FOCUS

Quarterly Economic Outlook Newsletter

No. 12 / June / 2018

FOCUS

Index

axesor

QUARTERLY ECONOMIC OUTLOOK NEWSLETTER

Executive summary.

In the first quarter of 2018, the Spanish economy grew by 0.7%, thus maintaining the pace of GDP growth observed in the previous two quarters. Domestic demand moderated its growth, both in terms of consumption and investment, with the exception of investment in housing construction, which maintained very strong growth. However, the contribution of foreign demand (the net contribution of exports minus imports) improved compared to the previous quarter, contributing positively to the growth of the Spanish economy in the first quarter of the year. The sector that grew the most was construction, while industry experienced a notable slowdown.

Year-on-year GDP growth moderated by one tenth in the first quarter to 3% – more than half a percentage point higher than in the euro area. The slower growth came from a slower boost in domestic demand, as the external sector once again contributed to growth, thus allowing for more balanced growth than in the previous quarter.

Domestic demand, despite its slowdown in the first quarter, consolidated itself as the driving force of the Spanish economy, contributing 2.8 percentage points to GDP growth, driven mainly by dynamic household consumption. External demand contributed two tenths of a percentage point to growth, once again contributing to the positive performance of the economy.

Domestic demand components include buoyant private consumption, driven by high job creation and favourable financing conditions and expectations. This rate became stronger in May, recording a record number of jobs over the historical series for that month.

The higher crude oil price observed since the beginning of the year is already reflected in a year-on-year inflation rate of 2.1% in May. The expected average for the whole year is 2%. This increase should not burden household consumption if the agreed wage increases of between 2% and 3% for this year finally materialises.

One of the most notable elements has been the great dynamism in investment in housing construction, which is the component of national demand that has grown the most, advancing even more strongly than in the previous quarter. However, this component has a very low weight in GDP, much lower than that observed by this component in the historical average.

On the general government side, final consumption in volume slowed by half a percentage point in the first quarter of 2018 to 1.9% year-on-year.

One of the main macroeconomic problems of the new government will be to reduce government deficits and debt. There is no fiscal space for ambitious spending proposals. The European Commission has already announced that, with the current budget, the deficit of the Spanish economy will not fall below 2.7% and that the structural deficit will increase. Public debt also grew in the first quarter of 2018. Our forecast is that the public deficit will close the year at 2.8%.

Exports of goods and services rose more than imports in real terms, although in nominal terms the growth of the latter was higher, mainly due to higher energy imports, although the price of non-energy imports also rose. But by eliminating the effect of the rise of oil, exports of non-energy goods slowed their growth in the first quarter to 2% year-on-year, while imports of goods rose by 4%, which increased the trade deficit. **With an external debt of over 80%, all those elements that imply a worsening of the current account balance increase the financial vulnerability of the Spanish economy and the impact of episodes of instability on currently more volatile and unstable markets**, introducing concerns regarding the sustainability of this debt.

Rising oil prices, the appreciation of the euro against the average exchange rate observed for the previous year, and the wage increases already agreed between employers and trade unions are elements that make the Spanish economy less competitive at a time when international trade is showing signs of greater weakness. In fact, the reduced growth in competitiveness, which is lower than in previous years, is already one of the few negative elements that the performance of the Spanish economy has shown in the first five months of the year.

More in the medium term, **the normalisation of**

monetary policy will also have a negative effect on the current account balance and, therefore, on the capacity to make progress in the progressive reduction of external debt.

Among the most positive features of the first five months of the year was the decline in unemployment, which fell in May for the fourth consecutive month at a rate of 2.5% per month. The total number of unemployed persons stands at 3.25 million, the minimum since the end of 2008.

The most recent short-term qualitative indicators of global activity show a prolongation of the expansion trend in coming quarters. Thus, the PMI comprised of global activity, prepared by Markit, reached a level of 55.9 in May, five tenths higher than the previous month, due to the acceleration of industry and, to a lesser extent, services.

Among the factors that explain the foreseeable good performance of domestic demand in the second quarter of 2018 and that affect private consumption and investment are the registration of both cars and freight vehicles. Among the qualitative indicators, the consumer confidence indicator published by the CIS rose by an average of 0.5% year-on-year in the first quarter, although it fell slightly again in May following the monthly rebound observed in March and April.

In view of these expectations, we have revised upwards our forecast for the Spanish economy, for which we expect growth of 2.9% in 2018 and 2.6% in 2019. This should lead to the creation of around 800,000 jobs and bring the average unemployment rate in 2019 to 13.3%.

In this way, the expansionary path begun in 2013 will be continued and employment will be created at a good pace, while at the same time
the main macroeconomic imbalances continue to correct themselves: the public deficit will be reduced to below 3%, economic agents will continue to deleverage, and a current account surplus will be maintained in 2018 for the sixth consecutive year, the latter being a totally 2018, and may even become slightly negative in 2019. This is due, fundamentally, to the fact that exports have increased somewhat less than the increase in imports, in a context of a slowdown in international trade and where both exports and imports will grow at a slower rate than that observed in 2017.

The value of the euro will also influence the external sector. Oil prices have stabilised, but favourable and new feature of the present expansionary cycle of the Spanish economy.

The contribution to the growth of domestic demand will be similar to that recorded in 2017 (2.8%). The upturn in consumption in the first quarter and the good pace of job creation, especially in recent months, have boosted domestic demand more strongly.

The slight slowdown expected can also be explained, to a large extent, by the need for families to adjust their spending to their disposable income, since the fall in the savings rate to historic lows will not allow a new boost to consumption in this way.

However, this could be partly offset by a further increase in public consumption, slightly higher than the 1.6% increase in 2017 (2%
forecast for 2018 and 2.2% for 2019), facilitated by the sharp adjustment in the deficit in recent years and by a considerable increase in revenue collection from an economy that consolidated three consecutive years of growth of over 3% in 2017. However, the implementation of an expansionary fiscal policy will increase the structural deficit, which could fall back in 2019 if there is no agreement to approve a new budget and the new government decides to extend the current one.

With regard to gross fixed capital formation, we expect it to slow down in 2018 to 4.2% per annum from 5% in 2017. The main cause of this change is the slowdown in the growth of investment in machinery and equipment, as investment in construction could advance at rates close to those observed in 2017, at around 4%. The end of much of this demand for investment, which was embalmed during the long period without a government and which was largely completed in 2017, as well as a lower expected demand for exports by 2018, would go a long way towards explaining the worst expected behaviour of the demand for investment in capital goods.

Net foreign demand will no longer make a positive contribution to growth, but will continue to make a virtually zero contribution to it

we anticipate that they will remain above the levels observed in recent years. The appreciation of the euro served during the first quarter to partly compensate for this increase in the price of oil by making imports of crude oil cheaper. But all indications suggest that the interest differential and fiscal expansion in the United States should tend to progressively appreciate the dollar against the single currency.

For growth to be stable, productivity needs to be increased. Otherwise, the Spanish economy's exports would suffer, increasing the external deficit and the external debt, which remains at very high levels.

The risks to which the Spanish economy is subject include protectionism, the normalisation of monetary policy, greater volatility and the existence of an incomplete monetary union. All this in a scenario of high external debt and a rapid increase in global indebtedness, especially in China in recent quarters. Finally, complacency, which implies the absence of the reforms that the country needs. Sustained and inclusive economic growth requires reforms that take over from the cyclical impulse of demand policies.

Global scenario.
Asset inflation and debt

In 2007, the debt to GDP ratio was at record highs. Years of financial deregulation, disorderly growth of global financial activity, lax monetary policies and minimal investor risk aversion had led to a global credit bubble and intense asset inflation:

Overvalued stock markets, corporate bond spreads, at record lows, especially in the worst rated and highly leveraged ones.

Eleven years later, the world has avoided another great depression, the US economy is in its second longest expansionary cycle since 1850, the unemployment rate is at its lowest and the Federal Reserve is firmly on its way to monetary normalisation. However, world growth is concentrated in Asia, especially in China and India due to their size, but it is the peripheral Asian countries that are the most dynamic.

All this does not prevent world debt from exceeding its 2007 highs. Most of it is still concentrated in developed countries, but China has accounted for 75% of the growth in private debt worldwide since 2007. Thus, asset prices are once again overvalued. According to the adjusted PER ratio of the Nobel Prize winner Robert Shiller, the US stock market has surpassed the overvaluation levels of 2007. The Russell 3,000 index of mid-cap companies is twice as high as in 2007.

As in the 1990s, the biggest excesses were in the technology sector, in the price of shares, but also in the bond market. Companies like Tesla are experiencing heavy losses each quarter and have financed them with poorly rated bonds. The market for such issues has virtually closed in 2018 and it is anticipated that an asset price correction may be in sight.

Another worrying sign is the flight of capital from emerging countries. It started in Argentina, which had to ask for a ransom from the IMF and whose currency is still in free fall, and its bonds anticipate a high probability of default. Capital flight has spread to Brazil, Mexico, Colombia, Turkey and, to a lesser extent, to the currencies of Eastern European and Asian economies.

As has always happened when the Federal Reserve lowered rates to 0%, this time, capital flowed to emerging countries and riskier assets to

ensure higher returns. In 2008, investors feared default and bought government bonds from the US, Germany and Japan to protect their capital, and 0% rates forced them to buy back risky assets. This allowed us to get out of the asset
deflation and the banking crisis, which led directly to another major depression.

But in 2018 we will yet again experience what is known in economics as the *Minsky moment*. The American economist defined the hypothesis of financial instability, which states that when the returns on assets fall, investors increase the risk assumed and this causes the systemic crises associated with the capitalist system. What the 2008 crisis demonstrated is the limited knowledge of economists of this financial phenomenon, which should now lead us to prudence. And it also demonstrated its high destructive capacity and the pernicious effects of financial excesses on countries' employment and public debt. This time, the statistics show less exposure to international banking, except in China, and it is likely that the next crisis will be more like the one in 2000 and the bursting of the technology bubble than the one in 2008. However, the last crisis taught us that there are *black swans* with low probability but devastating effects that investors, financial supervisors and analysts should not underestimate.

Growth prospects for the Spanish economy

The expansionary phase of the Spanish economy that began in the third quarter of 2013 continued in the first quarter of 2018 and will continue at a good pace in the coming months.

Quarterly national accounts data for the first quarter confirmed the robust progress of economic activity, with **growth of 0.7% quarter-on-quarter**.

The gradual and foreseeable slowdown of the Spanish economy is very weak. And according to our forecasts, as we will develop in the last part of the report, we hope that the Spanish economy will be able to maintain this cruising speed for the next three quarters, which would allow us to close **2018 with a year-on-year advance of 2.9% of GDP.**

Annual growth rebalanced after a slight negative contribution to net external demand growth in the fourth quarter. The year 2018 starts with a contribution of the external sector of 0.2%, which, together with the contribution of domestic demand of 2.8%, leaves GDP growth in the first quarter at 3%.
In inter-quarterly terms, the contribution to GDP of net external demand was zero, with the contribution of domestic demand of 0.7%, the same increase as that observed in GDP.

The increase in domestic demand is the result of the continued dynamism of private consumption and investment. Each of them is one tenth of what was observed in the last quarter of 2017.

The improvement in the labour market and consumer confidence, as well as in financial conditions, continued to favour the situation of households, which, in turn, allowed consumption growth to continue at a good pace, rising by a tenth of a percentage point compared with the previous quarter.

The medium-term outlook remains favourable, with our forecast of a GDP growth of 2.9% for the 2018 average. The main indicators seem to suggest that economic activity will continue to be strong in the second quarter of 2018 and that the Spanish economy will continue to lead growth in the Eurozone, with growth of around 0.7% quarter-on-quarter.

Last May, the labour market recovered the vigour lost in recent months, with the month of May being the month with the most jobs created in the entire historical series. However, the average increase in the two months of the second quarter is slightly lower than that observed in the first quarter.

Among the leading indicators linked to private consumption in the first quarter of 2018, ANFAC reported that car registrations rose by 7.2% in May, although they were 5.1 points lower than in the previous month. As regards the General Retail Sales Index, corrected for the calendar and deflated, this registered an increase of 0.1% year-on-year in April, which implies a significant deceleration of 1.6 points.

In addition, the slow rise in wages and the low rate of savings, which make it difficult to boost spending in households, should be added to the above. In relation to wages, and according to data recently published by the INE in the Quarterly Labour Cost Survey, the average labour cost per worker per month was in the first quarter of 2018 at 2,498 euros, a figure 0.7% higher than in the same quarter of 2017.

Against the slight intensification of the three-tenths of a percentage point increase in consumer spending to 2.8%, investment decelerated again in the first quarter of 2018 to 3.5% year-on-year, with less progress being seen for more than a year. Although the slowdown is widespread, it is more intense in capital goods than in construction, which may be leading to less dynamic future export performance.

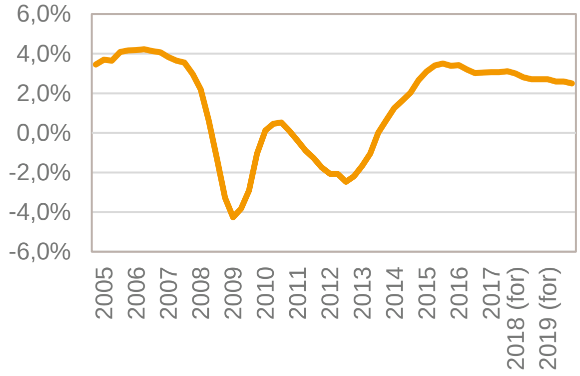
The conditions remain favourable for investment decisions, due to the very low interest rates, the good impulse of internal and external demand, the continued deleveraging of companies, the use of production capacity and the continuous improvement of expectations. However, some indicators give contradictory signals. While the registrations of cargo vehicles, according to ANFAC, and the portfolio of orders for capital goods showed very good results in April and May, progressing at a rate of 8.6% and 20% year-on-year respectively, the deflated sales of capital goods and software by large companies showed a bad result in April.

On the other hand, final consumption expenditure of the Public Administrations, in volume, and with seasonally and calendar corrected data, slowed half a point in the first quarter of 2018, to 1.4% year-on-year.

Demand and production

According to the results of the Quarterly National Accounts (CNTR), published by the INE, real GDP, corrected per year and seasonality, registered an inter-quarterly growth of 0.7% in the first quarter of 2018, a figure identical to that of the two previous quarters. In year-on-year terms, GDP grew by 3%, one tenth less than in the previous quarter.

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



Source: CNTR.

By component, economic growth continues to be supported by domestic demand, the main driver of growth, with growth at 2.8 percentage points, four tenths lower than in the fourth quarter of 2017 but above the average contribution recorded in 2017 as a whole. The contribution of net external demand was positive (0.2%) and reverses the previous situation, which was a tenth negative. This is therefore a more unbalanced composition of growth than that observed in the last two years and whose trend will continue throughout 2018.

Domestic demand aggregates

Its main components have contributed to the growth of national demand. The favourable performance of private consumption, driven by strong job creation, as well as by low interest rates and the improvement in financing conditions once again stands out. Real household and not-for-profit final consumption expenditure for households (NPISHs) grew by 2.8% year-on-year in volume terms in the first quarter of 2018 (three tenths more than in the fourth quarter of 2017). However, on a quarterly basis, the increase in private consumption (household consumption and non-profit institutions serving households) was 0.7%.

The good evolution of private consumption can be explained by the strong job creation, the improvement in access and conditions for financing and price moderation. However, the increase in the price of oil has contained consumption growth so far in 2018.However, the most recent short-term indicators, both qualitative and quantitative, show that the expansion path of growth of private consumption remains in the first quarter of 2018.

In fact, private consumption continued to grow in the first quarter, in nominal and real terms, outpacing the growth in compensation to employees, which means that household savings have stopped growing.

As regards investment, gross fixed capital formation fell by 2.1 percentage points, showing a year-on-year increase of 3.5% in the first quarter of 2018. In quarter-on-quarter terms, gross fixed capital formation rose by one-tenth to 0.8% in the first quarter, mainly due to a 1.4-point increase in investment in construction to 2.4%

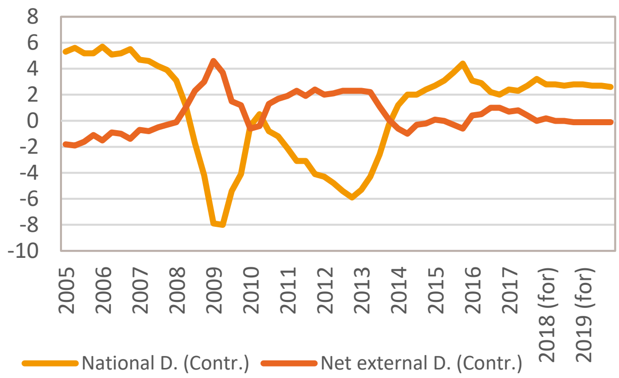
The conditions continue to be very favourable for investment decisions, due to the fact that companies are in a more advanced deleveraging process, good demand performance, low interest rates and the use of production capacity.

In turn, final consumption expenditure of the General Government, in volume and with corrected series of seasonal and yearly variations, slowed by five tenths compared to the previous quarter, to 1.9% year-on-year. In quarter-on-quarter terms, the growth rate of public consumption was maintained in the first quarter at 0.5%, one tenth higher than the previous quarter.

External demand

According to Quarterly National Accounts (QNA) figures, in the first quarter of 2018 the external sector contributed two tenths of a percentage point to annual GDP growth.

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



Source: INE

The first quarter of 2018 saw external demand contribute 0.2 points to GDP growth. This sharpens the downward trend in its contribution, which began in 2017, although it represents an improvement of one tenth compared with the last quarter of 2017, when it only contributed one tenth of a percentage point to annual GDP growth.

Compared to the main economies of the European

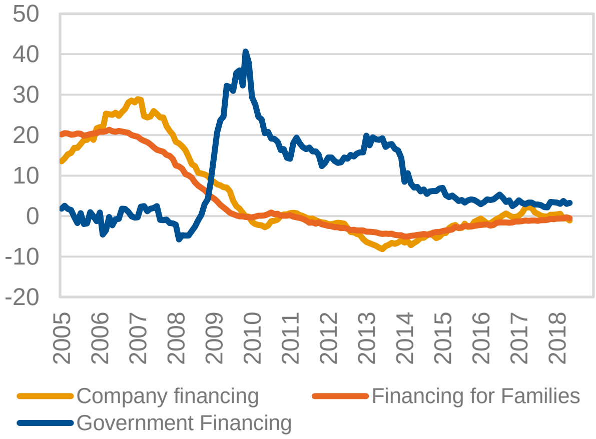
Union, the quarterly rate of Spanish real exports (1.3%) was higher than that of the United Kingdom (-0.5%), France (-0.3%), Germany (-1%) and Italy (-2.1%). Compared to the previous year, the increase in exports was 3.2%, higher than that observed in the United Kingdom (2.3%) and Italy (1.3%), but lower than the growth in French (5.7%) and German exports (4.5%).

Productive activity

On the supply side, the large sectors of activity show a positive, expanding performance. Gross Added Value (GVA), in volume and series, corrected per season and year, grew 6% year-on-year in the construction sector. The services sector, on the other hand, increased by 2.5%, the same as in the previous two quarters. The agriculture, livestock, forestry and fisheries sector accelerated its growth by 1.3 percentage points to 3.3% year-on-year.

At a quarter-on-quarter rate, the GVA of the industry slowed down in the first quarter of 2018 by 0.9%, compared to the growth of 1.8% recorded in the previous quarter. In the services sector, GVA continued at a moderate four-tenths of a percentage point increase to 0.8%, while the primary sector showed the most notable growth, with GVA falling from 1.1% in the last quarter of 2017 to 3.7% in the first quarter of 2018.
In relation to the financing of productive activity, Graph 3 shows the evolution of the rate of variation of financing for the different productive agents. In Spain, the balance of loans to households and companies continued to perform differently, falling by 1.09% in the case of companies in May and by 0.55% in the case of financing to families and increasing by 3.27% in the case of financing to public authorities.

Graph 3. Financing. Annual percentage change



Source: Banco de España.

On the supply side, the improvement in the banking sector is consolidating. The NPL ratio stood at 6.8% in March, a point lower than at the end of 2017.

Prices

The Consumer Price Index (CPI) for the month of May, published by the INE, rose to 2.1% year-on-year, a rate one point higher than that recorded three months ago. This increase is explained by the upturn in energy and, to a lesser extent, by the acceleration in the prices of services and food.

In inter-monthly terms, the CPI increased by 0.9% in May, compared to a decrease of 0.1% in the same month in 2017.

Core inflation (excluding unprocessed food and energy products, the most volatile elements of the CPI) rose by three tenths to 1.1% in May, mainly due to services, whose prices accelerated by seven tenths to 1.8%, driven mainly by package prices.

Labour market

The labour market was characterised in the first quarter of 2018 by the continuity of the dynamism observed in job creation in previous quarters, both in terms of the data provided by the Economically Active Population Survey (EAPS) and those of Social Security affiliations.

According to the EPA (Survey of the Working Population), published by the INE (National Statistics Institute), employment in the Spanish economy fell by 124,200 people in the first quarter of 2018, bringing the number of employed persons to 18,874,200. With seasonally corrected series, the number of employed persons increased by 0.5% quarter-on-quarter. In year-on-year terms, employment increased by 435,900 persons, 2.4%, two-tenths lower than in the previous quarter.

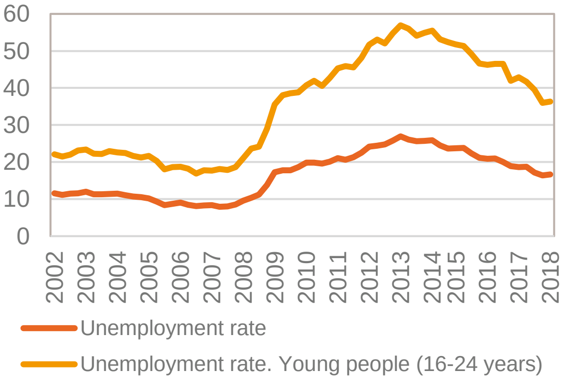
According to figures from the Contabilidad Nacional Trimestral (Quarterly National Accounts - CNTR), full-time equivalent employment, with seasonally adjusted and seasonally corrected series, decelerated by three tenths in quarter-on-quarter terms to 0.5%, with the year-on-year rate remaining at 2.9% for the third consecutive quarter.

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

According to CNTR figures, employment equivalent to full-time employment, with seasonally adjusted and seasonally corrected series, stood at 2.6%, showing an interquarterly rate of 0.5%.

If we look at the evolution of social security affiliations published by the Ministry of Employment and Social Security, the number of affiliates, with seasonally corrected series increased 0.8% quarter-on-quarter, the same variation as in the fourth quarter of 2017.

Graph 4. Unemployment rate. Percentage of active population



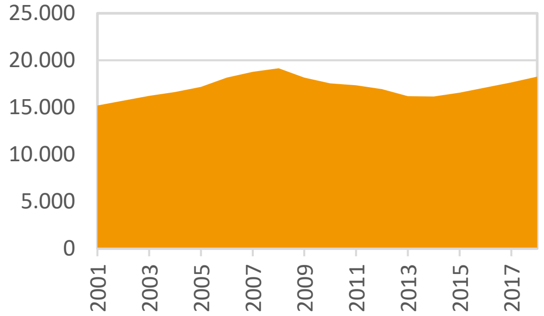
Source: INE

With seasonally adjusted series, in May the annualised monthly rate of change of the number of members was 15.4%, which gives an idea of the current strong rate of progress in employment and will allow for a repeat of a good quarter of job creation.

The total number of unemployed people stood at 3,796,100, below four million for the fourth consecutive quarter. In the last year, unemployment has fallen by 458,900 people, an annual decline of 10.8%, slightly less than the previous quarter. The unemployment rate stood at 16.7%.

In terms of age, it is worth noting the 12.9% year-on-year decline in youth unemployment (16 to 24 years old), with the youth unemployment rate standing at 36.3%, 1.2 points lower than a year earlier.

Graph 5. Social Security Affiliates (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 18% year-on-year in the first quarter of 2018, 2.2 points less than the previous quarter according to Eurostat figures, reaching a weight of 41.9% among the total unemployed.

Wage growth and unit labour cost growth continue to moderate. According to Quarterly National Accounts figures, compensation per employee increased by 0.4%, after rising by 0.2% in the fourth quarter of 2017, and apparent labour productivity increased by one tenth more than in the previous period, to 0.3%, so that the unit labour cost increased by 0.1% year-on-year. Hourly wage earning, on the other hand, grew 1% year-on-year, one tenth less than in the previous quarter.

Finally, the Agreement Statistics prepared by the Ministry of Employment and Social Security, with the information available up to the end of May 2018, shows that the average salary increase agreed is 1.6%, one tenth higher than the increase observed in the salary increase agreed in 2017.

Balance of payments

According to the available data from the Balance of Payments, the Spanish economy generated a financing capacity of 673 million euros in the first quarter of 2018, compared to a financing requirement of 179 million euros in the same period last year.

The Spanish economy presented a current account surplus for the fourth consecutive quarter of the year of 9 million euros, compared to a deficit of 540 million euros in the first quarter of 2017. This improvement is explained by the increase in the surplus of goods and services, which has more than compensated the greater deficit of primary and secondary income. The capital account, for its part, recorded a surplus of 664 million euros, 303 million more than in the first quarter of 2017.

The financial balance, on the other hand, experienced net capital outflows of 366 million euros, compared to net inflows of 1,932 million euros. This can be explained by the net outflow of capital (excluding the Bank of Spain), which was slightly higher than the increase in the Bank of Spain's net debit position.

The first quarter of 2018 allowed the Spanish economy to reduce its trade deficit. The foreign trade of goods and services in the period January-March 2018 resulted in a surplus of 3.34 billion euros, 28.8% higher than the same period of the previous year. In nominal terms, exports increased by 1.7% and imports by 0.9%, 6.1 and 6.5 percentage points respectively lower than in the fourth quarter.

Public sector

The State budget execution until April 2018 closed with a deficit, in terms of National Accounts, of around 0.5% of GDP, 22.2% lower than the accumulated deficit until April 2017. This improvement is due to a year-on-year increase in non-financial resources of 9.4%, higher than that recorded by non-financial jobs (5.6%).

The increase in non-financial resources can be explained mainly by the increase in collection via taxes of 9.3%. More specifically, the collection of VAT, which grew at a rate of 11% year-on-year, and of current taxes on income and assets, which enabled collection to be increased by 10.7%.

The increase in employment is explained by the growth in gross fixed capital formation of 130%, the higher contribution to the European Union from VAT resources and Gross National Income (25.7%) and the increase in current transfers to other Public Administrations, in particular to the Autonomous Communities, of 3.3%.

In terms of cash, the State recorded a deficit of 832 million euros until April 2018, compared to a surplus of 3.78 billion euros in the same period of 2017. Non-financial revenues rose 4% year-on-year to 49.32 billion euros, while non-financial payments rose 14.9% to 50.16 billion euros.

Public debt remains high. According to the methodology of the Protocolo de Déficit Excesivo (Excessive Deficit Protocol - EDP), general government debt reached 1,150,867 million euros in April, a year-on-year increase of 3%. This obliges them to avoid complacency and continue to make efforts to consolidate their fiscal position.

As far as fiscal policy is concerned, and in view of what is going to be a scenario of progressive normalisation of monetary policy by the ECB, it becomes more important for the country to meet its deficit targets during 2018 and 2019. By the time monetary normalisation arrives, it would be desirable for the sovereign rating to have regained the ground lost during the crisis to avoid a rebound in financing costs.

Our forecasts point to annual growth for 2018 and 2019 of 2.9% and 2.6%, respectively

_

2018-2019 scenario: sustained growth

The performance of the Spanish economy remains solid despite the slowdown in growth in the Eurozone and the financial turbulence. **Our growth forecast was met for the first quarter and our models anticipate that in the next two quarters the GDP will continue to grow at 0.7%**. It seems that the slowdown observed in the progress of most European economies did not occur in the case of Spain.

Looking ahead, we expect the pace of growth to remain robust, despite the slightly lower composite PMI business sentiment index observed in April at the end of the year
55.4 points, compared to the first quarter average of 56.5.

A further slowdown could come from an even greater increase in the price of oil than we have seen so far this year, although **we expect the price of oil to moderate in the coming months**, as some of the reasons for this rise were temporary. On the other hand, the greater volatility in the financial markets and the slight upturn in the Spanish risk premium could also negatively affect the performance of the Spanish economy if it were to continue over time.

In any case, both phenomena are unlikely to become permanent, so we are improving our GDP growth forecast for 2018 to 2.9%, compared to the 2.8% initially forecast.

The breakdown of first-quarter GDP shows that growth in household consumption accelerated, thus confirming that the slowdown in the final stage of 2017 was timely. We anticipate that the positive dynamics of private consumption will continue thanks to job creation and favourable financial conditions.

The investment, by its part, developed favourably in the first quarter, albeit with very notable differences by components. On the one hand, investment in capital goods fell by 1.6% quarter-on-quarter, a significant decline that does not correspond to the economic sentiment data observed throughout the month. Assuming that this component of GDP is very volatile, we forecast that business investment will continue its upward trend, although with prospects for less progress than in 2017. Business investment is, however, benefiting from good prospects of demand from companies and a high degree of utilisation of production capacity, and so further increases in production will require progress at a good rate of investment.

Meanwhile, investment in construction increased significantly to 2.4% quarter-on-quarter. This is explained by the upturn in residential housing construction to 3.5% quarter-on-quarter. The rise in house prices was 2.7% year-on-year in the first quarter, while home sales rose by 14.5% year-on-year, a figure that rose to 29.7% in April conditioned by the different date of Easter Week in the year-on-year comparison.

It is in this sector that we can foresee a greater improvement over our forecasts, especially in residential investment, which could grow almost twice as much as in 2017, above 6% year-on-year. Finally, the fact that municipal and regional elections will be held next year makes it foreseeable that public investment will increase from its current record low of 1.9% of GDP in 2018. Although job creation continued to progress at a rate of 3.1% year-on-year in April, it slowed down by a couple of tenths. The employment data from the National Accounts for the first quarter also showed a slight slowdown in the pace of job creation. Specifically, employment in terms of full-time equivalent jobs increased by 2.6% year-on-year, compared to 2.9% in the fourth quarter.

However, the labour market recovered with enormous vigour in May, with the largest job creation in the historical series being observed in that month. Average affiliation increased in May by 237,207 people, a monthly increase of 1.3%, bringing the total number of members to 18.92 million, the highest since October 2008.

The good employment performance is mainly due to the strong rate of enrolment in the service sector, which has enabled more than 50,000 people to escape unemployment. Construction and industry also contribute, but in a much more modest way, to the reduction of the unemployed in the construction and industry sectors by 11,200 and 8,200 people, respectively.

Indeed, the industrial sector lost strength in the first quarter, after the excellent fourth quarter of 2017. This trend was confirmed in April, when all the components of the Índice de Producción Industrial (Industrial Production Index - IPI) slowed down, highlighting the sharp deterioration of consumer durables with a year-on-year fall of 4.3%. The slowdown in the IPI in April compared to the first quarter is based on the worst performance of the chemical industry and the manufacture and repair of machinery and equipment, fundamentally. On the positive side are the supply of electricity and gas and, especially, the manufacture of motor vehicles. The external sector performed reasonably well in the first quarter thanks to the dynamism of exports and despite the rise in oil prices,although exports have been somewhat depleted in recent months. According to the National Accounts data, exports in real terms advanced by a robust 3.2% year-on-year in the first quarter, largely due to the positive performance of exports of services, both tourism and especially non-tourism services. Exports of goods, however, grew more moderately. Imports remained contained, advancing slightly below exports. Nominal balance of payments data show that the current account balance stood at 1.9% of GDP in March, the same as a year ago, despite the fact that oil prices (in euro) rose 8% year-on-year in the first quarter.

The general government deficit in the first quarter stood at 0.4% of GDP, implying an adjustment of one tenth of the total adjustment of nine tenths to be made this year in order to reach the 2.2% deficit target. Revenues maintained a good pace of progress, benefiting from the dynamism of economic activity. However, the slower pace of the adjustment of the government deficit is mainly due to an acceleration in general government expenditure. This was up 4.1% over the first quarter of 2017. The evolution of public spending over the remainder of the year will be driven by the new measures included in the General State Budgets, including a 1.6% increase in pensions in line with inflation, a 3% increase in minimum and non-contributory pensions and a reduction in personal income tax for low-income families.

The more expansive bias of Spanish fiscal policy will make it impossible to meet the target of a 2.2% public deficit in relation to GDP, as the European Commission has already announced. **Our**

forecast is that, by the end of 2018, the public deficit could be significantly below the proposed target of 2.8% of GDP.

The Spanish economy will grow by 2.9% in 2018 and by 2.6% in 2019, in part thanks to the best expected performance of the world economy. This should allow the creation of around 800,000 jobs and to bring the average unemployment rate in 2019 to 13.3%.

Our forecasts point to a very slight slowdown in GDP growth, to 2.9% in 2018, mainly due to a slight slowdown in the contribution of external demand,which would end the year with little or no contribution to growth, all of which is explained by the growth in domestic demand. This profile of sustained growth and continuity can be explained by the loss of strength of some factors that would have driven the activity temporarily, such as the drop in oil prices, the depreciation of the euro, or the demand for goods and services as a result of the uncertainty caused by the enormous economic and financial crisis suffered by the Spanish economy.

For 2018, we expect the pace of consumption to continue and a slight slowdown in investment, the latter being largely explained by the slower growth in investment in machinery and capital goods of the companies, after a very notable increase of 6.1% in 2017, well above the average of the last 20 years. The slower momentum of these factors should be partially offset by the gradual improvement of export markets, given the strong rebound in world trade and growth, although the new protectionist phase in the United States, with recent tariff increases on European and Chinese exports, could be an enormous obstacle to the growth of international trade in the second half of 2018 and during 2019.

The Spanish economy will be driven in the next two years by world trade, benefiting from the favourable competitive position of companies and low interest rates. However, the coming months could confirm a slowdown in international trade, which is already reflected in the indicators, with falls of 0.6% in the last few months to April. The demand for imports from the United States will be partially affected after the declaration of a trade war on the European Union, meaning that it will lose momentum, although momentum should continue to come from its main export market, the European Union, as well as from the emerging economies.

It is therefore crucial for the good performance of the Spanish economy that the intensity of trade with Europe and the rest of the world is maintained and that the risk of greater protectionism is dissipated. If the weight of exports of goods and services in the Spanish economy in 2007 at the dawn of the Great Recession was 25.7%, exports represented 34% of the Spanish economy's GDP at the beginning of 2018. The traction that was supposed by the construction for investment sector, both residential and non-residential, during the *real estate boom* is the foreign sector represented today by investment in machinery and equipment by Spanish companies.

To the above, it must be added that oil prices, which if they remain around their current price, will suppose a drop in income, with expenditure materialising, for Spanish families of between 15% and 20% higher than that experienced during 2017. The increase in the price of this basic raw material has not had a significant effect on household spending in the first quarter, which has rebounded with respect to the rate observed at the end of 2017. One possible explanation for this is that it has coincided with a strong appreciation of the euro. The recent depreciation of the single currency against the dollar could cause higher oil prices in the remainder of 2018 to have a greater negative impact on household consumption. However, our forecast for 2018 as a whole is a growth rate similar to that observed in 2017, after a very good first quarter and given the dynamism observed in the labour market in April and May.

In relation to domestic demand, despite being the main driver of growth, its contribution will gradually decline, from 2.9% in 2017 to 2.8% forecast for 2018 and 2.7% forecast for 2019. The slower progress in household final consumption expenditure will be partially offset by higher growth in general government expenditure, slightly higher than the 1.6% recorded in 2017. Nor will gross fixed capital formation be able to maintain its strong growth of 5% in 2018 and 2019, which is double the historical average of the last twenty years.

In a context of wage increases below the expected inflation rate, consumers will lose purchasing power, which would have a negative impact on private consumption, in contrast to the deflationary context experienced by the Spanish economy in 2015 and 2016, which allowed them not to lose purchasing power even with frozen wages. Therefore, the good performance of consumption will be linked to the good pace of job creation, which we hope will remain strong until the end of the year. The depletion of the use of savings (at record lows for households) as a means of increasing spending could only be partly offset by the recent strong growth rate in consumer credit. Finally, the upturn in household spending in the first quarter, if it continues as expected, would also have a positive effect on the growth of imports, which, even if lower than that observed in 2017, could grow at a very similar or slightly higher rate than that of exports, cancelling out any positive contribution of the external sector to GDP growth in 2018. This will result in a worsening of the projected current account surplus, which could be around 1% of GDP. In a favourable scenario, in which the tariff barriers already deployed did not have a very severe impact on world trade, we estimate that Spanish exports could progress further in 2019 as the euro maintains a more favourable exchange rate against the dollar and the good performance of the world economy continues, thus making it possible to maintain the current account surplus, which, with a crude oil price similar to or slightly higher than that of 2018, and already in the midst of monetary normalisation, would be slightly above 0.5% of GDP in 2019. This would make it possible to accumulate seven years of external surpluses, something unprecedented in the history of the Spanish economy, and essential to reduce our high external debt.

Investment, for its part, will continue to grow above the average of the last two decades. However, deceleration will be greater in investment in machinery and capital goods (from a growth of 6.1% in 2017, a growth of 2% and 4.1% is expected in 2018 and 2019) as a result of a slower rate of export growth and lower expectations of corporate profits, compared to what we will observe in the construction sector, which will grow strongly to 6.3% and 7.4%, respectively. This evolution will reflect the dynamism of the mortgage and real estate market, which is beginning to show sustained price increases, especially in those geographical locations with the greatest housing shortage, such as the centre of the large cities and in some tourist areas.

The labour market will continue at its high rate of job creation. By 2018 we expect a year-on-year increase in employment of at least 2.3% and by 2019 of 1.9%. Thus, **by the end of 2019, the figure of 19.5 million people employed would have been exceeded**, bringing the unemployment rate on average that year to 13.3%, with the reduction in unemployment having a limited impact on wages and prices.

In the area of general accounts, the general government joint deficit is expected to be 2.8% of GDP, falling to 2.3% of GDP in 2019, when government debt could reach 95% of GDP.

Among the main risks to the Spanish economy in the next two years is the new protectionist scenario on the world economy, which for the moment is worrying as it affects the foreign trade of the United States, the world's leading economic power. The extent of its extension to new products and over time, as well as its expansion to trade relations between other countries will depend, to a large extent, on the damage it may inflict on the world economy.

In a globalised world with production broken down into global value chains, when a country imposes a tariff to favour domestic production, it is not only making it more difficult for the rest of the world to export, it is also reducing the options for its own consumers and making the raw materials used by its industry more expensive. As a result of the foregoing, in general, the production and employment gains of the final producers are compensated for by losses in consumer welfare and losses in production and employment in other sectors.

A simulation by the IMF years ago of an overall US tariff increase of 10% would result in a fall of one percentage point in US GDP over the long term and 0.3 percentage point in the rest of the world. Applied to the current situation, it makes sense: in a context close to full employment, **tariffs and taxes by Trump will hardly increase employment in the steel or aluminium sectors**; on the contrary, they will harm the demand and employment of intensive companies in these important raw materials by increasing their costs. In any case, the open US trade war against Europe and China will slow the growth of world trade, which comes from gaining momentum and growing above world GDP in 2017.

Another risk lies in the possible impact of the monetary normalisation process in the United States and in the Eurozone. Its gradual nature 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 like Spain, with a high level of public and private debt, although the latter has been reduced considerably over the last few years.

The change in the trend in the monetary policy announced by the ECB from 2019 onwards will have a moderating impact on growth, which also explains, in part, the slight slowdown estimated for the Spanish economy to 2.6%. The 10-year public debt bond of the United States has recently reached levels close to 3%, compared to levels of 2% last summer. The reason is that higher growth has raised inflation expectations and investors are anticipating more rate peaks from the Federal Reserve, stressing bond yields or costs.

The ECB's monetary policy decisions therefore announce the end of the period of abundant liquidity in the Eurozone, a key factor in the recovery of the Spanish economy. The positive impact of monetary policy will moderate, although in his last speech, the President of the European Central Bank (ECB) made it clear that no rate peaks are expected until mid 2019. However, the pace of public debt purchases in the Eurozone member countries will slow down to 30 billion per month until September, when they will buy 15 billion in the last quarter of the year, and then stop buying debt from 2019 onwards.

These decisions should have an impact on the profitability demanded by investors for their purchases of debt securities, which will increase the financial burdens on the State. The Spanish economy is still heavily indebted. Spain also has the largest public deficit in the European Union.

Taking into account the clear orientation of monetary policy in the Eurozone in the coming months, the impact of monetary normalisation will influence the Spanish economy given its high level of indebtedness. However, this may be relatively limited, as banks have reduced their exposure to public debt, meaning that banks are now better positioned to cope with the link between sovereign risk and bank risk. In addition, the private sector, both in terms of families and companies, has significantly reduced its indebtedness since the beginning of the crisis, which means that if we were to return to a situation of stress such as that experienced in 2012 with the risk premium soaring (highly unlikely), **the impact on the financial burdens of families and companies would now be approximately half** that it was then.

The Federal Reserve, for its part, raised interest rates again to 1.75%-2%, and has planned two more increases for the remainder of the year. The Federal Reserve's firm decision to lighten its balance sheet has important consequences inside and outside the United States.

In domestic terms, the higher rates would have the direct effect of moderating the growth of the US economy in different ways: mortgage loans, which are already more expensive, or interest rates for private investment projects, which are also higher. In addition, asset prices also become another channel of transmission, which have to be lowered to compete with cheaper public debt. The government will have to pay more interest for refinancing its public debt and financing growing deficits in the future.

In key international terms, the US financial system and the US dollar play a major role in the functioning of the global financing system, and so changes in US prices and financing conditions have an impact on financing flows and conditions in the world economy. It is worth bearing in mind episodes such as the external debt crisis in the early 1980s, the collapse of the fixed income markets in 1994 or the instability suffered by emerging economies five years ago when the Federal Reserve announced a gradual reduction in its asset purchases.

While it is true that the growth of the world economy is at its best in recent years, it is no less true that debt levels are at record levels. The key is whether or not the world economy is prepared to live with higher interest rates.

While years ago it was thought that with flexible exchange rate systems, economies could isolate themselves from changes in the monetary policy of other countries, the

experience of the past decade has shown that even with floating exchange rates, there is a powerful global financial and liquidity cycle. Countries are integrated into the international financial markets through capital flows, with the evolution of credit and financing conditions heavily influenced by what is happening in the main money markets, particularly the dollar.

The Federal Reserve's ultra-expansive monetary policy stage between 2008 and 2014 fuelled a worldwide monetary easing financial dynamic. Capital was looking for better return alternatives, raising the demand for assets in emerging economies, as fixed-income assets in rich countries were very expensive due to historically low interest rates. This led to strong capital inflows into these countries, currency appreciation and acceleration of credit. Today, investors are re-evaluating return and risk ratios among assets, realigning their portfolios in favour of liquid assets and now also more profitable in dollars, at the same time reducing the weight of emerging economy assets. As a result, their currencies depreciate and a significant forced monetary contraction takes place, in the same way as what has happened in Argentina and other countries with weak fundamentals.

The rise in interest rates on public debt in the United States **is entering a new phase that is a serious test for the global economic and financial system**. The transmission channels of the above-mentioned driving forces go further than the exchange rate-monetary policy link. It has been very common for companies, banks and households to use the dollar not only for their transactions, but also for investment and financing decisions, and so their balance sheets are partly dollarized. Many companies that took advantage of the low interest rates to issue huge volumes of debt in dollars will have to adjust their spending and investment plans with effects on the performance of many emerging economies. According to the Basel Bank for International Settlements, the evolution of dollar funding to non-financial agents outside the United States increased by 8% in 2017 to 11.4 trillion, driven by debt securities issues, which grew by 22% in the second half of the year.

One of the important implications of the end of *Quantitative Easing* in the Eurozone will be that the shortcomings of European construction will emerge as the ECB reduces its monetary arsenal. Therefore, the European Union has only a few months to correct them, and in this sense, tension may return to the market earlier if the new Italian coalition government radicalises its position on the single currency. The risk is high. The institutional architecture of the single currency needs to be strengthened as never before in recent years.

In 2012, the Eurozone economy discovered that financial markets can exercise great power over an incomplete monetary union. The political crisis in Italy showed the monetary fragility of the Eurozone. High debt in an incomplete monetary union makes economies very vulnerable. It should not be ruled out that the political impetus that has been lacking from northern Europe (by making a misdiagnosis of the origin of the crisis) to tackle greater integration that strengthens the institutional architecture of the euro will appear when the US-sponsored trade war reaches the automobile sector.

To all of the above, we must add the complacency and absence of reforms in an economy in need of them, which the new government, as an historic minority in Congress, will have enormous difficulty in implementing. A new stage of less confrontation could open up between Catalonia and the central government, greatly facilitating performance both in that autonomous community and in Spain as a whole. The summit on the euro, which will be held on 28 and 29 June, with significant differences between France and Germany and between them and the rest of the countries, should be an enormous opportunity for the new Spanish government to make a decisive contribution to strengthening the pillars of economic and monetary union.

Table of annual forecasts for the Spanish economy

Table 1. Annual forecasts.

(% annual average change, unless otherwise indicated)

	2018	2019
Real GDP	2.9	2.6
Household final consumption	2.4	1.8
Public Administration final consumption	2.0	2.2
Gross Fixed Capital Formation	4.2	5.5
- Machinery and equipment (1)	2.0	4.1
- Construction	6.3	7.4
Stock changes (contribution to GDP growth)		
Domestic demand	2.8	2.7
Exports of g. and s.	3.5	4.2
Imports of g. and s.	3.7	4.7
Underlying CPI (annual average)	1.3	1.6
Total CPI (annual average)	2.0	1.9
Labour costs per employee (2)	1.2	1.5
Employment (National Accounts) (3)	2.3	1.9
Unemployment rate (SWP, % active population)	15.1	13.3
Current account balance (% GDP) (4)	1.2	0.7
Cap (+) or neg (-) financ. Public Administrations excluding aid to financial institutions (%	-2.8	-2.3

(1) Includes GFCF in transport equipment and other machinery and equipment. (2) Average compensation per employee, full-time equivalent. Includes gross wages received by employees and social security contributions. (3) Full-time equivalent jobs. (4) According to Banco de España estimates.

FOCUS

axesor {Primera **Agencia** **de Rating** española}

902 10 10 33

www.axesor.es
bccomunicacion@axesor.es