

1 Editorial

The Spanish economy continues to accelerate its growth rate and improve its fundamentals, while the downward risks have still not materialised. All of this means that we can revise the forecast for 2015 GDP growth upwards to 3.0% and assert that the economy will continue to advance at above its trend rate in 2016 (2.7%). However, a slowdown in growth is expected to occur during the coming quarters, as the drivers sustaining domestic demand run out of steam. If it happens that certain risks that relate to geo-political uncertainty do not arise, or if policies should have a greater-than-expected impact on activity, the bias to these forecasts would be on the upward side.

The data in the last three months confirm the pick-up in activity that was forecast in the previous edition of the Spain Economic Outlook. Specifically, GDP rose by 0.9% during the first quarter of the year, in line with the BBVA Research estimate of between 0.8% and 0.9%, showing a strong contribution from domestic demand and services exports to the upturn in activity. In contrast, higher imports and the virtual standstill in exports of goods persist in limiting increases on the supply side. In any case, trends for various indicators suggest that **growth could quicken to levels of around 1% in the second quarter of the year**, which is slightly higher than forecasted three months ago.

With respect to recent trends in domestic demand, the revisions for the figures on disposable income, family saving and house prices offer a more encouraging picture of how household income and wealth have improved in the last few quarters. Thus, **the buoyancy shown until now by private consumption appears to be more sustainable and longer-lasting than in the past.** This momentum could be amplified by a bigger-than-expected impact of some of the public policies, or by the non-materialise of risks noted in the past. For example, **such progress has coincided with a higher-than-expected deficit for the regions as a whole at the 2014.** Specifically, greater spending as a result of tax incentives to promote employment under permanent contracts or lower elasticity on aggregate of public revenues to economic recovery would explain the deviation. This fiscal policy, which was slightly more expansive in 2014, in conjunction with the measures taken from early on in the year (reduction in the average rate of personal income tax), could be having a larger effect on demand than initially estimated. On the other hand, although some uncertainties on a European level (for example Greece) or within the domestic orbit have still not been resolved, neither trends in spending **nor confidence indicators reflect any adverse impact at all from the geo-political risks that still persist.** Regarding to this point, the monetary policy of the European Central Bank, the institutions set up in recent years, and the measures taken domestically seem to confirm that the Eurozone and Spain are better equipped to face scenarios involving greater uncertainty.

Looking ahead, the “tail-winds” that were highlighted one quarter ago, and which will continue to underpin domestic recovery in the next few months, have intensified. On the one hand, the economy of the country’s key trading partners has performed rather better than expected as reflected in an upward revision of GDP growth forecasts for the EMU for 2015 to 1.6%, gathering pace in the following months to reach growth rates of close to or over 2%. On the other hand, gains in competitiveness boosted by the lower oil price, the exchange rate depreciation and the fall in interest rates over the next two years are likely to be greater than were forecast three months ago. All of this, together with the solid growth which continues to be observed in machinery and equipment investment, is laying a sound base for an upturn in exports and domestic demand.

Whatever the case, several risks still hover over this scenario. First, the vigour shown by services exports (especially tourism), **has not been accompanied by increased goods exports.** Although this stagnation is assumed to be a transitory phenomenon, and it’s likely to be a consequence of the pick-up

observed in the first nine months of 2014, the risk that the process of internationalisation has slowed down due to the growth in domestic demand exists. This scenario would be a cause for concern, as the sustainability of recovery and the correction to the imbalances in the Spanish economy depend to a large extent on consolidating the upward trend in exports of goods and services.

Second, one of the biggest challenges facing the economy over the next few years is **to step up investment, while at the same time cutting external borrowing**, for which purposes, besides inflows of foreign direct investment, an increase in domestic saving is required. In this respect, while the private sector has made substantial progress in the right direction (see Box 1), there is evidence that the process of fiscal consolidation is relying increasingly on economic recovery and not so much on discretionary measures. Given the way the regional financing system is designed, in 2014 the regions could not benefit from the increase in tax revenues and, in the absence of measures to balance this out in terms of expenditure, they have widened their deficit, thereby breaching to meet the targets set (see Box 4). Thus, it is important that there should be medium-term plans, with credible targets by type of administration, measures that soften the impact on both growth and the provision of social services as much as possible, as well as rigorous implementation budget.

Finally, although the risks of a geo-political nature do not seem to be having an impact on the consumption and investment decisions of families and businesses, or on the financing costs of the economy, there is no guarantee that this will remain the case. Moreover, in the short term **it is hard to conceive of a more suitable environment for growth prospects in Spain, given the fundamentals described above. Working towards the economy being able to continue growing at its current pace, even in less kind scenarios, should be the priority.** In this respect, the efforts are positive which are being made to incentivise employment under permanent contracts and enhancing the progressiveness of allowances granted for employer contributions to Social Security payments (first 500 euros). **Stimuli of this kind in any case still fall short** in resolving definitively the problem of duality in the Spanish labour market, as this needs a substantial change in the recruitment system that can reduce the temporality of employment.¹

Likewise, the reform of the professional training system for employment is welcomed, as this correctly diagnoses a large portion of the obstacles that hinder the reintegration of the unemployed within the labour market. In particular, the reform makes headway in increasing the employability of workers by better suiting the content of courses to the needs of the productive fabric and fomenting competition among suppliers. Given the heterogeneity among those who are jobless, it becomes necessary to **rebalance training efforts in favour of those with the most problems in obtaining work.** It is also advisable to implement rigorous processes of evaluation and supervision as soon as possible, to make it possible to distinguish what training activities are the most effective for any particular category of job-seekers.

On the other hand, **we welcome as positive the introduction of a framework for personal insolvency** (law on second chance), as appropriate regulation could encourage entrepreneurial initiative and smooth the adverse effects of a sudden drop in the income of individuals (see Box 3). **It would in any case be important to create tools to monitor and evaluate** legislation, so as to be able to find out what works well and correct what does not.

It is also worth remembering the **importance of fostering greater competition in non-tradable goods sectors, to gain in competitiveness.** Until now a large portion of the relative improvement with respect to key trading partners has come from increasing productivity, on a scale which will be hard to keep up, and wage restraint, and restoring part of the competitiveness lost before the crisis. Certain reforms which have been delayed, such as for professional services, are key to ensuring that Spanish companies have access to inputs in relatively favourable conditions (see Box 2), which would lead to an additional boost for the internationalisation process and growth for Spanish businesses.

1: See "Measures to promote permanent hiring", BBVA Research & Fundación Sagardoy, 14 November 2014, available at: <https://goo.gl/811EvQ>

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