1 OVERVIEW

After its somewhat more favourable than expected behaviour in Q1, the global economy has shown signs of slowing in recent months. At the start of the year, output growth was underpinned by an unusually high proportion in the contribution of stockbuilding (which in the case of the United Kingdom was associated with the possibility of a no-deal Brexit in late March), while the main demand components showed some slackness. Into Q2, the main indicators have shown some weakening in activity. Moreover, looking ahead, the worsening of trade tensions between the United States and China has heightened the risks surrounding the sustainability of the upturn in the global economy. That has had considerable consequences for developments on financial markets. In particular, the worsening outlook for activity, the decline in inflation expectations and the search for safe havens given the reduced appetite for risk have led to a marked decline in sovereign debt yields. And in many euro area countries, this has in turn led to broad segments of the sovereign debt yield curve posting negative yields.

In response to the increased uncertainty surrounding the economic outlook, central banks have reacted by adopting a more accommodative monetary policy stance. The US Federal Reserve's communiqué following its meeting on 19 June points to the possibility that the next interest rate movement will be downwards. Should this occur, it would end the cycle of monetary policy tightening in the US economy that began in 2015.

Euro area economic activity has continued showing signs of weakness, especially in industry, the sector most closely linked to global trade. As in other areas, there was a rise in GDP growth in Q1 in the euro area too; however, it largely reflected transitory factors. Having discounted the contribution of these factors, moderate growth generally remains in place, against a background of political uncertainty. Moreover, the slackness of manufacturing activity has increased, against the backdrop of the escalating protectionist tensions. In this setting, the Eurosystem revised its GDP growth projections slightly downwards for 2020 and 2021. Inflationary pressures have remained low. In the projection period, core inflation is expected to move on a rising trend underpinned by the continuing but relatively modest growth in activity, which would give rise to some rebound in firms' mark-ups following their recent compression.

In light of these developments, the ECB Governing Council adopted new monetary policy measures at its meeting on 6 June in order to support the convergence of the inflation rate towards its objective. Specifically, the Council changed its guidance about policy interest rates by announcing that these will hold at their current levels at least until the first half of 2020, six months later than previously communicated. Further, it laid out the details still to be defined concerning the rates applicable to the new targeted long-term-term refinancing operations (TLTRO-III). On 18 June, the President of the ECB indicated the institution's readiness to adopt new stimulus measures if necessary, which reinforced the above-mentioned downtrend in sovereign debt market yields.

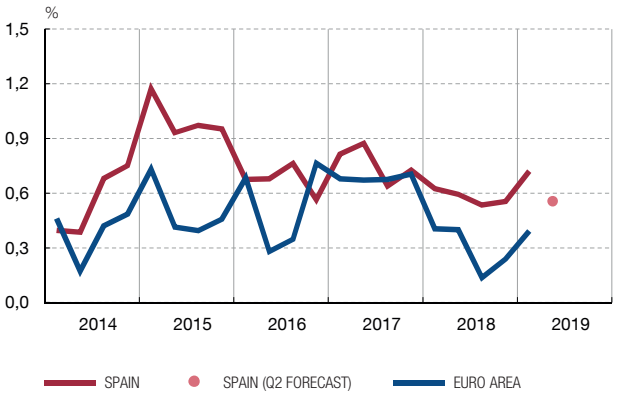
In contrast to the relative weakness of the euro area, the Spanish economy has remained robust. In Q1, on provisional data, Spanish GDP grew by 0.7% (0.3 pp more than the euro area).[1] The information available to date suggests that the increase in output

1 See Box 1.2 of the Banco de España Annual Report 2018 ("The resilience of the Spanish economy to the downturn in the external enviroment").

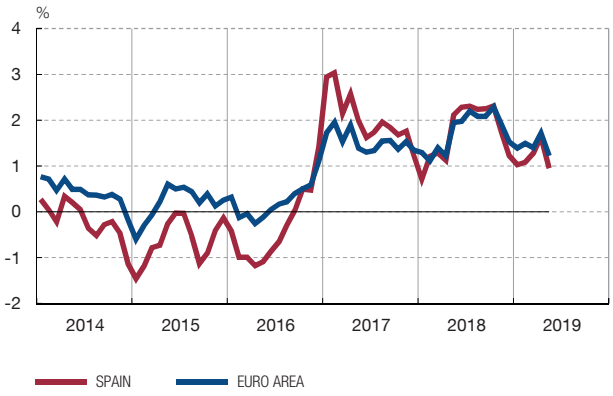
SPAIN: ACTIVITY REMAINS BUOYANT AND CONSUMER PRICES ARE HOLDING AT A LOW RATE OF INCREASE (a) CHART 1

Despite the slight slowdown in expected growth for Q2, activity in Spain continues to post higher rates than in the euro area. Consumer prices continue to grow at a moderate rate, somewhat below that for the euro area as a whole.

1 GROSS DOMESTIC PRODUCT (b)



2 HARMONISED INDICES OF CONSUMER PRICES



SOURCES: Eurostat, INE and Banco de España.

a Quarter-on-quarter rates of change on the seasonally adjusted series in the case of GDP, and year-on-year rate of change on the original series, in the case of the consumer price indices.
b The figure for Q2 is a Banco de España projection.

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in Q2 may be 0.6% in Spain (compared with the more marked slowdown in the euro area). Employment in the Spanish economy appears to have slowed over the quarter to a greater extent than activity. In particular, Social Security registrations in May showed some loss of momentum.

The sustained activity is being supported by the continuing buoyancy of domestic demand. The ongoing improvement in households' and firms' financial situation, along with the persistence of loose financial conditions (despite the emergence of signs that banks might be starting to apply stricter lending standards), continue to underpin private agents' spending. Going forward, the pace of private consumption might ease somewhat, in view of the likely increase in households' propensity to save – given the low level of saving – and of the slowdown in consumer credit that has already begun to be seen. Nonetheless, the rise in real wages will, on the contrary, tend to support this expenditure component.

The buoyancy of private domestic demand contrasts with the weakness of exports. Goods exports have continued to perform unfavourably, influenced by the slowdown in international trade and in global industrial activity. In turn, these developments are probably related to the escalation in protectionism. One sector that is contributing significantly to weighing down sales to the rest of the world is the car industry. Since last summer the sector has been affected by various shocks. Conversely, following the significant slowdown observed over much of 2018, exports of tourist services have since late last year been more expansionary. Imports from the rest of the world have felt the impact of the weakness of exports, given the high import content of this demand component. In the very short term, the sluggishness of sales to the rest of the world is likely to continue, judging by the adverse trend of foreign order books.

MAIN SPANISH MACROECONOMIC AGGREGATES (a) TABLE 1

			2018				2019	
	2017	2018	Q1	Q2	Q3	Q4	Q1	Q2
National Accounts								
Quarter-on-quarter rate of change, unless otherwise indicated								
Gross domestic product	3.0	2.6	0.6	0.6	0.5	0.6	0.7	0.6
Contribution of national demand (b)	2.9	2.9	0.8	0.8	0.5	0.3	0.5	0.7
Contribution of net external demand (b)	0.1	-0.3	-0.2	-0.2	0.0	0.3	0.2	-0.2
Year-on-year rate of change								
Employment	2.9	2.5	2.6	2.5	2.4	2.6	2.8	2.4
Price indicators (c)								
Harmonised index of consumer prices (HICP)	2.0	1.7	1.1	1.8	2.3	1.8	1.1	1.3
Harmonised index of consumer prices excluding energy and food	1.2	1.0	1.1	1.0	0.9	1.1	0.8	1.2

SOURCES: INE and Banco de España.

a Information available to 22 May 2019. The shaded cells in grey are Banco de España projections.
b Contribution to the quarter-on-quarter rate of change of GDP, in percentage points.
c The figure for 2019 Q2 is the average of the April and May year-on-year rates.

Core inflation has yet to feel the impact of the increase in price pressures which, a priori, might be expected as a result of the rise in labour costs and of the sustained robustness of demand. The rate of change of the HICP, excluding food and energy, remains at below 1%. This is in contrast to the rise in wages and to the gradual widening of the positive output gap. The overall indicator has also fallen below this level in May, as a result mainly of the slowdown in electricity and fuel prices. And, given the expected path of oil futures, the HICP may be expected to weaken further during the second half of the year.

The baseline scenario of the latest Banco de España projections envisages a prolongation of the upturn.[2] Underpinning this outlook is the fact that the sustained increase in activity observed to date has been compatible first, with the maintenance of certain macrofinancial equilibria, such as the improvement in external competitiveness, mirrored in the persistence of a surplus vis-à-vis the rest of the world; and further, with the continued ongoing correction of certain other variables, such as private-sector debt. Also adding to this projected favourable trend is the prospect that the accommodative monetary policy stance will continue to be conducive to the maintenance of highly favourable financial conditions. Moreover, under the assumptions used in the projections exercise about the growth of export markets (drawn from the latest Eurosystem projections[3]), in the absence of fresh shocks such growth is expected to pick up gradually as from the final stretch of this year.

This scenario is subject, however, to significant downside risks. These stem essentially from the external setting of the Spanish economy. In particular, as noted, recent weeks have seen a heightening of the trade tensions between the United States and China. This has led to an increase in the likelihood of an unsuccessful outcome for the negotiations currently under way. Moreover, the risks of a no-deal Brexit persist, which might have

2 See "June 2019. Macroeconomic projections for the Spanish economy (2019-2021): the Banco de España's contribution to the Eurosystem's June 2019 joint forecasting exercise".
3 See Eurosystem staff macroeconomic projections for the euro area, June 2019.

severe global consequences. Lastly, doubts have not been dispelled over the degree of effectiveness of the expansionary measures adopted by the Chinese authorities to boost activity in their economy. On the domestic front, a government has still not been formed following the elections held two months ago, meaning uncertainty over future economic policies prevails.

In the fiscal realm, the European Commission has recommended that the European Council abrogate the Excessive Deficit Procedure to which Spanish public finances have been subject over the past decade. However, the general government accounts remain in disequilibrium, which will require, according to the rules agreed by the EU Member States, the application of measures under the so-called preventive arm of the Stability and Growth Pact. Compliance with these obligations incurred with the rest of the European countries should act as a spur to step up budgetary consolidation. This is needed to shore up the resilience of activity and employment in the Spanish economy ahead of potential future shocks.

The price of a barrel of Brent has risen markedly to date this year. Specifically, from end-2018 to late April 2019, the oil price climbed 40%, to $75, the highest price for this commodity since October 2018 (that said, there has been a sharp decline subsequently) (see Chart 1). As this box sets out, the price rise seen in the first four months of the year is chiefly associated with various supply-side factors, including the recent cuts in production by OPEC and its partners, the US sanctions on Iran and the abrupt decline in Venezuelan output (see Chart 2).

Moreover, dearer crude between January and April may also have been partly in response to demand-side factors, insofar as it has been accompanied by a perception of some improvement in global activity. Initially, economic developments proved somewhat more favourable than expected at the start of the year. But the recent heightening of trade tensions has reignited doubts over the strength of global demand, which may have contributed to the fall in oil prices observed over the course of May.

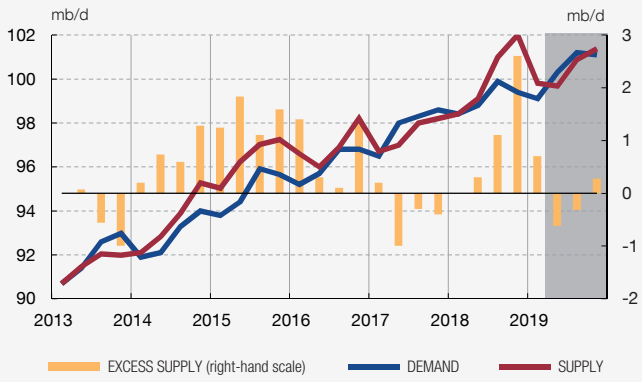
This box describes in detail the supply-side factors behind dearer crude in 2019 to date, and provides a quantification of the sensitivity of oil prices to shocks of this nature. One fundamental supply element when it comes to explaining price developments is the production strategy of OPEC and its partners (OPEC+). Last

Chart 1
OIL MARKET

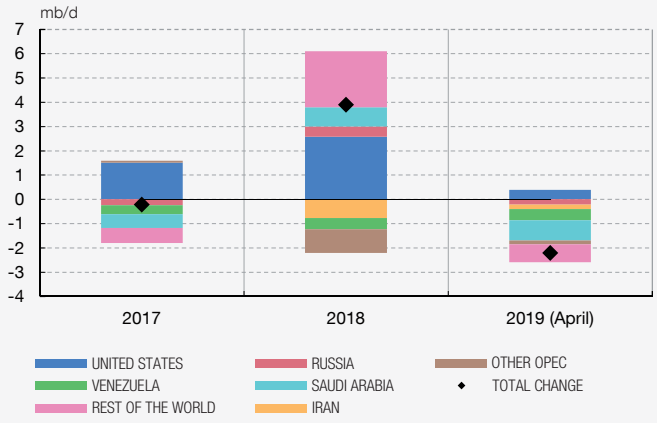
The price of a barrel of Brent has increased considerably in 2019. This rise is associated with the production cuts by OPEC+, with the US sanctions on Iran and with the sharp fall in Venezuelan output. The heightening of trade tensions in the recent period extends the doubts over the weakness of the global demand for oil.

1 OIL PRICES (BRENT)

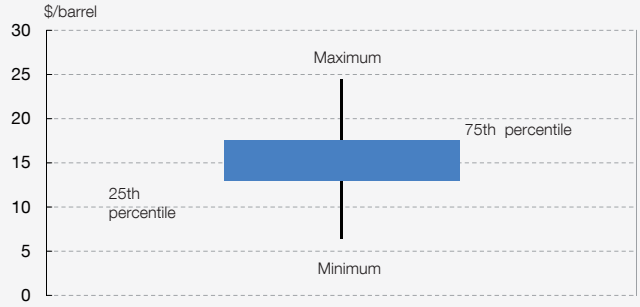
2 SUPPLY AND DEMAND (a)



3 CHANGE IN PRODUCTION (b)



4 IMPACT OF A PERMANENT SUPPLY SHOCK OF -1MB/DAY ON OIL PRICES



Range of simulations based on different Structural Bayesian VAR models

SOURCES: International Energy Agency, Bloomberg, IFS and own calculations.

a Supply projections calculated having regard to constant OPEC production.
b Q4 over Q4, except 2019: April over December.

December, OPEC+ agreed to cut crude oil extraction by 1.2 million barrels a day (mb/d), accounting for 1.2% of the global oil supply. This was an attempt to re-balance the market, after the rising trend in inventories and the decline in prices observed in the second half of 2018. Under the terms agreed, the OPEC countries' contribution to the cut would be 0.8 mb/d, and that of the non-OPEC members, 0.4 mb/d.[1] The aim of the agreement was to try and set a floor to the price per barrel of around $60 dollars. On data to April, the reduction in output is estimated to have exceeded the 0.4 mb/d agreed upon (see Chart 3).[2] At its forthcoming meeting in June, OPEC+ will have to decide, in view of market developments, whether it maintains the cuts and their size.

Another key factor behind the price rise is the resumption of US sanctions on Iran. These include, in particular, a halt in oil purchases from Iran.[3] As a result of the sanctions, Iranian oil production has dipped by almost one-third to 2.6 mb/d and might fall to a greater extent in the coming months (see Chart 3).

The third factor bearing on supply is the collapse of oil production in Venezuela.[4] True, Venezuelan crude oil production has been falling for almost two decades. But the decline has become more pronounced in the past three years, from 2.3 mb/d in January 2016 to 0.8 mb/d in April 2019 (see Chart 3). This slump has been in an environment of strong political tensions and a fresh round of US sanctions. In perspective, the factors behind this development would be related to the secular decline in investment and to the shortcomings in the management of firms in the sector. Looking ahead, against the backdrop of the difficult political context, the outlook is negative. That is due to financial difficulties and to the US sanctions, both of which factors prevent the necessary inputs being imported to maintain production and to check the progressive deterioration in the network of pipelines and infrastructure needed for extraction.

To assess the impact on crude prices of a worsening in the situation in Iran or Venezuela, a series of simulations have been performed with a set of ten alternative models. These consider different specifications of the price of a barrel of Brent in real terms based on a series of variables (world crude production, various indicators of global economic activity – as a proxy for demand – and oil inventories of the OECD countries).[5] The simulations show that a permanent unanticipated shock, consisting of a reduction in supply of 1 mb/d, would have an upward impact on the Brent per-barrel price of between $6 and $24, with the average effect around $15 dollars (Chart 4).

Against this background, if global demand for oil were to trend in line with International Energy Agency (IEA) projections, which were made before the recent rise in trade tensions, the market could tighten again in the short term. There could be possible upward risks to crude prices if the supply-side shocks described were to increase. However, in the medium term several factors can cap the rise in prices. First, OPEC and Russia might react with increases in their production to this hypothetical scenario of additional price rises. Hence, the Saudi authorities have suggested they might use a portion of their spare production capacity (some 2.2 mb/d) to accommodate supply. Moreover, the limited fiscal leeway of some of the OPEC+ members will foreseeably contribute to encouraging increases in production (although given their downward impact on prices, it is not obvious they will achieve their revenue-raising objective). Lastly, shale-oil production in the United States will continue growing, which might consolidate this country's position this year as the leading global oil producer and turn it into a net oil exporter.[6]

In sum, there are arguments that the increase in prices observed until end-April might conceivably respond to supply fluctuations. In the medium term, it is likely that several of the producer countries signatory to the agreement to cut output may not wish it to hold over time. And this, along with the supply of shale oil in the United States, would tend to restrict the rise in crude prices, at the expense of the evolution of demand. In any case, the upcoming IEA forecasts may portray a less favourable demand scenario, reflecting the forces that appear to have characterised recent oil market developments. That would add a downward risk to the price of this commodity.

1 In any event, Iran, Venezuela and Libya were exempt from production cuts.

2 In particular, Saudi Arabia's production has been 0.5 mb/d below its assigned target, while Russia, conversely, showed a compliance rate of only 80%.

3 Iran has the fourth biggest reserves in the world after Venezuela, Saudi Arabia and Canada. Whereas before the Iranian revolution in 1979 production rose to 6 mb/d, it subsequently fell drastically, recovering partly only after the lifting of the embargo in 2015, to 3.8 mb/d at the start of 2018, 4% of global supply. In principle, it was expected that the entry into force of the sanctions on oil purchases would be in November 2018. However, the US administration introduced exemptions, which expired in early May.

4 Venezuela, according to its authorities, has the biggest crude oil reserves in the world, some 300 billion barrels of heavy crude. However, much of these reserves have very high production costs. According to alternative sources, Venezuela's economically viable oil resources with per-barrel prices of $50 would only amount to 75 billion barrels.

5 These models use a Bayesian Structural VAR (BVAR) methodology with sign restrictions. The identification used allows a distinction to be drawn between supply shocks, global demand, speculative demand and idiosyncratic oil demand factors. In any event, it should be pointed out that the modelling of oil prices is not trivial, as academic debate shows, and the conclusions may change significantly depending on the model used.

6 Admittedly, however, other factors would tend to limit the downward pressures on prices. Firstly, there are doubts in the market about Saudi Arabia's capacity to expand its output in a sustained manner, and about the possibility of OPEC replacing the crude oil varieties produced by Iran and Venezuela. Secondly, shale-oil extraction in the United States is highly sensitive to prices; thus, if prices fall that would translate into output reductions.

The Chinese economy has experienced a slowdown in recent years. This stepped up in the second half of 2018 as a result, initially, of the measures previously adopted to reduce the high debt in the private sector and, shortly after, of the growing trade tensions with the United States. Consequently, Chinese, GDP growth has eased from year-on-year rates of over 10% at the start of the decade to 6.4% in 2019 Q1, the lowest rate since the global financial crisis (see Chart 1.1).

To address this downturn in activity, the authorities have implemented a series of expansionary demand-side policies since mid-2018. These have been strengthened following the March 2019 meeting of the National People's Congress (the legislative body), where, moreover, the growth target was lowered to a range of 6%-6.5% (from 6.5% previously). Specifically, the legislative body resolved to make fiscal policy more expansionary, whereas monetary policy would retain an accommodative but prudent stance, with a view to mitigating financial risks. On the fiscal front, a stimulus package of around 2% of GDP was incorporated. The stimulus would be through cuts in VAT and in Social Security contributions, and a raising of the local government debt ceiling (the quotas for special bond issuance have increased by over 50%), in order to boost infrastructure investment (see Chart 1.2). As regards monetary policy, the central bank has kept benchmark interest rates unchanged, but it has cut the reserve requirement ratio by 350 bp since 2018, placing it at 13.5% (see Chart 1.3). Furthermore, it has introduced two facilities: one is aimed at promoting the granting of medium-term loans to private companies, especially to SMEs; and the other enables commercial banks to replace perpetual bonds with central bank securities, thereby shoring up their capital and affording them greater liquidity, since the securities are eligible as collateral in the central bank's lending facilities. Compared with the stimuli applied in the global financial crisis and in the 2015-16 slowdown, the current measures are on a lesser scale, with a more contained monetary and credit impulse. Further, unlike the previous episodes, financial regulations and housing market controls are now stricter, which mitigates the risks to financial stability although, in turn, this limits the effectiveness of the stimulus.

At the start of the year, these measures appeared to have managed to stabilise the economy, with somewhat higher than expected growth recorded in 2019 Q1. However, activity appears to be turning down again at the start of Q2, which raises some doubts over the effectiveness of the policies implemented (see Chart 1.4). Admittedly, on one hand, there is normally some lag between the time at which the measures are adopted and when they begin to take effect; and, on the other, moreover, the fiscal package has not yet been fully rolled out. Nonetheless, the moderate impact of the measures adopted might be due to the fact that around half of the fiscal expansion has been implemented through tax cuts. That tends to reduce policy effectiveness in conditions of uncertainty, insofar as households and firms tend to save the resulting extra income.

In any event, the risks to economic growth in China are clearly tilted to the downside. In the external arena, the heightening of the trade war with the United States may check growth considerably. The United States account for almost 23% of total Chinese exports (4.2% of GDP). Accordingly, the trade tensions might significantly harm the Asian giant's economy. The damage would not only be through the tariffs channel, but also through other indirect channels, such as financial market confidence, the re-location of certain segments of global production chains and the effects on productivity. On the domestic front, the main challenge lies in correctly calibrating the stimuli stemming from economic policies. These must strike an appropriate balance between prudence and ambition, so as to effectively reduce the risks to short-term growth and, at the same time, prevent an increase in medium and long-term imbalances, which raises the risks of a more abrupt adjustment in the future. China would, then, be retaining some room for manoeuvre to further reinforce its expansionary demand-side policies should it have to face a more unfavourable environment. Specifically, new monetary policy measures cannot be ruled out. These might include, for example, further cuts in the reserve requirement or action through the credit mechanisms that channel liquidity to the sectors most affected. On the fiscal policy side, further stimuli will likely be announced in the coming quarters, chiefly involving cuts in VAT rates and in Social Security contributions, and higher infrastructure investment.

In any event, the space for potential demand-side policy measures has shrunk in recent years, owing to the increase in the Chinese economy's debt. The non-financial sector's debt/GDP ratio has grown by 120 pp in 10 years to 260% of GDP in 2018, and the deleveraging measures adopted in the past two years have managed to stabilise this ratio (see Chart 1.5). In the short run, the volume of debt will foreseeably resume its rising path, owing both to the recent measures to boost credit and to promote public investment in infrastructure, and to the lower growth outlook. That all entails greater risks to financial stability in the medium and long term.

In the monetary policy realm, the central bank does have tools to boost liquidity and credit. But the main obstacle lies in the limited effectiveness of the transmission mechanism, based on quantitative and credit-control instruments. These instruments are biased towards large corporations and entities linked to the public sector, meaning financial system reforms are needed to enable balanced access by private firms to financing. Moreover, as regards exchange rate flexibility, there are also constraints arising from the fear of capital outflows and of the repercussions that a heavy depreciation of the renminbi would have for the trade tensions with the United States.

Despite the fact that the official budget deficit and public debt ratios are not very high (3.9% and 37% of GDP, respectively), there is less fiscal space available if regard is had to a broader perimeter of the public sector and its contingent liabilities, along with other items, especially those pertaining to local governments and their financing vehicles. The IMF estimates that, with a broader definition than the usual one, the budget deficit would have been

To address the downturn in activity derived from the measures adopted to reduce China's high debt and, also, from the growing trade tensions with the United States. the authorities have applied a series of demand-side policies since mid-2018. However, the room for manoeuvre for these policies is increasingly smaller.

Chart 1
GDP by component

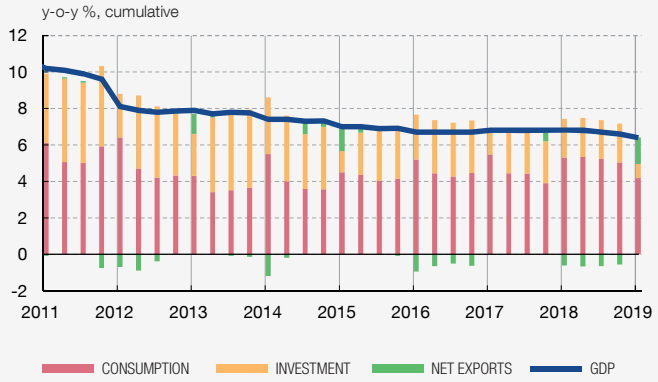


Chart 2
EXPANSION OF FISCAL STIMULUS: CUTS IN TAXES AND CHARGES

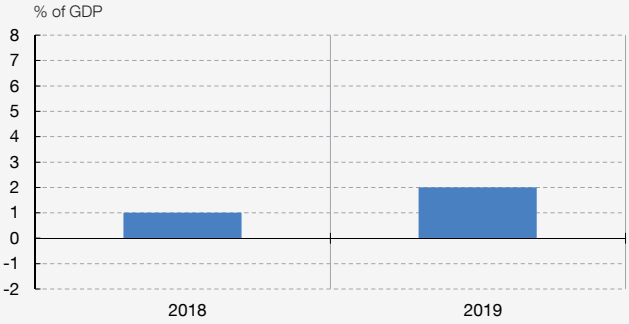


Chart 3
RESERVE REQUIREMENT RATIO FOR LARGE BANKS

Chart 4
KEY INDICATORS

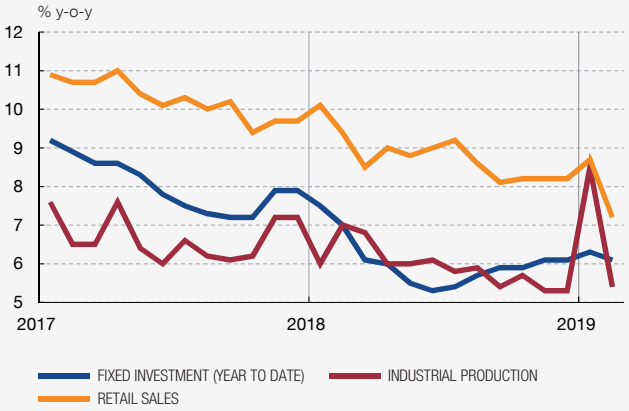


Chart 5
DEBT BY SECTOR

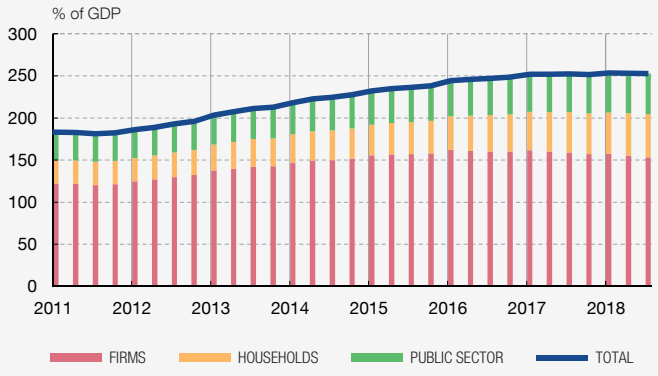
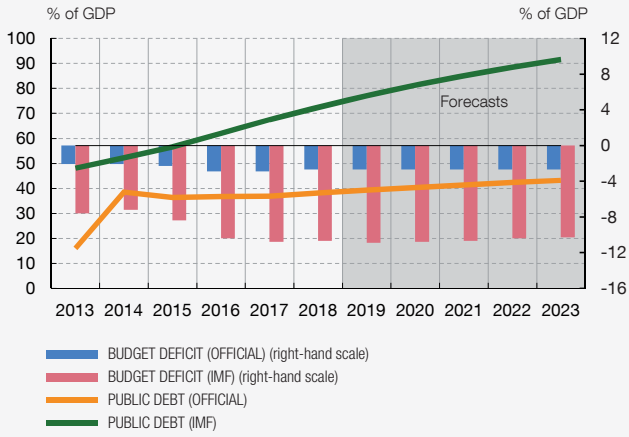


Chart 6
CHINA'S FISCAL SPACE IS LESS THAN OFFICIAL FIGURES SUGGEST



SOURCES: IMF, BIS and CEIC.

close to 10% of GDP last year, while public debt would have risen to 67.5% of GDP (see Chart 1.6). Compounding this in the medium term are the pressures on public finances stemming from population ageing, and from lower potential growth.

Against this background, Chinese economic policy should focus on structural reforms. Indeed, mindful of the limitations of demand-side policies, the Chinese authorities have so far opted for gradualism and for limiting the size of the stimuli applied. However, if growth were to be further impacted and measures on a greater scale were adopted, that might exacerbate the risks to financial stability. Ahead of this, the authorities should opt to promote comprehensive structural reforms that manage to reduce leveraging and enhance the efficiency of credit allocation, introducing greater competition into the markets and reconsidering the role of State companies.

At the end of 2018, the US Federal Reserve embarked on a shift in its monetary policy stance, which until then had followed a progressively tightening path. This shift appeared to have a significant impact on world financial markets, in particular contributing to reversing the downward trend observed in the stock markets of the main advanced and emerging market economies in the last four months of 2018. This episode underlines the importance of analysing the effect that US monetary policy shocks can have on the macro-financial conditions of all the other economies. It is also important to understand to what extent these shocks shape monetary policy in other jurisdictions, especially through short-term interest rates or, where these are close to their effective lower bound, medium and long-term rates.

This box analyses the global macro-financial effects of US monetary policy by estimating a global vector autoregressive (GVAR) model.[1] With the model, which comprises a network of interdependent economies that account for more than 90% of world GDP, it is possible to analyse the spillover effects of US monetary policy, considering not only its effects in the countries at the receiving end, but also the effects of the rest of the world on the US economy (spillback effects).

In the GVAR model, the macro-financial conditions of each economy are affected by domestic and external factors. The external factors may stem from another economy, as in the case of US monetary policy, or from global variables, as in the case of oil price fluctuations. Specifically, each economy is represented by a VAR model that includes the following national quarterly macro-financial variables: GDP, inflation, short and long-term interest rates, a stock market index and an effective exchange rate. The model also captures interaction between economies, as it includes a set of external variables, calculated as weighted averages of the domestic variables of the other countries, with the weightings based on bilateral trade flows, to reflect the relative importance of the other countries for each economy. Lastly, it also includes oil prices, which are relevant both for inflation and monetary policy, as a common factor to all countries.

Once estimated, the model is used to simulate an expansionary shift in the US monetary policy stance, in the form of a cut in the US short-term interest rate of 25 bp on impact.[2] Chart 1 shows the responses of US variables (medians and confidence bands at 68%) and, for purposes of comparison, the responses for the rest of the world, obtained by aggregating the individual responses of the other economies, weighted by GDP. The expansionary monetary shock has the following effects in the United States: on impact, GDP growth and inflation increase (by 0.2 pp in both cases), the dollar depreciates (by 2%) and stock market prices rise (by approximately 4%). More interesting, for the purposes of this box, are the macroeconomic and financial effects of the US monetary shock on the rest of the world. In particular, global GDP growth (excluding the United States) rises by 0.4%, that is, by even more than in the US economy itself, while stock market prices increase by 5% on impact and by up to 8% after one quarter.

This evidence confirms previous findings in the literature on the international effects of monetary shocks in the US economy.[3] These findings are consistent with the idea that US monetary policy shifts drive a global financial cycle, with the main implication being that monetary policy shocks in the United States trigger international synchronisation of financial asset prices and volumes.[4]

In order to explore whether a flexible exchange rate isolates other countries' monetary policy from the effects of US monetary policy, each economy is classified according to whether or not its currency is effectively anchored to the US dollar.[5] The effects at a country level are then aggregated into two groups, according to whether the exchange rate is flexible or is anchored to the dollar, weighting the different economies according to their share of the total GDP of each group. Chart 2 shows the medians of the maximum effects (minimum effects in the case of negative responses) for the two groups and the average effect at a global level. It is observed that the effects on GDP growth and stock market prices are more pronounced in the case of economies whose currencies are pegged to the dollar. At the same time, the effects on economies with flexible exchange rates are considerable, and in the case of inflation quite similar to those observed for

1 See S. Dées and A. Galesi (2019), "The Policy Trilemma and the Global Financial Cycle: Evidence from the International Transmission of Unconventional Monetary Policy", mimeo.

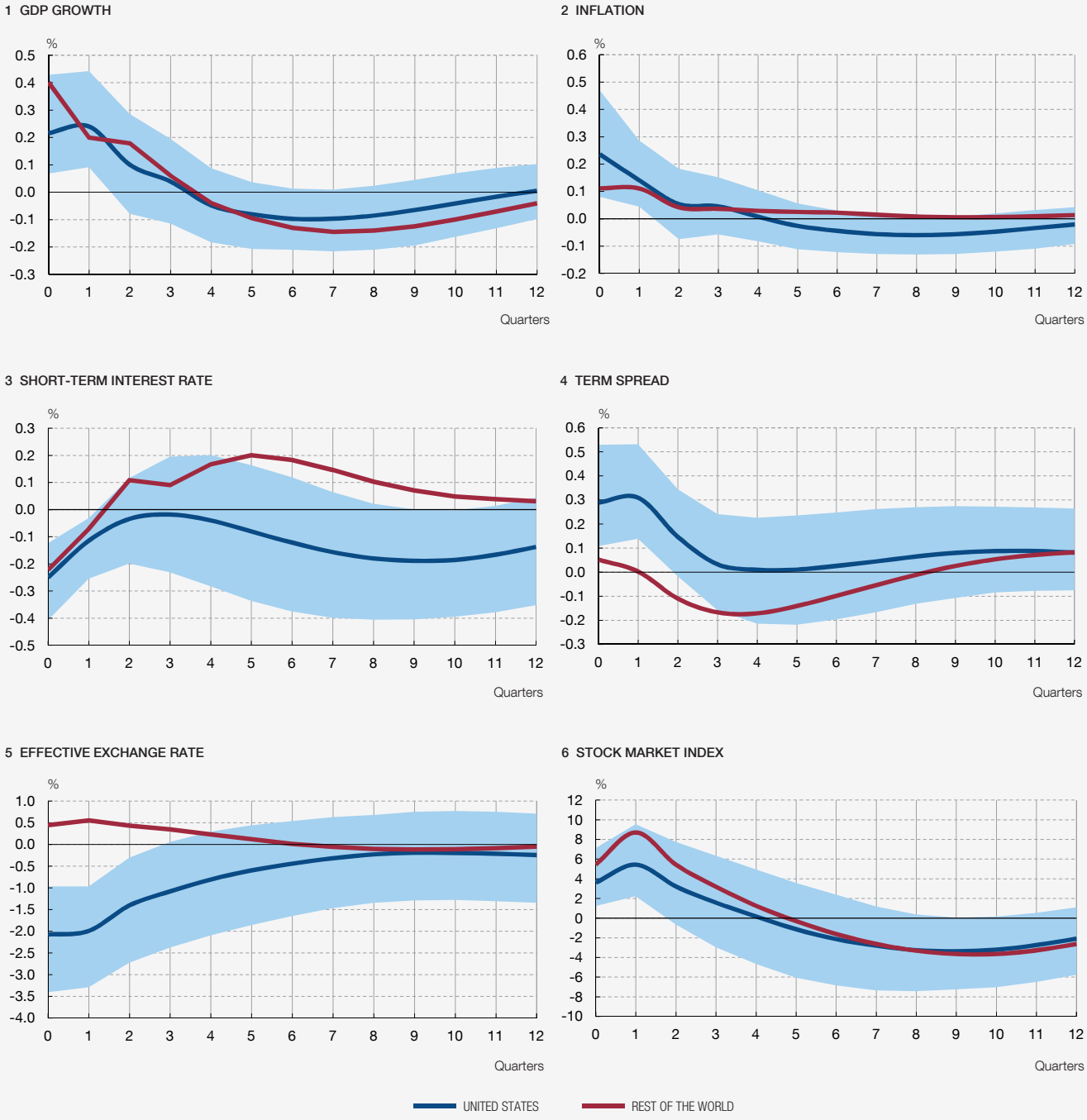
2 Identifying US monetary policy shocks consists in imposing sign constraints on the responses of US variables. An expansionary shock that reduces the short-term interest rate (and, to a lesser extent, the long-term rate) entails, both on impact and one quarter after the shock, increases in GDP growth, inflation and share prices, and also a depreciation of the dollar. As the strategy places no constraints on other countries' variables, it is completely agnostic as to the size and sign of the effects on the rest of the world.

3 Several studies have found that an expansionary shift in US monetary policy drives economic activity in many of the countries of the rest of the world. See, in particular: G. Georgiadis (2016), "Determinants of global spillovers from US monetary policy", *Journal of International Money and Finance* 67, pp. 41-61; L. Dedola, G. Rivolta and L. Stracca (2017), "If the Fed sneezes, who catches a cold?" *Journal of International Economics* 108, pp. 23-41; and M. Iacoviello and G. Navarro (2019), "Foreign effects of higher US interest rates", *Journal of International Money and Finance* 92, pp. 232-250.

4 The transmission mechanisms of the global financial cycle are several and complex, owing for instance to the presence of frictions in the credit channel, the presence of currency mismatch in commercial banks' balance sheets or the "fear of floating" of monetary authorities in economies with flexible exchange rates. See H. Rey (2016), "International channels of transmission of monetary policy and the Mundellian trilemma", *IMF Economic Review*, 64, pp. 6-35.

5 Using for this purpose the indicator developed in E. Ilzetzki, C. M. Reinhart and K. S. Rogoff (2017), "Exchange arrangements entering the 21st century: which anchor will hold?", National Bureau of Economic Research Working Paper No. 23134.

Chart 1
EFFECTS OF A UNITED STATES EXPANSIONARY MONETARY POLICY SHOCK ON THE UNITED STATES AND THE REST OF THE WORLD (a)



SOURCES: K. Mohaddes and M. Raissi (2018), "Compilation, Revision and Updating of the Global VAR (GVAR) Database, 1979Q2-2016Q4", University of Cambridge, Faculty of Economics, mimeo, and OECD Main Economic Indicators. Compiled drawing on S. Dées and A. Galesi (2019), "The Policy Trilemma and the Global Financial Cycle: Evidence from the International Transmission of Unconventional Monetary Policy", mimeo.

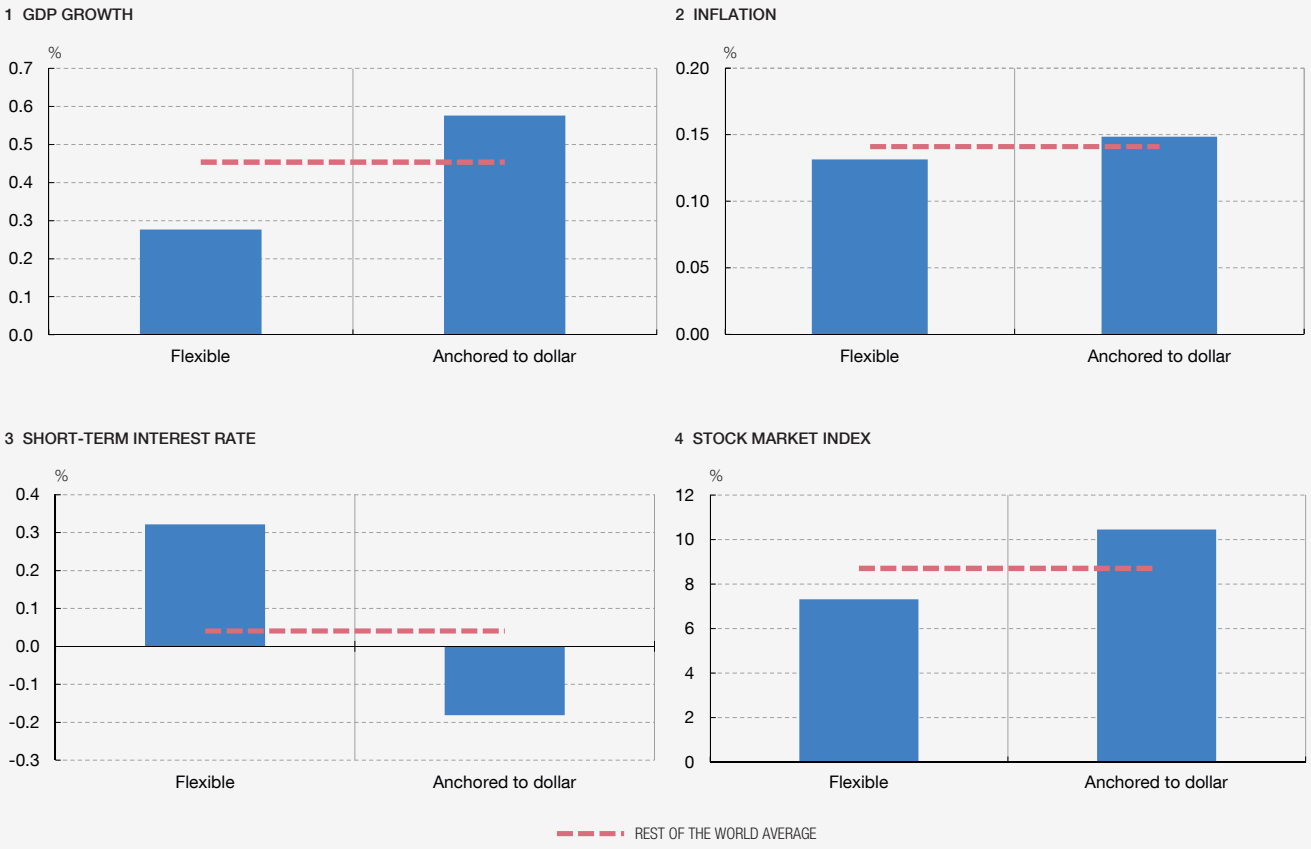
a Impulse responses of US variables, medians and confidence bands at 68%, to a US expansionary monetary policy shock that cuts the US short-term interest rate by 25 bp on impact. For purposes of comparison, the median responses for the rest of the world are shown, obtained by aggregating the responses of the other economies weighted by GDP.

economies with exchange rates pegged to the dollar. According to the logic of the global financial cycle, beyond the commercial effects, the credit channel is key to understanding these findings: US monetary policy easing drives up prices of financial assets, which in turn improves the financial position of banks and eases their financial conditions. This improvement in financial conditions translates into increased credit, which drives up activity and prices.[6] The main difference between the two groups of economies in Chart 2 is the short-term interest rate response: while central banks of countries whose currencies are pegged to the dollar cut interest rates to prevent exchange rate appreciation, monetary authorities in economies with flexible exchange rates raise interest rates to counteract the rise in inflation.

In short, the evidence presented in this box suggests that, even though the macroeconomic effects are greater in economies whose currencies are pegged to the dollar, US monetary policy has a major impact on all economies, including those that adopt a flexible exchange rate.

6 See H. Rey (2016), op cit.

Chart 2
EXCHANGE RATE REGIME AND EFFECTS OF A UNITED STATES EXPANSIONARY MONETARY POLICY SHOCK (a)



SOURCES: K. Mohaddes and M. Raissi (2018), "Compilation, Revision and Updating of the Global VAR (GVAR) Database, 1979Q2-2016Q4", University of Cambridge, Faculty of Economics, mimeo, and OECD Main Economic Indicators. Compiled drawing on S. Dées and A. Galesi (2019), "The Policy Trilemma and the Global Financial Cycle: Evidence from the International Transmission of Unconventional Monetary Policy", mimeo.

a Medians of the maximum effects (minimum effects in the case of negative responses) for both groups - flexible exchange rate and exchange rate anchored to the dollar - and average for the effect at a global level.

The dynamics of corporate mark-ups are one of the proxies generally used to explain changes in inflation, such that prices in the economy can be understood to be the results of firms applying a mark-up to their labour costs. The virtue of this approach is that although labour costs only account for some 20% of the cost structure of manufacturing firms, and for 40% in the case of firms in the services sector, these figures rise to almost 90% excluding inputs. Accordingly, when value added deflators, which exclude the cost of inputs, are analysed at aggregate level, changes in unit labour costs (that is, employee compensation corrected for productivity gains) are understood to be a fundamental determinant of future changes in prices.

Nevertheless, a wealth of evidence in the empirical literature advises caution regarding the stability of the relationship between labour costs and prices, and the shorter the time horizon of the analysis of changes in these two variables, the greater the caution advised. Much of this evidence relates to the United States, where numerous studies suggest that it is difficult to perceive a close link between changes in unit labour costs and changes in price indicators, and even that the causal relationship could be the opposite, with labour costs responding to changes in prices rather than vice versa.[1] There are also studies that argue that the relationship between cost and price could have diminished compared with previous decades, since independent monetary policy would have given rise to better anchoring of inflation expectations.[2]

In the case of the euro area, some recent studies suggest that the relationship between cost and price is closer than that observed in the United States, but that the degree of pass-through of costs to prices is incomplete and depends, among other factors, on the type of shocks predominant in the economy. For instance, a closer relationship is frequently found if demand shocks rather than supply shocks predominate. The degree of pass-through of costs to prices also depends on the inflation regime, with a lower degree of pass-through perceived in low inflation environments (Bobeica et al, 2019).[3]

Chart 1 depicts the GDP deflator and its labour cost and corporate mark-up components in the euro area since the start of the current upturn.[4] At first, as the chart shows, unit labour costs continued to post very moderate rates of growth (around 0.7% on average), at the same time as unit margins were rising, albeit at a modest pace. Towards the end of 2017 labour costs began to increase significantly, against the backdrop of a persistent decline in unemployment rates in the euro area as a whole and flat or even negative productivity growth (see Chart 2), while margins began to contract. As Chart 3 shows, a low degree of pass-through of labour costs to prices is also observed using consumer price indicators, and it has tended to intensify in the most recent period.

Although the performance of mark-ups through the cycle also depends on the shocks affecting the economy,[5] in the case of the euro area a relatively close and positive relationship is perceived between mark-ups and economic growth (see Chart 4), as mark-ups tend to increase in upturns and decrease in downturns.

In the most recent period, the slowdown in the rate of growth has been associated with a contraction in margins, a phenomenon not seen since mid-2012 when the economy was in the throes of the sovereign debt crisis. This margin contraction has had different levels of intensity in the four large euro area economies (see Chart 5). It should be noted, however, that the starting point may differ, as in some countries, such as Spain for instance, the adjustment of labour costs made during the crisis enabled margins to grow. Also, for the euro area aggregate, the margin contraction extends across all sectors of activity, with the exception of construction (see Chart 6).

Overall, the low inflation environment in the euro area, together with the heightened uncertainty regarding the strength of demand, could explain why firms remain highly cautious about passing higher labour costs through to prices.

1 R. Bidder (2015), "Are wages useful in forecasting price inflation?", *FRBSF Economic Letter,* 33; Y. Mehra (2000), "Wage-Price Dynamics: Are They Consistent with Cost Push?", *FRB Richmond Economic Quarterly* 86 (3); and G. Hess and M. Schweitzer (2000), "Does Wage Inflation Cause Price Inflation?", FRB Cleveland Policy Discussion Paper 1.

2 E. Peneva and J. Rudd (2015), "The Passthrough of Labor Costs to Price Inflation", Federal Reserve Board, Finance and Economics Discussion Series Paper 2015-042.

3 In the case of the euro area, E. Bobeica, M. Ciccarelli and I. Vansteenkiste (2019), in "The link between labor cost and price inflation in the euro area", ECB Working Paper No. 2235, find a causal relationship between labour costs and prices (Granger causality) that has strengthened over time. These findings are consistent with the main conclusions drawn from the surveys of firms conducted in the framework of the Wage Dynamics Network (WDN) (see ECB (2009), "Wage Dynamics in Europe", Final Report of the Wage Dynamics Network), which suggest that a high percentage of firms adjust their prices when faced with a permanent unexpected labour cost shock.

4 It is very difficult to measure corporate profits. This box uses as a mark-up indicator the ratio of GDP deflator to unit labour costs, which aims to proxy the relationship inferred in economic theory between prices and marginal production costs. In view of the difficulty of proxying these marginal costs, Spanish National Accounts use average costs and, more simply, labour costs. This ignores, for example, the contribution made by capital and financial costs, which may be very significant in the current low interest rate environment. In this respect, there are alternative profit measures, analysed in detail in V. Salas, L. San Juan and J. Vallés (2017), "The financial and real performance of non-financial corporations in the euro area: 1999-2015", Banco de España Occasional Paper 1708.

5 C. Nekarda and V. Ramey (2013), "The Cyclical Behavior of the Price-Cost Markup", Working Paper 19099, National Bureau of Economic Research.

Chart 1
EURO AREA. GDP DEFLATOR, UNIT LABOUR COSTS AND MARK-UPS (a)
Year-on-year growth

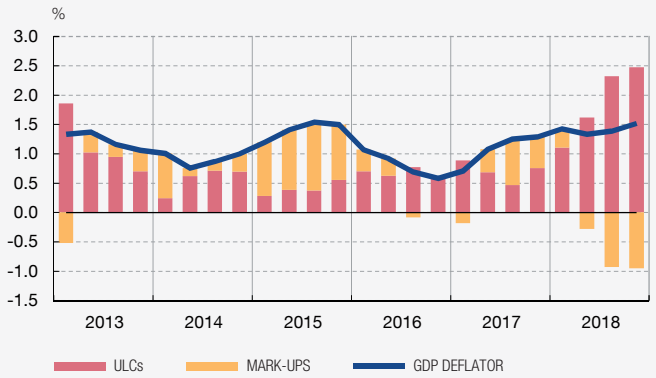


Chart 2
EURO AREA. PRODUCTIVITY AND COMPENSATION PER EMPLOYEE
Year-on-year growth

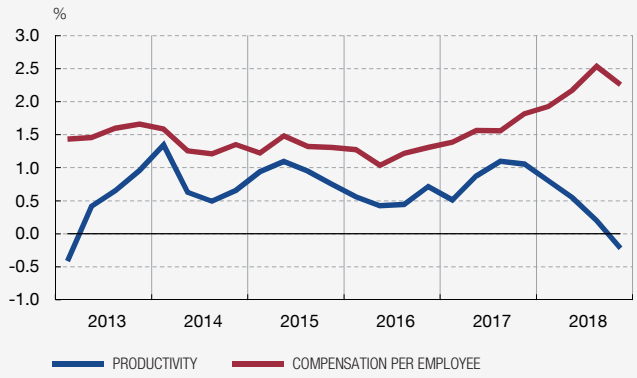


Chart 3
LABOUR COSTS AND CORE HICP (1997-2018)
Year-on-year growth

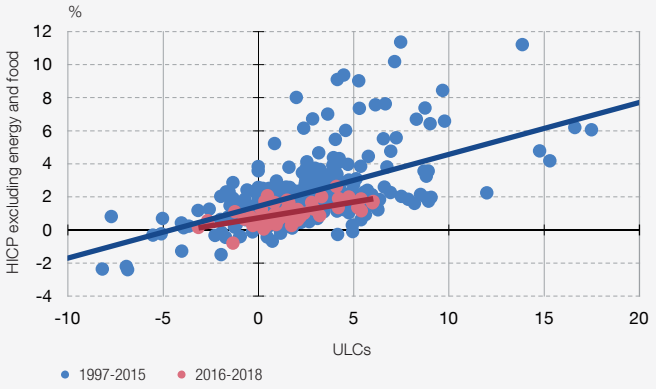


Chart 4
EURO AREA. GDP AND MARK-UPS
Year-on-year growth

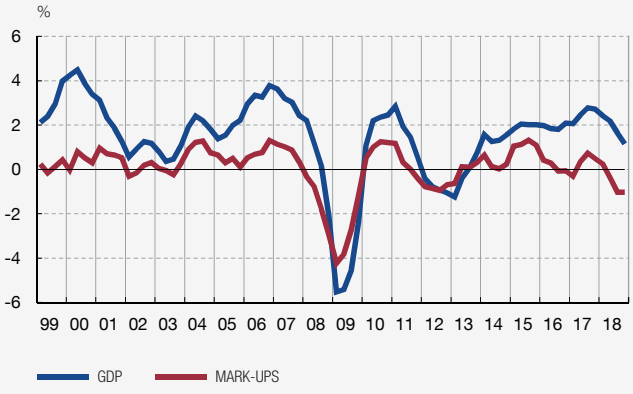


Chart 5
MARK-UPS
Year-on-year growth

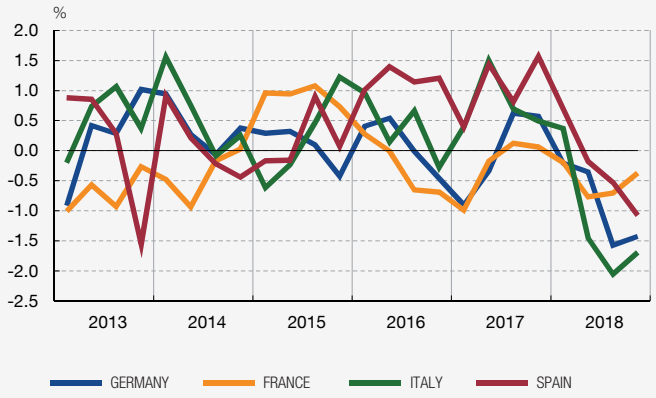
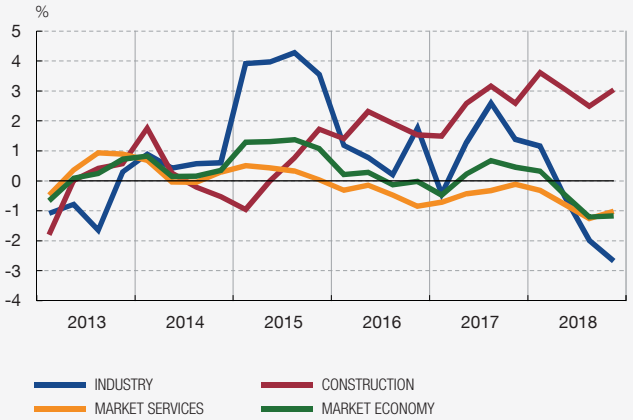


Chart 6
EURO AREA. MARK-UPS
Year-on-year growth



SOURCE: Eurostat.

a Mark-ups are defined as the ratio of the GDP (or GVA) deflator to ULCs.

The weakness shown by the euro area car industry from summer 2018 has continued in the year to date as a result of a combination of various factors. On the supply side, the entry into force of the new WLTP emissions regulations in the European Union (EU) in September 2018 caused some disruption to the manufacturing process due to the need to comply with the new legal requirements.[1] Also, the demand for motor vehicles made in the EU has been affected both by cyclical factors (such as the downturn in car purchases in some of the main emerging economies) and by more persistent influences (including particularly the uncertainties surrounding the dominant technology in the future and the possibility of further regulatory changes).

The car industry is extremely important in the euro area economies. This is particularly so in Germany, where it represents approximately 5.5% of total value added, a percentage which drops in Spain to 1.8% (although this is still twice the euro area average).[2] Furthermore, a high proportion of the industry's production of both final and intermediate goods is exported, making it highly dependent on foreign demand. Specifically, car industry exports represent, in gross terms, 17.7% of total sales of goods to the rest of the world in Germany, 12.1% in Spain and 4.3% in the euro area as a whole.

This box examines the propagation of a shock in car manufacturing in each of the four largest euro area economies to other industries of the country concerned and to the car industry and other industries of the other euro area countries. In this respect, it should be noted that the car industry participates extensively in global value chains and that its production is thus highly fragmented.[3] The involvement of other industries and countries, depending on their specialisation, in the various phases of car manufacturing allows the comparative advantages of each of those actors to be harnessed. This has positive effects such as the reduction of costs and the transfer of knowledge, technology and innovation. The downside is that, because of the tight links between industries and countries, the propagation of shocks is faster and more complex to analyse.

Chart 1 illustrates the structure of the value chain in the manufacture of final goods in the car industry for each of the four main euro area economies. In Germany, nearly 70% of the value added of this industry is generated domestically, while the other 30% is generated abroad, mainly in other EU countries (such as France, Italy and certain eastern European economies). In Spain, the weight of domestic value added is considerably lower, standing at 48%, while the other 52% is generated mainly in Germany, France, Italy and other EU countries. In this situation it can be expected that a shock to production in Germany and Spain of a certain size affects most strongly the domestic economy in the case of Germany and other countries in the case of Spain. In Italy, the weight of domestic value added is similar to that in Germany, while France is in an intermediate position.

Given these interlinkages, it is important to quantify the impact of a shock to the demand for cars produced in one country on the

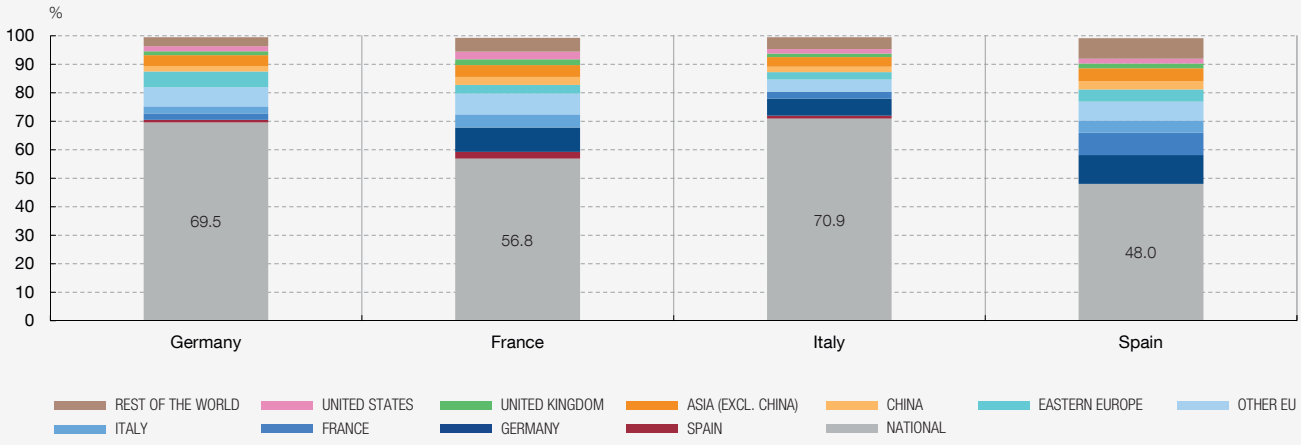
1 See Box "Impact of the new emissions regulation on the automobile market", Economic Bulletin, 4/2018, Banco de España.

2 Data taken from "Trade in Value Added (TiVA)" published by the OECD with information available to 2015.

3 See Prades E. and P. Villanueva (2017) "Spain in the global value chains" Analytical Article, Banco de España.

Chart 1
BREAKDOWN OF VALUE ADDED BY SOURCE FOR THE MANUFACTURE OF ONE UNIT OF OUTPUT

Value added contained in each country's car production, according to its source. In the case of the German car industry, approximately 70% of the value added contained is domestic, while the remaining percentage mainly comes from other EU economies and eastern European countries. In the case of Spain, the car industry is much more dependent on foreign value added, from Germany, France and Italy.



SOURCES: Banco de España calculations and WIOD 2016.

various industries of that and other countries which provide the inputs needed for car production.[4] Using the information in the world input-output database (WIOD),[5] the panels of Chart 2 illustrate the impact of a 10% fall in the demand for final goods in the car industry of each of the four economies considered. In the

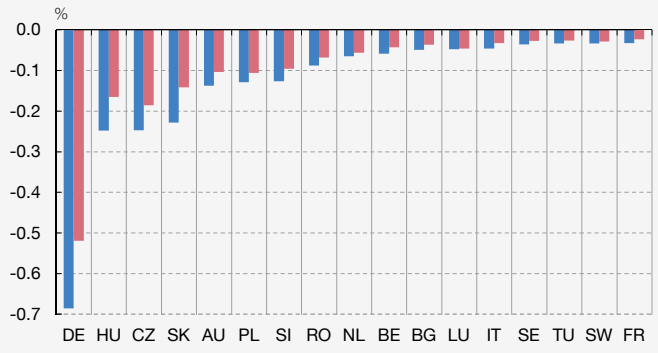
4 The exercise analyses the impact derived from a fall in vehicle production due to a fall in demand, which has an impact on all car industry suppliers. But it does not take into account the propagation to the industry's client industries (see Acemoglu et al (2016), "Networks and the macroeconomy: an empirical exploration". For an application to the Spanish economy, see Izquierdo, Moral-Benito and Prades (2019) "Propagation of sector specific shocks in Spain and other countries", forthcoming, Banco de España.

5 Specifically, the WIOD contains information, by country and sector, for the period 2000-2014. For more details on the construction of this global database, see Timmer et al. (2013) "Fragmentation, Income and Jobs. An analysis of European Competitiveness" and Timmer, M. P., Dietzenbacher, E., Los, B., Stehrer, R. and de Vries, G. J. (2015), "An Illustrated User Guide to the World Input–Output Database: the Case of Global Automotive Production", Review of International Economics., 23: 575–605.

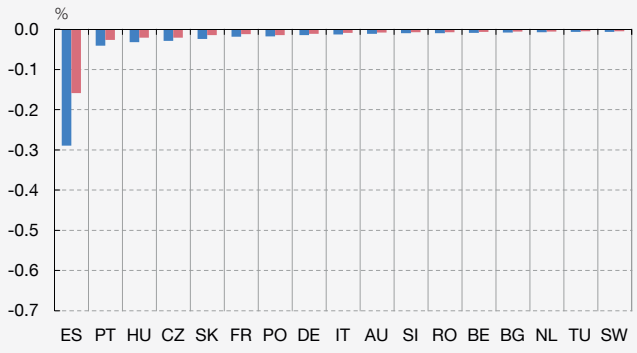
Chart 2
CAR INDUSTRY SPILLOVER EFFECTS IN THE EURO AREA (a)

A 10% decline in the demand for finished vehicles in each of the economies translates into an equivalent reduction in production. Given the integration of the car industry value chain, a decline in car production in each of the economies will have a knock-on effect on the industry itself (direct effect) and on other sectors and countries that provide the inputs needed for car manufacture (indirect effect). Germany and Spain are the countries that would suffer the greatest impact on their own gross output and value added, and would have the biggest knock-on effects on other economies, in particular in eastern Europe.

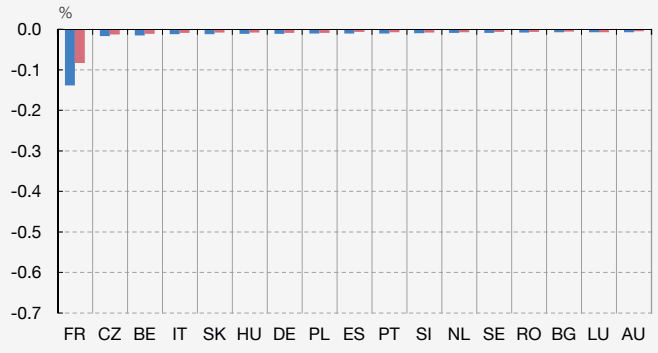
1 IMPACT ON ACTIVITY ARISING FROM A DECLINE IN OUTPUT IN THE GERMAN CAR INDUSTRY



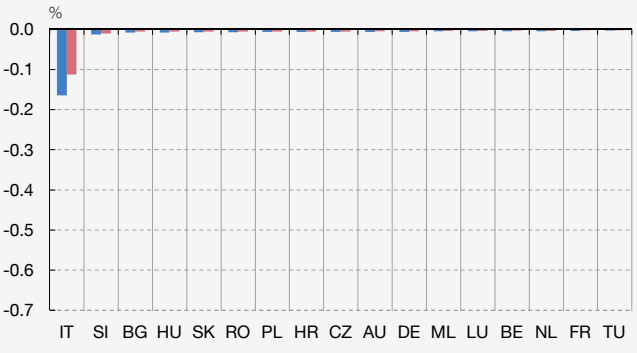
2 IMPACT ON ACTIVITY ARISING FROM A DECLINE IN OUTPUT IN THE SPANISH CAR INDUSTRY



3 IMPACT ON ACTIVITY ARISING FROM A DECLINE IN OUTPUT IN THE FRENCH CAR INDUSTRY



4 IMPACT ON ACTIVITY ARISING FROM A DECLINE IN OUTPUT IN THE ITALIAN CAR INDUSTRY



ON GROSS OUTPUT ON VALUE ADDED

SOURCES: Banco de España calculations and WIOD 2016.

a Note that the relevant impact is on gross value added and not on gross output. The difference between these two variables reflects the need for inputs from other countries.

case of Germany, that shock would have an impact of –0.5 pp on its aggregate value added. By economic sector, the most strongly affected, apart from that of manufacture of motor vehicles itself, would be some manufacturing industries such as *"manufacture of metals"* and *"manufacture of plastics"* and, within the services sector, which suffers one-third of the downturn in activity in Germany, there are notable falls in *"wholesale and retail trade; repair of motor vehicles and motorcycles"* and *"business process outsourcing"*. Furthermore, some eastern European economies (Hungary, the Czech Republic and Slovakia) would be directly prejudiced by this negative shock in Germany, with a decrease in their value added of around –0.15 pp. The impact on the Spanish economy would be very low, since the German car industry uses little input from Spain. In the case of the production of cars manufactured in Spain, a fall of 10% in their demand would give rise to a small impact on domestic value added, of around –0.15 pp, since the imports used in their manufacture are larger and the weight of the sector in Spain is lower than in Germany. Regarding the spillover effect on other economies, most notable is the estimated impact on Portugal and other eastern European economies such as Hungary and the Czech Republic.[6]

In addition to the considerable fragmentation in the production of the cars manufactured in a country, a second aspect of the interdependence between economies arises from the fact that a high proportion of the output of this industry is produced for export. Consideration of the bilateral exports of the finished good may distort the analysis, since the value added may reach its final destination in the form of a finished product or an intermediate input incorporated into the productive process in a third country that reaches its final destination indirectly.[7] To address these measurement problems, Chart 3 presents a breakdown by final destination of the value added generated in the four European economies analysed. Compared to other industries, the car industry is one of the most export orientated. Specifically, the percentage of value added that satisfied foreign final demand in 2015 ranged from 71.4% in Spain to 60.1% in Italy. Moreover, there is a certain degree of heterogeneity in geographical specialisation. The value added generated in Germany has as its main destination economies outside the EU, such as the United States, China and other Asian economies, while within the EU, the weight of the United Kingdom is notable. In the case of Spain, the main destination of the value added is the euro area economies and the United Kingdom, and to a lesser extent Asian economies and North America.

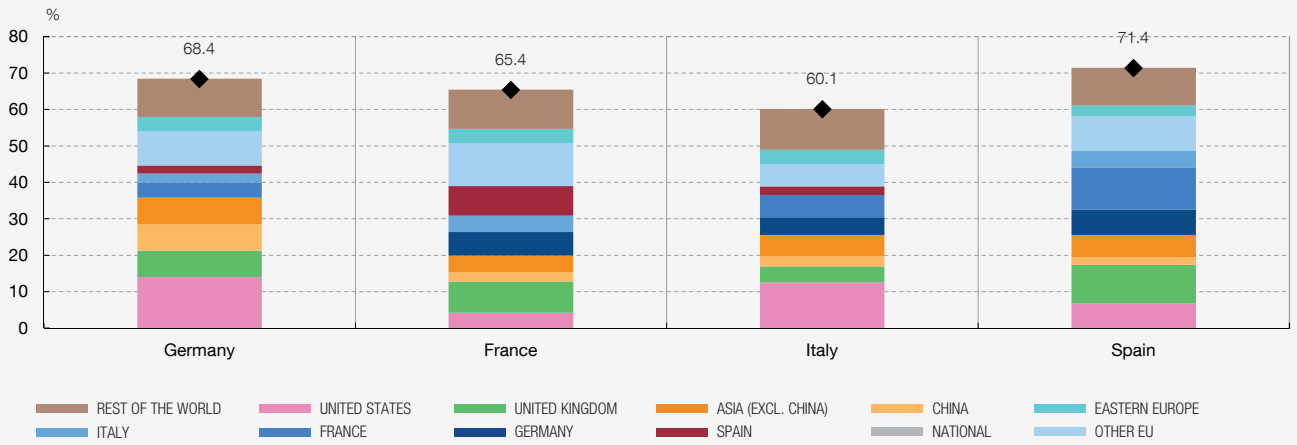
In the light of the information presented, it comes as no surprise that the recent shocks suffered by the car industry have particularly affected Germany, given the industry's significant weight in the economy's total value added, the comparatively high proportion of domestic value added employed in car production and the large

6 In the specific case of Portugal, for example, the most strongly affected sectors would be *"manufacture of motor vehicles"* itself, and *"manufacture of plastic products"* and *"manufacture of metals"*).

7 See Johnson and Noguera (2012) "Accounting for intermediates: Production sharing and trade in value added" Journal of International Economics 86(2).

Chart 3
BREAKDOWN OF DOMESTIC VALUE ADDED GENERATED IN THE CAR INDUSTRY BY FINAL DESTINATION WHERE IT IS ABSORBED

A high percentage of the value added generated in the car industries in Germany, France, Italy and Spain has a foreign economy as its final destination. Value added can arrive at its final destination directly as an export of the final product or as an intermediate product which will be directly absorbed in the importing economy; or indirectly as an intermediate good if it has been used for the manufacture of a good or service that has been re-exported from a third country. In Germany the weight of the US, UK and Asian markets is notable, whereas Spain has the euro area and UK economies as its main destinations.



SOURCES: Banco de España calculations and TiVA 2018.

weight of China in the final destinations for its output. These shocks, in turn, appear to have been passed through strongly to eastern European economies closely linked to German car production. In future, the industry faces further challenges arising from changing consumer preferences (e.g., there appears to be an increasing preference for car sharing as opposed to ownership) and growing environmental restrictions (which are already affecting each producing country differently according to, among other factors, the weight of diesel cars in total production). The information presented also suggests that materialisation of currently identified global risks would affect the various car-producing countries asymmetrically. In particular, while the imposition of tariffs on European car imports in the United States would disproportionately affect Germany and Italy, the Spanish economy might be especially harmed by the effects of a disorderly Brexit or, generally, by negative shocks to the demand for cars in EU countries.

The euro area sovereign debt crisis made it clear how, when the cycle turns down, the absence of sound public finances may exacerbate budgetary difficulties, the correction of which may ultimately require the adoption of fiscal adjustment measures which deepen the recession. With a view to the creation of budgetary headroom to mitigate these risks and ensure the long-term sustainability of Member States' public finances, the EU Stability and Growth Pact (SGP) establishes procedures for the supervision of national budgetary policies.[1] The purpose of this Box is to describe how compliance with these procedures affects the Spanish fiscal policy stance in the current economic situation.

There are two tools in the SGP framework which allow follow-up of Member States' public finances according to their situation. First, if the budget deficit is above 3% of GDP and/or public debt exceeds 60% of GDP and GDP is not being reduced to the relevant threshold at a sufficient pace,[2] the so-called "corrective component" is applied and the economy is said to be subject to an excessive deficit procedure. Second, when the government deficit and debt are not considered excessive under the aforementioned criteria, Member States become subject to the requirements of the so-called "preventive component" of the SGP. The latter aims to ensure that the fiscal policies of EU countries generate sufficient budgetary headroom for them to avoid excessive deficits. This means that Member States have to achieve budgetary balance in terms of the structural deficit net of temporary measures, with certain adjustments to take into account two factors which differ across countries: the need to reduce the public debt ratio below 60% of GDP and the size of the expected impact of population aging.[3] This materialises in a medium-term objective (MTO) which, in the case of the Spanish economy, is set at 0% of GDP.

Spain has been subject to an excessive deficit procedure (EDP) since 2009 because of a budget deficit exceeding the limit of 3% of GDP. At the cut-off date of this Box, the European authorities confirmed that Spain qualified to exit this procedure (which will be repealed by the EU Council in early July), because in 2018 the general government deficit was below the 3% threshold (specifically, 2.5% of GDP) and this situation was judged to be sustainable in the future.[4] Spain will exit the "corrective arm" and simultaneously enter the "preventive arm".

On the available estimates, the structural deficit in 2018 stood above 2% of GDP (see Chart 1). Spain was thus still a long way from the medium-term structural budget balance objective (MTO), which, as mentioned above, has been set at 0% of GDP. Therefore, within the SGP "preventive component" framework, two requirements intended to ensure sufficient progress towards that objective will be activated.

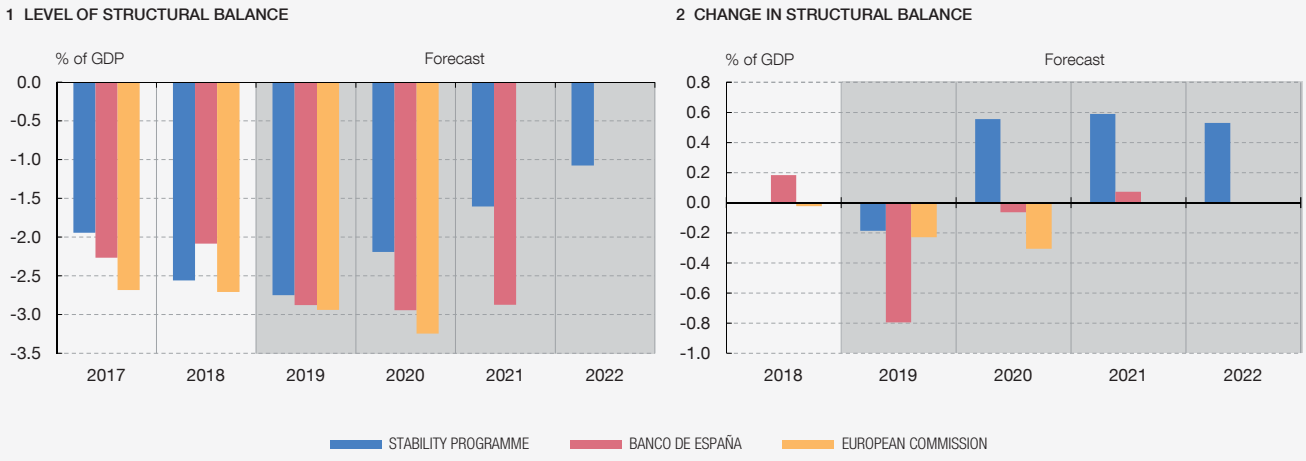
1 For more details, see García-Perea and Gordo (2016) "Los mecanismos de supervisión presupuestaria de la UEM", *Boletín Económico* of the Banco de España, 47-60.

2 See Vade Mecum on the Stability and Growth Pact – 2019 Edition.

3 It should be taken into account that the structural budget deficit is an unobservable variable and thus has to be estimated. For the purpose of the European procedure, it is estimated as the difference between the observed budget deficit and the cyclical deficit, stripping out the effect of temporary and exceptional factors. The cyclical deficit is calculated by applying the government revenue and spending elasticities to the output gap. The output gap is estimated using a methodology developed by the European Commission in conjunction with the Member States (see Havik et al. (2014) "The production function methodology for calculating potential growth rates and output gaps", Economic Papers, 535, European Commission).

4 Recommendation for a Council decision abrogating Decision 2009/417/EC on the existence of an excessive deficit in Spain.

Chart 1
STRUCTURAL BALANCE OF GENERAL GOVERNMENT



SOURCES: 2019-2022 Stability Programme Update, spring forecast of the EC (May 2019) and Spanish economic forecast of the Banco de España (June 2019).

First, based on its level of debt (above 60% of GDP) and its cyclical position (positive output gap), Spain will have to make an annual adjustment in structural deficit terms of 0.65 percentage points of GDP in 2019 and 2020.[5] Second, this structural adjustment must be compatible with the primary public spending growth rate below 0.6% and 0.9% in 2019 and 2020, respectively.[6]

Additionally, holding public debt above the 60%-of-GDP threshold makes it necessary to reduce GDP at a sufficient pace to prevent Spain returning to the "corrective arm", this time due to excessive debt (see Chart 2). Specifically, for a debt-to-GDP ratio exceeding 60% not be considered excessive, the general rule is that this ratio must be reduced annually at one-twentieth of the difference from 60%. However, in the three years following the repeal of the EDP (i.e. 2019-2021 in this case), Spain will remain in a transitional period which endows a certain degree of flexibility regarding the debt rule. This is because a minimum adjustment of the structural deficit is required, which ensures compliance with the debt criterion at the end of the transitional period.[7] In particular, the minimum annual structural adjustment required of Spain for 2019 would be 0.5 pp of GDP.[8]

However, on the Government's latest estimates sent to the European Commission in April as part of the 2019-2022 Stability Programme Update, the structural balance for 2019 is expected to worsen by -0.2 pp of GDP (see Chart 1), as compared with the required improvements of +0.65 pp under the preventive arm and of 0.5 pp under the debt rule. Meanwhile, compared with the maximum allowed growth rate of eligible public spending of 0.6%, the projected growth of this variable for 2019 in the Stability Programme Update is 3.9%.

In this respect, although the Council should not make any statement on the Spanish fiscal policy stance until spring 2020, once the 2019 data have been published,[9] the EU's recent recommendation emphasised that, for the current year, there is a significant risk of deviation from the established requirements. Should this deviation materialise, the Council would recommend that Spain adopt the necessary adjustment measures, non-compliance with which could even lead to a requirement to make a deposit of 0.2% of GDP.

5 See the Recommendation for a Council recommendation on the National Reform Programme of Spain and delivering a Council opinion on the 2018 and 2019 Stability Programmes of Spain.

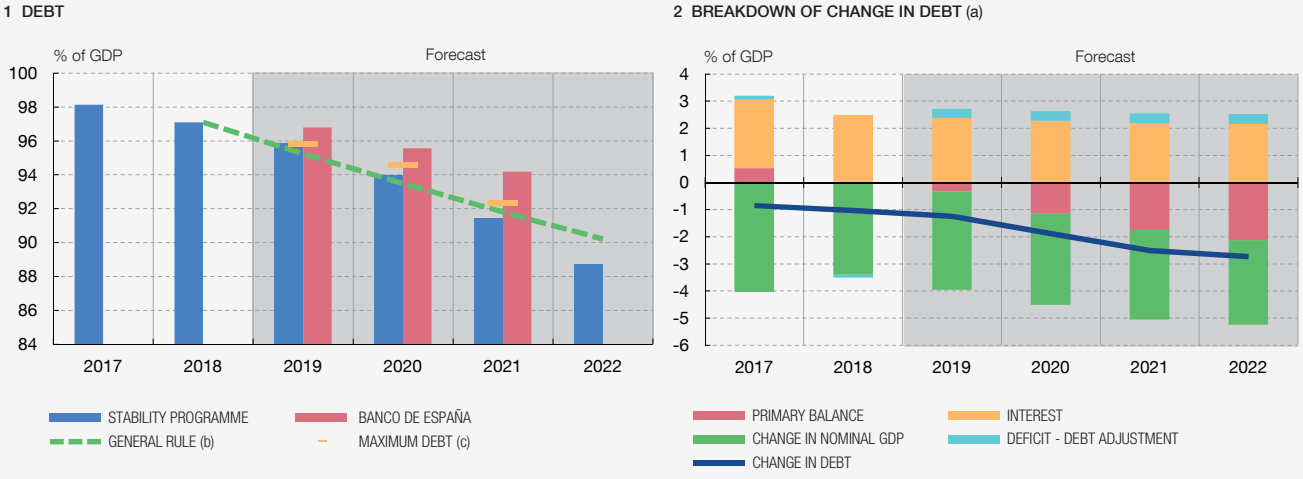
6 With a view to complying with the rule, public expenditure is defined excluding the interest burden and non-discretionary spending on unemployment benefits. Also excluded is EU programme expenditure which is fully offset by revenue from EU funds. Also, given its variability, government investment is not included at its annual amount, but rather as the average expenditure over four years.

7 This adjustment is known as the minimum linear structural adjustment (MLSA). Chart 2.1 shows various public debt paths for Spain in the period 2019-2021, including: that resulting from projections by the Directorate General Economics, Statistics and Research of the Banco de España, that compatible with the minimum structural adjustment (calculated from the EU's 2019 spring projections) and that resulting from application of the general rule.

8 See Assessment of the 2019 Stability Programme for Spain.

9 Compliance with the Council recommendations under the SGP "preventive component" is determined by an ex-post check, i.e. based on the data published after year-end (see "Vade Mecum on the Stability and Growth Pact – 2019 Edition").

Chart 2
GENERAL GOVERNMENT DEBT



SOURCES: 2019-2022 Stability Programme Update and Spanish economic forecast of the Banco de España (June 2019).

a 2019-2022 Stability Programme Update.
b Annual reduction by one-twentieth of the difference from 60%.
c Estimate of the maximum debt compatible with the requirements of the transition period.

Compliance with the fiscal rules set in the European budgetary governance process is a requirement which all member countries must meet in order to contribute to maintaining the macroeconomic stability of the euro area. But it also constitutes a desirable objective from the national standpoint, insofar as it helps to endow each country's public finances with the resilience needed to withstand possible future downturns and ensure their long-term sustainability.

On 29 May this year the ECB published the results of the twentieth edition of the survey on the access to finance of enterprises in the euro area (SAFE), which covers the period from October 2018 to March 2019. The survey questions firms, essentially SMEs, about developments in the past six months relating to their economic and financial situation, their external financing needs and the conditions in which they have obtained – or not – such financing.

In the case of Spanish SMEs, the data from this latest edition of the survey show overall somewhat less favourable developments in their economic and financial situation. The number of firms reporting an increase in their sales once again exceeded – for the ninth consecutive time – those reporting the opposite. But the difference between both groups (net percentage) was 20%, 4 pp down on the previous survey and also slightly below the figure recorded for the euro area as a whole (21%, see Chart 1). Costs, both labour and other, increased for a high net proportion of SMEs in the sample (57% and 58%, respectively, compared with 52% and 57% in the euro area). That led to a less favourable trend in profits than in sales. Specifically, the percentage of firms reporting a decline in profits exceeded that of those reporting the opposite. This had not occurred since 2015. Consequently, a net negative percentage of -4% was recorded, compared with the zero figure for the euro area as a whole. The breakdown by sector shows that the less favourable trend in sales and in profits was practically across the board. The exception was the wholesale and retail trade, the only sector with somewhat more positive percentages (in the case of sales) or less negative percentages (in the case of profits) than those recorded in the previous edition.

When questioned about their main source of concern, the lack of customers was the reply by the biggest percentage of Spanish SMEs (27%, see Chart 2), while in the euro area as a whole the problem mentioned with most frequency was, for the third time running, the lack of skilled labour (25%). Set against this, access to finance was, once again, among all the factors included in this question, that cited by the least number of firms: 7% of the total in Spain and 8% in the euro area, percentages very similar to those recorded six months earlier.

Against this backdrop, the proportion of Spanish SMEs applying for bank loans grew by 1 pp, to 29% (see Chart 3). This figure was slightly higher than that recorded in the euro area (28%), but remains close to the lower figures observed in recent years. Access to bank financing continued to improve, albeit at an increasingly lower rate (see Chart 4). Thus, in net terms, 16% of Spanish SMEs reported an improvement in this respect, 5 pp down on the previous survey, although 7 pp above the percentage recorded for their euro area counterparts. The respondent firms noted a positive trend in most of the factors affecting credit supply, albeit to a lesser extent than in the previous edition. Specifically, in net terms, 21% of Spanish SMEs perceived a greater readiness of banks to grant loans (6 pp below the figure six months earlier), 13% reported an improvement in the specific situation (4 pp less than the previous survey), and also 13% indicated a favourable impact associated with their credit track record (1 pp below the September 2018 figure). By contrast, 8% of SMEs, in net terms, considered that the general economic outlook hampered access to credit (compared with 1%, in net terms, that considered the opposite in the immediately previous period).

The percentage of SMEs whose financing applications were rejected fell slightly, by 1 pp, to 5%, a figure slightly below that recorded in the euro area as a whole (6%). Also, the broadest indicator of difficulties in obtaining bank loans[1] shows a slight improvement, with a 1 pp decline in the proportion of companies facing such difficulties to 8%, a figure slightly higher than that of the euro area (see Chart 5).

Concerning financing conditions, the net percentage of firms reporting a decline in interest rates was positive, for the ninth consecutive time. However, the resulting figure was very low (1%) and similar to that of the previous edition (see Chart 6). The net proportion of companies reporting an increase in the amount of loans also remained positive (7%, 8 pp less than six months earlier). By contrast, Spanish SMEs on the whole reported a slight reduction in loan maturities, and a tightening in collateral required and in other loan conditions.

In short, the latest edition of the SAFE shows that, between October 2018 and March 2019, access by Spanish SMEs to external financing continued to improve. However, it did so at a more moderate pace than in previous editions, against a background in which the economic and financial situation of these firms showed some signs of worsening. The survey also reveals that Spanish SMEs anticipated, at the time of being questioned, a positive trend in their access to bank financing between April and September this year.

1 This indicator includes companies in one of the following situations: those whose applications for funds were rejected; those to which the funds were granted but only in part; the companies to which the loan was granted but at a cost deemed by the companies to be very high; and those which did not apply for financing because they thought it would not be granted.

Chart 1
SALES AND PROFITS (a)

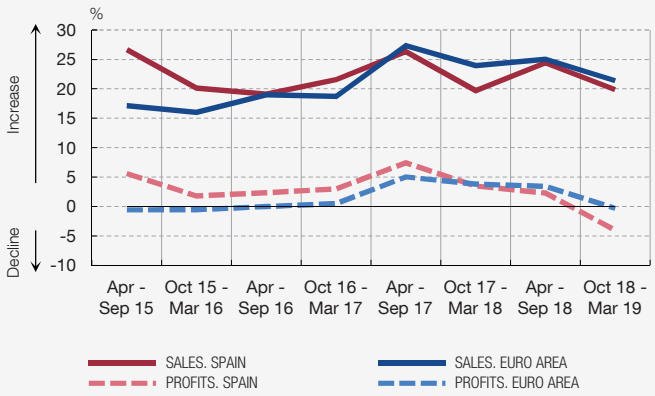


Chart 2
MAIN PROBLEMS AFFECTING ACTIVITY. OCTOBER 2018-MARCH 2019

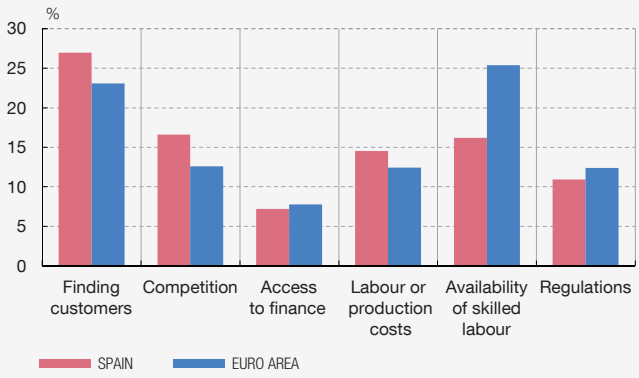


Chart 3
SMEs THAT HAVE APPLIED FOR BANK LOANS

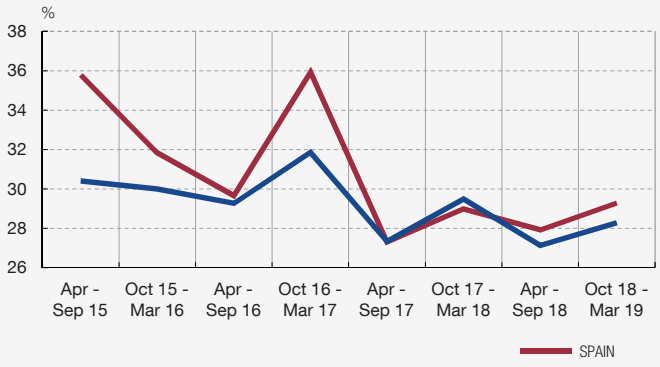


Chart 4
AVAILABILITY OF BANK LOANS (b)

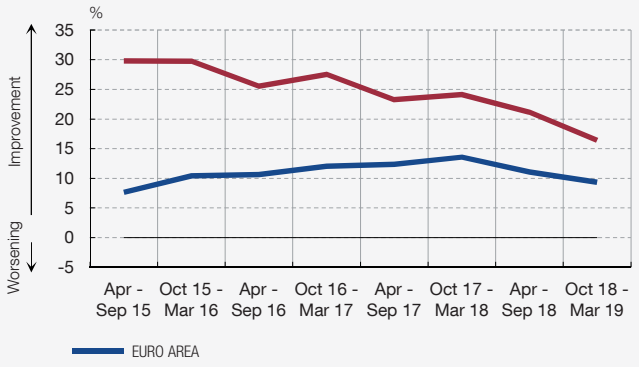


Chart 5
SMEs WITH DIFFICULTIES IN OBTAINING BANK LOANS (c)

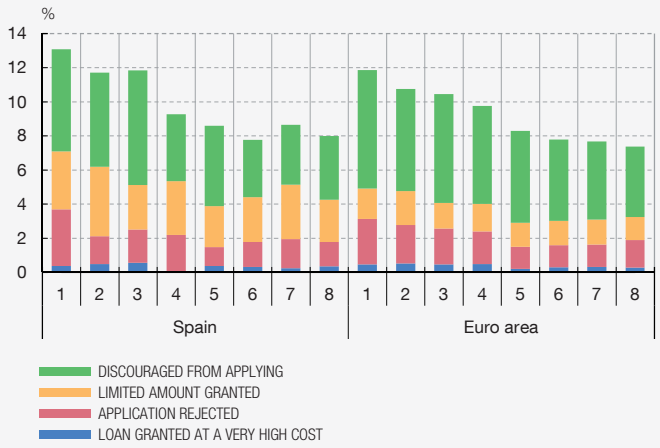
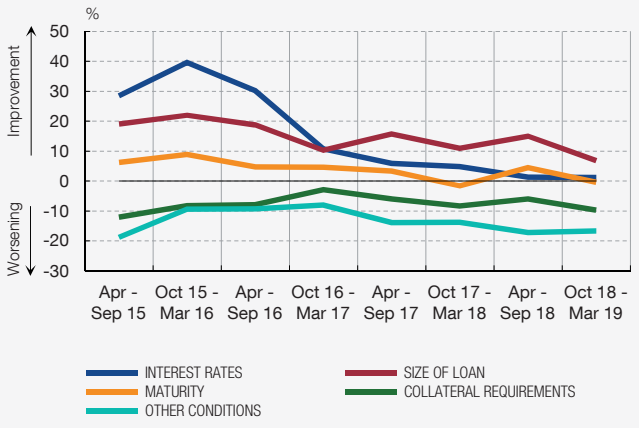


Chart 6
BANK LOAN CONDITIONS. SPAIN (d)



SOURCE: ECB.

a Percentage of firms reporting an increase minus percentage of firms reporting a decline.
b Percentage of firms reporting an improvement minus percentage of firms reporting a worsening
c This indicator reflects the proportion of firms in one of the following situations: those whose applications for funds were rejected; those which were granted funds but only a limited amount; those which were granted the loan but at a cost considered by the companies as too high; and those which did not apply for finance because they thought it would be rejected (discouraged from applying). The numbers on the horizontal axis depict the rounds of the survey, with 1 corresponding to the period April-September 2015 and 8 to the period from October 2018 to March 2019.
d Percentage of firms reporting an improvement in conditions (lower interest rates, increase in amounts and maturities, and reduction in collateral and other required conditions) minus percentage of firms reporting a worsening in these conditions.

Market performance was uneven, with small advances in the main stock indices and declines in sovereign debt yields, against a backdrop of high geopolitical uncertainty and a more accommodative monetary policy stance

Volatility in the international financial markets was greater in Q2 than in Q1 in light of the growing trade tensions. The fluctuating degree of optimism over the outcome of the US-China trade talks, and the news on other tariff measures that the United States considered imposing on, for example, Mexico and the European Union, largely determined the level of risk aversion in the international markets in the quarter. Market performance was also shaped to a great extent by the more accommodative monetary policy stance adopted by the main central banks in recent months, in view of the deterioration observed in certain key activity, price and confidence indicators. This more accommodative bias is having a very significant (downward) impact on investors' future interest rate expectations.

Equity markets remained on the upward path recorded since the start of the year until May, when they fell sharply. Following the subsequent recovery in June, the stock markets of the main advanced economies – with the exception of Japan – closed the quarter with gains (see Chart 2). Most emerging stock markets also rose in the quarter overall, except for the Asian markets, hardest hit by the increase in uncertainty and risk aversion.

Notable in the quarter was the performance of the bond market segment, with widespread falls in sovereign debt yields, down to all-time lows in Germany. This was consistent with investors' search for safe-haven assets, considering the heightened geopolitical uncertainty, and with a downward revision of market expectations for future benchmark interest rates. In particular, at the close of this report, the markets are factoring in, for December 2019, a US Fed Funds rate 75 bp below the current rate (compared with the 25 bp decrease they expected at the start of the quarter). The considerable uncertainty associated with these expectations was reflected in a significant increase in the implied volatility of US sovereign debt, proxied by the MOVE Index (see Chart 2). In turn, in the euro area, average investor expectations are for the deposit facility rate to be 10 bp below its current level at December 2019, compared with expectations of no change throughout the year at the start of the quarter.

High-risk asset spreads moved in accordance with the shifts in risk aversion in the quarter. Thus, for example, the US corporate high-yield spread (over the sovereign bond) continued to narrow in April, but then widened significantly in May. In June, in line with the more positive performance of other markets, these spreads narrowed again (by 38 bp). Sovereign spreads in the emerging market economies of Europe and Latin America performed very similarly. In the foreign exchange markets, the yen appreciated sharply in May, which is consistent with its traditional consideration as a safe-haven asset. In turn, the pound sterling depreciated by 2.7% in the quarter owing to the uncertainty surrounding Brexit.

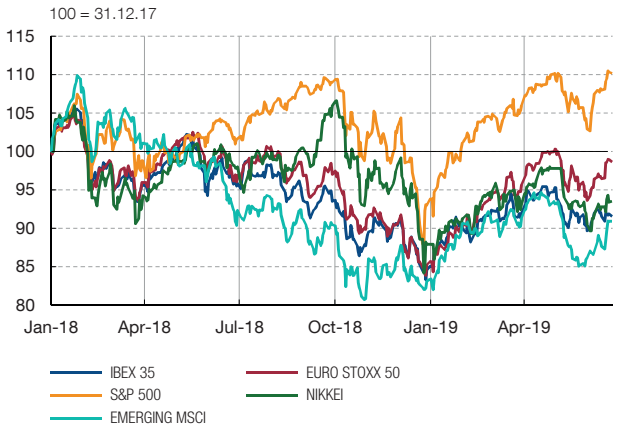
The communication policies and decisions of the main central banks are having a major impact on market dynamics. Thus, for example, an address by the chairman of the Federal Reserve in the first week of June, in which he considered the possibility of

STOCK MARKET PRICES RISE SLIGHTLY AND SOVEREIGN YIELDS DECLINE, AGAINST A BACKDROP OF INCREASED VOLATILITY

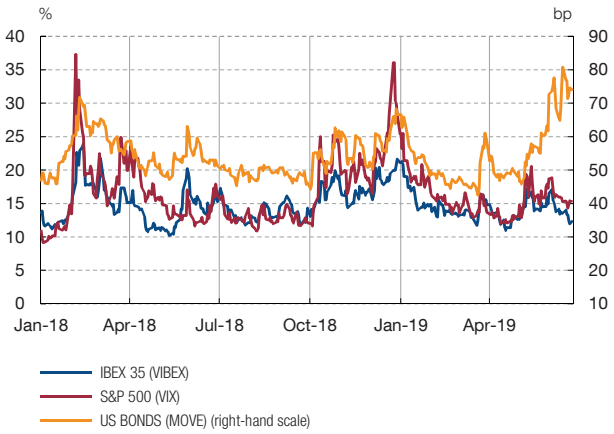
CHART 2

The quarter was characterised by an increase in volatility and risk aversion, against a backdrop of uncertainty owing to trade tensions and more accommodative monetary policies. The main stock markets recorded small gains, while in Spain the IBEX 35 index dropped back slightly. Falling sovereign debt yields were the common factor, shaped by the search for safe-haven assets and interest rate cut expectations.

1 STOCK MARKET INDICES



2 IMPLIED VOLATILITY



SOURCE: Datastream.

interest rate cuts in 2019, triggered a pronounced upward correction in the stock markets. This pattern continued when, at its June meeting, the Federal Open Market Committee (FOMC) left its benchmark policy rate unchanged, as expected, but announced possible rate cuts going forward. The ECB Governing Council, at its June meeting, extended its forward guidance, announcing that the policy rate will remain unchanged at least until the first half of 2020, and outlined the characteristics of the new targeted longer-term refinancing operations programme (TLTRO-III). The most notable market reaction to both these announcements was in the European banking sector, where stock prices fell. The address by the ECB President on 18 June, when he suggested that the ECB would be prepared to adopt additional monetary policy measures, if necessary, had a greater impact on the financial markets. Specifically, stock prices rose and sovereign debt yields fell, owing to the increased expectations of possible policy rate cuts.

3.1 External environment of the euro area

Although global activity was unexpectedly high in Q1, more recent indicators show signs of worsening

In 2019 Q1, global activity growth was somewhat higher than expected. In particular, GDP accelerated at the start of the year in the main advanced economies (see Chart 3.1) and maintained its rate of growth in China (see Chart 3.2). In the case of China, this possibly reflects the effect of the fiscal, monetary and financial stimulus measures introduced by the authorities since mid-2018. In general, these global patterns were largely a result of the increase in the positive contribution of changes in stock-building, which could be linked to a great extent to the high uncertainty stemming from the US-China trade tensions and, in the specific case of the United Kingdom, to the continuing doubts surrounding the outcome of the Brexit process. In view of these somewhat more positive figures, consensus growth forecasts for 2019 overall were revised up slightly or left unchanged (see Chart 3.3). In Latin America, activity was worse in Q1, with GDP falling in the region's main economies, while in eastern Europe, Turkey came out of its recent technical recession.

Nevertheless, the latest available figures suggest a generally less positive picture. Global activity indicators for Q2 continue to show signs of deceleration, primarily in the intermediate goods and investment sectors. In turn, consumer goods and services, which had been more resilient, are now also starting to look as if they are running out of steam (see Chart 3.4). In the specific case of the Chinese economy, the weakness of the economic indicators for Q2 could denote that the effects of the countercyclical economic policy measures taken by the Chinese authorities are petering out and that they might prove less effective than expected (see Box 2).

Inflation rates in the advanced economies headed down again in May, after the temporary upswing in April. The inflation profile has been closely tied to the performance of the energy component (see Chart 4.1). Core inflation, which excludes the most volatile components (energy and food) is generally still low from a historical standpoint (see Chart 4.2). In the emerging market economies, inflation has also been strongly influenced by the more volatile components, with core inflation remaining relatively steady or heading down.

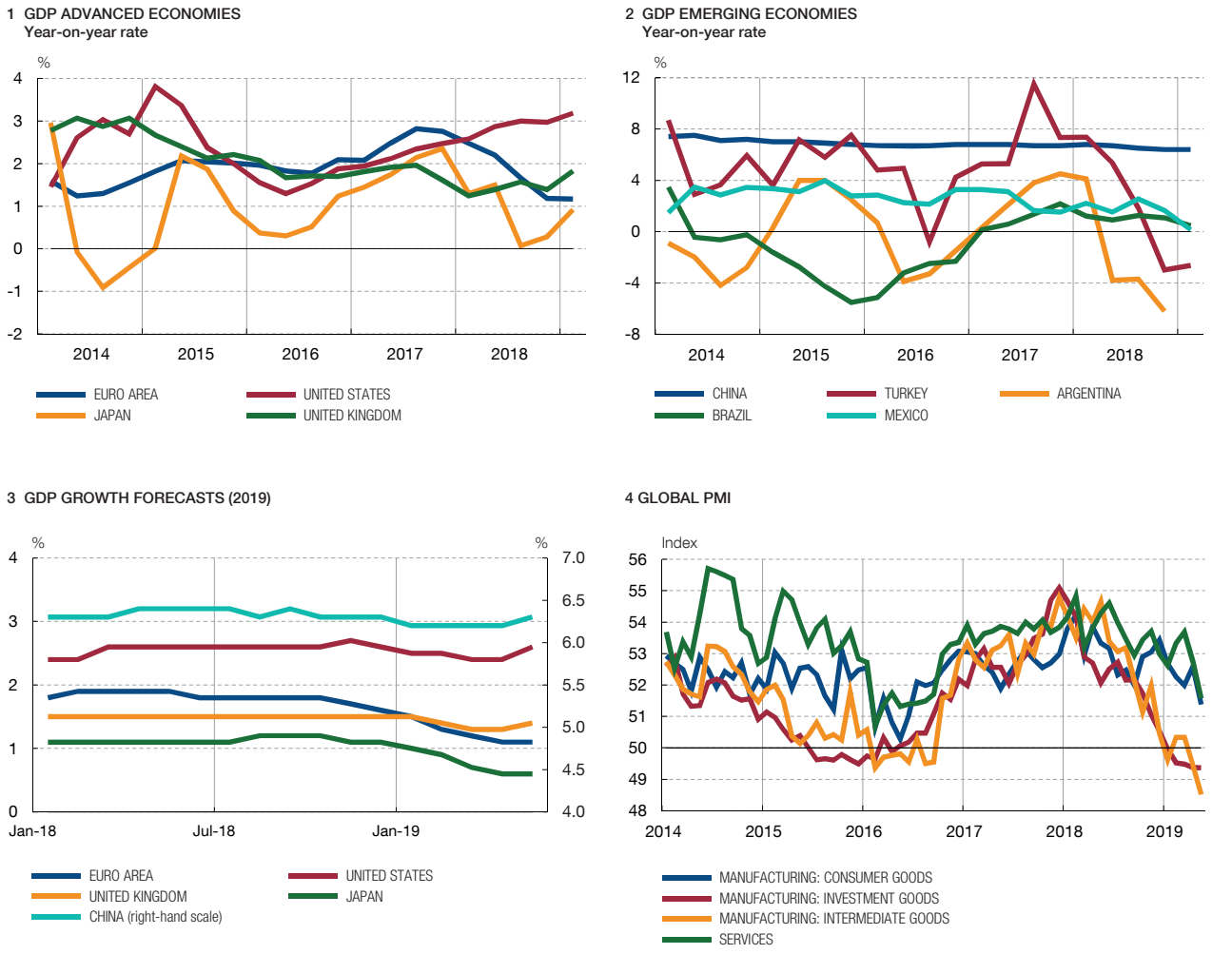
World trade remains weak as trade tensions escalate

World trade in goods contracted in 2019 Q1. This decrease (-0.3% compared with the previous quarter) was a consequence of the decline in trade in emerging Asia, Japan and Latin America and the rather sluggish trade in the United States and the euro area (see Chart 5.1). In this setting, US-China trade tensions escalated again in May-June. The United States raised its tariffs from 10% to 25% on $200 billion worth of Chinese imports and banned the sale of critical technology equipment to foreign suppliers (in addition, singling out a large technology equipment firm located in China). This was followed by retaliatory measures announced by the Chinese authorities and further threats from the United States on all other imports from China (see Chart 5.2). In turn, any decision on the possibility of the United States levying additional tariffs on imports of vehicles and components, which would hit the European Union and Japan the hardest, has been postponed for six months, until November. Lastly, the US threat to impose tariffs on

GLOBAL ACTIVITY WAS HIGHER THAN EXPECTED IN Q1, BUT MORE RECENT INDICATORS SHOW SIGNS OF WORSENING

CHART 3

In accordance with the higher than expected growth in Q1, the forecasts for the full year in the main economies have been revised up or left unchanged, but the high-frequency indicators point to a slowdown in activity more recently.



SOURCES: Thomson Reuters, IHS Markit, JP Morgan and Consensus.

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imports from Mexico has been neutralised, at least for the time being, by the migratory agreement recently reached between the two countries.

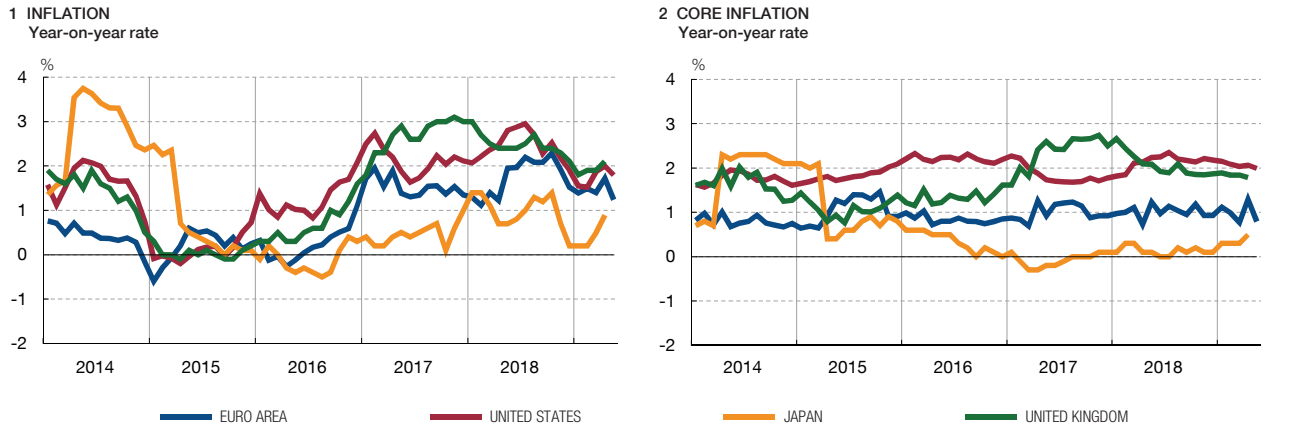
Oil prices were highly volatile in the first part of the year. Thus, the price of Brent rose until mid-May, up to $75 dollars per barrel, against a backdrop of low inventories, production cuts by OPEC and its partners, and lower production in Iran and Venezuela, partly explained by US sanctions. In June, however, crude prices fell sharply, down to just under $65 dollars in mid-June, owing to the foreseeably adverse effect of trade tensions on activity (see Box 1).

The risks to economic activity and the absence of inflationary pressures have prompted a shift in expectations on the future monetary policy stance

The central banks of the developed economies have shown that they intend to maintain their expansionary monetary policy stance for longer than was initially

CORE INFLATION REMAINS LOW CHART 4

Inflation rates in the advanced economies move in line with the more volatile components (energy and food); core inflation remains low in historical terms.



SOURCES: Thomson Reuters and Banco de España.

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planned, or even to strengthen it (see Chart 6.1). This change is mainly on account of weakening economic activity and the absence of inflationary pressures as described above. Thus, as indicated earlier, in the case of the Federal Reserve, in the space of three months futures markets have moved from expecting the policy rate to remain unchanged in 2019 to factoring in several rate cuts in the year (see Chart 6.2). Some economies, such as Australia and New Zealand, have already cut rates in 2019, while in others, such as the United Kingdom or Japan, markets expect benchmark rates to remain unaltered at least until the last stretch of 2020.

Emerging market economies have generally left their monetary policy stance unchanged, while in some cases it has become more accommodative. There are, however, some exceptions to this general rule, specifically Argentina, and temporarily Turkey, which have both been forced to tighten their monetary policy.

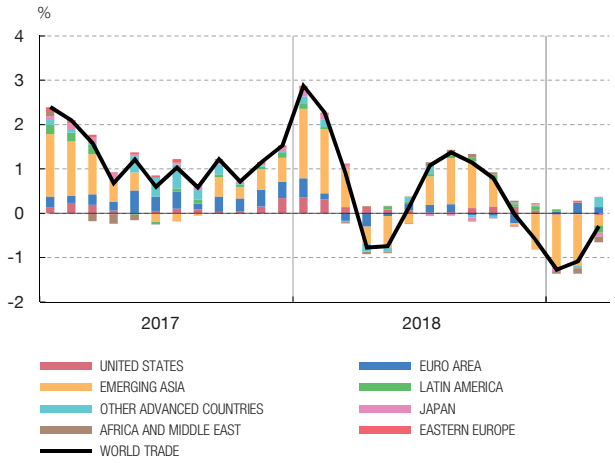
Emerging financial markets were quite volatile in Q2, on account of the renewed trade tensions and the increase in risk aversion

Emerging financial markets posted a changeable performance in the quarter, divided into different stages. First they performed well in April, with a marked decline in volatility that was underpinned by a favourable external environment, as US stock markets rose to new all-time highs on the good prospects for the US-China trade agreement and oil prices increased by almost 5%. In addition, the deterioration observed in April in the more vulnerable markets (Argentina and Turkey, owing to idiosyncratic factors) did not appear to have a significant impact on the other markets. Subsequently, in May, this positive pattern reversed as the global environment deteriorated: trade tensions and risk aversion in general increased, stock market volatility and interest rates rose and oil prices fell. In consequence, financial variables in emerging financial markets dropped back to their mid-January 2019 levels, with sharp stock market falls (especially in Asia), depreciation of currencies and increases in sovereign debt premia (see Chart 7). These markets stabilised in June, in line with some positive news flow on the trade front (such as the US-Mexico agreement) and the renewed expectations of interest rate cuts in the United States.

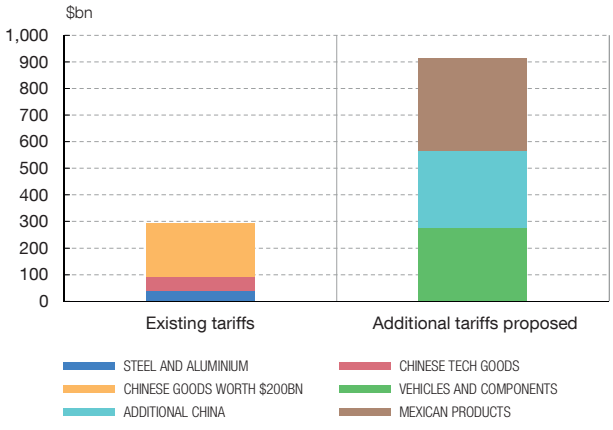
WORLD TRADE HAS CONTRACTED AGAINST A BACKDROP OF RENEWED TRADE TENSIONS CHART 5

Renewed trade tensions between the United States and China, and between the United States and other trading partners, will ultimately lead not only to lower trade but also to lower growth in activity.

1 WORLD TRADE GROWTH



2 TRADE AFFECTED BY PROTECTIONIST MEASURES



SOURCES: CPB, US Census, PIIE and ECB.

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3.2 The euro area and the ECB's monetary policy

The economic activity of the euro area, following a temporary rebound at the beginning of the year, continues to show signs of weakness, particularly in the industrial sector

In the euro area, GDP growth quickened in 2019 Q1, partly due to temporary factors. GDP grew by 0.4% quarter-on-quarter in that period, a higher rate than in 2018 Q4 and up on that expected some months earlier (see Chart 8.1). By country, the biggest surprises were in Germany and Italy, whose GDP returned to growth after two quarters of slippage or virtual stagnation (see Chart 8.2). However, this result partly reflects temporary factors related to increased sales to the United Kingdom owing to stockbuilding in this country prompted by the possibility of a no-deal Brexit at the end of March. Further, private consumption in Germany was boosted by an exceptional increase in car registrations due to the materialisation of car purchase decisions which had been postponed in the second half of 2018 as a result of the adaptation by industry to the new emissions protocol. Finally, activity in the construction sector of various countries was favoured by particularly good weather. In year-on-year terms the growth of the euro area as a whole remained moderate at 1.2%, since the decrease in the contribution from domestic demand was offset by a less negative contribution from net external demand (see Chart 8.3).

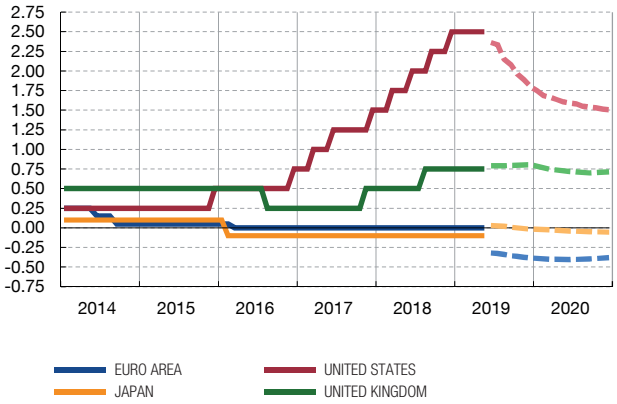
The most recent information extends the weak economic activity in the short term, against a more uncertain global background. A notable development is the worsening of economic sentiment, sharper in the sectors exposed to world trade, perhaps reflecting the effects of the new protectionist escalation and the prolonged negotiation of the United Kingdom's exit from the European Union. In this respect, the manufacturing confidence indicators, the export order book and the expectations of production have weakened with respect to the first quarter of the year, particularly in Germany, where the uncertainty surrounding the future of the automotive industry is particularly significant (see Box 5). Meanwhile, the quantitative indicators available are scant, although they show weakness. Specifically, in April the industrial production index (IPI) contracted, while goods exports in

EXPECTATIONS ON THE FUTURE MONETARY POLICY STANCE HAVE CHANGED

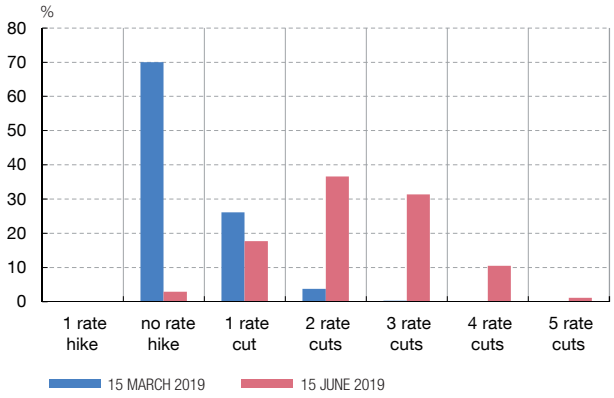
CHART 6

The central banks of the developed economies have shown that they intend to maintain their expansionary monetary policy stance for longer than was initially planned, or even to strengthen it.

1 POLICY RATES AND FUTURES (a)



2 EXPECTATIONS OF CHANGES IN FED FUNDS RATE IN 2019, DRAWING ON FUTURES MARKET



SOURCES: Thomson Reuters and Banco de España.

a Futures at 10/06/2019.

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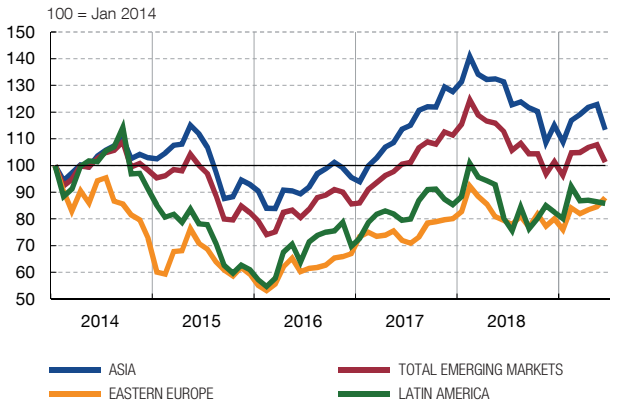
EMERGING MARKETS RECORDED A CHANGEABLE PERFORMANCE

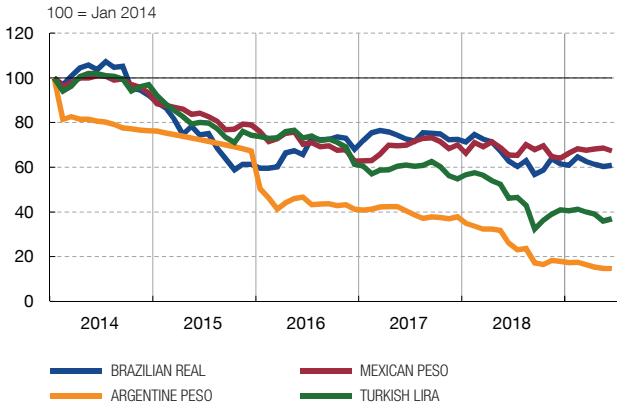
CHART 7

The financial markets performed well in April (save in Argentina and Turkey) and poorly in May and early June, before steadying later in the month.

1 EMERGING MARKET STOCK MARKET PERFORMANCE



2 EMERGING MARKET CURRENCY DOLLAR EXCHANGE RATES (a)



SOURCE: Thomson Reuters.

a A decline in the index denotes depreciation of the currency against the dollar.

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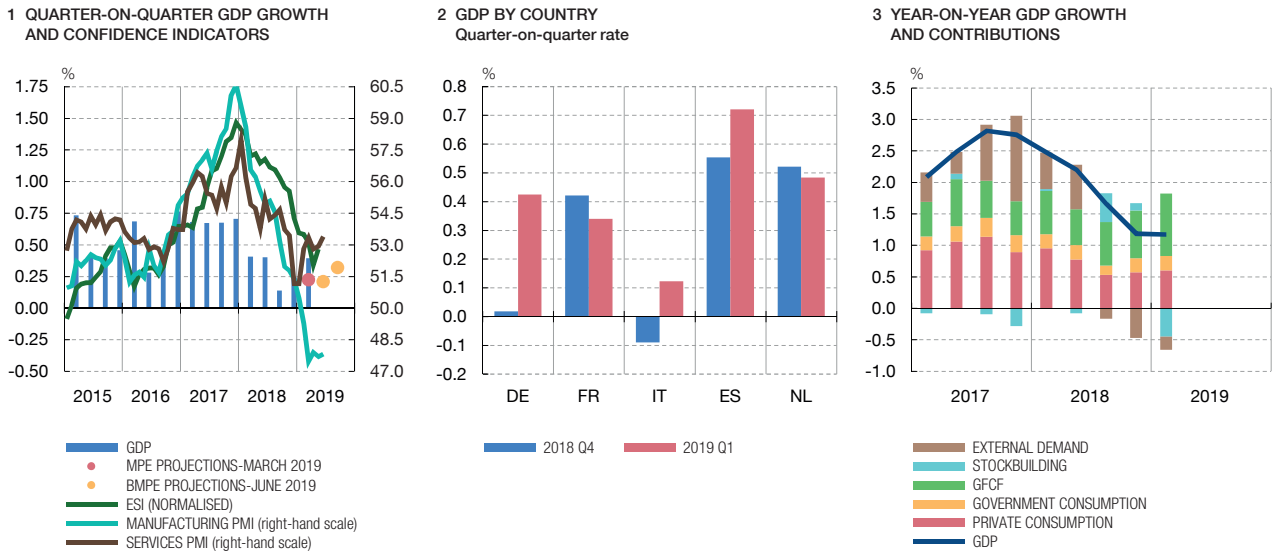
real terms remained stagnant in March. For its part, private consumption continues to be driven by employment growth, albeit at a somewhat slower pace than in previous quarters, while consumer confidence remains at lower levels than in recent years.

The macroeconomic projections for the Eurosystem included a slight upward revision of the euro area GDP growth expected for 2019, and pointed to a certain deterioration

ECONOMIC GROWTH IN THE EURO AREA REMAINS MODERATE CHART 8

Euro area GDP rose in 2019 Q1, probably due to temporary factors which mainly boosted growth in Germany and Italy, after two quarters of slippage and virtual stagnation. However, in the second quarter the momentum of economic activity remains moderate and the weakness of the industrial sector is more marked.



SOURCES: Eurostat, European Commission, Markit Economics and European Central Bank.

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of the medium-term growth outlook. GDP is currently expected to grow by 1.2% in 2019, just 0.1 pp more than was expected in March, as a result of the strong growth figure for the first quarter, while the growth expected for 2020 and 2021 is slightly lower at 1.4% (see Table 2). Domestic demand remains the basic driver of euro area growth over the projection horizon due to the accommodative stance of monetary policy, wage acceleration and a slightly expansionary fiscal policy. By contrast, the outlook for growth of external demand has worsened. In addition, there continue to be major risks associated with this scenario. Along with the increase in protectionism and in the uncertainty surrounding Brexit, there are continuing doubts on the domestic front as to the fiscal policy design in Italy, to which must be added a complex political scenario in various euro area countries.

Inflationary pressure in the euro area is moderate, although it will foreseeably increase gradually in the medium term

Inflation in the euro area has been affected by the seasonal variability of some components. Year-on-year growth of the harmonised index of consumer prices (HICP) decreased to 1.2% in May, following a transitory rise of 0.3 pp in April. This development was due to the behaviour of tourist package prices, which are highly seasonal. The measures of core inflation excluding the most volatile components reflected this pattern of volatility, while remaining in any event at very low rates. The CPI excluding unprocessed food and energy stood at 0.8% in May (see Chart 9). This low price growth contrasts with the robustness which negotiated wage increases continued showing in the opening months of the year. The contraction of margins taking place in European firms helps to explain this price moderation (see Box 4). Against this background, the Eurosystem inflation forecasts have been revised upward due to the expected behaviour of oil prices, although the forecast for core inflation is again revised downward for 2019 and 2020 to stand at 1.1% and 1.4%, respectively, 0.1 pp less than previous forecasts, after which it rises to 1.6% in 2001 (see Box 2).

EURO AREA GDP AND HICP GROWTH FORECAST (a) TABLE 2

	2019		2020		2021	
	GDP	HICP	GDP	HICP	GDP	HICP
European Central Bank (June 2019)	1.2 (0.1)	1.3 (0.1)	1.4 (-0.2)	1.4 (-0.1)	1.4 (-0.1)	1.6 (0.0)
European Commission (May 2019)	1.2 (-0.1)	1.4 (0.0)	1.5 (-0.1)	1.4 (-0.1)	—	—
OECD (May 2019)	1.2 (0.2)	1.2 (—)	1.4 (0.2)	1.5 (—)	—	—
International Monetary Fund (April 2019)	1.3 (-0.3)	1.3 (—)	1.5 (-0.2)	1.6 (—)	1.6 (—)	1.7 (—)
Consensus Forecast (June 2019)	1.1 (0.0)	1.3 (-0.1)	1.3 (0.0)	1.4 (0.0)	—	—

SOURCES: ECB, European Commission, Consensus Forecast, IMF and OECD.

a The figures in brackets are the change with respect to the previous forecast, which relates to March 2019 for the ECB, February for the EC, March for the OECD, January for the IMF and May for Consensus.

In the most recent review of the stability programmes of the EU Member States, Spain abandons the corrective arm of the excessive deficit procedure (EDP), while the European Commission considers that there are reasons for applying this procedure to Italy. According to the spring package of the European Commission (EC) relating to the European Semester, published on 6 May, Spain will be subject to the preventive arm of the Stability and Growth Pact from 2019. Regarding the other Member States, in line with the mandate set out in Article 126(3) of the Treaty on the Functioning of the European Union, the Commission has submitted the related reports on Italy, France, Belgium and Cyprus, in which it analyses whether or not they meet the conditions for initiating an EDP. The Commission's analyses suggest that Italy does not meet the debt criterion and that the related EDP is thus justified. It considers that France currently meets the deficit and debt criteria. Belgium does not meet the debt criterion, but there is not conclusive evidence on the existence of significant deviations from the path of adjustment to the medium-term objectives. The other economic policy recommendations to euro area countries more or less generally put increased emphasis on the need to raise investment and press ahead in education and social inclusion. It was also noted that slow headway has been made in complying with the previous year's recommendations.

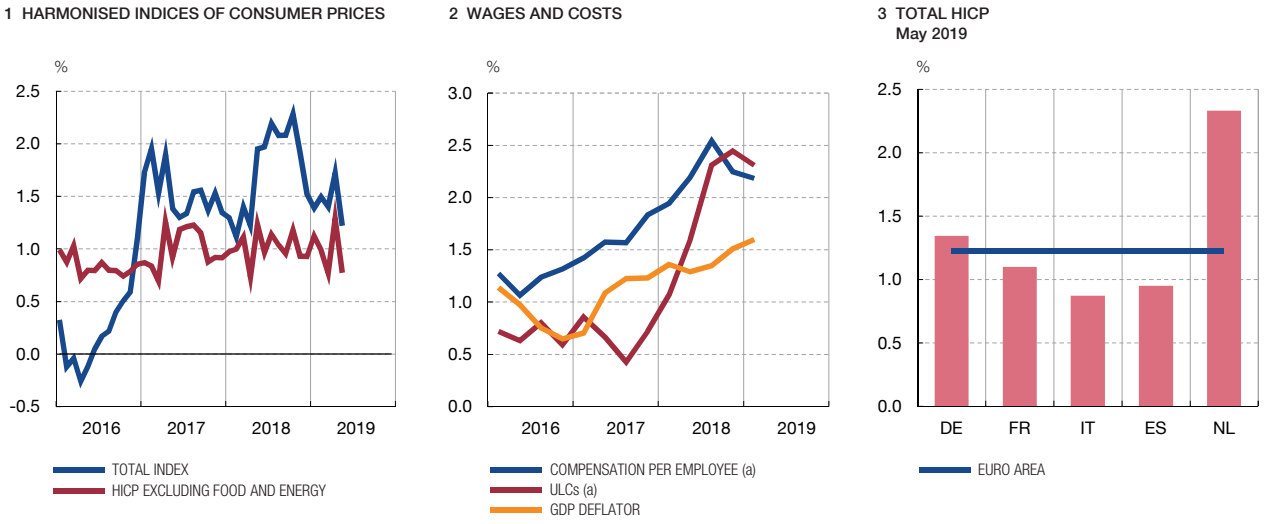
On 10 April and 6 June, the ECB Governing Council resolved to hold the reference interest rate unchanged. In addition, the June meeting extended the announced period for holding interest rates at the current levels until at least the first half of 2020. These decisions were prompted by the downside risks to activity and the growing geopolitical uncertainty associated with the trade disputes and the threat of protectionism.

The June meeting also specified the conditions of the new series of targeted longer-term refinancing operations (TLTRO-III) aimed at preserving favourable bank lending conditions. The interest rate on each transaction will be set at a level 10 bp above the average rate applied to Eurosystem main refinancing operations. Also, the rate applied for banks that sufficiently increase their net lending volume can be as low as the average deposit facility rate plus 10 bp. Immediately after the announcement of these conditions, which are more restrictive than those of the TLTRO-II programme but fairly near to the expectations of investors before the meeting, European banks posted moderate stock market gains which, however, subsequently gave rise to losses.

Market expectations as to the future behaviour of interest rates did not change substantially on the day the ECB's monetary policy decisions were announced. However, these expectations did vary during the quarter, since the expected date of the

EURO AREA INFLATION REMAINS LOW CHART 9

Overall inflation in the euro area decreased to 1.2% in May due to the effect of the energy and services components, while core inflation fell to 0.8%. No feed-through by firms of higher labour costs to prices is apparent.



SOURCE: Eurostat.

a In 2019 including the effect of the transformation in France of the tax deduction for competitiveness and employment (CICE) into a permanent decrease in social security contributions.

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first interest rate rise, which in mid-March was September 2020, has now changed to October 2022.

According to the Bank Lending Survey (BLS), 2019 Q1 saw a slight tightening of credit standards in housing loans and, to a lesser extent, in consumer credit and other lending, and a slight relaxation of those applied to firms. For the second quarter of the year, banks anticipate easier credit standards in corporate and consumer loans and a fresh tightening of credit standards for housing loans. Demand for credit continued to expand in 2019 Q1 in the household sector, particularly for house purchases, while it remained unchanged in firms. Looking forward to the second quarter of the year, banks expect demand to grow in all segments.

In recent months, credit to the non-financial private sector in the euro area has continued to expand. However, year-on-year growth of lending to firms moderated to 3.9% in April due to the delayed effect of the economic downturn on lending to this segment. For its part, household lending continued its gradual improvement (to 3.4% in April), since the deceleration of consumer credit is being offset by faster growth of house purchase loans and by a moderation in the fall in other lending. The year-on-year growth rate of the M3 monetary aggregate stood at 4.7% in April, somewhat higher than in the previous months. The narrowest aggregate (M1) grew more quickly in April (to 7.4%, up 0.8 pp on end-2018).

Financial markets reflected global developments

Spanish financial markets to date in Q2 have been marked by a more risk-averse global environment. This gave rise to increased volatility, declines in equity prices and a flight to quality. That said, these movements were more moderate than those in 2018 Q4. The banking sector was particularly affected by the downward stock market correction. Indeed, the level of practically all Spanish institutions' stock market prices is already lower than at end-2018, despite the price revaluation posted in 2019 Q1. By contrast, the market as a whole posted increases in valuations from the start of 2019. Specifically, at the cut-off date of this report, the IBEX-35 had risen by almost 8% since the beginning of the year, as compared with the 15.1% increase in the EUROSTOXX 50 during the same period.

On the government debt markets, the Spanish ten-year bond yield stood at a historical low. It fell to 0.37%, around 70 bp less than at the end of March. This change was the result of a narrowing by almost 45 bp of the risk premium on Spanish government debt vis-à-vis the German benchmark and of the decline, of around 25 bp, in German government debt yields, owing to the latter's role as a safe-haven asset and to the lower expectations as regards the future path of interest rates. This change in expectations also contributed to the 12-month Euribor having reversed in the last few weeks its rise in 2018. It now stands at -0.21%, marking a historical low.

Overall, financial conditions for households and firms have remained loose in recent months, although the easing cycle observed in recent years may be tailing off. Thus, the Bank Lending Survey (BLS) signals a slight tightening of lending standards in respect of households in 2019 Q1 (both in the house purchase and in the consumer credit and other lending segments). However, these standards remain unchanged for non-financial corporations. The results of the ECB's survey on the access to finance of enterprises in the euro area (SAFE) point to an improvement, once again, in Spanish SMEs' perception of the availability of bank financing during the period from October 2018 to March 2019. This increase, however, was the lowest recorded since 2014 (see Box 7). In recent months the cost of bank financing has remained at low levels in most segments (see Chart 10). Nonetheless, between September 2018 and April 2019 (latest available figure), the average interest rates applied to new loans for house purchase increased by 30 bp. This increase, which was not seen in the other segments in Spain or in the house purchase segment in other European countries, could be related to legislative changes adopted in recent months in Spain in connection with real estate and house purchase lending.

The expansionary course of the Spanish economy continues, mainly underpinned by domestic demand, and despite weak international trade

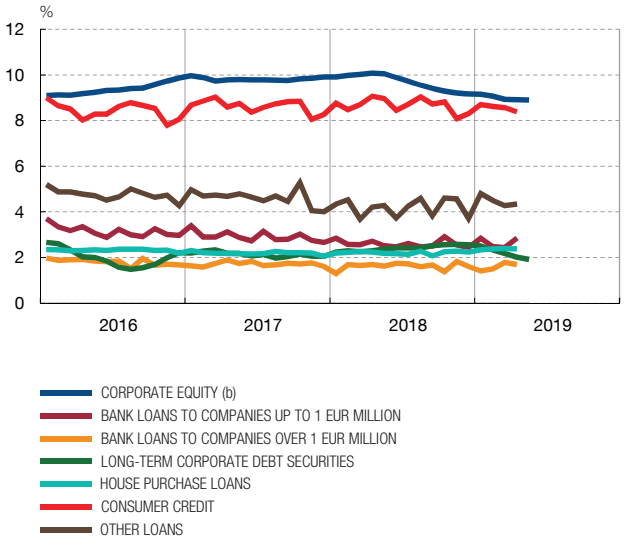
The Spanish economy's growth rate increased in 2019 Q1, against a backdrop of uncertainty and sluggish world trade. Specifically, GDP increased by 0.7% in terms of the seasonally adjusted quarter-on-quarter rate, 0.1 pp up on 2018 Q4. The slight acceleration in GDP is on account of a stronger contribution of domestic demand (see Chart 11). The external sector also contributed positively to GDP growth, as a result of imports declining more sharply than exports. The more marked decrease in purchases abroad is, at least in part, the result of the composition of the fall in exports, which was

ACCESS COSTS TO FINANCE ARE HOLDING AT LOW LEVELS, BUT IN THE HOUSE PURCHASE SEGMENT THEY ARE BEGINNING TO RISE

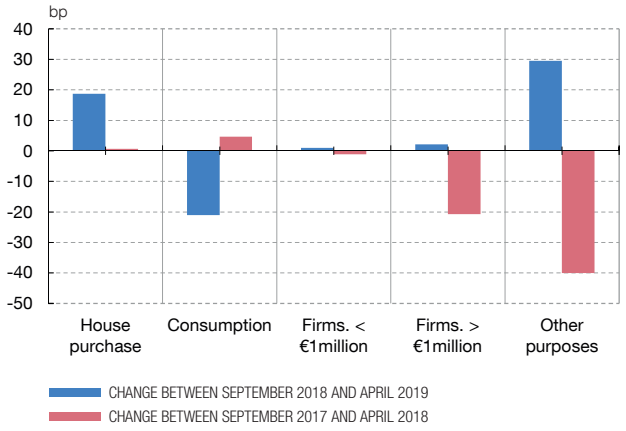
CHART 10

In recent months the interest rates applied to new lending and to other financing have held at low levels, very close to their historical lows. However, between September 2018 and April this year, the cost for house purchase has increased by around 20 bp (which would be 30 bp including bank commissions). This has not been observed in the other segments or in other euro area countries, and would appear to be the result of legislative changes recently introduced into the real estate lending market.

1 FINANCING COST (a)



2 CHANGE IN NDER INTEREST RATES ON NEW BUSINESS (c)



SOURCES: Morgan Stanley, Datastream and Banco de España.

a The interest rates on bank loans are APRC (Annual Percentage Rate of Charge), i.e. they take bank commissions into account; accordingly, they reflect the actual cost of finance for the customer.
b The cost of equity is based on a Gordon three-stage dividend discount model.
c The NDER (Narrowly Defined Effective Rate) interest rate is that which excludes from its calculation the attendant expenses, such as repayment insurance premia and the commissions offsetting related direct costs. The NDER definition is laid out in Banco de España Circular 1/2010 of 27 January 2010.

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biased towards high-import-content products, such as automobiles.

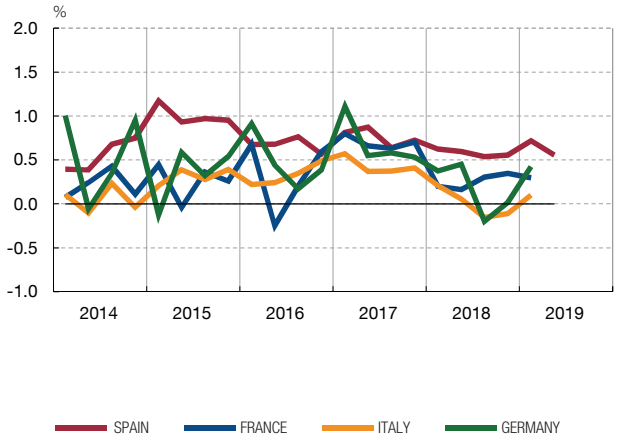
According to the Banco de España's updated projections, GDP is expected to hold on its expansionary path in 2019 Q2, with a slight slowdown. GDP is projected to rise by 0.6%, as compared with 0.7% in 2019 Q1. The increase in GDP in Q2 will be underpinned by domestic demand, with an acceleration in private consumption and investment in construction. This growth will offset the foreseeable negative contribution of external demand, for which, in any event, only very limited information is as yet available.

The Spanish economy is showing notable resilience in an external environment marked by uncertainty and weak global trade. The Spanish economy's growth differential relative to the euro area as a whole is expected to persist in 2019 Q2.

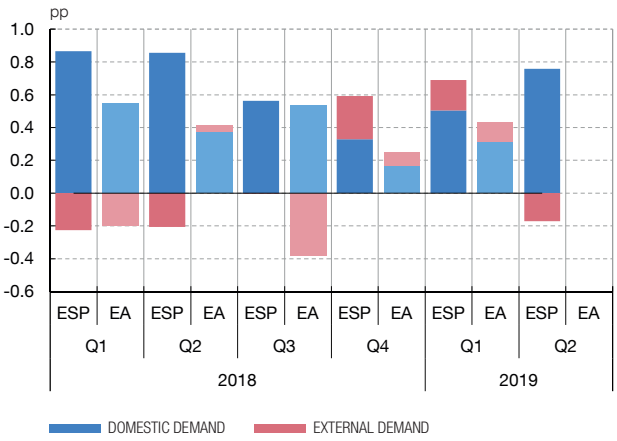
The pace of employment moderated to a greater extent than activity in Q2. The latest data available on social security registrations point to a slowdown in Q2. This is sharper in the market economy (see Chart 12). In the economy as a whole, employment grew in National Accounts terms at a quarter on quarter rate of 0.4%, 0.3 pp down on Q1. According to the Labour Force Survey, the unemployment rate stood at 14.7% in Q1, 2 pp lower than the same period a year earlier. Also in Q1 the rate of decline in the number of unemployed slowed somewhat, while the growth rate of the labour force increased.

The Spanish economy continues to be more dynamic than the other main euro area economies. Output growth will continue to be underpinned by domestic demand.

1 GDP GROWTH
Quarter-on-quarter rates (a)



2 CONTRIBUTIONS TO REAL QUARTERLY GDP GROWTH (a)



SOURCES: INE, ECB and Banco de España.

a Banco de España forecasts for 2019 Q2.

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The pace of domestic demand remains high, although consumption could lose momentum in the future

Household consumption continued to show substantial strength in Q2. Based on the information available, it is estimated that this component grew around 0.5% quarter-on-quarter in Q2, supported by the stabilisation of the confidence indices following the declines in prior quarters (see Chart 13). Employment creation continued to underpin the buoyancy of household income. Favourable financial conditions continue to support private consumption. The same is true for households' financial situation, insofar as the debt ratio has continued to decrease as has, to a lesser degree, the debt burden ratio relative to gross disposable income. At the same time, wealth increased, mainly on the back of higher house prices and lower financial liabilities.

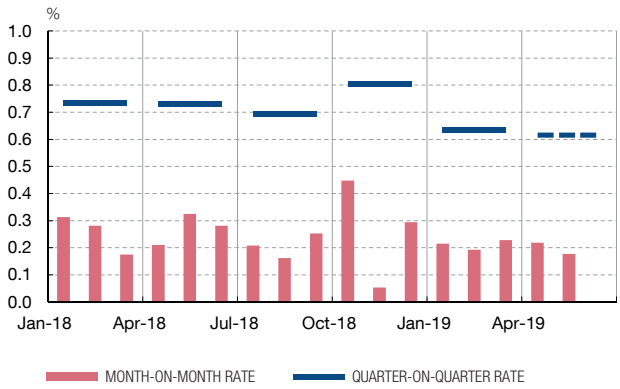
The lower saving rate and the robustness of credit earmarked for financing private consumption raise some uncertainty about the continuity of the strength observed in this type of expenditure. Households are assigning a higher proportion of their income to current expenditure, which has led the saving rate to a level close to its historical low, according to the latest available data. As a result, saving is insufficient to finance household spending on investment, giving rise to growing financing needs. Also, the volume of new consumer loans continued increasing, albeit on a slowing path. According to the BLS, this recent development appears to reflect tighter lending conditions and a decline in the demand for loans, a pattern not seen since 2013 Q1.

Residential investment has also remained expansionary in the most recent period. The real estate market remained buoyant, as regards both house sales and purchases, and house prices. However, there are certain signs of business confidence in construction and of the growth of Social Security registrations in the sector. The moderate, though ongoing,

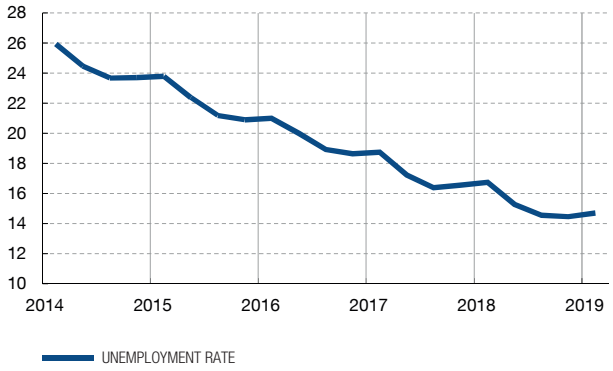
THE LABOUR MARKET CONTINUES TO PERFORM FAVOURABLY CHART 12

Employment growth has eased slightly in the most recent period, a development that will not prevent a prolongation of the declining path of the unemployment rate.

1 SOCIAL SECURITY REGISTRATIONS



2 UNEMPLOYMENT RATE (LFS)



SOURCES: INE, Ministerio de Trabajo, Migraciones y Seguridad Social and Banco de España.

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increase in building permits suggests that the recovery of this component of demand will continue in the future. As regards lending for house purchase, the latest BLS data point to an improvement in demand in 2019 Q1, a pattern which banks anticipated would continue in Q2, while pointing towards a tightening of lending standards.

Real estate activity and prices continue to show heterogeneity in terms of geographical location. There are appreciable regional differences in the real estate market's pace of recovery, both in terms of purchases and sales and of prices. The fastest growth rates relate to large cities and the coast, where activity and foreign demand for housing are more buoyant and there is a higher population density.

Following its strong rate of increase in Q1, the buoyancy of business investment has recently become more contained. The continuing strength of investment is in keeping with the extension of the expansionary path of the economy, against a backdrop of high capacity utilisation and accommodative financial conditions (see Chart 14). Also, the decrease in the sectoral debt ratio strengthened the financial position of non-financial corporations. In any event, ongoing uncertainty about economic policy and risks to global trade are factors that might check the expansion of this demand component.

The growth rate of non-financial corporations' external financing has risen in recent months, but remains moderate. This development mainly reflects the acceleration in fixed-income securities issuance, while lending continued to decline owing to demand-side factors, according to the BLS.

Foreign trade flows remain weak, especially on the export side

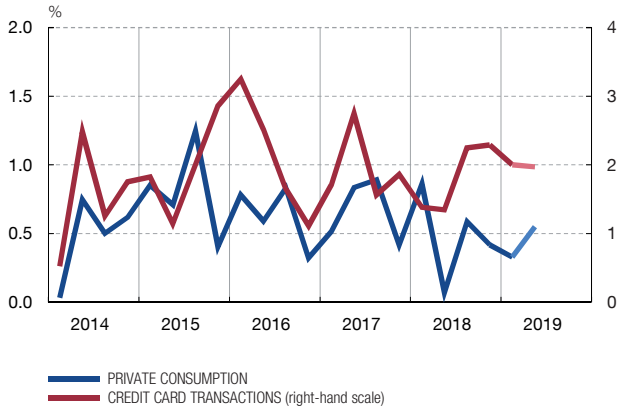
The external sector is expected to post a negative contribution in Q2, mirroring the more marked increase in imports as compared with exports. Foreign transactions posted unforeseen declines in Q1, which are expected to be gradually reversed. On the very partial information available, goods trade with the rest of the world shows signs of a

PRIVATE CONSUMPTION REMAINS BUOYANT

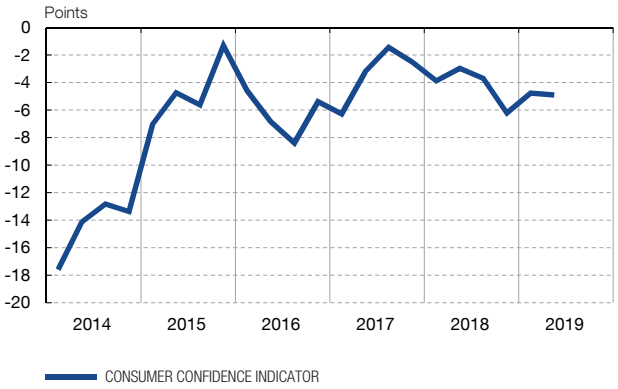
CHART 13

Private consumption is expected to continue posting relatively high growth rates in Q2, although the low saving rate and the slowdown in lending pose risks for the medium-term continuity of this trajectory.

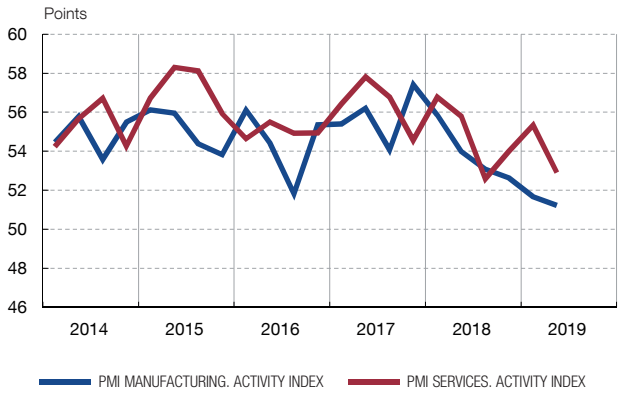
1 PRIVATE CONSUMPTION AND CREDIT CARD TRANSACTIONS
Quarterly rate (a)



2 CONSUMER CONFIDENCE



3 PURCHASING MANAGERS' INDEX



4 NEW CONSUMER LOANS
Year-on-year rates (b)

SOURCES: European Commission, IHS Markit, INE and Banco de España.

a Banco de España forecasts for 2019 Q2.
b Calculations using three-month cumulative flow.

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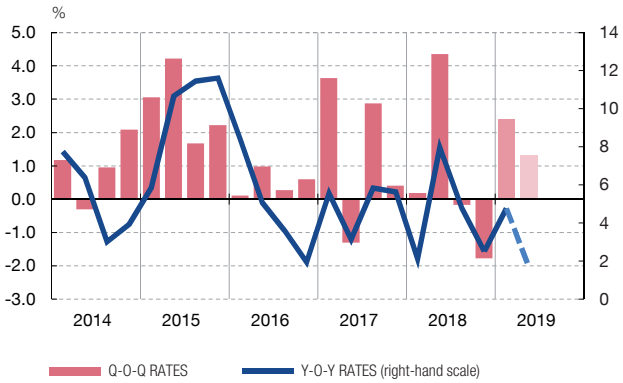
gradual realignment with its determinants, particularly in the case of imports (see Chart 15). On the export side, the depreciation by the euro since the start of the year would support a more favourable outlook for exports, following the significant appreciation since 2017. The impact of price competitiveness on Spanish exports is relatively high. This is due in part to their composition, given that low and medium-low technology-intensive exports have a greater relative weight than in the main euro area countries. However, the scale and persistence of the gradual improvement in exports over the coming quarters will depend on the extent to which external markets actually pick up. That follows the weakness shown by trade globally and in the euro area, which is Spain's main export market. In this respect, the indicators of the outlook for foreign orders by the main areas point to some continuation of this contractionary trend in the coming months. In addition, car exports still show no signs of recovery, following the adverse impact that the adoption of the new emissions regulations entailed. This path of exports has a bearing, in turn, on import dynamics, given the high import content of sales abroad, particularly in certain sectors,

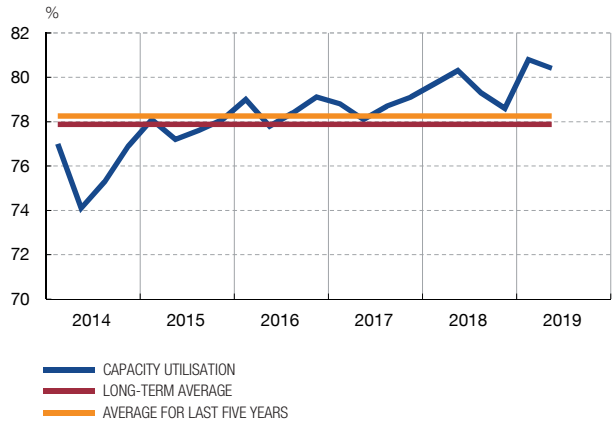
THE PACE OF BUSINESS INVESTMENT EASES FOLLOWING THE STRONG RISE THE PREVIOUS QUARTER CHART 14

Investment in capital goods and intangibles is underpinned by high capacity utilisation, the improvement in firms' financial position and the looseness of financial conditions. However, uncertainty in the external environment is a factor of risk.

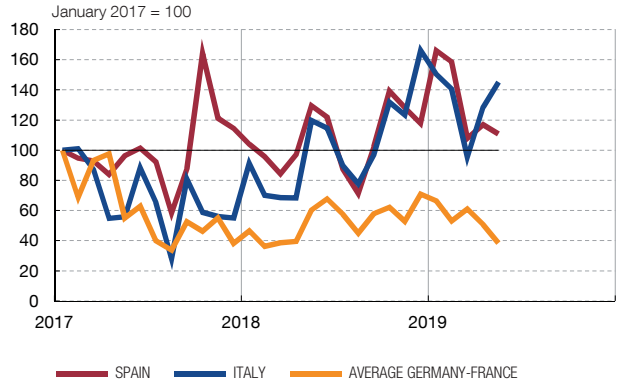
1 INVESTMENT IN EQUIPMENT, INTANGIBLES AND OTHER (a)



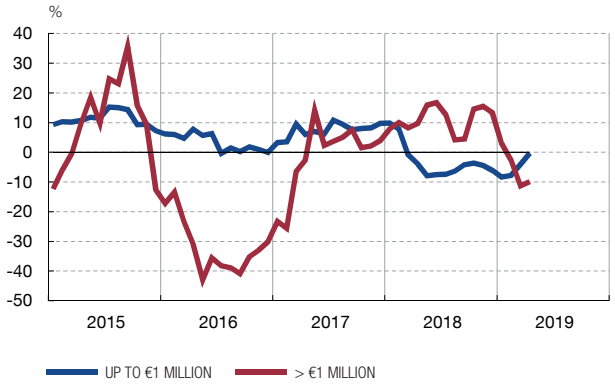
2 CAPACITY UTILISATION IN INDUSTRY



3 ECONOMIC POLICY UNCERTAINTY INDICATOR



4 NEW LOANS FOR CORPORATIONS
Year-on-year growth (b)



SOURCES: European Commission, www.policyuncertainty.com, INE and Banco de España.

a Includes machinery, capital goods, armament systems, cultivated biological resources and intellectual property products. Banco de España forecasts for 2019 Q2.
b Calculated using three-month cumulative flow.

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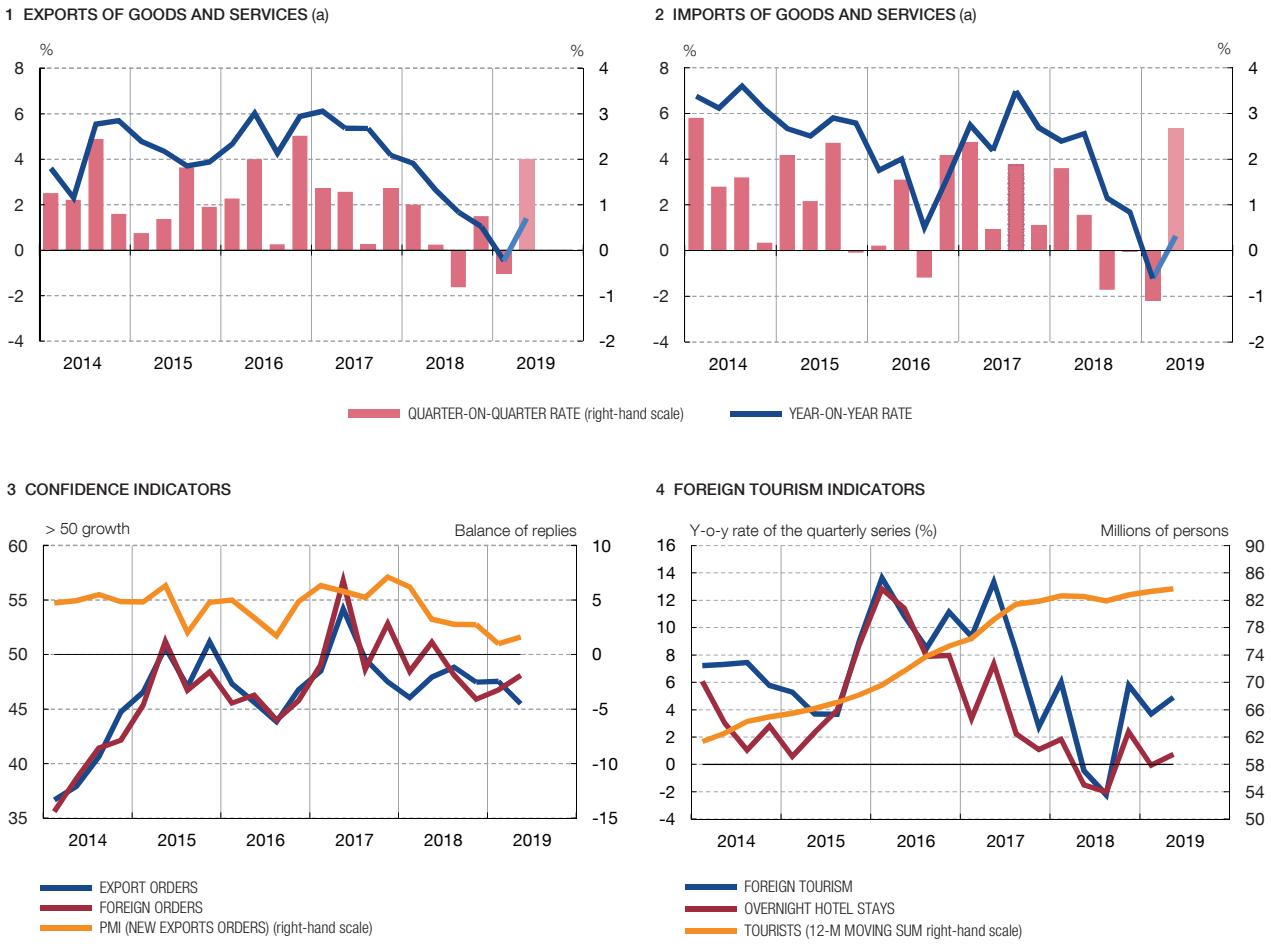
including most notably the car industry. Indeed, the significant decline in imports in Q1 was influenced, at least in part, by the fall-off in car sales abroad.

The slackness of goods exports in Q1 was across the board in terms of markets and particularly affected consumer goods. On Customs figures, the decline in real goods exports largely mirrored the reduction in sales of non-food consumer goods, in particular cars. Capital goods exports were also weak. By geographical area, the reduction was more marked in exports to the euro area and to non-Community markets. Real imports are moving, according to Customs figures, on a path of recovery, in line with the forecast trajectory of final demand, and despite the decline in energy purchases. Most notable among other products is the pace of capital goods imports.

Turning to services exports, the improvement observed in tourism since the final stretch of 2018 has continued. On the latest available indicators, to April, the rise in total tourist spending has been underpinned by the increase in average spending per tourist

EXPORTS IMPACTED BY WEAK GLOBAL TRADE, PARTLY OFFSET BY THE IMPROVEMENT IN TOURISM CHART 15

In 2019 Q2 a negative contribution by the external sector to quarter-on-quarter output growth is foreseen, against the background of a pick-up in imports more marked than that in exports.



SOURCES: INE, Ministerio de Industria Comercio y Turismo, European Commission, Markit and Banco de España.

a Quarterly National Accounts (QNA) figures at constant prices. Seasonally adjusted series. Banco de España forecasts for 2019 Q1.

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and in foreign tourist inflows. In the course of the year the geographical diversification of tourist inflows has continued, as a result of the rise in those from non-Community countries. Within the EU, inflows from Germany have picked up while British tourism has tended to flatten.

The increase in activity has been underpinned by construction and by the prolongation of the growth path of services

By sector, the indicators point to some slowdown in activity in industry. In recent months in particular there has been an observable slowdown in the pace of Social Security registrations and relatively unfavourable behaviour in the case of the scant indicators of activity available for Q2. Moreover, as regards the confidence indicators, the worsening path of the manufacturing PMI has become more entrenched as a result of the weakness of international trade and of the unfavourable outlook for the external environment (see Chart 14). As to services and construction, the conjunctural information drawn from the confidence indicators and from the figures on registrations is consistent with some easing in activity.

The slow correction of the budget deficit continues, against a background of growth in revenue and expenditure

The latest available information shows a continuation of the mild correction in the budget deficit. Excluding local government, the general government balance stood in 2019 Q1 at 0.3% of GDP, 0.1 pp down on the same period a year earlier. This slight improvement is chiefly the result of the buoyancy of revenue, in a setting in which expenditure is also moving at a brisk pace (of over 4%). Of note under revenue is the behaviour of Social Security contributions, whose growth partly reflects the measures approved in late 2018. These developments should contribute to improving the budgetary balance for the year as a whole.

The European authorities have confirmed in June that the general government sector has left its "excessive deficit" situation behind, but there is a risk of failing to comply with the recommendations for 2019. In early July the EU Council will approve the abrogation of the Excessive Deficit Procedure, to which the Spanish economy has been subject since 2009. Spanish public finances will now come under the so-called preventive arm of the EU's Stability and Growth Pact. Given the persistence of the Spanish public finances shortfall, the preventive arm also entails obligations for general government. In 2019 as a whole these will involve, according to the EC's recommendations, an adjustment in the structural balance of 0.65 pp of GDP and maximum growth in eligible spending of 0.6%. According to the Spanish government's Stability Programme Update last April, these figures would not be met (see Box 6).

Diminished dynamism of prices in the absence of significant external inflationary pressures, although wages are rising

Inflation, measured by the Harmonised Index of Consumer Prices (HICP), eased in May to 0.9% (see Chart 16). This reflected the slowdown in energy and food prices, habitually the most volatile components. Core inflation grew by 1% in May, a similar rate to that being observed since late 2017. This is despite the fact that the output gap, which measures the degree of use of productive factors, has widened. In terms of components, services inflation stood at 1.4%, after temporarily rising in April owing to Easter week falling on different dates in 2019 and 2018. Non-energy industrial goods prices quickened slightly, to 0.4%, their highest rate since early 2017. In the euro area as a whole, price-rise patterns were relatively similar across the different components, although inflation stood above that in Spain. As a result, the inflation differential in Spain vis-à-vis the euro area remains negative.

External inflationary pressures are moderate, despite the recent increase in oil prices. Crude oil prices moved on a rising trajectory to May and have declined thereafter. On information drawn from the futures markets, this decline is expected to continue to the end of the year. The year-on-year growth rate of industrial producer prices remains very moderate. Conversely, some quickening is discernible in the import prices of these products, whose inflation rates remains, in any event, at relatively contained levels.

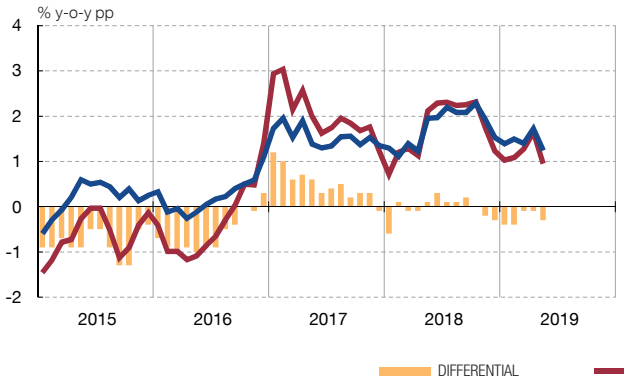
The inflation rate in Spain in recent months has tended to stand below forecast. In particular, the increase in the energy component has been lower than expected, as a result of the negative surprises in electricity and gas prices. That has led to a downward revision of HICP projections for 2019 as a whole. However, the projection for the HICP excluding energy and food for the whole of 2019 has scarcely moved in recent months, currently standing at somewhat above 1%.

MODERATE CONSUMER PRICES AND RISE IN WAGES

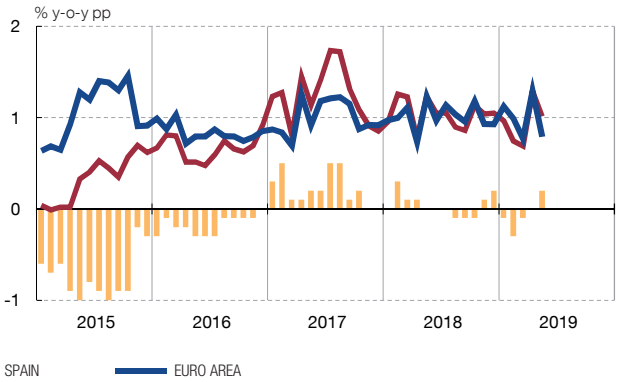
CHART 16

Inflation in Spain maintains a negative differential with that of the euro area, against the backdrop of lower-than-expected increases in the energy component, while core inflation is moving on a similar course. External inflationary pressures remain contained and a rise in wage costs is discernible.

1 OVERALL INDEX

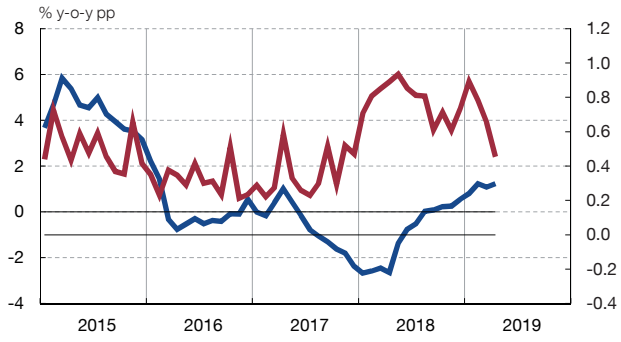


2 OVERALL INDEX EXCLUDING ENERGY AND FOOD



DIFFERENTIAL SPAIN EURO AREA

3 NON-ENERGY INDUSTRIAL GOODS (a)

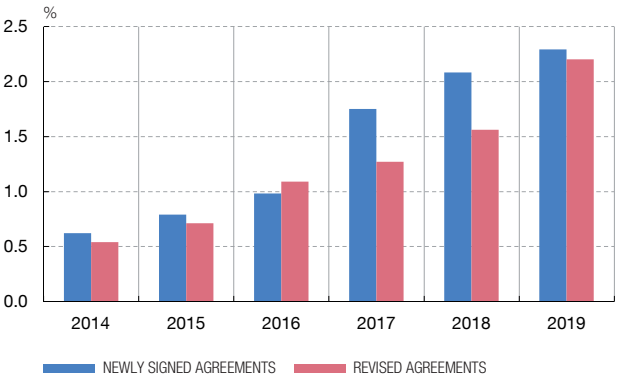


IMPORT PRICE INDICES FOR INDUSTRIAL PRODUCTS
PRODUCER PRICES (right-hand scale)

4 SPOT AND FUTURES MARKET OIL PRICES

QUARTERLY REPORT MARCH 2019
CURRENT PROJECTION

5 AGREED WAGE INCREASES (b)



NEWLY SIGNED AGREEMENTS REVISED AGREEMENTS

6 INFLATION EXPECTATIONS

ACTUAL INFLATION
BREAK-EVEN INFLATION QUARTERLY REPORT MARCH 2019 (c)
BREAK-EVEN INFLATION

SOURCES: INE, Eurostat, Reuters, Ministerio de Trabajo, Migraciones y Seguridad Social and Banco de España.

a Indices calculated on the basis of PPI and IPIIP items that are reflected in the HICP.
b On information to May 2019.
c Implied inflation calculated on the basis of inflation swaps.

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On the costs side, wage indicators have risen in 2019. Wage rates under collective bargaining agreements have, on data to May, risen appreciably on the previous year, affecting what is now a very high number of workers. Specifically, the agreed wage rise for 2019 is, on average, 2.2%, 0.5 pp up on 2018. For the moment, most of these agreements are those made in previous years, while newly signed agreements still account for a scarcely representative figure. In any event, the degree of pass-through of higher wage costs to prices is uncertain; as is occurring in the rest of the euro area, firms' mark-ups appear to be accommodating these increases.

24.6.2019.