



Perspectives on Global and Spanish Economy Q3-2018

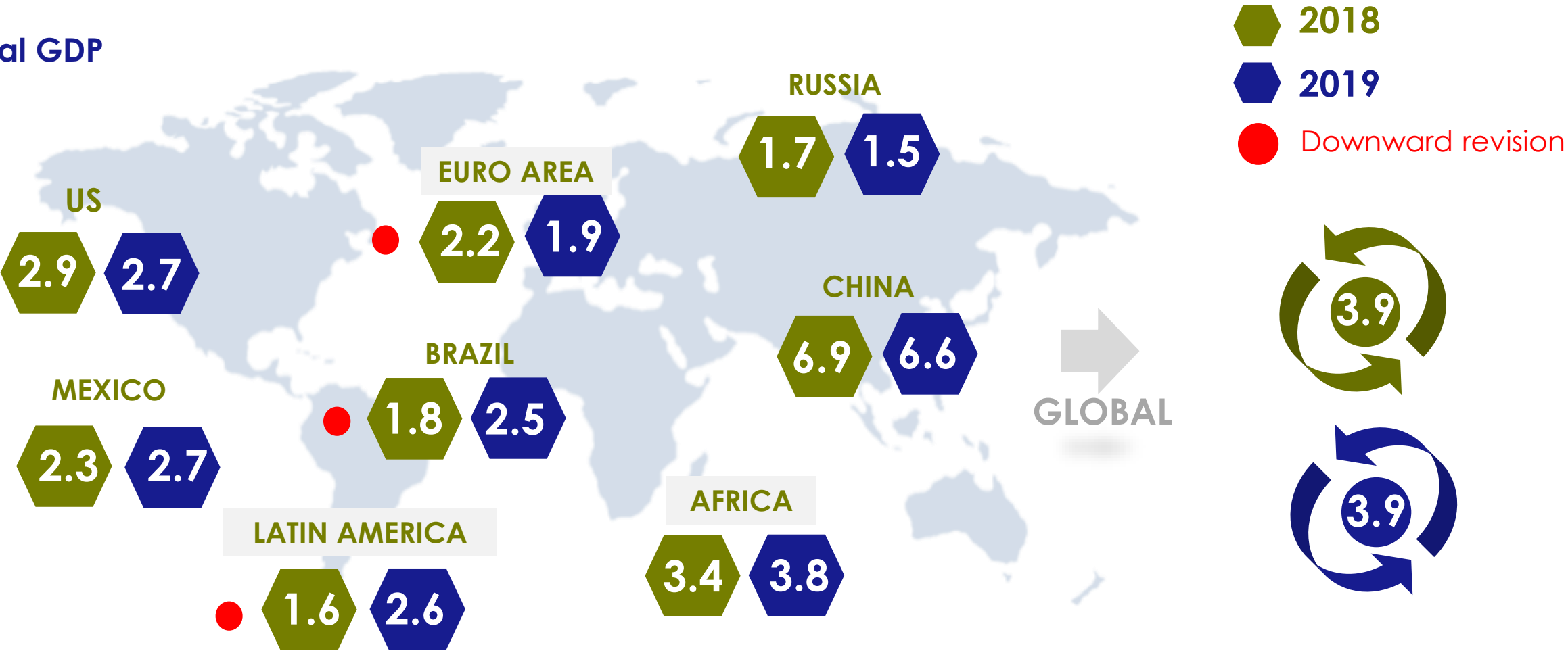
July 2018

GLOBAL

Economic growth in 2018 and forecasts for 2019

Robust economic growth, but with downward and less synchronised outlook

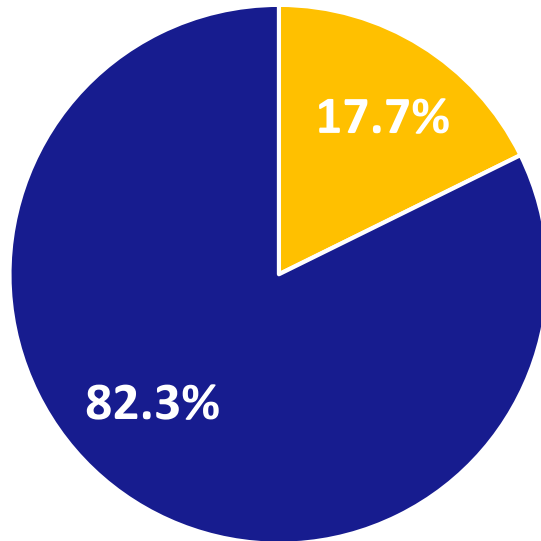
Real GDP
%



Solid global growth, but gloomy prospects for 2019

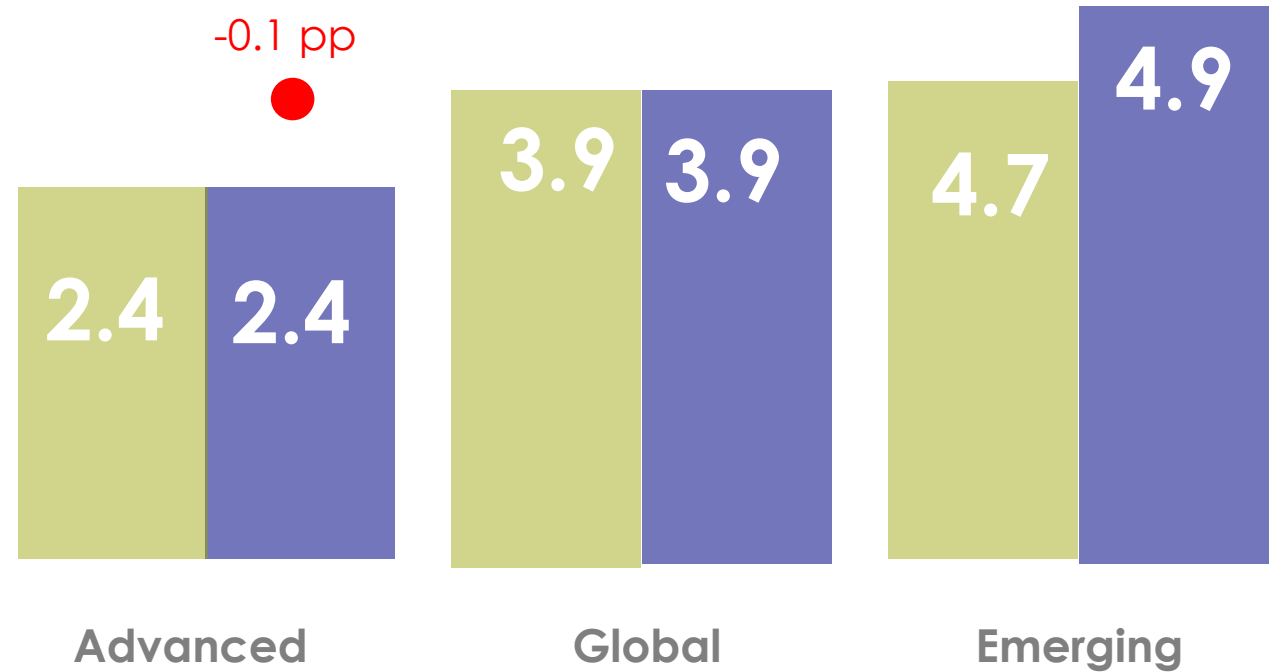
Countries with growth forecasts of >2%
% of total countries in the world as of 2018

- Countries with growth < 2%
- Countries with growth > 2%



Real GDP growth forecast
%

- 2017
- 2018
- Downward revision

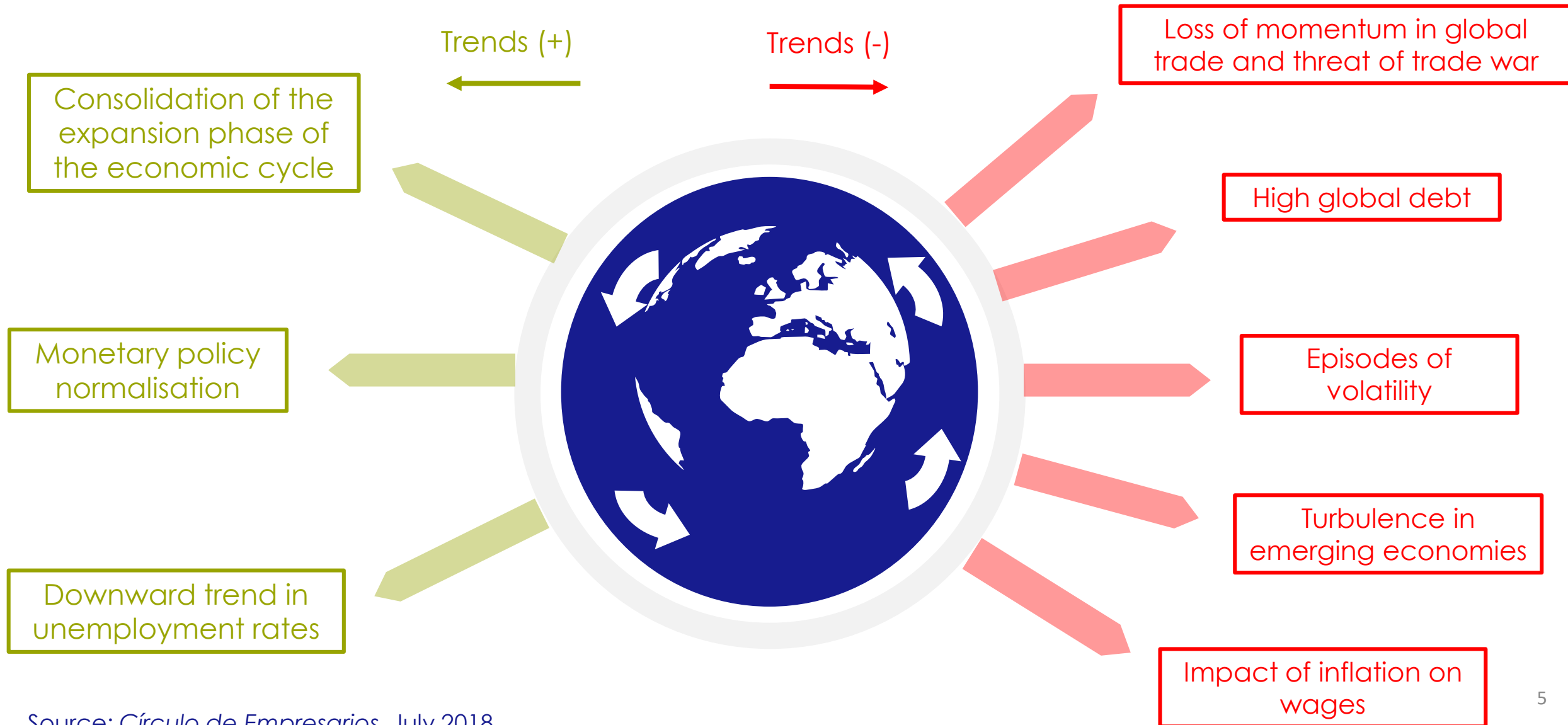


Note: the % of countries in recession in 2018 stands at 4.2%

Source: *Círculo de Empresarios* based on IMF, July 2018

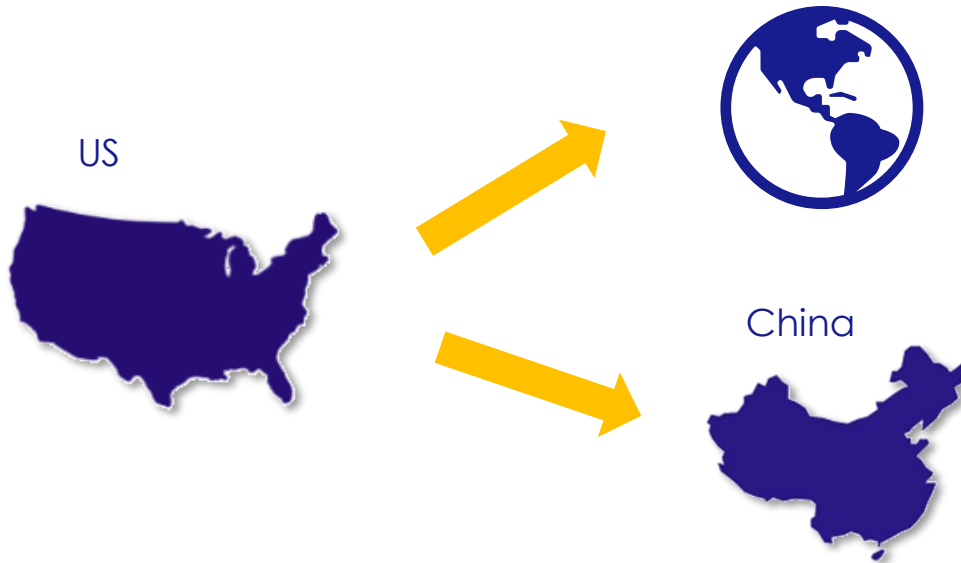
Global situation

In recent months, global risks are on the rise



Timeline of global trade war

US trade actions (June 2018)



Effective date: 1 June 2018

The US imposes tariffs on **steel** (25%) and **aluminium** (10%) which affects \$46 billion worth of US imports (0.2% of its GDP)

Effective date: 6 July 2018

\$32-34 billion on Chinese technology goods

+ Threatens tariffs on...

\$14-16 billion on Chinese technology goods

China's retaliatory tariffs on imports from US



Effective date: 6 July 2018

+ Threatens tariffs on...

\$15 billion on automobiles and auto parts, chemical products, petroleum products, and medical equipment

Note: Trump announced that he is ready to impose tariffs on \$500 billion of Chinese goods

Source: Círculo de Empresarios based on Economic and Security Review Commission, 2018

Trade scenario

In 2017, the US ran a **deficit in the balance of trade for goods & services of 2.9% of its GDP** (4.1% of its GDP if only goods) with its trading partners around the world

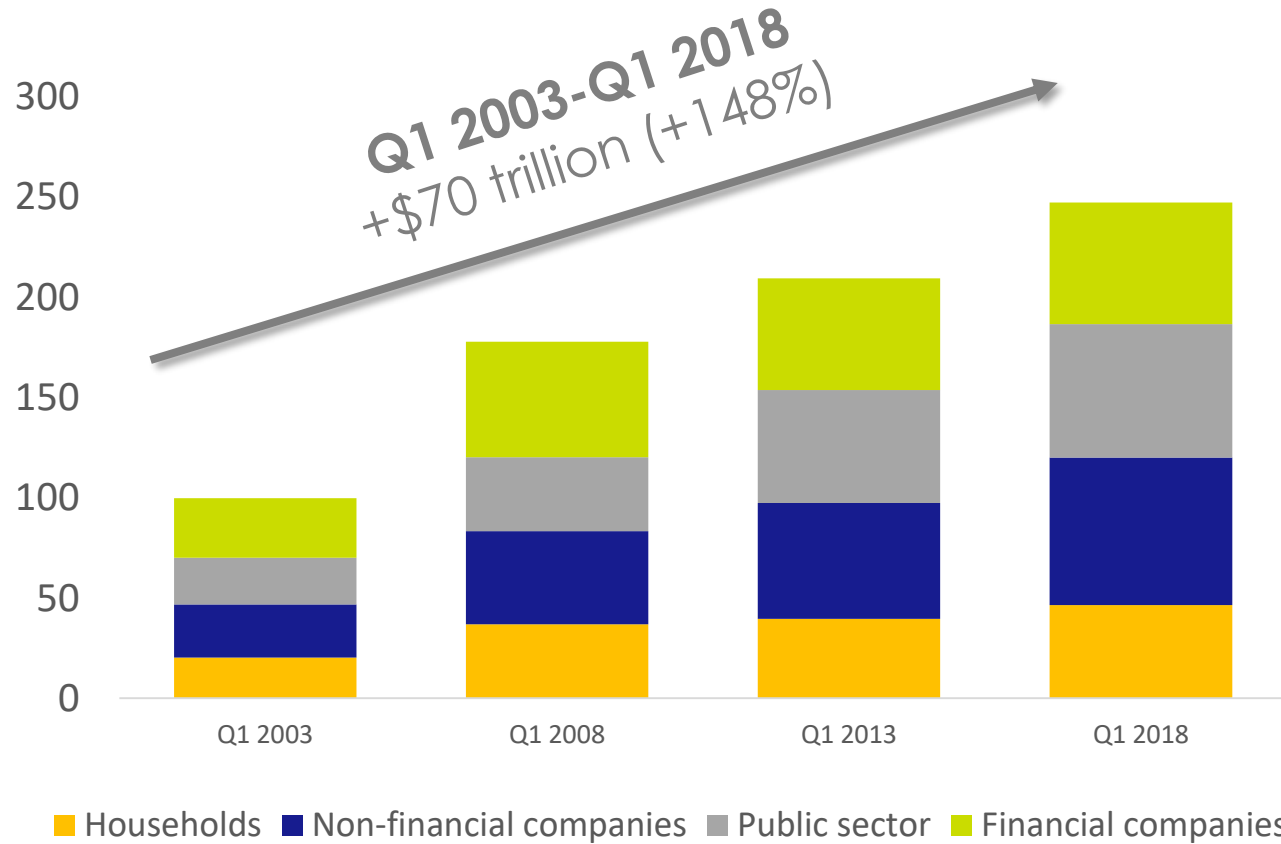


Global debt reaches 318% of global GDP

The increasing debt at a faster pace hits a record high of \$247 trillion (Q1 2018)

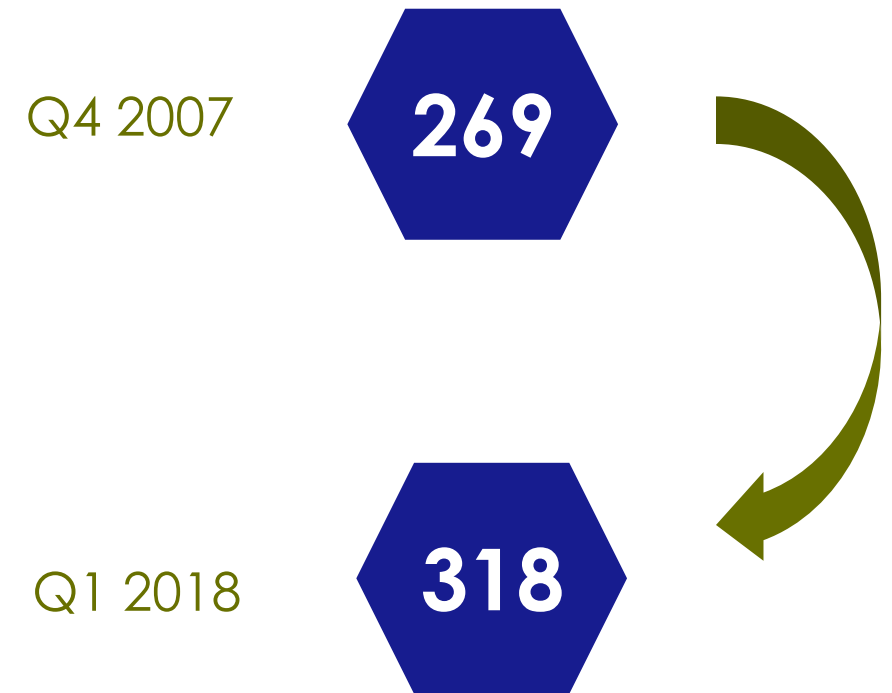
Global Sectoral Indebtedness

\$ trillion



Global debt

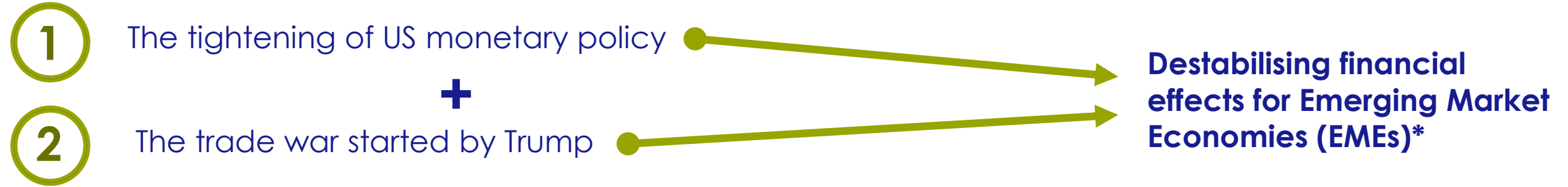
% of global GDP



Total global GDP estimated by the IMF for 2018: \$87.5 trillion

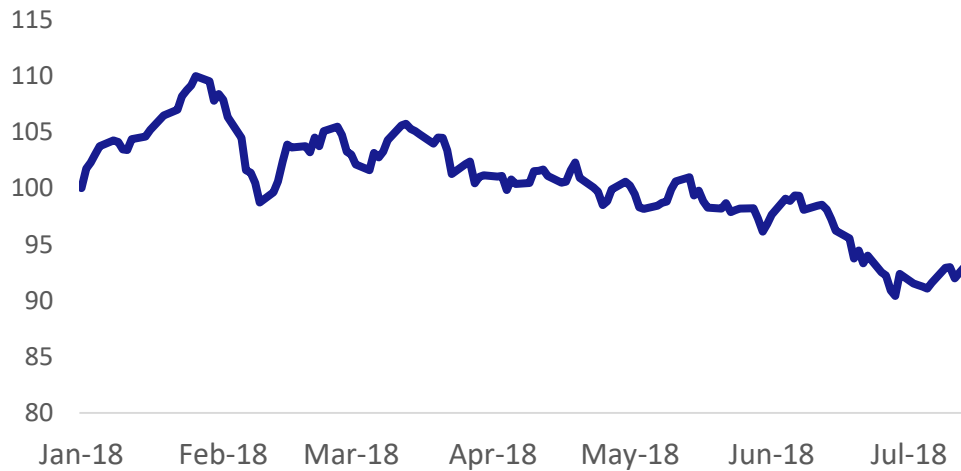
Source: *Círculo de Empresarios* based on IIF & Bloomberg, 2018

Imbalances in Emerging Market Economies (I)



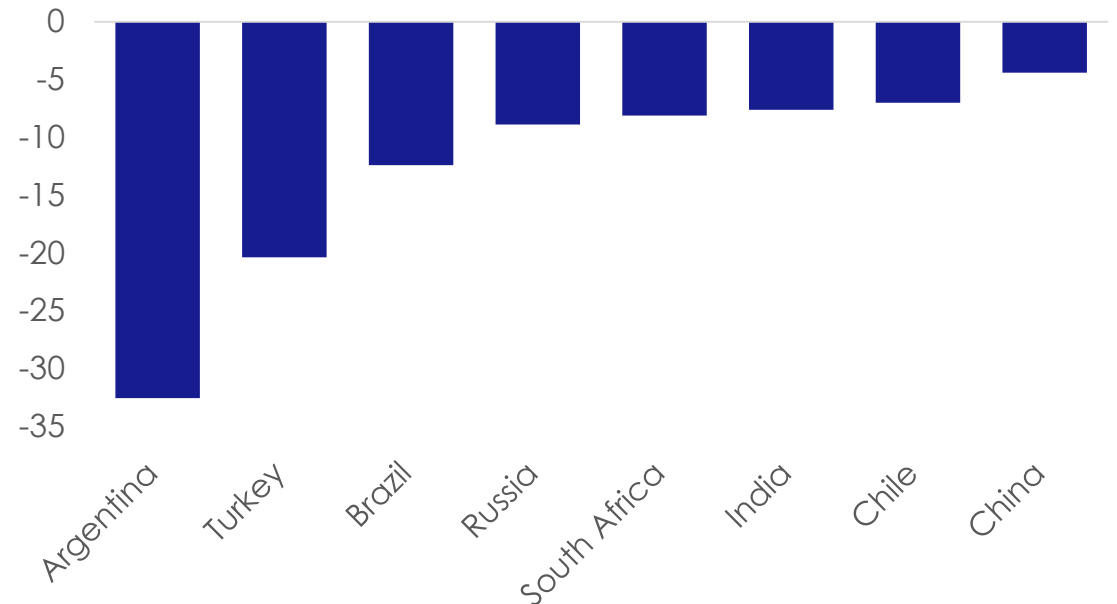
Which has resulted in a stock market correction in emerging markets ...

MSCI Emerging Markets
January 2018=100



* These countries account for 60% of global GDP, and two thirds of global GDP growth since 2010

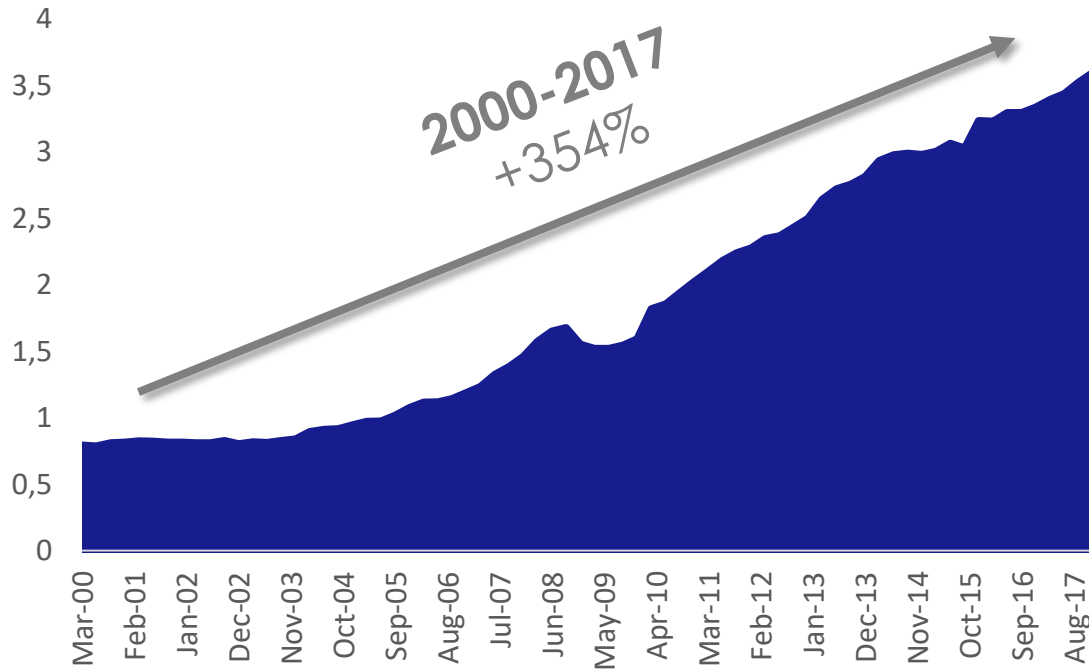
Emerging Market currencies in 2018
Variation between January – July (2018)



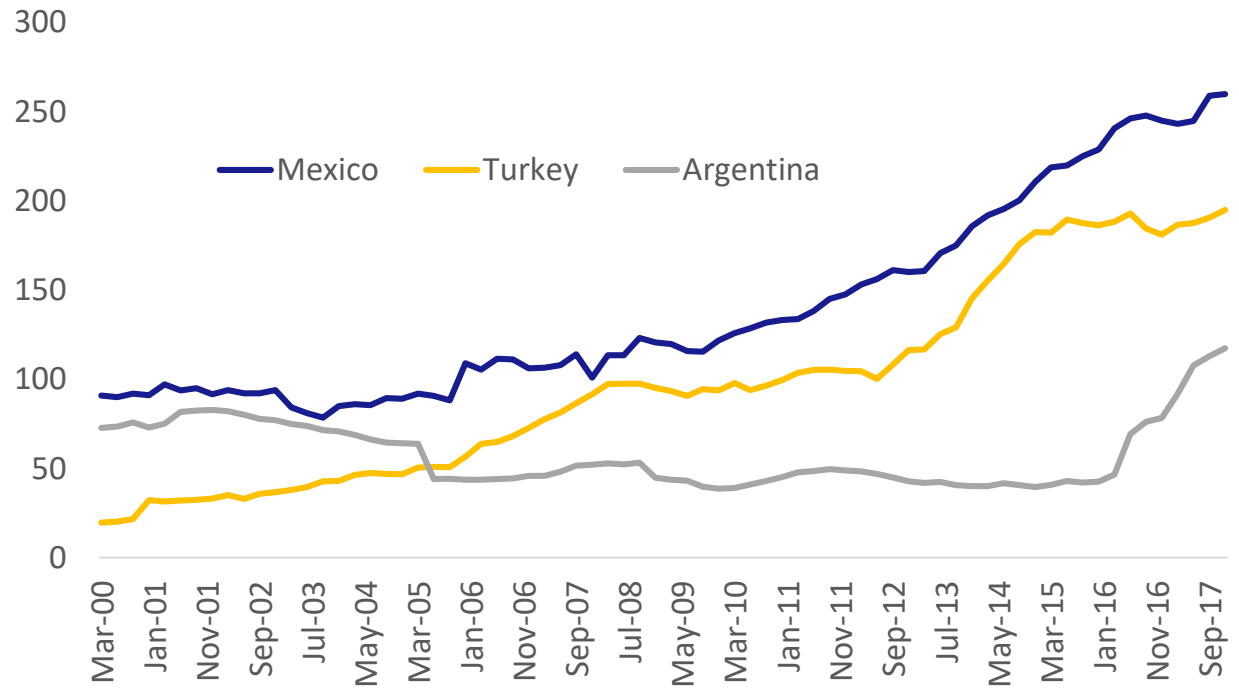
Imbalances in Emerging Market Economies (II)

Vast proportion of debt held in dollars in EMEs (mainly Mexico, Turkey, and Argentina)

EM debt denominated in dollars
\$ trillion



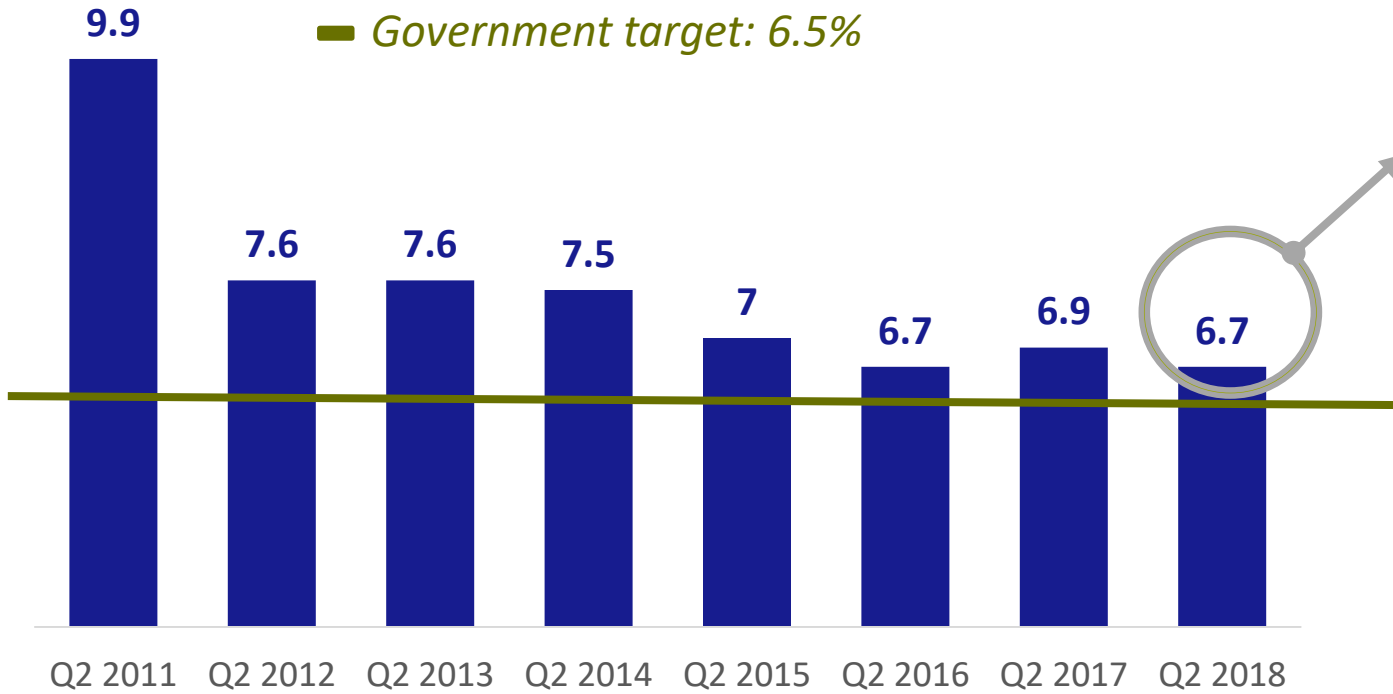
EM debt denominated in dollars, by country
\$ billion



In China, the signs of slowdown are accentuated...

...although data reveals performance was well above the government's target of 6.5% economic growth for 2018

China GDP growth % year-on-year



Signs of growth deceleration

- In May, the growth of **retail** was at its lowest since June 2003
- Fall of **investment in fixed assets** due to the negative impact of oil on global demand, the reduction of credit, and the fall of confidence due to the trade war with the US
- Industrial production decelerates markedly faster than forecasted

Financial crisis in Argentina: IMF bailout request

The IMF agrees to loan \$50 billion (7.8% of GDP*) in wake of the Argentine financial crisis to reduce its main imbalances: inflation and deficit.

Causes of the financial crisis

External factors



Falling **export revenues** due to the severe drought

Oil price increase

Tightening of US monetary policy (dollar appreciation and interest rates hike)

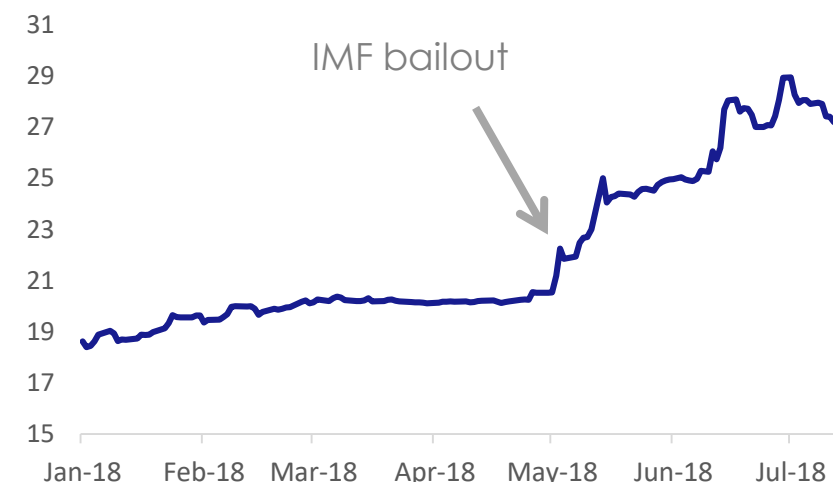
Internal factors



High levels of **deficit and public debt**

High **inflation** rate

Argentine pesos per dollar (USD/ARG)



Lagging economic indicators forecast, 2018

Inflation

27%

Unemployment

8.5%

Budget deficit

-5.1%

* In cumulative terms with respect to the GDP of 2018 in the 3 years in which the loan will be given

Source: Círculo de Empresarios based on Bloomberg & IMF, 2018

Mexico: Obrador wins the elections

Scoring a historic landslide victory (receiving more than double the total of his closest rival who had 22% of the votes)

Election Results



53.0 - 53.8%
INE's Rapid Count

53.0%
PREP

Andrés Manuel
López Obrador
MORENA

93.5628% of total vote



22.1 - 22.8%
INE's Rapid Count

22.5%
PREP

Ricardo Anaya
PAN



15.7 - 16.3%
INE's Rapid Count

16.4%
PREP

José Antonio
Meade
PRI



5.3 - 5.5%
INE's Rapid Count

5.1%
PREP

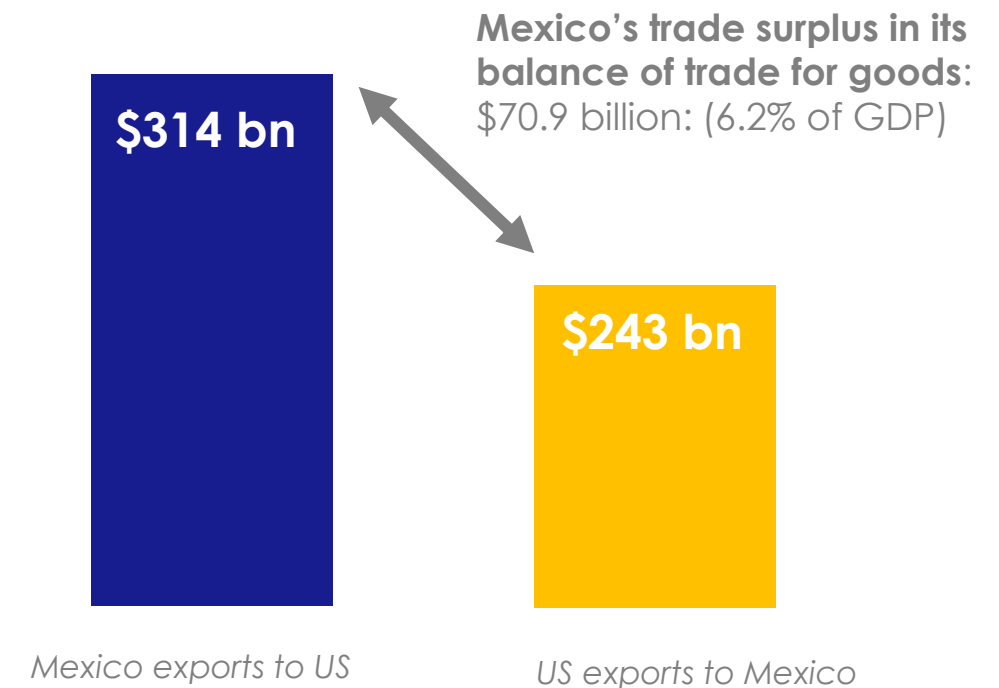
Jaime Rodríguez
IND



Trump's **immigration speech** and the **NAFTA renegotiation** may severely harm investor confidence in Mexico

In terms of trade

Mexico's exports to US account for 80% of its total exports



USA: robust growth

Fiscal reform and private consumption boost economic growth

Real GDP (%)

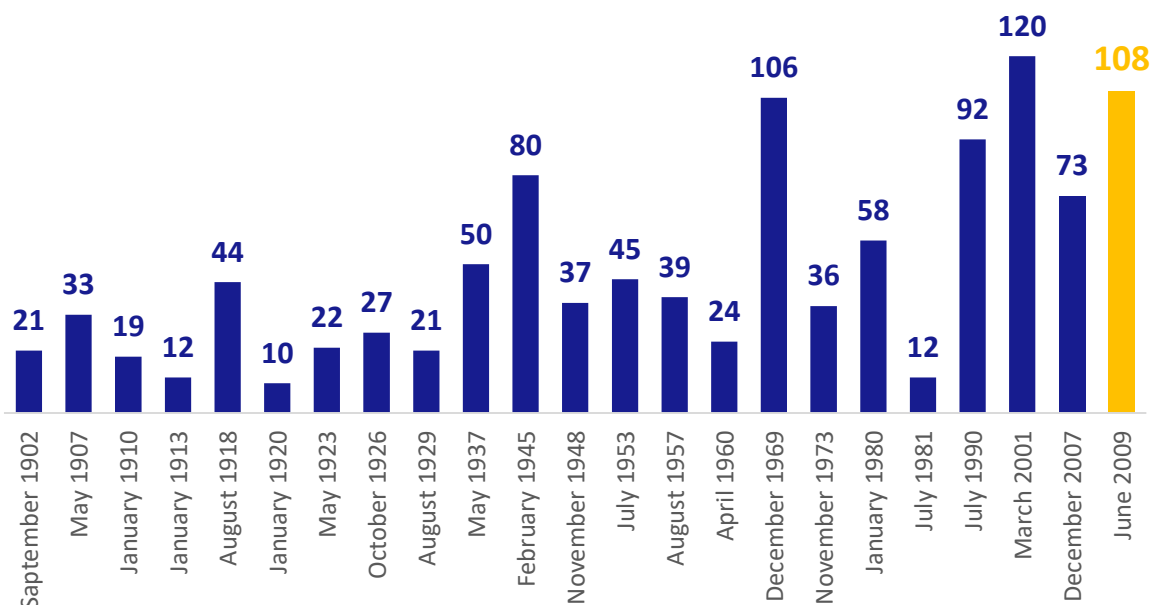


The current US expansion phase is the 2nd longest in its history

Since the Great Depression, the US has had 14 periods of economic expansion

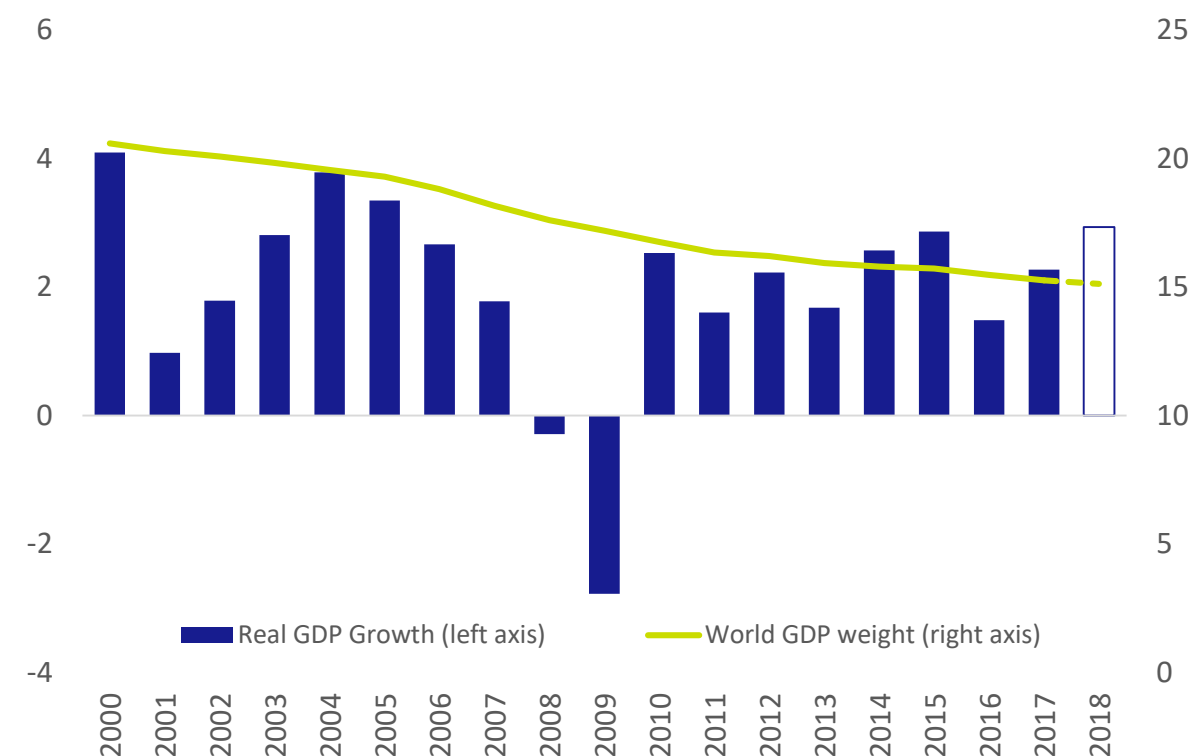
Length of economic expansion in the US

Months



US economic weight & economic growth

% of global GDP & annual change

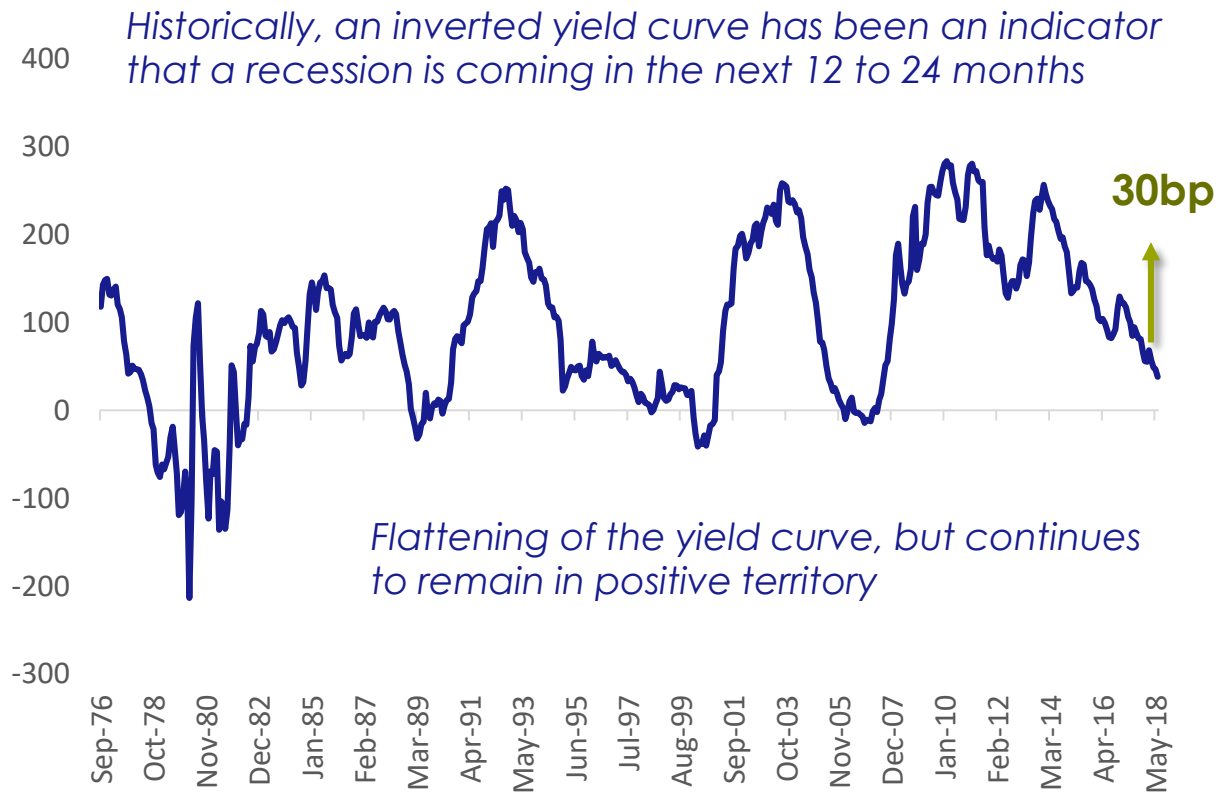


Since the recovery in 2010, the annual growth rate has been 2.3%

Although some leading indicators point to an unsettling possibility of the economy overheating

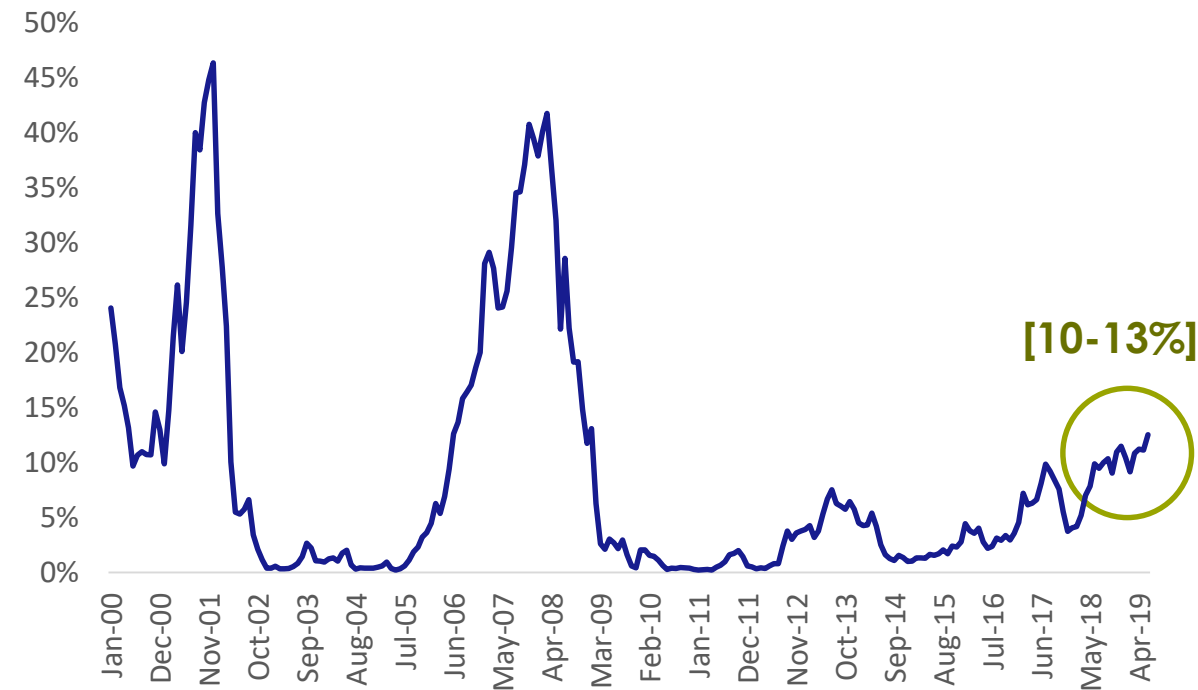
10Y/2Y US Treasury spread

%



Probability of recession in the US

% (next 12 months)

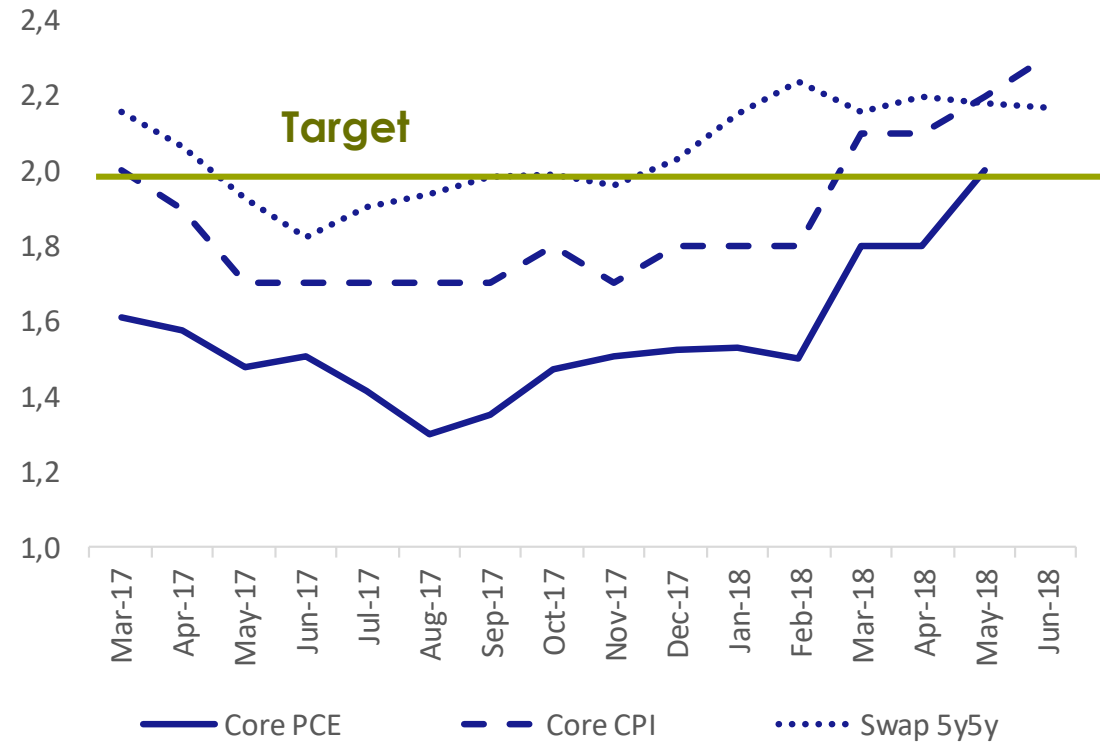


Inflation rate hits Fed goal

The indicator (core PCE*) that is most often followed by the Fed stands at 2% with an unemployment rate of 4%

US inflation indicators

Year-on-year change



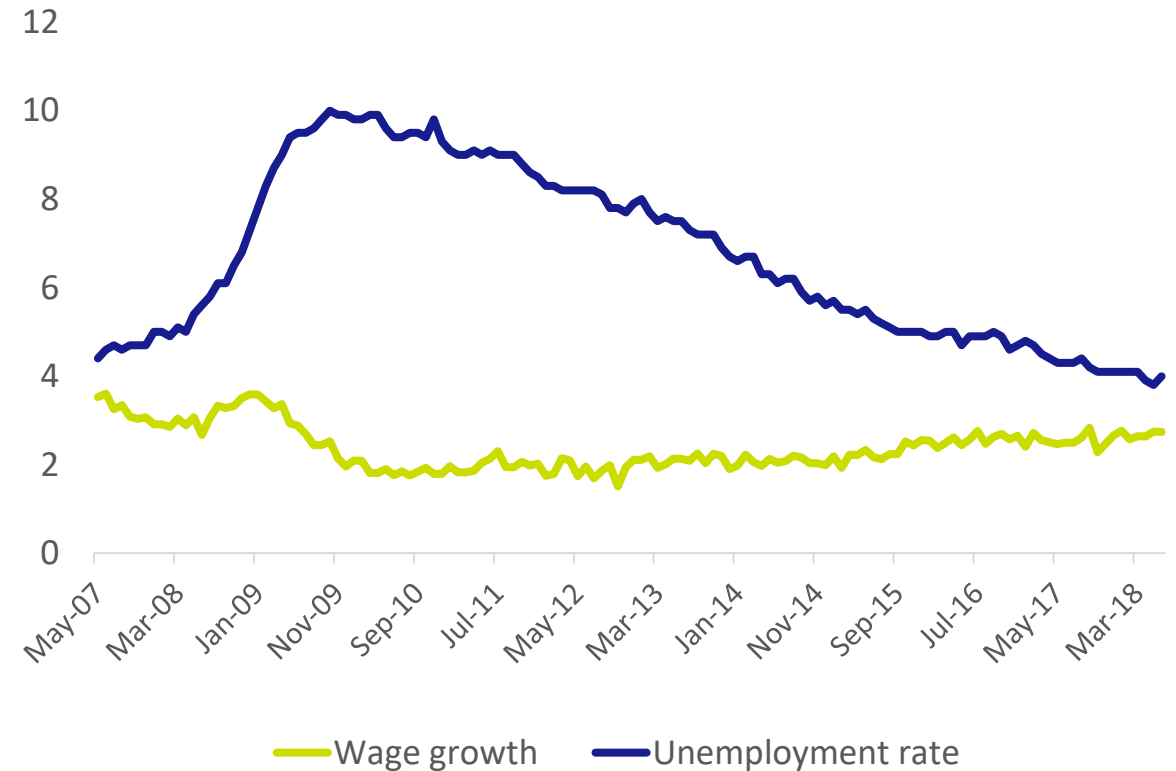
* Personal consumption expenditures excluding food and energy

Swap 5y5y: Measure of inflation expectations

Source: Círculo de Empresarios based on BEA, Focus Economics, & St. Louis Fed, 2018

US wage growth & unemployment rate

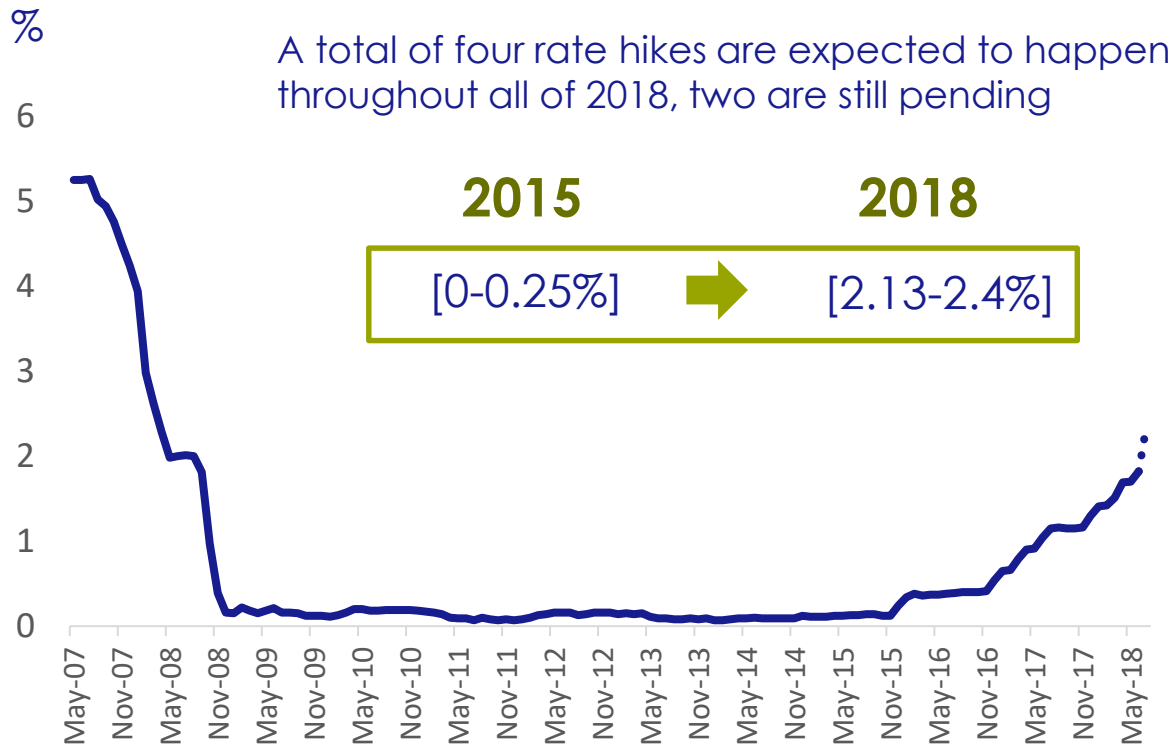
Year-on-year change, % of active population



The Fed increases the benchmark interest rate again

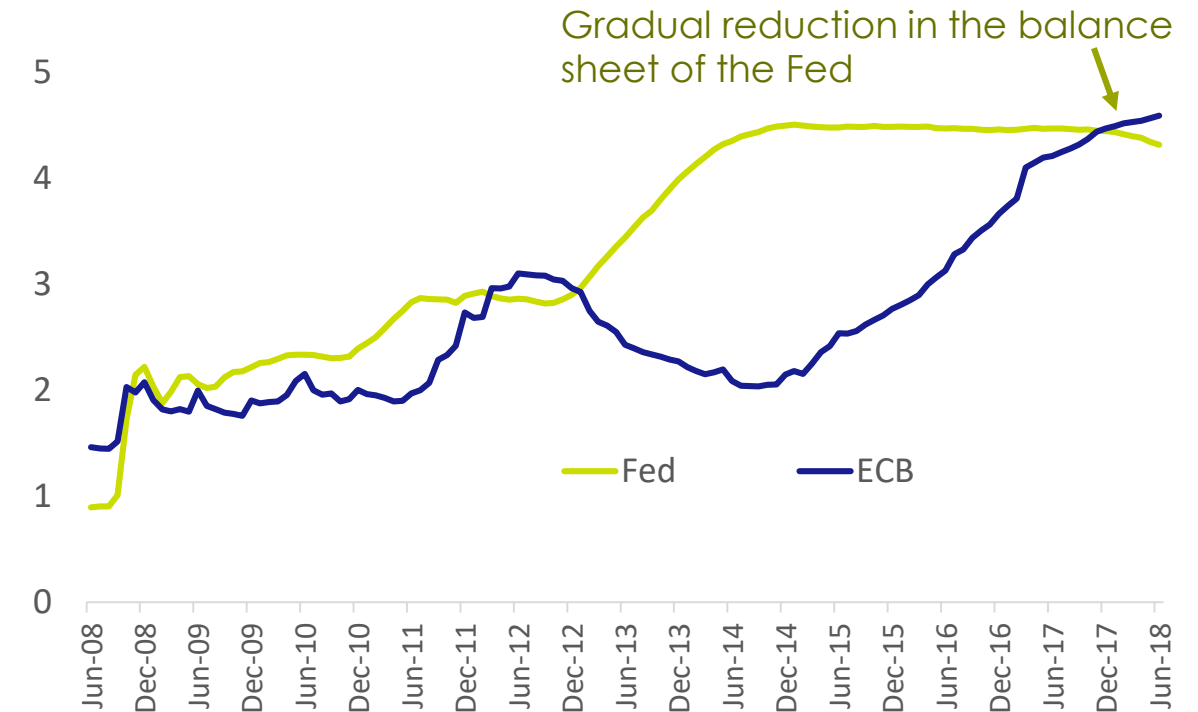
The Federal Reserve raises rates for the second time this year (2018) or the seventh time since the beginning of the **monetary policy normalisation**

Fed benchmark interest rates



Central bank account balance

\$ and € (trillion)

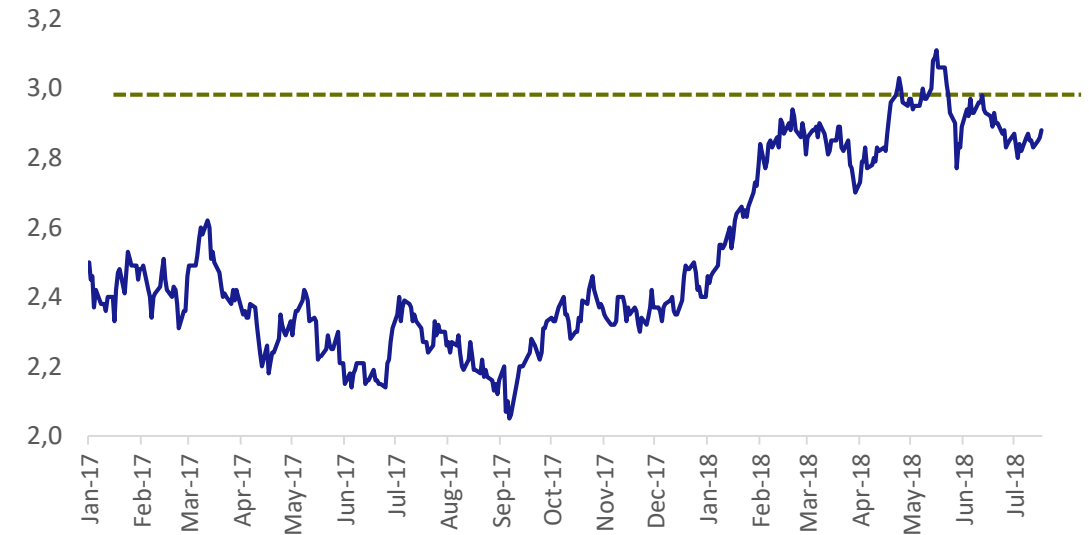


US 10-year Treasury yield climbs toward 3%

Causes...

- 1** The **core PCE** hits 2%, and the unemployment rate and growth are at robust levels
- 2** **Falling demand** for US government **bonds** on the part of **China** and the Fed
- 3** Supply of bonds increases due to **Trump's tax reform**, with a forecast that deficit widen from 3.9% of GDP in 2017 to 4.5% in 2019

Evolution of 10-year US bond (%)



US Treasury yield curve* (%)



* July 2018

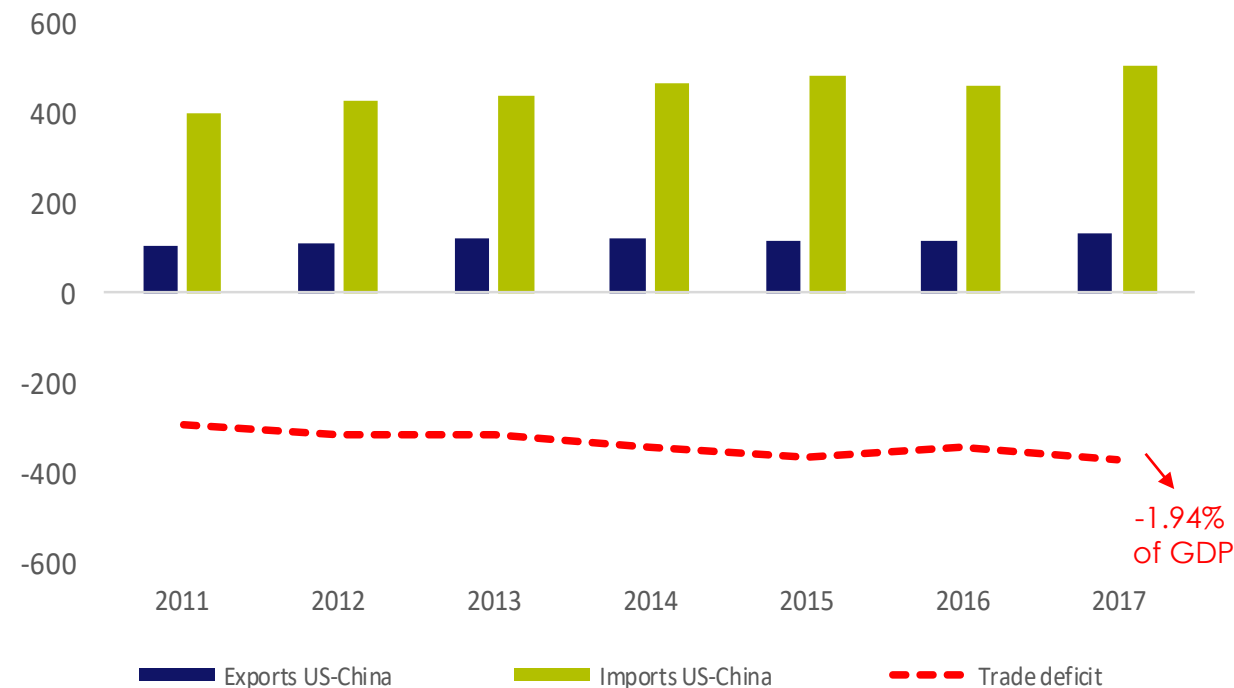
Source: Círculo de Empresarios based on Arcano & CBO, 2018

US: trade protectionism*

From January to May 2018, the deficit has widened with both China (+10% year-on-year) and with the EU (+15%)

US-China trade of goods

\$ billion



US-EU trade of goods

\$ billion

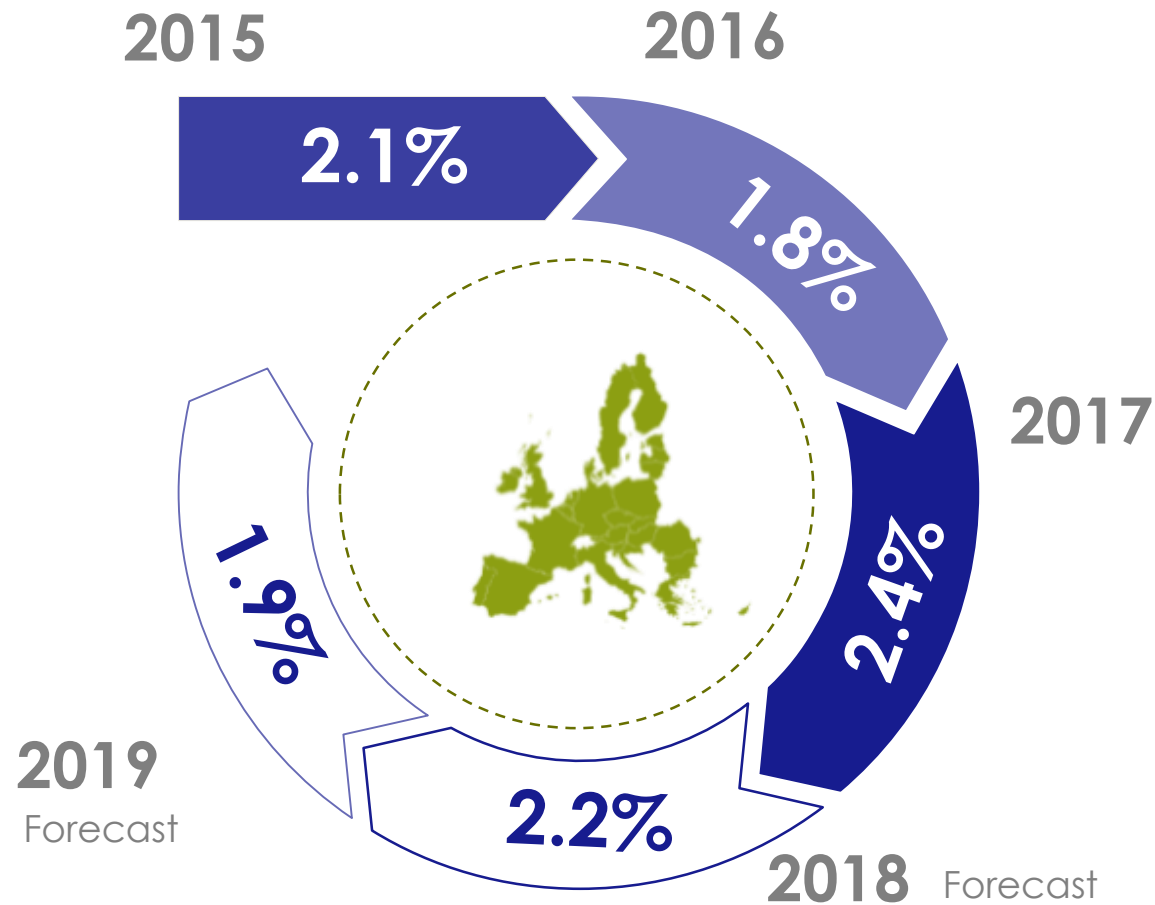


* In the last 50 years, global trade has gone from representing 10% of GDP to 60% of the world economy (BlackRock)

Source: Círculo de Empresarios based on BBVA Research, US Census, The Economist, Bruegel ,2018

Robust growth in the euro area with prospects on the decline in 2019

Real GDP growth (%)



Note: a darker colour represents greater growth

Source: Círculo de Empresarios based on IMF, July 2018



Growth enabling factors



Internal demand



Employment creation



Growth limiting factors



Ageing population & pensions



Low productivity & debt

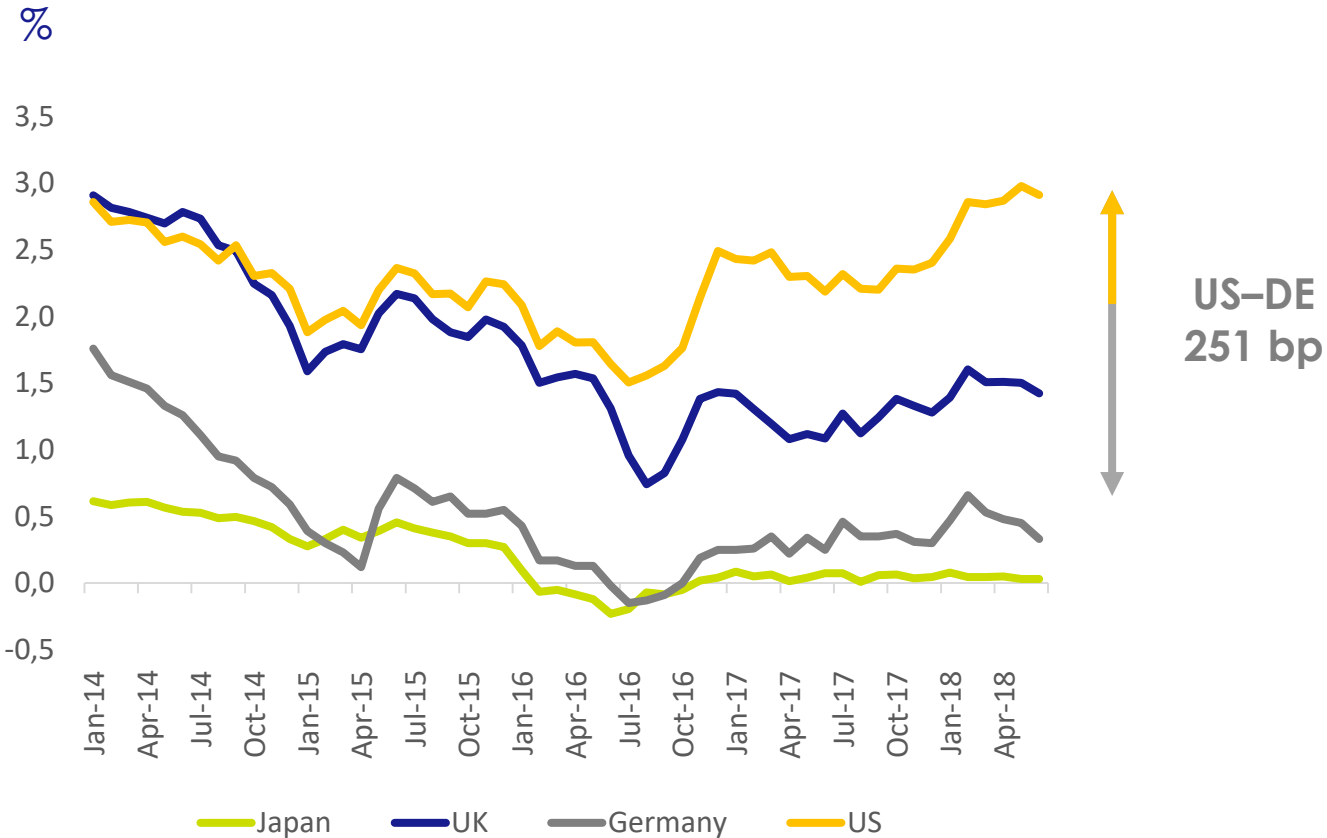


Euroscepticism

ECB: end of Quantitative Easing (QE) in December 2018

...while a stark divergence of the interest rate hikes between the ECB and the Fed is maintained, as observed in the debt issues

Yields on 10-year government bonds in advanced economies



ECB net monthly asset purchases



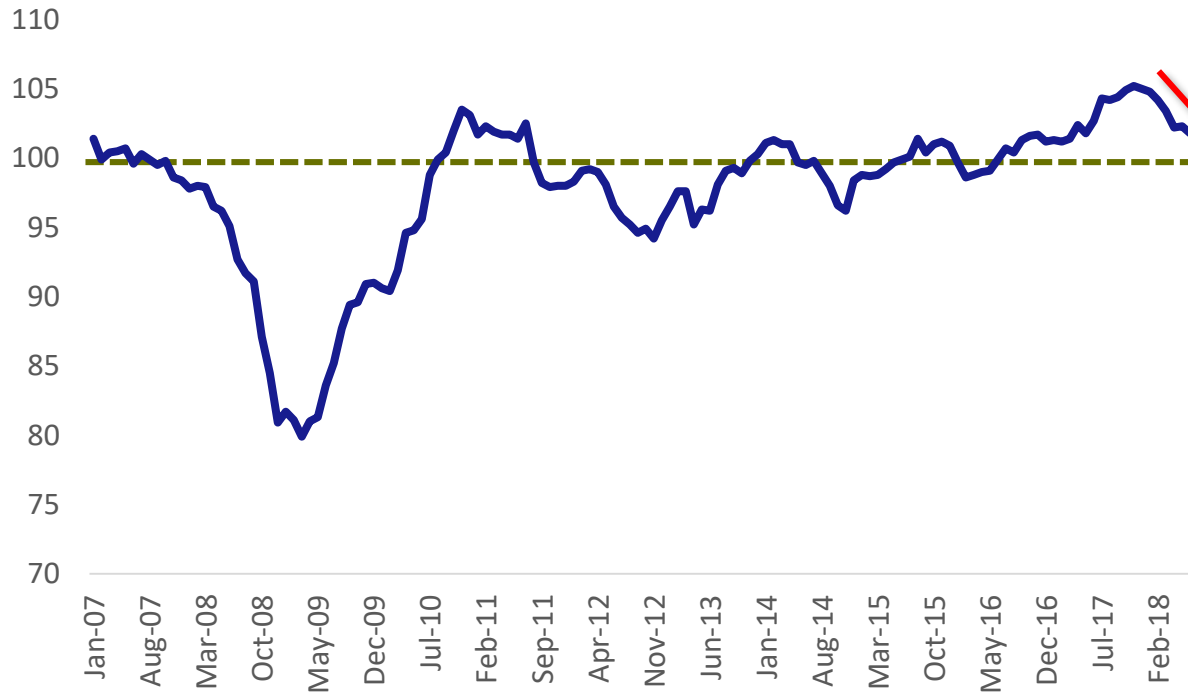
*“Interest rates will remain at their current level
until the summer of 2019” Mario Draghi*

Source: Círculo de Empresarios based on Bloomberg, 2018

Germany: business climate deteriorates

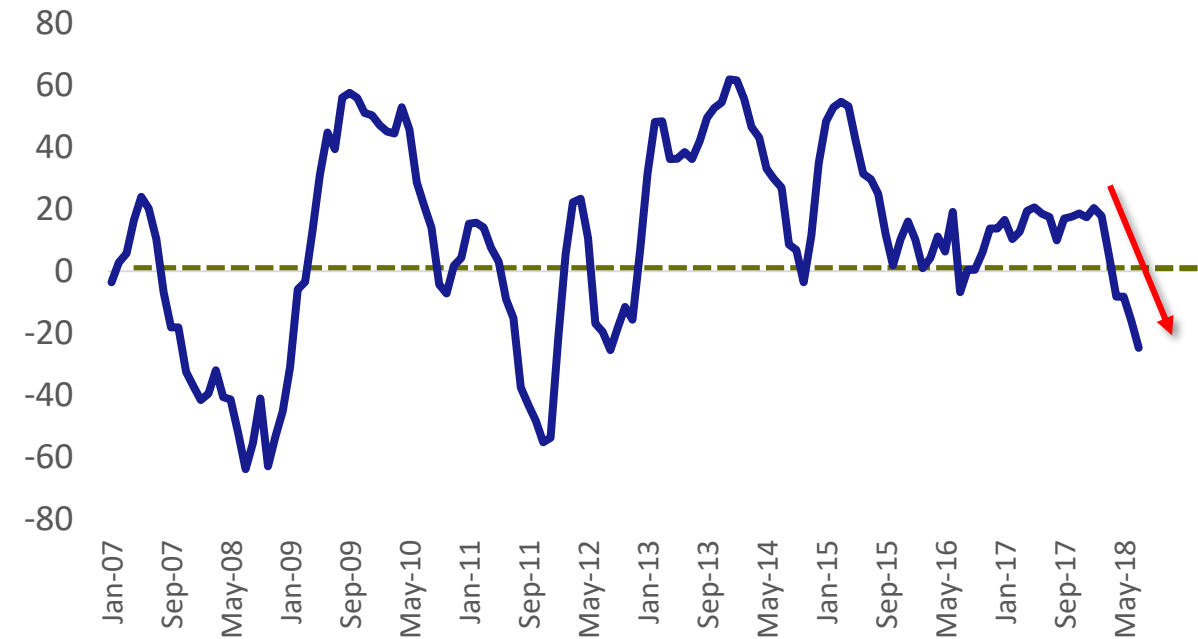
Escalating trade tensions with the US take a toll on business owner expectations

Ifo Business Climate Index, Germany



Note: the index value of 100 indicates the threshold between "good" and "poor" conditions.

Germany ZEW Economic Sentiment Index



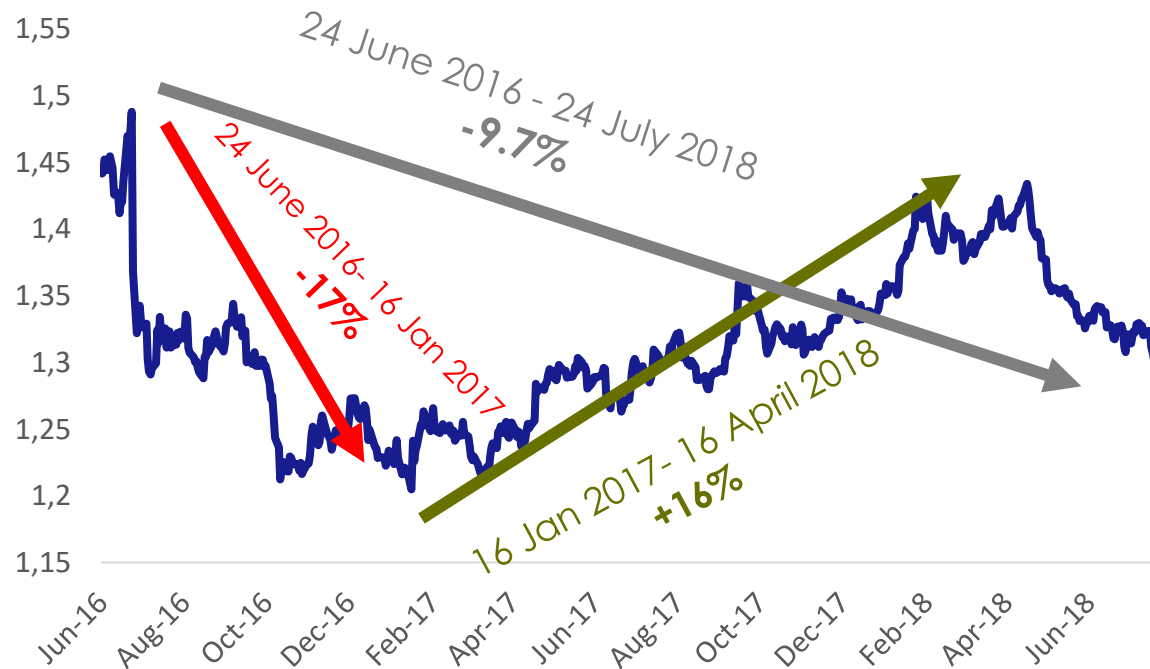
Note: a positive number means that the share of optimists outweighs the share of pessimists

Brexit: two years since the referendum in the UK (I)

Looming uncertainty remains over UK exit, especially after the resignations of Davis (Brexit secretary) and Johnson (Foreign secretary)

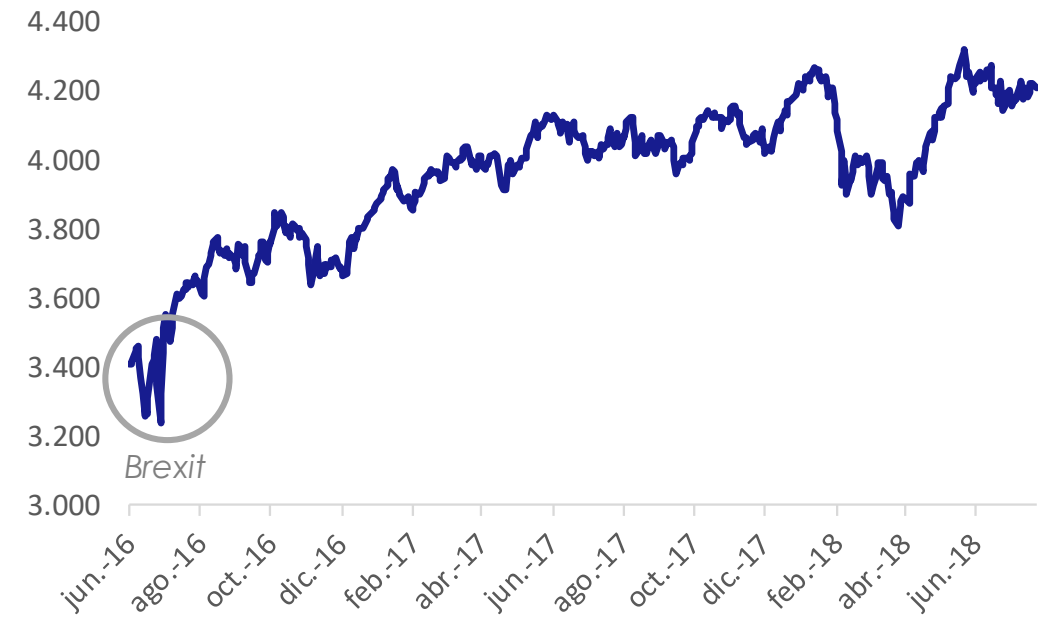
The impact of Brexit on the depreciation of the pound persists...

GBP/USD (Dollars per pound)



...which has boosted the growth of the stock market

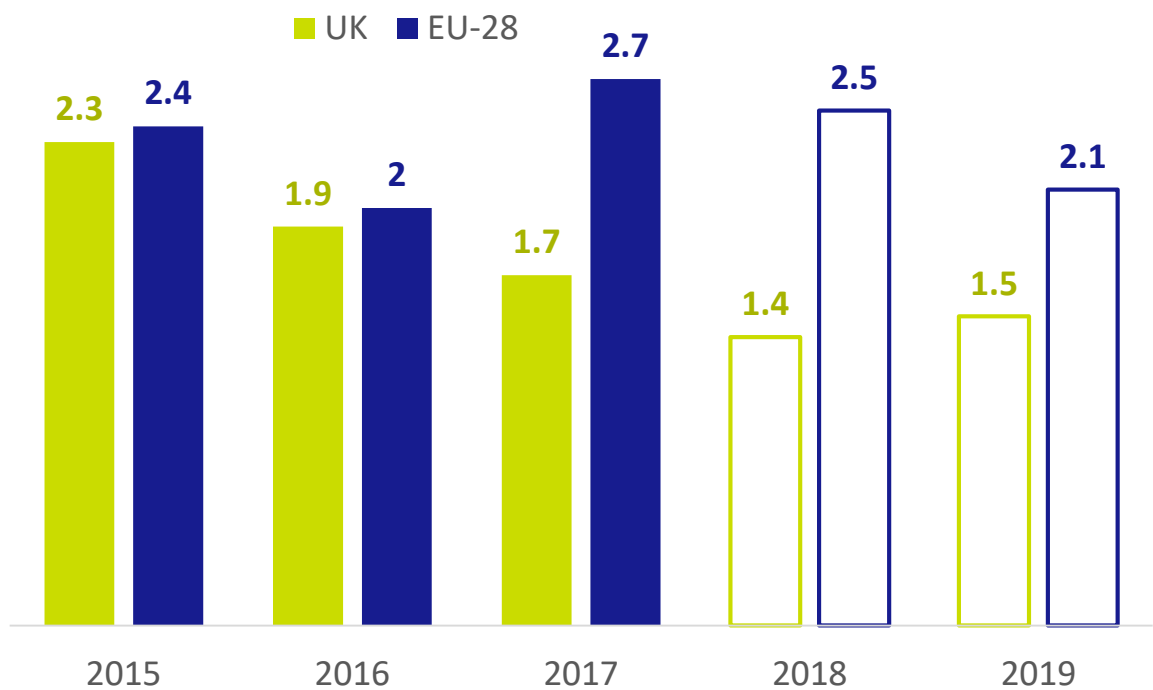
FTSE All-Share Index



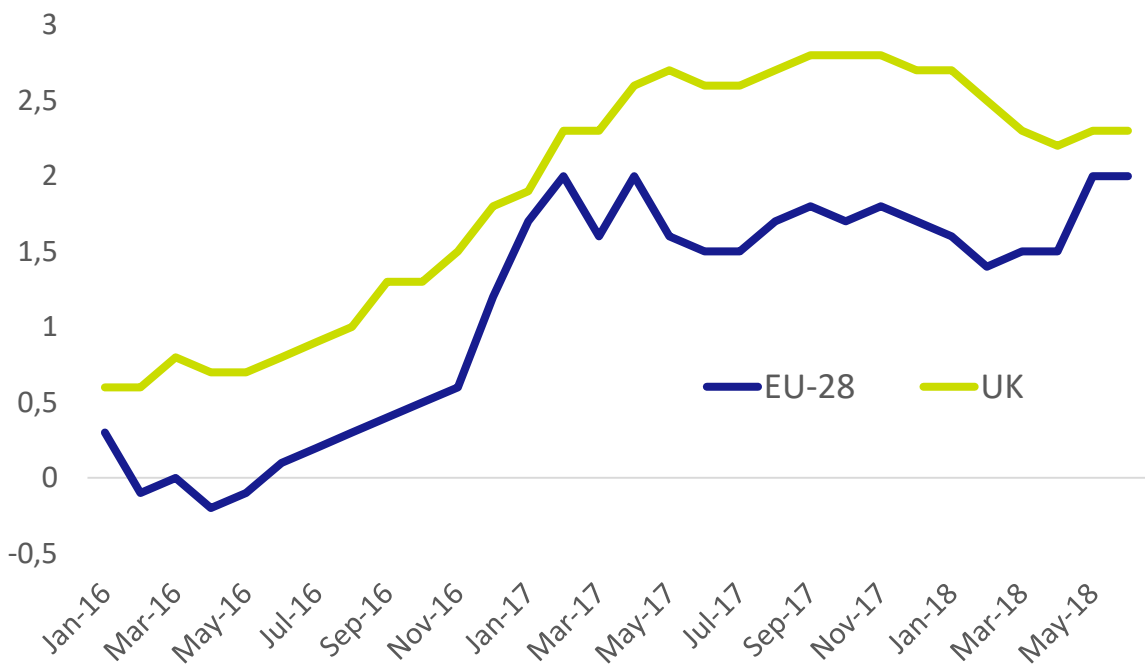
Brexit: two years since the referendum in the UK (II)

Negative impact on economic growth and inflation, conditioning its future to the terms of the final Brexit agreement

Real GDP growth
%



Rate of increase in prices
Annual change

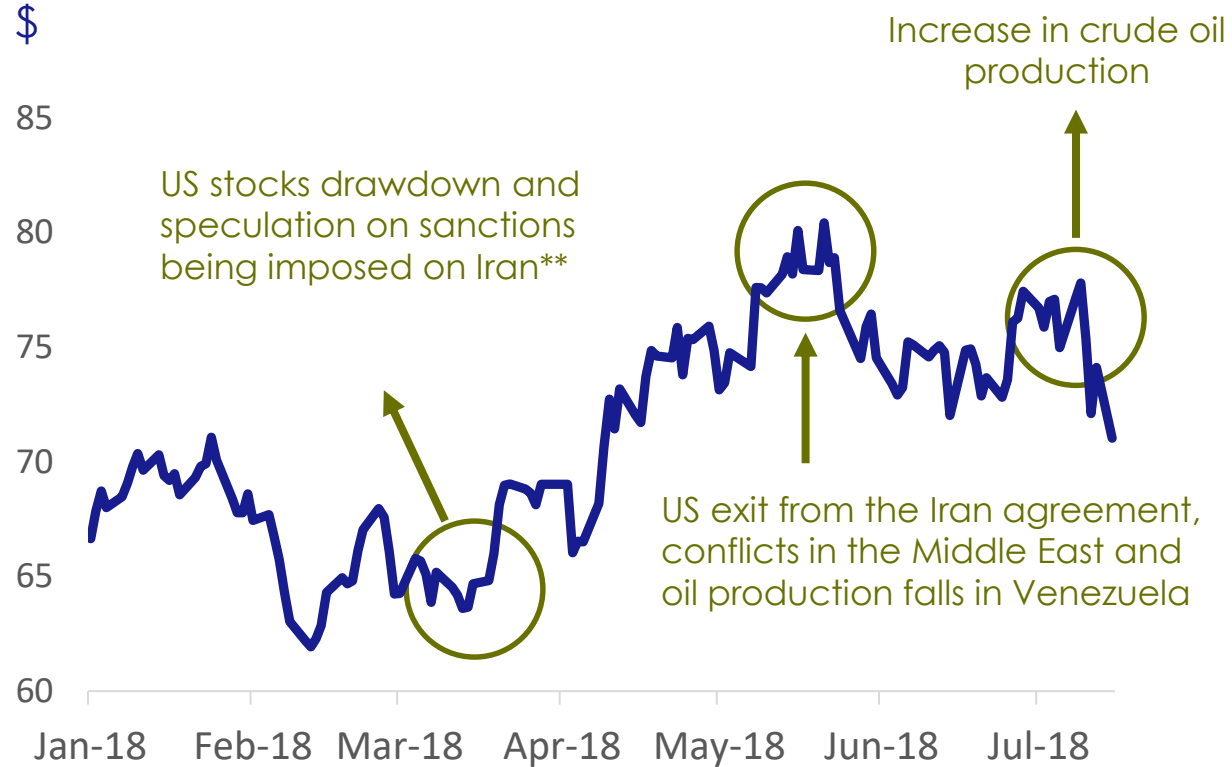


Source: Círculo de Empresarios based on OECD, IMF, 2018

Raw materials (I): oil prices on the rise

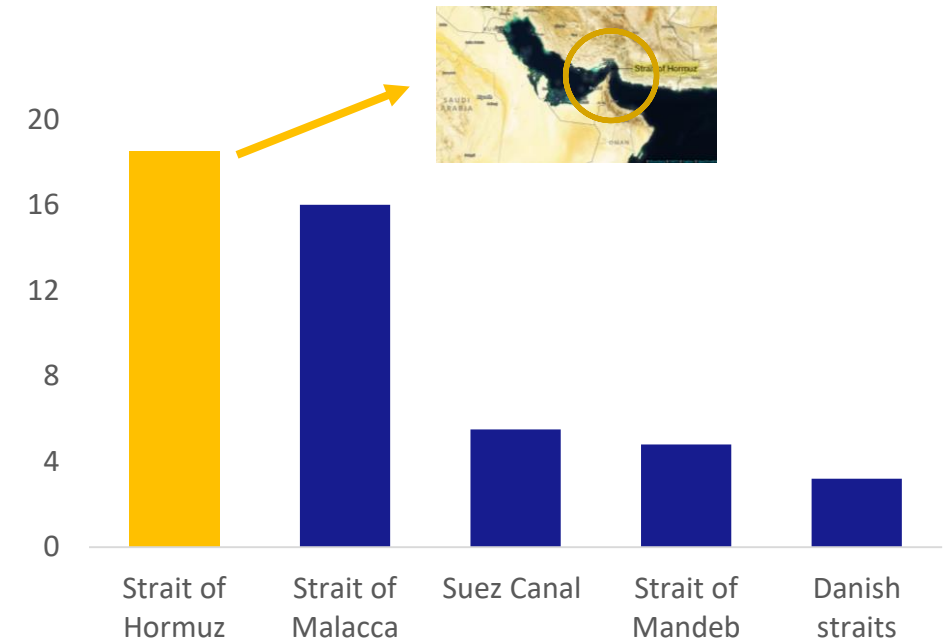
The actions of OPEC*, a greater global demand, and geopolitical instability condition the movements in oil price

Brent barrel spot price



Also, in the face of US sanctions, **Iran** has threatened to block the **Strait of Hormuz** (30% of global crude oil traffic)

Oil traffic (millions of barrels per day)



*OPEC accounts for approximately 70% of total oil reserves (BP)

**OPEC's third-largest producer

Source: *Círculo de Empresarios* based on EIA & Bloomberg, 2018

Currency market: dollar strength

The dollar appreciates against the main currencies of advanced and emerging economies

Main causes...

- 1 Solid **economic growth** in the US
- 2 **Interest rate** hikes by the Fed
- 3 Repatriation of foreign profits made possible by the **tax reform**

Weight of the dollar in the International Monetary System % of total

Debt and
international loans

60%

Forex market
transactions

43.8%

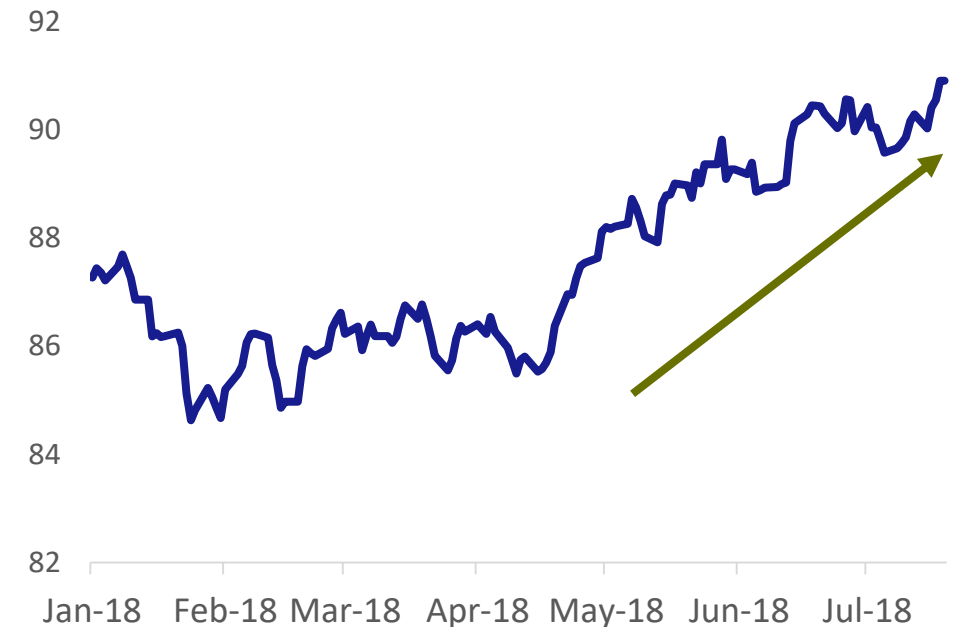
Means of
payment

39.9%

Reserve
currency

62.7%

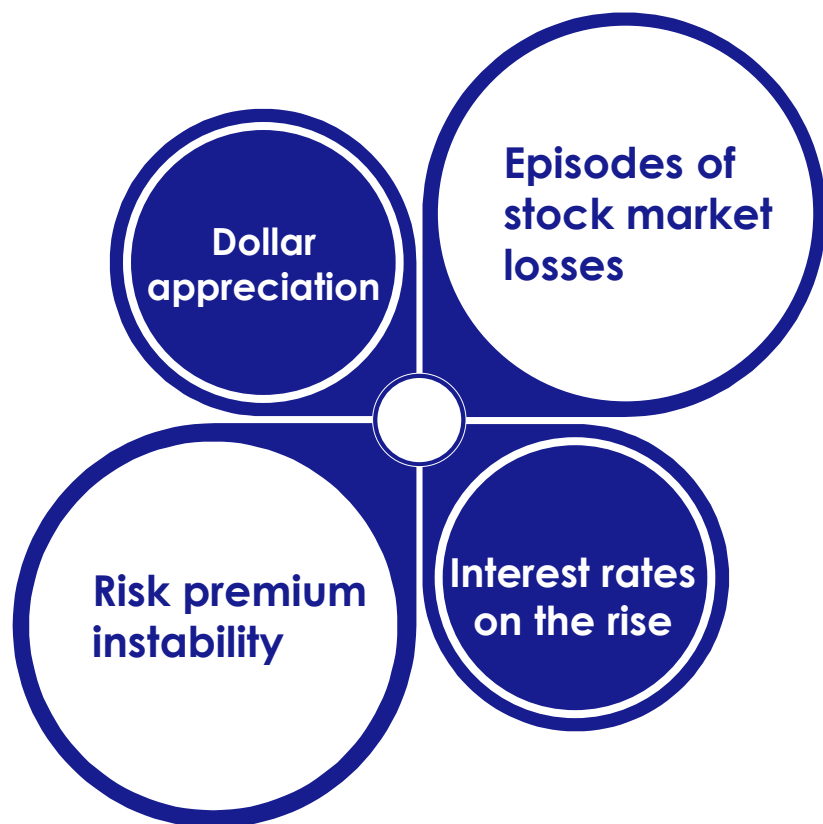
Exchange rate of the dollar against the major currencies of advanced economies (1975=100)



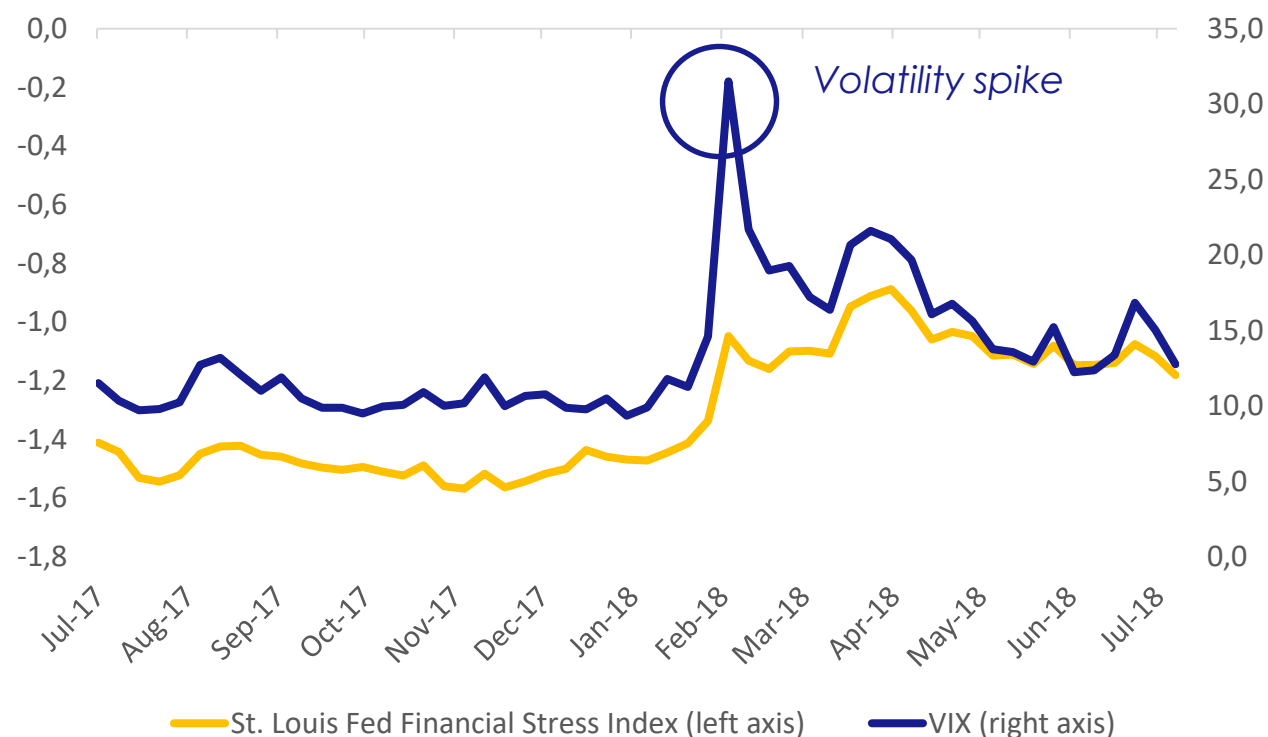
Financial markets (I)

Uncertainty increases financial instability

In the last 6 months, in the financial markets ...



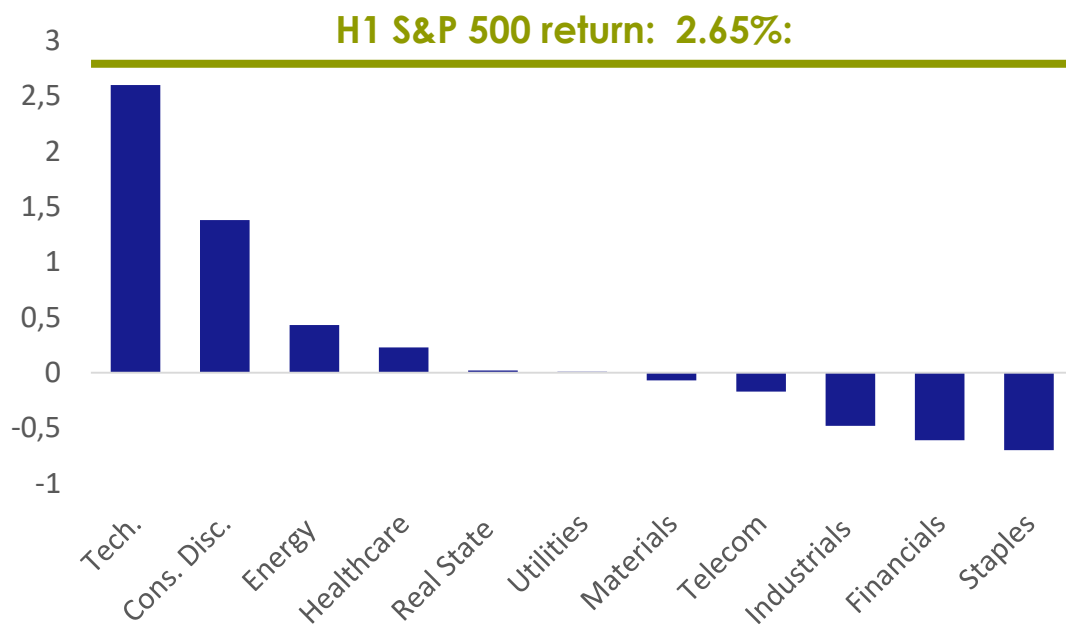
Financial conditions of financial markets



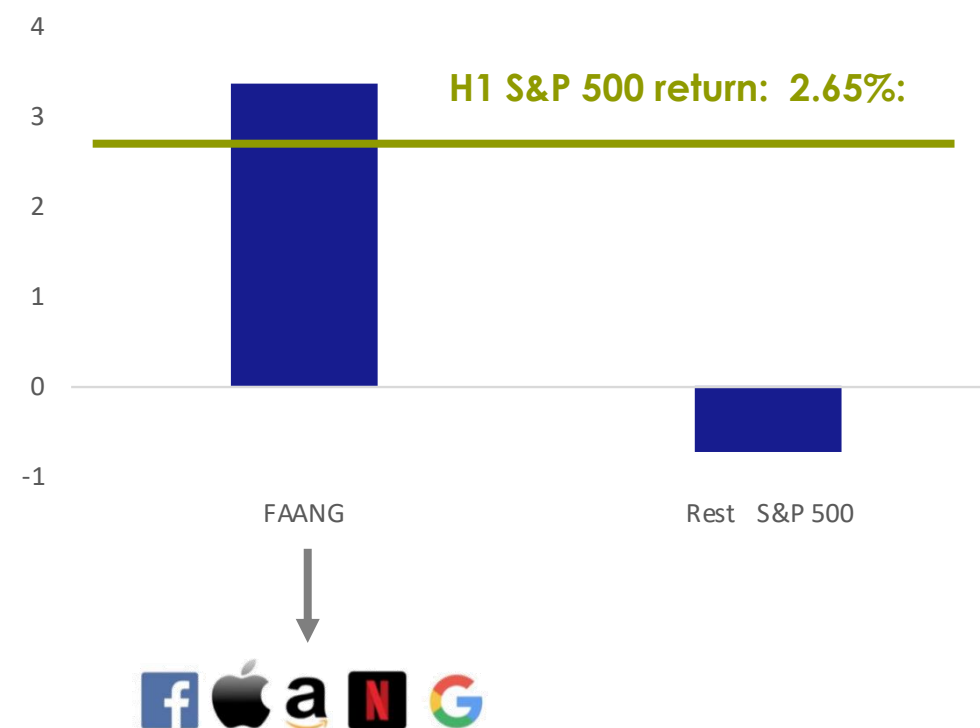
Financial markets (II)

Technology companies spearhead the stellar rise in US stock markets
(98% of the rise of the S&P 500 in H1 2018)

Contribution to the S&P 500 return, by sectors
H1 2018, %



Contribution of the FAANG to the S&P 500 return,
H1 2018, (%)



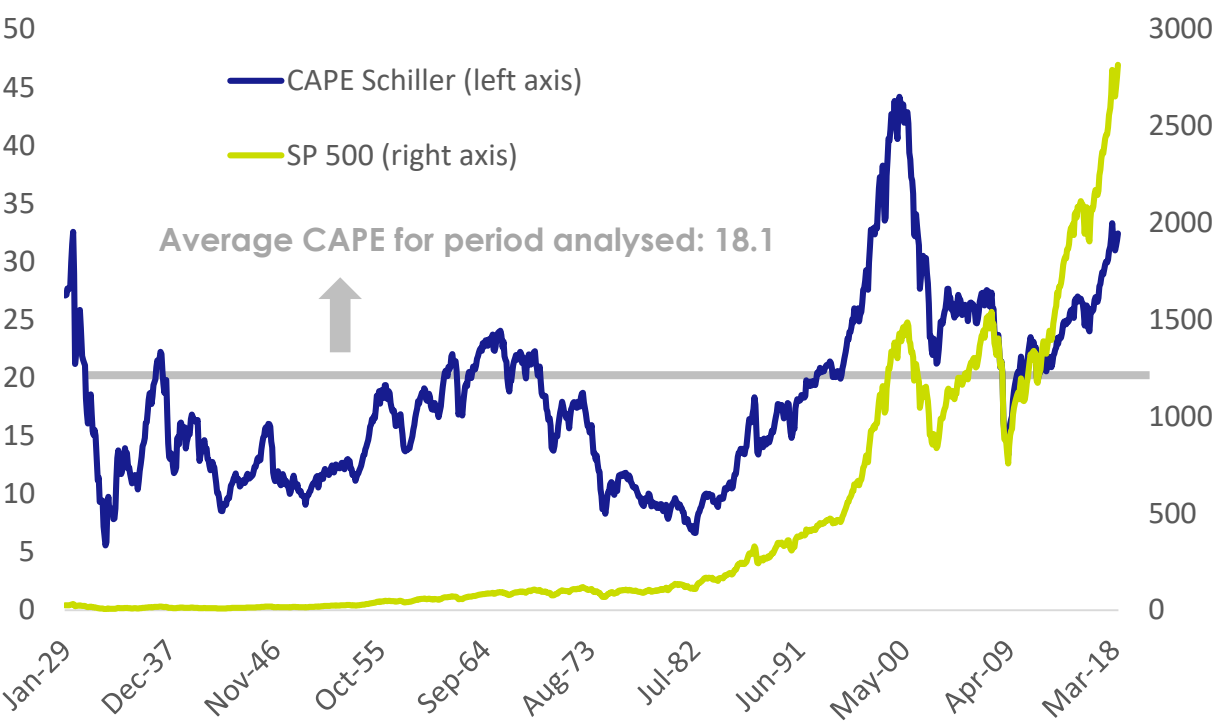
FAANG: Facebook, Apple, Amazon, Netflix, & Google

Source: *Círculo de Empresarios* based on S&P, Bank of America Merrill Lynch US Equity, 2018

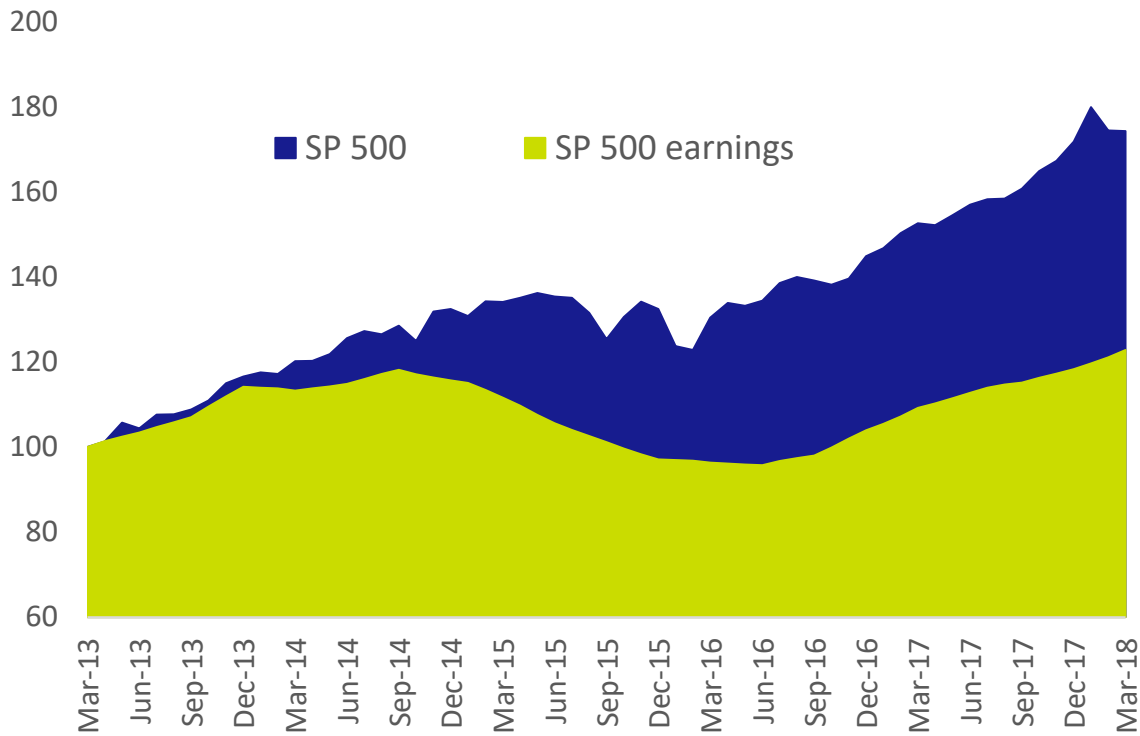
Financial markets (III)

Valuations higher than the historical average, although the earnings of S&P 500 in Q1 grew at their fastest rate in seven years

S&P 500 and CAPE (Cyclically Adjusted Price-to-Earnings ratio*)



S&P 500 growth vs S&P 500 Real Earnings Growth
March 2013=100



*CAPE Shiller: relation between the price of stock market and the average of 10 years of earnings adjusted for inflation

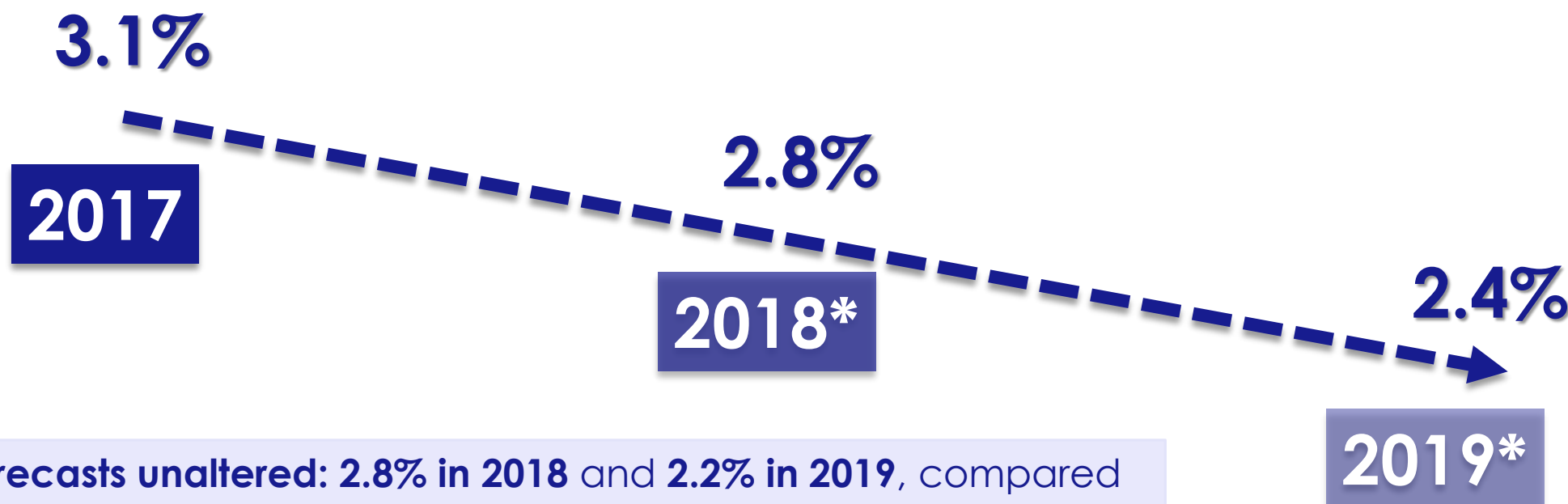
Source: Círculo de Empresarios based on Yale, 2018



SPAIN

Growth forecast at a slower rate

The **European Commission** has reduced Spain's growth by one-tenth for **2018** to **2.8%**, maintaining the figure for **2019** at **2.4%**



IMF forecasts unaltered: 2.8% in 2018 and **2.2% in 2019**, compared to the three-tenths downgraded for France, Italy and Germany

The **Spanish government upholds** its **forecasts** for **2018 (2.7%)** and **2019 (2.4%)**, while reducing them for 2020 (2.2%) and 2021 (2.1%)

* Forecast

Source: *Círculo de Empresarios* based on European Commission & IMF (WEO Update, July), 2018

Factors that curtail growth



- **Paralysis** of the **reform impulse** in the wake of a **minority government** and the near future **electoral period**
- Impact of the **easing** on the **fiscal consolidation policy**
- Persistent **structural unemployment**
- **Stagnation** of **productivity**
- Announcement of **increase** in **corporate tax**
- **Monetary policy normalisation**
- Impact of **inflation** on the **purchasing power**
- **Rise** in the **prices** of **raw materials**

Domestic demand sustains growth and the contribution of the external sector has slowed

Q1 2018

Year-on-year GDP growth= 3%

+ 2.8 pp contribution to growth

Domestic demand

% year-on-year change

- Private consumption = 2.8%
- Public consumption = 1.9%
- Gross Capital Formation = 3.5%

+ 0.2 pp contribution to growth

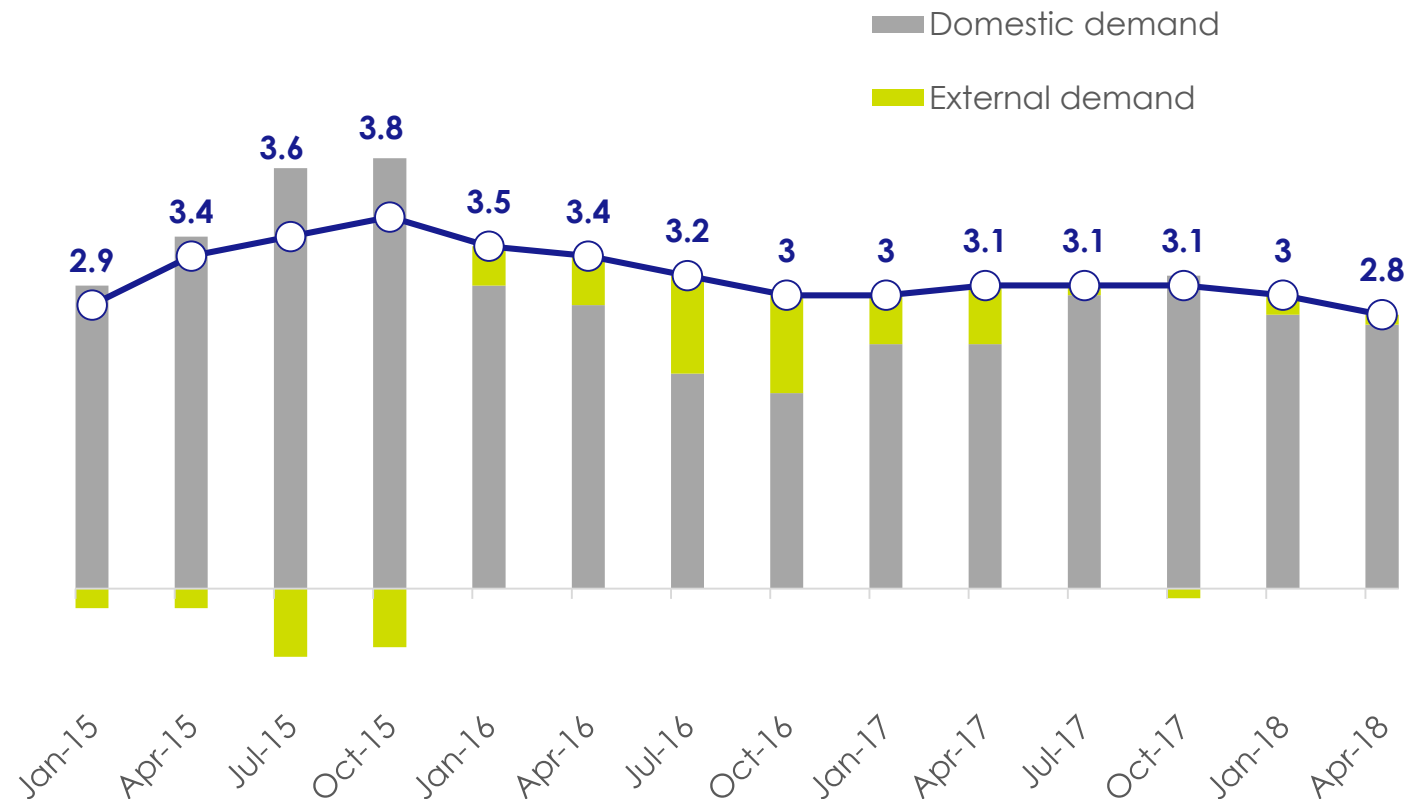
External demand

of goods and services
% year-on-year change

- Exports = 3.2%
- Imports = 2.8%

In April, growth eased = 2.8% year-on-year

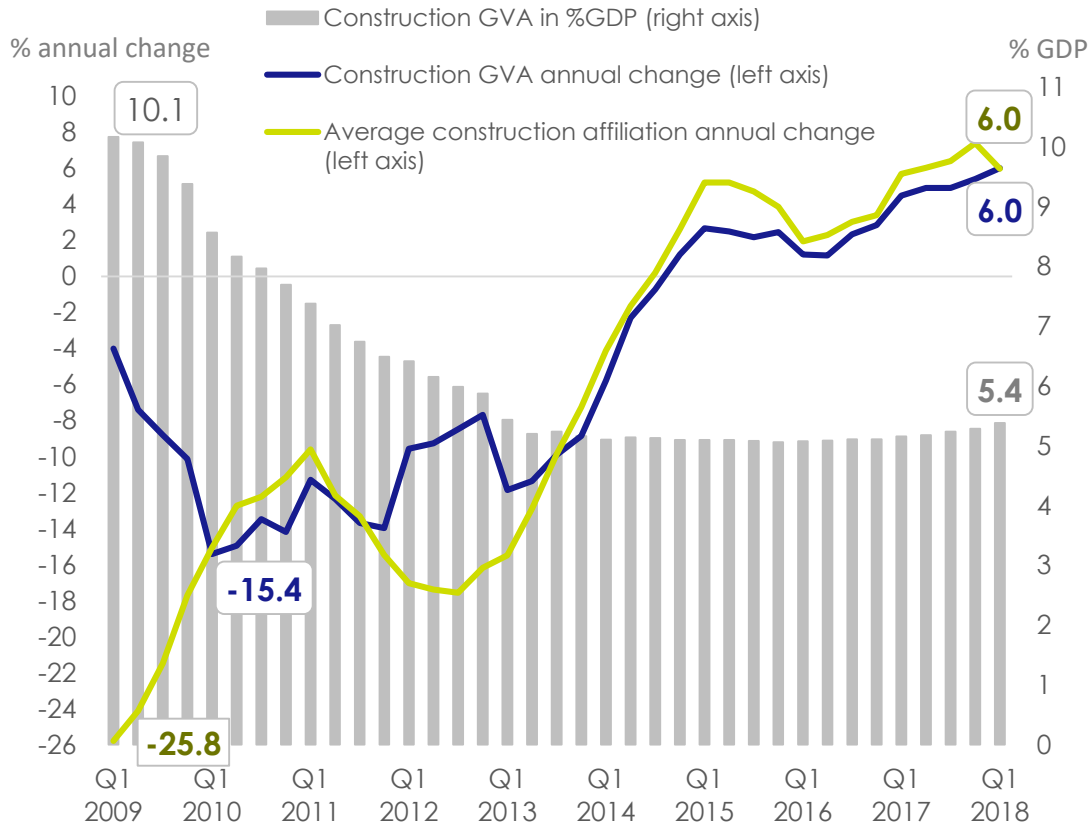
GDP (year-on-year change) and contribution of domestic and foreign demand (pp)



The construction sector and the residential market recover

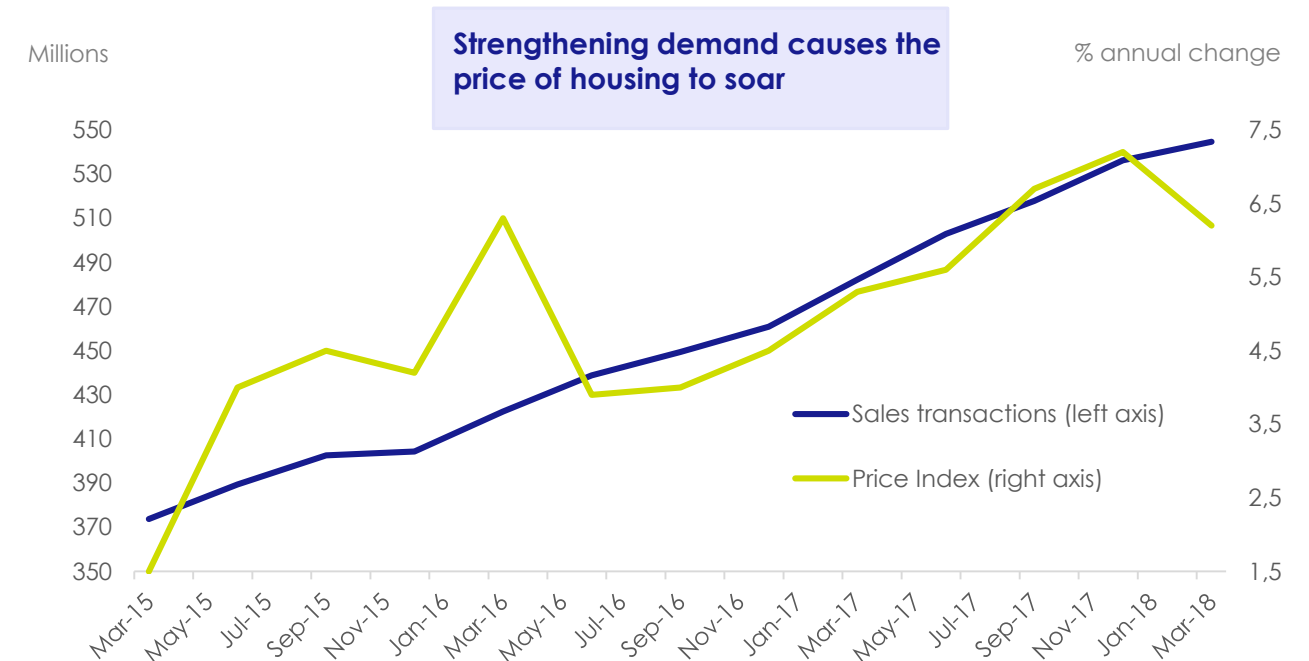
Evolution of the construction sector

% of GDP and annual change



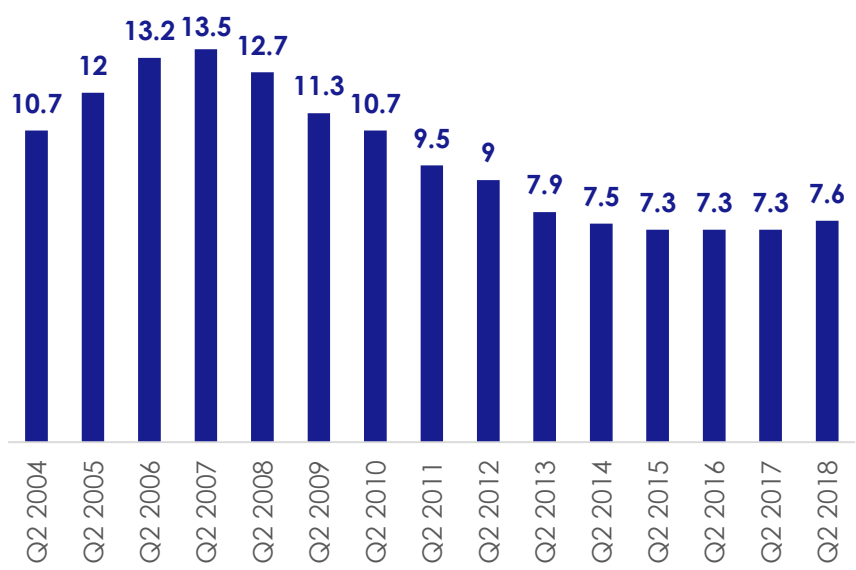
Evolution of sales transactions and the price of housing

Millions and % change year-on-year



The real estate effort* is greater in the Balearic Islands, Catalonia, and Madrid

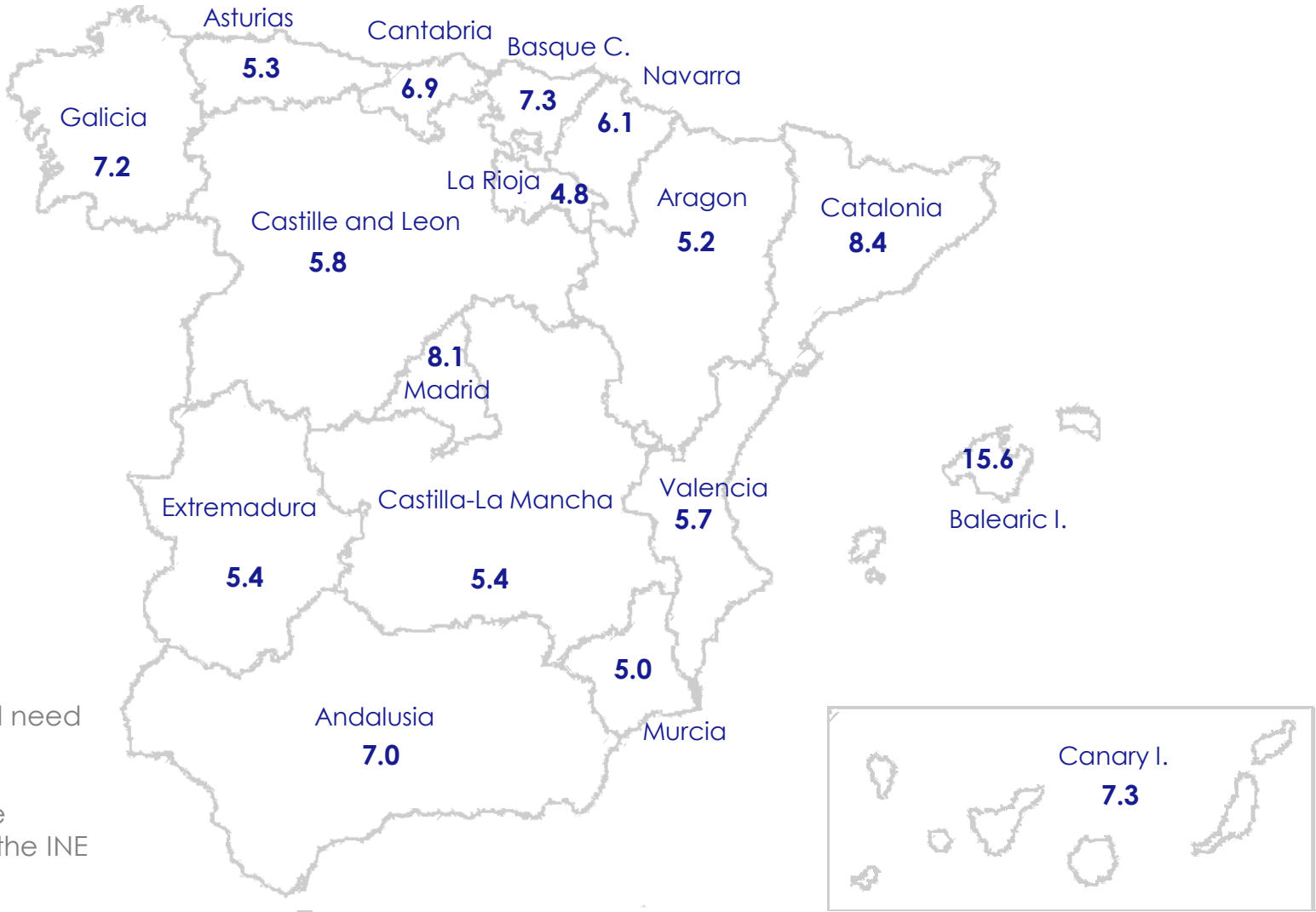
National total



* Real Estate Effort Index

Number of years of full salary that an average citizen would need to allocate for the purchase of a medium-sized home

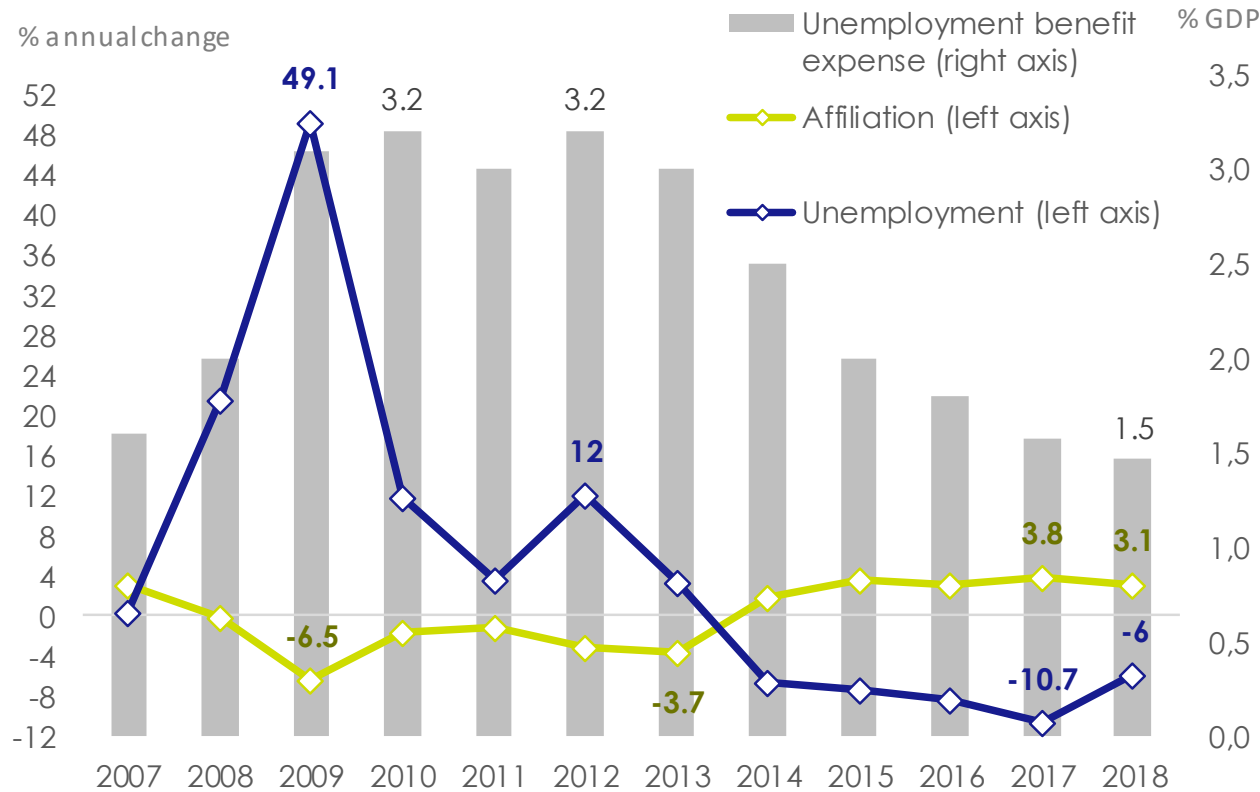
It is calculated using the quotient of the market value of the home and the gross annual average income published by the INE (Wage structure survey)



Job creation drops off

Evolution of affiliation, registered unemployment and unemployment benefit expense

% change year-on-year June/June and % of GDP



- In June, **the pace of unemployment reduction and affiliates growth** in year-on-year terms slows down
- From **all-time highs in 2013**, with more than 5 million unemployed, **unemployment has fallen by almost 2 million to 3.16 million**
- At the same time, **unemployment benefits expenses have been reduced since 2013**
- **2.63 million more affiliates** than 5 years ago, up to a total of 19 million
- The **affiliates-pensioners ratio** has recovered to **levels of 2016**, standing at **2.29**

Unemployment rate falls (LFS Q2 2018)

Unemployment rate & evolution of the number of employed

% of active population & number of people (thousands)



Q2 2018 vs Q1 2018

- The **unemployment rate** fell by 1.46 points to **15.28%** of the active population, to a total of **3,490,100 unemployed people**
- The **number of employed** people increased by 469,900 people (+2.49%) to **19,344,100**
- **79% of the increase** in employment is concentrated in the **service sector**

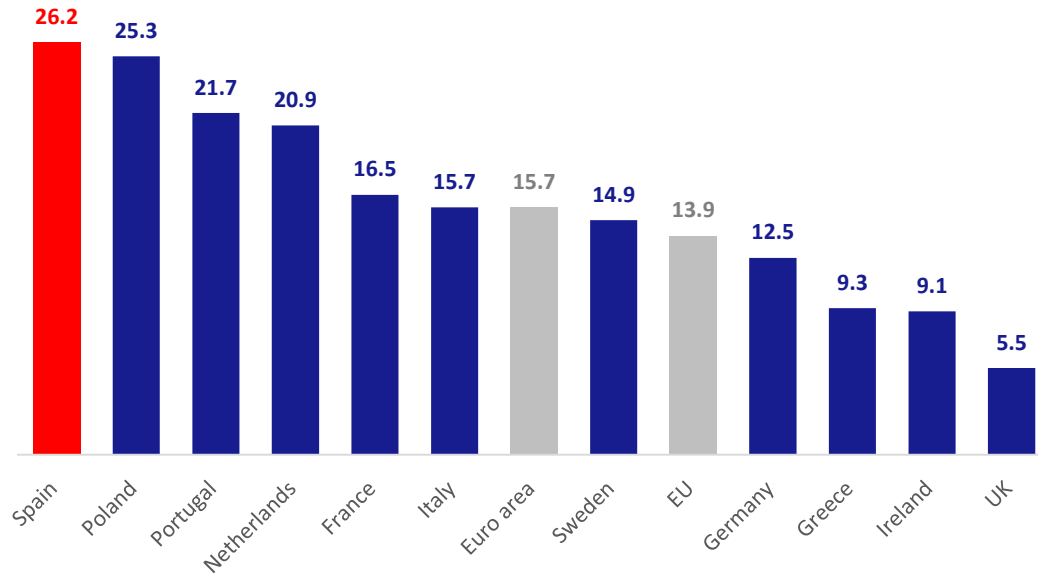
In **year-on-year** terms, **unemployment was reduced** by **424,200 people** and **530,800 jobs were created, 21.5% in the public sector**

The lack of reforms allow for duality to exist in the labour market in Spain

Spain is the EU country with the highest rate of temporary contract employment: 26.2%

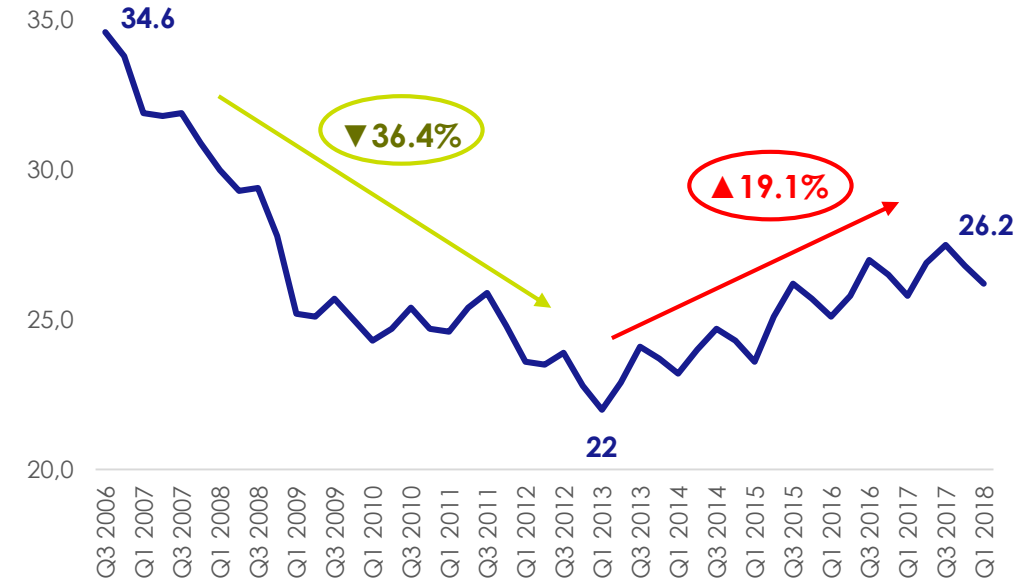
Rate of temporary employment

% of employed aged 16 to 65 years



Evolution of rate of temporary employment

% of employed aged 16 to 65 years

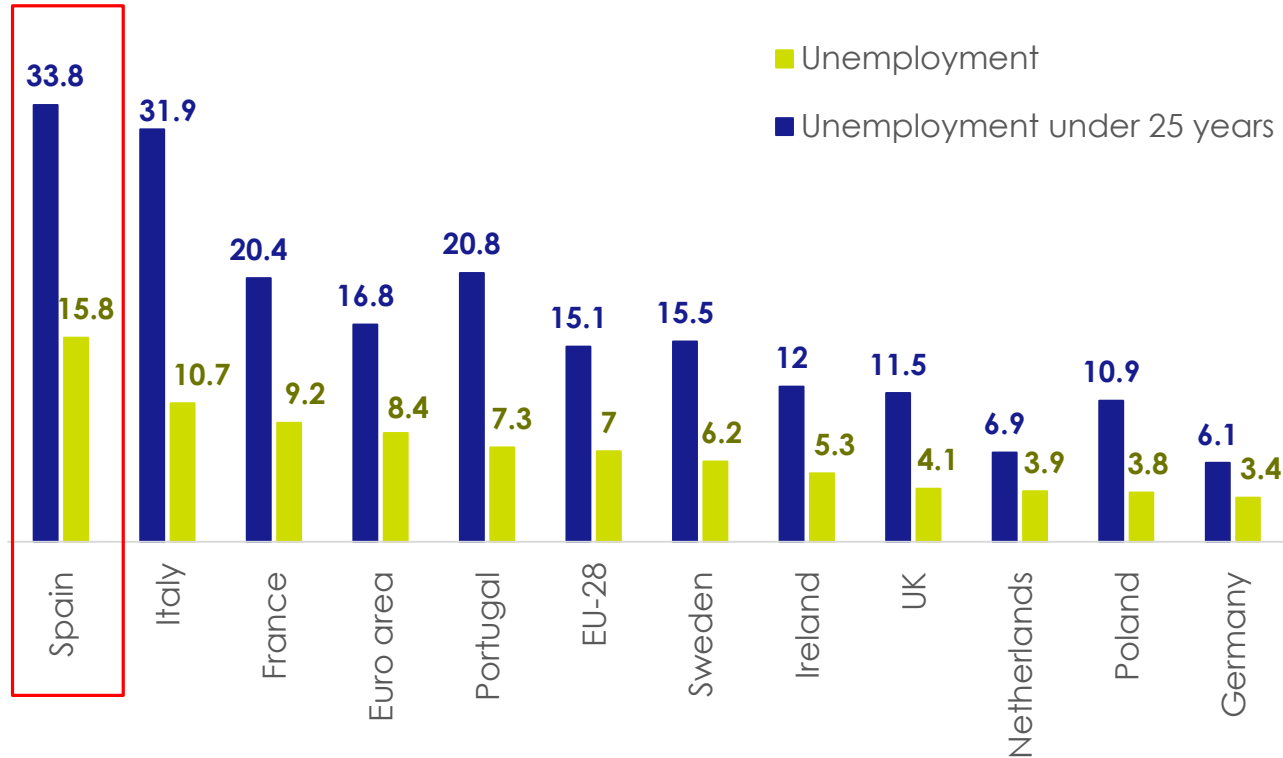


Source: Círculo de Empresarios based on Eurostat, 2018

And unemployment continues to double the euro area average




Unemployment EU 28

May 2018, % over active population



Spain continues to have very high rates of unemployment

2nd country of the EU 28 in total and youth unemployment after Greece

		<u>Total</u>	<u>< 25 years</u>
	<u>Greece</u>	20.1%	43.2%
	<u>Spain</u>	15.8%	33.8%
	<u>Italy</u>	10.7%	31.9%

Source: Círculo de Empresarios based on Eurostat, 2018

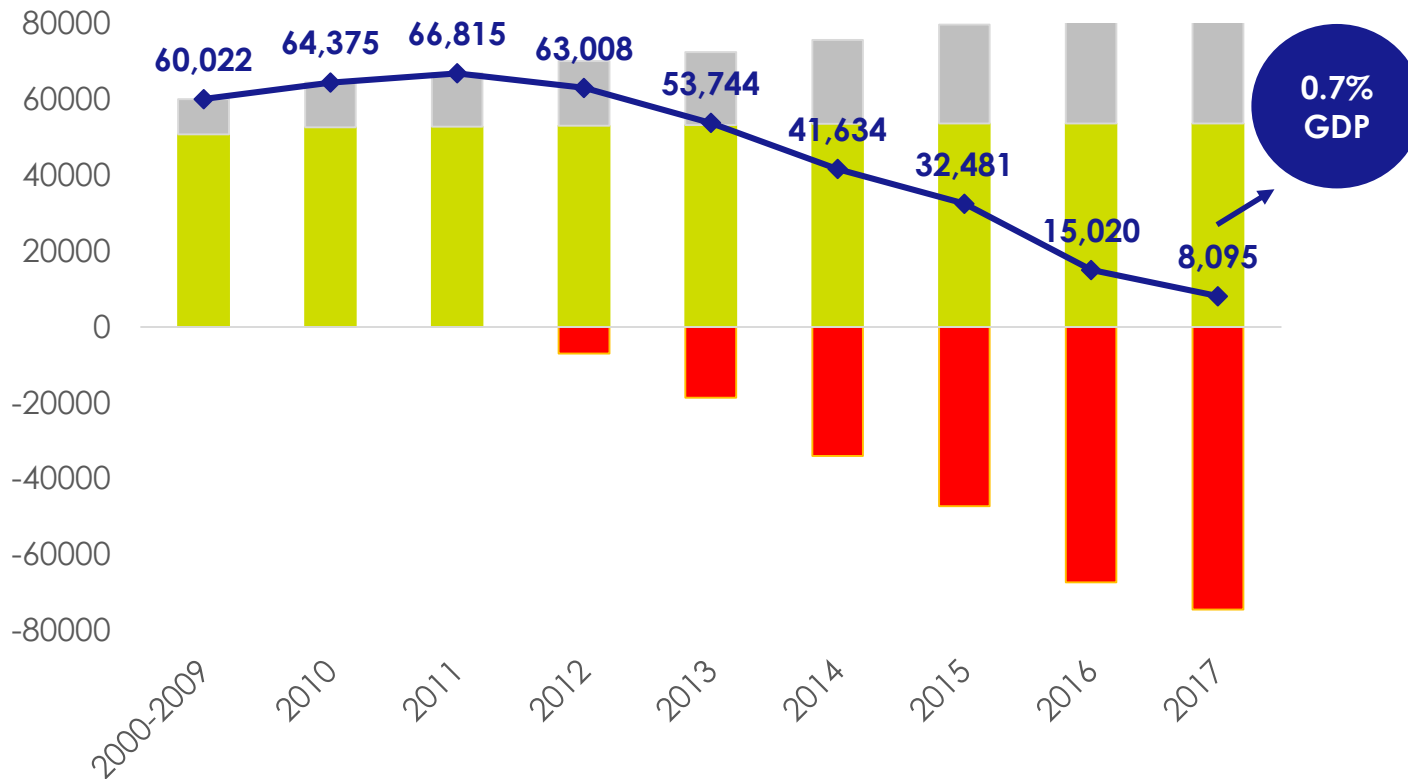
The Social Security Reserve Fund is running out

Accumulated balance of the Social Security Reserve Fund

Millions € (at acquisition price)

Position at year end 31 December of each FY

Endowments(1) Withdrawal(2) Yield(3) Balance



Between **2000 & 2017, €94.2 billion** have been used **along with the SS contributions** to pay pensions:

- **Provisions of the Reserve Fund:** €74.4 bn
- **Surplus from the Contingency Reserve Fund:** €9.6 bn
- **Loan of the Treasury** to the Social Security **in 2017:** €10.1 bn (€5.9 bn in July & €4.2 bn in December)

In 2018, a new loan of €15.1 billion is requested

(1) From its creation in 2000 to December 31, 2017

(2) From 2012 to December 31, 2017

(3) Since its creation in 2000 until December 31, 2017.

Profitability accumulated in the period stands at 4.27% in annualized terms

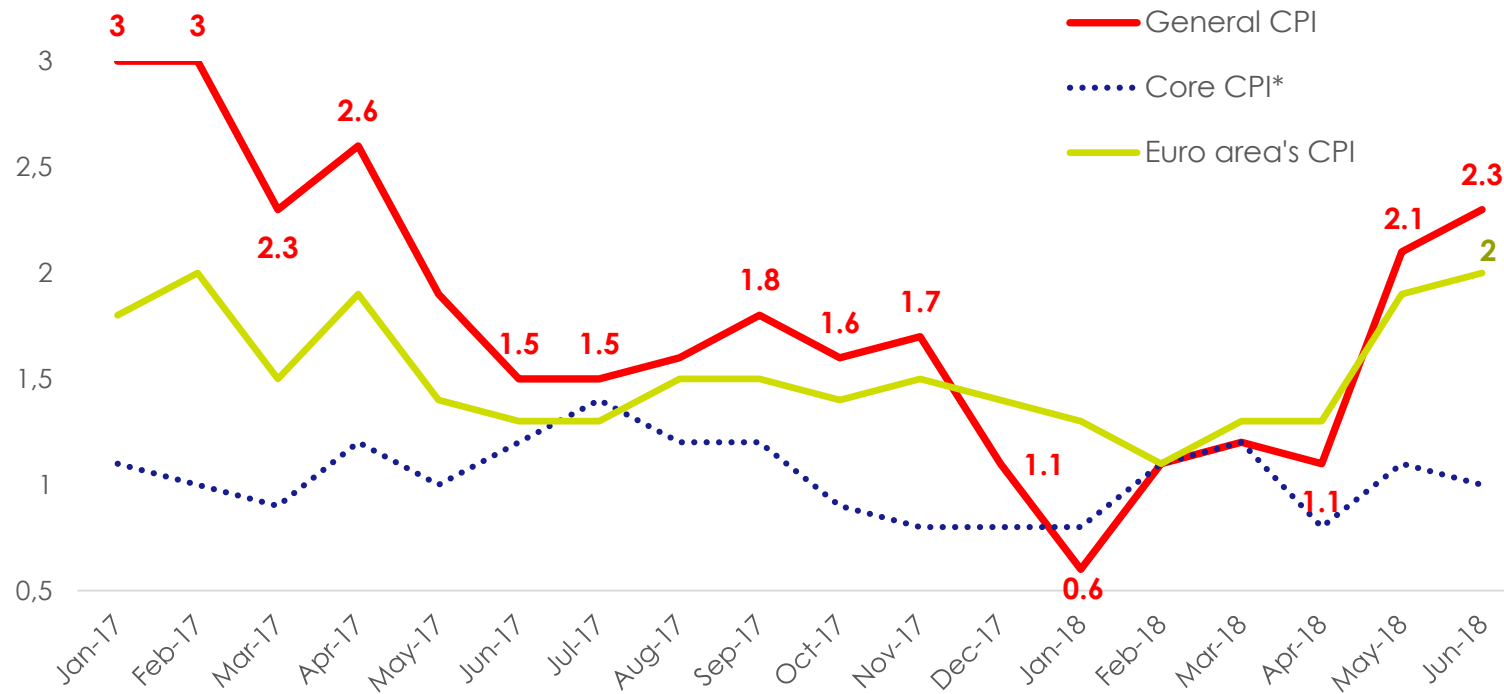
Source: *Círculo de Empresarios* based on Ministry of Labour, Migrations & Social Security, 2018

Risk for Spanish competitiveness: rise in inflation

In June, for the second consecutive month, inflation in Spain exceeds that of the euro area

Evolution of prices

% change year-on-year



* General index without unprocessed foods or energy products

Since January, inflation has **accelerated** in **Spain** by **1.7 pp.**

- **Increase in fuel prices (+11.9%)**
and its **impact** on:
 - ✓ **Transport (+6.1%)**
 - ✓ **Housing (+2.6%)**
- **Rise in fresh produce**

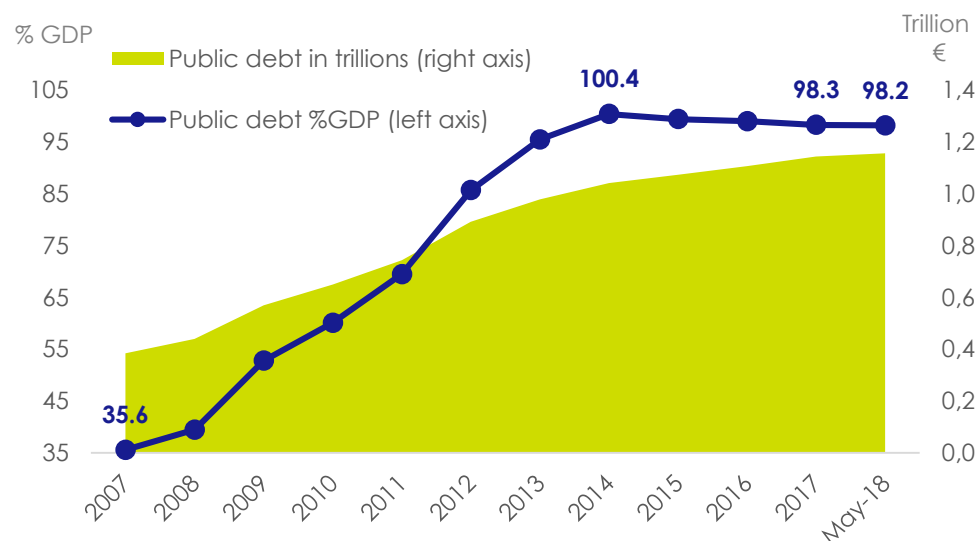
The **difference with the euro area** stands at 0.3 points, the highest in 8 months

Private debt maintains its downward trend...

In **Q1 2018**, the **private debt of non-financial corporations and households** reached **€1.83 trillion**, accounting for **156.4% of GDP**, 9.4 pp less than in Q1 2017

Evolution of debt of non-financial corporations & households

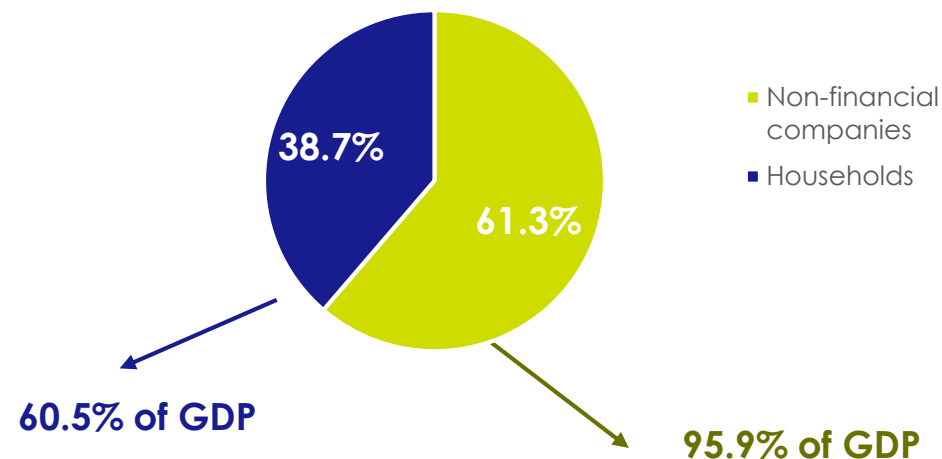
Unconsolidated debt*
Trillion € and % of GDP



* In consolidated terms, the debt of both sectors amounts to €1.6 trillion in Q1 2018, which is 137% of GDP

Debt of non-financial corporations & households

% of the total debt of non-financial corporations & households

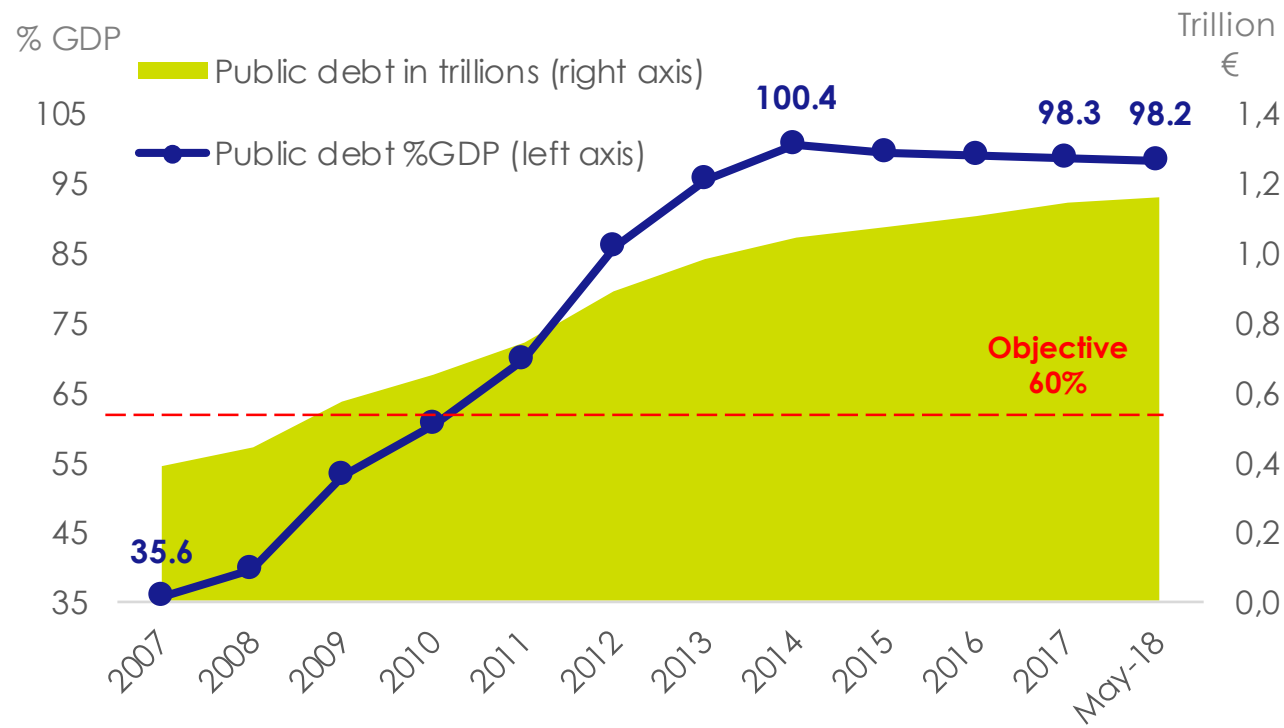


... while public debt remains at similar levels

Public debt stood at **98.2% of GDP** in May, exceeding the target set for 2018 (96.8%)

Evolution of public debt

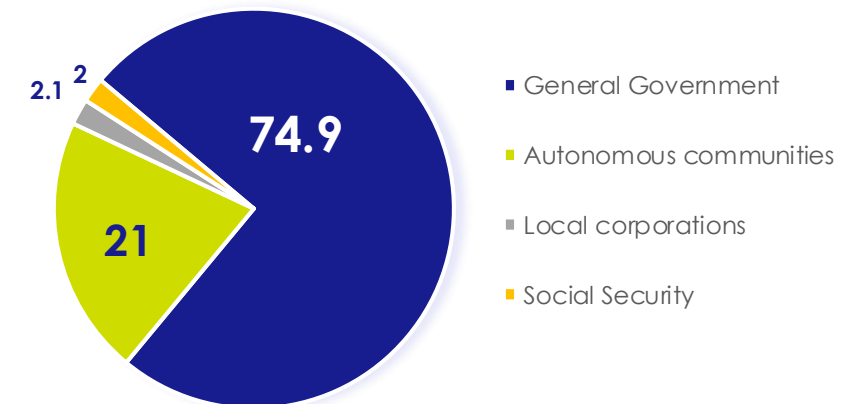
% of GDP and trillion €



- **Volume in May 2018: €1.15 trillion**
- **+2.7% year-on-year**, mainly due to an increase in the State's debt: 4.3%

By Administrations (May 2018)

% of total



The new deficit targets delay the reduction in public debt

The government slows down fiscal consolidation:

- **The deficit widens to 2.7% in 2018 and 1.8% in 2019**
(where the objectives of the Stability Program are 2.2% and 1.3%, respectively)



It would mean an **increase of the public debt** in almost €40 billion in gross terms (the largest since 2014)

- **Lowering of the Autonomous Communities deficit target in 2019 to 0.3%** (as opposed to the 0.1% forecast)
- **Proposed expenditure cap for 2019 = €125 billion** (+4.4% year-on-year)

Balance and deficit targets

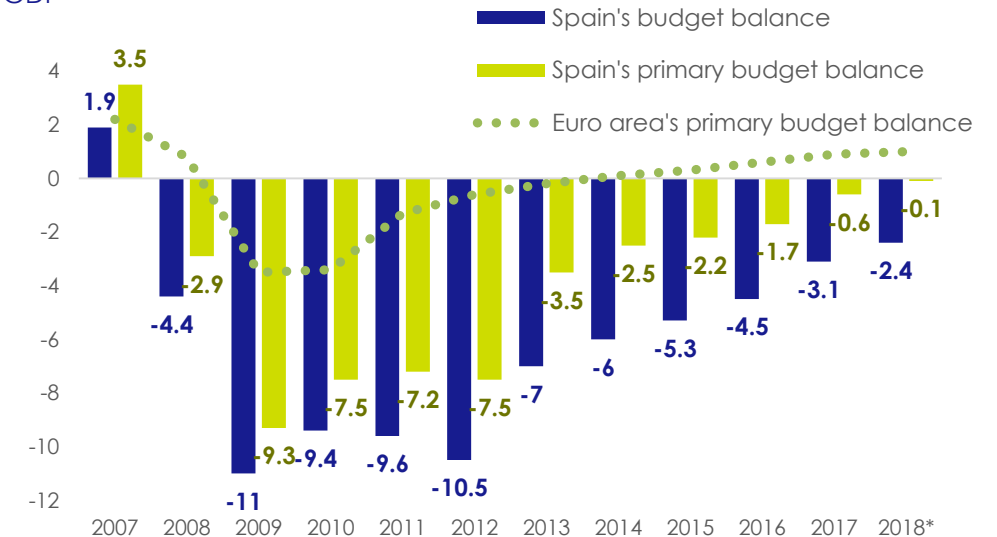
% of GDP

	Balance 2017	Target 2018	Target 2019
General Government	-1.9	-0.8	-0.4
Autonomous communities	-0.3	-0.6	-0.3
Local corporations	0.6	0.1	0,0
Social Security	-1.5	-1.3	-1.1
Total Public administration	-3.1	-2.7	-1.8

Note: data without financial help

Evolution of the public budget balance

% of GDP



* Forecast

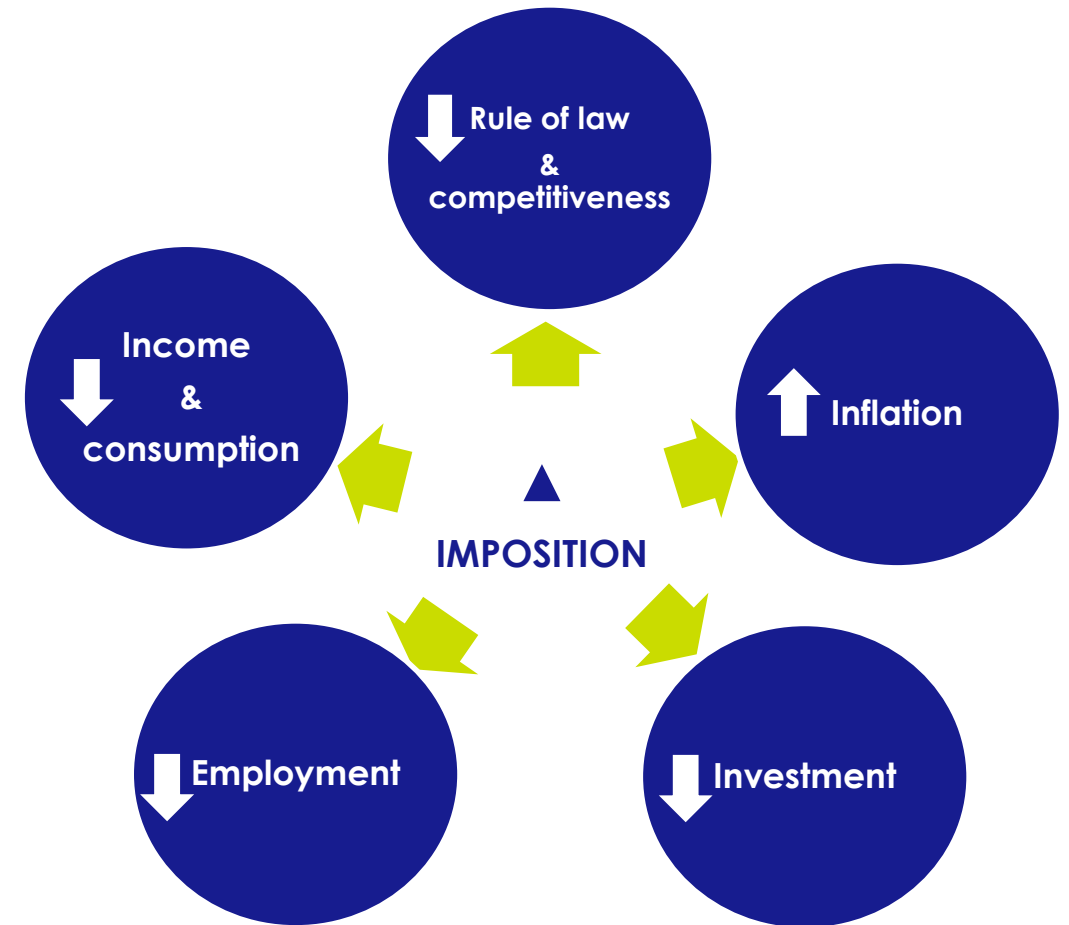
Risk of changing the tax policy

New measures announced

- **Tax increase** on diesel, technology and banking

- Set a **minimum Corporate Tax rate** for large companies: 15%

- **Dispose of the upper limit on Social Security contributions**

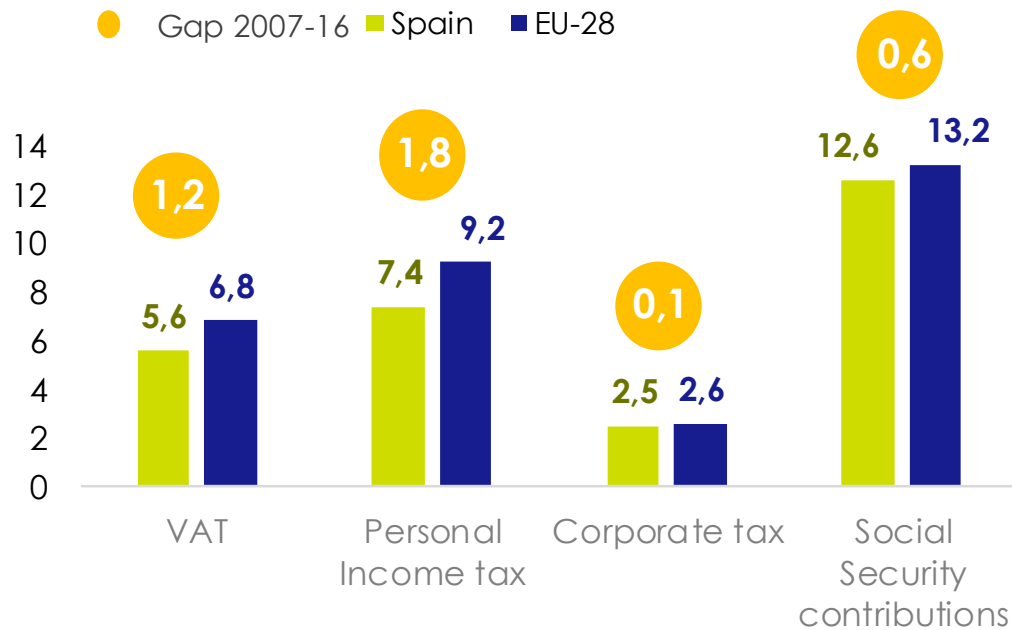


Fiscal situation compared to the European average

Although **Spanish rates** are in **line with the European average**, between 2007 and 2016 the **greatest difference in collection** with the **EU28** occurred in **income tax and VAT**

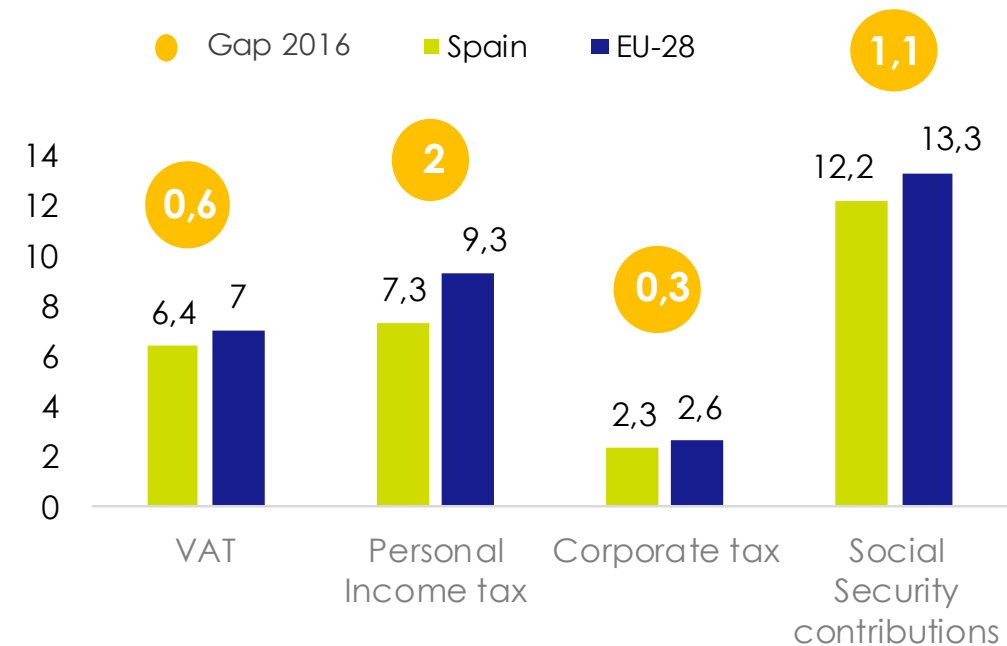
Average tax collection 2007-16

% of GDP



Tax collection 2016

% of GDP

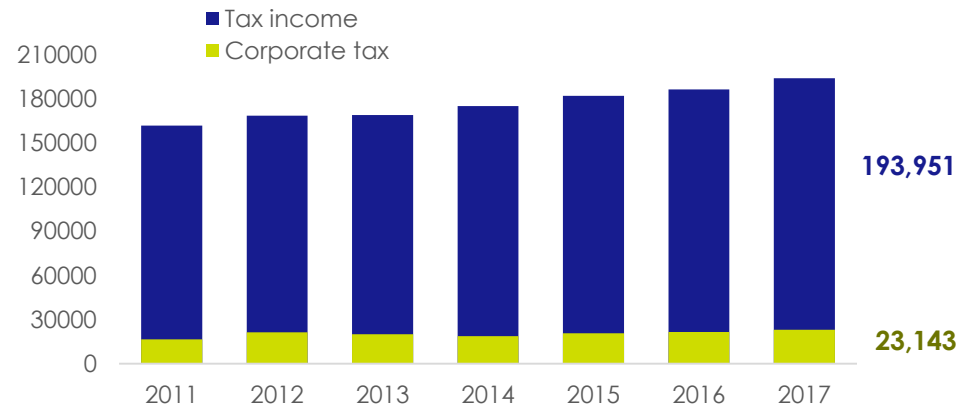


Corporation tax collection begins to recover

Between 2011 and 2017, **collection** has increased from **10.3% to 11.9% of total tax revenues**, despite the fact that 54.7% of companies presented losses in 2015 and the destruction of 300,000 companies during the crisis

Corporation tax collection 2007-17

Million €



Effective corporation tax rate

**On Consolidated
Accounting Result¹**

10%

**On consolidated tax
base**

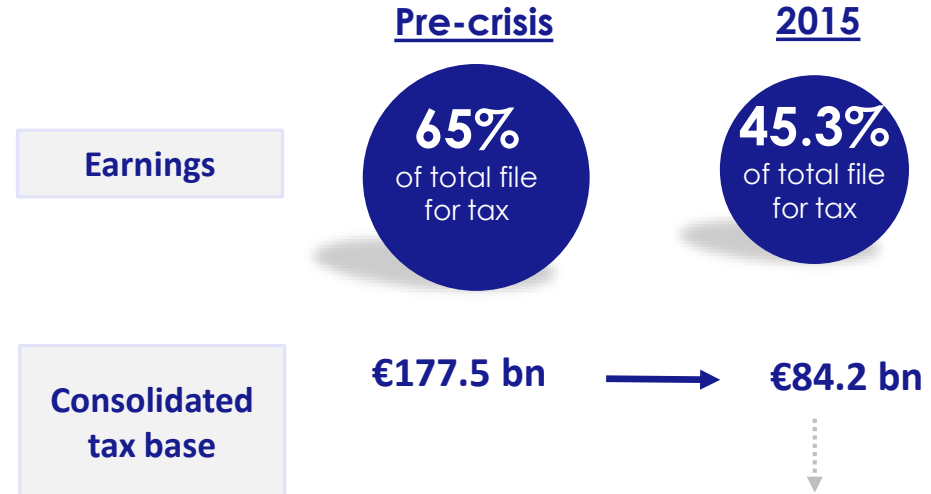
22.5%

¹ Does not take into account the taxation of companies in third countries nor the negative tax bases accumulated in prior years

Medium & large sized companies ➔ 55.4% collection²

1.4% of medium and large sized companies with positive tax bases or
0.6% of total respondents

Companies filing for tax²



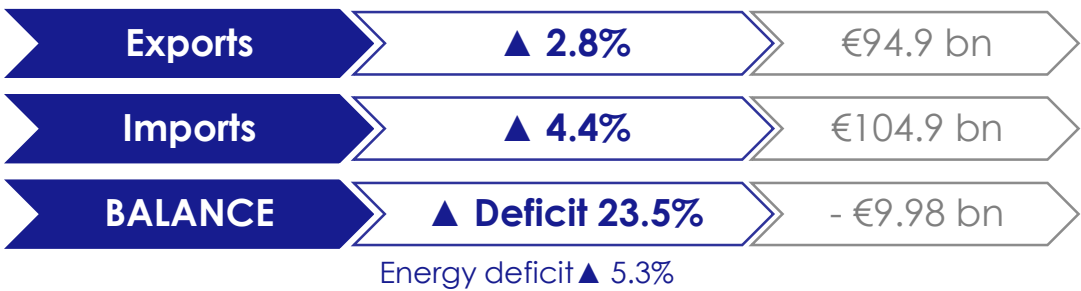
² Data for 2015 (latest available)

Due to accumulation of prior year losses and destruction ≈ 300,000 companies between 2008-2014 (DIRCE, INE)

The trade deficit widens

Balance of trade, Sectorial distribution

Change with respect to the same period of the previous year



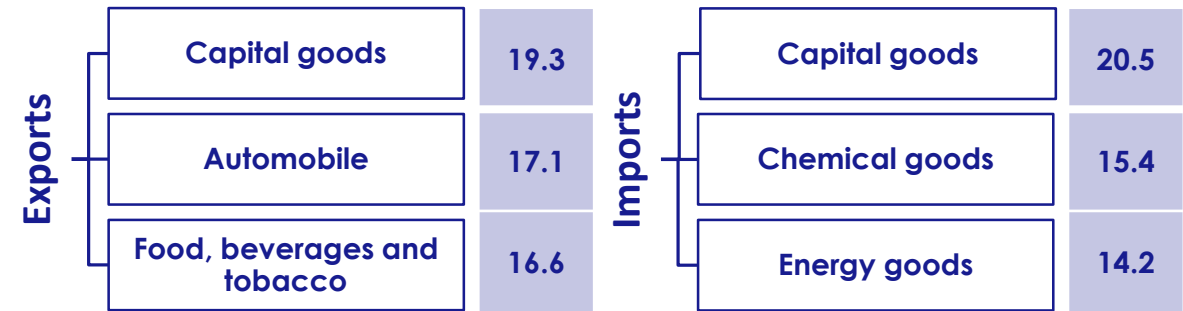
Evolution of trade in goods, January – May 2018

% of GDP



Sectorial distribution, January – May 2018

% of total



Geographical distribution, January – May 2018

% of total

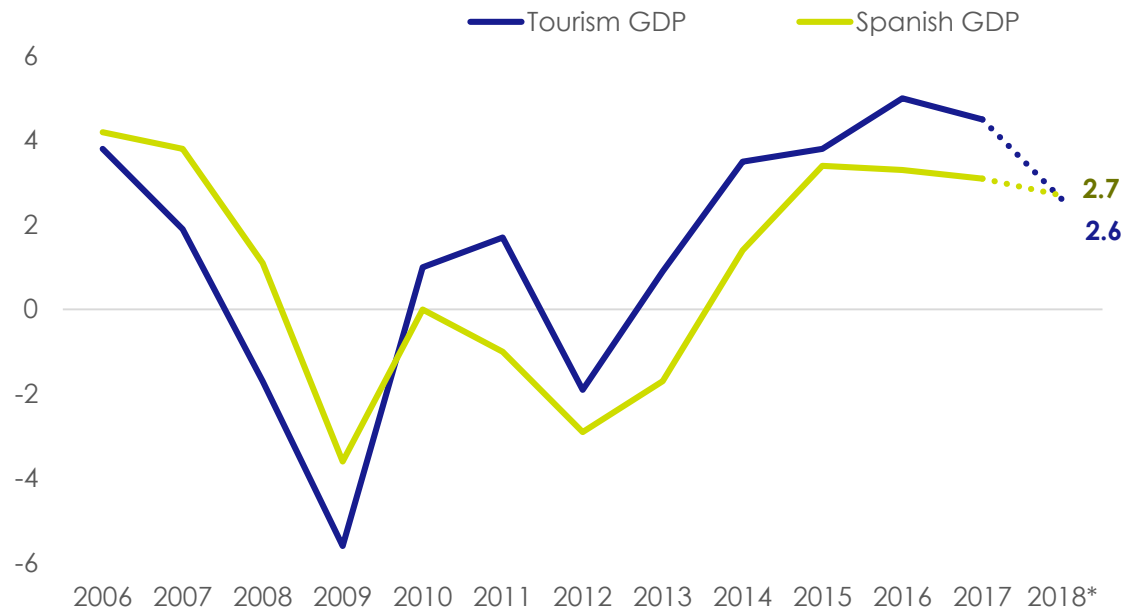
	Exports	Imports
Europe	72.5	60.6
EU	66.7	54.6
America	10.1	10.1
Asia	8.9	20.3
China	2.1	7.8
Africa	6.4	8.6
Others	2.1	0.4

Tourism contributes less to growth

In **Q2 2018**, the **growth of tourism GDP** in Spain slowed down to **2% year-on-year** (vs 3.1% in Q1 2018), **reducing** the growth **forecast** for the **whole year** to **2.6%**

Annual tourism GDP growth & general GDP of the Spanish economy 2006-2018

% change year-on-year



* Forecast




Determining factors of downward correction:

- Slowdown in Q2 due to the worst weather conditions and lower national demand
- Recovery of the market share by the Eastern Mediterranean competitors
- Fewer tourist arrivals from Germany and the UK

Tourists increase their spending

Between **January and May**, **28,573,668 international tourists** arrived in Spain, **2% more** than in the same period of the **previous year**, and **spent €29.5 billion**, **4.1% more than in 2017**

TOP 3 sender countries, January-May 2018

	% of total tourists	% change YoY	% of total spending
 United Kingdom	21.9%	-2.3%	19.2%
 Germany	13.8%	-2.7%	13.4%
 France	13.7%	0.6%	7.8%

TOP 3 host Autonomous Communities, January-May 2018

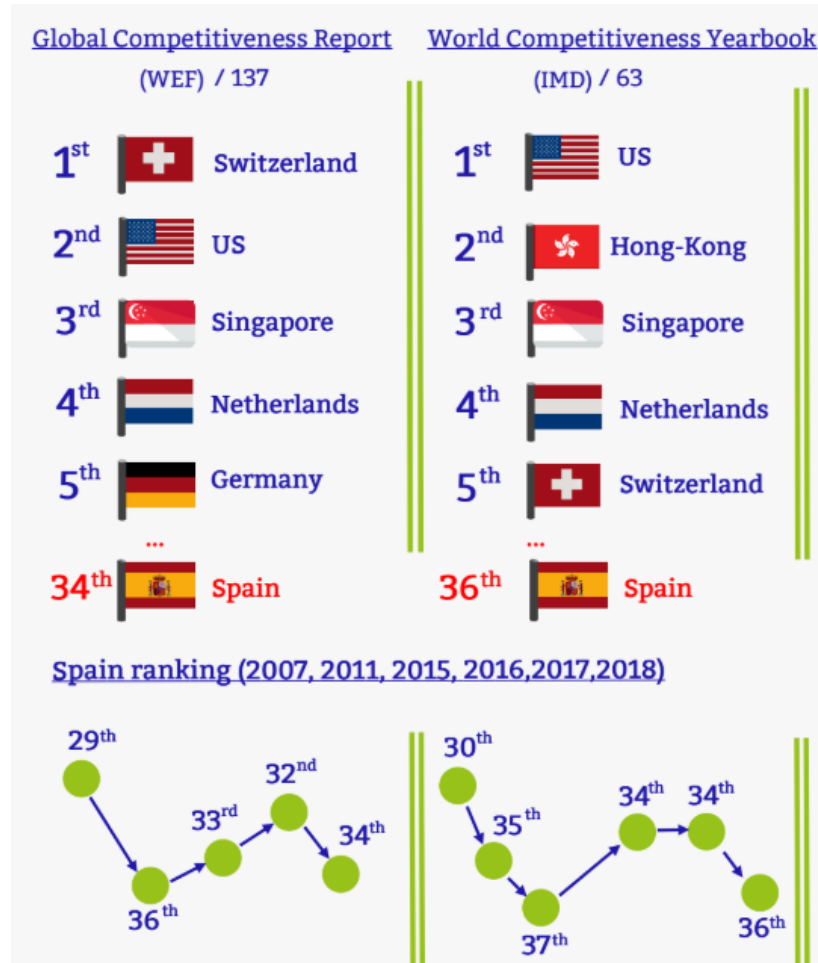
	% of total	% change YoY
Catalonia	23.2%	-2.1%
Balearic isles	13.8%	0%
Andalusia	13.7%	2.4%

Catalonia continues to lead the reception of tourists between January and May of 2018, **but the influx is reduced by 2.1% in year-on-year terms**

84.6% come to Spain for **holidays**, and the remaining 15.4% for professional reasons and others

Competitiveness of Spain

Spain is not ranked among the 20 most competitive countries in the world...



Advantages and difficulties identified in the Barometer of the Circles 2018

Advantages

- Quality assessment and cost of skilled labour
- Quality of physical infrastructure
- Size and location of the domestic market
- Important and growing export sector

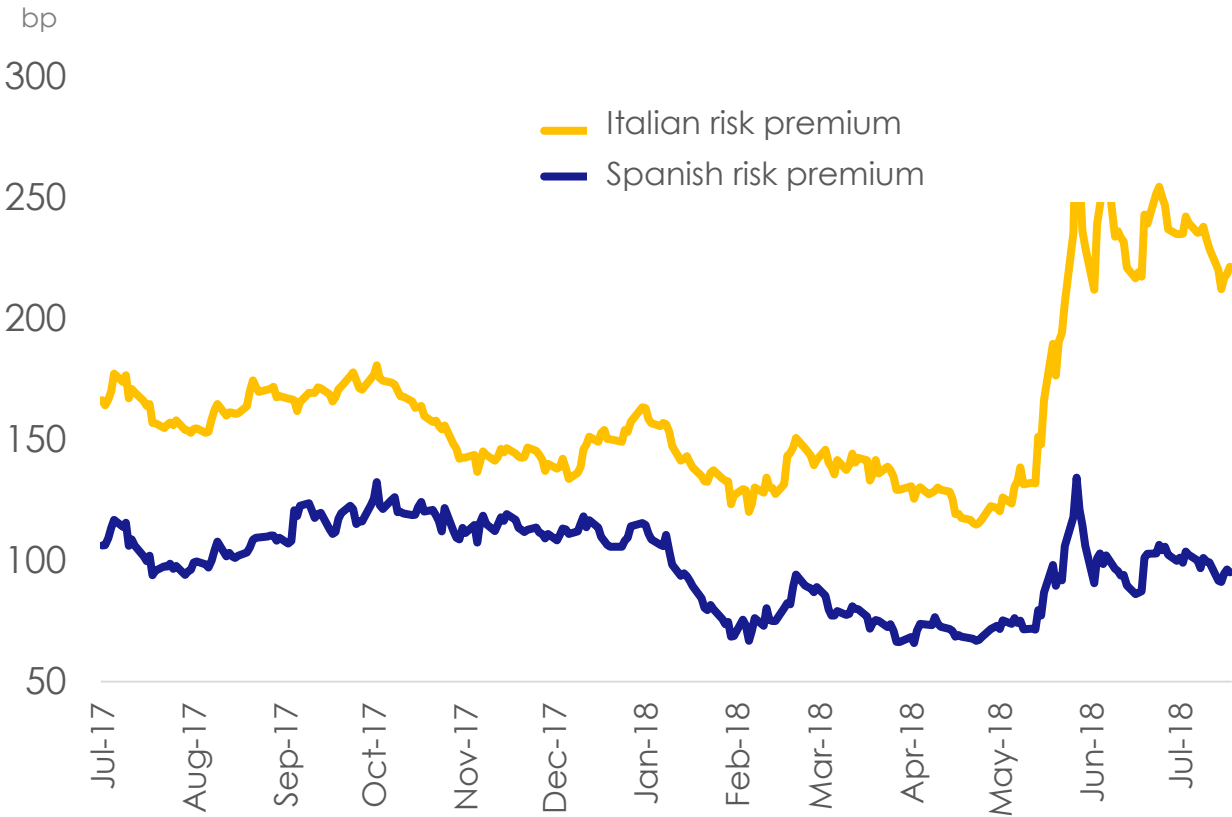
Difficulties

- Quality of the Spanish education system
- Effort put into innovation and technological adaptation
- Inefficient functioning of the public administrations
- Duality of the labour market
- Corruption and shadow economy
- Sustainability of the pension system

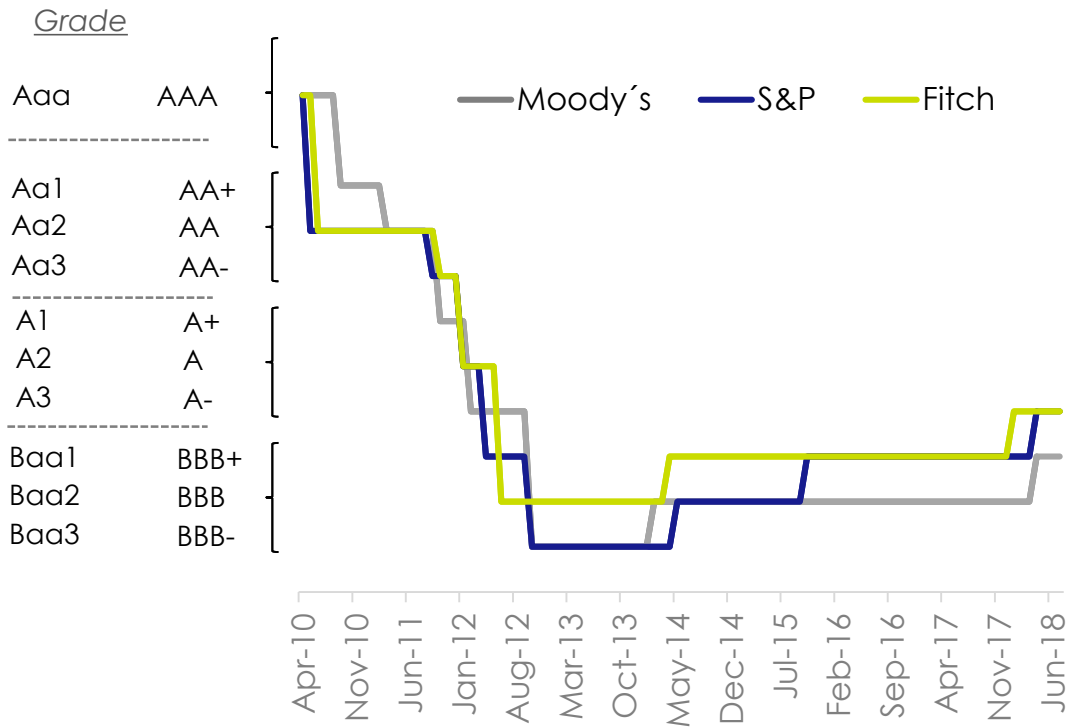
Interest rates and risk premium

The **risk premium** exceeds **90 basis points**, although it still maintains the gap with Italy

Risk premiums from Spain and Italy
compared with the 10-year German bond



Evolution of Spain's rating
2010-2018



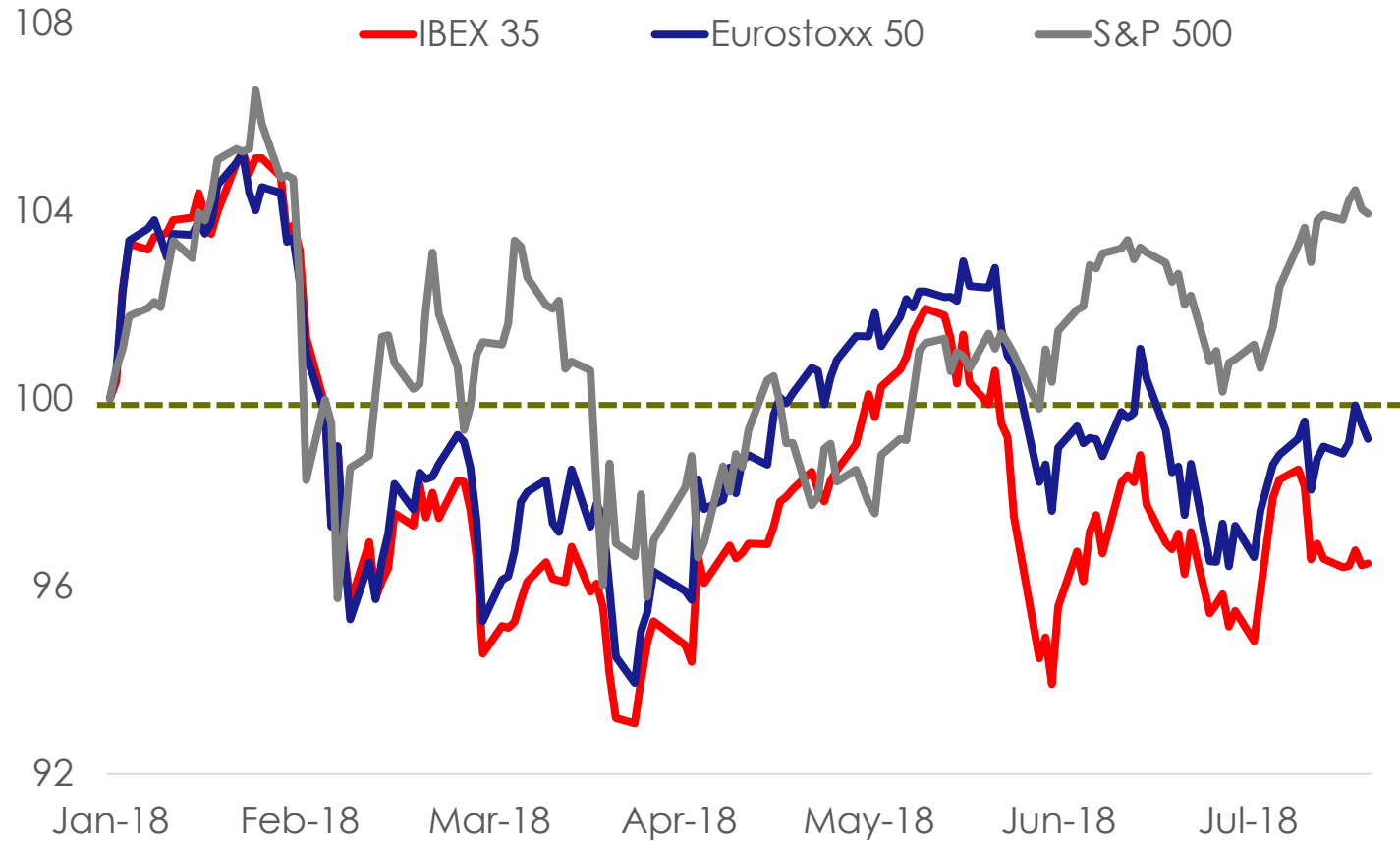
Source: Círculo de Empresarios based on Bank of Spain & Bloomberg, 2018

Financial markets

The stock markets face an environment of **higher volatility** and greater **political uncertainty**

Evolution stock market

January 2018=100



* Includes: Continuous market, trading floors of the four stock exchanges, MAB (The Alternative Spanish Equity Market), & Latibex

Source: Círculo de Empresarios based on BME, 2018



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