1

THE SPANISH ECONOMY AND THE MORE UNCERTAIN GLOBAL ENVIRONMENT

Recent developments, outlook and challenges

1 Introduction

The expansion of the Spanish economy continued for the fifth year running in 2018. GDP growth (2.6%) was 0.2 pp higher than expected at the start of the year, and slowed by 0.4 pp on 2017. As has been the case since the start of the recovery, the expansion in activity was job creation-intensive. That enabled the unemployment rate to fall to 14.4% of the labour force.

From the standpoint of the composition of growth, there was a notable decline in the contribution of the external sector. Net demand from the rest of the world, which subtracted 0.3 pp from GDP growth, was the source of the easing in the pace of expansion of activity. Exports lost notable momentum, dragged down mainly by negative developments in destination markets, which slowed significantly compared with 2017.

The unfavourable behaviour of external markets was the result of many compounding factors. Various factors dented the world economy, including most notably: the tightening of global financial conditions as a consequence of US monetary policy normalisation (which was, nevertheless, interrupted in early 2019); international trade tensions; the difficulties Chinese economic policy faces in reconciling the dual objective of redressing the country's high debt and sustaining the pace of activity; and uncertainty over the outcome of Brexit.

The euro area, in particular, slowed significantly from the start of 2018. Compared to forecasts which, at the start of the year, pointed to the continuation of the high growth rate of 2017, there were successive negative surprises. These were due both to transitory causes and to more persistent factors, such as the downturn in the external context of the euro area, to which this economy is particularly sensitive. This unfavourable economic setting was conducive to the adoption, in March 2019, of various monetary policy measures by the ECB to ensure that inflation should move steadily towards its price stability objective.

Countering the unfavourable behaviour of the external sector, domestic demand in Spain remained very buoyant. Compared with the slowdown in the euro area economy, activity proved more dynamic in Spain. Against the background of similar export weakness in both cases, the different behaviour had to do with more expansionary developments in spending by households, firms and the general govenment sector in Spain. Private consumption in particular was notably robust, more so than household income, which gave rise to a fresh decline in the saving rate to the lowest level in its time series. Along with the high growth posted by consumer credit, this development suggests that some households might be basing their spending plans on overly optimistic expectations about their future income. A more expansionary fiscal policy stance than expected before the start of the year also contributed to spurring the growth of domestic demand.

From a broader time perspective, the high growth of activity and employment is marking the recovery. The expansion in Spain, one of the sharpest among the developed countries, is due to a series of factors. These include the effects of the adjustments and reforms implemented in the first half of this decade, the contribution of demand-side policies (fiscal and monetary policy) and, especially in the initial stages of the upturn, tailwinds in the form of certain favourable, temporary shocks. In particular, enhanced competitiveness and the internationalisation of firms have boosted exports, which in turn has fuelled the strength of investment, of employment and, through this latter variable, of consumption too.

Looking ahead, the Spanish economy has certain factors of support which can continue to underpin the current upturn. The progress in correcting the macrofinancial imbalances since the crisis has been substantial. First, the economy's competitive position, in terms of its relative costs vis-à-vis the countries with which it trades, is favourable. And further, household and corporate deleveraging is at a very advanced stage, and financial institutions' balance sheets have been strengthened following the sector's restructuring and recapitalisation. Both processes have been assisted by the economic recovery.

However, the economy's vulnerabilities, including most notably high public debt, remain notable. In recent years the budget deficit has declined owing to the effect of the business cycle and the reduction in interest expenses on debt, but not to the adoption of structural deficit-cutting measures. Accordingly, given the high levels of public debt and the structural deficit, budgetary consolidation must urgently be undertaken to afford fiscal policy greater room for manoeuvre ahead of any future shocks.

Despite the notable correction to date, the negative net international investment position remains very high. The downturn in exports and dearer crude oil made in 2018 for a reduction in the external surplus. However, set against these predominantly conjunctural factors, the adjustment of the current account balance has a significant structural component. This is associated with the cumulative gains in competitiveness and with the increased geographical diversification of exports and the number of firms regularly selling their products to the rest of the world. In 2018, unit labour costs once again grew less than they did in the euro area, which provided for a small additional gain in competitiveness vis-à-vis the rest of the euro area. To continue reducing debt to the rest of the world, sustained external surpluses must be run. That in turn calls for gains in competitiveness to be maintained. Such gains have been based throughout the recovery on the moderation of labour and financial costs, but should depend to a greater extent, hereafter, on productivity gains.

One of the main current challenges in most of the advanced economies, including Spain, is to ensure that society as a whole benefits from the recovery. Ongoing employment generation has seen per capita income increase by 14% since the onset of the recovery, up to somewhat above its pre-crisis level. Yet the widening gap in terms of per capita income vis-à-vis the euro area as a whole – which stood at 16 pp in 2007 and increased to 26 pp in 2014, diminishing only to 24 pp in 2018 – has scarcely been corrected. Moreover, the crisis saw a rise in the main inequality indicators. In this respect, while job creation has had a positive and significant impact as regards reducing some income dispersion measures, these indicators are still at a higher level than in other EU economies.[1]

One of the main avenues for further improving standards of living and fairness is achieving additional increases in employment. The development of policies that help reduce the economy's vulnerability and, therefore, prolong the expansion is the most obvious means of preventing ongoing job creation from being interrupted. To this same end, it would be advisable to retain those elements of the current labour market legal framework that have proven most effective in ensuring that the adjustments in the face of adverse shocks are concentrated to a greater extent in labour costs, and that they therefore have less of a negative influence on employment. In addition, economic policy should be geared to fomenting the employability of the most disadvantaged and to promoting enhanced job quality. It is further necessary to reduce as far as possible the high disparity regarding the contractual protection of employees with permanent contracts as opposed to those on temporary contracts, without introducing elements that act as a deterrent to permanent hires.

Durable increases in citizens' general welfare require raising the productivity growth rate. The higher the increase in productivity, the greater the possibilities of raising wage levels and the quality of jobs created, and the greater also the resources available for funding public policies. In the recovery to date, the increase in per capita income has been the outcome of the rise in numbers employed, while the contribution of apparent labour productivity gains has been very small. That is in response to a wealth of institutional, regulatory and structural factors that public policy should seek to correct. These factors include shortcomings in the education system, scant generation and dissemination of technological advances, regulatory elements that stifle competition and the improvable quality of business management.[2]

1 See European Commission (2018).

2 Banco de España (2016b) addressed these last two aspects in detail.

Fiscal policy can contribute to improving long-term welfare, via budgetary consolidation, and the quality of public finances. In this area, re-defining the tax basket and re-directing spending towards items such as education, R+D and active labour market policies would help extend the benefits of the recovery and promote long-term growth.

One of the key dimensions of fairness is its intergenerational facet. Population ageing will have deep-seated consequences for public finances, in particular for the pensions system. Far-reaching measures will have to be adopted. In any event, the much-needed reform of the public pensions system should ensure that the funding of pensions for one generation is not at the expense of imposing an excessive burden on other generations.

The strengthening of the financial position of the banking system continued in 2018, with a significant improvement in asset portfolio quality. Underpinning this progress was the positive impact of the cyclical upturn on borrowers' ability to pay and on asset valuation. That contributed, in turn, to stepping up the ongoing reduction of impaired assets on bank balance sheets. The upshot was an improvement in the sector's profitability.

However, the scale of the challenges still facing credit institutions remains considerable. The banking sector should pursue its efforts to reduce its volumes of problem assets and streamline its operating expenses. In that way, the profitability of banking activity may continue gaining ground against the costs of capital, whose levels, moreover, should be strengthened, with a view to shoring up banks ahead of hypothetical adverse shocks. In addition, banks should adapt to the new sectoral structure being forged, in which new competitors are participating. They should also strive to improve their reputation, which was impaired in some respects following the crisis.

2 The global economic slowdown

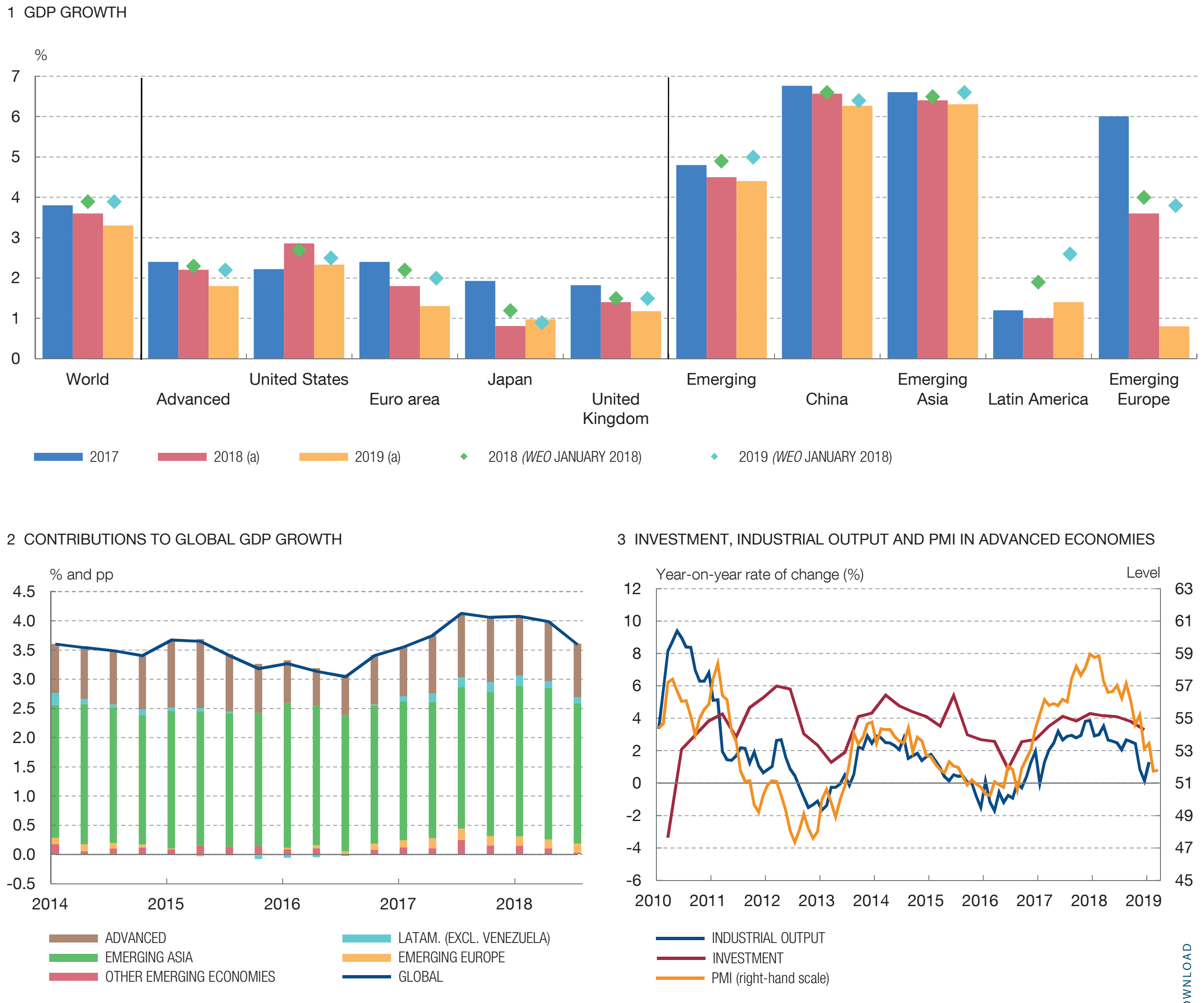
2.1 A weaker and heterogeneous external environment, with notable downside risks

The world economy slowed in 2018, against a background of growing trade tensions and tightening financial conditions. Global GDP grew by 3.6%. The rate was somewhat lower than expected at the start of the year and 0.2 pp down on 2017, with a slowing profile that steepened in the closing months of the year. Compared with the previous year, the divergences in the trend of output were more marked by geographical area (see Chart 1.1). Among the advanced economies, activity remained

Chart 1.1

THE WORLD ECONOMY SLOWED IN 2018 WITH DIFFERENCES BY AREA

The world economy grew 3.6% in 2018 (less than expected) in a setting of significant trade tensions and tighter financial conditions. Furthermore, unlike the previous year, activity was more uneven: it was more buoyant in the United States than in other advanced economies and slowed considerably in the emerging economies which were affected most by the financial tensions, in contrast to the gradual easing in China.



SOURCES: IMF (*WEO* April 2019, *WEO* January 2018), national statistics.

a Forecast from *WEO*, IMF, April 2019.

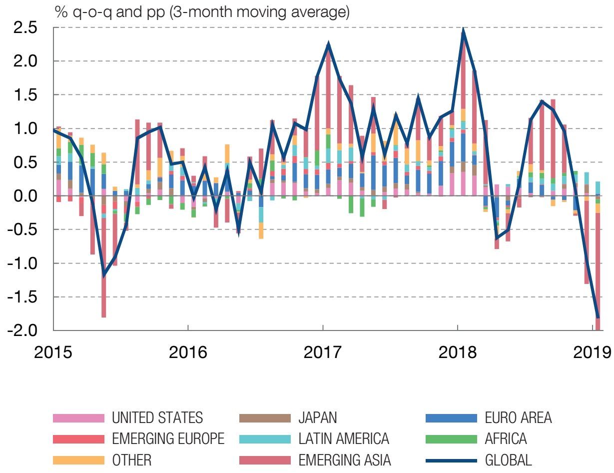
DOWNLOAD

robust in the United States, underpinned by the fiscal expansion and the soundness of private demand. In other areas, meanwhile, GDP growth was increasingly weak. This was partly the result of idiosyncratic factors. In Europe, these were linked to the new automobile emission standards (affecting Germany above all) and to the uncertainty over economic policy in Italy and the Brexit negotiations. In Japan, some unfavourable natural events were responsible. Among the emerging economies there were notable region-by-region differences. Growth rates remained buoyant in Asia, albeit with signs of deceleration, especially in China. In Latin America and in

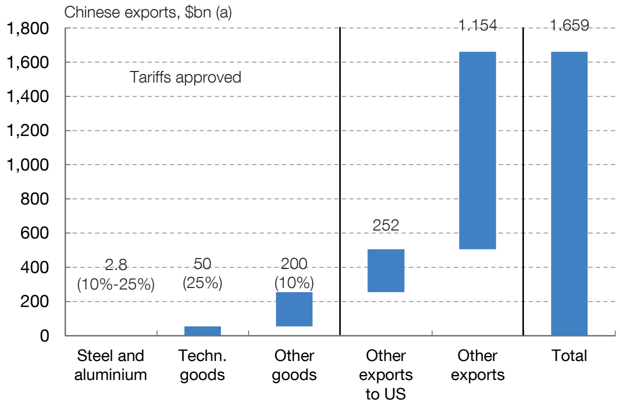
Chart 1.2
TRADE TENSIONS WEIGHED ON WORLD TRADE

World trade eased in 2018 and grew by around 4%, compared with 5.3% in 2017, weighed down by the effect of the trade tensions, especially between the United States and China. During the year several tariff measures were adopted by the US which were met with reprisals from the countries affected. At the expense of possibly resolving the conflicts through negotiations currently under way, the proliferation of protectionist measures is one of the biggest threats for the global economy.

1 GLOBAL TRADE GROWTH. CONTRIBUTION BY AREA



2 TARIFF MEASURES INTRODUCED BY THE US ON CHINESE EXPORTS



SOURCES: CPB, PIIE, US Census and FMI Dots.

a The percentages in brackets refer to the approved tariff rates.

DOWNLOAD

Eastern Europe, meantime, activity proved less dynamic, and especially in the economies most affected by the bout of financial tensions early in the summer.

International trade in goods and services, which had picked up sharply in 2017, slowed significantly in 2018. Having risen to rates of 5.4% the previous year, global trade increased by 3.8% in 2018. This slowdown was in response to the loss of momentum of activity (investment in particular) and to the growing trade tensions, chiefly between the United States and China. Indeed, the two factors were interrelated (see Chart 1.2).

The trade conflict unfolded in different stages in 2018. Spring saw the entry into force of higher US tariffs on different products (mainly imports from China), with the countries affected duly retaliating. Furthermore, the US government threatened to extend and step up tariff increases (including, in particular, vehicle imports, which are a substantial portion of the bilateral trade with Europe). This threat prompted a transitory pick-up in trade in the central months of the year, in anticipation of a possible future rise in the prices of products.

In the second half of the year, there were some positive trade developments. These included most notably the signing by the United States, Mexico and Canada of the agreement replacing NAFTA (parliamentary ratification is still pending), the opening of negotiations for a pact between the United States and the EU, and a temporary truce between the United States and China to resolve their differences. However, the main points of conflict have still not been resolved. In these circumstances, and after having risen in the summer, international trade ended 2018 running at negative rates (see Chart 1.2). For the moment, the direct repercussions on global activity of the tariff measures so far adopted are estimated to have been relatively limited; but additional effects will have begun to be seen through their adverse impact on confidence.

In the near future, any proliferation of protectionist measures that were to affect confidence and financial conditions might ultimately have a severe impact on global GDP. According to IMF simulations, the impact on activity of the tariff measures in force would be limited. But the stepping-up of such measures would significantly heighten the adverse effect on activity. If this were compounded by a potential loss of confidence (affecting business investment), and a tightening of financial conditions, the costs for the global economy in the horizon to 2020 would be much heavier, at around 0.8% of global GDP relative to the baseline scenario.[3]

In the United States, the continuation of the cyclical upturn in 2018 was underpinned by the fiscal expansion. GDP grew by 2.9%, 0.7 pp up on the previous year, but with a less balanced composition. The tax reform approved in 2017 and strong job creation provided support for private consumption, while investment and exports slowed forcefully in the second half of the year. The fiscal stimulus is expected to still have a positive impact on growth in 2019. But as this impulse fades, it is estimated activity will slow to a growth rate closer to 2%.[4]

In China, GDP eased slightly in 2018 as a whole, although the high-frequency indicators slowed more markedly as the year unfolded. The Chinese economy posted annual average growth of 6.6%, 0.2 pp down on 2017. This cooling was due to trade tensions and to the measures adopted earlier by the authorities to mitigate the risks stemming from high business debt. These measures included a tightening of the financial regulations on shadow banking and restrictions on local government investment. However, in response to the signs of slowing, the authorities adopted a raft of measures aimed at preventing more pronounced weakening.[5] On the monetary front, the central bank reduced reserve requirements, injected liquidity into the banking system and introduced loan facilities to boost credit to the private sector. In the fiscal area, local government debt issuance increased for infrastructure investment, and tax cuts for households and firms were approved.

3 See IMF (2018) and Banco de España (2018b).

4 See Banco de España (2108l).

5 See Banco de España (2018n).

In these circumstances, China faces a dilemma. Its authorities must choose between: i) stabilising economic activity in the short term, at the cost of exacerbating macrofinancial imbalances and increasing the risk of an abrupt correction later; or ii) maintaining the adjustments, allowing, in exchange, the slowdown to intensify. Given the importance of China for the world economy, a sharp slowdown would have major global consequences, through various channels (trade, financial and commodities prices), as analysed in Box 1.1.[6]

The other emerging economies were also impacted by the trade disputes and the tightening of global financial conditions. After a very favourable performance in 2017 and in 2018 Q1, the emerging economies began to undergo the effects of the tightening of international financial conditions and of the China/US trade dispute. Nonetheless, the economic and financial impact of these factors differed from country to country, depending on their specific circumstances, and, in particular, on their integration into global trade, and, especially, their macrofinancial vulnerabilities.[7] The adverse reaction of the markets particularly affected those economies with bigger external imbalances and foreign-currency-denominated borrowing requirements, such as Argentina and Turkey, whose authorities had to adopt adjustment measures to stabilise their economies (see Chart 1.3).

In Argentina, the adjustment measures took the specific form of an agreement with the IMF signed in June 2018. In order to redress the major imbalances built up in the previous decade, the government that came into power in late 2015 initially opted to pursue a gradual fiscal consolidation, with the central bank concurrently assuming ambitious inflation-reducing targets. However, after the raising of the inflation target in December 2017, unexpectedly announced by the central bank, the lack of progress on this front in 2018, the tightening of international financial conditions and a heavy drought placed Argentina under the market spotlight. That prevented it from continuing to finance its gradual correction process and meant the government had to request financial assistance from the IMF for an amount that would rise to $50 billion.[8] The agreement with the Fund included the application of a sharp fiscal and monetary adjustment, which was necessary to return the economy to a stable growth path. Set against this, the adjustment measures have, in the short term, had an adverse impact on activity which, along with bad weather, has led to a recession.

In Turkey, the need for corrective measures was the outcome of the overheating of the economy and of heavy dependence on external financing. This situation had arisen from the application over several years of lax fiscal and monetary policies, and the adoption of credit stimulus measures. Moreover, the dependence on external financing

---

6 See Banco de España (2016g) and Dieppe, Gilhooly, Han, Korhonen and Lodge (2018).

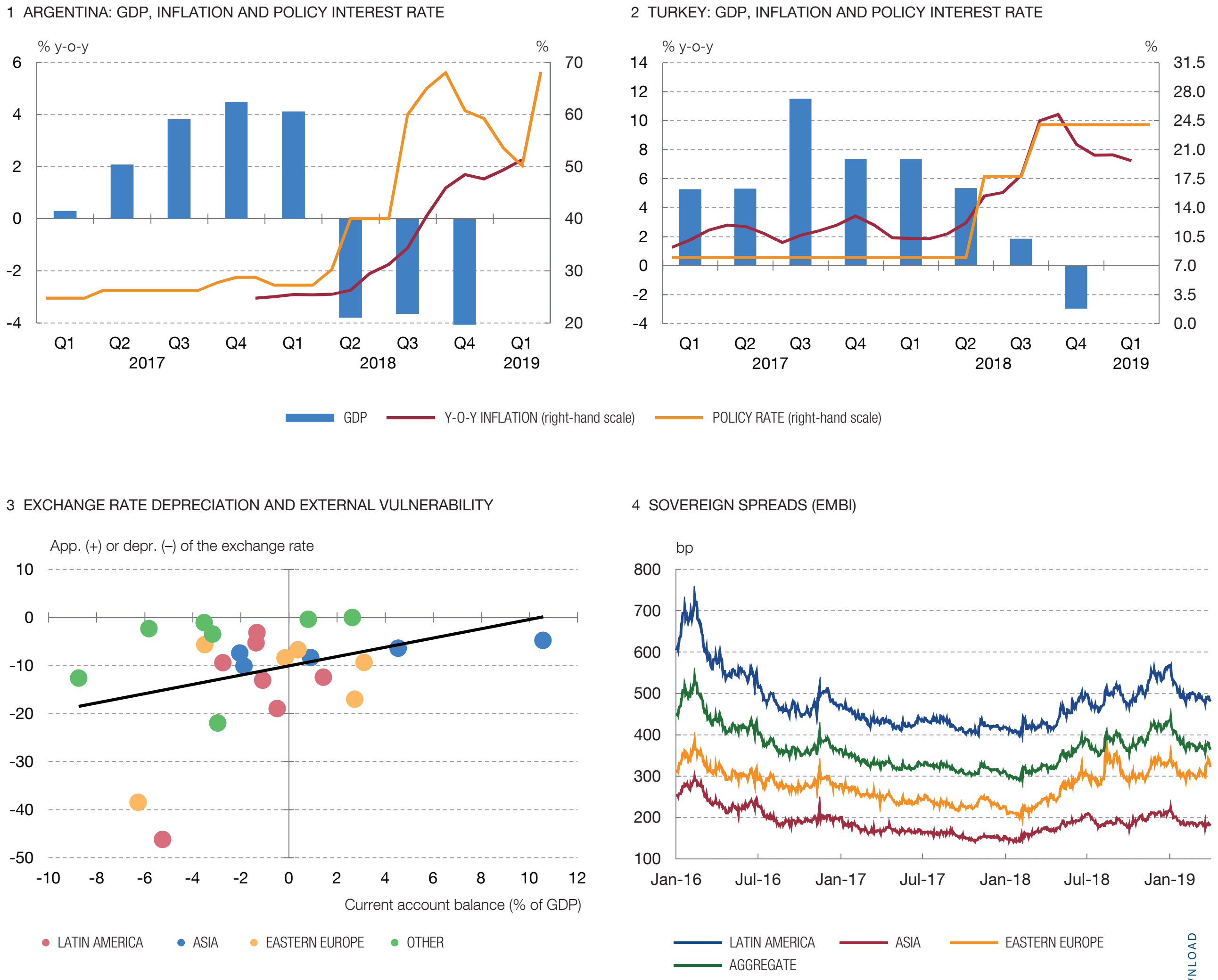
7 See Banco de España (2018m) and (2018g).

8 See Serra, Timini, Estefanía and Martínez Casillas (2018).

Chart 1.3

EMERGING ECONOMIES WERE HIT BY CONSIDERABLE FINANCIAL TENSIONS, ALBEIT DIFFERENTLY ACCORDING TO THEIR VULNERABILITIES

During the year emerging economies were subject to global trade tensions and a tightening of financial conditions, although the markets particularly penalised those emerging economies with greater external vulnerabilities, such as Turkey or Argentina, whose authorities had to adjust their macroeconomic policies sharply.



DOWNLOAD

SOURCE: Thomson Reuters.

(with high foreign-currency-denominated private debt) and the low level of international reserves, along with growing government interventionism, led to a notable worsening of Turkish financial markets and to a strong depreciation of the lira. That obliged the authorities, as from the summer, to adopt restrictive monetary and fiscal policies in an attempt to stabilise the situation, giving rise to an acute slowdown in activity.[9]

9 See Banco de España (2018k).

In 2018, global inflation held at a moderate level, without the gradual increase in wage growth in the main advanced economies managing to pass through to core inflation. In the advanced economies, inflation moved on a mild rising path until October, reflecting the significant hike in oil prices, which was interrupted towards the end of the year. The sound behaviour of employment, which saw unemployment rates fall to historical lows in some cases, contributed to sharper wage rises. However, the acceleration in productivity (in the United States) and the easing in business mark-ups (in Japan) checked the pass-through of higher wage increases to prices. Indeed, inflation expectations have eased once again in the opening months of 2019, ahead of the downturn in economic prospects. In the emerging economies, inflation rates generally remain moderate, with the exception of those countries whose currencies depreciated, such as Argentina and Turkey.

The rise in oil prices to October was essentially the outcome of various supply-side factors. Specifically, the agreements of the Organization of the Petroleum Exporting Countries (OPEC) to cut their production, the decline in extraction activity in Venezuela and the impact of the sanctions on Iran led to a reduction in the supply of crude oil. However, in the final stretch of the year, the prospect of lower global demand and some easing in supply conditions reversed the initial rises and led to a notable fall in prices. Into 2019, OPEC has finalised a new deal with other producer members to restrict production. Among other supply-side factors, this has prompted a fresh rise in prices.

The Federal Reserve maintained its monetary policy normalisation plans in 2018. In 2019, however, this normalisation has been interrupted. Given that the United States is ahead in the cycle, its central bank raised its policy interest rate by 25 pp on four occasions in 2018, placing it in a range of 2.25%-2.50%. Further, it continued with the gradual reduction of its balance sheet, as scheduled. These decisions contributed to a tightening of financial conditions, with increases in long-term rates and the appreciation of the dollar. Yet fears of an economic slowdown gave rise in the final months of last year to a change in market expectations about future monetary policy movements. This was confirmed by the Federal Reserve with a shift in its communication policy towards a more neutral stance; it announced that it expects interest rates to hold in 2019, and that the balance-sheet reduction will conclude in September this year (see Chart 1.4).

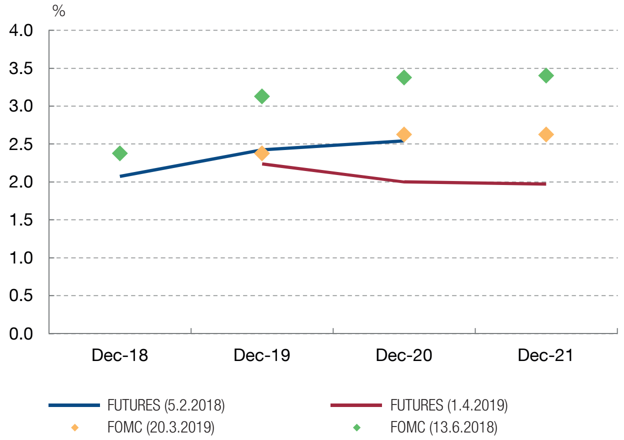
The monetary policies of other central banks generally retained an expansionary stance. As set out below, the ECB finalised its net asset purchases in December. But it signalled that monetary policy would remain broadly accommodative and that the reinvestment of the principal on maturing securities will continue beyond the first rise in policy interest rates. The decisions of the Bank of England, against a backdrop of high uncertainty over Brexit, and of the Bank of Japan, having made scarcely any headway in attaining its inflation target, maintained a highly accommodative stance. In the emerging economies, many central banks responded up to the summer with

Chart 1.4

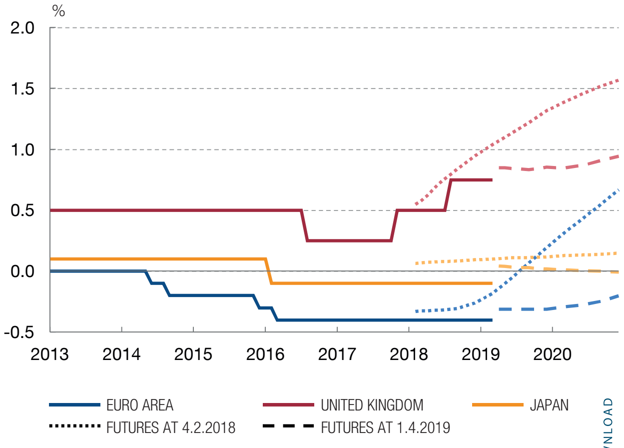
MONETARY POLICIES WILL BE LESS RESTRICTIVE THAN PREVIOUSLY FORECAST

Faced with the signs of a global economic slowdown and tensions in financial markets, monetary policies in the advanced economies are expected to be less restrictive than previously forecast. After raising policy interest rates on four occasions in 2018, the Fed adopted a more neutral stance in its communication policy and markets discounted fewer rate hikes. The monetary policy stance in the other economies is also expected to remain expansionary for longer.

1 UNITED STATES: POLICY INTEREST RATES. FOMC BASELINE PROJECTIONS AND FUTURES (a)



2 OTHER ADVANCED ECONOMIES: POLICY INTEREST RATES AND FUTURES



DOWNLOAD

SOURCES: Thomson Reuters and Bloomberg.

a The core trend of the Federal Open Market Committee (FOMC) excludes the three highest and the three lowest projections.

rises in policy rates. This was in light of the risks to inflation and financial stability arising from the depreciation of their currencies, although these rises have also halted in recent months.

The financial markets experienced a bout of high volatility, centred on the emerging economies, towards the end of the first half of the year (see Chart 1.5). At that time, the combination of the strong dollar, the increase in US long-term interest rates and the growing trade tensions bore down negatively on the emerging markets. Until then they had trended positively, but notable stock market declines and an across-the-board depreciation of their currencies ensued. As indicated, investors clearly discriminated on the basis of the vulnerabilities of each country.

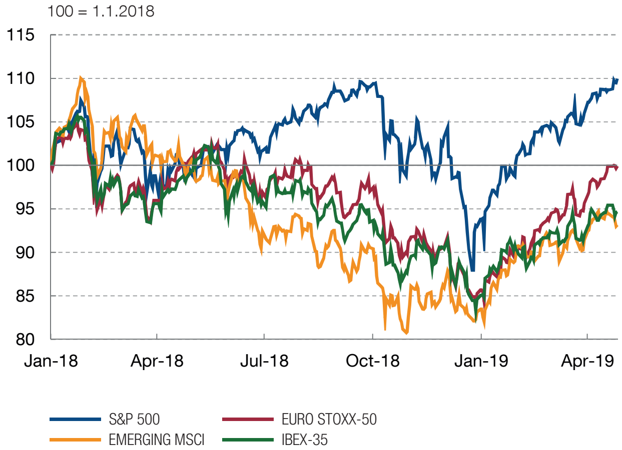
Over the year as a whole the main stock market indices in the advanced and emerging economies posted losses, after recording all-time highs in some cases. The biggest slump was on the Chinese stock market (-24.6%), while the EURO STOXX 50, the benchmark European index, underwent its biggest annual fall since 2012 (-14.3%). The US S&P 500, which posted a historical high in September, was down -6.2% at end-2018, reflecting the downturn in the macroeconomic outlook in the final stretch of the year. Evidencing the different cyclical moments of the United States and the euro area was the diverging trend of sovereign debt yields. These rose over the course of the year by 27 bp in the US economy, but declined by 18 pp in Germany.

Chart 1.5

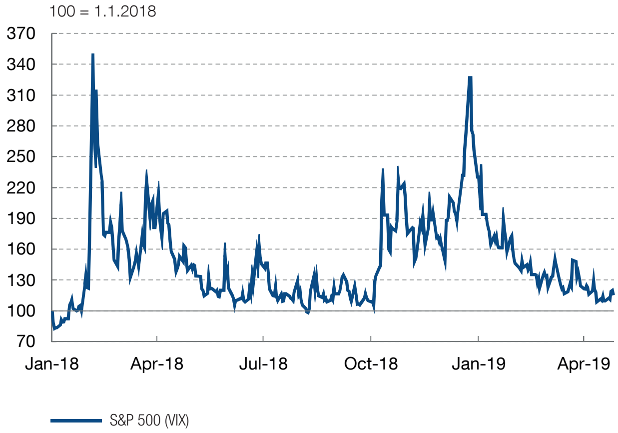
GLOBAL FINANCIAL MARKETS

The financial markets experienced several bouts of volatility, which particularly impacted the main stock market indices, against a backdrop of monetary policy tightening in the United States and increasing trade tensions, among other factors. In summer, the instability centred on emerging markets, although the markets discriminated on the basis of the vulnerabilities of each country.

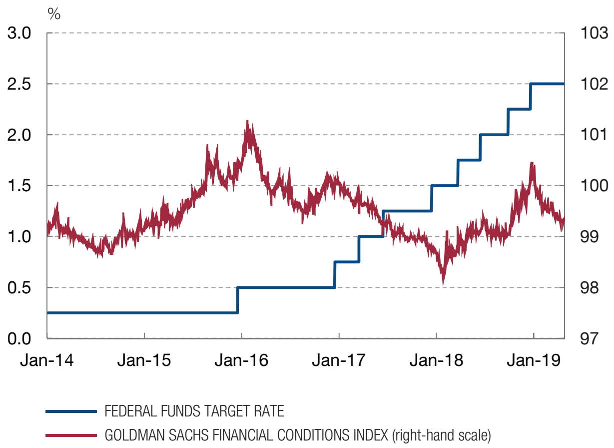
1 STOCK MARKET INDICES



2 IMPLIED VOLATILITY



3 FINANCIAL CONDITIONS IN THE UNITED STATES



4 EXCHANGE RATES AGAINST THE DOLLAR

DOWNLOAD

SOURCES: Thomson Reuters Datastream and Bloomberg Data License.

a Argentina, Tunisia, Nigeria, Brazil and Turkey.

While financial markets have picked up in early 2019, risks of further valuation adjustments persist. At the start of the year, several factors contributed to reversing the downturn on global financial markets in late 2018: the expectations of a less restrictive US monetary policy; the prospect of a potentially favourable outcome to the trade disputes; and the policies deployed by the Chinese authorities to counter the weakness of economic activity. However, the markets remain vulnerable to global financial conditions and the macroeconomic environment, and to the ups and downs linked to factors such as trade tensions, the fiscal situation in Italy and the Brexit negotiations.[10]

Moreover, some emerging economies remain vulnerable. Admittedly, financial conditions in the emerging countries as a whole have stabilised in recent months. But the build-up in some of them of high foreign-currency-denominated debt by the non-financial private sector makes them particularly fragile to any increase in financing costs and to a depreciation of their currencies. Finally, the ultra-expansionary monetary policies in recent years have been conducive to the search by investors for returns on riskier assets, such as high-yield debt, leveraged loans and CLOs (collateralised loan obligations). The growing exposure to these market segments, which occasionally pose a significant liquidity risk, is a cause of concern in the current context. As explained, in this setting investors' degree of risk aversion is liable to fluctuate markedly.

In sum, the outlook for the world economy in 2019 is one of a moderate slowdown, but with significant downside risks. The recent weakness of the global economy points to a baseline scenario with lower growth, on which risks tilted clearly to the downside are weighing down. In the advanced economies, the responsiveness of the authorities to act in a hypothetical scenario in which these risks materialise is – although there are cross-regional differences – relatively low. This is due to monetary policy limitations in a very low interest rate setting and to the constraints that high levels of public debt impose on budgetary policy in a large number of countries. In the emerging economies, the room for manoeuvre varies notably from country to country in terms of their vulnerabilities. Where these are greater, an adverse scenario may require a tightening of their macroeconomic policies, with adverse consequences for growth.

2.2 The euro area has felt the impact of global shocks particularly acutely.

The euro area has particularly felt the increase in global uncertainty over the past year and the slowdown in worldwide demand. Following high growth in 2017, the expansion of economic activity progressively eased during 2018. This trend has continued into the opening months of the current year. On average last year, GDP grew by 1.8%, 0.7 pp down on 2017. Year-on-year growth in late 2018 and early 2019 fell to around 1% (see Chart 1.6).

The geographical and sectoral specialisation of euro area exports and the lagged effects of the appreciation of the euro in 2017 and 2018 made for a

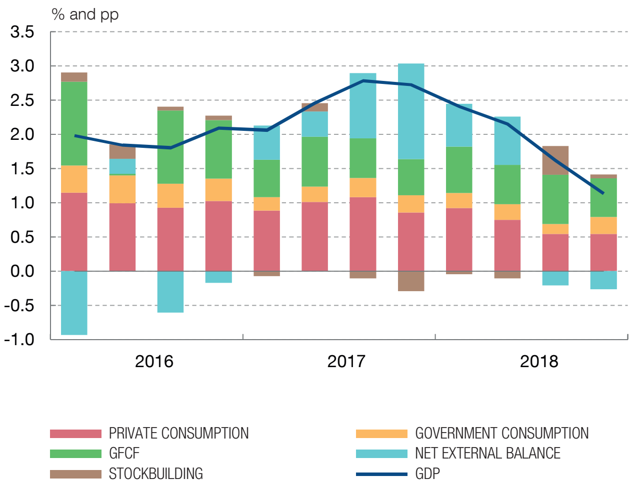
10 For a discussion on the consequences of a no-deal Brexit, see, for example, Bank of England (2018) and Vega, J. L. (2019).

Chart 1.6

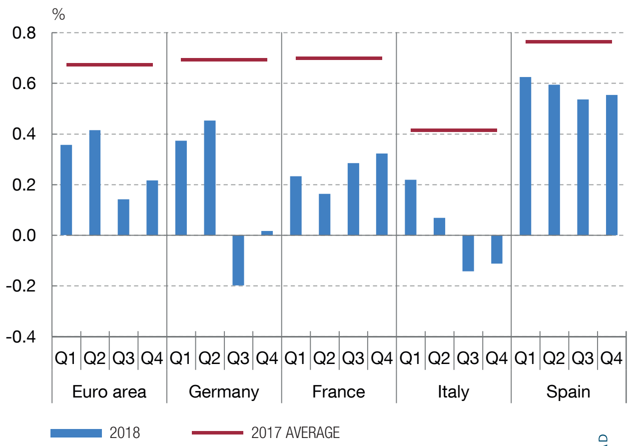
SIGNIFICANT MODERATION OF ECONOMIC GROWTH IN THE EURO AREA IN 2018

Economic activity in the euro area slowed during 2018 and in 2019 to date, with very low quarter-on-quarter growth rates at year-end. The gradual weakening was linked, essentially, to limited growth in euro area exports. By country, the economic slowdown is very marked in Italy (which technically went into recession in late 2018) and in Germany, which has been hard hit by developments in specific sectors such as the automotive sector.

1 EURO AREA. CONTRIBUTIONS TO YEAR-ON-YEAR GDP GROWTH



2 EURO AREA AND SELECTED COUNTRIES. QUARTER-ON-QUARTER CHANGE IN GDP



DOWNLOAD

SOURCE: European Commission.

notable slowdown in euro area sales to the rest of the world. Some transitory factors aside, the progressive weakening of activity was thus rooted in the small increase in exports, given, in particular, the high degree of openness of the euro area economies (see Chart 1.7). The loss of momentum in the area's export markets was sharper than that in global trade, owing to the euro area's relative specialisation in countries and products whose performance trended more adversely. Along with the decline in sales to Turkey, there was a notable slowdown in investment goods exports to Asian markets (in particular to China), and a contraction in sales to the United Kingdom, markedly so in the case of cars. Conversely, exports to the United States remained more buoyant.[11] In addition, the estimates available suggest that the notable appreciation of the euro in nominal effective terms in 2017 against the developed countries, and in 2018 against the emerging economies, also affected exports last year.

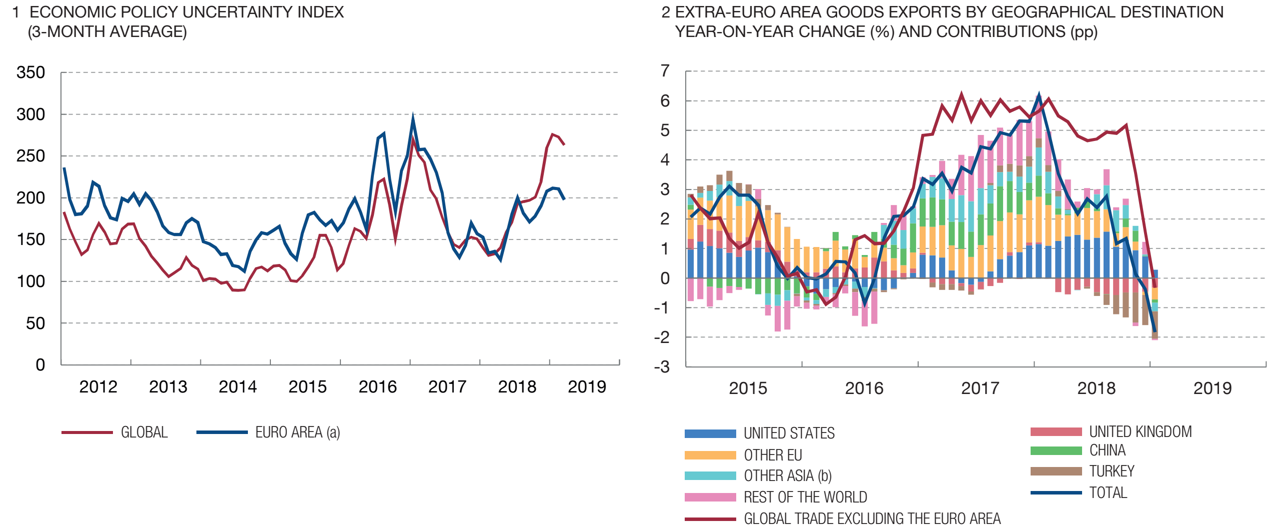
The weakness progressively spread to domestic demand, despite continuing slack monetary conditions. As a result of the ECB's decisions, euro area financial conditions continued to be expansionary. Both short and long-term interest rates

11 See Banco de España (2019b).

Chart 1.7

THE EURO AREA ECONOMY WAS WEIGHED DOWN BY THE MODERATION IN THE GROWTH OF ITS EXPORT MARKETS AND BY THE SETTING OF HEIGHTENED UNCERTAINTY

The slowdown of euro area export markets was sharper than that of world trade as a result of the euro area's relative specialisation in countries and products whose performance trended more adversely in 2018.



SOURCES: Baker, Bloom and Davis (2016), Banco de España, European Commission and CPB Netherlands Bureau for Economic Policy Analysis.

a Average weighted by the GDP of the indices of Germany, France, Spain and Italy.
b Excluding Middle East.

DOWNLOAD

held at low levels, without the financial tensions that arose in Italy – further to the heightened political uncertainty – spreading to other economies, except at specific times and on a limited scale.[12] The interest rates on new lending to businesses held at low levels, offering further support to the gradual pick-up in private-sector lending. However, business investment and consumption weakened over the course of the year, affected by the high uncertainty. In the case of investment, business spending plans were ultimately weighed down by the sluggishness of external demand, the doubts over the future UK/EU relationship and the moderation of business profits. Households reduced the pace of private consumption in the second half of the year. And given the increase in real income, that prompted a slight rise in the saving rate, which had reached a low in 2017.

Some transitory factors also contributed to the weakness of activity, which helps explain the differences across countries. The slowdown was particularly marked in Italy, which went into recession in late 2018. Factors bearing down on the country were the uncertainty over the course of its economic policies and the subsequent worsening in financing conditions and agents' confidence. Growth also

12 See Banco de España (2018i).

weakened notably in Germany. It was partly affected by the performance of some key productive sectors. Such was the case of the car industry, whose activity was temporarily disrupted by the entry into force of new emissions regulations, and perhaps more persistently by the structural transformation the sector is undergoing. Lastly, in France, social tensions left their mark on activity in late 2018.

Overall, euro area GDP posted a lower rate of increase at end-2018 than that of potential output. Hence the output gap, which proxies the pressures exerted by demand on prices, and which is estimated to have turned positive at the close of 2017, tended to narrow over the course of 2018 to close to zero. Indeed, it is estimated to have even turned slightly negative in early 2019. The ongoing weakness of activity at the start of the year has led to substantial downward revisions of the growth outlook for the year as a whole.

Employment also mirrored flatter activity. The number of jobs continued to grow in 2018. But they did so at lower rates than those observed in 2017 and moved on a declining trend, in line with the loss of momentum of activity throughout the year. This moderation in employment creation, which was particularly notable in manufacturing and in market services, did not prevent the euro area unemployment rate from continuing to fall. Unemployment ended the year at 7.8%. Despite the loss of dynamism in employment, wage rises were up on previous years. This was particularly so in those countries, such as Germany, whose labour market shows less slack. Thus, compensation per employee in the euro area increased by 2.2% in 2018 Q4, 0.6 pp up on the previous year. As a result, unit labour costs moved on a marked rising trend over the course of the year (see Chart 1.8), with the slowdown in productivity also contributing.

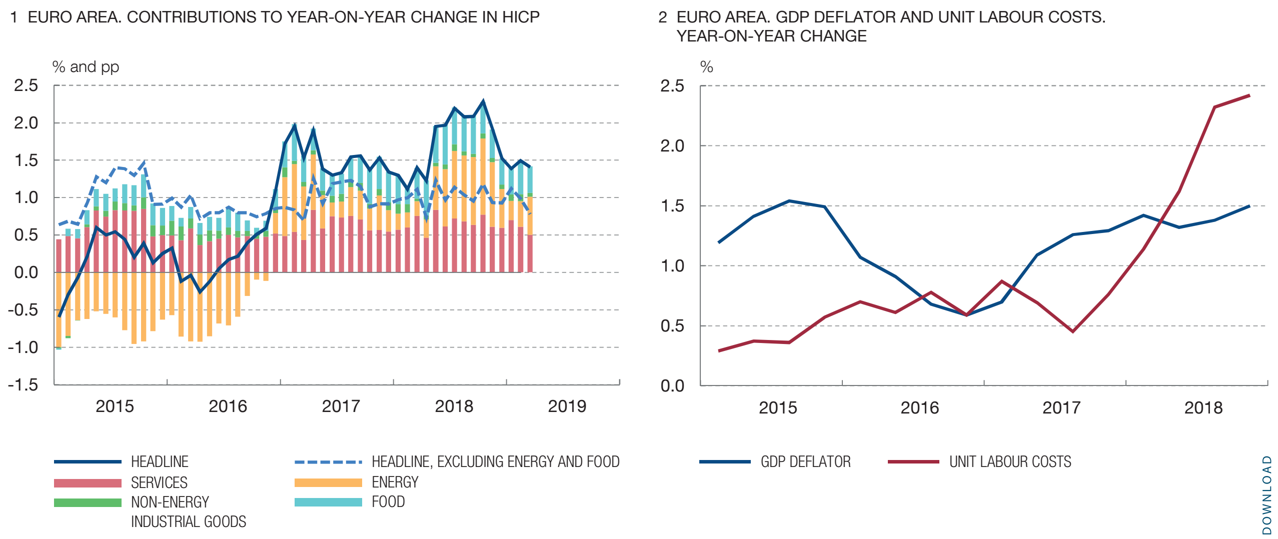
Overall inflation oscillated notably in 2018, shadowing the changes in crude oil prices. For the year as a whole, consumer prices increased by 1.8%. To date in 2019, inflation has turned down, growing by 1.4% in March. This movement was also linked to oil prices.

Core inflation, which excludes food and energy, grew by 1%, a similar rate to that in 2017. The trend both of this indicator and of its two components, services and non-energy industrial goods, held stable for most of the period (see Chart 1.8). Nor did the growth of domestic producer prices undergo any appreciable change in 2018. As a result, the rise in unit labour costs was offset by a narrowing of firms' mark-ups. This pattern, also seen in previous periods, might prove more persistent at the current juncture. The present circumstances are characterised by high uncertainty and some weakening in demand, which would make firms more reluctant to increase their final prices. Moreover, there are other, more permanent factors, and common to other countries and areas, which might be checking inflation. These include most notably heightened global competition, the emergence of new ways of marketing goods and services, and population ageing (see Chapter 2 of this Report

Chart 1.8

STABLE TREND IN CORE INFLATION AGAINST A BACKDROP OF QUICKENING LABOUR COSTS

Changes in oil prices were reflected in the large fluctuations in headline inflation, whereas core inflation held at around 1%. This stability was against a backdrop of quickening labour costs which was offset by a narrowing of profit margins.



DOWNLOAD

SOURCE: European Commission.

for a more detailed analysis). Against this backdrop, long-term inflation expectations have held at moderate levels, while at shorter horizons they slipped slightly towards the end of the year as global uncertainty influenced euro area activity.

The ECB continued to pursue an accommodative monetary policy. The interest rates on the main refinancing operations, the marginal credit facility and the deposit facility have held at their March 2016 low: 0%, 0.25% and -0.40%, respectively (see Chart 1.9). Moreover, the ECB set about gradually reducing its net purchases under its Asset Purchase Programme (APP), further to the decisions adopted in October 2017 and June 2018. Monthly purchases fell to €30 billion between January and September 2018, and to €15 billion between October and December, with net purchases concluding in the latter month.

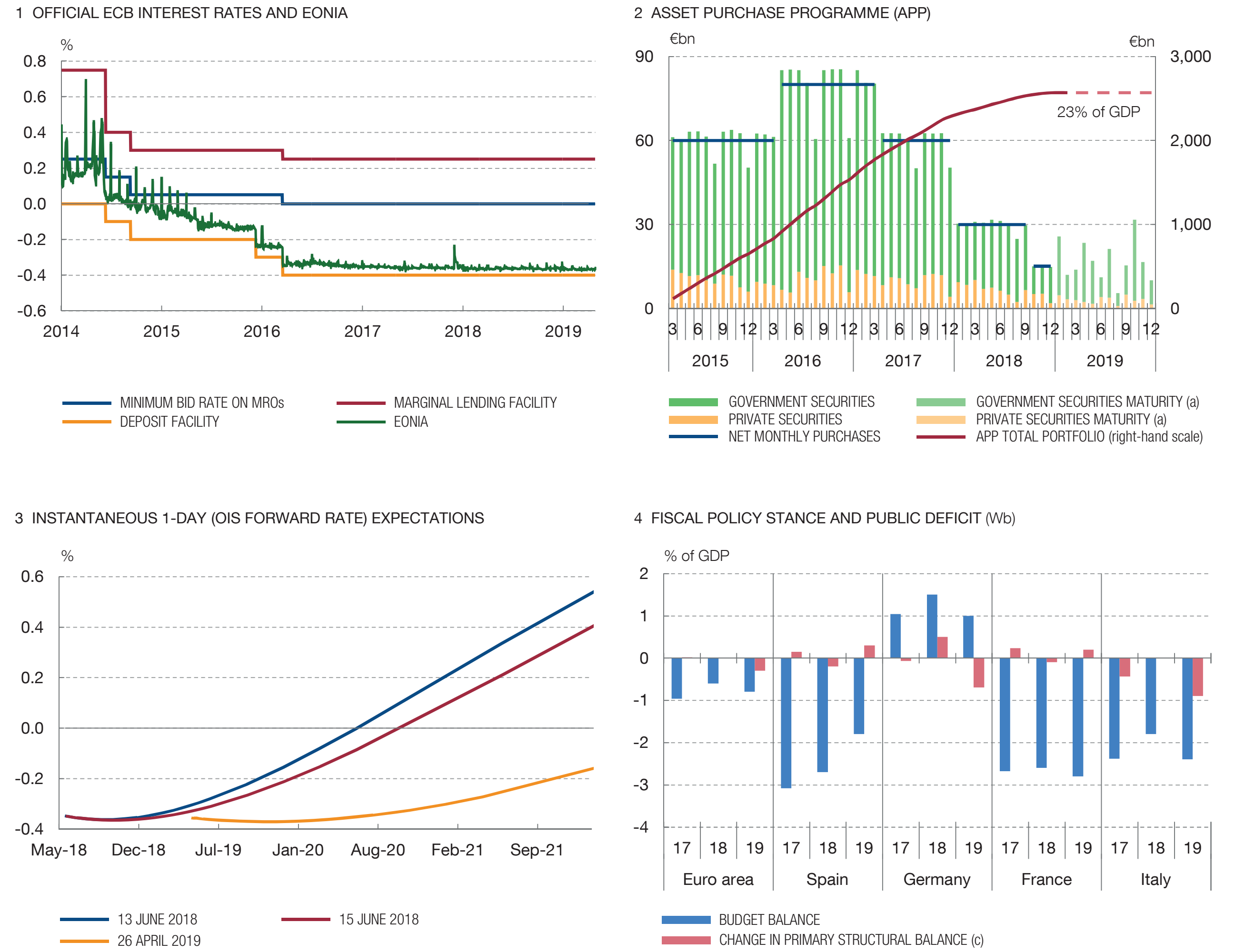
At its meeting in early June 2018, the Governing Council pointed ahead to the end of the APP programme. Since mid-2014, the ECB has been implementing a very expansionary monetary policy. It has been underpinned by several extraordinary measures. Overall, it is estimated these will contribute almost 2 pp to the growth both of GDP and of consumer prices in the euro area between 2016 and 2020.[13] After a period of continuous asset purchases since March 2015, the

13 Véase Banco Central Europeo (2018).

Chart 1.9

MONETARY AND FISCAL POLICY UNDERPINNED ECONOMIC GROWTH IN THE EURO AREA

Monetary policy remained highly expansionary, even though net asset purchases ended in December 2018. Prospects of interest rate hikes were put on hold, in keeping with the ECB's indications and in view of the economic slowdown. Fiscal policy maintained its neutral stance; it is expected to be slightly expansionary in 2019.



SOURCES: IFS Datastream, ECB, Banco de España and European Commission.

a Maturities expected after April.
b The 2018 and 2019 figures are those contained in the draft budgetary plans for 2019 presented to the European Commission in October 2018 within the framework of the European Semester.
c Percentages of potential GDP.

DOWNLOAD

size of the APP portfolio is over 20% of the area's GDP. While some of the targeted longer-term refinancing operations (TLTRO) were redeemed in 2018, the portfolio's outstanding balance continued to stand at over €700 billion. Moreover, with the aim of maintaining favourable bank lending conditions, the ECB announced a new series of quarterly TLTRO in March 2019. These operations will be instrumented between September 2019 and March 2021, and will have a maturity of two years.

Despite the end of net asset purchases, monetary policy remains broadly accommodative. The gradual reduction in purchases was carefully communicated so as to help ensure its progressive assimilation by the markets. In parallel, a change was announced in the signalling role of the central bank's different instruments and clear sequencing was introduced into future conduct. That will allow for the continuation of the accommodative stance needed to support the convergence of inflation towards the ECB's objective. As from June 2018, the ECB added in greater details on its expectations about policy interest rates. The ECB Council began referring to "at least through the summer of 2019" as the minimum indicative period in which it would maintain interest rate levels.

However, in March this year, given the weak macroeconomic data and the notable downward revision of growth and inflation prospects, this period was extended until end-2019 at least. In any event, as the Council has reiterated, rates will hold at current levels for as long as is needed to ensure the continuing and sustained convergence of inflation to lower levels, but close to 2% in the medium term. In the wake of this communication, short-term interest rate expectations have adapted to the ECB's indications and to the growing evidence of economic weakness in the euro area. The outcome has been a delay in expectations concerning the date of the first rise in policy rates (see Chart 1.9).[14] In this respect, markets have shown signs of understanding that the ECB's guidance concerning interest rates is conditional upon economic developments in the area and, in particular, upon the prospect of attaining in a sustained fashion inflation rates consistent with the definition of price stability. Consequently, further to the latest inflation figures, which have generally been lower than anticipated, the markets have factored in a cut in long-dated interest rates.

Furthermore, the Council has been progressively more explicit about the reinvestment policy for the assets accumulated on its balance sheet, which has become part of the future sequencing of the monetary authority's conduct. From June 2018, the Governing Council signalled its intention "to continue reinvesting, in full, the principal payments from maturing securities purchased under the APP for an extended period of time past the date when it starts raising the key ECB interest rates, and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation". In 2018 gross purchases amounted to €460 billion, of which approximately €140 billion were reinvested. In 2019, the maturities foreseen exceed €200 billion. Owing to reinvestments, the substantial size of the APP portfolio will remain stable for a prolonged period.[15]

---

14 For a more detailed analysis, see Banco de España (2019c).

15 The role that the new monetary policy instruments might play in the future, as part of the central bank toolbox, is analysed in Chapter 3 of this Report.

The public finances shortfall continued to be corrected in 2018. The favourable contribution of the economic cycle and a fresh reduction in the interest burden allowed for the continuing correction of the euro area budget deficit. At end-2018, the deficit stood at 0.5% of GDP. Public debt declined by 2 pp to 87.1% of GDP. On the figures provided by Governments to the European Commission, the fiscal policy stance was slightly contractionary in 2018, and is expected to become slightly expansionary in 2019, albeit with notable cross-country divergences (see Chart 1.9).[16] Of particular note is the projected expansion in Italy, which is running a high level of debt, and in Germany, which plans to increase spending in light of certain shortcomings detected in areas such as infrastructure investment.

Weak global demand, economic uncertainty and lower levels of business profitability are bearing down on the euro area's short and medium-term growth outlook. The European economies still have significant points of vulnerability. These include most notably the high levels of debt in some countries, the scant fiscal policy headroom in most of them and the weakness of certain banks. Consequently, the area's economy is liable to be acutely affected by any future external shocks. A possible case in point would be a disorderly no-deal Brexit, which might entail severe effects in terms of financial instability and the breakdown of international production chains.[17] It is worth recalling here that the euro area is, among the main global economies, that most exposed to international trade flows. Over the longer term, the demographic outlook and low productivity levels continue to pose major challenges for the European economies.

3 The Spanish economy in the recent period: underpinnings and factors of uncertainty

3.1 Stronger performance than that of the euro area

The Spanish economy expanded for the fifth consecutive year in 2018, albeit more slowly than in 2017. Specifically, GDP grew by 2.6%, down 0.4 pp on the previous year (see Table 1.1 and Chart 1.10). By component, the growth of activity was underpinned by the high domestic demand growth, which, as in 2017, was 3%. By contrast, exports weakened notably to 2.3%, nearly 3 pp less than a year earlier. Since this demand component has a high import content, purchases abroad also slowed significantly. As a result of these developments in trade flows, the net external

16 The neutral stance in 2018 is inferred from the budgetary plans of the euro area countries' Governments. However, according to estimates by other institutions, there may have been an increase last year of up to 0.5 pp in the structural primary balance.

17 See Vega (2019).

Table 1.1
MAIN INDICATORS OF THE SPANISH ECONOMY (a)

	2013	2014	2015	2016	2017	2018
Demand and output (b)						
Gross domestic product	-1.7	1.4	3.6	3.2	3.0	2.6
Private consumption	-3.1	1.5	3.0	2.9	2.5	2.3
Government consumption	-2.1	-0.3	2.0	1.0	1.9	2.1
Gross capital formation	-4.6	5.8	9.0	2.5	5.4	5.6
Investment in equipment	4.9	6.0	12.3	5.1	5.7	5.2
Construction investment	-8.6	4.2	3.6	1.1	4.6	6.2
Housing	-10.2	11.3	-0.9	7.0	9.0	6.9
Other construction	-7.3	-1.1	7.4	-3.7	0.6	5.5
Exports of goods and services	4.3	4.3	4.2	5.2	5.2	2.3
Imports of goods and services	-0.5	6.6	5.4	2.9	5.6	3.5
Contribution of national demand to GDP growth (pp)	-3.2	1.9	3.9	2.4	2.9	2.9
Contribution of net external demand to GDP growth (pp)	1.5	-0.5	-0.3	0.8	0.1	-0.3
Employment, wages, cost and prices (c)						
Total employment	-3.4	1.0	3.3	3.0	2.9	2.5
Employment rate (d)	55.6	56.8	58.7	60.5	62.1	63.4
Unemployment rate	26.1	24.4	22.1	19.6	17.2	15.3
Compensation per employee	1.4	0.1	0.8	-0.5	0.3	0.8
Apparent labour productivity	1.8	0.3	0.3	0.1	0.1	0.1
Unit labour costs	-0.4	-0.2	0.5	-0.6	0.2	0.8
GDP deflator	0.4	-0.2	0.5	0.3	1.2	1.0
Consumer price index (end of period)	0.3	-1.0	0.0	1.6	1.1	1.2
Consumer price index (annual average)	1.4	-0.2	-0.5	-0.2	2.0	1.7
Consumer price differential (HICP) with the euro area (pp)	0.2	-0.6	-0.8	-0.1	0.1	0.0
House prices	-10.6	0.3	3.6	4.7	6.2	6.7
Net lending (+)/net borrowing (–) and financial balance (e)						
Resident sectors: domestic net lending (+)/net borrowing (–)	2.1	1.5	1.7	2.4	2.2	1.5
General government	-7.0	-6.0	-5.3	-4.5	-3.1	-2.5
General government (excluding aid to financial institutions)	-6.7	-5.8	-5.2	-4.3	-3.0	-2.5
Household and NPISHs	4.0	3.4	2.4	1.7	-0.4	-1.2
Corporations	5.1	4.1	4.6	5.1	5.6	5.2
Financial institutions	2.2	2.3	1.8	2.1	2.3	2.5
Non-financial corporations	2.9	1.8	2.8	3.0	3.3	2.6
Net international investment position	-95.2	-98.0	-89.5	-85.3	-83.5	-77.1
General government gross debt	95.5	100.4	99.3	99.0	98.1	97.1
Monetary and financial indicators (f)						
ECB minimum bid rate on MROs	0.5	0.2	0.1	0.0	0.0	0.0
Ten-year government bond yield	4.6	2.7	1.7	1.4	1.6	1.4
Synthetic bank lending rate	4.1	3.8	2.9	2.7	2.5	2.4
Madrid Stock Exchange General Index (100 = Dec 1985)	879.8	1,066.6	1,080.5	879.2	1,034.5	971.4
Dollar/euro exchange rate	1.3	1.3	1.1	1.1	1.1	1.2
Nominal effective exchange rate vis-à-vis developed countries (g)	101.5	101.5	99.3	99.9	100.8	101.5
Real effective exchange rate vis-à-vis developed countries (h)	107.2	106.3	104.1	103.1	103.2	102.7
Real effective exchange rate vis-à-vis the euro area (h)	105.0	104.3	104.5	103.0	102.3	101.1
Households: total financing	-5.2	-3.6	-2.1	-2.0	-1.3	-0.6
Non-financial corporations: total financing	-6.1	-3.7	-0.4	-0.4	0.3	0.6

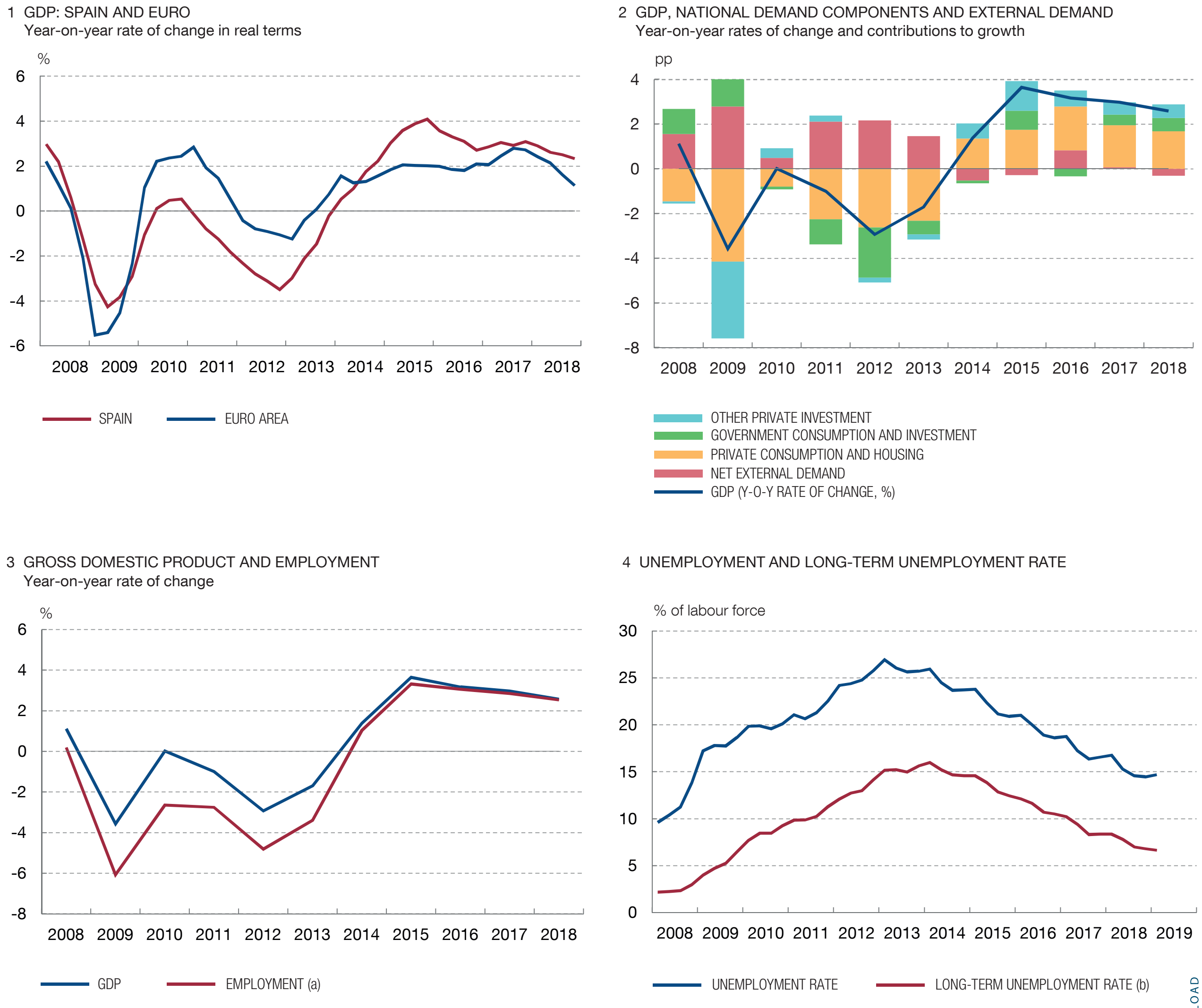
SOURCES: INE, IGAE, AMECO and Banco de España.

a Spanish National Accounts data, base year 2010.
b Volume indices. Annual rates of change.
c Rates of change, except employment and unemployment rates, which are in levels.
d Employment rate (16-64 years).
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 100 = 1999 Q1.
h 100 = 1999 Q1. Measured with unit labour costs.

Chart 1.10

GDP AND EMPLOYMENT GROWTH REMAINED HIGH, DESPITE THE DETERIORATION OF THE EXTERNAL ENVIRONMENT

Spanish GDP rose at a steady pace throughout the year, in contrast to the slowdown in activity in the euro area. Exports decelerated sharply, in keeping with the loss of momentum on the external markets. However, the contribution of domestic demand to GDP growth remained strong. Productivity growth was very low, as has been the case since the start of the recovery. Employment creation meant that the unemployment rate continued to head down, albeit at a slower pace among workers with longer spells of unemployment.



DOWNLOAD

SOURCES: INE and Banco de España.

a Employment on Quartertly National Accounts (QNA) data. Full-time equivalent jobs.
b Long-term unemployment: persons looking for work for a year or more.

balance made a negative contribution of 0.3 pp to output growth, the first of this sign since 2015.

The decrease in the rate of output growth was of a similar size to that expected before the beginning of the year. In fact, GDP growth in 2018 was 0.2 pp higher than anticipated in the Banco de España's December 2017 projections. However, the composition of its growth differed greatly from that predicted.

Specifically, the rate of change of domestic demand was 0.9 pp higher than expected, with a more dynamic performance of all of its components, while exports grew by 2.6 pp less, which, given that imports did not significantly depart from expectations, meant that the contribution of the external net balance was 0.7 pp worse than predicted.

In terms of average annual rates, the slowdown of the Spanish economy's output in 2018 differed little in size from that in the euro area. Specifically, the decrease of 0.6 pp in the euro area's GDP growth was 0.2 pp higher than in Spain. However, while in Spain the slowdown was anticipated, that of the euro area came as a surprise. From the standpoint of demand components, the downturn in exports came as a surprise in both cases. By contrast, unlike in Spain, the increase in domestic spending in the euro area was substantially lower than expected.

The differences between the performances of the Spanish and euro area economies in 2018 are easier to see in terms of the quarter-on-quarter profile of GDP growth. The rate of change of output in the last two quarters of 2017 was very similar in the two economies (around 0.7%). However, while in Spain that growth rate tended to hold steady in 2018, standing at 0.6% in each of the four quarters of the year (except in Q3, when it was 0.5%), the GDP of the euro area grew by 0.4% in Q1 and Q2, and by 0.1% and 0.2% in the following two quarters. Given these developments, Box 1.2 analyses in detail the factors which may explain why activity and, in particular, domestic demand performed better in Spain than in the euro area, against a background in which both economies were subject to a common external shock.

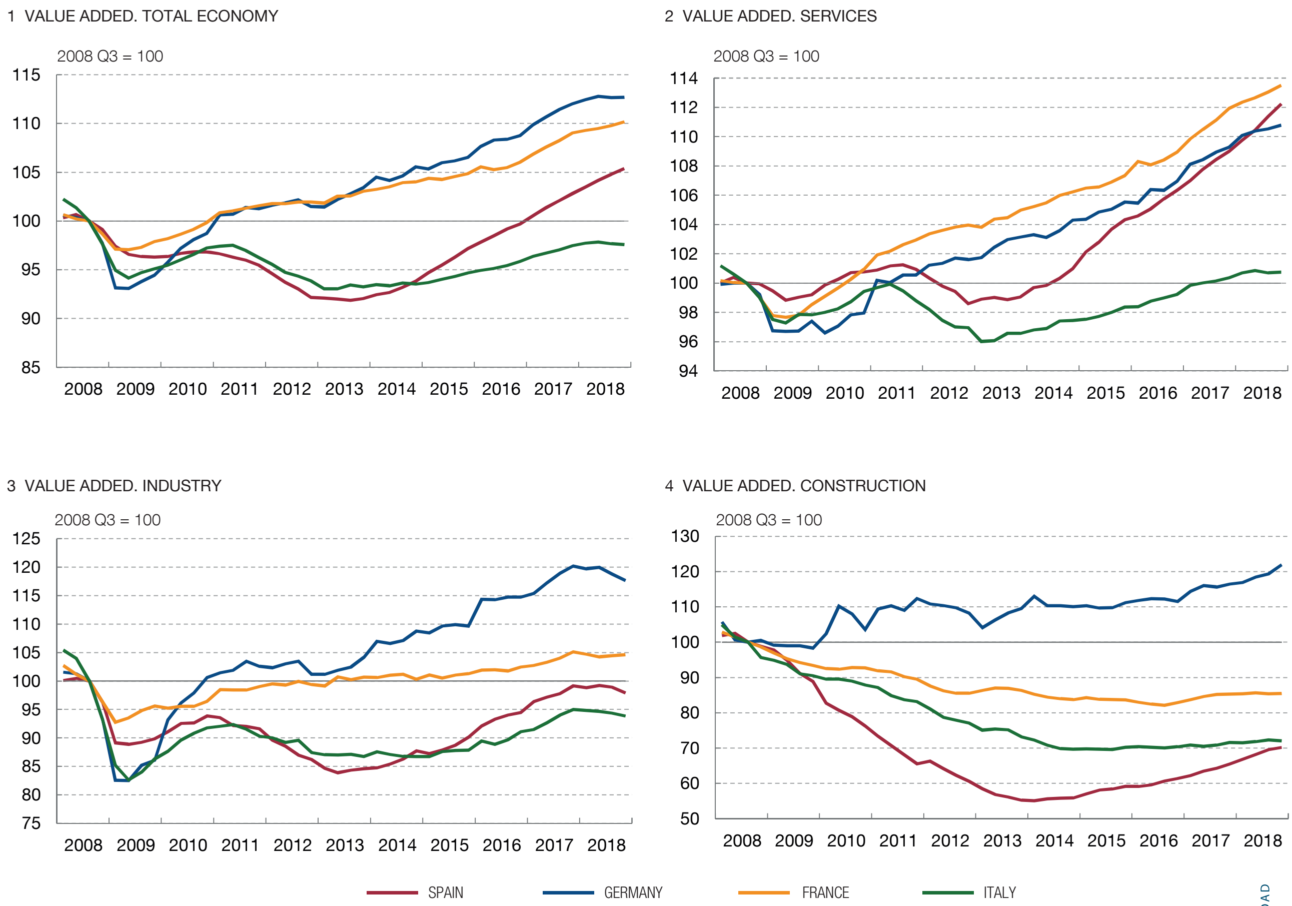
The deceleration abroad was reflected in the comparatively less favourable behaviour of industry. Specifically, in industry, 2018 saw slowdowns in value added and, above all, employment, a trend which has persisted unchanged into early 2019 (see Chart 1.11). This was partly a consequence of the difficulties besetting the automotive sector. Contrastingly, activity and employment rose strongly in construction, although their current levels are still far from those before the crisis. Noteworthy in services was the marked buoyancy of employment in the non-market branches, which rose to 3% and, in line with the information from the Labour Force Survey, reflected the strength of recruitment in the public sector.

The ability of the economy to continue growing at the high rate of recent quarters depends, however, on various factors. Box 1.2 concludes that the higher growth rate of household consumption than that of household income and the somewhat expansionary stance of fiscal policy (which are interrelated to some extent) contributed to explaining the strength of domestic demand and GDP in 2018. Looking forward, the ability of these factors to continue sustaining activity is limited because their prolongation in time may end up generating certain vulnerabilities in the financial position of households and general government.

Chart 1.11

AMONG THE PRODUCTIVE SECTORS, INDUSTRY FELT THE IMPACT OF THE DOWNTURN IN THE EXTERNAL ENVIRONMENT

The downturn in the world economy meant that industry, the productive sector most exposed to external competition, performed less strongly than other sectors, with stagnation of its value added and a backslide in employment, This was not so different from what happened in the main euro area economies. By contrast, value added in construction continued expanding apace, albeit from a still-low level, given the adjustment which took place in the crisis.



DOWNLOAD

SOURCES: Eurostat, INE and Banco de España.

At the same time, the economy retains significant underpinnings to enable it to continue growing rapidly. There has been no correction of the imbalance in public finances and certain groups of households may be raising their spending more than their income prospects would advise, but the aggregate balance sheet of the private sector has continued to improve in the recent period. The lower indebtedness in recent years reduces the vulnerability of households and firms to shocks prompted by higher borrowing costs or falls in income. Meanwhile, the behaviour of relative costs vis-à-vis the rest of the world in 2018 continued to favour external competitiveness and hence the adjustment of the structural current account balance. Furthermore, the prospect that the ECB will maintain its expansionary monetary stance for a lengthy period provides certain additional slack in the financial position of indebted agents.

Short and medium-term growth ability is favoured by the existing room to increase the use of factors of production. On Banco de España estimates, the output gap of the Spanish economy, i.e. the difference between observed and potential GDP expressed as a percentage of the latter, may have turned positive in 2018. According to the most recent macroeconomic projections of the Banco de España,[18] the growth of the economy under the baseline scenario will amply exceed the potential growth rate (estimated at somewhat below 1.5%) over the next three years, standing at 1.7% on average in 2021.

3.2 Domestic demand as the mainstay of activity

The main determinants of household spending behaved favourably in 2018. The consumer and investment decisions of households were encouraged by the expansionary behaviour of their income, the improvement of the sector's financial position and the availability of funding on easy conditions.

As in previous years, households continue to enjoy access to bank financing on easy terms. The continuing accommodative stance of the ECB's monetary policy allowed the average interest rates applied to loans to remain at historically low levels. Further, according to the Spanish Bank Lending Survey (BLS), households' access to credit continued to improve in 2018, although signs of the exhaustion of this pattern began to appear in late 2018 and early 2019 (see Chart 1.12).

The accommodative financial conditions underpinned the increase in new lending. New lending grew particularly strongly in the consumer credit segment, where new credit flows continued to grow, as throughout the whole of the recovery, at double-digit rates. In this respect, it should be kept in mind that excessively rapid credit growth may increase the vulnerability of lenders and borrowers to adverse shocks.[19]

In any event, consumer credit slowed in the second half of the year. This moderation seemed to be linked to both supply and demand factors. On the supply side, the two most recent BLSs point, for the first time since the beginning of 2013, to a certain tightening of credit standards, which may be associated with the higher risk perceived by lenders in this segment in light of the upturn in bad loans in 2018 and the general economic outlook (see Chart 1.12). For its part, demand seems to have been curtailed due to the slowdown in consumption of durable goods following several years of high growth.

---

18 See Banco de España (2019a).

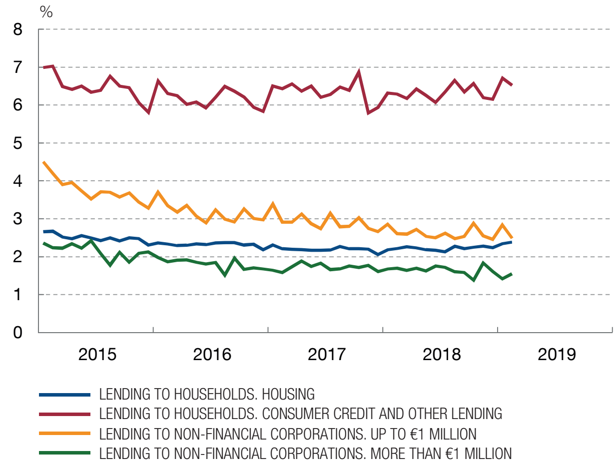
19 See Banco de España (2018d, 2018h and 2018j).

Chart 1.12

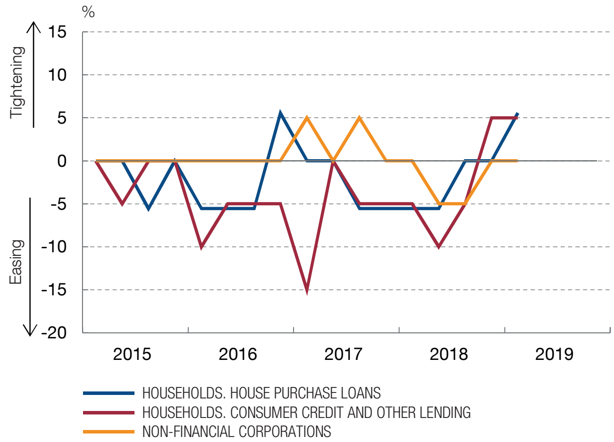
THE FINANCING CONDITIONS OF THE SPANISH ECONOMY CONTINUE TO BE LAX

Financing conditions continue to be lax, with low and stable costs, although there are signs that credit standards may be starting to tighten. The outstanding balance of household credit has shown positive increases since mid-2018 thanks to a moderation of the fall in house purchase lending, which has offset the deceleration in consumer credit. The overall balance of lending to non-financial corporations is also growing, since the contraction in lending by resident financial institutions has been offset by the dynamism of debt security issuance and lending to the rest of the world.

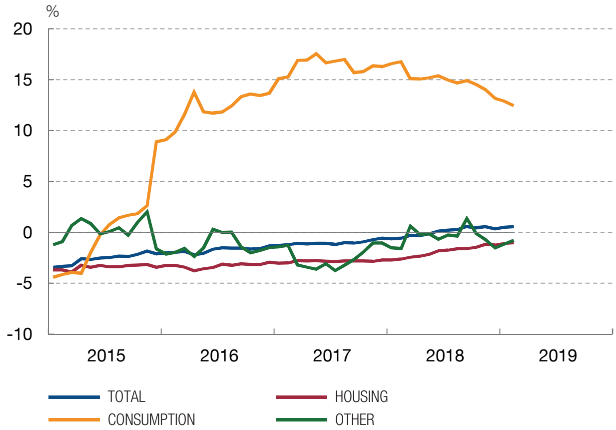
1 BANK LENDING INTEREST RATES. SPAIN



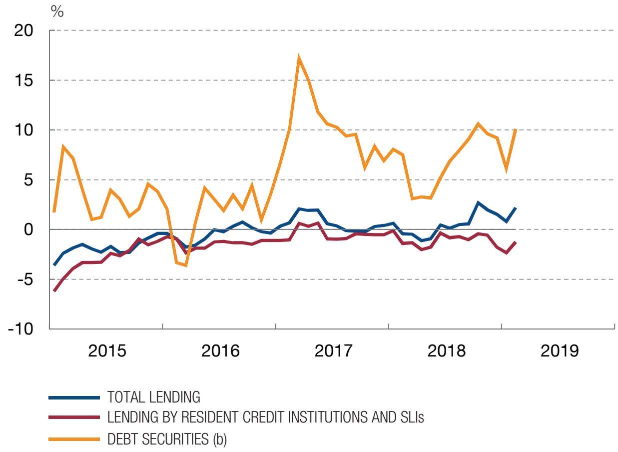
2 BLS. CHANGES IN BANK CREDIT STANDARDS (a)



3 LENDING TO HOUSEHOLDS. YEAR-ON-YEAR GROWTH



4 LENDING TO NON-FINANCIAL CORPORATIONS. GROWTH



SOURCE: Banco de España.

a Bank Lending Survey. Indicator = percentage of banks that have tightened their credit standards or their margins considerably × 1 + percentage of banks that have tightened their credit standards or their margins somewhat × 1/2 – percentage of banks that have eased their credit standards or margins somewhat × 1/2 – percentage of banks that have eased their credit standards or margins considerably × 1.

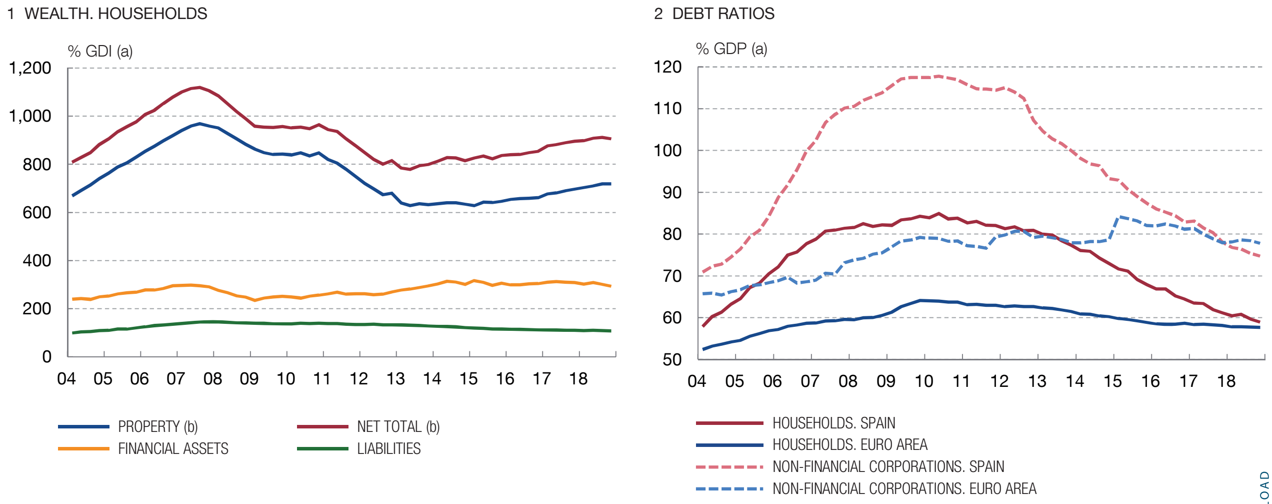
b Including issuance by resident subsidiaries.

DOWNLOAD

The total stock of household credit increased for the first time since 2010. Since mid-2018, the year-on-year growth rate of lending to this sector has been slightly positive. Along with the expansionary consumer credit described above, this development reflects the moderation of the rate of contraction of house purchase lending, in which segment new loan growth is being counteracted less and less by the volume of redemptions.

Chart 1.13
THE FINANCIAL POSITION OF HOUSEHOLDS AND NON-FINANCIAL CORPORATIONS CONTINUED TO STRENGTHEN

The debt ratios of households and non-financial corporations continued to decrease and now stand at levels near the euro area average (households) or below it (non-financial corporations). The net wealth of Spanish households continued to rise owing to property price appreciation, which offset the fall in the financial component basically due to a decline in equity security prices.



DOWNLOAD

SOURCES: INE and Banco de España.

a Data in four-quarter cumulated terms.
b Estimate based on estimated changes in stock of housing, average floor space and price per square metre.

The improved financial position of households also helped to boost their spending. Spanish households continued to reduce their debt in 2018, although at a more moderate pace than in previous years. At the end of the year, the debt of this sector stood at 59% of GDP, 2 pp less than in the previous year and 26 pp below the peak reached in mid-2008. This level is now very near (barely 1 pp above) the euro area average (see Chart 1.13).

The net wealth of households continued to rise. This was a consequence of property price appreciation in a setting in which average residential prices increased by 6.7% in 2018. By contrast, the value of the financial component decreased in both gross and net (i.e. after deduction of debt) terms, due mainly to lower stock market prices (see Chart 1.13). In addition, the improvement in the aggregate financial position of the sector masks the existence of some groups of more vulnerable households.

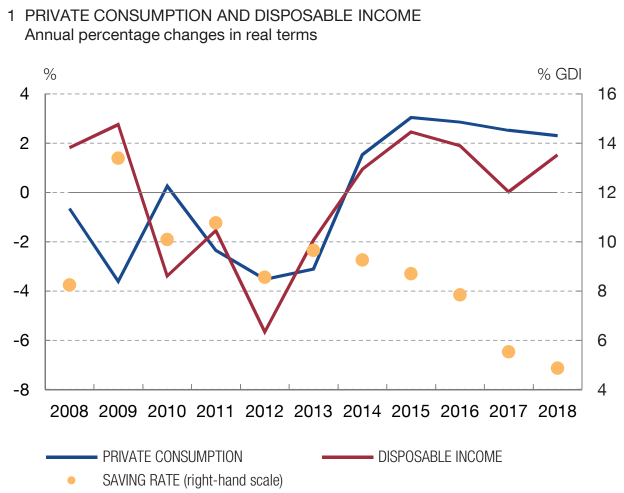
The growth rate of household income increased significantly in 2018. In nominal terms, the gross disposable income of households rose by 3.2% in the year as a whole, 1.6 pp more than in 2017 (see Chart 1.14). Given that inflation, as measured by the rate of change of the private consumption deflator, stood, as in 2017, at 1.6%, the greater vigour of nominal income fed through to real income, which grew by 1.5% last year, compared with the zero growth of 2017.

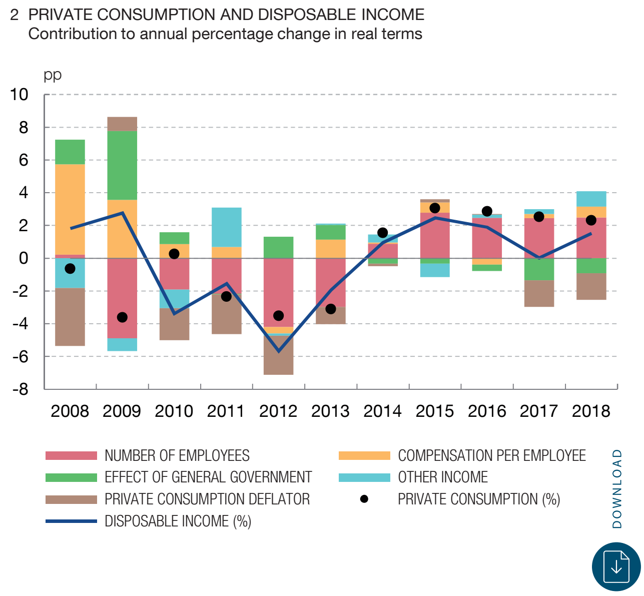
Chart 1.14

PRIVATE CONSUMPTION STRONG AND HOUSEHOLD SAVING RATE AT RECORD LOWS

Rate of change

The rise in the growth rate of household nominal income was contributed to by higher wages, lesser income depletion by general government and higher dividend income. In real terms, household consumption grew more rapidly than household income, pushing the saving rate down further to its lowest level in the time series.





SOURCES: INE and Banco de España.

Contributing to this greater vigour were both labour income and net transfers from general government. Employees' wages showed notable dynamism. In nominal terms, labour income increased by 4.1%, 0.5 pp more than in 2017, as a result of the greater buoyancy of nominal wages (up by 0.8%, 0.5 pp more than in 2017). By contrast, the growth rate of employment declined (by 0.4 pp to 2.5%). Contributing to wage buoyancy was the increase in remuneration of public-sector employees. In addition, the pension revaluation approved in the State budget in mid-2018 and, to a lesser extent, the higher personal income tax threshold, i.e. the lowest amount of income for which the tax payable is positive, gave rise to a higher contribution of net current transfers from general government to household income.

Private consumption continued to show notable strength, similar to that a year earlier. In the aforementioned setting of households' higher income growth, improved financial position and favourable financial conditions, the spending of these agents on consumer goods and services grew in 2018 as a whole by 2.3% in real terms, a significantly higher rate than that expected at the beginning of the year. During the course of 2018, households' confidence tended to fall somewhat as a result of their worsening unemployment expectations, their weaker perception of the overall economic situation in the future and the lower declared intention to make big-ticket purchases in the coming months. Indeed, in the final stretch of the year the rate of durable goods purchases underwent a loss of momentum which may have had many causes. These included the possible impact of the downturn in confidence, the exhaustion of the scope for re-absorbing the pent-up demand for goods of this type accumulated during the crisis,[20] and, in the case of automobiles, also some temporary factors.[21]

In line with the trend since the beginning of the recovery, the saving rate decreased again in 2018, although more moderately than in 2017. The decrease in the saving rate last year (by 0.6 pp) took this variable to 4.9% of disposable income, one of the lowest levels among the core European economies (see Chart 1.14). The decrease in the saving rate, in combination with the expansion of consumer credit, may reflect excessive risk-taking by some consumer groups.[22]

Investment in housing again showed high growth, albeit somewhat lower than in the previous two years. This demand component grew by 6.9% in 2018. Demand, spurred by the good performance of employment and by favourable financing conditions, continued to pass through to significant increases in (mainly used) housing transactions and in the number of new residential building permits. The latter were driven also by the fall in stocks of unsold new housing (particularly in those geographical areas where the market has been more buoyant). In any event, the number of housing starts in 2018 was in line with the creation of new households, in contrast with the situation at the peak of the previous real estate cycle, when in some years the former almost doubled the latter.

Against this background of buoyant housing demand, prices continued to recover. The level reached at the end of 2018 was, in real terms, 23% above the end-2013 low (see Table 1.1), but still approximately 18% below the high of 2007. According to the available indicators, the price rise throughout this expansionary period has, for the time being, not led to any appreciable overpricing.[23] Meanwhile, rental income has risen markedly during the recovery to levels significantly above those seen in the previous upturn.

The behaviour of the housing market is, in any event, notably uneven across regions. Specifically, the recovery has been stronger in Madrid, the Mediterranean coastal regions, and the Balearic and Canary Islands, which are areas of higher economic growth and population dynamism.[24] Compared with the significantly more

---

20 See González Mínguez, J. and A. Urtasun (2015) and Banco de España (2017d).

21 Specifically, the entry into force in September of the regulations on pollutant emissions may have given rise to a decrease in car purchases in the last part of the year due both to a certain bringing-forward of purchases to the preceding months and to a decrease in the number of vehicles for sale complying with the new regulations.

22 See Banco de España (2019e).

23 See section 1.2.2 of Banco de España (2019e).

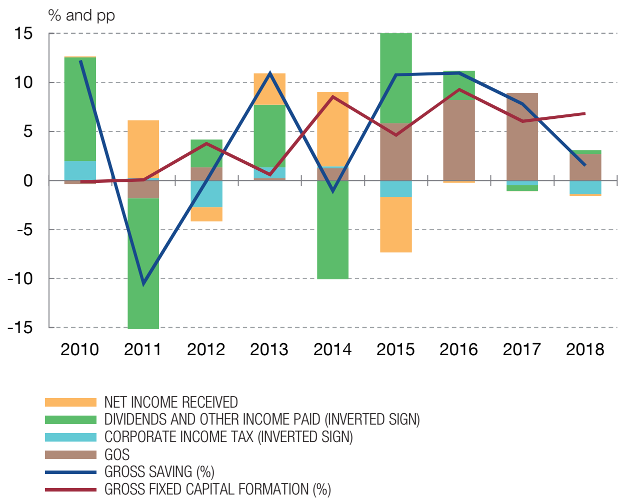
24 See Alves and Urtasun (2019).

Chart 1.15

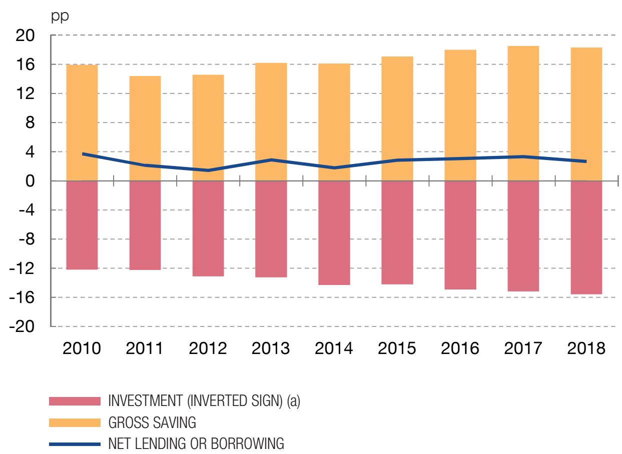
INVESTMENT BY NON-FINANCIAL CORPORATIONS CONTINUED TO BE SPURRED BY THE STRENGTH OF FINAL DEMAND, BY THE FAVOURABLE FINANCING CONDITIONS AND BY CORPORATE RESTRUCTURING

The internal generation of funds by firms was weakened by the slower growth of their operating surplus and, above all, by the bringing forward of taxation which may be reversed in 2019. This meant they had greater recourse to borrowing to finance their investment spending. Their strength remained unchanged thanks to the dynamism of final demand.

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



2 CORPORATE LENDING OR BORROWING
% of GDP



DOWNLOAD

SOURCES: INE and Banco de España.

a Including net capital transfers.

moderate increases shown by the national averages, in some of these locations prices rose by nearly 50% from their lows, housing transactions doubled and building permits tripled.

The decrease in saving and the rise in housing investment meant that households had to borrow more. In net terms, their borrowing amounted to 1.2% of GDP, 0.8 pp more than a year earlier, making 2018 the second year running in which households are net borrowers from the other sectors of the economy.

The growth rate of funds generated internally by firms to finance their investment spending decelerated in 2018. On National Accounts data, the growth rate of the gross operating surplus of non-financial corporations (NFCs) decreased significantly to 2%, nearly 5 pp less than at the end of 2017 (see Chart 1.15). Meanwhile, firms' gross saving slowed even more sharply, due to a strong increase in corporate income tax payments.

As in the case of households, firms continued to enjoy easy access to borrowed funds, and this underpinned investment by NFCs. The cost of corporate finance remained low and even decreased further in the case of smaller loans, which are generally those extended to SMEs (see Chart 1.12). Regarding quantities, both the

Spanish Bank Lending Survey and the euro area Survey on the Access to Finance of Enterprises (SAFE) indicate that NFCs' access to credit improved during the year. In the most recent Spanish Bank Lending Survey (relating to 2019 Q1), banks reported that they expected NFCs' credit conditions to steady. Also, in the latest SAFE (for the period from April to September 2018), the percentage of firms reporting access to finance to be a factor of concern was 6%, the lowest value since the survey was launched nearly a decade ago, although some other results of the survey pointed to signs of exhaustion of the improvements.[25]

The total volume of external financing raised by NFCs grew further. Overall, the total financing to firms from securities issuance and credit from resident and non-resident banks quickened to 2.2% in February 2019, compared with 0.4% in December 2017 (see Chart 1.12). This acceleration was possibly the flipside of the slowdown in growth of internally generated funds. In any event, some changes were apparent in the composition by instrument. Specifically, despite the prevailing favourable conditions, the demand for new loans and, therefore, the growth of originations was very moderate, resulting in a slightly faster contraction of total credit. By contrast, the funds raised through debt securities issuance continued to grow quickly, reflecting the continuation of the process of bank disintermediation observed in recent years. This increase in financing through securities at the expense of that provided through credit seems to have continued to be fostered by the ECB's corporate sector purchase programme launched in mid-2016.[26]

The financial position of firms continued to strengthen as a result of ongoing deleveraging and this favoured the strong performance of investment. The continuation in 2018 of the financial restructuring effort by firms in recent years reduced the year-end debt ratio to 75% of GDP, 43 pp below its peak at mid-2010. Compared with firms from the euro area as a whole, the debt of Spanish firms is now somewhat more than 3 pp lower. In any event, as in the case of households, some corporate segments are in a situation of greater fragility.[27]

In the setting described above, corporate investment seems to have grown by 4.5% in real terms in 2018.[28] Against a background characterised by the sector's improving financial position, a favourable profitability performance and the persistence of benign financing conditions, corporate investment continued to perform strongly, in line with the strength of final demand. However, the last part of

---

25 See Banco de España (2018p).

26 See Arce, Gimeno y Mayordomo (2017), which confirms these effects for Spain.

27 See Banco de España (2019e).

28 The figure given is an estimate by the Banco de España after removing the effects of some economically insignificant accounting reclassifications between NFCs and general government, and taking into account that the National Accounts only consider firms' investment in nominal terms.

the year saw a weakening of this demand component, possibly linked to the downturn in the external sector. The strength of NFCs' investment in the year as a whole and the slight decline in their saving did not prevent the sector from continuing to be a net lender (see Chart 1.15).

3.3 Loss of external demand momentum

Compared with the strength of domestic demand, net trade flows with the rest of the world decelerated significantly in 2018. This loss of momentum was more pronounced on the export than the import side. In consequence, the contribution of net exports to GDP growth was negative (-0.3 pp), for the first time since 2015. As indicated in section 2.2, exports also weakened significantly in all the other main euro area economies.

The considerable moderation in sales abroad – whose average annual growth rate fell by 3 pp to 2.3% – responded to a number of factors. Both the weakness of Spain's export markets and the effects of the exchange rate appreciation in 2017-18 helped to explain the slowdown in sales to the rest of the world observed in 2018 (see Chart 1.16). The loss of momentum on the external markets is the key factor behind the slowdown in exports. In 2018, export markets for Spanish goods and services grew by 3.1%, 2 pp less than in 2017 (see Chart 1.16). In addition, the loss of this momentum was more marked than the loss of steam in world trade flows, which is explained by the fact that the different geographical areas do not hold the same weight in the two aggregates. Specifically, the countries of the EU – where the slowdown in imports was comparatively greater than that seen at a global level – make up two-thirds of Spain's export markets. In addition, the emerging Asian markets, which are those that held up best in 2018, make up a much smaller proportion of Spain's export markets than of world markets overall.

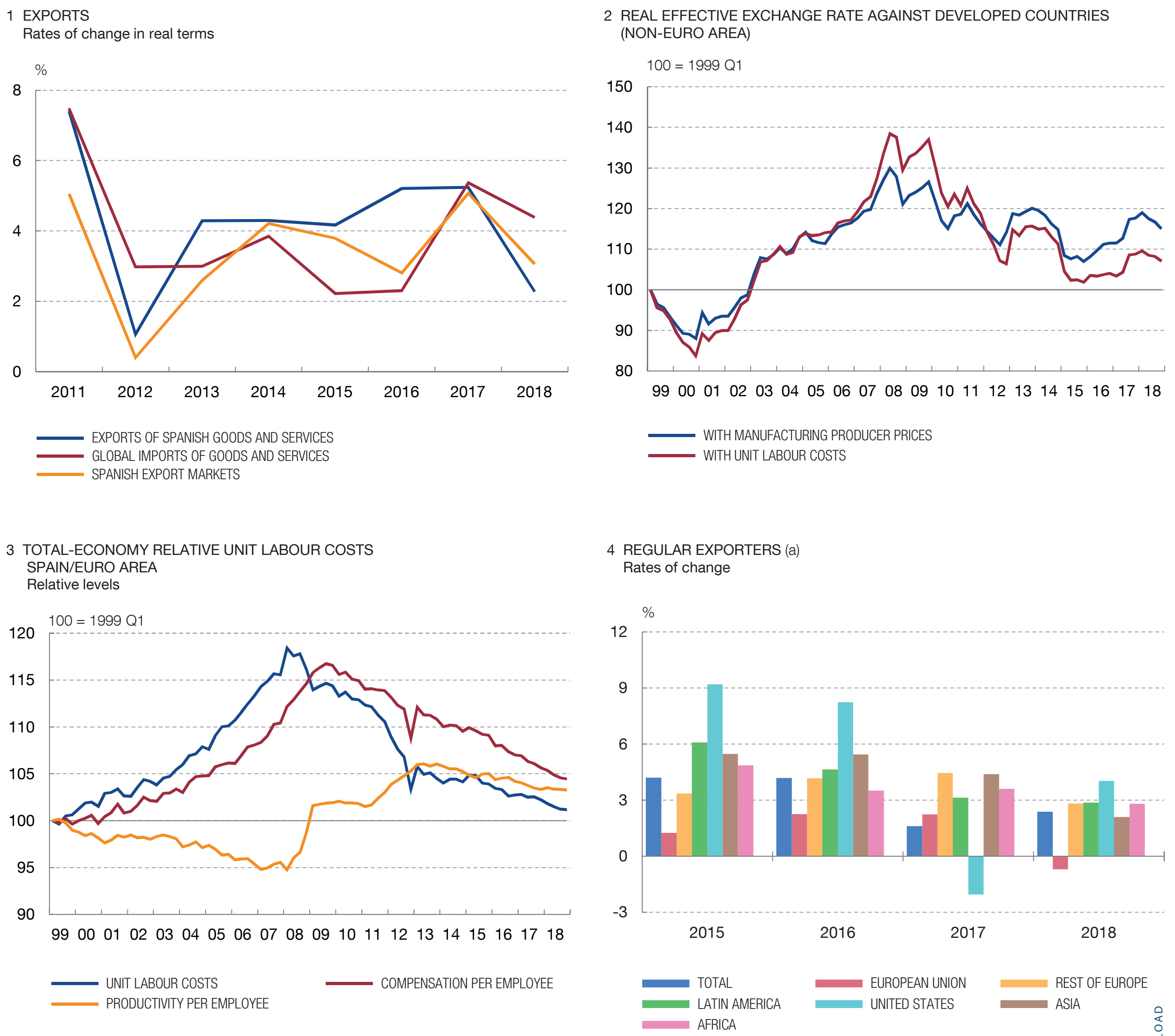
The euro exchange rate in the period 2017-18 also had a negative effect on export growth. In 2017, Spain's nominal effective exchange rate (NEER) appreciated by 7.4% against the non-euro area developed countries overall. This appreciation, which was concentrated in the first half of the year, gave rise to a loss of competitiveness that was only marginally offset by the fall in prices and in relative unit labour costs (ULCs) compared with the non-euro area developed countries (see Chart 1.16). In 2018 the NEER depreciated by 1.1%, thus helping to boost economic competitiveness. This effect was heightened by the favourable performance both of prices and relative ULCs compared with the non-euro area developed countries.

The lagged effect of the appreciation observed in 2017 had a strong negative impact on export sales in 2018. According to the Banco de España's Quarterly

Chart 1.16

EXPORTS DECELERATED SHARPLY

Growth in export sales was considerably lower than in previous years, partly because the slowdown in Spain's export markets was greater than that observed worldwide. The low export momentum was also due to the past appreciation of the euro, which prompted a loss of competitiveness compared with the non-euro area countries, with which, by contrast, the ULC correction continued. The number of regular exports continued to increase at a strong pace, which is a positive note for the future.



DOWNLOAD

SOURCES: ECB, INE, ICEX and Banco de España.

a Regular exporters are those that have exported in the year in question and in each of the three immediately preceding years.

Macroeconometric Model, there is some lag in the materialisation of the effects on trade flows of NEER appreciation against the developed countries. In addition, nominal appreciation is greater and more persistent when the NEER is calculated against country aggregates that include emerging market economies. Thus, the NEER against a group of 38 non-euro area countries not only appreciated (by 6.7%) in 2017, but again by a further 5% in 2018.

In 2018 the competitiveness of the Spanish economy improved somewhat compared with that of the other euro area member countries. The competitiveness gains amounted to 1.1% in terms of total-economy relative ULCs (see Chart 1.16), and to more than 1.7% in terms of manufacturing sector ULCs. However, on the information available, the improvement in competitiveness indicators did not translate into an increase in euro area market share, which held steady following the increases recorded in the two previous years (most likely owing to competition from non-euro area countries whose currencies depreciated).

Regarding trade in goods, the effects of the exchange rate appreciation help to explain why the slowdown in sales to the rest of the world was especially marked in the case of extra-EU markets. Indeed, the information available suggests that growth in goods exports to non-euro area countries was lower in the case of Spain than it was in the case of the other large euro area economies, in keeping with the fact that Spanish export markets include a relatively higher proportion of markets that have seen the most deceleration. An additional explanation would be that Spanish exports specialise in products with medium-low technology content, which makes export volumes comparatively more sensitive to a fall in price competiveness.

By product type, the negative contribution of car exports to the deceleration in total goods exports stands out. In the second half of 2018 sales of cars (whose main market is the EU, with 86% of the total, in nominal terms) and intermediate products were adversely affected by the new European regulations on contaminating emissions. Although this was a mainly temporary shock, it has had a more persistent effect than was initially expected. In the medium and long term, auto manufacturing and exports are subject to uncertainties stemming from the technological changes currently under way in the industry, insofar as they may give rise to decisions to relocate production.

The slowdown in exports was particularly marked in the case of travel services. In real terms, the rate of growth of non-resident tourism, which was around 9% per annum in the period 2016-17, fell to 1.7% in 2018, with growth in foreign tourist arrivals that was, for the first time in six years, lower than the growth in total tourism flows worldwide. One factor behind this loss of momentum is the gradual return to normal in the geopolitical situation of the competitor destinations in the Mediterranean basin. Other causes of the slowdown observed are the weakening economic activity in the main euro area countries of origin, rising oil prices (which drive up transport costs) and appreciation of the euro against the currencies of some other countries of origin. Growth in the number of tourists was lower than the growth in tourist spending, which suggests that higher-priced services gained weight compared with the low-cost segment (probably because this segment has underpinned the above-mentioned recovery in other Mediterranean destinations). In any event, the latest indicators suggest that exports of travel services improved somewhat in the final stretch of 2018 and the start of 2019.

Other services remained quite dynamic. With a growth rate of 4.5%, as in 2017, the strong growth pattern recorded since 2008 has continued, encouraged by the combination of various structural factors, mostly shared with the other advanced economies. These include, in particular, technological progress in information and communications (which lowers the barriers to cross-border provision of services) and in the development of the services sector. At a domestic level, the competitiveness gains observed since the crisis and firms' search for new markets would also have played a part.[29]

Compared with the slowing export momentum, the growing external orientation of the productive system continued in 2018. Thus, the rate of growth of the number both of regular exporters (defined as those that have exported in at least four consecutive years) and total exporters was slightly higher than in 2017, although lower than in the previous years (see Chart 1.16). Stronger domestic demand, which may have lessened the incentive for firms to search for export growth, combined with the decline in the pace of cost competitiveness gains compared with the first stages of the present recovery, could have contributed to the easing of the rate of international growth of Spanish firms in the last two years. Moreover, the geographical diversification of regular exporters increased in 2018, thanks to the growth recorded in extra-EU markets.

The uncertainty surrounding Brexit appears to have had a limited impact to date on the bilateral trade flows between the United Kingdom and Spain. Since 2016, when the Brexit referendum was held, Spanish exports to the United Kingdom have levelled off, in nominal terms, in contrast to the strong growth observed in the four previous years. However, given that the pound has depreciated since the referendum, it is not easy to discern the source of this lower export momentum in nominal terms. It could be due to lower prices of exports in euro, with exporters keen to maintain their volumes, or to lower real volumes as a result of the higher price of exports in pounds, or even to the consequences of Brexit on firms' export decisions. In addition, in the second half of 2018, exports to the United Kingdom were affected by the idiosyncratic impact that the new regulations on contaminating emissions have had on auto manufacturing and sales, a sector that accounts for almost 20% of total nominal sales to the United Kingdom. Looking ahead, the potentially negative impact of Brexit on the Spanish business sector may be cushioned by the fact that, on average, the firms that trade with the United Kingdom have greater geographical diversification and higher efficiency levels.[30]

The rate of growth of imports also moderated quite sharply in 2018. Specifically, purchases from the rest of the world grew by 3.5%, 2.1 pp less than in 2017. The slowdown was concentrated on goods imports, which rose by 2.5%, 3.3 pp less

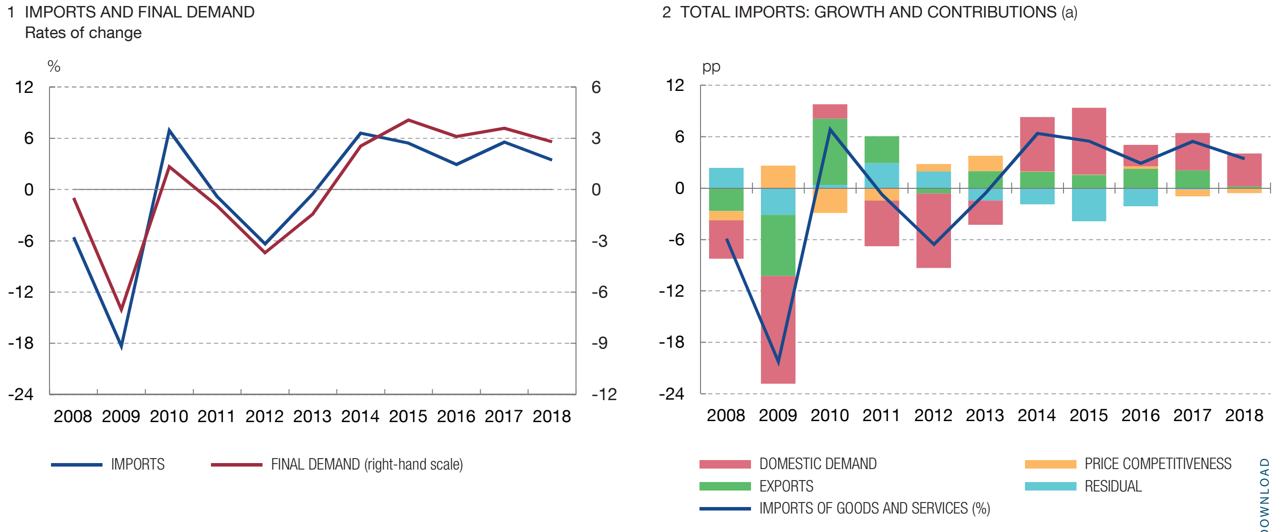
29 See Banco de España (2018a).

30 See Vega (2019).

Chart 1.17

IMPORTS ARE SLOWING, PARTLY AS A RESULT OF LOWER FINAL DEMAND MOMENTUM

The lower growth in final demand, owing to the loss of export momentum, gave rise to a lower rate of growth of purchases abroad. In any event, growth in imports was lower than their historical relationship with final demand would warrant.



SOURCES: INE and Banco de España.

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

than in 2017. As has been the case throughout the recovery, imports grew at a slightly slower pace than their historical relationship with final demand would warrant (see Chart 1.17).[31] Also, given the growth in final demand, import growth was weaker than in 2017. This may possibly be explained by the loss of momentum in exports, not only because their import content is the highest among all demand components, but also because recently it has tended to increase.

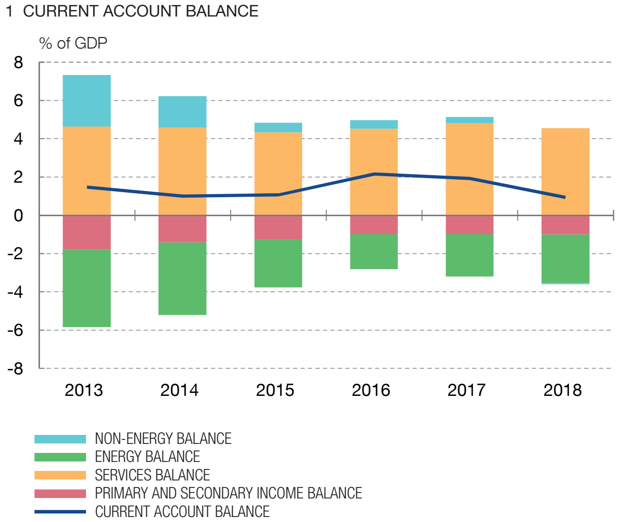
As a result of the adverse performance of trade flows with the rest of the world and the deterioration of the terms of trade, the external surplus narrowed again in 2018. Specifically, the Spanish economy's net lending position stood at 1.5% of GDP, 0.7 pp less than in 2017 and which is, together with the 2014 figure, the lowest level in the present growth phase. This smaller trade surplus on the rest-of-the-world account, owing to the narrowing of the surplus in goods and services, is broadly consistent with the fact that final demand in Spain has continued to grow at a stronger pace than demand on Spain's export markets, and with the rise in oil prices in annual average terms.

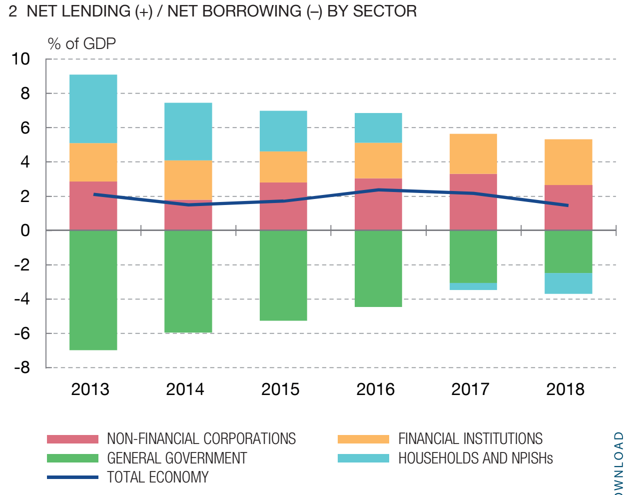
Considering the different headings of the rest-of-the-world account, the widening of the energy goods deficit may be highlighted. A consequence of the

31 See Banco de España (2017c).

Chart 1.18
THE EXTERNAL SURPLUS IS NARROWING

The current account surplus narrowed in 2018 as a result of the adverse performance both of the energy goods balance and the non-energy goods and services balance. From agents' standpoint, the explanation lies in the deterioration of household and firm balances, offset in part by the improvement in the budget deficit.





DOWNLOAD

SOURCES: INE and Banco de España.

increase in oil prices, this explains almost 60% of the total narrowing of the external surplus since early 2017 (see Chart 1.18). Specifically, the Spanish economy's net energy bill rose by 0.3 pp of GDP in 2018 (and by 0.7 pp in the last two years). The rise in crude prices has meant that almost half of the deterioration observed is a result of trade with the OPEC countries, from which most oil purchases come. In any event, the energy deficit has tended to remain below the level observed in the years before the crisis, when oil prices were at similar levels to today, as a result of the improved energy efficiency of the Spanish economy.[32] In turn, the external trade balance on non-energy goods narrowed by 0.4 pp in 2018, becoming slightly negative. From a longer time standpoint, the overall balance on non-energy goods and services has held very steady since end-2015, narrowing by just 0.4 pp of GDP, despite strong economic growth in Spain.

The negative net international investment position (IIP) remains very high. Specifically, at end-2018 the negative net IIP stood at 77% of GDP (see Table 1.1), while gross external debt amounted to 167% of GDP. Even though the negative net IIP has decreased by 23 pp from the high recorded in 2014, it is still a source of vulnerability, which means that large external surpluses need to be maintained for a prolonged period. However, there are a series of circumstances that mitigate the

32 See Banco de España (2018ñ).

risks associated with this external debt position. First, portfolio and other investment – whose flows are more likely to experience sharp adjustments as a result of shifts in market sentiment – have decreased as a proportion of the net IIP from the peak of 45% in 2006 to 35% at end-2018, at the expense of an increase in the share of direct investment. Second, the breakdown of the IIP by institutional sector shows that the public sector, whose instruments entail lower rollover and liquidity risk and have longer maturities, makes up the majority share, whereas the resident private sector accounts for just 19% of the total. In any event, insofar as most of the economy's net external liabilities correspond to general government, it is essential to reinforce the sustainability of public finances, to reduce exposure to episodes of investor risk aversion and, therefore, the possibility of a reversal of external financing inflows.

The prospect of a sharp correction in Spain's high external debt has become somewhat less likely. The decline in the economy's net lending position, together with signs that the competitiveness gains observed since the start of the recovery may now be coming to an end, suggest that the rate of decline of the negative net IIP may be slightly lower in the future. From the standpoint of sales to the rest of the world, the external surplus should benefit, in the future, from the product angle, from growing exports by high technology content sectors. These contribute more value added and are competitive thanks not to labour costs but mainly to innovation and human capital and, from a geographical standpoint, from expansion into high-growth areas such as the Asian economies.

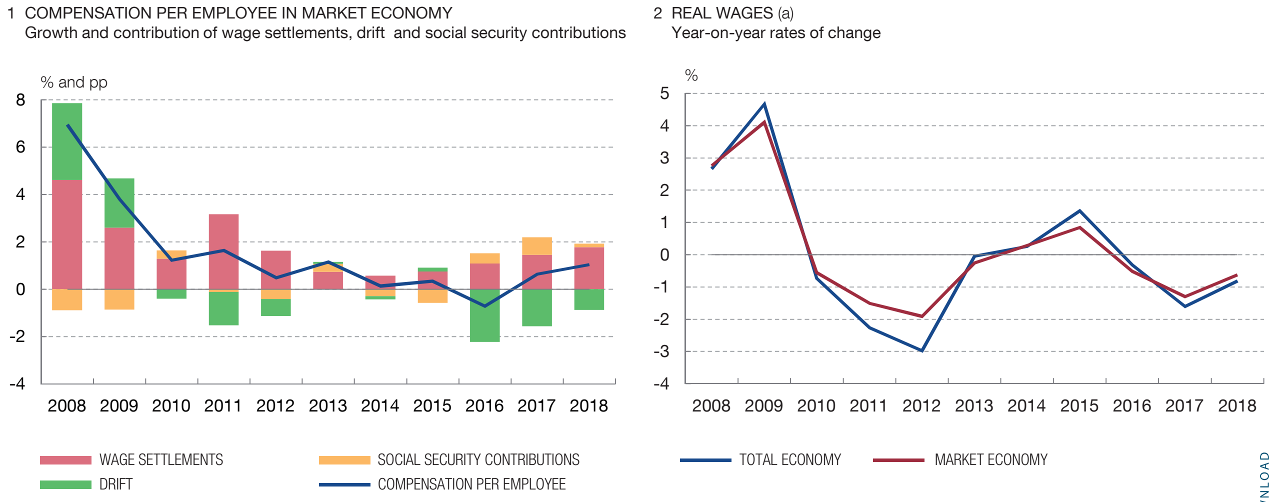
3.4 Inflationary pressures were again very modest over the past year.

The pattern of wage containment observed since 2014 eased in 2018. In the private sector compensation per employee rose 1%, 0.4 pp more than in 2017 and 0.9 pp above the average for the period 2014-2017 (see Chart 1.19). This upturn, slightly higher than that recorded for the economy as a whole, relied on the bigger wage increases agreed under collective bargaining which, as regards newly signed agreements, were influenced by the Employment and Collective Bargaining Agreement (AENC, by its Spanish abbreviation) for 2018-2020 entered into by the social agents in July 2018. Specifically, the wage increase recorded in the newly signed agreements was 2.1%, in line with the increases of around 2% per year, plus an additional variable component of up to 1%, which was promoted by the AENC. This rise in wage growth continued in the early months of 2019 with respect to the revised agreements, i.e. those signed in previous years, posting average increases of 2.2%. The information available about the newly signed agreements is still scarce.

Average compensation per employee continued to be curtailed by a negative wage drift. As in prior years, this is explained mainly by the negative composition effects resulting from the lower wage level of newly created jobs in comparison with

Chart 1.19
COMPENSATION PER EMPLOYEE AGAIN SHOWED MODEST GROWTH

Collectively agreed wages picked up moderately, but the contribution of wage drift to the growth of compensation per employee turned negative again, reflecting, among other factors, the lower pay levels of new employees. Measured in real terms, wages again declined in 2018.



DOWNLOAD

SOURCES: INE and Banco de España.

a The nominal wage is the compensation per employee in the QNA. The nominal wage deflator is the CPI.

those previously existing.[33] In any event, the magnitude of the drift decreased for the second year running and it is expected to continue on this path of moderation in the future.

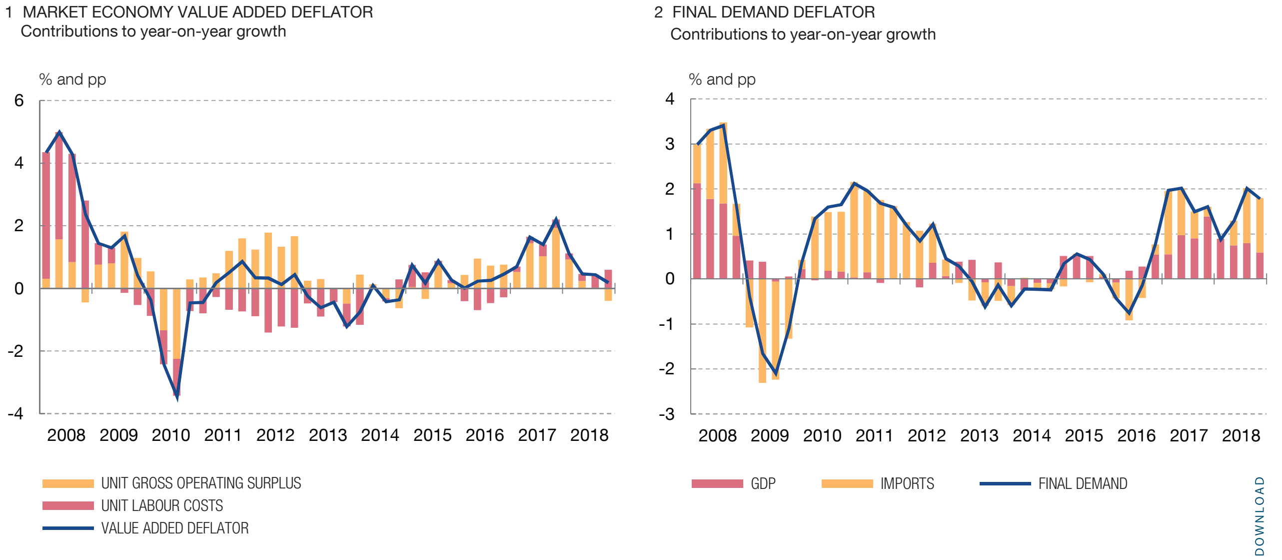
Looking ahead, a more expansive performance of wages is expected to continue. The continuation of economic expansion is translating into a progressive recovery of employment and a gradual widening of the positive output gap which, together with the AENC's recommendations, favours the prospects of ongoing wage increases.

In early 2019 the national minimum wage was increased by 22.3% to €900 (in 14 monthly payments), a much higher percentage increase than any other ever approved previously. The measure will likely affect a much higher proportion of workers than on prior occasions precisely owing to the magnitude of the raise. Specifically, in 2018, 6% of employees received compensation equal to or lower than the national minimum wage in force since 1 January 2019, 22.4% in the case of new entrants in the labour market. This percentage is particularly high in certain population segments (particularly women, young adults, low-skilled workers and employees with a temporary contract). A simulation of the potential impact of this increase on

33 See Banco de España (2018e).

Chart 1.20
DOMESTIC AND EXTERNAL PRICES

The market economy value added deflator again rose slowly, showing a downward trend throughout the year due to the decline in the unit surplus, since ULCs accelerated. The growth of the final demand deflator moderated slightly over the year owing to the slowdown in both domestic and external prices (measured by the GDP and import deflators, respectively).



SOURCES: Eurostat, INE and Banco de España.

the national minimum wage using estimates based on the 8% increase in 2017 suggests that the negative effect on aggregate employment could clearly be higher than that observed on that occasion.[34] Therefore, the impact of the national minimum wage increase should be closely monitored in order to apply, if necessary, appropriate measures to enhance the employability of the workers affected.

Given the continuation of the low rate of increase in productivity, the higher wage increases recorded in 2018 translated into a progressive acceleration of unit labour costs (ULCs). Specifically, ULCs increased in the market economy by 0.6% on average in 2018, and by 1.1% in Q4, thus continuing the rising path of this variable since 2016 (see Chart 1.20). This trend will foreseeably become more pronounced in the future, in a setting of continued low increases in productivity and wage growth rebound.

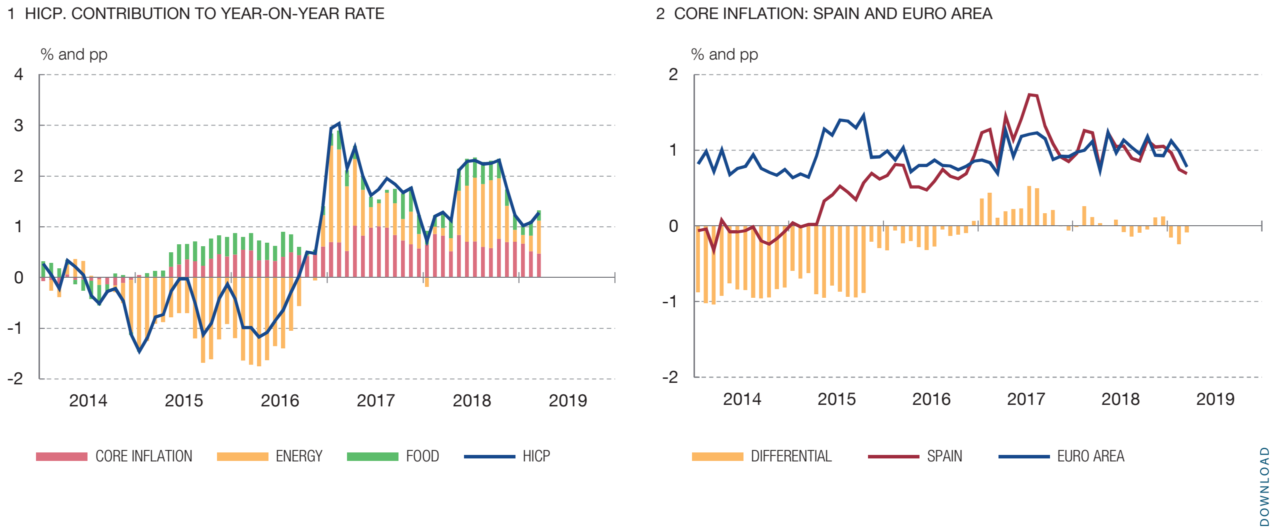
Once again, domestic prices increased at moderate rates. Specifically, the value-added deflator in the market economy, which is a measure of domestic inflationary pressures, slowed by 1 pp to 0.5%. Their increase was therefore lower than that of ULCs, such that business mark-ups posted a small contraction, the

34 See Lacuesta, Izquierdo and Puente (2019).

Chart 1.21

CONSUMER PRICES FLUCTUATED STRONGLY, WHILE CORE INFLATION REMAINED LOW

The annual average rate of the HICP (1.7%) masks strong fluctuations due to oil price shifts. The deceleration in core inflation relative to 2017 was due to the behaviour of the services component, such that the differential with respect to the euro area was zero in annual average terms.



SOURCES: European Commission, INE and Banco de España.

second largest since before the crisis.[35] For its part, the growth rate of the imports deflator was relatively high at 3.1%, very similar to that recorded in 2017 when, as in 2018, its performance was very conditioned by the severe increase in the euro price of oil (higher than 20% in each of these years in terms of annual average rates.

The final demand deflator and consumer prices recorded an acceleration over the course of 2018, which was corrected in the final stretch of the year. As a result of the changes in the external and internal components of the inflationary process, the final demand deflator increased by 1.5% in 2018, 0.3 pp less than in 2017 (see Chart 1.20). Consumer price growth, measured by the rate of change of the Harmonised Index of Consumer Prices (HICP) was, at 1.7%, very similar (and also 0.3 pp lower than in 2017) (see Chart 1.21). In any event, as in the two previous years, this annual average rate masks a trajectory marked by strong fluctuations which were mainly linked to the changes in oil prices. Thus, the slowing path which continued over the course of 2017 ended in January 2018 at a year-on-year low of 0.7%. From then on, the HICP posted increasing rates of growth during most of the past year, a trend which once again reversed from November, in line with the performance of its energy component. In March 2019 the HICP increased by 1.3%.

35 See Banco de España (2018e).

Core inflation remained low, at even slightly lower levels, on average, than those recorded in 2017. Despite the gradual widening of the positive output gap, which *a priori* should have prompted a heightening of domestic inflationary pressures, the rate of change of the underlying component – measured by the HICP excluding energy and fresh food – fluctuated around 1% during 2018, a figure slightly lower than that recorded in 2017, which on average stood at 1.2%. This slowdown was due to the behaviour of the services component, which grew 1.6%, 0.2 pp less than a year earlier. Given the high intensive use of the labour factor in this sector, this development contrasts with the rebound in ULCs. Non-energy industrial goods prices continued posting very modest growth (0.1%), as in 2017. Looking ahead, core inflation is expected to pick up, in line with the gradual widening of the positive output gap and the recent and forecast acceleration of ULCs. In any event, the prospects of an increase in inflation are subject to a high degree of uncertainty owing to the reasons set forth in detail in Chapter 2 of this report.

The inflation differential between Spain and the euro area, measured by the HICP, was zero in annual average terms. In 2017 the differential was 0.5 pp, mainly driven by the rise in the price of crude oil (with a greater impact on final fuel prices in Spain owing to the differences between the two areas in taxes on this product) and higher electricity prices. In 2018 the differential path was highly correlated with the changes in oil prices; it was negative at the start and end of the year and positive in Q2 and Q3. The annual average was zero both in the case of the rate of change of the overall indicator and in terms of core inflation (see Chart 1.21).

4 Some factors responsible for prolonging the current upturn

4.1 The key drivers of the recovery

Various processes set in motion in the first half of the present decade prompted the current recovery. First, the private sector has reduced its level of indebtedness significantly since 2010. As a result, the debt-to-GDP ratio of households and non-financial corporations had fallen by around 70 pp by the end of 2018, to stand somewhat below the euro area average, giving rise to a notable improvement in the financial position of these agents. Second, the Spanish banking system has undergone major restructuring. Capacity adjustment, along with reductions in non-performing assets, has had a positive impact on the capital ratios and income statements of credit institutions. Finally, although Spain's negative net international investment position remains high, it has been reduced by the external surpluses of the last six years, a notable development given the external deficits that have characterised previous cyclical upswings.

A set of policies adopted at both European and national level since the start of the current decade has reformed the institutional architecture of the euro area and driven the Spanish economic recovery. As regards the European institutional framework, the creation of the European Stability Mechanism (ESM), an instrument to resolve financial crises in the euro area, and the launch of the European Banking Union and the Single Supervisory Mechanism (SSM) and, subsequently, the Single Resolution Mechanism (SRM) were significant steps. The ECB also took relevant action to reduce segmentation in financial markets. At national level, the commencement of fiscal consolidation and the successive reforms to the pension system to ensure its long-term sustainability were notable. In the labour market, hiring was made more flexible and measures were introduced to foster the adjustment of working conditions to employers' circumstances, which helped improve their competitiveness and assisted the recovery in employment.

In addition to these factors, demand policies and certain factors of a more temporary nature, the so-called tailwinds, increased the strength of the recovery. As regards demand policies, the ECB has since 2012 deployed a broad set of standard and non-standard instruments in order to make its monetary policy stance highly expansionary. Turning to fiscal policy, from 2015 it ceased to be contractionary, so that the deficit reductions since then have basically reflected the cyclical improvement in the economy and the reduction in interest expenditure. The fall in oil prices in 2014-2015 and the favourable developments in external markets in 2017 were important additional external stimuli during the recovery.[36]

Together, these factors have enabled the Spanish economy to grow in 2018 for the fifth consecutive year at above its potential rate. Activity, as measured by real GDP, now exceeds its pre-crisis peak (of 2007) by 4.3% and the process of convergence with average euro area per capita income levels has been resumed. However, despite strong job creation since 2014, the level of employment is still 1.4 million lower than in 2008 and the unemployment rate remains very high.

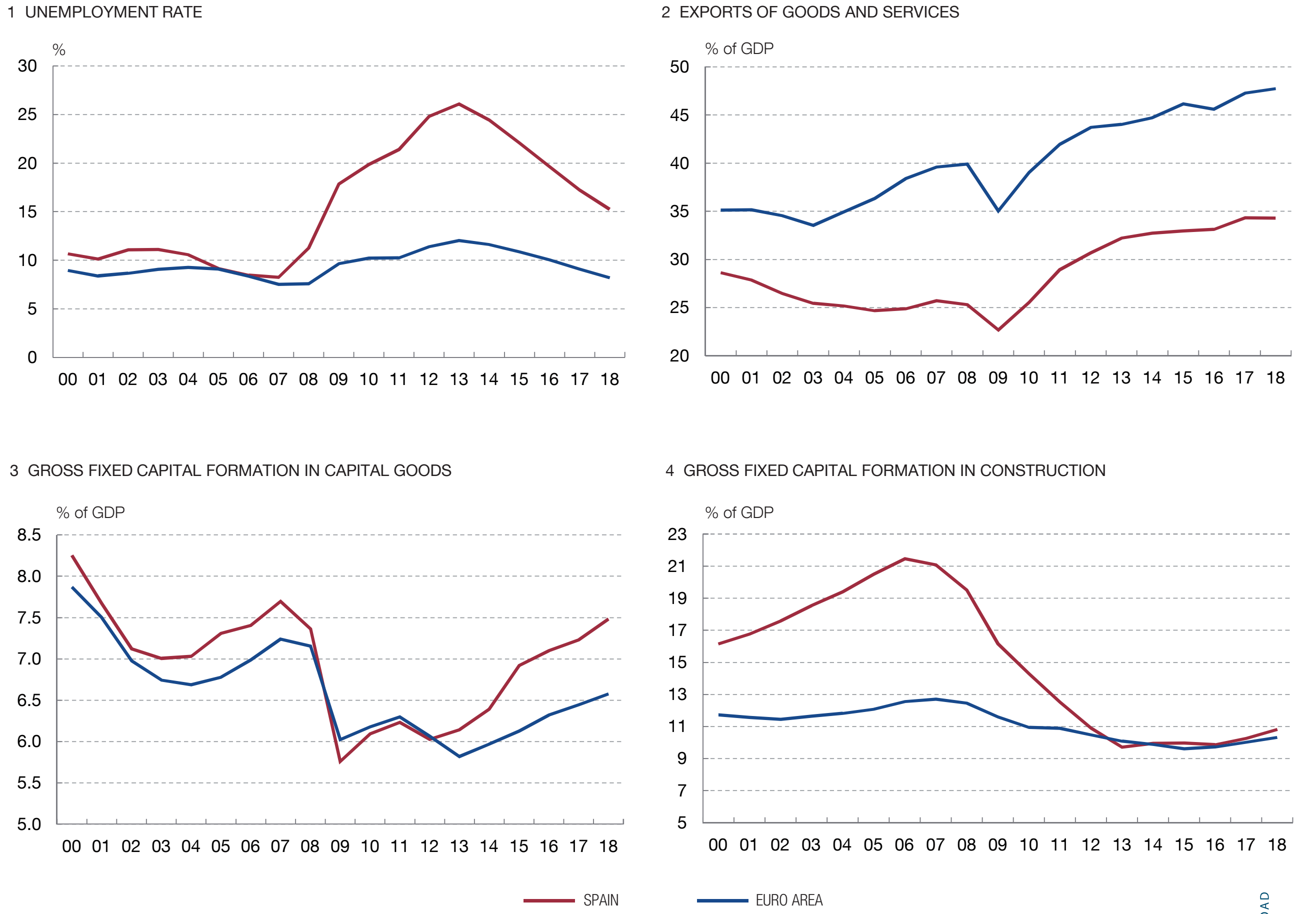
During the recovery, the foundations have been laid for more balanced growth, with the consequent improvement in resilience to future shocks. The combination of all the above-mentioned factors facilitated the recovery in the confidence of economic agents in the euro area as a whole and, in particular, in Spain, which suffered a more severe recession than on average in the main euro area economies. Since 2013, aggregate demand has grown at a higher rate in these other countries and the high unemployment rate has been reduced very significantly. Moreover, the productive structure has undergone a notable transformation, with a significant increase in the weight of exports and equipment investment in GDP and a reduction in that of construction (see Chart 1.22).

36 For a quantification of the tailwinds in 2014-2016 see Banco de España (2017a).

Chart 1.22

THE SPANISH ECONOMY HAS LAID THE FOUNDATIONS FOR MORE BALANCED GROWTH

The high unemployment rate is decreasing significantly, the weight of exports in GDP has risen by more than 10 pp since the crisis, investment in capital goods has recovered more strongly than in the euro area as a whole, and the weight of investment in construction is in line with that of the other EU countries.



DOWNLOAD

SOURCES: Eurostat, INE and Banco de España.

However, the deterioration in the external environment during 2018 and at the beginning of 2019 is having a negative effect on the pace and, above all, the composition of aggregate demand. As seen in Section 2, global trade and activity weakened last year, while in the euro area various idiosyncratic shocks have affected certain sectors and countries and had a negative impact on the confidence of agents. In Spain, as seen in section 3, the slowdown in trade, the appreciation of the exchange rate and the reduced strength of tourism flows led to a reduction in the current account surplus.

Also, there are certain external sources of uncertainty which suggest that the scenario of ongoing recovery is subject to downside risks. The projections made by the Banco de España in March considered the recent slowdown in the euro area to be a temporary phenomenon that would be reversed in the second half of the year.[37] However, the recent slowdown may be more persistent.[38] Moreover, the lack of details regarding the conditions of the United Kingdom's departure from the EU, the possible adoption of new protectionist measures at global level or a possible misstep by the Chinese authorities in the process of correcting the Chinese economy's indebtedness could give rise to unfavourable developments.

On the domestic front, the need for structural reforms to help increase the economy's potential growth persists. The last five years have been characterised by the practical absence of significant measures to take over the burden from the expansionary demand policies of recent years. Also, the application of the main elements of the 2013 public pension system reform designed to shore up its sustainability was suspended in 2018, without, to date, any alternative mechanisms having been put in place to do this.

The achievement of more sustainable and balanced growth must be a priority economic policy objective. At European level, it is necessary to press ahead with the creation of common instruments to strengthen the resilience of the euro area as a whole to future shocks. Domestically, in the currently more uncertain environment and, given the tailing-off of the stimulus provided by demand policies and other temporary factors, greater emphasis should be placed on the application of policies designed to lay the foundations for more sustainable and balanced growth (see Figure 1.1). The following sections address some key domestic and European policies that could contribute to this objective.

4.2 Towards a more sustainable and balanced recovery

4.2.1 Employment quality, wage inequality and housing

Since the start of the recovery employment growth has been very strong and has generated 2.5 million jobs, in net terms. These developments reflect a fall in the rate of job destruction, following its sharp increase during the crisis, and a gradual recovery in the rate of job creation. During this period, job creation has generally been more buoyant in services, as in the last upturn, particularly in activities relating to hotels and restaurants, transport and property. Also, although the level of employment in construction is still well below its pre-2008 level, it has recovered strongly since 2014. Thus, there do not appear to be significant sectoral composition

37 See Banco de España (2019a).

38 in this respect, the latest data as of the cut-off date of this report seem to give some support to the view that the slowdown is temporary in nature.

Figure 1.1

ECONOMIC POLICIES TO PROLONG THE CURRENT GROWTH PHASE OF THE SPANISH ECONOMY

AIM: TO REDUCE VULNERABILITIES, TO INCREASE ROOM FOR MANOEUVRE IN THE FACE OF HYPOTHETICAL FUTURE SHOCKS

Increase in global risk

— Threat of new protectionist measures
— Effects of Brexit
— Difficulties to redirect high debt levels in some countries (China, some emerging market countries)

Vulnerabilities

— Public debt verging on 100% of GDP
— High external debt

To reduce risks: policies that reduce vulnerabilities

- Spain:
  — Need for reforms to boost potential growth (maintaining the existing reforms)
  — Correction of fiscal imbalance
- Euro area: deepening of institutional architecture to permit risk-sharing and risk-mitigation

POLICIES FOR A MORE SUSTAINABLE AND BALANCED RECOVERY

Recovery to benefit society as a whole

— More and better quality employment (reducing temporary and involuntary part-time employment)
— Measures encouraging the supply of rental housing

Sustainability of public finances

— Medium-term fiscal consolidation programme
— In-depth review of composition of public revenue and expenditure

Addressing population ageing

Measures should be aimed at:
— Guaranteeing sustainability of public pension system
— Preserving intergenerational equity (which requires careful design in terms of revenue and expenditure)

Productivity growth

— Correction of educational system shortcomings
— Generation and dissemination of technological advances
— Review of regulations that curb competition

Challenges facing banking sector

— Improve asset quality and return on equity
— Strengthen capital levels
— Adaptation to technological changes

Institutional consolidation of euro area

— Complete Banking Union
— Create a risk-sharing budgetary instrument
— Provide a pan-European safe asset

SOURCE: Banco de España.

effects that would explain the low productivity growth, similar to that observed in the last upturn (see Box 1.3).

Job creation during the recovery has taken place against a background of wage moderation. The growth of compensation per employee in the market economy, in nominal terms, has been very low since 2013. During the initial phases of the recovery, wages were flat, while, in recent years, it has been possible to observe a rising trend, to 0.6% and 1% in 2017 and 2018 respectively. Moderate wage growth over the period considered as a whole can be explained by the high level of unemployment and the general under-use of labour (when broader indicators of cyclical labour market slack are taken into account), the low level of inflation and meagre productivity growth.[39] As a result, in real terms, wages fell by 0.8 pp in 2018 (see Chart 1.19).

Wage formation patterns during the current upswing have been comparable to those in previous cyclical growth phases. The measures included in the 2012 labour reform expanded the set of firm-level instruments available to employers to adjust wages and other employment conditions. Thus, in 2012 and 2013 there was a larger than expected downward wage adjustment, as firms in difficulty made extensive use of the various approved flexibility measures, including unilateral changes in employment conditions. This was conducive to an increase in the sensitivity of wages to economic conditions.[40] During the recovery, however, wage formation patterns remain in line with those in previous cycles. In particular, although there is a high degree of dispersion in productivity across firms and sectors, the level of heterogeneity in wage developments is low, indicating the lack of decentralisation in collective bargaining, despite the regulatory changes made (see Chart 1.23).

Among the structural deficiencies of the Spanish labour market the high level of unemployment and, in particular, of long-term unemployment continue to be notable. Robust job creation has reduced the unemployment rate by some 12 pp from its all-time high at the beginning of 2013, to 14.7% of the labour force in 2019 Q1 (see Chart 1.10). Unemployment is especially severe among the youngest workers (with a rate of over 25% for the under 30s) and among those with the lowest level of educational attainment (28%). Along with the over-55s, these are the groups of the population in which long-term unemployment is largely concentrated. The decline in the general level of unemployment since the beginning of the recovery has not prevented a situation in which 45% of the unemployed have currently been searching for a job for more than a year and 31% for more than two years.

---

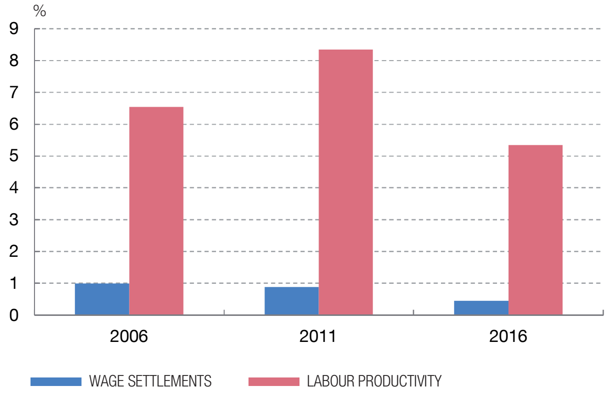
39 See Cuadrado and Tagliati (2018) and Chapter 2 of this Report.

40 See Font, Izquierdo and Puente (2015).

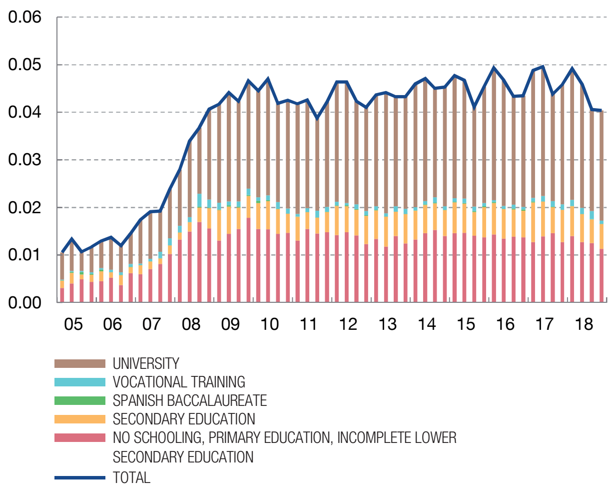
Chart 1.23
THE STRUCTURAL WEAKNESSES OF THE LABOUR MARKET PERSIST

The dispersion of wage settlements per economic sector is much lower than that of productivity. The mismatch between the skills of unemployed persons and those required by firms remains very high.

1 DISPERSION OF WAGES AND PRODUCTIVITY GROWTH BY ECONOMIC SECTOR (a)



2 MISMATCH INDEX



DOWNLOAD

SOURCES: Eurostat and Banco de España.

a Standard deviation of the annual growth rates of each variable. NACE Rev. 2 two-digit sectors.

The excessive use of temporary hiring is another serious dysfunctionality of the Spanish labour market. In 2018, more than 22 million contracts were signed, of which almost 90% were temporary. The proportion of temporary employment at the end of 2018 (26.9%), is below the level observed in the last upturn (32.6% on average between 2002 and 2007), especially in the private sector, but already stands almost 5 pp above the cyclical trough of 2013. This increase reflects patterns of hiring and dismissal that have hardly changed from those seen in the last cycle, insofar as new hires and dismissals are basically concentrated in the group of workers with temporary contracts.[41] That said, it should be mentioned that the latest developments in this area are relatively positive, since the temporary employment ratio fell slightly in the private sector in 2018 and the increase that year was exclusively due to its rise in the public sector. At the same time, there has been some pick-up in flows from temporary to permanent employment. The reduction in the temporary employment ratio in Spain to levels comparable to those in other European countries would require new regulatory measures to increase the attractiveness to employers of permanent hiring, while providing the necessary flexibility to adjust labour costs in the event of negative shocks and thus avoid excessive job destruction in recessions (see Box 1.3).

41 See Banco de España (2019d).

The employment growth in recent years has reduced indicators of wage income inequality, although levels of disparity in total income are still at relatively high levels. In the period 2014-2017, inequality in terms of labour income decreased significantly. This is because the increase in this type of income was higher for low-wage groups, which is in turn the result of a relative increase in the number of hours actually worked by these agents, since there have been hardly any changes in hourly wages. However, new temporary contracts continue to have a very short duration and involuntary part-time working remains at high levels (specifically 54% of all employees working part-time on average in 2018, down 9 pp from its high in 2014, but still well above its level in 2007, of 32.3%). In terms of total income, developments have been less favourable, given the persistence of unemployment (which is naturally concentrated in the lower part of the household income distribution) and the fall in the coverage rate of total benefits (contributory, non-contributory, re-insertion income, etc.), to 58% of all the unemployed (as against 80% in 2010). In addition, despite the recent increase in pensions, the notable recovery in income from (financial and non-financial) assets, which largely affects the medium-high part of the income distribution, has tended to increase the disparity between the incomes of agents whose income arises from other non-wage income during the recovery. As a result, on data to 2017, the diverging trend in wage and non-wage income in recent years has meant that the inequality of total income per capita barely changed during the initial phases of the economic recovery see Box 1.4).

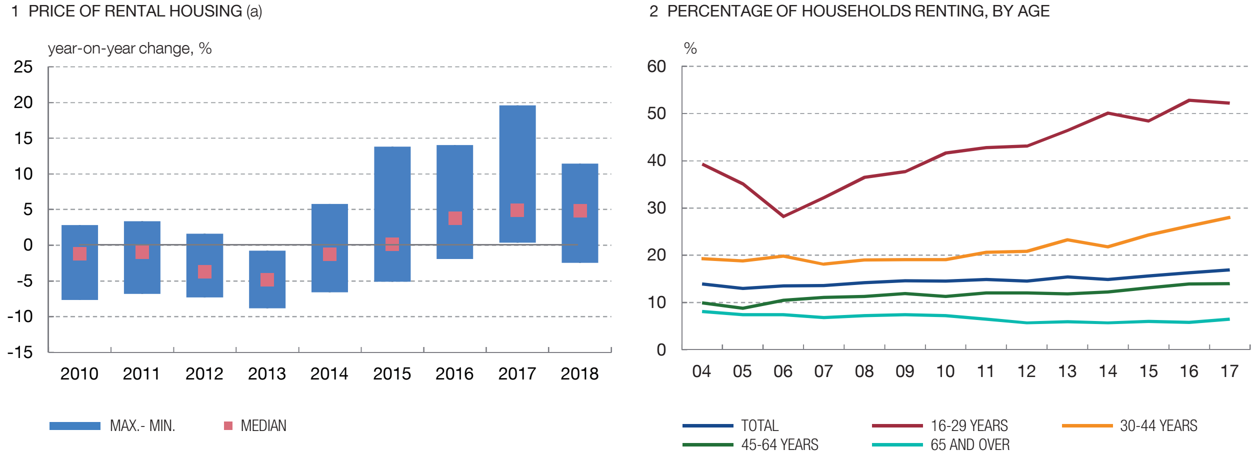
To reduce the rate of unemployment and per-capita income inequalities, it is crucial to improve the employability of the most disadvantaged groups. Among those who have not completed compulsory secondary education, the probability of being unemployed has fallen by 4.5 pp over the last four years. The reduction has been somewhat greater (7 pp) among those who did complete their compulsory education. Even so, the mismatch between the skills of the unemployed and those required by employers (approximated by the skills of employed persons) is at very similar levels to those reached during the crisis (see right-hand panel of Chart 1.23). In this respect, improving the human capital of unemployed persons with the lowest level of educational attainment is key to facilitating their reinsertion into the labour market. For this purpose, it would be desirable to maintain training contracts, with the greatest possible flexibility for young people and employers, and to assign funds to redesigning vocational training, as regards the combination of general training and work experience in industry, in order to facilitate the transition from education to the labour market. Finally, it is important to direct hiring incentives towards older job-seekers and those with low educational attainment, and to continuously evaluate their effectiveness so that their least satisfactory aspects can be redesigned.

Conditions of access to the housing market have tightened somewhat recently, particularly in the rental market. Also, access to housing is constrained to a greater extent by excessive labour market turnover and unemployment, which affect

Chart 1.24

THE LABOUR PROBLEMS OF CERTAIN GROUPS ARE AGGRAVATED BY HOUSING AFFORDABILITY

New rental contract prices have risen unevenly across municipalities in the recent expansion (in some places by more than 50%). Behind these developments lies an increase in the relative rental demand which could not be satisfied by changes in supply. Those most affected are young people, the less qualified groups and foreign nationals living in the cities with the fastest growing populations.



DOWNLOAD

SOURCES: INE (Survey of Income and Living Conditions), Idealista and Banco de España.

a Year-on-year change in price per square metre in December.

some groups of workers, such as the young, more than others. In 2014 (the latest available data), the median expenditure on rent as a proportion of the income of renting households in the lowest income decile was over 50%. Since that year, the increase in rents has been large, although this is not reflected in the growth of the consumer price index (CPI) for rents, the moderate growth of which (average annual rate of 2.2%) is explained by the fact that this index does not include information on additions to the stock of rented housing. Other statistical sources, with greater coverage of newly signed agreements, have recorded substantially higher growth, albeit with a high level of heterogeneity at the local level (see Chart 1.24). For example, according to the property portal with the greatest national coverage, the prices at which properties are offered for rental display a very geographically uneven pattern, growth since 2014 having been especially high in Barcelona and in Madrid (38% and 42% respectively).[42] These developments are relevant when analysing the difficulty certain groups have accessing housing and the delay in the age at which young people leave the family home (see Chart 1.24).[43]

In this context, priority should be given to those public policies that aim to boost the supply of rented housing. In this respect, it would not seem to be

42 See Alves and Urtasun (2>019)

43 Se Barceló and Villanueva (2018)

appropriate to limit the price of rented housing. According to international evidence, rent restrictions not only reduce supply, but also may lead to a significant deterioration in rented properties. Likewise, it would be desirable to improve legal certainty so that property owners have appropriate incentives to offer their properties on the rental market.[44]

4.2.2 Public finances: the fiscal consolidation required and the challenges posed by population ageing

No significant progress has been made in reducing the structural public deficit since 2015. The general government deficit stood at 2.5% of GDP in 2018, below the limit of 3% of GDP, which would appear to confirm a scenario of exit from the excessive deficit procedure (EDP) that general government has been subject to since 2009, within the framework of the corrective arm of the EU's Stability and Growth Pact (SGP). That said, the structural deficit, according to Banco de España estimates, was at a similar level to recent years, which indicates that practically the whole of the reduction in the budget deficit during the recovery has been due to the effect of the business cycle and the reduction in the interest burden; the average cost of public debt stood at an all-time low of 2.5% in 2018 (see Chart 1.25). Likewise, although the government debt ratio remained on a path of gradual decline in 2018, reaching 97.1% of GDP, this reduction was basically due to the economy's favourable nominal growth performance. Moreover, the government debt ratio remains close to its all-time high and well above 60%, the reference value in the current framework of European fiscal rules and in the Organic Law on Budgetary Stability and Financial Sustainability (see panel 2 of Chart 1.25).

If the EU Council confirms, as it is expected to in July, that the situation of excessive deficit has been corrected, then Spain would automatically move to the so-called "preventive arm" of the SGP. In this new situation, Spain would remain subject to a set of rules restricting its fiscal policy action. First, the structural government deficit would have to be reduced in general terms by 0.5 pp of GDP each year until the medium-term objective of structural balance is achieved.[45] Second, the public debt-to-GDP ratio, while above the objective of 60%, would have to be reduced annually by 5% of the excess over 60%, which would involve on average a reduction of 1.5 pp of GDP each year for the next decade. Finally the annual growth rate of general government expenditure would have to be less than or equal to the economy's medium-term potential growth rate. According to the

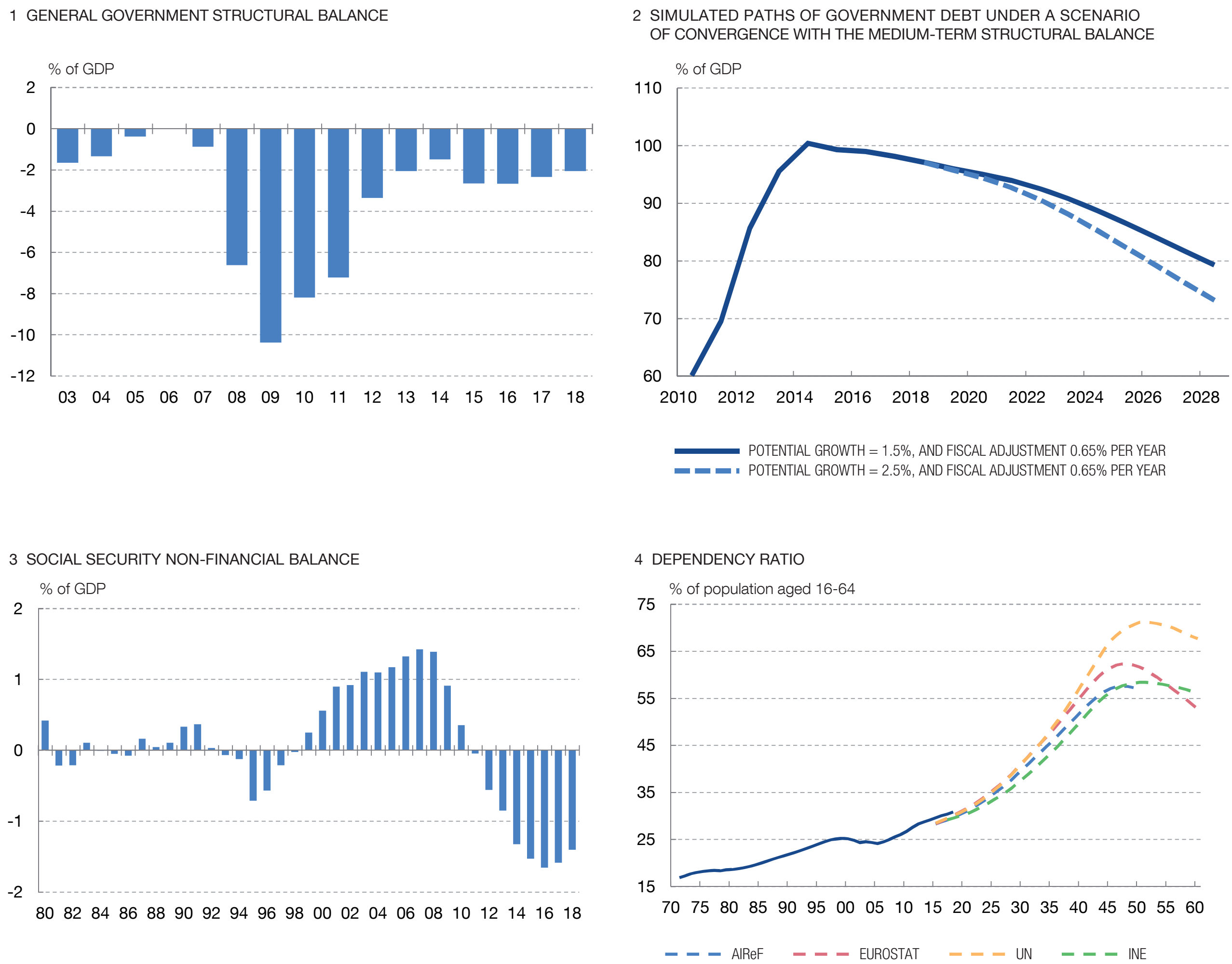
44 See López and Matea (2019). (Forthcoming)

45 The requirement to reduce the structural deficit by 0.5 pp is a general reference, which in practice varies for each country according to whether it has achieved its medium-term objective, whether the debt ratio exceeds 60% of GDP and the size of the output gap.

Chart 1.25

IT IS URGENT TO ENSURE THAT THE PUBLIC FINANCES ARE SUSTAINABLE

It is necessary to correct the high government deficit, the structural deficit and the government debt ratio above the reference value of 60%. In addition, the Social Security System has posted significant deficits since 2011 and its revenues and expenses have to be reformed to address the progressive population ageing.



SOURCES: Autoridad Independiente de Responsabilidad Fiscal, Eurostat, United Nations, INE, Social Security system and Banco de España. The chart on debt simulation was prepared 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 Scenario of maximum annual fiscal effort (change in structural balance) of 0.65 pp per year, until the medium-term target has been achieved (structural balance = 0).

DOWNLOAD

European Commission, this set of rules would entail a requirement for 2019 of a reduction in the structural government deficit of 0.65 pp of GDP.[46]

Consequently, foreseeable application of the preventive arm of the SGP will require a considerable fiscal effort in the coming years. To assess the impact of

46 See Commission Opinion of 21.11.2018 on the Draft Budgetary Plan of Spain.

these requirements, Chart 1.25 shows various hypothetical scenarios illustrating the effect of compliance with these rules on the public debt-to-GDP ratio over the next decade, obtained from a model simulating the dynamics of this variable.[47] Specifically, achieving this target would require an average primary surplus of 1.5% of GDP, as against the primary balance of 2018, which would reduce public debt to slightly below 80% of GDP in 2028. GDP growth 1 pp higher, on average, than in this scenario would, keeping the rest of the assumptions unchanged, result in a public debt-to-GDP ratio of less than 75% by 2028.

In the context described, a medium-term programme for the correction of fiscal imbalances needs to be designed. A lasting reduction in the structural public deficit and general government debt would help to provide scope for fiscal policy to react to the consequences of a possible slowdown in activity and limit the impact of a hypothetical rise in the cost of financing for public and private agents. Such a strategy should be based on a detailed definition of budgetary targets and of the time frames and measures needed to achieve them, as well as a prudent projection of macroeconomic developments and a rigorous plan for early response in the event of deviations from target. In this respect, on 30 April, the government presented the Stability Programme Update for the period 2019-22. Given the national elections at the time, this update was based on the assumption that economic policies would remain unchanged. However, the caretaker government indicated some of the actions it planned to take in relation to taxation and pension spending in the next few years.

A review of the composition of government spending and revenue, in parallel with the necessary reduction in public debt, could contribute to economic growth. The process of reducing fiscal imbalances should be compatible with an improvement in the quality of public finances. In this respect, the composition of the revenue and expenditure adjustment is very important to minimise the adverse effects of fiscal consolidation on economic growth. A prerequisite for such an improvement is an in-depth analysis of the structure of general government spending and revenue. On the expenditure side, there seems to be scope for further efficiency gains and for a shift in composition towards items that have a greater impact on the accumulation of physical, technological and human capital. The results of the public spending review currently under way may be fundamental for progress in this regard.[48] On the revenue side, there is also scope to redefine the structure of the

---

47 See P. Hernández de Cos, D. López-Rodríguez and J. J. Pérez (2018), The challenges of public deleveraging, Occasional Papers,1803, Banco de España. The model takes the observed level of public debt and the structural government deficit estimated by the European Commission for 2018 as given and assumes average nominal economic growth over the next decade of 3% and implicit interest rates on public debt of 2.5%.

48 On 2 June 2017 the Council of Ministers requested the Independent Authority for Fiscal Responsibility (AIReF) to carry out a review of public spending, starting with a review of spending on subsidies, the results of which are to be published shortly.

basket of taxes in order to make it more favourable to potential growth.[49] In this context, an important aspect that could be reconsidered is the current high level of fiscal benefits, arising from the presence of numerous exemptions, deductions and special reduced rates which generate significant revenue losses and distort the efficiency and equity of the tax system.[50]

A review of regional government financing arrangements is also a priority. In such a decentralised administrative structure as exists in Spain, the involvement of regional and local government in the budget consolidation effort is essential. In this respect, there is broad consensus on the need for reform of the financing arrangements for these tiers of government, in order to adjust revenue, on the basis of an objective estimate of needs, to ensure that the distribution of resources is transparent and to increase the degree of joint fiscal responsibility.[51]

The high level of public debt raises some significant challenges. Empirical evidence shows that maintaining a very high level of public debt over a prolonged period can have a negative impact on economic growth. Also, a high level of debt reduces the stabilising capacity of fiscal policy in adverse situations and requires primary surpluses over lengthy periods, which may in turn require higher levels of distortionary taxation or lower levels of productive expenditure. At the same time, a high level of debt increases the vulnerability of the public finances to changes in investor sentiment on the financial markets, given the need to regularly roll over a large volume of maturities. Thus, for example, general government as a whole issued a total of €212 billion (17.5% of GDP) of debt in 2018.

Population ageing will have a very pronounced effect on public finances. The importance of the reduction in budgetary imbalances and public debt is all the greater when the long-term challenge of population ageing is taken into account. The latest estimates anticipate a significant increase in public spending on pensions, health and long-term care arising from the substantial increase in the dependency ratio (see Chapter 4), which even in the most optimistic demographic projections would rise from the current level of 25% to more than 50% by the middle of the century (see Chart 1.25).

To guarantee the sustainability of the public pension system, significant measures are required that will foreseeably affect both revenue and expenditure. As seen in Chapter 4 of this report, demographic trends pose significant challenges for the sustainability of the welfare state. In the case of the

49 For an in-depth discussion of the Spanish tax system see López-Rodríguez and García Ciria (2018).

50 On 14 December 2018 the Council of Ministers requested the AIReF to carry out the second phase of the public spending review, focusing on fiscal benefits and spending on hospitals.

51 See Ministerio de Hacienda y Función Pública (2017).

pension system, the 2011 and 2013 reforms included certain adjustments to significantly counteract the effect of the expected increase in the dependency ratio in the long term.[52] However, the latest measures in this area have partially suspended the application of these mechanisms, by postponing the application of the sustainability factor until 2023 and returning to a system of annual pension increases in line with the CPI. The reintroduction of this indexation system on a permanent basis would generate, according to the Banco de España's calculations, a further increase in spending of more than 3 pp of GDP in 2050.[53] Against this background, ensuring the financial sustainability of the public pension system will require additional measures on both the revenue and expenditure side, as well as the introduction of new incentives to favour greater alignment between the effective retirement age and the legal reference.

Population ageing will also put to the test intergenerational equity and the intertemporal sustainability of total public revenue and expenditure. As also explained in Chapter 4 of this report, population ageing raises a number of additional challenges for fiscal policy that must be taken into account within the framework of the above-mentioned strategy to improve the quality of public finances. As regards public spending, societies with older populations require greater social expenditure (for example, on health and pensions) directed at the eldest population groups. This increase in ageing-related expenditure may be at the expense of the expenditure needed to boost the economy's future dynamism, such as that on education or infrastructure investment. On the revenue side, in the absence of changes to the current design of the main taxes, population ageing leads to lower receipts from social contributions (given the lower weight of wage-earners) and a certain loss of progressivity and of revenue-raising capacity for the personal income tax, given the lower effective rates paid by older taxpayers. Moreover, the latter have a higher proportion of unearned income, which is taxed at lower rates than employment income. In addition, it should be noted that indirect tax receipts may also be reduced, insofar as the elderly tend to consume goods and services typically taxed at lower effective rates. Finally, the greater expenditure associated with ageing, especially when financed through borrowing, may lead to an increase in the taxation of younger generations, raising important issues of intergenerational equity.

4.2.3 Productivity: the key to a sustainable increase in well-being

Throughout the current recovery phase, competitiveness gains have arisen mainly from adjustments in labour costs, while genuine productivity gains

52 Véase Hernández de Cos, Jimeno y Ramos (2017).

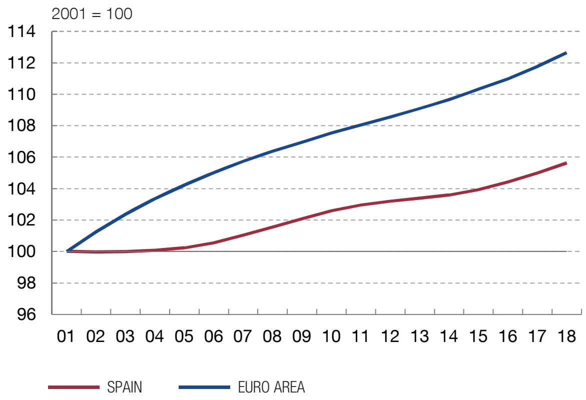
53 Véase Banco de España (2018o).

Chart 1.26

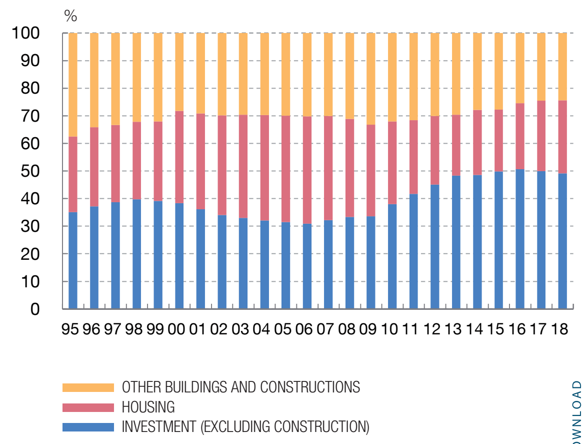
MORE BALANCED RECOVERY, BASED ON PRODUCTIVITY IMPROVEMENTS

In the recovery, total factor productivity grew by 0.4% in annual average terms (2013-2018),and, as a result, the productivity differential with respect to the euro area widened, albeit more slowly than in the previous expansion. Factors of production were reallocated to more productive projects, which is consistent with the higher weight of total investment accounted for by investment in capital goods and intangibles.

1 TOTAL FACTOR PRODUCTIVITY



2 STRUCTURE OF GROSS FIXED CAPITAL FORMATION



DOWNLOAD

SOURCE: INE, European Commission and Banco de España.

have been more modest. Competitiveness lost relative to the other euro area countries in the previous expansionary phase (measured through relative unit labour costs) was restored, in the initial stages of the crisis, through severe job destruction, but in subsequent stages through wage moderation. Accordingly, although some progress has been observed in total factor productivity (TFP) since the onset of the crisis, there is still no well-established growth model fostering activities with high productivity levels and high value-added. Thus, on European Commission figures, TFP rose by 0.4% in Spain in annual average terms between 2013 and 2018, compared with growth of 0.6% in the euro area. In consequence, the productivity gap in terms of TFP between Spain and the rest of the euro area countries, observed since the launch of the single currency, has continued to widen, albeit at a slower pace (see Chart 1.26).

The modest productivity growth in recent years stems mainly from a shift in investment towards business projects with higher technology content. The low productivity momentum in aggregate terms that characterised the Spanish economy from when it joined the euro area up to the start of the crisis was essentially the result of a composition effect, with the allocation of resources biased, especially in the case of investment, towards projects with low productivity levels. In the most recent period, the firms that have used the largest share of the resources available in the economy are those with higher productivity levels, so the above-mentioned composition effect would now be working in favour of higher aggregate productivity.[54] Indeed, since 2013 investment in capital goods and intangible assets has grown as a proportion of total investment (by more than 4 pp), to the detriment of investment in real estate assets (see Chart 1.26).

Part of that positive reallocation of factors stems from the destruction of firms with low productivity levels. According to the Central Companies Directory (DIRCE), fewer new firms have been created during the recovery than during the earlier growth phase, while the number of firms destroyed remains high, reflecting the disappearance of firms with low productivity levels. Since the crisis, the number of firms in the industry and construction sectors has decreased; this has been partially offset by the increase in the number of firms created in the services sector. In any event, this less dynamic business environment in net terms, which is not unique to Spain but is also observed in other developed economies, could be associated with an increase in the market power of certain companies in some sectors.

There continues to be no significant surge in the average productivity of Spanish firms. Specifically, this variable is 10% to 40% lower than the average productivity of European firms, with a wider gap among smaller firms (see Chart 1.27). In addition, the differences –which are especially notable in the services sector – remain even taking into account the sectoral composition of the Spanish economy.[55]

As a result of the improvement in human capital in the Spanish economy the gap with the rest of Europe has narrowed, but it remains large in terms of technological capital. The economic literature identifies the presence of a human and technological capital deficit as one of the main determinants of low average productivity levels at firms.[56] In recent years, educational attainment levels have improved markedly, as a result of the generational shift and the fact that, following the crisis, young people have acquired more education. However, despite this convergence towards the EU average in terms of human capital stock, the Spanish education system still faces key challenges, such as the high proportion of early leavers from education and training (18.3% between 18 and 24 years). Moreover, this educational improvement has still not passed through to technological capital. Indeed, investment in R&D activities is still very low both in the public and the private sector (0.8% and 1.4% of GDP, respectively, in 2016), which means that the technological capital gap with the EU has continued to widen (see Chart 1.27). Lastly, the structural weaknesses of the labour market referred to in section 4.2.1 – especially the marked dual structure between temporary and permanent contracts – place a constraint on productivity growth, insofar as the high proportion of

---

54 See Banco de España (2017b), and Fu and Moral-Benito (2018).

55 See Banco de España (2016b).

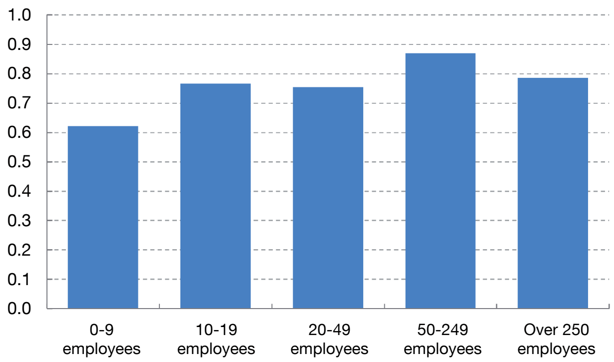
56 See Schivardi and Schmitz (2018) for evidence in southern European firms.

Chart 1.27

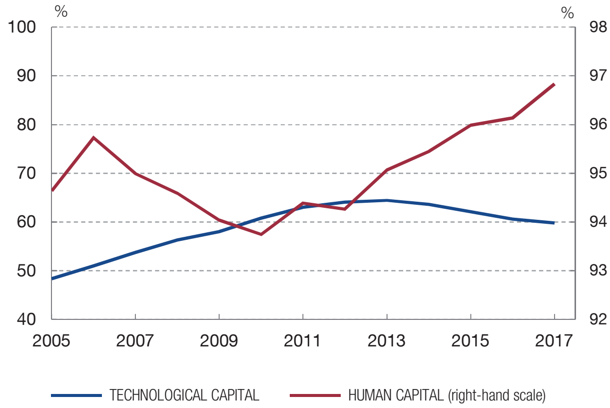
THE AVERAGE PRODUCTIVITY OF SPANISH FIRMS, EVEN THE LARGE ONES, IS LOW

The average productivity of Spanish firms is lower than that of French, German and Italian firms, whatever the size. This is partly because of Spanish firms' lesser human capital and technology. Although the crisis spurred convergence in the former factor, there continues to be a significant deficit in the latter.

1 SPANISH COMPANIES' RELATIVE PRODUCTIVITY (a)



2 SPANISH HUMAN AND TECHNOLOGICAL CAPITAL FOR EU-19 (b)



SOURCE: Eurostat.

a Apparent productivity ratio between Spanish firms and the average in France, Germany and Italy (average = 1). Year of estimate: 2016.

b The technological capital series are obtained by accumulating the flow of expenditure in R+D by the economy. The depreciation rate used is 15%. The deflator used is that of GFCF in capital goods. The human capital time series can be interpreted as the equivalent percentage of the working-age population with tertiary education [see S. Puente and M. Pérez (2004), "Las series de stock de capital humano y tecnológico en los indicadores de convergencia real", *Boletín Económico,* December, Banco de España].

DOWNLOAD

temporary employment has a negative impact both on workers' and firms' decisions to invest in human and technological capital.[57]

4.2.4 The banking sector's challenges

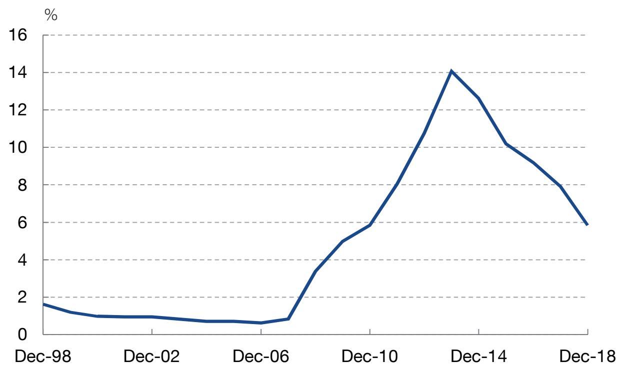
The process of strengthening the financial position of the Spanish banking sector continued in 2018 in terms of both the quality of its portfolio and profitability, although the CET1 capital ratios continue to be the lowest in the euro area. The recovery of asset quality was notable, with a decrease in the volume of NPLs to the resident private sector of 29% in 2018 which led to a decline in the NPL ratio by 2.1 pp to 5.8% (see Chart 1.28). The amount of foreclosed assets declined by more than 30%, to a total volume of €43 bn. The average return on equity rose 1.2 pp, up to 7.3% in December 2018, mainly driven by a reduction in impairment losses associated with an improvement in asset quality (see Chart 1.28). The common equity Tier 1 (CET1) capital ratio decreased by 43 bp in the past year to 12.2%, although this change is largely explained by the disappearance of the

57 See Dolado, Ortigueira and Stucchi (2016) on the effect of temporary employment on TFP growth at Spanish firms, or Albert, García-Serrano and Hernanz (2005) on the impact on training decisions.

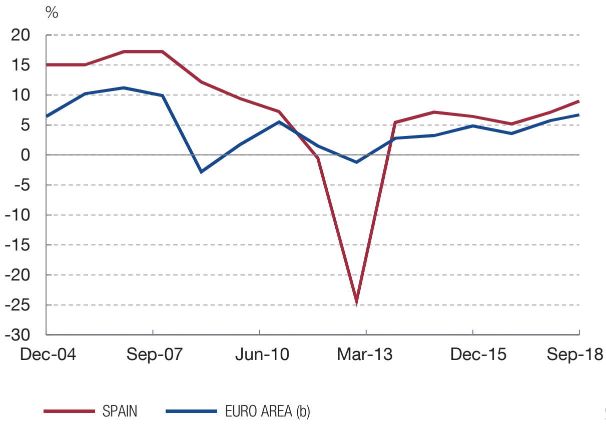
Chart 1.28
ASSET QUALITY AND PROFITABILITY OF DEPOSIT-TAKING INSTITUTIONS

The non-performing loans ratio grew sharply between 2008 and end-2013, when it started to decrease gradually. Nevertheless, at present it is still well above the levels before the crisis. The average profitability of the Spanish banking sector, expressed as ROE, has been recovering in recent years and now stands above the average for the euro area, albeit below its pre-crisis level.

1 RESIDENT PRIVATE SECTOR NON-PERFORMING LOANS RATIO
Individual data. Business in Spain



2 ROE (a)
Consolidated data



SOURCES: Banco de España, ECB and BIS.

a Until 2016, data taken from a report by the BIS Committee on the Global Financial System *(Structural changes in banking after the crisis)*. Data for 2017 and September 2018 drawn from the ECB *(Consolidated Banking Data)*.
b Weighted average of the available countries.

DOWNLOAD

transitory adjustments in capital deductions introduced by European regulations in the setting of the implementation of the Basel III Accord (see Chart 1.29).[58]

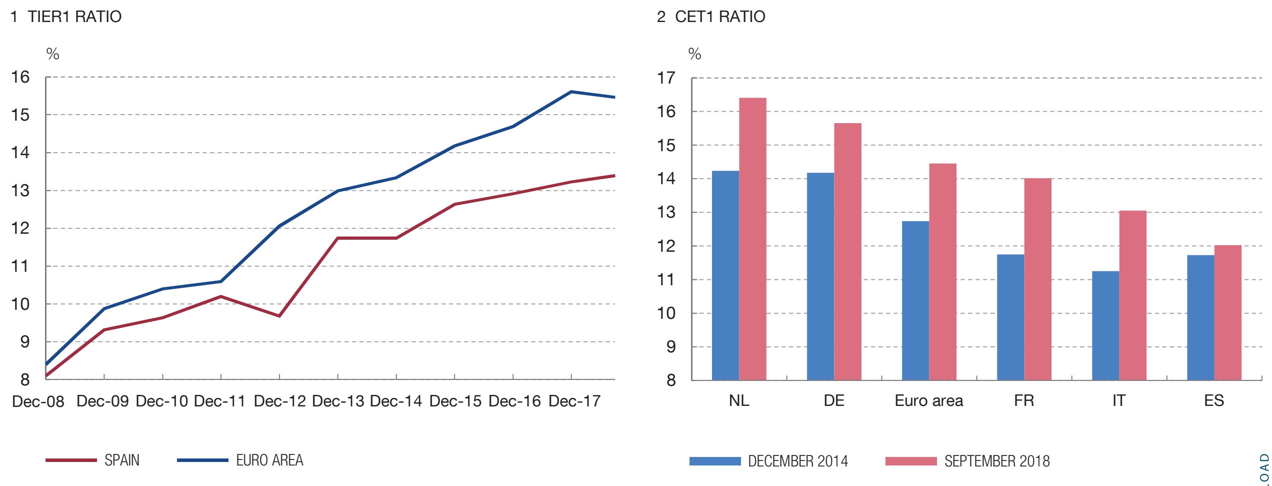
The clean-up of the financial position was favoured both by the continuation of the expansionary cyclical phase and by the troubled asset transfer and sale transactions carried out by the sector. Economic growth and easy monetary and financial conditions have contributed to improving borrowers' ability to pay and to sustain asset value, limiting the lending portfolio's entry into non-performance. Also, deposit institutions have taken advantage of the favourable cyclical moment to transfer unproductive assets to other agents. Specifically, last year the main banking institutions announced asset sale transactions of this kind for a gross book value in excess of €70 bn (of which €55 bn were recorded in 2018, the highest figure after the onset of the 2008 crisis). In the sector as a whole, these transactions were carried out with companies in which the sellers had minority shareholdings.

The international activity of Spanish banks has contributed to support the sector's profitability, although it is not free of risks. Activity abroad has a very

58 The purpose of these adjustments was to smooth over time the impact on the level of capital deriving from the deductions (or items that are subtracted in the eligible capital calculation).

Chart 1.29
SOLVENCY OF DEPOSIT-TAKING INSTITUTIONS. COMPARISON WITH EUROPE

The Tier 1 capital ratio has grown gradually in the last ten years, both in Spain and in the euro area as a whole. Spain has stood below the European average. The average CET1 ratio of Spanish banks has barely increased since 2014, and in 2018 it was below the values in other euro area countries, where it has grown by 2 pp on average.



DOWNLOAD

SOURCE: ECB.

substantial weight in total business (close to 48% of total consolidated financial assets at December 2018) and is concentrated in the larger entities. However, these exposures are not exempt from risks, including most notably those relating to geopolitical uncertainty in certain areas and countries (such as Turkey and Argentina), trade tensions, the possible tightening of financing conditions in the international financial markets or volatility in foreign exchange markets. Spanish institutions' business abroad is mostly denominated in local currency and is conducted under a decentralised management model, which mitigates, but does not completely eliminate, some of these elements of vulnerability. Thus, for example, the risk to the business in the United Kingdom for Spanish institutions operating there in the event of a hypothetical disorderly Brexit mainly derives from the possible deterioration of the British economy. This circumstance could be significant, given that the United Kingdom is the country in which the Spanish banking sector abroad is most present (nearly 30% of loans abroad).

The sector is facing important challenges, which in many cases are shared with other European banking systems. Certain challenges persist in connection with fully overcoming the legacy problems which arose from the latest crisis. Thus, despite having increased in recent years to a level above the average for the euro area, return on equity is significantly lower than the pre-crisis levels, against a background where the outstanding balance of lending in Spain declined significantly, mainly as a result of the private sector's intense deleveraging process. Also, the volume of troubled assets, which has decreased notably from its peak in 2013, is still relatively high from a historical perspective. In this connection, deposit-taking institutions should take advantage of the favourable cyclical moment to further reduce these assets. In addition to improving the quality of its average assets, these efforts will foreseeably lead to the recovery of profitability in the medium and long term. Streamlining operating expenses through improvements in efficiency would also contribute to this end.

The regulatory framework will oblige Spanish institutions to adapt to the new regulatory changes in the next few years. In particular, Spanish credit institutions will be required to adapt to the changes in the different components of the European regulatory framework (the Single Rulebook) for the financial sector: the Capital Requirements Directive (CRD), the Capital Requirements Regulation (CRR), the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism Regulation (SRMR).[59] The changes relate most notably to capital requirements that are more risk-sensitive, leverage and net stable funding ratio requirements, implementing the European regulations on requirements for loss-absorbing instruments in the event of resolution, i.e. the minimum requirement for own funds and eligible liabilities (MREL), and a harmonised regime applicable to non-preferred debt instruments.

Against this regulatory backdrop, Spain's banking sector faces the need to continue strengthening its capital levels. Capital ratios have risen progressively in recent years to levels clearly above the regulatory requirements during the process of implementing in the European Union a harmonised regulatory framework for the financial sector. However, the average CET1 capital ratio of Spanish institutions has hardly increased since the entry into force of Basel III in 2014 and stands at low values in comparison with the other European banking systems (see Chart 1.29). This highlights the need for institutions to strengthen their capital levels in order to improve their resilience to adverse shocks.

The sector's average liquidity ratios are above the regulatory requirements introduced for short-term funding. However, implementing the resolution regulations will foreseeably require a greater adaptive effort in the issuance of certain funding instruments. The position of Spanish institutions in terms of the new liquidity coverage ratio (LCR) is comparatively favourable, as its average level is slightly above that for the euro area, although they still significantly tap the Eurosystem for funding facilities. The upcoming adaptation to the binding MREL targets set by the Single Resolution Board (SRB) will also be an important challenge. To meet the MREL targets, institutions need to issue debt instruments with different degrees of

59 Implementation is scheduled to commence in 2019 and to extend for most reform elements to 2021. There are, however, regulatory developments, whose implementation schedule extends beyond 2021, such as the leverage buffer for global systemically important institutions (2022).

subordination and, therefore, with costs that are higher than those of senior debt or secured instruments such as covered bonds. In this connection, it should be borne in mind that issuance costs for these types of instruments are usually higher for institutions with lower CET1 capital ratio levels.

In common with other European countries, the Spanish banking sector also faces certain challenges relating to the changes in the financial system's structure. In recent years, an increase in the weight of financial business channelled through non-banking intermediaries, including both traditional agents (such as investment funds) and new agents, has been seen at national and international level. These include FinTech firms (whose business model consists of innovating financial services based on the application of new technologies) and, probably more significantly, BigTech firms (large technological firms that are starting to provide financial services and products to their customers), although their relative importance in Spain is still limited. Underlying this pattern are not only conjunctural factors, but also other more structural ones, such as regulatory changes and the introduction of new technologies. This suggests that the trend towards greater competition will likely persist in the future. Institutions will have to adjust to this new environment, making changes that improve efficiency by incorporating the opportunities offered by technological innovations.

In the coming years, the Spanish banking sector, as is the case for the global financial system as a whole, should assess and adapt to the risks which climate change involves for their activity. Climate change and the transition towards a more sustainable economy might affect the activity of credit institutions and financial stability through two types of risks: "physical risks" associated with the direct effect of climate change and "transition" risks connected with the process of technological and regulatory transition to a more sustainable economy.[60] Identifying, quantifying and mitigating these risks are the responsibility of regulators and supervisors and of financial institutions and will require a substantial effort in coming years to reduce the current shortcomings in terms of governance and the data and methodologies underpinning the analysis. In Spain the draft Climate Change and Energy Transition bill approved in February 2019 stresses the need to make progress on these fronts and establishes that credit institutions and national supervisors should prepare reports periodically assessing financial risks for their activity arising from climate change.

The final challenge which Spanish deposit institutions face is to improve their reputation. Following the crisis, customers' perception of the banking system

60 Physical risks would include, for example, those derived from sea-level rise or the proliferation of natural hazards that reduce the value of assets recorded as collateral in banks' credit portfolios. Transition risks would be connected, for example, to a sharp and structural fall in the profitability of a specific firm (and, therefore, in its credit quality) caused by the introduction of a regulatory measure aiming to address climate change.

deteriorated, in part owing to certain inappropriate practices applied by some banks. At the same time litigation rose significantly, leading in certain specific cases to economic losses for some financial institutions and to greater uncertainty about possible additional legal costs arising from such proceedings. These problems could also possibly lead to lower demand for services in this sector. Therefore, recovering their reputation is key for banking intermediaries to be able to successfully face the more competitive environment described above.

In an economy such as Spain's, where the banking sector continues intermediating most financial flows, overcoming all of these challenges is crucial for the sector to contribute to economic growth. Specifically, individual strengthening of the economic and financial position of deposit institutions would lead to the sector's greater resilience in the hypothetical case that the economic cycle goes into recession. Also, the improvements in efficiency recorded in recent years, in a setting of greater competition between institutions, should result in lower intermediation costs, with positive effects on the economy as a whole.

The recent creation in early 2019 of the Macroprudential Authority Financial Stability Board (AMCESFI by its Spanish abbreviation) represents an important institutional development in Spain.[61] The new authority will contribute to promoting coordination and the exchange of information between the Banco de España, the Ministry of Economy and Enterprise, the Spanish National Securities Market Commission and the Directorate-General of Insurance and Pension Funds. The AMCESFI is geared to analysing risks to the stability of the financial system and discussing macroprudential policy measures aimed at preventing and mitigating such risks. By setting up the AMCESFI, Spain endows itself with a structure similar to that set up by other EU member States, in line with the recommendations issued by the European Systemic Risk Board and the IMF. The Banco de España plays a prominent role in the AMCESFI by providing the positions of Vice-Chair of the Board and Chair and Secretary of the Technical Committee.

In parallel, the regulation of the financial system was reinforced by the extension of the range of macroprudential tools available to the sectoral supervisory authorities.[62] In particular, the Banco de España is authorised to require banking institutions to establish, for reasons of systemic risk, countercyclical capital buffers by credit segment, limits on concentration in relation to economic activity sectors, and limits and conditions on the granting of new loans (in terms of, for instance, loan-to-value and loan-to-income ratios, and repayment periods for

61 Royal Decree 102/2019 of 1 March 2019 creating the Macroprudential Authority Financial Stability Board, establishing its legal regime and implementing certain aspects on macroprudential tools.

62 Royal Decree-Law 22/2018 of 14 December 2018 establishing macroprudential tools. These new instruments complement those already available to the Banco de España through Regulation (EU) No 575/2013 and Directive 2013/36/EU on capital requirements.

new loan contracts). Some of these new macroprudential tools, in particular those based on borrowers' ability to pay, have already been introduced in other EU member States' national legislation and are being actively employed to prevent excessive easing of credit standards by banks and to contribute to the sustainability of household and corporate debt.

4.3 Regulatory and institutional development of the euro area

Various measures were taken in 2018 to strengthen the European governance framework and make it more resilient to future crises. These include, in particular, the reform of the ESM that was agreed at the meeting of the Eurogroup in December and comprises broadening its functions and its role in European policy oversight. In the sphere of economic policy oversight, an agreement was reached between the European Commission and the ESM for cooperation in overseeing macro-financial imbalances and analysing debt sustainability in the euro area. It was agreed that the ESM should act as the financial backstop for the Single Resolution Fund (SRF), by means of a credit line that can be used to address exceptional situations, where the SRF's own resources are not sufficient for resolution of some credit institutions. The backstop will have a limit of 1% of all euro area deposits guaranteed. It will come into force in 2024 at the latest and must be fiscally neutral in the medium term, so resources committed will subsequently be recovered through banking sector contributions. In addition, the introduction of the financial backstop will eliminate the ESM's tool for direct recapitalisation of banks.

The eligibility criteria for access to the ESM's precautionary credit lines were also redefined. These credit lines aim to ensure that liquidity problems arising in countries that have sound fundamentals and respect European governance rules do not trigger a solvency crisis. To access these credit lines, countries must comply, in the two years prior to the request, with the Stability and Growth Pact's deficit and debt criteria and must not be running excessive imbalances or be subject to the Excessive Deficit Procedure. In general, the new eligibility criteria are stricter than the previous ones; this will make it difficult for these instruments to come into play to address financial stress situations. A change was also made to the collective action clauses, aiming to facilitate the process of restructuring, where necessary, of an economy's sovereign debt. By contrast, consensus was not reached on speeding up the processes for approval of decisions by the ESM, which currently require in almost all circumstances the unanimous vote of all countries in the event that one of them needs financial assistance.

Despite these advances, the progress made in recent years in the reform of the euro area's economic and financial architecture is still insufficient. The new European Commission that will be formed following the recent elections to the European Parliament should address the reform process more ambitiously, to prevent the single currency from continuing to be exposed to significant stress in the event of serious adverse shocks.

In particular, Banking Union should be completed without delay, by means of the introduction of a European deposit insurance scheme (EDIS). Even though risks have been reduced at national level, the experience acquired during the crisis revealed that individual countries' deposit insurance schemes were not sufficient to substantially reduce the risk of loss of confidence episodes that might prompt a run on deposits. The Commission's proposal, which suggests introducing lending arrangements between the respective national funds, would increase the power to intervene, but it might not be sufficient if the loss of confidence were to extend to a significant number of countries. Accordingly, it remains essential that a broad common deposit insurance scheme be established to complete Banking Union, to ensure that all euro area depositors enjoy the same level of protection, irrespective of where they are located.

Progress in capital market integration remains slow. Euro area capital markets permit a much lower level of risk-sharing than other monetary unions, such as the United States. In consequence, the Capital Market Union project seeks to diversify and broaden European firms' funding sources and to increase capital market integration. Although European institutions gave a boost to some of these measures in early 2019, major barriers to capital market integration still exist in areas such as regulatory harmonisation and market oversight, insolvency proceedings and elimination of the debt bias in some countries' tax systems.

The Eurogroup has decided to make headway in the design and introduction of a budgetary instrument to foster competitiveness and convergence, but consensus has still not been achieved on a cyclical stabilisation function. Insofar as the design of the instrument to foster competitiveness and convergence is concerned, there is agreement on its function: to support public investment needs and the structural reforms identified in the European Semester. However, the political consensus needed to make headway in the case of the proposed cyclical stabilisation instrument has still not been achieved. This instrument is needed to smooth the differential impact of asymmetric shocks and increase the capacity for risk-sharing among euro area countries.

The existence of a genuinely pan-European safe asset is key to ensuring the correct functioning of the euro area. The day-to-day operations of markets and financial intermediaries require that a wide range of benchmark assets with high liquidity and minimum counterparty risk are available; these are commonly known as "safe assets". At the same time, the sovereign debt crisis that hit several euro area countries in the first half of the current decade underlined the fact that, in situations marked by high uncertainty, investors have a high propensity to accumulate assets that are perceived as low-risk as safe-haven assets. Given that, within the euro area, only a relatively small group of issuers are deemed to be sufficiently safe (generally the sovereign issuers of the core euro area countries), the supply of safe or safe-haven assets is too small. In consequence, these safe assets become scarce and over-priced and financial fragmentation ensues within the euro area. In this setting, mechanisms such as those mentioned above (the common deposit insurance scheme, capital market integration and a degree of budgetary stabilisation capacity in the euro area), need to be designed and introduced to enhance diversification, sharing and reduction of risk within the euro area. In turn, this would encourage a broader and more stable supply of safe assets and a less distorting and more equitable distribution of the associated rewards among the euro area members.

In short, deepening of the reform of the euro area's institutional architecture and of the instruments available to its economic and supervisory authorities is needed, without undue delay. Taking a broad view, significant progress has been made in the reform of European governance since the sovereign debt crisis was unleashed at the start of the decade. But there are still many elements outstanding for achievement of a more robust institutional architecture. In particular, mechanisms that provide for greater risk-sharing and risk-mitigation in the euro area are needed and this will necessarily imply further transfers of power by national authorities in different spheres. In a setting such as the present one, where there is limited room for significant further stimulus via demand policies across the euro area, the institutional architecture needs to be promptly strengthened to reinforce the whole of the euro area's macro-financial resilience in the event of a potential downturn.

REFERENCES

Albert, C., C. García Serrano and V. Hernanz (2005). "Firm provided training and temporary contracts", *Spanish Economic Review,* vol. 7, no. 1, March, pp. 67-88.

Arce, Ó., R. Gimeno and S. Mayordomo (2017). *Making room for the needy: the credit reallocation effects of the ECB's corporate QE*, Working Papers, no. 1743, Banco de España.

Alvés, P., A. Urtasun (2019). "Recent housing market developments in Spain", Banco de España, *Economic Bulletin* 2/2019, Banco de España.

Banco de España (2019a). "Macroeconomic projections for Spain (2019-2021)", Box 1 of the "Quarterly report on the Spanish Economy", *Economic Bulletin,* 1/2019.

— (2019b). "The impact of the slowdown in world trade on euro area exports", Box 2 of the "Quarterly report on the Spanish Economy", *Economic Bulletin,* 1/2019.

— (2019c). "Market expectations about the eruro area benchmark interest rate", Box 4 of the "Quarterly report on the Spanish Economy", *Economic Bulletin,* 1/2019.

— (2019d). "Job creation and destruction flows by type of contract during the recovery", Box 6 of the "Quarterly report on the Spanish Economy", *Economic Bulletin,* 1/2019.

— (2019e). "Financial Stability Report", 5/2019.

— (2018a). "Net exports of non-tourism services in Spain since 2008", Box 7 of the "Quarterly report on the Spanish Economy", *Economic Bulletin,* 1/2018.

— (2018b). "An estimate of the impact of the recent protectionist measures", Box 1 of the "Quarterly report on the Spanish Economy", *Economic Bulletin,* 2/2018.

— (2018c). "Distributive effects of the personal income tax reform in the State Budget for 2018", Box 6 of the "Quarterly report on the Spanish Economy", *Economic Bulletin,* 2/2018.

— (2018d). "Consumer credit: analysis of recent performance", Box 2.1 of the *Financial Stability Report*, 5/2018.

— (2018e). "The recovery in the Spanish economy: the limits of demand-side policies and future challenges", chapter 1 of the *Annual Report 2017*.

— (2018f). "The behaviour of mark-ups during the crisis and the recovery", Box 1.2 of the *Annual Report 2017*.

— (2018g). "Recent turbulence in emerging markets", Box 2 of the "Quarterly report on the Spanish Economy", *Economic Bulletin,* 3/2018.

— (2018h). "Recent developments in the consumer credit market in Spain", Box 7 of the "Quarterly report on the Spanish Economy", *Economic Bulletin,* 3/2018.

— (2018i). "The political and fiscal uncertainty in Italy and the repercussions on financial markets", Box 1.2 of the *Financial Stability Report*, 11/2018.

— (2018j). "Recent developments in consumer credit", Box 2.2 of the *Financial Stability Report*, 11/2018.

— (2018k). "Economic and financial situation in Turkey", Box 2.1 of the *Financial Stability Report*, 11/2018.

— (2018l). "The US economy: cyclical position and role of demand-side policies", Box 1 of the "Quarterly report on the Spanish Economy", *Economic Bulletin,* 4/2018.

— (2018m). "Vulnerabilities in the emerging market economies", Box 2 of the "Quarterly report on the Spanish Economy", *Economic Bulletin,* 4/2018.

— (2018n). "Some implications of the announced expansionary stance of China's macroeconomic policies", Box 3 of the "Quarterly report on the Spanish Economy", *Economic Bulletin,* 3/2018.

— (2018ñ). "Recent developments adn outlook for the Spanish economy's rest of the world account", Box 5 of the "Quarterly report on the Spanish Economy", *Economic Bulletin,* 4/2018.

— (2018o). "Recent pension system measures: analysis of impact on public finances", Box 6 of the "Quarterly report on the Spanish Economy", *Economic Bulletin,* 4/2018.

— (2018p). "Recent changes in access of Spanish SMEs to external financing in accordance with the ECB's half-yearly survey", Box 7 of the "Quarterly report on the Spanish Economy", *Economic Bulletin,* 4/2018.

— (2017a). "The possible effects of a reversal of globalisation", Box 1.1 of the *Annual Report 2016*.

— (2017b). "Financing and investment decisions of Spanish non-financial corporations", chapter 2 of the *Annual Report 2016*.

— (2017c). "Current Account Adjustment", Chapter 3 of the *Annual Report 2016*.

— (2017d). Reabsortion of the pent-up demand for consumer durables, Box 4 of the "Quarterly report on the Spanish Economy", *Economic Bulletin,* 4/2017.

— (2016a). "Situación y perspectivas de la economía mundial a principios de 2016", *Boletín Económico*, March.

— (2016b). "Business dynamics in Spain: characteristics, determinants and implications", Chapter 4 of the *Annual Report 2015.*

European Central Bank (2018). *Annual Report 2017.*

Bank of England (2018). *EU withdrawal scenarios and monetary and financial stability - A response to the House of Commons Treasury Committee*, November.

Barceló, C., and E. Villanueva (2018). *The risk of job loss, household formation and housing demand: evidence from differences in severance payments*, Working Paper 1849, Banco de España.

European Commission (2018). *European semester country reports - Spain.*

Cuadrado, P., and F. Tagliati (2018). "Wage moderation in Spain and in the euro area", *Analytical Articles*, *Economic Bulletin,* 4/2018, Banco de España.

Dieppe, A., R. Gilhooly, J. Han, I. Korhonen and D. Lodge (eds.) (2018). *The transition of China to sustainable growth - implications for the global economy and the euro area*, ECB Occasional Papers, no. 206.

Dolado, J. J., S. Ortigueira and R. Stucchi (2016). "Does dual employment protection affect TFP? Evidence from Spanish manufacturing firms", *SERIEs,* vol. 7, no. 4, pp. 421-459.

Font, P., M. Izquierdo and S. Puente (2015). *Real wage responsiveness to unemployment in Spain: asymmetries along the business cycle*, Working Papers 1504, Banco de España.

Fu, C., and E. Moral-Benito (2018). *The evolution of Spanish total factor productivity since the global financial crisis*, Occasional Papers, no. 1808, Banco de España.

González Mínguez, J., and A. Urtasun (2015). "Consumption dynamics in Spain by product type", *Economic Bulletin,* September, Banco de España.

Hernández de Cos, P., J. F. Jimeno and R. Ramos (2017). *The Spanish public pension system: current situation, challenges and reform alternatives*, Occasional Paper 1701, Banco de España.

International Monetary Fund (2018). «Scenario Box 1. Global Trade Tensions", World Economic Outlook: Challenges to Steady Growth, October, pp. 33-35.

Lacuesta, A., M. Izquierdo and S. Puente (2019). *An analysis of the impact of the rise in the national minimum wage in 2017 on the probability of job loss*, Occasional Paper 1902, Banco de España.

López-Rodríguez, D., and LL. Matea (2019). "El alquiler en España", Analytical Article, *Economic Bulletin,* 2/2019, Banco de España. Forthcoming.

López-Rodríguez, D. and C. García Ciria (2018). *Estructura impositiva de España en el contexto de la Unión Europea*, Documentos Ocasionales, no. 1810, Banco de España.

Menéndez, Á., and M. Mulino (2019). "Results of non-financial corporations to 2018 Q4: preliminary year-end data", Analytical Article, *Economic Bulletin,* 2/2019, Banco de España.

Ministerio de Hacienda y Función Pública (2017). *Informe de la Comisión de Expertos para la revisión del modelo de financiación autonómica*, July.

Schivardi, F., and T. Schmitz (2018). The IT Revolution and Southern Europe's Two Lost Decades, CEPR Discussion Papers, 12843.

Serra, X., J. Timini, J. Estefanía and E. Martínez Casillas (2018). "Argentina: economic challenges in an adverse international setting", *Analytical Articles*, *Economic Bulletin,* 4/2018, Banco de España.

Vega, J. L. (coord.) (2019). *Brexit: current situation and outlook*, Occasional Paper 1905, Banco de España.

Box 1.1

THE GLOBAL IMPACT OF A HYPOTHETICAL ECONOMIC SLOWDOWN IN CHINA

As a result of China's strong growth between 2000 and 2011, exceeding 10% in annual average terms, its economy has become the second-largest in the world, only behind that of the United States. This expansionary phase was underpinned by a government-directed economic model based on investment and on the external sector. However, this model, increasingly reliant on credit and fiscal stimuli, began to show signs of waning at the start of this decade, prompting the government to shift away from short-term growth towards sustainable growth in the medium and long term. To this end, the political authorities initiated an economic rebalancing process, set out in the 12th Five-Year Plan (2011-2015), which sought to promote private consumption over investment, domestic demand over external demand and services over industry.

The implementation of the plan has resulted in a significant slowdown in activity, with growth rates falling to close to 6.5% in 2018. This downturn in output has been compounded in the last two years by the authorities' efforts to reduce the high level of corporate and local government debt, given the risks they pose to financial stability, which have led to credit constraints, particularly aimed at controlling the shadow banking sector.

More recently, these domestic developments have been accompanied by new trade disputes between the United States and China, further curtailing growth. Given that sales to the United States account for almost 23% of total Chinese exports and close to 4.2% of the country's GDP, the possibility of escalating tariff disputes could seriously damage economy activity.[1] Specifically, an increase in trade barriers would further weaken profits and employment in the manufacturing industry and would have a negative impact on confidence, with the consequent adverse effects on private income, investment and consumption. In the longer term, a slowdown in trade and the displacement of Chinese firms in the global production chains could affect total factor productivity and potential growth.

The Chinese economy has come to represent a very significant share of global GDP (almost one-fifth of the total, in terms of purchasing power parity), and its contribution to GDP growth is also substantial, at close to 1 percentage point (pp) in annual average terms since 2005. Moreover, the country's interconnectedness with other geographical regions is rapidly increasing. As a result, the global repercussions of developments in the Chinese economy are increasingly important. A possible further slowdown in activity in China would be transmitted to the rest of the world through various direct and indirect channels.

Direct channels include those that operate through the international trade in final goods and services, and the demand for commodities (particularly oil and metals), areas in which China plays a dominant role. A third direct channel, that of financial exposures, is less significant, since capital account liberalisation in China remains limited. Indirect channels, whose impact would be all the greater the more unexpected, abrupt and persistent the slowdown of China's economy, include higher uncertainty and a decline in global confidence which could give rise to episodes of risk aversion in the international financial markets, entailing stock market falls and rising risk premia. Lastly, trade tensions with the United States may lead to changes in the location of global production chains, in which China has a dominant position, affecting activity in third countries, positively or negatively, depending on its degree of complementarity or substitutability with respect to China's production.

To assess the impact on the rest of the world of a possible sharp slowdown of the Chinese economy, a simulation was conducted using the NiGEM general equilibrium model, which takes into account interdependencies between economies.[2] This hypothetical scenario includes a series of permanent shocks associated with the aforementioned transmission channels, which have a simultaneous impact starting in 2019. Specifically, the

1 Following the initial phase of tariff rises imposed by the United States on its imports from China in July 2018 (which affected a volume of purchases of USD 50 billion), the Trump Administration placed a 10% tariff on another group of Chinese imports (with a value of USD 200 billion). This tariff could rise to 25% if the negotiations currently under way between the two countries are not successfully concluded. Moreover, the United States has threatened to impose tariffs on the remaining USD 267 billion of Chinese imports. Before these measures, the average tariff imposed by the United States on Chinese products was of around 3%. In response to the US tariffs, China has imposed tariffs on US imports amounting to USD 110 billion.

2 A number of assumptions are used in the simulation. Specifically, it is considered that expectations are adaptive, nominal exchange rates remain constant, monetary policy follows (in most countries) a Taylor rule and fiscal policy acts as an automatic stabiliser (simultaneously maintaining a medium-term budgetary target).

Box 1.1

THE GLOBAL IMPACT OF A HYPOTHETICAL ECONOMIC SLOWDOWN IN CHINA (cont'd)

Table 1
IMPACT ON REAL GDP GROWTH (%) IN THE EVENT OF DIFFERENT SHOCKS (in pp)

	Combined shock				Trade channel: 1 pp fall in potential growth and rebalancing of final demand				Commodities channel: –6.9 % in oil prices and –7.8 % in metal prices				Financial channel: 10 % fall in stocks, 50 bp rise of equity risk premium and 60 bp rise in long-term interest rates in emerging economies			
	China	Adv. eco.	Emer. eco.	World	China	Adv. eco.	Emer. eco.	World	China	Adv. eco.	Emer. eco.	World	China	Adv. eco.	Emer. eco.	World
t+1	-0.69	-0.27	-0.52	-0.41	-0.60	-0.07	-0.27	-0.19	0.07	0.08	-0.04	0.01	-0.09	-0.25	-0.15	-0.19
t+2	-0.68	0.14	-0.29	-0.11	-0.72	-0.04	-0.31	-0.20	0.15	0.18	0.15	0.16	-0.01	-0.02	-0.03	-0.02
Average	-0.68	-0.06	-0.40	-0.26	-0.66	-0.06	-0.29	-0.20	0.11	0.13	0.05	0.08	-0.05	-0.14	-0.09	-0.11

Table 2
CHANGE IN INFLATION (%) IN THE EVENT OF DIFFERENT SHOCKS (in pp)

	Combined shock				Trade channel: 1 pp fall in potential growth and rebalancing of final demand				Commodities channel: –6.9 % in oil prices and –7.8 % in metal prices				Financial channel: 10 % fall in stocks, 50 bp rise of equity risk premium and 60 bp rise in long-term interest rates in emerging economies			
	China	Adv. eco.	Emer. eco.	World	China	Adv. eco.	Emer. eco.	World	China	Adv. eco.	Emer. eco.	World	China	Adv. eco.	Emer. eco.	World
t+1	-0.48	-0.34	-0.98	-0.71	0.00	-0.02	-0.10	-0.07	-0.45	-0.25	-0.72	-0.52	-0.02	-0.07	-0.14	-0.11
t+2	-0.27	-0.40	-1.11	-0.82	0.02	-0.05	-0.22	-0.15	-0.17	-0.11	-0.41	-0.29	-0.01	-0.05	-0.09	-0.07
Average	-0.37	-0.37	-1.04	-0.77	0.01	-0.04	-0.16	-0.11	-0.31	-0.18	-0.56	-0.41	-0.02	-0.06	-0.11	-0.09

SOURCE: Banco de España.
NOTE: Simulations conducted using the quarterly macroeconomic model NiGEM. Shocks begin to have an impact in 2019 Q1.

Further slowdown in China would lead to a significant decline in world growth. While the expansionary effect of commodity prices would curb the effects of other shocks in advanced economies, the contraction in activity in emerging economies would be more marked among commodity producers and Asian economies.

Chart 1
IMPACT ON REAL GDP GROWTH - FIRST YEAR

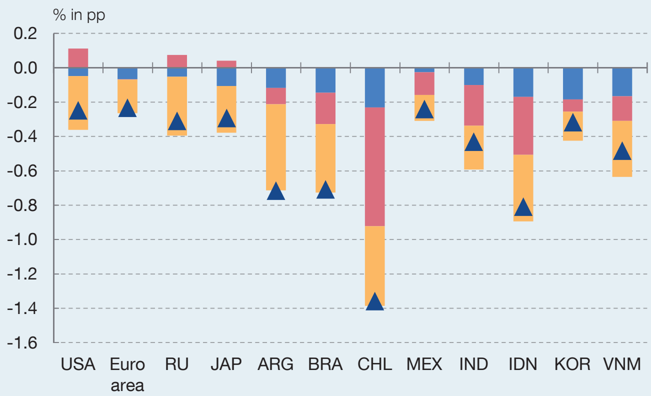
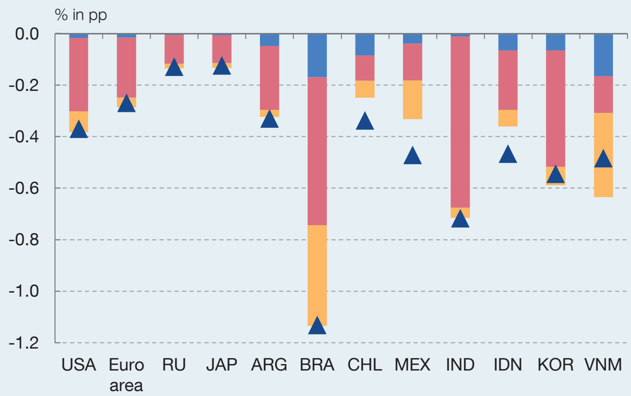


Chart 2
IMPACT ON ANNUAL INFLATION - FIRST YEAR



SOURCE: Banco de España.

scenario has three types of ingredients: i) a 1 pp fall in China's potential growth and a drop of the same magnitude in its domestic demand, to which investment contributes 80% (activating the "trade channel"); ii) a reduction of 7% in oil prices and of 8% in metal prices, associated with the slowing growth in China, which translates into a decline in final demand in commodity-producing economies (impacting on the "commodity channel"), and iii) adverse effects on financial markets, reflecting a decline in confidence ("financial channel"). These effects would hypothetically give rise to a stock market correction of 10% in China, Europe, Japan and the United States, an increase of 50 basis points (bp) in the equity risk premium and a rise of 60 bp in long-term interest rates in emerging economies.[3] To assess the significance of each of the three channels, combined and individual simulations were conducted.[4]

The results of the exercise are shown in Table 1 and Chart 1. The combined scenario would result in a decline in global growth of 0.4 pp after one year. This impact is delivered in equal measure by the trade and financial channels, with the channel of lower commodity prices being less relevant at global level. In fact, in advanced economies, the latter channel would have an expansionary effect, due to cheaper imports of commodities, curbing the effects of other shocks, so that the combined impact on the GDP would be -0.3 pp. The contraction in activity would be more pronounced in emerging economies (-0.5 pp), mainly affecting commodity producers and some Asian economies that have strong ties with China. This scenario would generate disinflationary pressures, more pronounced in emerging economies and, particularly, in commodity-producing countries. Broadly, the effects of the simulations are greater than those obtained in an exercise conducted recently by the European Central Bank (ECB),[5] in which the commodity price channel predominates and the financial channel is absent.

There are, however, a number of factors which could mitigate these effects. First, the exercise does not take into account the foreseeable expansionary reaction of monetary and fiscal policy in China, although, admittedly, the effects could even be amplified if one of the consequences of monetary expansion was a substantial depreciation of the renminbi. Second, the simulation carried out may have underestimated the recent transformation in China's productive, trade and financial structure. Despite the fact that China has become a major driver of the global trade in goods in recent years (it is currently the largest exporter and the second-largest importer), its potential for spillovers is declining for various reasons. On one hand, economic development has in itself led to a more diversified productive structure and thus to a lower import content of Chinese exports. On the other, the decrease in import intensity is also reinforced by changes in China's economic structure, with a shift away from investment towards a greater weight of consumption and a growing tertiary sector.

3 The calibration was based on various papers: Asian Development Bank (2016), "Structural Change and Moderating Growth in the People's Republic of China: Implications for Developing Asia and Beyond" (trade channel); A. Ghoshray and M. Pundit (2016), *The impact of a People's Republic of China slowdown on commodity prices and detecting the asymmetric responses of economic activity in Asian countries to commodity price shocks,* ADB Economics Working Paper Series, no. 493, Asian Development Bank (ADB), Manila (impact on oil and metal prices); World Bank and *International Council on Mining and Metals*, Caldara, Cavallo and Iacoviello (2018) and Stuermer (2017) (effects of changes in those prices on final demand in producing countries), and L. Metelli and F. Natoli (2017), "The effect of a Chinese slowdown on inflation in the euro area and the United States", *Economic Modelling,* no. 62, pp. 16-22 (rise in the risk premium). Finally, the rise in the EMBI (emerging markets bond index) is similar to that observed during the financial turbulence of early 2016, caused by the uncertainties surrounding the slowdown in China at the time.

4 Owing to the presence of non-linearities, the impact obtained in the combined simulation is somewhat greater than the sum of the effects obtained in the individual simulations. However, the difference is not quantitatively very relevant.

5 A. Dieppe, J. Han, R. Gilhooly, L. Korhonen and D. Lodge (eds.) (2018), *The Transition of China to Sustainable Growth – Implications for the Global Economy and the Euro Area,* Occasional Papers, no. 206, ECB.

Box 1.2

THE RESILIENCE OF THE SPANISH ECONOMY TO THE DOWNTURN IN THE EXTERNAL ENVIRONMENT

In 2018, Spain's GDP growth (2.6%) was not very different from the Banco de España's December 2017 projection (2.4%) (see Charts 1 and 2). However, its composition did differ notably from the expected one. Specifically, the contribution of net exports to GDP growth was 0.7 pp less than expected, while domestic demand contributed 0.8 pp more, a surprise to which private consumption and public consumption contributed 0.2 pp each, and to which investment in capital goods, in housing, in other construction and in stockbuilding contributed 0.1 pp each. By contrast, in the euro area, to the more-negative-than-expected behaviour of exports was added a surprise of the same sign in domestic demand, which gave rise to GDP growth of 1.9%, down 0.4 pp from the projection.[1]

There are many possible explanations of why activity and domestic demand held up more strongly in Spain, while weakening in the euro area. It is useful to group them into

Chart 1
SPAIN (ES) AND EURO AREA (EA):
GDP AND DEMAND COMPONENTS IN 2018
Annual average growth rates and contributions

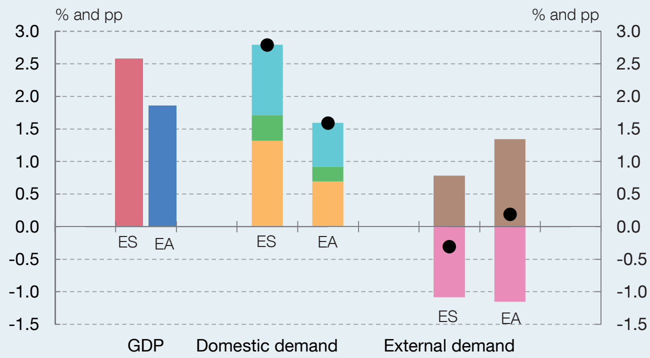


Chart 2
SPAIN (ES) AND EURO AREA (EA):
DIFFERENCES BETWEEN OBSERVED GDP AND DEMAND COMPONENTS
AND THEIR DECEMBER 2017 PROJECTIONS
Annual average growth rates and contributions

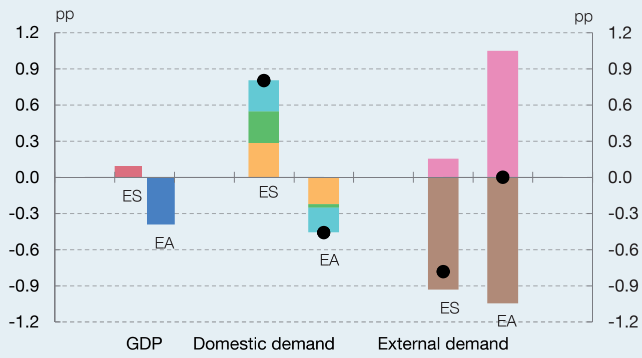


Chart 3
SPAIN AND EURO AREA: BEHAVIOUR OF VARIOUS VARIABLES
Growth rates and levels as a percentage of gross disposable income and of GDP
Real year-on-year rates of change

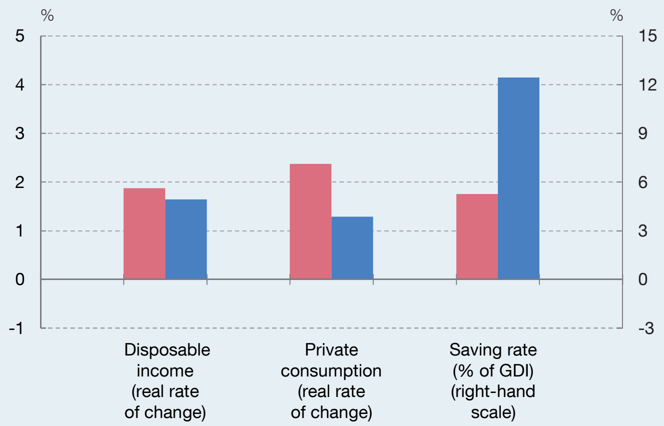
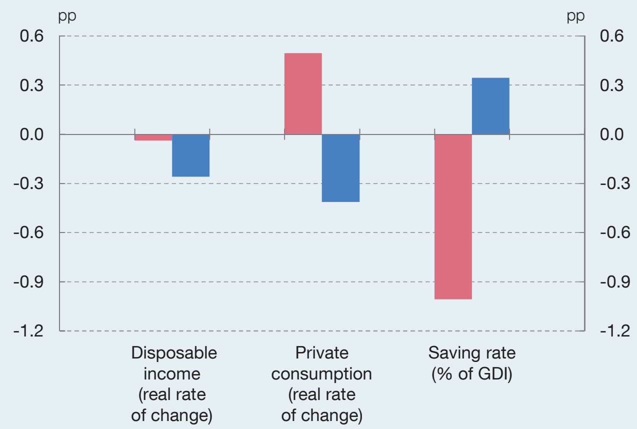


Chart 4
SPAIN AND THE EURO AREA:
DIFFERENCES BETWEEN OBSERVED VALUES AND THE DECEMBER 2017



SOURCES: INE, ECB and Banco de España.

1 See ECB (2019), *ECB staff macroeconomic projections for the euro area, March 2019*, and ECB (2017), *December 2017 Eurosystem staff macroeconomic projections for the euro area*.

two categories. First, the two economies may have been affected asymmetrically by common shocks. Second, idiosyncratic factors of various types may have acted only on one of them.

Starting with the first type of factors, the observed divergences might be explained partly because the surprises in the set of common assumptions made in the projections affected Spain differently from the euro area as a whole. Among these surprises, last year there was a notable unexpected deceleration in the external markets which, although detrimental to both economies, may have had more severe effects on one of them, either because its exports were comparatively affected to a greater extent or because the internal component of its demand was impacted more severely.

In 2018, Spain's export markets grew 1.9 pp less than projected in December of the previous year (see Table 1). Taking the average of the three largest euro area countries (Germany, France and Italy), that difference was smaller (1.2 pp). This is explained by the greater relative weight, within the Spanish external markets as a whole, of those which surprised by the greater extent of their slowdown. Furthermore, according to the simulations conducted using the models of the related national central banks, the impact on GDP growth of a 1% fall in external demand would be 0.18 pp at the end of one year, both in Spain and in the case of the average of the three countries considered. Therefore, given this elasticity, the worse behaviour of the respective external demands would have given rise to a decrease in the rate of change of GDP of 0.3 pp in the case of Spain and of around 0.2 pp in the average for the other three countries.[2] In addition, the negative impact on GDP and domestic demand of the higher oil prices with respect to those anticipated at the end of 2017 was very similar in the four countries considered (see Table 2), while the overall effect of the other surprises on the variables conditioning the projections was practically zero in all cases. Consequently, the asymmetric effects of the common shocks do not seem to be able to explain why GDP and domestic demand were subjected to positive surprises in Spain, in contrast to those of negative sign in the three largest countries of the euro area.

The idiosyncratic factors constitute, by their very nature, a highly heterogeneous category. First, throughout 2018 various unforeseen circumstances crystallised which, in an unexpected and mainly temporary manner, adversely impacted the main economies of the euro area, but did not directly affect Spain.[3] Second, Spain's fiscal policy was more expansionary than expected in December 2017. Specifically, the most recent estimates, made in the context of the formulation of the March 2019 macroeconomic projections, point to a worsening of the primary structural balance between 2017 and 2018, compared with the zero change expected in December 2017.

According to the simulations made using the Banco de España quarterly model, the size of the contribution of the expansionary discretionary measures to GDP growth in 2018 was roughly between 0.2 pp and 0.3 pp.[4]

---

2 Additionally, the more-unfavourable-than-expected behaviour of the export markets seems to have had a negative impact of 0.1 pp on the growth of domestic demand both in Spain and in the average of Germany, France and Italy.

3 At the beginning of the year, these factors included bad weather, flu epidemics in northern and central Europe and some sectoral strikes in this specific case of Germany (see Box 2, "Has the slowdown in economic activity in the euro area been a result of permanent or temporary factors?", *Economic Bulletin*, 2/2018, Banco de España). From spring, Italy was affected by uncertainties over the course of its economic policies, the consequence of which was to raise the cost of financing of that economy. Immediately after summer, the difficulties of automobile manufacturers in adjusting their supply to the new pollutant emissions regulations gave rise to a weakening of this industry's production (see Box 4, "Impact of the new emissions regulation on the automobile market", *Economic Bulletin*, 4/2018, Banco de España). However, Spain has not been immune to this latter circumstance, which particularly harmed Germany, while, by contrast, its impact on France was comparatively smaller. In the final stretch of the year, social unrest seems to have lowered GDP growth of the French economy by a few tenths of a percentage point.

4 These estimates are sensitive to the assumption made about the propensity to consume of the households which most directly benefitted from the measures to increase employment, wages and public transfers and to reduce certain taxes, included in the 2018 State budget. In any event, an accurate estimate of the impact of the budgetary policy stance on activity in the short term is subject to a high degree of uncertainty, since it depends on numerous factors, including the specific circumstances of the economy. Specifically, the literature reports that the value of the fiscal multipliers tends to be higher in the vicinity of an effective floor on interest rates and tends to be lower in a cyclical upturn. Both these circumstances existed in the Spanish economy in 2018, although it is not easy to determine the net impact of them.

Third, the behaviour of households in Spain in 2018, in terms of their spending and saving decisions, differed significantly both from that expected before the year began and from that observed in the euro area. Specifically, the private consumption growth of 2.3% in real terms exceeded by 0.8 pp that of income, giving rise to a decrease in the saving rate of 0.6 pp (see Chart 3). These developments contrast notably with the projections made in December 2017, which predicted that the saving rate would rise in 2018 by 0.1 pp, against a background of lower consumption growth (see Chart 4).[5] By way of illustration, an exercise using the Banco de España quarterly model – which simulates less expansionary household spending replicating the initially projected increase of 0.1 pp in their saving rate – leads to GDP growth which is around 0.4 pp lower in 2018.

The decrease in the saving rate in Spain, its unanticipated nature and the different behaviour of this variable from that in the euro area may have many distinct causes, some of which suggest the presence of certain limits on the ability of households to maintain in the future the

Table 1
EXTERNAL MARKETS IN 2018: IMPACT ON GDP GROWTH AND CONTRIBUTION OF DOMESTIC AND EXTERNAL DEMAND

	Market growth in 2018 (%)			Impact (pp) on…		
	Expected in December 2017 (1)	Observed in March 2019 (2)	Difference (pp) (2) – (1)	GDP	Domestic demand (contrib.)	External demand (contrib.)
Spain	5.0	3.1	-1.9	-0.3	-0.1	-0.2
Average (Germany, France and Italy)	4.8	3.5	-1.2	-0.2	-0.1	-0.1
Germany	4.5	3.5	-1.0	-0.4	-0.1	-0.3
France	4.9	3.6	-1.3	-0.1	-0.1	-0.1
Italy	4.9	3.5	-1.4	-0.1	-0.1	-0.1

SOURCES: INE, ECB and Banco de España.

Table 2
IMPACT (IN PERCENTAGE POINTS) OF VARIOUS FACTORS ON GDP GROWTH AND CONTRIBUTIONS OF DOMESTIC AND EXTERNAL

	Oil prices			Other variables (a)		
	GDP	Domestic demand (contrib.)	External demand (contrib.)	GDP	Domestic demand (contrib.)	External demand (contrib.)
Spain	-0.06	-0.10	0.04	0.02	0.00	0.02
Average (Germany, France and Italy)	-0.06	-0.09	0.03	0.01	-0.01	0.03
Germany	-0.09	-0.13	0.04	0.03	0.00	0.03
France	-0.03	-0.05	0.02	0.01	0.00	0.01
Italy	-0.06	-0.10	0.04	0.01	-0.03	0.03

SOURCES: INE, ECB and Banco de España.

a Including exchange rates, interest rates and stock market prices.

5 Although the income growth of households in the three main economies of the euro area was similar to that in Spain, their consumption was much lower, giving rise to an increase of 0.4 pp in their saving rate, somewhat higher than the projection a year earlier.

dynamism recently shown by their consumer spending.[6] Moreover, the decrease in the saving rate throughout the recovery has been accompanied by an increase in the proportion of consumption financed by credit[7] and hence paid for out of future income. This points to the possibility that some agents may perhaps be overestimating somewhat their future income, which in turn increases their vulnerability to potential adverse shocks.

In conclusion, the factors underpinning growth in Spain in 2018 included an expansionary budgetary policy stance and a high household propensity to spend. This analysis thus advises caution in extrapolating to the future the stronger behaviour of the Spanish economy relative to its main partners in the euro area. First, the achievement of higher short-term growth at the expense of putting off the required consolidation of public finances (observable basically from 2015) may entail certain additional costs in the future, as noted in Section 4.2.2 of this chapter. Second, the low saving rate, the fact that the household sector is a net borrower (i.e., its saving is insufficient to finance its investment) and the high growth of consumer borrowing point to a possible future moderation in the rate of growth of household spending.

6 The more benign explanations include a possible greater impact in Spain of the composition effects. These are associated with the fact that new labour market entrants have a higher propensity to consume or the possibility that the persistence of the process by which the pent-up demand during the crisis was being satisfied may be higher than had been supposed. These factors probably have a lower impact in other economies of the euro area. See Chapter 1 of the *2017 Annual Report* of the Banco de España for a description of the factors explaining the behaviour of the household saving rate in the past decade.

7 See Box 7, "Recent developments in the consumer credit market in Spain", *Economic Bulletin*, 3/2018, Banco de España.

Box 1.3

EMPLOYMENT AND SECTORAL PRODUCTIVITY IN THE RECOVERY

Since the start of the economic recovery in the second half of 2013, job creation has been very strong. According to National Accounts figures, 2.4 million jobs have been created since 2014 Q1. This amounts to cumulative growth of 14.9%, above the growth rate observed in the similar period of the last upturn (see Charts 1 and 2). However, the level of employment at end-2018 was still 8% lower than the pre-crisis level.

From the sectoral standpoint, the rise in employment from the cyclical trough is quite similar to that observed in the cycle that began in 1993. Above average growth has been recorded in construction and in market services. By contrast, the recovery has been more moderate in industry (which has also seen a recent slowdown) and in non-market services. At a greater level of disaggregation, on Spanish Labour Force Survey figures, most notable in the current cycle is the increase in employment in accommodation and food service activities (31.5%) and in transport (21.4%). In turn, within industry, job creation has been particularly strong in some branches of manufacturing, such as textiles (49.5%), leather goods and footwear (48.8%) or waste collection, treatment and disposal (40.1%), above the increases observed in the construction sector (29.3%).

Comparing employment levels by sector with those observed pre-crisis gives a very uneven picture. At end-2018, employment had returned to the 2008 level in market services and was 11% above that level in non-market services. But it was still very far from the 2008 levels both in industry (77%) and construction (48%), and it was still 8% lower in agriculture. These changes reflect a heightening of the long-term tendency, shared with other advanced economies, for services sectors to gain weight as a proportion of the total. By contrast, the industrial sectors, and especially construction, have shrunk as a proportion of the Spanish economy in the 10-year period.

Over the course of the recovery, employment and economic activity have risen at a very similar pace. This has given rise, as it did in the previous upturn, to very low labour productivity growth. Specifically, since 2014 it has risen by just 0.2% in annual average terms, and in 2018 labour productivity even recorded zero growth. By sector, value added has performed quite similarly to employment, with above average growth in construction (27.5%) and market services (14.4%) and high growth (15.5%) in industry where productivity has improved. Indeed, the correlation, at a greater level of sectoral disaggregation, between the level of productivity at the start of the recovery and the changes in the weight of employment in each branch of activity has been slightly positive (see Chart 3). In other words, employment growth, albeit very modest, has been somewhat stronger in the sectors that had higher productivity levels to start with.

Chart 4 decomposes productivity growth into the effects of the changes in sectoral weight (composition effects) and sector-level productivity (other). It was this latter factor that gave rise to the sharp increase in productivity during the crisis, associated with high job destruction. But this increase has not continued in the recovery phase, in keeping with the usual pattern in upturns in the Spanish economy.

By employment type, half of the employment created in the upturn, in net terms, was temporary employment, although this percentage is clearly heading down. Thus, while in 2014, at the start of the recovery, temporary employment accounted for 80% of the increase in employment, this figure has gradually declined since then, down to 31% in 2018 (see Chart 5). Although it is still high (and similar to the average observed in the 1995-99 recovery phase), it has allowed the ratio of temporary to total employment to stabilise in 2018, following the successive increases recorded in the previous four-year period. In addition, the changes observed were slightly more positive taking the private sector alone, where the share of permanent employment created, in net terms, rose from 55.4% of the total in the period 2014-18 overall to 80.5% in 2018. By contrast, all employment created, in net terms, in the public sector since 2014 has been temporary employment. In consequence, since 2013, the ratio of temporary to total employment has risen by 3.7 pp overall (3.1 pp in the private sector; 5.9 pp in the public sector), up to 26.8% in 2018 (see Chart 5). This is much higher than the European average, but below the average of 32.6% observed in the period 2002-07. This increase in temporary employment, associated with the low level of productivity of new hires, would also explain the low rate of productivity growth in each sector in the recent recovery phase (see Chart 4).

Lastly, a key characteristic of employment patterns during the crisis that began in 2008 was the marked relative increase in the number of part-time hires. This drove up the incidence of part-time employment by 4 pp to 15.8% in the period 2008 to 2013. By contrast, during the recovery that started in 2014, the vast majority of employment created (94.2%) has been full-time. In

Box 1.3

EMPLOYMENT AND SECTORAL PRODUCTIVITY IN THE RECOVERY (cont'd)

Chart 1
LEVEL OF EMPLOYMENT ON QNA DATA, BY LARGE SECTOR, SINCE THE START OF THE PRESENT RECOVERY (a)

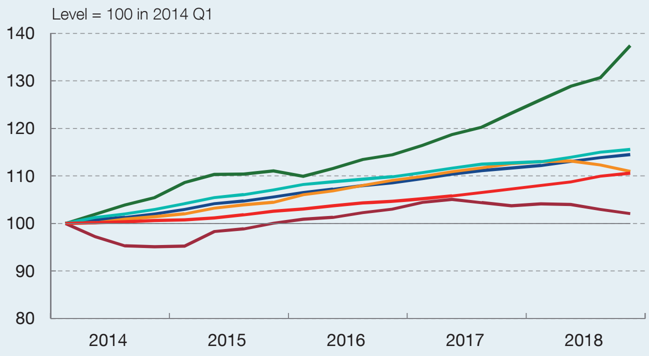


Chart 2
LEVEL OF EMPLOYMENT ON QNA DATA, BY LARGE SECTOR, SINCE THE START OF THE RECOVERY IN 1993 (a)

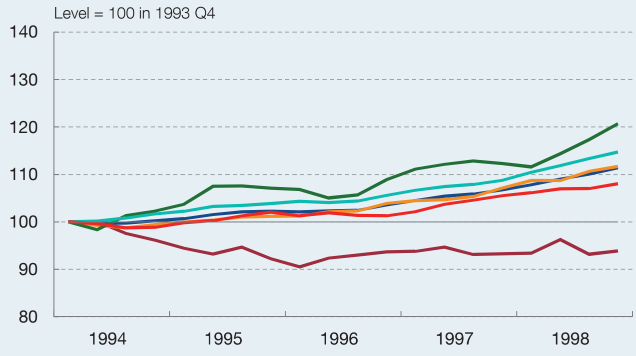


Chart 3
CHANGES IN SHARE OF EMPLOYMENT IN 2014-18, BY SECTOR, AND PRODUCTIVITY LEVEL (b)

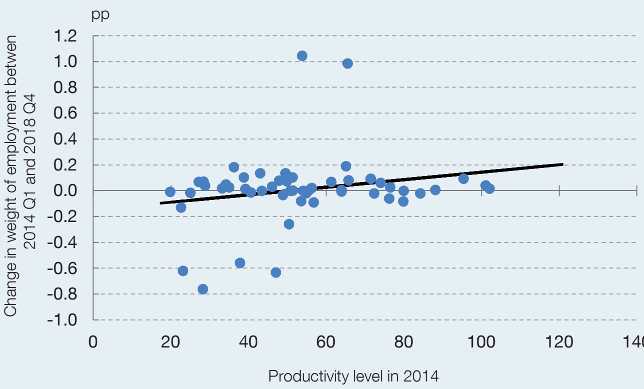


Chart 4
RATE OF CHANGE OF GVA APPARENT PRODUCTIVITY AND COMPOSITION EFFECT (a)

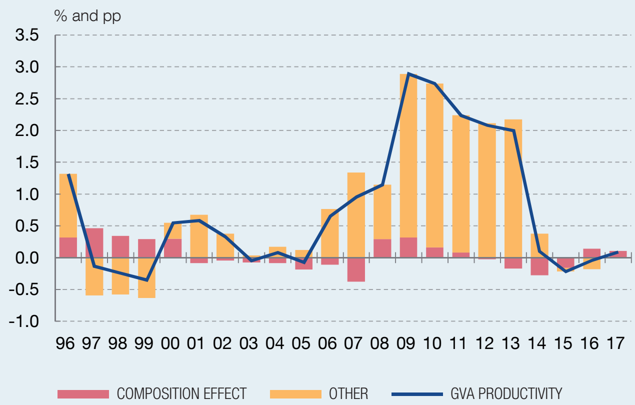


Chart 5
ANNUAL CHANGE IN TOTAL EMPLOYMENT ATTRIBUTABLE TO PERMANENT HIRES

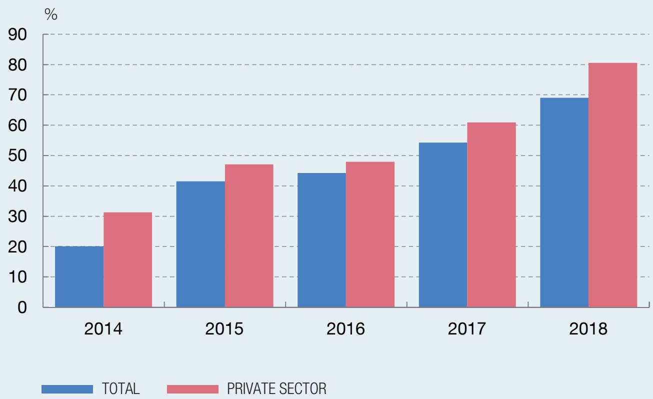
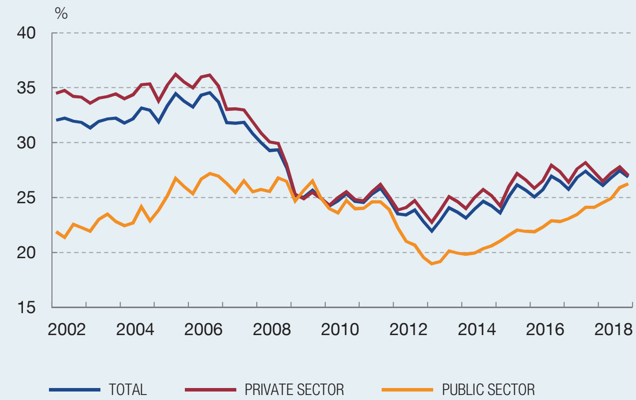


Chart 6
RATIO OF TEMPORARY TO TOTAL EMPLOYMENT



SOURCE: INE (Quarterly National Accounts (QNA) and Labour Force Survey (LFS)).

a QNA data. Employment measured in full-time equivalent jobs.
b Sectors according to 2-digit National Classification of Economic Activities (CNAE-2009). Change in share of employment according to LFS data. Eight sectors are excluded because of outliers.

Box 1.3
EMPLOYMENT AND SECTORAL PRODUCTIVITY IN THE RECOVERY (cont'd)

consequence, the incidence of part-time employment has declined, down to 14.6% in 2018.

To conclude, strong employment growth has gone hand in hand with growth in activity at a sectoral level and this, as in previous upturns in the Spanish economy, has resulted in low labour productivity growth. The temporary employment pattern is also similar to that observed in previous recoveries, although temporary employment is still below the highs reached pre-crisis and the most recent developments in the private sector reflect a decline in temporary employment contracts as a proportion of total contracts in 2018.

Box 1.4

WAGE AND TOTAL INCOME INEQUALITY IN THE ECONOMIC RECOVERY (2014-2017)

This box analyses changes in the inequality of households' wage and total income in Spain during the period 2014-2017.[1] Drawing on data from the Spanish Labour Force Survey (LFS), the wage income inequality of full-time workers (which is estimated to be closely related to the performance of hourly earnings)[2] remained relatively stable in the period under review (see the left-hand panel of Table 1).[3] For instance, the value of the P90/P10 ratio[4] was the same in 2017 (3.4 times) as it was in 2014, which is only 0.1 pp higher than in 2008. This stability was observed across all the wage income distribution.

When analysing the monthly wages of all workers, including part-time workers who display greater procyclicality in terms of hours and days worked, it can be seen that the inequality indicators declined significantly from 2014 to 2017 (the P90/P10 ratio fell from 5.12 to 4.7 during those years, see the right-hand panel of Table 1). These developments mean that almost half of the increase in wage income inequality according to this ratio, which was observed in the recession, was reversed. The reduction in inequality was sharper at the lower end of the wage distribution, which is the segment that was also affected most during the crisis. The results are qualitatively similar if the Continuous Sample of Working Histories is used (MCVL by its Spanish abbreviation) (see Chart 1).

The developments observed in 2017 were set in a context where the quality of new jobs showed similar patterns to those seen in the period 2014-2016. Thus, a high proportion of employment inflows continued to be temporary and brief, and to have a greater impact on part-term employment than in the pre-crisis period (see Charts 2 and 3). In any event, certain aspects of job creation have improved somewhat during 2017. In particular, the decline in the impact of part-time employment observed since 2014 has persisted, the conversion of temporary to permanent contracts has recovered and the temporary employment ratio in the private sector has decreased slightly, although historically this ratio has tended to rise during upturns. These factors mainly benefit lower-paid workers and, consequently, should contribute to improving inequality indicators at the lower end of the wage distribution. Against this, the average duration of temporary contracts continues to decline, essentially as a result of the higher proportion of those of a shorter duration (see Chart 4). Although sufficiently detailed information on wages is not available for 2018, the quality of new jobs continued to improve in terms of fewer short-term jobs and more permanent ones and, consequently, wage inequality is expected to have decreased even more last year. The duration of new temporary contracts has continued to decrease.

According to the 2017 Living Conditions Survey (LCS), inequality in terms of households' total per capita gross income (labour and non-labour income) held at similar levels to those in 2014 (see Table 2). Specifically, the P90/P10 ratio, which stood at 6.30 in the 2014 LCS, rose to 6.35 in the 2017 LCS.[5] This is applicable to the different brackets of the distribution of gross income per capita. Likewise, these developments were similar irrespective of whether household income per capita is measured in net or gross terms, since there were no fiscal changes in this period which altered income distribution.

The income of households at the lower end of the per capita income distribution is mainly from labour, unemployment benefits and pension benefits. Although unemployment has fallen notably in the period of

1 Using information from 2017, this box updates the findings presented in Section 5 of B. Anghel, H. Basso, O. Bover, J. M. Casado, L. Hospido, M. Izquierdo, I. A. Kataryniuk, A. Lacuesta, J. M. Montero and E. Vozmediano (2018), "Income, consumption and wealth inequality in Spain", *SERIEs,* 9(4), pp. 351-387.

2 The LFS and the Continuous Sample of Working Histories (MCVL by its Spanish abbreviation) do not have the information necessary to calculate hourly earnings accurately.

3 The wage income information in the LFS refers to the year of the survey. Thus, the 2017 LFS has information on wage income in 2017.

4 The P90/P10 ratio is defined as the ratio of the income level of the 90th percentile to that of the 10th percentile of the distribution. The 10% of individuals with the lowest income are found below the 10th percentile. The 10% of individuals with the highest income are found above the 90th percentile.

5 The information on income of the LCS for a specific year refers to the previous year. Thus, the 2017 LCS has information on wage income in 2016

economic recovery, it remains very high, especially among groups with a low level of educational attainment, which are concentrated at the lower end of the per capita income distribution (see Chart 5). The possibilities of individuals in this group increasing their income level are constrained by their low relative level of employability, given the high decoupling of the skills supplied by the unemployed and those in demand among employers.

Table 1
MONTHLY WAGE INEQUALITY INDICATORS (LFS)

	Monthly wage - full-time employees				Monthly wage - total employees			
	2008	2014	2016	2017	2008	2014	2016	2017
Gini	0.28	0.28	0.28	0.28	0.31	0.33	0.32	0.33
P90/P10	3.27	3.43	3.38	3.43	4.24	5.12	4.67	4.70
P50/P10	1.58	1.72	1.69	1.67	2.04	2.45	2.25	2.22
P75/P25	1.83	1.92	1.89	1.90	1.91	2.15	2.10	2.10
P90/P50	2.07	2.00	2.00	2.06	2.08	2.09	2.08	2.12

Table 2
MONTHLY WAGE INEQUALITY INDICATORS (MCVL) (a)

	Monthly wage - full-time employees				Monthly wage - total employees			
	2008	2014	2016	2017	2008	2014	2016	2017
Gini	0.32	0.33	0.33	0.33	0.36	0.38	0.38	0.38
P90/P10	3.52	3.71	3.69	3.61	4.84	5.87	5.70	5.54
P50/P10	1.64	1.74	1.73	1.69	2.19	2.62	2.53	2.48
P75/P25	1.92	1.96	1.96	1.94	2.04	2.25	2.23	2.19
P90/P50	2.14	2.13	2.14	2.13	2.21	2.24	2.25	2.23

Table 3
HOUSEHOLD GROSS AND NET INCOME INEQUALITY INDICATORS (SILC) (b)

	Household gross income per capita				Household net income per capita			
	2008	2014	2016	2017	2008	2014	2016	2017
Gini	0.36	0.38	0.38	0.38	0.33	0.35	0.34	0.34
P90/P10	5.27	6.30	6.07	6.35	4.54	5.40	5.28	5.35
P50/P10	2.30	2.65	2.57	2.71	2.17	2.56	2.53	2.56
P75/P25	2.46	2.63	2.61	2.64	2.22	2.29	2.30	2.33
P90/P50	2.29	2.37	2.36	2.35	2.09	2.11	2.09	2.09

	Household gross income				Household net income			
	2008	2014	2016	2017	2008	2014	2016	2017
Gini	0.40	0.41	0.41	0.41	0.37	0.38	0.38	0.38
P90/P10	7.62	7.20	7.17	7.38	6.42	6.23	6.00	6.26
P50/P10	3.14	2.79	2.80	2.92	2.86	2.65	2.60	2.72
P75/P25	2.86	2.92	2.90	2.95	2.62	2.67	2.66	2.69
P90/P50	2.42	2.58	2.56	2.54	2.25	2.35	2.31	2.30

SOURCES: INE (LFS and SILC) and Ministerio de Trabajo, Migraciones y Seguridad Social (MCVL).

a Monthly wage calculated on the basis of the fiscal module for workers working a full month.
b Household income per capita is adjusted with the OECD equivalence scale. 2014 income in euro.

Box 1.4

WAGE AND TOTAL INCOME INEQUALITY IN THE ECONOMIC RECOVERY (2014-2017) (cont'd)

Chart 1
CHANGE IN REAL MONTHLY WAGE BETWEEN 2014 AND 2017 (a)

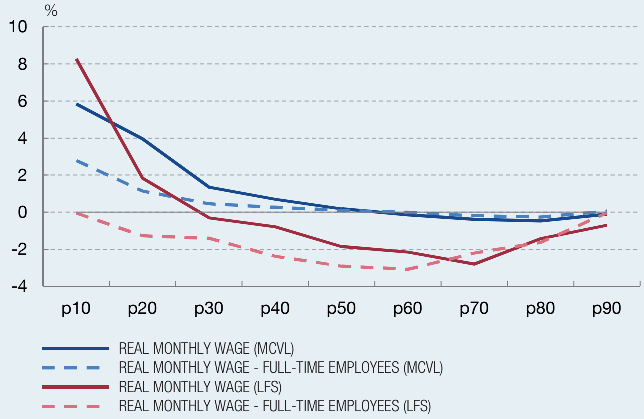


Chart 2
REGISTERED CONTRACTS (b)

Chart 3
RATIO OF PART-TIME AND NON-VOLUNTARY PART-TIME WORK

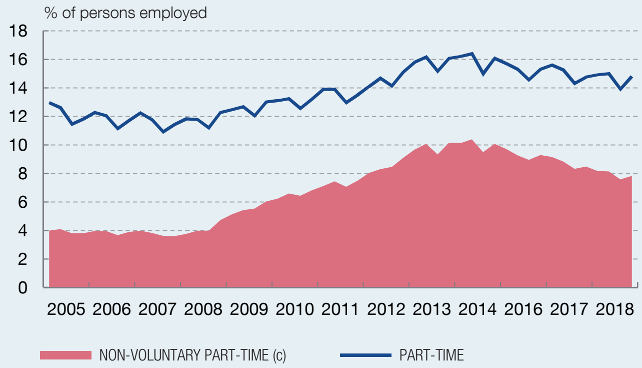


Chart 4
AVERAGE JOB TENURE OF TEMPORARY WORKERS (d)

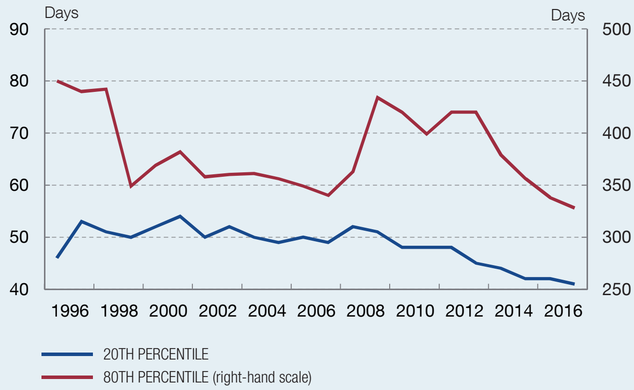


Chart 5
UNEMPLOYMENT RATE ACCORDING TO EDUCATIONAL ATTAINMENT LEVEL (e)

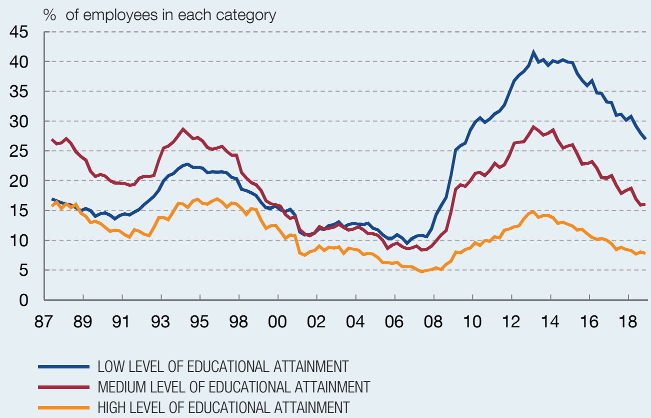
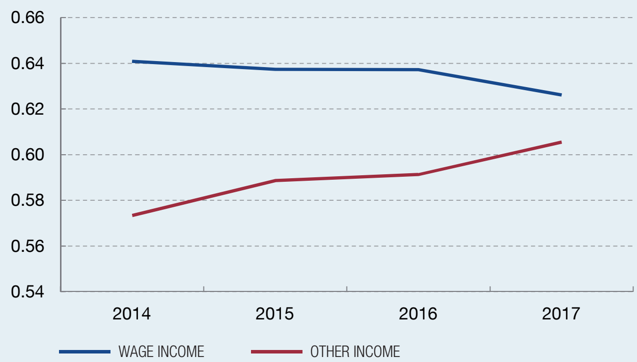


Chart 6
GINI INDEX OF HOUSEHOLDS' TOTAL WAGE INCOME AND OTHER INCOME (f)



SOURCES: Servicio Público de Empleo Estatal, Ministerio de Trabajo, Migraciones y Seguridad Social (MCVL), INE (LFS) and Banco de España.

a MCVL (Continuous Sample of Working Histories): monthly wage calculated on the basis of the fiscal module for workers working a full month. LFS: monthly wage associated with the main employment in the survey reference week.
b Including domestic service contracts only since October 2012.
c Employed persons who say they are working part-time because they were unable to find full-time work.
d Calculated based on MCVL data.
e Low: no or only primary education, or having failed to complete, or to successfully complete, lower secondary education. High: tertiary education.
f "Other income" includes: self-employed income, capital income, income of children under 16, old age and survival pension benefits, other social benefits, unemployment benefits and transfers from other households.

Box 1.4

WAGE AND TOTAL INCOME INEQUALITY IN THE ECONOMIC RECOVERY (2014-2017) (cont'd)

Furthermore, small increases in pension benefits from 2014 to 2017 contributed to modest growth in the non-wage income for the group with lower per capita income (see Chart 6). By contrast, self-employed and capital income recovered, which are income sources that are overrepresented in the middle and at the higher end of the distribution. This set of factors explains that the reduction in wage income inequality has not fed through to total per capita income. The inequality of total per capita income could be expected to have fallen more since 2017 as wage inequality has continued to decline and unemployment levels among individuals with a low level of educational attainment have improved. However, uncertainty persists about the role that changes in non-wage income in the different brackets of the total income distribution could play.

In conclusion, the recovery experienced by the Spanish economy since 2014 has helped reduce the indices of wage income inequality. These developments, nevertheless, have not resulted in a proportional decrease in per capita income inequality on account of the persistently high numbers of unemployed with a low level of educational attainment concentrated at the lower end of the distribution, and on account of the increase in recent years in non-wage income in the middle and, especially, at the upper end of the total income distribution.