

QUARTERLY REPORT ON THE SPANISH ECONOMY

During the summer months there has been some weakening of global activity, accompanied by a fall-off in world trade. These developments took place against a background of rising global uncertainty and deteriorating confidence, associated with the intensification of trade and geopolitical tensions. From the viewpoint of the components of demand, the increase in uncertainty has affected investment in particular. Private consumption, in contrast, is behaving relatively more favourably because employment and, therefore, household incomes have held up. By sector, the negative effects of the developments observed were stronger in manufacturing, in line with the deterioration of trade, than in services.

By geographic area, activity is proving more resilient in the United States and China than in Europe and in most of the emerging economies. In the euro area, Germany is being especially affected, given the high weight of exports and industrial sectors in its economy and, in particular, the importance of the production of capital goods, on top of which there was the specific shock suffered by the automotive industry.

Moreover, in August, the financial markets reacted to the increase in uncertainty. The increase in global risk aversion led to a shift in flows towards safe assets, with notable declines in sovereign debt yields, increases in corporate bond spreads and a rise in stock market volatility. Also, emerging currencies weakened against the dollar and commodity prices fell. In September, these movements tended to be reversed, and in the case of the oil price, this tendency has been reinforced more recently by the supply problems resulting from the attacks on Saudi Arabian oil facilities.

In this context, global growth projections depend upon the assumptions regarding the degree of persistence of the current sources of uncertainty. In the central scenario of numerous recent forecasts, the uncertainty dissipates after a few quarters and a path of robust expansion is then resumed. In this scenario, both intensification and persistence of the current slowdown are ruled out.¹ However, in other scenarios, the uncertainty takes longer to ease, in which case it would be more difficult for developments in the services sector to remain decoupled from those in

¹ This is the case of the latest ECB staff projections for the euro area. The assumption translates into a downward revision of the GDP and consumer price growth paths. Specifically, the revision in the case of output is of 0.1 and 0.2 percentage points (pp) in 2019 and 2020, respectively, and in the case of underlying inflation 0.1 pp in both 2020 and 2021.

the manufacturing sector and for the relatively positive tempo of employment to be sustained. Also, the negative effects of factors such as obstacles to trade and a hypothetical disorderly Brexit are not limited to a negative short-term demand impact, but also entail negative consequences for productivity and investment at longer time horizons.

Economic developments in recent months have led to the adoption of expansionary monetary policy measures. The weakening of activity during the summer, the deterioration in the economic outlook and continued low levels of inflation (in some cases, well below monetary policy targets), prompted a reaction by central banks. Specifically, the US Federal reserve has reduced the target range for its reference rate by 25 basis points on two occasions (in July and September). Also, it has brought forward completion of the reduction in the size of its balance sheet by a few months.

Meanwhile, the Governing Council of the European Central Bank (ECB) decided, at its meeting of 12 September, to adopt a number of measures to increase the degree of monetary accommodation. The package of measures includes a 10 basis point (bp) reduction in the interest rate on the deposit facility to -0.50%. The Governing Council also modified its forward guidance on the period in which it expects interest rates to remain at their present or lower levels, replacing the previous time reference with a formulation under which the path of rates depends on convergence of the inflation outlook, within its projection horizon, to a level sufficiently close to, but below, 2%, and on such convergence being reflected in underlying inflation dynamics. In addition, the restart of net asset purchases was announced, which will continue until shortly before the first rise in key ECB interest rates, as well as the reinvestment of the assets in its portfolio as they mature for an extended period of time, past the first rise in key ECB interest rates. Finally, in order to support the monetary policy transmission mechanism, certain parameters of the longer term refinancing transactions for euro area financial institutions (known as TLTRO-III) were recalibrated and a mechanism was introduced for reserve remuneration, under which part of banks' holdings of excess liquidity is exempt from the negative deposit facility rate.

At the same time, a growing consensus is emerging on the advisability of expansionary monetary policies being complemented by the contribution of other economic policies. Monetary policy has performed a very important role following the crisis by maintaining accommodative financing conditions to support private spending and by bringing inflation rates close to target. However, the capacity of this instrument to affect the economy is not unlimited. In the euro area, the ECB accompanied its recent package of monetary policy measures with calls for the adoption of a reform agenda to boost potential growth and for fiscal policy collaboration which, in the absence of an instrument at euro area level, depends on those national governments that have fiscal space available.

Table 1

MAIN SPANISH MACROECONOMIC AGGREGATES (a)

	2017	2018	2018				2019		
			Q1	Q2	Q3	Q4	Q1	Q2	Q3
National accounts									
Quarter-on-quarter rate of change, unless otherwise indicated									
Gross domestic product	2.9	2.4	0.5	0.5	0.5	0.6	0.5	0.5	0.4
Contribution of national demand (b)	3.0	2.6	0.6	0.7	0.4	0.2	0.3	0.1	0.5
Contribution of net external demand (b)	-0.1	-0.3	-0.1	-0.3	0.1	0.4	0.2	0.4	-0.2
Year-on-year rate of change									
Employment	2.8	2.5	2.6	2.4	2.5	2.7	2.7	2.4	1.6
Price indicators (c)									
Harmonised index of consumer prices (HICP)	2.0	1.7	1.1	1.8	2.3	1.8	1.1	1.1	0.5
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	1.1

SOURCES: INE and Banco de España.

a Information available to 19 September 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 Q3 is the average of the July and August year-on-year rates.

In Spain too, signs of activity weakening have also been observed. On National Statistics Institute (INE) estimates, the 0.5% rate of GDP growth recorded in Q1 was maintained in Q2 (see Chart 1).² By component, there was a notable weakening in domestic demand, along with a decline in investment in capital goods, in keeping with the uncertainty stemming from the external environment and with the weakness of manufacturing sectors. The slowdown in world trade was also apparent in the sluggishness of exports. In addition, the growth rate of private consumption was zero, possibly also reflecting the rise in uncertainty. The slowdown in final demand translated into very low import growth, and thus a significant positive contribution to output growth from the net external balance.

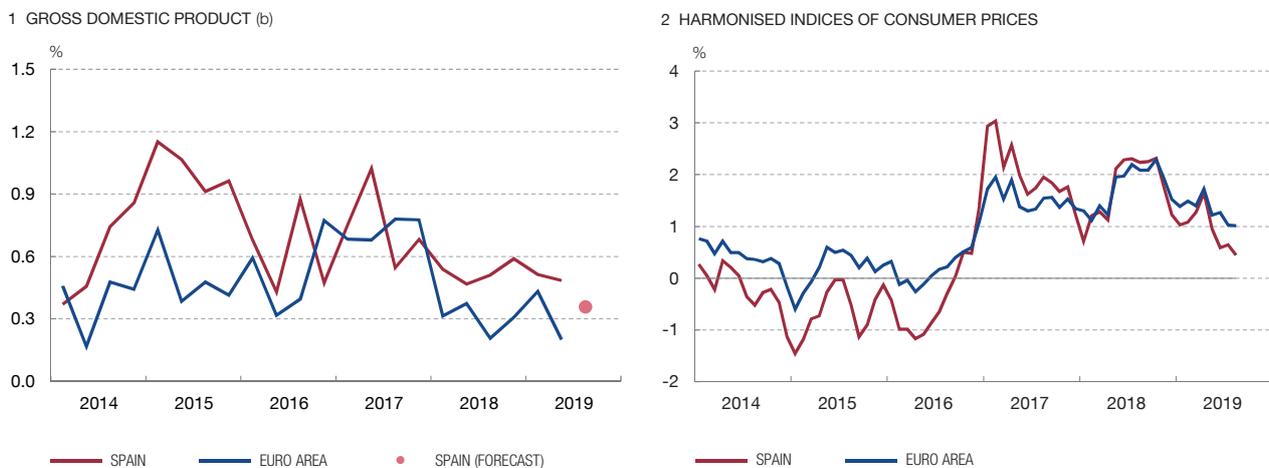
For the summer months, the indicators point to a modest additional slowdown in activity. Output in Q3 may have grown by 0.4%, relative to Q2. In particular, Social Security registration data have shown a loss of buoyancy since May which, although very marked in construction and industry, has also affected the various services industries. This sectoral pattern has also been replicated by other indicators of activity developments. The slowdown observed has, however, been milder than in the euro area as a whole. In the context of uncertainty described, the information available points to a prolongation of the current stage of certain short-term activity weakness.

² On 16 September, the INE published revised annual National Accounts time series (see Box 8). It also released quarterly time series consistent with the annual ones.

Chart 1

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

Despite the slowdown in expected growth for Q3, 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.



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 rates of change on the original series, in the case of the consumer price indices.
- b The figure for Q3 is a Banco de España projection.



Over the next two years, the current growth phase is expected to continue, albeit with a lower growth rate than in recent years. The projections for the Spanish economy presented in Box 1 envisage, on the assumption that the current uncertainties will tend to dissipate beyond the short-term, a continuation of the current growth phase, against a background of persistence of very favourable financial conditions for spending, prolongation of the process of job creation (albeit at a more moderate rate than in the past), real wage increases and recovery in the growth of world trade. In comparison with the June projections, the current ones reflect a moderate worsening of the outlook for activity. The downward revision to the average annual GDP growth rate for 2019 amounts to 0.4 pp. This is partly a result of the automatic effect of the new National Accounts time series, which now estimate lower output growth at the beginning of the year, and partly of less favourable projections for Q2.³ The downward revision to GDP growth in 2020 is 0.2 pp and in 2021, 0.1 pp.

The central scenario for economic activity developments is subject to significant downside risks. In particular, as mentioned above, the outlook of

³ See González Mínguez, J. and C. Martínez Carrascal (2019), *The relationship between average annual and quarter-on-quarter GDP growth rates: implications for projections and macroeconomic analysis*, Banco de España.

continued output and employment growth in the economy rests on the assumption that the sources of uncertainty that have weighed on the world economy in recent quarters will tend to be dispelled beyond the short term. However, the hypothetical introduction of new protectionist threats would give rise to prolongation of the current phase of weakness in world trade. Also, a possible disorderly Brexit would entail a negative shock with potentially significant implications for euro area activity. Finally, in China, there is a risk of a sharper slowdown than at present, which could entail greater weakness of international trade flows. Domestically, the ongoing political stalemate and absence of legislative activity is delaying the adoption of the measures needed to address the vulnerabilities that still afflict the Spanish economy and to raise its growth capacity.

MACROECONOMIC PROJECTIONS FOR SPAIN (2019-2021)

This box describes the most notable features of the update to the Banco de España's macroeconomic projections for the Spanish economy published on 7 June 2019.¹ In particular, the present projections take on board the changes to the technical assumptions arising from the new information that became available between the two exercises (see Table 1)² and the latest National Accounts data. The latter include a revision made by the National Statistics Institute (INE) to the time series for the period 1995-2018 and, also, preliminary results for the quarterly time series up to 2019 Q2 (see Box 8). This recent revision of the National Accounts time series means that it is

particularly hard to make comparisons with the June projections.³

The present projections point to continuation of the Spanish economy's expansionary phase over the period 2019-2021 (see Table 2). Growth will continue to be underpinned by the accommodative stance of monetary policy, reinforced by the measures adopted by the Governing Council of the European Central Bank (ECB) at its last meeting, the favourable financial position of firms and households on aggregate (although some groups of agents are still in a comparatively vulnerable situation),

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

Annual rates of change unless otherwise indicated

	September 2019 projections				Differences between September and June 2019 projections (b)		
	2018	2019	2020	2021	2019	2020	2021
International environment							
World GDP	3.6	2.8	3.2	3.3	-0.2	-0.2	-0.1
Spain's export markets	3.0	1.9	2.5	3.0	-0.7	-0.5	-0.2
Oil price in US dollar/barrel (level)	71.1	64.0	60.0	57.9	-4.1	-5.8	-4.8
Monetary and financial conditions							
US dollar/euro exchange rate (level)	1.18	1.12	1.10	1.10	-0.01	-0.02	-0.02
Nominal effective exchange rate against non-euro area (c) (2000 = 100 and percentage differences)	121.5	116.4	115.1	115.1	-0.3	-1.1	-1.1
Short-term interest rate (3-month EURIBOR) (d)	-0.3	-0.4	-0.5	-0.5	0.0	-0.2	-0.3
Long-term interest rate (10-year bond yield) (d)	1.4	0.6	0.4	0.6	-0.5	-0.9	-1.0

SOURCES: ECB and Banco de España.

- a** Cut-off date for assumptions: 17 September 2019. Figures expressed as levels are annual averages. Figures expressed as rates are calculated based on the relevant annual averages.
- b** Differences between rates for world output and export markets and between levels for oil prices and the dollar/euro exchange rate. Percentage differences for the effective nominal exchange rate and percentage point differences for interest rates.
- c** A positive percentage change in the nominal effective exchange rate denotes an appreciation of the euro.
- d** For the projection period, the figures in the table are technical assumptions, prepared using the Eurosystem's methodology. These assumptions are based on futures market prices or on proxies thereof and should not be interpreted as a Eurosystem prediction as to the course of these variables.

- 1 [Macroeconomic projections for the Spanish economy \(2019-2021\): the Banco de España's contribution to the Eurosystem's June 2019 joint forecasting exercise.](#)
- 2 The June 2019 projections were based on the information available as at 15 May for those variables that have a bearing on the projections. In the latest exercise the cut-off was 17 September, except for data on export markets and the prices of competitors in their national currencies, which were taken from the [ECB staff macroeconomic projections for the euro area, September 2019](#), which use information up to 19 August.
- 3 A further difficulty is that sector accounts consistent with the annual National Accounts and the preliminary quarterly results have still not been published.

MACROECONOMIC PROJECTIONS FOR SPAIN (2019-2021) (cont'd)

and the assumption that, following their recent weakness, export markets will tend to recover gradually over the projection horizon. As a result of all this, it is expected that the growth rate of the economy will continue to enable the still high volume of unemployment to be reabsorbed.

Notwithstanding this, activity will tend to become less buoyant over the projection horizon. In terms of average annual rates, after growing by 2.4% in 2018, GDP is projected to grow by 2% in 2019, and by 1.7% in 2020 and 1.6% in 2021. This profile of deceleration is partly a result of weaker domestic demand, revealed by the latest National Accounts data, and partly a consequence of the latest economic data available, which point to a weakening of activity over the summer months. Overall, this new information shows that the deterioration of the external

environment and the uncertainties originating from the rest of the world (and possibly also other domestic ones) appear to be having a moderating impact on business and household spending. This context of greater uncertainty is expected to continue to weigh on agents' spending decisions, particularly in the short term, leading to more moderate activity growth than in recent years.

Notable, in comparison with the June projections, are the significant changes made to three of the assumptions on which the projections are based. First, the expected dynamism of Spain's export markets is now less than it was three months ago, especially in 2019 and 2020, as a result of the lower growth projected for the euro area and, especially, for the economies outside the euro area (see Table 1). The cumulative growth of external markets over

Table 2
PROJECTIONS FOR THE MAIN MACROECONOMIC AGGREGATES OF THE SPANISH ECONOMY (a)

Annual rate of change in volume terms and % of GDP

	2018	September 2019 projections			Differences between September and June 2019 projections		
		2019	2020	2021	2019	2020	2021
GDP	2.4	2.0	1.7	1.6	-0.4	-0.2	-0.1
Private consumption	1.8	1.0	1.3	1.4	-0.8	-0.4	-0.1
Government consumption	1.9	1.8	1.3	1.2	0.0	0.0	0.0
Gross fixed capital formation	5.3	2.3	3.4	2.6	-1.9	-0.5	-0.3
Investment in equipment, intangibles and other (b)	4.1	2.3	2.9	2.3	-1.4	-0.6	-0.3
Investment in construction	6.6	2.3	3.9	2.9	-2.3	-0.4	-0.3
Exports of goods and services	2.2	2.2	3.0	3.3	0.6	-0.2	-0.2
Imports of goods and services	3.3	0.5	3.2	3.4	-0.9	-0.6	-0.2
Domestic demand (contribution to growth)	2.7	1.4	1.7	1.5	-0.9	-0.4	-0.2
Net external demand (contribution to growth)	-0.3	0.6	0.0	0.1	0.5	0.2	0.0
Harmonised index of consumer prices (HICP)	1.7	0.8	1.1	1.5	-0.3	-0.2	0.0
HICP excluding energy and food	1.0	1.1	1.4	1.6	-0.1	-0.1	-0.1
Employment (full-time equivalent jobs)	2.5	1.8	1.3	1.5	-0.2	-0.2	-0.1
Unemployment rate (% of labour force). End-of-period data	14.4	14.1	13.2	12.8	0.2	0.8	1.0
Unemployment rate (% of labour force). Annual average	15.3	14.1	13.6	13.0	0.2	0.6	0.9
General government net lending (+) / net borrowing (-) (% of GDP)	-2.5	-2.4	-1.8	-1.5	0.0	0.0	0.1

SOURCES: Banco de España and INE.
Latest QNA figure published: 2019 Q2.

a Projections cut-off date: 17 September 2019.

b Includes machinery, capital goods, weapons systems, cultivated biological resources and intellectual property products.

the whole of the time horizon considered has been revised downwards by 1.4 pp. Compared with the negative impact on activity that this change gives rise to, the other two changes work in the opposite direction. In particular, there has been a notable downward revision to the oil price, which boosts the growth of private agents' real incomes. Also, the paths of interbank market interest rates and government debt yields are now considerably below those anticipated three months ago, which results in lower financing costs for the economy as a whole. This revision to the interest rates expected by the financial markets is explained by two main factors: the latest euro area activity and inflation data (which is less favourable than was anticipated three months ago); and the loosening of monetary policy in the United States and the new monetary stimulus measures adopted by the Governing Council of the ECB on 12 September.⁴

The changes in the fiscal policy assumptions for the projection horizon, relative to the June projections exercise, are of little significance. As in June, the fiscal policy forecasts incorporate the extension to 2019 of the 2018 State and Social Security budgets, the measures approved by parliament before the April general elections,⁵ the regional government and local government budgets approved for 2019, as well as the information available on the budget outturn. As regards the assumptions for the rest of the time horizon considered, the upcoming general elections make it practically impossible for the draft budget for 2020 to be presented in 2019. Also, as at the cut-off date for the projections, the new National Accounts time series for general government, to be published on 30 September, were still not available. Accordingly, the projections take as their starting point the previously released 2018 data.

Against this background, when projecting the expected paths of certain budgetary items over the period 2020-2021, certain technical assumptions have been made, as in the June projections. First, that the items

subject to greater discretion, including notably, on account of their size, purchases of goods and services and public investment, will grow in line with the Spanish economy's potential growth rate. Second, it is considered that the paths of the other items, making up the general government accounts will be determined, in the absence of additional measures, by their usual determinants. Specifically, it is assumed that public revenues will grow in line with the tax bases, which basically depend on the macroeconomic context. Similar assumptions have been made for less discretionary spending items, including spending on pensions (which is determined, along with the increases agreed for 2018-2019, by the revaluation formula established by law and by population ageing), unemployment benefits (the growth of which will depend basically on developments in unemployment) and interest (changes in which reflect the growth of government debt and the course of interest rates). This last item, in particular, has been revised down on account of the changes observed in market interest rates compared with the previous projections. In accordance with these assumptions, the fiscal policy stance will be expansionary in 2019, and approximately neutral over the following two years.⁶

The changes to the assumptions on which the projections are based have, overall, a neutral impact on GDP growth over the projection horizon. Specifically, the negative impact of the deterioration in external markets on activity is offset by the positive effect of lower financing costs and lower oil prices. Notwithstanding this, the information that has become available since June has led to a downward revision in the GDP growth rates projected over the projection horizon, in comparison with those published in June. This is a consequence of two types of factors. First, the revised National Accounts time series indicate that the Spanish economy's resilience to the context of global uncertainty which began to gradually take hold last year is actually lower than estimated three months ago. Indeed,

⁴ See Section 3.2 of the main text for a detailed description of these measures.

⁵ Among these measures, which were already included in the March and June projections, the following are notable for the size of their impact on spending: (i) the increase in pensions in 2019 in line with CPI forecasts; (ii) the increase in public sector wages; (iii) the progressive extension of paternity leave to 8 weeks this year, 12 weeks in 2020 and 16 weeks in 2021; and (iv) the reintroduction of the unemployment benefits for the over-52s. As regards revenues, the projections include the increases in the minimum (due to the increase in the national minimum wage) and maximum contribution bases (by 7%), as well as in the rates for self-employed workers.

⁶ In 2018 and in 2019, a number of temporary measures are budgeted (such as the costs of the insolvent toll motorways, the asset protection schemes and deferred fiscal assets of banks, and the judgement on the exemption of maternity and paternity benefits from personal income tax), with a rising impact on the budget deficit of 0.4% and 0.3% of GDP, respectively.

the new data show a profile of slowing activity (and, in particular, of slowing domestic demand) that is more pronounced than the one according to the previous time series. Second, the increase in global uncertainty over the summer months and the deterioration of the external setting (the recovery in which is expected to be postponed by several quarters) led to a downward revision to the growth anticipated in the second half of the year and, more modestly, over the rest of the forecast. As a result of all this, the GDP growth projected for 2019 has been revised down by 0.4 pp, the revision of National Accounts data and the less favourable economic developments since the spring and their effects on the short-term outlook having made contributions of approximately the same magnitude to this revision. The downward revisions in 2020 and 2021 are of 0.2 pp and 0.1 pp, respectively.

The projected GDP growth path is underpinned by a lower positive contribution of domestic demand than in the recent past. The rate of growth of the main domestic demand components has also been revised down, largely because it has eased recently. Thus, the more recent data reflect a slowdown in spending on consumer goods and services. This loss of dynamism may be connected to the heightened uncertainty. Going forward, growth in consumption is expected to be underpinned by labour market developments, which are expected to remain positive (despite feeling the impact of the recent slowdown), and by continuing favourable financing conditions. Private consumption growth has been revised down compared with the June projections. This is the result of the inclusion of the more recent information, not only on the new historical series but also on the recent less expansionary labour market performance.

As regards the components of gross fixed capital formation, over the course of the projection horizon both residential and business investment are expected to be less dynamic than in recent years, against a backdrop of greater uncertainty, lower new plant capacity requirements and more moderate growth in the real estate market after years of recovery. In annual average terms, over the 3-year projection horizon analysed, both aggregates will record lower growth than forecast in June. The downward revision is especially marked for 2019 and is largely the result of the inclusion of the data on the latest quarters recently released by the INE.

The average growth projection for exports in 2019 has been revised up. This is due to the inclusion of the new data series since, conversely, the heightened uncertainty

and the weaker performance expected of the export markets suggest that in coming quarters sales abroad will be less robust than forecast three months ago. This deterioration in the external environment explains why export growth expectations have been revised down in the rest of the projection horizon. Import growth expectations over the projection horizon are also lower now than in June. This reflects both the import sluggishness observed in the latest quarters and the lower final demand momentum expected going forward.

The slower GDP growth forecast over the projection horizon will translate into a gradual decline in the pace of job creation, as has already been observed in the most recent employment indicators. In any event, the increase in employment will mean that the unemployment rate will continue to decline, although less markedly than expected in June. This is also a reflection of higher growth in the labour force owing to the higher population dynamism projected, which is in turn a consequence of the inclusion of the most recent information on net migration (see Box 5). The unemployment rate is now expected to fall to 12.8% at the end of the projection horizon, 1 pp above the level forecast three months ago.

Inflation, measured as the year-on-year rate of change of the harmonised index of consumer prices (HICP), is expected to rise over the projection horizon. This is a consequence of the decrease in the cyclical slack in the labour market, as a result of the continued economic expansion, which will drive up unit labour costs. The expansionary monetary policy stance will also contribute in the same direction. By contrast, the assumptions on which the projection exercise is based suggest that external inflationary pressure will decline in coming years, reflecting the downward path of oil prices. As a result of these combined effects, in annual average terms HICP growth is expected to rise gradually, from 0.8% in 2019 to 1.5% in 2021. For its part, the rate of growth of core inflation – measured as the rate of change of the HICP excluding energy and food – will rise over the projection horizon, from 1.1% in 2019 to 1.6% in 2021.

With all due caution, considering that budget deficit series consistent with the new national accounts series are not yet available, it is estimated that the general government budget balance in 2019 could be -2.4% of GDP. This would imply maintaining the deficit forecast for 2019 compared with the June projections, as it is estimated that the negative impact of the cyclical deterioration on public finances will be offset by the positive effect of lower

interest rates, together with the additional effects deriving from certain non-recurring items and from the better than expected performance of some tax revenues.

The current HICP growth projections entail a downward revision of 0.3 pp in 2019 and 0.2 pp in 2020. Part of the reason for this is that, in the more recent months, energy prices and, to a lesser extent, prices of other goods have been less dynamic than expected in the previous projection exercise. Moreover, the levels projected for crude prices are now lower and the growth forecast for non-energy prices is more contained. The forecasts for 2021 remain unchanged, as a result of two contrasting effects. On the one hand, the fall in crude prices expected in the futures markets has eased compared with that considered in the projection exercise three months ago. On the other hand, as in all the other years in the projection horizon, core inflation has been revised down by 1 pp owing to weaker demand and more moderate inflation expectations.

The risks to the central scenario for growth in activity remain on the downside. On the external front, as indicated, the near-term growth outlook for Spain's export markets has been revised down, in accordance with the recent data on activity worldwide (and in particular in the euro area which is Spain's main trading partner). The assumptions on future export market behaviour – taken from the latest ECB staff projections – assume that the recent adverse performance is temporary and that it will start to reverse in early 2020. However, if the recent weakening of activity proves to be more

persistent than envisaged in the assumptions, the course of the Spanish economy would be less favourable than envisaged in the central scenario. Other sources of uncertainty are the possible adoption of new protectionist measures and the question marks over the form that Brexit will take. Lastly, the recent spike in oil prices following the attacks on Saudi production facilities is a reminder that latent geopolitical tensions can give rise to reductions in the oil supply, with the consequent negative impact on activity. On the domestic front, there is still a high degree of uncertainty over the future economic policy stance and the adoption of measures that will increase the resilience of the Spanish economy to a possible deterioration of the global macro-financial environment and boost its potential growth. In particular, there are few details on fiscal policy, in a setting in which the persistently high levels of government debt mean that Spanish public finances still have pockets of vulnerability to possible adverse shocks.

The risks of inflation departing from the central scenario are also on the downside, as a consequence of the hypothetical materialisation of the risks to activity described above. However, some of these risks also contain potential inflationary elements. For instance higher tariffs, which imply higher import prices at the different stages of the value chain and, therefore, could have an indirect effect on the prices of purchases made by the Spanish economy abroad, and also hypothetical oil price rises as a consequence of an increase in certain geopolitical tensions.

RISING PROTECTIONISM BETWEEN THE UNITED STATES AND CHINA AND ITS EFFECTS ON THE GLOBAL ECONOMY

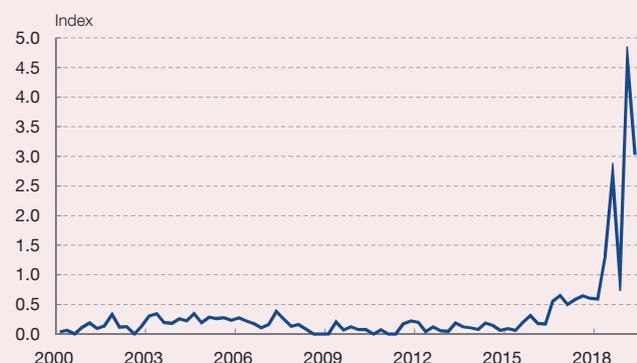
Trade tensions between the United States and China, materialised in several rounds of bilateral tariff increases between the two countries in the latest quarters, seem to be significantly affecting global economic activity. In addition to the impact on bilateral trade flows between these two countries, these tensions appear to be affecting

other countries through the fall in demand derived from lower global activity and as a result of the economic effects of greater global uncertainty (see Charts 1.1 and 1.2). The persistence of this situation over time could also significantly increase the adverse effects, given the integration of the different economies in global trade

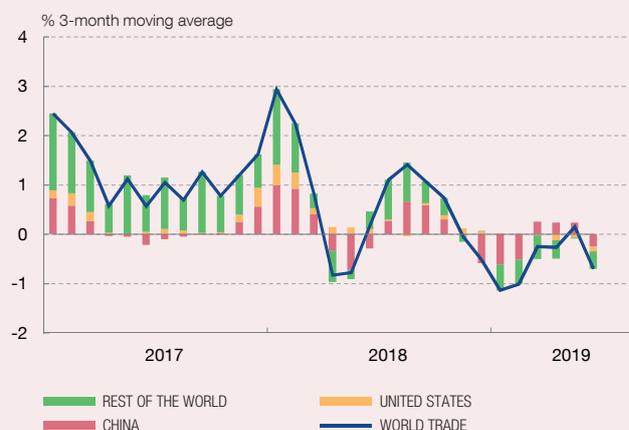
Chart 1
RISING PROTECTIONISM HAS NOTICEABLE CONSEQUENCES ON GLOBAL ACTIVITY

The escalation of tariff-related tensions between the United States and China, both highly significant economies at the global level in terms of their share and high degree of interconnectedness, affects the activity of both countries and is transmitted to other countries through many real and financial channels.

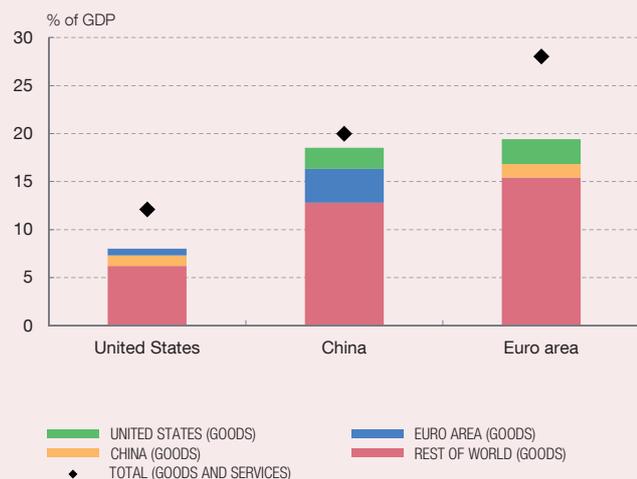
1 WORLD TRADE UNCERTAINTY INDEX (a)



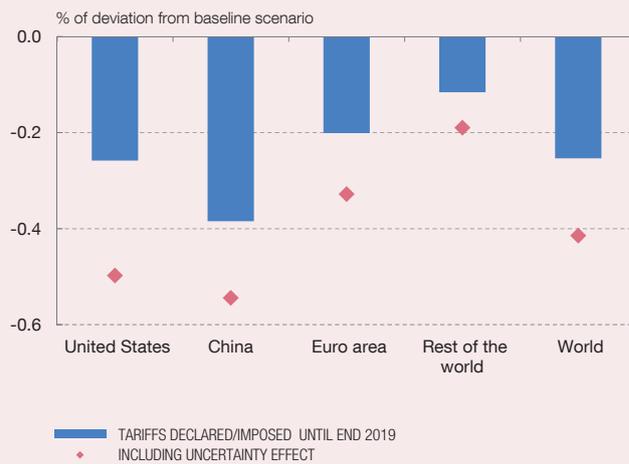
2 WORLD TRADE



3 EXPOSURE TO EXPORTS (2017) (b)



4 SIMULATIONS: EFFECT ON GDP IN THE FOURTH QUARTER OF 2021



SOURCES: Index of Ahir, Bloom and Furceri (2018), CPB, World Bank, European Central Bank and Banco de España.

- a The index is constructed by analysing how frequently concepts linked to uncertainty and trade appear in analysts' reports.
- b Intra-area trade is excluded for the euro area.

RIISING PROTECTIONISM BETWEEN THE UNITED STATES AND CHINA AND ITS EFFECTS ON THE GLOBAL ECONOMY

(cont'd)

through global value chains. This Box aims to summarise the developments in the trade conflict between the United States and China and to describe the main channels through which they seem to be affecting the world economy.

Several rounds of increases in tariffs on bilateral trade flows between the United States and China have been announced and applied since March 2018 (see Tables 1 and 2). Over the course of 2018, the measures adopted by the two countries resulted in the imposition of trade tariffs on different types of goods accounting for around 45% of US imports from China and 55% of Chinese imports from the United States. Following a truce which commenced in December 2018, the escalation of bilateral tariff increases entered a new phase in May 2019. Since then, new

decisions were made to increase tariffs, both on goods already affected by the measures adopted in 2018 and on other additional goods. As a consequence, all US imports from China and nearly three quarters of China's purchases from the United States would be subject to tariffs at the end of this year, in accordance with the scheduled dates for entry into force of the different tariffs. In addition to the tariff measures, announcements have been made of possible restrictions to the exchange of technology, although no specific actions have yet been determined.

Rising protectionism between these two economies, which are the largest worldwide and are increasingly interconnected with each other and the rest of the world, might have a substantial impact on the world economy through numerous direct and indirect channels. A direct

Table 1
TARIFFS IMPOSED BY THE UNITED STATES ON CHINA

Volume of imports (\$bn)	Cumulative % of imports from China subject to tariffs	Change since May 2019, projected date of entry into force	Products affected
34	6	25 to 30% (15 Oct-19)	Machinery, capital goods
16	9	25 to 30% (15 Oct-19)	Electrical equipment, capital goods
200	46	10 to 30% (15 Oct-19)	Furniture, electronics, cars, leather, other intermediate and capital goods
115	78	New: 15% (1 Sept-19)	Clothing, footwear, electronic components
160	100	New: 15% (15 Dec-19)	Mobile telephones, toys, computers

SOURCE: US Census Bureau.

Table 2
TARIFFS IMPOSED BY CHINA ON THE UNITED STATES

Volume of imports (\$bn)	Cumulative % of imports from US subject to tariffs	Change since May 2019, projected date of entry into force	Products affected
34	22	–	Agricultural products, car parts
16	32	–	Raw materials, medical equipment
60 (a)	56	5-10% to 5-25% (1 Jun-19)	Agricultural products, chemicals
75 (a)	71	New: 5-10% (1 Sept-19) New: 5-10% (15 Dec-19)	Agricultural products, chemicals, industrial machinery

SOURCES: CEIC and Peterson Institute for International Economics.

a There are overlaps regarding goods subject to tariffs in other rounds and, consequently, only the additional effect on the percentage of imports subject to tariffs is shown.

RISING PROTECTIONISM BETWEEN THE UNITED STATES AND CHINA AND ITS EFFECTS ON THE GLOBAL ECONOMY

(cont'd)

channel runs through changes in demand and in the relative prices of goods. Specifically, an increase in tariffs leads to the erosion of consumer disposable income, which negatively affects consumption and investment. Conversely, it also makes domestic production more attractive than imported production. In any event, if trade reprisals take place, external demand decreases. In the specific case of China and the United States, the effect arising from the fall in commodity prices as a result of the dominant position of the two countries in oil and industrial metals demand worldwide is especially significant. An additional direct mechanism is one which operates through cross-border financial positions (although the limited openness of China's capital account restricts this channel's potential). Indirect channels are related to rising uncertainty, which hampers consumer and business confidence, weakening consumption and investment. From a financial standpoint, they are related to an increase in risk aversion and a decline in asset valuations.

Based on the available data it is difficult to accurately estimate the specific impact which the different waves of tariff hikes may have had on global economic activity. This consideration particularly affects the latest actions announced within the escalation which started in May this year, since most of them have not yet come into force (they will in October and December) or have done so very recently (in September). To approximate the possible economic impact of these actions on global activity a simulation exercise using a macroeconomic model has been conducted.¹ Specifically, the effect of the tariffs announced by the United States and China since May this year, regardless of whether they had been applied yet, was simulated. These measures affect all US imports from China and 71% of the reciprocal flow. Chart 1.4 shows two

scenarios, reflecting the transmission channels described previously. The first scenario relates to the real direct channels, i.e. those which run through changes in bilateral trade between the two countries and the global effects of the second round owing to the decline in global demand. The second scenario also adds the possible effects arising from the fall in confidence and the increase in uncertainty. This channel is approximated through an ad hoc investment risk premium increase of 25 bp in the US and China combined with a 10 bp rise in the rest of economies, a smaller shock than that seen in August this year.^{2,3}

According to the simulations, the increase in tariffs (scenario 1) would entail a significant contraction in activity in the United States, China and also in the euro area, taking global GDP 0.25% below the baseline scenario in cumulative terms in 2019-2021, with declines in the GDP of the United States and China of 0.26% and 0.38%, respectively. The greater impact on the Chinese economy reflects the fact that the volume of imports subject to US tariffs as a share of China's GDP is higher than the volume on which the Chinese authorities imposed tariffs in retaliation. GDP of the euro area is estimated to contract by 0.2%, reflecting its high degree of trade openness, which makes it more vulnerable to the fall in global activity (see Chart 1.3). The second scenario shows how the confidence effect could ultimately generate significant adverse impacts in relation to those arising from the real channels. This is not only due to the direct impact from higher investment risk premia but also due to the second-round effect on global activity, which has a considerable repercussion on the euro area. However, it is difficult to calibrate the effect of the trade war on uncertainty and, consequently, its impacts should be regarded with more caution than those of the real channels.⁴

1 Specifically, the NiGEM model of the *British National Institute of Economic and Social Research*. The documentation for the model is available at <https://nimodel.niesr.ac.uk/>.

2 The magnitude of the investment risk premia shock is somewhat lower than that seen in reaction to those recorded in the corporate spreads in August 2019, at the height of the trade tensions.

3 A number of assumptions are used in the simulation. Specifically, it is considered that expectations are rational, monetary policy is exogenous and fiscal policy acts as an automatic stabiliser (simultaneously maintaining a medium-term budgetary target). The monetary policy assumption is introduced to prevent the increase in imported goods prices from triggering an increase in interest rates in the United States, as this would be contrary to the Federal Reserve's reaction.

4 The simulations show effects of the same order of magnitude as other studies, although they are not directly comparable due to the different nature of the shocks included. In the *World Economic Outlook* of October 2018, the IMF shows impacts on the pure trade scenario of -0.3% in the United States and -0.6% in China in 2021. Also, in the OECD's exercise included in the *Economic Outlook* of April 2019, the impact of an adverse scenario in which confidence deteriorates sharply is -0.8% for the United States and -1.2% for China in 2021.

RISING PROTECTIONISM BETWEEN THE UNITED STATES AND CHINA AND ITS EFFECTS ON THE GLOBAL ECONOMY

(cont'd)

Nevertheless, there are several factors which could produce different effects to those considered in these simulations. First, the exercise undertaken does not take into account the expansionary reaction of monetary policies globally, which has already begun and would tend to reduce the magnitude of the impact. Second, trade tensions may lead to changes in the location of global production chains, in which China has a dominant

position, affecting activity in third countries, positively or negatively, according to the case at hand, depending on its complementarity or substitutability with respect to China's production. Another factor not considered in the simulations, given the limitations of the model used, is trade potentially being diverted to third economies, such as the euro area, which could benefit in terms of their exports of certain types of products and services.

THE EU-MERCOSUR TRADE AGREEMENT AND ITS IMPACT ON THE EUROPEAN ECONOMIES

At the end of June, the European Union (EU) and the four Latin American countries which make up the MERCOSUR trading bloc (Argentina, Brazil, Paraguay and Uruguay) signed a historic trade agreement after 20 years of negotiations. The treaty – pending final wording and ratification¹ – envisages the removal of tariffs on more than 90% of the trade in goods between the two areas and includes provisions which facilitate trade in services and the liberalisation of public procurement processes. Given its broad scope, the agreement is expected to notably boost bilateral trade and economic integration between the two regions. The treaty is also a sign of the EU's commitment to maintaining free trade against a global setting of growing protectionist tensions. This box describes the main features of the agreement and discusses its scope from a sectoral standpoint.

Under the agreement, the MERCOSUR countries will remove the tariffs on 91% of the goods imported from the EU, which include key EU exports such as vehicles and machinery. In turn, the EU will liberalise 95% of the goods imported from MERCOSUR, including 82% of imports of agricultural products. Certain products such as meat and sugar, will be subject to a partial liberalisation. In general, tariffs will be reduced over a 10-year period from the ratification of the agreement. The agreement also includes some provisions, which reduce non-tariff barriers by simplifying customs procedures, and others, which facilitate trade in services through non-discrimination clauses against foreign companies. Likewise, the treaty envisages the liberalisation of public procurement processes by both parties. Thus, European firms will be the first non-MERCOSUR firms to have access to these processes on an equal footing with local firms; to date they could only participate through their subsidiaries.² In line with the model of trade agreements imposed in recent years, the treaty also includes provisions for safeguarding the environment and labour standards, such as employees'

freedom of association, the right to collective bargaining and non-discrimination at work.

After China, the EU is currently MERCOSUR's second most important trading partner and represents 20% of goods trade with the Latin American bloc. Trade with MERCOSUR only represents 2.2% of the EU's trade in goods and services.³ Following the usual pattern in trade between developed and emerging economies, the EU has a comparative advantage over MERCOSUR (Chart 1.3) in the supply of higher technology content products, such as machinery, electrical products or chemicals, whereas the comparative advantage of the MERCOSUR countries lies in raw material or natural resource intensive goods such as livestock, minerals, food and crop products. That is reflected in the bilateral trade patterns between the two areas shown in Charts 1.1 and 1.2, together with current tariff levels on the different product types. As can be seen, whereas the Latin American bloc's imports to the EU are concentrated in agricultural and food products, European exports to MERCOSUR mainly comprise chemicals, pharmaceuticals, machinery, vehicles and electrical products which are currently subject to high tariffs. Although services are not shown in the chart, the EU is a net supplier of all types of services.

The agreement is notably important for the EU in view of MERCOSUR's high tariff barriers in key areas of bilateral trade. The size of the trade flows affected by the MERCOSUR treaty is similar to or slightly lower than that covered by the recent treaties entered into with Canada and Japan. However, in comparison with the latter, the MERCOSUR treaty will entail a much higher reduction in export costs since the decrease in tariffs under this agreement will be comparatively sharper for Europe's main exports, according to European Commission estimates.⁴ In terms of the agreement's effect on EU activity, certain available studies indicate that its long-term positive impact on activity is estimated to be between 0.1% and 0.3% of GDP.⁵

-
- 1 The agreement must be approved by the European Parliament and probably - based on the provisions included in the final text - it must also be approved by the national parliaments of the states involved. (<https://ec.europa.eu/trade/policy/in-focus/eu-mercosur-association-agreement/agreement-explained/>).
 - 2 Firms based in the Latin American bloc and controlled by a European parent company.
 - 3 Europe's trade balance with the Latin American bloc has shown a slight surplus over recent years (+0.02% of GDP in trade in goods in 2018 and +0.08% in trade in services in 2017).
 - 4 The European Commission calculates that the MERCOSUR agreement would save around €4 billion in terms of lower tariffs. This saving was estimated to be lower or equal to €1 billion for the agreements with Canada and Japan.
 - 5 C. Kirkpatrick, and C. George (2009). "Trade sustainability impact assessment (SIA) of the association agreement under negotiation between the European Community and MERCOSUR". Institute for Development Policy and Management, University of Manchester and A. Burrell, et al. (2011) "Potential EU-MERCOSUR free trade agreement: impact assessment." Publications Office of the European Union.

THE EU-MERCOSUR TRADE AGREEMENT AND ITS IMPACT ON THE EUROPEAN ECONOMIES (cont'd)

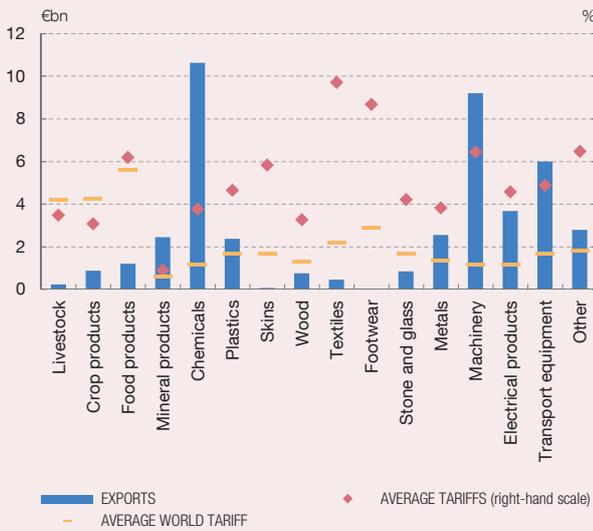
Chart 2.1 shows the EU economies which, in principle, could benefit most from the removal of the tariffs since they specialise in production in the sectors with a comparative advantage over MERCOSUR. Furthermore, they will stand to gain from substantial tariff cuts. Noteworthy among these countries are those specialising

in chemicals, transport, machinery and electrical products. Additionally, European countries which are relatively more specialised in providing services could enjoy new growth opportunities in these markets (Chart 2.2).⁶

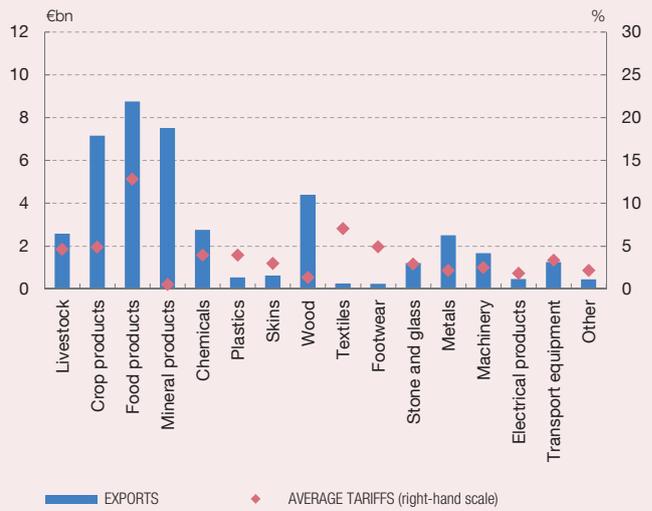
The MERCOSUR countries have, as mentioned, an advantage in the production of food, agricultural products

Chart 1
CURRENT TRADE RELATIONS BETWEEN THE EU AND MERCOSUR

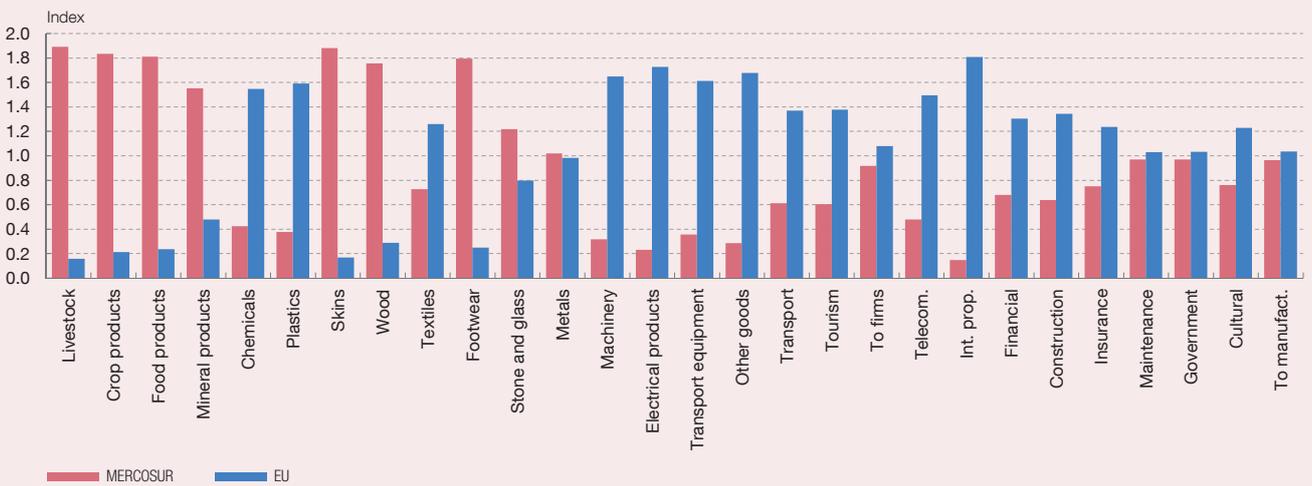
1 GOODS TRADE: EU EXPORTS TO MERCOSUR AND AVERAGE TARIFFS



2 GOODS TRADE: MERCOSUR EXPORTS TO THE EU AND AVERAGE TARIFFS



3 COMPARATIVE ADVANTAGE INDEX



SOURCES: Eurostat, WTO, World Bank and Banco de España calculations.

⁶ The analysis does not include tourism services, on which the agreement would have a low impact, or intellectual property rights, since the classification of the TIVA database does not quantify their weight in GDP.

THE EU-MERCOSUR TRADE AGREEMENT AND ITS IMPACT ON THE EUROPEAN ECONOMIES (cont'd)

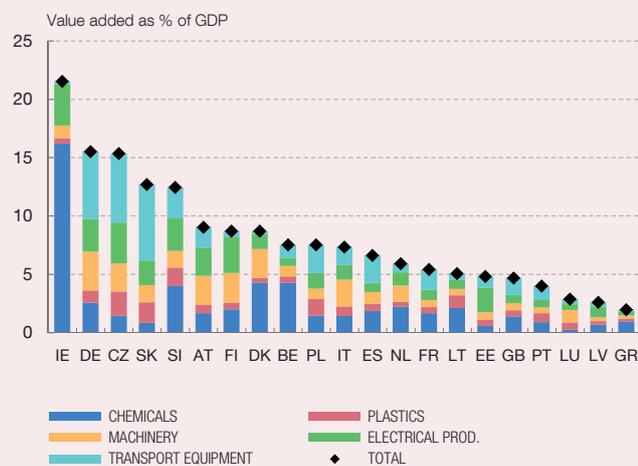
and minerals. Chart 2.3 shows, for the main European economies, the weight in GDP of sectors in which MERCOSUR has a comparative advantage, based on those sectors' value added share in terms of EU final demand. The countries most exposed to competition from MERCOSUR would be those where the agricultural and food sectors have the highest weight, along with France, since beef production is considered to be a

branch of the agricultural industry in which the Latin American bloc has a particularly high comparative advantage.

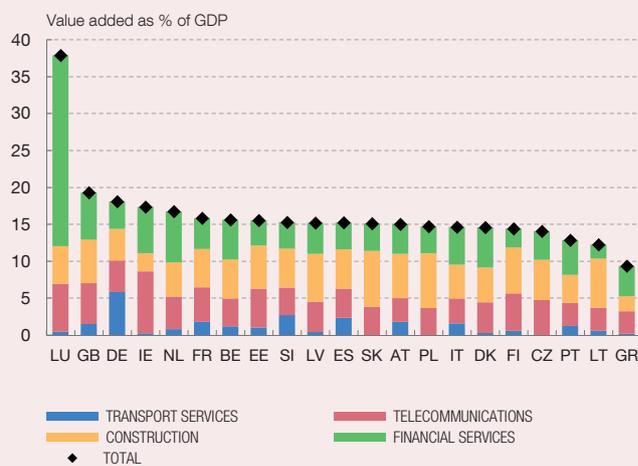
However, the analysis performed solely on the basis of the comparative advantages shown underestimates the opportunities offered by the agreement in currently highly protected sectors in Latin America, such as textiles and footwear, which relatively specialised European economies

Chart 2
COMPARATIVE ADVANTAGE OF THE TWO BLOCKS. COUNTRIES MOST FAVOURED BY THE AGREEMENT AND ECONOMIES MOST EXPOSED TO COMPETITION FROM MERCOSUR

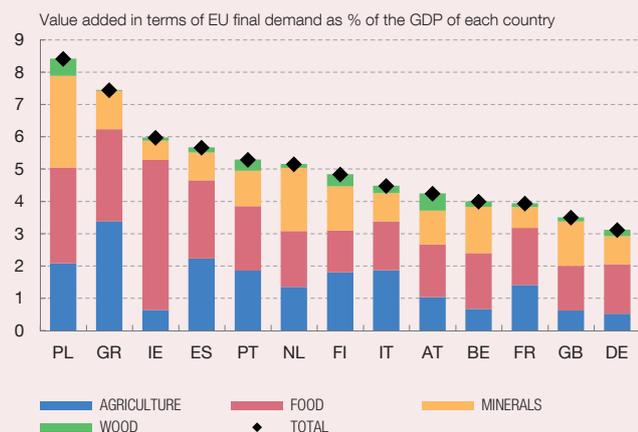
1 GOODS: SIGNIFICANCE OF THE SECTORS IN WHICH THE EU HAS A COMPARATIVE ADVANTAGE



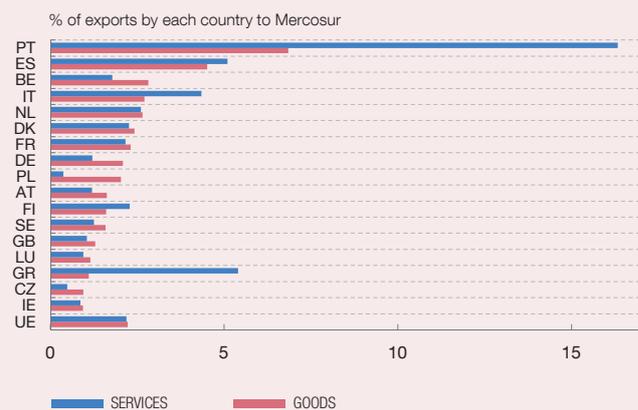
2 SERVICES: SIGNIFICANCE OF THE SECTORS IN WHICH THE EU HAS A COMPARATIVE ADVANTAGE (a)



3 EXPOSURE TO COMPETITION FROM MERCOSUR



4 SIGNIFICANCE OF TRADE WITH MERCOSUR



SOURCES: Eurostat, Comtrade, OECD TiVA, IMF and Banco de España calculations.

a For Poland, the Czech Republic and Slovakia, we omit the value added provided by road transport services, which foreseeably will not benefit from the agreement.

THE EU-MERCOSUR TRADE AGREEMENT AND ITS IMPACT ON THE EUROPEAN ECONOMIES (cont'd)

such as Portugal, Italy and Spain⁷ could benefit from. In addition, the analysis does not take into account the potential advantages of this agreement for countries such as Spain and Portugal, based on other driving factors of trade such as cultural and linguistic ties.⁸ In fact, goods and services trade with the Latin American bloc represents 4.5% of Spain's trade, which is double the EU average, a characteristic it shares with Portugal, the other EU country to have a language in common with a MERCOSUR

economy (Chart 2.4). Furthermore, of the European countries, Spain is currently the second most important service provider to the Latin American bloc. This puts Spain in a privileged position for taking advantage of the opportunities of this agreement, both commercially and as regards the provision of services and the participation in public procurement, although certain raw-material intensive sectors will experience greater competitive pressure.

7 The value added by these industries as a percentage of GDP is 2.6% in Portugal, 1.9% in Italy and 0.7% in Spain.

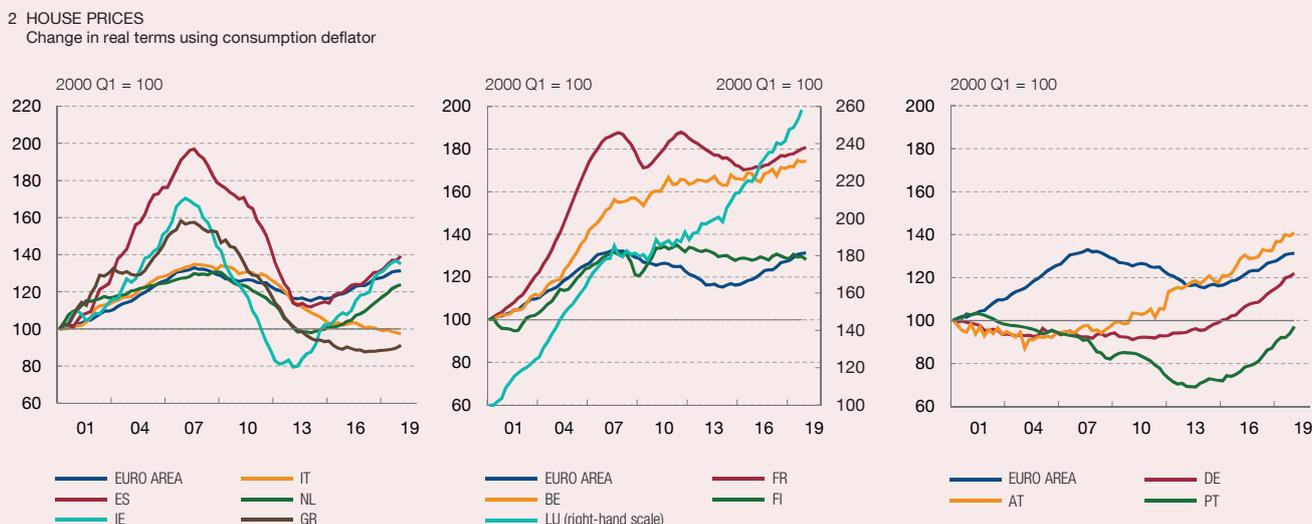
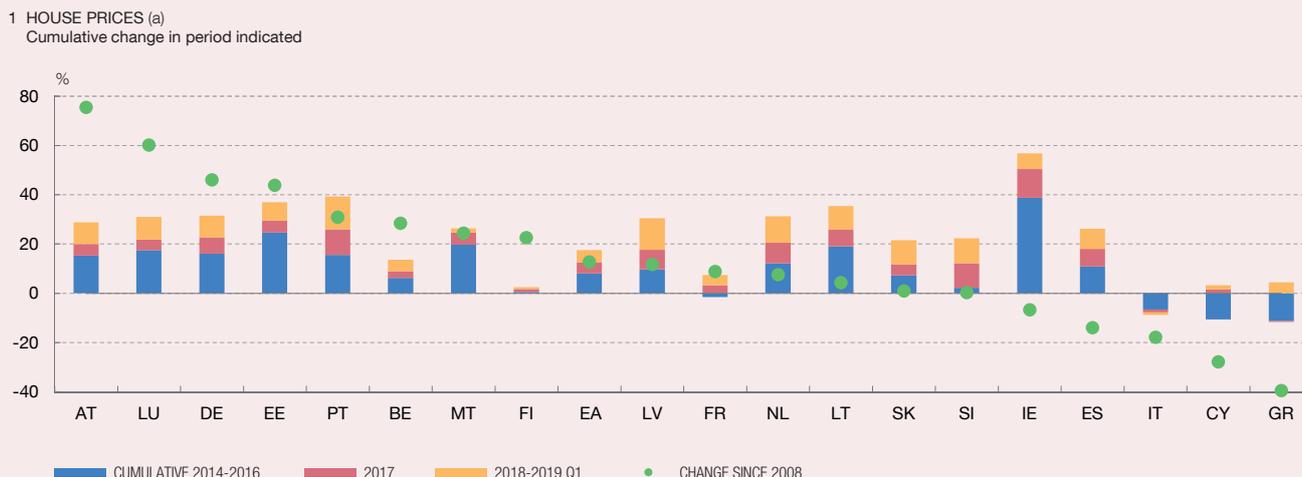
8 The literature supports the influence of these factors when explaining bilateral trade flows. See, for example, Bayer et al. (2007), "Free trade agreements in the Americas: are the trade effects larger than anticipated?" *The World Economy*.

RECENT DEVELOPMENTS IN HOUSE PRICES IN EURO AREA COUNTRIES

Euro area real estate markets have performed strongly in recent years which, among other factors, has been reflected in significantly higher house prices. The improvement in economic activity and, particularly, in labour market conditions has driven demand for residential assets. Likewise, the setting of very low interest rates has

provided a further stimulus to housing demand as a consumer good - due to the improvement in affordability measures - and as an investment. Together with these demand factors, other supply or more structural factors, such as demographic ones, have also shaped the performance of house prices in certain countries.¹

Chart 1
APPRECIATION OF HOUSING IN THE EURO AREA



SOURCES: Bank for International Settlements, Eurostat and European Central Bank.

a Nominal data. Data referring to Luxembourg, Cyprus and Malta are until 2018 Q4.

1 See ECB (2018), "The state of the housing market in the euro area", Economic Bulletin, No. 7. For an analysis of the significance of structural and institutional factors in an international comparison, see N. Geng (2018), "Fundamental Drivers of House Prices in Advanced Economies". Working paper 18/164. International Monetary Fund.

RECENT DEVELOPMENTS IN HOUSE PRICES IN EURO AREA COUNTRIES (cont'd)

There are several reasons which make it advisable for economic policymakers to closely monitor real estate market dynamics. On one hand, the sector is highly significant for economic performance² and it may give rise to risks to financial stability. In the specific case of Spain, the Banco de España performs regular monitoring in its financial stability reports and, in particular, to determine the countercyclical capital buffer. On the other, the path of prices and housing affordability conditions may have important social implications. This box focuses on recent developments in house prices and in credit in euro area countries.

Housing has appreciated by more than 18% in nominal terms in the euro area since 2014, as shown by Chart 1.1. This upward trend has been widespread, except for in Italy, Greece and Cyprus. In several euro area economies (such as Luxembourg, Austria and Belgium) prices have reached levels which are clearly higher than those before the crisis of 2008.

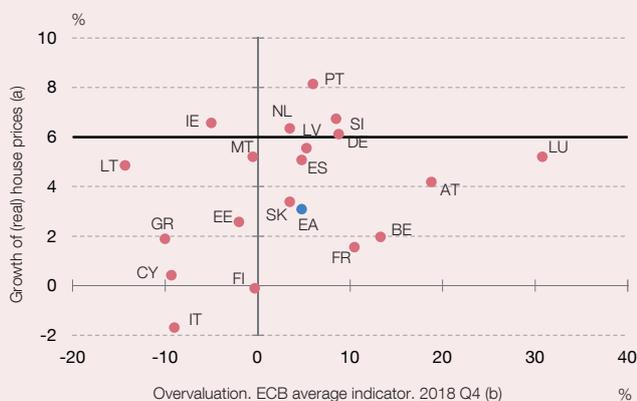
More recent data, however, point to a slight slowdown. House prices in the euro area grew by 4% year-on-year in 2019 Q1, compared with an average year-on-year rate of

4.8% in 2018. Nevertheless, house price growth remains robust in many countries and Italy is the only euro area member to post year-on-year declines in residential real estate values in the first quarter (0.8%). Thus, in the first quarter house prices increased by 9% year-on-year in Portugal, by 8% in the Netherlands and Slovenia, and by around 7% in Germany and Spain. They were clearly slowing down in some economies, such as Ireland and Austria, where the year-on-year increase stood at approximately 4% in the first quarter, following average gains of 10% and 7% during 2018. In terms of the average of the last four quarters, Germany, the Netherlands, Portugal, Ireland and Slovenia exceeded year-on-year growth of 6% in real terms, which is the threshold used by the European Commission as an alert mechanism for examining the presence and gravity of imbalances in the real estate market (see Chart 2.1).³

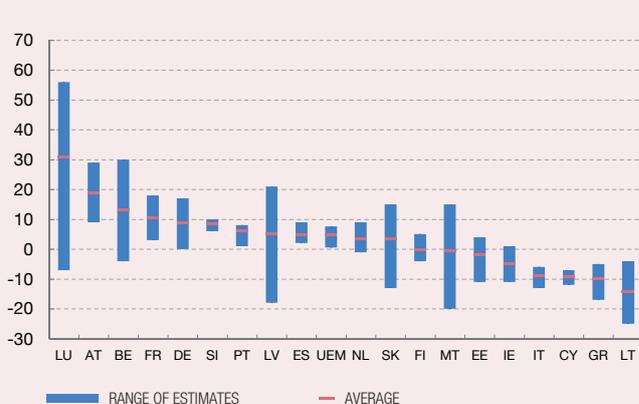
Considering a longer time frame, clearly different situations can be seen across countries. For instance, in Italy, Spain, the Netherlands, Ireland and Greece house prices fell sharply during the crisis, by more than 40% in real terms in certain

Chart 2
HOUSE PRICES AND VALUATION METRICS

1 GROWTH OF REAL HOUSE PRICES AND VALUATION



2 ECB METRICS ON THE DEGREE OF HOUSING OVERVALUATION. 2018 Q4 (a)



SOURCE: European Central Bank.

a The average of the year-on-year rates of the last four quarters available is considered.
 b Estimates from four methods, two of them are based on the price-rent ratio and the price-income ratio. See, ECB (2011), "Tools for detecting a possible misalignment of residential property prices from fundamentals", Financial Stability Review, Box 3, June; and ECB (2015), "A model-based valuation metric for residential property markets", Financial Stability Review, Box 3, November. The data for Belgium and Cyprus relate to 2018 Q3.

2 In the euro area, residential investment has accounted for almost 6% of GDP and 27% of gross fixed capital formation in terms of the historical mean since 2000. These ratios were somewhat lower in 2018. Furthermore, housing is also an important determinant of consumption via wealth effects and as loan collateral.

3 See European Commission (2018), *Alert Mechanism Report 2019*, November 2018.

RECENT DEVELOPMENTS IN HOUSE PRICES IN EURO AREA COUNTRIES (cont'd)

cases (see Chart 1.2). After this adjustment, prices levels tended to stabilise in Greece and Italy, whereas in Spain, the Netherlands and Ireland they once again followed an upward path, which was particularly steep in Ireland. In the second group of economies, which includes France, Belgium and Luxembourg, house prices corrected more moderately during the crisis even though they appreciated considerably before 2008. As a result, prices have reached very high levels

in some of these countries. Lastly, there is a third group of economies, which includes Germany, Austria and Portugal, where the appreciation of housing since 2014 was not preceded by strong pre-crisis price increases.

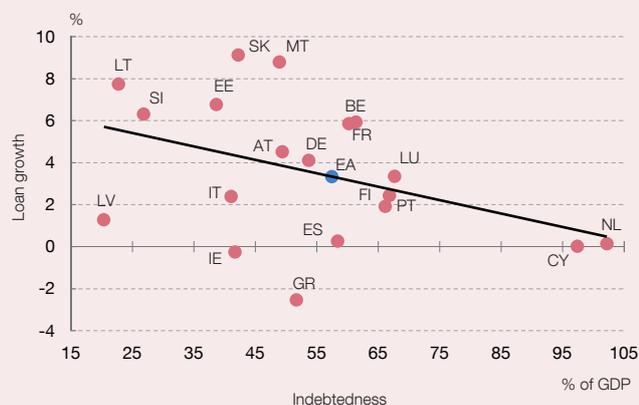
According to the various analyses available, house prices in some countries are showing signs of being overvalued with respect to their equilibrium levels.⁴ In the case of

Chart 3
HOUSE PRICES AND CREDIT GROWTH IN EURO AREA COUNTRIES

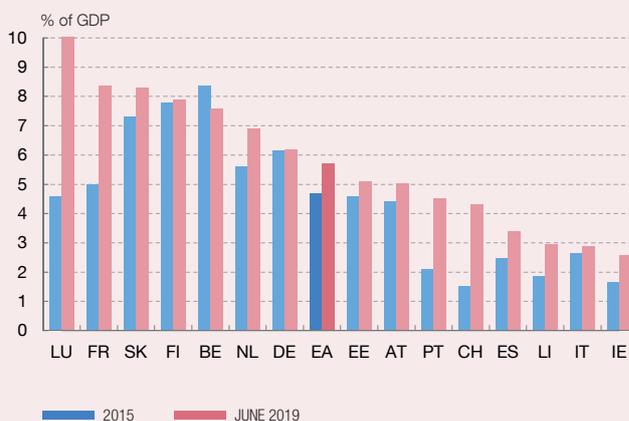
1 GDP, HOUSE PRICES AND LOANS IN REAL TERMS (a)
Year-on-year growth in deviations from historical average



2 INDEBTEDNESS AND HOUSEHOLD LOANS (b)



3 NEW LOANS FOR HOUSE PURCHASE
Excluding renegotiated loans. Cumulative twelve-months (c)



SOURCES: Eurostat and European Central Bank.

- a Expressed in real terms by using consumption deflator for household loans and house prices.
- b Data referring to 2019 Q1. Loan growth expressed in terms of year-on-year rate of change.
- c Renegotiated loans are excluded because they do not involve additional contributions of funds.

4 For a description of the various methodologies, see ECB (2011), “Tools for detecting a possible misalignment of residential property prices from fundamentals”, *Financial Stability Review*, June; and ECB (2015), “A model-based valuation metric for residential property markets”, *Financial Stability Review*, November.

RECENT DEVELOPMENTS IN HOUSE PRICES IN EURO AREA COUNTRIES (cont'd)

Spain, the Banco de España's estimates indicate that average house prices are not far off their equilibrium value.⁵ Assessing the level of house prices with respect to their fundamentals, their equilibrium levels or certain historical benchmarks is surrounded by major uncertainty, as shown by the different results of the various methodological approaches (see Chart 2.2). Furthermore, national estimates may conceal contrasting situations in regional or local housing markets.⁶ This type of indicators, as part of a broader analysis which also included an analysis of developments in lending, in 2016 led the European Systemic Risk Board (ESRB) to issue warnings on medium-term vulnerabilities in the residential real estate sector in eight EU countries,⁷ including Austria, Belgium, Luxembourg, Finland and the Netherlands in the euro area.

A characteristic of the current expansionary cycle of house prices and of economic activity in the euro area is that it has been accompanied by more moderate growth of mortgage lending than that suggested by past historical patterns (see Chart 3.1). Despite the setting of historically low interest rates, the deleveraging process in certain

countries is constraining the increase in the stock of credit (see Chart 3.2). Specifically, insofar as developments in this variable are determined by new loans and by repayments, a high volume of repayments could be masking the vigour of new loans. In fact, if the volume of new loans for house purchase is considered in isolation, it can be seen that loan origination has been more buoyant across the board since 2015 (see Chart 3.3). However, in more highly indebted countries or in those which have recently undergone deleveraging processes such as the Netherlands, Cyprus, Spain, Ireland and Portugal, the increase in new loans has not resulted in a significant rise in the aggregate stock of debt in the sector.

In short, the real estate market in the euro area is performing strongly with sustained price rises in numerous countries. These developments justify, particularly in the current low interest rate setting, authorities having to monitor the performance of the residential property market, given its close ties to the economic cycle and the credit cycle, and its social implications. This has already led to several countries applying macroprudential measures.⁸

5 See the *Financial Stability Report*, Spring 2019. See specifically Chart 1.4.B.

6 See ECB (2017), "Residential real estate prices in capital cities: a review of trend", Box 3. *Financial Stability Review*, May

7 See ERSB (2016), "Vulnerabilities in the EU residential real estate sector", November.

8 See ERSB (2019), "A review of Macroprudential Policy in the EU in 2018", April.

RECENT DEVELOPMENTS IN THE POPULATION OF SPAIN

According to the latest Spanish population figures published by the INE (National Statistics Institute), the population resident in Spain at 1 January 2019 was slightly above 46.9 million, somewhat more than 100,000 above the previous high reached in 2012. This represents an annual increase of nearly 280,000 people and, consequently, the annual growth rate rose to 0.6% from 0.3% a year earlier, continuing the trend of mild recovery seen in previous years (see Chart 1). This population increase exceeded that envisaged in the INE's latest projections of October 2018 (0.4%) and was due exclusively to the rise in the numbers of foreign nationals. This population group increased by 290,000 in 2018, its

growth rate rose to 6.3% and its relative weight in the total population moved above 10%, up 0.5% on the previous year.

The high migrant flows in 2018 counteracted the deterioration in the *natural increase*, defined as the difference between the number of births and the number of deaths (see Chart 2). This statistic was negative for the second consecutive year, exceeding 50,000 as a result of fewer births (-6.2% with respect to 2017, to 369,302, approaching the historical low of 1996) and a slight increase in deaths (0.4%). In particular, immigrant inflows increased by 21%, and this, combined with a drop of 16% in outflows with respect to the previous year, made for a

Chart 1
TOTAL POPULATION (a)
12-month % change



Chart 2
NATURAL INCREASE

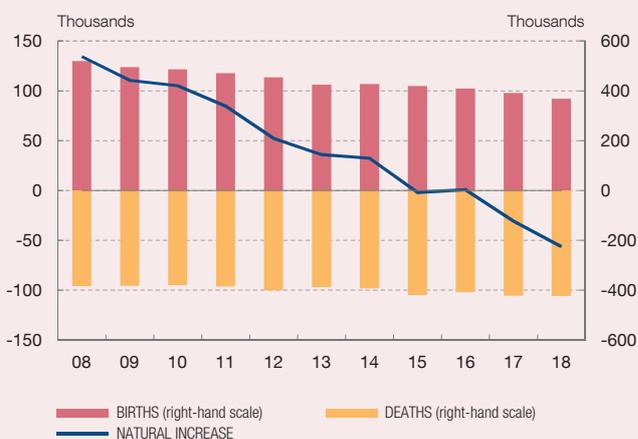


Chart 3
FOREIGN MIGRANT FLOW

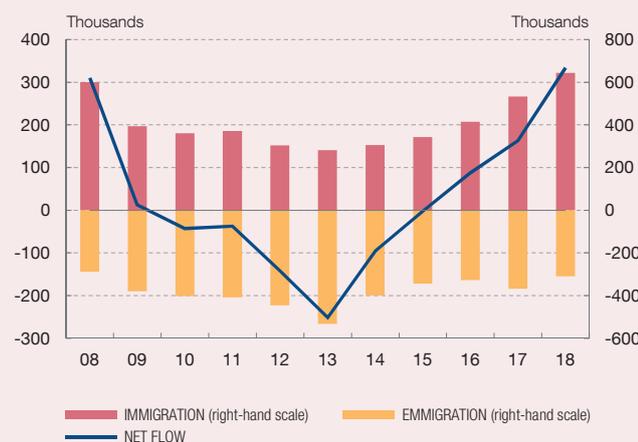


Chart 4
DEPENDENCY RATE (a) (b)



SOURCES: INE and Banco de España.

- a Data relating to 1 January of each year.
- b Defined as the population over 64 years of age divided by that between 16 and 64.

RECENT DEVELOPMENTS IN THE POPULATION OF SPAIN (cont'd)

net inflow which more than doubled that of 2017 to stand above 330,000, a level similar to that of 2008, after the sharp falls in net inflows during the crisis period (see Chart 3). These figures surprised by being around 80,000 higher than the INE's latest (October 2018) population projections, due to higher-than-expected inflows and to lower outflows.

By contrast, the number of nationals diminished slightly (by around 9,000). This was the result of two opposing forces. First, the negative natural increase exceeded 100,000 (it was thus twice as large as that for the total population, which includes both nationals and foreigners). Second, this factor was almost offset by the increase in new additions of Spanish nationality (nearly 100,000

against 26,000 in 2017). In all, this demographic development prolonged the process of progressive ageing of the population in Spain and raised the dependency rate, defined as the population over 64 years of age divided by that between 16 and 64, to 29.9%, nearly 6 pp above that in 2008 (see Chart 4).

Given the key role of migrant flows in explaining recent changes in the population, we analyse below in more detail the destination and origin of these flows. Regarding the destination of immigrant inflows, in absolute terms Catalonia, Madrid, Andalusia and the region of Valencia accounted for the bulk of inflows in 2018, although in relative terms, i.e. expressed as a proportion of the population of each region, the Balearic and Canary Islands

Chart 5
RELATIONSHIP BETWEEN FOREIGN IMMIGRATION AND FOREIGN POPULATION IN EACH REGION

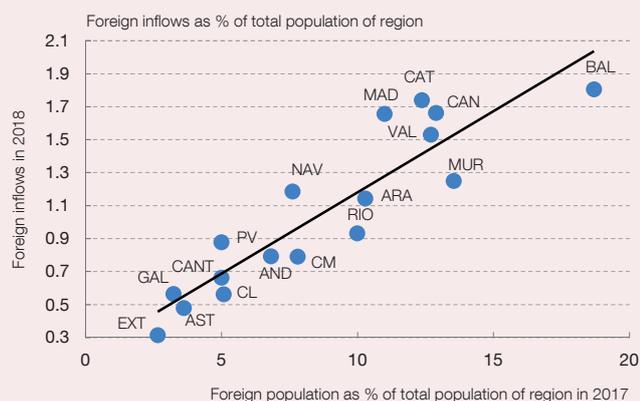


Chart 6
RELATIONSHIP BETWEEN FOREIGN IMMIGRATION AND JOB CREATION IN EACH REGION

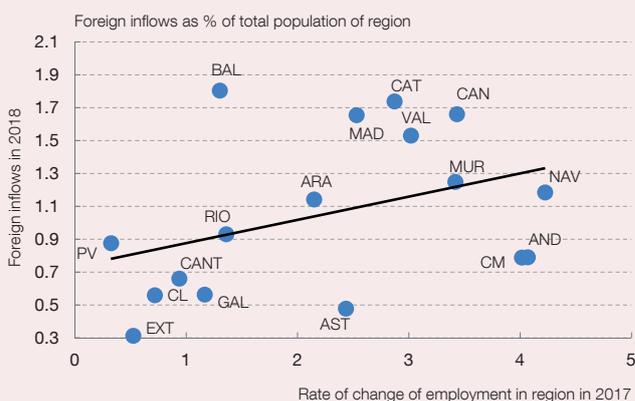


Chart 7
FOREIGN IMMIGRANTS BY NATIONALITY

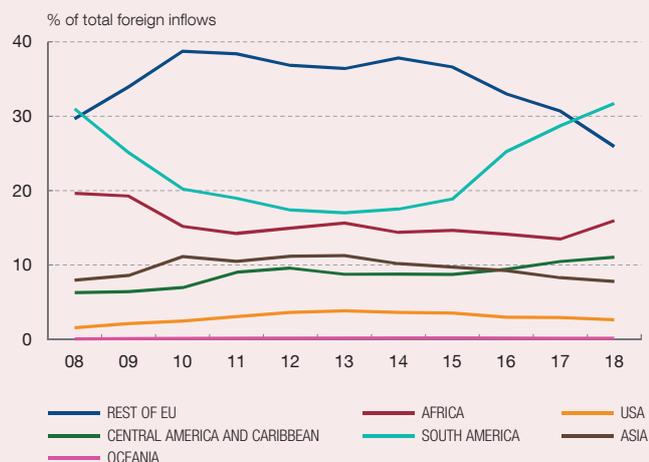


Chart 8
FOREIGN IMMIGRANTS BY EDUCATIONAL LEVEL



SOURCES: INE and Banco de España.

RECENT DEVELOPMENTS IN THE POPULATION OF SPAIN (cont'd)

received immigrant inflows similar to those of Catalonia and Madrid. Chart 5 shows that immigrant inflows took place in regions which already had a higher percentage of foreign population. This is normal because of the importance of network effects in the determination of migrant flows.¹ Also in line with what might be expected, economic factors seem to have played a role in attracting immigrants, such that immigrant flows have tended to be to regions with higher employment growth (see Chart 6) and, although here the relationship is not so clear, with lower unemployment rates. In addition, the concentration of foreign workers in the services sector meant that immigrant inflows preferentially targeted the regions most active in this sector.

The most recent Spanish Labour Force Survey data, relating to the second quarter, show that the dynamism of the foreign population continues, with an increase of 7.1%, slightly above the growth of 6.2% observed at the end of 2018.

Regarding the source of these immigrant flows, the recent rise in inflows has been accompanied by some

changes in their composition by country of origin with respect to that observed during the crisis period. Thus, during the economic recovery initiated in 2014, the relative weight of the inflows from Latin American countries rose from 17.5% of total inflows in 2014 to 31.7% in 2018 (see Chart 7). Most notable in this respect was the increase of around 6 pp in the relative weight of the flows from Colombia (to 9.5%) and Venezuela (to 8.4%). Smaller increases occurred in the flows from Central American and African countries. By contrast, the relative weight of inflows of immigrants from EU countries fell by nearly 12 bp to 25.9%. Notable in this case was the decline by more than 6 pp in the relative weight of inflows from Romania, although it continues to be one of the main sources of immigrant flows. These recent changes in the distribution of inflows by country have not given rise to significant changes in the composition by educational level of immigrant arrivals, since those with intermediate educational attainment remain the largest group, although notably the proportion of those with a lower educational level has fallen over the last 10 years (see Chart 8).

¹ See, for example, M. Izquierdo, A. Lacuesta and J. F. Jimeno (2016), *Spain: from massive immigration to vast emigration?*, IZA Journal of Migration, vol. 5(1), for an analysis of the determinants of migrant flows in Spain.

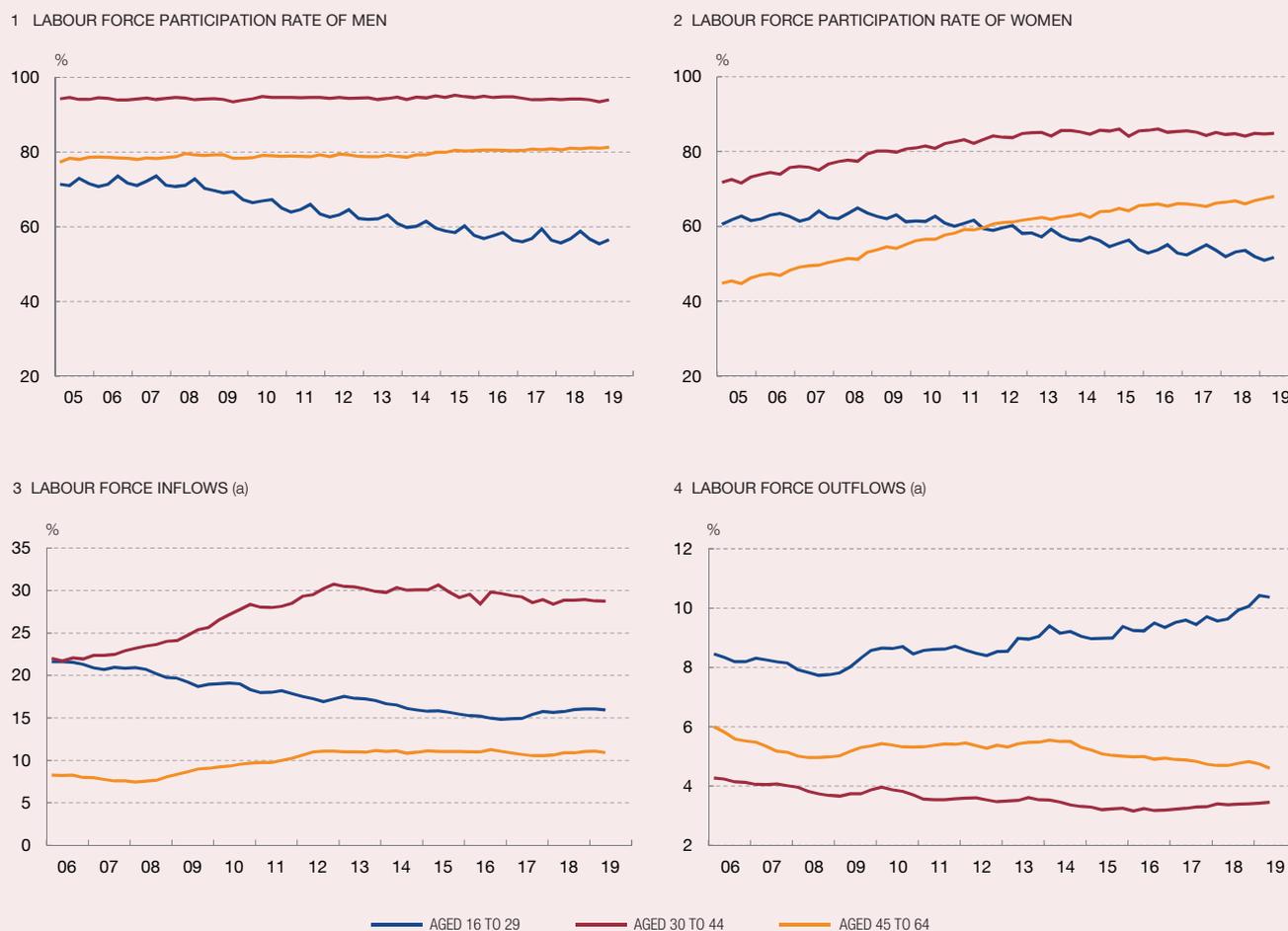
CHANGES IN THE YOUTH LABOUR FORCE PARTICIPATION RATE AFTER THE CRISIS

The labour force participation rate for young people under 30 years of age in Spain declined significantly after the crisis, from around 70% in 2007 to 53% in 2019 Q2. Charts 1.1 and 1.2 show that the decline for this population group was different from that of other, older groups, and also that the lower participation rate among young people affected men and women alike. Thus, according to the Spanish Labour Force Survey conducted by the National Statistics Institute (INE, by its Spanish abbreviation), the

participation rate for men under 30 years of age decreased from 72.2% in 2007 Q2 to 56.5% in the same period of 2019, while that of women in the same age group fell from 63.4% to 51.8%¹.

In terms of quarter-to-quarter flows, the decline in the participation rate was due both to the lower number of young people joining the labour force and to the higher number of people aged under 30 becoming economically

Chart 1
LABOUR FORCE PARTICIPATION RATE BY AGE AND GENDER, AND TOTAL EMPLOYMENT INFLOWS AND OUTFLOWS BY AGE



SOURCES: INE and Banco de España.

a As a percentage of the source population. Average for four quarters. Own calculations drawing on Spanish Labour Force Survey microdata. Men and women.

1 Within the population under 30 years of age, the decline in the labour force participation rate was sharper for those aged 18 and 19 (almost 20 pp). It was also notable among 20 to 24-year olds (around 10 pp), but remained largely unchanged for the group aged between 25 and 29.

CHANGES IN THE YOUTH LABOUR FORCE PARTICIPATION RATE AFTER THE CRISIS (cont'd)

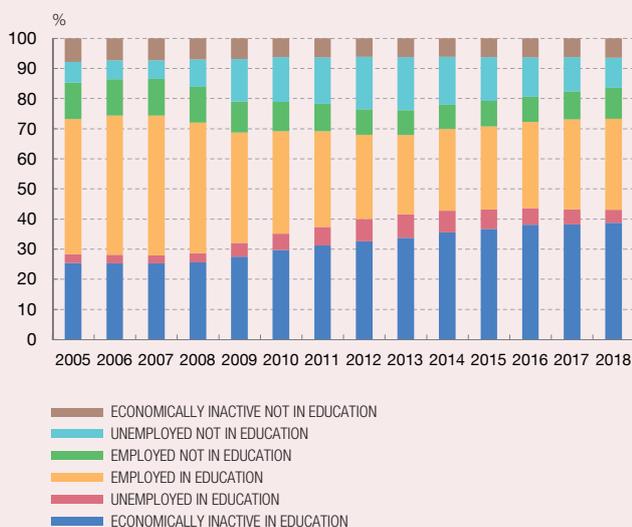
inactive, in contrast with other age groups. Thus, activity inflows of young people decreased from 20.7% in 2008 to 16.5% in 2014, compared with the increase observed in the population aged 30 and over (see Charts 1.3 y 1.4). During the recovery, from 2014 on, activity inflows have remained virtually unchanged, standing at 15.9% in 2019 Q2. In turn, outflows of young people from the active population during the crisis rose from 8.3% in 2008 to 9.2% in 2014, contrasting with the fall in the outflow rate among older people. In recent years, with the recovery, not only has this upward trend among young people not been checked, but it has continued to rise, reaching 10.4% in 2019 Q2.

During the crisis, the majority of young people who decided to delay joining the labour market or to abandon it because of the difficulties encountered in finding employment, did so in order to further their education.

Chart 2.1 shows that the percentage of economically inactive young people in education rose from 25.3% in 2007 to 38.7% in 2018. The fewer job opportunities in the wake of the crisis have led to a decline in the percentage of people aged under 30 in employment. However, the proportion of those who are not in education, employment or training has decreased considerably since the end of the crisis. Specifically, the number of people under 30 years of age who neither study nor work has fallen by more than 600,000, from the record high of 1.7 million reached in 2012, and by 17,000 compared with 2007 (see Chart 2.2). The temporary rebound observed during the recession in the number of young people who neither study nor work was due to the rise in the number of young people who had abandoned their studies during the expansionary period (1995-2007) and who became unemployed during the crisis (see Chart 2.2)². However, the level and percentage of young people who are

Chart 2
YOUNG POPULATION: STRUCTURE AND CHANGES VIS-À-VIS THE LABOUR MARKET AND EDUCATION (a)

1 STRUCTURE OF YOUNG POPULATION IN RELATION TO THE LABOUR MARKET. PROPORTION OF TOTAL NUMBER OF YOUNG PEOPLE



2 YOUTH NOT IN EDUCATION, EMPLOYMENT OR TRAINING



SOURCES: INE and Banco de España.

a Own calculations drawing on Spanish Labour Force Survey microdata. Considering both formal and non-formal education. Students on holiday are classed as students. Young people aged 16 to 30.

2 With respect to the rise in the percentage of young people who failed to obtain a lower secondary school qualification during the expansionary phase, see A. Lacuesta and A. Regil (2013), “Desempleo juvenil y cambios en las pautas de formación de los jóvenes sin empleo”, Box 1 in “La evolución del empleo y del paro en el año 2012, según la Encuesta de Población Activa”, *Boletín Económico*, Banco de España, February 2013.

CHANGES IN THE YOUTH LABOUR FORCE PARTICIPATION RATE AFTER THE CRISIS (cont'd)

economically inactive and not in education have remained relatively stable in the last 15 years, even during the crisis period.

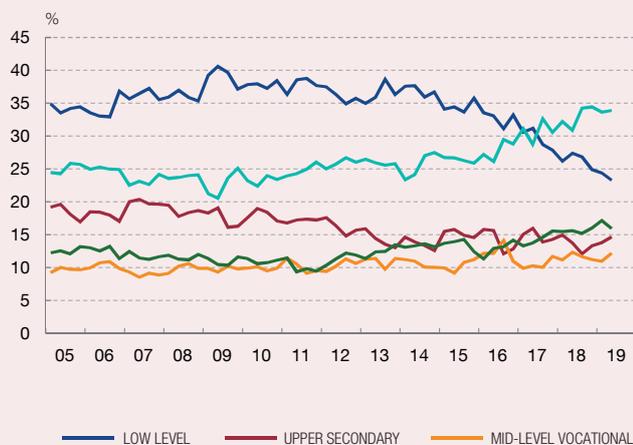
The increased length of time young people spend on schooling has been accompanied by an improvement in their level of educational attainment (Chart 3.1), but this has not had an impact on the early school leavers' rate, which remains high, albeit much lower than in the past³. To illustrate the improvement in the educational level, Chart 3.1 compares the highest level attained by the population aged 25 in different generations⁴. As can be observed, the percentage of young people whose highest level of educational attainment would have been a lower secondary school qualification by the age of 25 fell from 36.5% to 23.3% between 2007 Q2 and the same period in 2019⁵. Most of the decline was almost exclusively accounted for by an increase in the percentage of young

people obtaining a university degree (from 23.1% to 33.9%), while the proportion of those successfully completing other types of tertiary education rose from 11.5% to 15.9%.

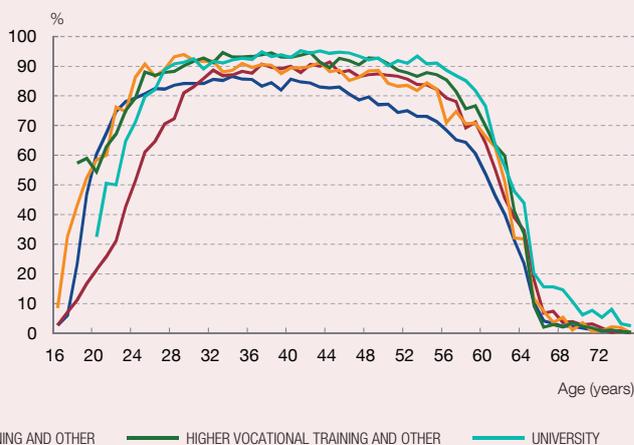
In general, having an academic qualification leads the better job opportunities. As Chart 3.2 shows, although the participation rates of those whose highest level of educational attainment is a lower secondary school qualification are comparatively high in the early years of employment, their working life tends to be shorter, affecting the overall income obtained. There are also differences in terms of unemployment rates and average remuneration. For example, drawing on data from the Spanish Labour Force Survey, it can be observed that, on average, the unemployment rate of persons aged between 25 and 30 in 2019 Q2 was 34% for those who only had a lower secondary qualification, but only 15% for university

Chart 3
YOUNG PEOPLE BY LEVEL OF EDUCATION AT THE AGE OF 25, AND PARTICIPATION RATE BY AGE IN 2018 ACCORDING TO LEVEL OF EDUCATION (a)

1 STRUCTURE OF YOUNG POPULATION BY LEVEL OF EDUCATION. PROPORTION OF TOTAL POPULATION AGED 25



2 PARTICIPATION RATE BY LEVEL OF EDUCATION AND AGE. 2018



SOURCES: INE and Banco de España.

a Own calculations drawing on Spanish Labour Survey microdata. The participation rate of young people with a university education is not considered before the age of 20, owing to its unpredictability. "Low level": no education, or only primary education or lower secondary with or without qualifications; "Mid-level vocational training and other" requires a lower secondary education qualification.

3 According to Eurostat, the early school leavers' rate for students aged between 18 and 24 was 17.9% in 2018 (11% in the euro area), compared with 30% in 2007.

4 The age chosen is 25 years, to consider students who have completed the first cycle of tertiary education.

5 See A, Lacuesta, S. Puente and E. Villanueva (2012), "The Schooling Response to a Sustained Increase in Low-Skill Wages: Evidence from Spain 1989-2009", Working Paper no. 1208, Banco de España.

CHANGES IN THE YOUTH LABOUR FORCE PARTICIPATION RATE AFTER THE CRISIS (cont'd)

graduates and 18% for groups with other higher education qualifications.

In short, the present recovery seems to be underpinned by a pattern that does not encourage young people to

leave the education system, unlike that observed during the previous expansionary phase. The current decline in the labour force participation rate for young people might be offset in the future by an increase in the labour force participation and productivity of this generation.

PROFITABILITY OF SPANISH NON-FINANCIAL CORPORATIONS

Between 2007 and 2013 the non-financial corporations sector underwent a severe crisis, which prompted considerable deterioration in their activity, profit and employment levels. Six years after the end of the downturn, this box compares the sector's present situation with both the pre-crisis and peak-crisis levels. The analysis concentrates on corporate profitability, as this variable is a good indicator not only of firms' economic and financial situation but also of their resilience to adverse shocks and their propensity to invest. The exercise draws on the Integrated Central Balance Sheet Data Office Survey (CBI), which has data up to 2017 for more than 600,000 non-financial corporations, and on the Central Balance Sheet Data Office Quarterly Survey (CBQ) which provides more recent data (up to June 2019) for a more limited sample (800 to 1,000 firms) where large corporations are over-represented. The measure of profitability used is the ordinary net profit to equity ratio.¹

The CBI data show that return on equity in the corporate sector fell sharply as a result of the crisis, down from 14.5% on average in the period 2003 to 2007 to 5.2% in 2013 (see Chart 1). The indicator then started to rise gradually in line with the macroeconomic recovery, reaching 9.7% in 2017 (the last year for which CBI data are available). The breakdown by firm size shows that profitability patterns at large corporations and at SMEs are similar to the patterns for the sector overall, although large corporations consistently record higher profitability levels than small firms.

However, the breakdown by sector reveals an uneven profitability recovery. Thus in 2017 profit levels in industry, in wholesale and retail trade and accommodation and food service activities and in transport and storage were similar to or higher than those of the period 2003 to 2007. Yet in construction, where profitability was negative in 2013, in 2017 it was still very distant from the pre-crisis level. Lastly, both the energy and the information and communications sectors recorded a sharp decline in profitability up to 2013, not only as a consequence of the crisis but also on account of the impact of the growing competition in both areas. This last factor continued to affect both sectors in the subsequent recovery and this is why, conversely to the other sectors, their average profitability levels continued to fall, albeit much less markedly, up to 2017.

An analysis of profitability distribution shows that between 2003 and 2007 the percentage of firms recording positive returns rose, reflecting the growth in the period (see Chart 2). Subsequently, as was to be expected, in 2013 a shift is observed in the distribution towards lower levels compared with the pre-crisis situation. This is explained both by the increase in the percentage of firms recording negative returns and the decrease in the percentage of firms with profitability levels over 10%. Following the recovery, the profitability distribution again shifted to the right. However, compared with the pre-crisis situation, in 2017 there is a greater concentration of firms with positive albeit moderate profitability levels, while the percentage of firms with relatively high profitability levels (over 10%) is lower than in 2007. Irrespective of the average level of corporate profitability in 2017, the fact that the distribution shows a very significant percentage of firms with relatively low (albeit positive) profitability would suggest that a considerable proportion of the companies analysed might still be quite sensitive to a possible adverse macro-financial shock.

It is also useful to examine the contribution made by the various different components of Ordinary Net Profit (ONP), which is the numerator of the profit ratio considered here. In this respect, Chart 3 shows that Gross Operating Profit (GOP) is the most important component underpinning the patterns observed, having made the largest contribution both to the decline in profitability during the crisis and to its subsequent recovery. There are, however, two additional elements that might also help explain the developments in return on equity. First financial costs, which fell as a proportion of total ONP over the period analysed, especially in the SME segment, owing to the deleveraging undertaken in the sector in recent years and, in particular, to the successive declines in interest rates in the period. And second, the significant increase in equity (the denominator) between 2007 and 2013, which drove down profitability in the period, most markedly among large corporations and in certain specific sectors (energy, construction, and information and communications). This increase in equity would be explained, *inter alia*, by significant capital increases made (for instance, through corporate debt to equity swaps) and by increases in reserves (arising, for example, from changes to dividend distribution policies or from extraordinary profits linked to investments in financial assets).

¹ The results obtained using alternative measures of profitability, such as return on net assets, are consistent with those obtained here.

PROFITABILITY OF SPANISH NON-FINANCIAL CORPORATIONS (cont'd)

Chart 1
RETURN ON EQUITY (R.2) (a)

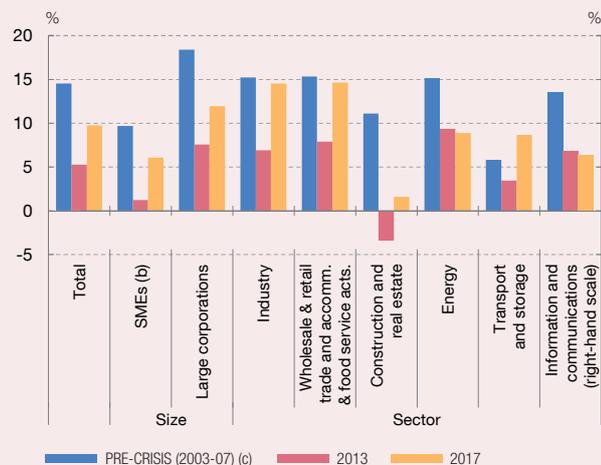


Chart 2
DISTRIBUTION OF R.2 PER YEAR (d)

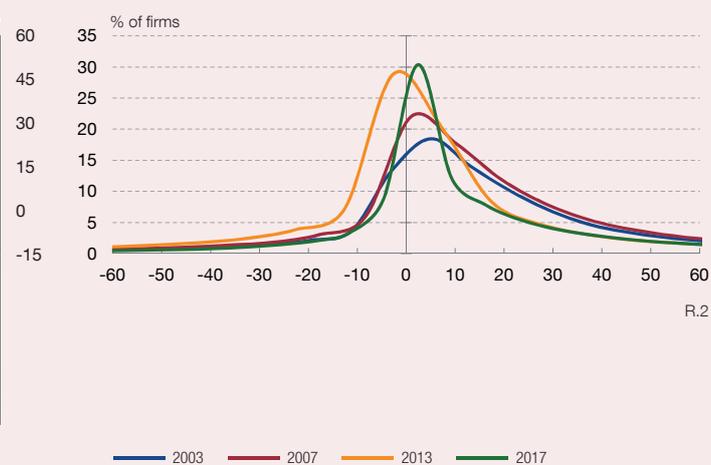


Chart 3
BREAKDOWN OF RETURN ON EQUITY (R.2)

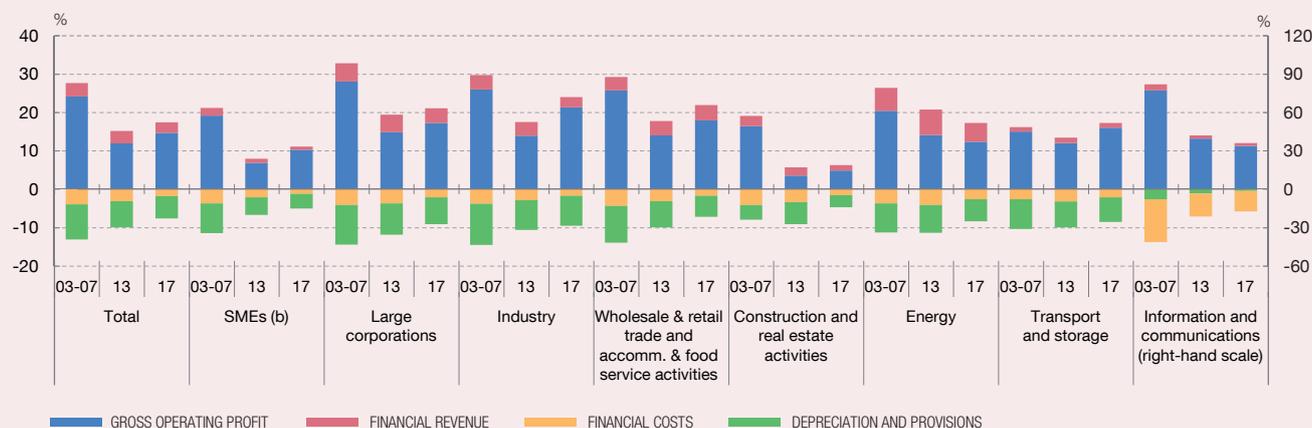
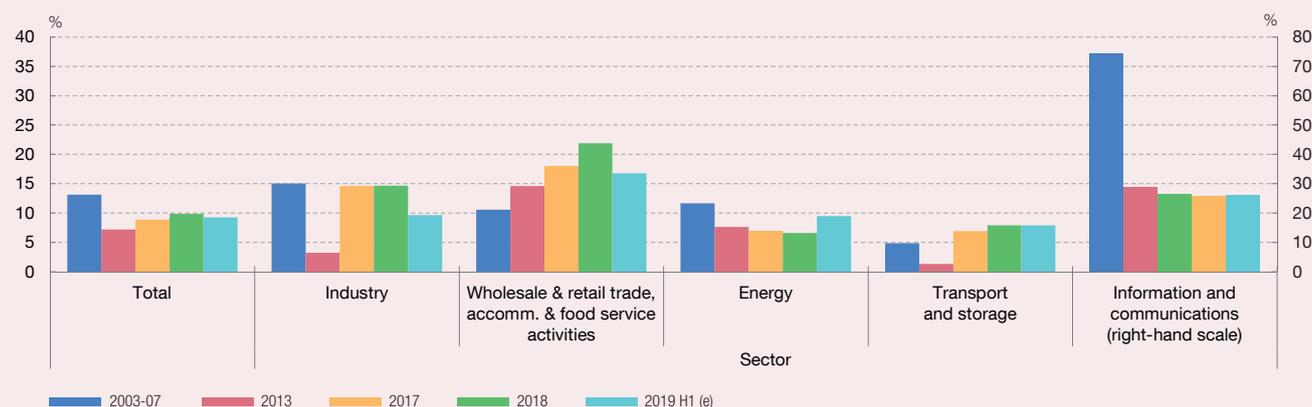


Chart 4
RETURN ON EQUITY (CBQ)



SOURCE: Banco de España.

- a Return on equity is defined as Ordinary net profit / Equity.
- b Definition of firm size as per Commission Recommendation 2003/361/EC.
- c Pre-crisis profitability calculated as the GVA weighted average of profitability levels in the years 2003 to 2007.
- d Excludes all firms with equity less than or equal to zero.
- e Profitability for 2019 corresponds to H1, annualised to facilitate comparison with the previous years.

PROFITABILITY OF SPANISH NON-FINANCIAL CORPORATIONS (cont'd)

Lastly, drawing on CBQ data, we analyse how corporate profitability has evolved in the more recent period.² These data show that, for the quarterly sample as a whole, average profitability levels continued to grow in 2018, before falling slightly in 2019 on data to June (see Chart 4). The main reason for this decline in profitability in recent

months appears to be the deterioration in operating activity in the period, against a backdrop of economic slowdown, prompting a widespread drop in Gross Operating Profit in all the main sectors covered by the quarterly sample, with the exception of energy which is the only sector that shows a somewhat more expansionary pattern.

2 The profitability levels reflected in the CBQ and the CBI are not directly comparable, either in terms of totals or breakdown by sector, owing to the lower number of firms reporting to the CBQ and the over-representation of large corporations. However, the CBQ is useful to assess more recent corporate profitability patterns.

REVIEW OF ANNUAL NATIONAL ACCOUNTS FOR 1995-2018: MAIN AGGREGATES

This box describes the main characteristics of the review of Annual National Accounts (ANA) for the years 1995-2018 published by the National Statistics Institute (INE) on 16 September 2019.¹ These benchmark reviews are carried out at least every five years and respond to the need to periodically update the sources and methods

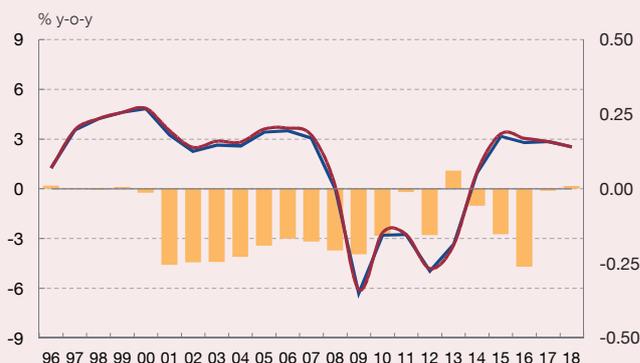
of estimation used to compile the Annual National Accounts.² In this case, the complete ANA series since 1995, which is the reference year, have been reviewed. The review of the series corresponding to the main ANA aggregates has been released to date. At the same time, a first update of the Quarterly National Accounts (QNA)

Chart 1
COMPARISON OF MAIN AGGREGATES OF NATIONAL ACCOUNTS

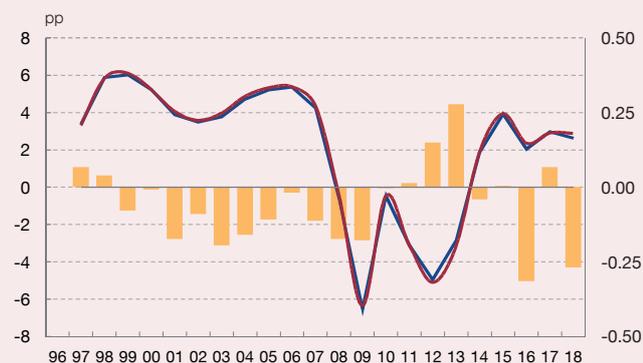
1 REAL GDP



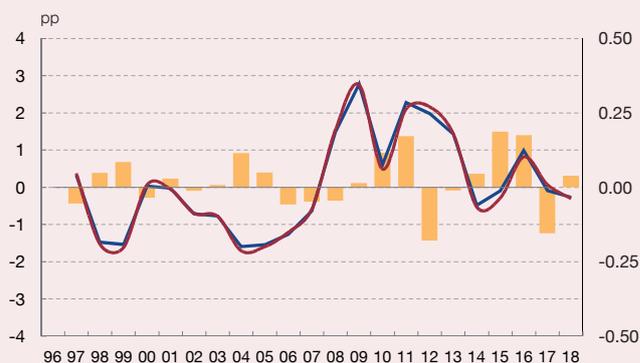
2 EMPLOYMENT



3 CONTRIBUTION OF DOMESTIC DEMAND



4 CONTRIBUTION OF NET EXTERNAL DEMAND



DIFFERENCE (right-hand scale) (a)

NEW DATA

PREVIOUS ESTIMATES

SOURCE: INE.

a Difference between the year-on-year growth rates (or contributions) for the various aggregates on the new data and the previous estimates.

1 The review was conducted in coordination with the corresponding processes carried out by the Banco de España (on the Financial Accounts for the Institutional Sectors of the Spanish economy and the Balance of Payments and International Investment Position statistics) and by the National Audit Office (IGAE) (on the General Government accounts). The data provided are, therefore, consistent with those provided by these other bodies.

2 For more details see the INE's press release published on 16 September 2019: "Annual National Accounts of Spain: Main aggregates. Statistical Review 2019. Series 1995-2018". On benchmark reviews and their implications for the balance of payments and international investment position, and for the financial accounts, see the following notes: https://www.bde.es/webbde/es/estadis/infoest/htmls/notamet/revBPPII2019_en.pdf and <https://www.bde.es/webbde/es/estadis/infoest/htmls/notamet/revCCFF2019.pdf> (the latter, on financial accounts, only available in Spanish).

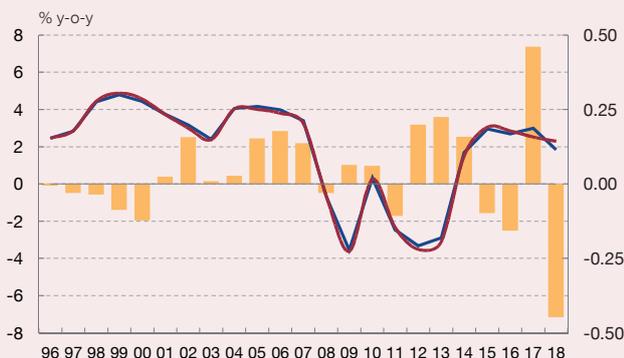
REVIEW OF ANNUAL NATIONAL ACCOUNTS FOR 1995-2018: MAIN AGGREGATES (cont'd)

series, consistent with the revised annual series, was released. However, these quarterly data are provisional; the revised series will be released on 30 September.³ These series will be consistent with the quarterly *Balance of Payments and International Investment Position* data to be released by the Banco de España on 26 September.⁴

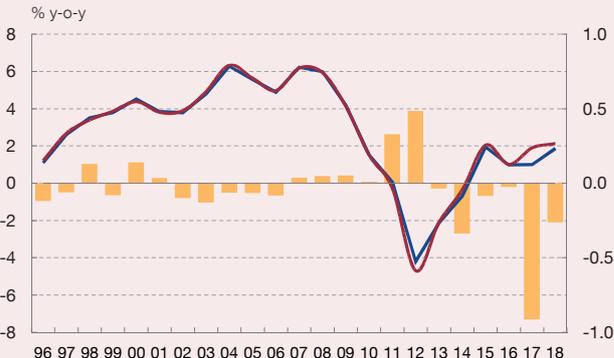
As a result of this review, nominal GDP in 2018 is 0.5% lower than the previous estimate. The reason for this is the less positive performance of real GDP. Specifically, the annual rate of growth of this variable is revised down somewhat on average, which translates into a cumulative decrease in its level since 1995 of 1.3 pp (see Chart 1 and Table 1). With the new series, the decline in GDP during

Chart 1
COMPARISON OF MAIN AGGREGATES OF NATIONAL ACCOUNTS (cont'd)

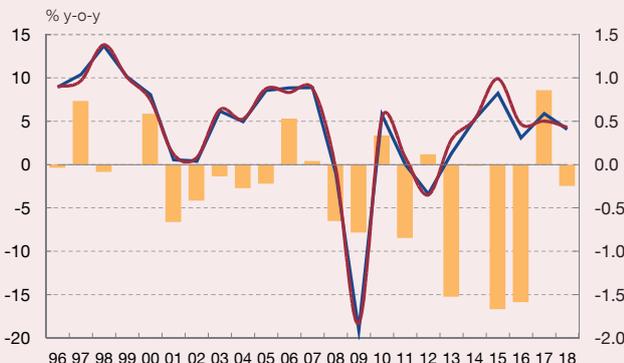
5 PRIVATE CONSUMPTION



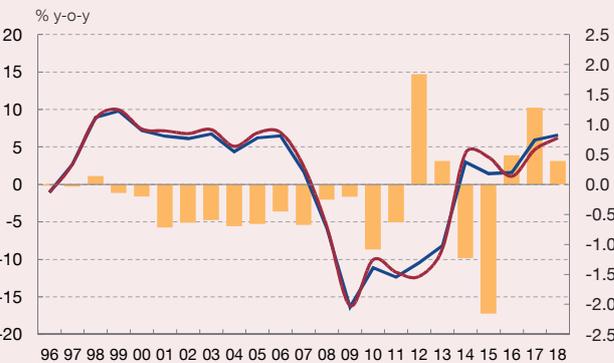
6 GOVERNMENT CONSUMPTION



7 INVESTMENT EXCLUDING CONSTRUCTION



8 CONSTRUCTION



DIFFERENCE (right-hand scale) (a) NEW DATA PREVIOUS ESTIMATES

SOURCE: INE.

a Difference between the year-on-year growth rates (or contributions) for the various aggregates on the new data and the previous estimates.

3 In accordance with the INE's release calendar, both the Quarterly National Accounts: Main aggregates (QNA) and the Quarterly Non-Financial Accounts for the Institutional Sectors (QNFAIS) up to 2019 Q2 will be published on 30 September. The Aggregates by Branch of Activity series and the Non-Financial Annual Accounts for the Institutional Sectors series will be released on that date. The Supply and Use tables for 2016 will be published in November 2019 and the Input-Output tables for 2016 in December 2019.

4 The revision of the Financial Accounts will be released on 15 October.

REVIEW OF ANNUAL NATIONAL ACCOUNTS FOR 1995-2018: MAIN AGGREGATES (cont'd)

the crisis is somewhat smoother. Similarly, the momentum in activity during the current upturn is also tempered, except in 2015 where there is an upward revision of 0.2 pp. Subsequently, GDP growth is revised down by between 0.1 pp and 0.2 pp in each of the following three years, giving rise to a more marked slowdown in the recent profile. In 2018 in particular real GDP growth is reduced by 0.2 pp to 2.4%.

Over the period as a whole, the revision of aggregate employment (in terms of full-time equivalent jobs) is in the same direction as, but more marked than, the revision of GDP, resulting in a cumulative reduction since 1995 of 3.6 pp. In the current growth phase, the downward revision is more pronounced in 2015 and 2016 than in later years.

The ANA revisions are most marked at the level of the demand components. The more moderate rate of growth of real GDP in the period as a whole is the result of a lower contribution of domestic demand, owing to lower than

previously estimated growth in both gross capital formation and government consumption. Conversely, between 1995 and 2018 private consumption increases, despite the downward revision made in the last years of the series. The revisions of the contribution of domestic demand show a similar time pattern to the revision of GDP (with a smaller decline during the crisis and lower momentum in the current upturn). The lower average contribution of domestic demand is partially offset by a generally higher contribution of net external demand, during the crisis and in the subsequent upturn.

In the more recent period, the part played by domestic demand in underpinning the GDP growth path is smaller than suggested by the previous ANA data. Specifically, the downward revision of the rate of growth of GDP in 2016 and 2018 reflects a smaller contribution of domestic demand, which is partially offset by the improved contribution of the external sector.

Table 1
REVIEW OF MAIN AGGREGATES OF NATIONAL ACCOUNTS

Year-on-year rates	Cumulative difference since 1995	2015		2016		2017		2018		
		New	Difference	New	Difference	New	Difference	New	Difference	
Gross domestic product	-1.3	3.8	0.2	3.0	-0.1	2.9	-0.1	2.4	-0.2	
National final consumption expenditure (76.9)	0.4	2.7	-0.1	2.3	-0.1	2.5	0.1	1.9	-0.4	
Of households and NPISHs (58.3)	1.1	2.9	-0.1	2.7	-0.2	3.0	0.5	1.8	-0.4	
Of general government (18.6)	-2.0	2.0	-0.1	1.0	0.0	1.0	-0.9	1.9	-0.3	
Gross capital formation (20.4)	-9.3	10.1	1.1	1.4	-1.1	5.6	0.2	6.1	0.6	
Fixed capital (19.4)	-9.4	4.9	-1.8	2.4	-0.5	5.9	1.1	5.3	0.0	
Capital goods (6.5)	-33.7	9.9	-2.4	1.9	-3.2	8.5	2.9	5.6	0.4	
Construction (9.6)	-6.6	1.5	-2.2	1.6	0.5	5.9	1.3	6.6	0.4	
Housing (5.3)	11.2	-3.2	-2.3	8.9	1.9	11.5	2.5	7.7	0.8	
Other construction (4.3)	-17.6	5.7	-1.7	-4.8	-1.2	0.2	-0.3	5.3	-0.2	
Intangible fixed assets (3.3)	38.6	5.3	0.7	5.2	1.6	1.3	-2.3	1.1	-1.1	
Change in inventories (b)	—	0.9	0.5	-0.2	-0.1	0.0	-0.2	0.2	0.1	
Domestic demand (97.3)	-1.9	4.1	0.0	2.1	-0.3	3.1	0.1	2.7	-0.3	
Exports of goods and services (35.1)	3.1	4.3	0.1	5.4	0.2	5.6	0.4	2.2	-0.1	
Imports of goods and services (32.4)	1.0	5.1	-0.4	2.6	-0.3	6.6	1.1	3.3	-0.2	
<i>Memorandum items</i>										
Contribution of domestic demand	—	3.9	0.0	2.0	-0.3	3.0	0.1	2.6	-0.3	
Contribution of net external demand	—	-0.1	0.2	1.0	0.2	-0.1	-0.2	-0.3	0.0	
Employment. Total economy	-3.6	3.2	-0.2	2.8	-0.3	2.8	0.0	2.5	0.0	

SOURCE: INE and Banco de España.

a In brackets, the share of each component in GDP in accordance with the new series.

b Contributions to growth.

REVIEW OF ANNUAL NATIONAL ACCOUNTS FOR 1995-2018: MAIN AGGREGATES (cont'd)

In recent years, both private and government consumption performed less favourably than had been estimated to date, especially in 2018. The revisions to gross capital formation are larger and more volatile. Thus the most marked increase in this aggregate in 2015 is reversed on account of a sharper slowdown, in the same amount, in 2016. In the last two years of the period analysed, the rate of growth of gross capital formation is revised up, especially in 2018.

Regarding transactions with the rest of the world, the improvement in the contribution of net external demand in 2015 and 2016 reflects somewhat higher growth in exports of goods and services, and especially a downward revision in the rate of growth of purchases abroad. In 2017, the higher increase in purchases abroad explains the deterioration in the contribution of the external sector in that year. Lastly, the rates of growth of trade transactions in 2018 are revised down, most markedly in the case of imports, resulting in a larger contribution of the external sector.

2 INTERNATIONAL FINANCIAL MARKETS

The increased geopolitical uncertainty and doubts regarding economic activity prompted sharp declines in sovereign debt yields and bouts of volatility in the stock markets, leading the main central banks to adopt new expansionary measures

Volatility in the international financial markets increased across the board in Q3. Financial asset prices fluctuated, mainly depending on the degree of optimism among investors about the outcome of the US-China trade talks, the changes in certain activity indicators, and the geopolitical uncertainty associated, for example, with Brexit, the stability of the Italian government or the recent tensions in the Middle East.

Equity markets remained on an upward path until end-July, but fell sharply in the first half of August. The positive performance of world stock markets in June continued during most of July, enabling some of the main international indices, such as those of the US stock markets, to reach annual highs in this period. However, between the end of July and the first half of August, the widespread increase in investors' aversion to risk led to sharp declines in stock indices. Share prices have subsequently started to recover, mainly because of the improved outlook regarding the future course of the US-China trade talks. As a result, at the cut-off date of this report, the stock indices of the main advanced economies (with the exception of United Kingdom), stood at levels that were higher than at end-Q2 (see Chart 2.1). By contrast, emerging stock markets declined across the board in the quarter, with a worse relative performance of Latin American markets.

In the sovereign debt markets, long-term yields fell to all-time lows in most euro area countries and in the US. Sovereign debt yields fell sharply across the board for most of the quarter (see Chart 2.2). In the United States, the sharp drop in ten-year US Treasury bond yields led to the slope of the sovereign debt yield curve inverting in the two to ten-year segment for the first time since 2007, which has historically been considered as a leading indicator of future recessions in that country⁴. For their part, the yield on thirty-year bonds fell to record lows in the quarter, to below 2%. The ten-year sovereign debt yields also posted record lows in most euro area countries in mid-August. Since then, these yields have recovered somewhat, as in the case of equity markets.

⁴ See "The flattening of the yield curve in the United States". J. C. Berganza and A. Fuertes, Economic Bulletin, Banco de España, March 2018.

Chart 2

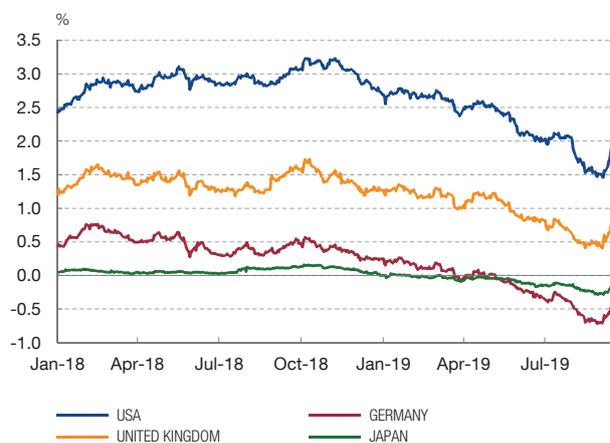
STOCK MARKET PRICES RISE MODERATELY AND SOVEREIGN YIELDS DECLINE, AGAINST A BACKDROP OF INCREASED VOLATILITY

The performance of financial markets in Q3 was influenced by the bout of volatility and strong risk aversion in August, mainly owing to the trade tensions between the United States and China, and by improved investor sentiment in recent weeks. The main stock markets recorded moderate gains, while in Spain the IBEX 35 dropped back slightly. Yields fell sharply on sovereign debt markets for most of the quarter, as a result of the weak macroeconomic setting and investors searching for safe-haven assets.

1 STOCK MARKET INDICES



2 10-YEAR SOVEREIGN DEBT YIELDS



SOURCE: Datastream.

The yield spreads on high-risk debt 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 July, but then widened significantly in August. In September, in line with the more positive performance of other markets, this spread narrowed again and, at the cut-off date of this report, stood at a level similar to that posted at the start of the quarter. In the foreign exchange markets, the yen appreciated sharply in August, which is consistent with its traditional consideration as a safe-haven asset. In turn, the pound sterling depreciated by 1.7% in the quarter owing to the uncertainty surrounding Brexit. The price of gold, also considered a safe asset in times of uncertainty, rose by 6.6% during the quarter.

3 EXTERNAL ENVIRONMENT OF THE SPANISH ECONOMY

3.1 External environment of the euro area

The global economy slowed down in Q2 and the high-frequency indicators suggest that weakness will persist over the coming months

In 2019 Q2 global activity slowed across the board, against a background of high uncertainty owing to trade tensions and higher geopolitical risks. Year-on-year global GDP growth decreased to 2.8%, 0.2 pp less than in Q1 and more than 1 pp below that recorded one year ago (see Chart 3.1). The weakness continues to be concentrated in investment, foreign trade and the manufacturing sector, while services and consumption remained robust (see Chart 3.2). The US economy remained on its slowing path, posting quarterly growth of 0.5%, compared with 0.8% in Q1. Likewise, Chinese GDP moderated slightly in Q2, from 6.4% to 6.2% year-on-year. In the United Kingdom, GDP contracted by 0.2% quarter-on-quarter between Q1 and Q2, largely owing to the reversion of the accumulation of inventories imported in Q1, reflecting a situation clearly marked by the ongoing uncertainty associated with the Brexit process. In Latin America, growth picked up slightly in Q2, owing to better data in Brazil and Mexico, while economic indicators for Turkey continued providing negative signals. In general, the information relating to Q3 points to continued weakness in activity, in both advanced and emerging market economies. Against this backdrop, growth projections for the whole of 2019 have been revised downwards (see Chart 3.3).

Inflation rates in the main advanced economies declined once again, often to below the central banks' targets. Inflation rates in most advanced economies declined in the last few months (see Chart 4.1), partly owing to changes in energy prices. Core rates remained very moderate overall and inflation expectations shifted downwards once again, particularly in the euro area and in the United States (see Chart 4.2). In the emerging market economies inflation slowed in almost all areas, as a result of the changes in the more volatile components, such as energy and food. One exception is the rise in inflation in China in recent months, largely as a result of the increase in food prices owing to the effects of swine fever.

World trade contraction has become sharper, against a background of heightened trade tensions

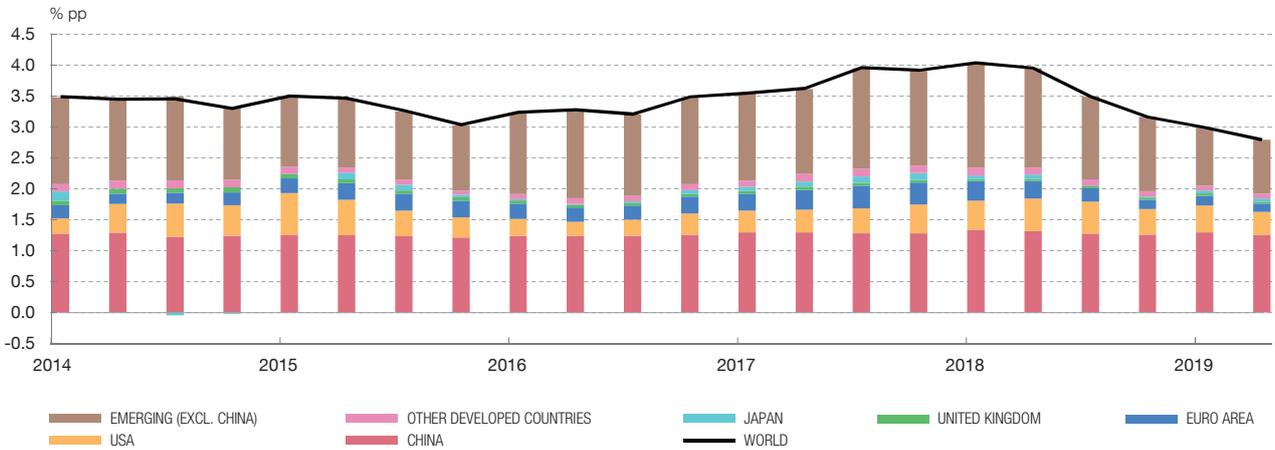
World trade contracted more markedly in Q2 than in Q1. Goods trade declined by 0.7% in the period from April to June as compared with the preceding quarter,

Chart 3

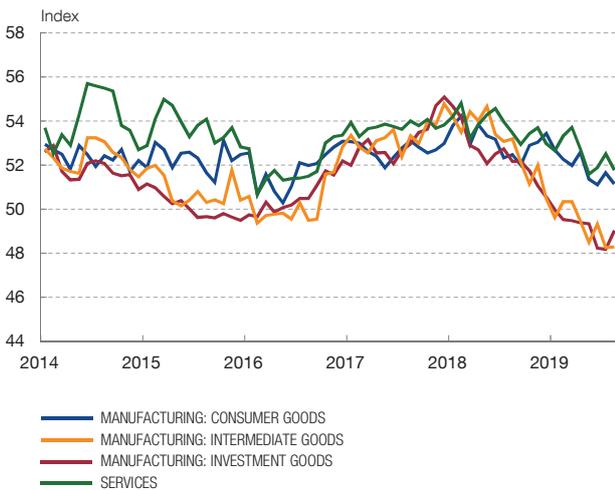
GLOBAL GROWTH SLOWED IN THE SECOND QUARTER IN LINE WITH EXPECTATIONS, AND GROWTH PROJECTIONS FOR THE YEAR AS A WHOLE HAVE BEEN REVISED DOWNWARDS

Growth of the world economy fell in the second quarter of the year in line with expectations and the high-frequency indicators remained weak which led to downward revisions to growth for this year.

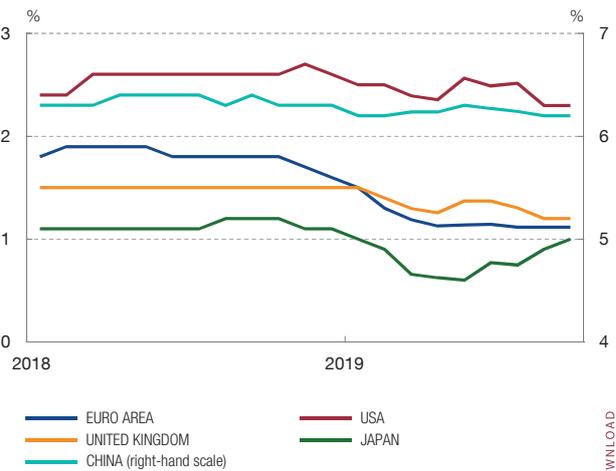
1 CONTRIBUTIONS TO GROWTH OF WORLD GDP
Y-o-y rate



2 GLOBAL PMI



3 GDP GROWTH PROJECTIONS



SOURCES: National sources, Thomson Reuters, Consensus and JP Morgan.

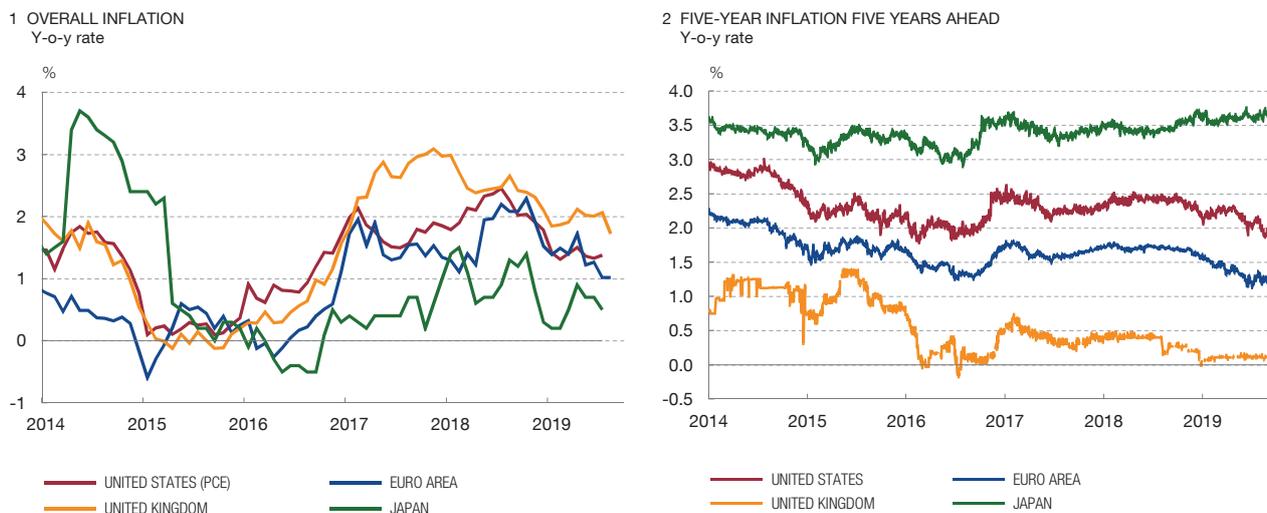


following the 0.3% decrease in the first part of the year (see Chart 5.1), reflecting lower import activity in most advanced economies and in China. As regards more recent information, the US-China conflict escalated over the summer months (see Chart 5.2). In August the United States announced it would impose higher tariffs (of 10%) on a broad set of imports of consumer goods from China worth \$260 billion (in some cases the tariff is to be applied starting on 1 September and in others from 15 December). China retaliated with tariffs of 5%-10% on \$75 billion worth of imports from the United States. In turn, the United States reacted by

Chart 4

OVERALL INFLATION AND INFLATION EXPECTATIONS HEADING DOWN

The inflation rates in the main advanced economies have tended to decrease, except for in the United Kingdom. Medium-term inflation expectations are also heading down, especially in the United States and the euro area.



SOURCES: National sources and Thomson Reuters.



threatening to raise the tariffs announced, from 10% to 15%, and others already in force previously, from 25% to 30%, starting on 1 October. Additionally, the depreciation of the renminbi against the dollar to values below the reference rate of seven yuan to the dollar, led the US Treasury to designate China as “a currency manipulator”, and to consider it had engaged in unfair practices in accordance with international rules, announcing that it could take retaliatory measures. The latest news point to some easing of tensions, with statements in favour of seeking an agreement between the two powers and announcements of deferrals and reductions for certain tariffs. However, there is still much uncertainty in this connection. Box 2 estimates the potential impact of these heightened trade tensions on the global economy. On a more positive note, a trade agreement reached between the European Union and Mercosur at the end of June is noteworthy. Its main aspects are described in Box 3.

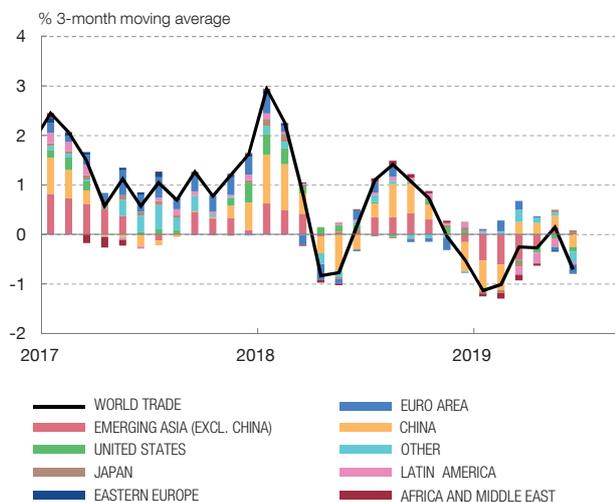
Oil prices were highly volatile in the days prior to the cut-off date of this report, despite following a predominantly bearish trajectory over the course of the past quarter. The sluggishness of oil prices was interrupted in mid-September by a terrorist attack on the oil infrastructure of Saudi Arabia, one of the world’s main oil producers. The impact of this attack, which is uncertain in the medium term, drove up the price of Brent crude oil to around \$65 per barrel. The effects of this could last for months. Other commodity prices, except those of safe-haven assets, such as gold, fell.

Chart 5

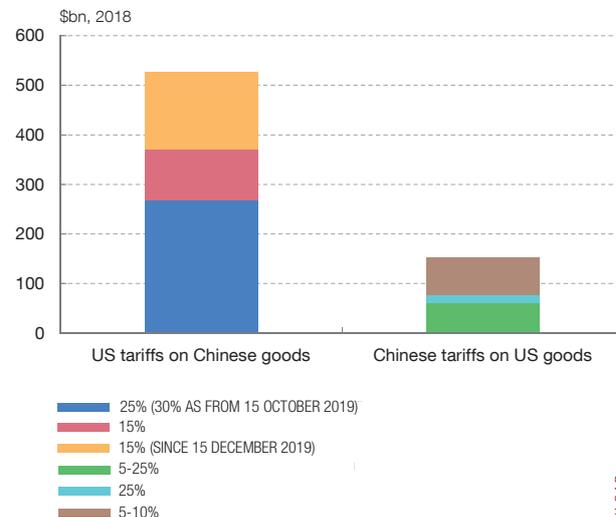
WORLD TRADE HAS CONTRACTED AGAIN AND TRADE TENSIONS HAVE ESCALATED

Trade data for most areas were weak in Q2. As a result of the heightening of trade tensions between the United States and China, with the introduction of new tariffs, the outlook for trade relations is gloomy.

1 WORLD TRADE GROWTH
Q-o-q rate



2 US AND CHINESE TARIFFS (a)



SOURCES: National sources and CPB.

a Tariffs announced or imposed by the United States and China on bilateral imports of various products by volume imported in 2018.



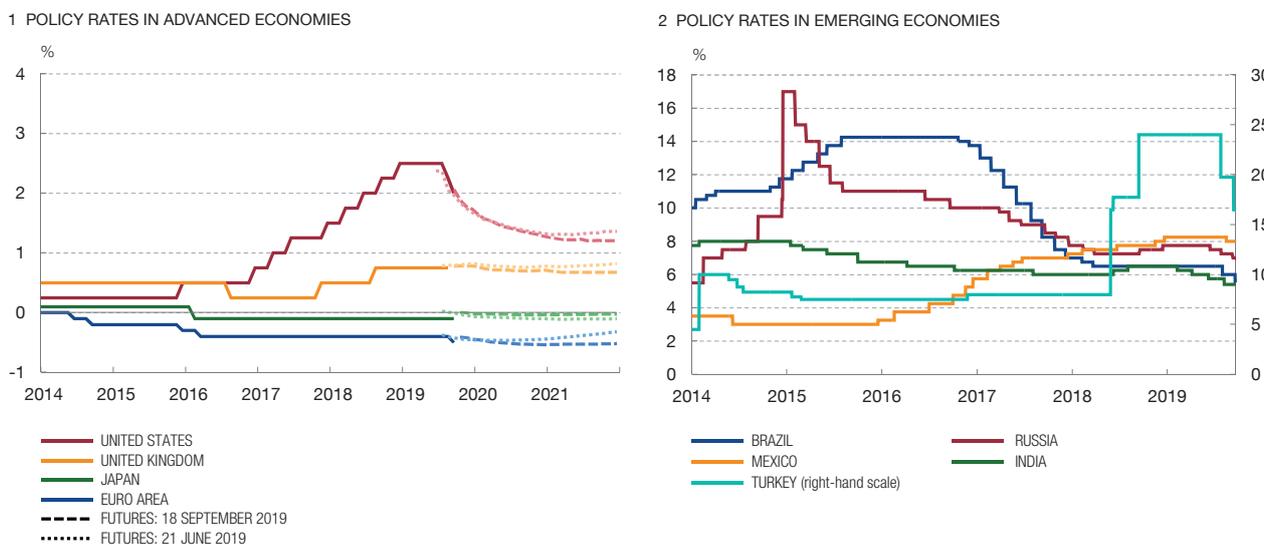
The monetary policy stance has become more expansionary, with the notable exception of Argentina, which is once again experiencing significant financial tensions

This configuration of greater risks to growth and absence of inflationary pressures has again led to an easing of monetary policies worldwide. In its July meeting, the US Federal Reserve cut the federal funds interest rate target by 25 bp to a range of 2%-2.25%, as a preventive measure against a global slowdown and the risks arising from the trade conflict. This was the first cut since 2008. It also brought forward the end of its balance sheet reduction process by two months. In September, the Federal Reserve further cut its benchmark interest rate range by 25 bp. For its part, as detailed below, the ECB approved a comprehensive package of measures with a strong accommodative bias at its September meeting, notably including the reduction of the interest rate on the deposit facility by 10 bp and the resumption of net asset purchases. At the cut-off date of this report, the markets assume that the Federal Reserve's benchmark interest rate will be 25 bp below its current level in December 2019 and that the interest rate on the deposit facility of the ECB will remain unchanged for the rest of the year. In both cases, benchmark interest rates are expected to be higher than anticipated a few weeks ago, most likely owing to the recent improved outlook on the trade conflict between the United States and China. The monetary policy stance in the emerging market economies has also become

Chart 6

THE CURRENT AND EXPECTED MONETARY POLICY STANCE IS MORE ACCOMMODATIVE WORLDWIDE

The Federal Reserve cut the federal funds rate at its July meeting and markets are discounting fresh rate cuts. A looser stance is expected from central banks in the advanced economies and several central banks in emerging countries have cut their policy rates.



SOURCES: Thomson Reuters and Bloomberg.



more dovish, with decreases in policy interest rates in a large number of countries in the face of signals of economic slowdown, greater global risks and generally contained inflation rates (see Chart 6.2).

The main exception to this overall picture is Argentina, which is once again in the midst of significant financial tensions. Following the primary elections held in early August, Argentina’s financial markets experienced a significant downturn. To curb the depreciation of the peso, the central bank responded by increasing the benchmark interest rate by 15 percentage points (see Chart 7.1). As tensions did not cease, the government announced its plan to implement a debt restructuring programme, extending the maturities of Treasury bills held by institutional investors mandatorily and those of longer-term debt securities held by resident and non-residents voluntarily. The government also requested a change in the payment path of its debt to the IMF. Finally, as a result of the continued financial deterioration, capital controls and limits to dollar purchases were introduced in early September and the central bank temporarily abandoned its commitment to zero growth in the monetary base, allowing it to increase somewhat to avoid a potentially excessive monetary contraction.

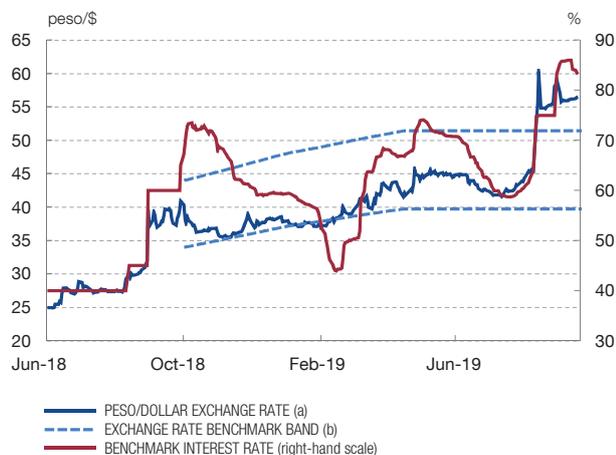
The rest of the emerging financial markets were also affected by global uncertainty, although to a lesser extent. In August the exchange rates of the currencies of many of these economies depreciated, their sovereign spreads increased and the stock indices posted declines. However, the situation seems to

Chart 7

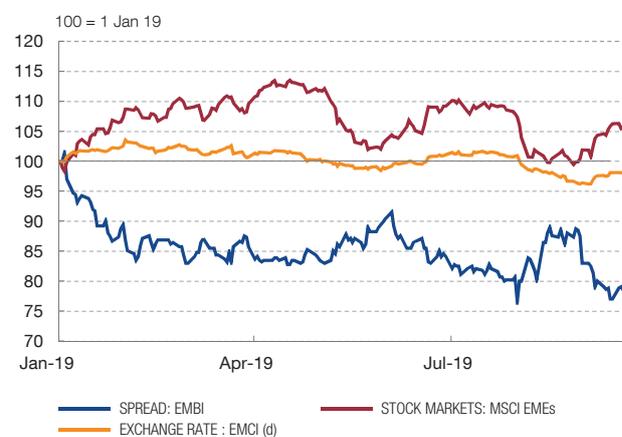
EMERGING FINANCIAL MARKETS, ESPECIALLY ARGENTINA, WERE HIT BY DEVELOPMENTS IN THE QUARTER

Following the primary elections in Argentina, the peso depreciated considerably and the central bank raised the interest rate to stem the currency's loss of value. Other emerging markets were also affected by global events in the summer, although the situation seems to have stabilised more recently.

1 ARGENTINA: EXCHANGE RATE AND INTEREST RATE



2 FINANCIAL CONDITIONS (EMERGING MARKETS) (c)



SOURCES: JP Morgan, Morgan Stanley and Thomson Reuters.

- a An increase represents a depreciation.
- b Until 29 April: "non-intervention zone".
- c EMBI (sovereign spread), EMCI: published by JP Morgan; MSCI, published by Morgan Stanley.
- d An increase represents an appreciation.



have stabilised more recently, as the prospects of a trade agreement between the United States and China have improved (see Chart 7.2).

3.2 The euro area and the monetary policy of the European Central Bank

Against this background of global uncertainty, the euro area continued to be immersed in a scenario of low growth and economic slowdown

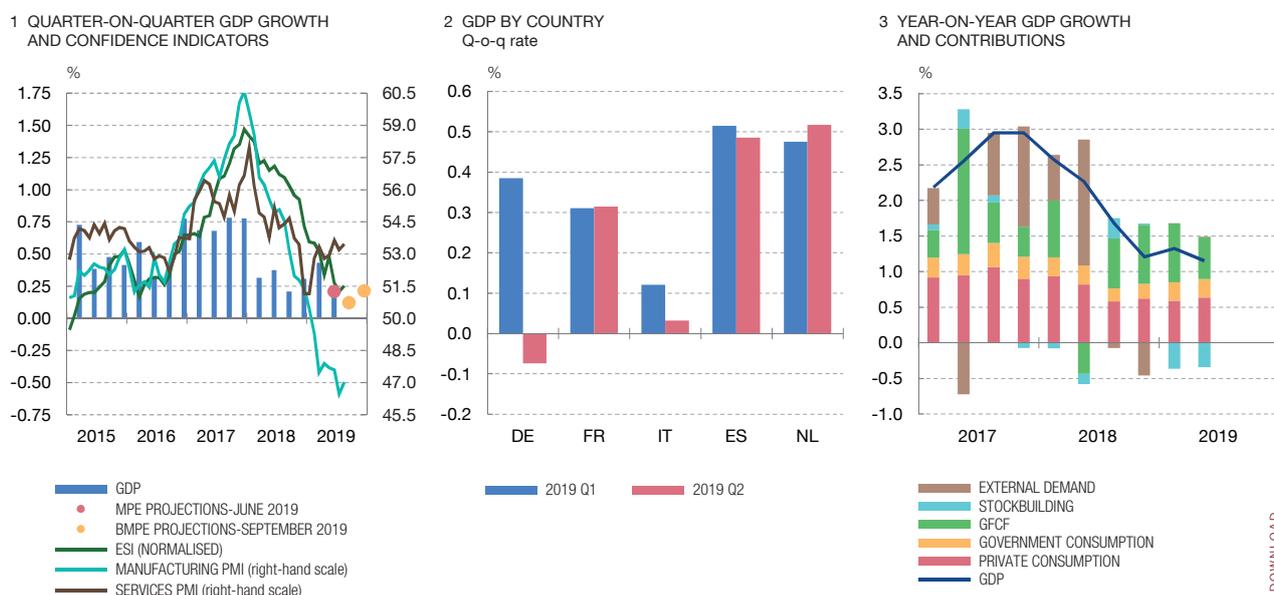
GDP growth decelerated in 2019 Q2, largely owing to the decline in exports.

The information received after the June report confirmed that the upswing in activity in Q1 was temporary. In Q2 GDP rose only by 0.2% quarter-on-quarter in the euro area as a whole, after posting 0.4% in Q1 (see Chart 8.1), weighed down by weak exports and subdued investment. Conversely, private consumption continued to expand, driven by the relative robustness of the labour market. From the supply standpoint, industrial activities contracted during this period, while services continued to perform more favourably. Of the four main economies in the area, the slowdown in activity affected Germany and Italy, while GDP in France and Spain grew at a similar rate to that in the previous quarter (see Chart 8.2). The contraction

Chart 8

ECONOMIC GROWTH IN THE EURO AREA REMAINS MODERATE

Euro area GDP resumed a low-growth path in Q2, in line with the decline in exports. Germany's economy cooled and Italy's continued to stagnate. As for Q3, weak industry and the fragile external sector have begun to affect services and employment.



SOURCES: Eurostat, Instituto Nacional de Estadística, European Commission, Markit Economics and European Central Bank.



of the German economy in Q2 is noteworthy. For the area as a whole, year-on-year growth declined by 0.1 pp, to 1.2% (see Chart 8.3).

Available indicators suggest that the weakness in economic activity in the euro area persisted in the third quarter of the year, particularly in industry. The information available for the current quarter points to the prolongation of the low growth path, in the complex international setting described previously. Indeed, the heightened US-China trade tensions and the increasing uncertainty associated with the Brexit process, together with the gradual slowdown in the Chinese economy and the vulnerability of certain emerging economies, shape an unfavourable environment for such open economies to international trade as the European ones. Thus, the indicators relating to trade and industrial activity (industrial production, export order books, manufacturing confidence and industrial production expectations) continued weakening in the third quarter of the year. Also, some of the qualitative indicators of activity and employment in services posted a shift downwards, which could indicate that the weakness is starting to spread to these activities. The slowdown in employment, together with the gradual decrease in consumer confidence in Q3, point to a more modest growth of private consumption, which has been to date the main driver of growth.

The Eurosystem's forecasts revised down the GDP growth expectations for the euro area, especially for 2020. The September projection exercise forecasts

Table 2

EURO AREA GDP AND HICP GROWTH FORECAST (a)

	2019		2020		2021	
	GDP	HICP	GDP	HICP	GDP	HICP
European Central Bank (September 2019)	1.1 (-0.1)	1.2 (-0.1)	1.2 (-0.2)	1.0 (-0.3)	1.4 (0.0)	1.5 (-0.1)
European Commission (July 2019)	1.2 (0.0)	1.3 (-0.1)	1.4 (-0.1)	1.3 (-0.1)	—	—
OECD (September 2019)	1.1 (-0.1)	—	1.0 (-0.4)	—	—	—
International Monetary Fund (July 2019)	1.3 (0.0)	—	1.6 (0.1)	—	—	—
Consensus Forecast (September 2019)	1.1 (0.0)	1.1 (0.0)	1.1 (-0.1)	1.3 (-0.1)	—	—

SOURCE: 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 June 2019 for the ECB, May for the EC, May for the OECD, April for the IMF and August for Consensus.

GDP growth of 1.1% for 2019 and 1.2% for 2020, in both cases below the June forecasts. This downward revision, against the backdrop of accommodative financing conditions for the economy overall, mainly reflects the deterioration in the growth expectations for world trade, on account of the renewed trade tensions and the economic slowdown in China and other emerging market economies (see Table 2). In the more medium term activity is expected to recover, underpinned by persistently favourable financial conditions, the slightly expansionary fiscal policy stance and the gradual disappearance of political and trade uncertainties. Nevertheless, there are still significant downside risks to this core scenario, mainly deriving from the possibility of a no-deal Brexit and of an escalation in trade tensions. By contrast, on the domestic front, the recent political tensions in Italy seem to have eased somewhat.

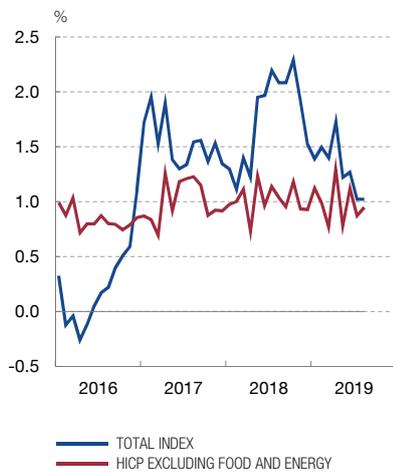
Inflation has remained low, distant from monetary policy reference values, and further reductions in inflation expectations were observed

Inflation in the euro area remains low. In Q3, euro area inflation was marked by the downward momentum in energy prices and the persistently moderate inflation rates in services and industrial goods. The year-on-year rate of change in the harmonised index of consumer prices (HICP) held steady at 1% in August, for the second consecutive month, after rising over 2% towards the end of 2018. This reflects the changes in energy prices, which contracted in August, a move that was partly offset by a marked increase in unprocessed food inflation. Core inflation, which excludes energy and food prices, remained at 0.9% (see Chart 9.1) as both services and non-energy industrial goods continued to record very moderate inflation. In the case of wage negotiations, the most recent information points to wage growth of around 2.5%, similar to that recorded in previous months. Lastly, the sharp fall in oil prices may have tempered business costs (Chart 9.2).

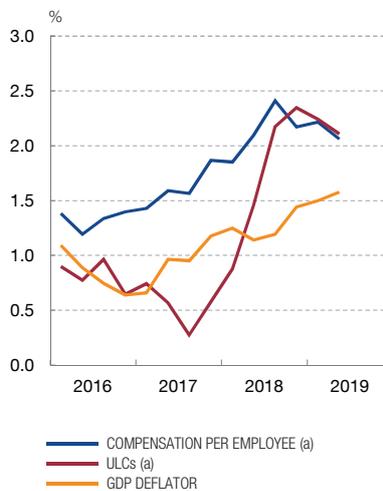
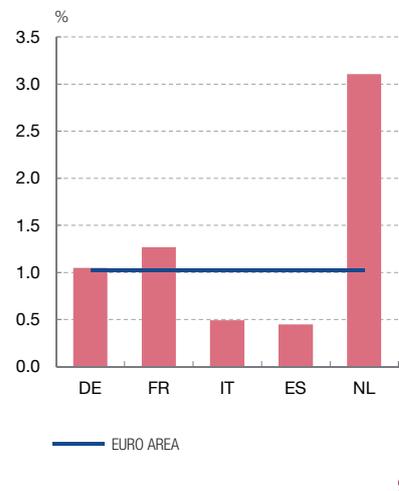
EURO AREA INFLATION REMAINS LOW

Overall inflation in the euro area stabilised at 1% in August due to the offsetting of the food and services components, while core inflation stood once again at 0.9%. The downward dynamics in energy prices will influence the path of inflation in the next few months.

1 HARMONISED INDICES OF CONSUMER PRICES



2 WAGES AND COSTS

3 TOTAL HICP
August 2019

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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This lack of inflationary pressure and the fragility of demand, together with expectations of lower oil prices and of deterioration of the global environment, prompted a new cut in the Eurosystem's inflation forecasts (see Table 2). These forecasts were revised down to 1.2% for 2019 and, following a cut of 0.4 pp, to 1% for 2020. The inflation forecast for 2021 is 1.5%, clearly below the monetary policy target.

At the Governing Council meeting of 12 September the ECB resolved to launch a package of measures with a clearly accommodative stance, to support the convergence of inflation to its medium-term target. In particular, the ECB resolved to lower the interest rate on the deposit facility by 10 bp, to -0.50%, and reinforced its forward guidance on interest rates, indicating that they will remain at their present or lower levels until the inflation outlook is seen to be “robustly converging” to a level “sufficiently close” to, but below, 2%. Such convergence should also be consistently reflected in core inflation dynamics. The ECB also resolved to resume net purchases under its asset purchase programme (APP), at a monthly pace of €20 billion as from 1 November and without a defined time limit. In order to preserve favourable bank lending conditions, the modalities of the new series of quarterly targeted longer-term refinancing operations (TLTRO III) were also changed, eliminating the 10 bp spread previously established on the interest rates applicable to these operations and extending their maturity from two to three years.

Lastly, to support the bank-based transmission of monetary policy, the introduction of a two-tier system for reserve remuneration was announced that will mean that part of banks' holdings of excess liquidity will be exempt from the negative deposit facility rate.

The Bank Lending Survey (BLS) shows that, in Q2, credit standards tightened for loans to enterprises, for the first time since 2014, and also for consumer credit and other lending to households, in this case in keeping with the pattern that began in 2018 H2. Credit standards remained broadly unchanged for housing loans. For Q3, banks expected credit standards to ease for consumer credit and to remain unchanged for loans to enterprises and housing loans. The BLS shows that demand rose in all segments in Q2. For Q3, banks expected demand to continue to grow, especially demand for consumer credit.

Growth in bank lending to non-financial corporations remains robust, up 3.9% year-on-year in July. In recent months firms have made more use of financing through debt securities, which grew by 4.7% in July, 0.7 pp more than in April. Lending to households continues to improve gradually: consumer credit rose by 6.2% in July (compared with 5.8% in April) while housing loan growth remained steady at 3.5%. As regards monetary aggregates, both M3 and M1 recorded year-on-year growth in July that was slightly higher than that observed in April.

The financial markets reflected the more risk-averse global environment

In Q3 to date, developments on Spanish financial markets have been determined mainly by a more risk-averse global environment. In this context, Spanish stock market indices suffered significant losses in August. In recent weeks, the easing of trade and geopolitical tensions has been conducive to a recovery in prices, so that, as at the cut-off date of this report, the IBEX 35 index stood at very similar levels to those recorded at end-June (a fall of 0.2%). This fall, which contrasts with the rise of 2.8% in the European stock market over the same period, appears to be mainly influenced by the poorer stock market performance of Spanish banks relative to other euro area banks and the relatively high weight of Spanish banks in the IBEX.

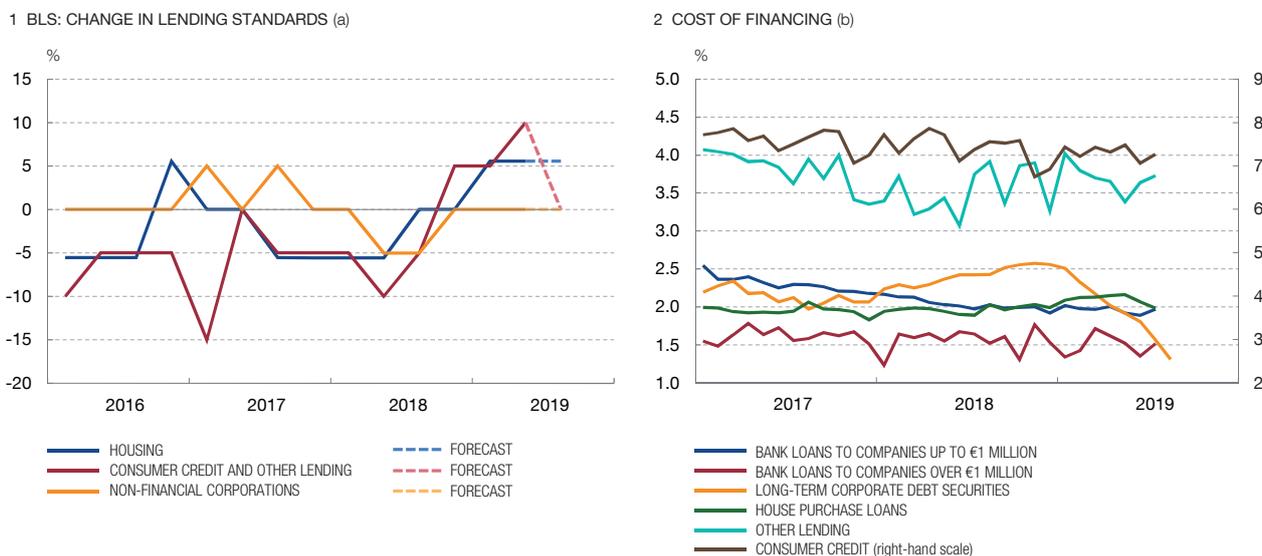
The greater risk aversion of investors in the quarter and the more accommodative monetary policy stance led to significant falls in government debt yields. The Spanish ten-year bond yield reached a historic low in August of 0.06%. Despite the rise in recent weeks, as at the cut-off date of this report, the yield was still some 20 bp below its end-June level. Given that the yield on the equivalent German bond has fallen by a similar amount during the quarter, the risk premium on Spanish debt over German debt has held stable, at around 75 bp. Finally, in line with the downward revision in July and August to the expected future path of interest rates, 12-month Euribor fell to -0.40%, although the subsequent rise in expected rates means that, at the cut-off date of this Report, it stood at -0.30%.

Financing conditions for households appear to have tightened slightly in 2019 Q2. As in the first quarter of the year, the Bank Lending Survey (BLS) for the second quarter signals a tightening of lending standards for households (see Chart 10.1). This appears to be the result of a fall in banks' risk tolerance and, in the case of consumer credit and other lending, a perception of lower borrower solvency, which would be consistent with the recent increase in non-performing loans in this segment. In the same vein, the BLS also shows a tightening of the margins applied to riskier loans for house purchase. In the case of non-financial corporations, lending standards appear to have remained unchanged, while the general terms and conditions appear to have even been eased. The cost of bank financing has remained relatively stable in all segments, except that of loans for house purchase, in which it fell somewhat in June and July (see Chart 10.2).

Chart 10

FINANCING CONDITIONS FOR HOUSEHOLDS APPEAR TO HAVE TIGHTENED SLIGHTLY IN 2019 Q2

According to the BLS, lending standards for households have tightened in recent months, while they remained stable for loans to corporations. The cost of financing for house purchase dropped by almost 20 bp in June and July. This fall may be partly a consequence of the decrease in interest rates during this period. It may also have been influenced by the entry into force of the new Real Estate Credit Law, although it is still early to assess the channels through which this effect would have materialised and whether they are temporary or permanent. The cost of market financing for non-financial corporations fell sharply in the year to date, increasing its appeal to companies.



SOURCES: Datastream and Banco de España.

- a Indicator = percentage of banks that have tightened their credit standards considerably \times 1 + percentage of banks that have tightened their credit standards somewhat \times 1/2 – percentage of banks that have eased their credit standards somewhat \times 1/2 – percentage of banks that have eased their credit standards considerably \times 1.
- b The interest rates on bank loans are NDER (narrowly defined effective rate).



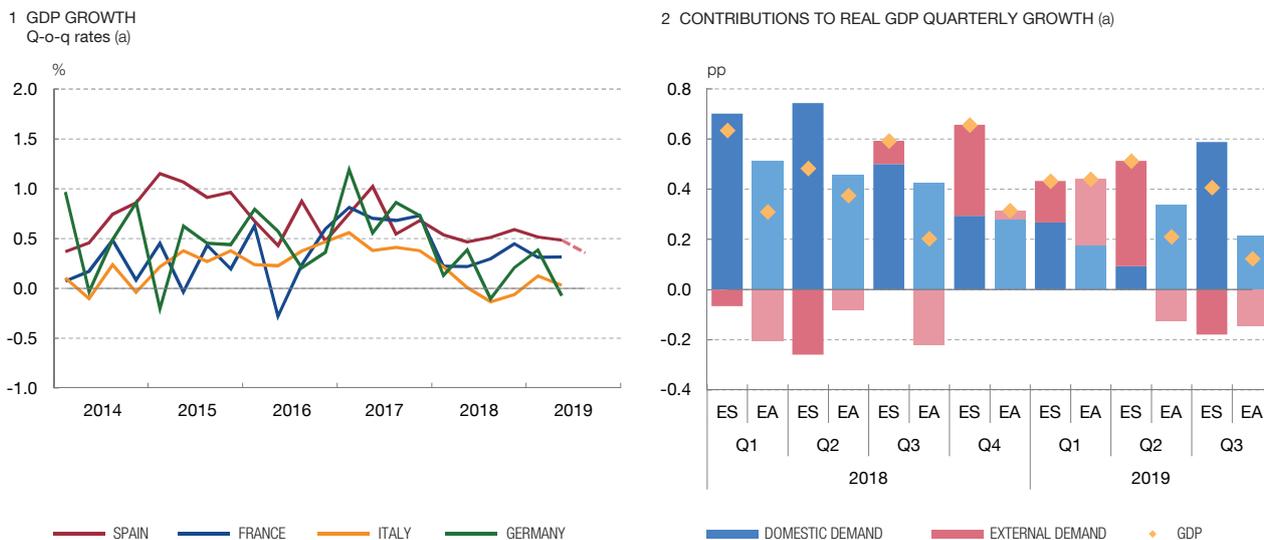
The Spanish economy remains on an expansionary course, although the rate of growth appears to be moderating, against a background in which the deterioration in the external sector appears to have begun to have a negative impact on domestic demand

The Spanish economy maintained a relatively sustained growth rate in 2019 Q2, against a backdrop of uncertainty and weak world trade. Specifically, GDP increased, as in the first quarter, by 0.5%, in seasonally adjusted quarter-on-quarter terms. That said, a change in the composition of growth was discernible, with a decline in the contribution of domestic demand and a larger positive contribution from the external sector (see Chart 11). The slowdown in domestic demand was particularly pronounced in the case of investment in capital goods, which fell relative to the previous quarter, in a setting characterised by the presence of elements of uncertainty and by the weakness of international trade, which is having a greater impact on the manufacturing sector. Also notable was the slowdown in private consumption, with a quarter-on-quarter growth rate of zero, the lowest rate since the start of the recovery. Meanwhile, the contribution of net external demand, positive

Chart 11

THE SPANISH ECONOMY REMAINS ROBUST

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.



SOURCES: INE, ECB and Banco de España.

a For 2019 Q3, Banco de España forecasts for the Spanish economy and ECB forecasts for the euro area.



for the fourth quarter in a row, increased, as a result of rather less pronounced growth in imports – which were unexpectedly low – than in exports.

According to new information available, activity was somewhat weaker in recent quarters than previously estimated. The INE has recently revised the National Accounts time series (see Box 8). The new data point to a certain loss of momentum in the growth of activity since the beginning of last year. Also, from summer 2018, the strength of domestic demand (and, in particular, of private consumption) appears to have been less pronounced than was estimated on the basis of the data previously available.

GDP is estimated to have slowed by 0.1 pp in Q3, to a rate of 0.4% quarter-on-quarter. Growth appears to have been supported by higher domestic demand growth, underpinned by a certain rise in investment (especially investment in capital goods, following its sharp contraction in Q2) and private consumption. These developments appear to have offset the foreseeably negative contribution from external demand, although the information available on the latter is still very incomplete.

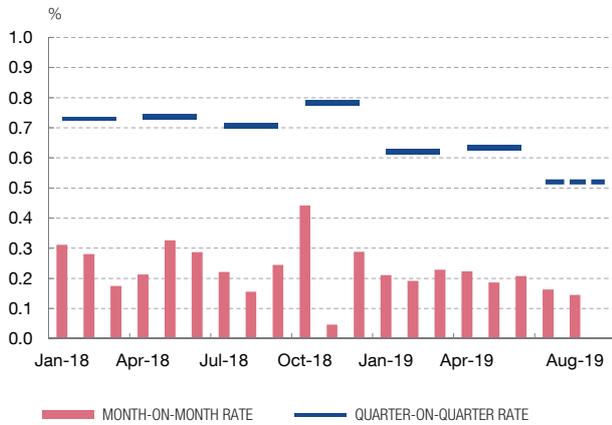
The Spanish economy maintains a positive growth differential relative to the euro area, but is not immune to the persistence of uncertainty and the deterioration in the external environment. The Spanish economy’s positive

Chart 12

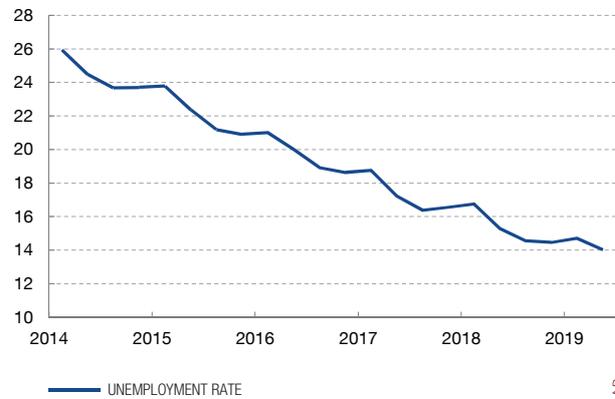
THE MODERATING TREND IN THE PACE OF JOB CREATION HAS BECOME MORE PRONOUNCED

Employment growth slowed in the summer months, although the downward trend in the unemployment rate has continued.

1 SOCIAL SECURITY REGISTRATIONS



2 UNEMPLOYMENT RATE (LFS)



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



growth differential relative to the euro area as a whole is estimated to have been sustained in Q3. This occurred against a background of widespread downward GDP growth revisions which, albeit with less intensity, are also affecting Spain.

Employment growth appears to have continued to slow in Q3. The latest data available on Social Security registrations point to a slowdown in employment during the summer months. On average, monthly employment growth between May and August was lower than during the first months of the year. This employment slowdown, which was relatively broad-based across the market-economy sectors, was somewhat more pronounced in construction and industry (see Chart 12). For its part, the unemployment rate, according to the Spanish Labour Force Survey, stood at 14% in Q2, down 1.3 pp from its level in the same period a year earlier. However, a slowdown was discernible, at the same time, in the rate of decline in the number of unemployed which, according to the registered unemployment data, continued in July and August, as a consequence of the moderation in employment and the increase in the labour force.

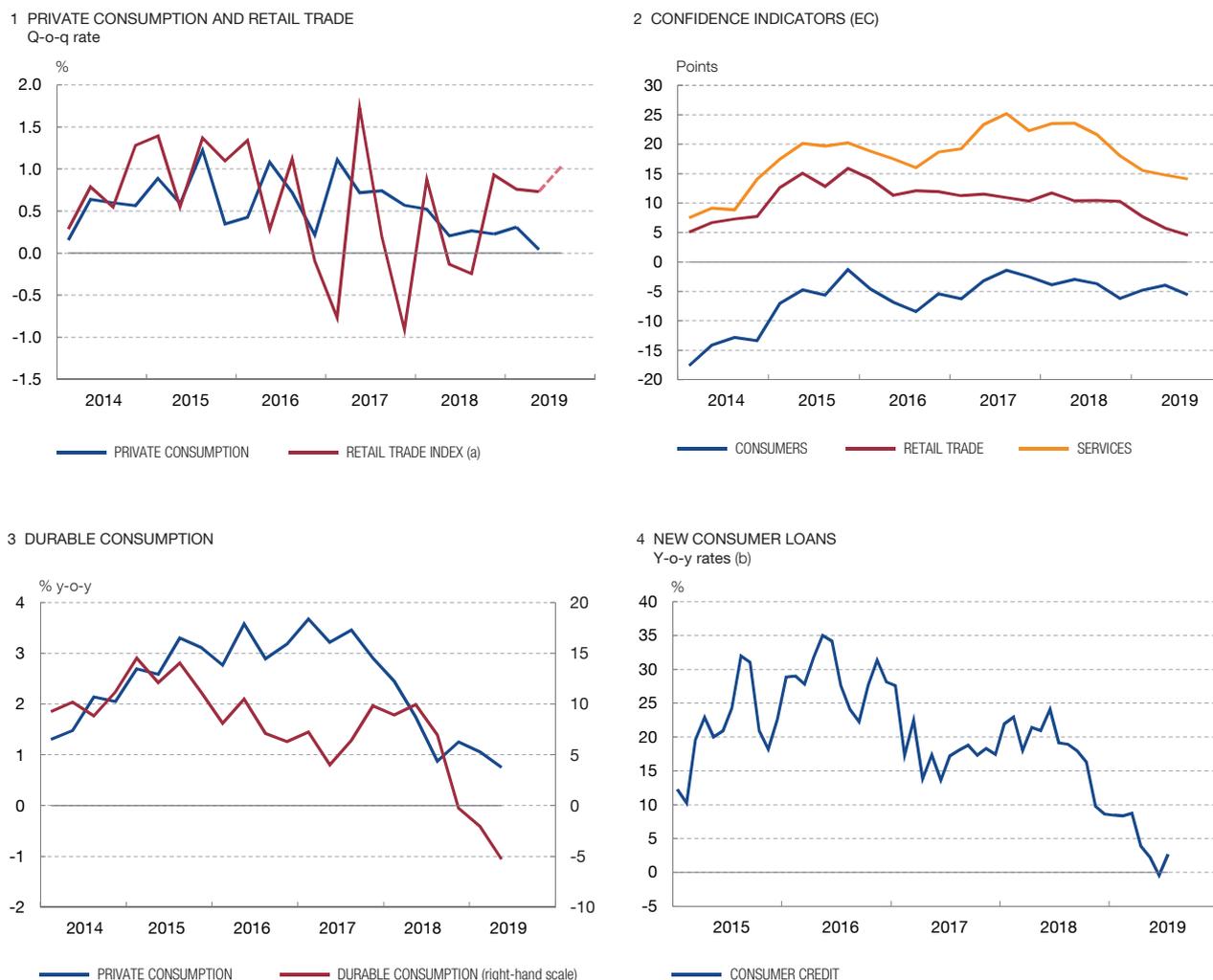
Domestic demand is expected to make a positive contribution to growth, although the outlook for private consumption and investment is subject to downside risks

Private consumption appears to have recovered some momentum in Q3. On the information available, the rate of growth of household spending is estimated to

Chart 13

PRIVATE CONSUMPTION HAS REGAINED SOME BUOYANCY

Private consumption is estimated to have regained some buoyancy in Q3, although recent developments in employment, slowing credit and a backdrop of greater uncertainty pose risks to this continuing in the medium term.



SOURCES: European Commission, INE and Banco de España.

- a Data observed until July and forecasts for the remainder of the quarter.
- b Calculations based on three-month cumulative flow.



have been slightly positive between July and September, having stood at zero in the preceding quarter (see Chart 13). Pointing in the same direction is the information on retail trade, which shows a somewhat more favourable performance in recent months, and the stock of consumer credit, which has risen slightly following the slowdown seen from mid-2018. However, as mentioned, Social Security registrations have grown more slowly than in previous quarters. Also, against the background of greater uncertainty described above, confidence indicators continue to behave unfavourably. Finally, spending on durable goods appears to be contracting, against a background in which the process of absorption of the pent-up demand for this type of goods that built up during the crisis appears to be nearing completion.

The low level of the household saving rate suggests that this type of spending will continue to be less buoyant in future quarters. In this respect, in the absence of complete revised time series for household accounts, the most recent National Accounts data relating to nominal consumption and employment income point to a saving rate that is possibly even lower than estimated up until now (although it appears to have risen recently). Conversely, consumption continues to be buoyed by the still sustained rate of job creation, the ongoing low level of financing costs and the strength of the financial position of the household sector at aggregate level.

The phase of less buoyant residential investment that began in 2018 appears to have continued. From the second half of 2018, a growing number of activity indicators for the sector began to show decreasing strength, a trend that has become more evident in 2019. In particular, in recent months, there has been a reduced buoyancy of housing sales (both in the new construction segment and, in somewhat more pronounced fashion, in the second-hand segment), and of new loans for house purchase, the volume of which declined year-on-year during the period from the beginning of June to the end of July. This phenomenon, which had not occurred since early 2014, may be partly a consequence of the entry into force of the new real estate credit law, which has given rise to a process of adaptation by financial institutions and other agents to the new legal framework (see Chart 14.1). As this adaptation is completed, the flow of property transactions can be expected to become more buoyant than that observed during the summer months.

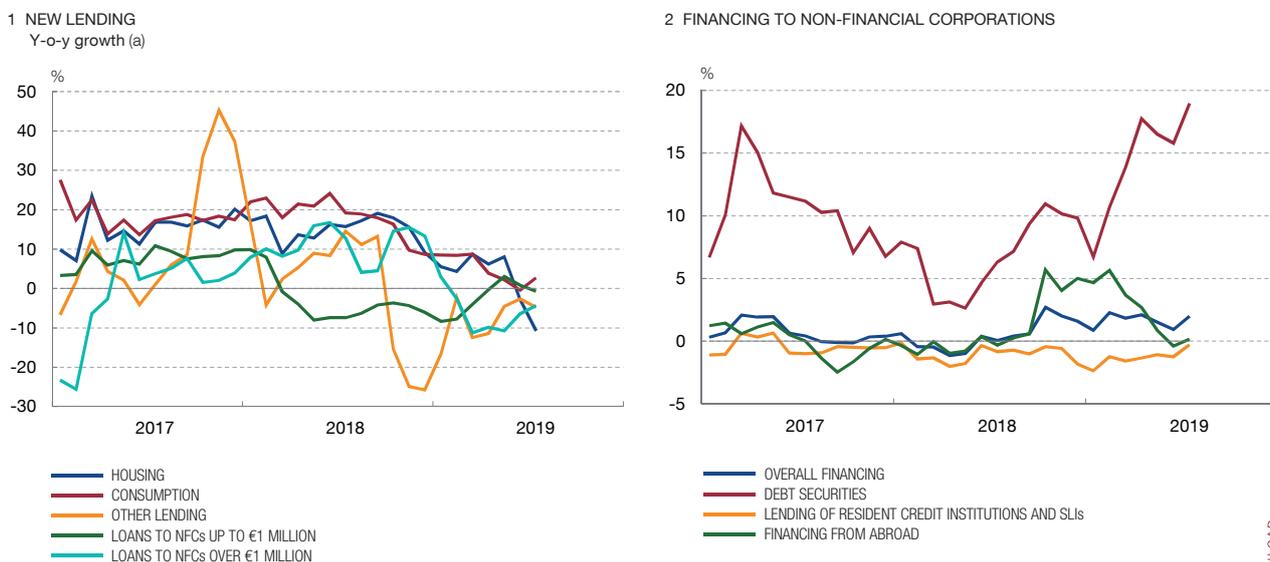
Also, the rate of growth of house prices has recently moderated. The slowdown in this variable began in late 2018 in the case of second-hand housing, while in that of new housing it has been limited to the latest data, for Q2. In the latter segment, prices continue to display high growth rates, which has brought their level close to the historic high of 2008 Q3. The price of second-hand housing, in contrast, is still well below its pre-crisis high, which was reached a year before that of new housing.

Following its decline in Q2, business investment appears to have picked up somewhat in Q3. This is what the latest data for certain indicators, such as capital goods imports and commercial vehicle registrations, suggest. Also, the environment in which this investment is made continues to have positive features, such as the persistence of a high level of capacity utilisation, financial conditions that remain favourable and the ongoing tendency for the financial position of non-financial corporations to improve. However, some indicators, such as the manufacturing PMI, suggest a certain intensification of the deterioration in confidence in the sector, against a background of continued global uncertainty, which may check the expansion of this demand component in future (see Chart 15).

In this context, the financing of non-financial corporations has continued to expand year-on-year. This is a consequence of the increase in corporate debt

NEW LENDING HAS CONTRACTED AT THE SAME TIME AS MARKET FINANCING OF NON-FINANCIAL CORPORATIONS HAS INCREASED

New lending has contracted in practically all segments. Lending in the house purchase segment has fallen since June, which could be related to the entry into force of the new Real Estate Credit Law, although it is still early to assess the temporary or permanent nature of the factors which have influenced this. In recent months non-financial corporations' financing through the issuance of debt securities has risen notably, boosted by the lower cost of these instruments.



SOURCE: Banco de España.

a Calculations based on three-month cumulative flow.

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issuance, boosted by the sharp decline in market interest rates, which has offset the contraction in the stock of credit obtained from resident institutions and in financing from abroad, the cost of which has fallen by comparatively less (see Chart 14.2).

Goods exports grew at a moderate pace, while the recovery of imports strengthened

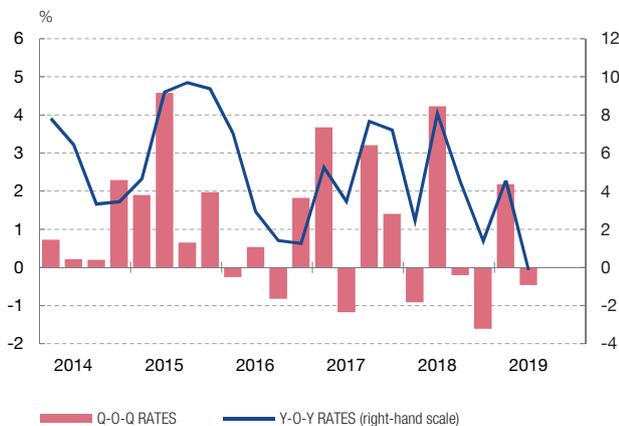
The external sector is expected to post a negative contribution to output growth in Q3, reflecting the more marked increase in imports as compared with exports. In Q2, foreign trade transactions gained some momentum, following the slackness observed in Q1. In any event, the subdued growth of imports, lower than projected, gave rise to a significant positive contribution from external demand to quarter-on-quarter GDP growth. On the very limited information available to date for Q3, export growth continues to be conditioned by the decline in external demand, affected by the renewed protectionist tensions and the slowdown in industrial activity (see Chart 16). The indicators of the outlook for foreign orders by the main areas — including the euro area, which is Spain's main export market— continue to point to a prolongation of this slackness in the coming months. For their part, imports show

Chart 15

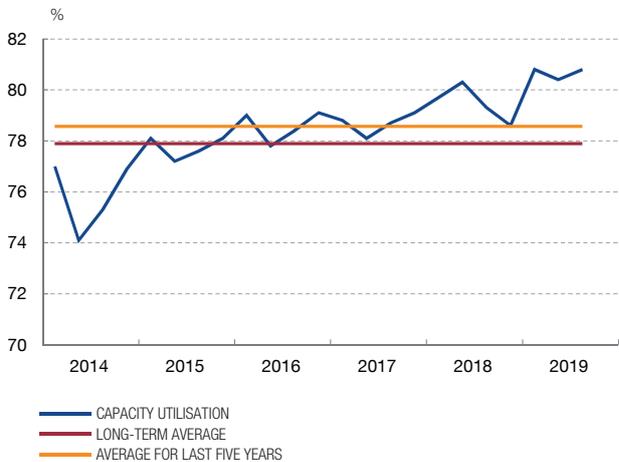
BUSINESS INVESTMENT HAS PICKED UP AGAIN SLIGHTLY, AFTER DECLINING IN THE PREVIOUS QUARTER

Investment in capital goods and intangibles is underpinned by high capacity utilisation, the improved financial position of firms and looser financial conditions. However, the recent downturn in industrial confidence and persisting uncertainty, both internally and externally, represent a risk factor.

1 INVESTMENT IN EQUIPMENT, INTANGIBLES AND OTHER (a)



2 CAPACITY UTILISATION IN INDUSTRY



3 PURCHASING MANAGERS' INDEX



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



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

- a Includes machinery, capital goods, armament systems, cultivated biological resources and intellectual property products.
- b Calculations based on three-month cumulative flow.



some signs of a gradual realignment with their determinants, following their recent relative weakness.

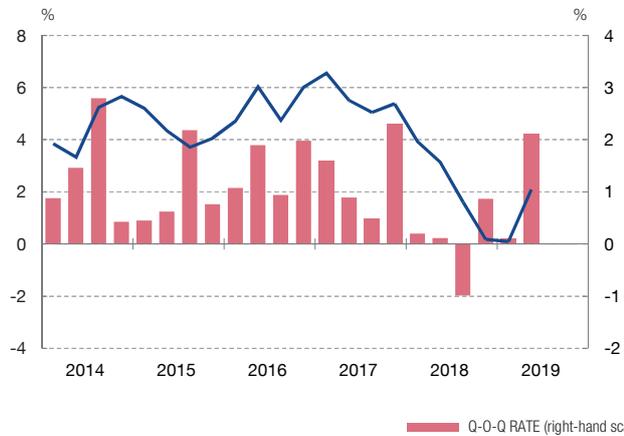
Goods exports returned to positive growth rates in Q2. This somewhat greater buoyancy comes after the cumulative contraction in 2018 and the early months of 2019. On Customs figures, the increase in real goods exports mirrored a relatively widespread improvement by type of product, more marked for capital goods and energy products. The exception were sales of durable consumer goods (particularly cars), which continued to decline in year-on-year terms. By geographical area, the

Chart 16

EXPORTS IMPACTED BY WEAK GLOBAL TRADE

In 2019 Q3 a negative contribution by the external sector to quarter-on-quarter GDP growth is anticipated, against the background of a more marked pick-up in imports than in exports.

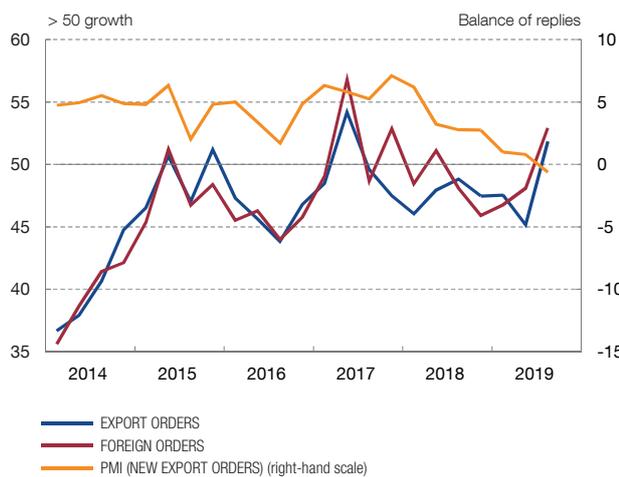
1 EXPORTS OF GOODS AND SERVICES (a)



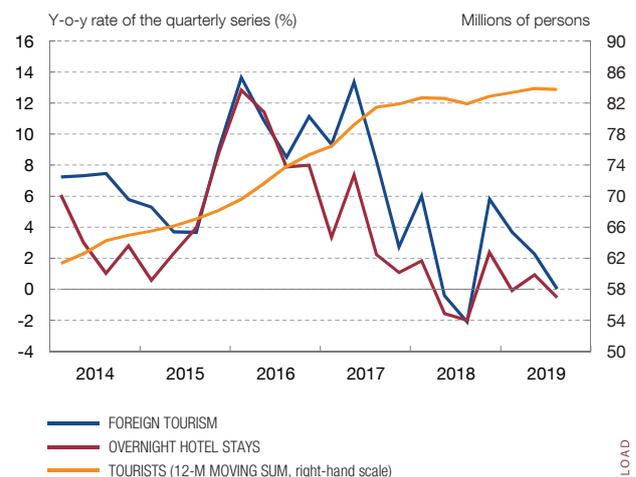
2 IMPORTS OF GOODS AND SERVICES (a)



3 CONFIDENCE INDICATORS



4 FOREIGN TOURISM INDICATORS



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.



increase in goods exports was somewhat more marked in sales to the EU, including the euro area. The trajectory of real imports appears to be moving in line with the behaviour of final demand. In this regard, the weak domestic and external demand for cars, a product with a very high import content, is having a downward impact on the growth profile of purchases abroad.

Turning to services exports, there were some signs of a slowdown in non-resident tourism during the summer months. According to the information available to July, year-on-year growth of total non-resident tourist spending is

moderating, although growth rates remain positive thanks to the increase in the average spending per tourist, which has offset the slowdown in total tourist inflows. This more restrained growth, which affects the main source markets (in particular, British tourism) appears to be chiefly due to the recovery of some competitor destinations in the Mediterranean region (especially Turkey). On a more positive note, in the last few months, the geographical diversification of tourist inflows has continued, as a result of the rise in those from non-EU countries, whose average daily spending is, on average, comparatively higher.

The downturn in activity reflects developments in industry and construction

On the supply side, the divergence observed between the manufacturing and services sectors has continued. In recent months, activity has slowed across the different sectors, albeit more markedly in industry. Specifically, the manufacturing PMI continued to gradually worsen until it contracted in August, while the related similar indicator for services remains consistent with activity growth, despite the declines observed. Social Security registrations confirm this diverging trend between the two sectors from the second half of 2018. The different relative performance of activity in industry and services could be related to factors such as the weakness of international trade and the unfavourable outlook in the external environment. More recently, the indicators relating to activity in construction, such as the figures on registrations, show that this sector has also slowed significantly.

The latest information available on general government points to a slight reduction in the budget deficit in 2019 with respect to the previous year

Recent developments appear to be consistent with a slight improvement in the balance of public finances in 2019. Excluding local government, the general government deficit stood in 2019 Q1 at 2.1% of GDP, 0.2 pp up on the same period a year earlier. This slight deterioration can be largely explained by the higher spending arising from the different timetables for approving the revaluation of pensions and public-sector wages in 2018 and 2019, which should be corrected in the second half of 2019⁵. Accordingly, the most recent information appears to be consistent with an improvement for the year as a whole, largely due to the favourable behaviour of

⁵ In 2018, the revaluation of pensions and public-sector wages became effective from July, albeit with retroactive validity from January, following approval of the State and Social Security Budget Law on 3 July (Law 6/2018). However, in 2019, the revaluation was approved in late December 2018, effective from January 1 (Royal Decree Law 24/2018 y 28/2018).

social security contributions which, in turn, partly reflects the measures approved in late 2018. By contrast, tax revenues have slowed somewhat, in line with economic developments, leading to a moderation in the growth of the tax bases.

The European authorities have confirmed that the Spanish general government sector has left its “excessive deficit” situation behind, but point to a high risk of failing to comply the requirements for convergence towards a balanced structural budget in the medium term. In June the EU Council approved the abrogation of the Excessive Deficit Procedure, to which the Spanish economy has been subject since 2009. Spanish public finances have now come under the so-called preventive arm of the EU’s Stability and Growth Pact. On the available estimates, the structural deficit of the Spanish general government is still a long way from the medium-term objective of 0%, requiring new measures to be adopted in the coming years. Specifically, the EC has recommended that the Spanish authorities make a structural adjustment of 0.65% of GDP in both 2019 and 2020, and to limit growth in eligible public spending⁶ to 0.6% and 0.9%, respectively. However, the upcoming general elections make it virtually impossible for the 2020 State budget to be approved before the end of this year, which would mean yet another extension of the 2018 State budget.

Growth in consumer prices has moderated as a result of the performance of the energy component, in a setting of contained external inflationary pressures, although wages are rising on the domestic front

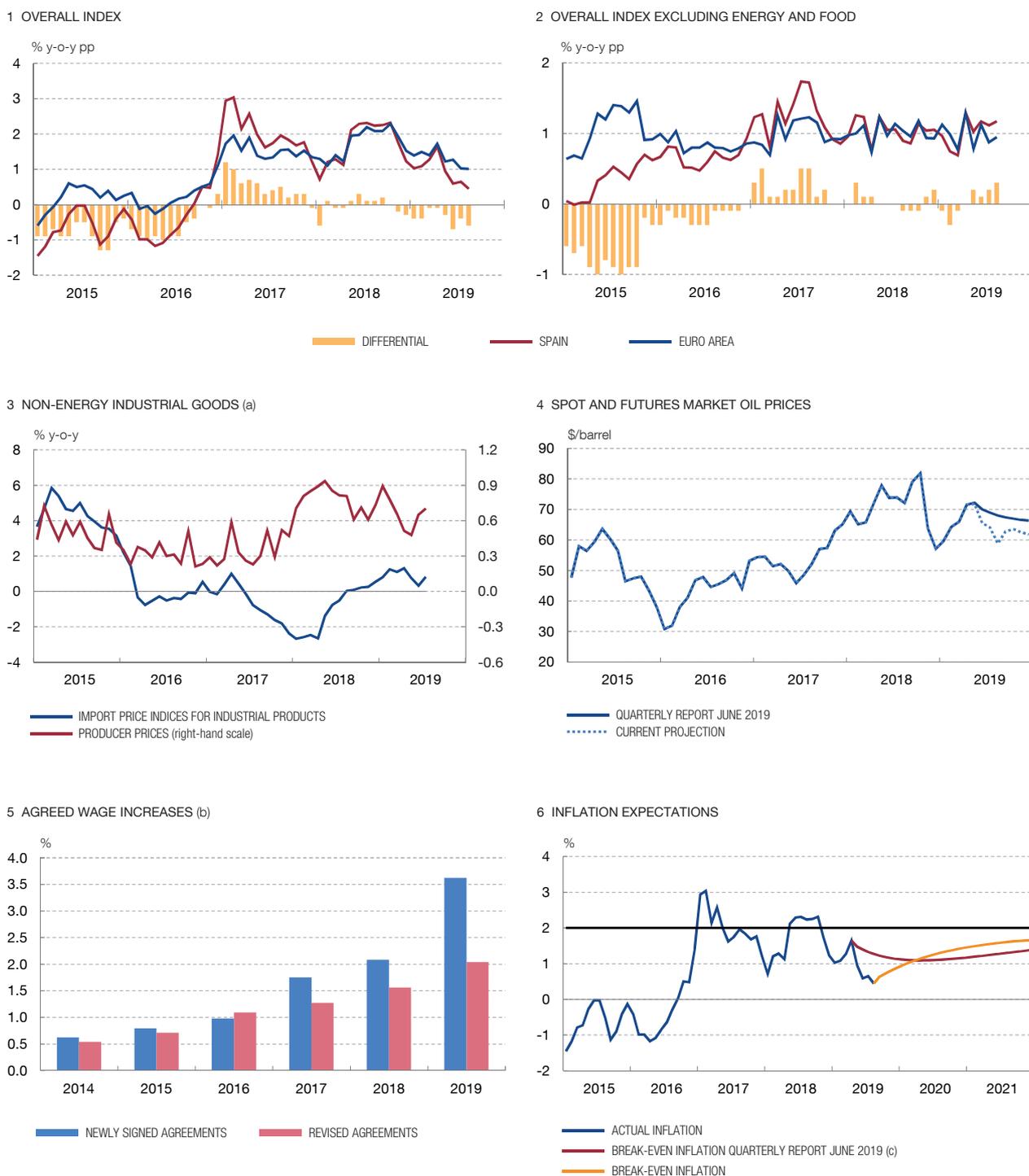
Inflation, measured by the Harmonised Index of Consumer Prices (HICP), has eased in recent months to stand at 0.4% in August (see Chart 17). This largely reflected the slowdown in energy prices. Core inflation grew by 1.2% in August (a similar rate to that observed since late 2017), despite the widening of the positive output gap, which points to a growing use of productive factors. In terms of components, services inflation stood at 1.5%, similar to the rate observed since the beginning of 2018, with temporary variations associated with tourism-related items. Non-energy industrial goods prices have quickened slightly in the last few months, to 0.6% year-on-year in August. The recent moderation of inflation has been somewhat more intense in Spain than in the euro area, thus broadening the negative differential between the two variables.

⁶ Eligible spending according to the expenditure rule applicable under the preventive arm of the SGP excludes interest expenditure, the non-discretionary elements of unemployment benefit expenditure and the expenses funded by the EU, and permanent revenue increases owing to regulatory changes (see *Vade Mecum on the Stability and Growth Pact 2019*).

Chart 17

MODERATE CONSUMER PRICES AND RISE IN WAGES

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.



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 August 2019.

c Break-even inflation calculated on the basis of inflation swaps.

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External inflationary pressures are very modest, in the context of the recent decline in oil prices. Crude oil prices moved on a downward path until mid-August, picking up slightly thereafter. This recovery intensified a month later, following the attacks on Saudi Arabian oil facilities. There is a much uncertainty as to whether the most recent rise in prices will last. In any case, this initial surge tended to moderate at the cut-off date of this report. In addition, the information drawn from the futures markets, which shows a markedly declining trend in crude oil prices, points to a predominantly temporary impact. For their part, the import prices of industrial non-energy goods have continued to post moderate year-on-year growth rates. Domestic industrial producer prices have also maintained very contained growth.

The inflation rate in Spain in recent months has tended to be lower than forecast. In particular, the increase in the energy component has been lower than expected, as a result of the negative surprises in electricity, gas and heating and vehicle fuel prices. That has led to a downward revision of HICP projections for 2019 as a whole. In recent months, the projection for the HICP excluding energy and food for this year has also been revised slightly downwards, from growth slightly below 1%, in view of the behaviour of services prices being less buoyant than expected.

On the costs side, wage indicators have risen in 2019. Wage rates under collective bargaining agreements have, on data to August, risen by an average of 2.3%, more than in the previous year (1.8%), affecting what is now a very large number of workers (8.4 million). These rises are considerably higher in newly signed agreements, benefiting 1.3 million workers to date. Specifically, the agreed wage rise in the latter is, on average, 3.6%, 0.6 pp higher than the upper bound of the benchmark range included in the most recent collective bargaining agreement. In the current context of heightened uncertainty about future economic developments, it would be desirable to ensure, on the one hand, that the agreed wage rises are closely aligned with the specific conditions of affected firms and sectors and, on the other, that the necessary flexibility instruments are put in place in collective bargaining processes to allow for labour costs to be adjusted in the event of adverse shocks and thus reduce their potential impact on employment.

20.9.2019.