1. OVERVIEW

1 Introduction

The pace of recovery in the Spanish economy increased in 2015, attaining growth of 3.2 %...

...providing for a sharp increase in employment and an improved external surplus, although the structural budget deficit worsened

The pace of the recovery in the Spanish economy dating back to mid-2013 increased in 2015. Despite lower global growth and the cyclical weakness of the euro area, the headway in restoring the main macrofinancial equilibria, the successive reductions in oil prices, the stepping up of monetary policy stimuli and the expansionary fiscal policy stance all helped quicken the growth rate from 1.4% in 2014 to 3.2% in 2015, a figure appreciably higher than that posted by Spain's main European partners.
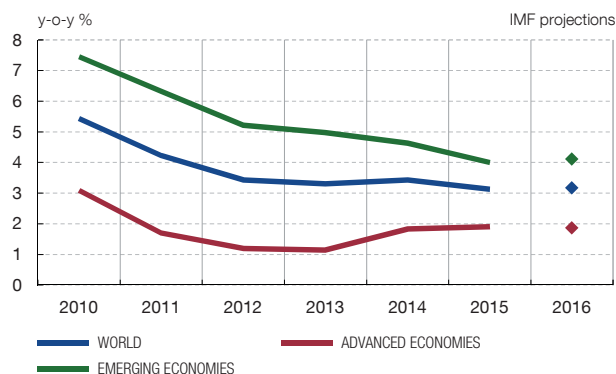
Household consumption, business investment and exports were the demand components that most contributed to the growth in activity. A further factor, in contrast to previous years, was the expansion in consumption and public investment. Employment creation remained notably intense, as evidenced by the increase of over half a million in workers employed. Households and firms (financial and non-financial alike) continued to pursue the deleveraging process they initiated some years ago and, overall, they generated net lending above the financial requirements of the public sector, meaning that the external financial surplus of the nation as a whole stood at slightly over 2% of GDP. The budget deficit declined to 5.1% of GDP as a result solely of the improvement in activity, as there was an increase in the structural budget deficit (that which is not adjusted for economic developments) to 2.9% of GDP, on European Commission (EC) estimates. The public debt/ GDP ratio stood at 99.2% of GDP (99.3% in 2014).

The progressive tailing off of certain factors that have contributed to the increase in output in 2015 will make way for more moderate growth rates in the short and medium term

The expansionary fiscal policy stance combined last year with other factors whose positive effects on growth are expected likewise to be temporary. These included the successive reductions in oil and other commodities prices, the depreciation of the euro for much of the year and the easing in financing costs. In this respect, as the impulse from these factors progressively tapers off, the Spanish economy will grow at a more moderate rate, as the latest Banco de España forecasts show.

Despite the progress made in recent years, significant challenges remain in place and must be addressed with an economic policy that is resolute in terms both of fiscal consolidation and of structural reform
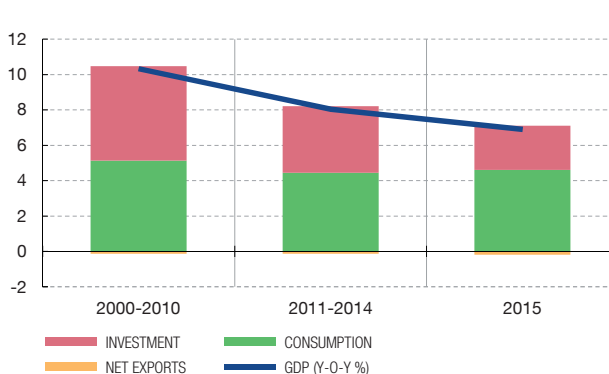
The current recovery phase is proving conducive to helping restore the main macrofinancial equilibria of the Spanish economy which, in turn, have a positive bearing on growth capacity. Improvements have been most visible in the fields of employment, competitiveness, private-sector deleveraging and the stabilisation and incipient recovery of the real estate sector, along with the clean-up and restructuring of the financial sector. Yet significant challenges remain, including most notably the need to reduce high unemployment, to see through the process of private-sector deleveraging and to resume a fiscal consolidation path consistent with a sustained reduction in public debt. And this in a setting in which high external debt and the corresponding sizeable refinancing needs continue to be a factor of vulnerability. For the medium-term outlook to improve, there is a need to boost productivity, the sluggishness of which curtails growth possibilities, and to tackle the effects of population ageing. These challenges call for a resolute economic policy agenda in terms both of fiscal consolidation and of structural reform.

This first chapter analyses the international and domestic factors underpinning growth last year. It also highlights the main challenges facing the Spanish economy and the economic policies needed to tackle them. The remaining chapters in this Report address specific aspects in greater depth, such as those relating to the determinants of the gains in competitiveness observed in recent years and their influence on the current recovery
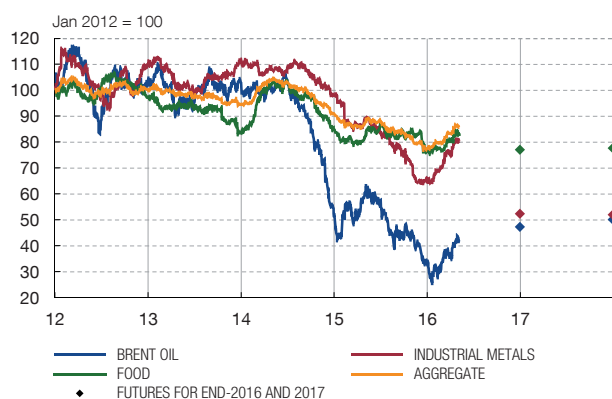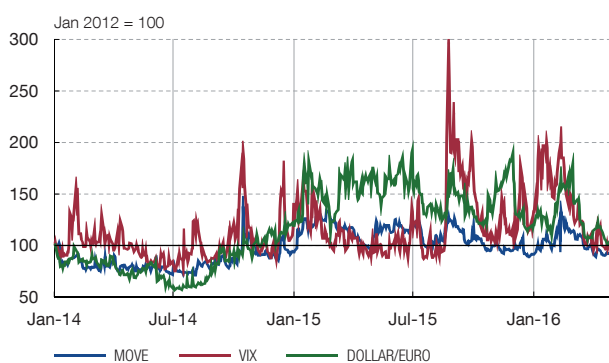
1 GDP GROWTH AND IMF FORECASTS

y-o-y %   IMF projections

WORLD
ADVANCED ECONOMIES
EMERGING ECONOMIES

2 RE-BALANCING IN CHINA

INVESTMENT   CONSUMPTION
NET EXPORTS   GDP (Y-O-Y %)

3 COMMODITIES PRICES

Jan 2012 = 100

BRENT OIL   INDUSTRIAL METALS
FOOD   AGGREGATE
FUTURES FOR END-2016 AND 2017

4 VOLATILITY INDICES

Jan 2012 = 100

MOVE   VIX   DOLLAR/EURO

SOURCES: IMF and Datastream.

phase (Chapter 2), the effects of the ECB's non-standard monetary policies on the Spanish economy (Chapter 3) and the significance of business dynamism and its impact on productivity (Chapter 4).

2 Economic developments in 2015

2.1 AN UNCERTAIN GLOBAL SETTING

The growth of the emerging economies slowed …

In 2015 the world economy grew by 3.1%, 0.3 pp down on 2014 (see panel 1 of Chart 1.1) and also down on expectations at the start of the year. The slowdown in activity was the result of the diminished dynamism of the emerging economies, whose growth fell, for the fifth year running, to 4% from 4.6% in 2014. The advanced economies maintained a modest rate of increase (1.9% against 1.8% the previous year), despite the expansionary stance of economic policies (monetary policy in particular) and the fresh declines in oil prices. The behaviour of the world economy was influenced mainly by three developments: the re-balancing of the Chinese economy, the acceleration of the fall in oil prices and expectations about the normalisation of US monetary policy.

… in a setting of uncertainty over the re-balancing of the Chinese economy…

The Chinese economy remains immersed in a transition towards a more sustainable growth model, with a greater prevalence of consumption over investment and exports, and of services over industry, and in which the markets play a more significant role in resource allocation (see panel 2 of Chart 1.1). Since summer 2015, the complexity of the process and the doubts about its future course have given rise to increased uncertainty globally, with adverse consequence for trade flows and international financial markets.

CHART 1.2

1 GROSS DOMESTIC PRODUCT (a)

%

SPAIN   EURO AREA

2 OUTPUT GAP (b)

pp
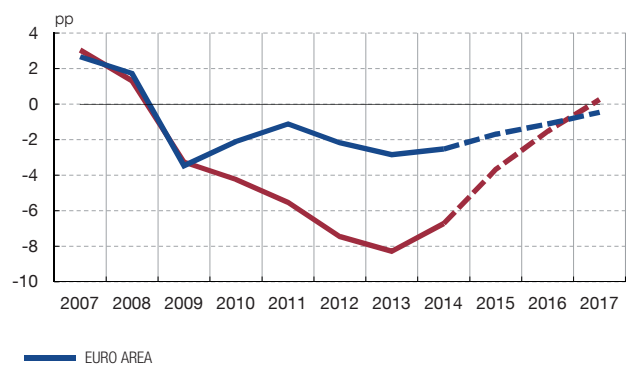
3 HARMONISED INDICES OF CONSUMER PRICES (a)

%

SPAIN   EURO AREA

4 EURO AREA INFLATION EXPECTATIONS DERIVED FROM INFLATION-LINKED SWAPS

2-YEAR INFLATION TWO YEARS AHEAD
5-YEAR INFLATION FIVE YEARS AHEAD

SOURCES: Eurostat, INE, European Commission and Banco de España.

a Year-on-year rate of change calculated on the basis of seasonally adjusted series in the case of GDP, and CPI original series.
b Defined as the percentage difference between actual GDP and potential GDP. European Commission estimate and projections (broken line) (May 2016).

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… and downward pressures on oil prices

Oil prices continued falling in 2015, albeit with a degree of volatility over the course of the year. The price of a barrel of Brent fell below $30 in early 2016, marking a low since 2003. Subsequently, however, it rebounded to around $50 per barrel (see panel 3 of Chart 1.1). Nonetheless, the global impact of cheaper oil prices is proving less favourable than anticipated, as a result of their adverse effect on investment in the extraction industries, the deterioration in the financial position of energy companies and the fiscal and external situation of the oil-exporting economies.

There was high volatility on financial markets in the second half of 2015 and in early 2016

Uncertainty over the Chinese economy and other emerging areas and the fall in oil prices were two of the main triggers of the turbulence on global financial markets during the second half of 2015 and in the opening months of the current year (see panel 4 of Chart 1.1). Against this background, the dollar appreciated against the benchmark currencies and, above all, relative to those of the emerging economies, owing to its safe-haven status and to the divergence in monetary policy cycles across the different regions. The high volatility on international financial markets in late 2015 and early 2016, and the limited prospects of global growth, however, contributed to tempering the pace of normalisation of the US monetary policy stance, which began last December with the first rate rise in seven years by the Federal Reserve.

2.2 THE EURO AREA AND THE MONETARY POLICY OF THE ECB

The euro area economy grew moderately, driven by consumption…

Euro area GDP grew by 1.5% in 2015, against 0.9% the previous year (see panel 1 of Chart 1.2). The increase in GDP was largely underpinned by household consumption, as a result of more favourable financial conditions and the increase in disposable income, in a setting of low inflation rates and improving labour market conditions. Government consumption also contributed positively to growth, boosted in some countries by the increased expenditure needed to address the refugee crisis, whereas investment remained sluggish.

… and the growth outlook has recently been revised downwards

Despite the improvement, the pace of recovery in the area remained modest, as compared with previous episodes of recovery and in relation to the recent experience of other advanced economies. Since late 2015, the context of lower global growth and greater uncertainty appears to have been contributing to moderating growth prospects, as may be inferred from the projections published last May by the EC, which revised the increase in GDP to 1.6% and 1.8%, respectively, for 2016 and 2017.

The pace of employment creation, while sustained, is still insufficient for significantly reducing the high unemployment still persisting in some countries

One of the highlights of the recent euro area performance is the relatively favourable behaviour of employment, which grew 1.1% in 2015 as a whole, partly driven by the effect of the structural reforms recently undertaken by certain economies in the area. However, job creation is not yet of a sufficient intensity to significantly reduce the high unemployment rates still besetting certain countries. More generally, European labour markets must face the challenges posed by structural unemployment, population ageing and the absorption of migratory flows.

Prices remained flat, in a setting of low inflation expectations

Inflation was dominated by the strong adjustment in oil and other commodity prices, which led the level of prices to hold practically unchanged over the year as a whole, in step with developments in other advanced economies. Temporary fluctuations aside, however, core inflation hovered at rates below 1% throughout 2015 and in early 2016, influenced by the still-wide negative output gap. Indicators of medium- and long-term inflation expectations continue to slip downwards (see Chart 1.2).

The monetary policy measures deployed since mid-2014 had a favourable impact on financial conditions in the area

As explained in detail in Chapter 3 of this Report, the build-up of downside risks to the price stability objective and the growing signs of a de-anchoring of inflation expectations led the ECB to extend its asset purchase programme in early 2015, with secondary market acquisitions of securities issued by the public sector. This measure, along with others previously adopted, such as the setting of negative interest rates on the deposit facility and on targeted long-term refinancing operations (TLTROs), favourably impacted the financing costs of public and private agents alike in the euro area, reducing the levels of financial fragmentation and providing for greater dynamism in the flow of credit. The depreciation of the euro in the opening months of the year had a positive effect on European exports, the relative weight of which on international markets duly increased considerably.

The ECB approved further stimulus measures in December 2015 and in March 2016 in response to the worsening inflation outlook

After the summer, however, the worsening global growth outlook and the increased volatility on financial markets impacted financial conditions in the area. And this, combined with the appreciation of the euro against the benchmark currencies as from that point, partly offset the positive effect of the monetary stimuli. In response to the new scenario, the ECB Governing Council approved further stimulus measures in December 2015 and in March 2016. The monetary authority cut the rate on the deposit facility on two occasions, lowering it to -0.40%, while the rates on the main refinancing operations and on the marginal lending facility stood at 0% and 0.25%, respectively. The Council further decided to expand its asset purchase programme and to introduce a new series of TLTROs in order to strengthen monetary policy transmission through the credit channel.

At the institutional level, it was agreed to approve a third assistance programme for Greece …

The European institutions agreed on a third financial assistance programme for Greece, against the background of the growing vulnerability of the Greek economy which prompted the setting of capital controls. Following the approval of the programme in July last year, there was a third round of recapitalisation of Greek financial institutions and an extensive list of measures – upon which the continuity of the programme and the potential adoption of debt-relief measures are conditional – began to be implemented.

… and there was further progress aimed at completing the Banking Union

After the start-up of the Single Supervisory Mechanism in 2014, further steps were taken throughout 2015 and earlier this year to complete the Banking Union. Thus, the creation of the Single Resolution Mechanism and the entry into force of the Bank Recovery and Resolution Directive will enable situations of non-viability of credit institutions to be tackled using common principles and rules, minimising the economic cost and the need for public funds. Likewise, the Single Resolution Fund, which draws on contributions from banks themselves, has been in place since January 2016 to finance possible resolution measures. Finally, the EC published its proposal regarding the third pillar of the Banking Union, namely the establishment of a European Deposit Insurance Scheme, which contemplates a progressive integration process that should be finalised within eight years.

2.3 THE CONTINUATION OF THE RECOVERY IN THE SPANISH ECONOMY

The Spanish economy was boosted by several factors, some more permanent and others temporary

The Spanish economy continued on a path of recovery in 2015, posting a year-on-year rate of increase of 3.5% in the final quarter of the year, the highest figure since the current expansionary phase began almost 3 years ago (see Chart 1.2 and Table 1.1). Growth was driven by a broad set of factors, some structural in nature and others more temporary.

Notable among the structural factors was the improvement in the macrofinancial setting…

The structural factors relate to the continuation of the still-incomplete adjustment of the main imbalances built up during the previous upturn and the most severe phases of the crisis, and to the improvement in the macrofinancial setting, to which the policies and reforms implemented both domestically and at the European level contributed. In particular, a key element of recent developments is the ongoing improvement in the competitiveness of the Spanish economy derived from the adjustment of relative prices and costs of goods and services. And the correction of a significant portion of the financial fragmentation problems within the euro area and the improved financing conditions for our economy's public and private sectors have also been instrumental in this connection. Further, throughout last year, patent headway was once again made in the deleveraging of households and firms.

The competitive adjustment is estimated to have operated, firstly, by invigorating exports. This, in turn, will have fed through to the domestic spending and employment components, enabling the unemployment rate to be cut considerably, although it remains at a very high level. In turn, the dynamics of employment creation discernible throughout the current phase of recovery have been a significant source of support for demand, in terms both of sustaining household disposable income and improving confidence. These developments are expected to have helped entrench the net lending capacity of the nation vis-à-vis the external sector, as is analysed in Chapter 2 of this Report.

... while the temporary factors included the fall in oil prices, the depreciation of the euro and demand-side policies

Notable among the more temporary factors, given their significance for economic activity and prices, were the new monetary measures. These entailed a further improvement in financial conditions and a depreciation of the euro, the expansionary fiscal policy stance, the fall in oil and other commodities prices, and, in the opposite direction, the slowdown

	2010	2011	2012	2013	2014	2015
Demand and output (b)						
GDP	0.0	-1.0	-2.6	-1.7	1.4	3.2
Private consumption	0.3	-2.4	-3.5	-3.1	1.2	3.1
Government consumption	1.5	-0.3	-4.5	-2.8	0.0	2.7
Gross capital formation	-3.8	-7.2	-8.1	-3.6	4.8	7.0
Investment in equipment	5.1	0.8	-8.4	3.9	10.5	10.2
Construction investment	-10.1	-11.7	-8.3	-7.1	-0.2	5.3
Housing	-11.6	-13.3	-5.4	-7.2	-1.4	2.4
Other construction	-8.5	-10.2	-10.7	-7.1	0.8	7.5
Exports of goods and services	9.4	7.4	1.1	4.3	5.1	5.4
Imports of goods and services	6.9	-0.8	-6.2	-0.3	6.4	7.5
Contribution of national demand to GDP growth	-0.5	-3.1	-4.7	-3.1	1.6	3.7
Contribution of net external demand to GDP growth	0.5	2.1	2.1	1.4	-0.2	-0.5
Employment, wages, costs and prices (c)						
Total employment	-2.7	-2.8	-4.9	-3.5	1.1	3.0
Employment rate (d)	59.7	58.8	56.5	55.6	56.8	58.7
Unemployment rate	19.9	21.4	24.8	26.1	24.4	22.1
Compensation per employee	1.1	0.9	-0.6	1.7	-0.6	0.5
Apparent labour productivity	2.7	1.8	2.4	1.9	0.3	0.2
Unit labour costs	-1.6	-0.9	-2.9	-0.2	-0.8	0.3
GDP deflator	0.2	0.0	0.0	0.6	-0.4	0.6
Consumer price index (12-month % change)	3.0	2.4	2.9	0.3	-1.0	0.0
Consumer price index (annual average)	1.8	3.2	2.4	1.4	-0.2	-0.5
Consumer price differential with the euro area (HICP)	0.4	0.3	-0.1	0.2	-0.6	-0.7
Net lending (+) or net borrowing (–) and financial balance (e)						
Resident sectors: domestic net lending (+) or net borrowing (–)	-3.3	-2.9	0.1	2.2	1.6	2.1
General government	-9.4	-9.6	-10.4	-6.9	-5.9	-5.1
General government (excluding aid to financial institutions)	-9.3	-9.1	-6.7	-6.4	-5.8	-5.0
Households and NPISHs	1.3	2.4	2.4	4.2	3.8	3.4
Firms	4.7	4.3	8.1	5.0	3.6	3.8
Financial institutions	1.0	2.1	6.8	2.0	2.1	1.6
Non-financial corporations	3.7	2.2	1.2	3.0	1.5	2.2
Net international investment position	-88.6	-91.9	-90.0	-96.2	-95.6	-90.5
General government gross debt	60.1	69.5	85.4	93.7	99.3	99.2
Monetary and financial indicators (f)						
ECB minimum bid rate on MROs	1.0	1.3	0.9	0.5	0.2	0.1
Ten-year government bond yield	4.2	5.4	5.8	4.6	2.7	1.7
Synthetic bank lending rate	3.3	4.1	4.1	4.1	3.8	2.9
Madrid Stock Exchange General Index (Dec 1985 = 100)	1,076.5	971.8	767.5	879.8	1,066.6	1,080.5
Dollar/euro exchange rate	1.3	1.4	1.3	1.3	1.3	1.1
Nominal effective exchange rate vis-à-vis developed countries (g)	101.7	101.6	100.2	101.5	101.5	99.3
Real effective exchange rate vis-à-vis developed countries (h)	116.1	114.1	107.1	107.0	105.1	102.3
Real effective exchange rate vis-à-vis the euro area (h)	113.5	111.7	106.3	104.6	102.6	102.3
Households: total financing	0.2	-2.4	-3.8	-5.1	-3.6	-2.2
Non-financial corporations: total financing	0.7	-2.0	-6.4	-5.9	-4.4	-0.9

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

a Spanish National Accounts data, base year 2010.
b Volume indices. Rate of change.
c Rate of change, except the unemployment rate, which is a level.
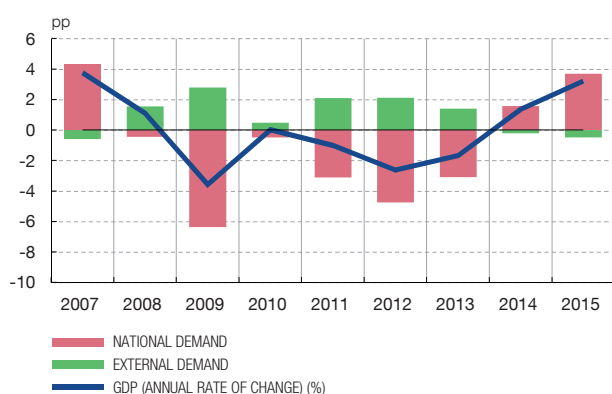**d** Employment rate (16-64).
e Levels as a percentage of GDP.
f Annual average levels for the Madrid Stock Exchange General Index, interest rates and exchange rates, and rates of change for finanancial assets and liabilities.
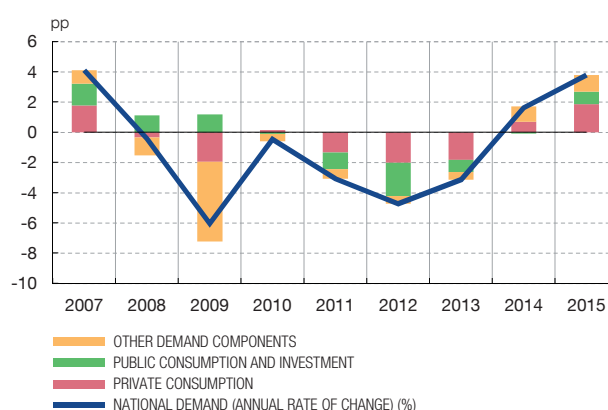**g** 1999 Q1 = 100.
h 1999 Q1 = 100. Measured with unit labour costs.

SPAIN: GDP AND NATIONAL DEMAND. CONTRIBUTIONS TO GROWTH

CHART 1.3

1 GDP, NATIONAL DEMAND AND EXTERNAL DEMAND

NATIONAL DEMAND
EXTERNAL DEMAND
GDP (ANNUAL RATE OF CHANGE) (%)

2 NATIONAL DEMAND AND COMPONENTS

OTHER DEMAND COMPONENTS
PUBLIC CONSUMPTION AND INVESTMENT
PRIVATE CONSUMPTION
NATIONAL DEMAND (ANNUAL RATE OF CHANGE) (%)

SOURCES: INE and Banco de España.

in world goods and services markets. Box 1.1 offers a quantification of these effects for 2015 in the Spanish economy, which, overall, accounted for around 1.1 pp of additional growth and a 1.6 pp decline in inflation.

Both household expenditure and business investment were markedly dynamic, against a background of expanding government consumption and public investment…

Among the national demand components (see Table 1.1 and Chart 1.3), household spending growth averaged 3.1% in 2015, compared with 1.2% the previous year, assisted by an improvement in its main determinants. Real disposable income thus rose thanks to the increase in labour income, fiscal stimuli and the fall in oil prices. Adding to the improvement in household spending capacity was a higher level of financial and of real estate wealth, which reflected the turnaround in the housing market and a further reduction in the saving ratio, which fell to 9.3% of disposable income. Business investment was also markedly dynamic, growing at a rate of 6.5% against 0.9% in 2014, in step with the brighter economic outlook, the pick-up in business profits and the greater degree of looseness in financing conditions. In general government consumption spending there was a break in the restrictiveness of recent years; this variable grew by 2.7% in 2015 (set against a zero change in 2014), up on the initial official plans for the year. The increase in net public sector employment creation, following several years of freezes or restrictions, and higher general government purchases appear to lie behind this upward trend in government consumption. Finally, public investment increased by 9% in nominal terms, once a set of temporary factors[1] due principally to the investment activity of the regional governments is stripped out, providing for the first positive figure since 2010.

… while the contribution of net external demand to output was negative, but with a fresh increase in the weight of Spanish exports on international markets

Net exports once again contributed negatively to the increase in GDP in 2015, by 0.5 pp (see Chart 1.3). Real exports increased by 5.4% (5.1% in 2014), given that the impact of the gains in competitiveness, derived above all from the nominal depreciation of the euro, exceeded that of the lower growth of export markets. This competitiveness effect progressively lost momentum in the final stretch of the year as the depreciation pressures on the euro ceased. Even so, real Spanish goods and services exports continued to gain

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1   These include most notably the reclassification within the general government sector of certain items of investment expenditure in prior years in public-private partnership projects (somewhat over €2 billion). Without excluding these temporary factors, general government investment in nominal terms grew by 21% in 2015.

market share over the course of 2015. The increase in goods sales to developed countries and, in particular, to the euro area, outstripped the fall in those to emerging and developing countries, many of which directly felt the impact of the fall in commodities prices. The foregoing external factors, along with the economic recovery in the main countries providing tourists to Spain and the incidence of the geopolitical conflicts in certain North African and Middle Eastern destinations, contributed to the Spanish tourism sector having a very positive year. Specifically, the number of visitors and revenues (in nominal terms) showed year-on-year increases of 4.9% and 3.9%, respectively.

The growth of imports was very significant, driven by final demand

Imports remained very buoyant, posting an increase of 7.5% following the 6.4% rise the previous year. The strength of private consumption and investment, and the resilience of exports, where some of the sectors with a high import content – such as automobiles – continue to grow significantly, boosted the increase in imports, despite the rise in prices of non-energy goods purchased abroad (see Box 2.2 in Chapter 2 of this Report).

The nation's lending capacity widened to 2.1% of GDP

Against this background, the Spanish economy's lending capacity stood at 2.1% of GDP in 2015 (0.5 pp of GDP up on the previous year). This is chiefly due to the increase in the current account surplus, associated with the reduction in the energy deficit, and in net investment income payments to the rest of the world. Specifically, last year there were savings of €11 billion in the energy bill and of €3.5 billion in net interest payments. The improvement in the terms of trade, owing to cheaper commodities prices, enabled the path of trade surpluses embarked upon in 2011 to be maintained, with the surplus standing at around 2.5% of GDP. Adding to these temporary factors is the improvement in competitiveness, which is more structural in nature and which is analysed in detail in Chapter 2 of this Report.
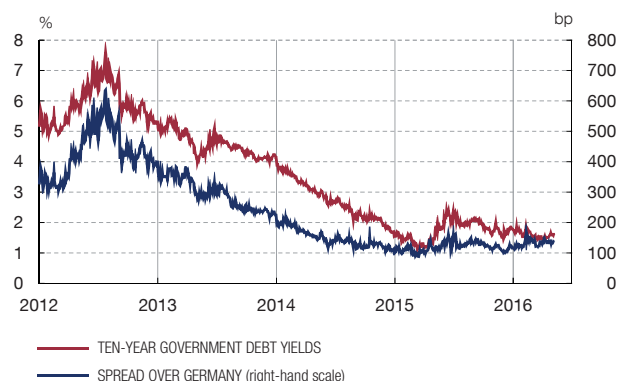
Household and corporate financing conditions eased and credit market activity continued to pick up

Household and corporate financing conditions continued to ease in 2015, benefiting from the monetary policy measures adopted by the ECB. There were thus across-the-board reductions in interest rates on new lending business in all segments, most acutely so in loans to small corporations, which translated into greater proximity to the costs of loans in other euro area countries. In annual average terms, the nominal cost of financing fell last year by between 60 and 110 bp, according to the segment. In real terms the decline was somewhat less (40-90 bp), as average long-term inflation expectations were somewhat lower in 2015 than a year earlier (see Chart 1.4). According to the Bank Lending Survey, throughout 2015 the spread applied to ordinary loans declined in all segments and lending standards were relaxed slightly in respect of loans to households, while they remained unchanged in loans to firms. The survey on SMEs' access to credit reveals a substantial improvement in these companies' perception of their access to financing. The demand of both households and firms for credit increased, boosted by the improvement in financing conditions and by the more favourable expectations of those demanding funds. In the case of general government, the cost of financing fell slightly at the short and medium end of the yield curve, while at the long end, following the significant reduction in the two previous years, it oscillated around end-2014 levels.
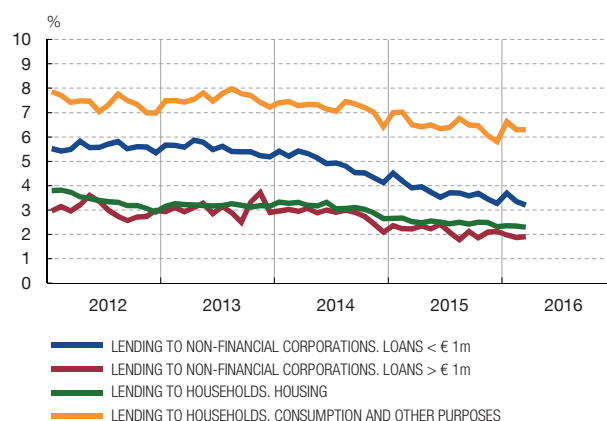
The fall in financial costs has boosted the funds available for expenditure, which has also been supported by the easing in the pace of decline of net financing flows

Both the recovery in gross financing flows and the reduction in payments associated with the repayment of debts incurred (the result of lower debt levels and of the decline in financing costs) have led to an increase in the volume of funds available for business and household expenditure (see panel 5 of Chart 1.4). Despite the increase in new lending, aggregate net financing flows remained negative, albeit for increasingly more moderate amounts. Specifically, the year-on-year rate of decline of household financing stood at 2.3% in December 2015, 1.4 pp less than 12 months earlier, and in the case of corporations it stood at 0.9%, the fall lessening by 3.5 pp in relation to 2014.
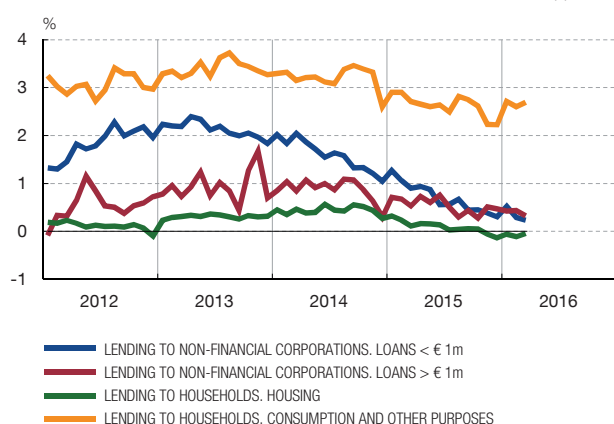
CHART 1.4

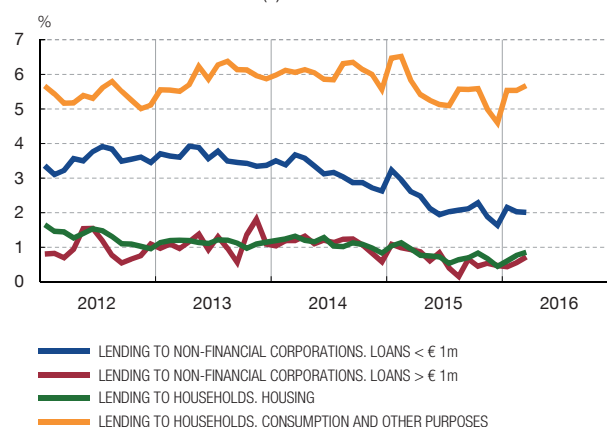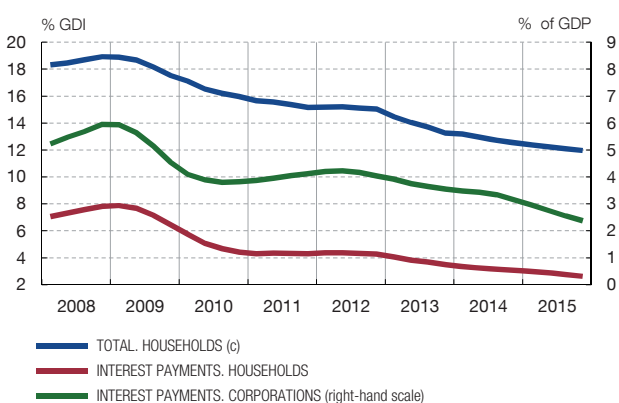**1 TEN-YEAR GOVERNMENT DEBT YIELDS AND SPREAD OVER GERMANY**

- TEN-YEAR GOVERNMENT DEBT YIELDS
- SPREAD OVER GERMANY (right-hand scale)

2 BANK INTEREST RATES. SPAIN

- LENDING TO NON-FINANCIAL CORPORATIONS. LOANS < € 1m
- LENDING TO NON-FINANCIAL CORPORATIONS. LOANS > € 1m
- LENDING TO HOUSEHOLDS. HOUSING
- LENDING TO HOUSEHOLDS. CONSUMPTION AND OTHER PURPOSES

3 BANK INTEREST RATES. SPAIN - CORE EURO AREA DIFFERENTIALS (a)

- LENDING TO NON-FINANCIAL CORPORATIONS. LOANS < € 1m
- LENDING TO NON-FINANCIAL CORPORATIONS. LOANS > € 1m
- LENDING TO HOUSEHOLDS. HOUSING
- LENDING TO HOUSEHOLDS. CONSUMPTION AND OTHER PURPOSES

4 REAL BANK INTEREST RATES (b). SPAIN

- LENDING TO NON-FINANCIAL CORPORATIONS. LOANS < € 1m
- LENDING TO NON-FINANCIAL CORPORATIONS. LOANS > € 1m
- LENDING TO HOUSEHOLDS. HOUSING
- LENDING TO HOUSEHOLDS. CONSUMPTION AND OTHER PURPOSES

5 DEBT BURDEN OF HOUSEHOLDS AND CORPORATIONS

- TOTAL. HOUSEHOLDS (c)
- INTEREST PAYMENTS. HOUSEHOLDS
- INTEREST PAYMENTS. CORPORATIONS (right-hand scale)

6 HOUSEHOLD WEALTH


- REAL ESTATE (d)
- FINANCIAL ASSETS
- NET TOTAL (e)
- LIABILITIES
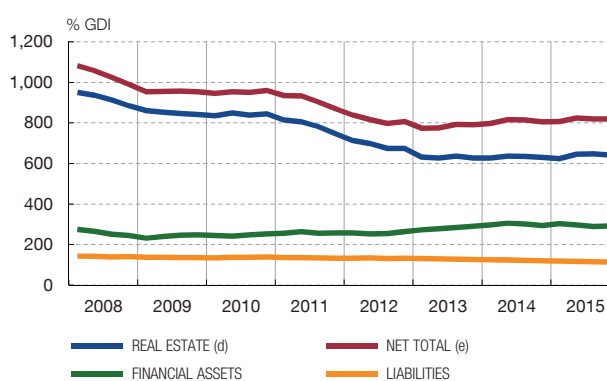
SOURCES: Datastream, Reuters, ECB and Banco de España.

a Defined as the aggregate weighted by GDP at current prices for the same year of Germany, Austria, the Netherlands, Finland and Luxembourg. In 2015 and 2016, 2014 GDP has been used. To aggregate the different categories by maturity within each country, the same weights (turnover) are used as in Spain, whereby the comparison is not affected by differences between these weights from one area to another.
b Real interest rates have been calculated by subtracting from nominal interest rates the inflation expectations at different horizons obtained from the inflation-linked swaps for Spain. For housing loans, the fifteen-year term has been used; for loans for consumption and other purposes, the five-year term; and for loans to non-financial corporations, the ten-year term.
c Estimate of interest payments plus principal repayments.
d Based on estimated changes in the housing stock, in the average surface area of such housing and in the price per square metre.
e Includes net financial wealth (financial assets - liabilities) and real estate wealth.

⬇ Download

**1 PER CAPITA GROSS DOMESTIC PRODUCT
(REAL IN PPP) (a)**

2007 = 100
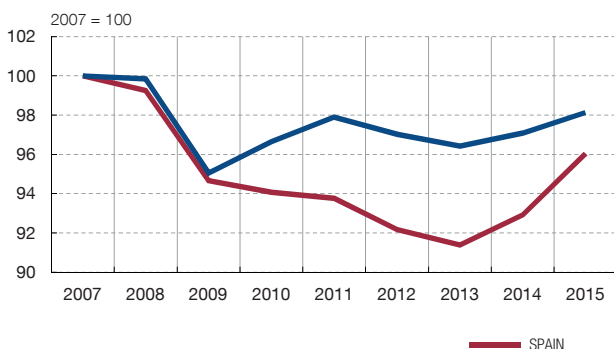
2 UNEMPLOYMENT RATE (b)

%

———— SPAIN   ———— EURO AREA
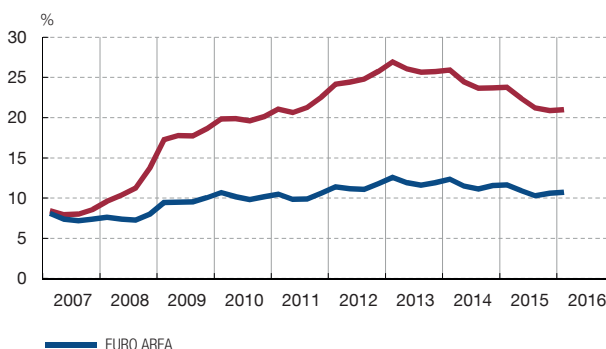
SOURCES: Eurostat, INE, European Commission and Banco de España.

a Data in annual frequency and in index numbers.
b Quarterly-frequency gross data of harmonised labour force surveys.

[Download]

Employment grew forcefully and across the board in terms of sectors of activity, albeit more sharply so in the case of temporary contracts

Over the year as a whole, employment continued to grow sharply, at a year-on-year rate of 3%; however, at end-2015 only around 30% of the jobs lost from 2008 to early 2014 had been recovered. In terms of the sectors of activity, the increase in employment was across the board, albeit somewhat sharper in industry and in construction. By type of contract, the rise in employment was centred on temporary employees (see panel 4 of Chart 1.6), while by working day the increase in those working full-time exceeded the figures observed for those employed part-time.

The pace of decline in the unemployment rate increased…

In 2015 as a whole, the declines observed in previous years in the labour force eased to -0.1%. The reduction in the final stretch of the year was basically due to the decline in the participation rate, especially among youths returning to training more intensely. This reduction in the labour force, along with the buoyancy of employment, translated into a reduction of almost 680,000 in numbers unemployed compared with the previous year. The unemployment rate fell 2.3 pp in 2015 as a whole to 22.1%, standing in 2016 Q1 at 21%, almost 3 pp down on the figure observed in the same period a year earlier (see Chart 1.5).

… against a background of wage moderation

Unit labour costs held on the moderating path of recent years, although their pace of decline eased. Compensation per employee in the market economy stabilised in 2015, posting a marginal increase of 0.1%, following the 0.6% decline in 2014. Wage rises agreed under collective bargaining moved on a moderately rising trend in the final stretch of the year, tending to converge towards the upper limit of 1% envisaged in the recommendation included in the Agreement for Employment and Collective Bargaining entered into by the social agents in mid-2015. As has habitually been the case in previous recovery phases, the dynamism of apparent labour productivity eased, growing by 0.3% in the market economy (0.9% in 2014).

Inflation moved on a declining trajectory from August, while the non-energy components held on a gradually accelerating course throughout the year

CPI-based inflation posted a negative change in 2015, falling off by 0.5%, against 0.2% the previous year. As in 2014, the declining year-on-year profile of the CPI during the year was strongly influenced by the effect of oil prices, the decline in which quickened as from August. The non-energy CPI and the CPI excluding energy and unprocessed food prices held on a slowly and gradually accelerating path, whereby both indices showed year-on-year rates in December of 0.9% and 1.1%, respectively (see Chart 1.2). These increases are in line with

the strength of domestic demand and the gradual reduction in the economy's cyclical slack, which made for a less marked adjustment in labour costs and more moderate growth than in previous years in the gross surplus.

The diminished contribution of some of the temporary factors that have recently boosted activity suggests more moderate economic growth in the short and medium term...

Following the double-dip recession that ended in mid-2013, the Spanish economy has seen a cyclical recovery phase take root that is significantly sharper, on average, than that of its European partners. However, the current expansion can hardly continue to be underpinned to the same extent as it was in the past by the aforementioned expansionary factors. Specifically, in the absence of further shocks, it is to be expected that the impact on growth rates of the more temporary factors such as those observed since mid-2014 and discussed in the previous section will begin to diminish.[2] Thus, growth in the Spanish economy will foreseeably hold at more moderate levels than those recorded last year, as is indeed reflected in the latest macroeconomic projections published by the Banco de España, according to which GDP is expected to grow at a rate of 2.7% in 2016 and 2.3% in 2017.

...and the risks to growth have increased as a result of the uncertainty about the global economy, the need to resume a path of fiscal consolidation and doubts over domestic economic policies …

On the international front, various factors – such as the slowdown (or recession in the odd case) in some of the main emerging economies, geopolitical conflicts in certain areas, the sluggishness of world trade, the supply glut in the oil market and the low profitability of banks – shape a complex setting for the global economy. At the domestic level, the need to resume and see through fiscal consolidation, which is essential for retaining confidence in the Spanish economy, will entail short-term costs but will give rise to benefits in the medium term. The uncertainty linked to the domestic political setting increases, in turn, the doubts over the future course of economic policies and the implementation of the reforms needed to bring to fruition the challenges outstanding for the Spanish economy and to improve its future growth prospects.

3 The challenges outstanding for the Spanish economy and the role of economic policies

Restoring macrofinancial equilibria and raising productivity are vital for further progress in the recovery of activity and employment levels

Compared with other euro area economies, the economic crisis impacted Spain with greater intensity (see Chart 1.5) and, despite the headway being made in the current recovery phase in absorbing the main imbalances, the persistence of some of them reveals factors of vulnerability and poses deep-seated challenges in respect of economic policies. Highlighted below are the adjustments outstanding as regards the labour market, fiscal consolidation, private debt, financial dependence on the external sector and productivity. Finally, some challenges outstanding in the construction of the EMU are briefly set out.

The persistence of high rates of joblessness increases the likelihood of unemployment becoming structural

Despite its recent favourable course, the Spanish labour market faces the challenge of reducing high unemployment, so as to prevent a considerable portion of such unemployment becoming structural, and to promote a more dynamic productivity performance (see Box 1.2). The unemployment rate dipped in early 2016 to 21%, almost 6 pp below its 2013 peak, but still far above the level observed in other European countries. Furthermore, this reduction has not passed through with sufficient intensity to the groups that have been unemployed for longest. Indeed, the percentage of long-term unemployment (those in this position for more than one year) still stood at 57.7% in early 2016. The persistence of such a high unemployment rate is one of the main factors that explains the increase in income inequality in Spain. The countercyclical behaviour of the commonest measures of inequality in Spain,

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2 See the "Quarterly report on the Spanish economy" in the March 2016 edition of the Banco de España Economic Bulletin.

which tend to show an increase in inequality in periods of recession, is closely related to the dynamics of job creation and destruction flows, which is highly asymmetrical across different jobs, depending on the level of skills required and the associated type of employment contract.[3]

|	
The new regulatory framework of the labour market provides for a better adjustment of wages to the macroeconomic situation and to the conditions prevailing in firms, which has boosted growth in employment	The successive labour reforms approved in recent years added substantial changes to the institutional design of this market. The analyses available about their effects reveal that these reforms, especially that in 2012, have provided for wage moderation by promoting a greater adjustment of working conditions to an environment characterised by sluggish demand and high unemployment.[4] And this has proven crucial for restoring the competitiveness of the Spanish economy and of employment (see Chapter 2 of this Report for a more detailed analysis).
In a very low or even negative inflation environment, wage flexibility is essential for sustaining the current path of employment creation	In 2015 the pattern of wage containment was maintained; however, in a negative inflation environment, real wages increased by 0.5% in the private sector, set against the declines recorded in previous years (see panel 2 of Chart 1.6). A portion of this increase in real wage income was as a result of the recent decline in oil prices, via their negative impact on consumer prices. In this respect, in a low inflation setting across the entire euro area and given the modest growth in productivity, as is projected for the Spanish economy in the coming quarters, excess downward rigidity in nominal wages might hamper the entrenchment of the gains in competitiveness obtained in recent years (see panel 1 of Chart 1.6).
There is still scant linkage of wages to firms' specific conditions...	The firming of a path of balanced growth also involves the reallocation of employment across firms and sectors of activity, requiring adjustments in relative prices and costs, in such a way that wages are linked to the specific conditions prevailing in the various sectors and firms. While the relationship between wage settlements and the cyclical position of the various productive sectors has become closer in recent years, it remains limited.[5]
... in a setting in which the weight of firm-level collective bargaining is still very low	Behind this phenomenon lies a collective bargaining structure characterised by the prevalence of sectoral agreements, with scant influence of firm-level agreements, which currently affect only 6% of workers. Disaggregated information on collective bargaining agreements highlights a limited dispersion across firms of the wage increases agreed in the past two years (see panel 3 of Chart 1.6). This may reduce the incentives for the efficient reallocation of resources across activities. Further, sectoral agreements pose obstacles to the entry of new firms, which have to match, from the outset, the working conditions agreed in sectoral, regional and national agreements.
Employment growth continues to be concentrated in temporary hires, an aspect which the successive labour reforms have not corrected...	The dynamism of employment in 2015 was concentrated in temporary hires, which rose by 8.3%, against 1.9% for permanent employees. That raised the ratio of temporary to total workers to 25.7% at the end of the year, almost 4 pp up on the level in early 2013, when this rate was at its cyclical low (see panel 4 of Chart 1.6). A disaggregated analysis at the

3 See Bonhomme, S., and L. Hospido (2012), "The Cycle of Earnings Inequality: Evidence from Spanish Social Security Data", Working Paper 1225, Banco de España,
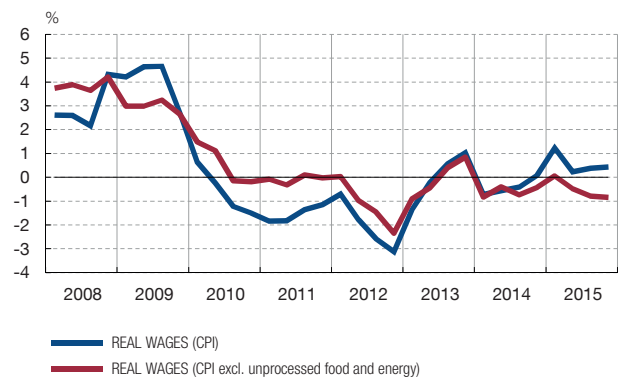
4 See, Izquierdo, M., A. Lacuesta and S. Puente (2013), "The 2012 labour reform: an initial analysis of some of its effects on the labour market", Economic Bulletin, Banco de España, September; Izquierdo.M and J.F.Jimeno (2015), "Employment, wage and price reactions to the crisis in Spain: firm-level evidence from the WDN survey", Occasional Paper 1503, Banco de España.

5 See Font, P., M. Izquierdo and S. Puente (2015), "Real wage responsiveness to unemployment in Spain: Asymmetries along the business cycle", IZA Journal of European Labor Studies.
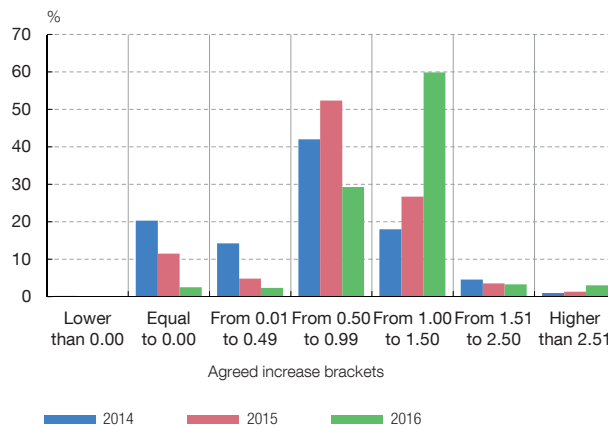
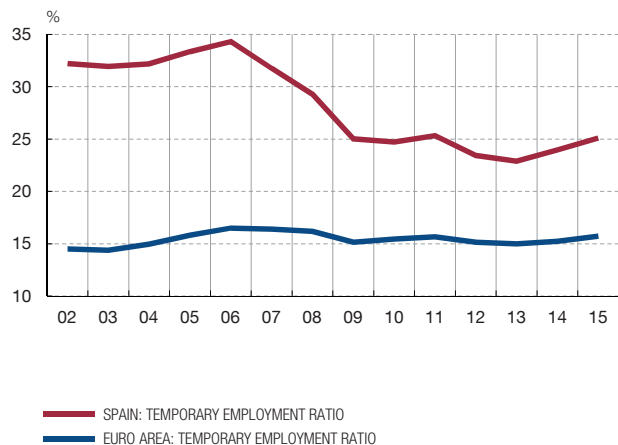1 UNIT LABOUR COSTS IN SPAIN RELATIVE TO THE EURO AREA

2000 = 100

ULCs
COMPENSATION PER EMPLOYEE
PRODUCTIVITY PER EMPLOYEE
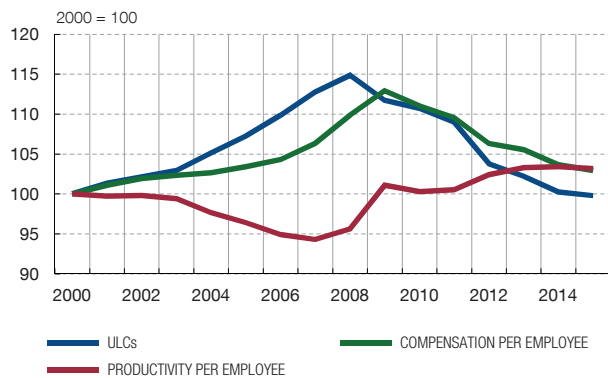
2 REAL WAGES. MARKET ECONOMY (a)
Year-on-year rates

%

REAL WAGES (CPI)
REAL WAGES (CPI excl. unprocessed food and energy)

3 DISTRIBUTION OF EMPLOYEES BY AGREED WAGE INCREASE (b)

%

Lower than 0.00 | Equal to 0.00 | From 0.01 to 0.49 | From 0.50 to 0.99 | From 1.00 to 1.50 | From 1.51 to 2.50 | Higher than 2.51

Agreed increase brackets

2014   2015   2016

4 TEMPORARY EMPLOYMENT RATIO (c)

%

SPAIN: TEMPORARY EMPLOYMENT RATIO
EURO AREA: TEMPORARY EMPLOYMENT RATIO

SOURCES: Eurostat, INE and Ministerio de Empleo y Seguridad Social.

a QNA nominal compensation per employee deflated by the CPI or the CPI excluding unprocessed food and energy. Rates are calculated on seasonally adjusted series.
b 2016, with information to March.
c Temporary employees as a proportion of total employees, calculated with Q2 data for each year.

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… while the pace of permanent job destruction has been checked

sectoral level, in which the change in the temporary employment ratio is related to employment growth, would suggest that this recent increase in temporary hires matches — on historical patterns — the behaviour expected in an expansionary period, without there being any discernible recent change that may be attributed to the various legal amendments made in recent years.

The recent increase in temporary hires is linked to the rise observed in unemployment outflows towards temporary employment, in a setting in which the flows towards permanent employment have risen slightly. And no significant increase been seen in conversions of temporary contracts into permanent ones, the latter having moved on a clearly declining course since the start of the crisis and, in the more recent period, held at low levels. Nonetheless, a better performance has been seen in permanent employment destruction flows, which eased in 2015 to levels similar to those observed pre-crisis. Conversely, temporary employment destruction remains at high levels.

| Further measures are therefore needed to quicken the decline in unemployment and reduce the weight of temporary employment | Reducing unemployment will require additional measures which, firstly, should enable firms to opt for aligning working conditions to their specific situation and to reinforce firms' internal flexibility, in line with the labour market institutions existing in other European countries. Furthermore, the attractiveness of permanent hiring should be increased, preventing an excessive protection of this type of employment from ultimately acting as a deterrent to the creation of stable jobs. Finally, active policies should contribute to enhancing the employability of those workers who have been unemployed for a lengthy period and who have lower skills than those required by firms. Here, it is vital to improve the link between active and passive policies, to modernise the public employment services and to increase the resources available per person in active policies for the unemployed. In particular, it would be desirable to re-launch vocational training activities which, in comparison with other European countries, are relatively scant in Spain, as opposed to the high weight of hiring incentives, whose effectiveness is usually limited.[6] In addition, a rigorous assessment should be made of the different measures that may help steer resources towards the most effective policies. |

3.2 FISCAL CONSOLIDATION

In the fiscal policy arena, there was a deterioration in the structural budget deficit in 2015…

According to the latest Excessive Deficit Protocol (EDP) notification, the Spanish general government sector posted a deficit of 5.1% of GDP, against 5.9% the previous year. This reduction was due exclusively to the cyclical improvement in the economy, whereas the structural primary budget deficit, which measures the fiscal policy stance, increased by 1 pp of GDP, and the total structural deficit was close to 3% of GDP, according to the European Commission's latest estimates. The year 2015 thus saw an interruption in the contractionary budgetary policy stance observed from 2010 to 2014, when the structural deficit improved by 5.2 pp of GDP (see panel 1 of Chart 1.7). The strong rate of increase in output along with a highly favourable deficit-debt adjustment[7] enabled the still-high budget deficit to be offset, thereby placing the public debt/GDP ratio at 99.2% (99.3% in 2014) (see panel 2 of Chart 1.7).
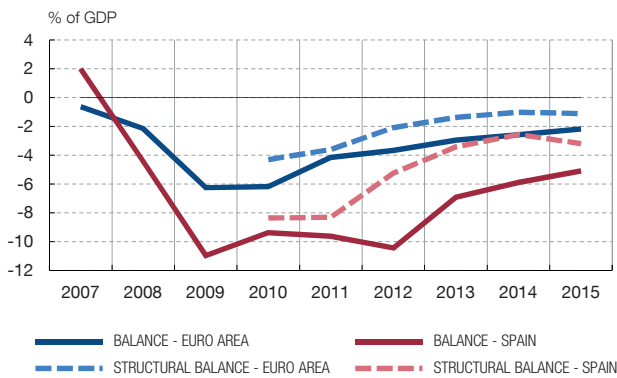
…which prompted significant slippage by the budget deficit from the target set by the European authorities

These developments entailed significant non-fulfilment in 2015, of close to 1 pp of GDP, of the budget deficit target of 4.2% set by the European authorities under the Excessive Deficit Procedure of the Stability and Growth Pact. By sub-sector (see panel 4 of Chart 1.7), the slippage was due to bigger deficits relative to the targets for the regional governments (1 pp) and the Social Security system (0.7 pp), which were partly offset by a better-than-expected outturn for central government (0.2 pp) and local governments (0.4 pp). The failure of the regional governments to meet targets was across the board, since only three of them fulfilled the objectives set. In terms of components (see panel 3 of Chart 1.7), comparison between the 2015 data and the estimates provided in the general government budgetary plan sent by the Government to the EC in September 2015 shows that the deviation of the deficit was due essentially to higher-than-forecast (by 1.4 pp of GDP) growth in public spending.
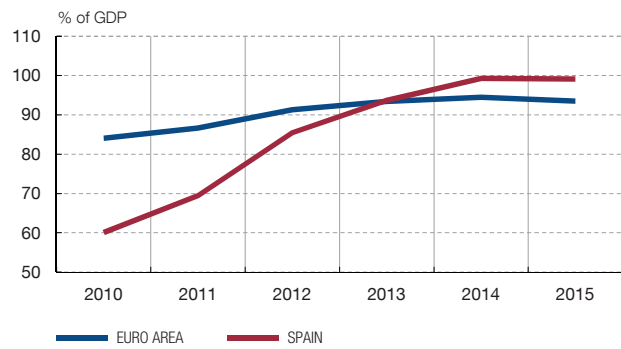
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6 See Arranz, J.M., C. García Serrano and V. Herranz (2013), "Active labour market policies in Spain: A macroeconomic evaluation", International Labour Review.

7 The deficit-debt adjustment allows general government deficit data to be reconciled with those relating to changes in the debt ratio. Specifically reflected in this adjustment are, along with the operations that do not affect the deficit but do bear on government debt, the need to finance the net acquisition of financial assets. In 2015 there were net sales of financial assets totalling €16.5 billion, providing for a reduction of 1.5 pp of GDP in the debt ratio. Specifically, there were repayments relating to the loans granted in previous years through the European Financial Stability Fund, and to the Electricity Deficit Amortisation Fund and the Fund for the Orderly Restructuring of the Banking Sector. Moreover, some financial assets were disposed of, including most notably the partial privatisation of AENA. For further details see M. Delgado, B. García, L. Gordo and RF. Martí (2016), "La evolución de la deuda pública en España en 2015", Boletín Económico, May, Banco de España.
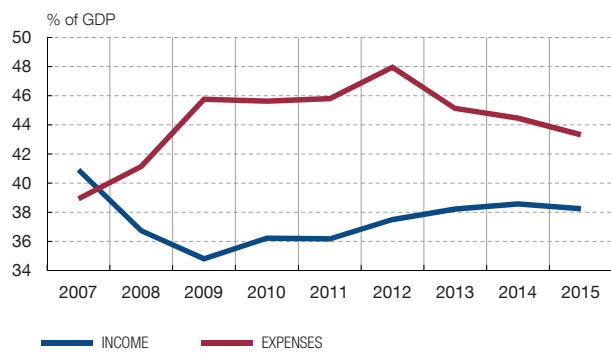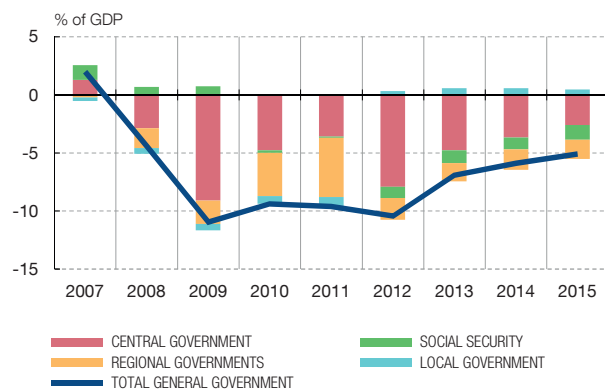
1 BALANCE AND STRUCTURAL BALANCE (a)

% of GDP

BALANCE - EURO AREA
BALANCE - SPAIN
STRUCTURAL BALANCE - EURO AREA
STRUCTURAL BALANCE - SPAIN

2 EDP DEBT

% of GDP

EURO AREA
SPAIN

3 GENERAL GOVERNMENT REVENUE AND EXPENDITURE

% of GDP

INCOME
EXPENSES

4 GENERAL GOVERNMENT BALANCE BY SUB-SECTOR

% of GDP

CENTRAL GOVERNMENT
REGIONAL GOVERNMENTS
TOTAL GENERAL GOVERNMENT
SOCIAL SECURITY
LOCAL GOVERNMENT

SOURCES: AMECO and Banco de España.

a Actual balance, cyclically adjusted and net of temporary measures.

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Correcting the fiscal imbalance is a priority …

The challenges the current fiscal imbalance poses for the economy as a whole, even under the prospect of its gradual reduction, should not be minimised.[8]High volumes of deficits and public debt sustained over prolonged periods are usually associated with higher interest rates and, therefore, with lower rates of private investment and growth in the medium term. In particular, the sustainability of a high level of public debt normally requires the recurrent running of significant primary budget surpluses; that may adversely affect the economy's potential growth if, for example, fiscal policy should entail tax levels unfavourable to growth or lower levels of productive spending. Moreover, high deficit and public debt levels restrict the room for manoeuvre available to fiscal policy to play a countercyclical role, a lever which is particularly valuable within a monetary union. Also, the need to resort repeatedly to the financial markets to roll over a high volume of debt and the current deficit raises the vulnerability of the economy to potential adverse reactions in investor sentiment, as has been evidenced in the successive episodes of tightening experienced by several European sovereign debt markets since 2010.

8 See Box 4.2 of the Banco de España 2013 Annual Report.

| ... that requires the definition of a detailed medium-term consolidation programme and the strict application of the preventive and coercive mechanisms of the Budgetary Stability Law | The scale of the adjustments needed to restore health to public finances remains significant.[9] That highlights the need to define a medium-term consolidation path detailing the measures to ensure the fulfilment of the fiscal targets covering each and every one of the different tiers of government (central government, Social Security system, regional government and local government), and that is anchored in a prudent forecast of macroeconomic developments and of public revenue. In this respect, the European Commission issued a recommendation on 18 May calling for a structural improvement in the Spanish overall general government balance of 0.25% and 0.5% in 2016 and 2017, respectively, which, according to the EC, would make for deficits of 3.7% and 2.5% of GDP in those years. Accordingly, Spain's exit from an excessive deficit position would be put back by one year to 2017.

In parallel, the use of all the preventive and coercive mechanisms of the Budgetary Stability Law across the general government sector as a whole must be ensured.[10] Further, in a setting in which central government mechanisms to support regional government liquidity have become widespread, it is vital that the explicit elements of conditionality be strictly applied to the budgetary actions of the tiers of government concerned.[11] |

| Fiscal consolidation should be accompanied by a design of the main budgetary elements that is more conducive to activity and employment … | In a scenario in which the budgetary consolidation process is prolonged, the composition of the adjustment takes on particular importance, paving the way for public finances to make a greater contribution to the economy's potential growth. In this respect, progress must continue to be made in the rationalisation and efficiency of public spending, considering a review of the basket of taxes that will allow the revenue needed to finance the desired level of public spending to be obtained in a stable fashion (see panel 3 of Chart 1.7). Experts' and international agencies' proposals suggest there is scope for considering a change in the tax mix, according greater weight to indirect taxation, and a further rationalisation of the wide range of deductions, credits and rebates that erode tax-raising capacity. |

| … and by a strategy with which to tackle the challenges posed by population ageing for public finances | From a medium and long-term perspective, it will be a priority to address the challenges arising from the impact of population ageing on public finances and, in particular, on the pension system. The reforms introduced in recent years are along these lines, including as they do a progressive raising of the retirement age, the definition of a sustainability factor, which links the initial pension to future developments in life expectancy, and a new pension indexation mechanism, making pensions conditional upon the financial equilibrium of the system.[12] These reforms have substantially shored up the system's sustainability, although tailoring arrangements to the needs of a progressively older population poses notable challenges. Specifically, in the absence of further modifications to the system's revenue, the adjustment mechanism operates chiefly through the average pension[13] which, given significant growth in the dependency ratio, raises the need to analyse the potential incorporation of other sources of financing into the system, to define the concepts that are financed through the system and, where appropriate, to develop the insurance and saving |

9 An approximate idea can be had of the challenges outstanding using a simple accounting simulation exercise based on the general government budget constraint. If it is assumed that the general government primary balance will, from 2016, every year, stand at 2% of GDP (as opposed to the primary deficit of 2% observed in 2015) and nominal GDP growth will be 3.5%, the public debt/GDP ratio would not fall below 30% before 2030.
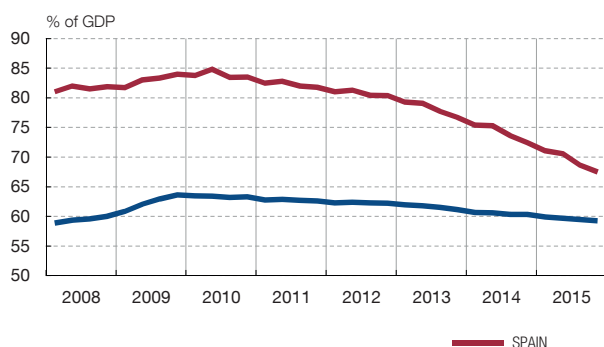
10 See P. Hernández de Cos and J. Pérez (2013), "The new budgetary stability law", Boletín Económico, April, Banco de España.

11 See Delgado, M., C. González and J.J. Pérez (2016), "Regional government access to market funding: international experience and recent developments", Economic Bulletin, February, Banco de España.

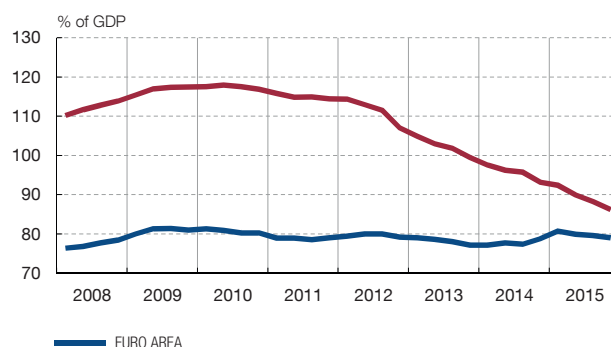12 See Ramos, R. (2014), "The new revaluation and sustainability factor of the Spanish pension system", Economic Bulletin, July, Banco de España.

13 Sánchez, A.R. (2014), "The automatic adjustment of pension expenditures in Spain: an evaluation of the 2013 pension reform", Working Paper 1420, Banco de España.
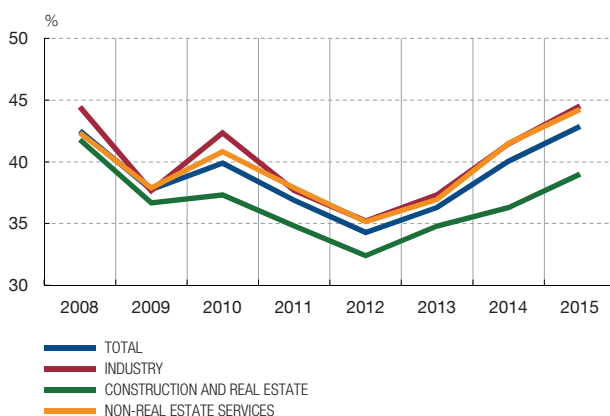
1 DEBT RATIO. HOUSEHOLDS

% of GDP

2 DEBT RATIO. NON-FINANCIAL CORPORATIONS

% of GDP

— SPAIN   — EURO AREA

3 PERCENTAGE OF FIRMS WHOSE CREDIT IS NOT DECLINING

%

— TOTAL
— INDUSTRY
— CONSTRUCTION AND REAL ESTATE
— NON-REAL ESTATE SERVICES

4 TOTAL FACTOR PRODUCTIVITY

Median productivity in 2008 of firms whose credit is declining = 100

■ FIRMS WHOSE CREDIT IS NOT DECLINING
■ FIRMS WHOSE CREDIT IS DECLINING

SOURCE: Banco de España.

a The calculations have been made using cross-matched information from the CCR (Central Credit Register) and the CBSO (Central Balance Sheet Data Office). Total factor productivity measures the relationship between the use of productive factors and the amount of output obtained, and approximates the level of efficiency of the firm. It is obtained drawing on regressions made at the sectoral level of the logarithm of real gross value added over the logarithms of total capital, inputs and employment (time fixed effects are also included). An approximation is thus attained of the weights of capital and employment in the production function, providing for calculation of total factor productivity at the level of the firm. The chart plots median productivity, calculated as the weighted average of the sectoral medians, where weights are assigned on the basis of the sectoral gross value added of each sector of activity. The resulting figure is normalised taking as a reference the 2008 value of the median productivity of firms whose credit is declining.

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mechanisms — such as those set in place in other countries — that will help complement unfunded public pensions in the future. The new system may also increase uncertainty over the future level of pensions, whereby its implementation should be as transparent as possible, in accordance with the mechanisms envisaged by the Law, so as to provide citizens with the necessary information about their future pension and to enable individuals to take optimal saving decisions for retirement during their working life.

3.3 PRIVATE-SECTOR DELEVERAGING

The reduction in the debt ratio of households and firms continued in 2015, underpinned to a greater extent by higher income …

Spanish household and corporate debt ratios continued to decline in 2015, falling to 69% and 88% of GDP, respectively (see panels 1 and 2 of Chart 1.8). As a result, the cumulative declines in these ratios from their mid-2010 peak were 17 pp and 32 pp, respectively. Also, the gap between debt levels in Spain and in the euro area has narrowed to 8 pp and 7 pp, respectively, suggesting that private-sector deleveraging is at an advanced phase. This process is, moreover, progressively becoming less costly, as it is underpinned to a lesser extent than in the past on negative net financing flows and more on increases in income.

| … which proved compatible with a pick-up in the flow of new financing operations	In 2015 there was an increase in new financing flows to households and non-financial corporations which, along with the reduction in the interest burden, proved conducive to buoyant expenditure. The Banco de España Central Credit Register (CCR) reveals that the proportion of firms not subject to deleveraging processes increased in 2015 for the third year running, to stand at close to 43%, almost 9 pp up on the 2012 figure. The net flow of financing channelled by these companies increased by almost 1 pp relative to GDP (see panel 3 of Chart 1.8). Likewise, in the case of households, there was a rise in the proportion of individuals whose debts held steady or increased, and in the net flow of financing raised by them.
The decline in the aggregate outstanding balance of lending to corporations has been accompanied by significant inter-sectoral and intra-sectoral shifts	The slowdown in the pace of the contraction in bank lending to firms (by 5.2 pp to 1.6%) has been extensive to all sectors of activity, although the decline continued to be sharper in sectors linked to the real estate market. In the industrial sector, the outstanding balance of loans fell by 1.6%, while in construction and real estate services, the declines continued to be notable (11.8% and 10.4%, respectively), albeit lower than those in 2014. There were also signs suggesting that credit flows tend to be routed increasingly towards more productive firms with a sounder financial position (see panel 4 of Chart 1.8).
Credit institutions' improved solvency and liquidity have also contributed to the pick-up in financing to households and firms…	In the case of credit institutions, the improvement in their financial position has also contributed to the pick-up in the flow of financing to households and non-financial corporations. Deposit institutions thus continued to shore up their solvency in 2015, whereby their CET1 (highest quality capital) ratio rose to 12.7% (14.5% in terms of the total ratio), after increasing notably during the year, standing clearly above the required regulatory minimum levels. In a setting of abundant liquidity, prompted by the Eurosystem's various expansionary measures, these institutions continued to finance themselves comfortably.
… although Spanish credit institutions show low profitability	That said, pressures on the profit and loss account were reflected in a 12.8% decline in consolidated profit attributable to the group, meaning that the return on equity (ROE) fell (from 6.9% to 5.6%, also owing partly to the increase in own funds), following the same trend as in the rest of the euro area. There are several factors exerting downward pressure on banks' profitability, especially in business in Spain. Firstly, low interest rates are constraining net interest income. Secondly, compounding this situation is the fact that the outstanding balance of credit continues to decline, albeit at increasingly lower rates. Finally, non-performing loans and foreclosures, which do not generate interest, make up a significant but declining part of bank balance sheets.[14]
There is still a portion of agents in a vulnerable financial position	The economic recovery, which has been accompanied by growth in income and a reduction in unemployment, along with the decline in interest rates, has had a favourable effect on the financial position of indebted households and firms. The effect has been comparatively more marked in those segments subject to a greater degree of financial pressure. The reduction in these agents' debt has benefited from the use of refinancing and, where appropriate, restructuring agreements, to which the improvements made to the successive regulatory changes in bankruptcy law have contributed (see Box 4.3 of this Report). Even so, the proportion of agents subject to high financial pressure still stands above pre-crisis levels, signifying a factor of vulnerability for the economy as a whole.

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14 In particular, last year, non-performing loans in Spain fell across the board at a greater pace than the previous year, whereby the ratio of these assets to resident private-sector credit declined to 10.1%, at the close of the year, compared with the high of 13.6% two years earlier.

1 CHANGES IN THE NATION'S SAVING AND INVESTMENT (a)

Differences in % of GDP

SAVING   INVESTMENT   ◆ SAVING-INVESTMENT
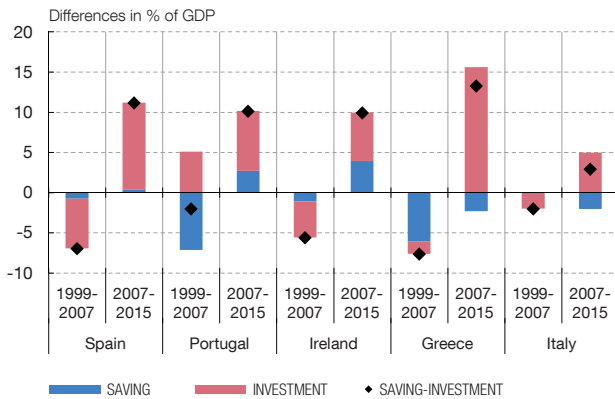
2 BALANCE OF GOODS AND SERVICES
2010 constant prices

% of GDP

ACTUAL BALANCE OF GOODS AND SERVICES
CYCLICALLY ADJUSTED BALANCE OF GOODS AND SERVICES (b)
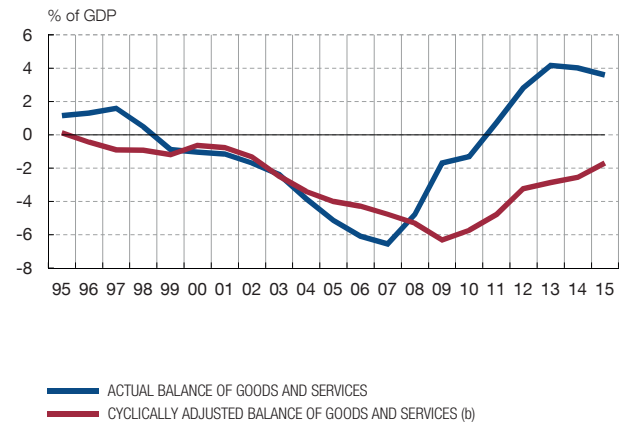
SOURCES: Banco de España, INE and IMF.

a Investment depicted with sign changed.
b Trade balance had both the Spanish economy and its main trading partners grown at a similar rate to the potential GDP rate.

3.4 REDUCING THE NET DEBTOR POSITION VIS-À-VIS THE REST OF THE WORLD

Progress in the external balance continued in 2015, both in terms of the nation's overall lending capacity and, to a lesser extent, of the international investment position. In the first instance, the balance has improved by around 11 pp of GDP since 2007, essentially as a result of the fall in investment – residential investment in particular – during the most acute phases of the crisis, although in the most recent period a pick-up in national saving has been observed (see Chart 1.9).

The recent recovery in national saving is allowing investment to be financed and recurrent external surpluses to be obtained

Since the start of the crisis there has been a structural improvement in the trade balance of goods and services…

The recent attainment of external lending capacity has a structural component that is reflected in the improvement in the cyclically adjusted balance of goods and services trade (see Chart 1.9). As analysed in detail in Chapter 2, this improvement in the structural component is related to the adjustment of labour costs and the easing in financial costs. In particular, the competitive adjustment made by the Spanish economy over these years has been conducive to an increase in firms' propensity to sell their products abroad and to their subsequent capacity to entrench.
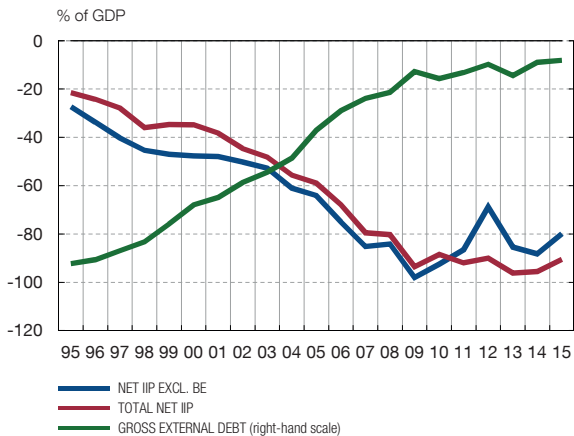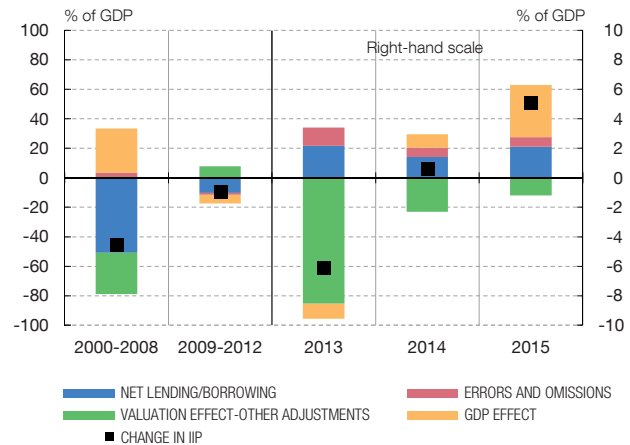
... but the net debtor position vis-à-vis the rest of the world, though it has begun to decline, is holding at very high levels and its correction will require further gains in competitiveness

Despite the reduction in private debt, Spain still has very high external debt, which is a significant factor of vulnerability when set against potentially adverse developments on international markets. Thus, at end-2015 the net international investment position (net IIP) stood at 90.5% of GDP, a very high figure when compared with other euro area countries and with other advanced economies, but one which entrenches the declining trend initiated the previous year. That said, the improvements in lending capacity have not been reflected in a reduction on the same scale in the external debit balance. That is due to the negative contribution of valuation effects and other adjustments, which showed the increase in the price of external liabilities derived from international investors' greater confidence in the Spanish economy's assets. There have also been changes in the composition of external liabilities, in terms of their callability (a shift towards a lesser weight of debt securities), the issuing institutional sector (greater
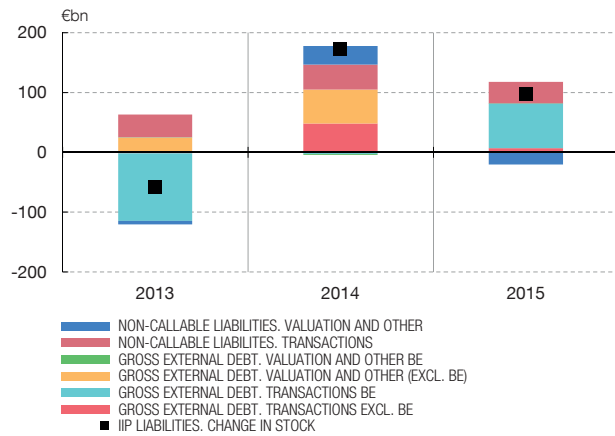
1 NET IIP AND GROSS EXTERNAL DEBT POSITION (a)

% of GDP

- NET IIP EXCL. BE
- TOTAL NET IIP
- GROSS EXTERNAL DEBT (right-hand scale)

2 DETERMINANTS OF THE CHANGE IN THE NET IIP (b)

% of GDP   % of GDP

Right-hand scale

- NET LENDING/BORROWING
- VALUATION EFFECT-OTHER ADJUSTMENTS
- CHANGE IN IIP
- ERRORS AND OMISSIONS
- GDP EFFECT

3 BREAKDOWN OF THE CHANGE IN EXTERNAL LIABILITIES (c) (d)

€bn

- NON-CALLABLE LIABILITIES. VALUATION AND OTHER
- NON-CALLABLE LIABILITES. TRANSACTIONS
- GROSS EXTERNAL DEBT. VALUATION AND OTHER BE
- GROSS EXTERNAL DEBT. VALUATION AND OTHER (EXCL. BE)
- GROSS EXTERNAL DEBT. TRANSACTIONS BE
- GROSS EXTERNAL DEBT. TRANSACTIONS EXCL. BE
- IIP LIABILITIES. CHANGE IN STOCK

4 STRUCTURE OF GROSS EXTERNAL DEBT BY INSTITUTIONAL SECTOR AND ISSUANCE MATURITY (e) (f)

% of GDP

- GG S-T
- OMFIs S-T
- ORSs S-T
- GG L-T
- OMFIs L-T
- ORSs L-T
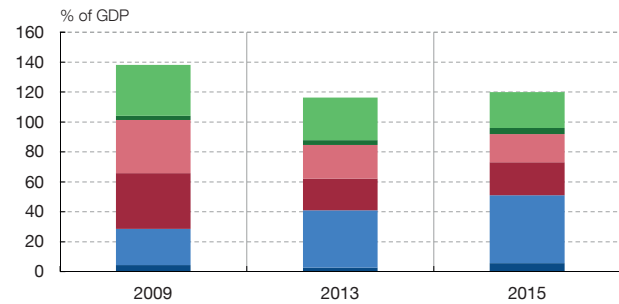
SOURCE: Banco de España.

a Gross external debt is the amount pending repayment at a given time of real and non-contingent current liabilities assumed by an economy's residents vis-àvis non-residents, with the commitment to make in the future payments of principal, interest or both. It therefore includes: debt securities, special drawing rights assigned, and deposits, loans, trade credit and other liabilities.

b Valuation effects are gains/losses relating to the exchange rate and/or financial instrument prices, while other adjustments are other changes in volume, including most notably write-offs owing to recognition of the impossibility of recovering funds, assets and/or liabilities reclassification, and changes in residence of holders or issuers of financial assets and liabilities.

c Non-callable liabilities include equity capital, financial derivatives and reserves. Callable liabilities coincide with gross external debt.

d The transactions in question are financial transactions between residents and non-residents..

e GG - general government; OMFI - Other Monetary Financial Institutions; ORS - Other Resident Sectors, which include non-monetary financial institutions, non-financial corporations, and households and non-profit institutions serving households.

f S-T and L-T refer to the classification of the term of issue depending on whether the maturity is short-term or long-term, respectively.

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proportion of securities issued by the public sector) and the maturity of the assets (longer average maturity), which, overall, may contribute to mitigating some of the risks posed by such a high volume of external liabilities (see Chart 1.10). All told, gross external debt, which encompasses callable liabilities, remains at a very high level (167.9% of GDP at end-2015). Accordingly, the correction of high external debt will require running current account surpluses sustainedly over a prolonged period, in which connection it will be vital to build on and entrench the gains in competitiveness attained in recent years.

POTENTIAL GROWTH AND BREAKDOWN OF PRODUCTIVITY

TABLE 1.2

POTENTIAL GROWTH AND CONTRIBUTIONS (a)

	2001-2007	2008-2014	2015-2025
Potential Growth	3.0	0.6	1.0
Contributions			
Employment	1.6	-0.2	0.0
Hours per employee	-0.2	-0.1	-0.1
Employees	1.8	-0.1	0.1
Population between 15 and 64	1.0	0.0	-0.3
Participation rate	0.9	0.3	0.1
NAIRU-PC	-0.1	-0.4	0.3
Capital	1.6	0.6	0.4
TFP	-0.1	0.2	0.6

BREAKDOWN OF PRODUCTIVITY GROWTH (b)

Firm level	1995-2007	2008-2013	Sector level	1995-2007	2008-2013
Intra-company	7%	-5%	Intra-sector	-115%	186%
Across companies	-107%	105%	Across sectors	15%	-86%

SOURCES: Central de Balances del Banco de España and P. Cuadrado and E. Moral-Benito (2016), *Potential growth of the Spanish economy,* Occasional Papers 1603.

a The figures show the average growth for the period.
b Aggregate productivity can be expressed as the weighted average of each company's (or each sector's) productivity, with weightings given by the weight of each company (or each sector) in economic activity. On the basis of this weighted average, productivity growth can be broken down into a term that shows the sum of the growth in productivity of each company weighted by the weight of each company in economic activity (intra-company term), and into another term that refers to the sum of the changes in the weights of each company weighted by their productivity levels (inter-company term). That is to say, the intra-company (or intra-sector) term quantifies the contribution of companies' (or sectors') productivity growth to aggregate productivity growth; the inter-company (or inter-sector) term shows the contribution of the reallocation of resources across companies (or sectors) given their initial productivity. For further details see L. Foster, J. Haltiwanger and C. Krizan (2006), "Market selection, reallocation, and restructuring in the US retail trade sector in the 1990s", *The Review of Economics and Statistics,* 88 (4), pp. 748-758. In the 1995-2007 period, the percentages total -100% because productivity growth was negative.

3.5 IMPROVING PRODUCTIVITY

Potential growth fell significantly during the crisis, as a result of the lesser contribution of the productive factors…

The available estimates of growth in the Spanish economy's potential output show a reduction from approximately 3% in the 2001-2007 period to around 0.6% on average from 2008 to 2014.[15] In the previous upturn, the increase in potential growth was based on the accumulation of productive factors, with a slightly negative contribution of total factor productivity (TFP) (see Table 1.2). There was a turnaround in this pattern with the onset of the crisis, giving rise to a lesser contribution of capital and a negative contribution of employment derived from the population decline – caused by net emigrant outflows during this period and progressive population ageing – and from the increase in structural unemployment. Conversely, the contribution of TFP turned round to become slightly positive.

…although there was a slight pick-up in TFP, based above all on a better reallocation of resources across firms…

For illustrative purposes, aggregate productivity growth can be broken down, first, into the contribution stemming from firms' average productivity, which is influenced by intrinsic improvements in worker and entrepreneurial skills, business organisation and technology; and further, into the contribution derived from the reallocation of resources across firms with different levels of productivity.[16] In Spain's case, this second factor has proven to be the most significant in explaining both the low growth of TFP in the previous upturn and the recovery observed in the recent period (see Table 1.2). This improvement would appear to be related above all to the destruction of the least efficient firms during the recession and the gain in market share of those that are most productive within each sector, whereas sectoral reallocation would be playing a limited role.

15 See Moral, E. and P. Cuadrado (2016), "Potential growth of the Spanish economy", Occasional Paper 1603, Banco de España.
16 That is to say, this channel explains an increase in TFP derived from a reallocation of resources that raises the weight of firms or sectors that show higher relative levels of productivity.

TOTAL FACTOR PRODUCTIVITY GROWTH
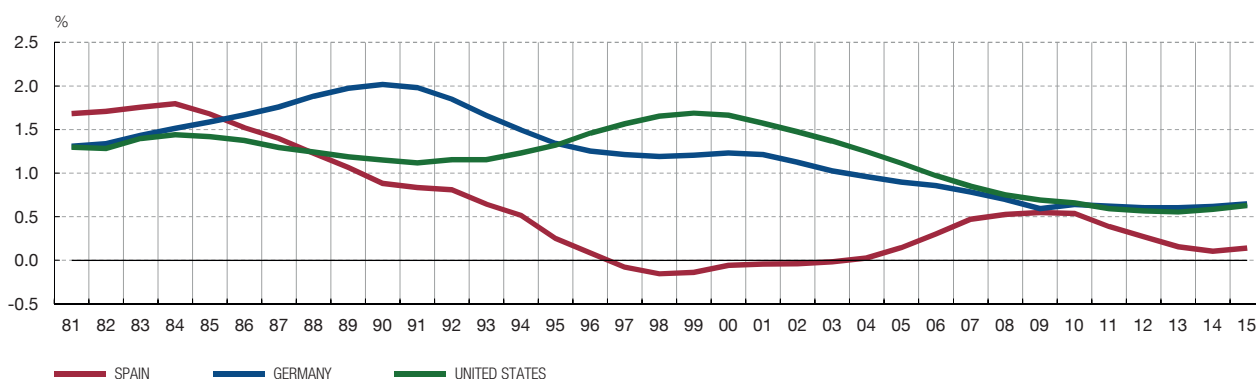
SOURCES: European Commission, *Competitiveness Research Network* of the ECB and Banco de España.

Improving potential growth in the economy in the medium term will hinge crucially on successfully achieving greater dynamism in productivity…	In any event, TFP in the Spanish economy is still holding at significantly lower growth rates than those of the other developed countries, such as the United States or Germany (see Chart 1.11). Higher productivity is crucial for attaining higher potential output growth rates in the medium term, given the adverse effect of the progressive ageing of the population on such growth. This should be a primary goal of the reforms to product and labour markets (see Box 1.3).

… suggesting the need for reforms generating greater efficiency in certain sectors

Converging on the productivity levels of those developed economies showing a better performance in this area therefore requires promoting an increase in firms' average productivity, which firstly calls for better regulation of certain sectors whose functioning is essential for business activity (see Chapter 4 of this Report). In this respect, some reforms have been approved in recent years but others are still pending. Hence, in the case of the electricity industry, measures have been adopted to contain the tariff deficit and a new interconnection with France has been opened, although the electricity price ultimately paid by firms and consumers continues to be high relative to other developed economies. The indicators available show greater regulatory constraints on other significant factors of production, such as transport and professional services.[17] These sectors also tend to evidence higher mark-ups in Spain than in other developed countries, and such mark-ups are expected to have increased over the course of the crisis.[18]

In this setting, it will be necessary to ensure the rigorous selection of infrastructure projects…

Infrastructure endowment and human and technological capital are also fundamental conditioning factors of business productivity. In the first instance, during the upturn prior to the crisis, Spain's volume of per capita public capital matched that of the euro area when in 1995 it was 15% below it. However, public investment has been one of the public spending items most affected by the ongoing reduction of the budget deficit. The need to continue pursuing fiscal consolidation will require a strict economic assessment of the different projects so that those with the greatest value-added may be selected.

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17 See Mora-Sanguinetti, J.S. and M. Martínez (2014), "La regulación en el mercado de productos en España según los indicadores de la OCDE", Boletín Económico, diciembre, Banco de España.

18 See Amador, Di Comite, Fuss, Hagemejer, Montero and Soares (2015), "Price-cost margin dynamics and heterogeneity: Evidence from European firm-level data", forthcoming ECB Working Paper; and Soares (2016), "Price-cost margin and bargaining power: A cross-country analysis using firm-level data", forthcoming ECB Working Paper.

… to promote the accumulation of human capital,…	In the case of human capital, there has been a most significant improvement in recent decades, although room remains for convergence in terms of the labour force's educational attainment in comparison with that of other European countries. In particular, the Spanish education system is notable for its high early school leaver rate, the under-use of vocational training arrangements and a low level of quality.[19] The economic crisis has, moreover, led to a concentration of job destruction among the least skilled and, in this way, it has substantially raised the degree of educational mismatch between labour supply and demand, which might hamper the employability of the least skilled (see Box 1.2).

… technological capital…

As regards technological capital, Spain is again characterised by lower levels than other developed countries. Specifically, the stock of technological capital as a percentage of GDP stood at 36% below the euro area average in 2013 (see Chapter 4 of this Report). This situation would affect both the public sector and, above all, the private sector, and would concern aspects such as workers' relative training, the excessive weight of small firms, which usually have a lesser propensity to innovate, and the limited development of alternative financial channels, such as venture capital, which is widely used in other countries by technology-based start-ups. Spanish firms also have a limited technological absorption capacity, while the public research system is characterised by fragmentation and a lack of connectedness to the business system.

... improved institutional quality...

The quality of the institutional framework has also been shown to be significant for explaining cross-country productivity differences.[20] In this respect, the indicators proxying the legal and administrative framework in which the public and private sectors interact show that Spain has considerable room for improvement in this area.[21] According to various statistical information sources, the efficiency indices for the Spanish legal system are below those of other comparable countries, while our litigation rate is higher[22], highlighting the need to identify the factors that lie behind these developments and to redress them.

… and to revise the regulations that hamper business start-ups and growth

It is also essential to build on the recent improvement observed in the allocation of resources across firms. In this connection, access by productive firms to financing for their investment projects should be ensured, while those aspects of the regulations that hamper the growth of the most efficient firms should be revised. In recent years there has been some progress here with the approval and implementation of the Law on the Guaranteeing of Market Unity, the Law on the Common Administrative Procedure and the added flexibility

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19 For instance, the OECD's PIAAC (2013) results (http://www.mecd.gob.es/inee/Ultimos_informes/PIAAC.html) highlight the Spanish population's poor maths skills, which range across the board among individuals with different levels of educational attainment, including higher education.

20 See, for example, R.E. Hall and C.I. Jones (1999), "Why do some countries produce so much more output per worker than others?", The Quarterly Journal of Economics, 114, pp. 83-116, and E. Helpman (Ed.) (2008), Institutions and economic performance, Harvard University Press, Cambridge, Massachusetts. For the Spanish case, M. García-Santana, F. Moral-Benito, J. Pijoan-Mas and R. Ramos (2016), "Growing like Spain: 1995-2007", Banco de España Working Paper 1609, find that the deterioration in resource allocation in Spain observed from 1995 to 2007 was more severe in sectors where the incidence of government regulations is greater.

21 For example, the indicator of the quality of public institutions constructed by the World Economic Forum as part of its "Global competitiveness report 2015-2016" ranks Spain 20th out of 28 European Union countries. This indicator is partly based on a questionnaire to firms and includes information on ownership rights and their protection, ethical and corruption-related issues, judicial independence, public sector efficiency or security, among other aspects. (For more detailed information see http://reports.weforum.org/global-competitiveness-report-2015-2016//). Similar results for Spain are obtained from the World Bank's "The Worldwide Governance Indicators" (see htpp://info.worldbank.org/governance/wgi/index.aspx#home).

22 See Mora-Sanguinetti, J.S. (2016), "Evidencia reciente sobre los efectos económicos del funcionamiento de la justicia en España", Boletín Económico del Banco de España, January.

to insolvency proceedings.[23] However, as may be inferred from the regional business climate indicators, Spain continues to face greater difficulties than its peers regarding business start-ups. Further, a wide range of regulations remain in place that distort company growth and which, therefore, directly influence the reallocation of resources across firms and sectors (see Chapter 4 of this Report).

3.6 PROGRESS PENDING IN THE CONSTRUCTION OF EMU

The euro area faces a complex scenario…

Beyond its domestic conditioning factors, the Spanish economy depends crucially on international developments, in particular those relating to the euro area. In this respect, the euro area faces a complex scenario, characterised by an outlook of moderate growth and low inflation and by still-high unemployment and debt levels in certain countries. The challenges posed for the functioning of the single market by the absorption of migratory flows, the UK referendum on the EU and security in the face of the terrorist threat are additional sources of uncertainty.

… requiring all economic policy strands to pull together…

To ensure the sustainability of the recovery and improve the medium-term outlook, economic policy measures on various fronts will be required. As regards monetary policy, the stimulus measures adopted by the ECB are allowing the economy's financing conditions to be relaxed and should contribute to quickening the progressive return by inflation to rates more compatible with the medium-term objective. Fiscal policy should use the headroom afforded it by the Stability and Growth Pact to adopt measures promoting activity and boosting medium-term growth. It is also vital to ensure the continuity of reform momentum aimed at improving the competitive environment and boosting the efficient working of the product and factor markets of those euro area economies departing from a position of relative disadvantage in these areas.

…and resolute progress in strengthening the institutional framework of EMU

In parallel, the member countries should continue making progress in strengthening the institutional framework of EMU. As noted in the June 2015 report "Completing Europe's Economic and Monetary Union" (known as the Five Presidents' Report), despite the notable headway made, EMU still rests on incomplete institutional architecture. Accordingly, it is necessary to continue moving towards greater economic, financial, fiscal and political integration.

In the short term, mechanisms will be needed to achieve greater economic policy coordination...

The Five Presidents' Report proposes a series of objectives deemed attainable in the short term that would not require amendments to the Treaty on the Functioning of the European Union. Thus, for instance, greater structural convergence is called for, including also more efficient labour markets generating better-quality jobs, and better-coordinated euro area economic policies. Along these lines, the European Commission has proposed creating national agencies entrusted with monitoring competitive imbalances and establishing a European Fiscal Council, which will be consultative in nature and should act within the multilateral fiscal surveillance framework, providing an independent assessment of the application of the Stability and Growth Pact rules by the EC and the EU Council. Ensuring the effectiveness of the new institution will, before its start-up in mid-2016, require that its institutional independence be reinforced and that certain aspects of its mandate be clarified, such as its role in the assessment of the euro area aggregate fiscal policy stance. Likewise, equipping the competitiveness councils with a European dimension would

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23 Law 39/2015 of 1 October 2015 on the Common Administrative Procedure for General Government, Law 9/2015 of 25 May 2015 on urgent matters in respect of insolvency and Law 25/2015 of 28 July 2015 on the second-chance mechanism, reduction of the interest burden and other social measures. Earlier, the bankruptcy legislation approved in 2003 had been amended on numerous occasions as a result of the crisis. Specifically, there have been changes in the wake of Royal Decree-Law 3/2009, Law 38/2011, Law 14/2013, Royal Decree-Law 4/2014, and Royal Decree-Law 11/2014.

provide for greater coordination of structural policies and a more harmonious adjustment of the imbalances still in place in the area.

…and to promote financial integration, completing the Banking Union and boosting the Capital Markets Union

In the short run, a further priority is to consolidate mechanisms allowing for a more efficient allocation and greater geographical diversification in terms of the risks assumed by financial institutions, so as to improve the area's ability to absorb potential asymmetric shocks. In this respect, the completion of the Banking Union should ensure a level playing field for all the member countries' banking systems, which will require, among other instruments, pooled public funds for the resolution of vulnerable institutions once private funds have been depleted, and the establishment of a European Deposit Insurance Scheme. The EC project for a Capital Markets Union is a further step, with more effective regulations, for achieving true financial integration geared to increasing the geographical diversification of portfolios and promoting firms' access to sources of financing other than bank lending under competitive conditions.

In the medium term, more resolute progress towards a Fiscal Union must be on the agenda

Beyond the short-term priorities, perseverance will be important for bringing about the medium-term objectives identified in the Five Presidents' Report. Hence, as regards Economic Union, structural convergence must eventually be more coercive in nature, setting standards or common minimum levels that countries have to meet in areas as significant as labour markets and tax systems. Fulfilling these greater economic policy demands will provide for the setting in place of common fiscal mechanisms, which will be entrusted with macroeconomic stabilisation functions that limit the influence and mitigate the economic and social effects of future crises in the area.

Notable among the more temporary factors underpinning activity and employment in 2015 were the additional decline in oil prices and the impulse from demand-side policies. These policies contributed to sustaining growth last year thanks to the introduction by the ECB of fresh monetary stimuli and to a fiscal policy stance that turned expansionary following the adoption of certain tax cuts and of an increase in consumption and public investment. Monetary policy also influenced the depreciation of the euro, which exerted an invigorating effect on companies' sales outside the euro area, especially in the first half of the year. Lastly, the fall-off in the pace of growth of world trade, especially that originating in connection with the emerging markets, was a factor that operated in the opposite direction and reduced activity.

Table 1 presents the results of an exercise approximately quantifying the effect of the above factors on GDP and inflation in 2015. In this connection, the MTBE (Quarterly Macroeconomic Model of the Banco de España) is used to simulate the effect that changes that were not anticipated in mid-2014 in the monetary policy stance, fiscal policy, oil and other commodities prices, and global demand have had on the two foregoing variables. Around that juncture, there was a fresh fall in oil prices, the ECB decided to adopt various additional expansionary measures and the Spanish government announced personal income and corporate income tax rate cuts for 2015. The model represents the Spanish economy as a small, open country integrated into the Monetary Union and, therefore, these factors may be incorporated into the model as changes in the exogenous conditions that affect the equations explaining the behaviour of the different economic agents.

As analysed in detail in Chapter 3 of this Report, the monetary measures improved financial and credit conditions and contributed to depreciating the euro and to expanding the activity of our euro area trading partners, therefore affecting nominal expenditure. The set of discretionary fiscal policy measures has been proxied by the change in the cyclically adjusted primary public balance/GDP

ratio, net of those measures of a temporary nature. In 2015, according to this indicator, a fiscal expansion of approximately 1% of GDP is estimated, and its effect on the macroeconomic variables is obtained by applying the average fiscal multipliers of the MTBE.

As regards the other two international factors, the fall in commodities prices affects the variables of the model not only via the reduction in production costs but also via the improvement in household disposable income, which boosts consumption and, consequently, employment and investment. The intensity of these channels depends on the initial level of the oil price which, in this simulation, has been set at €70 per barrel, which was the international market price prevailing as at mid-2014, compared with the average price observed in 2015, of €47 per barrel.[1] Lastly, the lower growth (down more than 2 pp) of world markets entails a decline in activity via the diminished demand for Spanish goods and services exports.

Of the four factors that may be considered as exogenous, the new monetary policy measures and the cut in the commodities prices exerted an estimated impact on GDP in 2015 of 0.6 pp in each instance, while the expansionary fiscal policy stance contributed around 0.5 pp. Conversely, the lower growth of world markets during the year subtracted 0.6 pp from the growth in activity. The net effect of the set of factors considered on economic growth last year is therefore expected to have been considerable, having reached an estimated magnitude of 1.1 pp. Furthermore, the lower-than-projected inflation in 2015 was chiefly determined by the decline in oil prices, which could only be offset in part by the fresh monetary stimuli, meaning that the negative effect, in net terms, on inflation was 1.6 pp.

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1 For a detailed analysis of the effect that different starting levels of the oil price have on the impact of this variable on GDP and inflation, see Box 4.2 in Chapter 4 of the Banco de España 2014 Annual Report.

Table 1
EFFECT OF THE CHANGE IN THE EXOGENOUS ASSUMPTIONS SINCE MID-2014 ON GDP GROWTH AND INFLATION FOR 2015 (a)

	GDP	Inflation
Monetary policy	0.6	0.6
Fiscal policy (b)	0.5	0.2
Global demand	-0.6	-0.1
Oil and other commodities prices	0.6	-2.3
TOTAL	**1.1**	**-1.6**

SOURCES: European Commission and Banco de España.

a Simulation using the MTBE. The simulation has taken into account the fact that, around mid-2014, the strong decline in oil and other commodities prices began to become discernible. Also, the ECB announced far-reaching monetary policy measures around that time, such as the adoption of negative interest rates in the case of the deposit facility.
b In this case the effect has been calculated on the basis of the estimate for the change in the cyclically adjusted primary budget balance in 2015 (-1% according to the EC), and its impact on GDP and on inflation, drawing on the MTBE multipliers.

Table 1
UNEMPLOYMENT AND LONG-TERM UNEMPLOYMENT, AND DISTRIBUTION OF LONG-TERM AND VERY LONG-TERM UNEMPLOYMENT BY CHARACTERISTIC IN 2015

	Unemployment rate	Incidence of long-term unemployment	Incidence of very long-term unemployment		Incidence of long-term unemployment	Incidence of very long-term unemployment
2006	8.5	25.7	13.0	Males	60.5	44.4
2007	8.2	23.8	12.3	Females	61.3	44.0
2008	11.3	21.5	9.9	< 30	49.0	29.7
2009	17.9	28.6	10.5	30 - 45	59.3	42.9
2010	19.9	42.6	17.0	> 45	72.0	57.0
2011	21.4	48.2	24.7	Primary education	66.6	51.7
2012	24.8	52.4	29.9	Secondary education	60.3	43.3
2013	26.1	58.5	36.1	Higher education	54.5	36.3
2014	24.4	61.8	42.5	Spaniards	61.7	45.3
2015	22.1	60.9	44.2	Foreigners	56.9	38.8

Table 2
DETERMINANTS OF THE PROBABILITY OF EXIT FROM UNEMPLOYMENT TO EMPLOYMENT (a)

	Coefficient	Z
Females	-0.03	-21.0
16 - 24	-0.03	-14.1
25 - 34	0.02	11.1
45 - 54	-0.03	-13.7
> 55	-0.08	-36.0
Primary education	-0.04	-22.9
Secondary education	-0.03	-14.6
GDP growth	0.01	13.0
6 months - 1 year unemployed	-0.05	-33.0
1 year - 2 years unemployed	-0.10	-64.7
> 2 years unemployed	-0.14	-93.0
Average probability	0.18	

Chart 1
EDUCATIONAL MISMATCH INDEX (b)

—— EMPLOYED VS UNEMPLOYED
—— NEWLY EMPLOYED (LESS THAN 1 YEAR OF SERVICE) VS UNEMPLOYED (Right-hand scale)

Chart 2
EXIT RATE FROM UNEMPLOYMENT TO EMPLOYMENT IN TERMS OF UNEMPLOYMENT DURATION

2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015
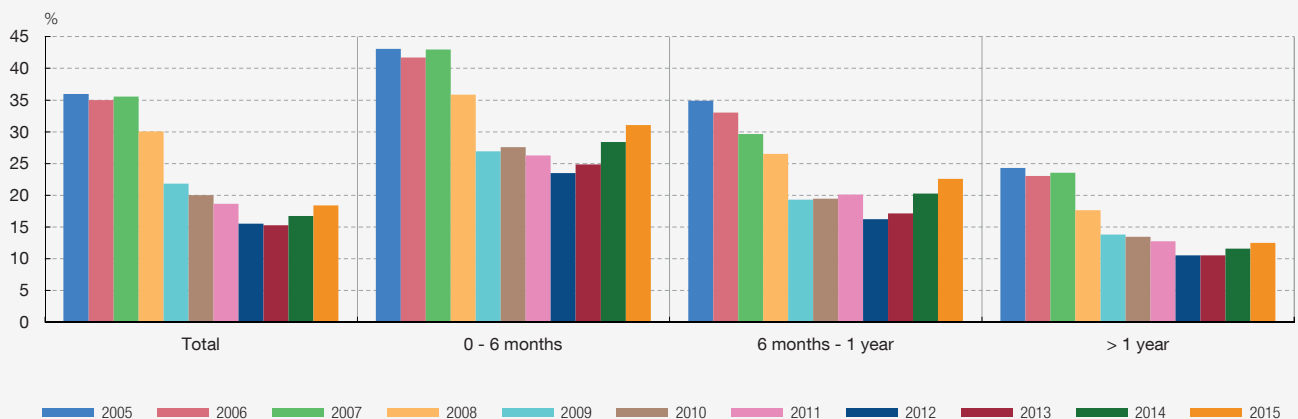
SOURCES: European Commission, INE and Banco de España.

a The regression also includes dummies for the year, quarter and regional government. Marginal effects and the Z statistic (ratio of the coefficient to the standard error) are reported. The estimation period spans that from 2005 Q1 to 2015 Q4. The reference category is an unemployed male, aged 35-44, with a higher education and unemployed for less than six months.

b This index measures the discrepancy between the distributions by educational attainment level of the employed, or newly employed, and the unemployed. Higher levels in the index are interpreted as a greater mismatch between the distribution by educational attainment of the employed and the unemployed and, therefore, greater potential difficulties for labour demand needs being covered by the supply of unemployed workers. The index is calculated as $I_t = \sum_{j=1}(O_{jt} - P_{jt})^2$, where O_{jt} measures the proportion of employees with educational attainment leve j in the period t and P_{jt} measures this same proportion in the case of the unemployed.

The unemployment rate stood in early 2016 at 21%, almost 6 pp down on its early-2013 peak, but still far above that observed in other European countries. Moreover, the incidence of long-term unemployment (over one year unemployed) has diminished only slightly, to 60.9% (from its peak of 61.8% in 2014), practically threefold the level observed in 2008 (see left-hand panel of Table 1). Similarly, the proportion of the unemployed without a job for over two years has continued to increase, rising to 44.2% in 2015, against 9.9% in 2008. This bias in the distribution of unemployment towards longer durations is much more marked in Spain than in the other European countries, except Greece, and poses an additional challenge to continuing along the path of falling unemployment.

These developments are related, at least in part, to the sizable educational mismatch that has come about since the onset of the crisis between labour supply and demand. This phenomenon has chiefly been the consequence of the concentration of employment destruction among the least skilled. Indeed, the proportion of employees with only a primary education, which stood at 18% before the crisis broke, has fallen to 10.2% in 2015.[1] Conversely, the weight of employees with a university education has moved on a growing trend, from 23.9% in 2008 to 29.5% in 2015. As a result, the incidence of lengthy unemployment durations is particularly high among groups with a lower level of educational attainment, as well as among older individuals. In both cases, more than two-thirds of the unemployed have been seeking employment for at least a year, and more than half have been in that situation for over two years (see right-hand panel of Table 1).

Chart 1 shows an educational mismatch index for the Spanish labour market that takes into account the distribution by educational attainment of the employed and the unemployed, respectively proxying labour demand requirements and the average skills of the labour supply available. The index reveals a most notable increase since 2007 that has not diminished in the recent quarters of greater employment buoyancy, which evidences the low employability of certain less skilled groups.[2]

The analysis of unemployment exit flows shows that the sharp decline in the probability of finding a job observed as from 2008,

from 35% in the years running up to the crisis to a low of 15.2% in 2013 (see Chart 2), was across the board but more acute in the group with the lowest unemployment durations, which were more affected by the labour market downturn. Likewise, the pick-up in employment creation in the past two years has allowed for a more marked increase in unemployment exit rates for durations of less than one year, which are already above the level observed in 2009. Conversely, the recovery is much more tenuous in the case of greater durations.

Individual information from EPA (Labour Force Survey) records enables the determinants of the likelihood of finding a job to be estimated (see Table 2). The results of the estimation[3] show that the youngest and oldest individuals, those least skilled and, above all, those having spent most time unemployed show a significantly lower probability of finding a job. The effect of the cyclical situation in the previous estimation is as expected, whereby higher GDP growth translates into a higher unemployment exit rate. However, the response of the unemployment exit rate to changes in GDP growth depends on unemployment duration. Specifically, it is found that a 1% increase in GDP raises the exit rate for durations of less than one year by 1.5 pp but by only 0.4 pp in the case of durations of over two years.[4]

If the evolution of these unemployment exit probabilities over recent years is analysed[5], the crisis can be seen to have reduced comparatively more the unemployment exit probability of the youngest cohort and, more recently, of those with a lower level of educational attainment, among whom a lesser recovery of the exit rate is observed in the current upturn. Likewise, a marked deterioration is seen in employment opportunities for those with longer durations in unemployment.

In sum, the results presented in this Box reveal the presence of certain hysteresis effects that may significantly hamper further reductions in unemployment in Spain. This is because, first, individuals having been unemployed for the longest periods account for a very high proportion of the total unemployed and this group also faces growing difficulties in finding a job; and, further, the cyclical upturn is exerting a relatively minor impact on the job-finding capacity of this group of unemployed workers.

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1   This effect is partly a consequence of the heavy job losses in the construction sector. Box 3.2 of the 2014 Annual Report analysed the employment status of construction workers who lost their job at the start of the economic crisis in 2008.

2   See Izquierdo, M., S. Puente and P. Font (2013), "Evolución del desajuste educativo entre la oferta y la demanda de trabajo en España", Boletín Económico, Banco de España. June. The course of this index is similar when the distribution of recently created employment instead of the total stock of employees is used to proxy labour demand needs.

3   Specifically, Table 2 shows the findings of a probit-type model in which, for the period running from 2005 de 2015 Q4, an estimate is made of the probability of finding an individual employed in a given quarter departing from a situation of unemployment in the preceding quarter, drawing on a set of aggregate variables and personal characteristics.

4   These findings are obtained in a version of the foregoing probit model, in which the GDP growth coefficient is allowed to differ for each unemployment duration.

5   Based on a probit model like that shown in Table 2 in which the coefficients of the different variables are allowed to vary over time.

Various factors point to a considerable reduction in the potential growth rate of the Spanish economy in the medium term, which could stand at around 1.2% in the 2020-2025 period, compared with rates close to 3% over the 2001-2008 period.[1] Notable among these factors is the impact of population ageing which, on current INE forecasts, would lead to a decline in the population of 0.2% per annum over the 2020-2025 period[2]; hence, once this aspect is taken into account, per capita potential growth would stand at similar rates to those observed during the upturn. The effects of population ageing on potential growth will be accentuated, first, by the disappearance of the cohort effects that have raised the female participation rate in recent decades and which are expected to peter out in the coming years.[3] The negative contribution of labour supply to potential growth may only be offset by a better productivity performance, which must overcome its declining trend, or by a

significant reduction in the structural rate of unemployment (NAIRU), beyond what was observed in previous cycles.

This Box offers different potential growth scenarios for the Spanish economy which seek to illustrate the effects of a sustainable improvement in the behaviour of productivity and structural unemployment, associated, for instance, with the application of structural reforms. In the baseline scenario it is assumed that these two variables will converge on the average values observed in the past two full cycles of the Spanish economy (1983-2013). Specifically, assumptions are made for a fall in structural unemployment from its current levels to its estimated historical average of 14.4%, and a productivity growth path consistent with the average of 0.8% observed from 1983 to 2013. These figures may be understood as the portion of unemployment and potential productivity that is explained by structural characteristics of the labour and product markets.

Hereafter, alternative scenarios are set out considering different equilibrium growth paths that reflect the effect of certain structural changes in the foregoing variables that would arise, according to the assumptions of the exercise, further to the implementation of product and labour market reforms. For a reference framework within which to analyse the impact of the reforms, the empirical evidence available at the international level is used. Specifically, the starting point is the regulatory indicators devised by the OECD, which measure both the efficiency of the regulatory framework in product markets and the legislation on employment protection. These indicators seek to quantify various aspects relating to the legal and institutional framework in place in each of the countries

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1   The estimates of potential growth strip out the effect of cyclical factors, thereby identifying the trend component of economic growth. These estimates are based on a production function approach in which the productive factors (capital and labour), along with total factor productivity, determine the economy's productive capacity. This methodology further allows potential growth scenarios to be devised over a medium-/long-term horizon under specific assumptions based on the neoclassical growth model (for further details see Cuadrado and Moral Benito, "Potential growth of the Spanish economy", Occasional Paper 1603, Banco de España).

2   While the uncertainty surrounding these forecasts may be relatively high, the Eurostat forecasts (see EUROPOP 2013) coincide and show a scenario of population declines over the medium term in the Spanish economy.

3   See Montero, J.M. y A. Regil (2015), "La tasa de actividad en España; resistencia cíclica, determinantes y perspectivas futuras" Documento Ocasional 1502, Banco de España.

Table 1
SCENARIOS FOR POTENTIAL GROWTH IN THE SPANISH ECONOMY IN THE MEDIUM TERM (a)

	Baseline scenario	Scenario 1	Scenario 2	Scenario 3
Potential growth	1.2	1.4	1.6	1.9
Contributions				
Employment	0.0	0.2	0.0	0.2
Hours by employee	-0.2	-0.2	-0.2	-0.2
Employees	0.2	0.4	0.2	0.4
Population aged 15-64	-0.2	-0.2	-0.2	-0.2
Participation rate	0.0	0.0	0.0	0.0
NAIRU-PC	0.4	0.6	0.4	0.6
Capital	0.5	0.6	0.7	0.8
TFP	0.6	0.6	0.9	0.9
Memorandum item				
Growth of per capita potential GDP	1.3	1.6	1.8	2.1

SOURCE: Banco de España.

a   The estimates correspond to the average for the period from 2020 to 2025. Scenario 1 considers a reduction in the equilibrium structural unemployment rate to 12% in 2025 instead of 14.4% in the baseline scenario. Scenario 2 considers an increase in equilibrium productivity growth to 1.3% in 2025, compared with 0.8% in the baseline scenario. Scenario 3 incorporates both changes simultaneously.

analysed. Although they are subject to different caveats, these measures are usually considered to be a useful tool for assessing the relative situation of a country's regulation and the changes therein over time. A lower score in these indicators denotes greater flexibility in product and labour markets.[4] On the basis of this information, the elasticities of the two variables of interest, namely structural unemployment and productivity growth, are considered relative to the previous indicators. In this connection, the estimates available in the literature are used in order to quantify approximately the effect on structural unemployment and productivity growth of structural reforms that add flexibility to labour and product markets. For Spain's case, it has been considered that a 1 pp reduction in the regulatory indicators would involve placing the Spanish regulatory framework at the level of the best practices of the OECD countries. Thus, the scenarios do not seek to quantify the effects of a specific structural reform but to illustrate the potential benefits of setting more efficient regulation in place. According to the elasticities available[5], an

improvement in the labour and product market regulatory framework on the above scale would reduce the equilibrium unemployment rate by 2.4 pp and raise annual productivity growth by around 0.5 pp.

On the basis of these estimates, three scenarios are constructed which illustrate the impact of these changes on potential growth in the medium term (2020-2025). Scenario 1 considers a 2.4 pp reduction in the equilibrium structural unemployment rate (to 12% in 2025), scenario 2 illustrates the 0.5 pp increase in equilibrium productivity growth (to 1.3% at the end of the period considered) and, finally, scenario 3 incorporates the effects of the changes in both variables simultaneously.

Table 1 shows the results of these scenarios for the 2020-2025 period. The scenario based on higher annual growth rates in productivity results in higher potential growth than the scenario that includes a more marked reduction in the structural unemployment rate, which partly reflects higher growth in the volume of capital given the higher growth of productivity.[6] In any event, when both types of reforms combine, potential growth would stand at rates close to 2%, exceeding the per capita growth observed in the upturn.

These simulations thus illustrate the importance of pushing through structural reforms that increase productivity growth and reduce the structural unemployment rate in order to offset the impact of population ageing and the tailing off of the expansion in the female participation rate recorded in recent decades.

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4   For example, the indicator of legislation on employment protection takes into account, inter alia, the amount of severance payments, the definition of unfair dismissal, the conditions for the use of temporary contracts and the different procedures applicable, while the product market regulation indicator encompasses concepts such as public sector intervention in private operations, regulatory complexity, explicit obstacles to trade and investment, and freedom of opening hours. For further details on product market regulation indicators, see Mora-Sanguinetti, J.S and M. Martínez-Matute (2014), "La regulación en el mercado de productos en España según los indicadores de la OCDE". Boletín Económico Banco de España 12, pp. 45 54. Regarding the employment protection legislation indicator, see OECD (2013), "Protecting Jobs, enhancing flexibility: A new look at employment protection legislation". OECD Employment Outlook.

5   See Bassanini, A. and R. Duval (2009), "Unemployment, institutions and reform complementarities: re-assessing the aggregate evidence for OECD countries", Oxford Review of Economic Policy; Nicoletti, G. and S. Scarpetta (2003), "Regulation, productivity and growth: OECD evidence", Economic Policy; and Bassanini, A., L. Nunziata and D. Venn (2009), "Job protection legislation and productivity growth in OECD countries", Economic Policy.

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6   In the neoclassical growth model considered in this Box, the growth of capital per employee is assumed, under equilibrium, to be equal to technological growth.