This box describes the key features of the most recent update of the Banco de España's economic projections for the Spanish economy. In comparison with the previous projections, published on 14 December 2018,[1] the current projections incorporate the preliminary results of the quarterly national accounts for the fourth quarter of 2018 and the changes in the technical assumptions derived from the information collected since the last exercise (see Table 1).[2]

The projections anticipate the prolongation of the upturn in the Spanish economy over the three-year period 2019-2021 (see Table 2). These expectations are based on the continued existence of the factors that have been underpinning growth since the start of the recovery including, in particular, the competitiveness improvements achieved since the start of the crisis, the strengthening of the financial situation of businesses, households and financial institutions and the accommodative stance of monetary policy. In addition, the prolongation, in the short run, of the expansionary budgetary policy stance should be mentioned. This combination of factors would allow the economy to continue to grow at significantly above its potential rate, which would facilitate further absorption of the high unemployment generated by the crisis.

That said, the buoyancy of activity will tend to moderate over the projection horizon. In terms of annual average rates, after growing by 2.5% in 2018, growth is projected to be 2.2% in 2019, 1.9% in 2020 and 1.7% in 2021. As regards 2019, the slowdown basically reflects a deterioration in the external environment, which has been having a negative effect on exports since 2018 and which in the short run will contribute, through the impact on uncertainty, to a weakening in private demand (in particular, business investment).

In the medium and long run, various factors explain the projected moderation in the rate of growth. First, although monetary policy will continue to be expansionary, the effects on GDP growth of the measures implemented in this area in recent years will gradually decline. The convergence towards a more neutral monetary policy stance is now expected to be notably more gradual than was anticipated three months ago, as a result of the downward shift in the path of short-term interest rates expected by the markets. This is partly a consequence of the action taken by the ECB to guide agents' expectations and, in particular, of the decisions adopted by the Governing Council on 7 March.[3]

1 Macroeconomic projections for the Spanish economy (2018-2021): the Banco de España's contribution to the Eurosystem's December 2018 joint forecasting exercise.

2 The cut-off date for the December 2018 projections was 21 November 2018. The cut-off date for the present exercise is 7 March 2018, except for the data on export markets and the prices of competitors in their national currency, which were taken from the ECB staff macroeconomic projections for the euro area, March 2019, which had a cut-off date of 12 February 2019.

3 See Box 4 ("Market expectations about the euro area benchmark interest rate") and Section 3.2 of this Quarterly Report.

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

Annual rates of change, unless otherwise indicated

		March 2019 projections			Difference between current projections and December 2018 projections (b)		
	2018	2019	2020	2021	2019	2020	2021
International environment							
World output	3.5	3.3	3.4	3.3	-0.1	0.0	0.0
Spain's export markets	3.1	2.7	3.6	3.3	-0.6	-0.2	-0.1
Oil price in dollars/barrel (level)	71.1	64.9	64.4	62.8	-2.7	-2.4	-3.1
Monetary and financial conditions							
Dollar/euro exchange rate (level)	1.18	1.14	1.14	1.14	0.00	0.00	0.00
Nominal effective exchange rate vis-à-vis the non-euro area (c) (2000 = 100 and percentage differences)	121.5	117.7	117.6	117.6	-0.3	-0.3	-0.3
Short-term interest rate (3-month EURIBOR) (d)	-0.3	-0.3	-0.2	0.0	0.0	-0.2	-0.3
Long-term interest rate (10-year bond yield) (d)	1.4	1.3	1.5	1.8	-0.6	-0.6	-0.6

SOURCES: ECB and Banco de España.

a Assumptions cut-off date: 7 March 2019. 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, percentages for the effective nominal exchange rate and in percentage points 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.

Also, although the expansionary fiscal measures approved since mid-2018 will support growth in the short run, in the absence of budget plans a neutral fiscal stance has been assumed for longer horizons. Finally, the projections incorporate the assumption that, given the current setting of continued relatively high levels of uncertainty and, above all, the historically low level of the savings ratio, households will be somewhat more cautious in their spending decisions. As a result, consumption dynamism is expected to moderate somewhat.

As for inflation, the extension of the upturn, with GDP growth rates above potential, is expected to lead to a gradual widening of the positive output gap and, therefore, to a rise in core inflation, as measured by the harmonised index of consumer prices (HICP), excluding food and energy. Specifically, the annual average rate of change of this indicator is projected to be 1.1% in 2019, 1.6% in 2020 and 1.8% in 2021. The path of the overall HICP is not very different, given the expected behaviour of the energy component.

In comparison with the preceding projections, the most important change in the assumptions on which the forecasts are based, in terms of the impact on the final variables, is some deterioration in the outlook for Spain's export markets. This is reflected in a downward revision of 0.9 percentage points (pp), in cumulative terms, in the growth of these markets over the time horizon considered (see Table 1). Other changes, in the opposite direction, counteract the negative impact on activity arising from this revision. There has been a downward shift in the expected path of oil prices (measured in US

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

Annual rate of change in volume terms and % of GDP

		March 2019 projections			Difference between current projections and December 2018 projections		
	2018	2019	2020	2021	2019	2020	2021
GDP	2.5	2.2	1.9	1.7	0.0	0.0	0.0
Private consumption	2.4	2.0	1.7	1.4	0.1	0.2	0.1
Public consumption	2.3	1.8	1.3	1.2	0.2	0.1	0.0
Gross fixed capital formation	5.2	3.9	3.8	2.7	-0.8	0.3	-0.1
Investment in capital goods, intangible and other (b)	4.9	3.2	3.3	2.1	-1.8	-0.2	-0.6
Investment in construction	5.5	4.6	4.3	3.2	0.1	0.7	0.4
Exports of goods and services	2.2	3.3	4.0	3.8	-0.1	0.0	0.0
Imports of goods and services	3.6	3.6	4.6	3.9	-0.4	0.5	0.2
National demand (contribution to growth)	2.9	2.3	2.0	1.7	-0.1	0.1	0.1
Net external demand (contribution to growth)	-0.4	-0.1	-0.1	0.0	0.1	-0.2	-0.1
Nominal GDP	3.5	3.6	3.5	3.5	-0.3	-0.2	-0.1
GDP deflator	0.9	1.4	1.6	1.8	-0.4	-0.1	-0.1
Harmonised index of consumer prices (HICP)	1.7	1.2	1.5	1.6	-0.4	-0.1	-0.1
HICP excluding energy and food	1.0	1.1	1.5	1.7	-0.4	-0.2	-0.1
Employment (full-time equivalent)	2.5	1.6	1.6	1.6	0.1	0.0	0.0
Unemployment rate (% of labour force). End-of-period data	14.4	14.0	12.8	12.1	-0.1	-0.1	-0.1
Unemployment rate (% of labour force). Annual average	15.3	14.2	13.2	12.3	-0.1	-0.1	-0.1
Nation's net lending (+) / net borrowing (-) (% of GDP)	1.2	1.1	0.8	0.7	0.3	0.1	0.1
General goverment's net lending (+) / net borrowing (-) (% of GDP)	-2.7	-2.5	-2.0	-1.8	-0.1	0.0	0.0

SOURCES: Banco de España and INE.
Latest QNA data: 2018 Q4

a Projections cut-off date: 13 March 2019.
b Includes machinery, capital goods, weapons systems, cultivated biological resources and intellectual property products.

dollars), which is beneficial to growth in the real incomes of private agents. At the same time, the expected paths of interbank market interest rates and public debt yields have moved downwards since the cut-off date for the assumptions of the preceding projections. Thus, although the cost of financing is expected to rise somewhat over the projection horizon, it is now not expected to rise by as much as three months ago.

Turning to budgetary policy, the changes in the assumptions are small. On 1 January 2019, the 2018 State budget was extended into 2019. This extension was accompanied by various royal decrees and remains in force following the rejection by Parliament on 13 February of the draft State budget for 2019 presented in January. These decrees included measures relating, in particular, to the updating of pensions, an increase in public sector wages, a rise in contribution bases (7%, in the case of the maximum base and in line with the increase in the national minimum wage, in the case of the minimum base) and changes in the arrangements for self-employed workers.[4] However, only the latter two measures amount to changes with respect to the previous projections exercise, since the others had already been announced before the cut-off date for such projections and were incorporated in them. Also, more recently, the Government has approved further expansionary measures, including notably the extension of benefits to unemployed persons over the age of 52 and the extension of paternity leave to eight weeks.

Apart from the measures already adopted, it was decided, as in other recent projection exercises, to use technical assumptions to obtain the expected path of fiscal variables. The items of the general government accounts subject to most discretionality (including notably, due to their size, government consumption and public investment) are assumed to change in line with the nominal potential growth of the economy, while the path of other items is linked to the behaviour of their usual determinants. In particular, it is assumed that public revenues will grow in line with tax bases, which mainly depend on the macroeconomic environment. For less discretionary items of spending, including the measures recently approved by royal decree law, similar assumptions are proposed. As a result, it is assumed that pension spending changes in line with the increases approved for 2019 and, subsequently, will be determined by the legally established formula for increases and by population ageing. At the same time, unemployment benefit is linked to the behaviour of unemployment, and debt interest payments to the behaviour of public debt and the cost of borrowing.[5] In accordance with all these assumptions for the behaviour of budgetary variables and with the output gap estimated consistently with the other macroeconomic projections, fiscal policy will be expansionary in 2019. The budget deficit is projected to fall slightly in 2019, to 2.5% (0.2 pp less than in 2018), this being a slight upward revision (of 0.1 pp) with respect to the previous forecast, and subsequently somewhat more sharply, to reach 1.8% by the end of the forecast horizon.

The projected average annual GDP growth rates are unchanged from December. The main reason for this stability is that the overall impact on activity of the changes described in the assumptions that form the basis for the projections is more or less neutral. Moreover, as regards 2019, there are factors with the opposite sign that offset each other, so that the GDP growth projection remains at 2.2%. On the one hand, at the end of 2018 growth was somewhat more favourable than anticipated in previous projections. Also, the short-term information indicates that the economy remained buoyant in 2019 Q1, when GDP growth is estimated to have been 0.6%. On the other hand, activity is expected to be less buoyant in Q2 and Q3, in comparison with the December projections, as a consequence of the continued weakness of the euro area economy at the beginning of the year, as reflected in the recent ECB staff projections.[6]

For the two-year period 2020-2021, the lack of revisions to GDP growth is explained by the fact that, in line with these projections for the euro area, it is assumed that the factors that have caused euro area activity to weaken are predominantly temporary, and will therefore cease to operate from the end of this year, assuming that the main areas of risk arising from the global environment will not fully materialise.

As for inflation, the net effect of the new assumptions is, as in the case of activity, approximately neutral. However, the recent surprising behaviour of the core component, which suggests that the degree of pass-through to prices of the observed rise in the growth rate of unit labour costs has been lower than was expected in the December projections, justifies a downward revision to the path of core inflation. This revision should be more pronounced at the beginning than at the end of the projection period, as the ongoing decline in the degree of slack in the economy will cause inflationary pressures to rise.

Growth in activity will continue to be driven by national demand, although the latter's positive contribution to GDP growth will tend to moderate gradually over the forecast horizon. By contrast, the negative contribution of external demand to GDP growth, which was relatively large in 2018, will gradually decline, to reach zero in 2021.

Within national demand, the buoyancy of private consumption will continue to be supported by strong job creation. Also, the growth rate of household income will be driven by the projected rise in real wages and, in the short term, by the stimulus from the budgetary

4 Also incorporated in the projections for 2019 is the fact that a significant part of the impact of the changes in personal income tax approved in the budget for 2018 has, contrary to what was expected, still not been observed in the budget outturn data and has therefore been shifted to the current year.

5 An increase in public spending in 2018 was included in the December projections as a result of a Supreme Court judgment annulling the privatisation of Aigües del Ter i Llobregat, which took place in 2012. In practice, the increase in spending has been recorded in 2012, which resulted in a reduction in spending last year. Also, the income from the re-tendering of the insolvent toll motorways, which was previously expected in 2019 but is now expected later, has been excluded.

6 ECB staff macroeconomic projections for the euro area, March 2019.

measures approved in 2018 and early 2019. In comparison with the December projections, the slight upward revision to the growth rate of private consumption reflects the increase in the purchasing power of nominal household income against a background in which, as mentioned above, price increases are more contained than they were forecast to be three months ago. In any case, private consumption is expected to slow gradually, due to a number of different factors. First, as already indicated, the current projections incorporate the assumption that, in an environment of greater global uncertainty, households will tend to raise their savings ratio, which is currently close to its all-time low. Also, the propensity to consume increases in employment income will tend to be lower than in the recent past. This is because such increases derive to a greater extent from rises in real wages than from job creation and the propensity to consume is lower for the former than for the latter. The final factor underlying the projected slowdown in private consumption is the completion of the process of taking the decisions to acquire the durable and semi-durable goods whose acquisition had been postponed during the crisis.

Favourable funding conditions will continue to support the expansionary behaviour of the various components of investment. In particular, residential investment is expected to continue to grow at high rates, driven by buoyant household creation and vigorous job creation. That said, the momentum of this aggregate is expected to gradually decline over the projection horizon.

The growth of business investment will be based on the strength of final demand, the high capacity utilisation and the sustained balance sheet clean-up in the sector. However, this component is also expected to slow somewhat, in line with the reduced strength of final demand and the outlook of continuing moderate export growth, which will limit the investment spending of firms with a high proportion of foreign sales. In comparison with the December projections, the downward revision to this component is more pronounced than for the other components of private demand, since it is affected more directly by the increase in uncertainty in the rest of the world.

The projected improvement in the contribution of the external sector to GDP growth is based on the expected increase in export dynamism. Exports weakened very significantly in 2018, by more than their markets, due to predominantly temporary factors. These include the delayed impact on sales outside the euro area of the euro depreciation in 2017 and the recovery in tourist flows to certain competitor countries in the Mediterranean basin. The disappearance of these effects should allow the market share gains that have been recorded for most of the recovery, as a consequence of the competitiveness gains accumulated since the start of the crisis and the increase in regular exporters, to resume. However, as mentioned when describing the changes to the assumptions, the deterioration in the external environment has led to a downward revision to expected growth in external markets. This is reflected in lower expected export growth than in the December projections. As in December, the import projections incorporate the assumption that the elasticity of this final demand component will be somewhat higher than during the initial years of the recovery (although lower than in the last two years).

The weakening of GDP growth rates over the projection horizon will be accompanied by a loss of momentum in employment of similar magnitude, except in the short term, when the slowdown in employment will tend to be intensified by the impact of the increase in the national minimum wage at the beginning of 2019. Continued job creation will allow further reductions in the unemployment rate, although their magnitude will be reduced by the rise in the labour force. Current projections envisage a fall in the unemployment rate to 12% by the end of the projection horizon, similar to the level expected three months ago.

On currently available information, the Spanish economy's net lending is expected to fall in 2018 by approximately 1 pp to around 1.2% of GDP, as a result of the decline in real flows of goods and services and the deterioration in the real terms of trade, basically due to the rise in oil prices. During the projection period a further modest decline is expected in the nation's net lending, of 0.5 pp of GDP to 2021, similar to the reduction expected three months ago.

The growth of compensation per employee is expected to be significantly higher during the projection period than in recent years. This reflects the gradual reduction in labour market slack, wage settlements, as at mid-2018, under the collective bargaining agreement for the period 2018-2020 (which recommends annual rises of 2% plus a variable component) and, in 2019, the increase in the national minimum wage. The pick-up in compensation per employee, against a background of continuing low productivity growth, will lead to higher unit labour cost growth rates. Despite the projected containment of profit margins, this will increase domestic inflationary pressures. By contrast, those of external origin, as measured by the import deflator, are expected to weaken in the short run.

Specifically, in terms of consumer prices, the energy component has slowed significantly since the end of last year, due to the fall in oil prices in the latter part of 2018 and the base effects deriving from their previous rise. This trend is projected to intensify during 2019. For the rest of the projection horizon, according to futures prices, the expected path of oil prices has a mildly negative profile. This, combined with the assumptions for electricity prices, is expected to produce rates of change in the energy component of close to zero. Given these developments, the rate of change of the HICP will fall slightly in the short run, increasing gradually thereafter in line with core inflation. Thus, the average annual rate of change of the HICP is expected to be 1.2% in 2019, 1.6% in 2020 and 1.7% in 2021.

The risks to the central growth scenario are on the downside, mainly as a result of external uncertainties. In particular, as already mentioned, the prospects for short-term growth in Spanish export markets have been revised downwards, in line with recent activity data for the world (and, in particular, for the euro area, Spain's main trading partner), and are now less favourable than they were assumed to be three months ago. At the same time, the hypotheses regarding the future behaviour of Spanish export markets (deriving from the latest ECB staff forecasting exercise) consider that the recent slowdown is temporary and will be reversed in the second half of the year. However, the recent activity weakness, especially in the euro area, could be more persistent, leading to a less favourable performance by the Spanish economy than envisaged in the central scenario.

In addition, a number of risk factors persist that would lead to less favourable developments were they to materialise. Specifically, the lack of clarity regarding the terms of the United Kingdom's departure from the European Union means that certain scenarios that could have very severe consequences for both areas cannot be completely ruled out. Also, uncertainty persists regarding the possible adoption of new protectionist measures at global level that would distort world production and result in the revision of business investment plans. Finally, the Chinese authorities are facing the difficulty of balancing fiscal and monetary stimulus for the economy, to alleviate the current slowdown, with attempting to halt the rise in the indebtedness of private and public agents.

Domestically, a high degree of uncertainty persists regarding the future economic policy stance and, in particular, fiscal adjustment (which is needed to reduce the high level of public debt that is still one of the main sources of vulnerability for the Spanish economy) and the adoption of measures to raise the long-run potential growth rate. Also, continuation of the current upturn requires that the competitiveness gains relative to the rest of the world achieved in recent years be maintained. It would therefore be desirable for wage rises to reflect the specific circumstances of each firm or sector and, in particular, productivity growth, avoiding general economy-wide increases that bear no relation to such specific conditions. In addition, price and wage setting mechanisms should be sufficiently flexible to allow adaptation, where necessary, to a more pronounced slowdown in activity, so as to limit possible activity and employment losses.