

What is the cyclical position of the Spanish economy?

Vozpópuli (Spain)

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Over the last few months, there has been an interesting debate on the cyclical position of the Spanish economy, its potential growth and the output gap. As Antonio [Pulido](#) correctly pointed out recently, this debate reflects the discussion under way beyond our borders, for instance at the Institute of International Finance ([IIF](#)), which is generating a lot of interest on social media.

Surely public opinion will be satisfied with seeing incomes rise and unemployment fall, thus considering this discussion somewhat superfluous. However, it is not superfluous at all. It is much more important than it would seem at first sight. The actual underlying question is whether current growth rates are sustainable and how long this can continue without generating imbalances that must be corrected in the future. For this reason experts, analysts, institutions and economic authorities (for example, in the [2019 Stability Program](#)) have spent a lot of time ascertaining the stage of the business cycle that economies are presently in.

The output gap measures how far GDP is from a balanced growth path and is closely related to the gap between unemployment and its equilibrium rate, which may change across countries and over time. It is, therefore, a different concept to that of maximum potential production with full utilization of production factors and minimum unemployment. When activity is above its balanced growth path, the output gap is positive, cyclical unemployment is negative and the economy grows accumulating imbalances (debt, loss of competitiveness, inflation, etc.) which are corrected sooner or later. On the contrary, when it falls below that balance growth path, the output gap is negative, cyclical unemployment is positive and the economy is able to grow without generating significant imbalances.

The problem is that neither the equilibrium unemployment rate nor the balanced growth path of GDP are observable variables. These are estimated with uncertainty and therein lie both the debate and the discrepancy. With a seasonally adjusted unemployment rate of 14.1% in the first quarter of 2019, the quality of growth of the Spanish economy and the economic policy implications would be very different if the equilibrium unemployment were 16% or 12%. If cyclical unemployment were positive, there would be arguments in favor of implementing well designed, selective and transitory expansive demand policies. If unemployment is equal to the equilibrium rate, the best course of action to grow is to implement structural reforms that increase potential growth and reduce structural unemployment.

Some analysts believe that the estimation of the GDP or unemployment cyclical component is of little use in light of the uncertainty of its results, which may be highly sensitive to the method used and the availability of new observations. Others like Adam [Tooze](#) have gone even further by stating that it is a tool that works in favor of certain economic policy positions. Although there are reasons to be critical, the solution requires producing better estimations. Not all are the same and some are better than others. The existence of uncertainty in the estimation of the equilibrium unemployment rate cannot be used to rule out this concept and justify any type of economic policy according to individual interests.

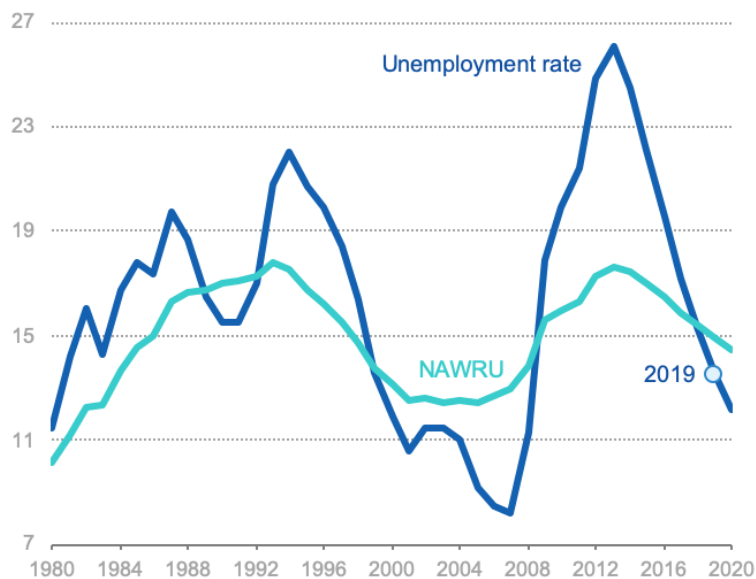
Since well before the start of the crisis, but particularly since 2007, when I defended before the European Commission in Brussels that the Spanish economy was showing very clear signs of overheating instead of a negative output gap as estimated at that time, my [experience](#) is that the estimation methods have improved considerably. The research by Alberola, Estrada and Santabárbara ([2014](#)) or Cuerpo, Cuevas and Quilis ([2018](#)), to mention but two, are good examples for the Spanish economy. They have expanded the set of variables that help to estimate structural unemployment, price inflation ([NAIRU](#)) and salaries ([NAWRU](#)) to include other variables, including those of a [financial nature](#). And the results are not applied mechanically lacking common sense. In the European Union, output gap estimates are one more element, but not the only one among the economic policy

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recommendations. Since 2011 the European Commission has been using a broad range of 14 economic indicators (complemented by another 25 auxiliary ones) to detect alert signals on the existence of macroeconomic imbalances.

What do the estimates available for Spain tell us? The cyclical position forecast for the Spanish economy in 2019 is practically neutral according to the estimates of the output gap of the **OECD** (-0.2%) or the **AIReF** (-0.1%), slightly expansive for the **IMF** (0.7%) and even more so in the case of the European **Commission** (1.6%). These last two estimates are in line with those of the Bank of Spain, that estimates that the output gap became slightly positive by the end of **2018**.

Figure 1 Unemployment rate and its structural component, Spain 1980-2020 (%)



Source: Own elaboration based on AMECO, European Commission, Spring 2019

The indicators of **imbalances** used by the Commission can help to discriminate between these estimates. The last time that Spain had an unemployment rate of 14.1% during an expansion was precisely twenty years ago, during the first quarter of 1999. We must bear in mind that this unemployment rate of 14.1% is below the average observed since the beginning of 1980 (16.7%). However, the fact that the unemployment rates are the same does not mean that the cyclical position at the start of 2019 is the same as that of 1999. Nor that the output gap is positive only because it is below the average of the last 40 years or negative because it is higher to that of other countries. During the first quarter of 1999, the current account balance was negative and the deficit accounted for 3.3% of GDP (compared to the small surplus, albeit waning, of the last four quarters), the unit labor costs grew by 2.1% (now less than half this rate and below the rest of the Eurozone), the flow of credit to the private sector grew by 15% (+0.7% in 2018), private sector debt increased by more than 9 percentage points (now down by more than 5 points due to firms), house prices grew by over 9% (now at 4.4%), the inflation rate was twice that of the Eurozone (now one decimal point below) and the temporary employment rate was 32.9% (currently 26.6%). Although the evidence shows that with the same unemployment rate in 2019 there are fewer imbalances than in 1999, certain areas for concern are beginning to appear which will require further examination over the coming quarters. The rate of vacancy rate is higher now than in 1999 (0.6% vs. 0.4%), which shows that the mismatch in the labor market between supply and demand is now larger. Productivity per hour worked has been on a downward trend in the last four quarters. Households are already increasing their debt since 2017, with savings rates at minimum levels. And the supply factors, which have supported the economic recovery since 2014, have gradually lost weight to the extent of having a virtually neutral contribution by the end of 2018, as shown in a recent **study** by BBVA Research.

This comparison allows to obtain at least three conclusions. The first is that, given the same rate of unemployment, in 2019 there are fewer imbalances than in 1999 and that the output gap is neutral or slightly negative. The growth of the economy over the next few months along a balanced growth path will depend on its job creation capacity without generating pressures on inflation or unit labor costs, without impairing the current account balance and without generating any other imbalances. The second is that the reforms and production improvements implemented by firms have allowed to reduce the structural unemployment rate during the recovery and to grow for a longer period without generating imbalances. Insofar as this situation is coming to an end, it has become essential to implement new reforms to increase potential growth and reduce an unacceptably high unemployment rate, which is an international anomaly and, at the very least, is double that in other advanced economies, increasing inequality. Growing only on the basis of demand impulses will not be sustainable in the medium and long term. And third, with a cyclical position approaching neutrality, the structural public deficit most probably falls within the range between 2.5% of GDP in 2018 and the 2% forecast for the end of 2019. [Resuming](#) the fiscal adjustment is another one of the pending tasks of the Spanish economy.

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