ECONOMIC OUTLOOK

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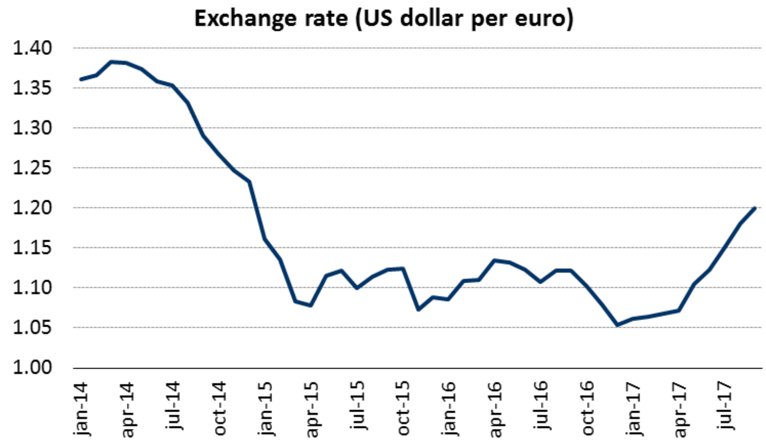
Following the positive start of the year in financial markets, the geopolitical crisis with North Korea has caused renewed tension in the main stock markets around the world, putting a stop to their upward trend and leading to moderate declines. In contrast, demand for safe haven securities, such as bonds or gold, has risen. Thus, yields for US and European bonds dropped, in the case of the former to around 2% and the German bond fell below 0.4%, although its downward trend seems to be slowing down. Meanwhile, gold reached maximum levels for the year so far ($1,336/ounce).

It is also worth noting the appreciation of the Euro throughout 2017, which followed an upward trend and reached $1.2 per euro. The depreciation of the dollar against the Eurozone currency is due to several reasons: lower US growth forecasts for 2017; a less active economic policy than initially expected from the Trump government; and, more recently, lower inflation, which could delay a further rise in interest rates by the Fed; lastly, greater growth momentum in the EMU.



Source: MInistry of Economy, Industry and Competitiveness

In addition, at its last meeting, on September 7, the ECB did not announce any changes in interest rates, which are expected to remain at the same levels for an extended period of time. No changes were announced either for the asset purchase program, and the institution will, therefore, continue to buy bonds at a rate of 60 billion until December, even mentioning the possibility of extending the purchase program beyond said date. The bank's spokesman said, literally, that the fall season was the time when they would decide on *"the calibration of our monetary policy instruments"*. In this regard, market forecasts point to October as the month for the possible announcement of the expected "tapering": a first reduction in purchases starting in December, although we will have to be on the lookout to see the development of the inflation and the currency.

The ECB was cautious about the recent strength of the Euro. On the one hand, it revised its growth forecast upwards (3 additional tenths) for 2017, to set it at 2.2%, but it also pointed out that the recent exchange rate volatility has added uncertainty and requires some monitoring of the implications it may have for price stability. On the other hand, it kept its CPI forecast for 2017 unchanged (1.5%), although it revised its estimations for 2018 downward (to 1.2%) as well as for 2019 (to 1.5%), mainly due to the aforementioned strength of the Euro. On this issue, in its forecast report it stresses that, despite the recent appreciation of the euro and since it is linked to expectations of stronger economic growth, its depressing effect on prices is significantly lower, as it is offset by the strength of domestic demand.

With the backdrop of this international scenario, the growth of the Spanish economy for the second quarter still stands out among its surrounding countries, posting a quarterly 0.9%, which exceeds the quarterly rates reached in Germany (0.6%), France (0.5%), Italy (0.4%) or the United Kingdom (0.3%). In the Eurozone as a whole, quarterly growth was set at 0.6%. The year-on-year rate for the Spanish economy reached 3.1%. Behind this positive growth trend there are a number of factors that are progressing better than expected (exports, job creation and activity of the construction sector) and compensating for other elements that could be slowing down the economy (oil prices, fiscal policy and political uncertainty). In addition, other elements favouring growth are still present, such as low interest rates and the extension of the implementation period for the ECB's expansionary monetary policy measures, which contribute to positive financial conditions.

In addition to the strength of activity, one of the most relevant aspects is that a balanced growth pattern remains in effect, whereby domestic demand slightly increased its contribution to GDP growth, reaching 2.4 percentage points, and the external sector also contributed positively, with 0.7 percentage points, within a context where both exports and imports slowed down. As far as domestic demand goes, it is worth highlighting the strength of private consumption, with a quarterly growth rate that rebounded from 0.4% to 0.7%, although the year-on-year rate remains at 2.5%. Significant job creation and low interest rates have enabled this behaviour. In addition, inflation for said months remained restrained with respect to the first months of the year.

Meanwhile, investment in capital goods still stands as the most dynamic component within domestic demand in year-on-year terms, with a 4.1% rate, although there are some signs of a certain exhaustion in this growth rate due, in part, to the uncertainty affecting the global as well as the national economic situation. Investment in construction, which had already been improving in previous quarters, again recorded a notable improvement in the second quarter (3.0% year-on-year), due to the higher growth in the residential segment, while segments dealing with other types of buildings and constructions showed signs of deterioration.

CEOE’s activity indicator for the third quarter points to a slight economic deceleration (0.8%), in line with some indicators already released for this period. Thus, the number of workers registered with the Social Security in July and August signal a slowdown, with a year-on-year growth rate of 3.5%, compared to 3.8% in the second quarter, although the job creation rate remains high. In addition, other indicators such as car registrations, the retail index or the IPI have also slowed down in recent months.

Although initial forecasts for the Spanish economy in 2017 predicted a continuation of the decelerating trend posted in 2016, the rebound shown by activity and employment in the first months of 2017 now lead to an expected growth similar to that of 2016, possibly reaching 3.2% rate this year and 2.7% for 2018.

On the other hand, inflation has almost halved since the beginning of 2017, when it stood at around 3%. The upward impact of oil prices is not as significant now as it was at the beginning of the year, but it still has an effect on the evolution of the overall inflation. However, year-end forecasts set the year-on-year CPI rate at around 1%, a similar rate to what is expected for core inflation, despite the mild upward trend since April.

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