MACROECONOMIC PROJECTIONS FOR THE SPANISH ECONOMY (2018-2020): THE BANCO DE ESPAÑA'S CONTRIBUTION TO THE EUROSYSTEM'S JUNE 2018 JOINT FORECASTING EXERCISE

Introduction and summary

This note describes the macroeconomic projections for the Spanish economy for the period 2018-2020, which are part of the projections for the euro area as a whole published by the ECB on 14 June.[1] The current projections for Spain incorporate the new information that has become available since the publication of the previous projections on 20 March in *Economic Bulletin 1/2018.*[2]

In the most recent period the expansionary inertia of the Spanish economy has continued. In Q1, GDP grew, as in the two previous quarters, at a quarter-on-quarter rate of 0.7%. This is in contrast to the related rate in the euro area as a whole, where output slowed in 2018 Q1 to 0.4%, after having increased, as in Spain's case, by 0.7% in each of the last two quarters of 2017.

This comparison underscores the resilience of the Spanish economy in the face of factors such as the slowdown in the main developed economies and the exchange rate appreciation observed since early 2017. The current outlook suggests an extension of the present growth phase, against the backdrop of the continuing accommodative monetary policy stance, the strengthening of private agents' financial position and the prolongation of the favourable trajectory of the global economy. A new element to be added to these factors – which were already in place – is the somewhat more expansionary fiscal policy stance discernible in the draft State and Social Security Budget (SSSB) for 2018.[3]

Set against this prolongation of the recovery phase, it is nonetheless forecast that GDP growth will tend to ease gradually over the course of the projection period. That would be a consequence, among other factors, of the recent rise in oil prices, from the degree of diminished momentum in foreign markets and from a gradual easing in the expansionary effects of the monetary policy measures adopted in recent years. As a result, after posting growth of 3.1% in 2017, GDP is expected to ease to 2.7% in 2018, 2.4% in 2019 and 2.1% in 2020.

In the short term, consumer price dynamics will be greatly influenced by the expected course of the energy goods component, as a result of the recent strong rise in oil prices. As from the end of the year, a gradual reduction in the contribution of the energy component to the overall indicator is projected, owing both to the base effects derived from the increase in oil prices observed a year earlier and to the declining profile of oil prices implicit in futures market prices. These developments will tend to be progressively offset by the gradual strengthening of the core component, in step with the foreseeable widening of the positive gap between actual and potential output. As a result of the opposite-running trajectories of the energy and core components, the overall indicator will ease from 1.9% in 2018 to 1.7% and 1.6%, respectively, in the two following years.

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1 See Eurosystem staff macroeconomic projections for the euro area, June 2018.

2 Specifically, compared with the Macroeconomic Projections for the Spanish Economy (2018-2020), published in Box 1 of the "Quarterly Report on the Spanish Economy" in *Economic Bulletin,* 1/2018, the current projections incorporate the changes observed from 9 March to 22 May in the technical assumptions, in the budgetary assumptions and in the projections for the Spanish economy's external setting. Moreover, the present forecasting exercise includes the QNA data from Q1 and all the data available to 31 May, the cut-off date.

3 The budgetary policy assumptions included in this macroeconomic projections exercise envisage the adoption of the draft SSSB in its version as of 23 May approved by Parliament and subsequently submitted to the Senate. Insofar as the passage through Parliament of this draft legislation has not concluded as of the projections cut-off date, the fiscal policy details applied in 2018 might differ from those considered in the baseline scenario. For further details about the fiscal assumptions, see Box 1.

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

Annual rate of change in volume terms and % of GDP

		June 2018 projection			Changes from March 2018 projection		
	2017	2018	2019	2020	2018	2019	2020
GDP	3.1	2.7	2.4	2.1	0.0	0.1	0.0
Private consumption	2.4	2.4	1.8	1.6	0.3	0.2	0.0
Government consumption	1.6	1.5	1.3	1.2	0.1	0.1	0.0
Gross fixed capital formation	5.0	4.2	4.2	4.0	0.0	0.1	0.1
Investment in capital goods	6.1	2.5	4.2	3.9	-2.5	0.1	0.2
Investment in construction	4.6	5.7	4.5	4.3	1.7	0.1	0.0
Exports of goods and services	5.0	4.6	4.8	4.5	-0.3	0.0	0.0
Imports of goods and services	4.7	4.5	4.6	4.4	0.2	0.1	0.1
National demand (contribution to growth)	2.8	2.5	2.2	2.0	0.1	0.1	0.1
Net external demand (contribution to growth)	0.3	0.2	0.2	0.1	-0.2	0.0	-0.1
Nominal GDP	4.0	4.2	4.1	4.0	0.3	0.3	0.2
GDP deflator	1.0	1.4	1.7	1.9	0.3	0.2	0.2
Consumer price index (CPI)	2.0	1.9	1.7	1.6	0.6	0.4	0.0
CPI excl. energy and unprocessed food prices	1.1	1.3	1.7	2.0	0.1	0.1	0.0
Employment (full-time equivalent)	2.8	2.4	2.0	1.9	-0.3	0.0	-0.1
Unemployment rate (% of labour force). Data at end of period	16.5	14.6	12.9	11.4	0.3	0.3	0.3
Unemployment rate (% of labour force). Average data	17.2	15.2	13.4	11.8	0.1	0.1	0.2
Net lending (+)/ net borrowing (-) of the nation (% of GDP)	2.0	1.6	1.6	1.5	-0.2	-0.2	-0.2
General goverment net lending (+)/ net borrowing (-) (% of GDP)	-3.1	-2.7	-2.3	-2.0	-0.3	-0.3	-0.3

SOURCES: Banco de España and National Statistics Institute (INE).
Latest QNA figure: 2018 Q1.

a Projection cut-off date: 31 May 2018.

Compared with the March projections, the GDP growth path will be practically unchanged. Among the factors that would prompt a downward revision are the higher levels of oil prices, throughout the projection horizon, and the somewhat more unfavourable performance of the euro area’s export markets, in the short term. It is estimated that these adverse effects will be countered by the impact of the budgetary measures included in the SSSB for 2018 and, to a lesser extent, by the slightly lower exchange rate of the euro. The bulk of the effects of the budgetary measures will materialise as from their hypothetical enactment, in Q3 this year, and will continue to be rolled out in the subsequent quarters. Overall, joint consideration of the impact of these changes on the assumptions gives rise to a 0.1 pp upward revision in GDP growth in 2019, while the projections for this variable will remain unchanged in 2018 and 2020, compared with the projections three months earlier. The inflation projections are revised upwards in 2018 and 2019 (by 0.6 pp and 0.4 pp, respectively), which is chiefly attributable to the new projected trajectory of oil prices.

Activity and employment

As has been the case since 2014, output growth throughout the projection horizon will continue to be underpinned by the buoyancy of private national demand, which will be assisted by the headway made in ongoing household and corporate deleveraging and by continuing easy financial conditions. Net external demand will also contribute to the expansion of output, although this contribution is forecast to be relatively modest.

Among the various national demand components, household expenditure on consumer goods and services will continue to be spurred by the continuation of the employment creation process, the persistence of favourable financial conditions and the improvement observed in these agents' financial position. Compared with March, the current projections envisage an upward revision in this demand component as a result of the inclusion of the aforementioned budgetary measures. Given their nature, the actions adopted will contribute to boosting the revenue of the lowest-income households, which are those whose propensity to consume is higher, meaning that the additional income will tend to feed through to spending on goods and services in a relatively higher proportion.[4]

In any event, as in March, a gradual easing in this demand component is expected throughout the projection period, as a result of various factors. First, although household labour income will increase in a sustained fashion in real terms throughout the projection period, this will increasingly rest on quickening real wages, set against the slowdown in employment. These developments will tend to dampen the dynamism of consumption, since the empirical evidence shows that the propensity to consume is less when the increase in labour income stems from a rise in real wages than when its origin lies in job creation.[5] Second, the strength of household spending will be diminished by the tendency of household agents to rebuild their saving rate following the heavy decline in recent years, which led this rate in late 2017 to its lowest level since the introduction of the euro. Finally, private consumption growth will also be dented by the gradual tailing off of the durable goods expenditure decisions that have materialised during the current recovery phase and that had been postponed during the last recessionary period.[6]

Among the components of gross fixed capital formation, the pick-up in residential investment will continue throughout the projection period, assisted, among other factors, by the sustained increase in employment and the availability of low-cost financing. However, the pace of this demand component will be tempered in the medium term by the contained rate of new household formation discernible in demographic trends. Business investment will remain substantially dynamic in the medium term, in a setting in which rising capacity utilisation, expectations of expanding activity and higher profits, the restructuring of business balance sheets and the persistence of favourable financing conditions will all support this demand component. Nonetheless, its rate of increase over the entire projection horizon will be lower than that observed in recent years, in step with the projected slowdown in final demand. Moreover, the negative surprise recorded in 2018 Q1 has prompted a downward revision for the year as a whole.

In 2017 Spanish exports grew, for the first time since the onset of the recovery, at the same rate as their end-markets, set against the gains in share observed until then, which probably reflects the effects of the appreciation of the euro witnessed during the year. In the projection period a gradual slowdown in export markets is expected (see Box 1). However, the projections for Spanish exports envisage a less marked easing in their growth rate, as the adverse impact of the past appreciation of the euro on sales outside the euro area progressively tails off. Similarly, as regards imports, it is assumed that the rise in implicit elasticity with respect to final demand observed in 2017 will reverse over the period considered, once the effects of the appreciation of the euro fade.

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4 See Box 1 for a detailed description of the measures.

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

6 See Box 4 in the "Quarterly Report on the Spanish Economy" in *Economic Bulletin* 4/2017.

As is habitually the case in upturns in the Spanish economy, apparent labour productivity will continue to post a low rate of increase in the coming years. Accordingly, employment will continue to evidence robust growth, albeit lower than in the past three years, in step with the expected slowdown in activity. Along with the modest fall projected in the labour force, sustained job generation will provide for further declines in the unemployment rate, which is expected to stand at somewhat over 11% at end-2020.

The projections envisage a decline of several tenths of a percentage point in the nation's lending capacity from the figure of 2% of GDP posted both in 2016 and in 2017, as a result of dearer oil prices and of the expected modest rise in interest rates, which would respectively cause the energy deficit and net factor income payments to rise.

The introduction of the new budgetary policy assumptions translates into a less acute decline in the public finances shortfall over the projection horizon compared with the baseline scenario envisaged in March. The fall in the general government deficit, in terms of GDP, will essentially arise from the prolongation of the cyclical upturn, while the structural balance is expected to worsen, as a result of the expansionary fiscal policy stance, especially in the first two years of the projection horizon.

Prices and costs

Turning to consumer prices, the CPI is expected to quicken in the coming months as a result of the recent rise in oil prices. As from autumn, the contribution of the energy component to CPI growth is projected to begin to diminish, owing initially to the negative base effects arising from the comparison of the course of oil prices with that of the same period in the previous year and, subsequently, to the negative slope of oil prices on the futures market. These developments will, however, be largely offset by the gradual rise in the core component, in step with the increase in the use of productive factors associated with the prolongation of the expansionary phase. From the standpoint of costs, the wage rises associated with the reduction in cyclical slack in the labour market will lead to an acceleration in unit labour costs. The CPI excluding fresh food and energy prices is thereby expected to evidence a growing profile throughout the projection horizon, quickening from 1.3% in 2018 to around 2% in 2020. Conversely, the rate of change of the overall indicator will continue on a moderately declining path, dominated by the increasingly lower rates of change of the energy component. As a result, in annual average terms, consumer prices are expected to slow from 1.9% in 2018 to 1.7% in 2019 and 1.6% in 2020.

Risks

The risks to the baseline scenario of the projections for GDP growth are tilted predominantly to the downside. On the external front, the uncertainty associated with the ongoing normalisation of monetary policies, in particular in the United States, and the resurgence of geopolitical tensions might entail potential future bouts of volatility on the financial markets, as occurred in early February. Moreover, a potential escalation in the adoption of protectionist measures might affect the buoyancy of trade and of activity at the global level and adversely impact the Spanish economy, whose exports have been an essential support to growth throughout the recovery. In addition, the projections for activity in the euro area rest on the premise that the recent loss of momentum is essentially temporary in nature. However, this weakness could be partly due to more persistent factors. Finally, the uncertainty over the economic policy decisions the new Italian government may adopt might give rise to further bouts of tension on euro area financial markets.

In the domestic arena, the current parliamentary fragmentation may hinder the budgetary consolidation process – which, as earlier mentioned, has been slowed by the SSSB for 2018 – and the adoption of reforms to boost growth potential. The lack of progress on both fronts may entail adverse effects for agents' confidence. Moreover, a hypothetical rise in uncertainty over the political situation in Catalonia cannot be ruled out.

As regards inflation, the risks of deviation from the baseline scenario are likewise tilted moderately to the downside. This is as a result of a hypothetical materialisation of several of the risks to activity described above, and of the possibility that the reduction in the degree of cyclical slack may not translate into as sharp a rise in core inflation as projected, against a background in which heightened uncertainty persists over the volume of idle resources in the economy and the responsiveness of prices to developments in activity.

15.6.2018.

The assumptions on interest rates and the prices of oil and other commodities are based on the prices quoted on the relevant markets over the ten business days prior to the date on which the data used to calculate them are collected (in this case, 22 May). Specifically, the price per barrel of oil is expected to rise to an average of $74.5 in 2018 (almost 40% higher than the 2017 average). In the following two years, oil is expected to move on a moderately downward path to $68.7 per barrel in 2020. Compared with the previous projections, in March, the new oil-price assumptions translate into a significant upward revision of the level of this variable, by as much as an annual average of 17.5 pp over 2018-2020.

In accordance with the procedure described above, the expected levels of long-term interest rates over the projection horizon remain unchanged from the March exercise, whereas there is a slight downward revision at the short end of the curve. Thus, the expected level of the three-month EURIBOR is now around 10 basis points (bp) lower in 2019, with this revision increasing to almost 20 bp in 2020. By contrast, ten-year government bond yields continue to follow an upward path, rising from an average of 1.6% in 2017 to 2.2% in 2020. The expected revision of short-term interest rates will lead to a slight drop in the cost of borrowing for households and businesses relative to the levels in previous projections, as loan contracts with these agents envisage floating interest rates that are usually referenced to short-term rates.

The nominal effective exchange rate of the euro over the projection horizon, which, on the methodology used, is that observed on spot foreign currency markets in the two weeks prior to the cut-off date for the assumptions, shows a slight depreciation – approximately 2.5% – with respect to the level of the previous projections. This depreciation is somewhat larger in the case of the exchange rate of the euro against the dollar, at close to 4%.

The growth of Spain's export markets has been revised downwards in 2018, reflecting less dynamism than expected in the euro area at the start of the year. There has been a slight upward revision over the remainder of the projection horizon. Despite these changes, a slight loss of momentum by external markets continues to be forecast over the course of the projection horizon, with the rate of increase being expected to slow from 4.4% from 2018 to 3.7% in 2020.

Compared with the March projections, the most significant changes in the assumptions underlying the projections concern budgetary policy. In this area, the range of measures included in the draft budget for the current year have been factored in, as have some elements of the medium-term scenario of the 2018-2021 Stability Programme Update for the Kingdom of Spain sent by the government to the European Commission at the end of April. Among the key measures are a number of updates to pensions (in particular, delaying the entry into force of the sustainability factor until 2023, and an across-the-board pension

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

Annual rates of change, unless otherwise indicated

		June 2018 projections			Difference between the current projections and those made in March 2018 (b)		
	2017	2018	2019	2020	2018	2019	2020
International environment							
World output	3.6	3.8	3.6	3.5	-0.1	-0.1	0.0
Spain's export markets	5.0	4.4	4.3	3.7	-0.6	0.1	0.1
Oil price in US dollars (level)	54.4	74.5	73.5	68.7	10.1	12.5	9.6
Monetary and financial conditions							
US dollar/euro exchange rate (level)	1.13	1.20	1.18	1.18	-0.03	-0.05	-0.05
Nominal effective exchange rate against the non-euro area (c) (2000 = 100 and percentage differences)	117.0	122.8	121.8	121.8	-1.8	-2.6	-2.6
Short-term interest rate (3-month EURIBOR) (d)	-0.3	-0.3	-0.2	0.2	0.0	-0.1	-0.2
Long-term interest rate (10-year bond yield) (d)	1.6	1.5	1.9	2.2	0.0	0.0	0.0

SOURCES: ECB and Banco de España.

a Assumptions cut-off date: 22 May 2018. The figures expressed as levels are annual averages; the figures expressed as rates are calculated based on the relevant annual averages.
b Differences are between rates in the case of world output and export markets, between levels in the case of oil prices and the dollar/euro exchange rate, percentage differences for the effective nominal exchange rate, and percentage point differences in the case of 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.

revaluation of 1.6% this year and next), the budget's reflecting the public-sector wage agreement for 2018-2020 reached in the first quarter between the government and the main trade unions (largely factored into the Banco de España's March projections[1]), or certain regulatory amendments to income tax (such as lowering the threshold above which taxpayers on lower incomes are required to file a return, and introducing new deductions for families). The budget and the Stability Programme Update also incorporate the buoyancy of government investment in 2018,[2] in line with that in the previous year, and the continuing moderation of goods and services purchases. However, it is worth noting, that, in any event, these assumptions are subject to a certain degree of uncertainty, as the 2018 budget had not been passed on the cut-off date for the information used in these projections.

Moreover, as in the March projections, various technical assumptions have been made in order to project some elements of the expected paths of the various fiscal policy variables. First, it is assumed that, as of 2019, the more discretionary budget items –particularly public investment and spending, given their size– will generally evolve in line with the nominal potential growth of the Spanish economy. Second, in the absence of additional measures, the trajectory of the remaining items of the general government accounts are assumed to be governed by their usual determinants.[3] The projections also take into account recent trends in the budget outturn data over the near horizon of the current year.

Based on these assumptions in conjunction with the projections for to fiscal policy variables and with the output gap estimated in a manner consistent with the other macroeconomic projections, the fiscal policy stance is expected to become more strongly expansionary, with a worsening of the general government primary structural balance of 0.5 pp, 0.6 pp and 0.1 pp of GDP in 2018, 2019 and 2020, respectively (0.2 pp, 0.4 pp and 0.1 pp in the previous forecasts), compared with the more neutral stance estimated for 2017.

1 See Box 1 in the "Quarterly Report on the Spanish Economy", *Economic Bulletin*, 1/2018.

2 The forecasts also include costs associated with the financial liability deriving from legal proceedings over toll motorways currently under administration, which the government estimates at approximately €1.8 billion.

3 Specifically, it is assumed that government revenue will grow in line with tax bases, which mainly depend on the macroeconomic context. Similar assumptions are made for less discretionary expenditure items. This is the case of pension expenditure (which varies according to the revaluation formula established in the legislation and population ageing, as well as the increments envisaged in the budget), unemployment benefits (which depend mainly on how unemployment evolves) and interest payments (which are determined by changes in debt levels and interest rates).