9. SPAIN

Growth continues to surprise, but signs of deceleration emerging

Economic growth exceeded expectations in recent quarters. As favourable tailwinds gradually subside, the pace of growth is set to ease but remain robust throughout the forecast horizon. Unemployment is set to continue to fall steadily, and inflation is picking up as oil prices increase and core inflation recovers. Thanks to both new revenue measures and a positive macroeconomic outlook, the general government deficit is expected to continue declining over the forecast horizon. Public debt is set to stabilise at about 100% of GDP.

Growth continues to outpace the euro area average

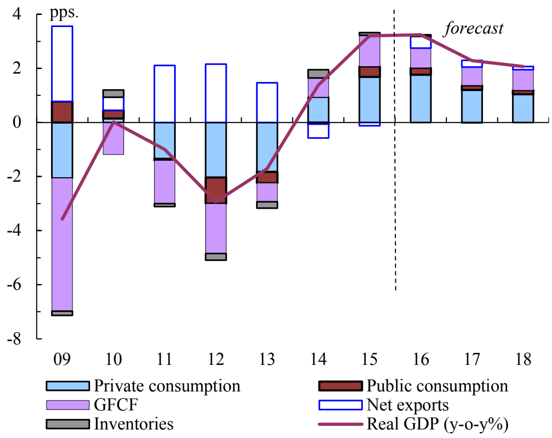
On its third year of expansion, Spain has continued to grow faster than the euro area average, and GDP almost reached its pre-crisis peak last year. Growth surprised on the upside in the first three quarters of 2016, and reached an annual average of 3.2%, despite a slight deceleration in the fourth quarter. The composition of growth is expected to have been more balanced than in previous years. Although domestic demand is expected to have remained the main growth driver, the contribution of net exports to GDP growth is projected to have been positive in 2016 for the first time since the recovery started.

GDP set to decelerate but remain robust

The rate of GDP growth is expected to ease over the forecast horizon to a still robust 2.3% in 2017 and 2.1% in 2018. Private consumption is expected to slow down as employment growth decreases and other factors that supported the growth of disposable income in recent years (i.e. the decline in oil prices, tax cuts, and improving financing conditions) gradually abate. Investment growth is set to ease somewhat in 2017 before increasing again in 2018, driven by the gradual recovery of construction investment, both residential and non-residential. Equipment investment growth, by contrast, is forecast to moderate in line with final demand.

Export growth is expected to have declined in 2016 compared to 2015. However, Spain is projected to have gained market shares, partly driven by record tourist arrivals. Total exports are then expected to slow down again in 2017, before picking up in 2018, as Spain's trading partners recover. Imports are also forecast to have decelerated in 2016 and continue to moderate in 2017, before picking up again in 2018, in line with final demand. As imports are expected to continue to grow more slowly than exports in 2017, net trade is set to make a positive contribution to growth until 2018. After widening in 2016, Spain's current-account surplus is forecast to decline in 2017 and 2018, as a consequence of worsening terms of trade. Net external lending is similarly expected to gradually decline.

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



Inflation expected to pick up

The assumed oil price increases are set to continue dominating inflation developments in the short term. Hence, headline inflation is forecast to rise from −0.3% in 2016 to 1.9% in 2017, before decreasing to 1.7% in 2018, as the base effects of energy price increases in 2017 fade away. Core inflation is projected to gradually increase over the forecast horizon, as wages pick-up, the output gap closes, and second round effects from energy price increases are passed-through into consumer prices.

Employment growth expected to moderate

Strong job creation has continued throughout 2016, despite having slowed down in the fourth quarter compared to the previous quarter. Although employment growth is set to ease over the forecast period, it is projected to remain strong, allowing for further reductions in unemployment. The unemployment rate, which amounted to 18.6%

of the labour force in the fourth quarter of 2016, is expected to continue falling to 16% by 2018. Wage growth is expected to pick up this year, and, combined with low productivity gains, is set to lead to increases in nominal unit labour costs over the forecast horizon. After years of competitiveness gains, Spain's unit labour costs are foreseen to converge to the euro area average.

The budget deficit is still high, but narrowing

Despite strong economic growth, Spain's general government deficit narrowed by only 0.3% of GDP in the first three quarters of 2016. To limit revenue shortfalls resulting from the expiry at the end of 2015 of minimum advance payments in corporate income taxation, the parliament adopted measures to strengthen corporate tax revenues in October 2016. While this yielded a positive effect on revenues in October, November revenue data were rather weak. This is expected to result in the general government deficit decreasing from 5.1% of GDP in 2015 to 4.7% in 2016.

In 2017, the forecast incorporates a number of additional measures adopted by parliament in December 2016. These consist primarily of base-broadening measures in the field of corporate taxation, but also of increases of excise duties on alcohol and tobacco as well as a broadening of the base for social contributions. Previous improvements in financing conditions imply that interest expenditure is set to continue decreasing. In combination with the positive macroeconomic outlook, which should continue supporting tax revenues and keeping social transfers in check, the deficit is expected to narrow to 3.5% of GDP in 2017. In 2018, at unchanged policies, the deficit is expected to narrow further to 2.9% of GDP on the back of the cyclical recovery.

Risks to the fiscal outlook mainly relate to contingent liabilities and uncertainty regarding the impact of the recent tax measures.

After deteriorating significantly in 2015, Spain's structural deficit is expected to have widened further by around 1¼% of GDP in 2016. It is set to improve marginally in 2017, and stabilise in 2018. Over the forecast horizon, the general government debt ratio is expected to stabilise at around 100% of GDP, as a result of relatively strong nominal GDP growth largely offsetting the budget deficit.

Table II.9.1:

Main features of country forecast - SPAIN

		2015		Annual percentage change						
	bn EUR	Curr. prices	% GDP	97-12	2013	2014	2015	2016	2017	2018
GDP		1075.6	100.0	2.2	-1.7	1.4	3.2	**3.2**	**2.3**	**2.1**
Private Consumption		625.0	58.1	1.9	-3.1	1.6	2.9	**3.0**	**2.1**	**1.8**
Public Consumption		208.5	19.4	3.5	-2.1	-0.3	2.0	**1.3**	**0.9**	**0.8**
Gross fixed capital formation		212.1	19.7	1.8	-3.4	3.8	6.0	**3.7**	**3.4**	**3.8**
of which: equipment		72.7	6.8	2.9	5.0	8.3	8.9	**5.9**	**4.0**	**3.8**
Exports (goods and services)		356.9	33.2	4.5	4.3	4.2	4.9	**4.3**	**4.0**	**4.3**
Imports (goods and services)		330.5	30.7	4.2	-0.5	6.5	5.6	**3.2**	**3.5**	**4.3**
GNI (GDP deflator)		1074.9	99.9	2.2	-1.5	1.6	3.5	**3.2**	**2.3**	**2.1**
Contribution to GDP growth:		Domestic demand		2.3	-2.9	1.6	3.2	**2.7**	**2.0**	**1.9**
		Inventories		0.0	-0.2	0.3	0.1	**0.1**	**0.0**	**0.0**
		Net exports		0.0	1.5	-0.5	-0.1	**0.4**	**0.2**	**0.1**
Employment				1.3	-3.5	1.1	3.0	**2.9**	**2.0**	**1.7**
Unemployment rate (a)				14.1	26.1	24.5	22.1	**19.6**	**17.7**	**16.0**
Compensation of employees / f.t.e.				3.0	1.4	-0.1	0.4	**0.5**	**1.4**	**1.6**
Unit labour costs whole economy				2.1	-0.5	-0.4	0.2	**0.2**	**1.1**	**1.2**
Real unit labour cost				-0.4	-0.8	-0.1	-0.3	**-0.3**	**-0.3**	**-0.4**
Saving rate of households (b)				10.2	9.6	9.0	8.2	**8.3**	**8.3**	**8.2**
GDP deflator				2.6	0.4	-0.3	0.5	**0.4**	**1.4**	**1.6**
Harmonised index of consumer prices				2.7	1.5	-0.2	-0.6	**-0.3**	**1.9**	**1.7**
Terms of trade goods				-0.2	0.6	-0.5	2.0	**0.3**	**-1.0**	**-0.3**
Trade balance (goods) (c)				-5.5	-1.4	-2.2	-2.0	**-1.5**	**-1.7**	**-1.9**
Current-account balance (c)				-4.6	1.5	1.0	1.3	**1.8**	**1.7**	**1.6**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-3.9	2.1	1.5	2.0	**2.5**	**2.2**	**2.0**
General government balance (c)				-3.1	-7.0	-6.0	-5.1	**-4.7**	**-3.5**	**-2.9**
Cyclically-adjusted budget balance (d)				-3.2	-2.3	-2.1	-2.8	**-3.8**	**-3.5**	**-3.6**
Structural budget balance (d)				-	-1.9	-1.8	-2.6	**-3.8**	**-3.6**	**-3.6**
General government gross debt (c)				54.3	95.4	100.4	99.8	**99.7**	**100.0**	**99.7**

(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.