SPAIN IN 2018

The Spanish economy will end 2017 with growth exceeding 3% for the third consecutive year, outpacing the euro area average. In doing so, GDP will return to peak levels for the first time in nine years.

This impressive recovery has been underpinned by a variety of factors. First of all, the vigorous cyclical upswing primarily reflects the domestic response to the accumulation of pent-up demand during the double-dip recession between 2009 and 2014.

Secondly, Spain has enjoyed a windfall from the European Central Bank's monetary policy. The reduction in interest rates has supported a dismantling of burgeoning household and corporate debts, which were significantly above the euro area average at the start of the crisis. Meanwhile, quantitative easing has been crucial in preventing an explosion in public debt growth. The latter continues to provide a firewall against future episodes of idiosyncratic risk, as was the case during the 2016 caretaker government, and is so far proving to hold up during the political crisis in Catalonia, which has come to a head in the last quarter of 2017.

Thirdly, given the economy's significant energy dependence, the easing of oil prices in recent years has also had a particularly significant impact on the Spanish economy's export competitiveness, making a major contribution to reducing the external trade balance. Spain's net lending position has swung from -10% of GDP in 2007 to +2% since the start of the recovery.

Fourthly, the relaxing of the public administration's fiscal adjustment path also provided an important stimulus to growth in 2015

and 2016. The Bank of Spain estimates that fiscal policy contributed 0.3 and 0.8 percentage points, respectively, to GDP growth in these two years, compared to the 1.0 and 1.7 ppts impetus from ECB monetary policy, and a further 0.3 and 1.1 ppts of momentum from oil price developments.

Fifthly, it is also worth highlighting the spike in demand for tourism in Spain due to geopolitical instability in many of the country's main competitors in the Mediterranean. This has led to record tourism revenues.

Finally, a significant labor cost reduction during the crisis facilitated an exceptional increase in labor productivity, which in turn accounts for most of the competitiveness gains made by the export sector (also supported by exchange rate and oil price developments). The decline in Spanish labor costs from 2009 is unparalleled within Europe, reflected in zero wage growth over 2008-2015 (8% loss in purchasing power) and the loss of approximately 2 million jobs between 2008 and 2017 (at constant GDP).

This contraction in wage remuneration has been the cornerstone of the improvement in corporate competitiveness seen in recent years. And is reflected by the fact that in 2017 household consumption remains some €25 billion below pre-crisis levels, despite GDP returning to similar levels. This gap, together with the €90 billion reduction in real estate investment, has been countered by a larger contribution from exports.

However, while it is true that Spain will present a more balanced growth profile in 2018 than it did in 2008, with exports set to contribute positively to growth (unusual for the Spanish economy during an upswing), it is equally true that the overall deterioration in wage remuneration remains to be addressed. And, though unemployment is still far too high, it is increasingly approaching estimated structural levels. This issue is likely to come to the fore in the political agenda in 2018 as social agents begin to intensify their demands for pay increases.

We see GDP growth as levelling off somewhere between 2.5% and 3% in 2018 – without a more pronounced deterioration in risk factors – but this will be particularly sensitive to developments in

the household savings rate. Private consumption growth has gradually eased over the course of 2017, accompanied by a drop in the household savings rate which has recently nosedived towards record lows. A hypothetical spike in the savings rate for precautionary reasons in the face of some unidentified risk event could lead to a more abrupt slowdown in consumption.

Meanwhile, 2018 should see the public finances finally leave the control of the Excessive Deficit Procedure. This will take place against the backdrop of an absence of parliamentary support, forcing the government to roll over the State budget for the second time since the start of the current legislature. While 2018 is unlikely to see a recovery of public investment – which remains at around half of historic levels – the budget carry-over should not have a significant impact on the economic cycle.

All of the above remains strongly contingent on the outcomes of two historically unprecedented political developments: Brexit and the Catalan conflict. Regarding the former, suffice it to note that the Spanish economy has stronger trade, tourism and FDI links with the United Kingdom than with the euro area on average. Meanwhile, growth in Catalonia, which represents 20% of Spanish GDP, is likely to be weakened by the uncertainty generated following the intensification of tensions with the central government. A decline in both national and international investment and a weakening of tourism revenues look to be all but inevitable. The scope and duration of this conflict will ultimately influence the extent to which Spain can continue outperforming the other euro area economies (as has been the case since 2014), and the stability of the region as a whole.

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