

Summary

The projections report of the Banco de España's Directorate General for Economics, Statistics and Research is the basic document of the information that the Bank sends to the Ministry for Economic Affairs and Competitiveness on the cyclical position of the economy pursuant to the Law on Budgetary Stability and Financial Sustainability.¹ In previous years this report was the only occasion on which the Bank published a full range of macroeconomic projections (with a two-year time horizon). However, in line with recent developments in relation to the publication of macroeconomic projections by official bodies and central banks, the Banco de España has decided to publish a regular update of these projections in future editions of the quarterly report on the Spanish economy, starting in April.

This report describes the current situation of the Spanish economy and the outlook for 2014 and 2015, on the basis of the information available as at 14 March 2014.

The financial tensions that have been afflicting the Spanish economy with varying intensity since the beginning of the crisis have gradually eased over the past year. This normalisation of aggregate financial conditions has been most apparent in the significant narrowing of sovereign spreads over the German *bund*, from around 360 basis points (bp) at the beginning of 2013 to around 180 bp as at the cut-off date for this report. The fall in the cost of financing has also been perceived, albeit generally less strongly, in other resident sectors (especially financial institutions), and the net flow of external financing has turned positive again.

Along with the moderation in the intensity of the budgetary adjustment and the progress made in correcting macroeconomic imbalances, the easing of financial tensions and the consequent reduction in uncertainty allowed activity to improve gradually over the course of 2013. In Q3 the Spanish economy emerged from the recession that had begun in spring 2011, and, in the final quarter, net job creation was recorded for the first time since 2008. However, the carryover effect of the sharp decline in output in the final quarter of the previous year meant that 2013 ended with a fall in GDP of 1.2% and a decline in employment of 3.4%.

In 2014 and 2015 the incipient recovery in activity is expected to firm, with growth rates of over 1% and a pattern of demand similar to that seen in the final quarter of 2013, when domestic demand, boosted by the improvement in confidence and some further easing of financial conditions, gradually took over from external demand as the main engine of growth. However, the recovery in domestic demand will take place at a more moderate pace than in previous recoveries, given the magnitude of the effects of the crisis on the real and financial position of many agents and sectors. In particular, household consumption is expected to be positive in the projection period, buoyed by the improvement in the labour market, although spending growth will remain muted.

The low level of housing starts in recent periods points to a continuation of the decline in residential investment. However, the rate of decline is projected to slow, and to reach a turning point towards the end of the projection horizon. Private productive investment is

¹ Article 15.1 of this Law provides that the government must in the first half of each year set budgetary stability and debt targets for the following three years, while Article 15.5 states that the proposed targets must be accompanied by a report of the Ministry of Economic Affairs and Competitiveness evaluating the economic situation foreseen over this horizon, prepared after consulting the Banco de España, and taking into account the forecasts of the European Central Bank and the European Commission.

projected to strengthen in the coming quarters, driven by the buoyancy of the export sector and by the need of many firms to replace capital. Finally, it is assumed that the rate of adjustment of general government consumption and investment expenditure will slow slightly in 2014, relative to 2013, and accelerate again in 2015.

According to projections for the global economy, the slowdown in Spanish export markets at the end of 2013 will prove to be temporary, with a gradual improvement that will firm over the projection horizon. As in previous years, further gains in competitiveness are expected, which will allow Spanish exports to grow at somewhat higher rates than the markets themselves. As a result, exports are projected to grow at somewhat higher annual average rates than in 2013. The growth rate of imports is also expected to increase, not only as a consequence of the gradual strengthening of final demand, but also its composition, since the weight of business investment and exports, which are highly intensive in their use of imported goods and services, is projected to increase. As a result of the projected trade flows, the contribution of the net external balance to output growth will fall significantly, although it will remain positive.

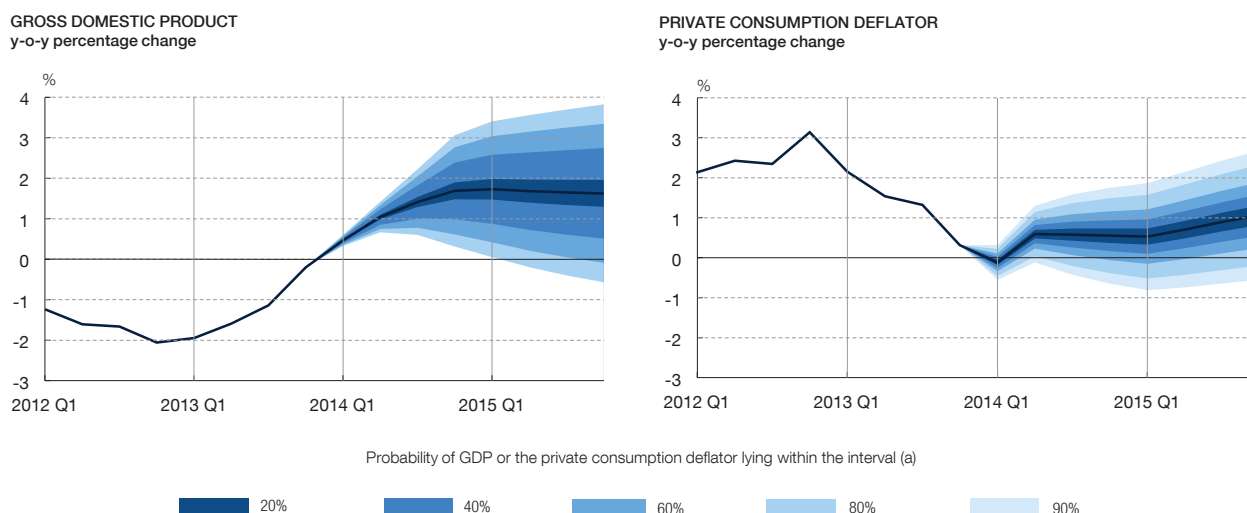
Among other factors, the wage moderation recorded in the latest period and the general increase in labour market flexibility arising from the reform approved in 2012 have speeded up the process of net job creation, despite the fact that the recovery in activity remains weak. During the projection period output growth is expected to become more labour intensive. The resulting slowdown in apparent labour productivity will not halt the downward path of unit labour costs, given the expected continuation of wage moderation.

Inflation, as measured by the private consumption deflator, is expected to remain at very modest positive levels, albeit increasing slightly over the projection horizon, given the subdued recovery in private consumption and the slowdown in the decline in the cost of labour. The high degree of slack in the economy means that the rise in consumption cannot be expected to put much pressure on prices.

The improvement in the external balance is expected to continue over the next two years, allowing the economy's net lending to increase to 2.1% of GDP in 2014 and 2.5% in 2015. This will enable modest progress to be made in reducing the level of external debt, but it will remain very high. By sector, the improvement in net lending will basically stem from correction of the budget deficit, according to the projections derived from the assumptions contained in the third section of this report. The net lending of households and non-financial corporations will be relatively high, in line with the levels observed in 2013. In the case of corporations this lending position will help to underpin investment.

For the reasons given above, the projections made in this report are surrounded by somewhat less uncertainty than in previous years. However, the Spanish economy is still undergoing adjustment, and the completion of this process is subject to difficulties and risks. One way of approximating the uncertainty surrounding these projections is by means of confidence intervals for the deviations from the central scenario, which can be expected with different probabilities, based on the forecast errors made in the past. These ranges are summarised in Chart 1.

In the current projections exercise the risks of GDP deviation from the central scenario are considered to be skewed towards the side of lower activity growth, as a result of the possibility of a more pronounced slowdown in the emerging economies than is anticipated in the central scenario and of a more intense fiscal adjustment, especially in 2015, than the



SOURCES: INE and Banco de España.
Latest data: 2013 Q4.

a The chart shows the uncertainty surrounding the central projection. The intervals have probabilities of 20%, 40%, 60%, 80% and 90%, respectively, based on past forecasting errors.

one implicit in the projections of this report and, therefore, more consistent with the budget deficit reduction targets formulated. On the upside, it is possible that the pace and future scope of the processes that have enabled the Spanish economy to resume positive growth in recent quarters, in particular those relating to the recovery in employment and the normalisation of financial conditions, are being underestimated. In both cases these are key elements for improving agents' confidence. Also, the impact of the recent reforms to the functioning of some goods and services markets and the labour market, which is currently difficult to quantify, may lead to a more favourable path for activity and employment than envisaged in this report.

As regards inflation, the risks are considered to be slightly skewed to the downside over the projection horizon. In particular, the rise in the private consumption deflator projected as a consequence of the greater dynamism of household spending may not fully materialise given the high degree of slack in the economy. Also, a possible slowdown in some of the emerging economies that account for much of the demand for commodities and energy, along with a larger than anticipated appreciation of the euro, may lead to greater moderation in the cost of these inputs, with a negative impact on domestic prices. By contrast, possible adjustments to the fiscal consolidation path involving changes in indirect taxes or in certain regulated prices would lead to price increases.

The next two sections describe, in turn, the external and the fiscal assumptions underlying the projections. Later, the macroeconomic projections for the Spanish economy, whose main features are described in this summary, are developed in greater detail. The report concludes with a discussion of the main risks surrounding the central scenario. In addition, there is a box analysing the revisions made to macroeconomic projections and the role played by changes in the assumptions on which they are based.

The external assumptions underlying the projections

The projections in this report are based on specific assumptions regarding the behaviour of a number of exogenous variables over the projection horizon (see Table 1). The procedure used to formulate these assumptions is the same as the one used by experts at the ECB

Macroeconomic projections are usually subject to revisions of varying intensity, depending on the lag between the time when they are formulated and the availability of the definitive figures, and on the scale of the changes that might arise in the macrofinancial environment during this period. One means of evaluating these revisions is to calculate forecasting errors, defined as the difference between the actual figure for a variable and the forecast previously made.

Panel 1 presents the forecasting errors for the rate of change of GDP for the current year and following year in the Banco de España projection reports, alongside those published at similar points in time by the International Monetary Fund (IMF) and the European Commission (EC). Broadly, the size of the errors can be seen to be similar across the different institutions.

Furthermore, forecasts with a shorter lag are more accurate, given that the prevailing uncertainty is lower. As can be seen in Panel 2, which shows the GDP growth projections for the Spanish economy for the years 2009 to 2014 by each of the above institutions at each point in time, the projections tend to be revised in the same direction by all analysts once they have processed the new information available. Consequently, institutions' forecasting errors can only be compared appropriately if the exact time at which each projection was formulated is taken into account.

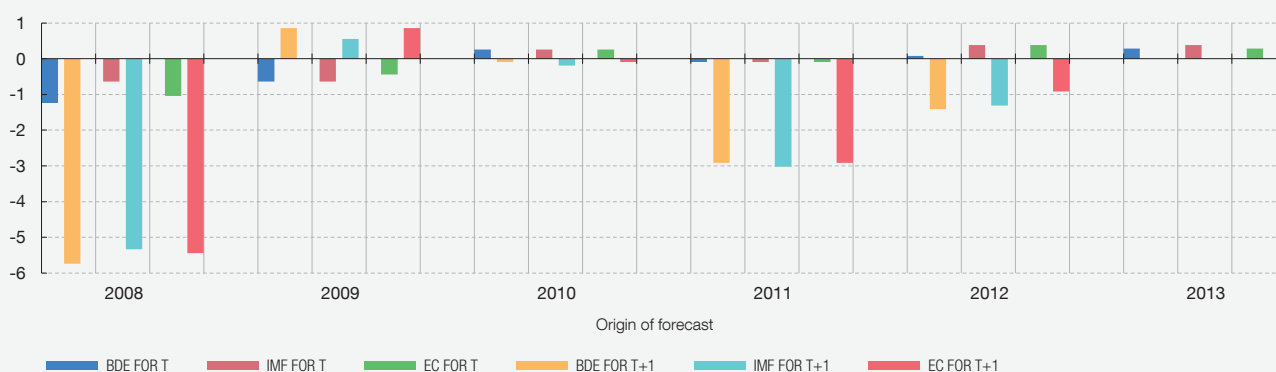
Taking a broader time perspective, another key point is that there has been a widespread deterioration in predictive power during the crisis at all the institutions analysed, associated with a significant increase in uncertainty over this period. As regards the Banco de España projections, for instance, mean absolute errors in GDP forecasting in the 2008-13 period are more than double those observed in the 1999-2007 period, which has also given rise to a widening of the confidence intervals used to measure the uncertainty surrounding the central projection.

It is also worth identifying the factors underlying the forecasting errors. In this respect, given that the projections rest on a set of assumptions relating to certain exogenous variables over the course of the forecasting horizon, an initial approximation involves determining which part of the errors is attributable to deviations in those assumptions. The results of an exercise of this nature, using the Banco de España Quarterly Macroeconometric Model (MTBE), are presented below for the projections of the Banco de España in the period 2009-13. Specifically, Panel 3 gives a breakdown of these projection errors, using the model's estimated coefficients of the sensitivity of GDP to changes in each exogenous variable. It is broadly seen that deviations in the exogenous assumptions relating to the growth of world markets, oil prices, interest rates, credit supply, stock market and house prices, population growth and the assumptions about the behaviour of fiscal policy enable practically all the mean absolute forecasting error for two-year projections to be explained.

Of all these exogenous factors, that relating to the behaviour of global demand has been especially relevant since the international economic and financial crisis broke, as there have been sharp changes in the global macroeconomic outlook. The assumptions on fiscal policy behaviour have also played a very important role, particularly in recent years with the unprecedented fiscal consolidation and the changes in budgetary plans in the course of a single year. Specifically, the differences between the assumptions on world demand and actual outcomes account for close to 43%, on average, of the errors observed in the period analysed. In turn, the discrepancy between the fiscal assumptions of the projections (which basically affect the budgetary measures included in the forecast) and the budgetary policy finally implemented explains around 24%, on average, of the projection errors in the period under analysis.

To understand properly the effect of the fiscal assumptions on the macroeconomic projections, it should be borne in mind that the

1 ONE- AND TWO-YEAR-AHEAD FORECASTING ERRORS (a)



SOURCES: Banco de España (BDE), International Monetary Fund (IMF) and European Commission (EC).

a. The forecasting errors for T and T+1 are the difference between actual GDP growth and each institution's forecast in the current year and in the year following the origin of the forecast, respectively.

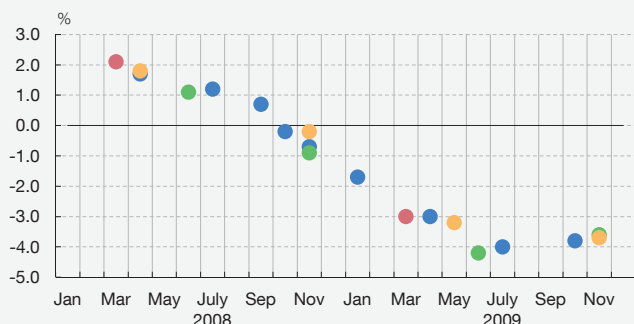
latter are usually made under the assumption of no change in fiscal policy over the forecasting horizon, meaning that only the fiscal measures already approved are incorporated into the projections. However, in the recent period of fiscal consolidation a more flexible definition of this assumption has generally been adopted, such that not only the fiscal measures already approved are included but also those that are considered highly likely to be implemented as they have been announced in a sufficient degree of detail. The advantage

of this more flexible approach is that it significantly reduces the discrepancies between the initial fiscal assumptions and the fiscal policy finally adopted; however, it does not remove discrepancies completely, in particular for more distant forecasting horizons, for which budgetary plans are normally defined in less detail.

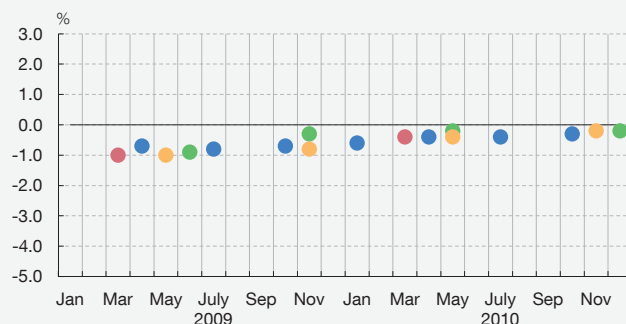
The macroeconomic projections presented in this report for 2014 and 2015 have been formulated according to the latter criterion

2 GDP GROWTH FORECASTS BY SELECTED INSTITUTIONS (a)

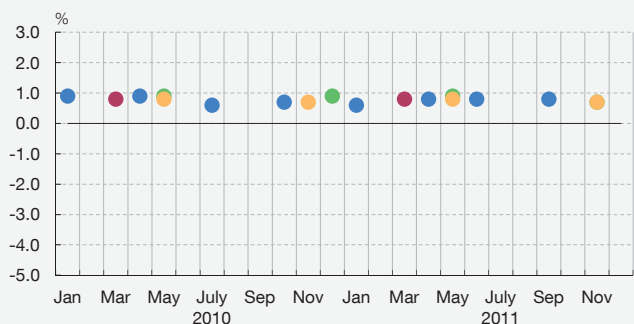
GDP 2009



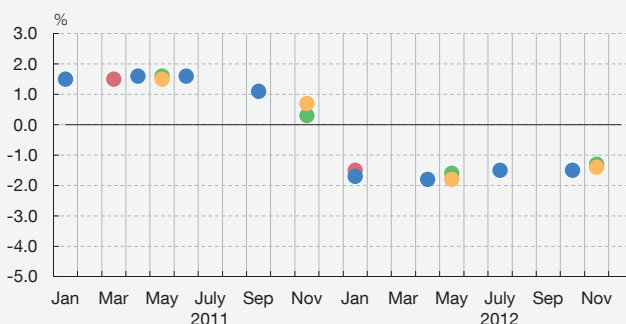
GDP 2010



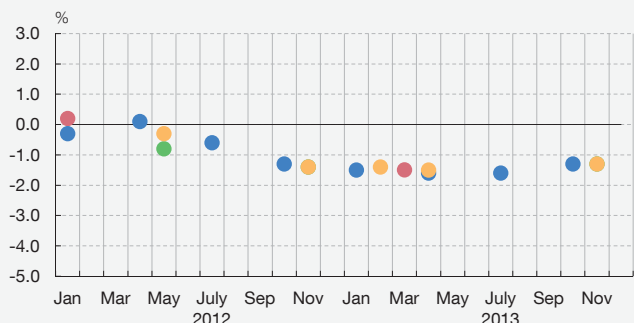
GDP 2011



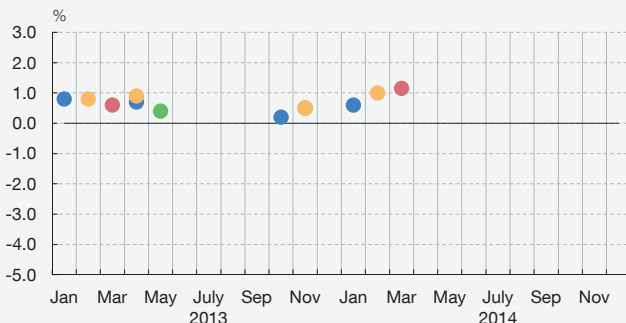
GDP 2012



GDP 2013



GDP 2014



● BANCO DE ESPAÑA ● IMF ● OECD ● EC

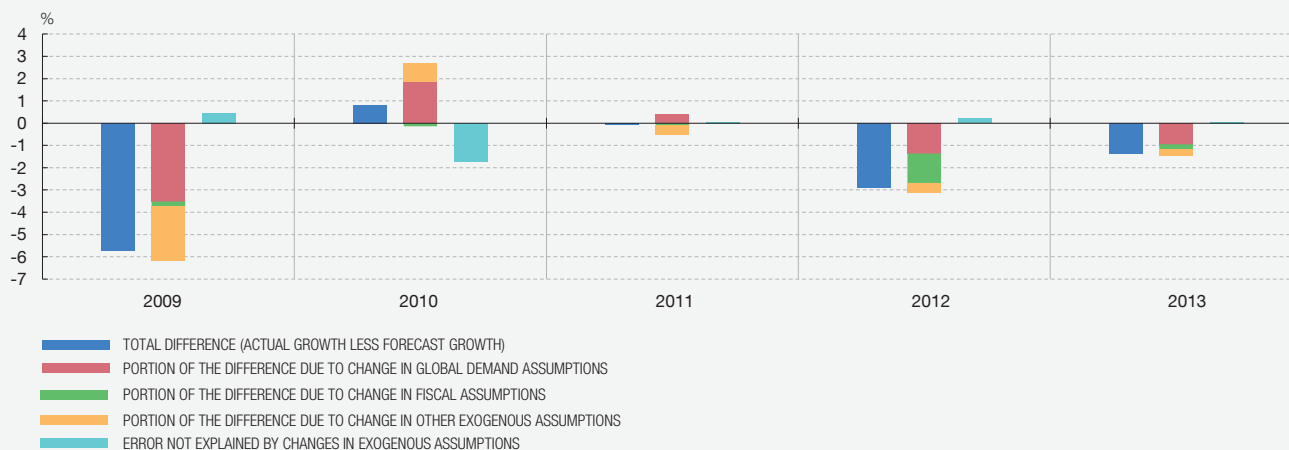
SOURCES: Banco de España, IMF, OECD and European Commission.

a The x-axis indicates the time at which each forecast was formulated.

(see main body of the text). It cannot be ruled out, therefore, that once all the budgetary adjustment measures for this year are known, with a more restrictive content than that included in this

projection exercise, the rise in GDP will be lower in 2015 than envisaged in this exercise, of an order that is difficult to accurately quantify.

3 CONTRIBUTIONS OF THE CHANGES IN ASSUMPTIONS TO TWO-YEAR-AHEAD GDP FORECASTING ERRORS



SOURCES: Banco de España, IMF and European Commission.

and the Eurosystem national central banks in the quarterly macroeconomic projections exercises. In the case of the euro exchange rate, Spanish share prices, oil prices and three-month and 10-year interest rates, the assumptions are based on the developments in the relevant markets over the 10 business days immediately preceding the cut-off date for the information used in this report.² The exchange rate is assumed to hold throughout the projection period at the average level observed on the spot market, that is to say at USD 1.38 per euro, on average, in both 2014 and 2015, which is 3.9% higher than its average level in 2013. The assumptions for the US-dollar oil price are based on futures market prices, with falls of 1.5% in 2014 and 3.9% in 2015. Three-month Euribor interest rates, based on the expectations implicit in futures markets, are assumed to remain at very low levels, albeit somewhat above those in 2013. Specifically, this reference rate is assumed to rise by 10 basis points in 2014, to 0.3%, and by a further 10 basis points in 2015. Ten-year government bond yields, based on the expectations implicit in the yield curve, are assumed to stand on average in 2014 at 3.6%, a significant fall from 4.6% in 2013, and to rise in 2015 to 4%.

The assumptions made for these two reference interest rates serve as the basis for the projections of the cost of financing for households and firms. This cost is expected to remain little changed from current levels. Credit conditions, other than interest rates, are also expected to improve gradually over the projection period. Among the determinants of

² The cut-off date is 14 March 2014. Considering solely the average prices of transactions conducted on the markets on the cut-off date itself would have the drawback that the level of some of these variables might be disproportionately affected by large price movements on that particular day. As this drawback is considered potentially more important than the advantage to be gained from using the latest information on price formation, the assumptions are based on a ten-day period instead.

Annual rates of change, unless otherwise indicated

	2010	2011	2012	2013	Projection	
					2014	2015
International environment						
World output	5.2	3.9	3.1	2.8	3.6	3.7
Global markets	12.9	6.4	3.1	2.8	4.6	5.8
Spain's export markets	10.8	4.8	1.0	1.7	3.8	5.0
Oil price (in USD)	79.6	111.0	112.0	108.8	107.2	103.1
Competitors' export prices in euro	7.0	4.6	3.9	-2.1	-1.2	1.1
Monetary and financial conditions						
Dollar/euro exchange rate (USD per euro)	1.33	1.39	1.28	1.33	1.38	1.38
Short-term interest rate (3-month EURIBOR)	0.8	1.4	0.6	0.2	0.3	0.4
Long-term interest rate (10-year bond yield)	4.2	5.4	5.8	4.6	3.6	4.0

SOURCES: ECB and Banco de España.
Latest QNA data: 2013 Q4.

a Projections cut-off date: 14.3.2014.

household wealth, share prices are expected to fluctuate moderately, while it is assumed that house prices will continue their current trend of progressively smaller falls, stabilising towards the end of the projection horizon.

The assumptions for Spanish export markets are based on the recent macroeconomic projections for the euro area made by ECB experts published in the March edition of the ECB's *Monthly Bulletin*. In particular, the growth of these markets is expected to recover progressively, as a consequence of the more expansionary behaviour of the developed economies, following their modest buoyancy in 2013. Specifically, export markets are projected to grow by 3.8% in 2014 (2.1 pp more than in 2013) and by 5% in 2015.

Fiscal assumptions

After four years of budgetary consolidation, the fiscal adjustment still pending will continue to be one of the main factors shaping macroeconomic developments in the projection horizon of this report. Since 2009 the general government deficit has been reduced by 4.6 pp of GDP (excluding assistance to financial institutions). According to the budget targets approved at European level, the government deficit will be decreased further by nearly 2.5 pp in 2014-2015.

The exceptional nature of the fiscal consolidation process and its macroeconomic impact made it advisable for the treatment of fiscal policy measures in these projections to depart in certain respects from the usual practice of assuming fiscal policy to remain unchanged over the projection horizon. Under this assumption, only those fiscal measures that have already been approved are incorporated into the projections. As has been pointed out in the projections reports of the last three years, the automatic application of this assumption is not appropriate in situations of extraordinary fiscal adjustment, since it would introduce significant bias into the macroeconomic projections. To minimise this problem, in this report we have proceeded as follows. In the case of expenditure, the projections incorporate, in addition to the fiscal policy measures already approved, an estimate of the impact of official medium-term plans and the continuation of the trend adjustment of certain items. In the case of revenue, only the impact of measures already approved has been included.

Against this background, the fiscal assumptions which have served as a basis for the macroeconomic projections incorporate the 2014 Budget Plan measures, which were

subsequently validated by the State, Social Security System and regional government budgets for this year. Specifically, included on the expenditure side are a 0.25% rise in pensions, in line with application of the adjustment factor, the public sector wage freeze, the public sector employment plans, which will continue to limit government hiring, the restriction of government investment and the decrease in final consumption expenditure associated with the entry into force of the local government reform, particularly from 2015 onwards, in line with official estimates. Also assumed is a significant moderation in transfers and subsidies and a fall in spending on unemployment benefits due to the labour market dynamics.

On the revenue side, the main measures include the effects in 2014 and 2015 of the broadening of corporate income tax bases, the increase in maximum social security contribution bases, the recently approved decrease in social security contribution bases for permanent hires, and the actions envisaged in the entrepreneurs law. It is also assumed that the supplementary personal income tax levy, which presumably boosted tax revenue in 2012, 2013 and 2014, will expire in 2015 pursuant to current legislation, with an estimated negative impact on revenue in that year of around 0.5 pp of GDP.

As a result of all these assumptions, the general government deficit in 2014 is expected to be in line with the target set by the European Council last June (5.8% of GDP). For 2015, however, a lower reduction — of 0.3 pp of GDP — is assumed in the government deficit, taking it to 5.5% in this projection exercise. This assumption reflects the fact that the measures for 2015 have yet to be specified, and this figure should be reduced once all the budgetary adjustment plans for the year are known. They will be published in the Stability Programme Update on 30 April and/or in the budgets of the various sub-sectors of general government, which will be known in autumn.

Outlook for the Spanish economy

After the incipient recovery in activity from the second half of 2013, the Spanish economy is expected to continue making headway throughout this year. Specifically, under the set of assumptions described above, GDP growth of 1.2% in 2014 is projected (see Table 2). This rate will be the first positive one, in annual average terms, since the 0.1% of 2011, and the highest since 2007.

The projected improvement in the macroeconomic environment is based on various factors, including most notably a lower level of aggregate uncertainty, the recent improvement in the behaviour of employment and a gradual easing of financial conditions. These developments have been accompanied by a return to normal of the Spanish economy's access to foreign financing. Over the projection period a strengthening of the external environment and a certain additional improvement in financial conditions are expected, which, in particular, should be gradually reflected in less strict credit conditions. If this trend continues, activity and employment will continue to recover, although the recovery cannot be expected to be vigorous or risk-free in these initial phases, given that the adjustment processes under way (deleveraging and budgetary consolidation) will continue to have a dampening effect on activity.

As regards the composition of output growth, the trend in 2013 Q2 of the weight of domestic demand growing at the expense of that of net external demand is expected to firm in the projection period (see Chart 2). Specifically, domestic demand is projected to grow by 0.3% in 2014, its first positive rate since 2007. Meanwhile, the contribution to output growth made by net external demand is projected to be 0.8 pp. In 2015 these trends will continue, with domestic demand accelerating to a rate of 1% and the

PROJECTION OF THE MAIN MACROECONOMIC AGGREGATES OF THE SPANISH ECONOMY (a)

TABLE 2

Annual rate of change in volume terms and % of GDP

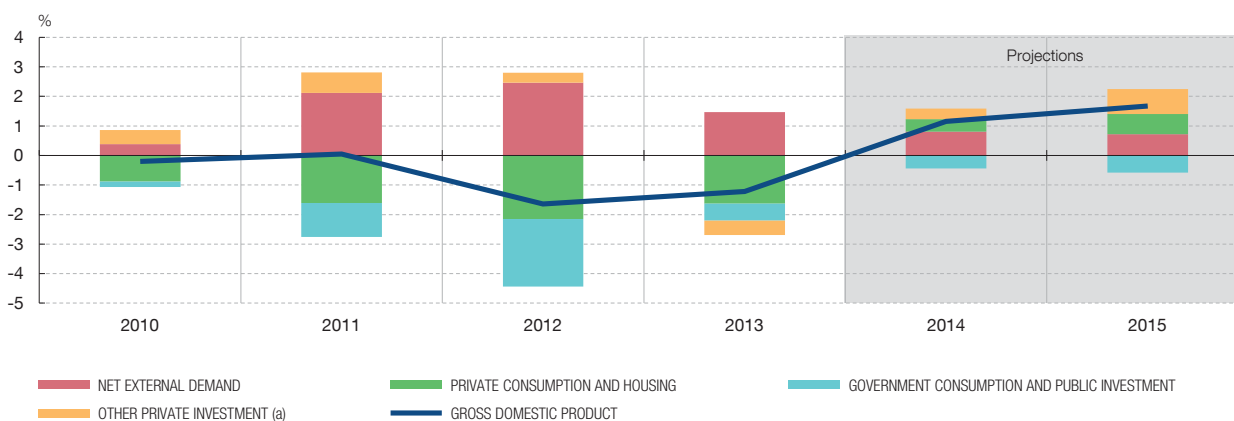
	2010	2011	2012	2013	Projection	
					2014	2015
GDP	-0.2	0.1	-1.6	-1.2	1.2	1.7
Private consumption	0.2	-1.2	-2.8	-2.1	1.1	1.2
Government consumption	1.5	-0.5	-4.8	-2.3	-1.5	-2.5
Gross fixed capital formation	-5.5	-5.4	-7.0	-5.1	0.0	4.2
Investment in capital goods	4.3	5.3	-3.9	2.2	6.3	7.5
Investment in construction	-9.9	-10.9	-9.7	-9.6	-4.4	1.7
Exports of goods and services	11.7	7.6	2.1	4.9	5.1	6.1
Imports of goods and services	9.3	-0.1	-5.7	0.4	3.0	4.4
National demand (contribution to growth)	-0.6	-2.1	-4.1	-2.7	0.3	0.9
Net external demand (contribution to growth)	0.4	2.1	2.5	1.5	0.8	0.7
Private consumption deflator	1.9	2.5	2.5	1.3	0.4	0.8
Unit labour costs	-1.7	-1.0	-3.0	-1.6	-0.7	-0.9
Employment (full-time equivalent jobs)	-2.3	-2.2	-4.8	-3.4	0.4	0.9
Unemployment rate (% of labour force)	20.1	21.6	25.0	26.4	25.0	23.8
Saving rate of households and NPISHs	13.9	12.7	10.4	10.0	9.5	9.7
National economy's net lending (+)/net borrowing (-) (% of GDP)	-3.8	-3.5	-0.6	1.5	2.1	2.5
General government net lending (+)/net borrowing (-) (% of GDP) (b)	-9.6	-9.6	-10.6	-7.1	-5.8	-5.5

SOURCES: Banco de España and INE.
Latest QNA data: 2013 Q4.

- a Projections cut-off date: 14.3.2014.
- b At the time of this report going to press, the final figure for the general government sector account in 2013 is not known. It will be published at end-March. The forecast for 2013 includes the estimated impact on the general government deficit of the assistance to financial institutions. The fiscal projections for 2014-15 have been made using the Eurosystem methodology (no change in fiscal policy).

CONTRIBUTIONS TO GDP GROWTH

CHART 2



SOURCES: INE and Banco de España.
Latest data: 2013 Q4.

- a Includes changes in inventories.

contribution of the net external balance to output growth dropping by a further 0.1%, which, taken together, will result in GDP growth of 1.7%.

Among the components of private demand, it is envisaged that household consumption will grow in 2014 and 2015 following decreases in the three preceding years. This growth will be favoured by a moderate rise in nominal disposable income, driven in turn by

employment gains and, in 2015, by a less negative contribution from the fiscal component, in accordance with the assumptions described in the preceding section. The low projected growth of consumer goods prices will contribute additionally to an increase in real income. However the increase in household spending over the projection horizon will be relatively modest because the deleveraging needs of the sector will continue to constrain the recovery in household spending. Thus private consumption is expected to increase by 1.1% in 2014 and by somewhat more in 2015. These projections are consistent with a slight decrease in the household saving rate to 9.5% in 2014 and a modest rise of 0.2 pp in 2015.

The decreases observed in residential investment between 2008 and 2013 are expected to continue in the two-year projection horizon. However, the declines will be progressively smaller, with projected falls of around 5% in 2014 and a negative but close-to-zero rate in 2015. This projection is based on the recent course of the number of residential building permits, which seems to suggest that the adjustment of this demand component may be complete by the end of the projection horizon. Against a background in which a high number of houses remains unsold, this outlook is supported, moreover, by the foreseeable continuing low volume of house purchases and sales as a result of the weak demand for residential properties.

The recovery in business spending is expected to continue, gaining strength towards the end of 2014 and in 2015. It is expected that the average annual rates of change of business spending will stand at around 3% this year and at 7% next year. Specifically, firms will tend to replace their obsolescent capital equipment, the renewal of which seems to have been postponed in the last few years as a result of the unfavourable outlook for demand, the difficult financial conditions and the high uncertainty. Initially, investment activity will probably be carried out most by exporting firms. Subsequently, the strengthening domestic demand will tend to broaden the base of investing firms. Also, at the beginning of the projection horizon, the share of internal funds in the financing of investment will be relatively high, although over the course of the period analysed the less severe credit conditions will lead to a gradual rise in debt financing. In any event, it should be noted that, in accordance with the disaggregated information available, firms with better performing sales and revenue and with a healthier financial position have had readier access to credit in the recent period. If the recovery gradually allows those variables to perform more strongly in an increasing number of firms, the financial obstacles which may be constraining some firms' investment plans can be expected to progressively recede.

In 2014 and 2015, government consumption and investment will continue to fall, as they have been doing since the onset of the process of fiscal consolidation. Based on the envisaged behaviour of goods and services purchases by general government and of the number of employees in the sector, government consumption is projected to fall at a rate of 1.5% and 2.5% in 2014 and 2015, respectively. On average, the decrease in government investment projected for 2014 and 2015 should be slightly higher than the fall of 6.6% estimated for 2013.

In the external sector, it is expected that, as has been occurring since 2009, exports will continue to grow at somewhat higher rates than export markets. Their relative price is expected to continue to fall, this process being related to the declines in unit labour costs prompted by the wage moderation and, albeit more contained than in the past, productivity gains. Also, despite the envisaged gradual recovery in domestic demand, Spanish firms can be expected to keep making inroads into foreign markets. In the specific case of

exports of tourism services, the recovery of price competitiveness and the growing dynamism of some markets of origin presage the ongoing notable vigour of this sub-component over the projection period. As a result, it is estimated that total goods and services exports will grow by 5.1% in the current year, up 0.2 pp on 2013, and will quicken to 6.1% in 2015.

Moving on to imports, the basic assumption is that they will move in line with final demand, with an elasticity in line with historical average levels. This is a result of two factors. First, although the crisis can be expected to have prompted the substitution of imports by domestically produced goods, it has been difficult to identify the scope and persistence of that substitution in recent years, which would advise exercising caution when incorporating it in these projections. Second, the envisaged composition of final demand growth continues to be biased towards items with a higher import content (basically exports and capital equipment), which will tend to contribute to a relatively high growth of goods and services imports. Thus, following growth of 0.4% in 2013, imports are expected to rise by 3% in 2014 and by 4.4% in 2015.

In the labour market, employment is expected to grow at rates which, although modest in absolute terms, are high compared with the foreseeable growth of output. The higher job growth in the market sectors could be attributable to the prolongation of wage moderation and to the greater flexibility permitted by the labour market's current legal framework when firms adjust their internal labour arrangements to business cycle conditions. In non-market sectors, in view of the plans announced by general government, it is expected that government employment will continue to decrease in 2014-2015, albeit more slowly than in 2013. Thus employment in the economy as a whole is expected to rise by 0.4% in 2014 and by 0.9% in 2015, giving rise to productivity growth of 0.8% in both years.

In the projection period, the rate of decline of the labour force is expected to ease compared with 2013, which would be the result of a smaller fall in the participation rate – due to improved labour market conditions – and of a projected continuing decline in the number of working-age individuals, estimated at an annual rate of approximately 0.5%. The contraction of the labour force is estimated to contribute, together with the rise in employment, to an increase in the incipient decline in the unemployment rate that began to be seen during 2013. Thus, the unemployment rate is projected to decline by approximately 1 pp in each year of the two-year projection period, to around 23% at end-2015.

Projections for the growth of private-sector compensation per employee for 2014 and 2015 point to continued moderation of the wage growth observed in recent years, which is partly related to the effects of the labour reform. In particular, the information available on the results of collective bargaining in 2014 is compatible with the fulfilment of the recommendations of the Agreement for Employment and Collective Bargaining (“AENC” by its Spanish abbreviation) signed in 2012, which advised that wages should increase by 0.6% this year. The social security contributions component will make a positive contribution to wage growth as a result of the increase in the maximum contribution bases and the inclusion of salaries in kind in the contribution base. Finally, wage drift is estimated to continue to be negative, in line with its behaviour in recent years. Consequently, compensation per employee in the market economy in 2014 is projected to be stable. For next year, it has been assumed that both wage rates and wage drift will be slightly more expansive, owing to the gradual improvement in activity, whose effect on labour costs will be countered, however, by the impact of the recent reduction in social security contributions for permanent contracts, which will be felt more sharply that year.

Since the beginning of the crisis, inflation has become more sensitive to the degree of demand pressure. During the projection period, household spending is expected to recover moderately, leading to a very modest increase in inflation in a setting where the degree of slack in the economy will remain high. The projected decreases in unit labour costs will also contribute to growth in prices holding at low levels. Among the other determinants of inflation, the fiscal assumptions underlying this exercise do not envisage changes in indirect taxation and the available projections for commodity prices and the exchange rate point to highly contained inflationary pressures. These developments make for a projection for growth of the private consumption deflator of 0.4% in 2014 and of 0.8% in 2015.

After the rest of the world account posted its first positive balance since 1999 last year, the surplus is expected to increase over the projection period, boosted by the rise in the goods and services component. Also, the income deficit is projected to widen slightly. Taking into account these factors, Spain's net lending is projected to increase from 1.5% of GDP in 2013 to 2.1% and 2.5% in 2014 and 2015, respectively. The difficulties involved in cutting the deficits on the energy and income balances, given the servicing of the high debt built up vis-à-vis the rest of the world, will continue to limit Spain's ability to make greater progress.

From a sectoral standpoint, the increase in Spain's net lending is especially due to general government, which is expected to contribute 1 pp to the improvement in the balance on the rest of the world account over the projection period, excluding the effect of the capital transfers made in 2013 to financial institutions, whereas the balance of households and both financial and non-financial corporations will fare more modestly. In the case of households, the projected improvement of 0.2 pp in their net lending would be based on reductions in their saving/GDP and investment/GDP ratios, whereas the slight decrease in non-financial corporations' net lending would be attributable to the rise in their investment rate. Household debt as a proportion of disposable income is projected to decline by 4 pp between 2013 and 2015, following the fall of 11 pp between 2008 and 2013. According to the projections, the lending to non-financial corporations/GDP ratio is estimated to decline over the next two years by around 6 pp (in addition to the deleveraging of the order of 20 pp recorded between 2010 and 2013).

On the provisional estimates available, the year is expected to have ended with a general government deficit of around 6.6% of GDP, if the assistance to financial institutions is excluded. According to the projections of this report, the budget deficit is expected to decrease by 0.8 pp in 2014 and by a further 0.3 pp in 2015, according to the assumptions explained earlier. This moderation in net lending, however, would not be sufficient to end the rise in the public debt/GDP ratio in the projection horizon envisaged by this report. Projected developments in public debt illustrate the magnitude of the budget consolidation drive that remains to be made and the need to persevere with a budget consolidation strategy that continues to improve confidence in the Spanish economy. Given this target, it is essential to ensure strict compliance with budget outturn reporting and monitoring obligations under the Budgetary Stability and Financial Sustainability Law and to set out in detail medium-term budget plans that specify the measures for attaining the agreed targets, in line with European requirements.

Risks to the projections

Developments in the Spanish economy since the publication of the *Spanish economic projections report* in March 2013 have not differed significantly from those indicated at the time; GDP fell in the first half of last year and Q3 marked a turning point after which GDP

began to grow modestly. However, set against what was projected, the re-balancing of domestic and external demand began earlier and employment performed more favourably than estimated, recovering slightly at the end of the year. Furthermore, last year's report envisaged a gradual strengthening of GDP growth during 2014, which this analysis would confirm, although the recovery is expected to be slightly earlier and stronger than projected at that time.

Additionally, the 2013 report was drafted in a setting of notable uncertainty; it followed the stepping-up of the budget adjustment at end-2012 – in the light of the delicate situation of public finances – amid the complex process of restructuring and reorganisation of financial institutions and doubts about the process of European monetary unification which had not been fully dispelled. This exercise presents, in comparative terms, a lower level of uncertainty.

The risks of deviations in economic activity from that projected in the baseline scenario are skewed moderately downwards in 2014 and more sharply so in 2015. On the external front, the main risk stems from the possibility of foreign markets performing more unfavourably than projected. In particular, emerging markets – which have made a very high contribution to the growth of Spanish exports – could slow down more markedly than the projection in the baseline scenario. On the domestic front, stepping up fiscal consolidation in 2015, which would be required for the fulfilment of the budget targets, may give rise to a more moderate increase in activity that year. The magnitude of this increase is difficult to quantify accurately; however, in general terms, it would be in line with the size of the multipliers estimated for the Spanish economy. Conversely, the actions taken by Spanish and European authorities to move ahead with the future institutional arrangements for the euro area may possibly lead to financial conditions returning to normal earlier than projected in this report. Similarly, harnessing more vigorously the possibilities offered by the labour legislation adopted in 2012 and approving further measures in this area, together with adopting reforms for certain goods and services markets, could boost activity and employment above the estimations in the baseline scenario of these projections. Furthermore, a speedier restoration of price competitiveness would be conducive to increasing the contribution of net external demand to economic growth.

As for inflation, the risks of deviations are skewed slightly to the downside. It is estimated in the projections that the slowdown in the fall of labour costs and the subdued recovery of private consumption will favour a modest rise in inflation, measured by the deflator of that aggregate. However, the persistence of a high degree of under-utilisation of productive capacity and of the labour factor, despite the projected improvement in both variables over the projection horizon, could exert sharper disinflationary pressure than that projected in this report. Furthermore, a possible quickening in the slowdown of emerging economies and a greater appreciation of the euro exchange rate could lead to lower external price pressures. Lastly, resolve in the application of structural reforms to boost competition in goods and factor markets will contribute to a further easing in inflation which, however, would be compatible with higher real household income. In the opposite direction, a sharper fiscal adjustment than that projected could prompt increases in administered prices or indirect taxation which would give rise to higher inflationary pressures.

21.3.2014.

