

ANNUAL REPORT 2017

CHAPTER 1

THE RECOVERY IN THE SPANISH ECONOMY:

THE LIMITS OF DEMAND-SIDE POLICIES AND FUTURE CHALLENGES

IMPROVED EXTERNAL OUTLOOK



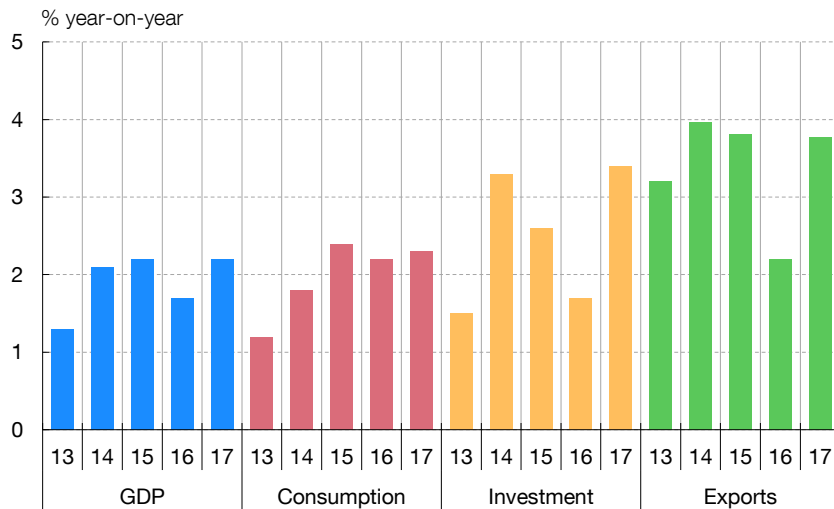
Greater buoyancy of world trade.

Rise in investment in the advanced economies.

Inflation contained despite rise in oil prices.

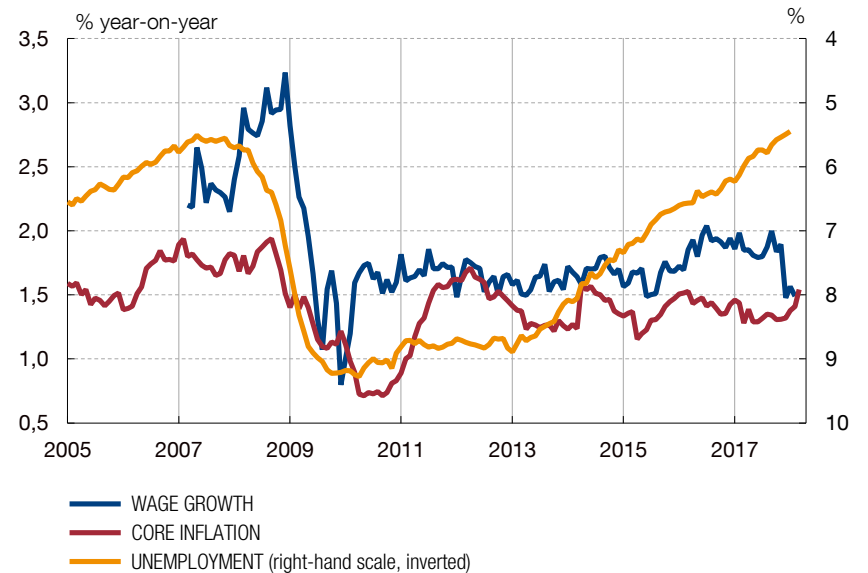
Risks: re-pricing in some financial markets; Brexit negotiations; restrictions on international trade.

GDP AND DEMAND COMPONENTS IN ADVANCED ECONOMIES



SOURCES: WEO (World Economic Outlook) and Datastream.
a. Aggregate of United States, euro area, United Kingdom and Japan.

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



ROBUST EURO AREA GROWTH WITH MODERATE INFLATION

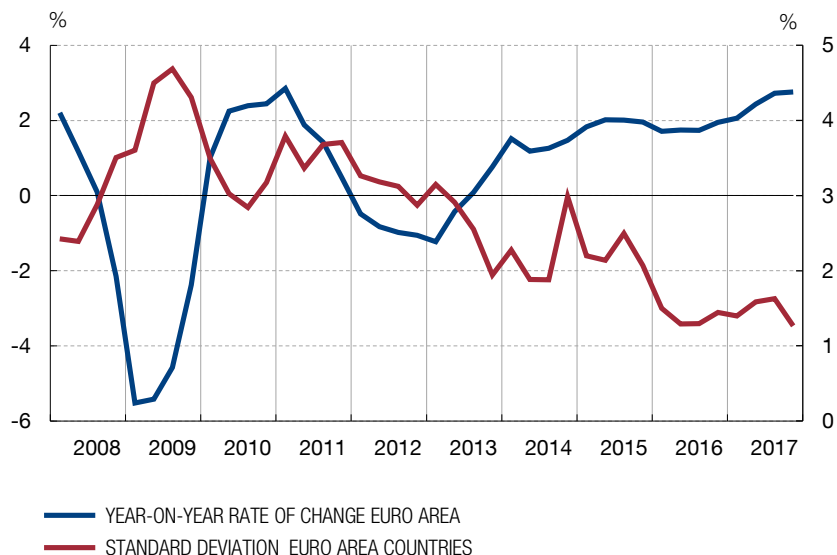


The strength of activity is underpinned by favourable financial conditions and intense job creation.

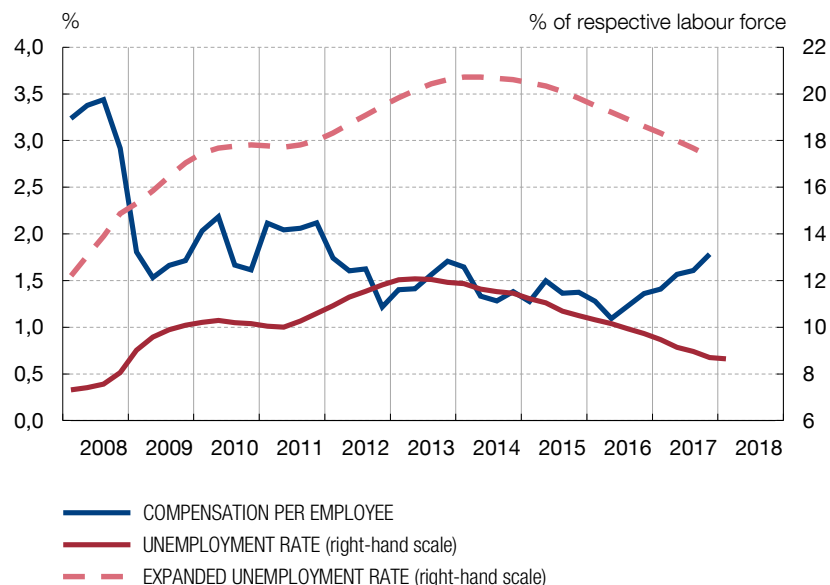
Moderate inflation outlook that determines the ECB's accommodative monetary policy stance.

Ahead there is room for improvement in the use of productive factors, conducive to the continuity of the current upturn.

GDP



COMPENSATION PER EMPLOYEE AND UNEMPLOYMENT RATE (a)



SOURCES: Banco de España, ECB and Eurostat.

a. 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.

THE STRENGTH OF ACTIVITY IN SPAIN WAS EXTENSIVE TO ALL THE DEMAND COMPONENTS



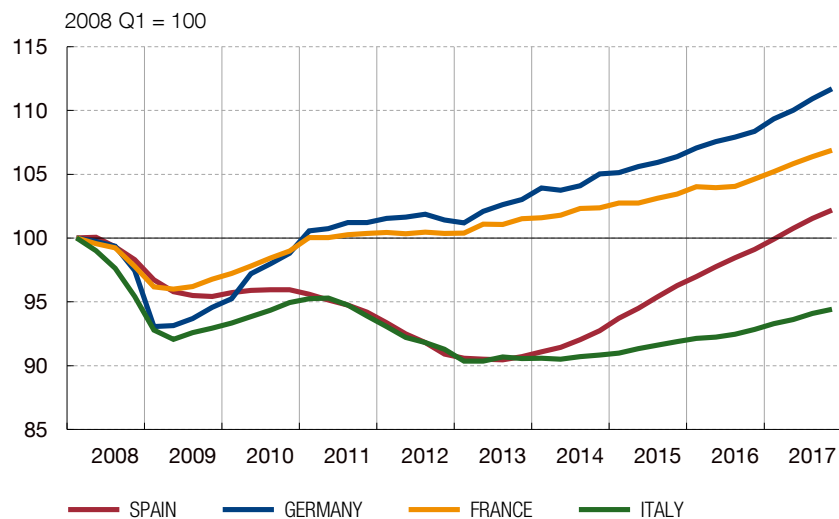
Along with structural factors (gains in competitiveness), transitory factors remain in place that have helped prolong the current recovery.

Recovery more balanced between domestic and external demand than in previous expansions.

Moderate impact of the political situation in Catalonia.

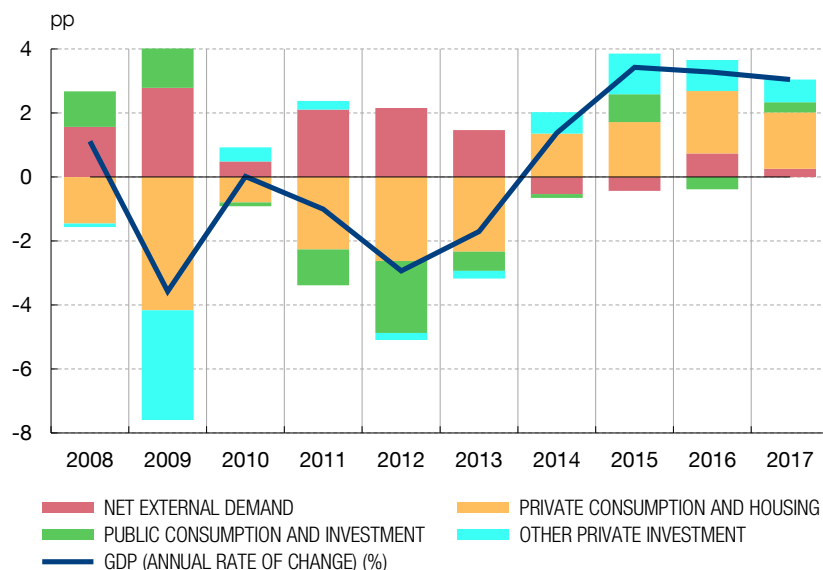
The increase in activity once again exceeded the expectations at the start of the year. This was due to the more favourable behaviour of foreign markets.

GDP
Levels in real terms



SOURCES: INE and Banco de España.

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



LOSS OF MOMENTUM OF CONSUMPTION AND DECLINE IN THE SAVING RATE



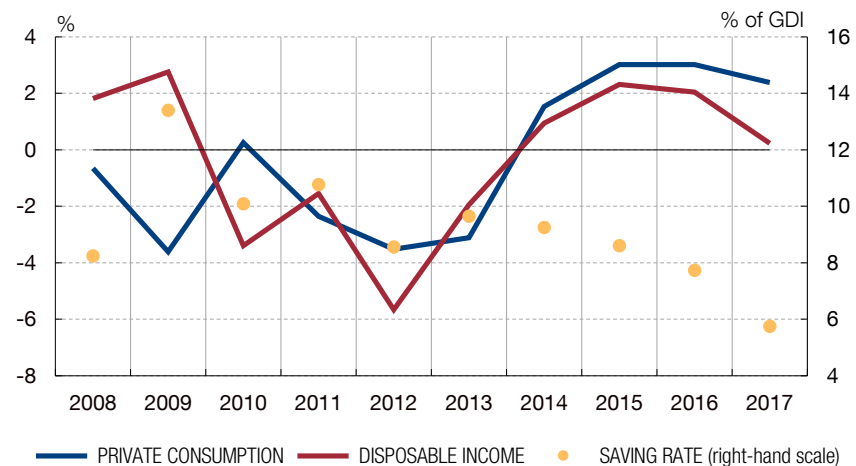
Very easy financial conditions and improved household wealth position.

In 2017 the slowdown in consumption (to 2.4%) was less than that in disposable income (to 0.6%).

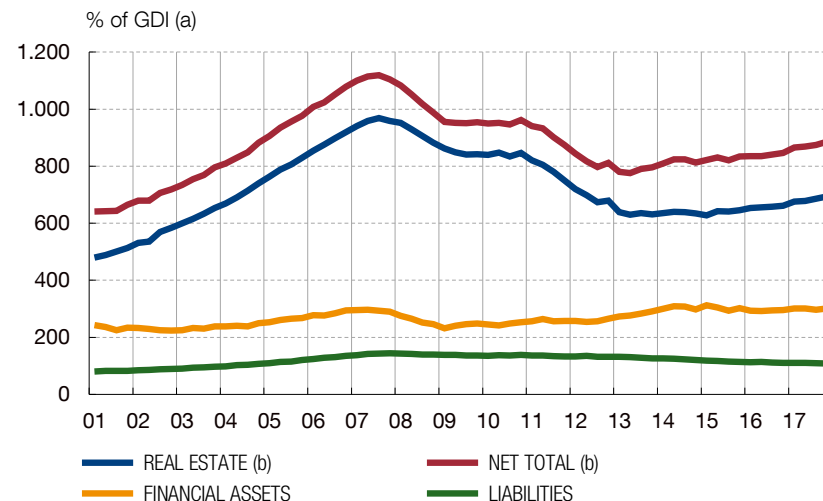
The decline in the saving rate (by 7 pp since 2009) is in response to various factors (labour market; interest rates; growth expectations; oil prices).

The improvement in residential investment has contributed to the reduction in households' financing capacity.

PRIVATE CONSUMPTION AND DISPOSABLE INCOME
Real annual rates of change



HOUSEHOLDS. WEALTH



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.

FINANCING CONDITIONS AND PROFITS SUSTAINED INVESTMENT



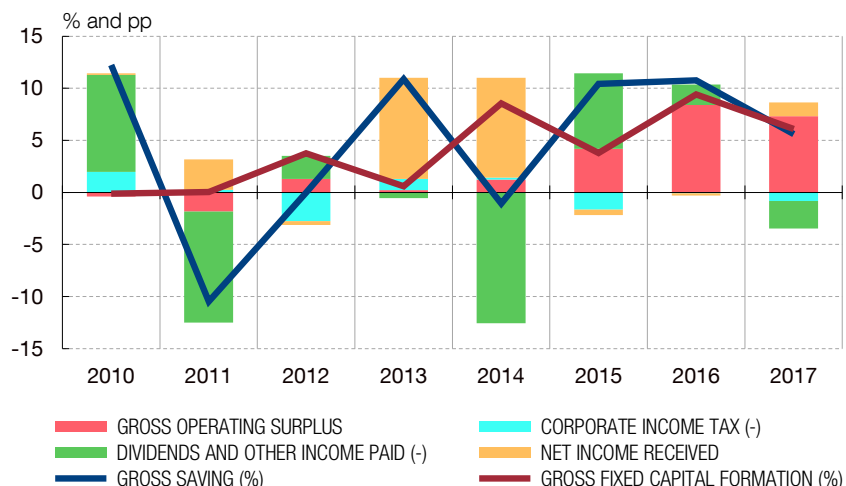
Pick-up in credit flows, especially to SMEs, despite the contraction in outstanding loans to NFCs (1.1%).

Strength of financial position: the debt ratio stood at 80% of GDP.

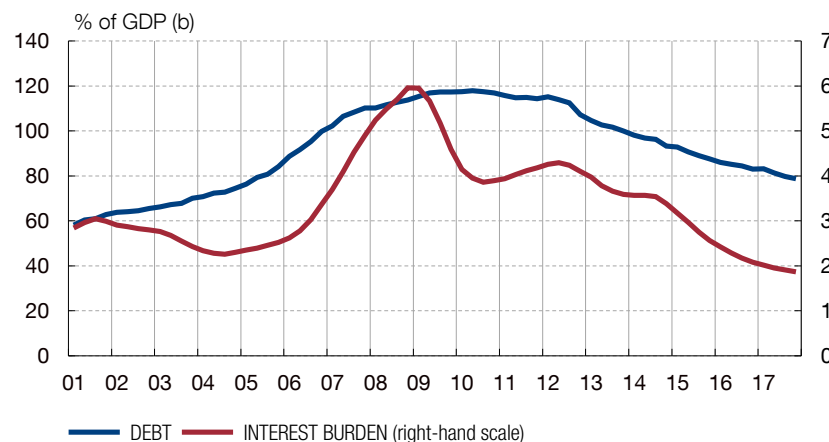
The estimated growth of investment (5%) was somewhat lower than that of the previous years.

The sector's lending capacity has continued to be the main support for maintaining the nation's positive balance (1.9% of GDP).

CORPORATE SAVING AND GROSS FIXED CAPITAL FORMATION
Nominal growth and contributions



NON-FINANCIAL CORPORATIONS. DEBT (a) AND INTEREST BURDEN



SOURCES: INE and Banco de España.
a. Interest-bearing borrowing.
b. Seasonally and calendar-adjusted series.

ACCELERATION IN EXPORTS IN 2017

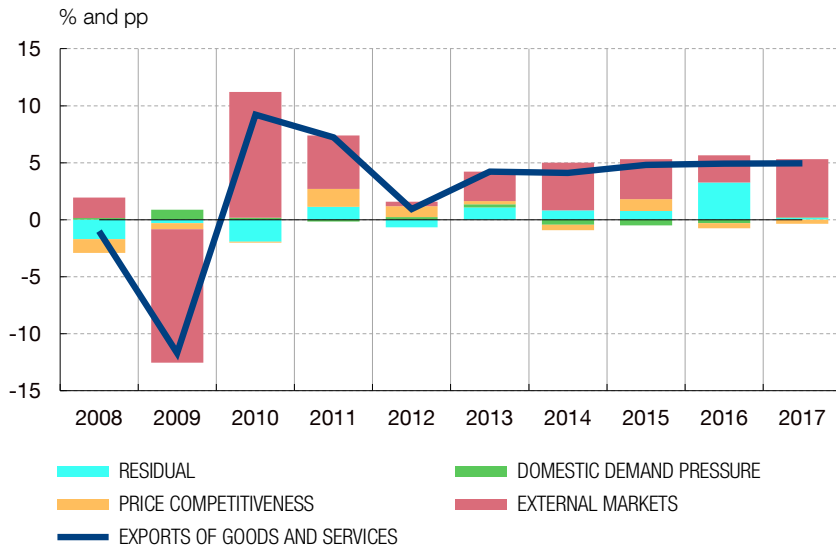


Exports accelerated in 2017 (5%) but did so to a lesser extent than markets.

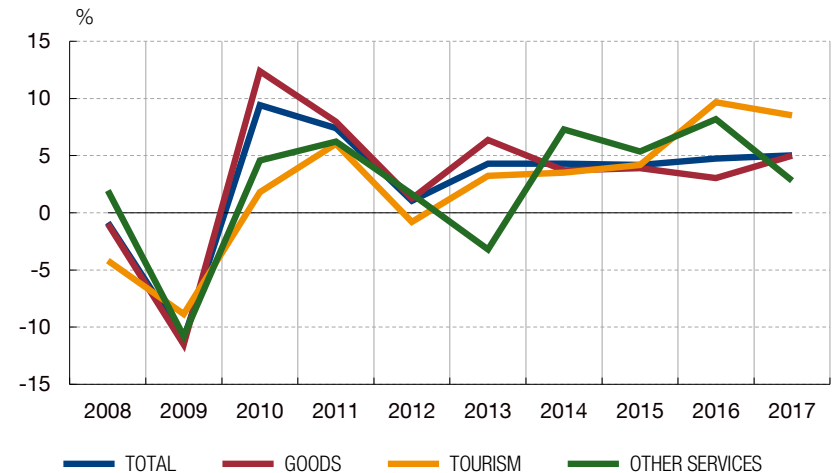
Of note was the dynamism of tourism services, as in 2016, and the acceleration in goods exports.

Following the crisis, the increase in regular exporting companies is providing structural support to exports.

TOTAL EXPORTS: GROWTH AND CONTRIBUTIONS (a)



EXPORT COMPONENTS
Real annual 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.

THE PERFORMANCE OF CONSTRUCTION AND INDUSTRY WAS MORE EXPANSIONARY THAN THAT OF SERVICES

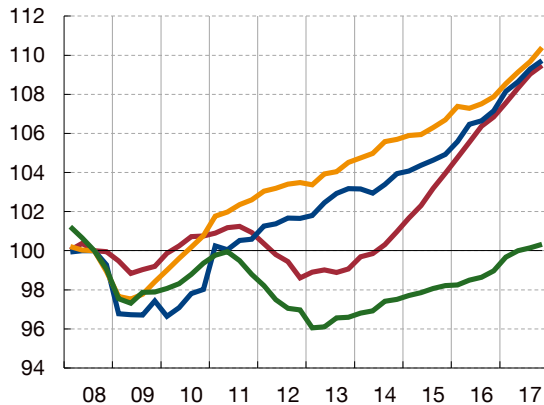


Value added in construction showed the highest growth, followed by industry, which regained its pre-crisis level.

The sector that has gained most weight since the crisis (9 pp) both in terms of employment and of value-added is services.

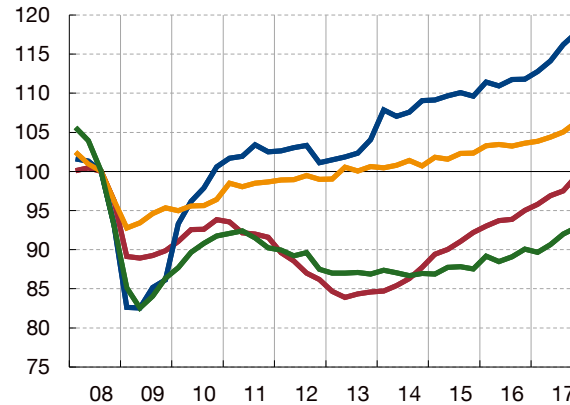
VALUE ADDED. SERVICES

2008 Q3 = 100



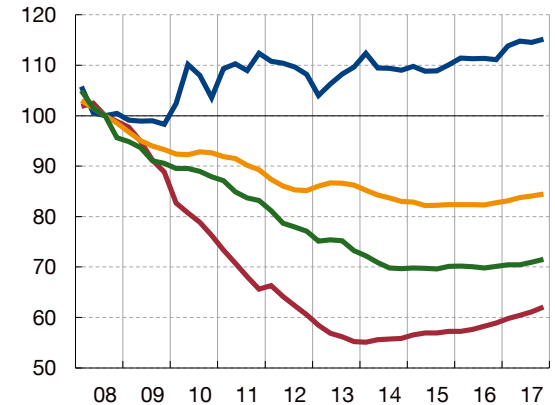
VALUE ADDED. INDUSTRY

2008 Q3 = 100



VALUE ADDED. CONSTRUCTION

2008 Q3 = 100



— SPAIN

— GERMANY

— FRANCE

— ITALY

SOURCES: Eurostat, INE and Banco de España.

HIGH JOB CREATION AND WAGE MODERATION

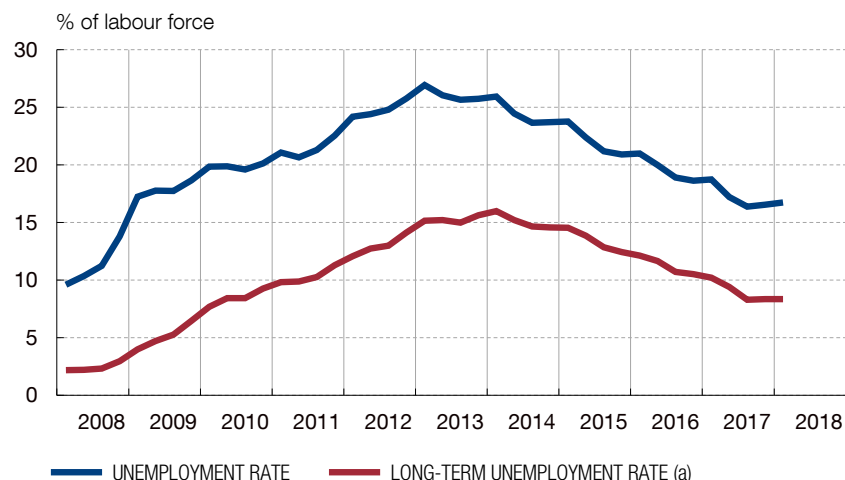


Notable job creation has contributed to significantly reducing the unemployment rate (16.5%; 10 pp down on the 2013 peak) and long-term unemployment relative to total unemployment stands at 50.4%.

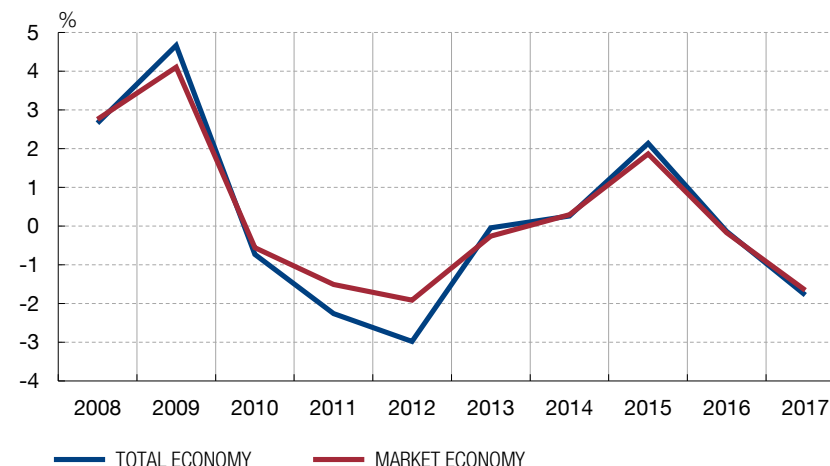
Modest increase in wage remuneration in real terms (0.4% in the 2014-2017 period).

Composition effects (new entrants) have contributed to the moderation in wages and productivity.

UNEMPLOYMENT AND LONG-TERM UNEMPLOYMENT RATES



REAL WAGES (b)
Annual rates of change



SOURCES: INE and Banco de España.

a. 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.

b. Nominal wage is the compensation per employee according to Quarterly National Accounts. The nominal wage deflator is the CPI.

COSTS AND PRICES CONTINUED TO SHOW LOW RATES OF INCREASE

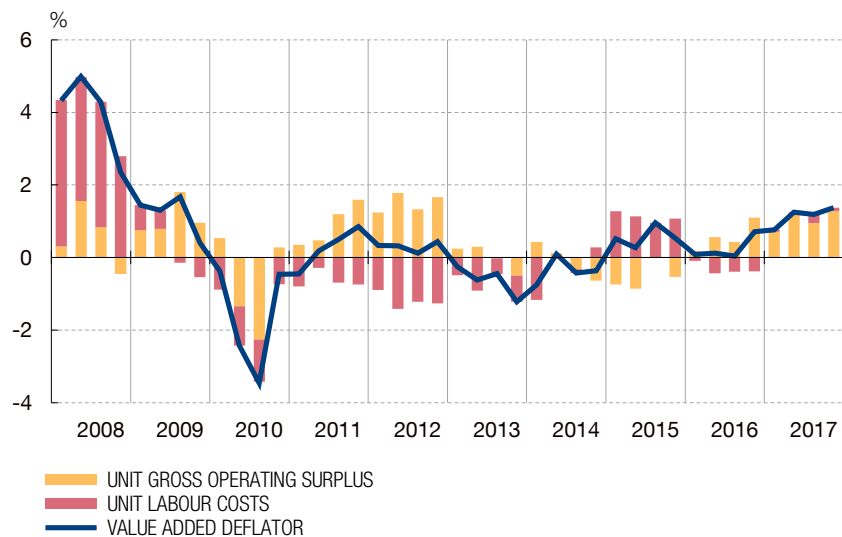


Stability of unit labour costs (up 0.2%) and bigger increases in domestic prices (1.2% increase in the value-added deflator).

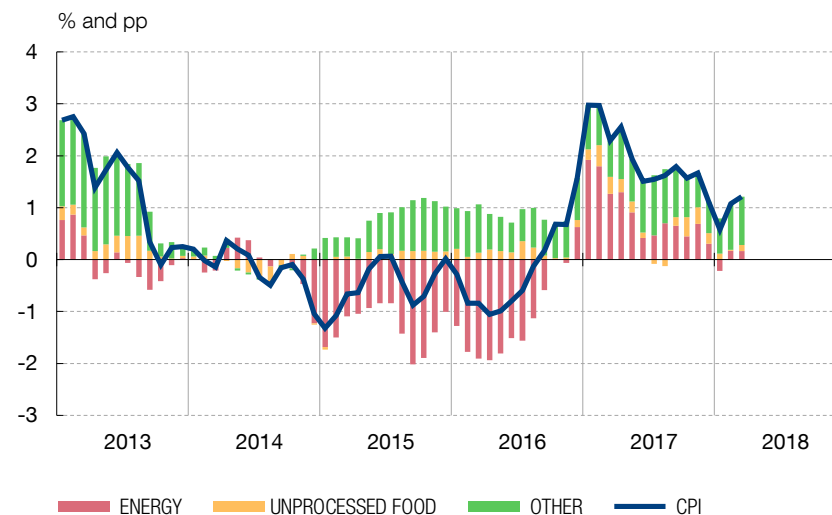
The growth of the CPI (2%) was greatly determined by the increase in oil prices in the first half of the year.

Core inflation posted a low rate (1.1%)

MARKET ECONOMY VALUE ADDED DEFLATOR
Contributions to year-on-year growth



CPI. CONTRIBUTIONS TO THE YEAR-ON-YEAR RATE



SOURCES: Eurostat, INE and Banco de España.

THE LIMITS OF DEMAND-SIDE POLICIES



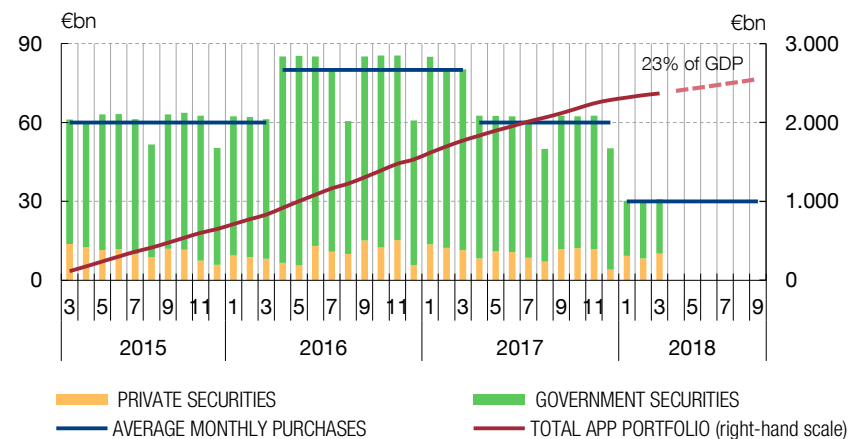
Along with other transitory factors, demand-side policies have contributed to the dynamism of the recovery.

Monetary policy measures have contributed notably to the real growth of GDP and of the CPI in the 2014-2018 period (Box).

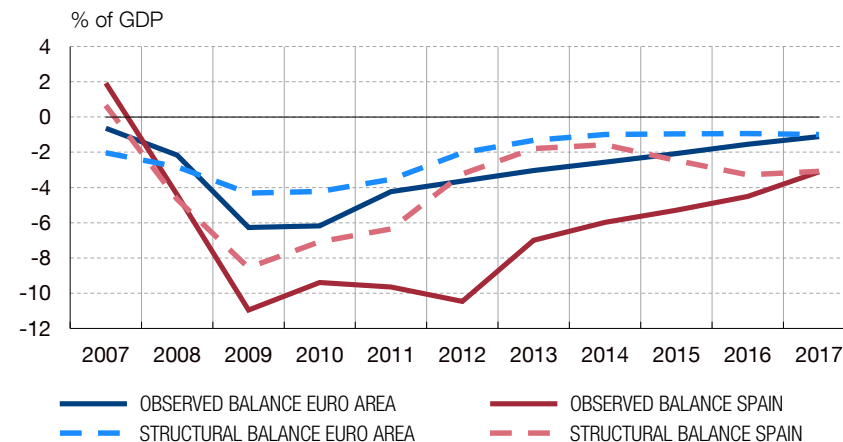
Fiscal policy boosted growth in the two years spanning 2015 and 2016, and evidenced a neutral stance in 2017. Financial conditions also assisted the fiscal position, both directly (interest burden) and indirectly (aggregate growth).

These demand-side policies will progressively tend to have a more limited role.

ASSET PURCHASE PROGRAMME (APP)



OBSERVED AND STRUCTURAL (a) GENERAL GOVERNMENT BALANCE



SOURCES: ECB, Bloomberg and Thomson Reuters.
a. The cyclically-adjusted balance, net of temporary measures.

PERSISTENCE OF THE EXTERNAL AND PUBLIC FINANCES IMBALANCES

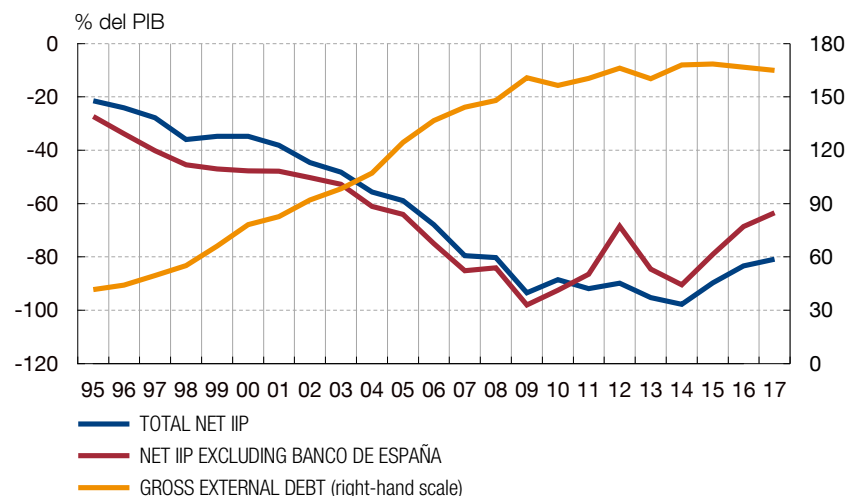


The persistence of a high level of external and public debt is a factor of vulnerability.

External vulnerability has been partly alleviated by the structural adjustment of the current account balance and the improved balance sheet positions of resident issuers.

Even complying with the (demanding) requirements of the "corrective arm" of the European fiscal rules framework, which may be met in 2018, and under benign macrofinancial assumptions, public debt is expected to hold at high levels in the coming decades.

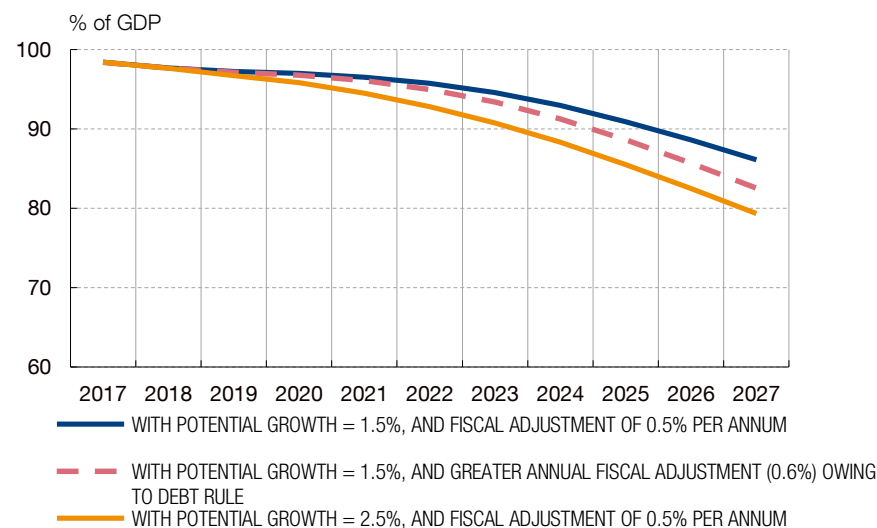
NET INTERNATIONAL INVESTMENT POSITION (IIP) AND GROSS EXTERNAL DEBT



SOURCE: Banco de España.

a. Drawn from the model described in P. Hernández de Cos, David López Rodríguez and J. J. Pérez (2018), *The challenges of public deleveraging*, Occasional Paper, no.1803, Banco de España.

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

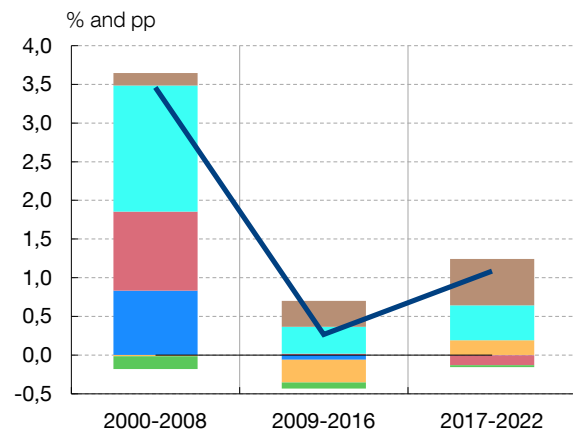


LOOKING AHEAD, THE ECONOMY PROJECTS RELATIVELY MODEST POTENTIAL GROWTH

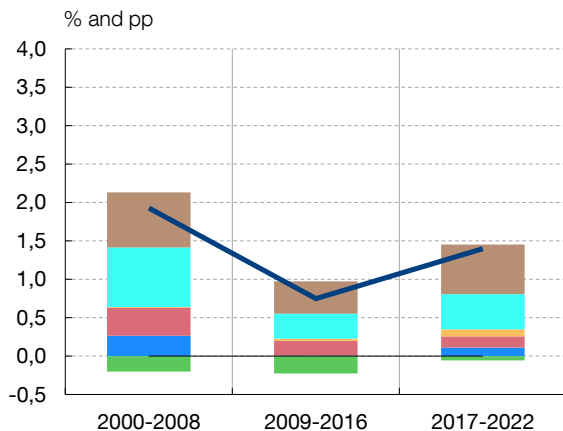


Various structural factors restrict the Spanish economy's potential growth (between 1% and 1.5%): population ageing, a lower participation rate, high structural unemployment and low productivity.

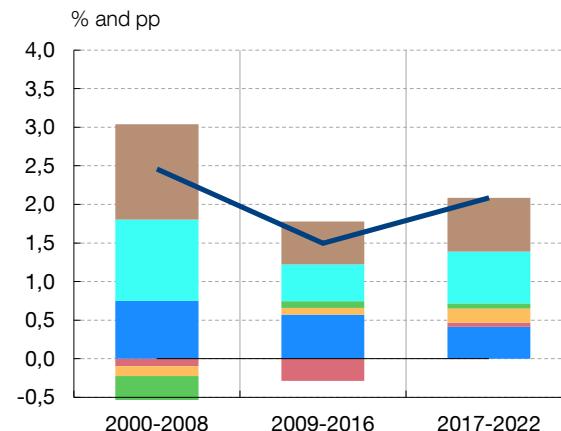
SPAIN



EURO AREA



UNITED STATES



WORKING-AGE POPULATION LABOUR FORCE PARTICIPATION RATE NAIRU HOURS PER EMPLOYEE CAPITAL TFP POTENTIAL GDP

SOURCE: European Commission (autumn 2017).

THE PERSISTENCE OF UNEMPLOYMENT AMONG THE LEAST SKILLED AND HIGH LABOUR MARKET SEGMENTATION HAMPER PRODUCTIVITY GAINS



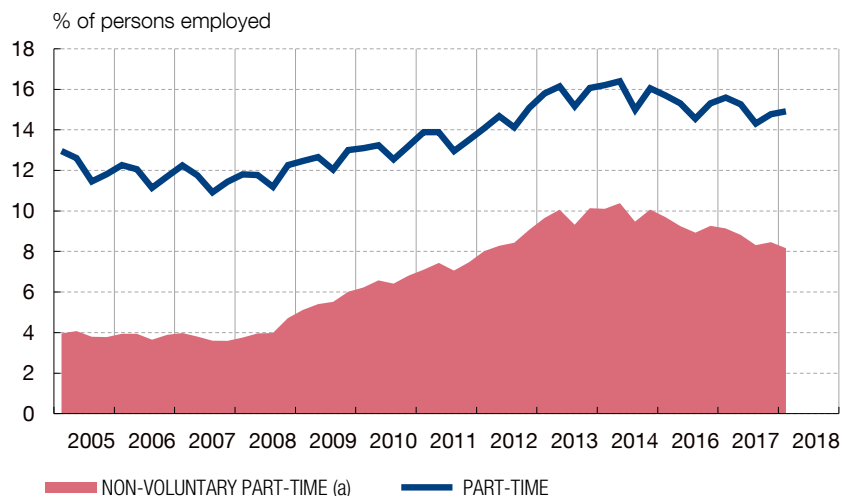
The pattern of higher growth of temporary employment has been maintained.

The part-time ratio (and non-voluntary part-time work) is high.

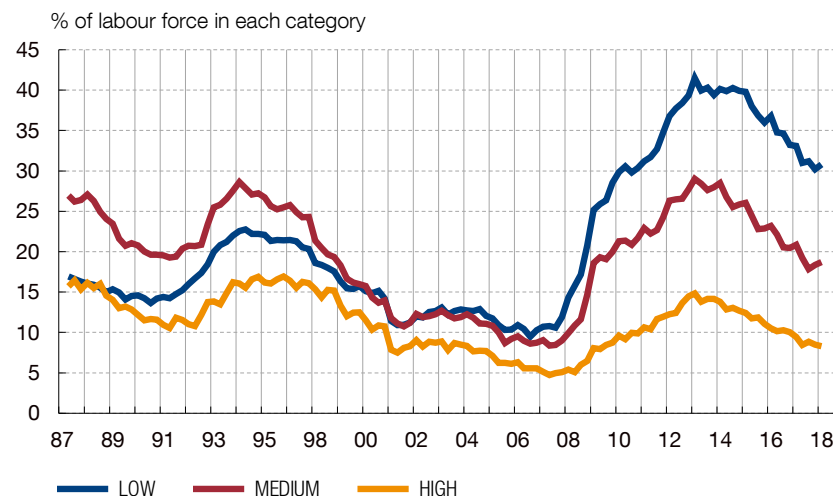
Firms continue to prefer to adjust (temporary) employment rather than wages.

There is a high unemployment rate among workers with a lower level of educational attainment (30%) which affects the young and the elderly.

RATIO OF PART-TIME AND NON-VOLUNTARY PART-TIME WORK



UNEMPLOYMENT RATE BY LEVEL OF STUDIES (b)



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

a. Employed persons who say they are working part-time because they were unable to find full-time work.

b. Low: no or only primary education, or having failed to complete, or to successfully complete, lower secondary education. High: tertiary education.

SCANT CORRECTION OF BUSINESS MARK-UPS IN THE RECOVERY

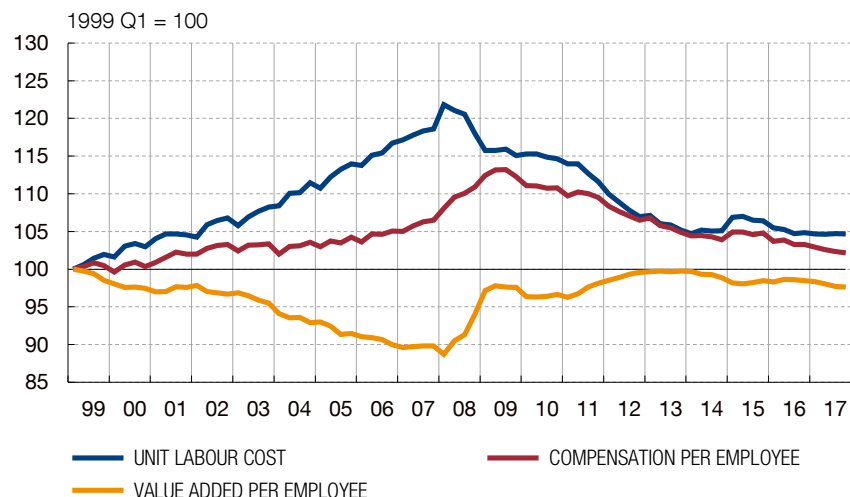


Since the crisis, the relative adjustment of wages has borne the brunt of gains in competitiveness vis-à-vis the euro area.

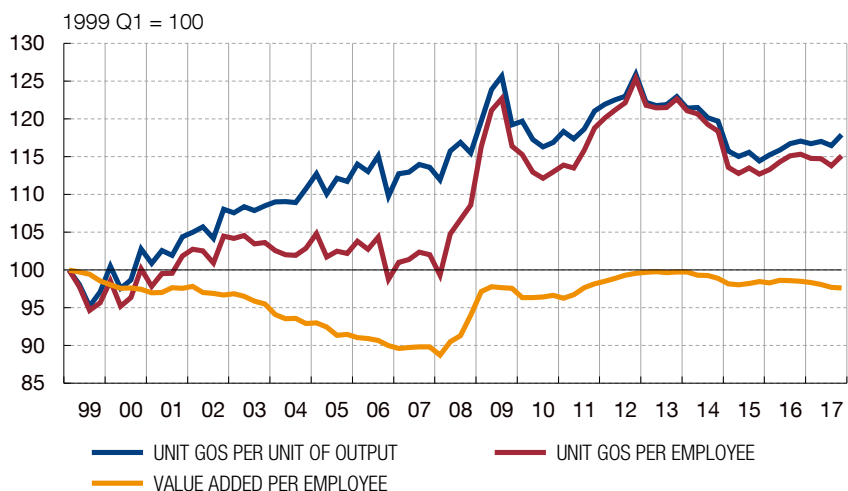
The correction of the unit operating surplus has been much less than that of wages.

The scant correction of mark-ups in the recovery may be due to the lack of competition in specific productive sectors.

MARKET ECONOMY UNIT LABOUR COSTS
SPAIN/EURO AREA
Relative levels



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



SOURCES: Eurostat, INE and Banco de España.



Maintaining sustained growth in the future will require reforms that replace the cyclical boost stemming mainly from demand-side policies.

Addressing the challenge of population ageing

- Policies that foment increases in the participation rate (migratory policies; work-family balance; promotion of the birth rate).

Headway in reducing fiscal policy imbalances

- The persistent maintenance of high public debt reduces growth. A public deleveraging process such as that required by the SGP for the case of the Spanish economy will call for a still-significant fiscal consolidation drive that must last over time.
- The fiscal consolidation process should be compatible with an improvement in the quality of public finances.
- Population ageing generates pressures on pensions spending, health care spending and long-term care. The potential reforms should ensure the sustainability of the pensions system.
- The regional government financing arrangements should be revised to enhance their transparency; to adapt resources to spending requirements; and to increase fiscal co-responsibility.



Increasing potential growth requires productivity gains

- Application of policies promoting the training of the least-skilled unemployed.
- Elimination of frictions in the labour market that allow an excessive turnover of contracts and that restrict firm-level representativeness in wage bargaining.
- Correction of regulatory barriers that restrict the efficient allocation of resources and business competition.
- Increased investment in human and technological capital.

Addressing challenges to the financial system

- Credit institutions should adapt to the new regulatory environment and to technological advances in order to continue pursuing their role as intermediaries in financial flows.



Need to continue with reforms in the euro area

- On the financial front, the priority is to complete the Banking Union:
 - *Creation of a common financial backstop for the Single Resolution Fund*
 - *Revision of the sufficiency of liquidity provision mechanisms in resolution*
 - *Creation of a European Deposit Guarantee Scheme*
 - *Boost to the Capital Market Union*
- In the fiscal policy arena, the difficulties associated with the current decentralised decision-making framework underscore the advisability of designing supranational instruments that allow adverse shocks to be tackled. Further, the current budgetary governance framework should encourage countries to generate room for manoeuvre during expansionary phases.
- Lastly, in the political area, reforms should seek to entrench more effective and transparent governance.