ECONOMIC OUTLOOK

January 2019

- ***The Government presented the General State Budget for 2019, in which the public deficit objective is set at -1.3% of GDP.***
- ***The expenditure policy is expansionary in the social field, which means that the improvement in the budget balance is based on a notable increase in tax revenues, especially those that fall on the business sector.***
- ***The government revised down by one tenth its GDP growth forecast for 2019, to set it at 2.2%.***
- ***The number of workers registered with the Social Security closes 2018 with more than 19 million contributors, the highest figure since December 2007. In 2018, the number of people registered with the Social Security increased by an annual average of 3.1%, five tenths less than in 2017.***
- ***Inflation slows down rapidly and closes the year at 1.2% due to the decrease in energy prices. The average for the year stands at 1.7%.***
- ***Significant losses in the main stock markets during the month of December.***
- ***The global economy continues to show signs of a mild deceleration that will continue throughout 2019.***
- ***The Federal Reserve hiked interest rates again in December, to the 2.25%-2.5% range.***
- ***Oil prices continued to decline during December, down to $56.2 per barrel on average, the lowest since August 2017.***

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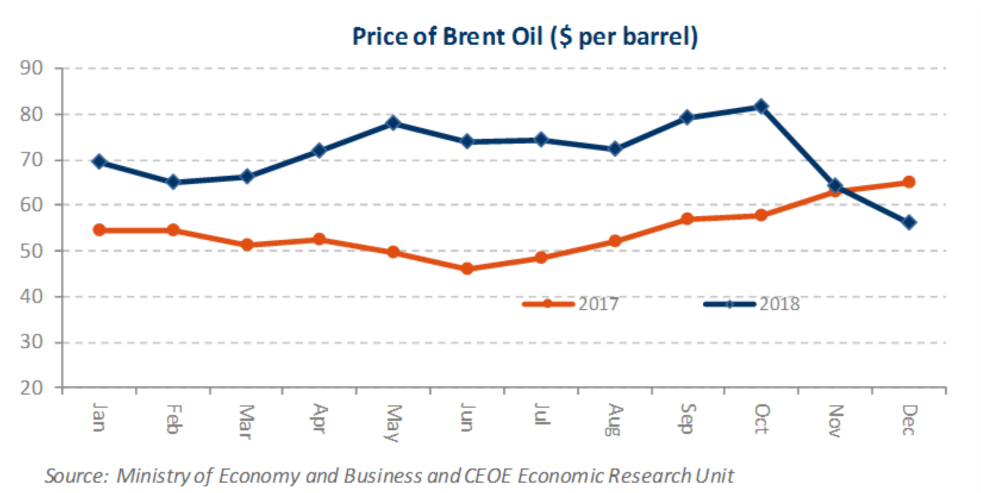

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INTERNATIONAL SCENE: in December, the Federal Reserve hiked interest rates once again

During the month of December, the main stock markets showed a clearly bearish behaviour, despite the commercial truce between the United States and China. However, uncertainties regarding Brexit, increasing doubts about the strength of the global economy and a series of poor economic results in certain US companies, mostly in the technology sector, have resulted in a severe setback for global stock markets, which has led, in many cases, to a negative balance for 2018.

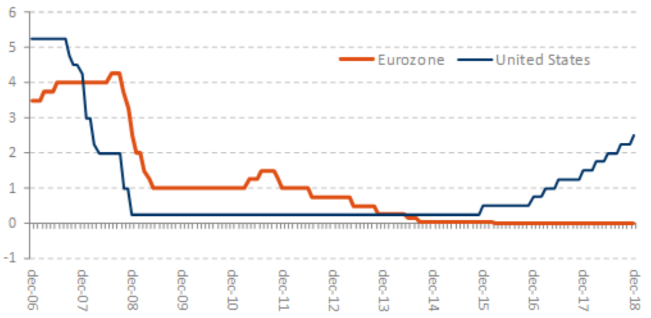
With regard to the world economy, it is worth noting that the signs of a gradual deceleration are still present. In the third quarter, growth of the Eurozone was very moderate, a quarterly 0.2%, two tenths lower than in the previous quarter, while, in Japan, the economy contracted by -0.6%. In contrast, the United Kingdom showed an improvement in growth posting 0.6%, two tenths more than in the second quarter due, in part, to the accumulation of inventories and, in the United States, the economy is still showing remarkable dynamism, with a 0.8% growth rate, two tenths lower than in the preceding months.

Meanwhile, leading confidence and economic sentiment indicators show that during the fourth quarter activity will continue to lose momentum, although it will still post solid growth rates. In this regard, the global manufacturing PMI for December registered its lowest value in more than two years. This loss of dynamism is observed both in advanced economies, with the composite PMI for the Eurozone at four-year lows and the one for the United States at the lowest values of the last year and a half, as well as in emerging economies, where China's composite PMI fell two tenths, and the manufacturing PMI was below 50 points, suggesting a contraction in manufacturing activity. Moreover, in Russia, India or Turkey there was a decrease in business confidence indicators, while Brazil is showing some improvement.

This deceleration in activity is expected to continue throughout 2019, in an environment in which financial conditions at a global level will be less accommodative, with the Federal Reserve expected to continue with its monetary policy normalization and the ECB ending its purchases of new assets. In addition, there is still a lot of uncertainty over the agreements that will be adopted for Brexit and on whether trade tensions between the United States and China will intensify. In addition, the US Administration has been partially closed for the past two weeks due to the impossibility of reaching an agreement over the budget, a situation that, if extended over time, will significantly affect the country's growth and consumption.

On the other hand, in December the Federal Reserve implemented its fourth rate hike in 2018, setting rates between the 2.25%-2.5% range. However, its president, Jerome Powell, has stated that the next moves will be conditioned by the evolution of the economy and employment figures. In this sense, the Fed has revised its forecasts downwards for 2019 and, therefore, its monetary normalization pace is expected to slow down in the future, with two rate increases foreseen in 2019 and an additional increase in 2020.

Interest rates in the United States and the Eurozone



Source: Federal Reserve, ECB and CEOE Economic Research Unit

In contrast, the Bank of Japan and the Bank of England decided to keep their monetary policy unchanged. Meanwhile, the ECB also kept its interest rates unchanged and, although it ended its asset purchase program, it indicated that it would reinvest the maturities over a long period of time, even beyond the start of future interest rates hikes.

In December, oil prices continued declining, with Brent crude trading at its lowest value since August 2017, at an average of $56.2 per barrel. This price is 12.1% lower than in November and 13.4% cheaper than a year ago. The price decrease is mainly due to the fear among investors of a slowdown in the global economy and of the market experiencing an oil over-supply. Thus, the price of Brent oil showed a descending trend throughout the month, closing near $50 per barrel, despite the fact that, on December 7, the OPEC countries and their trading partners, among them Russia, agreed to reduce production by 1.2 million barrels per day, starting in January 2019.

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THE SPANISH ECONOMY: State Budget 2019: expansionary in the social field, higher contributions to the Social Security and lower growth

The Government presented the General State Budget for 2019, in which the public deficit objective is set at -1.3% of GDP, in comparison to the preliminary figure included in the Budgetary Plan (-1.8% of GDP). Therefore, the initial fiscal consolidation path is resumed. Meanwhile, a reduction in public debt to levels of 95.4% of GDP is expected over the year.

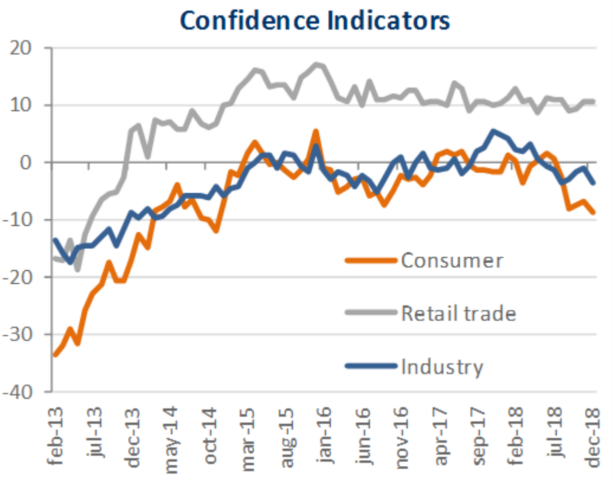
With the release of more detailed figures still pending, the expenditure policy will be expansionary on the social front (whose weight rises to 57.3% of consolidated expenditures), especially in pensions (which increases by 6.2%) and dependency (which grows by 59%). Therefore, the improvement in the budget balance is based on a notable increase in tax revenues, especially those that fall on the business sector. For 2019, tax revenues are estimated at €227.356 billion, 9.5% higher than the final revenue figure estimated for 2018, an estimation that seems too high, in light of the slowdown expected for the Spanish economy (the Government has revised downwards its GDP forecast for 2019 to 2.2%).

In CEOE's opinion, the State Budget-2019 is not what the Spanish economy needs at a time when it is undergoing a decelerating phase and in light of the current public debt levels (96.9% of GDP in 2018). Thus, an increase in expenditures that become structural hinders the fiscal consolidation process and constitutes an obstacle to the sustainability of the public finances in the medium and long term. In addition, this budget does not include measures aimed at solving the major challenges of the Spanish economy, such as the sustainability of the public pension system or the reduction of the unemployment rate through the promotion of active employment policies.

In addition, the Government had previously approved a series of measures related to the labour market that fully affect business competitiveness and are based on an increase in labour costs. Thus, there is an increase in the contributions to the Social Security paid by the companies (among them, the maximum and minimum contribution bases increase, the latter in line with the increase in the Minimum Wage for the General Scheme, by 22.3%).

DEMAND AND ACTIVITY: the economy is growing at the same rate due to strong consumption and investment

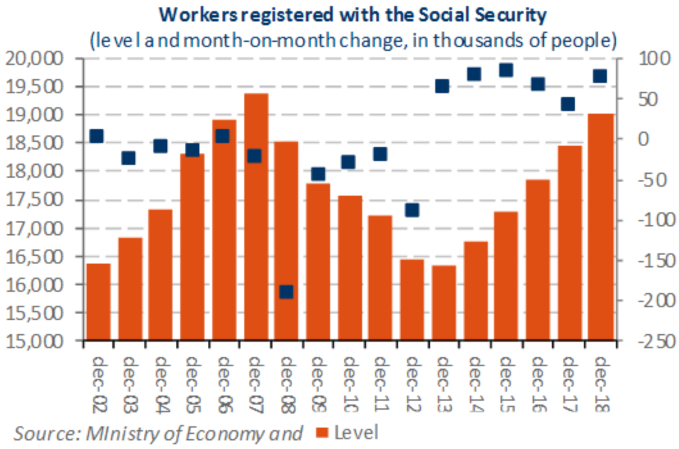
The Spanish economy continues to grow at a good pace. After three consecutive quarters growing at rates of 0.6%, and according to the information available, over the last stretch of 2018 the activity may have followed a similar trend. This dynamism has continued based on the strength of private consumption and investment. On the one hand, the increase in household spending has been supported by the favourable progress in the creation of employment and the increase in wages. In this sense, the retail trade index rebounded strongly in October and November, breaking the decelerating path shown throughout the year. Consumer expectations, however, have continued to worsen, especially in regard to expectations about the general economy and employment. Although car registrations posted a rather negative fourth quarter, they show an increase of 7% for the year as a whole, which is a positive fact, even though the sector is nervous due to the uncertainty faced by manufacturers and buyers. In regard to family consumption ahead of 2019, the low savings rate is worrying, and it is foreseeable that part of the improvement in the gross disposable income of households resulting from the increase in wages will be used to rebuild savings. In regard to investment, it continues to be the most dynamic component of the economy and, although it showed a certain deceleration in Q3, the information available for Q4 points to a positive evolution. Thus, the industrial climate index for investment goods showed a recovery in comparison to the deterioration of Q3, and in October both, the turnover and the entry of orders, registered a higher growth than the Q3 average. Regarding the foreign sector, in terms of national accounts, it continued to subtract growth in Q3 (-0.4 pp), although, according to our estimates, this negative contribution will improve in the coming quarters, thanks to a lower dynamism of imports.



Source: European Commission

THE LABOUR MARKET: the number of workers registered with the Social Security closes 2018 with more than 19 million people, the highest since December 2007

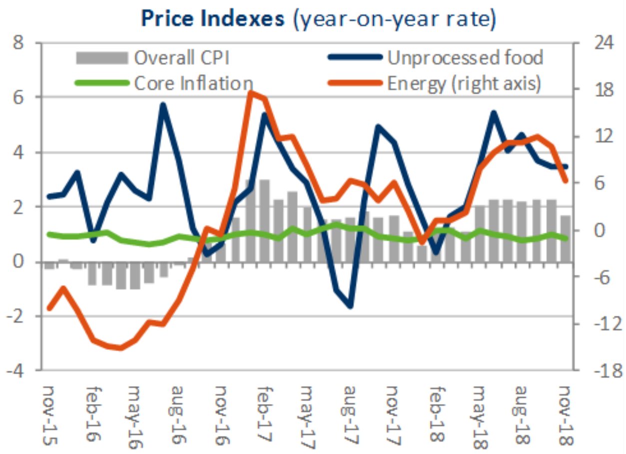
The number of workers registered with the Social security increased by 78,541 in December, driven mainly by the agricultural, trade and health sectors, and represents a higher increase than the one recorded in the previous two years. Thus, 2018 closes with 19.02 million people registered with the Social Security, the highest figure for the month of December since 2007. Meanwhile, the year-on-year rate accelerates two tenths to 3.1% (+563,964 people), while in Q4 it stands at 3.0%, a rate that has been pretty much unchanged since April. Thus, in 2018, the number of contributors to the Social Security grew by an annual average rate of 3.1%, five tenths less than in 2017, in line with the lower dynamism of the economy. It is expected that in 2019 the loss of momentum in job creation will continue.



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

PRICES: inflation slows down rapidly due to the decrease in energy prices

According to the National Statistics Institute's flash estimate, year-on-year CPI will drop to 1.2% in December, after registering 1.7% in November and 2.3% in October. This drastic deceleration in inflation has been due to the decline in oil prices, which has led to lower growth in the price of energy products. Specifically, oil stood at $56.2 per barrel in December, 13.4% lower than a year ago. On the other hand, core inflation continues registering very moderate rates (0.9% in November), showing price stability in the core components of inflation. Thus, 2018 closed with an average increase in prices of 1.7% and, if oil prices remain at current levels, inflation may continue to fall over 2019, with the corresponding decrease in the average annual rate.



Source: INE

THE PUBLIC SECTOR: 2018 will close with a public deficit of –2.7% of GDP

According to the presentation of the General State Budget 2019, in 2018, and still awaiting final figures, tax revenues are estimated to reach €207 billion, 1.5% lower than what was budgeted, but higher, for the first time, that the historical high in revenues that was recorded in 2007, a year which ended with a budget surplus. It is quite clear that, if revenues have recovered pre-crisis levels and, despite this, we are still posting a deficit, it is because expenditures have not been contained. In particular, the Government estimated that the public deficit would close 2018 at –2.7% of GDP.

In terms of budget execution for 2018, the State's net borrowing until November reached €12.378 billion in terms of National Accounts, which corresponds to 1.0% of GDP, below the 1.5% of GDP registered in the same period of the previous year. This improvement in the budget balance is explained by the strength of non-financial resources, which increased by 8.5%, and a rebound in uses, which also increased by 4.6%.

With regard to the deficit of the General Government, at September it stood at -1.2% of GDP, lower than the -1.6% of GDP registered in the same period in 2017. It should be noted that the surplus registered by the Local Government (0.4% of GDP) and the Autonomous Regions (0.2% of GDP) is offset by the negative balance of the Central Administration (-1.2% of GDP) and the Social Security Funds (-0.6% of GDP).

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