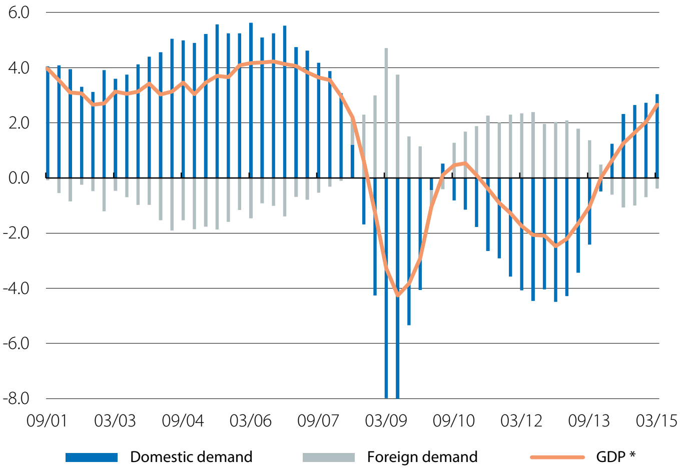
ECONOMIC OUTLOOK · **GDP takes flight with a favourable wind**

The economic recovery speeds up in Q1, supported by domestic demand. Data from the National Accounts system confirm 0.9% growth in GDP quarter-on-quarter in Q1 (0.7% in Q4), thanks especially to a very dynamic domestic demand. The contribution by foreign demand has also been positive due to the good performance by exports. This acceleration in activity observed over the last few months, and which the latest business indicators suggest will continue, is supported by both external and internal factors. Of note among the former is the drop in oil prices, the euro's depreciation and growth speeding up for European partners. On the domestic front, particularly important is the rapid improvement in the confidence of agents, boosting business investment and private consumption. Given this scenario, we have maintained our GDP growth forecast at 2.8% for 2015 but note that this rate may once again be even higher if the effects of the aforementioned factors gain strength over the coming months.

Domestic demand consolidates as the driving force behind economic growth. The advance in private consumption slowed up by 0.2 pps in Q1, to 0.7% quarter-on-quarter. However, this was offset by the drive from public consumption, up by 1.6% quarter-on-quarter. Private consumption is expected to continue to perform well over the coming quarters thanks to the improved financial situation of households, boosted by the good trend in the labour market and better financial conditions (see the Focus «The financial situation of Spanish households is getting stronger»). On the other hand growth in investment in capital goods has eased slightly, posting a rise of 1.3% quarter-on-quarter in Q1 (1.8% in Q4), as already suggested by the figures for the composite indicator for capital goods. This slight slowdown compared with previous quarters coincides with the usual pattern for investment in the different stages of recovery. Capital goods investment is the most volatile component of GDP because the timescale used to take business investment decisions is much longer than the one used, for example, to take consumption decisions and is therefore more sensitive to changes in the economic environment. In the first quarters of a recovery, it tends to grow at a faster rate than the long-term rate and then stabilises at a more sustainable pace (in the first two years of the recovery, investment grew by 3.0% quarter-on-quarter on average).

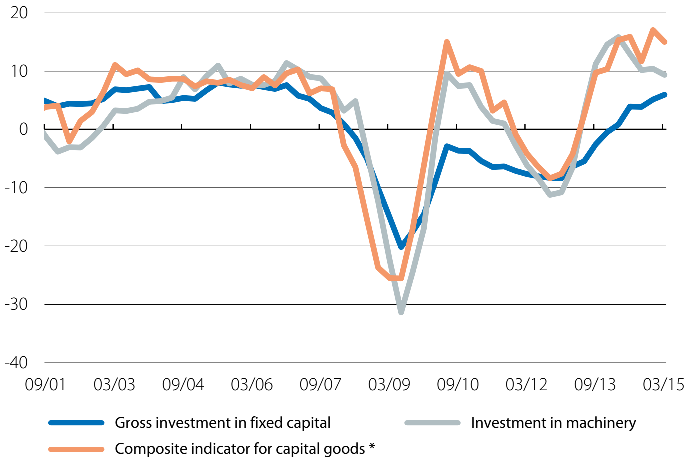
Economic activity shows no signs of tiring in Q2. According to available business indicators for Q2, the good trend in GDP seen at the start of the year has continued. One example of this is the sharp upswing in the services PMI, increasing to 60.3 points in April, a level not seen since 2000, while the manufacturing index remained clearly in the expansionary zone at 54.2 points. Confidence indicators also point to the

GDP
Contribution to year-on-year growth (pps)



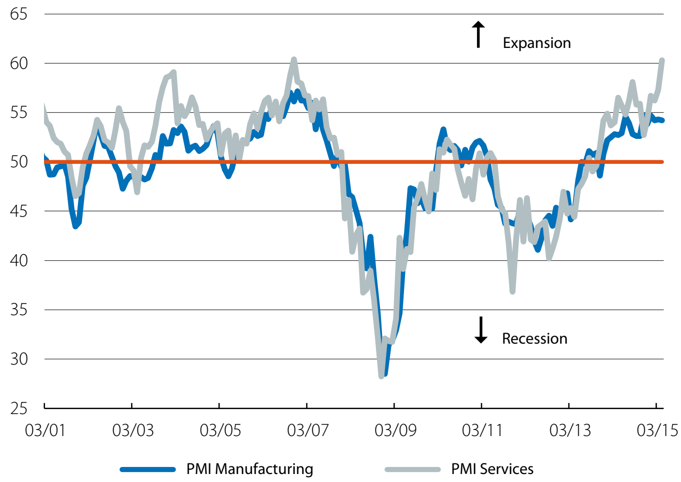
Note: * Year-on-year change.
Source: "la Caixa" Research, based on INE data.

Demand indicators: investment
Year-on-year change (%)



Note: * Year-on-year change in the moving average of three months.
Source: "la Caixa" Research, based on data from INE and the Ministry of Finance and Competitiveness.

Activity indicators
Level



Source: "la Caixa" Research, based on data from Markit.

positive momentum of economic growth continuing in Q2. This is indicated by the economic sentiment index of the European Commission which reached 110.4 points in May, its highest level since 2001. With regard to the factors making up this index, of note is the greater confidence in the construction sector thanks to the increase in activity and in demand for housing.

The good rate of economic growth is helping to create jobs. Data from the National Accounts system for Q1 corroborate the good figures provided by the labour force survey, with a 0.8% increase in the number of employees, in terms of full-time equivalent jobs, compared with the previous quarter. Wages per employee also grew by 0.9% year-on-year, partly reflecting the repayment of some of the 2012 bonus to civil servants, raising unit labour costs by 1.0% compared with the previous year. With a view to Q2, the data for registered workers affiliated to Social Security suggest that the labour market was still dynamic in April, accelerating by 0.2 pps to 3.5% year-on-year (see the Focus «A review of Spain's good employment figures»). Lastly, employers and trade unions reached a pre-accord regarding the wage agreement after months of negotiations. This contains a pay rise of 1.0% in 2015 and 1.5% in 2016.

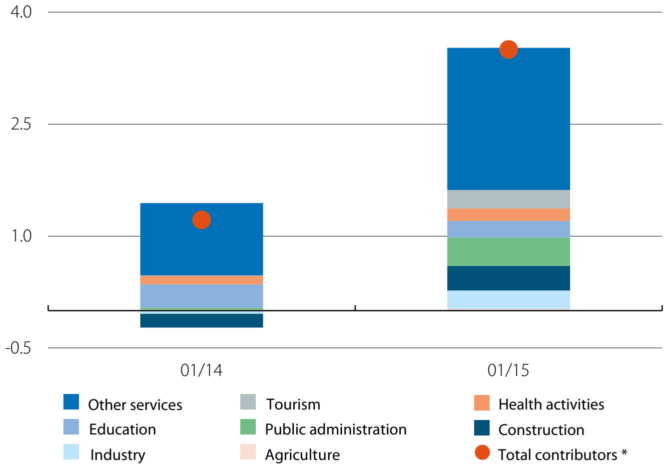
The trend of prices is still strongly affected by oil. The trend in the price of crude has affected both the consumer price index (CPI) and producer prices, both posting a negative year-on-year change rate for almost a year. However, the recent rise in oil prices is gradually helping to moderate the rate of contraction in both indices. Specifically, the year-on-year rate of change for producer prices increased by 0.3 pps in April to –1.0%, 0.2 pps of which were due to an increase in the energy component. The same effect has also been seen in the general inflation rate, up by 0.4 pps in May to –0.2%. In this case it is not only due to the rise in fuel prices but also to the progressive improvement in core inflation, supported by the recovery in domestic demand and the euro's depreciation.

The trend in prices leaves its mark on the trade balance. The current account balance posted a surplus of 10.7 billion euros in March (cumulative figures over 12 months), 1.5 billion higher than February's figure. This improvement comes largely from the effect of falling oil prices on the trade balance. Given that these figures are in line with our scenario of a gradual improvement in the balance throughout 2015, we have maintained our forecast of a current account surplus of 1.1% of GDP for this year. Figures for the tourism industry confirm the good performance of the foreign sector. In April Spain received 6.0% more international tourists than in April last year (cumulative over 12 months). Particularly of note is the increase in tourists from outside the euro area, specifically the United States, benefitting from the euro's depreciation.

Signs of recovery in the real estate market are increasingly evident. Residential investment grew by 0.2% quarter-on-

Registered workers affiliated to Social Security

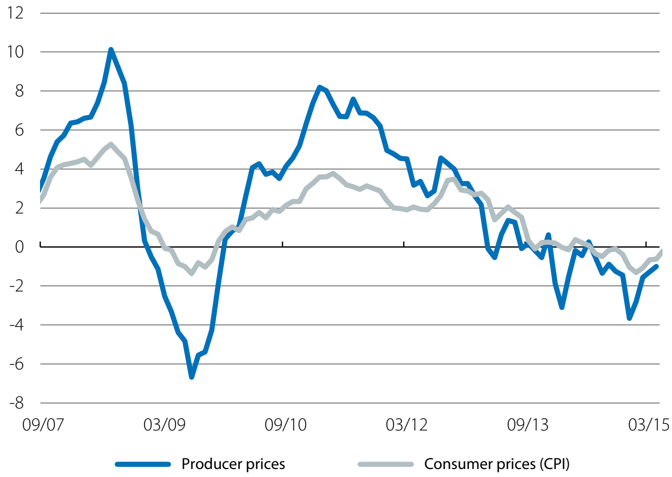
Contribution to the year-on-year change by sector (pps)



Note * Year-on-year change.
Source: "la Caixa" Research, based on data from the Ministry of Employment and Social Security.

Price index

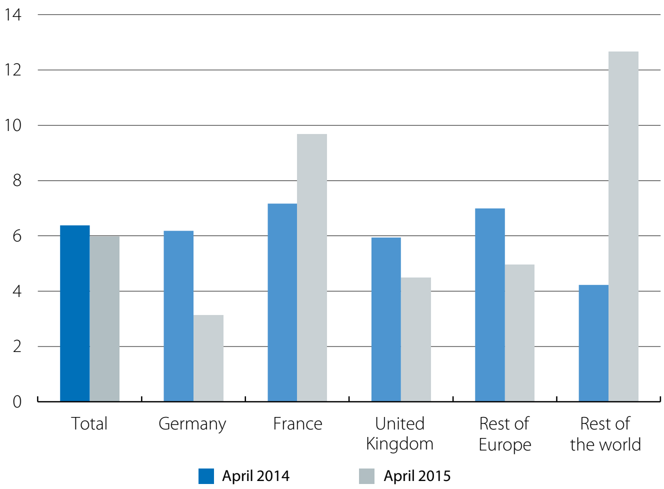
Year-on-year change (%)



Source: "la Caixa" Research, based on INE data.

Tourist visits by country of origin

Year-on-year change in the 12-month cumulative figure (%)



Source: "la Caixa" Research, based on INE data.

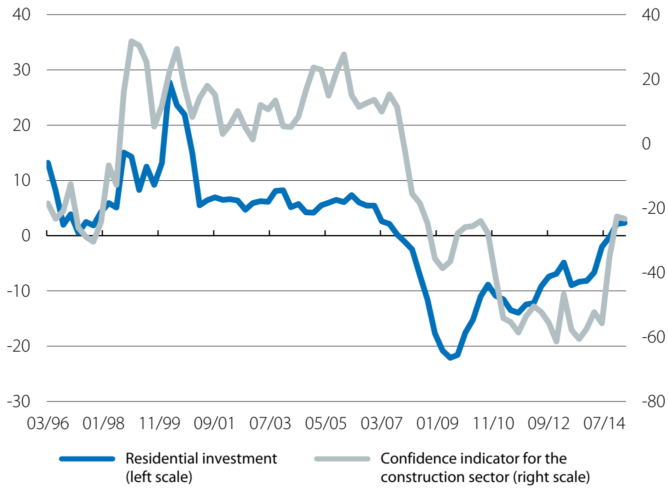
quarter in Q1, posting a positive rate of growth for the fifth consecutive quarter. The good trend in business and demand indicators suggest this recovery in the sector will gradually gain traction in the coming quarters. The number of new building permits grew by 12% year-on-year in March according to the cumulative figure over 12 months. With regard to demand, of note is the rise in house purchases, up by 9.5% year-on-year in March (cumulative over 12 months) thanks to the improvement in financing conditions and the labour market. House prices have stabilised after adjusting by 30% in nominal terms since the peak reached in 2008 Q1.

The European Commission stresses the importance of taking advantage of the current economic situation to adopt pending reforms. April's state budget execution figures show a 0.3 pps improvement in the deficit compared with last year. However, this slight advance is due more to the vigorous recovery in economic activity than fiscal consolidation efforts, so achieving the deficit target for the whole of 2015 is still not guaranteed. In this respect, the European Commission, in its report containing recommendations on the stability programme, has underlined the importance of ensuring a durable correction in the public deficit. To this end, it repeats that it is vital to approve more structural reforms, a task it suggests should be carried out in years of growth, such as the present. Regarding the business environment, it stresses the importance of eliminating obstacles to corporate growth and of adopting reforms in professional services. In the area of labour, it recommends matching wages to productivity, implementing more effective active employment policies and encouraging mobility between regions. Lastly, it repeats that the banking sector must complete its reform of savings banks and the restructuring and privatisation of nationalised institutions.

A favourable economic environment for the banking sector. The third assessment report after the end of the bank bail-out concludes that the restructuring and privatisation of banks owned by the state is progressing as planned although this has yet to be completed. The business environment for the banking industry is increasingly favourable thanks to much of the regulatory uncertainty disappearing and improved economic activity. Given this situation, the sector's figures are improving little by little: the outstanding balance of non-performing loans has been falling for more than a year, allowing the NPL ratio to drop by 1.5 pps to 12.1%, from the peak reached in 2013. More credit is also being granted by banks thanks as the improved economic environment has increased solvent demand.

Indicators for the construction sector

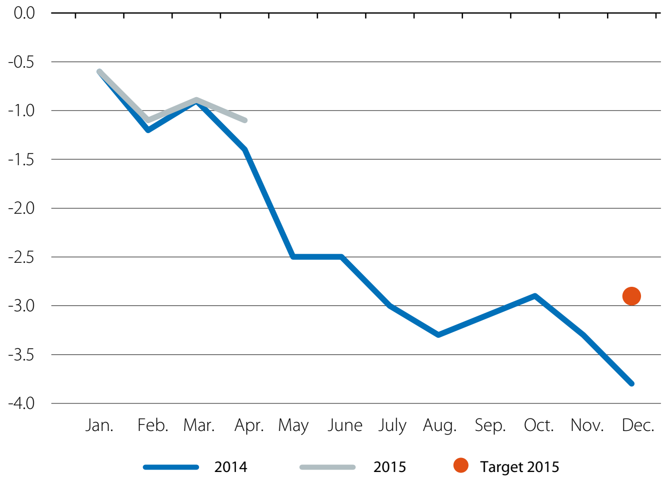
Year-on-year change (%) *Level*



Source: *"la Caixa" Research, based on data from the Ministry of Public Works.*

State budget execution

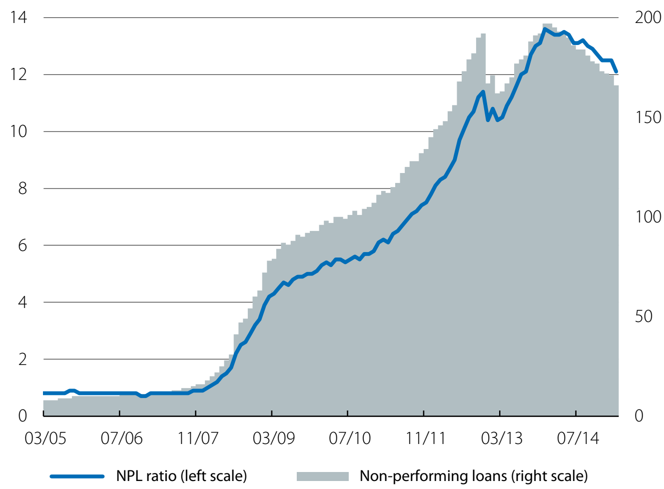
(% of GDP)



Source: *"la Caixa" Research, based on IGAE data.*

NPL ratio and non-performing loans

(%) *(Billion euros)*



Source: *"la Caixa" Research, based on data from the Bank of Spain.*