MACROECONOMIC PROJECTIONS FOR THE SPANISH ECONOMY (2016-2019): THE BANCO DE ESPAÑA'S CONTRIBUTION TO THE EUROSYSTEM'S DECEMBER 2016 JOINT PROJECTION EXERCISE

Executive summary

This report contains the main elements of the macroeconomic projections for the Spanish economy for the period 2016-2019, which are part of the forecasts for the euro area as a whole recently published by the ECB on 8 December.[1] Compared with the projections for Spain for the years 2016-2018 that the Banco de España published in its September *Economic Bulletin*[2], the current ones include for the first time forecasts for 2019. These projections incorporate the changes observed up to 17 November in the technical assumptions and in the forecasts for the external environment (see Box 1), as well as in the fiscal assumptions, and the new information available up to the exercise cut-off date, on 24 November. It is particularly worth mentioning that the budgetary measures approved by the Council of Ministers on 2 December were adopted after the cut-off date for the assumptions and are thus not included in the projections.

The Spanish economy has shown notable strength in recent quarters, on the back of the reduction in the macroeconomic imbalances built up in the previous expansionary phase and during the crisis, the improvement in financial conditions induced by the accommodative monetary policy, the expansionary fiscal policy stance and the lagged effects of the decline in oil prices. It is estimated these factors have softened the potential impact of the uncertainty generated throughout the year by the presence, until recently, of a caretaker government in Spain and, from the summer, by the United Kingdom's decision to leave the European Union (EU). Indeed, the information available suggests that, in the final stretch of 2016, economic activity is expected to be somewhat more expansionary than forecast in September. GDP growth at the onset of 2017 might also be more dynamic compared with that projected three months ago.

Throughout the projection period, the expansionary phase of the economy is expected to continue, underpinned – inter alia – by the maintenance of the monetary stimulus and by the headway made in the ongoing deleveraging of private agents and the pick-up in external competitiveness. The favourable recent developments do not, however, alter the prospect of a moderate slowdown in the pace of output growth during the first half of 2017, against a background in which the recent path of oil prices will constrain private agents' purchasing power, the room for further lowering the cost of credit is limited and fiscal policy will abandon the expansionary stance of the past two years. Hence, after standing in 2016 at 3.2% (the same rate as that observed a year earlier), average GDP growth is expected to ease to 2.5% in 2017 (see Table 1). In 2018 and 2019, the estimated increase in output would stand at 2.1% and 2%, respectively. As to consumer prices, the CPI, after declining by -0.3% in 2016, is expected to increase by 1.6% in 2017, reflecting the notable rise in the energy component and the moderate acceleration of the CPI excluding energy and unprocessed food prices. In the subsequent two-year period, the annual average rates of the CPI are expected to increase by 1.5% in 2018 and by 1.7% in 2019, as a consequence of the opposite-trending courses of, on one hand, the energy component for which, on the information available at the exercise cut-off date, a significant slowdown is foreseen, in line with the expected course of oil prices on futures markets, and, on the other, the non-energy component, which is expected to continue rising gradually, as the economy's cyclical slack diminishes.[3]

1 See December 2016: Eurosystem staff macroeconomic projections for the euro area.
2 Macroeconomic projections for the Spanish economy 2016-2018.
3 The path of the annual average rates of change of the HICP, the harmonised index of consumer prices in the area's various countries on the basis of which the monetary policy objective is defined, is -0.4%, 1.5%, 1.5% and 1.7% in each of the four years of the projection horizon.

PROJECTIONS OF THE SPANISH ECONOMY'S MAIN MACROECONOMIC VARIABLES (a) — TABLE 1

Annual rate of change in volume terms and % of GDP

		December 2016 projection				Changes from the September 2016 projection		
	2015	2016	2017	2018	2019	2016	2017	2018
GDP	3.2	3.2	2.5	2.1	2.0	0.1	0.2	0.0
Private consumption	2.9	3.1	2.1	1.5	1.5	-0.3	0.2	0.0
Government consumption	2.0	1.4	0.8	0.8	1.0	0.4	0.0	0.0
Gross fixed capital formation	6.0	3.6	3.8	4.6	4.3	-0.5	-1.0	0.1
Investment in capital goods	8.8	5.7	5.1	5.7	5.0	-2.2	-1.6	0.1
Investment in construction	4.9	2.3	3.5	4.4	4.5	0.2	-0.7	0.0
Exports of goods and services	4.9	4.3	4.2	4.5	4.5	-1.0	-0.2	-0.2
Imports of goods and services	5.6	3.2	3.7	4.6	4.7	-2.1	-1.1	-0.3
National demand (contribution to growth)	3.3	2.8	2.2	2.0	1.9	-0.3	-0.1	0.0
Net external demand (contribution to growth)	-0.1	0.4	0.3	0.1	0.1	0.3	0.3	0.0
Nominal GDP	3.7	3.7	3.4	3.7	3.9	0.3	0.1	0.0
GDP deflator	0.5	0.5	0.9	1.6	1.8	0.2	-0.1	0.0
Consumer price index (CPI)	-0.5	-0.3	1.6	1.5	1.7	0.0	0.1	-0.1
CPI excl. energy and unprocessed food prices	0.6	0.8	1.0	1.4	1.8	-0.1	-0.3	-0.3
Harmonised index of consumer prices (HICP)	-0.6	-0.4	1.5	1.5	1.7	0.0	0.0	-0.4
Employment (full-time equivalents)	3.0	3.0	2.3	1.8	1.7	0.1	0.3	0.0
Unemployment rate (% of labour force). End-of-period data	20.9	18.5	17.0	15.6	14.5	-0.5	-0.8	-1.1
Unemployment rate (% of labour force). Average data	22.1	19.6	17.7	16.3	15.0	-0.2	-0.6	-0.9
Net lending (+)/net borrowing (–) of the nation (% of GDP)	2.0	2.3	2.1	1.9	1.8	-0.2	-0.1	0.0
General government net lending (+)/net borrowing (–) (% of GDP)	-5.1	-4.4	-3.6	-3.2	-2.8	0.6	0.0	-0.1

SOURCES: Banco de España and INE.
Latest QNA figure: 2016 Q3.

a Projections cut-off date: 24 November 2016. In particular, the budgetary resolutions adopted by the Council of Ministers on 2 December are not included.

Activity and employment

From the standpoint of the composition of aggregate demand, output growth is expected to continue to be underpinned by domestic spending, although the contribution of net external demand would also be positive, though declining, over the projection horizon. Among the national demand components, household consumption is forecast to continue running at a relatively high rate of growth over the period in question. This expenditure component will be underpinned by, among other factors, the prolongation of the current process of intense job generation, in a setting in which the evidence available indicates that, given a specific increase in their income, households spend a far higher proportion of it if it stems from job creation than if it comes from an increase in their real wages.[4] Also, the improvement in these agents' balance sheets, owing to the increase in the value of their non-financial wealth and to the process of progressive deleveraging, will contribute to the recovery in their spending capacity. However, from 2017 the pace of increase of consumption will be lower than that observed in the past two-year period, as a result of the discontinuation of the positive influence on real household income derived from the fall in oil prices and from direct tax cuts. As a result, following an increase of 3.1% this year, private consumption is projected to slow down to 2.1% in 2017 and 1.5% in the two following years.

4 See section 4 of the Banco de España Annual Report (2015), Chapter 2.

The recovery in residential investment will continue to be boosted by the favourable developments in the labour market and in the financing conditions applied both to house purchases by households and to their development and construction by firms in the sector. Against this backdrop, housing starts and sales are expected to continue posting sustained increases. That will lead to a moderate acceleration in this demand component, whose intensity will, however, be constrained by the low rate of increase in the projected number of households.

It is estimated that the buoyancy of business investment will ease slightly over the projection period, in line with the somewhat less expansionary behaviour of final demand, in a setting in which neither the availability of financing nor its cost are expected to pose an obstacle to non-financial corporations' expenditure. Indeed, the prolongation of the expansionary stance of monetary policy will prove conducive to firms accessing external financing at a low cost, both via credit and via the issuance of securities, boosted in this case by the Eurosystem's corporate debt purchase programme. Moreover, the recent notable growth of business saving will enable own funds to continue playing a significant role among the sources of financing for investment projects. Finally, the investment process will also be assisted by the decline in the sector's debt levels and the restructuring of corporate balance sheets. In this setting marked by companies' accumulation of liquid assets and by the ease of access to external financing at a low cost, it is estimated that the impact on business spending of the bringing forward of corporate income tax prepayments, adopted in the final stretch of this year, will be limited.

Following the slowdown observed in 2016, Spain's export markets are expected to grow more strongly over the projection period. From the geographical standpoint, such growth would be concentrated in certain non-euro area regions such as Asia and Latin America. Against this background, exports of goods and non-tourism services will continue to outgrow the rates of increase of the markets themselves, driven by the price-competitiveness gains accumulated and by the sustained increase in the number of stable exporting firms. As to incoming tourism, its growth rate is projected to ease following the high pace of increase in 2016 set against the rise in global geopolitical tensions. Overall, it is estimated that total exports might increase by somewhat over 4% per annum over the whole of the projection horizon. Following the weakness shown recently, import flows are expected to quicken moderately in the period in question. However, the projected growth is somewhat lower than might be inferred by the course of final demand, reflecting the recent evidence suggesting some substitution of domestically produced output for imports, which would so far be on a modest scale.

Projected real external trade flows, along with the foreseeable worsening in the terms of trade prompted by the rise in oil prices, would give rise to a slight reduction in the positive net balance of the goods and services account, which, in combination with a small increase in the deficit on the income account, would lead to a reduction in the nation's lending capacity, from the figure of 2.3% of GDP estimated in 2016 to 1.8% in 2019.

Employment is expected to continue growing at a high rate throughout the projection period, which partly reflects the fact that the increase in value-added is falling more than proportionately on highly labour-intensive sectors, as is habitually the case in the Spanish economy during recovery phases such as the present one. In any event, since a slowdown in activity is projected, the rate of job creation would also be lower than that of the last two-year period. In a setting in which the labour force is expected to begin posting increases only towards the end of the projection horizon, the growth envisaged in employment would lead to continuous declines in the unemployment rate to below 15%.

In accordance with the fiscal assumptions discussed, which do not include the budgetary decisions approved in early December this year, the general government deficit would fall to 4.4% of GDP this year and 3.6% in 2017, declining by 0.4 pp more in each of the last two years of the projection horizon. Compared with the September projections exercise, the deficit envisaged in 2016 is lower by 0.6 pp, which essentially reflects the effect on total public revenue of the reintroduction of the minimum corporate income tax prepayments.

Compared with the September forecasting exercise, the projections of GDP growth for 2016 and 2017 have been revised upwards by 0.1 and 0.2 pp, respectively, as a result of the better recent performance than that anticipated three months earlier, an improvement which would also run into the opening months of 2017. The changes observed since September in the overall assumptions conditioning the projections are very modest, so their impact on the expected GDP growth rate is also very limited. In particular, the somewhat lower increase in export markets, the rise in long-term interest rates and the slightly dearer oil prices are practically offset, in terms of their effects on the GDP growth rate, by a certain acceleration in competitor countries' prices.

Prices and costs

Following year-on-year decreases from mid-2014, consumer prices measured in terms of the CPI started to show positive rates of change from last September as a result of the rise in the energy component associated with the path of oil prices, despite which 2016 is expected to end with an estimated fall of 0.3% in annual average terms. Under the current oil price assumptions, the higher energy goods inflation will quicken further in early 2017. This will lead to a rise in the overall CPI of around 2% between February and April, easing off somewhat thereafter. In the coming year as a whole, consumer prices will grow by 1.6% in annual average terms, very similar to the rate in the following two years. Core inflation, proxied by the rate of change of the CPI excluding unprocessed food and energy, is expected to gradually accelerate at a modest pace as a result of decreasing slack in the economy and of quickening unit labour costs, against a background in which wage increases will tend to rise and low productivity growth rates will prevail. The rate of change of the GDP deflator will also tend to increase progressively over the projection horizon, from 0.5% in 2016 to 1.8% in 2019.

Compared with the projections made in September, the inflation projections as measured by consumer prices have scarcely changed. This is a result of revisions of opposite sign in the energy component, the higher growth of which is explained, in the short term, by the greater-than-anticipated increases in electricity, butane and natural gas prices compared with the previous projections, and in 2018 by the upward revision of the path of oil prices measured in euro and of the CPI excluding unprocessed food and energy, reflecting the lower-than-expected increase in these prices in recent months.

Risks

As in the September projection, the risks surrounding the baseline scenario for economic activity are considered to be tilted to the downside.

In the international environment, uncertainty has stepped up over the course of global economic policies, most particularly in connection with the US economy. This might ultimately have an adverse effect on the world economy, chiefly through the financial markets and global trade flows. Despite the fact that long-term global interest rates continue to stand at historical lows, additional rises to those posted recently cannot be ruled out, potentially leading to an adjustment in the prices of other financial assets and to the materialisation of the latent risks in some emerging economies, particularly those with a higher financial dependence on the external sector. In the euro area, apart from the uncertainty prompted by various upcoming national elections, regard must also be had to that derived from the impending negotiation of the UK's exit from the EU and, in particular, from the doubts as to the future form of the relationship between the two areas.

In the domestic arena, the formation of Spain's new government has begun to dispel the uncertainty surrounding the future course of economic policy. In the area of fiscal policy, subsequent to the information cut-off date for the preparation of these projections, the Government approved a Royal Decree-Law containing budgetary consolidation measures. Against this background, and in the absence of knowledge of the 2017 budgets of the various tiers of government, it seems that the fiscal policy stance for the coming year will turn contractionary, in contrast to the neutral tone of these projections, and this development could lessen the momentum of activity in the short term. At the same time, priority has to be given to resuming the process of budgetary consolidation in order to reduce the Spanish economy's vulnerability to potential changes in financing conditions on the international markets. This vulnerability is linked mainly to the high budget deficit and public debt and to the substantial borrowing of the nation as a whole from the rest of the world. The uncertainty, however, is higher in relation to the programme of structural reforms needed to boost the productivity growth rate and improve the functioning of the markets for goods and services and for factors of production. In this respect, the early approval of the measures for this purpose would tend to favour the growth of activity and mitigate the vulnerability of the economy to external shocks. Conversely, the recently demonstrated resilience of domestic demand points to the possibility that the momentum of economic activity – related to the robust job creation and to the vigorous transmission of monetary stimuli to financing conditions in the resident sector – may enable the dynamism of GDP to exceed the projection in the short term.

The risks of deviation from the inflation projections are also tilted to the downside, basically because of the possible crystallisation of the unfavourable contingencies for activity described above. On the upside, the recently observed rise in the energy component of inflation may give rise to a higher and more persistent impact on the consumer prices of other goods and services than that considered in the baseline scenario. Also, the oil price assumptions used in the projections do not include the upward impact of the agreement by the OPEC countries on 30 November to restrict oil production, because that date is after the cut-off date of the baseline scenario of the projections.

14.12.2016.

Assumptions relating to the path of interest rates and of oil and other commodities prices are based on the respective market prices observed in the ten working days prior to the cut-off date which, as indicated earlier, was 17 November 2016 (accordingly, market developments from that date until the release date of this note are not included). Specifically, the average oil price for 2016 would stand at a level of $43.1 per barrel, increasing in the following years to $54.6 in 2019, which, in comparison with previous projections, entails a moderate downward revision in 2017 and an upward one in 2018.

The expected path of the three-month Euribor rate involves a somewhat sharper rebound over the projection horizon than was considered in the September exercise, although this rise is lower than that recorded in the ten-year government debt interest rate curve. Specifically, in this projection exercise it is expected that the latter will stand at 2.2% and 2.5% in annual average terms in 2017 and 2018, respectively, in both cases 0.6 pp higher than projected in September. That said, it is estimated that the cost of credit received by households and firms will remain at low levels throughout the projection period, although, as a reflection of the rebound in the Euribor rates, it would experience a rise, albeit modest, since the cost of debt at credit institutions will continue to be low as a result of the accommodative monetary policy stance.

After the growth of Spanish export markets in 2016, estimated at 1.9%, it is projected that growth will steepen, reaching 3.2% in 2017 and 3.7% in both 2018 and 2019. Compared with the September exercise, this implies a downward revision for the next two-year period, mainly attributable to the lower expected increase in imports from certain euro area member countries. Additionally, competitor prices in euro are expected to grow at a slightly higher rate than was expected three months ago, mainly owing to the moderate depreciation since experienced by the euro against a broad range of currencies.

The fiscal policy assumptions for 2016 rest on the measures approved in the budgets of the different tiers of government for this year and on the available related outturn data until the projection exercise cut-off date. Also, the regulatory change approved in October in connection with the re-establishment of minimum amounts for corporate income tax prepayments was implemented, having the direct impact of increasing the tax take by approximately €8 billion in 2016 Q4, according to the official estimates available. As regards 2017, as noted above, at the cut-off date for the assumptions used in preparing these projections, the budgetary cycle of the different tiers of government had not yet been set in train. Consequently, they were not taken into account for the projections because the resolutions of the Council of Ministers of 2 December 2016 were adopted after the cut-off date. These resolutions were to be submitted to Parliament and related to budgetary stability objectives, the approval of the State expenditure ceiling and a detailed package of corrective measures.[1] Against this background,

1 These measures relate to corporate income tax, excise duties, social contributions, wealth tax, property tax, combating tax fraud and improving tax management. In any event, the draft State budget is not available for 2017, which introduces a high degree of uncertainly about the precise formulation of overall general government fiscal policy.

Table 1
INTERNATIONAL ENVIRONMENT AND MONETARY AND FINANCIAL CONDITIONS (a)
Annual rates of change, unless otherwise indicated

		December 2016 projection				Changes from the September 2016 projection		
	2015	2016	2017	2018	2019	2016	2017	2018
International environment								
Real world GDP growth	3.1	2.9	3.3	3.4	3.5	0.0	-0.1	-0.1
World trade	1.9	1.5	3.2	3.9	4.0	0.0	-0.1	0.0
Spanish export markets	3.2	1.9	3.2	3.7	3.7	0.2	-0.1	-0.3
Oil price (in USD)	52.4	43.1	49.3	52.6	54.6	-0.4	-0.9	1.8
Monetary and financial conditions								
Dollar/euro exchange rate (USD per euro)	1.11	1.11	1.09	1.09	1.09	-0.01	-0.03	-0.03
Nominal effective exchange rate vis-à-vis the non-euro area countries (c) (2000=100 and pp changes)	113.0	113.9	113.2	113.2	113.2	-0.3	-1.4	-1.4
Short-term interest rates (3-month Euribor) (b)	0.0	-0.3	-0.3	-0.2	0.0	0.0	0.1	0.2
Long-term interest rates (10-year bond yields) (b)	1.7	1.5	1.9	2.2	2.5	0.1	0.6	0.6

SOURCES: ECB and Banco de España.

a Assumptions cut-off date: 17 November 2016. Figures in levels are annual averages and the percentage rates are calculated on the basis of the related annual averages.
b For the projection period, the values in the table are technical assumptions, prepared following the Eurosystem's methodology. These assumptions are based on the prices on futures markets or on approximations thereto, and they should not be interpreted as a Eurosystem forecast about the course of these variables.
c A positive percentage change in the nominal effective exchange rate denotes an appreciation of the euro.

in accordance with the methodology adopted by the Eurosystem, it has been decided in the present projections, as in those published in September, to prepare a scenario that involves assuming a neutral fiscal policy stance for 2017-19, following the expansionary stance in 2016 (during which period a deterioration of the primary structural balance is estimated at close to 1 pp of GDP, similar to that estimated for 2015).[2]

Overall, the net impact of the changes in the different assumptions on the pace of GDP growth, as compared with those used in September, is approximately neutral. The effect of the changes in the assumptions on the inflation rate is positive, especially in 2018, as a result of the upward revision of the path of oil prices.

2 Specifically, the maintenance of a neutral stance in 2017-19 rests on the assumption that the Budget items subject to a greater degree of discretionality (e.g. inputs or public investment) will move in line with the (nominal) trend growth projections for the economy. Notwithstanding this assumption, the forecast for public revenues and the dynamics underlying certain expenditure items, such as that earmarked for the payment of unemployment benefits, are derived from the forecast macroeconomic aggregates. In-house estimates are also made of demographic trends, with an impact on pension spending, and of the debt interest burden.