MACROECONOMIC PROJECTIONS FOR THE SPANISH ECONOMY (2017-2019): THE BANCO DE ESPAÑA'S CONTRIBUTION TO THE EUROSYSTEM'S JUNE 2017 JOINT FORECASTING EXERCISE

Introduction and summary

This note outlines the key features of the macroeconomic projections for the Spanish economy for the period 2017-2019, which are part of the projections for the euro area as a whole published by the European Central Bank on 8 June.[1] The current projections incorporate the new information that has become available since the publication of the previous projections on 3 April in Economic Bulletin 1/2017.[2]

The Spanish economy has continued to perform strongly so far this year. After the modest acceleration in GDP growth at the start of the year, the data available on the cut-off date for these projections suggests that output could register a slightly higher rate of growth in the second quarter than forecast three months ago. In particular, although, as expected at that time, the recent upturn in inflation has led to less vigorous household spending on consumer goods and services in real terms, export markets were more buoyant than initially projected.

The strength of GDP growth, despite the weakening of some of its recent driving factors, confirms the solidity of the foundations on which the current expansionary phase rests.[3] Specifically, progress on correcting the economy's macrofinancial imbalances, and in particular, competitiveness gains and private-sector deleveraging, have created a favourable context for the current phase of growth in activity and employment to continue. Nevertheless, the change in budgetary policy stance, after the expansionary stance of the last two years, and the expectation that monetary and financial conditions will not be relaxed further over the projection horizon, suggest the pace of economic expansion will moderate, while still remaining brisk. Thus, after an average rate of 3.1% this year, GDP growth could slow to 2.5% and 2.2%, in 2018 and 2019, respectively (see Table 1).

In the case of consumer prices, the slowdown in CPI seen since March, related to trends in energy prices, is expected to continue for the rest of the year. Inflation should then subsequently rise slightly in response to the cyclical strengthening of activity. Thus, after annual growth averaging 2% in 2017, consumer prices are expected to rise by 1.3% in 2018 and 1.6% in 2019.

Activity and employment

Buoyant domestic demand will continue to underpin the expansion of activity over the projection horizon. Nevertheless, net exports are expected to continue making a positive contribution to output growth throughout the period. Domestic demand will continue to benefit from the persistence of favourable financial conditions and from the gradual deleveraging of households and businesses, such that debt will progressively represent less of a constraint on spending.

Among the components of national spending, private consumption is expected to

1 See Eurosystem staff macroeconomic projections for the euro area, June 2017

2 Specifically, vis-à-vis the Macroeconomic projections for the Spanish economy (2017-2019), published on 3 April, the current projects incorporate the changes observed as at 16 May in the technical assumptions, in the projections for the Spanish economy's external context , and in the fiscal assumptions, as well as new data published before the cut-off date for the period on 23 May. The QNA data for the first quarter of 2017 were published after this date, meaning that this information could not be included in these projections.

3 Box 1.2 of the Banco de España's 2016 Annual Report estimates the contributions of a range of temporary factors to the Spanish economy's growth in 2014-2016.

PROJECTIONS OF THE SPANISH ECONOMY'S MAIN MACROECONOMIC VARIABLES (a) TABLE 1

Annual rate of change in volume terms and % of GDP

		June 2017 projection			Changes from March 2017 projection		
	2016	2017	2018	2019	2017	2018	2019
GDP	3.2	3.1	2.5	2.2	0.3	0.3	0.0
Private consumption	3.2	2.7	2.0	1.5	0.3	0.3	0.0
Government consumption	0.8	0.8	0.8	0.8	0.0	0.0	0.0
Gross fixed capital formation	3.1	3.7	4.6	4.3	0.4	0.3	-0.1
Investment in capital goods	5.0	3.6	5.1	4.8	0.6	0.1	-0.4
Investment in construction	1.9	4.0	4.9	4.6	0.3	0.5	0.1
Exports of goods and services	4.4	6.9	4.9	4.9	0.8	0.1	0.1
Imports of goods and services	3.3	5.8	4.5	4.4	0.6	0.1	0.0
National demand (contribution to growth)	2.7	2.5	2.2	1.9	0.2	0.2	0.0
Net external demand (contribution to growth)	0.5	0.6	0.3	0.3	0.1	0.0	0.0
Nominal GDP	3.6	4.2	4.0	3.7	0.4	0.4	0.0
GDP deflator	0.3	1.0	1.4	1.5	0.0	0.1	0.0
Consumer price index (CPI)	-0.2	2.0	1.3	1.6	-0.2	0.0	0.0
CPI excl. energy and unprocessed food prices	0.8	1.1	1.5	1.8	0.0	0.0	0.0
Employment (full-time equivalents)	2.9	2.9	2.3	1.8	0.3	0.4	0.0
Unemployment rate (% of labour force) Data at end of period	18.6	16.5	14.7	13.2	-0.2	-0.7	-0.7
Unemployment rate (% labour force). Average data	19.6	17.3	15.4	13.8	-0.2	-0.6	-0.7
Net lending (+)/ net borrowing (–) of the nation (% of GDP)	2.0	1.8	1.9	1.8	-0.1	0.1	0.1
General government net lending (+)/ net borrowing (–) (% of GDP)	-4.5	-3.2	-2.6	-2.2	0.0	0.2	0.2

SOURCES: Banco de España and National Statistics Institute (INE).
Latest QNA figure: 2016 Q4.

a Projections cut-off date: 23 May 2017.

continue to grow rapidly, mainly underpinned by robust job creation. Nevertheless, the rate of household consumption growth is expected to progressively slacken in comparison with the recent past, as households' real incomes become less buoyant, in a context of inflation rates above those observed in previous years and the absence of tax cuts such as those in 2015-2016. Moreover, the gradual exhaustion of the strong stimulus to demand for durable goods in the years following the last downturn will tend to rein in consumer spending growth. In any event, in line with an upturn in prices that is currently projected to be weaker than forecast in March, the rate of private consumption growth has been revised upwards slightly, with growth of 2.7% expected this year, gradually slowing to 1.5% in 2019.

The recovery in residential investment is also expected to continue, against the backdrop of a strong labour market and the availability of cheap borrowing. This favourable context will be strengthened by the gradual decrease in stocks of finished housing. Nevertheless, this demand component's progress will be limited by the slow expected rate of net household formation.

The rate of business investment growth slowed in the second half of 2016. There was possibly a significant transitory component in this phenomenon, associated with changes in corporation tax that were introduced during that period. Robust final demand, the reduced need for businesses to deleverage, and the availability of internal and external financing, suggest that investment will become more dynamic over the projection horizon.

An increase in the growth rates of Spain's export markets was apparent in the second half of 2016, and this trend continued into the early months of the current year. The expansionary impact of this trend on sales of goods and services to the rest of the world should be bolstered by the effects of the Spanish economy's past competitiveness gains. Overall, exports are expected to grow by 6.9% in 2017, with this rate moderating by 2 percentage points (pp) in the next two years as a result of the slowing of external markets, on the assumption that the recent upturn in the elasticity of world trade to global activity is temporary. Similarly, current projections assume that following the drop in the elasticity of imports to final demand observed in 2016, elasticity will, to some extent, return to slightly higher levels. However, it is expected to remain below historical averages, reflecting growing evidence of an incipient process of imports being substituted by domestic production.[4]

The Spanish economy is expected to continue to have a net lending position against the rest of the world over the projection horizon. Nevertheless, the surplus balance could be two tenths of a percent lower than the 2% of GDP observed in 2016, in a context in which the favourable trend in net external demand in real terms would be offset by the recent decline in the positive contribution made by the reduction in net interest payments and, in particular, by the change in sign of the contribution of the terms of trade, as a consequence of the rise in oil prices from their low levels reached in the first few months of 2016.

Employment will continue to grow rapidly, although the rate will slow over the projection horizon, in step with the forecast slackening of the pace of output expansion and very modest rates of growth of apparent labour productivity. The workforce will continue to contract over the next three years, as a result of the ageing population.[5] In conjunction with the projected continuation of the process of job creation, this trend in the workforce will continue to push down the unemployment rate, which is expected to stand at around 13% at the end of 2019.

On the basis of the fiscal assumptions made (detailed in Box 1), the public deficit should drop to 3.2% of GDP in 2017, 1.3 pp below last year's level. This trend will benefit from the favourable economic cycle, in a context in which the orientation of fiscal policy is neutral, after the expansionary stance of the last two years. The correction to the budgetary imbalance is expected to continue over the next two years, such that the general government balance should drop to below 3% of GDP as of 2018.

GDP growth in both 2017 and 2018 has been revised upwards by three tenths of a percent relative to the previous projections made three months ago. This is due to the improvement in the trend in the middle of this year suggested by the short-term data available, relative to the projections made three months ago, and the favourable impact of changes to the assumptions underlying the forecasts. Specifically, the improved GDP growth projections are underpinned by the better outlook for global markets, particularly over the short term, lower oil prices, and lower interest rates.

4 Chapter 3 of the Banco de España's 2016 Annual Report analyses the available evidence on the scale of this process.

5 See Box 6 of the September 2016 Quarterly Report..

Prices and costs

The expected trend in consumer prices in the second half of 2017 will continue to be strongly influenced by the course of the energy component. In January and February, CPI growth stood at 3%, its highest level since 2012, as a result of the rebound in energy prices that began to be seen in early 2016. Inflation began to drop in March of this year, and this pattern is expected to continue over the coming months as a result of the declining contribution of energy prices to inflation, although this will be offset to some extent by a gradual rise in the underlying component, against the backdrop of the slack in the economy gradually being absorbed.[6] On balance, overall CPI is expected to increase by an average of 2% in 2017, subsequently slowing to 1.3% in 2018 and picking up slightly to 1.6% in 2019.

In comparison with previous projections, the rise in consumer prices should be lower than in 2017, then remain stable over the two following years. The downward revision for this year is due to oil prices being weaker than expected and the surprises in the prices registered in the most recent months. Over the period 2018-2019 the effect of the changes in assumptions on forecast consumer prices should be neutral.

Risks

The risks surrounding the trajectory of economic activity are mainly on the downside, although less so than in the projections published on 3 April. These unfavourable contingencies mainly originate in the international environment. In particular, a possible stepping up of the protectionist trends that have begun to emerge in some areas could have negative consequences for demand for Spanish exports from outside the euro area. This variable could also be affected by possible financial shocks, which could arise from various factors, such as a combination of policies in the United States that lead to the country's tightening monetary policy more and faster than expected,[7] or a hypothetical disorderly unwinding of the Chinese economy's high level of debt. In both cases, the impact on economic activity in the emerging economies would tend to be negative. Finally, activity in Europe could be adversely affected by the uncertainty over how the negotiations towards a new type of relationship between the United Kingdom and the EU will develop.[8] On the upside, the recent improvement in the short-term economic indicators for the euro area could result in more robust activity growth than envisaged in the baseline scenario.

Similarly, also on the domestic level, recent economic developments have been characterised by output's being more vigorous than expected, even in a context in which some of the temporary factors previously driving output have lost momentum. This economic resilience, which could be related to progress towards the correction of macrofinancial imbalances and a stronger pass-through of monetary policy stimulus than previously estimated, as well as the the improved external context, could continue over the next few quarters, resulting in higher rates of GDP growth than forecast in the baseline scenario. The high level of public debt underlines the need to adhere to the course of fiscal consolidation set, taking advantage of the existing context of strong growth and low interest rates to moderate future borrowing costs, reduce the economy's vulnerability to a

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6 Box 4 of March 2017 Quarterly report on the Spanish economy analyses the temporary nature of the upturn in inflation at the start of the year. For their part, in "The effect of oil price fluctuations on Spanish inflation", Álvarez, Sánchez and Urtasun (2017) evaluate the magnitude of the pass-through of variations in oil prices to other prices in the economy and to wages and conclude that the impact is relatively minor.

7 In relation to the proposed reform of corporate income tax in the United States, see Box 2 of the Economic Bulletin 1/2017. For a more comprehensive view of the policies the new US administration could implement, and their implications for the global economy, see Box 1 of the December 2016 Quarterly report on the Spanish economy.

8 Boxes 3 and 5 of the September 2016 Quarterly report on the Spanish economy analyse the impact of the United Kingdom's exit from the EU on the British and global economies, and the exposure of the Spanish economy to the United Kingdom, respectively.

possible tightening of financial conditions, and restore a degree of leeway for fiscal policy to respond to any shocks that arise. Moreover, the improvement in the Spanish economy's medium- and long-term outlook for growth in activity and employment requires that structural reforms are pursued further in several areas.

The risks of deviation from the inflation projections are also slightly on the downside as a result of two types of factors. First, the outlook for a rebound in underlying inflation is conditional upon the assumptions made about the inflationary impact of a reduction of the degree of slack in the economy. However, the available evidence on the scale of the positive correlation between activity and prices, in a context like that at present in which there is a significant volume of unused resources, is inconclusive.[9] Second, should the downside risks to the progress of economic activity just described materialise, the result would be a moderation of inflationary pressures, with the possible exception of the scenario in which increased protectionist pressures materialise. Finally, swings in the oil price are likely to continue, creating uncertainty as to the behaviour of inflation.

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9 In particular, in P. Cuadrado and E. Moral- Benito (2016), "Thresholds in the relationship between inflation and economic activity", *Economic Bulletin*, December, Banco de España, concludes that the sensitivity of inflation to Spanish economic activity is only high in periods when the output gap reaches high levels in absolute terms (whether positive or negative).

The assumptions for interest rates and the prices of oil and other commodities are based on the prices quoted on the relevant markets during the ten working days prior to the cut-off date (in this case, 16 May 2017). On this occasion, the procedure leads to a very stable path for oil prices, which stand at around $51.5 per barrel throughout the projection period, an average downward revision of approximately 8.5% with respect to the previous projections.

In accordance with the procedure described above, the interest rates expected by the markets over the projection period have fallen with respect to the March exercise. Specifically, both three-month EURIBOR and ten-year public debt yields moderated by ten basis points (bp), so that debt rates are expected to stand at 1.7% on average in 2017 and subsequently to rise by 40 bp each year, to reach 2.5% in 2019. These expected market interest rate developments lead to a decline in the cost of borrowing for households and businesses, in comparison with the levels in the last projections.

The level of the nominal effective euro exchange rate over the projection horizon, which, according to the methodology used, corresponds to that observed on the spot currency markets over the two weeks prior to the cut-off date of the assumptions, is a little higher than in the last projections.

The growth of Spain's export markets is revised upwards, significantly in 2017 and rather more modestly over the rest of the projection horizon, giving rise to a downward path for the rate of change of this variable, from 4.7% in 2017 to 3.7% in 2019.

The projections for the fiscal policy variables for 2017-2019 are based on three elements. First, it is assumed that those budget items subject to greater discretion (including notably, by virtue of their volume, expenditure on goods and services and public investment) will move in line with the medium-term potential nominal growth of the Spanish economy and the measures announced in the Stability Programme submitted by the government to the European Commission in April this year. Second, it is assumed that the other items of the general government accounts will, in the absence of new measures, behave according to their usual determinants. Specifically, government revenue, besides the effects of the legislative changes approved at the end of last year, is expected to grow in line with the tax bases, which basically depend on the macroeconomic environment. This is also the case for less discretionary items of expenditure, such as pensions (developments in which are essentially determined by the revaluation formula established by law and by population ageing), unemployment benefits (which mainly depend on the behaviour of unemployment) and the interest burden (changes in which reflect developments in public debt and

Table 1
INTERNATIONAL ENVIRONMENT AND MONETARY AND FINANCIAL CONDITIONS (a)

Annual rates of change, unless otherwise indicated

		June 2017 projections			Difference between the current projections and those made in March 2017		
	2016	2017	2018	2019	2017	2018	2019
International environment							
World output	3.0	3.3	3.6	3.5	0.0	0.1	0.0
World markets	1.5	4.5	3.9	4.0	0.9	0.1	0.1
Spain's export markets	2.2	4.7	3.9	3.7	1.0	0.3	0.1
Oil price in US dollars (level)	44.0	51.6	51.4	51.5	-0.8	-0.7	-0.4
Monetary and financial conditions							
US dollar/euro exchange rate (level)	1.11	1.08	1.09	1.09	0.01	0.02	0.02
Tipo de cambio efectivo nominal frente a la zona no euro (b) (nivel 2000 = 100 y diferencias porcentuales)	113.6	112.9	113.6	113.6	0.8	1.3	1.3
Short-term interest rate (3-month EURIBOR) (c)	-0.3	-0.3	-0.2	0.0	0.0	-0.1	-0.1
Long-term interest rate (10-year bond yield) (c)	1.4	1.7	2.1	2.5	-0.1	-0.1	-0.1

SOURCES: ECB and Banco de España.

a Assumptions cut-off date: 16 May 2017. The figures expressed as levels are annual averages; the figures expressed as rates are calculated on the basis of the related annual averages.
b A positive percentage change in the nominal effective exchange rate denotes an appreciation of the euro.
c For the projection period, the figures in the table are technical assumptions, prepared following the Eurosystem's methodology. These assumptions are based on futures market prices or on proxies thereof and should not be interpreted as a Eurosystem prediction as to the course of these variables.

interest rates). Finally, these forecasts include an assessment of the impact of the short-term data available on developments in government revenue and expenditure as at the cut-off date of this report. It should be stressed that they do not incorporate a number of temporary factors reflected in the Stability Programme that have yet to materialise, relating in particular to possible amounts for which the government may be liable under the legal proceedings relating to the insolvency of the toll motorways, which may be payable in the period 2017-2018. In accordance with these assumptions and forecasts for the fiscal policy variables, and the output gap estimated in line with the rest of the macroeconomic projections, the fiscal policy stance will be approximately neutral over the period 2017-2019, following the expansionary stance in 2015 and 2016.