The Spanish economy in 2018… and beyond

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The positive momentum of global growth at the end of last year is expected to persist in 2018, with monetary policy gradually tightening, but remaining accommodative enough to sustain the better than expected scenario observed across both advanced, in particular European, and most emerging economies. A sharp rise in inflation and a faster than expected monetary tightening across the main central banks remain among the major risks to this positive scenario, although they are unlikely to materialize.

In this context, this month's edition of Spanish and International Economic & Financial Outlook (SEFO) *features the latest key insights from Funcas' Director General Carlos Ocaña on the outlook for the Spanish economy and financial sector in 2018 and beyond. Kicking off the year ahead, the following text presents the view for Spain in 2018 and into the medium-term, weighing the balance between political tensions, downside risks and opportunities.*

Barring any unexpected shocks, in 2018, the Spanish economy will continue to grow strongly at 2.6%, half a percentage point below last year's growth, but in line with that of the last two to three years. In the longer term, we expect a similar growth performance. GDP is anticipated to increase 2.4% in 2019. This modest deceleration is due, in part, to the moderation of consumption growth, reflecting both a household savings rate at historical minimums and the depletion of pent up demand after two years of strong rebound in consumption. The anticipated impact of the slowdown in consumption could shave off 0.3 percentage points of GDP.

In addition, ongoing political tensions in Catalonia will have a negative impact on investment in the region that we do not expect to be completely offset by increased investment flows to other parts of Spain. We estimate the net impact to be moderate in the short term, accounting for a reduction of an additional 0.2 percentage points in our 2018 forecast for Spanish overall GDP growth. At the political level, uncertainties that accompanied 2017, particularly those linked to the tensions surrounding the independence movement in Catalonia, have dissipated somewhat after the Central Government and Constitutional Tribunal decisions. In the longer term, there remains a risk that the situation in Catalonia becomes chronic, which could lead to less investment and a gradual reduction in the weight of the Catalan economy. At this stage, it is not possible to quantify the potential impact from such a scenario, but the experience in Quebec and elsewhere suggests this risk merits consideration.

In contrast to other periods of growth, the recovery is not expected to fuel inflation. In line with many other advanced economies, inflation remains low. CPI is expected to increase by 1.6% but remains below the ECB's threshold for price stability. Meanwhile, the GDP deflator, reflecting the trend in core inflation, will be even lower.

Growth should translate into significant job creation. Our estimates point to the creation of 400,000 net new full-time equivalent jobs in 2018 that will bring unemployment down to 15.1%, a substantial decline from the peak of 26% reached five years ago, but still high. Spain's government has just agreed to a

4% increase in the minimum wage to 735.9 euros for 2018. This will benefit around 3.6% of the approximately 16 million salaried workers in Spain earning at or close to the minimum wage (an estimated 576,000 workers). The impact on other higher salaries is expected to be very limited, as is the impact on inflation. In other words, we do not expect the increase in minimum wage to erode competitiveness.

In short, the economic outlook for 2018 is optimistic, marked by a moderate deceleration with respect to 2017 or, in other words, convergence to Eurozone growth rates. From this central scenario, the main downside risks are those related to a faster than anticipated tightening of monetary conditions. In the base case scenario, these risks are unlikely, but they do remain. It is therefore crucial to take advantage of the current environment of growth and of access to extraordinarily favorable financing conditions to correct the two main outstanding weaknesses of the Spanish economy, namely the high levels of unemployment and debt.

Labour markets

There is scope for improvement of the Spanish labour market. The main challenge is to increase productivity and this requires increasing skills and education. According to the OECD, in 2016, the employment rate in Spain for workers between the ages of 25-64 years with tertiary education was 79.8%, much higher than the 53.9% that had less than upper secondary education. Moreover, despite recent improvement in some of the Autonomous Regions, the rate of early school leavers in Spain in 2017 was 18.3%. On the basis of latest available comparable data from 2016, this is 80% above the European average (19% *vs.* 10.7%). In addition, the percentage of young people in Spain who neither study nor work is also higher than the European average and the unemployment rate among those under 25 years of age is twice that of the EU.

Reducing duality in the labour market would also help to improve productivity by reducing the number of temporary workers. The incidence of temporary work is high by European comparison. This is also a source of both precariousness and low productivity, which may hinder the ability of Spain to seize the benefits of the digital economy.

It is also necessary to increase the efficiency of active labor market policies. The goal is to improve re-employment prospects of jobseekers, notably the long-term unemployed. This requires more effective public employment services, with a view to strengthening job-search support and enhancing contacts with employers who might be interested in recruiting jobseekers.

Public deficit and debt

The public deficit – at 3.1% of GDP in 2017- is now under control, and this year's target of 2.2% of GDP seems within reach. As a result, Spain will be able to exit the EU's Excessive Deficit Procedure (EDP).

Public debt levels are expected to continue their slow decline in 2018 to 96.4% of GDP, down 1.4% of GDP from the previous year, but remain uncomfortably high. While the government has been able to take advantage of savings on interest payments under the ECB's monetary accommodation, the announcement of policy normalization will push up the cost of debt service, and, in the absence of a long-term debt reduction strategy, increase sovereign risk. Private debt, that of both households and non-financial corporations combined, has declined significantly since the on-set of the crisis. After reaching a peak of over 215% of GDP, private debt levels as of the third quarter of 2017 stand at 159.9% of GDP, having converged to the Eurozone average. But Spain's private debt remains high and recent indicators point to a notable slowdown in the deleveraging process for both households and firms in the future.

Current, benign economic and financial market conditions will begin becoming less so in 2019 as monetary policy normalization begins to run its course in Europe (in accordance with the ECBs latest announcement). At present, given the positive macroeconomic outlook in Spain and in the Eurozone overall, it is expected that even as the ECB continues its tapering of sovereign debt purchases over the coming year, private buyers will come in. OMT and low policy rates remain in place for the time being as additional support. Moreover, we expect this downward trend in public debt to GDP to continue and that by 2020, public debt will converge down to 92% of GDP. But the new environment will nevertheless place additional pressures on the debt.

The deficit of the pension system (a structural problem given the demographic forecasts pointing to an aging population that exerts an upward pressure on spending on pensions), and the uncertainty over the possible reform of the financing system of the Autonomous Regions (that would add pressure to public spending), do not help to reduce uncertainty over the medium and long-term future of public finances. At the same time, in the absence of a new budget, the extension of last year's budget until, at the very least, mid-year, will probably reduce pressure on public expenditure.

Spain could benefit from the establishment of a credible and sustainable horizon to address these key issues: labour markets, public debt, pension system, regional financing system. However, the overall political situation does not contribute to positive reform momentum on the key challenges outlined above.

Financial sector

After 8 years of intense consolidation, clean-up and recapitalization, Spain's financial sector now stands more resilient, with improved profitability and solvency indicators since the onset of the restructuring process.

Profitability of the Spanish banking sector is among the highest across the main EU economies and notably above the EU average. The latest ECB quarterly consolidated banking data up to Q2 2017 point to an ROE for Spain of 4.1% versus 3.3% for the EU as a whole. While a significant improvement from the low point reached in 2012, Spanish banks' profitability is still low in historical terms (and is expected to remain so as long as interest rates stay at their current levels).

In addition, in line with the implementation of new global capital regulations, Spanish banks have boosted their solvency relative to pre-crisis levels. At the end of the second quarter of 2017, the solvency ratio for the sector stood at 14.4%, above minimum capital requirements, even in the event of an adverse scenario – as demonstrated by the Bank of Spain's latest stress-test (the Forward-Looking Exercise on Spanish Banks) published in its November 2017 *Financial Stability Report*. Nonetheless, Spain's banks' solvency ratios rank among the lowest of the main EU economies and below the EU average of 18.7%. Still, internal restructuring fueled by digitalization continues at a fast pace (banks are adjusting capacity as they transform their business model).

These improvements in the financial health of Spain's banks, together with stronger demand, have resulted in an increase in credit. According to the latest Bank of Spain data on bank lending to the private sector, total credit has increased 0.6% in November 2017 on a monthly basis from the previous month, the third consecutive month of positive growth rates this year. Despite this improvement, credit growth is still negative on a year on year basis. In line with this result, the latest Bank of Spain *Bank Lending Survey* published January 2018 shows that during Q4 2017, credit standards for new loans in Spain eased slightly in loans to households and were stable in loans to enterprises, mostly in line with the observed pattern in the euro area. Moreover, households' demand for credit rose moderately, while demand from enterprises grew in the euro area but remained stable in Spain.

Against this backdrop, although we do not rule out further consolidation in the financial sector, we believe that most of the major changes to the Spanish financial sector landscape (*i.e.* major operations) have already taken place – other than the privatization of Bankia, which should be completed in the next couple of years.