QUARTERLY REPORT ON THE SPANISH ECONOMY
OVERVIEW

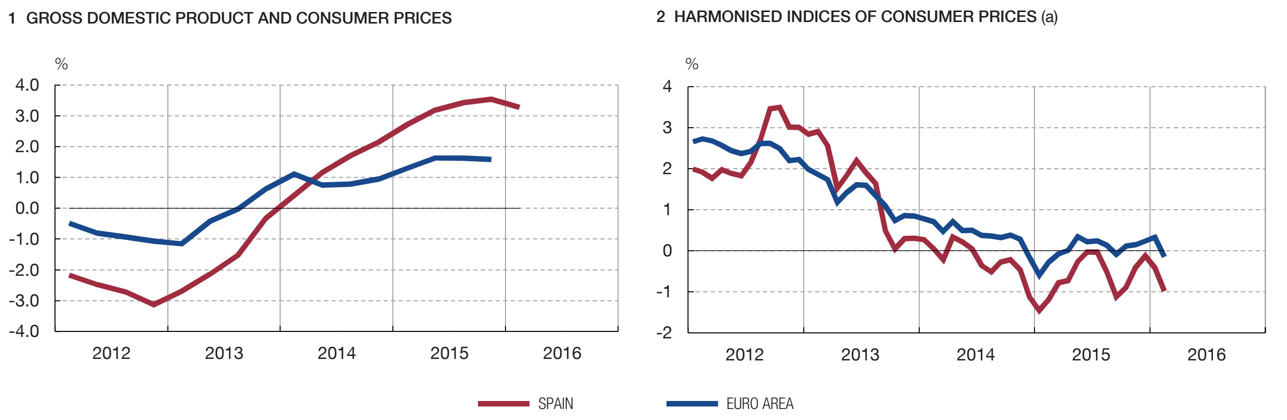
Since the release of the December *Quarterly Report,* the global economy has performed somewhat more weakly than was then expected, against a background marked by increased volatility on the financial markets of emerging and advanced economies alike, and the sluggishness of international trade flows. These developments are indicative of the fact that the recovery of the world economy might be weaker and might prove somewhat more gradual than anticipated three months ago. As regards the external setting of the euro area, some emerging economies might be hampered by the recent tightening in their financing conditions, foreign currency indebtedness in an environment of depreciation pressures on their national currencies and, in the case of the commodity-producing countries, the decline in commodities prices. In the advanced economies, in general, there appear to be fewer obstacles to growth given the more propitious financial conditions and the fact that, on the whole, cheaper commodities favour them more. However, it should not be expected they will be immune to a further downturn in the outlook for the emerging economies.

The euro area does in fact appear to have felt the effect of the worsening outlook for the emerging economies and the bout of financial instability at the start of the year, and the conjunctural information available suggests that the estimated rate of expansion of activity in 2016 Q1 will have been somewhat lower than that projected some months back. Into the medium term, the outlook continues to be consistent with a gradual pick-up in activity, in a setting in which the monetary policy stance has continued to become more expansionary. That said, the latest ECB projections have revised expected growth for this year down by 0.3 pp, and the composition of growth will now foreseeably be more biased towards domestic demand, at the expense of exports. Furthermore, the recent worsening of the international geopolitical context and increased uncertainty over developments in the euro area economy itself suggest that these projections are subject to downside risks.

In Spain, the information available is consistent with a gradual, moderate slowdown in activity from the high pace of expansion sustained throughout 2015, in line with the projections made last December. Indeed, in 2016 Q1, the Spanish economy continues to evidence a more favourable pattern of behaviour compared with the rest of the euro area, with estimated quarter-on-quarter GDP growth of 0.7% in the first three months of the year. If confirmed, this rate would be 0.1 pp lower than that recorded in the two preceding quarters (see Chart 1). The increase in output over this period is estimated to have been underpinned by the sound behaviour of household and corporate spending, to which favourable financial conditions, among other factors, would have contributed (see Table 1). In particular, household income is expected to have been strengthened by the fall in oil prices, growth in employment and, to a lesser extent, the introduction of several budgetary measures. Business investment continues to be underpinned by the favourable outlook for final demand. The information from January foreign trade flows suggests that the pace of exports might have been diminished slightly in the opening weeks of the quarter, potentially reflecting a slowdown in external markets. Turning to the labour market, the recent course of Social Security registrations suggests that employment growth might, as in 2016 Q4, be running at 0.6%.

The slight slowdown in GDP in 2016 Q1 is compatible with the prolongation of the current recovering course of activity over the next two-year period. Specifically, for this year, GDP

GROSS DOMESTIC PRODUCT (a) CHART 1



SOURCES: Eurostat, INE and Banco de España.

a Year-on-year rate of change based on seasonally adjusted series in the case of GDP and on original series in consumer price indices.

MAIN MACROECONOMIC VARIABLES OF THE SPANISH ECONOMY (a) TABLE 1

			2015				2016
	2014	2015	Q1	Q2	Q3	Q4	Q1
National Accounts							
Quarter-on-quarter rates of change, unless otherwise indicated							
Gross domestic product	1.4	3.2	0.9	1.0	0.8	0.8	0.7
Contibution of national demand (b)	1.6	3.7	1.4	1.0	1.2	0.6	0.7
Contibution of net external demand (b)	-0.2	-0.5	-0.5	0.0	-0.4	0.2	0.0
Year-on-year rates of change							
Employment	1.1	3.0	2.9	2.9	3.1	3.0	2.9
Price indicators (year-on-year change in end-of-period data) (c)							
CPI	-0.2	-0.5	-0.7	0.1	-0.9	0.0	-0.8
CPI excl. energy and unprocessed food prices	0.0	0.6	0.2	0.6	0.8	0.9	1.0

SOURCES: INE and Banco de España.

a Information available to 31 March 2016.
b Contribution to the quarter-on-quarter rate of change of GDP (pp).
c Latest available figure for consumer price indices: February 2016.

is forecast to grow at an average rate of 2.7%, with a marginally declining quarterly profile, as the above-mentioned factors that have recently boosted household income and spending progressively lose momentum (see Box 1). This growth rate incorporates a downward revision (of 0.1 pp) on the December projections, and mainly reflects the worsening outlook for export markets and the recent appreciation of the euro exchange rate, with both factors only partly offset by lower oil prices. In 2017, the increase in GDP is projected to ease to 2.3%.

As regards prices, the opening months of the year were marked by the CPI resuming negative year-on-year rates of change (-0.8% in February), as a result of the fresh fall-off in energy prices. By contrast, the stable trajectory of core inflation since mid-2015 has continued into the start of 2016. Specifically, in February, the CPI excluding energy and unprocessed food prices grew by 1%. Under current assumptions about the growth of oil prices, inflation is expected to hold in negative territory until the end of the summer and to begin to show positive rates of change thereafter, against the background of a gradual acceleration in the measure of core inflation as a result of the reduction in the degree of slack in the economy. In annual average terms, the CPI is forecast to fall by 0.1% this year and to increase by 1.6% in 2017.

Although the downward revision in the growth path of output presented in this Report is moderate, the balance of risks surrounding this baseline scenario has worsened considerably in recent months. On one hand, the recent financial market tensions have highlighted the weaknesses to which global growth is exposed and, in particular, the fragility of certain emerging markets. Moreover, the heightening of geopolitical tensions in different areas is a further source of risk to the world economy. On the other, from the domestic standpoint, doubts over the future course of economic policies may have a negative bearing on private agents' spending decisions, especially if the current situation of uncertainty extends over time.

The risks to the baseline scenario for inflation are moderately tilted to the downside, as a result of disinflationary pressures from abroad in the event of a more unfavourable global growth scenario materialising. In the opposite direction, it cannot be ruled out that these projections may be underestimating the positive impact of the monetary policy measures recently adopted by the ECB on inflation in the euro area as a whole.

The Spanish economy has raised its resilience to risk scenarios such as those described here as a result of the headway made in recent years in redressing its macroeconomic imbalances. Such progress has, however, been uneven across the different areas, meaning that factors of fragility persist. In this respect, while the European Commission's (EC) recent in-depth examination of Spain, as part of the Macroeconomic Imbalances Procedure, has ceased to classify these imbalances as excessive, it highlights the vulnerability generated by the high rate of structural unemployment, the high level of private and public-sector agents' debt and, as a result of this, the high dependence on financing from abroad. Also stressed is the fact that low productivity gains are restricting future growth possibilities.

In the context of the Excessive Deficit Procedure of the Stability and Growth Pact in which Spain is immersed, the EC addressed an *Autonomous Recommendation* to the Government on 9 March calling for additional budgetary efforts to be made to ensure the correction of the excessive (a budget deficit above 3% of GDP) deficit in 2016, in step with the commitments undertaken with the European Council in 2013. The budget deficit for 2015 notified by the Spanish authorities to Eurostat, at 5.2% of GDP, surpassed the target of 4.2% agreed with the European Council, and even that forecast by the EC in its projections last February, which was estimated at 4.8% of GDP.[1]

These developments highlight the need for economic policies to give priority both to seeing through fiscal consolidation, which is essential for maintaining confidence, and to persevering with the application of structural reforms that reduce the vulnerabilities of the Spanish economy and enable its future growth capacity to be enhanced.

31.3.2016.

1 The projections presented in Box 1 do not take into consideration the measures announced in response to this slippage (see Box 2 for a full description of the fiscal assumptions underlying the projections).

This Box updates the macroeconomic projections for 2016 published by the Banco de España in December last year. The update incorporates the latest Quarterly National Accounts (QNA) estimates and the effects of the changes observed in the external assumptions from 11 December to 22 March, the cut-off dates for the information in the preceding and current exercises, respectively (see Panel 1).[1] Furthermore, projections for the year 2017 are published for the first time.

On the estimates made, the expansionary phase of Spanish output will continue over the next two-year period. GDP growth is expected to stand at 2.7% this year and slow gradually to 2.3% in 2017, as certain temporary factors that have recently been boosting activity, such as the recent reductions in oil prices and the budgetary stimuli introduced over the past year, progressively lose momentum (see Panel 2). With regard to prices, it is estimated that, after posting a decline of 0.1% in 2016, the CPI might grow by 1.6% next year, reflecting the trajectory of oil prices and a gradual, modest rise in core inflation.

Compared with the forecasts released in December, the main changes in the external assumptions for 2016 include a $5 reduction in the price per barrel of oil, according to the path observed in the spot and future markets for oil. The growth of Spanish export markets is revised downwards chiefly as a result of the worsening outlook for the emerging markets, with the expected growth of imports to the euro area countries as a whole remaining practically unchanged. It is further estimated that competitors' prices will fall modestly this year compared with the December projection, partly in response to the appreciation by the euro since then against a broad basket of currencies. The assumption about stock market prices this year entails a decline of close to 20%, reflecting the fall-off seen since December. Finally, the cost of bank financing received by households and non-financial corporations will be lower than projected in the previous forecasts by approximately 0.1 pp, evidencing the downward revision of the Euribor interest-rate path and of 10-year government debt yields, in accordance with the expectations implicit in the yield curve.

Against a background of notable uncertainty over the future course of budgetary policy, the macroeconomic projections hinge crucially on the attendant assumptions. Box 2 details the fiscal policy assumptions for the 2016-2017 period underpinning this projection exercise.

Compared with the December exercise, the GDP growth forecast for this year is revised slightly downwards, by 0.1 pp, in a setting in which the QNA results for 2015 Q4 were very similar to those projected. Likewise, the latest conjunctural information has tended to corroborate the projections then made for Q1, which entail a

1 The projected course of Spain's export markets is as set out in the March 2016 ECB Staff Macroeconomic Projections with data to 15 February.

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

Annual rates of change, unless otherwise indicated

		Current projection		Changes from the December 2015 projection	
	2015	2016	2017	2015	2016
International environment					
Real world GDP growth	2.9	3.0	3.5	0.0	-0.3
World trade	1.8	2.8	4.2	0.3	-0.7
Spanish exports markets	2.8	3.1	4.5	0.4	-0.2
Oil price (in USD)	52.5	40.2	45.7	-0.1	-5.2
Monetary and financial conditions					
Dollar/euro exchange rate (USD per euro)	1.11	1.11	1.11	0.00	0.03
Nominal effective exchange rate vis-à-vis the non-euro area countries (b) (2000=100 and pp changes)	113.0	113.4	113.6	0.1	2.6
Madrid Stock Exchange General Index (2000=100 and pp changes)	107.2	84.6	81.9	-0.2	-16.7
Short-term interest rates (3-month Euribor)	0.0	-0.2	-0.3	0.0	-0.1
Long-term interest rates (10-year bond yields)	1.7	1.6	1.9	0.0	-0.2

SOURCES: ECB and Banco de España.

a Assumptions cut-off date: 22.3.2016.
b A positive percentage change in the nominal effective exchange rate denotes an appreciation of the euro.

slight slowdown in the pace of output at the start of the year. Hence, the downward revision of expected GDP growth in 2016 is prompted by the changes in the external assumptions considered as a whole. Specifically, the main changes in these assumptions, with an adverse impact on activity, include the worsening in the expected behaviour of external markets, the appreciation of the euro and the decline in stock market prices. These effects are only partly countered by the positive consequences for activity of the recent decline in oil and other commodities prices, and of the additional easing in financial conditions.

The expansion in output during the projection period is expected to continue to be underpinned, as has been the case over the past two years, by the momentum of national demand. It is estimated that net external demand will continue making a negative contribution to GDP growth, albeit on a lesser scale than in 2015. Among the national demand components, household consumption is projected to remain notably robust, supported by the continuing strength of employment creation and by the aforementioned temporary expansionary effects on disposable income, in particular those derived from the fall in oil prices. The impact of these temporary effects will reach a peak in the short term, which explains the slowdown in this demand component over the course of the projection period. Specifically, after growth of 2.9% this year, an increase of 2% is projected in this demand component in 2017.

Along with favourable financing conditions, employment creation will also be conducive to the continuation of the gradual recovery in residential investment. In a setting in which new housing needs will continue to be moderate, in line with demographic developments, the rise is expected to be gradual, as is also inferred from the recent trend of building approvals and house purchase figures.

Business investment will continue to post increases that are sizable although down on those observed in 2015, given the easing of the expansionary behaviour of final demand, in a context in which borrowing costs are projected to hold at very low levels. The slackening of the rate of increase will be more marked in the case of other construction than in that of investment in equipment, since the former of these two aggregates will be further affected by the projected slowdown in public investment.

As to foreign trade flows, export growth is projected to be relatively modest in the short run, and lower than the December projections,

Panel 2
PROJECTIONS OF THE SPANISH ECONOMY'S MAIN MACROECONOMIC VARIABLES (a)
Annual rate of change in volume terms and % of GDP

			Current projection		Changes from the December 2015 projection	
	2014	2015	2016	2017	2015	2016
GDP	1.4	3.2	2.7	2.3	0.1	-0.1
Private consumption	1.2	3.1	2.9	2.0	0.0	-0.3
Government consumption	0.0	2.7	1.0	0.5	0.2	0.6
Gross fixed capital formation	3.5	6.4	5.0	5.4	0.2	-0.4
Investment in capital goods	10.5	10.2	8.3	7.3	0.4	-0.3
Investment in construction	-0.2	5.3	3.5	4.9	-0.2	-0.7
Exports of goods and services	5.1	5.4	4.4	5.2	-0.4	-0.3
Imports of goods and services	6.4	7.5	5.3	5.9	0.0	-0.6
National demand (contribution to growth) (b)	1.6	3.7	2.9	2.4	0.1	-0.2
Net external demand (contribution to growth)	-0.2	-0.5	-0.2	-0.1	-0.1	0.1
Nominal GDP	1.0	3.8	3.4	3.4	-0.2	-0.3
GDP deflator	-0.4	0.6	0.7	1.0	-0.2	-0.2
Consumer price index (CPI)	-0.2	-0.5	-0.1	1.6	0.0	-0.8
CPI excl. energy and unprocessed food prices	0.0	0.6	1.1	1.4	—	—
Employment (full-time equivalents)	1.1	3.0	2.3	1.9	0.0	-0.1
Unemployment rate (% of labour force)	24.4	22.1	20.3	18.9	—	—
Net lending (+)/ net borrowing (–) of the nation (% of GPD)	1.6	2.1	1.9	1.5	0.1	0.3
General government net lending (+)/net borrowing (–) (% of GDP)	-5.9	-5.2	-4.4	-3.4	—	—

SOURCES: Banco de España and INE.
Latest QNA figure: 2015 Q4.

a Projections cut-off date: 31.3.2016.
a One-decimal figure difference between the GDP growth rate and the contribution of net external demand.

in line with the lesser buoyancy of external markets and with the appreciation of the euro, which restricts gains in competitiveness. In 2017, it is estimated that exports to the rest of the world will be somewhat more expansionary. The performance of exports by geographical area is expected to reflect not only cyclical differences, but also the trajectory of the exchange rate against the currencies concerned. Hence, the strength of exports to the United States will foreseeably reflect both the robustness of US domestic demand and the depreciation of the euro against the dollar; conversely, the weakness of exports to the emerging economies will be due not only to their less favourable cyclical trend but also to the loss of value of these countries' currencies. Imports, meanwhile, are projected to perform in line with final demand. In particular, the profile of purchases abroad will follow that of exports, given that it is this variable that marks the path of final demand over the course of the projection horizon. In any event, substantial changes are not expected from the pattern observed since the start of the crisis, characterised by limited substitution of domestic output for imports.

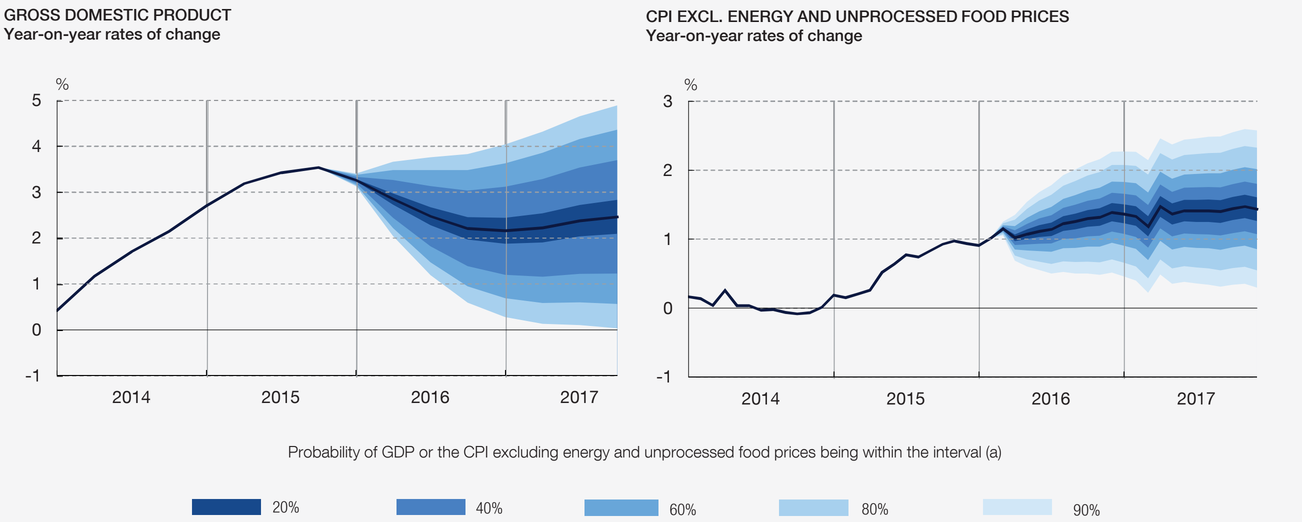
In 2016, the nation's lending capacity is projected to stand at 1.9% of GDP. This is 0.3 pp up on the related December estimate, which is explained by the lower energy bill and lesser interest burden associated with the improved foreign financing conditions. In parallel with these factors, increases are foreseen for the trade and income balances compared with the previous projection. The scale of the surplus on the rest of the world account will lessen in 2017 as crude oil prices rise, according to the technical assumption used, based on futures market prices.

Employment growth will continue to be driven by the buoyancy of activity, despite the slight acceleration estimated for labour costs as a result of the fact that growth in compensation per employee is expected to outpace that of labour productivity. It is projected that job creation will lead to further reductions in the unemployment rate, taking it to slightly above 18% of the labour force at the end of the projection horizon.

Consumer prices will, under the assumptions of the exercise, show negative rates of change until the end of the summer, which would give rise to a 0.1% decline in the related annual average. The subsequent rise, essentially associated with the expected stabilisation in the year-on-year rate of oil prices, would lead to a 1.6% increase in the average for 2017. Against the backdrop of the expansionary behaviour of household spending and the closing of the output gap, core inflation is expected to quicken gradually, albeit on a modest scale (see Box 6 in the original Spanish edition of this Report). The accelerating profile of consumer prices would also be seen in terms of the GDP deflator, for which average growth of 0.7% and 1% is projected for 2016 and 2017, respectively.

Panel 3 presents the results of a statistical procedure commonly used to approximate the uncertainty inherent in projections based on the construction of confidence intervals, for different levels of probability, drawing on the historical deviations of the projections. This approximation would assign a probability of below 5% to declines in GDP towards the end of the projection horizon, while the probability of core inflation posting negative rates over the

Panel 3
GROWTH AND INFLATION PROSPECTS FOR SPAIN



SOURCES: INE and Banco de España.
Latest figure: 2015 Q4 for GDP and February 2016 for the CPI excluding energy and unprocessed food prices.

a The right- and left-hand charts show the uncertainty around the central projection. Intervals with probabilities of 20%, 40%, 60%, 80% and 90%, respectively, based on historical projection errors.

next two-year period is marginal according to the deviations in past forecasts.

This methodology provides symmetrical confidence intervals, ignoring the fact that, at each point in time, the risks in a certain direction may be more prevalent. Specifically, on this occasion, the risks around the above-mentioned baseline scenario for output growth are more on the negative side than in December.

From the standpoint of the external environment, uncertainty persists over the course of the global economy, to a particularly high degree in the case of some emerging economies. A greater slowdown in those economies demanding commodities might prompt further reductions in commodities prices, harming activity in the producer countries and heightening tensions on certain financial markets, with potential knock-on effects to other economies, including Spain. Furthermore, increased geopolitical tensions are an additional source of risk to the international environment.

On the domestic front, the current situation of political uncertainty over the process of forming the nation's Government introduces doubts about the future course of economic policies. Such doubts may have an adverse effect on agents' decisions in the short term. Insofar as this uncertainty encroaches on different areas, such as budgetary policy or the reform agenda, estimating its macroeconomic impact and, especially, its distribution over time, proves extraordinarily complex. In the fiscal arena, the deviation of the deficit from budgetary plans in 2015 evidences the need to prioritise seeing through the process of fiscal consolidation in order to maintain confidence. The adoption of budgetary measures additional to those considered in the baseline scenario for these projections might alter the growth profile of output, entailing costs in the short term and generating benefits, in terms of the attendant gains in confidence, which would only become fully visible after some time. The materialisation of the positive effects of structural reforms on the functioning of markets and institutions normally involves what may be extensive time lapses. Accordingly, it is advisable to avoid delays in applying those reforms still needed.

Turning to inflation, the risks of slippage are also on the downside. Specifically, a more marked slowdown than hitherto anticipated in some emerging economies might generate an additional and widespread disinflationary impact. A scenario of these characteristics is more likely if the recent worsening in the global growth outlook is accompanied by exchange rate depreciations in these economies and by additional declines in the demand for and prices of commodities. In the opposite direction, it is likely that the recent ECB decisions will contribute to a more expansionary behaviour of consumer prices compared with the baseline scenario, by means of their positive impact on aggregate demand and the lesser probability of a deflationary scenario materialising, with persistent and widespread falls in prices.

FISCAL POLICY ASSUMPTIONS FOR THE 2016-17 TWO-YEAR PERIOD

BOX 2

The preparation of the fiscal policy assumptions used in the macroeconomic projections exercise for 2016 resides on the measures approved in the budgets of the different tiers of government for this year and, therefore, they are similar to those in last December's projection exercise. For 2017, regard is had to those measures featuring in the multi-year plans (Stability Programme) devised by the Government and whose adoption is considered likely. The projected budget deficit path reveals, in any event, differences from the Government's budget targets, arising essentially from the fact that the former takes into account the slippage observed in 2015, of 1 pp of GDP, and from the different macroeconomic scenario, which influences the projections for public revenue and the underlying dynamics of certain expenditure items, such as that earmarked for unemployment benefit payments. In-house estimates are also made of demographic trends, with an impact on pension spending, and of the interest burden on debt.

In the current setting, however, there are notable doubts about the course of fiscal policy over the projection horizon. In this respect, there is uncertainty over how the national authorities may respond to the European Commission's recent Autonomous Recommendation, which requires the Kingdom of Spain to take restrictive budgetary measures additional to those included in its budgetary plans.

As regards the main fiscal policy measures incorporated into the projection exercise, mention may be made on the revenue side of the impact in 2016 of the second plank of the corporate income tax reform, which came into force on 1 January 2015, and of the delayed effects of the personal income tax reform. On the expenditure side, under wages and salaries, the following are included: the 1% wage increase approved in the State Budget; the payment of the second half of the "extraordinary" salary payment (equivalent to one-fourteenth of annual wages) eliminated in 2012; and the increase in the average rate of staff replacement to 50% in general (following the zero rate in 2015) and to 100% for the health care, education, law and order, and security sectors, among others (from 50% in 2015). For 2017, a rise in public-sector employee wages is assumed, in line with the projections for the market economy in this Report, as is a continuing path of moderation in new hires in the general government sector. As regards Social Security spending, a 0.25% rise in pensions is included both in 2016 and in 2017, linked to the application of the pension indexation formula in force since January 2014.

In addition to these measures, the fiscal policy assumptions include the impact in 2017 on general government final consumption spending that would arise from the application of a series of ongoing reforms, including the reform of local government and that of general government (defined in the Commission's CORA report), and some containment in the increase in public investment, in line with official estimates. A reduction in transfers and subsidies is also considered, along with cuts in spending on unemployment benefits owing to the buoyancy of the labour market, and in the interest burden owing to the more favourable financial conditions.

Finally, it should be noted that it has not been possible to consider among the fiscal policy assumptions underlying this exercise the measures announced by the Government on 31 March (i.e. one day ahead of the publication of this Report), following the presentation of the figures in the 2015 general government accounts.

Overall, the application of the assumptions described in the foregoing paragraphs and of the macroeconomic framework presented in this Report results in budget deficit projections for 2016 and 2017 of 4.4% and 3.4% of GDP, respectively. In the Report's baseline scenario, therefore, the degree of fiscal consolidation and the ensuing improvement in the general government balance in 2016-17 is considerably less than that which would arise from fulfilment of the official deficit targets, set at 2.8% of GDP for 2016, and at 1.4% of GDP for 2017. Specifically, the fiscal policy stance, measured by the change in the general government balance adjusted for the effect of the economic cycle (see Box 6 in the original Spanish edition of this Report for estimates of the output gap), was expansionary in 2015 (-0.7 pp of GDP) and is expected to turn neutral over the projection horizon.