

QUARTERLY REPORT ON THE SPANISH ECONOMY

1 OVERVIEW

The information that has become available in Q3 has tended to confirm the strengthening of world activity that was already apparent before the summer. This trend has been driven by persistently favourable financial conditions, stemming from, *inter alia*, the maintenance of a highly expansionary monetary policy stance. The latter has, however, still not led to a rise in core inflation, the response of which to the reduction in cyclical slack has been limited. As in the case of activity, world trade has strengthened somewhat over the recent past and is expected to grow over the next two years at similar rates to output (somewhat below 4%).

On global financial markets, Q3 has seen an increase in capital flows to the emerging economies as a whole, accompanied by a narrowing of their sovereign and corporate debt spreads and large gains in their stock markets. On the foreign exchange markets, the dollar has weakened notably, especially against the euro, probably reflecting, among other factors, the perception that in the United States the rate of monetary policy tightening may be more gradual and the fiscal stimulus smaller than was anticipated a few months ago, as well as the strengthening of activity and decline in political risks in the euro area.

Despite the improvement in the outlook for the world economy the central scenario continues to be surrounded by significant risks, including the recent intensification of global geopolitical tensions, and the uncertainty surrounding the Brexit process and economic policies in some advanced economies, especially fiscal policy in the United States. As regards the financial markets, currently characterised by an abundance of cheap liquidity and a very low volatility in the main capital markets, sharp adjustments in the valuations of certain assets, which would have adverse consequences for financing conditions, cannot be ruled out.

The latest indicators of economic activity in the euro area also point to a firming of the recovery, which is, moreover, becoming more broad-based across countries. Both domestic demand, supported by the accommodative financial conditions, and external demand, against the background of strengthening export markets that are expected to substantially mitigate the contractionary effects of the appreciation of the euro, are contributing to this recent improvement. With regard to prices, a pick-up in the core component of inflation has been observed recently but this does not yet amount to a sufficient sign of sustained convergence towards the medium-term reference level of monetary policy, justifying the continuation of an expansionary monetary policy stance on the part of the ECB.

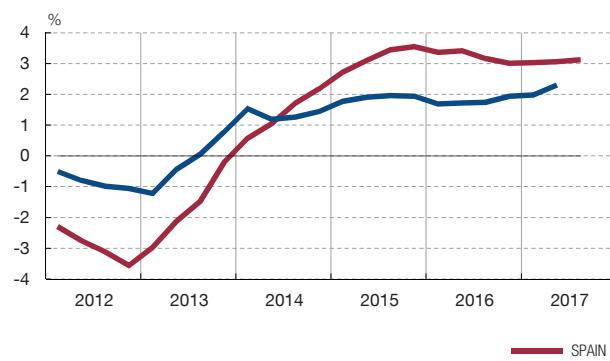
Against this background, the Spanish economy continued to grow at a high rate in Q3. Specifically, the quarter-on-quarter GDP growth rate is estimated to have been 0.8%, a slight slowdown, of 0.1 percentage points (pp), from the rate observed in the previous quarter. This mild slowdown in activity, anticipated in the Banco de España's June projections is signalled by – among other high-frequency indicators – the moderation in rates of job creation and net trade flows, following their particularly favourable performance at the start of Q2.

The projections presented in Box 1 of this report envisage an extension of the current upturn, based on the cumulative correction of the economy's imbalances. In particular, the competitiveness improvements, which have contributed to the achievement of a sustained

GROSS DOMESTIC PRODUCT AND CONSUMER PRICES (a)

CHART 1

1 GROSS DOMESTIC PRODUCT



2 HARMONISED INDICES OF CONSUMER PRICES



SOURCES: Eurostat, INE and Banco de España.

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

MAIN MACROECONOMIC AGGREGATES OF THE SPANISH ECONOMY (a)

TABLE 1

| | 2015 | 2016 | 2016 | | | | 2017 | | | | |
|--|------|------|------|------|-----|-----|------|-----|-----|--|--|
| | | | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | | |
| National Accounts | | | | | | | | | | | |
| Quarter-on-quarter rates of change, unless otherwise indicated | | | | | | | | | | | |
| Gross domestic product | 3.2 | 3.2 | 0.8 | 0.8 | 0.7 | 0.7 | 0.8 | 0.9 | 0.8 | | |
| Contribution of national demand (b) | 3.3 | 2.8 | 0.6 | 0.5 | 0.5 | 0.6 | 0.7 | 0.6 | 0.6 | | |
| Contribution of net external demand (b) | -0.1 | 0.5 | 0.1 | 0.3 | 0.2 | 0.1 | 0.1 | 0.3 | 0.1 | | |
| Year-on-year rates of change | | | | | | | | | | | |
| Employment | 3.0 | 2.9 | 3.1 | 2.7 | 2.9 | 2.7 | 2.5 | 2.8 | 2.6 | | |
| Price indicators (year-on-year change in end-of-period data) (c) | | | | | | | | | | | |
| CPI | -0.5 | -0.2 | -0.8 | -0.8 | 0.2 | 1.6 | 2.3 | 1.5 | 1.6 | | |
| CPI excl. energy and unprocessed food prices | 0.6 | 0.8 | 1.1 | 0.6 | 0.8 | 1.0 | 0.9 | 1.2 | 1.2 | | |

SOURCES: INE and Banco de España.

a Information available to 25 September 2017.

b Contribution to the quarter-on-quarter rate of change of GDP (pp).

c Latest available figure for the consumer price indices: August 2017.

positive external balance, and the progress in reducing the over-indebtedness of private agents provide solid foundations for the recovery to continue further. That said, the progressive waning of the boost provided since the early stages of the recovery by spending on consumer durables and investment that had been put off during the crisis, along with the neutral fiscal policy stance (in contrast to the expansionary stance of recent years) and the partial reversal of the decline in oil prices that had continued until the beginning of last year will lead to a gradual transition towards more moderate growth rates. Specifically, following a growth rate of 3.1% this year, GDP is projected to grow by 2.5% in 2018 and by 2.2% in 2019.

Consumer prices are expected to slow in the short term as a consequence of the developments in the energy component. From the beginning of 2018 inflation is projected to rise progressively, driven by the gradual cyclical tightening. In annual average terms, the CPI is projected to rise by 1.9% this year and by 1.3% next year, before accelerating again to 1.6% in 2019.

The recent appreciation of the euro will have a somewhat adverse effect on activity and inflation in Spain, which will tend to be countered, under the central projection scenario, by the recent strengthening of the external environment of the Spanish economy, in particular the euro area.

This report contains six boxes. The first one presents the macroeconomic projections for the Spanish economy for the period 2017-2019. Box 2 then assesses various alternative interpretations of the low levels of volatility prevailing on global financial markets, Box 3 examines possible reasons for the relatively low wage growth in the euro area, Box 4 analyses developments in the Spanish housing market since the start of the recovery, Box 5 provides a view of the sectoral composition of job creation and, finally, Box 6 examines recent developments in the prices of the financial liabilities issued by European financial institutions.

This box sets out the latest update of the Banco de España's macroeconomic projections for the Spanish economy. Compared with the previous projections in June,¹ this exercise includes, among other recent information, the Quarterly National Accounts data for the first two quarters of 2017,² and also information on the changes in the technical assumptions on which this projection exercise is based (see Table 1).³

The estimates point to the continuation of the economic expansion that began four years ago. In the medium term, the enhanced

competitive position of the Spanish economy, the growing deleveraging of private agents and continuing favourable financial conditions, among other factors, will continue to underpin the present activity and employment growth cycle.

At the same time, the strength of activity since the start of the recovery has been partly in response to other forces whose momentum has gradually declined over the past year.⁴ In particular, compared with the expansionary fiscal policy stance of the period 2015-16 and the declines in oil prices observed between mid-2014 and 2016 Q1, in the most recent period the budgetary policy stance has been neutral and crude prices have risen moderately, although they are still around half their peak level. In consequence, these factors have ceased to act as growth drivers and now exert a virtually zero or even slightly contractionary impact. Moreover, the expansionary effect resulting, in recent years, from certain spending (on consumer durables) and investment decisions being taken after their postponement during the most acute phases of the crisis is expected to gradually peter out. Indeed it is estimated that, in 2017 Q3, GDP growth could have decelerated somewhat, as anticipated in the June projections. As a result of all the above, it is estimated that, after growing by 3.1% this year, GDP will grow by 2.5% in 2018 and by 2.2% in 2019 (see Table 2).

⁴ Box 1.2 of Chapter 1 of the Banco de España's 2016 Annual Report has an estimate of the contribution made by predominantly temporary factors to GDP growth throughout the current expansionary phase.

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

Annual rate of change, unless otherwise indicated

| | September 2017 projections | | | | Changes from the June 2017 projections (b) | | |
|--|----------------------------|-------|-------|-------|--|------|------|
| | 2016 | 2017 | 2018 | 2019 | 2017 | 2018 | 2019 |
| International environment | | | | | | | |
| World output | 3.0 | 3.5 | 3.6 | 3.6 | 0.1 | 0.0 | 0.0 |
| Spain's export markets | 2.5 | 5.1 | 3.9 | 3.6 | 0.4 | 0.0 | -0.1 |
| Oil price in dollars/barrel (level) | 44.0 | 52.7 | 54.3 | 54.6 | 1.2 | 2.9 | 3.1 |
| Monetary and financial conditions | | | | | | | |
| Dollar/euro exchange rate (level) | 1.11 | 1.13 | 1.20 | 1.20 | 0.05 | 0.10 | 0.10 |
| Nominal effective exchange rate against non-euro area countries (c) (2000=100 and percentage differences) | 113.6 | 117.3 | 122.5 | 122.5 | 3.9 | 7.8 | 7.8 |
| Short-term interest rates (3-month Euribor) (d) | -0.3 | -0.3 | -0.3 | -0.1 | 0.0 | -0.1 | -0.1 |
| Long-term interest rates (10-year bond yield) (d) | 1.4 | 1.6 | 1.9 | 2.3 | -0.1 | -0.2 | -0.2 |

SOURCES: ECB and Banco de España.

a Cut-off date for preparation of assumptions: 18 September 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 The differences are in growth rates for world output and export markets, in levels for oil prices and the dollar/euro exchange rate, in percentages for the nominal effective exchange rate and in percentage points for interest rates.

c A positive percentage change in the nominal effective exchange rate reflects an appreciation of the euro.

d 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.

As regards consumer prices, the rate of change of the non-energy component is expected to rise gently, as a consequence of the continuation of the expansionary phase, prompting first a narrowing of the negative gap between actual and potential output levels and subsequently a shift to a positive gap. However, this is only expected to translate into a pick-up in headline inflation from the beginning of next year, since until then the impact of the slowdown in energy prices compared with a year earlier will prevail.⁵ Thus, it is estimated that, in annual average terms, the rate of increase of the CPI will decelerate from 1.9% in 2017 to 1.3% in 2018, before reaccelerating to 1.6% in 2019.

5 For a description of the role played by base effects in the behaviour of inflation, see Box 4 "Inflation developments and outlook in Spain" in the Quarterly Report on the Spanish Economy, *Economic Bulletin* 1/2017, Banco de España.

Compared with the June projections, the most significant change in the technical assumptions underlying this exercise is the appreciation of the euro exchange rate, which in nominal effective terms amounts to approximately 8% against the non-euro area countries. Changes in the other assumptions are more modest. In particular, the path of oil prices measured in US dollars is similar to that considered in the previous projection exercise, with a slightly steeper slope, meaning that at the end of the projection horizon this variable is approximately \$3 per barrel higher than three months ago. In the period elapsed since the previous projections, the expected paths of sovereign bond and, to a lesser extent, interbank market interest rates have fallen slightly, in accordance with the expectations implicit in the yield curves, giving rise to a decline in the cost of credit to households and non-financial corporations. Lastly, there has been an upward revision of the rate of growth of export markets in 2017. However, this change in the

Table 2
PROJECTIONS OF THE SPANISH ECONOMY'S MAIN MACRO MAGNITUDES (a)

Annual rate of change in volume terms and % of GDP

| | 2016 (b) | 2016 | September 2017 projections | | | Changes from the June 2017 projections | | |
|--|----------|------|----------------------------|------|------|--|------|------|
| | | | 2017 | 2018 | 2019 | 2017 | 2018 | 2019 |
| GDP | 3.3 | 3.2 | 3.1 | 2.5 | 2.2 | 0.0 | 0.0 | 0.0 |
| Private consumption | 3.0 | 3.2 | 2.4 | 2.0 | 1.5 | -0.3 | 0.0 | 0.0 |
| Government consumption | 0.8 | 0.8 | 1.0 | 0.8 | 0.8 | 0.2 | 0.0 | 0.0 |
| Gross fixed capital formation | 3.3 | 3.1 | 4.3 | 4.4 | 4.0 | 0.6 | -0.2 | -0.2 |
| Investment in equipment | 4.9 | 5.0 | 5.4 | 4.8 | 4.6 | 1.8 | -0.4 | -0.2 |
| Investment in construction | 2.4 | 1.9 | 3.6 | 4.7 | 4.3 | -0.4 | -0.1 | -0.3 |
| Exports of goods and services | 4.8 | 4.4 | 6.4 | 4.6 | 4.5 | -0.5 | -0.3 | -0.3 |
| Imports of goods and services | 2.7 | 3.3 | 5.0 | 4.1 | 4.2 | -0.8 | -0.4 | -0.3 |
| National demand (contribution to growth) | 2.5 | 2.7 | 2.5 | 2.2 | 1.9 | 0.0 | 0.0 | 0.0 |
| Net external demand (contribution to growth) | 0.7 | 0.5 | 0.6 | 0.3 | 0.3 | 0.1 | 0.0 | 0.0 |
| Nominal GDP | 3.6 | 3.6 | 4.0 | 3.9 | 3.6 | -0.1 | -0.1 | -0.1 |
| GDP deflator | 0.3 | 0.3 | 0.9 | 1.4 | 1.5 | -0.1 | 0.0 | -0.1 |
| Consumer price index (CPI) | -0.2 | -0.2 | 1.9 | 1.3 | 1.6 | -0.1 | 0.0 | 0.0 |
| CPI excluding energy and unprocessed food prices | 0.8 | 0.8 | 1.1 | 1.4 | 1.7 | 0.0 | -0.1 | -0.1 |
| Employment (full-time equivalents) | 3.0 | 2.9 | 2.7 | 2.2 | 1.8 | -0.2 | 0.0 | 0.0 |
| Unemployment rate (% of labour force). | | | | | | | | |
| End-of-period data | 18.6 | 18.6 | 16.3 | 14.4 | 12.9 | -0.2 | -0.3 | -0.3 |
| Unemployment rate (% of labour force). | | | | | | | | |
| Average data | 19.6 | 19.6 | 17.1 | 15.1 | 13.4 | -0.2 | -0.3 | -0.4 |
| Net lending (+) / net borrowing (-) of the nation (% of GDP) | — | 2.0 | 2.1 | 2.3 | 2.2 | 0.3 | 0.4 | 0.4 |
| General government net lending (+) / net borrowing (-) (% of GDP) | — | -4.5 | -3.2 | -2.6 | -2.1 | 0.0 | 0.1 | 0.0 |

SOURCES: Banco de España and INE.
Latest QNA figure: 2017 Q2.

a Projections cut-off date: 25 September 2017.

b The rates of change in 2016 that refer to the National Accounts series have been updated to include the revision of the Annual National Accounts for the years 2014-16 published by the INE on 12 September. The new figures for net lending / net borrowing of the nation and of the general government will be published on 2 October.

annual average is actually due to the better performance observed in the year to date compared with the June projection, as the changes are almost negligible over the entire projection horizon.

The changes to the public finance assumptions for 2017-19 compared with the previous projection exercise are minimal. For 2017, the fiscal projections are based on the measures approved in the budgets of the different tiers of general government for this year and on the budget outturn observed to date. Regarding the assumptions for the rest of the projection horizon, on the cut-off date for preparation of these projections the draft State and Social Security Budget for 2018 had not been submitted. In this setting, various technical assumptions have been used to estimate the fiscal variables for 2018-19. First, it has been assumed that the budget headings subject to greater scope for discretion – notably including, by virtue of their volume, procurement and public investment – will evolve in keeping with the nominal potential growth of the Spanish economy, and second, that all other general government account items will evolve, in the absence of measures, in keeping with their usual determinants.⁶

As was the case in June, these projections do not take into account a number of temporary factors that are included in the April 2017 Stability Programme but have not yet taken shape.⁷

In accordance with these assumptions and projections on fiscal policy variables, and with the output gap estimated on a consistent basis within the whole projection exercise, the fiscal policy stance is expected to be virtually neutral in the period 2017-19, after the expansionary phase of 2015-16.

Overall, the changes in the various assumptions – including the fiscal assumptions – compared with the previous projection exercise would give rise, in accordance with historically estimated impacts, to a modest downward revision of the growth projections for activity and prices.

However, the present projections coincide, in terms of annual average GDP and CPI growth rates, with those published in June, save for consumer price inflation in 2017 which is now expected to be 0.1 pp lower than projected in June.

In terms of GDP, the reason for the absence of revisions to the June projections is that the effects of differing signs that several

⁶ Specifically it has been assumed that, aside of the deferred impact of the legislative changes approved in the second half of 2016, public revenue will increase in keeping with its tax bases, which depend mainly on the macroeconomic environment. Similar assumptions have been made for 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 depend mainly on the level of unemployment) and interest (affected by changes in public debt levels and interest rates).

⁷ This refers, in particular, to possible costs associated with the public liability arising from court proceedings relating to toll motorway company insolvency proceedings, expected to materialise in the period 2017-19.

significant factors have had on activity have offset each other. The data on the Spanish economy's external markets in the most recent period have been more favourable than was expected a few months ago. This effect essentially counters the overall moderately adverse impact of the changes in some of the other technical assumptions and, in particular, of the effect of the appreciation of the euro.

As regards the latter, the baseline scenario considers that the impact of the exchange rate appreciation on activity and prices will be quite limited. The reasons for this are twofold. First, the available estimates indicate that the response of prices and activity depends on the shock that gave rise to the exchange rate movement. In particular, the more closely related that movement is to an improved outlook for economic activity in the euro area vis-à-vis its trading partners, as in the present case, the lower the impact. Second, the available evidence suggests that in recent years the scale of pass-through of exchange rate movements has decreased, possibly as a result of factors such as heightened global competition (that would encourage foreign exporters competing with domestic products to refrain from passing the full extent of exchange rate movements through to their prices, in order to maintain their market shares) or a more stable inflation environment (that would contribute to only the most persistent and largest exchange rate movements being passed through).⁸

The reason for the downward revision by 0.1 pp in estimated average inflation for 2017 is that recently some components have shown lower than expected rates of growth. CPI inflation projections are unchanged for the following two years as a result of two contrasting effects: specifically the steeper oil price curve, prompting an upward revision of the energy component, which is countered by the moderate downward revision of the CPI excluding energy and unprocessed food prices as a result of the appreciation of the euro.

GDP growth will continue to be underpinned by national demand momentum, which is backed, in turn, by the improvement in the balance sheets of private agents in the economy and by the continuing favourable financial conditions. However, despite remaining high, national expenditure will tend to become less buoyant over the projection horizon, in a continuation of the pattern already observed in 2016, as the effects of the positive impact of fiscal policy and lower oil prices on private agents' income fade. Similarly, although foreign trade in goods and services will also continue to make a net positive contribution to GDP growth, that contribution is expected to be lower in 2018 and 2019 than in the two previous years, owing to the exchange rate appreciation effect, the expected gradual growth slowdown in external markets and a prudent extrapolation to the future of the relatively weak import performance in the recent past.

⁸ See "Exchange rate pass-through into euro area inflation", *Economic Bulletin*, ECB, November 2016.

The strength of the job creation process will continue to underpin private consumption. However, although no significant changes are expected in apparent labour productivity, the projected slowdown in GDP growth implies a lower increase in employment and, therefore, also in household income. It is estimated that the savings rate will tend to stabilise, after the recent decline, and the good employment performance and continued favourable financial conditions will help prolong the recovery in residential investment, although unequally across the regions (see Box 4).

After the volatile pattern observed in recent quarters, shaped by changes to corporate income tax legislation in the last stretch of 2016, business investment will grow at a pace consistent with that of final demand; this entails a moderate deceleration over the projection horizon. This slowdown will, however, be quite limited, in a setting in which business funding will be supported by the continued strong generation of internal funds, restructuring of balance sheets and the availability of external financing at a low cost.

Exports are expected to continue growing at a slightly higher pace than their destination markets over the entire projection period, reflecting both the competitiveness gains achieved compared with the rest of the euro area in past years and those expected over the projection horizon. Imports, for their part, are expected to grow at a slower pace than their historical relationship with final demand would warrant, reflecting the inclusion of the assumption that the competitive adjustment of the economy has begun to translate into a certain degree of import substitution.

As has been the case throughout the expansionary phase, GDP growth will remain highly labour intensive, assisted by the moderate rate of growth of unit labour costs. The relatively high rates of job creation will continue to help reduce the unemployment rate which, at the end of the projection horizon, will be below 13% of the labour force.

Under the assumptions for the exercise, the Spanish economy will continue to record a net lending position vis-à-vis the rest of the world that is expected to remain slightly over 2% of GDP throughout

the period considered, in a setting in which, as indicated above, net external demand is expected to continue to make a positive contribution to GDP growth.

In the final stretch of 2017, consumer price inflation will be shaped by the slowdown in the energy component, as the impact of the spike in oil prices in the second half of 2016 disappears from the year-on-year comparison, resulting in a very low headline inflation rate at the end of 2017 and the start of 2018. At the same time, the CPI excluding energy and unprocessed food prices is expected to climb gradually throughout the period considered, in a setting in which the prolonged recovery will push up the degree of use of productive resources. However, these prices will increase gradually and moderately, against a backdrop in which unit labour costs are expected to slowly rise. As a result of all the above, it is estimated that the rate of increase of the CPI excluding energy and unprocessed food prices will pick up from 1.1% in 2017 to 1.7% in 2019, while that of the CPI will decelerate from 1.9% in 2017 to 1.3% in 2018, before reaccelerating to 1.6% in 2019.

Turning to the risks surrounding these GDP growth projections, on the domestic front, the political tension in Catalonia could potentially affect agents' confidence and their spending decisions and financing conditions. On the external front, several sources of geopolitical risk persist that may threaten the global economic recovery, on top of the uncertainties surrounding the course of the Brexit process and economic policies in some advanced economies, such as the doubts regarding the future course of fiscal policy in the United States. On the financial markets, the ample liquidity and low volatility levels may give rise to sharp adjustments in some asset prices, with adverse effects on financing conditions for agents. Also, given the high degree of uncertainty surrounding the course of the euro exchange rate and its determinants, and its final impact on the Spanish economy, the possibility that this variable may have a higher impact on these projections than is considered in the baseline scenario cannot be ruled out. In general, the downside risks relating to the external context of the Spanish economy described above tend to shape a downside risk environment for prices also.

Investors' uncertainty about future returns on their assets is a key variable in explaining their portfolios' composition, size and leverage. This uncertainty is factored in to the most widely used risk valuation models and therefore influences the risk premium on market traded assets and the cost of funding certain projects. It can also explain the movement of capital between the various international markets, as it affects the returns on the carry trade.¹

1 A carry trade involves taking on debt in a currency with low interest rates (for example, the yen) to invest in assets in another country where interest rates are higher (e.g. Brazil). The return on the transaction is calculated based on the interest rate spread and the volatility of the exchange rate between the currencies involved, or between these currencies and the market benchmark, which is normally the dollar.

In short, uncertainty is a key variable in explaining economic agents' investment and consumption decisions. This uncertainty is usually measured from the volatility of the returns on each individual asset. This may be observed directly from markets or implicitly from financial instruments based on the future course of certain prices (such as those of futures and options) enabling investors' expectations regarding this uncertainty to be estimated.²

2 The volatility of the US stock market is measured with the VIX index calculated by the Chicago Board Options Exchange (CBOE) based on the market prices of one-month S&P 500 options. The CBOE also publishes an indicator of the implied volatility of options on the MSCI Emerging Markets Index. The benchmark indicator for interest rates is Bank of America's MOVE, which reflects the implied volatility in one-month

Chart 1
VOLATILITIES AND POLITICAL RISK

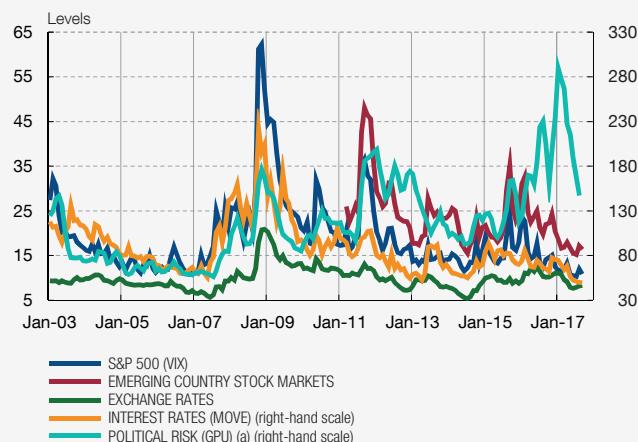


Chart 2
VOLATILITY AND BASE RATES

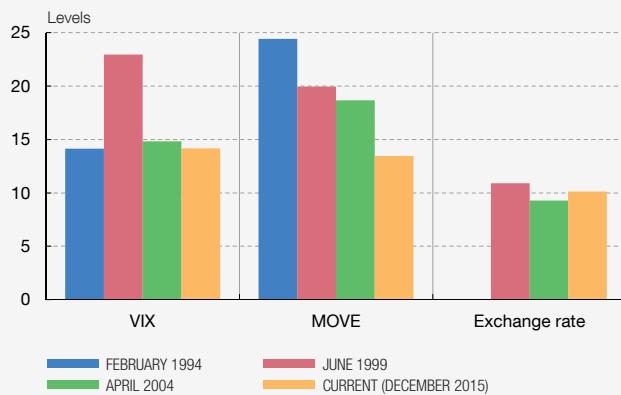


Chart 3
VOLATILITY AND ECONOMIC INDICATORS

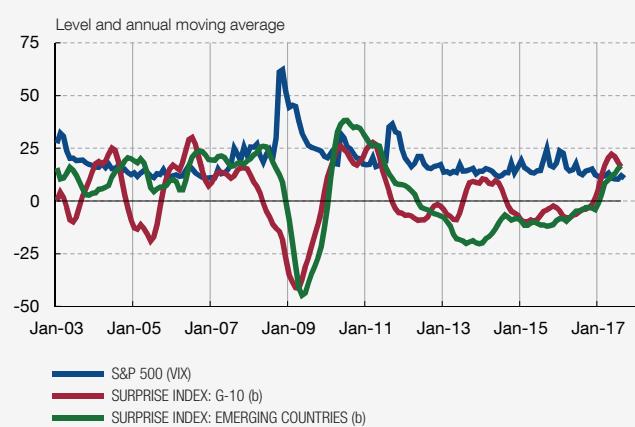
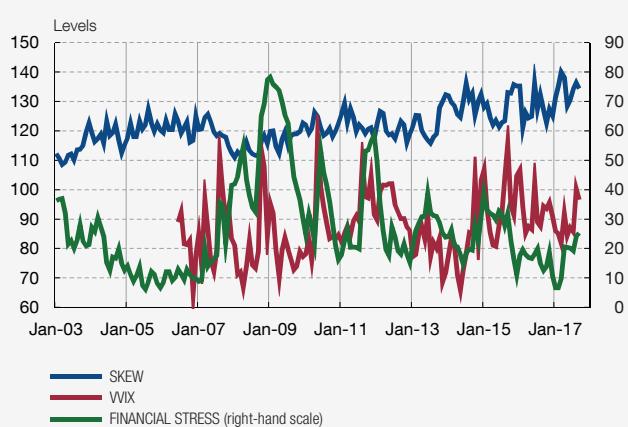


Chart 4
TAIL RISKS AND FINANCIAL STRESS



SOURCES: Datastream and own calculations.

- a Global Economic Policy Uncertainty Index. Baker, Bloom and Davis (2016), Measuring Economic Policy Uncertainty, *The Quarterly Journal of Economics*, Volumen 131, Issue 4, pp 1593-1636.
- b The Citigroup Economic Surprise Index is defined as the weighted historical standard deviations of "surprises", which are defined as the difference between the published data and the consensus forecast. A positive figure indicates that the published figures exceed the consensus. The emerging countries CESI includes China, Hong Kong, India, Indonesia, South Korea, Malaysia, the Philippines, Singapore, Taiwan, Turkey, South Africa, Poland, the Czech Republic, Hungary, Brazil, Mexico, Chile, Colombia, and Peru, whereas the G-10 includes the United States, the euro area, the United Kingdom, Japan, Norway, Sweden, Australia, New Zealand and Canada.

One of the most notable characteristics of recent developments in international financial markets has been their low volatility. Thus, after rising in mid-2015 on the back of turbulence caused by the fall in the Chinese stock market and the slump in the oil price, the volatility of a range of financial assets, such as the stock market, interest rates, or exchange rates, has remained on a constant downward trend (see Chart 1). What makes this pattern particularly striking is that it is taking place in a context in which there have been a number of unexpected political events, such as the United Kingdom's vote to leave the EU or the outcome of the US presidential election in November 2016. Similarly, many emerging economies, including the largest of them, have registered increases in their political risk indicators and cuts to their sovereign ratings.³

Moreover, this downward trend in volatility is taking place against the backdrop of a gradual rise in base rates and the announcement of the withdrawal of monetary stimulus in the United States, something that has traditionally coincided with periods of low stock market volatility and higher interest rate volatility. In this instance, however, after four base rate hikes, the average volatilities of the stock market and the exchange rate are close to the average observed in other periods of rising base rates, but interest rate volatility is clearly lower (see Chart 2).

The possible causes of the decrease in volatility may include certain short-term factors, together with other factors of a more structural nature, associated with changes taking place in the operation and structure of financial markets. As regards short-term factors, the effect of geopolitical uncertainty may have been offset by the positive surprises in the economic indicators (see Chart 3). Similarly, the profits of banks and listed companies beat expectations in the first quarter of 2017. Meanwhile, the ultra-expansionary monetary policies of advanced economies' central banks, and their reaction to certain bouts of instability⁴ may have created expectations among investors that the monetary authorities will try to avert or curb abrupt corrections in asset prices and the accompanying spikes in volatility. Finally, high volumes of equity buybacks could also have contributed to reducing stock-market volatility by supporting share prices.

As regards considerations of a more structural nature, in recent years the share of active investors has shrunk relative to that of investors holding assets to maturity or with passive investment strategies, i.e.

options on US Treasury note futures. To ensure a variety of underlying instruments when calculating the various segments of the interest rate curve, options on bonds with two-, five-, ten- and thirty-year maturities are used. Finally, for foreign exchange markets, the implied volatility of three-month options on the exchange rate of the euro, the yen and the pound sterling against the dollar are used.

- 3 Since December 2015, a number of countries, including Nigeria, Tunisia, South Africa, Saudi Arabia, Poland, Turkey, Brazil, China, Chile, Venezuela and Ecuador, have had their sovereign ratings cut by one or more of the three major rating agencies, whereas only Argentina, Hungary, Indonesia and South Korea have had their ratings upgraded.
- 4 Such as the delay in the first base rate hike in the United States, which was expected in September 2015, the deterioration in the external environment, or the cut in the United Kingdom's base rate, and the postponement of the second rate rise in the United States after the Brexit referendum in the summer of 2016.

those tracking asset allocations determined by indices, as in the case of exchange traded funds (ETFs).⁵ This would tend to reduce volatility, given the smaller presence of investors with positions differing from that of the average investor.⁶ Furthermore, the emergence of new financial products allowing investors to bet on future volatility,⁷ in a context of negative or ultra-low interest rates and the search for returns,⁸ could be leading to trading strategies focusing on volatility itself, resulting in its becoming more persistent.⁹

In any event, volatility is only an approximate measure of the really important variable, namely uncertainty about future returns. In purely statistical terms, implied volatility measures expected average deviation in asset prices, but situations may arise in which this average deviation may be small, although the probability of extreme events occurring is high (tail risk). In order to measure these risks, the Chicago Board Options Exchange (CBOE) calculates an indicator of the skew of the distribution of S&P 500 index and VVIX (the implied volatility of the VIX) options. The recent behaviour of these metrics suggests that although low levels of volatility are expected to continue, investors are demanding ever increasing protection against a sharp change in volatility (see Chart 4). There are also alternative financial stress indices produced by various banks, such as the CSFB (Credit Suisse Fear Barometer), which has moved in closer synchrony with political risks. Finally, Chart 4 shows a financial stress index (FSI) for the United States, which is basically calculated using volatilities and stress indicators in six US financial market segments.¹⁰ This indicator has risen slightly since the start of the year.¹¹

5 In the case of global bond markets, almost 50% of the total volume is held by central banks and commercial banks, which often keep their positions to maturity. In 2002 their share was 40%. In the case of the US stock market, the share of active investors dropped from 85% to 62% between 2005 and 2017. For evidence regarding other markets, see the IMF's *Global Financial Stability Report (GFSR) April 2014, Chapter 2*, and *GFSR April 2015, Chapter 3*.

6 The substitution of active investors by passive investors also produces a reduction in trading volumes and market liquidity, making it more expensive to take a position against the general trend. This reinforces the tendency to drive out the more active investors. This leads to lower volatility of each individual security and ultimately lower aggregate market volatility.

7 The Chicago Board Options Exchange (CBOE) currently trades around 1.5 million options and 500,000 futures on the VIX.

8 For example, the Velocity Shares Daily Inverse VIX (XIV), an investment product offering a return that depends inversely on the VIX, has produced a return of 80% so far this year, and has a daily trading volume of USD 818 million. Strategies of "selling volatility" over the medium term would also be reflected in the short, non-commercial positions on VIX futures, which reached peak levels in the summer of 2017.

9 Recently there has also been a proliferation of so-called "controlled volatility funds", which aim to keep a given institutional investor's portfolio volatility levels stable. These funds behave procyclically, as they reinforce low volatility when it is low, but amplify its rise in the face of unexpected changes in market conditions.

10 The United States FSI is constructed daily using information from six financial markets (equities, public fixed income, private fixed income, banks, money markets, and exchange rates). It has been designed such that an increase in the FSI indicates an increase in financial stress.

11 Other indicators referring to the value of put and call options on the S&P 500 and on the VIX would also suggest that investors' demand for protection against an upturn in volatility is increasing.

The current apparently benign scenario of low volatility should not lead to complacency. Firstly, as we have seen, other indicators are behaving less reassuringly than traditional indices. Secondly, some of the factors that appear to underlie the trend in volatility, such as the reaction of the monetary authorities to certain events or the participation of passive investors, could change in the future or intensify sudden price adjustments. In this regard, in the current context it is important to ensure that excessively leveraged

positions do not build up, based on this context of low volatility levels.¹²

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- 12 On the effects of low volatility on the build-up of imbalances, see: The volatility paradox, in OFR Markets Monitor, Second Quarter 2017 (Office of Financial Research). Also, Learning from History: Volatility and Financial Crises, by J. Danielson, M. Valenzuela and Ilknur Zer (2016, Board of Governors of the Federal Reserve System) highlights that a protracted period of low volatility in stock markets can herald the outbreak of financial crises.

One of the features of current economic growth in the euro area has been the strength of job creation. Thus, despite considerable cross-country differences, in mid-2016 the euro area as a whole had already recovered pre-crisis employment levels - even though the number of hours worked is still lower than before the crisis - and the labour force surveys published by the European Commission are showing signs of shortages in certain sectors and countries. Against this background, unemployment levels have continued to fall, despite the increasingly buoyant labour force participation rate.

In contrast to this improvement in employment, nominal wage growth - measured both in terms of compensation per employee and negotiated wage settlements - was persistently subdued in

most sectors and countries, except for Germany (see Chart 1), with rates of change far removed from the figures of almost 2.5% posted in the pre-crisis boom.

Chart 2 presents the contributions of the traditional determinants of wage growth estimated using a Phillips curve which shows the relationship between the rate of change of wages and productivity growth, past inflation and labour market slack measured as the difference between the rate of unemployment observed and the structural rate of unemployment (NAIRU). As can be seen, all these factors contribute to explaining lower wage growth with respect to its historical average. The negative contribution associated with the low levels of inflation observed in the past is particularly noteworthy insofar as the negative contribution of labour market

Chart 1
NOMINAL REMUNERATION GROWTH PER EMPLOYEE AND SECTOR
(2015-17) (a)

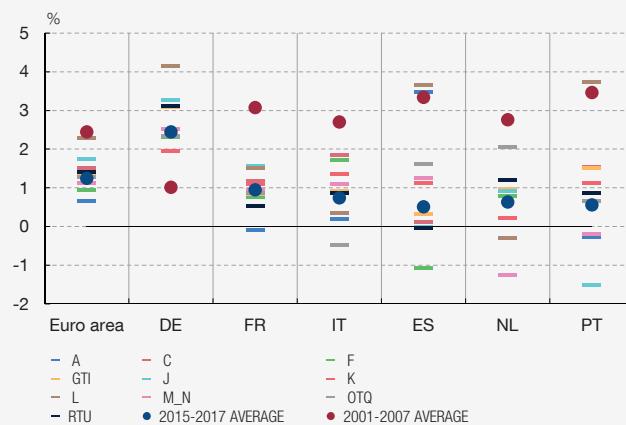


Chart 2
REMUNERATION GROWTH BY EMPLOYEE
(Deviations from period average)
Breakdown based on Philips curve (a)

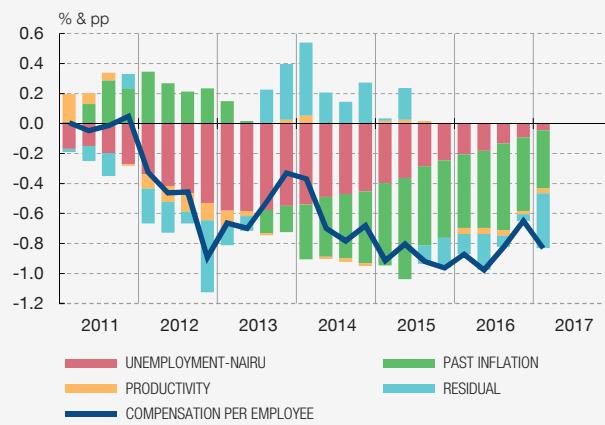
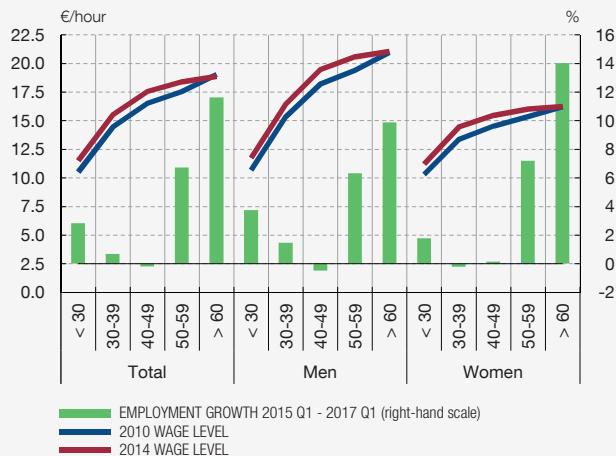


Chart 3
BROADER ESTIMATIONS OF LABOUR UNDERUTILISATION IN THE EURO AREA



Chart 4
EURO AREA. WAGE LEVELS AND EMPLOYMENT GROWTH BY AGE GROUP



SOURCES: Encuesta de Estructura Salarial, Labour Force Survey and National Statistics Offices.

a: A: agriculture; C: manufacturing; F: construction; GTI: commerce, transport and catering; J: information and communication; K: financial activities; L: real estate activities; M_N: administrative activities; OTQ: general government; RTU: recreational activities and other services.

slack decreased notably in recent quarters as a result of the positive performance of employment. Similarly, low productivity growth also puts downward pressure on wages, although the magnitude of this factor's contribution is lower.

That said, persistent negative residuals suggest that, besides the conventional determinants, other factors could be exerting downward pressure on wages. Noteworthy among these factors are the higher immigrant inflows in recent years and the structural reforms implemented in certain Member States which could have been conducive to trade unions, in certain countries and sectors, giving more priority to job creation and better working conditions than to wage increases during negotiations. However, there is limited evidence of this.

There are some developments shared with other advanced economies, such as the United States which could explain wage moderation that are not related to the usual determinants of this variable. First, there is evidence that the labour market slack may be higher than that inferred by conventional unemployment rates which may put downward pressure on wages. Indeed, when broader measures of unemployment are considered, which include not only the proportion of the unemployed actively seeking work but also those individuals who are discouraged from looking for work, those who are looking but are not available to work and, especially, part-time workers who want to work more hours, unemployment levels are estimated to virtually double during the period of the crisis¹ (see Chart 3).

Second, the changes in the composition of employment could likewise be playing a role in the moderation of wage growth. In the absence of up-to-date information from the Structure of Earnings Survey to corroborate this diagnosis (the 2014 edition is the latest one available), certain signs seemingly point in this direction. For instance, as shown in Chart 4, since 2013 the recovery of

employment has been particularly buoyant in older population groups and, to a much lesser degree, in younger ones. Although older employees generally earn higher wages, the 2014 Survey reveals that it is precisely among these groups that wage growth has stalled. Insofar as older cohorts, who are at present increasingly relevant in the labour force composition mainly due to population ageing, begin to reach retirement age, the fraction of employment outflows from above-median compensation scales will be greater, thus contributing to reinforcing wage moderation².

Lastly, another factor which may be contributing to wage moderation is the process of technological change which has been taking place over the last two decades. In general, technological developments generate labour substitution effects, but also complementarities which may boost job creation and wage growth through productivity improvements. There is some evidence in economic literature that technological progress in the past such as the automation of agriculture³ or the introduction of automated teller machines⁴, among others, have shown a greater prevalence of the positive complementary effects. However, recent papers⁵ suggest that the latest technological advances in information processing, the development of artificial intelligence and the perfecting of robotics could ultimately have a negative impact on employment and wages owing to the greater magnitude of the substitution effect.

In short, the moderation of wage growth could be explained by a series of variables that have recently gone beyond what the usual determinants would suggest, although the evidence available is not conclusive when determining their respective contributions.

¹ See also Box 6 "Alternative measures of unemployment for the Spanish economy" in the Banco de España's *Economic Bulletin* 02/2017 and "Assessing Labour Market Slack" *ECB Economic Bulletin* Issue 3/2017.

2 M. Daly et al (2016), "What's Up with Wage Growth?" FRBSF Economic Letter 2016-07.
 3 D. Autor (2015), "Why Are There Still So Many Jobs? The History and Future of Workplace Automation" *Journal of Economic Perspectives*. Vol. 22(3).
 4 J. Bessen (2015), "Toil and Technology" *Finance and Development* 52(1).
 5 D. Acemoglu and P. Restrepo (2017), "Robots and Jobs: Evidence from US Labor Markets" NBER Working Paper 23285.

The housing market continued on the path to recovery that started in early 2014 both regarding prices and house purchases, and new residential project starts, following the sharp correction observed during the previous seven years. This box revises the main characteristics of recent developments.

Between 2014 Q4 and 2017 Q3 investment in housing increased on average around 1.5% quarter-on-quarter, a pace higher than that recorded for construction as a whole (1% on average). Accordingly, housing gained weight in construction investment during this period, to stand at approximately 50% of the total, in line with the average for the last two decades (see Chart 1). Recent changes reflect, among other factors, the favourable performance of the labour market and of the financing conditions applied both to house purchases by households and to housing development and construction by firms in this sector. In terms of GDP, the weight of this investment component stood slightly above 4.5% in 2017, rising from a low of 4.1% in 2013, similar to the average for other European countries and very far from the 12% reached in 2007, the peak of the expansionary phase posted

by the sector before the crisis (see Chart 2). Compared with this peak, the level of this demand component accumulated a fall of around 65% until 2013, having recorded an increase of slightly over 20% since then.

House prices, which dropped by 37% in nominal terms (45% in real terms) from their all-time high in 2007 Q3 to their minimum in 2014 Q1, have been on a growth path since then, recording an accumulated increase of 16% (see Chart 3), with very uneven rates of growth across regions, Madrid, Catalonia and the Balearic Islands being the autonomous regions where price growth was highest. By housing type, the growth of new home prices since the minimum reached in 2014 was slightly higher than that of second-hand homes, although this difference has decreased in recent quarters.

Housing transactions have also been on an upward trend since 2014. Specifically, approximately 455,000 housing purchases were recorded in 2016, 14% more than in 2015 which, however, is equivalent to only slightly above 50% of the annual average

Chart 1
COMPOSITION OF CONSTRUCTION INVESTMENT (a)

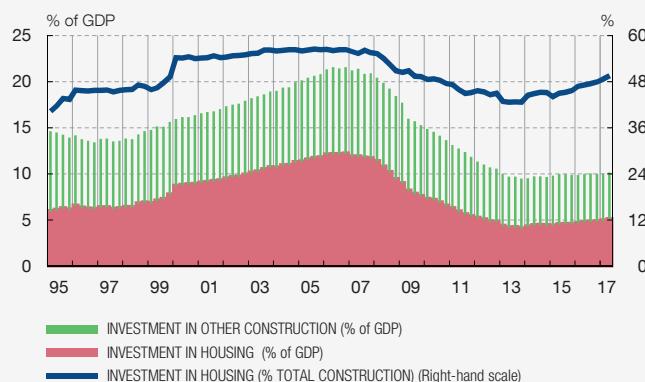


Chart 2
INVESTMENT IN HOUSING (% OF GDP). INTERNATIONAL COMPARISON (b)

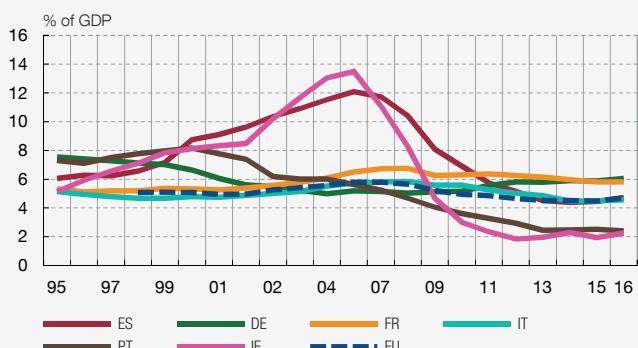


Chart 3
CHANGES IN HOUSING PRICES FROM THEIR PEAK IN NOMINAL TERMS
(2007 Q3) (a)



Chart 4
NUMBER OF HOUSING TRANSACTIONS (c)



SOURCES: See notes.

a INE.

b EUROSTAT.

c Ministerio de Fomento.

purchases carried out between 2004 and 2007 (around 885,000).¹ Housing transactions are mainly sustained by the second-hand home segment, whereas new home purchases maintain a slightly downward trajectory (see Chart 4). Likewise, the increase in housing sales is seen both in purchases by foreigners (around 17% of the total in the last three quarters vis-à-vis an average of 10% during the period 2006-2013) and in purchases by Spanish residents (see Chart 5).

The better tone of sales is also reflected, albeit to a lesser degree, in the mortgage market, with a moderate increase since early 2015 in the number of new mortgages, against a backdrop of gradually declining household debt at aggregate level (see Chart 6). In terms of balances, a year-on-year contraction of loans for house purchase persists, meaning that new loans granted for house purchase are not sufficient to offset the loan repayments. As regards loan terms, an increase has been observed since the market began to recover in the proportion of housing loans with an

initial interest rate fixation period of between one and five years and, starting in 2016, with a fixed interest rate at more than ten years.²

On the supply side, residential housing starts have also improved, although with a certain delay,³ in part owing to the high stock of unsold dwellings resulting from the previous expansionary phase. In any event, the level of housing starts is still low and well under that recorded during the early phases of recovery in the sector following the early-1990s crisis (see Chart 7).

The process of absorbing the ample stock of unsold dwellings is moving slowly, against a backdrop of a relatively small volume of new house purchases, which acts as a factor limiting the degree of recovery of residential construction. In any event, the market shows a high degree of heterogeneity by geographical area, such

¹ 2004 is the first item of the series that is available.

² See Box 6 of the "Quarterly report on the Spanish economy", 2017 Q1.

³ The building permits published by the Ministry of Public Works are used as a leading indicator of housing construction.

Chart 5
NUMBER OF HOUSE PURCHASES BY SPANISH NATIONALS AND FOREIGNERS (d)



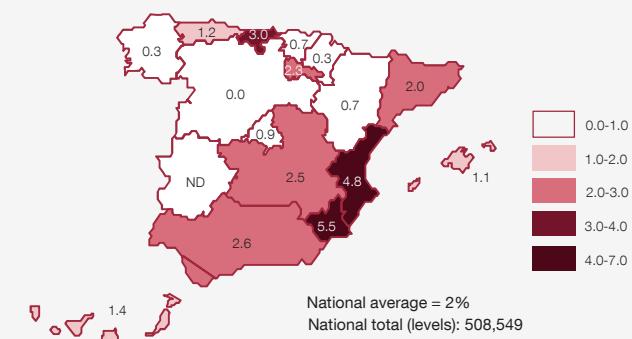
Chart 6
NEW HOUSING MORTGAGES AND CHANGES IN THE BALANCE OF LOANS FOR HOUSE PURCHASE (e)



Chart 7
NUMBER OF HOUSING APPROVALS (d)



Chart 8
ESTIMATE OF STOCK OF UNSOLD HOUSING (2017 Q1) (f)
Housing stock as a proportion of the total in 2016



SOURCES: See notes.

d Ministerio de Fomento.

e INE and Banco de España..

f Banco de España estimates based on data from the Ministerio de Fomento.

that demand is concentrated in areas not necessarily coinciding with those where the unsold houses are located, which is also giving rise to very uneven price performance. In this connection, from a geographical perspective, the autonomous regions that continue to have a larger volume of unsold housing relative to the stock of houses are mainly located in coastal areas, where the property boom prior to the crisis was especially intense (see Chart 8).

At medium and long term the performance of the housing market is driven by demographic factors, among others. Given the current projections of a moderate decline in Spain's population in the medium term,⁴ residential demand growth may be expected

to be more subdued than during the previous expansionary cycle that started in the late 20th century, when this variable was buoyant.⁵ This factor could be mitigated in a shorter time horizon insofar as the crisis may have delayed the decision to form a household by the cohorts of younger individuals, an element which would now be reversing as a result of the improvement in employment.

⁴ See P. Cuadrado (2017), "Population of Spain: latest developments and projections", *Economic Notes*, 19 January 2017, Banco de España.

⁵ Conditioned by the ample margins of uncertainty shown by population projections at medium and long term, the estimates available indicate that the potential demand for main residences would be much lower than the number of finished dwellings during the upturn in the previous real estate cycle. See M.^a Ll. Matea Rosa and M.^a C. Sánchez Carretero (2015), "Household formation and the need for new primary dwellings in the medium term", *Economic Bulletin*, October 2015, Banco de España, and Á. L. Gómez and M.^a C. Sánchez (2017), "Indicadores para el seguimiento y previsión de la inversión en construcción", *Documentos Ocasionales*, No. 1705, Banco de España.

The latest economic crisis resulted in the loss of more than four million jobs (20% of the total) between 2008 and 2013. The severity of job destruction was far greater than in the previous two recessions, which had started in the mid-1970s and early 1990s and had led to job losses accounting for approximately 10% of the total.

By sector, the fall in employment during the most recent crisis was particularly pronounced in construction, which lost more than 60% of its jobs, in cumulative terms (see Chart 1). However, the recession also had a strong impact on industry, where around 30% of jobs were destroyed, while employment in the agriculture and market services sectors declined by around 15%. Lastly, employment remained fairly stable in non-market services, consistent with the limited cyclical fluctuations usually associated with employment in these sectors.

If these developments are compared with those of the preceding recession, in the early 1990s, a relatively similar pattern can be observed in qualitative terms, with the exception of the agricultural sector, where the secular process of job reduction associated, among other factors, with the mechanisation of agricultural activity had not yet concluded in that decade. In the preceding crisis, construction, followed by industry, were also the sectors which suffered the greatest job losses, while the services sectors barely destroyed jobs (see Chart 2)¹.

The recovery which began in the second half of 2013 has recently enabled the GDP to return to its pre-crisis level. However, employment is still 10% lower than it was before the crisis, despite the intense pace of job creation in the four years since the start of the recovery, clearly higher than that observed in the same period of the previous expansionary phase (see Charts 3 and 4). From a sectoral standpoint, in both cycles, the recovery of employment from the cyclical trough was again very similar, with above-average growth in the construction and market services sectors and a slower recovery in industry, while employment growth in non-market services was more subdued². At a higher level of disaggregation, in market services, the employment growth in the current cycle in accommodation and food services is higher than that in construction, in contrast with the preceding recovery, where job growth was higher in professional and business sectors. Employment gains in industry

are concentrated in the manufacturing sectors (in contrast with the previous recovery, in which job creation was much more intense in the mining and quarrying sectors).

Sectoral employment patterns since the previous cyclical peak in 2007 have led to profound changes in the weight of each sector in total employment (see the table below). Specifically, the proportion of workers employed in the construction sector has fallen by more than 7 pp (from 13.2% of the total to 5.9 %), and by almost 3 pp in the manufacturing sectors. The sectors which have gained weight all relate to market services, namely accommodation and food services, transportation, warehousing and communication, education, healthcare and social services, with an overall increase of 7.5 pp (from 24.5% to 32%). Thus, compared with the situation at the end of the previous expansionary cycle before the onset of the crisis, accommodation and food services have notably gained weight at the expense of the construction sector, and the fact that the skills it requires are generally of a relatively low level could facilitate the transferability of workers between sectors³.

In general, the shifts in employment between sectors observed during the recovery have not had a significant impact on aggregate productivity levels. Chart 5 shows the correlation between productivity by sector at the start of the recovery and the changes in the weight of each sector in total employment. As can be seen, this correlation is only marginally positive, with employment flowing towards more productive sectors, albeit at a subdued pace. In particular, construction is one of the sectors with the highest employment growth since 2014, with above-average productivity, which broadly offsets the lower productivity in accommodation and food service activities.

From a broader time perspective, the sectoral changes in the composition of employment observed since the start of the crisis have contributed positively to apparent labour productivity, although on a limited scale. When aggregate productivity growth is broken down into the contributions of the changes in sectoral weights and productivity changes within each sector (see Chart 6), the latter factor is found to have largely led to the observed increase in productivity, which took place during the crisis but not in the recovery phase. This can be explained by the fact that job destruction during recessions tends to concentrate on workers with temporary contracts (which are widespread across sectors), whose productivity level tends to be relatively low since they have less experience. Moreover, the average productivity of the flow of new hires is declining in the recovery

¹ Similarly, in the recession which began in the mid-1970s, the level of employment in the services sectors remained relatively stable, while it fell by approximately 30% in construction, industry and agriculture, although, as mentioned above, the nature of job reduction in the latter was more than just cyclical.

² In any case, while the level of employment in construction and industry in 2014, in absolute terms, was not so different from that observed in 1994, employment in the services sectors as a whole had almost doubled in that period, as a result of the tertiarisation of the economy.

³ See Lacuesta, A., S. Puente and E. Villanueva (2012), "Sectoral change and implications for occupational mismatch in Spain", *Economic Bulletin*, July, Banco de España and *Annual Report 2012*, Banco de España, box 5.3 ("Sectoral reallocation since the onset of the crisis").

Chart 1
LEVEL OF EMPLOYMENT ON QNA DATA, BY LARGE SECTOR, SINCE 2008



Chart 2
LEVEL OF EMPLOYMENT ON QNA DATA, BY LARGE SECTOR, IN THE PREVIOUS CRISIS

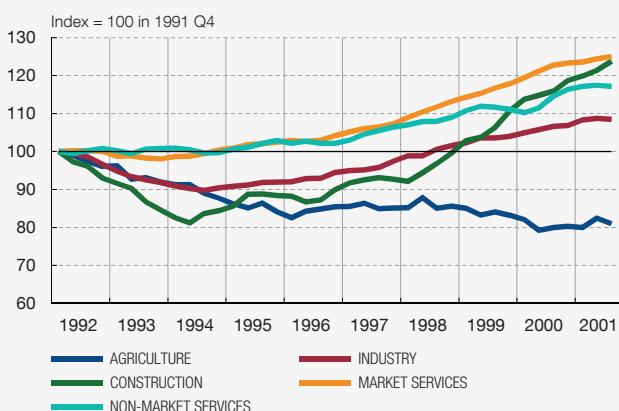


Chart 3
LEVEL OF EMPLOYMENT ON QNA DATA, BY LARGE SECTOR,
SINCE THE START OF THE CURRENT RECOVERY

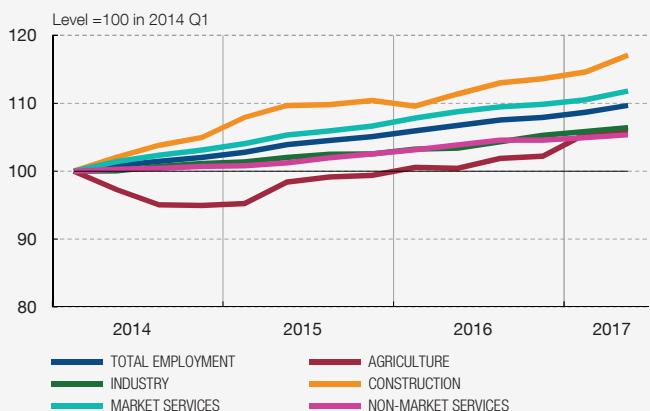


Chart 4
LEVEL OF EMPLOYMENT ON QNA DATA, BY LARGE SECTOR,
SINCE THE START OF THE 1993 RECOVERY

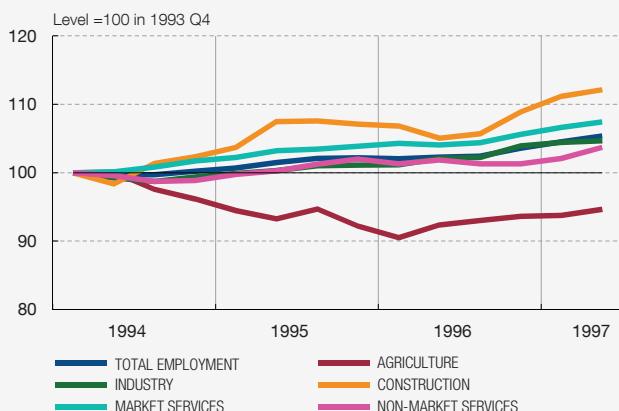


Chart 5
CHANGES IN THE SHARE OF EMPLOYMENT BETWEEN 2014 AND 2017
BY SECTOR, ACCORDING TO PRODUCTIVITY LEVEL (a)

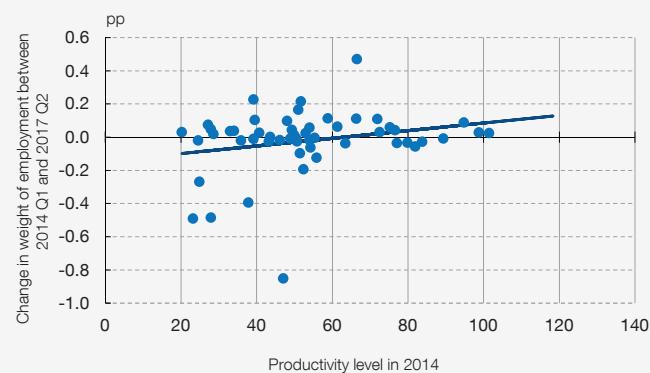
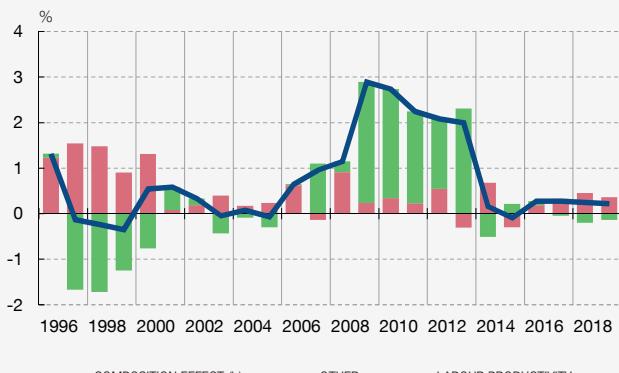


Chart 6
RATE OF CHANGE OF APPARENT LABOUR PRODUCTIVITY
AND COMPOSITION EFFECT



SOURCE: Instituto Nacional de Estadística (QNA and EPA).

a 2-digit sectors of the NACE-2009. EPA employment. Eight sectors with atypical values are excluded.

b Includes the effect of change in employment, based on constant productivity in the 11 sectors considered between two consecutive periods.

phase, since there are individuals returning to work after long periods of unemployment, probably in different tasks to those performed in their previous jobs⁴.

To conclude, the recovery of employment in the current expansionary phase has tended to concentrate, in absolute terms, in several service sectors, some closely linked to the growth in tourism. From the trough recorded after the crisis, employment

has risen notably in the construction sector, which is key to explaining the cyclical swings in the Spanish economy, as is also shown by the fact that this sector had higher relative employment growth after the recession of the early 1990s. In view of the possibility that the accommodation and food services and construction sectors may approach their limits on job creation in the near future, it seems necessary to look for formulas to improve employment opportunities for the lower-skilled unemployed. Finally, one of the consequences of the crisis has been the fact that young people have remained in the education system for longer periods. In the future, a higher level of education among new generations will be the factor that determines the transferability of employment to activities associated with higher productivity levels. It is therefore essential to improve the quality of the education system.

⁴ Although the absorption of relatively low-skilled unemployed individuals observed recently may lead to a decline in labour quality at aggregate level, there has been a simultaneous increase in total factor productivity, which could be due to the reallocation of productive factors to more efficient firms. (see chapter 2 "Financing and investment decisions of Spanish non-financial corporations", *Annual Report 2016*, Banco de España).

**Table
WEIGHT OF EMPLOYMENT IN THE MAIN SECTORS IN SPAIN AND THE G4 (GERMANY, ITALY, FRANCE AND UNITED KINGDOM)**

| | Spain | | | G4 (a) | | | Difference Spain - G4 | | |
|--|-------------|-------------|-----------------|-------------|-------------|-------------|-----------------------|---------------|-------------------|
| | 1993 (1) | 2007 (2) | 2016 (b) (3) | 1993 (4) | 2007 (5) | 2016 (6) | 1993 (1-4) | 2007 (2-5) | 2016 (b) (3-6) |
| Agriculture; fishing | 9.5 | 4.4 | 4.2 | 4.1 | 2.5 | 2.0 | 5.4 | 1.9 | 2.2 |
| Mining and quarrying | 0.5 | 0.3 | 0.2 | 0.6 | 0.3 | 0.2 | -0.1 | 0.0 | 0.0 |
| Manufacturing | 20.6 | 15.2 | 12.5 | 23.8 | 18.2 | 15.2 | -3.2 | -3.0 | -2.7 |
| Electricity, gas and water supply | 0.7 | 0.6 | 1.1 | 1.1 | 0.8 | 1.4 | -0.4 | -0.2 | -0.3 |
| Construction | 9.5 | 13.2 | 5.9 | 7.6 | 7.5 | 6.7 | 1.8 | 5.7 | -0.8 |
| Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods | 17.0 | 15.3 | 16.1 | 17.3 | 14.3 | 13.7 | -0.3 | 1.0 | 2.5 |
| Hotels and restaurants | 5.5 | 7.1 | 8.8 | 3.3 | 4.1 | 4.7 | 2.2 | 3.0 | 4.1 |
| Transport, storage and communication | 6.0 | 5.8 | 8.1 | 6.2 | 6.0 | 8.2 | -0.2 | -0.2 | -0.2 |
| Financial intermediation | 2.9 | 2.5 | 2.5 | 3.7 | 3.5 | 3.4 | -0.8 | -1.1 | -0.9 |
| Real estate, renting and business activities | 5.1 | 10.0 | 10.8 | 4.8 | 10.8 | 11.6 | 0.3 | -0.8 | -0.8 |
| Public administration and defence; compulsory social security | 6.5 | 6.1 | 6.9 | 8.3 | 7.7 | 7.1 | -1.9 | -1.6 | -0.1 |
| Education | 5.4 | 5.5 | 6.9 | 6.5 | 7.1 | 7.9 | -1.1 | -1.6 | -0.9 |
| Health and social work | 4.8 | 6.1 | 8.2 | 7.8 | 10.9 | 12.4 | -3.0 | -4.7 | -4.2 |
| Other community, social and personal service activities | 3.2 | 4.2 | 4.4 | 4.2 | 5.2 | 4.4 | -1.0 | -1.0 | 0.0 |
| Activities of households | 2.9 | 3.7 | 3.4 | 0.8 | 1.1 | 1.1 | 2.1 | 2.6 | 2.3 |
| Extra-territorial organizations and bodies | 0.0 | 0.0 | 0.0 | 0.1 | 0.1 | 0.1 | -0.1 | -0.1 | -0.1 |

SOURCES: Eurostat and Banco de España.

a Simple average of the weights of Germany, France, Italy and United Kingdom.

b 2016 data back-calculated at the Banco de España to ensure consistency with previous classification.

In recent months an improvement has been observed in investors' perception of European credit institutions, which has been reflected in less volatility in bank stocks (see Box 2 of this report), lower risk premia and a recovery in stock market prices.

In fixed-income markets, European banks' credit risk premia, measured through 5-year CDS on senior debt, have decreased notably since the beginning of the year, barely fluctuating, which has contributed to narrowing the gap between these credit risk

Chart 1
RISK PREMIA OF BANKS AND NON-FINANCIAL CORPORATIONS IN THE EURO AREA (5-YEAR CDS) (a)

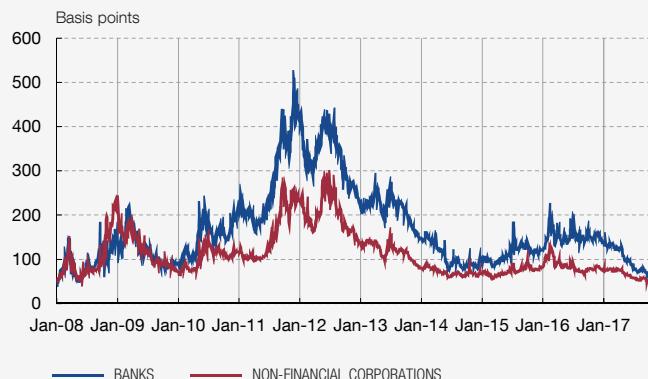


Chart 2
BANK RISK PREMIA BY COUNTRY (5-YEAR CDS) (b)



Chart 3
GENERAL AND BANK STOCK MARKET INDICES IN THE EURO AREA (c)



Chart 4
BANK STOCK MARKET INDICES (c)



Chart 5
COST OF FINANCING SENIOR DEBT (d)



Chart 6
COST OF FINANCING SENIOR DEBT (d)



SOURCES: Banco de España and Datastream.

a Weighted average of GDP of Germany, Austria, Belgium, Spain, France, Greece, the Netherlands, Italy, Ireland and Portugal.

b The weighted average for each country was calculated using the stock market capitalisation of the 5-year CDS of the major listed banks.

c The weighted average for each country was calculated using the stock market capitalisation of the share prices of the major listed banks.

d The weighted average for each country was calculated using the issuance volume of the major listed banks' bond yields.

premia and those of non-financial corporations since 2010 (see Chart 1). As a result of this decline, in the third quarter bank risk premia were averaging less than 80 basis points (bp), reaching levels not seen since mid-2008, although they were still higher than in the run-up to the crisis. These developments spread to most euro area countries (see Chart 2).

Amid general low volatility in the stock markets, bank share prices have grown since early in the year to a greater extent than European indices on the whole, although their performance has been slightly worse in recent months (see Charts 3 and 4).

The more favourable market perception of European banks arose against the backdrop of an improvement in the marcoeconomic outlook and in the financial position of banks. Thus, the strengthening of the euro area economy (currently in its fifth consecutive year of growth), higher capital and liquidity levels at banks, together with their better quality assets, have contributed to investors' more positive outlook for European banks.

This course has not been altered by the winding up and restructuring of certain European institutions mid-year and, consequently, there has been no notable contagion to other assets, whether fixed-income securities or equities. The stability shown by financial markets in the face of potentially negative news contrasts with events in the past. Thus, in previous episodes (such as that in February 2016, when uncertainty arose about a certain institution's ability to meet the payment of the interest on its contingent convertible securities (Cocos), turbulence ensued in securities markets which was reflected in higher volatility, rising risk premia and significant declines in stock prices.

Investors' lower risk perception has resulted in a decrease in banks funding costs in the markets in the third quarter. For instance, interest rates on senior debt have fallen during the year to historically low levels (see Chart 5). Subordinated debt yields, which would potentially absorb losses if these were to exceed banks' capital, have also fallen noticeably in the main euro area countries (see Chart 6).

2 EXTERNAL ENVIRONMENT OF THE SPANISH ECONOMY

- 2.1 External environment of the euro area** In 2017 Q3 to date, the international economic and financial situation has continued to move on the gradually improving path of the previous quarter. Overall, the GDP data available so far are better than expected and have led to an upward revision of GDP growth forecasts for 2017 and, to a lesser extent, for the medium term. The positive news on activity contrasts with the inflation data on developed countries, whose core components stand at low levels, generally below the objectives of their central banks. Financial market volatility indicators, for their part, recorded new lows, against a backdrop of high risk for appetite where capital flows to emerging markets regained momentum.

Notable in international financial markets during Q3 has been the dollar's sharply depreciating trend, both against the currencies of other developed countries (especially the euro, which appreciated by close to 6% against the dollar) and against the main emerging market currencies, especially in Latin America. Against this backdrop, US long-term interest rates have remained stable (around 2.2%), as have those of the euro area, Japan and the United Kingdom, although in the latter case they have risen slightly last week. Stock market trends have diverged, with price rises in the United States, which posted new highs, and declines in the United Kingdom, Japan and the euro area, although in the two latter cases the indices rebounded in the past month. In terms of PERs, values have hardly changed over the quarter, remaining 15% above the historical average in the case of the United States. The stock markets in the emerging economies rose sharply (8%), driven by Latin America and, especially, Brazil (21.5%). Sovereign spreads have narrowed to levels similar to those of mid-2014, despite the perception of increased political risk in certain cases and the downgrading of some credit ratings. Capital flows to emerging economies have remained positive over the quarter and debt issues in 2017 to date already exceed 25% of the volume accumulated in the first nine months of 2016, although their growth has moderated in the last two months.

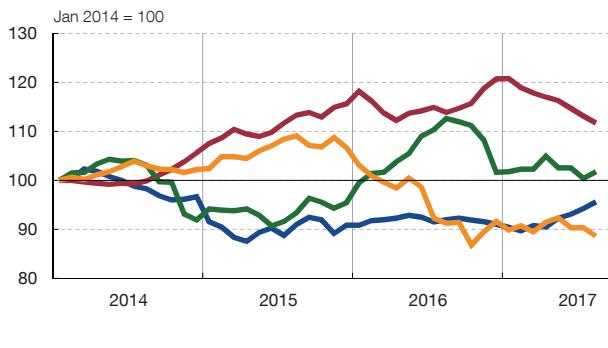
The commodities price index decreased by around 3% in Q3 to date because the correction of the food index (-9.3%) amply offset the increase in the price of industrial metals (7%). The latter's performance is being conditioned by the improvement of demand in China and the contraction of supply associated with labour conflicts in certain producer countries. As regards oil, the price of a barrel of Brent crude increased by 30% during the quarter to approximately 58 dollars. The initial negative reaction to the agreement reached by the OPEC and other oil producers in May has moderated since then against a background of more buoyant demand, contributing to a decline in oil inventories, and of a damaged oil infrastructure in the United States as a result of a particularly virulent hurricane season.

Economic growth gained robustness in developed economies during Q2, surpassing the records posted in Q1. GDP in the United States grew at an annualised quarterly rate of 3%, driven by the positive performance of durable goods consumption and non-residential investment. In Japan, GDP grew by 2.5%, also in terms of an annualised quarterly rate, sustained by the sound performance of public investment and private consumption. In the United Kingdom, despite weak private consumption GDP increased by 0.3% quarter-on-quarter, sustained by public consumption and non-residential investment. The leading indicators for Q3 point to a slight deceleration in the United States and the maintenance of the rate of growth in the United Kingdom and Japan.

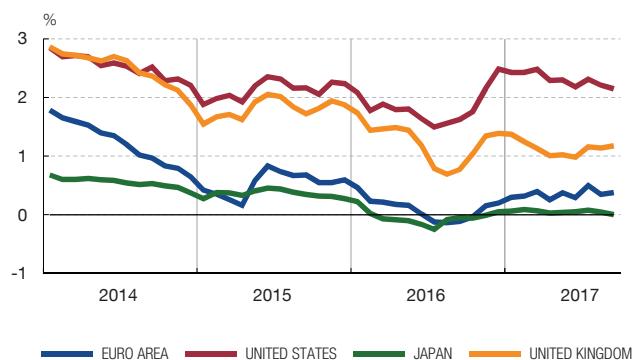
1 STOCK EXCHANGE INDICES



2 CPI-BASED REAL EFFECTIVE EXCHANGE RATES VIS-À-VIS DEVELOPED COUNTRIES (a)



3 LONG-TERM INTEREST RATES (b)



4 COMMODITIES

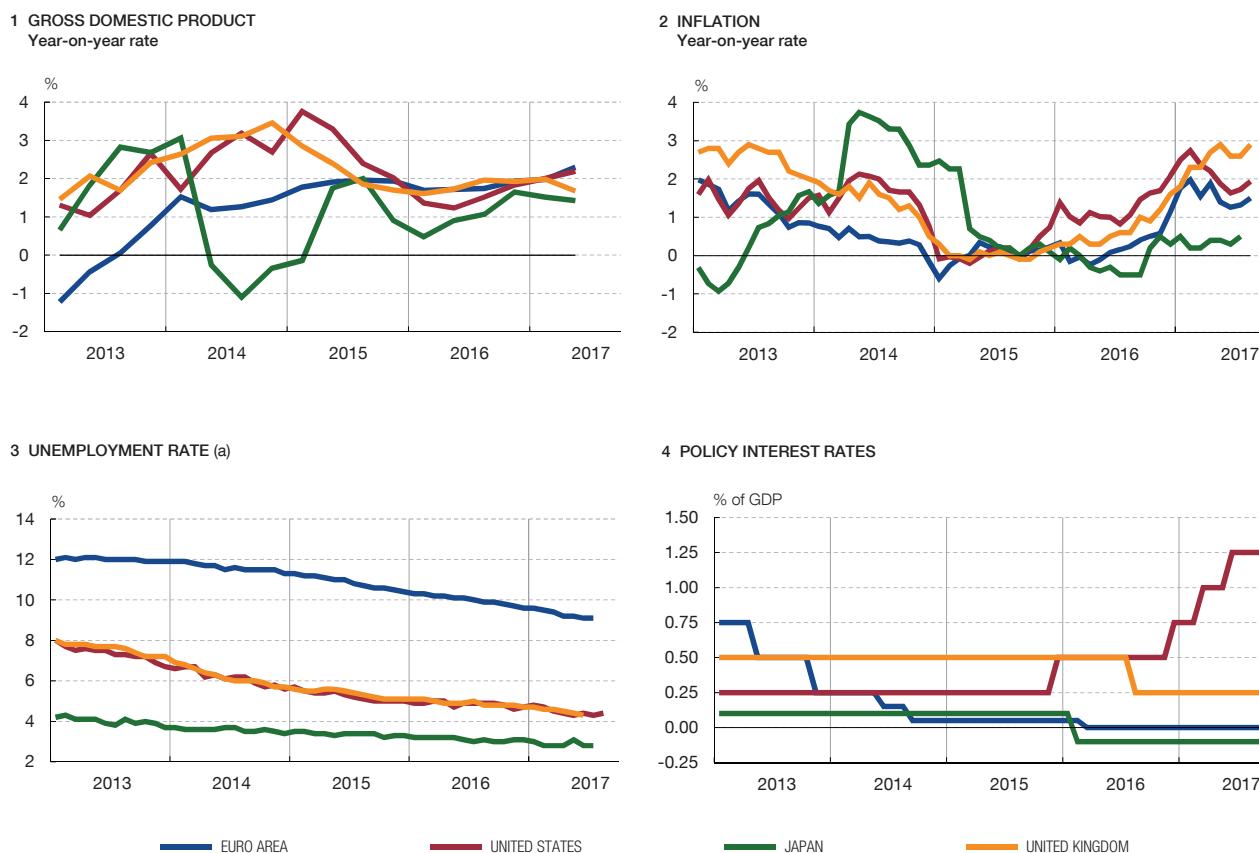


SOURCES: Datastream and Banco de España.

- a An increase in the index represents an appreciation of the currency.
 b Ten-year government debt yields.

Inflation rates in developed countries were affected by the performance of food and energy prices. In the United States, following the highs recorded at the beginning of the year, the year-on-year inflation rate decreased progressively until July (1.7%), as the base effect of oil prices tempered gradually. However, this decline was interrupted by an increase in inflation in August, to 1.9%, owing to the energy component. Inflation in the United Kingdom continued to rise, reflecting the effect of the depreciation of sterling, while remaining low in Japan. With the exception of the United Kingdom, core inflation holds at levels lower than the aims of the central banks. Against this background, the monetary authorities of the above-mentioned three countries have kept their monetary policy unchanged, although the tone of their announcements has changed. In the United States, the publication of the June Federal Open Market Committee (FOMC) minutes lessened the prospects of an increase in interest rates in 2017. However, interest rates rebounded following the September meeting during which the FOMC approved the start of the reduction of the Federal Reserve's balance sheet, in accordance with the plans announced in June, and most of its members continued to forecast an additional rate hike for this year. In the United Kingdom, the minutes published in September changed expectations in favour of a more forceful tightening of monetary policy.

Activity in the emerging economies in Q2 was also favourable. In China, GDP growth held at 6.9% year-on-year, with significant contributions from investment, including in



SOURCES: Datastream and Banco de España.

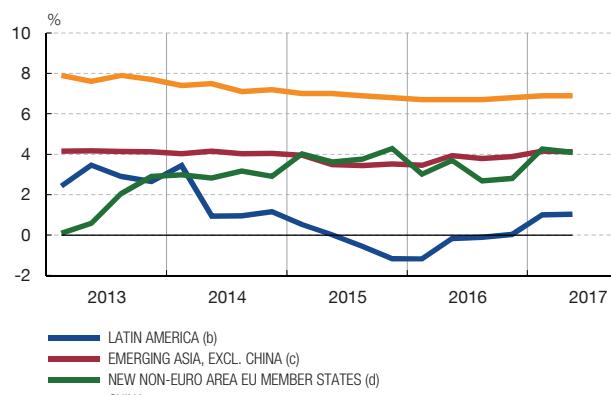
a Percentage of labour force.

infrastructure, and from the external sector. Activity in India slowed slightly and GDP grew by 5.6% in Q2, evidencing a contraction in industry offset by an improvement in the services sector. Inflation in the region tended to rise from previously low levels.

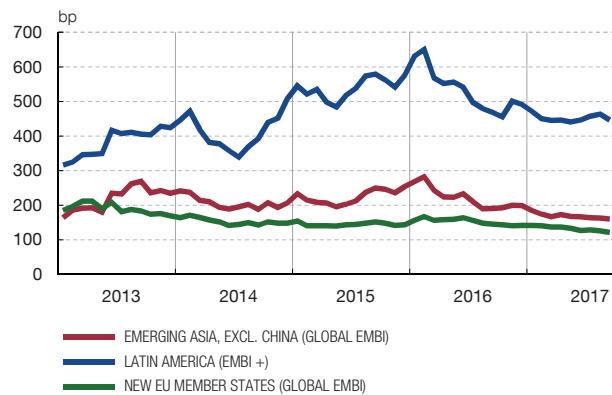
Latin America's six most important economies returned to positive growth rates in Q2. Specifically, Brazil grew 0.2% quarter-on-quarter, moving the year-on-year growth rate to positive terrain (0.3%). Activity in Mexico remained buoyant despite restrictive monetary and fiscal conditions, posting quarter-on-quarter growth of 0.6%. Argentina, Chile, Colombia and Peru grew at a pace of 0.7% quarter-on-quarter. Although inflation decreased in all of them, it remains above the target in Mexico (6.7% in August) and Argentina (22.8% in August), whose central banks have not modified their monetary policy while they wait for the effect of the tightening during the first half of the year to reduce inflation rates. Chile has also maintained its monetary policy unchanged after a looser stance in Q1. The region's other central banks reduced interest rates as inflation dropped. Brazil's central bank slashed interest rates by 100 basis points (bp) twice, to 8.25%; Colombia's did so three times (once by 50 bp and twice by 25 bp), to 5.25%; lastly, Peru also cut its policy rate twice, to 3.50%.

In other emerging regions, Turkey recorded notable GDP growth (5.1% year-on-year), in part owing to the stimulus measures implemented by the government at end-2016 and at the start of 2017. Inflation remained high (10.7% in August) and the central bank has not changed its monetary policy, maintaining a restrictive stance. Growth in the new non-euro area EU

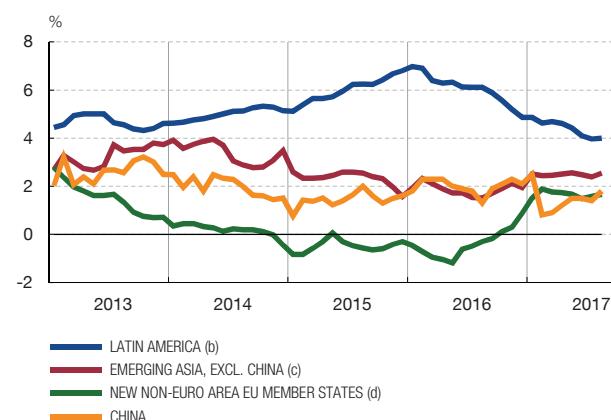
**1 GROSS DOMESTIC PRODUCT
Year-on-year rate**



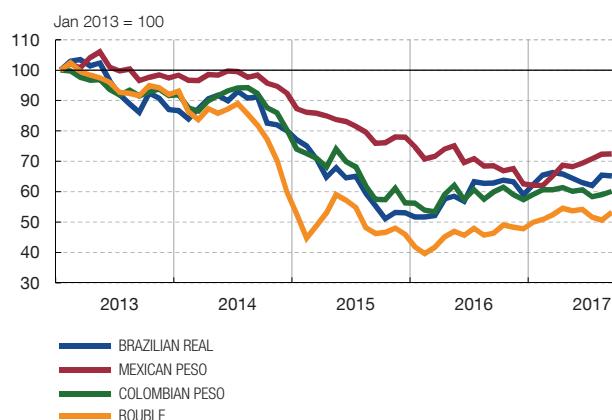
2 INTEREST RATE SPREADS OVER THE DOLLAR (e)



**3 CONSUMER PRICES
Year-on-year rate**



4 EXCHANGE RATES AGAINST THE DOLLAR (f)



SOURCES: Datastream, Banco de España, IMF and JP Morgan.

- a The aggregate of the different areas has been calculated using the weight of the countries that make up these areas in the world economy, drawing on IMF information.
- b Brazil, Chile, Colombia, Mexico and Peru.
- c Malaysia, Korea, Indonesia, Thailand, Hong-Kong, Singapore, Philippines and Taiwan.
- d Poland, Hungary, Czech Republic, Bulgaria, Romania and, from July 2013, Croatia.
- e JP Morgan EMBI spreads. Latin America includes Argentina, Brazil, Colombia, Ecuador, Mexico, Panama, Peru and Venezuela. Asia includes China, Indonesia, Iraq, Kazakhstan, Malaysia, Pakistan, Philippines, Sri Lanka and Vietnam. The data on the new EU Member States relate to Hungary, Poland, Romania and, from July 2013, Croatia.
- f A decrease in the index represents a depreciation of the currency against the dollar.

member countries was notably buoyant in Q2, especially in Poland, Romania and the Czech Republic. In Russia, GDP growth stood at 2.5% year-on-year in Q2, the best record in more than four years, thus confirming the favourable signs shown by the leading indicators.

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

The latest National Accounts estimates and the indicators relating to Q3 confirm the gradual improvement of economic activity in the euro area, underpinned by a very accommodative monetary policy and a relatively benign global environment. In this framework, the ECB's macroeconomic projections published at the start of September revised upwards the growth expectations for 2017, to 2.2%, while projecting a slowdown for 2018 and 2019.

Also, although core inflation, which excludes the more volatile components of prices, increased slightly, there are still no signs of a sustained adjustment towards the ECB's

| | 2015 | | 2016 | | | 2017 | | |
|---|------|------|------|-----|------|------|------|-----|
| | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 |
| National Accounts (quarter-on-quarter rate) | | | | | | | | |
| Gross domestic product | 0.4 | 0.5 | 0.3 | 0.5 | 0.6 | 0.5 | 0.6 | |
| Contributions to quarter-on-quarter change in GDP (pp) | | | | | | | | |
| Internal demand, excluding inventories | 0.6 | 0.6 | 0.8 | 0.3 | 0.7 | 0.2 | 0.6 | |
| Change in inventories | 0.1 | -0.1 | -0.3 | 0.2 | 0.1 | -0.1 | -0.1 | |
| Net external demand | -0.2 | 0.0 | -0.2 | 0.0 | -0.1 | 0.4 | 0.1 | |
| Other indicators | | | | | | | | |
| Unemployment rate (b) | 10.5 | 10.3 | 10.2 | 9.9 | 9.7 | 9.5 | 9.2 | 9.1 |
| HICP (year-on-year rate) (c) | 0.2 | 0.0 | 0.1 | 0.4 | 1.1 | 1.5 | 1.3 | 1.5 |
| CPI excl. unprocessed food and energy (year-on-year rate) (c) | 0.9 | 1.0 | 0.8 | 0.8 | 0.9 | 0.8 | 1.2 | 1.3 |

SOURCES: Eurostat, ECB and Banco de España.

a Information available up to 25 September 2017.

b Average for the quarter. Latest figure available, July 2017.

c End of the period. Latest available figure, August 2017.

reference of below, but close to, 2% over the medium term. In this connection, the latest ECB projections scarcely revise estimated inflation, which would stand at 1.5% in 2017, 1.2% in 2018 and 1.5% in 2019. The pass-through to consumer prices of the ECB's estimated appreciation of the euro is relatively modest, insofar as the recent exchange rate appreciation would be reflecting in part the improvement in domestic demand.

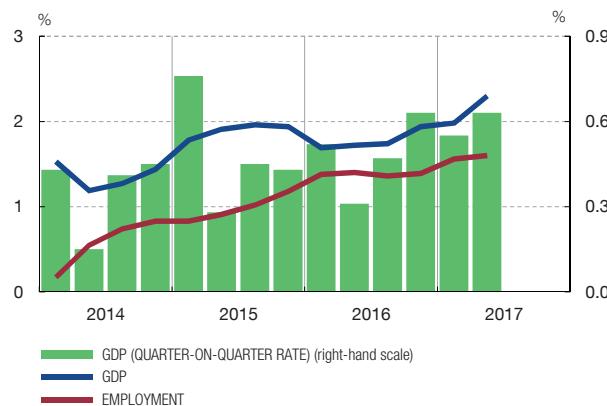
Against this background, The ECB Governing Council emphasised at its September meeting the need to preserve a high degree of monetary accommodation and announced that in October it will, in principle, adopt the bulk of decisions on the future of the asset purchase programme beyond the current horizon ending in December. Moreover, the Council reiterated the need, in the current circumstances, for the remaining economic policies to contribute resolutely to shoring up potential economic growth and to reduce possible vulnerabilities.

ECONOMIC DEVELOPMENTS

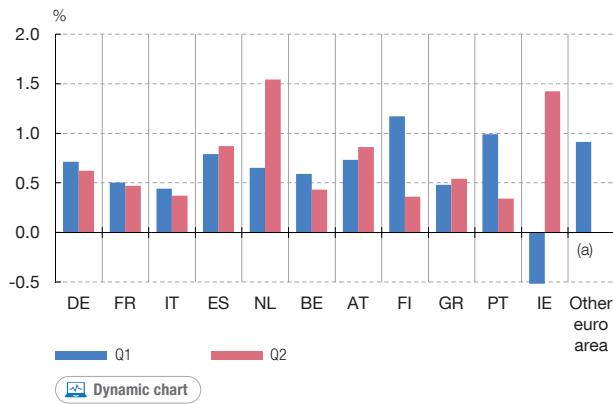
According to National Accounts, euro area GDP grew by 0.6% in 2017, 0.1 pp more than in the preceding quarter, buoyant across all countries and economic sectors (see Table 2). Year-on-year GDP grew to 2.3%, up from 2.0% in Q1. In terms of components, the increase in output was once again underpinned by consumption, both private and government, and by gross fixed capital consumption. The contribution of net external demand remained positive, although lower than in the previous quarter. In the main countries of the area, the stance of growth was of marked stability. Thus, it slowed down by 0.1 pp in Germany, to 0.6%, sped up by 0.1 pp in Spain, to 0.9%, and remained unchanged in France and Italy (at 0.5% and 0.4%, respectively). Employment in the euro area remained notably strong, increasing in 2017 Q2 by 0.4% quarter-on-quarter, following the 0.5% increase of the preceding quarter.

The conjunctural information available for 2017 Q3 generally suggests that the buoyancy of activity will continue (see Chart 5). The business confidence indicators prepared by the European Commission (EC) and the PMI surveys recorded additional increases across the board. Also, the EC consumer confidence indicator remained at historically high levels, as occurred with job creation expectations in services and construction, while expectations relating to industry prolonged their rise. As regards external demand, the assessment of export orders backtracked in July and August, in contrast to better expectations in export performance in Q3.

1 OUTPUT AND EMPLOYMENT
Year-on-year rate



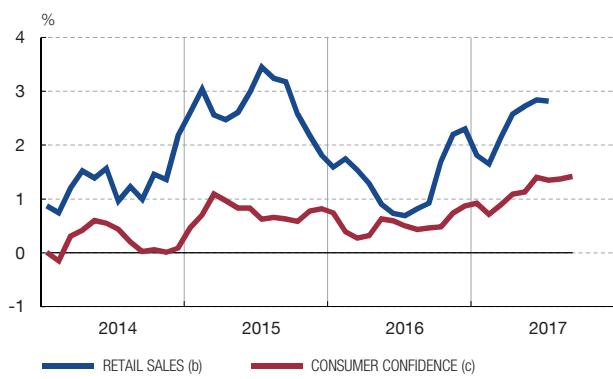
2 GDP BY COUNTRY
Quarter-on-quarter rate



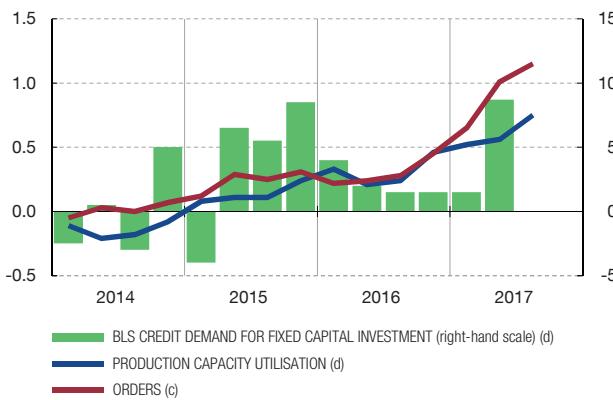
3 INDUSTRIAL ACTIVITY AND SERVICES INDICATORS



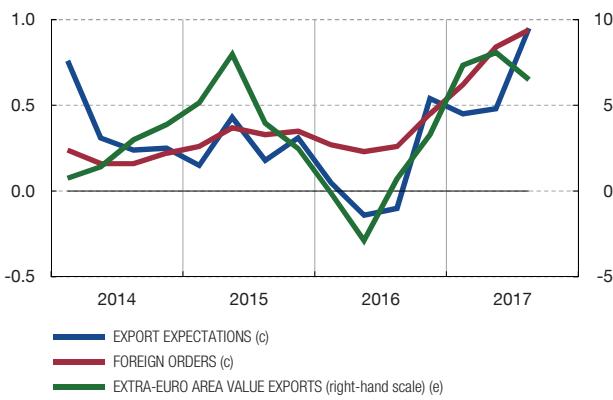
4 CONSUMPTION INDICATORS



5 INVESTMENT INDICATORS



6 EXPORT INDICATORS



SOURCES: Eurostat, Markit Economics and Banco de España.

- a Q2 figure not available.
- b Year-on-year rates, calculated on the basis of the non-centred quarterly moving average of the seasonally adjusted series.
- c Normalised series for the period represented.
- d Bank Lending Survey. Indicator = percentage of banks reporting a considerable increase + percentage of banks reporting some increase $\times 0.5$ – percentage of banks reporting some decrease $\times 0.5$ – percentage of banks reporting a considerable decrease. A positive value denotes an increase.
- e Year-on-year rates of the original monthly series. Quarterly average.

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| | 2017 | | 2018 | | 2019 | |
|---|------|------|------|------|------|------|
| | GDP | HICP | GDP | HICP | GDP | HICP |
| European Central Bank (September 2017) | 2.2 | 1.5 | 1.8 | 1.2 | 1.7 | 1.5 |
| European Commission (May 2017) | 1.7 | 1.6 | 1.8 | 1.3 | — | — |
| OECD (June 2017) | 1.8 | 1.7 | 1.8 | 1.4 | — | — |
| International Monetary Fund (July 2017) | 1.9 | — | 1.7 | — | — | — |
| Consensus Forecast (September 2017) | 2.1 | 1.5 | 1.8 | 1.3 | — | — |
| Eurobarometer (September 2017) | 2.1 | 1.5 | 1.8 | 1.3 | — | — |

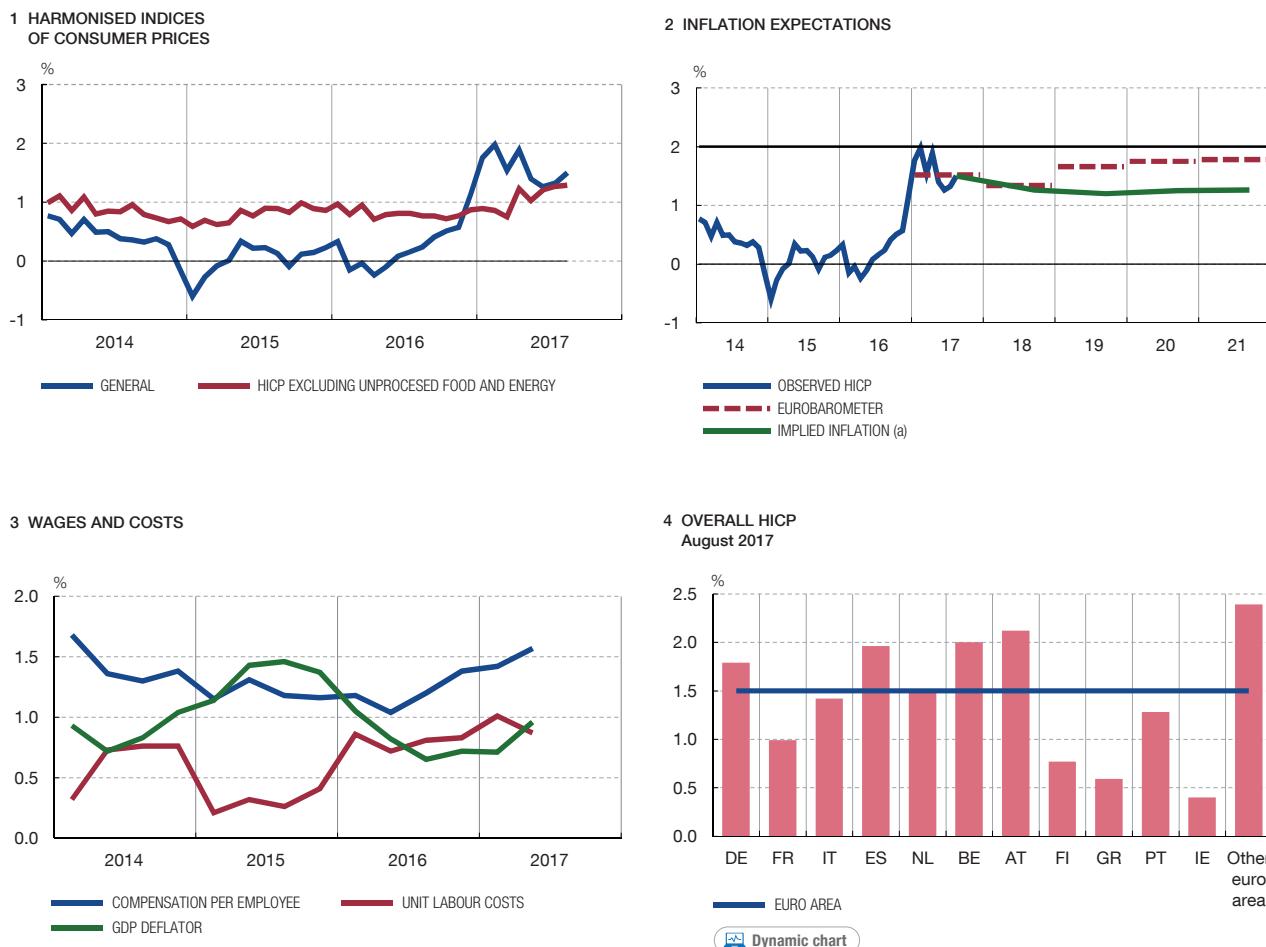
SOURCES: ECB, European Commission, Consensus Forecast, IMF, MJ Economics and OECD.

In contrast, the quantitative indicators available, with more lagged information, provide somewhat less favourable results. Thus, retail sales and new car registrations declined in July, although the latter rebounded in August. On the supply side, the industrial output index posted a marked fall-off in June, followed by a slight increase in July. The unemployment rate held at 9.1% in July.

In summary, the latest information available broadly confirms the strength of the recovery in the euro area. Economic growth continues to rest on private consumption, driven by the favourable financial conditions, the buoyancy of employment and higher household wealth. Greater dynamism of investment is also seen, sustained by higher corporate profitability. Lastly, the recovery of global trade is having a positive effect on exports, offsetting the negative impact associated with the appreciation of the euro. The projections available for the medium term point to an extension of the economic recovery that is consistent with some moderation of the recent momentum. Thus, in its projections exercise of early September, the ECB has raised growth expectations for 2017 by 0.3 pp – to 2.2% – as a result of the revisions of the National Accounts figures in late 2016 and the greater momentum recorded in 2017 H1, and has maintained the projections for 2018 and 2019 at 1.8% and 1.7%, respectively (see Table 3).

As regards prices, inflation was more stable in the last few months, following the volatility recorded at the start of the year, standing at 1.5% in August. Core inflation reached 1.3% for the second month running, although the signals indicating a sustained increase in core inflation are still preliminary. Despite the vigour of activity, the moderate rise in unit labour costs and the appreciation of the euro exchange rate are contributing to keeping the inflation rate at low levels. In this context, the latest ECB projections marginally revised inflation rates downwards for the horizon 2017-2019, to 1.5%, 1.2% and 1.5%, respectively. The indicators of medium- and long-term inflation still remain far from the target of 2%.

Low interest rates and sound recovery have underpinned the gradual reduction in the euro area budget deficit in recent quarters. Overall, it is considered that the fiscal policy stance will remain practically neutral in 2017 owing to a combination of discretionary measures, marginally expansionary in Germany and The Netherlands, and slightly contractionary in France. In addition, the Council has closed the Excessive Deficit Procedure for Greece in view of the improvement in the budgetary position of its economy following several years of fiscal consolidation. Accordingly, only two euro area economies – Spain and France – remain under the corrective arm of the Stability and Growth Pact.



SOURCES: Eurostat, Reuters and ECB.

a Implied inflation calculated on the basis of inflation swaps.

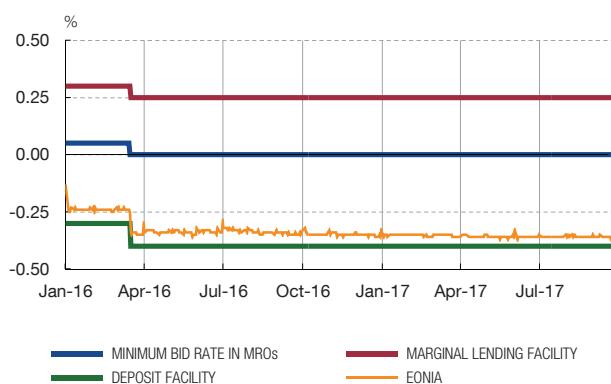
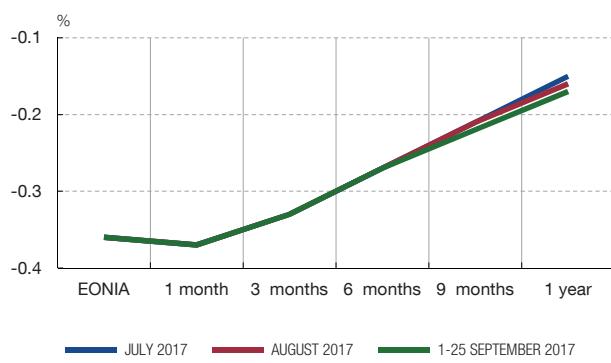


FINANCIAL DEVELOPMENTS AND MONETARY POLICY

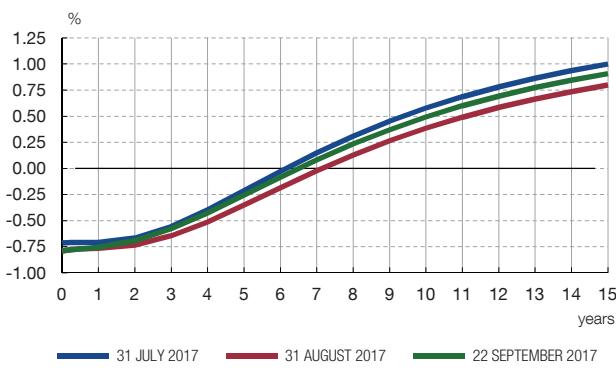
Financial market performance in Q3 was marked by the appreciation of the euro exchange rate (see Chart 7). In the sovereign bond markets, the yields and spreads over the benchmark German bund experienced uneven and generally small movements. Stock market prices held, with fluctuations, within a relatively narrow range. Also, the decrease in bank stock volatility and in risk premia observed in the first half of the year was not affected by the winding up and restructuring of certain European institutions mid-year and, although bank share prices checked their rising trajectory, no notable episodes of contagion were observed (see Box 6).

Against a background of containment of core inflation (which is generally a sound predictor of headline inflation in the medium term), the ECB Governing Council, at its September meeting, held policy interest rates (at 0% for the main financing operations and at 0.25% and -0.40% for the marginal lending and deposit facilities, respectively), indicating that they would continue at the current levels for a prolonged period extending beyond the horizon of the asset purchase programme (APP). In connection with the latter, the Council confirmed that purchases will continue at the current pace of €60 billion net per month until December 2017 or later if necessary and, in any event, until a sustained adjustment in inflation is observed to values more consistent with the medium-term objective. The Council

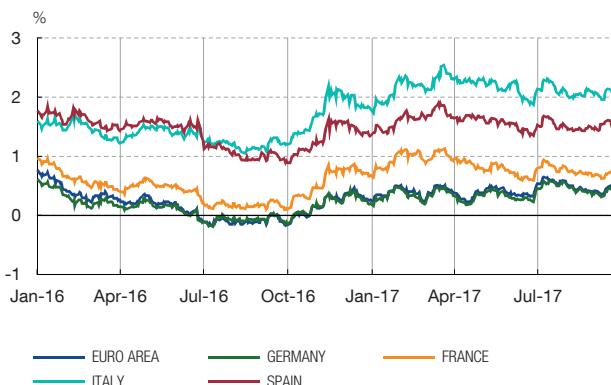
1 EONIA AND ECB INTEREST RATES

2 INTERBANK MARKET
Monthly average

3 ZERO COUPON CURVE (a)



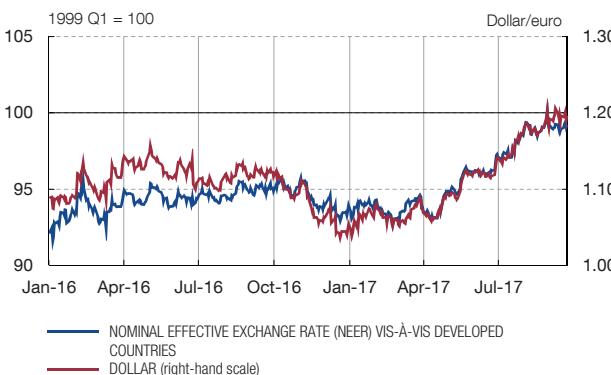
4 TEN-YEAR GOVERNMENT DEBT YIELDS



5 EURO STOXX 50 INDEX AND IMPLIED VOLATILITY



6 NOMINAL EURO EXCHANGE RATES

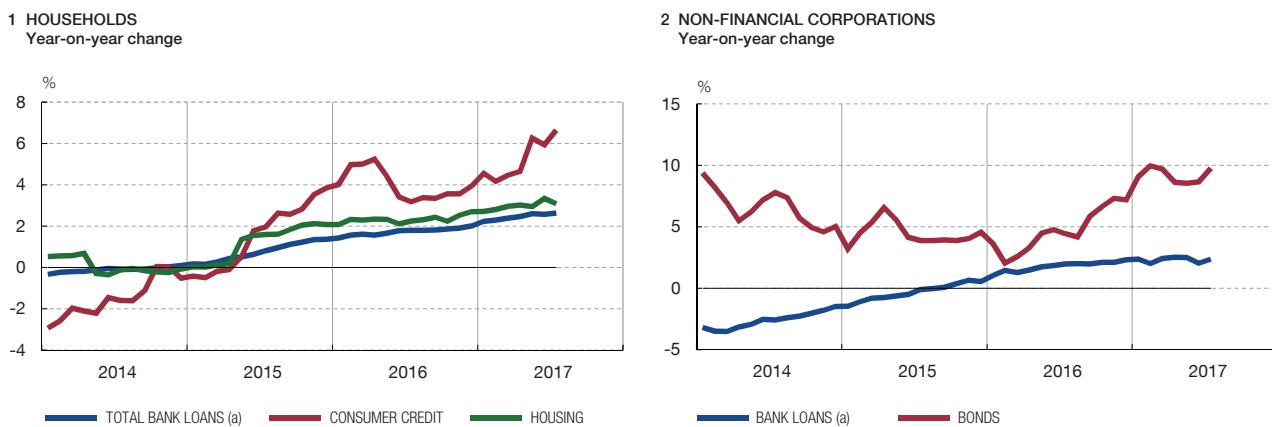


SOURCES: ECB and Banco de España.

a Estimated by the European Central Bank using swap market data.

considered that a highly substantial degree of monetary accommodation was still necessary for inflation to reach in a sustained manner a level more consistent with the medium-term reference of 2%, announcing that in autumn it will decide on the changes to the parameters of the asset purchase programme that will become effective after end-2017.

Government debt yields and the spreads over the benchmark German bund – whose yields stood at 0.42% at end-September – have trended unevenly (see Chart 7.4), with



SOURCE: ECB.

a Adjusted for securitisation and other transfers.

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changes which were generally small, except in Portugal, where a decline was observed, and Greece, with an increase. The yield spread between the US 10-year government bonds and the Bund stood at around 180 bp, similar to the level reached at end-June.

On the stock markets, the Eurostoxx 50 posted a rise of 2.8% for the quarter as a whole, meaning it is up by 7.5% since the start of the year in a setting of low volatility. Bank share prices fluctuated within a small range, halting the rising trend recorded in the first half of the year (see Box 6).

The most notable development on the currency market in Q3 was the appreciation of the nominal effective exchange rate of the euro, by 2.0%, after having appreciated by 4.2% in Q2 (see Chart 7.6). By currency, the euro appreciated across the board. In particular, the single currency appreciated by 4.0% against the dollar, standing as this bulletin went to press at \$1.19, a level not reached since early 2015.

Lastly, loans to non-financial corporations and households continued on their recovering path in July, reaching year-on-year rates of change of 2.4% and 2.6%, respectively. This reflects an acceleration of the loans granted to companies and a stabilisation at similar rates to the preceding month of those extended to households (see Chart 8). The euro area bank lending survey for 2017 Q2 suggests that the growth of credit is supported both by an improvement in lending conditions (except in the case of consumer loans) and by the increase in demand in all segments. As regards the monetary aggregates, the year-on-year growth rate of M3 decreased by 0.5 pp in July, to stand at 4.5%, and that of the narrowest aggregate, M1, slowed by 0.6 pp, to 9.7%.

3 THE SPANISH ECONOMY

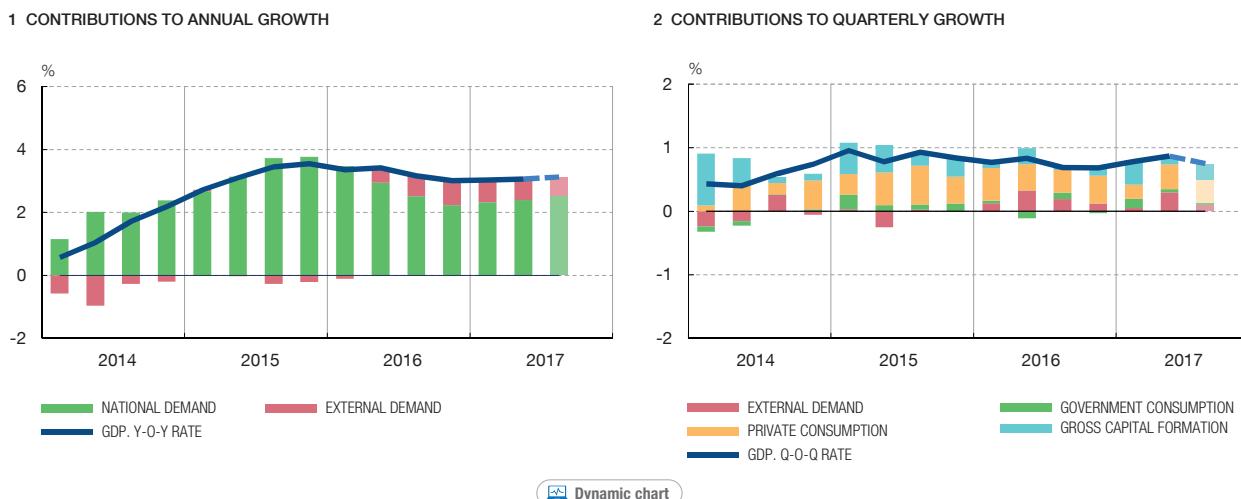
In 2017 Q2 Spanish GDP grew by 0.9% quarter-on-quarter, which rate was 0.1 pp higher than in Q1 (see Chart 9). GDP growth in April-June was largely based on domestic demand, although its positive contribution of 0.6 pp was somewhat lower than in the preceding quarter. The diminished buoyancy of this aggregate was a reflection of the slowdown in investment (excluding the construction component) and in government consumption that was not offset by the step-up in private consumption. The positive contribution of net external demand was up 0.2 pp on the previous quarter to 0.3 pp, as a result of a greater slowdown in imports than in exports, following the notable strength of both flows at the beginning of the year. In year-on-year terms, GDP grew by 3.1% in Q2, up 0.1 pp on the previous quarter, and employment accelerated by 0.3 pp to 2.8%.

According to the latest conjunctural information, in Q3 GDP grew at a slightly lower rate than in the previous quarter, to around 0.8%, and continued to be underpinned by national demand. The indicators available for the external sector, which are still rather incomplete, point to a slightly positive contribution from external demand, albeit lower than that recorded in Q2. Lastly, employment weakened in Q3, after the high growth rate observed in the previous quarter.

In Q3 to date, consumer prices have maintained a stable growth rate, following the sharp increase at the beginning of the year and subsequent slowdown to June. However, a certain degree of heterogeneity across components has been observed in the most recent period. Thus, unprocessed food prices and, to a lesser extent, prices of non-energy industrial goods and of services decelerated between June and August, which slowdown was more than offset by the rise in energy and processed food prices. As a result, the annual rate of change of the CPI rose to 1.6 % in August, 0.1 pp more than that observed in the two preceding months, while the CPI excluding unprocessed food and energy, which proxies core inflation, rose by 1.2%, the same annual rate as in June.

In 2017 Q3, the volatility of the Spanish financial markets remained low, at levels close to historical lows, without the various bouts of financial stress recorded in the period causing significant turbulence (as observed at global level, see Box 2). In the stock markets, as at the cut-off date for this report the IBEX 35 was down 2.2% on its end-June levels, performing less favourably than the EURO STOXX 50 which, over the same period, climbed by 2.8%. On the sovereign debt markets, the Spanish 10-year bond yield rose slightly in the period, to 1.6%, while its German equivalent declined marginally, broadening the spread between the two by 13 bp to 120 bp (see Chart 10.1). Credit risk premia on debt securities issued by financial and non-financial corporations have barely changed. Finally, on the interbank market, interest rates have not varied, meaning that the one-year EURIBOR remains in negative territory (-0.17%).

Interest rates on bank loans to households and corporations have remained at low levels, helping to boost activity on credit markets, with a further upturn in the volume of new credit. However, the year-on-year falls in the outstanding balances of bank loans to households and corporations intensified somewhat in recent months, although in the case of corporations this was linked to ad hoc transactions by one credit institution. Lastly, according to the most recent information on the financial position of households, relating to 2017 Q2, it seems that the household debt ratio hardly varied in this period, while the debt burden declined slightly. In the case of corporations, both indicators seem to have declined again.



SOURCES: INE and Banco de España.

a Seasonally adjusted series.

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Dynamic chart

3.1 Household spending decisions

The latest information seems to show that household consumption expenditure rose by 0.6% quarter-on-quarter in Q3, slightly below the 0.7% observed in the period April-June (see Chart 11). In general terms, both the qualitative and quantitative indicators performed more moderately than in the previous quarter. Qualitative indicators that lost momentum included the consumer confidence index and the consumer goods PMI, although they remain at relatively high levels. In addition, most of the quantitative indicators performed less favourably, with more moderate increases than in the previous quarter in Social Security registrations and in the retail trade and consumer goods industrial production indices.

In the case of residential investment, the information available points to a continuation of its recent slowdown in Q3, although growth rates remain high, against a background of lower growth of coincident indicators, particularly in employment and the production of construction materials. The prices of open market housing, according to INE data, further accelerated in Q2 to a year-on-year rate of 5.6%, compared with 5.3% in Q1. This greater buoyancy was explained by developments in the prices of second-hand housing, which accounts for the bulk of transactions. Box 4 has an overview of developments in residential investment since the start of the recovery.

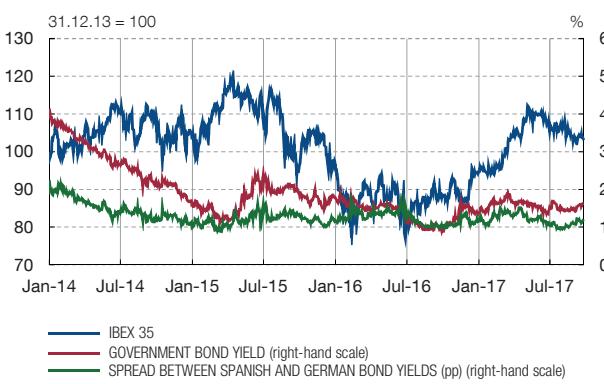
From March to July, interest rates on new loans to households held at low levels. The cost of new house purchase loans remained at its historical low (2.2%), while the cost of new credit for consumption and other purposes, which is more volatile, fell by 0.3 pp to 6.3% (see Chart 10.2).

According to the information from the July edition of the Bank Lending Survey (BLS), institutions' credit standards for households remained unchanged in Q2, both for house purchases and for consumption and other purposes, while the general conditions applied to loans eased in both segments (especially margins on average loans). On the demand side, institutions participating in the BLS pointed to further increases in credit applications both for house purchases and for consumption and other purposes, and demand was expected to increase again in both segments in 2017 Q3.

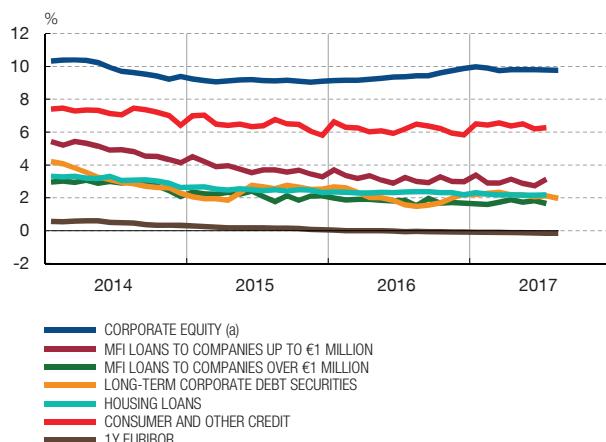
FINANCING CONDITIONS

CHART 10

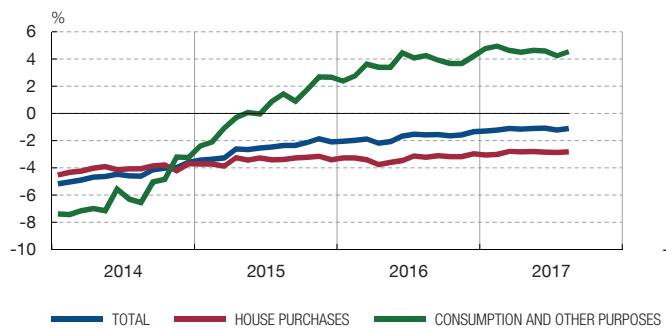
1 EQUITY AND 10-YEAR GOVERNMENT BOND MARKETS



2 COST OF FINANCING



3 LENDING TO HOUSEHOLDS Year-on-year rates (b)



4 FINANCING OF COMPANIES Year-on-year rates (b)



SOURCES: Bloomberg, Reuters, Datastream, MSCI Blue Book, INE and Banco de España.

- a The cost of equity is based on the three-stage Gordon dividend discount model.
- b Lending includes off-balance-sheet securitisation and loans transferred to Sareb.
- c Loans from resident credit institutions and specialised lending institutions.

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In this setting of favourable financing conditions and growing demand, the volume of new loans to households, both for house purchases and for consumption and other purposes, continued to rise between March and July. However, the year-on-year fall-off in the outstanding balance of household debt stood at 1.4% in July, 0.3 pp higher than in March, against a background of an increase in loan repayments (see Chart 10.3). A breakdown by type of loan shows that this was due to a greater contraction in credit for house purchases (3.1% in July, compared with 2.8% four months earlier), while credit for consumption and other purposes increased by 4.2%, slightly down on the March figure (4.6%).

According to the latest available data, the household debt ratio barely changed between March and June 2017, since the slight increase in debt, in line with the seasonal pattern for this quarter, was offset by the growth in income. This, together with a moderate reduction in the average cost of liabilities, translated into a decline in the associated debt burden (see Chart 12). The net wealth of households continued to expand in this period, as a result of the increase in their real estate wealth, driven by the rise in the value of housing, and to a lesser extent in their financial wealth (as a result of a higher increase in financial assets than in liabilities).

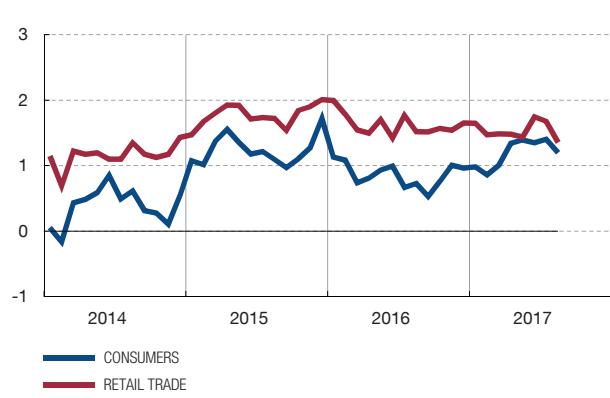
1 HOUSEHOLD SPENDING (QNA) (a)



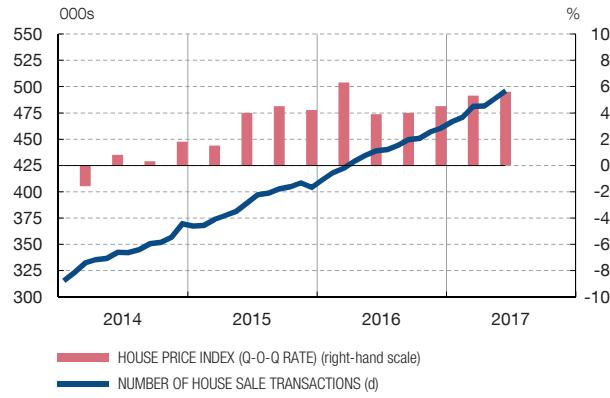
2 CONSUMPTION INDICATORS (b)



3 CONFIDENCE INDICATORS (c)



4 HOUSE PRICES AND TOTAL TRANSACTIONS



SOURCES: INE, European Commission, ANFAC, Centro de Información Estadística del Notariado and Banco de España.

- a Quarter-on-quarter rates calculated using seasonally adjusted series.
- b Rates of change of moving average of three terms with three time lags, calculated using the seasonally adjusted series. The dots represent quarter-on-quarter rates.
- c Normalised confidence indicators (difference between the indicator and its mean value, divided by the standard deviation).
- d 12-month moving sum.

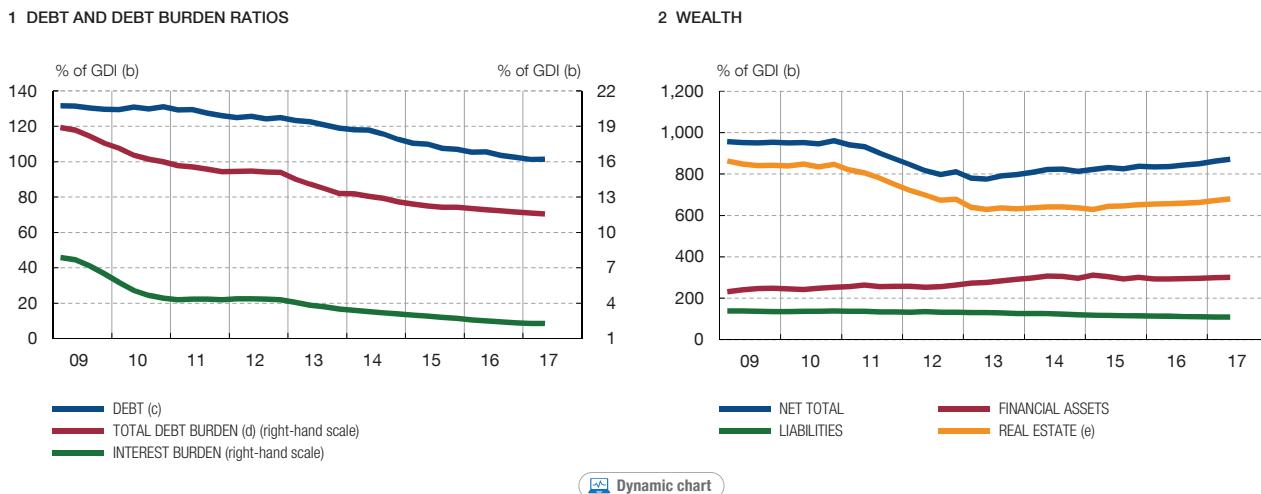


3.2 Business activity and investment

Business activity, proxied by the real value added of the market economy, largely appears to have maintained the growth rate observed in Q2, with no notable differences among the main sectors of activity.

Specifically, the information on industry and energy seems to point to similar growth in Q3 as in Q2. In this respect, the pace of growth of Social Security registrations in industry was steady, similar to that observed in the first half of the year. The signal given by the industrial production index (IPI) was in the same vein. Among the qualitative indicators, the European Commission's industrial confidence indicator fell in the period July-August, continuing on the downward path that emerged in the previous quarter. As regards the manufacturing PMI, the most recent data show a decline, in contrast with the improvement in the case of the euro area.

The pace of growth of activity in market services also seems similar to that observed in Q2, although there are signs that this growth is tailing off. This is the case of the quantitative indicators, where both the services sector activity indicator (IASS, by its Spanish acronym) and Social Security registrations seem to show a slight loss of momentum in Q3. Among



SOURCES: INE and Banco de España.

- a Last data point in each series is an estimate.
- b Cumulative four-quarter data.
- c Includes MFI lending and off-balance-sheet securitised lending.
- d Estimate of interest payments and capital repayments.
- e Valuation based on estimated changes in stock of housing, average floor space and price per square metre.

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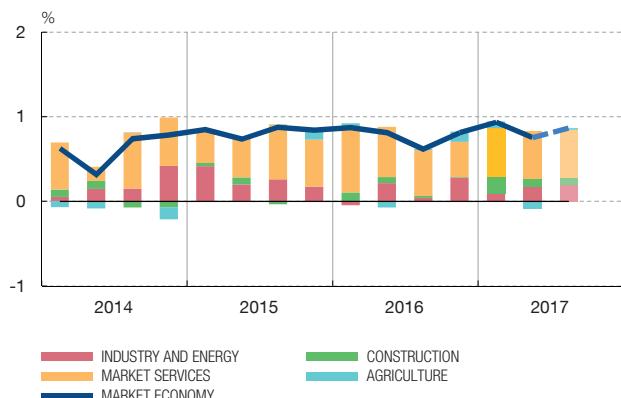
the qualitative indicators for market services, the European Commission's services confidence indicator posted an improvement in Q3 while, by contrast, the average level of the services PMI was lower in Q3 than in Q2.

Compared with the developments in all other sectors of activity, in the construction sector value added recorded a slight loss of momentum, although growth rates remained high. The most recent indicators, such as the industrial production index for manufacture of non-metallic mineral products and the number of Social Security registrations in the sector, seem to confirm this slowdown.

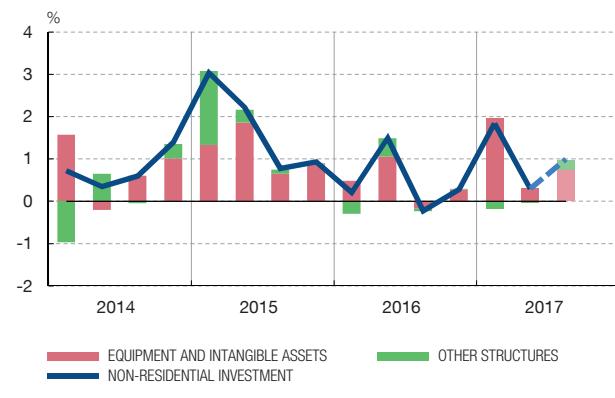
Lastly, investment in capital goods is expected to have quickened compared with Q2, although the growth pattern observed in the first half of the year could reflect investment decisions being taken that had been postponed in the last stretch of 2016, most likely owing to the legislative changes affecting corporate income tax. Thus, the increase in Q3 would be around 1.5%, implying a return to growth rates closer to those observed in the first half of 2016. In this respect, of particular note is the improvement in the industrial production index for capital goods and in commercial vehicle registrations. The qualitative indicators, however, were generally weak, with a decline in new orders both in the manufacturing sectors overall and in the capital goods industry.

In recent months, average interest rates on new bank loans to non-financial corporations have remained at low levels. According to the most recent data, interest rates on new loans over €1 million have remained at 1.7%, while interest rates on new loans under that amount stood at 3.1% in July, compared with 2.9% in March. In addition, between March and August the cost of equity barely changed, while the cost of long-term corporate debt issues fell (see Chart 10.2). Moreover, according to the latest BLS, there was no change in credit standards for loans to firms in Q2. Margins on average loans remained unchanged,

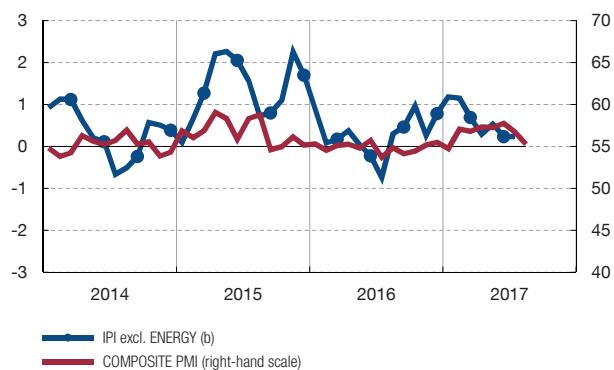
1 MARKET ECONOMY GVA (a)
Quarter-on-quarter rates and contributions



2 NON-RESIDENTIAL INVESTMENT (a)
Quarter-on-quarter rates and contributions



3 ACTIVITY INDICATORS



4 INVESTMENT INDICATORS (b)



SOURCES: INE, Ministerio de Fomento, Markit, Oficemen and Banco de España.

a Seasonally adjusted series.

b Rates of change of moving average of three terms with three time lags, calculated using the seasonally adjusted series. The dots represent quarter-on-quarter rates.



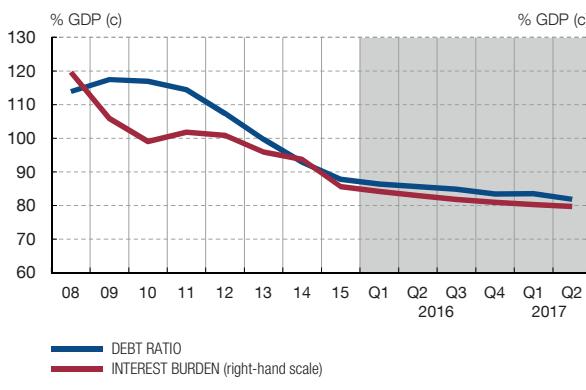
while margins on higher risk loans widened slightly. In turn, in accordance with the BLS, demand for loans by firms was steady in 2017 Q2.

In this setting, the volume of new lending in loans of less than €1 million, which is the segment most used by SMEs, accelerated again between March and July, while the recent pick-up observed in the volume of new lending in loans over €1 million strengthened, posting positive growth rates year-on-year since May. Nevertheless, in terms of outstanding balances, loans granted by resident institutions to non-financial corporations, which had risen modestly between March and May, contracted in year-on-year terms from June. It should be noted, however, that this turnaround stems from extraordinary transactions related to debt write-offs by one credit institution. If credit flows are corrected for these transactions, the rate of change of bank loans is moderately positive. For its part, market-based debt financing, including financing by subsidiaries abroad, remained buoyant, although slightly less so than in Q1 (see Chart 10.4). On information from the Banco de España's Central Credit Register, the aggregate contraction in the balance of lending was compatible with a further rise in the proportion of firms that maintained or increased their lending levels.

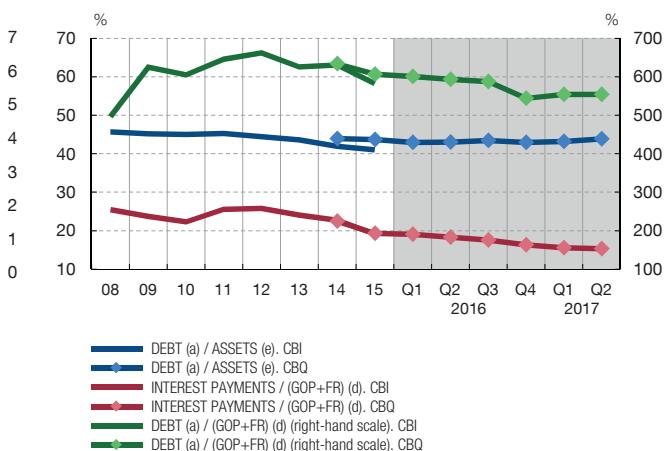
INDICATORS OF THE FINANCIAL POSITION OF NON-FINANCIAL CORPORATIONS

CHART 14

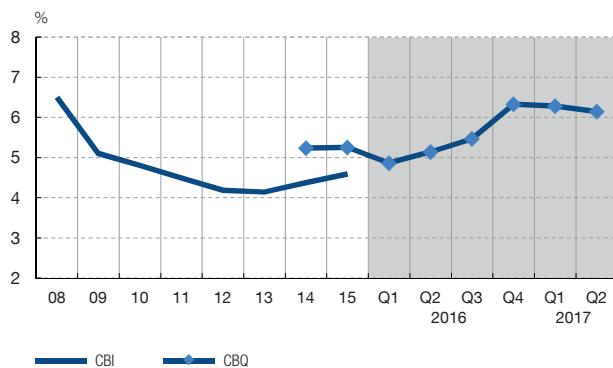
1 DEBT (a) AND INTEREST BURDEN. NATIONAL ACCOUNTS (b)



2 DEBT AND DEBT BURDEN. CBSO



3 RETURN ON INVESTMENT. CBSO (f)



4 SYNTHETIC INDICATORS OF FINANCIAL PRESSURE (g)



SOURCES: INE and Banco de España.

a Interest-bearing borrowing.

b The last data point in each series is an estimate.

c GDP data series is seasonally adjusted.

d Gross operating profit (GOP) plus financial revenue (FR).

e Defined as total inflation-adjusted assets less non-interest bearing liabilities.

f Defined as ordinary net profit/net assets.

g Indicators calculated on the basis of annual CBSO data, or quarterly data where no annual data are available. A value of more (less) than 100 denotes higher (lower) financial pressure than in the base year.

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Lastly, the financial position of non-financial corporations is estimated to have continued to strengthen in Q2. Specifically, the debt ratio and, to a lesser extent, the debt burden ratio are expected to have continued to decline as a percentage of GDP, as a result both of debt contraction and GDP growth (see Chart 14). Also, for the sample of corporations reporting to the Central Balance Sheet Data Office Quarterly Survey (CBQ), productive activity contracted in 2017 H1 compared with 2016 H1 (gross value added generated by these firms fell by 0.5%, compared with growth of 2.7% a year earlier).¹ However, this was strongly influenced by the performance of a number of large corporations that account for a substantial share of this sample, concentrated above all in the energy sector. Excluding

¹ See Analytical Article, "Results of non-financial corporations for 2017 Q1-Q2", *Economic Bulletin* 3/2017, Banco de España.

this sector, gross value added (GVA) rose by 2.2%, which is very close to the figure for the same aggregate a year earlier (2.1%). Despite the overall contraction in GVA, the favourable performance of financial revenue and costs led to a slight increase in ordinary profit, but this was not sufficient to prevent a moderate fall in ordinary profitability levels compared with a year earlier. Lastly, there was no significant change in the debt and debt burden ratios of the firms in the sample.

3.3 The external sector and the balance of payments

The scant information available for Q3, exclusively for the month of July, seems to point to a decline in the positive contribution of net external demand to quarter-on-quarter GDP growth, after it rose to 0.3 pp in Q2. This, against a background of stronger growth in foreign trade in goods and services, especially imports, following the sluggishness observed in Q2. The pace of growth of trade with the rest of the world is also expected to be somewhat higher in year-on-year terms in Q3 (see Chart 15).

Customs data for July showed growth in export and import flows of 4.3% and 8.6%, respectively, year-on-year in real terms. By type of goods, the growth in exports of intermediate goods, especially energy goods, was noteworthy, while exports of consumer durables continued in the downward pattern observed in Q2. By geographical area, sales outside the EU remained buoyant, while sales to the EU decelerated. For their part, imports increased in July in all types of goods, particularly energy and capital goods and consumer durables.

On the most recent information, for July and August, inbound tourism seems to have continued to expand at a vigorous pace, in a setting in which the economic position of Spain's main European markets has improved. There are still very scant data available from indicators to permit an accurate assessment of the repercussions of the terrorist attacks perpetrated in mid-August in Catalonia. Specifically, the information from hotel and flight reservations and tourist packages seems to indicate that the impact could be quite contained. Overnight hotel stays continued to increase in August, although at a more subdued pace than in previous months, while foreign tourist arrivals maintained their strong momentum in July, underpinned by the solidity of inflows of British and German tourists and by the strength of other more minor markets for the Spanish industry such as the United States and Russia. In addition, the growth in nominal tourist expenditure heightened in July, with increases in average spend per day and per tourist.

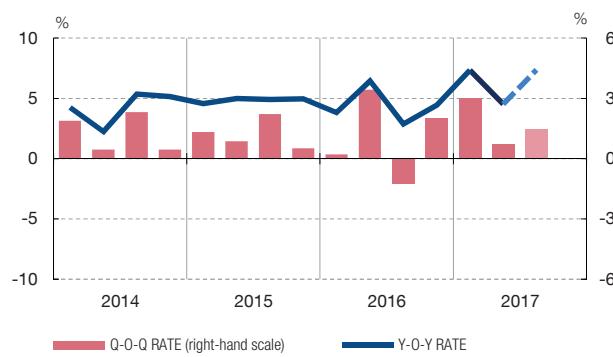
The net lending position of the Spanish economy declined moderately in the most recent period. Specifically, in cumulative 12-month terms, the surplus on the balance of payments stood at 1.9% of GDP in June (0.2 pp lower than in 2016 as a whole). This decline is essentially explained by the widening of the energy deficit, linked to higher oil prices, which offset the improvement in the income deficit. The services surplus, which declined very slightly as a percentage of GDP, reflects both the higher outbound tourism expenditure of Spanish residents and the lower surplus on other services which, combined, countered the strong pace of the revenue associated with the record high foreign tourist arrivals.

Regarding cross-border financial flows, the latest balance of payments data (for 2017 Q2) show that foreign agents increased their holdings of assets issued by residents by €27.6 billion, the highest quarterly change since early 2015. These were chiefly portfolio investment (€26.7 billion) and, to a lesser extent, direct investment (€3.3 billion), while the net change in other investment was negative (-€2.3 billion). At the

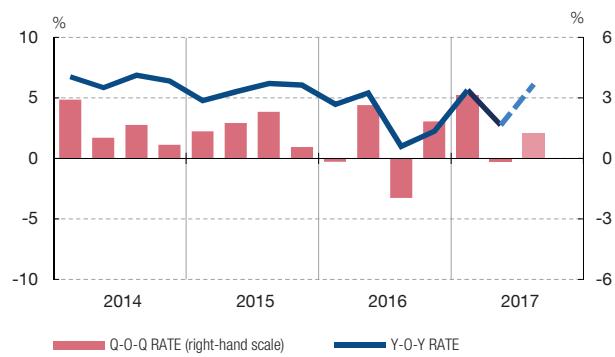
FOREIGN TRADE AND BALANCE OF PAYMENTS

CHART 15

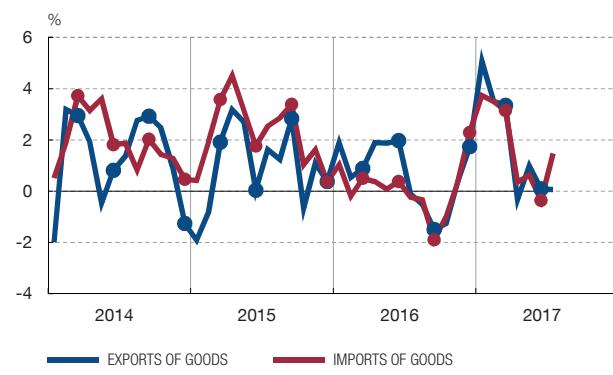
1 EXPORTS OF GOODS AND SERVICES (a)



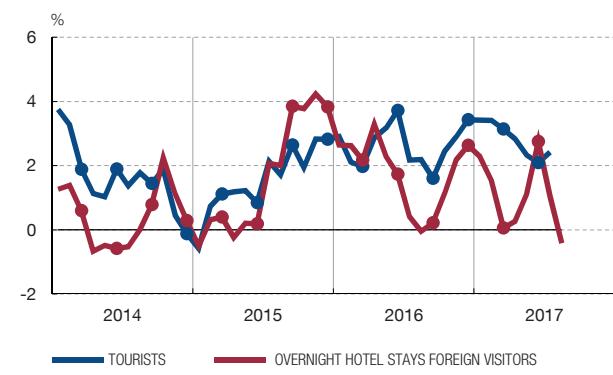
2 IMPORTS OF GOODS AND SERVICES (a)



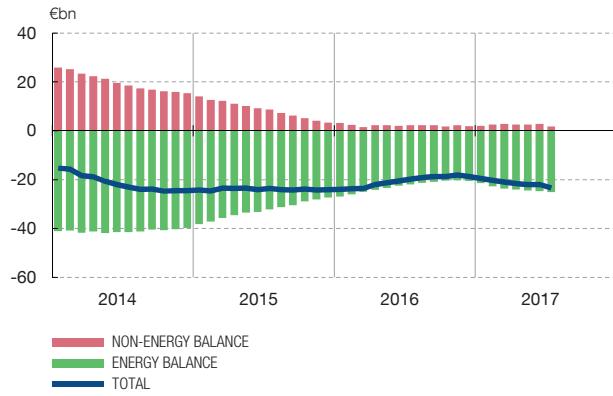
3 CUSTOMS INDICATORS (b) (c)



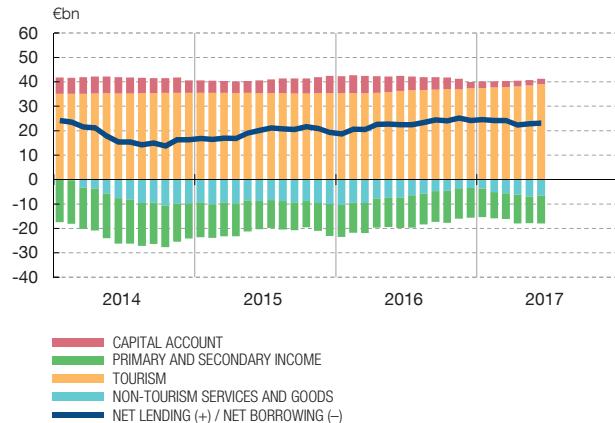
4 TOURISM INDICATORS (c)



5 FOREIGN TRADE IN GOODS
Cumulative last 12 months



6 BREAKDOWN OF CURRENT AND CAPITAL ACCOUNT (d)
Cumulative last 12 months

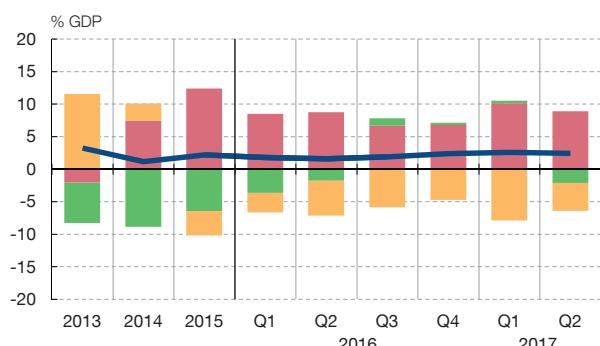


SOURCES: INE, Ministerio de Economía, Industria y Competitividad and Banco de España.

- a QNA data at constant prices. Seasonally adjusted series.
- b Series deflated using export (IPRIX) and import (IPRIM) price indices for industrial products.
- c Rates of the 3-month moving average with three time lags, calculated using seasonally adjusted series. Dots depict quarter-on-quarter rate.
- d Data conform to the sixth edition of the IMF's Balance of Payments and International Investment Position Manual (BPM6).

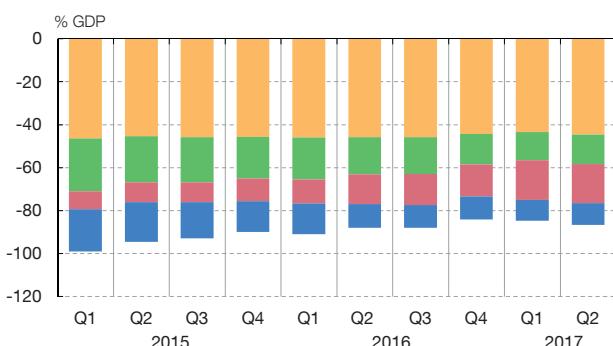


1 FINANCIAL ACCOUNT OF THE BALANCE OF PAYMENTS (a)



█ NET CHANGE BANCO DE ESPAÑA
█ CHANGE IN LIABILITIES EXCL. BANCO DE ESPAÑA (b)
█ CHANGE IN ASSETS EXCL. BANCO DE ESPAÑA
█ BALANCE ON FINANCIAL ACCOUNT

2 INTERNATIONAL INVESTMENT POSITION (c)



█ MONETARY FINANCIAL INSTITUTIONS (EXCL. BANCO DE ESPAÑA)
█ BANCO DE ESPAÑA
█ OTHER RESIDENT SECTORS
█ GENERAL GOVERNMENT

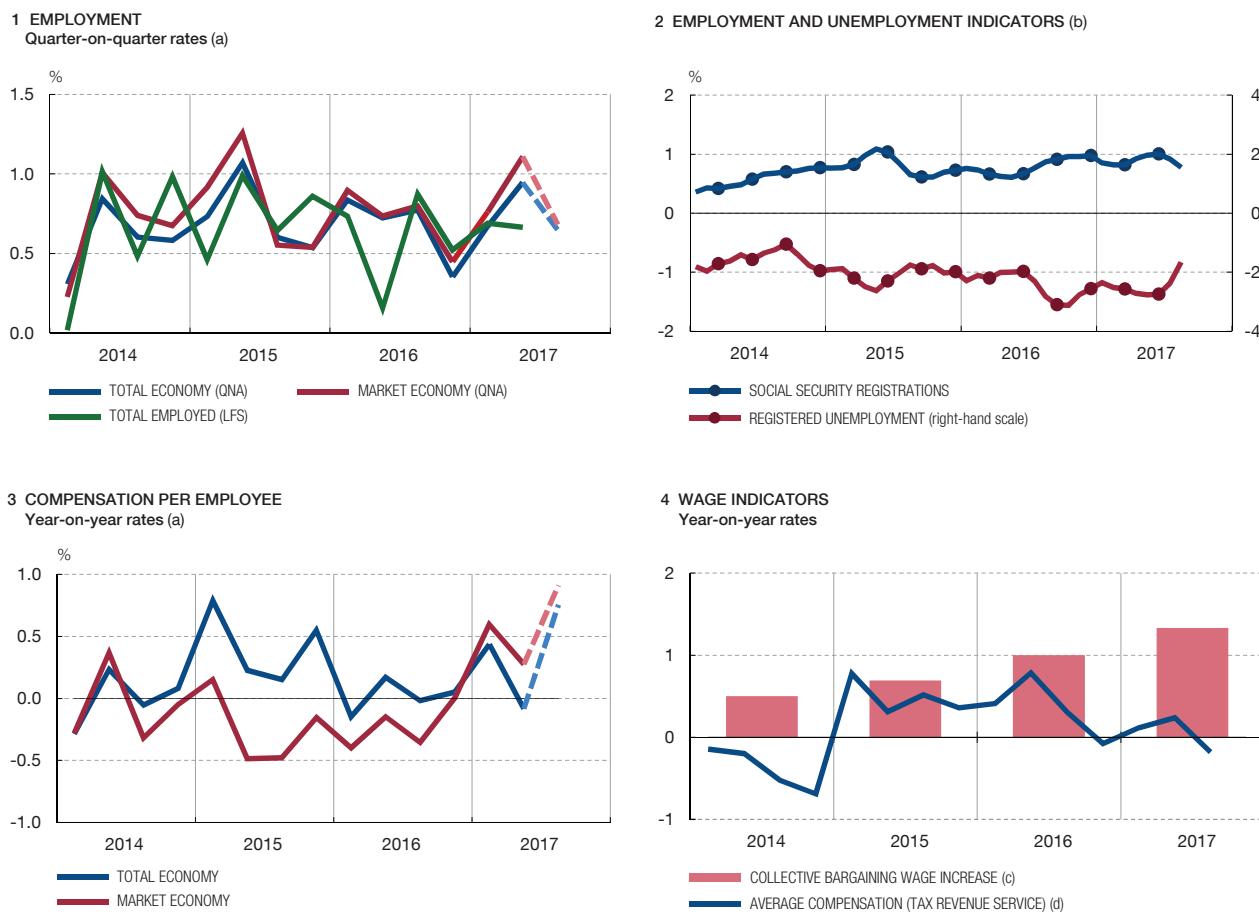
SOURCE: Banco de España.

- a Four-quarter cumulative quarterly data.
- b Sign changed.
- c Assets minus liabilities vis-à-vis the rest of the world.

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same time, net purchases of assets abroad by resident agents, excluding the Banco de España, amounted to €25.8 billion, in the shape of portfolio investment (€23.6 billion) and, to a lesser extent, direct investment (€7.6 billion), while the net change in assets in other investment was negative (-€5.4 billion). This, combined with a slightly negative net change in operations linked to financial derivatives (-€0.2 billion), gave rise to a deficit (of €2 billion) on the financial account, excluding the Banco de España, for the first time since 2014 Q4. By institutional sector, net flows associated with external assets and liabilities were positive for the other resident sectors (€22.6 billion), while the general government and the other monetary financial institutions raised funds abroad in net terms (€13.5 billion and €10.9 billion, respectively). The negative balance on cross-border transactions, excluding the Banco de España, and the nation's net lending position in the period, was reflected in a decline (of €5.9 billion) in the Banco de España's debtor position vis-à-vis the rest of the world. In cumulative 12-month terms, the financial account of the Spanish economy, including the Banco de España, recorded a surplus in an amount equivalent to 2.5% of GDP (see Chart 16.1), a reflection of the fact that foreign investment by residents was higher than investment by foreign agents in Spain.

As regards the international investment position, the most recent information, for 2017 Q2, shows that the Spanish economy's net debtor position vis-à-vis the rest of the world increased by €30.7 billion compared with three months earlier, to 86.8% as a proportion of GDP, 2 pp more than in March (see Chart 16.2). The reason for this increase in the net debtor position was that the positive cumulative flow of net financial transactions in the period (€3.9 billion) was amply offset by the negative amount of the other flows (€34.5 billion) and, in particular, the changes owing to the appreciation of the euro. For its part, the nation's gross external debt declined slightly, by 0.2 pp as a proportion of GDP, to 169.9%.



SOURCES: INE, Ministerio de Empleo y Seguridad Social and Agencia Tributaria.

- a Rates of change calculated on adjusted series. QNA employment measured in equivalent job terms.
- b Rates of the 3-month moving average with three time lags, calculated using seasonally adjusted series. Dots depict quarter-on-quarter rate.
- c With data to August 2017. Excludes indexation clauses.
- d Gross quarterly data. Last quarter, with data only for July 2017.

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3.4 The labour market

Following the notable momentum observed in Q2, the latest labour market indicators point to a slowdown in employment in Q3. Specifically, Social Security registrations in August rose by 0.8% in terms of the three-month quarter-on-quarter moving rate of change of the seasonally adjusted series, 0.2 pp less than in Q2. By sector of activity, the deceleration affected all sectors, with the exception of non-market services, and was especially marked in agriculture and construction and, in market services, in hotels and restaurants. This suggests that, in QNA² terms, the quarter-on-quarter rate of growth of employment fell by 0.3 pp to 0.6%, compared with 0.9% in Q2. The slowdown in employment growth in the market economy would be more severe, down 0.4 pp to 0.7% (see Charts 17.1 and 17.2).

In turn, the rate of decline in the numbers of unemployed registered with the National Public Employment Service (SEPE, by its Spanish acronym) fell back in August to 1.7% in terms of the three-month quarter-on-quarter moving rate of change of the seasonally

2 In terms of full-time equivalent jobs.

adjusted series, compared with the decrease of 2.7% in Q2. Also, employment contracts registered with the SEPE have lost momentum in recent months, recording a cumulative year-on-year increase to August of 5.8%. This slowdown was somewhat greater in the case of temporary contracts, with the result that permanent contracts accounted for 7.5% of total contracts, still a slightly higher share than a year ago.

Turning to wages, an agreement between the social partners with wage recommendations for the current year has still not been signed. In this setting, the information on collective bargaining agreements registered in the period January-August, which cover 5.7 million workers, reveals an increase of 1.3% in wage rates in 2017 (0.2 pp higher than the increase agreed for 2016). As is usual around these dates, most wage and salaried workers with an agreement already signed (76.3% of the total) have multi-year agreements signed in previous years; these established a wage increase of 1.2% for 2017. In recent months the agreements signed in the current year have become more representative, covering almost 1.4 million workers; these set a slightly higher wage increase of 1.6% for those workers.³ The information from other wage indicators for Q3 suggests a continuation of the sluggishness observed in previous quarters. Thus, average gross remuneration at large non-financial corporations fell slightly in July (-0.2%). In QNA terms, seasonally adjusted compensation per employee decelerated in Q2, both in the economy as a whole, where it fell back by 0.1% year-on-year, and in the market economy, where the rate of growth moderated to 0.3% year-on-year. Both indicators are expected to rise somewhat in Q3, posting similar rates of growth to those observed at the start of the year (see Charts 17.3 and 17.4).

3.5 Prices

In 2017 Q3 the year-on-year growth of the import deflator is estimated to have declined notably, prolonging the slowdown observed in Q2. The appreciation of the effective euro exchange rate is expected to have played a key role here. This profile runs counter to the projected dynamics of domestic producer prices, proxied by the GDP deflator, which posted an acceleration in Q3 (see Chart 18.1).

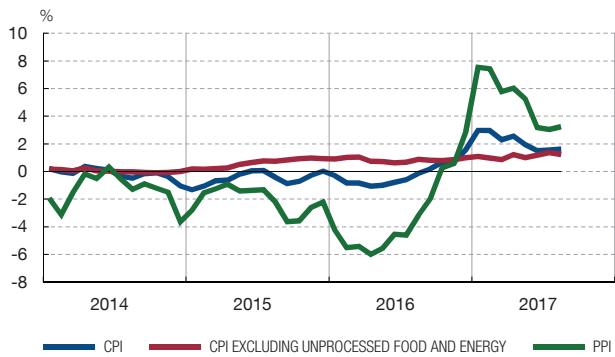
As regards consumer prices, measured by the private consumption deflator, the year-on-year growth rate is estimated to have stabilised in Q3. That would confirm the pattern of lower growth of prices, following their peak in Q1, which was attributable to transitory factors linked to the rise in energy prices and to the comparison effect.⁴

The latest available information for the CPI, for August, revealed a slight increase in its year-on-year growth rate, by 0.1 pp to 1.6%, while the year-on-year growth rate of the CPI excluding unprocessed food and energy prices was 1.2%, 0.2 pp down on July. Among the main components, energy prices quickened, owing to heating and vehicle fuel, as opposed to electricity prices which were unchanged. Among the non-energy components, services and non-energy industrial goods prices slowed, while processed food prices increased slightly. Conversely, unprocessed food prices declined, posting a rate of change of -1.6% in August, with fresh fruit prices decelerating notably. Both the overall index and the core inflation index are projected to have slowed over the course of Q3, posting declines relative to the previous quarter.

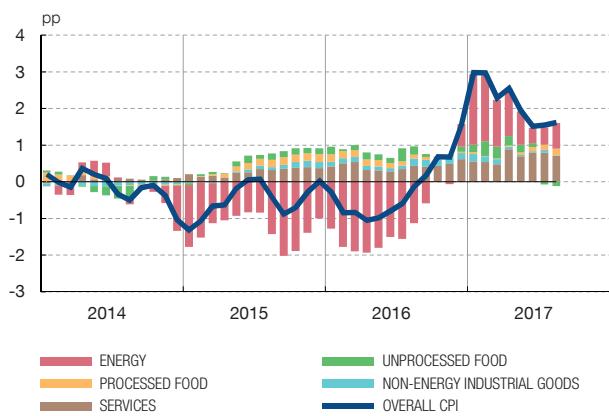
³ One of the reasons for this greater dynamism in wage rates in the new agreements signed over the course of the year could be that the year-on-year rate of change of consumer prices taken into account in the new negotiations was that recorded at end-2016, i.e. 1.6%.

⁴ See Box 4, "Inflation developments and outlook in Spain", in the *"Quarterly Report on the Spanish Economy"*, *Economic Bulletin* 1/2017, Banco de España.

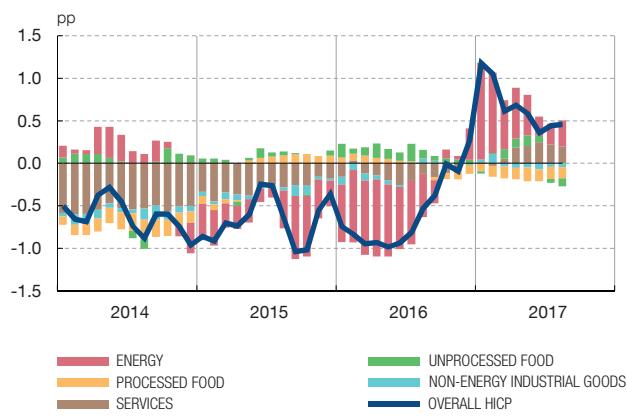
1 GDP DEFULATOR AND UNIT LABOUR COSTS (a)

2 PRICE INDICATORS
Year-on-year rates

3 CONTRIBUTIONS TO CPI YEAR-ON-YEAR GROWTH RATE



4 CONTRIBUTIONS TO SPANISH-EURO AREA HICP DIFFERENTIAL



SOURCES: INE, Eurostat and Banco de España.

a Year-on-year rates of change calculated on seasonally adjusted series.



The harmonised index of consumer prices (HICP) increased to 2%. The unusually high discrepancy between the growth rates of the CPI and the HICP can be explained in part by the fact that the HICP includes non-residents' expenditure in Spain, which falls to a much greater extent than that of residents on items relating to accommodation and food service activities, which are undergoing higher price growth than items in the overall consumption basket. The inflation rate for the euro area as a whole increased to 1.5% year-on-year. As a result, the inflation gap widened by 0.1 pp to 0.5 pp, a figure in line with the average differential since the outset of EMU.

25.9.2017.