MACROECONOMIC PROJECTIONS FOR THE SPANISH ECONOMY (2017-2020): THE BANCO DE ESPAÑA'S CONTRIBUTION TO THE EUROSYSTEM'S DECEMBER 2017 JOINT FORECASTING EXERCISE

Introduction and summary

This note describes the macroeconomic projections for the Spanish economy for the period 2017-2020, which are part of the projections for the euro area as a whole published by the ECB on 14 December.[1, 2] The current projections incorporate the new information that has become available since the publication of the previous projections on 28 September in Economic Bulletin 3/2017[3], and, for the first time, the year 2020 is included in the projection horizon.

Spanish economic activity continued to show notable strength in the latest period, posting a quarter-on-quarter GDP growth rate of 0.8% in Q3, 0.1 pp down on Q2. The heightening of political tensions in Catalonia at the start of Q4 might lead to some additional weakening in activity in this period, the scale of which is subject to notable uncertainty, given the limited amount of information available in this connection. The adverse effects on spending decisions arising from this increase in uncertainty, however, are expected to be partly countered by the improved international economic context, in particular in Europe, which has led to a significant upward revision in our export markets.

The medium-term outlook for the Spanish economy remains favourable. The progress in restoring the macro-financial balance following the onset of the crisis is adding intensity and sustainability to the recovery, as confirmed by the resilience the Spanish economy has shown in the face of various adverse shocks during this recovery phase. In any event, unlike in the recent past, macroeconomic policies are expected to provide less support to activity, against a background in which fiscal policy is forecast to remain neutral and where the additional impact of monetary policy on agents' financing conditions, which are very loose, will be moderate.

Against this backdrop, the political uncertainty surrounding Catalonia, both as regards the scale such uncertainty may reach and its prolongation over time, will partly determine the course of the Spanish economy over the forecast period. In this projections exercise, it has been assumed that the level of uncertainty of recent months will abate at the beginning of 2018.[4] Given all these ingredients, GDP might slow to 2.4% in 2018 and 2.1% in each of the two following years after its projected growth of 3.1% in 2017.

Turning to inflation, the slowdown in the CPI observed since March this year is expected to run into early 2018, as a result of the base effects of the rise in oil prices over much of 2016 being stripped out of the calculation of the year-on-year rates. Hence, from spring next year, consumer prices are expected to be determined above all by the core component, for which a gradual rise is estimated in step with the continuation of the pick-up in activity.

1 See The macroeconomic projections prepared by the Eurosystem's experts for the euro area, December 2017.
2 The cut-off date for the information used to prepare the projections is 30 November.
3 Compared with the Macroeconomic projections for the Spanish economy (2017-2019), published as Box 1 in the Quarterly Report on the Spanish Economy in Economic Bulletin 3/2017, the current projections incorporate the changes observed between 18 September and 22 November in the technical assumptions, in the budgetary hypotheses and in the forecasts for the external context of the economy. Moreover, the current projections exercise includes QNA data for Q3.
4 The baseline scenario of the current projections includes effects arising from the increase in uncertainty whose magnitude and persistence are in line with that contemplated in the more benign scenario of the two considered in Box 1.1 ("The economic impact of uncertainty arising from political tensions in Catalonia") of the *Financial Stability Report,* Banco de España, November 2017.

PROJECTIONS OF THE SPANISH ECONOMY'S MAIN MACRO MAGNITUDES (a) **TABLE 1**

Annual rate of change in volume terms and % of GDP

		December 2017 projections				September 2017 projections		
	2016	2017	2018	2019	2020	2017	2018	2019
GDP	3.3	3.1	2.4	2.1	2.1	3.1	2.5	2.2
Private consumption	3.0	2.4	1.9	1.4	1.4	2.4	2.0	1.5
Government consumption	0.8	1.1	0.9	0.7	0.7	1.0	0.8	0.8
Gross fixed capital formation	3.3	5.0	4.0	3.7	3.7	4.3	4.4	4.0
Investment in equipment	4.9	5.9	4.4	3.7	3.8	5.4	4.8	4.6
Investment in construction	2.4	4.5	3.8	4.2	4.2	3.6	4.7	4.3
Exports of goods and services	4.8	5.2	4.9	4.7	4.4	6.4	4.6	4.5
Imports of goods and services	2.7	4.1	4.1	4.2	3.9	5.0	4.1	4.2
National demand (contribution to growth)	2.6	2.6	2.0	1.8	1.8	2.5	2.2	1.9
Net external demand (contribution to growth)	0.7	0.5	0.4	0.3	0.3	0.6	0.3	0.3
Nominal GDP	3.6	4.1	3.5	3.6	3.8	4.0	3.9	3.6
GDP deflator	0.3	1.0	1.0	1.5	1.7	0.9	1.4	1.5
Consumer price index (CPI)	-0.2	2.0	1.5	1.4	1.7	1.9	1.3	1.6
CPI excluding energy and unprocessed food prices	0.8	1.1	1.2	1.6	1.8	1.1	1.4	1.7
Employment (full-time equivalents)	3.0	2.9	2.3	1.7	1.6	2.7	2.2	1.8
Unemployment rate (% of labour force). End-of-period data	18.6	15.8	14.2	12.3	10.7	16.3	14.4	12.9
Unemployment rate (% of labour force). Average data	19.6	17.0	14.9	13.2	11.5	17.1	15.1	13.4
Net lending (+) / net borrowing (–) of the nation (% of GDP)	2.1	2.1	2.1	2.1	2.2	2.1	2.3	2.2
General government net lending (+) / net borrowing (–) (% of GDP)	-4.5	-3.2	-2.5	-2.1	-1.8	-3.2	-2.6	-2.1

SOURCES: Banco de España and INE.
Latest QNA figure: 2017 Q3.

a Projections cut-off date: 30 November 2017.

As a result, following their 2% rise in 2017, prices will subsequently slow, before rebounding to 1.7% on average in 2020.

Compared with the September projections, GDP growth has been revised downwards by approximately 0.1 pp both in 2018 and in 2019, as a result of the increased uncertainty linked to the political situation in Catalonia. The effects of this uncertainty, whose estimated magnitude is 0.3 pp in cumulative terms in the 2018-19 period, will be partly offset by the improved outlook for foreign markets (euro area markets in particular), although its positive impact on the projections for the Spanish economy will be curtailed by the recent rise in oil prices. The inflation projections are revised upwards in 2017 and 2018 (by 0.1 pp and 0.2 pp, respectively) and downwards in 2019. This pattern of revisions is chiefly in response to the expected changes in the path of crude oil prices.[5] Moreover, the inclusion of the latest information points to somewhat weaker core inflation.

Activity and employment

The increase in output throughout the projection period will continue to be underpinned both by the buoyancy of private domestic demand – spurred by the progress in deleveraging

5 Specifically, the current course of oil prices on futures markets entails higher prices throughout the projection horizon, but to a greater extent in 2018 than in 2019, which leads to a downward revision of the growth rate of the energy component in 2019 (see Box 1).

by households and non-financial corporations, and by the persistence of favourable financial conditions – and by the positive contribution of net external demand.

Among the components of domestic demand, private consumption is expected to continue showing sustained growth, albeit at a more moderate pace than that observed in recent years. Real household incomes – labour income in particular – are expected to show sustained increases throughout the projection period, albeit with a different composition to that witnessed in the recent past. For one thing, the projected slowdown in the economy will translate into a similar moderation of employment creation flows. For another, labour income purchasing power will tend to rebound, against a background of more moderate inflation rates than those posted in the most recent period. However, the marginal propensity to consume is less when labour income originates from an increase in real wages than when it stems from the generation of jobs,[6] and this will tend to reduce the buoyancy of household spending. Moreover, the latter will also be affected by the tendency of consumers to rebalance their savings rate following the heavy fall this variable has undergone in recent years. Lastly, the pace of growth of household consumption will also be dampened by the gradual tailing off of the build-up, during the recovery, of the durables purchasing decisions that were postponed during the recession.[7]

Among the components of gross fixed capital formation, the pick-up in residential investment will remain strong throughout the projection period, spurred by the same factors that have propelled it in recent years, including the process of sustained job creation and the availability of cheap credit. However, the expectations of a modest pace of household formation will tend to limit the growth rate of this demand component.

Business investment will remain notably buoyant, in step with the increase in capacity utilisation, the prospect that the current expansionary period will continue and, as earlier stated, the prolongation of highly favourable financing conditions and the restructuring of corporate balance sheets. However, private productive investment will tend to slow somewhat in the initial stages of the projection horizon owing to the increase in political uncertainty, the slowdown in final demand and the less pressing need to renew productive capacity, following the drive in this connection in the initial years of the recovery.

Exports will be notably buoyant in the short term, in line with the expected strength of foreign markets. However, as the projection period unfolds, a gradual reduction in the strength of exports is expected in accordance with the common assumptions of the Eurosystem's exercise, under which the buoyancy of global imports will tend to diminish to some extent in the coming years (see Box 1).[8] In any event, the fading of the adverse impact of the recent appreciation of the euro on exports to non-euro area countries will allow total exports to increase, in the final stages of the projection horizon, at a higher rate than their markets. The growth of imports, meantime, is expected to be lower than the expected growth rates of final demand would suggest, reflecting the rising degree of substitution of domestic production for imports, linked to the improvement in competitiveness following the crisis.[9]

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6 See Chapter 2 of the Banco de España *Annual Report* for 2015.

7 See Box 4 in the Quarterly Report on the Spanish Economy, *Economic Bulletin 4/2017* (forthcoming).

8 Box 1 of the Quarterly Report on the Spanish Economy, to be published shortly in *Economic Bulletin 4/2017*, describes the reasons why the recently observed high elasticity of trade with respect to global GDP is temporary.

9 See Chapter 3 of the Banco de España 2016 Annual Report for a description of the available evidence in this respect.

The volume of job creation per unit of GDP growth will continue to be very high, assisted by contained unit labour costs. However, job creation will slow insofar as GDP also slows. The sustained increase in employment will allow the unemployment rate to continue falling to around 11% of the labour force by the end of 2020.

The projections suggest the nation's net lending will hold at a very similar level to that observed in 2016, in a setting in which the strength of net trade in goods and services in real terms will tend to offset some worsening in the real terms of trade (related above all to the recent increase in oil prices) and in net factor income payments (owing to the expected modest rise in interest rates).

The budget deficit is expected to fall to 3.2% of GDP in 2017. Under the assumptions of the projection exercise (described in Box 1), the deficit will continue to diminish gradually in the subsequent years – essentially due to the favourable economic cycle – given that, in the absence of detailed information on the budgetary plans for these years, a neutral fiscal policy stance has been assumed for the 2018-2020 period.

Prices and costs

In the short term, consumer prices will be greatly influenced by the trajectory of the energy goods component. Specifically, until the start of the coming year, base effects derived from the oil price rises recorded in the final stretch of 2016 are expected, which would mean that the headline rate might dip below 1% in early 2018. Subsequently, inflationary dynamics will be dominated by the projected strengthening of the core component, in a setting in which the continuation of the expansionary phase is translating into a growing use of the productive factors, which will ultimately entail an acceleration in unit labour costs and some widening of profit margins. As a result, the overall CPI is projected to slow in terms of annual averages from 2% in 2017 to 1.4% in 2019, before rebounding to 1.7% on average in 2020.

Risks

The baseline scenario of GDP growth is subject to various sources of risk. Externally, the risks are considered to be balanced when the whole projection period is considered. In the short run, upside risks tend to be more prevalent. In particular, the latest conjunctural information on euro area activity has produced positive surprises, suggesting that the strengthening of output seen in recent months might persist for longer than is assumed in this forecasting exercise. Moreover, after the projections cut-off date, the information available points to the size of the US fiscal expansion package potentially exceeding that considered in the baseline scenario. Conversely, in the medium term, downside risks prevail, associated with factors such as the high valuations certain financial assets have reached, the difficulties surrounding the ongoing redressing of imbalances in the Chinese economy and how Brexit may unfold.[10, 11]

On the domestic front, uncertainty over Catalonia persists. The effect incorporated into the baseline scenario draws on the latest conjunctural data and on the assessment of the uncertainty indicators.[12] The ultimate incidence of this factor of risk for the Spanish

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10 Box 3 "Impact of the U.K.'s exit from the EU on the British and global economies", Quarterly Report on the Spanish Economy, *Economic Bulletin,* Banco de España, September 2016, assesses the possible consequences of the process. Box 5 "The Spanish economy's exposure to the United Kingdom", in the same report, sets out the main sources of vulnerability for our economy.

11 On 8 December the European Commission announced a preliminary agreement with the United Kingdom on the conditions of separation, to be ratified at the forthcoming European Council. Following this step, a second phase of negotiations will be launched focusing on the transition process and on the design of a new framework of relations between the United Kingdom and the European Union.

12 See Box 1.1 ("The economic impact of the uncertainty arising from the political tensions in Catalonia") in the Banco de España's *Financial Stability Report*, November 2017. For a description of the econometric models that measure the response of economic activity and of the demand components to fluctuations in uncertainty, see Gil, M., J. Pérez and A. Urtasun (2017), "Incertidumbre económica: medición e impacto sobre la economía española".

economy as a whole will depend on the magnitude and persistence of political tensions. An easing of the tensions in this region, as has begun to be perceptible in recent weeks, might be conducive to a scenario of higher GDP growth than that considered in the baseline. On the contrary, a hypothetical resurgence of tensions in the coming months might lead to a more pronounced impact on private agents' spending decisions.[13]

As regards inflation, an important source of risks of deviation with respect to the baseline is related to the possibility that the reduction in cyclical slack may not take the form of a rise in core inflation as intense as projected, against a background of uncertainty over the volume of idle resources in the economy and over the scale of the influence of the fluctuations in activity on price developments. Finally, the reduction in inventory volumes in the oil market suggests that oil prices might be more sensitive in the future to fluctuations in supply and demand.

15.12.2017.

13 For an analysis of the potential impact of a deeper and more protracted increase in political uncertainty in Catalonia, see Box 1.1 ("The economic impact of uncertainty arising from political tensions in Catalonia") in the *Financial Stability Report*, Banco de España, November 2017. Specifically, this box presents an alternative scenario to that included in the baseline, under the assumption that uncertainty would pick up in the fourth quarter of this year to an all-time peak and diminish thereafter in a linear fashion until disappearing by the end of 2019. In this case, the cumulative negative effect on GDP would be somewhat more than 2.5 pp between 2017 and 2019.

The assumptions on interest rates and the prices of oil and other commodities are prepared on the basis of the prices quoted on the relevant markets during the ten business days prior to the date on which the data used to calculate them are collected (in this case, 22 November). Specifically, after averaging $54.3 per barrel in 2017, the price of oil is expected to rise to $61.6 per barrel in 2018. Over the next two years, it is expected to move on a slightly downward path to reach $57.3 per barrel in 2020. Compared with the last projections, made in September, the new oil price assumptions represent a significant upward revision of this variable. In terms of annual averages, the scale of this revision is higher in 2018 (7.3 pp) than in 2019 (4.3 pp).

According to the procedure described above, market expectations of interest rate levels during the projection period fell with respect to the September forecasting exercise, a decline which is more evident at the long end of the curve. Specifically, the path of the three-month EURIBOR has been revised downwards by several basis points in 2018-2019, whereas ten-year government bond yields have seen their rise over this two-year period moderate by approximately 20 bp, increasing from an average of 1.6% in 2017 to 2.4% in 2020. These expected developments in market rates lead to a slight decline in the cost of credit to households and corporations compared with the previous projections.

The level of the nominal effective exchange rate of the euro over the projection horizon which, according to the methodology used, corresponds to that observed on spot foreign currency markets in the two weeks prior to the cut-off date of the assumptions, shows a slight depreciation - of less than 2% - with respect to the level of the previous projections.

Growth of Spain's export markets is revised upwards over the projection horizon, more markedly so in 2018. In any event, as the projection horizon unfolds this variable becomes progressively less buoyant, and thus, after increasing by 5.4% in 2017, its growth rate is estimated to ease to 3.6% in 2020.

The changes to public finance assumptions during the projection period compared with the last projection exercise are small. The fiscal policy projections for 2017 are based on the measures approved in the budgets of the different tiers of government for that year as well as on their outturn. As for the assumptions for the remainder of the projection horizon, as at the cut-off date for this exercise the draft State and Social Security budget for 2018 had not been submitted. However, in compliance with the European Semester calendar, on 16 October the Government sent the European Commission the "2018 Budgetary Plan", which includes the outline of the regional and local government budgets and which, as far as the rest of the general government sector is concerned, includes no new measures. It was therefore decided that different technical assumptions should be used to estimate fiscal variables in the period 2018-2020. First, it is assumed that those budget items subject to greater discretionality - including most notably, on account of their size, purchases, remuneration of public sector employees and government investment - will behave

Table 1
INTERNATIONAL ENVIRONMENT AND MONETARY AND FINANCIAL CONDITIONS (a)

Annual rate of change, unless otherwise indicated

		December 2017 projections				Changes from the September 2017 projections (b)		
	2016	2017	2018	2019	2020	2017	2018	2019
International environment								
World output	3.0	3.6	3.6	3.6	3.5	0.1	0.1	0.0
Spain's exports markets	2.5	5.3	4.9	4.0	3.6	0.5	1.0	0.3
Oil price in dollars/barrel (level)	44.0	54.3	61.6	58.9	57.3	1.6	7.3	4.3
Monetary and financial conditions								
Dollar/euro exchange rate (level)	1.11	1.13	1.17	1.17	1.17	-0.01	-0.02	-0.02
Nominal effective exchange rate against non-euro area countries (c) (2000=100 and percentage differences)	113.6	116.9	121.1	121.1	121.1	-0.3	-1.1	-1.1
Short-term interest rate (3-month Euribor) (d)	-0.3	-0.3	-0.3	-0.1	0.2	0.0	0.0	-0.1
Long-term interest rates (10-year bond yield) (d)	1.4	1.6	1.7	2.1	2.4	0.0	-0.2	-0.2

SOURCES: ECB and Banco de España.

a Cut-off date for preparation of assumptions: 28 November 2017 for Spain's exports markets and 22 November for the rest. The figures expressed as levels are annual averages; the figures expressed as rates are calculated on the basis of the related annual averages.
b The differences are in growth rates for world output and export markets, in levels for oil prices and the dollar/euro exchange rate, in percentages for the nominal effective exchange rate and in percentage points for interest rates.
c A positive percentage change in the nominal effective exchange rate denotes an appreciation of the euro.
d For the projection period, the figures in the table are technical assumptions, prepared following the Eurosystem's methodology. These assumptions are based on futures market prices or on proxies thereof and should not be interpreted as a Eurosystem prediction as to the course of these variables.

in 2018 as projected by the Budgetary Plan[1] and, over the remainder of the projection horizon, in line with the Spanish economy's nominal potential growth. Second, the trajectory of the remaining items of the general government accounts are assumed to be governed, in the absence of measures, by their usual determinants.[2]

According to these assumptions and projections relating to fiscal policy variables, together with the output gap estimated in a manner consistent with the other macroeconomic projections, the fiscal policy stance is expected to be approximately neutral in the period 2017-2020, following its expansionary stance in 2015 and 2016.

1 The projection of general government investment therefore includes the 2018 Budgetary Plan's estimate of the possible costs linked to the liability arising from the legal proceedings of the insolvent toll motorway concessionnaires, which amount to more than €2 billion and are expected to materialise early next year. However, these projections do not include the possibility mentioned by the Plan that a tender process for these toll roads will probably be held in the next few years, which would generate future income.

2 Specifically, it is assumed that government revenue grows in line with its tax bases, which mainly depend on the macroeconomic context. Similar assumptions are made for those less discretionary expenditure items. This is the case of expenditure on pensions (essentially determined by the legally established revaluation formula and population ageing), unemployment benefits (which depend mainly on changes in unemployment) and debt servicing payments (the changes in which reflect movements in public debt and interest rates).