QUARTERLY REPORT ON THE SPANISH ECONOMY

1 OVERVIEW

The information that has come to light in the opening months of the year has continued to point to the increasing buoyancy of the world economy. This has been extensive to the main regions – advanced and emerging alike – and has thus prolonged the trend observed since mid-2017. This outlook, underpinned by the continuing expansionary stance of monetary policies, has been further boosted by the fiscal expansion plans laid out by the United States, which include tax cuts and an increase in infrastructure spending. Most recently, world trade has retained its notable dynamism which, moreover, has also been widespread from the geographical standpoint. Along with certain transitory factors, the sound recent performance of international trade is linked to the strength of investment, a particularly import-intensive demand component, and, in the case of the emerging economies, to improved purchasing power prompted by the rise in commodities prices.

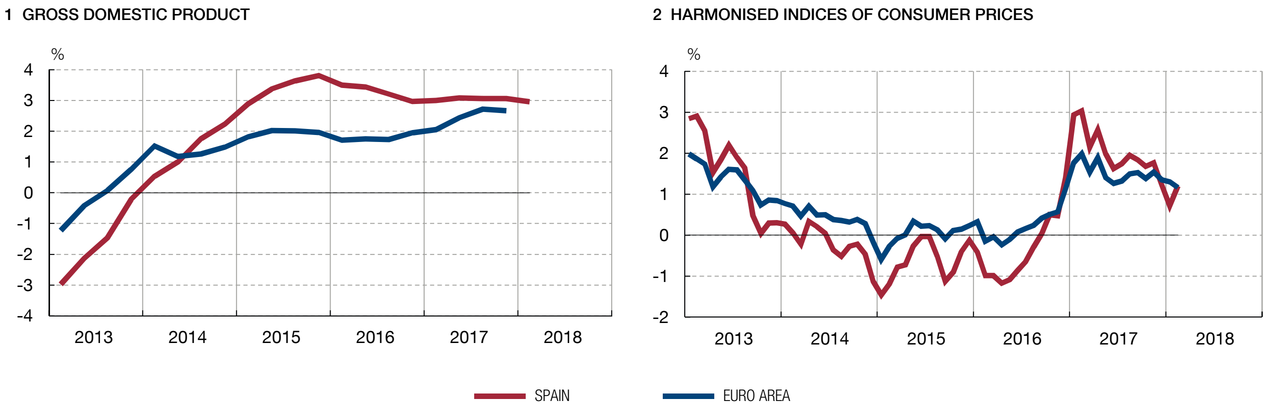
The latest information points to the upturn continuing, although the areas of risk have not disappeared. One such area where risks are most prominent is related to the process of monetary policy normalisation in the advanced economies and, most especially, in the United States, which is ahead in the business cycle. In early February there was an abrupt share prices slump and increased volatility on the main global stock markets, apparently triggered by the emergence of US economic data suggesting a sharper than anticipated rise in wages (see Box 3). These developments are a warning that the current expansionary process may face setbacks should similar surprises recur, and that might give rise to changes in the projected pace of interest rate rises by the Federal Reserve and cause abrupt changes in financial asset prices. This possibility appears to have been exacerbated by the US budgetary impulse which, in the current setting, might take the form rather of inflationary rises than increases in activity, as well as resulting in a bigger US public finances shortfall and external deficit (see Box 2).

In the euro area, the available indicators suggest that activity continues to expand at a high pace in the opening months of the year. Behind this trajectory are the expansionary financial conditions induced by the accommodative monetary policy stance, the strong momentum of the global economy – which is providing for vigorous exports even in the presence of an exchange rate appreciation – and, possibly too, some abatement in political uncertainty. As regards consumer prices, the recent path of the core component still offers no conclusive signs of reacting to the cyclical upturn. That said, the progressive decline in the degree of productive slack may be expected to ultimately raise the upward pressures on wages and prices, a development that would be assisted by the ECB maintaining its expansionary monetary policy stance. The latest ECB projections, published in early March, revised expected GDP growth for the area as a whole for this year upwards by 0.2 pp to 2.4 %, a similar rate to that observed in 2017.

The Spanish economy has continued to exhibit considerable dynamism in early 2018. Specifically, it is estimated that, as in the last two quarters of 2017, GDP will have grown by 0.7% in Q1 this year. The outlook for the 2018-2020 period, set out in Box 1 of this Report, augurs a prolongation of the expansionary phase, although the intensity of growth is expected to gradually ease over the projection horizon. As a result, following the projected increase of 2.7% on average for this year, output is expected to increase at a rate of 2.3% in 2019 and 2.1% in 2020, tending thus to draw progressively closer to the estimated potential growth rate for the economy (see Box 6).

GROSS DOMESTIC PRODUCT AND CONSUMER PRICES (a)

CHART 1



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.

These favourable projections rest on the headway made in correcting the economy's imbalances, and, from a more conjunctural perspective, on the ongoing firmness of activity and world trade, on the persistence of favourable financing conditions for economic agents and on a somewhat more expansionary fiscal policy stance than that projected to date. In addition, this outlook has been supported by some easing in the political uncertainty linked to the situation in Catalonia.

However, the pace of growth of export markets is expected to slow during the projection period, while the additional impact of the monetary policy measures adopted to date on output growth rates will move on a diminishing course, with both factors warranting the gradual easing in the rate of increase in activity. In parallel, the improved financial position of households and firms, along with enhanced external competitiveness, which is resulting in recurrent surpluses in the rest of the world account, increase the economy's resilience to potential shocks.

As regards prices, there was recently a notable slowdown in the overall indicator to a low of 0.6% in January, before a rebound commenced a month later. These developments have been much influenced by the base effects in the energy component. While the core component continued to evidence a degree of slackness, to which both non-energy industrial goods prices and services prices contributed, this appears to have been interrupted in February. In the course of 2018, the rate of change of the CPI is expected to undergo swings related to the trajectory of oil prices. As a result, after reaching a growth rate of over 1.5% in the summer months, the CPI is expected to slow once more in the final stretch of the year. Subsequently, it is estimated there will be a gradual rise in the overall inflation indicator, as a result of the impact of the reduction in cyclical slack on the rate of increase of the core indicator.

Against this macroeconomic backdrop, characterised by a growing positive output gap in the Spanish economy, expansionary and, therefore, procyclical budgetary policies should be avoided. Conversely, economic policies should prioritise further headway in fiscal consolidation, allowing a gradual reduction in the budget deficit in structural terms and in the public debt-to-GDP ratio, in accordance with the requirements laid down in the Stability and Growth Pact at the European level, and with the budgetary stability law on the domestic front. Fiscal consolidation is necessary in order to mitigate the vulnerability of

MAIN SPANISH MACROECONOMIC AGGREGATES (a)

TABLE 1

	2016	2017	2017 Q1	2017 Q2	2017 Q3	2017 Q4	2018 Q1
National Accounts							
Quarter-on-quarter rates of change, unless otherwise indicated							
Gross domestic product	3.3	3.1	0.8	0.9	0.7	0.7	0.7
Contribution of national demand (b)	2.5	2.8	1.1	0.7	0.8	0.6	0.6
Contribution of net external demand (b)	0.7	0.3	-0.3	0.2	-0.1	0.1	0.0
Year-on-year rates of change							
Employment	3.0	2.8	2.6	2.9	2.9	2.9	2.9
Price indicators (year-on-year change in end-of-period data) (c)							
CPI	-0.2	2.0	2.3	1.5	1.8	1.1	1.1
CPI excl. energy and unprocessed food prices	0.8	1.1	0.9	1.2	1.2	0.8	1.1

SOURCES: INE and Banco de España.

a Information available to 13 March 2018.
b Contribution to the quarter-on-quarter rate of change of GDP (pp).
c Latest available figure for the consumer price indices: February 2018.

the economy derived from the current high public debt and to restore the stabilising capacity of the public budget in the event of potential adverse shocks. In parallel, the current macroeconomic context is particularly propitious for undertaking the structural reforms still outstanding, which should be geared to improving productivity dynamics, addressing the challenges arising from population ageing and reducing structural unemployment.

The Report has a total of eight boxes. The first presents the macroeconomic projections for the Spanish economy for the three-year period from 2018 to 2020. There are then three boxes covering the external environment of the Spanish economy; respectively, these describe the change in the stance of US economic policies (Box 2), assess the stock market correction episode in early February (Box 3) and analyse the explanatory factors behind the recent dollar depreciation (Box 4). Box 5 details the latest developments in the debate on euro area governance reform. Lastly, Boxes 6 to 8 examine various aspects relating to the Spanish economy, respectively addressing an assessment of the current cyclical position, an analysis of the factors underlying the non-tourism services export performance since the crisis, and a diagnosis of the recent pension schemes and funds reform.

This latest update of the Banco de España's macroeconomic projections for the Spanish economy includes the new information obtained since the last projections were published in December 2017.[1] The exercise includes, in particular, the Quarterly National Accounts data for the last quarter of 2017, and also information on the changes in the technical assumptions on which the projection exercise is based (see Table 1).[2]

The projections envisage a continuation of the current expansionary phase of the Spanish economy. This outlook is based, on one hand, on the gradual correction of the macrofinancial imbalances that built up in the expansionary cycle which preceded the crisis and in the more deeply recessionary stages of the crisis. This correction has given rise, in particular, to lower private sector debt, continued and sizeable external surpluses and the consequent moderation in net external borrowing, the gradual correction of the budget deficit, the fall in unemployment, which is however still too high, and the stabilisation and incipient recovery of the real estate sector. On the other hand, a number of more temporary factors also continue to support economic activity, such as the strength of the export markets, against a backdrop of ever more widespread global growth, and the expected expansionary stance of demand policies throughout the projection horizon. In particular, on the information available at this stage (which does not include the draft State Budget as it has still not been published), and following the neutral fiscal policy stance observed in 2017, a return to a somewhat more expansionary stance is expected as from 2018.

GDP has grown at a rate of more than 3% in the last three years; it is estimated that it will grow at a somewhat lower rate over the projection horizon. On one hand, the outlook for the global economy points to a gradual loss of momentum of the external markets. On the other, the present rate of expansion of economic activity in the euro area makes it more likely that inflation will converge towards its medium-term target. This reduces the need for additional monetary policy measures, in a setting in which the measures adopted previously should have a progressively lower incremental impact on financial conditions, activity and prices. Moreover, as discussed below, household spending on consumer goods and services should continue to show the signs of moderation that first appeared in 2017. The short-term information suggests that GDP growth in 2018 Q1 may have remained at the level of 0.7% observed in the third and fourth quarters of 2017. The minor slowdown in activity that is expected in coming quarters would give GDP growth of 2.7% in 2018, 2.3% in 2019 and 2.1% in 2020 (see Table 2).

1 Macroeconomic projections for the Spanish economy (2017-2020): the Banco de España's contribution to the Eurosystem's December 2017 joint forecasting exercise.

2 The cut-off date for the assumptions underlying the December 2017 projections was 22 November. The cut-off date for preparation of the assumptions underlying this exercise is 9 March, except for those relating to Spain's export markets, for which the assumptions for the current exercise are taken from the March 2018 ECB staff macroeconomic projections for the euro area, whose cut-off date is 13 February. Lastly, the cut-off date for preparation of these projections is 13 March.

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

Annual rate of change, unless otherwise indicated

		March 2018 projections			Changes from the December 2017 projections (b)		
	2017	2018	2019	2020	2018	2019	2020
International environment							
World output	3.6	3.9	3.7	3.5	0.2	0.1	0.0
Spain's export markets	5.2	5.0	4.1	3.6	0.1	0.2	0.0
Oil price in dollars/barrel (level)	54.4	64.4	61.1	59.1	2.8	2.1	1.7
Monetary and financial conditions							
Dollar/euro exchange rate (level)	1.13	1.23	1.23	1.23	0.06	0.06	0.06
Nominal effective exchange rate against the non-euro area (c) (2000 = 100 and percentage differences)	117.0	125.0	125.0	125.0	3.2	3.2	3.2
Short-term interest rates (3-month Euribor) (d)	-0.3	-0.3	-0.1	0.4	0.0	0.1	0.2
Long-term interest rates (10-year bond yield) (d)	1.6	1.5	1.9	2.2	-0.2	-0.2	-0.3

SOURCES: ECB and Banco de España.

a Cut-off date for assumptions: 9 March 2018. Cut-off date for foreign markets assumptions: 13 February 2018. 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 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 denotes 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.

The prolongation of the expansionary phase, on the back of increased capacity utilisation, will give rise to a gradual pick-up in the rate of growth of the underlying component of the CPI which, after climbing by 1.2% in 2018, is expected to accelerate to 1.9% in 2020. In the case of headline inflation, the projections point to an average annual rate of change of 1.2% in 2018, rising to 1.7% in 2020.

The main changes in the assumptions on which these projections are built in comparison with the December projections concern budgetary policy. In this respect, the recent agreement on public sector pay and employment between the Government and the main trade union organisations for the period 2018-2020[3] is particularly noteworthy. The agreement includes a fixed pay increase for public sector employees of 6% in cumulative terms in the period (1.75% in 2018, 2.25% in 2019 and 2% in 2020). It also establishes two additional tranches that are dependent on certain conditions being met; if these conditions are satisfied, the cumulative increase would be just under 9%.[4] As regards public sector employment, the agreement adds momentum in 2018 to the more dynamic hiring policy of the past two years.[5] In particular, it broadens the range of cases where up to 100% of general

3 See http://www.lamoncloa.gob.es/serviciosdeprensa/notasprensa/minhap/Paginas/2018/090318-funcionarios.aspx (available only in Spanish).

4 In particular, regarding the pay increase, the first variable tranche is tied to economic growth: if GDP grows by 2.5% or more in 2019 and 2020, the pay increase would be 2.5% in 2019 and 3% in 2020. If GDP grows by less than 2.5%, the pay increase would decline in proportion to the extent to which the figure falls short of 2.5%. The second variable tranche consists in adding a further 0.55 pp to the 2020 pay increase if the budgetary stability target is met.

5 See the agreement signed between the Government and the trade unions on 29 March 2017 (available only in Spanish). In this respect, see also the discussion in "General government employment over the past decade", *Economic Bulletin* 4/2017, Economic Notes, Banco de España.

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

Annual rate of change in volume terms and % of GDP

		March 2018 projections			Changes from the December 2017 projections		
	2017	2018	2019	2020	2018	2019	2020
GDP	3.1	2.7	2.3	2.1	0.3	0.2	0.1
Private consumption	2.4	2.1	1.6	1.6	0.3	0.2	0.2
Government consumption	1.6	1.4	1.2	1.2	0.5	0.5	0.5
Gross fixed capital formation	5.0	4.3	4.1	3.9	0.3	0.4	0.2
Investment in equipment	6.1	5.0	4.1	3.8	0.6	0.4	0.0
Investment in construction	4.6	4.0	4.4	4.3	0.1	0.1	0.2
Exports of goods and services	5.0	4.9	4.8	4.5	0.0	0.1	0.0
Imports of goods and services	4.7	4.2	4.5	4.3	0.1	0.3	0.5
National demand (contribution to growth)	2.8	2.4	2.1	1.9	0.4	0.3	0.1
Net external demand (contribution to growth)	0.3	0.3	0.2	0.2	-0.1	-0.1	-0.2
Nominal GDP	4.0	3.9	3.8	3.8	0.5	0.2	0.0
GDP deflator	1.0	1.2	1.5	1.7	0.2	0.0	0.0
Consumer price index (CPI)	2.0	1.2	1.4	1.7	-0.2	-0.1	0.0
CPI excluding energy and unprocessed food prices	1.1	1.2	1.7	1.9	0.0	0.1	0.1
Employment (full-time equivalents)	2.8	2.7	2.0	1.9	0.4	0.3	0.3
Unemployment rate (% of labour force). End-of-period data	16.5	14.2	12.6	11.0	0.1	0.4	0.3
Unemployment rate (% of labour force). Average data	17.2	15.1	13.3	11.6	0.2	0.1	0.1
Net lending (+) / net borrowing (–) of the nation (% of GDP)	1.9	1.8	1.8	1.7	-0.3	-0.3	-0.5
General government net lending (+) / net borrowing (–) (% of GDP)	-3.1	-2.5	-2.1	-1.7	0.1	0.1	0.1

SOURCES: Banco de España and INE.
Latest QNA figure: 2017 Q4.

a Projections cut-off date: 13 March 2018.

government staff vacancies may be filled (and adds some cases where the replacement rate may be even higher), and includes additional measures relating to working hours and temporary employment. The agreement includes certain conditional factors tied to compliance with the budgetary rules.

At the cut-off date for this exercise, the draft State and Social Security Budget for 2018 had not been submitted. Accordingly, as in December 2017, various technical assumptions have been used to estimate the expected trajectories of fiscal policy variables. It has been assumed, first, 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 the latest developments in budget outturn,[6] and second, that all other general government account items will evolve, in the absence of measures, in keeping with their usual determinants.[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 set to be slightly expansionary in 2018, compared with the neutral stance estimated for 2017.

As regards all the other assumptions, there are few new developments and their impact on activity and prices tend to cancel one another out. The main change, in terms of its effects on the projections, is the improved global economic outlook, which is reflected in the upward revision, by 0.3 percentage points in cumulative terms between 2018 and 2019, in the rate of growth of Spain's export markets. In addition, since the cut-off date for the previous projections, the euro exchange rate has appreciated further, by 3.3 pp in effective nominal terms and rather more markedly (by 5.4 pp) against the dollar. Oil prices in dollars have risen slightly more than expected, especially in the short term, hence the upward revision of 4.9% for 2018 (tempered to a great extent in euro terms by the appreciation of the currency) and the more modest downward revision for 2019 and 2020.

In accordance with the expectations implicit in the yield curves, since the cut-off date for the assumptions underlying the previous projections the expected trajectory for interbank market rates has moved up, while the expected trajectory for government debt yields has moved down. In any event, these are minor changes, with a negligible impact on the expected cost of lending to households and non-financial corporations.

On the impacts estimated drawing on historical evidence, the changes in the assumptions overall – including the fiscal policy assumptions – compared with the December projections would give rise to an upward revision of expected GDP growth of approximately 0.1 pp in each of the three years of the projection horizon. This is mainly attributable to the expansionary fiscal measures (in particular, the stronger growth expected in public sector pay and employment) and, to a lesser extent, to the improved situation of the external markets, factors which are restrained somewhat by the exchange rate appreciation.

This revision of the outlook for Spanish economic activity is slightly more extensive in the first years of the exercise than would be justified by automatic application of the effect of the new assumptions. Specifically, the upward revisions to GDP growth amount to 0.3 pp in 2018, 0.2 pp in 2019 and 0.1 pp in 2020. This reflects a combination of factors. First, the information on the opening months of 2018 points to a somewhat higher rate of growth in Q1 than was expected at the end of 2017, and this more favourable pattern is also being carried over into Q2. Second, the flow of data on the external environment of the Spanish economy received in the month that has elapsed since the cut-off date for the relevant assumptions has been more positive than expected at the time. Lastly, the baseline scenario includes a slight easing of the political tension in Catalonia, as a consequence of the decline in the level of uncertainty since December.

In terms of growth in consumer prices, the impact of the new assumptions is broadly neutral, since the upward effects deriving from the fiscal expansion are countered by the exchange rate appreciation and by the rather more moderate rate of growth of oil prices in 2019 and 2020. However, the information now available on the most recent period warrants a downward revision of 0.2 pp in the rate of change of CPI for 2018, essentially owing to the performance of the energy component in the last few months. The projections for 2019 and 2020 are virtually unchanged.

In the projection period, spending on consumer goods and services will continue to be underpinned by the strength of the job creation process, continuing favourable financial conditions and the improvement in recent years in the financial position of the sector, as a consequence of the reduction in indebtedness and the appreciation in both real and financial asset prices. However, it is estimated that the slowdown observed in this spending component in 2017 will continue. This is as a result of various factors. First, spending decisions on consumer durables, which had been put off during the years of the crisis and which households have gradually resumed in the recovery years,[8] are expected to peter out over the projection period. Second, it is estimated that households will start to rebuild their savings from

6 The projections also include possible costs associated with the public liability arising from court proceedings relating to toll motorway company insolvency proceedings, which the Government estimates as around €2 billion.

7 Specifically it has been assumed that 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. This is the case of pensions (where developments are essentially determined by the revaluation formula established by law and population ageing), unemployment benefits (which depend mainly on the level of unemployment) and interest payments (affected by changes in public debt levels and interest rates).

8 J. González Mínguez and A. Urtasun (2015), "Consumption dynamics in Spain by product type", *Economic Bulletin,* September, Banco de España, pp. 29-37.

the low level estimated at the end of 2017 (just under 6% of disposable income, the lowest level since the start of 2008). Indeed, in 2017 households experienced a squeeze on their real income as a result of a temporary rebound in inflation that agents apparently recognised as such, since they responded by reducing both their real spending and their saving. The assumption underlying these projections is that households will tend to moderate their consumer spending, in favour of a certain degree of recovery in their saving rate.

Lastly, the projections assume a rise in interest rates which, per se, has a minor impact on household income as it affects interest paid and interest received alike. However, it also has a negative effect on consumption, given that borrowers generally have a higher marginal propensity to consume than creditors.

In the case of gross fixed capital formation, it is expected that the residential component will continue to post high rates of growth, albeit slightly lower than those observed in 2017, in a context in which the trend towards favourable mortgage terms (such as lower interest rates and longer repayment periods) seen in recent years looks to be starting to fade and net lending by households has fallen sharply. Business investment, for its part, will continue to be underpinned by the strength of demand and the increase in capacity utilisation, in a setting in which the high generation of internal funds and the availability of borrowed funds on favourable conditions will continue to ease the way for financing of business investment.

Over the projection period as a whole, exports should continue to grow at a faster pace than their destination markets, thanks to the competitiveness gains achieved since the crisis and which are expected to continue into coming years, albeit at a slower pace. In the near term, however, the rate of growth of export sales will be mitigated by the effects of the appreciation of the euro since early 2017. By components, it is estimated that tourism services will moderate somewhat following the exceptional performance in recent years, as some Spanish tourist destinations become overcrowded and alternative destinations in the Mediterranean basin start to recover. Imports, for their part, as in other recent projection exercises, are expected to grow at a slower pace than their historical relationship with final demand would warrant, as a result of the incipient import substitution process prompted by the competitiveness gains achieved.

As is commonly the case during the expansionary phases of the Spanish economy, employment growth is set to remain closely pegged to growth in economic activity. The rapid pace of job growth will push down the unemployment rate further, although it will remain well above pre-crisis levels, at around 11% at the end of the projection horizon. This high level of unemployment is one of the factors constraining wage growth, although wages are expected to pick up over the next three years as the slack in the labour market decreases. Given that a parallel rise in productivity is not anticipated, this will push up unit labour costs. However, the rise in ULCs will be less than the ECB projects for the euro area as a whole, so the increase will still be compatible with continuing competitiveness gains relative to the euro area.

The Spanish economy will maintain its net lending position vis-à-vis the rest of the world, although it will be a few tenths of a percent lower than estimated for 2017 (when it stood at 1.9% of GDP). In particular, the goods and services surplus will remain around 2.7%, driven by two opposing forces: improved net trade flows in real terms and the deterioration in terms of trade. However, the rising interest rates foreseen in the external assumptions point to a slight worsening of the income balance.

On the consumer prices front, current projections envisage core inflation accelerating gradually from its current low levels. Forecast GDP growth over the projection horizon outpaces the existing estimates of the rate of growth of potential output. Therefore, the positive output gap that emerged, on our estimates, at the end of 2017 will tend to widen over the next three years, which is likely to drive up domestic inflationary pressures. Profit margins are expected to stabilise after the cumulative gains made in recent years. After a sharp increase in 2017, on the back of rapidly rising prices of oil and other commodities, external inflationary pressures will tend to moderate at the start of the projection horizon, thanks to the recent appreciation of the euro. However, they are likely to pick up again further down the line, given the expected gradual increase in global inflationary pressures while the slack in the global economy is gradually absorbed. Consequently, the CPI is projected to rise by 1.2% this year, following a path largely determined by the energy component which, on current oil-price assumptions, is likely to head up over the coming months to reach a peak in the summer before subsequently slackening off. For the next two years, the CPI is forecast to rise by 1.4% in 2019 and 1.7% in 2020.

The risks to the baseline economic growth scenario are mainly on the upside in the near term, as ongoing revisions to the projections for the global economy suggest that its expansionary momentum may be underestimated. By contrast, towards the end of the projection horizon, the risks are likely to be on the downside. On the domestic front, current projections assume that the decline in political uncertainty regarding the situation in Catalonia observed since the December projections will continue going forward. However, a resurgence of tension cannot be ruled out, with the consequent negative impact on the economy, particularly in Catalonia itself. Moreover, some recent announcements suggest a possible easing of budgetary consolidation efforts, beyond those already included in the baseline scenario. Although this would have expansionary effects in the short term, over a longer horizon it would exacerbate the economy's vulnerability to adverse shocks, given the high level of public debt and the need to undertake significant public debt reduction over the medium term. In the opposite direction, the baseline scenario includes the assumption of a partial recovery in the household saving rate, particularly after the sharp drop in 2017. However, the upturn in this variable may be less pronounced, leading to faster household consumption growth, and thus higher GDP growth.

On the external front, the new grand coalition agreement in Germany could give rise to a more expansionary budgetary policy in that country, which in the near term could boost the rate of growth in the euro area as a whole. However, the tensions in financial markets seen in early February suggest that the process of monetary policy normalisation in the advanced economies, and especially in the United States, is not without its uncertainties. In particular, an unexpectedly severe intensification of inflationary pressures could trigger fresh bouts of abrupt price corrections in financial markets. In this connection, the recent adoption of fiscal expansion plans in the United States has heightened these risks, as it has taken place in an economy with a very high degree of capacity utilisation. Other causes of uncertainty include, first, the possibility that the decision by the United States to impose tariffs on imports of steel and aluminium may trigger a spiral of similar measures by the authorities in other countries, with the attendant adverse effects on world trade. Second, various sources of geopolitical tension persist, including in Europe the continuing lack of clarity about the shape the future relationship between the European Union and the United Kingdom will ultimately take and the uncertainty surrounding the formation of a government in Italy, following the outcome of the last election.

The risks to prices appear to be balanced. The downside risks described above for the global economy also represent downside risks for the external component of inflation. Moreover, as noted, the projections rely on the assumption that wages and prices will respond to the reduction in the degree of slack to a greater extent than they have done since the start of the expansionary phase – a hypothesis that may fail to materialise. Nevertheless, the existence of non-linear effects in the relationship between economic activity and prices cannot be ruled out, such that after a certain point is passed, the reduction in cyclical slack starts to have ever larger inflationary impacts. Furthermore, the synchronisation of strong global economic growth suggests possible upward pressures on commodity prices. However, in the specific case of oil, these pressures would be offset by the fact that they would make a larger number of unconventional oil sources economically viable.

The economic recovery is allowing monetary policy normalisation to be initiated in some of the main advanced economies after nearly 10 years of monetary stimulus. This applies particularly to the United States. In December 2015 the Federal Reserve commenced, with a 0.25 pp increment, a gradual process of official interest rate rises, with another increase in 2016 and three more in 2017, initiating the process of balance sheet reduction in October of that same year. Other central banks have not made so

Chart 1
GDP FORECAST (WITH EXOGENOUS MONETARY POLICY)

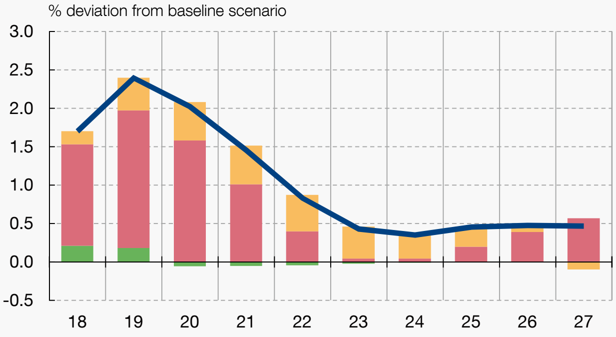


Chart 2
INFLATION FORECAST (WITH EXOGENOUS MONETARY POLICY)

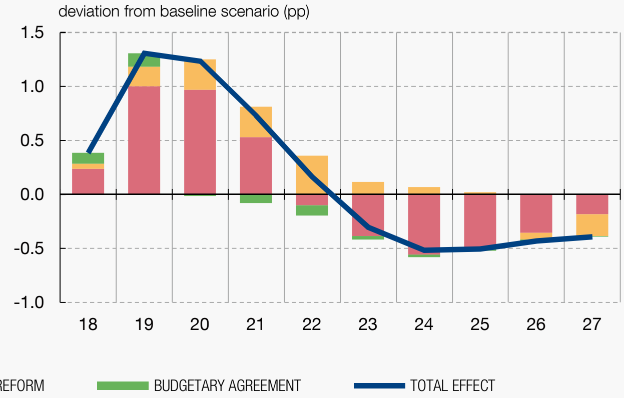


Chart 3
TWIN DEFICIT FORECAST (WITH EXOGENOUS MONETARY POLICY)

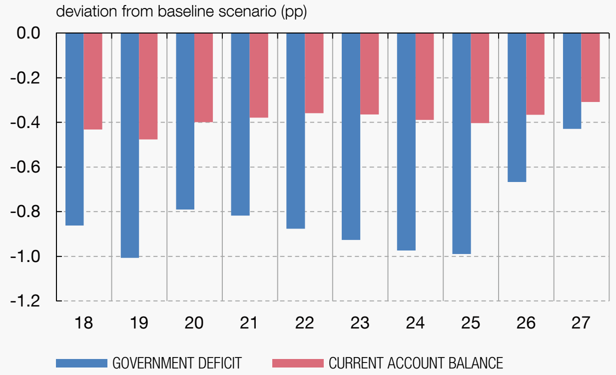


Chart 4
GDP FORECAST

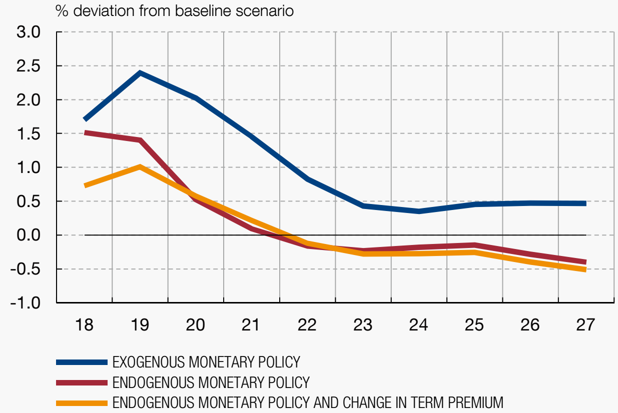


Chart 5
INFLATION FORECAST

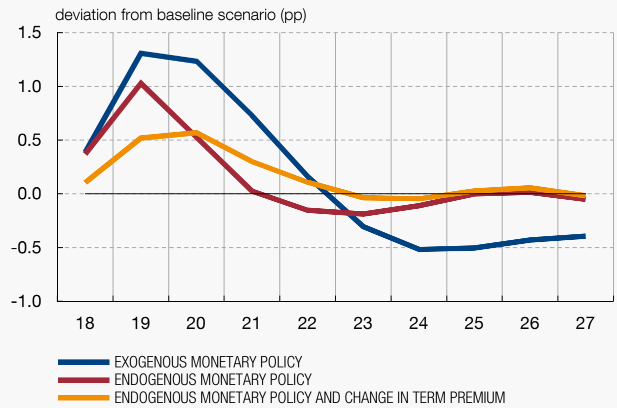
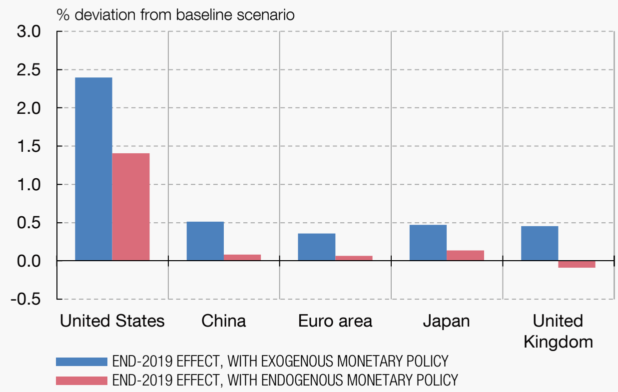


Chart 6
INTERNATIONAL GDP SPILLOVERS



SOURCE: Banco de España calculations using the NiGEM model.

much progress in withdrawing monetary stimuli, although the Bank of England raised its reference rate in November, and even the ECB and, to a lesser extent, the Bank of Japan are already beginning to define their exit strategy. In particular, the Federal Reserve faces major dilemmas in this process, since the output gap of the US economy is positive and the degree of slack in its labour market is very small, but the prevailing rate of inflation continues to be very moderate. Furthermore, should there be a greater-than-expected tightening of monetary policy stance, some markets could be exposed to a significant correction, as evidenced by the turmoil in February 2018.

To this should be added a fiscal policy which has adopted a markedly expansionary slant in recent months with the approval of a fiscal reform in late December and a bipartisan agreement in early February which raises the expenditure ceiling by $296 billion in fiscal years 2018 and 2019.[1] The tax reform includes most notably a corporate income tax cut from 35% to 21% and the immediate deduction of 100% of expenses arising from investment — which will be temporary — as well as other measures affecting taxation of multinationals' profits generated abroad. The reform also introduces changes to the direct taxation of households which will reduce their tax burden at all income levels between 2018 and 2025.

In principle, the procyclicality of these tax measures may contribute to an overheating of the economy, leading to inflation above the central bank target which may eventually require interest rates to be raised more rapidly than anticipated. To illustrate this, the results of a NiGEM model simulation of the effect of expansionary fiscal policy (with and without a monetary policy response) are analysed below for the USA and other economies.

In the first simulated scenario, monetary policy does not respond to the effects of the fiscal stimulus, so that the interest rate follows the course currently expected by the Federal Reserve. The impact of the fiscal expansion on the level of GDP exceeds 1.5 pp in the period 2018-2021 and drops to 0.5 pp towards the end of the forecasting horizon, between 2023 and 2027 (see Chart 1). Inflation increases more than expected under the baseline scenario between the years 2018-2022 (see Chart 2). Additionally, it is important to take into account that the expansionary measures will contribute to raising the path of the government deficit by nearly 1 pp of GDP in the next decade, which is all the more significant in a situation of high government debt (see Chart 3). According to the model, aggregate demand and, consequently, imports would increase more rapidly than exports, which would worsen the external deficit by 0.4 pp as a percentage of GDP with respect to the scenario without fiscal stimulus.

Under the second scenario, monetary policy is allowed to respond to the effect that the fiscal stimulus has on the output gap and inflation. And under the third scenario, in addition to this endogenous response of monetary policy, it is assumed that the term premium increases by 75 bp, thus returning to its average historical level. Under these two scenarios, short-term interest rates increase above the trend currently expected by the Federal Open Market Committee (FOMC) to a lesser extent than in the aforementioned case, since the increase in the term premium implies that financial conditions tighten. This response of monetary policy causes both GDP and inflation to increase to a lesser extent than under the initial scenario (see Charts 4 and 5).

Regarding the effects on other areas, under the exogenous monetary policy scenario, the GDP of China, Japan and the United Kingdom would rise by around 0.5 pp at end-2019 with respect to the baseline scenario due to higher demand for their exports by the United States (see Chart 6). In the euro area, the impact would be somewhat less (0.35 pp). Under a scenario with a monetary policy response, the effects would be lower, between 0.1 pp and 0.2 pp in China, the euro area and Japan, and would even be negative in the United Kingdom (-0.1 pp with respect to the baseline scenario). Furthermore, the US term premium may spread to the other countries in view of this economy's central position in the global financial markets, with the attendant contractionary effects on the GDP of the rest of the world. In some countries, this financial channel may outweigh the commercial channel referred to above.

In short, the fiscal expansion will foreseeably contribute to greater dynamism of the US economy in the short term, even if the Federal Reserve responds by stepping up the pace of monetary policy normalisation against a background marked by a positive output gap and growing inflation. However, this baseline scenario of higher short-term growth in activity is accompanied, in a medium-term horizon, by an increase in the risks associated with worsening public finances and with a widening current-account deficit. The international impact of this fiscal expansion will foreseeably be modest and even negative if there is a contagion effect in the financial markets of other countries, particularly if the US authorities decide to introduce protection measures to counteract the worsening US external balance.

1 In addition, in February President Trump unveiled an infrastructure improvement plan for $200 billion in 10 years, which could foreseeably generate total investment of at least $1.5 billion by fostering the investment of state and local governments and of private firms. However, this plan is currently at the initial discussion stage and its approval is expected to be complicated.

Between 1 and 8 February 2018, the US S&P 500 Index fell by 8.5%. The fall was concentrated in two days' trading – 2 and 5 February – with the biggest correction since 2011 recorded on 5 February. In addition, implied volatility rose significantly, after a lengthy period at historically low levels (see Chart 1). Subsequently, stock prices have tended to recover and volatility has moderated, although neither have returned to the levels recorded before the market turmoil.

Various reports prepared by international organisations, such as the IMF and the ECB and the Banco de España,[1] had warned of the risk of a sharp correction in equity prices, particularly in the United States. One supporting factor for that view was the strong appreciation of the US stock market in recent years (see Chart 2). Thus, between January 2012 and January 2018, the S&P 500 Index gained 125%, compared with 72% for the EUROSTOXX 50 Index and 35% for the FTSE 100. As a result, in the United States, some of the metrics generally used to measure share prices had moved some distance from their historical median, prompting concern among investors that shares were possibly overvalued (see Chart 3).

In this setting, one catalyst of the stock market correction in the United States was the publication, on 2 February, of figures that showed an unexpected increase in wage growth in the country in

1 See Financial Stability Report, Banco de España, November 2017.

Chart 1
IMPLIED VOLATILITY

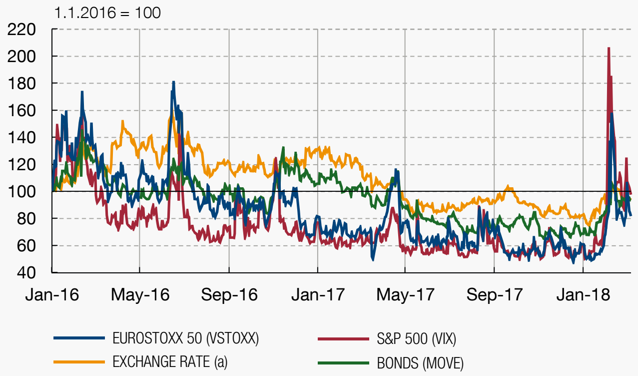


Chart 2
STOCK MARKET INDEXES

Chart 3
STOCK MARKET METRICS (b)

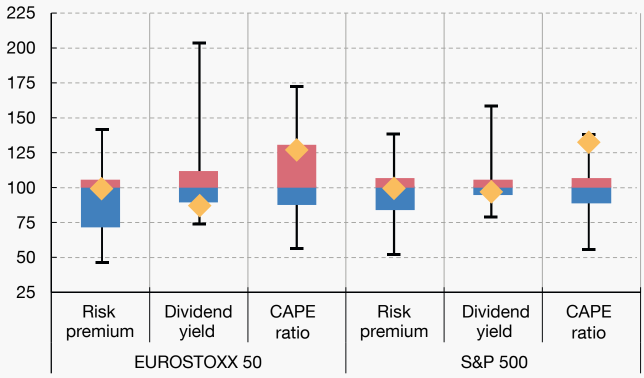
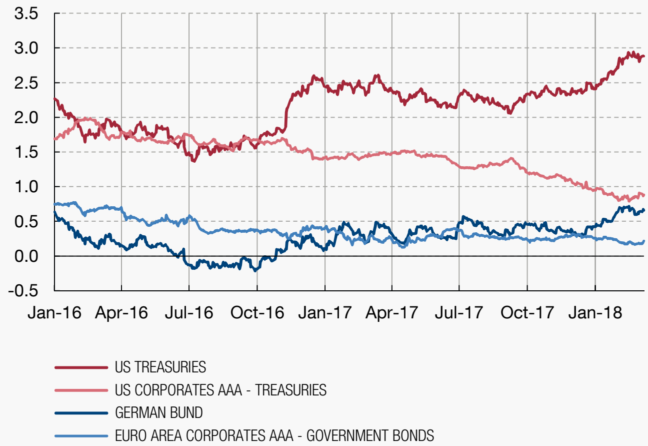


Chart 4
10-YEAR BOND YIELDS



SOURCES: Thomson Reuters, Robert Shiller and Banco de España.

a Average 3-month USD/EUR, USD/GBP and JPY/USD volatility.
b Metrics obtained since January 2005, taking the median of the distribution, represented by the horizontal line between the blue and red areas, as 100. The upper and lower limits of both areas correspond to the 75th and 25th percentiles. The end of the lines represent the minimum and maximum of the distribution. The green rhombi show the current levels. Last observation: 7 March 2018. Risk premium is calculated by subtracting the corresponding 10-year inflation-indexed bond yield from the real cost of capital of each index, obtained using a dividend discount model. Dividend yield is the dividend of the past year of index firms as a percentage of index capitalisation. CAPE ratio is the cyclically-adjusted price/earnings ratio. The lower the green rhombus value, the higher the overvaluation in the case of risk premium and dividend yield, whereas for the CAPE ratio, the higher the rhombus value the higher the overvaluation.

January (2.9% year-on-year), while unemployment was at its lowest levels since 2000. This unexpected wage growth was interpreted as a sign that inflation could be heading up and, therefore, that official interest rates could rise faster than was previously expected. Indeed, the likelihood of rates rising by 75 basis points (bp) in 2018 had already increased, even before the employment figures were published. The expectation that official interest rates would rise was also reflected in the increase of more than 30 bp in US 10-year sovereign bond yields in January, up to 2.85%. These higher sovereign yields could have prompted some investors to favour debt securities over equities.

There are signs that this episode of stock price correction and heightened volatility may have been amplified by certain market practices. Particularly noteworthy was the surge of 177% in implied volatility (in terms of the VIX Index) in just two sessions, to levels not seen since 2012; this was extraordinarily strong given the scale of the decline in share prices (see Chart 1). Exchange-traded products (ETPs) which replicate the VIX may have contributed to this sharp increase. Although ETPs are moderate in size in aggregate terms, some of their trading practices can have a significant impact on price formation. Thus, given the initial surges in volatility at the start of the trading session on 5 February, investors knew that ETPs would have to buy more VIX futures, either to be able to replicate the index or, in the case of those that had wagered on low volatility, to limit their losses. Accordingly, in anticipation of these rebalancing effects, some market participants may have positioned themselves to benefit from increases in the VIX, triggering a more pronounced climb in this indicator as the session neared its close. Such strategies may in turn have caused a contagion effect on the spot market, owing to trading practices based on the negative correlation between prices on the VIX Index and the underlying share index. Moreover, the fall in share prices could also have been amplified by arbitrage strategies conducted by certain hedge funds, seeking to exploit the close correlation between the VIX and the underlying shares and derivatives. Lastly, the fact that several lower levels of support based on moving averages were crossed may have triggered sale orders in some algorithm-based trading systems.

The fall in share prices on the US markets spread to other stock markets around the world, mainly the Asian and European markets. Thus, between 1 and 9 February, the euro area's EUROSTOXX 50, the United Kingdom's FTSE 100 and Spain's IBEX 35 all fell by around 7%. The VSTOXX, the implied volatility index associated with the EUROSTOXX 50, also rose significantly, albeit more moderately than its US counterpart (see Chart 1). The correction occurred even though, in comparison with the United States, there was less concern that European markets could be overvalued; this is shown in the metrics generally used to measure share prices, which were close to their historical medians (see Chart 3). In any event, this episode demonstrates that even if European markets are not apparently overvalued, on the metrics analysed in this box, this does not protect them from stress episodes in the US markets. In the weeks following, share price volatility on the European markets tended to return to normal, although without reaching the levels seen before the episode in February, and stock market indexes have recovered slightly, albeit less so than in the United States.

Bond markets were hardly affected by the stock market turmoil (see Chart 4). Thus, in Europe and in the United States, corporate bond spreads over the corresponding sovereign bonds were virtually unchanged in the period. In the euro area, sovereign spreads widened only slightly in the first week of February. Likewise, bonds and exchange rates did not experience the sharp surge in volatility observed in the stock market indexes (see Chart 1). This would be consistent with the argument that the technical elements mentioned above played a major part in the stock market correction, over and above the effect associated with fundamentals.

The US dollar exchange rate has experienced strong and fairly widespread depreciation vis-à-vis other currencies since early 2017, following a period that began in 2014, in which the dollar appreciated notably in a context in which the economic recovery and, therefore, the normalisation of monetary policy, was at a more advanced stage in the United States than in other economies. As shown in Chart 1, the nominal effective exchange rate of the dollar appreciated by 25% between early 2014 and the end of 2016, subsequently depreciating by around 10% in effective terms. This depreciation was particularly pronounced against the euro (18%).

The behaviour of the dollar may seem somewhat surprising considering that the short-term economic outlook in the United States has gradually improved, especially after the approval of tax reform and the increase in public spending, and that the Federal Reserve's monetary normalisation process continues to be comparatively more advanced. Indeed, the short-term interest rate spreads vis-à-vis other areas – normally associated with exchange-rate appreciation given that capital usually flows to areas where returns are higher for a certain level of risk – have tended to increase (see Chart 2). Nevertheless, from a financial standpoint, a possible explanation of the recent depreciation of the dollar could be that, since the United States is further ahead with the withdrawal of monetary stimuli – to a large extent already discounted by the markets – it is to be expected that in the future it will be other areas that will normalise their monetary policies, such as the euro area, which would be reflected in a widening in their favour of the interest rate spreads at the intermediate maturities of the curve. This would be corroborated by developments in the difference in the spread between the two- and five-year rates in Germany, on one hand, and in the United States, on the other. This difference has shown, in the past year, a high correlation with the path of the euro-dollar exchange rate, as show in the same chart.

An alternative explanation of the widespread depreciation of the dollar in the past year may be the fact that the economic outlook has improved not only in the United States, but more globally, and thus, in a favourable global financial environment, the appetite for risk and the search for returns in other markets has continued, contributing to the appreciation of other currencies. As Chart 3 shows, in the past year GDP growth projections for 2017 and 2018 in the euro area, for example, were revised upwards to a higher degree than those of the United States, which may have favoured a further appreciation of the euro.

However, aside from the temporary factors, there are other, more structural, determinants that would explain the depreciating trend of the dollar. For instance, the sizeable external imbalance in the US economy, with a persistently high current account deficit which, having peaked at around 6% of GDP in the years before the crisis, has remained above 2.5% of GDP in recent years (see Chart 4), contrasting with the current account surpluses recorded in other areas. According to the IMF's most recent analysis of the global external imbalances (published in the External Sector Report, July 2017), in 2016, the United States ran an excess external deficit of around two percentage points of GDP, and the dollar was overvalued by between 10% and 15%, and therefore, the depreciation observed in 2017 would be part of the adjustment required to correct the imbalance vis-à-vis the rest of the world.

The fiscal stimulus measures that the United States is implementing will have a positive effect on economic activity and prices in the short term, and this could lead to higher-than-expected interest rate rises, triggering appreciation pressures on the dollar. However, it is very likely that the fiscal and external imbalances in the US economy will worsen, given its diminished cyclical slack (see Charts 4 and 5)[1]. In this context, the protectionist measures adopted by the US government to keep the external deficit in check may lead to the appreciation of the dollar, but in the medium term, they may give rise to a trade confrontation that would exacerbate the external imbalance of the United States and reinforce the depreciation pressures on the dollar.

Indeed, the historical evidence of recent decades shows that the emergence in the United States of high budget and current account deficits (known as "twin deficits") has been associated with strong depreciation of the dollar, as occurred in the mid-1980s with the expansionary fiscal policies of the Reagan administration and in the early 2000s following several tax cuts, as shown in Chart 6. In both cases, the increase in the external deficit of the US economy, triggered by a higher budget deficit, was followed by a substantial depreciation of the nominal effective exchange rate of the dollar of 35% between 1985-88 and 30% between 2002-2007. In the latter period, the introduction of tariffs in the United States was also accompanied by dollar depreciation.

1 According to Congressional Budget Office (CBO) estimates of June 2017, the projected public debt (held by the public) would increase from the current 77% of GDP to 91% in 2027, before taking into account the effects of tax reform. Although it has not yet published the new projections which include these effects and the recently approved increase in spending, the Committee for a Responsible Federal Budget estimates that, as a result of tax reform, the debt will increase to 97% of GDP in 2027 and up to 99%, taking into account the rise in spending in 2018-19. Should the rise in spending and the tax cuts, which are temporary (such as those relating to personal income tax) become permanent, something that cannot be ruled out, the ratio of debt held by the public would increase to almost 110% of GDP within 10 years.

Chart 1
EXCHANGE RATE VS DOLLAR

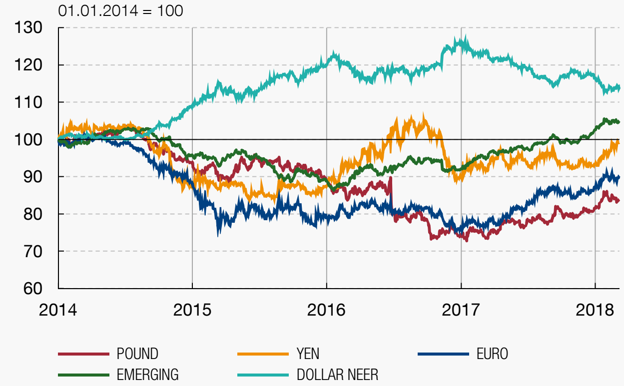


Chart 2
DOLLAR EXCHANGE RATE AND SPREADS

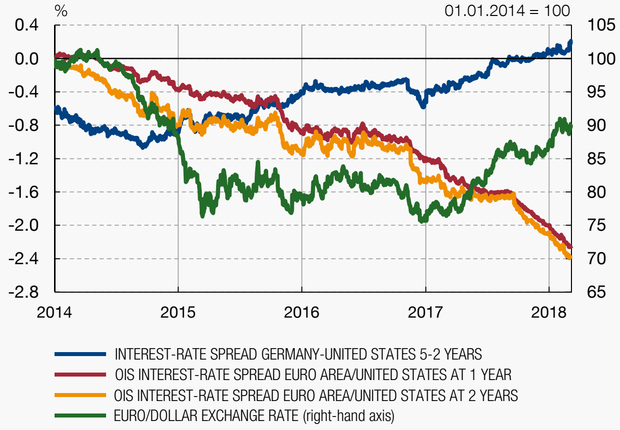


Chart 3
SPREAD. CONSENSUS PROJECTIONS GDP FEB 2018 VS JAN 2017

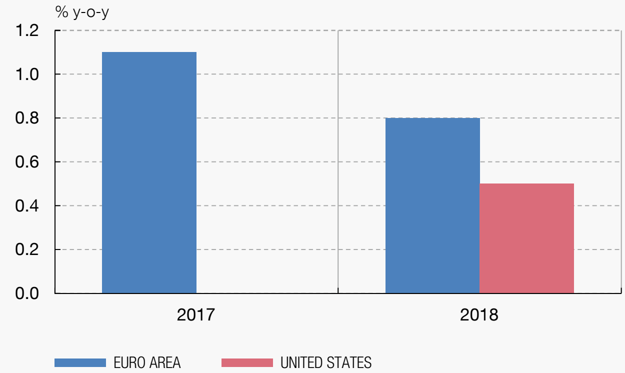


Chart 4
CURRENT ACCOUNT BALANCE

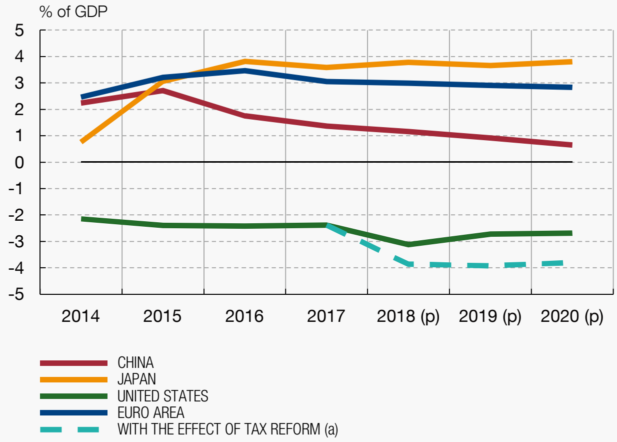


Chart 5
OUTPUT GAP AND PUBLIC DEFICIT RATIO (1967-2020)

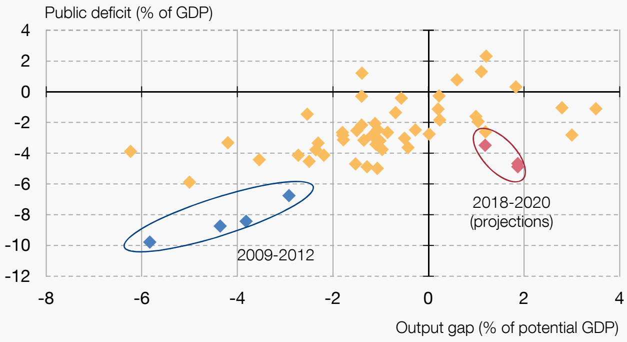
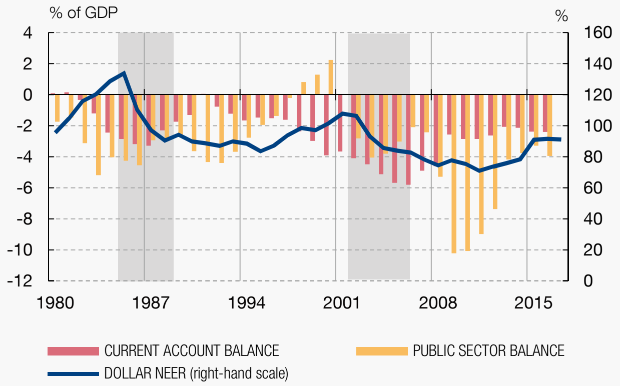


Chart 6
UNITED STATES: PUBLIC AND CURRENT ACCOUNT DEFICIT, AND DOLLAR NEER



SOURCES: Datastream, Consensus Forecast, Congressional Budget Office, IMF (World Economic Outlook), World Bank, own calculations with model NiGEM, Federal Reserve Bank of St. Louis.

a Assuming exogenous monetary policy.

After years of scant headway in the ongoing reform of the institutional framework underpinning the single currency, the economic recovery and the current political outlook open a window of opportunity for progress towards the design of a more complete Economic and Monetary Union better equipped to absorb adverse shocks. The European Commission has taken the initiative in this respect and, on the basis of the 2015 Five Presidents' Report, it has tabled specific proposals for possible approval in the course of this year and early 2019,[1] before the current parliamentary legislature concludes, while other elements should be defined between 2020 and 2025 (see accompanying table).[2] At the same time, some alternatives have also been suggested in political and academic circles.[3] This box sets out the main elements under debate.

Banking and Financial Union

The weaknesses of banking systems and the force of the financial fragmentation processes that emerged during the recent crisis, along with evidence that in more complete monetary unions it is the private channels operating through financial markets that enable a greater proportion of risks to be shared[4], led the euro area governance reform agenda to place the initial emphasis on the need to complete the banking and financial union. Accordingly, notable progress has been made in the banking arena, through the creation of the Single Supervisory Mechanism and the Single Resolution Mechanism. But certain elements that are vital for preventing a climate of mistrust such as that experienced in the past from taking hold in future crises have yet to be set in place. Such elements include most notably the need to create a common backstop (or lender of last resort) for the Single Resolution Fund, should this Fund's resources not prove sufficient to tackle potential banking crises. In this connection, there is some political consensus on the EC's December 2017 proposal, which considers that it is the European Stability Mechanism (ESM) that should assume these functions, although possible arrangements and significant technical aspects are still under discussion.

There is less consensus, however, on the design of a European Deposit Insurance Scheme (EDIS), which the EC suggests be approved in the course of 2018. The major discrepancies focus on the degree to which risks would be shared at the end of the launch process, since set against the EC's initial proposal (2015)[5], which contemplated a full pooling of risks, other less ambitious alternatives suggest a model based on national insurance schemes, which would co-exist with an EDIS and would absorb the initial losses where necessary. Another essential element of the discussion is financing; while there is agreement that this should be through bank contributions weighted by such banks' risks, it has also been suggested that there should be differentiation based on national considerations to take into account the quality of the regulatory framework or the probability of one bank's problems ultimately spreading to others (CEPR, 2018). Lastly, some believe the creation of the EDIS should be conditional upon a prior reduction of European banks' exposure to sovereign debt.

Turning to the Capital Markets Union, the EC plans to set in train various initiatives before 2019 which, in principle, will not arouse major controversy. The aim here is to bring about a greater development and integration of European capital markets with various objectives in mind: to diversify sources of financing (including through the promotion of private equity funds), to strengthen investment in infrastructures, to enhance corporate bond market oversight and to improve access by small and medium-sized enterprises to funding.

Lastly, the conclusions reached by a High-Level Task Force of the European Systemic Risk Board[6] help highlight the advantages associated with the creation of securities backed by a diversified portfolio comprising sovereign debt of the euro area countries (Sovereign Bond-Backed Securities – SBBS). Unlike Eurobonds, these securities do not entail the joint liability of governments, but they would enable bank debt portfolios to be diversified and thereby weaken the link between this and sovereign debt. Nonetheless, the report also reveals the difficulties posed by their creation in the current regulatory framework. The EC will table a proposal for the creation of SBBS in spring 2018, postponing until later the debate on the possibility of introducing European public debt with joint and several liability.

Economic and Fiscal Union

As regards the Economic and Fiscal Union, the need is raised once again to strike a balance between reducing risks and creating risk-pooling mechanisms. In the former case, the EC intends to duplicate between 2018 and 2020 the structural reform support

1 The European Council at the end of June 2018 is expected to arrive at specific commitments in this respect.

2 See the "Reflection paper on the deepening of the economic and monetary union (EC, 2017); the Communication from the EC on "Completing the Banking Union (2017) and the December 2017 package [which contains a legislative proposal to transform the ESM into the European Monetary Fund or EMF, a communication on new budgetary instruments for the stability of the euro area within the European Union, a communication on the possible functions of a Minister of Economy and Finance, and a legislative proposal to include the so-called Fiscal Compact in the European legal framework (https://ec.europa.eu/info/publications/economy-finance/completing-europes-economic-and-monetary-union-policy-package_en)].

3 See, for example, the German non-paper for paving the way towards a Stability Union (2017), which takes up the position of the previous German government and, in the academic arena, CEPR(2018), *"Reconciling risk sharing with market discipline: A constructive approach to euro area reform",* Policy Insight 91, http://bruegel.org/2018/01/reconciling-risk-sharing-with-market-discipline-a-constructive-approach-to-euro-area-reform/.

4 On risk-sharing mechanisms in the euro area and in the United States, see Chapter 4, *Annual Report 2016,* Banco de España.

5 CE (2015), Proposal for a Regulation of the European Parliament and of the Council in order to establish a European Deposit Insurance Scheme, COM 2015/0586. http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52015PC0586.

6 Report of the "High-level Task force on Safe Assets", 2018, European Systemic Risk Board.

programme already in place for EU Member States, reinforcing it as from 2020, when the new EU budgetary framework is agreed.

It is also intended to strengthen and simplify the European fiscal framework, to promote fulfilment of the rules and to generate sufficient leeway so as to deploy countercyclical fiscal policies in the face of adverse shocks. In this connection, the EC made a proposal in December to integrate the main elements of the Fiscal Compact into European legislation[7] and to improve the medium-term fiscal policy stance by establishing a commitment regarding the path of expenditure. However, simplifying the complex framework of rules comprising the current European fiscal arrangements, whose practical implementation is difficult, has been left till later.

All told, the difficulties entailed in coordinating common fiscal policy measures in severe crises, when the national stabilisers prove insufficient and monetary policy is constrained by the existence of an effective bound on the scope for interest rate cuts, mean that it might be advisable to introduce supranational fiscal mechanisms that contribute to increasing the shock-absorbing effectiveness of economic policies. In this respect, the recent literature considers various alternatives for moving towards such European fiscal capacity. The most ambitious proposals suggest creating a European

7 This agreement was introduced in 2013 to respond to the need to strengthen the European fiscal framework with national rules and to reinforce the synergies between the rules and national independent institutions. Its main elements include most notably the obligation to incorporate the balanced-budget commitment into national legislation.

EC initiatives to complete EMU	Possible calendar
Financial union	
Banking union	
Backstop for the Single Resolution Fund (SRF) through the ESM/EMF	
European Deposit Insurance Scheme (EDIS)	Approval in 2018
Reduction of risks	
Regulatory treatment of bank sovereign exposure	Mutual understanding mid-2018, coming into force in 2020-2025
Capital Markets Union and safe assets	
Various initiatives (European supervisory authorities, regulation of market infrastructures…)	Finalise legislation pending before mid-2019
European Sovereign Bond-Backed Securities —no common liability—, under study by the ESRB	EC proposal in spring 2018
Safe asset —common liability—	Mutual understanding by mid-2018, coming into force in 2020-2025
Economic and fiscal union	
Structural Reform support instrument	
Specific convergence facility for non-euro area countries	EC proposal in May 2018 for approval before mid-2019. All as part of new multi-year financial framework, 2020-2025
Common stabilisation function for investment in the event of asymmetric shocks	
Reinforcement of the Structural Reform Support Programme to 2020 (technical assistance for reforms and convergence by non-euro area countries)	Approval in 2018
Change in European structural and investment funds so that countries use reserve funds until 2020	
Simplification of the Stability and Growth Pact	Mutual understanding mid-2018, coming into force in 2020-2025
Political union	
Fiscal Compact Into Union law (including flexibility criteria)	Approval before mid-2019
European Monetary Fund (EMF) as a successor to the ESM	
Minister of Economy and Finance	Political discussion
European Treasury	Mutual understanding mid-2018, coming into force in 2020-2025

SOURCES: European Commission and Banco de España.

budget with functions geared to macroeconomic stabilisation, the funding of common expenditure (on defence and security) and revenue-raising and debt-issuance capacity.[8] Others consider establishing a new ESM credit line that can extend low-cost loans to countries facing particularly adverse cyclical circumstances.

The EC's December proposal considers the creation of a stabilisation function or a function for the safeguarding of public investment against asymmetric shocks. Although the instrument is not fully defined, the aim would be to prevent – through loans and subsidies charged to the EU budget – public investment from being the first victim of periods of economic slowdown. While it is a positive initiative, we should not lose sight of the potential advantages of alternative instruments, such as cyclical insurance funds or unemployment insurance arrangements; although they elicit greater controversy, these instruments enable a greater cyclical stabilisation capacity to be attained with a limited volume of resources.[9]

Finally, on the institutional front there is some consensus on transforming the ESM into a European Monetary Fund. This institution would assume greater responsibilities for overseeing the economic policies of countries that need financial assistance and would act as a lender of last resort to the Single Resolution Fund. Some proposals suggest that the future ESM should assume the economic policy oversight and coordination functions that the Treaty assigns to the European Commission, to strengthen the capacity to prevent future crises; but it seems the best way forward would involve cooperation between both institutions. Perhaps the most controversial aspect, however, is whether financial assistance from this institution should be conditional or not upon the automatic restructuring of debt, as the German proposal suggests and as the CEPR (2018) less categorically intimates. In this respect, the ESM itself has voiced its opposition to automatic mechanisms given the complexity of discerning in real time whether the country is facing liquidity or debt-sustainability problems and in light of the impact that the possibility of restructuring may have on financing costs.

8 See, for example, the article by several European economists, academics and former heads of European institutions, *"Blueprint for a democratic renewal of the Eurozone",* published in Político on 28 February 2018. https://www.politico.eu/article/opinion-blueprint-for-a-democratic-renewal-of-the-eurozone/

9 See Chapter 4, *Annual Report 2016,* Banco de España.

Knowing the Spanish economy's position in the economic cycle is essential when evaluating the stance of the various economic policies that have been implemented or when performing a diagnosis of the possible emergence of inflationary pressure. For example, in the case of budgetary policy, in order to assess fiscal drive, the structural component of the budget deficit needs to be calculated which requires knowing the size of the output gap. The output gap[1] is defined as the difference between actual and potential GDP. Potential GDP is usually defined as the result of full utilisation of available capacity – labour force and installed capital stock – and which is consistent with the absence of inflationary pressure. Thus, for instance, following several years of below-potential GDP growth, this gap would be negative, as corresponds to a situation with idle productive resources. By contrast, after several years of above-potential GDP growth, a positive gap would be achieved, namely, a situation of over-utilisation of productive capacity which would lead to inflationary pressure.

Potential output, however, cannot be observed and, consequently, it has to be estimated and that estimate, particularly in real time, is subject to high uncertainty and should therefore be interpreted with due caution. Basically, there are two ways of estimating an economy's potential output: those which use statistical procedures to discount cyclical factors and those based on the use of a production function. The main advantage of the latter is that they analyse sources of economic growth[2].

According to the estimates of the Banco de España, the potential output growth of the Spanish economy is expected to be recovering from the low reached in 2013 as a result of the economic crisis which chiefly reflected the strong slowdown on the employment side (see Chart 1). This gradual recovery is underpinned by a slightly more positive performance, in relation to other growth periods, of productivity[3] and by a less negative contribution from employment, supported by the fall in structural unemployment, which partially offsets the negative impact of the ageing population and the sluggish labour market participation. Similarly, capital accumulation seems to have shown a somewhat more favourable profile in recent years.

In terms of cyclical position, available estimates suggest that the recovery of potential growth in recent years will have been notably lower than the vigour observed in GDP and, consequently, the pronounced negative output gap which arose during the recessionary phase of the crisis will have narrowed relatively rapidly in recent years to very close to zero – albeit still in negative territory – in 2017 (see Chart 2). This pattern is expected to continue over the next few years giving rise to positive, increasing gaps until 2020. Broadly speaking, taking into account the uncertainty surrounding these estimates, these results are consistent with those obtained by other organisations which concur that the negative output gap that built up during the years of crisis should close in 2018, or, at the very latest, in 2019[4].

Chart 3 shows the relationship between the unemployment gap (difference between the unemployment rate and structural unemployment) and wage growth in the market economy which, as can be seen, is negative in the sense that negative unemployment gaps are related to higher wage increases. Similarly, Chart 4 shows how the correlation between the output gap and underlying inflation (measured by the CPI excluding the more volatile components of energy and unprocessed food prices) is positive. Nevertheless, the two relationships are far from perfect; thus, individual data may be significantly far removed from the regression line showing the historical average. In particular, in the last two years, wage growth and underlying inflation are estimated to have been slightly lower than would be determined by the historical relationship with the unemployment gap and the output gap, respectively. For the forecast period, a gradual approximation to these two historical relationships is projected, on the basis of the existence of certain evidence that the relationship between inflation of prices and wages, on one hand, and the cyclical position, on the other, is not linear with the result that it is closer in deep recessions and strong upturns[5]. In any event, the materialisation of this approximation is subject to significant uncertainty.

1 In order to measure an economy's position in the cycle, other variables can be used such as the unemployment rate which, in turn, can be measured using several alternatives (see Box 6 of the Quarterly Report of the Banco de España 2/2017 "Alternative measures of unemployment for the Spanish economy"). In this case, the equivalent to the production gap would be the NAIRU gap, which measures the difference between the unemployment rate (or labour market slack) observed and the rate consistent with a situation free from inflationary pressure.

2 The methodology used at the Banco de España to estimate potential output is based on the production function. See in this respect, Cuadrado, P. and E. Moral-Benito (2016) "Potential growth of the Spanish economy", *Occasional Paper,* 1603.

3 That is a consequence of the far-reaching process of reallocation of resources towards more efficient firms observed in the Spanish economy during the crisis which seems to have continued without interruption afterwards.

4 A comparison with other estimates for the Spanish economy (made by the Ministry of Economic Affairs, the OECD, the IMF, the European Commission and the ECB) shows a similar pattern of gradual recovery of the cyclical position from the lows of 2013 and, in most cases, the gap turns positive in 2018.

5 See in this respect, Cuadrado, P. and E. Moral-Benito (2016) "Thresholds in the relationship between inflation and economic activity", *Economic Bulletin,* Banco de España, 12/2016.

Chart 1
POTENTIAL AND ACTUAL GROWTH IN REAL TERMS (a)

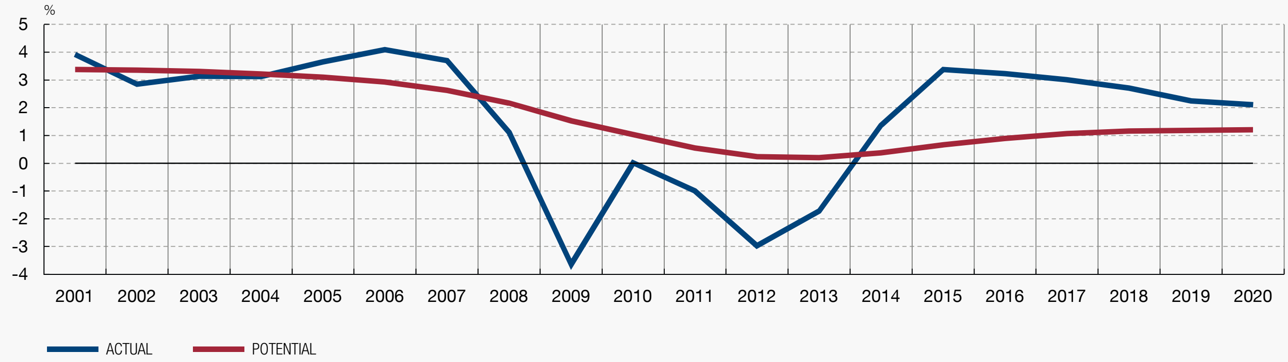


Chart 2
ACTUAL VS. POTENTIAL GDP AND OUTPUT GAP (b)

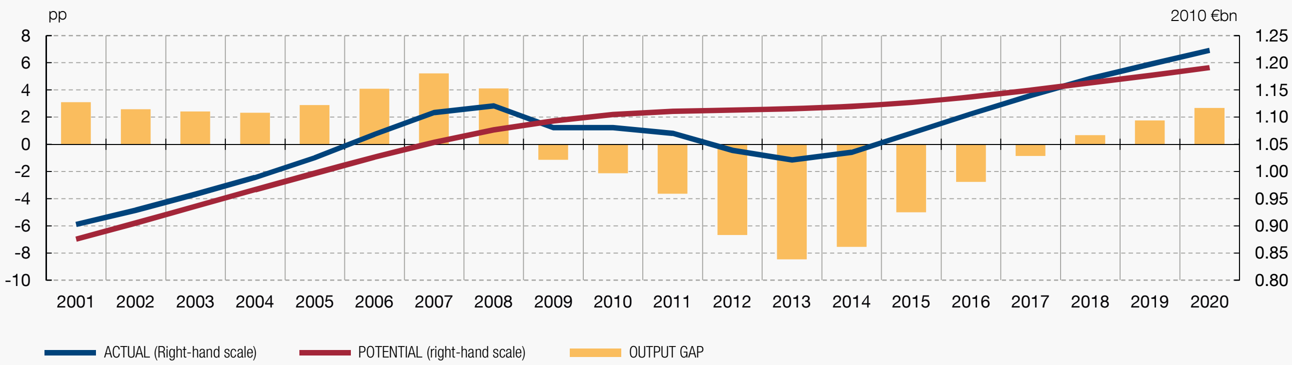


Chart 3
CYCLICAL POSITION AND WAGE INFLATION BETWEEN 1999 AND 2020
Rates of change

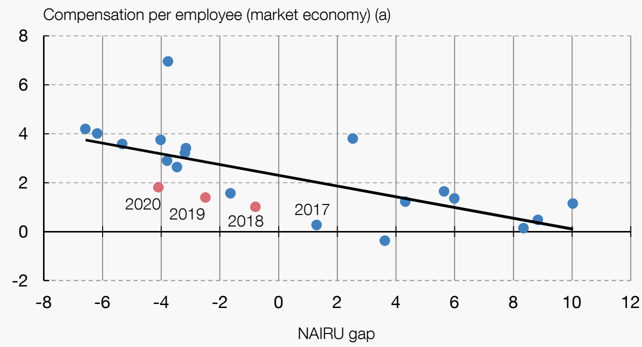
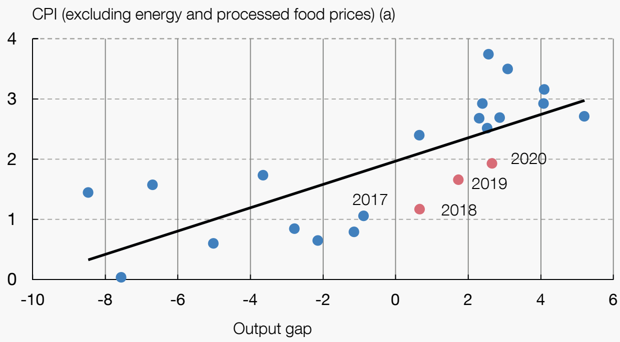


Chart 4
CYCLICAL POSITION AND INFLATION BETWEEN 1999 AND 2020
Rates of change



SOURCES: INE and Banco de España.

a Rates of change.
b Output gap defined as the percentage difference between the level of actual and potential GDP, in relation to potential GDP.

One of the factors contributing to the strong adjustment in the current account balance of the Spanish economy since 2008 has been the increasingly positive contribution of net non-tourism services (also referred to here as “Other services”).[1] This box aims to offer a detailed analysis of the factors underlying the structural change taking place in trends in imports and exports of these services.

For this purpose, the disaggregated data available from the balance of payments published by the Banco de España allows the sectors and geographical destinations making the biggest contributions to the strength of these flows to be identified.[2] The non-tourism services heading of the balance of payments mainly draws upon the Survey on International Trade in Services *(Encuesta de Comercio Internacional de Servicios – ECIS – in Spanish)*, published quarterly by the National Statistics Institute and based on a representative sample of 7,975 units (companies and other entities) registered as being resident in Spain. The survey records transactions between Spanish-resident units and those resident elsewhere in the world at market prices at the time the service was provided or received.[3]

Despite the drop in sales of financial and construction services to the rest of the world caused by the recession, exports of non-tourism services grew strongly, in line with trends in goods and tourism, with the pace of growth even accelerating in recent years. According to Banco de España data, nominal exports of Other services grew by an average of 3.3% a year between 2008 and 2016, compared with 3.5% for goods and 2.9% for tourism, thus exceeding the latter’s share since 2008 and representing 16% of total trade in 2016. Meanwhile, imports of most items under the heading of Other services have stagnated since 2008. As a result of these trends in the two types of flows, the persistent deficits observed during the expansionary phase gave way to sustained surpluses during the crisis, which widened further as the recovery began to take hold in 2014 (see Chart 1).

This performance of the trade in non-tourism services is set in a context characterised by technological advances facilitating the international trade in services, and a long-term process in which advanced economies are becoming increasingly services based. Therefore, between 2008 and 2016, the share of non-tourism services in world trade rose by almost 3 pp to 18%. Other developed countries that underwent positive growth of the external balance of non-tourism services between 2008 and 2016 include the United Kingdom and the United States. However, in France, Italy and Germany the balance remained relatively constant, even deteriorating in some cases (see Chart 1). Broadly, relative to other countries, the positive trend in Spain’s exports has been concentrated in other business services whereas, from the international viewpoint, the stagnation of imports has mainly been due to slower imports of financial services and other business services (see Chart 3).

At the more detailed level, Spain’s exports of transport services and other business services accounted for approximately 60% of income in 2016. Nevertheless, the relative importance of these two headings followed divergent paths over the period 2008-2016: the share of transport services dropped by 6 pp to around 24% of the total, while the share of other business services rose by slightly more than 8 pp to account for close to 36% of income. For their part, although exports of telecommunications, computer and information services grew, their share declined by 2 pp to 18%. Services relating to insurance and pensions and charges for the use of intellectual property also grew strongly, although they continue to represent a small share. By contrast, the share of construction and financial services exports dropped by almost 6 pp to around 8% (see Chart 4).

Other business services have played a fundamental role in the progress of exports in recent years, explaining almost two thirds of the rise in income from non-tourism services since 2008. This is mainly due to income growth among engineering and consulting firms (which grew by an average of 8.2% and 17.6%, respectively, from 2008-2016) to account for 27% and 8%, respectively, of other business services, although the strong performance of advertising and market research services, which grew by 5.1% a year to 11% of the total, also contributed (see Chart 5).[4] It should be noted that these other business services grew against the background of a decline in domestic demand, particularly in the case of civil engineering, forcing Spanish companies to increase their sales in external markets.

As regards the destination of Spain’s exports, it is worth noting that the increase in exports of non-tourism services was accompanied by a degree of geographical diversification, with a strong increase in the presence of Spanish companies in the countries of Asia and Latin America, supported by government-backed comprehensive market development plans, which have allowed companies better access to strategic markets.[5] Chart 6 shows the contribution of the main regions to cumulative export

1 See Chapter 3, *Annual Report 2016,* Banco de España.

2 The non-tourism services heading includes the following: transport, construction, insurance and pension services, financial services, charges for the use of intellectual property, telecommunications, computer and information services, other business services, personal, cultural and recreational services, and government goods and services. For more details see The Balance of Payments and the International Investment Position: Methodological Note, January 2018, Banco de España.

3 There was a discontinuity in the structure of the Other services heading in 2013 as a result of changes in the ECIS, which made it necessary to estimate disaggregation by component based on additional information from transactions with the rest of the world provided to the Banco de España by financial institutions. More detailed information on the ECIS can be found at: https://goo.gl/zuGktx.

4 This greater disaggregation of other business services is based on own estimates made using information from the records of transactions with the rest of the world and from the Survey on International Trade in Services.

5 Comprehensive market development plans are managed by ICEX and aim to support companies’ entry into difficult-to-access markets. The countries for which plans existed in 2015 were Algeria, Australia, Brazil, China, the Gulf Cooperation Council, the United States, the Philippines, India, Indonesia, Japan, Morocco, Mexico, Russia, Singapore, South Africa and Turkey.

Chart 1
OTHER SERVICES BALANCE. BALANCE

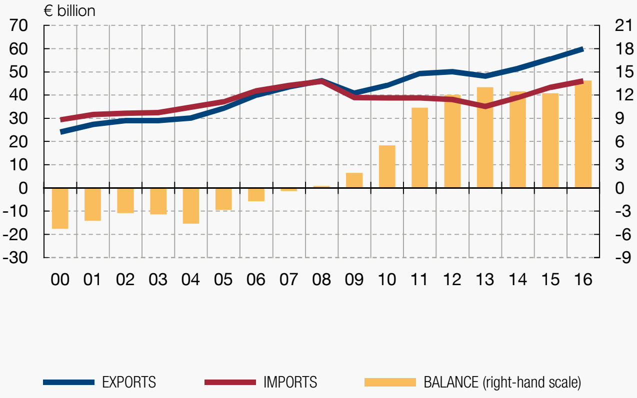


Chart 2
OTHER SERVICES BALANCE. INTERNATIONAL COMPARISON

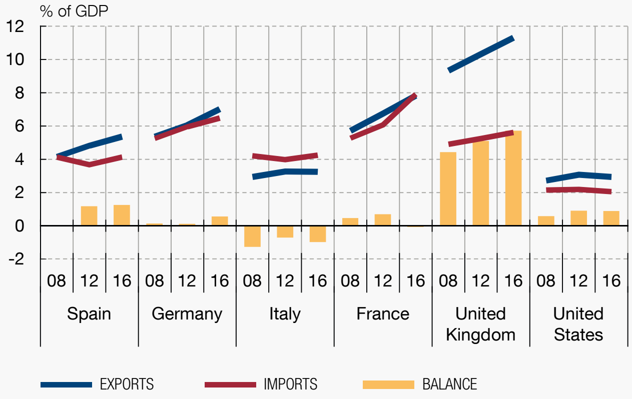


Chart 3
TRADE IN OTHER SERVICES BY SECTOR 2008-2016. INTERNATIONAL COMPARISON

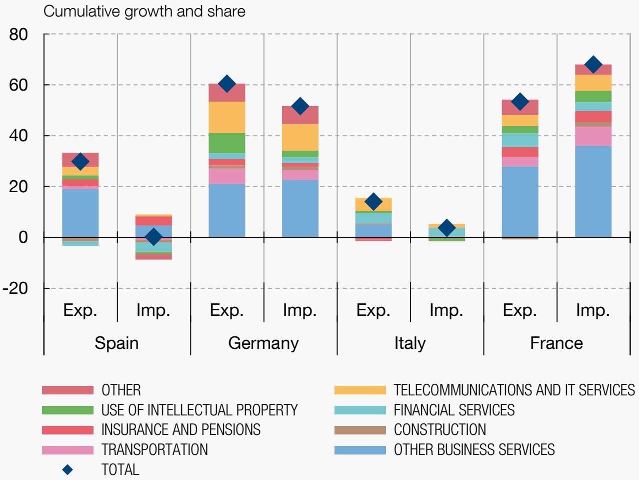


Chart 4
EXPORTS OF OTHER SERVICES. BY SERVICE TYPE

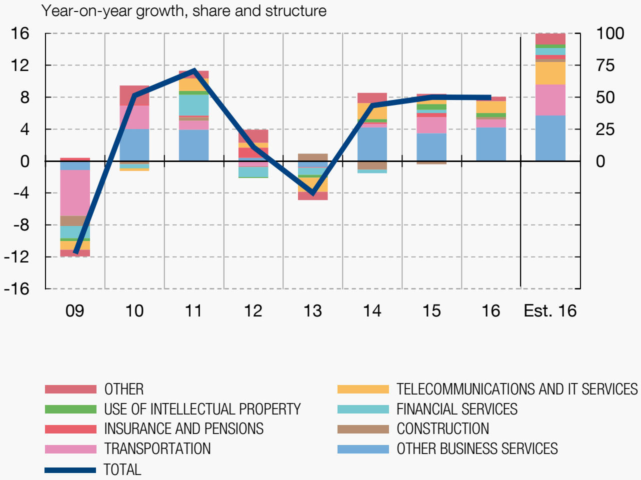


Chart 5
EXPORTS OF OTHER BUSINESS SERVICES. BY SERVICE TYPE

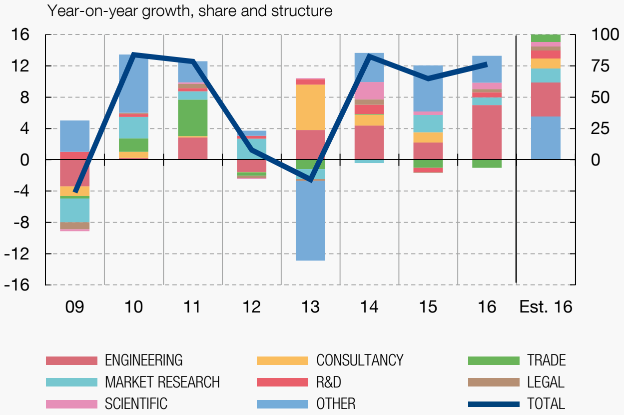
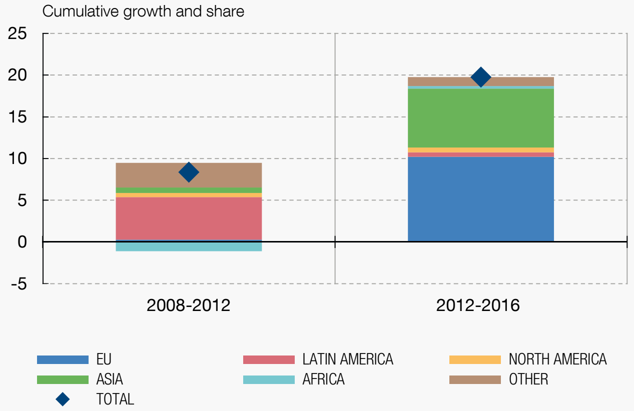


Chart 6
EXPORTS OF OTHER SERVICES. BY REGION



SOURCES: Banco de España, Eurostat and WTO.

growth in 2008-2012 and 2012-2016, with Latin America in first place, followed by Asia in second. Thus, although the European Union represented the main destination for Spain's exports of non-tourism services in 2016 (approximately 52% of the total), its relative importance dropped by 4 pp between 2008 and 2016.

Bearing in mind the kind of service exported to each market, the boom in other business services is mainly explained by rising income from Asia and Europe, associated in Asia's case with engineering firms, and in Europe's case, with consultancy, and advertising and market research firms. Nevertheless, despite this positive trend in exports of engineering services to Asian countries in 2008-2016, the available information suggests that growth was weaker in 2017, which led to a slight slowdown in the expansion of non-tourism services exports as a whole last year. However, the growth trend under other headings and to other geographical destinations appears to have been sustained, with an increase in the share of exports to Europe, which, in conjunction with slower growth in imports, resulted in a slight increase in net exports of non-tourism services over the course of 2017.

To conclude, Spain's trade in non-tourism services underwent considerable expansion in 2008-2016, driven by a diverse mix of internal and external factors. On the international level, the role of technological progress and trade deregulation stand out, together with the shift to a more service-based economy. Moreover, this process was more pronounced in the case of the Spanish economy as a result of competitiveness gains and the process of companies looking for new markets in response to the recession and supported by the comprehensive market development plans. It seems likely that global factors will continue to encourage the expansion of trade in other services over the coming years, and that internal factors will have a permanent impact on the levels of these trade flows, provided that the recent drive towards greater internationalisation of the Spanish productive system proves lasting.

Pension schemes are long-term purpose-driven savings products mainly devoted to cover retirement. There are three types in Spain: occupational, professional-association[1] and individual pension schemes. The first two are sponsored by firms, entities, trade unions or professional associations, and their beneficiaries are their employees or members, as appropriate. The third kind is sponsored by one or several financial institutions and their beneficiaries are individuals who make contributions. Pension funds are holding companies without legal status through which the savings generated by pension schemes are invested.

As Chart 1 shows, pension funds' total assets have trended upwards from 2012 after several years of stability, exceeding €111 billion at December 2017 (€74.4 billion relate to individual pension funds and €36.7 billion to the other two categories together). This figure accounts for 9.5% of GDP which, in comparison with other OECD economies, would place Spain among the countries with the lowest weight of these instruments (see Chart 2). The differences between countries arise from differences in the degree of coverage by state schemes, household savings preferences and the policies adopted by each State to encourage these private schemes. In the case of Spanish households, the weight of pension funds relative to other financial investment alternatives is low (accounting for only 5% of their financial wealth). Also, although the share of pension funds has increased recently with respect to bank deposits, it has decreased very significantly in comparison with assets managed by collective investment undertakings (CIUs), i.e. investment funds and companies, and foreign CIUs.[2]

1 Professional-association pension schemes are of scant importance, accounting for only 1% of the total, and have been grouped together with occupational pension schemes for analysis.

2 For further details on the changes in and characteristics of pension schemes and funds, see the article "Evolución reciente de los planes y fondos de pensiones en España", Boletín Económico, diciembre 2016, Banco de España.

Chart 1
TOTAL ASSETS OF PENSION FUNDS IN SPAIN

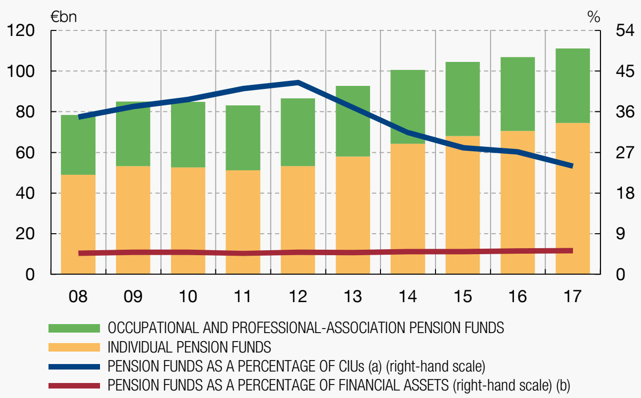


Chart 2
TOTAL ASSETS OF PENSION FUNDS. INTERNATIONAL COMPARISON.
December 2016

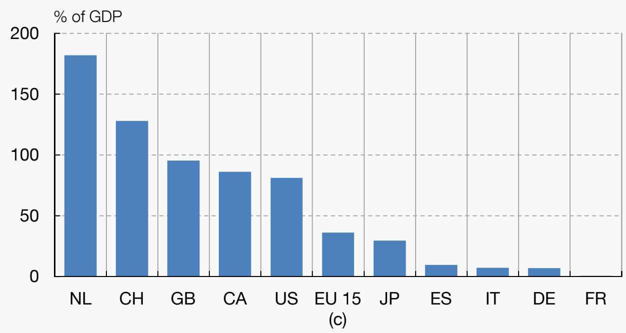


Chart 3
MANAGEMENT FEES

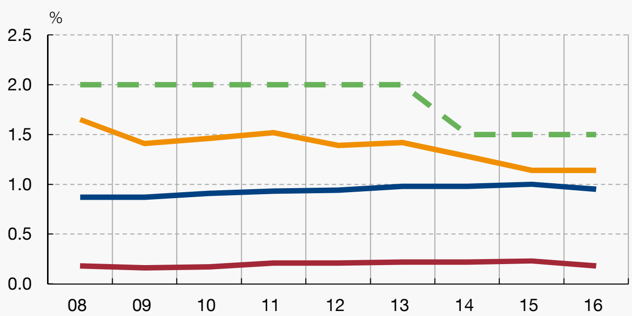
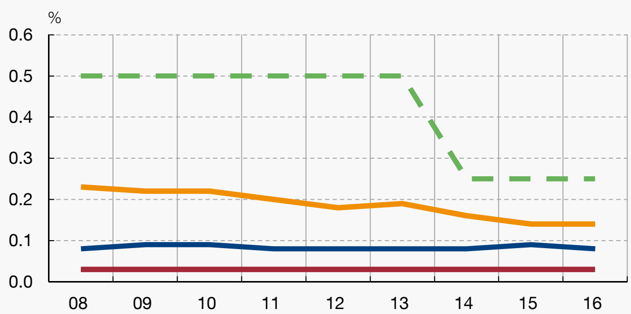


Chart 4
CUSTODIAN FEES



SOURCES: Banco de España, OECD and Inverco.

a CIUs are Collective Investment Undertakings.
b Data on financial assets of households at September 2017.
c Weighted average. Greece and Luxembourg are not included.

RD 62/2018 amending the pension scheme and pension fund regulations was enacted on 9 February 2018 to enhance the appeal of pension schemes as a long-term investment alternative. In this connection, it includes changes in different areas. Specifically, it incorporates the new provision on liquidity introduced in the pension law reform of 2014. This permits early access (effective from 1 January 2025) to rights corresponding to contributions made at least ten years previously starting from January 2015. It also adapts the procedures for mobilisation of pension scheme members' rights in all cases of early withdrawal, and updates and relaxes the regime for assets eligible for pension fund investments, in line with the European regulations. Additionally, it reduces management costs by changing the maximum management and custodian fee limits applicable. Lastly, the maximum periods for the execution of orders relating to transfers between funds and for settlements in the event access is gained to vested rights are shortened, certain aspects relating to the valuation of contributions, rights and benefits are clarified, and the information requirements for members are extended, including those relating to the dates on which contributions are made and to possible future liquidity and taxation in the event of access to vested rights.

The possibility for members to gain access to rights corresponding to contributions made at least ten years before to individual and professional-association pension schemes was established by the RD without setting any additional quantitative limit or condition in order to encourage the arrangement of and contribution to pension schemes, since this improves the liquidity of these products. As regards occupational schemes, the RD maintains the possibility of incorporating this option provided the scheme's specifications allow it.

The other important change introduced by the RD is the reduction of the maximum management and custodian fees collected by pension fund management and custodian companies as remuneration. Also, a system is established under which the single management fee (1.5% from October 2014) is replaced by fees that are applied based on the scheme's focus and related risk levels. Thus, pension funds are classified into bond funds (no exposure to equities), mixed-income funds (less than 30% exposure to equities) and other (equity exposure of 30% or more of total assets), and the maximum fees are set at 0.85%, 1.3% and 1.5%, respectively. The maximum custodian fee, which is common to the three categories, is reduced by five basis points, to 0.2%. This new system aims to contribute to improving pension scheme profitability and, consequently, to encourage enrolment in such schemes. It also encourages a larger fee reduction for funds with more prudent investment criteria (those with a greater fixed-income component), which are predominant in Spain.

As shown in Charts 3 and 4, the management and custodian fees of pension funds linked to individual schemes are substantially higher than for occupational and professional-association schemes, which could be due to the greater negotiating power of the holders of the latter over fund managers. These fees are also higher than those applied to other savings instruments such as investment funds. However, these differences have declined in recent years, in line with the decrease in the legal ceilings applied to pension schemes. Against this background, it could be expected that the lowering of these limits in accordance with the RD will contribute to the narrowing of the distance between the fees applied to individual schemes and those applied to other financial products.

It is therefore foreseeable that the recent reform of pension schemes and funds will help to enhance the appeal of these instruments and will thus have a positive, albeit difficult to quantify, effect on the volume of schemes arranged, gaining importance as a supplement to the state pension scheme.

2 EXTERNAL ENVIRONMENT OF THE SPANISH ECONOMY

2.1 External environment of the euro area

The slight additional acceleration in global economic activity in 2018 Q1 and the expected effects of the US fiscal expansion (see Box 2) have given rise to upward revisions of the growth forecasts for the current year, in particular in the cases of the United States and the euro area. This has meant a further reduction in the expected productive slack in some advanced economies; accordingly, inflation forecasts have also been revised upwards. Indeed, albeit with a heterogeneous performance from one country to another, inflation has increased in the advanced economies as a whole to date in 2018, which might have implications for the pace of monetary policy normalisation. The financial markets, for their part, experienced some turbulence in early February, characterised by an across-the-board correction of stock market indices and strong rises in volatility on these markets. Subsequently, these developments were partly reversed (see Box 3). This turbulence was related to a greater-than-expected increase in US wage data, which might prompt the Fed to step up the pace of monetary normalisation, and to the tariffs imposed by the US government.

The turbulence closed a period which, until late January, had been marked by investor optimism, low volatility and the search for additional yield. Nonetheless, a prominent characteristic of the performance of international financial markets during this turbulence was that other market segments, such as sovereign debt and corporate debt spreads, were affected to a much lesser extent. The depreciating trend of the dollar which had been witnessed throughout the previous year – linked partly, perhaps, to the US economy's external imbalance, as noted in Box 4 – appeared to come to a halt after this turbulence. However, the materialisation of the announced protectionist measures and the possible response by other countries notably hamper any future forecast for exchange rates. On bond markets, the fiscal impulse approved in the United States and the ensuing fears of sharper monetary tightening in this economy raised the yield on US long-term debt to 2.9%, a development likewise observed – with less intensity – in other advanced economies.

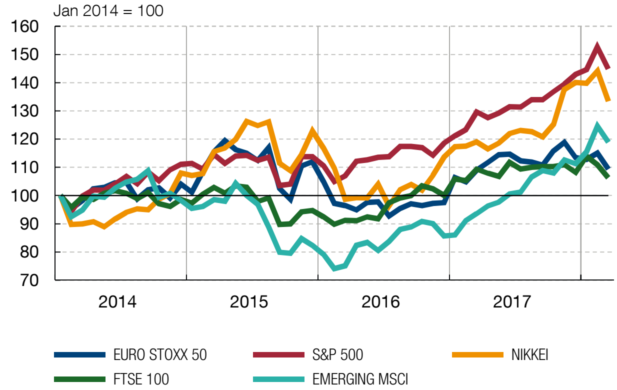
In the emerging economies, stock markets posted across-the-board gains until the above-mentioned period of turbulence. In any event, during the quarter only China posted losses, compared with the significant equities-related increases in Latin America. The weakness of the dollar enabled most emerging currencies to appreciate, with the exception of the Argentine peso, whose central bank anticipated a more expansionary monetary policy following the increase in the inflation target in 2018 and 2019 decided by the government. Net capital flows into these economies were substantial until mid-January, in terms of both debt flows and, especially, stock market flows, rising to two-year highs. However, negative flows were recorded in both cases in early February, especially in bonds, which subsequently picked up in part.

Commodities prices rose by 3% in the last quarter, owing to the combined effect of dearer industrial metals and food. The developments in industrial metals prices are due to the sound performance of global economic activity. As to oil, the price of Brent oscillated throughout the quarter, rising to over 70 dollars per barrel, although it currently stands at levels close to those of the start of the year, at around 64 dollars. The increase in US production, among other factors, helps explain this correction. In any event, oil inventories have fallen considerably, though they still stand above the average for the last

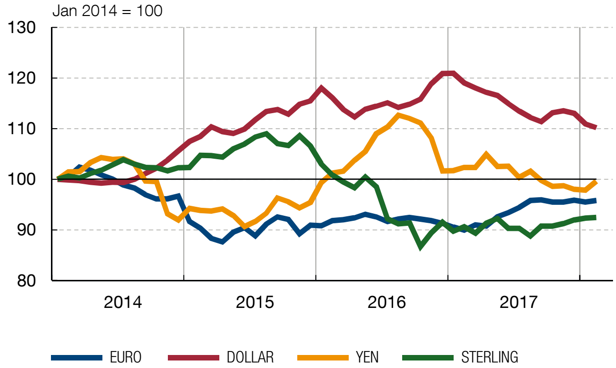
FINANCIAL MARKETS AND COMMODITIES

CHART 2

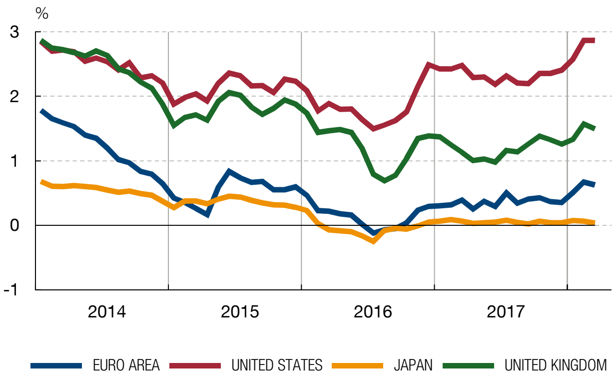
1 STOCK EXCHANGE INDICES



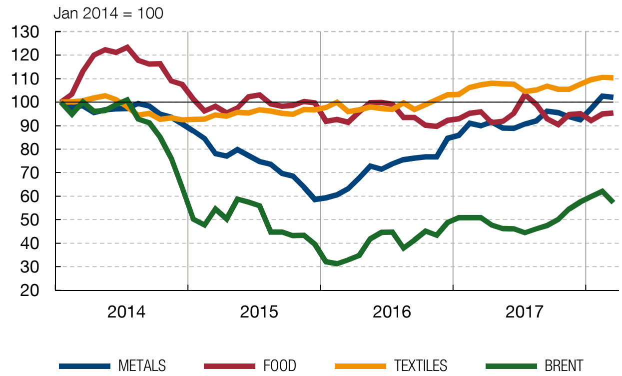
2 CPI-BASED REAL EFFECTIVE EXCHANGE RATES VIS-À-VIS DEVELOPED COUNTRIES (a)



3 LONG-TERM INTEREST RATES (b)



4 COMMODITIES



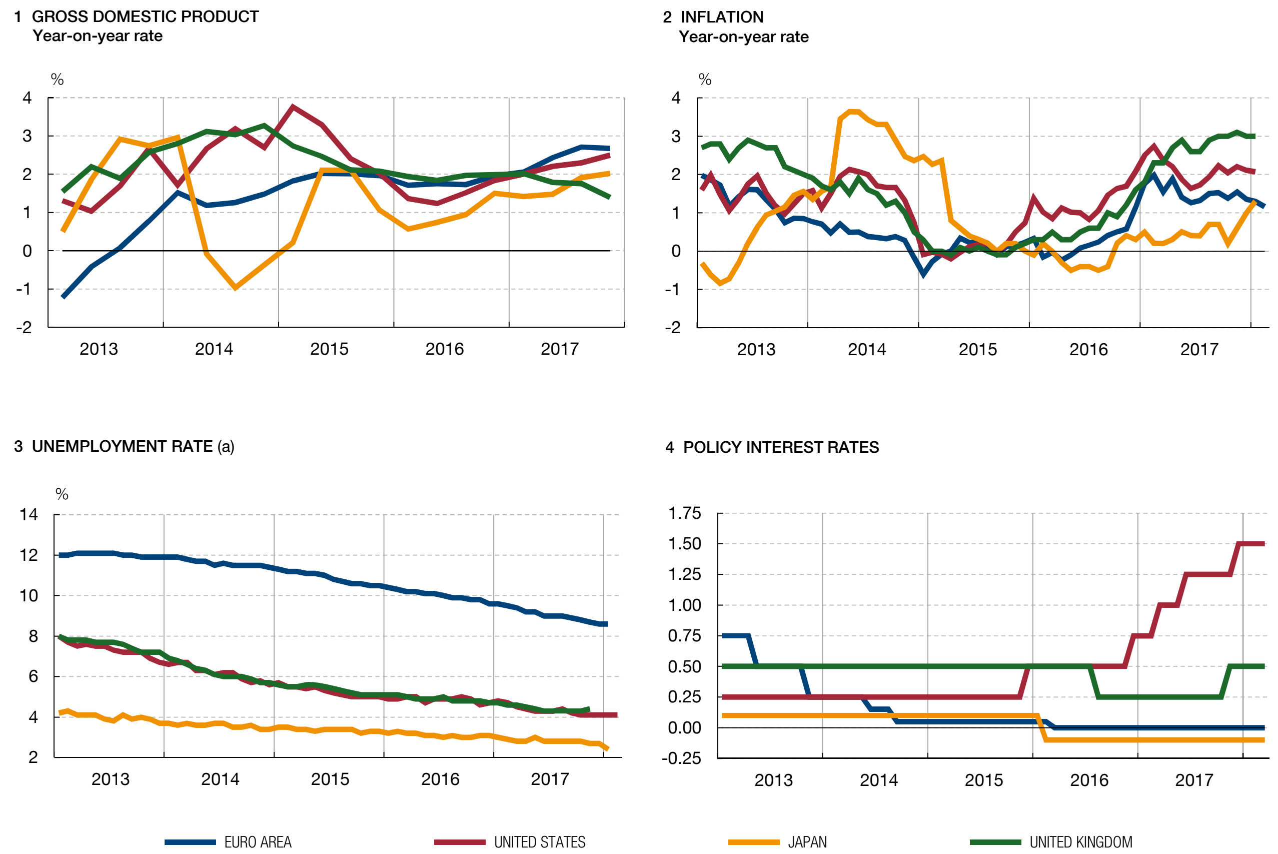
SOURCES: Datastream and Banco de España.

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

five years, not only owing to the buoyancy of demand but also to the high degree of fulfilment of the output agreement entered into by the OPEC countries and other leading global producers.

The GDP growth data for 2017 Q4 and the latest high-frequency indicators confirm the current robustness of global economic activity. In the advanced economies, US GDP grew at an annualised quarter-on-quarter rate of 2.5%, chiefly underpinned by private consumption and investment. In Japan, activity grew by 1.6% in annualised quarter-on-quarter terms, attesting to the firmness of growth. The United Kingdom posted a quarter-on-quarter growth rate of 0.4%, slightly down on the previous quarter, owing to the lower growth of private consumption and the negative contribution of external demand. In these economies, the overall inflation rates trended in line with energy prices, evidencing something of an increase in certain areas. In the United States, the inflation rate held slightly above 2% from late 2017 to early 2018, while Japan posted in January its highest inflation rate since March 2015 (1.4%), driven mainly by an increase in food prices. The UK inflation rate held above its target, as a result of the depreciation of sterling, although in recent months it has stabilised at around 3%. Against this background, central banks have not made changes to their monetary policies, although expectations of policy rate rises have actually been revised. This was specifically the

DEVELOPED ECONOMIES: MAIN MACROECONOMIC INDICATORS CHART 3



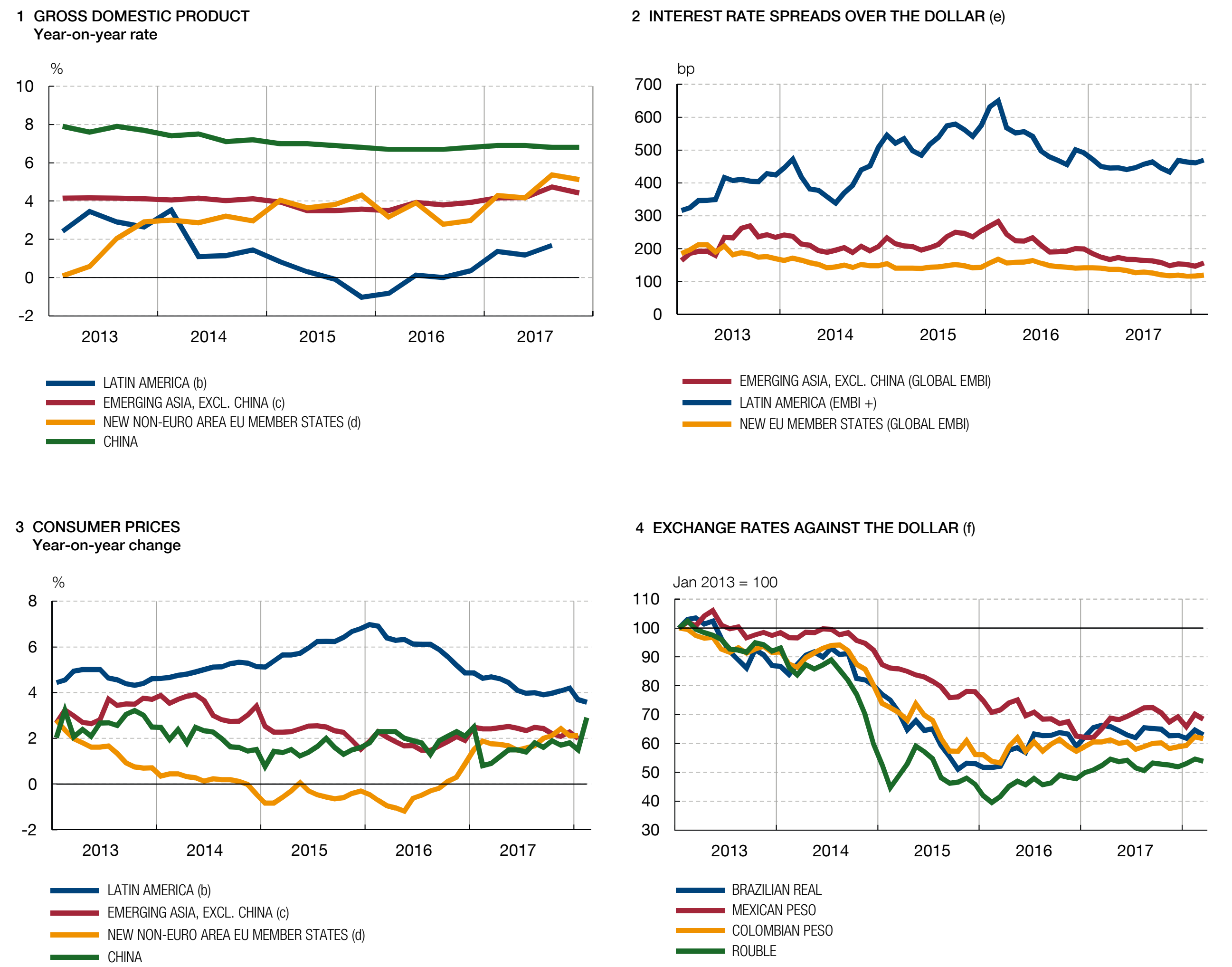
SOURCES: Datastream and Banco de España.

a Percentage of labour force.

case in the United States – where a rise is expected at the March meeting and where the probability that there will be four rises in 2018 increased – and in the United Kingdom, where the Bank of England might raise its policy rate at its forthcoming meetings.

In the emerging economies, activity in Q4 also performed favourably. In the case of China, GDP growth stabilised and, for 2017 as a whole, the related rate was 6.9%, with the economy's dynamism increasing slightly for the first time since 2010. In India, GDP grew by 7.2% in Q4, posting its highest rate of increase since 2016 Q3, thanks to a strong rise in investment and in public spending, which allowed the adverse effects of demonetisation to be overcome. In Latin America, the data for Q4 showed positive growth rates, although in some cases, such as Brazil, these were very modest. In Mexico it was confirmed that the decline in activity in Q3 was temporary, while in Colombia and Peru GDP lost momentum. In Eastern Europe, the current favourable economic setting was confirmed by the growth data for Q4. As regards prices, inflation in Asia was uneven across the different countries, with opposing trends which, however, did not alter the stance of their monetary policies. In Latin America and Eastern Europe, meanwhile, inflation continued to fall in general. Consequently, the central banks of Brazil, Colombia and Peru cut their policy interest rate by 25 bp (to 6.75%, 4.50% and 2.75%, respectively), signalling in the first two cases that the rate-reduction cycle might be over. Finally, the Russian central bank also continued to cut its policy rate, placing it at 7.5%.

EMERGING ECONOMIES: MAIN MACROECONOMIC INDICATORS (a) CHART 4



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, Philiippines, 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 denotes a depreciation of the currency against the dollar.

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

The economic expansion in the euro area continued to be sound and across the board, with GDP growing by 2.5% over the year as whole. Activity continues to be driven by the ECB's accommodative monetary policy and favourable financing conditions, improvements in the labour markets and increasingly stronger foreign trade. However, in the year to date, financial conditions became less easy, basically as a result of the fall in stock prices, affected by the adjustment in the US markets, and the additional euro exchange rate appreciation. Confidence indicators have also undergone a correction, although they are holding at historically high levels, suggesting that the expansionary inertia extended to the first quarter of the year. This is also suggested by the macroeconomic projections for the euro area drawn up by the ECB and published in March, which foresee quarter-on-quarter GDP growth for the area of 0.7% in Q1. Forecasts for the year as a whole revise growth expectations for 2018 upwards by 0.2 pp in comparison with the December exercise, to 2.4%, and they maintain the forecasts for 2019 and 2020 at 1.9% and 1.7%, respectively (see Table 2).

EURO AREA GDP AND HICP GROWTH PROJECTIONS

TABLE 2

	2018		2019		2020	
	GDP	HICP	GDP	HICP	GDP	HICP
European Central Bank (March 2018)	2.4	1.4	1.9	1.4	1.7	1.7
European Commission (February 2018)	2.3	1.5	2.0	1.6	—	—
OECD (November 2017)	2.1	1.5	1.9	1.7	—	—
International Monetary Fund (January 2018)	2.2	—	2.0	—	—	—
Consensus Forecast (February 2018)	2.3	1.5	1.9	1.5	—	—
Eurobarometer (February 2018)	2.3	1.6	1.9	1.6	—	—

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

Despite the more favourable outlook for economic activity, a scenario of relatively low inflation persists in the euro area, still conditioned by the context of wage restraint. Core inflation, which excludes the more volatile components of prices, rose slightly to 1.2% in February, while the wage settlements stood at 1.6% at end-2017. The ECB's latest forecasts foresee annual inflation of 1.4% in 2018 and 2019, which entails a downward revision for 2019 owing to the effect of the appreciation of the euro. For 2020 the expectation remains that overall inflation and the index which excludes energy and food will move closer to 2% (1.7% and 1.8%, respectively).

Against this backdrop of robust expansion and a contained inflation outlook, the Governing Council of the ECB has confirmed the measures it adopted in October, indicating the need to maintain the monetary stimulus. The accommodative monetary stance is determined by the low level of interest rates and the expectation that they will remain low over a prolonged period, by the extension of net purchases of securities under the net asset purchase programme (APP) at least until September 2018, by the large volume of the securities portfolio acquired over the three years during which the APP has been in place and by the commitment to reinvest securities as they mature for so long as may be necessary. Nevertheless, the Governing Council in March deleted from its statement the reference whereby, in the event of a deterioration in the economic situation or in financial conditions to levels incompatible with achieving the inflation objective, it would continue to be willing to increase the volume and/or duration of the asset purchase programme.

Also, following the proposals and the road map published by the European Commission (EC) in 2017 Q4, in recent months the Eurogroup and the Ecofin have discussed on several occasions how to continue progressing towards a monetary union that is more complete and capable of absorbing shocks. Box 5 summarises the main elements of this discussion.

ECONOMIC DEVELOPMENTS

In 2017 Q4, euro area GDP grew at a pace of 0.6% quarter-on-quarter, slightly lower than in Q3 when it had been revised upwards (see Table 3). Growth was underpinned by the increase in domestic demand (with investment playing a more central role) and in the external sector. In particular, private and government consumption slowed mildly, while investment quickened substantially, growing by 0.9% (as compared with 0.2% in Q3), against a background of very favourable financing conditions, high capacity utilisation and better profit expectations. As a result, the contribution of domestic demand, excluding changes in inventories, to GDP growth stood at 0.3 pp (against 0.2% pp in Q3). Meanwhile, the positive contribution of net external demand was once again significant, maintaining a contribution of 0.5 pp to quarter-on-quarter growth of GDP, accounted for by the

EURO AREA ECONOMIC INDICATORS (a)

TABLE 3

	2016			2017				2018
	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
National Accounts (quarter-on-quarter rate)								
Gross domestic product	0.4	0.4	0.6	0.6	0.7	0.7	0.6	
Contributions to quarter-on-quarter change in GDP (pp)								
Internal demand, excluding inventories	0.7	0.4	0.5	0.3	0.7	0.2	0.3	
Change in inventories	-0.1	0.1	0.2	-0.2	0.2	0.0	-0.2	
Net external demand	-0.2	-0.1	0.0	0.5	-0.2	0.5	0.5	
Other indicators								
Unemployment rate (b)	10.2	9.9	9.7	9.5	9.1	9.0	8.7	8.6
HICP (year-on-year rate) (c)	0.1	0.4	1.1	1.5	1.3	1.5	1.4	1.2
CPI excl. unprocessed food and energy (year-on-year rate) (c)	0.8	0.8	0.9	0.8	1.2	1.3	1.1	1.2

SOURCES: European Commission, Eurostat, ECB and Banco de España.

a Information available up to 13 March 2018.
b Average for the quarter. Latest figure available: January 2018.
c End of the period. Latest available figure: February 2018.

increase in exports associated with the improvement in world trade which enabled the adverse effects of the appreciation of the euro to be offset.

GDP grew across the board in Q4. In the larger economies, the increases were 0.6% in Germany and France, 0.7% in Spain and 0.8% in the Netherlands, set against a smaller increase in Italy (0.3%).

The latest conjunctural information points to a continuation of the expansionary stimulus in the opening months of the year. According to the ECB's forecasts, GDP could grow by around 0.7% in 2018 Q1, easing subsequently. The qualitative indicators have shown a degree of contraction over the quarter. The declines were practically across the board, extending to the European Commission's (EC) business confidence indicators (except those relating to construction, which improved) and to the survey-based opinions of purchasing managers (PMI), as well as to consumer confidence and job creation expectations reflected in the EC surveys (except, once again, in construction) (see Chart 5). Nevertheless, in many cases the confidence indicators remain close to their all-time highs. Turning to external demand, the assessment of order books from abroad and export expectations point to a favourable performance in these months. The information available from quantitative indicators for Q1 is still very incomplete and giving mixed signals. Thus, retail sales declined slightly in January, following a bigger fall in December, while new car registrations edged up in January for the second consecutive month. Lastly, the unemployment rate held at 8.6% in January.

As regards prices, inflation eased slightly in February, in line with expectations, to stand at 1.2%, influenced by base effects on changes in the non-processed food and energy components. Core inflation increased slightly, to 1.2%, owing to a mild increase in services prices and in non-energy industrial goods. According to the ECB's forecasts, inflation will rise to 1.5% in the coming months, with the average annual rate for 2018 standing at 1.4%. Therefore, the contained behaviour of prices persists, to which the modest increase in unit labour costs contributes, against a background of a still-high degree of slack in certain labour market segments, despite the robust expansion of employment. The reforms made in this field in certain countries, the moderate increase in productivity and the application of indexation mechanisms – explicit or implicit – which index wages to past inflation, also contribute to explaining the low wage growth.

The strength of the economic expansion is reflected in the general government deficit, which could decline to 0.7% of GDP in 2018 for the euro area as a whole, according to the ECB's March projections. In structural terms, however, the expected balance remains practically stable (around -1% of GDP); thus, the contribution of fiscal policy to growth would be practically neutral, although this diagnosis is subject to some uncertainty associated with the new German government's budgetary plans.

The European Semester 2018 Winter Package confirmed the existence of imbalances in France, Portugal, Germany, Ireland, the Netherlands and Spain, and of excessive imbalances in Cyprus and Italy. In the euro area as a whole, the EC highlights the correction of the current-account deficits and the high levels of public and private indebtedness, fuelled particularly, in this case, by the economic recovery. By contrast, current account surpluses remain at high levels. The banking sector has also reduced its vulnerability as a result of the increase in capital ratios and the decrease in non-performing loans, although some countries require further progress in this connection. However, new risks are discernible relating to the rise in house prices in some of the Member States, with signs of overvaluation in some cases.

FINANCIAL DEVELOPMENTS AND MONETARY POLICY

Euro area financial conditions tightened somewhat during Q1, essentially as a result of the appreciation of the euro and the correction in equities markets (see Chart 7). Nonetheless, in the above-mentioned setting of robust expansion and a contained inflation outlook, the ECB Governing Council, at its January and March meetings, retained its accommodative monetary policy stance and reiterated its expectations that interest rates will hold at their current low levels for a prolonged period far beyond the horizon for net securities purchases. The interest rates for the main refinancing operations, the marginal lending facility and the deposit facility stand at 0%, 0.25% and -0.40%, respectively. The Council confirmed the decision taken in October last year to extend the APP program to at least September 2018, with a monthly pace of net securities purchases of €30 billion. The Council also foresees continuing to reinvest the principal of the securities in its portfolio as they mature for a prolonged period after the end of net purchases and, in any event, as long as may be necessary. With the APP having been in place for three years, the value of the portfolio acquired is €2,316 billion (more than 20% of euro area GDP) and reinvestments from March 2018 to February 2019 are expected to amount to €167 billion.

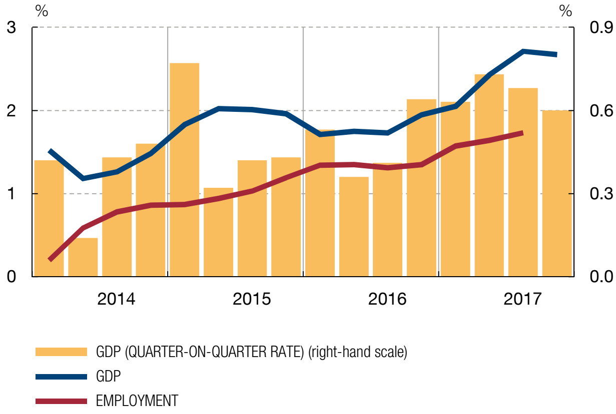
In the bond markets, government debt yields increased by around 20 bp as from end-2017 in the case of the German Bund, whose average yield is standing at around 0.65% in March to date. This increase is consistent with a brighter macroeconomic outlook for the euro area, although a spillover effect cannot be ruled out from the rise in US long-term rates, which was somewhat sharper, widening the rate spread over Germany to more than 220 bp (compared with 200 bp late last year). The slight rise in German yields did not pass through fully to the other euro area sovereign bonds, which translated into a fairly widespread contraction in sovereign spreads that was more marked in the case of the Spanish and Portuguese bonds.

Turning to stock markets, the Eurostoxx 50 index fell by 3% over the quarter as a whole (after having receded by more than 9% from the highs recorded in January), against the

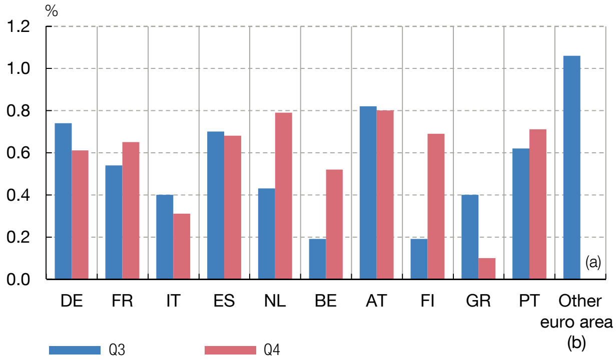
EURO AREA. ACTIVITY INDICATORS

CHART 5

1 OUTPUT AND EMPLOYMENT
Year-on-year rate

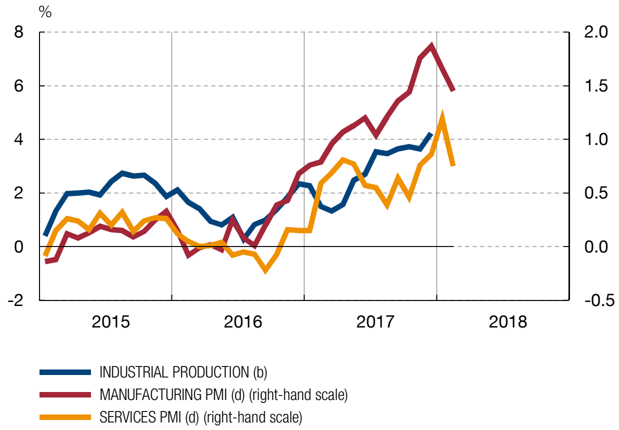


2 GDP BY COUNTRY
Quarter-on-quarter rate

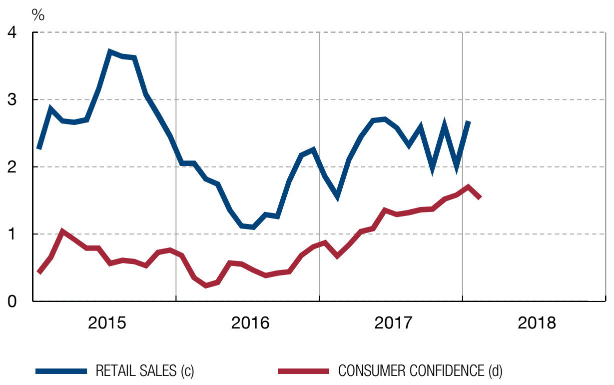


Dynamic chart

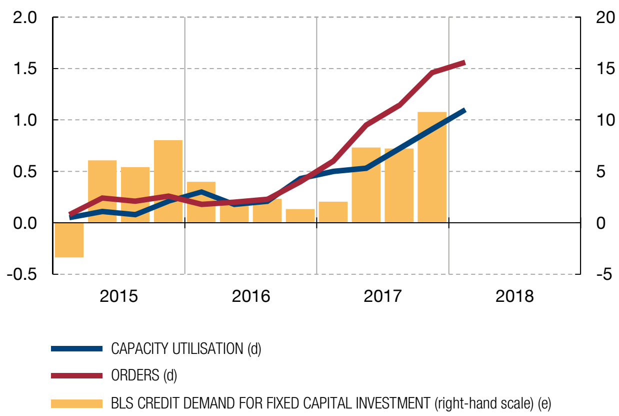
3 INDUSTRIAL ACTIVITY AND SERVICES INDICATORS



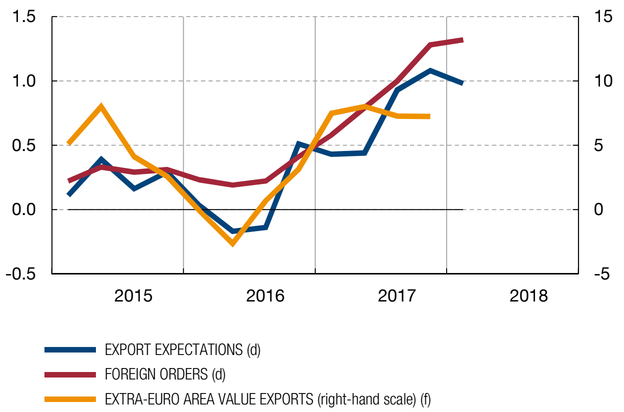
4 CONSUMPTION INDICATORS



5 INVESTMENT INDICATORS



6 EXPORT INDICATORS



SOURCES: Eurostat, Markit Economics and Banco de España.

a Q4 figure not available.
b Ireland is not included owing to the high volatility of its data.
c Year-on year rates, calculated on the basis of the non-centred quarterly moving average of the seasonally adjusted series.
d Normalised series for the period represented.
e Bank Lending Survey. Indicator = percentage of banks reporting a considerable increase + percentage of banks reporting some increase × 0.5 – percentage of banks reporting some decrease × 0.5 – percentage of banks reporting a considerable decrease. A positive value denotes an increase.
f Year-on-year rates of the original monthly series. Quarterly average.

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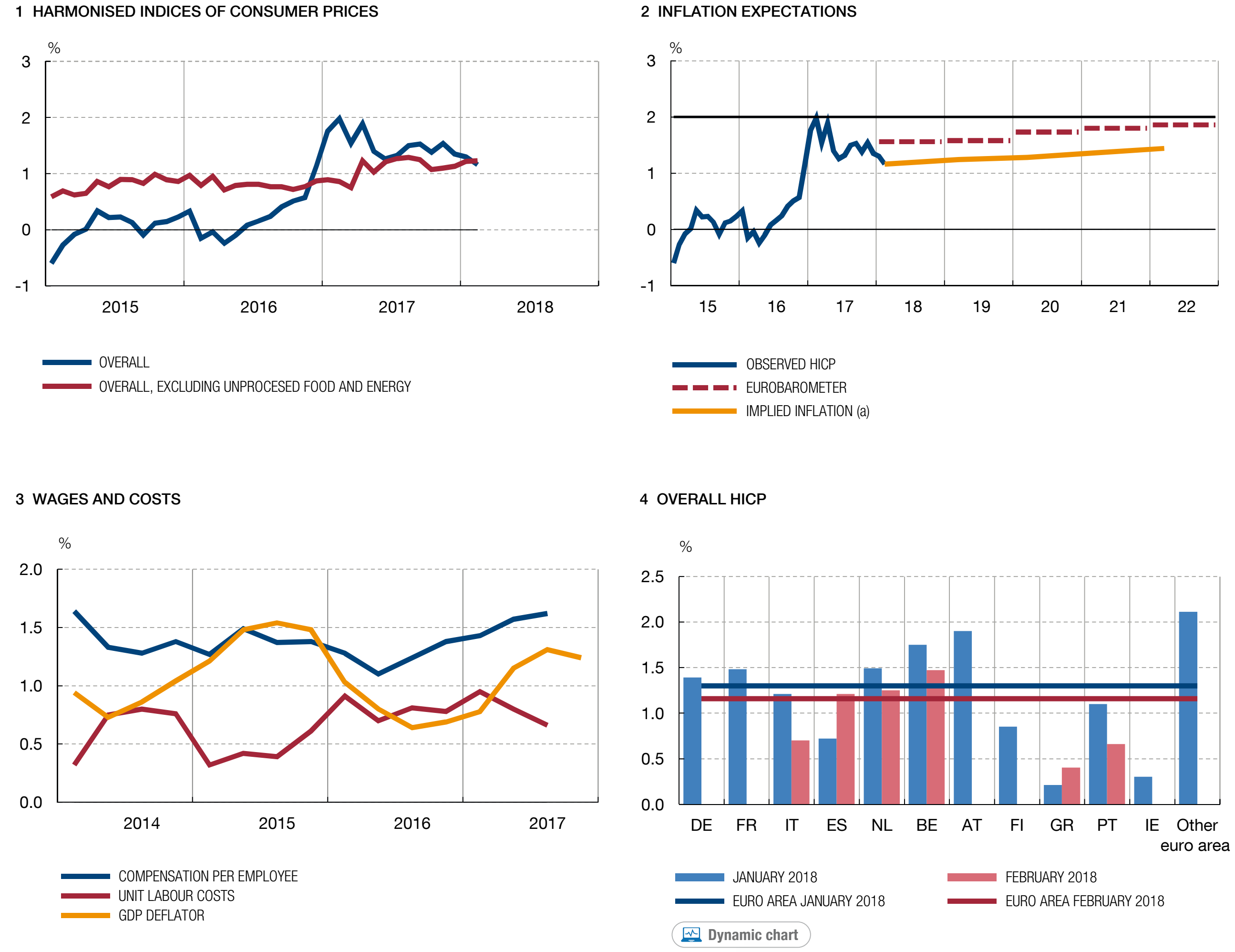
EURO AREA. PRICE INDICATORS
Year-on-year percentage changes

CHART 6



SOURCES: Eurostat, Reuters and ECB.

a Implied inflation calculated on the basis of inflation swaps.

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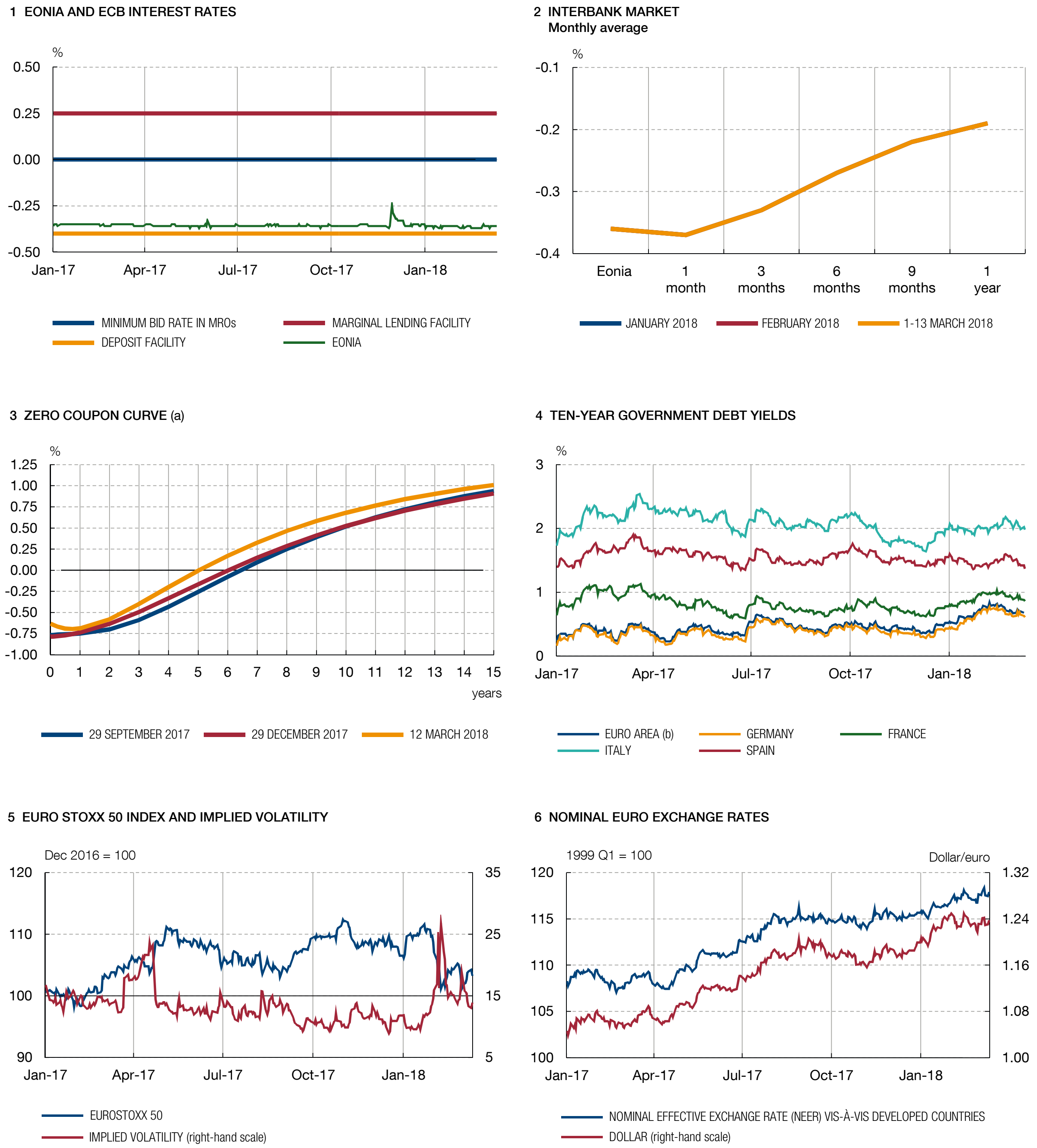
background of a substantial rise in volatility. The stock market adjustment episode in February – prompted by the perception of a greater inflationary risk and the implications for the course of US monetary policy – had a notable impact on other international markets, including those of the euro area, which have undergone sizeable corrections, despite the fact that the various market valuation metrics were not at levels as high as those in the United States.

On the currency market, the exchange rate of the euro resumed an upward course, appreciating by around 2% in nominal effective terms during Q1 (see Chart 7.6). This behaviour was highly influenced by the euro's appreciation against the dollar (by over 3%), which might prove paradoxical judging by the growing divergences in the outlook for the future course of monetary policy in both regions (see Box 4 concerning the factors explaining, from the standpoint of the dollar, the exchange rate between both currencies). The bilateral exchange vis-à-vis the yuan also entailed an appreciation of the euro, while the rate against the yen, on the contrary, weakened.

POLICY INTEREST RATES AND FINANCIAL CONDITIONS

CHART 7

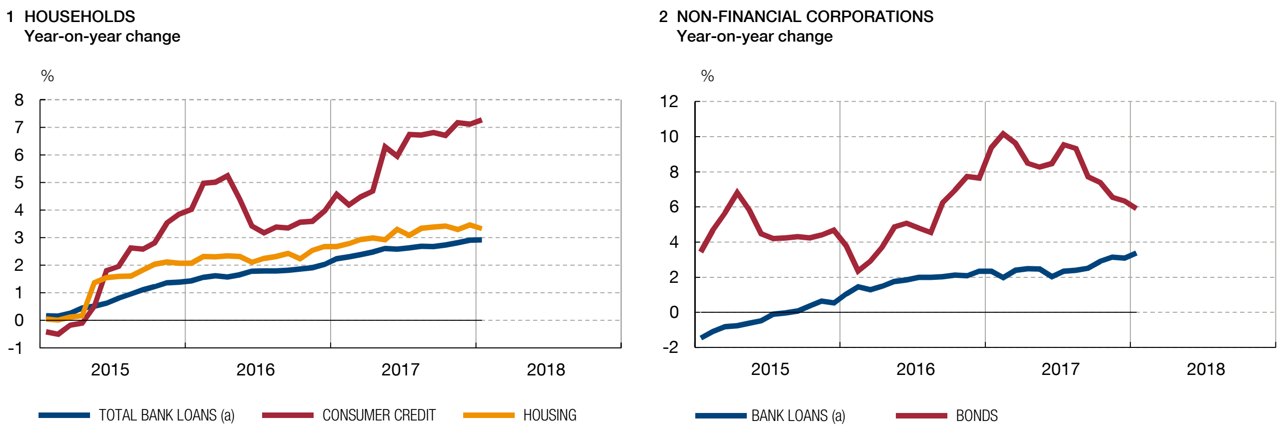


SOURCES: ECB and Banco de España.

a Estimated by the ECB using swap market data.
b AAA-rated issuers.

The rate of expansion of loans to the private sector increased (see Chart 8). In the case of lending to non-financial corporations, the year-on-year increase rose in January to 3.4%, while the related increase for loans to households held at 2.9%. The Bank Lending Survey in the euro area for 2017 Q4 suggests that the buoyancy of credit is being sustained by easier lending standards and by an increase in demand, in both cases for households and non-financial corporations alike. The year-on-year rate of M3

PRIVATE SECTOR FINANCING **CHART 8**



SOURCE: ECB.

a Adjusted for securitisation and other transfers.

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stood at 4.6% in January, within the range in which it has been oscillating since spring 2015. The year-on-year rate of the narrowest aggregate, namely M1 (cash plus sight deposits), was up 0.2 pp to 8.9%.

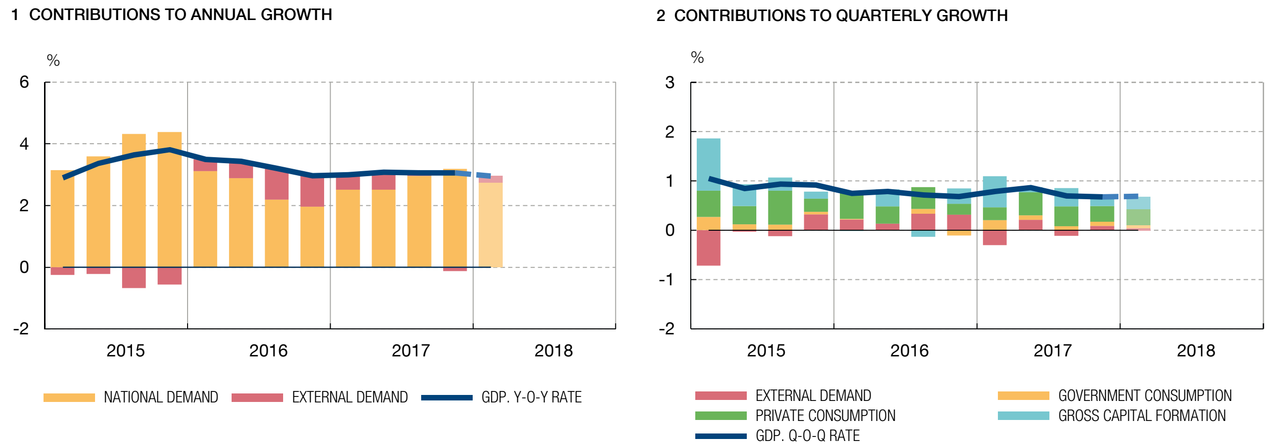
The quarter-on-quarter growth rate of the Spanish economy's GDP stood at 0.7% in 2017 Q4, coinciding with that seen in the previous quarter (see Chart 9). The increase in output in the October-December period was essentially due to growth of domestic demand, whose positive contribution, nevertheless, decreased by 0.2 pp to 0.6 pp. This aggregate was less buoyant on account of the slowdown of investment in capital goods and other products, and of private consumption, which the quickening of residential investment failed to offset, while the rate of government consumption remained unchanged. Similarly, net external demand made a positive contribution of 0.1 pp to aggregate growth in Q4, in contrast with its negative contribution of 0.1 pp in the previous quarter. There was a slowdown of both exports and imports, although it was sharper in the case of the latter. In year-on-year terms, the growth rate of GDP held at 3.1% in 2017 Q4 and that of employment at 2.9%. In 2017 as a whole, GDP and employment both slowed by 0.2 pp, resulting in growth rates of 3.1% and 2.8%, respectively.

According to the latest conjunctural information, GDP is estimated to have grown by around 0.7% in 2018 Q1, a similar rate to that of the two preceding quarters. Domestic demand appears to continue to be the chief mainstay of GDP growth, at the same time as the available external sector indicators, which are still incomplete, would suggest a largely neutral contribution from external demand. Employment is estimated to have quickened in Q1. The regional information available for this period reveals that the adverse effects, which emerged in 2017 Q4 and were linked to heightened uncertainty resulting from the political situation in Catalonia, have stabilised somewhat. These effects – mainly limited to the Catalan economy – were more manifest in the indicators of domestic private spending and foreign tourism in the final stretch of 2017, although some of them are estimated to have unwound in the early months of 2018. As a result of the foregoing, this region could experience a slightly lower growth rate in the current quarter than the Spanish economy as a whole, as occurred in the previous quarter, and in contrast with its higher buoyancy in preceding quarters.

During 2017, inflation in terms of consumer prices showed a decreasing trend following its sharp rise at the beginning of that year which continued into early 2018. However, in February there was an increase in overall inflation whose dynamics in recent months have been dominated by the trajectory of energy prices. This performance differs from that of core inflation which has remained relatively stable over the last year, within a range of 0.8%-1.4%. In the most recent period (January and February), the prices of services, non-energy industrial goods and processed food quickened moderately, which has been offset by the deceleration of unprocessed food prices and a negative contribution over these two months as a whole from energy prices. Consequently, the year-on-year rates of change in the CPI and in the CPI excluding unprocessed food and energy – the latter proxies core inflation – both reached 1.1% in February, a similar figure to that seen in December in the case of the former, whereas in the case of the latter it represents a quickening of 0.4 pp.

Spanish stock markets, in line with those of the rest of the euro area and the major international markets, were affected by the bout of instability which arose on US stock markets in early February, interrupting the rising trend in market prices since the beginning of the year. Following this episode, volatility stood at higher values than those prevalent in previous months and national indices have hardly recovered, accumulating losses in the

MAIN DEMAND AGGREGATES. CONTRIBUTIONS TO GDP GROWTH (a) CHART 9



Dynamic chart

SOURCES: INE and Banco de España.

a Seasonally adjusted series.

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year to date. Specifically, at the cut-off date of this report, the IBEX-35 was 3.5% below its end-2017 levels, performing similarly to the EUROSTOXX 50, which slipped 3% in the same period (see Chart 10.1). The political situation in Catalonia has hardly influenced developments in the Spanish markets after the regional elections held in December 2017. On the sovereign debt markets, the Spanish ten-year bond yield stood at around 1.4% at the cut-off date, lower than at end-December, whereas the yield on its German equivalent rose by approximately 20 bp. Thus the spread between them narrowed to about 75 bp, although during the quarter it reached even lower levels (66 bp) not seen since April 2010. This movement is a consequence of the perceived improvement in the Spanish Treasury's credit quality which was also reflected in the upgrading of its credit rating in January by Fitch. The average risk premia on fixed-income securities issued by Spanish financial and non-financial corporations on private debt markets have remained relatively stable since the end of 2017. Lastly, interbank rates have hardly changed and, consequently, the one-year EURIBOR remains at a record low (-0.19%).

In recent months, financing conditions for households and non-financial corporations have continued to be very loose. These developments were reflected in the interest rates applied to loans to the private sector which have held at historically low levels. This is estimated to have boosted continued growth in demand for loans, as reflected by the pace of expansion of new lending, which has remained higher in the case of household financing. The growth in new lending volumes has contributed to the ongoing moderation of the year-on-year rate of decline in the stock of bank debt.

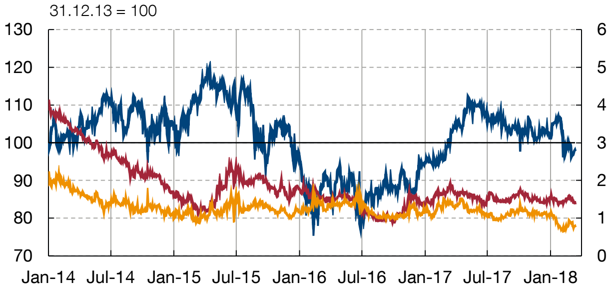
3.1 Household spending decisions

The latest conjunctural information suggests that the quarter-on-quarter rate of change in household consumer spending stood at 0.6% in Q1, a similar performance to the previous quarter (see Chart 11). So far this year, quantitative indicators have slowed down somewhat compared with the previous quarter, as in the case of industrial production of consumer goods, or have shown the same performance as at the end of 2017, as in the case of social security registrations. Conversely, the qualitative indicators such as the indices of consumer confidence and retail trade or services PMI have tended to be more robust.

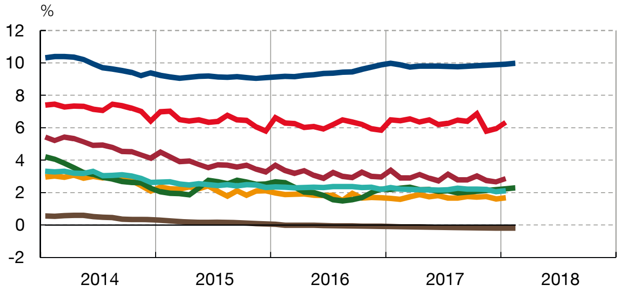
FINANCING CONDITIONS

CHART 10

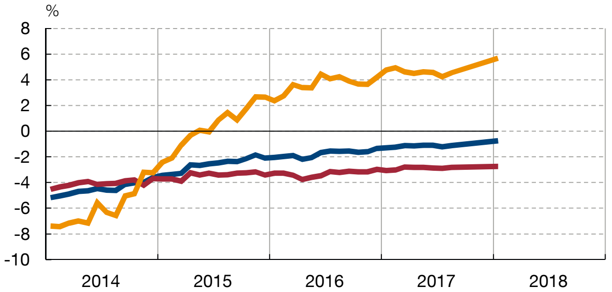
1 EQUITY AND 10-YEAR GOVERNMENT BOND MARKETS



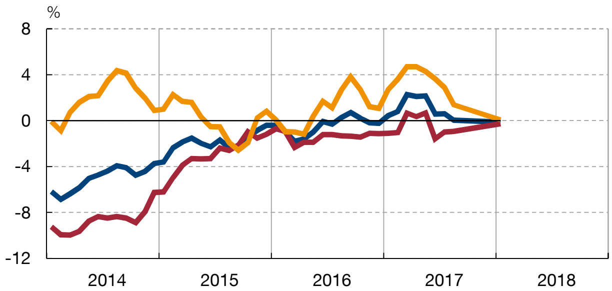
2 COST OF FINANCING



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



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



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

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

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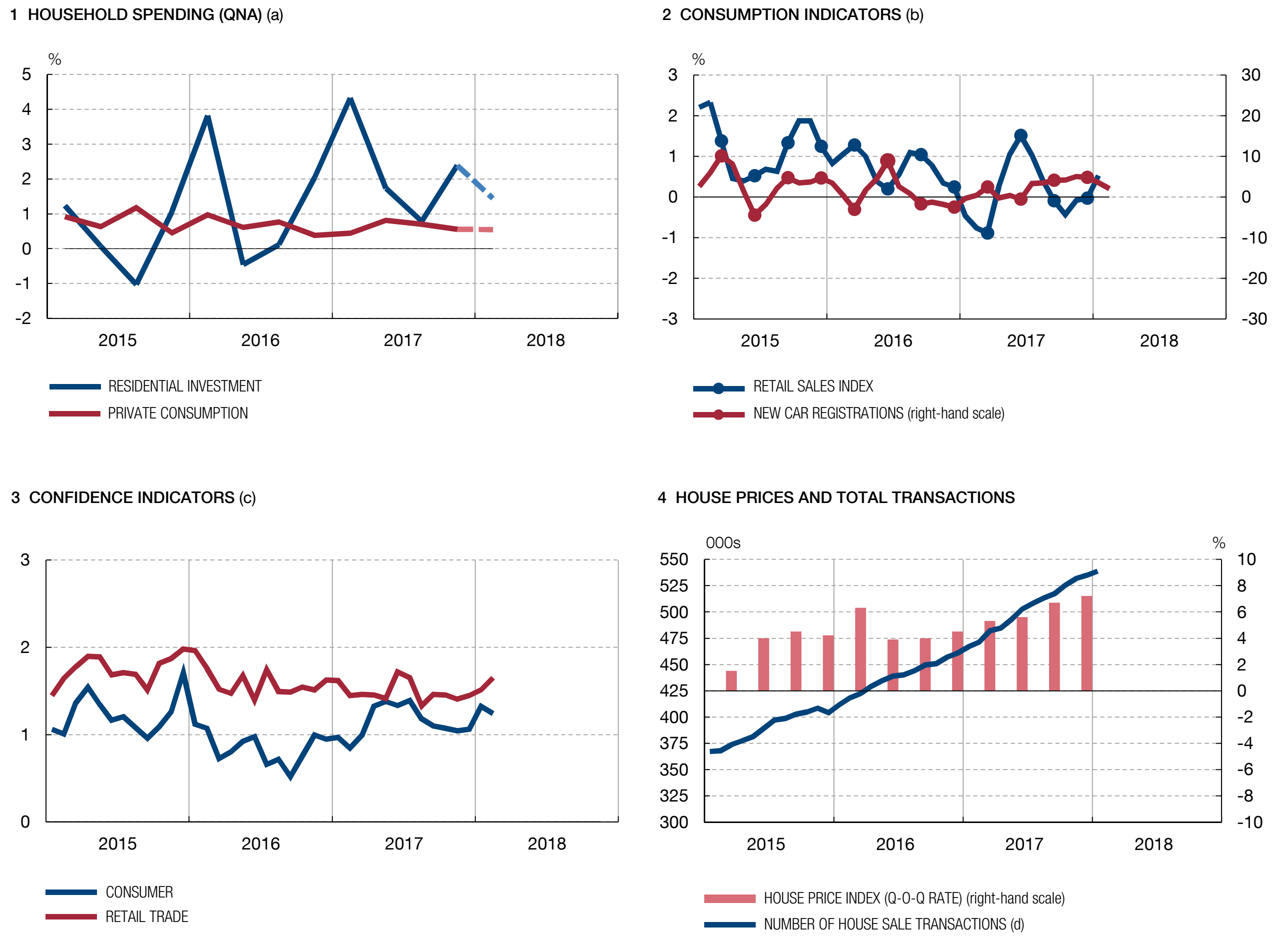
Available economic information confirms high growth rates of residential investment in Q1, although a slight slowdown is perceived with respect to 2017 Q4, a period when it experienced an unexpected, essentially temporary, rise. The coincident indicators, particularly those for employment, were notably buoyant. Open-market house prices, on information provided by the INE, continued to quicken in 2017 Q4, reaching a year-on-year growth rate of 7.2% compared with 6.7% in the previous quarter. This greater momentum in house prices was apparent in the new home and second-hand segments.

The interest rates applied to new loans to households varied slightly and held at low levels between September and January. The cost of bank financing for house purchases was 2.1% in January, and that for new consumer credit and other lending was 6.3%, close to their historical lows in both cases (see Chart 10.2).

The proportion of new fixed-rate mortgages stabilised in recent months at around 40% after the considerable increase seen in 2015 and 2016. The improvement in mortgage

HOUSEHOLD SPENDING

CHART 11



SOURCES: INE, European Commission, ANFAC and Banco de España.

a Quarter-on-quarter rates calculated on the basis of the seasonally adjusted series.
b Quarter-on-quarter rates of 3-month moving average with three lags, calculated on the basis of the seasonally adjusted series. The dot corresponds to the quarter-on-quarter rate.
c Normalised confidence indicators (difference between the indicator and its mean value, divided by the standard deviation).
d 12-month moving sum.

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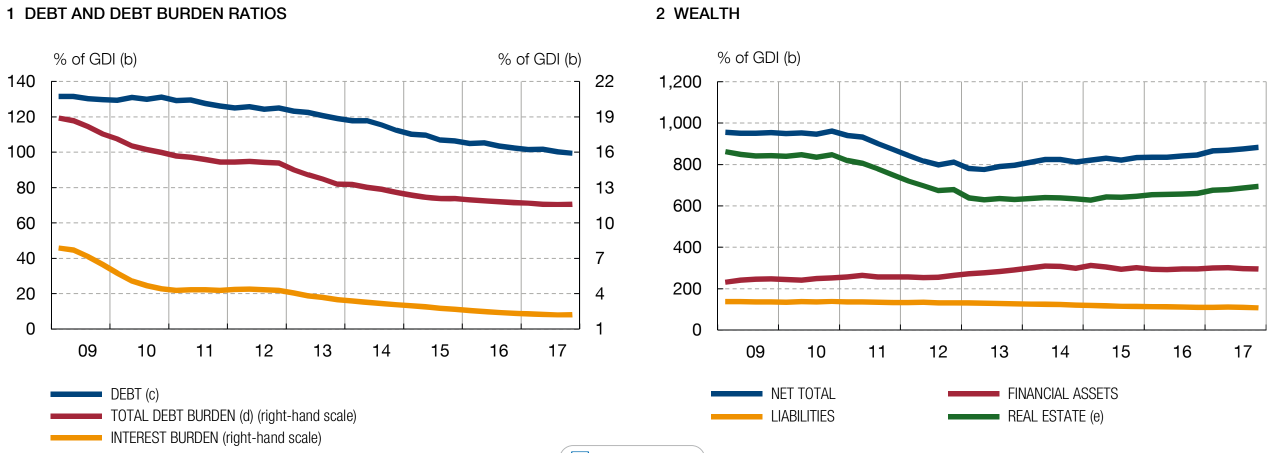
conditions in terms of maturity and interest rate has come to an end. The average loan-to-value ratio (LTV) on new mortgage loans has increased since 2013 and stood at 65.6% at end-2017, its highest level since this series began. Nevertheless, that has not been accompanied by an increase in the proportion of higher-risk new mortgages, namely those with an LTV of more than 80%.

The replies received to the January edition of the Bank Lending Survey (BLS) indicate that banks relaxed lending standards for households during 2017 Q4 in both segments (house purchase and consumer credit and other lending). Similarly, overall terms and conditions applied to credit to the household sector were also relaxed, specifically the margins on average loans, while those applied to riskier loans were tightened slightly. As for demand for loans, the BLS shows that requests for funds increased once more in both segments, anticipating that they will rise again in 2018 Q1.

This favourable mix of supply and demand factors resulted in the continued high momentum in the volume of new loans for house purchase and for consumer credit and other lending.

HOUSEHOLDS AND NPISHs FINANCIAL POSITION INDICATORS (a) CHART 12



Dynamic chart

SOURCES: INE and Banco de España.

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

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The growth of lending contributed to an easing of the year-on-year rate of decline in the stock of household debt to 0.7% in January, down 0.4 pp from September (see Chart 10.3). By loan type, these developments were the result of a slight decline in the pace of contraction of loans for house purchase (down 0.1 pp to 2.7%) and a rise in the rate of increase of consumer credit and other lending (up to 5.7% in January from 4.8% recorded in September). In the house purchase segment, the rate of decline of the outstanding balance of debt is easing more slowly since the high rate of increase of new lending is being virtually offset by the quickening of repayments.

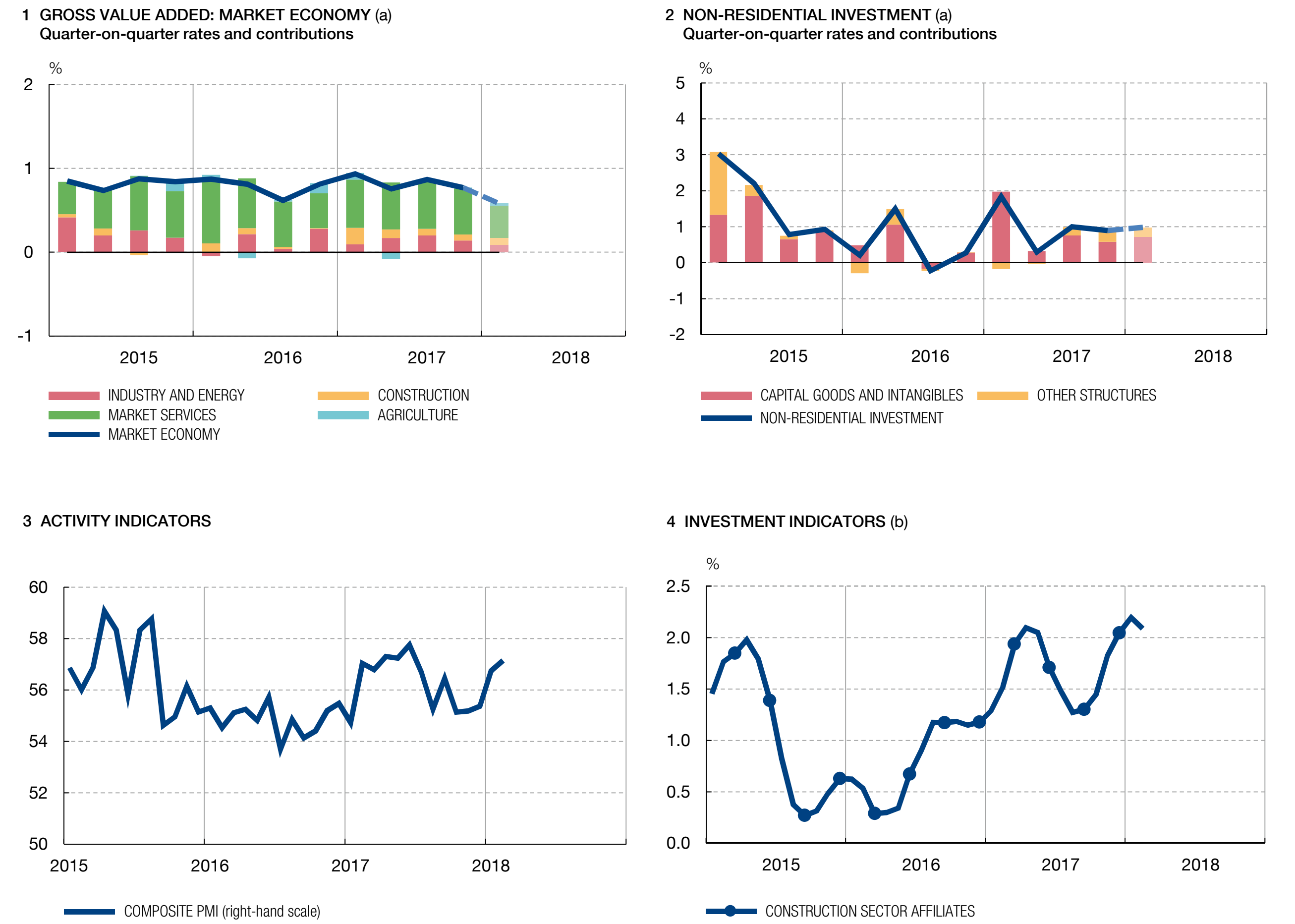
The latest available data suggests that the financial position of households has continued to strengthen in 2017 Q4. Thus, the debt ratio is estimated to have fallen to below 100% of GDI, owing to the expansion of income and, to a lesser degree, the decrease in the stock of debt. The debt burden ratio has barely changed (see Chart 12.1). Household net wealth seems to have increased again during the last quarter of the year given that the real estate component and, to a lesser degree, the financial component, have appreciated (see Chart 12.2). In recent years, the increase in financial assets held by Spanish households has been accompanied by portfolio rebalancing away from bank deposits towards other products such as investment funds and, to a lesser extent, pensions, which offer higher expected returns. The relative appeal of the latter could increase following the recent legal reform of pension funds and plans (see Box 8).

3.2 Business activity and investment

Business activity, proxied by the real value added of the market economy, appears to have grown in 2018 Q1 at a similar rate to that in 2017 Q4. The moderation of the industrial and energy sectors was worth noting.

Investment in capital goods in 2018 Q1 is estimated to have increased by slightly more than 1%. This would mean that this domestic demand component has grown somewhat more than in 2017 Q4. Nevertheless, it should be pointed out that the available information on quantitative and qualitative indicators is still very limited.

CORPORATE DECISIONS CHART 13



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

a Seasonally adjusted series.
b 3-month moving average rates with three time lags, calculated on seasonally adjusted series. Dots depict quarter-on-quarter rate.

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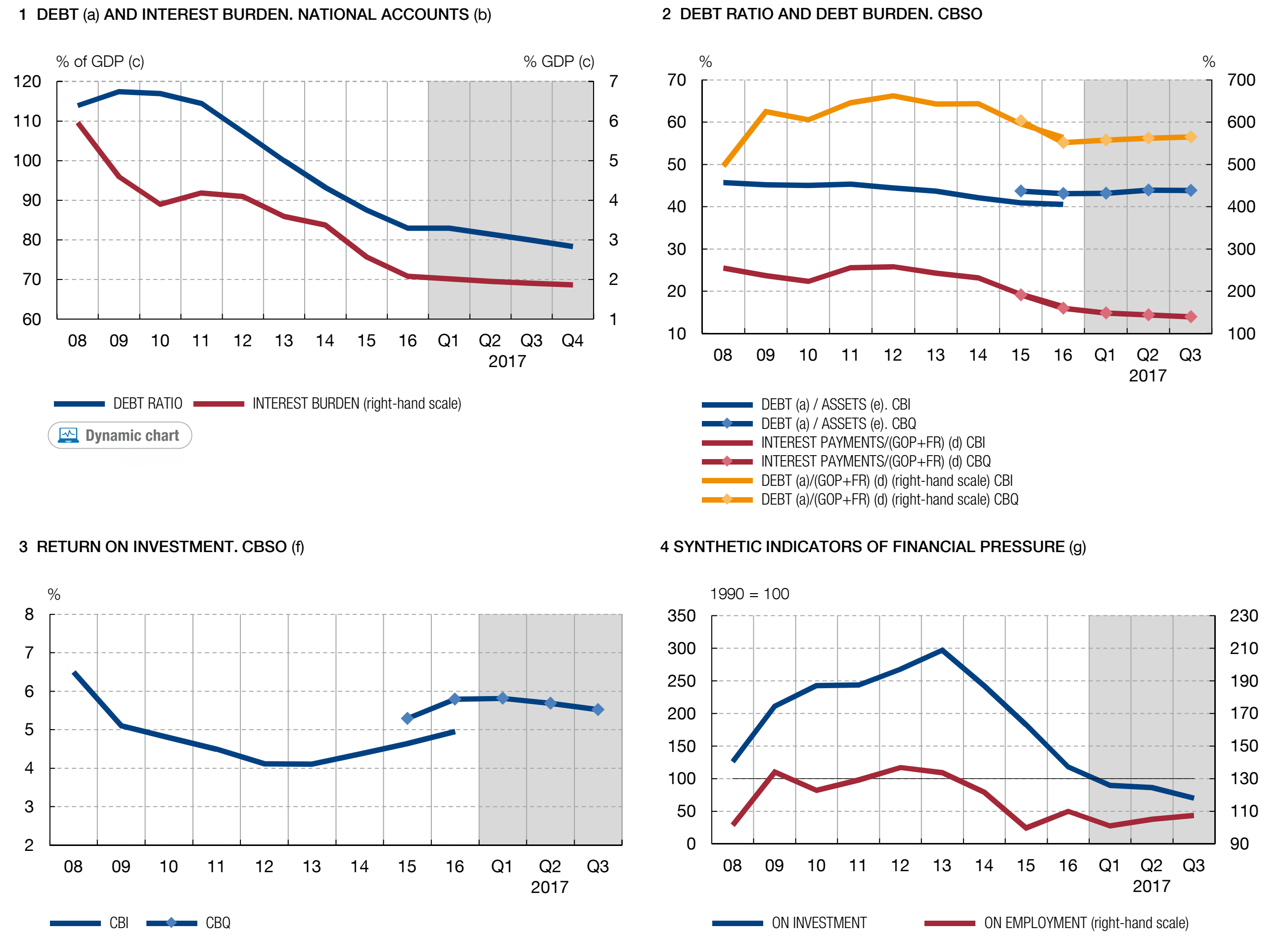
During recent months, the cost of bank lending to non-financial corporations has held at historically low levels. For instance, on the latest available information referring to January, the average interest rates on new loans for less than €1 million, a segment in which SME transactions are concentrated, stood at 2.9%, while the average interest rates on new loans for €1 million or more reached 1.7%. The cost of equity and the issuance of long-term fixed-income rose slightly by approximately 20 bp and 30 bp, respectively, between September and February, while the cost of short-term fixed-income issues barely changed (see Chart 10.2).

Deposit-taking institutions participating in the BLS reported, in the latest edition for January, that credit standards for non-financial corporations remained unchanged in 2017 Q4 as did overall terms and conditions. However, according to this survey, margins on average loans fell, whereas those on riskier loans were tightened (as with the terms and conditions for the collateral required, the amounts and non-interest expenses). According to the BLS, the demand for funds from this sector did not change either, although institutions anticipated that it would expand in 2018 Q1.

Against this background, lending activity to corporations continued to grow in recent months at a higher rate than in previous quarters, both in the segment of loans for less

INDICATORS OF THE FINANCIAL POSITION OF NON-FINANCIAL CORPORATIONS

CHART 14



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 Total inflation-adjusted asssets less non-interest bearing liabilities.
f 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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than €1 million and in the segment for loans of €1 million and above, although in the latter case the rate of increase remains more moderate. As a result of these developments, in terms of balances outstanding, the rate of decline of loans extended by resident institutions to non-financial corporations eased slightly to 0.3% in January, 0.2 pp lower than four months earlier (see Chart 10.4). Financing via fixed-income securities, including debt issued by Spanish subsidiaries, continued to slow, a trend which has been present since March 2017, although the rate of increase held at positive values (4.2% in January). Consequently, the growth rates of the sector’s total debt remained at practically zero.

The financial position of non-financial corporations is estimated to have improved again in 2017 Q4, continuing the trend of recent years. Thus the debt ratio and, to a lesser degree, the debt burden ratio as a percentage of GDP appear to have fallen, essentially as a result of GDP growth (see Chart 14).

3.3 The external sector and the balance of payments

Although as yet incomplete, the information available for the first quarter suggests that net external demand made a broadly neutral contribution to quarter-on-quarter GDP growth following the slightly positive contribution recorded the previous quarter. This contribution is estimated to have taken place in a context of accelerating foreign trade in goods and services, on both the import and export sides, compared with sluggish exports and stagnant imports in the previous quarter. In year-on-year terms, the contribution of net external demand to GDP growth appears to have returned to its previous upward path after a slightly negative contribution in the previous quarter, against the backdrop of an improving global economy, particularly in the euro area countries, which are Spain's main export markets (see Chart 15).[1]

Customs records for December showed higher growth in real flows of exports of goods than imports, at 4.7% and 1.6% year-on-year, respectively. By types of goods, the strong momentum of consumer durables, particularly vehicles, stands out among exports, after several months of weaker performance, partly associated with the process of adapting manufacturing plant to produce new models. Broken down by geographical region, exports to EU markets gained pace, such that, for the first time in several months, their growth exceeded that of non-EU exports, which slowed considerably after performing strongly the rest of the year. On the imports side, the increase in imports mainly comprised purchases of foreign consumer durables and intermediate goods. According to data for January, real export flows reported by large corporations showed sustained export growth in that month, alongside a slight acceleration in imports, with year-on-year rates reaching around 4% in both cases.

According to the most recent information, foreign tourism picked up in the early part of the year, after slowing towards the end of last year, affected by the political conflict in Catalonia and the gradual normalisation of the geopolitical situation in some of Spain's main competitor destinations, such as Turkey and some North African countries. Thus, the data for January reflected a recovery in the indicators for foreign tourism in Catalonia, with a marked upturn in tourist arrivals, overnight hotel stays, and tourist spending. Meanwhile, tourist arrival numbers for Spain as a whole returned to strong growth (5.2% year-on-year) after a slight drop the previous month. This reflected the recovery in some of Spain's main source markets, such as France, Germany and Portugal (whereas the number of tourists from the United Kingdom barely rose) and the continued dynamism of markets further afield, such as the Nordic countries or the United States. Larger visitor numbers in January also meant higher nominal tourist spending growth (to 5.6% year-on-year), despite the timid increase in average tourist spending, influenced by the slightly larger decrease in the length of average stay.

The Spanish economy's net lending position decreased in the most recent period. Specifically, the balance-of-payments surplus for 2017 as a whole was 1.9% of GDP (0.3 pp less than in 2016), as a result of the rising energy bill (driven by higher oil prices), which was partially offset by the bigger tourism services surplus and smaller income deficit, in a context of low interest rates.

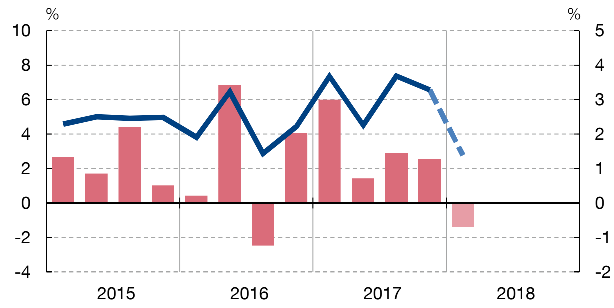
The most recent data available on cross-border financial flows show that the financial account of the balance of payments, excluding the Banco de España, had a credit balance of €10.3 billion in the fourth quarter of 2017. This performance was the result of an increase

1 Box 7 in this Quarterly Report gives a description of the trend in Spain's net exports of non-tourism services over a longer time horizon.

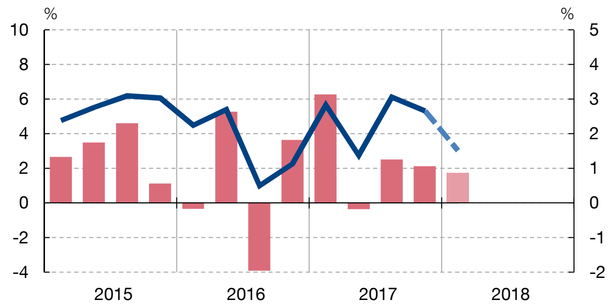
FOREIGN TRADE AND BALANCE OF PAYMENTS

CHART 15

1 EXPORTS OF GOODS AND SERVICES (a)

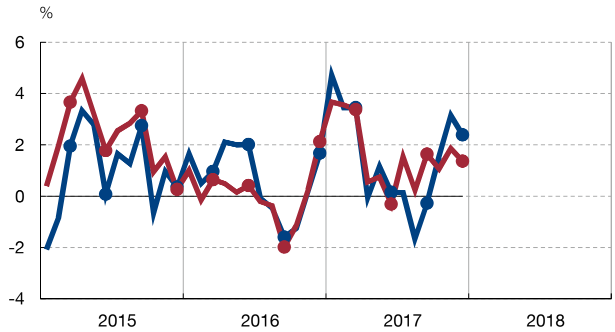


2 IMPORTS OF GOODS AND SERVICES (a)



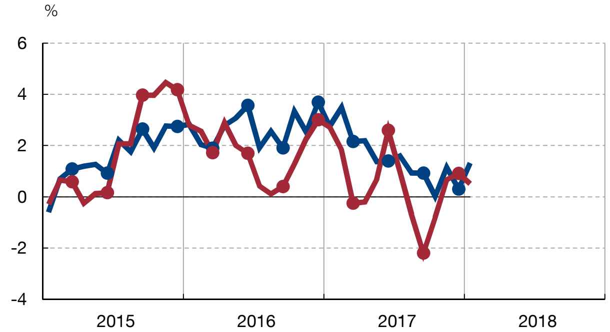
Q-O-Q RATE (Right-hand scale)
Y-O-Y RATE

3 CUSTOMS INDICATORS (b) (c)



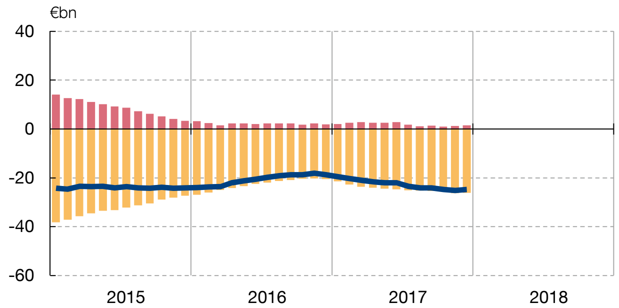
EXPORTS OF GOODS
IMPORTS OF GOODS

4 TOURISM INDICATORS (c)



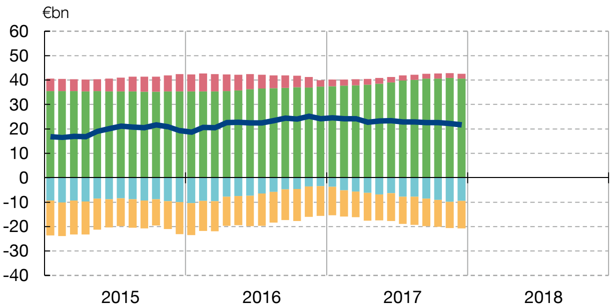
TOURISTS
OVERNIGHT HOTEL STAYS BY FOREIGN VISITORS

5 FOREIGN TRADE IN GOODS
Cumulative figures for the last 12 months



NON-ENERGY BALANCE
ENERGY BALANCE
TOTAL

6 BREAKDOWN OF CURENT AND CAPITAL ACCOUNT (d)
Cumulative figures for the last 12 months



CAPITAL ACCOUNT
PRIMARY AND SECONDARY INCOME
TOURISM
NON-TOURISM SERVICES AND GOODS
NET LENDING (+) / NET BORROWING (-)

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 3-month moving average rates with three time lags, calculated on 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).

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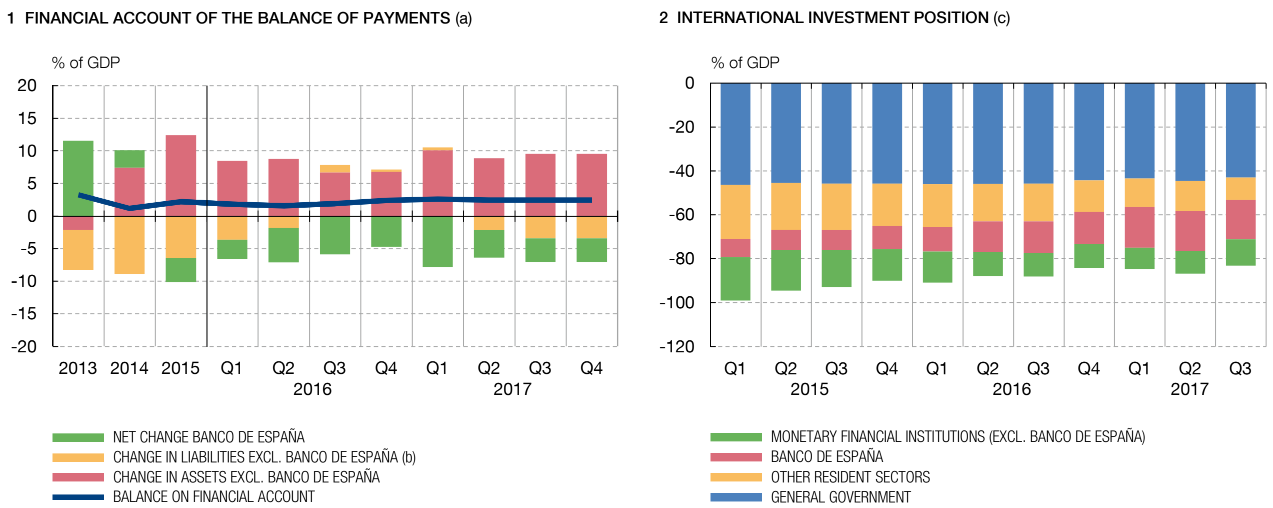
BALANCE OF PAYMENTS AND INTERNATIONAL INVESTMENT POSITION

CHART 16



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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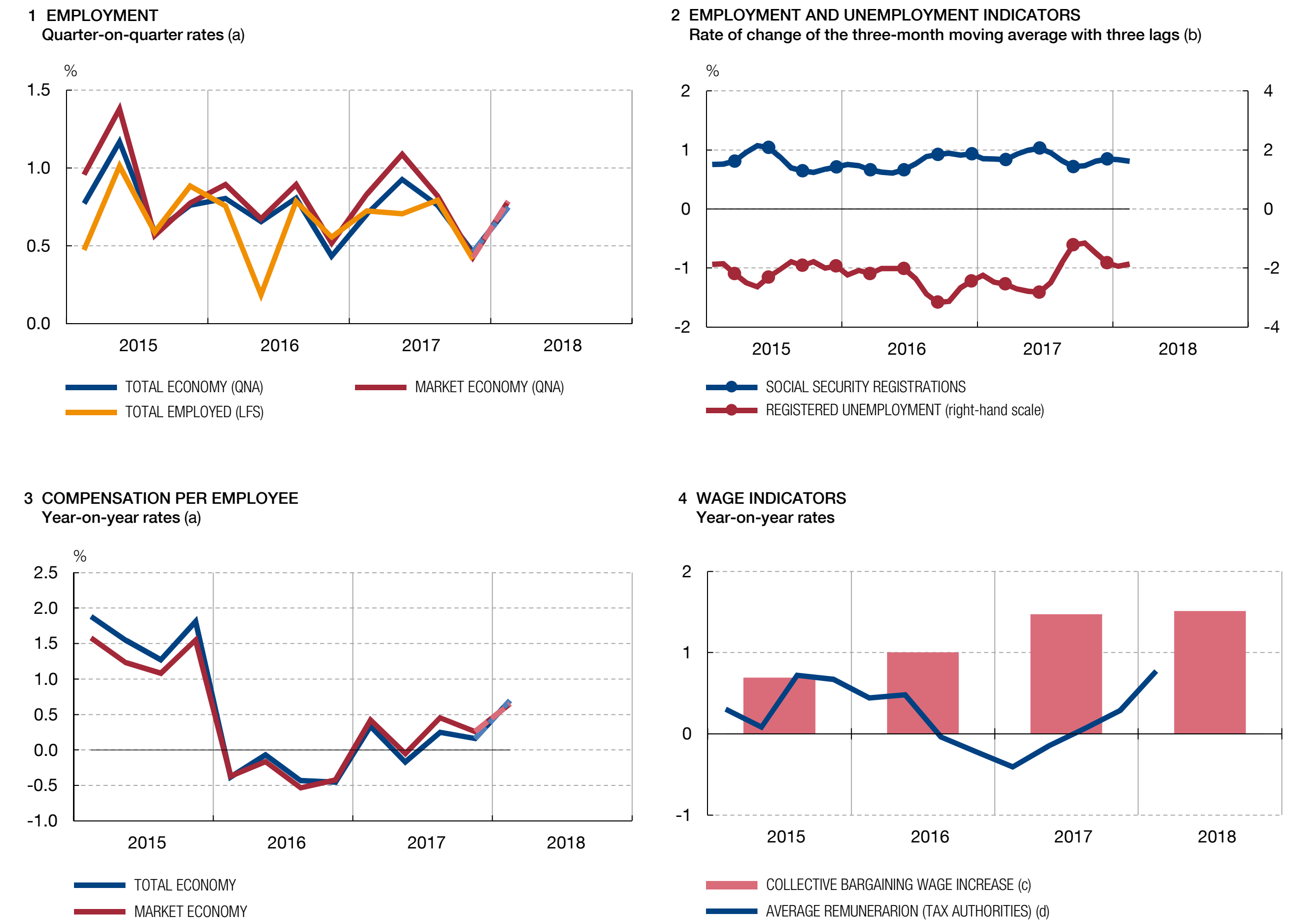
in resident agents' exposure to foreign assets (€33.8 billion), which exceeded the increase in holdings of assets issued by Spanish residents that were held by agents in the rest of the world (€23.5 billion) and, to a lesser degree, the slightly positive net flow (around €650 million) of transactions associated with financial derivatives. The positive flow of net acquisitions abroad by resident sectors was the outcome of investments under the heading of other investments (€17.3 billion), in the form of short-term bank deposits, portfolio investment (€14.8 billion) and, to a lesser extent, direct investment (€1.1 billion). Meanwhile, net investments in Spain by foreigners were concentrated mainly in portfolio investment (€23 billion), in particular the purchase of government debt securities (both short and long term), and other investment (€7.8 billion), whereas the flow of direct investment was negative (-€7.2 billion). By institutional sector, the sign associated with the net flow (difference between flows of assets and liabilities vis-à-vis the rest of the world, including derivatives) was in line with their net lending/borrowing. Thus net flows to the rest of the world were positive for other resident sectors (€26.6 billion), while other monetary financial institutions and, particularly, general government, raised funds from abroad in net terms (€3 billion and €13.9 billion, respectively). The Banco de España's net financial transactions with the rest of the world presented a credit balance (€5.7 billion), which, since the start of the Eurosystem's asset purchase programme, had only happened in the second quarter of 2017 (and marginally in the third quarter of 2015). This is probably a reflection of the fact that, in the last few months, a larger share of the liquidity generated by this programme in Spain was not passed on to the rest of the world. Cross-border financial flows, including those of the Banco de España, were also positive in 2017 as a whole, totalling an amount equivalent to 2.6% of GDP (see Chart 16.1), as resident sectors made net investments in foreign assets that exceeded those of foreign investors in Spain.

The latest information available on the international investment position (IIP) shows the Spanish economy's net debt to the rest of the world to have dropped by €28.7 billion in the third quarter of 2017, to stand at 83.2% of GDP, 3.3 pp less than three months earlier (see Chart 16.2). This decrease in the debit balance was driven by the positive flow of both net

EMPLOYMENT AND WAGES

CHART 17



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

a Rates of change calculated on adjusted series. QNA employment measured in equivalent job terms.
b Calculated on seasonally adjusted series at the Banco de España. Dots depict quarter-on-quarter rates.
c With data to February 2018. Excludes indexation clauses.
d Seasonally adjusted series. Last quarter, with data only for January 2018.

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financial transactions (€12.3 billion) and other flows (€16.5 billion) in the period. The performance of the latter was partly due to the rising value of foreign assets held by residents and the decrease in holdings of non-resident agents, which offset the effect in the opposite direction caused by the rising euro. Spain's gross external debt fell by 2.8 pp relative to GDP to 166.2%, which is 8.4 pp less than the peak reached in the first quarter of 2015.

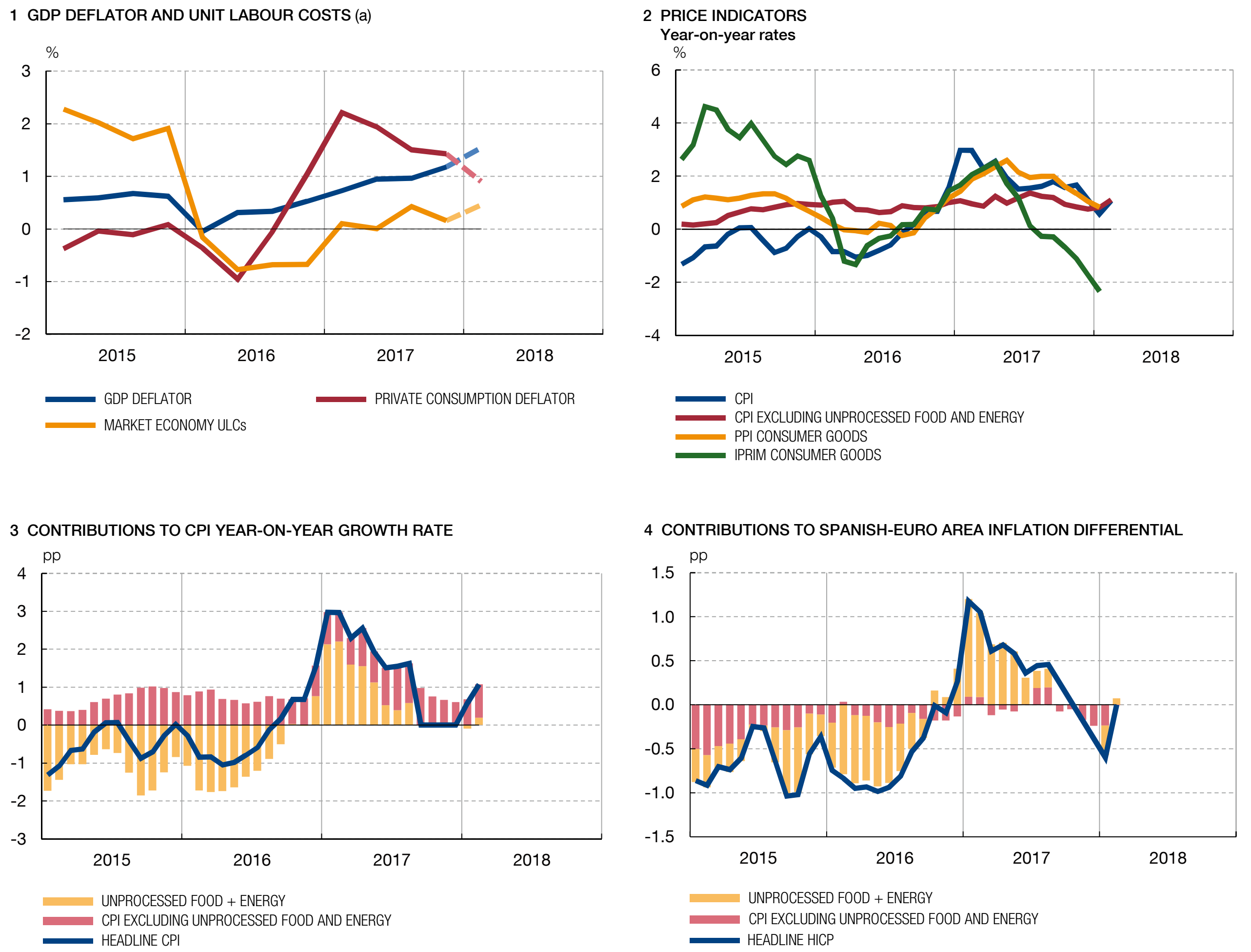
3.4 The labour market

After the deceleration in the last quarter of 2017, the labour market indicators for the first few months of the year suggest that employment may be more buoyant in the first quarter of 2018. Social security registrations continued to grow strongly, at a rate of 0.8% in February, in terms of the three-month moving quarter-on-quarter rate of change for the seasonally adjusted series. The employment growth figures broken down by sector were also highly stable relative to the last quarter of 2017, with a slight slowing in non-market services and industry, which was offset by increased dynamism in construction. This information suggests that the quarter-on-quarter growth rate of employment in the first quarter of the year, in QNA terms,[2] is likely to rise by 0.2 pp to 0.7 %, narrowing the gap

2 In terms of full-time equivalent jobs.

PRICES

CHART 18



SOURCES: INE, Eurostat and Banco de España.

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

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relative to growth in social security registrations, which widened in the previous quarter. In the case of the market economy, the rate of employment growth is expected to rise by 0.4 pp to 0.8% (see Charts 17.1 and 17.2).

The drop in unemployment registered by the National Public Employment Service (SEPE by its Spanish abbreviation) maintained its pace in February at 1.9% in terms of the three-month moving average and seasonally adjusted quarter-on-quarter rate of change (see Chart 17.2). In this context, the number of new contracts registered by the SEPE reverted to the more moderate path seen throughout 2017, with a year-on-year increase of 6.5% in February. The faster pace of hiring affected permanent contracts more than temporary ones, such that the share of permanent relative to total contracts rose by almost 1 pp compared with the same period of the previous year, to 11.3%.

As regards the performance of wages at the start of 2018, there is no agreement between social partners to guide wage recommendations. In this context, the information on collective bargaining agreements registered between January and February reflects an increase in wage rates of 1.5% for this year, slightly higher than that agreed for the previous year. The agreements registered up to February cover almost 4.8 million workers, a higher figure than was observed in the same period in the eight preceding years. Almost all the agreements originate in those signed in previous years, as is commonly the case in the early part of the year. Moreover, the information from the tax collection agency on average gross compensation of large non-financial corporations showed a slight acceleration in January, with a year-on-year increase of 0.8% in terms of the seasonally adjusted series (0.3% in the fourth quarter of 2017). In line with the foregoing indicators, compensation per employee in the fourth quarter of 2017, in terms of the QNA seasonally adjusted series, registered moderate year-on-year growth, in both the total economy and the market economy, at 0.2% and 0.3%, respectively. Wage growth is expected to pick up slightly in the first quarter of 2018, albeit with less intensity than that observed in the tax revenue agency data, rising by around 0.3 pp to 0.6% in the market economy (see Charts 17.3 and 17.4).

3.5 Prices

Year-on-year growth in the import deflator is estimated to have decreased considerably in the first quarter of 2018, continuing the downward trend from the preceding quarters. Domestic producer prices, approximated by the GDP deflator, gained pace at the start of 2018, whereas the growth of the private consumption deflator remained moderate (see Chart 18.1).

The CPI data for February, the most recent month for which data are available, shows a sharp increase in the year-on-year growth rate, rising 0.5 pp from January to 1.1%. The acceleration in the overall index is basically a result of changes in energy prices, for which the year-on-year rate rose 3.1 pp, influenced by base effects, although the non-energy component also accelerated 0.1 pp to a year-on-year rate of 1%. Inflation in unprocessed-food prices decelerated in February, as it did in the preceding months. Core inflation, measured in terms of the year-on-year growth rate of CPI excluding unprocessed food and energy rose by 0.3 pp, also coming to 1.1%. All the components of this aggregate accelerated: prices of services rose by 0.4 pp, prices of processed food by 0.3 pp and prices of non-energy industrial goods rose by 0.2 pp.

Lastly, the year-on-year rate of change of the harmonised index of consumer prices (HICP) rose by 0.5 pp in February to 1.2%. By contrast, according to the preliminary estimate, the inflation rate across the Euro area as a whole dropped by 0.1 pp in February to 1.2% year-on-year. As a result, if the estimated rise in the HICP in the euro area is confirmed, the inflation differential between Spain and the euro area as a whole would shrink to zero (-0.6 pp in January).

13.03.2018.