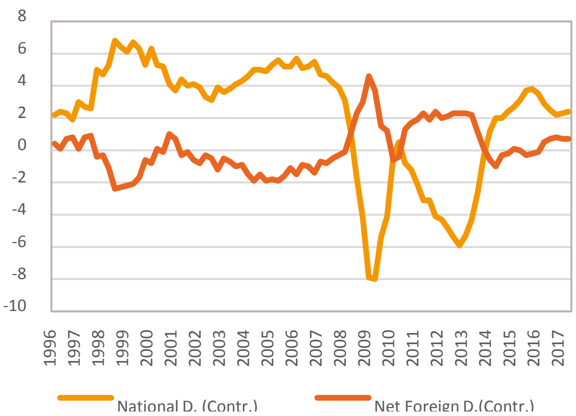
Figure 1. GDP (year-on-year change in %)



Source: QNA.

By its component, economic growth is based on domestic demand, the main driver of growth, with growth of 2.4 percentage points, one tenth higher than in the first quarter of 2017, although slightly lower than the average contribution registered when taking 2016 as a whole. The contribution of net foreign demand was positive, as in the previous three quarters, reaching 0.7 percentage points. It is a more balanced composition of growth, with net foreign demand contributing more and the growth of domestic demand contributing less when compared to 2016.

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



Source: INE.

National demand aggregates

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

The good performance of private consumption is explained by strong job creation, improved access to financing and the conditions thereof, and price moderation, thanks to the lower price of oil seen on average throughout the second quarter.

The most relevant indicators, both qualitative and quantitative, point towards the expansionary path of private consumption growth being followed in the fourth quarter of 2017.

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

Also noteworthy was the behaviour of the final consumption expenditure by Public Administrations, adding to its advance of 0.8% in the first quarter further growth of 0.3% in the second quarter, leading it to grow by 1.3% year-on-year, its biggest increase in the past year.

Fixed capital investment, on the other hand, showed a new boost of 0.8% quarter-on-quarter despite the strong increase of 3.1% already experienced in the previous quarter. The strong growth in investment in capital goods in the first quarter did not prevent this type of investment from continuing to advance 0.8% more in the second quarter. Investment in construction grew 1.1% again, as in the second quarter. This growth is explained by the advance of investment in housing construction, which showed growth in the second quarter of 2.4%, three tenths lower than in the first quarter.

Foreign demand

According to figures from the National Quarterly Accounts (NQA), in the first quarter of 2017 the external sector contributed three tenths to the quarter-on-quarter change in GDP, two tenths more than in the first quarter, as a result of an increase in the exportation of goods and services (0.7% quarter-on-quarter, after growth of 3% in the first quarter) and a slight decrease in imports (-0.2%, compared to 3.1% in the previous quarter). On a year-on-year basis, net foreign demand contributed seven tenths to the variation in GDP in the second quarter of 2017, as was the case in the previous quarter, due to a similar deceleration of exports and imports to 4.5% and 2.8%, respectively.

Compared to the main European Union economies, the quarter-on-quarter rate of Spanish real exports (+0.7%) was higher than that of Italy (+0.6%), similar to that of Germany and the United Kingdom (+0.7%) and lower than that of France (3.1%). In year-on-year terms it is slightly above all the major European economies, with the exception of Italy, with a year-on-year growth rate of 4.5%.

On a year-on-year basis, net foreign demand contributed seven tenths to the variation in GDP in the first quarter of 2017. **Both domestic and foreign demand therefore contributed positively to growth in the first quarter.**

Exports of goods and services decelerated in the second quarter of 2017, following the strong recovery seen in the previous quarter, in a context of a moderate recovery in the activity of major trading partners and major emerging economies.

On the other hand, in the second quarter of 2017 the competitiveness trend index based on consumer prices vs. developed countries reflected a slight loss of competitiveness of 0.1% year-on-year, after 0.3% growth in the first quarter, due to an increase in relative prices (0.2%), partially offset by the 0.1% depreciation of the nominal effective exchange rate. In respect to the European Union, there was a loss of competitiveness of 1.1% due to the appreciation of the nominal effective exchange rate (0.7%) and the increase in the relative consumer price index (0.4%). Finally, in respect to the BRICS countries, competitiveness grew 2%, thus making it three consecutive quarters of growth which was due to the depreciation of the nominal exchange rate index (2%) while the relative price index remained stable.

On a year-on-year basis, real exports of goods and services increased by 4.5% in the second quarter of 2017, compared to the 7.3% increase in the first quarter. Exports of goods rose by 3.2%, down 5.1 points from the previous year, while services grew by 2.4 points to 7.5%. In quarter-on-quarter terms, exports grew 0.7% compared to a 3% increase in the previous quarter, with goods declining 0.6% and services growing by 3.8% (4.5% and -0.3% in the previous quarter, respectively).

Year-on-year growth in real goods exports in the second quarter (3.2%) was lower than that of world trade in goods, which grew by 4.3% according to the Netherlands Central Planning Bureau. In the global computation of the first half of the year, a real market share gain of 0.03 points was recorded, bringing it up to 1.98%. The export sector which shrank most in the second quarter was the automobile sector, with exports rising 9.3% year-on-year in the first quarter and falling 9.8% in the second quarter.

Non-resident household expenditure in the Quarterly National Accounts increased by 4% quarter-on-quarter in the second quarter of 2017, compared to a 2.1% increase in the previous quarter, and a 9.8% year-on-year increase, nine tenths more than in the previous quarter. The main indicators of foreign tourism, including the arrival of tourists and overnight stays of foreigners in domestic hotels, offer favourable signs, with year-on-year rates of 10.1% and 3% in July, respectively.

Real exports of non-tourism services rose by 3.6% quarter-on-quarter in the second quarter of 2017, compared to the 2% decline in the first quarter. In year-on-year terms, this figure grew by 5.9%, 3.2 points higher than the previous quarter.

Real imports of goods and services declined by 0.2% in the second quarter of 2017 compared to the previous quarter, following growth of 3.1% increase in the preceding period. By components, imports of goods fell 1.5% compared to the previous quarter and services grew by 5.5%. Real imports of goods, deflated by unit value indices, grew 3% in the second quarter of 2017, following 8% in the previous quarter. According to QNA figures, real expenditure of households residing abroad, decreased by 1.3%, in quarter-on-quarter terms, following a decline of 1.6% in the previous quarter. Imports of non-tourism services fell by 7.9% quarter-on-quarter, after a 3% decline in the previous quarter.

The surplus of goods and services at current prices and according to QNA data was at 3.3% of quarterly GDP in the second quarter of 2017, three tenths lower than the previous year, due to the greater deficit of goods (-1.4% versus -1% of GDP) that offset the increase in the services surplus. Among services, the surplus of net revenue from tourism (3.1% of GDP) increased by three tenths compared to the second quarter of 2016, but the surplus of non-tourism services (1.6% of GDP) fell by two-tenths.

Productive activity

In terms of supply, the large sectors of activity show a mixed performance in the third quarter of the year. The Gross Value Added (GVA), in volume and with series corrected for seasonality and calendar effects, grew by 4.4% and, within this, the construction sector advanced by 4.8%, while the services sector remained unchanged at 2.8%. Agriculture, livestock, forestry and fishing slowed by three tenths while industry fell by two tenths compared to the same period last year.

In quarter-on-quarter terms, the GVA of the services sector and of industry accelerated by one and four tenths, respectively, both registering a quarter-on-quarter rate of 0.8%. The GVA of the construction sector increased by 1.5%, almost half of the previous quarter (2.9%) and the GVA of agriculture, livestock, forestry and fishing declined by 2.6%, following an increase of 2.5% in the previous quarter.

Apparent productivity of those actively involved in the labour force, in terms of the National Accounts, grew by 0.3% in the second quarter of the year as a result of the 3.1% increase in GDP and a 2.8% increase in full-time equivalent employment.

Early indicators for the industry show signs of weaker business dynamism at the beginning of the second half of 2017. The Industrial Production Index, with series corrected for calendar effects and seasonality, calmed seven tenths in July in terms of the annual growth rate to 1.9%, mainly due to the deceleration of its energy component and the intensification of the deceleration of its consumer goods component. On the other hand, capital and intermediate goods accelerated. Finally, the manufacturing PMI decreased by 1.7 points in the July-August period to 53.2, indicating that the sector's expansion continues.

The Industrial New Order Index, with calendar-adjusted series and advanced activity indicators for the sector, recorded high annual growth of 7.5% in the second quarter, although this was lower than the first quarter. This is essentially due to the deceleration in the components of investment goods and energy.

In the construction sector, the Construction Production (Volume) Index, published by Eurostat, rebounded in June, reaching a year-on-year rate of 6.5% with corrected calendar data, after three months of uninterrupted falls. This improvement was motivated by the progress of its two components: building and civil works.

Among the leading indicators, the surface area destined for new builds, according to work permits, slowed the year-on-year progress rate to 13.3% up to May, almost seven points lower than the total for 2016. Nevertheless, official tendering rose in the second quarter of the year, to a year-on-year rate of 16.7%, compared to the 6.5% fall in the first quarter.

The services sector, on the other hand, shows, in general, favourable indicators, such as the service confidence indicator published by the European Commission and which presented progress in July and August, although the PMI services index, published by Markit, slowed one point to 56,8, indicative level of high dynamism.

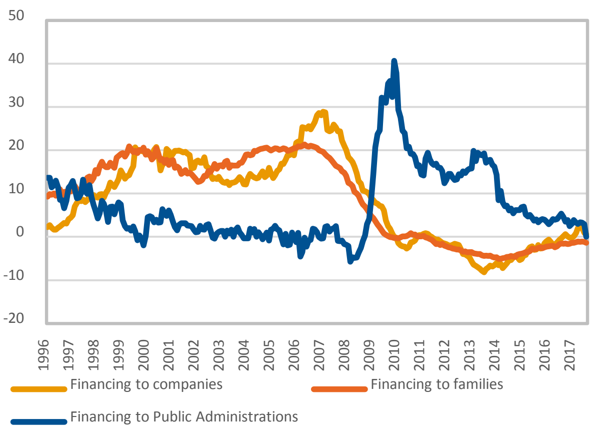
We must add to this the exceptional tourist season, which, having broken records in 2016, is likely to do the same in 2017. At the moment, in the first half of the year, tourist arrivals and spending by tourists increased by 11.3% and 14.8% respectively. Overnight hotel stays also increased by 3.8% year-on-year between January and July, both in 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. The good moment in which the Spanish economy find itself favours the expansion of credit, supported by the continuity of the expansive monetary policy of the European Central Bank (ECB). The amount of new loans and credit to households, in cumulative terms for the last twelve months, increased by 0.6% year-on-year in July, compared to the 2% decrease of the previous month. This favourable performance is explained by the smaller fall in credit destined for housing

(-6.8% compared to -10.7% in the previous month) and for other purposes (-5.9% compared to -8.3% of the previous month), offset by the slight deceleration of consumer credit of two tenths to 18.7%. The amount of new loans and credits to SMEs (using a proxy of less than one million euros) increased by 5.5% year-on-year to July, accumulating 1.7 points more than in the preceding month. On the other hand, the amount of new loans and credits of over one million euros fell by 15.3% year-on-year, down 6.3 percentage points when compared to that of June.

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

Figure 3. Financing Year-on-Year rate



Source: Bank of Spain.

In the year-on-year comparison, the stock of financing received by the three economic agents (companies, families and public administrations) slowed down. Financing to companies slowed by three tenths and grew only 0.6% year-on-year, while the financing obtained by Public Administrations also grew less than in previous months, increasing by 2.9% year-on-year in July Financing destined for families fell three tenths more than in July reaching 1.4%.

In terms of supply, the improvement of the banking sector strengthened. The banking sector's delinquency rate, which was 9.2% at the end of the third quarter of 2016 and reached 9.11% at the end of the year, maintains a downward trend that is supported by the improvement in economic activity and, specifically, the labour market. Our forecasts suggest that it could be below 8% by the end of the year.

Prices

The Consumer Price Index (CPI), published by INE, rose 0.1% in August from July to 1.6% year-on-year after two consecutive months of holding stable at 1.5%.

The upturn in August is mainly due to rising fuel prices and, to a lesser extent, processed food, partially offset by the lower growth rate of non-energy industrial goods and services prices.

Prices of energy products rose in May by 8.3% year-on-year, although this means 3.7 points less than in April. The price of fuels and lubricants went from 11.5% growth year-on-year in April to 4.9% in May.

Underlying inflation, excluding unprocessed food and energy, elements with higher CPI volatility, fell by two-tenths in August to 1.2%, mainly due to the deceleration of the prices of services and, to a lesser extent, non-energy industrial goods.

The INE has also published the harmonised CPI for the month of August 2017, with a year-on-year rate of 2%, three tenths higher than in July. The advanced rate provided by Eurostat for the Eurozone as a whole was 1.5% in August, two tenths higher than the same month in the Eurozone, resulting in an inflation differential for Spain with respect to the Eurozone of 0.5 points, one tenth higher than that of July.

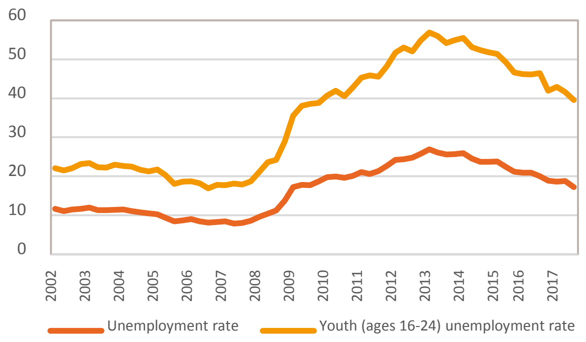
Labour market

The labour market was characterised in the second quarter of 2017 by an extension of the dynamism observed in the creation of employment in previous quarters, both in the Labour Force Survey (LFS) and in Social Security data.

With seasonally adjusted series, quarter-on-quarter growth in the number of newly registered workers grew by 1.2% in the second quarter, three tenths more than in the previous quarter. In year-on-year terms, the number of registered workers grew by four tenths to 3.8% in the second quarter. In July and August 2017, there was a slight slowdown in the rate of job creation, according to the figures from Social Security.

According to Quarterly National Accounts (QNA), full-time equivalent employment, with seasonally adjusted and calendar-adjusted series, rose by 0.9% quarter-on-quarter in the second quarter, two tenths higher than in the previous quarter and, in year-on-year terms, it grew 2.8%, three tenths more than in the first quarter.

Figure 4. Unemployment rate. Active population percentage



Source: INE

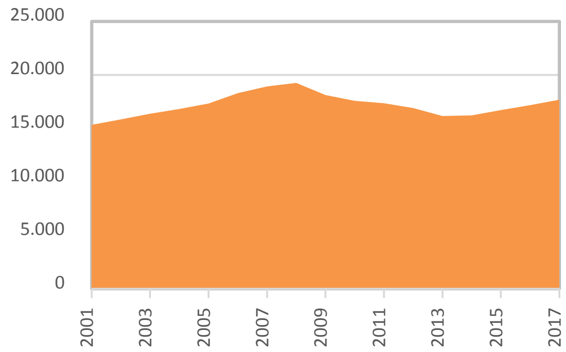
The increase in employment was extended in the first quarter to all branches of activity. According to LFS figures, and in year-on-year terms, employment growth was widespread across all major sectors, mainly services, with an increase of 244,100 employed (1.7% per year), followed by industry, with 139,500 (5.6%), agriculture with 72,400 (9.5%) and construction with 56,300 (5.2%).

With regard to the professional situation of the employed, wage earners increased by 502,500, a year-on-year rate of change of 3.3%, compared to 2.7% in the first quarter. The group of self-employed workers also increased by 0.3%, compared to 0.1% in the first quarter.

If we look at the type of contract, the annual increase in wage employment of 3.3% places the net creation of wage employment at 40% of the total, while 60% of the increase in wage employment was temporary. As a result of this dynamic, the temporality rate stood at 26.8%, seven tenths higher than a year earlier.

By age, all groups showed declines in unemployment in the first quarter. The youth unemployment rate stood at 39.5% in the first quarter, down seven points from a year earlier.

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



Source: Social Security.

According to the Labour Force Survey (LFS) for the second quarter of 2017, published by the INE, employment in the Spanish economy increased by 375,000, 100,000 more than in the second quarter of 2016, with the number of employed persons at 18,813,300 people, up 2% on the previous quarter and the highest since the third quarter of 2010. When compared to the same quarter of the previous year, employment increased by 512,300, 2.8%, a rate half a point higher than the previous quarter.

Moderation in the growth of salaries and unit labour costs has continued. According to the Quarterly Labour Cost Structure Survey for the first quarter of 2017, the average labour cost by worker and month remained unchanged in relation to that recorded in the first quarter of 2016, compared to a fall of 0.8% in relation to the same quarter of 2015.

And, according to the QNA figures, the remuneration per employee decreased in the second quarter of 2017 by 0.1% year-on-year, following growth of 0.4% in the previous quarter. Meanwhile, the apparent productivity of labour increased by 0.3%, two tenths less than in the previous quarter, such that the unit labour cost decreased by 0.4%, thus accumulating eight consecutive quarters of declines. Lastly, the Statistics of Labour Conventions prepared by the Ministry of Employment and Social Security points to an average agreed increase until August of 1.3%, three tenths higher than the salary increase agreed in 2016.

Balance of payments

In the first half of 2017, and according to the Balance of Payments data available, the Spanish economy generated an external financing capacity of €4,561 million, compared to the financing capacity of €6,346 million in the same period of the previous year.

The accumulated surplus of the current account amounts to €3,571 million, lower than that reached in the first half of 2016, which amounted to €5,752 million. This fall is due to the decrease in the surplus of goods and services, partially offset by the moderation of the deficit of primary and secondary incomes. For its part, the capital account surplus increased by €400 million to €992 million.

At the same time, the financial balance recorded net outflows of capital amounting to €610 million compared to net outflows of €1,230 million a year earlier due to net outflows of capital excluding the Bank of Spain of €37,937 million, which is slightly higher than the increase in the net debit position of the Bank of Spain (€37,326 million). This statistic can be subject to important oscillations.

Foreign exchanges of goods and services recorded a surplus, although 23.7% less than in the first half of 2016. This has had much to do with the rise in the price of oil, which led to a 42.6% increase in the trade deficit of energy goods, in line with the evolution of the price of imported oil, which, measured in euros, got 45% more expensive on average in this period. However, the non-energy component of the trade balance improved, increasing 50% over the same period of the previous year. The total balance is an increase in the trade deficit of 40.7%.

In the first half of 2017, the balance of tourist services reached a surplus of €16,964 million, 9.8% higher than in the same period of the previous year and which was hampered by the 12% increase in tourism revenues, while spending by foreign tourists, according to the Tourism Expenditure Survey (EGATUR), increased by 14.8% year-on-year, with tourist arrivals increasing by 11.6% year-on-year, a tenth higher than the previous quarter.

Payments for tourism as a result of movements of Spaniards abroad grew 16.7% in the first half, a rate that means an acceleration of 2.5 points compared to the first half of 2016.

The balance of primary and secondary incomes, in turn, accumulated a deficit of €7,502 million in the first half of the year, 14.4% lower than the one registered in the equivalent period in 2016. This was made possible by the reduction in revenues (-0.6%) being less than in payments (-3.5%).

The financial account, on the other hand, accounted for net outflows of €610 million in the first half of 2017, compared to net outflows of €1,230 million in the first half of 2016. Excluding the Bank of Spain, net outflows of €37,937 million were recorded up to June, compared to net outflows of €43,020 million recorded a year earlier, a result that includes positive balances (investments) in assets and liabilities. Therefore, both foreign investment in Spain and Spanish investment abroad increased.

Finally, the Bank of Spain's net debtor position increased compared to the Eurosystem (mainly due to the reduction of €37,326 million in the net assets of the Bank of Spain) and the debit balance of the Net International Investment Position (NIIP) increased by €28,477 million, to reach €973,000 million, equivalent to 86.6% of GDP, a percentage 5.8 points lower than in the first quarter of 2016. Gross foreign debt in the first quarter of 2017 amounted to €1.911 trillion (170.1% of GDP), compared to €1.865 trillion for the same period in 2016 (170.2% of GDP), even though it increased with respect to the weight seen at the end of 2016 (167.5% of GDP).

Public sector

The consolidated deficit of the Public Administrations, without Local Corporations, stood at 2.35% of GDP in June, 22.5% lower than in the same period of 2016. This decline is explained by a year-on-year increase in non-financial resources (4.5%) higher than the increase in jobs (0.1%).

The increase in revenue comes from the improvement in social contributions (4.9%) and taxes (5.6%). In terms of non-financial employment, the increase in intermediate consumption (3.2%), subsidies (14.3%), social benefits (1.5%), social transfers in kind (4.7%) and transfers to other public administrations (3.7%) more than offset the fall in interest rates (-5.3%) and remuneration of employees (-0.4%).

In terms of the national accounts, the State deficit up to July was 1.86% of GDP, representing a reduction of 28.6% year-on-year. This smaller deficit was due to the year-on-year increase in non-financial resources (4.8%) and the decline in non-financial employment (-3.2%).

As the Independent Authority of Spanish Fiscal Responsibility (AIRef) states, the good performance of tax collection, both taxes and contributions and, above all, the containment of public expenditure, have increased the probability of ending 2017 with a deficit of 3.1% of GDP, in line with the target set by the Government. In the first half of the year, in terms of twelve cumulative months, the general government deficit fell by seven tenths, to 3.6% of GDP, making it feasible to meet the objective of budgetary stability.

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

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

According to the methodology of the Excessive Deficit Protocol (EDP), Public Administration debt reached 100.03% of GDP in the first half of 2017, i.e. €1,138,899 million, almost 3% higher compared to the same period of the previous year.

State debt registered a year-on-year increase of 4% to €976,285 million. The debt of other entities belonging to the Central Administration stood at €36,289 million, representing a decrease of 23.1% compared to June of the previous year. The EDP debt of the Autonomous Communities reached €286,212 million, 4.6% higher than that observed in the same month of the previous year. In the Social Security Administrations, debt reached €17,173 million, a figure very similar to that registered in June 2016. Finally, Local Authorities showed EDP debt of €32,520 million, 7.4% lower than in June 2016.

2017-2018 scenario: sustained growth

In 2015 and 2016 the Spanish economy benefited from an extremely favourable environment, which, thanks also to the good performance of companies, families and the public sector, allowed expectations to be exceeded quarter after quarter and an advancement at an average rate of 3.2%, but 2017 will, with a high probability, lead to a very slight deceleration in GDP growth, which we estimate to be 3.1%.

At the beginning of the year the expected deceleration of GDP was the result of several factors that are not favourable and could contribute negatively to GDP growth in 2017. On the one hand, the **increase in oil prices** will raise costs for the Spanish economy and reduce consumption or savings income. In June the price of oil in international markets fell to $45 per barrel and, despite the gradual increase since then placing it at two-year highs, its effect is being partially neutralised by the strength of the euro, which has been estimated at around 16% since the beginning of the year and 7.5% since the end of June. In this sense, one of the keys to explaining the momentum observed in private consumption during the second quarter was undoubtedly the lower price of oil.

On the other hand, a sharp and rapid rise in interest rates was expected, which would make funding more expensive. But the long-term interest rates referenced by the Spanish 10-year bond ended the second quarter at the lowest levels of the year and, despite the recent rise to 1.6%, the cost of financing is at a comfortable level to manage and facilitate growth. Therefore, in this sense, the deceleration via consumption and investment will be much lighter than expected at the beginning of the year and the economy may even maintain the growth rate registered in the last two years given the strong GDP growth observed in the second quarter.

The Spanish economy continues to benefit from strong competitive adjustments in recent years, extraordinarily low interest rates and the still low oil price. With annualised growth that could reach around 4% in the second quarter, macroeconomic data are very positive. Thus, confidence indicators are at high levels and data regarding industrial production, the services sector and exports are giving positive surprises as well as PMI once again showing upward trends. On the other hand, the demand for credit continues to strengthen and tourism is at its best and it is unlikely that it will be excessively affected by the Barcelona bombing. Prospects for the real estate sector are equally clearly positive.

Additionally, third quarter leading indicators such as car sales or overnight hotel stays of residents maintain a high rate of growth. Regarding equipment investments, expansion is seen to be continuing even more intensely than in the first half of the year, improving businessmen's perception of the current situation of their businesses in the third quarter, according to the business confidence indicator. The degree of utilisation of the productive capacity of capital goods expanded by more than one point, reaching 84.2% in the third quarter and the qualitative indicator of investment goods in July-August registered a positive balance (0.5 points). Finally, the registrations of freight vehicles accentuated the rate of growth in July, registering a year-on-year increase close to 18%, according to data of the Spanish Association of Manufacturers of Automobiles and Trucks (ANFAC).

All this would allow for a 3.1% growth in 2017, with domestic demand slightly lower than in 2016, offset by the higher contribution of foreign demand, which would be corrected again in 2018 to grow at a rate of 2.8%. **A slightly lower rate of job creation and a higher average price per barrel of oil in 2017 will be the main factors responsible for slowing the progress of private consumption.** Quite the opposite is the case for investment, which we expect to increase to 4% in 2017, almost one percentage point more than in 2016. The demand for stockpiled investment pending government formation, favourable financial conditions and good performance of GDP and employment will allow business investment in both capital goods and construction to advance faster than it did in 2016. Public consumption, meanwhile, will also increase at around 1.1% year-on-year, three tenths above the previous year, and its growth will probably be even higher in 2018. The strong performance of tax collection, especially VAT and personal income tax (which registered an increase of 9.2% and 7% up to July, respectively) should allow the public deficit target of 3.1% of GDP to be met in 2017.

The Consumer Price Index (CPI), published by INE, rose 0.1% in August from July to 1.6% year-on-year, after two consecutive months of holding stable at 1.5%. The upturn in August is mainly due to rising fuel prices and, to a lesser extent, processed food, partially offset by the lower growth rate of non-energy industrial goods and services prices. Nevertheless, underlying inflation, excluding unprocessed food and energy, elements with higher CPI volatility, fell by two-tenths in August to 1.2%, mainly due to the slower pace of the prices of services and, to a lesser extent, non-energy industrial goods.

In relation to the price of oil, the OPEC's efforts are being met by the increase in the production of the main producing countries outside the organisation and by the shale oil that the United States is already able to make profitable even with prices below $50 a barrel Brent.

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, as the current oil futures curve anticipates that oil prices will remain very stable, we expect the future contribution of energy prices to inflation to be very limited.

In any case, the rise in prices in Spain at the beginning of the year became a temporary increase in prices that had a greater impact in the first half of 2017, an impact which became less significant in the second half of the year, albeit with the capacity to situate the year's average inflation at around 2%. The interpretation is broadly similar for the Eurozone, even though inflationary tensions should probably be higher in the central Eurozone countries in the medium term, especially in Germany, whose unemployment rate in July fell to 3.7 %, a record low, or in the US, where the unemployment rate stood at 4.4% in August. It should also be noted that although overall trends in unemployment are clearly positive in the Eurozone (if the current rate of job creation is maintained, the unemployment rate could fall to 8.5% by the beginning of 2018, which is nonetheless high compared to the US or Japanese economy, but would put unemployment in the Eurozone at average pre-crisis historical levels), the slack in labour markets is still noticeable when considering broader measures of underutilisation of labour.

According to the forecasts of major international organisations, the global economy will accelerate its growth by over 3% in 2017, 2018 and 2019. World trade gained momentum in the second half of 2016 and according to available data has remained this way in the first half of 2017.

In the first half of 2017, world exports continued to grow strongly, just as they did in the second half of 2016. The emerging countries are what drive world growth, especially those in Asia where imports grow more than exports. The main cause of 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 their foreign surplus 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, also benefits from the growth of world trade and is the main engine which drives recovery and coming out of recession. However, falling commodity prices have caused the region to return to external deficits of 2% of GDP in the area, although, it should be noted that this deficit is far from the levels that caused decades of severe balance of payments crises. Foreign debt over GDP is also lower and has accumulated a buffer of foreign exchange reserves.

Over the last few months**,** increased global growth has translated into better performance in terms of business results. And, what's more, fixed income has been favoured by the moderation of inflation and, therefore, central banks have perceived it as being highly prudent. The global economy is progressing well and the absence of worrisome inflationary pressures (we have even seen falling underlying inflation in the US in recent months) could lead to the permanently low interest rate scenario being lengthened.

However, it is not easy for this scenario of high growth and low inflation to be sustained over time. As the idle capacity of the global economy continues to decline, wage and price pressures are bound to increase. This, in turn, will require a gradual reaction by the central banks in the form of a gradual rise in interest rates (nominal and real) and a reduction, also slowed, of the sizes of their respective balances.

In line with the above, the Federal Reserve has decided to put an end to the process of quantitative easing (QE) and has announced that it will begin to gradually shed its more than four trillion dollars in state and mortgage bonds in October. At first it will get rid of $6 billion in Treasury bonds and $4 billion in mortgage bonds every month for a quarter. Above this initial limit, the debt will be reinvested. After the first quarter, the threshold will gradually rise with a similar rate if the economic and financial situation allows it.

The Plan agreed by the Federal Reserve states that after one year it could sell up to $30 billion a month in Treasury bonds and $20 billion in mortgage debt. In any case, the actual sale of the securities will not take place, rather they will be allowed to expire without renegotiating or repurchasing them. This in practice will mean that the Federal Reserve will stop reinvesting the equivalent of $200 billion over the next twelve months, a figure that will amount to $600 billion in successive years.

In line with the stronger growth forecasts for the US economy in the next few years, having increased their projections by two-tenths for this year to 2.4% have kept the forecast for 2018 at 2.1%, and with a rate of unemployment rate at 4.4% in March 2007, risks are well balanced and, although the short-term rate band between 1% and 1.25% is maintained, a new increase in 2017 is possible (which would be the third this year), as are three more in 2018.

The unemployment rate in the United States is already below a stable level and it is most likely that in the coming months we will see further improvements in the American labour market. The result of this should be a progressive acceleration of wages, which would also tend to translate into progressive price pressures (thus demonstrating that the fall in underlying inflation that we have seen during the first months of this year has been fundamentally due to temporary factors, as Fed Chairman Janet Yellen said in her last appearance after the meeting of the Federal Open Market Committee). Furthermore, the recent weakness of the dollar will tend to generate additional price pressures.

The Federal Reserve has assumed that, after achieving 3% annualised growth in the second quarter, the US economy will show strong economic performance over the coming quarters. The fundamentals of private consumption remain strong and corporate investment continues to provide good signals. The real estate sector, for its part, still has a significant margin for further expansion and the external sector should benefit from a weaker dollar, despite the likely appreciation following the withdrawal of stimulus announced by the Federal Reserve.

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

Among the emerging economies, it is noteworthy the effort made by the Chinese authorities to keep their banking system in order, where the threat of a major financial crisis, despite high levels of debt, is losing strength. However, private debt is at record highs and continues to grow. Among the negative news, the slowdown of the Indian economy is surprising, where everything indicates that a nation which has long been one of the emerging economies that has maintained a strong rate of growth will stop being so.

On a European level, and with less political uncertainty within the heart of the European Union, the macro data of the Eurozone continue to be frankly positive: growth almost doubles the potential, expansion benefits virtually all countries, and we are witnessing good news both in terms of domestic demand and exports.

A good example of this is the return to GDP growth in Greece and the return of Portuguese debt to being investment grade, abandoning the levels of high risk or junk bond. The improvement in the Portuguese debt rating allowed the interest charged on its 10-year bond to register the largest daily fall in more than a year and a half in mid-September, placing the Portuguese risk premium close to dropping below the 200 basis points limit, which it will probably exceed.

Although there are still significant levels of idle capacity in the Eurozone, this is rapidly shrinking and not infinite. It is enough that unemployment is being reduced at the same rate as it was last year to lead to unemployment reaching rates of 8% by this time of next year. This rate, despite being high compared to America, is below the average unemployment rate in the pre-crisis Eurozone and is therefore a reasonable estimate of what could be the natural unemployment rate for our continent. This is despite the fact that the unemployment rate most probably underestimates the levels of idle capacity in the Eurozone. Nonetheless, what is certain is that whatever the idle capacity may be, it is difficult not to see the output gap of the Eurozone closing in about a year and a half (knowing, moreover, that there are already countries like Germany boasting positive output gaps). And this could have greater effects on underlying inflation than expected today by the market.

The European Central Bank, for its part, has revised its inflation forecasts downwards due to the appreciation of the euro and has postponed any new developments in its stimulus withdrawal schedule until autumn.

Monetary policy remains intact. Thus, a significant degree of monetary accommodation remains necessary for underlying inflationary pressures to increase and support general inflation in the medium term.

The perception is, therefore, that the underlying inflationary pressures are very contained. This explains financing conditions being kept so favourable in order to achieve their transmission to the financing conditions of households and companies and thus stimulating demand for credit, which is insufficient given the current financial conditions for the firm recovery of the Eurozone economy, as the ECB Survey on SMEs' access to finance recently showed. In recent months the deflationary component of the appreciation of the euro has been added, something which could condition the final decision on the optimal moment for the withdrawal of stimuli. The euro has appreciated against the dollar more than 15% since the beginning of the year.

In order to ensure a sustained return of inflation rates to close to 2%, the Governing Council of the ECB has decided to keep the ECB's official interest rates unchanged and expects them to remain at current levels or lower for the foreseeable future, a timeline which will far exceed the horizon of net purchases of assets. The interest rates applicable to the main refinancing operations, the marginal lending facility and the deposit facility at 0%, 0.25% and -0.40%, respectively, remain unchanged. Regarding non-conventional monetary policies, the ECB will continue to make purchases under the asset purchase program at the current rate of €60,000 million per month until the end of December 2017 and, as of April, net purchases are expected to continue at a rate of €60,000 million per month, until the end of December 2017 or later, if necessary. The ECB foresaw Eurozone GDP growth for 2017 at 2.2%, a rate above potential, and three tenths higher than the July forecast. And it downscaled price growth in the Eurozone as it is far from reaching the 2% target of the bank**.** Prices are not expected to grow by 2% before 2019. Inflation forecasts are 1.5%, 1.2% and 1.5% for 2017, 2018 and 2019, respectively.

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

In 2018, GDP growth in the Spanish economy is expected to slow down to 2.8%, partly as a result of the lower contribution from the external sector. Exports of goods and services are likely to continue to gain market share but at a slower pace, while imports would gain some growth as domestic demand grows. The contribution of national demand to growth would be similar to that of 2017, perhaps slightly higher as the slight expected slowdown in the consumption of households due to a somewhat lower rate of job creation could be offset by an increase in public consumption and the relative stability of investment.

However, uncertainty remains high due to a number of factors, including the design of US administration policies and their effects on the US economy, as well as the effects of potential contagion with global activity. We should add to this the 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 rapid rebound in inflation, protectionism, and the risk of hard Brexit in the process of negotiating future relations between the UK and the European Union.

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

In Spain and the Eurozone, exports are highly important in the economy, as such, recovery in foreign trade explains the higher growth of GDP and employment in the first half of 2017, with France and Germany increasing their growth rate up to an annualised 2%.

And this, in turn, explains the excellent performance of Spanish exports of goods and services in the first half of 2017 and the good prospects for the second half. **A protectionist drift in the coming years would affect the dynamism of current European exports.** New episodes of appreciation of the euro are also a risk to consider as they would slow the growth of the Eurozone.

The vulnerability of the Spanish economy to future rate hikes is another of the great risks that hang over the economy. The ECB's speed in stimulus withdrawal will condition the impact of monetary policy measures on the real economy. While short-term interest rates in the Eurozone have not been significantly affected by the fact that the European Central Bank (ECB) has not changed its policy of negative rates, this policy is likely to be withdrawn in 2018, which could start to be discounted by markets in the second half of 2017.

Long-term interest rate increases, although slow in impacting interest payments on general government debt, will end up taking their toll on both Public Administrations and, more immediately, companies, and this is worrying given the high financial vulnerability of the Spanish economy.

On the other hand, short-term interest rate increases will impact the Spanish economy since it is especially sensitive to increases in the Euribor given the high quantities of debt held by households, thus affecting the Spanish families' waterline.

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

As far as fiscal policy is concerned, and given what may be a scenario for the ECB's gradual normalisation of monetary policy, the country meeting deficit targets will become more relevant during 2017 and 2018.

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. 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 external sector could be of some importance even throughout 2017. 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, the ECB's monetary policy has also been instrumental in helping to achieve significant current account surpluses in recent years by reducing the burden of debt and helping to reduce the income-deficit Spanish balance. The reduction of the surplus to 1.3% of GDP in 2017 from 2% in 2016 will be mainly due to the increase in the energy bill after the higher average oil price in 2017.

Within Europe, 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 important imbalances, must come from the community budget. But a more federal Europe and the political will towards a true political union was far from being forged as a real project. The arrival of Emmanuel Macron at the Élysée Palace may give a new impetus to the European integration project in a context where political risk has softened but where Brexit, an incomplete monetary union, the anti-European dialectic of the United States president, nationalism, the entry of the ultra right into the German Parliament, the migratory crisis and the terrorist threat force the European Union to decisively encourage the European project.

Further progress in the process of European integration would make the Spanish economy less vulnerable when the withdrawal of monetary stimulus arrives and would significantly strengthen market confidence in the euro area economy. The Spanish economy has more solid foundations than in previous years, with the economy growing at a strong pace, driven by both consumption and investment and exports. Among the reasons for the good investment data, we could highlight the competitiveness achieved after the significant adjustment effort made by the companies in their unit labour costs (significantly lower than the average of our Eurozone partners, and which have also allowed for strong job creation), job creation which, in turn, makes the improvement experienced by domestic demand, which began in 2014, sustainable and, finally, the radical change in available financing as well as in the financing conditions since the European Central Bank decided to intervene and curb the risky episode of financial fragmentation and credit restriction that the Eurozone lived.

Finally, a war between the United States and North Korea could also strongly destabilise the future evolution of the Spanish and world economy.

At national level, the situation in Catalonia is of concern. The Generalitat has not had access to international markets since 2010 and it is the Public Treasury that finances its deficit, remunerates its officials and suppliers, and deals with debt maturities. At the moment, the tension of the situation after the operation of the central government to dismantle the organisation of the referendum has not been reflected in a significant way in the prices of the Spanish public debt or in the risk premium against Germany. But this situation is susceptible to deterioration and the risk of greater financial instability which, although very small, still exists.

The real economy could also be affected, although employment levels, at the moment, remain high. Even the terrorist attacks of last August have had no significant effects on tourism, yet.

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

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

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

Annual forecast for the Spanish economy.

Table 1. Annual forecasts.

(% annual average change, unless otherwise indicated)

	2017	2018
Real GDP	3.1	2.8
Final household consumption	2.5	2.4
Final Public Administration consumption	1.1	1.6
Gross Fixed Capital Formation	4.0	3.3
- Machinery and capital goods (1)	5.3	4.0
- Construction	3.3	3.2
Stock variation (contribution to GDP growth in pp)	0.0	0.0
National demand	2.6	2.4
Exports of goods and services	6.3	4.6
Imports of goods and services	4.6	3.4
Underlying CPI (annual average)	1.2	1.5
Total CPI (annual average)	2.1	1.8
Labour costs per worker (2)	1.2	1.5
Employment (National Accounts) (3)	2.7	2.3
Unemployment rate (EAPS, % of active population)	17.9	16.1
Balance of balance-of-payments current account (% GDP) (4)	1.3	0.5
Financing capacity (+) or requirements (-) Public Administrations **excluding aid to financial institutions** (% GDP)	-3.1	-2.6
(1) Includes GFCF regarding transportation and other machinery and capital goods. (2) Average remuneration per employee in equivalent to full-time employment. Comprises gross wages received by employees and contributions to Social Security. (3) Full-time equivalent jobs. (4) According to estimates of the Bank of Spain.		

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