MACROECONOMIC PROJECTIONS FOR THE SPANISH ECONOMY (2019-2022): THE BANCO DE ESPAÑA'S CONTRIBUTION TO THE EUROSYSTEM'S DECEMBER 2019 JOINT FORECASTING EXERCISE

Introduction and summary

This note describes the macroeconomic projections for the Spanish economy for the period 2019-2022, which are part of the projections for the euro area as a whole published by the ECB on 12 December.[1] These projections incorporate the new information that has come to light since the publication of the previous projections on 24 September in *Economic Bulletin* 3/2019, and on 27 November.[2] They also include for the first time the year 2022 in the projection horizon.

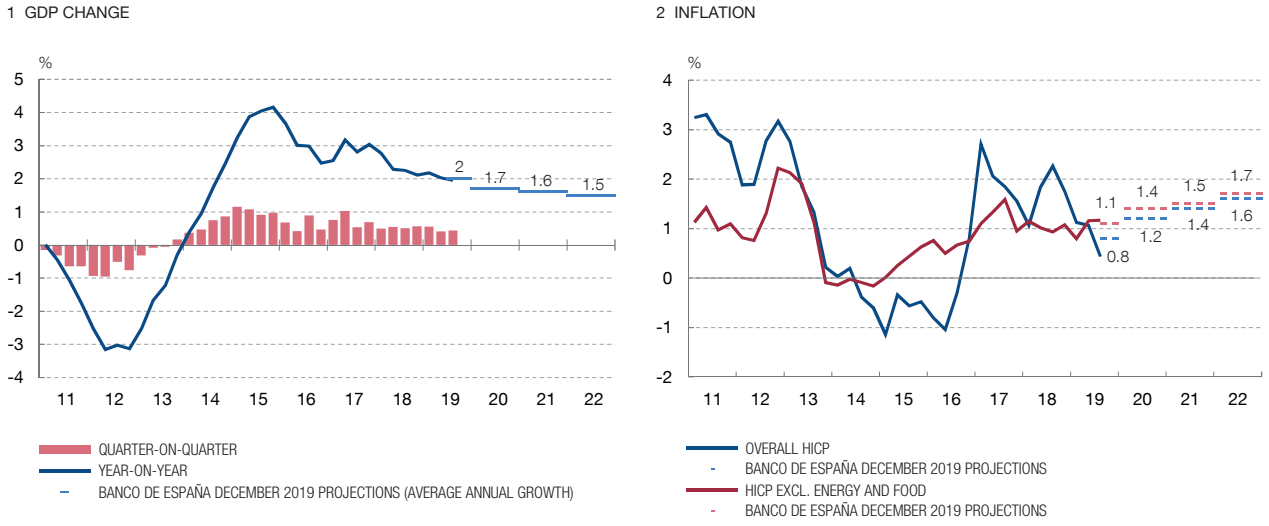
The performance of the Spanish economy in the second half of 2019 has continued to be expansionary. It has sustained higher growth rates than those recorded in the euro area as a whole. In Q3, as in the previous quarter, GDP grew at a quarter-on-quarter rate of 0.4% (compared with 0.2% in the euro area). The information available up to the cut-off date for this report suggests that, in Q4 to date, the pace of growth has remained similar. Looking ahead, the current projections foresee the present expansionary phase continuing over the next three years. Growth will continue to be underpinned by the improvements over recent years in the financial position of households and firms. This will provide key support for the buoyancy of domestic demand. A second underpinning is the ECB's accommodative monetary policy stance, which has been strengthened following the measures adopted by the Governing Council in September. That will in turn be conducive to continuing easy financial conditions. As to external demand, the assumptions anchoring the projections in this report consider that, following the recent weakening in exports and in the absence of fresh adverse developments, export markets will tend to gradually pick up throughout the projection horizon. Accordingly, in the coming years the Spanish economy's growth rate is expected to continue outpacing the rate of potential growth and, as a result, the positive output gap stemming from the prolongation of the current upturn will continue widening. That will enable the still-high level of unemployment to carry on being reabsorbed.

In any event, as has been the case since mid-2017, GDP growth is forecast to continue moving on a gradually slowing path over the projection horizon. Hence, in

1 See the Eurosystem staff macroeconomic projections for the euro area, December 2019.

2 Specifically, compared with the Macroeconomic projections for Spain (2019-2021), published as Box 1 in the "Quarterly report on the Spanish economy", in *Economic Bulletin* 3/2019, the current projections include the changes observed between 17 September and 19 November in the technical assumptions, in the budgetary assumptions and in the projections for the Spanish economy's external setting. The projections further include the Quarterly National Accounts (QNA) preliminary estimates for 2019 Q3.

Chart 1
GROWTH AND INFLATION OUTLOOK FOR SPAIN



SOURCES: Banco de España and INE.

average annual terms, the GDP growth rate is expected to stand at 2% in 2019, down on the figure of 2.4% posted in 2018, and to ease to 1.7%, 1.6% and 1.5% in each of the three following years (see Chart 1 and Table 1). This slowdown, which would be consistent with gradual convergence by the economy's growth rate to its potential growth rate, is due to smaller contributions by external and domestic demand alike to output growth. As regards the contribution of external demand to GDP growth, which is estimated to have been slightly positive in 2019, this will diminish as a result of a projected sharper increase in imports than in that of exports. Despite the relative strength of domestic demand, this variable is expected to lose momentum in the coming years. In this respect, the latest National Accounts data on private consumption, along with some weakening in the flows of new lending granted to households to finance their spending on goods and services, appear to suggest the end of the process involving the absorption of the demand for durable goods built up during the crisis, which would also curb the future buoyancy of this demand component. Moreover, the rebound in the household saving rate from its early 2018 low seems to be reflecting a more cautious attitude of these agents in their spending decisions. The projected easing in consumption is likewise grounded in the slowdown recently witnessed in job creation. Furthermore, the diminished buoyancy of final demand suggests that business investment will also hold at a more moderate rate of expansion than that posted in recent years.

As regards inflation, the average annual Harmonised Index of Consumer Prices (HICP) growth rate is expected to move on a rising course over the projection horizon. This path reflects the expected behaviour for the core component (i.e. the HICP excluding food and energy goods), the gradual rise in which will be the outcome of

Table 1
PROJECTIONS FOR THE MAIN MACROECONOMIC AGGREGATES OF THE SPANISH ECONOMY (a)

Annual rate of change in volume terms and % of GDP

		December 2019 projections				Differences between current and September 2019 projections		
	2018	2019	2020	2021	2022	2019	2020	2021
GDP	2.4	2.0	1.7	1.6	1.5	0.0	0.0	0.0
Private consumption	1.8	1.2	1.6	1.4	1.3	0.2	0.3	0.0
Government consumption	1.9	2.2	1.7	1.5	1.4	0.4	0.4	0.3
Gross fixed capital formation	5.3	2.7	3.3	2.5	1.9	0.5	-0.1	0.0
Investment in equipment, intangibles and other (b)	4.1	4.1	4.9	2.3	1.7	1.8	2.0	0.0
Investment in construction	6.6	1.4	1.6	2.8	2.1	-0.9	-2.3	-0.1
Exports of goods and services	2.2	1.8	2.3	2.9	2.9	-0.4	-0.6	-0.4
Imports of goods and services	3.3	1.0	3.3	3.2	3.0	0.5	0.1	-0.3
National demand (contribution to growth)	2.7	1.7	1.9	1.6	1.5	0.3	0.2	0.1
Net external demand (contribution to growth)	-0.3	0.3	-0.2	0.0	0.0	-0.3	-0.3	-0.1
Harmonised index of consumer prices (HICP)	1.7	0.8	1.2	1.4	1.6	0.0	0.1	-0.1
HICP excluding energy and food	1.0	1.1	1.4	1.5	1.7	0.0	0.0	-0.1
Employment (full-time equivalent jobs)	2.5	2.0	1.3	1.4	1.2	0.2	0.0	-0.1
Unemployment rate (% of labour force). End-of-period data	14.4	14.3	13.6	13.0	12.5	0.2	0.4	0.2
Unemployment rate (% of labour force). Annual average	15.3	14.2	13.8	13.1	12.6	0.1	0.2	0.1
General government net lending (+)/net borrowing (–) (% of GDP)	-2.5	-2.5	-2.1	-1.8	-1.4	-0.1	-0.3	-0.3

SOURCES: Banco de España and INE.
NOTE: Latest QNA figure published: 2019 Q3.

a Projections cut-off date: 19 November 2019.
b Includes machinery, capital goods, weapons systems, cultivated biological resources and intellectual property products.

the progressive widening of the positive output gap caused by the prolongation of the upturn and by the consequent gradual decline that the unemployment rate will continue to experience. The upshot of this will be a degree of dynamism in unit labour costs. The expansionary monetary policy stance (and, in particular, the policy measures recently adopted) will also contribute to the rising trajectory of core inflation. In terms of the overall indicator, also reinforcing this expected path will be the projected course of oil prices on futures markets, with increasingly smaller percentage declines as the projection horizon unfolds. The outcome of all these factors will see the growth of the overall HICP, in average annual terms, increase gradually from 0.8% in 2019 to 1.6% in 2022, with core inflation rising from 1.1% to 1.7% over the same period.

Compared with the September projections, GDP growth holds unchanged over the projection horizon. This is as a result of several factors which, taken individually, have a very modest impact on the projections and whose net effect is approximately zero, since they offset one another. On one hand, the assumptions underpinning the

current projections, described in Box 1, are on the whole somewhat less conducive to dynamic activity than those in September. In particular, despite the fact that a gradual recovery is projected for export markets, this pick-up will be less robust than that expected three months ago. This relative downturn in performance will be partly offset by the expansionary effect on activity stemming from lower oil prices. On the other hand, the latest data suggest the GDP growth path will stabilise in the second half of the year, in contrast to the weakening augured by the conjunctural information available at the time the September projections report was drafted. In any event, although the GDP growth path remains unaltered in the new projections as a result of these counteracting developments, the composition of GDP growth has been slightly revised. This is chiefly as a consequence of the incorporation of the Q3 National Accounts data. Specifically, an increase in the contribution of domestic demand to output growth and a reduction of the same order in that corresponding to the external component are now projected.

The projections relating to the HICP are practically unchanged on those published three months earlier, regarding both the overall and the core indicators. The small scale of the revisions is consistent first, with the absence of inflation surprises in recent months; and further, with the scant changes both in the assumptions on which the projections are based and in the outlook for activity and the labour market.

Activity and employment

From the standpoint of the composition of aggregate demand, output growth will continue to be underpinned largely by the buoyancy of private domestic spending, whose contribution to GDP growth will, in any event, be smaller than in recent years. The contribution of net external demand to the expansion of output will, after having been positive in 2019, turn slightly negative in 2020 and stand at practically zero in the following two years.[3]

The favourable trajectory of private national demand will continue to be assisted by the persistence of propitious financial conditions and by the improvements witnessed during the current expansionary phase in the financial position of households and firms. Household spending on consumption and investment will be further spurred by the expansionary behaviour of household income and, in particular, by the

3 The negative contribution of net external demand in 2020 will be the outcome of the carry-over effect associated with its high negative value in 2019 Q3. For an analysis of the so-called carry-over effect (and, in general, of how the average annual course of a variable is explained by developments in the various quarters of the preceding and of the current year), see González Mínguez, J. and C. Martínez Carrascal (2019), "The relationship between average annual and quarter-on-quarter GDP growth rates: implications for projections and macroeconomic analysis". Banco de España, *Economic Bulletin*, 2019/3.

prolongation of the positive course of employment. Private consumption will, however, be somewhat less buoyant in the future than in previous years owing to the confluence of several factors. Firstly, the increase in household labour income is expected to rest progressively more in the coming years on the recovery in real wages and less on net job creation. This composition of labour income growth will be less conducive to increases in consumption than in previous years, given that the marginal propensity to spend tends to be lower when the rise in labour income stems from higher wages than when its origin lies in an increase in employment.[4] Secondly, there is the decline in spending on durable goods observable, according to the National Accounts, since mid-2018. This suggests that the process whereby the pent-up demand for such goods that built up during the crisis has progressively been met in recent years is close to completion.[5] Thirdly, in a setting in which numerous sources of uncertainty persist, the household saving rate is expected to increase moderately over the projection horizon, drawing close to its historical average. These dynamics would be consistent with the rise already observed in this variable since early 2018 and with the recent worsening of certain consumer sentiment indicators. Compared with the September projections, the expected path of household spending on goods and services has been revised upwards in the short term. This is as a result of the incorporation of the latest National Accounts information, with a positive surprise that entails a significant carry-over effect.[6]

Residential investment slowed notably in 2019, after posting very high growth rates in the initial years of the recovery starting from the low level reached due to the crisis. Over the projection horizon this aggregate is expected to expand at rates similar to those recently observed. Compared with the September projections, the pace of growth envisaged for this demand component is now more moderate, especially in the 2019-2020 period. This is due to the (more favourable than expected) course of the National Accounts variable in Q3, and to its less expansionary future behaviour predicted by the high-frequency indicators. These developments might be partly associated with transitory reasons, although the presence of other, more persistent factors that might likewise subtract further momentum from this demand component cannot be ruled out. The moderation in the buoyancy of housing investment, combined with the projected rise in the saving rate, would lead to a modest increase in household net lending capacity to somewhat above 1% of GDP.

The outlook for an expansion in activity and the headway made in redressing firms' financial position will continue to be conducive to business investment growth. In any event, in step with the projected lower momentum of final demand, and against

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4 See Chapter 2 of the *Annual Report*, 2015, Banco de España.

5 For an analysis of recent developments in consumption by type of spending (and in terms of the changes in labour market status of household members), see "The relationship between the behaviour of consumption and employment during the recovery", Banco de España, Economic Bulletin, 2019/4.

6 See, once more, González Mínguez, J. and C. Martínez Carrascal (2019), op. cit.

a background of uncertainty, business investment is also expected to increase at a lesser pace than in recent years. The sizeable upward surprise in the growth of this aggregate in Q3 will in any case give rise to a significant carry-over effect, leading to current expectations of growth rates in the 2019-2020 period greater than those projected in September. Partly countering this revision, however, are the effects of the updated assumptions of the projections exercise (and, in particular, the outlook for flatter export markets).

On the external front, sales to the rest of the world will gradually increase over the forecasting horizon, in line with the projected recovery in export markets. In any event, the average growth of exports has been revised downwards relative to the forecasts three months ago. For one thing, this revision is due to the incorporation of more recent data, which show a less favourable performance by this aggregate (concentrated under the capital and intermediate goods headings) in Q3 this year than was anticipated three months ago. For another, the expected diminished robustness of exports is also due to the less dynamic behaviour foreseen for Spain's external markets.

The projections on imports point to their elasticity to final demand drawing gradually but only partly closer to its historical mean. Elasticity will thus remain below this mean at the end of the projection horizon. This is attributable, on one hand, to the observation globally that the increase in world trade per unit of GDP growth is lower post-crisis than pre-crisis. And, on the other, to the assumption that the recent, unusually low growth of Spanish imports cannot be attributed in full to the composition of final demand or to a possible import substitution process following the competitive adjustment in the economy. Accordingly, it is estimated that a transitory component must also be at play. The projected increase in imports is now, compared with what was expected three months ago, somewhat higher in 2019 and 2020 and somewhat lower in 2021. This pattern of import revisions reflects both the impact of the latest National Accounts data for this aggregate and the changes to the projected paths for the various final demand components (particularly for gross fixed capital formation and exports, which have a high import content), over the entire course of the projection horizon.

As regards employment, the gradual moderation in output growth rates which is anticipated over the projection horizon will translate into a progressive reduction in the pace of job creation compared with that observed in recent years. The latest labour market indicators are consistent with this progressive slowdown. In any event, the increase in employment will enable the unemployment rate to continue falling, albeit at a lesser pace than that observed in previous years. This slowdown in the declining path of unemployment reflects both the lower pace of job creation and a modest rise in the rate of increase of the labour force. Compared with the September projections, the expected reduction in the unemployment rate is now somewhat less pronounced. This is due to the fact that the recent behaviour of the labour force has

been somewhat more dynamic than was then projected. In 2022 on average, the unemployment rate is expected to stand at 12.6% of the labour force.

The budget deficit will gradually be corrected over the projection horizon, being estimated to stand at 1.4% of GDP in 2022. However, this improvement would rest exclusively on the favourable effects of the economic cycle and on the continuation of the ongoing reduction in the average cost of debt, as a result of the current low interest rate environment. Conversely, under the assumptions of the projections exercise, no significant changes are expected in the primary structural balance over the projection horizon. Consequently, the fiscal policy stance, which had been clearly expansionary in 2019, would be approximately neutral in the 2020-2022 period. Compared with the projections three months ago, the current forecasts entail an upward revision of the budget deficit. This is of the order of 0.1 pp in 2019, further to the incorporation of the latest available information[7], and of an additional 0.2 pp in 2020 and 2021, due largely to the fact that the fiscal assumptions on which these projections are based include a revision of the assumption on the revaluation of pensions[8].

Prices and costs

The expected growth of compensation per employee in each of the projection horizon years fluctuates around 2%, which exceeds the rate seen from the onset of recovery until 2018. The factors behind this more dynamic behaviour of wages include a lower unemployment rate and, in 2019 and 2020, the application of the recommendations made in the *Acuerdo para el Empleo y la Negociación Colectiva* (Employment and Collective Bargaining Agreement).[9] Furthermore, the increase in labour costs in 2019 also reflects the rises in the national minimum wage and in the maximum contribution base. Against a background in which productivity growth will continue to be low, the faster growth of compensation per employee will lead to unit labour costs increasing more steeply than in recent years. Meanwhile, the external component of price formation, measured by the imports deflator, will grow somewhat more slowly than in

7 Specifically, for 2019, the budget outturn figures to September for overall general government, excluding local government, show a more dynamic than expected increase in employee compensation and in welfare benefits. Along these same lines, the October figures for tax revenue indicate a significant slowdown in revenue raised from corporation tax, since the high advance payments observed in 2018 have not been repeated this year.

8 In particular, the current projections assume an increase in pensions in line with the CPI for the 2020-2022 period, set against the 0.25% revaluation – the outcome of the formula laid down in the 2013 legislation being applied – that was assumed in the September projections exercise.

9 The agreement establishes, as a reference, annual wage rises between 2% and 3% in the three years it is in force. This rise is made up of a 2% fixed portion and a 1% variable portion linked to variables such as productivity, business profits and absenteeism.

recent years owing to the projected decline in oil prices, according to the assumptions made in the exercise, in contrast to the increase in the 2017-2018 period.

After moderating significantly in 2019, dominated by the behaviour of the energy component, the growth of the consumer price index (CPI) is projected to quicken progressively, rising from 0.8% in 2019 to 1.6% in 2022. Also, core inflation — measured by the rate of change of the index which excludes energy and food — will foreseeably rise gradually (from 1.1% in 2018 to 1.7% in 2022), reflecting the behaviour of unit labour costs and a widening output gap.

Risks

The risks to the baseline scenario for GDP growth remain predominantly on the downside. These risks stem mainly from the external environment of the Spanish economy, whose behaviour since the beginning of 2018 has been characterised by persistently negative surprises in the growth rate of global activity and, in particular, by rates of expansion of world trade which, given the output growth, been very low. In the current projection exercise, this behaviour has, as in previous exercises, led to a downward revision of the growth rate of Spain's export markets. However, despite the recent signs of stabilisation of activity and world trade, we cannot rule out further downside surprises which may threaten the external market recovery projected under the baseline scenario. In particular, this scenario relies on the assumptions that global trade tensions will tend to dissipate in the coming quarters and that Brexit will be orderly. The non-materialisation of these assumptions or a hypothetical resurgence of geopolitical tensions in some regions (such as the Middle East and Latin America) may ultimately impinge negatively on export activity and business investment in Spain.

On the domestic front, uncertainty persists about the future design of economic policies and, in particular, about the elements needed to resume the process of fiscal consolidation, insofar as a new government has yet to be formed after the recent general elections. Similarly, Spain's resilience to hypothetical adverse developments would be strengthened by the adoption of a programme of structural reforms to boost economic growth potential.

With regard to inflation, the risks of departure from the baseline scenario are also on the downside and arise mainly from a possible materialisation of the risks to activity described above. Also, the prospect that core inflation may rise during the projection horizon is conditional upon the degree of price sensitivity to the cyclical improvement in activity, a factor subject to considerable uncertainty.

16.12.2019.

Box 1

ASSUMPTIONS FOR PREPARATION OF PROJECTIONS

The assumptions on the paths of interest and exchange rates and of oil and other commodity prices are based on the prices quoted on the respective markets during the ten business days prior to the cut-off date (19 November). Specifically, in accordance with this methodology, the oil price is expected to average $63.8 per barrel in 2019 and to then fall by nearly 11% in cumulative terms over the following three years, to $56.8 per barrel in 2022. Compared with the previous forecasts, this oil price trajectory entails a small downward revision (of 0.2% in 2019 and 0.4% in each of the following two years).

As regards interest rates, on average, 3-month EURIBOR in the period 2019-2021 is expected to be around -0.4%, rising slightly in 2022 to -0.3%. For their part, Spanish 10-year government debt yields are forecast to fall in 2020 to 0.5%, 0.7 pp less than the 2019 average, and to rise by 0.2 pp in each of the following two years, up to 0.9% in 2022. This entails a slightly upward revision for both references for the period 2020-2021 (0.1 pp in each year). In line with this projection, the cost of credit to households and firms has also seen a modest upward revision (between 0.1 pp and 0.2 pp) for the two-year period.

The nominal effective exchange rate of the euro is lower in 2019 and 2020 than in the previous projection exercise and no significant changes are expected for 2021. The assumptions on the euro/dollar exchange rate are unchanged on three months earlier.

The projections for economic activity and imports in the main geographical areas with which Spain trades are now less favourable than in the September projections, especially for 2020. This has given rise to a downward revision of the growth forecast for Spain's export markets, which are expected to grow by 1.8% in 2019, followed by a gradual increase, up to 2.7% in 2022.

The budgetary policy assumptions include, as in the September projection exercise, extension for 2019 of the State and Social Security Budget for 2018, the measures approved by Congress before the general election in April, the regional and local government budgets approved for the year and the latest information available on budget outturn. The assumptions for the rest of the projection horizon considered envisage that at 31 December 2019 the 2018 Budget will be extended, for the second year in

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

Annual rates of change unless otherwise indicated

		December 2019 projections				Difference between current and September 2019 projections (b)		
	2018	2019	2020	2021	2022	2019	2020	2021
International environment								
World GDP	3.6	2.7	2.9	3.1	3.1	-0.1	-0.3	-0.1
Spain's export markets	3.2	1.8	1.9	2.5	2.7	-0.1	-0.6	-0.4
Oil price in US dollar/barrel (level)	71.1	63.8	59.6	57.4	56.8	-0.2	-0.4	-0.4
Monetary and financial conditions								
US dollar/euro exchange rate (level)	1.18	1.12	1.10	1.10	1.10	0.00	0.00	0.00
Nominal effective exchange rate against non-euro area (c) (2000 = 100 and percentage differences)	121.5	116.4	114.8	114.8	114.8	0.0	-0.3	-0.3
Short-term interest rate (3-month EURIBOR) (d)	-0.3	-0.4	-0.4	-0.4	-0.3	0.0	0.1	0.1
Long-term interest rate (10-year bond yield) (d)	1.4	0.7	0.5	0.7	0.9	0.0	0.1	0.1

SOURCES: Banco de España and ECB.

a Cut-off date for assumptions: 19 November 2019. Figures expressed as levels are annual averages. Figures expressed as rates are calculated based on the relevant annual averages.
b Differences between rates for world output and export markets and between levels for oil prices and the dollar/euro exchange rate. Percentage differences for the effective nominal exchange rate and percentage point differences for interest rates.
c A positive percentage change in the nominal effective exchange rate denotes an appreciation of the euro.
d For the projection period, the figures in the table are technical assumptions, prepared using 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.

a row, this time for 2020, given the difficulties that the legal time limits for formation of a new government after the November general election entail for presentation of the draft budget before year-end. Moreover, by contrast to the assumptions made in the previous forecasting exercises, in these projections it is assumed that pensions will be indexed to CPI growth in the period 2020-2022, given that the various political forces appear to share the same criteria in this respect.[1] Regarding all the other assumptions, first, it is assumed that the more discretionary budget items – particularly public investment and procurement, on account of their size – will evolve in line with the potential growth of the economy. Second, in the absence of other measures, it is considered that the trajectory of the other headings of the general government accounts will be governed by their usual determinants. Specifically it is assumed that public revenue will grow in line with tax bases, which mainly depend on the macroeconomic environment. Similar assumptions are made for less discretionary expenditure items. This is the case of unemployment benefits (which mainly depend on how unemployment evolves) and interest payments (which are determined by changes in government debt levels and interest rates).

In accordance with these assumptions and projections for the budgetary policy variables, and bearing in mind the output gap estimated in this projection exercise, the budgetary policy stance in Spain would be expansionary in 2019, before turning neutral in the following three years.[2]

1 On 15 October, in accordance with the European Semester schedule, the government sent the draft budgetary plan for 2020 to the European Commission. This plan is based on the assumption of no new measures, with two exceptions: the increase in public sector wages for 2020 that was agreed with the unions in 2018 is maintained, and pension indexation to the CPI is introduced.

2 Measuring structural balances in the recent period is hampered by the effect of certain one-off measures affecting 2018 and 2019. These include, in particular, those linked to the cost of the insolvent motorway companies, to the asset protection schemes and deferred tax assets of the banking sector, and to the court ruling stipulating that maternity and paternity benefits are exempt from personal income tax. These measures would be equivalent to 0.4% of GDP in 2018 and to 0.3% of GDP in 2019.