The economic recovery: Short-term outlook and principal challenges

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Spain´s economic recovery is a reality. However, in and of itself, the recovery will not be sufficient to address the main challenges facing the Spanish economy in the medium-term, such as creating quality jobs and reducing public debt.

The outlook for the global economy continues to be characterized by uncertainty deriving from the direction of US monetary policy, the weakening of global trade and Brexit. Recent indicators in Spain point to the beginning of a slowdown in economic recovery, which will continue to be felt over the course of the coming year, mostly driven by a slowdown in domestic demand, as well as external factors. Beyond 2017, specific policies aimed at job creation and public debt reduction will be needed if Spain is to address its key medium-term challenges.

International context

According to the latest IMF forecasts presented at the G20 summit recently held in China, the world economy will grow by 3.1% in 2016, one tenth of a percentage point less than estimated in the forecasts presented by the IMF in April. For the eurozone, both the IMF and the ECB expect modest growth of around 1.6%.

These forecasts reflect an international environment characterized by further turbulence as a result of the uncertainty regarding the conditions of the UK's exit from the European Union, the direction of US monetary policy and the weakening of world trade.

The UK public's decision to leave the EU has indeed initiated a period of uncertainty for the global economy and especially the European economy. To date, the new UK government has not formally notified this decision to the European institutions, nor has it defined the model of the relationship it seeks to establish with the EU. After the strong market reaction, the strength of the British currency against the Euro has started to normalise and risk premiums have stabilised. However, greater volatility is expected in capital flows and international direct investments.

The European institutions, meanwhile, have not been able to develop a strategy either, beyond what the UK's exit directly involves. The EU appears to lack the cohesion required to make progress in the negotiations on the trade agreement with the US (TTIP). And the construction of a social pillar –which could contribute to reducing the

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disaffection of much of public opinion with respect to globalization– has not translated into concrete initiatives. In this context, the announcement by the President of the European Commission of a significant increase in the volume of investments set out in the “Junker plan” has been welcomed as a step in the right direction.

Major changes are anticipated in US monetary policy. The Federal Reserve has begun a rollback of the stimulus measures that were adopted in response to the financial crisis and a further increase in interest rates is expected as well as a reduction in the asset purchase programme. However, the monetary authorities appear divided on the timetable and pace of the adjustment, which could lead to tensions in currency markets and a strategic repositioning by certain investors.

The ECB has confirmed that it will keep in place the exceptional monetary policy measures introduced in recent months (TLTRO II). Interest rates remain at negative levels and the ECB has proceeded to purchase public and corporate debt up to a monthly ceiling of 80 billion euros. This policy has helped to reduce eurozone risk premiums. However, inflation remains at levels well below the annual target of 2%. Moreover, new uncertainties are arising in relation to the solidity of Italy’s banking system, which raise questions about the credibility of stress tests.

Despite a reduced volume of trade in goods, international investment and trade in services are progressing at higher rates than before the crisis.

In general, emerging economies are evolving somewhat better than expected. The growth of the Chinese economy, which had fallen at the beginning of the year, is showing signs of stabilising at around 6-6.5%. Russia could resume growth this year and Brazil next year, putting an end to two years of recession.

However, the IMF estimates that world trade is growing at an anaemic rate of 2.6%. The weakening of world trade is partly due to the transition of the Chinese economy towards meeting domestic demand, moving away from an export-led development model. Meanwhile, the World Trade Organization (WTO) has warned of the rise of protectionist barriers in the majority of the G20 countries. Lastly, the growing incidence of services in the global economy is bringing with it a reduced volume of trade in goods. However, international investment and trade in services are progressing at higher rates than before the crisis.

Recent performance of the Spanish economy

GDP grew 0.8% in the second quarter of 2016, the same figure as in the three preceding quarters. In annualized terms, this growth is equivalent to 3.3% – hereinafter, the quarter-on quarter growth rates will be expressed in these terms. Year-on-year growth was 3.2%.

Growth in domestic demand slowed sharply to 1%, resulting in a 0.9 percentage point contribution to quarterly GDP growth. The slower growth of this variable was counteracted by a greater contribution from the foreign sector, which amounted to 2.4 percentage points. Since the second quarter of 2015, domestic demand has shown a tendency –with strong quarterly oscillations– towards a slowdown in the growth rate, offset by an upward trend in the contribution from the foreign sector.

The intense slowdown in domestic demand in the second quarter of 2016 is mainly explained by the 6.1% fall in public consumption. The growth rate of private consumption slowed to 2.7%. At the start of the third quarter, retail sales were growing at a rate similar to that seen in the previous quarter, although car registrations and sales of large consumer goods companies slowed, and confidence indices showed a worsening of the downward trend seen since the start of the year (Exhibits 1.1 and 1.2).

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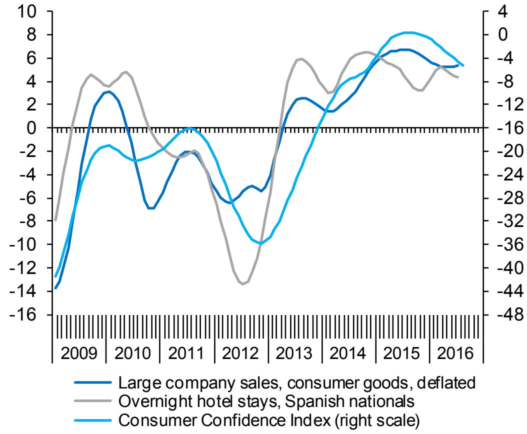
Exhibit 1

Consumption and capital goods investment indicators

1.1 - Consumption indicators (I)

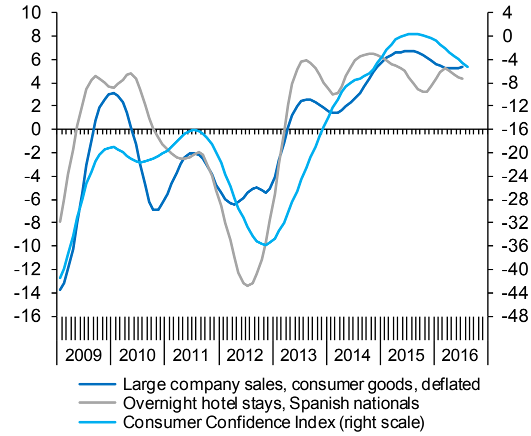
Annualised moving quarterly change in %, smoothed series



Sources: Ministry of Economy, INE, DGT and Funcas.

1.2 - Consumption indicators (II)

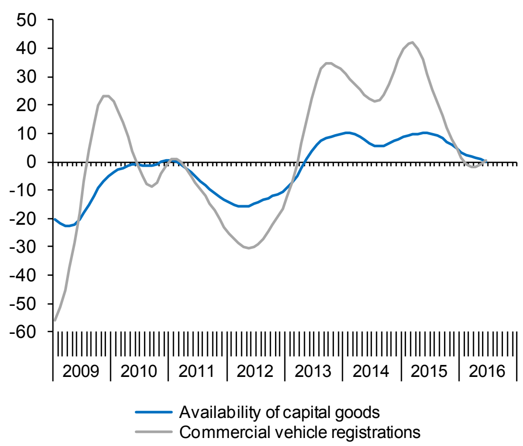
Annualised moving quarterly change in % and index (CCI), smoothed series



Sources: European Commission, INE, AEAT and Funcas.

1.3 - Capital goods GFCF indicators (I)

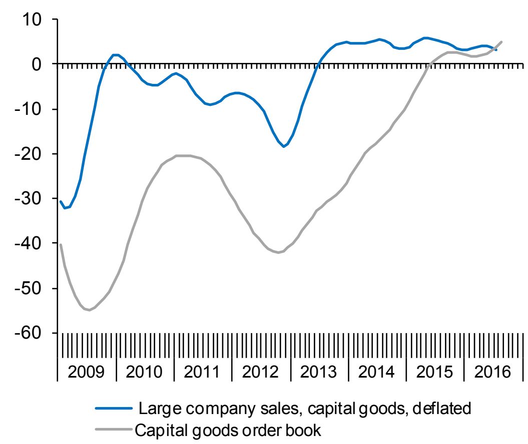
Annualised moving quarterly change in %, smoothed series



Sources: Ministry of Economy, DGT and Funcas.

1.4 - Capital goods GFCF indicators (II)

Annualised moving quarterly change in %, smoothed series



Sources: Ministry of Industry, AEAT and Funcas.

Investment in capital goods and other products accelerated in the second quarter to 6.4%, extending the upturn of this variable since the start of the recovery. Indicators for the beginning of the third quarter point to a possible slowdown in this variable in that period; capital goods orders rose at the same time as sales of large capital goods companies and commercial vehicle registrations stagnated (Exhibits 1.3 and 1.4).

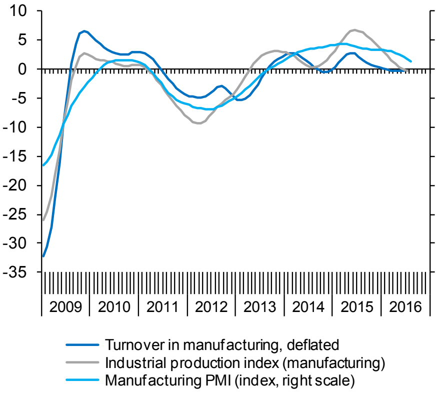
Investment in housing construction suffered a slight setback after eight consecutive quarters of

Exhibit 2

Industrial activity, services and construction indicators

2.1 - Industrial sector indicators (I)

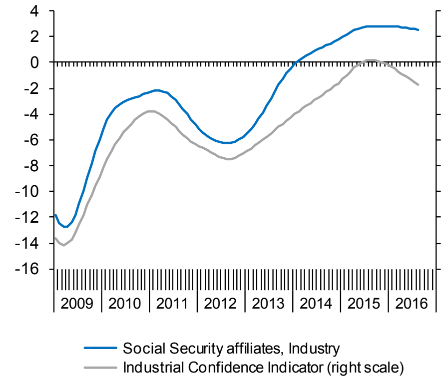
Annualised moving quarterly change in % and index, smoothed series



Sources: INE, Markit Economics and Funcas.

2.2 - Industrial sector indicators (II)

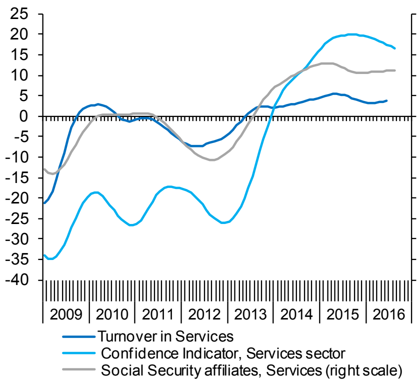
Annualised moving quarterly change in % and index, smoothed series



Sources: European Commission, Ministry of Labour and Funcas.

2.3 - Services indicators (I)

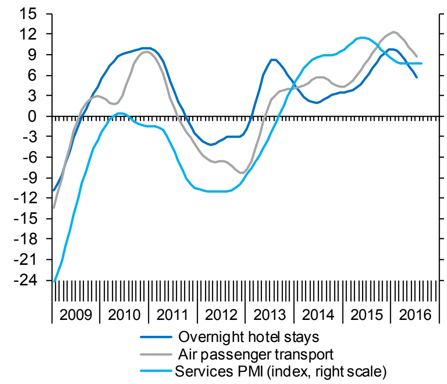
Annualised moving quarterly change in % and index, smoothed series



Sources: European Commission, Ministry of Labour, INE and Funcas.

2.4 - Services indicators (II)

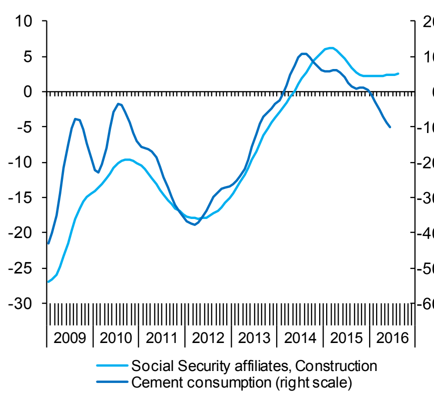
Annualised moving quarterly change in %, smoothed series



Sources: INE, AENA, Markit Economics Ltd. and Funcas.

2.5 - Construction sector indicators (I)

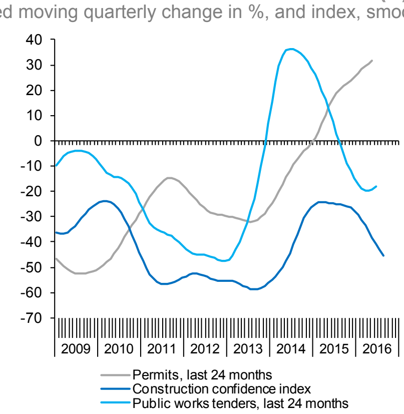
Annualised moving quarterly change in %, smoothed series



Sources: Ministry of Labour, OFICEMEN and Funcas.

2.6 - Construction sector indicators (II)

Annualised moving quarterly change in %, and index, smoothed series



Sources: Ministry of Industry, SEOPAN and Funcas.

growth. However, the increase in the number of permits for new builds indicates that this is a temporary interruption of the path to recovery. Real estate market indicators continue to offer positive signs: house sales saw an accelerated rate of growth since the start of the year, and at the same time prices continued to rise. Non-residential construction experienced a recovery in the second quarter, although it is to be expected that the public works component continues to decline, in line with the significant fall shown in official calls for tender since the middle of last year (Exhibit 2.6).

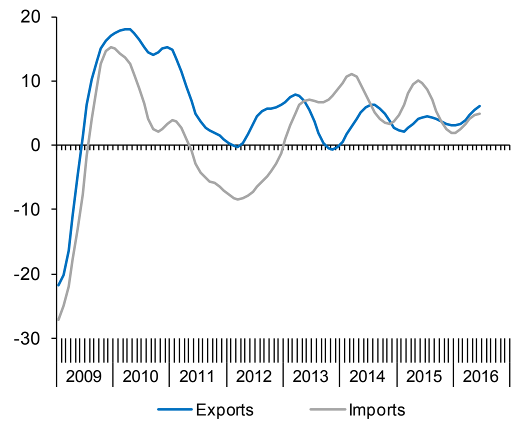
Total exports increased 18.5% in real terms, driven by the strong rise in sales of goods and non-tourism services. Tourism services rose, albeit at a moderate rate when compared with the dynamism shown by indicators such as tourist arrivals or

Exhibit 3

External sector

3.1 - Exports/Imports at constant prices (Customs)

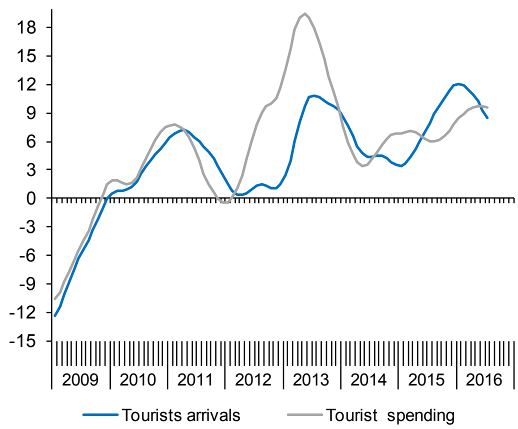
Annualised moving quarterly change in %, smoothed series



Source: Ministry of Economy.

3.2 - Tourist sector

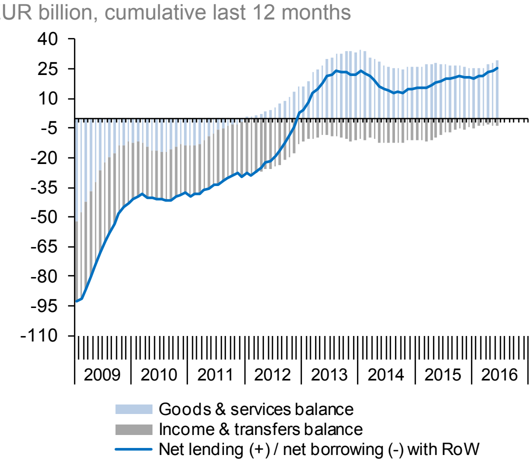
Annualised moving quarterly change in %, smoothed series



Source: INE.

3.3 - Balance of payments

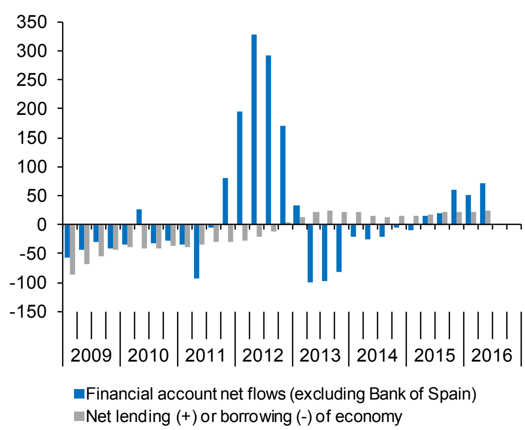
EUR billion, cumulative last 12 months



Source: Bank of Spain.

3.4 - Balance of payments

EUR billions, moving sum 4 quarters



Source: Bank of Spain.

overnight stays by non-residents. Total imports increased at a lower rate than exports, resulting in a positive contribution by the foreign sector to growth in the second quarter.

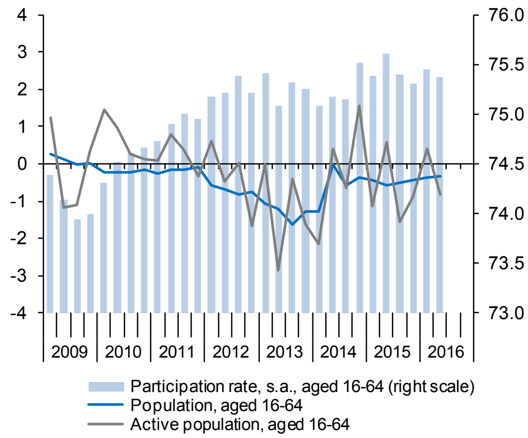
On the supply side, the sector showing most progress was that of predominantly market services –*i.e.* excluding public administration, health and education– followed by industry, while construction recorded a drop in activity. With regard to the third quarter, available indicators of the industrial sector such as the sector PMI, the industrial climate index or sales of large industrial goods companies are on a clearly decelerating path, although job creation, according to the social security system registration figures, remains at

Exhibit 4

Labour market indicators

4.1 - Labour supply

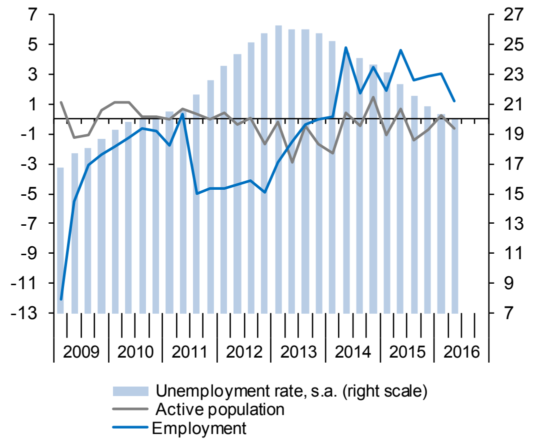
Annualised change q-o-q in % and percentage of population aged 16-64



Source: INE (LFS).

4.2 - Employment and unemployment (LFS)

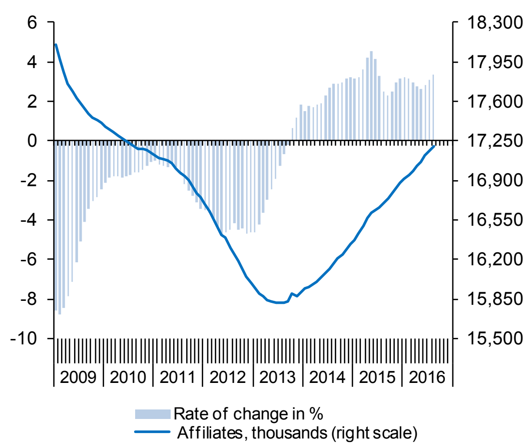
Annualised change q-o-q in % and percentage of working age population



Source: INE (LFS).

4.3 - Social Security affiliates

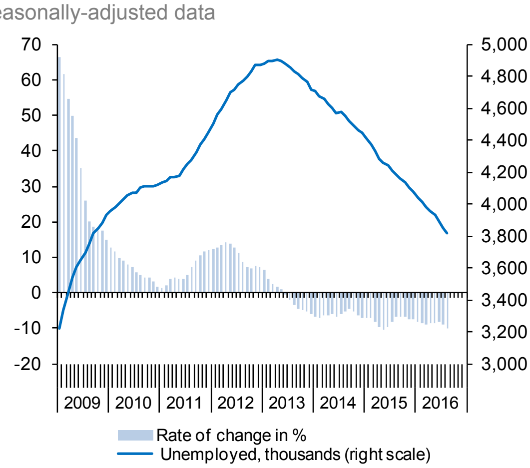
Annualised moving quarterly change in % and thousands, seasonally-adjusted data



Sources: Ministry of Labour and Funcas.

4.4 - Registered unemployment

Annualised moving quarterly change in % and thousands, seasonally-adjusted data



Sources: Ministry of Labour and Funcas.

a solid and stable rate (Exhibits 2.1 and 2.2). In relation to services, available sector PMI indices have moved at levels only slightly lower than those of previous months, as is the case of job creation (Exhibits 2.3 and 2.4). In construction, noteworthy is the negative trend of indicators such as cement consumption, construction materials industrial production index or the confidence index. Nevertheless, employment in the sector increased in the second quarter, a trend that also remained in the third (Exhibit 2.5).

Employment in terms of full-time equivalent jobs saw a slowing of growth in the second quarter. Except for the primary sector, employment grew in all other sectors. The seasonally adjusted unemployment rate fell by 0.3 percentage points compared to the previous quarter to 20%. As has been happening since the start of the recovery, the fall in the unemployment rate was favoured by the reduction in the workforce, as a result not of a lower rate of activity but of the decrease in the working-age population (Exhibits 4.1 and 4.2). With respect to the third quarter, according to the seasonally adjusted figures for affiliates to the social security system, the growth in employment weakened somewhat in August, albeit on the back of a very positive result the previous month, such that the average quarterly rate hardly changed in relation to the previous quarter (Exhibits 4.3 and 4.4).

Indicators point to a slowdown in economic activity in the third quarter of the year, coming from a slowdown in domestic demand, which may be affecting the labour market.

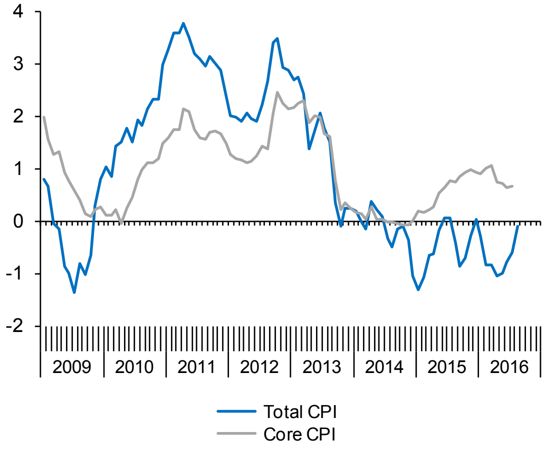
In summary, the available indicators point to a slowdown in economic activity in the third quarter of the year, although with a limited reflection in the rate of employment growth. This slowdown would come from the reduced growth in domestic demand, although there are as yet no data on the foreign sector for that period. From the supply perspective, the slowdown would mainly affect the industrial sector.

Exhibit 5

Price indicators

5.1 - Consumer Prices Index

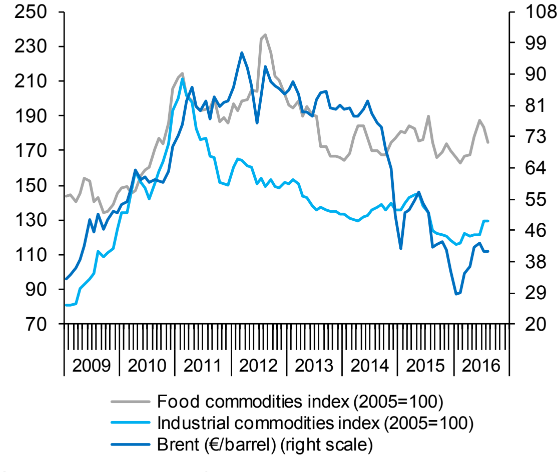
Change y-o-y in %



Source: INE.

5.2 - Commodities prices in €

Euros and index



Sources: Ministry of Economy and The Economist.

Remuneration per employee recorded year-on-year growth of 0.8% in the second quarter. This rise can be largely explained by the repayment of part of the 2012 extra salary payment to civil servants. In the non-agricultural market segments, the year-on-year growth in wages was more contained, 0.1%. Unit labour costs for the whole of the economy rose slightly in that period in year-on-year terms, although this was due to the significant rise in unit labour costs in the public administration. In the non-agricultural market segments, the downward trend of recent years continued.

Inflation recorded negative rates in the first eight months of the year, with a minimum of -1.1% in April, after which it rose to reach -0.1% in August. These negative rates can be explained by falling energy prices, whilst core inflation has been around 0.7% in the most recent months (Exhibits 5.1 and 5.2).

Up to the month of June, the current account balance showed a surplus of 6.3 billion euros, compared to one billion recorded in the year-ago period. The improvement was a result of both the rise in the trade surplus and the fall in the income deficit (Exhibit 3.3). The growth in the trade surplus was due, according to national accounting figures, on the one hand, to the increase in the services surplus (derived above all from the strong growth in non-tourism services exports), and on the other hand, to the fall in the prices of imports, both of energy products and other intermediate products.

With regard to the financial account of the balance of payments excluding the Bank of Spain, the deficit recorded up to June was greater than that obtained in the same period last year, which can be explained by the sharp drop in portfolio investments from abroad in Spain. Direct investments from abroad, however, remained at a level similar to 2015 (Exhibit 3.4).

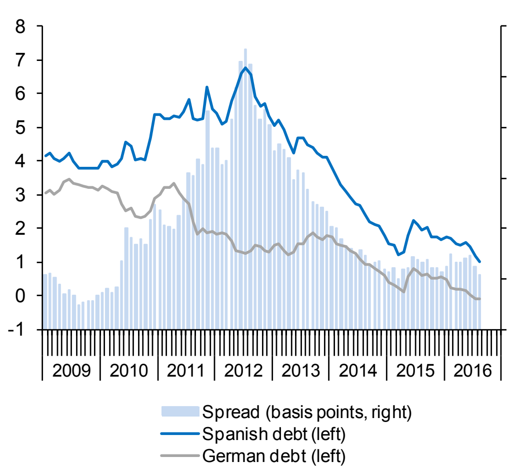
The savings rate for the economy as a whole increased in the first quarter to 22.3% of GDP– the four quarter moving average. This increase came from the business sector. The savings rate in the public sector remained stable, whilst that of households decreased slightly (Exhibits 7.1 and 7.2).

Exhibit 6

Financial indicators

6.1 - Government 10 years bonds rate

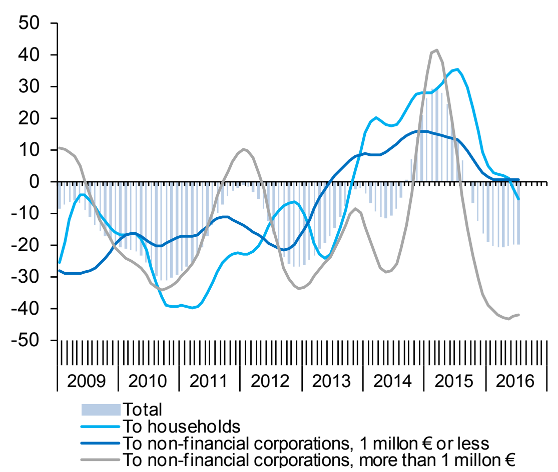
Percentage and basis points



Sources: ECB and Bank of Spain.

6.2 - New business loans

Annualised moving quarterly change in %, smoothed and s.a. series



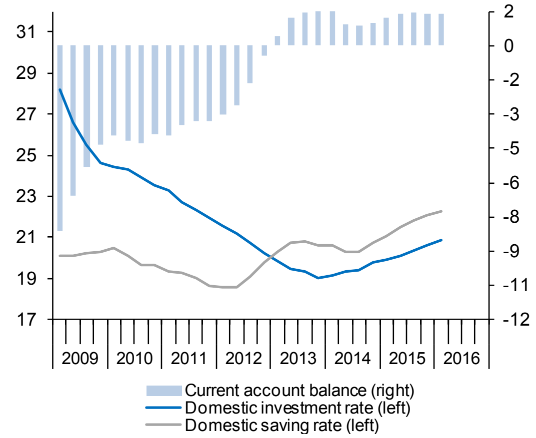
Sources: Bank of Spain and Funcas.

Exhibit 7

Financial imbalances

7.1 - Domestic saving, investment and current account balance

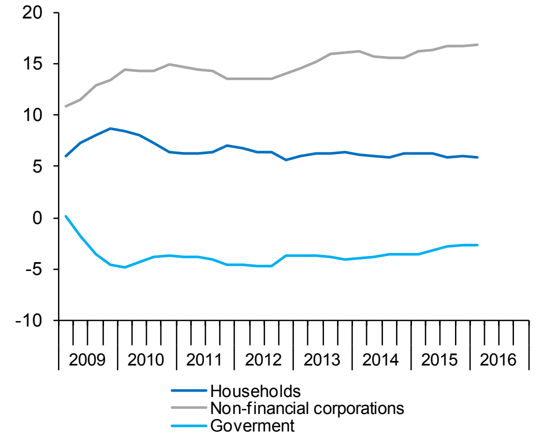
Percentage of GDP, 4-quarter moving average



Source: INE.

7.2 - Saving rates

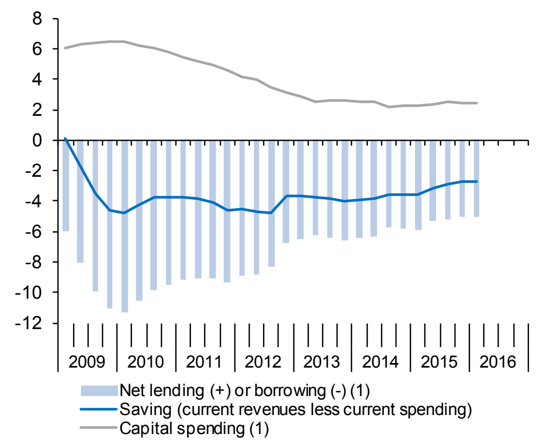
Percentage of GDP, 4-quarter moving average



Sources: INE.

7.3 - General Government deficit

Percentage of GDP, 4-quarter moving average

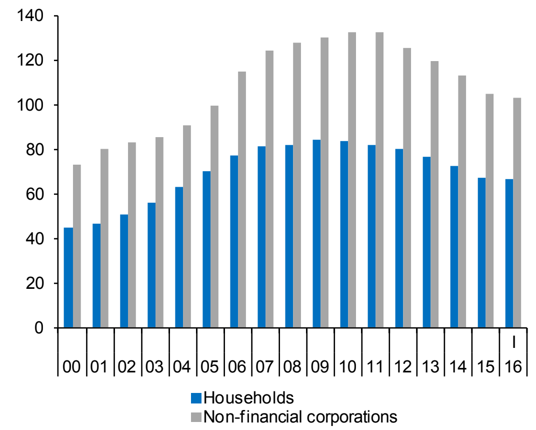


(1) Excluding financial entities bail-out.

Sources: INE.

7.4 - Gross debt

Percentage of GDP, 4-quarter moving average



Source: Bank of Spain (Financial Accounts).

In the case of the latter, the reduction in the savings rate, coupled with the slight increase in the investment rate, gave rise to a reduction in the financing capacity. This was allocated, as has been happening in recent years, partly to financial asset acquisition, and partly to debt reduction. Thus, the rate of household indebtedness fell in the first quarter to 104.6% of gross disposable income, 1.4 percentage points less than the previous quarter (Exhibit 7.4).

Non-financial companies' growing savings rate continues to exceed their (also rising) investment rate, such that this sector continues to show a notable financing capacity equivalent to 2.4% of GDP. This surplus is also allocated largely to the reduction of debt, which decreased in the first quarter to 102.9% of GDP, almost two percentage points less than in the preceding quarter (Exhibit 7.4).

In short, in the first quarter of 2016, we continued to see two of the most noteworthy features of the Spanish economy since the beginning of the recovery, namely the growth in investment by private players in tandem with the reduction of indebtedness, both in relative and nominal terms.

Business investment has been boosted by solid profit margins and reduced enterprise indebtedness.

The deficit of the public administrations excluding local government corporations up to May was 24.6 billion euros, up 1.6 billion euros on the year-ago period. This deterioration came in part from the central government, which is suffering a sharp drop in corporate income tax collection, because, among other things, the measures adopted in previous years aimed at increasing prepayments came to an end this year. Income tax collection is also falling because of lower tax rates. The deterioration of the public administrations' fiscal balance also stems from the social security system, mainly due to the fact that benefits –pensions– are growing at a faster rate than social security contributions. The autonomous regions, in contrast, reduced their deficit by 1.3 billion euros thanks to an increase in income resulting from the functioning of the financing system.

The returns on Spanish public debt have fallen more sharply than expected, especially after the result of the UK referendum. In August, returns were on average 1.01%, compared to 1.73% at the start of the year. The yield vis-à-vis German debt has also fallen considerably to 108 basis points, the lowest level since the start of the European sovereign debt crisis in May 2010. In addition, 3-year debt rates were negative (Exhibit 6.1).

The returns on Spanish public debt have fallen more sharply than expected, especially after the result of the UK referendum.

Outlook for 2016 and 2017

For the remainder of 2016, the Spanish economy is expected to continue to grow at a steady pace. GDP growth could reach 3.1% in 2016, one tenth of a percentage point more than predicted in the previous forecast, and almost double that of the eurozone as a whole (Table 1). However, the signs of weakening seen in recent months are expected to be confirmed, which would cause a slowdown. The GDP growth forecast for 2017 remains unchanged at 2.3%, half a percentage point more than in the eurozone. This implies a somewhat sharper than expected slowdown.

These forecasts have been made using two macroeconomic policy assumptions. Firstly, unchanged monetary conditions, *i.e.* the continuation of the ECB's asset purchase policy extended to corporate debt securities (TLTRO II), as well as zero 12-month interest rates for the interbank market, and around 1.1% for 10-year public debt. During the forecast horizon, the euro would trade at its current level of around 1.10 dollars. Secondly, despite the complex political situation and lack of government, a budgetary effort is expected to improve compliance with public deficit targets.

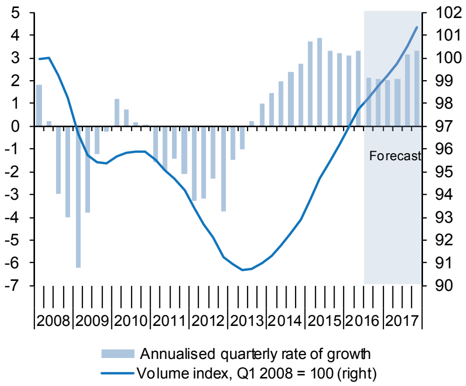
In this context, a slowdown is predicted, mainly originating from domestic demand –notably private and government consumption. The contribution by the foreign sector would remain slightly negative (Exhibits 8.1 and 8.2).

Exhibit 8

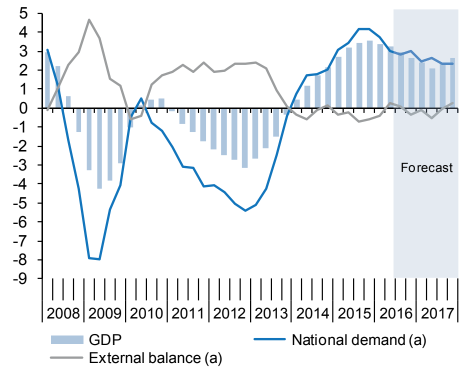
Economic forecasts for Spain, 2016-2017

Change y-o-y in %, unless otherwise indicated

8.1 - GDP

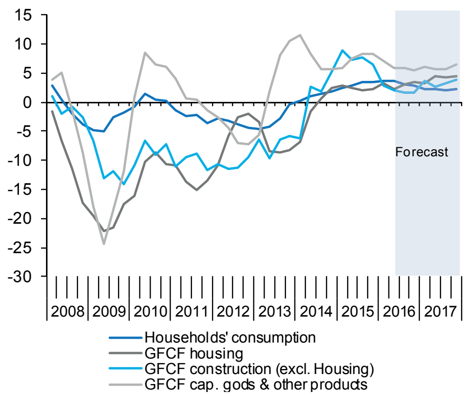


8.2 - GDP, national demand and external balance

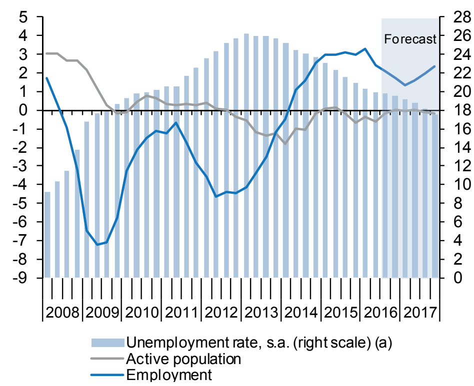


(a) Contibution to GDP growth in percentage points.

8.3 - National demand aggregates

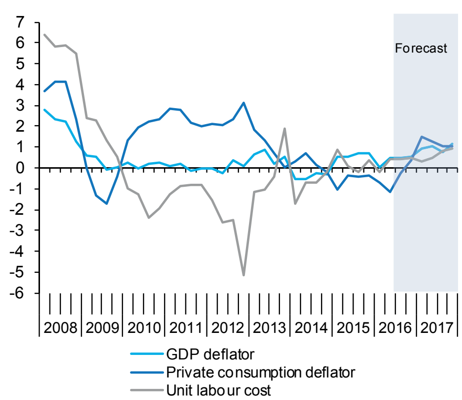


8.4 - Employment and unemployment

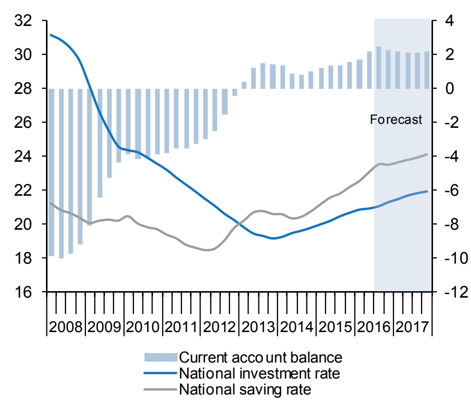


(a) Percentage of working age population.

8.5 - Inflation



8.6 - Saving, investment and c/a balance (% GDP, 4MA)



Sources: INE (Quarterly National Accounts) and Funcas (forecasts).

Table 1

Economic Forecasts for Spain, 2016-2017

Annual rates of change in %, unless otherwise indicates

	Actual data				*Funcas forecasts*		*Change in forecasts (a)*	
	Average 1996-2007	Average 2008-2013	2014	2015	2016	2017	2016	2017
1. GDP and aggregates, constant prices								
GDP	**3.8**	**-1.3**	**1.4**	**3.2**	**3.1**	**2.3**	**0.1**	**0.0**
Final consumption households and NPISHs	3.6	-2.2	1.2	3.1	3.3	2.2	-0.2	0.1
Final consumption general government	4.3	0.7	0.0	2.7	0.6	0.6	-1.5	-0.4
Gross fixed capital formation	6.4	-7.0	3.5	6.4	4.2	4.8	0.0	-0.2
Construction	5.9	-9.8	-0.2	5.3	2.4	3.7	0.1	0.1
Residential construction	7.8	-11.2	-1.4	2.4	3.0	4.1	-0.9	-0.3
Non-residential construction	4.2	-8.2	0.8	7.5	2.0	3.4	1.0	0.4
Capital goods and other products	7.5	-2.4	7.7	7.5	6.1	6.0	-0.1	-0.4
Exports goods and services	6.6	1.7	5.1	5.4	5.1	4.2	1.1	-0.1
Imports goods and services	8.7	-4.1	6.4	7.5	5.8	4.9	0.4	-0.4
National demand (b)	**4.5**	**-3.0**	**1.6**	**3.7**	**3.1**	**2.4**	**-0.2**	**-0.1**
External balance (b)	-0.7	1.7	-0.2	-0.5	-0.1	-0.1	0.2	0.1
GDP, current prices: - € billion	--	--	1,041.2	1,081.2	1,118.4	1,155.6	--	--
- % change	7.4	-0.8	1.0	3.8	3.4	3.3	-0.1	-0.1
2. Inflation, employment and unemployment								
GDP deflator	3.5	0.5	-0.4	0.6	0.4	1.0	-0.1	-0.1
Household consumption deflator	**3.1**	**1.8**	**0.2**	**-0.5**	**-0.4**	**1.2**	**-0.1**	-0.2
Total employment (National Accounts, FTEJ)	3.4	-3.3	1.1	3.0	2.7	1.9	0.1	0.0
Productivity (FTEJ)	0.4	2.1	0.3	0.2	0.3	0.4	-0.1	0.0
Wages	7.5	-1.1	0.9	3.9	3.6	3.1	0.2	0.1
Gross operating surplus	6.9	-0.2	0.4	3.1	3.1	3.2	-0.2	-0.2
Wages per worker (FTEJ)	3.3	2.4	-0.6	0.5	0.6	1.1	0.0	0.1
Unit labour costs	2.9	0.3	-0.8	0.3	0.3	0.7	0.1	0.1
Unemployment rate (LFS)	**12.5**	**20.2**	**24.4**	**22.1**	**20.0**	**18.5**	**0.2**	**0.4**
3. Financial balances (% of GDP)								
National saving rate	22.4	19.9	20.8	22.1	23.4	24.0	0.3	0.3
- of which, private saving	18.6	23.1	24.3	24.8	26.0	25.6	1.1	0.9
National investment rate	26.9	23.2	19.8	20.7	21.3	21.9	0.1	0.0
- of which, private investment	23.0	19.4	17.7	18.2	19.1	19.7	0.1	0.0
Current account balance with RoW	**-4.5**	**-3.3**	**1.0**	**1.4**	**2.1**	**2.1**	**0.3**	**0.3**
Nation's net lending (+) / net borrowing (-)	-3.7	-2.8	1.6	2.1	2.7	2.7	0.1	0.2
- Private sector	-2.8	5.9	7.5	7.2	7.3	6.2	0.9	0.8
- Public sector (general governm. deficit)	**-0.9**	**-8.6**	**-5.9**	**-5.1**	**-4.6**	**-3.6**	**-0.8**	**-0.6**
- General gov. deficit exc. financial instit. bailout	**--**	**-7.9**	**-5.8**	**-5.0**	**-4.6**	**-3.6**	**-0.8**	**-0.6**
Gross public debt	52.2	66.8	99.3	99.2	100.4	101.1	0.9	1.6
4. Other variables								
Household saving rate (% of GDI)	10.2	10.2	9.6	9.4	9.3	9.1	-0.3	-0.4
Household gross debt (% of GDI)	82.1	127.2	112.2	106.0	100.1	94.0	-0.3	-3.3
Non-financial coporates gross debt (% of GDP)	80.0	127.9	112.7	104.8	98.9	92.6	-0.2	-0.2
Spanish external gross debt (% of GDP)	90.8	158.2	166.6	167.7	164.2	158.9	0.0	0.0
12-month EURIBOR (annual %)	3.7	1.9	0.5	0.2	0.0	0.0	0.0	0.0
10-year government bond yield (annual %)	5.0	4.7	2.7	1.7	1.4	1.1	-0.1	-0.3

Notes:
(a) Change between present and previous forecasts, in percentage points.
(b) Contribution to GDP growth, in percentage points.
Sources: 1996-2015: INE and Bank of Spain; Forecasts 2016-17: Funcas.

Private consumption will suffer from slower job creation, stagnating wages and the end of the impact of the cuts in personal income taxes. In addition, disposable household income would be affected by the moderate rise in oil prices which is predicted. OPEC's production decisions are expected to have an impact, and the Brent price per barrel is expected to increase slightly to 48.5 dollars in 2017. This would put an end to the improvement in terms of trade that buoyed real income and consumption during 2015 and much of 2016. The savings rate would fall slightly, but it would leave room for housing purchases by households without excessive recourse to borrowing (Exhibit 8.3).

A moderate evolution in public consumption is anticipated, as a consequence of the end of the electoral cycle and the need to reduce the deficit to meet targets. It is likely that, in the absence of any agreement between political parties to form a government, the State Budget for 2016 will be extended until 2017, which would mean the freezing of some expenditure. Projections envisage an increase in expenses compatible with that extension, adjusted to take into account the updating of pensions and wages of civil servants.

It is likely that, in the absence of any agreement between political parties to form a government, the State Budget for 2016 will be extended until 2017, which would mean the freezing of some expenditure. However, the government deficit is likely to exceed targets.

Despite uncertainties in the financial markets and the slowdown in domestic demand, companies continue to make new investments. For 2017, a 6% increase in capital goods investments is expected, similar to that recorded in 2016. Investor dynamism reflects a reduction in financial burdens facilitated by the ECB's accommodative policy and corporate debt reduction.

The slowdown is also due to external factors. Annual growth of export markets, an essential driver of economic recovery, could suffer from the weak growth of emerging economies and the direct and indirect effects of Brexit. For 2017, exports of goods and services are expected to grow by 4.2%, two tenths of a percentage point higher than the growth of worldwide markets but one percentage point less than in 2016.

The economic slowdown would be reflected in the labour market. It is estimated that for 2016 as a whole employment will grow by around 2.7%. For 2017, it is expected to grow more slowly, by 1.9%. The unemployment rate, although falling, would remain very high, almost double that of the eurozone (Exhibit 8.4).

Despite the increase in the price of imports, inflation would remain below the 2% target. A moderate change is predicted for unit labour costs, less than that seen in other European countries (Exhibit 8.5).

The current account balance is expected to record a surplus of 2.1% of GDP in 2016, 0.7 percentage points more than in 2015. For 2017, a similar result is expected (Exhibit 8.6). This being so, the favourable differential of economic growth appears to be sustainable from the standpoint of external accounts.

Lastly, the outlook for the general government deficit in 2016 has deteriorated substantially. Now it is estimated that the deficit will reach 4.6% of GDP, *i.e.* 0.8 percentage points higher than initially predicted and 1 percentage point higher than predicted officially in the Stability Programme Update. This situation has resulted in the setting of new targets in agreement with the European Commission. According to the agreement, the deficit should be around 4.6% in 2016, 3.1% in 2017 and 2.2% in 2018. However, the absence of new tax collection measures suggests a 3.6% deficit in GDP, *i.e.* a 0.5 percentage point deviation from the new targets.

Principal challenges in the medium-term

While the recovery is a reality, it is questionable whether it will be enough to correct the main imbalances of the Spanish economy in terms of unemployment and public debt. This is a crucial issue, since reducing imbalances depends on maintaining sustained growth. And, *vice versa,* the persistence of imbalances shapes economic progress, convergence towards the most advanced countries and the reduction of social inequalities.

Economic growth, in and of itself, will not be enough to tackle the main imbalances of the Spanish economy in terms of unemployment and public debt. Specific measures are needed.

According to the projections made under the assumption of broadly unchanged policies, unemployment could fall between now and 2020 and the public debt would stabilize. However, this trend would be insufficient to correct existing imbalances (Table 2). In these projections, the growth of the economy would gradually converge towards its potential to stand at 2% in 2020.

Currently, the jobs deficit is obvious. Only 65% of the population aged 20 to 64 years –the core of the labour market– has a job. The employment rate is 10 percentage points below the most successful countries. Two thirds of those who do not work are unemployed and the rest are not even looking for a job – they are “inactive” in employment terms.

The projection for 2020, assuming that policies remain unchanged, is an increase in the employment rate but without reaching European standards. 14.3% of the labour force would continue to be unemployed by 2020, while one in four working-age people would be inactive.

These results would be all the more problematic because they arise in an adverse demographic context. The working-age population would fall by half a million people over the next five years, as a result of the drop in birth rates over recent years and access to retirement by the boom generation of the 1960s. The shortage of quality jobs could drive many young people to emigrate, intensifying the adverse demographic trends.

In addition to the threat that this poses to social cohesion, the persistence of a low employment rate would generate a serious problem in terms of the sustainability of the pension system. The number of active persons per person of retirement age would be 2.5 in 2020, compared to 2.7 in 2016 and 3.1 in 2007 before the start of the crisis.

Table 2
Unemployment and public indebtedness in 2020

	2000	2007	2016	2020
Employment imbalance				
Population aged 16-64 (million)	27.0	30.6	30.0	29.6
Unemployment rate, %	11.9	8.2	20.0	14.3
Ocupation rate, 16-64, %	57.9	67.3	60.9	65.9
Active population / population aged more than 64	2.4	3.1	2.7	2.5
Public accounts imbalance				
Net lending (+) or borrowing (-) (% GDP)	-1.0	2.0	-4.6	-2.5
Public debt, total Government (% GDP)	58.0	35.5	100.4	100.9

Source: Funcas.

There are solutions to the shortage of quality jobs, which include facilitating the participation in the labour market of young people, women and persons aged over 55. These are groups that are especially hard hit by the shortcomings in active policies on employment and the reconciliation of professional and family life, gaps in the educational system and discrimination.

Moreover, in many cases, permanent needs are covered by temporary or short-term contracts. The result is greater job insecurity, together with a loss of human capital and productivity. Lastly, school failure rates are still excessive and the educational system is not always in alignment with the needs of the economy, technological transformation and the evolution of society.

As for public debt, recent trends are for a further increase despite strong economic growth. In 2016, general government debt is estimated to represent 100.4% of GDP, almost three times higher than in 2007. This increase is the result of an accumulation of public deficits as well as the granting of aid to banks –which took place in a context of restructuring and losses by the financial institutions resulting from the bursting of the real estate bubble. Worryingly, public debt has continued to grow during the recovery phase.

The central scenario assumes a stable public expenditure as a percentage of GDP. In other words, the public administration would make a constant effort to provide basic services and meet social needs.

The decrease in spending on unemployment benefits –in line with a reduction in unemployment– would be offset by an increase in expenditure on pensions and health resulting from the ageing of the Spanish population. In addition, it is assumed that financial costs on government debt would increase moderately as a result of the ECB's gradual interest rate rises (on the assumption that the ECB's exceptional measures would be phased out slowly).

Tax collection would rise slightly above GDP growth to reflect the expected normalization of corporate income tax revenue. The projections do not envisage further tax cuts.

Based on these assumptions, public debt as a percentage of GDP would cease its upward trend and in 2020 would be at a level close to that observed in 2016. However, a swifter normalization of monetary policy would have significant repercussions on interest payments and would cause public debt to spiral.

To address this risk, a strategy is required that could involve greater tax collection efforts, reconsidering tax relief on the payment of social contributions and taxes and upping the fight against tax fraud. Higher taxes on fossil fuels would be another option, which is also consistent with commitments to fight climate change. There is little leeway for tightening public expenditure, which is already below the European average, especially in education. There is also the need to prepare Spain for the digital revolution.

In short, creating quality jobs and reducing public debt are two of the principal challenges facing the Spanish economy. Economic growth, on its own, will not be enough. A strategy with specific long-lasting measures is urgently called for.