ECONOMIC OUTLOOK

April 2019

- ***The world economy continues to show signs of a mild slowdown due to trade tensions, geopolitical uncertainty and falling confidence in companies and consumers.***
- ***Within this scenario of lower global dynamism, central banks have announced more cautious behaviour with regards to normalizing their monetary policy.***
- ***In Spain, the INE (National Statistics Institute) revised GDP growth for the fourth quarter significantly downward, which confirms that the deceleration path of the Spanish economy in 2018 was more intense than initially estimated***
- ***Spain's growth expectations for 2019 suggest that the economic activity would continue to slow down and GDP could increase by 2.1%***
- ***Slight slowdown in the number of workers registered with the Social Security in the first quarter.***
- ***The net lending position of the Spanish economy stood at 1.5% of GDP in 2018.***
- ***The Public Administrations registered a net borrowing position of -2.6% of GDP in 2018, somewhat below the level initially announced by the Government (-2.7% of GDP), but far from the initial target (-2.2% of GDP).***

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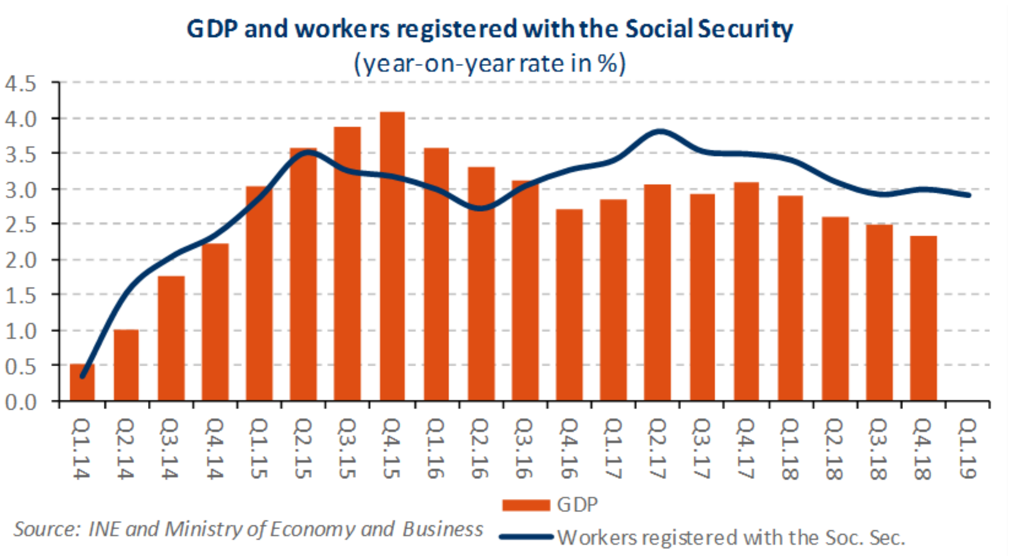

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INTERNATIONAL SCENE: the global economy continues to lose momentum

In March, the main global stock markets posted mixed behaviours, with a certain predominance of moderate increases, although within an environment marked by high volatility. The high likelihood of a trade agreement between China and the United States has coexisted with the ECB's measures to delay its monetary policy normalization and the slower pace announced by the Federal Reserve, together with the prospects of a slowdown in the global economy.

All of the above is coupled with the growing uncertainty about the British Parliament's decisions with regard to Brexit. For the time being, the House has rejected the agreement reached between Theresa May and Brussels as well as other proposals on possible trade agreements between the United Kingdom and the European Union. However, it did approve the processing of a law to force the British Government to request Brussels for an extension of the exit deadline and, thus, avoid a Brexit with no agreement.

Meanwhile, the global economy continues to show signs of a mild deceleration. The OECD revised downward its forecasts for global GDP growth to 3.3% in 2019 vs. 3.6% in 2018, highlighting a notable slowdown in world trade, largely due to the existing commercial tensions. Other factors that influence the economy's loss of momentum are political uncertainty and the decrease in consumer and business confidence. For her part, Christine Lagarde also advanced that the IMF will revise its forecasts for world growth downwards, below the 3.5% estimated last January.

This deceleration of global trade is especially notable in the manufacturing sectors of the different countries, and the manufacturing PMIs reflect this lower activity. Thus, the manufacturing PMI for March in the Eurozone fell 1.7 points after having fallen 1.2 points in February, standing at 47.6 points. This shows the contraction of activity in the sector, which is greatly affected by the automotive industry. In this regard, Deutsche Bank estimates that the negative impact of the change in emission regulations (WLTP) could be coming to an end. However, the sector could still be affected by lower demand in some key markets. In addition, in Japan, the manufacturing PMI became negative in February and this followed through to March, as a result of lower growth in China. In other countries, such as the United States or the United Kingdom, manufacturing PMIs also declined, although they remain above 50 points. In contrast, service PMIs show positive behaviour in most countries, a fact that softens the deterioration of activity in regions such as Japan or the Eurozone, where consumer confidence in March improved by two tenths, or helps composite PMIs to improve in the United States, the United Kingdom and some emerging countries. In China, exports, and to a lesser extent, imports, declined in the first months of the year. In addition, the government revised downwards its growth target for 2019, setting it between 6% and 6.5%. At the same time, it announced a series of measures to stimulate activity, such as tax reductions for small and medium-sized companies and investments in railway infrastructures.

The slowdown in the world economy is forcing the main central banks to modify their plans with regards to their monetary policy normalization, turning them more cautious. In this sense, the Federal Reserve, after its downward revision of growth and inflation forecasts for the United States, announced that it is going to slow down its balance sheet reduction and, starting in May, it will reinvest principal payments from maturing bonds that exceed the monthly cap amount, which will be reduced from the current $30 billion to $15 billion, also pointing out that the balance sheet reduction will end at the end of September. However, it will continue to reduce the amount of mortgage-backed assets, reinvesting only principal payments in excess of $20 billion per month. The minutes of the meetings also indicate that the outlook for interest rate hikes has declined markedly and rates are expected to remain unchanged in 2019, with a possible hike in 2020. Meanwhile, the ECB stressed that its rates will stand at their current levels at least until the end of 2019, and it announced a series of targeted longer-term refinancing operations (TLTRO-III) to ensure the liquidity of the financial system. This comes after it also lowered its growth and inflation forecasts for the Eurozone.

With regard to oil prices, it should be noted that during March they continued their upward trend, with Brent crude trading at $66.0 per barrel on average, 2.7% higher than in February, which leads to an unchanged year-on-year rate. However, in euros this represents a 9.1% increase vs. March 2018, due to the depreciation of the euro against the dollar over the past year.

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THE SPANISH ECONOMY: the deceleration path was more pronounced in 2018, although the correction of imbalances continued

In its final estimate for the fourth-quarter GDP, the INE has revised quarterly growth for the Spanish economy downwards, setting it at 0.55%, one tenth lower than the growth rate posted in January. In year-on-year terms, activity slowed down two tenths to 2.3%, confirming that the slowing trend in economic activity in 2018 was more intense than initially estimated. Growth has been less balanced than in previous years, since contribution from the external sector was negative due to the loss of dynamism in exports. In addition, more uncertainty and higher companies costs are hindering investment decisions, which is reflected in the capital goods component at year-end.

For 2018 as a whole, GDP grew by 2.6%, still a positive result in comparison to the rest of Europe, and improvement was made in the correction of imbalances. Thus, the Spanish economy was able to attain a net lending position in 2018 for the seventh consecutive year, standing at 1.5% of GDP (2.1% in 2017) and the public deficit in 2018 closed at -2.6% of GDP, vs. -3.0% of GDP in 2017.

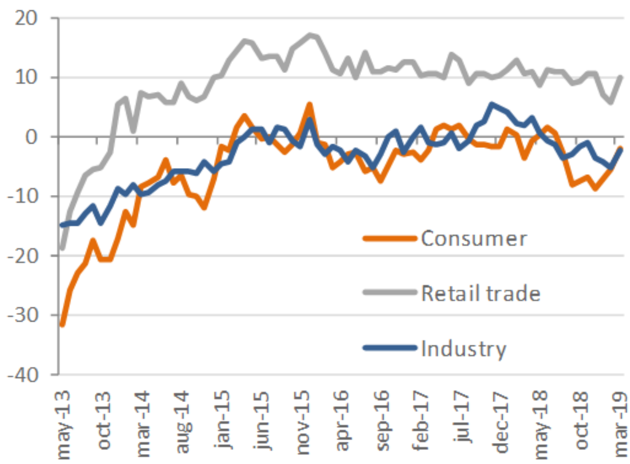
Looking ahead at 2019 and in terms of growth, in light of the international context foreseen, exports are not expected to increase strongly, while the lack of economic and political stability and the resulting uncertainty might dampen the dynamism shown by domestic demand. In this respect, the decelerating trend seen at the end of 2018 negatively affects the outlook for 2019, as we have anticipated by revising our GDP estimation down to 2.1%

One of the risks that hovers over this scenario is the final outcome of Brexit. The Bank of Spain has estimated the macroeconomic impact of Brexit in our country under different scenarios. In the event of a Brexit with agreement and in which the commercial relationship is based on a treaty similar to that of the EU and Canada (CETA), the impact on GDP would be minimal (0.02 pp. in five years). If, in the end, there is no trade agreement, our GDP would decrease 0.5 percentage points if the exit takes place in an orderly way, while if it is disorderly, GDP would contract 0.8 percentage points in five years.

DEMAND AND ACTIVITY: domestic demand may support GDP growth in the first quarter

Finally, as we have just mentioned, the Spanish economy grew a mere 0.55% in the last quarter of 2018. Those indicators available for the first few months of 2019 point to a similar growth rate in Q1. Thus, the dynamism in employment and improved expectations, coupled with contained inflation, continue to support the growth in consumption and will continue to do so in the coming months. In this regard, consumer expectations improved in Q1 in comparison to the last part of last year. However, the confidence of the retail trade sector has worsened slightly, despite the favourable evolution of the sales indicators. Thus, the retail trade index registered an average rate in January and February similar to the figure for Q4, and domestic sales of large companies in January grew 4.1% y-o-y. Car registrations continue to be the item that shows the greatest weakness, due to the different problems that are affecting the sector and which we have already mentioned on previous occasions. With regard to investment, more uncertainty at a national and international level is weighing down on decision-making by companies, as reflected on the slowdown in investments in capital goods in Q4. However, according to the first indicators available (industrial climate index, turnover, entry of orders and capital goods imports), the evolution in Q1 could be more favourable than the figures registered in Q4. Meanwhile, investment in construction remains positive, mainly in the residential component. Thus, taking into account data for January only, we can see that home sales and new mortgages maintain a positive momentum at the beginning of the year. With regard to the external sector, in January, exports decreased by 1.3% y-o-y, due to the fall in sales to the European Union (-3.1%), although there were also negative variations in the other geographic areas. Imports also decelerated significantly, being set at 0.9% y-o-y.

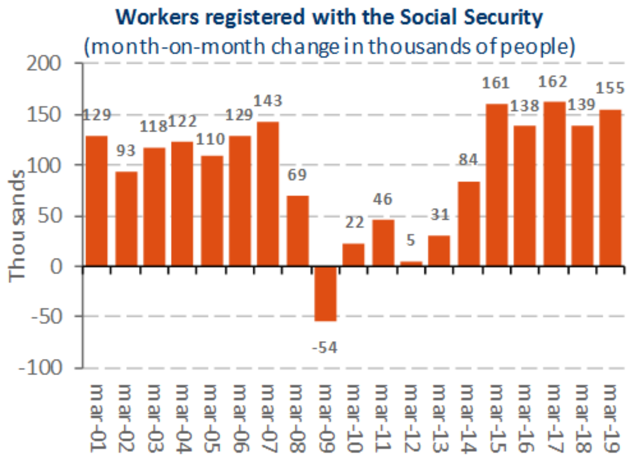
Confidence Indicators



Source: European Commission

THE LABOUR MARKET: growth in the number of workers registered with the Social Security decreases one tenth in the first quarter

The number of workers registered with the Social Security increased in March by 155,104, the third highest record in the historical series for this month, following 2015 and 2017, and even taking into account that Easter lands in April this year, while in 2018 it was celebrated in March. However, in Q1, which tends to be seasonally unfavourable, the number of people registered decreased by 70,505 in comparison to Q4 of 2018, due to a decrease by 84,334 people in the private sector, which was offset by an increase in 13,829 people in the public sector. In year-on-year terms, the number of workers registered posted an increase of 2.9% in March for the third consecutive month, so in Q1 as a whole, the growth rate is one tenth lower than in the previous quarter.

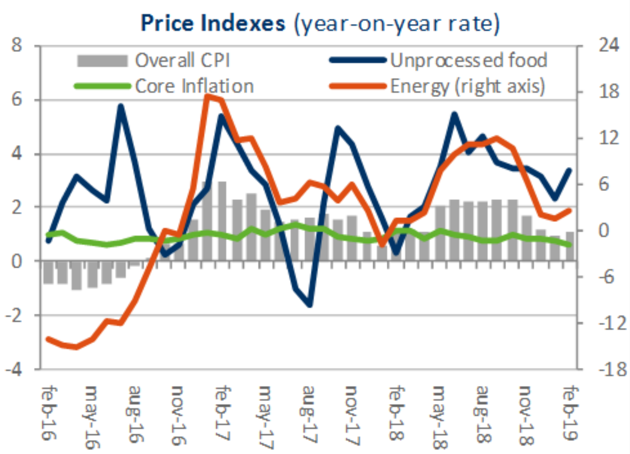


Source: Ministry of Economy and Business

PRICES: energy prices are responsible for a slight upturn in the CPI for march

In February, inflation increased one tenth to 1.1% due to the higher increase in energy and unprocessed food prices. Underlying inflation declined one tenth to 0.7%, continuing its downward trend and showing a clear absence of inflationary pressures in terms of core CPI.

In March, according to the INE's flash estimate, inflation will be set at 1.3%. This is mainly due to the evolution of fuel and electricity prices, in line with higher oil prices, which were set at $66.0 per barrel on average in March. In the coming months, inflation is expected to remain subdued, at around 1%.



Source: INE

THE PUBLIC SECTOR: the public deficit in 2018 was set at -2.6% of GDP

The General Government registered a net borrowing position of -2.6% of GDP in 2018, somewhat below the Government's preliminary figure (-2.7% of GDP), but far from the initial target (-2.2% of GDP). On a positive note, it is worth highlighting that this result ensures Spain's exit from the Excessive Deficit Procedure, a process in which it had been immersed since 2009, and that the primary deficit has been significantly reduced, from -0.5% of GDP in 2017 to -0.1% of GDP. However, as negative aspects it should be noted that the effort to consolidate public finances last year was minimal compared to 2017, when it stood at -3.0% of GDP, and that the structural deficit is not being reduced, as AIREF pointed out.

By Government levels, the State deficit stood at -1.6% of GDP, compared to -1.9% of GDP in 2017. This improvement is mostly due to non-financial revenues, which grew 8% thanks to the increase in tax revenues, while non-financial expenditures increased by 5.7%, showcasing the expansionary policy through public spending. Meanwhile, the Autonomous Regions also reduced their deficit in 2018 from -0.4% of GDP to -0.2% of GDP, while the Local Governments posted a budget surplus for the seventh consecutive year. The Social Security System continues to have a large deficit (-1.5% of GDP) that is barely lower than the figure posted in 2017, despite the dynamism of revenues from social contributions.

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