

FOREWORD BY THE GOVERNOR

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In 2017 the recovery in the Spanish economy continued for the fourth year running. GDP grew by 3.1%, only marginally down on the rates for the two previous years. This expansion in output, which amounts to 13% in cumulative terms since the start of the upturn in 2014, is providing for rapid growth in employment and a significant reduction in the unemployment rate which, however, still remains at very high levels. The increase in GDP in 2017 exceeded, as has been the case throughout the recovery, the expectations at the start of the year, which was mainly due in this instance to more favourable than expected developments in the global economy and in international trade, particularly as regards the euro area. Further, for the third year running, output in the Spanish economy expanded at a significantly higher rate than that of the euro area countries as a whole, and this difference was even more marked in terms of job creation.

The recovery is benefiting from the correction of the Spanish economy's imbalances, a correction particularly patent in terms of the gains in external competitiveness and the reduction in private agents' overindebtedness, and discernible in the reduction in the debtor position vis-à-vis the rest of the world. These positive features of the current recovery are fuelling expectations that the expansion will be durable. At the same time, despite the above-mentioned headway, progress remains limited in other areas, notably so as regards any reduction in the high level of public debt. This means that, in the medium term, the Spanish economy will continue to evidence a notable degree of vulnerability to potential shocks, especially in a setting in which demand-side policies are expected to provide an increasingly smaller stimulus to growth. The challenges ahead are more considerable over a longer time horizon, in which structural policies will be called on to play a more active role to ensure a sustained increase in our economy's growth capacity and levels of well-being. Chapter 1 of this Report plots a course between the achievements of the Spanish economy to date, on one hand, and, on the other, the challenges ahead, to which I shall refer later.

The world economy had been posting modest growth in recent years, and showed signs of greater dynamism in 2017, when global GDP recorded its highest rate of increase since 2011. Moreover, international trade appeared to emerge last year from the slackness of the preceding years, which was partly associated with the momentum of investment, an expenditure component that is highly intensive in trade flows. Underpinning these favourable developments was the expansionary stance of economic policies and, in particular, of monetary policy. The gradual firming of the pick-up in activity and the incipient signs that inflation might be embarking on a rising path are beginning to prompt, in some geographical regions, a gradual withdrawal of monetary stimuli, a process not free from risks, as shown by the bout of increased volatility on financial markets at the start of 2018.

In the euro area economies, the head of steam of the recovery was across the board. On available estimates, the increase in activity is estimated to have enabled the negative output gap that gave rise to the crisis to be absorbed in late 2017. Inflation, however, remains at very low levels, meaning that unlike the United States, where the Federal Reserve has already initiated a monetary policy normalisation process, in the euro area it has been necessary to prolong its expansionary stance.

The monetary stimuli have enabled financial conditions to be kept very easy in Spain, with bank lending rates at levels close to all-time lows and rises in flows of new lending, which

are compatible with the ongoing deleveraging by private agents. Among the main GDP components, consumption slowed in 2017, albeit to a lesser extent than household disposable income, meaning that the rate of decline by the saving rate marking recent years increased. Investment, whose trend over the course of the recovery is analysed in detail in Chapter 3 of this Report, continued to expand against a background in which the course of final demand gave rise to further increases in capacity utilisation. Finally, exports reflected the greater buoyancy of foreign markets, despite the brake on gains in competitiveness vis-à-vis the rest of the euro area and of the appreciation of the effective exchange rate against the rest of the world.

There are positive aspects to the provisional assessment of the recovery, whose roots lie in the economic policies implemented since the recession. Although many measures addressing highly diverse areas have been adopted, the significance of some in explaining the current recovery may be highlighted.

Notable on the domestic front is the role played by the labour market reforms (which have contributed to restoring the competitiveness lost during the previous expansionary phase), and the recapitalisation and restructuring of credit institutions; and in the European arena, the launching of the Banking Union, along with the European Central Bank's monetary policy, has provided for the correction of the euro area's fragmented financial markets.

As a result of all these measures, the current recovery evidences characteristics that may be considered to be very favourable. The buoyancy of activity is being accompanied by notably robust employment creation, a typical feature of expansionary phases in the Spanish economy which, in the current cycle, is being bolstered by wage moderation and a greater degree of flexibility in the use of the labour factor. Moreover, the gradual absorption of idle resources in the economy has been no obstacle to maintaining an external surplus.

Undoubtedly progress has been made. But the collective effort Spanish society at large must make to embed and build on what has been achieved is also significant. On one hand, the economy continues to be somewhat vulnerable to potential external shocks. On the other, the expansion has been underpinned by certain factors whose effects will tend to gradually fade, which includes monetary and fiscal policies. As the momentum of these levers progressively tails off, greater store should be set by the measures aimed at promoting a greater degree of productive factor use, fomenting a more efficient functioning of factor and product markets, and raising our economy's long-term growth capacity.

Several of the sources of fragility of our economy remain significant: the net debtor position vis-à-vis the rest of the world, which remains high; the public debt ratio is close to its historical high; and, as detailed in Chapter 2 of this Report, the financial system still has major challenges to address. In all these areas, moreover, the uneven progress observed rests partly on the very improvement in the business cycle, which spells a warning about the possible fragility of some of the achievements attained in the face of any future downturn.

Prominent among the challenges ahead is the correction of the imbalance in public finances. This is a pressing task, given the adverse consequences that maintaining a level of general government debt as high as that at present entail. In particular, a high level of public debt tends to tighten the financing conditions for private agents, negatively affecting productive investment, and to diminish the headroom available to budgetary policy to counter adverse shocks. Additionally, assigning a high volume of funds to meet the interest burden means that such funds are not available for other productive spending.

The structural correction of the public finances imbalance should, moreover, be compatible with a greater contribution of public finances to the growth of the economy. On the expenditure side, there is room to raise the efficiency of public spending and to tilt its composition more towards those items with a greater bearing on productivity. On the revenue side, a revision and definition of the tax basket should be considered, moving towards structures more favourable to medium-term growth. In the case of regional and local government, which are responsible for more than 40% of public spending, financing arrangements should be reformed with the aim of adapting revenues to expenditure needs, ensuring their transparent distribution and increasing the degree of fiscal co-responsibility. As regards the pensions system, whose initial starting point is one of deficit and will be pressured by the effect of population ageing, a reform strategy would be desirable that increased the transparency of the system, strengthened the relationship between contributions and benefits, and, in particular, maintained an automatic adjustment mechanism ensuring its sustainability.

Despite the progress observed in recent years, the ongoing transformation of the Spanish credit system should continue over the coming years in order to ensure that it efficiently performs its task of intermediating financial flows. In particular, banks should continue striving to reduce the volume of non-performing loans and foreclosures on their balance sheets. Moreover, credit institutions must be proactive when addressing the effects of regulatory changes and technological progress. Lastly, the sector should complete the downsizing process, adapting its size to foreseeable future business volumes, which will be substantially lower than before the crisis.

From a longer-term perspective, in order to raise levels of well-being, the potential growth rate – which on available estimates is somewhat lower than 1.5% – must be increased. Several causes are constraining long-term growth, adversely affecting the degree of use of the labour factor, the level of productivity, or both simultaneously. The obstacles to growth most closely related to the low level of use of the labour factor include high structural unemployment and population ageing which, among other effects, restricts the labour participation rate. Other barriers to long-term growth, such as the high degree of labour market duality, regulations that restrict competition and prevent the efficient reallocation of resources, and human and technological capital shortcomings, all act as a drag on productivity growth.

One particularly pressing challenge is the necessary reduction of unemployment. Joblessness is particularly high and persistent among specific groups, such as the youngest and oldest cohorts, and the least skilled. Here, public policy should be geared to preventing these workers from remaining unemployed for long spells, with the subsequent loss of skills. Indeed, reducing unemployment, and in particular long-term unemployment, is one of the main levers for promoting socially sustainable growth, thereby fomenting the distribution of the benefits of the economic recovery amongst the greatest possible number of population segments. In this respect, a recent study by several Banco de España experts (whose publication is forthcoming)¹ highlights the fact that the strong deterioration in the labour market during the initial phases of the crisis was the main catalyst for the rise in inequality in per capita income at that time. Symmetrically, it is expected that the dynamism of employment creation during the current upturn, and the subsequent decline in unemployment, will have enabled the previous worsening in inequality indices to be corrected in recent years.

¹ Occasional Paper “Income, consumption and wealth inequality in Spain”, forthcoming.

One aspect on which employment dynamics and the distribution of income, wealth and household consumption capacity are largely conditional are demographic trends. The latest such trends, in particular, entail various adverse effects in respect of the use of the labour factor and, therefore, of the economy's potential output. These are manifest, on one hand, in a dip in the total working-age population, which calls for the implementation of policies that promote a life-work balance and therefore foment a higher birth rate, and a migratory policy in step with labour market needs. Further, population ageing negatively affects participation and employment rates. To alleviate these effects, measures are needed to promote the participation in the labour market of the elderly population groups.

Turning to productivity gains, the high degree of labour market segmentation must be tackled. The current recovery is once again evidencing a characteristic feature of upturns in the Spanish economy, involving a rise in the rate of temporary employment contracts, accompanied by a reduction in contract duration and an increase in unwanted part-time employment. These developments have adverse consequences for long-term growth, insofar as they discourage investment in human capital.

In the current upturn we are witnessing something of a rise in the rate of increase of total factor productivity. However, its growth remains limited, highlighting the need to raise investment in both human and technological capital. In the first of these two areas, there has been some perceptible progress since the crisis broke, such as the extension of training periods for the young, which is conducive to human capital accumulation. Evidently, however, lengthening training periods is not, in itself, sufficient; the quality of education must also be raised. In particular, skills acquired must be geared to a greater extent to face the challenges arising from technological progress and globalisation.

As regards technological capital, an increase has been observed since the start of the crisis in the distance separating Spain from the other European economies in terms of R&D spending, especially in the private sector. Closing this gap and promoting innovation by companies calls for action in many different areas, ranging from an increase in the allocation of public funds for research and development to the promotion of financing for innovative activities, and improving human capital endowment. Moreover, actions that improve levels of competition are a powerful stimulus to innovation. In this respect, the fact that the gains in competitiveness in recent years vis-à-vis the euro area as a whole should have borne above all on the correction of unit labour costs, while unit operating surpluses remained practically stable, suggests the need to introduce competition-enhancing measures into different goods and services markets.

The low rates of total factor productivity growth may also be associated with the presence of regulatory obstacles which, in particular, might be hampering business start-ups or hindering their growth. The delays in rolling out the Law on Market Unity or the restrictions to companies growing above certain thresholds due to certain legislative provisions are examples of regulations that may be generating inefficiencies, and that therefore require revision.

Lastly, I should mention that progress has been limited in the construction of the euro area's institutional architecture. Here, the priority continues to be the completion of the Banking Union, with the creation of a common financial backstop for the Single Resolution Fund, a European deposit guarantee scheme, and further headway with the capital markets union. Moreover, the governance of public finances must also be reformed, with the dual aim, first, of promoting healthier public finances and, second, of setting in place the basic building blocks needed to develop a fiscal stabilisation capacity at the overall euro area level.