

MACROECONOMIC PROJECTIONS FOR THE SPANISH ECONOMY (2016-2018):
THE BANCO DE ESPAÑA'S CONTRIBUTION TO THE EUROSISTEM'S JUNE 2016
JOINT PROJECTION EXERCISE

Introduction

Since the inception of Economic and Monetary Union (EMU), experts from the national central banks of the euro area countries and from the European Central Bank (ECB) have, on a half-yearly basis, prepared macroeconomic projections for submission to the ECB Governing Council at the start of the months of June and December each year. In these exercises, the projections for the area are the result of aggregating those of each country. The methodology for the technical assumptions used (which affect variables such as interest rates, oil and other commodities prices, the exchange rate and stock markets) and for the fiscal assumptions, along with the projections for the external setting of the euro area, is common to all the Eurosystem countries.

The ECB Governing Council has recently decided to alter the Eurosystem's communication policy regarding these macroeconomic projections. Accordingly, in addition to publishing details for the euro area as a whole, as has hitherto been done, the Eurosystem will also publish the figures of the main variables country by country. Against this background, in June and December, the Banco de España website will disseminate the projections for the Spanish economy that make up its contribution to each of the joint Eurosystem exercises. They will be published once the aggregate projections have been submitted to the ECB Governing Council, which, compared to the Banco de España's current arrangements, involves bringing forward the dissemination of the macroeconomic projections for June and December by several weeks.¹

The present macroeconomic projections for the Spanish economy for the 2016-2018 period are those incorporated into the overall euro area projections published by the ECB on 2 June.²

Compared with the latest forecasts published by the Banco de España in its *Economic Bulletin* last March, covering the 2016-2017 period, the current projections include, first, the changes in the technical assumptions, in the projections for the external environment (see Table 1) and in the fiscal assumptions; and further, the new information available up to the cut-off date for the exercise.³ Of note in this connection is the inclusion of the GDP growth flash estimate for 2016 Q1, but not the subsequent estimate and the disaggregated information, which were released by the National Statistics Institute (INE) after the conclusion of this exercise. Furthermore, projections for the year 2018 are published for the first time.

According to the estimates made, the upturn in activity is expected to continue throughout the projection period, albeit at a gradually declining pace. The increase in output will continue to be underpinned by the progress made in correcting the economy's imbalances (in particular, the improvement in competitive conditions and deleveraging by households

1 Specifically, the Banco de España has hitherto published its macroeconomic projections on a quarterly basis, in March, June, September and December each year. The projections are included in the Banco de España *Economic Bulletin*, which is published in the last few days of each of these months or early in the following month. The current change means that, in June and December, dissemination of the projections will be brought forward to the start of the month and will take place separately from the publication of the *Economic Bulletin*. In March and September, the dissemination practice will remain unchanged.

2 See <http://www.ecb.europa.eu/pub/pdf/other/eurosystemstaffprojections201606.en.pdf>.

3 The cut-off dates for the calculation of the assumptions and for data collection were, respectively, 10 and 18 May.

Annual rates of change, unless otherwise indicated

	2015	June 2016 projection			Changes from the March 2016 projection	
		2016	2017	2018	2016	2017
International environment						
Real world GDP growth	2.9	2.9	3.4	3.5	-0.1	-0.1
World trade	1.9	2.5	4.0	4.3	-0.3	-0.2
Spanish exports markets	3.1	3.0	4.0	4.2	-0.2	-0.4
Oil price (in USD) (b)	52.4	43.4	49.1	51.3	3.2	3.4
Monetary and financial conditions						
Dollar/euro exchange rate (USD per euro)	1.11	1.13	1.14	1.14	0.02	0.03
Nominal effective exchange rate vis-à-vis the non-euro area countries (c) (2000=100 and pp changes)	113.0	114.9	115.6	115.6	1.3	1.7
Madrid Stock Exchange General Index (b) (2000=100 and pp changes)	107.2	87.2	85.4	83.4	3.0	4.3
Short-term interest rates (3-month Euribor) (b)	0.0	-0.3	-0.3	-0.3	0.0	0.0
Long-term interest rates (10-year bond yields) (b)	1.7	1.7	2.0	2.3	0.1	0.1

SOURCES: ECB and Banco de España.

- a Assumptions cut-off date: 10.5.2016. Figures in levels are annual averages; rates of growth are based on the corresponding annual averages.
- b For the projection period, the figures in the table represent technical assumptions made in accordance with Eurosystem methodology. These assumptions correspond to futures market prices or an approximation of these, and should not be interpreted as a Eurosystem forecast of the path of these variables.
- c A positive percentage change in the nominal effective exchange rate denotes an appreciation of the euro.

and firms) and by the persistence of favourable financing conditions for private agents, fostered in turn by the expansionary stance of monetary policy. In terms of annual average rates, GDP growth is expected to stand at 2.7% this year and to slow to 2.3% in 2017 and 2.1% in 2018 (see Table 2). This path for output is the result of the diminished momentum of certain temporary factors that have boosted activity in the most recent phase, such as lower oil prices, the depreciation of the euro or certain budgetary stimuli, which will be partly offset in the medium term by the gradual improvement in export markets. Turning to prices, it is estimated that, after posting a decline of 0.5% in 2016, the national CPI will grow by 1.5% in 2017 and 1.7% in 2018, in line with the projected recovery for oil prices and a modest and gradual rise in core inflation.⁴

Assumptions underlying the projections

The assumptions for oil and other commodity prices and for interest rates are based on the information available in the respective markets in the period immediately prior to the cut-off date. According to the path observed on futures markets, the oil price is expected to stand at an average level of \$43.4 per barrel in 2016, and to rise in the following two years to \$51.3 in 2018, marking a modest upward revision of the March projections. The expected paths for the three-month Euribor rate and 10-year government bond yields are very close to those of the March exercise, reflecting futures market prices in the former, and implied yield curve expectations in the latter. Consequently, the cost of bank financing received by households and non-financial corporations will stand at levels that are likewise similar to those projected in March and, in any event, that are low, sustained by the accommodative stance of monetary policy. In terms of annual averages, it is assumed that stock market prices in 2016 will be 20% lower than in 2015, a somewhat less pronounced change than was assumed for the last projections.

⁴ In terms of the HICP, the harmonised indicator for all euro area countries on the basis of which the monetary policy objective is defined, the projected rates of change are the same as those of the CPI for 2016 and 2017, and 0.1 pp more in 2018.

Annual rate of change in volume terms and % of GDP

	2015	June 2016 projection			Changes from the March 2016 projection	
		2016	2017	2018	2016	2017
GDP	3.2	2.7	2.3	2.1	0.0	0.0
Private consumption	3.1	3.0	1.8	1.5	0.1	-0.3
Government consumption	2.7	1.1	0.9	0.7	0.1	0.5
Gross fixed capital formation	6.4	4.8	5.5	4.9	-0.2	0.1
Investment in capital goods	10.2	8.1	7.1	6.7	-0.2	-0.2
Investment in construction	5.3	3.3	5.5	4.5	-0.1	0.6
Exports of goods and services	5.4	4.3	4.8	4.9	0.0	-0.4
Imports of goods and services	7.5	5.2	5.5	5.3	0.0	-0.4
National demand (contribution to growth)	3.7	2.9	2.4	2.1	0.0	0.0
Net external demand (contribution to growth)	-0.5	-0.2	-0.1	0.0	0.0	0.0
Nominal GDP	3.8	3.2	3.4	3.8	-0.3	0.0
GDP deflator	0.6	0.4	1.1	1.7	-0.3	0.0
Consumer price index (CPI)	-0.5	-0.5	1.5	1.7	-0.4	-0.1
CPI excl. energy and unprocessed food prices	0.6	0.9	1.3	1.7	-0.3	0.0
Harmonised index of consumer prices (HICP)	-0.6	-0.5	1.5	1.8	-0.1	-0.2
Employment (full-time equivalents)	3.0	2.5	1.9	1.8	0.2	0.0
Unemployment rate (% of labour force) End-of-period level	20.9	19.7	18.3	17.3	0.1	0.1
Net lending (+)/net borrowing (-) of the nation (% of GDP)	2.1	1.9	1.4	1.2	0.0	0.0
General government net lending (+)/net borrowing (-) (% of GDP)	-5.1	-4.1	-3.4	-2.9	0.3	0.0

SOURCES: Banco de España and INE.
Latest QNA figure: 2015 Q4.

a Projections cut-off date: 18.5.2016.

The growth of Spanish export markets will pick up over the course of the projection horizon, albeit at a lesser pace than forecast in March, as a result of the downward revision of the growth outlook for activity in the main non-euro area regions and, to a lesser extent, owing to the reduction in the foreseen pace of increase in imports from countries in the area. Competitors' prices, expressed in euro, will fall this year to a greater extent than was estimated in March, partly in response to the appreciation of the euro since then against a broad basket of currencies.

In relation to the fiscal assumptions it should be kept in mind that the common methodology for their preparation in the Eurosystem's macroeconomic projection exercises is based on the so-called "no budgetary policy change" scenario, which only incorporates tax or public expenditure decisions that are sufficiently detailed and have been or are very likely to be approved. In a setting such as the present one, marked by notable uncertainty over the future course of budgetary policy, macroeconomic forecasts hinge crucially on the assumptions made about the discretionary changes in public revenue and expenditure policies. The assumptions included in the current projections are based on the measures approved in the budgets of the different tiers of government for this year, which were already included in the March exercise (see Box 2 of the March quarterly report on the Spanish economy) and in the official multi-year plans available for 2016-2018. A novel feature of the latter, compared with the preceding projections, is the information contained in the Stability Programme Update (SPU) that the acting government submitted to the European Commission on 30 April. Specifically, the SPU introduces additional public spending control measures totalling €3.5 billion, €2 billion of which relate to the non-incurrence

of State expenditure, previously approved by the Council of Ministers, while it is expected that the remainder will be adopted by the regional governments. As regards the fiscal policy stance implicit in these projections, measured by the change in the cyclically adjusted general government balance,⁵ which was expansionary in 2015, it is assumed it will turn neutral, on average, over the projection horizon.

Overall, the impact on the GDP growth rate of the changes in the assumptions (including budgetary assumptions), compared with those used in March, is moderately negative in net terms. The impact of the changes in the external assumptions on the inflation rate is positive in 2016 (mainly due to the upward revision of the path of oil prices), entailing few changes to the rest of the projection horizon.

Activity and employment

The expansion in output during the projection period will continue to be underpinned, as has been the case since 2014, by the momentum of domestic demand. The contribution of net external demand to GDP growth will continue to be negative, though it will be increasingly smaller compared with 2015. Among the national demand components, household consumption is forecast to remain robust, supported by the strength of job creation flows and by the improved financial position of households, against a background of ongoing deleveraging and rising non-financial wealth. In the recent past, a significant factor of additional support has been provided by the expansionary effects on disposable income stemming from certain temporary factors, including most notably the successive reductions in oil prices. These factors will progressively lose steam during the current year, thereby explaining the moderation in the pace of private consumption over the course of the projection period. Specifically, following growth of 3% this year, this demand component is projected to slow to 1.5% in 2018.

In the setting of favourable financing conditions and employment generation described above, the progressive recovery in residential investment is expected to continue. The intensity of this recovery will be tempered, however, by the prospect of a modest rate of increase in the number of households. Business investment, for its part, will continue to be robust, in a setting in which borrowing costs are projected to hold at very low levels, reflecting the expansionary monetary policy stance in the area. In any event, the rate of increase of this investment component will tend to ease in step with that of final demand.

As regards foreign trade flows, exports are forecast to grow relatively modestly in the short term, in line with the expected performance of foreign markets and with the appreciation of the euro. It is estimated that the behaviour of sales to the rest of the world in 2017 and 2018 will be somewhat more expansionary, reflecting the rebound in Spain's export markets, in a setting in which continued gains in competitiveness are expected. Imports will continue to be notably buoyant throughout the projection horizon, in line with final demand, without substantial changes in the pattern observed since the start of the crisis, marked by a limited degree of substitution of national products for foreign purchases.

As a result of this trend in real trade flows and of the projected path for the foreign trade deflators, a gradual moderation in the nation's net lending is projected, as a percentage of GDP, from 1.9% in 2016, to 1.4% in 2017 and 1.2% in 2018. These figures are, for the first two years, very similar to those estimated in March.

⁵ Using the Banco de España output gap estimate and applying the elasticity estimated by the European Commission.

The dynamism of activity will continue to boost job creation, further supported by the fact that the composition of output growth, from the standpoint of the productive sectors, is geared towards services-sector activities that are highly labour intensive. Employment growth, somewhat greater than in the previous forecasts, will enable the unemployment rate to continue declining, standing at end-2018 at around 17% of the labour force.

Turning to forecasts for the budget deficit, the incorporation of the aforementioned fiscal assumptions and the impact of the various macroeconomic magnitudes on the budgetary aggregates results in general government balances for 2016, 2017 and 2018 of -4.1%, -3.4% and -2.9% of GDP, respectively. The differences from the official targets are chiefly due to the fact that these projections show more moderate increases in public revenue and in nominal GDP, whereas the assumed nominal increase in public spending, at 1.9% on average from 2016 to 2018, is similar to that of the SPU.

Relative to the previous projections exercise, the GDP growth forecast for the 2016-2017 two-year period has not changed. In the particular case of this year, this is a consequence of various counteracting factors. Specifically, the adverse impact arising from the less expansionary behaviour of foreign markets, the appreciation of the euro, the slight increase in oil prices and the somewhat higher degree of budgetary consolidation is offset by the fact that the increase in GDP in Q1 has been slightly higher than forecast in March.

Prices and costs

Consumer prices measured by the national CPI will, under the assumptions of the exercise, show negative rates of change until the end of the summer, giving rise to a 0.5% decline on average for the current year. The subsequent rebound, essentially associated with the recovering trajectory of oil prices, is projected to lead to an increase of 1.5% and 1.7% in the two following years. At the same time, core inflation, proxied by the rate of change of the CPI excluding unprocessed food and energy prices, is expected to pick up gradually, though modestly, in response to the expansionary behaviour of household spending, to the reduction in the degree of slack in the economy and to the rise in unit labour costs, against a backdrop of progressively accelerating nominal wages and continuing low labour productivity growth rates. The accelerating path of consumer prices will also be discernible in the GDP deflator, for which average growth of 0.4%, 1.1% and 1.7% in 2016, 2017 and 2018, respectively, is projected.

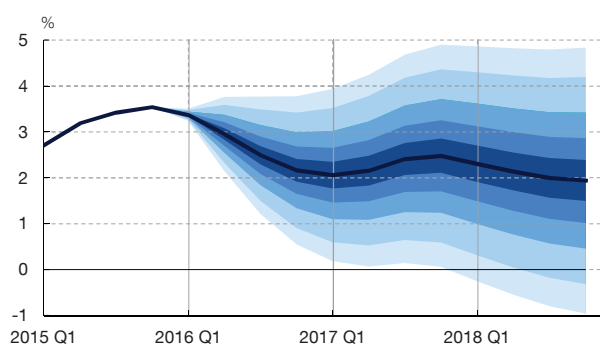
The projection for CPI-based inflation has been revised downwards in 2016 as a result of the surprises in this connection in recent months in the core component of inflation, i.e. the CPI excluding unprocessed food and energy prices, which has countered the impact of the upturn in oil prices. The positive effect of this latter factor on the imports deflator also explains the downward revision in the growth of the GDP deflator in 2016.

Risks

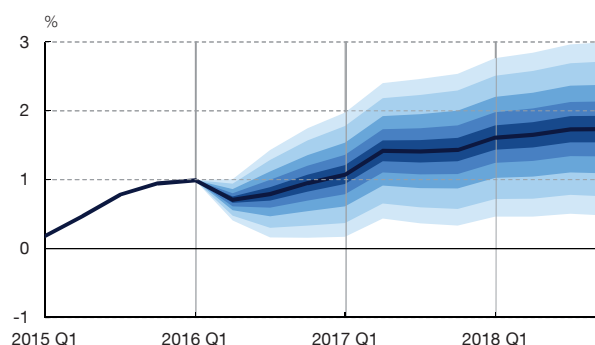
Chart 1 shows the results of a statistical procedure commonly used to approximate the uncertainty inherent in projections based on the construction of confidence intervals, for different levels of probability, drawing on the historical deviations of the projected values of the variables relative to their actual outturn. There are some shortcomings associated with this methodology insofar as it considers that the risks under the baseline scenario are symmetrically distributed, without taking into account that, at the time at which the projection is formulated, there may be factors causing the uncertainty to be more pronounced in a specific direction.

It is considered that the risks under the baseline scenario for output growth described above are somewhat more on the negative side. Firstly, from the standpoint of the external

1 GROSS DOMESTIC PRODUCT
Year-on-year rates of change



2 CPI excl. energy and unprocessed food prices
Year-on-year rates of change



Probability of GDP or the CPI excluding energy and unprocessed food prices being within the interval (a)



SOURCES: INE and Banco de España.

Latest figure: 2015 Q4 and April 2016 for the CPI excluding energy and unprocessed food prices.

- a The right- and left-hand charts show the uncertainty around the central projection. Intervals with probabilities of 20%, 40%, 60%, 80% and 90%, respectively, based on historical projection errors.

environment, uncertainty persists over the recovery of the global economy envisaged in the baseline scenario. Such uncertainty is linked, in particular, to the future performance of certain emerging economies. The materialisation of these risks might lead to a less favourable Spanish export performance, both because of the lower growth of foreign markets and a potential appreciation of the euro against the currencies of the more vulnerable economies. Other sources of risk from the external sector have to do with a hypothetical intensification of geopolitical tension in certain areas in conflict (which might give rise to an appreciation of the euro and to an increase in oil prices) and with the outcome of the referendum called in the United Kingdom on its continued membership of the European Union. Conversely, an upside risk to growth might arise from the possibility that the positive impact of the monetary policy measures approved to date may exceed that assumed in the baseline scenario.

On the domestic front, the continuation of the period of political uncertainty, following the calling of new general elections, may give rise to agents temporarily postponing certain spending decisions as a result of the future course of economic policies not having been clearly defined. In terms of fiscal policy, the uncertainty over the process of budgetary consolidation relates to its intensity, its timing and its composition. Insofar as these fiscal policy aspects, as finally applied, may differ from the assumptions included in this projection exercise, there might be effects on the envisaged scenario for economic activity.⁶ Macroeconomic developments will also be influenced by the structural reform agenda pursued. In particular, the approval of reforms geared to improving the functioning of product and factor markets and the dynamism of productivity⁷ will exert positive effects

6 The consolidation path will hinge crucially on the decisions reached by the European Council in respect of the application of the Stability and Growth Pact. In this respect, as this text was being drafted, the European Commission proposed to the European Council a recommendation whose approval by the latter would entail a new budgetary consolidation timetable for Spain, whereby the budget deficit would have to be lowered to 3.7% of GDP in 2016 and 2.5% of GDP in 2017.

7 See the 2015 *Annual Report* of the Banco de España http://www.bde.es/bde/es/secciones/informes/Publicaciones_an/Informe_anual/.

on confidence and growth, which would materialise more forcefully towards the end of the projection period, given that some time usually elapses between the actual introduction of the reforms and the moment when they begin to have a favourable effect on the economy. That underscores the advisability of avoiding delays in applying the reforms still needed.

With regard to prices, the risks of deviation are tilted slightly to the downside, as a result especially of a hypothetical materialisation of the earlier-described risks relating to the external environment of the euro area. On the upside, the package of monetary policy measures adopted to date might boost inflation beyond what has been projected in the baseline scenario, as a result of their positive impact on demand and on agents' inflationary expectations.