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).

1 Macroeconomic projections for the Spanish economy (2017-2019): the Banco de España's contribution to the eurosystem's June 2017 joint forecasting exercise.

2 On 12 September, the National Statistics Institute (INE) published a revision of the Annual National Accounts series which entails slightly higher GDP growth in 2015 and 2016, together with more significant changes in the rates of growth of other variables, such as the different demand components. Accordingly, for example in 2016, GDP growth was more reliant on the external component than had been estimated to date. It has not been possible to include this information in the projections, since the models used require quarterly series and such series consistent with the latest annual data will not be published until 2 October.

3 The cut-off date for preparation of the assumptions underlying the June exercise was 16 May. The cut-off date for preparation of the assumptions underlying this exercise is 18 September, except for those relating to external market developments for which the assumptions for the current exercise are taken from the September 2017 ECB staff macroeconomic projections for the euro area, whose cut-off date is 14 August. The cut-off date for preparation of the projections is 25 September.

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

			September 2017 projections			Changes from the June 2017 projections		
	2016 (b)	2016	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 Annnual 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 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.

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.

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.