9. SPAIN

Strong, balanced growth set to continue

Economic activity accelerated in the first half of this year, underpinned by private consumption and exports. Growth is set to remain robust but ease going forward, driven by a slowdown in private consumption. The unemployment rate is projected to continue declining. Thanks to the positive macroeconomic outlook and continued expenditure restraint, the general government deficit and debt ratios are forecast to continue declining.

Strong growth in the first half of the year defers the expected deceleration

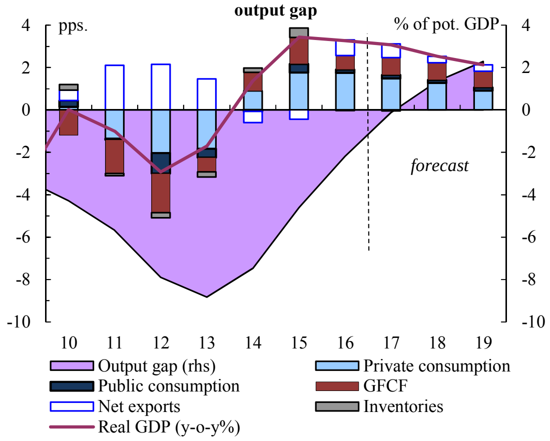
Rather than slowing as expected in spring, economic activity accelerated in the second quarter of 2017. Real GDP posted a strong 0.9% expansion on a quarterly basis in 2017-Q2, finally surpassing its pre-crisis peak. Domestic demand remains the main engine of growth, as strong job creation supports private consumption and residential construction investment rebounded. Net exports also continue to sustain GDP growth. The available hard and soft indicators signal that the pace of growth is easing in the second half of the year, but real GDP is still expected to increase by a robust 3.1% in 2017 as a whole, 0.3pps. higher than projected in spring.

Growth is expected to continue easing over the forecast horizon, to an annual average rate of 2.5% in 2018 and 2.1% in 2019. Private consumption is projected to remain the main driver of growth, but to slow down as the pace of job creation moderates, pent-up demand is absorbed, and other factors that supported the growth of household disposable income in recent years, such as the decrease in oil prices, abate. Residential construction and equipment investment are set to ease gradually, the latter in line with the projected slowdown in final demand.

Net exports set to continue contributing to growth

Exports have been accelerating this year, as Spain continues to record gains in export market shares and the external environment improves. Export growth is expected to moderate somewhat in 2018 and 2019, despite faster growth in Spain's export markets, as gains in market shares slow down. After rebounding this year, imports are also expected to moderate in 2018 and 2019, in line with final demand. As exports are expected to continue growing faster than imports, net trade should make a significant contribution to growth throughout the forecast horizon. After widening in 2016, Spain's current account is forecast to remain in a surplus of close to 2% of GDP until 2019, as swings in the terms of trade are largely offset by changes in export and import volumes and primary income. Spain's net external lending position is also expected to remain firmly positive over the forecast horizon.

Graph II.9.1: **Spain - Real GDP growth and contributions, output gap**



The unemployment rate to fall to about 14% by 2019

Job creation accelerated in the first half of the year, but administrative data suggest that the pace of job creation slowed down in the third quarter. Although employment growth is set to ease over the forecast period, it is projected to remain strong, allowing the unemployment rate to fall to about 14% by 2019, a reduction of almost 12 pps. from its peak in 2013. Wage growth is projected to remain subdued this year despite the pickup in inflation, partly due to a negative wage drift, and then gradually increase in 2018 and 2019. Productivity is expected to grow only moderately, leading to modest increases in nominal unit labour costs over the forecast horizon. However, further cost-competitiveness gains *vis-à-vis* the rest of the euro area are expected.

Inflation expected to moderate again

Base effects from oil price developments, the appreciation of the euro, and the pickup in core inflation are expected to dominate inflation dynamics over the forecast horizon. After a strong rebound in the first half of this year, headline inflation is forecast to moderate to an annual average of 2%. HICP inflation is then projected to decrease to 1.4% in 2018, before increasing again to 1.5% in 2019, as oil prices stabilise. Core inflation is projected to recover gradually over the forecast horizon, as wages pick up and the output gap turns firmly positive.

Risks to the outlook

Market reactions to recent events in Catalonia have remained contained. The risk exists that future developments could have an impact on growth, the size of which cannot be anticipated at this stage. On the upside, growth could benefit from a stronger than expected contribution from net exports, as signs of a structural improvement in export performance and import substitution start to emerge.

Strong growth continues to reduce the deficit

After narrowing to 4.5% of GDP in 2016, Spain's general government deficit continued to decrease in the first half of 2017, by 0.8 pps. Available data for July and August point to a continued reduction in the third quarter. For the year as a whole, a general government deficit of 3.1% of GDP is expected. In the absence of a budget, the fiscal forecast for 2018 is driven by the relatively strong macroeconomic performance supporting revenue growth and by continued expenditure restraint. This is expected to lead to a narrowing of the deficit to 2.4% of GDP in 2018. In 2019, at unchanged policies, it is expected to narrow further to 1.7% of GDP on the back of the cyclical recovery. Risks to the fiscal outlook mainly relate to contingent liabilities, in particular the impact of any settlement involving distressed toll motorways, and uncertainty about the 2018 budget. After deteriorating by some ¾% of GDP in 2016, Spain's structural deficit is expected to improve by about ¼% of GDP in 2017 and to remain broadly stable in 2018 and 2019. Over the forecast horizon, the general government debt ratio is expected to decrease slightly to 95.5% of GDP in 2019, as a result of relatively strong nominal GDP growth and the narrowing budget deficit.

Table II.9.1:

Main features of country forecast - SPAIN

	2016		Annual percentage change						
bn EUR	Curr. prices	% GDP	98-13	2014	2015	2016	2017	2018	2019
GDP	1118.5	100.0	1.9	1.4	3.4	3.3	**3.1**	**2.5**	**2.1**
Private Consumption	644.7	57.6	1.5	1.5	3.0	3.0	**2.6**	**2.2**	**1.6**
Public Consumption	210.9	18.9	3.2	-0.3	2.1	0.8	**0.9**	**0.8**	**0.8**
Gross fixed capital formation	223.6	20.0	1.2	4.7	6.5	3.3	**4.1**	**4.0**	**3.7**
of which: equipment	77.4	6.9	2.5	5.9	11.5	5.0	**5.1**	**4.5**	**4.1**
Exports (goods and services)	368.5	32.9	3.9	4.3	4.2	4.8	**6.0**	**4.8**	**4.5**
Imports (goods and services)	334.8	29.9	3.4	6.6	5.9	2.7	**4.4**	**4.3**	**4.0**
GNI (GDP deflator)	1118.3	100.0	1.9	1.6	3.6	3.5	**3.1**	**2.3**	**2.1**
Contribution to GDP growth:	Domestic demand		1.9	1.7	3.4	2.6	**2.5**	**2.2**	**1.8**
	Inventories		0.0	0.2	0.4	0.0	**0.0**	**0.0**	**0.0**
	Net exports		0.1	-0.5	-0.4	0.7	**0.6**	**0.3**	**0.3**
Employment			0.9	1.0	3.2	3.0	**2.7**	**2.1**	**1.6**
Unemployment rate (a)			14.6	24.5	22.1	19.6	**17.4**	**15.6**	**14.3**
Compensation of employees / f.t.e.			2.9	0.1	1.6	-0.3	**0.5**	**1.2**	**1.4**
Unit labour costs whole economy			2.0	-0.2	1.4	-0.6	**0.2**	**0.7**	**0.8**
Real unit labour cost			-0.4	0.0	0.7	-0.9	**-0.7**	**-0.9**	**-0.5**
Saving rate of households (b)			10.0	9.3	8.6	7.7	**6.6**	**6.4**	**6.8**
GDP deflator			2.4	-0.2	0.6	0.3	**0.9**	**1.6**	**1.4**
Harmonised index of consumer prices			2.7	-0.2	-0.6	-0.3	**2.0**	**1.4**	**1.5**
Terms of trade goods			-0.2	-0.5	2.4	0.1	**-2.4**	**0.7**	**-0.7**
Trade balance (goods) (c)			-5.4	-2.1	-2.1	-1.6	**-1.9**	**-1.6**	**-1.6**
Current-account balance (c)			-4.5	1.0	1.0	1.9	**1.7**	**1.9**	**1.9**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-3.8	1.5	1.7	2.1	**2.0**	**2.2**	**2.2**
General government balance (c)			-3.3	-6.0	-5.3	-4.5	**-3.1**	**-2.4**	**-1.7**
Cyclically-adjusted budget balance (d)			-3.1	-1.9	-2.8	-3.3	**-3.1**	**-3.1**	**-3.0**
Structural budget balance (d)			-	-1.6	-2.5	-3.3	**-3.1**	**-3.1**	**-3.0**
General government gross debt (c)			56.2	100.4	99.4	99.0	**98.4**	**96.9**	**95.5**

(a) as % of total labour force. (b) gross saving divided by adjusted gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.