OVERVIEW

During Q3 the Spanish economy saw a prolongation of its expansionary phase, albeit at a somewhat slacker pace than in the first half of the year. On the conjunctural information available, GDP is expected to have increased by 0.8% in the July-September period, which would place its year-on-year rate of change at 3.4%.[1] As in previous quarters, this increase in activity has been underpinned by the strength of private domestic demand, while the contribution of net external demand to GDP has remained negative.

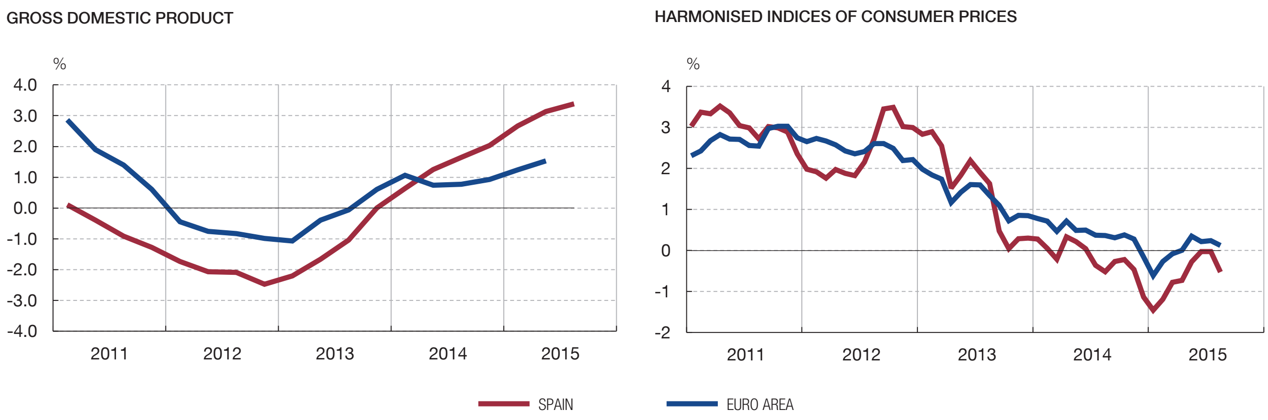
Overall, the economic and financial developments in recent months, along with the changes observed since June in the technical assumptions used, confirm the scenario of recovery augured by the June *Quarterly Report,* with estimated growth of 3.1% and 2.7% in 2015 and 2016, respectively (see Box 1). In recent months the external environment has worsened owing to the effects of the slowdown in China, which has led to the downward revision of the growth outlook for the global economy this year, and more sharply so for next year. However, it is estimated that the foreseeable weakening in our export markets over the projection horizon will be offset by the lower level of oil prices and commodities, the prolongation of the improvement in financing conditions and the new fiscal policy measures included in the draft State budget for 2016, currently in passage through Parliament (see Box 2). Since June, the degree of uncertainty surrounding these projections has increased and the risks of downward slippage have heightened, owing to the worsening outlook for global growth.

As regards inflation, the recent falls in the price of energy have interrupted the path of recovery of the overall price index. After having posted positive figures in June and July for the first time over the past year, the CPI fell once more in August (by 0.4%). This fresh bout of disinflation is linked to the recent and additional decline in oil prices on international markets. Indeed, core inflation held at slightly higher rates than those of the previous quarter, standing in August at 0.7%, 0.1 pp up on June. As a result of these developments, the projections for the overall price index have been revised downwards from those prepared in June, although the latest data do not alter the prospect of a gradual pick-up in inflation contained in the latest forecasts. The CPI may conclude the year at a marginally positive year-on-year rate, although it would fall back by 0.5% in annual average terms. In 2016 the rate would rise to 0.8%. Nonetheless, the uncertainty surrounding these projections has increased and the risks incline to lower inflation owing to the doubts over the global economic outlook and the future path of oil prices.

Despite the growing volatility on financial markets, financing conditions in the Spanish economy continued to improve in Q3, against a background in which the ECB's monetary policy and, specifically, its asset purchase programme continued deploying their effects on the cost of financing and bank credit. The general government sector once again financed itself under favourable conditions and the cost of bank loans to the private sector continued declining to July, which made for a further year-on-year increase in the volume of new lending

1 This estimate and its breakdown into domestic and external demand is somewhat more preliminary in nature than is habitually the case owing to the fact that it has not been possible to integrate the latest Annual National Accounts (ANA) estimates, published on 15 September. The non-inclusion of this information is due to the fact that the quarterly series consistent with the published annual data will not be available until 26 November. Moreover, the flash GDP estimates to be published by INE on 30 October will be made drawing on the Quarterly National Accounts (QNA) series consistent with the updated annual series. As can be seen in Box 5 in the original Spanish report, this update has entailed changes of some size in the level and composition of GDP at the annual level, which might feed through to the new quarterly series, whereby the figures discussed below should be viewed with particular caution.

GROSS DOMESTIC PRODUCT AND CONSUMER PRICES (a) | CHART 1



SOURCES: Eurostat, INE and Banco de España.

a Year-on-year rate of change calculated on the basis of seasonally adjusted series in the case of GDP and CPI original series.

SPAIN: MAIN MACROECONOMIC AGGREGATES (a) | **TABLE 1**

	2014				2015		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
National Accounts							
Quarter-on-quarter rate of change, unless otherwise indicated							
Gross domestic product	0.3	0.5	0.5	0.7	0.9	1.0	0.8
Contribution of national demand (b)	0.6	0.9	0.7	0.5	0.9	1.2	1.1
Contribution of net external demand (b)	-0.3	-0.4	-0.2	0.2	0.0	-0.2	-0.3
Year-on-year rate of change							
Employment	-0.4	1.0	1.7	2.4	2.8	2.9	2.9
Price indicators (year-on-year change in end-of-period data) (c)							
CPI	-0.1	0.1	-0.2	-1.0	-0.7	0.1	-0.4
CPI excluding unprocessed food and energy	0.0	0.0	-0.1	0.0	0.2	0.6	0.7

SOURCES: INE and Banco de España.

a Information available up to 25 September 2015.
b Contribution to the quarter-on-quarter rate of change of GDP in pp.
c The latest CPI data are for August 2015.

business. These developments passed through to households' and firms' outstanding credit which, though it continued falling, did so at a lesser pace than in the previous months.

Private domestic demand remained on an expansionary course, although the available indicators point to a slight loss of momentum of the various spending components. The expansion of household spending (both on consumption and on residential investment) was underpinned by the dynamism of disposable income and by the progressive improvement in financial conditioning factors. Business investment also performed favourably, driven by the high level of capacity utilisation and the improvement in the availability of credit, especially in the SME segment. The contribution of net external demand to the increase in GDP is expected to have been slightly more negative than in Q2 as import growth is estimated to have outpaced that of exports, although in both cases at lower rates than in Q2. Finally, the pace of expansion of employment is expected to have slackened during the summer to a greater extent than that of output, giving rise to a small increase in productivity in Q3.

25.9.2015.

This update of the projections for the Spanish economy was prepared by the Directorate General Economics, Statistics and Research using the information available as at 21 September. Compared with the previous projections made in June, this update includes, as is usual practice, the changes in the main variables since then (see Table 1).[1] It also contains some items of information not available in June, such as data from the Q2 Quarterly National Accounts and the Q1 Quarterly Non-Financial Accounts for the Institutional Sectors. However, the latest estimates of the Annual National Accounts, released on 15 September, have not been included, despite the fact that they contain significant revisions of the annual data for the period 2011-2014 (see Box 5). The reason for not including this information is that the quarterly time series consistent with the published annual data will not be available until 26 November.

According to the update presented here, the expansionary phase of Spanish economic activity will continue in late 2015 and throughout 2016. Specifically, average GDP growth is projected to reach 3.1% this year and 2.7% next year (see Table 2). These increases coincide with those estimated in June, although the figures entail some changes in the composition of output as detailed below.

The external assumptions entail some significant new developments compared with the projections of the previous *Quarterly Report.* In particular, as described in Section 2 of this Report, the summer months were characterised by a significant worsening of the outlook for some emerging economies (which gave rise to a substantial downward review of the expected growth rates of demand for Spanish exports originating in these markets). This also helps explain some developments observed in the international commodities and financial assets markets. Specifically, oil prices fell markedly in both the spot and futures markets, and the decrease in metal prices, although smaller, was also notable. Moreover, the worsening of the growth outlook for the world economy and the deflationary effect of cheaper commodities prompted a general decline in interest rates across the various terms, most notably at longer maturities. Finally, the exchange rate of the euro appreciated slightly against the dollar and remained roughly steady against a broad range of currencies. An additional development among the assumptions made in the projections is the incorporation of the effects of the measures included in the draft State Budget, details of which are given in Box 2.

Overall, the impact on GDP growth of the changes in the projection assumptions is roughly neutral, since the negative impact of the worsening in export markets is more or less offset by the expansionary effect of the lower prices of oil and other commodities, lower financing costs and the new fiscal policy measures. All these effects place GDP growth, as mentioned above, at average rates of 3.1% and 2.7% for 2015 and 2016, respectively, the same as in the June update. However, these projections entail a downward revision of 0.4 pp in the envisaged contribution of the net external balance in each of the two years, offset by an equal balance of opposite sign in the contribution of national demand, against a background of slowing external markets over the projection horizon and of buoyant imports. Thus, output growth throughout the projection period will continue to be underpinned by the strength of domestic demand, while net external demand will make a moderate negative contribution in each of the two years of the projection period.

1 The data cut-off date for the formulation of the external assumptions is 21 September, except in the case of the behaviour of the Spanish export markets, for which use was made of the information included in the September 2015 ECB staff macroeconomic projections for the euro area based on information available up to 12 August.

1 INTERNATIONAL ENVIRONMENT AND MONETARY AND FINANCIAL CONDITIONS (a)

Annual rates of change, unless otherwise indicated

		Current projection		Change from June 2015 projection	
	2014	2015	2016	2015	2016
International environment					
World output	3.4	3.0	3.5	-0.2	-0.3
Global markets	3.4	2.2	3.9	-0.3	-1.1
Spain's export markets	3.1	3.1	4.1	-0.3	-0.9
Oil price (in USD)	98.9	53.6	53.4	-8.2	-14.7
Monetary and financial conditions					
Dollar/euro exchange rate (USD per euro)	1.3	1.1	1.1	0.0	0.0
Short-term interest rate (3-month EURIBOR)	0.2	0.0	0.0	0.0	-0.1
Long-term interest rate (10-year bond yield)	2.7	1.8	2.3	-0.2	-0.4

SOURCES: ECB and Banco de España.

a Assumptions cut-off date: 21.09.2015.

Among the components of national demand, household consumption is expected to remain highly dynamic in the period in question, buoyed by the favourable performance of the labour market and by the growth of net wealth against a background of modestly rising house prices and of continuing deleveraging. Further, household spending on consumer goods and services will continue to be driven by the expansionary impact on disposable income of lower oil prices, the reduction in direct taxation and the refund to public workers of the missed 2012 Christmas bonus payment, together with the implementation of certain spending decisions postponed by agents during the crisis.[2] As a result, private consumption is expected to grow by 3.5% this year, slowing to 2.9% in 2016 as some of the previous factors – of a temporary nature – start to lose momentum.

Against a background of improvement in financing conditions, the current gradual recovery in residential investment is expected to continue, as reflected by the modest rise in housing starts and the higher transaction figures. Business investment will keep posting high growth rates as a result of the continuing strength of final demand against a backdrop of improved financial conditions.

2 See, in this respect, the article entitled "Consumption dynamics in Spain by type of product" in this *Economic Bulletin*.

As regards foreign trade, exports are expected to post moderate growth rates over the projection horizon, in a setting in which the favourable performance of sales to the rest of the euro area, as a result of the improvement of these markets and of the achievement of additional gains in competitiveness, will be offset by the relative weakness of exports to the rest of the world, hampered by the slowdown of these markets. Compared with the previous projections, there is a downward revision of the course of this demand component. Meanwhile, imports will continue to show notable dynamism, growing at rates slightly higher than those foreseen in June, in line with the strength of final demand.

The nation's net lending is expected to be somewhat higher than the June projection (1.4% of GDP and 1.2% of GDP this year and next year, respectively), mainly due to the downward revision of the income deficit.

The dynamism of activity will mean ongoing job creation, favoured by the projected moderation of labour costs. The growth of employment, slightly slower than in the previous projections, will allow the unemployment rate to continue downward to around 20% of the labour force at the end of the projection horizon.

Under the projection assumptions, consumer prices would undergo negative rates of change practically up to the end of this year, resulting

2 PROJECTIONS OF THE SPANISH ECONOMY'S MAIN MACROECONOMIC VARIABLES (a) (b)

Annual rate of change in volume terms and % of GDP

		Current projection		June 2015 projection	
	2014	2015	2016	2015	2016
GDP	1.4	3.1	2.7	3.1	2.7
Private consumption	2.4	3.5	2.9	3.4	2.3
Government consumption	0.1	1.1	0.3	0.1	0.1
Gross fixed capital formation	3.4	6.5	6.6	5.9	6.1
Investment in capital goods and intangible assets	12.2	9.8	9.5	8.8	8.9
Investment in construction	-1.5	5.3	4.9	4.8	4.5
Exports of goods and services	4.2	4.9	5.0	5.1	5.7
Imports of goods and services	7.6	6.3	6.4	5.3	5.9
National demand (contribution to growth)	2.2	3.4	3.0	3.1	2.6
Net external demand (contribution to growth)	-0.8	-0.3	-0.3	0.0	0.1
Nominal GDP	0.9	4.1	3.7	3.3	3.3
GDP deflator	-0.5	0.9	1.0	0.2	0.6
Consumer price index (CPI)	-0.2	-0.5	0.8	-0.2	1.3
Employment (full-time equivalents)	1.2	2.8	2.5	2.9	2.6
National economy's net lending (+)/net borrowing (-) (% of GDP)	1.0	1.4	1.2	1.2	1.1

SOURCES: Banco de España and INE.
Latest QNA figure: 2015 Q2.

a Projections cut-off date: 25 September 2015.
b These projections were prepared from figures published by the INE in the 2015 Q2 QNA. They do not therefore include the latest update of the 2011-2014 annual accounting time series which was published on 15 September.

in a fall of 0.5% in yearly average terms. The subsequent gradual rise would give an average rate of 0.8% in 2016, and levels approaching 2% would still not be reached at the end of the projection period. The oil price falls in the summer months entailed a downward revision of nearly 0.5 pp in consumer price projections for 2016 on those of June. In terms of the CPI excluding unprocessed food and energy, however, the outlook barely changed, with a gradual – albeit moderate – pick-up of this indicator, against a background of decreasing cyclical slack in the economy and of continuing moderate growth of labour costs. It is estimated that the GDP deflator may grow on average by 0.9% this year and by 1% next year.

The balance of risks that the path of GDP will deviate from that of the central scenario is somewhat more negatively tilted compared with three months ago, basically due to external factors. In particular, there is a probability that some of the main emerging economies, including most notably China, will undergo a sharper showdown. In the domestic arena, the main risk is that the uncertainty over medium-term economic policies may influence agents' spending decisions.

The risk of deviation from the central inflation scenario is tilted moderately to the downside, basically because of the possible materialisation of more unfavourable scenarios at the international level. By contrast, the latest actions of the ECB notably limit any possible risk of deanchoring of inflation expectations. In any event, the uncertainty over the behaviour of the energy component of consumer prices continues to be high as a result of the marked oil price volatility.

The latest figures published on public finance developments in National Accounts (NA) terms cover the January-May period this year and relate to the sub-sectors of central government, the regional governments and the Social Security system. According to this source, these sub-sectors as a whole posted a deficit of 2.2% of GDP in the January-May period, 0.2 pp down on the same period in 2014. The latest information refers to the State, and shows that this sub-sector posted a deficit of 2.4% of GDP in the January-July period, 0.6 pp of GDP up on the same period a year earlier. Information to July is also available on revenue raised from the taxes shared by the State, the regional governments and local governments in terms of budget accounting, which shows an acceleration on the cumulative rate to the end of Q2. The general government debt ratio stood at 97.7% of GDP at end-June, similar to the end-2014 figure.[1]

It is further worth noting that the Government has submitted the draft State and Social Security Budget (PGE by its Spanish initials) for 2016.[2] Its early passage through Parliament has also led to the early submission, in the first half of September, of the overall General Government Budgetary Plan for 2016 to the European Commission. This document is an essential part of the budgetary cycle[3], given that it describes the overall general government (State, Social Security, Regional Government and Local Government) fiscal policy strategy and provides information on the link between this strategy and the budgets of each general government sub-sector. However, the early presentation of the State Budget has meant it was impossible for the Plan to include the information on the fundamental aspects of the regional and local government budgets, given that the term set under the Stability Law[4] for their transmission to the Ministry of Finance and Public Administration is 1 October. As regards the regional and local government budgetary plans, the new information provided in the Plan is essentially confined to the personnel measures contained in the PGE for 2016, given that such measures are basic and affect all general government sub-sectors, although they are only optional.

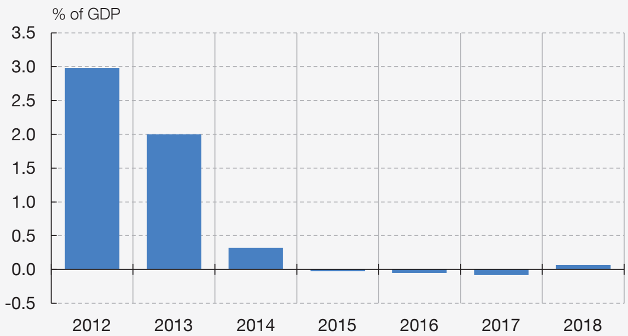
The updated fiscal policy plans confirm the overall general government budget deficit targets for 2015 and 2016, in line with the recommendations of the European Council, to be 4.2% of GDP and 2.8% of GDP, respectively. As a result, the commitment to cease to be in an “excessive deficit” position (a deficit of more than 3% of GDP, according to the Stability and Growth Pact) would be met, following eight years of having exceeded this threshold. Starting from the macroeconomic scenario included in the PGE, the fulfilment of these objectives would, on the latest official estimates, entail a virtually zero change in the primary structural general government balance in 2015 and 2016, whereby the budgetary policy stance would become neutral in that period, in contrast to the significant budgetary correction made in the 2012-2014 period (see accompanying panel). The reduction in the general government deficit in 2016 (1.4 pp of GDP) would come about chiefly due to the decline in the public spending/GDP ratio (by 1.3 pp of GDP), which would stand in 2016 at 40.7% of GDP compared with the figure of 42.1% estimated for 2015, while the public revenue/GDP ratio would improve marginally (by somewhat

1 These ratios may change as a result of the impact on GDP of the recently published revisions to the Annual National Accounts by INE (see Box 5 in the original Spanish report).
2 In this respect see the testimony by the Governor of the Banco de España before the Senate in connection with the Draft State Budget for 2016.
3 The recent reform of governance in the euro area has strengthened the European Commission’s competencies in respect of the oversight of the euro area countries’ public finances. One of the elements applied since end-2013 is the obligation on the part of governments to submit before 15 October each year their draft general government budgets for assessment by the Commission before such budgets are approved in national parliaments.
4 Organic Law 2/2012 of 27 April 2012 on Budgetary Stability and Financial Sustainability.

BUDGET BALANCE TARGETS (a)

% of GDP, National Accounts	2014	2015	2016
General government (c)	-5.7	-4.2	-2.8
Central government and Social Security (c)	-4.6	-3.5	-2.5
Central government (c)	-3.5	-2.9	-2.2
Social Security	-1.1	-0.6	-0.3
Regional government	-1.7	-0.7	-0.3
Local government	0.5	0.0	0.0
General government debt	97.7	98.7	98.2

CHANGE IN GENERAL GOVERNMENT PRIMARY STRUCTURAL BALANCE (b)



SOURCES: Ministerio de Hacienda y Administraciones Públicas and Ministerio de Economía y Competitividad.

a Draft State Budget 2015 and 2016 targets.
b 2016 Budgetary Plan (September 2015) for 2015-2016 and 2015-2018 Stability Programme (April 2015) for 2017-2018.
c Excluding impact in 2014 derived from financial system restructuring operations.

more than 0.1 pp of GDP) to 38% of GDP in 2016. The public debt/GDP ratio would stand at 98.7% and 98.2% of GDP in 2015 and 2016, respectively, entailing the first reduction in this ratio since 2007.[5]

The rest of the Box cites the main fiscal policy measures defined in the PGE and included in the budgetary plan, owing to the fact that their estimated impact on economic activity is an input into the updated macroeconomic projections presented in this *Quarterly Report.* On the revenue side, mention may be made of the tax reform affecting personal and corporate income tax which came into force on 1 January 2015, to be phased in in two steps, in 2015 and 2016, and the subsequent bringing forward to July this year of the second phase of the reduction in personal income tax.[6] On official estimates the budgetary cost of the personal income tax reform in 2015 and 2016 will be €3.87 billion and €1.57 billion, respectively, while that of the corporate income tax reform is estimated at €87 million and €2.34 billion in 2015 and 2016, respectively.

In terms of spending, the personnel heading for 2016 includes an approved wage increase of 1%, for the first time in the last six years, payment of the second half of the Christmas bonus salary payment eliminated in 2012 and an increase in the average staff replacement rate in 2016 to 50% generally (this rate was zero in 2015) and up to 100% for the healthcare, education and law and order sectors, among others (50% in 2015). Further, the Government has established that, over the remainder of 2015, an additional quarter of the 2012 Christmas bonus salary payment be paid, and that public-sector employees recoup one day for personal matters and several long-service days.[7] Overall, the Budgetary Plan estimates that these regulatory changes entail higher overall general government personnel spending of the order of 0.27 pp of GDP and 0.13 pp of GDP in 2015 and 2016, respectively. With regard to Social Security spending, pensions have been raised by 0.25% in 2016, in application of the pension indexation formula in force since January 2014.

In addition to these measures, the fiscal policy assumptions acting as a basis for the macroeconomic projections in this *Quarterly Report* include the impact on general government final consumption spending that would arise from the application of a series of ongoing reforms, including the reform of local government and that of general government (defined in the CORA report), and some moderation in the increase in public investment, in line with official estimates. Moreover, some restraint is assumed in transfers and subsidies, along with the cut in spending on unemployment benefits owing to labour market buoyancy, and in the interest burden owing to the more favourable financial conditions.

5 These ratios may be affected by the impact on nominal GDP of the Annual National Accounts revisions recently published by INE.

6 Royal Decree-Law 9/2015 of 10 July 2015 on urgent measures to reduce the tax burden borne by personal income taxpayers and other economic measures.

7 Royal Decree-Law 10/2015 of 11 September 2015 granting extraordinary credits and credit supplements in the State Budget, and adopting other public employment and economy-boosting measures.