1 THE RECOVERY IN THE SPANISH ECONOMY: THE LIMITS OF DEMAND-SIDE POLICIES AND FUTURE CHALLENGES

Screen, 1st Annual Research Conference.

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1 Introduction

During 2017 the expansionary phase of the Spanish economy continued, with GDP growth exceeding the forecasts in place at the start of the year. Specifically, output in the economy increased by 3.1%, slightly down on the figure observed for the two previous years. The continuation of a high rate of expansion of activity, which has held up in the opening months of 2018, has helped the unemployment rate to continue declining rapidly, although at the end of Q1 this year it still remained at a very high level (16.7%).

The greater increase in activity in Spain compared with previous expectations was largely due to the favourable behaviour of external markets. The acceleration in the pace of growth of the global economy came about against a background of highly favourable financial conditions, higher business and consumer confidence, and a rise in commodities prices. Notable among the advanced economies was the dynamism of the euro area, which experienced robust growth that spread across the board to all its members. Despite the buoyancy of activity, euro area inflation held at very moderate rates.

The recovery in Spain evidences features that should contribute to its prolongation over time. The current expansion is proving compatible with the running of an external surplus. Beyond the contribution of certain transitory factors, such as the low levels of oil prices and of interest rates, the positive external balance is largely due to the gains in competitiveness recorded since the crisis. As a result, and unlike the expansion that preceded the crisis, the current upturn is more balanced in terms of domestic and external demand, and it has been compatible with private-sector deleveraging in the economy.

However, the economy continues to show elements of vulnerability, compounded by an external environment in which pockets of risk and instability persist. Despite the headway in reducing the budget deficit, the structural budgetary imbalance remains pronounced and the correction of the sector's high debt has, to date, been but very modest. Also, the positive external balance since 2013 has not prevented the net debtor position vis-à-vis the rest of the world from continuing to be high. In place alongside these accumulated imbalances are certain inefficiencies in the functioning of the markets for labour and for goods and services, which detract from the quality of the recovery. Population ageing is, moreover, a primordial challenge for economic growth and the sustainability of public finances. In the external environment, while expansionary inertia may be expected to continue in the short term, certain risks persist. These are associated with re-pricing on international financial markets, with uncertainty over the negotiations as to the shape of the new arrangements between the EU and the United Kingdom, and with the changes under way in respect of US trade policy, which point to increased constraints on global trade.

The medium- and long-term challenges should be tackled by a far-reaching reform agenda, both domestically and at the European level. Demand-side policies – both fiscal and, especially, monetary policy – have set in place conditions favourable to economic growth in recent years. In future, however, budgetary policy should be geared to reducing the high public debt. As the recovery takes root in the euro area as a whole, the increase in the degree of capacity utilisation will foreseeably translate into a rise in inflation and, therefore, open the way for a less expansionary monetary policy stance. Against this background, sustained and inclusive economic growth requires reforms that provide for the replacement of the cyclical impulse of demand-side policies. The necessary reform momentum should take advantage of the exceptional macroeconomic bonanza to resolve the Spanish economy's outstanding structural problems. Momentum is also necessary at the European level to reinforce the Economic and Monetary Union project, which requires combining a greater degree of solidarity and risk-sharing among Member States.

2 Towards an improved external outlook

2.1 A SHARPER AND MORE DIVERSIFIED GLOBAL RECOVERY

The global economy raised its growth rate in 2017 to a greater extent than expected. Global GDP grew by 3.8% last year, around 0.5 pp up on 2016 (see Chart 1.1.1). Moreover, for the first time since the end of the global financial crisis, growth outperformed the expectations set at the beginning of the year. This acceleration in activity, which was fairly widespread geographically, was more marked in the case of the advanced economies, whose growth increased by 0.6 pp to 2.3%. Among the main countries in this group, the United Kingdom was the sole exception in respect of the greater dynamism shown. The pace of output in the emerging economies increased by 0.4 pp to 4.8%, partly as a result of the emergence by Brazil and Russia from recession.

The greater robustness of the global economy was mainly due to cyclical factors and, in the case of the advanced economies, the momentum of investment was the most notable reason. The improvement in activity came about against a background of continuing highly favourable financial conditions, a predominantly accommodative macroeconomic policy stance, greater business and consumer confidence, and a pick-up in commodities prices, which eased the delicate situation of the commodities-exporting economies. Moreover, following a prolonged period of weak investment in the main advanced economies, this component rebounded, assisted by the high level of plant capacity utilisation and by the sound behaviour of business profits (see Chart 1.1.2).[1]

International trade rose appreciably in 2017, ***following its marked slackness in 2015 and 2016.*** Trade growth during 2017 was 4.9%, the best figure since 2011. The intensity of the various factors behind such growth and its geographical scope changed progressively during the year. In early 2017 Chinese trade activity was highly dynamic, related partly to the fiscal stimuli activated in order to check the slowdown in the Chinese economy, which would have fed through to other Asian economies through the regional value chains. In the second half of the year, the thrust of trade resided to a greater extent on the strength of the euro area and other advanced economies, and was associated with the reactivation of business investment, the domestic expenditure component to which trade is most sensitive.

Global inflation in 2017 remained contained despite the rise in oil prices. Oil has become significantly dearer over the course of 2017 and in 2018 to date, chiefly in response to the widespread recovery in global demand and, to a lesser extent, to the extension of the agreement of the OPEC countries and other producers to cut production throughout the year, to episodes of geopolitical tension in the Middle East and to the depreciation of the dollar (see Chart 1.1.3). In the advanced economies, consumer price inflation rose significantly to 1.7%, after having posted a figure of 0.8% in 2016. This reflected, above all, the rise in oil prices, whose impact was mainly felt in the first half of the year (see Chart 1.1.4). Conversely, in the emerging economies inflation fell by 0.3 pp to 4%, in some cases as the effects of the past depreciations of their currencies petered out. Beyond the energy component, core consumer price inflation has held at moderate levels and, in most advanced economies, below central bank targets.

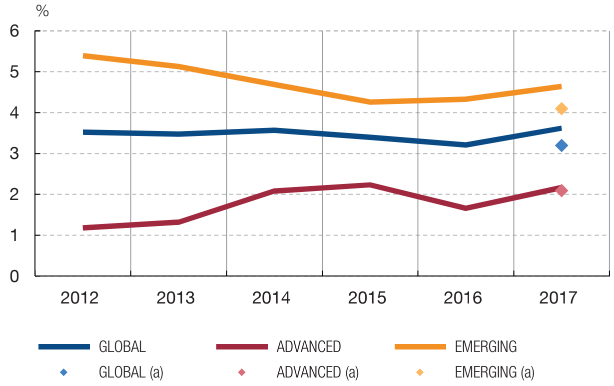
1 In this respect see Chapter 3 of this Report.

THE GLOBAL ECONOMY SAW A STRONG AND WIDESPREAD RECOVERY IN 2017 AGAINST A BACKDROP OF CONTAINED INFLATION

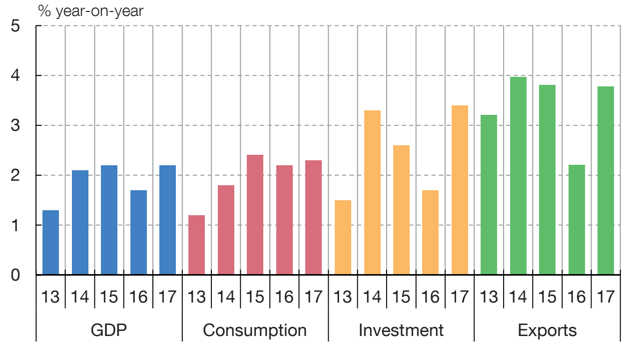
CHART 1.1

The global economy recorded a higher than expected rate of growth in 2017. This greater dynamism of the global economy was reflected in strong investment momentum and in the recovery of global trade. However, despite the renewed strength of global demand and the rise in oil prices, inflation remained contained in the main geographical areas. As the economic cycle progressed in advanced economies, the Federal Reserve tightened its monetary policy and expectations of rate rises by other advanced economy central banks were factored in, against a backdrop of high risk appetite and low volatility.

1 GDP GROWTH



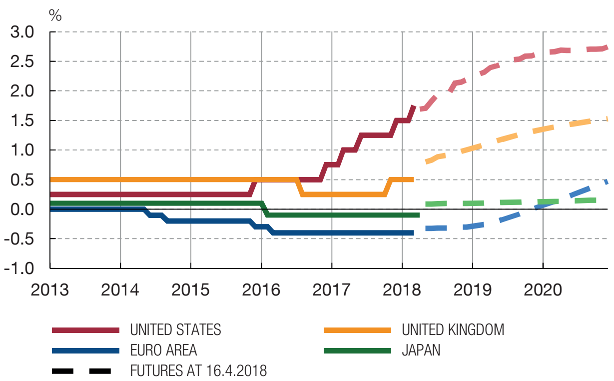
2 GDP AND DEMAND COMPONENTS IN ADVANCED ECONOMIES



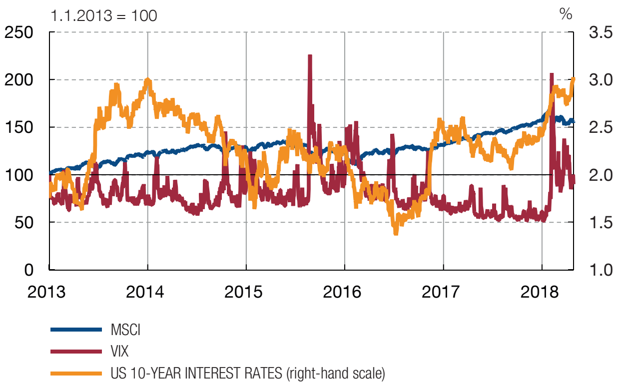
3 COMMODITY PRICES

4 UNEMPLOYMENT RATE, WAGE GROWTH AND CORE INFLATION IN ADVANCED ECONOMIES (b)

5 OFFICIAL INTEREST RATES IN ADVANCED ECONOMIES AND EXPECTED FUTURE RATES



6 LONG-TERM INTEREST RATES IN UNITED STATES AND GLOBAL STOCK INDICES



SOURCES: WEO (World Economic Outlook) and Datastream.

a Forecasts from IMF World Economic Outlook Update, January 2017.
b Aggregate of United States, euro area, United Kingdom and Japan.

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Monetary policy in the United States and the United Kingdom has progressively tilted towards a less easy stance. In the United States, where the economy is relatively ahead in the cycle, the Federal Reserve raised its policy rate by 25 bp on three occasions during 2017 and once again in March 2018, placing it in a range between 1.5% and 1.75% (see Chart 1.1.5). Moreover, in October it began gradually to reduce its balance sheet, following the plans announced before the summer. These movements took place in a setting in which the Federal Reserve has had to address the dilemma of adopting decisions in an economy with moderate inflationary pressures but with a very low unemployment level and with signs of overvaluation in certain financial market segments. The Bank of England, for its part, raised its policy rate by 25 bp in November, the first rise in 11 years, after noting that inflation was holding above target in its forecasting horizon.

The current US Administration announced some significant changes in its economic policies. On the fiscal front, a tax reform was approved in late 2017 and, into 2018, a budgetary agreement was reached to raise the expenditure ceiling and an infrastructure investment plan was announced. Although the fiscal reform was of a more limited scope than that contained in the electoral programme, the set of measures adopted has entailed a significant raising of the US growth forecast in the short term, with growth estimated to stand at around 3% and 2.5% in 2018 and 2019, respectively. As regards trade policy, the negotiations on the reform of the North American Free Trade Agreement (NAFTA), which began in mid-2017, have seen scarcely any progress. Moreover, the tariff rises announced by the US Administration in the opening months of 2018 on specific products from a broad range of countries confirm the feared turn towards protectionist positions. These measures, along with the responses by the authorities of the countries concerned, may ultimately result in a trade war, which could weigh down trade and economic activity globally. The historical evidence available shows that protectionism is harmful to well-being and global growth. Trade barriers distort the allocation of resources in the short term, prompting losses in efficiency. In the medium and long term, they have an adverse bearing on total factor productivity, chiefly as a result of the downturn in innovation and in the adoption and dissemination of new technologies, and lower managerial quality.[2]

In the emerging economies, macroeconomic policies have been fairly heterogeneous, differing in terms of the cyclical position and of the imbalances accumulated. In the monetary policy sphere, the moderation in inflation has provided for the prolongation of the cycle of easing in the main Latin American economies (with the exception of Mexico) and in Russia, in contrast to the muted rises in policy rates agreed by some central banks in other emerging areas. In particular, in China, the economic authorities have continued to pursue an economic policy course that has had as its dual objectives the lessening of financial risks and support for growth. With regard to the goal of safeguarding financial stability, the central bank adopted, over the course of the year, small-scale rises in interest rates, while the government approved the launch of the fiscal stimulus package ahead of the signs of a slowdown in activity.

The international financial markets saw a continuing appetite for risk and low volatility. This behaviour can be attributed to an environment of favourable economic activity figures, contained inflation and abundant liquidity built up after several years of highly expansionary monetary policies. Against this backdrop, investors' search for yield

2 See the box entitled "The possible effects of a reversal of globalisation" in *Annual Report 2016,* Banco de España and the analytical article "Situation of and outlook for the global economy at the start of 2018", *Economic Bulletin,* 2/2018, Banco de España.

remained intense, materialising in increases in the prices of numerous assets. Hence the main stock market indices, for developed and emerging economies alike, increased in 2017, with a notable rise of close to 20% in the United States to a new all-time high (see Chart 1.1.6). Moreover, emerging economies' sovereign debt spreads and those on the worst-rated corporate bonds were squeezed significantly during the year. As a result of these equity and bond market trends, and of the depreciation of the dollar, US financial conditions tended to ease, despite the tightening of monetary policy.

Nonetheless, in the opening months of 2018, there was a bout of notable volatility on the financial markets. At the start of the year, coinciding with a further improvement in the outlook for economic activity and with an increase in inflation expectations, the rise in US 10-year government bond yields that began in September 2017 steepened. In February this year, moreover, there was a significant correction of share prices on the main international markets, following the sudden signs of an increase in wage inflation in the United States which were interpreted as indicative of an inflationary rise and, therefore, of the fact that the pace of policy interest rate rises might accelerate relative to what had hitherto been anticipated. This episode of price corrections and rising volatility, which was amplified by certain market practices, spread to other international stock markets, but scarcely influenced bond markets.[3]

The global outlook remains complex despite the recent robustness of the world economy. The recent improvement in activity is predominantly rooted in the economic cycle, without significant increases in potential growth having apparently been recorded. Against this backdrop, the rate of increase of output in the advanced economies will foreseeably resume more moderate levels in the medium term and the increases in output above the potential rate may be expected to ultimately feed through to prices, leading inflation to converge on central bank targets. In the case of the emerging economies, expected growth would, on average, be around its potential rate, although there is notable heterogeneity across countries and regions.

Notable among the main risks to global growth are the potential correction of values on certain international financial market segments and the increase in protectionism. While additional positive surprises cannot be ruled out in the short term, in the medium term several significant risks persist. A hypothetical adjustment of asset prices might come about as a result of geopolitical events or in the face of unanticipated economic policy measures which, in some cases, might trigger sharp rises in financing costs and sudden capital switching, which would be particularly harmful for the economies most exposed to external financing. Also, the negotiations on the new shape of the EU-UK economic relationship, along with the protectionist slant adopted by the United States in its trade policy, remain areas of risk insofar as they point to an increase in the restrictions on global trade.

2.2 ROBUST EURO AREA GROWTH

The euro area economy expanded robustly in 2017, across all its members, and, as in other regions, the upturn was greater than forecast at the end of the previous year. Following several years of moderate growth, GDP adjusted for calendar effects increased by 2.5% in 2017, one of the highest rates observed since the launch of the euro (see Chart 1.2.1), set against the Eurosystem's December 2016 forecast of 1.7%. The buoyancy of domestic demand – in terms both of private consumption and investment –

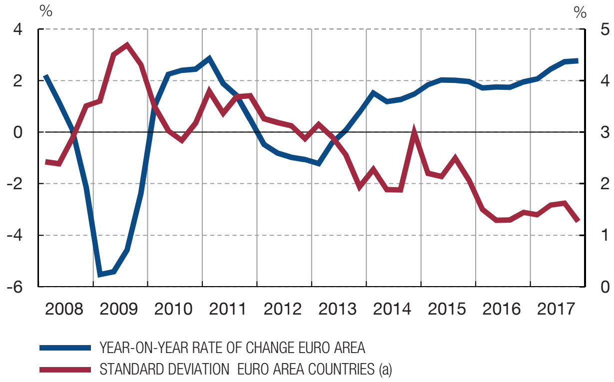
3 See the box "Global stock market correction and volatility episode" in the *Quarterly Report on the Spanish Economy,* March 2018, Banco de España.

THE EURO AREA EXPANSIONARY PHASE GAINED STRENGTH IN A SETTING OF MODERATE INFLATION

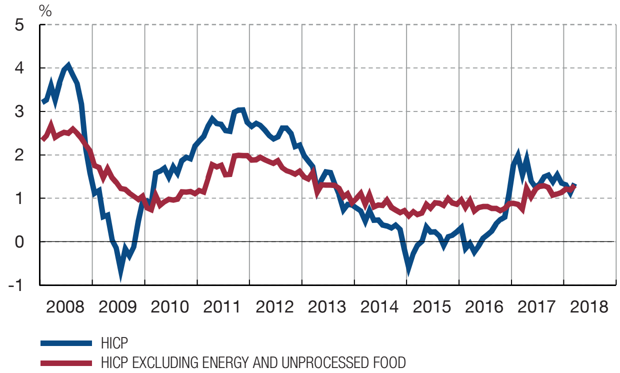
CHART 1.2

Widespread robust economic growth, with a lower level of dispersion in terms of GDP growth between the different countries. Inflation remained at moderate levels, despite the dynamic growth in activity which was accompanied by intense job creation. The unemployment rate continued to fall, although complementary indicators suggest that there is still a high degree of labour market slack, and wages climbed moderately. Financial conditions remain very favourable, despite the appreciation of the euro.

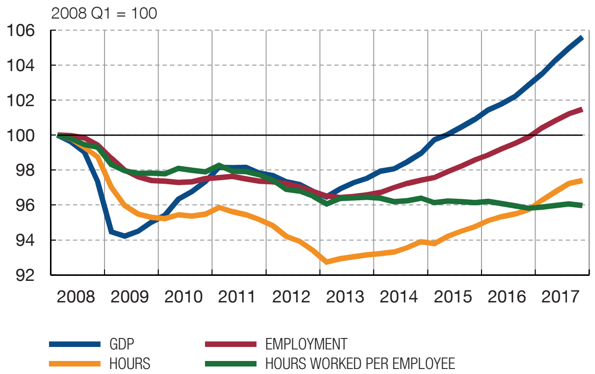
1 GDP



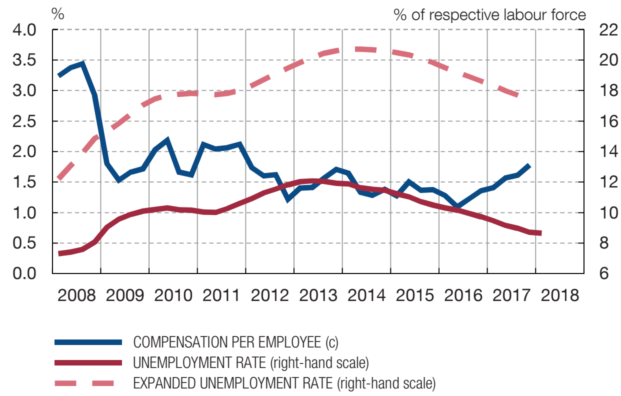
2 HARMONISED INDICES OF CONSUMER PRICES
Year-on-year rates of change



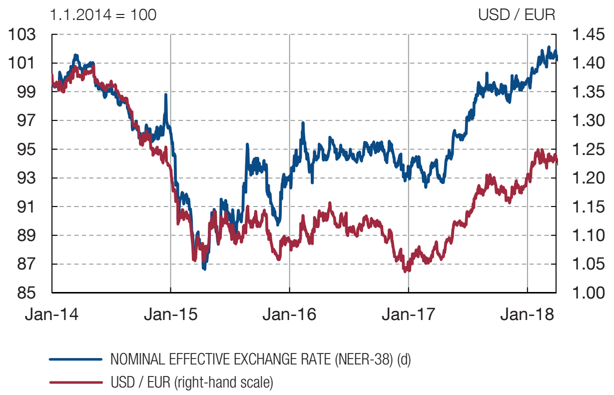
3 GDP, EMPLOYMENT, HOURS AND HOURS WORKED PER EMPLOYEE



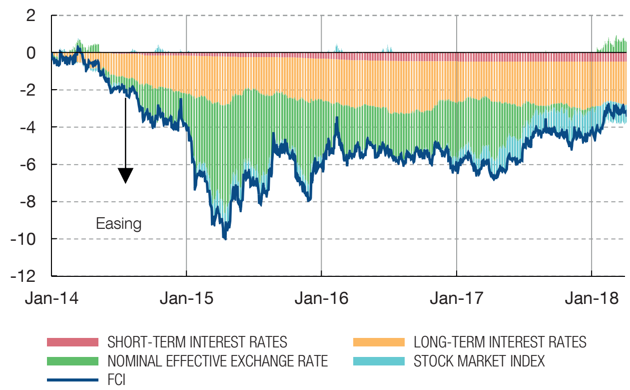
4 COMPENSATION PER EMPLOYEE AND UNEMPLOYMENT RATE (b)



5 EURO EXCHANGE RATES



6 FINANCIAL CONDITIONS INDEX (FCI) (e)



SOURCES: Banco de España, ECB and Eurostat.

a Unweighted standard deviation of year-on-year rates of change of euro area countries' GDP.
b The unemployment rate is the quarterly average of the monthly rates. The expanded unemployment rate takes into account individuals who are unemployed, underemployed, available for but not seeking work and unavailable for work. It is calculated by including in the denominator, in addition to the labour force, workers who are available for but not seeking work and those who are unavailable for work. See the influence of these factors on alternative measures of unemployment in "Quarterly report on the Spanish economy", Economic Bulletin, 2/2017, Banco de España.
c Year-on-year rate of change.
d NEER-38 is the nominal effective exchange rate of the euro against the currencies of the 38 most important trading partners of the euro area.
e The FCI is a weighted aggregation of changes in financial variables: 3-month Euribor (with a weighting of 0.18), the euro area 10-year interest rate (0.23), the NEER (0.10) and the EURO STOXX (0.012). It is expressed normalised by the weighting of short-term interest rates.

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combined with the strength of exports to drive this acceleration in activity. Moreover, the growth in the economy helped lead, on the estimates available, to the practical disappearance in late 2017 of the negative output gap that arose further to the crisis. The favourable economic situation was extensive to both sectors and countries, as shown by the dispersion indicators, which are at historically low levels.

The expansion in activity is proving intense in terms of employment generation. In 2017, numbers employed grew by 1.6%. The strength of job creation, which has benefited from the labour reforms undertaken in certain member countries and from a moderate rise in real wages, allowed for continuing reductions in the unemployment rate, which stood at the end of the year at 8.6%, still 1.3 pp above its pre-crisis level (see Chart 1.2.4). However, this aggregate figure masks substantial cross-country differences, which range from an unemployment rate below 4% in Germany to 20% in Greece and 16.5% in Spain.

Easy financial conditions prevailed in 2017, fundamentally reflecting the maintenance of a highly accommodative monetary policy. Money and debt market yields held at low levels, with sovereign spreads over the German Bund narrowing, especially in some of the countries that had been most affected by the crisis, such as Portugal and Greece. This narrowing has continued in 2018 to date and has spread to Spain, against a background of perceived improvements in its debt ratings, reflected also in upgrades by several agencies.[4] Share prices also rose notably in 2017 (the Eurostoxx index was up 10%), as a result of the improvement in expected profits. Private sector financing costs also held at historically low levels, while lending standards did not undergo significant changes during the year, thereby supporting the recovering trajectory of loans granted to households and firms. Nonetheless, the favourable course of these variables was offset by the notable appreciation of the euro (up 14% against the dollar over the year as a whole; see Chart 1.2.5), meaning that, for the purposes of the financial conditions indicator, standards tightened slightly in the second half of 2017 and somewhat more in early 2018 as a result of the stock market correction (see Chart 1.2.6).

The favourable financial conditions, the sound performance of employment and, consequently, the growth of income have all supported private demand. Of note under the private demand heading is the improvement in business investment, further spurred by the increase in confidence, profits growth and the sound behaviour of final demand. Specifically, investment in equipment increased by 4.9%, rising at end-2017 close to its pre-crisis level.

Exports, boosted by the improvement in world trade, have contributed to the momentum of activity, despite the notable appreciation of the euro. The strength of exports, which increased by over 5%, was practically extensive to all the euro area countries, with German and Italian sales standing out. In terms of geographical destinations, goods exports increased within the euro area as did those targeted on China and the United States, despite the adverse impact of the appreciation of the euro observed in 2017, whereby the euro area's share in overall global trade was hardly affected.

Following the consolidation process in the previous years, fiscal policy maintained a practically neutral stance in 2017. The budgetary policy stance took the form of the maintenance of the cyclically adjusted primary balance at approximately its 2016 level.

4 Specifically, for the Spanish case, the revisions were as follows: in January, Fitch changed its rating to A-; in March, S&P, also to A-; and in April, DBRS to A and Moody's to Baa1.

The favourable cyclical juncture and lower interest payments led, in the area as a whole, to a reduction in the budget deficit to 0.9% of GDP and to a further reduction in the public debt/GDP ratio to 86.7%, although this variable remains at notably higher levels in some countries.

Despite the buoyancy of activity, inflation has held at very moderate rates. Following the rise in the opening months of 2017, associated mainly with base effects of the energy component, overall consumer price inflation resumed a lower rate, standing in March 2018 at 1.3% (see Chart 1.2.2). Core inflation, too, which excludes the most volatile components from the overall index, has held at very stable levels – at around 1% – for most of the period, despite the narrowing of the output gap and the impact stemming from higher oil prices. Such price behaviour is in response to the confluence of different factors that have also affected other developed economies. These factors include some of a more structural type, such as the increase in competition arising from globalisation or the less inflationary dynamics linked to technological progress, along with others which, though more transitory in nature, have exerted very persistent effects, such as the low levels of oil prices and other commodities in past years. Moreover, in the case of the euro area, the easing in inflation may also have been due in part to predominantly domestic factors, such as the appreciation of the euro and the moderate increase in margins and in unit labour costs (ULCs). Wages grew by 1.6%, rising somewhat at the end of the year. Behind this wage moderation are various factors: low productivity growth, the existence of indexing mechanisms that take as a reference the past behaviour of inflation and the persistence of a certain slackness in the labour market the degree of which exceeds what may be inferred from the more traditional measures of unemployment, owing above all to the presence of a high number of part-time workers who would wish to extend the duration of their working day (see Chart 1.2.3).[5]

The moderate inflation outlook determined the accommodative stance of monetary policy in 2017. The monetary stimulus continued to rest on the operation of a broad set of monetary policy instruments, as has been the case since 2014, in the absence of clear signs of a sustained increase in inflation towards rates consistent with the price stability definition.[6] The financial indicators of inflation expectations pointed in early 2017 to the prospect of very slow convergence by the rate of change of consumer prices towards levels close to 2%, although they also noted that the risks of deflation had been dispelled (see Chart 1.3.1). In this scenario, policy interest rates held at very low levels, namely 0% on the main refinancing operations and -0.40% on the deposit facility rate (see Chart 1.3.2). The Eurosystem, for its part, continued to inject liquidity through its large-scale private and public asset purchase programmes (APP).[7] Net public and private bond purchases totalled €780 billion in 2017, meaning that at the end of the year the APP portfolio amounted to almost €2.3 trillion (see Chart 1.3.3). Gross purchases were higher, since the maturing securities acquired in prior years were reinvested, a policy that will continue for a long period after net purchases have finalised. In a complementary fashion, to reinforce monetary transmission through the credit channel, the last targeted longer-term refinancing operation (TLTRO-II) was conducted in March 2017. There was exceptional demand for funds, and the operation concluded with a net injection of almost €217 billion, raising the financing granted under the TLTRO programmes to over €760 billion. Lastly, the ECB

5 These factors are analysed in detail in Box 1.3 "Wage growth in the euro area", "Quarterly report on the Spanish economy", *Economic Bulletin,* 3/2017, Banco de España.

6 Section 4.2 of this chapter describes the actions undertaken during this phase by the ECB, while Box 1.3 assesses their impact on activity and prices.

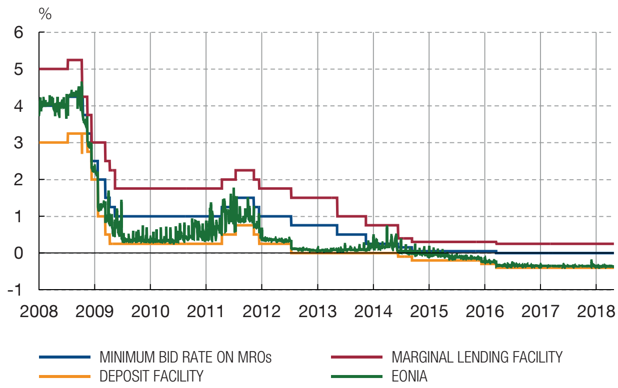
7 The private securities are asset-backed bonds, covered bonds ("cédulas hipotecarias" in Spain) and corporate bonds, acquired respectively under the ABSPP, CBPP-3 and CSPP programmes.

EURO AREA MONETARY POLICY REMAINED EXPANSIONARY CHART 1.3

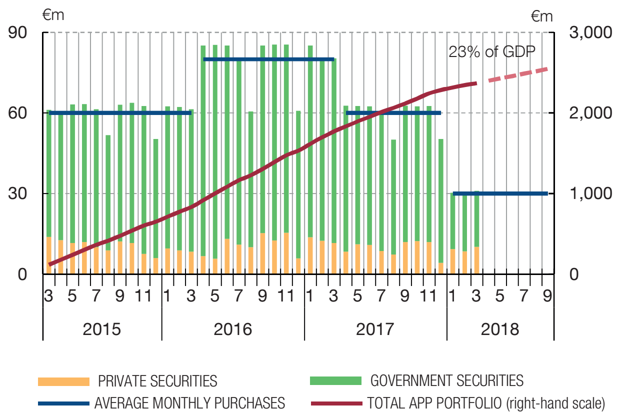
The ECB's monetary policy maintained its expansionary stance as there were no clear signs of a sustained rise in inflation towards levels consistent with the reference value, against a backdrop of a small climb in medium-term inflation expectations. Monetary stimulus continued to be based on historically low official interest rates, asset purchases and the communication policy. Interest rate expectations remain low.

1 EURO AREA INFLATION EXPECTATIONS
Derived from inflation-linked swaps

2 OFFICIAL ECB INTEREST RATES AND EONIA



3 ASSET PURCHASE PROGRAMME (APP)



4 INTEREST RATE EXPECTATIONS

SOURCES: ECB, Bloomberg and Thomson Reuters.

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continued to resort to forward guidance in respect both of its policy rates and the APP in order to underscore expectations that monetary policy will retain an accommodative stance over a prolonged period (see Chart 1.3.4).

The expansion of activity in the euro area as a whole progressively firmed, leading to some adjustments in monetary policy instruments. In June 2017, the improved economic outlook and the easing in downside risks for inflation led the ECB to withdraw the accommodative bias still present in its indications as to policy interest rates, eliminating the reference to the possibility of such rates being lowered from those then prevailing. Months later, in October, the temporary extension of the APP until at least September 2018 was announced, along with the reduction in the pace of net monthly purchases from €60 billion to €30 billion as from January 2018 (see Chart 1.3.3).[8] The improved outlook has led more recently, in March 2018, to the elimination of the reference whereby, faced with a

8 See the box "Monetary policy decisions adopted by the Governing Council of the ECB in October", in *"Quarterly report on the Spanish economy"*, *Economic Bulletin*, 4/2017, Banco de España.

potential deterioration in the economic situation or in financial conditions to levels not consistent with achieving the inflation objective, the Council would stand ready to increase the size and/or the duration of the purchase programme. Nonetheless, the progress observed in the convergence of inflation towards rates more compatible with the monetary policy medium-term objective is still insufficient, which warrants monetary policy remaining geared to continuing easy financial conditions.

Available forecasts suggest continuity in the medium term of the current upturn and gradual convergence by the inflation rate on the price stability objective. The information received in 2018 to date points to the maintenance of the economic expansion, albeit at a lesser pace than that recorded at end-2017. As regards prices, the widening of the positive output gap is expected to translate into a gradual increase in core inflation.

Over a longer time horizon, there is room for improvement in the use of productive factors so that they may contribute to the continuity of the expansionary phase. High youth and long-term unemployment, along with the high percentage of employees involuntarily working part-time and the moderate recovery in total hours worked, suggest that, despite the significant reduction in the unemployment rate, the degree of underutilisation of the labour factor is still high (see Charts 1.2.3 and 1.2.4). Also, following the low levels of private investment in past years, in an environment of corporate and household deleveraging, a strengthening in the rate of investment may be expected for the coming years, underpinned by the observed improvement in its determinants and supported by the restored health of bank balance sheets. A rebound in public investment is likewise desirable, especially in those countries with greater budgetary headroom, which would contribute to the correction of current account imbalances in the euro area falling more evenly between surplus- and deficit-running countries.[9] Moreover, greater dynamism in aggregate investment would help correct the persistence of the high current account surplus in the euro area as a whole and raise the potential growth rate.

3 The prolongation of the upturn in the Spanish economy in 2017

The expansionary trajectory of the Spanish economy continued into 2017, with GDP growth once again exceeding 3% for the third year running. Specifically, output increased by 3.1%, 0.2 pp down on the previous year (see Table 1.1 and Chart 1.4.1). The contribution of national demand to the increase in GDP was 2.8 pp, 0.3 pp up on 2016, with the contribution of investment increasing somewhat (see Charts 1.4.2 and 1.4.3). Net external demand made a positive contribution of 0.3 pp, less than that in 2016, when it amounted to 0.7 pp. Also for the third year running, the increase in output clearly outpaced that in the euro area as a whole (see Charts 1.4.1 and 1.4.4).

Growth slowed slightly towards the end of 2017. The rising path of GDP scarcely varied in the course of last year, posting quarter-on-quarter growth of 0.8%, on average, a similar rate to that observed since mid-2014, with a slight downturn at the end of last year. As a result, the increase in political uncertainty in the second half of the year, as a result of the situation in the Catalonia region (see Box 1.1), is estimated to have had a moderate impact on GDP growth for the Spanish economy as a whole, which will moreover have been offset by the improved external setting.[10] The expansion has continued at a similar pace to date

9 See Chapter 4 "Fiscal policy in the euro area", *Annual Report 2016,* Banco de España.

10 Box 3 of the "Quarterly report on the Spanish economy", *Economic Bulletin,* 4/2017, Banco de España reviews the effects observed in the final stretch of 2017 as a result of the uncertainty associated with the political situation in Catalonia. In turn, Box 1.1 of the *"Financial Stabilty Report",* 11/2017, Banco de España describes the possible medium-term effects under different hypothetical scenarios relating to the scale and persistence of the rise in uncertainty.

MAIN INDICATORS OF THE SPANISH ECONOMY (a) — TABLE 1.1

	2012	2013	2014	2015	2016	2017
Demand and output (b)						
GDP	-2.9	-1.7	1.4	3.4	3.3	3.1
Private consumption	-3.5	-3.1	1.5	3.0	3.0	2.4
Government consumption	-4.7	-2.1	-0.3	2.1	0.8	1.6
Gross capital formation	-9.5	-4.6	5.8	8.7	3.1	5.5
Investment in equipment	-6.2	4.9	6.0	11.6	4.9	6.1
Construction investment	-12.3	-8.6	4.2	3.8	2.4	4.6
Housing	-10.3	-10.2	11.3	-1.0	4.4	8.3
Other construction	-13.9	-7.3	-1.1	7.9	0.9	1.5
Exports of goods and services	1.1	4.3	4.3	4.2	4.8	5.0
Imports of goods and services	-6.4	-0.5	6.6	5.9	2.7	4.7
Contribution of national demand to GDP growth	-5.1	-3.2	1.9	3.9	2.5	2.8
Contribution of net external demand to GDP growth	2.2	1.5	-0.5	-0.4	0.7	0.3
Employment, wages, costs and prices (c)						
Total employment	-4.8	-3.4	1.0	3.2	3.0	2.8
Employment rate (d)	56.5	55.6	56.8	58.7	60.5	62.1
Unemployment rate	24.8	26.1	24.4	22.1	19.6	17.2
Compensation per employee	-0.6	1.4	0.1	1.6	-0.3	0.1
Apparent labour productivity	2.0	1.8	0.3	0.3	0.3	0.2
Unit labour costs	-2.5	-0.4	-0.2	1.4	-0.6	-0.1
GDP deflator	0.1	0.4	-0.2	0.6	0.3	1.0
Consumer price index (end of period)	2.9	0.3	-1.0	0.0	1.6	1.1
Consumer price index (annual average)	2.4	1.4	-0.2	-0.5	-0.2	2.0
Consumer price differential with euro area (HICP)	-0.1	0.2	-0.6	-0.7	-0.1	0.1
House prices	-13.7	-10.6	0.3	3.6	4.7	6.2
Net lending (+) or net borrowing (-) and financial balance (e)						
Resident sectors: domestic net lending (+) or net borrowing (-)	0.1	2.1	1.5	1.7	2.1	2.0
General government	-10.5	-7.0	-6.0	-5.3	-4.5	-3.1
General government (excluding aid to financial institutions)	-6.8	-6.7	-5.8	-5.2	-4.3	-3.1
Households and NPISHs	2.2	4.0	3.4	2.3	1.6	-0.3
Firms	8.3	5.1	4.1	4.7	5.1	5.4
Financial institutions	6.9	2.2	2.3	1.8	2.0	2.4
Non-financial corporations	1.4	2.9	1.8	2.9	3.1	2.9
Net international investment position	-89.9	-95.2	-97.8	-89.7	-83.4	-80.8
General government gross debt	85.7	95.5	100.4	99.4	99.0	98.3
Monetary and financial indicators (f)						
ECB minimum bid rate on MROs	0.9	0.5	0.2	0.1	0.0	0.0
Ten-year government bond yield	5.8	4.6	2.7	1.7	1.4	1.6
Synthetic bank lending rate	4.1	4.1	3.8	2.9	2.7	2.6
Madrid Stock Exchange General Index (Dec 1985 = 100)	767.5	879.8	1,066.6	1,080.5	879.2	1,034.5
Dollar/euro exchange rate	1.3	1.3	1.3	1.1	1.1	1.1
Nominal effective exchange rate vis-à-vis developed countries (g)	100.2	101.5	101.5	99.3	99.9	100.8
Real effective exchange rate vis-à-vis developed countries (h)	107.2	106.9	106.0	104.7	103.6	103.2
Real effective exchange rate vis-à-vis euro area (h)	106.6	104.8	104.0	105.2	103.5	102.3
Households: total financing	-3.8	-5.2	-3.6	-2.1	-2.0	-1.3
Non-financial corporations: total financing	-6.4	-6.1	-3.7	-0.4	-0.4	0.2

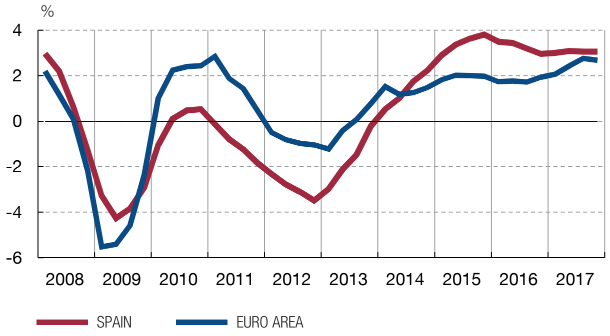
SOURCES: INE, IGAE, AMECO and Banco de España.

a Spanish National Accounts data, base year 2010.
b Volume indices. Annual rates of change.
c Rates of change, except the unemployment rate which is a level.
d Employment rate (16-64 age group).
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 financial liabilities.
g 1999 Q1 = 100.
h 1999 Q1 = 100. Measured with unit labour costs.

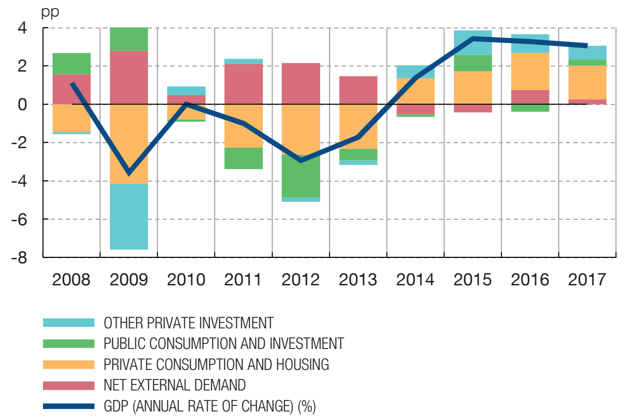
ANOTHER YEAR OF STRONG GROWTH FOR THE SPANISH ECONOMY **CHART 1.4**

Once again the rate of growth of GDP exceeded 3%, with a relatively uniform time profile throughout the year. The expansionary behaviour of domestic demand was favoured by accommodative financial conditions. The net external demand contribution was positive again, albeit somewhat less so than in 2016, against a backdrop of higher exports and, particularly, higher imports.

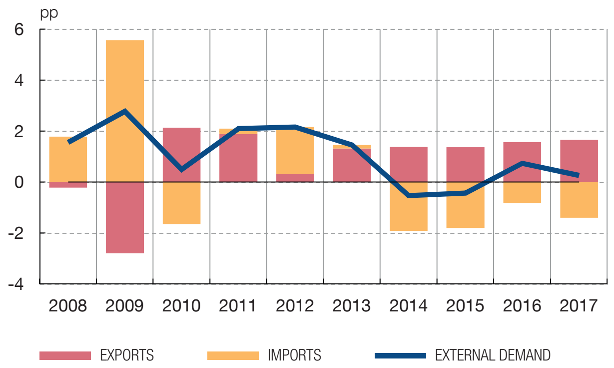
1 GDP: SPAIN AND THE EURO AREA
Year-on-year rates of change in real terms



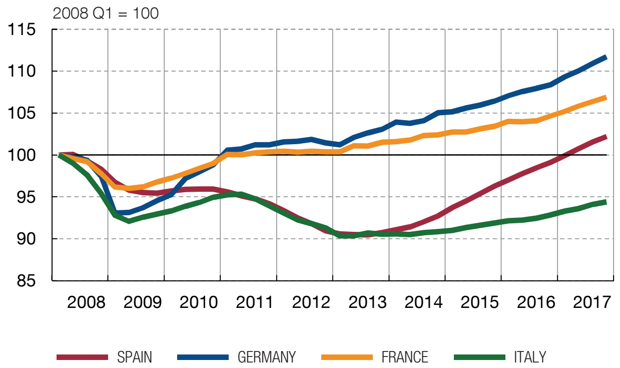
2 GDP: DOMESTIC AND EXTERNAL DEMAND COMPONENTS
Annual rates of change and contributions to growth



3 NET EXTERNAL DEMAND
Contributions to GDP growth



4 GDP
Levels in real terms



SOURCES: INE and Banco de España.

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in 2018, giving rise to a positive cyclical gap which is expected to carry on increasing in the coming years.[11]

As in previous years, the rate of increase of activity once again exceeded prior expectations at the start of the year. Specifically, the Banco de España projected in December 2016 that growth in 2017 would be 2.5%, 0.6 pp down on the figure finally observed. In general, all the final demand components increased by more than expected, with exports and investment notably strong compared with the projections.

The positive surprise is mainly attributable to external markets performing more favourably than envisaged before the start of the year. The formulation of macroeconomic forecasts usually rests on a set of technical assumptions about various variables upon which the projection is conditional. The gap between the forecast and the actual GDP growth figure observed in 2017 would largely be because there was a significant deviation in the behaviour

11 See Box 6 "The cyclical position of the Spanish economy" in "Quarterly report on the Spanish economy", *Economic Bulletin*, 1/2018, Banco de España.

of foreign markets, which proved more favourable than was expected at end-2016. The deviations in the rest of the technical assumptions (interest rates, stock market prices, oil prices, etc.) are estimated, overall, to have had a much lesser impact. To reach this conclusion the 2017 GDP growth projections formulated in December 2016, using the MTBE (Quarterly Macroeconomic Model of the Banco de España) with the set of assumptions then prevailing, have been compared with those that would have been formulated had the finally observed figures for the assumptions then been known.[12] The fact that the actual growth of 3.1% should have exceeded the MTBE forecast by 0.2 pp, once the assumptions upon which the projection is conditional were known, suggests that factors other than those captured by the historical relationships estimated in the model may have been operating in a positive direction.

Prices and costs in the economy once again grew very moderately. Consumer prices increased on average by 2% in 2017, but this increase was influenced by the higher level, in annual average terms, of oil prices; as a result, the rate of increase of the indicator that excludes the energy component was far lower, at 1.2%. The GDP deflator, which proxies the prices of domestically produced goods, posted a similar (1%) increase for the latter figure, as a result of very modest growth in labour costs per unit of value added, which increased in the market economy by 0.2%, while the rise in the unit operating surplus, including taxes, was close to 2.5%.

3.1 THE ROBUSTNESS OF ACTIVITY WAS EXTENSIVE TO MOST DEMAND COMPONENTS

In 2017, Spanish households' financial conditions remained very easy. The maintenance of the expansionary monetary policy stance is allowing the average interest rates on bank financing to hold at low levels, close to their historical lows (see Chart 1.5.1). Further, the Bank Lending Survey (BLS) registered a slight improvement in access to lending during the year as a whole, which has helped lending activity continue to recover (see Chart 1.5.2). The increase in new lending business has translated into an easing in the rate of decline of the outstanding balance of household debt (from 1.3% in December 2016 to 0.8% one year later). By end-use, the outcome was a lesser contraction in lending for house purchases and greater dynamism in consumer credit and other lending.

As has been the case since the crisis broke, the low level of financing costs has continued to be a factor supporting household income. It is thus estimated that the cumulative decline in interest rates from 2008 to 2017 has contributed, in net terms, to raising household disposable income in 2017 by around 1 pp.[13]

Households' financial situation continued to strengthen during 2017, which also contributed to boosting expenditure in the sector. Household debt fell to below 100% of its gross disposable income (GDI) and 61% of GDP, ratios still somewhat higher than – though now very close to – average euro area ratios. Net wealth in this sector has also been boosted by increased asset values, especially property, with a rise in house prices of 7.2% in 2017 (see Chart 1.6.1).

12 Specifically, the model's projections before the introduction of the experts' opinions would, in each case, have been 2.5% and 2.9%, respectively. Three-quarters of the difference of 0.4 pp between these two figures would be due to the fact that external markets fared better than projected, with the remainder attributable to the surprises in the remaining assumptions as a whole. See New version of the Quarterly Model of Banco de España (MTBE), *Documento Ocasional,* no. 1709, Banco de España for a description both of the model's main mechanisms and of the simulations of the effects of the errors in the assumptions on those upon which the projection is conditional.

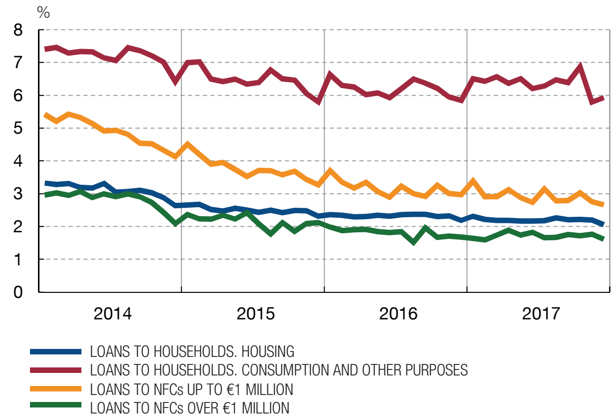
13 This reduction in interest rates has affected both asset-side and liabilities-side operations, with a highly heterogeneous impact on the income of different households, depending on the sign and magnitude of their net assets, as illustrated by the fact that the figures relating to the cumulative effect of the fall in interest rates from 2008 to 2017 on disposable income for this latter year through interest received and paid were, respectively, negative of the order of 2.9 pp and 3.9 pp.

THE SPANISH ECONOMY'S FINANCING CONDITIONS REMAIN HIGHLY FAVOURABLE

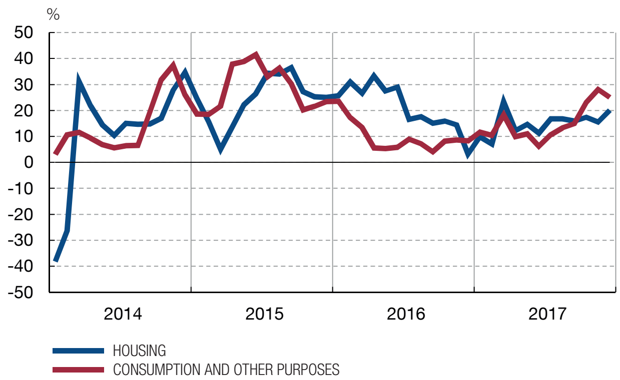
CHART 1.5

Households' and NFCs' financing conditions remained very favourable, with financing costs continuing at historically low levels. In addition, access to bank credit continued to improve for these sectors, especially for SMEs. In this setting, credit activity continued to recover.

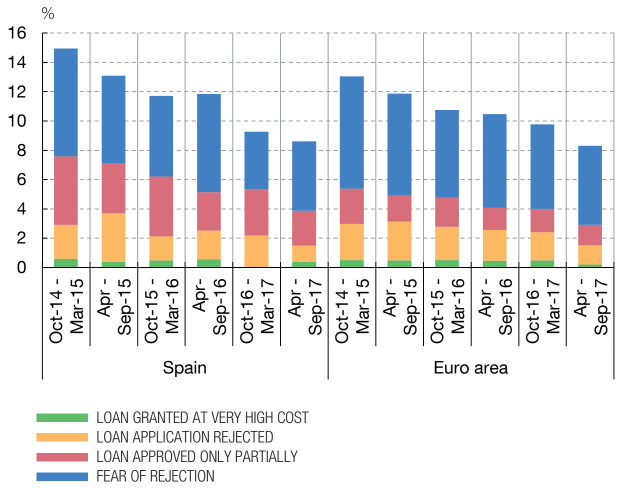
1 BANK LENDING RATES. SPAIN



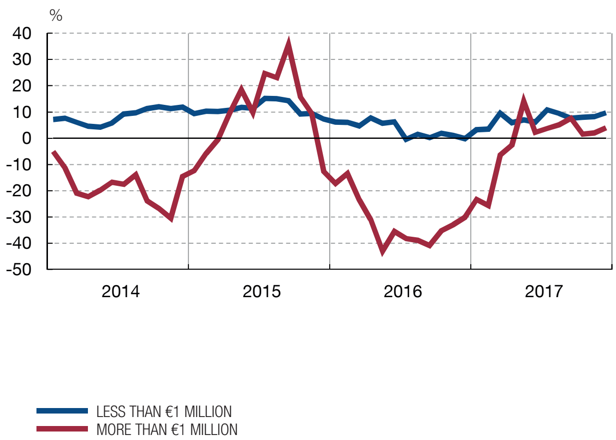
2 NEW LENDING TO HOUSEHOLDS. YEAR-ON-YEAR GROWTH (b)



3 SMEs FINDING IT DIFFICULT TO OBTAIN BANK LOANS (a)



4 NEW LENDING TO FIRMS. YEAR-ON-YEAR GROWTH (b)



SOURCE: Banco de España.

a This indicator reflects the proportion of firms to which any of the following apply: loan application rejected; loan approved only partially; loan approved at what firm considered to be a very high cost; and loan not requested because firm did not expect it to be approved (fear of rejection).
b Cumulative 3-month flow.

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From 2014 to 2017, real wages grew by 0.4% in cumulative terms. These overall developments mask very different sub-periods, with a 2.4 pp increase in real wages from 2014 to 2015, stabilisation in 2016 and a 2 pp loss in purchasing power in 2017, linked to the rise in the inflation energy component.

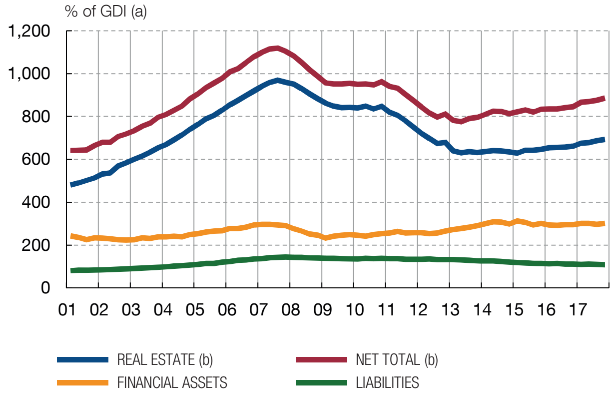
The slowdown in real household income led, given the lesser scale of the loss of momentum in consumption, to a steepening of the decline in the saving rate. Household income grew by 2% in nominal terms in 2017, a similar rate to that observed a year earlier. Nonetheless, the inflationary rise due to the energy component of consumer prices meant that, in real terms, the increase in income was only 0.2% (1.8 pp down on the previous year) (see Chart 1.7). The magnitude of the slowdown in private consumption in real terms was far less (0.6 pp, to 2.4%), whereby the compression of household income gave rise to a 2 pp reduction in the household saving rate, to 5.7% of disposable income, its lowest level since the creation of the monetary union.

THE FINANCIAL POSITION OF HOUSEHOLDS AND NON-FINANCIAL CORPORATIONS CONTINUED TO STRENGTHEN

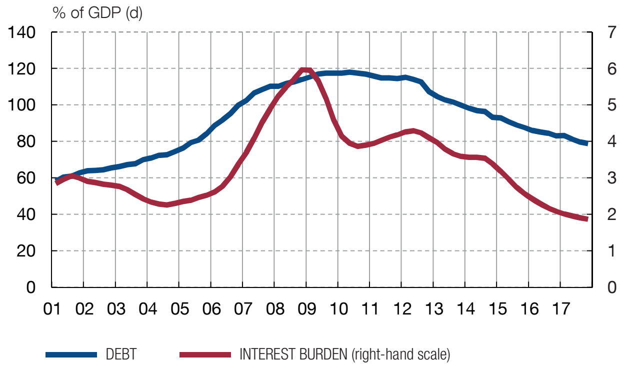
CHART 1.6

In 2017 the financial position of Spanish households and non-financial corporations continued to strengthen, with further reductions in their indebtedness ratios and, in the case of households, increases in their net wealth also, mainly thanks to rising house prices. The lower indebtedness ratios, along with the decline in the average cost of liabilities, led to a reduction in the degree of financial pressure.

1 HOUSEHOLDS. WEALTH



2 NON-FINANCIAL CORPORATIONS. DEBT (c) AND INTEREST BURDEN



SOURCES: INE and Banco de España.

a Cumulative four-quarter data.
b Estimate based on estimated change in housing stock, average floor area of housing and price per m2.
c Interest-bearing borrowing.
d Seasonally and calendar-adjusted series.

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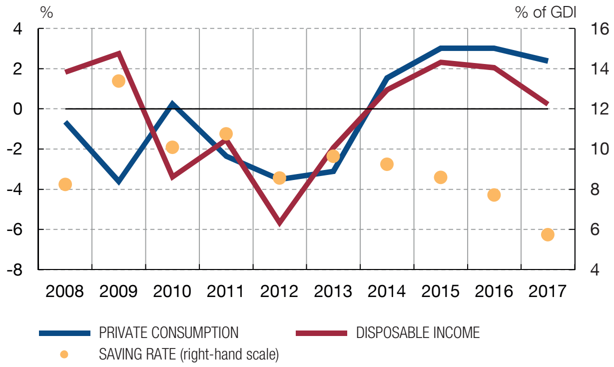
REAL HOUSEHOLD INCOME GROWTH HAS MODERATED AND THE DECLINE IN THE SAVING RATE HAS INTENSIFIED

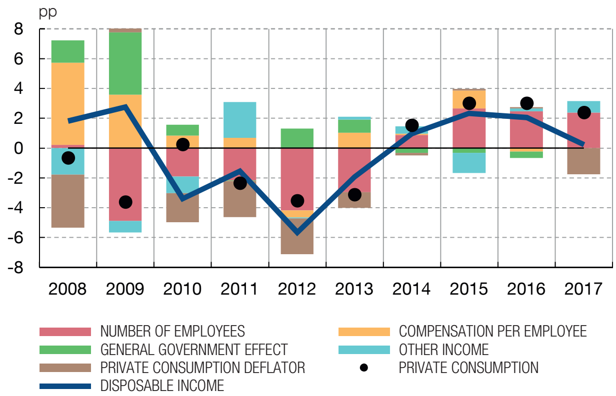
CHART 1.7

The continued decline in the saving rate in recent years is probably linked to factors such as diminished uncertainty and satisfaction of the demand, especially for durable goods, that built up during the crisis. In 2017 household income continued to grow at a fast pace in nominal terms. However, higher inflation meant that, in real terms, there was a significant slowdown in income. Given that households reduced their consumption to a lesser extent, the decline in the saving rate intensified.

1 PRIVATE CONSUMPTION AND DISPOSABLE INCOME
Real annual rates of change



2 PRIVATE CONSUMPTION AND DISPOSABLE INCOME
Contributions to real annual rate of change



SOURCES: INE and Banco de España.

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The reduction in the saving rate in 2017 entails the prolongation of a downtrend under way over the past eight years. In Spain, the fluctuations in the saving rate since the onset of the crisis have been much greater than in the core euro area countries, since the oscillations in consumption and income have also been greater. The Spanish household saving rate increased at the start of the crisis to a level of over 13% of disposable income at end-2009.[14] Since then, until end-2017, the rate has gradually fallen (by over 7 pp in cumulative terms). The causes of this decline have varied over time. During the recession, the reduction in the saving rate was linked to the need to maintain spending on essential goods and services against the background of a heavy decline in household income. Greater uncertainty led households to defer a substantial portion of their consumption decisions, but not those taken to meet their most basic needs.[15]

Several aspects of the recovery are estimated to have prompted a sustained reduction in household saving. Specifically, the improved labour market situation has contributed to diminishing the need for precautionary saving. Set against the increase in employment and income, and the reduction in uncertainty, households have stepped up their purchases of consumer goods and services and, in particular, they have satisfied the spending decisions they deferred during the crisis, which has led to a progressive absorption of pent-up demand.[16] Moreover, the low level of interest rates may have lessened saving incentives, and the favourable financial conditions have boosted debt-fuelled consumption. Finally, the recovery has coincided with an increase in the share of labour income in total income, a factor that is estimated to have likewise contributed to spurring a reduction in the saving rate, given that the marginal propensity to consume of labour income is greater than in the case of the remaining sources of income.[17]

Looking ahead, the room for households to further reduce their saving appears to be limited. Following the cumulative declines, the current level of the saving rate stands somewhat below the pre-crisis level. However, it should be borne in mind that the significant decline in household debt has lessened the portion of saving earmarked for repaying this debt and that it may now be allocated to current spending. For these purposes, an alternative definition may be considered of the saving rate that discounts therefrom an estimate of the payments made by households under the heading of debt repayment. Under this definition, the saving rate would still be 2 pp above its 2008 low, reflecting the deleveraging undertaken by the sector in the period since.

Households posted a net borrowing requirement in 2017, after having recorded a net lending capacity since 2009 Q2, against the background of a significant rise in residential investment. Investment in housing increased by 8.3% last year (3.9 pp up on a year earlier), assisted by the strength of employment creation and propitious financial conditions. Moreover, the momentum of demand from abroad continued, since the fall-off in British buyers was offset by the acquisitions made by residents of other countries. The rise in residential investment, in the above-mentioned setting of diminished saving, led households to cease to be net lenders to the other sectors in the economy. Specifically, households' net borrowing requirements amounted to 0.3% of GDP in 2017, in contrast to the net lending capacity of 1.6% at end-2016 or the average of over 3% in the two years spanning 2014 and 2015.

---

14 Ó. Arce, E. Prades and A. Urtasun (2013), *"Changes in household saving and consumption in Spain during the crisis", Economic Bulletin,* September, Banco de España find as a possible cause of the decline in the saving rate since 2010 the existence of minimum consumption thresholds for certain goods.

15 See the *Analytical Article* "The recovery of private consumption in Spain by product type and household", *Economic Bulletin,* 2/2017, Banco de España. J. González Mínguez and A. Urtasun (2015), "Consumption dynamics in Spain by product type", *Economic Bulletin*, September, Banco de España, document the differential impact of the crisis on various categories of goods and services, finding that durable goods and non-essential goods and services underwent notably sharper falls in the crisis (and likewise far higher increases in the recovery) than other staple products or products whose consumption it is not possible to adjust (e.g. owing to the existence of contractual obligations).

16 See Box 4 of "Quarterly report on the Spanish economy", *Economic Bulletin,* 4/2017, Banco de España.

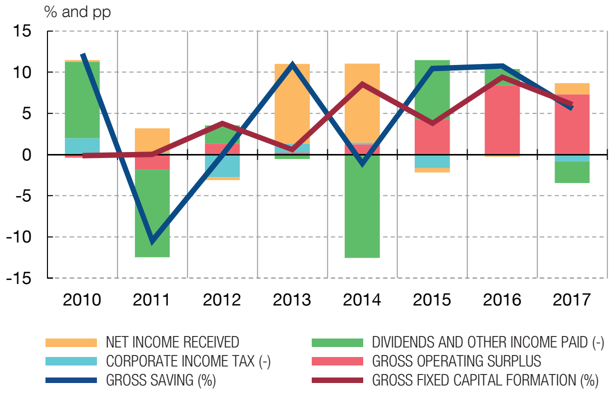
17 G. de Bondt, A. Gieseck and Z. Zekaite (2018), "Forecasting euro area private consumption using thick modelling", ECB, mimeo.

FINAL DEMAND AND FAVOURABLE FINANCIAL CONDITIONS CONTINUED TO DRIVE INVESTMENT BY NON-FINANCIAL CORPORATIONS

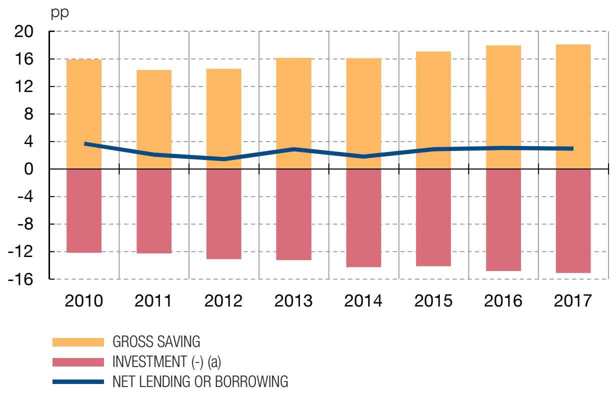
CHART 1.8

The benign financial conditions and the improved financial position of NFCs were conducive to growth in business investment, against a backdrop of strong final demand. High income generation in the sector meant that, despite the investment momentum, net lending remained high.

1 CORPORATE SAVING AND GROSS FIXED CAPITAL FORMATION
Nominal growth and contributions



2 FIRMS' NET LENDING OR BORROWING
% of GDP



SOURCES: INE and Banco de España.

a Includes net capital transfers.

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The favourable trend of business profits has continued to spur investment by non-financial corporations (NFCs). On National Accounts data, the sector's gross operating surplus is estimated to have retained its forceful dynamism in 2017, increasing by 5.5%, a slightly lesser pace than that of the previous year (see Chart 1.8.1). In terms of gross corporate saving, the slowdown was greater, dipping from 10.8% to 5.6%, which is due both to the rise in dividends paid and to the impact of the changes in corporate income tax.[18]

As in the case of households, the financing conditions of NFCs, both in terms of the cost and availability of funds, remains supportive of spending decisions. The cost of borrowed funds has held at historically low levels, with a further slight decline in the case of loans of less than €1 million, the segment in which operations with SMEs are concentrated (see Chart 1.5.1). The Survey on the Access to Finance of Enterprises (SAFE) evidences a further improvement in access to credit by small companies, such that the percentage of Spanish SMEs reporting themselves to be financially constrained stands below 9%, in line with the euro area average (see Chart 1.5.3).

This context has been conducive to the continued expansion of new borrowing business. The pick-up in activity in the credit market was particularly pronounced in the segment encompassing SMEs (see Chart 1.5.4). In terms of stocks, the increase in the volume of new business has led the rate at which credit to resident NFCs was slipping to ease slightly over the course of 2017 (from 1.1% at end-2016 to 0.6% a year later).[19]

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18 The information from the Central Balance Sheet Data Office likewise points to a dynamic behaviour of profits for the case of large corporations, with ordinary profit growth of 7.4%. See the *Analytical Article* "Results of non-financial corporations to 2017 Q4: preliminary year-end data".

19 In June 2017, a credit institution conducted an intra-group operation under which the loans granted to a real estate subsidiary were converted into parent company equity holdings. As a result, there was a 1.6% decline in the outstanding balance of credit to NFCs. Had this operation not taken place, the year-on-year growth rate of credit extended to NFCs in December 2017 would have been 1.6 pp higher.

Fixed-income financing was notably buoyant, particularly in the first half of 2017, contributing to making the flow of external financing (credit from resident institutions, fixed-income securities and external loans), in the year as a whole, positive for the first time since 2010. As a result, the weight of fixed-income financing in the total has increased, thereby providing continuity to the bank disintermediation initiated further to the crisis which, in the most recent period, has been boosted by, inter alia, the ECB's Corporate Sector Purchase Programme (CSPP) launched in June 2016.[20]

Another significant factor of support for non-financial corporations' investment decisions has been the strengthening of their financial position. The sector's aggregate debt ratio continued to fall in 2017, standing at year-end at 78% of GDP, similar to the euro area average, when it was almost 40 pp above this level in mid-2010. This reduction in debt, combined with a slight decrease in the average cost of its outstanding balance, translated into a further reduction in the debt burden ratio which, set against the figure of 6% in early 2009, stood below 2% of GDP. This historically low level, along with the decline in debt, explains the low degree of financial pressure borne by the sector as a whole (see Chart 1.6.2).

The favourable financial conditions and the improvement in corporate balance sheets were conducive to investment by non-financial corporations increasing in 2017 by around 5% in real terms.[21] This rate of increase, while high, was slightly below the average for the first three years of the recovery. As has been the case throughout this period, the buoyancy of business investment spending has continued to be underpinned by the momentum of final demand, whose growth, at 3.3%, was once again very similar to that averaged during the previous three years (see Chapter 3 of this Report).[22] The increase in investment once again significantly exceeded fixed-capital consumption; however, capacity utilisation continued to increase throughout the year on the back of the strength of demand. As a result, the sector continued to show a notable lending capacity, of 2.9% of GDP (see Chart 1.8.2), reflecting the ongoing balance sheet restructuring at non-financial corporations as a whole.

Exports accelerated slightly in 2017, albeit to a lesser extent than their end-markets. Goods and services exports increased by 5% over the year as a whole (see Chart 1.9.1). This rate, 0.2 pp up on the previous year, was slightly lower than that posted by external markets. These developments were in contrast to 2016, when exports to the rest of the world outgrew end-markets by more than 2 pp. The pattern of diminished relative buoyancy of exports compared with their scale variable is shared when regard is had to the breakdown between the euro area and the rest of the world; that suggests that several factors other than the appreciation of the exchange rate recorded last year may be at play, an appreciation which, vis-à-vis the non-euro area developed countries, was 2.4% in nominal effective terms.[23]

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20 O. Arce, R. Gimeno and S. Mayordomo (2017), "Making room for the needy: the credit reallocation effects of the ECB's corporate QE", Documento de Trabajo, no. 1743, Banco de España, document the effects of the CSPP on the financing of Spanish firms. In particular, the announcement of the programme led large corporations to replace bank loans with debt issues. In turn, the fall in these corporations' demand for credit enabled an increase in that granted to smaller firms, which do not usually have the capacity to gain access to primary corporate debt markets.

21 This rate is an in-house estimate, since National Accounts offer this magnitude solely in nominal terms.

22 Chapter 3 of this *Annual Report* analyses in detail the trend of investment in equipment and intangibles during the current recovery phase. The determinants of the sound behaviour of these variables include most notably the easing of financial conditions, the availability of own funds, diminished uncertainty and the fact the business sector was more export-oriented.

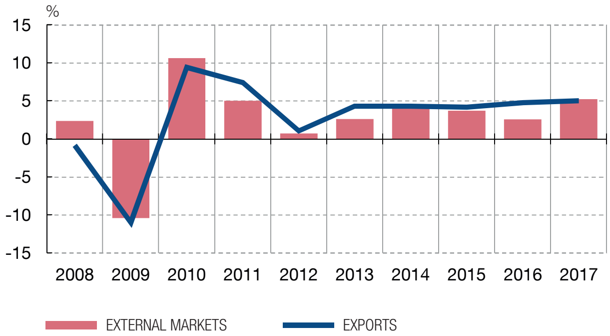
23 Analysis of contributions to export growth by the various explanatory variables suggest that the factors not included in the equations made a zero contribution to the increase in sales abroad, unlike 2016, when they had contributed 3 pp (see Chart 1.9.2).

EXPORTS RECORDED A SIMILAR RATE OF GROWTH TO 2016

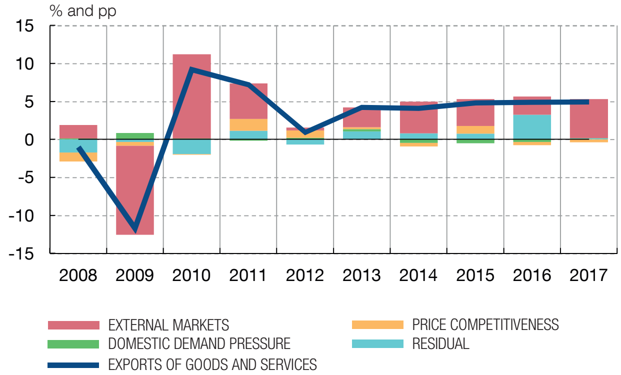
CHART 1.9

Export growth was slightly higher than in 2016. However, the rate of growth was lower than that of the external markets. By component, tourism services remained particularly robust, while by contrast other services weakened significantly. The continuing increase in the number of exporting firms had a positive impact on goods exports.

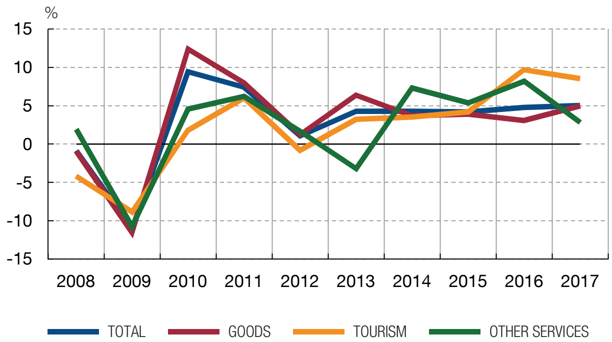
1 GROWTH OF EXPORTS AND EXTERNAL MARKETS
Real rates of change



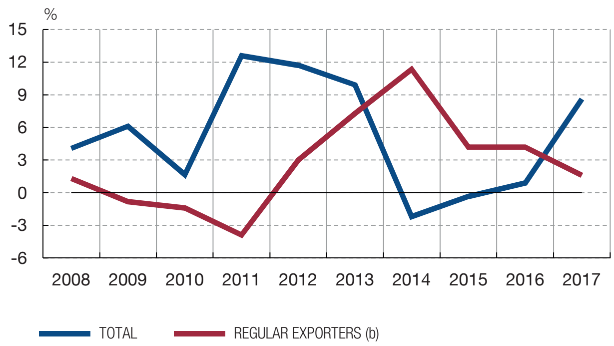
2 TOTAL EXPORTS: GROWTH AND CONTRIBUTIONS (a)



3 EXPORT COMPONENTS
Real rates of change



4 EXPORT FIRMS: REGULAR EXPORTERS AND TOTAL
Rates of change



SOURCES: INE and Banco de España.

a Using the export equation of the Banco de España's satellite model for the foreign sector.
b Regular exporters are those that have exported in the year concerned and in each of the three immediately preceding years.

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Goods exports were the sole foreign sales component that accelerated. Specifically, goods exports to the rest of the world grew by 5%, 1.9 pp up on 2016 (see Chart 1.9.3). In 2017 the base of firms that started exporting expanded significantly, although there was some easing in the rise in the number of regular exporters (understood to be those that have been exporting for at least four years; see Chart 1.9.4). In any event, the increase recorded since the onset of the crisis in the number of companies that regularly export provides structural support to sales abroad. In particular, the empirical evidence suggests that firms generally begin to export on a small scale, increasing the volume subsequently, once they see that their products are successful in end-markets.[24] This mechanism would account for growth in the volume of exports by companies already established in foreign markets, even though the enlargement of the export base were to be checked.

As in 2016, the tourism services component of exports was notable for its greater dynamism. These services grew by 8.5%, 1.2 pp down on the previous year. The

24 See C. Arkolakis, T. Papageorgiou and O. Timoshenko (2018), "Firm Learning and Growth", *Review of Economic Dynamics*, forthcoming.

continuing strength of this variable was underpinned, on the demand side, by the improved economic situation in the euro area countries and the increase in the proportion of tourists from other regions (whose average daily expenditure is higher) and, on the supply side, by the quality improvements to the services provided, which helps lure higher-spending visitors.[25] Conversely, the depreciation of sterling would not seem to have exerted any significant impact on arrivals of British tourists, who are Spain's main market.[26] That said, since the final stretch of 2017, some weakening in tourist exports has been observed, linked possibly to the August terrorist attacks in Barcelona, to the subsequent period of uncertainty in Catalonia, and to the incipient recovery of competing destinations in the Mediterranean.[27] This latter factor, along with the strength of the euro and dearer oil prices, suggests a more moderate growth outlook. Finally, the pace of exports of other services eased notably following their exceptional performance in 2016, centred on business services.[28]

Generally, the impact of Brexit on the Spanish economy in terms of trade flows appears so far to have been limited. In particular, exports to the United Kingdom do not appear to have suffered from the dearer prices caused by the depreciation of sterling, since they have not behaved differently to those whose end-destination is the EU as a whole, except as regards consumer goods sales, especially of cars.[29]

The pace of imports accelerated in 2017. Purchases abroad rose to a rate of 4.7% (1.2 pp up on 2016), partly in response to the fact that the growth rate of final demand was somewhat higher, but above all to an increase in the elasticity observed between both variables compared with previous years. In any event, the elasticity observed stood below its average historical value (see Chart 1.10.1), in keeping with the microeconomic evidence suggesting the existence of signs of an incipient process involving the replacement of imported inputs by domestically produced ones.[30] In turn, the rise in the elasticity of imports to final demand during 2017 might be partly attributable to the fact that the composition of this latter aggregate was skewed to a greater extent towards more import content-intensive variables, such as investment in capital goods and in intangible assets, and exports.

The lending capacity of the economy as a whole declined slightly to 2% of GDP (see Chart 1.11.1). Maintaining positive balances vis-à-vis the rest of the world over a prolonged period is an unavoidable requisite for reducing the Spanish economy's high external debt. In this respect, the fact that the sharp expansion in domestic demand throughout the recovery phase is proving compatible with relatively high external surpluses is a positive feature of the current expansionary cycle.[31] In 2017, the merchandise trade deficit widened

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25 For a classification of the tourist offer, see "The Travel &Tourism Competitiveness Report 2017", *World Economic Forum* (2017). For greater details about the recent course of the tourism export determinants, see Box 7 "Dynamism of non-resident tourism in 2016 and its determinants", in the "Quarterly report on the Spanish economy", *Economic Bulletin,* 1/2017, Banco de España.

26 See Box 3 in the "Quarterly report on the Spanish economy", *Economic Bulletin,* 2/2017, Banco de España.

27 There were significant increases in 2017 in tourist arrivals in North Africa and the Middle East, with year-on-year rates climbing by around 8 pp. For an assessment of the impact of the changes in tourist flows towards Spain as a result of the trend in these alternative destinations, see Box 7 "Dynamism of non-resident tourism in 2016 and its determinants", in the "Quarterly report on the Spanish economy", *Economic Bulletin,* 1/2017, Banco de España.

28 See Box 7 "Net exports of non-tourism services in Spain since 2008" "Quarterly report on the Spanish economy", *Economic Bulletin,* 1/2018, Banco de España.

29 See Analytical Article, "Un análisis de la expansión comercial de las empresas españolas en el Reino Unido", Boletín Económico, Banco de España, forthcoming.

30 See Chapter 3 of the *Annual Report, 2016,* Banco de España.

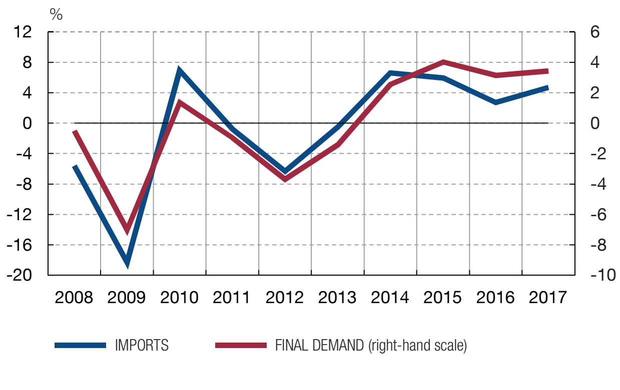
31 Chapter 3 of the *Annual Report, 2016,* Banco de España, contains an estimate of the structural component of the external balance.

IMPORTS ROSE, IN PART OWING TO STRONGER FINAL DEMAND MOMENTUM

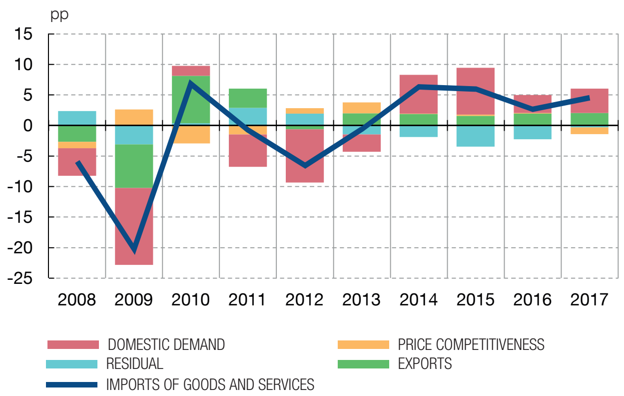
CHART 1.10

Following the unusually low value observed in 2016, the elasticity of imports to final demand rose in 2017. However, it remains low compared with historical values, tending to confirm that the competitive gains achieved by the economy are giving rise to a certain degree of import substitution.

1 IMPORTS AND FINAL DEMAND
Rates of change



2 TOTAL IMPORTS: GROWTH AND CONTRIBUTIONS (a)



SOURCES: INE and Banco de España.

a Using the import equation of the Banco de España's satellite model for the foreign sector.

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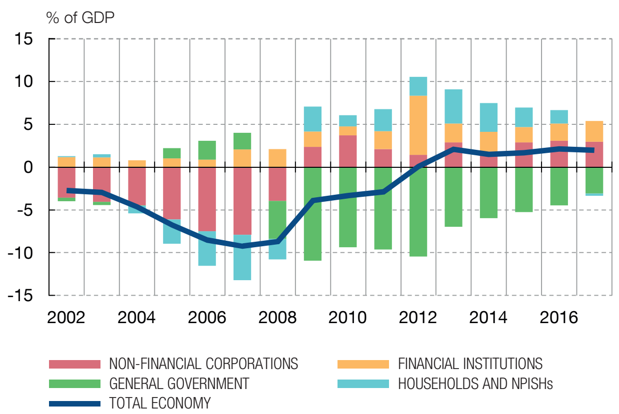
THE EXTERNAL SURPLUS WAS HIGH AGAIN

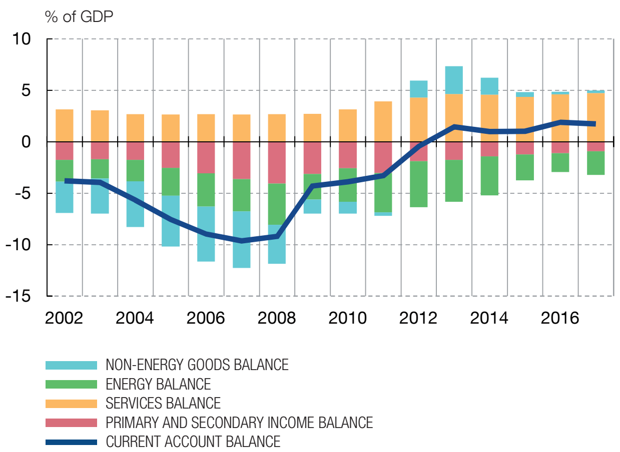
CHART 1.11

The current account surplus was very similar to that of 2016, against a backdrop of worsening real terms of trade but with an improving real non-energy balance. As for the sectoral balances, both the disappearance of household net lending and the decline in the general government deficit are notable, while non-financial corporations again recorded high net lending.

1 NET LENDING (+) / NET BORROWING (-) BY SECTOR



2 CURRENT ACCOUNT BALANCE



SOURCES: INE and Banco de España.

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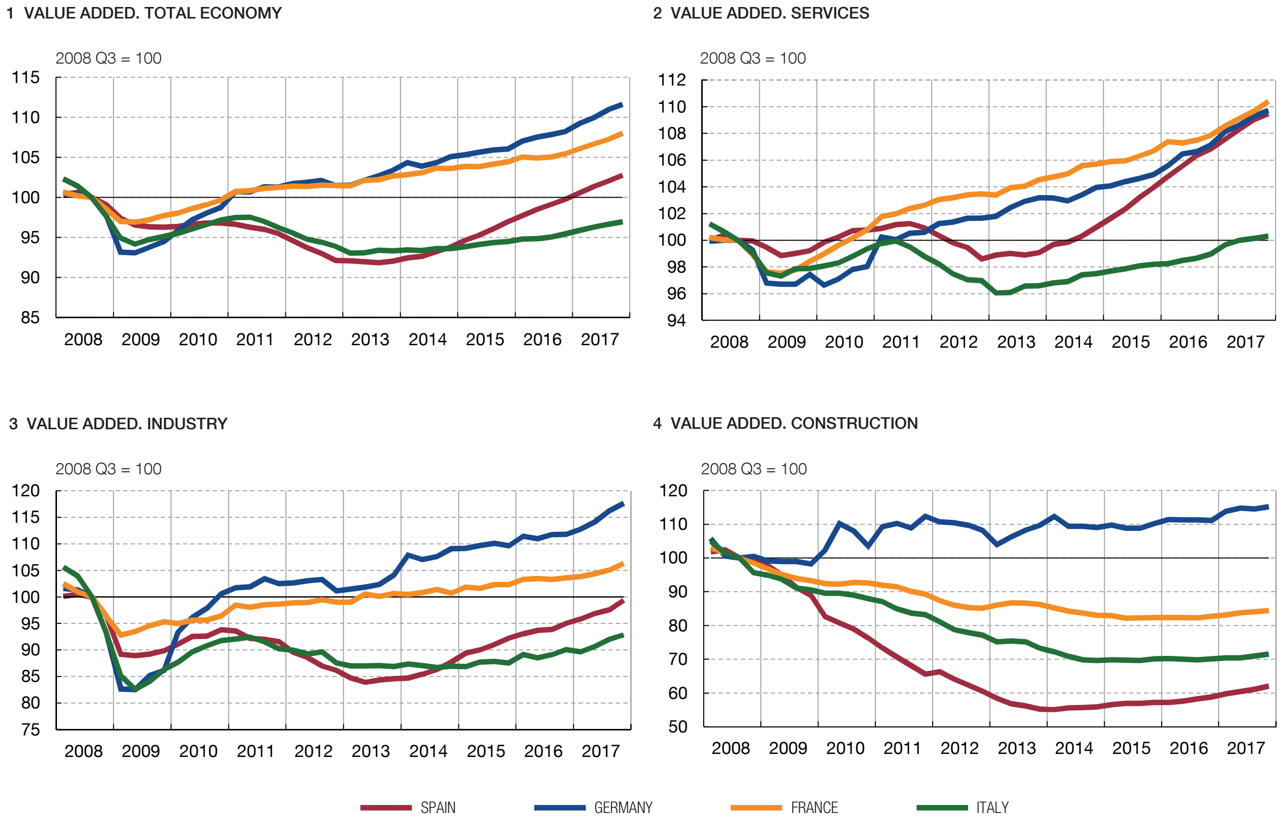
by 0.3 pp to 1.9% of GDP, which chiefly reflected the worsening of the real terms of trade (affecting energy products, in step with dearer oil, and non-energy products alike), while the non-energy balance improved significantly in real terms, for the first time since 2013 (see Chart 1.11.2). This fall in the merchandise balance was partly countered by an improvement in the surplus on services – linked above all to the increase in tourism exports – and by a further slight reduction in the deficit on the income balance, assisted by the environment of low interest rates.

CONSTRUCTION AND INDUSTRY MORE EXPANSIONARY THAN SERVICES IN 2017 CHART 1.12

In 2017 industry value added was similar to the pre-crisis level, whereas services value added was 10% higher and construction value added was 40% lower. In terms of international comparison, since the start of the downturn the rate of growth of the services sector has been very similar to that observed in Germany or France. There are larger differences in industry, where Spain has underperformed in comparison with both Germany and France, and especially in construction, reflecting the sharp correction observed in Spain.



SOURCES: Eurostat, INE and Banco de España.

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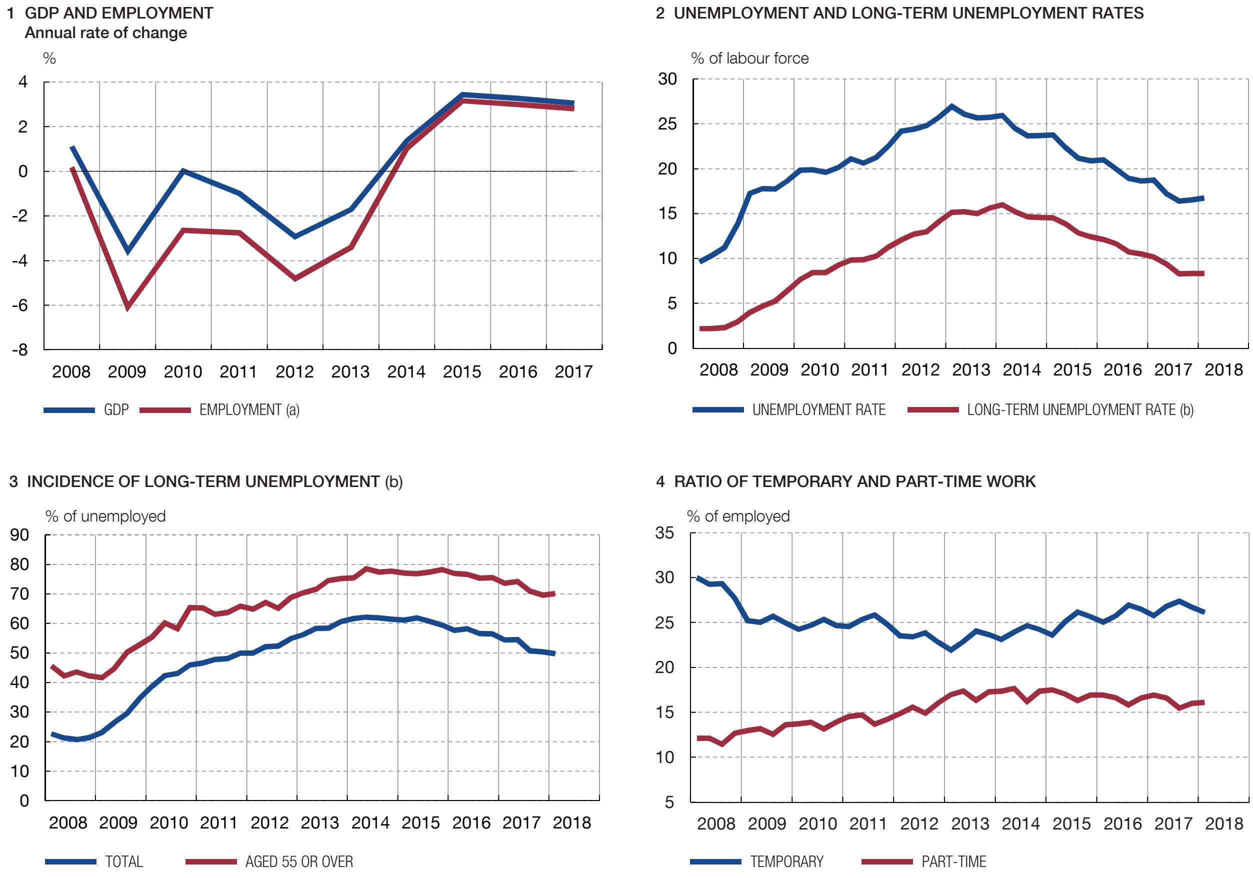
From a sectoral perspective, the strength of activity was across the board. Among the main sectors, value added grew most in construction, by 4.9%, the highest rate since 2001. From a more medium-term standpoint, value added in services as a whole was almost 9% higher than its pre-crisis level at end-2017, while in construction it is 40% lower, posting a very similar performance in industry (see Chart 1.12). Compared internationally, this pattern is in contrast to that in countries such as Germany, where value added in industry and construction is significantly higher than that observed in 2008.

Job creation remained robust. Numbers employed increased by 2.8% in 2017 (see Chart 1.13.1), meaning that, since the end-2013 low, more than 1.9 million jobs have been created. However, the current level is still 10.4% down on that prevailing in early 2008, when the historical high in occupation was recorded. This intense job creation process has contributed to reducing the high unemployment significantly. Specifically, at end-2017, the unemployment rate stood at 16.5%, more than 10 pp below its early-2013 peak (see Chart 1.13.2), but still some distance off the euro area average (8.6%). The reduction in unemployment has also been assisted by the changes in the working population, where the declining trend of recent years continued in 2017. This chiefly reflected an increase in the weight of the oldest population groups, against a background of progressive population ageing, alleviated partly by the rise in the participation rate of the oldest groups. The

JOB CREATION WAS AGAIN VERY STRONG

CHART 1.13

As has been the case since the start of the recovery, productivity growth was very low. Thanks to job creation and the decline in the labour force, the unemployment rate continued to fall, although to a lesser extent among workers with longer spells of unemployment. The percentage of employees with temporary contracts continued to increase, and the percentage of those working shorter than usual hours continued to decline.



SOURCE: INE.

a Employment as per Quarterly National Accounts. Full-time equivalent jobs.
b Long-term unemployed: persons who have been unemployed for a year or more. Incidence: proportion of total unemployed who have been unemployed for a year or more.

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incidence of long-term unemployment (i.e. the definition that considers those individuals who have been seeking a job for more than one year) declined to 50.4% at end-2017, a rate which, after the cumulative reduction over the past three years of over 10 pp, is very similar to the euro area average (see Chart 1.13.3). Nonetheless, the incidence of long-term unemployment remains very high among certain groups, in particular among the least skilled (56.3%).

Employment generation was sharper in some of the sectors that had experienced greater destruction at the onset of the crisis. Thus, according to the EPA (Spanish Labour Force Survey), employment grew by over 5% in construction and by around 3% both in industry and in market services, while in non-market services it increased by scarcely more than 1%. Moreover, some slowing was observed in some of the services activities that had been most buoyant in previous years, such as hotels and restaurants, transport and distribution. Overall, however, if the structure of employment by productive sector at end-2017 is compared with that prevailing pre-crisis, the weight of services can be seen to have gained 9 pp, equally distributed between market and non-market services, at the expense of industry (-2 pp) and construction (-7 pp).

3.2 COSTS AND PRICES CONTINUED TO EVIDENCE LOW RATES OF INCREASE

Strong job creation has moved in step with a very modest increase in wage remuneration throughout the recovery phase. During the 2014-2017 period, the annual growth of economy-wide compensation per employee averaged 0.4% (see Chart 1.14.1). In 2017 this rate was 0.1 %. The increase in the market sectors, the scale of which was 0.1 pp higher, was the outcome of the opposite behaviour of the two main components. On one hand, wages negotiated under collective bargaining agreements grew by 1.4% (0.4 pp up on 2016).[32] On the other, these increases were offset by the portion of wage growth not attributable to collective bargaining, i.e. the component known as wage drift, whose contribution to the growth of compensation per employee was -1.5 pp, of a similar magnitude to that estimated for 2016.

The negative contribution of wage drift mainly reflects composition effects in the flow of employment generation. Negative drift is occurring in an environment of very low rates of increase in apparent labour productivity. From the standpoint of workers' individual characteristics, one factor simultaneously limiting aggregate wage increases and productivity would appear to be the increase in the weight of new entries in the total numbers employed, given that the more limited job tenure of the former is associated with a lower-than-average wage level (and presumably productivity level). Specifically, on information from Social Security records, available to 2016, it is estimated that the greater weight of newcomers has contributed to reducing average compensation by somewhat more than 0.5 pp in each of the three years of the 2014-2016 period (see Chart 1.14.2). This effect is estimated to have been partly countered by other changes in the characteristics of workers that operate in the opposite direction, such as the rise in the average age of the working population or the increase in the average level of educational attainment. In addition, there is some evidence that, given the characteristics of the job and of the person employed, the wage difference between those who have been in the job for respectively more and less than one year has increased since the crisis (see Chart 1.14.3).[33]

Set against the significance of individual characteristics, the changes in the sectoral composition of employment creation appear to play a secondary role when explaining the low increases in aggregate wages and productivity. Employment creation is falling more than proportionately in sectors where the level of productivity is lower. However, the magnitude of this effect on wages is small. Specifically, the estimated contribution of the change in the sectoral composition of employment to the growth of compensation per employee in the market economy in cumulative terms from 2014 to 2017 was 0.4 pp.

In early 2017, an 8% rise in the minimum wage was approved, followed by a further increase of 4% in 2018. The increase approved for 2017, which directly affected somewhat more than 3% of wage-earners, is estimated to be exerting a limited aggregate effect both on employment and on wages.[34] Nonetheless, on the evidence available for other, past increases in the minimum wage, the impact on the probability of job loss might be significant for certain specific groups of workers, such as youths and the elderly, insofar as

32 Specifically, wage settlements were higher in newly signed agreements (1.8%) than in revised agreements, which usually react more slowly to the changes in wage determinants and which on this occasion, too, reflected to a lesser extent the labour market improvement and the rise in consumer prices.

33 See the *Economic Note* «La evolución del empleo y del paro en el primer trimestre de 2017, según la Encuesta de Población Activa", *Boletín Económico,* 2/2017, Banco de España. Specifically, the wage gap, once controlled for by the differences in observable characteristics, between workers already present in the labour market and new entries, rose from approximately 9% in 2008 to 15.3% in 2016. This gap has widened, in part owing to the drop in the number of hours worked per employee.

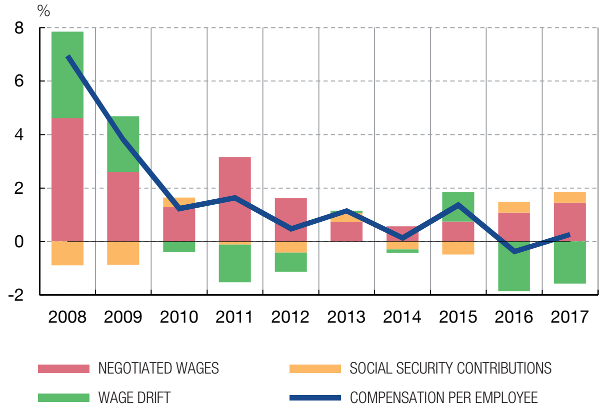
34 See Box 5 "The effects of the recent rise in the minimum wage on employment and wages" in the "Quarterly report on the Spanish economy", *Economic Bulletin,* 1/2017, Banco de España.

COMPENSATION PER EMPLOYEE AGAIN RECORDED MODEST GROWTH

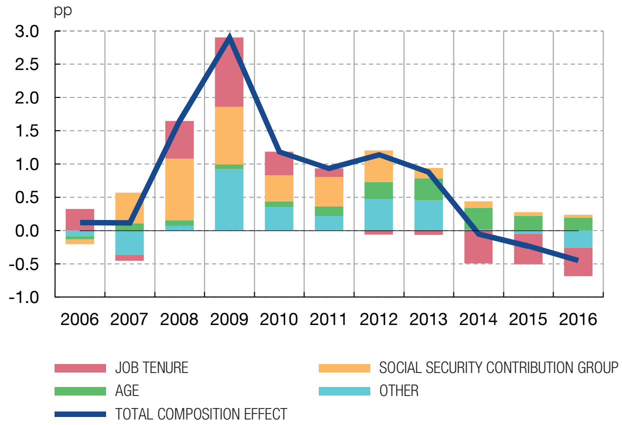
CHART 1.14

Negotiated wages accelerated moderately, but wage drift again made a highly negative contribution to growth in compensation per employee, reflecting, among other factors, the lower pay levels of new labour market entrants. In addition, the difference between wage levels of individuals with respective job tenure of more or less than one year has increased since the crisis.

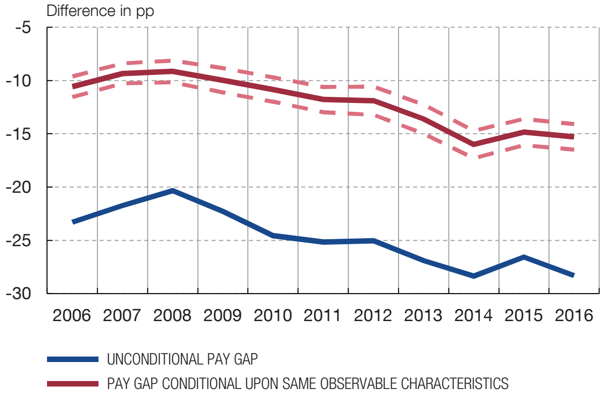
1 MARKET ECONOMY COMPENSATION PER EMPLOYEE
Growth and contributions of negotiated wages, wage drift and social security contributions



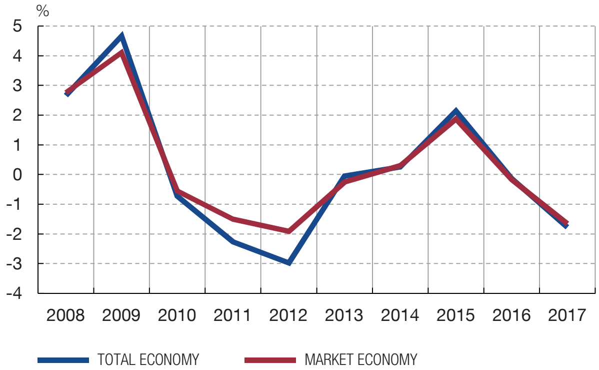
2 CONTRIBUTION OF DIFFERENT FACTORS TO COMPOSITION EFFECTS IN WAGES



3 NEW LABOUR MARKET ENTRANTS' PAY GAP (a)



4 REAL WAGES (b)
Annual rates of change



SOURCES: INE and Banco de España.

a The unconditional pay gap is defined as the percentage wage difference between a worker with length of service of less than one year and all other workers. The conditional pay gap is estimated using a wage equation that controls for differences between both groups of workers by sex, age, level of education, nationality, sector of activity and firm size.
b Nominal wage is the compensation per employee according to Quarterly National Accounts. The nominal wage deflator is the CPI.

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they may have, on average, a lower level of productivity. These effects may be exacerbated in future given that, in addition to the minimum-wage increases that have already been introduced, a path of additional rises has been agreed to raise the minimum wage by 2020 to an amount comprising 14 payments per annum of €850.[35]

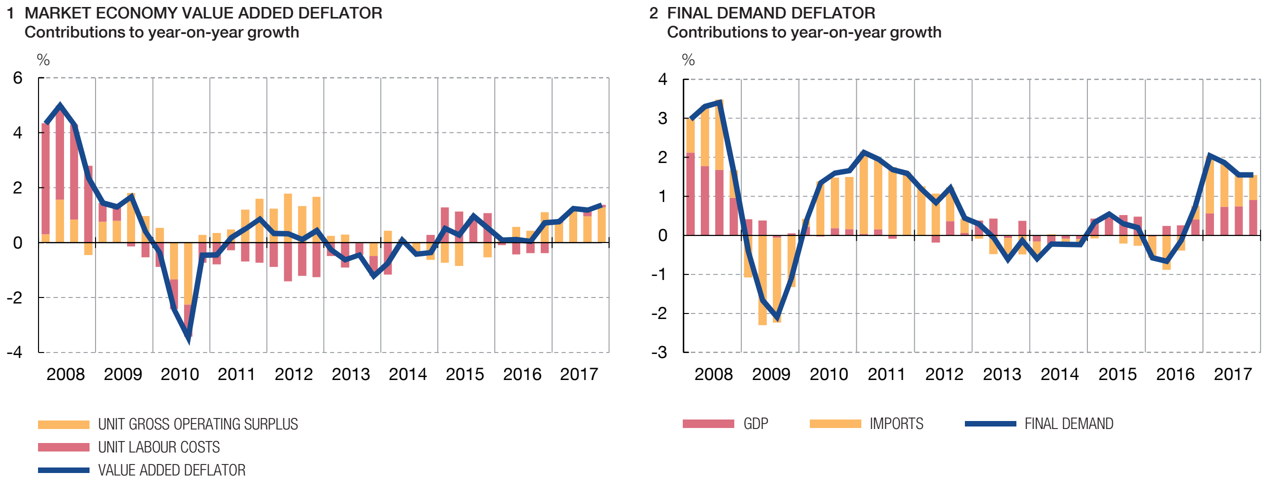
The low rate of increase in wages and productivity translated into a virtual stability of unit labour costs (ULCs), albeit on a rising profile over the course of the year. ULCs increased by 0.2% in annual average terms in the market economy. However, this variable

35 In each of the two years covering the period 2019-2020, these increases are conditional upon real GDP growth being higher than 2.5%, and increases in average Social Security registrations exceeding 450,000 people. Should these increases materialise, there would be a 20% rise in the minimum wage from €707 in 2017 to €850 in 2020 (in both cases in 14 payments per annum).

MINOR ACCELERATION DURING THE YEAR IN DOMESTIC PRICES AND, TO A GREATER EXTENT, IN EXTERNAL PRICES

CHART 1.15

The value added deflator of the market economy again recorded a low rate of growth, although with an increasing profile throughout the year, thanks to the contribution both of ULCs and the unit surplus. The final demand deflator accelerated in annual average terms, but with a decreasing profile, owing to the deceleration in the import deflator.



SOURCES: Eurostat, INE and Banco de España.

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has been rising since mid-2016, reflecting a modest acceleration in wages, which in turn might be related to the reduction in the degree of cyclical slack and, in particular, to the ongoing decline in unemployment. Looking ahead, it seems likely that composition effects will continue to give rise to negative drift and to low increases in productivity. However, the gradual improvement in the labour market might continue to exert upward pressure on wage settlements, which would translate into some acceleration in compensation per employee and, therefore, in ULCs.

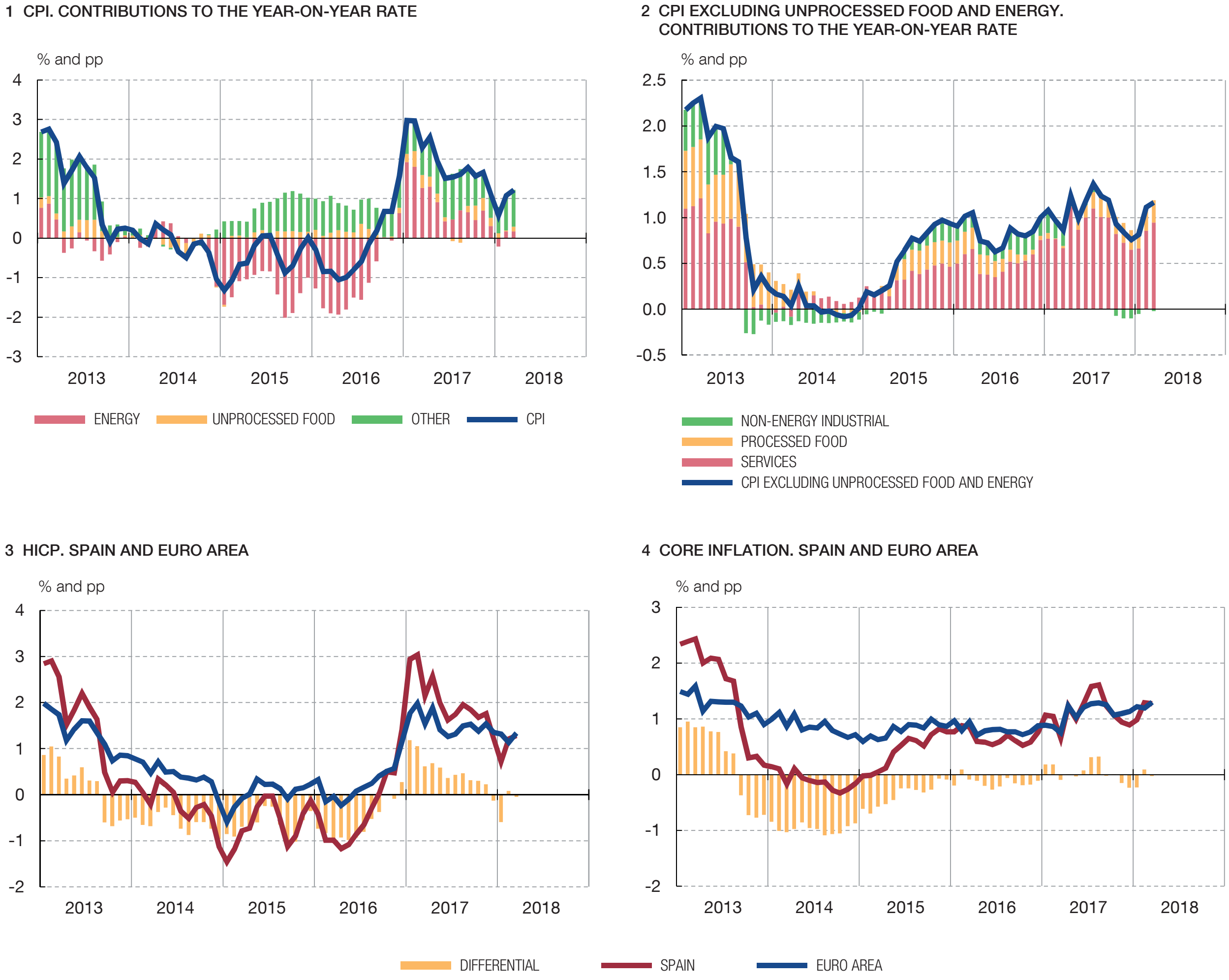
Domestic prices increased at moderate rates, albeit higher than the previous year, which is consistent with the gradual reduction in cyclical slack. Specifically, the value-added deflator in the market economy, which is a measure of domestic inflationary pressures, continued to quicken moderately during 2017, extending the trend observed in the final stretch of 2016 (see Chart 1.15.1). In annual average terms, the rate of change of the value-added deflator in the market economy increased by 0.9 pp to 1.2% in 2017, a movement to which, as indicated, the rising path of ULC growth contributed. But the acceleration in domestic prices was in response, moreover, to the higher growth of the gross operating surplus per unit of value added, which rose by 2.4%. Reflecting these developments was the increase in mark-ups, which grew by 1% when measured by the difference between the respective rates of change of the value-added deflator and of ULCs (for the market economy), which points to the advisability of exploring possible avenues for raising the degree of competition in some goods and services markets, as discussed in Box 1.2 and in Section 5.2 in this Chapter, and in Box 3.4 of Chapter 3.

The acceleration in final demand prices over the year as a whole was more pronounced, given the rise in the contribution of the external component. The imports deflator quickened by somewhat less than 6 pp to a growth rate of 4.4% (see Chart 1.15.2). This largely reflected significantly dearer oil and other commodities on international

CONSUMER PRICES ROSE SHARPLY AT THE START OF THE YEAR BUT THE RATE OF GROWTH THEN SLOWED

CHART 1.16

After climbing markedly at the beginning of 2017, consumer prices decelerated, owing especially to the energy component and, to a lesser extent, to the core component. The differential vis-à-vis the euro area narrowed but remained positive for most of the year, reflecting the performance of the energy component. In the case of the core indicator, the differential oscillated around zero.



SOURCES: European Commission, INE and Banco de España.

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markets, which was countered only marginally by the exchange rate appreciation. That said, the annual average increase in commodities – 24% in the case of crude oil measured in dollars – masks a strongly diminishing profile over the course of the year, which explains why the imports deflator slowed from 6.4% in Q1 to 2.8% in Q4.

Given the course of domestic and external inflationary pressures described, the final demand deflator accelerated from -0.2% in 2016 to 1.8% in 2017, with a similar trajectory to consumer prices. Specifically, the CPI grew at an annual average rate of 2%, compared with the declines of several tenths of a percentage point in each of the three previous years (see Chart 1.16.1). Nonetheless, the year 2017 as a whole masks a clearly declining annual profile, from 3% in January to 0.6% in the same month in 2018, following which something of a rise began. This trajectory was, as in the case of the imports deflator, much determined by the energy component. Indeed, the strong rise in the overall inflation rate at the start of 2017 was due mainly to the comparison effect resulting from the notable fall in oil prices just one year earlier.[36] But, despite the rise in oil prices, the persistence of the high inflation of the energy component was limited, owing to the comparison effect of the opposite sign derived from the rises observed as from February 2016.

Core inflation continued to post very moderate figures. The rate of change of core-component consumer prices (encompassing non-energy industrial goods, services and processed food) remained very low. While over the year as a whole the growth of the CPI excluding unprocessed food and energy was 0.3 pp up on 2016, at 1.1%, it moved on a declining course in the second half of the year, ending 2017 at 0.8% (see Chart 1.16.2). This slowdown, which was more marked in the case of non-energy industrial goods than it was for services, contrasts with the reduction in the degree of slack in the economy, which a priori should have prompted a heightening of domestic inflationary pressures. It is estimated that this factor has been dominated by another two factors of the opposite sign: the appreciation of the exchange rate – which might continue contributing to upholding very moderate inflationary pressures in the short term, given the lagged transmission of exchange rate movements – and some pass-through to domestic producer prices of the lower external inflationary pressures stemming from the slowdown in oil prices.

The consumer price inflation differential with the euro area narrowed during the year as the energy component slowed. The rise in the energy component at the start of 2017 was much sharper in Spain, which was due both to the fact that the oscillations in oil prices have a greater impact in our country on final fuel prices (given the lesser weight of ad valorem taxation) and to the rise in the cost of electricity in early 2017 (see Chart 1.16.3).[37] The differential in terms of the indicator that excludes energy prices was slightly positive throughout most of the year (at around 0.1 pp), but changed sign in December (-0.1 pp) (see Chart 1.16.4). In March 2018 the differential was zero.

4 A provisional assessment of the recovery: achievements and limits

4.1 A PROLONGED AND BALANCED RECOVERY PHASE

The Spanish economy has completed a growth phase of more than four years. Since late 2013[38], GDP has grown by almost 13% in cumulative terms, exceeding the pre-crisis level since mid-2017. In per capita terms, end-2017 GDP was almost 1% above the 2007 level, recouping a portion of the cumulative loss vis-à-vis the average for the euro area countries during the crisis.

The share of the domestic and external components of demand in output is proving more balanced than in previous expansionary phases. One positive characteristic of the Spanish economy during this period has been the fact that the absorption of the economy's idle resources, which is still under way, is proving compatible with a high external balance. Initially, the improvement in activity was export-led, thanks to the recovery of the competitiveness lost in the previous upturn, with the various domestic demand components subsequently joining the expansionary process (see Figure 1.1).[39]

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36 For an explanation of the comparison effect, see Box 3 of the "Quarterly report on the Spanish economy", *Economic Bulletin,* December 2016, Banco de España.

37 See the Analytical Article "The effect of oil price fluctuations on Spanish inflation", *Economic Bulletin,* 2/2017, Banco de España.

38 The "Spanish Business Cycle Dating Committee of the Spanish Economic Association" (see http://asesec.org/CFCweb/) dates the end of the Spanish economy's double-dip recession at 2013 Q2, one quarter later than the end of the recession in the euro area, dated in turn by the Business Cycle Dating Committee of the Centre for Economic Policy Research (CEPR).

39 Chapter 2 of the Annual Report, 2015, Banco de España contains an account of the sequence whereby the various demand components joined the recovery in the economy.

SPANISH ECONOMIC RECOVERY: CONSTRAINTS ON ROLE OF DEMAND POLICIES AND FUTURE CHALLENGES

FIGURE 1.1

CHARACTERISTICS AND STRENGTHS OF RECOVERY (2013-17)

PROVISIONAL ASSESSMENT OF RECOVERY (2013-17)

- Strength attributable both to temporary and more structural factors
- Balance between domestic and external demand
- Employment intensive
- In 2017 GDP returned to its pre-crisis level

EXPLANATORY FACTORS AND STRENGTHS

STRUCTURAL REFORMS IN THE DOWNTURN AND PARTIAL CORRECTION OF IMBALANCES
Competitiveness gains, with recurrent external surpluses
Correction of weight of real estate sector
Labour market and pension system reform
Restructuring of financial system
Significant reduction in private indebtedness

EXOGENOUS FACTORS
Lower oil prices
More dynamic external markets

DEMAND POLICY STIMULUS
Conventional and unconventional monetary policy
Expansionary fiscal policy

VULNERABILITIES PERSIST - A BROAD REFORM AGENDA IS NEEDED

VULNERABILITIES AND CHALLENGES

Unemployment rate remains high
Large net debtor position vis-à-vis the rest of the world
High level of public indebtedness and structural deficit
Inefficiencies in operation of labour and goods and services markets
Population ageing: a key challenge for potential growth and public expenditure
Low average productivity

AREAS OF REFORM

CONTINUE WITH FISCAL CONSOLIDATION PROCESS
Compliance with fiscal targets in accordance with Stability Pact
Composition of adjustment conducive to growth
Reform of regional government financing system

ADDRESS CHALLENGE OF POPULATION AGEING
Policies to ensure sustainability of pension system
Higher labour force participation and employment. Productivity gains
Migration policy. Policies to encourage higher birth rate

BOOST LABOUR MARKET EFFICIENCY
Reduction in temporary contracts. Work-life balance policies
Wage-setting mechanisms more geared to firm and sector-specific conditions

IMPROVE PRODUCTIVITY DYNAMICS
Need to invest in human capital
Policies to promote innovation

REMOVE REGULATORY BARRIERS AND INCREASE COMPETITION
Effective application of Market Unity Law
Review of regulatory thresholds that penalise firms' growth

PROMOTE REFORMS AT THE EUROPEAN LEVEL
Completion of banking union: a) common backstop for resolution process; b) European deposit insurance scheme
Development of joint issues or sovereign bond-backed securities
Fiscal policy: a) supranational instruments to address adverse shocks; b) reform of governance and fiscal rules

SOURCE: Banco de España.

Output growth is proving more job creation-intensive. The strong employment creation in the current upturn is in step with the usual pattern of other expansionary phases of the Spanish economy, although on this occasion the dynamism of this variable has also been assisted by the wage moderation observed following the crisis and the effects of the labour reforms. Another difference with previous recovery phases is a sectoral composition more tilted towards the services sector.

The structural reforms set in train during the recession contributed to laying the foundations of the recovery. Overall, the various measures adopted allowed national and foreign agents to regain their confidence in the Spanish economy. Notable among the main reforms are those involving the labour market, which added further flexibility to the possibilities of adjusting firms' labour costs in contractionary periods, and the recapitalisation and restructuring of credit institutions. Other significant structural changes were the successive reforms to the pension system, progress in ongoing fiscal consolidation and the new national framework of fiscal rules. In the European arena, the various institutional measures and advances in recent years, which notably include the start-up of the Banking Union, have also contributed to shoring up confidence in the common euro project, which has been propitious to the normalisation of financing conditions within the euro area and the correction of its fragmented financial markets.

Moreover, a series of more transitory – though persistent – factors also contributed to the dynamism of the recovery. These factors include most notably the role played by the ECB's monetary policy and, in 2015 and 2016, the application of an expansionary fiscal policy, joined by the significant reduction in oil prices from mid-2014 to early 2016 and, more recently, the improvement in foreign markets.[40]

Overall, notable progress has been made in recent years in correcting some of the Spanish economy's disequilibria. These imbalances built up in the previous expansionary period, in terms of private-sector debt, dependence on external financing and losses in competitiveness.[41] In addition to the above-mentioned reduction in the unemployment rate, the current cyclical phase has been underpinned by, and in turn has boosted, the ongoing recovery of the losses in competitiveness accumulated in terms of labour costs, the running of current account surpluses and the reduction in high private-sector debt.

Progress, however, has been less in other areas, meaning that the economy still has elements of vulnerability. As set out in Section 5.1, there has been less headway in correcting other imbalances, including in particular high public indebtedness and the still-high net debtor position of the nation, despite the recent current account surpluses. Also, significant structural dysfunctions persist in the labour market and a pattern of growth more forcefully conducive to high-productivity and high-added-value activities has not yet taken root. And this against a background in which population ageing will significantly reduce the economy's potential growth at the same time as it is posing far-reaching challenges regarding public pensions. Tackling these matters requires resolute reforms, as is detailed in Section 5.2.

4.2 TOWARDS A SCENARIO WITH A MORE LIMITED ROLE FOR MONETARY POLICY

The pick-up in the Spanish economy has been accompanied by a highly expansionary monetary policy stance. When, in mid-2014, the difficulties in fulfilling the medium-term price stability objective began to become discernible, the ECB Governing Council set about launching a broad range of measures aimed at ensuring the proper anchoring of

40 See Box 1.2 "The effect of temporary factors on recent developments in the Spanish economy: a comparison with the euro area", in Chapter 1 of *Annual Report 2016,* Banco de España.

41 See "Report on the financial and banking crisis in Spain, 2008-2014", Banco de España.

inflation expectations around values consistent with the central bank's objective and, more generally, at avoiding the adverse consequences of the prolongation over time of excessively low inflation.

The monetary stimuli have been underpinned by the joint action of conventional and unconventional instruments. The measures pursued since 2014 have included the use of tools other than policy interest rates, given the limited effectiveness of this instrument as a result of the proximity to its effective lower bound. Specifically, monetary measures have been pursued along four avenues: the setting of a negative interest rate for the deposit facility; communication policy and forward guidance; the application of specific programmes geared to making the transmission channel running through bank credit more fluid; and, finally, the implementation of the APP.

Monetary policy transmission to financial conditions and to demand has proven effective, reversing downward inflation expectations. Both negative interest rates and the injection of liquidity have provided for the maintenance of easy financial conditions, acting as a stimulus to credit and to household and corporate expenditure. Further, forward guidance has enabled the ECB to emphasise the continuity of its expansionary stance, increasing its effectiveness through the additional stimulus provided by the anchoring of agents' expectations and the reduction in so-called interest rate term premia. This has been the case for policy rates, which will hold at current levels over a period that will stretch substantially beyond the conclusion of net asset purchases, for which there is no defined date. Moreover, the large size of the portfolio acquired under the APP[42] and the reinvestment commitment over a long period after the conclusion of the net asset purchases are elements that also shape the expansionary stance of monetary policy, under whose influence the downside risks of the inflation projections have begun to be balanced out, as reflected by the rise since summer 2017 by the inflation expectations indicators based on financial market information.[43]

Monetary policy conduct has been a determining factor in the current economic expansionary phase, both in the euro area as a whole and in Spain. The measures adopted have significantly eased financial conditions. And, as illustrated in the estimates presented in Box 1.3, monetary policy has contributed notably to the growth of real GDP and of the CPI, both in the euro area and in Spain.

Foreseeably, however, in the future monetary policy will begin to progressively play a more limited role. In the euro area, the gradual overcoming of the legacies of the crisis and a position further ahead in the cycle, with an output gap which, on available estimates, is expected to be positive as from 2018, will lead, according to the ECB forecasts, to a progressive recovery in inflation to levels compatible with medium-term price stability (which the monetary authority for the area establishes as an inflation rate lower than but close to 2%).[44] As this normalisation of euro area price dynamics takes shape, it is to be expected that the exceptionally expansionary stance of monetary policy at present will gradually be tightened.

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42 Specifically, after three and a half years of uninterrupted purchases, the APP portfolio will amount to almost €2.6 trillion in September 2018, equivalent to 23% of euro area GDP.

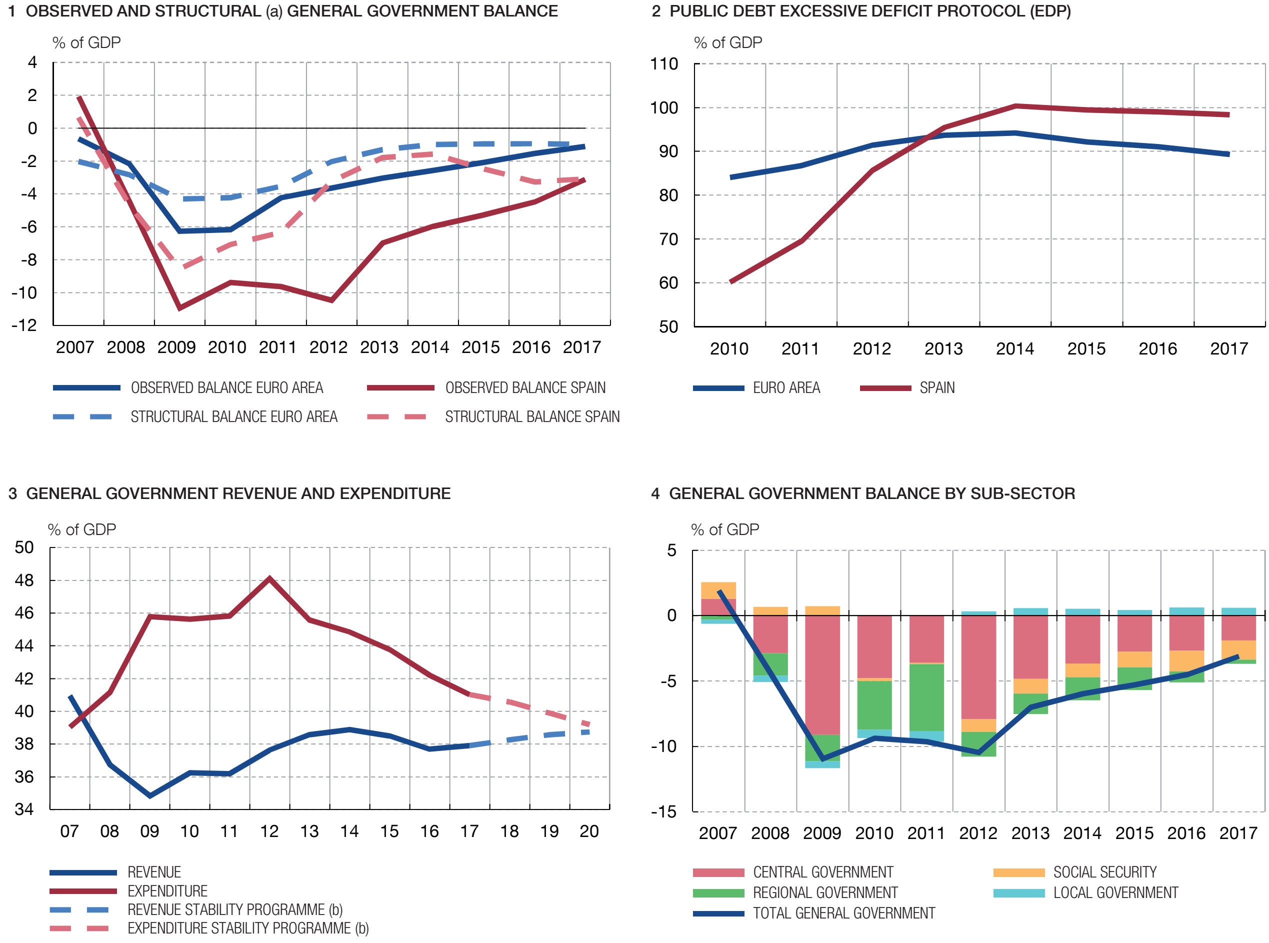
43 See the Analytical Article, "Euro area inflation expectations", *Economic Bulletin,* 1/2018, Banco de España.

44 Specifically, according to the "March 2018 ECB staff macroeconomic projections for the euro area", the HICP for the area as a whole will grow by 1.7%, on average, in 2020 (and by 1.8% in terms of the indicator that excludes the fresh food and energy component).

THE GENERAL GOVERNMENT DEFICIT CORRECTION CONTINUED THANKS TO THE FAVOURABLE EFFECT OF THE ECONOMIC CYCLE

CHART 1.17

In 2015-16 fiscal policy remained clearly expansionary, before becoming almost neutral in 2017, but strong economic growth allowed the fiscal consolidation process that had begun in 2013 to continue, albeit at a much slower pace, and permitted a slight reduction in public debt. In 2017 the deficit target was met, thanks to modest growth in public revenue and, above all, to the moderation in expenditure. However, the structural deficit is still one of the highest in the euro area and debt is very far from the 60% of GDP target.



SOURCES: AMECO and Banco de España.

a The cyclically adjusted balance, net of temporary measures.
b Stability Programme projections.

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4.3 THE FISCAL CONSOLIDATION PROCESS SHOULD CONTINUE IN THE COMING YEARS

Fiscal policy temporarily stimulated growth in the 2015-2016 period, with a clearly expansionary stance. Having regard to the standard values of the fiscal multipliers, almost 1 pp of economic growth in 2015-2016 could be attributed to the impulse of budgetary policy,[45] given that in those two years the structural primary budget deficit, which measures the budgetary policy stance, worsened – according to the European Commission's latest estimates – by 2.5 pp. Despite this expansionary stance, the favourable cyclical conditions allowed for the continuation of the declining path of the budget deficit/GDP ratio (see Chart 1.17.1).

The fiscal policy stance in 2017 turned broadly neutral, following the approval and delayed entry into force of the budgetary plans. The reduction in the deficit was due to

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

the cyclical improvement in the economy and to the fall-off in interest expenditure, while the structural primary balance held broadly stable, according to the latest European Commission estimates. The high rate of increase of nominal output allowed the effects of the still-high public debt/GDP ratio to be more than offset, meaning that the ratio once again posted a slight reduction to 98.3%, 0.7 pp less than in 2016 (see Chart 1.17.2). The budget deficit stood last year at 3.1% of GDP, a rate matching the objective set under the Excessive Deficit Procedure (EDP) of the Stability and Growth Pact (SGP). The reduction in the aggregate deficit was extensive to the different tiers of government, whereby Central Government, the Social Security System and Regional Government posted deficits of 1.9%, 1.5% and 0.3% of GDP, respectively, while Local Government once again recorded a surplus in 2017, at 0.6 pp, similar to that of the previous year.

Over the recovery phase as a whole, fiscal policy has been supported by the significant reduction in financing costs associated, inter alia, with the ECB's monetary policy measures. In particular, it is estimated for Spain's case that the reduction in financing costs will have had a direct impact on sovereign debt interest payments in the 2014-2016 period that could be quantified at around 0.9 pp of GDP. Moreover, the positive macroeconomic effects of unconventional monetary policy on economic growth and inflation are expected to have indirectly affected the cyclical revenue and expenditure items of the public budget, entailing an additional reduction in the budget deficit during this period of around 0.9 pp.[46]

In the coming years fiscal policy should resume the reduction of the structural deficit. The European Commission has recommended a return to the neutral fiscal stance for the euro area as a whole in 2018, differing across Member States in terms of their fiscal room for manoeuvre. In Spain's case, both the public debt/GDP ratio and the structural budget deficit are holding at levels some distance off the limits set in the SGP, which will require continuing with the fiscal consolidation process in the coming years (see Box 1.4).

4.4 THE LIMITS ON DEMAND-SIDE POLICIES EVIDENCE THE NEED TO MAKE PROGRESS IN REDUCING VULNERABILITIES AND IN STRUCTURAL REFORMS

The positive assessment of the current recovery phase should not lead to the challenges outstanding being forgotten. As noted, the strength of the expansion has been underpinned, in part, by factors that will tend progressively to fade, particularly as regards demand-side (monetary and fiscal) policies. As these latter policies lose momentum, the measures aimed at improving the use and quality of productive factors and the efficient functioning of the markets for goods and factors should gain in prominence as a factor for shoring up medium- and long-term growth. There is consensus in the economic literature about the positive effects of reforms in periods of expansion, as the resistance and adjustment costs that such reforms entail can be better tackled.[47] Also, in a monetary union with interest rates close to zero, the positive impact of the structural reforms undertaken in the peripheral countries may be amplified by an expansionary monetary policy.[48]

The economy maintains factors of vulnerability. While there has been substantial progress in the correction of some of the imbalances built up in the previous expansionary cycle, the economy remains exposed to specific shocks owing to the confluence of various

46 See the Analytical Article "The impact of unconventional monetary policy on euro area public finances", *Economic Bulletin,* 3/2017, Banco de España.

47 See "Structural policies in the euro area", forthcoming as an ECB Occasional Paper, which contains a detailed discussion on the relationship between the cyclical position and reform costs.

48 See O. Arce, S. Hurtado and C. Thomas (2016), "Policy Spillovers and Synergies in a Monetary Union", *International Journal of Central Banking,* September, and "Reducing income inequality while boosting economic growth: can it be done?", *Economic Policy Reforms,* 2012, OECD.

factors. Hence, although the high net external liabilities position has declined by 17 pp of GDP from its 2014 peak, public debt remains at towering levels and household and corporate debt are at high levels from a historical perspective despite the fact the available estimates point to the deleveraging needs for these sectors being already very low[49] following the significant progress made in recent years. The banking system continues to face significant challenges (as is described in detail in Chapter 2), and unemployment remains very high, while the quality of jobs created is, in many cases, improvable, given the high ratio of temporary to total employment, the maintenance of a high rate of unwanted part-time employment and the limited duration of employment contracts, while there are no appreciable changes in the wage-setting mechanism towards a greater sensitivity to firm-and sectoral-level conditions. Likewise, although inflationary pressures are proving moderate, such that gains in competitiveness continued to be achieved, the widening of business mark-ups suggests a potentially insufficient degree of competition in some sectors (see Box 1.2).

However, there are few initiatives to resolve the economy's structural problems. A divided Parliament means it is currently difficult to set far-reaching legislative initiatives in train. It should be borne in mind that many of the tasks outstanding in the Spanish economy require courses of action in the medium and long term extending beyond the usual political cycle and, therefore, they need launching without delay and with extensive and lasting political backing behind them.

Furthermore, the experience of the crisis has evidenced the need for resolute headway in completing the Economic and Monetary Union, a pivotal aspect of the sustainability and stability of the growth of the Member States. In addition to correcting the still-persisting macroeconomic imbalances, it is necessary to complete the Banking Union, to promote the creation of a true single market for capitals, to introduce budgetary mechanisms geared to aggregate stabilisation and to simplify the governance of fiscal rules.

5 Challenges ahead

5.1 PERSISTENT EXTERNAL AND FISCAL IMBALANCES

After almost five years of strong growth, the persistently high level of external and public debt is a source of vulnerability. The intensity and nature of the economic expansion have corrected these imbalances to some extent. First, the aggregate expenditure of economic agents has been lower than their income, which has helped to contain net external debt. Second, the cyclical strength has helped to correct the budget deficit and, therefore, to check the growth of public debt. The low interest rates have been conducive to these adjustments. However, despite such favourable conditions, progress in reducing external and, especially, public debt remains modest.

The two imbalances are closely interrelated. At end-2017, the negative net international investment position (IIP) of the Spanish economy stood at 80.8% of GDP, 17 pp below the

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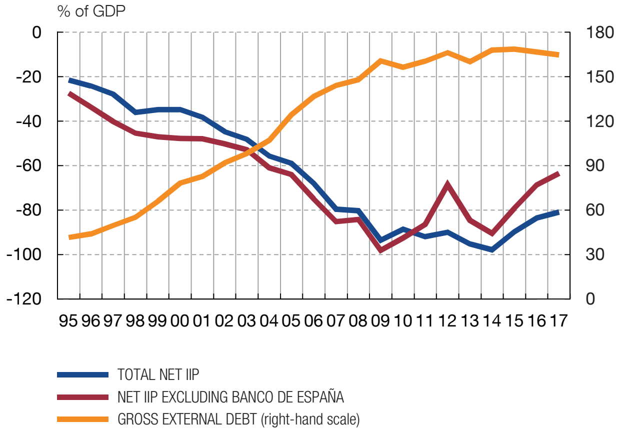
49 In its 2016 report for Spain the European Commission, in accordance with various alternative methodologies, estimated that household deleveraging needs stood at between 10-20 pp as at mid-2015, and those of firms, at less than 10 pp. However, it should be borne in mind that, between that date and end-2017, debt ratios fell by 10 pp in the case of households and by 12 pp in that of firms, meaning that deleveraging needs as at the latter date would foreseeably be much lower than the initial estimates. Moreover, applying the experience of past episodes of deleveraging, which shows that during these phases two-thirds of the previous increase in the corporate debt ratio and practically 100% of the household debt ratio were corrected, on average [see F. Bornhorst and M. A. Ruiz-Arranz (2013), "Indebtedness and Deleveraging in the Euro Area", 2013 Article IV Consultation on Euro Area Polices: Selected Issues Paper, Chapter 3, *IMF Country Report* No. 13/206, Washington], and taking as the starting point the deleveraging process in 2002 Q3, which is when the average euro area levels were obtained, the outcome would be that deleveraging needs at the end of last year would be 11 pp for households and zero for firms. In any event, these results should be viewed with caution given that the various methodologies used in these calculations are subject to certain constraints.

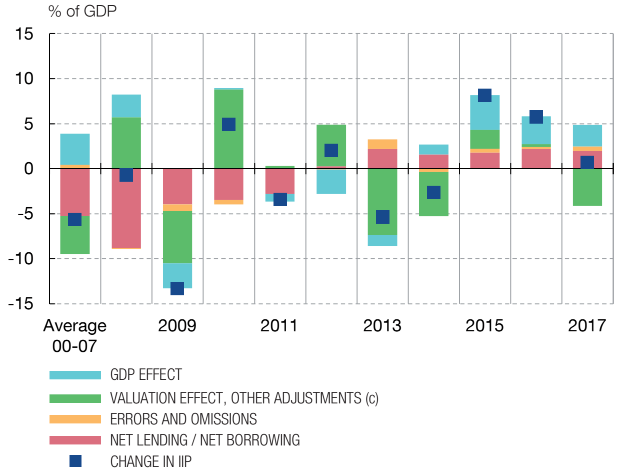
THE SLOW PROCESS OF EXTERNAL DELEVERAGING OF THE SPANISH ECONOMY CONTINUED IN 2017 — CHART 1.18

The negative net international investment position (IIP) has fallen to 80.8% of GDP, although it is still high by international standards. Since the onset of the crisis, the net debtor position of firms, households and financial institutions has decreased, while the general government contribution has increased.

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



2 BREAKDOWN OF CHANGE IN NET IIP (b) (c)



SOURCE: Banco de España.

a Gross external debt is the amount pending repayment at a given time of real and non-contingent current liabilities assumed by an economy's residents vis-à-vis non-residents, with the commitment to make in the future payments of principal, interest or both. It therefore includes debt securities, special drawing rights assigned, and deposits, loans, trade credit and other liabilities.
b A positive (negative) sign denotes an increase (decrease) in the net IIP.
c Valuation effects are gains/losses owing to the exchange rate and/or price of financial instruments, while other adjustments are other changes in volume, including in particular write-offs owing to recognition of the impossibility of recovering funds, reclassifications of assets and/or liabilities and changes in residence of holders or issuers of financial assets and liabilities.

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2014 peak (see Chart 1.18.1). This level, which is very high by international standards, means that Spanish agents' income and financial position are more sensitive to changes in global financial conditions. The breakdown of the IIP by sector shows how, since the onset of the crisis, the general government's net liability position has increased significantly, while that of financial institutions, firms and households has decreased. In recent years, vulnerability has been mitigated in part by the structural adjustment of the current account balance and the increase in the financial position of resident issuers[50] (see Chart 1.18.2).

The continuation of high public debt levels over a prolonged period may have adverse effects on economic growth. These effects arise insofar as public debt absorbs funds that could be used for more productive purposes and alters the overall financing conditions of the economy, distorting private investment decisions. Moreover, in a setting of high public debt, fiscal policy may be subject to constraints owing to the need to support substantial primary deficits that require higher levels of taxation or lower levels of productive

50 A combination of factors have helped to reduce this vulnerability in recent years (see Chapter 3 of Banco de España *Annual Report, 2016,* and Ó. Arce (2017), *"La posición de inversión internacional de la economía española: Tendencias, análisis y evaluación"*, in «¿Es la economía española financieramente vulnerable?», *Documento de Trabajo nº 13,* Fundación de Estudios Financieros. On the one hand, the structural adjustment of the current account balance in recent years, along with the return to normal in the financial markets and the restructuring of liabilities, have helped to temper the external vulnerability of the economy. On the other, valuation effects, which in recent years have reflected an improvement in the financial position of resident issuers, have limited the correction of the book value of the negative external position. Specifically, the improvement since 2012 in the solvency and prospective earnings of resident issuers has given rise to a revaluation of their liabilities, although, in terms of the IIP, this has negative valuation effects that increase the negative external balance.

expenditure. At the same time, the countercyclical room for manoeuvre in fiscal policy to address adverse macroeconomic shocks may be significantly reduced in a high-debt scenario. In addition, this produces greater vulnerability to changes in investor (market) sentiment.[51]

Complying with European and national tax rules will require continued fiscal consolidation. Since 2013, Spain's general government agencies have been subject to an EDP, in the framework of the corrective arm of the SGP. In August 2016 the EU Council updated the conditions for exit from the EDP in 2018. In particular, the general government deficit must be no higher than 2.2% of GDP in 2018 and the structural effort between 2016 and 2018 at least 0.6 pp of GDP. Although it is very likely that Spanish general government agencies' deficits will be below 3% in 2018, there is greater uncertainty regarding strict compliance with the degree of reduction required of the structural government deficit, which according to the European Commission would still be high (3.3% of potential GDP in 2018), the largest of the 19 euro area countries. Exiting the EDP would entail redefining the path of fiscal adjustment, to adapt to the requirements of the preventive arm of the SGP. These requirements include reducing the structural deficit at an annual rate of 0.5 pp in normal circumstances, until the medium-term equilibrium target is reached,[52] and reducing the general government debt to GDP ratio per annum by one-twentieth of the distance from the medium-term benchmark of 60% (see Box 1.4).

Population ageing is a key challenge for the sustainability of public finances. The most recent estimates of the impact of population ageing on public expenditure on pensions, health care and long-term care show that it would increase expenditure over the next three decades, by a maximum of some 3.5 pp of GDP by around 2050.[53] In the case of the pension system, in a favourable macroeconomic scenario, application of the sustainability factor, which links starting pension to the increase in life expectancy, and especially application of the annual pension revaluation index, which links increases in pension to the balance between the revenue and expenditure of the system, would gradually reduce the pension system's current deficit (1.8% of GDP in 2018) and would significantly counter the effect of the expected rise in the dependency ratio in the long term. In the absence of additional increases in revenue, the adjustment would come mainly from a decrease in the replacement rate of public pensions, which could amount to 20 pp between 2013 and 2060.[54] Looking forward, the key is to limit the replacement rates of the Spanish public pension system, in step with social preferences, to adapt them to revenues so as to ensure sustainability. The conclusion that may be drawn from the analyses available is that maintaining the present replacement rates, which are high by international standards, would require a very significant increase in pension system revenues. In any event, any reform strategy chosen should heighten the system's transparency, strengthen the contributory principle, that is, the relationship between contributions and benefits,

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51 See P. Hernández de Cos, D. López-Rodríguez and J. J. Pérez (2018), *"The challenges of public deleveraging"*, Banco de España *Occasional Paper* 1803.

52 In the European tax framework, convergence towards the medium-term target is strengthened by application of the "expenditure rule", which determines that public expenditure growth, after deducting extraordinary revenues, cannot exceed the medium-term potential GDP growth of the economy. For an overview of the European tax framework, see P. García-Perea and E. Gordo (2016), "Los mecanismos de supervisión presupuestaria de la UEM", *Economic Bulletin,* March, Banco de España.

53 See The 2015 Ageing Report, European Commission, and Actualización del Programa de Estabilidad del Reino de España 2018-2021.

54 See R. Ramos (2014), "The new revaluation and sustainability factor of the Spanish pension system", *Economic Bulletin,* July-August, Banco de España, and P. Hernández de Cos, J. F. Jimeno and R. Ramos (2017), " The Spanish public pension system: current situation, challenges and reform alternatives", Banco de España *Occasional Paper* 1701.

and, in particular, maintain an automatic adjustment mechanism that ensures the sustainability of future pensions.

The fiscal consolidation process should be compatible with an improvement in the quality of public finances. The adjustment pending should be anchored to a medium-term programme setting out the detailed measures that would allow the budgetary objectives to be met, and to a prudent macroeconomic and public revenue projection. In addition, the composition of the adjustment is particularly important, as it should seek to ensure that public finances make a greater contribution to the potential growth of the economy. On the expenditure side, according to the detailed analyses performed in some European economies, including Spain,[55] there seems to be scope for further progress in increasing the efficiency of public expenditure and redirecting its composition towards those items that have a greater impact on the accumulation of physical, technological and human capital and, in consequence, on total factor productivity and economic growth in the long term.[56]

On the revenue side, there is scope to consider an overhaul and redefinition of the basket of taxes, with a shift towards structures more conducive to potential growth. These structures should be underpinned by taxes that produce less distortion in the behaviour of economic agents and that allow sufficient revenue to be obtained, in a stable and efficient manner, to fund the desired level of public expenditure. It should be noted that taxation of consumption in Spain is lower as a proportion of GDP than the EU average, reflected in the lower revenues obtained from both VAT and excise duties (especially on hydrocarbons, transport and alcohol). Environmental taxation is also lower. Revenue from taxation on employment in Spain is similar to the EU average as a proportion of GDP, although the weight of social security contributions is higher, especially firms' contributions. In turn, the weight of revenue from taxation on capital is higher than the EU average, as the taxation of wealth is higher in Spain, while the weight of taxation on firms and on unearned income is similar. In this context, however, the available evidence[57] shows that the tax rates of Spain's main taxes (VAT, personal income tax, corporate income tax) are generally equal to or higher than the EU average, although the effect of exemptions, tax credits and special reduced rates tends to generate revenue losses, in addition to possible distortions in the efficiency and fairness of the tax system.

The regional government financing system should be reviewed. In an administrative structure with such a high level of decentralisation as Spain's, where regional and local government are responsible for more than 40% of public expenditure decisions, their cooperation is essential to ensure budgetary stability. In this respect, the general consensus is that there should be an overhaul of the financing system of these administrations, based on an objective estimate of their expenditure needs, to adapt the revenue at their disposal to those needs, ensure transparent distribution between the regional governments and

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55 See, among others, C. Vandierendonck (2014), *Public Spending Reviews: design, conduct, implementation,* European Economy, Economic Papers, no. 525. For the case of Spain, see OECD (2015), *Spain: From Administrative Reform to Continuous Improvement,* OECD Public Governance reviews, Paris.

56 In this context, on 2 June 2017 the Spanish government commissioned the AIReF to undertake a public expenditure review, comprising a detailed analysis to assess the quality of public policies. This is an ongoing arrangement, including an initial agreement for three years and the results of a first phase assessing expenditure on subsidies, to be presented before end-2018. In general, expenditure policy reviews can reveal fiscal scope to improve the allocation of public funds.

57 See, among others, the Informe de la Comisión de Expertos para la Reforma del Sistema Tributario Español (2014); and P. Hernández de Cos and D. López Rodríguez (2014), *Tax structure and revenue-raising capacity in Spain: A comparative analysis with the EU,* Banco de España *Occasional Papers* 1406.

increase the degree of fiscal co-responsibility.[58] In addition, capital market access by regional governments should be resumed as a fundamental way to finance their fiscal imbalances, making use of the various State funds rolled out during the crisis only in exceptional circumstances. In any event, while these arrangements remain operational, there must be strict application of their explicit conditions relating to the budgetary activities of the administrations concerned to avoid incentivising inappropriate budgetary policies.[59]

5.2 FACTORS LIMITING SPANISH ECONOMIC GROWTH IN THE LONG TERM

The Spanish economy projects relatively modest future potential growth. On the estimates available, the potential growth of the Spanish economy – which measures its ability to grow in a sustainable and balanced manner in the medium term – is less than 1.5%, close to the level for the euro area but below that of other developed economies such as the United States (see Chart 1.19). Among the main structural factors limiting the potential growth of the Spanish economy the following stand out: high structural unemployment, population ageing, the lower rate of growth of the labour force participation rate owing to demographic change and low productivity as a result of excessive labour market duality, regulations that restrict competition and the efficient reallocation of resources, and the human and technological capital deficit.[60] By contrast, the available estimates for potential GDP are possibly not fully factoring in the positive impact on the long-term growth of the economy of the past structural reforms in Spain.

Cutting the persistently high level of unemployment, especially among certain groups, is a priority. The employment recovery is weakest among the unemployed with a lower level of education. Specifically, in 2017, the unemployment rate among persons with a low educational level was more than 30%, affecting in particular the youngest and the oldest age groups (see Chart 1.20.4).[61] In consequence, public policy should be directed at ensuring the employability of these groups, preventing hysteresis effects that hinder further reductions in the unemployment rate.

During the last economic crisis there was a notable increase in inequality both in terms of per capita income, a pattern which is estimated to have begun to reverse during the upturn. The main determinant of this turnaround has been the decline in the unemployment rate. Looking forward, further reductions in the income inequality indicators will depend on unemployment continuing to decline, which requires improvements to the employability of the least skilled, along with an increase in the hours actually worked by employees with lower wages. In any event, the causes behind the dynamics of inequality and their effects are complex, and learning about them will require an in-depth analysis of the various relevant dimensions (wages, household income, consumption and wealth, inter alia), as a prerequisite for the design of public policies that promote socially sustainable growth.[62]

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58 See the Informe de la Comisión de Expertos para la Reforma del modelo de financiación autonómica (2017) and P. Hernández de Cos and J. J. Pérez (2018), "Regional government financing: options and challenges", Banco de España *Occasional Paper,* forthcoming.

59 See P. Hernández de Cos and J. J. Pérez (2015), "Reglas fiscales, disciplina presupuestaria y corresponsabilidad fiscal", *Papeles de Economía Española,* 143, pp. 174-184, and M. Delgado, J. J. Pérez and C. I. González (2016), "Regional government access to market funding: international experience and recent developments", *Economic Bulletin,* February, Banco de España.

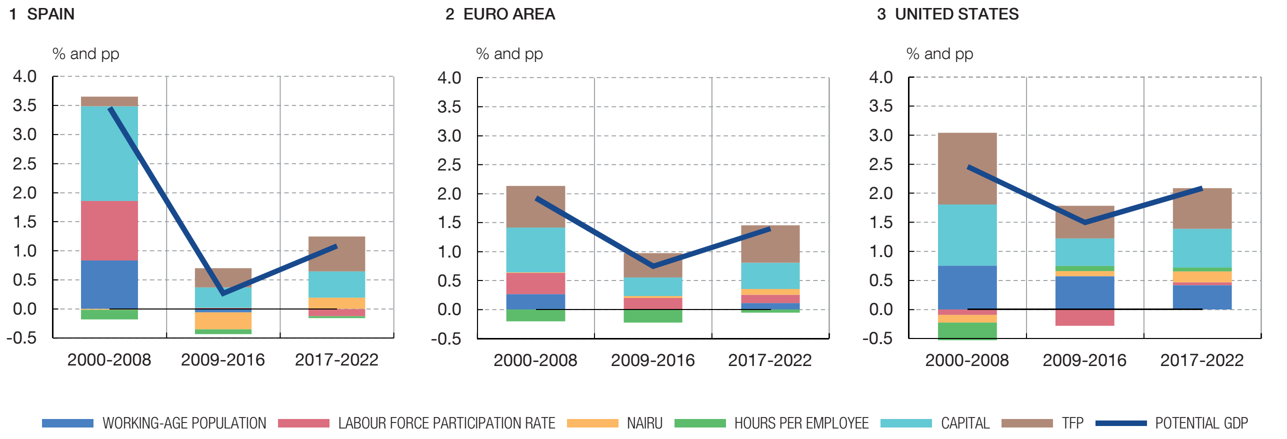
60 Moreover, R. Gordon (2016), "The Rise and Fall of American Growth: The US standard of living since the Civil War", Princeton University Press, documents other factors common to the majority of developed economies that limit productivity, such as tertiarisation, lower competition or the exhaustion of educational gains.

61 See Box 1.2 on the persistence of unemployment in Spain, in *Annual Report*, *2015,* Banco de España.

62 In this respect, the forthcoming Occasional Paper, "Income, consumption and wealth inequality in Spain", analyses in detail the level of and changes in inequality in Spain during the economic crisis and, insofar as the available information allows, in the initial phases of the recovery.

THE SPANISH ECONOMY PROJECTS RELATIVELY MODEST FUTURE POTENTIAL GROWTH CHART 1.19

The potential growth of the Spanish economy has fallen from almost 3% pre-crisis to 1%-1.5% in 2017-22. This modest potential growth is attributable to the lower working-age population, the lower labour force participation rate, the lower accumulation of capital and low total factor productivity (TFP). This potential growth is similar to that of the euro area but is lower than that estimated for the United States.



SOURCE: European Commission (autumn 2017).

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Demographic patterns will have negative effects on the potential growth of the economy. According to INE population projections, the dependency ratio (defined as the ratio between the over-65s and those in the 16-64 age group) will grow from 29% at present to 65% over the next five decades (up to 2065).[63] This population ageing has a negative impact on the working age population and pushes down both the labour force participation rate and the employment rate.

The challenge posed by demographic change requires that a strategy be defined to mitigate its long-term economic impact. In particular, policies that boost the labour force participation rate become especially important, given that, if the present participation rates by sex and age and the demographic trends towards a larger proportion of older population cohorts are maintained, the overall labour force participation rate would fall significantly (by approximately 2 pp over the next decade). To counter this effect, policies that encourage workers – especially older ones – to join the labour force are required, such as, for example, making collecting a pension compatible with working. In addition, migration policy restrictions should be reviewed periodically, seeking to adapt them to labour market needs, and measures should be taken to encourage a higher birth rate, to bring it closer to those in other European countries, encouraging a better work-life balance and reducing job instability for women of child-bearing age.

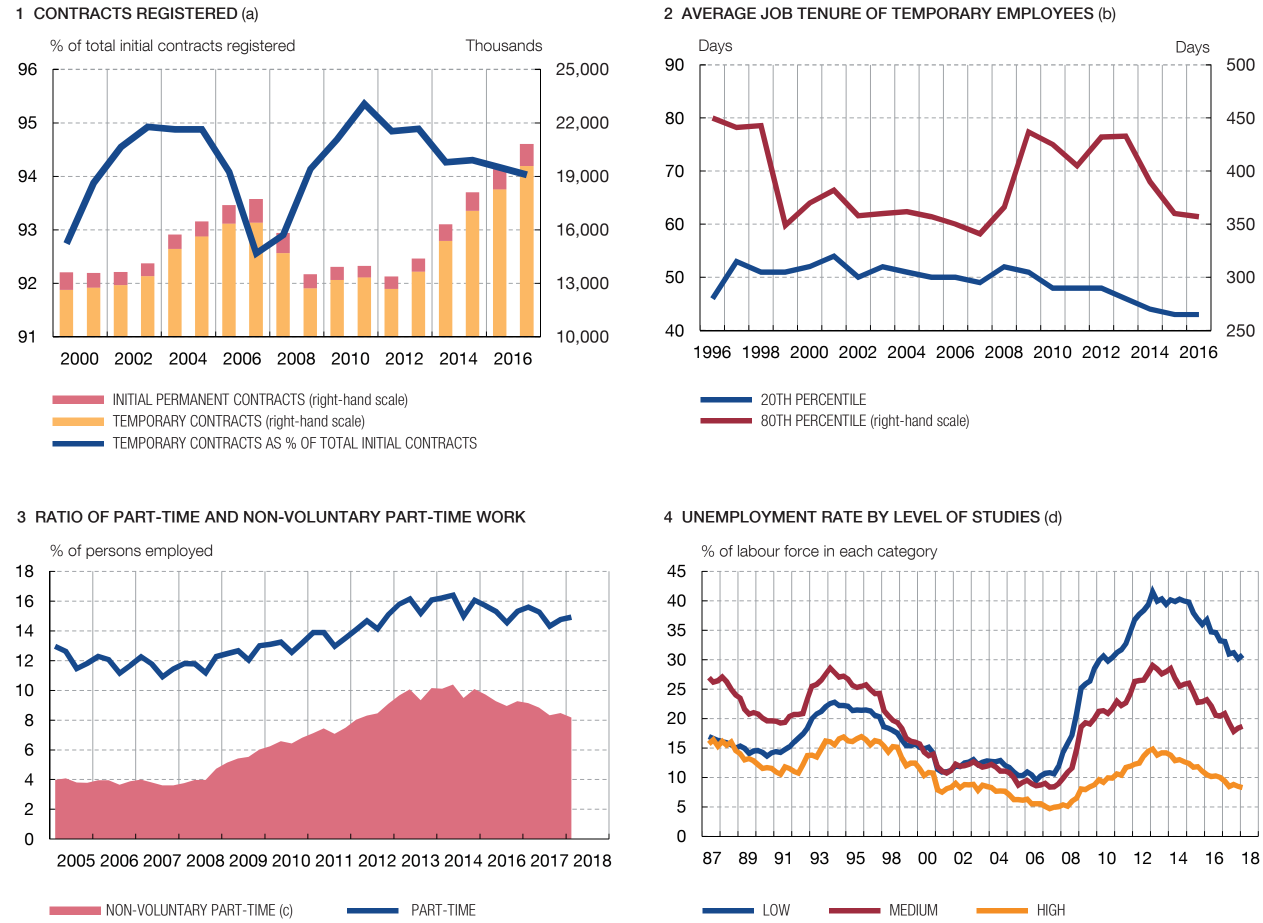
High labour market segmentation hampers productivity gains. In the present recovery phase, as was the case before the crisis, temporary employment has continued to grow at a faster pace than permanent employment (see Chart 1.20.1). Thus, at end-2017, the ratio of temporary to total employment was 26.7%, 0.2 pp above the end-2016 level and 3 pp

63 See «Población y fenómenos demográficos proyectados», *INE*. On these projections, over the next 50 years the Spanish population will fall from the present 46 million to 41 million, even in a scenario of net inflows of immigrants of between 50,000 and 100,000 per annum. In any event, demographic projections rely heavily on fertility rate and migration balance assumptions. Indeed, using different assumptions for these two variables, Eurostat projects an increase in population up to almost 50 million (Population on 1st January by age, sex and type of projection, *Eurostat*).

THE PERSISTENTLY HIGH RATE OF UNEMPLOYMENT AMONG INDIVIDUALS WITH LOW LEVELS OF EDUCATION AND THE HIGH LEVEL OF LABOUR MARKET SEGMENTATION HAMPER PRODUCTIVITY GAINS

CHART 1.20

The unemployment rate among workers with lower educational levels remains very high. In addition, in the recovery the ratio of temporary to total employment has risen, temporary contracts have become shorter and there is a high proportion of non-voluntary part-time work.



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

a Including domestic service contracts only since October 2012.
b Calculated using MCVL (Social Security administrative labour records) data.
c Employed persons who say they are working part-time because they were unable to find full-time work.
d Low: no or only primary education, or having failed to complete, or to successfully complete, lower secondary education. High: tertiary education.

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above the cyclical low recorded in 2013. It was, however, still some distance from the pre-crisis levels (33.8% at end-2006).[64] This ratio is still the highest among the euro area countries, where it stood at 16.2% at end-2017. Moreover there is some evidence that new temporary contracts have recently become shorter, increasing labour turnover and hindering human capital accumulation (see Chart 1.20.2). In addition, although the part-time employment rate is 1 pp below the peak observed in 2014 and is below that of other European countries, its present level (16.0% at end-2017) is substantially higher than its pre-crisis level (12%) and, moreover, there is a high percentage of non-voluntary part-time work (see Chart 1.20.3).[65] As a result of all the above, the number of hours actually worked has fallen, affecting not only average productivity but also wage income inequality.

64 Excluding general government, the ratio of temporary to total employment was 27.3% in 2017, similar to the figure for 2016 and 2.7 pp higher than at end-2013.

65 See the influence of these factors on alternative measures of unemployment in "Quarterly report on the Spanish economy", *Economic Bulletin*, 2/2017, Banco de España.

In general, when facing difficulties, firms continue to prefer to use temporary employment to adjust. The latest annual Labour Force Survey available, for 2016, confirms that among firms that would cut their labour costs in response to a negative demand shock, 54.4% would opt to reduce their temporary workforce, whereas 21.1% would opt to cut the number of hours worked. By contrast, only 1.8% of firms would opt to cut the fixed portion of wages and 8.8% the variable portion. The most noteworthy difference compared with the previous survey available, for 2008, previous to the 2012 labour market reform, is the increase in the percentage of firms that would opt to cut the number of hours worked, from just 5% before the crisis. This change may be attributable to the internal flexibility measures in terms of working hours and the changes to employment contracts according to the hours worked introduced in the 2012 labour market reform and to the regulatory changes made to part-time contracts. That said, the latest figures show that regulatory friction persists, relating to the hiring framework and to the limited level of representativeness at firm level of the present wage bargaining system, hindering a reduction in the high employee turnover rate that characterises the Spanish economy.

Improving potential growth requires improving productivity dynamics. Labour productivity has barely risen during the present recovery phase. This is similar to the case of the last upturn, although then labour productivity was based on growth in the capital-labour ratio which offset the increase in the proportion of firms with lower total factor productivity, whereas since 2014 genuine efficiency gains are being achieved, countered by a less intensive use of capital compared with labour. Even so, total factor productivity growth remains low.

In this setting, investment in human and technological capital becomes especially important. The available evidence shows that during the crisis young people remained in education longer, postponing their entry into the labour market, and this pattern has continued in the recovery. Thus, the labour force participation rate of young people aged 16-19 in Spain has fallen from 30% to 15%, parallel to an increase in the percentage of young people in formal education or undertaking some form of training, narrowing the gap between Spain and other European countries in this respect (see Chart 1.21).[66] In any event, reform of the Spanish education system is needed in order to close the gap with other developed countries in terms of education quality indicators and address the challenges posed by globalisation, technological progress and automation, which require a re-think of the apprenticeship system and of curriculum content. Furthermore, the technological capital gap between Spain and its European partners widened during the crisis, owing to lower R&D expenditure as a percentage of GDP in the public sector and, especially, in the private sector where the differences are greater. In addition to the structural characteristics that limit firms' ability to innovate (in terms of human capital, business capacity, productive structure and financing), and the design of the public R&D system which is susceptible to improvement, there are other more temporary cyclical aspects, such as the low public budget allocations to innovation and the adverse effects on firms' innovation efforts of the insufficient degree of business competition in certain sectors.[67]

66 In any event, in 2017 the early school-leaving rate, at 18.3%, was still higher than the Europe 2020 strategy target of 15% and at some distance from the European rate of 10.7%. The target refers to the population aged 18-24 with at most lower secondary education and not in education or training.

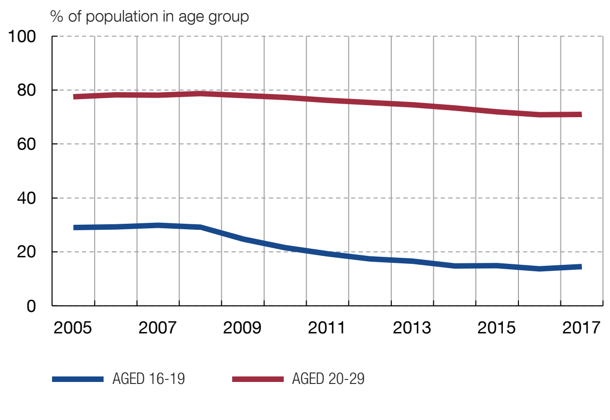
67 In this respect, in addition, see Chapter 3 of this report on the lower level of investment in intangible assets by Spanish firms overall.

POST-CRISIS, YOUNG PEOPLE ARE REMAINING IN EDUCATION LONGER

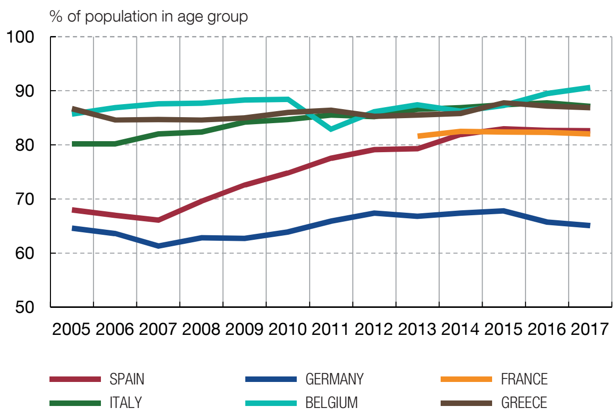
CHART 1.21

The labour force participation rate of young people in Spain has been falling since the crisis, in tandem with an increase in the percentage of the population receiving some form of education or training. This pattern has continued throughout the past four years of recovery.

1 LABOUR FORCE PARTICIPATION RATE, YOUNG PEOPLE



2 ECONOMICALLY INACTIVE POPULATION AGED 15-19 IN EDUCATION



SOURCES: Eurostat and INE.

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Various regulatory barriers limit the efficient allocation of resources and business competition. According to DIRCE statistics,[68] 9% of active companies were lost between 2008 and 2014 in Spain. In the period 2014-16, 5 pp of that decline was recovered, although the rate of creation of new companies is still low and the rate of destruction of companies is still high. Notable among the factors that may be limiting the emergence of new business projects are the regulatory barriers to entry in certain markets, such as, for example, delays or moratoria in granting licences to pursue certain activities at the local level and the limits on competition in certain sectors, such as road and rail passenger transport, or those stemming from the delay in the implementation of the Market Unity Law.[69] Moreover, certain elements of tax and labour regulations penalise companies that exceed certain thresholds.[70] In addition, there are the problems that arise when non-productive companies are lost as a result of insolvency proceedings that are not sufficiently fast or efficient, along with certain distortions that may favour less productive companies.[71]

The limited correction of mark-ups in the recovery may be attributable to a lack of competition in certain productive sectors. During the crisis, the fact that many firms needed to improve their financial position, against a backdrop of rising borrowing costs and tighter financing conditions, may have justified the increase in unit mark-ups. By contrast, in the current phase of the cycle, failure to adjust relative unit operating surpluses vis-à-vis the other euro area countries could indicate a lack of competition in some markets, with negative implications for continued competitiveness gains that are essential for correction

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68 DIRCE, the Central Companies Directory, is a single information system for all Spanish firms and their local units located in Spain.

69 In particular, the Constitutional Court judgment against certain articles of the Law required that its effective implementation be reviewed. Specifically, the judgment should encourage regions to pool their practices on a sector-by-sector basis, to achieve regulatory standards in keeping with best practice, continuing to seek to enhance productivity and not erect barriers to entry to potential competitors.

70 See M. Almunia and y D. López-Rodríguez (2018), "Under the Radar: The Effects of Monitoring Firms on Tax Compliance", *American Economic Journal: Economic Policy,* Vol. 10, pp. 1-38, and M. Almunia, J. F. Jimeno and D. Lopez-Rodriguez (2018), "Size-Dependent Regulations in Spain", Working Paper, forthcoming.

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

of the external imbalance.[72] It is also important for sectors that are not open to trade that there is competition and that relative prices grow in a contained manner, given that sectors that produce tradable goods include a high proportion of non-tradable goods and services.

Indeed, competitiveness gains vis-à-vis the euro area have been concentrated on wage adjustments rather than mark-ups. The productivity gains associated with the high rate of job destruction in the first stages of the crisis, and the wage restraint observed throughout the subsequent period, have restored most of the competitiveness lost vis-à-vis the other euro area countries, measured in terms of relative unit labour costs (ULCs). Specifically, while for the whole of the market economy, between 1999 and 2008 ULCs rose in Spain by 22 pp more than in the euro area, the present relative level is just 5 pp higher. However, in terms of unit operating surpluses, the loss of competitiveness in the expansionary phase was on a similar scale to that of ULCs, but the subsequent correction has been much more modest. This explains why the present level of the value added deflator has risen in cumulative terms by 10 pp more in Spain than in the euro area overall since the start of Monetary Union (see Chart 1.22).

Despite the recent improvements, Spanish credit institutions face important challenges stemming, inter alia, from the legacies of the crisis, the new regulatory framework and technological progress.[73] Credit institutions should anticipate these changes, continuing to serve as effective intermediaries of financial flows in the economy, providing the necessary funds on competitive terms to agents in need of financing. Although other European credit institutions must also address this challenge, Spain's credit institutions must do so in a setting in which, despite the considerable efforts made in recent years in terms of adjustments, write-downs and restructuring, some of the consequences of the crisis continue to weigh heavily on them, as analysed in detail in Chapter 2. This is the case of the relative volumes of troubled assets, which despite having been considerably reduced in recent years are still relatively high, the low levels of return on the banking business in Spain and the comparatively low solvency ratios by international standards, although they are clearly above the regulatory minimum levels (see Chart 1.23). In 2017 the Single Resolution Board resolved Banco Popular Español on account of the serious difficulties it was facing. Although the economic recovery will continue to reduce troubled (non-performing and foreclosed) assets, it is essential that credit institutions persevere in their efforts to continue to pare down these assets. It is equally essential that they continue to cut the operating costs of their business in Spain, bearing in mind that bank lending is not expected to return to the levels achieved in the expansionary phase that preceded the crisis either in the short or the medium term.

5.3 NEED TO CONTINUE WITH THE REFORMS IN THE EURO AREA

The crisis revealed the need to reform the institutional architecture of the euro area. In 2017, the European Commission (EC) headed up several initiatives for progress on four fronts: political, financial, economic and fiscal union.[74] The process proposed by the EC is governed by two complementary principles: a higher degree of solidarity and risk-sharing between Member States, and greater assumption of responsibility by national authorities, including specific measures to reduce risk in their economies. Recent experience in the crisis advises the need for simultaneous progress in the aspects highlighted by the EC.[75]

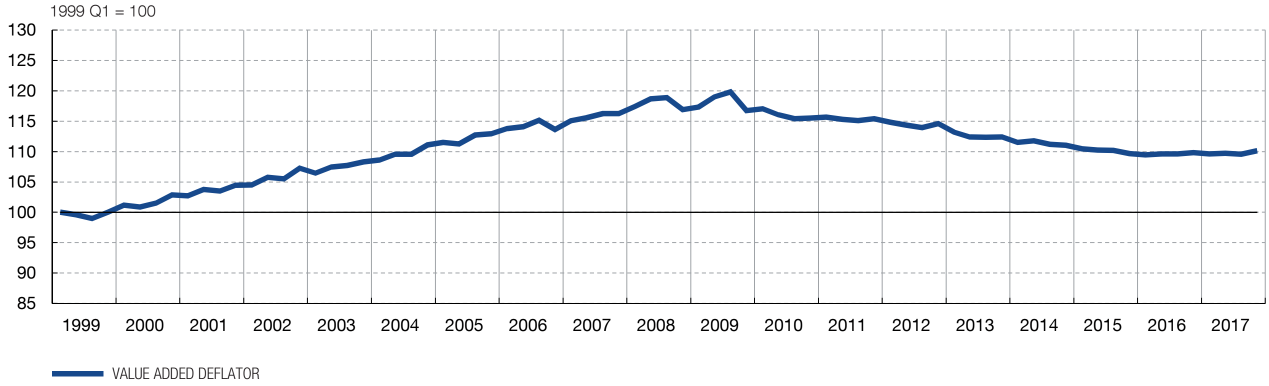
72 See Box 1.2, which documents the development of mark-ups in Spain and considers the possible causes.
73 See Chapter 2 of this *Annual Report*.
74 See the "White Paper on the future of Europe and the way ahead", March 2017, European Commission, and the "Reflection Paper on the deepening of the Economic and Monetary Union", May 2017, European Commission, which build on the "Five Presidents' Report", June 2015, European Commission.
75 Some of the initiatives to complete the euro area and a possible calendar are set out in Box 5 "The debate on euro area governance reform", "Quarterly Report on the Spanish economy", *Economic Bulletin,* 1/2018, Banco de España.

COST COMPETITIVENESS CORRECTION CONTINUED IN 2017

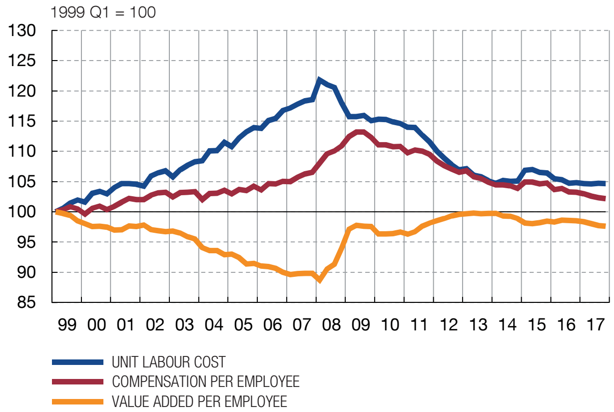
CHART 1.22

In 2017, relative ULCs continued to improve vis-à-vis the euro area, meaning that the competitiveness lost during the previous expansionary phase has been almost recovered. However, in terms of relative gross surplus per unit of output, the present level is very close to the pre-crisis level.

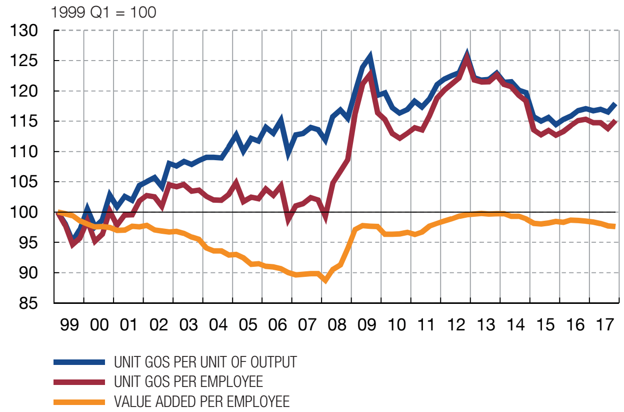
1 MARKET ECONOMY VALUE ADDED DEFLATOR, SPAIN/EURO AREA
Relative levels



2 MARKET ECONOMY UNIT LABOUR COSTS
SPAIN/EURO AREA
Relative levels



3 MARKET ECONOMY UNIT GROSS OPERATING SURPLUS (UNIT GOS)
SPAIN/EURO AREA
Relative levels



SOURCES: Eurostat, INE and Banco de España.

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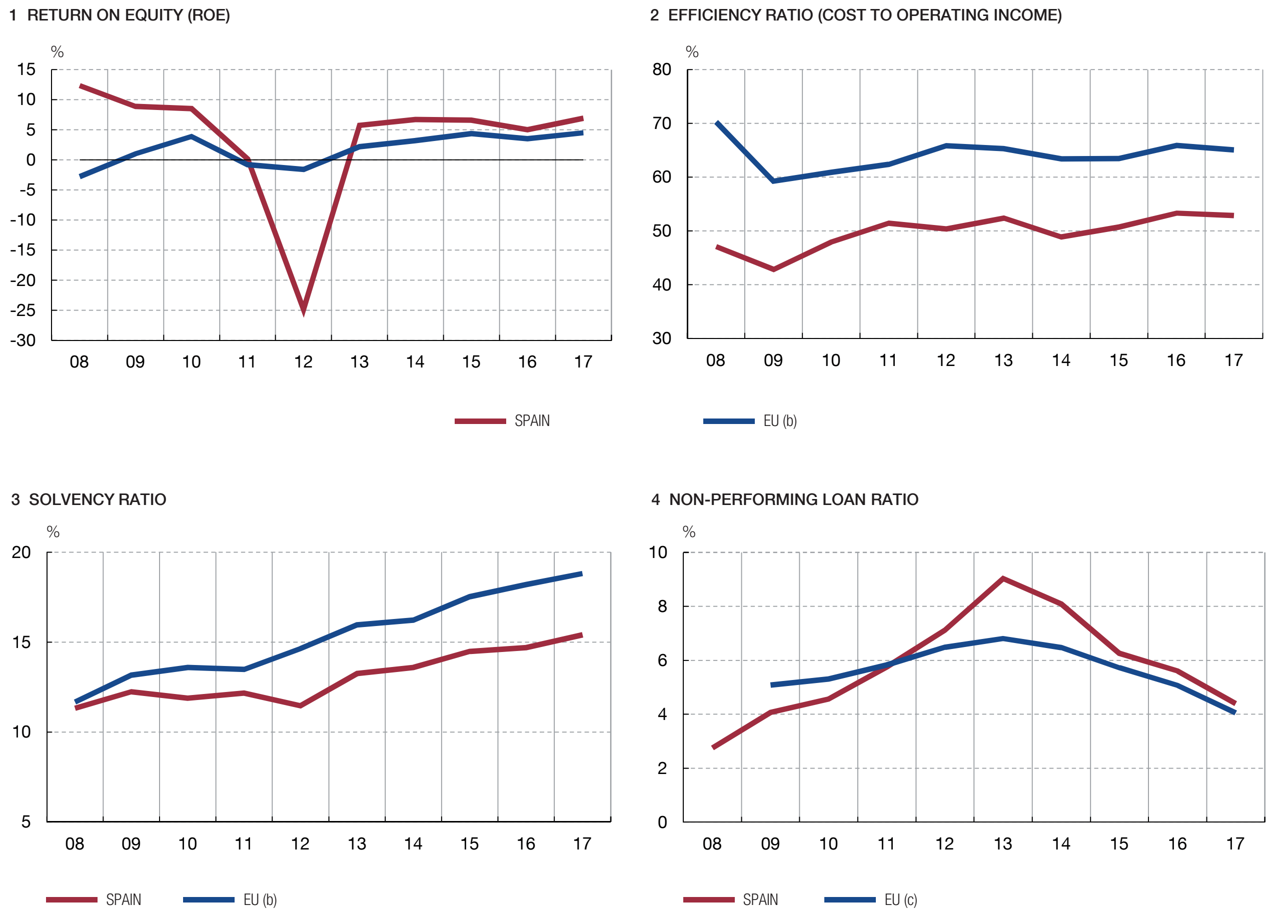
On the financial front, the priority should be to complete banking union. In this area, several fundamental issues remain. The first is the creation of a common financial backstop for the Single Resolution Fund (SRF), where there is broad consensus in favour of the European Stability Mechanism (ESM) assuming this function, possibly through a credit line. The adequacy of the liquidity provision facilities in all the phases of the resolution process also needs to be reviewed, as there are certain constraints on the availability of SRF funds and of ECB liquidity (through either monetary policy operations or emergency liquidity assistance). A second fundamental issue pending is the creation of a European Deposit Insurance Scheme (EDIS) that will provide all depositors with the same level of protection irrespective of where they are located, reduce the likelihood of the emergence of mistrust that can lead to mass withdrawals of deposits, and weaken the links between banks and sovereigns. In this area progress has been more modest, with a certain degree of consensus being reached on the fact that introducing elements into national banking systems that entail future risk-sharing will require the parallel implementation of measures to reduce the existing risk. There have also been proposals for the creation of sovereign

CHALLENGES FACING SPANISH CREDIT INSTITUTIONS (a) **CHART 1.23**

Spanish credit institutions have lower capital levels and higher non-performing loan levels than their European peers overall. However, they compare favourably in terms of efficiency and rate of return, despite their less favourable recent performance. Thus, the efficiency ratio has tended to deteriorate in Spain in recent years and rates of return are at historically low levels.



SOURCES: ECB (Consolidated Banking Data), EBA (Risk Dashboard) and Banco de España.

a Consolidated data.
b EU figure for 2017 is at September.
c Owing to comparability and availability issues, in this case the EBA's Risk Dashboard data have been used.

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bond-backed securities (SBBS) which, under certain conditions, could facilitate greater diversification of banks' current sovereign debt portfolios, which have some bias in favour of the sovereign debt of the country of issue.[76] For the longer term, the possibility of developing arrangements for joint debt issues has also been raised, providing safe European bonds that would allow governments to obtain funding at a reasonable cost at times of crisis. Lastly, the momentum behind the Capital Market Union project should permit greater diversification of private sector funding sources and greater robustness of private risk-sharing arrangements. The actions adopted in 2017 notably included those aimed at promoting funding for innovation and for new and unlisted firms, helping firms gain access to capital market funding, and fomenting long-term, sustainable investment and investment in infrastructure.

76 See the ESRB document "High-Level Task Force on Safe Assets".

In the area of fiscal policy, the difficulties associated with the present decentralised decision-making framework underline the need for supranational instruments to be designed to address adverse shocks. In particular, progress is desirable in the creation of some kind of common cyclical insurance mechanism that would help relieve the effects of the lack of a centralised fiscal capacity and the low stabilisation capacity of the existing public and private risk-sharing mechanisms (as evidenced by the limited size of the EU budget). Some of the studies available suggest that a mechanism could be designed, involving committing a relatively low volume of funds (1% of GDP, which is less than the present European budget) and no permanent transfers between States, which would provide a fiscal stabilisation capacity similar to that of the federal transfer system in the United States.[77]

Moreover, the current budgetary governance framework should encourage countries to generate headroom during expansionary phases. The lack of incentives that are sufficiently powerful to create the necessary headroom reduces the stabilisation capacity of fiscal policy throughout the euro area at times of crisis. Recent proposals, which seek to give more weight to government debt as a medium-term anchor and to the spending rule as an operational tool, are appropriate. In any event, it is essential that supervision of compliance with the fiscal rules is strengthened. Simplification of the European budgetary framework would be conducive to this, as the present framework is overly complex and not sufficiently transparent.

Lastly, on the political front the initiatives seek to secure more effective and more transparent governance. There is a growing perception of the need to ensure that the project to deepen EMU be linked to an increase in its acceptance by European citizens. In this respect, the European Parliament's capacity for oversight is expected to be strengthened and existing intergovernmental treaties to be incorporated into the EU legal framework. Consensus has also been achieved on the need to create a European Monetary Fund (EMF), anchored in European legislation, to assume the functions and increase the potential for action of the ESM. Lastly, the European Commission has proposed that the post of European Minister for Economy and Finance be created, to improve economic policy coordination and accountability to the European Parliament.

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

The political situation in Catalonia continues to be one of the main domestic risks for the future performance of the Spanish economy as a whole, and of this region in particular. However, the escalation of tensions, which peaked with the events of October 2017, has tended to subside since November.

Against this background, the economic indicators relating to the final months of 2017 and the first few months of this year suggest that, in contrast to the greater buoyancy recorded in early 2017, the Catalan economy has slowed more sharply than the economies of the other large regions. This poor relative performance is primarily reflected in a set of indicators relating to firms' employment decisions (social security registrations), household consumption (retail trade indices), tourism (non-residents' overnight hotel stays), residential investment (house purchases) (see Charts 6 to 9) and business investment, according to the evidence available. As for financial market indicators, they are showing a return to normal (see Charts 1 and 2), following the period immediately after the escalation at the beginning of October 2017, when stock market volatility increased and the Spanish market performed less favourably than the EURO STOXX index. In particular, this was a result of the negative behaviour of the share prices of banks, especially those that were then headquartered in Catalonia.

However, it is not easy to determine the extent to which the less favourable performance of the economic indicators of this region is linked to the political situation, since other factors may be affecting the Catalan economy simultaneously. It is also difficult to

Chart 1
GENERAL STOCK MARKET INDICES

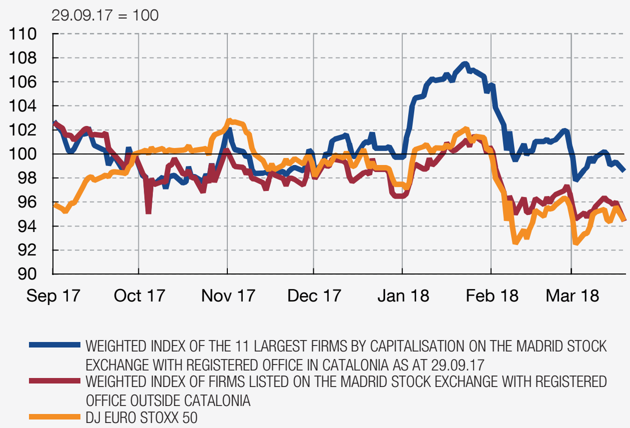


Chart 2
IMPLIED VOLATILITY

Chart 3
FINANCIAL MARKET UNCERTAINTY (a)

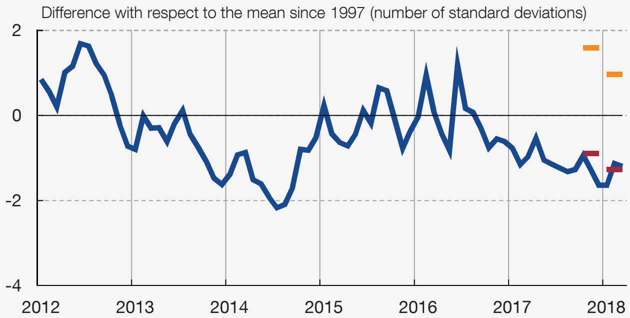
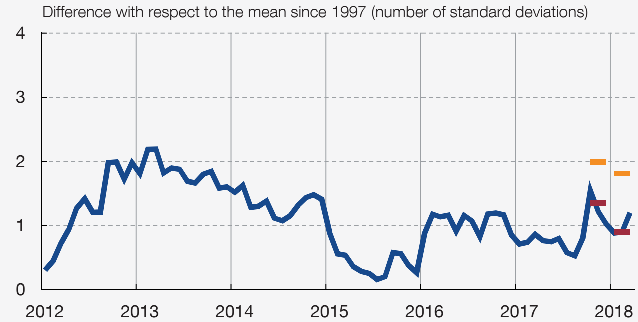


Chart 4
ECONOMIC UNCERTAINTY AND POLICY UNCERTAINTY (b)



OBSERVED SCENARIO 1 (c) SCENARIO 2 (c)

SOURCES: INE, IESE Business School, FUNCAS, CIS Barometer, PRS Group and Banco de España.

a Synthetic indicator based on indicators of the volatility of the IBEX-35, exchange rates, oil prices and ten-year bonds.
b Synthetic indicator based on CIS political assessment indicators (current and expectations), political risk indicator (PRS Group), national parliament fragmentation index, Economic Policy Uncertainty Index (EPU), and disagreement in the public deficit forecasts.
c The scenarios correspond to the hypotheses used in Box 1.1, "The Economic Impact of Uncertainty Arising from Political Tensions in Catalonia", *Financial Stability Report,* November 2017, Banco de España. In scenario 1 it is assumed that the level of uncertainty increases temporarily in 2017 Q4, and returns to the 2017 Q3 level in 2018 Q1. This increase is calibrated on the basis of the statistical distribution of the measures of uncertainty considered, which increase by a magnitude that is in the 90th percentile of each series (i.e. only 10% of the historical changes in each individual indicator are higher than those assumed). Scenario 2 assumes an increase in uncertainty in 2017 Q4 equivalent to that recorded in the historical episode with the sharpest rise and that following this initial shock the level of the uncertainty indicators decreases linearly over the simulation horizon.

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estimate the extent to which these events may have affected the economic buoyancy of other regions, through the direct trade links existing between the different geographical points of Spain and the general climate of uncertainty they may have given rise to. In fact, the main channel through which the political situation in Catalonia may be affecting its economy, and the Spanish economy as a whole, would be the latter one, insofar as it has an impact on agents' confidence and, consequently, their spending decisions and financing conditions.

In this respect, the available indicators of economic uncertainty, relating to the country as a whole, show that the significant

Chart 5
QUARTERLY GDP GROWTH BY REGION (a)

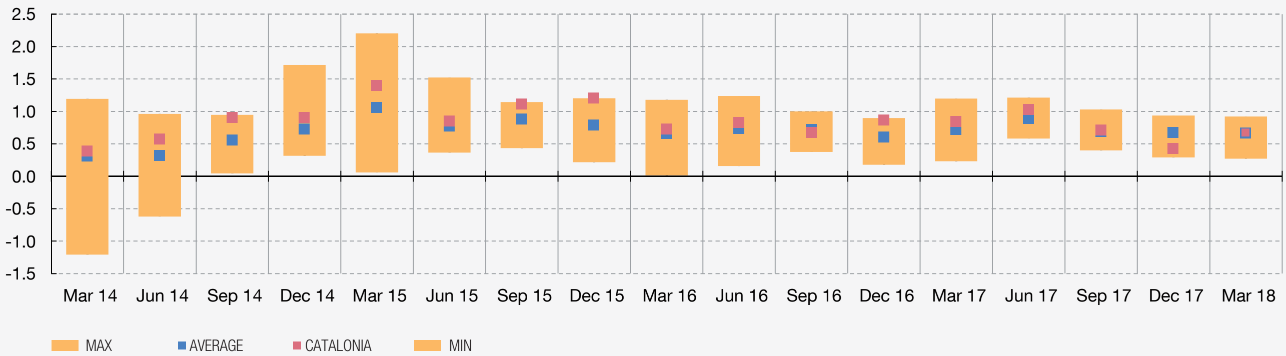


Chart 6
SOCIAL SECURITY REGISTRATIONS
Year-on-year rates based on adjusted series

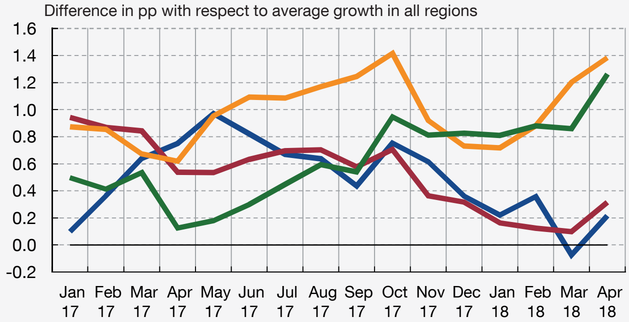


Chart 7
RETAIL TRADE INDEX
Year-on-year rates based on adjusted series

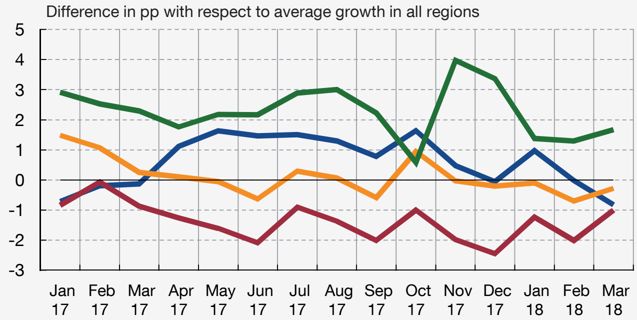


Chart 8
OVERNIGHT STAYS OF NON-RESIDENTS
Year-on-year rates based on adjusted series

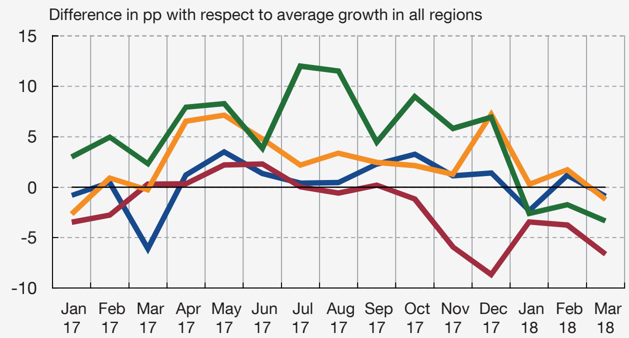
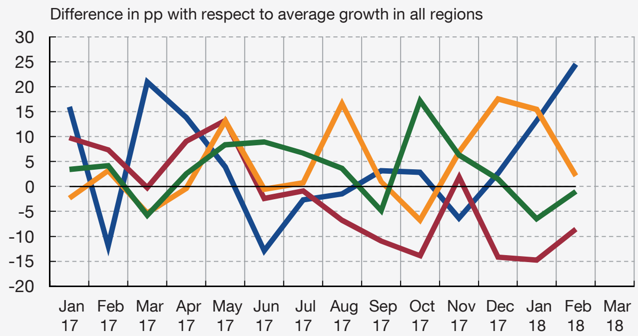


Chart 9
HOUSE PURCHASES
Year-on-year rates based on adjusted series



ANDALUSIA CATALONIA VALENCIA MADRID

SOURCES: INE, AIReF and Banco de España.

a AIReF estimations.

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increase in October last year was temporary; in subsequent months the values of the indicators returned towards more normal levels, in line with those observed in the months leading up to the peak in political tensions late last year (see Charts 3 and 4). The developments in the indicators are in keeping with the most benign hypothetical scenario of those for which simulations were presented in the Banco de Espana's *Financial Stability Report* published on 11 November 2017.[1] These hypothetical scenarios were based on historical episodes in which significant increases in uncertainty were observed and incorporated various hypotheses regarding how long the current episode may last.

In the short and medium term, the ultimate impact on the Spanish economy as a whole of this element of risk will depend on the eventual magnitude and duration of the current episode of political uncertainty. An easing of tensions in Catalonia could lead to a scenario of higher growth. On the other hand, the recent fresh outbreak of tensions could have an adverse effect on the confidence of agents and on activity. The persistent uncertainty regarding the future of the current legislature, following the regional elections of last December, may affect the process of normalisation that was perceptible just a few months ago.

1 See Box 1.1, "The economic impact of uncertainty arising from political tensions in Catalonia", *Financial Stability Report,* Banco de España, November 2017. In particular, it was assumed in an initial scenario that there would be a temporary, limited increase in uncertainty leading to a cumulative loss of GDP by the end of 2019 of some 0.3 percentage points, while another more severe and prolonged scenario had a substantially larger loss of output. For a description of the econometric models that measure the response of economic activity and the components of demand to fluctuations in uncertainty, see the analytical article "Macroeconomic uncertainty: measurement and impact on the Spanish economy", *Economic Bulletin,* 1/2017, Banco de España.

Since the start of the crisis there has been a major improvement in the competitiveness of the Spanish economy. Relative to the euro area, the competitiveness gains have been more apparent in terms of unit labour costs than in terms of prices. Between 2008 and 2017, the losses in competitiveness that had built-up since the start of EMU, as measured by relative unit labour costs, were almost completely corrected. However, the correction is much more modest when the change in the real effective exchange rate – based on the CPI or relative industrial prices – is considered. That is to say, although price increases have in recent years been more contained in Spain than in the euro area, this has not been sufficient to offset the sharp relative price deterioration that occurred during the pre-2008 upswing.

An analysis of the behaviour of mark-ups, defined as the difference between the selling price and production costs, may shed light on the factors underlying the differing behaviour of prices and compensation per employee. However, one of the difficulties involved in analysing mark-ups is that they cannot be directly observed, although they can be estimated.

Charts 3 and 4 show estimates of mark-ups – defined as the ratio between the gross operating surplus and gross value added of non-financial corporations – for various euro area countries based on national accounts data. During the crisis mark-ups in Spain and Portugal increased, in contrast to the more-or-less-pronounced declines recorded in Italy, France and Germany.

Although there is no widely accepted theoretical approach to explain the cyclical behaviour of mark-ups, there is an abundant economic literature documenting a pattern similar to that seen in Spain during the crisis and relating it to the need for firms to continue to have internal funds available when financing conditions are unfavourable. This argument appears to be particularly appropriate to account for events during the financial crisis, when mark-ups rose very significantly in the peripheral euro area countries and in other economies such as the United States.[1] Gilchrist et al. (2017)[2] show that, in a context of intense financial pressure (high levels of debt, tightening financing conditions and restricted access to new lending), US firms decided to raise their mark-ups at the beginning of the crisis in 2008, despite the weakness of demand and the possibility of losing market share, as a means of generating internal funds and meeting their financial obligations, improving their financial position, financing investment projects and accommodating potential financial shocks.

However, the validity of the above argument is less clear when we consider the developments in mark-ups during the current recovery. As seen in Charts 3 and 4, despite the significant improvement in financial conditions in recent years, mark-ups have not been reduced since 2014 in the countries included and, in the case of Spain and Portugal, have remained as firm as in the early years of the crisis.[3]

Based on information for individual non-financial Spanish firms, Montero and Urtasun (2014)[4] analyse the relationship between the increase in price-cost mark-ups and financial pressure in various industries over the period 2007-2011, and also consider other variables that may, in principle, help to explain the behaviour of mark-ups, which approximate the degree of competition, business size and the degree of innovation within companies. The results confirm the relevance of the degree of financial pressure as a significant determinant of the mark-ups of non-financial corporations, and also show the relevance of the degree of competition in the industry to explain changes in mark-ups in Spain. In particular, mark-ups increase to a greater extent in those industries subject to greater financial constraints, but also in those in which the level of competition is lower.

This latter finding may mean that the maintenance of high mark-ups during the current upturn reflects a lack of competition in some industries, and that this factor predominates over the effect, with a negative sign, that the improvement in financial conditions may be having on mark-ups. As seen in Chart 5, external financing channels[5] – essentially bank finance in the case of Spanish SMEs –[6] have been reviving over the last three years. Against a background of recovering activity, this should be conducive to a gradual reduction in the mark-ups charged on top of the firm's various costs. However, Chart 6 shows that the decline in the degree of competition that occurred during the crisis as a result of the disappearance of a significant number of firms has still not been corrected. In particular, although the concentration indices considered show significant losses of competition between the period of global financial crisis (2008-2009) and the subsequent recession (2010-2013), levels of competition in the Spanish economy remained practically unchanged during the start of the current recovery (2014-2015). For instance, the degree of concentration, as approximated by the market share of the four

1 Although developments in mark-ups were qualitatively similar, the adjustment during the crisis in terms of employment and wages was more pronounced in the case of Spain than in other advanced economies such as the United States.

2 S. Gilchrist, R. Schoenle, J. Sim and E. Zakrajsek (2017), "Inflation Dynamics during the Financial Crisis", *American Economic Review*, vol. 107(3), pp. 785-823.

3 Also, firm-level data from the Banco de España's Central Balance Sheet Data Office show that the accounting mark-ups of Spanish firms – measured as the ratio of gross operating surplus to value added – increased during the initial years of the recovery (2014-2015).

4 J. Montero and A. Urtasun (2014), *Price-cost mark-ups in the Spanish economy: a microeconomic perspective,* Working Paper 1407, Banco de España.

5 Another factor to take into account is the decline from 2013 in bank lending rates, which stood, especially in some segments, well above those observed in the core euro area countries and which have tended since then to converge on those of these countries, as a consequence of the various measures taken both nationally (restructuring of the financial system) and at the European level (the ECB's monetary policy measures).

6 Specifically it can be seen how the proportion of Spanish firms facing borrowing constraints, which in the depths of the crisis was much larger than in the euro area as a whole, has been gradually falling, to around average euro area levels (see Chapter 2, *Annual Report 2016,* Banco de España, for more details).

Chart 1
COST-BASED COMPETITIVENESS INDICES VIS-À-VIS THE EURO AREA

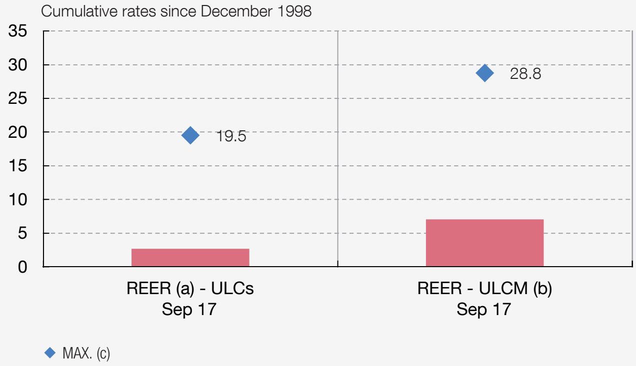


Chart 2
PRICE-BASED COMPETITIVENESS INDICES VIS-À-VIS THE EURO AREA

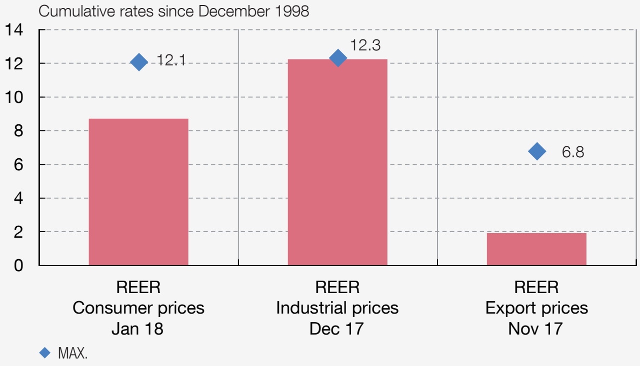


Chart 3
GROSS OPERATING SURPLUS OF NON-FINANCIAL CORPORATIONS

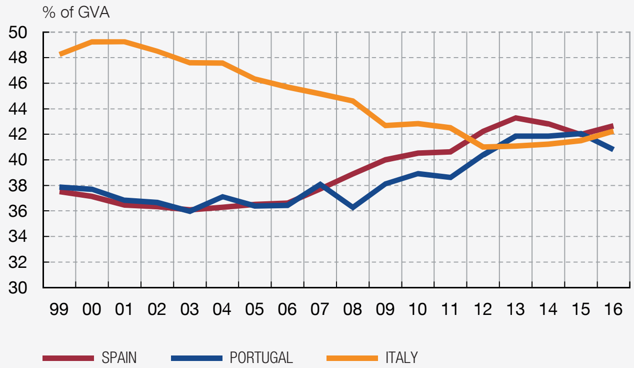


Chart 4
GROSS OPERATING SURPLUS OF NON-FINANCIAL CORPORATIONS

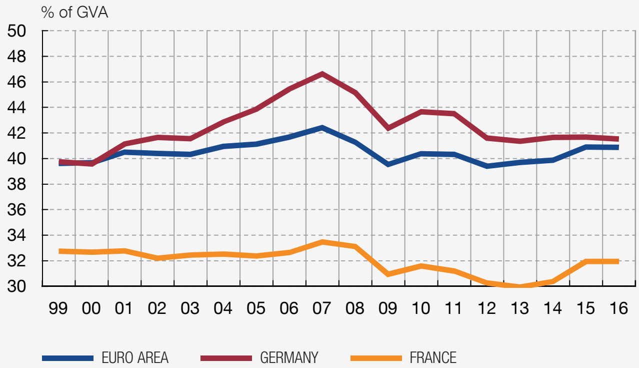


Chart 5
AVAILABILITY OF BANK LOANS TO SMEs (d)

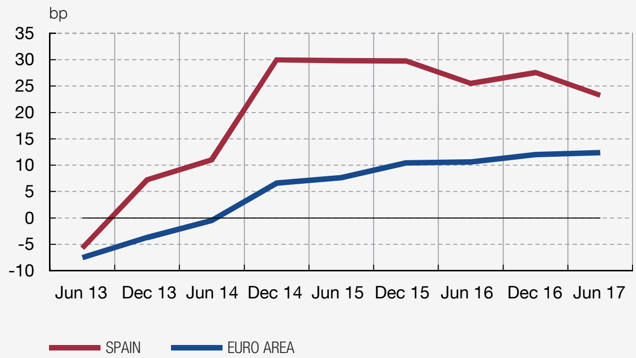
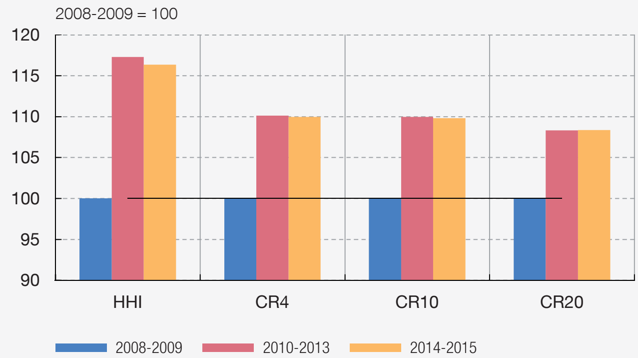


Chart 6
COMPETITION/CONCENTRATION INDICES FOR SPAIN (e)



SOURCES: Banco de España, INE and European Central Bank.

a REER: real effective exchange rate.
b ULCM: unit labour costs in manufacturing.
c Maximum loss of competitiveness since 1998.
d Percentage of firms reporting an improvement less the percentage reporting a deterioration in the survey on the access to finance of enterprises (SAFE).
e Four concentration indices are considered, normalised to 100 in 2008-2009, based on the market shares of the 4, 10 and 20 largest firms in each industry and the Herfindahl index (HHI). These indices were calculated for each 4-digit industry of the NACE rev. 2. and the aggregate index for the economy as a whole was obtained as a weighted average, using the weight of each industry in GVA

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largest firms in each industry (CR4), increased by 10% during the crisis and only declined by 0.1% during the subsequent recovery.[7]

In the current circumstances, it is necessary to assess in which industries there may be insufficient competition and to review certain barriers, including regulatory ones, to the participation of a greater number of competitors, in order not only to improve consumer welfare, but also to increase the positive effects of the reforms introduced in labour and financial markets.

7 The concentration indices considered have a number of drawbacks as indicators of the degree of effective competition as they depend crucially on how the relevant market is defined. In this case the relevant market is considered to be the industry in which firms operate at national level, without taking into account, for example, the geographical dimension, which in some industries may be a factor in determining the relevant market.

Over the last few years, the ECB's monetary policy has provided a significant stimulus, through historically low key policy rates and the implementation of non-standard measures, including the expansion of its balance sheet (asset purchase programme (APP) and targeted longer-term refinancing operations (TLTROs)), and of forward guidance. These actions have contributed to loosen financial conditions, acting as one of the fundamental drivers of the economic recovery in the euro area and have helped to counter deflationary pressures. This box presents empirical evidence on the macroeconomic impact of the measures taken by the ECB in recent years, both in the euro area and on the Spanish economy, updating the findings presented in Banco de España (2016).[1]

To measure the impact of monetary measures in the euro area, a structural autoregressive vector model[2] is used that captures the effect of monetary policy through the size of the Eurosystem's balance sheet. As a first step, a baseline scenario with no balance sheet expansion measures and an alternative scenario incorporating APP asset purchases and TLTRO allotments are constructed. A comparison of these two scenarios shows that over the period 2015-2018 the ECB's measures had a cumulative impact of some 2.3 pp on the real GDP growth rate and of 1.7 pp on the euro area inflation rate, as measured by the HICP (see Chart 1).[3]

The impact of the monetary measures on the Spanish economy is analysed using the Quarterly Model of the Banco de España (MTBE), which includes with a high degree of detail the interrelationships among the aggregate variables.[4] The model incorporates the effects of monetary policy on the Spanish economy through the trade channel, deriving from an increase in exports due to higher euro area growth, as well as those operating through changes in financial conditions, such as the exchange rate, stock prices and the cost of bank financing. The methodology used to estimate the effects of monetary measures on the exchange rate and stock prices is the "event study approach", which considers as an impact the response of the prices of various financial assets to the announcements of monetary policy measures.[5] As a result of this exercise, it is estimated that the ECB's monetary policy prompted a depreciation of the euro of around 11% and a rise in stock prices of around 18% between mid-2014 and the last event considered (see Chart 2).[6] The transmission of the ECB's measures to the cost of bank financing is slower and its identification is based on models seeking to approximate the behaviour of bank rates, which incorporate interbank rates as determinants, as well as proxy variables for the business cycle and the risk premium. The methodology of Banco de España (2016) is followed, with the preparation of a counterfactual scenario "in the absence of measures", which assumes, inter alia, that interbank rates would have remained unchanged. On the basis of this approximation, the impact of the ECB's measures on bank lending rates is estimated to range between 85 and 110 bp (see Chart 2).[7]

When all these assumptions are incorporated into the MTBE, an estimate is obtained of the effect of the monetary stimulus measures on real GDP and the CPI in Spain. As seen in Charts 3 and 4, the measures have had significant positive effects on both variables. It is estimated that, by the end of this year, the measures will have raised real GDP by 2.3% and the CPI by 1.4%. These effects are of a very similar magnitude to those estimated for the euro area as a whole.[8] As regards their composition, Table 1 shows the contributions of domestic demand and net exports to the impact on GDP, the improvement in domestic demand explaining somewhat more than two-thirds of this boost, in cumulative terms.

In addition to the macroeconomic estimations presented, the effects of recent monetary policy on other variables of interest are also relevant. On one hand, according to successive Bank Lending Surveys, the Eurosystem's monetary measures since 2014 have had positive effects on liquidity, financing conditions and the capital of euro area banks.[9] However, the effects on bank profitability seem to be more ambiguous: the (qualitative) surveys mentioned above suggest that the various measures have

1 See Chapter 3, *Annual Report 2015,* Banco de España.

2 See P. Burriel and A. Galesi (2018), "Uncovering the heterogeneous effects of ECB unconventional monetary policies across euro area countries", *European Economic Review*, 101, January, pp. 210-229.

3 These values are within the ranges of effects estimated by the ECB. See, for example, V. Constâncio (2017), "Effectiveness of Monetary Union and the Capital Markets Union", speech, 6 April, Malta.

4 See A. Arencibia, S. Hurtado, M. de Luis López and E. Ortega, 2017, *New Version of the Quarterly Model of Banco de España (MTBE),* Occasional Paper 1709, Banco de España.

5 Specifically, the change in prices within a two-day window (between the close of business on the day preceding and on the day following the event considered) is calculated for around 45 events, including meetings of the ECB's Governing Council at which measures are announced, publication of the accounts of meetings and speeches by Council members perceived as indicating the possibility of imminent adoption of measures. The selection of dates is similar to that of Banco de España (2016), adding the meetings of the Governing Council and the publication of accounts up to the decisions of October 2017, the final event considered. For further details of the hypotheses and other considerations in relation to this methodology, see Chapter 3, *Annual Report 2015,* Banco de España. Alternative measures of the impact of actions on financial conditions are to be found in V. Constâncio (2017). "Effectiveness of Monetary Union and the Capital Markets Union", speech, 6 April. Malta.

6 Also, it is estimated that the measures reduced Spain's sovereign risk premium by some 70 bp, with respect to the German Bund, information that is used later to measure the impact of the actions on bank rates.

7 In the case of corporate loans of less than €1 million, that part of the fall in rates attributed to monetary policy is small. However, it is possible that the effects are being underestimated as the equations do not capture the positive effect of TLTROs on the cost of bank liabilities and the terms and conditions of these loans.

8 The similarity of the macroeconomic effects of monetary measures does not mean, however, that the transmission channels have been the same as those in the euro area as a whole. For an analysis of the transmission channels of non-standard monetary policy in the context of a monetary union with heterogeneity among its members, see Box 3.3, *Annual Report 2015,* Banco de España.

9 The evidence can be found, for example, in Ó. Arce and A. del Río (2018), "Las implicaciones macroeconómicas y sobre el sector bancario de la política monetaria del BCE", *Papeles de Economía Española,* No. 155

The monetary policy measures introduced since 2014 have led to a significant easing of financial conditions in Spain and the rest of the euro area (bank lending rates, sovereign debt spread, exchange rate, etc.). This in turn has had a notably positive effect on GDP and inflation in Spain and in the euro area as a whole in the period 2014-17, which is projected to continue to some degree in 2018.

Chart 1
EURO AREA. CONTRIBUTION OF MONETARY POLICY TO GDP AND HICP GROWTH. 2015-2018 (a)

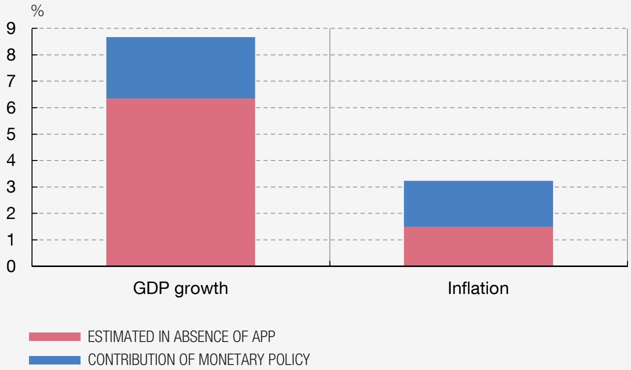


Chart 2
CHANGES IN FINANCIAL CONDITIONS MAY 2014-DECEMBER 2017

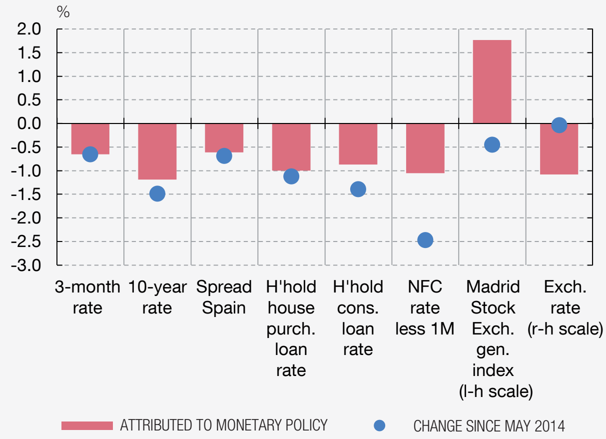


Chart 3
SPAIN. CONTRIBUTION OF MONETARY POLICY TO GDP

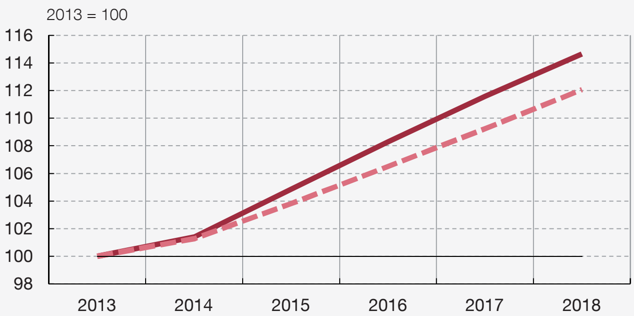
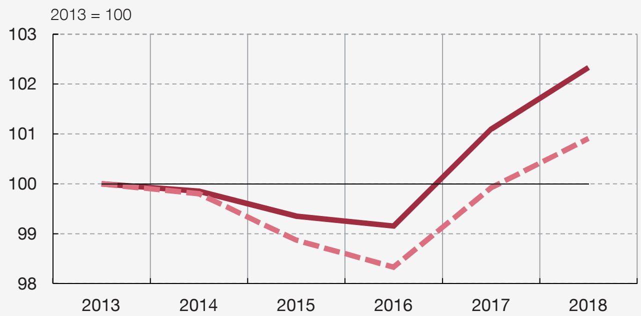


Chart 4
SPAIN. CONTRIBUTION OF MONETARY POLICY TO INFLATION



OBSERVED AND BANCO DE ESPAÑA'S MARCH 2018 PROJECTIONS
ESTIMATED WITHOUT MONETARY STIMULUS

SOURCES: Eurostat, ECB and Banco de España.

a Estimation based on Burriel and Galesi (2018): "Uncovering the Heterogeneous Effects of ECB Unconventional Monetary Policies across Euro Area Countries", *European Economic Review,* 101, pp. 210-229. The 2018 data are March MPE projections.

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Table 1
THE EFFECT OF QUANTITATIVE EASING MEASURES IN SPAIN (a)

	2014	2015	2016	2017	2018
HICP	0.05	0.49	0.84	1.17	1.40
GDP	0.10	1.01	1.66	2.13	2.29
Contributions to real GDP growth					
Domestic demand	0.04	0.46	0.97	1.39	1.57
Net exports	0.05	0.58	0.71	0.73	0.69

SOURCE: Banco de España.

a Percentage deviations from baseline scenario levels, calculated using the Quarterly Model of the Banco de España (MTBE).

counteracting effects,[10] while the quantitative analyses show neutral net effects.[11] The empirical evidence also suggests that the measures have had clearly positive effects, especially the corporate sector purchase programme (CSPP) on market financing to non-financial corporations and, indirectly, on the availability of credit to small businesses.[12] Finally, monetary measures appear to have had a positive impact on the public finances of the main euro area countries, by reducing the burden of public debt interest payments and, indirectly, through the macroeconomic impact on cyclical items of revenue and expenditure.[13]

10 According to the BLS, the TLTRO and APP programmes have had opposite effects on banking profitability, although the number of banks reporting positive effects of the former far exceeds the number of those reporting negative effects of the latter. There appears to be greater consensus among banks regarding the adverse effects on their profitability of the negative interest rate policy.

11 For a quantitative analysis of the various channels through which monetary measures affect banking profitability, see, for example, B. Cœuré (2016), *Assessing the implications of negative interest rates*, *speech* at the Yale Financial Crisis Forum, 28 July 2016, ECB, and Ó. Arce, M. García-Posada, S. Mayordomo and S. Ongena (2018), *Adapting lending policies when negative interest rates hit banks' profits*, Banco de España, mimeo.

12 See *Making room for the needy: The credit-reallocation effects of the ECB's Corporate QE,* Working Paper 1743, Banco de España (2017).

13 See the analytical article "The impact of unconventional monetary policy on euro area public finances", *Economic Bulletin,* 3/2017, Banco de España.

Spain's government debt-to-GDP ratio and structural budget deficit are both well above the limits established within the framework of the budgetary rules defined in the European Union's Stability and Growth Pact (SGP), which means that further fiscal consolidation will be required in the coming years. Apart from these constraints, there are economic reasons, relating to the need to reduce the vulnerabilities of the Spanish economy (as mentioned in the main text of this chapter), which make it advisable to continue with this process. This box presents a discussion of various short and medium-term scenarios for public finances.

The Spanish government is currently subject to an excessive deficit procedure (EDP), which was opened in April 2009,[1] under the so-called corrective arm of the SGP. Apart from France, whose EDP is expected to be closed this year, Spain is currently the only country in the Union recording an "excessive deficit", i.e. a budget deficit of more than 3% of GDP. The deadline set by the EU Council for remedying this situation is 2018.[2] In this respect, the draft state budget for 2018, presented on 27 March, projects a budget deficit of 2.2% of GDP this year.

When the Council determines that a member country has overcome an EDP situation it automatically becomes subject to the "preventive arm" of the SGP. In this new situation, the country remains subject to a set of rules that restrict its fiscal policy actions, which in the case of Spain would involve the following requirements. First, the structural budget deficit, which according to the European Commission stood at 3.1% in 2017, should decline by 0.5 pp of GDP each year under normal conditions,[3] until the medium-term budgetary objective (MTO) of structural balance is achieved. Second, the public debt-to-GDP ratio must be reduced each year by one-twentieth of the difference between the level that year and the 60% target. Given that the debt ratio stood at 98.3% of GDP in 2017 this rule would require an average annual reduction of 1.5 pp of GDP over the next decade. Finally annual growth of general government spending should be less than or equal to the medium-term potential growth of the economy.[4]

In order to assess the impact of these requirements, hypothetical scenarios are provided below illustrating the impact of compliance on the medium-term public debt-to-GDP ratio, depending on a number of macroeconomic and financial assumptions. The chart

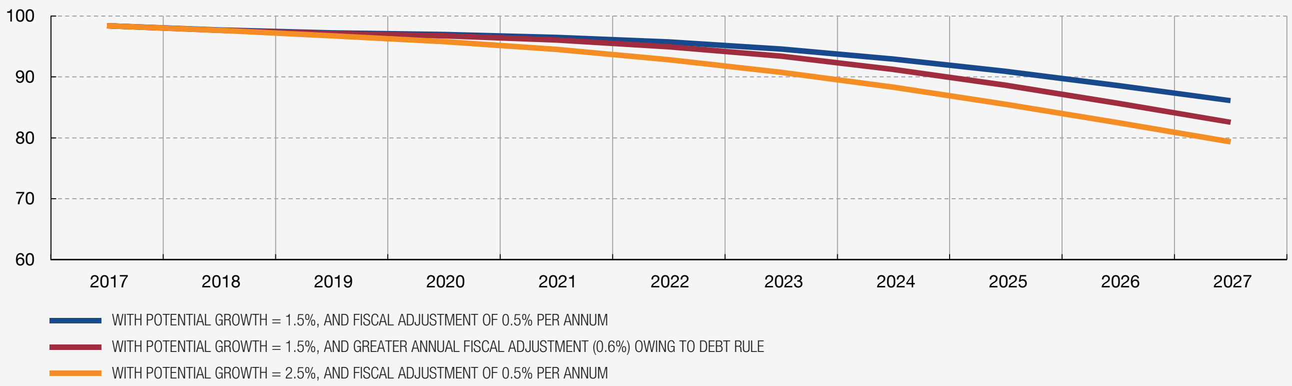
1 Determined in the EU Council Decision of 27 April 2009.

2 According to EU Council Decision of 8 August 2016, Spain must reduce its general government deficit to 2.2% of GDP in 2018 and achieve a cumulative improvement of 0.6 pp of GDP in the structural balance between 2016 and 2018.

3 More generally, under European regulations, the adjustment required, in terms of the change in the structural balance, is modulated in accordance with a matrix of cases that takes into account the levels of the output gap and public debt and the European Commission's assessment as to whether or not there is a debt sustainability risk. Thus, for example, if the output gap is greater than 1.5 pp, public debt is greater than 60% and the Commission's assessment is that there is no public debt sustainability risk, the structural adjustment required would be either more than 0.75 pp, if GDP growth is below potential, or more than 1 pp, if growth is above potential. For further details, see European Commission (2016), "Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence Programmes"

4 The Commission and the Council monitor compliance with these requirements, so that, in the event that "significant deviations" are identified, a process is launched to correct them. If this is not observed, sanctions can be imposed.

Chart 1
SIMULATED PUBLIC DEBT PATHS IN A SCENARIO OF CONVERGENCE TO THE MEDIUM-TERM STRUCTURAL BALANCE OBJECTIVE (a)



SOURCE: Banco de España, using the model described in P. Hernández de Cos, D. López Rodríguez and J. J. Pérez (2018), *The challenges of public deleveraging,* Occasional Paper 1803, Banco de España.

a Maximum annual fiscal effort scenario (change in structural balance) of 0.5 pp per annum, until the Medium-Term Objective is attained (structural balance = 0). In the scenario of potential growth = 1.5% and compliance with the debt rule, the constant annual fiscal adjustment is calculated so that the rule is complied with on average, i.e. so that the annual average change in the public debt-to-GDP ratio is a reduction of 1/20 of the difference between the debt value for each year and the 60% reference.

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presents hypothetical scenarios for public debt over the next decade based on a model simulating the dynamics of public debt.[5] It can be seen that a process of public deleveraging as required by the SGP in the case of the Spanish economy will require a significant and long-lasting fiscal consolidation.

Specifically, given the level of the public debt-to-GDP ratio in 2017 and the European Commission's estimates of the Spanish general government structural deficit for the same year, and assuming average nominal economic growth over the coming decade of 3% and implicit public debt interest rates of 2.5%, meeting this objective would require an average primary surplus of 0.8% of GDP, as compared with the deficit of 0.6% of GDP estimated for 2017, which would place the public debt-to-GDP ratio slightly above 85% in 2027. Average real GDP growth 1 pp higher than in this scenario would, keeping the other assumptions unchanged, lead to a public debt-to-GDP ratio of around 80% in 2027 or, alternatively, a public debt-to-GDP ratio similar to that in the preceding scenario, but with a significantly lower fiscal effort. In the latter case, the average primary surplus necessary to achieve this level of debt would be 0.2% of GDP, 0.6 pp per year below the baseline scenario.

These simulations highlight the importance of pressing ahead with fiscal consolidation while at the same time implementing the structural reforms necessary to increase the economy's growth capacity. The simulations presented also show the difficulty of meeting the conditions laid down in the First transitional provision of the Organic Law on Budgetary Stability and Financial Sustainability (LOEPSF by its Spanish abbreviation) on the transitional period for convergence with the reference values set by that law, which are in line with those in the SGP, i.e. 60% for general government as a whole. According to this provision, the public debt-to-GDP ratio for each tier of government should be reduced at the annual average rate necessary to achieve this aggregate limit in 2020.[6] Given the current levels of the public debt-to-GDP ratio of slightly above 98% of GDP, meeting the objective in 2020 would require a reduction of around 40 pp in the ratio over three years, an even larger correction than in the previous public-sector deleveraging process that took place between 1997 and 2007, when this ratio was reduced by some 30 pp over somewhat more than a decade, against a very favourable macroeconomic backdrop. In this respect, in line with the recommendations of the Spanish Independent Authority for Fiscal Responsibility (AIReF by its Spanish abbreviation), it would be advisable to use the appropriate legal mechanisms to extend the transitional period for meeting the limit set in the LOEPSF, adapting the requirements specified in the first transitional provision of this law and defining a credible and demanding reference path for sustained reduction of the debt ratio, that is consistent in any event with the requirements of the SGP.[7]

5 See P. Hernández de Cos, D. López-Rodríguez and J. J. Pérez (2018), *The challenges of public deleveraging,* Occasional Paper 1803, Banco de España.

6 Some further requirements are also established for the transition phase, under normal conditions: i) the change in the non-financial expenditure of each tier of government may not exceed the Spanish economy's real GDP growth rate; ii) when the Spanish economy achieves a real growth rate of at least 2% per annum or generates net employment with growth of at least 2% per annum, the public debt ratio must be reduced annually by at least 2 pp of GDP; iii) the structural deficit of general government as a whole must be reduced on average by at least 0.8% of GDP per annum, although in the event of an EDP, the deficit reduction must be in line with the requirements of the latter. Also, the LOEPSF gives an absolute priority to the payment of public debt interest and capital charges over all other budgetary commitments, which may be especially important to dispel any doubts that may arise regarding the public finances at times of financial instability or deterioration in confidence.

7 See the AIReF's report of 20 July 2016 "Report on compliance with the Budget Stability and debt targets and with the expenditure rule 2016 by the different public administrations".