

ANNUAL REPORT 2016

CHAPTER 1

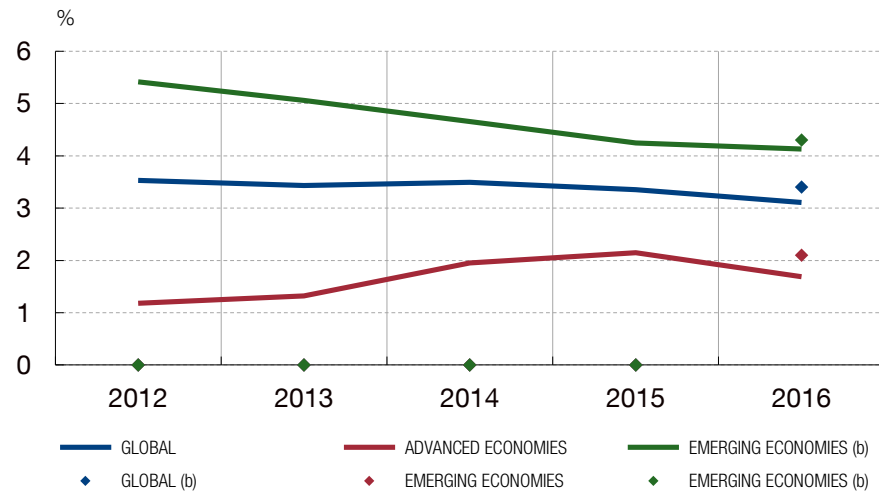
OVERVIEW

A NEW GLOBAL ENVIRONMENT

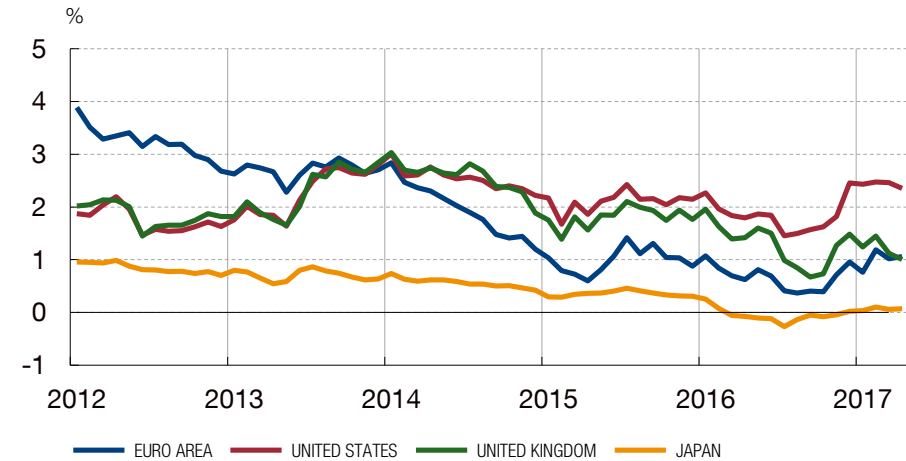


World economic growth was again lower than expected in 2016. Looking ahead, a somewhat better outlook is accompanied by an increase in global uncertainty, arising from possible changes in the US policy stance, Brexit and the challenges involved in achieving an orderly unwinding of the imbalances in the Chinese economy.

GROSS DOMESTIC PRODUCT (a)



LONG-TERM INTEREST RATES IN ADVANCED ECONOMIES (c)



SOURCES: IMF (*WEO*, April 2017) and Datastream.

a Annual rates of change.

b Forecasts from *WEO Update*, January 2016.

c Ten-year sovereign bonds.

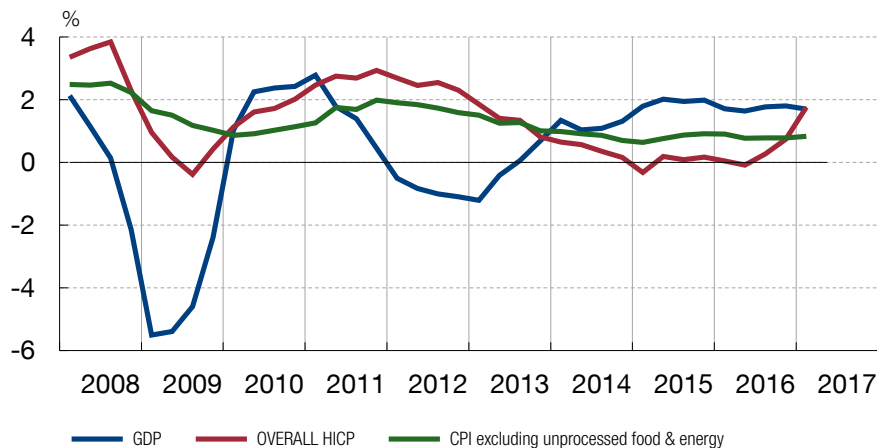
THE MODEST RECOVERY IN THE EURO AREA CONTINUES



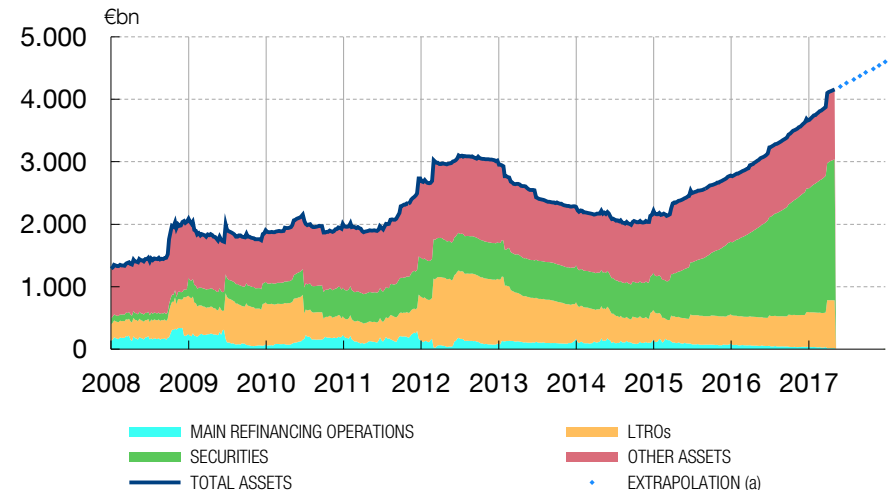
Structural unemployment, indebtedness and the situation of some financial institutions are constraints on growth.

The absence of signs of sustained convergence of inflation towards the medium-term reference of 2% and the prevalence of downside risks to growth justified the ECB's ongoing asset purchases.

EURO AREA GDP AND INFLATION
Annual rates of change



EUROSYSTEM BALANCE SHEET



SOURCES: Eurostat, ECB and Banco de España.

a For the extrapolation, the latest observed balance sheet value is increased monthly on the basis of the securities acquisitions scheduled in the Expanded Asset Purchase Programme, while maintaining the observed rate of reduction of the portfolio of securities from the inactive programmes (SMP, CBPP and CBPP2).

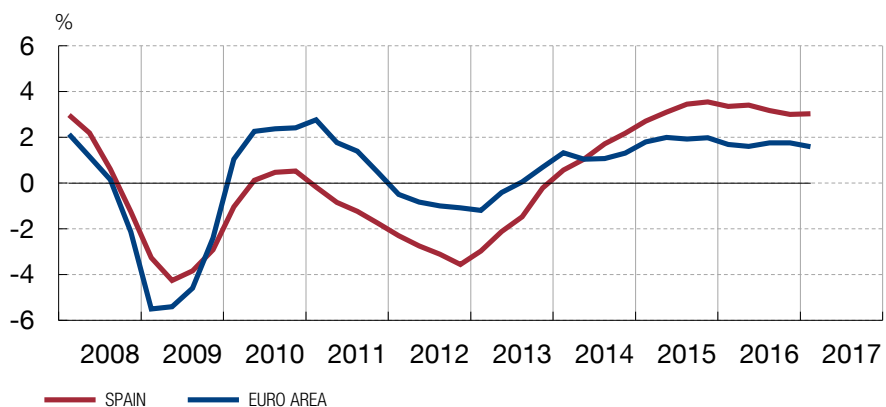
THE RECOVERY IN SPAIN GAINS TRACTION



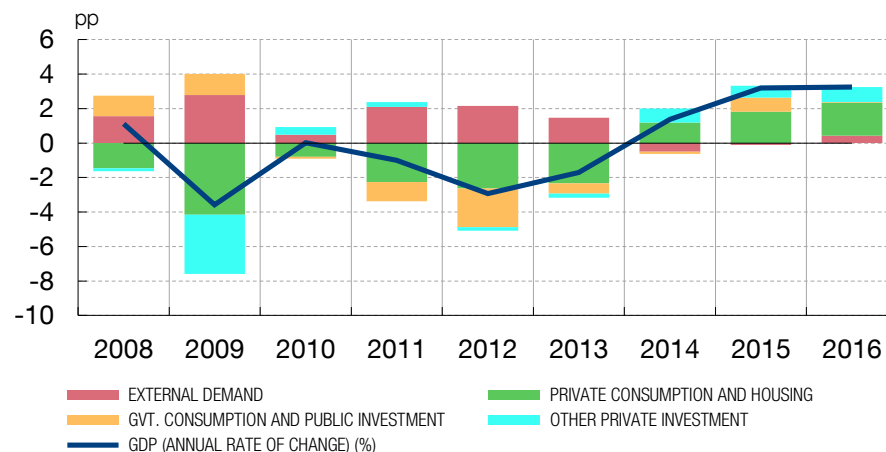
In 2016, in a complex international and European environment, Spain's economy grew by 3.2%, significantly faster than those of its European partners. Employment remained buoyant, while developments in domestic demand and the net external balance were very favourable, leading to continued high net lending.

The pre-crisis level of activity is expected to be regained in 2017 Q2.

GROSS DOMESTIC PRODUCT (a)



GDP, NATIONAL DEMAND COMPONENTS AND EXTERNAL DEMAND
Annual rate of change and contribution to growth



SOURCES: Eurostat, INE and Banco de España.

a Annual rates of change in seasonally adjusted series.

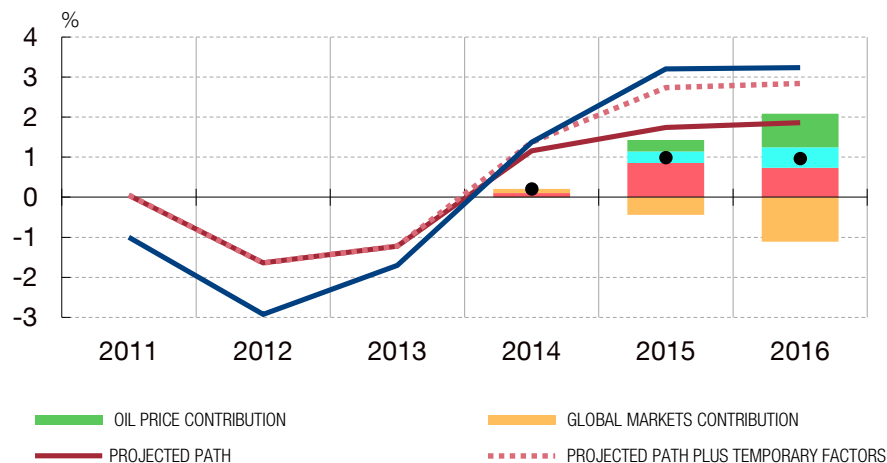
THE STRENGTH OF THE RECOVERY IS PARTLY DUE TO TEMPORARY FACTORS



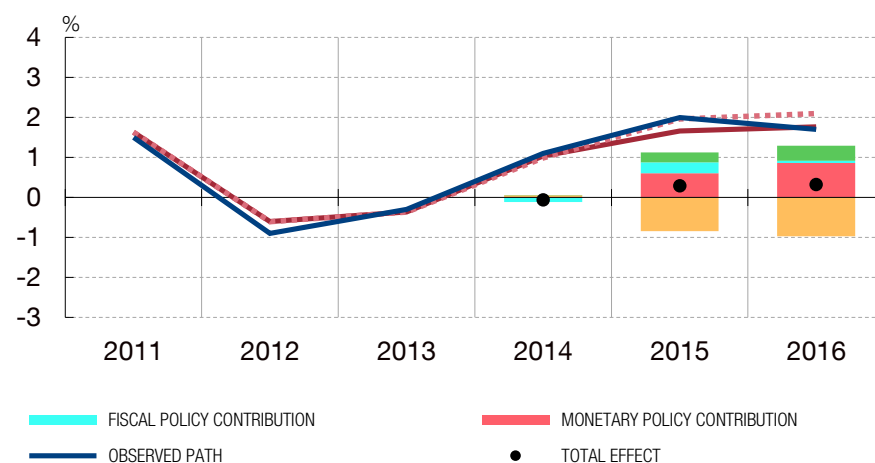
In the period 2014-2016, the impact of positive shocks to demand (monetary and fiscal expansion) and to supply (fall in the price of oil) more than made up for the negative surprises in export market developments.

These factors were more important in Spain (2.2 pp) than in the euro area (0.6 pp), although the portion of GDP growth not explained by these factors (1 pp in Spain, as against -0.3 pp in the euro area) suggests the existence of idiosyncratic factors in Spain that provided an additional stimulus.

SPAIN: OBSERVED GDP PATH, PATH PROJECTED IN JUNE 2014 AND CONTRIBUTION OF TEMPORARY FACTORS
Annual rates of change



EURO AREA: OBSERVED GDP PATH, PATH PROJECTED IN JUNE 2014 AND CONTRIBUTION OF TEMPORARY FACTORS
Annual rates of change



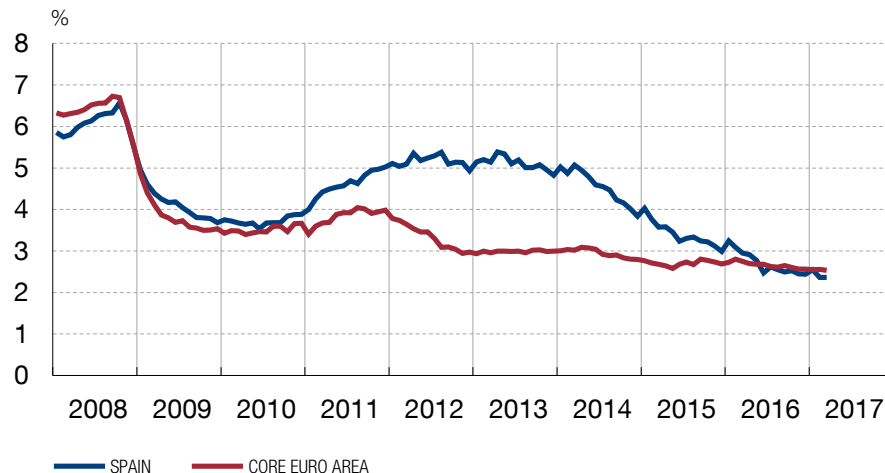
SOURCES: INE and Banco de España.

SOME MORE PERMANENT FACTORS ARE ALSO BEHIND THE CURRENT UPTURN

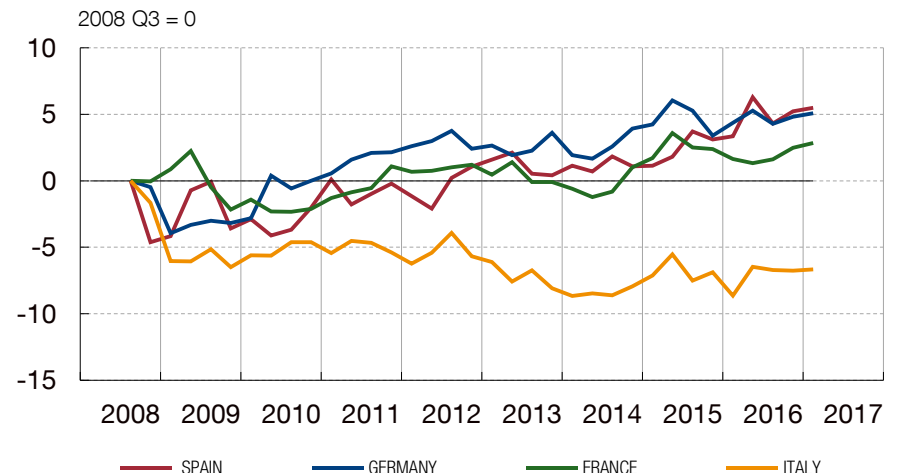


The re-establishment of competitiveness, in terms of labour and financial costs (partly associated with the implementation of various reforms), also explains the higher rate of growth than in the euro area as a whole.

INTEREST RATES ON BANK LOANS TO NON-FINANCIAL CORPORATIONS OF UP TO ONE MILLION EURO



CUMULATIVE EXPORT GROWTH RELATIVE TO EXPORT MARKET GROWTH (a)



SOURCES: Eurostat, INE and Banco de España.

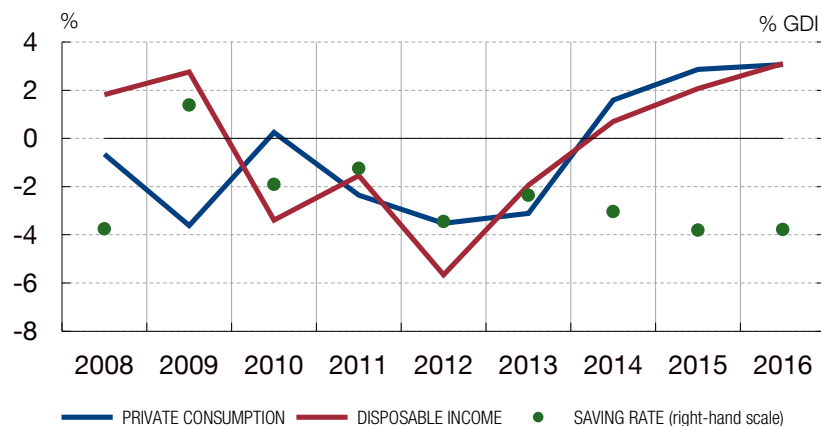
a The line for each country represents the difference between the cumulative change in goods and services exports and the cumulative growth of the markets in which they are sold.

HOUSEHOLD SPENDING AND BUSINESS INVESTMENT REMAINED BUOYANT

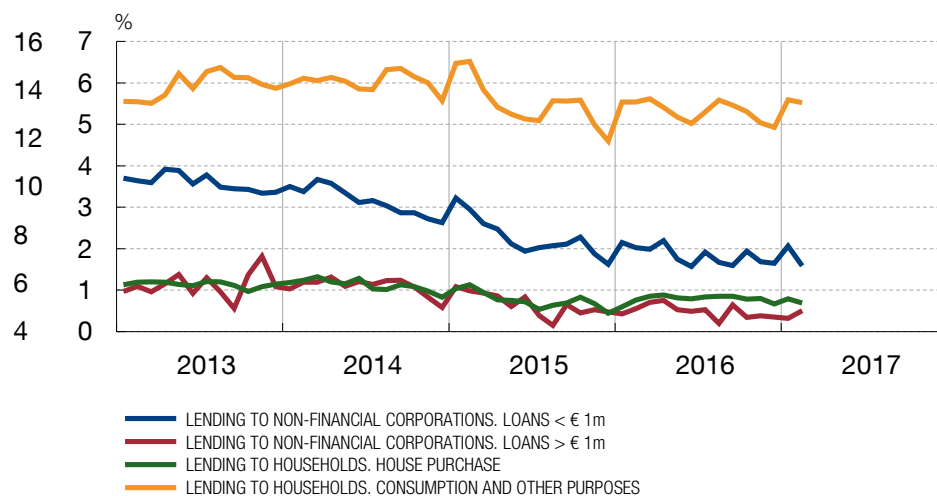
Household spending remained highly buoyant driven by the robust rate of employment creation, the improved financial position of households and the decline in the debt burden.

The generation of high levels of income by non-financial corporations and the availability and cost of borrowed funds favoured investment spending (see Chapter 2 of the *Annual Report*).

PRIVATE CONSUMPTION AND DISPOSABLE INCOME
Annual rates of change in real terms



REAL BANK LENDING RATES (a). SPAIN



SOURCES: INE and Banco de España.

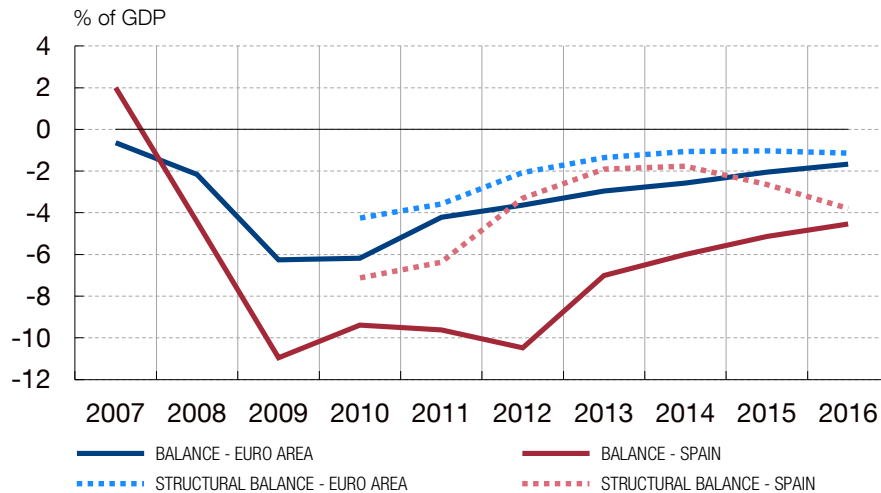
a The real interest rates were calculated by deducting from nominal rates inflation expectations at different horizons obtained from inflation-linked swaps for Spain. For lending for house purchase, 15-year rates were used; for consumption and other purposes, 5-year rates; and for lending to non-financial corporations, 10-year rates.

FISCAL POLICY REMAINED EXPANSIONARY

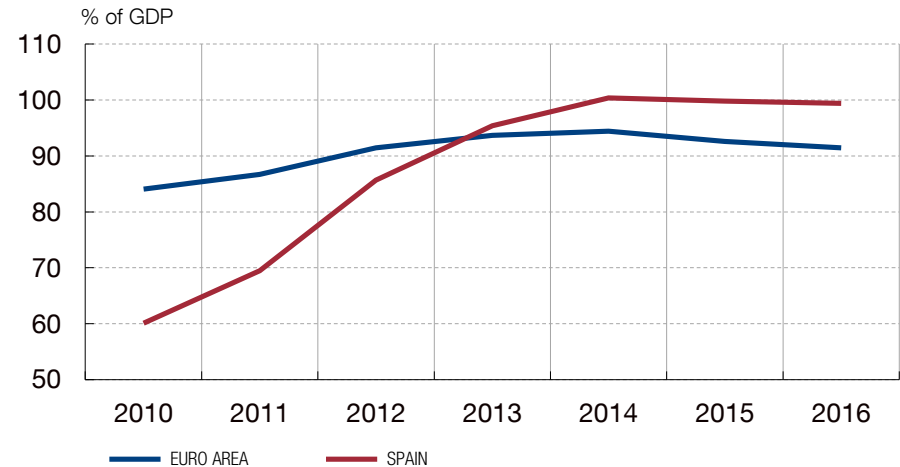


The primary structural deficit deteriorated by 1.3 percentage points, so that the budget target was achieved as a result of the cyclical improvement and the reduction in the interest burden. The public debt ratio fell slightly.

ACTUAL BALANCE AND STRUCTURAL BALANCE (a)



EXCESSIVE DEFICIT PROTOCOL (EDP) DEBT



SOURCES: AMECO and Banco de España.

a The cyclically adjusted actual balance, net of temporary measures.

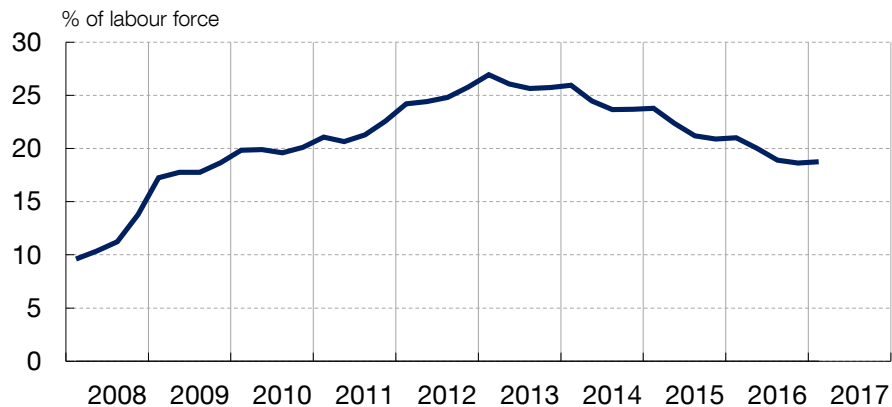
ECONOMIC GROWTH CONTINUED TO BE EMPLOYMENT-INTENSIVE



High employment growth occurred against a background of wage moderation.

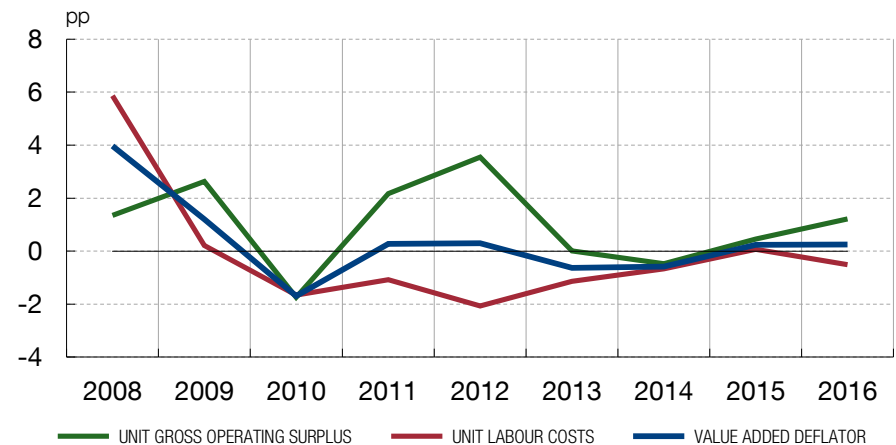
Price competitiveness continued to improve vis-à-vis the euro area in 2016, despite rising mark-ups.

UNEMPLOYMENT RATE



VALUE ADDED DEFLATOR OF THE MARKET ECONOMY

Annual rate of change



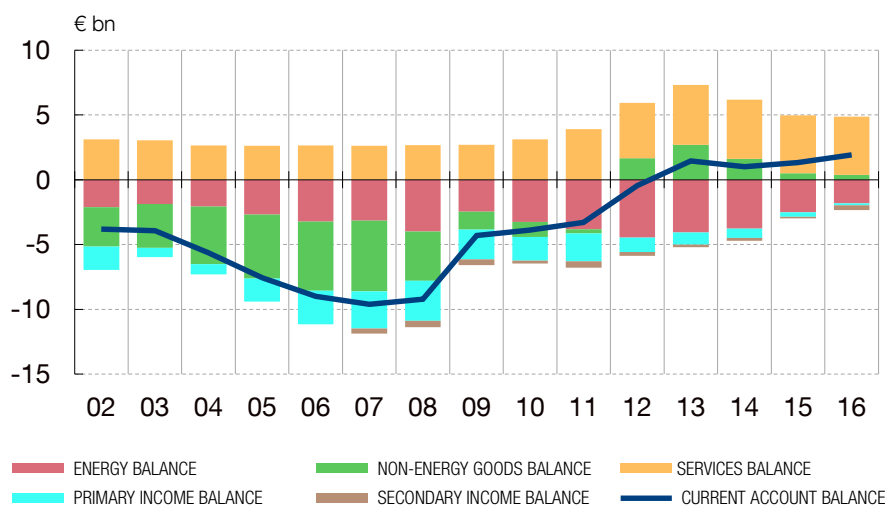
SOURCES: INE and Banco de España.

THE NET LENDING OF THE ECONOMY REMAINED HIGH

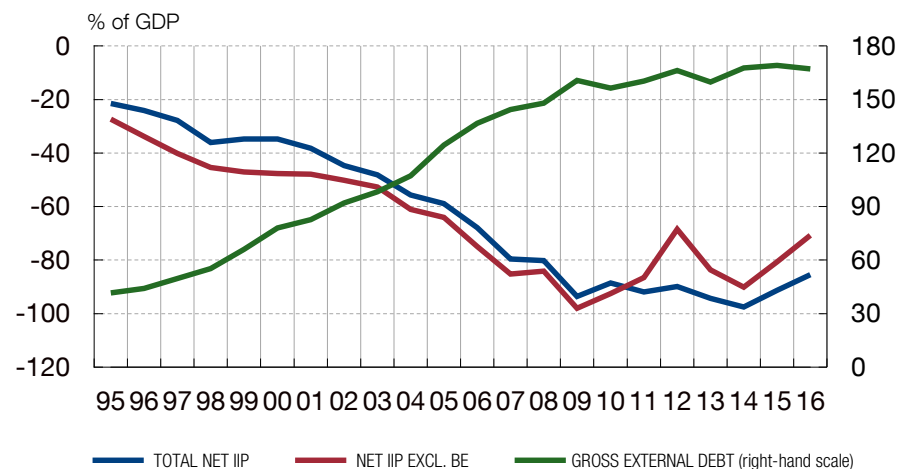


In 2016 exports remained notably robust, with tourism performing especially well, while the growth rate of imports eased (see Chapter 3 of the *Annual Report*).

CURRENT ACCOUNT BALANCE



NET INTERNATIONAL INVESTMENT POSITION (IIP) AND GROSS EXTERNAL DEBT POSITION (a)



SOURCE: Banco de España.

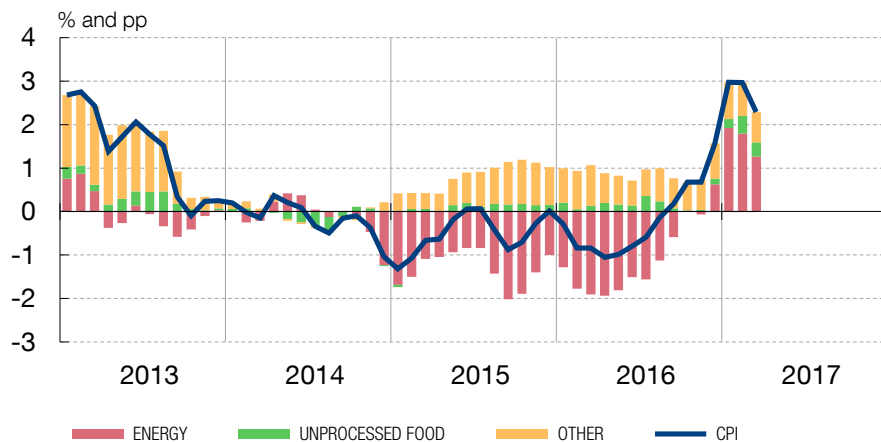
a Gross external debt is the amount pending repayment at a particular moment of the non-contingent real current liabilities assumed by residents of an economy vis-à-vis non-residents with the commitment to make future payments of principal and/or interest. It therefore includes: debt securities, allocated special drawing rights and deposits, loans, trade credit and other liabilities.

INFLATION PICKED UP, DRIVEN BY THE ENERGY COMPONENT

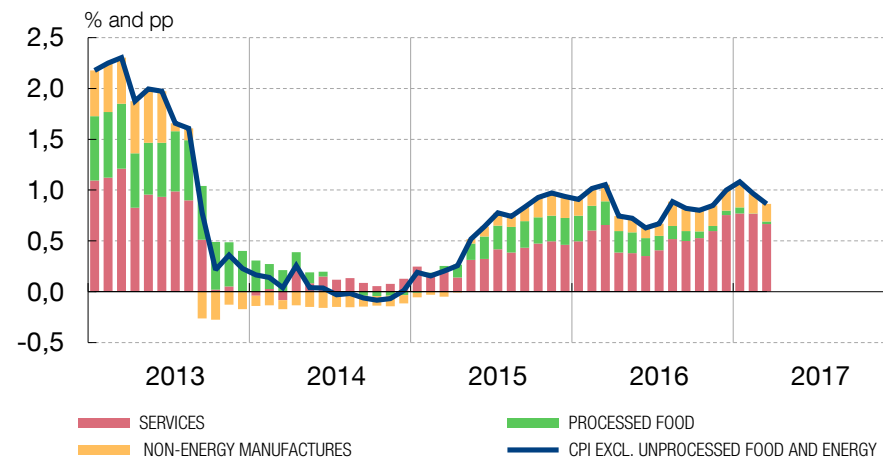


Core inflation remained relatively steady, at low levels.

CPI. CONTRIBUTIONS TO YEAR-ON-YEAR RATE



CPI EXCLUDING UNPROCESSED FOOD AND ENERGY. CONTRIBUTIONS TO YEAR-ON-YEAR RATE



SOURCES: INE and Banco de España.

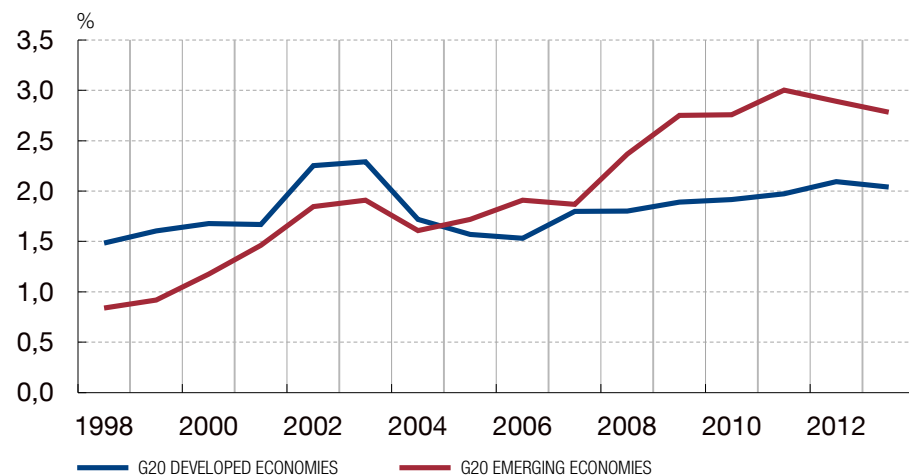
RISKS TO GROWTH: GLOBAL ECONOMIC POLICIES



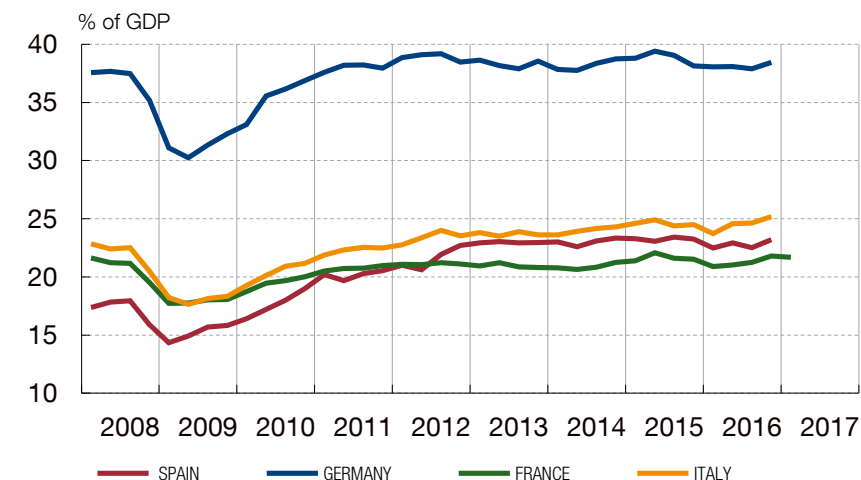
Trade protectionism is a notable risk for the recovery of the Spanish economy, which is increasingly dependent on the external sector.

The exposure of the Spanish economy to the UK is very high, making it especially sensitive to the future arrangements and relationship between the UK and the EU.

PERCENTAGE OF PRODUCTS AFFECTED BY NON-TARIFF BARRIERS



GOODS EXPORTS AS A PROPORTION OF GDP



SOURCES: IMF, Datastream, Dealogic, United Nations, Ministry of Economic Affairs, Industry and Competitiveness, INE and Banco de España.

RISKS TO GROWTH: THE HIGH LEVEL OF PUBLIC DEBT IS A VULNERABILITY

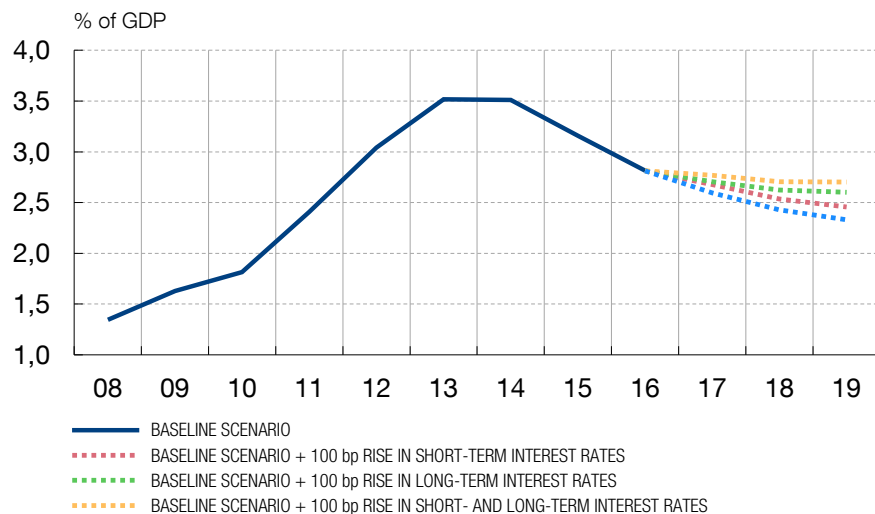


Despite the notable reduction in the aggregate levels of business and household indebtedness, certain economic agents, in particular general government, continue to have a high level of debt.

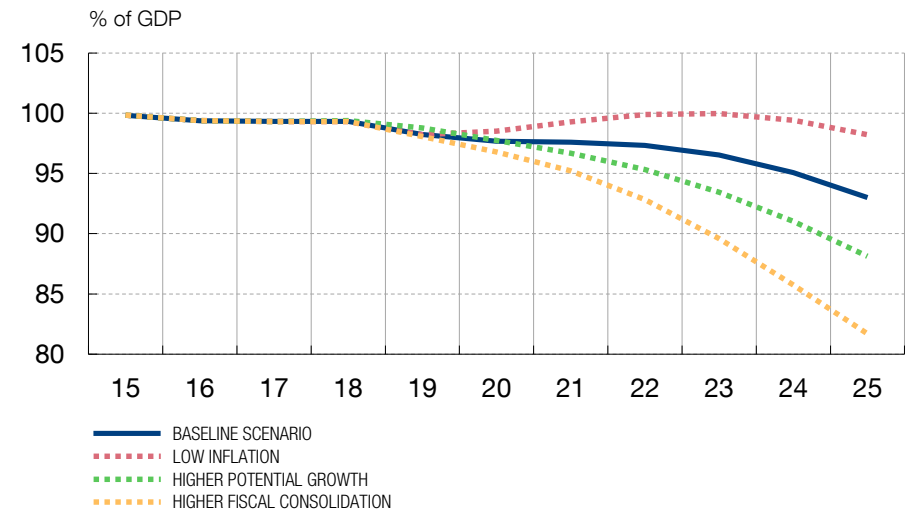
The sensitivity of the general government debt burden to interest rate changes has risen as a result of the increase in indebtedness.

In this context, resuming fiscal consolidation is a priority.

GENERAL GOVERNMENT. NET INTEREST BURDEN



PUBLIC DEBT SCENARIOS: SPAIN



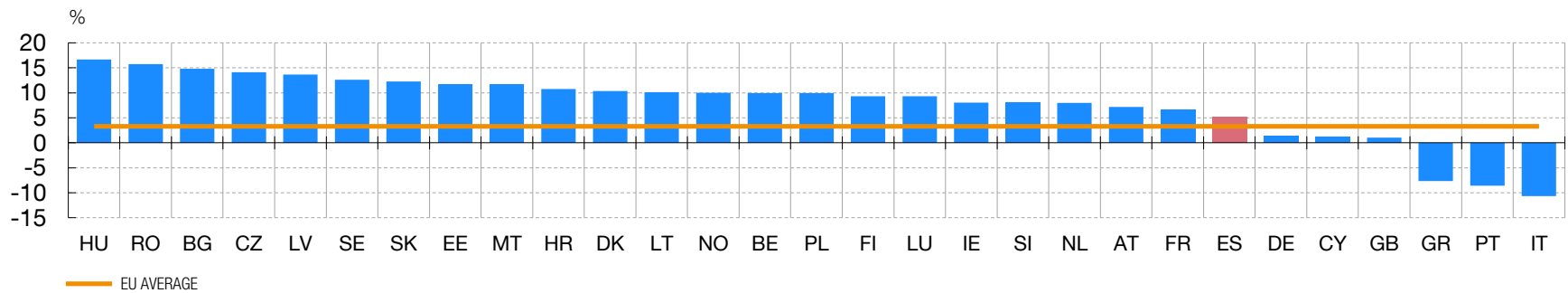
SOURCES: INE and Banco de España.

RISKS TO GROWTH: LOW PROFITABILITY OF CREDIT INSTITUTIONS

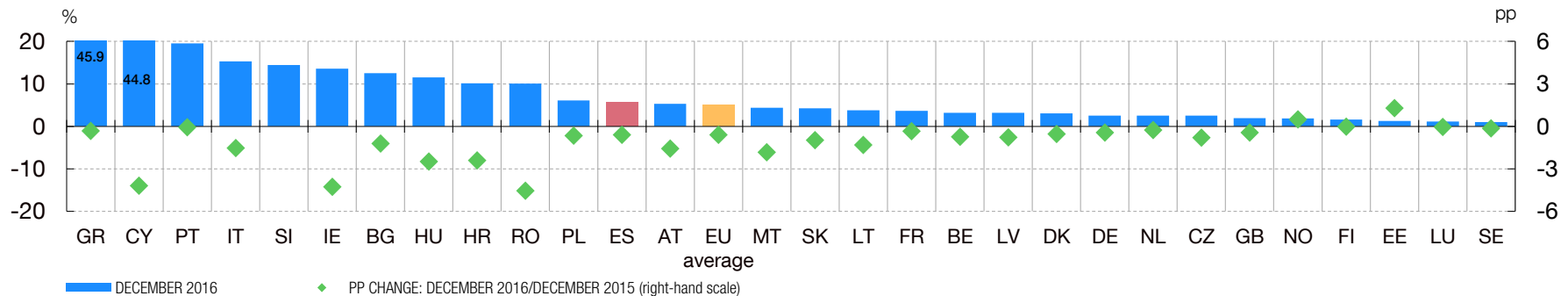


The recovery in the profitability of credit institutions is a challenge in the current context of low net interest income, limited activity volumes and persistence of non-productive assets.

ROE OF CREDIT INSTITUTIONS: EUROPEAN COMPARISON. DECEMBER 2016



NON-PERFORMING LOANS RATIO (a): EUROPEAN COMPARISON. DECEMBER 2016



SOURCE: EBA.

a The NPL ratios in Greece and Cyprus are 45.9% and 44.8%, respectively.

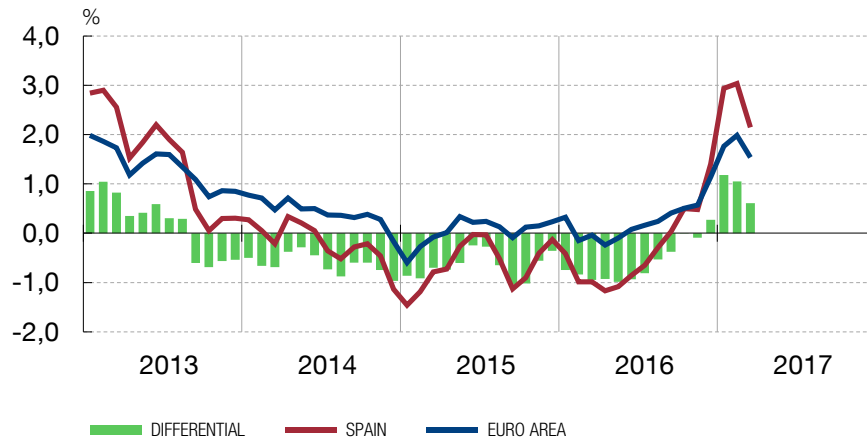
RISKS TO GROWTH: COMPETITIVENESS, ENERGY PRICES AND INFLATION



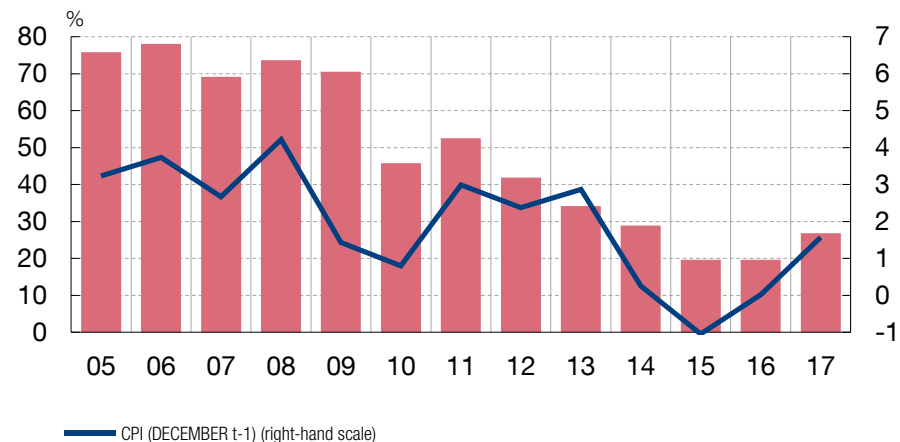
Higher oil prices are estimated to have a comparatively larger contractionary impact on the Spanish economy than on the euro area as a whole.

The indirect effects of intermediate cost rises on final prices, as well as the second-round effects of the temporary rise in the energy component on wage demands, which reduce past competitiveness gains, need to be avoided.

HICP: SPAIN AND EURO AREA



PERCENTAGE OF WORKERS COVERED BY INDEXATION CLAUSES



SOURCES: INE, Ministry of Employment and Banco de España.

CHALLENGES FOR SUSTAINED GROWTH



High structural unemployment

- A priority instrument to prevent unemployed people losing skills are on-the-job training and apprenticeship policies, and policies to assist the unemployed with job search.

Progressive population ageing reduces growth capacity

- And is a challenge for the public pension system, which needs a strategy to address it.

Raising potential growth requires improvements in productivity

- Certain aspects of sectoral regulation and the excessive duality of hiring has negative effects on productivity.
- The increase in productivity also requires an improvement in the educational system and promotion of technological capital accumulation.

The positive outlook for the Spanish economy also depends on the **ability of the EU and the euro area to achieve balanced growth**

- The monetary policy stimulus should be supplemented by the synergic action of an appropriate policy mix at national and supranational level (see Chapter 4 of the *Annual Report*).