

# FOCUS

*Quarterly Bulletin of the  
economic situation*

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# Quarterly Bulletin of the economic situation

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## *Executive summary*

In the fourth quarter of 2017, the Spanish economy grew by 0.7%, thus maintaining the growth rate observed in GDP in the third quarter. National demand moderated its growth, both for consumption and investment, except for investment in housing construction that maintained very strong growth. However, the contribution of foreign demand (the net contribution of exports minus imports) improved in relation to the previous quarter, contributing positively to the growth of the Spanish economy in the last quarter of the year. **The sector that grew the most was industry, while services experienced a notable downturn.**

As for investment demand, the fourth quarter of 2017 closed with a quarter on quarter increase that was half of that observed in the third quarter, showing a significant downturn in the strong investment rate shown by the Spanish economy in the middle quarters of 2017. And this is due, above all, to the downturn in investment in intellectual property products (which went from increasing to an annualized quarterly rate of 6.8% in the third quarter to 2% in the fourth quarter) and of investment in capital goods, which went from 11.2% annualised quarterly growth in the third quarter to 3.6% in the fourth quarter.

**In the whole of 2017, annual GDP growth slowed to 3.1%, two tenths of a percentage point less than the previous year, but more than half a point higher than that of the Euro zone.** The lower growth came from a lower contribution from the external sector.

**Domestic demand consolidated as the growth engine of the Spanish economy** in 2017, contributing 2.8 percentage points to the increase of GDP, three tenths more than in 2016, driven mainly by buoyant investment. External demand contributed, on the other hand, three tenths of a percentage point to growth, four less than in 2016, due to the greater acceleration of imports

of goods and services on the increase observed in exports.

The components of domestic demand include the dynamism observed in private consumption and the more expansive tone of investment in capital goods, driven by the high rate of job creation and the positive expectations and financing conditions. Private consumption grew 2.4% in 2017, in volume and with cvec series (corrected for seasonal and calendar variations), six tenths less than in 2016, while investment in fixed capital grew 1.7 points, up to 5%, showing favourable behaviour in all its components. Thus, **investment in capital increased by 6.1%, 1.2 points more than in 2016 and well above the historical average**, and investment in construction increased by 4.6%, 2.2, more points than in previous year. And the same happened with the investment in intellectual property products, which grew 3.7%, one point above the record observed in 2016.

The downturn in domestic demand was therefore focused on private consumption, which grew by 2.4% in real terms, although the rise in prices accelerated its nominal growth to 4.2%, a rate higher than that observed by households' gross disposable income. As a result, households responded to the increase in inflation, in part, by moderating spending, but also by reducing the rate of saving.

One of the most noteworthy elements has been the great dynamism in investment in construction in housing that is the component of national demand that has grown the most. However, this component has a very low weight in GDP, much lower than the weight observed in the historical average.

As for Public Administrations, final consumption expenditure in volume and with cvec series accelerated one point in the fourth quarter of 2017, up to 2.4% year-on-year, closing the year with an annual average increase of 1, 6%.

Exports, on the other hand, grew more than imports in real terms, although in nominal terms the growth of the latter was higher, mainly due to the increase in energy imports, although non-energy prices also rose.

**Among the most positive features of the macroeconomic figures for 2017, it is worth highlighting the intense creation of employment**, the acceleration of growth in investment in capital goods and the positive

contribution of external demand to growth for the second consecutive year.

**Among the negative elements the reduced growth in productivity should be mentioned,** even lower than the weak records of recent years, and high unemployment, despite the strong rate of job creation throughout the year.

However, the slight improvement observed in productivity in previous quarters is explained, in part, by the higher employment growth in sectors of higher than average productivity. To this we must add the closure of the least productive companies in all sectors. This has also allowed companies that are able to withstand the challenges of the crisis to be reinforced by less competition and by the strict adjustment of costs carried out, which in turn drives their profits upwards in greater proportion to the increase of your sales.

The most recent qualitative indicators of global economic activity show an extension of the expansive trend in the first months of 2018. Thus, the PMI composed of global activity, prepared by Markit, reached 57.1 in February, four tenths higher than in January, due to accelerated growth in the industry and, to a lesser extent, in services. Similarly, the European Commission's Economic Sentiment Indicator remained high in February, ten points above the average observed since 1990, although seven tenths below that observed in January. In the Euro zone as a whole, this indicator went down by eight tenths, but remains almost four points above that published for the Spanish economy (110.2 against 114.1).

Among the factors that explain the predicted good behaviour of domestic demand in the first quarter of 2018 and that affect private consumption are vehicle registrations, which according to ANFAC, recorded a mean year-on-year increase of 16.4% in the January-February period; 5.8 points higher than that observed in the fourth quarter. Among the qualitative indicators, the Consumer Confidence Indicator, published by the CIS, was one tenth higher than the level recorded in the fourth quarter of 2017 and also one tenth above the threshold of 100, indicative of a positive perception of consumers, thanks to the improvement of the component of expectations. The consumer confidence indicator published by the European Commission shows this along the same lines.

Another indicator that shows the dynamism of the Spanish economy in the first quarter of the year are January retail sales, which increased by 0.3%

monthly, eliminating the seasonal effect. Meanwhile, the annualized rate rose to 2% growth, levels which have not been observed since 2016.

Public consumption, on the other hand, remained stable at the quarter-on-quarter rate in the fourth quarter, matching the progress observed in the third quarter of 0.4%.

**The Spanish economy will grow 2.8% in 2018 and 2.4% in 2019, in part thanks to the better than expected performance of the world economy. This should lead to the creation of around 800,000 jobs and bring the average unemployment rate for 2019 to 13.3%.**

In this way, the expansion path initiated in 2013 will ensure continuity, following the creation of employment at a good rate while the main macroeconomic imbalances continue to be corrected: the public deficit will be reduced below 3%, agents will follow their process of de-leveraging and a current account surplus will be maintained for the fifth consecutive year, the latter being a totally positive and a new feature of the present expansive cycle of the Spanish economy.

There are several factors that lead to an upward revision of our forecasts from 2.5% previously to 2.8% at present. Firstly, after the Unilateral Declaration of Independence in the fourth quarter, the situation is back to normal in the first quarter of 2018, although there is still a continued risk. To this we must add a predicted improvement in private consumption, which also favours a better forecast of investment, partly explained by an expected, albeit still tenuous, improvement in salaries, following the drop in unemployment and which could grow at a rate close to the expected growth of inflation. Salary costs, adjusted for seasonal and calendar effects, rose by 0.5% year-on-year in the fourth quarter according to the INE, the second consecutive rise after the change in trend observed in the third quarter, as salaries were falling for more than one year or with year-on-year increases of less than 0.1%. Finally, the price of oil in Euros has stabilized thanks to the appreciation of the single currency, so that the predicted price increase and its impact on household and business spending is somewhat lower.

The contribution to the growth of domestic demand will be somewhat lower (2.5% compared to 2.8% in 2017) due to the lower downturn in private consumption, as a result of the slight downturn expected in the creation of

employment, stagnation or very weak salary increases and at average higher oil prices, expected to be between 15% and 20% more than in 2017.

The expected downturn is also explained, and to a large extent, by the need for families to adjust their spending to their disposable income, **since the drop in the savings rate to historic minimums will not allow a new boost to consumption through this route.**

However, this could be partially offset by a greater improvement in public consumption, slightly higher than the 1.6% seen in 2017 (1.8% forecast for 2018 and 1.7% for 2019), facilitated by the strong adjustment of the deficit in recent years and a considerable increase in the collection of an economy that consolidated, in 2017, three consecutive years of growth above 3%.

Gross fixed capital formation, meanwhile, is also expected to slow down in 2018 to 3.8% per year from 5% in 2017, given the downturn in the growth of investment in machinery and equipment since investment in construction could grow at rates close to those observed in 2017, of around 4%. The end of much of that investment demand which took place during the long period without government and that was largely completed in 2017, the Catalan crisis, as well as a lower expected demand for exports for 2018 would explain, to a large extent, the worse than expected behaviour of investment demand for capital goods.

Net external demand, meanwhile, will continue to make a positive contribution to GDP growth, both in 2018 and 2019, although slightly decreasing, mainly due to export growth being somewhat lower than that observed in 2017, although also favoured by an even smaller increase in imports, as a result, in part, of the slowdown in the Spanish economy itself.

The value of the Euro will also influence the foreign sector. Oil prices have stabilized but the Euro has strengthened, making imports cheaper. In February prices have picked up again and private consumption will remain moderate until salaries rise above inflation.

For growth to be stable it is imperative that productivity increases. If not, with the Euro strengthening, the exports of the Spanish economy would suffer, increasing the external deficit and external debt, which remains at very high levels.

Among the risks to which the Spanish economy is subject are protectionism, the normalization of monetary policy and increased volatility, the high level and the rapid increase in global borrowing, especially in China in the last few quarters. Finally, complacency, which implies the absence of the reforms that the country needs. To this we should add the Catalan question to the more internal political arena and in the external arena, a possible international conflict in North Korea with the potential to destabilize the world economy.

## *Global scenario.*

### **Dynamic world trade, monetary normalization and greater volatility**

In the fourth quarter of 2017 world trade maintained its dynamism. Domestic demand and imports recovered in developed countries, especially in the US where it increased by an annualized rate of 15%. In contrast, the Eurozone kept its import demand stagnant in that quarter. In emerging countries, Latin America stands out with 10% growth in 2017 and remained annualized in the last quarter. The intense weakening of their exchange rates together with the recovery of world trade and the prices of raw materials explain the improvement. Africa and the Middle East recorded a fall in imports in 2017 and in the fourth quarter of 2017, a weak annualized growth rate of 2%. Therefore, they were the areas with least dynamic economies in the world last year.

As for exports, in the US they grew 10%. In Asia and especially in China, exports grew 5% in 2017, but in the fourth quarter of 2017, they only grew 1%. These two large world economies are engines for the rest of the world, which benefits via exports. China has ceased to be only the factory of the world and begins to be crucial in the growth of global consumption, especially in Asia. The Eurozone is the area that benefits the most with an export growth of 7% in 2017. In the fourth quarter of 2017, exports from the Euro zone increased by an annualized rate of 10%, so they went into 2018 with more intensity than in previous quarters. Eastern Europe stands out with an annualized growth rate of 15% in the fourth quarter of 2017, the most dynamic area in

the world. In Latin America they grew at an annualized rate of 8% in the fourth quarter of 2017 and in Africa and the Middle East they remained stagnant.

In February the global PMIs registered their highest level in the last six months, so it is expected that the dynamism of world trade will continue in the first half of 2018. The US, the Eurozone, Japan and the United Kingdom stand out positively, taking advantage of the weakening of the pound after Brexit. And in emerging countries such as Brazil, Russia and India. In China, the PMI in the manufacturing sector has improved since last summer but remains weak at close to 50. While the PMI of services is at a maximum not seen since 2010. Therefore, the new Chinese growth model is maintained, where the main driver is internal consumption and the service sector.

In this environment of strong growth of world trade, central banks use this to their advantage by normalizing their monetary policies. The 10-year public debt bond in the US has risen to levels close to 3% from levels of 2% last summer. The reason is that higher growth has raised inflation expectations and investors predict further increases in Fed rates. The replacement of the president in the Federal Reserve is a source of additional uncertainty.

In the Eurozone the ECB already announced the end of its purchasing policy in early 2019 and at its last meeting in February Draghi took the opportunity to proceed with the normalization of its monetary policy. The 10-year German public debt bond has gone from 0.3% last summer to 0.6% at present. Although expectations of rate hikes are lower in Europe, the Euro has weakened against the dollar. That will mean an economic headwind for European exports, so it is most likely that growth in 2018 will be less intense than the previous year. Two-thirds of Spain's exports are within Europe so we will also be affected by the lower expected growth.

Risks remain concentrated in geopolitics and financial markets. The nuclear crisis with North Korea continues, but Trump has agreed to meet with Kim Jong-un. The US president has started to follow through on his campaign promises and has announced increases in tariffs for European steel and aluminium imports to protect American industry. And he has raised the tone in the renegotiation of the Treaty with Canada and Mexico. The normalization of long-term interest rates has increased volatility in the markets. This

volatility has not only affected Bitcoin and other Cryptocurrencies, it has also been noted in the stock markets, especially in companies with high debt, and in bonds with a lower credit quality. Another additional risk in the Eurozone is the candidacy of the German Jens Wiedmann to succeed Draghi. When the Euro was introduced, Germany had its highest rate of unemployment since the Second World War and the ECB set low rates to get them out of their crisis causing bubbles and over-indebtedness in the periphery, especially in Spain and Ireland. Now Germany has an unemployment rate at a historical low and if the ECB sets appropriate rates for them, financial instability and problems will return to the periphery.

### ***Growth prospects of the Spanish economy.***

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

The data of the quarterly national accounts for the fourth quarter confirmed the robust progress of economic activity, observing growth of 0.7% quarter-on-quarter, a rate identical to that of the second and third quarters.

The gradual and predictable slowdown in the Spanish economy is still very weak. And according to our forecasts, the Spanish economy has possibilities to maintain this rate during the next four quarters, which would allow closing 2018 with a year-on-year GDP increase of 2.8%.

Year-on-year growth stopped maintaining the balance that has characterized it during the last two years, with the contribution of net external demand to growth in the fourth quarter of 2017 being negative. Therefore, more than 100% of growth is explained in the last year by the strength of domestic demand, which grew by 3.2% in the year-on-year comparison of the fourth quarter, above GDP growth, which grew by 3.1%.

The contribution of net external demand lost strength as the year progressed, conditioned by the higher growth of imports compared to the increase in exports. If in the third quarter the contribution of net external demand was reduced by half compared to the second quarter, in the fourth quarter it has become a brake on the growth of the Spanish economy.



In quarter-on-quarter terms, the contribution to GDP was positive, contributing one tenth to quarterly growth, as a result of a stabilization of imports of goods and services in real terms and a slight increase in exports.

The increase in domestic demand is the result of the continuation of the dynamism of private consumption and investment, although both slowed slightly in the last quarter of the year, making the slight contribution of net external demand possible thanks to the increase in exports and the stagnation of imports, which allowed the Spanish economy to maintain its cruising speed in the fourth quarter of 2017.

The improvement of the labour market and consumer confidence, as well as financial conditions, favoured the situation of households, which, in turn, allowed for the good growth rate of consumption to be maintained, which only decreased one tenth in the fourth quarter compared to the third quarter increase.

The outlook for the medium term continues to be positive, with a GDP increase of 2.8% for the 2018 average expected. The main indicators seem to indicate that economic activity will remain strong in the first quarter of 2018 and that the Spanish economy will continue to lead growth in the Euro zone, leading to an estimated quarter-on-quarter GDP growth of around 0.7%.

The PMI Index composed of Global Activity, registered 57.1 points in February, four points higher than the already high level in January, showing a clear acceleration of the global activity, due to the more intense growth of the activity in industry as well as in construction and services.

The number of Social Security affiliates in the construction sector is increasing at annual and annualized rates that exceed 7% and 8% respectively. The industry is also accelerating and generating employment at high rates, challenging the Law of Robotics, after the decline observed in the third quarter. Thus, after a good fourth quarter, employment in the industrial sectors accelerated to 4.6% annualized bimonthly from 3.4% year-on-year registered in February, an example of the strength with which the sector began 2018.

Among the leading indicators linked to private consumption in the first quarter of 2018, the increase in vehicle registrations should be noted, according to ANFAC, 13% in February, although lower by 7.3 points than in January, but looked at bimonthly, it is a year-on-year average growth of 16.4%, 5.8 points higher than that observed in the fourth quarter. With regard to the General Retail Sales Index, seasonally corrected and deflated, it registered an increase of 0.3% in January, with the annual rate of the General Retail Sales Index at constant prices with a 2.2% year-on-year increase. Finally, an important indicator that shows worsening instead of improvement in consumption in the first month of the year is internal sales of goods and consumer services of large companies collected by the Tax Agency, predicting a possible weakening of consumption in the first quarter of the year. The previous quantitative indicators that show improvement in the increase of household consumption are reinforced by the good behaviour of qualitative indicators such as the improvements observed both in the Consumer Confidence Index drawn up by the European Commission as well as that drawn up by the CIS in Spain.

To this, the **slow increase in salaries and the low savings rate, which makes it difficult to increase the spending of domestic economies by sacrificing savings should be added.** In relation to salaries, and according to the data recently published by the INE in the quarterly salary survey, these have started to rise 0.5% annually in the fourth quarter of 2017.

Faced with the increase in consumption, investment slowed down in the fourth quarter, although throughout the year the expansion of investment in capital goods stood out, encouraged by the high rate of job creation and positive expectations and financing conditions. Thus, total investment grew 1.7 points to 5% year-on-year for the whole year, driven largely by the strong increase in investment in construction (4.6%) and capital goods (6.1%).), 1.2 points more than in 2016 and 1.5 points above the historical average. And the same happened with the investment in intellectual property products, growing 3.7%, one point above that observed in 2016.

**The conditions remain favourable for investment decisions**, due to the very low interest rates, good domestic and external demand, the continuation of the deleveraging of companies, the use of productive capacity and the continuous improvement in expectations. In fact, **the conjunctural indicators of investment in equipment indicate the continuation of the dynamism in the first months of 2018**. The Industrial Climate Indicator of capital assets showed a balance in the January-February period 3.2 points higher than in the fourth quarter of 2017 and the degree of utilization of the productive capacity of capital assets increased 2.4 points, until reaching 87.1% in January. Similarly, the registrations of freight vehicles, according to ANFAC, increased in January, reaching a year-on-year growth of 14.9%, compared to the fall of 2.2% in December.

The conjunctural indicators related to the residential sector were less dynamic. The number of home sales rose 9.2% in December, half as much as in November and a third of the increase observed in October. And the number of homes that started being built. The rate of increase in the demand for construction approval continues to grow at a very strong double-digit rate, but very far from the almost 700,000 homes started in 2007.

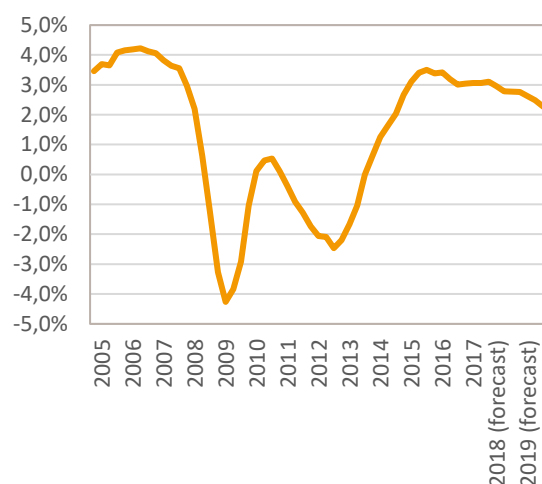
Likewise, the Final consumption expenditure of the Public Administrations, in volume, and with data adjusted for seasonal and calendar effects, increased one point in the fourth quarter of 2017, up to 2.4% year-on-year, closing 2017 with an annual average increase of 1.6%.

In terms of net external demand, and in quarter-on-quarter terms, the external sector contributed one tenth of a percentage point to the variation in GDP, after a negative contribution of one tenth in the previous quarter, as a result of a slowdown in exports of goods and services lower than that of imports.

### Demand and production

According to the results of the Quarterly National Accounts (CNTR), published by the INE, real GDP, adjusted for seasonal and calendar effects, recorded a quarter-on-quarter growth of 0.7% in the fourth quarter of 2017, exactly the same as the previous quarter. In year-on-year terms, GDP grew by 3.1%, the same rate registered in the two previous months.

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



Source: CNTR

By components, economic growth continues to rely on domestic demand, the main driver of growth, with 3.2 percentage points, three tenths higher than the one observed in the third quarter of 2017, and above the average contribution recorded in the whole of 2017. The contribution of net external demand was negative (-0.1 points), something that had not occurred for two years, in the fourth quarter of 2015. It is, therefore, a more unbalanced composition of growth than that observed in the last two years, although everything indicates that it will not stay like this in 2018.

### National demand aggregates

The main components have contributed to the growth of domestic demand. The favourable behaviour of private consumption, driven by the strong creation of employment, as well as by low interest rates and improved financing conditions, stands out. The real expenditure on final consumption of homes and non-for-profit institutions that serve homes (NPISH), showed volume growth of 2.5% year-on-year in the fourth quarter of 2017 (one tenth more than in the third quarter). However, in quarter-on-quarter terms, the increase in private consumption (NPISH) remained stable at 0.7%.

The positive evolution of private consumption is explained by the strong creation of employment, the improvement in access and financing conditions and the moderation of prices, thanks to the latter the moderation in year-on-year increases in the price of a barrel of oil registered on average throughout the fourth quarter. Private consumption continued to grow in the fourth



quarter, in nominal terms and in real terms, above the growth in compensation to employees, which implies that household savings have stopped growing.

The most recent qualitative and quantitative conjunctural indicators indicate that the expansion path of private consumption growth has remained stable in the first quarter of 2018.

With regard to investment, gross fixed capital formation recorded a year-on-year increase of 5.6% in the fourth quarter of 2017, identical to the previous quarter, the highest rate since the beginning of 2016, and a contribution of more than one percentage point to the annual increase of GDP, highlighting the growth of investment in capital assets by components. In quarter-on-quarter terms, gross fixed capital formation grew 0.7% in the fourth quarter, half of the rate seen in the previous quarter, due to the sharp slowdown in the growth of investment in capital assets from 2.8% in the third quarter to 0.9% in the fourth.

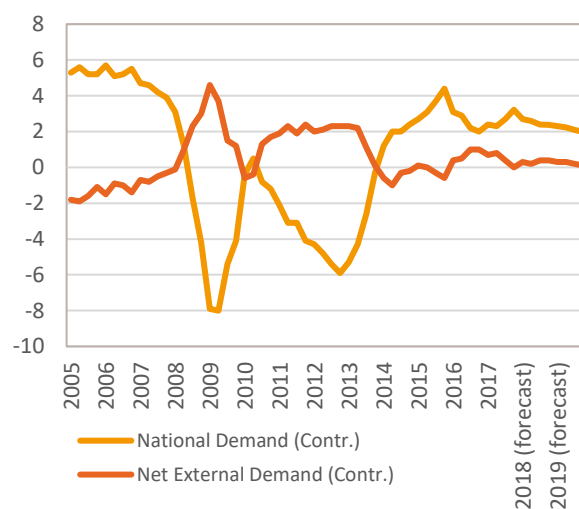
Conditions continue to be very favourable for investment decisions, mainly due to companies immersed in a more advanced deleveraging process, good demand performance, low interest rates and improved use of productive capacity.

Final consumption expenditure of the Public Administrations, in volume and adjusted for seasonal adjustment effects, increased one point in the fourth quarter of 2017, up to 2.4% year-on-year, closing the year with an average annual increase of 1.6%. In quarter-on-quarter terms, the growth rate of public consumption remained at 0.4% in the fourth quarter.

### External demand

According to figures from the Quarterly National Accounts, in the fourth quarter of 2017 the external sector detracted one tenth from the year-on-year change in GDP since exports decreased more than imports.

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



Source: INE.

The year 2017 closed with a contribution of the net external demand to the average growth of GDP of 0.3 points, compared with the contribution of 0.7 points in 2016, due to an increase in exports of goods and services (0, 2% to 5%) lower than that of imports (2 points, up to 4.7%).

Compared to the main economies of the European Union, the quarter-on-quarter rate of real Spanish exports (0.3%) was higher than that of the United Kingdom (-0.2%) but lower than that of Germany (2.7%)., Italy (2%) and France (2.4%), while year-on-year growth in exports is 4.4%, a notable figure and higher than that observed in the United Kingdom (1.7%), but lower than the increase in French, German and Italian exports.

*The favourable evolution of private consumption is explained by the creation of employment and the improvement in access and financing conditions*

### Productive activity

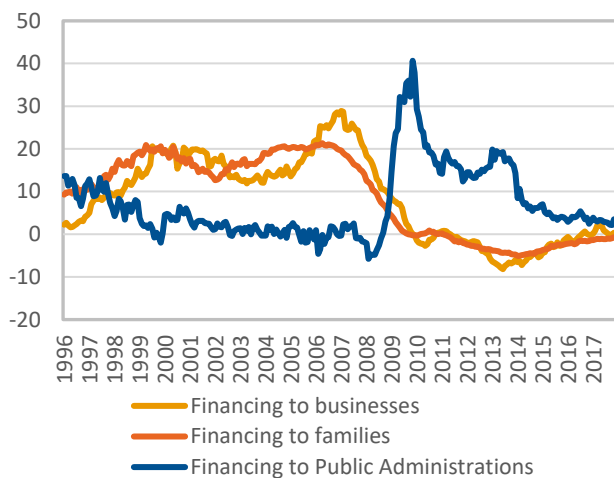
From the supply side, the key sectors of activity show positive, expansionary behaviour. The Gross Value Added (GVA), in volume and adjusted for seasonal and calendar effects, grew in the construction sector by 4.6% year-on-year, three tenths less than in the third quarter and the GVA of the industry grew seven tenths up to 4.6%. The service sector, on the other hand, grew by 2.5%. Agriculture, livestock, forestry and

fishing experienced decreased growth by 2.2 points to 2% year-on-year.

In the quarter-on-quarter rate, the GVA industry grew six tenths of a point in the fourth quarter, 1.2 points to 1.8%, the most biggest increase, followed by that observed in the construction sector, whose GVA went up by four tenths, to 1.5%. In the services sector, the VAB moderated its rate of increase at three tenths, up to 0.4%, while in the primary sector, the VAB fell to 1.1%, when in the third quarter it grew by the same percentage.

In relation to the financing of productive activity, figure 3 shows the evolution of the variation rate of financing for the different productive agents. In Spain, the balance of credit to households and companies performed differently, with a 0.35% increase for companies in December and a decrease of 0.76% in financing to families. On the other hand, the Public-Sector financing grew by 3.4% year-on-year in December.

Graph 3. Financing. Year-on-year rates of increase



Source: Bank of Spain.

From the supply side, the improvement of the banking sector is strengthened. The default rate of the sector ended 2017 at 7.8%, the lowest rate since December 2011.

**Prices**

The Consumer Price Index (CPI) for the month of February, published by the INE, rose to 1.1% year-on-year, a rate half a point higher than that registered in January. This increase is explained by the upturn in energy, after the fall of the previous month and, to a lesser extent, by the increase in the prices of services and non-energy

industrial goods, partially offset by the lower growth rate of the food prices.

In month-on-month terms, the CPI registered an increase of 0.1% in February, compared to a decrease of 0.4% in the same month of 2017.

Core inflation (which excludes unprocessed food and energy products, more volatile elements of the CPI), increased 1.1% in February. This was mainly due to services, whose prices went up by four tenths, to 1.7%, driven mainly by the prices of tour packages.

**Labour market**

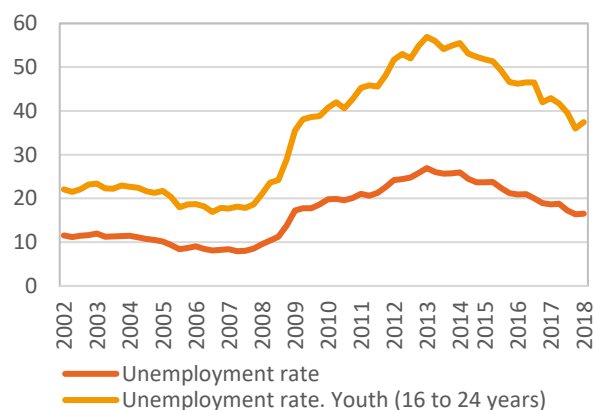
The labour market has been characterized in the fourth quarter of 2017 by the continued dynamism observed in the creation of employment in previous quarters, both in response to the data provided by the Labour Force Survey (EPA) and by the Social Security affiliations.

According to the Labour Force Survey (EPA), published by the INE, employment in the Spanish economy was reduced in the fourth quarter of 2017 by 50,800 people, which showed the number of people employed at 18,998,400. In corrected seasonal figures, the number of people employed increased by 0.4% quarter-on-quarter, three tenths less than in the previous quarter. In year-on-year terms, employment increased by 490,300 people, 2.6%, two tenths lower than the previous quarter.

According to figures from the Quarterly National Accounts (CNTR), in full time equivalent terms, with series adjusted seasonally and by working days, it slowed by three tenths in quarter-on-quarter terms, to 0.5%, maintaining the year-on-year rate of 2.9 % for the third consecutive quarter.

If the evolution of Social Security affiliations published by the Ministry of Employment and Social Security is reviewed, the number of Social Security affiliates, with series adjusted for seasonally, increased by 0.8% quarter-on-quarter in the fourth quarter of 2017, two tenths more than in the previous period. In year-on year terms, and with gross series, the number of affiliates increased 3.5% in the fourth quarter, the same as in the third quarter. And, the progress of the affiliation in the first two months of 2018 allows us to predict an increase for the first quarter of 2018, similar to the 3.5% increase experienced since the middle of 2017.

Graph 4. Unemployment rate Percentage active population



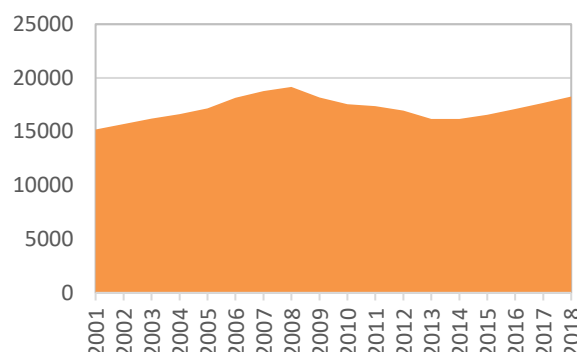
Source: INE

This evolution is due to the fact that the acceleration in employment growth in construction (7.4% year-on-year in the two-month period) and in industry (3.3%) compensated for the lower rate of growth in services, while agriculture maintained the rate of decrease by 0.6% year-on-year. In corrected seasonal figures, in February the annualized monthly variation rate of the number of affiliates was 4.5%, which gives an idea of the current strong increase in employment and that will lead to a good quarter for job creation.

The total number of unemployed people stood at 3,766,700, below four million for the third consecutive quarter. In the last year, unemployment has dropped by 471,100 people, an annual decrease of 11.1%, 2.5 points lower than the previous quarter. The unemployment rate stood at 16.5%.

Taking age into account, it is worth mentioning the decrease of youth unemployment (16 to 24 years) of 9.1% year-on-year, placing the youth unemployment rate at 37.5%, 5.4 points lower than in the previous year.

Graph 5. Social Security affiliation (monthly average) Thousands



Source: Social Security.

Long-term unemployment, defined as the number of people who have been unemployed for more than a year, fell by 20.2% year-on-year in the fourth quarter of 2017, according to Eurostat figures, reaching a weight in total unemployed of 42.9%.

**Moderation continues in wage growth and unit labour costs.** According to the figures of the Quarterly National Accounts, the compensation per employee increased 0.2%, after the 0.1% increase in the third quarter, and the apparent productivity of work rose one tenth more than in the previous period, up to 0.2%. The compensation per hour paid grew 1.1% year-on-year, two tenths less than in the third quarter.

Finally, the Statistics of Agreements drawn up by the Ministry of Employment and Social Security, based on the information available until the end of February 2018, the average salary increase agreed upon is 1.5%, the same variation that was agreed in the year 2017.

### Balance of payments

According to the available Balance of Payments data, **the Spanish economy generated, in 2017, a financing capacity vis-à-vis the exterior of 21.704 billion Euros, equivalent to 1.9% of GDP**, compared to the financing capacity of 24.166 billion (2.2 % of GDP) in the same period of the previous year.

The cumulative surplus of the current account balance amounted to 19.806 billion Euros, equivalent to 1.7% of GDP, compared to 1.9% of 2016 GDP, which was the highest of the current historical series. This result was due to the 2.617 billion Euro decrease of the surplus of goods and services, which stood at 31.054 billion (2.7% of

GDP), partially offset by the 939 million Euro reduction in the deficit of primary and secondary incomes, which stood at 11.249 billion (-1% of GDP).

At the same time, the financial balance registered net capital outflows of 30.163 billion Euros, compared to the net outflows of 26.695 billion a year ago, due to net capital outflows, excluding the Bank of Spain, of 61.991 billion Euros, partially offset by an increase of 31.832 billion of the Bank of Spain's net debit position.

The trade balance worsened as a result of the increase in the energy deficit. The trade deficit of energy-related goods increased by 27.5%, in line with the evolution of the price of imported oil which, measured in Euros, increased by 29.5% on average in the first nine months of the year (data available today from the Bank of Spain), while the surplus of the non-energy balance fell by 18.9%.

### Public Sector

As reflected by the Independent Authority for Fiscal Responsibility (AIRef), the good performance of tax collection, both taxes and contributions, but above all, the containment of public expenditure will predictably end the year 2017 with a deficit of 3.1% of GDP, in line with the objective set by the Government. This would allow Spain to exit the Excessive Deficit Procedure (PDE) in which it has been immersed since 2009, after having managed to reduce the deficit from 9.3% of GDP where it stood at the beginning of 2011.

Despite the improvement in the public balance adjustment, public debt remains at high levels. After ending 2017 at 98.4% of GDP, six tenths below the level reached in 2016, according to data from the Bank of Spain, Government debt, according to the methodology of Excessive Deficit Protocol, in January 2018 was at 1.145,813 billion Euros, representing a year-on-year increase of 3%, four tenths lower than the one registered in December of last year. Therefore, we must guard against complacency and continue making fiscal consolidation efforts.

By sectors, the Excessive Deficit Procedure Debt of the State grew 4.3%, while the autonomous communities increased debt by 3.2%. However, the increase in the EDP debt of the Social Security Administrations, which increased by 59.3%, stands out. The debt of Other Bodies belonging to the Central Government was

reduced by 14.3% in January, with a reduction of 9.2% in Local Government debt.

As far as fiscal policy is concerned, and in view of what may be a scenario of progressive normalization of monetary policy by the ECB, **it becomes more important for the country to meet the deficit targets in 2018 and 2019.** By the time monetary normalization arrives, it would be desirable for the sovereign rating to recover the lost ground throughout the crisis to avoid a rise in financing costs.

*Our forecasts indicate an annual growth for 2018 and 2019 of 2.8% and 2.4%, respectively*

### 2018-2019 outlook: sustained growth

The Spanish economy will grow 2.8% in 2018 and 2.4% in 2019, in part thanks to the better expected performance of the world economy. This should allow the creation of around 800,000 jobs and put the average unemployment rate of 2019 at 13.3%.

Our forecasts indicate a very slight downturn in GDP growth, up to 2.8% in 2018, mainly due to a slight decrease in the contribution of domestic demand, keeping external demand at the same contribution to GDP in 2017, around 0,3%. This slight deceleration is explained by the loss of strength of some factors that would have driven the activity on a temporary basis, such as the fall in the price of oil, the weakening of the Euro, or the demand for goods and services, a result of the uncertainty caused by the enormous economic and financial crisis suffered by the Spanish economy.

However, the forecast of GDP growth of the Spanish economy improves by three tenths. This rise in expectations of even stronger growth is partially explained by factors of a political nature. After the Unilateral Declaration of Independence in Catalonia, the situation has returned to normal in the first quarter of 2018, although the risk has not disappeared. In addition, there is an expected relative improvement in salaries, which could be close to, but even lower than, expected inflation and a weaker Euro rate than the average observed in 2017, which would justify the higher

growth planned for private consumption and, therefore, also for investment.

**For 2018 we expect a deceleration of consumption and above all of investment**, the latter largely explained due to the lower increase in investment in machinery and capital goods of companies after a very notable increase of 6.1% in 2017, well above the average of the last 20 years. The lower impetus of these factors should be partially offset by the gradual improvement of export markets, given the strong upturn in trade and global growth.

The Spanish economy comes with a lot of inertia and the beginning of the year is still better than the end of 2017, taking into account a good part of the leading indicators. This suggests that if the political risk in Catalonia is normalized, real GDP for 2018 could be two or three tenths higher than estimated.

**The Spanish economy will be given a boost in the next two years due to the good period that world trade is experiencing**, favoured by the good competitive position of companies and low interest rates. This boost will come not only from its main export market such as the European Union but also from the strong increase in imports observed in the fourth quarter and with a view to maintaining itself, both in the United States and in China, with those two main economies of the world becoming the motors of world trade, and in the places with increasing national exports. Despite a slight deceleration of the still strong growth expected for the Chinese economy, the United States and the Euro Zone still have expectations, according to analysts' consensus, of maintaining solid growth rates in 2018 and 2019, slightly above 2% for American economy and slightly below 2% for the economy of the Eurozone.

It is therefore crucial for the good performance of the Spanish economy that the intensity of trade with Europe and with the rest of the world be maintained and the risk of greater protectionism be dissipated. If the weight of exports of goods and services in the Spanish economy in 2007, at the beginning of the Great Recession was 25.7%, in the fourth quarter of 2017, eleven years later, exports represent 33.9% of GDP for the Spanish economy, exceeding for the first time the 100,000 million Euros of sales abroad in a quarter. The traction that the construction sector meant for both residential and non-residential investment during the real estate boom is what today represents the foreign sector for investment in

machinery and capital goods by Spanish companies.

However, we must not lose sight of the fact that the United States Government is beginning to follow through on its campaign promises and although for the time being it has decided to stop its tariff policy for European imports of steel and aluminium, this may be the beginning of a commercial dispute in order to protect American industry. **A protectionist drift (and the European Union has already announced that it will take measures in the form of retaliation) is a clear downward risk on the current growth forecasts for the Spanish economy in 2018 and, fundamentally, in 2019.** In the same way, the Brexit negotiations will also have an impact on trade between Spain and the United Kingdom, one of our main trading partners.

To the above, it would be advisable to add the price of oil, which if maintained at its current price, will mean a reduction in income, if the expenditure is materialized, for Spanish families between 5% and 10% higher than that experienced. Throughout 2017, its impact was partially softened by the strength of the Euro against the dollar.

Finally, the change in monetary policy trend announced by the ECB starting in 2019 will have a moderating impact on growth, which also partly explains the slight estimated downturn. The United States' 10-year of public debt bond has reached levels close to 3%, from levels close to 2% recorded in the summer. **The reason is that higher growth has raised inflation expectations and investors predict further increases in Federal Reserve rates, putting a strain on profitability or the cost of bonds.** In the Euro zone, the ECB also announced the end of its quantitative easing policy at the beginning of 2019, and at the last meeting it took advantage to move forward with the normalization of its monetary policy.

Thus, the 10-year German public debt bond went from 0.3% in the summer to 0.6% today. And, despite the fact that the expectations of rate hikes are lower in Europe, the Euro has weakened against the dollar, which will mean an additional difficulty for European exports, and it is more likely that their growth in 2018 will be less intense than the previous year, despite the good health of world trade.

The Spanish economy exports two thirds of its exports within Europe, so it will also be affected



by the lower expected growth of the rest of the EU partners. As inflation expectations for the Spanish economy are lower, the Spanish 10-year bond has not been affected yet, standing at 1.3% in March, the lowest rate for more than a year, although one is a result conditioned by a policy of ECB purchases that will tend to be less and less lax.

In relation to domestic demand, its contribution to the growth of the Spanish economy will gradually lose intensity, from 2.8% in 2017 to 2.5% in 2018 and 2.2% in 2019. **The smallest increase in the final household consumption expenditure of households will be partially offset by a higher growth in General Government expenditure, slightly higher than the 1.6% recorded in 2017.** The gross formation of fixed capital will not be able to realistically keep up its strong growth of 5% in 2018 and in 2019, which doubles its historical average of the last twenty years.

In the fourth quarter, private consumption showed signs of slowing, when compared with the previous quarter. In a context of wage increases below the inflation rate expected for 2018 and for 2019 of 1.5% and 2%, respectively, consumers will lose purchasing power, which would have a negative impact on private consumption, to the deflationary context experienced by the Spanish economy in 2015 and 2016, which allowed purchasing power not to be lost even with frozen salaries. If we add to this the end of demand during the years of crisis and that allowed consumption to progress above the increase in disposable income and the slowdown in the rate of job creation (which will go from growing at a very strong rate of 2.9% to moderate to 2.3% in 2018 and 1.9% in 2019), the result is lower growth in household spending that will be reflected in the lower expected GDP growth in 2018 and, to a greater extent, in 2019.

The depletion of the use of savings (at historic lows for families) as a way to increase spending could be offset, only in part, by the strong growth rate recently observed in consumer credit. In January, the growth of new consumer credit to households was 26% year-on-year. Finally, the lower dynamism of household spending would also have a positive effect on the lower growth of imports, which could increase by half of what was observed in 2017, thus favouring maintaining the current account surplus, **which would be around 1% in 2018 and 2019, which would allow accumulating seven years of external surpluses, something unprecedented in the history of the Spanish economy, and**

#### **essential to reducing our high external debt.**

In 2019, with a probable progressive withdrawal of economic stimuli, the increase in financing, especially residential, will also have an impact on other European countries, which will help to slightly reduce the contribution of the foreign sector.

#### **Investment, meanwhile, which will continue to grow above the average of the last two decades,**

will slow down after the strong upturn of 2017, partly due to investments foreseeably deferred due to the lack of a government. One of the keys will be to see if part of the investments that could have been lost in Catalonia due to the political situation experienced have been permanently lost or will return in 2018 either to Catalonia or to the rest of Spain.

However, the slowdown will be greater in investment in machinery and capital goods (from 6.1% growth in 2017 growth of 5.1% and 4.1% in 2018 and 2019 is expected) as a result of a lower rate of increase of exports and lower expected profits for companies, compared to what we will see in the construction sector, whose slowdown would still allow it to grow by 3.7% and 3.4% year-on-year in 2018 and in 2019, respectively. This favourable evolution will be a reflection of the dynamism of the mortgage and property market that is beginning to show sustained increases in prices, especially in those geographical locations with the greatest scarcity of housing, such as the centre of large cities and in some tourist areas. In January, the new credit granted to companies increased by 24% year-on-year, with the increase in financing for housing acquisition operations moderating to 13.9%.

#### **Finally, a tightening in financing conditions from 2019 is also expected, which together with lower growth expectations also explain the expected downward trend for gross capital formation in 2019.**

The labour market, meanwhile, will continue with its high rate of job creation. For 2018 a year-on-year increase in employment is expected of 2.3% and in 2019 of 1.9%. Thus, by the end of 2019, the figure of 19.5 million employed persons would be exceeded, with the unemployment rate averaging 13.3%, with the reduction of unemployment having a limited impact on salaries and prices.

For public accounts, the joint deficit of Public Administrations will be expected to reach 2.5% of GDP, reducing to 2% of GDP in 2019, when public debt could be 95% of GDP.

**Among the main risks for the Spanish economy in the next two years is the impact of the monetary normalization process in the United States and in the Eurozone.** Its gradualness and the absence of volatility generated by the monetary policy decisions of the Federal Reserve and the European Central Bank will condition the behaviour of economic agents in 2018 and, especially, in 2019, in an economy with high public and private debt, although the latter has been reduced considerably over recent years.

However, and despite the fact that the global balance of risks has become more balanced, the sources of uncertainty in the global economy must not be overlooked. On the one hand, a category of risks that can condition strong global expansion from the financial point of view, with the accumulation of debt as a prominent player, a particularly vulnerable element in a context of tightening global financial conditions, which would have a greater impact if it were to be carried out more abruptly than expected. Others will be added throughout 2018 to the recent rise in interest rates of the Federal Reserve. In addition, the process of reducing the balance of both the Federal Reserve and the European Central Bank will affect long-term interest rates, especially in the case of North American due to its greater intensity. This monetary tightening could make the Euro and the Dollar more expensive compared to the currencies of emerging countries, hindering the progress of certain exports. However, the low inflation in both economies shows the absence of significant impact on salaries, which allows both monetary authorities discretion when it comes to accommodating monetary tightening.

To this we must add that protectionism in the field of international trade, especially from the United States, will hinder the progress of an economy like the Spanish economy in the face of increased protectionist measures, increasingly open and more dependent on exports to maintain its income level.

Finally, a possible conflict between the United States and North Korea, although increasingly remote from the real probability of it occurring,

would also have the potential to destabilize the world economy.

**To all this, we must add the complacency and the absence of reforms in an economy in need of them,** as well as the impact of uncertainty related to the domestic political context, which is much more complex at present. Assessing how the increase in political uncertainty in Spain can affect the consumption and investment decisions of economic agents and, therefore, the forecast of growth, is not easy. We only need to remember that the most recent experience during the ten months of the acting government demonstrated the difficulty involved in incorporating these types of effects into macroeconomic forecasts. Most forecasts failed and, except for the slight negative impact on capital equipment investment observed, the economy continued to grow at a strong pace.

## Annual forecast of the Spanish economy.

**Table 1.** Annual forecasts.

(% annual average variation, unless otherwise indicated)

	2018	2019
Real GDP	2.8	2.4
Final household consumption expenditure	2.3	1.8
Collective consumption expenditure of general government	1.8	1.7
Gross fixed capital formation	3.8	3.5
- Machinery and equipment goods (1)	5.1	4.1
- Construction	3.7	3.4
Variation in stocks (contribution to GDP growth in pp)	0.0	0.0
National demand	2.5	2.2
Export of goods and services	3.3	4.1
Import of goods and services	2.5	3.6
Core Consumer Price Index (CPI)	1.2	1.5
Total Consumer Price Index (yearly average)	1.5	2.0
Labour costs per employee (2)	1.0	1.3
Employment (National Accounts) (3)	2,3	1,9
Unemployment rate (EAP, % active population)	15,1	13,3
Balance payments current account (% GDP) (4)	1,2	0,7
Cap (+) or nec (-) financ. AAPP excluding aid to financial entities (% GDP)	-2,5	-2,0
(1) Includes GFCF in transport material and in other machinery and capital goods. (2) Average remuneration per employee equivalent to full time. It includes gross wages received by employees and Social Security contributions. (3) Full-time equivalent jobs. (4) According to estimates by the Bank of Spain.		

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