FOREWORD BY THE GOVERNOR

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The Spanish economy sustained a high rate of growth in 2016, exceeding the expectations prevailing before the year began. For the second year running, GDP grew by 3.2%, outpacing – as in 2015 – the rate observed in the euro area as a whole by around 1.5 pp. This performance was, moreover, against the background of the continuing external surplus, despite the positive growth differential vis-à-vis Spain's trade partners as a whole. The balance in terms of employment generation is also favourable. However, while the pre-crisis level of GDP is expected to be regained during the current quarter, employment is still almost 12% lower.

The prolongation of the upturn has contributed to correcting the imbalances of the Spanish economy. This has been particularly visible in terms of the improvement in the degree of competitiveness in recent years, the notable reduction in the volume of households' and non-financial corporations' debt, and the progressive normalisation and pick-up in the real estate sector. While – as the Banco de España projections suggest – the outlook is favourable, in recent quarters a series of risks have been taking shape, stemming essentially from the external sector, the interaction of which with the elements of fragility still in place might adversely affect how the economy evolves.

Chapter 1 in this Report discusses the factors driving growth in the Spanish economy, and both the key vulnerabilities to the various risks in place and the medium- and long-term structural challenges ahead are discussed.

Growth in the global economy was once again modest in 2016, although some improvement was observed as the year unfolded. The pace of expansion of international trade flows was moderate, which might partly reflect a reversal of global value chains and also, perhaps, the effect of a rise in protectionist tendencies. In the advanced economies, the relatively subdued pace of growth contributed to expansionary monetary policies being maintained. Among the emerging economies, the recessions in some commodity-producing countries, as a result of the falling prices of these goods, tended to ease over the course of the year as commodity prices rebounded. Global financial markets were buffeted by some short-lived bouts of turbulence. One such episode was at the beginning of 2016, when doubts began to arise over the possibility that the Chinese authorities might not be able to cope with the simultaneous objective of preventing a significant slowdown in activity and containing indebtedness. Subsequently, unexpected UK and US election results led to periods of some volatility on capital markets.

In the euro area, as has been the case since the start of the recovery in mid-2013, GDP growth remained modest, against the backdrop of a relatively unfavourable external environment and the prevailing high levels of uncertainty. Inflation trended upwards as a result of the acceleration in energy prices, although the core component has shown no signs of picking up to date. The lack of any sign that inflation may sustainably be drawing close to its medium-term objective of 2% led to a further easing in monetary policy, involving fresh policy interest rate cuts and successive adjustments to the asset purchase programme, including most notably its extension to December this year and the inclusion of high credit quality debt securities issued by non-financial corporations operating in the euro area.

In Spain, the recovery continued to be underpinned by a combination of factors. On one hand, the expansionary stance of fiscal policy and of the common monetary policy, along with the decline in commodity prices up to the start of 2016, has increased the pace of recovery in the Spanish economy to a greater extent than in the rest of the euro area. On the other, the impact on competitiveness of the reforms undertaken in recent years, together with the ongoing deleveraging of private agents (which is covered in detail in Chapter 2 of this Report for the case of non-financial corporations), has laid the foundations for more balanced and sustained growth.

The outlook for the cyclical upturn in the economy continuing is favourable, owing to the foreseeably persistent effects of the correction of the Spanish economy's imbalances. Also, there is here a more conjunctural factor, namely the greater momentum of global activity projected for the next two years. Nonetheless, it is expected that the adoption of a more restrictive fiscal policy stance, which is needed to see through the budgetary consolidation process, and the impact of the recent rise in oil prices on households' and firms' real income will result in some easing in the pace of growth of the economy.

This favourable picture is, however, subject to several risks. On the external front, there are several factors of uncertainty. First, the transition of the Chinese economy from an export-, investment- and industry-based model to one more sustainable in the longer run based on consumption and services is a desirable process which, however, entails significant risks, particularly in the current context of private over-indebtedness. Further, a possible expansionary bias to US fiscal policy might contribute to tightening financial conditions both in the United States and globally. An element of particular risk to the global economy is the possibility that the authorities in various countries, with a sizeable weight in global trade, may take a turn more conducive to the adoption of protectionist measures. That would prove particularly adverse for an economy such as Spain's, whose external openness has stepped up notably since the crisis. In addition, our economy will foreseeably be directly affected by the form relations between the United Kingdom and the European Union ultimately take, given Spain's high degree of exposure to the British economy in certain areas, such as exports of tourism and non-tourism services and the financial sector.

Secondly, agents' debt levels remain high, despite the intense deleveraging under way in recent years, which adds a factor of vulnerability to a hypothetical future tightening of financing conditions. In this respect, it should be stressed that despite the economy as a whole attaining a net lending capacity position, the dependency on foreign saving remains very high, as analysed in depth in Chapter 3 of the Report.

In recent years, interest rates have fallen substantially, to historically low levels, which has contributed to boosting the different agents' income. The onset of the normalisation of financing conditions would naturally see the opposite effect. However, the degree of vulnerability of the different agents to this eventuality is not the same, since their respective debts have also trended differently. In particular, the public debt ratio has risen to a very high level close to 100% of GDP, after increasing by more than 60 pp since the onset of the crisis. This situation highlights the need to draw up a budgetary consolidation plan in the medium term, in a context in which, for the second year running, in 2016, fiscal policy adopted an expansionary bias. At the same time, regard should be had to the composition of the necessary budgetary adjustment, so that the expenditure/revenue mix is conducive to fiscal policy contributing to the economy's potential growth.

As regards private agents, the progress in ongoing deleveraging has been most significant. Nonetheless, the level of debt in relation to income and, therefore, the financial burden, remains very high across certain groups of agents. Among non-financial corporations, this includes companies engaging in construction and real estate services, from the sectoral standpoint, while involving the smallest firms in terms of size. As far as the household sector is concerned, debts and the attendant burden are concentrated among lower-income households.

A hypothetical rise in the cost of financing would not feed through equally to all agents in the economy. The impact of a rise in interest rates might be swift but relatively modest in the case of households and non-financial corporations if, as occurred in the closing months of 2016, this rise is concentrated in the longer-dated segments of the yield curve, in a setting in which the bulk of the debt of these agents is short-term or floating-rate. Conversely, in the case of general government, and given the sizeable weight of this sector's long-term debt, the pass-through to new financing operations is expected to be sharper, but also slower in terms of the aggregate cost.

A third factor of vulnerability of the Spanish economy is banks' relatively low profitability, a feature they share with their peers in other euro area countries. The lower volumes of non-productive assets in bank portfolios have exerted a favourable impact on profitability, but this has been lessened by the compression of net interest margins, in a setting in which the rebound in lending activity is still moderate.

Lastly, final production in the Spanish economy evidences a greater dependency on imported oil than other developed economies, while the oil price oscillations have a greater impact on the rate of change of consumer prices. Both facts underscore the need to prevent a generalised pass-through of the recent rises in oil prices to the prices of other goods and to wages, given the adverse effect this would exert on the economy's external competitiveness.

Beyond these risks, longer-term economic policy priorities should focus on the need to address the effects of a series of growth-constraining factors, including most notably high structural unemployment, population ageing and low productivity.

Firstly, there are broad population groups, such as those with a lower skills level, who, given that they have remained unemployed for a lengthy period, cannot directly benefit from the economic recovery. It should therefore be a priority to promote the employability of the long-term unemployed, preventing any loss of their skills, in which connection training policies should play a key role. Furthermore, hiring-incentives programmes may prove effective in helping these individuals return to work, provided such programmes focus on the target population and avail themselves of the appropriate mechanisms for monitoring and evaluating results.

Secondly, population ageing is a constraint on the economy's potential growth which operates principally – inter alia – via the lesser availability of human capital. In addition, these demographic developments place upward pressure on public spending on certain items, including health care and, above all, pensions. In this latter respect, the reforms undertaken in recent years enable the effect on spending of the increase in the dependency ratio to be contained, albeit at the expense of a reduction in the average pension amount relative to average wages. Tasks outstanding for the future in this area thus involve determining the desired relationship between wages and pensions, and the means for ensuring the system's sufficiency of revenue.

Thirdly, the sluggishness of productivity means that the projected potential growth rates are also relatively low, even when considered in per capita terms. Raising long-term growth calls for measures in widely differing areas, with the aim of facilitating the reallocation of resources to the most productive firms. On the regulatory front, those elements hampering market entry by new firms or those constraining their growth need to be amended. Moreover, regulatory constraints in certain sectors, services in particular, need to be countered, and the efficiency of legal proceedings should be improved and the excessive duality of the current labour market reduced, given the adverse effect duality has on employee productivity. Finally, the evidence available suggests there is ample scope for improving the quality of education and for promoting technological capital accumulation.

Lastly, developments in the Spanish economy in the medium and long term will be influenced by those in the EU and the euro area. In the economic policy realm, an enhanced medium-term outlook, making the possibility of an entrenched low-growth scenario more remote, will call for the extraordinary monetary policy stimulus being provided at present to be supported by domestic policies which, in the fiscal sphere, harness the headroom available (while simultaneously taking into account the budgetary discipline rules in force) and, in respect of structural policies, promote productivity growth.

Furthermore, rising demands for the introduction of greater restrictions on the free movement of people, goods and services should act as a catalyst for both the EU and the euro area to seek out avenues for stepping up their degree of integration. In the case of the euro area, deepening financial integration through the completion of the Banking Union and progress on the Capital Markets Union are a priority. Beyond the financial realm, the aim is to achieve a genuine Economic Union encompassing economic policies other than monetary policy and including common stabilisation mechanisms, such as those discussed in Chapter 4 of this Report.