

## QUARTERLY REPORT ON THE SPANISH ECONOMY OVERVIEW

The publication of the previous “Quarterly report” coincided with a surge in volatility on financial markets further to the results of the UK referendum, contrary to the country remaining a Member State of the European Union (EU). Following that initial reaction, the summer months have been characterised by a return to lower levels of volatility, declines in interest rates, accompanied by a compression of spreads, and across-the-board increases in asset prices, in a setting in which expectations continue to point to expansionary monetary policies being maintained over a lengthy period of time.

In recent months the flow of information relating to global economic activity has broadly pointed to its stabilisation, with somewhat more favourable data in the emerging economies than in the developed countries. In any event, the growth outlook for the world economy remains modest and subject to a high degree of uncertainty, with different sources of risk that include the persistence of certain geopolitical tensions and doubts over the capacity of the economic authorities, chiefly in some emerging economies, to redress the prevailing macrofinancial imbalances in an orderly fashion.

In the developed economies, the UK vote in favour of leaving the EU appears so far not to be entailing high costs in terms of economic activity. That should nonetheless not mask the possibility that further, protracted uncertainty about the future UK-EU relationship, in terms both of trade and other areas, and the final shape of the arrangements reached, may ultimately affect economic developments significantly in both areas.

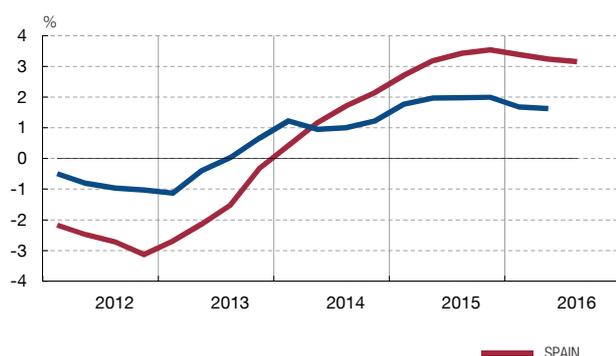
In the euro area, the ECB projections presented this month envisage a continuation of the current moderate cyclical upturn, albeit at a slightly lesser pace than that considered in the Eurosystem’s June projections, as a result of the worsening outlook for export markets, linked above all to the adverse impact of the UK referendum result. In the inflation domain, the ECB continues to project a gradual acceleration in the core component from its current low levels as cyclical slack progressively diminishes.

The information available on the Spanish economy points to a continuation of the expansionary course of activity, at a quarter-on-quarter rate in Q3 which is expected to be 0.7%. If confirmed, this figure would be 0.1 pp down on that observed in each of the four previous quarters (see Chart 1). The contribution of the net external balance to GDP growth in Q3 is estimated to have been lower than that observed in Q2, when exports performed very positively despite the sluggish global setting.

In 2016 as a whole, GDP growth in the Spanish economy is expected to rise to 3.2%, an upward revision of 0.4 pp on the June projections (see Box 1). Behind this revision lies both the more favourable course of activity in Q2 compared with expectations in June, and the improved outlook for the rest of the year, judging by the information available.

In the two years spanning 2017-18, the expansion of the Spanish economy is expected to run further, continuing to be underpinned by comfortable financial conditions associated with the prolongation of the expansionary monetary policy stance, by the headway in the ongoing deleveraging by private agents (meaning that additional reductions in indebtedness have an increasingly less adverse impact on activity), and, as the projection period unfolds, by the foreseeable strengthening of export markets. However, the diminished momentum

1 GROSS DOMESTIC PRODUCT



2 HARMONISED INDICES OF CONSUMER PRICES



SOURCES: Eurostat, INE and Banco de España.

a Year-on-year rates of change based on seasonally adjusted series in the case of GDP and on original series in that of the consumer price indices.

of some of the factors supporting activity recently, such as the fall in oil prices, the depreciation of the euro and the expansionary fiscal policy, will prompt a reduction in the pace at which the economy is increasing.

Specifically, GDP growth is estimated to stand at 2.3% and 2.1% in 2017 and 2018, respectively, rates unchanged on the June projections. In the specific case of next year, the absence of changes is the outcome of two opposing and mutually offsetting forces. On one hand, the improved estimated growth rate for 2016 incorporates a positive carryover effect on the rate from next year. On the other, the change from June to September in the set of assumptions underlying the projections has a negative net impact on expected growth in 2017. In turn, this is the result of the downward revision of the rate of increase of export markets (chiefly reflecting expected lower imports in the United Kingdom), which is offset only in part by the reduction in resident agents' borrowing costs, prompted by the recent cuts in interest rates.

In terms of the composition of demand, a notable change in the 2017-18 period is the reduction in the foreseeable contribution of private consumption. Indeed, although this will continue to be underpinned by the prolongation of the strong pace of job creation, the expansion of household income, in real terms, will be less pronounced than in the recent past owing to the petering out of the factors that had temporarily been boosting it. Business spending, for its part, will slow in line with final demand, although financial conditions are expected to remain favourable. Finally, the contribution of exports to GDP growth will be slightly lower than that observed this year, given the worsening external environment, due in part to the Spanish economy's trade exposure to the United Kingdom, the recipient of a sizeable portion of Spanish exports of tourist and non-tourist services.

Turning to the labour market, jobs are expected to continue to be created at a high rate during the projection period, with low growth in apparent labour productivity, as is habitual in upturns in the Spanish economy. Job creation will allow further reductions in the unemployment rate, which is expected to stand at slightly below 17% of the labour force at end-2018.

As to prices, it is estimated that the CPI, after slipping 0.3% in 2016, might grow by around 1.5% in 2017 and by a further 0.1 pp in 2018, in line with the projected recovery for oil prices and the expected gradual rise in core inflation. Set against the June projections, the expected growth of the overall CPI rises by 0.3 pp and 0.1 pp in 2016 and 2017, respectively, essentially as a result of the upward revision in the path of oil prices.

	2014	2015	2015				2016		
			Q1	Q2	Q3	Q4	Q1	Q2	Q3
National Accounts									
Quarter-on-quarter rates of change, unless otherwise indicated									
Gross domestic product	1.4	3.2	0.9	1.0	0.8	0.8	0.8	0.8	0.7
Contribution of national demand (b)	1.6	3.7	1.4	1.0	1.2	0.6	1.0	0.2	0.9
Contribution of net external demand (b)	-0.2	-0.5	-0.5	0.0	-0.4	0.2	-0.2	0.6	-0.1
Year-on-year rates of change									
Employment	1.1	3.0	2.9	2.9	3.1	3.0	3.2	2.9	2.8
Price indicators (year-on-year change in end-of-period data) (c)									
CPI	-0.2	-0.5	-0.7	0.1	-0.9	0.0	-0.8	-0.8	-0.1
CPI excl. energy and unprocessed food prices	0.0	0.6	0.2	0.6	0.8	0.9	1.1	0.6	0.9

SOURCES: INE and Banco de España.

a Information available to 23 September 2016

b Contribution to the quarter-on-quarter rate of change of GDP (pp).

c Latest available figure for consumer price indices: August 2016.

The risks surrounding the baseline scenario for GDP growth remain tilted, as in June, to the downside. Compounding the external risks described are others stemming from the prolongation of the period of interim government in Spain, which generates uncertainty about the future course of economic policies and, in particular, about the fiscal consolidation path and the potential budgetary measures needed to meet the budget deficit targets agreed by the European Council in August for the coming years. In this respect, any delay in the scheduled correction of the budgetary imbalance, compliance with which is vital for entrenching the sustainability of public finances, and in the approval of structural reforms, needed to raise potential growth, increases the vulnerability of the economy in the face of potential exogenous shocks.

Conversely, the strength shown by the Spanish economy in the recent phase, against the background of uncertainty described, suggests that activity retains a degree of inertia that would lead to the impact of the foregoing factors of risk being mitigated in the short term. Moreover, in a setting in which knowledge about the effects of the broad set of monetary policy measures set in train by the ECB is necessarily limited, in light of the novel nature of such measures, the impact on the baseline scenario might be greater than that considered.

In relation to inflation, the risks of deviation are considered to be moderately tilted to the downside, as a result of a hypothetical materialisation of a more unfavourable global growth scenario. Nonetheless, the expansionary monetary policy measures might drive inflation above the baseline scenario projection.

The Report contains six boxes. These present the Banco de España's new macroeconomic projections (Box 1); a description of the latest public finances developments (Box 2); an analysis of the impact of the UK's exit from the EU on the British and world economy (Box 3); a study of the effects of the corporate sector purchase programme (CSPP) on the cost and volumes of euro area issues (Box 4); a description of the Spanish economy's exposure to the United Kingdom (Box 5); and an analysis of the factors behind the recent course of the Spanish economy's participation rate (Box 6).

23.9.2016.

This box presents the Banco de España's latest macroeconomic projections, updating those published on 7 June.<sup>1</sup> The new projections include the information that has come to light between 18 May and 23 September, the respective cut-off dates for the previous and current exercises (see Table 1).<sup>2</sup> One specific and significant change arises in the latest Quarterly National Accounts (QNA) estimates, which include the data for the first two quarters of 2016 (these were not available at the time the projections published in June were prepared).<sup>3</sup>

The estimates point to the continuation throughout the projection period of the expansionary phase of the Spanish economy. This

1 Available in this [link](#).

2 The respective cut-off dates for information-gathering in respect of the assumptions are 10 May and 19 September, except in the case of developments in Spain's export markets, for which the assumptions for the current exercise are taken from the [September 2016 ECB staff macroeconomic projections for the euro area](#), produced by ECB staff members, whose cut-off date is 15 August.

3 INE has also published in September a revision of the Annual National Accounts series for the period 2012-2015, which revises downwards the real GDP growth rate for the first of these years and leaves the rest unchanged, and it sets out, in cumulative terms, a higher contribution of external demand to GDP growth (at the expense of less robust national demand). These annual series have not been used for the preparation of the current projections, given that the methodology employed requires the use of quarterly series and INE will not disclose the series with this frequency consistent with the annual data now published until 24 November.

development will be assisted by a series of different factors, including some that have conferred a high degree of sustainability on the expansion (including most notably the correction, over recent years, of imbalances such as the loss of external competitiveness), along with others that entail a greater or lesser degree of temporariness, such as the improvements in resident agents' financial conditions, largely supported by monetary policy conduct, the expansionary fiscal policy stance applied in the two years spanning 2015-2016 and the delayed effects of the recently observed fall in oil prices and depreciation of the euro. Specifically, it is estimated that GDP will grow by 3.2% this year, slowing to 2.3% and 2.1% in 2017 and 2018, respectively (see Table 2), as a result of the disappearance of a significant portion of the temporary impulses listed. Turning to consumer prices, after posting a fall of -0.3% in 2016 on average, they are expected to rise to 1.5% and 1.6% in each of the next two years, driven by higher oil prices and by the progressive reduction in cyclical slack.

The main change from the June to the September exercise in the assumptions underlying the projections is the downward revision in the expected rate of expansion of the Spanish economy's external markets. This is chiefly a consequence of the estimated impact on UK imports arising from this country's referendum to remain in or exit the European Union and, to a lesser extent, of a downward reassessment of the growth rate

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

Annual rates of change, unless otherwise indicated

	2015	September 2016 projection			Changes from the June 2016 projection		
		2016	2017	2018	2016	2017	2018
<b>International environment</b>							
World output	3.0	2.9	3.3	3.5	0.0	-0.1	0.0
World markets	1.9	1.8	3.3	3.9	-0.7	-0.6	-0.3
Spanish export markets	3.1	1.8	3.4	3.8	-1.2	-0.7	-0.4
Oil price (in USD) (b)	52.4	43.6	50.2	50.8	0.1	1.2	-0.5
<b>Monetary and financial conditions</b>							
Dollar/euro exchange rate (USD per euro)	1.11	1.12	1.12	1.12	-0.01	-0.02	-0.02
Nominal effective exchange rate vis-à-vis the non-euro area countries (c) (2000=100 and pp changes)	113.0	114.2	114.8	114.8	-0.6	-0.7	-0.7
Short-term interest rates (3-month Euribor) (b)	0.0	-0.3	-0.3	-0.4	0.0	0.0	-0.1
Long-term interest rates (10-year bond yields) (b)	1.7	1.3	1.3	1.5	-0.3	-0.7	-0.8

SOURCES: ECB and Banco de España.

a Assumptions cut-off date: 19 September 2016. Figures in levels are annual averages and the percentage rates are calculated on the basis of the related annual averages.

b For the projection period, the values in the table are technical assumptions, prepared following the Eurosystem's methodology. These assumptions are based on the prices on futures markets or on approximations thereto, and they should not be interpreted as a Eurosystem forecast about the course of these variables.

c A positive percentage change in the nominal effective exchange rate denotes an appreciation of the euro.

of world trade.<sup>4</sup> Moreover, compared with the June forecasts, a somewhat higher level of oil prices is projected, in line with the observed trend on the spot and futures markets for this commodity. It is further estimated that competitors' prices will grow somewhat less than expected three months ago, despite

4 In the projections for the United Kingdom it is assumed that the referendum outcome will give rise to a significant downward revision of household and business spending, as a prolonged stage of uncertainty commences. This reduction in demand, along with the depreciation of sterling, will prompt a significant decline in British imports, which affects Spanish exports (along with the second-round effects via third markets). Following the referendum, a notable downward revision has been observed in the expected path of long-term interest rates which, in part, might be related to the referendum result, in so far as it reflects expectations of monetary policy easing. For further details on the way in which the United Kingdom's exit from the EU impacts the projections for Spain and for the rest of the euro area, see Box 1 in [September 2016 ECB staff macroeconomic projections for the euro area](#).

the slight depreciation of the euro since then. Finally, there will be a further reduction in the cost of credit financing to households and non-financial corporations, prompted by the downward revision of the expected interest-rate paths on interbank and government debt markets, according to the expectations implied in the yield curve. Moreover, in the case of firms a reduction in the cost of financing received via securities issues is included, which reflects in part the effects of the launch of the corporate sector purchase programme (CSPP) by the ECB (see Box 4).

The fiscal policy assumptions for 2016 rest on the measures approved in the budgets of the different tiers of government for this year, as in June, and on the budget outturn figures available. However, none of the further measures announced have been included, such as that relating to the re-establishment of minimum amounts for corporate income tax prepayments, given the failure

**Table 2**  
**PROJECTIONS OF THE SPANISH ECONOMY'S MAIN MACRO-MAGNITUDES (a)**

Annual rate of change in volume terms and % of GDP

	2015	September 2016 projection			Changes from the June 2016 projection		
		2016	2017	2018	2016	2017	2018
GDP	3.2	3.2	2.3	2.1	0.4	0.0	0.0
Private consumption	3.1	3.4	2.0	1.5	0.4	0.2	0.0
Government consumption	2.7	1.0	0.8	0.8	-0.1	-0.1	0.1
Gross fixed capital formation	6.4	4.0	4.8	4.5	-0.7	-0.7	-0.4
Investment in equipment	10.2	7.9	6.6	5.7	-0.2	-0.5	-1.0
Investment in construction	5.3	2.1	4.2	4.4	-1.3	-1.2	-0.2
Exports of goods and services	5.4	5.3	4.5	4.8	0.9	-0.3	-0.2
Imports of goods and services	7.5	5.4	4.9	4.9	0.1	-0.6	-0.4
National demand (contribution to growth) (b)	3.7	3.1	2.3	2.0	0.2	-0.1	-0.1
Net external demand (contribution to growth)	-0.5	0.1	0.0	0.1	0.3	0.1	0.1
Nominal GDP	3.8	3.5	3.3	3.7	0.3	0.0	-0.1
GDP deflator	0.6	0.3	1.1	1.6	-0.1	0.0	-0.1
Consumer price index (CPI)	-0.5	-0.3	1.5	1.6	0.3	0.1	-0.1
CPI excl. energy and unprocessed food prices	0.6	0.9	1.3	1.7	0.0	0.0	-0.1
Employment (full-time equivalents)	3.0	2.9	2.0	1.8	0.4	0.0	0.0
Unemployment rate (% of labour force)							
End-of-period data	20.9	19.0	17.8	16.7	-0.7	-0.5	-0.6
Average data	22.1	19.8	18.3	17.1	-0.3	-0.6	-0.6
Net lending (+)/net borrowing (-) of the nation (% of GDP)	2.1	2.6	2.2	1.9	0.6	0.7	0.7
General government net lending (+)/net borrowing (-) (% of GDP) (c)	-5.0	-4.9	-3.6	-3.1	-0.8	-0.2	-0.2

SOURCES: Banco de España and INE.  
Latest QNA figure: 2016 Q2.

a Projections cut-off date: 23.09.2016.

b Difference, to one decimal place, between GDP growth and the contribution of net external demand.

c Excludes aid to financial institutions.

to specify such amounts at the time these forecasts were formulated (see Box 2). With regard to 2017 and 2018, the fact that the preparatory cycle for the budgets of the different tiers of government has not been set in train means that there is a high degree of uncertainty about how budgetary policy will be specifically formulated. Against this background, it has been decided to prepare a scenario that involves assuming a neutral fiscal policy stance. Specifically, it is assumed that budget items subject to a greater degree of discretionality (e.g. inputs or public investment) will move in line with the (nominal) trend growth projections for the economy. Notwithstanding this assumption, the forecast for public revenues and the dynamics underlying certain expenditure items, such as that earmarked for the payment of unemployment benefits, are derived from the forecast macroeconomic aggregates. In-house estimates are also made of demographic trends, with an impact on pension spending, and of the debt interest burden. The fiscal policy stance derived from the projections in this report is expansionary in 2016 (for which year a deterioration in the primary structural balance of close to 1 pp of GDP is estimated, similar to that estimated for 2015) and, in accordance with the foregoing criterion, it is neutral in 2017-18.

Compared with the projections published over three months back, the GDP growth forecast in 2016 has been revised upwards by 0.4 pp. This revision for the current year incorporates the more favourable course of activity in Q2, according to QNA results, compared with what had been anticipated in June. Moreover, the conjunctural information for the summer months suggests a more dynamic behaviour of activity in the second half of the year than was projected in the previous exercise.

The growth envisaged for 2017 remains unchanged, which is the outcome of two opposing effects. As regards the technical assumptions, the less favourable outlook for the behaviour of export markets and, to a lesser extent, competitors' lower prices and higher oil prices entail, overall, unfavourable consequences for activity which are offset only in part by the additional easing in financial conditions that private agents face. Further, this is not ultimately reflected in a lower average GDP growth rate for the coming year, as it is offset by a more favourable carryover effect for 2016.<sup>5</sup> In 2018, the changes in the external assumptions exert, overall, a neutral impact on activity.

The expansion in GDP throughout the projection period is explained by the buoyancy of national demand which, however, will tend to be less robust as from the coming year. Net external

demand, whose contribution to GDP growth was negative in the period 2014-2015, will make an approximately neutral or slightly positive contribution over the time horizon envisaged.

Among the components of national demand, household spending on goods and services will continue to show notable strength in the short term. Subsequently, the high rate of job creation will continue to underpin this spending component, although the disappearance of the effects of some temporary factors that have been supporting household income in the recent period (and which include, in particular, the decline in oil prices and the reductions in income tax that came into force in 2015) are expected to contribute to tempering the rate of increase of private consumption. As a result, following the projected increase of 3.4% this year, a slowdown to 2% in 2017 and to 1.5% in 2018 is expected.

Favourable developments on the labour market and the persistence of benign financing conditions will prove conducive to the continuation of the course of recovery of residential investment. The increases in the pace of housing starts and house sales recently observed are along these lines. Notwithstanding the propitious context described, the intensity of the rise in this demand component will be checked by the prospect that the net household creation figures will be modest and, possibly, in some regions, by the high stock of unsold housing.

Business investment in capital goods will continue to expand at a high though diminishing rate, in step with the easing in the dynamism of final demand, in a setting in which financial conditions are expected to continue to be conducive to spending by non-financial corporations. The slowdown under the heading of other construction, prompted for reasons similar to those described in the case of investment in equipment, will be mitigated by the assumption made that the level of the public investment components will stabilise in 2017, after the fall-off observed in 2016.

As regards exports, which have recently moved on a very favourable trajectory, the moderate dynamism of external markets (and, to a lesser extent, lower competitors' prices) will give rise to somewhat more modest rates of increase. However, sales abroad are expected to continue showing a more expansionary course than the markets on which they are targeted, owing to the gains in competitiveness accumulated in the past (and which are not projected to continue in the future) and to the sustained increase in the number of firms which, having initiated export activity in a specific external market, remain present in such markets after several years. Furthermore, it is estimated that the tourism component will continue to be boosted by the political instability and the security problems in some of Spain's Mediterranean competitors. The course of imports will be determined by the slowdown in the main components of final demand.

On the estimates made, the surplus on the rest-of-the-world account may rise to 2.6% of GDP in 2016, 0.5 pp up on 2015,

5 The carryover effect denotes the arithmetic contribution that the quarter-on-quarter growth rates of one year exert on the annual average growth rate of the following year. On this occasion, specifically, the estimated contribution of the quarter-on-quarter GDP growth rates in 2016 to the average growth of this variable in 2017 is now greater than was estimated in June. On one hand, as indicated, the behaviour of activity was more expansionary in 2016 Q2 than expected in June. Moreover, on the other hand, the present projections include an upward revision of expected growth in the final two quarters of this year. In mechanical terms, this gives a higher increase in GDP not only in 2016 but also in 2017.

underpinned by the favourable trend of trade flows in real terms, the previous fall in oil prices and the lower net interest charge paid abroad. In subsequent years, the nation's lending capacity may be expected to ease as a result of the higher level of oil prices.

With regard to the labour market, the high pace of job generation is expected to persist, with low growth in apparent labour productivity, as is habitual in expansionary phases in the Spanish economy. The buoyancy of employment will be underpinned, moreover, by the projected continuation of wage moderation, which will contribute to the maintenance of modest though rising rates of increase in unit labour costs. The growth of employment will lead to further declines in the unemployment rate, which will be strengthened by a downward revision of the estimated growth of the labour force related to population ageing, as is set out in greater detail in Box 6.

Inflation, measured by the rate of change of consumer prices, has been rising since the spring, exhibiting increasingly less negative rates. This has essentially been the result of the increase in oil prices, although the indices that exclude the energy component – and, in particular, the index excluding unprocessed food and energy – have recently begun to show signs of picking up.

The CPI index excluding unprocessed food and energy is expected to continue quickening over the projection period, as a result of the prolongation of the period of expansion in spending on consumer goods, the gradual closing of the output gap and, towards the end of the projection horizon, the above-mentioned moderate rise in unit labour costs. As regards the energy

component, and under the assumptions for the exercise, the recent quickening phase is projected to run into the coming months, with increasingly higher rates of change that will peak in spring 2017, slowing subsequently.

As a result of the course of the various components, the overall indicator is expected to start posting increasingly positive rates as from September this year, which would nevertheless not prevent a fall-off of -0.3% being observed for 2016 on average. In 2017 and 2018, respective increases of 1.5 % and 1.6 % are estimated, in a setting in which the overall effect of the changes in the assumptions on the inflation rate is slightly negative, which explains the 0.1 pp downward revision in 2018 with respect to the June projections.

Chart 1 shows the year-on-year growth paths for GDP and for the CPI index excluding energy and unprocessed food under the baseline scenario, along with a measure of uncertainty surrounding these paths, constructed drawing on the past deviations of projections with respect to the figures actually observed. Under this approach, the probability that declines in GDP may be observed towards the end of the projection horizon would be around 10%, while the probability of the CPI index excluding unprocessed food and energy posting negative rates from now to end-2018 is very low according to the deviations in past projections. These probabilities have not undergone substantial changes from the June projections exercise.

A limitation of this type of approach based on past forecasting deviations is that it ignores the possibility that, at a specific point in time, the perceived level of uncertainty may be higher than at

GROWTH AND INFLATION OUTLOOK FOR SPAIN

Chart 1  
GROSS DOMESTIC PRODUCT  
Year-on-year rate of change

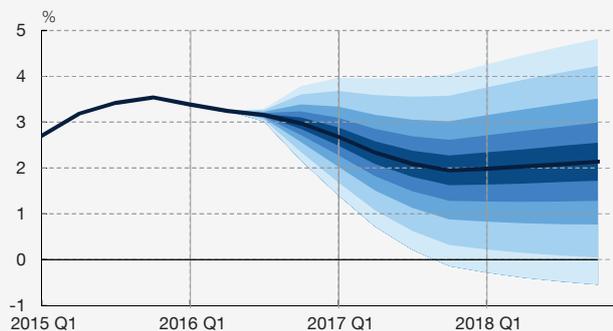
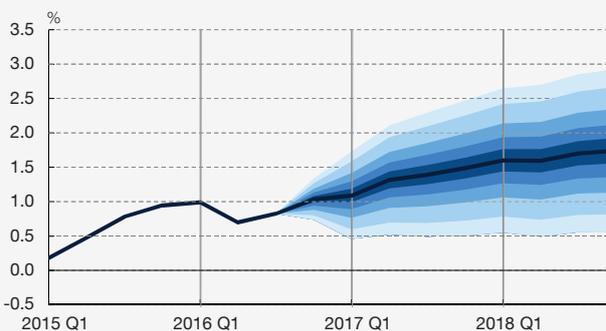
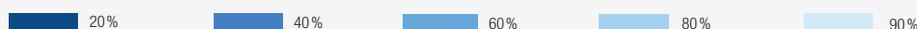


Chart 2  
CPI EXCL. ENERGY AND UNPROCESSED FOOD PRICES  
Year-on-year rate of change



Probability of GDP or the CPI excluding energy and unprocessed food prices being within the interval (a)



SOURCES: INE and Banco de España.

Latest figure: 2016 Q2 for GDP and August 2016 for the CPI excluding energy and unprocessed food prices.

a The right- and left-hand charts show the uncertainty around the central projection. Intervals with probabilities of 20%, 40%, 60%, 80% and 90%, respectively, based on historical projection errors.

others, or that the risks may appear more likely in one direction than in the opposite direction. In this respect, in the present projections exercise it is considered that the risks surrounding the baseline scenario for GDP growth will, as in June, remain tilted to the downside.

From the standpoint of the external environment, doubts remain in some emerging economies in particular concerning their ability to redress in an orderly fashion some of the imbalances observed. Moreover, in these projections it has been assumed that the impact on the baseline scenario of British voters' decision to exit the EU will be manifest only through a downward revision of UK imports, meaning that the referendum outcome will not have direct adverse consequences on euro area agents' confidence and spending decisions. However, it cannot be ruled out that, during the negotiation of the new trading arrangements between the United Kingdom and the EU, certain adverse effects of this type not envisaged in the baseline scenario may materialise.

External risks also include a potential stepping up of global geopolitical tensions, which might harm both world trade and euro area agents' confidence. In addition, the foreseeable tightening of monetary policy in the United States might exert certain adverse consequences on the net capital flows received by the most vulnerable emerging economies. Further, although the normalisation of financial conditions in the euro area in train since late 2012 appears to be firmly embedded, this process might not be completely immune to any potential increase in the perception of risks to the banking sector in certain countries in the area. Conversely, it cannot be ruled out that the impact on activity of the set of monetary policy measures deployed by the ECB may be greater than envisaged in these projections, owing to possible delays in the transmission of some of them to real activity.

Regarding domestic risks, the stability of GDP growth throughout the present exercise reflects the fact that the possible adverse effects arising from the prolongation of the current interim status of the government may have been offset during this period by other factors. Yet it cannot be ruled out that the adverse effects in question may ultimately materialise. In particular, the provisional nature of the central executive power has consequences for the budgetary process (as set out in Box 2) and, generally, for legislative activity, which may ultimately affect private agents'

confidence and, therefore, their consumption, investment and hiring decisions.

In the fiscal policy arena, the macroeconomic projections have, as indicated, been prepared on the basis of the absence of additional budgetary measures in the current exercise and under the assumption of a neutral fiscal policy stance in respect of activity during these years. Under these assumptions, the budget deficit is expected to exceed the fiscal targets agreed with the EU Council last August, thereby illustrating the need for fiscal policy to resume a restrictive stance in order to strengthen the sustainability of public finances and to ensure compliance with the targets. Any such additional budgetary consolidation measures could entail some cost in terms of growth over the course of the projection horizon.

The extended delay in forming a Spanish government also affects the timing of the approval of the structural reforms needed to increase the economy's potential growth. Any delay along these lines has adverse consequences for activity, since there are usually considerable lags between the adoption of the measures and the time at which such measures begin to have palpable effects.

Conversely, the resilience recently demonstrated by the economy, despite the prevailing uncertainty surrounding economic policies and the materialisation of certain significant risks in the external environment, suggests that the dynamics of activity in our country retain a high degree of inertia which, should this hold for some time longer, might lessen the final incidence of the foregoing factors of risk.

In terms of inflation, it is considered that the balance of risks is moderately tilted to the downside. In particular, the materialisation of any of the adverse events described affecting activity might give rise to a fresh disinflationary impulse, in particular under those scenarios in which external markets might perform less favourably, possibly accompanied by declines in commodities prices and an appreciation of the euro. Moreover, the recent situation of very low inflation rates might tend to be prolonged should agents extrapolate the trend observed to their expectations-formation process. Conversely, these risks would be alleviated if the expansionary monetary policy measures were to give rise to more buoyant consumer prices than was described under the baseline scenario.

The latest figures published on general government's performance in national accounts terms cover the period from January to July 2016 and refer to central government, regional governments and the Social Security.<sup>1</sup> According to the national accounts, these subsectors registered a combined deficit of 3.1% of GDP<sup>2</sup> in January-July, in line with the data for the same period in 2015 (see Chart 1). Information for the most recent period refers to central government and shows it to have registered a deficit of 2.8% of GDP in the period to August. This represents a deterioration of three tenths of a percent of GDP relative to the same period the previous year. Information is also available to August for tax revenues shared by central government,

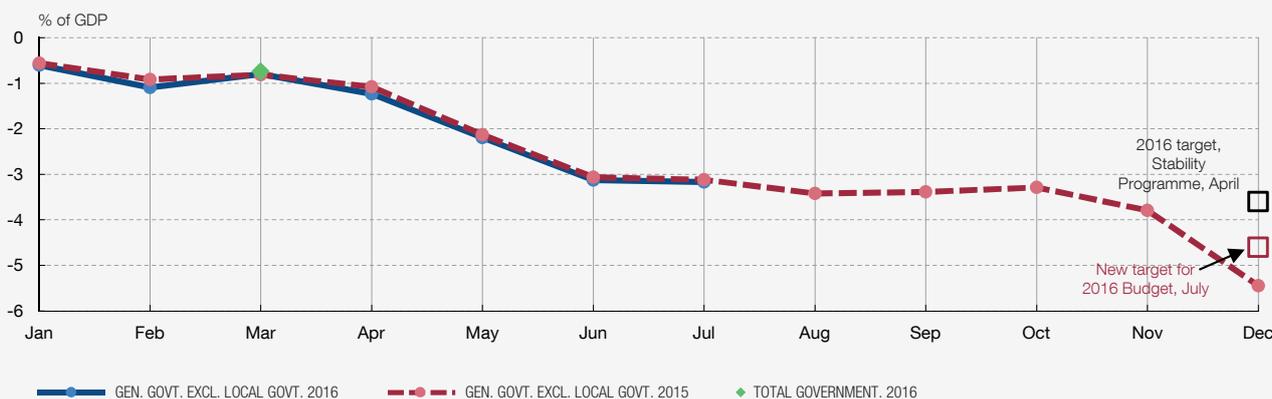
the regional governments and local authorities in budgetary accounting terms. This shows a smaller drop than at the end of the second quarter. Taken together, these developments highlight the risk of failing to meet this year's deficit target.

The general government debt-to-GDP ratio barely changed in the second quarter of 2016, at 100.5%, as a result of the slight increase in the sector's liabilities being offset by GDP growth (see Charts 2 and 3).<sup>3</sup> In conjunction with the reduction in average borrowing costs, this trend further lightened the interest burden,

1 These are monthly national accounts figures published by the National Audit Office (IGAE).  
 2 Net of the funds dedicated to the assistance of financial institutions.

3 The debt-to-GDP ratio was calculated using nominal GDP published by the National Statistics Institute (INE) in the latest quarterly national accounts (25 August) in the denominator. It does not, therefore, incorporate the INE's update to the 2012-2015 Annual National Accounts on 14 September 2016.

Chart 1  
 GENERAL GOVT. BUDGETARY BALANCE IN THE NATIONAL ACCOUNTS (excl. assistance for financial institutions)  
 Accumulated data from January



SOURCES: National Audit Office (IGAE) and European Council.

Chart 2  
 GROSS FINANCING  
 Year-on-year rate and contribution of instruments

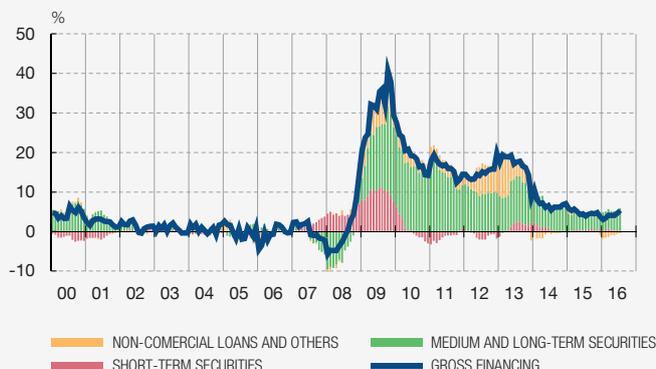
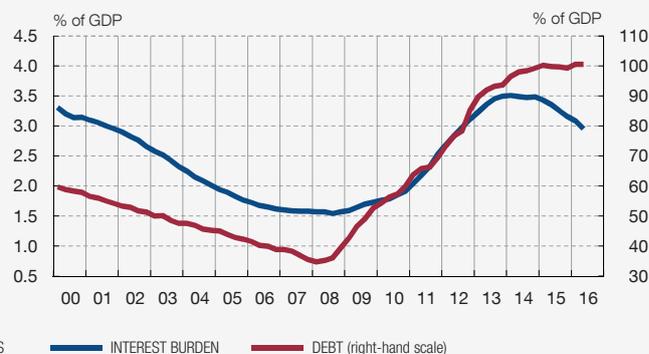


Chart 3  
 FINANCIAL BURDEN (INTEREST AND DEBT RATIO)  
 Accumulated data over four quarters



SOURCE: Banco de España.

which shrank to 3% of GDP. The breakdown by instruments reveals the issuance of medium and long-term securities to have remained general government's main channel for borrowing in the second quarter. By holders, the main net purchasers of securities issued by central government during the period were domestic financial institutions other than credit institutions, and in particular, the Banco de España, which made net purchases worth €21.9 billion, primarily as part of the Eurosystem asset purchase programme. By contrast, non-residents, credit institutions, households, and non-financial corporations reduced their holdings of these instruments.

On the institutional level, it should be recalled that on 12 July 2016 the Council of the European Union decided that Spain had taken insufficient measures to correct its excessive deficit in 2016. This deadline for Spain to reduce the public deficit to 2.8% of GDP in 2016 was set in the Council Recommendation of 21 June 2013. The Council Decision legally bound the European Commission to propose a fine, and suspend certain commitments regarding the execution of European Structural and Investment Funds in 2017. Nevertheless, availing itself of the option provided for by the Stability and Growth Pact, on 27 July 2016 the Commission proposed to the Council that the fine be cancelled, in the light of the reasoned application submitted by the Spanish government, which referred to the difficult economic climate, the reform efforts made, and the commitment to comply with the Pact. The Council decided to follow this recommendation on 8 August. The resolution on the partial suspension of the structural funds is currently pending discussion between the European Parliament and the Commission.

As recommended by the Commission, the Council also extended the deadline for Spain to correct its excessive deficit by two years, to 2018. The new path for the deficit targets sets a

maximum deficit of 4.6% of GDP this year, 3.1% of GDP in 2017, and 2.2% of GDP in 2018. The Spanish Government, like all the members of the European Union, is due to submit its annual budgetary plan for 2017 by 15 October 2016, and to give notice of the effective steps it plans to take to ensure compliance with the new deficit path. In particular, the reasoned request by the Ministry of Economic Affairs and Competitiveness in reply to the Council Decision of 12 July 2016 proposed the reinstatement of minimum amounts for corporate income tax prepayments as a possible corrective measure.

Full compliance with these European requirements is severely constrained by central government's current caretaker status. Indeed, the lack of an agreement enabling a government to be formed has meant that the budgetary process has not yet begun. Likewise, neither the new path for the public deficit targets agreed by the European Council in August, nor the distribution of the deficit across the various levels of government, have been formally adopted by the Spanish authorities. Specifically, in the current year this fact gives rise to the practical difficulty of identifying the reference objectives for the application of the monitoring and control mechanisms laid down by the Budgetary Stability Law, and, in particular, the criteria for the release of funds linked to the Regional Government Liquidity Fund. According to the Spanish Constitution, if no new budget has been passed by 1 January 2017, the 2016 budget will be extended. On the basis of past extensions to the General State Budget, it is possible that the Spanish parliament may approve amendments to certain specific items, such as an increase to pensions or public-sector employees' salaries.<sup>4</sup>

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<sup>4</sup> Since the current constitutional regime was established, the General State Budget has been extended on four occasions, namely in 1982, 1989, 1995 and 2011.

The UK referendum result to leave the European Union (EU) opens up a new scenario for the British economy, which may have significant consequences on the EU as a whole and, to a lesser extent, on the world economy. The lack of clear references regarding the model of the future relationship with the EU to be sought by the UK in the negotiation process – continued membership of the European Economic Area (EEA), free trade agreements similar to the agreement with Switzerland or bilateral trade agreements under the aegis of the World Trade Organization (WTO), among other possibilities – and the doubts as to how the negotiations will develop, and how long they will last, present a highly uncertain picture in the short and medium term.

As indicated in the main body of this report, the days after the referendum were marked by widespread stock market declines and sterling depreciation, as the pound fell by some 10% against both the dollar and the euro. However, following the initial turmoil, many of these moves reversed and most stock indices rose above their pre-referendum levels, in a setting marked by a recovery in risk appetite and lower volatility. The steps taken by the monetary authorities, including the Bank of England (which adopted a package of stimulus measures) and other central banks (which continued with their accommodative monetary policy), helped to ease the initial tensions. Nevertheless, between July and September, international bodies and institutions and also private sector analysts revised down their activity forecasts for the British economy, and for other, mainly European, economies, which are those with the closest links to the UK (see Table 1).

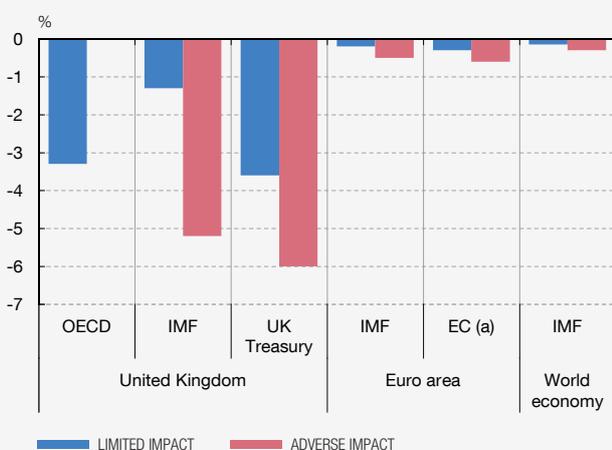
The UK's exit from the EU is expected to have various adverse effects on the British economy. Thus, although the markets have shown considerable resilience to date, over a one or two-year horizon financial conditions may tighten and asset prices may decline, especially in the real estate sector. Such developments,

together with a deterioration in agents' confidence, which will foreseeably be erratic over the coming months, would have a negative impact on domestic demand. On the positive side, sterling depreciation will provide an initial boost to competitiveness, partially offsetting those effects, assisted also by the more expansionary monetary policy stance and, farther ahead, by the more moderate fiscal policy adjustment. Although there will be no changes in tariffs or other non-tariff barriers until the UK actually leaves the EU, there could be a decline in trade in the near term given the uncertainty surrounding future trade relations, insofar as the possible future loss of markets may prompt a shift in global production processes. Longer term, it is difficult to foresee the effects on productive capacity in the UK since they will largely depend on the new trade and financial relationship that is finally agreed with the EU and with other key areas such as the US and the Asian economies.

The role of the British economy as a global financial centre and a hub for multinationals' investment flows – largely owing to the access it provides to the Single Market – entails the potential risk that any shocks affecting the British economy may spread to the international financial markets. This could lead to a tightening of financial conditions and a drop in confidence, and to spending decisions in the economies most exposed to the British economy being put on hold. In turn, the UK's trading partners will be adversely affected by the lower level of activity in the UK, although in some cases there could also be a positive impact as a result of activities being relocated outside the UK.

In recent months numerous studies have attempted to quantify the impact of the UK's exit from the EU both on the British economy and the rest of the world, envisaging different scenarios as to the UK's future relationship with the other economies and as to the effect of the uncertainty on financial conditions and agents'

Chart 1  
IMPACT ON GDP (2018)



SOURCES: OECD, IMF, European Commission and UK Treasury.

a Figures refer to 2017.

Table 1  
PRE- AND POST-REFERENDUM FORECASTS  
Pre-referendum forecast in brackets

	Projections		
	2016	2017	2018
<b>United Kingdom</b>			
Bank of England (Aug/May)	1.8 (1.9)	0.8 (2.3)	1.8 (2.3)
IMF (July/April)	1.7 (1.9)	1.3 (2.2)	—
European Commission (July/May)	1.6 (1.8)	1.1 (1.9)	—
OECD (Sep/June)	1.8 (1.7)	1.0 (2.0)	—
<b>Euro area</b>			
IMF (July/April)	1.6 (1.5)	1.4 (1.6)	—
European Commission (July/May)	1.6 (1.6)	1.5 (1.8)	—
OECD (Sep/June)	1.5 (1.6)	1.4 (1.7)	—
<b>World economy</b>			
IMF (July/April)	3.1 (3.2)	3.4 (3.5)	—
OECD (Sep/June)	2.9 (3.0)	3.2 (3.3)	—

confidence. Broadly speaking, the scenarios considered range from “limited impact”, with most current trade relations being maintained, through to “adverse impact”, with the UK becoming subject to WTO rules. These studies estimate the impact on the British economy as a decline in GDP of between 1% and 6% in 2018, according to the scenario and assumptions considered (see Chart 1), illustrating the high level of uncertainty surrounding the

future process of cutting ties with the EU and the possible economic implications. The consequences for the euro area and the world economy should be significantly more subdued, although naturally there will be substantial differences between countries, according to how close their ties are to the UK (see Box 5 for a description of the Spanish economy's trade and financial exposure to the UK).

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The Governing Council of the ECB announced a new corporate sector purchase programme (CSPP) in March 2016, in addition to the other three ongoing programmes under its asset purchase programme (APP).<sup>1</sup> The initiative, which was part of a broad package of new expansionary monetary policy measures<sup>2</sup>, aimed to help reduce the cost of issues and strengthen the APP's impact on financial conditions in the euro-area economy.

Under the CSPP, the Eurosystem buys corporate sector bonds, specifically, euro-denominated securities with an investment-grade credit rating issued by non-banking corporations established in the euro area.<sup>3</sup> In order to be eligible, the remaining maturity must be between 6 months and 30 years and there is no minimum issuance volume.<sup>4</sup> Purchases began on 8 June and reached a cumulative volume of nearly €23 billion over the three months the programme has been in operation. Monthly purchases of corporate bonds, averaging €6 billion euros over the period to August, have accounted for between 7% and 11% of total monthly purchases under the APP in this period. Although quantitatively less significant, in line with the size of the private non-bank bond markets in the euro area, its relative impact is high.

- 1 Namely, the third edition of the Covered Bond Purchase Programme (CBPP3), the Asset Backed Securities Purchase Programme (ABSPP) and the Public Sector Purchase Programme (PSPP). The CBPP3 and the ABSPP were introduced in 2014, and are aimed, respectively, at covered bonds and simple, transparent securitisations of loans to businesses and households. The Eurosystem has been buying public sector bonds through the PSPP since March 2015.
- 2 See the box on "las nuevas medidas expansivas del Banco Central Europea" (available in Spanish only) in the March 2016 Economic Bulletin.
- 3 Issues by credit institutions and their subsidiaries, and by asset management companies created as a result of financial sector resolution and restructuring processes are excluded. For more information see "More details on the Eurosystem's corporate sector purchase programme (CSPP) – Questions & answers" available at <http://www.ecb.europa.eu/mopo/implement/omt/html/cspp-qa.en.html>.
- 4 As in the case of the other private sector purchase programmes, the Eurosystem can buy up to 70% of an issue. This issue share limit is lower in the case of public undertakings, to which the same limit is applied as in the PSPP.

The announcement of the CSPP has had a highly positive impact on the cost of corporate bonds in the euro area. As Chart 1 shows, the yield on BBB issues by non-financial corporations has dropped by more than a percentage point relative to values in February, falling to record lows, making this form of borrowing cheaper than bank loans. This improvement has been seen across the board in the corporate bond market, including financial corporations' bonds and high-yield bonds.

Similarly, the programme has contributed to a reactivation of the primary market for non-financial corporation issuances. As Chart 2 shows, the volume of euro-denominated issues by euro-area corporations has grown significantly. This was despite the slowdown in June, possibly as a result of the uncertainty created by the referendum in the United Kingdom. This growth in the volume of issuances seems to be due more to the larger size of issues than to an increase in the number of issues or in the new issuers (see Chart 3).<sup>5</sup>

In net terms, issues are contributing to sustaining an increase in corporate borrowing (see Chart 5) and may explain, at least in part, the contraction in bank lending of loans over a million euros (see Chart 6). The introduction of the CSPP is expected to have a positive side effect on the supply of bank loans to smaller firms as larger firms' shift their financing decisions towards bond markets.

Overall, the additional easing of financing conditions and more vigorous lending this new monetary policy tool seems to have brought about should help support the economic recovery in the euro area and speed up inflation's gradual return to rates compatible with the medium-term monetary policy target.

- 5 The chart was prepared with information from Dealogic, using the name of the parent company to identify new issues. Dealogic's information is incomplete, particularly in the case of small issues, such that the data in the Chart may underestimate the importance of new issuers.

Chart 1  
COST OF CORPORATE DEBT FINANCING



Chart 2  
DEBT SECURITIES GROSS ISSUES BY NON-FINANCIAL CORPORATIONS (a)  
Accumulated volume for year

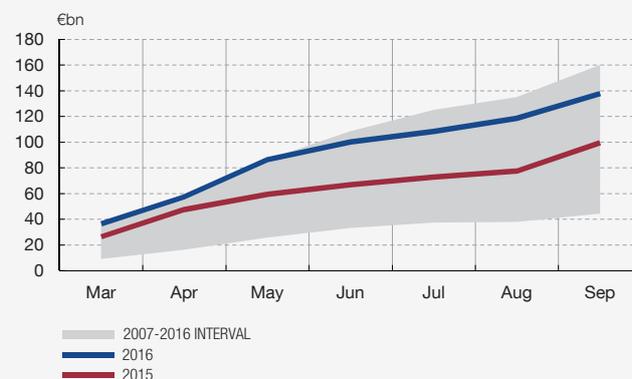


Chart 3  
DEBT SECURITIES GROSS ISSUES BY NON-FINANCIAL CORPORATIONS (a)  
Number of issues between March and September

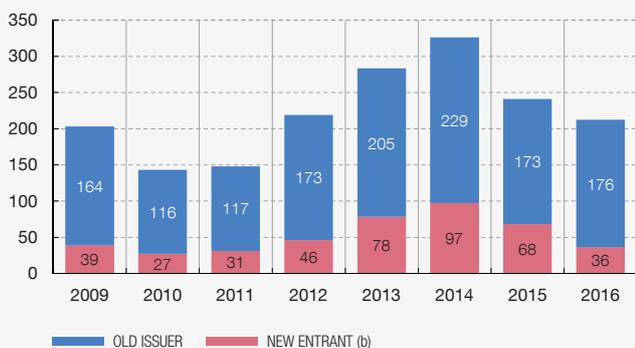


Chart 4  
SIZE OF ISSUES

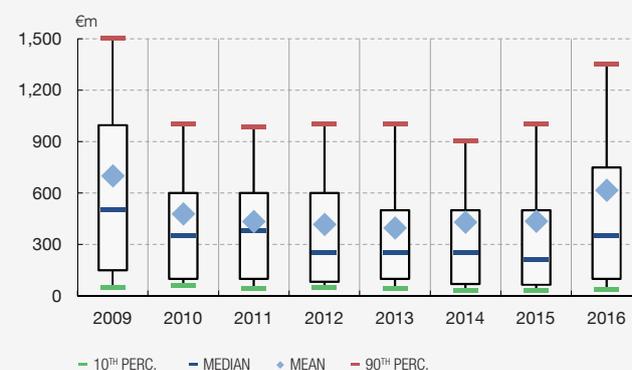


Chart 5  
LONG-TERM DEBT SECURITIES NET ISSUES

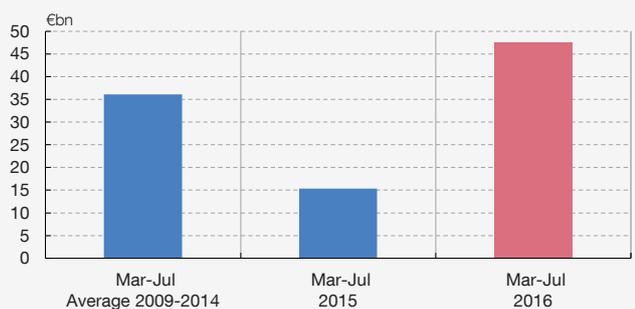
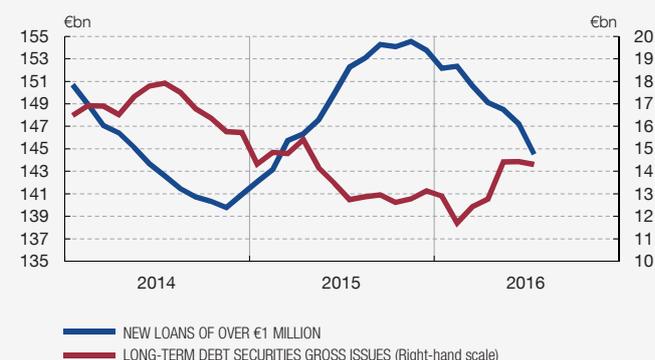


Chart 6  
BANK LOANS AND DEBT SECURITIES GROSS ISSUES  
12 month average



SOURCES: European Central Bank, Datastream, Dealogic and JP Morgan.

a Issues by euro-area non-financial corporations (following the parent nationality criterion). Includes Corporate Bond Investment Grade, Corporate Bond High Yield and Medium Term Notes, following Dealogic nomenclature.

b Companies that have not previously issued bonds are considered "new entrants" by taking into account the name of the parent company.

This box outlines the extent of Spain's commercial and financial exposure to the United Kingdom with a view to giving a preliminary assessment of the Spanish economy's possible vulnerabilities following the result of the UK's referendum on EU membership in June. In terms of trade flows, Spanish exports of goods and services to Britain account for approximately 10% of the total and are worth 3.2% of GDP (see Chart 1). The figure for exports as a share of GDP is somewhat lower than the euro area average of 4%. In particular, measured this way, Spain's trade exposure is less both than that of Germany, with its outward looking economy, and that of smaller countries. The case of smaller countries is logical given the positive correlation usually found between an economy's size and its degree of external openness. However, compared to France and Italy, which are of a similar size to Spain, its exposure to the United Kingdom is somewhat greater.

If this dependence of the various euro-area economies on the British economy is examined based on a breakdown into goods and services, certain clear differences emerge in Spain's case. Specifically, services exports account for a bigger share of GDP in Spain than in the other major EMU economies, with the United Kingdom being the leading market for Spain's products (30% of the total). This feature is apparent in the case of both tourism and non-tourism services.

In the specific case of tourism, the British economy accounts for 21% of total receipts. Moreover, given the rapid growth rate in recent years, UK residents' spending in Spain has been making a very strong contribution to the sector's recent good performance (see Chart 2). The significance of non-tourism services exports to the United Kingdom is even greater (39% of the total), with telecommunications and financial services standing out, followed by transport and business services. This clearly reflects the presence of Spanish multinationals that have commercial ties with their head offices and other companies based in Spain.

The United Kingdom is less important in comparative terms as a destination for Spanish goods exports (accounting for around 7% of the total). Even so, it is still Spain's fourth largest trading partner (after France, Germany and Italy). In the consumer goods category, the branches with the biggest exposures include the automotive industry (including parts), for which exports to the United Kingdom represent 12.7% of total sales abroad', along with food, drink and tobacco, which account for 9.5% of the total. In the case of capital goods, air and non-rail terrestrial transport equipment stand out (with exports to the United Kingdom of 13.3% and 11% of the total, respectively).

Similarly, on the imports side, Spain's purchases from the United Kingdom are less significant than in the euro area as a whole in the case of goods, but not in that of services. In any event, aggregate exposures in this case of both the Spanish (1.2% of GDP) and EMU economies (2.5%) are significantly smaller. Considering export and import flows together, Spain's bilateral commercial transactions with the UK economy yield a surplus of almost 1.5% of GDP.

As in the case of trade, Spain's financial exposure to the United Kingdom, although significant, is less than the euro area average, with the exception of direct investments (see Chart 3). In 2015, external assets and liabilities with the United Kingdom accounted for 11% and 8% of the total, respectively (15% and 20% of GDP, such that Spain has a negative net international investment position (IIP) of 5% of GDP with Britain).<sup>1</sup> In terms of currency type, most assets, and particularly liabilities, are denominated in euros, the net position in sterling being slightly positive.

Direct investments – at 8% of GDP – stand out among Spain's assets in the United Kingdom (see Chart 4).<sup>2</sup> In fact, the country is the top destination for Spanish foreign direct investment (FDI), followed by the United States and Brazil. As noted, Spanish FDI is concentrated in telecommunications and the financial sector. Other investments (i.e. basically deposits, loans and repos) come to 4% of GDP, largely as a reflection of financial investments by Spanish financial institutions in the British banking system, taking the form of deposits and other debt instruments. Portfolio investments in securities play a fairly minor role, and are concentrated in fixed income.

By contrast with Spain's assets in the UK, British investments in Spain are more mixed. Here portfolio investment securities, primarily fixed income (7% of GDP according to the IMF's final investor criterion), and other investments play a bigger role (also 7% of GDP, but in this case based on the first counterparty criterion), in line with the City of London's importance as an international financial centre (see Chart 5). Finally, according to data from the Coordinated Direct Investment Survey (CDIS), British shareholdings in Spanish firms are relatively small. Specifically, the United Kingdom's direct investments in Spain in 2104 were equivalent to 2% of GDP.<sup>3</sup> Apart from financial assets, British property investments in Spain are also significant. According to data from the *Centro de Información Estadística del Notariado* (CIEN), British buyers account for the largest share of total foreign purchases. Specifically, their investments in 2015 accounted for 4% of all housing purchases. This percentage was higher still in certain geographical areas (such as the Mediterranean coast and the Canary and Balearic Islands) where there is a larger share of holiday homes (see Chart 6).

In short, the Spanish economy's degree of exposure to that of the United Kingdom does not differ significantly from that of the other

1 However, it should be noted that some liabilities are recognised according to the first-known counterparty, which may not be in the same country of the ultimate owner of the assets, such that this figure may differ from the real value.

2 The bulk of FDI assets (over 80% of the total) are in the form of shares and other equity.

3 According to data from the Foreign Investment Register, telecommunications and the tobacco industry were the biggest destinations of British direct investments (with 21% and 22%, respectively, of the total in 2013).

main euro-area economies. Nevertheless, there are some specific areas, such as inward tourism, non-tourism services, and Spanish direct investment in certain sectors of the British economy

(particularly finance and telecommunications), and second homes, where, in relative terms, the Spanish economy is more sensitive to developments in the United Kingdom.

Chart 1  
EXPORTS OF GOODS AND SERVICES. 2015

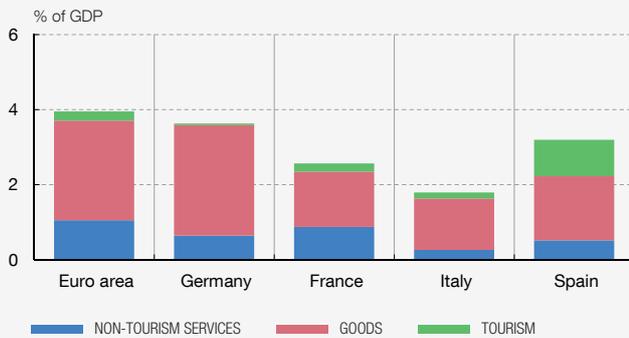


Chart 2  
FOREIGN TOURISTS IN SPAIN BY NATIONALITY

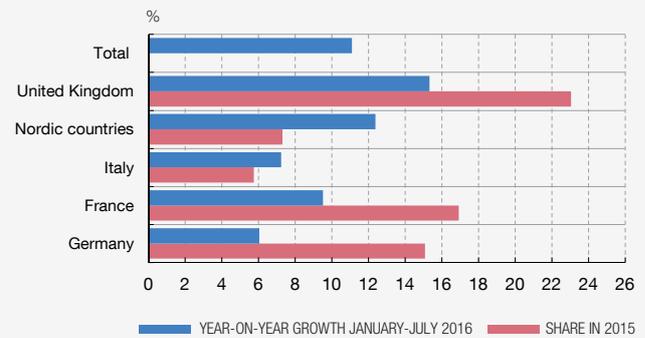


Chart 3  
DIRECT AND PORTFOLIO INVESTMENT IN THE UNITED KINGDOM. INTERNATIONAL COMPARISON. Data according to final investor criterion (IMF)

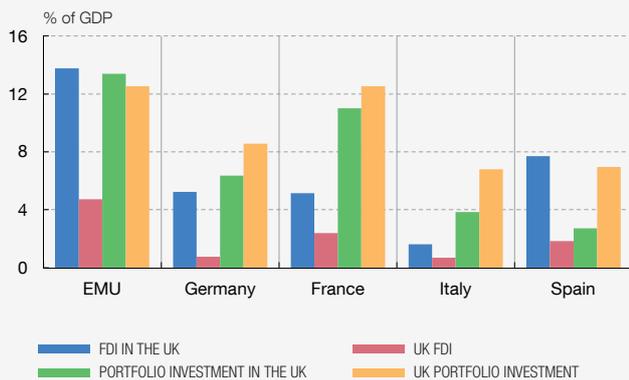


Chart 4  
SPANISH FOREIGN ASSETS IN THE UNITED KINGDOM. 2015 IIP data

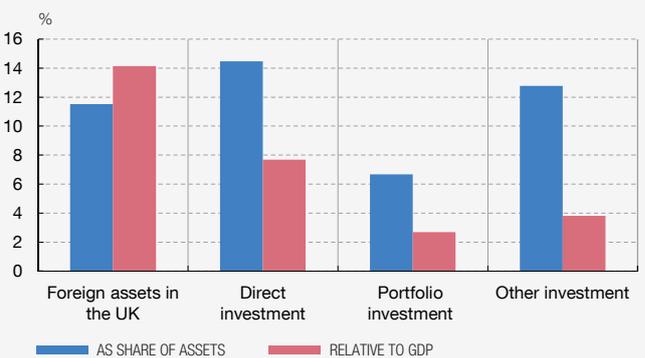


Chart 5  
UK-OWNED SPANISH FOREIGN LIABILITIES. 2015 IIP data

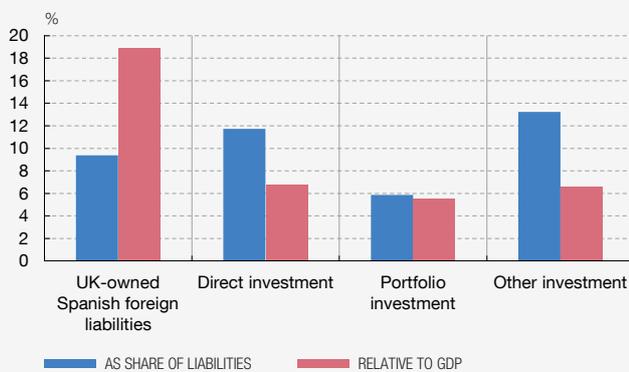
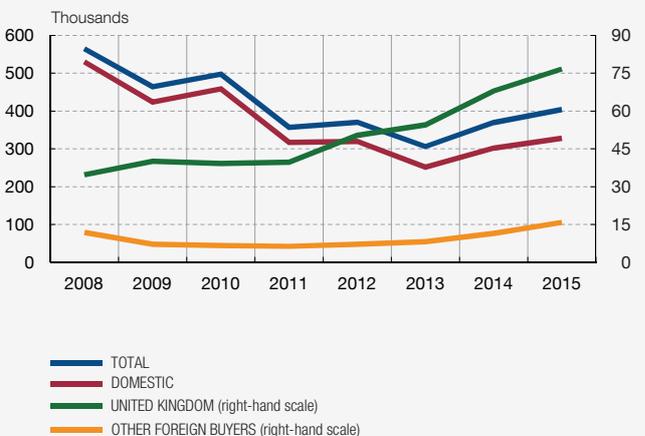


Chart 6  
HOUSING PURCHASES BY NATIONALITY



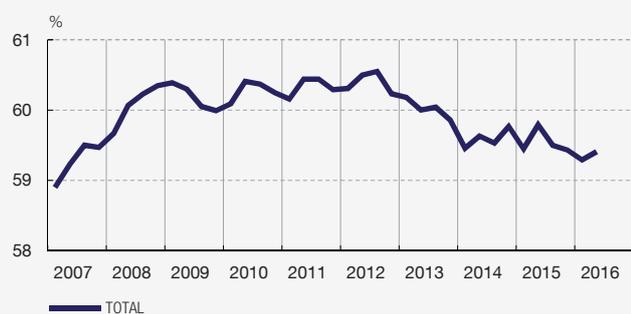
SOURCES: Eurostat, International Monetary Fund, National Statistics Institute and Banco de España.

Since the second half of 2013, when the economic recovery began, the Spanish labour force participation rate has continued on the downward path that commenced in mid-2012 when it peaked at 60.5%. It is common in downturns for the participation rate to decline. This is usually attributed to the discouragement effect, i.e. as the unemployment rate and the average duration of unemployment rise, the unemployed become discouraged and give up looking for work, exiting the workforce. This effect

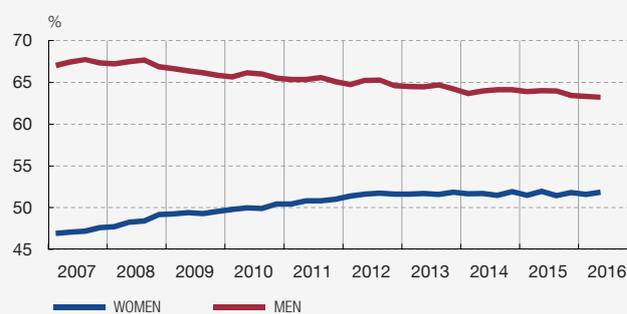
generally reverses when the business cycle improves, so that increases in the employment rate tend to be accompanied by increases in the labour supply. However, in the current economic recovery in Spain, the participation rate has continued to decline, falling by slightly more than 0.5 pp to 59.4% since the employment creation process began. The pattern is particularly striking among Spanish men (see Chart 1), for whom the participation rate has decreased by 1.3 pp since the second half of 2013, despite their

**Chart 1**  
PARTICIPATION RATES AND ECONOMICALLY INACTIVE STUDENTS, BY AGE

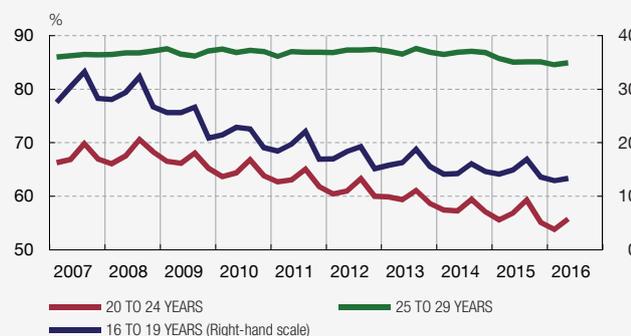
1 AGGREGATE PARTICIPATION RATE (a)



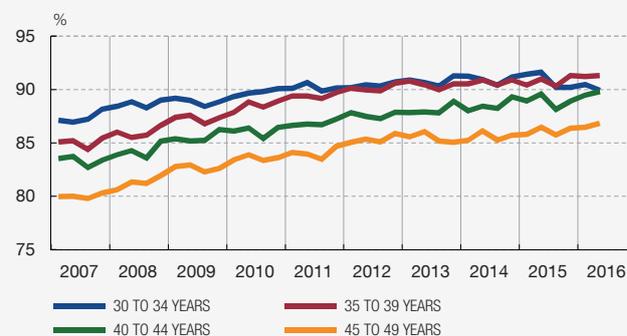
2 PARTICIPATION RATE: SPANISH NATIONALS, BY SEX (a)



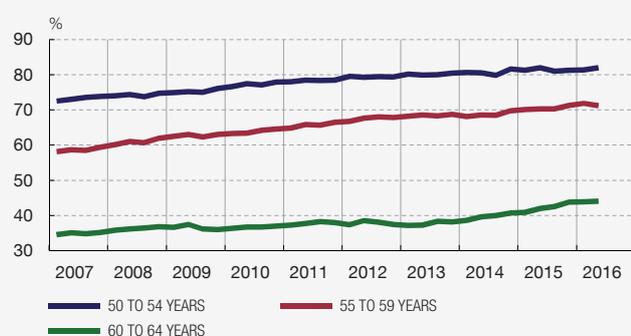
3 PARTICIPATION RATE BY AGE: YOUNG



4 PARTICIPATION RATE BY AGE: MIDDLE AGE



5 PARTICIPATION RATE BY AGE: OLD



6 ECONOMICALLY INACTIVE STUDENTS, RATES OF CHANGE (b)



SOURCE: INE (Labour Force Survey).

a Population of 16 years and over.  
b The 2016 figure is the y-o-y rate of change of the first half of the year.

being one of the groups whose participation in the labour market usually shows a high correlation with the cycle.<sup>1</sup> Also noteworthy is the participation rate of Spanish women, which has held steady around 51.7% in the same period, after more than four decades of continuous growth as Spanish women gradually joined the labour market.<sup>2</sup> This box analyses the causes of these changes in the participation rate, in an attempt to determine whether they are permanent or temporary and thus assess the advisability of projecting these trends over the forecasting horizon.

By age group, the decline in the participation rate of Spanish nationals has been concentrated among young people (16 to 24 years), although more recently it has also been observed, to a lesser extent, in the 25 to 34 age groups (see Charts 1.3 and 1.4). One factor that could explain this pattern is that, in light of the limited demand for labour with lower educational attainment levels,<sup>3</sup> younger people are either re-entering the education system, because of the lack of job opportunities, or deferring joining the labour market in order to acquire greater human capital (thus extending their education). Chart 1.6 illustrates the change in the numbers of economically inactive young people who are studying (whether in regulated or unregulated studies). In general, the chart shows that the number of economically inactive people who are studying has risen since the second half of 2013, especially in the 25 to 34 age groups when it is less frequent for people to be economically inactive because they are studying. Analysis of the type of studies undertaken shows a significant increase in general secondary education and

tertiary education.<sup>4</sup> Conversely, the participation rate is rising among all other age groups (see Charts 1.4 and 1.5). The link between the lower participation rate of young people in the labour market and their acquiring greater human capital, which appears to have a cyclical component insofar as it is related to job opportunities existing at a given time, would in any case have beneficial effects in the medium term, not only because the quality of labour will be higher, but also because people with higher educational attainment levels have higher participation rates throughout their life cycle.

One crucial element to explain the recent sluggishness of labour force participation is population ageing, in a setting in which the participation rate is defined as the number of persons over 16 years of age, thus including those over 64 years of age, for whom participation rates are extremely low.<sup>5</sup> Indeed, as Chart 2 shows, over the last 15 years the older age groups, which are those with the lowest participation rates, have grown as a proportion of the total. Moreover, this process has intensified in recent years, when the share of workers over 64 has increased significantly (by more than 2 pp in the last six years).<sup>6</sup> To assess the potential impact of ageing on the aggregate participation rate, a counterfactual path has been prepared by setting the proportion of each age group as a percentage of the population at their 2007 level and applying the change in participation rates of each group. This gives us what would have been the aggregate participation rate had there been no change in the population structure by age since 2007. As Chart 3.1 shows, the participation rate of the population over 16 would have been almost 2 pp higher with the 2007 population structure, which is a very

1 See Montero and Regil (2015), "La tasa de actividad en España: resistencia cíclica, determinantes y perspectivas futuras", Banco de España Occasional Paper No. 1502.

2 Changes in the participation rate among working-age foreigners, who account for some 12% of the total working-age population, were also consistent with the sluggishness of the labour supply. The participation rate fell by almost 2 pp for foreign women, and by 1 pp for foreign men.

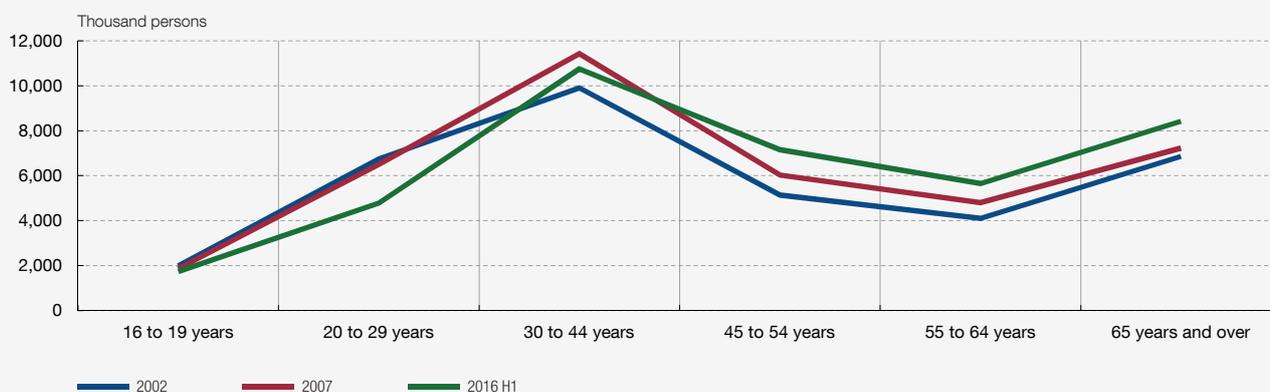
3 See Izquierdo, Puente and Font (2013): "Evolución del desajuste educativo entre la oferta y la demanda de trabajo en España", Boletín Económico, June, Banco de España.

4 There is no clear pattern in the changes in the numbers of students enrolled in unregulated programmes (non-formal personal and vocational training programmes).

5 The participation rate of the 65 to 69 age group is barely over 5%, while for the over-70s it is 0.6%.

6 This demographic pattern coincides with the post-war generation (marked by a rising birth rate) reaching retirement age and the continuing entry into the labour market of those born in the 1990s (a period marked by a very low fertility rate).

Chart 2  
POPULATION BY AGE GROUPS IN 2002, 2007 and 2016



SOURCE: INE (Labour Force Survey).

significant impact. Several recent studies have estimated a similar effect for the US economy, for example, Aaronson *et al* (2014)<sup>7</sup> who found that approximately 1.5 pp of the decline in the participation rate between 2007 and 2014 is due to population ageing.

The apparent impact of population ageing on the participation rate is considerably lower when it is calculated using only the population between 16 and 64 years rather than the population over 16 years (see Chart 3.2), given that, as indicated earlier, participation rates among the over-64s are very low, since most of this population group are retired. In fact, for this definition of the participation rate, the effect of population ageing is virtually zero. Hence, for certain types of analysis, the usual definition of the participation rate may not be the most appropriate one.

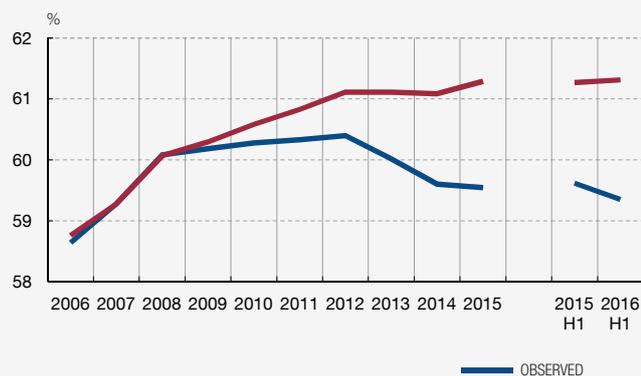
7 Aaronson, Cajner, Fallick, Galbis-Reig, Smith and Wascher (2014): "Labor force participation: recent developments and future prospects", *Brookings Papers on Economic Activity*, Fall 2014.

Given the potential future impact of the ageing process, Charts 3.3 and 3.4 illustrate the results of a projection exercise of labour force participation similar to that indicated above, but in this case setting participation rates by population group at their 2016 level and changing the future percentage weights of the population groups in accordance with the population projections of the National Statistics Institute (INE) up to 2020.<sup>8</sup> As the charts show, the participation rate calculated using the population over 16 records a further decline of approximately 2 pp between 2016 and 2020, owing to the demographic changes resulting from ageing, whereas the participation rate calculated using the population between 16 and 64 years declines by just 1 pp. The quantitative significance of this demographic change in the past and its foreseeable continuation in the future mean that this factor should be taken into account in the projection exercise, automatically reducing the participation and unemployment rates projected to date.

8 Using the INE's population projections published in October 2014.

Chart 3  
PARTICIPATION RATES: OBSERVED AND COUNTERFACTUAL, AND PROJECTIONS

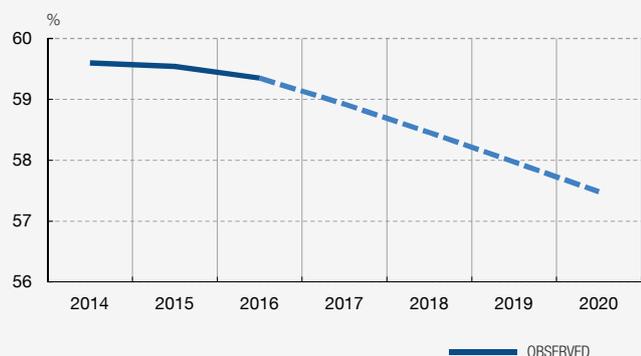
1 PARTICIPATION RATE FOR OVER-16s



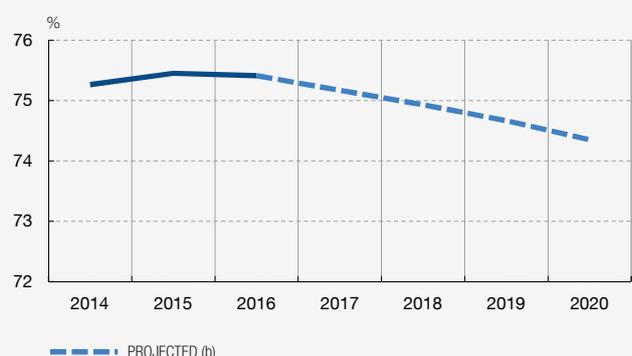
2 PARTICIPATION RATE FOR 16 TO 64 AGE GROUP



3 PROJECTED PARTICIPATION RATE FOR OVER-16s



4 PROJECTED PARTICIPATION RATE FOR 16 TO 64 AGE GROUP



SOURCES: INE and Banco de España.

a Participation rate setting the proportion of each population group at their 2007 level.  
b Aggregate participation rate, calculated by setting the participation rate of each age group at their 2016 level and aggregating with the INE's population projections for the period 2017-2020.

