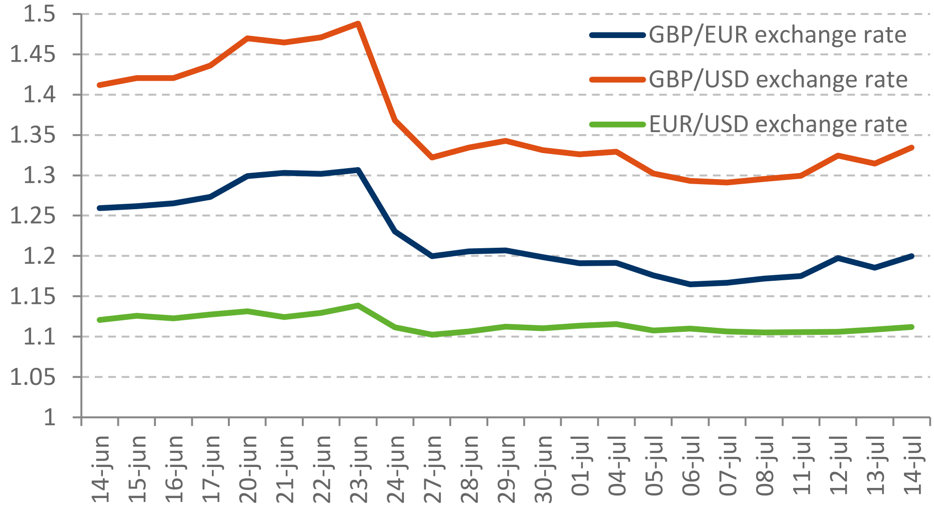
ECONOMIC OUTLOOK

July 2016

- ***After the victory for Brexit, volatility in financial markets increased and the British pound depreciated against major currencies. Two rating agencies, Standard and Poor´s and Fitch, lowered the UK's credit rating, and one of them lowered the EU's rating. The IMF revised economic growth downwards for both, the British economy and the Eurozone.***
- ***The Spanish economy again grew at a high rate in the second quarter, with the quarterly rate being set at between 0.7% and 0.8%, according to several institutions.***
- ***June saw a rebound in the number of people registered with the Social Security, although in the second quarter as a whole employment creation slowed down.***
- ***Inflation slowed its pace of decline due to a lower decrease in energy products, while core inflation decelerated. CPI is expected to post positive rates in the last few months, although the average for the year will be slightly negative.***
- ***After the assessments by the European Commission on the budgetary situation in Spain, it has concluded that Spain did not take efficient action to meet the deficit commitments for 2014 and 2015. The ECOFIN ratified this assessment and has initiated an excessive deficit procedure that may trigger sanctions for Spain.***

CONTENT:

Evolution of the exchange rates



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

CEOE CONFEDERACIÓN ESPAÑOLA DE ORGANIZACIONES EMPRESARIALES

INTERNATIONAL SCENE: the United Kingdom votes to leave the European Union

International attention in recent weeks was focused on the UK's referendum to decide the country's continuity or exit from the European Union, which ultimately resulted in the victory of the "leave" option. This decision contributed to increasing volatility in stock markets due to the uncertainty existing on two fronts: first, on the impact it will have on the economy, both the British and the EU economy, and second, on the state of the relationship between the United Kingdom and its European partners once the separation occurs.

Thus, following the outcome of the vote on June 23, the world's major stock markets recorded significant falls, which were especially intense in the European banking sector because of its links with London and also due to the high non-performing loan (NPL) ratio being experimented by Italian banks. Nonetheless, in subsequent days, part of the losses were reversed. In fact the London Stock Exchange and the United States indices are trading at record highs, boosted by the actions taken and statements made by central banks and the quick election of Theresa May as the new UK prime minister.

In this regard, the Bank of England lowered the capital requirements for banks from 0.5% to 0%, in order to avoid credit restrictions. And although it has decided to keep interest rates at 0.5% and maintain its debt purchase programme, it has opened the door to applying new stimuli at its next meeting in August, once new growth forecasts are available. At said meeting, it is expected that it may lower interest rates and expand its bond purchase programme. Meanwhile, the ECB said it was prepared to inject more liquidity into the markets, if necessary, in order to ensure price stability.

In addition, following the referendum results, the risk premiums increased in many European countries, but have decreased again in most of them. On the other hand, the effect was seen much more clearly on the exchange rate, as the pound has depreciated against major currencies; the most notable depreciation (of almost 14%) was against the dollar, which was trading at the lowest level of the last few 31 years. Conversely, the dollar and the yen have appreciated to act as safe havens.

Meanwhile, the rating agency Standard and Poors has withdrawn its AAA rating to UK debt for the first time since 1978, taking it two steps down to AA and with a negative outlook. Fitch has also lowered its rating from AA+ to AA with a negative outlook, while Moody's has maintained its Aa1 rating, although it has changed to negative outlook. The expected slowdown in growth in the short term, the high external financing needs and the threat to constitutional and economic integrity in the event of a new referendum in Scotland, are among the factors that have most influenced these decisions.

Furthermore, Standard and Poor´s has lowered the EU rating from AA+ to AA, because they believe that the Brexit weakens the EU's fiscal flexibility and reflects a weakening of its political cohesion. The agency estimates that after the departure of UK, there will inevitably be new and complicated negotiations for the next budgetary framework, between 2021 and 2027.

On the other hand, the IMF revised downward its growth forecasts for the Eurozone and the UK as a result of Brexit. It estimates that the impact on the Eurozone will amount to five tenths between 2016 and 2018, while it will have a higher impact in the UK, which will lose 1.5 points of its expected GDP growth up to 2019, provided it reaches a favourable agreement similar to the one in place between the EU and Norway.

In addition, it updated its forecasts for the United States, noting that activity remains strong, despite having lost some momentum due to the strength of the dollar, a weak external demand and the impact of oil prices on investments in the energy sector. Thus, it lowered its GDP growth forecasts for 2016 down to 2.2% and maintains 2.5% for 2017. Additionally, it warns about the risk of a global economic slowdown.

Oil prices kept their upward trend in June, helped by lower inventories in the US, although the rise in prices has been milder than in the preceding months, with Brent crude being set at an average of 47.8 dollars per barrel. However, it is still 21% lower than the price in June 2015. In the last days of June and early July, the price was geared down by uncertainties after the "Brexit" and improved production in Canada and Nigeria.

THE SPANISH ECONOMY: the public deficit in the spotlight

Despite the context of high uncertainty currently present abroad as well as in the domestic front, the Spanish economy continued growing at a healthy pace in the second quarter. This was confirmed by the first GDP estimations issued by the Bank of Spain (0.7% quarterly rate), as well as by the Independent Fiscal Authority (0.75% quarterly rate), and also by CEOE, whose forecasts are along the same lines.

A still strong private consumption, and, to a lesser extent, investment in equipment goods explain the strong domestic demand, which is supported by favourable financial conditions, containment of prices and costs and the notable creation of employment, which has consolidated with a very positive Social Security registration figure in June. Regarding the foreign sector, the increase in exports to the EU and a degree of restraint in imports suggest a more neutral contribution to the GDP in the second quarter.

With inflation at negative rates and an external surplus, which has practically remained stable for the past twelve months, the focus in macroeconomic terms is placed on the public deficit. Following the assessments from the European Commission (EC) on Spain's budgetary situation, it has concluded that Spain did not take efficient measures to meet the deficit commitments for 2014 and 2015.

In this regard, the ECOFIN ratified, on July 12, the assessment and initiated an excessive deficit procedure whereby, after the appropriate allegations that the Spanish State is entitled to submit, it may decide to sanction Spain on the basis of a proposal set forth by the EC and scheduled for the end of the month. These allegations could favour the reduction of the proposed fine, which could end up representing a symbolic action. On a parallel note, the EC must make a recommendation to Spain, within the next two months, to undergo a new set of fiscal adjustment measures for 2016 and 2017, given the impossibility of reaching the fiscal targets currently set.

DEMAND AND ACTIVITY: growth is still robust

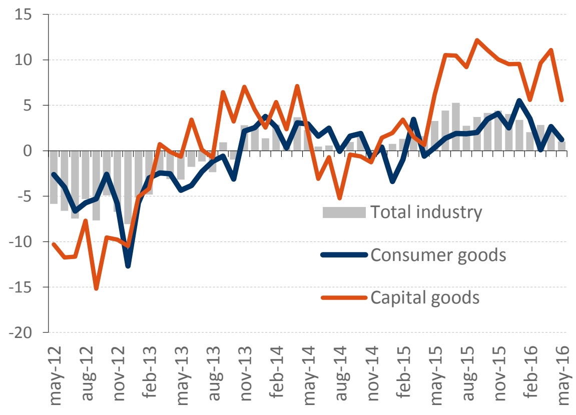
Estimations for the second quarter point to a high growth rate for the Spanish economy (0.7%), although somewhat lower than in the first quarter. This slight slowdown in growth falls within the estimated forecast scenario for 2016, in which the economy will post a progressively milder growth rate, albeit still consistent with a robust growth figure for the year as a whole (2.9% according to CEOE estimates) This progression is due to the exhaustion of some of the driving factors that have supported growth in recent quarters, such as lower tax rates or oil prices, coupled with an foreign context of greater uncertainty.

The economy's momentum in the second quarter has again been supported by private consumption, investment in equipment goods and exports. Regarding the first one, the favourable evolution of employment together with negative inflation and improving financing conditions have contributed to an increase in household disposable income and purchasing power, together with greater consumer expectations following the sharp deterioration over the first quarter. Business investment has also continued to drive growth in the second quarter, although at a more moderate pace than in previous quarters, and exports have shown greater progress, especially those to the EU.

On the other hand, within a context of improved credit accessibility and conditions, home sales have been highly dynamic in the second quarter, even though confidence indicators and construction sector activity indicators are still reflecting a negative trend. The Industrial Production Index has also given signs of some slowdown in the month of May, due to a slowdown in its capital goods and consumer goods components, which had shown remarkable strength in the previous months.

The most positive note comes from indicators in the tourism sector, where the figures for overnight stays, entry of visitors or expenditure per tourist up to May grow at high rates when compared with the positive data from the same period last year, which anticipates a very favourable summer season in 2016.

Industrial Production Index
(year-on-year growth rate)

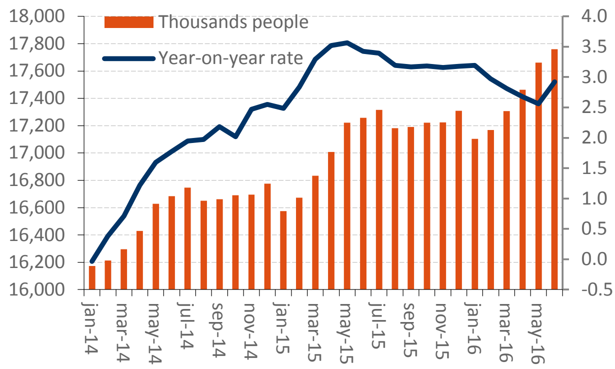


Source: INE

THE LABOUR MARKET: rebound in the number of people registered with the Social Security in June, following a slowdown over the past four months

The number of workers registered with the Social Security increased by 98,431 individuals in June, which is the highest figure since 2006. By sectors, the number of contributors increased in the industrial sector, the construction sector and, especially, the services sector, and it decreased in agriculture. By activity branches, Accommodation and food service activities deserves special mention, up by more than 38,000 people (within the General Social Security System), with a year-on-year rate of 7.4%, driven by the favourable evolution of tourism. The increase in the number of contributors in June has led to a rebound in the annual rate, to be set at 2.9%, after showing a slowdown throughout 2016. Even so, over the second quarter, the annual rate has slowed down to 2.7%, from 3.0% in the first quarter.

Workers registered with the Social Security
(thousands of people and year-on-year rate -right-)

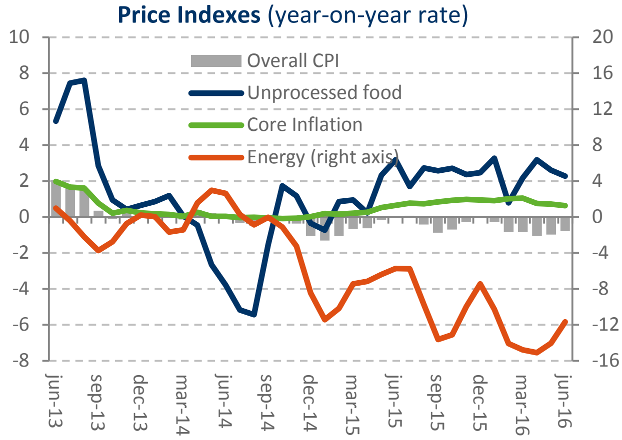


Source: INE, Ministry of Economy and Competitiveness and CEOE Economic Research Unit

PRICES: the drop in CPI stops due to energy prices

Inflation slowed its decrease in June to -0.8% due to the lower decrease in energy products (fuels and lubricants, mainly, but also electricity and gas). Core inflation, meanwhile, decreased one tenth and stands at 0.6% due to the slowdown of all components (processed foods, beverages and tobacco, services and non-energy industrial goods). Prices of non-processed food also increased with less intensity, but continued to be the most inflationary item in the basket. In the coming months, with oil prices at current levels, the price differential of energy products in relation the previous year will be positive, and inflation will also move into positive rates. The average for the year will yield a negative inflation rate.

Price Indexes (year-on-year rate)



Source: INE

THE PUBLIC SECTOR: little progress in fiscal consolidation at the beginning of the year

The deficit of all the Public Administrations (except Local Governments) stood at -1.2% of GDP up to April, above the number registered in the same period in 2015 (-1.1% of GDP). Both the Central Government and the Social Security system posted worse number than last year; in the case of the former because of its higher deficit, and in the case of the latter due to its lower surplus. Thus, the Regional Governments are the only ones that reduced their negative balance in the first quarter (-0.2% of GDP vs. -0.3% in 2015).

Regarding the Central Government budget performance up until May, the net borrowing remains stable in comparison to the same period in 2015 (-2.08% of GDP) as a result of a fall in spending (-2.9%) as well as in revenues, which, unlike in previous years, decreased significantly (-5.8%). This performance of revenues is explained by the impact of the tax reform in direct taxes and, additionally, by the Corporate Income Tax because of the decrease of its first fractioned payment, since transitional measures from previous years have disappeared in 2016.

In short, over the first few months of the year there is no significant progress in terms of budgetary consolidation compared to 2015, year in which the public deficit target was not met. Consequently, the European Commission has taken further steps within the excessive deficit procedure in which the Spanish economy is immersed.