

Foreword by the Governor Pablo Hernández de Cos



The *Annual Report* of the Banco de España is the institution's main instrument for contributing to the dissemination of its analyses on our economy.<sup>1</sup> The introduction to the Report provides the Bank's overview of the latest developments, highlighting the challenges facing the economy and exploring possible avenues for addressing them. The report also has three theme-based chapters. These respectively tackle the study of the factors behind the current lengthy period of low inflation, not only in Spain but also in the euro area as a whole; considerations on monetary policy design in the long term following the experience gained in the crisis; and the economic consequences of the far-reaching demographic changes facing Spain.

Since the start of 2018 the Spanish economy has faced a more adverse international environment, notably marked by the uncertainty over trade tensions

The international economic environment turned more unfavourable in 2018, with a particularly sharp slowdown in global economic activity as regards trade. Various factors account for this downturn. They include most notably the impact of trade disputes, especially between the United States and China, and the uncertainty over the outcome of Brexit.

In this environment, the Chinese economy evidenced the difficulties involved in managing, in an orderly fashion, the impact on activity of its necessary deleveraging. Some of the emerging economies with the biggest imbalances, such as Argentina and Turkey, were particularly affected by the tightening of global financial conditions associated with US monetary policy normalisation.

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<sup>1</sup> The *Annual Report* complements other regular economic publications by the Banco de España. These include the *Financial Stability Report*, which offers a half-yearly analysis of the specific risks to the Spanish financial system and explains the institution's macroprudential policy; the *Economic Bulletin*, which sets out quarterly the developments in the Spanish economy, within the international and euro area settings, and the projections for the coming years; the *Annual Accounts*, published yearly; and the likewise annual *Institutional Report*, which offers the public at large an overview of the organisation and its functions, and a summary of the key activities undertaken during the year. This information is supplemented with the publication, inter alia, of specific annual reports on banking supervision activities, claims and the oversight of market infrastructures.

Growth in the euro area economy eased significantly, and the ECB maintained a very accommodative monetary policy

Given its high degree of external openness, increased uncertainty and the slowdown in global activity and trade particularly impacted the eurozone. As a result, growth in the area's economy eased significantly in 2018. It was also affected by various negative idiosyncratic shocks.

These were particularly acute in Italy, as a result of uncertainty over the course of its economic policies, and in Germany, where they were concentrated in certain key productive sectors, such as the car industry.

Against this background, marked also by low core inflation levels, the ECB continued to pursue a very expansionary monetary policy. Thus, although it set an end to net asset purchases in December, it communicated its intention to hold interest rates at their current historically low levels at least until the end of 2019, and to continue reinvesting the assets accumulated on its balance sheet over an extended period past the date when it will start raising interest rates. It further announced a new series of targeted long-term refinancing operations (TLTRO). As a result, the financial markets expect low interest rates to continue over an extensive period.

The outlook for global and European growth is subject to downside risks which, in the case of the euro area, will require resolute action to strengthen its institutional architecture

Looking ahead, the outlook for global and European growth remains subject to sizeable downside risks. Notable among these is the impact on the world economy of the potential proliferation of protectionist measures. And compounding factors include the vulnerabilities of some emerging economies, in particular – given its importance – the Chinese economy, and the high levels of debt globally.

On top of the effects arising from the potential materialisation of these risks, the European economies also have substantial idiosyncratic factors of vulnerability: uncertainty over Brexit, the weakness of specific banks, the demographic outlook and low productivity levels, among others.

Addressing these challenges to the European economy calls for resolute action by national authorities to raise growth potential and reduce vulnerabilities. It must also



be acknowledged that the institutional and regulatory architecture of Economic and Monetary Union (EMU) remains incomplete, despite the reforms agreed on in recent years. The revision of this architecture must be completed, so as to prevent the single currency from continuing to be exposed to tensions should serious shocks occur. The need to act is most pressing in three areas. First, the Banking Union is still missing a very important pillar, namely the creation of a common deposit guarantee scheme. Second, fresh momentum must be given to the integration of capital markets, an area where progress continues to be very slow. And third, mutual insurance capacity would be strengthened if the creation of a cyclical stabilisation instrument were approved, although sufficient consensus has not yet been forged for this proposal.

Central banks in general, and the ECB in particular, face numerous difficulties. These include most notably the persistence of low inflation and the proximity of interest rates to their effective lower bounds. Central bank strategies for action may need to be reviewed

The developed economies – and among them, in particular, the euro area – have been immersed in a prolonged period of low inflation. This is partly in response to the high degree of cyclical slack stemming from the deep recession. Moreover, the prolongation of the period of flatter prices is expected to have contributed to reinforcing their persistence, by exerting downward pressure on agents' inflation expectations.

Adding to this are the effects of certain structural factors, such as population ageing, globalisation and the generalisation of new technologies. Further effects specific to the euro area include the impact of reforms and of competitive adjustments undertaken in some countries in the wake of the crisis. More recently, in the eurozone and in other areas, there has been a rise in wage growth that has so far not passed through to prices. Looking ahead, we cannot know to what extent this pass-through may occur, or whether, on the contrary, the impact of higher labour costs will tend to be absorbed, as in recent quarters, by a squeeze on firms' mark-ups.

The proximity of interest rates to their effective lower bound narrows central banks' room for manoeuvre to react to future recessions, which has opened a debate about possible avenues for alleviating this constraint. Specifically, consideration has recently been given to resorting to alternatives such as raising the numerical inflation

target or setting a price level target. However, such possibilities are not free from costs or disadvantages. Central banks will also have to assess whether their balance sheets should retain their substantial current size, or whether, on the contrary, it would be preferable for that size to come closer to its habitual pre-crisis level. Notwithstanding operational aspects, this issue is significant not only in terms of the effectiveness of monetary policy; it may also have consequences for the stability of the financial sector as a whole.

Against this external background,  
the behaviour of the Spanish  
economy remained favourable in  
2018

With this hardly propitious external setting, the Spanish economy slowed slightly. But it showed substantial resilience compared with other developed countries. As a result, the recovery in activity continued for the fifth year running and the intensity of employment creation was maintained, which contributed to a further reduction in the unemployment rate.

Behind these favourable developments is highly dynamic domestic demand, which helped counter the notable loss of momentum of exports. Specifically, expansionary household and non-financial corporate income, the improvement in these sectors' financial position (essentially as a result of continuing deleveraging) and very favourable financing conditions all helped uphold private consumption and investment.

However, the strength of domestic demand was spurred by other less positive factors, insofar as they give rise to possible sources of vulnerability for the future. On one hand, budgetary policy remained expansionary, proving particularly conducive to the growth of household income. On the other, there was a fresh decline in the household saving rate, down to a historical low.

The expansion of the economy is  
underpinned by the correction of  
certain imbalances, in the form of  
private-sector deleveraging and  
improved competitiveness

From a broader time perspective, the assessment of the years elapsed since the start of the upturn may generally be viewed as positive. The last five-year period has been marked by high GDP and employment growth, which has clearly exceeded that observed in the euro area. Moreover, the recovery has enabled and,

in parallel, has been underpinned by the correction of some of the imbalances that built up in the previous upturn.

The current cyclical upturn is, in particular, thanks to the significant reduction in household and corporate debt, the far-reaching restructuring of the financial system and the pick-up in external competitiveness, which has provided for successive external surpluses. This latter development, in contrast to events in Spain in previous upturns, has enabled the nation's net debt to the rest of the world to begin to be reduced.

The notable improvement in external competitiveness has helped boost exports. And that has allowed the export share in the economy's output to increase notably. This, along with the increased weight of investment in equipment, has been a key feature of the changes in the productive structure of the economy over the course of the last few years.

**The economy faces different challenges and vulnerabilities, which should be promptly addressed**

Despite these developments, the economy faces major challenges and vulnerabilities, which need to be addressed in order to promote sustainable and balanced growth. The list of challenges – which, while not comprehensive, contains the main ones – includes:

reducing the high public and external debt, and the high unemployment rate; raising productivity; the need to face up to the consequences of progressive population ageing; and the shoring up of the banking system.

The prevailing circumstances underscore the need to address these challenges urgently. First, it is crucial to harness the still-favourable economic setting to speed through the necessary reforms. The potential transitory costs that some of the structural reforms occasionally entail can be better addressed in benign economic scenarios. Also, the effect of some of these reforms is, precisely, to make the economy more resilient in the face of an adverse scenario. It should be borne in mind that the international scenario is, on top of the previously mentioned slowdown in global activity and trade, characterised by the presence of various sources of risk. The hypothetical materialisation of such risks would check the expansion, and the ensuing effects might be amplified by the presence of specific factors of fragility in

our economy. In contrast, the economic policy initiatives pursued in recent years to address these challenges have been scarce.

**The current upturn should be harnessed to drive through an improvement in public finances**

Among the difficulties requiring attention is the absence of a significant correction in the structural component of the budget deficit in recent years. While there has been a reduction over the course of the recovery in the general government deficit, it has essentially been due to the buoyancy in activity and the fall in interest rates. There has been no genuine improvement in the structural balance, which remains at very high levels. As a result, the public debt ratio has scarcely fallen from its 2014 peak, meaning that at the end of the first quarter this year it stood at slightly over 98% of GDP.

Running such high levels of public debt significantly constrains the fiscal policy room for manoeuvre ahead of a potential recessionary scenario; accordingly, budgetary consolidation is a priority.

**Correcting the economy's external debt calls for maintaining the gains in competitiveness built up**

Despite the notable correction to date, the negative net international investment position stands far above that observed in other developed economies. Moreover, the nation's gross debt is only slightly below its peak during the crisis.

Continuing to reduce debt vis-à-vis the rest of the world calls for external surpluses to be run in a sustained fashion over time. And that, in turn, requires additional gains in competitiveness to be achieved. Unlike in the recovery to date, when such gains have been based on the moderation of labour and financial costs, they must depend to a greater extent hereafter on productivity gains.

**Extending the benefits of the recovery to all of society requires policies that boost job creation and job quality and promote productivity**

In a context in which inequality increased during the crisis, one of the priorities of economic policy should be to ensure that the benefits of the recovery spread to as many layers of society as possible. Among other actions, this will involve achieving additional increases in employment and enhancing job quality.

The Spanish labour market continues to evidence symptoms of a high degree of dysfunctionality, chief among which is the persistence of very high unemployment. True, the unemployment rate has fallen most significantly since the start of the recovery; but it still remains very high. This is particularly so in some specific groups such as the young and the less skilled. And it is in these groups where long-term unemployment is largely concentrated. In addition, there is significant room for improvement in the quality of existing jobs, where the rates of temporary employment and unwanted part-time employment are very high.

Given this diagnosis, the remedies involve reducing the mismatch between the skills of the unemployed and those demanded by employers. This in turn, requires improving the human capital of the less-skilled unemployed, to allow for their reinsertion into the labour market. Moreover, the need to address phenomena such as globalisation and digitalisation calls for reconsideration of the institutional design of the education system, learning methods and the very content of the educational curriculum.

Reducing the high rate of temporary employment requires the adoption of regulatory changes that make permanent hiring more attractive. Collective bargaining should, moreover, take into account the high dispersion between sectors and firms in terms of productivity, in order to better align productivity and wage remuneration. Progress on these two fronts would help prevent adverse shocks from bearing down so disproportionately on employment, as has historically been the case in the Spanish economy.

Improving citizens' well-being hinges crucially, moreover, on increasing productivity gains, which have been very poor in the past decade. Indeed, compared with the mere accumulation of production factors, an increase in productivity is the sole mechanism capable of generating sustained and stable economic growth in the long run. The structural reforms needed to improve the dynamics of this variable must therefore be undertaken. Among other aspects, there is ample scope to pursue reforms that: reduce labour market duality; revise those regulations that unduly curb sectoral competition and deter or hamper business growth; improve the quality of institutions; and eliminate the human and technological capital shortfall. At the same



time, a review of public spending and revenue, so as to increase efficiency, and a general periodic and systematic assessment of public policies might contribute decisively to improving productivity.

### The phenomenon of population ageing is a first-order challenge

The phenomenon of population ageing under way in the advanced economies will have far-reaching consequences. The effects of this demographic development will become patent in many areas of the economy. They will affect consumption and saving patterns; prompt a reduction in the workforce and, possibly, in the pace of productivity; and test the effectiveness of demand-side policies in stabilising activity.

It is thus important to stress that addressing the population challenge will require a multidisciplinary strategy. Among other aspects, this strategy must encourage the participation of older workers, tailor migratory policy to labour market needs and boost the birth rate. In this scenario, education and vocational training policies will be crucial.

Population ageing is also a first-order challenge for the sustainability of our welfare system. It will involve a most pronounced increase in public spending on specific items, which notably encompass the public pensions system. The reforms approved in 2011 and 2013 included certain adjustment elements that enabled the effect of ageing on public spending on pensions to be significantly countered by, above all, a likewise significant reduction in the replacement rate. The latest measures approved have delayed the application of the sustainability factor and have reintroduced in recent years the CPI-based revaluation of pensions. In this setting, ensuring the financial sustainability of the system will require additional measures. The importance of this issue highlights the need to forge broad consensus, without unwarranted delay, on the measures needed for our pension system to preserve intertemporal sustainability and intergenerational equity.

### Progress has been made in shoring up the banking system, but significant work remains to be done

The strengthening of the banking system's financial situation continued in 2018, with a significant improvement in asset portfolio quality. The balance-sheet clean-up was underpinned both by the

continuation of the cyclical expansion and by the transfer and sale of problem assets undertaken in the sector. The overall result was the continuing pick-up in financial institutions' profitability.

Nonetheless, we must continue to tackle the considerable challenges still facing the banking system, which are in many cases shared by other European banking systems. In particular, further reductions in the volume of problem assets and the continuing streamlining of operating expenses are vital for restoring higher levels of profitability, which remain very low relative to the cost of capital these institutions must bear. Moreover, Spanish banks must reinforce their capital and liabilities susceptible to bail-in in order to address outstanding regulatory challenges and improve their resilience in the face of adverse shocks.

In addition, institutions must adapt, first, to the new sectoral structure taking hold, characterised by the influx of new competitors; and further, to the new technological environment, in which the digitalisation of many financial services poses significant risks but also offers many opportunities to credit institutions. Banks must also strive to improve their reputation, which was tainted in some respects in the wake of the crisis.

The recent creation of the Spanish macroprudential authority (AMCESFI) and the extension of the macroprudential tools available to the sectoral supervisory authorities strengthen the capacity for preventing and mitigating risks to financial stability

AMCESFI was created at the start of 2019. Its aims are to boost coordination, information exchange and the analysis of risks to financial stability among the Ministry of Economy and Enterprise, the Banco de España, the National Securities Market Commission (CNMV) and the Directorate General for Insurance and Pension Funds (DGSFP). In parallel, the set of instruments available to the sectoral authorities for application to the institutions subject to their regulation has been extended. In particular, the Banco de España is empowered to require, where appropriate, countercyclical capital buffers of banks by credit segment, limits on concentration vis-à-vis economic sectors and conditions on the extension of new loans. These instruments join those already in place (countercyclical capital buffer and capital

buffers for global and domestic systemically important institutions, among others). These developments should contribute to enhancing the authorities' capacity both for identifying risks to financial stability and for responding to mitigate them.

In sum, the positive course of the economy in recent years should not have us lose sight of the enormous challenges still ahead. Only by resolutely addressing these challenges can we give extra momentum to the current upturn, improve our economy's capacity to withstand negative scenarios in the future and steal a march on the numerous consequences of the major demographic changes that Spain must face.

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