QUARTERLY REPORT ON THE SPANISH ECONOMY
1 OVERVIEW

In the opening months of the year, global activity and trade showed some signs of a loss of momentum. These were concentrated above all in the developed economies and, at least in part, were in response to temporary causes. Beyond these developments, various factors continue to point to a favourable outlook, underpinned in particular by the persistence of easy financial conditions. Moreover, in the commodities-producing emerging economies, the rise in commodities prices is acting as an additional factor of support.

This predominantly positive outlook has, however, been clouded in recent months by a series of risk factors. Among the sources of uncertainty, one that has come to the fore is the possibility that international trade relations will be significantly altered by the successive announcements by the US authorities of import tariff increases, and by the subsequent corresponding responses by other countries. Moreover, certain features characterising financial markets in Q2 have acted as a reminder of the presence of additional sources of risk. On one hand, the ongoing normalisation of US monetary policy, against the background of a certain increase in inflationary pressures in the US economy, has translated into an across-the-board appreciation of the dollar, markedly so against the most vulnerable emerging economies, some of which have witnessed significant capital outflows. On the other, the political uncertainty in Italy prompted a tightening of euro area sovereign debt markets in late May, highlighting the shortcomings still marking the institutional design of Economic and Monetary Union.

Inflation rates have begun to reflect the rise in oil prices. Nonetheless, with the above-mentioned exception of the United States, there are still no perceptible and conclusive signs of a sustained rise in core inflation, although this variable is expected to quicken gradually as the reduction in the degree of global slack intensifies.

The euro area was one of the regions where the loss of dynamism at the start of the year was most prominent. In Q1, GDP grew at a quarter-on-quarter rate of 0.4%, 0.3 pp below any of the four quarters of 2017. When explaining this deceleration, certain purely transitory factors have been identified; however, other more durable factors appear to be playing some part, such as the lagged effects on foreign trade flows of the appreciation of the exchange rate observed throughout 2017 (see Box 2). Reflecting these more recent developments, the latest Eurosystem projections, which were submitted to the ECB Governing Council on 14 June, include a 0.3 pp downward revision in expected GDP growth for 2018 to 2.1%, with the rates for the two following years holding virtually unchanged at 1.9% and 1.7%, respectively.[1]

Inflation in the euro area, measured by the HICP, increased significantly in May, driven by unprocessed food and, in particular, energy goods prices, which reflected the rise in oil prices and the depreciation of the euro in the most recent period. However, the indicator that excludes these two more volatile components has trended much more steadily, posting a rate of 1.3% in May, not very different from that recorded since summer 2017. Conversely, the greater dynamism of wages observed in the previous quarters has

---

GROSS DOMESTIC PRODUCT AND CONSUMER PRICES (a)   CHART 1
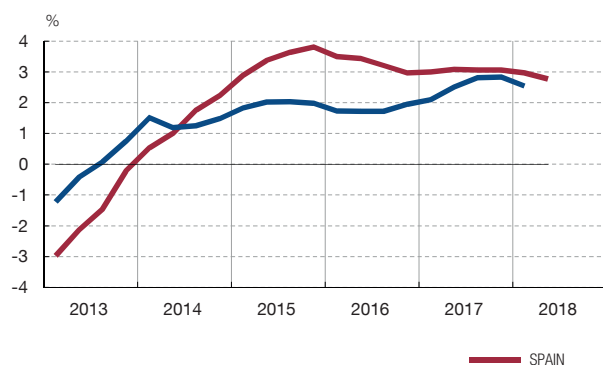
1 GROSS DOMESTIC PRODUCT   2 HARMONISED INDICES OF CONSUMER PRICES

SPAIN ────   EURO AREA ────
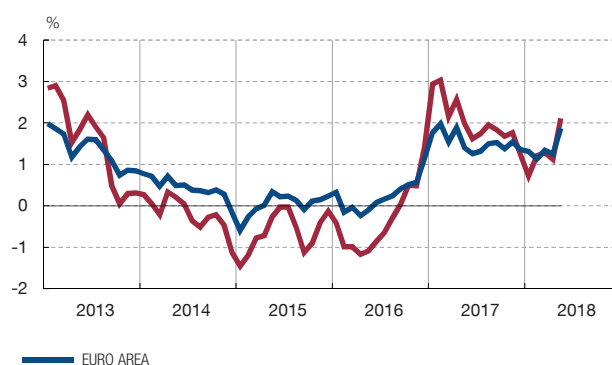
SOURCES: Eurostat, INE and Banco de España.

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

continued. Against the background of the sustained growth of activity above potential in the previous quarters, that suggests that inflation may embark in the coming quarters on a rising path that places it in a sustained fashion close to the level that is the monetary policy objective, namely close to but below 2%. This is duly reflected in the Eurosystem projections, which expect the overall and core inflation indicators to grow by 1.7% and 1.9%, respectively, in 2020.

The Governing Council thus concluded that progress towards a sustained adjustment of inflation has been substantial to date. With inflation expectations firmly anchored, the underlying strength of the euro area economy and the continuing high degree of monetary accommodation uphold confidence that the sustained convergence of inflation on its objective will be maintained, even after asset purchases have come to an end. Accordingly, the ECB Governing Council on 14 June decided to commence a process of monetary policy normalisation that includes the end of net asset purchases in December this year. At the same time, for the purpose of retaining a degree of monetary accommodation that ensures that the adjustment of the inflation rate is not interrupted, the Council announced the maintenance, for a prolonged period, of the size of its asset portfolio as it will stand in December (through the reinvestment of maturing assets) and of its policy interest rates at their current levels (at least up to and including the summer of 2019).[2]

In Spain, where the slowdown described for the area as a whole has not been witnessed, the quarter-on-quarter growth rate of GDP in Q2 is expected, as in Q1, to stand at 0.7% (see Chart 1 and Table 1). It is estimated that the buoyancy of activity will continue to be underpinned by the strength of domestic demand, where private consumption will have maintained high rates of increase, in a setting in which the sustained improvement in employment continues to underpin household income and, therefore, household expenditure. However, in the final stretch of the quarter consumption may have weakened somewhat, as a result of the loss of purchasing power derived from the rise in inflation. Investment in equipment is expected to have picked up in Q2, following its weakness in Q1, as suggested in particular by the industrial production index for these goods, the positive expectations about profitability and demand, and the favourable financial conditions in place.

───────────────
2 For further details, see Section 2.

TABLE 1

	2016	2017	2017				2018	
			Q1	Q2	Q3	Q4	Q1	Q2
National Accounts								
Quarter-on-quarter rates of change, unless otherwise indicated								
Gross domestic product	3.3	3.1	0.8	0.9	0.7	0.7	0.7	0.7
Contribution of national demand (b)	2.5	2.8	1.1	0.7	0.8	0.6	0.7	0.7
Contribution of net external demand (b)	0.7	0.3	-0.3	0.2	-0.1	0.1	0.0	0.0
Year-on-year rates of change								
Employment	3.0	2.8	2.6	2.9	2.9	2.9	2.6	2.3
Price indicators (year-on-year change in end-of-period data) (c)								
CPI	-0.2	2.0	2.3	1.5	1.8	1.1	1.2	2.1
CPI excl. energy and unprocessed food prices	0.8	1.1	0.9	1.2	1.2	0.8	1.2	1.1

SOURCES: INE and Banco de España.

a Information available to 25 June 2018.
b Contribution to the quarter-on-quarter rate of change of GDP (pp).
c Latest available figure for consumer price indices: May 2018.

The scant information available on foreign trade flows in Q2 suggests a continuation of the slackness observed in Q1. Along with the signs of the diminished strength of global trade in the year to date, this behaviour might partly be due, according to the models available, to the lagged effects of the appreciation of the exchange rate in 2017, which would have tended to contain the increase not only in exports, but also, given their high import content, in purchases from the rest of the world.

In the medium term, the latest projections published by the Banco de España[3] point to a prolongation of the cyclical upturn, in a setting in which the expansionary stance of demand-side policies and the favourable trajectory of the global economy are expected to be maintained. GDP growth will, however, tend to ease in the coming years as a result of the recent rise in oil prices, a gradual containment of the expected rates of increase in foreign markets and some tempering of the expansionary impulse stemming from monetary policy. Specifically, after having increased by 2.7% this year, GDP is expected to post growth of 2.4% and 2.1% in 2019 and 2020, respectively. Along with the above-mentioned relative risks to the external setting, this favourable scenario is subject to uncertainty over the future course of domestic economic policies. Such uncertainty stems from a setting in which the configuration of Parliamentary forces may hamper the forging of majorities to push through legislation.

As regards consumer prices, there was a significant and euro area-wide rise in May in connection with the more volatile components, while core inflation, on the contrary, moved on a more stable path. Under core inflation, price growth remains higher for services than for non-energy industrial goods, being more directly influenced by the effects of the past appreciation of the euro. Wages, for their part, continue to post low rates of increase, in step with the modest growth rates of productivity and prices.

The Report contains eight boxes: a description of the recent increases in import tariffs in various geographical areas and an assessment of their effects; an analysis of the relative weight of temporary and more persistent factors when explaining the recent slowdown in

---

3 See Macroeconomic projections for the Spanish economy (2018-2020): the Banco de España's contribution to the Eurosystem's June 2018 joint forecasting exercise.

euro area activity; an assessment of the consequences of oil price rises on the Spanish economy; an analysis of the effects of non-tariff trade barriers on Spanish exports; a description of the latest budgetary policy developments in Spain; an estimate of the distributive effects of the personal income tax reform included in the draft State budget; an evaluation of the sensitivity of Spanish public and private agents' incomes to hypothetical interest rate rises; and an analysis of recent developments in small and medium-sized enterprises' access to external financing.

During the first year of President Trump's mandate, few decisions were taken involving the adoption of protectionist measures, despite the stress on this issue during the election campaign.[1] However, since March of this year, the US administration has been much more active in this area, and has adopted some markedly protectionist measures.

The first significant action, taken in March 2018, consisted in raising the tariffs on US steel and aluminium imports to 25% and 10%, respectively. South Korea, Argentina, Australia and Brazil were exempted from these tariffs under bilateral agreements. China, one of the countries affected, adopted retaliatory measures applicable to imports from the United States with a value of $3 billion. Meanwhile, Canada, Mexico and the European Union (EU) were temporarily exempt, until 1 June, when this exemption was revoked, prompting the announcement by their authorities of retaliatory measures affecting imports from the United States worth $23 billion. The amounts affected by these measures may seem large, but it is widely agreed that their direct impact will be relatively small, since the goods currently affected account for a low proportion of total trade flows (see Chart 1).[2] However, the indirect impact of the tariffs may be greater, since, among other reasons, when they are applied to intermediate goods used as inputs in the productive process, they may affect the shape of global production chains.

In mid-June, trade tensions soared when the US presidency announced the imposition of 25% tariffs on imports from China of 1,100 products worth $50 billion. The reason given for this measure was the alleged unlawful appropriation of US intellectual property by Chinese firms.[3] The Chinese authorities responded by announcing retaliatory measures with an equivalent value, involving the introduction of 25% tariffs on more than 650 US products.[4]

In Chart 2, the blue bars show the sectoral breakdown of the bilateral exports between the United States and China (as a percentage of their total bilateral trade flows) and the red bars the proportion of such exports that would be affected by the new tariffs. Overall, these measures (applied to trade flows worth $100 billion) would affect around 15% of bilateral trade flows. Within each sector, the new 25% tariffs would involve a significant increase in those currently in force (the diamonds in Chart 2), especially in the case of the tariffs faced by Chinese exporters.

In order to estimate the impact of this escalation of protectionist measures on the GDP and inflation of various economies, two simulations have been performed using the NIGEM global econometric model. The first one is a simulation of the effects of this recent increase to 25% in the duties applied to imports worth $100 billion ($50 billion in each direction of the bilateral trade between China and the United States). The second simulation also involves tariffs of 25% on Chinese imports from the United States worth $50 billion, with the amount affected in the other direction being much larger ($150 billion).[5] The results show that the US economy will be the most affected (see Chart 3). Specifically, its GDP, after four years, will be 0.2 pp lower than in the baseline scenario in the first simulation and more than 0.5 pp lower in the second. The adverse effects on China will be smaller, since the tariffs affect a smaller proportion of its total exports. As for third countries, the impact will be greatest in Canada and Mexico, given their close trade ties with the United States, and somewhat lower in the euro area, Japan and the rest of Asia. Moreover, since higher duties will push up the price level, the inflation rate is forecast to rise in all the economies, as seen in Chart 4.[6] These estimates may understate the total effects, as they are based on simulations that only consider the trade channel, and therefore ignore others, such as a possible negative impact on confidence or the generation of tensions in financial markets that may result in higher financing costs.

Looking ahead, there is great uncertainty surrounding the adoption of further measures. As regards the bilateral relations between the United States and China, the most likely scenario, following the latest decisions, is no longer one of agreement between these two economies, as appeared to be implied by the agreement in principle reached in May, with the commitment on the part of China to increase its imports of goods and services from the United States.

The future of trade relations between the United States and other economies is also uncertain, with the EU and Mexico and Canada having declared their readiness to respond to any protectionist measures that may be taken by the United States, such as those that may arise from the investigation commenced in mid-May by

---

1 The measures adopted during the first year of the president's mandate were primarily in the form of executive orders designed to increase purchases of US goods and services (such as the "Buy American, Hire American" order of April 2017, addressed to government agencies) or to investigate the effectiveness and consequences of international trade agreements of which the United States is a signatory.
2 Specifically, the US steel and aluminium imports subject to the new duties and the US exports affected by the reprisal measures amount, respectively, to only 1.8% and 1.7% of the total imports and exports of this country. In terms of the impact on US GDP, Barclays (2018), *The Trade-Offs of Free Trade* estimates that the new duties on aluminium and steel may reduce it by somewhat less than 0.2 pp in the short term, while Sposi and Virdi (2018) "Steeling the U.S. Economy for the Impact of Tariffs," *Federal Reserve Bank of Dallas Economic Letter*, estimate a reduction of 0.25 pp in the long term.
3 The new measures would affect the imports of high-technology goods, and electronic and chemical products, aircraft parts, medicines and machinery.
4 The products affected include soya (among other agricultural products), motor vehicles, chemical products and aircraft.

5 The reason is that the president of the United States has threatened to impose duties on an additional flow of $100 billion of imports from China, if China retaliates, which it has done.
6 It is assumed in these simulations that the monetary authorities react to trade restrictions by changing interest rates in response to the rise in inflation and the reduction in activity.

the US Department of Commerce to determine whether vehicle imports pose a threat to national security. The results of this investigation may lead to the imposition of elevated duties on such imports, which would affect the EU (especially Germany and Italy) and Japan in particular. Canada and Mexico would also be severely affected, both directly and through the effects on the renegotiation of the terms of the North American Free Trade Agreement (NAFTA) which was initiated at the beginning of the current US presidency. Thus, in the present circumstances, a

further escalation in the adoption of protectionist measures, representing a risk to growth in trade and global activity, cannot be ruled out.[7]

---

7   ECB, *Economic Bulletin,* May 2018, Box 1 ("Implications of rising trade tensions for the global economy") contains simulations of scenarios in which protectionist measures spread, as a result of imposition by the United States of significant duties on imports from all countries and of equivalent retaliatory measures by the latter, with a pronounced impact on global activity.

Chart 1
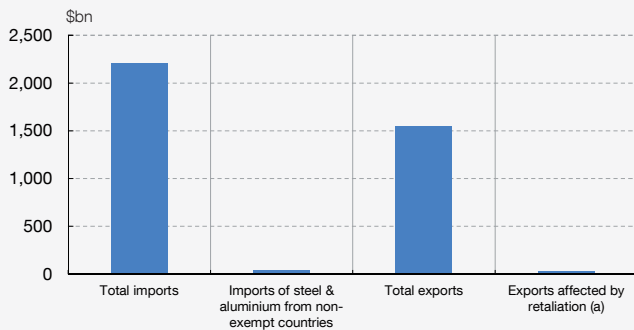**US TRADE FLOWS AFFECTED BY TARIFFS ON STEEL & ALUMINIUM AND RETALIATION (2017)**

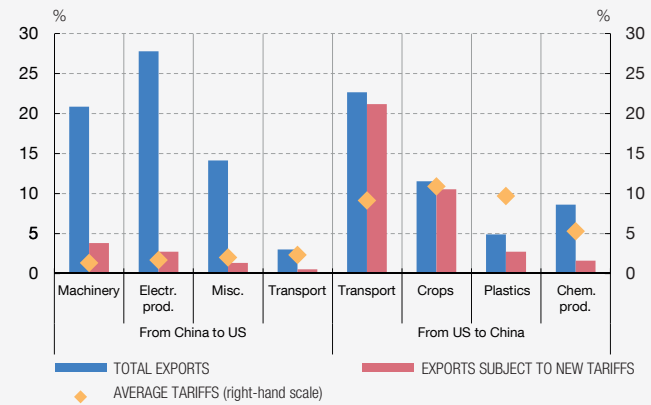
Chart 2
BILATERAL EXPORTS BY SECTOR AND AVERAGE TARIFFS (b)

Chart 3
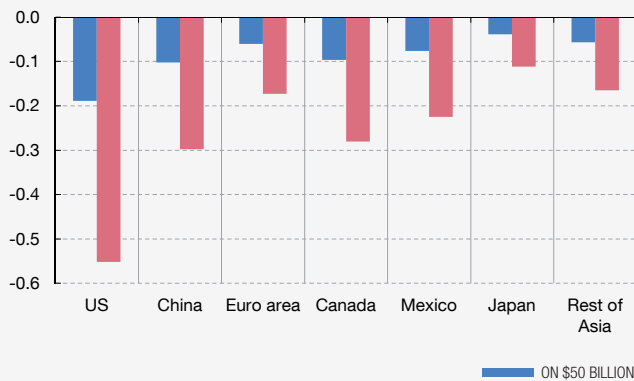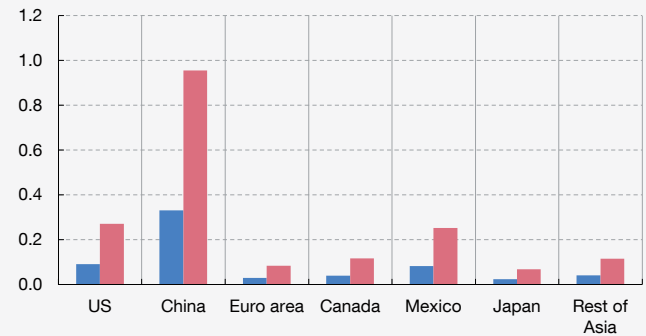**IMPACT OF TARIFFS ANNOUNCED BY US AND CHINA ON GDP (c)**

Chart 4
IMPACT OF TARIFFS ANNOUNCED BY US AND CHINA ON INFLATION (c)

SOURCES: US Census Bureau, IMF DOTS, Peterson Institute for International Economics, US International Trade Commission, WTO and BdE simulations using NIGEM.

a By China, Canada, Mexico and the EU.
b Exports of each sector: % of exports of each country.
c Maximum deviation from baseline scenario.

Having been highly buoyant in 2017, economic activity in the euro area slowed significantly in 2018 Q1. As seen in Chart 1, the March 2018 ECB staff macroeconomic projections for the euro area had forecast quarter-on-quarter GDP growth of 0.7%, well above the 0.4% actually recorded. This unexpected weakness in activity had been anticipated by the indicators published before the National Accounts figures were made known,[1] as reflected in the economic surprise index compiled by Citigroup (see Chart 2). [2] Moreover, the surprises were a general phenomenon across countries.

To explain the slowdown in output, the information available points to the impact of both temporary factors and other more

persistent ones. As regards temporary factors, four circumstances have been highlighted as possibly having affected the performance of activity in Q1. First, production and demand may have been curbed by the unusually adverse weather conditions.[3] However, value-added in construction, one of the sectors in which the effects of bad weather are usually most apparent, was buoyant in Q1, with quarter-on-quarter growth of 0.7% in the area as a whole. Second, in the specific case of the German economy, a winter flu epidemic that was more severe and longer-lasting than usual may have increased absenteeism in February and March. In addition, there was the impact of various strikes in certain important sectors.[4] Finally, the decline in government consumption in Germany in Q1 may be explained by a delay in goods and

---

1 The preliminary estimate of euro area GDP for Q1 was published on 2 May 2018.
2 Citigroup's economic surprise index shown in Chart 2 is based on the differences between the data published for each indicator and the Bloomberg consensus forecast.

---

3 In particular, unusually low temperatures were recorded in February and March.
4 Specifically, there were labour disputes in Germany (in the metalworking industry in January) and in France (in the transport industry in March).

Chart 1
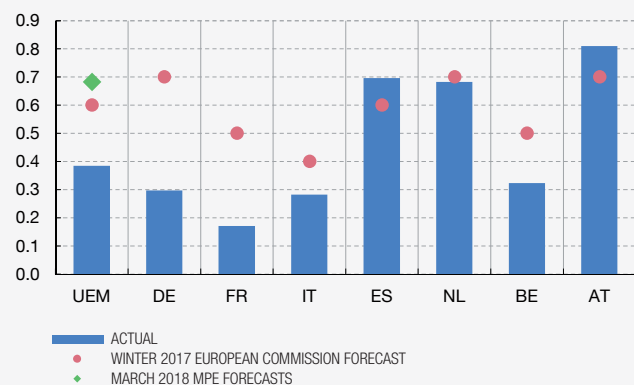QUARTER-ON-QUARTER GDP GROWTH
2018 Q1

ACTUAL
WINTER 2017 EUROPEAN COMMISSION FORECAST
MARCH 2018 MPE FORECASTS

Chart 2
CITIGROUP'S ECONOMIC SURPISE INDEX FOR THE EURO AREA

EURO AREA   UNITED STATES

Chart 3
GDP GROWTH AND CONTRIBUTIONS
2017

PRIVATE CONSUMPTION   GOVERNMENT CONSUMPTION
GFCF   CHANGE IN INVENTORIES
NET EXTERNAL BALANCE   GDP
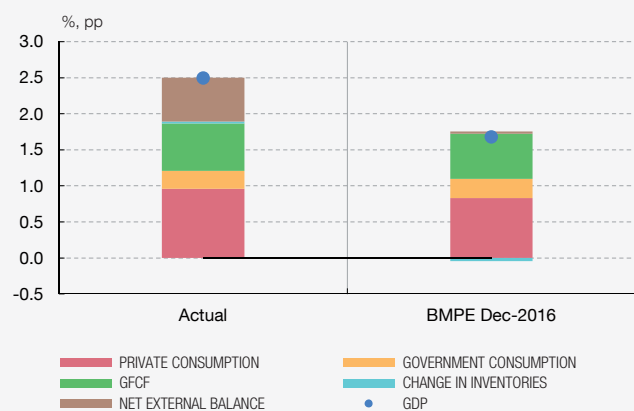
Chart 4
QUARTER-ON-QUARTER GDP GROWTH FORECAST
Euro-sting. 7 June 2018

80TH PERCENTILE   60TH PERCENTILE   40TH PERCENTILE
20TH PERCENTILE   ACTUAL   MEDIAN
EUROSYSTEM
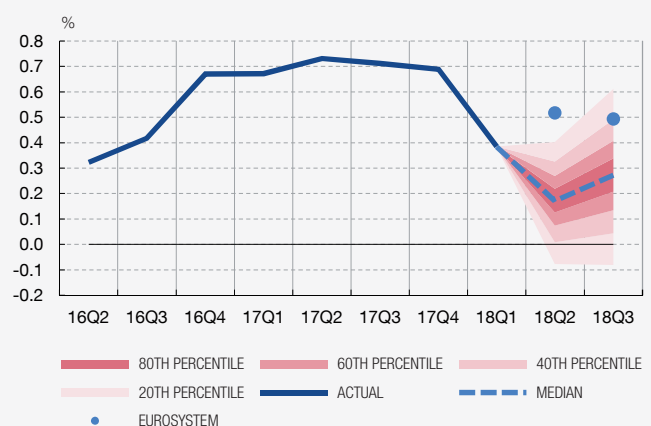
SOURCES: Eurostat, European Commission, Banco de España and Citigroup.

services purchases owing to the time taken to form a new government. The negative impact of this set of factors on economic activity is difficult to quantify. However, as they are all associated with specific countries and sectors, it is not clear how, on their own, they can explain the strength and broad-based nature of the slowdown.

Consequently, it seems likely that the recent loss of buoyancy is a result of more persistent factors, common to the whole area. Notable in this respect is the sharp slowdown – and in some cases even fall – in exports, in quarter-on-quarter terms, in most euro area countries in 2018 Q1. This behaviour may reflect a reversion of export growth to levels more in line with the cyclical position of the world economy, following exceptionally high growth last year, especially in the second half, when it explained the entire positive surprise in economic activity in the year as a whole (see Chart 3). However, the delayed effects of exchange rate appreciation last year and the slowdown in world trade that some indicators suggest may be happening at the beginning of 2018 may also be having a negative impact on exports. The latest information provided by export-related leading indicators (such as order books and export expectations) suggests that exports continued to slow in Q2.

Leaving aside the search for the origin of activity's loss of buoyancy among the demand components, the information available on Q2 presages lower GDP growth than in 2017 and suggests that there are risks that growth will be below the 0.5% rate contained in the June Eurosystem macroeconomic projections. Indeed, the Banco de España's Euro-sting model,[5] which estimates the short-term growth of the area in real time using the information supplied by a wide range of indicators, suggests that the GDP growth rate in 2018 Q2 will be similar to that recorded in Q1 (see Chart 4).

Nonetheless, the economic fundamentals of the euro area remain robust, so that the current upturn can be expected to continue in the medium term, at rates that are still above the economy's potential growth rate, despite being more moderate than in 2017. Economic activity will continue to be driven by a monetary policy that is still highly accommodative, favourable financial conditions, conducive to greater lending to the private sector, and an expanding labour market, which will continue to shore up household and business confidence when consumption and investment decisions are taken.

5   See M. Camacho and G. Pérez-Quirós (2008): "Introducing the Euro-sting: short-term indicator of euro area growth", Working Papers, No 0807, Banco de España.

The price of Brent oil rose by around 70% from June 2017 to May 2018, when it reached nearly $80 per barrel, the highest level since autumn 2014, although it has fallen in recent weeks to somewhat below $75 per barrel. This box estimates the macroeconomic impact on various economies of an oil price rise stemming from supply factors and discusses to what extent the size of the estimated effect for Spain may have decreased in the more recent period.

As in any other market, the formation of oil prices is influenced by both demand and supply factors. The supply factors affecting oil prices include possible geopolitical tensions in oil producing areas, producers' strategic behaviour, oil discoveries or new extraction techniques, while demand is determined basically by developments in world activity and, in the longer term, improvements in energy efficiency. Higher oil prices bring negative macroeconomic effects for importing countries, since they entail a transfer of income to producers and reduce the purchasing power of households and firms. However, these effects tend to be more adverse if the oil price rise derives from a supply shock than if it is due to an increase in world demand for this commodity, in which case the lower domestic expenditure can be offset by increased exports.

In practice, any analysis of the respective contributions of the supply and demand factors to oil price behaviour is subject to great uncertainty. That said, there is a certain consensus that the rise in the second half of last year was basically in response to an increase in demand generated by a synchronised upturn in economic activity and world trade. However, supply factors seem to have played a larger role in the price rises in the first half of 2018, as a result of the high compliance of agreed cuts among producers, the sharp fall in Venezuelan production and the recent geopolitical tensions exacerbated in recent weeks by the re-imposition of sanctions on Iran by the United States.

Given that the consequences of an oil price rise for oil importers are more severe when the price rise is due to supply factors, and that the evidence points to the increase in the first half of 2018 being predominantly due to such factors, we will focus on the impact of supply-side shocks. For this purpose, we used the NiGEM global macroeconomic model[1] to simulate the effects on

1 The model is specified as a set of error correction equations in which the dynamics are governed by short-term demand and in which supply subsequently takes on a progressively growing role. The technical assumptions are that nominal exchange rates remain unchanged and expectations are adaptive.

Chart 1
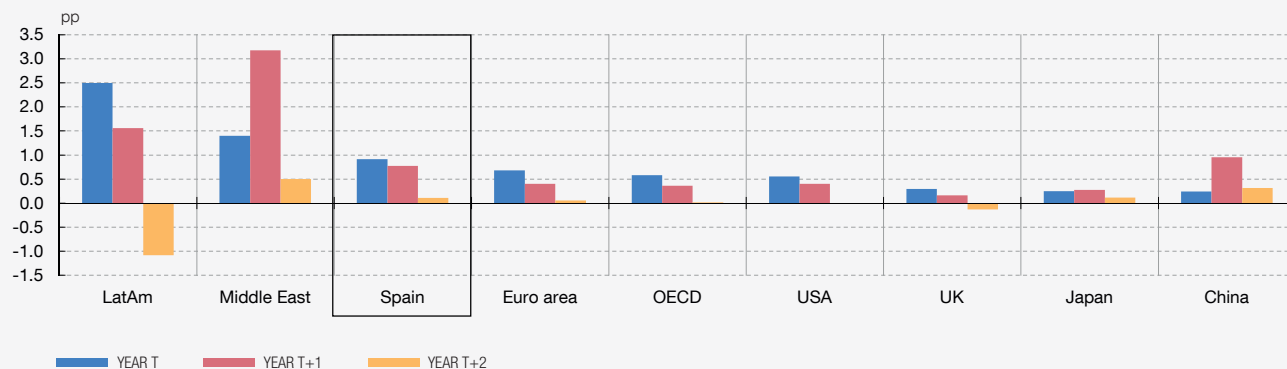DEVIATIONS FROM THE BASELINE SCENARIO

1 CURRENT ACCOUNT BALANCE AS % OF GDP, ANNUAL DEVIATION FROM BASELINE SCENARIO
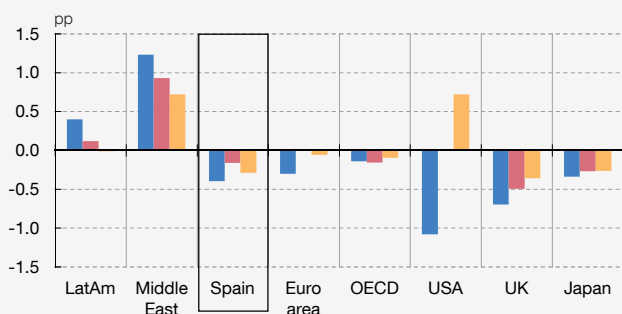
2 GDP, ANNUAL DEVIATION FROM BASELINE SCENARIO
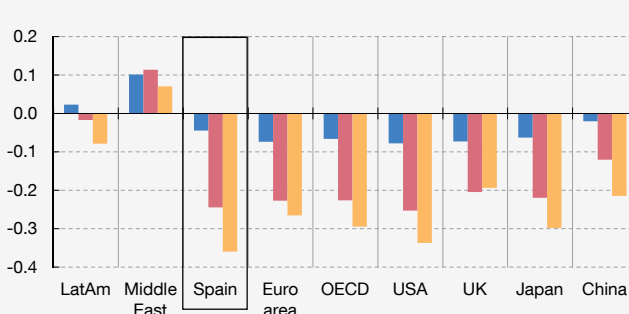
3 INFLATION, ANNUAL DEVIATION FROM BASELINE SCENARIO

YEAR T   YEAR T+1   YEAR T+2

SOURCES: Banco de España and NiGEM.

GDP, consumer prices and the current account balance in various regions of the world that would result from a Brent oil price rise of $10 per barrel (equivalent to a percentage increase of 15% with respect to a base level of $65).

The impact is uneven across economies, depending on factors such as producer or importer status, oil derivatives intensity in consumption, tax structure and monetary policy response. As might be expected, the sign of the effects on activity and the external balance is positive in exporting countries and negative in importers (see Chart 1). The impact on inflation is always positive, being more marked in producing countries, since the expansionary effect on domestic demand must be added to the increase in costs, which is also seen in importers.[2]
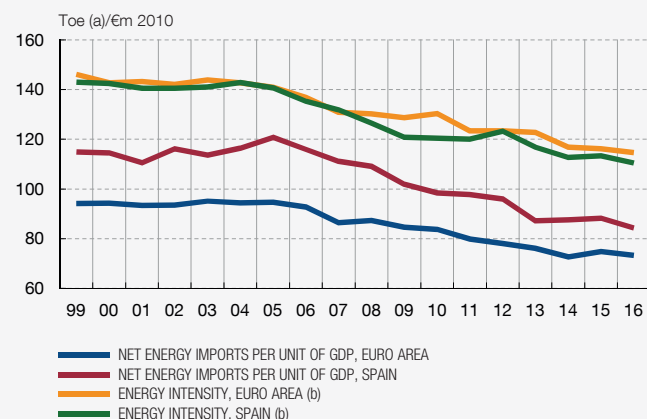
_____

2 The increase in costs tends, however, to be relatively smaller in producing countries, given that the use of oil derivatives is often subsidised.

The impact on the Spanish economy is comparatively large, which is explained by Spain's high import intensity of energy products, especially oil. In particular, Spain's current account balance undergoes a worsening of approximately 0.3 pp of GDP, which moreover shows a high degree of persistence. The estimated loss of GDP in Spain is -0.2 pp on average in the three years following the shock, which is somewhat higher than in other importers, and inflation is estimated to increase somewhat more in Spain (0.9 pp in the first year).
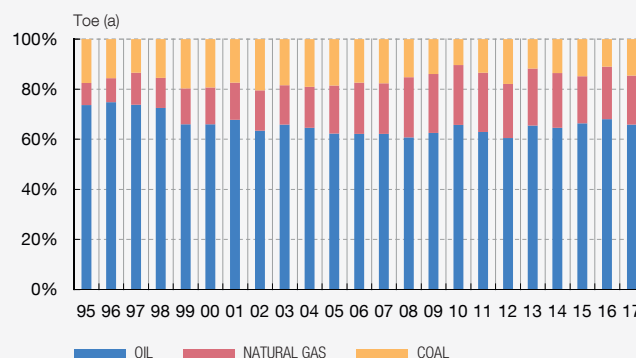
These impacts estimated using the model should be interpreted as an upper bound for two reasons. First, because in practice any oil price rise reflects not only supply but also demand factors. In this respect, simulations performed using the Quarterly Macroeconometric Model of the Banco de España *(Modelo Trimestral del Banco de España)* show somewhat smaller effects, which is consistent with the fact that the estimated elasticities in this model are an average of the effects of all the historically observed supply and demand
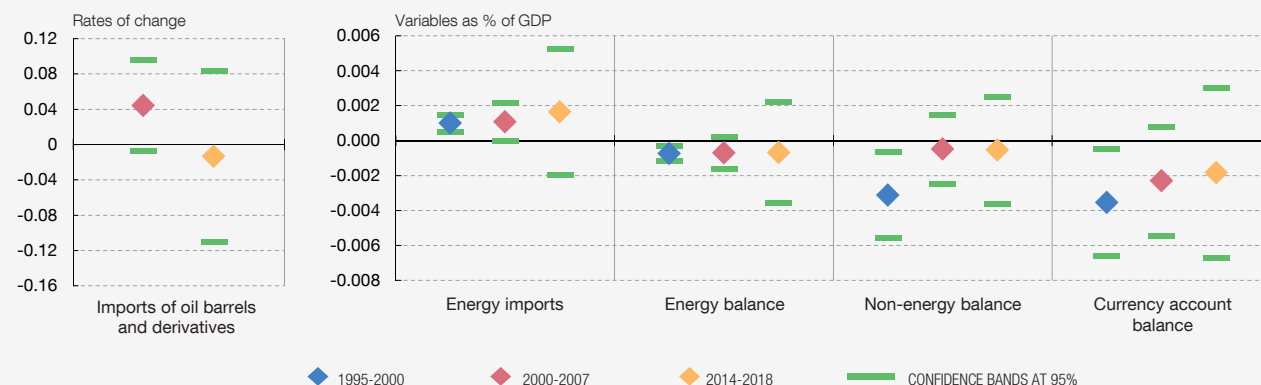
Chart 2
ENERGY IMPORTS

1 NET ENERGY IMPORTS PER UNIT OF GDP AND DEGREE OF ENERGY INTENSITY

Toe (a)/€m 2010

NET ENERGY IMPORTS PER UNIT OF GDP, EURO AREA
NET ENERGY IMPORTS PER UNIT OF GDP, SPAIN
ENERGY INTENSITY, EURO AREA (b)
ENERGY INTENSITY, SPAIN (b)

2 COMPOSITION OF ENERGY IMPORTS

Toe (a)

OIL   NATURAL GAS   COAL

3 IMPACT OF CHANGE IN OIL PRICES IN EURO

Rates of change

Variables as % of GDP

Imports of oil barrels and derivatives

Energy imports   Energy balance   Non-energy balance   Currency account balance

◆ 1995-2000   ◆ 2000-2007   ◆ 2014-2018   ▬ CONFIDENCE BANDS AT 95%

SOURCES: Eurostat and Banco de España.

a Toe = Tonne of oil equivalent.
b Degree of energy intensity = Domestic energy consumption/GDP.

shocks.[3] Second, because there is evidence that in recent years importing economies have reduced their oil dependence. Indeed, Chart 2.1 shows that both energy consumption and net energy imports, in both cases per unit of GDP, have been decreasing approximately since 2005 in the euro area as a whole and particularly in Spain, where net imports per unit of GDP nevertheless continue to be comparatively greater. Among the factors explaining this behaviour are the improvement in energy efficiency (driven by technology), the improvements in renewable primary energy sources and the changes in the structure of the economy (particularly tertiarisation).[4] In addition, although oil continues to be the main source of imported primary energy, its share in the total has been decreasing (see Chart 2.2).[5]

All these developments are estimated to have contributed to a certain weakening of the negative relationship between oil price movements and the energy trade balance. The main question is whether, in addition, they have reduced the sensitivity of the non-energy balance to oil price fluctuations, given the lower share of oil derivatives in the cost structure of production, an effect which would be magnified by a decrease in the sensitivity of wages to oil price fluctuations in recent years reported in the literature.[6] If this were so, an oil price rise might be expected to have a somewhat less adverse impact on the economy's external competitiveness than in the past.

Chart 2.3 shows the results of a tentative test of the hypothesis that, over time, the various components of Spain's goods and services balance and its current account balance as a whole have become less sensitive to oil price movements.[7] In particular, this tool appears to indicate that, while from 1995 to 2000 an increase of 10% in oil prices caused the current account deficit to worsen by between 0.3 pp and 0.4 pp, the effect decreased to 0.2 pp in the period 2014-2018. In any event, this evidence is very preliminary, so it should be regarded with due caution until it is confirmed by further analysis.

───────────────

3 Specifically, compared with the figures presented in the exercise conducted using NiGEM, the worsening of the current account balance would be 0.2 pp of GDP (instead of 0.3 pp), the estimated loss of GDP would be somewhat more than 0.1 pp on average in the three years following the shock (instead of 0.2 pp), and the increase in inflation would be 0.6 pp (instead of 0.9 pp). For an evaluation with these elasticities of the role of the oil price fall observed from mid-2014 to end-2015 in explaining the upward surprises in Spanish GDP growth during the period 2014-2016, see Box 1.2 of the 2016 *Annual Report*, 2016, Banco de España.

4 Thus, for example, final energy consumption per unit of value-added in the transport sector, the main user of oil derivatives, has decreased in recent years. Furthermore, this cutback will foreseeably become more marked in coming years as vehicles are more efficient (in 2016 only 21% of the stock of road motor vehicles were less than five years old, while in 2005 this percentage was 42%). Regarding the tertiarisation of the economy, the share of services in the GVA of the economy rose from 67% in 2005 to 74% in 2017.

5 In Spain, this has occurred at the expense of natural gas (see Box 3.1 of Chapter 3 "Current account adjustment", *Annual Report,* 2016, Banco de España).

───────────────

6 See Blanchard and Galí (2007), "The macroeconomic effects of oil shocks: why are the 2000s so different from the 1970s?", National Bureau of Economic Research, Working Paper 13368 and, for Spain, Álvarez, Sánchez and Urtasun (2017), "The effect of oil price fluctuations on Spanish inflation", *Economic Bulletin,* 2/2017, Banco de España.

7 Specifically, monthly data and five-year windows are used to estimate bivariate regressions of the various components of the goods and services balance as a ratio of GDP to year-on-year oil price growth.

Protectionist policies most commonly take the form of import taxes or tariffs. The negative impact of tariffs on trade flows and economic welfare has been extensively analysed in the economic literature.[1] Measures of this type have come into the spotlight due

to announcements such as the introduction of import tariffs on steel and aluminium in the United States.[2] In principle, the direct

1 See for example Lileeva, A. and D. Trefler (2010) "Improved Access to Foreign Markets Raises Plant-level Productivity for Some Plants," Quarterly Journal of Economics, pp. 1051-1099.

2 On 8 March, the US Department of Commerce imposed import tariffs on steel and aluminium (of 25% and 10%, respectively), from which European Union (EU), Canadian and Mexican exports were exempted. However, at the end of May the suspension of that exemption from 1 June was announced.

Chart 1
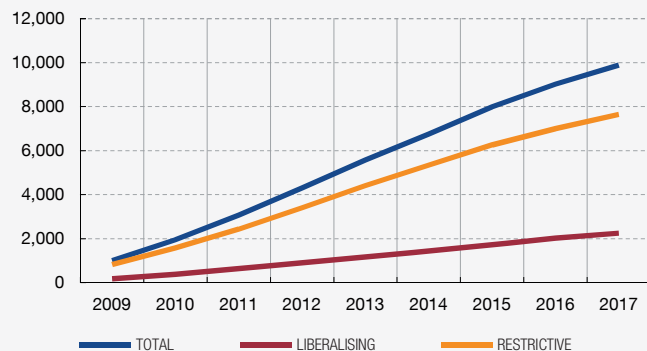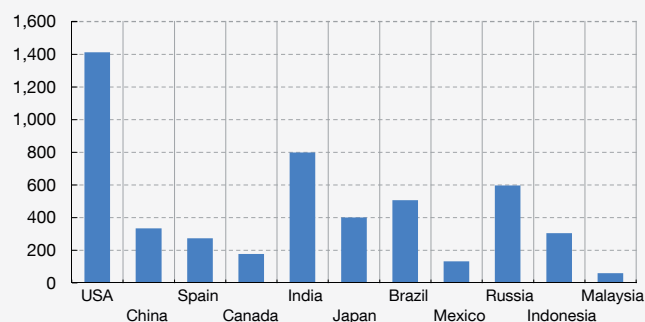NON-TARIFF MEASURES ADOPTED BY G20 COUNTRIES BETWEEN 2008 AND 2017

TOTAL   LIBERALISING   RESTRICTIVE

Chart 2
NEW NON-TARIFF BARRIERS (2009-2017)

Chart 3
NUMBER OF NEW NON-TARIFF BARRIERS (2009-2017)

IMPOSED BY SPAIN   IMPOSED ON SPAIN
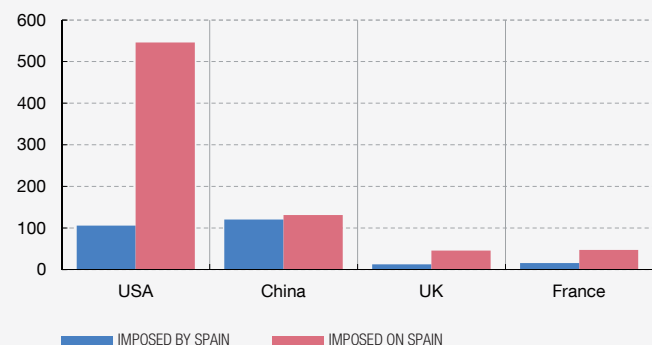
Chart 4
NON-TARIFF BARRIERS IMPOSED BY THE UNITED STATES ON SPAIN BETWEEN 2009 AND 2017

COMMON IRON AND STEEL   OTHER PROCESSED METAL PRODUCTS
STRUCTURAL METAL PRODUCTS   IRON AND STEEL PRODUCTS
HOUSEHOLD APPLIANCES   OTHER
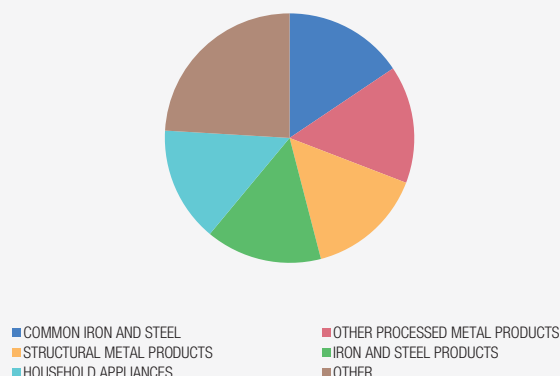
Chart 5
COUNTERFACTUAL EXPORTS WITHOUT NON-TARIFF BARRIERS

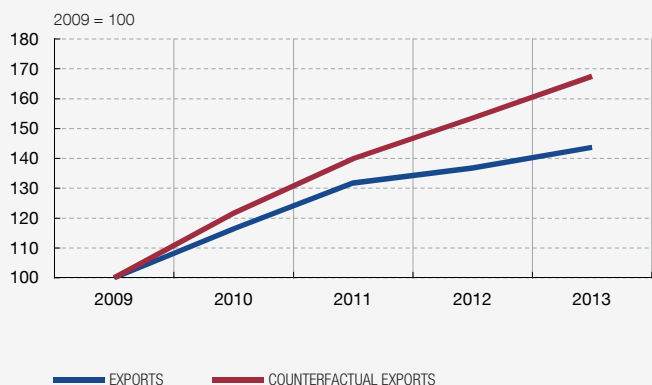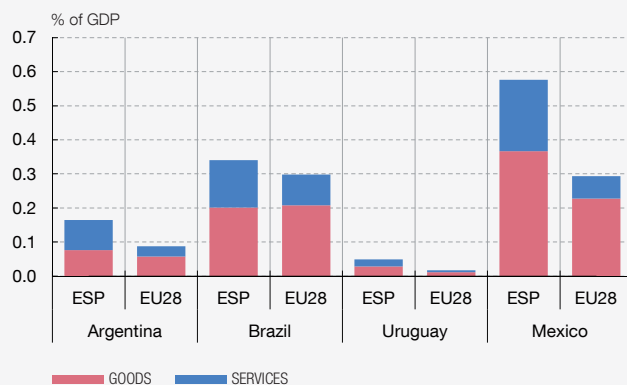EXPORTS   COUNTERFACTUAL EXPORTS

Chart 6
GOODS AND SERVICES EXPORTS TO MERCOSUR AND MEXICO (2016)

GOODS   SERVICES

SOURCES: Banco de España, Eurostat and Global Trade Alert Project.

impact of this decision should be relatively small. That said, the consequences for world trade and economic activity may end up being severe if the measure triggers successive rounds of mutual retaliation measures between the countries involved.

This box, however, draws attention to another type of protectionist policies, of a non-tariff nature, which are less transparent and have been subject to less analysis in the economic literature. This non-tariff protectionism has been much used by various developed countries in recent times. We analyse below the recent increase in the number of non-tariff barriers in order to shed light on how this kind of protectionism may affect Spanish exports.

Non-tariff barriers may take diverse forms, including, for example, financial aid to national industries, the inclusion of conditions in public procurements which lead to effective constraints on foreign competitors or the imposition of phytosanitary requirements on imported products. Chart 1 of the chart shows the increase in the number of non-tariff protectionist measures by developed economies, adopted in some cases in an attempt to mitigate the effects of the global crisis on their national industries.[3] The United States has been particularly active in the use of measures of this type, as can be seen in Chart 2. Thus, while China and Spain have introduced around 300 non-tariff trade barriers since 2009, the United States has implemented in that time more than 1,400 new protectionist measures of this nature.

Regarding imports from Spain, since 2009 the United States has imposed a total of 546 restrictive measures (Chart 3). By contrast, sales of Spanish products to other destinations have generally faced a smaller number of new non-tariff barriers. Thus, for example, in that same period China has implemented 131 new protectionist measures affecting Spanish exports. From a sectoral standpoint, the products most strongly protected by the United States through measures of this type are basic metals (see Chart 4), which have been identified by that country as one of the areas most affected by international competition. This is illustrated by the fiscal expansion package "American Recovery and Reinvestment Act of 2009", which imposed the condition that all steel and aluminium products used under the programme had to be of US manufacture. This same requirement has been imposed again more recently in other legislation such as the "New York Buy American Act" of 2017 passed by the state of New York or the public tender for the installation of railway security systems called by the Department of Transport in 2018.

To quantify the possible impact of this kind of protectionism on Spanish exports, we used, firstly, the compilation of non-tariff measures of the *Global Trade Alert Project* for each combination of product, country and year[4] and, secondly, the microeconomic information on firm, product, country and year drawn from the Banco de España's registers of cross-border transactions between 2009 and 2013. This information can be used to compare the behaviour of a firm's exports of a given product to two different countries: one which has imposed a non-tariff constraint on imports of that product and another which has not.

The results indicate that the growth of exports to a country imposing a non-tariff barrier is 3.1 pp lower than that of exports of the same firm and the same product to other countries. This negative effect is economically significant, taking into account that the annual average growth of exports observed in the aforementioned period 2009-2013 is 6.5%.[5] Chart 5 shows how, in the absence of new non-tariff barriers, aggregate annual growth of Spanish exports in nominal terms would have been around 14%, compared with the 11% observed.[6]

It should be noted that the new generation of trade agreements negotiated recently by the European Union with its trading partners tend to reduce both non-tariff barriers to trade in goods and, in general, any barriers which constrain the movement of goods, services, persons and investment flows, without neglecting to include rules on the environment, the labour markets or intellectual property rights.[7] In this respect, by way of counterbalancing the increase in non-tariff measures in certain developed countries, the negotiations under way between the European Union and Latin American destinations such as MERCOSUR or Mexico may, if they culminate in full free trade agreements, benefit Spanish firms especially, given their experience in some sectors with high potential growth in these countries, such as public works, and their closer cultural affinity, already apparent in their greater trade presence in those areas compared with the rest of the EU (see Chart 6). To illustrate this, in the first year after Ecuador's signature in January 2017 of the European Union's free trade agreement with Colombia and Peru, Spanish exports to this country rose by 47%, compared with growth of 4.8% of the exports of Germany, France and Italy.

---

3 The source of information on non-tariff measures is the Global Trade Alert Project: https://www.globaltradealert.org/. Since it is difficult to assign them a monetary value, their measurement is based on the number of measures adopted, regardless of the value of the imports affected by each measure.

4 See footnote 2.

5 Note that this rate refers to the unweighted annual average growth of firm-country-product flows in nominal terms. Since it is an unweighted average, it does not coincide with the aggregate annual growth.

6 Readers interested in this analysis can find more details in Banco de España Working Paper 1814 "The costs of trade protectionism: evidence from Spanish firms and non-tariff measures".

7 For more details of agreements of this type in general and of that with Canada in particular, see the Analytical Article of the Banco de España "The EU's new-generation trade agreements: the CETA treaty".

The last decade has been marked by a process of general government deficit reduction in Spain, from the peak of 11% of GDP in 2009 to 3.1% in 2017. In parallel, general government debt also began to decline slightly, in step with the economic recovery, from 2014 when the debt-to-GDP ratio peaked at 100.4%, compared with 98.3% in 2017.[1] Maintaining healthy public finances is indispensable for macroeconomic stability and the correct provision of public services, as it provides, in particular, room for manoeuvre for fiscal policy in the event of adverse shocks and reduces the vulnerability to possible changes in investor sentiment in the markets.

In this setting, on official estimates, the budgets and plans of the different general government sectors for 2018 combined should give rise to a further reduction in budgetary imbalances this year. Specifically, the official budget deficit target is 2.2% of GDP, which would be an improvement of 0.9 pp, mainly reflecting a decline in the public expenditure-to-GDP ratio. In turn, the official general government debt forecast has been set at 97% of GDP, which if met would be a decrease of 1.3 pp in public indebtedness. In this scenario, the budget deficit would fall below 3% of GDP, which is the limit set by the Stability and Growth Pact (SGP) for exiting the excessive deficit procedure, the deadline for which, in the case of the Spanish general government sector, is precisely this year.[2]

According to the 2018-2021 Stability Programme Update (SPU), sent to the European Commission at the end of April within the framework of the European Semester, the general government structural deficit is expected to improve only marginally in 2018, by 0.1 pp, remaining above 2%.[3] In consequence, there would be no progress this year in the necessary process to achieve a structural improvement in public finances, in a setting in which, according to the SPU, the Spanish economy's output gap would be positive for the first time since 2008.

The practically neutral stance of fiscal policy in 2018, according to SPU estimates,[4] is determined by a series of budgetary measures raising public expenditure and introducing tax cuts that are included in the Budget for the State and the Social Security system for 2018, countering the broadly moderate expenditure stance under other headings. In comparative terms, the more expansionary legislative measures include, in particular, those relating to pensions, employment and public sector wages, and personal income tax, all of which are discussed in detail below.

In the case of pensions, the 2018 Budget establishes an across-the-board increase of 1.6% (both for 2018 and 2019), an increase of 3% for minimum and non-contributory pensions in 2018, and an increase in the regulatory base of widow(er)s' pensions from 52% to 56% in 2018 and from 56% to 60% in 2019 (see Chart 1). These measures combined will raise general government expenditure by an estimated 0.2 pp of GDP, approximately, in 2018, and by a further 0.2 pp in 2019, in respect of the revaluation of 0.25% resulting from application of the Revaluation Index. Moreover, the 2018 Budget defers until 2023 application of the Sustainability Factor, initially set for 2019. Both these automatic mechanisms – the Revaluation Index and the Sustainability Factor – were approved by Law 23/2013, which came into force in January 2014, aiming to ensure the long-term sustainability of the pension system. Thus the Revaluation Index, applied between 2014 and 2017, links annual pension growth to the relative change in the system's expenses and revenue, while the Sustainability Factor adjusts starting pension for new pensioners taking into account their life expectancy at the time. According to the SPU, this higher expenditure is to be countered in part by introducing a new tax on digital services, as yet undefined.

Regarding public sector wages, the 2018 Budget reflects the agreement between the government and the main public sector unions signed in March 2018 for the period 2018-2020,[5] with wage increases of more than the 1% applied in 2017. Specifically, under the agreement signed, wage rises would comprise fixed increases of 1.5%, 2.25% and 2%, in 2018, 2019 and 2020, respectively, and additional increases tied to GDP growth and to compliance with the stability target in 2020 (see Chart 2).[6] Additional funding was also agreed (of 0.4%, 0.25% and 0.3% of total gross wages in each of the respective years) to cover, inter alia, equal pay for members of certain professional corps and contributions to pension schemes.[7] The agreement also includes a relaxation of the public sector hiring policy of the last two years, increasing the replacement rate in certain sectors (raising it, in total, by some 10 pp, to 90%),[8] together with additional measures relating to working hours and temporary employment.

---

1 See M. Delgado, B. García and L. Zubimendi (2018), "Developments in public debt in Spain in 2017", Economic Notes, 7 June, Banco de España.

2 The Spanish general government sector has been subject to an Excessive Deficit Procedure since 2009, under the corrective arm of the SGP, with a 2018 deadline. In August 2016 the Council of the European Union updated the deficit target for the Spanish general government sector for 2018, setting it at 2.2% of GDP. It also established that the sector would have to make a structural effort (that is, an improvement in the structural balance) in the period 2016-2018 of 0.6 pp of GDP in cumulative terms.

3 On other estimates, it would be considerably higher than 2%. Thus, for example, according to the European Commission's May forecasts, the structural deficit would be 3.3%.

4 According to the European Commission's May forecasts, the fiscal policy stance in 2018 would be slightly expansionary.

---

5 See II Acuerdo Gobierno-Sindicatos para la mejora del empleo público y las condiciones de trabajo (available only in Spanish).

6 Specifically, wages would rise, with effect as at 1 July of each year, by an additional 0.25%, 0.25% and 1%, in 2018, 2019 and 2020, respectively, in the event that GDP growth in the previous year amounted to at least 3.1%, 2.5% and 2.5%, respectively. In addition, if the general government public deficit target of 0.5% of GDP in 2020 was met, wages would rise by an additional 0.55% in that year.

7 In 2018, this includes both the 0.2% envisaged in the agreement signed in March with the unions and the additional equivalent increase included in the Budget to place the wages of law enforcement officers on an equal footing.

8 The agreement sets the replacement rate at 100% for all sectors if the stability targets are met, providing for an additional increase of up to 8% (10% for local government) in some cases. If the targets are not met, the rate is 100% for priority sectors and 75% for the remainder, with the additional possibility of a 5% increase for certain sectors. Moreover, in the case of local governments that have had to provide more services in any year of the period 2013-2017, the replacement rate may be raised by a further 5%. Lastly, the replacement rate is set at 115% for law enforcement officers.

Chart 1
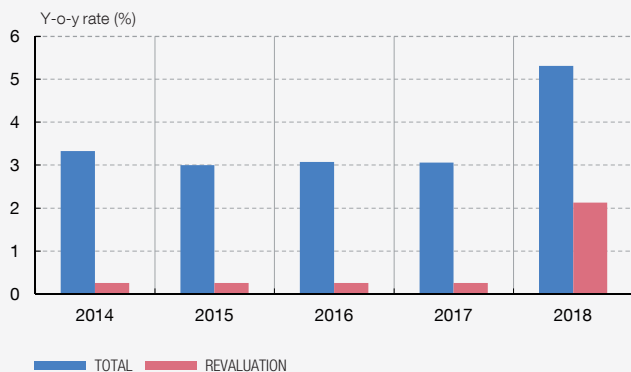**GROWTH IN CONTRIBUTORY PENSIONS (a)**

Y-o-y rate (%)

TOTAL   REVALUATION

Chart 2
AGREED PUBLIC SECTOR WAGE RISE (b)

Base 100 = 2017

MINIMUM (c)   MAXIMUM

Chart 3
REDUCTION FOR EMPLOYMENT INCOME IN PERSONAL INCOME TAX (d)

Euro

Net employment income (€)

BEFORE TAX REFORM   AFTER TAX REFORM
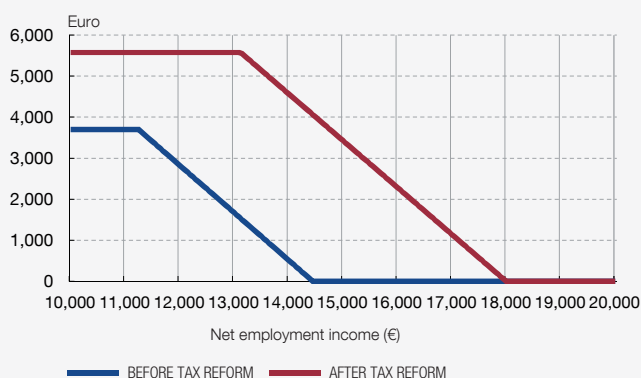
Chart 4
SPANISH GENERAL GOVERNMENT DEBT

% of GDP

OBSERVED   2018-2021 SPU   EC FORECAST (e)
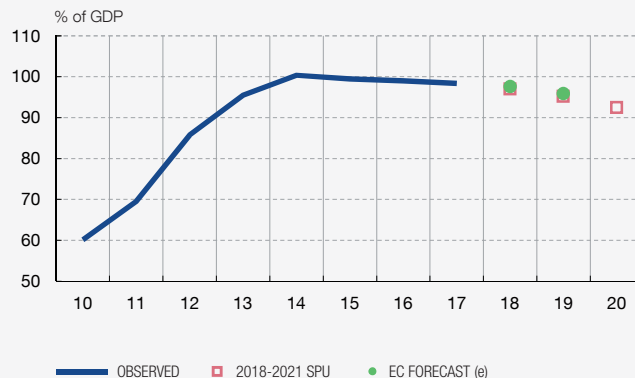
Chart 5
SPANISH GENERAL GOVERNMENT NET LENDING/NET BORROWING

% of GDP

NET LENDING/NET BORROWING   TARGETS
EC FORECAST (e)   3% LIMIT
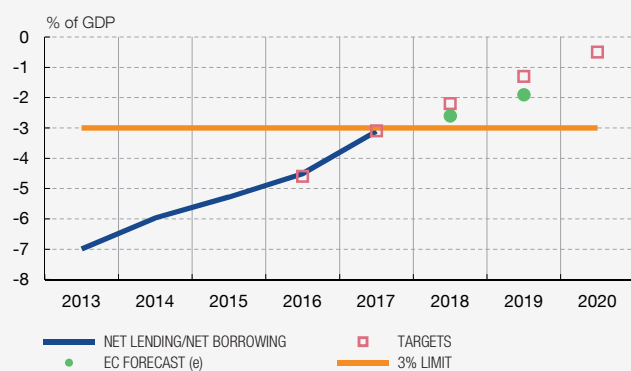
Chart 6
FISCAL POLICY STANCE IN SPAIN (e) (f)

% of GDP

Contractionary

Expansionary
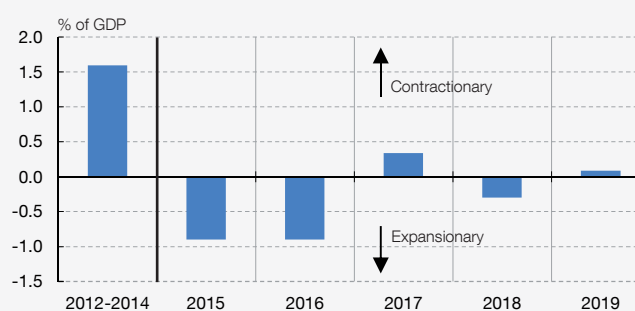
SOURCES: European Commission, IGAE, State Budget for 2018, SPU 2018-2021 and Banco de España.

a In 2018, own estimate drawing on 2018 Budget and 2018-2021 SPU data.
b Includes additional funds for equal pay measures and other expenses.
c Already includes the 2018 rise conditional on GDP growth in 2017, as this was equal to the minimum required (3.1%).
d The chart depicts the reduction in the personal income tax base for each level of taxpayer net employment income. The maximum reduction increases from €3,700 to €5,575, and becomes zero for net income of €18,000, compared with €14,450 before the tax reform.
e Commission spring forecasts, which do not take into account the across-the-board increase in pensions in 2018 and 2019, agreed subsequently. For 2018, the EC estimates an impact of the additional increase of 0.1 pp of GDP.
f Change in the structural balance (cyclically-adjusted) estimated using EC methodology.

Lastly, the Budget also makes changes to the Personal Income Tax Law, raising the tax allowance (the amount a person is entitled to earn before paying income tax) from €12,000 to €14,000 gross, significantly increasing the reduction for employment income under €18,000 (see Chart 3). It also introduces new tax credits for childcare (nursery) costs and for a disabled spouse, and extends existing tax credits for large families. The government estimates that these measures will have a cost in terms of revenue verging on 0.2 pp of GDP between 2018 and 2019.[9]

If Spain is to comply with the general government deficit target of 2.2% of GDP in 2018, an extremely strict expenditure outturn will be needed, and also materialisation of the increase in public revenue projected in the Budget. In this respect, any departure from these conditions poses a risk of noncompliance. In particular, the European Commission, in its opinion on the Budget published on 23 May,[10] expects the Spanish budget deficit to amount to 2.7% in 2018, 0.5 pp above the 2.2% target (see Chart 5).[11] In the

view of the Commission, this decline in the general government deficit would be fully attributable to the impact of economic growth, since in its opinion the budgetary measures adopted would give rise to an increase in the structural deficit of around 0.3 pp of GDP (see Chart 6). However, despite this departure from target, the Commission believes that the revised budgets are broadly compliant with the SGP, since in accordance with its forecasts, the excessive deficit will be corrected in a timely manner (that is, in 2018).

If Spain does in effect exit the excessive deficit procedure this year, it would become subject to the preventive arm of the SGP and should continue to make progress in the process of improving public finances. In this respect, the Commission recommendation for a Council Recommendation of 23 May 2018 asks the Spanish government to ensure that net primary public expenditure growth does not exceed 0.6% in 2019, corresponding to a structural adjustment of 0.65 pp of GDP, in view of the Commission's macroeconomic forecast. In turn, in accordance with the public debt rule whereby public debt should fall, each year, by a twentieth of the difference between the level that year and the 60% of GDP target level, the public debt-to-GDP ratio should decrease by 1.9 pp this year.

---

9 The effects of these tax measures on the income of different groups of taxpayers are simulated in Box 6.

10 Commission Opinion of 23.5.2018 on the updated Draft Budgetary Plan of Spain.

11 The Commission 2018 spring forecast pointed to a deficit of 2.6% of GDP in 2018, not taking into account the impact of the across-the-board increase of 1.6% in pensions that was approved subsequently. The estimated impact of this measure would be a further 0.1% of GDP.

Similarly, the Banco de España's latest projections, published on 15 June, forecast a deficit of 2.7% of GDP in 2018.

The Law on the State Budget for 2018 contains a number of measures designed to reduce the incidence of the personal income tax (IRPF) on workers with income between €12,000 and €18,000, and on certain groups of taxpayers with specific personal circumstances, including those with greater family responsibilities, such as working women, large families and the disabled.

The Banco de España has recently developed various microsimulation models to evaluate the effects of tax reforms on the incomes of different groups of taxpayers.[1] These models simulate the incidence of tax changes on a representative sample of the total population of taxpayers, so that they are especially appropriate to identify the extent to which the tax obligations of different groups of individuals may change.

This box presents the effects of the changes to the IRPF included in the State Budget Law on different groups of taxpayers, according to characteristics such as their level of income and age, making use of the abovementioned microsimulation tools.

In the case of the IRPF, the following changes – reflecting the measures included in the law – have been simulated.[2]

— A rise in the income tax threshold from €12,000 to €14,000.

— An increase in the amount of the reduction in the tax base for gross earnings from employment of between €14,000 and €18,000.[3]

— The introduction of a new tax credit of €1,200 for a disabled spouse.

— An increase of €600 in the large-family deduction, for each child above the minimum number required for the family to obtain the status of ordinary or special large family.

The microsimulation model estimates that some 3.1 million taxpayers will directly benefit from the reform, with an average reduction in the tax of approximately €500.[4] The deciles of the

---

1 See O. Bover, J. M. Casado, E. García-Miralles, J. M. Labeaga and R. Ramos (2017), *Microsimulation tools for the evaluation of fiscal policy reforms at the Banco de España,* Occasional Papers, No 1707, Banco de España.

2 The model data correspond to the 2014 IRPF sample of the IEF-AEAT (persons filing tax returns), which is a random sample of somewhat more than two million anonymised IRPF returns for 2014.

3 The maximum amount of the deduction is raised to €5,575 and is applicable to gross income from employment of €14,000 (i.e. the new tax threshold), provided that other income does not exceed €6,500. In practice, other elements of the tax ensure that in that case the tax liability is zero. For incomes of more than €14,000, the deduction declines linearly, reaching zero for gross income from employment of €18,000. Before the reform the maximum amount of the deduction (€3,700) was applicable up to the tax threshold then in force of gross income of €12,000 (with a similar mechanism of linear decline in the abovementioned deduction, which reached zero for gross employment income of approximately €15,400).

4 In aggregate terms, the microsimulation model estimates that the total cost of the tax reduction is somewhat more than €1.5 billion, while the presentation of the draft State Budget Law estimates a tax reduction of some €2.2 billion. There are three explanations for the difference between the model estimate and the official one. First, the model does not take into account the new deduction for nursery expenses, as this variable is not included in the IRPF return. Second, as the model uses 2014 data the distribution of income is outdated. This may be particularly relevant to the estimate of the cost associated with the increase in the deduction for employment income, insofar as the employment creation observed since 2014 might be expected to have increased the number of persons benefiting from this measure. Third, the model estimates the reductions in tax liability using socio-demographic data for 2014.

Chart 1
SIMULATION OF THE REDUCTION IN IRPF

1 REDUCTION IN IRPF: CHANGE IN REVENUE BY INCOME DECILE
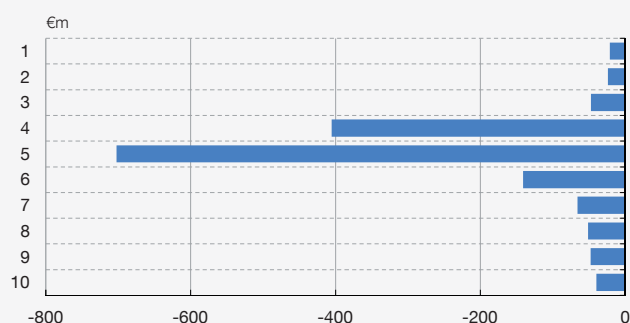
2 REDUCTION IN IRPF: CHANGE IN REVENUE BY AGE GROUP
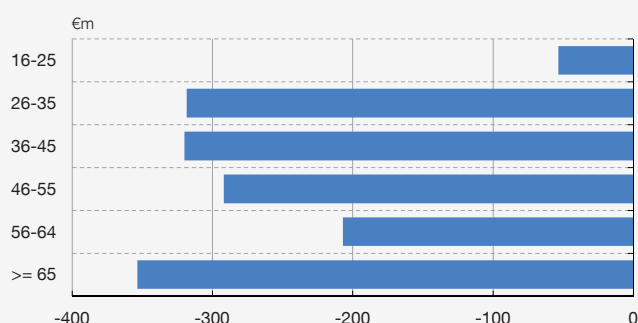
SOURCE: The Banco de España's IRPF microsimulation model.

income distribution that benefit most from the reform are the fourth and fifth, since it is in these that employees with gross income between €12,000 and €18,000 are mainly situated (see Chart 1.1 and Table 1). Specifically, 2.3 million taxpayers would see an average reduction in their tax liability under the IRPF of some €480. By age group, almost 21% of taxpayers under the age of 35 would pay less tax under the IRPF (some 0.8 million persons), with an average reduction of somewhat less than €450. For their part, 16% of the over-65s (some 0.6 million taxpayers) would see their tax liability under the IRPF reduced by an average of around €600 (see Chart 1.2 and Table 1.2). It should be pointed out that no taxpayers would suffer an increase in their tax liability under the IRPF as a consequence of the reform.

However, it should be noted that the analysis was performed in a partial equilibrium context, so that it does not take into account any effect of the tax changes on agents' economic decisions. In particular, in principle, changes in the taxation of employment income affect individuals' labour supply decisions, and thus, given the increase in net-of-tax wage earnings, there may be economically inactive persons who decide to enter the labour force or persons already in employment who choose to work more hours. Presumably, all these effects will be modest, given the small size of the measures adopted. Finally, the methodology used does not capture the fact that, over a longer time horizon, the financing of measures adopted now will require either reductions in spending or else the raising of additional resources, which would probably affect the net income of the various groups of taxpayers unevenly.

Table 1
REDUCTION IN IRPF: CHANGE IN TAX BY INCOME DECILE

	Total			Income increases			Income decreases			Income unchanged	
Deciles	Population (millions)	Change (€m)	Change (€)	Number (millions)	Percentage of total	Average increase (€)	Number (millions)	Percentage of total	Average reduction (€)	Number (millions)	Percentage of total
1	1.9	21	10.8	0.0	1.1	946.5	0.0	0.0	0.0	1.9	98.9
2	1.9	24	12.3	0.0	1.2	1,027.6	0.0	0.0	0.0	1.9	98.8
3	1.9	47	24.1	0.2	8.6	281.5	0.0	0.0	0.0	1.8	91.4
4	1.9	405	208.0	0.9	43.9	473.9	0.0	0.0	0.0	1.1	56.1
5	1.9	702	360.2	1.4	73.7	489.0	0.0	0.0	0.0	0.5	26.3
6	1.9	141	72.3	0.4	21.6	335.2	0.0	0.0	0.0	1.5	78.4
7	1.9	66	33.8	0.1	4.0	855.4	0.0	0.0	0.0	1.9	96.0
8	1.9	51	26.3	0.0	2.4	1,102.6	0.0	0.0	0.0	1.9	97.6
9	1.9	47	24.4	0.0	2.2	1,094.6	0.0	0.0	0.0	1.9	97.8
10	1.9	39	20.3	0.0	2.0	990.5	0.0	0.0	0.0	1.9	98.0
TOTAL	**19.5**	**1,544**	**79.3**	**3.1**	**16.1**	**493.3**	**0.0**	**0.0**	**-**	**16.3**	**83.9**

SOURCE: The Banco de España's IRPF microsimulation model.

Table 2
REDUCTION IN IRPF: CHANGE IN TAX BY AGE GROUP

	Total			Income increases			Income decreases			Income unchanged	
Age groups	Population (millions)	Change (€m)	Change (€)	Number (millions)	Percentage of total	Average increase (€)	Number (millions)	Percentage of total	Average reduction (€)	Number (millions)	Percentage of total
16-25	0.6	53	87.6	0.1	18.5	474.6	0.0	0.0	0.0	0.5	81.5
26-35	3.5	318	92.2	0.7	21.3	433.6	0.0	0.0	0.0	2.7	78.7
36-45	4.8	320	66.6	0.7	15.4	432.5	0.0	0.0	0.0	4.1	84.6
46-55	4.1	292	72.0	0.6	14.2	507.8	0.0	0.0	0.0	3.5	85.8
56-64	2.7	207	76.7	0.4	13.2	579.0	0.0	0.0	0.0	2.3	86.8
>= 65	3.8	353	92.0	0.6	15.9	578.6	0.0	0.0	0.0	3.2	84.1
TOTAL	**19.5**	**1,544**	**79.3**	**3.1**	**16.1**	**493.3**	**0.0**	**0.0**	**-**	**16.3**	**83.9**

SOURCE: The Banco de España's IRPF microsimulation model.

SENSITIVITY OF THE INCOME OF SPANISH GENERAL GOVERNMENT, NON-FINANCIAL CORPORATIONS
AND HOUSEHOLDS TO INTEREST RATE RISES

BOX 7

This box analyses the impact that a hypothetical rise in market interest rates would have on the income of Spanish general government, non-financial corporations and households.[1] For this purpose, a three-year horizon (2018-2020) is considered, on the basis of the data observed to March 2018, and a baseline scenario and three other alternatives – including various hypothetical situations involving market interest rate rises – are assessed. The exercises consider the impact on interest revenue and interest payments associated with the financial assets and liabilities, respectively, of the various sectors.

The baseline scenario envisages a gradual, moderate rise in market interest rates, in keeping with the expectations implicit in the yield curves. This scenario coincides with the baseline projections of the latest macroeconomic scenario published by the Banco de España.[2] The alternative scenarios envisage an increase in market interest rates – merely for illustrative purposes – of 100 bp above the levels of the baseline scenario. In the first such scenario, the rise is confined to yields up to a term of one year; in the second, to the medium- and long-dated segments of the curve; and in the third, the entire yield curve is shifted upwards. To simplify the exercise, it is assumed in these three scenarios that the macrofinancial variables, such as GDP and the volume of debt or assets, are not affected by the interest rate shock, such that the levels of these variables remain at the same values as in the baseline scenario.

---

1 This box is an update of Box 1.3 of the *Annual Report, 2016,* Banco de España.

2 See "Macroeconomic projections for the Spanish economy (2018-2020): the Banco de España's contribution to the Eurosystem's June 2018 joint forecasting exercise".

Chart 1
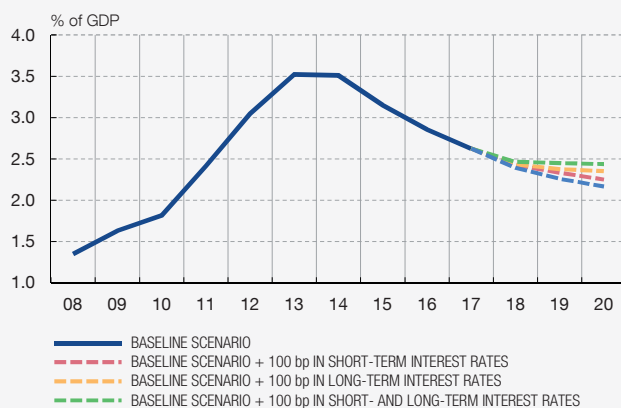GENERAL GOVERNMENT. NET BURDEN (a)

Chart 2
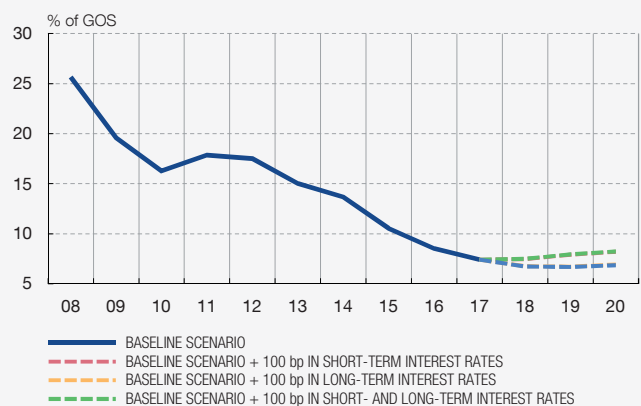NON-FINANCIAL CORPORATIONS. NET BURDEN (a)
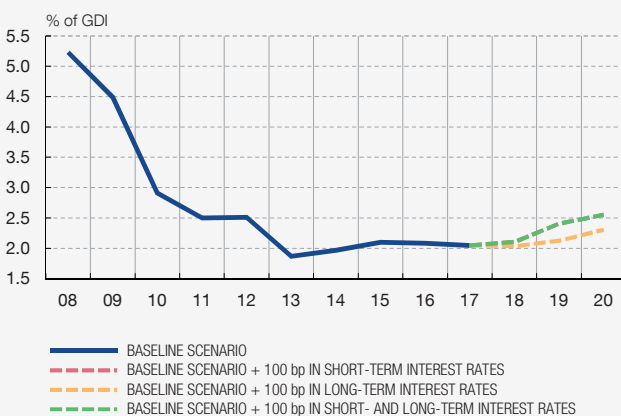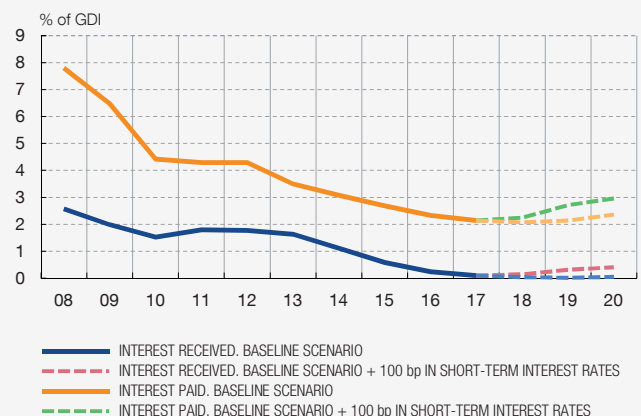

Chart 3
HOUSEHOLDS. NET BURDEN (a)

Chart 4
HOUSEHOLDS. FINANCIAL CHARGES AND REVENUE

SOURCES: INE and Banco de España.

a Interest paid on financing received less interest return on deposits.

SENSITIVITY OF THE INCOME OF SPANISH GENERAL GOVERNMENT, NON-FINANCIAL CORPORATIONS
AND HOUSEHOLDS TO INTEREST RATE RISES (cont'd)

BOX 7

To simulate the impact that market interest rate rises would have on economic agents' income, we estimated the behaviour of the fundamentals over the forecasting horizon under the various scenarios considered. Thus we estimated, firstly, the balances of certain financial assets (sight and fixed-term deposits) and liabilities (credit and debt securities) and, secondly, the interest rates linked to these instruments. Specifically, to determine the impact on the average return on deposits and the cost of households' and firms' outstanding loans, we used equations estimated from historical information that measure the habitual pass-through from market rates to these yields. In the case of debt securities issued by general government and firms, the maturity schedule for outstanding debt and future financing needs have been taken into account. Also, in new issues it was assumed that the proportion of short-term to long-term securities will be the same as that set by the Treasury for 2018, in the case of general government, and that observed in March 2018, in that of non-financial corporations.

Charts 1 to 3 present the results of the simulations for each of the three sectors analysed. For general government, given the predominance of long-term, fixed-rate financing, the impact of an interest rate rise on its net interest burden (difference between interest payments and interest revenue) is gradual and, comparatively, more marked when this rise is concentrated in the long-dated segment of the curve. The high inertia of interest payments in this sector, linked to the long duration of its liabilities, means that the net interest burden does not increase over the three-year horizon simulated under a scenario of moderately rising interest rates such as the baseline scenario, nor does it do so under the alternative scenarios. Regarding the effect of shocks, the results of the simulations show that a 100 bp increase in short-term interest rates would translate into a net interest burden that would be 0.1 pp higher in terms of GDP than under the baseline scenario at the end of the forecasting horizon (end-2020), while an increase of the same amount in long-term interest rates would mean a burden 0.2 pp higher. Under a scenario in which both rates increase simultaneously, general government net interest payments would rise by 0.3 pp of GDP compared with the baseline scenario. These effects are substantially larger than those estimated some years ago before the notable rise in general government debt, which has raised the sensitivity of the balance to changes in interest rates. The size of the effect is significant because, as disclosed when the Banco de España's most recent forecasts[3] were published, the envisaged intensity of the process of budgetary consolidation over the period 2018-2020 is, given the expected favourable cyclical environment, modest.

As shown in Chart 2, the business sector's net interest burden is more sensitive to increases in the short-term segment of the yield

curve, which reflects the prevalence of financing with a near-dated maturity and at a floating rate. This same characteristic means that the pass-through of market interest rate movements to the average costs of outstanding balances is swifter than in the case of general government. Even under the baseline scenario, which, as noted above, envisages gradual, moderate rises in interest rates, the net interest burden would eventually stand above the level recorded at March 2018, which indicates that there is no room left now for lowering the average cost of financing. The simulations show that a 100 bp rise in short-term interest rates would result in an increase in the sector's gross interest burden of 1.4 pp relative to its gross operating surplus (GOS) at the end of the forecasting horizon, in comparison with the baseline scenario. In the case of a rise in long-term interest rates, the net interest burden would scarcely increase by 5 bp. Combining the two shocks, the net impact would be somewhat less than 1.5 pp (i.e. approximately 0.35% of GDP). These effects are quantitatively high, but more moderate than those estimated just before the last crisis as a result of the notable deleveraging of this sector in recent years.

In the case of households, given the prevalence of variable-rate financing and the short duration of deposits, their financial expenses and revenue are fundamentally linked to the changes in short-term interest rates and practically insensitive to changes in the long-dated segment of the yield curve. Specifically, the impact associated with a 100 bp increase in short-term interest rates on debt interest payments is estimated at 0.6 pp of gross disposable income (GDI) at the end of the horizon considered (see Chart 3). The impact in net terms is more moderate, at somewhat less than 0.2 pp of GDI, since, for the sector as a whole, the higher debt interest payments are largely offset by the increase in the return on the sector's deposits (nearly 0.5 pp of GDI) (see Chart 4). As in the case of firms, it can be seen how, even under the scenario envisaging a gradual, moderate rise in interest rates (baseline scenario), both the gross and the net interest burden tend to rise over the course of the forecasting horizon, which suggests that the scope for further decreases in these two variables has been exhausted. Furthermore, and again similar to what occurred with firms, the notable household deleveraging in recent years, along with the growing trend of household deposits, has contributed to substantially moderating the negative income effect associated with interest rate rises.

In conclusion, the results of this Box show to what extent the income of the three sectors considered would be negatively affected by interest rate rises, this effect differing in each sector. In the case of general government, the impact is comparatively slower and takes place basically as a consequence of increases in medium- and long-term yields. By contrast, for households and firms the effects are much more rapid and mainly result from rises in short-term interest rates. Of these latter two sectors, firms are comparatively more affected by these shocks owing to their higher net debt.

3   See "Macroeconomic projections for the Spanish economy (2018-2020): the Banco de España's contribution to the Eurosystem's June 2018 joint forecasting exercise".

On 4 June 2018 the ECB published the results of the 18th round of the Survey on the Access to Finance of Enterprises (SAFE), covering the period from October 2017 to March 2018. The survey asks respondent firms, essentially small and medium-sized enterprises, about developments in the past six months in their economic and financial situation, their external financing needs and the conditions under which they have obtained or not such financing.

In the case of Spanish SMEs, the data for this latest round of the survey show, overall, that their economic and financial situation is trending positively, although with some signs of a certain deceleration. Hence, the number of firms reporting an increase in sales exceeded, for the eighth time running, those indicating the contrary. The difference of 20% (net percentage) between the two groups was lower than both the figure in the previous round (26%) and that for the euro area as a whole (24%, see Chart 1). Both labour and other costs rose for a high net proportion of SMEs of the sample (48% and 54%, respectively, compared with 50% and 54% in the euro area), and, as a result, profits performed somewhat less favourably than sales. Specifically, the percentage of companies that reported an increase in profits was 4 pp higher than those that stated the opposite, exactly the same as in the euro area as a whole and 3 pp lower than in the previous round.

When asked about their main source of concern, that indicated by the highest percentage of Spanish SMEs (25%, see Chart 2) was a lack of customers, while in the euro area as a whole the problem most frequently cited for the first time in the survey was a lack of skilled labour (24%). Set against this, access to financing was, among all the factors included in this question, once again that signalled by the fewest companies, 8% of those in both Spain and the euro area, this percentage being barely 1 pp more than six months earlier

Against this background, the proportion of Spanish SMEs that applied for bank loans grew by some 2 pp to 29% (see Chart 3), a figure slightly below that recorded in the euro area (30%) and close to the lowest values observed in the last few years. The access to bank loans continued to improve (see Chart 4). Thus, in net terms, 24% of Spanish SMEs reported an improvement in this aspect, 1 pp more than in the previous survey and 10 pp up on the

percentage recorded for their euro area counterparts. Moreover, the firms surveyed observed a favourable change in most of the factors affecting credit supply. Specifically, in net terms, 33% of Spanish SMEs perceived a greater willingness of banks to grant loans (a similar figure to that in the previous round of the survey), 25% reported an improvement in their specific situation (5 pp less than six months earlier), and 24% indicated an improvement in the general economic outlook (the same percentage as in the previous period).

The percentage of SMEs whose bank loan applications were rejected increased slightly by 1 pp to stand at 5%, a figure somewhat higher than that recorded in the euro area as a whole (4%). However, the broader indicator of the difficulties in obtaining bank loans[1] shows a slight improvement, with a decrease of 1 pp to 8% in the proportion of firms with this type of difficulty, very similar to the euro area figure (see Chart 5).

As regards financing conditions, the net percentage of firms reporting a decline in interest rates was positive for the seventh time running, albeit low (6%), and slightly (1 pp) down from the previous round (see Chart 6). Also remaining positive was the net proportion of companies that reported an increase in loan amounts (11%, down 5 pp from six months earlier). By contrast, Spanish SMEs as a whole perceived a slight shortening of maturities and a tightening in collateral required and in other loan conditions.

In sum, the latest round of the SAFE shows that, from October 2017 to March 2018, the access of Spanish SMEs to external financing continued to improve against a backdrop in which the economic and financial situation of these firms continued its favourable trend, although with some signs of a certain deceleration. The survey also shows that at the survey date Spanish SMEs anticipated favourable developments in their access to bank financing in the period from April to September 2018.

---

1 This indicator captures companies in the following situations: those whose applications for funds were rejected, those to which the funds were granted but only in part, companies to which loans were granted but at a cost deemed by the companies to be very high and those which did not apply for financing because they believed it would not be granted to them.
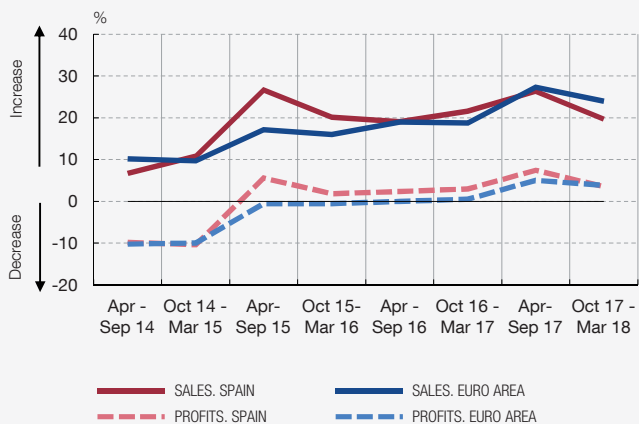
Chart 1
SALES AND PROFITS (a)

SALES. SPAIN
PROFITS. SPAIN
SALES. EURO AREA
PROFITS. EURO AREA

Chart 2
MAIN PROBLEMS AFFECTING ACTIVITY.
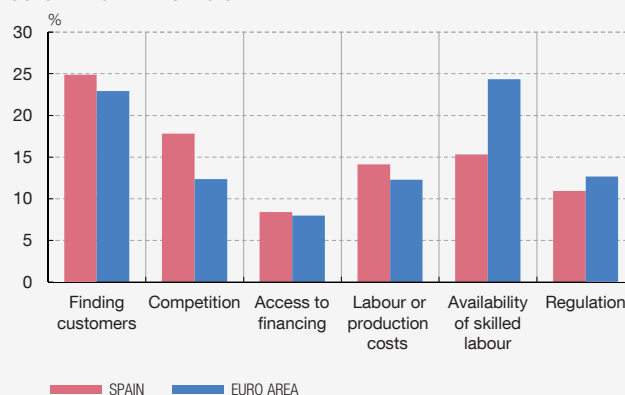OCTOBER 2017-MARCH 2018

SPAIN
EURO AREA

Chart 3
SMEs THAT HAVE APPLIED FOR BANK LOANS
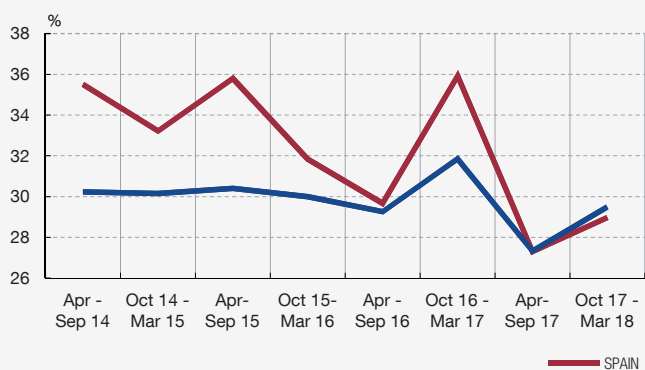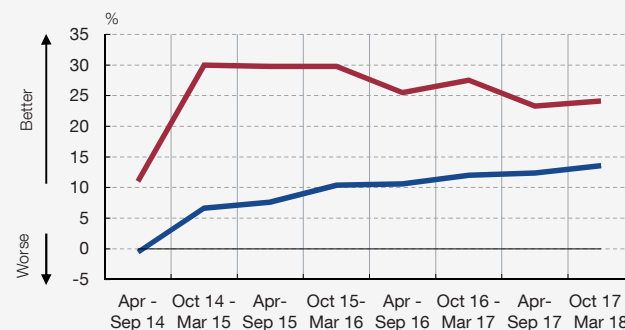

Chart 4
AVAILABILITY OF BANK LOANS (b)

SPAIN
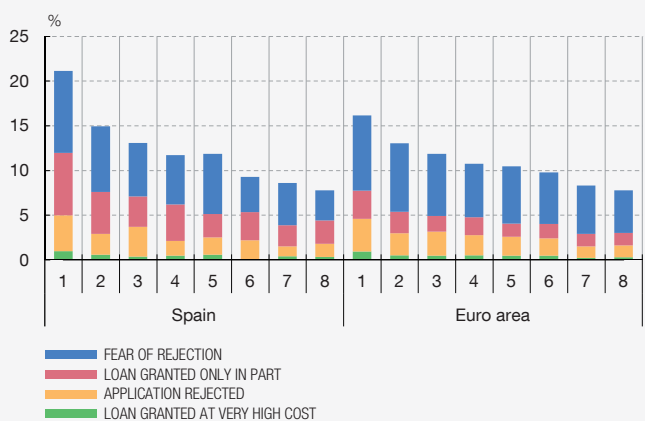EURO AREA

Chart 5
SMEs FACING DIFFICULTIES OBTAINING BANK LOANS (c)

FEAR OF REJECTION
LOAN GRANTED ONLY IN PART
APPLICATION REJECTED
LOAN GRANTED AT VERY HIGH COST

Chart 6
BANK LOAN CONDITIONS. SPAIN (d)

INTEREST RATES
MATURITY
OTHER CONDITIONS
LOAN AMOUNT
COLLATERAL REQUIRED
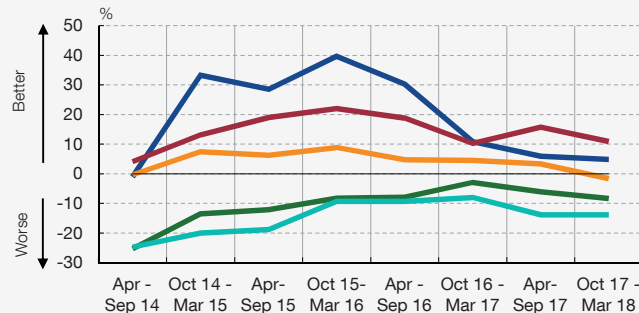
SOURCE: ECB.

a   Percentage of firms indicating an increase less the percentage of those indicatiing a decrease.
b   Percentage of firms indicating an improvement less the percentage of those indicating a deterioration.
c   This indicator captures the proportion of firms that are in one of the following situations: those whose loan applications were rejected, those whose loans weregranted but only in part, those whose loans were granted but at a cost deemed by the firms to be very high and those who did notapply for financing becausethey thought it would not be granted to them (fear of rejection). The numbers on the horizontal axis represent the survey rounds, with "1" denoting the period April-September 2014 and "8" the period October 2017 -March 2018.
d   Percentage of firms indicating better conditions (lower interest rates, higher amounts, longer maturities, less demanding collateral and other required conditions)less the percentage of firms indicating worse conditions.

2 EXTERNAL ENVIRONMENT OF THE SPANISH ECONOMY

**2.1 External environment of the euro area**

Global activity in 2018 Q1 slowed, there being some divergence between the weakening of the advanced economies -less marked in the United States- and the behaviour of emerging economies, with slightly more robust growth in general. The decelerating activity in the advanced economies seems to have continued in Q2, judging by the more frequent indicators, with the exception, once again, of the United States, where a strong rebound in growth is expected. In any event, the world economic outlook has been revised slightly downwards in recent weeks, against a background of growing risks derived from uncertainty over world trade relations and financial tensions arising in some emerging economies. Inflation rates have remained moderate in most of the regions. In the United States inflation has risen more sharply, spurring an increase in short and long-term interest rates in this economy and the strong appreciation of the dollar against most currencies. All of this has had a significant impact on the financial conditions in the emerging market economies with greater vulnerabilities.

The performance of international financial markets was uneven, with stock market gains in the developed markets, in a setting of low volatility, and a deterioration of emerging economies' markets. Long-term interest rates in the United States increased above 3%, ultimately reflecting monetary normalisation and the better growth prospects for this economy, although they subsequently dropped below this level, in part owing to political tensions in the euro area at the end of May, which prompted a flight to quality. The dollar appreciated across the board, particularly against emerging economies' currencies. The most weakened currencies were those of Latin America (especially the Argentine peso) and the Turkish lira (see Chart 4.4). The vulnerabilities of these two economies -with high inflation, substantial current account deficits and a high short-term external debt in the case of Turkey- led to downward pressure on their exchange rates and forced the reaction by the economic authorities of increasing interest rates substantially and, in the case of Argentina, requesting financial support from the IMF. Uncertainty about trade policies and the imposition of tariffs by the United States (see Box 1), together with certain global political factors and other idiosyncratic factors (such as the elections in Brazil, Mexico and Turkey) also contributed to generating financial tensions on emerging economies. Against this backdrop, there were significant capital outflows, particularly relating to debt markets, which led some central banks to intervene in foreign exchange markets to reduce exchange volatility (Brazil and Hong Kong) or to also raise the policy rates (Indonesia).
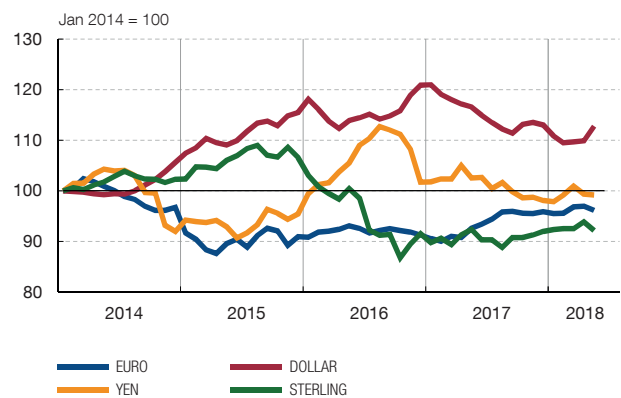
The aggregate index of commodities prices rose by 3.2% in the last quarter, owing to the combined effect of dearer energy and industrial metals, which offset the drop in agricultural commodity prices. The price of Brent increased by 18% during the last quarter, rising to 80 dollars per barrel, owing to the sharp fall in Venezuela's output, the re-imposition of US sanctions to Iran and the restriction of the supply by the OPEC and its members, in an environment of relatively buoyant global demand. The downward correction in the last few weeks, to 75 dollars per barrel, appears to be related to the prospect of increased output by both OPEC countries and the United States.

In the advanced economies, the GDP growth data for 2018 Q1 displayed a slowdown in activity, which could have had a temporary component (such as adverse weather or strikes in certain countries), although the latest high-frequency indicators suggest that the
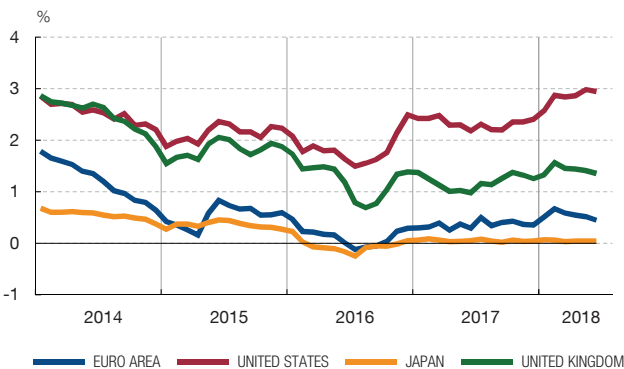
1 STOCK EXCHANGE INDICES

Jan 2014 = 100

EURO STOXX 50 — S&P 500 — NIKKEI
FTSE 100 — EMERGING MSCI
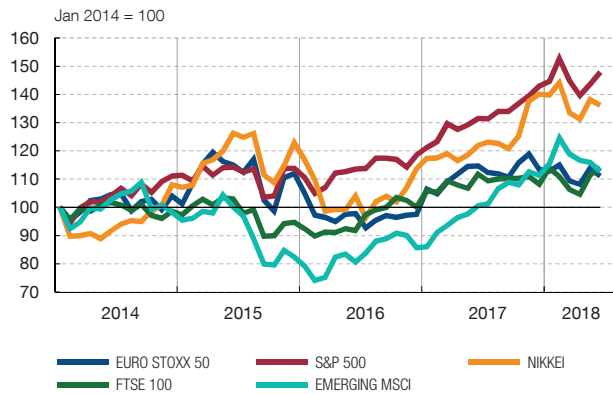
2 CPI-BASED REAL EFFECTIVE EXCHANGE RATES VIS-À-VIS DEVELOPED COUNTRIES (a)

Jan 2014 = 100

EURO — DOLLAR
YEN — STERLING

3 LONG-TERM INTEREST RATES (b)

%

EURO AREA — UNITED STATES — JAPAN — UNITED KINGDOM

4 COMMODITIES

Jan 2014 = 100

METALS — FOOD — TEXTILES — BRENT

SOURCES: Datastream and Banco de España.

a An increase in the index denotes an appreciation of the currency.
**b** Ten-year government debt yields.

slowdown may be more persistent in certain economies.[4] This is not the case in the United States, where, after moderating in Q1 (from 2.9% to 2.2%, in terms of an annualised quarter-on-quarter rate) a significant rebound is expected in Q2, underpinned by the expansionary effects of the tax reform. In Japan, GDP in Q1 contracted by 0.1% quarter-on-quarter, owing to the weakness of private consumption, and in the United Kingdom it grew by only 0.1% quarter-on-quarter, which reflects a strong slowdown relative to the previous quarter (0.4%), as a result of the negative contribution of external demand and, to a lesser extent, the slowdown of household consumption. The performance of inflation in these economies was also divergent. In the United States the year-on-year inflation rate reached 2.8% in May, and year-on-year core inflation stood at 2.2%, while growth in consumer prices moderated once again in Japan (to 0.7% year-on-year in May, having started the year at 1.4%) and in the United Kingdom, declining to 2.4% year-on-year from 3% at the beginning of the year. Against this background, the Federal Reserve raised the policy rates by 25 basis points (bp) at its June meeting (to the range of 1.75%-2%) and strengthened its communication about the path of future raises, while the remaining central banks maintained their monetary policy stance.

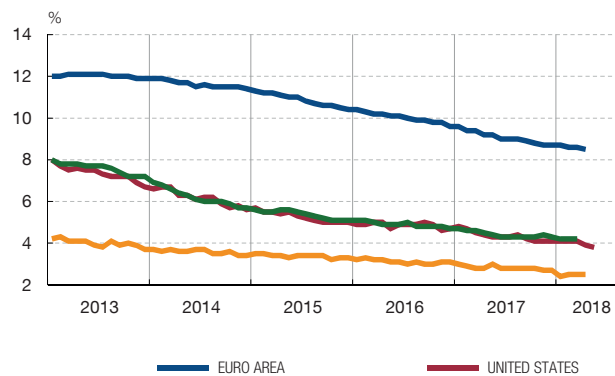────────────────

4   For the case of the euro area, see Box 2.
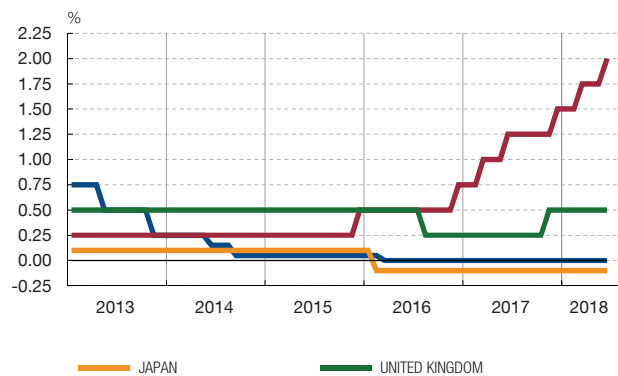
1 GROSS DOMESTIC PRODUCT
Year-on-year rate
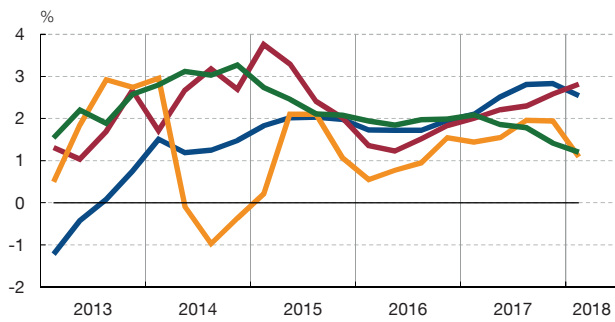
2 INFLATION
Year-on-year rate
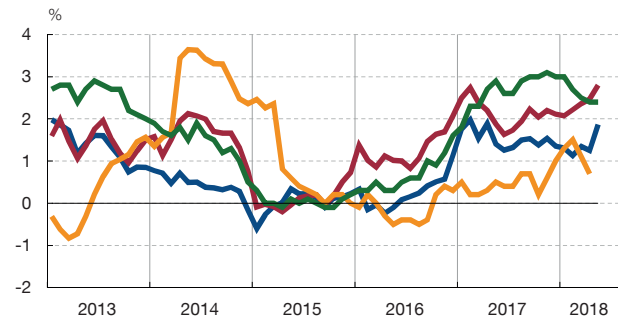
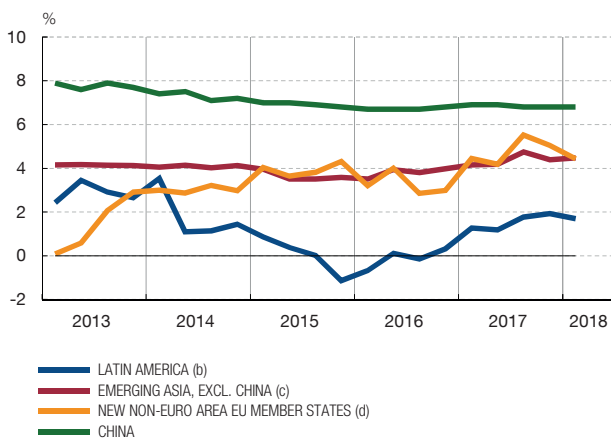3 UNEMPLOYMENT RATE (a)

4 POLICY INTEREST RATES

EURO AREA   UNITED STATES   JAPAN   UNITED KINGDOM

SOURCES: Datastream and Banco de España.

a Percentage of labour force.

In the emerging economies, activity in Q1 performed, in general, more favourably than in the advanced economies as a whole. In Asia, GDP growth in China remained at the rates of end-2017 (6.8% year-on-year), while in India GDP increased to 7.7%, 0.5 pp more than in the previous quarter. In Latin America, activity data for Q1 also showed an acceleration, especially in Mexico, with the notable exception of Argentina. Finally, growth rates remained high in Eastern Europe. As regards prices, the increase in inflationary pressures in India, which led the central bank to raise the policy rate, stood out, while in Latin America and Eastern Europe inflation remained low (except in Argentina and Turkey). Monetary policies hardly changed, except in the countries most affected by recent turmoil in the exchange markets or by incipient inflationary pressures (such as Mexico, which raised its policy rate by 25 bp following the Federal Reserve's decision).

2.2 The euro area and the monetary policy of the European Central Bank

The economic expansion in the euro area lost momentum in the early months of 2018, after several quarters of high growth. Although the slowdown reflects the effect of certain temporary factors, the weakness of the latest figures on industrial output and exports suggests that other elements, like the past appreciation of the euro or the uncertainty caused by recent protectionist pressures on world trade, might also be playing a role in the moderation of growth (see Box 2). Additional factors were the political tensions in Italy and the uncertainties posed by the new government's economic policy with regard to European commitments, which triggered bouts of financial instability in May that reverted in part over the course of June.

1 GROSS DOMESTIC PRODUCT
Year-on-year rate

LATIN AMERICA (b)
EMERGING ASIA, EXCL. CHINA (c)
NEW NON-EURO AREA EU MEMBER STATES (d)
CHINA

2 INTEREST RATE SPREADS OVER THE DOLLAR (e)

LATIN AMERICA (EMBI +)
EMERGING ASIA, EXCL. CHINA (GLOBAL EMBI)
NEW EU MEMBER STATES (GLOBAL EMBI)
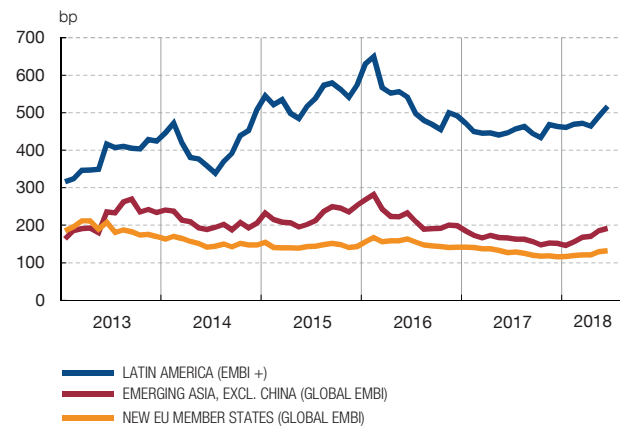
3 CONSUMER PRICES
Year-on-year change

LATIN AMERICA (b)
EMERGING ASIA, EXCL. CHINA (c)
NEW NON-EURO AREA EU MEMBER STATES (d)
CHINA
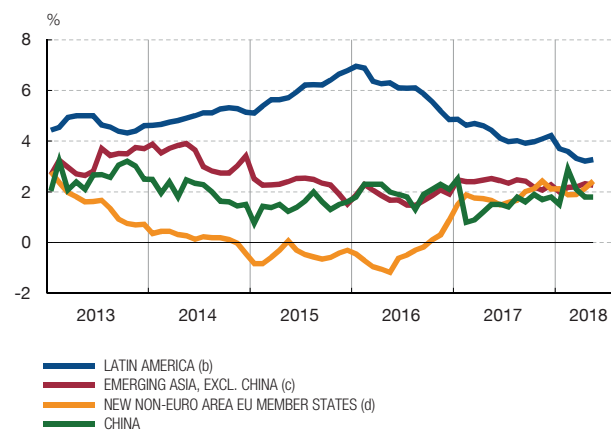
4 EXCHANGE RATES AGAINST THE DOLLAR (f)

BRAZILIAN REAL
MEXICAN PESO
ARGENTINE PESO
TURKISH LIRA
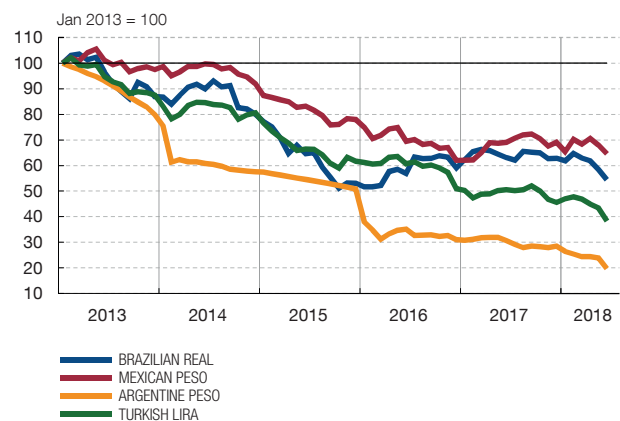
SOURCES: Datastream, Banco de España, IMF and JP Morgan.

a The aggregate of the different areas has been calculated using the weight of the countries that make up these areas in the world economy, drawing on IMF information.
b Brazil, Chile, Colombia, Mexico and Peru.
c Malaysia, Korea, Indonesia, Thailand, Hong Kong, Singapore, Philippines and Taiwan.
d Poland, Hungary, Czech Republic, Bulgaria, Romania and, from July 2013, Croatia.
e JP Morgan EMBI spreads. Latin America includes Argentina, Brazil, Colombia, Ecuador, Mexico, Panama, Peru and Venezuela. Asia includes China, Indonesia, Iraq, Kazakhstan, Malaysia, Pakistan, Philiippines, Sri Lanka and Vietnam. The data on the new EU Member States relate to Hungary, Poland, Romania and, from July 2013, Croatia.
f A decrease in the index denotes a depreciation of the currency against the dollar.

That said, world trade growth prospects, the continuation of a very accommodative monetary policy, the favourable performance of labour markets and a slightly expansionary fiscal policy suggest that GDP growth in the area will remain above its potential in the medium term. This is the scenario envisaged by the latest Eurosystem staff macroeconomic projections, which, after revising growth expectations for 2018 downwards (to 2.1%), owing to the negative surprise of Q1, maintain the projections for 2019 and 2020 at 1.9% and 1.7%, respectively (see Table 2). The exercise also noted that inflation can be expected to rise on a sustained basis to levels close to the medium-term monetary policy benchmark. Thus, inflation forecasts for 2018 and 2019 were revised upwards, to 1.7%, owing to the increase in energy prices and, to a lesser extent, to expectations of higher wage growth. For 2020 the expectation remains that overall inflation will stand at 1.7%, while core inflation will rise to 1.9%.

TABLE 2

	2018		2019		2020	
	GDP	HICP	GDP	HICP	GDP	HICP
European Central Bank (June 2018)	2.1	1.7	1.9	1.7	1.7	1.7
European Commission (May 2018)	2.3	1.5	2.0	1.6	—	—
OECD (May 2018)	2.2	1.6	2.1	1.8	—	—
International Monetary Fund (April 2018)	2.4	1.5	2.0	1.6	1.7	1.8
Consensus Forecast (June 2018)	2.2	1.6	1.8	1.6	—	—
Eurobarometer (June 2018)	2.3	1.6	1.9	1.6	—	—

SOURCES: ECB, European Commission, Consensus Forecast, IMF, MJ Economics and OECD.

Against this backdrop, at its mid-June meeting the ECB Governing Council considered that the conditions have been met to initiate a process of monetary normalisation, concluding that progress towards a sustained adjustment of inflation towards levels that are below, but close to, 2% over the medium term, has been substantial and is expected to continue in the next few months, underpinned by firmly anchored long-term inflation expectations, the underlying strength of the economy in the euro area and the continuing ample degree of monetary accommodation. Consequently, the Council announced that it would end net purchases of securities under the net asset purchase programme (APP) if the current inflation outlook is maintained and reiterated its intention to continue reinvesting maturities as they arise in its APP portfolio over a prolonged period after the end of the net asset purchases and, in any case, for as long as necessary. The Council maintained the key interest rates unchanged, also indicating that they will remain at their current levels at least through the summer of 2019 and, in any case, for as long as necessary to ensure that the evolution of inflation remains aligned with the current expectations of a sustained adjustment path.

ECONOMIC DEVELOPMENTS

In 2018 Q1, euro area GDP grew at a pace of 0.4% quarter-on-quarter, three percentage points below that of 2017 Q4 (see Table 3). In year-on-year terms, the growth rate declined to 2.5%, from 2.8% in the preceding quarter. By component, output growth was underpinned by private consumption, which accelerated to 0.5% (compared with 0.2% in the previous quarter), and by gross fixed capital formation, which also grew by 0.5% against a background of continuing highly favourable financing conditions and high capacity utilisation. As a result, the contribution of domestic demand, excluding inventories, to GDP growth, held steady at 0.4 pp. Meanwhile, the contribution of net external demand was negative as a result of the sharp fall in exports, exceeding by far that recorded for imports, which may reflect, with some delay, the adverse effects of the appreciation of the euro observed in 2017. Growth slowed down across the board in most euro area countries at the start of the year, with the exception of Spain, where the output growth rate held steady at 0.7%. In the other larger economies, the pace of growth slowed by 0.3% in Germany and 0.5% in France (to 0.3% and 0.2%, respectively), and somewhat less in Italy and the Netherlands. In contrast with the slowdown of GDP, employment in the euro area continued to show signs of notable buoyancy, with an increase of 0.4% in 2018 Q1, compared with 0.3% in the preceding quarter.

Overall, the conjunctural information available for 2018 Q2 points to the moderation of the growth rate continuing in the most recent period (see Chart 5). In this connection, the qualitative indicators displayed a contractionary trend across the board. Thus, the

	2016		2017				2018	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
National Accounts (quarter-on-quarter rate)								
Gross domestic product	0.4	0.7	0.7	0.7	0.7	0.7	0.4	
Contributions to quarter-on-quarter change in GDP (pp)								
Internal demand, excluding inventories	0.4	0.6	0.3	0.8	0.2	0.4	0.4	
Change in inventories	0.1	0.1	-0.1	0.1	0.0	-0.1	0.2	
Net external demand	0.0	0.0	0.5	-0.1	0.5	0.4	-0.1	
Other indicators								
Unemployment rate (b)	9.9	9.7	9.5	9.1	9.0	8.7	8.6	8.5
HICP (year-on-year rate) (c)	0.4	1.1	1.5	1.3	1.5	1.4	1.3	1.9
CPI excl. unprocessed food and energy (year-on-year rate) (c)	0.8	0.9	0.8	1.2	1.3	1.1	1.3	1.3

SOURCES: Eurostat, ECB and Banco de España.

a Information available up to 12 June 2018.
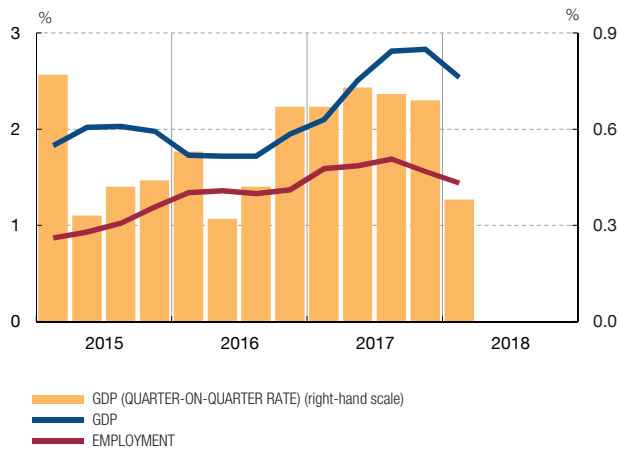b Average for the quarter. Latest figure available: April 2018.
c End of the period. Latest available figure: May 2018.

European Commission's (EC) business confidence indicators (except that relating to construction, which improved) declined until May, while the survey-based opinions of purchasing managers (PMI) increased slightly in June, after four months of decline. However, it is worth noting that consumer confidence and the job creation expectations reflected in the EC surveys remained stable, close to all-time high levels. Turning to external demand, the assessment of export order books also remained favourable, in contrast with the worsening outlook for exports and new orders from abroad since late 2017. As regards quantitative indicators, retail sales remained practically unchanged in April (0.1% compared with March), while new car registrations increased in May (2.1% compared with April), following three consecutive months of decline. On the supply side, industrial production fell by 0.9% in April with respect to the previous month and the unemployment rate decreased by 0.1pp, to 8.5%.
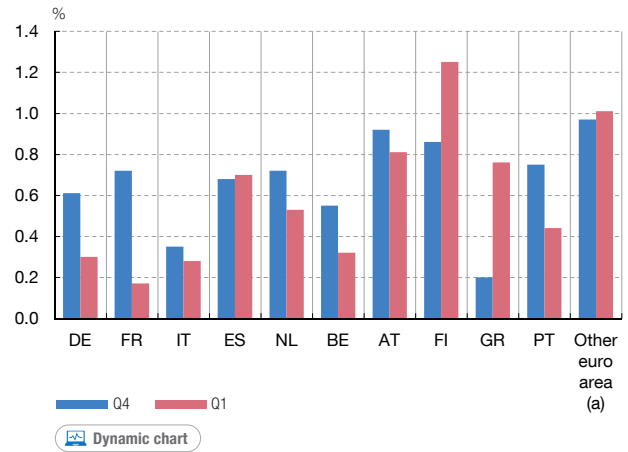
As regards prices, inflation accelerated to 1.9% in May, compared with 1.3% in April, reflecting more dynamic behaviour of all its components (in particular, energy), as a result of higher oil prices and the recent depreciation of the euro/dollar exchange rate (see Chart 6). Core inflation increased to a lesser extent, by 0.2 pp, to 1.3%, owing to a slight rise in services prices. Information on developments regarding collective bargaining in some euro area countries points to stronger wages, which could contribute to underpinning inflation in the medium term.

This year, the 2018 budgets of euro area countries point to a slightly more expansionary fiscal policy stance, which had been somewhat contractionary in 2017. As a result, the general government deficit could decline to 0.7% of GDP in 2018 for the euro area as a whole, according to the Eurosystem's June projections, owing both to the favourable impact of the economic cycle on government revenue and expenditure and to the containment of debt interest payments, which will offset some of the expansionary measures adopted in France and Italy. The EC assessed the stability programmes that countries had submitted in the spring, following which the Council approved France's exit from the excessive deficit procedure. In Italy, the new government's fiscal expansion plans generated
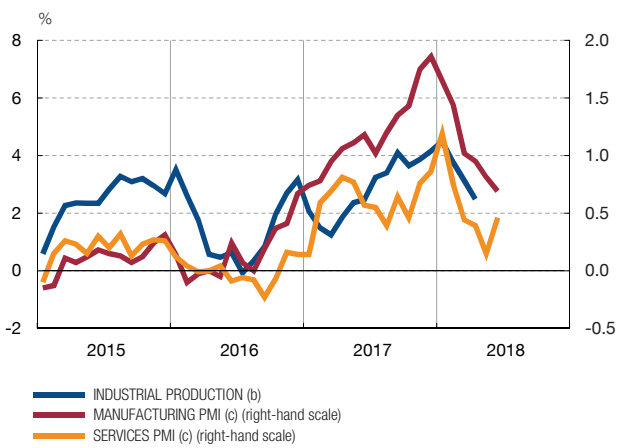
1 OUTPUT AND EMPLOYMENT
Year-on-year rate

%   %

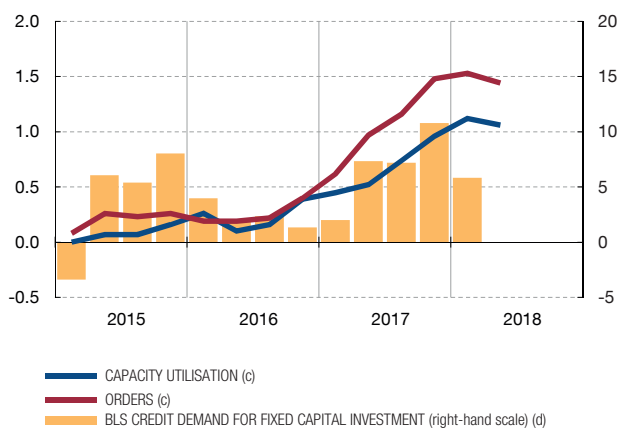GDP (QUARTER-ON-QUARTER RATE) (right-hand scale)
GDP
EMPLOYMENT

2 GDP BY COUNTRY
Quarter-on-quarter rate

%

DE FR IT ES NL BE AT FI GR PT Other euro area (a)

Q4   Q1

Dynamic chart

3 INDUSTRIAL ACTIVITY AND SERVICES INDICATORS

%

INDUSTRIAL PRODUCTION (b)
MANUFACTURING PMI (c) (right-hand scale)
SERVICES PMI (c) (right-hand scale)

4 CONSUMPTION INDICATORS

%

RETAIL SALES (b)
CONSUMER CONFIDENCE (c)

5 INVESTMENT INDICATORS

CAPACITY UTILISATION (c)
ORDERS (c)
BLS CREDIT DEMAND FOR FIXED CAPITAL INVESTMENT (right-hand scale) (d)

6 EXPORT INDICATORS

EXPORT EXPECTATIONS (c)
FOREIGN ORDERS (c)
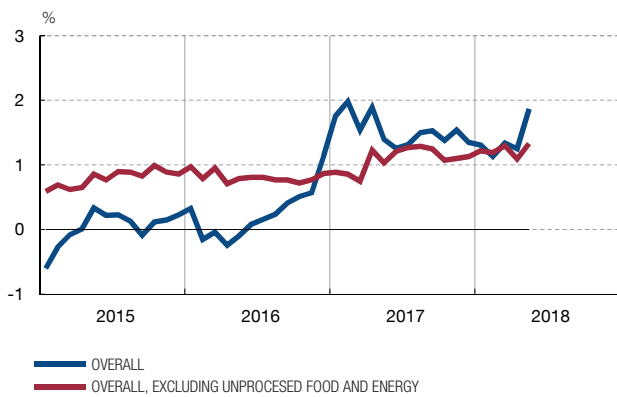EXTRA-EURO AREA VALUE EXPORTS (right-hand scale) (e)
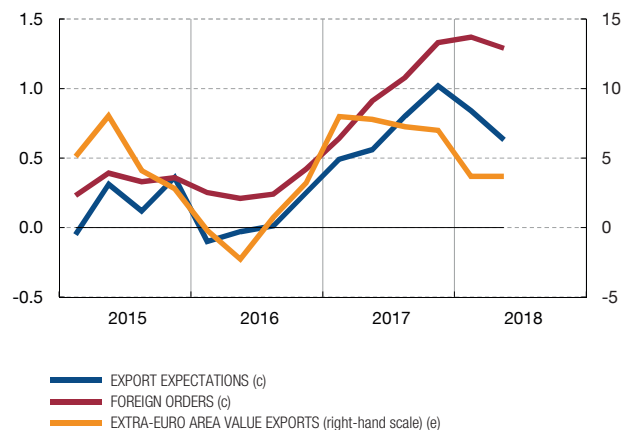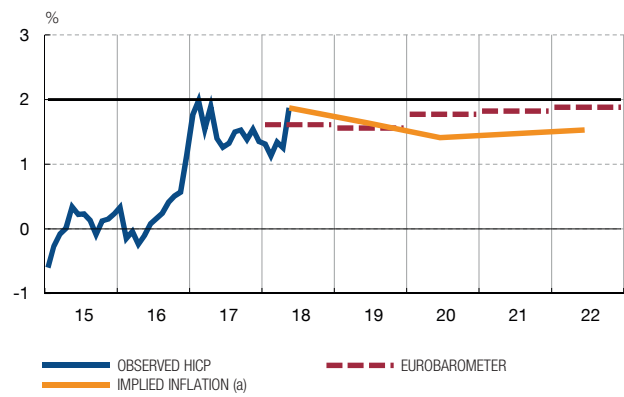
SOURCES: Eurostat, Markit Economics and Banco de España.

a   Ireland is not included owing to the high volatility of its data.
b   Year-on year rates, calculated on the basis of the non-centred quarterly moving average of the seasonally adjusted series.
c   Normalised series for the period represented.
d   Bank Lending Survey. Indicator = percentage of banks reporting a considerable increase + percentage of banks reporting some increase × 0.5 – percentage of banks reporting some decrease × 0.5 – percentage of banks reporting a considerable decrease. A positive value denotes an increase.
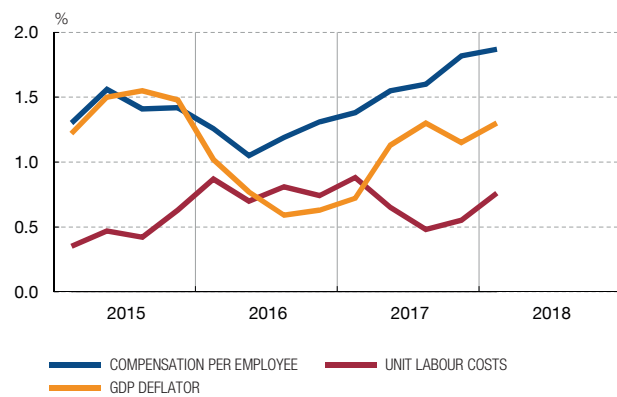e   Year-on-year rates of the original monthly series. Quarterly average.

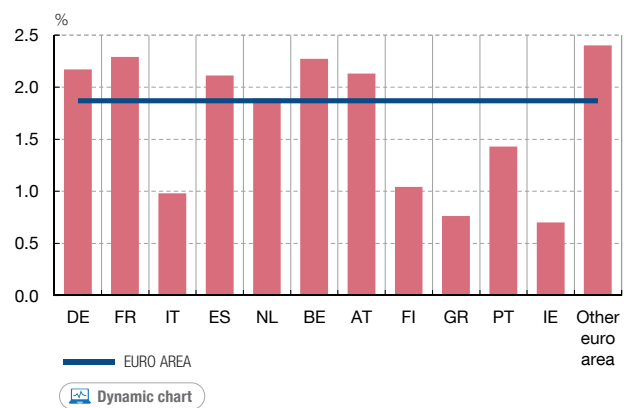Download

1 HARMONISED INDICES OF CONSUMER PRICES

OVERALL
OVERALL, EXCLUDING UNPROCESED FOOD AND ENERGY

2 INFLATION EXPECTATIONS

OBSERVED HICP
IMPLIED INFLATION (a)
EUROBAROMETER

3 WAGES AND COSTS

COMPENSATION PER EMPLOYEE
GDP DEFLATOR
UNIT LABOUR COSTS

4 OVERALL HICP
May 2018

EURO AREA

🔲 Dynamic chart

SOURCES: Eurostat, Reuters and ECB.

a Implied inflation calculated on the basis of inflation swaps.

📥 Download

a great deal of controversy. If implemented, these plans would lead to a breach of the debt reduction commitments acquired in the framework of the Stability and Growth Pact (SGP).

In addition, the Council approved the economic policy recommendations to countries in the context of the European semester, following analysis by the EC of compliance with these recommendations since 2011. In this respect, progress was reported in the reform of the financial system and in labour markets to foster permanent employment. However, there were hardly any reforms aimed at increasing tax bases and improving the long-term sustainability of public finances. In the horizon of the next 12 to 18 months, the recommendations centre on improving the business environment and investment conditions, through product and services market reforms. They also highlight the need to prepare the workforce (particularly young people) for the challenges posed by increasing digitalisation.

FINANCIAL DEVELOPMENTS
AND MONETARY POLICY

Developments in the financial markets of the euro area in 2018 Q2 were driven by doubts regarding the continued economic slowdown and, in particular, by the political uncertainty in Italy and the challenges posed by the government agreement to compliance with European commitments in crucial aspects such as fiscal rules in the euro area. This latest

development led to a marked increase in Italian sovereign debt spreads, with a limited contagion effect in other Southern European countries, while there were episodes of stock market correction which were most significant in the banking segment. Nevertheless, financial conditions eased somewhat over the quarter as a whole, owing to the depreciation of the exchange rate of the euro against the dollar and the across the board stock market gains, despite the aforementioned episodes (see Chart 7).

Against this backdrop, at its June meeting, the ECB Governing Council announced the start of a process of monetary policy normalisation, indicating that it expected to end net asset purchases in the framework of the APP in December. The Council also reinforced its forward guidance on policy rates, announcing that they would remain at their current levels[5] at least through the summer of 2019. Specifically, as regards the APP, the Council confirmed that the pace of purchases (a monthly €30 billion) would continue until September 2018 and that, if the current inflation outlook was maintained, monthly purchases would be reduced to €15 billion until December 2018, and would then come to an end. The Council intends to continue reinvesting the maturities as they arise in its APP portfolio over a prolonged period after the end of the net asset purchases and, in any event, for as long as necessary. With the APP having been in place for more than three years, the value of the portfolio acquired was more than €2.4 billion until May (more than 20% of euro area GDP) and reinvestments from June 2018 to May 2019 are expected to amount to more than €180 billion.
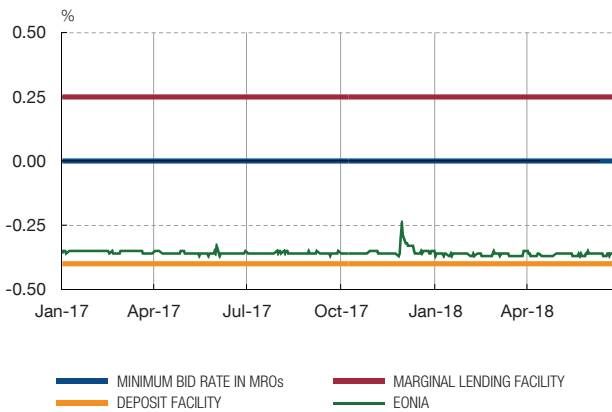
In the bond markets, the uncertainty observed in Italy since mid-May led to a sharp rise in interest rates on Italian government bonds, which was curbed in early June, when the new government made clear its commitment to remain in the single currency. This episode of instability spilled over, albeit with less momentum, into Portugal, Spain and Greece. In contrast, the German Bund yield declined owing to its role as a safe-haven asset, and an across-the-board increase in spreads was observed vis-à-vis German government debt. In the case of Italy, the spread reached almost 300 basis points (bp) at the end of May (compared with 132 bp at end-Q1), and subsequently moderated somewhat. In Greece, which will return to the market this summer once the third assistance programme ends, the spreads increased to 400 basis points, 100 bp higher than those observed in early 2018. The yield spread of US government debt vis-à-vis the German Bund continued its upward trend over the quarter, to stand at 258 bp (compared with 230 bp at end-March).

Turning to stock markets, the Eurostoxx 50 index moved on an upward path until May, when the uncertainty surrounding Italian economic policy led to a fall in stock prices on the main European markets, particularly in the banking sector, and to a rise in volatility. Overall, from the end of March, the Eurostoxx 50 barely changed, increasing by only 0.2%, following the decline observed in Q1.
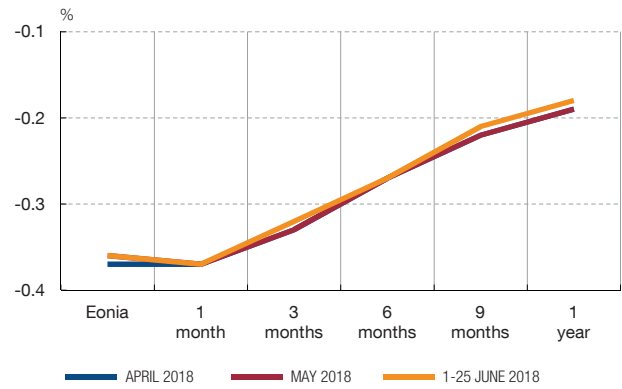
On the currency market, the euro exchange depreciated against the dollar (around 5%), probably owing to the divergences in the outlook for the future course of monetary policy in the euro area and the United States. The euro also depreciated against the yen, but appreciated vis-à-vis the pound sterling. Overall, in nominal effective terms, the euro exchange rate depreciated around 0.2% over Q2 (see Chart 7.6).

---

5 The interest rates on the main refinancing operations, the marginal lending facility and the deposit facility stood at 0%, 0.25% and 0.40% respectively.
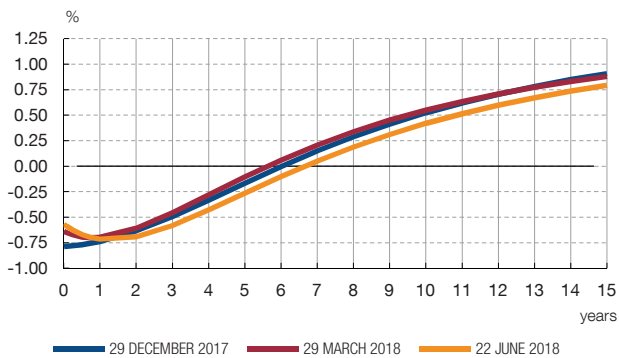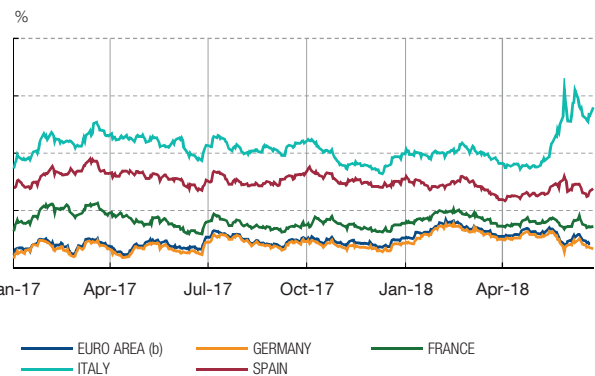
POLICY INTEREST RATES AND FINANCIAL CONDITIONS

CHART 7

1 EONIA AND ECB INTEREST RATES

%

0.50	
0.25	
0.00	
-0.25	
-0.50	

Jan-17   Apr-17   Jul-17   Oct-17   Jan-18   Apr-18

——— MINIMUM BID RATE IN MROs   ——— MARGINAL LENDING FACILITY
——— DEPOSIT FACILITY   ——— EONIA

2 INTERBANK MARKET
Monthly average

%

-0.1	
-0.2	
-0.3	
-0.4	

Eonia   1 month   3 months   6 months   9 months   1 year

——— APRIL 2018   ——— MAY 2018   ——— 1-25 JUNE 2018

3 ZERO COUPON CURVE (a)

%

1.25	
1.00	
0.75	
0.50	
0.25	
0.00	
-0.25	
-0.50	
-0.75	
-1.00	

0 1 2 3 4 5 6 7 8 9 10 11 12 13 14 15

years

——— 29 DECEMBER 2017   ——— 29 MARCH 2018   ——— 22 JUNE 2018

4 TEN-YEAR GOVERNMENT DEBT YIELDS

%

4	
3	
2	
1	
0	

Jan-17   Apr-17   Jul-17   Oct-17   Jan-18   Apr-18

——— EURO AREA (b)   ——— GERMANY   ——— FRANCE
——— ITALY   ——— SPAIN

5 EURO STOXX 50 INDEX AND IMPLIED VOLATILITY

Dec 2016 = 100

120			35
110			25
100			15
90			5

Jan-17   Apr-17   Jul-17   Oct-17   Jan-18   Apr-18

——— EUROSTOXX 50
——— IMPLIED VOLATILITY (right-hand scale)

6 NOMINAL EURO EXCHANGE RATE

1999 Q1 = 100   Dollar/euro

120			1.32
115			1.24
110			1.16
105			1.08
100			1.00

Jan-17   Apr-17   Jul-17   Oct-17   Jan-18   Apr-18

——— NOMINAL EFFECTIVE EXCHANGE RATE (NEER-38)
——— DOLLAR (right-hand scale)
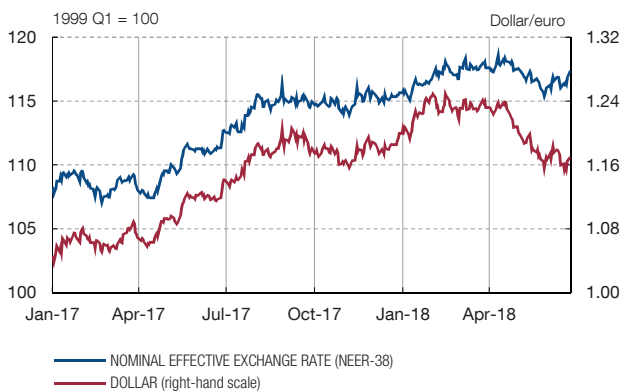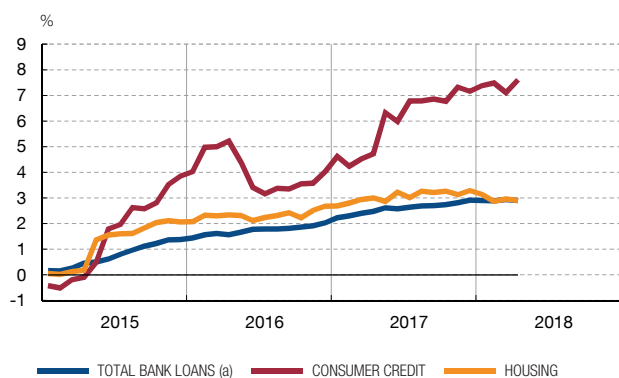
SOURCES: ECB and Banco de España.

a Estimated by the European Central Bank using swap market data.

1 HOUSEHOLDS
Year-on-year change

%

TOTAL BANK LOANS (a) — CONSUMER CREDIT — HOUSING

2 NON-FINANCIAL CORPORATIONS
Year-on-year change

%

BANK LOANS (a) — BONDS

SOURCE: ECB.

a Adjusted for securitisation and other transfers.

Download

The rate of expansion of loans to the private sector was maintained (see Chart 8). In the case of lending to non-financial corporations, the year-on-year increase held at 3.3% in April, while the related increase for loans to households did so at 2.9%. The Bank Lending Survey in the euro area for 2018 Q1 suggests that the buoyancy of credit is being sustained by easier lending standards and by an increase in demand, for households and non-financial corporations alike. The year-on-year rate of M3 stood at 3.9% in April, somewhat below the range in which it has been oscillating since the spring of 2015. The year-on-year rate of the narrowest aggregate, namely M1 (cash plus sight deposits), fell by 0.5 pp to 7%.
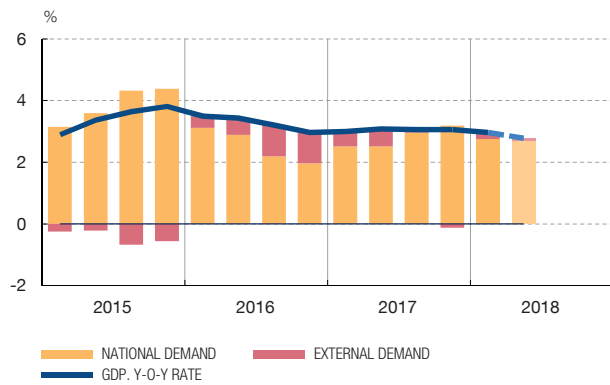
3 THE SPANISH ECONOMY

The quarter-on-quarter growth rate of the Spanish economy's GDP stood at 0.7% in 2018 Q1, coinciding with that seen in the two previous quarters (see Chart 9). The increase in output in the January-March period mainly arose from the growth of domestic demand, whose positive contribution increased by 0.1 pp to 0.7 pp. All the components of this aggregate quickened, except for investment in capital goods which contracted. Conversely, the contribution of net external demand decreased slightly by 0.1 pp to zero. Exports accelerated slightly less than imports following the muted rise of exports and the flattening of imports in 2017 Q4. In year-on-year terms, the GDP growth rate eased by 0.1 pp to 3% and the employment rate fell back 0.3 pp to 2.6%.

On the latest conjunctural information, GDP is estimated to have grown by around 0.7% in Q2, a similar rate to that of the preceding quarter. Domestic demand appears to continue to be the chief mainstay of GDP growth, whereas the contribution from external demand, on which there is limited information, appears to be very low and even slightly negative. The growth rate of employment seems to have increased somewhat.
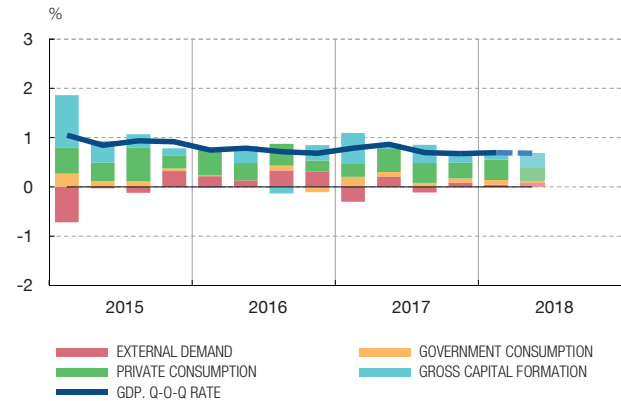
In the two months spanning April and May, consumer prices accelerated as a result of the stronger growth of energy prices, in keeping with the recent rise in oil prices and, to a lesser degree, the higher rate of increase of non-processed food prices. Core inflation showed much more stable behaviour in this period; its components – services, processed food and non-energy industrial goods – increased at rates similar to those posted in March. Thus the year-on-year rate of change in the CPI climbed from 1.2% in March to 2.1% in May, while the CPI excluding unprocessed food and energy – the price indicator used to proxy the core component – stood at 1.1% (1.2% in March).

The second quarter of the year began with stock price rises in Spanish markets, in line with those recorded in the rest of the euro area, and some stability of the risk premia of public and private debt securities. This changed in mid-May when political uncertainty in Italy had an adverse impact on the stock prices of European and Spanish companies, especially banks, and on the risk premia of public and private debt securities. In addition to this episode, there was political uncertainty in Spain stemming from the motion of no confidence in the government, which contributed further to the temporary rise in stock market volatility. After the new government was formed in Italy, there was a partial correction of these movements. Consequently, at the cut-off date for this report, the IBEX-35 was barely 0.2% above its levels at end-March, matching identically the change in the EURO STOXX 50 over the same period (see Chart 10.1). On the Spanish government bond market, despite the upgrade in the sovereign debt credit rating by two agencies in the quarter, the Spain-Germany 10-year government bond yield spread widened from 69 bp at end-March (a level not seen since April 2010) to just over 100 bp, although at the height of the tension it reached 132 bp. At the cut-off date for this report, the Spanish sovereign bond yield stood at 1.4%, some 20 bp above its levels at end-March, while its German counterpart was down by close to 20 bp. On the private debt markets, the risk premia of securities issued by non-financial corporations rose (by some 20 bp) as did – to a greater extent – those of financial corporations (by some 40 bp). Lastly, interbank market rates have hardly changed and, consequently, the one-year EURIBOR remains at levels very close to its all-time low (-0.18%).

1 CONTRIBUTIONS TO ANNUAL GROWTH

%

NATIONAL DEMAND　　EXTERNAL DEMAND
GDP. Y-O-Y RATE

2 CONTRIBUTIONS TO QUARTERLY GROWTH

%

EXTERNAL DEMAND　　　　　　　GOVERNMENT CONSUMPTION
PRIVATE CONSUMPTION　　　　　GROSS CAPITAL FORMATION
GDP. Q-O-Q RATE

Dynamic chart

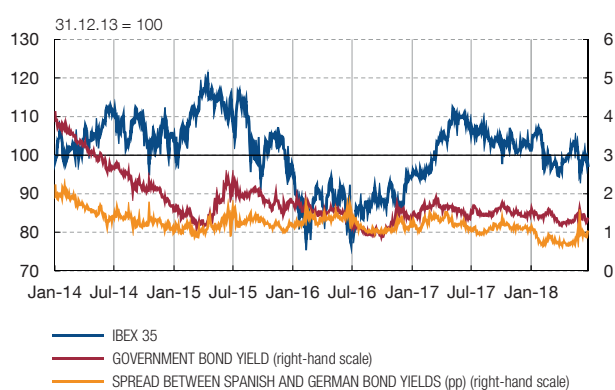SOURCES: INE and Banco de España.

a Seasonally adjusted series.

Download

In the year to date, financing conditions for the non-financial private sector have remained very accommodative, with the cost of bank credit holding at low levels, very close to its all-time lows. That has been conducive to the continued expansion of new lending volumes across all segments in recent months, albeit at slightly more moderate year-on-year growth rates than those observed at end-2017. These credit flow patterns have not led to any easing of the pace of the year-on-year rate of contraction of household or non-financial corporations' outstanding bank debt, and the decline of the latter's banking liabilities has intensified. Finally, the financial position of households and non-financial corporations has apparently continued to strengthen, owing to their higher income and lower debts against a background in which the average cost of liabilities has held at very low levels. This is reflected in the fact that the proportion of the net income of these sectors used to pay interest on debt is at historically low levels. Simulations of the effects of hypothetical rises in market interest rates on the income of households and corporations show that these impacts are relatively swift in the case of short-term interest rates and are more marked for corporations, given their greater net indebtedness (see Box 7).
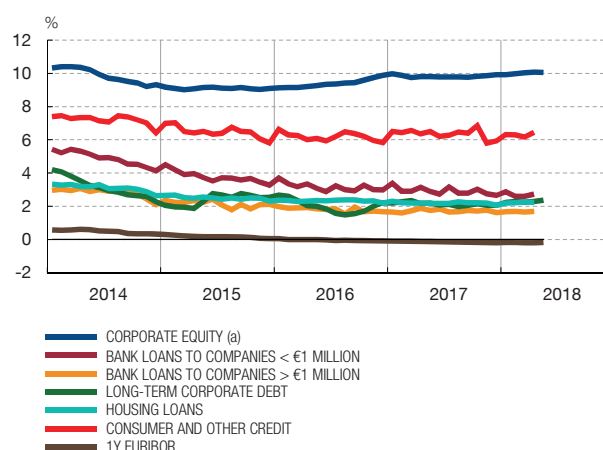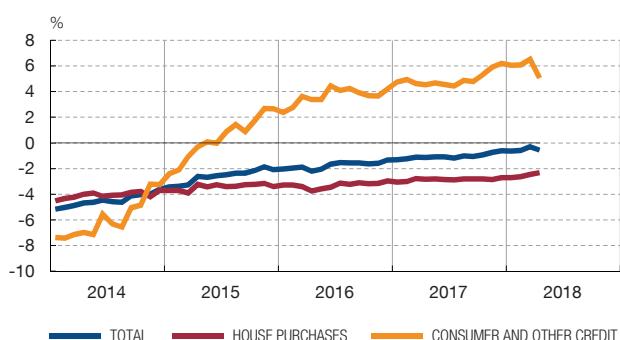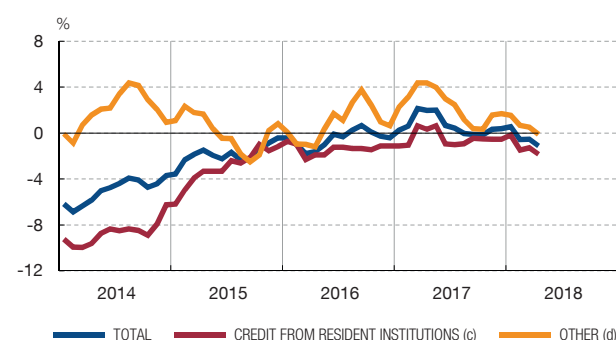
3.1　Household spending decisions

On the latest conjectural information available, the quarter-on-quarter rate of change of household consumer spending is estimated to have stood at 0.6% in Q2, a slightly lower rate of increase than that of the previous quarter (see Chart 11), against a favourable backdrop both of financial conditions and job creation. The quantitative indicators published since the last Report offer mixed signals. The retail trade index has slowed somewhat, while Social Security registrations have followed a similar pattern to that of the previous quarters. However, other indicators, such as the industrial production index (IPI), have moved on a more expansionary course. The qualitative indicators, such as the services and consumer goods manufacturing PMIs, have tended to be less resilient than in the opening months of the year, and the same pattern has been the case for the retail trade confidence index.

Turning to investment in housing, the latest conjectural information indicates that the growth rate in Q2 was high, although appreciably lower than that recorded at the start of the year. The coincident indicators, especially those for employment, are notably robust, although somewhat less so than in Q1. Open market house prices, according to information

1 EQUITY AND 10-YEAR GOVERNMENT BOND MARKETS

31.12.13 = 100

Jan-14 Jul-14 Jan-15 Jul-15 Jan-16 Jul-16 Jan-17 Jul-17 Jan-18

— IBEX 35
— GOVERNMENT BOND YIELD (right-hand scale)
— SPREAD BETWEEN SPANISH AND GERMAN BOND YIELDS (pp) (right-hand scale)

2 COST OF FINANCING

%

2014   2015   2016   2017   2018

— CORPORATE EQUITY (a)
— BANK LOANS TO COMPANIES < €1 MILLION
— BANK LOANS TO COMPANIES > €1 MILLION
— LONG-TERM CORPORATE DEBT
— HOUSING LOANS
— CONSUMER AND OTHER CREDIT
— 1Y EURIBOR

3 LENDING TO HOUSEHOLDS
Year-on-year rates (b)

%

2014   2015   2016   2017   2018

— TOTAL   — HOUSE PURCHASES   — CONSUMER AND OTHER CREDIT

4 FINANCING OF COMPANIES
Year-on-year rates (b)

%

2014   2015   2016   2017   2018

— TOTAL   — CREDIT FROM RESIDENT INSTITUTIONS (c)   — OTHER (d)

SOURCES: Reuters, Datastream, MSCI, INE and Banco de España.

a The cost of equity is based on the three-stage Gordon dividend discount model.
b Includes off-balance-sheet securitisation and loans transferred to Sareb.
c Loans from resident credit institutions and specialised lending institutions.
d Includes loans from non-residents and the issuance of debt securities (including that by resident subsidiaries).
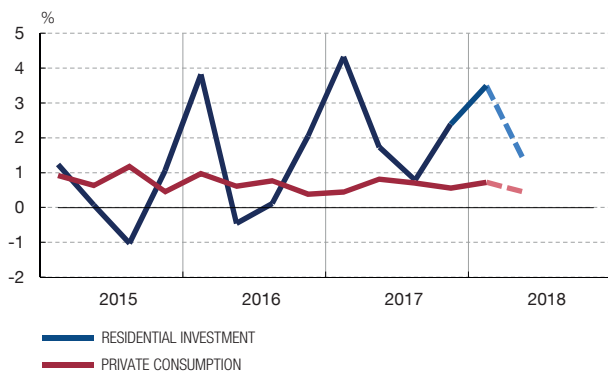
Download

published by INE, slowed in Q1 to a year-on-year growth rate of 6.2%, 1 pp down on the previous quarter. This diminished increase in house prices was the case both in the new housing and second-hand segments.

In 2018 to date, the profile of household financing costs has been fairly flat, holding at low levels. Hence the average interest rate applied to new lending for house purchases stood in April (the latest figure available) at 2.2%, and that on funds earmarked for consumption and other purposes at 6.4% (see Chart 10.2).

According to the Bank Lending Survey (BLS), financial institutions eased their lending standards once more in respect of households in Q1, both in the house purchase segment and in that for consumer credit and other lending. Likewise, the BLS signals softening in the general conditions applied to credit to households, which was more marked in the consumer segment. Specifically, the margins on average loans narrowed, while on the contrary those on credit for house purchases entailing greater risk increased. On the demand side, the BLS shows that loan applications by this sector rose in 2018 Q1, with this increase somewhat more marked in consumer credit and other lending.
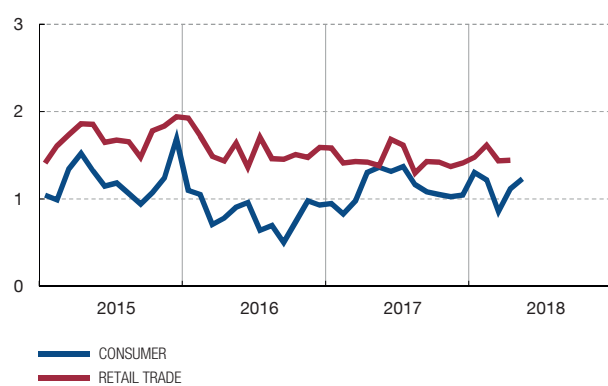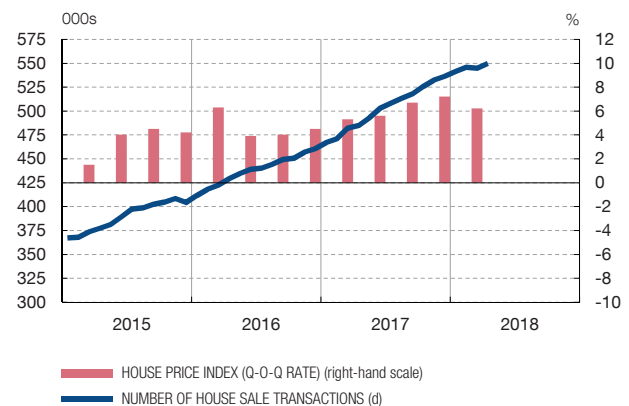
1 HOUSEHOLD SPENDING (QNA) (a)

RESIDENTIAL INVESTMENT
PRIVATE CONSUMPTION

2 CONSUMPTION INDICATORS (b)

RETAIL SALES INDEX
NEW CAR REGISTRATIONS (right-hand scale)

3 CONFIDENCE INDICATORS (c)

CONSUMER
RETAIL TRADE

4 HOUSE PRICES AND TOTAL TRANSACTIONS

HOUSE PRICE INDEX (Q-O-Q RATE) (right-hand scale)
NUMBER OF HOUSE SALE TRANSACTIONS (d)

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

a Quarter-on-quarter rates calculated on the basis of the seasonally adjusted series.
b Quarter-on-quarter rates of 3-month moving average with three lags, calculated on the basis of the seasonally adjusted series. The dot corresponds to the quarter-on-quarter rate.
c Normalised confidence indicators (difference between the indicator and its mean value, divided by the standard deviation).
d 12-month moving sum.

⬇ Download

This context of very accommodative lending standards and growing demand has continued to boost the increase in new lending volumes for households; however, in recent months the year-on-year rates of expansion have been more moderate than those posted in late 2017. This behaviour of lending activity has not been reflected in a reduction in the year-on-year rate at which the sector's banking debt has been falling back, which stood at 0.6% in April, unchanged on four months earlier (see Chart 10.3). This was as a result of consumer credit and other lending losing momentum, with its rate of increase diminishing to 5.1% in April, from 6.2% in December, a slowdown which was offset by the moderation of the rate of decline of loans intended for house purchase, which dipped to 2.3% in April, 0.4 pp less than at end-2017.

On the latest available data, households' financial position continued to improve during the first quarter of the year. Thus, the debt ratio relative to gross disposable income (GDI) continued to fall, attributable to the decline in outstanding debt and, to a greater extent, to the expansion in income, while the debt burden ratio scarcely changed (see Chart 12.1). Net household wealth is estimated to have increased once more in 2018 Q1, as a result of

1 DEBT AND DEBT BURDEN RATIOS
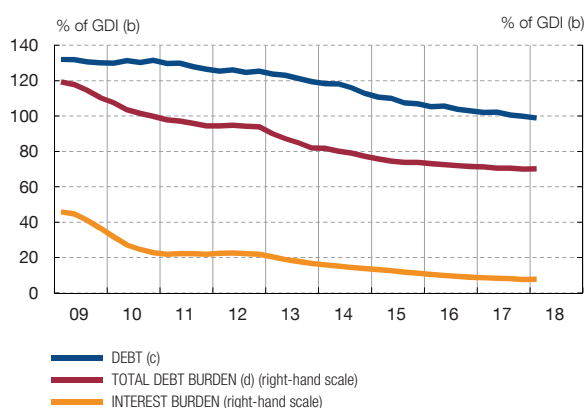
2 WEALTH
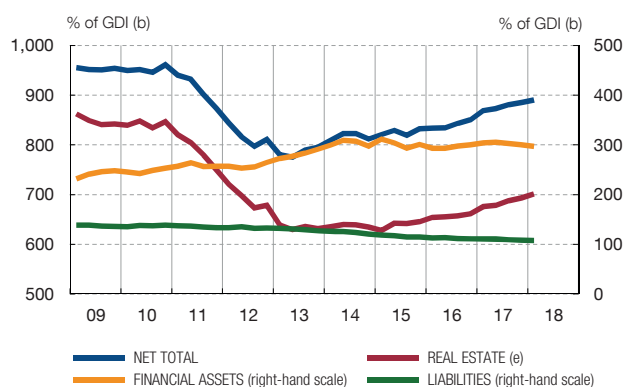
SOURCES: INE and Banco de España.

a The last data point in each series is an estimate.
b Cumulative four-quarter data.
c Includes bank lending and off-balance-sheet securitised lending.
d Estimate of interest payments and repayments of principal.
e Valuation based on estimated changes in stock of housing, average floor space and price per square metre.

the revaluation of households' real estate assets, which offset the reduction in their financial wealth, the latter influenced by the fact that the decline in assets outpaced that in liabilities (see Chart 12.2).

3.2 Business activity and investment

Business activity, proxied by the real value added of the market economy, appears to have grown at a faster pace in 2018 Q2 than in the opening months of the year, with stronger growth in particular in industry and energy.

Regarding business investment, the component associated with investment in capital goods in 2018 Q2 is estimated to have increased by around 1% quarter-on-quarter, compared with the decline observed in Q1 (-1.6%). The available information is still very limited, but the quantitative indicators, such as the capital goods IPI, point to such an improvement. For its part, investment in intangible assets appears to have maintained the favourable rate of growth recorded in Q1. The expected firmness of business investment in the near and medium-term, following the decline in Q1, would be consistent with a prolongation of the upturn, in a setting in which capacity utilisation is at historically high levels.
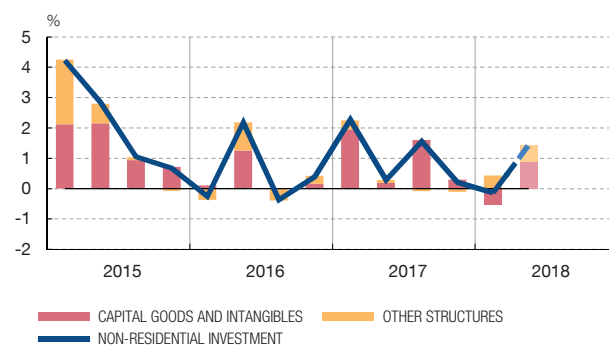
During the first months of the year, average interest rates on new bank loans to non-financial corporations remained close to their all-time lows. Thus in April (the latest data available), the average cost of a loan of less than €1 million was 2.7%, and 1.7% for a loan over that amount, almost the same as in the closing months of 2017, although down slightly, with small fluctuations, in the case of loans of less than €1 million. By contrast, between December and May, interest rates on long-term debt securities rose by approximately 30 bp to 2.4%, while the cost of equity rose by 15 bp (see Chart 10.2).

According to the results of the April BLS, institutions' credit standards for non-financial corporations remained unchanged in 2018 Q1, although overall terms and conditions

1 GROSS VALUE ADDED: MARKET ECONOMY (a)
Quarter-on-quarter rates and contributions

INDUSTRY AND ENERGY
MARKET SERVICES
MARKET ECONOMY
CONSTRUCTION
AGRICULTURE
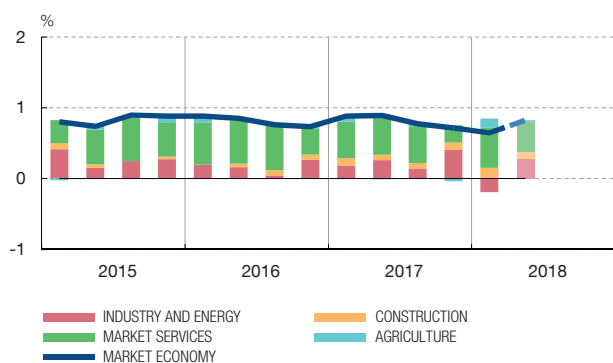
2 NON-RESIDENTIAL INVESTMENT (a)
Quarter-on-quarter rates and contributions

CAPITAL GOODS AND INTANGIBLES
NON-RESIDENTIAL INVESTMENT
OTHER STRUCTURES

3 ACTIVITY INDICATORS

COMPOSITE ACTIVITY PMI

4 INVESTMENT INDICATORS (b)

CONSTRUCTION SECTOR SOCIAL SECURITY REGISTRATIONS

SOURCES: INE, Ministerio de Fomento, Markit, Oficemen and Banco de España.

a Seasonally adjusted series.
b 3-month moving average rates with three time lags, calculated on seasonally adjusted series. Dots depict quarter-on-quarter rates.

Download

eased, with a decline in margins on average loans. In turn, perceived demand for funds remained steady. By contrast, according to the results of the latest ECB survey on the access to finance of enterprises in the euro area (SAFE), covering the period October 2017 to March 2018, Spanish SMEs perceive a further improvement in the availability of bank loans (see Box 8). This is the view expressed by 24% of Spanish SMEs, in net terms, which is 1 pp more than in the previous survey wave and 10 pp more than the figure recorded by their euro area counterparts. In addition, only 8% of Spanish SMEs (the same figure as for their European counterparts) reported having difficulties in accessing bank loans. Also according to the SAFE, the proportion of SMEs applying for loans rose by 2 pp to 29%, a figure that is close to the lowest levels of recent years.

Continuing favourable credit standards have underpinned continued year-on-year growth in credit activity in the segment of lending to non-financial corporations in recent months, albeit at a more moderate pace than at end-2017. The breakdown of new lending by volume shows a deceleration in the segment of loans for less than €1 million, which essentially covers SME transactions, and greater momentum in the segment of loans over €1 million. In terms of balances outstanding, in year-on-year terms the rate of contraction of loans extended by resident institutions to non-financial corporations rose to -1.9% in April, compared with -0.5% at end-2017 (see Chart 10.4). This was attributable to the lower rate of growth of new loans by volume, mentioned above, and in particular to higher repayments in the last three months, possibly related, in part, to the end (in January) of the calculation period for setting the interest rate on loans drawn by institutions under the

ECB's TLTRO II.[6] In turn, funding by issuance of debt securities, including issues made by resident subsidiaries, continued to grow year-on-year, albeit at a significantly slower pace (2.7% in April, compared with 7.5% in December), mainly attributable to base effects.

Lastly, it appears that the financial position of non-financial corporations continued to strengthen in 2018 Q1. Thus it is estimated that the debt ratio and, to a lesser degree, the debt burden ratio continued to decline in that period, as a result both of GDP growth and the decline in the sector's liabilities, in a setting in which the average cost of the outstanding balance of borrowed funds remained stable (see Chart 14). In accordance with the sample of non-financial corporations reporting to the Central Balance Sheet Data Office's Quarterly Survey, which are mainly large corporations, growth in productive activity and the favourable performance of financial revenue and costs drove ordinary profit up 15.9% year-on-year in 2018 Q1, a slightly lower rate of growth than that recorded a year earlier.[7] In turn, according to the SAFE, in the period October 2017 to March 2018 a net proportion of 4% of SMEs reported increases in profits, although this was 3 pp less than in the previous six-month period (see Box 8).

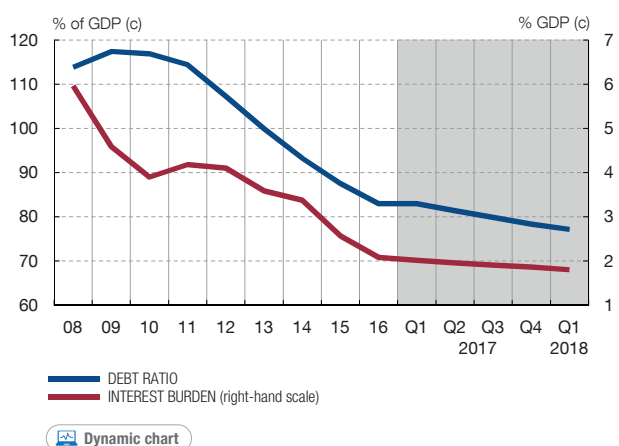## 3.3 The external sector and the balance of payments

Although still limited, the information available for Q2 suggests that net external demand made a neutral contribution to quarter-on-quarter GDP growth, similar to that observed in Q1. In year-on-year terms, the contribution of net external demand to GDP growth appears to have moderated, becoming practically neutral, against the backdrop of a certain decline in global growth momentum, possibly linked to growing uncertainty associated with escalating trade tensions (see Chart 15).

According to the latest Customs data, in March-April (thus avoiding the calendar effect of the different timing of Easter in 2017 and 2018), real flows of exports of goods continued to post all-time highs, despite decelerating somewhat (to year-on-year rates of around 1%), partly reflecting the difficulty in maintaining high year-on-year increases on export levels that were already high in March-April 2017, and possibly also factors associated with a loss of competitiveness owing to the exchange rate, built up in the past year vis-à-vis non-EU markets. By type of goods, the recovery of consumer durables, essentially vehicles, stands out among exports, linked to the gradual completion of the process of adapting Spain's manufacturing plants to produce new models. By geographical area, exports to Spain's main EU markets – France and Germany – were sound, while sales to extra-EU economies, especially South-East Asia, Japan and Latin America, weakened. However, qualitative indicators for May, such as new export orders in manufacturing PMI or export orderbooks in the business confidence indicator, would appear to point to a possible acceleration of exports in Q2, in a setting marked by a weakening of the euro. On the side of imports, the increase of around 3.5% year-on-year in purchases abroad in March-April was mainly underpinned by consumer durables and non-energy intermediate goods. In recent months, this rate of growth may have been adversely affected by rising commodity prices and the depreciation of the euro.
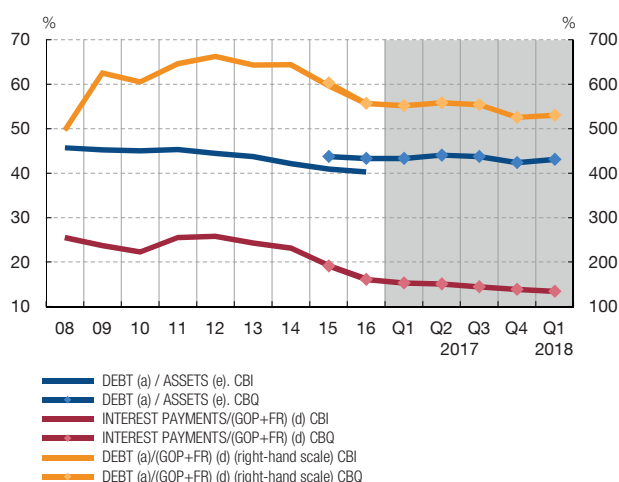
---

6 The interest rate on these operations was set so as to encourage lending and depended on the credit balance at January 2018. Specifically the interest rate was: i) -0.4% (the lowest possible rate) if the credit balance exceeded, by 2.5% or more, a bank-specific benchmark set according to the balance as at January 2016 and the net lending granted between February 2015 and January 2016; ii) 0% if the credit balance was below that benchmark; or iii) between 0% and -0.4% if the credit balance exceeded the benchmark but by less than 2.5% (in which case the interest rate was graduated linearly between 0% and -0.4%, depending on the percentage by which the credit balance exceeded the benchmark). See ECB Decision (ECB/2016/10) on a second series of targeted longer-term refinancing operations.

7 See Analytical Article, "Results of non-financial corporations in 2018 Q1" (forthcoming), *Economic Bulletin*, 2/2018, Banco de España.
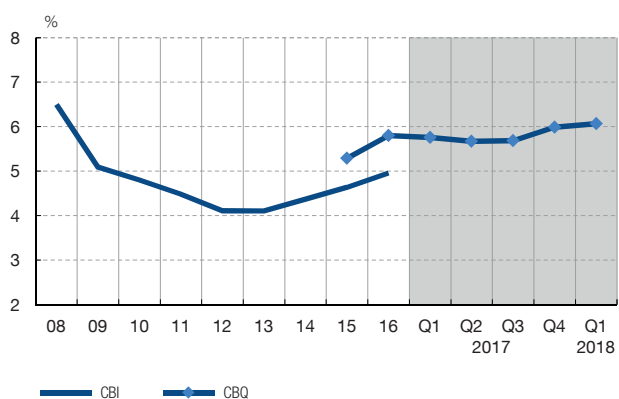
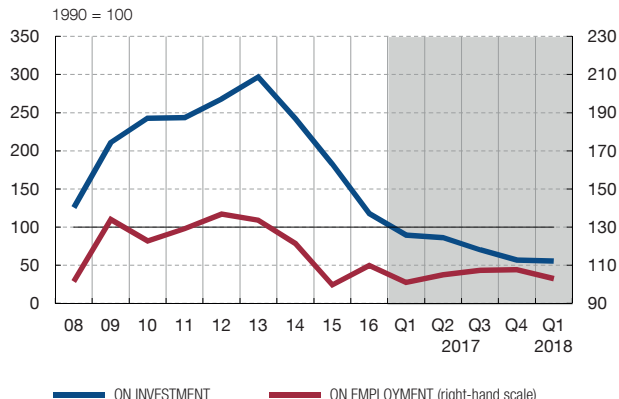**1 DEBT (a) AND INTEREST BURDEN. NATIONAL ACCOUNTS (b)**

% of GDP (c) — % GDP (c)

DEBT RATIO
INTEREST BURDEN (right-hand scale)

Dynamic chart

2 DEBT RATIO AND DEBT BURDEN. CBSO

% — %

DEBT (a) / ASSETS (e). CBI
DEBT (a) / ASSETS (e). CBQ
INTEREST PAYMENTS/(GOP+FR) (d) CBI
INTEREST PAYMENTS/(GOP+FR) (d) CBQ
DEBT (a)/(GOP+FR) (d) (right-hand scale) CBI
DEBT (a)/(GOP+FR) (d) (right-hand scale) CBQ

3 RETURN ON INVESTMENT. CBSO (f)

%

CBI   CBQ

4 SYNTHETIC INDICATORS OF FINANCIAL PRESSURE (g)

1990 = 100

ON INVESTMENT   ON EMPLOYMENT (right-hand scale)
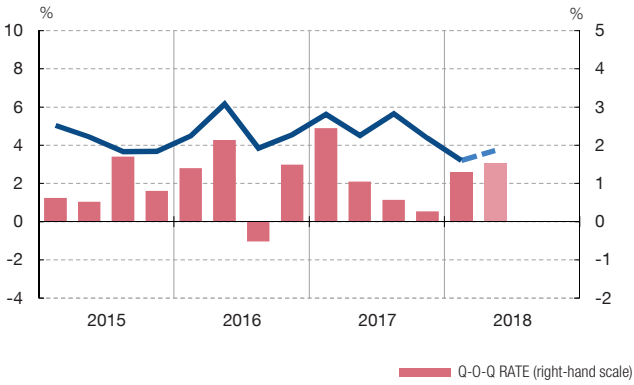
SOURCES: INE and Banco de España.

a   Interest-bearing borrowing.
b   The last data point in each series is an estimate.
c   GDP data series is seasonally adjusted.
d   Gross operating profit (GOP) plus financial revenue (FR).
e   Total inflation-adjusted asssets less non-interest bearing liabilities.
f   Ordinary net profit/net assets.
g   Indicators calculated on the basis of annual CBSO data, or quarterly data where no annual data are available. A value of more (less) than 100 denotes higher (lower) financial pressure than in the base year.
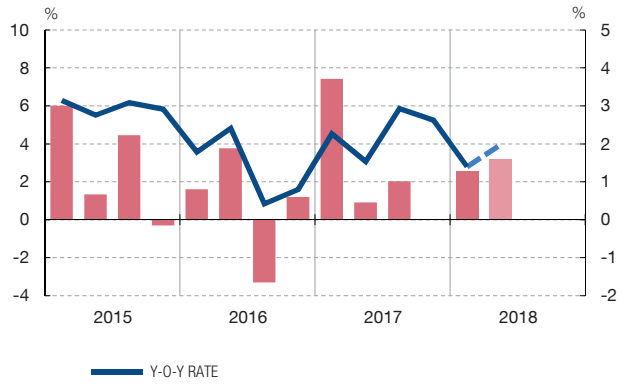
Download

Despite the historically high starting levels, foreign tourist arrivals continued to increase in March-April, albeit at a moderate pace (1.3% year-on-year), reflecting the gradual return to normal in the geopolitical situation of some of Spain's main competitor destinations, such as Turkey, the countries of North Africa and Greece. However, these figures mask a decline in the number of tourists from Spain's traditional source markets, such as the United Kingdom, France and Germany, that was countered by sound growth in other European source markets (Belgium, the Netherlands, Portugal, the Nordic countries and Russia), and by the continued notable momentum of other more distant source markets, such as the United States and the rest of the American continent. Despite the slower rate of growth of foreign tourist arrivals, their total spend continued to escalate (4.2% year-on-year), thanks to the renewed momentum of average spending per tourist.

CHART 15

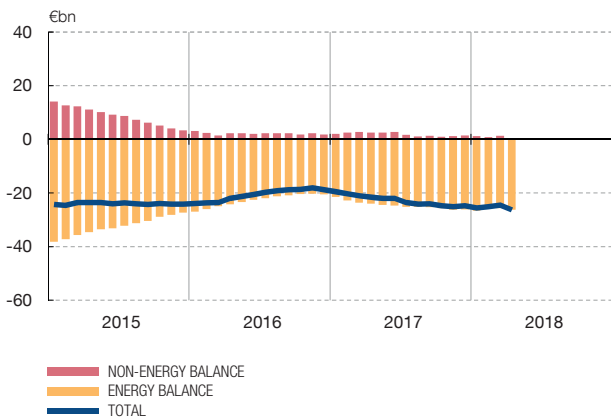**1 EXPORTS OF GOODS AND SERVICES (a)**

2 IMPORTS OF GOODS AND SERVICES (a)

Q-O-Q RATE (right-hand scale)   Y-O-Y RATE

3 CUSTOMS INDICATORS (b) (c)

EXPORTS OF GOODS   IMPORTS OF GOODS

4 TOURISM INDICATORS (c)

TOURISTS   OVERNIGHT HOTEL STAYS BY FOREIGN VISITORS

5 FOREIGN TRADE IN GOODS
Cumulative figures for the last 12 months

NON-ENERGY BALANCE
ENERGY BALANCE
TOTAL

6 BREAKDOWN OF CURRENT AND CAPITAL ACCOUNT (d)
Cumulative figures for the last 12 months

CAPITAL ACCOUNT
PRIMARY AND SECONDARY INCOME
TOURISM
NON-TOURISM SERVICES AND GOODS
NET LENDING (+) / NET BORROWING (-)
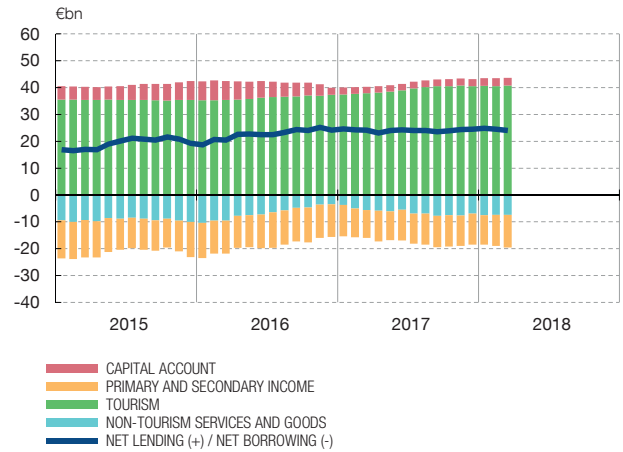
SOURCES: INE, Ministerio de Economía y Empresa, and Banco de España.

a QNA data at constant prices. Seasonally adjusted series.
b Series deflated using export (IPRIX) and import (IPRIM) price indices for industrial products.
c 3-month moving average rates with three time lags, calculated on seasonally adjusted series. Dots depict quarter-on-quarter rates.
d Data conform to the sixth edition of the IMF's Balance of Payments and International Investment Position Manual (BPM6).

Download

The Spanish economy's net lending position decreased in the most recent period. Specifically, on cumulative 12-month data, the balance-of-payments surplus stood at 2% of GDP in March (2.1% in 2017 as a whole). This resulted from the respective deteriorations in the goods and services surplus and in the primary and secondary income deficits, partially offset by an improvement in the capital account surplus (due to the recovery of EU funds, particularly the ERDF). For the second quarter, the recent rise in oil prices on the international markets, along with a less buoyant euro, point to a significant increase in the energy bill.[8]
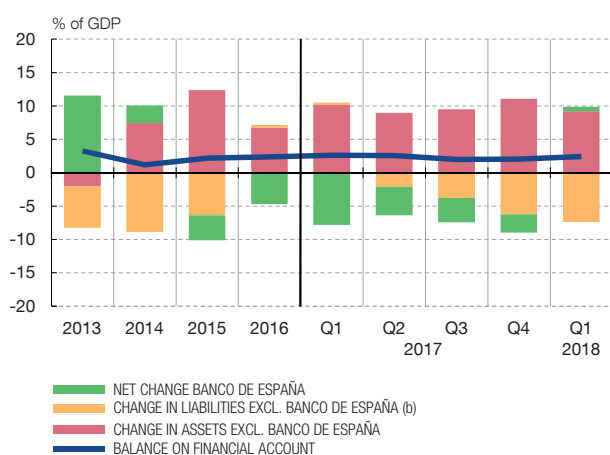
The most recent information available on the financial account of the balance of payments, relating to 2018 Q1, shows that the Spanish economy, excluding the Banco de España, had a credit balance of €5.9 billion, down from €9.2 billion in the previous quarter. This resulted from net acquisitions of foreign assets by Spanish agents (€34 billion) exceeding the increase in non-residents' holdings of Spanish assets (€28.7 billion) and from the positive net flow of transactions associated with financial derivatives (€0.5 billion). Acquisitions abroad by residents were mainly channelled through portfolio investment (€23.8 billion), which, as has been the case in recent quarters, consisted particularly of shares in investment funds of other resident sectors and of long-term debt securities of other monetary financial institutions. The amount of the transactions associated with direct investment and other investment was also positive, albeit smaller (€8.7 billion and €1.5 billion, respectively). On the liabilities side, net investments in Spain by foreigners were essentially concentrated in portfolio investment (€15.3 billion), mainly long-term general government debt securities (€14.2 billion). The remainder of non-residents' net investment was direct investment (€10 billion) and, to a lesser extent, other investment (€3.3 billion).

By institutional sector, the net flows associated with the assets and liabilities vis-à-vis the rest of the world were negative for general government (-€8 billion), in line with the net borrowing of this sector, and also for other resident sectors (-€5.3 billion), a circumstance not seen since 2014 Q2. Other monetary financial institutions posted a positive net flow vis-à-vis the rest of the world (€19.2 billion). The net credit balance of the financial account, excluding the Banco de España, together with the Spanish economy's slight net borrowing position in 2018 Q1, was reflected in an increase in the Banco de España's net debtor position (€3.2 billion) vis-à-vis the rest of the world. However, in cumulative 12-month terms, there was a decrease in the Banco de España's net debtor position (of €8.2 billion – see Chart 16.1), which had not happened since 2015 Q3.
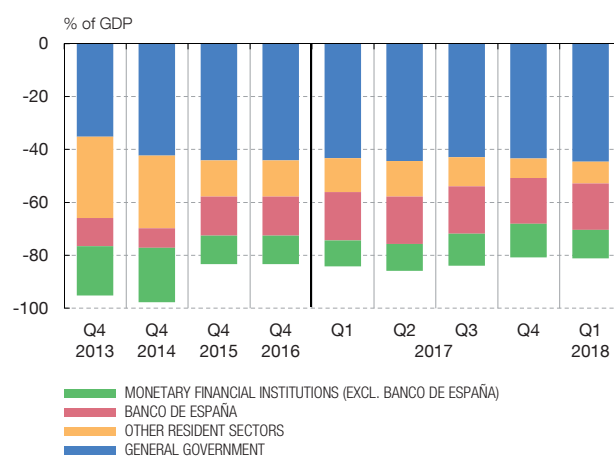
The most recent information available on the international investment position (IIP), relating to 2018 Q1, shows that the Spanish economy's net debt to the rest of the world increased by €13.2 billion in the first quarter, to stand at 81.3% of GDP, 0.4 pp more than in December (see Chart 16.2). This increase in Spain's debit balance resulted from the positive flow of net financial transactions in the period (€2.7 billion), offset by the negative amount of other flows (-€15.9 billion). The amount of the latter was determined by a decrease in assets exceeding that in liabilities. In the case of assets, the fall basically resulted from the appreciation of the euro and, to a lesser extent, from other changes in volume. The net losses in the value of liabilities were mainly due to a fall in the prices of shares and of investment fund shares which was only partially offset by the revaluation of debt instruments. Spain's gross external debt rose by 1.8 pp in terms of GDP with respect to December to stand at 166.7% in March 2018, which is 7.8 pp less than the peak reached in 2015 Q1.

---

8 Box 3 gives certain evidence that the negative effects of an oil price rise on the current-account balance may have decreased relative to past experience. This seems to be associated with a lower energy dependence and less powerful second-round effects on wage growth owing to higher inflation.

1 FINANCIAL ACCOUNT OF THE BALANCE OF PAYMENTS (a)

% of GDP

NET CHANGE BANCO DE ESPAÑA
CHANGE IN LIABILITIES EXCL. BANCO DE ESPAÑA (b)
CHANGE IN ASSETS EXCL. BANCO DE ESPAÑA
BALANCE ON FINANCIAL ACCOUNT

2 INTERNATIONAL INVESTMENT POSITION (c)

% of GDP

MONETARY FINANCIAL INSTITUTIONS (EXCL. BANCO DE ESPAÑA)
BANCO DE ESPAÑA
OTHER RESIDENT SECTORS
GENERAL GOVERNMENT

SOURCE: Banco de España.

a Four-quarter cumulative quarterly data.
b Sign changed.
c Assets minus liabilities vis-à-vis the rest of the world.

Download

3.4 Labour market

In 2018 Q1 employment growth was similar to that in 2017 Q4 (0.5%). The recent labour market indicators point to the persistence of notable dynamism of employment in the second quarter of the year. Social Security registrations continued to grow strongly, at a rate of 0.8% in May, in terms of the three-month moving quarter-on-quarter rate of change for the seasonally adjusted series, this growth rate having held steady since the end of 2017. The sectoral employment figures show a slowdown with respect to 2018 Q1 in construction, although this sector continues to show the highest growth, and in industry, while employment in services maintained a high rate similar to that in Q1. Employment in agriculture picked up. This information suggests that the quarter-on-quarter growth rate of employment in Q2, measured in QNA terms,[9] seems set to rise by 0.1 pp to 0.6%, slightly reducing the gap relative to the rise in Social Security registrations. In the case of the market economy, the rate of employment growth is also estimated to rise, to 0.7% (see Charts 17.1 and 17.2).

The drop in unemployment registered by the National Public Employment Service (SEPE by its Spanish abbreviation) moderated its pace slightly in May to 1.6% in terms of the three-month moving quarter-on-quarter rate of change of the seasonally-adjusted indicator (see Chart 17.2). In this context, the new contracts registered by the SEPE grew on average in the two-month April-May period by more than in the first quarter of the year. New hires accelerated more in permanent contracts than in temporary ones, such that the share of permanent contracts in the total rose by 1.5 pp relative to the same period of the previous year, moving up to 9.7%.

As regards wages, collective bargaining maintained up to May the trend shown since the beginning of the year. Thus, collective bargaining agreements registered up to May covered more than 5.7 million employees (4.4 million a year earlier) and the wage increases specified in them are slightly higher than those registered for 2017, being 1.6% for the current year. 89% of workers with a registered agreement had one entered into in previous years

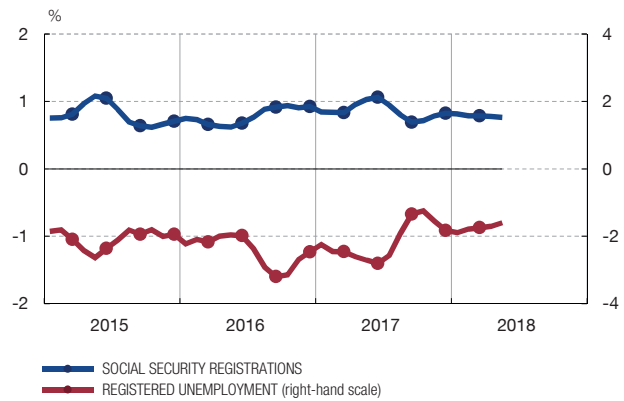9   In terms of full-time equivalent jobs

1 EMPLOYMENT
Quarter-on-quarter rates (a)

TOTAL ECONOMY (QNA)   MARKET ECONOMY (QNA)
TOTAL EMPLOYED (LFS)
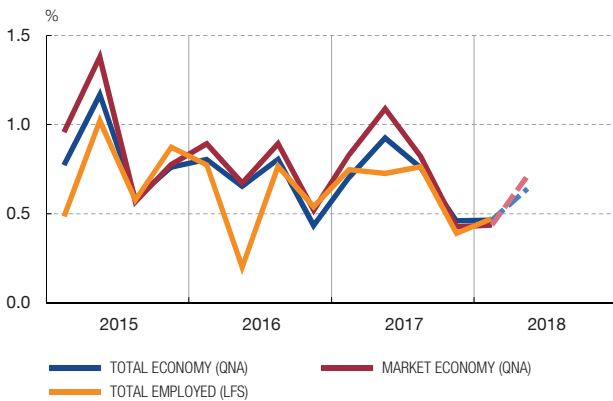
2 EMPLOYMENT AND UNEMPLOYMENT INDICATORS
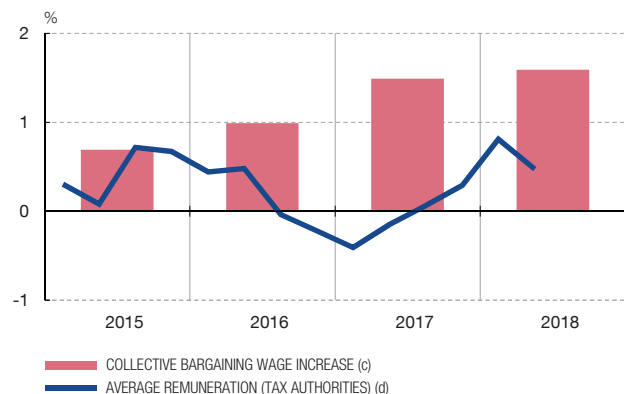Rate of change of the three-month moving average with three lags (b)

SOCIAL SECURITY REGISTRATIONS
REGISTERED UNEMPLOYMENT (right-hand scale)

3 COMPENSATION PER EMPLOYEE
Year-on-year rates (a)

TOTAL ECONOMY
MARKET ECONOMY

4 WAGE INDICATORS
Year-on-year rates

COLLECTIVE BARGAINING WAGE INCREASE (c)
AVERAGE REMUNERATION (TAX AUTHORITIES) (d)

SOURCES: INE, Ministerio de Trabajo, Migraciones y Seguridad Social, Agencia Tributaria and Banco de España.

a Rates of change calculated on adjusted series. QNA employment measured in equivalent job terms.
b Calculated on seasonally adjusted series at the Banco de España. Dots depict quarter-on-quarter rates.
c On data to May 2018. Excluding indexation clauses.
d Seasonally adjusted series. Last quarter, with data only for April 2018.
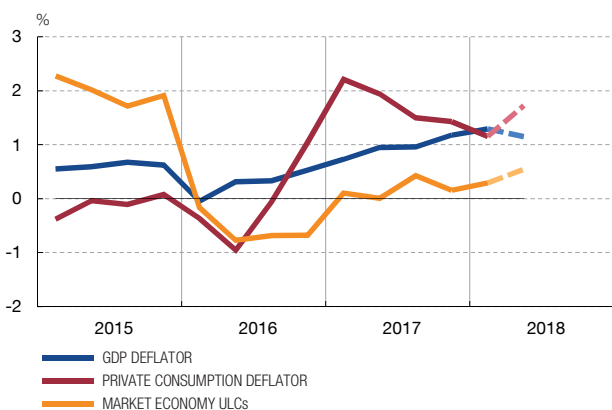
Download

stipulating a wage increase of 1.5%, i.e. higher than the 1.3% set in these same agreements for 2017. The agreements entered into up to May specify a higher increase for this year, namely 1.9%, affecting 655,000 employees, after the significant advances of the last two months. By contrast, the information published by the tax collection agency on average gross pay at large non-financial corporations showed a year-on-year increase of 0.5% in April in terms of the seasonally-adjusted series, compared with 0.8% in Q1. Compensation per employee on QNA data picked up somewhat in 2018 Q1, in both the total and the market economy, posting year-on-year growth rates of 0.4% and 0.6%, respectively. This upward trend is expected to hold steady in Q2, with year-on-year growth slightly above 1% in both indicators (see Charts 17.3 and 17.4).
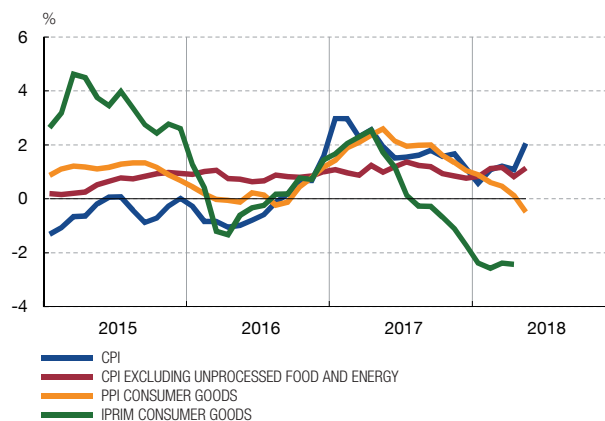
3.5 Price developments

In 2018 Q2, it is estimated that the year-on-year growth of the imports deflator will have increased notably, against a background of higher oil prices, interrupting its slowing trend in the previous quarters. The year-on-year rate of increase of overall domestic producer prices, proxied by the GDP deflator, will have eased in Q2, while that of the private consumption deflator is estimated to have increased (see Chart 18.1).
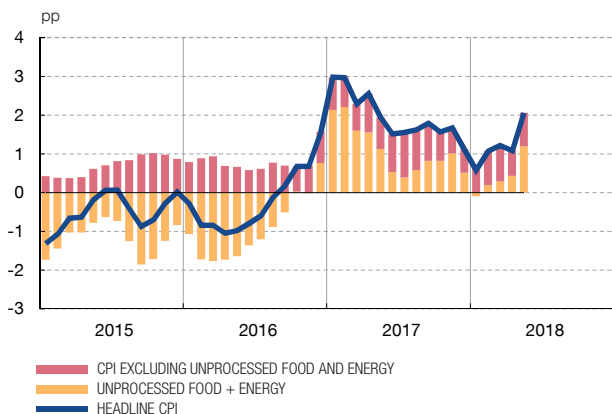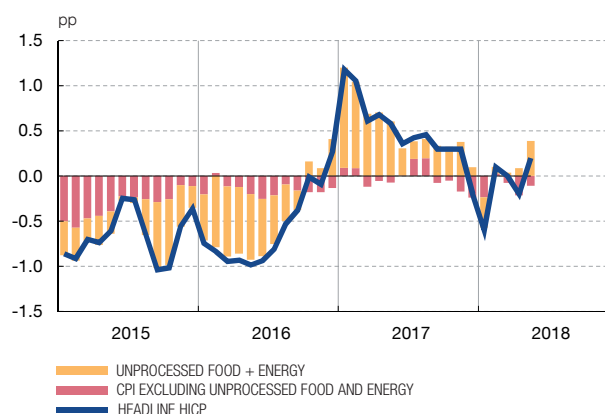
1 GDP DEFLATOR AND UNIT LABOUR COSTS (a)

%

GDP DEFLATOR
PRIVATE CONSUMPTION DEFLATOR
MARKET ECONOMY ULCs

2 PRICE INDICATORS
   Year-on-year rates

%

CPI
CPI EXCLUDING UNPROCESSED FOOD AND ENERGY
PPI CONSUMER GOODS
IPRIM CONSUMER GOODS

3 CONTRIBUTIONS TO CPI YEAR-ON-YEAR GROWTH RATE

pp

CPI EXCLUDING UNPROCESSED FOOD AND ENERGY
UNPROCESSED FOOD + ENERGY
HEADLINE CPI

4 CONTRIBUTIONS TO SPANISH-EURO AREA INFLATION DIFFERENTIAL

pp

UNPROCESSED FOOD + ENERGY
CPI EXCLUDING UNPROCESSED FOOD AND ENERGY
HEADLINE HICP

SOURCES: INE, Eurostat and Banco de España.

a Year-on-year rates of change calculated on seasonally adjusted series.

Download

The latest CPI figure, for May, shows a marked increase in its year-on-year growth rate, 1 pp up on February to 2.1%. The acceleration in the overall index is essentially due to the trajectory of energy prices, whose year-on-year rate increased by 6.4 pp over this period, affected by oil price developments and, to a lesser extent, unprocessed food prices, whose rate of increase rose by 3.2 pp. Core inflation held at 1.1% year-on-year, measured both by the year-on-year growth rates of the CPI excluding food and energy and by that of the CPI excluding unprocessed food and energy. Among the components of this latter indicator, services prices quickened by 0.1 pp to 1.8% year-on-year and non-energy industrial goods prices held at a year-on-year rate of 0%. Lastly, processed food prices slowed by 0.1 pp to 1.3% year-on-year.

The year-on-year rate of change of the harmonised index of consumer prices (HICP) was up 0.9 pp on February to 2.1% in May. In turn, the year-on-year rate of change of the HICP for the euro area as a whole increased in May by 0.8 pp relative to February, to 1.9%. As a result, Spain's inflation differential vis-à-vis the euro area stands at 0.2 pp (0.1 pp in February).

25.6.2018.