

MACROECONOMIC PROJECTIONS FOR THE SPANISH ECONOMY (2018-2021):
THE BANCO DE ESPAÑA'S CONTRIBUTION TO THE EUROSISTEM'S DECEMBER
2018 JOINT FORECASTING EXERCISE

Introduction and summary

This report describes the macroeconomic projections for the Spanish economy for the period 2018-2021, which are part of the projections for the euro area as a whole that the ECB published on Thursday 13 December.¹ The current projections for Spain incorporate the new information that has become available since the publication of the previous projections on 21 September² and for the first time the year 2021 is included in the projection horizon.

The notable expansionary inertia of the Spanish economy continued in the second half of 2018. In 2018 Q3, GDP is estimated to have grown, as it did in Q1 and Q2, by 0.6% quarter-on-quarter and the information available indicates that it will grow by a similar rate in Q4. The stable growth of the Spanish economy over this year contrasts with the developments observed in the euro area as a whole, where activity weakened notably in comparison with 2017, owing partly to temporary factors. One of the reasons why such factors do not seem to have been reflected in the Spanish economy would be because their effects were offset in the second half of the year by the entry into force of the State budget for 2018, which includes several measures that have boosted household income.

The projections envisage that the cyclical upturn which began at the end of 2013 will continue over the period 2018-2021. The factors on which these projected developments are based are the continuation of the accommodative monetary policy stance, the strengthening of corporations' and households' financial position and, in the short term, the effects of the above-mentioned expansionary fiscal measures and the recent decline in oil prices. Overall, these factors should allow the economy to continue to grow at a considerably higher pace than its potential rate and, consequently, the high volumes of unemployment generated by the crisis would continue to be absorbed.

However, GDP growth is expected to move on a gradually slowing path over the projection horizon. This would be as a consequence, among other factors, of the gradual weakening of the expansionary effects of the monetary policy measures adopted in recent years, which will cause financial conditions to progressively become somewhat less favourable for private agents' spending, as indicated by the interest rate assumptions underpinning the projections. Additionally, against a backdrop of relatively high uncertainty, it is considered that the proportion of household income earmarked for consumption will be lower than in recent years, thus reversing part of the marked downward trend of the saving rate during the past decade. Thus, following growth of 2.5% in 2018, the pace of GDP growth is expected to moderate to 2.2% in 2019, 1.9% in 2020 and 1.7% in 2021.

Consumer prices quickened notably during 2018, spurred by the energy component. However, from November onwards they began to slow significantly, in step with the mechanical decrease in the year-on-year rate arising from the spike in oil prices in the last

¹ See [The macroeconomic projections prepared by the Eurosystem's experts for the euro area, December 2018](#).
² Specifically, compared with the [Macroeconomic projections for Spain \(2018-2010\)](#), published as Box 1 of the "Quarterly report on the Spanish economy", in *Economic Bulletin* 3/2018, the current projections include the changes observed between 14 September and 21 November in the technical assumptions, in the budgetary assumptions and in the projections for the external setting of the Spanish economy. Furthermore, the projections incorporate the most recent data of the Quarterly National Accounts (QNA), which include the preliminary results for the third quarter of 2018 and a review of the time series for the period 2014-2017.

Annual rate of change in volume terms and % of GDP

| | 2017 | December 2018 projections | | | | Difference between current projections and September 2018 projections | | |
|--|------|---------------------------|------|------|------|---|------|------|
| | | 2018 | 2019 | 2020 | 2021 | 2018 | 2019 | 2020 |
| GDP | 3.0 | 2.5 | 2.2 | 1.9 | 1.7 | -0.1 | 0.0 | -0.1 |
| Private consumption | 2.5 | 2.4 | 1.9 | 1.5 | 1.3 | 0.2 | 0.2 | 0.1 |
| Government consumption | 1.9 | 2.1 | 1.6 | 1.2 | 1.2 | 0.2 | 0.2 | 0.0 |
| Gross fixed capital formation | 4.8 | 6.2 | 4.7 | 3.6 | 2.7 | 1.1 | 0.7 | -0.3 |
| Investment in capital goods | 5.7 | 7.8 | 5.9 | 3.8 | 3.0 | 2.7 | 2.1 | 0.1 |
| Investment in construction | 4.6 | 6.1 | 4.5 | 3.7 | 2.8 | 0.6 | 0.1 | -0.7 |
| Exports of goods and services | 5.2 | 1.8 | 3.4 | 4.0 | 3.8 | -0.8 | -0.6 | 0.0 |
| Imports of goods and services | 5.6 | 3.8 | 4.1 | 4.1 | 3.8 | 0.7 | 0.1 | 0.2 |
| National demand (contribution to growth) | 2.9 | 3.1 | 2.4 | 1.9 | 1.6 | 0.4 | 0.3 | 0.0 |
| Net external demand (contribution to growth) | 0.1 | -0.6 | -0.2 | 0.0 | 0.1 | -0.5 | -0.2 | -0.1 |
| Nominal GDP | 4.3 | 3.6 | 4.0 | 3.7 | 3.5 | -0.1 | 0.1 | -0.1 |
| GDP deflator | 1.2 | 1.0 | 1.8 | 1.8 | 1.8 | 0.0 | 0.1 | 0.0 |
| Harmonised index of consumer prices (HICP) | 2.0 | 1.8 | 1.6 | 1.6 | 1.7 | 0.0 | -0.1 | 0.1 |
| HICP excluding energy and food | 1.2 | 1.1 | 1.5 | 1.7 | 1.8 | 0.1 | 0.1 | -0.1 |
| Employment (full-time equivalents) | 2.9 | 2.5 | 1.6 | 1.6 | 1.6 | 0.1 | -0.3 | -0.1 |
| Unemployment rate (% of labour force). End-of-period data | 16.5 | 14.6 | 14.1 | 12.9 | 12.2 | 0.0 | 0.9 | 1.0 |
| Unemployment rate (% of labour force). Annual average | 17.2 | 15.3 | 14.3 | 13.3 | 12.4 | 0.0 | 0.5 | 0.9 |
| Nation's net lending (+) / net borrowing (-) (% of GDP) | 2.2 | 1.0 | 0.8 | 0.7 | 0.6 | -0.2 | -0.3 | -0.4 |
| General government's net lending (+) / net borrowing (-) (% of GDP) | -3.1 | -2.7 | -2.4 | -2.0 | -1.8 | 0.0 | 0.1 | 0.2 |

SOURCES: Banco de España and INE.
Latest QNA data: 2018 Q3.

a Projections cut-off date: 28 November 2018.

stretch of 2017 (base effect) and their more recent decline. The smaller contribution of the energy component to the rate of change in the harmonised index of consumer prices (HICP), which will become practically imperceptible as from mid-2019, is expected to be gradually offset by the rise in the core inflation component, namely that excluding energy and food prices, in step with the gradual widening of the output gap since the pace of GDP growth remains above its potential rate. As a result of the opposite directions of the energy and core components, the average annual rate of change in the HICP will moderate by 0.2 percentage points (pp) to 1.6% in 2019 and subsequently edge up marginally to 1.7% in 2021. Core inflation is expected to rise gradually over the projection horizon from an average of 1.1% in 2018 to 1.8% in 2021.

Compared with the September projections, the GDP growth path has been revised downwards, albeit by a limited amount. The changes are due to several factors operating in opposite directions. In 2018, the reason for the downward revision of 0.1 pp was that the latest National Accounts data indicate that the growth in the economy's output at the beginning of the year was slightly lower than estimated up to now. As for 2019, current developments in activity, which are slightly more favourable than expected a few months ago, together with the expansionary effects of cheaper oil prices and a lower exchange

rate, are offset by the recent downturn in the outlook for external markets. This latter factor explains the limited downward revision of the growth outlook for 2020. Small changes have been made to the HICP growth projections: lower for 2019 and higher for 2020, in line with the changes in the path of oil prices on futures markets.

Activity and employment

As in recent projection exercises, the slowdown in activity over the projection horizon reflects expectations that the buoyancy of private domestic demand will gradually ease, although it will continue to be driven by persisting favourable financial conditions and the improved financial situation of households and corporations. It is estimated that the negative contribution of net external demand to output growth, which in 2018 is reaching significant proportions, will tend to decrease over the remainder of the projection horizon, based on the assumptions of the projection exercise.

In the area of domestic demand, private consumption growth will continue to be buoyed by job creation and higher real wages. Compared with the September projections, the current projections constitute a slight upward revision in this demand component. This change is essentially due to the recent decline in oil prices, although household spending will also be impacted positively by the increase in income arising from the implementation of the recent Supreme Court judgment that maternity and paternity benefits are exempt from personal income tax. As a result, the tax authorities have already begun to process the refunds on the amounts received from 2014 to 2017. As described in Box 1, the projections incorporate the announcement of the increase in the national minimum wage – which has been yet to be approved – whose impact on consumption is expected to be more or less neutral. Since it represents a significant amount (22.3%), this increase will directly affect a substantial proportion of current employees (6.2% of them earn a wage which is the same as or lower than the national minimum wage proposed for 2019). However, based on the estimates made, the impact of the measure on the compensation of employees, as a whole, will be virtually zero since, in percentage terms, the upside effects on the average wage will be more or less offset by a loss of employment of a similar size.³

As in previous projection exercises, consumption is projected to gradually slow over time, owing to the incorporation of the assumption that households will tend to increase their saving rate after its marked decline since the beginning of the decade to record lows. In the current setting, this assumption partly reflects higher uncertainty about global economic developments. Additionally, as the projection horizon moves forward, the growth in household income will tend to be driven to a greater extent by real wage rises and to a lesser extent by job creation. This growth structure of employment income will tend to curtail the buoyancy of consumption since, in aggregate terms (unlike developments at the lower levels of wage distribution), the marginal propensity to consume an additional unit of income is smaller when it stems from a wage rise than when it arises from a new job.

As for the gross fixed capital formation components, residential investment will continue to show high growth rates, against a backdrop in which access to financing for house purchases will continue to be boosted by employment growth and persistently low interest rates. Business investment will continue to perform strongly, driven by the high degree of capacity utilisation, the expansionary outlook for activity and profits, the continued availability of low-cost financing and the sector's increasingly healthy financial position. In

³ A. Lacuesta, M. Izquierdo, and S. Puente (2018), "An analysis of the impact of the increase in the National Minimum Wage", analytical article, Banco de España, forthcoming.

any event, this aggregate will also show a slightly slowing profile as final demand growth eases and uncertainty heightens due to mounting trade tensions.

On the external front, exports showed some weakness in 2018, growing at a slower pace than their end-markets, as a result of the significant role played by factors such as the adverse impact of the past appreciation of the common currency on sales outside the euro area or the recovery of tourist flows towards competitor countries in the Mediterranean. These effects are expected to tail off, allowing for a return to market share gains, albeit modest, throughout the projection horizon. In any event, as described in Box 1, the outlook for the performance of the export markets is somewhat less favourable than in the previous projection exercise, which has prompted a downward revision of the projected path of sales of goods and services to the rest of the world.

The most recent National Accounts data suggest an upward revision of import penetration within final demand in 2017-2018, compared with the time series available when the previous projections were made. In line with this new information, the current projections also include an upward revision of import penetration for the next three years (2019-2021). However, this revision is on a limited scale, owing to the change envisaged in the composition of growth in final demand, where the relative weight of exports, which have a high import content, will decline. Consequently, the elasticity of imports with respect to final demand will stand at levels that are somewhat lower than those of the last two years, but still higher than in the early years of the recovery.

The slowdown in activity growth in the projection horizon will translate into a decline in the rate of job creation, compared with that observed in recent years. Moreover, and specifically in 2019, an additional factor that largely explains the downward revision of employment growth is the inclusion of the national minimum wage rise⁴ as one of the assumptions on which the projections are based. However, the negative impact on employment of a higher national minimum wage in 2019 is partly offset by the fact that the recent behaviour of employment has been more favourable than envisaged in the September projections.⁵ The projected developments in employment, despite the expected rise in the labour force, will prompt further decreases in the unemployment rate, leaving it at slightly above 12% at end-2021. Compared with the previous projections, in September, the projected unemployment rate for end-2020 (12.9%) is almost 1 pp higher.

The Spanish economy's lending capacity has declined significantly in 2018 and could stand at around 1% of GDP (1.2 pp lower than in the previous year) for the year as a whole. This reduction in the external balance appears to be partly due to a combination of several factors that are, in principle, predominantly temporary in nature, such as rising oil prices, the slowing of global trade flows, the past appreciation of the euro or the aforementioned recovery of tourist destinations that compete with Spain.⁶ However, there also some emerging signs that point to the possible exhaustion of the positive effects of the gains in competitiveness observed after the crisis. These merit particular attention in a setting in which the Spanish economy still needs to maintain ample external surpluses to reduce its still high external indebtedness. In the three-year period 2019-2021, a slight moderation is

⁴ See A. Lacuesta, M. Izquierdo, and S. Puente. (2018), *op. cit.*

⁵ Arithmetically, the growth of a variable in annual average terms is automatically pushed up the better its performance at the end of the preceding year. Therefore, the upward surprises in job generation at end-2018 have prompted an upward revision of the average rate of this variable in 2019.

⁶ See Box 5 of the Quarterly Report on the Spanish economy "Recent developments in and the outlook for the rest-of-the-world account of the Spanish economy", Economic Bulletin 4/2018.

expected in the Spanish economy's lending capacity, in addition to that observed in 2018, which would be explained by the projected developments in the real flows of goods and services and by some widening of the income deficit (as a result of the higher cost of financing external debt).

The public deficit would be reduced to 2.7% of GDP in 2018. Based on the assumptions used (described in Box 1), the budgetary imbalance would continue to be corrected gradually in subsequent years, at a pace similar to that envisaged in the September projections, to stand at 1.8% of GDP in 2021. The projected improvement in the deficit will, however, be due to the favourable effects of the economic cycle while, by contrast, the structural balance is expected to worsen, particularly at the beginning of the projection horizon.

Prices and costs

In 2019, the growth of compensation per employee will be buoyed by the effects of the projected rise in the national minimum wage. It is estimated that this rise will contribute 0.8 pp to growth in the average wage per employee. Since the impact of this measure on productivity growth is expected to be of a similar magnitude, the increase in the national minimum wage alone is thus expected to have a more or less neutral effect on the rate of change of unit labour costs. This variable will accelerate, however, throughout the projection period, as a result of the gradual rebound in wage growth brought about by the projected steady decrease in cyclical slack in the labour market, and the implementation of the recommendations of the Agreement for Employment and Collective Bargaining for the three-year period 2018-2020.

The higher rate of growth of unit labour costs will lead to rising internal inflationary pressures. Conversely, the external component of final demand price formation, measured by the imports deflator, will continue to show positive, albeit declining, rates throughout the projection period, reflecting the slight downward trend of oil prices. As a result, current projections envisage core inflation (measured by the rate of change of the HICP excluding energy and food) accelerating from 1.1% in 2018 to 1.8% in 2021. Growth of the overall indicator will follow a declining path until the summer of 2019, dominated by the increasingly lower rates of change of the energy component, and will from then on begin to pick up, in step with the changes in the core component. As a result, in annual average terms, consumer prices are expected to slow by 0.2 pp to 1.6% in 2019. This rate would be maintained in 2020 and increase by 0.1 pp in 2021.

Risks

The risks to the baseline scenario for future economic activity remain on the downside. The uncertainties come mainly from the external environment, where certain risks that have begun to have a negative impact on the baseline scenario of the projections could have even more adverse effects in the future. This is the case of the possible repercussions that the economic policy mix in the United States could have on global financial conditions, as further hypothetical tightening could hinder refinancing, both in terms of cost and volume, for those economies with high dollar indebtedness. In addition, uncertainty persists surrounding the possible adoption of new protectionist measures that would distort global production chains and deter business investment. To date, the direct impact on Spanish exports of these measures introduced around the world has been limited, as they essentially affect bilateral trade between the United States and China. However, given the complexity of the current interconnectedness between global value chains, the possibility that they may ultimately trigger indirect effects on other key economic areas cannot be ruled out. Moreover, in a setting characterised by a flow of rapidly changing news on developments in the Brexit process, some of the possible scenarios could have

very serious consequences for the financial markets of both the United Kingdom and the European Union and for their trade relations.

Furthermore, the projections rest on the premise that the recent loss of momentum in the euro area, which is the Spanish economy's main export market, is essentially a temporary development. However, it is possible that this weakness may be due, in part, to certain more persistent factors, such as, in particular, the above-mentioned sources of global uncertainty. In addition, although the effects of the uncertainty surrounding the future path of budgetary policy in Italy have been confined to date to this economy, the possibility of their spreading further afield cannot be ruled out.

In the domestic sphere, the current parliamentary fragmentation is giving rise to a notable degree of uncertainty about the future economic policy stance and, especially, about the budgetary consolidation process and the adoption of reforms to boost economic growth potential. Additionally, a hypothetical resurgence of political tension in Catalonia could adversely affect economic growth, especially in this region.

With regard to inflation, the risks of departure from the baseline scenario are also mainly on the downside, as a consequence of the possible materialisation of the risks to activity described above, especially from the external environment. Accordingly, lower growth momentum could give rise to lower wage increases and, therefore, to weaker inflationary pressure. Moreover, in recent weeks oil prices have been highly volatile and this is a further source of uncertainty for the future path of consumer prices.

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The assumptions on interest rates and oil prices and other commodities are prepared on the basis of the prices quoted on the relevant markets during the ten business days prior to the calculation date (in this case, 21 November). Specifically, the price of oil per barrel is expected to average \$67.5 in 2019, 6% less than in 2018, and to decline a little more in the next two years, reaching \$65.9 in 2021. Compared with the September projections, the new oil price assumptions represent a significant downward revision. In annual average terms, the scale of this revision is slightly larger in 2019 (8 pp) than in 2020 (5.1 pp).

Market expectations of short-term interest rates over the projection horizon have barely changed compared with the September projection exercise. In annual average terms, three-month EURIBOR in 2019 is expected to remain around the levels recorded in 2018 (-0.3%), before rising by 30 bp in each of the following two years, to 0.3% in 2021. At the long end of the curve, 10-year government debt yields continue to rise: in annual average terms, they are expected to increase from 1.4% in 2018 to 2.5% in 2021. In turn, the cost of credit to households and firms, which is generally linked to short-term interest rates, has hardly changed compared with the previous projections.

The level of the nominal effective exchange rate of the euro over the projection horizon, which according to the methodology used corresponds to that observed on spot foreign currency markets in the two weeks prior to the assumptions cut-off date, shows a

slight depreciation of almost 2% compared with the previous projection exercise. In the case of the euro/dollar exchange rate, the revisions made are approximately of the same scale.

In the main geographical areas with which Spain trades, economic activity and imports are now expected to perform less favourably, in the initial stretch of the projection period, than in September. This has led to a certain downward revision of the growth forecast for Spain's export markets in the near term. The rates of growth expected for this variable are relatively modest, ranging from 3.1% to 3.7% between 2018 and 2021, which is significantly lower than the rate of growth recorded in 2017.

Among the assumptions on which the projections are based, one important change compared with the September projection exercise is the inclusion in the baseline scenario of an increase in the national minimum wage, from €735 at present (in 14 monthly payments per annum) to €900 in 2019, in response to an economic policy measure announced by the Government but not yet approved at the cut-off date for these projections. A further change is the inclusion in the baseline scenario of the refund of personal income tax paid since 2014 on paternity and maternity benefits that the tax authorities have begun to process, implementing a recent Supreme Court judgment.

The assumptions relating to fiscal policy over the projection horizon show minor changes compared with the previous

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

Annual rates of change, unless otherwise indicated

| | December 2018 projections | | | | | Difference between current projections and September 2018 projections (b) | | |
|--|---------------------------|-------|-------|-------|-------|---|-------|-------|
| | 2017 | 2018 | 2019 | 2020 | 2021 | 2018 | 2019 | 2020 |
| International environment | | | | | | | | |
| World output | 3.6 | 3.6 | 3.3 | 3.4 | 3.3 | -0.1 | -0.1 | 0.0 |
| Spain's export markets | 4.9 | 3.1 | 3.3 | 3.7 | 3.4 | -0.4 | -0.5 | 0.1 |
| Oil price in dollars/barrel (level) | 54.4 | 71.8 | 67.5 | 66.8 | 65.9 | -1.5 | -8.0 | -5.1 |
| Monetary and financial conditions | | | | | | | | |
| Dollar/euro exchange rate (level) | 1.13 | 1.18 | 1.14 | 1.14 | 1.14 | -0.01 | -0.03 | -0.03 |
| Nominal effective exchange rate vis-à-vis the non-euro area (c) (2000 = 100 and percentage differences) | 117.0 | 121.5 | 118.0 | 118.0 | 118.0 | -0.3 | -1.8 | -1.8 |
| Short-term interest rate (3-month EURIBOR) (d) | -0.3 | -0.3 | -0.3 | 0.0 | 0.3 | 0.0 | 0.0 | -0.1 |
| Long-term interest rate (10-year bond yield) (d) | 1.6 | 1.4 | 1.8 | 2.2 | 2.5 | 0.0 | 0.1 | 0.1 |

SOURCES: ECB and Banco de España.

- a** Assumptions cut-off date: 21 November 2018. The figures expressed as levels are annual averages; the figures expressed as rates are calculated based on the relevant annual averages.
- b** Differences are between rates in the case of world output and export markets, between levels in the case of oil prices and the dollar/euro exchange rate, percentage differences for the effective nominal exchange rate and percentage point differences in the case of interest rates.
- c** A positive percentage change in the nominal effective exchange rate denotes an appreciation of the euro.
- d** For the projection period, the figures in the table are technical assumptions, prepared using the Eurosystem's methodology. These assumptions are based on futures market prices or on proxies thereof and should not be interpreted as a Eurosystem prediction as to the course of these variables.

projection exercise. In any event, these assumptions are subject to greater than usual uncertainty as a result of the current lack of definition of the budgetary cycle. For 2018, the projections include the measures approved in the budgets of the different tiers of government for this year, together with the available information on their execution. As regards the assumptions for the remainder of the projection horizon, on 15 October, in accordance with the European Semester calendar, the Government sent a "2019 Draft Budgetary Plan" to the European Commission, containing new revenue and expenditure measures. However, at the cut-off date for this projection exercise, neither the draft 2019 State and Social Security budgets nor the projects for creation of the new taxes announced in the Draft Budgetary Plan had been presented to Parliament, so the uncertainty surrounding the scope and details of these new measures persists. In consequence, the assumptions considered do not include these new measures, bar those that have actually been approved¹ or those that respond to specific agreements and are, therefore, more clearly defined (such as the pension increase in accordance with real CPI in 2018 and 2019 or the measures relating to public sector wages and employment in 2019-20).

In this setting, as in the September projections, certain technical assumptions were used to project the expected trajectories of a number of budget headings in the period 2019-21. First, it was assumed that those budgetary items subject to greater discretionality – public investment and procurement, in particular, given their volume – will grow in line with the potential growth of

the Spanish economy.² Second, it was assumed that, in the absence of specific measures, the course of the remaining items in the general government accounts will be shaped by the usual factors. Specifically, it was assumed that public revenue will grow in keeping with the tax base, which depends primarily on the macroeconomic environment. Similar assumptions are made for less discretionary expenditure items. This is the case of pension expenditure (which is basically determined by the revaluation formula established by law and by population ageing, in addition to the increases agreed for 2018-19), unemployment benefits (which depend mainly on changes in the unemployment rate) and interest expenditure (which changes according to the level of government debt and interest rates).

In accordance with these assumptions and projections relating to fiscal policy variables, together with the output gap estimated in a manner consistent with the other macroeconomic projections, the fiscal policy stance is expected to be expansionary in 2018 and 2019, before turning neutral in the following two years.³

¹ These include the tax cuts set out in Royal Decree-Law 15/2018 of 5 October 2018 on urgent measures for energy transition and consumer protection and, as indicated in the main text, those resulting from the Supreme Court judgment of 5 October 2018 stipulating that maternity benefits are exempt from personal income tax.

² Specifically in the case of public investment, the scenario considered includes assuming, in 2018, €1.8 billion for the financial liability costs of the toll motorways subject to insolvency proceedings (an amount already recorded by the State) and a further sum of approximately €1.0 billion for court decisions affecting the regional governments and that it is assumed will also be recognised in 2018. As a counterpoint, the projections maintain the assumption that the different tiers of government will receive approximately €1.0 billion from the re-tendering of the toll motorways in 2019, in accordance with the estimate contained in the 2018-21 Stability Programme.

³ It is important to note the significant impact of non-permanent measures in 2018 (cost of insolvent toll motorways, court decisions affecting regional governments, asset protection schemes and deferred tax assets in the banking sector), which amount to the equivalent of 0.5% of GDP, partially offset by a stronger than expected revenue performance.