1 OVERVIEW

1 Introduction

In 2014 the Spanish economy posted significant growth rates in output and employment that exceeded those in the euro area and confirmed the entrenchment of the recovery initiated the previous year following several years of prolonged recession. The recovery was underpinned by a notable improvement in certain external conditioning factors and by significant headway towards restoring macroeconomic equilibrium. In the second half of the year, it was also assisted by the additional expansionary boost of the fall in oil prices and the depreciation of the euro. However, the depth of the crisis in the previous years, which led certain structural fragilities of the Spanish economy to emerge, has left a weighty legacy in terms of debt and unemployment, the full re-absorption of which will require time and further efforts by economic policies to complete the adjustments undertaken and to strengthen the foundations of the recovery.

This chapter analyses the factors underpinning this recovery and addresses the challenges economic policies must meet for a new sustained growth path to take root. The rest of this Report analyses in depth some of the issues of particular relevance for the future growth of the Spanish economy, such as the role of the expansionary monetary policy measures, the importance of the reallocation of resources towards the most efficient firms and industries for sustaining growth, price- and cost-formation dynamics in a low-inflation environment and the contribution of the reactivation of credit in a manner consistent with the necessary ongoing deleveraging of the economy.

2 The firming of the recovery in 2014

The firming of the recovery in the Spanish economy in 2014 was in contrast to the loss of momentum seen in the world economy as a whole

The Spanish economy moved in 2014 on a trajectory marked by firming recovery. For the first time since the start of the crisis, GDP grew significantly over 2014 as a whole (1.4%) and ended the year posting an annual rate of increase of 2% (see Chart 1.1).

This progressive buoyancy of Spanish activity was in contrast, however, to the loss of momentum in the ongoing recovery of the global economy. Contrary to the expectations of most analysts at the start of the year, 2014 ended with the same annual rate of increase in GDP as in 2013 (3.3%). As the months unfolded, global growth forecasts were revised downwards and, at the time of this Report going to press, they point to rates of expansion in 2015 only slightly higher than those of the past two years. This trajectory shows that the positive impulses induced by the fall in energy prices and the easing of financial conditions are largely being offset by other, contrary signs linked probably to the weakness of growth potential in the medium term in extensive areas of the world economy and their contractionary effects on investment.

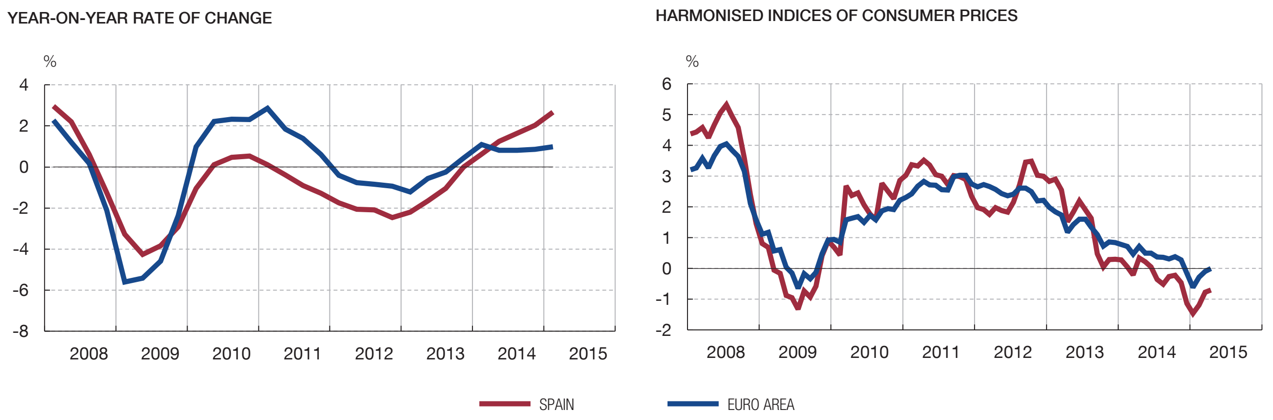
From a more disaggregated perspective, the gap between GDP growth in the emerging and in the advanced economies narrowed by almost 1 pp, largely as a result of the differential effect on both groups of countries of the decline in commodities prices. The heterogeneity of the behaviour in each of these blocks, however, remained notable.

The loss of momentum was particularly significant in the euro area during the central months of the year and this, combined with the persistence of excessively low inflation

Given its significance for the Spanish economy, the euro area's loss of buoyancy in the central months of the year proved particularly important, thwarting the expectations generated at the start of 2014. GDP for the area as a whole increased by only 0.1 pp in Q2 and by scarcely 0.2 pp in Q3. Unlike in other years, the weakness affected on this occasion not only the most vulnerable euro area economies but also others such as Germany and France. As regards prices, the inflation rate held on a declining trajectory, posting figures

GDP AND INFLATION IN SPAIN AND IN THE EURO AREA (a)

CHART 1



SOURCES: ECB, INE and Banco de España.

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

rates, led to a further deepening of the expansionary stance of the ECB's monetary policy

that would ultimately turn negative at the end of the year and in the opening months of 2015.

In combination, inflation rates far removed from the medium-term objective of 2% and the marked weakness of demand shaped a scenario posing risks to the anchoring of price expectations, thereby obliging the ECB to take fresh steps towards deepening the expansionary stance of its monetary policy. This movement diverged clearly from the course followed by other central banks such as the US Federal Reserve and the Bank of England. The ECB made additional cuts to its official interest rates, it embarked on new measures to boost the growth of credit to the private sector and, finally, it launched in March this year an extended programme of public and private asset purchases, scheduled to run until September 2016 at least and, in any case, until it sees a sustained adjustment in the path of inflation consistent with its price stability objective.

Combined with lower energy costs, the depreciation of the euro and the more neutral fiscal policy stance in the area, the new monetary policy impulses and enhanced transmission mechanisms have led a good number of analysts to revise upwards the growth outlook for the area this year and next, thereby consolidating the positive signs recorded in the final stretch of 2014, which enabled the quarter-on-quarter growth rate of GDP to rise to 0.3% in the final quarter.

GDP in Spain quickened over the course of the year as the recovery in domestic demand strengthened and job creation stepped up

In Spain, GDP moved on a markedly accelerating path during the year. The buoyancy of the components of private demand (which contributed 2.2 pp to GDP growth) confirmed the capacity of the economy's domestic expenditure to sustain and entrench the recovery, in contrast to the weakening of net external demand, which made a negative contribution to growth. Ongoing job creation, reflected in annual average growth of 1.2% in numbers employed – the first positive rate since 2008 – and a year-on-year rate of 2.4% at year-end, gathered notable momentum over the course of 2014. Overall, both domestic demand and employment expanded more than expected in 2014, and the re-balancing of domestic and external demand also came about earlier than anticipated (see Table 1.1 and Chart 1.2).

The change in sign of the contributions of domestic spending and of external demand to the increase in GDP marked a drastic turnaround on the patterns prevailing in the 2008-2013 period, with continuous declines in national demand (for a cumulative amount of

MAIN INDICATORS OF THE SPANISH ECONOMY (a)

TABLE 1.1

	2009	2010	2011	2012	2013	2014
Demand and output (b)						
GDP	-3.6	0.0	-0.6	-2.1	-1.2	1.4
Private consumption	-3.6	0.3	-2.0	-2.9	-2.3	2.4
Government consumption	4.1	1.5	-0.3	-3.7	-2.9	0.1
Gross capital formation	-17.2	-3.8	-6.4	-8.3	-3.7	4.2
Equipment investment	-23.5	5.1	0.8	-9.0	5.6	12.2
Construction investment	-16.5	-10.1	-10.6	-9.3	-9.2	-1.5
Housing	-20.6	-11.6	-12.8	-9.0	-7.6	-1.8
Other construction	-11.8	-8.5	-8.6	-9.6	-10.5	-1.3
Exports of goods and services	-11.0	9.4	7.4	1.2	4.3	4.2
Imports of goods and services	-18.3	6.9	-0.8	-6.3	-0.5	7.6
Contribution of national demand to GDP growth	-6.4	-0.5	-2.7	-4.3	-2.7	2.2
Contribution of net external demand to GDP growth	2.8	0.5	2.1	2.2	1.4	-0.8
Employment, wages, costs and prices (c)						
Total employment	-6.1	-2.7	-2.5	-4.4	-3.3	1.2
Employment rate (d)	60.8	59.7	58.8	56.5	55.6	56.8
Unemployment rate	17.9	19.9	21.4	24.8	26.1	24.4
Compensation per employee	4.4	1.1	0.9	-0.6	1.7	-0.2
Apparent labour productivity	2.7	2.7	2.0	2.4	2.1	0.2
Unit labour costs	1.6	-1.6	-1.1	-3.0	-0.4	-0.4
GDP deflator	0.3	0.2	0.1	0.2	0.7	-0.5
Consumer price index (12-month % change)	0.8	3.0	2.4	2.9	0.3	-1.0
Consumer price index (annual average)	-0.3	1.8	3.2	2.4	1.4	-0.2
Consumer price differential with the euro area (HICP)	-0.5	0.4	0.3	-0.1	0.2	-0.6
Net lending (+) or net borrowing (–) and financial balance (e)						
Resident sectors: domestic net lending (+) or net borrowing (–)	-4.0	-3.4	-2.9	0.1	2.1	1.0
General government	-11.0	-9.4	-9.4	-10.3	-6.8	-5.8
General government (excluding aid to financial institutions)	-11.0	-9.3	-8.9	-6.6	-6.3	-5.7
Households and NPISHs	4.2	1.8	3.0	2.3	3.6	3.2
Companies	2.7	4.2	3.6	8.1	5.3	3.7
Financial institutions	1.8	1.0	2.0	6.7	2.1	2.6
Non-financial corporations	0.9	3.1	1.6	1.4	3.2	1.1
Net international investment position	—	—	—	-90.0	-93.8	-93.5
General government gross debt	52.7	60.1	69.2	84.4	92.1	97.7
Monetary and financial indicators (f)						
ECB minimum bid rate on MROs	1.2	1.0	1.3	0.9	0.5	0.2
Ten-year government bond yield	4.0	4.2	5.4	5.8	4.6	2.7
Synthetic bank lending rate	3.8	3.3	4.1	4.1	4.1	3.9
Madrid Stock Exchange General Index (Dec 1985 = 100)	1,042.4	1,076.5	971.8	767.5	879.8	1,066.6
Dollar/euro exchange rate	1.4	1.3	1.4	1.3	1.3	1.3
Nominal effective exchange rate vis-à-vis developed countries (g)	103.5	101.9	101.8	100.4	101.7	101.7
Real effective exchange rate vis-à-vis developed countries (h)	119.2	116.1	113.8	106.7	106.2	104.4
Real effective exchange rate vis-à-vis the euro area (h)	111.8	110.4	108.4	103.1	99.9	99.9
Households: total financing	-0.3	0.2	-2.4	-3.8	-5.1	-3.7
Non-financial corporations: total financing	-1.4	0.7	-2.0	-6.4	-6.6	-4.4

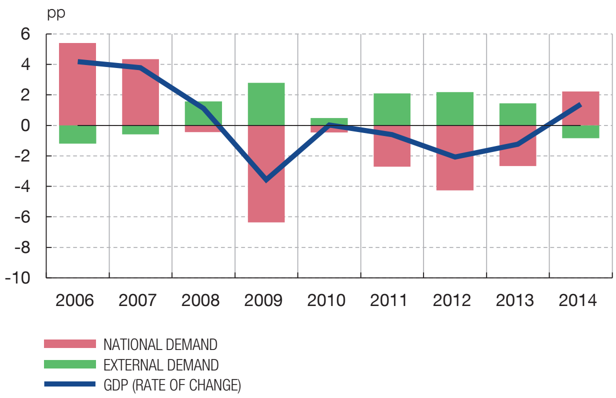
SOURCES: INE, IGAE, AMECO and Banco de España.

a Spanish National Accounts data, base year 2010.
b Volume indices. Rate of change.
c Rate of change, except the unemployment rate, which is a level.
d Employment rate (16-64).
e Levels as a percentage of GDP.
f Annual average levels for the Madrid Stock Exchange General Index, interest rates and exchange rates, and rates of change for finanancial assets and liabilities
g 1999 Q1 = 100.
h 1999 Q1 = 100. Measured with unit labour costs.

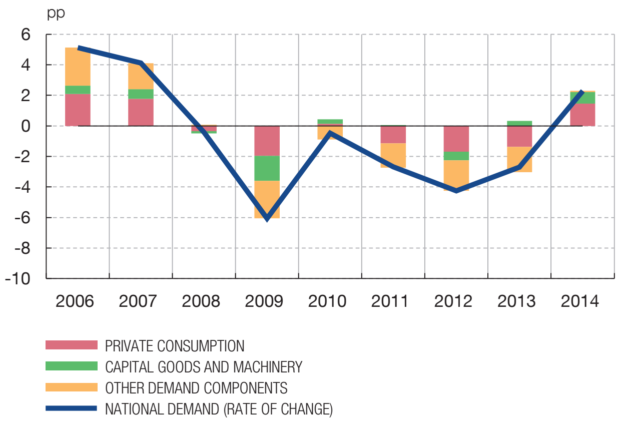
SPAIN: GDP AND NATIONAL DEMAND. CONTRIBUTIONS TO GROWTH
FIXED CAPITAL FORMATION

CHART 1.2

GDP, NATIONAL DEMAND AND EXTERNAL DEMAND



NATIONAL DEMAND AND ITS COMPONENTS



SOURCES: INE and Banco de España.

16 pp) and systematically positive contributions by the external sector (for up to a total amount of 9 pp), which had been pivotal to containing contractionary trends and to the start of the recovery.

The improvement in financing conditions and in employment were determining factors in the intensity of the recovery, as was too the additional expansionary boost provided by the fall in oil prices

Among the growth-boosting factors, mention should be made of the reduction in the degree of financial fragmentation in the euro area and the progressive normalisation of financial conditions in Spain. Favourable labour market trends also played a key role in reactivating demand as they contributed to sustaining household disposable income and to improving confidence. The marked decline in oil prices from June entailed a further expansionary impulse since it increased household purchasing power and lowered firms' production costs. Finally, the depreciation of the euro had a galvanising effect on Spanish sales outside the euro area which added to the indirect impact on exports of the recovery of the area in the final stretch of the year. All these factors have continued supporting domestic spending and activity in 2015 to date.

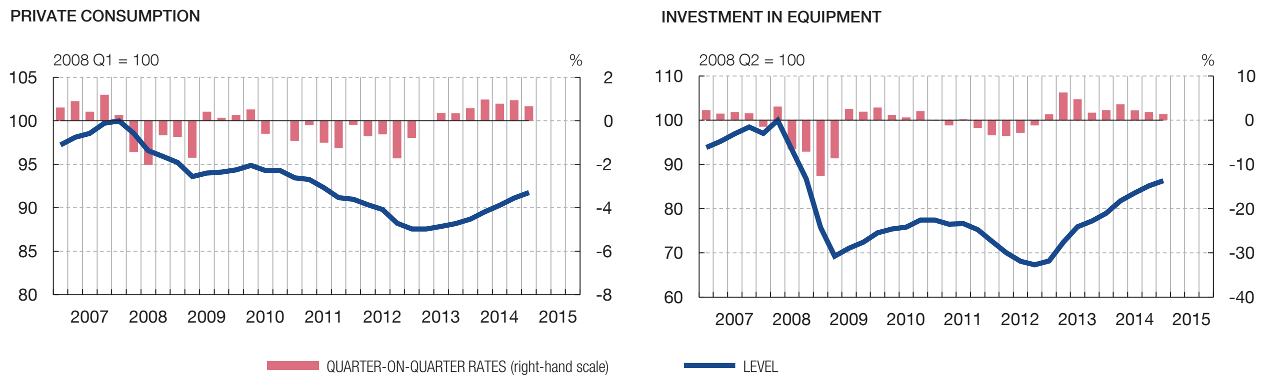
The increase in domestic demand was underpinned by the pick-up in household consumption and in business investment

Among the domestic demand components, there was a notable recovery in household consumption, which grew by close to 2.5% in 2014 as a whole, compared with a 2.3% decline the previous year. Household spending was assisted by an improvement in its main determinants. Real disposable income increased moderately, as a result above all of the rise in labour income, boosted by the buoyancy of employment and, in the final stretch of the year, the improvement in purchasing power induced by lower oil prices. Financial wealth gradually rose and, for the first time in six years, real estate assets ceased to lose value as the year unfolded. As has been the case in recent years, consumption outpaced disposable income, meaning the saving rate continued on its declining trajectory, to stand at 9.8%, below its average for the past 15 years (10.6%).

To properly understand the substantial dynamism of household spending in 2014, regard must be had, among other factors, to the low level of consumption at the start of the recovery (see Chart 1.3), which in per capita terms stood at a level equivalent to that of 2001. This points to the existence of pent-up demand for certain goods and services (in particular durables and non-staple goods), that would only begin to be met further to the improvement in labour market prospects and the reduction in uncertainty. The aggregate behaviour of consumption is the outcome of relatively differentiated patterns having to do with income levels, labour market status or the level of household debt. Job creation must have particularly

PRIVATE CONSUMPTION AND INVESTMENT IN EQUIPMENT

CHART 1.3



SOURCE: INE.

boosted consumption by a segment of households whose labour market situation has improved (after exiting unemployment) and which are characterised by a high propensity to consume. This latter aspect also appears significant when it comes to understanding the sizeable consumption response by the most indebted households in light of increases in their disposable income, as illustrated by the evidence analysed in Box 1.1.

Business investment in 2014 continued on the path of recovery initiated in 2013, which translated into annual average growth of 12% and a positive contribution by this component to GDP growth for the second year running. The brighter economic outlook spurred firms' spending plans, in a financial setting in which the generation of own funds during the crisis would have provided a buffer with which to negotiate the potential financial constraints in place and in which the thrust of domestic consumption would have added to the buoyancy shown by exports in the early stages of the recovery, reducing the possible slack in capacity utilisation. In comparative terms, the recovery in business investment in Spain is proving sharper than that in other European countries.

The contribution of net external demand to output was negative owing to the buoyancy of goods and services imports. One year more, exports increased their market share

Foreign trade flows exhibited sizeable changes in 2014, prompted by the loss of momentum of export markets, more markedly so in the central months of the year, and by the acceleration in imports, as the pick-up in domestic demand took root. As a result, net external demand subtracted 0.8 pp from output and checked the improvement in the nation's net lending, which stood at 1% of GDP (2.1% of GDP in 2013).

Goods exports increased by 4.5% in 2014 (5.7% in 2013), in a setting in which our export markets grew by around 2.5%; accordingly, Spain's export shares increased, albeit on a lesser scale than in previous years. The improvement in relative costs and the depreciation of the euro had a positive effect on the price-competitiveness of exports and were also felt in the greater buoyancy of sales abroad in the final stretch of the year. It was, once again, a record year for tourism.

The growth of goods imports was very high in 2014 (7.8%, against 0.4% the previous year). The recovery in the domestic demand components with a higher import content (consumption and investment) and the very structure of Spanish exports, with a growing weight of activities integrated into global production chains, boosted the notable increase in goods purchases from the rest of the world. Despite the possible temporary component linked to pent-up demand following the long recession, the vigour of imports in 2014 is indicative of the Spanish economy's high dependence on imported goods, chiefly on those with highest value added.

The inflation rate moved on a markedly declining trajectory. The containment of prices was extensive to all CPI components against a background marked by the absence of domestic inflationary pressures

The rate of change of consumer prices continued on the declining path initiated in the second half of 2013 (once the effects of the VAT increase and other measures adopted in 2012, such as the increase in administered prices or charges, were absorbed). This pattern was largely influenced by the trajectory of the most volatile components, which underwent year-to-year oscillations that were particularly marked in the case of fuel prices. However, in a situation characterised by the absence of domestic inflationary pressures, the containment of prices was extensive to all CPI components. Attesting to this was core inflation, which posted zero rates for practically the entire year. The change in the pattern of behaviour of services and processed food prices is perhaps the most characteristic feature of the disinflationary process the Spanish economy is undergoing. The slowdown in inflation intensified from the second half of the year, further to the decline in oil prices, which placed the CPI at negative year-on-year rates as from July, and consumer prices have continued in negative territory in the opening months of 2015. The CPI declined by 0.2% over the year as a whole (-1% year-on-year in December).

This is the second bout of negative inflation since the euro area came into being, following that recorded in 2009 and, as was then the case, the decline in oil prices has played a leading role. On this occasion, however, there have been elements of greater persistence as part of a tendency towards lower inflation that is affecting most of the CPI components and having a greater bearing on medium-term inflation expectations. The fall in prices in Spain is proving more marked than in the euro area, whereby the inflation differential has remained negative since September 2013, indicating improved competitiveness.

To date, the flatness of prices is proving compatible with a strong recovery in private consumption. It is important, however, to determine the macroeconomic consequences of a persistent reduction in inflation. Chapter 4 of the *Annual Report* offers a detailed analysis of the disinflationary process of the Spanish economy, its causes and its macroeconomic implications.

3 The factors underpinning growth

The firming of the recovery in 2014 was underpinned by the progress made in restoring the Spanish economy's macroeconomic equilibria, linked to the fiscal consolidation, restructuring and reform pursued in recent years, but also to other, more temporary factors such as the decline in oil prices and the depreciation of the euro. From a broader standpoint, however, the role played by the strengthening of the euro area should be underscored, as this prompted a substantial improvement in Spanish household, corporate and general government financing and a recovery in investor confidence about the future of the euro and our economy.

3.1 THE STRENGTHENING OF THE EURO AREA

Last year the euro area took significant steps in evolving towards a genuine economic and monetary union. This translated into substantial progress in the ongoing reintegration of the area's financial markets and, by extension, had significant beneficial effects on the financing conditions of the Spanish financial, private and public sectors.

The creation of the Single Supervisory Mechanism marked significant progress by the euro area towards a genuine economic and monetary union

The Single Supervisory Mechanism (SSM) formally commenced operating in November, with the ECB, assisted by the national competent authorities, assuming micro-prudential supervisory functions in the area. The SSM is a basic – but not the only – pillar of the Banking Union. In 2014 and in 2015 to date, progress has also been made in relation to the Single Resolution Mechanism (SRM). The SRM is entrusted with ensuring that when a bank in the area enters into difficulties requiring its resolution, this is carried out efficiently and irrespective of the bank's geographical location. In turn, the SRM comprises two parts: the Single Resolution Board, which heads an integrated system of national resolution authorities, and a Single Resolution Fund, under the control of the Board. Lastly, the Banking Union also resides on the legal harmonisation of the euro area's Deposit Guarantee Schemes, which was implemented by means of the Directive on Deposit Guarantee Schemes agreed upon in late 2013.

The results of the Comprehensive Assessment dispelled the uncertainties weighing on part of the sector

It should likewise be recalled that prior to the start-up of the SSM and as part of the process of creating the Banking Union, the ECB, assisted by the national supervisory authorities, conducted a comprehensive assessment of the significant credit institutions that would from November be under their supervision. A total of 130 institutions were assessed, jointly accounting for 82% of the euro area's banking assets. The results were made public in October and contributed to increasing investor confidence in European credit institutions and to normalising the situation on the area's financial markets, helping bring about the reversal of the fragmentation caused by the crisis. Spanish banks comfortably passed the test, which contributed to dispelling uncertainty and reducing their financing costs (and, as a result, those of a substantial part of our economy).

The expansionary measures adopted by the ECB also contributed to reducing financial costs in the area and in Spain, and to the gradual normalisation of the situation on European financial markets

Financing conditions in the Spanish economy also benefited from the new monetary policy measures adopted by the ECB both in 2014 and in early 2015. Among other decisions, the fresh cuts to official rates and the new credit-linked lending facility and securities purchase programmes contributed not only to further reducing the level and slope of the yield curve in the area but also provided for a more uniform transmission of monetary impulses and, consequently, a reduction in the dispersion of financial costs among the different member countries. As explained in detail in Chapter 2 of the Spanish original of the *Annual Report*, this process was given particularly significant momentum at the start of the year when the ECB Governing Council announced that it would launch an extended programme of private and government securities purchases from March.

All these developments affected to a greater extent financing conditions in economies which, like Spain's, had undergone with greater intensity the adverse effects of the euro crisis

Jointly considered, all these factors contributed to substantially reducing the Spanish economy's financing costs, which have now drawn closer to a greater extent to levels more in keeping with the strongly expansionary stance of the single monetary policy (see Chart 1.4).

Spanish 10-year government bond yields, which at the height of the euro crisis exceeded 7.5%, stood below 1.8% at the time of this Report going to press. The spread over the related German benchmark, which was over 600 bp in the summer of 2012, currently stands at 130 bp. And in terms of volumes, the proportion of Spanish public debt held by non-residents had increased to similar levels to those recorded in 2010.

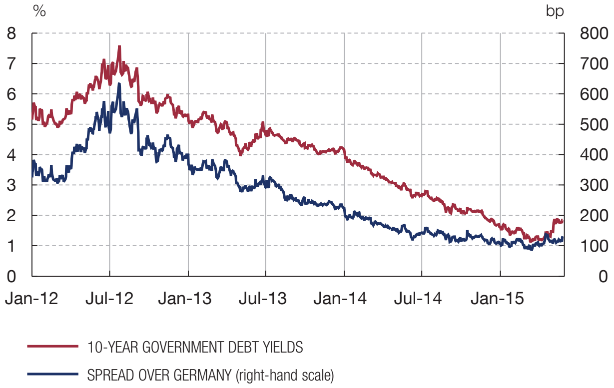
The improvement has also been notable in the financing costs of credit institutions. Credit default swaps, yields on covered bonds and asset-backed bonds, and the cost of deposits stood, at the cut-off date for this Report, at the levels corresponding to the rest of the euro area, after having undergone significant additional cuts over the course of 2014 and to date in 2015.

This contraction in banks' financing costs was ultimately passed through, albeit with some delay, to interest rates on bank loans, which also underwent substantial cuts which have translated into a closer proximity to lending costs in other euro area countries. The process has, however, unevenly affected the different types of loans. This has been most evident in the case of consumer loans and loans for purposes other than house purchase extended to households, and in loans to firms for amounts less than €1 million, under which heading those granted to SMEs are mainly included. In the case of loans for house purchase and to

FINANCING CONDITIONS IN THE SPANISH ECONOMY

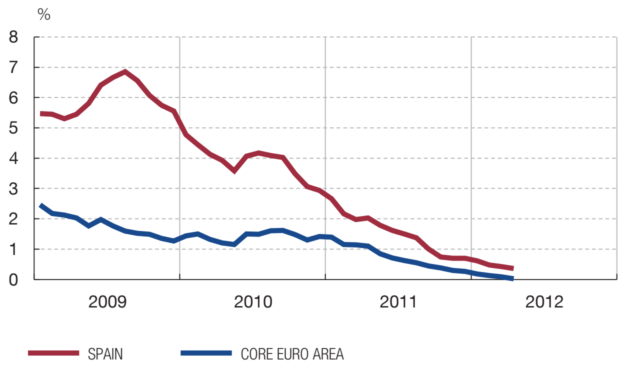
CHART 1.4

TEN-YEAR GOVERNMENT DEBT YIELDS AND SPREAD OVER GERMANY

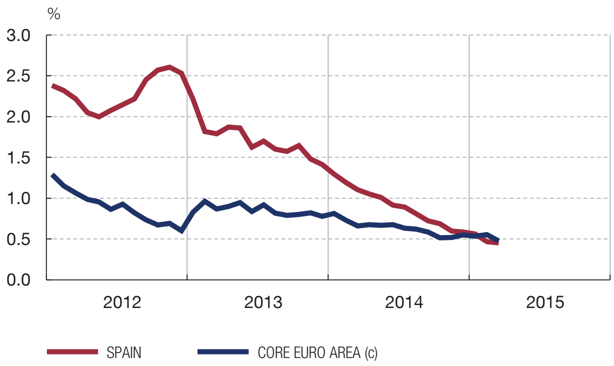


5-YEAR NON-FINANCIAL CORPORATIONS' CDS PREMIUM (a)

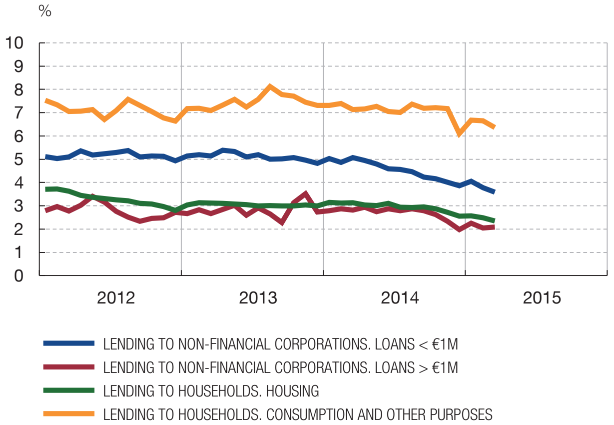
5- TO 7-YEAR YIELDS ON COVERED BONDS (b)



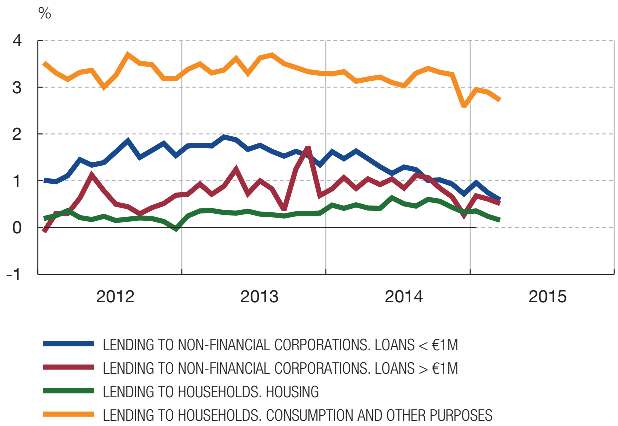
BANK INTEREST RATES: FIXED-TERM DEPOSITS



BANK INTEREST RATES: SPAIN



BANK INTEREST RATES. SPAIN -CORE EURO AREA (c)



SOURCES: Datastream, Reuters, ECB and Banco de España.

- **a** Series constructed by weighting the CDS premia of the corporations included in the iTraxx Europe index and domiciled in each country on the basis of their stock market capitalisation as at 31 December the previous year. The core euro area series aggregates the CDS of Germany, Austria, the Netherlands, Finland and Luxembourg, weighted by GDP at current prices for the same year. In 2015, 2014 GDP has been used.
- **b** Series constructed for each country as the average of the yields on the covered bonds included in J.P. Morgan's Maggie index. The core euro area series aggregates the covered bonds of Germany, Austria, the Netherlands, Finland and Luxembourg, weighted by GDP at current prices for the same year. In 2015, 2014 GDP has been used.
- **c** Defined as the aggregate weighted by the GDP at current prices for the same year of Germany, Austria, the Netherlands, Finland and Luxembourg. In 2015, 2014 GDP has been used. To aggregate the different categories by maturity within each country, the same weights (turnover) are used as in Spain, meaning that the comparison is not affected by differences between these weights from one area to another.

companies for amounts over €1 million, the decline has been on a lesser scale (around 50 bp since mid-2013, compared with approximately 110 bp in the other two cases). Regarding this latter type of loan, however, it should be borne in mind that it is dominated by the behaviour of large corporations, which during the crisis largely replaced this source of financing by directly tapping the markets. In this respect, it is important to note that the credit default swaps of this type of company, which are a relevant indicator of the changes in their direct financing costs on the markets, have also shrunk significantly since mid-2013.

Notwithstanding, the distance between financing costs in Spain and in other euro area countries remains significant in some segments, most particularly in those in which borrower risks are more marked (consumer loans and loans to firms for amounts less than €1 million).

3.2 PROGRESS IN RESTORING MACROECONOMIC EQUILIBRIUM

The improvement in financing conditions has been significantly buoyed by the progress made in the ongoing adjustment and domestic reforms that have placed the Spanish economy in a healthier and more competitive position, which is paving the way for the pick-up in activity to feed through forcefully to job creation and the take-off of investment.

One of the key features in 2014 was the change in employment dynamics following five years of consecutive declines. The recovery was across all sectors and more intense in temporary employment

Employment growth quickened progressively during the year, to the point of outpacing the rate of increase of GDP in Q4. Actual productivity slowed markedly, increasing by scarcely 0.2% after having posted an average rate of change of 2.4% in the five preceding years (see Chart 1.5). The behaviour of employment shows, among other things, the effects of the legislative changes introduced since 2012, which may be said to have contributed to smoothing the adaptation of firms' working conditions to their cyclical and competitive situation. Labour flows in 2014 (number of transitions from employment to unemployment, or vice versa) were indeed along these lines, showing a progressive easing in the pace of job destruction, especially of permanent employment, and some pick-up in exit flows from unemployment, more markedly so for workers who had been jobless for less time and with higher levels of educational attainment.

The recovery in temporary employment gathered steam (5.3% at the end of the year) although permanent employment also showed a progressive improvement over the course of the year (2% year-on-year in Q4). However, this latter result should be seen as still insufficient in light of the numerous measures taken in the recent past to encourage permanent hiring, including most notably the reduction in 2014 in the employer's contribution in respect of common contingencies for new hires of this type. Into 2015, this measure has been replaced by a new scheme that will direct incentives towards the lower part of the wage distribution, where the least employable groups and those with the highest unemployment rates are concentrated.

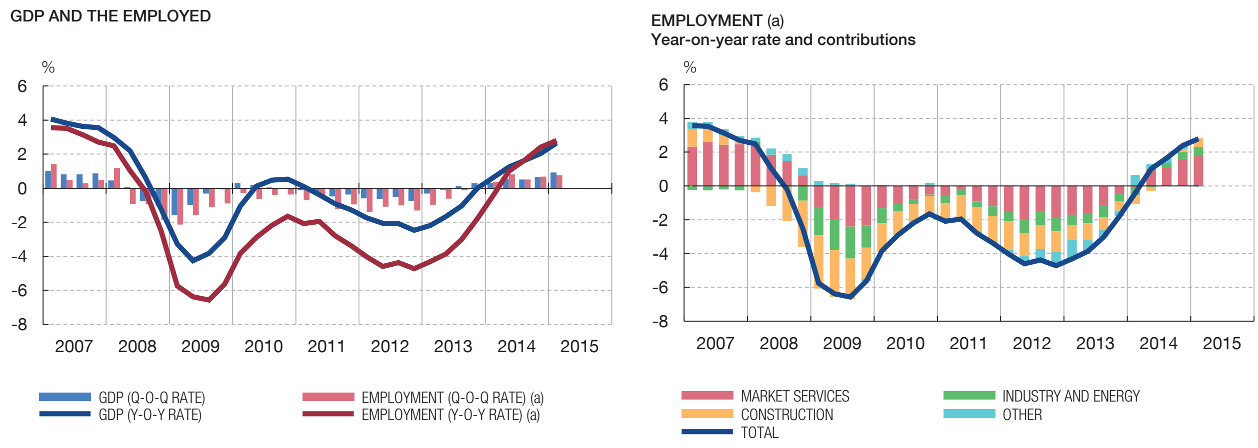
The labour force declined in 2014 at a similar rate to that observed the previous year (-1%). Contributing to this was both the fall in the working-age population concentrated among foreign nationals, and the decline in the participation rate, more marked among the immigrant population. The rate of decline of labour supply eased over the course of the year, virtually stabilising in the final quarter.

The unemployment rate declined but continues to be very high for youths and the less skilled, who face greater difficulties in re-joining the labour market

Against the background of the fall in labour supply in 2014, the dynamism of employment was conducive to a significant reduction in the number of unemployed (8% for the year on average, taking the jobless total to 5,485,000 people), and the unemployment rate fell by 2 pp during 2014 to 23.7% of the labour force, more than 15 pp above its 2008 level. The unemployment rates for the young and the less skilled remained at very high levels (39.7% and 41.2%, respectively) and, in this latter case, it scarcely declined in 2014. Long-term

GDP AND EMPLOYMENT

CHART 1.5



SOURCES: INE and Banco de España.

a FTEs in Quarterlty National Accounts.

unemployment rose to a level close to 62.8%, although it moved on a declining trend in the second half of the year.

The competitive adjustment of the economy continued as a result of the internal devaluation process…

Labour costs continued to move on the moderate path of recent years. Compensation per employee fell back slightly (-0.2% in annual average terms) as a result of its stabilisation in the market economy and of a small decline in the non-market economy. Wage increases agreed under collective bargaining were in a very similar vein to the preceding year (0.6 %). In addition, the temporary modification of working conditions and the activation of collective bargaining opt-out clauses, along with the composition effects arising from the wage-level differences between employment entry and exit flows, also contributed to turning labour costs downwards.

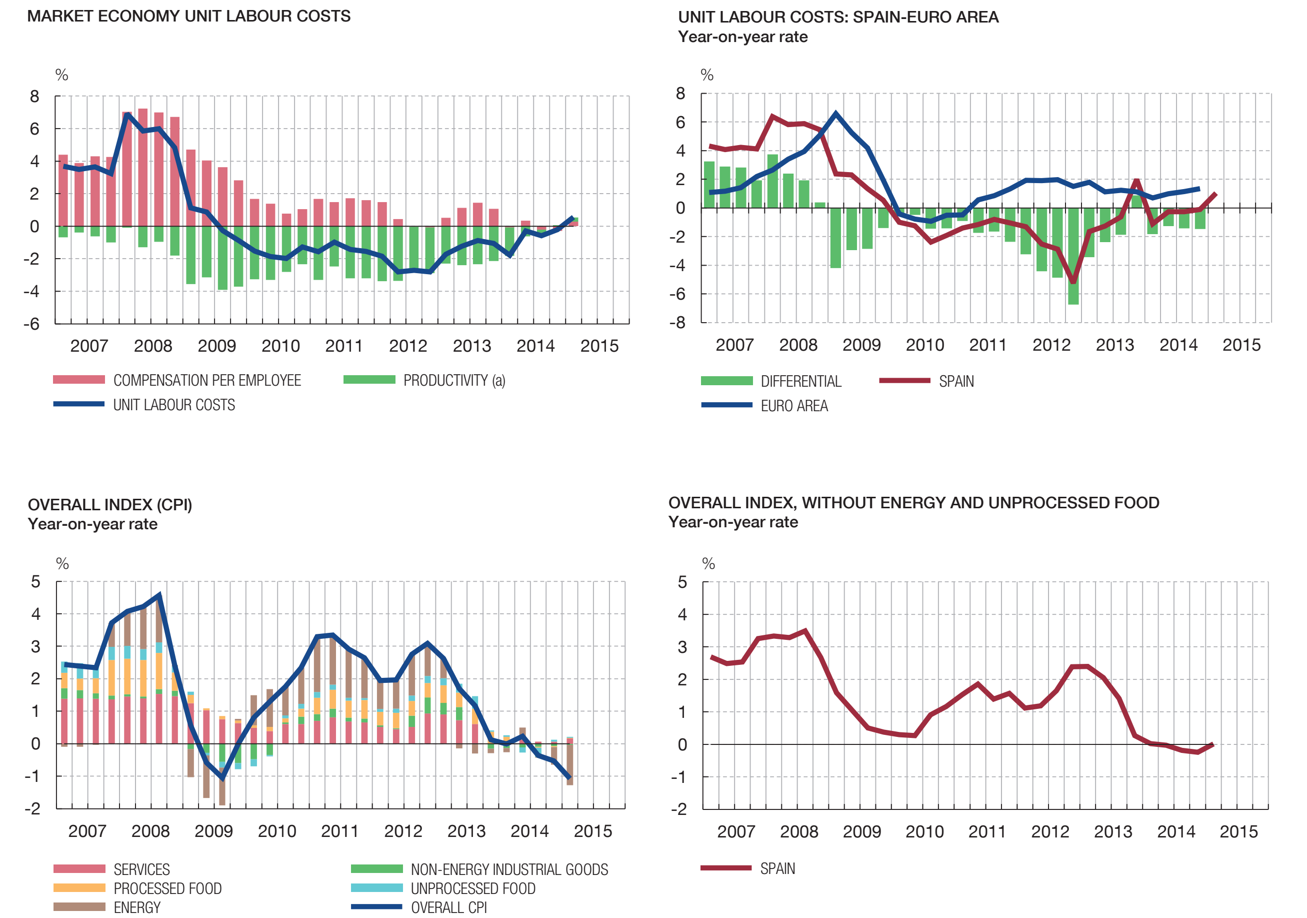
In recent years, the easing in labour costs has been somewhat greater than can be explained by their determinants, which might be attributable to the effect of the aforementioned legislative changes, in particular those that have permitted a greater response by wages to the cyclical situation. But a growing proportion of negotiation outcomes can be seen to set wages at the minimum levels of collective bargaining agreements and a high concentration of wage rates at around 0% in a context of negative inflation for most of the year. Wage increases under firm-level agreements were somewhat smaller than sector-wide agreements, but continue to affect a very small percentage of workers, meaning that the room for a greater decentralisation of collective bargaining remains very extensive.

As indicated in Chapter 4 in this Report, the regulatory changes made in the labour market may be conducive to the adaptation by the Spanish economy to the patterns of stability in the euro area, enhancing its responsiveness to shocks and cyclical oscillations. A greater degree of flexibility in wage formation allows adjustments to operate through relative prices, reducing the impact of wages on economic activity and employment. From this standpoint, it is important to avoid a return to now-superseded wage indexation practices.

Unit labour costs fell for the fifth year running, causing a further adjustment of relative costs with respect to the euro area (see Chart 1.6). Nonetheless, the intensity of the adjustment is slackening, partly as a result of the lessening rate of increase of productivity.

LABOUR COSTS AND INFLATION

CHART 1.6



SOURCES: Eurostat and Banco de España.

The improvement in competitiveness spread to a broad range of price indices. Overall, the competitive adjustment of the Spanish economy continued in 2014 via the internal devaluation process.

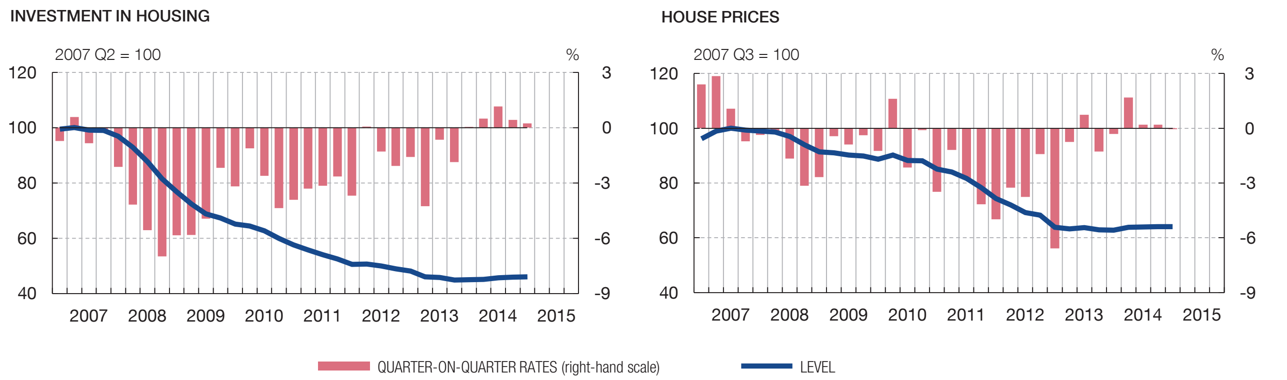
... although maintaining external equilibrium calls for further and deeper gains in competitiveness

Hereafter, the necessary continuity in improving competitiveness will face a somewhat less propitious environment, given the widespread low inflation in the euro area, and potential obstacles as a result of the nominal rigidity of wages and, above all, the low productivity growth envisaged, given the habitual countercyclical behaviour of this variable.

The correction of the external imbalance over recent years has acquired great intensity, as the generation of external surpluses in the past three years has shown. In 2014 the nation's net lending was on a slightly lower scale than that of 2013, largely as a consequence of the rise in imports (see Box 1.2). Despite the improved balance of flows vis-à-vis the external sector, headway in reducing the International Investment Position (IIP) is proving to be very gradual, standing at 93.5% of GDP in 2014 (93.8% the previous year), which illustrates the need for perseverance in attaining external surpluses over a sufficiently prolonged period. As analysed in Box 1.2, the high import content of final demand, excessive energy dependence on the rest of the world and sizeable interest payments – all of which should gradually ease – require a further drive in terms of exports, which should continue on the path of gaining market share, through additional price-competitiveness and quality improvements.

INVESTMENT AND HOUSE PRICES

CHART 1.7



SOURCE: INE.

The residential sector stabilised following a large-scale adjustment, although its recovery is not free from uncertainty

Following six years of contraction, activity in the residential sector evidenced small positive changes from the onset of 2014 Q2. Despite this turnaround, the contribution of housing investment to activity in 2014 was slightly negative (0.1 pp), far removed from the level of subtraction it exerted during the crisis (1 pp on average over the six previous years). Both new building permits, on the supply side, and housing transactions, on the demand side, rose slightly, albeit from very low levels. The absorption of the high stock of unsold new houses generated following the collapse of the sector continued at a slow tempo owing to the small number of new-house transactions and showed sizeable differences at the regional level. The biggest supply-demand mismatches are concentrated in the coastal areas, where the biggest overhang built up during the expansion.

The fall in house prices bottomed out in 2014 Q1 according to the information from the INE index, increasing by 0.3% in annual average terms following six years of declines and ending the year with a positive year-on-year rate of 1.8%. House prices also behaved unevenly across the different geographical areas, although at the close of the year practically all the Spanish regions were posting house price rises.

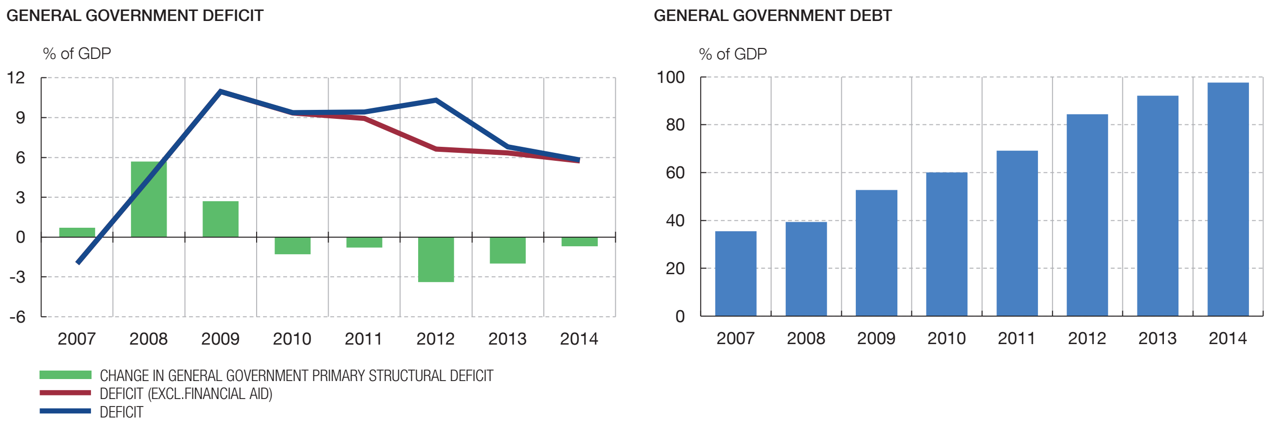
Developments in 2014 indicate that the severe adjustment of the residential sector appears to have culminated in a drastic reduction in its size and a large-scale correction of prices. The weight in GDP of residential activity shrank by 68% from its last cyclical peak to 4% of GDP in 2014, and real estate prices fell by 36% in nominal terms (44% in real terms) from their peak, thereby correcting a high proportion of the increase witnessed during the expansionary phase (see Chart 1.7). With a view to the future, the outlook for recovery in the sector is not free from uncertainty. On one hand, it is difficult to determine to what extent the change in trend observed will be reflected in a sustained recovery in activity, given the high volume of unsold houses and their particular geographical distribution. On the other, into the medium term, there are doubts over the incidence of demographic developments on the potential demand for housing.

The general government deficit target was met, while fiscal policy began to be a less prominent determinant of macroeconomic developments

The general government deficit fell in 2014 to 5.8% of GDP (5.7% once the impact of the assistance to financial institutions is excluded), attaining the target set for this year by the European Council (5.8% of GDP); however, this final figure was somewhat higher than that set by the Government in the April 2014 Updated Stability Programme. The fiscal policy stance (approximated by the change in the primary structural balance) was moderately contractionary, in marked contrast to the strongly restrictive stance of recent years (see Chart 1.8). In turn, meeting the deficit target for the third year running

GENERAL GOVERNMENT DEFICIT AND DEBT

CHART 1.8



SOURCE: IGAE.

contributed to improving macroeconomic agents' confidence in the sustainability of public finances and, thereby, to lessening uncertainty over the overall performance of the Spanish economy.

The reduction in the deficit came about as the result of similar-sized contributions by public revenue, whose ratio relative to GDP increased by 0.3 pp to 37.8% of GDP, and by public spending, which fell by a similar amount, to 43.5% of GDP. The increase in revenue gathered steam during the year, in step with the cyclical improvements and the change in composition of GDP, shifting from external demand towards domestic demand, which is conducive to a higher indirect tax take. In addition, growing labour market buoyancy boosted the bases of the taxes linked to employment income (personal income tax and social security contributions).

The decline in the public spending ratio was due to the adjustment of primary spending, based on the reduction of the weight of government consumption and of welfare benefits (owing to the decline in unemployment), and of public investment, which contracted moderately from already very low levels. The rate of increase of interest payments slackened as these began to reflect the significant decline in the cost of financing for the Treasury over the course of the year, meaning they maintained a similar level to that of the previous year (3.3% of GDP) despite the increase recorded in public indebtedness.

Measures taken in relation to payments to general government suppliers have helped normalise financial relations with the private sector

The latest payments under the Supplier Payment Plan were made in February last year, but a new set of funds intended chiefly for payments to regional and local government suppliers has been launched. All these initiatives have given rise to an increase in regional and local governments' debt with the State and, in parallel, a reduction in private-sector debt, and they should be accompanied by a demand for strict compliance with the adjustment plans upon which these extraordinary financing mechanisms are conditional.

In the short and medium term, perseverance with the fiscal consolidation strategy is unavoidable given the challenges posed by the stabilisation and subsequent reduction in the public debt ratio

The public debt/GDP ratio increased by around 3 pp in 2014 to 97.7% of GDP, in line with the official target. The increase in debt was chiefly the outcome of the still-high primary deficit. In 2015 debt will continue rising, according to official plans, up to 98.9% of GDP, beginning to fall timidly thereafter in 2016. The challenges posed by such a high level of public debt for the economy as a whole, even in a process of gradual debt reduction in the medium term, should not be minimised.

Private-sector deleveraging advanced significantly. Although the contraction in lending remained the driving force of the process, this eased substantially in 2014

Spanish household and corporate debt fell once more to levels of 71% and 92% of GDP, respectively, at the close of the year. The related gaps between these ratios and those in the euro area as a whole narrowed to 10 pp and 12 pp, namely one-half and one-third of the figures recorded in 2010, when Spanish private-sector debt reached its relative peak.

Real GDP growth contributed to the reduction in these ratios but inflation developments, which up to this year had also helped reduce them (albeit moderately), had the opposite effect. In any event, the driving force behind private-sector deleveraging was once more the contraction in bank lending. Yet it should be stressed that last year, and for the first time since this necessary correction process began, the rate of decline of bank loans to households and firms eased significantly. Additionally, from a more disaggregated perspective, there were once more signs pointing to a reallocation of new lending flows to firms in a more favourable economic and financial situation. Thus, taking both the aggregate and disaggregated perspectives together, the trend of credit over the course of last year is consistent with a trajectory of progressive normalisation, whose consequences for the financing of the economic recovery are analysed in detail in Chapter 5 of the original Spanish version of this Report.

The results of the Comprehensive Assessment attested to the effectiveness of the clean-up, restructuring and recapitalisation of the banking system

The Comprehensive Assessment undertaken as part of the groundwork for the launch of the SSM revealed, first, that Spanish banking assets were fairly valued, since the revisions required affected only 0.2% of their total risk-weighted assets, the lowest percentage in the whole of the euro area. And further, it was evident that Spanish banks had the required capital to overcome a potential extremely adverse macroeconomic scenario, since the stress tests performed did not detect capital shortfalls for any of them.

The process of adjustment of the banks that received public aid advanced as scheduled, whereby at the end of 2014 virtually the entire projected reduction in terms of assets, number of offices and employees have been completed. The FROB (Fund for the Orderly Restructuring of the Banking Sector) formalised the sale, via auction, of two (NCG and Catalunya Banc) of the four banks under its control, and it also sold, by means of a public offering, 7.5% of its stake in Bankia (through BFA).

Further ahead, the sector's capacity to finance the economy will also be reinforced by the regulatory progress being made on the agenda set by the G-20 to achieve a sounder and more stable global financial system. In Europe, the year 2014 also saw the entry into force of the Basel III Accord, once it was transposed into Community law. The methodology and list of global systemically important institutions was updated and the FSB tabled its proposal to increase the total loss-absorption capacity of these banks and its initiatives to improve the resolution mechanisms for banks active in numerous jurisdictions.

4 Challenges in entrenching the recovery and the role of economic policies

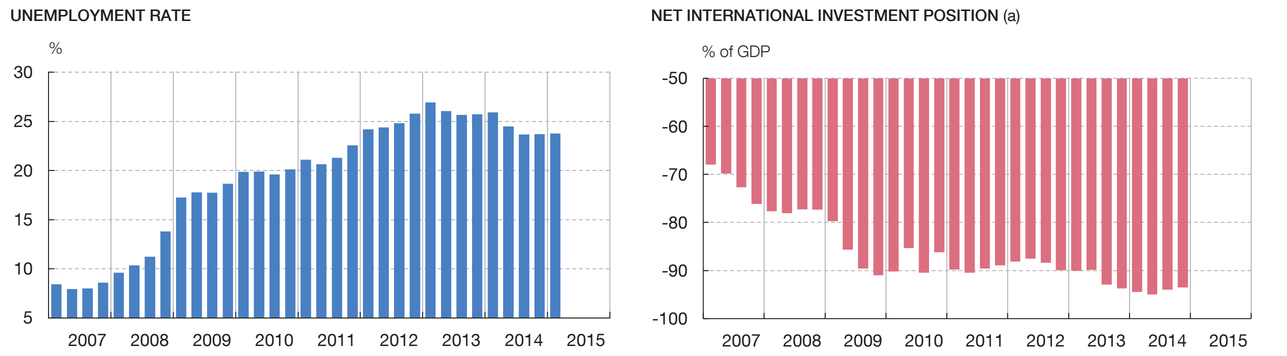
Underpinning the recovery in the economy in 2014 was the progress made in restoring macroeconomic equilibrium, but also other, more temporary factors with less influence on the medium-and long-term growth of the Spanish economy.

Economic policies must build on the adjustments in order to entrench and prolong the recovery phase

The results achieved in economic growth and job creation are encouraging and indicative of the success yielded by the efforts made; but it should not be forgotten that the adjustment and re-balancing of the Spanish economy is not yet over and that the impact of the depth of the crisis on Spain's situation has not been fully dispelled.

Although the recovering trajectories of GDP and employment have firmed, they are still below their respective levels at the onset of the crisis. Per capita GDP, too, has begun to

UNEMPLOYMENT RATE AND NET INTERNATIONAL INVESTMENT POSITION CHART 1.9



SOURCES: INE and Banco de España.

a Data prior to 2012 Q4 follow previous methodology based on 5th Balance of Payments Manual.

increase, but it has not regained its 2007 level. The demographic setting has changed in the past six years, with population declines that might continue in the future.

From the financial standpoint, the upward trajectory of the public debt ratio has not yet come to a halt and the high levels of private debt, despite notable headway in deleveraging, continue to bear on the dynamism of spending and are a factor of vulnerability given the possible emergence of fresh bouts of uncertainty.

Economic policies must therefore continue to play a leading role to ensure the re-balancing of the economy, further sound growth and the re-absorption of the durable effects of the heavy legacy of the crisis, the most visible features of which are high unemployment and high debt (see Chart 1.9).

The euro area must continue advancing towards a genuine economic and monetary union

Although it exceeds the exclusive remit of Spanish economic policy, the importance of the euro area continuing to move towards a genuine economic and monetary union should be reaffirmed. Despite the significant progress made in the reform of the governance of the area and in the construction of the Banking Union, the tensions generated by the situation in Greece show that the risks and challenges for the euro have not disappeared. The course was clearly set in the roadmap detailed in the so-called Four Presidents Report and was clearly assumed and backed by the area's Heads of State and of Government. What are involved are undoubtedly complex steps which, as in the case of the fiscal union, will require major efforts to extend the areas of shared sovereignty in directions that will prove key to consolidating the euro and the euro area, and which, as the recent experience with the Banking Union suggests, will ultimately entail more benefits than costs for member countries and their citizens.

And in Spain, economic policies must ensure that the recovery is underpinned by durable conditions of stability

As regards national public finances, the fiscal consolidation process of recent years has been supported by the stronger commitment to budgetary stability and the oversight of public finances, in which connection various instruments such as the Budgetary Stability Law and the start-up of the Independent Authority for Fiscal Responsibility (AIReF by its Spanish name) have been developed, under the new European Governance framework. After the experience of the sovereign debt crisis, one of the priorities of this raft of measures is to step up co-responsibility in the fulfilment of deficit targets by the different tiers of government (central, regional and local). Pre-emptive and corrective mechanisms have been devised to avert the risk of persistent slippage by each level of government, along with extraordinary financing formulas, subject to conditionality, in situations of tension in the financial conditions of the different general government sectors.

There has been progress in strengthening budgetary discipline, but there are ways of enhancing the preventive procedures in place to ensure the fulfilment of fiscal targets

There have been significant achievements here. However, in 2014 a majority of regional governments exceeded their deficit targets. This means new avenues for improving the application of the existing procedures must be explored. In particular, strict compliance must be ensured with the early warning mechanisms envisaged under the Budgetary Stability Law and, in cases where recurring slippage occurs, the corrective steps stipulated by the Law must be activated. The AIReF, as part of its remit, should contribute to making these procedures effective.

The generalisation of the regional government financial support mechanisms poses certain challenges that need to be jointly addressed with the reform of regional government financing arrangements, so that a transparent and stable financing framework is ensured for the implementation of spending powers.

Meeting budgetary targets might require reinforcing the fiscal consolidation

The government's medium-term budgetary strategy establishes that the adjustment will fall in the coming years on public spending. This item is expected to be reduced by the efficiency gains brought about by the various expenditure-rationalisation reforms enacted under the aegis of the CORA (Commission for General Government Reform) report, which considers simplifying competencies as they are currently outlined, in particular in the corporate public sector and in respect of local government reform. In addition, the Government's Budgetary Plan bases the achievement of its objectives on a more expansionary behaviour of public revenue, against a background of tax reform.

Overall, the objectives are demanding and to ensure their fulfilment it may be necessary, were the risks of slippage to materialise, to reinforce the fiscal consolidation plan with supplementary measures. With regard to public spending, the effectiveness of the rationalisation plans in place would have to be guaranteed, conducting a thoroughgoing review of the different expenditure items with the aim of prioritising those with a greater impact on growth. In respect of revenue, consideration would have to be given to a tax structure enabling sufficient resources to be raised so as to finance the desired level of public spending. In this respect, regard could be had to increasing the relative weight of indirect tax (broadening of VAT bases, rise in excise duties and environmental taxation) and rationalising the wide range of deductions, rebates and reductions that erode tax-raising capacity, in line with the proposals by experts and international agencies. It is vital that both the composition of the spending adjustment and the revision of the tax basket should be designed attempting to minimise the potential adverse effects on the economy's long-term growth.

And the challenges posed by population ageing for public finances in the medium term must be addressed

The pension system reform adopted in 2013 will contribute decisively to easing the growth in public spending that foreseeable population ageing will entail. The latest available projections at the European level (using harmonised methodology) foresee a slight decline in the weight of public spending in pensions in Spain between 2013 and 2060 (of 0.8 pp, accounting in the latter year for a ratio of 11.7% of GDP) compared with the 3.6 pp increase that would have come about in the absence of the aforementioned reform. To avoid uncertainties over the future amount of pensions, the new system needs to be implemented with the greatest possible transparency, in keeping with the procedures established by the Law. Enacting these changes raises the need to promote the introduction of insurance and saving mechanisms that will help complement pensions under the unfunded public system in the future, along with tax incentives.

The ongoing transformation of the labour market must continue…

The labour market faces the twin challenges of reducing unemployment to rates comparable with those in other developed economies and of adding greater dynamism to productivity so as to encourage sustained growth in per capita income in the medium term. The short-term outlook is favourable, but it is vital to maintain the reform-inspired momentum that will give the Spanish economy the flexibility needed to prevent the high unemployment rate from becoming structural and to drive improvements in productivity and the continuity of gains in competitiveness.

… with better-working active employment policies…

The effectiveness of the raft of active policies whose main goal is to provide for the reinsertion of the unemployed into the labour market should be improved. As indicated throughout this chapter, this task is proving particularly difficult for those groups who have been unemployed for longest and who have a lower level of educational attainment. Significant steps have been taken in this connection over the past year with a view to improving coordination between central and regional government, increasing the link between the financing and outcome of different programmes and promoting participation by the private sector. Along these same lines, the recent reform of vocational training arrangements includes competition among different skills-providers, reducing the role of social agents in the management and imparting of training. But resolute progress in the effective implementation of this broad set of changes will be vital, requiring, in some cases, a regulatory roll-out that has yet to be undertaken. The experience of other countries shows that the effectiveness of such programmes depends on the economic and institutional conditions in place. Accordingly, the change in strategy in Spain should be accompanied by a rigorous assessment of the different programmes, which will call for better information on the cost and effectiveness of the different measures of support to the unemployed.

The weight of rebates for new hires as part of the overall spending on active policies is very high, and its impact on employment possibilities for the most underprivileged groups is uncertain. An assessment and reorganisation of the group of rebates in place, such as that envisaged in the 2015 National Reforms Programme, would help free up resources that could be used to further the ongoing modernisation of public employment services, enabling, for example, individualised insertion itineraries to be efficiently designed for the unemployed in terms of their characteristics and of the needs detected in firms' demand for labour.

… more extensive changes in collective bargaining…

The different changes made to the collective bargaining framework have sought to increase the system's degree of decentralisation and to adapt working conditions to the specific situation of firms and sectors. Progress has been made here, but the degree of wage dispersion across sectors and firms remains limited. Further action in this field would involve reviewing the automatic extension principle governing industry-wide agreements to promote the adaptation of negotiations to the specific situation of firms and to workers' participation therein. Such measures would bring the Spanish labour market closer to common practices in other European countries.

… and the rationalisation of hiring arrangements

Progress in reducing the duality of the labour market appears to be less visible. It would seem reasonable that after a prolonged episode of job destruction, marked by high levels of uncertainty, the pick-up in employment should turn initially on temporary hiring. However, the resort to permanent hiring remains weak, despite the changes introduced to promote it. It is acknowledged that a high temporary employment ratio ultimately shapes a labour market with excessive employment volatility and adversely affects productivity, essentially through the scant incentives that excessive labour turnover generates for investment in human and technological capital by firms and employees. Here, then, measures should be aimed at re-balancing incentives in favour of permanent hires, narrowing the gap between termination conditions and the different types of hiring arrangements, and providing for greater continuity between these modalities.

Increasing the Spanish economy's long-term growth possibilities calls for structural reforms to be sustained and deepened

The future growth of the Spanish economy will be influenced by the way in which it manages to overcome the effects wrought by the crisis on productive factor endowment but also by its capacity to raise the low productivity growth rates that have continuously beset it.

In this respect, growth potential will be greatly influenced by the capacity to reduce the unemployment rate and its persistence, and to increase the economy's degree of capitalisation by means of higher business investment seeking to harness the appreciable improvement in Spanish firms' financing conditions and costs. It will also depend on the possibility of speeding gains in efficiency through an appropriate allocation of productive resources across sectors and firms.

Against this background, investment- and job-creation-boosting structural reforms must be maintained and furthered, lowering obstacles to competition and eliminating barriers that prevent the appropriate reallocation of productive resources towards firms and industries with greater growth potential. As analysed in the next chapter of this *Annual Report*, these barriers are the outcome of inadequate regulations, a small average business size, limited regional and sectoral mobility in employment, a degree of educational mismatch between labour supply and demand, which increased during the crisis, and low innovative capacity. To overcome these shortcomings, precise and ambitious economic policy responses will be required. Furthermore, the implementation of structural reforms may bring about positive synergies with the expansionary monetary policy the ECB is pursuing by means of the application of non-standard measures, including in the short run, owing to their impact on expectations about higher growth in incomes in the future.

Despite recent progress, some reforms are still outstanding in various sectoral areas

In recent years there has been progress in various regulatory fields and, more recently, reforms have been introduced geared to lessening the degree of indexation in the economy, eliminating the build-up of further tariff deficits in the electricity sector and improving the climate for entrepreneurship. These include the various amendments to insolvency legislation, most notably the recent Royal Legislative Decree 1/2015, which extends the mechanisms for the restructuring of and reprieve from debt (the so-called "fresh-start" legislation) for sole proprietors and individuals; progress in the application of the legislation guaranteeing market unity; and improvements in the area of retail trade. However, the room for improvement is still significant in various areas and there should be no let-up here. In particular, it is a priority to push through full implementation of the guidelines of the law guaranteeing market unity at all levels of government, and to build up the reforms outstanding in the fields of justice, professional services and infrastructure.

It is likewise necessary to improve the level and quality of education and the economy's technological capacity

The Spanish economy continues to exhibit a level and quality of education and a degree of technological capitalisation below those of the developed countries, which diminishes the capacity for growth of productivity. In this respect, the academic year 2014-2015 saw the initial implementation of a new education law and certain specific aspects of basic vocational training were regulated with the aim of helping keep pupils in the educational system. However, on the university front, progress has been more limited. Enhancing Spain's stock of technological capital will require a reassessment of the current instruments for fomenting private-sector innovation, closer links with public research institutions and changes in the governance and funding of such institutions, an objective that may be assisted by the creation of the new State Agency for Research, as set out in the 2015 National Reforms Programme.

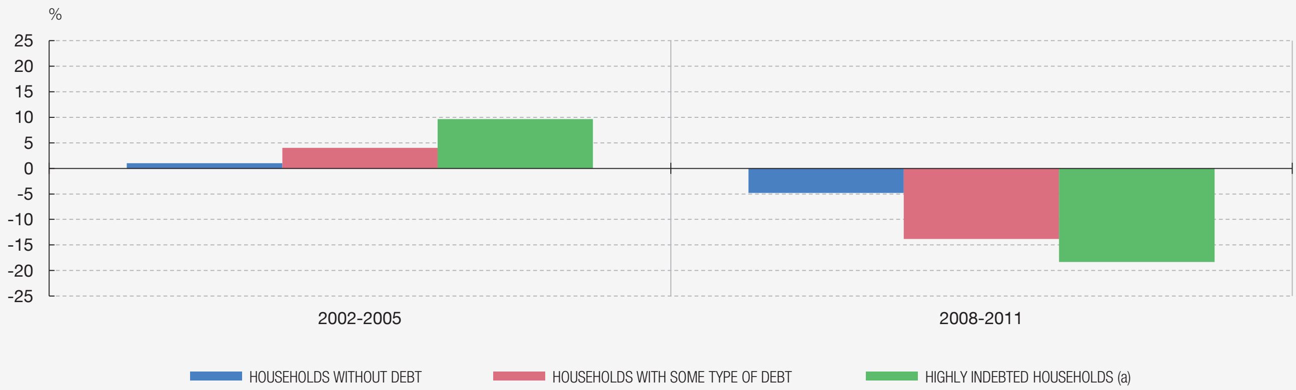
The financial situation of households, and particularly their level of indebtedness, can affect their spending decisions. The debt/income ratio of Spanish households – a standard indebtedness indicator – rose significantly up to 2010 and has subsequently declined, also significantly. However, it remains high compared both with past periods of economic recovery and with other developed countries. This box analyses the implications for recent and future consumption patterns.

Panel 1 compares consumption patterns among different groups of households, according to their level of indebtedness, and shows that the most marked decline in consumption during the crisis was among the most highly indebted households. Further regressions to explain household level consumption growth on the basis of income, wealth and indebtedness levels confirm this inverse relationship between debt and spending.[1]

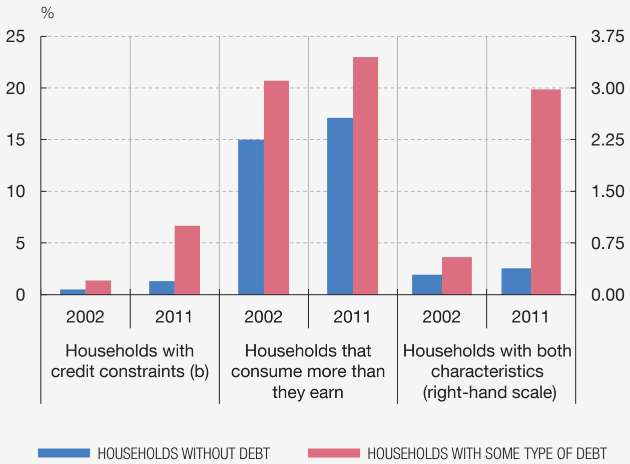
However, for a more in-depth analysis of the possible effects of the present indebtedness levels on Spanish household consumption (and, therefore, on the economic recovery momentum), a further angle must be included in the study, namely the behaviour of households that have no ability to save after debt servicing and that find it more difficult to access new credit. Panel 2, obtained from the Spanish Survey of Household Finances (EFF), depicts the percentage of households whose annual spending is in excess of their income and the percentage of households that reported credit

1 See Casado and Folch (2015) for more details on these findings.

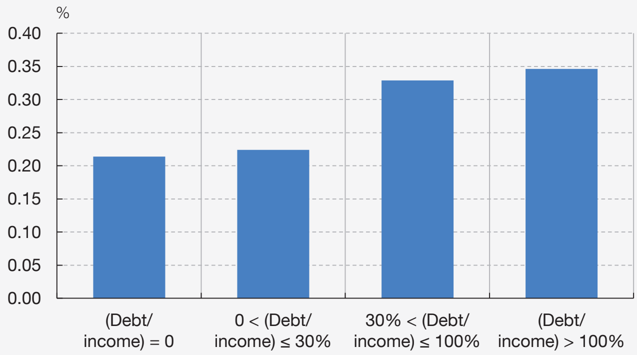
1 CONSUMPTION GROWTH



2 HOUSEHOLDS WITH FINANCIAL DIFFICULTIES



3 RESPONSE OF CONSUMPTION TO CHANGES IN INCOME BY DEBT LEVEL (c)



SOURCE: Survey of Household Finances (EFF).

a Households that have a debt/income ratio of over 300%, a debt/wealth ratio of over 75%, or who pay more than 40% of their income on loan interest and principal repayments.
b Households with credit constraints are defined as those whose loan application has been partly or fully rejected.
c This panel shows the elasticity of consumption to income. See J.M. Casado and M. Folch (2015) for further details.

constraints[2] (as well as the percentage of households that simultaneously conform to both criteria). As may be observed, these figures are clearly higher for indebted households and they have risen during the crisis. For these households, consumption growth relies more on their current income than on possible expected increases in their future income, as these cannot be transformed into spending until they actually materialise. The above-mentioned regressions confirm this hypothesis and show that the consumption response to changes in (current) income rose during the crisis. Panel 3 depicts the estimates of this response for different groups of households, according to their level of indebtedness, and shows that higher consumption associated with higher income is most marked among the more highly indebted households.

Accordingly, the conclusion may be drawn that high indebtedness levels among Spanish households have adversely affected household consumption, which was to be expected, but at the same time that they have also rendered it more sensitive to changes in current income. This increased sensitivity of consumption to current income helps to explain the recent growing momentum in household consumption, in light of the clear recovery observed in household income. It also signals that, in this recovery phase, the improvement in employment could have a comparatively more positive effect on consumption than in comparable periods in the past. In any event it should also be recalled that the still-high level of indebtedness makes household demand more sensitive to changes in borrowing costs, although in the medium term a sharp rise in interest rates that could have a significantly contractionary effect on household spending levels is unlikely.

2 Defined as the proportion of households whose loan applications have been partly or fully rejected.

The Spanish economy, on balance of payments data, again recorded net lending in 2014 (1.2% of GDP), although the level was lower than in 2013 (2.1%). This box identifies the variables that contributed to the slowdown in the improvement in the external balance in 2014, as well as the factors underlying its behaviour, in an attempt to determine the effects of the recent moderation on the external balance.

Both the current account balance and, to a much lesser extent, the capital account balance helped to reduce the external surplus last year (by 0.6 pp and by 0.3 pp of GDP, respectively). In relation to the current account, the component that caused the largest reduction in its balance (to 0.8% of GDP, from 1.4% the previous year) was the goods and services balance, the surplus of which shrank notably in 2014 (by 0.8 pp to 2.6% of GDP). In contrast, the primary and secondary income balances improved slightly (by 0.2 pp, to -1.8% of GDP).

The deterioration of the goods and services balance was a result, in turn, of the reduction in the non-energy goods surplus, which was only partly mitigated by the improvement in the energy goods and services balances (see Panel 1). In particular, as regards goods trade, the sharp recovery in non-energy imports counteracted the growth in exports (see Panel 2), which continued to gain world market share, and the positive impact on the energy bill derived from the decline in the price of oil, which became more obvious by the end of the year.[1] Accordingly, most of the reduction in the current surplus in 2014 was notably due to external purchases of non-energy goods, while exports continued to grow at a high rate.

The healthy performance of goods exports, which since the start of the crisis have grown at a faster rate than world demand and price competitiveness,[2] reflects the impact of several developments that, together, would indicate that there has been a certain structural change in their behaviour. A simple way of illustrating this possible effect is to analyse whether the relationship between exports and their determinants has changed during the crisis. The historical relationship between these variables is therefore estimated for the period 1998-2008 and, on the basis of this estimate, the growth of exports is predicted for subsequent years using the observed path of world demand and the competitiveness of Spanish products.[3] If the predicted path of exports is similar to the actual path then there would appear to have been no change in the relationship between this variable and its determinants.

As seen in Panel 3, exports have grown systematically at a faster rate than predicted by the estimated equation, which suggests that there have been significant changes in the historical relationship between external sales and their determinants. The geographical diversification of exports, the increase in the number of regular exporters (15.6% more than in 2008) and, also, the increasing internationalisation of SMEs would explain the improved performance of exports, in relation to their determinants, in the most recent period. Especially important, given the average small size of Spanish companies, is the increasing role of SMEs in recent export developments (see Panel 4). Without a doubt, the wage moderation that began in 2010, along with the consequent competitiveness gains,[4] has facilitated the internationalisation of Spanish businesses and their penetration of increasingly competitive markets, since their lower costs have enabled Spanish firms to access markets in which prices were low in comparison with production costs in Spain. Against this backdrop of recovering cost competitiveness, the attractiveness of the Spanish economy as a destination for direct investment flows has increased, which has had a positive impact on the efficiency and competitiveness of the target firms. Thus, insofar as a large part of the competitive adjustment achieved in recent years has been of a structural nature, the level of exports can be expected to remain higher in future.

With regard to imports, as mentioned above, one of the most significant developments in 2014 was the sharp recovery in purchases of goods from abroad. In order to try to determine whether this surprisingly sharp increase was a consequence of a change in the historical relationship between imports and their determinants (basically final demand and competitiveness) or of the latter's own behaviour, a similar exercise to the one described for exports was performed. On this occasion, the growth of total imports is observed to have been in line with that derived from the estimated prediction, so that there does not appear to have been any significant change in the historical relationship between purchases from abroad and their main determinants (see Panel 5).

A similar conclusion is reached for 2014 when this analysis is performed at a disaggregated level, except in the case of imports of non-energy intermediate goods,[5] which continued to grow at a faster rate in 2014 than would have been expected on the basis of the behaviour of their main determinants, reflecting the dynamism of certain vertically integrated industries (e.g. the car industry).[6] By contrast, the notable rise in consumer durables and capital goods imports is in keeping with the greater buoyancy displayed by these components in final demand (see Panel 6).

1 The energy bill appears to have fallen by 5% in 2014 as a whole (0.2 pp of GDP). This decline reflects the impact of cheaper oil (8%), while the energy balance in real terms deteriorated by 2.7%. The decline in the oil price predicted for 2015 can be expected to reduce the energy bill further this year. On average, the energy bill falls by around 0.5% of nominal GDP for every €10 by which the price of a barrel of oil declines.

2 García, C. and E. Prades (2015), "Actualización de la función de exportaciones españolas de bienes", *Boletín Económico,* April, Banco de España.

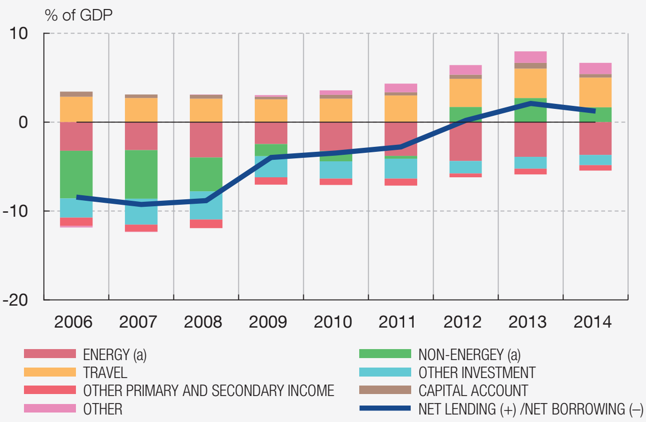
3 Specifically, the equation includes the variable that reflects the evolution of Spain's export market and goods export and import deflators. In alternative specifications national demand is also included.

4 See Box 5, "Competitividad, costes laborales y empleo", in Informe Trimestral de la Economía Española, *Boletín Económico,* December 2014.

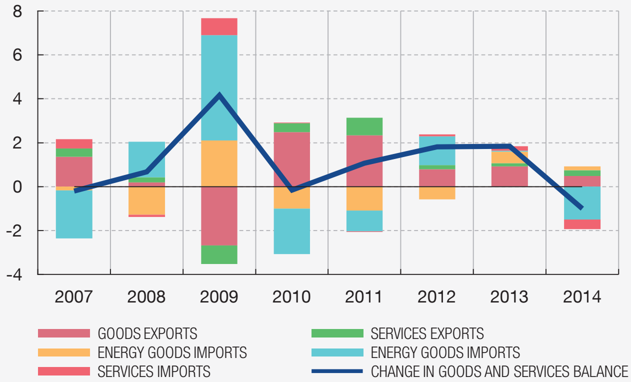
5 Energy imports declined, in nominal terms, in response to the fall in the price of oil.

6 See Box 5, "The recent behaviour of imports and their determinants", *Economic Bulletin,* April 2014.

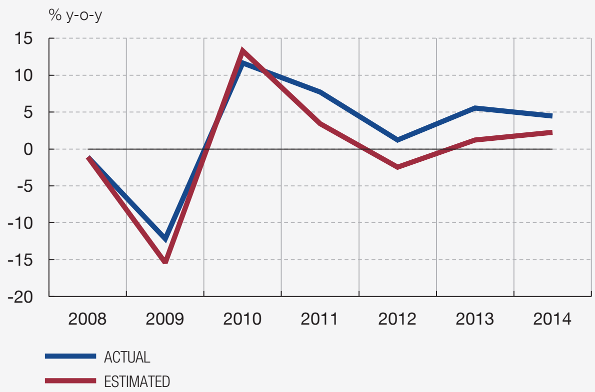
1 NET LENDING/ NET BORROWING



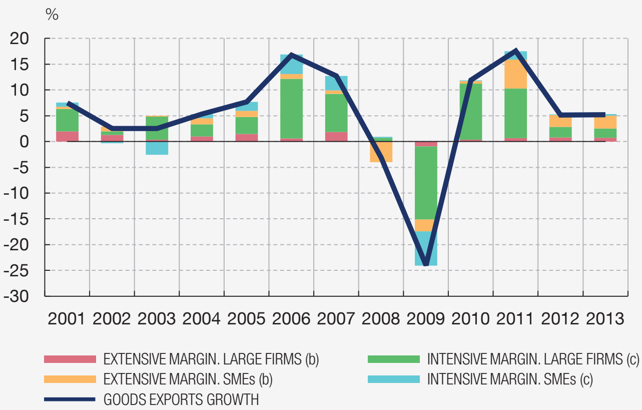
2 CHANGE IN GOODS AND SERVICES BALANCE: CONTRIBUTION BY COMPONENT



3 GOODS EXPORTS

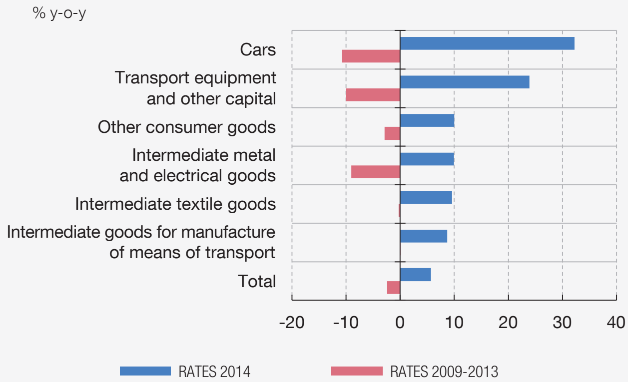


4 EXTENSIVE AND INTENSIVE MARGIN: CONTRIBUTION TO CHANGE IN GOODS EXPORTS



5 GOODS IMPORTS

6 GOODS IMPORTS (NOMINAL)



SOURCES: Banco de España (based on Balance of Payments, CBA and mercantile registries statistics) and the AEAT (Spanish Tax Revenue Service) Customs and Excise Department.

- **a** The energy and non-energy balances are estimates by the Banco de España drawing on Customs data.
- **b** The extensive margin is defined as the contribution to the increase (decrease) in the exported value derived from an increase (decrease) in the number of "firm-country of destination" trade relations.
- **c** The intensive margin is defined as the contribution to the increase (decrease) in the exported value derived from an increase (decrease) in the amount exported by each firm to each country.

In any event, in the current stage of the cycle, spending is being directed towards goods with a high import content, which suggests that the effects of the changes in the composition of demand have been contributing to the recent growth in imports. The rise in capital goods imports (18.7% year-on-year in 2014 as a whole), linked to the recovery of investment and to the above-mentioned growth in exports, reflects the dependence of Spanish industry on high value added imported inputs. Also notable in this respect is the vigorous growth of consumer durables imports (20% year-on-year in real terms), which may reflect a certain overreaction linked to the large cumulative fall in the consumption of such goods since the start of the crisis (-6.2% over the period 2008-2013, as against –1.9% in the case of total spending). As for imports of non-durable consumer goods, with the firming of the recovery, a greater coincidence has been observed between actual purchases abroad and those predicted by the model, so that no significant substitution effect between domestic production and imports has yet been detected.

In conclusion, the improvement in the cyclical position of the Spanish economy, along with the realisation of purchase decisions that had been postponed during the crisis, appears to have had a significant impact on the external balance in 2014, having led to strong import growth. On the other hand, the fall in the price of oil, competitiveness developments and the expansion of the export base and its geographical diversification partly offset the negative impact of the cycle. In the future, while the business cycle will continue to support import growth, the impact of pent-up demand will ease over time. Moreover, despite the lack of evidence of a substitution effect on total imports, one would expect the gains in competitiveness arising from the still-ongoing internal devaluation, together with the changes in the productive structure, to be conducive to a reduction in import dependence in the medium term.[7]

7 See Chapter 3 "Growth and reallocation of resources in the Spanish economy", *Annual Report,* 2014, Banco de España.