QUARTERLY REPORT ON THE SPANISH ECONOMY
OVERVIEW

As of the cut-off date of this report (24 June), the results of the referendum held the previous day in the United Kingdom on this country's continuing membership of the European Union (EU)[1] have become known. A majority voted in favour of leaving the EU, which has triggered very sharp movements on global financial markets. Against this background of heightened uncertainty, the main central banks have announced extraordinary liquidity-providing measures to counter the increased volatility on markets. In this respect, it should be stressed that it is still very early to determine what portion of this initial reaction by the financial markets reflects the impact that the results of the British referendum may entail in the medium and long term as opposed to the temporary effects related to the sharp rise in volatility associated with the assimilation of news of this importance.

Prior to the referendum news, there had been some timidly positive developments in the world economy since the publication of the previous *Quarterly Report.* As regards the non-euro area advanced economies, the latest information, following the easing in activity at the start of the year, had provided more favourable signs. Among the emerging economies, meanwhile, the expansionary stance of demand policies in China appears to be stabilising this economy in the short term. Oil prices firmed on the rising trend on which they embarked in late January. Indeed, this would appear to be one of the factors behind the calm that marked global financial market developments for most of the quarter. However, since early June, the persistence of factors of vulnerability in the world economy has become patent, as the uncertainty surrounding the result of the referendum in the United Kingdom paved the way for a bout of turbulence that has been greatly magnified by the outcome of the consultation, as indicated.

In the euro area, there was an upward surprise in GDP growth in Q1, although this appears to have been associated with essentially temporary factors. As a result, it has not led expected medium-term growth to be revised, as may be inferred from the latest Eurosystem projections[2], which remain unchanged for the 2017-2018 period, albeit subject to downside risks, in particular owing to the UK referendum result. Inflation in the area continues to show no signs of picking up, with some additional negative surprises in the latest data, which have translated into a downward revision of the projected growth rate for core inflation in the short term.

In Spain, the information available points as before to the continuation of the upturn in activity. In Q1, GDP grew by 0.8%, a rate matching that observed in the two preceding quarters and 0.1 pp up on the Banco de España's projection in its March *Quarterly Report.* The Quarterly National Accounts detailed a continuing expansionary course for domestic demand, while the contribution of net external demand to the increase in GDP was negative, against a background in which trade flows weakened notably.

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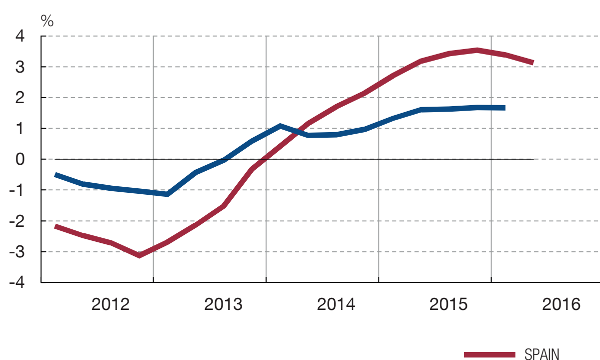
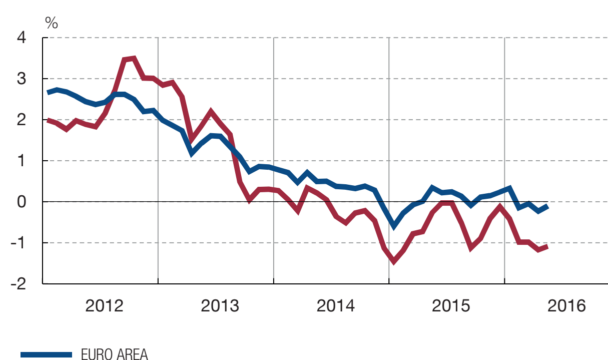
1 The referendum had been called to ratify the European Council's February 2016 resolution on the United Kingdom's special status in the European Union. See the article (in Spanish) Acuerdo sobre un nuevo régimen para el Reino Unido en la Unión Europea in the March 2016 Boletín Económico.

2 The projections for the euro area as a whole are available at: http://www.ecb.europa.eu/pub/pdf/other/eurosystemstaffprojections201606.en.pdf, and those for the Spanish economy at: http://www.bde.es/f/webbde/INF/MenuVertical/AnalisisEconomico/AnalisisEconomico/ProyeccionesMacroeconomicas/ficheros/be1606-proye.pdf.

GROSS DOMESTIC PRODUCT (a) — CHART 1





SOURCES: Eurostat, INE and Banco de España.

a Year-on-year rate of change based on seasonally adjusted series in the case of GDP and on original series in consumer price indices.

MAIN MACROECONOMIC VARIABLES OF THE SPANISH ECONOMY (a) — TABLE 1

			2015				2016	
	2014	2015	Q1	Q2	Q3	Q4	Q1	Q2
National Accounts								
Quarter-on-quarter rates of change, unless otherwise indicated								
Gross domestic product	1.4	3.2	0.9	1.0	0.8	0.8	0.8	0.7
Contibution of national demand (b)	1.6	3.7	1.4	1.0	1.2	0.6	1.0	0.6
Contibution of net external demand (b)	-0.2	-0.5	-0.5	0.0	-0.4	0.2	-0.3	0.1
Year-on-year rates of change								
Employment	1.1	3.0	2.9	2.9	3.1	3.0	3.2	2.9
Price indicators (year-on-year change in end-of-period data) (c)								
CPI	-0.2	-0.5	-0.7	0.1	-0.9	0.0	-0.8	-1.0
CPI excl. energy and unprocessed food prices	0.0	0.6	0.2	0.6	0.8	0.9	1.0	0.7

SOURCES: INE and Banco de España.

a Information available to 24 June 2016.
b Contribution to the quarter-on-quarter rate of change of GDP (pp).
c Latest available figure for consumer price indices: May 2016.

The latest conjunctural information continues to point to robust growth in activity. Specifically, GDP is estimated to have increased at a quarter-on-quarter rate of 0.7% in Q2. From the demand standpoint, the composition of this increase in output is not expected to have changed substantially from that observed in the opening stretch of the year. Hence, favourable labour market developments and improved financial conditions are expected to have continued sustaining the expansion in household consumption, at a very similar rate to that of the previous quarters, while business investment has slowed somewhat, but held nonetheless on an expansionary path. The residential component of investment in construction is estimated to have continued picking up, against the backdrop of the rise in house sales. The recent weakness of some indicators, such as cement consumption or Social Security registrations in the civil engineering sector, suggests that investment in other construction might be feeling the impact of a slowdown in public works.

The still very limited information on trade with the rest of the world in real terms in Q2 suggests a rise in goods exports, in a setting in which euro area markets retain their growth

momentum. Conversely, sales to the rest of the world are estimated to have continued showing, in comparative terms, less firmness, as a result of the weakness of certain emerging regions and of the modest exchange rate appreciation. The expansionary behaviour of exports has, moreover, been supported by the prolongation of the positive trajectory of tourist service flows. In net terms, the contribution of the external balance might ultimately be more favourable than in the preceding quarter, potentially posting neutral or slightly positive figures.

Inflation has in recent months recorded somewhat higher declines than those foreseen a quarter ago, reflecting the slowdown in its core component. The inflation differential vis-à-vis the euro area has held in recent months at -1 pp, owing to the energy component. Thus, in terms of the HICP excluding energy, the differential has stood at zero since the start of the year, after having evidenced negative figures since mid-2013.

The report includes six boxes devoted, respectively, to the analysis of the oil market outlook (Box 1), progress in the third assistance programme for Greece (Box 2), general government budgetary developments in the first half of the year (Box 3), the European Commission's recommendations in respect of the European semester (Box 4), the competitive adjustment of the Spanish automobile industry (Box 5) and recent developments in Spanish SMEs' access to financing (Box 6).

24.6.2016.

From 2014 H2 to January 2016 the price of crude oil decreased by 75% to a low of $28 dollars per barrel of Brent(see Chart 1). This decline occurred against a backdrop of the progressive transformation of the oil industry in the US due to the expansion of shale oil and the reaction of the OPEC, particularly that of Saudi Arabia, which ceased to accommodate production to stabilise prices and so avoid the entry of new competitors. However, crude oil prices have gradually recovered since February, climbing to more than $50 a barrel, due to both supply and demand issues. With respect to supply, at first the price thrust was explained by signs of a possible agreement between the OPEC and Russia to contain production; subsequently, temporary supply disruptions in Canada and Nigeria, together with a sustained fall in production in the US as the improvements in yields from its extractive technologies tapered off, reduced the supply to the market. Demand issues have also gained importance as the main tail risks to global growth envisaged in early 2016 – a hard landing of the Chinese economy or a recession in the United States – began to clear. In any event, crude oil production continues to exceed consumption and OECD stocks are very high. Analysts' projections point to a gradual and limited price recovery until 2017 (see Chart 1). The price of futures maturing in December 2016 and 2017 is $50 and $53 per barrel of Brent oil, respectively.

The outlook for oil prices at medium term will depend on the relative incidence of three factors: (i) agreements within the OPEC and Iran's output increase; (ii) non-OPEC producers' supply response, particularly of shale oil in the US; and (iii) on the demand side, the macroeconomic risks in China and other EMEs. This Box focuses especially on supply-side issues: the situation in the OPEC following the lifting of sanctions on Iran; and the production of shale oil in the US.

Independently of the changes in prices and crude oil production in the rest of the world, since 2014 OPEC production commenced to

Chart 1
OIL PRICES (BRENT)

Chart 2
OPEC PRODUCTION

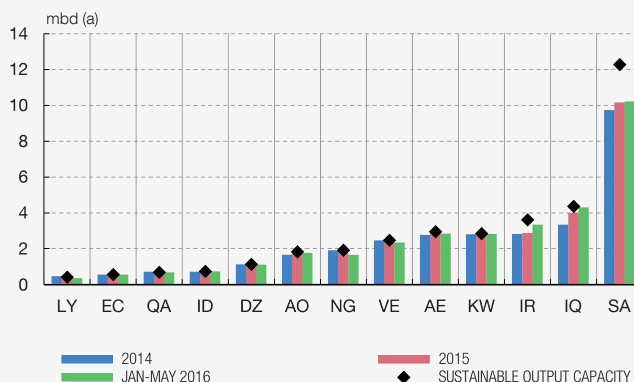


Chart 3
US: OIL PRODUCTION AND NUMBER OF OIL RIGS

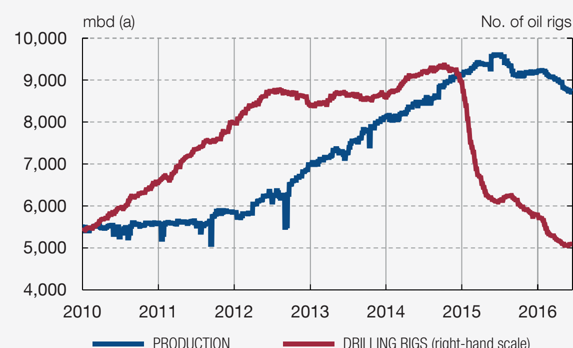
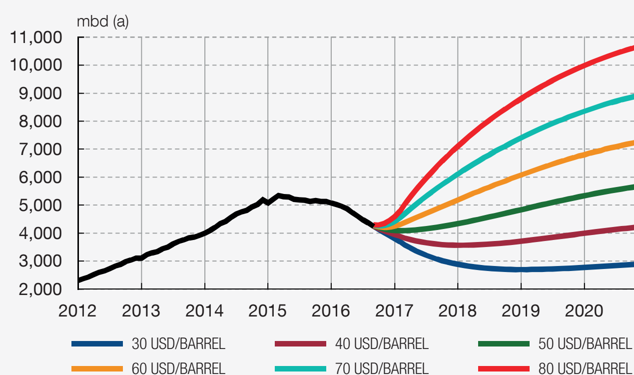


Chart 4
US: SHALE OIL PRODUCTION UNDER DIFFERENT PRICE SCENARIOS (b) (c)



SOURCES: Datastream, International Energy Agency, Baker Hughes, Lasky (2016).

a mbd (million barrels/day).
b WTI oil price per barrel in 2014 dollars; the shock starts in July 2016.
c In the four major areas of shale oil production.

increase as a result of Saudi Arabia having abandoned its traditional policy of accommodating production (see Chart 2).[1] The purpose was allowing prices to fall in order to, on the one hand, discourage production of shale oil in the US (more costly to produce), and, on the other, hamper Iran's repositioning following the lifting of international sanctions. Thus, at its half-yearly meeting in December 2015, the OPEC postponed its official production target until Iran's increase in production could be assessed, which was interpreted as a sign of weakness of the cartel. Nor have agreements been reached in 2016 at the meetings of OPEC members with Russia in April or at those among OPEC members only in June, as a result of Saudi Arabia's refusal to freeze production if the agreement was not binding for Iran. Additionally, Saudi Arabia is currently involved in the privatisation of its state oil company, Aramco, which could lead to increased production, especially if climate change or energy efficiency issues curb the demand for oil at long term.

Moreover, the so-called "shale oil revolution" that started around 2010 gave rise to an enormous increase in crude production in the US, thanks to the introduction of new extraction methods like hydraulic fracturing (see Chart 2). Considering the initial cost of these projects, the US's production resilience after the abrupt price drop was a surprise at first. Some reasons include productivity increases achieved in drilling and hydraulic fracturing due to cost falls decreases (wages, services and electricity) of more than 10 %, and lower royalties and taxes linked to the value of production.

1 Saudi Arabia, the OPEC's major producer with output in excess of 10 mbd, also holds the largest spare capacity (around 2 mbd). Its behaviour is key for the cartel, since other large producers such as Iraq, Iran or Venezuela have traditionally not complied with their output quotas and have tried to produce at their maximum capacity. Following the lifting of sanctions against Iran, the OPEC's third largest producer, there has been a 0.7 mbd rebound in production that could rise in the future if Iran manages to increase its installed capacity by attracting new investment.

Greater productivity and lower input costs have given rise to substantial decreases in the variable costs of operating wells and in the breakeven on the new wells. At short term, production continues in an existing well provided that prices cover the variable costs. It is estimated that the weighted average variable cost dropped from $28 to $24 per barrel between 2013 and 2014 (although it increases with crude oil price). Additionally, extraction projects will be initiated if the expected trend for oil prices renders the new oil operations profitable, including all costs. These price estimates, which have been falling, are in the $50 to $80 range, so the current prices would be at the lower limit needed to guarantee the economic viability of shale oil production at long term. The slight increase recorded in oil rigs after the recovery of crude oil prices supports this hypothesis (see Chart 3).

Based on current prices, the US Energy Information Administration foresees that shale oil production will decrease in the short term but will recover at medium term, fuelled by future productivity gains. In this regard, the Congressional Budget Office (CBO) expects that productivity improvements will give rise to increased shale oil production from 2017 and will match in 2020 the maximum level recorded in 2015.[2] Only a scenario of prices lower than $40 per barrel over a lengthy period of time would give rise to significant output declines at medium term (see Chart 4).

In short, the supply glut is expected to continue in 2016 in the absence of an OPEC agreement. Starting in 2017, oil prices could increase slightly due to the impact on global supply of the depletion of certain wells and investment contraction, exacerbated by the financial pressures on the energy industry. The high levels of stocks and the economic viability of shale oil in the US at the current prices will tend to limit price rises at medium term.

2 "The Outlook for U.S. Production of Shale Oil" by Mark Lasky, CBO Working Paper 2016-01.

On 24 May 2016, the Eurogroup reached an agreement with the Greek government and the IMF that permits the completion of the first review of the programme and paves the way for the disbursement of the second tranche of financial assistance.[1] Further, the agreement allowed the ECB once again to accept Greek debt as collateral for its monetary policy operations. For the first time, the agreement envisages the sequential introduction of a set of debt relief measures that are conditional upon compliance with the programme. Although these measures have still not been fully specified, it was agreed that they would be of a sufficient magnitude to keep Greece's financing needs below 15% of GDP in the medium term and below 20% thereafter.

Since the third assistance programme was launched, the Greek government has been making headway in the process of structural reform of the economy. In particular, relatively fast progress has been made in recapitalising the banks, a process that has now been completed. There has also been progress on the fiscal front, although this has taken the form of spending cuts that are not sufficiently supported by structural reforms and no action has been taken to broaden the contribution bases. These developments meant that, despite the capital controls put in place in the summer of 2015, GDP growth and the fiscal performance in 2015 surpassed the expectations prevailing at the start of the programme. At the same time, however, the implementation of certain measures – considered key to setting debt back on a path to more sustainable levels – continued to be postponed, leading to a delay in the completion of the first review of this third programme.

1 The third assistance programme for Greece was approved in August 2015 and will run until August 2018. The programme provided for a disbursement of €86 billion, of which €21.4 billion was disbursed in 2015. The disbursement of each tranche is conditional on the passing of concrete measures. The second tranche of assistance (€10.3 billion) was approved by the Board of Governors of the European Stability Mechanism on 16 June 2016, as follows: €7.5 billion in June 2016 to cover debt maturities and deferred State expenditure, and the remainder after the summer, subject to verification that deferred State expenditure has indeed been reduced.

Table 1
RECENT EVOLUTION OF CERTAIN ECONOMIC VARIABLES

	2013	2014	2015
GDP (a)	-3.2	0.7	-0.2
Unemployment (b)	27.5	26.5	24.9
HICP (a)	-0.9	-1.4	-1.1
Current account balance (c)	-2.0	-2.1	-0.1
Unit labour costs (a)	-7.4	-2.6	0.4
Total budget balance (c)	-12.4	-3.6	-7.2
Primary budget balance (c)	-8.4	0.4	-3.4

Chart 1
DISTRIBUTION OF PUBLIC DEBT BY HOLDER. 2015

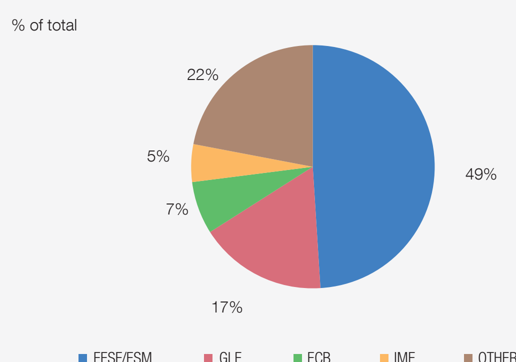


Chart 2
PUBLIC DEBT. SUSTAINABILITY ANALYSIS SCENARIOS

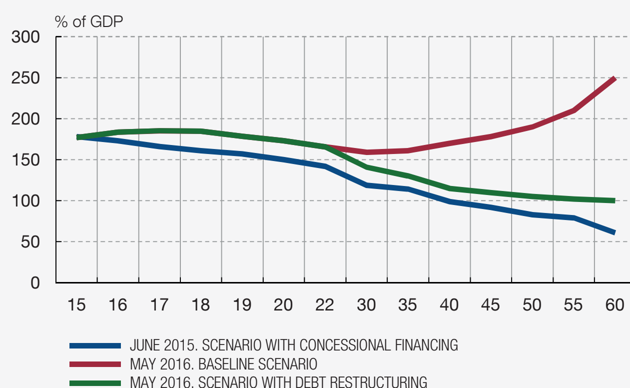
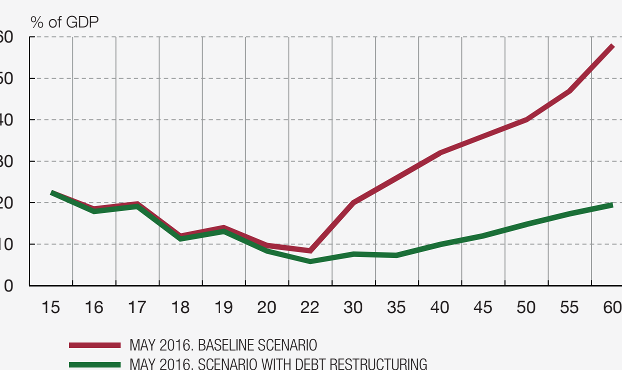


Chart 3
FINANCING NEEDS. SUSTAINABILITY ANALYSIS SCENARIOS



SOURCES: National Bank of Greece, IMF and the Hellenic Statistical Authority.

a Annual rate of change.
b Percentage of labour force.
c Percentage of GDP.

For this reason, the Greek government has recently approved new reforms to the pension system and the tax system and to modernise public administration, and has launched the asset privatisation fund and a new insolvency proceeding to deal with bad loans. Finally, with a view to the final agreement, Greece passed parametric fiscal measures amounting to 3% of GDP and a contingency mechanism that makes the adoption of structural reforms or tax rises binding, in the event of deviations from the primary surplus target.

In the agreement reached in May, the creditors recognise the progress that has been made, but also highlight that much remains to be done. Specifically, additional reforms to improve competitiveness and increase productivity in the Greek economy are still on hold. These affect very sensitive areas, such as competition in markets for goods and services, and collective bargaining.

Thus, a high level of uncertainty still remains regarding the ability of the Greek economy to achieve the productivity gains that would support sustained growth over the medium term and maintain a sufficient fiscal surplus to enable the continuing high levels of public debt to be reduced. As a result, the creditors have agreed for the first time to introduce debt relief measures that address the complex outlook foreseen by the available projections of public debt and the financing needs of the economy (see Charts 2 and 3). These play a key role when it comes to assessing the sustainability of Greece's public finances, given the high proportion of debt held by official creditors at low interest rates (see Chart 1). In this regard, recent analyses performed by both the IMF and the European creditors concur in anticipating that the evolution of Greek debt will not be sustainable without relief measures, both because it is not returning to a downward trajectory over the medium term, and because the country would be faced with financing needs that are too high and that it would have to fund at non-concessional interest rates in the market. Therefore, a key part of the agreement – which opens the door to the possibility of the IMF participating in the programme – is the relief measures that aim to keep Greece's financing needs below 15% of GDP over the medium term, and below 20% subsequently.

These measures, which are sequential in nature, are still not precisely defined, so that it is difficult to calculate their scope in terms of the discounted present value of the debt.[2] In the short term, before the conclusion of the programme in 2018, these measures include the possibility of smoothing the maturity profiles of the loans from the European Financial Stability Facility (without altering their average maturity of 31.5 years) and using the financing strategy of the European Stability Mechanism to reduce the interest rate risk spreads applied to loans to Greece. In the medium term, and subject to the satisfactory conclusion of the programme and compliance with the fiscal criteria, it would be possible, among other things, to use the surplus funds from the programme (€20 billion assigned to recapitalisation, which has not been used) for early repayment of the loans from the IMF, which are relatively more expensive, and to smooth the maturity profiles. These funds could also be used, if necessary, to extend the terms of the loans from the European Financial Stability Facility and impose limits on the interest payments to ensure that the financing needs comply with the established framework criterion. In the long term, and also subject to compliance with the primary surplus criterion of 3.5% of GDP and with the requirements of the Stability and Growth Pact, a mechanism could be established for introducing additional relief measures that may be necessary to satisfy the criterion for the maximum financing needs.

2 The IMF's proposal, which is much more detailed, entails relief of 50 pp of GDP at discounted present value.

The latest figures on the general government sector in National Accounts terms refer to the first quarter of 2016 and cover the central government, the regional governments and the Social Security system (see accompanying table).[1] According to that information, the general government sub-sectors combined posted a deficit in January-March of 0.8% of GDP, similar to the figure recorded in the same period of 2015.

1 Monthly National Accounts figures released by the National Audit Office (IGAE).

Consolidated general government (excluding local government) revenue was virtually unchanged year-on-year in the quarter, compared with the increase of 3.2% recorded in 2015, mainly as a result of the performance of direct and indirect tax revenues. The latest data, for April, on revenue from taxes shared by central, regional and local governments show a continuation of that revenue weakness at the start of the second quarter.

In turn, general government (excluding local government) expenditure rose by 0.5% year-on-year to March, compared with

Table 1
DEVELOPMENTS IN GENERAL GOVERNMENT ACCOUNTS (a)

	€m	Year-on-year rate of change			
	2015 Jan-Dec	2015 Jan-Dec	2015 Jan-Mar	2016 Jan-Mar	Official targets 2016
1 Total resources (b)	368,724	3.2	0.6	-0.5	3.5
Taxes on production and imports	102,148	7.4	5.0	-0.3	5.9
Income and wealth taxes	101,115	4.0	3.9	-10.2	0.6
Social contributions	132,078	1.7	0.5	1.9	3.0
Other resources (b)	33,383	-5.1	-30.3	28.2	5.1
2 Total uses (b)	416,475	1.1	1.5	0.3	0.1
Employee compensation	97,543	3.5	4.4	0.1	2.7
Other final consumption expenditure (d)	65,178	3.1	0.8	1.8	-1.0
Social benefits (not in kind)	169,847	-0.2	-0.2	1.4	1.7
Actual interest paid	32,498	-6.1	-3.9	-5.6	-3.5
Subsidies	11,102	12.1	70.0	-38.6	-1.3
Other uses and current transfers (b)	14,953	-4.8	5.8	-8.7	—
Gross capital formation	20,397	25.8	-3.5	8.3	-15.5
Other capital expenditure (b)	4,957	-35.6	-29.6	—	

	€m	As a percentage of annual nominal GDP (f)			
Net lending (+) or net borrowing (–)	2015 Jan-Dec	2015 Jan-Dec	2015 Jan-Mar	2016 Jan-Mar	Official targets 2016
3 Consolidated aggregate (3 = 3.1 + 3.2 + 3.3) (c)	-60,583	-5.4	-0.8	-0.8	-3.6
3.1 Central Government (c)	-29,029	-2.5	-0.9	-0.8	-1.8
3.2 Social Security funds	-13,592	-1.3	0.3	0.2	-1.1
3.3 Regional Government	-17,962	-1.7	-0.2	-0.1	-0.7
4 Local Government	4,765	0.4	0.1	—	0.0
5 Total General Government (5 = 3 + 4) (c)	-55,818	-5.0	-0.7	—	-3.6
Memorandum item					
Aid to financial institutions (e)	-853	-0.1	0.0	0.0	—
Public debt (EDP)	1,072,170	99.2	100.2	100.5	99.1

SOURCES: IGAE and Stability Programme (2016-2019).

a The revenue and expenditure data refer to the accounts of the central government, regional government and Social Security funds consolidated aggregate. Local government data are therefore not included, since monthly information is not available.
b Consolidated figures for transfers to other general government tiers (local government).
c Excludes aid to financial institutions.
d Includes inputs and market producers' social transfers in kind.
e Capital transfers granted to financial institutions.
f For 2016 the annual nominal GDP envisaged in the Stability Programme (2016-2019) was taken. In the case of debt, GDP at market prices was prepared drawing on the official series of the Quarterly National Accounts published by INE, aggregating the last four quarters for each reference date.

an increase of 1.2% in the same period of 2015, although this more restrained growth was partly due to the base effect of the temporary impact on wage expenditure in 2015 Q1 of the payment to public-sector employees of one-quarter of the "extraordinary" salary payment (equivalent to one-fourteenth of annual wages) that was suspended in December 2012. For its part, government consumption remained robust in real terms in 2016 Q1, according to Quarterly National Accounts.

General government debt as a proportion of GDP rose by 1.4 pp in 2016 Q1 to 100.5%. In any event, the decline in average financing costs meant that borrowing costs as a proportion of GDP continued to decline, down to 3.1% (see accompanying chart). The breakdown by instrument shows that the main financing channel for general government in the first quarter continued to be issuance of long-term securities. The breakdown by holder shows that the main net purchasers of these securities in the period were non-residents and credit institutions.

At end-April, the Spanish government submitted the Stability Programme Update (SPU) to the European Commission. The SPU establishes the main lines of budgetary policy for the period 2016-2019. It sets the general government budget deficit target for 2016 at 3.6% of GDP, compared with the existing 2.8% target set by the European Council in the framework of the Excessive Deficit Procedure (EDP) in July 2013. In order to meet the official target, the budget deficit would have to fall by 1.5 pp of GDP in 2016. According to the SPU, this improvement would be achieved as a result of the positive cyclical developments forecast, given that the fiscal policy stance envisaged is practically neutral, with a change in the general government's primary structural balance of -0.2 pp of GDP. The SPU also includes budget deficit targets for the medium term, specifically 2.9%, 2.2% and 1.6% of GDP in 2017, 2018 and 2019, respectively, which would set back the commitment to exit the "excessive deficit" situation established in the EDP (a deficit over 3% of GDP) by one year to 2017.

This year, the improvement in the general government deficit would be concentrated, according to the SPU, on the reduction in public expenditure as a proportion of GDP (-1.5 pp), while public revenue would remain unchanged as a proportion of GDP. The SPU's expenditure projections are based on the measures already included in the budgets of the various tiers of general government, adding in a set of corrective measures recently adopted by the central government (expenditure cuts amounting to €2 billion) and the regional governments (expenditure cuts and adjustments for non-execution of budget already envisaged, amounting to €1.5 billion). The assumption in the SPU that revenue will remain unchanged as a proportion of GDP stems from the fact that the impact of the personal and corporate income tax reforms, with an estimated overall cost of some 0.3 pp of GDP, is expected to be more than offset by the application of certain administrative measures (particularly relating to the fight against fraud) and, especially, by the estimated degree of responsiveness of taxes to changes in the tax bases.

The SPU also sets out government debt targets. Specifically, government debt as a proportion of GDP is expected to continue on the downward path that began in 2015, to reach 99.1% in 2016. This pattern is expected to continue throughout the time horizon of the Programme, backed by the primary budget surpluses foreseen and the continuation of sustained economic growth, such that government debt as a proportion of GDP is estimated at 99%, 97.9% and 96% in 2017, 2018 and 2019, respectively.

Overall, in light of the budget outturn figures available, in order to meet the budget deficit target set in the SPU for this year, the increase in revenue and/or containment of expenditure in the rest of 2016 will have to be greater than that observed in the opening months of the year. Specifically, revenue will have to improve in coming quarters to move closer to the official forecast of an increase in revenue of 3.5% in 2016 as a whole. In turn, in order to meet the aggregated public expenditure target of an increase of 0.1%, the budget outturn will have to be strict at all tiers of general government.

Chart 1
GROSS FINANCING
Rate (y-o-y) and contribution by instrument

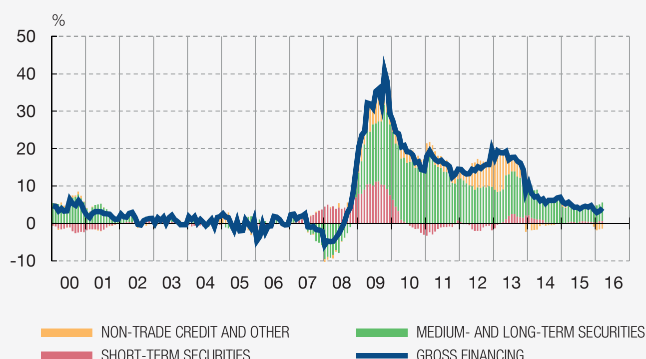
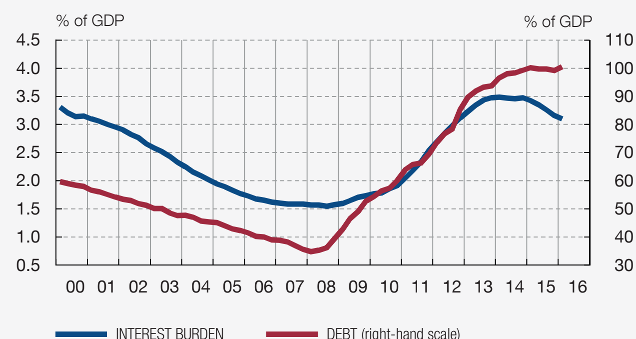


Chart 2
INTEREST BURDEN AND DEBT RATIO
Cumulative four-quarter data



SOURCE: Banco de España.

In 2011, the European Union set up an annual cycle of economic policy coordination between Member States known as the "European semester". It encompasses the Macroeconomic Imbalance Procedure and the Excessive Deficit Procedure and follows a timeline which is summarised in the accompanying diagram. The objectives of this process are to identify the emergence of fiscal and macroeconomic imbalances early on, to supervise the implementation of the policies required to correct these imbalances, and, lastly, to contribute to achieving the medium-term objectives of the European 2020 Growth Strategy. Based on the analyses it has performed in the course of this year, the European Commission (EC) presented a set of economic policy recommendations to the various Member States on 18 May 2016. These are known as the *country-specific recommendations* or CSR, and are to be approved by the European Council over the coming weeks. This box gives an overview of the main developments of the past eight months and describes the recommendations for Spain.

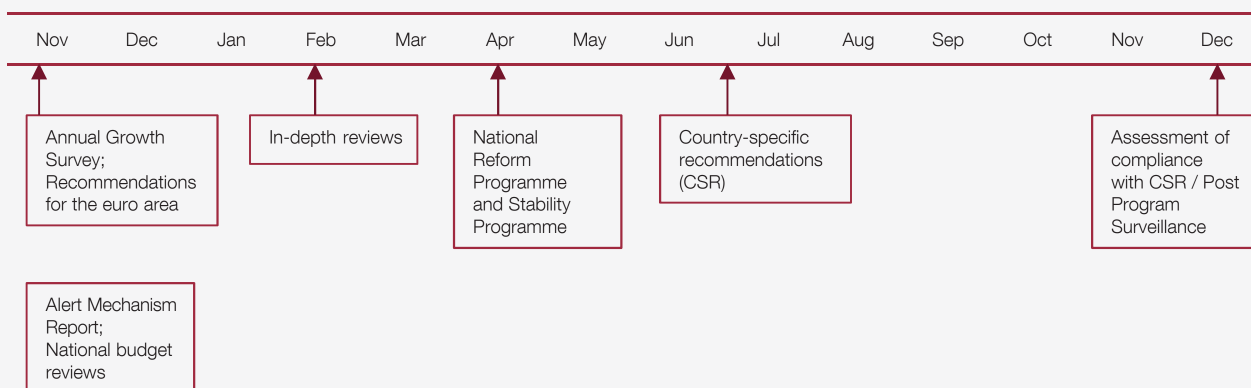
The 2016 European semester kicked off in November 2015 with the publication, by the EC, of a set of three documents, which notably included the *Alert Mechanism Report* (AMR), the content of which is described below. The second document is the *Annual Growth Survey* which, like the AMR, affects the EU as a whole and establishes three areas for priority action, with the objective of boosting job creation and economic growth. In particular, the EC highlights the importance of re-launching investment, pursuing structural reforms and implementing fiscal policies to enhance budgetary consolidation. Lastly, the EC published, for the first time within the framework of the European semester, its recommendations for the euro area as a whole, aimed at reinforcing coordination of the country-specific recommendations.

The AMR uses a scoreboard of economic and social indicators to identify countries which require a closer analysis known as the "in-depth review". As a new feature, the scoreboard presented in the latest report includes three new indicators relating to employment (activity rate, long-term unemployment and youth unemployment) to strengthen the analysis of the consequences of the crisis on the labour market, since it is considered that they may adversely affect potential output and aggravate the risks associated with macroeconomic imbalances.

Based on the review of the indicators, the EC deemed that it was necessary to carry out in-depth reviews for the majority of Member States.[1] In the case of Spain, the Commission identified seven indicators which exceed the thresholds above which a country is deemed to experience imbalances (see Chart 1). Most of these indicators relate to stock variables which are subject to very gradual changes, and, therefore, correcting them at excessive levels is necessarily a slow process. These variables include the international investment position, and private and public debt which stood at 94.1% (net debtor position), 165.8% and 99.3% of GDP in 2014, exceeding, in some cases by a very ample margin, the respective thresholds of 35%, 133% and 60% above which imbalances are deemed to exist. The situation is similar with respect to the unemployment rate, whose average in the three-year period (2012-2014) was significantly higher than the established threshold (10% for this variable). As regards flow indicators, there are imbalances in the long-term and youth unemployment rates, which increased by 4 pp and 7 pp, respectively, from 2012 to 2014, against the minimum thresholds of 0.5 pp and 2.2 pp, and in the world market share of Spanish exports, which fell by 0.2 pp in the five-year period (2012-2014),

1 In-depth reviews have been performed on a total of 18 countries. Of these, Estonia and Austria have been reviewed for the first time, the former owing to demand pressures, and the latter, because of the difficulties facing its financial sector. Belgium, Bulgaria, Germany, France, Croatia, Italy, Hungary, Ireland, the Netherlands, Portugal, Romania, Spain, Slovenia, Finland, Sweden and the United Kingdom are reviewed as a result of the imbalances detected in the previous European semester. Lastly, the supervision of imbalances in Greece and Cyprus and the monitoring of corrective measures are being conducted within the framework of their financial assistance programmes.

Diagram 1
EUROPEAN SEMESTER: TIMELINE



SOURCE: European Commission.

approximately double the reduction on which basis imbalances are considered to exist.[2] The values observed for the remaining flow indicators (current account balance, private sector asset and liability flows, changes in the activity rate or in the effective exchange rate, unit labour costs or house prices) are consistent with the absence of imbalances, given the established thresholds.

In February, the Commission published the in-depth reviews, with the objective of assessing the macroeconomic risks in each of the Member States subject to the procedure. If, on the basis of this assessment, the existing imbalances are deemed to be excessive, the EC will need to strengthen monitoring of the policies recommended to correct them. When determining whether or not the imbalances are excessive, the EC also takes into account compliance with the recommendations approved by the Council in the previous year. If these have been complied with, it is understood that the government is taking the necessary steps to correct the imbalances.

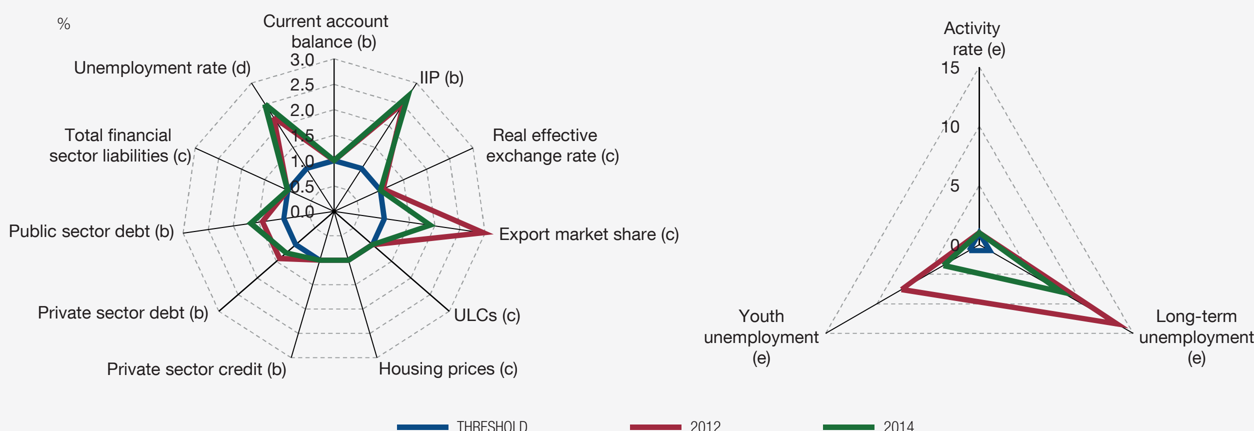
In the in-depth review on Spain, the EC pointed out that although the imbalances have been reduced, partly as a result of structural policies, and cannot be classified as excessive, they have not disappeared and still pose risks for the future. Specifically, although the level of vulnerability is lower owing to the improvement in the current account balance, credit flows or the fiscal consolidation process, the still-high external debt, both public and private, and the unemployment rate, constitute elements of weakness in the event of shocks. The review also indicates that, although on track, private sector deleveraging still has some way to go, since a high percentage of households is still very vulnerable to possible interest rate increases. Likewise, the review highlights that the stronger-than-expected GDP growth has not been used to reduce the government deficit and the debt ratio.

According to the report, low productivity continues to be the main factor limiting growth in the long term. It is closely linked to the inefficient allocation of factors across firms and the mismatch between the labour force and labour market needs. As regards compliance with the recommendations approved by the European Council in 2015, the report endorses the measures adopted by the Spanish authorities in recent years, particularly with respect to the financial sector, the corporate and personal insolvency frameworks, and labour legislation. However, the Commission considers that there was limited compliance as regards assessment of healthcare spending, streamlining the minimum income schemes and liberalising professionals services (see Table).

In April 2016, the Member States submitted their Stability Programmes (in the case of euro area countries) or Convergence Programmes (in the case of the other Member states), along with their National Reform Programmes. These documents include economic policy proposals to address the problems identified. Based on the analysis of these documents, the European Commission published its economic policy recommendations for each Member State for the upcoming 12 months. The EU Council

2 With respect to this variable, it should be borne in mind that the loss of export market share in terms of world exports is a phenomenon that is common to the majority of European countries (and, in general, developed countries), owing to the incorporation of the emerging economies into the world trade scene.

Chart 1
DEVIATION OF SPANISH INDICATORS FROM THEIR THRESHOLDS (a)



SOURCE: Banco de España, based on Eurostat data.

a Number of times the indicator value surpasses the threshold.
b As a percentage of GDP.
c Percentage change.
d 3-year average.
e Change in pp between 2011 and 2014.

will formally adopt the recommendations for each country shortly.[3] In the case of Spain, the EC recommends that measures be adopted in the following areas in 2016 and 2017:

1 Fiscal policy: ensure a correction of the excessive deficit by 2017, reducing the imbalance in public finances to 3.7% of GDP in 2016 and to 2.5% of GDP in 2017. According to the EC's calculations, this would mean a structural adjustment of 0.25 pp of GDP in 2016 and of 0.5 pp in 2017. In addition, it recommends using any hypothetical improvement in the projected budget outturn to speed up the consolidation process and implementing the tools set out in the Budgetary Stability Law to ensure that at all government levels contribute to achieving these objectives. It also recommends improving the control mechanisms for public procurement and coordination across government levels.

2 Labour market: encourage labour market integration, by focusing measures on training and individualised support. In addition, it recommends streamlining the existing schemes for guaranteed minimum income.

3 Education and innovation: provide incentives for cooperation between universities and firms in order to improve the matching of labour market needs to tertiary education skills. Increase performance-based funding of universities and public research centres and improve mechanisms to foster research by the private sector.

Product market: speed up implementation of the law on preserving market unity, ensure compliance by regional governments of the law on the retail trade and adopt the reform on professional services.

3 The Council is considered to have approved the Commission's proposals and recommendations unless a qualified majority of countries vote against them.

Table 1
SPAIN'S COMPLIANCE WITH THE RECOMMENDATIONS OF THE 2015 EUROPEAN SEMESTER

Progress	Recommendations
Substantial progress	— Reform of savings banks.
Some progress	— Transparency and accountability of regional public finances. — Wage setting. — Improve the quality and effectiveness of job search assistance and counselling, including as part of tackling youth unemployment. — Remove the barriers which prevent businesses from growing.
Limited progress	— Improve the cost-effectiveness of the healthcare sector and rationalise hospital pharmaceutical spending.
No progress	— Professional services.

SOURCE: European Commission.

The automotive sector in Spain was severely affected by the fall in demand due to the crisis.[1] However, these branches of industry are among those which have shown the strongest recovery, perhaps because of certain of the sector's structural features which may have facilitated its adjustment after the adverse shocks. In fact, Chart 1 shows that the sector's production decreased by nearly 30% in 2009, compared with a fall of somewhat more than 15% in other manufacturing industry as a whole. Nevertheless, after this sharp initial fall, the automotive sector showed high growth, which by end-2015 had lifted production to its pre-crisis level, while the other manufacturing sectors showed an approximately 20% gap with respect to their pre-crisis level.

The strong performance shown by the sector from 2012 is partly attributable to demand factors. First, car manufacturing in Spain is an eminently export oriented activity, the main markets of which are the rest of the euro area, the core countries of which exited the crisis before Spain did. It is therefore natural that the automotive sector should recover more strongly than others whose sales depended to a larger extent on domestic demand. Second, the sector's production was also stimulated by government-sponsored car purchase incentives which boosted the domestic component of demand. However, it should be taken into account that these measures also favoured car imports, the share of which in total car

1 In this Box, the automotive sector is taken to be Division 29 of NACE Rev. 2, which comprises the following three subdivisions: manufacture of motor vehicles (Group 29.1), manufacture of bodies (coachwork) for motor vehicles (Group 29.2) and manufacture of parts and accessories for motor vehicles (Group 29.3).

Chart 1
INDUSTRIAL PRODUCTION IN SPAIN

Chart 2
INDUSTRIAL PRODUCTION OF THE MOTOR VEHICLE SECTOR. INTERNATIONAL COMPARISON

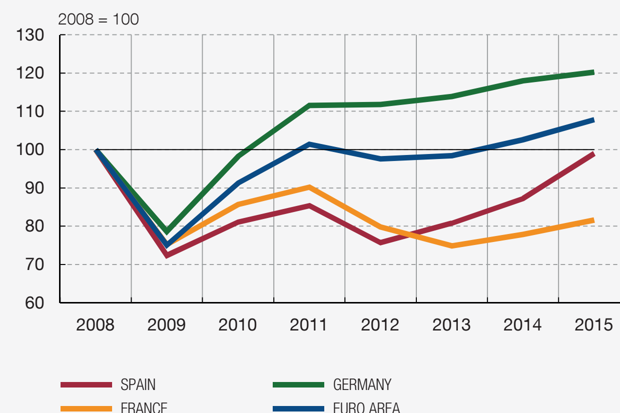


Chart 3
UNIT LABOUR COSTS OF THE MOTOR VEHICLE PRODUCTION SECTOR. INTERNATIONAL COMPARISON

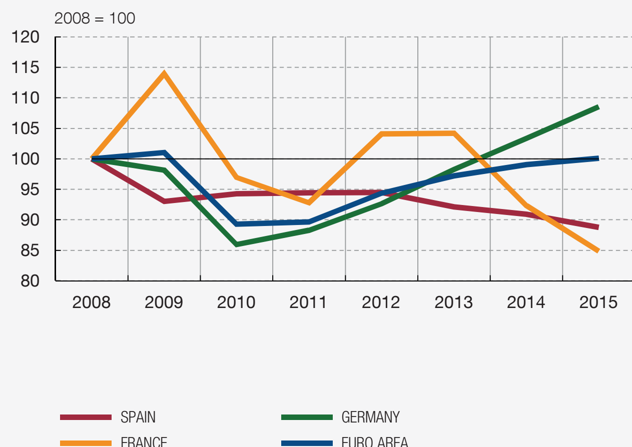
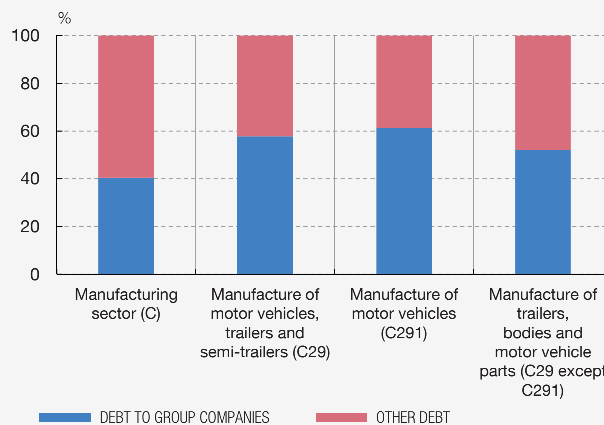


Chart 4
BREAKDOWN OF AUTOMOTIVE SECTOR FINANCING.
Total percentage of debt 2008-2014



SOURCES: Eurostat, BACH, COMEXT, INE and Banco de España.

sales rose by six pp to 41% between 2011 and 2015. In addition, car purchase assistance programmes have also been operating in other European countries.

In sum, the existence of demand factors not very different from those in other European economies suggests that the strong relative performance of this sector's production in Spain since 2013 (see Chart 2) also has some other causes. In particular, the decrease in unit labour costs (ULCs) in relative terms compared with other producer countries (see Chart 3) has been a crucial factor in enabling Spanish factories to attract additional production volumes, materialised through foreign direct investment by foreign parent companies, which ultimately resulted in higher employment in the sector. The adjustment of ULCs has occurred, firstly, through wage moderation and, secondly, through adjustment of the total hours worked per employee. Indeed, compared with others, this sector showed a relatively high adjustment of this variable during the crisis, which, although having the attendant impact on compensation per worker, allowed workforces to be maintained.[2] A possible explanation for the different behaviour in this latter respect may lie in certain particularities of the labour relations framework that has been in place in the automotive industry for nearly two decades. Specifically, firm-level agreements in this sector are virtually the sole collective bargaining mechanism, affecting 99% of workers compared with a proportion below 10% in the rest of the economy. It seems reasonable to believe that this particularity may have given producers greater flexibility to change the parameters of labour conditions in response to shocks.

Certain financial factors may have also contributed to the strong performance of the sector in recent years. In particular, its investment decisions have not been particularly constrained by debt, which at 15 pp at the onset of the crisis was lower than that of manufacturing industry as a whole. In addition, there are reasons why national automotive sector producers have not suffered the financing difficulties of other industries when it comes to accessing traditional credit channels. Firstly, since the factories in Spain are subsidiaries of foreign multinationals, national producers make extensive use of intra-group financing, which represents 60% of the total (20 pp more than in the manufacturing sector as a whole – see Chart 4). Secondly, this sector resorts to a greater extent than others to financing through trade credit. The low financial burden of the sector, along with the recovery of demand, has allowed the sector to recoup its pre-crisis level of profitability.

2 This was achieved in a variety of ways. For example, this sector is characterised by greater use of tools such as short-time working, flexible working hours or shift work. All these mechanisms allow the total hours worked to be adjusted to cope with unforeseen changes in demand.

On 1 June the ECB released the results of the 14th edition of its survey on the access to finance of SMEs in the euro area (SAFE) covering the period between October 2015 and March 2016. The firms surveyed are asked how their economic and financial situation, their external financing needs and the conditions of the financing received or rejected have changed over the past six months.

The latest survey data show that, overall, the economic situation of Spanish SMEs has continued to improve. Thus, the number of firms reporting an increase in sales was once again much higher than the number of firms reporting a drop in sales, with a relative difference between the two groups (net percentage) of 20%, somewhat higher than in the euro area as a whole (16%) but lower than the figure for the previous six months (27%) (see Chart 1). The profit performance was somewhat less favourable, owing to the increase both in labour and other costs, a circumstance that was reported by a high net proportion of the sample (38% and 30%, respectively, compared with 44% and 29% in the euro area as a whole). Thus, the proportion of firms that reported an increase in profits was barely 2 pp higher than that which reported a drop in profits, 4 pp less than six months earlier. In the euro area as a whole, that difference remained slightly negative (-1 pp).

The indicators of access to external financing improved once again in the period analysed. Thus, the percentage of Spanish SMEs that classed this factor as the most pressing problem for

Chart 1
CHANGE IN SALES AND PROFITS (a)

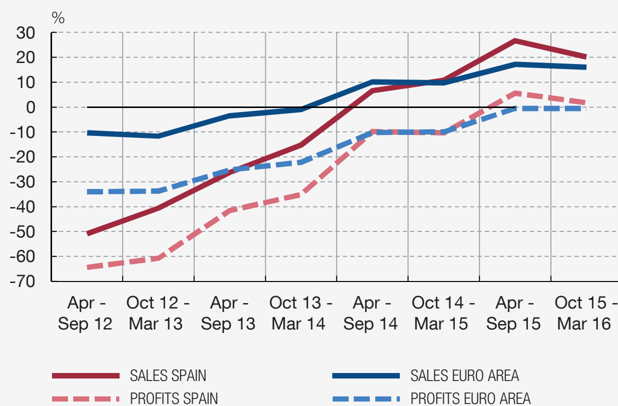


Chart 2
CHANGE IN AVAILABILITY OF BANK LOANS (b)

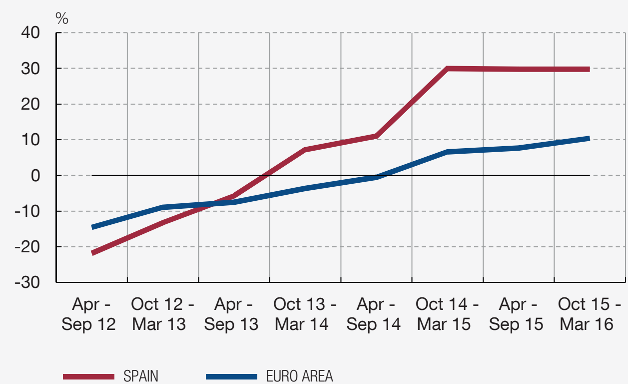


Chart 3
SMES FACING DIFFICULTIES OBTAINING BANK LOANS (c)

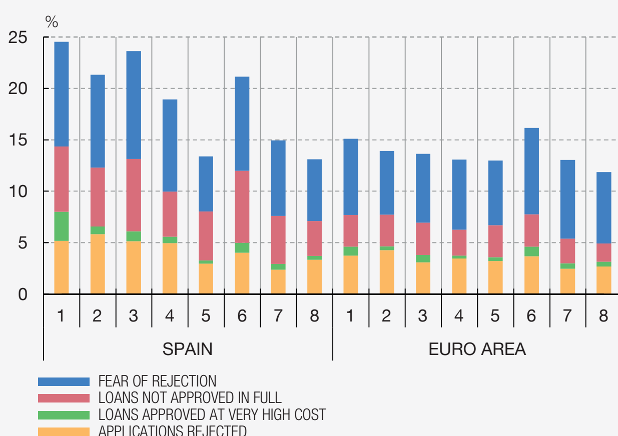
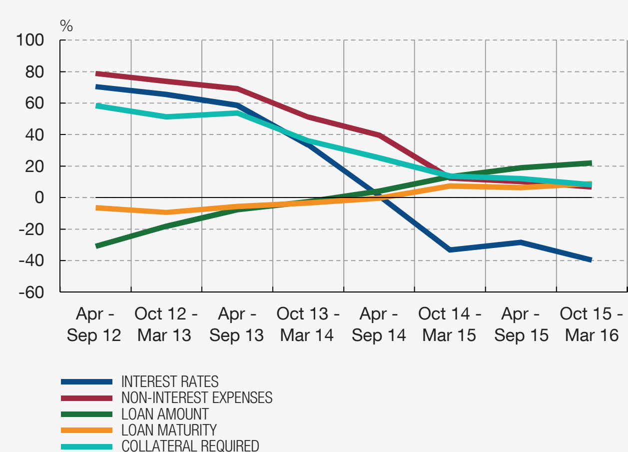


Chart 4
CHANGE IN BANK FINANCING CONDITIONS. SPAIN (a)



SOURCE: ECB.

a The proportion of firms reporting an increase minus the proportion reporting a decrease.
b The proportion of firms reporting an improvement minus the proportion reporting a deterioration.
c The numbers on the horizontal axis indicate the rounds of the survey: 1 is the period April to September 2012 and 8 is the period October 2015 to March 2016. The indicator reflects the proportion of firms that are in any of the following situations: firms whose applications for financing were rejected; firms that did not receive all the funding they had requested; firms that received bank loans but at what they considered to be a very high cost; and firms that did not request financing because they believed it would probably not be approved (fear of rejection).

their business fell again, becoming the factor, among all those included in the question, cited by the lowest number of firms (10% of the total, a proportion similar to that of the euro area as a whole and the lowest figure recorded since the survey was launched in 2009). Finding customers was the predominant concern (selected by 32% of firms), followed by competition (18%).

In this setting, the proportion of Spanish firms that requested bank loans fell by some 4 pp, down to 32%, slightly above the figure for the euro area as a whole (30%). In turn, the availability of bank financing continued to improve (see Chart 2). Thus, in net terms, 30% of firms reported an increase in this respect, identical to the previous survey and 20 pp above the figure for their euro area peers. In addition, SMEs perceived positive developments in most factors affecting the supply of credit. Specifically, in net terms, 39% reported greater willingness of banks to provide credit (2 pp more than in the previous survey) and 16% signalled an improvement in macroeconomic prospects (18 pp less than six months earlier).

The proportion of Spanish SMEs whose requests for bank financing were rejected declined by 4 pp compared with the previous six months, standing at 5%, below the figure for the euro area as a whole (8%). An improvement is also perceived when a broader indicator of difficulties obtaining bank loans is considered.[1] Those difficulties affected 12% of Spanish SMEs, which is slightly more than for the euro area as a whole (11%) and 1 pp less than six months earlier (see Chart 3).

Regarding financing conditions, the net percentage of SMEs that reported a drop in interest rates was positive for the third consecutive six-month period, standing at a high 40%, 11 pp more than in the previous period (see Chart 4). In addition, the net proportion of firms that reported an increase in loan amount and loan maturity remained positive (22% and 9%, respectively). In the case of collateral requirements and other terms and conditions of financing, the tightening perceived by Spanish SMEs continued to moderate and was lower than that perceived by SMEs in the euro area as a whole.

To conclude, the latest SAFE shows that, between October 2015 and March 2016, access of Spanish SMEs to external financing continued to improve. As their economic and financial situation became progressively sounder they reported, overall, that in the period they perceived an increase in the availability of bank financing and a greater willingness of banks to provide credit on more favourable conditions. Lastly, the survey also shows that Spanish SMEs expected their access to bank financing to improve in the period April-September 2016.

1 This indicator reflects the proportion of firms in any of the following situations: firms whose applications for financing were rejected; firms that did not receive all the funding they had requested; firms that received bank loans but at what they considered to be a very high cost; and firms that did not request financing because they believed it would probably not be approved (fear of rejection).