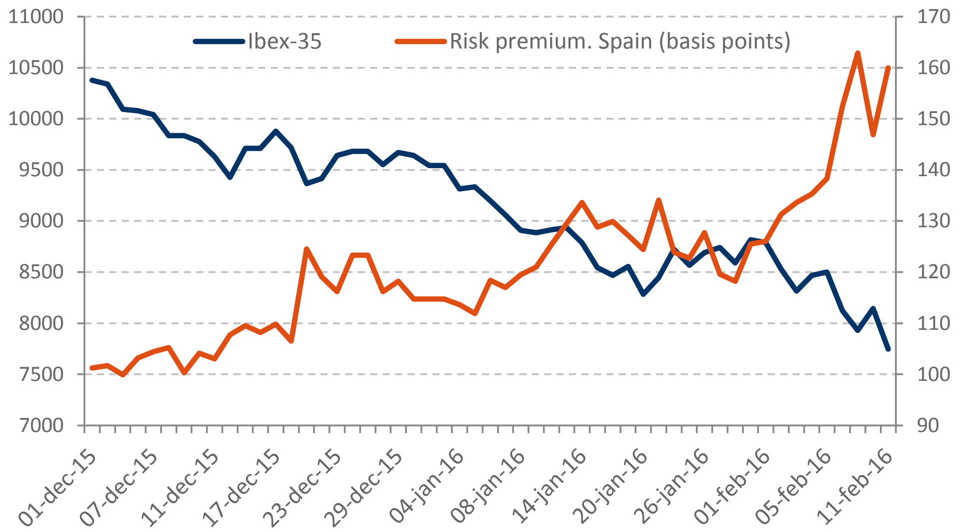
ECONOMIC OUTLOOK

February 2016

- ***Downward revision for world growth forecasts due to weakness in emerging economies.***
- ***Significant declines in global stock markets on fears of a further slowdown in the global economy.***
- ***Notable impact of global financial instability on Spanish stock markets. The IBEX fell below the 8,000 level and the risk premium rebounded to more than 150 bps.***
- ***For now, the outlook for the Spanish economy has not been revised downward and, in fact, the European Commission has increased its growth forecast to 2.8% in 2016.***
- ***The job creation rate remains stable at the beginning of the year, standing at around 3.2%.***
- ***Inflation returns to negative territory in January, with a rate of –0.3% year on year.***
- ***Awaiting detailed information, the overall Government deficit could have closed 2015 at -4.5% of GDP.***

CONTENT:

IBEX-35 and the Spanish risk premium



Source: MInistry of Economy and Competitiveness and CEOE Economic Research Unit

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INTERNATIONAL SCENE: downward revision for world growth

Volatility in financial markets, with significant losses in major world stock markets, continues to be the focus of attention at an international level. Causes for these losses are varied. Among the most relevant, it is worth noting the uncertainty over the extent of the global economic slowdown, especially among large emerging economies, led by China. Also a factor is the decrease in the price of commodities, especially oil, as well as the unease created by the possibility of the Federal Reserve continuing its monetary policy normalization at a faster pace than markets were expecting and the consequences this could have on emerging economies that are highly indebted in dollars, even though Yellen has stated that hikes will be gradual and will take the economy's situation into account. Furthermore, doubts over a future devaluation of the yuan and its possible impact, together with new tensions in Greece, the problems in the Italian banking sector and the poor results showed by Deutsche Bank have contributed to the negative performance of the stock markets in the last few weeks.

In this sense, both the IMF and the European Commission have revised their forecasts for global growth downwards by two tenths for 2016 and another two tenths for 2017. This revision occurs because they believe that the rebound from emerging economies will be weaker than expected a few months ago, specifically in Brazil, where the recession is proving to be deeper and longer. In addition, other Latin American and Middle Eastern countries have seen their growth perspectives reduced due to the decline in oil prices. For the US, the growth forecast is less robust as well, while world trade is expected to see an also milder improvement, influenced by the slowdown in China.

However, these bodies estimate that in 2016 the economy will have greater momentum than in 2015, the year with the lowest global growth rate since 2009, and they expect consolidation in 2017. Advanced economies are foreseen to continue their recovery, with the US remaining dynamic and supported by stronger labour and housing markets, although it will notice the effects of a stronger dollar and low oil prices may affect investment in mining equipment and infrastructures. Japan will also see a growth improvement encouraged by low crude oil prices and supported by very lax financial conditions, much the same as the Eurozone.

With regards to central banks, it is worth highlighting that the Bank of Japan cut the interest rate applied to financial entities to -0.1%, with the aim of pushing inflation towards the 2% goal. Sweden has also cut its interest rate to -0.5%. Meanwhile, the ECB is increasingly expected to, in its upcoming March meeting, expand its public debt purchase program.

On the other hand, oil prices have continued to drop, recording an average of 31.1 dollars per barrel in January, 35% lower than a year before and the lowest price since February 2004.

IMF (Jan. 2016) and **European Commission** forecasts (Feb. 2016)

	IMF			European Commission		
GDP (y-o-y rate)	2015	2016	2017	2015	2016	2017
World growth	3,1	3,4	3,6	3,0	3,3	3,5
United States	2,5	2,6	2,6	2,5	2,7	2,6
Japan	0,6	1,0	0,3	0,7	1,1	0,5
Eurozone	1,5	1,7	1,7	1,6	1,7	1,9
Germany	1,5	1,7	1,7	1,7	1,8	1,8
France	1,1	1,3	1,5	1,1	1,3	1,7
Spain	3,2	2,7	2,3	3,2	2,8	2,5
Italy	0,8	1,3	1,2	0,8	1,4	1,3
United Kingdom	2,2	2,2	2,2	2,3	2,1	2,1
China	6,9	6,3	6,0	6,9	6,5	6,2
Advanced economies	1,9	2,1	2,1			
Emerging economies	4,0	4,3	4,7			
World trade	2,6	3,4	4,1	2,6	3,5	4,2

Source: IMF and European Commission

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THE SPANISH ECONOMY: global financial instability has a significant impact on Spanish stock markets

The instability of financial markets at a global level is having a very significant impact on Spanish stock markets. The IBEX was seen falling below 8,000 basis points, accumulating a drop of around 17% since the beginning of the year, with the financial sector being the most affected. In turn, investors turning to German bonds as refuge have caused the risk premium to rise above 150 bps, versus the 125 bps average for January. Thus, the interest rate of the 10-year Spanish bond has surged to 1.75%.

In Spain, this situation in financial markets is coupled with the political standby. In the short term, our economy has inertia and data for the first quarter points to a GDP growth of around 0.8% in quarterly terms, according to official sources. At the same time, data regarding Social Security registrations for January shows a continued trend in job creation, which remains stable at 3.2% year on year. Moreover, the 2016 Central Government Budget is approved, and therefore the Public Administration remains active.

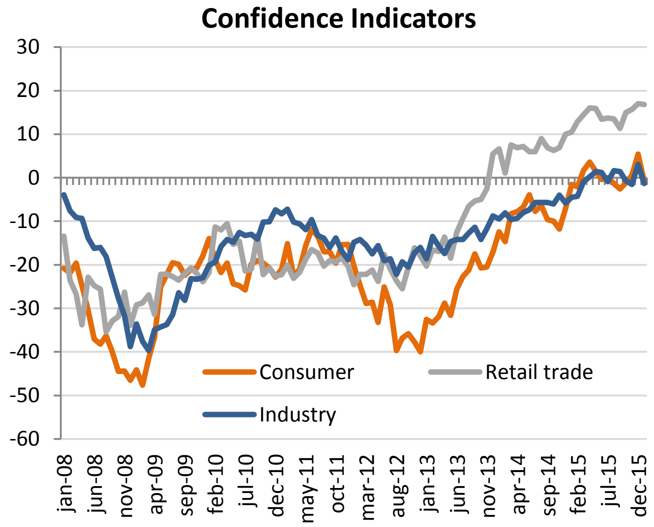
However, we need to be on the lookout for confidence indicators, firstly, and for investment data, secondly, in order to assess the impact of this situation of general uncertainty in real activity and, in particular, of the behaviour of financial markets and the global economy. For the time being, there have been no major changes in growth forecasts for the Spanish economy. In fact, at the beginning of February the European Commission reviewed GDP growth for 2016 up to 2.8% in annual average.

DEMAND AND ACTIVITY: deteriorated expectations at the beginning of 2016

The Spanish economy closed 2015 with growth rates of 0.8%, and a yearly growth of 3.2%, according to the flash estimate released by the National Statistics Institute. This momentum is still due mostly to strong domestic demand, in particular from consumption and investment in capital goods. At the beginning of 2016, the few indicators available suggest a similar behaviour of private consumption, which is being supported by on-going negative inflation and very low interest rates (one-year Euribor is negative for the first time). The drop in interest rates has been reflected in the terms for new loans, which have, in turn, experienced an increased volume, especially those aimed at consumption. Within this context, although household disposable income is still rising, the significant increase in spending is resulting in a lower savings rate, as indicated in the Non-Financial Accounts for the Institutional Sectors for the third quarter.

Even though consumption indicators are positive, the consumer confidence indicator suffered a significant decline in January in all components, but particularly in the component for the general economic trend. Confidence indicators of different sectors (industrial, construction, services) have also shown a worsening outlook, although much less pronounced than in the case of the consumer confidence indicator. In fact, the PMIs for the manufacturing and services industries are still turning values over the 50 level and they have even increased in the industry sector.

Nonetheless, both for the final part of last year as well as for the beginning of the present one, the situation can be described as positive in terms of demand and activity: the industrial production index closed the year with a 3.2% growth, with a 7% growth in the production of capital goods deserving a special mention; the purchase-sale of homes shows a clear recovery; 2015 was a record year for tourist entries, reaching 68.1 million and pending December's data, Spanish exports could set a new annual record with an important reduction of the trade deficit.

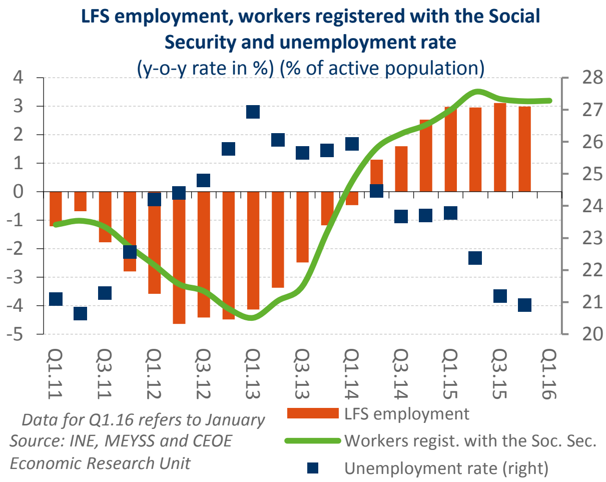


Source: European Commission.

THE LABOUR MARKET: The job creation rate remains stable at the beginning of 2016

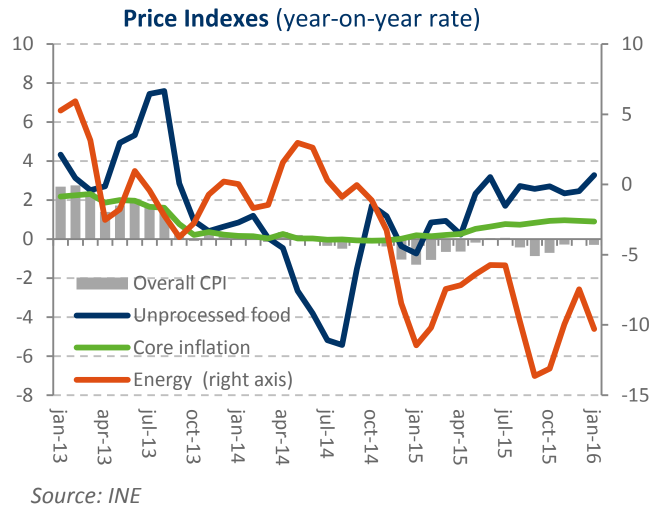
The LFS for the fourth quarter of 2015 reflects a further improvement in the labour market, although signs of stabilization are seen in employment growth rates. The Spanish economy is still creating employment in annual terms, at a rate of 3.0%, which translates into nearly 18.1 million people employed, the highest number since 2011. Furthermore, unemployment declined again, to be set at 4.8 million people, 2010 levels, and the unemployment rate has dropped to 20.9%, the lowest since 2011.

Already in January 2016, the number of people registered with the Social Security shows a steady pace of job creation, and the annual rate remains at 3.2% since August of last year.



PRICES: Inflation returns to negative rates due to energy prices

Oil prices continued to decline in January, leading to a further decrease in the price of fuels and lubricants, which, together with a drop in electricity prices, has driven inflation to negative territory once again (-0,3% year on year in January). However, core inflation remains stable at 0.9%, supported by the favourable behaviour of household spending. The Harmonized Index of Consumer Prices stood at -0.4%, below the average for the Monetary Union (flash estimate at 0.4% in January), accumulating 29 months of improved price-competitiveness with the Euro Zone. This is also reflected in the Competitiveness Trend Index prepared by the Ministry of Economy, which recorded a gain in price-competitiveness for Spain vs. the EU, the OECD and the BRICS throughout 2015.



Source: INE

THE PUBLIC SECTOR: the Social Security and the Autonomous Regions are unlikely to meet the deficit target in 2015

Awaiting detailed information, the acting Government has anticipated that the public deficit could have reached -4.5% of GDP in 2015, above the target of -4.2% of GDP.

Data from the National Accounts indicated that the net borrowing up to November of the Central Government, the Autonomous regions and the Social Security Funds was set at -3.9% of GDP, vs. a -4.5% of GDP in 2014. The increase in non-financial resources up to November was set at 3.8%, being noteworthy the good performance of taxes, while spending grew at a more moderate rate, of 1.7%. It is worth pointing out among the latter the rise in current expenses (intermediate consumptions, subsidies and compensation of employees) and the recovery of Central Government investment. Cost restraint is reflected in the figure for social benefits, which has stalled, and in the decrease in the interest chapter.

The breakdown by level shows the central Administration as having done the greatest effort towards deficit contention, accumulating a balance until November of -2.3% of GDP, vs. a -3,2% of GDP in 2014. The Regional Government drifts away from the target (-0.7% of GDP) and accumulates an imbalance of -1.3% of GDP up to November, while Social Security Funds are the ones that increase their negative balance the most in comparison to 2014. Specifically, -0.3% vs. -0.1% accumulated up to November 2014, due to a worse performance of the Social Security System.