BBVA | RESEARCH

Spain Real Estate Outlook

SECOND HALF OF 2016 | SPAIN UNIT AND REAL ESTATE UNIT

01
Residential demand holds firm

02
Sector expectations turn positive

03
New building continues to grow

04
Housing prices will rise again in 2017

Index

1 Editorial 3

2. Recovery of the Spanish economy: the strength seen in 2016 will slacken somewhat in 2017 4

3 The real estate industry will continue to recover in 2017 7

Closing date: 13 October 2016

1 Editorial

Maintaining economic growth, both globally and domestically, will be crucial for consolidating the recovery of the real estate market. In a context of improving global economic conditions in the first half of the year, the Spanish economy is performing better than forecast for 2016. However, uncertainty and reduced impetus from tailwinds lead us to tone down growth expectations for 2017. Economic growth will continue to rely on both internal and external factors. Domestic demand will be driven by the recovery of its fundamentals, the correction of imbalances and the expansionary tone of fiscal and monetary policies.

In the first half of 2016, both sales and starts of new housing performed better than in the same period of last year, and this was due to the increase in demand, which was underpinned by three factors. In the first place, the positive trend in employment and incomes maintained the confidence of households at relatively high levels. Secondly, the expansive monetary policy made it possible to offer credit at low rates of interest. Lastly, the positive trend in foreign demand also contributed to the increase in the number of housing transactions.

Thanks to increased sales in a context of falling stock, housing prices are slowly recovering. In an environment of declining yields, the path seen in residential prices is **generating positive expectations, which will become a new factor supporting demand for housing**. In this regard, the development of the Internet and on-line applications provides new analytical instruments which complement existing ones. Thus, based on the data gathered by the GoogleTrends, we have developed a new indicator of demand allowing us to detect shifts in trends in demand for housing in real time. The result indicates that in the next few months housing sales will continue to grow.

The positive trend in demand, which has now had ten consecutive quarters of YoY growth, has led to a revival in building activity. **Housing starts are at their highest level for the past few years**. Since touching bottom in 2013, the number of building permits has increased by more than 50%. However, they still do not amount to even 10% of those approved in the first half of the past decade. Looking ahead, everything points to the growth trend continuing in 2017 and to residential construction contributing to GDP growth for the second year running.

However, the recovery of the real estate market continues to show marked geographical disparities, being more solid in regions with the most economic activity and in those benefiting most from the good performance of tourism. In other words, **in Spain, the sector's recovery is led by Madrid, the Mediterranean coast and the islands**.

The pace of growth in the real estate market will be maintained in 2017. **The slackening in the macroeconomic determinants of demand will be partly offset by recovering expectations as to the sector's future development**. Thus, we expect an increase of around 6.5% in the number sales for the year, bringing it close to half a million. All this will be helped by the maintenance of favourable financing conditions. Also, **the dynamism of sales in a context of falling stocks will translate into an increase in the average price of housing** in 2017, of about 3.5%. The market will react to these developments with an increase in the number of housing projects, leading to nearly 100,000 housing starts, which is still far short of the figure seen in the period immediately before the crisis, but starting to move away from the low point reached in 2014.

2. Recovery of the Spanish economy: the strength seen in 2016 will slacken somewhat in 2017[1]

The growth rate observed so far this year has allowed us to **revise upwards that for the whole year 2016**. However, certain new factors in the situation (Brexit, fiscal measures and above all uncertainty regarding economic policy) compel us to **moderate our expectations for 2017**. In any case, this improved activity will be enough to create around eight hundred thousand net new jobs and reduce the unemployment rate to 18.2% by the end of next year. **Growth will continue to rely on both internal and external factors**. Despite the revisions, the decline in global growth and the rise in the euro exchange rate and oil prices, the international environment will continue to support growth in export demand. Thus domestic demand will be driven by the recovery of its fundamentals, progress in correcting imbalances and expansionary fiscal and monetary policies.

The global economic situation improved in the first half of the year

The world economy is finding it difficult to achieve more than limited growth compared with pre-crisis levels. Looking ahead, the most recent indicators seem to confirm the continuation of this trend. This, together with the reduction in financial stresses in both developed and emerging markets, points to global growth of 3.1% for 2016.

The uncertainty associated with the potential impact of Brexit and the strengthening of the downward bias in the monetary policies of the major central banks have affected the dynamic of financial markets in the past few months. Brexit brought a substantial increase in financial volatility and punished share prices in the European corporate sector. Its effect, however, was transitory and non-systemic. The response of central banks helped cushion the effect of Brexit, with the Fed delaying the process of interest rate normalisation and the ECB, BoE and BoJ remaining predisposed to boost stimulus schemes.

In short, **the political shock in the UK** will have an impact on confidence and lead to a period of recession in the British economy, but its estimated short-term effect **on the rest of Europe will be relatively limited** (three to four tenths of a percent lower growth in 2017), mainly through trade. In the rest of the world the impact will be almost negligible. The greatest risk of an overall effect from the referendum is its potential political contagion to the rest of Europe, an effect which is still to be determined.

In the US, several factors have led us to revise our growth forecasts for 2016 and 2017 downwards to around 2%: disappointing first quarter growth, the persistent weakness of non-residential investment, the uncertainty associated with the November elections, and global risks. Additionally, in its latest meetings the US Federal Reserve expressed increased doubts about the US economy's potential for long-term growth in productivity and GDP, which implies greater uncertainty as to where the equilibrium interest rate lies.

In China, fears of a sharp slowdown in the economy have partly dissipated following the stabilisation of GDP growth at 6.7% in the second quarter, somewhat better than expected, supported by strong consumption and an increase in lending. Accordingly, we are maintaining our forecast of a moderate slowdown in growth to 6.4% in 2016 and to 5.8% in 2017.

In the euro zone, the improved performance of the economy in the first half of the year brings the GDP growth forecast for 2016 up to 1.6%. However, the recent increase in oil prices, and above all the UK's vote to leave the EU justify a downward revision for 2017, to 1.5%. The risks in Europe continue to be

1: For more detailed information on Spain's economic situation, please refer to Spain Economic Outlook, Third Quarter 2016, available at: https://www.bbvaresearch.com/en/publicaciones/presentation-spain-economic-outlook-third-quarter-2016/

biased downwards, and are mainly of a political nature. Added to the uncertainty about Brexit is the possibility of political contagion to other member states: The Netherlands, France and Germany with elections in 2017 and Italy with an upcoming constitutional referendum and a fragile banking system. Risks, albeit reduced, also persist in Greece.

Growth will continue to rely on both internal and external factors

Confirmation of upward bias to Spain's GDP growth in 2016, but numerous pointers to downward bias in 2017. Growth is expected to reach 3.1% on average this year and 2.3% in 2017. Although activity data show no slowing so far, the materialisation of certain external and domestic risks points to a slowdown in the next few quarters. In any case, we expect the recovery and job creation to continue, given the impetus from supports such as monetary policy. However, the Spanish economy is becoming increasingly vulnerable, so the policies to be adopted in the next few years need to be defined as soon as possible.

GDP growth remains at annualised levels of around 3%, with hardly any signs of a slowdown. The strength of domestic demand, mainly of household consumption, continues to be the determinant factor behind this trend, despite the high level of volatility, the downward correction of financial markets and the persistent uncertainty about economic policy. **Also, everything points to the slowdown in growth of private investment having touched bottom, at least for the time being**. On the one hand, residential investment looks set to complete nine consecutive quarters of growth, performing appreciably better in the first half of 2016 than in the latter part of 2015. On the other hand both capital expenditure on machinery and equipment and exports of goods seem to have picked up in the second quarter of the year. And this in an ongoing environment that has been favouring the growth of tourism. The only component of demand that is dragging is investment in non-residential construction, which is suffering from the effects of a fiscal policy that concentrates part of the adjustment to the public accounts in spending on infrastructure.

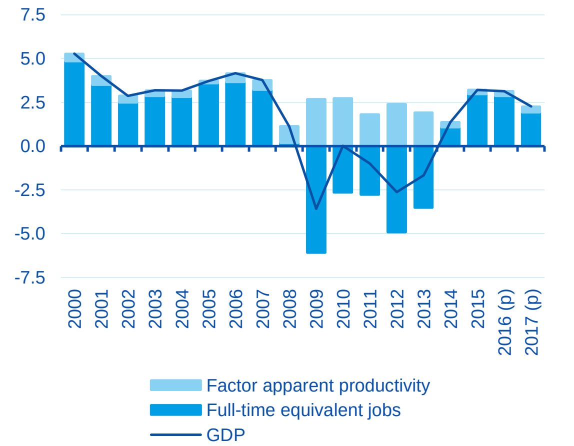
Recent trends in the US economy and the materialisation of risks in Europe have led to expectations of growth in developed countries being revised downwards and, therefore, to deterioration in the outlook for Spanish exports. **In the short term, the effect of Brexit on the Spanish economy will be limited (between 0.3 and 0.4 pp of GDP in 2017).** In this regard, the two main channels of transmission will be trade and finance. As regards trade, there are sectors (agrifood, automotive, chemical products and tourism) and regions (Aragon, the Balearic Islands, the Canary Islands, Valencia, La Rioja, Murcia and Navarre) which may find themselves being particularly affected. In particular, the expected fall in UK demand and the depreciation of the pound against the euro will act as a drag on export growth in the next few months. Apart from this, Brexit has given rise to a new bout of volatility in financial markets, albeit temporary for now and not having become a systemic event. Taken together, the two channels will have a negative impact on activity and mainly on Spanish exports, which will increase by 1.0% less in 2017 as a result of Brexit effects. The negative impact on GDP next year will also vary between 0.3 pp for the least exposed autonomous regions and 0.5 pp for the most exposed.

Added to the external risks is the materialisation of some internal ones and the slackening of the tailwinds which could slow down growth in the next few quarters. The imbalance in the public accounts remains constant at around 5% of GDP (12 months cumulative), and this has forced the authorities to reconsider their objectives. The new deficit target for the end of 2016 (4.6% of GDP) is credible, given the steps taken so far and the growth prospects for the year. In any case, if the policies announced are fulfilled, public spending will be adjusted in the second half of the year and will act as a drag on the growth of domestic demand. Apart from this, the growth in consumption and investment continue to reflect levels that are hard to explain in terms of the dynamic of employment and wage incomes. In this regard it may be that the demand pent up during the crisis has been nearly exhausted.

Despite this, the recovery will be helped by the expansive monetary policy being kept in place for an extended period. The environment described has led central banks to reaffirm their commitment to supporting growth. In the case of the ECB, it is possible that in the next few months we will see changes in the asset purchasing programme and that this programme will be extended beyond March 2017. This should provide certainty that interest rates will be held low for a long time, allowing economic agents to continue to deleverage or to borrow on advantageous terms. Given the solvency of the Spanish financial sector, the monetary policy transmission mechanisms are not blocked, as they seem to be in other peripheral European economies. Also, the price of oil will remain at relatively low levels, which together with the expected recovery in the growth of emerging countries next year and the increase in investment, should support exports despite the lower growth in developed countries. Lastly, increased geopolitical uncertainty continues to benefit the Spanish tourism sector, which will maintain its positive contribution to growth in the coming months.

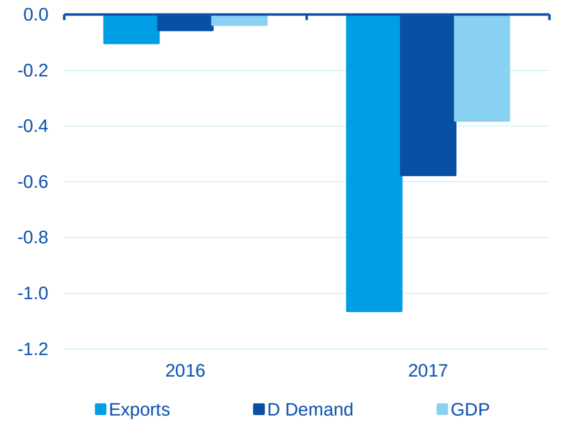
All the same, the Spanish economy is becoming more vulnerable, and there is now a need for certainty as soon as possible on the policies to be implemented in the coming years. Externally, there has been an increase in the frequency of negative events, whether related to the financial markets or of a geopolitical nature. In Spain, although the new deficit target agreed for 2016 is credible, its fulfilment in 2017 will require the implementation of measures to the extent of about 0.5% of GDP. Defining the composition of the adjustment will be crucial for assessing the impact on the economy and the sustainability of the public accounts in the long term. Apart from this, part of Spain's growth differential relative to other European economies is due to the reforms implemented in previous years. The exhaustion of the most recent impetus factors seen may increase the vulnerability of Spain's economy given the failure to define policies to be implemented in the next few years. Given the ever more limited leeway for fiscal and monetary policy, it may be that the only way to maintain growth and job creation in Spain is to continue with the process of improvements.

Figure 2.1
Spain: contributions to annual GDP growth (%)



(p): projected.
Source: BBVA Research based on INE

Figure 2.2
Spain: estimated impact of Brexit (difference compared to baseline scenario in pp)



Source: BBVA Research

3 The real estate industry will continue to recover in 2017

Félix Lores – Spain Unit | Ignacio San Martín, David Cortés, Leopoldo Duque – Real Estate Unit

Spain's real estate market continues to move forward on the path to recovery. In the first half of the year both housing sales and housing starts performed better than in the same period of last year. The encouraging performance of the real estate market is largely based on the **positive trends shown by the determinants of residential demand**, which include: growth in employment, increased supply of credit and low interest rates, strong foreign demand and, more recently, expectations of higher housing prices. In this regard, the increase in sales in a context of falling stock continues to favour a gradual increase in housing prices and also the first signs of a revival in new housing construction projects.

Thus we expect **the industry to continue recovering in 2016 at a similar rate to that of last year**. In line with forecasts for the economy as a whole, those for **residential investment** show a **slight moderation in growth for 2017**. However, this moderation is expected to be less marked than that of the economy as a whole in view of the importance of expectations in this market and the fact that for now those concerning housing are positive at the forecast horizon.

Sales show a clear growth trend…

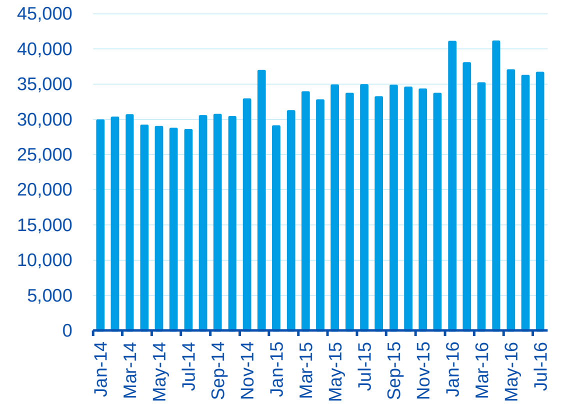
In the first half of 2016, the positive trend in the factors driving residential demand translated into a further quickening in the pace of sales. Although the general trend is one of increasing demand, a geographical breakdown continues to show great disparities among autonomous regions, with the Mediterranean regions performing better than the interior and north of the peninsula, except for Madrid, where sales remain strong.

Analysing the trend by period, we see that housing sales in the first half of 2016 were marked by good performances in January and April. In fact May and June saw sales growth slacken relative to the rates observed earlier in the year, as a result of which the number of transactions in the second quarter was practically unchanged from the first quarter (Figure 3.1). Despite this, sales continue to perform better than last year: **the number of housing transactions increased by 11.8% YoY in the first seven months of the year**, according to data from the Notarial Statistical Information Centre (CIEN). In other words from January to July of this year 265,793 residential properties were sold in Spain, as against 237,884 in the same period of 2015. Thus sales show a clear growth trend, as can be seen in Figure 3.2, which shows the cumulative number of transactions in the past twelve months.

The gradual **fall in new housing stock and the limited number of new-build properties coming onto the market is conditioning the options available to households**, which are turning to second-hand properties in view of the scarcity of new housing in the most dynamic markets. Accordingly the statistics indicate **greater dynamism in sales of second-hand housing**. Data from the Ministry of Public Works and Transport for the first half of the year show that sales of new housing fell by 5.7% while those of second-hand residential properties increased by just over 21% year-on-year[2]. Taking account of the definition of new housing and in view of this dynamic, we see a reduction in the weight of new housing in transactions. Thus in the first half of the year new housing transactions accounted for barely 10% of the total.

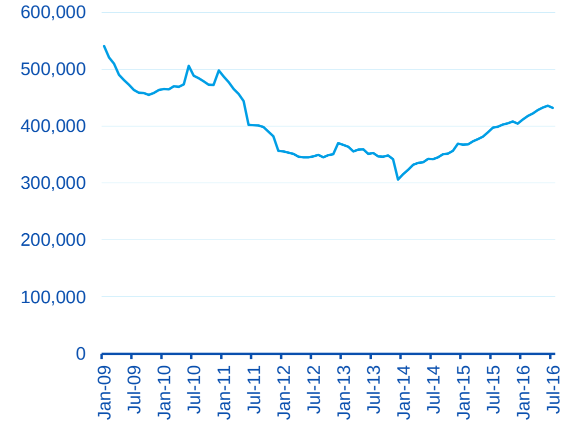
2: New housing is defined as housing that has never been the subject of a transaction and is less than five years old. In this regard, all residential properties which despite being less than five years old have been the subject of any kind of transaction, not necessarily a sale, are considered as second-hand, even if they have never been occupied. As we shall see presently, this definition is crucial in analysing the figures for over-supply published by the Ministry of Public Works and Transport.

Figure 3.1
Spain: sales of residential properties (SWDA)



Source: BBVA Research, based on data from CIEN (Notarial Statistical Information Centre)

Figure 3.2
Spain: sale of residential properties (12-month cumulative)



Source: BBVA Research, based on data from CIEN (Notarial Statistical Information Centre)

… showing great geographical disparities

At the end of June 2016, the aggregate data show that housing sales had grown year-on-year for ten consecutive quarters, and this trend is seen not just at national level but also in nearly all the autonomous regions. Only in Castile-La Mancha, Extremadura, Navarre and, to a lesser extent, Galicia, the Basque Country and La Rioja, has sales growth been interrupted in any of the last ten quarters. This demonstrates that **the recovery in demand really has been consolidated in nearly all regions**, although there are some in which growth is still weak.

In this regard, the data for the first half of the year show differing growth rates for housing sales in Spain's seventeen autonomous regions. In all except Navarre, where sales for the first six months of the year grew by just 1.8% YoY, sales for H1 2016 comfortably surpassed those of H1 2015. Growth rates varied between 6.7% in Galicia and 27.1% in Aragon.

Analysing the market dynamics in each of the autonomous regions in the first half of 2016 (Figure 3.3), we see that **in some markets**, such as those of the Balearic and Canary Islands, Catalonia and Madrid, **demand has already outstripped the process of adjustment of the past few years and is now normalising, whereas other markets** such as those of Extremadura, Galicia, Castile-La Mancha and Navarre **are still in the adjustment phase**[3].

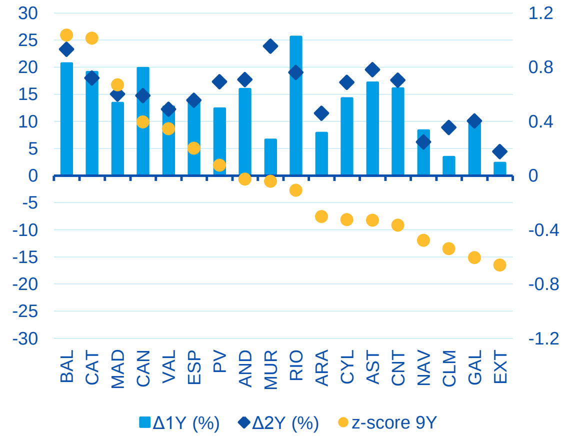
The growth breakdown shows the different extents to which **the main contribution to sales growth in each region comes from residents of that same region**. For example in Asturias, Extremadura, Galicia, Navarre and the Basque Country, the role played by other demand segments is negligible, with demand from residents of each region accounting for some 90% of the total.

On the other hand **there are regions where the real estate market continues to attract demand from abroad**. For example in both the Balearic and the Canary Islands housing purchases by foreigners accounted for approximately 40% of the total in H1 2016. This segment of demand also made notable contributions to the increase in sales in Murcia, Valencia and Andalusia.

3: To analyse the market dynamic of demand we looked at how it has evolved since the year the adjustment started, 2007. For each autonomous region we compared average monthly sales for the whole period selected with monthly average sales for H1 2016, estimating the distance from the mean in the number of standard deviations (z-score). Values in excess of the mean indicate that the market has normalised, while markets with values below the mean are still in the process of adjustment.

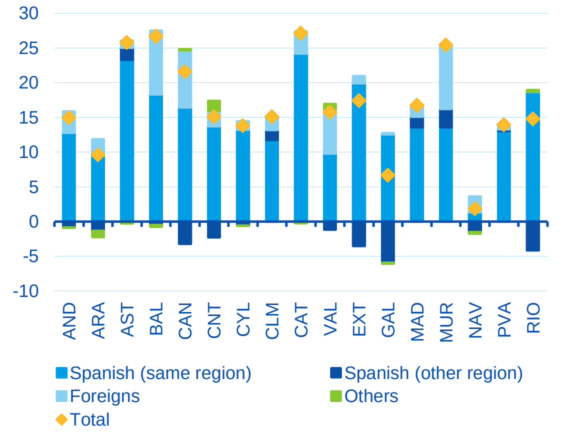
Lastly, housing purchases by residents of other regions show greater disparity. Although at national level this segment of demand contracted by 4.2% YoY in H1 2016, in some regions it increased. The increases in Madrid and Murcia stand out, with 19.4% of residential units sold being acquired by residents of other regions. However, in Galicia, the Canary Islands and Extremadura, this segment of demand contracted considerably. (Figure 3.4).

Figure 3.3
Spain: housing sales (indicator of normalisation, latest data Q2 2016)



Source: BBVA Research, based on MFOM (Ministry of Public Works & Transport) data

Figure 3.4
Spain: contribution to YoY growth in sales of residential properties in H1 2016 (in pp)

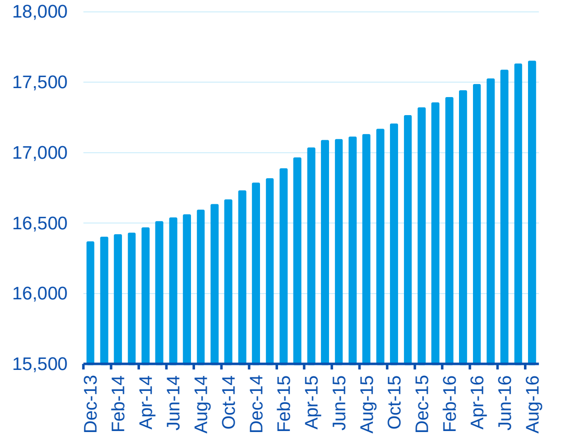


Source: BBVA Research, based on MFOM (Ministry of Public Works & Transport) data

The increase in demand is underpinned by that in employment and incomes, …

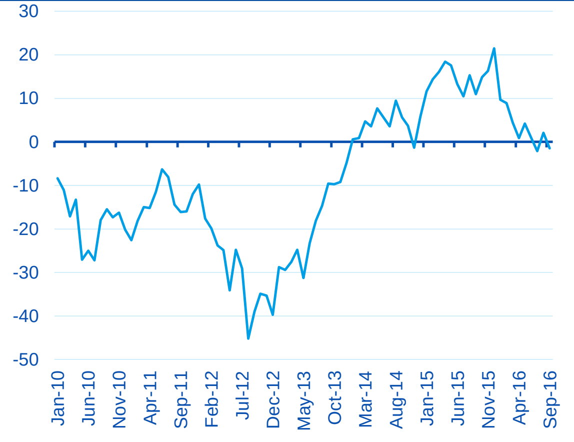
The good sales performance is due to the trends in the determinants of demand. During the first half of the year, economic growth was accompanied by **job creation**. In the first six months of the year, according to data of the National Statistics Institute's (INE)Labour Force Survey, the number of people with employment increased by approximately 200,000. At the same time, the number of unemployed persons fell by just over 200,000. This improvement in employment is appreciably smaller than that seen in the same period of last year. The reality of this will undoubtedly apply to the year as a whole, given the July and August data for new Social Security registrations, which show an appreciable decline which will be reflected in a slower pace of job creation in the following months (Figure 3.5). The decline in unemployment was also somewhat smaller than that of last year. All this favoured **growth in households' gross disposable income**, of which wages and salaries continue to be the main component. In particular, in the first half-year, household income increased by 2.8% YoY.

Figure 3.5
Spain: number of people registered with the Social Security (monthly average, SWDA)



Source: BBVA Research based on INE

Figure 3.6
Spain: consumer confidence (outlook on the economic situation in the coming 12 months, %, SWDA)



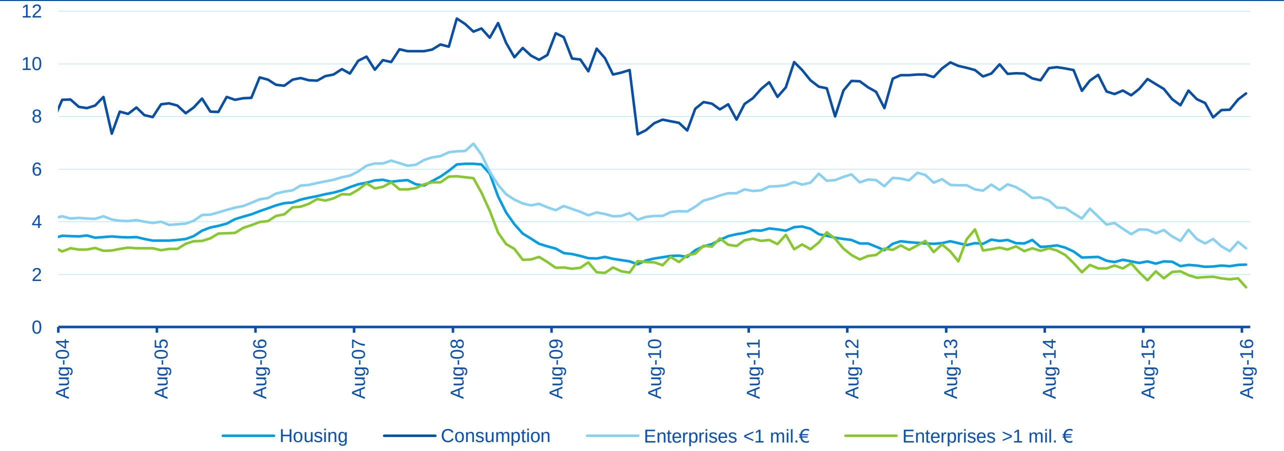
Source: BBVA Research based on Banco de España data

Despite the downturn in the past few months, consumer confidence remains at its highest level for the past few years (Figure 3.6). The latest available data, for September, indicate that most consumers are optimistic as regards the economic situation for the coming twelve months. Although this indicator has fallen over the course of 2016, it is still at a much higher level than those of the past few years, despite the uncertainty about economic policy and despite events adding further uncertainty, especially Brexit, and doubts about the robustness of growth of economies such as those of the US and China.

… the positive trend in mortgage lending…

The European Central Bank's ultra-expansive monetary policy continues to stimulate the recovery in lending to the retail sector (SMEs and households) in Spain. The mechanisms for transmitting the extraordinary measures taken by the ECB are working, and can already be seen in interest rates on loans (Figure 3.7) and in the growth of new lending to the sectors that are most reliant on bank financing.

Figure 3.7
Spain: trends in official interest rates (%)

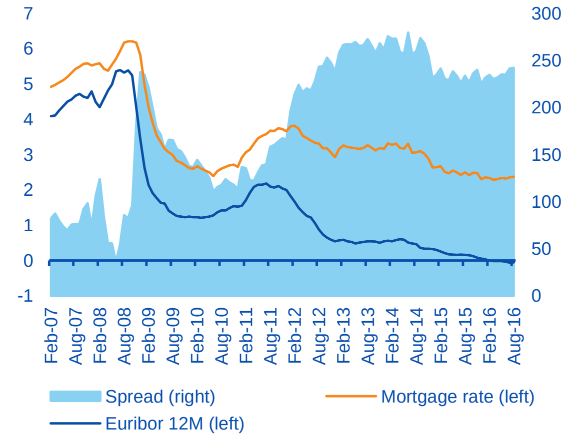


Source: BBVA Research based on Banco de España data

In August, the rate of interest applied to new lending to households to finance housing acquisition was 2.37% (APR), according to Banco de España data, representing a reduction of 13 basis points relative to the same month last year. The trend in the past few months shows some downward resistance, possibly due to the increasing weight of fixed rate mortgage loans. In this regard the composition of mortgage lending has changed over time. Whereas a few years ago **fixed rate mortgages** were few and far between (according to data of the Association of Property Registrars, in 2012 fewer than 3.5% of mortgage loans were at fixed interest rates), since the second half of 2015 **they have shown a remarkable increase**, accounting on average for 10% of all mortgage loans signed since then.

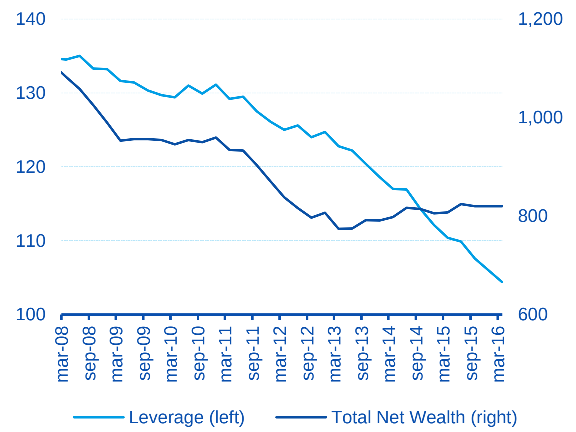
Breaking down the mortgage interest rate into a reference rate, the most commonly used being 12-month EURIBOR, and the margin applied by the financial institutions, which mainly measures the credit risk, and the commissions, we see that the decline in mortgage rates has been determined by the successive reductions in 12-month EURIBOR (Figure 3.8). Margins have remained relatively stable at around 230 bps, partly due to the shift in new lending towards fixed rates which tend to be higher than variable ones, showing that **the reduction in mortgage rates continues to owe more to central bank action** than to any relaxation of criteria for granting loans to households. In this regard, to the extent that households continue to deleverage and their disposable incomes to increase (Figure 3.9), criteria for granting loans could gradually be relaxed in the coming months.

Figure 3.8
Spain: mortgage rate, 12-month EURIBOR and margin (%)



Source: BBVA Research based on Banco de España and Haver data

Figure 3.9
Spain: households' indebtedness and total net wealth (% of gross disposable income)

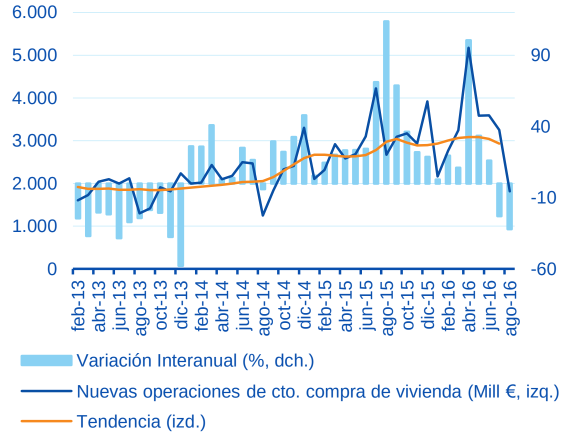


Source: BBVA Research based on Banco de España data

In this context, **the volume of new loans to households for home acquisition has continued to grow in 2016**, with the cumulative figure for the first eight months of the year up by 13.2% on the same period of 2015, despite the slowdown seen in the past few months (Figure 3.10). In July and August, new housing loans were down by 23.0% and 32.1% respectively on the same months of last year. However, this fall is explained by the significant base effect deriving from an increase in refinancing transactions as a result of the elimination of floor clauses by certain institutions (between July and September 2015 new home lending increased at an average YoY rate of 85%). If we eliminate this base effect, the number of new home loans increased by 29.8% YoY in August, representing YoY growth of 24.4% for the first eight months of 2016.

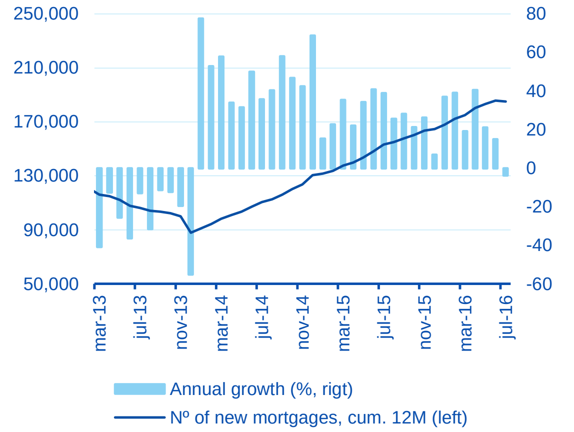
The data of the General Council of Notaries point in the same direction as those of Banco de España. **Mortgage lending showed a positive dynamic in the first part of 2016**, although the past few months have seen growth moderating: in July mortgage lending fell by 3.8% YoY (Figure 3.11). In the first seven months of the year 115,815 new mortgages were signed, compared with 95,530 in the same period of 2015, representing an increase of 21.2%.

Figure 3.10
Spain: flow of new credit to households for home purchase



Source: BBVA Research based on Banco de España data

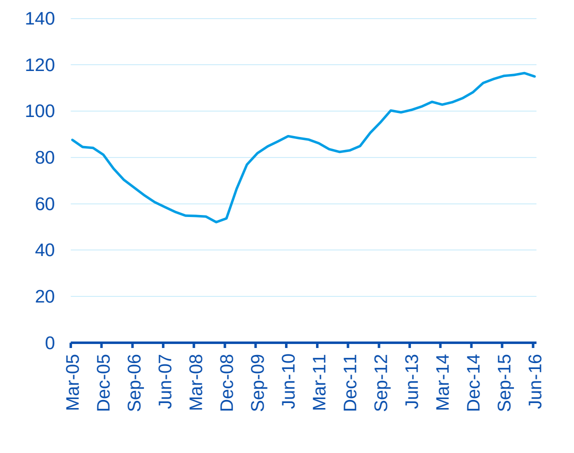
Figure 3.11
Spain: residential mortgage loans (SWDA)



Source: BBVA Research, based on data from CIEN (Notarial Statistical Information Centre)

The low cost of financing and the gradual improvement in households' disposable income continues to allow housing accessibility ratios in Spain to improve, in spite of the gradual recovery in prices (Figure 3.12). BBVA's accessibility/risk ratio, which measures households' borrowing capacity against housing prices[4], remains close to its highest rate, and in June 2016 it stood at 115%, 1 pp less than in Q1 2016.

Figure 3.12
Evolution of BBVA's accessibility/risk ratio (%)



Source: BBVA Research based on data from national sources

Table 3.1
BBVA accessibility/risk ratio. Regions (%).

	Q2 2015	Q3 2015	Q4 2015	Q1 2016	Q2 2016
SP	**114.0**	**115.3**	**115.7**	**116.4**	**115.0**
AND	117.4	118.1	119.2	121.4	119.8
ARA	138.6	142.3	144.2	146.5	145.5
AST	132.4	135.0	134.0	135.0	136.8
BAL	86.0	85.6	84.3	83.3	83.6
CAN	114.9	116.7	117.1	117.1	114.9
CNT	109.3	112.5	117.3	117.4	113.9
CLM	136.9	136.8	137.3	139.6	139.2
CYL	180.9	183.7	184.0	187.4	188.2
CAT	112.1	113.2	112.1	112.1	110.3
VAL	132.0	133.4	133.9	135.0	134.6
EXT	151.2	152.5	153.1	151.8	151.9
GAL	124.1	125.4	126.3	126.1	125.8
MAD	104.6	105.8	105.9	105.3	102.6
MUR	148.2	149.6	150.5	152.8	153.0
NAV	132.7	135.3	136.2	140.3	139.6
BSQ	79.9	81.9	83.7	85.2	83.6
RIO	144.7	143.5	149.2	153.7	148.9

Source: BBVA Research based on data from national sources

However, at regional level the situation is uneven, since in some of them this ratio is starting to deteriorate, due largely to the process of price recovery we are seeing. For example in Q2 2016 in the Balearic Islands, Catalonia and Madrid, BBVA's accessibility/risk ratio deteriorated relative to the same period of last year, falling by around 2 pp in each of them. In contrast, other regions such as Aragon, Castile and León and Navarre have seen the ratio continue to improve thanks to a more moderate rate of recovery in house prices (Table 3.1). In any case the ratio continues very close to all-time highs in all the autonomous regions.

4: For more information on the construction of the indicator, please refer to Box 2 in Spain Real Estate Outlook, Second Half of 2015: https://www.bbvaresearch.com/wp-content/uploads/2015/12/Situacion_Inmobiliaria_dic15.pdf

… and the dynamism of demand from foreigners, which continues to be a significant pillar

In 2015, a year in which a new record was set for the number of foreign tourist arrivals, purchases of residential properties by foreigners increased by 13.4% YoY, according to transaction data from the Ministry of Public Works and Transport. Foreign tourist Figures so far this year point to a new all-time high, so foreign demand can be expected to contribute once more to housing sales in Spain. For the moment, **the latest data available from the Ministry of Public Works and Transport, for the first half of the year, show year-on-year growth of 20.8% in purchases by foreigners**.

As regards buyers' nationalities there are no big changes. As shown in Table 3.2, **the British are still the leading buyers in Spain, although in the first half there was a slight moderation in their weight**: in Q2 2016 19.7% of foreigners buying residential properties were British, compared with 23.9% in the last quarter of 2015. Furthermore, **bearing in mind the implications of Brexit for the UK economy, this percentage may well continue to fall**. The possible devaluation of the pound against the euro and the moderation of the UK economy's growth, with the consequent impact on household incomes, are factors that could affect Britons' purchases of homes in Spain. However, the UK will most likely continue to be one of the main countries of origin for foreign demand for homes in Spain. The UK is followed by Germany and France in terms of Spanish homes purchased: in Q2 2016 they each accounted for just over 7%. In this respect, whereas Germans maintained their weight in the past few quarters, the French proportion fell by some 3 pp. As regards the remaining purchasers' nationalities, we would highlight the **reduction in the weight of Russians**, which is closely related to the slowdown of their economy. The relative weight of buyers from Sweden and Italy increased, as did that of those from Morocco and Romania, whose weight increased by 1 pp to 3.5% and 4.8% respectively of the total number of homes bought by foreigners.

Table 3.2
Spain: main nationalities of home buyers (% of total purchases by foreigners)

	Q2 2015	Q2 2016	Difference
United Kingdom	19.9	19.7	-0.1
Germany	7.7	7.4	-0.3
France	8.1	7.1	-1.1
Sweden	5.6	7.0	1.4
Italy	5.3	6.0	0.7
Belgium	6.5	5.6	-0.9
Romania	3.9	4.8	1.0
China	3.9	3.9	0.0
Morocco	2.6	3.5	1.0
Russia	3.9	3.0	-1.0

Source: BBVA Research based on data from the Association of Property Registrars

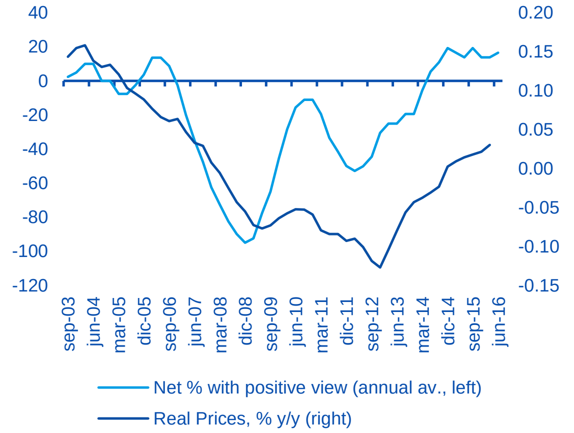
A new factor: improved price expectations will give a new boost to demand

The economic literature[5] shows that the way the housing market evolves does not just depend on fundamental factors such as household wealth, demographics and the housing stock, but that **expectations also play an important role, affecting both the demand for and the supply of housing**. Measuring these expectations in Spain is a complex task since there are no specific surveys, which continuously and relatively frequently record the sentiment of the agents involved in the sector. Given this situation, in order to try to infer these expectations, we analysed other types of surveys and economic indicators.

First, we study the **Banco de España Bank Lending Survey**. In this quarterly survey, the major banking institutions provide information on the granting of credit to households and businesses, and on their outlook. One of the sections of the survey specifically covers expectations of the real estate market. Figure 3.13 shows how these have evolved in the past thirteen years, and we see how the dynamic of actual house prices is anticipated, so the positive trend of the past few months augurs well for future growth in house prices.

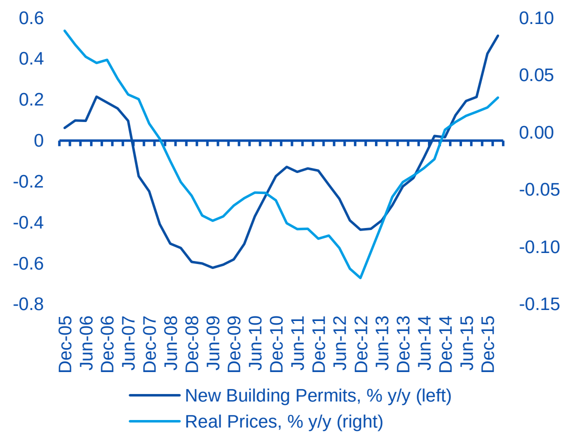
The second analysis is carried out based on trends in new building permits. Among the many factors that might explain the development of new projects by builders and developers, two in particular stand out. Firstly, future expectations of demand for the new project. And secondly, the ability to obtain a profit margin. As with the Bank Lending Survey, **we see a historical relationship between price movements and the number of new building permits** (Figure 3.14), and the uptick in the past few months points to the sector's being more positively perceived by builders and developers.

Figure 3.13
Spain: movement in real housing prices and housing market outlook



Source: BBVA Research based on MFOM (Ministry of Public Works & Transport) and Banco de España data

Figure 3.14
Spain: movement in real housing prices and new building permits



Source: BBVA Research, based on MFOM (Ministry of Public Works & Transport) data

Lastly, we analyse the **extrapolated expectations**. Numerous studies have found evidence to show that **past trends in housing prices are a good predictor of future expectations** (Bracke (2010), Case and Shiller (1990) and Poterba (1991), among others). The difficulty in finding these extrapolated expectations lies in determining the appropriate historical window for calculating them. Previous studies have obtained good results working with four-to-five-year windows[6], although they have also been calculated with shorter

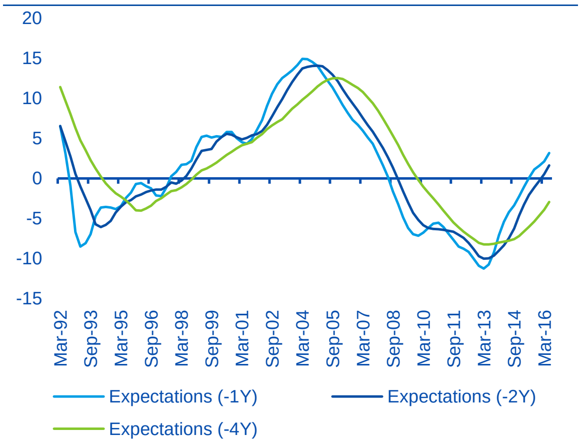
5: Muellbauer (2012) observes that expectations of future developments in home prices have to be incorporated into both price models based on supply and demand functions and those based on the price-to-rent or rent-arbitrage approach. In both types of models, future expectations of real house prices should be incorporated into the calculation of the user cost of residential capital, which is an important explanatory variable for determining the correct pricing of the sector.
6: Duca, et al. (2011, 2012 a,b) found that to estimate user costs, the average of the real house price appreciations over the past four years was the most suitable. Himmelberg et al.(2005) found similar evidence, but with five-year windows.

windows of one to two years, thus giving greater weight to the most recent past. The results show that expectations of price developments show clear improvement from 2013 on (Figure 3.15); the time window used would change only the levels obtained.

The three above-mentioned indicators point to a **clear improvement in expectations concerning the development of the real estate market from mid-2013 on**, and this improvement should gradually be transmitted to pricing in the sector, through **reductions in the user cost of residential capital**[7]. This factor is composed of the sum of all the costs incurred when acquiring a home (cost of mortgage, maintenance costs, depreciation of the property, taxes and a risk premium to compensate the owner for investing in the asset), less the expected capital gain on the property, i.e. less expectations. In this way, residential demand depends negatively on the cost of use, such that reductions in that cost (for example due to cheaper mortgages or improved price expectations) have a positive effect on demand and vice versa.

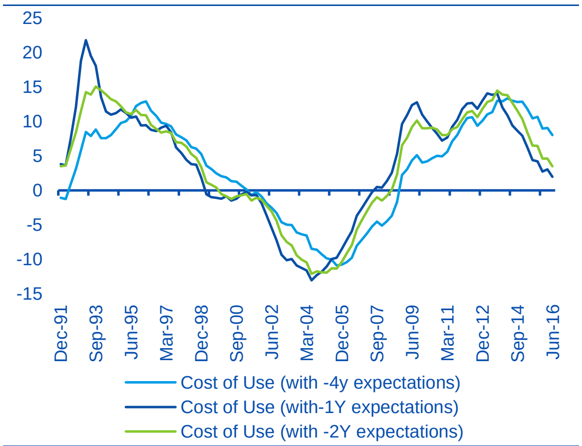
Estimating[8] this cost is complex, because it includes variables that are difficult to calculate, such as expectations, risk premiums and even the different tax policies of each region studied. For this reason we have calculated a simplified cost (Figure 3.16), which takes account of the real financial cost of buying a home (official mortgage rates less inflation), the costs of depreciation and maintenance, which would be 2% of the value of the home (Poterba (1991) and García Montalvo (1999)), and the previously calculated extrapolated price expectations. In all three expectation scenarios calculated, **the user costs obtained have fallen drastically since the end of 2013, lending weight to the view that factors such as low financing costs and growing expectations may continue to drive prices and demand in the sector**.

Figure 3.15
Spain: changes in extrapolated expectations (%, change in housing prices)



Source: BBVA Research based on MFOM (Ministry of Public Works & Transport) and Banco de España data

Figure 3.16
Spain: changes in user cost of residential capital (%)



Source: BBVA Research based on MFOM (Ministry of Public Works & Transport), Banco de España and National Statistics Institute (INE) data

Lastly, **expectations of price appreciation are also a clear incentive to investment**, especially when alternative assets offer relatively unattractive risk-adjusted returns. The current low interest rates and high volatility of financial markets are making alternatives to residential investment such as fixed income securities or equities less attractive. At the closing date of this publication, ten-year Spanish government bonds offered a yield of 0.91%, long-term bank deposits -0.12% and the return on the IBEX so far this year was -6.25%, whereas the annual return on the residential property sector stood at 4.6% in March according to Banco de España data.

7: In financial terms, the user cost of residential capital could be interpreted as the opportunity cost involved in buying a home and not buying any other good or service.
8: At national level there are estimates of the user cost of residential capital carried out by, among others, professors López García, M.A. (1996, 1997, 1999), Taltavull, P. (2000), García Montalvo, J. and Mas, M (2000) and Barrios García, J.A. (2001).

The digital age at the service of the real estate market: an indicator of demand

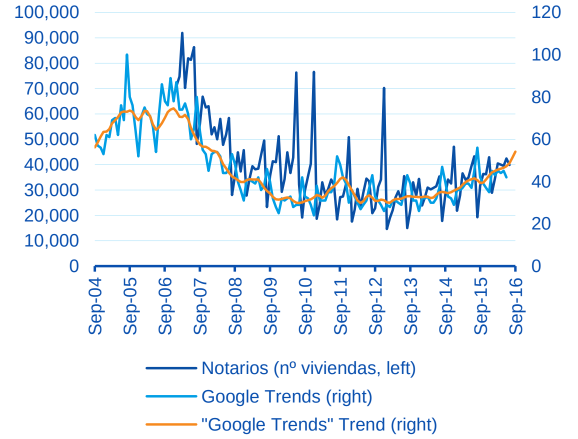
Nowadays the Internet is a great source of data that can help us understand, in real time, how users are behaving, and this is enabling new economic analysis indicators to be developed. In this regard Google's "Google Trends" application provides a graphic representation of how users' search terms evolve in real time and month by month.

With the aim of obtaining an advance indication of how housing demand in Spain may be developing, we searched for "comprar casa" (buying a house) from January 2004 to September 2016 in Google Trends. This simulation could be further refined by combining other search criteria such as "housing purchases", "looking for a house" or similar, but in this case we used just the one term.

Figure 3.17 represents **the Google Trends search results and the official data provided by notaries for housing conveyancing in Spain**. Although the Google series shows considerable seasonality, its dynamic is similar to that of the series obtained from the CIEN (Notarial Statistical Information Centre) database. To eliminate the noise from both series and study their interrelation, they were processed using ARIMA models. Figure 3.18 shows that there is a **linear correlation between the two**, and a simple regression analysis confirms that this correlation is statistically significant.

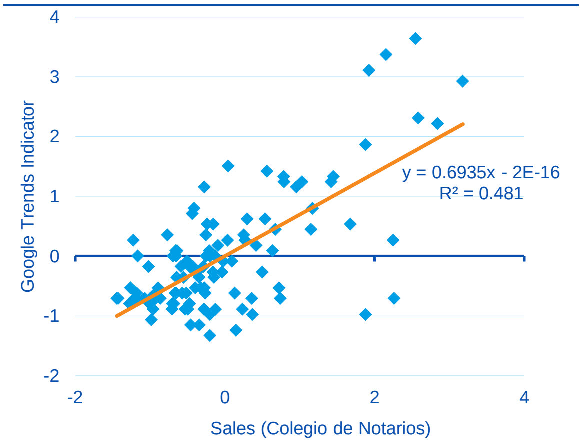
The advantage of Google Trends is that it allows the information to be observed almost in real time and any shift in trend arising in the market to be detected months in advance of when the official data can do so. This indicator has its limitations: in particular it does not provide information on search volumes, but the preliminary studies suggest that it may be very useful. At present, **the indicator points to the positive trend shown by residential demand in the first part of the year having continued in August and September**.

Figure 3.17
Spain: Google Trends "buying a house" index and Notaries' home sales



Source: BBVA Real Estate based on Google and Notarial Statistical Information Centre (CIEN) data

Figure 3.18
Spain: Google Trends "buying a house" index and Notaries' home sales (standardised data*)



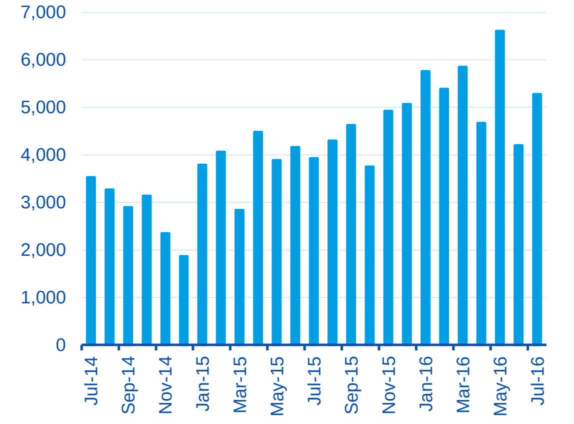
*Note: application of a standard normalisation
Source: BBVA Real Estate based on Google and Notarial Statistical Information Centre (CIEN) data

Building activity is at its highest point for several years

Housing starts in the first half of the year evolved very positively. The number of new residential building permits from January to July increased by 36.9% YoY, with nearly 39,500 permits issued, 10,650 more than in the same period of 2015 (Figure 3.19). This new growth in building permits –in 2015, increasing by nearly 43% from the previous year - augurs well for an increase in residential new build in the next few months.

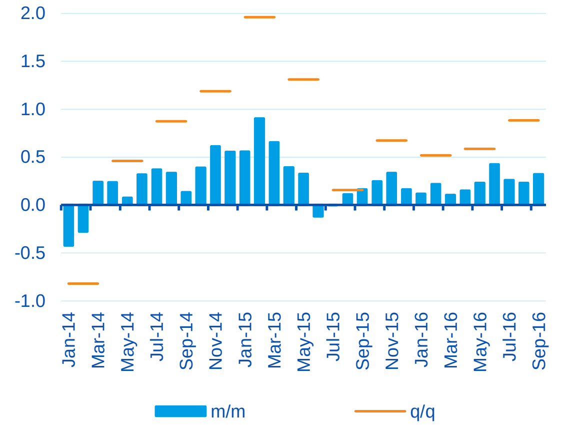
Not only permits attest to the advance in building activity. **Employment in the construction industry is also evolving positively**. Moreover, it is doing so in a context of continuing cutbacks on public works: in 2015 calls for tender fell by 28.3% and in the eight months to the end of August this year they have fallen by 6.3% YoY. In other words residential construction is cushioning the fall in employment deriving from the decrease in public works. Thus in the first nine months of the year the number of construction workers registered with the Social Security system grew by an average of 0.2% per month, a similar rate to that of total persons registered (Figure 3.20).

Figure 3.19
Spain: building permits for residential properties (SWDA)



Source: BBVA Research, based on MFOM (Ministry of Public Works & Transport) data

Figure 3.20
Spain: construction workers registered with the Social Security system (monthly average, SWDA)

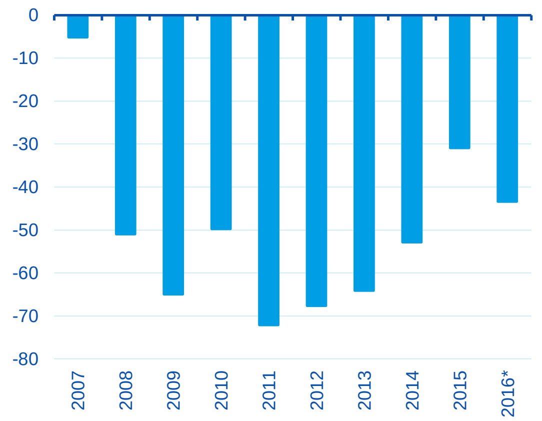


Source: BBVA Research, based on MESS (Ministry of Employment & Social Security) data

The Construction Climate Indicator (ICC), published by the Ministry of Industry, Energy and Tourism, showed some deterioration in the first eight months of the year, in line with the trend observed since the latter part of 2015. Despite this, **business confidence in the sector remains above the average recorded in the crisis years** (Figure 3.21).

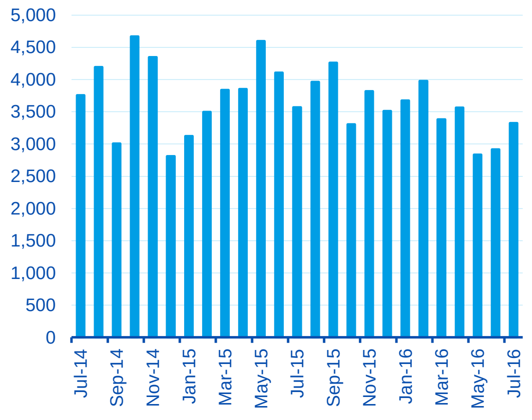
In this environment, with housing starts increasing, **new house completions continue to decline**, and following the fall seen in 2015, in the first seven months of this year housing completions fell by 10.9% YoY (Figure 3.22). This reduction, together with the increase in sales, continues to favour the absorption of the existing surplus supply of housing.

Figure 3.21
Spain: residential construction climate indicator (monthly average)



*Note: data from January to September 2016
Source: BBVA Research, based on MINETUR (Ministry of Industry, Energy and Tourism) data

Figure 3.22
Spain: residential completion certificates (SWDA)



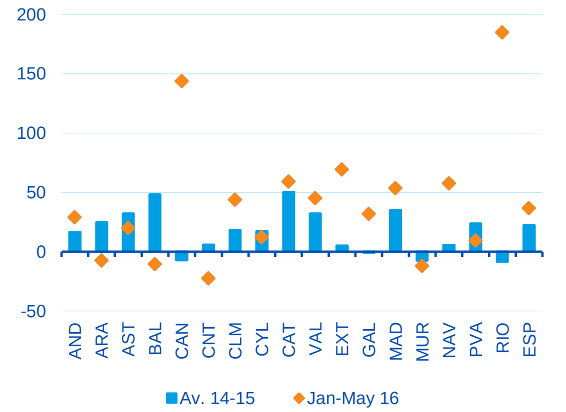
Source: BBVA Research, based on MFOM (Ministry of Public Works & Transport) data

Residential building is recovering at different speeds

As we saw with sales, **housing starts are evolving differently from one autonomous region to another**. The number of new housing permits issued in the first seven months of the year increased in all regions except Aragon, the Balearic Islands, Cantabria and Murcia. In Asturias, Castile-La Mancha, Castile and León, Catalonia and Valencia, where housing starts are still at a very low level, given the ferocity of the recent crisis in the industry, the start of the year was positive, coming on top of two consecutive years of growth (three in the case of Valencia). Moreover, Madrid and the Basque Country, where the number of permits fell less sharply than the national average during the crisis, are also seeing a relatively sustained growth trend. In any case, in all the autonomous regions the level remains low, as a result of which any small variation in the numbers gives rise to relatively high growth rates. (Figure 3.23).

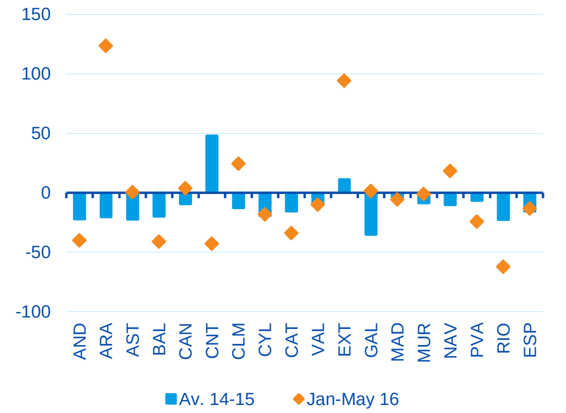
The reactivation of completed residential properties, as one would expect, comes with a lag, given the period that elapses between start and completion. **For the time being we see no consolidation of the growth in completed homes in any of the regions**. Extremadura is perhaps the region showing the greatest solidity, with positive average growth in the past two years and a significant year-on-year increase in the five months to the end of May 2016. For the rest, we are starting to see slight changes in trends. For example, in the Canary Islands, Madrid, Murcia and Navarre, the number of homes completed in the past two years fell at a relatively low average annual rate, and in the first seven months of 2016 held relatively steady or showed slight year-on-year growth (Figure 3.24). **Little by little the increase seen in housing starts since the second half of 2014 will translate into an increase in completions and therefore an increase in stock for sale**.

Figure 3.23
Spain: new housing permits (YoY growth, %)



Source: BBVA Research, based on MFOM (Ministry of Public Works & Transport) data

Figure 3.24
Spain: residential completion certificates (YoY growth, %)



Source: BBVA Research, based on MFOM (Ministry of Public Works & Transport) data

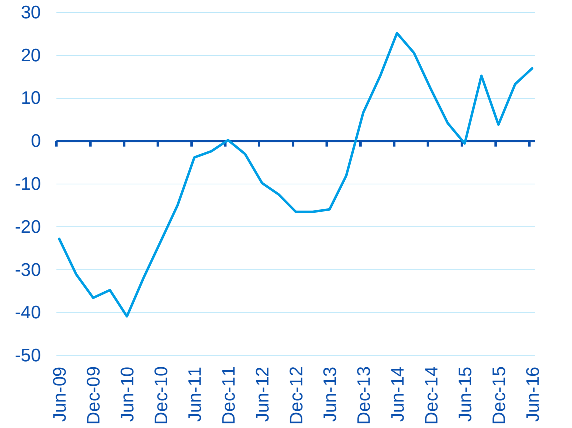
At regional level, the figures for new housing stock published by the Ministry of Public Works and Transport also show great disparities. While **in some regions there is practically no surplus supply** (Cantabria, Extremadura and Navarre), in others unsold new residential properties still represent a relatively large proportion of the region's total real estate. Such is the case of La Rioja (3.7%), Castile-La Mancha (3.5%), Murcia and Valencia (approximately 3.0% in both cases) and the Canary Islands (2.8%). In other autonomous regions such as Madrid and the Basque Country, the surplus supply is already below the so-called frictional stock level (around 1.5% of total real estate).

The market for land is reviving: a sure sign of activity in the next few years

The land market is also showing greater dynamism. Data collected by the Ministry of Public Works and Transport indicate that the increase in area sold in 2015 continued in the first half of 2016 and even intensified. Thus, following a 3.8% increase in land area bought and sold in 2015, in the first six months of this year the area increased by 19.2% in YoY terms (Figure 3.25). Moreover, this increase was accompanied by an increase in average prices both last year as a whole (4.3%) and in the first half of the current year (5.9% YoY).

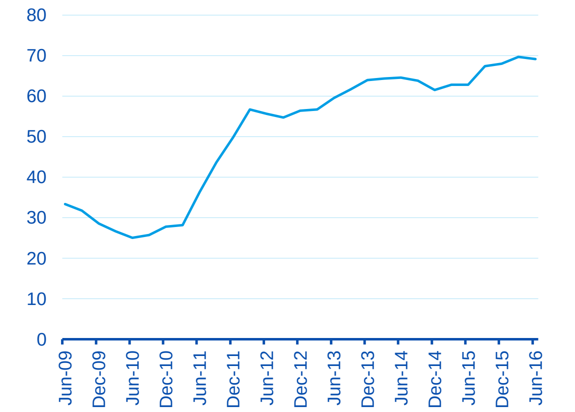
Another of the positive data for market trends is the **increase in the proportion of transactions carried out by businesses**. In other words, during the crisis we saw the majority of land purchases were by private individuals. In the last few quarters, the weight of companies has increased, from which we infer that the activation of the market is coming from companies in the sector (Figure 3.26). This is consistent with the slight increase seen in financing granted to companies in the sector: mortgage loans for the construction of housing in the first half of the year grew both in number and average amount by around 25% in each case.

Figure 3.25
Spain: area of land conveyanced (%, 12-month moving average YoY)



Source: BBVA Research, based on MFOM (Ministry of Public Works & Transport) data

Figure 3.26
Spain: area of land acquired by companies (%, 12-month moving average)



Source: BBVA Research, based on MFOM (Ministry of Public Works & Transport) data

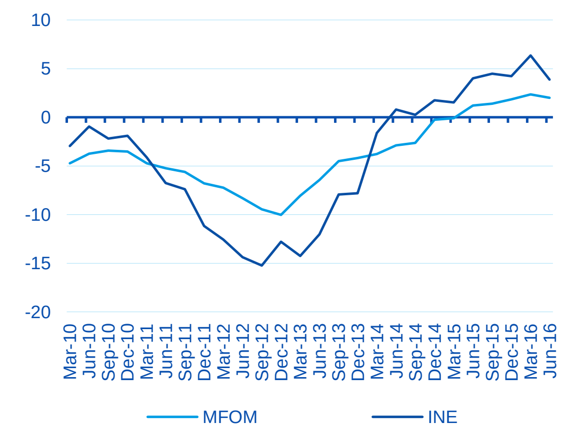
The first part of the year saw a recovery in house prices, but by less and less as the months went by

During the first half of the year housing prices continued to increase. Both the Ministry of Public Works and Transport's appraisal data and the National Statistics Institute's housing price index, which shows changes in the price of houses sold, indicate that housing prices continue to rise, although **the appreciation seen in the second quarter was more moderate than in the first**. The National Statistics Institute's price index shows that in the first quarter housing prices rose by 2.8% QoQ (SWDA), the biggest increase since housing prices started to recover. In contrast, in the second quarter prices rose by just 0.2% QoQ (SWDA). This translates into YoY revaluations of 6.3% and 3.9% respectively (Figure 3.27). The moderation in prices can also be seen in appraisal values. According to the Ministry of Public Works and Transport, while in the first quarter prices rose at a quarterly rate of 0.6% (SWDA), in the second quarter growth moderated to 0.4% QoQ (SWDA). This is equivalent to YoY rates of 2.4% and 2.0% respectively. **This put the average housing price in the second quarter of the year at €1,506.40 per square metre, a similar level to that of the first half of 2004**.

Thus, as has been seen since the beginning of the recovery, **the revalued price of homes sold**, reflected in the National Statistics Institute's price index **is greater than that of homes on offer** which can be inferred from the Ministry of Public Works and Transport's appraisal values.

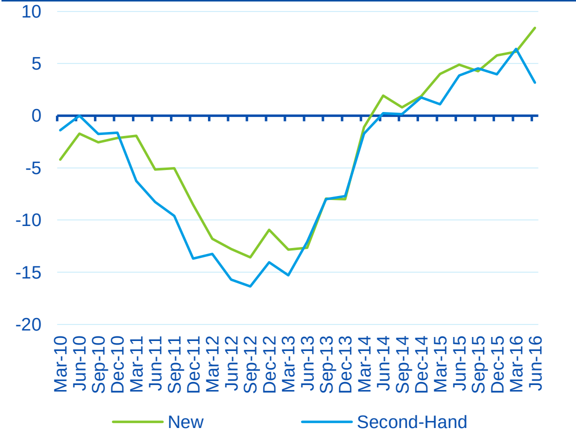
By type, prices have increased for both new and second-hand residential properties. However, they have behaved differently: **growth in second-hand residential property prices moderated in Q2 2016m while that of new properties intensified**. According to National Statistics Institute (INE) data, in each of the first two quarters of the year the price of second-hand homes grew by an average of 4.8% YoY, while that of new homes grew by 7.3%. Behind this difference is without doubt the ever scarcer supply of new-build homes, which might be pushing prices up (Figure 3.28).

Figure 3.27
Spain: housing prices (%, change YoY)



Source: BBVA Research based on MFOM and INE

Figure 3.28
Spain: housing price index (%, change YoY)

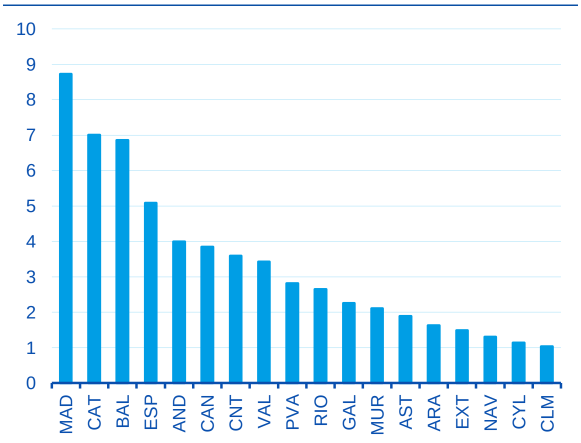


Source: BBVA Research based on INE

As was the case last year, **prices remained uneven in the first half of 2016**. Thus we could say that prices continue to show solid increases in municipalities with active economies and in major tourist centres, while in general terms they remain weak in the interior and the north of the country.

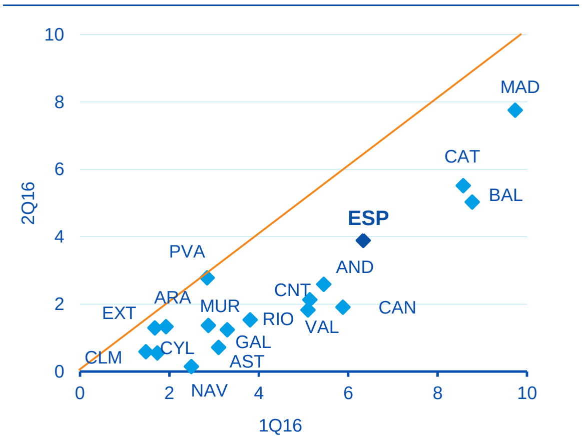
According to INE data, during the first half of the year housing prices rose in all the autonomous regions. The most notable year-on-year increases were in Madrid (8.7%) and in Catalonia and the Balearic Islands - around 7.0% in both cases. In contrast, prices in Castile and León and Castile-La Mancha showed less dynamism, growing by close to 1.0% (Figure 3.29). The first three regions are characterised by stronger economic recovery and by being tourist magnets (particularly Catalonia and the Balearic Islands), whereas in the two Castiles economic recovery arrived later and with less intensity. Moreover, the weight of the surplus supply, especially in Castile-La Mancha, could be acting as a brake on price recovery.

Figure 3.29
Spain: YoY change in housing prices in the first half of 2016 (%)



Source: BBVA Research based on INE

Figure 3.30
Spain: housing price index



Source: BBVA Research based on INE

The breakdown by time shows in general terms that the price dynamic was different in the first two quarters of 2016. **The sharp increase seen in the first quarter of the year moderated appreciably in the second quarter in most of the autonomous regions**. Only in the Basque Country was the YoY price increase in Q2 2016 similar to that of Q1 2016. The nearly 4 pp moderation in growth in the Canary and Balearic Islands stands out, these being two of the regions with the biggest price appreciation in Q1 2016 (Figure 3.30).

For the moment this moderation in the growth of housing prices does not appear worrying given the growth in sales and the solidity of its determinants. In fact, the lower growth of the second quarter of the year might be due to the volatility associated with the beginnings of a process of recovery.

Housing price appreciation continues to be accompanied by an increase in the value of urban land. In the first half of the year the average price of land increased by 5.9% YoY, consolidating the growth trend seen in the past few quarters. Nevertheless, the increase shows **great disparities depending on the size of municipalities**. In the first half of 2016, the biggest price increases in YoY terms were seen in small municipalities (8.5%). This change has to be carefully analysed given the thinness of the market in these municipalities, which together account for around 9% of land transactions, as a result of which single transactions have a significant effect on the total change. In medium-sized municipalities of between 5,000 and 50,000 inhabitants, land was revalued by around 3% in the first half of the year. In the large municipalities, which account for nearly 20% of transactions, prices rose by 0.8% YoY. Only in municipalities with between 1,000 and 5,000 inhabitants was there a decrease in the price of land in the first half of the year. All in all, since touching bottom, land has revalued by 13.5% on average. The biggest increase from lows was in municipalities with more than 50,000 inhabitants (44.0%) and the smallest was in those with between 10,000 and 50,000 inhabitants (8.0%) (Figure 3.31).

Figure 3.31
Spain: average price of urban land by size of municipality in H1 2016 (% annual change)

Source: BBVA Research, based on MFOM (Ministry of Public Works & Transport) data

Prospects

For the next few quarters, **BBVA Research forecasts point to a moderation in economic growth**. Despite this 2016 will close with strong average annual growth of around 3.1%. However, the moderation will leave its mark on growth in 2017, and we expect next year to end with an annual advance in GDP of 2.3%. Although this moderation will no doubt affect many of the country's productive sectors, **we expect the real estate market to deal with this moderation relatively well**.

There are two reasons for thinking that the real estate industry will continue to grow at a good pace in 2017. The first is that an **improvement in the sector's expectations** may become an important lever in the next few years. The second is that the moderation in growth will translate not into job destruction or falling household incomes but into lower-than-hoped-for growth. In other words jobs will be created in 2017 and household incomes can be expected to increase. Moreover, as regards financing, another important determinant of residential demand, we do not foresee significant changes but continued stability and we expect interest rates to be held at relatively low levels.

Development of the market in 2016 and 2017

In general terms the **recovery of the real estate industry** can be said to have been consolidated. **We expect the sector to continue its advance towards normalisation in the next few years**. It will do so at different speeds, since the residential market will continue to show **marked disparities among regions**.

Economic growth, job creation and financial conditions will continue to be the most decisive factors for housing demand, but the development of Spain's residential market in general, and in certain regions in particular, will also be influenced by external demand. In this regard, forecasts point to the Spanish economy continuing to grow in the next few quarters. Spain's GDP will grow, albeit at a more moderate pace, at a sufficient rate for the economy to continue creating employment. In particular, **the 3.1% GDP growth for 2016 and the 2.3% expected for next year will be enough to create around eight hundred thousand net new jobs** and reduce the unemployment rate to around 18.2% by the end of 2017.

Monetary policy will support the economic recovery. In view of the risks hanging over growth and inflation, the ECB has again confirmed its commitment to using all the stabilising instruments envisaged within its mandate, if necessary. Thus we do not expect an increase in interest rates in the forecast interval, so they will be held at low levels. Nor do we expect an increase in margins in the next few quarters. In the latest Banco de EspañaBank Lending Survey, the institutions surveyed responded that increased competition among activities, improved prospects in the economy generally and in the housing market and lenders' improved solvency explained a certain relaxation of criteria for granting mortgage loans.

On top of all this, **forecasts for Spanish tourism continue to be positive**, and although the moderation in global growth could weaken its growth, everything points to levels remaining high, and this implies a new stimulus to foreign demand for housing in Spain. However, **the development of this segment of demand is not without risks**, the most obvious one for many of the Mediterranean regions being that deriving from the consequences of Brexit. The decisions on the mechanisms for the UK's exit from the EU will be decisive for quantifying its impact on residential demand, especially in regions such as Murcia, the Canary Islands and the Balearic Islands where the weight of British demand is relatively high.

Thus **the macroeconomic determinants of residential demand are expected to continue to evolve positively in the next few quarters, albeit more moderately** than hitherto. This moderation will be partly offset by the **recovery of expectations for the real estate market**. Following several years of negative expectations regarding the real estate industry, the recovery in housing prices and the ever greater certainty of the consolidation of this recovery have turned prospects around for the sector's near future.

All in all, **residential demand is expected to continue to gain in strength in the next few quarters**. Thus the forecasts point to 2016 closing with growth in housing sales similar to that of last year, around 10%. Similarly, for 2017 sales will grow at a slightly lower rate of around 6.5%, implying a volume of transactions of approximately 475,000.

In the same way, **housing prices will end the current year on a positive note, with average annual growth of around 2.5%. For 2017, this increase will be around 3.5%.** In this way prices are gradually recovering from the fall of just over 38% suffered during the crisis. Thus by the end of 2017, we expect housing prices to be at a similar level to that of mid-2004. Nevertheless, **recovery will be very uneven in geographical terms**. While some regions will once again see growth in prices well above the average, in others there could still be corrections.

Several consecutive years of growth in housing sales will translate directly into building activity. Although still at low levels, the forecast suggests that this year and next year's number of permits will close with an annual growth of around 40% and 25%, respectively. Thus 2017 could end with the issue of nearly 90,000 residential building permits, which is a high level when compared with the just over 34,000 permits issued in 2014, but still far below pre-crisis levels.

All the same, for the second year in a row **the residential segment of the construction industry will contribute positively to the growth of the economy**. In particular, forecasts point to residential investment growing in 2017 by slightly over 3.0%, which would represent 0.15 pp of GDP growth.

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