This box describes the main features of the latest update of the Banco de España's macroeconomic projections. Compared with the previous projections,[1] presented in December 2016, the latest ones include the impact of the changes in the technical assumptions observed between 17 November 2016 and 23 March 2017, with the exception of the assumptions relating to performance of the external markets where the cut-off date is 20 February 2017 (see Table 1).[2] The projections also incorporate all information known since the close of the previous projection exercise up to 24 March, including in particular the latest QNA (Quarterly National Accounts) estimates up to 2016 Q4.

The current projections envisage continued economic expansion in Spain throughout the three-year period 2017-2019. Growth will continue to be assisted by the competitive gains obtained since the onset of the crisis and the enduring favourable financial conditions, underpinned by the accommodative monetary policy stance. Together, these factors will allow the process of continued job creation to keep progressing. In addition, although some of these temporary growth drivers of the last two years, such as low oil prices or the expansionary fiscal policy, have tended to reverse, their lagged effects are still lending a certain amount of momentum to activity in the short term.

Based on our estimates, GDP could rise by 2.8% this year, before slipping to more moderate growth rates of 2.3% and 2.1%, respectively, in 2018 and 2019 (see Table 2), precisely as the effects of those temporary growth drivers wear off. As regards consumer prices, it is estimated that the annual rate of change of CPI will increase to 2.2% this year, driven by the uptick in the energy component that is largely related to the positive base effects linked to oil prices, although it is expected to decline moderately as the year progresses in line with oil prices on the futures markets.[3] When these base effects are exhausted at the beginning of 2018, the inflation rate will decelerate, to 1.4% in 2018, before rising slightly again, up to 1.6% in 2019, as a consequence of the decrease in cyclical slack in the economy.

Compared with the December 2016 projection exercise, the changes in the assumptions on which the projections are based are quite modest. The most notable change is the upturn in oil prices as a result of the agreements reached between the oil producing countries in late November and early December, shortly after the cut-off date for the last projections. Although crude prices have dropped again recently, the level projected for 2017 is still 6.3% higher, on average, than the previous projection.

The changes in the other assumptions are minimal. Specifically, the cost of credit financing for the private sector of the economy is

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1 Macroeconomic projections for the Spanish economy (2016-2019): the Banco de España's contribution to the Eurosystem's December 2016 joint projection exercise.

2 The projections for the external markets (and for competitors' prices in their national currency) are taken from the March 2017 ECB staff macroeconomic projections for the euro area.

3 The reversal of a temporary increase in electricity prices at the beginning of the year also plays a key role in the gradual decline projected over the course of the year (see Box 4).

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

Annual rate of change, unless otherwise indicated

		March 2017 projections			Difference between current and December 2016 forecast		
	2016	2017	2018	2019	2017	2018	2019
International environment							
World output	2.9	3.3	3.5	3.6	0.1	0.1	0.1
World markets	1.7	3.5	3.9	3.9	0.4	-0.1	-0.1
Spain's export markets	2.2	3.7	3.7	3.6	0.5	0.0	0.0
Oil price in dollars (level)	44.0	52.4	52.1	51.9	3.1	-0.6	-2.7
Monetary and financial conditions							
Dollar/euro exchange rate (level)	1.11	1.07	1.07	1.07	-0.02	-0.02	-0.02
Nominal effective exchange rate against the non-euro area (b) (2000=100 and percentage differences)	113.6	112.0	112.2	112.2	-1.1	-1.0	-1.0
Short-term interest rate (3-month Euribor) (c)	-0.3	-0.3	-0.1	0.1	0.0	0.1	0.1
Long-term interest rate (10-year bond yield) (c)	1.4	1.8	2.2	2.6	-0.1	0.0	0.1

SOURCES: ECB and Banco de España.

a Assumptions cut-off date: 23 March 2017. The figures expressed as levels are annual averages; the figures expressed as rates are calculated on the basis of the related annual averages.
b A positive percentage change in the nominal effective exchange rate denotes an appreciation of the euro.
c For the projection period, the figures in the table are technical assumptions, prepared following 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.

expected to be very similar to that envisaged in the December 2016 projection exercise, in keeping with the steady paths traced by interbank market rates and government debt yields over the past quarter. Nor is the expected growth of Spain's export markets over the projection period significantly different from that considered in the previous projections. The changes are somewhat greater in the case of competitors' prices, which are expected to grow at a slightly higher pace than that envisaged in the December exercise, in line with the moderate depreciation in the euro exchange rate observed since then, and in relation to the fiscal policy assumptions.

The most significant change in the fiscal ambit is the inclusion of the changes in corporate income tax legislation contained in the package of extraordinary tax measures approved on 2 December 2016 by the Council of Ministers (Royal Decree-Law 3/2016) and ratified by Parliament on 15 December. Specifically, the government has quantified the impact of these measures, which seek to broaden the corporate income tax base (limiting tax losses and double taxation tax credit, reversing asset value impairment and

placing limits on the ability to deduct own funds losses), at close to 0.5 pp of GDP. In addition, the measures approved include higher excise duties on alcoholic beverages and tobacco products and an increase in the maximum contribution base to the Social Security system.

At the cut-off date for the projection assumptions (which, as indicated above, was 23 March), the draft State and Social Security Budget for 2017 had not been submitted; the draft budget was finally approved by the Council of Ministers on 31 March.[4] Accordingly, like the December projections, these projections do not include the content of the draft budget. In consequence, also as in December, various technical assumptions have been used to estimate the tax variables. First, it has been assumed that the budget headings

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4 The draft was submitted, therefore, between the cut-off date for the information used and the publication date of this Report, meaning that it was not possible to include the contents in the projections. In any event, the draft budget may naturally undergo changes in its passage through parliament.

Table 2
PROJECTION OF THE SPANISH ECONOMY'S MAIN MACROECONOMIC MAGNITUDES (a)

Annual rate of change in volume terms and as a % of GDP

	2016	March 2017 projections			Difference between current and December 2016 forecasts		
		2017	2018	2019	2017	2018	2019
GDP	3.2	2.8	2.3	2.1	0.3	0.2	0.1
Private consumption	3.2	2.4	1.6	1.5	0.3	0.1	0.0
Government consumption	0.8	0.8	0.8	0.8	0.0	0.0	-0.2
Gross fixed capital formation	3.1	3.3	4.4	4.4	-0.5	-0.2	0.0
Investment in capital goods	5.0	3.1	5.1	5.1	-2.0	-0.7	0.1
Investment in construction	1.9	3.7	4.4	4.5	0.1	0.0	0.0
Goods and services exports	4.4	6.1	4.8	4.8	1.9	0.3	0.2
Goods and services imports	3.3	5.2	4.4	4.4	1.5	-0.3	-0.2
National demand (contribution to growth)	2.8	2.3	2.0	1.9	0.1	0.0	0.0
Net external demand (contribution to growth)	0.5	0.5	0.3	0.2	0.2	0.2	0.1
Nominal GDP	3.6	3.8	3.6	3.7	0.4	-0.1	-0.2
GDP deflator	0.3	1.0	1.3	1.5	0.1	-0.3	-0.3
Consumer price index (CPI)	-0.2	2.2	1.4	1.6	0.5	-0.1	-0.1
CPI excluding unprocessed food and energy	0.8	1.1	1.5	1.8	0.1	0.1	0.0
Employment (equivalent jobs)	2.9	2.6	1.9	1.8	0.3	0.2	0.1
Unemployment rate (percentage of the labour force). End-of-period data	18.6	16.7	15.4	13.9	-0.3	-0.2	-0.5
Unemployment rate (percentage of the labour force). Average data	19.6	17.5	16.0	14.5	-0.2	-0.3	-0.5
Net lending (+)/ net borrowing (-) of the nation (% of GDP)	2.1	1.9	1.8	1.7	-0.1	-0.1	-0.1
General government net lending (+)/ net borrowing (-) (% of GDP) (b)	-4.5	-3.3	-2.8	-2.4	0.4	0.5	0.4

SOURCES: Banco de España and INE.
Latest QNA figure: 2016 Q4.

a Projections cut-off date: 24 March 2017.
b Does not include information on the draft State Budget for 2017 as it was submitted after the projections cut-off date.

subject to greater scope for discretion, notably including, by virtue of their volume, public investment and procurement, evolve in keeping with the nominal potential growth of the Spanish economy;[5] and second, that all other general government account items evolve, in the absence of measures, in keeping with their habitual determinants. Specifically, in the case of public revenue, irrespective of the inclusion of the legislative changes approved at end-2016, it has been assumed that it will grow in keeping with its tax bases, which chiefly depend on the macroeconomic environment. Likewise the expenditure items that offer less scope for discretion, such as pensions (where developments are essentially determined by the revaluation formula established by law, and by population ageing), unemployment benefits (which primarily depend on developments in unemployment) and the interest burden (affected by changes in government debt levels and interest rates).

Overall, it is estimated that the changes observed in the assumptions used in these and the December projections, considered in isolation, will result in a small upward revision in the rate of growth of GDP over the projection horizon. In the case of inflation, the new trajectory of oil prices dominates the revisions prompted by the changes in the assumptions. Prices have been revised up in 2017, in keeping with the higher crude prices on the spot markets compared with the levels considered in the December projections. However, for 2018 and 2019 the slope of the oil price curve on the futures markets has flattened somewhat; this will result in smaller percentage increases than envisaged in the December assumptions and, therefore, in a more moderate consumer price performance.

Nevertheless, although compared with the projections published in early December the positive impact on activity of the change in assumptions is very limited, GDP growth has been revised up by a larger amount (specifically by 0.3, 0.2 and 0.1 pp, respectively, in 2017, 2018 and 2019). The revision in the first half of 2017 is explained by the latest conjunctural information which points to a more upbeat pace of activity in the opening months of the year than projected in December. Notable in this respect are the strength of the survey-based soft data and of the monthly Social Security registrations in the first two months of 2017.

The revision made beyond the short-term is backed by two considerations. First, as indicated earlier, the assumptions relating to the performance of the external markets were prepared by ECB staff on the information available up to 20 February 2017, so they do not include the conjunctural information on the performance of the world economy released after that date and which, as indicated in Section 2 of this Report, is predominantly positive. Looking forward, this suggests that global activity and trade will both be stronger than was envisaged in the assumptions used in the projection exercise, prompting a more favourable assessment of the Spanish economy's external markets and, therefore, an upward revision of Spanish export growth.

Second, competitiveness gains have been a key factor in the story of the economic upturn, but although they have played a crucial role in export sales, there was no clear proof that they had resulted in any import substitution. However, the latest QNA data, together with the microeconomic evidence available, are beginning to provide increasing signs that incipient import substitution is now under way. Accordingly, in this projection exercise, a somewhat less dynamic import performance than would derive from its traditional relationship with final demand has been considered.

As regards the composition of GDP on the demand side, it is estimated that GDP growth will essentially continue to be underpinned by the contribution of domestic demand, even though the slowdown in domestic demand observed in 2016 is expected to continue. Net external demand should continue to make a positive contribution to the increase in GDP over the entire projection horizon.

Among the components of domestic demand, in 2017 private consumption will be shaped by the decline in the rate of growth of households' real income, in a setting of higher inflation caused by the higher rates of change in the energy component. In this respect, the high-frequency indicators have started to point to the first signs of slowdown. However, as in the recent past, low interest rates, household wealth revaluation and, especially, the strength of job creation will continue to play an important role underpinning consumption. Given the duration of these factors and the temporary nature (in principle) of the rise in inflation, it is estimated that households will soften the impact on their real income in 2017, offsetting it in part by reducing their saving rate. In the rest of the projection horizon, household consumption is expected to grow at a slightly lower rate than household income, providing for a modest readjustment of saving. In consequence, consumption would increase by 2.4% in 2017 (0.8 pp less than in 2016), slowing to 1.6% in 2018 and 1.5% in 2019.

The high-frequency data on housing starts and housing market transactions point to a continuation of the gradual improvement in residential investment, which is expected to persist over the entire projection horizon on the back of a positive employment performance and the expectation that credit conditions will remain favourable and that housing prices will rise. As in recent years, however, the pace of the recovery is expected to be unequal across the country, stronger in the main cities and in the more tourism-oriented regions, although the latest figures available would seem to suggest that demand may decline somewhat in these regions as a consequence of the Brexit process. In any event, there has been no change in the assessment made in previous projection exercises that the scale of the strengthening of this demand component will be mitigated by the relatively low rate of new household formation.

Firms' expenditure on capital goods fell in the second half of 2016, most likely influenced by the negative impact of the new corporate income tax rules on firms' cash flows. The new rules provided, among other measures, for the reintroduction of (and increase in)

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5 On the latest in-house estimates, nominal potential growth will be around 2% in 2017 and slightly below 2.5% in 2018.

minimum advance payments (in September) and a reduction in the limit on the offset of tax losses and a limit on tax credits to prevent international double taxation (in December). In the short term, investment by non-financial corporations is expected to grow moderately, driven by the continuation of these effects, although their impact will be predominantly temporary as in the main they are advance payments rather than a genuine increase in the tax burden. In a favourable setting for borrowing and against a backdrop of strong final demand, business investment, after slowing in 2017, is expected to pick up again thereafter.

In 2016 exports performed extremely well, posting a rate of growth that was significantly higher than that of the markets themselves and than that of euro area exports overall, assisted by the positive development of the tourism services component (see Box 7). Exports have been revised up for the projection period, in keeping with their recent favourable performance, with higher competitiveness gains relative to the rest of the world than in the previous forecasts and, especially, considering the favourable assessment of the performance of the external markets since the cut-off date for the information relating to this assumption (which, as indicated above, was 20 February). As regards the tourism component, the medium-term projection assumes no further increase over the projection period of the part of the recent flow of foreign visitors that is a consequence of heightened insecurity in certain alternative destinations. Moreover, as indicated earlier, the projections relating to imports incorporate the assessment that evidence is starting to emerge of an incipient process of import substitution, as yet of modest proportions, as a result of the competitive adjustment undertaken by the economy since the onset of the crisis.

Spain will continue to be a net lender to the rest of the world over the projection period. However, in 2017 the Spanish economy's surplus is expected to contract by 0.2 pp of GDP compared with the 2016 figure, as a consequence of higher oil prices, reaching 1.9% of GDP. For the following years it is estimated that the net lending position will hold steady around that level, in a setting in which a further deterioration in the terms of trade would offset the impact of the positive contribution of net exports to GDP growth.

Turning to the labour market, the projections envisage that employment generation will continue at a strong pace, giving rise to quite moderate increases in apparent labour productivity, in accordance with past experience of economic expansion in Spain.[6] Wage growth is expected to remain moderate, against the backdrop of a temporary rise in inflation in 2017, keeping unit labour costs contained and thus helping to sustain the process of employment creation. The increase in the employment rate will prompt a further decline in the unemployment rate, which by the end of the projection horizon is expected to be around 14%.

The rise in inflation, measured by the year-on-year rate of change in the CPI, observed since spring 2016 has gathered momentum in

recent months, up to 3% in January and February (see Box 4). This is a consequence of the acceleration in the energy component, while the rate of growth of the CPI excluding unprocessed food and energy has continued to move, as it has since mid-2015, within a narrow band around a level just below 1%. On the assumptions underpinning these projections (and, in particular, given the expected trajectory of oil prices), the rates of change of the energy component should have peaked, decelerating as from March. In addition, it is assumed that, in line with past experience, the pass-through of higher crude (and electricity) prices to other prices in the economy and to wages will be modest, so the non-energy CPI should be scarcely affected. In this setting, it is estimated that the CPI excluding unprocessed food and energy will gradually rise, from 1.1% in 2017 to 1.8% in 2019, as the output gap gradually narrows and unit labour costs gradually rise. In turn, the rate of change of overall CPI is expected to accelerate to an average of 2.2% in 2017, as a consequence of the performance of the energy component, before decelerating to 1.4% in 2018 and 1.6% in 2019. The expected trajectory of energy prices, with slightly negative fluctuations in 2018 and 2019 as a result of the path expected to be followed by oil prices according to the futures markets, also explains the positive gap between core inflation, measured by the rate of change of the CPI excluding unprocessed food and energy, and overall inflation towards the end of the projection horizon.[7]

The risks surrounding these GDP growth projections are mainly on the downside. The sources of risk arise particularly in the Spanish economy's external context. Specifically, the recent positive trend in the financial markets seems to be discounting the start of a phase of higher growth and a disappearance of deflation risks, which may not be entirely founded. The current market buoyancy partly reflects the expectations that an expansionary fiscal policy will be implemented in the United States. However, this may either not be fully achieved, or may, through its possible interference with that country's monetary normalisation process, cause a reversal of recent capital flows into emerging economies.

In this regard, since last summer yields on securities traded on developed countries' sovereign debt markets have begun to rise, although it is still too early to determine what underlies this recent upward trend in interest rates or how far it will go. However, possible further tightening of the yield curve, particularly if it is sudden, could cause shocks on the financial markets, which, as mentioned, could, in particular, lead to an outflow of capital from those emerging economies with the highest levels of foreign currency debt, undermining activity in those countries and, consequently, demand for Spanish exports. Moreover, given the Spanish economy's high level of debt and its substantial foreign financing needs, the possible start of an upward cycle in interest rates could have a negative impact on some agents' income and the strength of their balance sheets.

The tendency to introduce protectionist barriers has also recently gained strength in some developed economies. The materialisation

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6   Box 5 analyses the potential impact of the recently approved increase in the national minimum wage.

7   A difference that is also attributable, in part, to the projected slowdown, from the current high rates of growth, in the unprocessed food component.

of these incipient trends would have an adverse effect on global trade, which could be particularly detrimental to economies such as Spain's, whose recovery has relied heavily on export growth and which is still in the process of correcting its external imbalance.

Additionally, much uncertainty remains about the possible implications of the United Kingdom's exit from the EU, in a context in which the duration and outcome of the bilateral negotiations are as yet unknown. In this regard, the most recent data show little sign of any specific negative impact of the depreciation in sterling on the Spanish economy, except in the case of house purchases by British nationals, which slowed in the second half of 2016. Nevertheless, it cannot be ruled out that the uncertainty over the final shape of the relationship between the EU and the United Kingdom while negotiations are under way, or a potential negative effect on volumes of goods and services transactions once negotiations have been concluded, could have an adverse effect on Britain's imports from other European countries, which in Spain's case, could be exacerbated by the high level of exposure of its tourism and non-tourism service exports.[8]

Meanwhile the Chinese authorities are facing a difficult balancing act as they try to support activity by means of credit expansion, while seeking to rein in high levels of financial and non-financial private sector debt. A hypothetical disorderly correction of the imbalances over the projection horizon could put China's financial stability at risk and cause a sharp downturn in the country's activity, with adverse effects for the global economy as a whole.

Finally, the recent fragile growth in activity in some euro area countries has caused a weakening of some financial institutions' profitability. If this situation were to become more pronounced or excessively prolonged, it could have adverse impacts on their capacity to extend credit and, ultimately, on the stability of some parts of the European financial system, with the consequent negative impact on borrowing conditions and agents' confidence.

On the domestic front, last November a new government was formed following a lengthy caretaker period. This has reduced the risks associated with the potential negative impact of the provisional status of the executive branch on legislative activity, and on the budgetary process in particular. However, the uncertainty has not been entirely dispelled, given the lack of a stable parliamentary majority. In this regard, it should be recalled that the improvement in the Spanish economy's medium and long-term outlook for growth in activity and employment still relies on various structural reforms being pursued further. Any delay in

implementing these reforms, or a possible reversal of those introduced since the start of the crisis, could have a negative effect on investor confidence in the Spanish economy and harm growth prospects.

In the fiscal policy sphere, the outstanding adjustment needed to restore the public finances to health is still significant. This is despite the current context of rapid growth in activity and low interest rates, highlighting the need to return to the path of budgetary consolidation, taking advantage of the current relatively favourable conditions to reduce the structural government deficit and public-debt-to-GDP ratio. A budgetary plan of this kind can entail costs in terms of short-term economic growth. However, it is necessary to moderate future financial costs associated with the public debt, reduce the economy's vulnerability to a potential tightening of financial conditions and restore a degree of flexibility to fiscal policy so it can respond to possible shocks.

Lastly, the historical evidence seems to suggest that the extent to which price changes in the energy component are passed through to wages and other prices in the economy would be relatively modest, in both Spain and the euro area. Nevertheless, due to the higher degree of energy dependence (see Box 4), and the presence of indexation clauses in collective bargaining agreements (despite their significant reduction in recent years; see Box 5), the Spanish economy may be more prone than its euro area partners to generate indirect and second-round inflationary effects on consumer prices and wages. Against this backdrop, the priority remains averting the risk of the recent upturn in inflation having a bigger spillover effect on labour costs and final prices in Spain than in other euro area countries, as this would cause a partial reversal of the competitiveness gains achieved in recent years.

The balance of risks regarding inflation is also moderately negative. On the external front, the downside risks derive from the possible materialisation of the negative events identified in relation to activity. From the domestic standpoint, the accumulated evidence from the past two years indicates persistent difficulty in translating a reduction in the cyclical slack in the economy into more dynamic price behaviour. This suggests that the anticipated upturn in the CPI excluding unprocessed food and energy over the projection period as a consequence of the additional increase in the degree of utilisation of the economy's resources may not fully materialise. Lastly, as discussed above, a risk of the opposite sign would be the possibility that the recent oil price rise be passed on to prices of other goods and services more strongly than suggested by the historical evidence. More generally, the partial reversal in early March of last autumn's oil price rise, against the backdrop of doubts as to how the various market suppliers will act, adds an extra element of uncertainty to these inflation projections.

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8 See Box 5 in the Banco de España's September 2016 Quarterly report on the Spanish economy.