Annual Report
Digest

Developments in 2018

- **The expansion of the Spanish economy continued in 2018. GDP growth was 2.6%,** somewhat down on 2017. Growth remained very intensive in employment creation.
- The slight slowdown observed was in line with expectations, but the composition of GDP was very different: **domestic demand** continued to be very robust, set against the significant slowdown in **exports.**
- **Activity and world trade** were affected by the tightening of global financial conditions and heightening uncertainty over trade conflicts and the Chinese authorities' difficulties in redressing this economy's debt [Box 1.1].
- This scenario particularly impacted the **exports** of the (generally very open) **euro area** economies. Compounding this were the effects of the cumulative appreciation of the euro and the uncertainty arising from Brexit. Moreover, in some countries, such as Italy and Germany, there were other adverse factors bearing down on the weakness of **domestic demand.** As a result, year-on-year **growth** in the area dipped from 2.7% at end-2017 to 1.2% a year later.
- The buoyancy of domestic demand **in Spain** accounts for **GDP growth exceeding that of the euro area as a whole in 2018** [Box 1.2]. Underpinning the favourable course of household and business spending were the expansionary behaviour of these sectors' incomes, their improved financial position and the availability of financing under favourable conditions.
- In the case of **households,** the fresh decline in the saving rate and the high growth of borrowing to finance consumption suggest that households might be basing their spending decisions on overly optimistic expectations about their future incomes.
- Also upholding the strength of activity last year was the **expansionary fiscal policy stance.**
- Overall **inflation continued to be somewhat volatile,** owing to the ups and downs of energy prices. Core inflation, meanwhile, remained low, against a background of rising unit labour costs.

Underpinnings and vulnerabilities

- The projected prolongation of the expansion in Spain is underpinned by several **supporting** factors:
  - The **improved financial situation of households and firms,** following the significant reduction in their debt over the past decade.
  - The **balance-sheet clean-up and restructuring of the banking system.** This helps the sector fulfil its function of financing agents' spending, and thus contribute to growth.
  - Recurrent **external surpluses,** thanks to improved competitiveness. Contributing factors here were the easing in labour costs and the greater flexibility in the use of the labour factor afforded by the latest labour market reforms.
  - The openly expansionary **ECB monetary policy stance,** which is expected to hold over a prolonged period.
  - The strengthening of the **euro area's institutional architecture.** Though incomplete, this has seen the introduction of new tools and institutions in the prudential supervision and macrofinancial stability area (such as the Single Supervisory Mechanism, the Single Resolution Mechanism and the European Stability Mechanism). Contributing at the national level in this connection is the recently created Spanish macroprudential authority (AMCESFI).
- But there are still some factors of fragility leaving our economy **vulnerable** to potentially adverse shocks:
  - The high **overall general government structural deficit** and high **public debt.**
  - **External indebtedness,** despite running current account surpluses in recent years.
  - The vulnerability of some **household** groups as a result of the increased share of their spending against future income.
  - The **risk of reversal of some of the reforms** conducive to fomenting the current recovery.

How to address the challenge of achieving balanced and sustainable growth in the long term	

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- Challenges in the **public finances** domain:
  - — Resumption of budgetary consolidation to afford fiscal policy greater room for manoeuvre ahead of future shocks.
  - — Adoption of far-reaching measures to ensure the sustainability of the pension system and that pensions are fair from the standpoint of the attendant costs and benefits for different generations.
  - — Revision of the composition of public spending and revenue, seeking to maximise their contribution to growth.
- The need for **sustained external surpluses** to continue reducing the net debtor position vis-à-vis the rest of the world. That will require holding on the path of improved **competitiveness** which, unlike to date, should rest more on **productivity** gains than on wage moderation. This will call for improvements in **human and technological capital.**
- The need to **correct structural shortcomings in the labour market.** Symptoms here include a high unemployment rate (especially among the young and less skilled), and high levels of temporary unemployment and unwanted part-time time employment [Box 1.3]. This requires measures that will:
  - — Maximise employment generation and help increase the number of hours worked per person. These aspects would help prolong the recent reduction in income disparity [Box 1.4]. It will be crucial in this connection to revise active labour market policies and continuous training.
  - — Increase the attractiveness of permanent hiring without giving up much-needed flexibility to prevent recessions translating into mass job losses.
- The **strengthening of the banking system's** capacity to contribute to the financing of the economy as a whole: improved profitability, reduction in problem assets, strengthening of capital levels, adaptation to a new technological and competitive environment (FinTech, BigTech), and restoring of reputation.
- The **deepening of the euro area's institutional architecture,** with a particular emphasis on introducing and developing risk-sharing and risk-mitigation elements more intensely and efficiently than has so far been the case.

Price stability and inflation targets	• Price stability contributes to the sustainable development of the economy and, therefore, is part of most central banks' mandate. At the ECB, **price stability** is set in terms of annual increases in the euro area HICP close to – but below – 2% in the medium term. • Since the launch of the single currency in 1999, the **area's inflation** has been in line, on average, with the ECB's objective; **since 2013**, however, it has been persistently **below the medium-term objective.** • More recently, the **ECB** has resorted extensively to extraordinary measures to provide the expansionary stimuli needed to raise actual inflation towards its objective [Box 2.1].
Inflation developments and expectations	• Diagnosing the determinants of the current **low-inflation scenario** characterising some of the main advanced economies, including the euro area, is crucial for monetary policy conduct. • This low-inflation scenario is partly the outcome of **transitory factors,** linked to cyclical circumstances and to energy prices. • But there are also more permanent, **structural factors.** These include population ageing, globalisation and new technologies and forms of trade, which are exerting downward pressure on inflation globally [Boxes 2.2 and 2.3]. • Low inflation over a long period can lead long-term **expectations** ultimately to reflect, in part, current inflation. That may prompt some deanchoring of inflation expectations in relation to the ECB's medium-term objective.
Changes in the composition of inflation: by country and by sector	• To understand the low inflation in **the euro area,** regard should be had to its composition by country and sector: **inflation in the peripheral countries has converged on that of the core members** (1999-2018), and the reduction in services inflation has been particularly sharp. • Inflation has eased more in the countries which felt the impact of the crisis more acutely, pursued economic and financial adjustment programmes and implemented a more contractionary fiscal policy during the sovereign debt crisis; namely, in Portugal, Greece, Ireland and Spain. Inflation averaged 0.4% in these countries in 2013-2018, compared with 0.9% in the euro area. In the other members current inflation is only slightly lower, on average, than in the years following the launch of the euro. • **Energy prices** now have a more determining influence on inflation fluctuations. This is because the more stable components of price indices have tended to ease, especially **prices in services,** a traditionally more inflationary sector.
Some additional explanatory factors	• **Monetary policy** contributed positively to the rise in inflation and in GDP. It did so during the crisis and the recovery, and in the euro area and Spain alike, easing financial conditions and countering deflationary pressures. • The **limited cyclical sensitivity** of inflation in the euro area partly explains why the current economic upturn has not been accompanied by greater inflationary pressures. The **influence of the exchange rate** on euro area inflation has increased in the most recent period. • **After the crisis,** inflation eased more in Spain than in the euro area. In particular, **the moderation of labour costs has been central to flatter domestic prices.** — At the start of the crisis, prices partly reflected the reduction in labour costs because business mark-ups, in the face of tighter financing conditions and sectoral competition problems, did not adjust to the cyclical situation. • **More recently, the rise in wages has coincided with an easing in business mark-ups** (especially in services), both in Spain and in the euro area. As a result, the pass-through of higher labour costs to prices is proving very moderate.
Inflation outlook	• **Core inflation forecasts have been revised systematically downwards** in the past two years. In 2018, these revisions were across the board by country and by sector and, in particular, in services, despite the ongoing economic recovery. • The recurrent underestimation of inflation in recent years shows that the persistence of deviations from target is significantly higher than estimated to date. • Permanent supply-side factors (previously referred to) might also be operating. Their short-term impact is difficult to quantify.

Current monetary policy scenario and outlook	• The monetary policy response of the main advanced economies to the global financial crisis that broke a decade ago mainly involved the following actions: — Cutting **policy interest rates to historically low** and, in some cases, even negative levels. — **Quantitative easing:** large-scale asset purchases, and liquidity-provision and bank-refinancing operations. Outcome: unprecedented growth in the size of the main central banks' balance sheets. • Both aspects – low interest rates and large balance sheets – pose **challenges and dilemmas for monetary policy** in the coming decade.
Monetary policy strategies in a low interest rate environment	• Central banks currently face a scenario where interest rates are likely to oscillate around levels close to their lower bounds (hence, it may not be possible to further reduce the interest rate to provide additional monetary stimulus). — This occurs owing, among other factors, to the downward pressure exerted by adverse demographic developments on the interest rate [Boxes 3.1 and 3.2]. • To gain leeway, central banks are considering **alternative strategies** [Box 3.3]: — **Raising the numerical inflation target:** from the current 2% to 3% or 4%, for example. — Replacing inflation **targeting** with a **price level** (either permanently or only if interest rates reach their lower bound and, hence, high-inflation expectations are required). — **Replacing cash with digital money:** as a means of eliminating the lower bound on interest rates. — Yet these measures **are not free from costs and risks,** which should not be underestimated. • Other authorities can implement economic policies, such as **structural reforms and fiscal policy,** to raise natural rates, thus providing more room for monetary policy.
The size and composition of the central bank balance sheet: options	• The **Eurosystem balance sheet** has increased from 13% of euro area GDP in 2006 to 41% at end-2018: — On the asset side, through banks' long-term refinancing operations and large-scale asset purchase programmes (APP). — On the liabilities side, with the increase in bank reserves deposited by commercial banks in the Eurosystem. • **ECB monetary policy implementation** has evolved, adapting to the new scenario determined by the following measures: — Switching from a **"corridor" system:** when, in a context of scarce reserves, the ECB steers interbank rates (such as EONIA) within the corridor formed by its marginal lending facility rate ("ceiling" or upper limit of money market yields) and deposit facility rate ("floor" or lower limit). — To a **"floor" system:** when banks have abundant reserves, and the EONIA is close to its "floor", i.e. the deposit facility interest rate. • Central banks must **decide whether to maintain the size of their balance sheets at the current expanded levels, or whether they shrink them to pre-crisis levels.** — Since their liabilities consist mainly of (short-term) bank reserves, the central banks' choice between a large or small balance sheet (whose pros and cons are summarised in Fig. 3.4) amounts to that between maintaining the current floor system (with a large balance sheet) or returning to the pre-crisis corridor system (with a much smaller balance sheet) [Box 3.4]. — In this context, the possibility of lengthening the maturity of central bank liabilities is also discussed. • **Maintaining the floor system has certain advantages** (e.g. in terms of a greater control of interest rates). In the Eurosystem it would be **possible to maintain the floor system with a lower volume of excess reserves** (and, hence, a smaller balance sheet) **than at present.**

Changes in population structure: birth rate, longevity, immigration	• **Demographic changes,** along with **technological advances,** are transforming our economies, and will do so even more in the coming decades. • The **age-based structure of the Spanish population is going to change in the coming years:** we are moving towards a considerably older population. According to forecasts, the proportion of the over-66s compared with those aged 16-66 will double between 2018 and 2050: for each person over 66, there will only be two persons aged 16-66 [Box 4.1]. • This **population ageing** can be explained: — Among the elderly, by the increase in life expectancy and by the arrival of the 1960s baby boomers into this group. — Among younger cohorts, by the decline in birth rates as from the 1980s. • This leads to **an increase in the relative weight of retirees in relation to the population of working age,** which we are already witnessing in the advanced economies. This has come to pass later in Spain, and will occur more swiftly in the coming years.
Impact on supply and demand and macroeconomic policies	• Population ageing affects aggregate supply and demand. — **Demand. Consumption, saving, investment, income and wealth** patterns differ in each age group. Foreseeably, both consumption and its composition will vary (if the patterns of behaviour of the current generations hold). There will also be changes in the asset portfolios of the new cohorts of retirees [Box 4.2], which, at present, point to a higher weight of real estate relative to total wealth and a lower weight of pension funds and financial assets. — Supply. Potential growth in the economy responds to changes in **employment** and in **productivity.** There is evidence that, in the advanced countries in recent decades, population ageing has been associated with a reduction in potential growth attributable to a lower employment rate and to a decline in productivity [Box 4.3]. To alleviate these effects on supply, education policies should be pursued to assimilate technological changes and to provide incentives to raise the age individuals exit the labour market. • As the proportion of the elderly increases, macroeconomic policies will be transmitted differently, and their effects will vary: — **Monetary policy:** interest rates will foreseeably be low [Box 3.3], inflation-aversion greater and inflationary pressures lower. — **Fiscal policy:** the level and composition of public spending and tax revenue will vary, with changes in the weight of social contributions relative to spending on pensions, and lower levels of personal and labour income tax revenue and, foreseeably, indirect tax revenue. The means of transmission of fiscal impulses to economic activity will likewise change [Box 4.4].
Social policies	• The decline in the weight of the working-age population relative to retirees means that **revenue from social security contributions will fall relative to the higher spending on pensions, healthcare and dependency.** • The revenue/expenditure imbalance calls for a **far-reaching reform of the pension system and other social policies** (spending on the health system and on dependency programmes). Their sources of financing and the level and efficiency of benefits will need revising. • The reforms **must be financially sustainable, offer sufficient benefits** and **distribute fairly the costs and benefits between current and future generations.** • Work-life balance policies and policies to boost birth rates may contribute to attaining more balanced demographics.