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4/2018

BANCO DE ESPAÑA

Eurosistema

CONTENTS

1 OVERVIEW

The expansion in global activity has continued in the final stretch of 2018, although some signs of slowing have become evident. Moreover, the behaviour from region to region has become more heterogeneous than at the start of the year. This is reflecting the partial materialisation of some of the uncertainties that have been assailing the global economy since the beginning of the year, in particular trade tensions and some tightening of global financial conditions. The upshot has been several episodes of volatility on financial markets, resulting in falls in share prices and rises in corporate spreads.

Looking ahead, a potential worsening of the repercussions of these two sources of uncertainty cannot be ruled out. And additional, Europe-centred uncertainties, such as the future of Italy's budgetary policy and the ultimate shape of the United Kingdom's exit from the European Union, should be kept in mind. Furthermore, more recently concerns have arisen over the course of the Chinese economy, where growing signs of weakening activity have emerged, despite the stimulus provided by demand-side policies. Against a background in which agents' debt has increased very swiftly in recent years, there is a fear that a hypothetical deepening of the deceleration in the Chinese economy may adversely affect the stability of its financial system. In this setting, it is unclear to what extent the authorities may be able to reverse the slowdown by implementing a fresh round of monetary and fiscal stimuli.

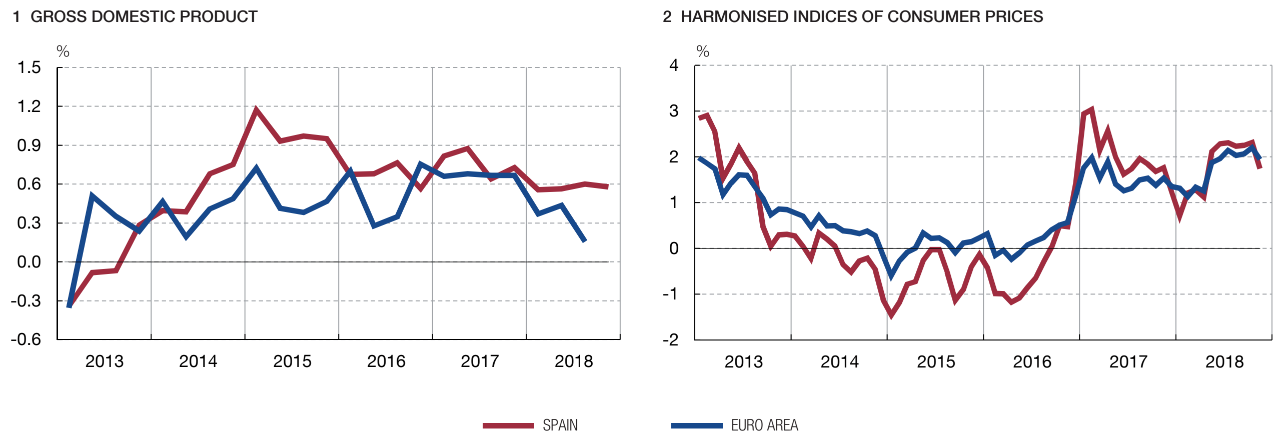
In the euro area, the second half of the year saw the extension of the more moderate growth phase evident since early 2018. These developments are partly due to a successive combination of different, transitory factors. The latest such factor has been the impact on the car industry of a new regulation on vehicle emission pollutants. However, there appear to be ever-greater signs of a more persistent component, linked to the weakening of the euro area's external setting, that would account for this phase of more contained growth. Along these lines is the loss of momentum in exports targeted on the rest of the world. These developments have been reflected in the latest Eurosystem projections, which have revised expected GDP growth in 2018 and 2019 downwards by 0.1 percentage points (pp). In order to ensure that inflation converges on its medium-term objective, the December ECB Governing Council decided that, following the discontinuation of net asset purchases at the end of the year, it will reinvest the principal payments of maturing assets acquired under the programme for an extended period of time following the start of interest rate rises.

The Spanish economy is, on the information available to date, expected to have grown at a quarter-on-quarter rate of 0.6% in 2018 Q4, unchanged on the two previous quarters (see Chart 1 and Table 1). The slowdown in activity in Spain during 2018 is estimated to have been notably less acute than in the euro area as a whole, a development partly due to the inclusion in the State Budget for 2018, which came into force in the summer, of certain measures boosting household income. Moreover, the introduction of the new regulation on vehicle emission pollutants would appear to have exerted a comparatively less marked effect on activity in the car industry in Spain than in other euro area economies, such as Germany.

In terms of components, the buoyancy of output in the recent period has been underpinned by the expansionary course of domestic demand. In particular, household consumption has

GROSS DOMESTIC PRODUCT AND CONSUMER PRICES (a)

CHART 1



SOURCES: Eurostat, INE and Banco de España.

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

continued to be supported by the strength of employment generation and also by the expansionary effect on household income of the aforementioned fiscal measures and, more recently, the fall in oil prices. Turning to foreign trade flows in goods and services, the as yet substantially incomplete information available for the closing months of the year tentatively suggests some improvement in exports of both goods and tourist services, following their notable weakness during the year. The loss of momentum in the external sector of the Spanish economy in recent quarters would be due to a confluence of several explanatory factors, among which the loss of strength in the demand from the rest of the world has been fundamental. The lagged effects of the appreciation of the euro in 2017 and, in the domain of tourist services, the recovery by competing Mediterranean destinations that had been affected In previous years by heightened security concerns were also contributing factors.

In the medium term, the Banco de España foresees a continuation of the expansion in activity, assisted by the correction of the economy's imbalances and by the still-expansionary effects of the monetary policy measures adopted in the past. Nonetheless, these stimuli will tend to have a diminishing impact over the course of the projection period (running to 2021), which will mean, among other reasons, that GDP growth will tend to ease. Specifically, after increasing by 2.5% in 2018, GDP will post respective rates of 2.2%, 1.9% and 1.7% in the three following years.[1]

As regards consumer prices, the core component has continued to hold relatively stable in recent months and is expected to begin to rise as capacity utilisation intensifies in step with the continuation of the upturn. The announced increase in the minimum wage is not, on its own, expected to exert a significant upward effect on inflation, since in terms of unit labour costs it is estimated that the rise in average wage growth will be offset by a similar rise in productivity, given the impact that the measure would have in terms of job destruction.

The baseline scenario for activity in the Spanish economy would not be immune to a hypothetical materialisation of any of the above-mentioned shocks stemming from the

1 Macroeconomic projections for the Spanish economy (2018-2021): the Banco de España's contribution to the Eurosystem's December 2018 joint forecasting exercise.

MAIN SPANISH MACROECONOMIC AGGREGATES (a) — TABLE 1

	2017	2018	2017 Q1	2017 Q2	2017 Q3	2017 Q4	2018 Q1	2018 Q2	2018 Q3	2018 Q4
National Accounts										
Quarter-on-quarter rates of change, unless otherwise indicated										
Gross domestic product	3.0	2.5	0.8	0.9	0.6	0.7	0.6	0.6	0.6	0.6
Contribution of national demand (b)	2.9	3.1	1.1	0.6	1.2	0.4	0.9	0.8	0.8	0.5
Contribution of net external demand (b)	0.1	-0.6	-0.3	0.3	-0.5	0.3	-0.3	-0.2	-0.2	0.0
Year-on-year rates of change										
Employment	2.9	2.5	2.7	2.9	2.9	2.9	2.6	2.5	2.5	2.6
Price indicators (year-on-year change in end-of-period data) (c)										
HICP	2.0	1.8	2.7	2.1	1.8	1.6	1.1	1.8	2.3	2.0
HICP excl. energy and unprocessed food prices	1.2	1.1	1.1	1.3	1.6	1.0	1.2	1.0	0.9	1.1

SOURCES: INE and Banco de España.

a Banco de España contribution to the December 2018 joint Eurosystem projections exercise.
b Contribution to the quarter-on-quarter rate of change of GDP (pp).
c The 2018 Q4 figure is the average of the October and November year-on-year rates. The November 2018 figure was published after the cut-off date for these projections.

external setting. However, economic policies can make a significant contribution to reducing the degree of vulnerability. In particular, the design of a well-defined strategy to durably reduce the structural budget deficit and general government debt would help create some room for manoeuvre so that fiscal policy may address the consequences of any future slowdown in activity and contribute to limiting any potential rise in borrowing costs for public and private agents.

Further, launching a raft of reforms to promote the more efficient functioning of the markets for labour and for goods and services would also help raise the economy's potential growth and its resilience in the face of external shocks. In this respect, maintaining and strengthening the main elements of the current labour market legal framework in such a way as to help ensure that adjustment in this market is compatible with less job destruction during recessions would prove timely, as would the lifting of the regulations restricting competition in some product markets.

In this respect, it should be recalled that the costs associated with the introduction of all these measures are lower when they are adopted in times of economic buoyancy such as the present.

The current economic expansion in the USA is on the verge of becoming the longest on record.[1] Specifically, the duration of this period of sustained growth, largely underpinned by the expansionary stance of economic policies, is now nine years.[2] However, the high recent GDP growth (with annualised quarter-on-quarter rates above 3.5% in the middle two quarters of 2018), which has taken the output gap into positive territory (see Chart 1) and reduced the unemployment rate to 3.7% of the labour force (its lowest level for the last 50 years), has given rise to a less balanced composition of aggregate demand, with a higher weight of consumption and a certain fall-off in investment, perhaps signalling a certain exhaustion of the cycle. Looking forward, it is expected that the more restrictive stance to be adopted by demand-side policies will contribute to raising the likelihood of a change of cycle in the US economy. This box analyses the foreseeable behaviour of fiscal and monetary policy and their effect on expected US growth in the next few years.

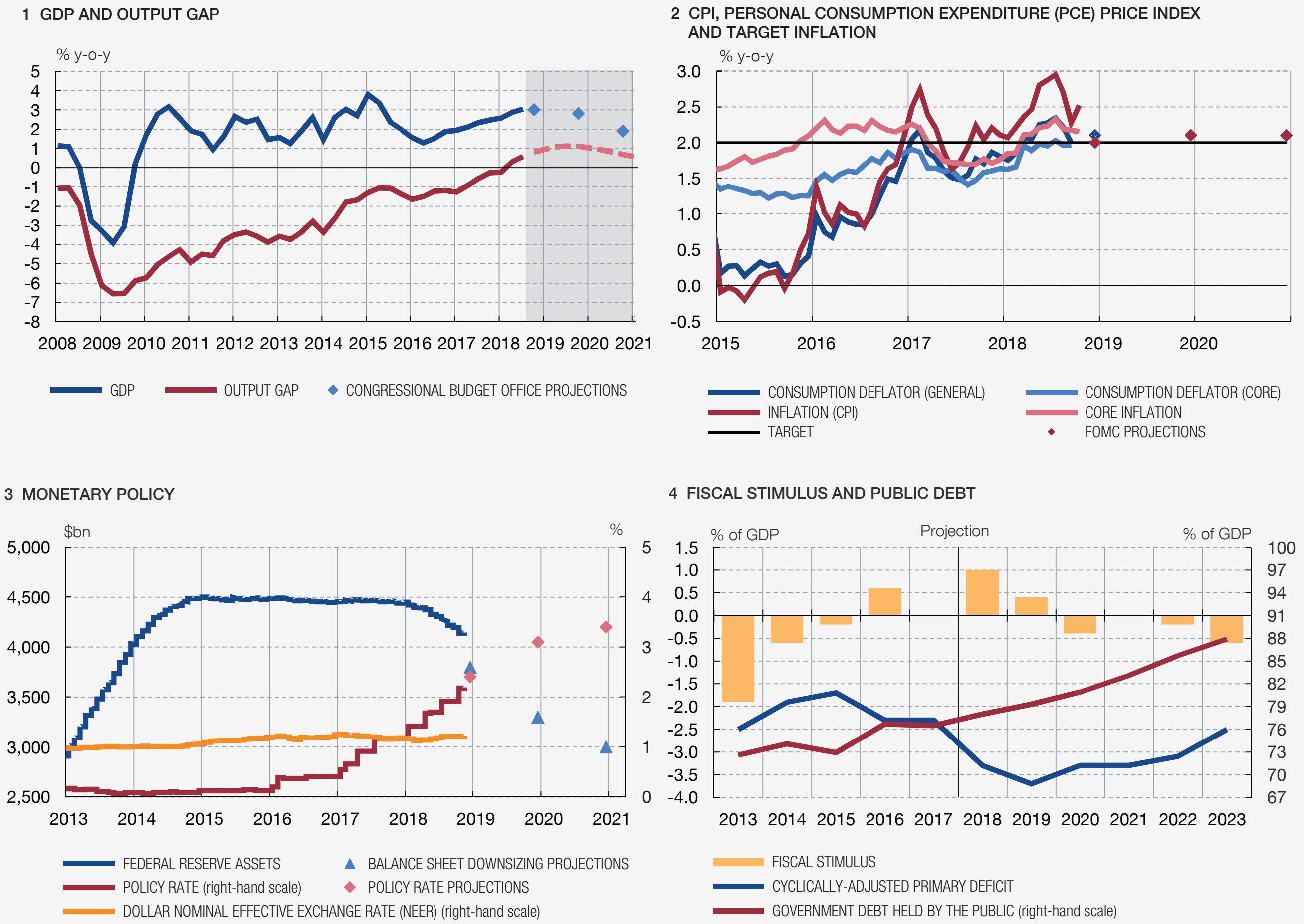
In the monetary arena, against a background of gradually rising inflation (see Chart 2) and progressive improvement in the labour market, the Federal Reserve has raised its policy rate by 200 bp since December 2015 (see Chart 3) and may further raise it by another 125 bp up to the end of 2020, according to the median of the projections of the Federal Open Market Committee (FOMC) members. Furthermore, in October 2017, the Federal Reserve began to downsize its balance sheet, and is expected to continue to do so gradually over the coming years. Although the Federal Reserve expects inflation to remain around the target of 2% in the near future, the scant slack in the labour market and the effects of the tariff increases pose upside risks to the baseline price scenario, the materialisation of which would prompt additional tightening of monetary policy and further toughening of domestic and global financial conditions.[3]

1 See the business cycle dating published by the National Bureau of Economic Research since the middle of the 19th century.

2 The average duration of expansions in the USA since 1945 is approximately five years.

3 Specifically, it is estimated that a tightening in financial conditions of 1 standard deviation may clip as much as 1.6 pp from the annual growth of the USA, See Hatzius, J. and S. Stehn (2018), "The case for a financial conditions index", Goldman Sachs Global Economics Paper.

Chart 1
CYCLICAL POSITION AND ROLE OF DEMAND POLICIES



SOURCES: Bureau of Economic Analysis, Congressional Budget Office, Bureau of Labor Statistics, Federal Reserve and Bloomberg.

As regards fiscal policy, it is estimated that the stimulus derived from the expansionary measures adopted in late 2017 and early 2018 will have a positive impact on GDP growth of 0.6 pp in both 2018 and 2019.[4] As this fiscal stimulus peters out after 2020 (see Chart 4), activity will tend to slow, falling back towards its trend growth rate in the medium term, slightly below 2%, according to the projections of the Congressional Budget Office.

Lastly, it should be noted that the protectionist about-face of the current US administration will continue to be another key factor in the US economic outlook. The imposition of trade tariffs is a prerogative of the president and it is unlikely that the outcome of the mid-term elections will alter the protectionist trade policy agenda. If the threats made were to be carried out, the trade conflict could trim nearly 0.5 pp from US GDP growth in 2019, according to estimates by the main international organisations.[5]

In short, the loss of support for expansionary demand-side policies against a background of high uncertainty due to trade tensions, points to a slowdown in US economic activity in the coming years to growth rates more in line with potential. Moreover, in the event of a hypothetical recession in the medium term, the room for manoeuvre of demand-side policies is now more constrained than in previous recessions. Firstly, monetary policy faces a setting of lower natural interest rates and a higher likelihood of hitting the policy rate floor. Secondly, the action of automatic stabilisers and the application of a discretionary expansionary fiscal policy would be partially limited by the severe fiscal imbalances built up in recent years.

4 *An Update to the Economic Outlook: 2018 to 2028.*

5 See for example, IMF (2018), *World Economic Outlook,* October 2018; and OECD (2018), *Economic Outlook,* November 2018.

The financial strains recently experienced by some emerging market economies (EMEs) reflect growing global interdependence, which has accentuated these countries' exposure to international economic and financial events. Specifically, in the past year, EMEs have been shaken by the effects of the trade tensions between China and the United States, and to those arising from the US fiscal and monetary policy mix, which have prompted an appreciation of the dollar and a tightening of international financial conditions.[1]

However, the deterioration in the EMEs' financial indicators has not been uniform; rather, investors have taken the degree of vulnerability of the different countries into account in their portfolio decisions, as was the case in previous bouts of turbulence linked to changes in US financial conditions, the so-called "taper tantrum" from May to August 2013 being a case in point. Specifically, in the episode from April to September 2018, the financial tensions particularly affected those economies with sizeable vulnerabilities, in particular in terms of a weak external position (see Charts 1 and 2). The two countries that most suffered in this phase of instability were Argentina and Turkey, which have already been the subject of recent detailed analysis.[2]

This box assesses the current degree of vulnerability in EMEs as a whole, before focusing on the most relevant countries, either in terms of their weight in global activity and their systemic relevance (as is the case of China), or because of their importance to the Spanish economy (Brazil and Mexico).[3]

The indicators habitually used to examine the emerging economies' vulnerabilities include some relating to their external position (current account balance, external debt and international reserves), their fiscal stance (budget deficit and public debt), their macroeconomic situation (GDP growth and inflation), the soundness of their banking systems (credit growth, traditional funding via deposits versus external financing) and political risks.[4] In aggregate terms, when considering this set of indicators the diagnosis about whether the degree of vulnerability is higher or lower currently compared with the aforementioned episode in 2013 is not clear, since some of these indicators have improved, but others have worsened (see Chart 3). In particular, inflation has fallen compared with five years earlier (from 5% to 3.8%), growth rates have remained high (slightly over 5% in both cases) and the situation of the banking sector is sounder (their banks' net external assets have risen from 0.5% to 2% of GDP). Conversely, the fiscal margin has now diminished (the average deficit has dipped from 2.1% of GDP in 2013 to 3.5% in 2018 Q1), public debt and external debt ratios have risen, international reserves have fallen and the geostrategic risk indicators and domestic political tensions are greater than they were in 2013.[5] . Furthermore, from a shorter time perspective, the emerging economies' vulnerability has increased in the external and fiscal arena since early 2017.

As to the three individual economies considered, the main risks in the case of Brazil are in the fiscal domain, since the budget deficit has been standing above 7% of GDP for three years and public debt has climbed to 77.2% of GDP, a historical high (see Chart 4). Against this background, it is essential to curb the expected high growth of Social Security spending, through the reform of the pension system, which has been pending for over a year.[6] Further, there are several factors of vulnerability in some financial institutions, including banks and investment funds, which have absorbed a very high proportion of new government debt issues, and in public-sector banks, owing to the segmentation of credit markets (in which almost half of total loans have been granted at subsidised interest rates by public banks, as opposed to the rest, granted at higher rates – and with bigger margins – by private banks, which are concentrated in segments such as consumer credit). These factors have given rise to a deterioration in the sector's valuation by analysts and investors. However, other indicators have tended to improve recently. The usual indicators of political uncertainty, which had risen owing to the uncertainty surrounding the presidential vote, have abated following these elections. Moreover, Brazil has managed to adjust its current account deficit in recent years (from 4.4% of GDP in early 2015 to 0.5% in 2018, Chart 4), meaning external debt has fallen slightly. Inflation, meanwhile, has been substantially cut from 10.8% on average in 2015 to 4.5% in September 2018. Finally, reserves stand at historical highs ($338 billion), with very limited exposure by the public sector to the external sector.

The fiscal position is also a factor of vulnerability in Mexico, although the imbalances are far lower than in Brazil: the budget deficit has held at between 2.5% and 3% of GDP since 2010, while public debt increased by more than 10 pp from 2010 to 2016, stabilising thereafter at around 45% of GDP (see Chart 5). On the contrary, the current account imbalance and external debt

1 Box 2 ("Recent turbulence in emerging markets") of the "Quarterly Report on the Spanish Economy", *Economic Bulletin* 3/18, Banco de España, describes the tensions experienced this year by these economies.

2 See the reference in footnote 1.

3 See Molina L., E. Alberola and E. López (2016), "El posicionamiento exterior de la economía española", Documentos Ocasionales, No 1602, Banco de España, in which a hierarchy is established of the significance of various economies to Spain, based on goods export figures, tourism revenues, non-tourist services exports and direct investment assets.

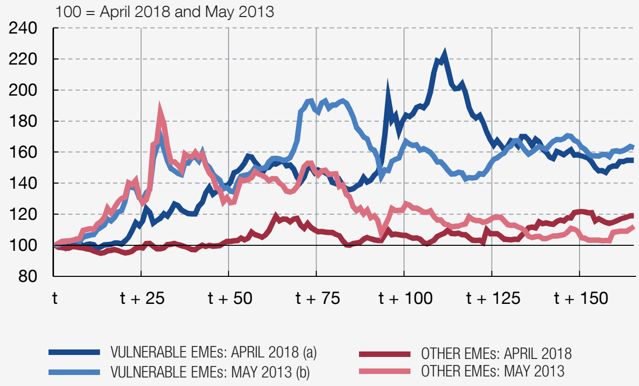
4 The identification of these variables is based on various models of foreign exchange and banking crises: Krugman, P. (1979), "A model of Balance of Payments crises", *Journal of Money, Credit and Banking* Vol.11; Obstfeld, M. (1986), "Rational and Self-fulfilling Balance-of-Payments Crises", *American Economic Review,* Vol. 76(1); Eichengreen, B. and R. Hausmann (1999), *Exchange Rates and Financial Fragility,* NBER WP 7418.

5 In some of these indicators, the deterioration observed is due to the Chinese economy. Specifically, if China is excluded, an increase in international reserves and a reduction in the current account deficit of almost 0.6 pp of GDP can both be seen.

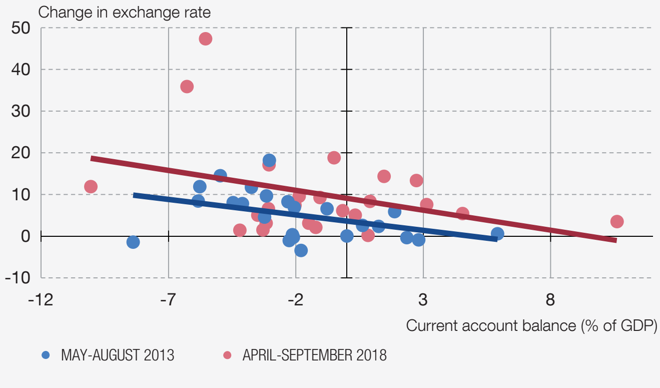
6 For further details see Banco de España (2016), "Report on the Latin American economy. Second half of 2016", *Economic Bulletin,* October 2016.

Chart 1
VULNERABILITIES IN EMERGING MARKETS

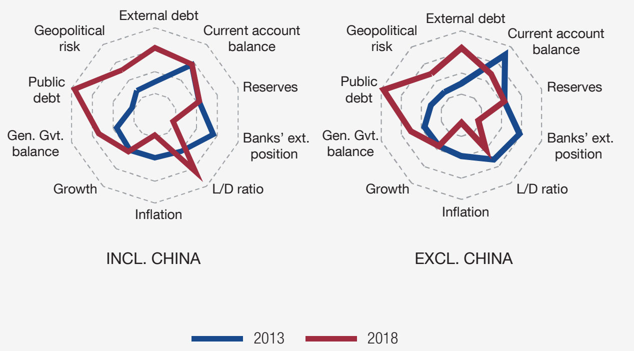
1 SOVEREIGN CDSs



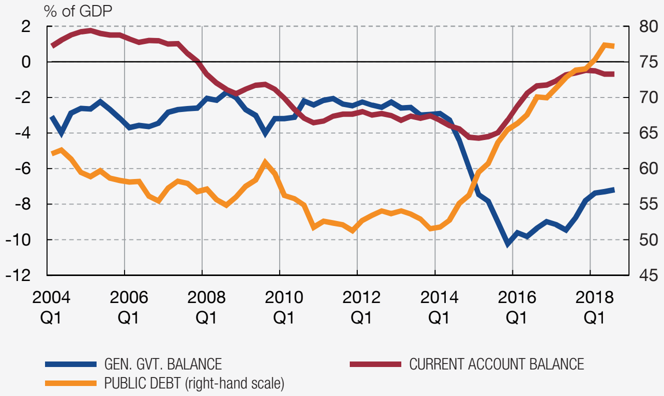
2 VULNERABILITIES AND EXCHANGE RATE DEPRECIATION



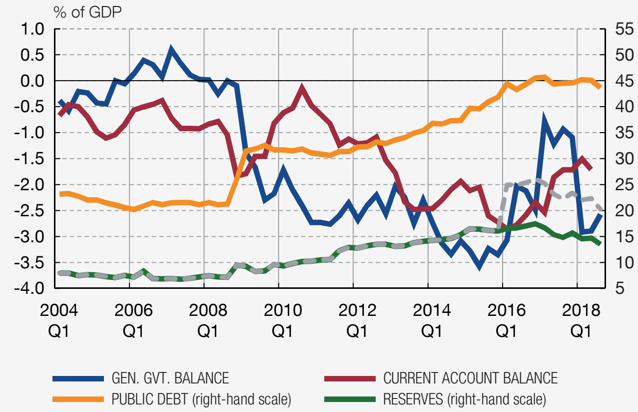
3 EMERGING ECONOMIES' VULNERABILITY INDICATORS (c)



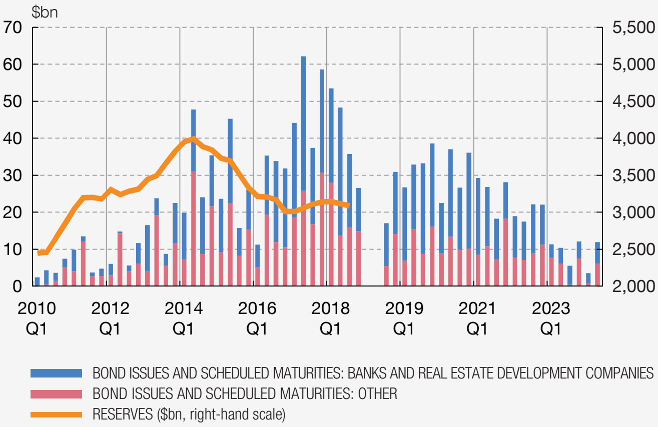
4 VULNERABILITIES AND STRENGTHS IN BRAZIL



5 VULNERABILITIES AND STRENGTHS IN MEXICO (d)



6 VULNERABILITIES AND STRENGTHS IN CHINA



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

a Argentina, Brazil, Turkey, Tunisia and Nigeria.
b India, Indonesia, Brazil, South Africa and Turkey.
c Standardised series with average and standard deviation from 2008. Outward movement by the variables entails greater vulnerability.
d The dotted line depicts reserves as a percentage of GDP were Mexico to receive the $88 bn of the FCL entered into with the IMF.

have been adjusted in the past two years and international reserves, despite having fallen, hold above their historical average. Moreover, in this latter area, Mexico has a Flexible Credit Line (FCL) with the IMF worth $88 billion, half its current reserves.

In the case of China, the main vulnerabilities stem from the trade tensions with the United States and, from a more structural perspective, from the ongoing re-balancing of the Chinese economy towards a growth model based more on the services sector and private consumption, and less on investment and exports, with very high rates of corporate debt. In the transition from one model to the other, the Chinese authorities face the dilemma, in the current context of less favourable external conditions, of choosing between maintaining the pace of the process of transformation, on one hand, and supporting economic growth, on the other, even though this may check the correction of its macrofinancial imbalances. Against this backdrop, the corporate debt ratio exceeded 150% of GDP in 2017; that said, the proportion accounted for by shadow banking in this figure has declined at the expense of bank lending, which has grown at a real rate of 9% in the past two years.[7]

7 See, in this connection, Box 3 ("Some implications of the announced expansionary stance of China's macroeconomic policies"), "Quarterly Report on the Spanish Economy", *Economic Bulletin* 3/2018, Banco de España.

The financial vulnerabilities of the Chinese economy are also significant. Firstly, banks increasingly resort to the markets for financing (the issuance of certificates of deposits in 2017 and 2018 doubled) which, together with the slowdown in deposits, has raised the loan/deposits ratio to close to unity. Secondly, a strong increase in Chinese banks' and real estate development companies' bond issues on international markets was observed throughout 2017, which might entail certain risks when these sectors have to face their external debt maturities, most of which are concentrated in the next three years (see Chart 6). Notwithstanding, China continues to hold a high volume of international reserves ($3.1 trillion) and its levels of external and public debt are low, which affords it substantial room for manoeuvre.

In short, analysis of the vulnerabilities of the main emerging economies points to an increase in fiscal imbalances in the cases of Brazil and, to a lesser extent, Mexico, and to high corporate sector debt in China. Nonetheless, the high volumes of reserves in China and Brazil (along with Mexico's contingent borrowing arrangement with the IMF) and the healthy external position of these economies are factors that offer a degree of protection to mitigate the effect of the potential risks that might arise in a setting of tighter global financing conditions and uncertainty over international trade developments.

During the past decade, euro area fiscal policy has been marked by the ongoing reduction in the budget deficit from the peak of 6.2% of GDP in 2009 to the forecast figure of 0.6% for 2018. The correction of the budgetary imbalance was the outcome, first, of a package of discretionary structural measures involving expenditure cuts and tax increases; and further, of the effects of the pick-up in activity and of the reduction in interest rates. This ultimately prompted a decrease in the public debt ratio from 94% of GDP in 2014 to below 87% of GDP in 2018.

The budgetary plans for 2019 submitted by the euro area countries to the European Commission suggest a change in tack in the area's fiscal policy towards a slightly expansionary stance, i.e. one conducive to demand growth. The deficit is thus expected in 2019 to post its first increase in the past decade as a percentage of GDP (0.2 pp) to stand at 0.8%.[1] That would not prevent a fresh cut in debt, to 85.1% of GDP, assisted by the economic expansion and the pick-up in inflation.[2] In structural terms, the increase in the deficit will be somewhat greater (0.3 pp), placing it at 1% of potential GDP[3] (Charts 1 and 2).

While on a very modest scale, this expansionary stance is in notable contrast to the recommendation published last July by the European Fiscal Council. This body, taking into consideration the robust pace of growth of activity in most euro area countries and the still-high levels of public debt, advised maintaining a restrictive fiscal policy, especially in the countries with high debt levels, that would provide for budgetary room for manoeuvre so as to address adverse future situations.[4]

Country by country, the fiscal policy stance in 2019 is, in most cases, expansionary or neutral, in a setting in which positive output gaps prevail (Chart 3). On these estimates, there would only be five countries (in addition to Greece) for which fiscal policy would act in a countercyclical fashion in 2019: France[5], Austria, Finland, Estonia and Latvia. Among the countries projected to have a more lax budgetary policy are some, such as Italy and Cyprus, that also have high debt ratios (Chart 4).[6] Conversely, it is worth noting the fiscal expansion planned by some countries which, having posted low deficit and debt levels, have greater fiscal space, Germany and the Netherlands being cases in point.

Italy is the country planning a more expansionary fiscal stance, with an increase in its structural deficit of close to 1% of potential GDP (Chart 2). This is in contrast to its commitment under the Stability and Growth Pact (SGP) to a 0.6 pp adjustment to its deficit.[7] This breach, along with that relating to the debt reduction criterion, whose ratio, on European Commission November 2018 forecasts, is expected to stand at 131% of GDP in 2019, has given rise to the Commission's recommendation that an Excessive Deficit Procedure based on debt be initiated.[8] That has led the government to reconsider some of the measures planned.

Given the environment of limited fiscal space currently characterising the euro area, the appropriate composition of fiscal policy measures is vital as far as the instruments used are concerned.[9] The fiscal impulse inferred by the aggregation of draft budgetary plans for 2019 stems in full from the revenue side, while expenditure offers a more neutral aspect.[10] The expansionary measures affecting the expenditure side include most notably, the increase in public investment (following the cut observed in the wake of the crisis) and in welfare benefits, especially in Germany and Italy[11] (see Chart 5). The reduction in tax revenue in 2019 stems above all from social contributions, which have generally fallen across the board, most notably in France.[12] In terms of the revenue ratio, this has been offset in part by an increase in indirect taxation, which chiefly affects France, Spain and the Netherlands (see Chart 6).

1 The aggregate budgetary magnitudes for the area as a whole mask substantial heterogeneity from country to country. Eleven members project a surplus or balanced budget for 2019, while of the eight countries forecasting a deficit for the coming year, only France and Italy foresee an increase on 2018. It is indeed these two countries that project the highest deficits, although neither exceeds the reference value of 3% of GDP.

2 In its November projections, the European Commission coincides with the draft budgetary plans as regards the deficits forecast for 2018 and 2019; for debt, meanwhile, it envisages a somewhat greater reduction in 2018 and a slightly lower one in 2019, when debt is expected to stand at 84.9% of GDP.

3 Estimated by the European Commission, using the common methodology for the calculation of potential GDP, based on budgetary planning data. For the area as a whole it coincides practically with that published in November 2018 by the European Commission on the basis of its own forecasts. However, according to these forecasts, if Italy is excluded the euro area's fiscal policy stance in 2019 will be practically neutral, with an increase in the structural deficit of 0.1 pp of potential GDP.

4 European Fiscal Board (2019). Assessment of the prospective fiscal stance appropriate for the euro area in 2019.

5 France's budgetary plan does not include the government's recently announced expenditure-increasing measures.

6 The budgetary plans of 10 countries contain debt ratios that exceed the 60%-of-GDP threshold. Among these, two (Greece and Italy) exceed 120%, with the Portuguese debt ratio just below the threshold in 2019, and with another four members (Belgium, France, Spain and Cyprus) with ratios close to 100%.

7 Specifically, Italy projects an increase of 0.9 pp in its structural deficit, to 2.6% of potential GDP. The European Commission estimates an even higher structural deficit for Italy, rising from 1.8% of potential GDP in 2018, to 3% in 2019.

8 The Council should decide within four months whether it approves this Procedure, following the opinion of the Economic and Financial Committee and the subsequent submission to the Council and the European Parliament of a new report by the Commission with the details of the adjustment programme.

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

10 The cyclically adjusted expenditure ratio holds at 47.1% of potential GDP, while the cyclically adjusted revenue ratio falls by 0.4 pp to 45.8% of potential GDP.

11 In Italy's case, the bringing forward of the minimum retirement age and the introduction of the "Citizen's Income" account for 0.7 pp of GDP.

12 The conversion of the tax credit for competitiveness and employment (CICE by its French acronym) into a permanent reduction in payroll charges accounts for approximately 0.8 pp of French GDP.

Chart 1
FISCAL OBJECTIVES OF DRAFT BUDGETARY PLANS FOR 2019 IN THE EURO AREA AND ITS MEMBER STATES (a)

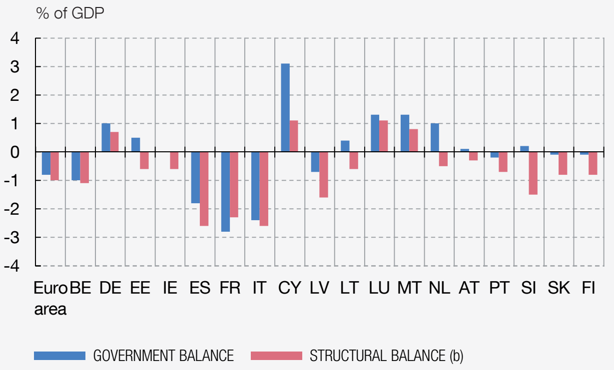


Chart 2
BREAKDOWN OF THE CHANGE IN THE BUDGET BALANCE FOR 2019 IN THE EURO AREA AND ITS MEMBER STATES (a)

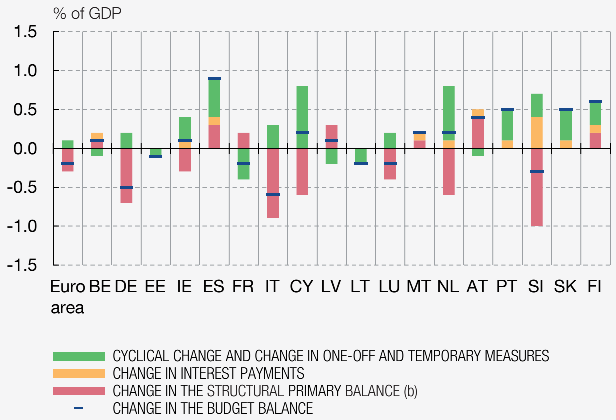


Chart 3
FISCAL POLICY STANCE AND OUTPUT GAP. DRAFT BUDGETARY PLANS FOR 2019 (a)

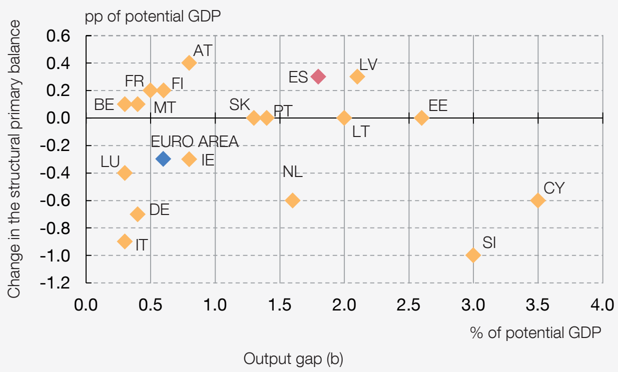


Chart 4
FISCAL POLICY STANCE AND PUBLIC DEBT. DRAFT BUDGETARY PLANS FOR 2019 (a)

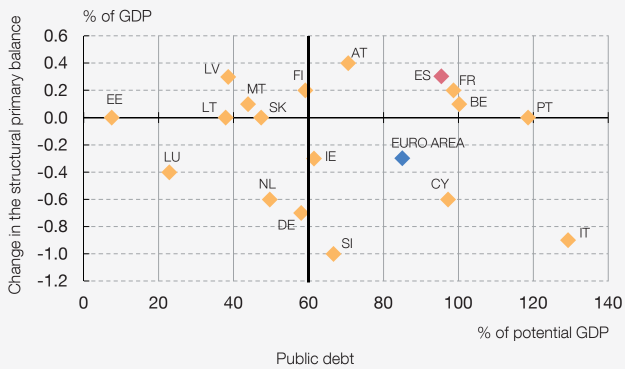


Chart 5
CHANGES IN THE MAIN TYPES OF EXPENDITURE. DRAFT BUDGETARY PLANS FOR 2019 (a)

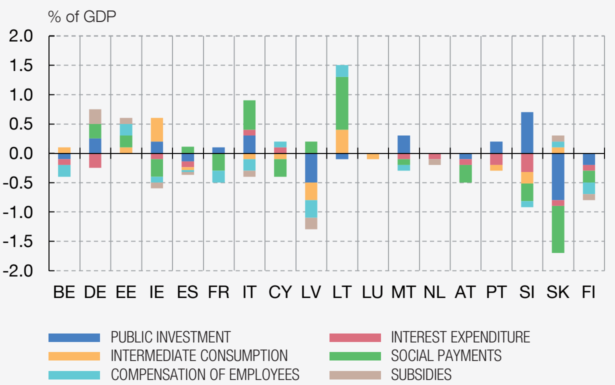
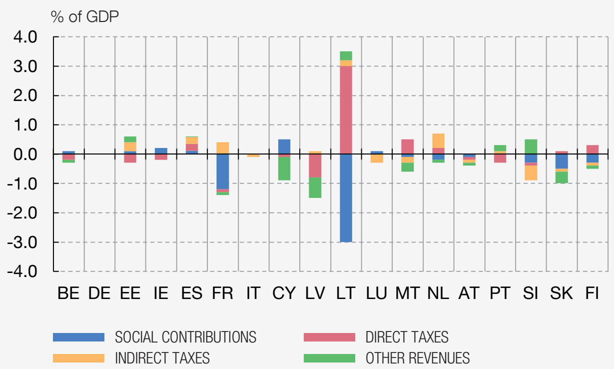


Chart 6
CHANGES IN THE MAIN TYPES OF REVENUE. DRAFT BUDGETARY PLANS FOR 2019 (a)



SOURCE: European Commission.

a The data for Greece are not depicted so as not to distort the charts.
b European Commission estimate.

Regulation (EU) 2017/1151 came into force across the EU on 1 September 2018. Under this regulation, the application of a new protocol for the measurement of automobile pollutant emissions known as the Worldwide Harmonised Light-Duty Vehicles Test Procedure (WLTP) is mandatory. All vehicle registrations performed after that date must comply with this protocol. In practice, this means that measurements of fuel consumption and emissions are more stringent than those obtained under the previous system. This regulatory change has immediate tax effects, since vehicle registration tax is calculated based on CO2 emissions,[1] and it also obliges manufacturers to adapt their production systems to ensure that vehicles comply with the new legal requirements.

The two measurement systems will coexist until 31 December 2020. The European regulations provide a tool that permits correlating the values of CO2 emissions of the WLTP with those of the New European Driving Cycle (NEDC) for the purpose of having a comparable base. The Ministry of Industry, Trade and Tourism has approved the use of this transitional system[2] to reduce the impact on the automotive industry. This measure does not exempt any vehicle from complying with the emissions established in the new standards, but rather intends to graduate the tax impact of the change in procedure and facilitate manufacturers' implementation of the technologies and developments required to adapt their range of products to the new cycle requirements.

This regulatory change is giving rise to several consequences for the automotive industry. During the summer car dealers tried to dispose of the stocks of vehicles that would not meet the new standards,[3] offering heavy discounts. They also resorted to self-registration for their final sale at a later date, since the new regulations will not be applied to second-hand cars. The main effect, however, derives from the need for manufacturers to change their production so that the new models comply with the regulatory change. The volume of economic activity that is directly affected by this legislative change is significant, given the weight of the automotive industry[4] in the euro area (see Charts 1 and 2), accounting for somewhat more than 20% of Germany's manufacturing production (around 7% of the economy's total output) and increasing since 2009, and for 8% in France and 7% in Italy. These figures are relatively large in Spain, albeit lower than in Germany, accounting for 11% of total manufacturing output (around 3% of total output). In employment terms, the weight of the automotive industry as a percentage of total manufacturing in Germany, France, Italy and Spain is 12%, 4.1%, 4.4% and 7.5%, respectively (approximately 2%, 0.4%, 0.7% and 0.8%, respectively, in the total economy.

Additionally, this sector is very important for the export activity of euro area countries. In Spain, motor vehicle exports accounted for around 11% of the total in 2017 in nominal terms, although the sector's relative weight in the total has been decreasing in recent years, given the degree of external openness of the rest of the economy seen since the crisis.[5] In Germany the weight of the

1 Vehicle registration tax in Spain is divided into brackets, based on vehicles' emission levels. Those with emissions lower than 120 gr/km are exempt from paying the tax. The tax rate for those with emissions between 121 gr/km and 160 gr/km is 4.75% and for those between 161 gr/km and 200 gr/km it is 9.75%. Cars with emissions in excess of 200 gr/km are taxed at 14.75%. The fact that the new legislation addresses higher emission levels means that certain vehicles will no longer be tax exempt and others will move to a higher bracket.

2 See press release https://www.mincotur.gob.es/es-es/GabinetePrensa/NotasPrensa/2018/Paginas/20180831.aspx

3 Car dealers may continue to register vehicles certified under the NEDC protocol until 1 September 2019, provided the volume does not exceed 10% of the previous year's total sales.

4 Unless expressly stated otherwise, the automotive industry refers to sector 29 of the Spanish National Classification of Economic Activities (CNAE, by its Spanish abbreviation): Manufacture of motor vehicles, trailers and semi-trailers.

5 See M. Almunia, P. Antràs, D. López-Rodríguez and E. Morales (2018) *Venting Out: Exports during a Domestic Slump*, Banco de España Working Paper No. 1844.

Chart 1
MOTOR VEHICLE INDUSTRY OUTPUT / TOTAL ECONOMY

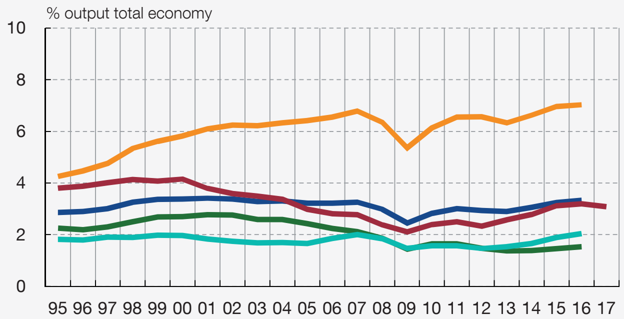
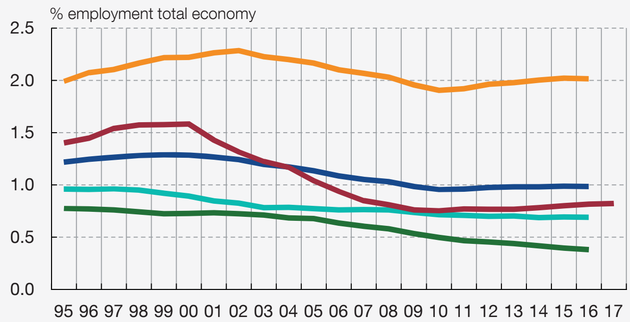


Chart 2
MOTOR VEHICLE INDUSTRY EMPLOYMENT / TOTAL ECONOMY



EURO AREA GERMANY FRANCE ITALY SPAIN

SOURCE: Eurostat.

automotive sector in exports is also 11%, while in France and Italy it is lower, accounting for 4.7% and 4.4%, respectively.

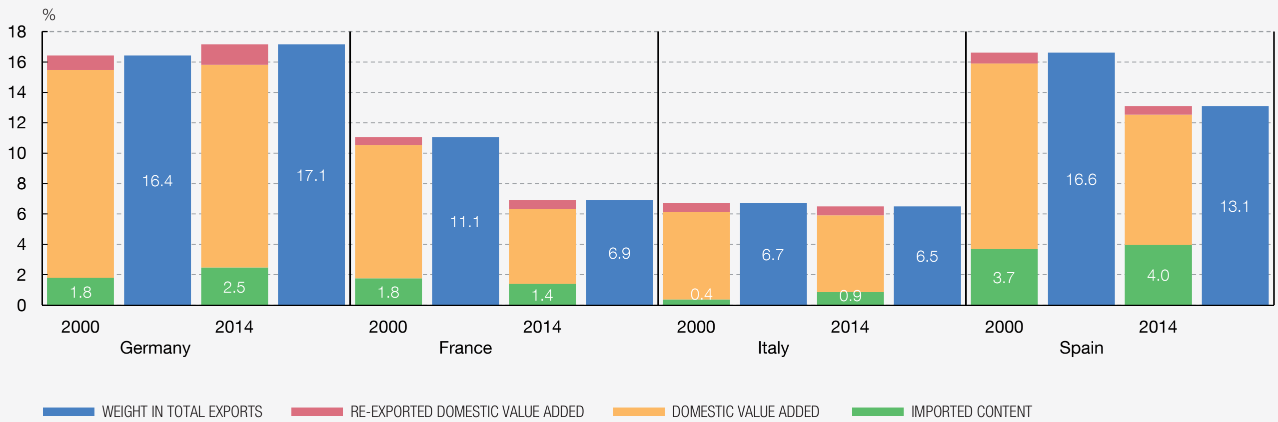
Nonetheless, the sector is more important for foreign trade than what these figures reflect. The automobile production process involves successive interactions between different firms that are located in different countries so that it is not possible to be immediately aware of the position and participation of each economy in the global supply chains. The world input-output database (WIOD) allows breaking down exports into the fraction relating to foreign value added (imported content) and domestic value added, i.e. the respective contributions of non-resident and local production factors to total value added, separating from the latter a third component, which is domestic value added that is re-exported in the form of intermediate goods.[6] Chart 3 shows how, in comparison with the other large countries of the euro area, Spain has a greater weight of the so-called "backward" component (inputs from abroad) and a lower weight of the "forward" component (intermediate inputs that will be re-exported to a third country), although the differences are very small in the latter case. This composition indicates that the automotive industry in Spain is more oriented towards the final product, which could lead to the negative impact of regulatory changes on production in the sector materialising with some delay in comparison with the other countries considered, whose automotive industry focuses more on the initial phases of production.

As regards the effect of the regulatory change on the most recent activity data, a distinction should be made between demand and supply elements. In the case of demand, vehicle registration figures were significantly affected in the most recent phase both in Spain and in the other European countries where the new legislation has been implemented. Thus, very high growth was recorded in the months prior to the change in regulation, particularly in August (with the exception of Italy, where the rise was more moderate), linked in part to the self-registration policy discussed previously. In Spain, registrations in August grew close to 50% year-on-year, compared with increases of between 15% and 25% in the same month during the four previous years, a pattern that was also seen in Germany and France. Once the regulation came into force, these increases were followed by falls of varying intensity which offset in some cases the increases of August. In the case of Spain, despite the declines in September and October, the cumulative growth of registrations during the period August-October stood at 5.9%, while falls of 11.3% and 5.6% were recorded in Italy and Germany, respectively (see Chart 4).

As regards supply, car production figures also appear to have become distorted around the dates of entry into force of the regulation (see Chart 5). In Spain the auto component of the Industrial Production Index (IPI) fell by approximately 20% in September, partly owing to demand having been brought forward to the summer months, but also because the need to certify vehicles under the new regulation could have prompted delays in the supply chains of the different production plants, according to the anecdotal evidence available. The decline in October was much more moderate (-1.9%), such that in cumulative terms, car production in the period August-October fell by 5.4% vis-à-vis the decrease of 2% recorded in the same period in 2017. As regards the rest of the European countries analysed, the situation is mixed. A significant decline was observed in the period August-October in Germany (-11.9%, compared with a 2.4% increase in 2017), which was slightly more moderate in Italy (-8.7%, compared with a 4.5% increase in 2017) and the effect was minor in France, increasing by 0.7% (12.9% in the same period in 2017).

6 For further details see E. Prades and P. Villanueva (2017), "Spain in the Global Value Chains", *Economic Bulletin*, 3/2017, Banco de España, and M.P. Timmer et al. (2015), "An illustrated user guide to the World Input-Output Database: the case of global automotive production", *Review of International Economics*, vol. 23, No. 3, pp. 575-605.

Chart 3
SHARE OF THE AUTOMOTIVE INDUSTRY IN TOTAL EXPORTS AND GLOBAL VALUE CHAIN PARTICIPATION



SOURCES: WIOD 2016 and Banco de España calculations.

Chart 4
VEHICLE REGISTRATIONS
Year-on-year rates

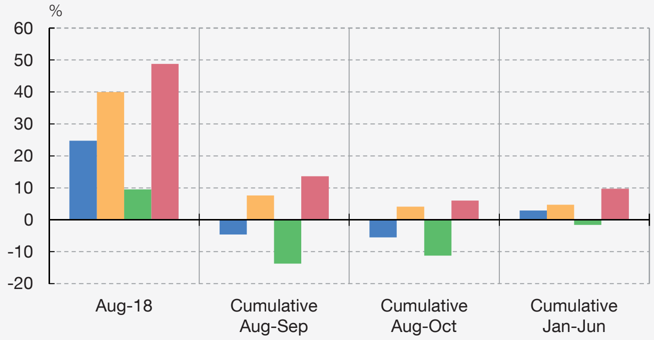
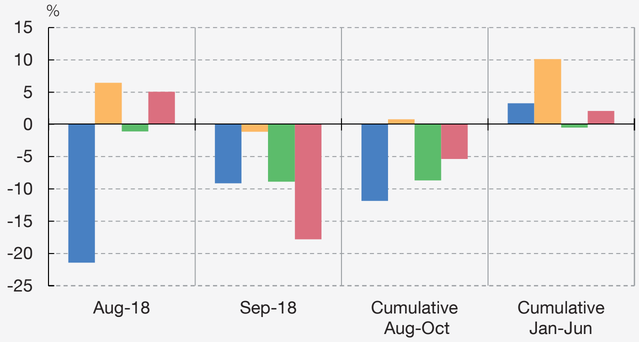


Chart 5
INDUSTRIAL PRODUCTION INDEX - VEHICLES (a)
Year-on-year rates



GERMANY FRANCE ITALY SPAIN

SOURCES: European Automobile Manufacturers Association and Eurostat.

a Data relating to sector 291: Manufacture of motor vehicles.

Chart 6
CONFIDENCE INDICATOR FOR AUTOMOTIVE INDUSTRY

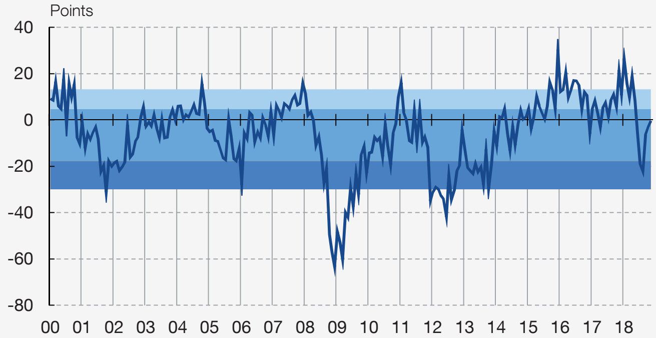


Chart 7
ASSESSMENT OF ORDER BOOK LEVELS

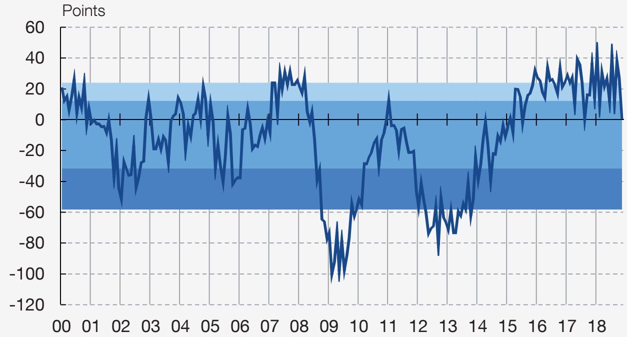


Chart 8
ASSESSMENT OF STOCKS OF FINISHED PRODUCTS

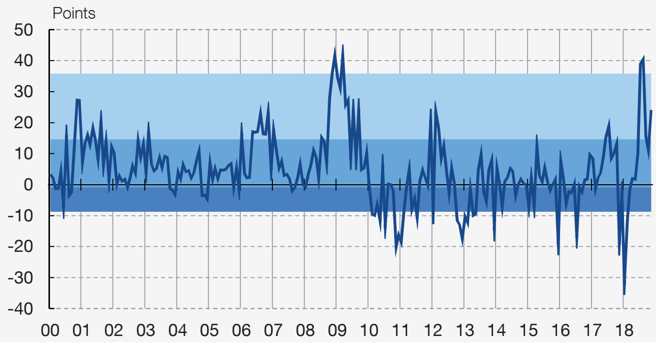
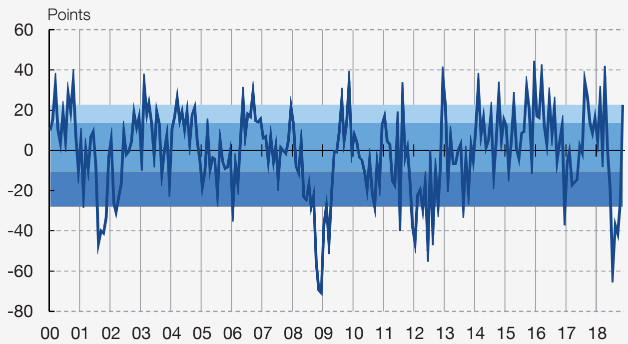


Chart 9
PRODUCTION EXPECTATIONS FOR THE COMING MONTHS



10-25 PERCENTILE 25-75 PERCENTILE 75-90 PERCENTILE INDICATOR

SOURCE: European Commission.

As regards the outlook for the industry, the indicators available reflect a downturn in the months leading to the entry into force of the new legislation, which is reversing in subsequent months, an effect which appears to be temporary. Specifically, in Spain the confidence indicators for the auto industry have shown a downturn since May, which worsened in July and August, although this trend has reversed. The behaviour of the aggregate indicator is explained by the uneven performance of its components. First, in the summer months there was a significant accumulation of inventories, possibly reflecting the initial problems in demand, which, however, declined in later months. As regards the assessment of order books, the levels remain high, which seems to point to a temporary phenomenon. Finally, the downturn shown in production expectations since the summer months also reversed in November, pointing to a possible normalisation of activity in production chains over the coming months (see Charts 6 to 9).

One feature that marks out the current upturn favourably is that the Spanish economy's high GDP growth has been compatible with maintaining relatively high external surpluses (averaging 2% of GDP, in terms of net lending over the period 2013-2017). However, more recently, the Spanish economy's lending capacity has decreased somewhat, dropping to 1.4% of GDP in cumulative twelve-month terms in September 2018, compared with 2.1% over 2017 as a whole (see Chart 1). It is therefore worth analysing the factors underlying these developments and, in particular, whether they are predominantly transitory or permanent, particularly given that, despite the recent correction, the Spanish economy still has a high net debtor position against the rest of the world. To bring down this debt it will be necessary to run an external surplus for an extended period. This box examines these factors and how they affect likely future developments in the external balance.

From the viewpoint of the various items of the rest of the world account, the recent decrease in the economy's lending capacity has been concentrated in the balance of goods and services. By components, the reduction in the surplus in non-energy goods and non-tourism services, the widening deficit in energy goods, and the falling surplus in tourism services account for around 65%, 20% and 15% of the total reduction in the external surplus since the start of 2017. Unlike the situation observed in the case of the goods and services balance, the changes during the period in the balance of primary and secondary income and the balance of the capital account were insignificant.[1]

There were a number of factors underlying the deterioration in the various components of the balance of goods and services in recent quarters. Some of the most significant of these are intrinsically transitory, and some, such as the oil price, are difficult to predict. In particular, as regards the energy balance, the net bill has risen by 0.2 pp of GDP since the start of 2018 (and 0.5 pp since end-2016), as a consequence of rising oil prices, with the price of a barrel climbing from €28 in January 2016 to €57 in January 2018 and €71 in October 2018 before subsequently declining somewhat to €56 in November (see Chart 2). The role of dearer oil is also reflected in the breakdown of the trade balance by counterparties' geographical area, with the deterioration in the trade balance with countries outside the euro area being more pronounced than that with euro area countries, given that oil is mainly bought outside the euro area (see Chart 3). Nevertheless, the deficit under this heading has tended to remain below that observed in previous periods in which oil price levels were similar to those today, probably as a result of improvements in the Spanish economy's energy efficiency (see Chart 4).[2]

1 Among other items, the primary income balance includes interest payments and collections for liabilities and assets vis-à-vis the rest of the world. Secondary income includes, among other items, payments and collections of migrants' remittances, and the capital account balance includes capital transfers with the rest of the world.

2 See Box 3 of the Banco de España's September 2018 Quarterly Report.

For its part, the recent reduction in the balance of non-energy goods and non-tourism services was partly a response to losses in competitiveness induced by the rise in the value of the euro since early 2015 (see Chart 2). On the sales side, the slowdown in Spanish export market growth since early 2017 – slowing more than growth in global trade flows – has also had a negative impact on this sub-balance (see Chart 5).[3] Lastly, in the case of tourism, the recent deceleration is largely a response to the progressive normalisation of the geopolitical situation in competing destinations around the Mediterranean, such as Turkey or North Africa.[4]

In the specific case of real terms export flows, a simple econometric model proxying how this variable behaves based on its key determinants helps quantify the relative importance of each determinant in explaining the recent slowdown in this demand component. As can be seen in Chart 6, the slowdown in external demand and loss of competitiveness[5] together account for the majority of Spanish exports' loss of vigour so far in 2018.

Nevertheless, other more persistent factors in the domestic sector have also played a significant role in explaining the recent moderation of the foreign surplus. In particular, the process of substituting certain imported factors with domestic inputs observed in recent years[6] could have begun to reverse in 2017 (see Chart 7). This process, in conjunction with an ongoing increase in the share of exports, which have a high import content, in final demand, would have been reflected in rising elasticity of imports to final demand. In any event, the import content of exports and of final demand as a whole remains significantly smaller than that observed in the pre-crisis period, such that the improvement in the trade balance appears to include a structural component (see Chart 8).[7]

The Banco de España's latest projections suggest that, as a result of the factors just discussed, the economy's lending capacity could decrease in 2018 as a whole to around 1% of GDP.[8] Over the period from 2019 to 2021, the Spanish economy's external balance

3 The possible role of adaptation to the new emissions standards for the type-approval of new vehicles in the European Union, which came into effect on 1 September, is less clear-cut, given that as has happened in neighbouring countries, it has affected both sales and foreign purchases.

4 See Box 6 of the Banco de España's September 2018 Quarterly Report.

5 For more details on the estimation of these contributions, see E. Prades and C. García (2015), Actualización de la función de las exportaciones españolas de bienes, Economic Bulletin, April, Banco de España

6 See Chapter 3 of the Banco de España's September 2016 Annual Report. In order to distinguish to what extent these developments are due to companies importing more inputs from abroad or companies with a larger import content have gained market share in 2017 and 2018 a company-level granular analysis is needed, for which up-to-date data are not available.

7 See Chapter 3 of the Banco de España's September 2016 Annual Report.

8 See Macroeconomic projections for the Spanish economy (2018-2021): the Banco de España's contribution to the Eurosystem's December 2018 joint forecasting exercise.

will also be shaped by the various assumptions on which the projections are based. These include interest rates following an upward path – steeper in the case of longer maturities – in line with market expectations, the oil price following a slightly downward path (indicated by futures markets), exchange rates remaining at current levels, and the Spanish economy's external markets growing at an annual average of 3.5%.

Meanwhile, the projections anticipate the values of elasticity of imports to final demand to be similar to those observed in the last two years, in turn somewhat higher than in the early years of the recovery, and that exports will make further gains in external market share, although smaller than those in the period 2014-2016. This somewhat less favourable behaviour by external trade flows may reflect the fact that competitiveness gains relative to the rest of the world have tended to slow and that stronger domestic demand means Spanish companies are facing less pressure to find new markets.[9]

With these ingredients, the Spanish economy's lending capacity is expected to further moderate somewhat over the three year period from 2019 to 2021 (by around 0.4 pp of GDP), which would be explained in equal parts by a modest additional reduction in the balance of goods and services and a certain expansion in the income deficit (driven by the rising cost of the economy's external debt).

In short, the reduction in net lending observed over the course of 2018 is due to a convergence of a variety of different factors, such

9 See Almunia, M., P. Antràs, D. Lopez-Rodriguez, E. Morales (2018) "Venting Out: Exports during a Domestic Slump," Working Papers, No. 1844, Banco de España.

Chart 1
NET LENDING (+)/NET BORROWING (-). BALANCES

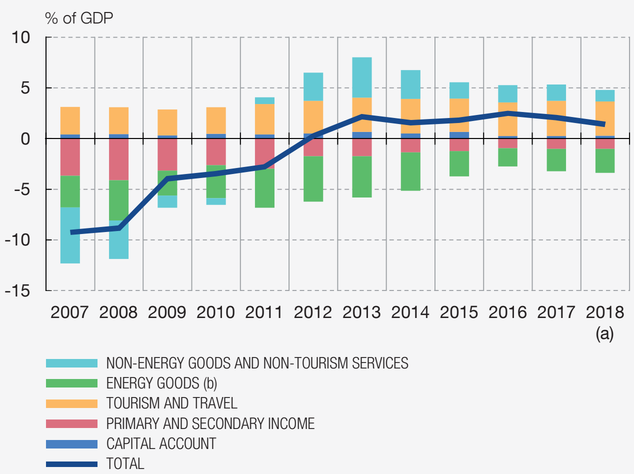


Chart 2
OIL PRICE AND NOMINAL EFFECTIVE EXCHANGE RATE

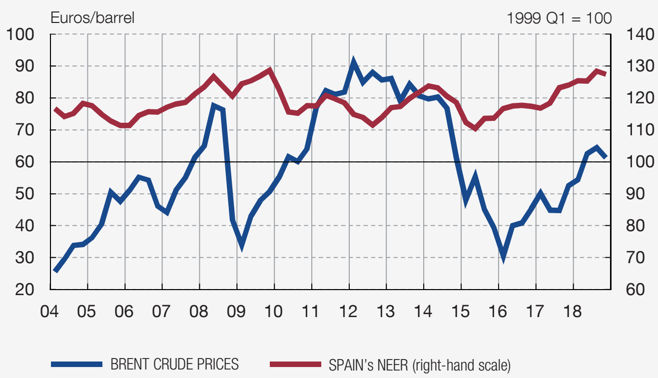


Chart 3
GOODS TRADE BALANCE

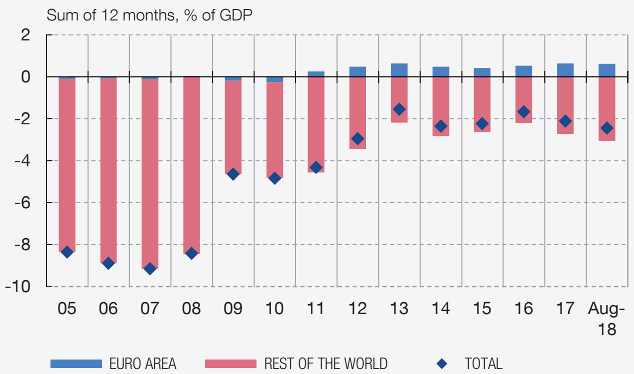
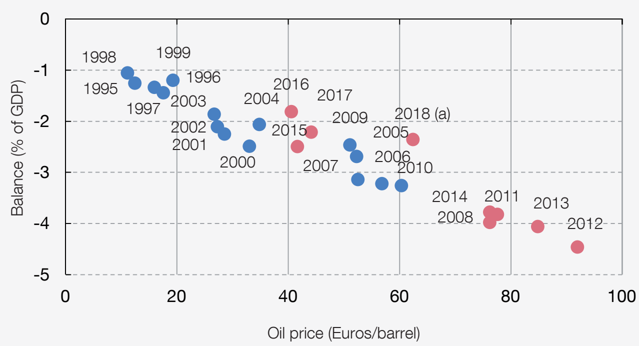


Chart 4
ENERGY GOODS BALANCE AND OIL PRICE



SOURCES: Banco de España and INE.

a 2018 data calculated as the sum of the data for the 12 months to September.
b The energy and non-energy balances are Banco de España estimates based on customs data.

as the appreciation of the euro, rising oil prices, the slowdown in world trade flows, and a degree of recovery of import penetration in final demand. Some of these factors may have only a passing impact, such that if the variables concerned (such as the oil price or exchange rate) remain close to their current values, no further deterioration is to be expected. However, the existence of signs of a partial reversal in 2017 and 2018 of the more (less) expansionary behaviour shown by exports (imports) in relation to their determinants between the start of the recovery and 2016 may perhaps indicate that the process of competitiveness gains under way since the start of the recovery has lost momentum, in a context in which the Spanish economy needs to run broad external surpluses to reduce its external debt from its current high levels.

Chart 5
SPAIN'S EXPORT MARKETS AND WORLD TRADE IN GOODS AND SERVICES

Chart 6
GOODS AND SERVICES EXPORTS AND THEIR DETERMINANTS: CONTRIBUTION TO ANNUAL GROWTH

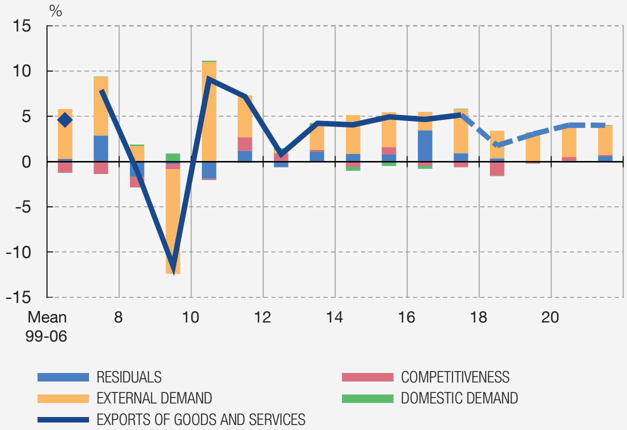


Chart 7
RATIO OF IMPORTS BY GOODS TYPE TO FINAL DEMAND COMPONENT

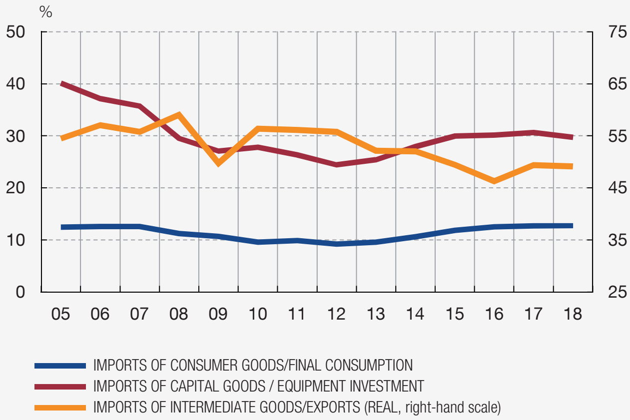
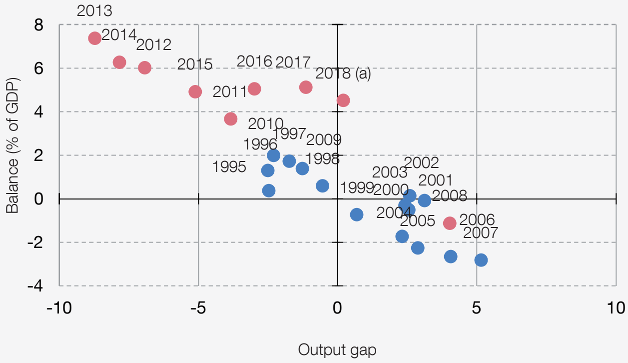


Chart 8
NON-ENERGY GOODS AND SERVICES BALANCE AND THE OUTPUT GAP



SOURCES: Banco de España and INE.

a 2018 data calculated as the sum of the data for the 12 months to September.
b The energy and non-energy balances are Banco de España estimates based on customs data.

In recent years, demographic pressure, both observed and expected, and the impact of the recent economic crisis on Social Security accounts (see Chart 1) have given rise to several reforms that seek to maintain the financial sustainability of the system, the last of which was approved in 2013.[1] This reform introduced two automatic mechanisms for adjusting pension expenditure. First, a new Pension Revaluation Index (PRI) was created, replacing the previous CPI-indexation system. This index, which has been in force since 2014, links annual pension increases to the financial situation of the pension system: if the system records a deficit, pension increases are capped at 0.25%. The PRI also sets a maximum increase of CPI growth in December of the preceding year plus 0.5%. In practice, between 2014 and 2017, application of the PRI has given rise to annual increases of 0.25%. Second, the "sustainability factor" (envisaged in the 2011 reform)[2] was established, whereby starting pension would be linked to the observed increase in life expectancy at the age of 67, so that the greater the increase in life expectancy, the lower the starting pension.[3] This factor was to come into effect in 2019.

The innovations described above helped to significantly improve the long-term sustainability of the system, as reflected in the projected pension expenditure for the Spanish economy included in the latest European Commission report on ageing.[4] However, in the absence of further legal changes in income or expenditure, the counterpoint to this enhanced sustainability would be a gradual decrease in the ratio of average pension to average wages in order to offset the negative effects of the dependency ratio (see Chart 2), essentially by operation of the automatic adjustment mechanisms introduced in 2013 and, in particular, the PRI. Thus, in the absence of further legal changes, the projections would entail annual pension revaluation of 0.25%, the minimum rate set, for much of the next three decades. With inflation rates around 2% – the ECB's medium-term benchmark – this would entail a gradual erosion of pensioners' purchasing power as they grow older (see Chart 3).

However, in the State Budget Law for 2018 (Law 6/2018 of 3 July 2018), a series of measures were adopted that modify the application of both the above-mentioned automatic adjustment mechanisms, with a significant impact on the pension system accounts. First, the Budget Law stipulated a pension increase in 2018 and 2019 above the 0.25% that would result from applying the PRI (see Chart 4). Specifically, an increase of 1.6% was set for all pensions in 2018, and if no alternative agreement is reached by the committee responsible for monitoring and evaluating the Toledo Pact agreements, that same increase will also apply in 2019. Moreover, minimum and non-contributory pensions rose by an additional 1.4% in 2018. Lastly, in terms of pension revaluation, the Budget Law for 2018 raised the regulatory base of pensions for widow(er)s receiving no other income from 52% to 56% in 2018 and from 56% to 60% in 2019. Second, in the case of the sustainability factor, its entry into force was postponed until the Toledo Pact committee comes to a new agreement, or until 2023 at the latest.

Compared with the scenario of a 0.25% increase in pensions according to the PRI, the present government estimates that, in the near term, the revaluation measures will entail additional expenditure of some €2.5 billion in 2018 and some €5.3 billion (0.4% of GDP) in 2019.[5] In turn, on Banco de España estimates, postponing the entry into force of the sustainability factor until 2023 would entail an increase in annual pension expenditure of 0.1 pp of GDP on average over the next decade (2020-30) and of 0.3 pp over the following decade. This higher expenditure would be a result of the increase in average pension for the cohorts retiring between 2019 and 2022, which are now exempt from application of the sustainability factor, and for the cohorts retiring after 2023, for which the four-year delay in application of the factor would entail a higher starting pension.

More recently, the Toledo Pact parliamentary committee reached an agreement whereby pensions will be revalued, in general, according to observed CPI, which would mean eliminating the current PRI. The potential implications of this agreement for pension expenditure in the long term are much greater than those stemming from the measures already adopted in the Budget Law for 2018. Specifically, compared with the scenario in which the 2013 reform is applied, a simulation of the impact on pension expenditure in the period 2018-50 of a scenario in which average pension is linked to the CPI and the sustainability factor comes into force in 2023 gives an increase in pension expenditure of 1.9 pp of GDP in 2030 and 3.4 pp in 2050 (see Charts 5 and 6).[6, 7]

1 Law 23/2013 of 23 December 2013 regulating the Sustainability Factor and the Social Security Pension System Revaluation Index.

2 Law 27/2011 of 1 August 2011 updating, adapting and modernising the Social Security system.

3 Thus, in cumulative terms, the more years during which a pension is received would be offset by the lower pension level.

4 European Commission, *The 2018 Ageing Report,* May 2018.

5 According to the 2019 Draft Budgetary Plan sent to the European Commission on 15 October.

6 The accounting exercise projects future pension expenditure based on assumptions relating to the number of pensions and the average pension amount, considering that the average amount differs for new pensions, pensions leaving the system and existing pensions. Each year, the number of pensions multiplied by their average amount determines the total system expenditure, expressed in the charts as a percentage of nominal GDP. Higher pension revaluation results in higher average pensions both for those already in the system and for those leaving it, generating a net increase in pension expenditure. Assumptions on the behaviour of the different variables are based on the European Commission's *2018 Ageing Report*. Specifically, on average in the period 2018-50, real GDP is expected to grow by 1.2%, inflation by 2%, wages by 3.3% and the number of pensions by 1.6%. Lastly, the effect of the sustainability factor on the average pension of new entrants is also taken into account.

7 A recent paper, based on an overlapping generation model with heterogeneous agents, placed the higher pension expenditure in a scenario of CPI indexation and non-application of the sustainability factor at between 3 pp and 3.6 pp of GDP on average over the next five decades, peaking at more than 5 pp of GDP in 2060 (see De la Fuente, A., M. A. García Díaz and A. R. Sánchez, 2018: *"¿Hacia una nueva reforma de las pensiones? Notas para el Pacto de Toledo."* *Fedea Policy Papers 2018/09).*

Although these simulations are subject to a not insignificant degree of uncertainty, given the length of the time horizon considered, it may be concluded that, under the projected demographic and macroeconomic scenario, the recent pension system measures adopted will require further steps either to increase the income or reduce the expenditure of the system in order to guarantee its financial sustainability.

Chart 1
SOCIAL SECURITY INCOME AND EXPENDITURE

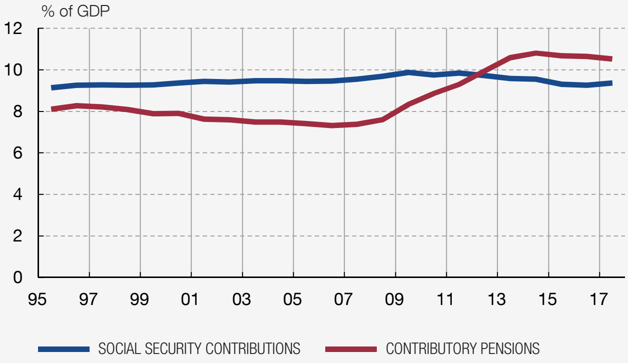


Chart 2
IMPACT OF 2013 REFORM ON SUSTAINABILITY OF SYSTEM

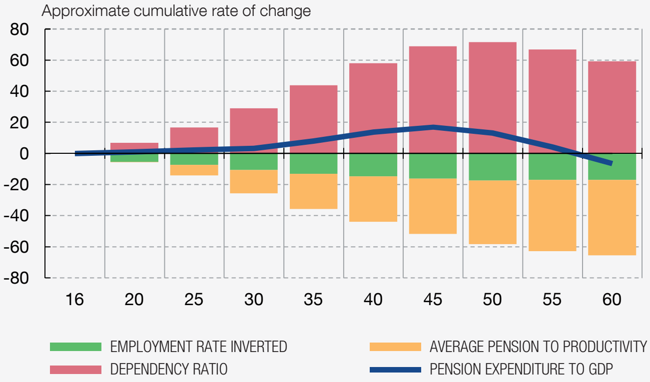


Chart 3
SIMULATION OF IMPACT OF 2013 REFORM ON REAL PENSION

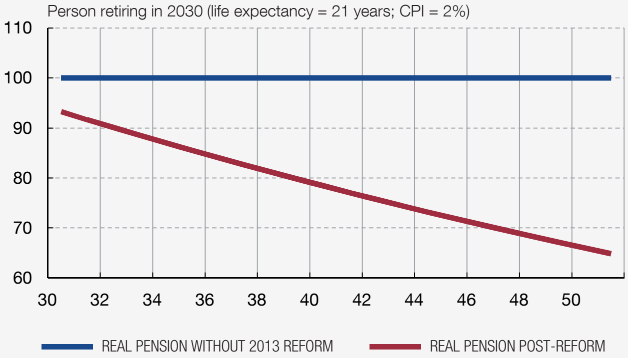


Chart 4
PENSION AND CPI GROWTH

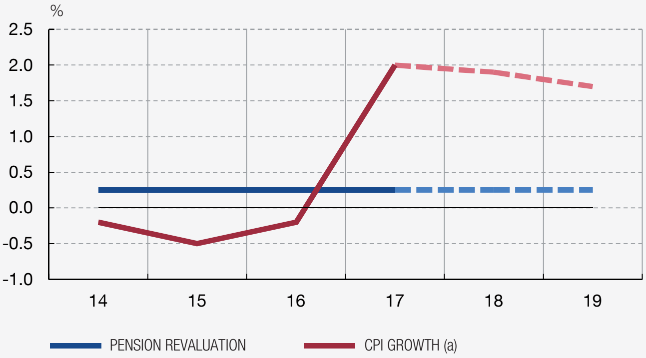


Chart 5
PROJECTED PENSION EXPENDITURE

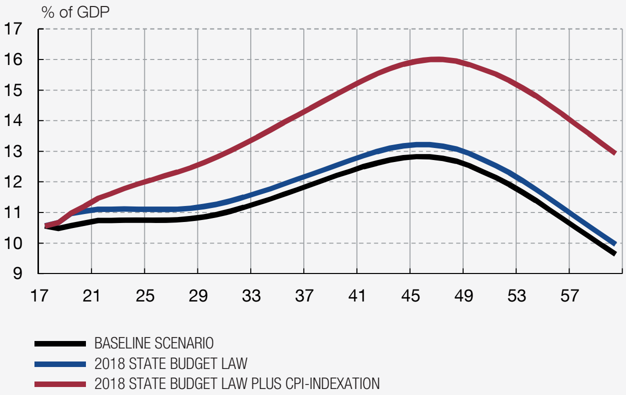
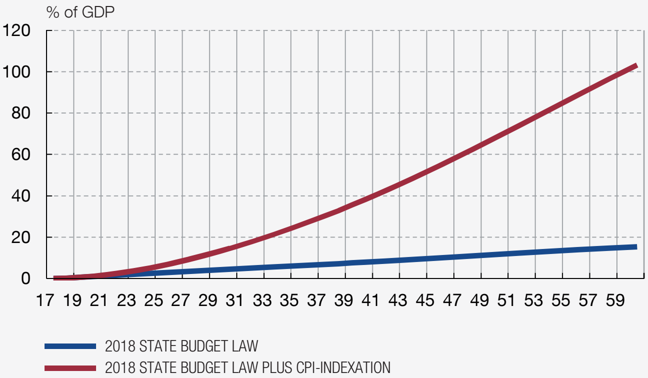


Chart 6
CUMULATIVE PENSION EXPENDITURE COMPARED WITH BASELINE SCENARIO



SOURCES: Seguridad Social, European Commission *(The 2018 Ageing Report)* and Banco de España.

a For 2018 and 2019, Banco de España projections published in June 2018.

On 28 November the ECB published the results of the 19th round of the Survey on the Access to Finance of Enterprises in the euro area (SAFE), covering the period from April 2018 to September 2018. The survey asks respondent firms, essentially small and medium-sized enterprises (SMEs), about changes in this period in their economic and financial situation, their external financing needs and the conditions under which they have obtained or not such financing.

In the case of Spanish SMEs, the data for this latest round of the survey show, overall, that the improvement in their economic situation has continued, although there are some signs of a slight slowdown. The number of firms reporting an increase in sales once again exceeded those indicating the contrary, which has happened uninterruptedly since 2014. In this case the relative difference between the two groups (net percentage) of 24% is slightly higher than in the previous round (20%, see Chart 1) and similar to that for the euro area (25%). The profit performance was less favourable, owing to the increase both in labour and other costs, a circumstance that was reported by a high net proportion of SMEs in the sample (50% and 66%, respectively, compared with 51% and 57% in the euro area). Thus, the proportion of firms that reported an increase in profits was 2 pp higher than those that stated the opposite, which was 2 pp lower than in the previous round. This difference was 3 pp in the euro area, 1 pp lower than six months earlier.

A lack of customers was cited as the main source of concern by 28% of Spanish SMEs (see Chart 2), while in the euro area, for a large number of firms (26%), it was a shortage of skilled labour. Set against this, access to financing was, among all the factors considered, once again that signalled by the fewest companies: 6% in Spain and 7% in the euro area, which are slightly lower percentages than in the previous round but represent historical lows in both areas since the survey began.

Against this background, the proportion of Spanish SMEs that applied for bank loans fell slightly, by 1 pp, to 28% (see Chart 3), which is marginally higher than that recorded in the euro area (27%). In turn, the availability of bank financing continued to improve (see Chart 4). Thus, in net terms, 21% of Spanish SMEs reported an improvement in this aspect, 3 pp less than in the previous survey, and 10 pp more than the figure for their euro area peers. The firms surveyed perceived that most of the factors affecting the availability of bank loans performed favourably, albeit to a lesser degree than in the previous six months.[1] Specifically, in net terms, 27% of firms perceived a greater willingness of banks to grant loans (a figure 6 pp lower than that recorded in the previous round of the survey) and 17% reported an improvement in their specific situation (8 pp less than six months earlier). By contrast, macroeconomic expectations seem to no longer have a positive effect on access to bank loans since the proportion of SMEs which think that the economic outlook has worsened is somewhat higher (by 1 pp) than that which considers it has improved, whereas six months earlier the latter amply exceeded the former (by 24 pp).

The percentage of Spanish SMEs whose bank loan applications were rejected increased slightly by 1 pp to stand at 6%, a figure somewhat higher than that recorded in the euro area as a whole (5%). The broader indicator of the difficulties in obtaining bank loans[2] shows a slight deterioration. Thus, the difficulties affected 9% of these companies which was 1 pp higher than the figure for the euro area and that recorded in the previous round of the survey (see Chart 5).

As regards financing conditions, the net percentage of firms reporting a decline in interest rates was positive for the eighth time running; it was, however, very low at 1% and 4 pp down from the previous round (see Chart 6). The net proportion of companies indicating an increase in loan amounts was also positive (15%, 4 pp up on six months earlier), as was that indicating a lengthening of maturities (5%, compared with -2% recorded six months earlier). By contrast, 6% of Spanish SMEs as a whole perceived a tightening in the collateral required, and 17% in other terms and conditions of loans.

In short, the latest round of the SAFE shows that from April 2018 to September 2018, the access of Spanish SMEs to external financing continued to improve. The firms reported, as a whole, that during that period they detected an increase in the availability of bank financing, bolstered by a greater willingness of banks to grant loans with favourable conditions and by the improvement in their specific situation. In particular, their financial and economic situation continued to improve, although some signs of a slight slowdown are perceptible. Finally, the survey also shows that Spanish SMEs expected that their access to bank credit would improve from October 2018 to March 2019, albeit at a more moderate pace than in previous rounds.

1 The availability of bank loans is the perception that firms have of their access to financing, which is affected by supply-side (relating to banks), demand-side (the firm's creditworthiness) and macroeconomic factors (general economic situation).

2 This indicator captures companies in the following situations: those whose applications for funds were rejected, those to which the funds were granted but only in part, companies to which loans were granted but at a cost deemed by the companies to be very high and those which did not apply for financing because they believed it would not be granted to them.

Chart 1
SALES AND PROFITS (a)

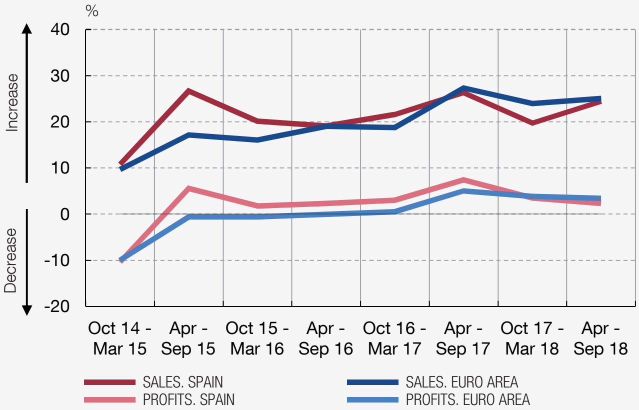


Chart 2
MAIN PROBLEMS AFFECTING ACTIVITY. APRIL 2018 -SEPTEMBER 2018

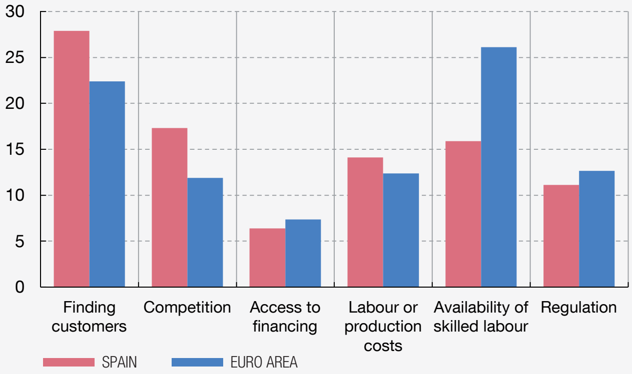


Chart 3
SMEs THAT HAVE APPLIED FOR BANK LOANS

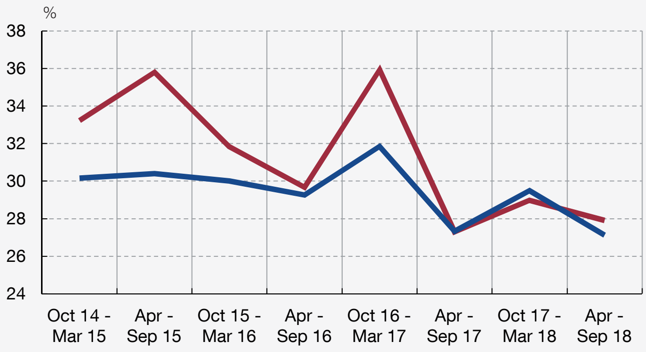


Chart 4
AVAILABILITY OF BANK LOANS

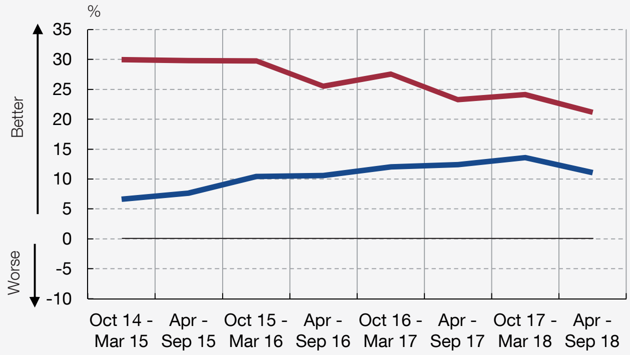


Chart 5
SMEs FACING DIFFICULTIES OBTAINING BANK LOANS (c)

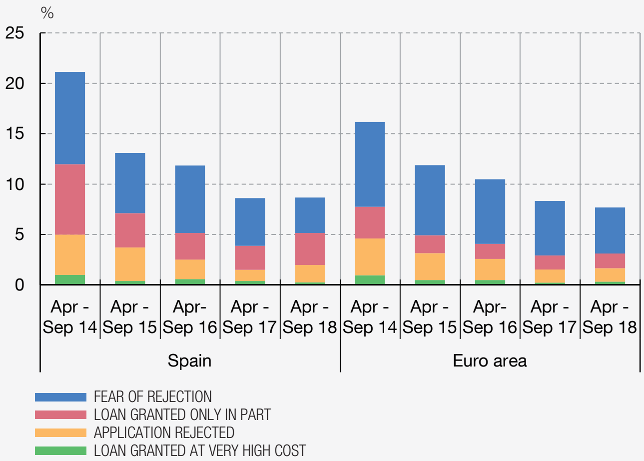
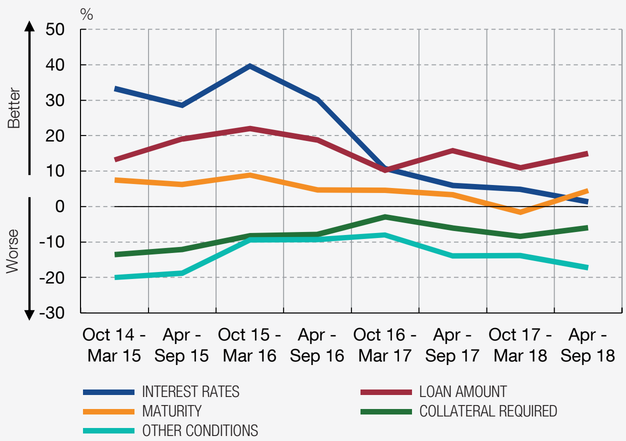


Chart 6
BANK LOAN CONDITIONS. SPAIN (d)



SOURCE: European Central Bank.

a Percentage of firms indicating an increase less the percentage of those indicating a decrease.
b Percentage of firms indicating an improvement less the percentage of those indicating a deterioration.
c This indicator captures the proportion of firms that are in one of the following situations: those whose loan applications were rejected, those whose loans were granted but only in part, those whose loans were granted but at a cost deemed by the firms to be very high and those who did not apply for financing because they thought it would not be granted to them (fear of rejection).
d Percentage of firms indicating better conditions (lower interest rates, higher amounts, longer maturities, less demanding collateral and other required conditions) less the percentage of firms indicating worse conditions.

2 THE EXTERNAL ENVIRONMENT OF THE SPANISH ECONOMY

2.1 The external environment of the euro area

In 2018 Q3, global activity remained buoyant, although there were signs of deceleration. Specifically, global GDP is estimated to have grown by around 3% year-on-year, as compared with 4% in Q2. Moreover, widening divergences between areas were discernible. The United States and emerging Asia posted higher growth rates than other regions. As regards world trade, the Q3 goods trade data show a quarter-on-quarter increase of 1.4%, after the stagnation seen in the previous quarter. The bringing forward of transactions to before the entry into force in September of the new US tariffs on Chinese imports appears to have contributed to this recovery in trade, which was especially strong in the Asian economies, meaning that the upturn can be expected to be temporary. Indeed, the monthly fall in trade in September and the highest frequency leading indicators tend to confirm this. The above-mentioned tariffs are charged at a rate of 10% on US imports from China worth $200 billion. They were due to be raised to 25% in January 2019, but the US and Chinese presidents agreed at the G20 summit in late November to postpone this rise by three months, to allow time for the negotiation of a trade agreement.

International financial markets have also showed differing behaviour during the current quarter, with strong corrections in the advanced-economy stock markets and a certain flattening in those of the emerging market economies (see Chart 2.1). In the developed economies, the stock market losses have been a consequence of the poorer growth outlook, partly resulting from trade tensions, and of the uncertainty associated with the budget problems in Italy and the outcome of the Brexit negotiations. The interest rate on ten-year bonds has fallen in the United States to around 2.85%, from over 3.20% in mid-October (see Chart 2.3). On the foreign exchange markets, the dollar has continued to appreciate against the other major developed currencies. The greater stability of the emerging markets, following the deterioration in Q3, has been especially pronounced in those economies that had previously displayed most vulnerability, such as Argentina and Turkey. On the other hand, Asian stock markets – affected by trade tensions – behaved less favourably.

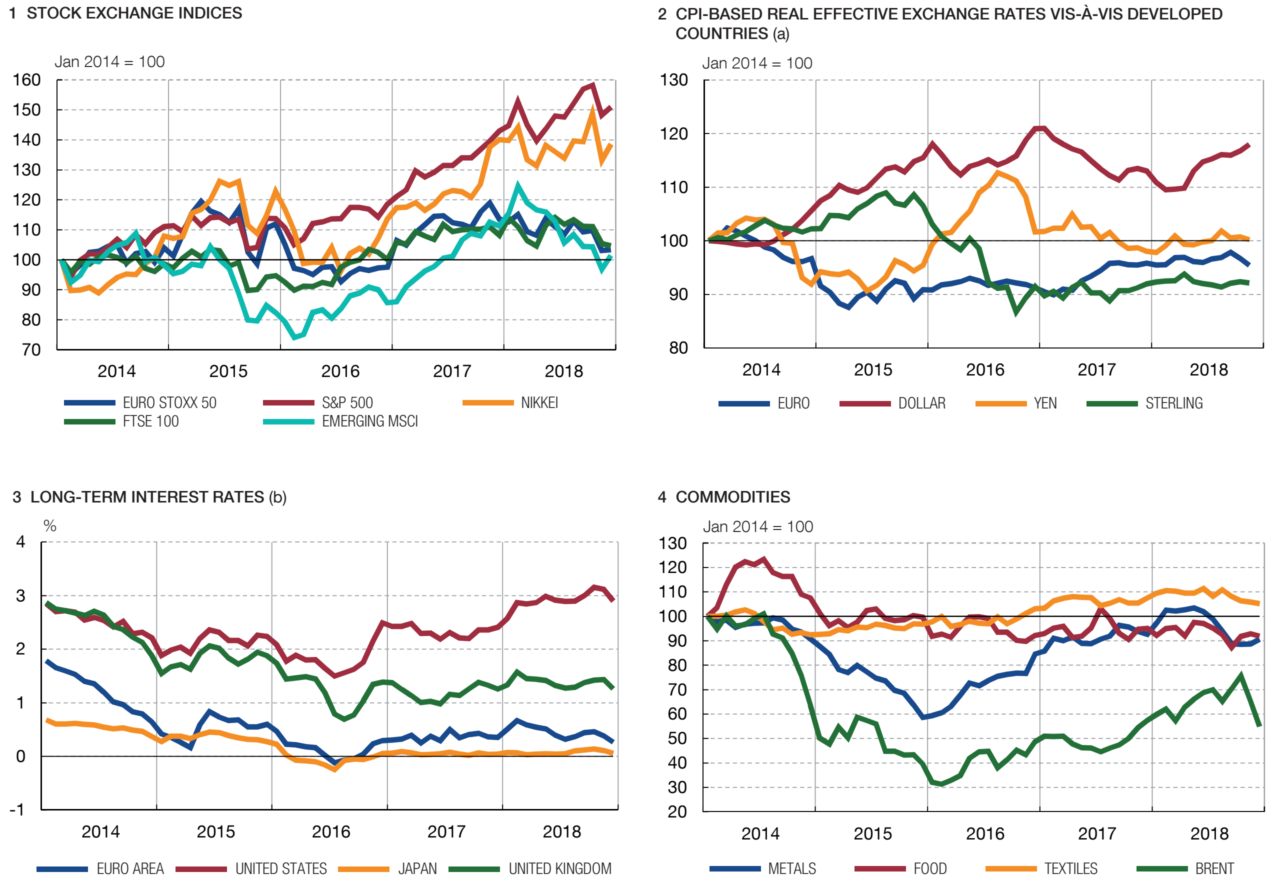
The commodities price index has risen by 2% during Q4, with the rises in metal and food prices offsetting the falls in textile and, above all, oil prices (see Chart 2.4). The price of Brent crude has fallen from over $80 per barrel at the beginning of October to around $60, owing to the outlook of lower world demand and higher-than-expected supply, due to the increase in production in the United States and the exemptions from the sanctions imposed on Iran. At the beginning of December, OPEC and Russia decided to cut their production of oil in an attempt to stabilise prices.

As regards the main developed economies, GDP growth in the United States was 3.5% in Q3, in annualised quarter-on-quarter terms, down from 4.2% in Q2 (see Chart 3.1). With regard to its composition, there were notable negative contributions from investment and net exports, which may be anticipating a turning point in the cycle (see Box 1). In Japan, the fall in GDP in Q3 of 2.5%, in annualised quarter-on-quarter terms, was attributable to the natural disasters in the period, while in the United Kingdom, the quarter-on-quarter GDP growth of 0.6% was based on private consumption, with the weakness of investment, which appears to be reflecting the impact of Brexit, persisting. Monetary policy was unchanged in the advanced economies, against a background of gradually rising overall inflation rates and flat core rates (see Charts 3.2 and 3.4).

Activity developments in the emerging economies were varied. GDP growth edged down in Q3 in China, from 6.7% year-on-year to 6.5% (see Chart 4.1), against a background in which the

FINANCIAL MARKETS AND COMMODITIES

CHART 2



SOURCE: IFS and Banco de España.

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

authorities attempted to use economic stimulus policies to offset the effects of the trade confrontation with the United States. In India, growth remained highly buoyant in the same period, albeit slowing by somewhat more than one percentage point, to 7.2%. Argentina and Turkey, the economies most severely affected by financial tensions during the year, suffered a considerable decline in activity over the summer, as a result of the financial instability and economic policy adjustments. In the other Latin American economies, the Q3 activity data show a mild recovery, although with significant divergence across countries. While Brazil and Mexico showed signs of improvement, activity in Chile, Peru and Colombia slowed. Box 2 analyses the vulnerabilities in the emerging market economies, focusing on China, Mexico and Brazil.

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

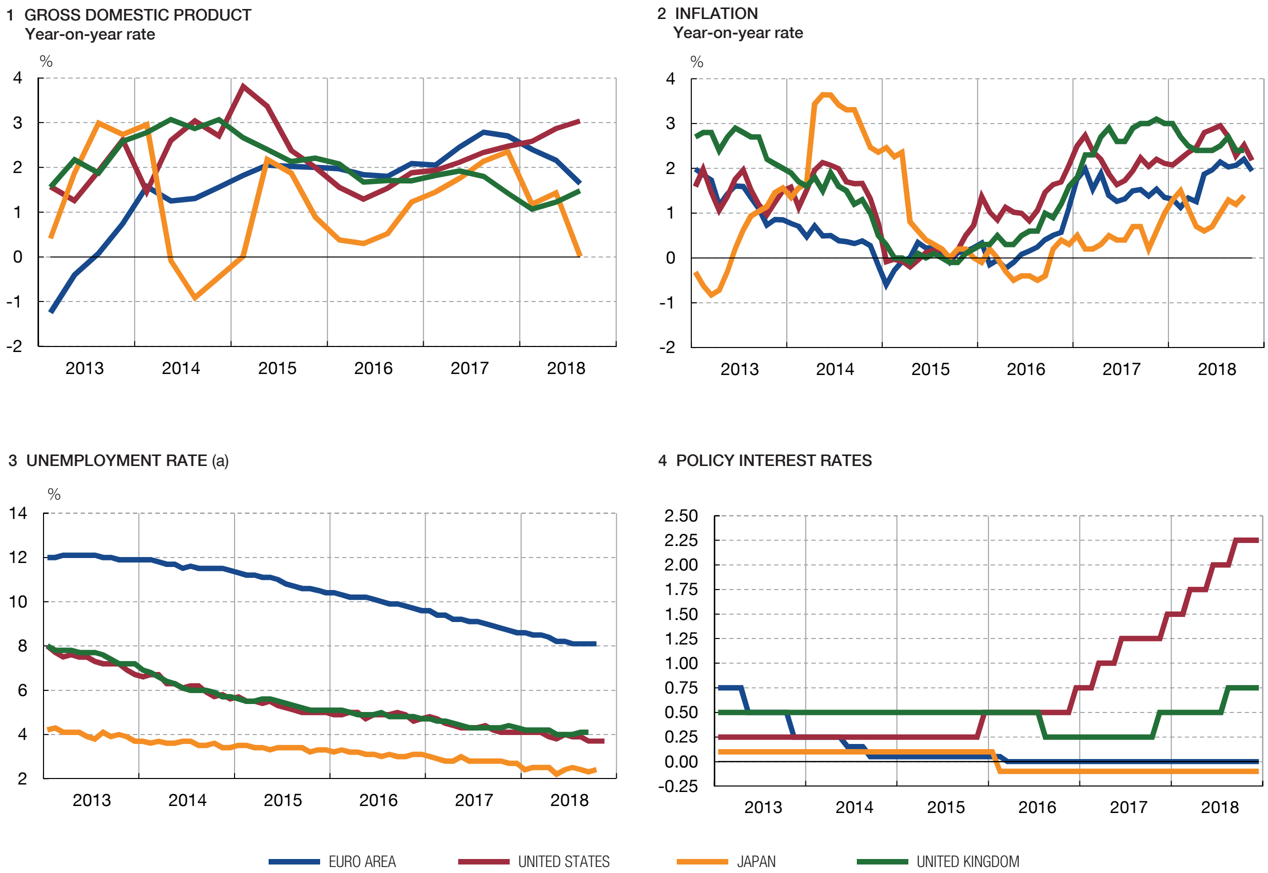
ECONOMIC DEVELOPMENTS

At the beginning of 2018, economic activity in the euro area was affected by a variety of temporary factors (such as strikes and bad weather) that had a negative impact on growth. The impact of temporary factors increased in Q3, when the changes to the regulation of emissions in the automotive industry led to a contraction in the production of motor vehicles, especially in Germany.[2] However, the information available suggests

2 The production of motor vehicles declined during the summer months in some euro area countries, principally Germany, as a result of adaptation to the new emissions testing regulation, known as WLTP (Worldwide Harmonised Light Vehicles Test Procedure), that came into force in Europe for newly registered vehicles on 1 September). This reduction in the production of motor vehicles during the summer was basically reflected in a contraction of exports and private consumption and, in some countries (such as Germany) was accompanied by a build-up in inventories above their desired level (see Box 4).

DEVELOPED ECONOMIES: MAIN MACROECONOMIC INDICATORS

CHART 3



SOURCES: IFS and Banco de España.

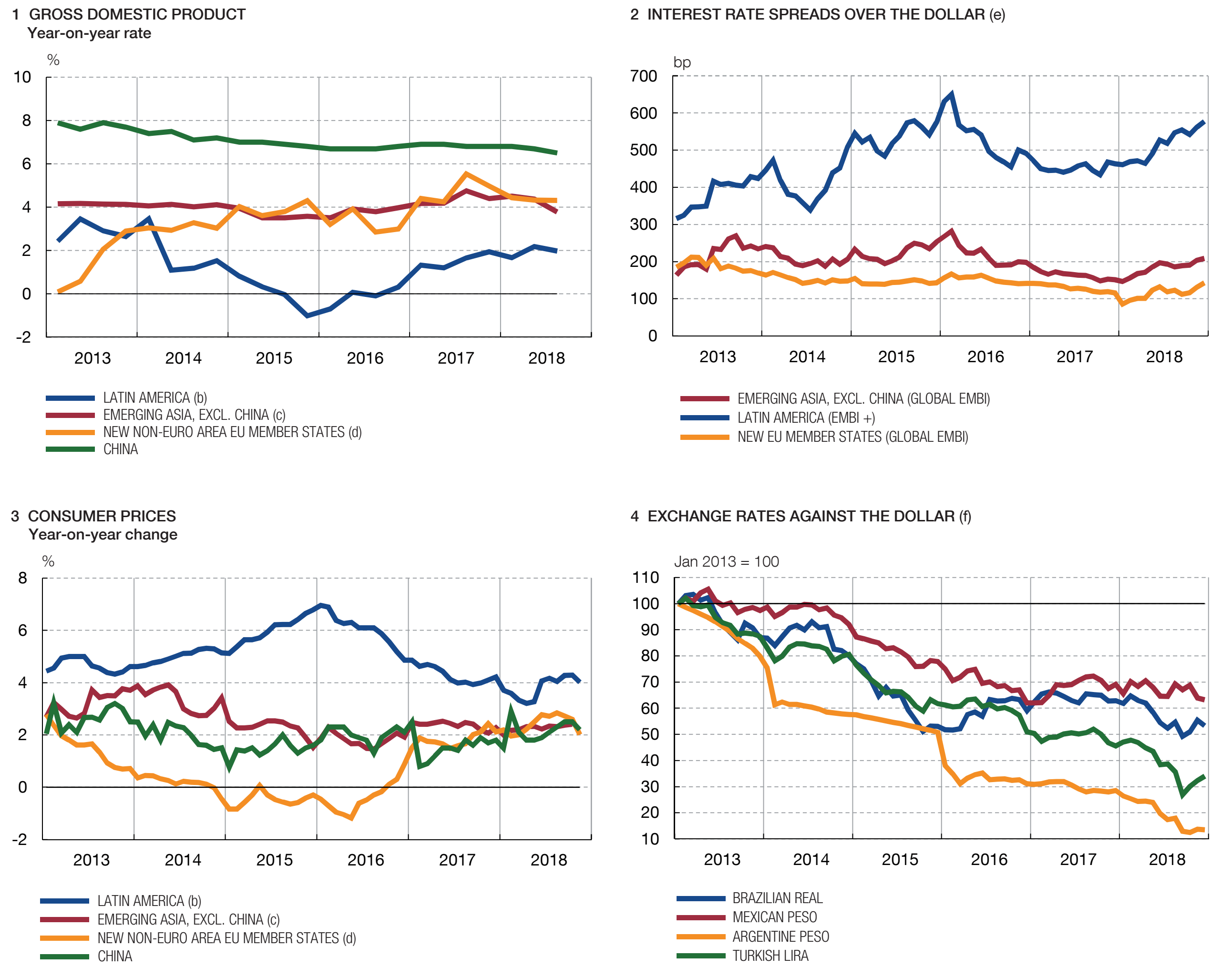
a Percentage of labour force.

that, even allowing for these temporary effects, the euro area growth rate has slowed significantly in comparison with 2017. In terms of the components of demand, this slowdown is attributable to the weakness of exports, which were held back by the levelling-off of world trade, against a background of greater uncertainty, arising from the drift towards protectionism in some economies and the fact that the terms of the final Brexit agreement are still unknown, and possibly by the delayed effects of appreciation of the euro. In contrast, domestic demand was steadier, supported by the favourable financial conditions, the buoyancy of employment and the growth of household and corporate income. However, business investment slowed notably in Q3, which may be a sign that the environment of uncertainty, which has already caused business confidence to decline, is beginning to be passed through to businesses' investment decisions. In addition, financial tensions remain heightened in Italy, against a background of uncertainty regarding the economic policy stance and a recent deterioration in economic growth.

In this context, the Eurosystem staff macroeconomic projections, published in mid-December, revised the growth projected for 2018 and 2019 slightly downwards, to 1.9% and 1.7%, respectively, with the projection for GDP growth in 2020 standing at 1.7% and that for 2021 at 1.5% (see Table 2). Even so, euro area GDP is expected to continue to grow at somewhat above its potential rate over the projection horizon. In line with the lower projected growth and the persistence of subdued price increases, expected core

EMERGING ECONOMIES: MAIN MACROECONOMIC INDICATORS (a)

CHART 4



SOURCES: IFS, 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.

inflation (excluding energy and food) was revised slightly downwards, to 1.4% in 2019 and 1.6% in 2020, before it reaches 1.8% in 2021. Meanwhile, the path projected for the consumer price index was revised downwards by 0.1 pp in 2019, in line with the recent reduction in oil prices, with CPI inflation projected to be 1.8% in 2021.

The slowdown in growth observed since the start of the year, in a setting of more prominent downside risks, highlights the need to retain the current monetary stimulus, so as to ensure convergence by inflation on its medium-term reference. Against this background, the December ECB Governing Council confirmed, on the one hand, the end of net asset purchases under the APP programme at the end of the year, as it had first announced in June, subject to its analysis of economic developments. But, on the other, it indicated that it intends to continue reinvesting, in full, the principal payments from maturing assets purchased under the programme for an extended period of time past the date when it starts

EURO AREA GDP AND HICP GROWTH PROJECTIONS TABLE 2

	2018		2019		2020	
	GDP	HICP	GDP	HICP	GDP	HICP
European Central Bank (December 2018)	1.9	1.8	1.7	1.6	1.7	1.7
European Commission (November 2018)	2.1	1.8	1.9	1.8	1.7	1.6
OECD (November 2018)	1.9	1.8	1.8	1.9	1.6	1.9
International Monetary Fund (Octubre 2018)	2.0	1.7	1.9	1.7	1.7	1.8
Consensus Forecast (December 2018)	1.9	1.8	1.6	1.6	—	—
Eurobarometer (November 2018)	2.0	1.8	1.7	1.7	—	—

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

EURO AREA ECONOMIC INDICATORS (a) TABLE 3

	2017				2018			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
National Accounts (quarter-on-quarter rate)								
Gross domestic product	0.7	0.7	0.7	0.7	0.4	0.4	0.2	
Contributions to quarter-on-quarter change in GDP (pp)								
Internal demand, excluding inventories	0.1	0.7	0.3	0.4	0.3	0.5	0.1	
Change in inventories	0.0	-0.1	-0.1	-0.1	0.2	-0.1	0.3	
Net external demand	0.6	0.0	0.4	0.4	-0.1	0.0	-0.2	
Other indicators								
Unemployment rate (b)	9.5	9.2	9.0	8.7	8.5	8.3	8.1	8.1
HICP (year-on-year rate) (c)	1.5	1.3	1.5	1.4	1.3	2.0	2.1	1.9
HICP excluding energy and food (year-on-year rate) (c)	0.7	1.1	1.1	0.9	1.0	0.9	0.9	1.0

SOURCES: Eurostat, ECB and Banco de España.

a Information available up to 17 December 2018.
b Average for the quarter. Latest figure available: October 2018.
c End of the period. Latest available figure: November 2018.

raising the ECB interest rate and, in any case, for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation. Furthermore, the Council does not anticipate any changes in the short run in policy interest rates, which are expected to remain at their present levels at least until the end of the summer of 2019.[3]

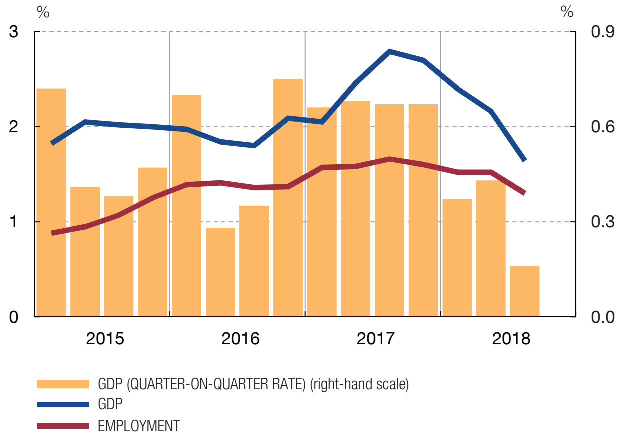
On National Accounts figures, euro area GDP grew by 0.2% quarter-on-quarter in 2018 Q3, 0.2 pp below the rates recorded in the first two quarters of the year (see Table 3 and Chart 5) and very much below the rates of growth of close to 0.7% posted in 2017. As indicated at the start of this sub-section, the year-on-year growth rate was 1.6%, compared with 2.2% in Q2. A substantial part of this slowdown in the economy over the summer may be explained by an exceptional temporary effect linked to the decline in car manufacturing. This was especially marked in Germany, where GDP fell by 0.2%, after growing by 0.5% in Q2. GDP also declined in Italy, by 0.1%. By contrast, GDP accelerated in France, to 0.4%, while in Spain GDP growth held steady at 0.6%. The reason, by component, for this slowdown in GDP was the fall-back in exports and the weak increase in private demand (both household consumption and investment in capital goods), while the contribution of

3 The main refinancing rate, the marginal lending facility rate and the deposit facility rate stand at 0%, 0.25% and -0.40 %, respectively.

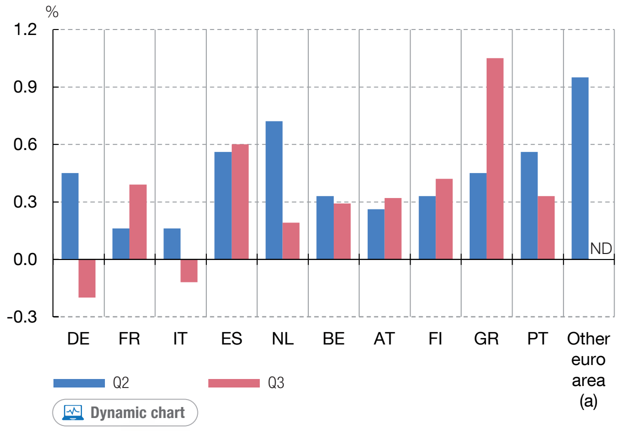
EURO AREA. ACTIVITY INDICATORS

CHART 5

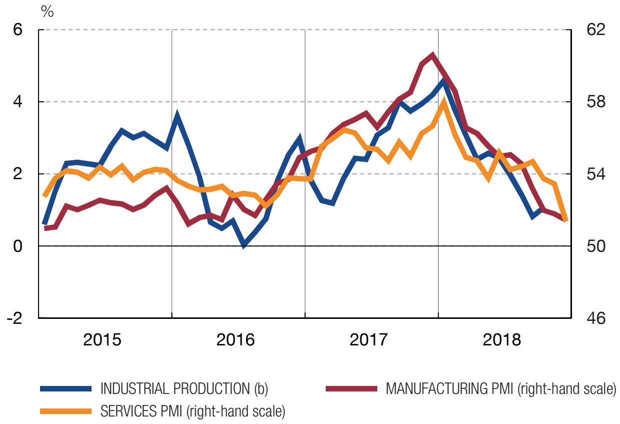
1 OUTPUT AND EMPLOYMENT
Year-on-year rate



2 GDP BY COUNTRY
Quarter-on-quarter rate

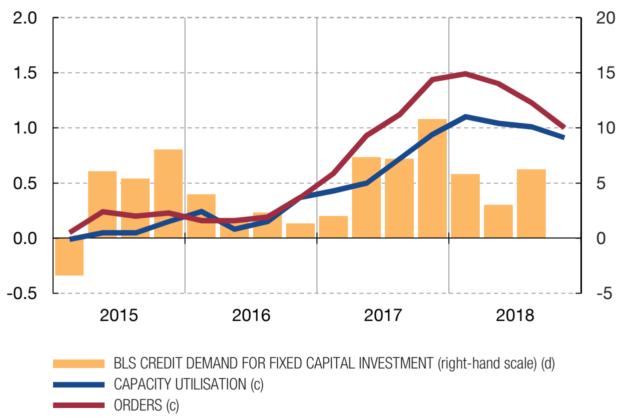


3 INDUSTRIAL ACTIVITY AND SERVICES INDICATORS

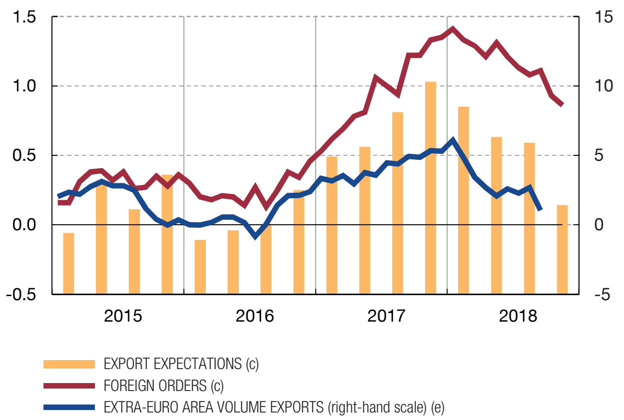


4 CONSUMPTION INDICATORS

5 INVESTMENT INDICATORS



6 EXPORT INDICATORS



SOURCES: Eurostat, Markit Economics and Banco de España.

a Ireland is not included owing to the high volatility of its data.
b Year-on year rates, calculated on the basis of the non-centred quarterly moving average of the seasonally adjusted series.
c Normalised series.
d 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.
e Year-on year rates, calculated on the basis of the non-centred quarterly moving average of the original series.

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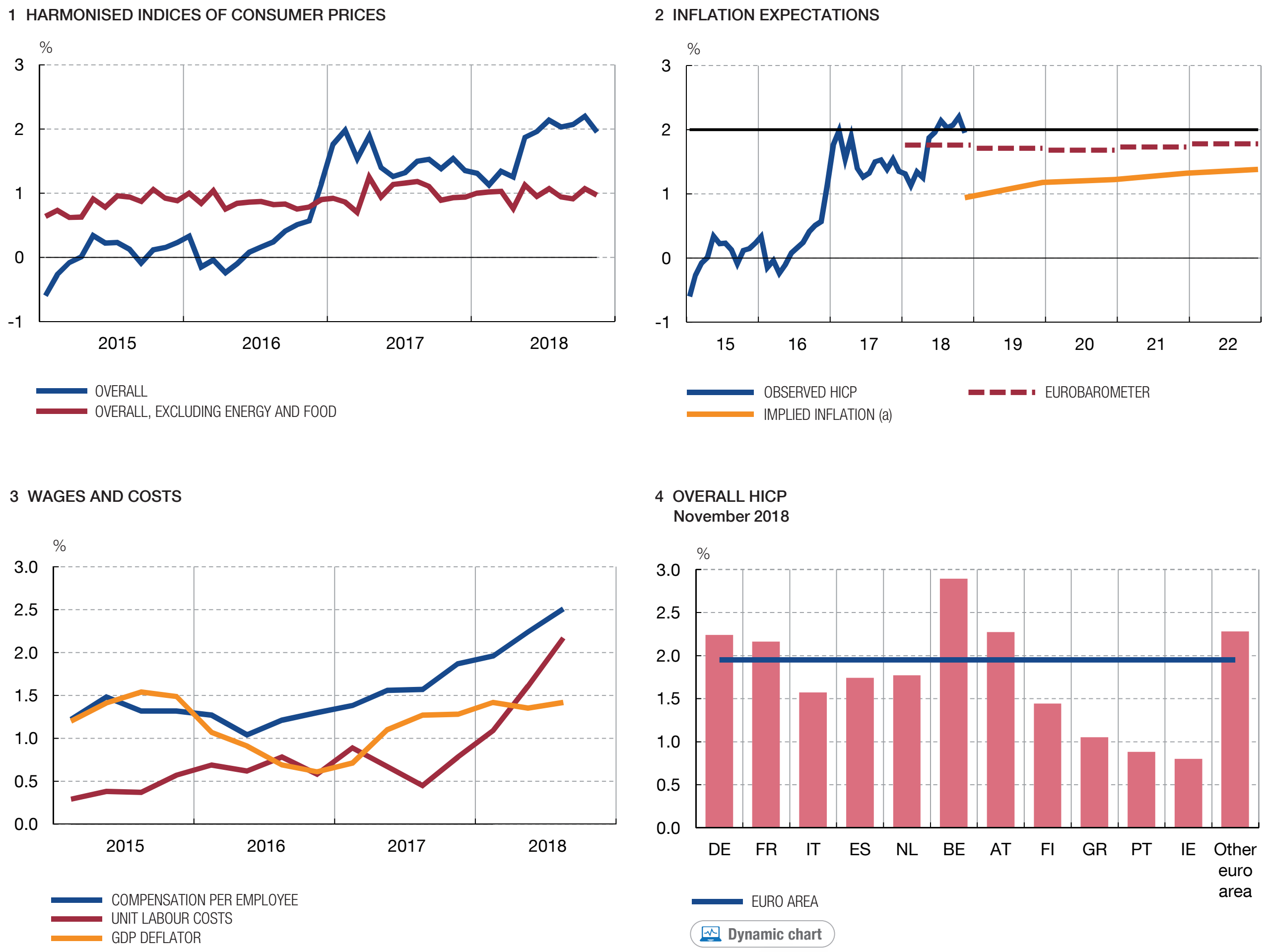
EURO AREA. PRICE INDICATORS
Year-on-year percentage changes

CHART 6



SOURCES: Eurostat, Reuters and ECB.

a Implied inflation calculated on the basis of inflation swaps.

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stocks increased, and was indeed very high in some countries (in Germany, 0.6 pp). Euro area employment remained strong in 2018 Q3, up 1.3% year-on-year.

The short-term economic information available for Q4 points, in general, to a small rebound in GDP growth, but within a framework of modest growth (see Chart 5). The business confidence indicators based on the Purchasing Managers (PMI) surveys have declined in Q4 both in industry and services, although they are still in growth territory. The indicators compiled by the European Commission for those two sectors point in the same direction, with values above the historical mean, while those for the construction sector remain strong. In addition, consumer confidence decreased sharply in November, and the component relating to job creation expectations declined both in industry and services but improved in construction. As regards external demand, export expectations and the assessment of export orders continued to worsen in the last stretch of the year (entering negative territory according to the PMI index). Meanwhile, the quantitative indicators available, with more lagged information, generally confirm a slightly more favourable performance in Q4. Specifically, vehicle registrations rose in October and November, as did retail sales (October figures only). On the supply side, the industrial production index excluding energy was 0.4% higher in October than in the previous month and the unemployment rate in October held steady at 8.1% for the fourth consecutive month.

Turning to prices, inflation as measured by the HICP has remained around 2% in recent months. The year-on-year rate of growth in November was 1.9%, 0.3 pp less than in October, owing to the slowdown in all its components with the exception of non-energy industrial goods prices which maintained their rate of growth (see Chart 6). In turn, core inflation (measured by the headline index excluding energy and food) fell by 0.1 pp to 1%. By contrast, wage settlements have continued to increase notably in recent months.

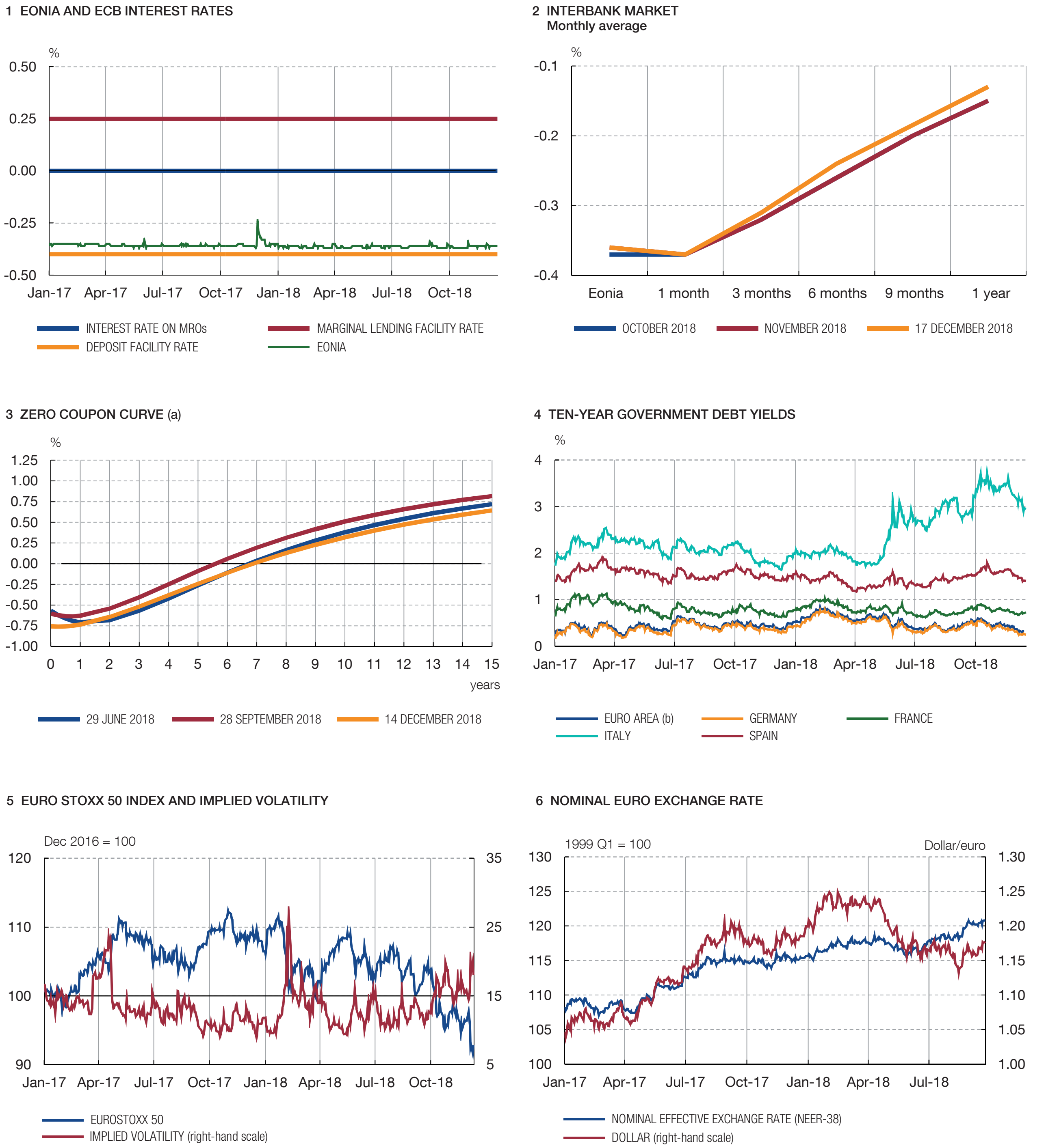
In November, the European Commission set out its economic priorities for 2019 within the framework of the European Semester and completed its assessment of the draft budgets prepared by the Member States for the coming year. It also published the annual edition of the *Alert Mechanism Report* in the context of the Macroeconomic Imbalance Procedure.

In the fiscal sphere, the draft budgets for 2019 project an increase in the general government deficit for the euro area as a whole, up to 0.8% of GDP, from the estimated level of 0.6% for 2018. Government debt is expected to fall to 85% of GDP in 2019, compared with 87% in 2018. In structural terms, it is anticipated that the fiscal policy stance will be slightly expansionary in 2019, following the neutral stance finally estimated for 2018, even though the budgetary plans pointed to a certain degree of fiscal expansion (see Box 3). The European Commission has called on the Council to launch an excessive deficit procedure against Italy, owing to *particularly serious* non-compliance by the Italian budget with the commitments to reduce debt and contain expenditure. This has led the Italian government to reconsider some of the planned measures. The European Commission also considered that the budget plans of Belgium, France, Portugal, Slovenia and Spain pose a high risk of departing significantly from their medium-term budgetary objectives and that, except in the case of Slovenia, they will breach their debt reduction commitment. In the case of France, the plan does not include the government's recently announced measures to increase expenditure.

On the basis of the *Alert Mechanism Report* in the context of the Macroeconomic Imbalance Procedure, the European Commission considers that in-depth reviews (IRDs) should be undertaken in the eight euro area member states where imbalances were identified during the last European Semester, namely the five largest euro area economies – Germany, Spain, France, Italy and the Netherlands – plus Cyprus, Ireland and Portugal. Greece will also be subject to an in-depth review, having exited the financial assistance programme in August.

The Euro Summit in December endorsed all the elements of the Eurogroup's report on EMU deepening. In particular, it was agreed that the European Stability Mechanism (ESM) would be strengthened and that it would act as the common backstop to the Single Resolution Fund (SRF) in the event that it lacked sufficient resources to address bank resolution processes. An agreement was also reached on strengthening the preventive instruments available to the ESM. In addition, it was agreed to introduce new class-action clauses (CACs) in sovereign debt issued from 2022 to facilitate, where necessary, possible debt restructuring. By contrast, no significant progress was made either in the design of a European deposit insurance scheme (EDIS) or in the introduction of a common budget or cyclical stability mechanism, although the Eurogroup was entrusted with continuing to work on the design of an instrument within the EU budget framework conducive to convergence and competitiveness in the euro area. Lastly, the Council approved the Banking Package which aims to reduce risks in the banking sector.

POLICY INTEREST RATES AND FINANCIAL CONDITIONS CHART 7



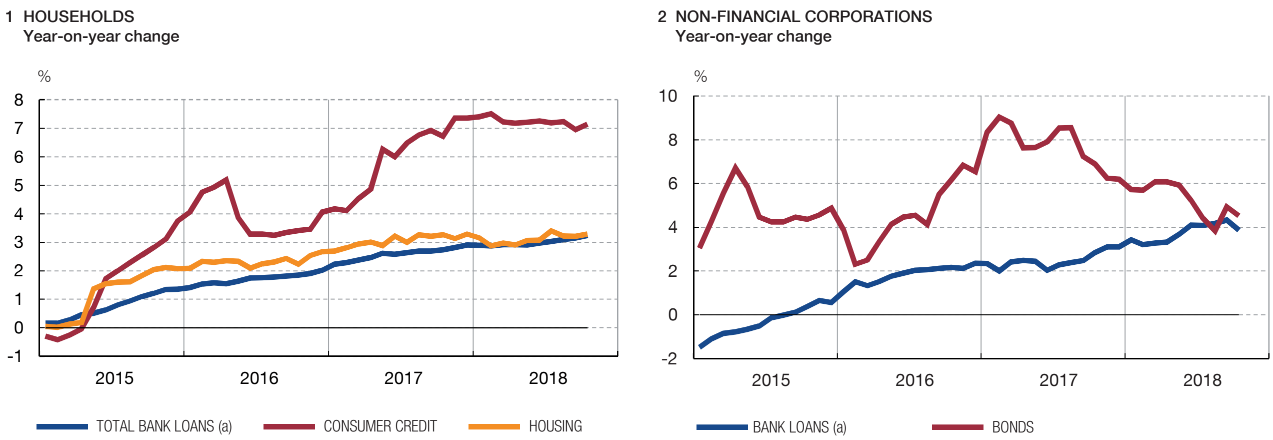
SOURCES: ECB and Banco de España.

a Estimated by the ECB using swap market data.

FINANCIAL DEVELOPMENTS

High levels of instability persisted in the euro area financial markets over the course of Q4, affected not only by the Brexit negotiations but also by developments in the European Commission's review of the Italian budget (see Chart 7). However, changes in euro area financial conditions have been very contained in the quarter as a whole, with small increases in sovereign spreads, falls in stock market prices and a slight depreciation of the euro both against large economy and emerging market economy currencies.

PRIVATE SECTOR FINANCING CHART 8



SOURCE: ECB.

a Adjusted for securitisation and other transfers.

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The small but widespread increase in spreads over the 10-year German bund is partly due to the decline in the 10-year German bond yield, which stood at 0.25% at the cut-off date for this report. By contrast, in the case of Italy, the spread has narrowed by 7 bp in Q4, although it remains high at around 270 bp. The spread between the German and the US bond yield has reached 265 bp, close to the level recorded at end-September.

On the stock markets, the EURO STOXX 50 has fallen sharply in the quarter overall, down almost 10% (with a cumulative decline of 12% in the year), in line with the drop in US stock markets in Q4. Banking sector stock prices in the euro area have fallen by almost 15% in the quarter as a whole.

On the currency markets, the nominal effective exchange rate of the euro has fallen by 1.3% in Q4, after rising by a similar figure in Q3 (see Chart 7.6). By currency, the euro has depreciated by 2% against the US dollar and has appreciated by 1.3% against sterling. The euro has depreciated sharply against various emerging market currencies: 12.5% against the Turkish lira, 6.2% against the Argentine peso and 1.8% against the Chinese yuan.

Lastly, the rate of growth of lending to non-financial corporations decelerated by 0.4 pp in October, to 3.9% year-on-year, while the rate of growth of lending to households held steady at 3.2% year-on-year (see Chart 8). The euro area bank lending survey for 2018 Q3 suggests that lending growth continues to be underpinned, in all categories, by an increase in demand, an easing of credit standards and an improvement in financing conditions. Regarding monetary aggregates, the rate of growth of M3 rose by 0.3 pp in October, to 3.9% year-on-year, while the rate of growth of M1, the narrowest aggregate, held steady at 6.8% year-on-year.

Spain's GDP grew at a quarter-on-quarter rate of 0.6% in 2018 Q3, a similar rate to that observed in the preceding quarter (see Chart 9). The expansion in output over the period July-September was solely due to increasing domestic demand, which maintained its positive contribution at 0.8 pp. The acceleration in (private and public) consumption and residential investment offset the slowdown in other investment components (equipment and other goods and other structures). Conversely, net external demand continued to make a negative contribution, similar to that in Q2, at 0.2 pp. The decline in exports was slightly larger than that in imports, following modest progress by both variables in the period from April to June. In year-on-year terms, both GDP and employment continued to grow at a rate of 2.5%.

The available short-term economic data points to GDP growth in the fourth quarter again being around 0.6%. Increased output is expected to be further supported by growing domestic demand, with the contribution of external demand – for which only very limited information is yet available – being virtually zero. Employment, however, will gradually slow.

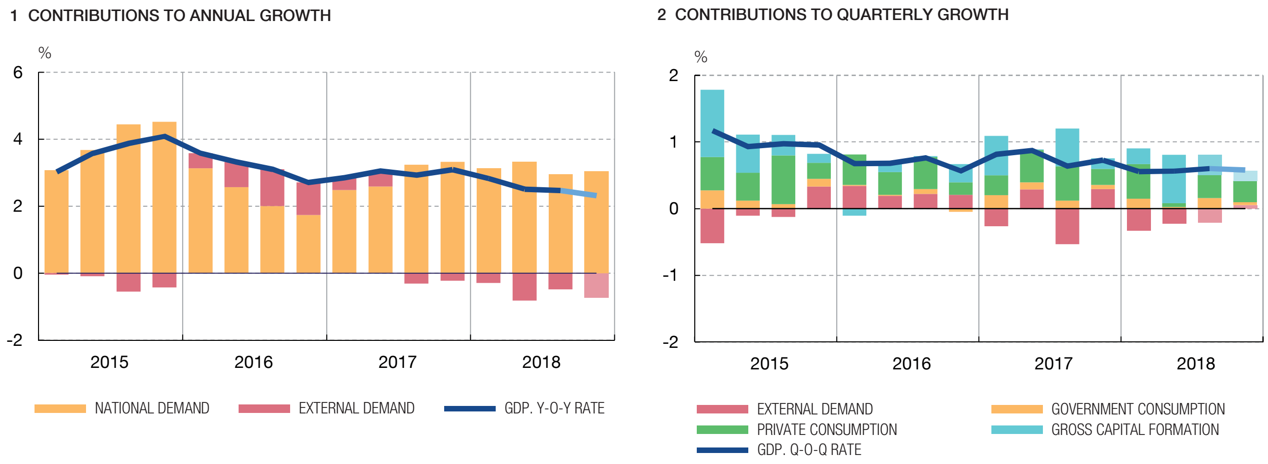
So far in the last quarter of 2018 the behaviour of domestic financial markets has basically been driven by external factors. These have led to falling stock-market indices, which have been more pronounced in the case of bank shares, with a moderate rise in volatility and credit risk premia. Thus, at the cut-off date of this report, the IBEX-35 had dropped by 6.1% relative to end-September levels, which was less negative than the EUROSTOXX 50, which had dropped by 9.9% over the same period (see Chart 10.1). In the sovereign-debt market, ten-year Spanish bond yields stood at 1.4%, approximately 10 bp below their level at end-Q3. This was a more moderate drop than that in the yield on the equivalent German bond, such that the spread between them widened to 115 bp. Average risk premia on private fixed-income securities picked up by almost 10 bp in the case of financial corporations and around 5 bp in that of non-financial corporations. In the interbank market the twelve-month EURIBOR rose slightly, but remains in negative territory at -0.13%.

Financing conditions for households and non-financial corporations have remained loose, with the cost of debt still low. In this context, new lending volumes have continued to expand in recent months. In terms of outstanding balances, the positive rate of growth of lending to households has consolidated. In the case of funding raised by companies, in a context of low borrowing needs, bank lending has continued to contract moderately, while fixed-income security issuance has accelerated. Lastly, the financial position of households and non-financial corporations continued to strengthen in the third quarter of the year.

3.1 Household spending decisions

Based on the available short-term economic information, the quarter-on-quarter rate of change in household consumer spending is estimated at around 0.6% in Q4, similar to growth in Q3 (see Chart 11). The indicators appearing since publication of the September report suggest certain upside risks in the near term. First of all, both the retail price index and the consumer goods industrial production index (IPI) accelerated markedly in October after their weakness in previous months. Moreover, social security registrations also showed a slight upturn in growth in Q4. Lastly, qualitative indicators, such as the services and consumer goods manufacturing PMI, or the retail trade confidence index, have tended to perform more positively in the last two months.

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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As regards housing investments, the most recent indicators suggest that the growth rate in the fourth quarter was similar to that over the period July-September. Meanwhile, the data published by the INE on unsubsidised housing prices showed an acceleration in Q3, rising to a year-on-year rate of 7.2%, 0.4 pp higher than the previous quarter. Faster price rises affected both the new and used housing segments.

Households' borrowing costs remained low. Thus, the average interest rate applied to new lending for house purchase stood at 2.2% in October (the latest available figure), a figure close to that in previous months. For their part, consumer credit and other lending was 6.6% on the same date, around 20 bp higher than the average for the preceding three months. This change basically reflected the upturn in the other lending segment[4] and is within the usual range of variation of this series (see Chart 10.2).

According to the October BLS, financial institutions further eased lending standards for households for consumption and other purposes in Q3, while they remained unchanged in the housing purchase segment.[5] Moreover, general conditions applicable to consumer credit and other lending also eased (specifically, margins on average loans, as maturities shortened), while loans for housing purchases remained unchanged. On the demand side, the BLS shows that households' applications for funds rose in 2018 Q3 (particularly in the consumer credit and other lending segment). It also showed them to be still rising in the last quarter of the year, while the credit supply further eased.

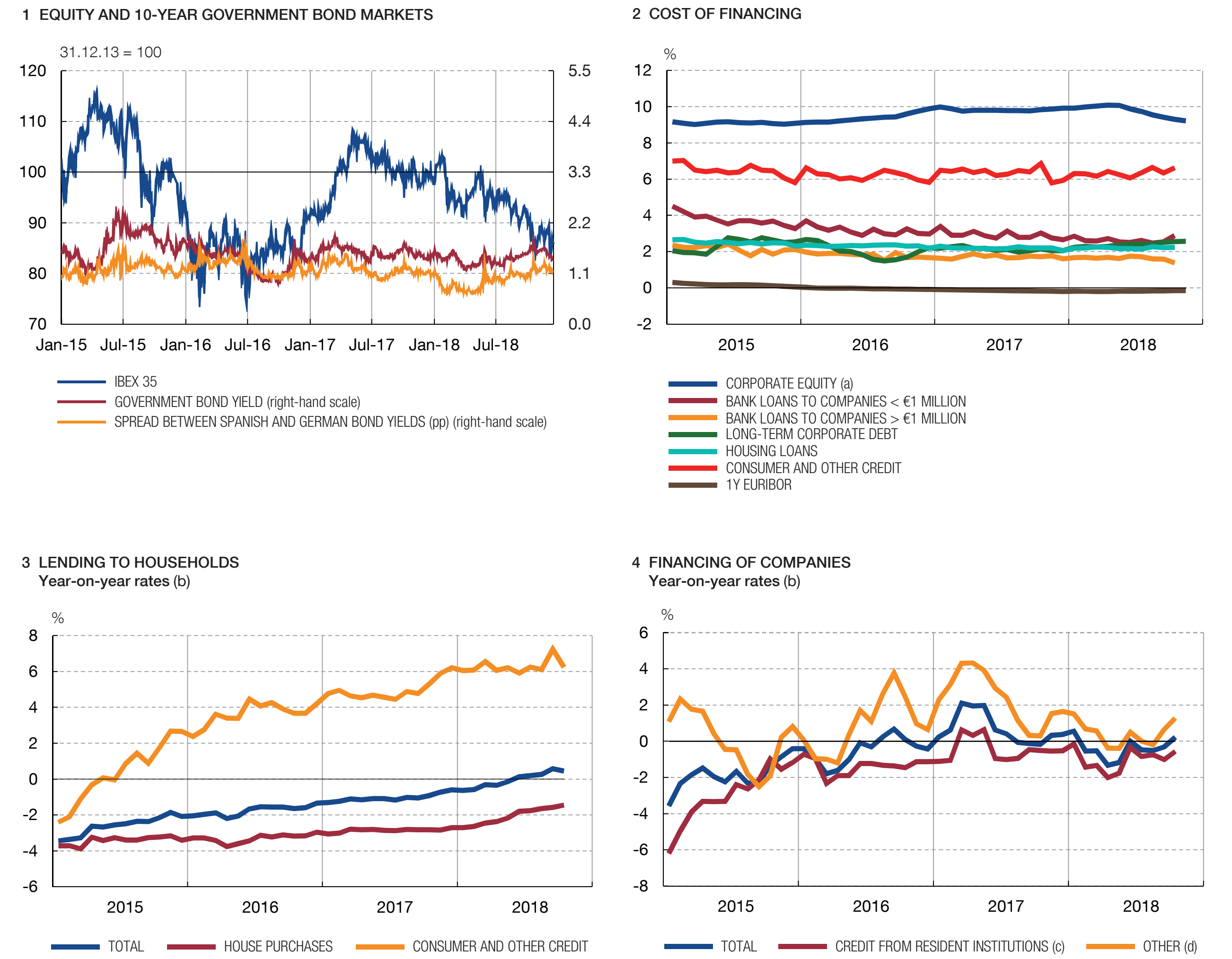
This context of favourable conditions for access to financing continued to support the expansion of new lending volumes in recent months. The legal uncertainty over stamp duty does not seem to have affected the volume of new lending for housing purchase in

4 This segment includes loans to households for purposes other than consumer credit or housing, such as business (i.e. sole proprietors), debt consolidation and education, and all lending to non-profit institutions serving households. For more information, see Banco de España Circular 4/2017 of 27 November 2017 to credit institutions on public and confidential financial information rules and formats.

5 For more details, see the Analytical Article "The October 2018 Bank Lending Survey in Spain", *Economic Bulletin,* 4/2018, Banco de España.

FINANCING CONDITIONS

CHART 10



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.
d Includes loans from non-residents and the issuance of debt securities (including that by resident subsidiaries).

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October, which continued to grow at rates similar to those in previous months. Progress in lending activity contributed to the rate of year-on-year growth in households' outstanding debt balance[6] rising to 0.4% in October, 0.3 pp higher than in June (see Chart 10.3). By purposes, this was the result of the slowdown in lending for housing purchase continuing its trend towards moderation shown since the start of the year (to 1.5% in October, compared with 1.8% in June), together with an increase in the rate of progress of consumer credit and other lending (0.3 pp, to 6.2%), as a consequence of the increased dynamism of the other lending segment, given that consumer credit slowed slightly.

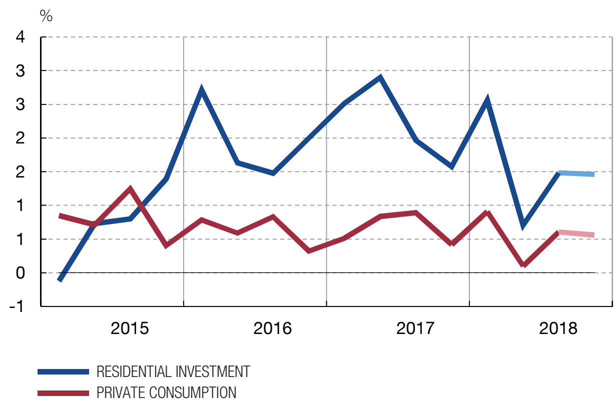
On the latest available data, households' financial position continued to strengthen during 2018 Q3. Thus, the debt and debt burden ratios relative to gross disposable income (GDI)

6 The outstanding balance of credit is adjusted by credit transfers and bad loans, which do not represent an effective flow of financing.

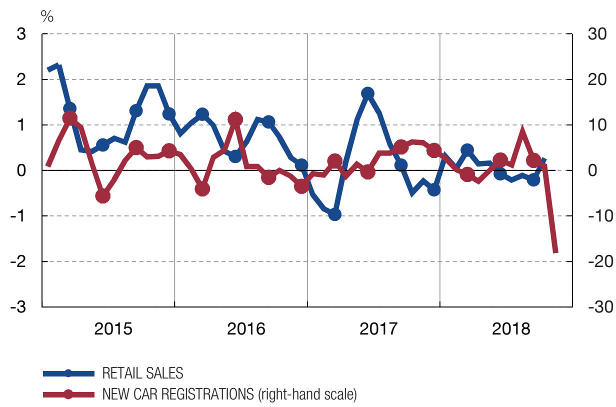
HOUSEHOLD SPENDING

CHART 11

1 HOUSEHOLD SPENDING (QNA) (a)

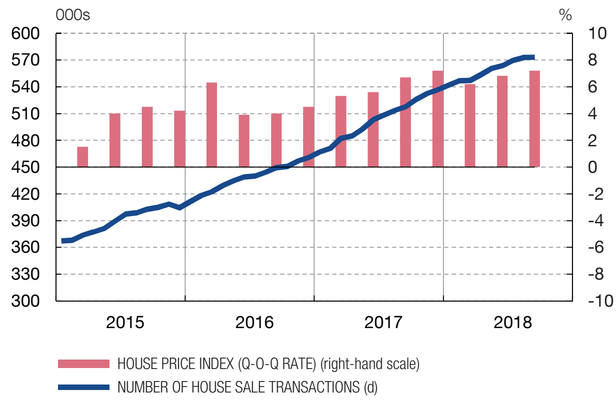


2 CONSUMPTION INDICATORS (b)



3 CONFIDENCE INDICATORS (c)

4 HOUSE PRICES AND TOTAL TRANSACTIONS



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

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

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seem to have continued to fall (see Chart 12.1). Net household wealth is estimated to have increased once more in 2018 Q3, as a result of the appreciation of households' real estate assets, which offset the decrease in their financial wealth, the latter influenced by the fact that the decline in assets outpaced that in liabilities (see Chart 12.2).

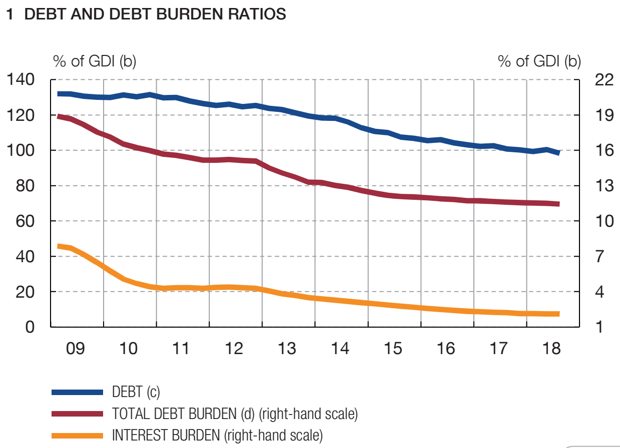
3.2 Business activity and investment

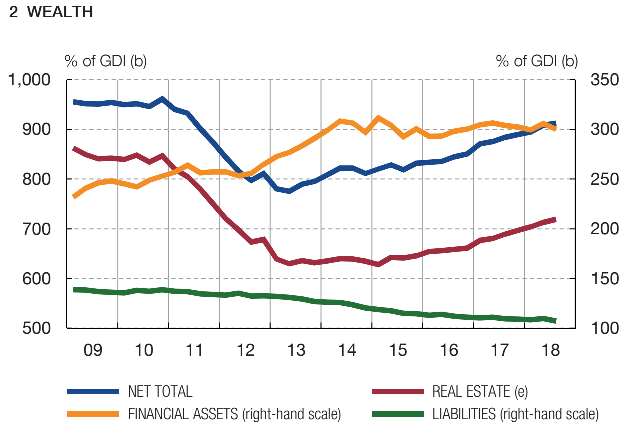
Business activity, proxied by the real value added of the market economy, appears to have grown at a slightly faster pace in 2018 Q4 than in the period July-September, the most notable feature being the acceleration of industry and energy.

Regarding business investment, the capital goods component is estimated to have increased by around 0.8% quarter-on-quarter in 2018 Q4, down on its growth in Q3 (2.2%, see Chart 13). The available information is still scant, but the recent behaviour of the quantitative indicators, relating to October, such as the capital goods IPI and commercial vehicle registrations, points to this development. For its part, investment in intangible assets appears to have picked up somewhat following its unfavourable performance in Q3.

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 metre.

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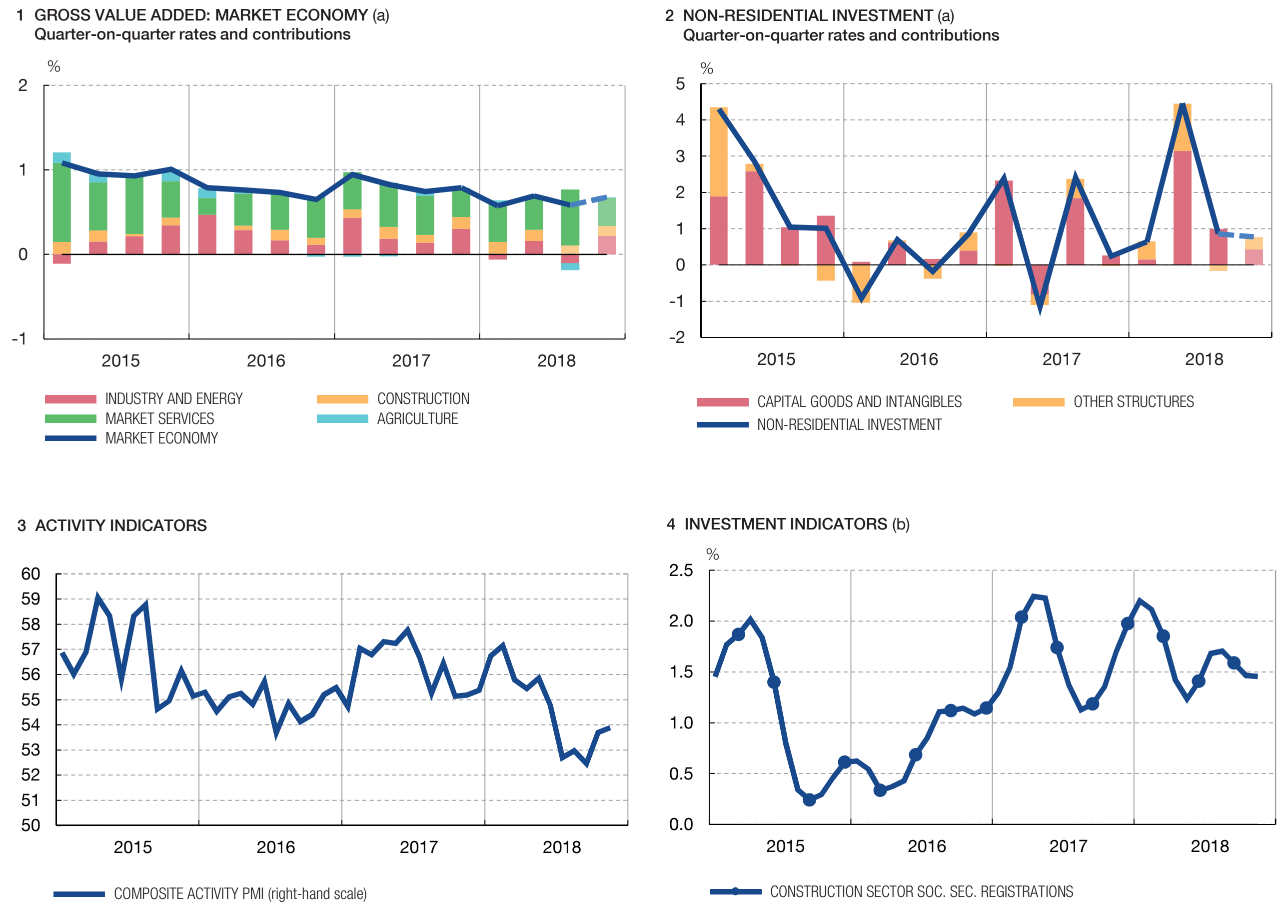
In the last few months, the cost of bank financing to non-financial corporations has remained low. Thus in October the average interest rate on new bank loans below €1 million was 2.9%, some 30 bp above the average for the previous three months, a rise which seems to reflect seasonal factors in the behaviour of bank fees. The interest rate on loans above €1 million was 1.4%, an all-time low. Meanwhile, the estimated cost of equity seems to have decreased in recent months to 9.2% in November (70 bp less than in June), while that of long-term fixed-income securities issuance appears to have increased by 20 bp since June to 2.6% in November (see Chart 10.2).

The banks responding to the latest (October) BLS reported that credit standards for loans to non-financial corporations eased in 2018 Q3. A similar easing seems to have been shown by overall terms and conditions, particularly the margins on average loans and the length of maturities. Banks reported a decrease in the demand for funds by non-financial corporations. According to the results of the latest ECB survey on firms' access to finance in the euro area (SAFE), covering the period April to September 2018, Spanish SMEs perceive a further improvement in the availability of bank loans. This is the view expressed by 21% of them, in net terms, which is 3 pp less than in the previous survey wave (see Box 7). In line with the BLS, this source also indicates that loan applications seem to have decreased as a result of lower borrowing needs.

Against this background, the volume of new lending to non-financial corporations has continued to grow in the last few months, both in the segment of loans below €1 million and in that above that threshold. In terms of outstanding balances, the loans extended by resident institutions to non-financial corporations continued to contract, the year-on-year rate of decline standing at 0.5% in October, below that of the previous months (see Chart 10.4). Meanwhile, funds raised by issuance of debt securities, including issues made by resident subsidiaries, accelerated, their year-on-year growth rate rising to 8.6% in October, compared with 4.3% in June. By contrast, the rate of decline of corporate financing through loans received from abroad has quickened in recent months. As a result

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 rates.

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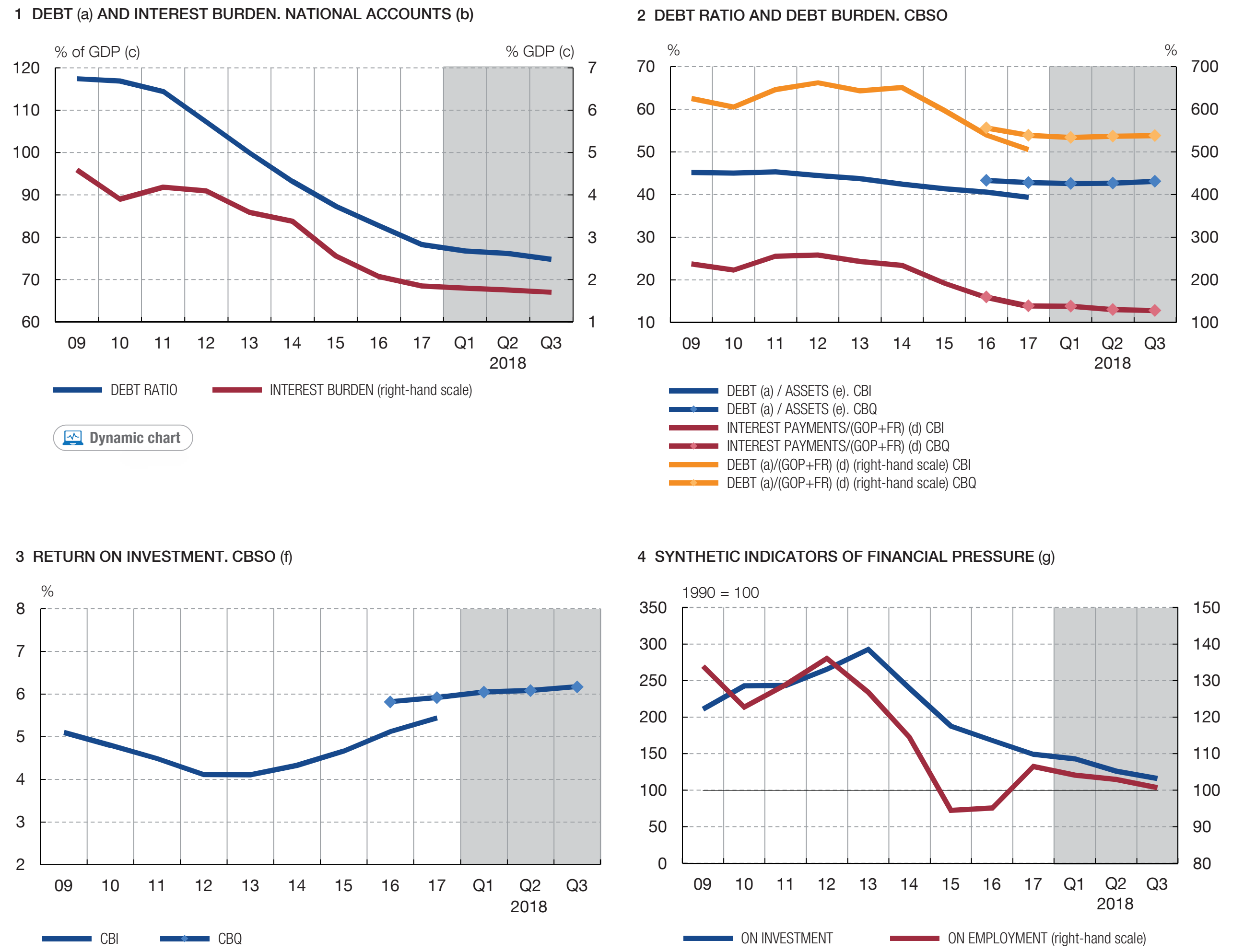
of these developments, the total credit to non-financial corporations seems to have switched to a slightly positive growth rate in October (0.2% year-on-year), for the first time since January.

Meanwhile, continuing its trend over the last few years, the financial position of non-financial corporations appears to have continued to strengthen in 2018 Q3. Thus it is estimated that the debt ratio and, to a lesser degree, the debt burden ratio continued to fall in that period, as a result of both GDP growth and the decline in the sector's liabilities (see Chart 14). In accordance with the sample of non-financial corporations reporting to the Central Balance Sheet Data Office's Quarterly Survey (CBQ), which are mainly large firms, the expansion of productive activity and the favourable performance of financial revenue and costs enabled ordinary profit to grow by 11.1% year-on-year in 2018 Q3.[7] These developments have allowed the return on assets to increase to 4.7%, up 0.2 pp on the same period a year earlier. The information from the SAFE also points to an improvement, albeit very slight, in the performance of SMEs in recent months. Thus, between April and

7 See Analytical Article, "Results of non-financial corporations in 2017 and in the first three quarters of 2018", *Economic Bulletin* 4/2018, Banco de España.

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 The GDP data series is seasonally adjusted.
d Gross operating profit (GOP) plus financial revenue (FR).
e Total inflation-adjusted assets 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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September the net proportion of surveyed SMEs which reported an increase in their profits was positive, albeit small (2%) and 2 pp below that six months earlier.

3.3 The external sector and the balance of payments

Although still limited, the information available for Q4 suggests that the contribution of net external demand to quarter-on-quarter GDP growth was zero in this quarter, up 0.2 pp from Q3. This development apparently took place against a backdrop of recovery of cross-border trade in goods and services, both exports and imports, following declines of 1.8% and 1.2%, respectively, in the previous quarter. In year-on-year terms, the contribution of net external demand to GDP growth appears to continue to be negative (for the sixth quarter running), in a setting characterised by the deceleration of the euro area (the main destination for Spanish exports), the uncertainty associated with the Brexit negotiations, the moderation of world trade growth (affected by the prolongation of protectionist tensions) and the continuing pronounced weakness of the currencies of some emerging economies (see Chart 15).

The rise in industrial production and car exports (according to the ANFAC) in October and the improvement in the PMI manufacturing index in November point to a recovery in foreign trade in the closing months of the year, following the weakness of the summer months. Also in this vein is the pick-up in real exports and imports of goods and services reported by large corporations in October, according to information from the tax authorities (rise in year-on-year rates to 3% and 1.3%, respectively). The Customs data are more out of date, covering only until September. In this month, in deflated terms, the real flows of goods exports and imports decreased appreciably (-7.3% and -6% year-on-year, respectively), particularly of those items relating to the automotive sector (vehicles and intermediate goods used in the manufacture of transport equipment). Trade in goods of this kind seems to have been temporarily affected by the entry into force of the new EU vehicle emissions regulation, which caused a sharp fall in European car registrations in that month and partial shut-downs of some vehicle production lines owing to the scarcity of duly certified engines. By geographical area, September saw significant decreases in both exports to Spain's main EU markets (particularly Germany) and sales to extra-EU economies (most notable were the sharp falls in those to Turkey, Argentina and Brazil, adversely affected by the strength of the euro against the currencies of these countries).

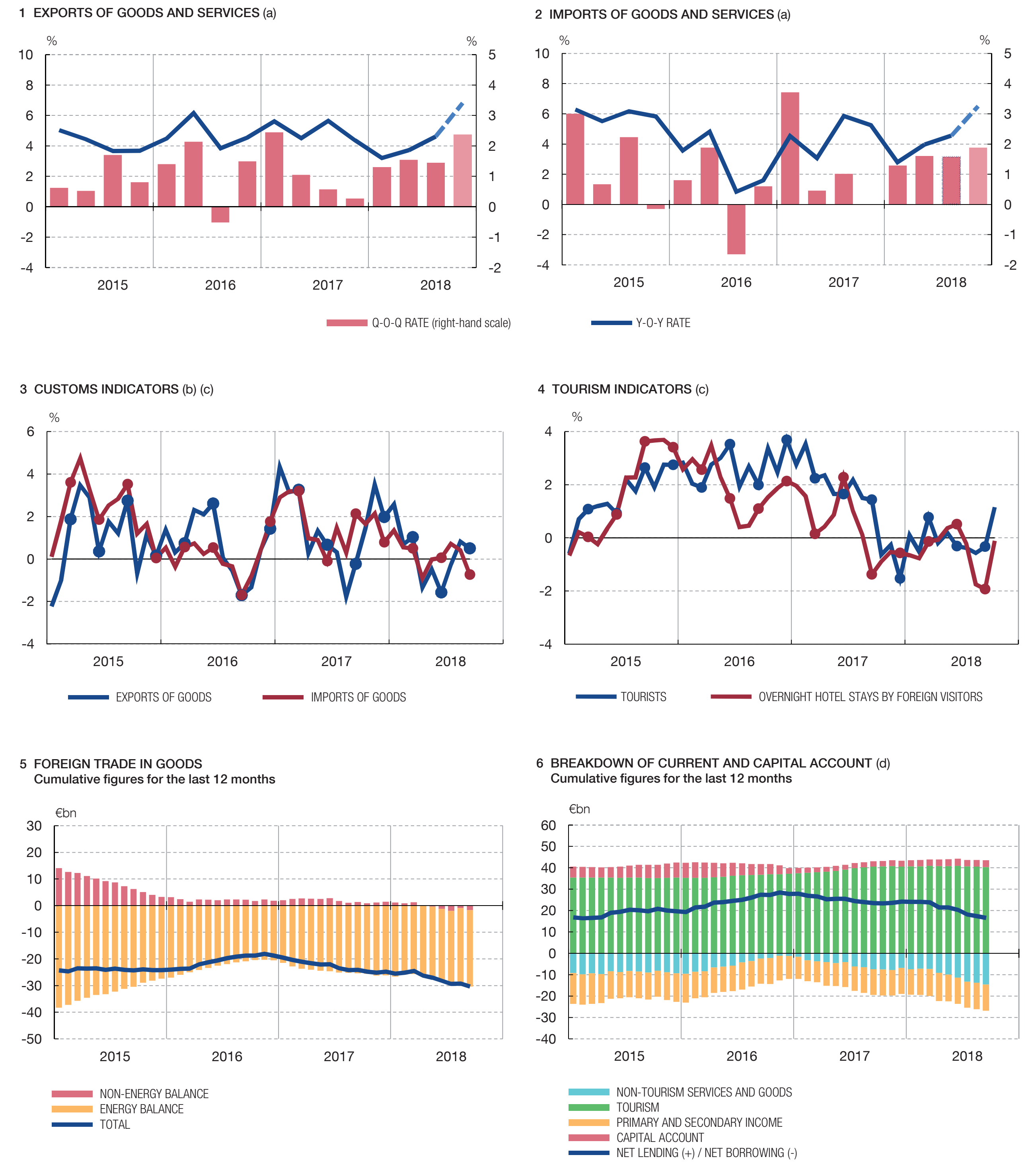
Similarly, foreign tourist arrivals rebounded in October (5% year-on-year), contrasting with the fall in the summer quarter (-2.2%) due to the progressive normalisation and recovery of Spain's main Mediterranean competitor destinations in the sun and sand segment. This month saw a recovery in tourist arrivals from Spain's main source markets, such as the United Kingdom, France and, to a lesser extent, Germany, accompanied by the ongoing momentum of its more distant source markets, particularly the United States. In addition, the average daily spending and the total spending by tourists gathered pace in October to year-on-year rates of 6% and 4.6%, respectively. The outlook is favourable in the view of tourism sector entrepreneurs, whose projections are for an improvement in the fourth quarter as a whole, basically due to the comparison effect with the low levels recorded in the same quarter a year earlier, which coincided with the escalation of political tensions in Catalonia. Other one-off factors, such as the scheduling of a world sporting event in December, would seem to point to a certain recovery in foreign tourism.

The Spanish economy's net lending position decreased in the second and third quarters of the year (Box 5). Specifically, on cumulative 12-month data, the balance of payments surplus to September decreased to 1.4% of GDP (down from 2.1% for 2017 as a whole). This resulted from the striking deterioration of the balance of goods and non-tourism services – largely reflecting the increase in the energy bill – and the slight narrowing of the tourism surplus. However, the primary and secondary income deficit stabilised and the capital account surplus widened.

From July 2018 to September 2018, unlike almost every quarter since 2015, the financial account of the balance of payments, excluding the Banco de España, showed a slight debit balance (of approximately €850 million). This was the result of an increase in foreign assets held by residents (€25.3 billion) that was lower than the increase in net liabilities issued by residents vis-à-vis the rest of the world (€27.6 billion) and the positive net flow of transactions associated with financial derivatives (€1.4 billion). Residents mainly channelled their purchases from the rest of the world through portfolio investment

FOREIGN TRADE AND BALANCE OF PAYMENTS

CHART 15



SOURCES: INE, Departamento de Aduanas, Ministerio de Economía y Empresa 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 rates.
d Data conform to the sixth edition of the IMF's Balance of Payments and International Investment Position Manual (BPM6).

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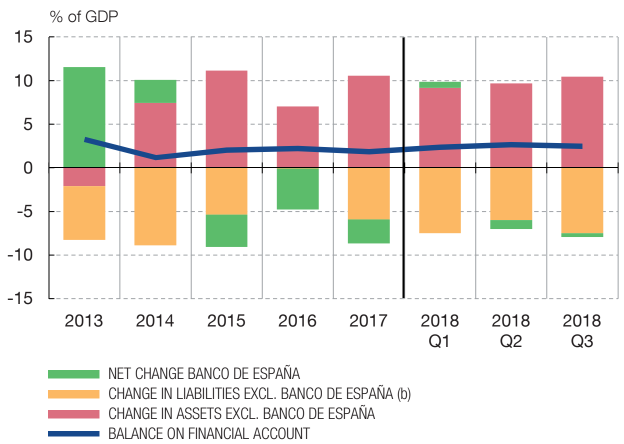
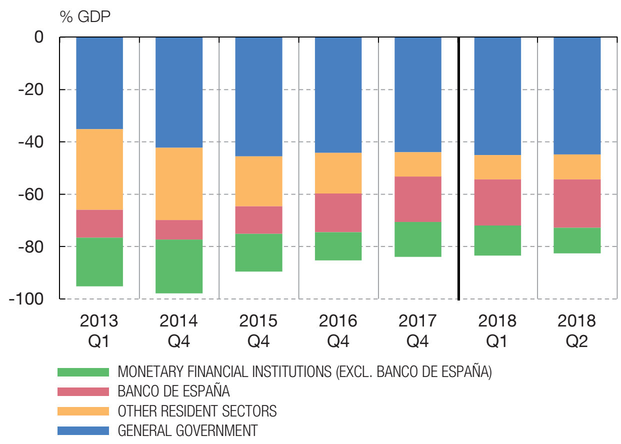
BALANCE OF PAYMENTS AND INTERNATIONAL INVESTMENT POSITION

CHART 16

1 FINANCIAL ACCOUNT OF THE BALANCE OF PAYMENTS (a)



2 INTERNATIONAL INVESTMENT POSITION (c)



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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(€11.8 billion) and, to a lesser degree, through other investment (€7.5 billion) and direct investment (€6.1 billion). Net foreign investment in Spain was concentrated essentially in portfolio investment (€19.3 billion), mainly long-term debt securities issued by general government (€12.9 billion). Other net investment by non-residents was in the form of direct investment (€6.1 billion) and, to a lesser degree, other investment (€2.1 billion).

The debit balance on the financial account, excluding the Banco de España, together with the Spanish economy's net lending position in 2018 Q3, led to a reduction of €5.9 billion in the Banco de España's debit position vis-à-vis the rest of the world. Since the beginning of the Eurosystem's asset purchase programme, this had only happened in certain quarters of 2017. Nonetheless, in 12-month cumulated terms, the Banco de España's financial flows still show a debit position (see Chart 16.1).

The Spanish economy's international investment position (IIP) debit balance decreased by €3.5 billion in 2018 Q2 (latest available data). This reduction resulted from the positive amount of net financial transactions (€6 billion), which fully offset the negative amount of the other flows (-€2.4 billion), essentially due to a higher decline in the value of assets, mainly equities, than in that of liabilities. In GDP terms, the Spanish economy's net debt to the rest of the world stood at 82.6% in June, almost 1 pp lower than three months earlier (see Chart 16.2). Gross external debt relative to GDP hardly varied and stood at 168.2%, which is 6.4 pp less than the peak reached in 2015 Q1.

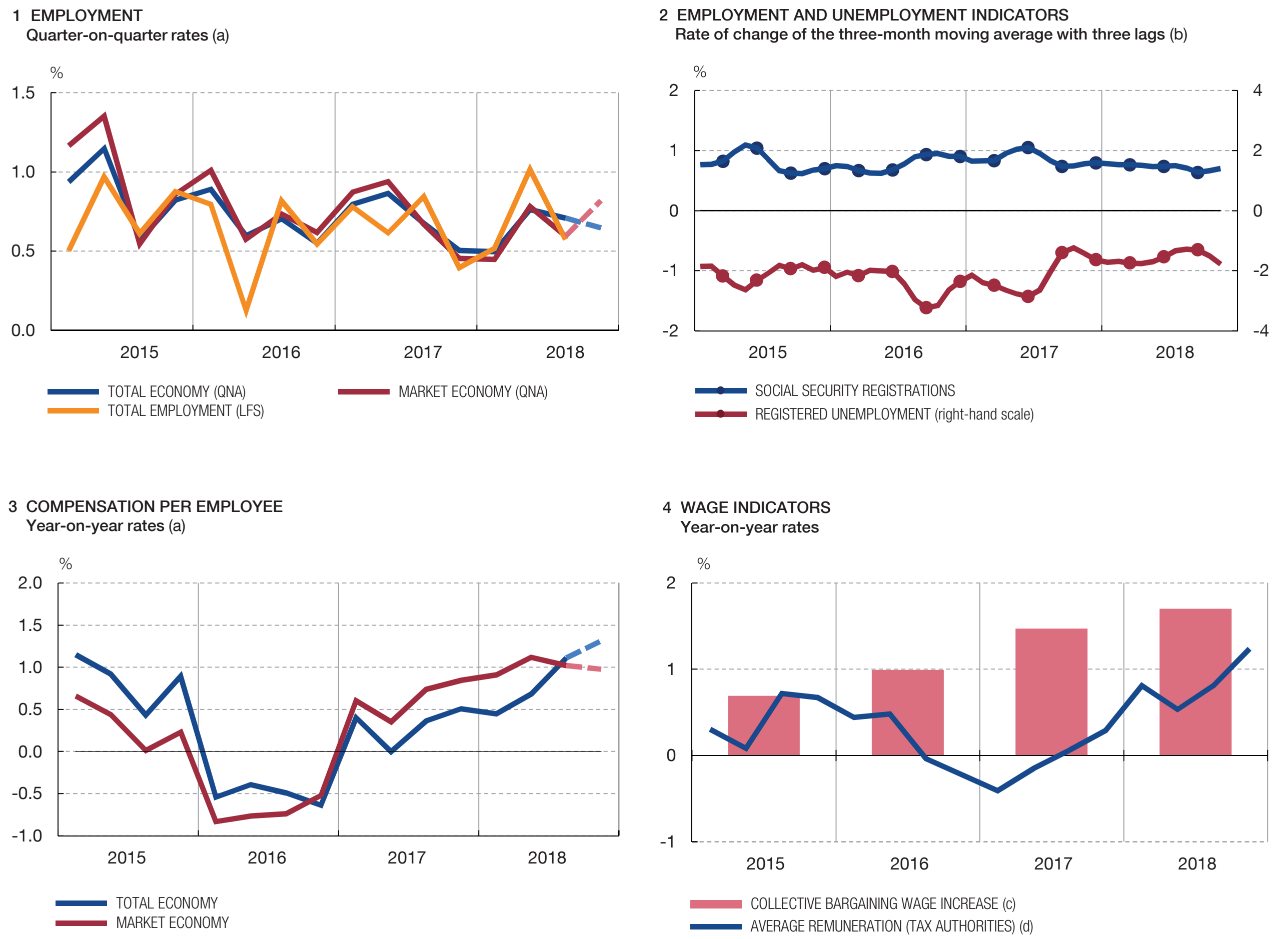
3.4 The labour market

On QNA information,[8] employment grew 0.7% in quarter-on-quarter terms in Q3, 0.1 pp less than in Q2. This slowdown was smaller than that observed in terms of the LFS. The most recent labour market indicators suggest that employment will remain buoyant in Q4, after taking into account the volatility shown by some indicators in October and November in the agricultural sector. Social security registrations slowed in those two months in the

8 In terms of full-time equivalent jobs.

EMPLOYMENT AND WAGES

CHART 17



SOURCES: INE, Ministerio de Trabajo, Migraciones 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 On data to November 2018. Excluding indexation clauses.
d Seasonally adjusted series. Last quarter, with data only for October 2018.

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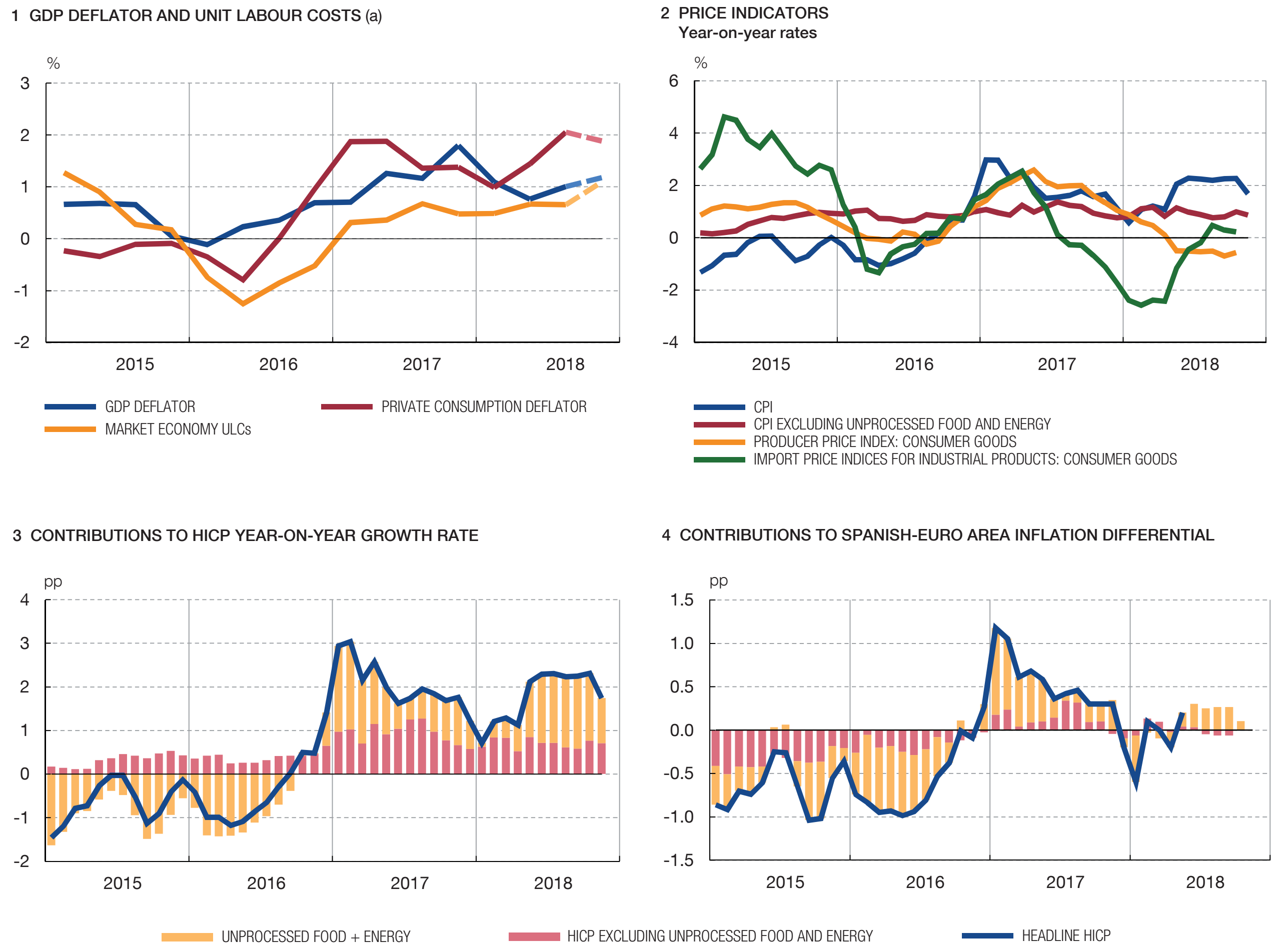
industry and construction sectors, which was offset by the quickening in the non-market services sector. In QNA terms, employment growth is expected to decline slightly in Q4 to a rate of somewhat more than 0.6% in quarter-on-quarter terms (see Charts 17.1 and 17.2).

The decline in unemployment registered by the National Public Employment Service (SEPE by its Spanish abbreviation) steepened in November, reaching -1.8%, in terms of the three-month seasonally adjusted moving quarter-on-quarter rate (see Chart 17.2). Consequently, the moderating path of this variable's decline since early in the year was interrupted. The new contracts registered by the SEPE showed higher average growth in the period October-November than in Q3. This faster pace of hiring was due to temporary contracts whereas permanent contracts slowed. However, permanent contracts remained more vigorous than the other contracts, with the result that their share in the total rose to 10.6%, which was 1.2 pp higher than a year ago.

As regards wages, the collective bargaining agreements registered until November showed an increase in wage rates for 2018 of 1.7%, which was around 0.2 pp higher than that agreed for 2017, with a high coverage of employees (almost 8.5 million). The agreements

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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reached in previous years recorded wage rates of 1.6% for 2018, whereas for those entered into this year the increase is slightly higher at 2%, which coincides with the recommendation of the Employment and Collective Bargaining Agreement. Similarly, the rate of increase of average gross compensation at large non-financial corporations published by the tax authorities climbed to 0.8% year-on-year in Q3 in terms of the seasonally adjusted series, expanding in October, to a rate of 1.2%. On QNA data for Q3, compensation per employee in the total economy showed a growth rate of 1.1% year-on-year, up 0.4 pp on the previous quarter, as a result of the quickening of compensation in the non-market economy. Compensation per employee in the total economy is projected to accelerate further in 2018 Q4 to 1.3% year-on-year on account of the impact of the increase budgeted in civil servants' compensation for 2018 (see Charts 17.3 and 17.4). Growth in compensation per employee in the market economy is expected to stabilise at around 1% year-on-year.

3.5 Prices

In 2018 Q4 the import deflator is estimated to have slowed, in an environment of lower oil prices. Domestic producer prices, proxied by the GDP deflator, are estimated to have quickened somewhat in Q4, while continuing to post moderate growth (1.2% year-on-year). In this setting of weakened external inflationary pressures and slightly higher domestic pressures, year-on-year growth of the private consumption deflator is estimated to have slowed marginally (see Chart 18.1).

More recently, the rate of growth of the HICP also declined. In November, its year-on-year rate of change was 1.7%, 0.6 pp lower than that observed in October. In turn, the year-on-year rate of change of the HICP for the euro area as a whole fell by 0.3 pp to 1.9% in November, relative to the previous month. As a result, the inflation differential in Spain compared with that of the euro area turned negative (-0.2 pp against 0.1 pp in October).

The deceleration of overall HICP was extensive to all components, with a particularly large contribution from the energy component, whose year-on-year growth moderated to 6.4% (10.7% in October), given the slowdown in electricity, heating and vehicle fuel prices. Core inflation, measured by the year-on-year rate of change of the HICP excluding energy and foods, declined to 1.1% in November, 0.1 pp less than in October. The prices of non-energy industrial goods and of services decelerated by the same amount.

18.12.2018

Chronology of Analytical Articles. 2018 Q4.

THE INCREASE IN TARGET BALANCES IN THE EURO AREA SINCE 2015

Pana Alves, Antonio Millaruelo and Ana del Río

Published on 5 December 2018

The TARGET2 platform, which is owned by the Eurosystem, processes payments in euro with reserves, i.e. central bank money. The cross-border payment transactions channelled through this platform give rise to central bank claims and liabilities which, when aggregated and netted, produce the so-called TARGET balances. Since 2015, when various extraordinary monetary stimulus measures were introduced by the ECB, there has been a marked increase in aggregate TARGET balances, to levels above those reached during the sovereign debt crisis which took place in the first few years of the current decade. Unlike then, the recent developments do not reflect financial stress or general funding problems in euro area economies, as during the sovereign debt crisis, but are instead mainly linked to the execution of the Eurosystem's asset purchase programme (APP).

RESULTS OF NON-FINANCIAL CORPORATIONS IN 2017 AND IN THE FIRST THREE QUARTERS OF 2018

Álvaro Menéndez and Maristela Mulino

Published on 3 December 2018

Central Balance Sheet Data Office Annual and Quarterly Survey data point to a continuation of the recovery in non-financial corporations' activity, both in 2017 and in the first nine months of 2018, giving rise to growth in ordinary profit and employment in the majority of sectors and firms. As a result of the good corporate earnings performance, rates of return rose in both periods and the spread over the cost of borrowing continued to widen. Extraordinary costs and revenue had a negative impact on net profit in 2017; however, in the first nine months of 2018 the impact was positive, resulting in very strong net profit growth in the period. Average debt ratios continued to decline in 2017, while in the first three quarters of 2018 the debt-to-asset ratio rose slightly and the debt-to-ordinary income ratio was practically unchanged. Lastly, the debt burden ratio fell in both periods, driven in particular by the lower cost of borrowing. The article includes two boxes analysing the recent economic and financial performance of Spanish SMEs and consolidated groups, respectively, on data up to 2017.

THE INTERNATIONAL MONETARY FUND AND ITS ROLE AS A GUARANTOR OF GLOBAL FINANCIAL STABILITY

Sonsoles Gallego, Pilar L´Hotellerie-Fallois and Fernando López-Vicente

Published on 21 November 2018

Given the growing real and financial integration of economies worldwide, there is a need for the presence of supranational mechanisms to address crisis situations. The International Monetary Fund (IMF) is the multilateral institution at the core of the global financial safety net (GFSN). The swift development of other elements of this net since the last global financial crisis, such as the regional financing arrangements, has made the system sounder but also poses fresh challenges. The broad membership of the IMF, the volume of its resources and its accumulated global experience in crisis management make the organisation key to shoring up global monetary and financial stability. However, the IMF is subject to recurrent discussions about its governance and lending policies, including the size and composition of its resources, and the distribution of power within the organisation. The IMF is currently immersed in the Fifteenth General Review of Quotas. The backdrop to this negotiation is the risk that, in the absence of a satisfactory agreement on the size and distribution of its resources, the IMF's financial sufficiency and its degree of representativeness among its members may be diminished in the coming years. This might significantly undermine the stabilising capacity of the GFSN.

RECENT DEVELOPMENTS IN NON-BANK FINANCING OF SPANISH FIRMS

Víctor García-Vaquero and Irene Roibás

Published on 15 November 2018

The banking sector has traditionally played a key role in the financing of Spanish non-financial corporations (NFCs), much more substantial than other alternative sources, such as securities markets or venture capital. The past crisis evidenced that a high degree of dependence on a single source of funding may constitute an element of vulnerability for firms. Against this backdrop, in recent years there has been a process of financial disintermediation, with firms replacing part of their bank loan financing with the issuance of securities (bonds or equity) in official or alternative markets and with equity financing through venture capital entities. Specifically, in the period 2009-2017 NFCs raised funds for an average annual amount of €50 billion through securities markets, compared with an average annual decline of €34 billion through loans. Also, the recently created crowdfunding platforms have become a new alternative channel and although their volumes are marginal for the time being, they could experience stronger growth in the next few years, as has occurred in other European countries.

ARGENTINA: ECONOMIC CHALLENGES IN AN ADVERSE INTERNATIONAL SETTING

Xavier Serra, Jacopo Timini, Enrique Martínez Casillas and Julia Estefanía

Published on 6 November 2018

The Argentine economy is in a complicated transition phase. To correct the major fiscal and inflationary imbalances built up in the previous decade, the new government that took office in December 2015 opted for a gradual fiscal adjustment, supported by a situation of abundant international liquidity. In parallel, the Argentine central bank assumed ambitious inflation-reducing objectives. However, in 2018 the lack of progress on the inflation front, the tightening of international financial conditions and a severe drought placed Argentina under the market's gaze and prevented it from pursuing the financing of this gradual adjustment; accordingly, the government decided to apply for IMF financial assistance. The agreement with the Fund, approved in June and amended in October 2018, plans for a rapid fiscal and monetary adjustment that will provide for a reduction in its twin deficits (fiscal and external alike) and an effective decline in inflation, moving the economy onto a stable growth path. The success of the programme, to which the Argentine authorities have made a clear commitment, is nonetheless subject to internal and external risks, and poses a significant challenge for the country.

REPORT ON THE LATIN AMERICAN ECONOMY. SECOND HALF OF 2018

Published on 6 November 2018

This article reviews, as usual, the recent performance of the main Latin American economies, in a setting where the emerging economies have faced a series of adverse shocks. There has been a considerable downward revision of the growth forecast for the region in 2018, driven mainly by idiosyncratic factors: the severe recession in Argentina and a slower-than-expected recovery in Brazil. Furthermore, the risks remain predominantly on the downside. One of these risks – a tightening of the pace of monetary policy normalisation in the United States – is analysed in more detail in the article.

THE GROWTH OF THE FINTECH INDUSTRY IN CHINA: A SINGULAR CASE

Sergio Gorjón

Published on 30 October 2018

In scarcely two decades, the People's Republic of China has become one of the most prominent countries in the FinTech field. This has been the result of a singular set of factors, including most notably the structural shortcomings of China's financial system, the growth of its middle classes and their attitude to privacy, a high level of digital connectivity, the volume of e-commerce and a series of public policies and enabling regulations. In addition, the emergence of the FinTech industry in China is marked by the success of the national technological giants, which have recently embarked on an international expansion. The Chinese Government continues to pursue ambitious strategic plans which, for the first time, evidence greater concern for a framework of robust safeguards to protect customers and ensure financial stability.

THE OCTOBER 2018 BANK LENDING SURVEY IN SPAIN

Álvaro Menéndez Pujadas

Published on 23 October 2018

In 2018 Q3, according to the Bank Lending Survey, credit standards for loans to enterprises eased somewhat, both in Spain and in the euro area, while the terms and conditions applied to such loans also eased. As for lending to households, Spanish banks reported an easing in the credit standards and terms and conditions for consumer credit and other lending to households, and no change in those for housing loans, while in the euro area banks reported no significant changes in the first of these segments and a slight easing in the second. The demand for loans to enterprises fell somewhat in Spain and increased in the euro area as a whole, while in the two segments of loans to households, loan applications increased in both areas. In Spain, banks' conditions of access to wholesale funding markets deteriorated, while their conditions of access to retail funding markets barely changed. In the euro area as a whole, on the other hand, the changes were very small in both cases. The ECB's expanded asset purchase programme continued to contribute, over the six month period prior to the survey, to improving the liquidity position and funding conditions of banks in both areas and to easing the terms and conditions for loans, while the impact on profitability was mildly positive in Spain and negative in the euro area as a whole. Both Spanish and euro area banks reported that the ECB's negative deposit facility rate had led to a reduction in net interest income over the previous six months, and a general fall in interest rates and margins on loans, as well as a slight increase in the volume of lending.

COMPOSITE INDICATORS OF INFLATIONARY PRESSURES

Luis Julián Álvarez and Isabel Sánchez

Published on 18 October 2018

This article analyses a broad set of relevant variables for monitoring inflationary pressures in the Spanish economy. On the basis of these variables, composite indicators are calculated that proxy inflation expectations, the degree of slack in the economy and other inflation pressures, domestic and external alike. On the information analysed, the recent period of low inflation in the Spanish economy is estimated to have come about in a setting in which domestic factors particularly eased, with a notable reduction in inflation expectations.

DISTRIBUTED LEDGER TECHNOLOGY (DLT): INTRODUCTION

José Luis Romero Ugarte

Published on 16 October 2018

Distributed ledger technology is attracting the attention of the financial sector, both owing to its use in transactions with crypto-assets and to the proliferation of initiatives which have the potential to increase the efficiency, transparency, speed and resilience of processes underlying financial transactions. This article aims to introduce this technology, describing a series of basic issues surrounding it and attempting to identify opportunities and intrinsic limitations. Additionally, it addresses possible applications in the financial sector and outlines some of the main challenges which its use poses for the authorities.

WAGE MODERATION IN SPAIN AND IN THE EURO AREA

Pilar Cuadrado and Federico Tagliati

Published on 9 October 2018

One of the most visible characteristics of the recent economic recovery is the moderation of wage growth in a good number of advanced economies. This article analyses quantitatively the contribution of several factors to changes in the wage growth rate in Spain and in the euro area during the current upturn. In both cases, the results show that the recent wage moderation is attributable to relatively high levels of labour market slack and low inflation expectations. For the euro area, another significant factor is low productivity growth, in contrast to other similar phases of the economic cycle. The analysis also reveals that, in the most recent period, it is important to take into account broader slack indicators than the unemployment rate, given that the high proportion of involuntary part-time and discouraged workers are exerting some downward pressure on wages.

RECENT MOVEMENTS IN THE EURO EXCHANGE RATE AND THE IMPACT ON INFLATION IN THE SPANISH ECONOMY

Danilo Leiva, Jaime Martínez-Martín and Eva Ortega

Published on 4 October 2018

The effect of the euro exchange rate on inflation has taken on significant importance recently, with the application of the ECB's expansionary monetary policy measures having coincided with episodes of euro appreciation, such as that observed between the second half of 2017 and early 2018, which tend to exert downward pressure on imported prices. This article analyses the factors behind the fluctuations in the euro exchange rate against the dollar during the recent period, and finds that this appreciation may have largely been due to the higher relative growth of the euro area, compatible with a pick-up in expected euro area inflation. However, the subsequent depreciation, since February 2018, might reflect factors related to changes in the relative confidence of financial markets to the detriment of the euro, and to the lower relative growth of the euro area compared with the United States. Further, it is documented how the pass-through of exchange rate movements to overall consumer-price inflation in the Spanish economy has increased slightly in recent years, owing mainly to the energy component, while core inflation remains much less sensitive to exchange rate changes.

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Most of these documents are available in pdf format and can be downloaded free of charge from the Banco de España website at http://www.bde.es/webbde/en/secciones/informes/. Requests for others should be addressed to publicaciones@bde.es.

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ACRONYMS AND ABBREVIATIONS

ABS	Asset-backed securities
APP	Asset Purchase Programme
BCBS	Basel Committee on Banking Supervision
BE	Banco de España
BIS	Bank for International Settlements
BLS	Bank Lending Survey
BOE	Official State Gazette
CBA	Central Balance Sheet Data Office Annual Survey
CBQ	Central Balance Sheet Data Office Quarterly Survey
CBSO	Central Balance Sheet Data Office
CCR	Central Credit Register
CDSs	Credit default swaps
CESR	Committee of European Securities Regulators
CNE	Spanish National Accounts
CNMV	National Securities Market Commission
CPI	Consumer Price Index
CSPP	Corporate sector purchase programme
DGF	Deposit Guarantee Fund
EBA	European Banking Authority
ECB	European Central Bank
ECOFIN	Council of the European Communities (Economic and Financial Affairs)
EDP	Excessive Deficit Procedure
EFF	Spanish Survey of Household Finances
EFSF	European Financial Stability Facility
EMU	Economic and Monetary Union
EONIA	Euro overnight index average
EPA	Official Spanish Labour Force Survey
ESA 2010	European System of National and Regional Accounts
ESCB	European System of Central Banks
ESFS	European System of Financial Supervisors
ESM	European Stability Mechanism
ESRB	European Systemic Risk Board
EU	European Union
EURIBOR	Euro interbank offered rate
EUROSTAT	Statistical Office of the European Communities
FASE	Financial Accounts of the Spanish Economy
FDI	Foreign direct investment
FROB	Fund for the Orderly Restructuring of the Banking Sector
FSB	Financial Stability Board
FSF	Financial Stability Forum
GDI	Gross disposable income
GDP	Gross domestic product
GFCF	Gross fixed capital formation
GNP	Gross national product
GOP	Gross operating profit
GVA	Gross value added
HICP	Harmonised Index of Consumer Prices
IASB	International Accounting Standards Board
ICO	Official Credit Institute
IFRSs	International Financial Reporting Standards
IGAE	National Audit Office
IIP	International Investment Position
IMF	International Monetary Fund
INE	National Statistics Institute
LTROs	Longer-term refinancing operations
MFIs	Monetary financial institutions
MROs	Main refinancing operations
MTBDE	Banco de España quarterly macroeconomic model
NAFTA	North American Free Trade Agreement
NAIRU	Non-accelerating-inflation rate of unemployment
NCBs	National central banks
NFCs	Non-financial corporations
NiGEM	National Institute Global Econometric Model
NPISHs	Non-profit institutions serving households
OECD	Organisation for Economic Co-operation and Development
ONP	Ordinary net profit
OPEC	Organisation of Petroleum Exporting Countries
PER	Price/earnings ratio
PMI	Purchasing Managers' Index
PPP	Purchasing power parity
QNA	Quarterly National Accounts
SAFE	ECB Survey on the Access to Finance of Enterprises
SDRs	Special Drawing Rights
SEPA	Single Euro Payments Area
SGP	Stability and Growth Pact
SMEs	Small and medium-sized enterprises
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
TFP	Total factor productivity
TLTROs	Targeted longer-tem refinancing operations
ULCs	Unit labour costs
VAT	Value Added Tax
WTO	World Trade Organization

COUNTRIES AND CURRENCIES

In accordance with Community practice, the EU countries are listed using the alphabetical order of the country names in the national languages.

BE	Belgium	EUR (euro)
BG	Bulgaria	BGN (Bulgarian lev)
CZ	Czech Republic	CZK (Czech koruna)
DK	Denmark	DKK (Danish krone)
DE	Germany	EUR (euro)
EE	Estonia	EUR (euro)
IE	Ireland	EUR (euro)
GR	Greece	EUR (euro)
ES	Spain	EUR (euro)
FR	France	EUR (euro)
IT	Italy	EUR (euro)
HR	Croatia	HRK (Croatian kuna)
CY	Cyprus	EUR (euro)
LV	Latvia	EUR (euro)
LT	Lithuania	EUR (euro)
LU	Luxembourg	EUR (euro)
HU	Hungary	HUF (Hungarian forint)
MT	Malta	EUR (euro)
NL	Netherlands	EUR (euro)
AT	Austria	EUR (euro)
PL	Poland	PLN (Polish zloty)
PT	Portugal	EUR (euro)
RO	Romania	RON (New Romanian leu)
SI	Slovenia	EUR (euro)
SK	Slovakia	EUR (euro)
FI	Finland	EUR (euro)
SE	Sweden	SEK (Swedish krona)
UK	United Kingdom	GBP (Pound sterling)
JP	Japan	JPY (Japanese yen)
US	United States	USD (US dollar)

CONVENTIONS USED

M1	Notes and coins held by the public + sight deposits.
M2	M1 + deposits redeemable at notice of up to three months + deposits with an agreed maturity of up to two years.
M3	M2 + repos + shares in money market funds and money market instruments + debt securities issued with an agreed maturity of up to two years.
Q1, Q4	Calendar quarters.
H1, H2	Calendar half-years.
bn	Billions (10^9).
m	Millions.
bp	Basis points.
pp	Percentage points.
...	Not available.
—	Nil, non-existence of the event considered or insignificance of changes when expressed as rates of growth.
0.0	Less than half the final digit shown in the series.