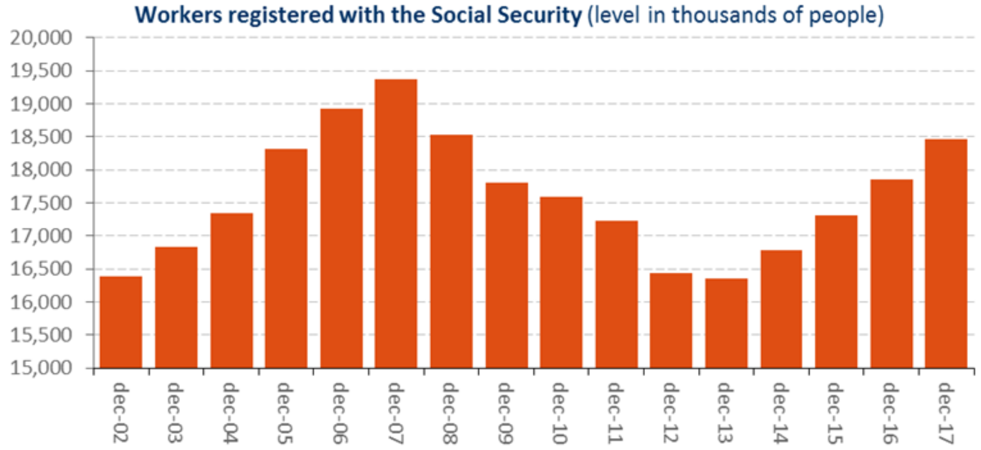
ECONOMIC OUTLOOK

January 2018

- ***The global economy continued growing at a healthy pace in the third quarter, and confidence indicators suggest that this will follow through onto the fourth quarter of 2017.***
- ***The Federal Reserve hiked interest rates again in December, to set them between 1.25% and 1.5%.***
- ***Oil prices are still following an upward trend, set at an average of $65 per barrel in December.***
- ***Low impact of the environment of uncertainty that the Spanish economy experienced in the fourth quarter. According to the Bank of Spain, GDP maintained a 0.8% quarterly rate of growth. Therefore, the Spanish economy will have grown over 3% (3.1%) for the third consecutive year.***
- ***Positive balance in the labour market in 2017 according to the number of workers registered with the Social Security: 611 thousand new contributors.***
- ***The year-on-year CPI rate for December was set at 1.1%, with the moderation in core inflation over the latter part of 2017 being noteworthy.***
- ***The Social Security deficit soared at the end of 2017, but there is still room, albeit scarce, to meet the public deficit objective.***

CONTENT:

Workers registered with the Social Security (level in thousands of people)



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

INTERNATIONAL SCENE: the Fed hikes interest rates

In December, financial markets showed mixed behaviour, with negative results prevailing in European stock markets as a result of the political uncertainty in some countries and the negotiations over Brexit. In contrast, in the United States and Japan, the indexes continued to reach new highs, driven by the approval of the tax reform in the United States, despite the increase in interest rates by the Federal Reserve, and the extension of expansionary policies in Japan.

With regards to the world economy, it is worth highlighting that it is still growing at a healthy pace. In the third quarter, the European Union as well as Japan and the United States accelerated their year-on-year growth rates to reach 2.6%, 2.1% and 2.3% respectively. Among the emerging economies, the mild deceleration in China stands out, posting growth of 6.8% year-on-year in the third quarter, just one tenth less than in the previous two quarters, as well as the momentum of other Asian economies such as India, South Korea and Indonesia, whose year-on-year growth rates increased. Russia and Brazil also posted improved year-on-year growth rates, while Mexico showed a notable deceleration.

Confidence indicators suggest that the good performance of the economy will continue over the fourth quarter of the year. Thus, the global composite PMI increased three tenths in December to 54.4 points, marking the highest growth rate of the world economy since the beginning of 2015.

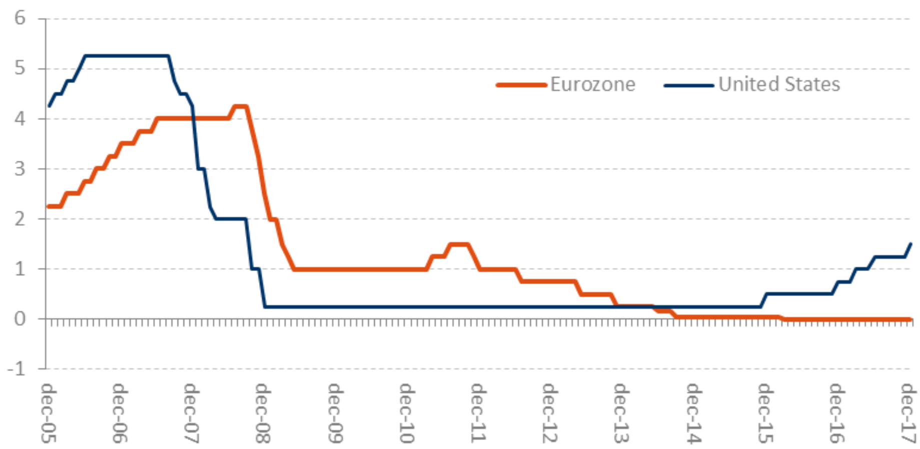
Meanwhile, in the United States, the most extensive tax reform of the past 30 years was passed in December. It aims to energize the economy by favouring the production of companies inside the country as opposed to production in third countries. The central axis of the reform is the reduction of the corporate tax rate from 35% to 21%, with the aim of encouraging job creation and wage increases. In addition, a rate between 8% and 15.5% is established for repatriation of overseas capital.

Regarding the decisions by central banks, the main highlights include the rate hike by the Federal Reserve, who raised them 25 basis points to 1.25%-1.5%. This is the third increase in 2017. By 2018, three additional increases are expected, following the Fed's upward revision of growth forecasts to 2.5% for both 2017 and 2018.

Meanwhile, the ECB kept its interest rates unchanged and they are expected to remain that way for a prolonged period of time. From January to September, asset purchases have been reduced to €30 billion per month, compared to the previous €60 billion per month. The Bank of Japan also kept its interest rates unchanged, although it announced it would reduce the purchases of long-term debt.

In December, oil prices continued their upward trend. Brent crude was set at a monthly average of $ 65 per barrel, an increase of 2.9% in comparison to November and 22.3% compared to December 2016. In euros, the increase was more moderate (8.9%) due to the currency's appreciation. The reasons for higher prices include the agreement between OPEC countries and other producers to prolong production cuts throughout 2018, several failures in a major pipeline in the North Sea and geopolitical tensions in Iran.

Interest rates in the United States and the Eurozone



Source: Freelunch.com and CEOE Economic Research Unit

THE SPANISH ECONOMY: positive balance in the fourth quarter despite the environment of uncertainty

According to estimates by the Bank of Spain, the Spanish economy reached a quarterly GDP growth rate of 0.8% in the fourth quarter. This means that GDP kept growing at a steady pace in the fourth quarter, despite the environment of uncertainty derived from the crisis in Catalonia. Thus, the good performance of international markets and, in turn, of exports, may have managed to counteract the slight deceleration in domestic demand, concentrated on components such as investment in capital goods and consumption. If this forecast is confirmed, the Spanish economy could close 2017 with a very positive balance, meaning growth above 3% (3.1%) for the third consecutive year and more than half a million new jobs, according to the number of workers registered with the Social Security.

In fact, according to Social Security data, the behaviour of the labour market was very favourable in 2017. In particular, the increase in the number of workers that contribute to the Social Security in December (42.4 thousand people) enabled job creation throughout 2017 to rise to 611 thousand people, the second best closing of the year in the historical series, following 2005.

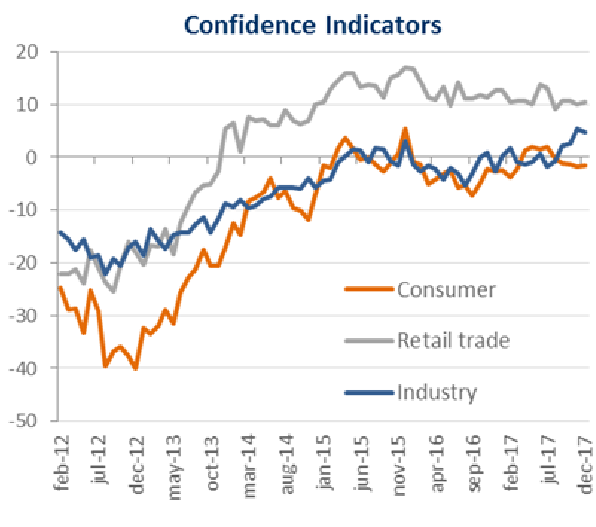
There is no doubt that the environment of uncertainty associated with the crisis in Catalonia has a greater weight in estimates for 2018. However, the possible return to normality of the political situation coupled with the drive, although increasingly smaller, of those factors that support growth, such as favourable financing conditions, the strength of the world economy and the gains in competitiveness of the Spanish economy, set a favourable scenario for growth in activity and employment. Therefore, although a deceleration is anticipated for 2018, it could be lower than expected and GDP could grow at around 2.8%.

DEMAND AND ACTIVITY: the economy is still strong in the fourth quarter driven by improved exports

The Spanish economy continued to grow at a good pace in the fourth quarter, as indicated by the preliminary estimate from the Bank of Spain. Although lower GDP growth was expected in the last quarter of the year, mainly due to the political and economic uncertainty generated in Catalonia, in the end the slowdown during this period seems to have impacted only this Autonomous Community, affecting tourism and private consumption. In addition, this effect would have been offset by the favourable evolution of sales abroad, which are showing greater dynamism within a context of greater growth of the Spanish export markets.

Indeed, with the information available for the fourth quarter, there has been a slight deceleration in private consumption as a result of both, the uncertainty in Catalonia and the depletion of retained spending after the crisis. In this sense, the consumer confidence indicator has shown a clear worsening in recent months due to decreased optimism about employment and the economy in general, although it is still at very positive levels. The deceleration of family consumption is also noticed in car registrations, which overall increased by 7.7% for the year, but if we take into account just those made by individuals, then the increase was only 4.4%.

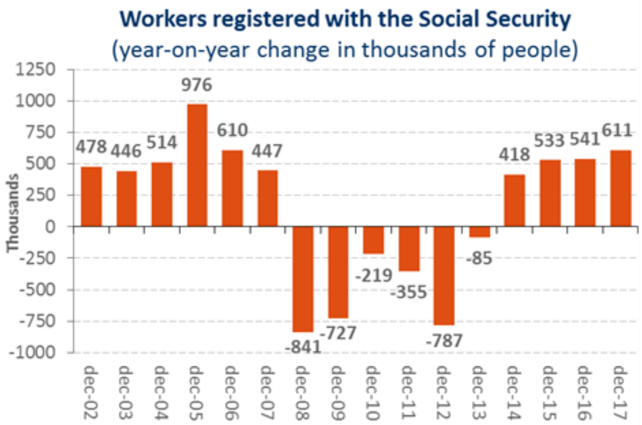
According to business investment indicators for the fourth quarter, this component has grown at rates similar to those registered in the previous quarters, driven by the positive performance of exports and industrial production. In addition, the financing conditions for families and businesses continue to be very favourable and demand for new credit continues to increase, which may enable further growth in consumption and investment. Regarding the foreign sector, the scarce information, only available for the month of October, shows an acceleration of both exports and imports, which, if maintained over the latter months, would be compatible with a positive contribution from the foreign sector.



Source: European Commission

THE LABOUR MARKET: 2017 concludes with 18.46 million people registered with the social security, the highest number for a month of December since 2008

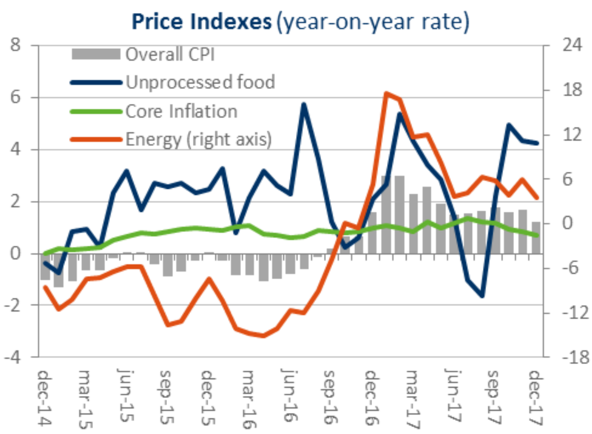
The number of workers registered with the Social Security increased by 42,444 people in December, mainly driven by the trade and health sectors, although the increase is lower than the one registered in the previous four years. In this way, 2017 concludes with 18.46 million contributors, the highest number for a month of December since 2008. In year-on-year terms, the number of workers registered increased by 611,146 people, the second highest number for a month of December in the historical series (following 2005). Meanwhile, the year-on-year rate went down two tenths to 3.4%, but in the fourth quarter as a whole it remained at 3.5%, the same as in the third quarter. Thus, in 2017, the number of workers registered with the Social Security grew by an annual average of 3.6%, six tenths more than in 2016, which confirms the positive momentum of the labour market.



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

PRICES: inflation subdues in December due to the year-on-year decrease in oil prices and the moderation in core inflation

As we had been anticipating in previous monthly reports, inflation in December subdued significantly, posting a year-on-year rate of 1.1%. With this data, average inflation for 2017 is set at 2.0%, following decreases over the past three years. The deceleration of core inflation during the past months, closing the year at 0.8%, and the increase of the exchange rate of the euro against the dollar have made it possible for overall inflation to follow a decelerating path throughout the year, despite the increase in oil prices since July. During the coming months, if oil prices remain at current levels ($ 65 per barrel so far in January), inflation is expected to continue decreasing to around 1%.



Source: INE

THE PUBLIC SECTOR: the social security deficit soared at the end of 2017, but there is still room, albeit scarce, to meet the public deficit objective

The Social Security deficit at the close of 2017 rose to €18 billion (around -1.6% of GDP), which counteracts the containment trend followed by other levels of the public sector. In fact, the budget implementation in the General Government up to September pointed to a significant containment of the budget imbalance (-1.5% of GDP), which seemed to indicate that the projected public deficit objective for 2017 (-3.1% of GDP) was attainable. Thus, the surplus registered by the Local Government (+0.5% of GDP) and the Regional Government (+0.1% of GDP) offset the deficit registered by the Central Administration (-1.5% of GDP) and the Social Security funds up to September (-0.6% of GDP).

Focusing on the State and with information up to November, it is worth noting the significant effort made by this level of Government, both in terms of reducing the negative balance (one point to -1.6% of GDP), and increasing the primary balance, which posted a surplus of 0.5% of GDP. The key to this result is increased revenues (3.7%), especially from VAT and income and property taxes, and a drop in expenditures of 2.1%, which is spread among almost all items, except for social benefits in kind and aids for investment. Therefore, taking into account the deficit reduction of the Central Government, the surplus in local and regional governments and how much the negative Social Security balance amounts to, the public deficit objective for 2017 could be met.