BBVA RESEARCH

Spain Economic Outlook

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01
The Spanish economy will grow by around 2.7% p.a. over the next two years

02
With an upward bias in 2016 and a downward one in 2017

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Tailwinds hold course, but losing strength

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A more flexible labour market would have led to less job destruction during the crisis

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Closing Date: 6 May 2016

1 Editorial

In line with our forecast of three months ago, we expect GDP to grow by 2.7% p.a. in both 2016 and 2017 and the Spanish economy to create a million jobs over the course of the two years. These forecasts, made on the assumption that there are no changes of economic policy other than those already approved, may be affected by the greater strength shown by the various indicators of activity (upward bias) or by the materialisation of certain risks that were anticipated at the time (downward bias). Despite the continuing high degree of economic policy uncertainty, we do not see any significant slowdown in activity, probably thanks to the positive contribution of other factors. On the other hand, some of the tailwinds that have underpinned the recovery are losing strength. In any case, the probability of some risks' materialising is increasing, and we may see a slowdown in activity in the next few quarters, which would be consistent with the scenario envisaged here.

According to the indicators available at the time of writing, 2Q2016 will have been the fourth consecutive quarter with GDP growth of around 0.8%, which brings a positive bias to the forecasts for 2016. This growth is explained by the strong increase in domestic demand, mainly household consumption, in spite of the moderation seen in the growth of certain items of public spending and of investment. Also, exports of services continue to perform exceptionally well, unlike those of goods, which are affected by the deteriorating growth prospects of certain emerging economies. Lastly, although the recovery in housing investment seems to be consolidating, it is doing so at a rather slower pace than initially foreseen. In summary, the contributions of the various demand components have changed little over the past few quarters, although that of the public sector has declined and weaker growth has affected some of Spain's trading partners.

Some of the factors that have been underpinning the recovery are still in place. Various factors have reduced the risks related to growth prospects for the world economy. Among them is an improvement in expectations regarding activity in China, a partial reversal in the trend in commodity prices (both of which are grounds for optimism for the emerging economies), and the perception that the US Federal Reserve will not increase interest rates to a level that would jeopardise the growth of the US economy. Also, the price of oil will continue to be considerably below the level of the past few years. Finally, the monetary policy stance in Europe will continue to be expansionary, while Spain's fiscal policy could be neutral or slightly expansionary.

However, the tailwinds are slackening. The improvement in the global situation is weak and fragile, with growth rates below those seen in the period 2011-2015 (3.2%) or in the decade prior to 2008 (4.0%). We are also starting to see an upturn in oil prices, for which the main reason seems to be the adjustments being made on the supply side as opposed to a recovery in world demand. Additionally, although the European Central Bank (ECB) has announced a wide range of measures (cuts in official interest rates, cash injections, asset purchases, etc.), the effect of monetary policy on growth may be starting to run out of steam (see Box 3). On the one hand, although businesses, households and the public sector have all benefited from lower interest rates on borrowings, this relief may be nearing its limit. Thus, both the nominal interest rates zero lower bound and the downward resistance in sovereign risk premiums and private sector financing (for reasons of solvency) will prevent financing costs from falling further. On the other, the euro has stabilised somewhat, and we do not expect any further depreciation aimed at boosting competitiveness. Lastly, in regard to fiscal policy, during 2015 the public administrations as a whole are estimated to have implemented discretionary measures for a total of approximately 1% of GDP. This impetus will not be repeated in 2016.

This balance of forces among the different supporting factors for growth comes about in an environment in which some of the risks foreshadowed have materialised, while the resolution of

others is still up in the air. The overshoot of the public deficit target seen at the end of 2015 could lead to a loss of credibility as regards the process of righting the imbalances in the Spanish economy. Also, even if the new path proposed by the current government is approved, following that oath will require the rigorous execution of the measures committed to in the Stability and Growth Programme. Even in this scenario it will be very difficult for the autonomous regions as a whole, and even more so for some of them in particular, to attain the objective set. In any case, failure to meet the deficit target has costs. Firstly, it makes economic growth unnecessarily volatile, given the difference there will be in fiscal impetus between 2015 and 2016. Secondly, the discretionary measures taken last year, which are largely responsible for the overshoot, will have to be offset somehow in the future. This generates uncertainty about what form the adjustment will take in the next few years. Lastly, credibility is an asset that is quickly lost. For the time being, the effect of the overshoot on the cost of borrowing for Spanish sovereign bonds has been limited, largely thanks to the ECB's asset purchases. However, this will not last forever, and in an economy as indebted as Spain's it will be crucial to contain the cost of financing so as to be able to ensure that the recovery continues.

Uncertainty about the future of economic policy remains high, although so far the costs appear to be limited. While there is no obvious deterioration in activity due to the difficulties in installing a government in Spain, this does not mean that it is not already having an impact on GDP. In particular, the growth forecasts presented in this publication could have been as much as 0.8 of a percentage point higher (cumulative 2016 and 2017) if the increase in economic policy uncertainty seen between January and April had not occurred. What is more, there is no guarantee that these negative effects will not continue to increase. It would therefore be advisable, in order to counter these effects, for the new government to implement an ambitious programme of economic reforms to boost potential growth. BBVA Research recently presented a proposal in this respect, focused on increasing efficiency and fairness in the labour market. In particular it seeks to make indefinite employment contracts more attractive to employers, modernise collective bargaining, introduce a tax system that would favour job creation and improve the design of active and passive employment policies. The advantages of moving forward in this direction can be considerable, as shown by the analysis of the effects of the change observed in workers' response to economic activity in the past few years (see Box 1). Apart from this, improving the credibility of the control over the public accounts and in particular of the imbalances of the autonomous regions would seem to be an obvious priority objective for the next government. In general terms the regional governments have made considerable efforts over the past few years (see Box 2). However, the lack of market discipline (since they access financing through the Autonomous Regions' Liquidity Fund), together with the lack of certainty as to the application of the measures available through the Budgetary Stability Act, has acted as a brake on the process of adjustment. Going forward, and not forgetting the need to reform the Autonomous Regions Financing System, it is necessary to achieve a consensus on a credible consolidation plan for each autonomous region. These plans must reward the regions that meet their objectives and encourage reform of regional markets (single market, reduced operating costs for businesses, etc.) as an alternative to more painful measures and a way of enabling them to return to the financing markets.

2 World growth is slow and fragile[1]

Data available for the first quarter of 2016 confirm the stabilisation **of growth in the world economy, still at a low rate, but slightly higher than at the end of 2015.** Thus the BBVA-GAIN[2] model puts quarterly growth in world GDP at 0.6% (2.6% as an annualised rate), significantly below the average recorded between 2010 and 2015 (see Figure 2.1). Nonetheless, the pace of growth could accelerate in the second quarter if the signs of lesser deterioration shown by available indicators of output, trade and business confidence are confirmed and/or if there is **substantial improvement in economic growth in the US and Japan**.

The sharp increase in financial volatility seen between December 2015 and February 2016 occurred in response to the slowdown in global activity, and threatened to exacerbate it if it persisted with the same intensity. Since then, financial tensions, as well as the probability of the manifestation of a stress scenario on a global scale, have subsided. In this regard, the **better-than-expected behaviour of economic indicators in China** has been of decisive influence, as have the reduced downward pressure on the value of the yuan, **the stabilisation of commodity prices and the moderation of expectations of interest rate increases on the part of the US Federal Reserve.**

All the same, **the improvement in the global economic scenario in the last quarter continues to be fragile** and dependent on how China's economy evolves and on the resolution of the sources of instability in Europe (geopolitical, "Brexit" and payment of the Greek debt, mainly) or a possible slowdown in the US. In any case, repeat bouts of financial volatility like the one seen at the beginning of this year must not be ruled out, in a context of high uncertainty about the ability of the emerging markets to manage their slowdown and of the developed countries' central banks to reactivate growth.

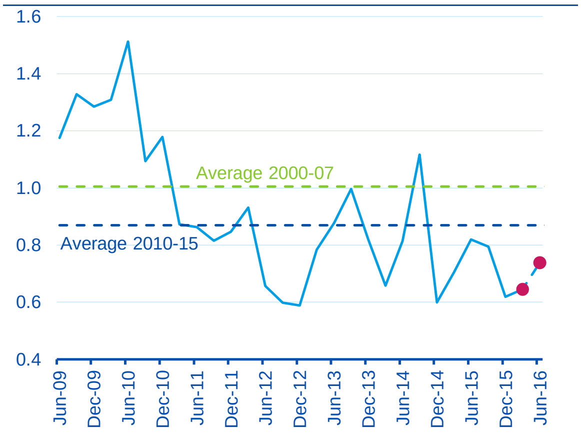
Euro zone: downward revision of growth prospects, with short-term political risks

Following moderate growth in the second half of 2015 (with quarterly GDP growth rates of 0.3%), **the pace of progress of the euro zone economy increased to 0.6% in the first quarter of 2016.** The better-than-expected performance of France and Germany (with growth rates in the order of 0.5 - 0.6%) and the dynamism of Spain (increase of 0.8% for the third quarter running) were behind the improvement of the euro zone as a whole at the beginning of this year.

The strength of private consumption, which has recovered to pre-crisis levels, **continues to be crucial to the euro zone's growth pattern**, although the recent fall in agents' confidence and the level of household debt in some peripheral countries limit the scope of its additional support to aggregate activity. This, together with the **continuing modest recovery in capital expenditure** (in a context of great external and political uncertainty and downward pressure on corporate earnings) and the **weakness of foreign trade**[3] justifies the **downward revision of growth forecasts for 2016 and 2017** (see Figure 2.2). Thus, euro zone GDP could grow by 1.6% this year and 1.9% in 2017 (respectively 0.2 pp and 0.1 pp less than forecast three months ago).

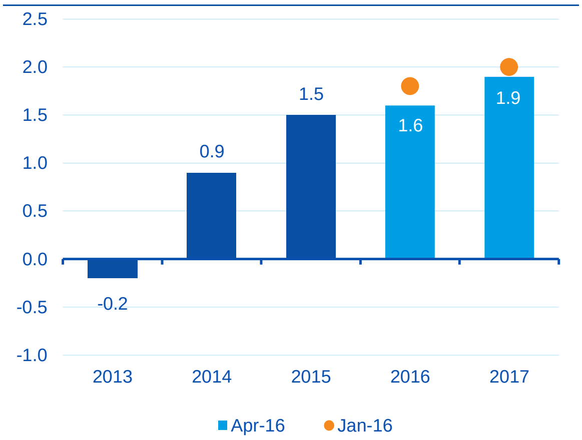
1: For further detail, see BBVA Research's publications Global Economic Outlook and Economic Observatory Europe for the second quarter of 2016, available at: https://www.bbvaresearch.com/
2: See: https://www.bbvaresearch.com/en/publicaciones/global-gdp-growth-to-benefit-from-a-less-stressed-financial-outlook/
3: In particular, we observe that the effect of the euro's cumulative depreciation since mid-2014 has started to fade, especially in the past few months when it has returned to levels of around US$1.15.

Figure 2.1
World GDP (% QoQ) Forecasts Q1 and Q2 2016 based on BBVA-GAIN



(e): estimated.
Source: BBVA Research

Figure 2.2
Euro zone: GDP growth (%)



Source: BBVA Research and Haver

In the most likely scenario, **any support for activity from the ECB's new stimulus measures**[4] **and the slightly expansive nature of fiscal policy** in the major euro zone countries **is likely to be moderate and therefore insufficient to offset the negative effect of the aforementioned factors** on confidence and private sector spending decisions. Moreover, we do not rule out the possibility of the proximity of large debt repayments by Greece creating tensions in the markets if the agreement being negotiated with public creditors is not reached beforehand.

In regard to the inflation scenario, it remains practically unchanged, which would put the average headline rate for 2016 at 0.2% and at 1.3% for 2017. The increase observed in oil prices may alleviate downward pressure on the energy component of the CPI in the shorter term, but in the absence of a sustained increase in the prices of the underlying core (stable at rates of 1%) headline inflation will not meet the ECB's price stability target until 2018.

4: See https://www.bbvaresearch.com/wp-content/uploads/2016/04/ECB-Watch-Minutes-April162.pdf

3 Growth outlook for the Spanish economy

The recovery is not yielding ground, despite the fact that the risks are still present

The Spanish economy started 2016 continuing the recovery that started in mid-2013. Despite the economic situation being marked by both internal and external uncertainty[5], in the past few months we have seen the **rate of expansion of activity stabilise at around the levels observed over the course of 2015** and thus above the trend growth rate. Prominent among the external factors continuing to support growth are **the low price of oil, the gradual improvement in European demand and the ECB's monetary policy** (see section 2).

At the domestic level, the gradual improvements in the labour market and in financing for businesses and households, as well as the correction of internal imbalances, continue to favour consumption and investment decisions. At the same time **fiscal policy continues to be slightly expansive and will gradually turn neutral over the course of the two-year period 2016-2017,** contributing to growth in the short term despite the increasing risks associated with failure to meet budget targets (see section 4).

In summary, the fundamentals of the Spanish economy support continuing recovery over the two-year period. **We expect GDP to continue growing at a healthy rate**, which in view of the climate of uncertainty and the slackening tailwinds from certain factors such as the price of oil and fiscal and monetary policy, would be compatible with a moderation in the pace of quarterly growth in the next few quarters. Specifically, BBVA Research estimates indicate that GDP will grow by 2.7% in both 2016 and 2017, which will allow the creation of around one million jobs during the period as a whole and reduce unemployment rate to around 17.5%[6].

Although the scenario presented in this report does not incorporate revisions to expectations of growth, **certain internal and external risks persist and in some cases the likelihood of them actually materialising has even increased.** Among those persisting is uncertainty, about both the global economic recovery[7] and domestic economic policy decisions. Among those that are increasing we find the deteriorating credibility of the process of consolidation of the public accounts as a result of the overshoot of the targets set.

Growth held steady at the beginning of the year

In the absence of detailed results, the advance estimate of GDP published by the National Statistics Institute (INE) indicated that the Spanish economy grew by 0.8% QoQ in the first quarter of 2016[8], in line with what we anticipated three months ago (BBVA Research: 0.8% QoQ). If this is confirmed, it will mean that the pace of growth in activity has stabilised at similar rates to those recorded in the second half of 2015 (0.8% QoQ in 3Q2015 and 4Q2015) and will bring year-on-year growth above 3.0% for the fourth consecutive quarter (3.4% YoY).

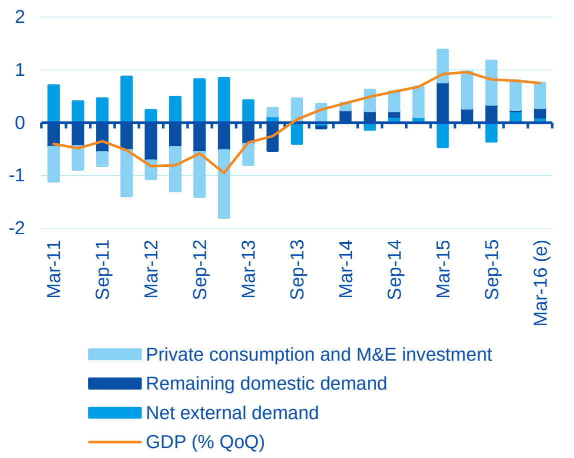
Analysing the composition of growth, the partial short-term economic indicators signal that domestic (especially private) demand will prove to have been the main factor underpinning activity (0.7pp QoQ).

5: Notably about economic policy internally, and externally about financial volatity, the weakness of the global economic cycle and geopolitical tensions.
6: In average terms, employment will grow at an annual rate of 2.8% and the unemployment rate will be around 18.5% in 2017.
7: In particular, we continue to see risks associated with the slowdown in emerging economies, especially China and oil exporting countries.
8: The details of the Quarterly National Accounts (CNTR from its Spanish initials) for Q1 2016 will be published on 26 May, possibly with a revision of the advance estimate.

Despite the positive export performance, the increase in imports will have meant that the positive contribution of external demand to growth was only marginal (0.1 pp QoQ) (see Figure 3.1).

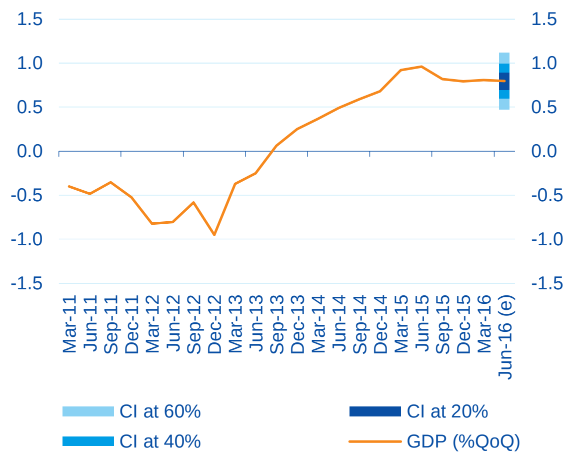
Looking ahead to the second quarter of 2016, the information known at the time of writing suggests that the **recovery trend of the Spanish economy is being extended (MICA-BBVA forecast**[9]: **0.8% QoQ)** (see Figure 3.2). However, uncertainty remains high, and as indicated by the expectations gathered by the BBVA Economic Activity Survey (EAE-BBVA)[10], a slowdown, albeit moderate, in the rate of expansion of activity in the next few months cannot be ruled out (see Figures 3.3 and 3.4).

Figure 3.1
Spain: contributions to quarterly GDP growth (%)



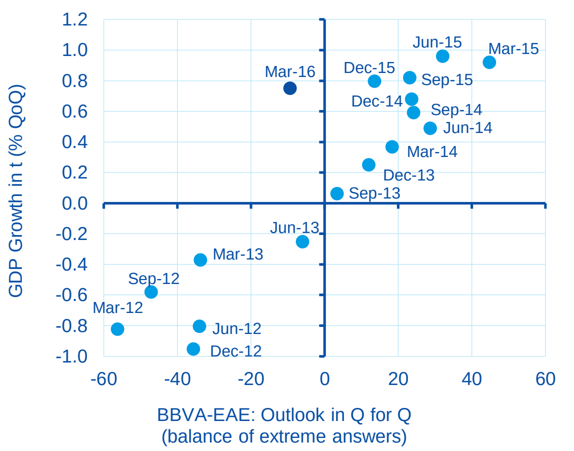
(e): estimated.
Source: BBVA Research based on INE

Figure 3.2
Spain: observed growth in GDP and MICA-BBVA Model forecast (% QoQ)



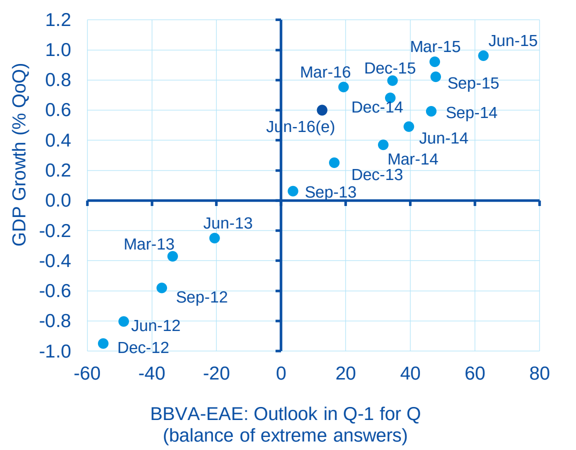
(e): estimated.
Source: BBVA Research based on INE

Figure 3.3
Spain: economic growth and view of respondents in the EAE-BBVA



Source: BBVA Research based on INE

Figure 3.4
Spain: economic growth and expectations of EAE-BBVA respondents in the previous quarter



(e): estimated.
Source: BBVA Research based on INE

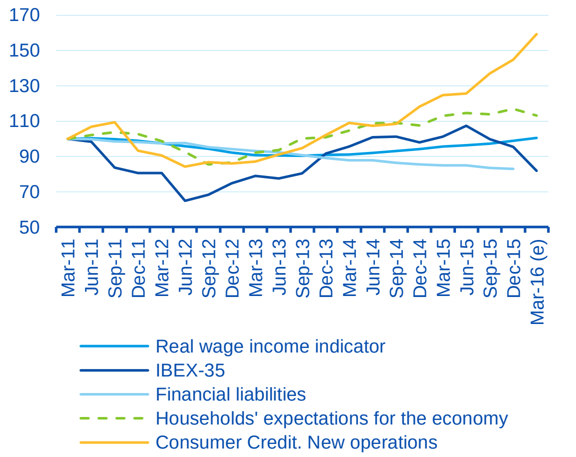
9: For more details on the MICA-BBVA model, see M. Camacho, M. and Domenech, R. (2010): "MICA-BBVA: A Factor Model of Economic and Financial Indicators for Short-Term GDP Forecasting" BBVA WP 10/21, available at: http://goo.gl/zeJm7g
10: For more information on the BBVA Economic Activity Survey (EAE-BBVA), see Box 1 of the Spain Economic Outlook journal for the second quarter of 2014, available at: http://goo.gl/epUinr

Private domestic demand continued to grow, despite the uncertainty

Private consumption seems to have increased once again in 1Q2016 at a similar rate to that seen in the previous quarter. Although indicators of household spending on both goods and services have shown less dynamism from January to March, some of the variables that determine consumption have evolved favourably. For example households' disposable income apparently increased once again, thanks to both the effect of job creation on the wage component and the cut in the rate of personal income tax. Similarly, the pace of new consumer lending seems to have picked up (see Figure 3.5). By contrast, the fall in equity prices was expected to have reduced the contribution of net wealth to the growth in spending, for the second quarter running, despite the expected reduction in financial liabilities and increase in housing prices. Furthermore, households' perception of the economic situation deteriorated during 1Q2016.

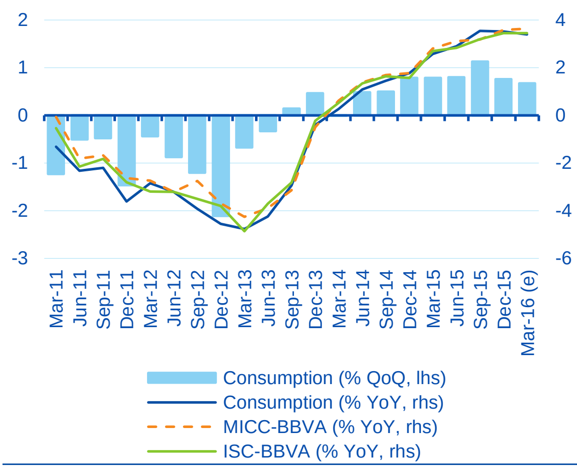
As a result, both the synthetic consumption indicator (ISC-BBVA) and the coincidental consumption indicator model (MICC-BBVA) suggest that **household spending grew once more by around 0.7% QoQ in 1Q2016** (see Figure 3.6)

Figure 3.5
Spain: determinants of consumption (SWDA data. 1Q11 = 100)



(e): estimated.
Source: BBVA Research based on MINECO, Datastream, CE and Banco de España

Figure 3.6
Spain: observed data and real time forecast of household consumption

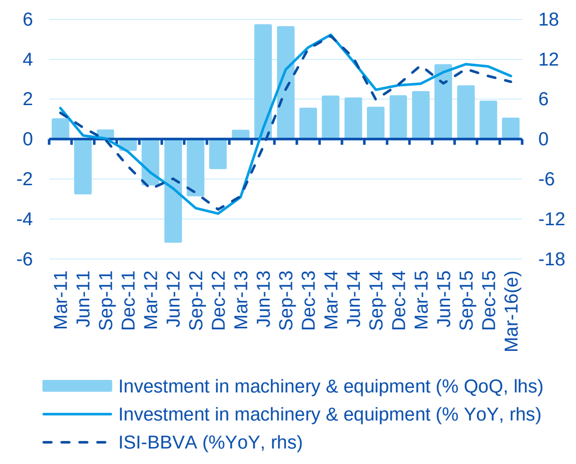


(e): estimated.
Source: BBVA Research based on INE

Investment expenditure on machinery and equipment continued to grow at the beginning of 2016, although the rate of growth seems to have slowed for the third consecutive quarter. Although financing conditions remained favourable in 1Q2016, it could be that the launching of investment projects is being affected by the persistent climate of high uncertainty, both internal and external. Thus the partial indicators of this component of investment continue to send mixed signals. On the one hand imports of capital goods and industrial confidence showed signs of recovery following a negative end to 2015. On the other, industrial output of capital goods moderated its growth, while falls were seen both in order books for capital goods and, for the first time in a year and a half, in sales of industrial vehicles. Thus **the synthetic investment indicator (ISI-BBVA) points to growth of 1.2% QoQ (9.7% YoY) in investment in machinery and equipment in the first quarter of 2016** (see Figure 3.7).

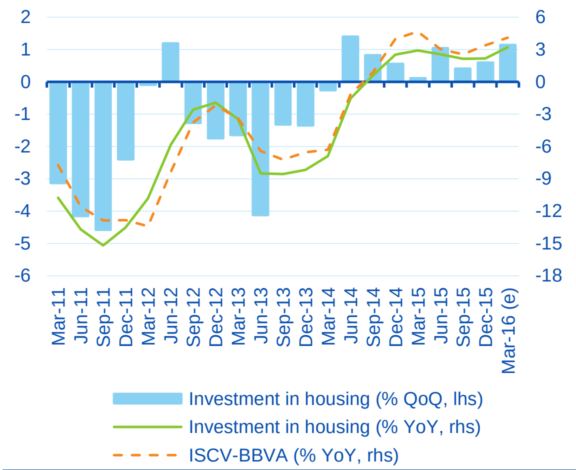
The residential investment indicators point to a first quarter with little change from 4Q2015. We thus infer from the moderation of the growth in both the number of permits for new starts and employment in the sector that 1Q2016 hardly changed at all relative to the previous quarter. Following the stagnation seen in the second half de 2015, available data so far point to a recovery in housing sales in the first quarter of the year. As a result, **the synthetic indicator of investment in housing construction (ISCV-BBVA) points to an increase in this component of investment of 0.8% QoQ (2.9% YoY) 1Q2016** (see Figure 3.8).

Figure 3.7
Spain: observed data and real-time forecast for machinery and equipment investment



(e): estimated.
Source: BBVA Research based on INE

Figure 3.8
Spain: observed data and real-time forecast of housing investment



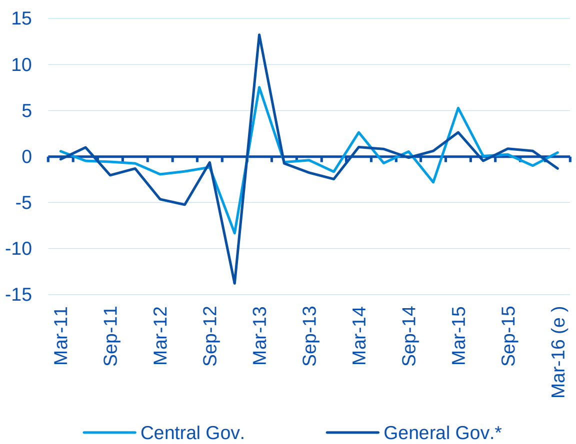
(e): estimated.
Source: BBVA Research based on INE

Public sector demand again increased, despite some of its components slowing

Although the expansionary stance seen in fiscal policy during 2015 is being extended, it would appear to have lost some of its intensity in the first quarter of 2016. Although government budget execution figures show a marginal decline in nominal public consumption compared with the previous quarter, the information available indicates that **real consumption of the public administrations grew by 0.3% QoQ (2.0% YoY)**, 0.3 pp less than in 4Q2015 (see Figure 3.9). In this regard, the trend in public sector employment according to the Labour Force Survey (LFS) suggests a positive contribution from the wage component to public spending, albeit a smaller one than that observed in the previous quarter. In fact, job creation in the sector slowed in the first quarter of the year to 0.3% QoQ swda (see Figure 3.10).

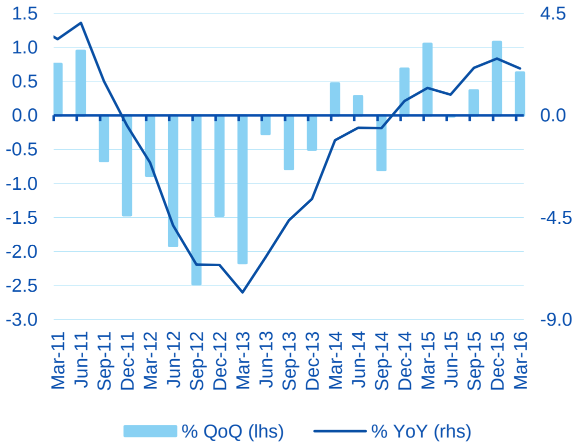
The decline in the number of official public bidding processes recorded in 2015 points to public investment in 1Q2016 having remained at similar levels to those seen in the latter part of last year. In contrast, the positive trend in new non-residential building permits suggests that private sector investment mat be leading the slight upturn in **investment in non-residential construction, with first quarter growth of around 0.9% QoQ** (5.1% YoY), 0.3 pp more than in 4Q2015.

Figure 3.9
Spain: observed data and estimates for nominal public consumption (% QoQ, swda)



(e) = estimated.
(*) Among other items, this does not include fixed capital consumption (depreciation).
Source: BBVA Research based on MINHAP and INE

Figure 3.10
Spain: salaried public sector employees (swda)

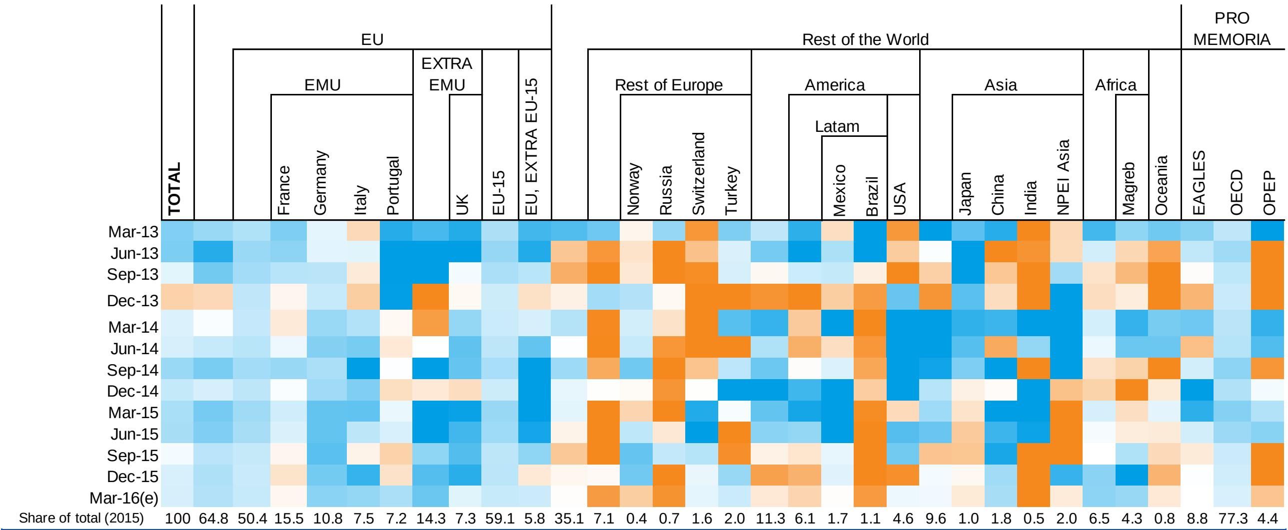


Source: BBVA Research based on INE

Trade flows staged a modest recovery in the early part of the year

During the first quarter **we saw mixed signals from the global situation** for Spanish external trade. On the positive side, we saw an **unexpected acceleration in growth in the euro zone** to 0.6% QoQ (0.3% QoQ in Q4 2015), while at the same time **oil prices remained at record low levels.** However, the **global climate of uncertainty** carried over into the early part of the year, with growth expectations being adjusted downwards, especially in emerging markets, and a high degree of financial volatility. Nonetheless, the balance for the quarter was slightly positive, and the upward trend in exports to most European destinations (except France) again made up for **reduced demand from outside the EU** (mainly from certain major emerging economies such as Russia, Brazil and India) (see Figure 3.11). Thus available indicators for external trade signal a **modest recovery in exports of goods in 1Q2016 (0.6% QoQ, 4.3% YoY)** following the decline of 0.2% QoQ observed in 4Q2015.

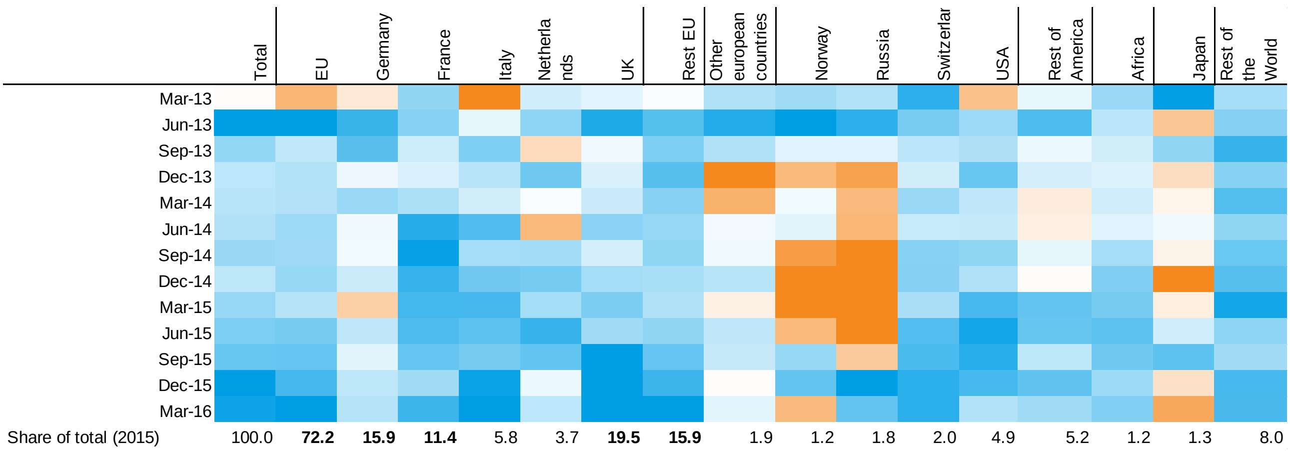
Figure 3.11
Spain: goods exports (% QoQ, trend)



(e) = estimated.
Note: A deeper blue indicates a more positive value. A deeper orange indicates a more negative value.
Source: BBVA Research based on INE and the Customs Office

On the other hand, **growth in exports of services during the first quarter of 2016 (0.4% QoQ, 6.2% YoY) looks to have been lower than in the previous quarter**. With regard to tourism, foreign visitor arrivals (hotel check-ins) increased by 3.0% in 1Q2016.maintaining the positive trends for the major countries of origin (see Figure 3.12). However, **the rate of growth in non-residents' consumption in Spain** is estimated to have **slowed to 0.3% QoQ (5.9% YoY)**, due mainly to the base effect of the unusual growth seen in the last quarter of 2015 (4.1% QoQ). Similarly, **exports of non-tourism services** are estimated to have **continued growing in the first quarter de 2016 (0.5% QoQ; 6.3% YoY)**, albeit with less intensity than that seen in the second half of last year (3.2% QoQ in both Q3 and Q4).

Figure 3.12
Spain: entry of foreign visitors in hotels QoQ, % trend)



Note: A brighter blue indicates a more positive value. A brighter orange indicates a more negative value.
Source: BBVA Research based on IET and INE

In all, exports of goods and services grew moderately in the first quarter of 2016 (0.6% QoQ, 4.8% YoY), 0.3 pp less than in Q4 2015. As for imports, the behaviour of final demand suggests **growth of around 0.3% QoQ (5.3% YoY),** which would equal that recorded in the previous quarter. Thus the aforementioned factors allow us to anticipate a **positive, albeit marginal contribution of net external demand to growth in 1Q2016** (0.1pp).

After three consecutive years of surplus in the current account balance, recent trends in external sector aggregates suggest that the consolidation of the positive balances continues to be underpinned by the gradual reduction in structural and energy deficits. Thus **the current account surplus may have reached 1.7% of cumulative annual GDP at the end of the first quarter** (1.4% of GDP at the end of 2015)[11].

The labour market shows a positive balance in 1Q2016

The recovery of the labour market gained traction during the first quarter. Controlling for variations caused by seasonal factors, average Social Security membership increased by 0.8% QoQ, one tenth more than in 4Q2015, marking its tenth successive quarter of growth. The fall in registered unemployment – for the eleventh consecutive quarter – increased to 2.4% QoQ swda, 0.6 pp more than in the fourth quarter of last year. On the other hand, total new hiring ran out of steam, although the number of new hires on indefinite employment contracts increased by 4.3% QoQ swda[12] (see Figure 3.13).

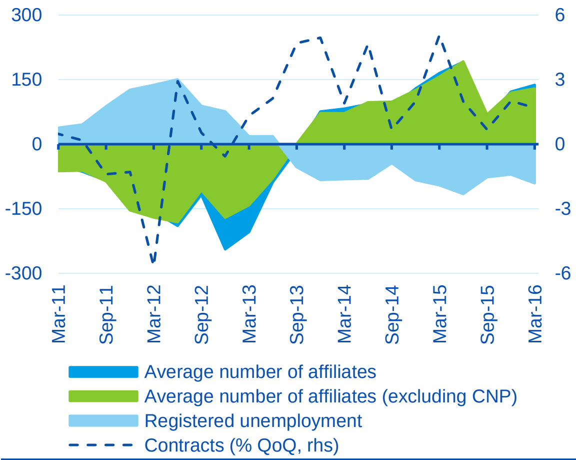
The Labour Force Survey (LFS) for 1Q2016 confirmed the employment trend pointed to by Social Security registration figures. The total number of employees fell by 64,600 for seasonal reasons between January and March[13]. Discounting this factor, **employment grew by around 0.9% QoQ, one tenth of a point more than in the previous quarter.** Manufacturing industry, and in particular services led job creation.

The gross increase of 52,300 in the number of employees with indefinite contracts, and the decline of 106,000 in the number of those with temporary contracts caused a seasonal decline of 0.6 pp in the temporary employment rate in 1Q2016 to 25.0%. **Seasonally corrected, the percentage of employees with temporary contracts increased by three tenths of a percentage point to 25.9%,** 3.2 pp above its cyclical trough reached in the first quarter of 2013.

The decline of 52,700 in active population lessened the effect of the fall in the number of people in work on the unemployment rate, which increased marginally in 1Q2016 (by 0.1 pp to 21.0%). **After eliminating the negative effect of the seasonality inherent to the period, the unemployment rate is estimated to have fallen by 0.7 pp to 20.3% swda,** 6 pp less than the cyclical peak of 1Q2013 (see Figure 3.14).

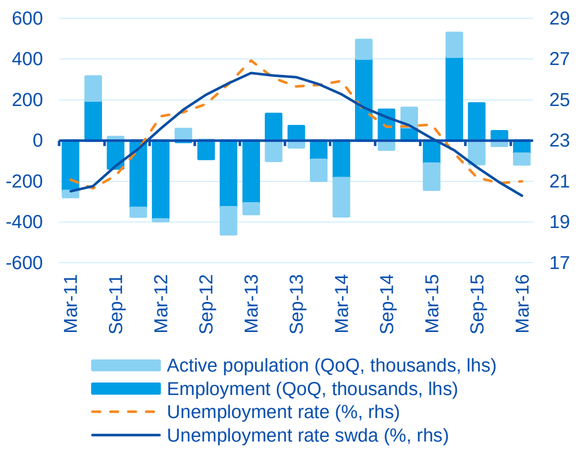
11: See Economic Watch: “Un análisis de la evolución y los determinantes del saldo por cuenta corriente en España” (“An analysis of the trend and determinants of the current account balance in Spain”), available at: https://goo.gl/UzNSeu
12: The April figures April extended the positive trend of 2015. Adjusted for seasonality, BBVA Research estimates indicate that the increase in Social Security membership was around 52,000 people, while the fall in unemployment was 20,000. For more information, see https://goo.gl/cJG9ka
13: The detailed evaluation of the data from the EAPS of Q1 2016 can be found at https://goo.gl/7ZL4KP

Figure 3.13
Spain: labour market figures (QoQ var. in thousands of persons, unless otherwise indicated, swda)



Source: BBVA Research based on ME and SS

Figure 3.14
Spain: labour market indicators



Source: BBVA Research based on INE

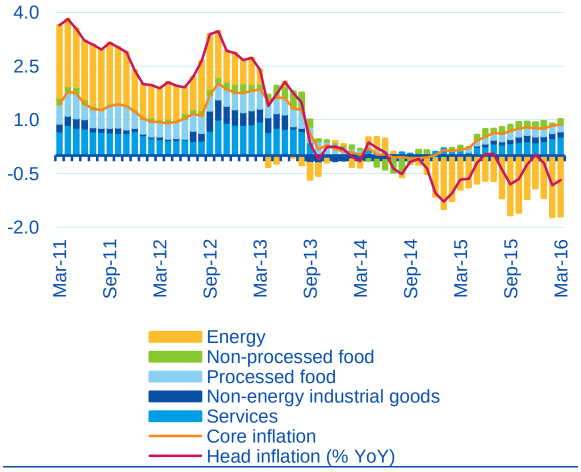
Although energy prices pushed headline inflation down, core inflation increased again in the first quarter

Following the pause in December 2015, headline consumer inflation returned to negative territory during the first quarter of the year, to reach a negative 0.8% YoY in March[14]. In 1Q2016 the downward pressure on prices continued to be concentrated in the energy component (down by 13.6% YoY in March), due mainly to the low price of oil (US$48.20 a barrel at the time of writing) and on this occasion to the fall in the price of electricity (by 14.2% YoY in March). For its part, **core inflation extended its moderate growth trajectory (1.1% YoY in March),** to which the expansive monetary policy implemented by the ECB and the recovery in the labour market and domestic demand contributed positively. Thus, the contribution of core inflation to the year-on-year growth of prices stood at around 0.9 pp in March, while that of the residual component was at -1.7 pp (energy: -1.8 pp and non-processed food: 0.1 pp) (see Figure 3.15).

According to BBVA Research estimates, the gradual increase in Spain's core inflation continues to take place in an environment of low and stable inflation in Europe, and consequently limits the Spanish economy's gains in price competitiveness. Thus, although it remains favourable, **the differential in trend inflation relative to the euro zone as a whole fell by 0.4 pp over the course of last year to -0.2 pp in March 2016** (see Figure 3.16)[15].

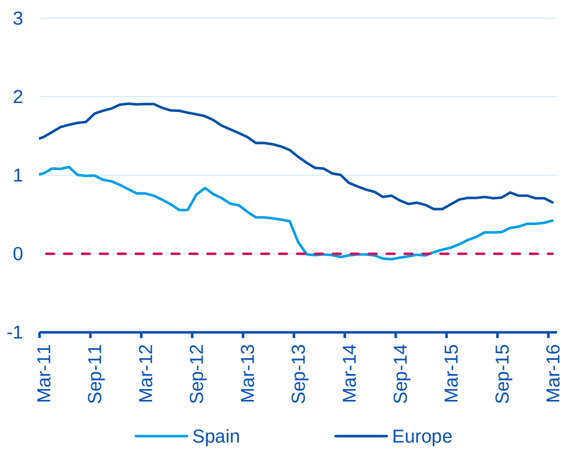
14: The advance CPI indicator signalled a decline in headline inflation of 0.3pp to -1.1% YoY in April, which corresponds to a fall in prices of electricity and base effects associated with the price of energy and the timing of the Easter holidays. Our estimates suggest that core inflation may have been 0.9% YoY. For more details, please see https://goo.gl/bJI0G5
15: For more details on the calculation of trend inflation through the trimmed mean method, see Box 1 of the Spain Economic Outlook journal for the first quarter of 2014, available at: http://goo.gl/j0rlT8

Figure 3.15
Spain: contribution to CPI growth (pp YoY)



Source: BBVA Research based on INE

Figure 3.16
EMU: trend inflation (trimmed mean method, % YoY)



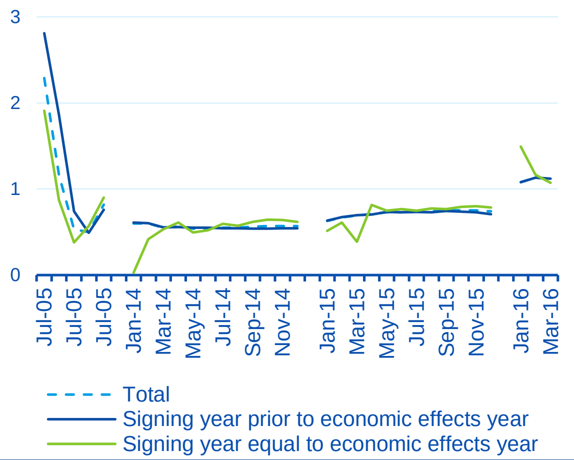
Source: BBVA Research based on INE and Eurostat

Wage demands intensified during the first quarter, in line with the upturn in core inflation. The average wage increase agreed in collective agreements was 1.1% YoY from January to March, both for the revised multi-year agreements and for agreements signed during the current year, involving 103,600 workers[16] (see Figure 3.17). Although increases in wages in 1Q2016 were 0.4 pp more than those agreed in the previous quarter, they were less than the 1.5% set as a maximum limit in the 3rd Agreement for Employment and Collective Bargaining (AENC from its Spanish initials) for the full year[17].

As shown in Figure 3.18, the gain in cost competitiveness relative to the euro zone as a whole driven by this process of wage moderation since 1Q2012 seems to have come to a halt.

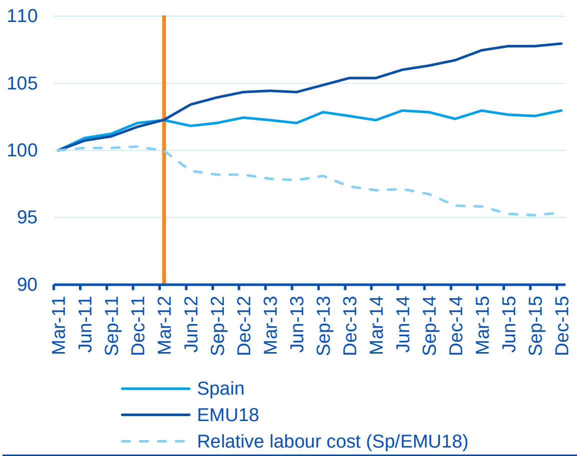
16: The number of workers covered by collective agreements surpassed four million up to March including those affected by agreements signed before 2016 (3,954,000). This figure is double that recorded to March 2015, but must not be interpreted as an increase in the number of workers covered by collective bargaining agreements, because since the beginning of the year Collective Agreements Statistics have also included agreements signed but not yet registered.
17: The III AENC, signed in early June 2015 by CEOE, CEPYME, Comisiones Obreras and UGT, sets limits on wage increases agreed in collective agreements. In 2015 they were not allowed to exceed 1%, and in 2016 the figure is 1.5%. The increase in 2017 will depend on the development of GDP growth in 2016 and the government's macroeconomic forecasts. Although the agreement does not expressly impose the inclusion of wage revision clauses, it does indicate that the wage growth agreed in the 2015-2016 two-year period must be greater than the sum of the inflation in both years.

Figure 3.17
Spain: average wage increase under collective bargaining agreements (%)



The annual data includes agreements registered after December each year and incorporates the review under the wage guarantee clause.
(*) Provisional data. The figures since 2013 are not comparable with years previous to this. See: http://goo.gl/WQkvNU
Source: BBVA Research based on ME and SS

Figure 3.18
EMU: labour cost per effective hour worked in the market economy (1Q11 = 100)



Source: BBVA Research based on Eurostat

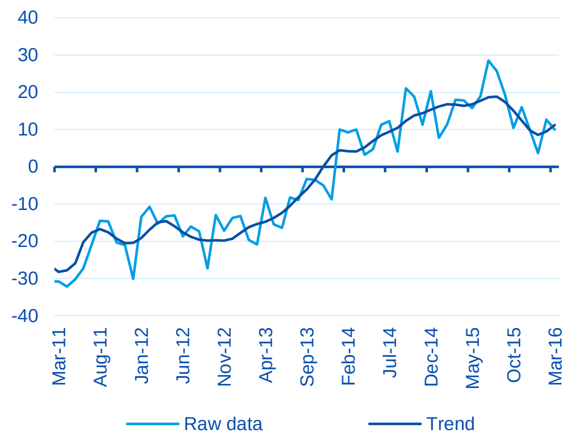
The total credit flow slowed in the first quarter, but lending to the retail sector remained robust

Private sector loan outstandings continued to fall in the first few months of 2016, albeit more and more slowly (-3.8% YoY in February). The number of new loan transactions also continued to fall, ending the first quarter down by an average of 7.2% YoY (23.7% YoY in March). Thus **new credit flows continued to be dragged down by loans to major corporates of more than €1 million,** which fell by an average of 23.6% YoY in the first quarter (and by 52.2% YoY in March). It could be that this apparently reduced demand for bank borrowing by major companies is due at least in part to the climate of uncertainty (national and international) and to the growing tendency to meet financing requirements from other sources (basically by generating their own resources, and to a lesser extent by issuing debt in the capital markets).

However, **lending to the retail sectors (households and SMEs), which had slowed somewhat at the beginning of the year, has recovered its pace** and is now showing a growth trend that has increased over the course of the first quarter (8.9% YoY). Thus borrowings by SMEs (approximated by loans of less than a million euros) increased by 7.3% YoY in 1Q2016 (9.7% YoY in March), surpassing the volume of new loans granted to major companies for the first time (€15.3 billion, compared with €11.4 billion). **Lending to households also regained traction and showed robust growth in the first quarter (12.5% YoY),** with its major components posting double-digit growth. Thus new lending for the acquisition of residential property grew by 11.4% YoY in 1Q2016 and consumer lending grew by 25.1% YoY, whereas other types of lending were practically stagnant. Looking ahead to the next few months, we can expect the current trends to hold, with a resurgent retail sector taking the leading role (it already accounts for 59% of the YTD total for 2016), and lending to major companies falling back.

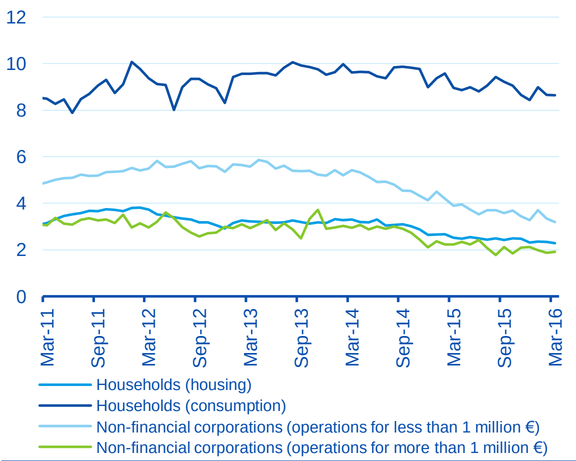
Apart from this, the cost of new borrowing has maintained its downward trend, although in some portfolios there are signs that it has touched bottom, given the low levels reached by benchmark rates and the narrowing of margins. For example, in March the rate for house purchases stood at 2.29% (APR), 23 basis points (bps) lower than in March 2015 but barely 2 bps less than at year-end 2015. Rates for consumer credit stood at 8.64% APR, approximately 31 bps lower than in the same month of 2015. As for lending to companies, the average interest rate for new loans to SMEs fell between December 2015 and March 2016 by 7 bps to 3.20% APR (bringing the total decline in the past 12 months to 70 bps), while the rate for loans to large companies stood at 1.91% APR (31 bps less than a year ago). This trend has been helped by the reduction in EURIBOR and the reduced sovereign and credit risks faced by banks.

Figure 3.19
Spain: new lending transactions (% YoY)



Source: BBVA Research based on Banco de España data

Figure 3.20
Spain: interest rates on new lending transactions (% APR)



Source: BBVA Research based on Banco de España data

2016-2017 Scenario: the recovery continues

As already mentioned in the introduction to this section, **the elements incorporated in the updating of the macroeconomic scenario allow us to maintain our growth forecasts** for the Spanish economy for the next two years. **Activity will grow by 2.7% in both 2016 and 2017,** a sufficiently brisk pace to create about a million jobs by the end of the period and reduce the unemployment rate to around 17.5%.

The expansion of activity will continue to be supported by both internal and external factors. The global economy will continue to grow gradually, and this, together with the low oil prices and favourable exchange rate, will keep the volume of exports high. Similarly, the expansionary tone of monetary policy will encourage domestic expenditure. Domestically, the recovery of the fundamentals, the progress in correcting imbalances and a moderately expansionary fiscal policy will contribute to an increase in demand (see Table 3.1). The increase in final demand will bring about a significant increase in imports, which will probably result in a **marginal contribution of net external demand to growth**.

Table 3.1
Spain: macroeconomic forecasts

(% YoY unless otherwise indicated)	Q1 2015	Q2 2015	Q3 2015	Q4 2015	Q1 2016 (e)	2015	2016 (p)	2017 (p)
National Final Consumption Expenditure	2.3	2.8	3.4	3.5	3.0	3.0	2.4	2.2
Private FCE	2.6	2.9	3.6	3.5	3.4	3.1	2.6	2.4
Public Admin. FCE	1.5	2.5	3.0	3.7	2.0	2.7	1.6	1.8
Gross Fixed Capital Formation	6.1	6.3	6.7	6.4	5.9	6.4	4.1	4.5
Equipment and Machinery	8.3	10.1	11.2	10.9	9.7	10.2	5.5	4.7
Construction	6.2	5.2	5.2	4.6	4.2	5.3	3.1	4.1
Housing	2.9	2.6	2.1	2.2	2.9	2.4	2.8	4.4
Other Buildings and Constructions	8.8	7.3	7.6	6.4	5.1	7.5	3.3	3.9
Domestic demand (*)	**3.1**	**3.4**	**4.1**	**4.1**	**3.4**	**3.7**	**2.6**	**2.6**
Exports	5.8	6.0	4.5	5.3	4.8	5.4	4.4	5.6
Imports	7.6	7.4	7.2	7.7	5.3	7.5	4.4	6.0
External balance (*)	**-0.4**	**-0.2**	**-0.7**	**-0.6**	**0.0**	**-0.5**	**0.1**	**0.0**
Real GDP at market prices (mp)	2.7	3.2	3.4	3.5	3.4	3.2	2.7	2.7
Nominal GDP mp	**3.2**	**3.7**	**4.1**	**4.3**	**3.8**	**3.8**	**3.6**	**4.9**
Pro-memoria								
GDP excluding housing investment	2.7	3.2	3.5	3.6	3.4	3.2	2.7	2.6
GDP excluding construction	2.3	3.0	3.2	3.4	3.3	3.0	2.7	2.5
Total employment (EAPS)	3.0	3.0	3.1	3.0	3.3	3.0	2.8	2.5
Unemployment rate (% Active Population)	23.8	22.4	21.2	20.9	21.0	22.1	19.8	18.5
Total employment (FTE)	2.9	2.9	3.1	3.0	2.9	3.0	2.4	2.2

(*) Contributions to growth.
(e): estimated; (p): projected.
Source: BBVA Research based on INE and Banco de España

Low oil prices will continue to support activity

Over the past few months the price of oil has partly corrected its falling trend, with Brent crude trading at around US$50 per barrel at the time of writing. Nonetheless, **the price of crude oil is still 35.2% less than it was a year ago (37.6% less in euro terms),** representing a cumulative fall of 65.5% compared with the end of the first half of 2014 (58.1% in euros) when it started to fall (see Figure 3.21).

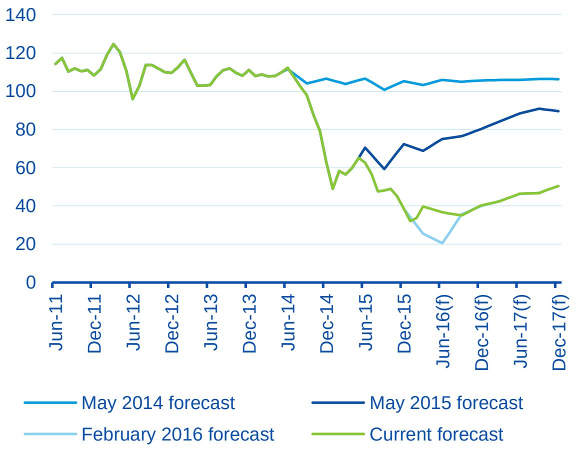
Despite the uncertainty about the factors depressing the price of oil, available information indicates that **the bulk of the cumulative fall derives from supply factors**[18]. Consequently, the net impact of this fall in the cost of energy on activity continues to be both positive and significant: it increases households' disposable income and reduces companies' production costs, encouraging consumption and investment and tending to improve corporate margins and trade flows.

The forecasts by BBVA Research point to a gradual stabilisation of prices which, as an annual average, will be around US$37 and US$46 per barrel in 2016 and 2017 respectively, slightly higher than estimates of three months ago (US$30 and US$45 a barrel), but 40% and 30% below the forecast of

18: Prominent among the supply factors are the production of non-conventional crude in the US (shale oil) and OPEC's failure to act on production quotas. On the demand side too there have been pressures on the price of crude, linked to the moderation in expectations of world growth, mainly in the emerging markets. However, estimates by BBVA Research suggest that this factor has played a secondary role.

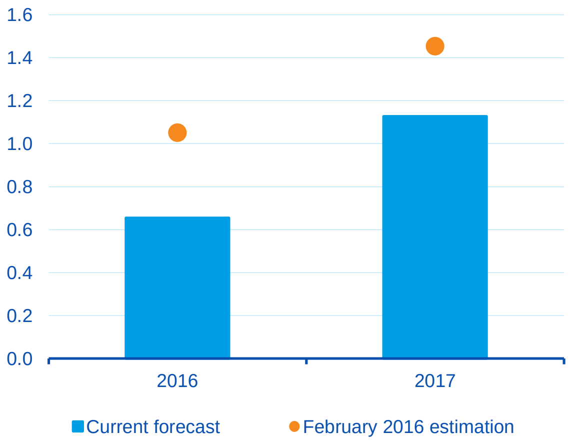
six months ago. Given the Spanish economy's high degree of energy dependence, **the continued support provided by cheap oil could add an average of just under one percentage point to growth during this two-year period**, 0.4 pp less than the effect estimated three months ago (see Figure 3.22)[19].

Figure 3.21
Oil price scenarios (USD/bbl, Brent)



Source: BBVA Research based on Bloomberg

Figure 3.22
Spain: impact of downward revision of the price of oil caused by increase in supply (deviation of annual growth in pp from base scenario of six months ago)



Source: BBVA Research

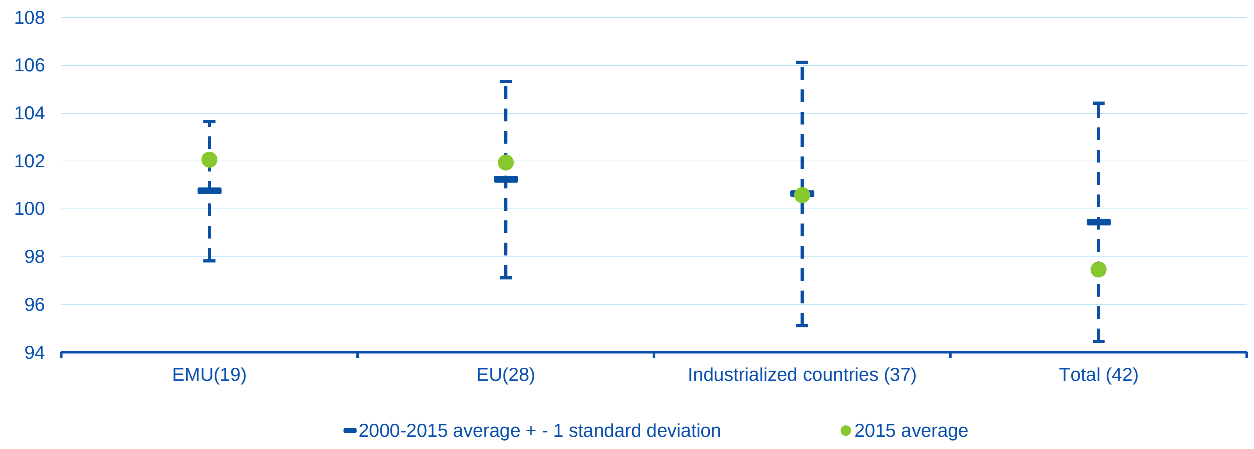
Monetary policy and European demand are contributing to the recovery

In view of the risks that continue to hang over growth and inflation in the European economy, **the ECB has again gone into action, confirming its readiness to use all the stabilising instruments envisaged within its mandate if necessary**. In March, the ECB's Governing Council cut rates to new all-time lows - the reference rate by 5 bps to 0.0%, the deposit rate by 10 bps to -0.4% and the marginal lending rate by 5 bps to 0.25%. Moreover, as regards non-conventional measures, it announced the expansion of the asset purchase programme o €80 billion a month and the widening of its scope to include investment grade non-banking corporate bonds denominated in euros, as well as presenting a new round of TLTROs (targeted longer-term refinancing operations) at four years[20].

These monetary policy easing measures in Europe, along with expectations that the Federal Reserve will continue the gradual process of normalisation of monetary policy in the US, contribute to **holding down the real effective exchange rate of the euro for Spain and mitigating the increase in financial stresses and in the risks associated with European growth (see Figure 3.23).** Nonetheless, given the current starting point (with interest rates and exchange rates at rock bottom and a wide range of non-conventional measures deployed), the impact of the new monetary policy measures will probably be less than that observed in previous episodes of easing. In this regard, BBVA Research's estimates suggest that the non-conventional monetary policy measures adopted since mid-2014 reached their maximum impact (0.5 pp on growth) in 2015 (see Box 3).

19: For details about estimating the effects of oil prices by type of shock on activity and prices in the Spanish economy, see Box 1 of the Spain Economic Outlook journal for the second quarter of 2011, available at: https://goo.gl/iijivP
20: For further details, please refer to BBVA Research's ECB Observatories of 10 March and 21 April 2016. Available at https://goo.gl/he4Kv3 and https://goo.gl/2Uma59

Figure 3.23
Spain: real effective exchange rate of the euro (deflated by harmonised CPI, 2005 = 100)



UEM = euro zone, EU = European Union, PI = EU + Australia, Canada, Japan, Mexico, New Zealand, Norway, Switzerland, Turkey and the US, Total = PI + Brazil, China, Hong Kong, South Korea and Russia
Source: BBVA Research based on Eurostat

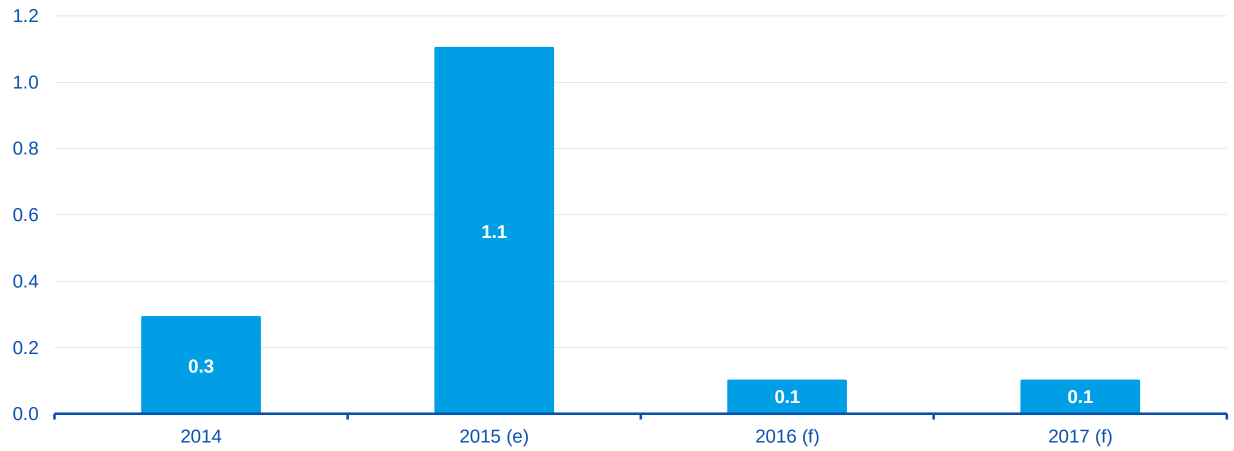
Financing flows returned to the path of recovery

Going forward, we expect new lending to halt its retreat, for reasons of both demand and supply. Providing the economic policy uncertainty is cleared up, we expect the businesses', and especially exporters' cyclical improvement and the lower rates of interest to encourage demand for credit. On the supply side, the improvement experienced in liquidity conditions (thanks to the banking union and the ultra-expansionary policy of the ECB), the lower risk of portfolios and the progress made in bank restructuring will be positive forces. One of the banking sector's prime objectives is to promote the recovery in new lending transactions, accompanying the improvement in economic activity and attending to solvent demand, especially from the retail sector, which is more reliant on bank financing.

Fiscal policy will remain moderately expansionary during 2016

The recovery in activity and the improvement in financing costs seen in 2015 gave public administrations some leeway to implement expansive fiscal policy measures which eventually led to the deficit target's being overshot by 0.8 pp of GDP (see Figure 3.24). For the current year **we expect fiscal policy to be practically neutral, which in the absence of additional measures** will give rise to growth of 1.6% in real public consumption. In a scenario with no changes in economic policy, **the tone of fiscal policy will again be neutral** in 2017, with real growth in public spending of around 1.8%.

Figure 3.24
Spain: discretionary increase in public deficit (% of GDP)



(e): estimated; (p): projected.
Source: BBVA Research based on MINHAP and INE

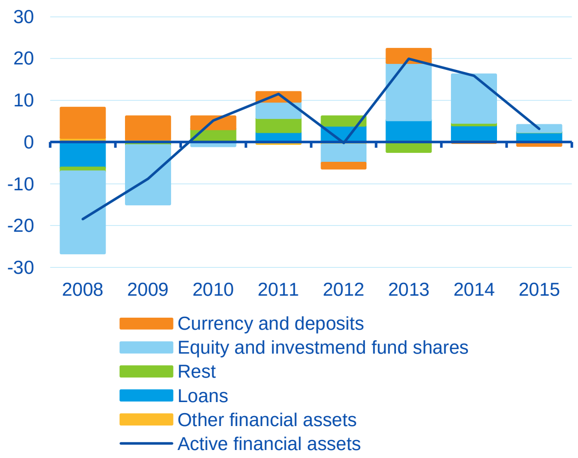
As for investment in other construction, we expect it to continue to grow in the two-year period 2016-2017, albeit at a more moderate pace than that seen in 2015 (3.3% and 3.9% YoY respectively). In particular, we see private sector non-residential investment again being the support for other construction, given the trend in non-residential building permits, which would offset the outlook for a slowdown in public sector works.

Growth in private domestic demand will slow

Prospects for household consumption remain positive. Job creation, lower tax pressure and the absence of inflationary pressures will boost real disposable income in the coming quarters. The expected growth in housing wealth and the expectation that official interest rates will remain at historically low levels will also encourage private consumption. In addition, new consumer finance transactions will continue to increase and will sustain spending in the medium term, especially on durable goods.

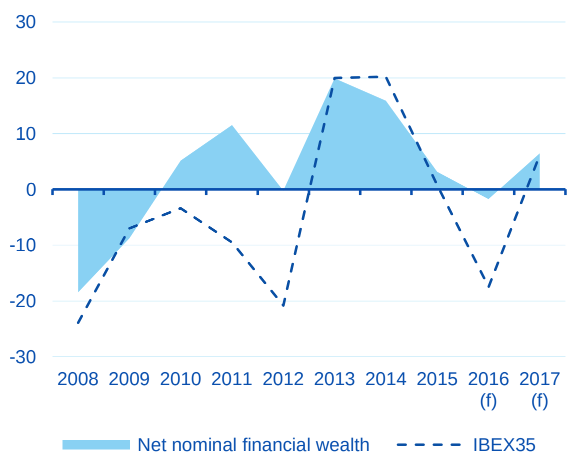
In contrast, the contribution of financial wealth to net growth in household spending will be more modest than in previous years, especially in 2016. The envisaged trend in stock market prices will reduce the weight of direct shareholdings and units in investment funds that explained nearly 70% of the increase in household's financial wealth since 2012 (see Figures 3.25 and 3.26). As a result, **private consumption will increase by about 2.7% in 2016**, in line with our forecast of three month ago. **In 2017**, the transitory factors that will encourage household spending in the current year will either disappear, as in the case of the tax cut, or play a less significant role than in the past, as in the case of the low cost of oil. Consequently, **growth in private consumption will slow to 2.4%**.

Figure 3.25
Spain: contributions to net growth in financial wealth of households (annual averages in %)



Source: BBVA Research based on Banco de España data

Figure 3.26
Spain: net financial wealth of households and IBEX 35 (% change in annual averages)



Source: BBVA Research based on Banco de España and Bloomberg data

The fundamentals sustaining growth in investment on machinery and equipment will remain latent during the next few quarters. Despite the upturn in uncertainty and the recent slowdown in productive investment, the upward trend in domestic and external demand allows us to foresee extension of installed productive capacity. The expansive monetary policy will in turn continue to facilitate the financing of investment at low rates of interest, while the low price of oil will favour savings of internally generated resources which can subsequently be used to finance new investment projects. **The above-mentioned factors justify growth in this component of demand of 5.5% in 2016 and 4.7% in 2017**, quite high rates, and similar to those forecast three months ago (4.8% and 5.0% respectively).

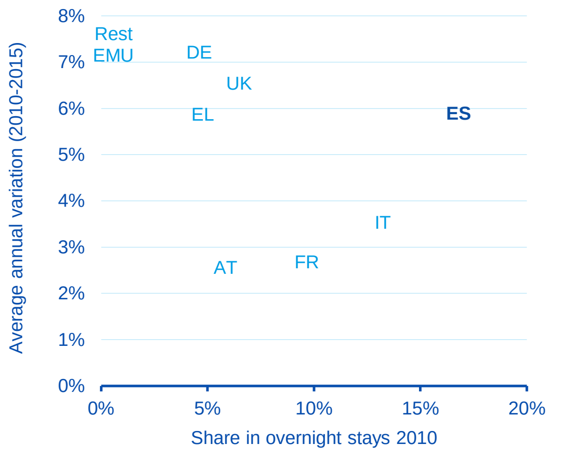
The recovery of the real estate sector continues, albeit at a slower pace than expected. Looking ahead, the fundamentals of housing demand (recovery in the labour market and low interest rates) remain solid, which allows us to foresee further increases in sales in the coming quarters. The construction sector will continue to respond to meet this demand, having shown significant impetus in the past year, albeit from a record low starting point. We therefore expect residential investment to continue to evolve positively in the next few years. However, **the persistent uncertainty about economic policy,** together with the negative surprises seen over the course of 2015, lead us to **revise our forecast for growth downwards in residential investment** in the next few quarters. We now expect this component of investment to show **growth of 2.8% in 2016** (1.4 pp less than we expected three months ago) **and 4.4% in 2017** (3.9 pp less).

Trade flows will continue growing at a healthy rate

The international economic situation has become somewhat less favourable for Spanish exports in the first few months of 2016 This is reflected in the slight revisions to the global scenario: downwards for growth in the euro zone, upwards for the euro's real rate of exchange and oil prices. However, these marginal changes to the forecasts take place in **a context of stable growth, both in the global economy (3.2% in 2016 and 3.4% in 2017) and in that of the euro zone** (1.6% in 2016 and 1.9% in 2017). Also, the euro exchange rate will continue to be favourable, and transport costs will remain under control thanks to oil prices which will continue at historically low levels. Thus we maintain expectations of solid growth in Spanish exports for the two-year period 2016-2017: **the totals will increase at an average annual rate of 5.0% and exports of goods will grow at an average of 4.5%**, 3 pp and 4 pp more than forecast three months ago.

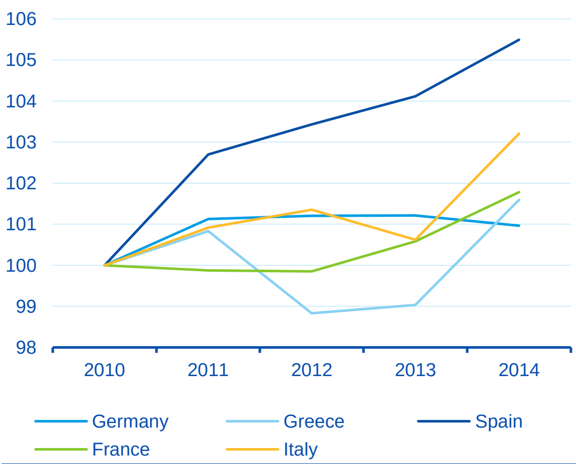
As for exports of services, we expect them to grow at an average of 6.2% a year over the two-year period. In this regard, we continue to see that foreign tourism shows no signs of weakening, and therefore **we expect consumption by non-residents to increase at an average annual rate of around 3.8% over the forecast period**, almost one percentage point more than previously envisaged. This dynamism will continue to be underpinned at least in part by the high degree of geopolitical instability being suffered by some of Spain's Mediterranean competitors. Although this, together with the recovery in European demand, has encouraged travel to other destinations, Spain has performed well over the past five years (see Figure 3.27). Moreover, the increase in the number of visitors to Spain has been accompanied by increases in supply (accommodation capacity), which stands out notably against the major European competitors (see Figure 3.28).

Figure 3.27
Overnight stays of non-residents at major European destinations (average change and market share)



Source: BBVA Research based on Eurostat data

Figure 3.28
Capacity in the main European tourist destinations (2010 = 100)



Capacity is approximate by the number of beds available in hotels and similar accommodation, tourist apartments, camp-sites and caravan parks.
Source: BBVA Research based on Eurostat data

As a result of the positive behaviour of final demand, **imports of goods and services will continue to grow during the next two years (average: 5.2% p.a.)** Thus **the contribution of net external demand to growth will be slightly positive in 2016 (0.1 pp) and zero in 2017 (0.0 pp)**. Cheaper oil prices will continue to lighten the Spanish economy's energy import bills over the next two years, which will help maintain **positive current account balances (average: 2.3% of GDP).**

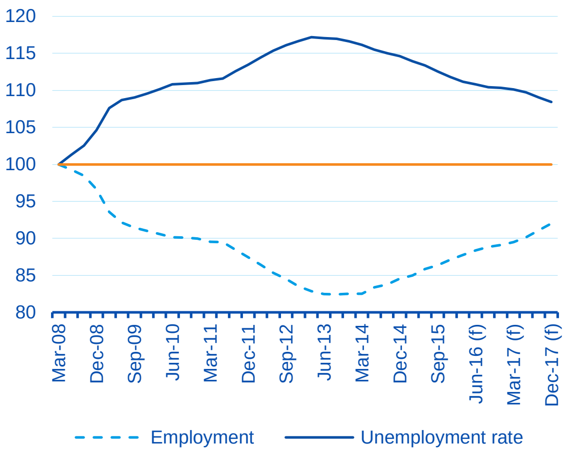
The recovery of the labour market will continue, though there is still a long way to go

Job creation will continue during the next few quarters. Given the expected economic growth, employment could increase by around 2.8% in 2016, while the unemployment rate would fall by 2.2 points to 19.8%. In 2017, job creation would be slightly lower (2.5%), while the unemployment rate would drop to 18.5%.

Although prospects for the labour market are positive, much still remains to be done. As Figure 3.29 shows, in the fourth quarter of 2017 employment would be about 8% lower than at the beginning of 2008, while the unemployment rate would be more than 8 points higher. In addition, the expected development of activity and full-time equivalent employment – which will grow by more than 2.0% in 2016 and 2017 –

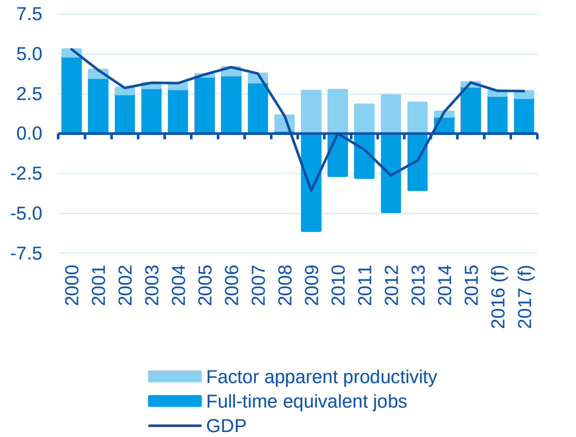
suggests a meagre rebound in the apparent productivity of labour until it converges in 2017 with pre-crisis figures (see Figure 3.30). **In order to breathe new life into the recovery in employment, it would be desirable to undertake a thorough reform of the labour market** including a change in the job protection system so as to encourage hiring on indefinite contracts, modernisation of the collective bargaining system and far-reaching changes to labour market policies. A proposal in this regard can be seen in BBVA Research (2016)[21].

Figure 3.29
Spain: employment level and unemployment rate (1Q08 = 100. SWDA)



(p): projection.
Source: BBVA Research based on INE

Figure 3.30
Spain: contributions to annual GDP growth (%)



(p): projection.
Source: BBVA Research based on INE

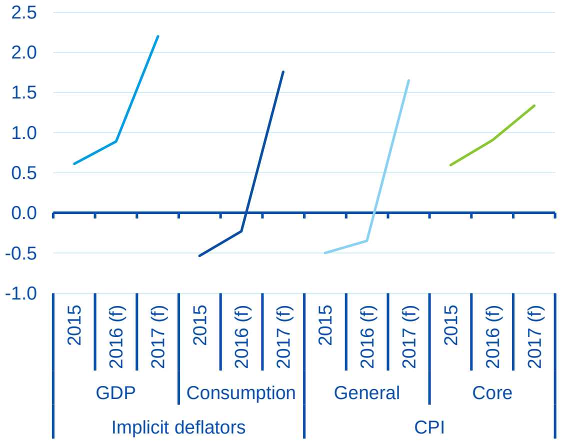
The underlying trend in the behaviour of prices is positive, in spite of oil

Despite the euro's having appreciated against the dollar by rather more than what was forecast three months ago and the fall in the price of oil having been less, the negative surprises at the beginning of the year indicate that **the fall in headline CPI for the whole year 2016 will be greater than previously anticipated (by 0.2 pp to -0.3% as an annual average)**. However, domestic determinants continue to indicate that both core inflation and the implicit GDP deflator will be positive this year (0.9% as an annual average, in both cases) (see Figure 3.31).

In 2017, both headline and core inflation will be positives (1.3% and 1.6% annual average respectively), but will remain clearly below the inflation target set by the ECB for the euro zone as a whole (see Figure 3.32). This forecast improvement in inflation continues to be based both on the recovery of activity and employment and on **monetary policy stimulus measures** (record low interest rates, encouragement of credit availability and quantitative easing).

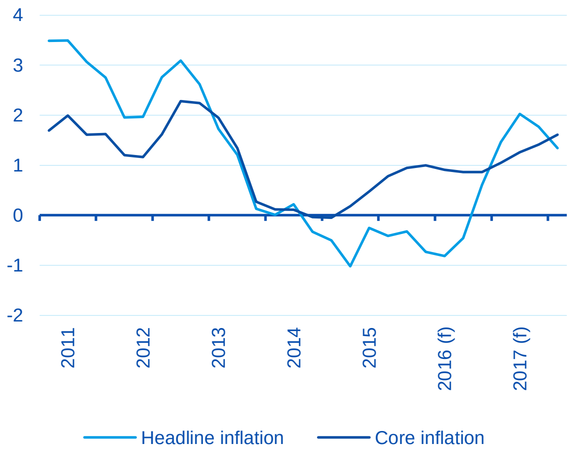
21: BBVA Research (2016): *"Hacia un mercado de trabajo más eficiente y equitativo"* ("Towards a more efficient and fairer labour market"), *Observatorio Económico BBVA*, May. Available at: https://goo.gl/zcwmsn.

Figure 3.31
Spain: price indicators (% YoY)



(e): estimated; (p): projected.
Source: BBVA Research based on INE

Figure 3.32
Spain: observed data and expectations for inflation (% YoY)



(f): forecast.
Source: BBVA Research based on INE and Consensus Forecast Inc.

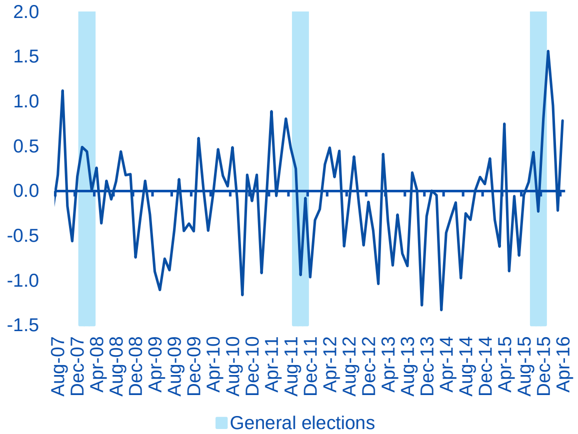
Downside risks in the scenario

Although we can expect the growth of the Spanish economy to remain healthy in the next few quarters, **the external and internal risks hanging over the scenario persist, and some have even increased.** Among the former, we note those associated with the slowdown in emerging economies, especially China and oil exporting countries, and the consequent increase in financial volatility.

Domestically, uncertainty persists (Figure 3.33) and we expect it to remain at a high level in the short term. Although so far the favourable trend in activity and employment has held, BBVA Research's estimates point to the possibility that **the economic policy uncertainty seen to date may be cutting 0.3 pp off GDP growth in 2016 and 0.5 pp in 2017** (Figure 3.34). If the uncertainty increases, or even if it fails to dissipate favourably, it could have a significant impact on businesses' and households' economic decisions[22].

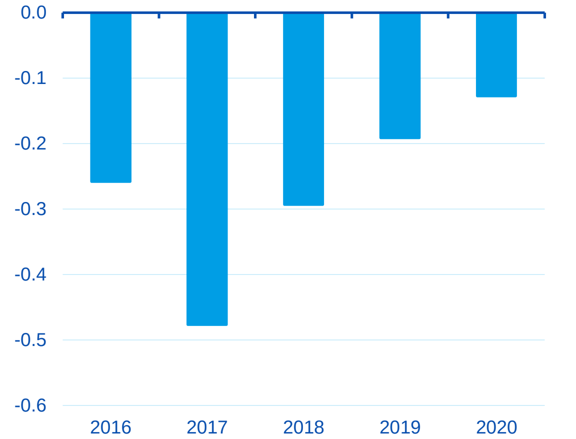
22: For details about estimating the effects of economic policy uncertainty on the Spanish economy, see Box 1 of the Spain Economic Outlook journal for the first quarter of 2016, available at: https://goo.gl/nRnxi7

Figure 3.33
Spain: idiosyncratic component of the economic policy uncertainty (EPU) index (normalised data)



The shading corresponds to a period of three months surrounding each political event
Source: BBVA Research based on the EPU index produced by Baker et al. (2015)

Figure 3.34
Spain: response of GDP to the increase in uncertainty about economic policy recorded since January (pp)



Source: BBVA Research

Aside from this, **the overshoot of the public deficit target of stability for 2015 was bigger than expected,** and the updating of the Stability and Growth Programme for 2017-2019 proposes more flexible targets for the next few years. If it is accepted by the EU authorities, the probability of its being complied with in the next few years will increase, and at the same time the uncertainty as to the effects on activity will diminish. However, doubts remain as to the ability of some public administrations to make the adjustments needed to meet the new targets. This, together with the sanctions that might be proposed by the European Commission for having failed to meet the target for 2015, would affect the Spanish government's credibility and its ability to contain the cost of financing an economy with excessive external debt.

4 The recovery will favour fiscal adjustment, but control of spending will have to be intensified

The expansionary policies of 2015 delayed the positive impact of the recovery on the public accounts

The Spanish public administrations ended 2015 with a deficit of 5.0% of GDP[23], 0.2 pp more than expectations and 0.8 pp more than the target of 4.2% of GDP. Spain's public deficit was thus once again among the biggest of the eurozone countries once assistance to the financial sector is taken out of the equation. All the same, this figure represented an improvement of 0.8 pp compared with 2014, and the sixth biggest deficit reduction in Europe (see Figures 4.1 and 4.2).

BBVA Research estimates shows that the adjustment to the deficit observed in 2015 was basically cyclical, despite the fact that a structural fall in primary spending was observed, concentrated in capital transactions. In this way, Spain's public accounts benefited both from the reduction in the risk premium and from the recovery in activity and employment, which the government took advantage of in order to implement an expansionary fiscal policy. However, the low rate of inflation and above all the measures relating to the tax reform had a negative effect on tax revenues, which partly offset the positive effect of the recovery.

As can be seen in Figure 4.2, adjustments to spending in 2015 more than offset the flagging revenues. Thus, **public spending fell in 2015 by about 1.2 pp to 43.2% of GDP, with the reduction concentrated mainly in central government and, to a lesser extent, in the social security system due to the reduction in social benefits**. In the case of central government, the fall in spending was favoured by the reduction in transfers to other public administrations (partly related to the fall in social benefits) and by the low interest rates on public debt. As for the regional governments[24], the containment of spending was due almost exclusively to the reduced cost of debt, helped by the improvement in financial conditions on the central government's liquidity mechanisms. The remaining expenditure, especially in the autonomous regions, reflected the impact of non-recurring transactions such as the reallocation of investments from previous fiscal years, the launch of the treatment for hepatitis C and expansionary measures such as returning part of the extra payment withheld from civil servants in December 2012 and measures to promote capital expenditure.

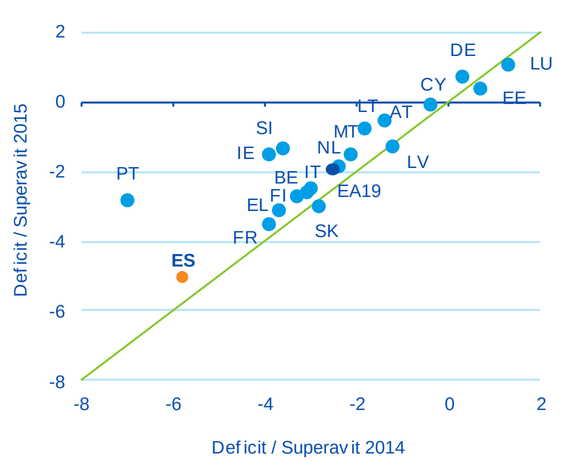
Public revenues halted their recovery, affected by the tax cuts, and came to around 38.2% of GDP, 0.4 pp below the 2014 figure. The fall in revenues was more intense in the social security system, with incentives for indefinite-contract hiring[25] offsetting the positive effects of the recovery in employment on social security contributions. Also, the fall in returns on public debt and the tapping of the reserve fund reduced the social security administration's interest income. In the case of central government, the tax cut penalised growth in tax revenues and total revenues fell by about 0.1% of GDP. Meanwhile, the impact of the tax cut on the regional governments was less, although local authorities saw their revenues fall, largely as a result of the settlements for 2013 under the social security direct contribution system, which turned out negative for them.

As a result, **the fiscal adjustment observed in 2015 came almost entirely from central government, which reduced its deficit by about 1.0 pp to 2.5% of GDP**, 0.4 pp below its stability target. Next best were the **autonomous regions, which held their deficit at around 1.7% of GDP, although this was more than**

23: The deficit analysed in this section excludes assistance to the financial sector in all cases.
24: For a detailed analysis of how the autonomous regions ended 2015, see Box 2 "Autonomous regions' finances in 2015 and the effect of the financing system and of some atypical factors" in this publication.
25: Flat rate €100 contribution for indefinite contracts representing net job creation (Royal Decree Law 3/2014 of 28 de February) and exemption for companies from the first €500 of wages under new indefinite contracts (Royal Decree Law 1/2015 of 27 February).

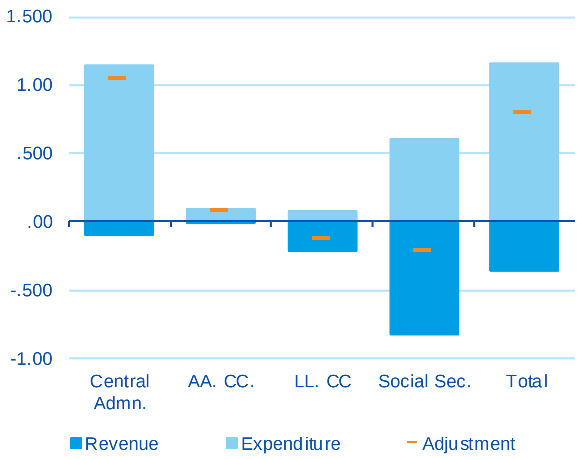
double the target of 0.7% set for the year. For their part, both local authorities and the social security administration saw their balances deteriorate relative to the previous year. On the one hand, local authorities' surplus fell by 0.1 pp to 0.4% of GDP, beating its target of budgetary equilibrium. On the other, the social security system posted a deficit of 1.3% of GDP, compared with the 1% seen in 2015, and failed to meet its stability target.

Figure 4.1
Eurozone: net lending net borrowing, excluding assistance to the financial sector (% of GDP)



Source: BBVA Research based on Eurostat

Figure 4.2
Public administrations: adjustments to net borrowing in 2015, excluding assistance to the financial sector (% of GDP)

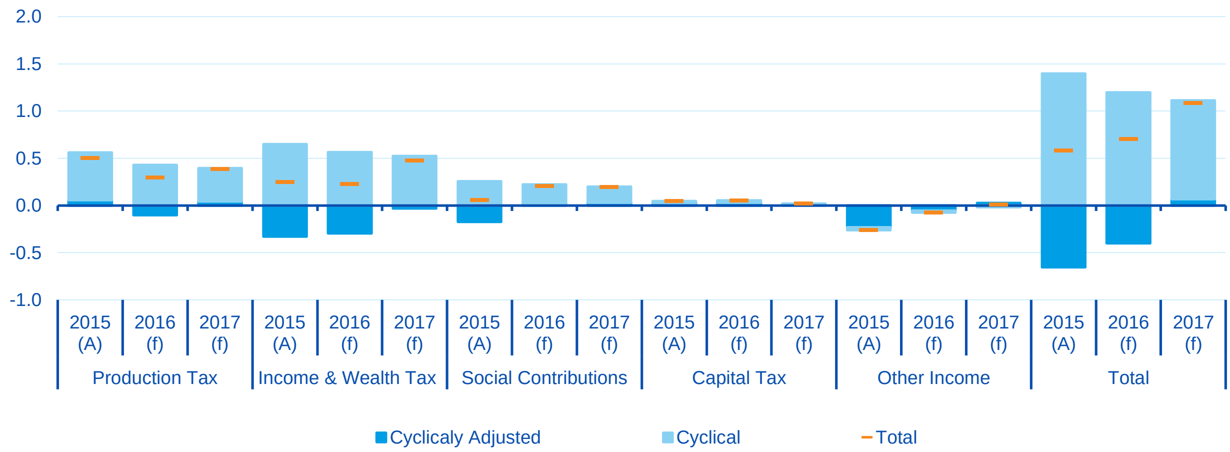


Note: (+) revenues up, expenses down, deficit decreases. (-) revenues down, expenses up, deficit increases.
Source: BBVA Research based on MINHAP data

By breaking down revenue and expenditure into cyclical factors associated with short-term variations in activity and structural factors deriving from discretionary fiscal policy decisions or permanent deterioration of some of its components, we can assess the nature of the fiscal adjustment carried out in 2015. According to BBVA Research estimates **the economic cycle boosted tax revenues in 2015** by about 1.4 pp of potential GDP, through taxes on income and production (see Figure 4.3). This increase in tax resources was largely due to the **improvement in tax bases, which was essentially cyclical.** In the case of a gross disposable income, the cyclical recovery more than offset the structural decline of nearly 0.3 pp of potential GDP deriving from the tax cut.

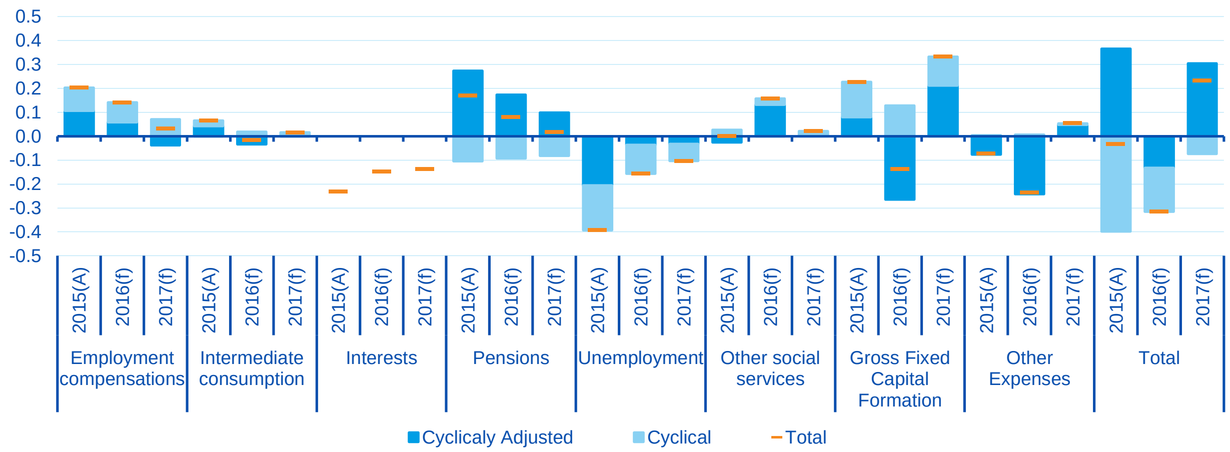
Apart from this, in terms of potential GDP, **the economic cycle will have favoured the reduction in spending in 2015 by about 0.4 pp, mainly due to the decline in unemployment benefits**. In contrast, the increased spending on pensions reflects increases in both the number of pensioners and the average pension amount. Together with this, the figures for 2015 confirm that the adjustment policies ground to a halt, and we see instead **an increase in the discretionary component of items such as employee remuneration, intermediate consumption and gross capital formation** (see Figure 4.4).

Figure 4.3
Public administrations: change in non-financial revenues (pp of potential GDP)



Note: (+) revenues up, deficit down; (-) revenues down, deficit up.
(A): advance; (p): projected.
Source: BBVA Research based on MINHAP and INE

Figure 4.4
Public administrations: change in non-financial expenses (pp of potential GDP)



Note: (+) expenditure and deficit both increase; (-) expenditure and deficit both decrease.
(a): advance; (p): projected.
Source: BBVA Research based on MINHAP and INE

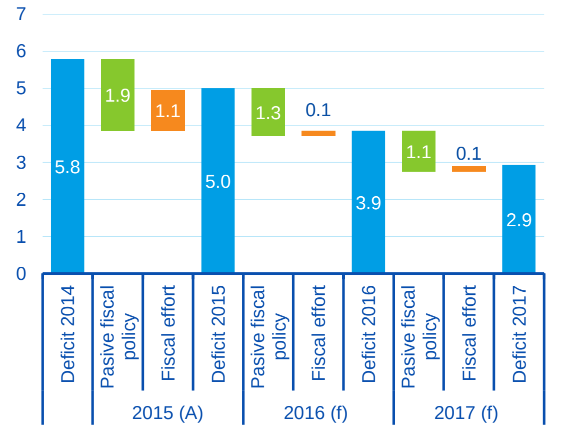
The economic cycle will again favour the adjustment of public accounts, but it will not be enough to bring the deficit back to the stability target

BBVA Research forecasts suggest that **the tax cut will continue to have a negative effect on tax revenue and will lead to a fall in structural revenues from taxes on income, which in the short term will be offset by the cyclical recovery of tax bases**. Also, the measures aimed at encouraging indefinite-contract hiring will continue to act as a brake on growth in social security contributions during 2016. However, the economic cycle will again boost revenues from taxes on both production and capital. Thus, public revenues in 2016 will amount to 38.2% of GDP (nearly 0.3 pp more than in 2015) and to 38.4% of GDP in 2017.

As for expenditure, **we expect it to continue adjusting slightly over the next two years**, partly as a result of the deficit reduction policies launched in previous years, but above all thanks to the forecast improvement in the labour market, which will reduce unemployment benefits, and to the reduction in financial costs. As a result, public spending will be about 41.6% of GDP in 2017, a similar level to those seen before the crisis.

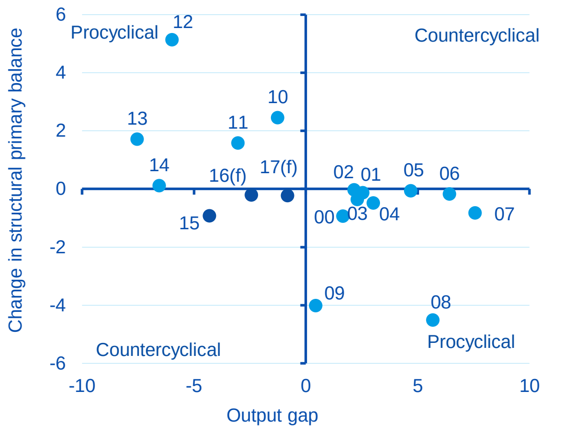
Thus **for 2016 we expect the business cycle to correct the fiscal deterioration again, both through the effect of automatic stabilisers and thanks to the reduced burden of interest and social benefits.** Together with this, the effect of the expansionary policies put in place in 2015 will bring the deficit for 2016 to around 3.9% of GDP, above the target of 2.8% agreed for the year and the 3.6% proposed in the new Stability Programme. As for 2017, it is expected that the economic cycle will continue correcting the deterioration in public accounts, so that in a scenario with no change in fiscal policy, the deficit will decrease by 1.3 pp to 2.7% of GDP (see Figure 4.5).

Figure 4.5
Public administration: breakdown of fiscal adjustment (pp of GDP)



(a): advance; (p): projected.
Source: BBVA Research based on MINHAP and INE

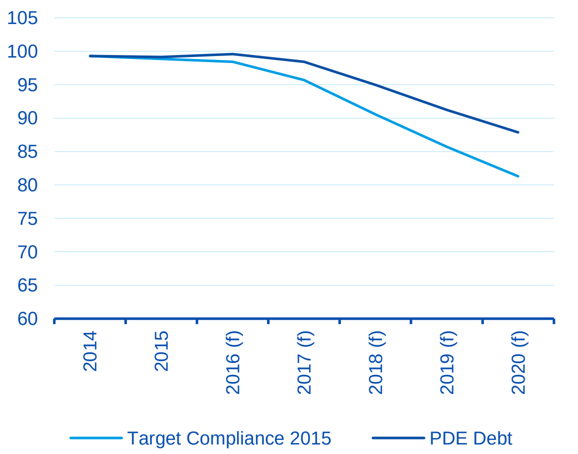
Figure 4.6
Public administrations: fiscal impulse and economic cycle (pp of GDP)



(a): advance; (p): projected.
Source: BBVA Research based on MINHAP and INE

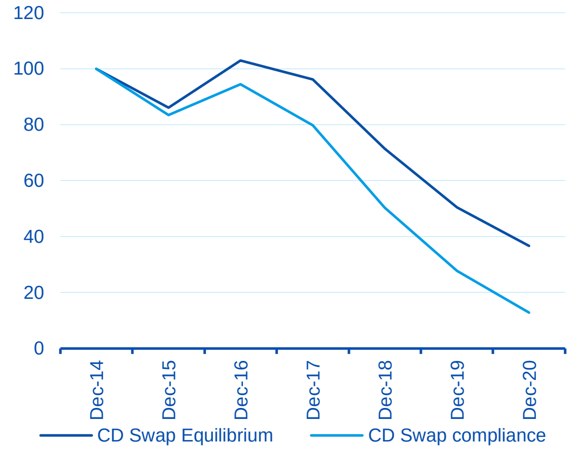
If this scenario occurs, **the cyclically adjusted budget balance will be around -2.1% at the end of 2017.** If we disregarded interest paid, we would have a structural primary surplus of around 0.5% of GDP, representing an adjustment of nearly 10 pp since 2009. As can be seen from Figure 4.6, nearly all the reduction in the structural imbalance in the public accounts was made between 2010 and 2013, whereas the expansionary policies of 2015 and their effects on 2016 seem to have led to a deterioration in the structural primary surplus. This implies that in a scenario with no changes in fiscal policy during the next few years Spain's public accounts would maintain the primary surplus at around 0.5% of GDP, which would imply a relatively neutral direction of fiscal policy. In this context, and given the high level of debt attained (over 99% of GDP in 2015), there is a need for a fiscal policy that ensures achievement of the deficit targets, in order to control the growth of public debt. As can be seen from Figures 4.7 and 4.8, if the stability target had been met in 2015, public debt would be around 6 pp of GDP lower than now expected in the medium term, which in terms of cost means a reduction of nearly 25 bps. Therefore, Spain should continue to move ahead with structural reforms so as to increase its ability to generate primary surpluses of sufficient magnitude to be able to bring down the level of public debt at the pace needed to comply with its commitments under the European Fiscal Compact and reduce the cost of its debt, freeing up resources that can be allocated to productive public policies.

Figure 4.7
Public administrations: debt path according to EDP (% of GDP)



Source: BBVA Research based on Banco de España data

Figure 4.8
Public administrations: projected cost of debt (bps. 2014 = 100)



Source: BBVA Research based on Datastream data

Thus **in the recent update of the Stability and Growth Programme, the government proposes that the stability targets should be made more flexible and postpones its commitment to bring the deficit down below the level of the excessive deficit procedure to 2017.** If it were to be accepted by the EU authorities, the relaxation would reduce the uncertainty as to the effects of a new adjustment plan while at the same time increasing the probability of the stability target being met. However, this programme does not dispel the doubts about the ability of the autonomous regions and the social security to meet the new targets. In this regard, despite the fact that substantial fiscal efforts have been made, repeated non-compliance by the autonomous regions makes it necessary to establish more credible objectives and to strengthen controls on the regional governments. Nonetheless, as shown in Box 2 of this publication, part of the imbalance in the accounts of some autonomous regions seems to derive from shortcomings in the system of financing. Consequently, policies for control of public spending should be tightened up so that we can advance on the path of fiscal consolidation, and this must involve strict compliance with the Budgetary Stability Law, including the Spending Rule.

Table 4.1
Public administrations: financing requirement, excluding assistance to the financial sector

% GDP	2014	2015 (A)	2016 (P)	2017 (P)
Compensations of employees	11.0	11.0	10.9	10.8
Intermediate consumption	5.3	5.2	5.1	5.0
Interest	3.4	3.1	2.9	2.7
Unemployment benefits	2.4	1.9	1.7	1.6
Pensions	11.0	10.9	10.8	10.6
Other social benefits	3.0	3.0	3.1	3.0
Gross capital formation	2.2	2.3	2.2	2.5
Other expenses	6.1	5.9	5.5	5.5
Non-financial expenses	**44.4**	**43.2**	**42.1**	**41.6**
Taxes on production	11.5	11.7	11.8	12.0
Taxes on income, wealth, etc.	10.1	10.1	10.2	10.5
Social contributions	12.5	12.2	12.2	12.2
Taxes on capital	0.5	0.6	0.6	0.6
Other income	4.0	3.6	3.4	3.4
Non-financial income	**38.6**	**38.2**	**38.2**	**38.7**
Net lending / net borrowing	**-5.8**	**-5.0**	**3.9**	**-2.9**
Stability target	-5.5	-4.2	-3.6	-2.9

(A): advance; (p): projected.
Source: BBVA Research based on MINHAP and INE

Box 1. The role of wage flexibility in the recovery of the Spanish labour market

Introduction

The purpose of this box is to show the effects of the greater wage and businesses internal flexibility since 2012 on the labour market[26]. To do so, we use a model that allows us to break down the trends in the main macroeconomic aggregates into the different types of disturbances to which the Spanish economy has been subjected so as to simulate two counterfactual scenarios. The first describes how employment would have evolved since 2012 in the absence of the changes that have favoured greater wage flexibility. In the second we estimate the effects of having made the mechanism for determining wages more flexible at the beginning of 2008.

The results indicate that the reduced rigidities have had positive effects on production and employment. The data show that job destruction between 2012 and 2013 was less intense than in the early part of the crisis, despite the fiscal adjustment and the increased financial stress. What is more, the recovery since then has been compatible with a current account surplus, an increase in price competitiveness relative to the rest of the eurozone and a shift in the Beveridge curve towards the origin due to both a possible improvement in matching processes and the decline in the labour force participation rate.

Estimates for the first counterfactual exercise suggest that if the wage demands seen on average in 2010 and 2011 had been replicated between 2012 and 2015, nearly nine hundred thousand more jobs would have been lost at the end of last year. The second exercise allows us to conclude that, if in 2008 there had been greater wage flexibility such as that seen from 2012, the destruction of close to two million jobs in the long term could have been avoided, as could an increase of eight points in the unemployment rate.

The deterioration of the labour market during the crisis

Because of the configuration of the institutions characterising the Spanish labour market, adjustments in response to macroeconomic disturbances have traditionally been inefficient. The expansionary cycles have been characterised by increased duality of the labour market, lacklustre growth in productivity and sluggish growth in real wages. In the recessive cycles, the fall in demand has led to large-scale job destruction instead of adjustments to working hours and/or remuneration per worker.

The response of the labour market in the Great Recession that started in 2008 was no different from what it had been in previous crises. The downturn in domestic demand from the beginning of 2008 led to cumulative declines in GDP and employment of 9.3% and 19.0% respectively, while the response of the intensive margin (hours worked per employee)[27] and especially of wages, was negligible. In fact, nominal compensation per employee increased by 9.2% between the first quarter of 2008 and the fourth quarter of 2011, while real compensation increased by 8.2%[28]. The fall in employment and the counter-cyclical changes in the labour force during the initial stages of the crisis[29] translated into an increase of 18 percentage points (pp) in the unemployment rate, to 26.3% in Q1 2013.

26: A more extensive version of this box can be found in Doménech, García and Ulloa (2016).
27: After falling by around 4% since 2002, hours worked per employed person increased during 2008 and 2009 by about 1% and then stabilised until the beginning of 2012.
28: Part of the compensation growth was the result of a composition effect caused by the concentration of job destruction in groups with below-average wages. However, real wage increases included in collective bargaining agreements reached 3.6% in 2008 and 2.3% in 2009.
29: As shown in Box 1 of BBVA Research (2008), the growth of the active population during the early part of the crisis was explained by an added worker effect characterised by an increased propensity to participate in the labour market on the part of groups with traditionally limited prospects of obtaining employment (women, young people, people with few or no qualifications etc.).

The upturn in wages, along with a **limited competition in the market for products**[30], the **tax changes** and the **rise in regulated tariffs made it difficult for prices in the economy as a whole to adjust**[31]**,** which led in turn to reduced demand for labour. The increase in compensation per employee also pushed unit labour costs (ULC) during 2008 and 2009, in spite of the notable increase in apparent labour productivity. Given that the ULC of the eurozone as a whole grew by nearly four points less during the same period, the price competitiveness of the Spanish economy suffered.

Reforms as response

With the aim of reversing the deterioration of the labour market, successive governments have approved reforms since 2010 which have mainly sought to rebalance the adjustment by facilitating changes in wages and the intensive margin, at the expense of moderating the response of the extensive margin (employment).

Focusing on the measures adopted since 2012, we would highlight the reform of the labour market passed in February 2012 as Royal Decree-Law and in July as Law. Among the numerous changes introduced by the reform, three stand out[32]:

- The decentralisation and modernisation of the collective bargaining system, by giving greater priority to company agreements and eliminating the indefinite extension of collective bargaining agreements where new ones cannot be agreed (*ultra-activity*).
- The reduction in the cost of dismissal, whether unfair (the special "express" dismissal was abolished and the severance payment of 33 days per year worked with a maximum of 24 month applied across the board) or for just cause (the economic grounds for fair dismissal were simplified and transitional wages during the procedural period were abolished except for reinstatement cases).
- The promotion of internal flexibility mechanisms[33]. Firstly, the reform facilitates the adoption of substantial amendments to the terms of employment contracts (particularly the amount of wages or salary) and removes the requirement for a prior administrative authorisation for suspending the contract or reducing the working day for economic, technical, organisational or production-related reasons. Secondly, it reduces the uncertainty as regards the economic causes that enable collective bargaining agreement opting-out and extends the fields in which the employer can deviate from it (workday, work hours, shift work, workflows, tasks, etc.). Lastly, the reform allows functional mobility among occupational groups, not only between categories.

The labour reform of 2012 represented a significant advance from the previous legislation and mitigated some of the dysfunctions of the Spanish labour market. However, despite its scope, it did not address other aspects, which subsequently required further **complementary measures**. Without attempting to be exhaustive, we would highlight those aimed at:

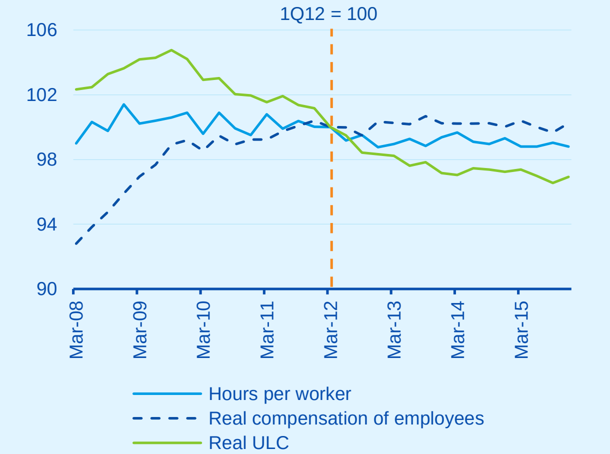
30: According to Koske et al. (2015), Spain's indicator of barriers to competition is similar to that of the average of Germany, France, Italy, the UK and Portugal, but those for regulatory complexity, barriers to entry for firms and to private initiative are more restrictive. The analysis of the effects of competition in the markets for goods and services on the labour market can be found in Blanchard and Giavazzi (2003).
31: For further details on the determinants of price movements during the crisis, see Box 1 in BBVA Research (2014).
32: A summary of the changes introduced by the reform of the labour market can be seen in BBVA Research (2012).
33: The Second Agreement on Employment and Collective Bargaining for 2012-2014, signed by trade unions CEOE, CEPYME, CCOO and UGT at the end of January 2012, also contributed to promoting the use of internal flexibility mechanisms as an alternative to job destruction. See: http://www.boe.es/boe/dias/2012/02/06/pdfs/BOE-A-2012-1778.pdf

- Encouraging the job search among the unemployed people who receive unemployment benefits.
- Facilitating hiring and promoting the use of part-time contracts.
- Fostering indefinite-term hiring.
- Increasing the efficiency of active labour market policies (ALMP).
- Promoting young people's employability[34].

2012: turning point

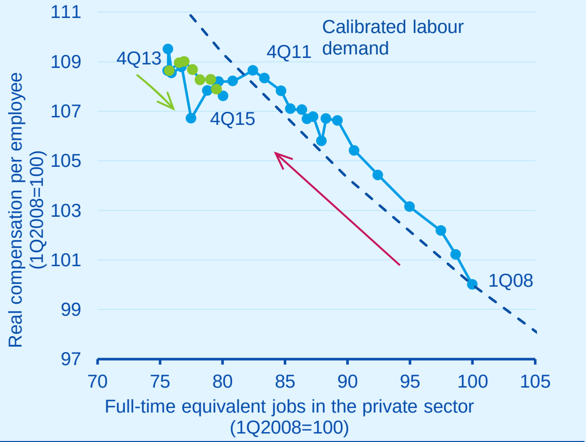
The coming into force of the labour market reform in March 2012, along with the commitment to internal flexibility and wage moderation made in the Second Agreement on Employment and Collective Bargaining 2012-2014 gave rise to a **new phase in the workings of the labour market**. Since then we have seen a halt in increases of real compensation per employee and a slight reduction in the number of hours worked (see Figure B.1.1), which have made possible a more efficient response of employment to the macroeconomic disturbances (see Figure B.1.2).

Figure B.1.1
Spain: compensation per employee, hours worked and unit labour cost (SWDA data, Q1 2012 = 100)



Source: BBVA Research based on INE

Figure B.1.2
Spain: labour demand curve (Q1 2008 = 100)



Source: BBVA Research based on INE

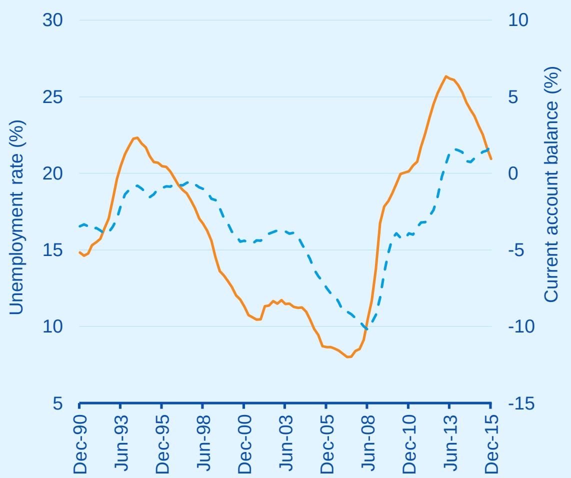
In comparison with what happened up to 2012, the second phase of the recession – marked by the European debt crisis and a contractive fiscal policy – was characterised by a reduction in the elasticity of employment to a fall in activity. **The Spanish economy has been creating employment since the end of 2013, without repeating the imbalances built up in previous expansionary phases**:

- Between 2014 and 2015, Spain created 900,000 FTE jobs, while at the same time regaining price competitiveness with the rest of the eurozone. Whereas at the end of the crisis of the early 1990s growth in employment was accompanied by a positive differential in ULCs (which grew at an average of 1.5% in Spain between 1994 and 1995, compared with 1.1% for the eurozone as a whole), in the current recovery the differential is negative (-0.3% in Spain as against 0.9% for the eurozone as a whole in 2014 and 2015).
- For the first time in the past few decades employment has grown without incurring deficits in the current account balance or resort to currency devaluations (see Figure B.1.3). Although the behaviour of oil prices since the summer of 2014 has helped avoid deterioration in the external balance[35], it should be remembered that in other episodes of cheap

34: The measures listed can be seen in Table B.1.A.1.
35: From the end of 2013 to the end of 2015, the decline in the energy deficit of 1.5 pp of GDP has partly offset the 2.3 point reduction in the non-energy trade surplus.

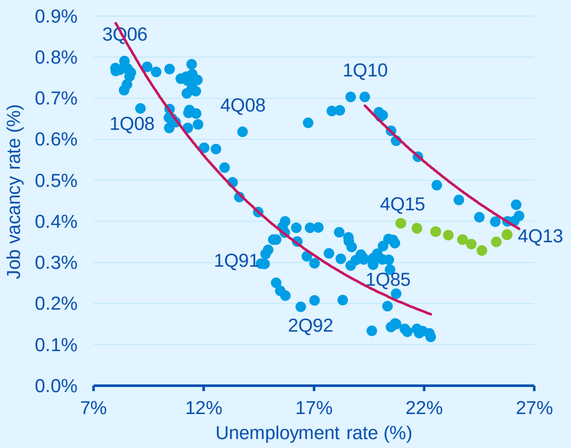
energy[36] the increase in activity and employment led to a deterioration in the current account balance.

Figure B.1.3
Unemployment rate and current account balance (%)



Source: BBVA Research based on Banco de España and INE data

Figure B.1.4
Spain: Beveridge curve (1985-2015)



Source: BBVA Research based on BDREMS, Eurostat and INE

- As can be seen in Figure B.1.4, the recent increase in employment has been accompanied by a shift in the Beveridge curve (ratio of unemployment rate to vacancies) towards the origin, which could suggest reduced friction in the labour matching processes.

An estimate of the effects of wage flexibility on employment

Although the preliminary evidence seems to indicate that the greater flexibility has had positive effects on the adjustment and recovery of the Spanish economy, **the structural effects of the regulatory changes are difficult to estimate, since the variables of the labour market are affected by other simultaneous disturbances**.

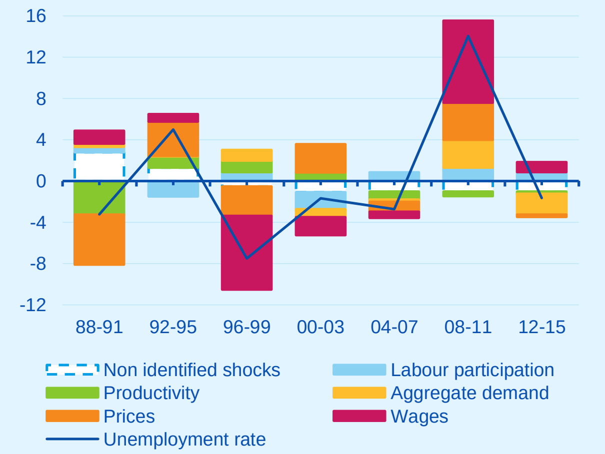
With the aim of analysing how the rigidities in price and wage formation affect job creation and the magnitude and persistence of the unemployment rate, we estimated a Structural Vector Autoregression (SVAR) model which allows us to identify the effect of different shocks on the main variables of the labour market: economic demand policy (fiscal and monetary), productivity, participation in the labour market and rigidities in wage and price formation. One of the advantages of this type of model is that it makes it **possible to isolate wage shocks that are explained not by their endogenous response to changes in the unemployment rate but by other causes** such as changes in labour legislation[37].

Figures B.1.5 and B.1.6 show the contributions of both the identified shocks and the deterministic components to the Spain's unemployment rate dynamics seen over the past forty years. **The greater part of the increase in the unemployment rate during the Great Recession is explained by rigidities in price and wage formation**, with greater intensity than in the economic crisis of the early nineties. The increase in unemployment in the first three years of the crisis was due to the growth in real wages, such that instead of remuneration being adjusted downwards, jobs were destroyed. In 2011 and 2012 the biggest contribution to the increase in

36: For example, between September 1997 and September 1998, or between December 2006 and September 2007.
37: The specifications of the model can be examined in Doménech, García and Ulloa (2016). For the estimate we used data from the quarterly Spanish national accounts from Q1 1980 to Q4 2015. The variables included in the SVAR were the wage share, the unemployment rate, real wages, GDP and the GDP deflator.

the unemployment rate came from price shocks, given the increase in indirect taxes and companies' efforts to recover profits[38].

Figure B.1.5
Historical decomposition of the cumulative change in the unemployment rate (pp)

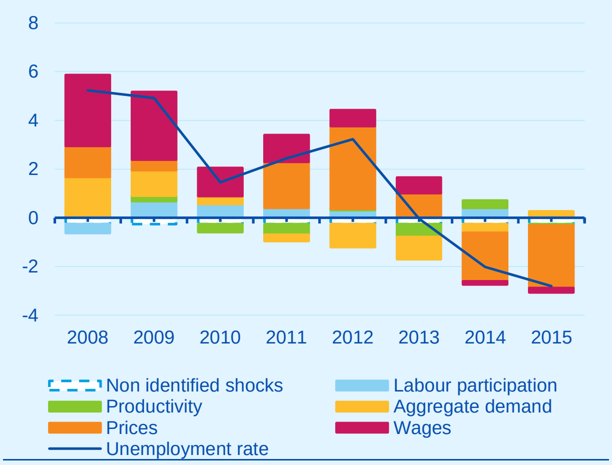


Source: BBVA Research

Figure B.1.6 shows the effects of the greater wage flexibility that has existed since 2012. **The contribution of the wage shock to the change in the unemployment rate fell from 1.1 pp in 2011 to -0.2 pp in 2015**. The persistence of the effects of the wage shock of course explains the still positive contribution up until 2013.

Given that the methodology allows us to identify the structural disturbances determining the fluctuations on the economy, it is possible to simulate what would have happened in the absence of either of them or if one of them had had a different sign and/or magnitude from that observed. In particular, **we carried out two counterfactual experiments** which answer the following two questions:

Figure B.1.6
Historical decomposition of annual changes in the unemployment rate (pp)



Source: BBVA Research

- *Counter-factual 1:* How many additional FTE jobs would have been destroyed without the wage flexibility seen since 2012? This would be equivalent to maintaining the average wage shocks estimated for the period 2010-2011 such that real remuneration per employee would have increased by 4.5% relative to the base scenario.
- *Counter-factual 2:* How many FTE jobs would have been saved if the process of making wages more flexible had started at the beginning of 2008? This would be equivalent to replacing the wage shocks from 2008 to 2011 with those estimated for the period 2012-2015, such that real remuneration per employee would have increased by only 4.2% instead of the 8.2% observed between the first quarter of 2008 and the last quarter of 2011.

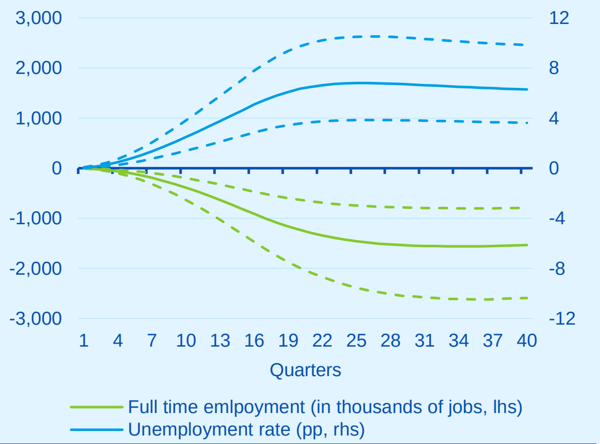
As regards the first of these questions, the results indicate that **if the wage demands seen on average during 2010 and 2011 had continued between 2012 and 2015, there would have been 910,000 fewer jobs by the end of the period and the unemployment rate would have**

38: The extent to which the positive contribution of prices was in reaction to the wage shocks of previous years or to the financial crisis which gave rise to a significant increase in risk premiums and lending restrictions is a question that the model used cannot address. As argued by Andrés and Doménech (2015), when financial stresses increase drastically, the businesses that are most dependent on banking finance can remain in the market only by resorting to self-financing (retaining profits) or supplier financing. Even though competition is tougher, businesses in this situation strive to maintain or even increase their margins (price over costs). Gilchrist, Schoenle, Sim and Zakrajsek (2013) and Montero and Urtasun (2014) found evidence in the US and in Spain showing that the businesses with the worst liquidity problems at the height of the financial crisis were those that increased their prices, whereas those with a sounder financial position reduced them.

been 5.1 pp higher than it actually was (see Figure B.1.7). In the long term, the number of additional jobs destroyed could reach 1.5 million, and the unemployment rate could rise by 6.3 pp.

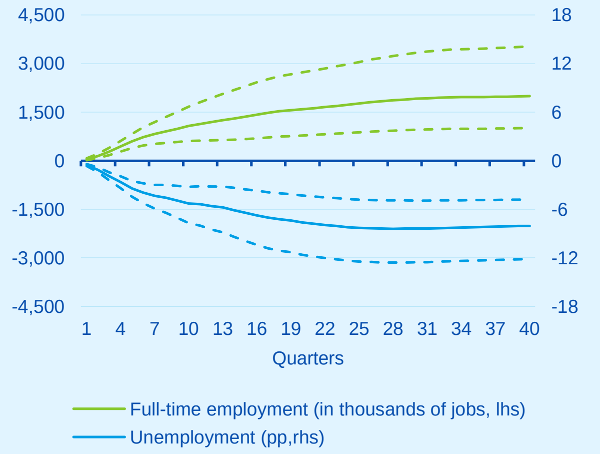
With regard to the second question, Figure B.1.8 shows that **if wages had responded to the cyclical situation of the economy and contributed to a more efficient adjustment from 2008 on** – or in other words, if the Spanish labour market had had more flexible worker institutions at the beginning of the crisis – **the destruction of nearly two million jobs could have been avoided in the long term and the unemployment rate today would be eight points lower** (at 12.9% instead of 20.9% in Q4 2015).

Figure B.1.7
Results of counter-factual 1 (deviation from baseline scenario)*



*The dotted lines represent the confidence interval (percentiles 16 and 84).
Source: BBVA Research

Figure B.1.8
Results of counter-factual 2 (deviation from baseline scenario)*



*The dotted lines represent the confidence interval (percentiles 16 and 84).
Source: BBVA Research

The foregoing results need to be put into context. Firstly, the exercises carried out illustrate the economic importance of wage flexibility for the labour market, but this cannot be attributed solely to the reforms. In particular, this phenomenon may also be due, at least in part, to the results achieved in the Second Agreement on Employment and Collective Bargaining. To what extent this agreement was an attempt by the social agents to anticipate the effects of the reforms, and how much of the greater flexibility is thanks to this agreement are difficult questions to answer.

Secondly, although the estimated wage disturbances are of a structural nature, meaning that from a statistical point of view they are exogenous to trends in the labour market, economic agents may discretionally take uncoordinated decisions to moderate wages when the unemployment rate reaches levels that risk becoming intolerable from a social and individual point of view. In this context, the labour reforms may bring forward, accelerate and intensify the effects of wage flexibility, which possibly would have happened in any case, but more slowly and with greater costs.

Conclusions

In this box we analyse the effects of the greater wage flexibility from 2012 on the labour market. Preliminary evidence shows that during the recession that followed these changes there was less job destruction than in previous years, despite the fiscal adjustment and the increased financial stress. Moreover, the subsequent recovery has been compatible with the current account surplus, the improvement in price competitiveness relative to the rest of the eurozone and the shift in the Beveridge curve towards the origin.

Using a model that allows us to break down the trend in the main macroeconomic aggregates into the different types of structural disturbances confirms that the effects of the reduced wage rigidities observed since 2012 are economically significant. The results of a first counterfactual exercise indicate that if the trend in wages observed in 2010 and 2011 had continued between 2012 and 2015, nearly nine hundred thousand more jobs would have been lost. The second counterfactual exercise presented in this study allows us to conclude that, if there had been greater flexibility in the labour market in 2008 such as was seen from 2012, the destruction of close to two million jobs in the long term could have been avoided, as could the increase of eight points in the unemployment rate.

Although the preliminary evidence appears to indicate that the changes in the labour market have had positive effects on the adjustment and recovery of the Spanish economy, many of the structural weaknesses of the labour market, such as the high proportion of temporary contracts, long-term unemployment, the mismatch between supply and demand for labour and a still very high structural unemployment rate, continue to require additional measures in line with the proposals analysed in BBVA Research (2016).

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Appendix

Table R1.A.1
Main reforms approved since the coming into force of the labour reform

Objective and regulations	Most notable measures
Providing incentives to unemployed people in receipt of benefits to look for work. *Royal Decree-Law 20/2012 of 13 July on measures to ensure budgetary stability and promote competitiveness.*	Reduction in contribution-based benefits for newly unemployed to 50% of the regulatory base from the sixth month of receipt. Increase by three years in the minimum age for receiving the unemployment subsidy for people over 52 years of age. Elimination of the special subsidy for people over 45. Tightening of the requirements for being a beneficiary of the “Active Insertion Income Programme”.
Facilitating hiring and promoting the use of part-time contracts. *Royal Decree-Law 16/2013 of 20 December on measures to promote stable hiring and improve workers' employability.*	Administrative simplification of employment contracts and creation of a virtual assistant which guides employers towards the contracts best suited to their needs. Extension of the working day under part-time contracts by means of overtime. Irregular distribution of working time made easier by allowing working-time surpluses and shortfalls to be carried forward for offset in subsequent years. Indefinite term entrepreneur support contract authorised for part-time contracts.
Promoting indefinite-term hiring. *Royal Decree-Law 3/2014 of 28 February on urgent measures to promote employment and indefinite-term hiring.* *Royal Decree-Law 1/2015 of 27 February on the second chance mechanism, debt reduction and other measures on the social agenda.*	Temporary (24-month) reduction in employers' social security contributions for new employees with indefinite employment contracts signed between 25 February and 31 December 2014 (subsequently extended to 31 March 2015). Since March 2015 the flat rate has been replaced by an exemption on the first €500 of the employer's contribution base for new full-time indefinite-term contracts.
Increasing the efficiency of active employment policies (AEP). *Royal Decree 751/2014 of 5 September approving the Spanish Employment Activation Strategy for 2014-2016.* *Royal Decree-Law 4/2015 of 22 March on the urgent reform of the Occupational Training for Employment System*	The results-oriented approach partly determines the regional distribution of the budget for AEP. Priority is given to the design of a personalised itinerary for each job seeker, improvements to the fit between occupational training and labour market needs, coordination between public employment agencies and collaboration between public and private placement agencies.
Promoting young people's employability. *Royal Decree-Law 8/2014 of 4 July approving urgent measures for growth, competitiveness and efficiency*	Approval of the Entrepreneurship and Youth Employment Strategy 2013-16. A salient aspect is the launch of the National Youth Guarantee System.

Source: BBVA Research

Box 2. Finances of the autonomous regions in 2015 and the impact of the financing system and of some atypical factors

Ángel de la Fuente - FEDEA and Instituto de Análisis Económico (CSIC) – April 2016

1. Introduction

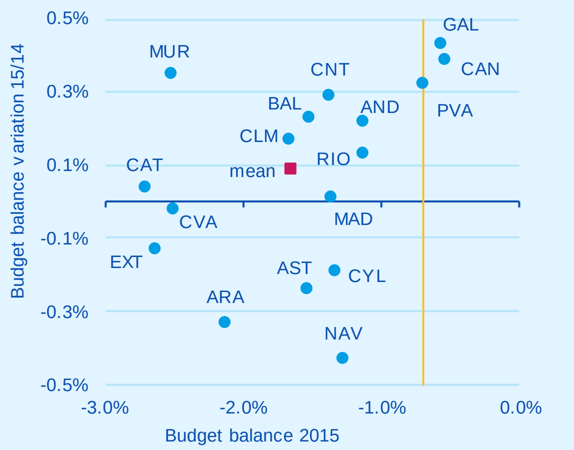
Regional budget balances improved only slightly in 2015, despite a fall of nearly €3.5 billion in interest charges as a result of the improved conditions offered by central government through the various financial facilities. The stagnation of the regional deficits is partly due to a "technical" weakness in revenues under the regional financing system; they declined by some €2.7 billion due to the inertia of payments on account at times of changes in the cycle, and also in part to the atypical increase in certain items of expenditure which practically absorbed all the savings on interest. After correcting for all these factors, the regions' *underlying* deficit fell by an additional quarter of a percentage point, from 1.66% of GDP to 1.40%, which is still double the stability target.

2. Analysis of autonomous regions' finances in 2015

The IGAE (*Intervención General de la Administración del Estado* or Comptroller General of the State Administration), (IGAE, 2016a and b) recently published of the autonomous regions' accounts for 2015. Figure B.2.1 shows the budget balance of each region according to this source, together with the change in the balance relative to the previous year. The vertical orange line indicates the budgetary stability target, which was set at 0.7% of GDP for 2015 for all the autonomous regions, and the red square corresponds to all the regional governments as a whole.

In 2015 the autonomous regions as a whole presented a budget deficit of 1.66% of Spain's GDP, 0.09 pp below the provisional figure for 2014. Since the deficit target for 2015 was 0.3 pp less than that for 2014, this result means that on average the autonomous regions came nearer to meeting it. However there is great disparity among the situations of the various regions. As can be seen in the Figure, only three of them (the Canary Islands, the Basque Country and Galicia) met their deficit targets. These three regions and eight others managed to reduce their budget deficits relative to the previous year. The remaining six regions not only did not meet the stability target but saw their deficits increase. Prominent in this group are Navarre, Asturias and Aragón, whose public account imbalances grew by more than 0.2 pp of GDP compared with the year before.

Figure B.2.1
Budget balance by region in 2015 and change relative to 2014



Source: In-house based on MINHAP data

The effects of the financing system and of atypical factors

In order to assess the effect of the regional financing system on recent trends in regional deficits, we need to restate the accounts of the autonomous regions as a whole, as in Table B.2.1, by making "transfers to other public administrations" a deduction from revenues instead of an expense. The transfer is logical because the item comprises transfers from the autonomous regions to the State in respect of items related to the regional financing system (such as the Navarre contribution[39] and the negative balances of the Sufficiency Fund of certain "common regime" regions) which reduce the net revenues available to the regional governments. Also included here are transfers to local authorities, which are largely financed by State transfers for specific purposes, so that they too should be deducted from regional revenues.

Looking at Table B.2.1, in 2015 we see a very slight improvement in the aggregate budget balance of the autonomous regions as a whole, amounting to 0.09 pp of GDP. This improvement represents just one quarter of the reduction in interest expense (-0.35% of GDP in the national accounts), which was cut almost in half as a result of the improvement in the financial conditions of the liquidity mechanisms. The remaining expenditure items contributed little or nothing to the reduction of the deficit, and the same is true of revenues, which were down as a proportion of GDP, basically as a result of the weakness of net revenues from transfers from other administrations.

However, things are not as bad as might appear at first sight, for two reasons. The first is that the relatively slow growth in revenues of the regional financing system has more to do with the inertia of payments on account than with any real weakness in tax revenues. The second is that the relatively fast growth in expenditure which we see in 2015 was partly the result of certain atypical and in principle non-recurring items. As well as certain investment items for a total amount of nearly €1.8 billion which the Comptroller General of the State Administration has reclassified as public expense,[40] we must include here some €1 billion earmarked for new treatments for hepatitis C and another €800 million linked to the return - in a year in which elections took place in most of the autonomous regions - of half of the extra payment withheld from civil servants in 2012.

Based on Table B.2.1 and some of the figures referred to, it is easy to calculate an *underlying deficit* which would show the situation of the regional accounts after normalising revenues from the regional financing system and deducting various atypical items that affected the results of 2015. To do so, in Table 2 we calculate the deficit that would have been observed in 2015 if the autonomous regions' revenues from net transfers from other public administrations had grown at the same rate as the central government's tax revenues corrected for uncertain collection, namely 5.15% p.a. According to data of the Comptroller General of the State Administration (IGAE 2016b). In Table B.2.2 we also eliminate the atypical expenditure items, including the substantial subsidy implicit in the favourable financial conditions of the regional liquidity funds and for payments to suppliers which, pending detailed analysis, we approximate by the reduction in the interest burden recorded in 2015 according to the national accounts (€3,453 million).

39: Not however including the *cupo vasco* (the amount the Basque government pays for services provided by central government), which does not go through the budgets of the autonomous regions but through those of the *diputaciones forales* (provincial governments).
40: The adjustments to the national accounts for 2015 include components of investment for a total of €1,777 million, of which €1,542 million relate to Catalonia, €121 million to the Balearic Islands and €114 million to Asturias. The bulk of the projects are for road building, but in the case of Catalonia they also include the construction of prisons, courthouses and police stations. These items correspond to expenses from other fiscal years linked to public-private cooperation projects which has hitherto been booked under the private sector. Upon review, the Comptroller General of the State Administration considered that, given the stipulated division of risks, such projects actually belong in the public administration sector, and proceeded to allocate them accordingly with effect from 2015.

Box B.2.1

Net revenue and expenditure of the autonomous regions as a whole and components of their budget balance, situation observed

	(% of GDP)			€ millions		
	2014	**2015**	**diff.**	**2014**	**2015**	**chge. %**
Net revenues	12.61	12.52	-0.09	131.294	135.316	3.06
Taxes	4.62	4.73	+0.11	48.086	51.127	6.32
Transfers from other public administrations	7.82	7.75	-0.07	81.420	83.795	2.92
Other revenue	1.63	1.59	-0.04	16.941	17.182	1.42
Transfers to other public administrations	-1.46	-1.55	-0.10	-15.153	-16.788	10.79
Net expenditure (excl. tfrs to other pub. admins)	14.36	14.18	-0.18	149.476	153.278	2.54
Capital expenditure	1.36	1.56	+0.20	14.165	16.833	18.84
Interest	0.74	0.39	-0.35	7.672	4.219	-45.01
Other current expenses	12.26	12.23	-0.03	127.639	132.226	3.59
Budget balance	**-1.75**	**-1.66**	**+0.09**	**14.165**	**16.833**	**18.84**
Note: net transfers received	6.36	6.20	-0.17	66.267	67.007	1.12

Source: In-house based on MINHAP data

Table B.2.2

Net revenues and expenditure of the autonomous regions as a whole and components of their budget balance, alternative 2015 scenario: calculation of the underlying deficit without atypical items and with net revenues from transfers growing at the same rate as central government's tax revenues

	(% of GDP)			€ millions		
	2014	**2015**	**diff.**	**2014**	**2015**	**chge. %**
Net revenues	12.61	12.76	0.15	131.294	137.989	5.1
Taxes	4.62	4.73	0.11	48.086	51.127	6.32
Net tfrs. from other pub. admins.	6.36	6.44	0.08	66.267	69.680	5.15
Other revenue	1.63	1.59	-0.04	16.941	17.182	1.42
Net expenditure (excl. tfrs to other pub. admins)	14.36	14.16	-0.19	149.476	153.131	2.45
Capital transactions	1.36	1.39	0.03	14.165	15.056	6.29
Interest	0.74	0.71	-0.03	7.672	7.672	0
Other net current expenses	12.26	12.06	-0.2	127.639	130.403	2.17
Budget balance	**-1.75**	**-1.4**	**0.35**	**-18.182**	**-15.143**	**-16.72**

Source: In-house based on MINHAP data

With these adjustments, the regions' deficit would have fallen by 0.35 pp of GDP in 2015 instead of only 0.09, bringing it to 1.40% of GDP, still double the target. In the corrected accounts in Table B.2.2, for the first time in several years, we see healthy growth in revenues, but also a certain upturn in expenditure, including capital items which, after excluding atypical items, grew by about 6%, although still far below pre-crisis levels.

3. Conclusion

As has been shown in this box, once we correct for the technical distortions generated by the structure of the regional financing system and certain atypical components of expenditure recognised in 2015, we see an appreciably greater improvement in the regional governments' *underlying* budget balance than that seen in the gross balance. Despite that, the situation of the regional accounts is still delicate, because the underlying deficit is still double the stability target and because the improvement in the regions' balances seen in the past few years comes largely from a reduction in the investment components to historically very low levels which will not be possible to maintain for long without them starting to affect the quality of public services. Although the expected recovery in revenues over the next few fiscal years should lead to an appreciable improvement in the situation, *ceteris paribus*, it would be advisable for the autonomous regions to continue working on containing current expenditure items, which are starting to move upwards even after the elimination of atypical items.

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Box 3. Effect of unconventional monetary policy measures on the Spanish economy

Introduction

In its March meeting, the ECB Governing Council (GC) confirmed its intention of continuing to take all unconventional monetary policy measures within its mandate if necessary. The ultimate aim of these actions is to ease financing conditions so as to boost the supply of credit to the private sector and thus hedge against the risks of low inflation and growth in the euro zone as a whole. The new package of measures, which also includes conventional ones[41], follows on from those of mid-2014 and is based on the expansion of the asset purchase programme[42] and the extension of the liquidity policies (new rounds of TLTROs[43] with a maturity of four years). **In this box we assess the effect of the measures put in place during the last one and a half years through the supply of credit and changes in expectations regarding official interest rates.**

The results of the analysis suggest that the unconventional monetary policy measures have had a positive and significant effect on Spanish economic activity, but only a temporary one. **Thus, it is estimated that they contributed 0.5 pp to GDP growth in 2015** through channels linked to the credit supply and to changes in expectations regarding official interest rates. Despite the foregoing, **we expect the effect over the two-year period 2016-2017 to be considerably less.** Firstly because the impetus of the measures put in place in 2014 and 2015 is running out of steam. Secondly, because given how close nominal interest rates are to the zero-lower-bound, the actions recently approved by the GC will have only marginal effects on companies' and households' cost of financing.

All the same, these results are indicative and must be interpreted with caution, for several reasons. On the one hand, the characteristics of the shock brought about by the unconventional measures taken by the ECB remain uncertain, as regard both magnitude and effect. On the other, there are different potential channels beyond the scope of this study, the effect of which could be significant. For example, while in this box we stress the effect of policies promoted by the ECB on the supply of credit, we do not explore their possible consequences for demand for financing.

Potential channels of transmission of ECB measures

Transmission channels to the real economy depend on each of the measures announced by the ECB. As regards the large-scale purchase of government bonds and private sector assets program, **one of the potential channels is directly associated with demand for sovereign bonds** and their respective interest rates. When this programme was presented in 2015, it consisted of €60 billion a month from March 2015 to September 2016. Despite the fact that the measures were announced in January 2015, the markets had been discounting their implementation since mid-2014; since then yields on 10-year Spanish bonds have fallen by some 120 bps.

Apart from this, **the introduction of the programme may have had an indirect effect associated with economic agents' expectations regarding conventional monetary policy measures.** Despite the ECB's insistence that it is not prepared to cut rates indiscriminately, it also made it clear that any possible hikes would not take place until well after the end of the asset purchase programme (March 2017). In fact, expectations regarding increases in benchmark interest rates have been postponed following the successive announcements made since June 2014.

41: Cut to all-time lows in reference rate by 5 bps to 0.0%, the deposit rate by 10 bps to -0.4% and the marginal lending rate by 5 bps to 0.25%.
42: The amount of monthly purchases is increased to €80 billion and the scope is extended to include euro-denominated bonds issued by non-bank corporations
43: "Targeted longer-term refinancing operations"

The effects on monetary policy expectations could also influence how exchange rates evolve (depreciation of the euro). However, this effect will be largely limited by the kind of policies implemented by other central banks[44].

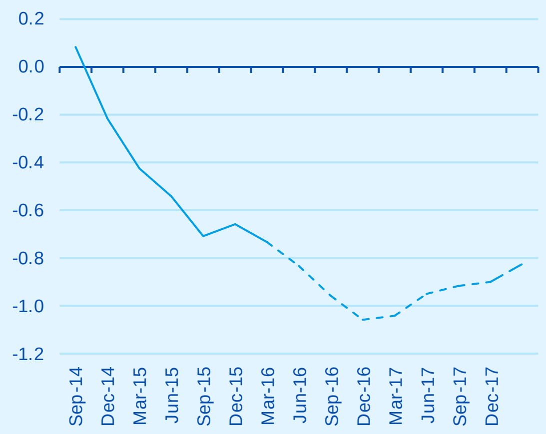
As regards the TLTROs, there are several possible channels for transmitting their effects to the real economy. On the one hand, **there is less risk of liquidity stresses arising** for European banks in the next few years. The measure will also allow a **reduction in the cost of banks' funding** which will eventually lead to **an increase in the supply of credit**. In practice, this mechanism has been verified during the past year, especially in the periphery, where interest rates on new lending transactions have moderated substantially.

The cumulative effect of unconventional monetary policies

Taking account of the unconventional monetary policy measures previously described, in this section we assess their **potential effect on the Spanish economy through the supply of credit and the changes in expectations regarding official interest rates**. To this end we estimated a structural vector autoregression (SVAR) model, identified with sign and zero restrictions, enabling us to isolate the impact of disturbances in the credit market and the conventional money supply from that of others of a macroeconomic nature, such as increases in aggregate supply or demand (See appendix 1).

Figure B.3.1

Spain: estimated fall in credit spread (pp relative to the base scenario of mid-2014)



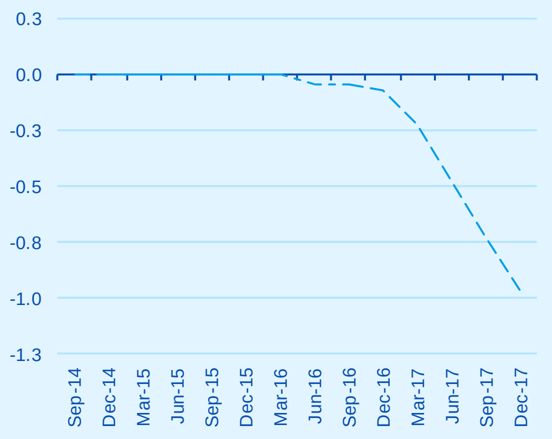
Source: BBVA Research

Two types of shock are analysed, accounting for the transmission channels described in the foregoing section. **On the one hand, we see the successive rounds of TLTROs and their effect through the supply of credit**. BBVA Research's current estimates incorporate a differential between the synthetic interest rate on new lending transactions and the benchmark interest rate which is 80 bps less than that estimated in mid-2014, before the implementation of the TLTROs (counterfactual scenario). In the next few months the difference could reach as much as 100 bps, reverting in the medium term to around 60 bps (see Figure B.3.1). This estimate is in line with the Bank of England's assessment regarding the programme launched by the UK in mid-2012 to stimulate lending to households and non-financial companies (*Funding for Lending Scheme*) [45]. This assessment estimated that the programme had led to a gradual reduction in the interest rate differential on borrowings and debt issues of around 100 bps in the 18-month period[46].

44: Since the beginning of the financial crisis in 2008 we have seen the announcement of a succession of unconventional monetary policy measures by various central banks around the world: the US Federal Reserve (November 2008), the Bank of England (March 2009) and the Bank of Japan (October 2010). Indeed, more recently, the Bank of Japan has added to the ranks of central banks that have taken (deposit) interest rates into negative territory.
45: See Bank of England (2014).
46: In BBVA Research (2014) we used this diagram as a first approximation of the effect of unconventional monetary policy on activity in Spain, given the similarities between this programme and that implemented by the ECB (type, geography and timing.)

On the other hand, we consider the indirect effect of the large-scale programme of bond and other asset purchases through market expectations of benchmark interest rates. The macroeconomic scenario envisaged by BBVA Research before the programme was imposed assumed that the market would have discounted staggered increases in official interest rates from the end of 2016 (practically two years earlier than now expected). The difference between this counterfactual scenario and the current base scenario in terms of the projected benchmark interest rate is gradually increasing and is expected to reach 100 bps by the end of the forecast period (Figure B.3.2).

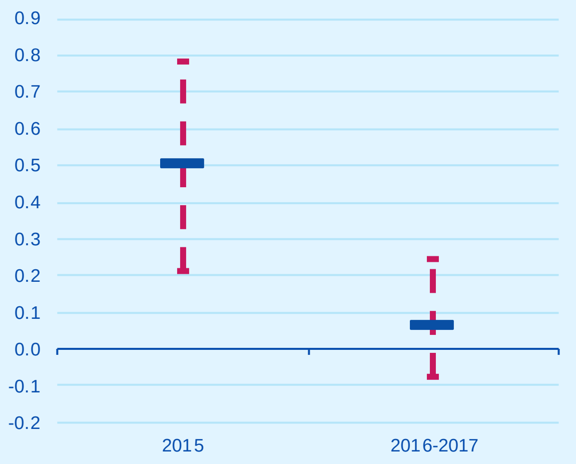
Figure B.3.2
Spain: deviation of the reference interest rate following the delay in expectations of an increase (pp relative to the base scenario of mid-2014)



Source: BBVA Research

Figure B.3.3 shows the total effect that the two shocks described above have on the Spanish economy. As can be seen, **the results indicate that their contribution to the annual growth of the economy peaked in 2015 at around 0.5 pp of GDP.** For the two-year period 2016-2017 we expect the effect on growth to be marginally positive, although of no statistical significance.

Figure B.3.3
Spain: effect of non-conventional monetary policy on annual GDP growth (pp relative to the base scenario)



Source: BBVA Research

However, the results obtained are indicative and must be interpreted with caution. In first place, because as can be seen in Figure B.3.3 **the degree of uncertainty revealed by the estimates is high.** In second place, because the magnitude of the shocks caused by the measures introduced by the ECB is still largely uncertain, and the simulations presented start out from the differences between expected scenarios. For example, the ECB's estimates, which include a broader set of channels with somewhat more restrictive assumptions on the response of the economy, signal that the effect on the euro zone could be as much as 1.5 pp of GDP between 2015 and 2018[47].

Lastly, **there are other channels of unconventional monetary policy beyond the scope of this study**. For example, the results of the ECB's programme may depend largely on future trends in demand for credit: the delay in decisions on normalising conventional monetary policy might stimulate not only supply but demand for credit too. Also, the more productive new projects are and the more appropriate in terms of risk, the stringer the support from supply of credit is likely to be.

47: In particular, the analysis assumes that, first, the package of policies gives rise to an improvement in financing and borrowing conditions. Secondly, it assumes that the improvement in these conditions leads to more activity, less economic sluggishness and upward pressure on inflation. For further details, see ECB (2016).

The new measures announced

In its March 2016 meeting the GC decided to extend the asset purchase programme, in amount (to €80 billion a month) **and scope** (to include euro-denominated bonds issued by non-bank corporations).[48] Although the extension of the programme could lead to a further reduction in interest rates on public debt, there is little room for further reductions in interest rates on euro zone countries' bonds, and furthermore the marginal effects of successive rounds of bond purchases may well be diminishing (see Wu T., 2014). Also diminishing is the indirect effect that the programme's extension might have on expectations of monetary policy, given the proximity to the zero-lower-bound in the euro zone.

Apart from this, the GC also announced in March four new rounds of TLTROs (referred to as TLTROs II) which will start in June 2016 and last for four years. Not only did the ECB make it easier for private sector banks to access this type of financing[49] but it also reduced its cost by imposing a potentially negative interest rate[50]. However, given that at present neither liquidity nor price pose limits to expansion of credit, the effect of the new TLTROs on lending and consequently on the real economy is uncertain.

Lastly, we are unlikely to see any new conventional monetary policy measures (interest rate cuts). While still keeping the option open, the ECB's GC is starting to reconsider the costs and benefits of a strategy of taking rates into ever more negative territory. In particular, the implications of negative interest rates for costs of transmitting monetary policy, for the profitability of the banking system and on financial volatility. In fact, following the March meeting, expectations of further cuts corrected notably, favouring a recovery of assets linked to the banking sector.

Conclusions

Since mid-2014, the ECB has opted to make use of a non-conventional monetary policy geared to stimulating the supply of credit in the euro zone as a whole. In this study we have assessed the effect on the Spanish economy of the increase in the supply of credit and the changes in expectations regarding benchmark interest rates brought about by this policy. **The results of the study indicate that the measures have had a positive and significant effect on activity, but only in the short term.** Thus we estimate that they contributed 0.5 pp to GDP growth in 2015, while for the two-year period 2016-2017 the expected effect is limited.

All the same, these results are indicative and must be interpreted with caution for several reasons. In the first place, because the magnitude and impact of the shocks caused by the unconventional measures adopted by the ECB are still uncertain. Secondly, because there are other potential channels not addressed in this study, the impact of which could be significant. For example, the results finally observed will depend on how demand for credit accompanies the increase in supply.

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48: For further details on the measures announced, see ECB Observatory "Greater monetary expansion relying heavily on non-conventional measures" available at https://goo.gl/PyNJEC.
49: Not including mandatory prepayments and not involving banks' increasing their lending to the economy.
50: The interest rate to be applied will be set for each transaction at the ECB's MROs (main refinancing operations) rate at the time of the allotment. (currently 0%). Commercial banks whose net level of lending exceeds the benchmark established for the period from 1 February 2016 to 31 January 2018 will pay a lower rate (as low as the deposit facility rate at the time of the allotment with a minimum of -04%).

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Appendix 1 Methodological framework

Using the methodology proposed by Arias, Rubio-Ramírez and Waggoner (2013)[51], in this box we present the results of estimating **a structural VAR for the Spanish economy which identifies, with sign and zero restrictions,** the main disturbances simultaneously affecting activity and the credit market. In particular, we have identified domestic shocks (supply and demand of credit and aggregate supply and demand) and external shocks (conventional monetary policy and European aggregate demand). For the case that concerns us, they are included in the estimate of quarterly GDP growth, prices (core component of the CPI), the flow of credit (real credit to risk-free transactions as a percentage of GDP) and growth in the GDP of the eurozone. We have also taken account of real short-term interest rates (three-month EURIBOR deflated by the core component of the CPI) and the rate differential for risk-free transactions (difference between the synthetic nominal rate on these transactions and the three-month EURIBOR). The period covered by the estimate is from the first quarter of 1992 to the second quarter of 2014[52]

Table B.3.A.1
Diagrammatic representation of identification of structural shocks with sign and zero restrictions

Shock / Variable	GDP	CPI (core)	Relative flow of credit	Credit spread	Real short-term interest rate	GDP of the euro zone
1) Aggregate demand	(+)	(+)	0	0	0	0
2) Aggregate supply	(+)	(-)	0	0	0	0
3) Relative demand for credit			(+)	(+)	0	0
4) Relative supply of credit			(+9	(-)	0	0
5) Monetary policy					(-)	**(+)**
6) European demand						**(+)**
The shocks are also required to be statistically independent of one another						

Note: in the identification exercise we required the sign restrictions to be complied with in at least two periods, whereas the zero restrictions were complied with only in the period in which each shock took place.
Source: BBVA Research

51: In their work the authors show that Mountford and Uhlig’s (2009) penalty function approach (PFA), until now the most widely used to identify structural shocks with sign and zero restrictions, significantly biases estimates.
52: Official data on flows of credit are available only from 2003. In this study we have extrapolated the figures backwards to 1991 using the figures for loan outstandings and assuming an exogenous rule for movement and constant repayment schedules. Robustness checks indicate that the results of this study do not change significantly when the assumptions regarding constant repayments are relaxed.

In Table B.3.A.1 we summarise the sign and zero restrictions imposed on the estimated model[53]. Going into detail, the restrictions illustrated imply that:

a. **A positive aggregate demand shock pushes up volumes and prices of goods and services** traded, but does not immediately affect volumes and prices of credit, real benchmark interest rates or the GDP of the eurozone.

b. **An aggregate supply shock leads to an increase in activity and a reduction in prices**, but also does not have an immediate effect on credit volumes and prices, real benchmark interest rates or the GDP of the eurozone.

c. **Positive shocks to both supply of and demand for credit push the relative volume of new credit up, although in the case of a supply shock the interest rate differential tends to increase and in the case of demand to decrease.** Additionally, it is assumed that these shocks do not contemporaneously affect real benchmark interest rates or GDP of the Eurozone.

d. **Only a monetary policy shock – a positive** one from the Spanish domestic point of view, **is capable of immediately reducing the real short-term interest rate and** increasing the GDP of the eurozone.

As can be seen in table B.3.A.1, **the identification system implemented is "agnostic"** (i.e. without r estrictions) as regards the real economy's response to credit supply and demand shocks and to external shocks (conventional money supply and European aggregate demand). The model is also "agnostic as regards the shock effect of conventional money supply on the credit market. The foregoing is an important characteristic, since it **ensures that the results obtained in this study are not imposed by construction**[54].

53: The shocks are also required to be statistically independent of one another
54: In their work, the authors show that, unlike pre-existing methods, the proposed identification algorithm ensures agnosticism as regards the unrestricted variables.

5 Tables

Table 4.1

Macroeconomic Forecasts: Gross Domestic Product

(Annual average, %)	2012	2013	2014	2015	2016	2017
United States	2.2	1.5	2.4	2.4	2.5	2.4
Eurozone	-0.8	-0.2	0.9	1.5	1.6	1.9
Germany	0.6	0.4	1.6	1.4	1.7	1.8
France	0.2	0.7	0.2	1.2	1.3	1.6
Italy	-2.8	-1.8	-0.3	0.6	1.0	1.4
Spain	-2.6	-1.7	1.4	3.2	2.7	2.7
United Kingdom	1.2	2.2	2.9	2.3	1.8	1.9
Latam *	2.9	2.6	0.7	-0.5	-1.0	1.7
Mexico	4.0	1.4	2.1	2.4	2.2	2.6
Brazil	1.9	3.0	0.1	-3.9	-3.0	0.9
Eagles **	5.8	5.5	5.2	4.6	4.7	4.9
Turkey	2.1	4.2	3.0	4.0	3.9	3.9
Asia Pacific	5.8	5.8	5.6	5.5	5.3	5.1
Japan	1.7	1.5	0.0	0.5	0.8	0.8
China	7.7	7.7	7.3	6.9	6.4	5.8
Asia (ex. China)	4.3	4.3	4.2	4.3	4.4	4.5
World	3.4	3.3	3.4	3.1	3.2	3.4

* Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.
** Bangladesh, Brazil, China, India, Indonesia, Iraq, Mexico, Nigeria, Pakistan, Philippines, Russia, Saudi Arabia, Thailand and Turkey.
Forecast closing date: 6 May 2016.
Source: BBVA Research and IMF

Table 4.5

Macroeconomic Forecasts: 10-year government bond yield

Annual Average, %	2012	2013	2014	2015	2016	2017
United States	1.79	2.34	2.53	2.13	2.02	2.49
Germany	1.57	1.63	1.25	0.54	0.47	0.75

Forecast closing date: 5 February 2016.
Source: BBVA Research and IMF

Table 4.6

Macroeconomic Forecasts: Exchange Rates

Annual Average	2012	2013	2014	2015	2016	2017
USD-EUR	0.78	0.75	0.75	0.90	0.91	0.89
EUR-USD	1.29	1.33	1.33	1.11	1.10	1.12
GBP-USD	1.59	1.56	1.65	1.53	1.49	1.66
USD-JPY	79.77	97.45	105.82	121.07	118.44	128.50
USD-CNY	6.31	6.20	6.14	6.23	6.63	6.99

Forecast closing date: 5 February 2016.
Source: BBVA Research and IMF

Table 4.7

Macroeconomic Forecasts: Official Interest Rates

End of period, %	2012	2013	2014	2015	2016	2017
United States	0.25	0.25	0.25	0.50	1.00	2.00
Eurozone	0.75	0.25	0.05	0.05	0.00	0.00
China	6.00	6.00	5.60	4.35	4.10	3.60

Forecast closing date: 6 May 2016.
Source: BBVA Research and IMF

Table 4.5

EMU: macroeconomic forecasts (YoY change, %, unless otherwise indicated)

	2010	2011	2012	2013	2014	2015 (f)	2016 (f)	2017 (f)
Real GDP	**-0.2**	**0.9**	**1.5**	**1.6**	**1.9**	**-0.2**	**0.9**	**1.5**
Private consumption	-0.6	0.8	1.7	1.7	1.8	-0.6	0.8	1.7
Public consumption	0.2	0.8	1.3	1.5	1.1	0.2	0.8	1.3
Gross fixd capital formation	-2.5	1.4	2.6	3.1	3.8	-2.5	1.4	2.6
Inventories (contribution to growth)	0.1	0.0	-0.1	0.0	0.0	0.1	0.0	-0.1
Domestic demand (contribution to growth)	**-0.6**	**0.9**	**1.6**	**1.9**	**2.0**	**-0.6**	**0.9**	**1.6**
Exports	2.2	4.1	4.9	2.7	3.6	2.2	4.1	4.9
Imports	1.4	4.5	5.6	3.9	4.0	1.4	4.5	5.6
Net exports (contribution to growth)	**0.4**	**0.0**	**-0.1**	**-0.4**	**-0.1**	**0.4**	**0.0**	**-0.1**
Prices								
CPI	1.4	0.4	0.0	0.2	1.3	1.4	0.4	0.0
CPI core	1.3	0.9	0.8	1.0	1.5	1.3	0.9	0.8
Labour market								
Employment	-0.7	0.6	1.0	1.1	0.9	-0.7	0.6	1.0
Unemployment rate (% of labour force)	12.0	11.6	10.9	10.1	9.6	12.0	11.6	10.9
Public sector								
Budget balance (% GDP)	-3.0	-2.6	-2.1	-1.9	-1.6	-3.0	-2.6	-2.1
Debt (% GDP)	91.1	92.0	90.7	90.4	88.8	91.1	92.0	90.7
External sector								
Current account balance (% GDP)	2.1	2.5	3.2	3.2	3.0	2.1	2.5	3.2

(f): forecast.
Forecast closing date: 6 May 2016.
Source: BBVA Research

Table 5.6
Spain: macroeconomic forecasts (Annual rate of change in %, unless otherwise indicated)

	2013	2014	2015	2016 (p)	2017 (p)
Activity					
Real GDP	-1.7	1.4	3.2	2.7	2.7
Private consumption	-3.1	1.2	3.1	2.6	2.4
Public consumption	-2.8	0.0	2.7	1.6	1.8
Gross Capital Formation	-3.6	4.8	7.0	3.6	4.5
Equipment and Machinery	4.0	10.6	10.2	5.5	4.7
Construction	-7.1	-0.2	5.3	3.1	4.1
Housing	-7.2	-1.4	2.4	2.8	4.4
Internal Demand (contribution to growth)	-3.1	1.6	3.7	2.6	2.6
Exports	4.3	5.1	5.4	4.4	5.6
Imports	-0.3	6.4	7.5	4.4	6.0
External Demand (contribution to growth)	1.4	-0.2	-0.5	0.1	0.0
Nominal GDP	-1.1	1.0	3.8	3.6	4.9
(Billions of euros)	1031.3	1041.2	1081.2	1120.3	1175.5
GDP excluding housing investment	-1.4	1.5	3.2	2.7	2.6
GDP excluding construction	-1.0	1.5	3.0	2.7	2.5
Labour market					
Employment, EPA	-2.8	1.2	3.0	2.8	2.5
Unemployment rate (% of labour force)	26.1	24.4	22.1	19.8	18.5
CNTR Employment (full-time equivalent)	-3.3	1.1	3.0	2.4	2.2
Apparent productivity of labour factor	1.6	0.3	0.2	0.3	0.4
Prices and costs					
CPI (annual average)	1.4	-0.2	-0.5	-0.3	1.7
CPI (end of period)	0.3	-1.0	0.0	0.6	1.3
GDP deflator	0.6	-0.4	0.6	0.9	2.2
Compensation of employees	1.7	-0.6	0.5	1.8	1.1
Unit labour cost	0.2	-0.8	0.3	1.5	0.7
Foreign sector					
Balance of payments on current account (% of GDP)	1.5	1.0	1.4	2.1	2.5
Public sector (*)					
Debt (% of GDP)	93.7	99.3	99.2	99.6	98.4
Balance Public Admin. (% GDP)	-6.6	-5.8	-5.0	-3.9	-2.9
Households					
Nominal disposable income	-0.8	0.9	2.3	3.6	3.3
Savings rate (% nominal income)	10.2	9.8	9.6	10.6	9.8

Annual change in %, unless indicated expressly
(f): forecast.
Forecast closing date: 6 May 2016
(*): Excluding aid to Spanish banks
Source: BBVA Research

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