FOREWORD BY THE GOVERNOR

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A key characteristic of the Spanish economy in 2015 was the step-up in the pace of recovery initiated in mid-2013, raising GDP growth to 3.2%. This also fed through to the labour market, with the creation of more than half a million jobs over the year as a whole. The dynamism of our economy, which has continued into early 2016, is a most notable feature of recent developments in the euro area.

The current phase of recovery has allowed significant progress to be made in the correction of the main imbalances built up by the Spanish economy in the previous upturn and in the early years of the crisis. However, some of these imbalances persist and are factors of vulnerability, posing significant economic policy challenges.

The *Annual Report* analyses the factors underpinning the recent growth in the Spanish economy, identifies the challenges outstanding and discusses the most suitable economic policies for facing such challenges.

In 2015, the growth rate of the global economy fell to 3.1%. This was a result of the diminished dynamism of the emerging economies, in a setting in which the advanced economies maintained a modest pace of increase, despite the expansionary stance of economic policies and the fall in oil prices. This decline, along with the re-balancing of the Chinese economy and expectations about the normalisation of US monetary policy, raised uncertainty globally, giving rise to significant increases in volatility on financial markets.

The euro area grew moderately compared with past episodes of recovery, while prices remained stagnant and medium- and long- term inflation expectations slipped downwards. These circumstances led the ECB to extend its asset purchase programme in early 2015 to include securities issued by the public sector, and to approve further measures in December last year and in March this year. As analysed in Chapter 3 of the Report, these measures, along with earlier adopted ones such as the setting of a negative deposit facility rate and the targeted long-term refinancing operations (TLTROs), have contributed significantly to easing financial conditions.

In Spain's case, the current recovery phase began three years back with the improvement in the economic and financial environment, to which the policies and reforms applied both domestically and at the European level contributed. The adjustment in the relative prices and costs of goods and services has helped enhance the Spanish economy's competitive capacity, invigorating exports and boosting domestic expenditure and employment. The process of household and corporate deleveraging has continued, in a setting in which many of the financial fragmentation problems within the euro area have been corrected. These developments have been conducive to the correction of the external imbalance and the generation of a net lending capacity of the nation vis-à-vis the external sector, both of which aspects are addressed in detail in Chapter 2 of the Report.

Along with the foregoing more structural factors, the sound pace of growth in 2015 was enhanced by other eminently temporary elements. The new monetary measures and their impact on public- and private-sector financing conditions, the depreciation of the euro, the change in fiscal policy stance and the fall in oil prices had a most notable effect on activity, which was only partly offset by the slowdown in global markets.

The analyses available discount a progressive tailing off of some of these temporary factors, which will result in a gradual moderation of growth rates in the short and medium term.

Against this background, further headway in restoring levels of activity and employment and in improving medium- and long-term growth prospects will require tackling the challenges still outstanding, namely reducing unemployment, fiscal consolidation, private-sector deleveraging, the moderation of the external debt position and improved productivity.

First, unemployment. The unemployment rate dipped in early 2016 to 21%, after having stood at almost 27% in 2013; but it remains far above the rate observed in other European countries, at what is a socially unacceptable level. Moreover, the incidence of long-term unemployment (where workers have been jobless for more than one year) affects almost 60% of the unemployed. The persistence of such a high unemployment rate is one of the main factors behind the increase in income inequality in Spain in the context of the crisis.

To entrench balanced growth and a sustainable employment rate requires maintaining and building upon the competitive gains achieved in recent years. This calls for a labour market framework that strengthens internal flexibility and provides for the adjustment of wages to companies' specific conditions. To correct the strong incentive offered by current regulations to temporary hiring, it is necessary to boost the attractiveness of permanent hires, preventing their excessive protection from encouraging the resort to temporary employees. In turn, active policies must be improved, especially those geared to promoting the employability of lesser-skilled workers.

In the fiscal arena, last year's high budget deficit of 5.1% of GDP interrupted the sustained restrictiveness of budgetary policy in recent years. There was slippage from the target and an increase in the structural component of the deficit, to almost 3% of GDP. Together with this, the public debt/GDP ratio stands at close to 100% of GDP, more than 60 pp of GDP up on the pre-crisis level.

The risks for the economy as a whole that such high levels of public debt and budget deficit have, even in an environment of very low interest rates, should not be taken lightly. Accordingly, it is a priority to resume the corrective path of the fiscal imbalance, in which connection it is necessary to define a detailed medium-term consolidation programme. Such a plan should include a more efficient mix of public revenue and spending, and the strict application of the preventive and coercive mechanisms of the Budgetary Stability Law. Furthermore, it should be accompanied by a strategy that enables the challenges posed to public finances to be tackled, in particular the challenge of population ageing for the pensions system.

The third challenge is linked to corporate and household debt. Despite the reduction of almost 50 pp of GDP in private debt since 2010, this ratio still stands above the average euro area level, and the financial position of certain segments of the population, encompassing households and firms alike, remains vulnerable.

In aggregate terms, bank lending continued to ease in 2015, albeit at a lesser pace than in previous years. These dynamics at the aggregate level are compatible with an environment in which new financing flows continue to increase; in the business area, these flows are earmarked in the main for sectors and companies with a greater growth capacity. Credit institutions' improved solvency and liquidity is expected to have contributed to this recovery in financing to households and firms, although the environment of low interest rates, the reduction in the outstanding balance of credit and the presence of a still-significant volume of non-performing loans and foreclosures continue to bear down on banks' profitability.

Foreign debt, though it has begun to decline, remains very high and is a significant factor of vulnerability, especially given the recurrent financing needs vis-à-vis the external sector that are entailed. Correcting it will require entrenching the capacity to run current account surpluses in a sustained manner, whereby it will also be crucial to build on the gains in competitiveness attained in recent years.

Improving productivity is one of the major challenges facing our economy in the long run. Only increased efficiency in the use of the productive resources available will enable us to improve potential growth, in particular under a scenario of population ageing, such as that looming in the coming decades.

Converging on the productivity levels of the more advanced economies is a complex task requiring various actions sustained over time. As the analysis in Chapter 4 of the Report infers, providing financing for new investment projects and reducing the obstacles to business dynamism will be essential for promoting the efficient allocation of resources across firms and sectors. Some of these obstacles arise from various regulatory elements, which advises revising those that excessively constrain competition in certain markets or that establish incentives running counter to business growth.

At the same time, raising productivity calls for promoting the accumulation of human and technological capital, and improving the institutions that set the framework of legal and administrative relations between the public and private sectors.

Finally, the deep-seated consequences of our membership of the European Union and of the Economic and Monetary Union should be underscored. The decisions adopted in this realm in recent years and, in particular, those relating to the development of the common institutional architecture and to monetary policy, have been major factors of support in this recovery phase. Giving continuity to this impulse requires, at present, completing the institutional arrangements for EMU and moving forward towards greater economic, financial, fiscal and political integration.